kotak® Institutional Equities

INDIA DAILY

June 23, 2008

EQUITY MARKETS

		Change, %		
India	20-Jun	1-day	1-mo	3-mo
Sensex	14,571	(3.4)	(12.5)	(2.8)
Nifty	4,348	(3.5)	(12.1)	(5.0)
Global/Regional indices				
Dow Jones	11,843	(1.8)	(5.1)	(4.2)
Nasdaq Composite	2,406	(2.3)	(1.6)	6.6
FTSE	5,621	(1.5)	(7.7)	2.3
Nikkie	13,780	(1.2)	(1.7)	10.4
Hang Seng	22,547	(0.9)	(8.8)	6.8
KOSPI	1,707	(1.4)	(6.6)	3.7

Value traded - India

			Moving avg, Rs bn	
	20-Jun		1-mo	3-mo
Cash (NSE+BSE)	174.2		192.2	195.3
Derivatives (NSE)	585.3		332.9	464
Deri. open interest	866.8		796	641

Forex/money market

		Change, basis points		
	20-Jun	1-day	1-mo	3-mo
Rs/US$	43.1	0	35	285
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.6	19	55	98

Net investment (US$mn)

	19-Jun		MTD	CYTD
FIIs	(87)		(1,382)	(5,255)
MFs	(23)		134	1,660

Top movers -3mo basis

		Change, %		
Best performers	20-Jun	1-day	1-mo	3-mo
Chambal Fert	80	(6.6)	6.3	78.2
Infosys	1,827	(1.9)	(0.1)	36.0
i-Flex	1,253	(4.8)	(13.0)	35.4
Tata Chem	348	(4.5)	(9.4)	29.6
United Phos	310	0.8	(11.3)	25.1
Worst performers				
BPCL	265	(1.2)	(26.4)	(31.4)
Siemens India	451	(4.9)	(23.3)	(30.9)
Tata Motors	490	(3.0)	(23.2)	(24.7)
BHEL	1,405	(1.3)	(19.5)	(24.1)
HPCL	196	1.2	(19.5)	(23.0)

Contents

Results

Hindalco: Novelis 4Q results unimpressive; new funding plans can cause turmoil; retain ADD

Dredging Corporation of India: Weak operating performance; upgrade to ADD based on attractive valuations

Change in recommendations

GAIL (India): Upgraded to ADD on favorable reward-risk balance (20%)

Updates

Economy: Further monetary tightening imminent as inflation keeps its tryst with double-digit destiny

Banks/Financial Institutions: Higher inflation may lead to higher rates

Mid-cap Radar: Scalable Opportunities conference

News Roundup

Corporate

- S. Kumar's subsidiary Reid & Taylor is close to signing a deal for a US$100 mn fund infusion. Sources said the company may issue fresh equity to a Europe-based fund at 150 rupees a share. (ET)
- Private equity firm Warburg Pincus has picked up around 15% in Laqshya Media, an outdoor media advertising company for Rs2.76 bn. (ET)
- Diamond jewelry maker and exporter Suashish Diamonds Ltd is planning to invest Rs1.5 bn in setting up a new manufacturing facility in Mumbai. (ET)
- Bangalore-based iron ore miner Mineral Enterprises plans to shell out $25 mn for an additional 45% stake in Australia's Lincoln Minerals. (ET)
- Birla Cotsyn, part of the Yash Birla group, is entering the capital market with an initial public offering to raise up to Rs1.44 bn. The price band is Rs15-18 a share. (ET)
- The Bombay Stock Exchange has begun discussions with the Securities and Exchange Board of India on a proposed initial public offer and listing. (FE)

Economic and political

- Indian goods being exported to the European Union may face higher barriers if the 27-member grouping goes ahead with a proposal to place a carbon tax on goods imported from advanced developing countries. (ET)

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, BL = Business Line.

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

For Private Circulation Only. FOR IMPORTANT INFORMATION ABOUT KOTAK SECURITIES' RATING SYSTEM AND OTHER DISCLOSURES, REFER TO THE END OF THIS MATERIAL, GO TO HEDGES AT http://www.kotaksecurities.com.

Metals

HALC.BO, Rs161	
Rating	ADD
Sector coverage view	Attractive
Target Price (Rs)	215
52W High -Low (Rs)	240 - 135
Market Cap (Rs bn)	210.7

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	196.5	203.8	210.2
Net Profit (Rs bn)	22.8	23.6	21.6
EPS (Rs)	17.5	18.1	16.5
EPS gth	*(10.9)*	*3.4*	*(8.6)*
P/E (x)	9.2	8.9	9.8
EV/EBITDA (x)	5.8	5.2	5.1
Div yield (%)	1.1	1.1	1.1

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	31.4	-	-
FIIs	24.0	0.6	0.1
MFs	3.7	0.5	(0.0)
UTI	-	-	(0.5)
LIC	10.7	1.4	0.8

Hindalco: Novelis 4Q results unimpressive; new funding plans can cause turmoil; retain ADD

Amit Agarwal : agarwal.amit@kotak.com, +91-22-6749-3390

- **Novelis 4QFY08 net profit at US$54 mn versus net loss of US$64 mn in 4QFY2007**
- **Novelis FY2008 normalized operating EBITDA growth of 62% in line with estimates**
- **High spreads in international debt market forces Hindalco to rethink debt funding; tilts plan to equity funding now**
- **Retain ADD rating with target price of Rs215**
- **Novelis 4QFY2008 revenues up 8.8% yoy; net profit at US$54 mn versus net loss of US$64 mn in 4QFY2007**

Novelis reported 4QFY2008 revenues at US$2.9 bn—up 8.8% yoy led mainly by higher aluminum realizations. Novelis reported 4QFY2008 net profit at US$54 mn versus a loss of US$64 mn in the corresponding period of last year. However, underlying EBITDA (adjusted for can sheet losses and metal price lag) at US$88 mn was lower by 44% despite higher shipments and higher realizations on account of reversal of provisions relating to purchase accounting.

Novelis' FY2008 normalized operating EBITDA growth of 62% in line with estimates

Novelis' FY2008 normalized operating EBITDA at US$491 mn grew 62% yoy—in line with our estimates. The normalized EBITDA was higher on account of higher volumes and higher realizations resulting in sharp improvement in EBITDA. Besides, lower exposure to price ceilings, improved product mix and lower corporate office expenses also contributed to improvement in underlying EBITDA.

Can-sheet contract losses have reduced to US$45 mn, as exposure of such contracts reduced to 10% of shipments in 4QFY08—the Novelis management has guided that this will reduce to 8% of global sales for FY2009. This is in line with our estimates for the current fiscal. We adjust this for reversal of provisions made earlier for can-sheet losses.

Change in funding plans forced by high spreads. In our downgrade note on Hindalco dated March 7, 2008, we had pointed out that Hindalco's bridge debt will come up for renegotiation, which will push the cost of borrowing substantially higher.

Forced by very high spreads in international debt markets (currently L+230-350 bps), Hindalco's board has proposed to refinance the bridge debt (currently at L+35 bps) with higher treasury and new equity offering. This coupled with subdued mood in equity markets may substantially worsen the cost of capital working for LBO of Novelis. We await clarity on (a) spread on proposed international bond offering, (b) proportion of treasury that Hindalco's board is willing to commit to refinance non-recourse bridge debt and (c) price that investors are willing to pay for Hindalco's new equity offering (and therefore a clearer sense on dilution involved).

Retain ADD rating with TP for Rs215 till further clarification. As mentioned above, clarity on the three issues raised earlier will have significant impact on (a) cost of capital used for LBO funding of Novelis, as well as on (b) our SOTP-based target price (this will alter following (a) change in debt leverage and (b) extent of dilution involved). However, our best expectations will suggest a negative impact on target price since (a) we had assumed lower post-tax cost of debt versus cost of capital and (b) assumed returns on treasury were higher than post-tax cost of debt. We await for clarity before making changes in our SOTP-based target price.

Novelis, interim results, March fiscal year-ends (US$ mn)

	4Q 2008	3Q 2008	4Q 2007	% change		FY2008	FY2007	% change
	JFM 2008	OND 2007	JFM 2007	qoq	yoy	A-D 2007	A-D 2006	
Operating matrix								
Shipments (kt) (including ingots)	631	772	610	(18.3)	3.4	2,988	2,951	1.3
Aluminium prices (US$/ton)	2,790	2,520	2,748	10.7	1.5	2,681	2,672	0.3
Quarterly results								
Revenue	**2,862**	**2,735**	**2,630**	4.6	8.8	**11,246**	**10,160**	10.7
Expenditure	**(2,742)**	**(2,585)**	**(2,554)**			**(10,713)**	**(10,085)**	
Cost of goods sold	(2,576)	(2,475)	(2,447)			(10,247)	(9,629)	
SG&A	(154)	(99)	(99)			(414)	(417)	
R&D	(12)	(11)	(8)			(52)	(39)	
EBITDA	**120**	**150**	**76**	(20.0)	57.9	**533**	**75**	610.7
Other income	-	-	-			-	-	
Depreciation	(107)	(105)	(58)			(395)	(233)	
EBIT	13	45	18			138	(158)	
Interest	(45)	(47)	(50)			(199)	(208)	
Pre-tax profits	(32)	(2)	(32)			(61)	(366)	
Extra-ordinary items reported	92	(43)	(23)			3	5	
Extra-ordinary items (adjusted)	-	-	-			-	-	
Pre-tax profits - reported	**60**	**(45)**	**(55)**			**(58)**	**(361)**	
Taxes	1	(4)	(7)			(7)	99	
Minority interest	(7)	-	(2)			(4)	(3)	
Net income	**54**	**(49)**	**(64)**			**(69)**	**(265)**	
Adjusted net income for taxes	**(40)**	**(2)**	**(38)**			**(72)**	**(178)**	
EBITDA analysis								
Reported EBITDA	120	150	76			533	75	
Add: Can sheet losses in N.A.	45	45	80			230	460	
Less: Reversal of provision	(65)	(76)	-			270	-	
Underlying EBITDA	**100**	**119**	**156**	(16.0)	(35.9)	**1,033**	**535**	93.1
Less: Metal price lag	12	(9)	-			(20)	-	
EBITDA adjusted for metal price lag	**88**	**128**	**156**	(31.3)	(43.6)	**1,053**	**535**	96.8
Calculations								
Realization (US$/ton)	4,433	3,444	4,311	28.7	2.8	3,673	3,443	6.7
Underlying EBITDA (US$/ton)	158	154	256	2.8	(38.0)	346	181	90.7
EBITDA margins (%)	3.6	4.5	5.9			9.0	5.3	

Source: Company, Kotak Institutional Equities.

Hindalco, Novelis operating EBITDA comparison, March fiscal year-ends (US$ mn)

	FY2007	FY2008	Variaton (%)	Comments
Reported EBITDA	81	536	562	
Adjusted for:				
Sales transaction fees	32	32		Related to Hindalco's acquisition; non-recurring
Net other expenses	18	2		
Unrealized changes in FV of derivatives	150	2		Novelis runs derivatives to manage commodity risk
Proportionate consolidation of entities	36	72		Entities where Novelis owns less than 50%
Metal price lags	(43)	21		Timing difference between purchase and sale of metal
Purchase accounting benefit	-	(219)		Reversals from Revenue on account of can sheet loss
Stock compensation	30	45		Triggered on acquisition by Hindalco
Normalised Operating EBITDA	**304**	**491**	**62**	

Source: Company, Kotak Institutional Equities.

Hindalco, Interim results, March fiscal year-ends (Rs mn)

				% change		Full year			
	4Q 2008	3Q 2008	4Q 2007	qoq	yoy	2008	2007	% change	Comments on interim results
Quantitative details ('000 tons)									
Alumina	303,928	304,059	296,411	(0.0)	2.5	1,192,709	1,198,658	(0.5)	Flattish production on qoq basis, marginal improvement on a yoy basis
Primary aluminium	121,329	121,971	114,334	(0.5)	6.1	477,726	442,685	7.9	
Copper cathodes	87,134	78,333	81,460	11.2	7.0	323,883	290,425	11.5	Cathode production up both on yoy and qoq basis
Earnings drivers									
LME Aluminium prices (US$/ton)	2,790	2,502	2,748	11.5	1.5	2,676	2,672	0.1	Prices up on qoq basis, but flat on yoy basis
Spot copper TC/RC (cents/pounds)	9.0	8.1	11.3	11.1	(20.3)	6.1	12.7	(51.7)	Spot TC/RC down 20%
Average INR:USD exchange rate	39.8	39.5	44.2	0.8	(9.9)	40.3	45.2	(11.0)	Rupee appreciate sharply on yoy basis; flat on qoq basis
Interim results									
Net revenues	**50,102**	**45,317**	**47,489**	10.6	5.5	**192,010**	**183,130**	4.8	Higher aluminium prices on qoq basis lead qoq growth in earnings
Expenditure	**(42,135)**	**(37,311)**	**(36,990)**			**(157,999)**	**(142,980)**		
Stock adjustment	3,054	(1,145)	(3,612)			1,327	(4,425)		Higher crude oil prices lead to higher input costs (CP Coke, Pitch etc)
Raw materials	(34,619)	(27,108)	(23,386)	27.7	48.0	(121,399)	(101,933)		
Employee cost	(1,841)	(1,440)	(1,465)	27.8	25.7	(6,212)	(5,196)		Huge increase in employee costs
Other costs	(8,729)	(7,618)	(8,527)	14.6	2.4	(31,715)	(31,426)		Other expenses increase on qoq basis as well
EBITDA	**7,967**	**8,006**	**10,499**	(0.5)	(24.1)	**34,011**	**40,150**	(15.3)	
Other income	1,442	1,143	1,233			4,929	3,701		Higher yeilds, higher treasury deployment leads to higher other income
Depreciation	(1,516)	(1,460)	(1,576)	3.8	(3.8)	(5,878)	(6,380)		
EBIT	7,893	7,689	10,156			33,062	37,470		
Interest	(988)	(622)	(577)	58.8	71.2	(2,806)	(2,424)		Higher value of borrowings and higher interest rates leads to higher net interest expense
Pre-tax profits - as reported	6,905	7,067	9,579			30,256	35,046		
Unusual or infrequent items	-	-	-			-	-		
Pre-tax profits - as adjusted	**6,905**	**7,067**	**9,579**	(2.3)	(27.9)	**30,256**	**35,046**	(13.7)	
Taxes	(1,542)	(1,640)	(2,366)			(7,054)	(9,403)		Higher tax exempt income leads to lower ETR
Reported profits - as reported	5,363	5,427	7,213			23,202	25,643		
Adjustment for one-time tax writeback	5,407	-	-			5,407	-		One-time tax write-back
Reported profits - as adjusted	**10,770**	**5,427**	**7,213**	98.5	49.3	**28,609**	**25,643**	11.6	
Recurring net earnings	**5,363**	**5,427**	**7,213**	(1.2)	(25.6)	**28,609**	**25,643**	11.6	Adjusted net earnings stays flat
Ratios									
Costs as % of revenue (%)	84.1	82.3	77.9			82.3	78.1		
EBITDA margin (%)	15.9	17.7	22.1			17.7	21.9		EBITDA margins fall as higher costs undo better realizations
ETR (%)	22.3	23.2	24.7			23.3	26.8		Higher tax exempt income leads to lower ETR
EPS (Rs/share)	8.2	4.2	5.5			21.9	19.6		
Segmental information									
Segmental revenue	**50,105**	**45,352**	**47,536**			**192,104**	**183,220**		
Aluminium	18,557	17,290	20,424	7.3	(9.1)	71,449	73,444	(2.7)	Revenues increase following stronger LME and higher production
Copper	31,548	28,062	27,112	12.4	16.4	120,655	109,776	9.9	Higher copper prices lead to better revenues; does not mean a lot in terms of profitability though
EBIT	**7,158**	**6,729**	**9,267**			**29,265**	**34,463**		**Qoq growth in EBIT driven by copper division**
Aluminium	5,448	5,789	7,902	(5.9)	(31.1)	24,231	29,292	(17.3)	Higher costs leads to qoq dip in EBIT despite better realizations
Copper	1,710	940	1,365	81.9	25.3	5,034	5,171	(2.6)	Higher price for by-products, higher production and better mix drivers copper divisions qoq EBIT

Source: Company data, Kotak Institutional Equities estimates

Hindalco, change in funding pattern, March fiscal year ends (US$ mn)

	Previously	Now proposed	Comments
Total funding	**5,950**	**5,950**	
Recource financing	**3,550**	**1,450**	
Debt (at L+35 bps)	3,100	-	
Equity treasury	450	1,450	Incremental treasury of US$1 bn available
Non-recourse financing (8% pre-tax)	**2,400**	**2,400**	
Term-loans	1,000	1,000	Refinanced through ABL
High-yield bonds	1,400	1,400	
International bond offering		850	Incremental borrowing required
New incremental equity offering	**-**	**1,250**	

Source: Company, Kotak Institutional Equities.

Hindalco, consolidated profit and loss account and balance sheet, March fiscal year-ends, 2007-08 (Rs mn)

Consolidated profit and loss (Rs mn)	2007	2008
Net sales	193,161	600,128
EBITDA	48,395	72,911
EBIT	39,750	48,346
Net profit	26,858	23,873
EPS (Rs)	26.7	20.5

Consolidated balance sheet (Rs mn)	2007	2008
Sources of funds		
Share capital	1,040	2,620
Reserves and surplus	127,100	170,844
Total borrowings	84,430	323,520
Minority interest	8,570	16,174
Deferred tax liabilities	11,710	49,512
Total	**232,850**	**562,670**
Application of funds		
Fixed assets (net)	108,244	254,540
Goodwill	1,592	88,330
Other intangibles	1,701	38,170
Investments	78,743	138,920
Net current assets	42,570	42,710
Total	**232,850**	**562,670**

Source: Company, Kotak Institutional Equities.

Hindalco, SOTP-based target price, 2009E basis

	EBITDA	EV/EBITDA	EV	Stake	Attiutable EV		Value
	(Rs bn)	(X)	(Rs bn)	(%)	(Rs bn)	(US$ mn)	(Rs/share)
Copper business	3	7	21	100	21	512	16
Aluminium business	35	8	280	100	280	6,829	214
ABML (a)	-	-	-	51	15	373	12
Novelis (c), (e)	21	7	153	100	153	3,723	117
PV of Novelis beverage can contracts (d)					-	(558)	(18)
Total Enterprise value					**469**	**10,880**	**341**
Total Debt					**263**	**6,409**	**201**
Hindalco's debt (excl LBO debt)					22	531	17
LBO debt					127	3,100	97
Novelis standalone debt					114	2,778	87
Value of investments (b)					**95**	**2,314**	**73**
Resultant Market capitalization					**301**	**6,785**	**213**
Target price (Rs/share)							**215**

Notes:

(a) Stake in ABML is valued based on market-capitalization of ABML.

(b) We have valued investments at 20% discount to market value (for quoted investments) and 20% discount to book (for unquoted investments).

(c) We value Novelis' EBITDA without its loss-making contracts.

(d) Loss-making beverage can contracts will likely exhaust over the next three years. We use 12% discounting for calculating its PV.

(e) We have valued Novelis at 10% discount to Hindalco's aluminium business valuations.

Source: Kotak Institutional Equities estimates

Hindalco (standalone), profit model, balance sheet and cash flow model, March fiscal year-ends, 2005-2010E (Rs mn)

	2005	2006	2007	2008E	2009E	2010E
Profit model (Rs mn)						
Net sales	95,235	113,965	183,130	196,491	203,824	210,204
EBITDA	**22,765**	**26,051**	**40,150**	**38,498**	**40,069**	**38,357**
Other income	2,700	2,439	3,701	3,648	4,358	4,319
Interest	(1,700)	(2,252)	(2,424)	(3,316)	(2,947)	(2,947)
Depreciaiton	(4,633)	(5,211)	(6,380)	(7,542)	(9,137)	(10,152)
Profit before tax	**19,042**	**21,057**	**35,046**	**31,289**	**32,343**	**29,577**
Current tax	(5,705)	(3,342)	(9,954)	(7,181)	(7,423)	(6,788)
Deferred tax	(43)	(1,160)	551	(1,267)	(1,310)	(1,198)
Net profit	**13,294**	**16,556**	**25,643**	**22,841**	**23,610**	**21,591**
Earnings per share (Rs)	**10.2**	**12.7**	**19.6**	**17.5**	**18.1**	**16.5**
Balance sheet (Rs mn)						
Equity	76,666	96,063	124,180	170,534	191,806	211,058
Deferred tax liability	11,297	12,334	11,258	12,525	13,835	15,033
Total Borrowings	38,000	49,034	73,686	73,686	73,686	73,686
Current liabilities	25,182	31,527	40,275	42,055	43,032	43,882
Total liabilities	**151,145**	**188,958**	**249,400**	**298,801**	**322,359**	**343,659**
Net fixed assets	69,265	76,157	84,831	112,290	123,153	128,002
Investments	37,021	39,713	86,753	69,553	69,553	69,553
Cash	4,010	9,173	6,655	41,551	51,915	66,339
Other current assets	40,755	63,855	71,128	75,375	77,705	79,732
Miscellaneous expenditure	94	60	32	32	32	32
Total assets	**151,145**	**188,958**	**249,400**	**298,801**	**322,359**	**343,659**
Free cash flow (Rs mn)						
Operating cash flow excl. working capital	23,488	23,168	34,551	31,649	34,057	32,941
Working capital changes	(5,878)	(16,085)	(1,185)	(2,466)	(1,354)	(1,178)
Capital expenditure	(11,205)	(11,982)	(13,472)	(35,000)	(20,000)	(15,000)
Free cash flow	**6,404**	**(4,899)**	**19,893**	**(5,817)**	**12,703**	**16,763**
Ratios						
Debt/equity (%)	43.2	45.2	54.4	40.3	35.8	32.6
Net debt/equity (X)	0.4	0.4	0.5	0.2	0.1	0.0
RoAE (%)	16.1	16.9	21.0	14.3	12.2	10.0
RoACE (%)	**12.6**	**13.0**	**14.9**	**10.9**	**9.7**	**8.2**

Source: Company, Kotak Institutional Equities estimates.

Transportation

DRDG.BO, Rs536	
Rating	REDUCE
Sector coverage view	Neutral
Target Price (Rs)	550
52W High -Low (Rs)	1356 - 480
Market Cap (Rs bn)	15.0

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	7.1	8.2	9.5
Net Profit (Rs bn)	1.5	1.6	1.8
EPS (Rs)	55.3	57.1	65.6
EPS gth	*(8.5)*	*3.3*	*15.5*
P/E (x)	9.7	9.4	8.2
EV/EBITDA (x)	5.7	4.6	3.8
Div yield (%)	2.8	2.8	2.8

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	78.6	-	-
FIIs	4.3	0.0	0.0
MFs	4.1	0.1	0.1
UTI	-	-	-
LIC	3.0	0.0	0.0

Dredging Corporation of India: Weak operating performance; margins decline due to higher wage costs and increased in-chartering

Lokesh Garg : lokesh.garg@kotak.com, +91-22-6634-1496

Sandip Bansal : sandip.bansal@kotak.com, +91-22-6749-3327

- **Revenue exceeds expectations led by increased in-chartering, while margins decline; higher other income and likely IT refund boost PAT**
- **Margin decline due to higher wage costs and likely slowdown in Sethusamudram project work**
- **Revise earnings estimates based on lower margin assumptions; revise target price to Rs550 (from Rs775 earlier)**
- **Reiterate REDUCE rating; concerns on Sethusamudram project and old fleet profile remain**

DCI reported 4QFY08 revenues of Rs1.9 bn (5.6% decline yoy), higher than our expectation of Rs1.6 bn, led by increased in-chartering. Operating margins at 7.4% were significantly below our expectations of 27.3%. PAT at Rs502 mn (down 22% yoy and up 236% qoq) was higher than our expectation of Rs410 mn led by (1) high other income of Rs349 mn and (2) tax refund of Rs150 mn. The decline in margins is led by (1) increase in staff costs, (2) higher proportion of lower-margin in-chartering business and (3) likely slowdown in Sethusamudram project. We revise our EPS estimates to Rs57.1 (from Rs63.4 earlier) and Rs65.6 (from Rs66.7 earlier) for FY2009E and FY2010E respectively. We reiterate our REDUCE rating.

Revenues exceed expectations led by increased in-chartering, while margins decline; higher other income and likely IT refund boost PAT

DCI reported 4QFY08 revenues of Rs1.9 bn (5.6% decline yoy), higher than our expectation of Rs1.6 bn, led by increased in-chartering (in-chartering costs increased 230% qoq to Rs548 mn versus Rs166 mn in 3QFY08). It seems that lease for one of the in-chartered vessels which had expired last quarter (as suggested by news reports) was renewed in 4QFY08. Operating profit declined by about 80% yoy (25% qoq decline) to Rs141 mn versus our expectation of Rs430 mn. Operating margins of 7.4% were significantly below our expectations of 27.3%. PAT at Rs502 mn (down 22% yoy and up 236% qoq) beat our expectation of Rs410 mn due to (1) high other income of Rs349 mn (up 169% yoy and 288% qoq) versus our expectation of Rs147 mn and (2) likely tax refund (as income tax is a positive of Rs150 mn in 4QFY08). As expected stores and spares costs were lower in 4QFY08 (2% of sales). Repairs and maintenance costs however increased by 19% yoy.

Margin decline due to higher wage costs and likely slowdown in Sethusamudram project work

Margin decline is led by (1) increase in staff costs, (2) higher proportion of low-margin in-chartering business and (3) likely slowdown in Sethusamudram project work. Staff costs have increased significantly by 97% qoq, likely led by provisioning related to Sixth Pay Commission recommendations, which seem to have been made for the entire year in this quarter. There is likely a slowdown in Sethusamudram project work as it seems that some vessels may have been idle on the project. We highlight that while in FY2008 revenues have increased by 24% yoy, margins have declined by 13% (primarily due to the above stated reasons).

Revise earnings estimates based on lower margin assumptions; revise target price to Rs550 (from Rs775 earlier)

We revise our EPS estimates to Rs57.1 (from Rs63.4 earlier) and Rs65.6 (from Rs66.7 earlier) for FY2009E and FY2010E, respectively. The change in our estimates is led by lower EBITDA margin assumptions of 20.4% (versus 23.1% earlier) and 19.7% (versus 20.5% earlier) for FY2009E and FY2010E, respectively, due to (1) higher employee costs and (2) higher in-chartering expenses than estimated earlier. We revise our FY2009E-based DCF target price to Rs550 (from Rs775 earlier, Exhibit 2) based on (1) lower margin assumptions and (2) higher WACC of 13.5% (versus 12.5% earlier). We highlight that DCI is currently trading at 9X and 8X our FY2009E and FY2010E EPS estimates respectively. We estimate DCI to have about Rs4 bn of net cash on books as of FY2008-end (current market cap of about Rs15 bn).

Reiterate REDUCE earlier; concerns on Sethusamudram project and old fleet profile remain

We reiterate our REDUCE rating. We highlight that in spite of strong sectoral growth opportunities greater optimism on the stock is precluded by (1) concerns on the Sethusamudram project with regular negative news flow (and possible risks to DCI's near-term earnings estimates), (2) old fleet profile (average age of fleet is very high with 5 vessels being over 30 years old and 2 vessels over 20 years old out of a total fleet of 12 vessels), (3) lack of an aggressive capex program (no fleet augmentation over the last few years and possible new orders would also largely be for replacement of existing fleet), and (4) may not aggressively bid for upcoming private ports (given its focus on public ports, limited spare capacity and limited capital dredging capabilities). We highlight that news-flow and investor communication on the stock is also scarce. DCI has underperformed the market by 18.6%, 9.2% and 1.5% over the past 6-month, 3-month and 1-month periods, respectively.

Exhibit 1: DCI - 4QFY08 key numbers (Rs mn)

	yoy			qoq			yoy		
	4QFY08	4QFY07	*% chng*	4QFY08	3QFY08	*% chng*	FY2008	FY2007	*% chng*
Net revenues	**1,907**	**2,020**	**(5.6)**	**1,907**	**1,483**	**28.6**	**7,053**	**5,705**	**23.6**
Total Expenditure	(1,766)	(1,318)	34.0	(1,766)	(1,294)	36.5	(5,777)	(3,933)	46.9
Staff cost	(294)	(80)	267.3	(294)	(149)	97.0	(781)	(548)	42.6
Repairs and maintenance	(217)	(182)	19.4	(217)	(122)	78.8	(616)	(465)	32.4
Spares and stores	(39)	(128)	(69.5)	(39)	(229)	(83.0)	(550)	(495)	11.1
Fuel and lubricants	(470)	(587)	(20.0)	(470)	(433)	8.4	(2,024)	(1,762)	14.8
Hire charges of in-chartered dredgers	(548)	-		(548)	(166)	229.6	(1,256)	-	
Others	(198)	(341)	(41.9)	(198)	(195)	1.5	(550)	(663)	(17.0)
Operating profit	**141**	**702**	**(79.9)**	**141**	**189**	**(25.1)**	**1,277**	**1,773**	**(28.0)**
Other income	349	130	168.8	349	90	288.2	661	440	50.3
EBIDTA	**491**	**832**	**(41.0)**	**491**	**279**	**76.1**	**1,938**	**2,213**	**(12.4)**
Interest	(3)	(5)	(42.2)	(3)	(3)	(10.3)	(13)	(21)	(38.1)
Depreciation	(140)	(135)	3.6	(140)	(95)	47.6	(417)	(445)	(6.2)
PBT	**348**	**693**	**(49.7)**	**348**	**181**	**92.4**	**1,508**	**1,747**	**(13.7)**
Tax	153	(49)		153	(32)		41	(181)	
PAT	**502**	**644**	**(22.1)**	**502**	**149**	**236.8**	**1,548**	**1,566**	**(1.1)**
Key ratios (%)									
OPM	7.4	34.8		7.4	12.7		18.1	31.1	
PAT margin	26.3	31.9		26.3	10.0		22.0	27.4	
Effective tax rate	(44.0)	7.0		(44.0)	17.7		(2.7)	10.4	

Source: Company data, Kotak Institutional Equities estimates.

Exhibit 2. DCI - DCF model, March fiscal year-ends 2009E-2019E (Rs mn)

	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E
Revenues	**8,207**	**9,495**	**9,970**	**10,468**	**10,992**	**11,541**	**12,118**	**12,724**	**13,360**	**14,028**	**14,730**
Change %	*16.4%*	*15.7%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*	*5.0%*
EBITDA	**1,671**	**1,871**	**2,094**	**2,303**	**2,638**	**2,770**	**2,908**	**3,054**	**3,206**	**3,367**	**3,535**
Margin %	*20.4*	*19.7*	*21.0*	*22.0*	*24.0*	*24.0*	*24.0*	*24.0*	*24.0*	*24.0*	*24.0*
Depreciation	(450)	(450)	(650)	(850)	(1,050)	(1,070)	(1,090)	(1,110)	(1,130)	(1,150)	(1,170)
EBIT	**1,221**	**1,421**	**1,444**	**1,453**	**1,588**	**1,700**	**1,818**	**1,944**	**2,076**	**2,217**	**2,365**
Tax	(168)	(193)	(137)	(138)	(151)	(161)	(173)	(185)	(197)	(211)	(225)
Change in net working capital	(569)	(635)	(195)	(205)	(215)	(226)	(237)	(249)	(261)	(275)	(288)
Capex	(300)	(300)	(4,000)	(4,000)	(4,000)	(400)	(400)	(400)	(400)	(400)	(400)
Free cash flow	**634**	**743**	**(2,239)**	**(2,040)**	**(1,728)**	**1,983**	**2,098**	**2,220**	**2,348**	**2,482**	**2,622**
FCF growth (%)	1,458	17	(401)	(9)	(15)	(215)	6	6	6	6	6
Years discounted	-	1	2	3	4	5	6	7	8	9	10
Discounted cash flow	**634**	**655**	**(1,738)**	**(1,395)**	**(1,041)**	**1,053**	**982**	**915**	**852**	**794**	**739**

PV of cash flows	2,449	21%
PV of terminal value	9,130	79%
EV	11,579	100%
Net debt	(3,882)	
Equity value	15,461	
Shares outstanding (mn)	28.0	
Equity value (Rs/share)	**552**	
Exit EBITDA multiple (X)	0.7	

WACC calculation	
Terminal growth - g (%)	5.0
Used WACC (%)	13.5

FCF in terminal year (Rs mn)	2,622
Exit FCF multiple: (1+g)/(WACC-g)	12.4
Terminal value of FCF (Rs mn)	32,392

Sensitivity of DCF value to WACC, Terminal Growth rate

	WACC (%)					
		11.5	12.5	13.5	14.5	15.5
Terminal Growth rate (%)	3.0	627	548	485	434	393
	4.0	683	588	515	457	411
	5.0	755	639	552	485	432
	6.0	853	706	599	519	457
	7.0	995	796	661	563	489

Source: Kotak Institutional Equities estimates.

Energy

GAIL.BO, Rs380	
Rating	ADD
Sector coverage view	Cautious
Target Price (Rs)	450
52W High -Low (Rs)	556 - 284
Market Cap (Rs bn)	321

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	180.1	267.8	421.3
Net Profit (Rs bn)	26.0	31.0	35.5
EPS (Rs)	30.8	36.6	42.0
EPS gth	*21.7*	*19.0*	*14.8*
P/E (x)	12.3	10	9.0
EV/EBITDA (x)	7.1	6.4	6.4
Div yield (%)	2.6	2.9	3.4

Shareholding, March 2008

	Pattern	% of Portfolio	Over/(under) weight
Promoters	57.3	-	-
FIIs	18.5	0.9	(0.1)
MFs	3.9	1.0	0.0
UTI	-	-	(0.9)
LIC	5.9	1.3	0.4

GAIL (India): Upgraded to ADD on favorable reward-risk balance (20%)

Sanjeev Prasad : sanjeev.prasad@kotak.com, +91-22-6634-1229

Gundeep Singh : gundeep.singh@kotak.com, +91-22-6634-1286

- **20% potential upside to 12-month SOTP-based target price of Rs450**
- **Higher gas volumes may overcome potential negatives**
- **Raised earnings to factor in (1) higher LPG and petchem prices and (2) higher gas volumes**

We have changed our rating on GAIL stock to ADD from REDUCE noting a potential 20% upside to our revised 12-month SOTP-based fair valuation of Rs450 (Rs440 previously). We have raised FY2009E and FY2010E EPS by 12% and 18% to Rs36.6 and Rs42 and introduced FY2011E EPS at Rs41.2. The upward revisions to earnings primarily reflect (1) higher LPG and petchem prices, which impacts FY2009E EPS positively and (2) higher gas transmission volumes for FY2010E. Key downside risks stem from higher-than-expected subsidy losses, weaker-than-expected commodity prices and unfavorable regulations on gas transportation business.

SOTP-based fair valuation of Rs450. Exhibit 1 gives our SOTP-based valuation for GAIL. We use 5-6X FY2010E EBITDA for GAIL's three major segments (gas transmission, LPG production and petrochemicals). We see the following risks to our fair valuation for GAIL stock.

1. **Higher-than-expected subsidy losses.** We assume subsidy losses for FY2009-12E such that it results in stable 'net' EBITDA for the LPG segment (gross EBITDA of LPG segment less subsidy amount) and similar to FY2008 segment EBITDA of Rs11.4 bn. We assume FY2009E subsidy loss at Rs27.5 bn and FY2010E subsidy loss at Rs19 bn compared to Rs13.1 bn for FY2008.
2. **Unfavorable regulations and low capital employed for extant pipeline assets.** We assume 14% ROCE (post-tax) on pipeline assets to compute transmission tariffs for new pipelines. This is in line with the return fixed by the regulator for city gas distribution networks. We assume the regulator will fix similar returns for transmission networks; the draft regulations of the two were similar. In addition, the regulator may fix a low capital employed for GAIL's extant pipeline network (some portions are fully depreciated both in terms of book and recovery of investment), which may result in lower-than-current transmission tariffs for GAIL's extant HVJ and DV pipeline system.
3. **Higher price of gas used for LPG and petrochemical segments.** We assume gas price at US$5.65/mn BTU throughout the forecast period (FY2009-12E) for gas consumed by GAIL for its LPG and petrochemical segments. This corresponds to about US$33/bbl in crude oil price equivalent terms. GAIL's LPG and petrochemical segments benefit from relatively higher prices of LPG and petrochemical segments versus that of natural gas, especially at high crude prices.

Earnings revisions. We have made significant changes to our earnings model—(1) higher gas transmission volumes based on earlier-than-expected start of certain new pipelines (expanded Dahej-Vijaipur-Dadri system and related pipelines), (2) higher LPG and petrochemical prices based on higher crude prices, (3) weaker rupee and (4) other minor changes. Exhibit 2 gives our key assumptions behind our GAIL's earnings model and Exhibit 3 gives key financials.

FY2009. We have revised FY2009E EPS by 12% to Rs36.6 (+19% yoy) to reflect (1) higher LPG prices based on higher crude prices (US$110/bbl versus US$100/bbl previously), (2) rupee-dollar exchange rate at Rs42/US$ versus Rs39.5/US$ previously and (3) higher subsidy burden at Rs27.5 bn compared to Rs25 bn previously.

GAIL's share of gross under-recoveries of upstream companies was about 5.1% in FY2008 (Rs13.14 bn out of Rs257 bn). Our assumed amount of Rs27.5 bn is 6.1% of the amount (Rs450 bn) fixed by the government for upstream companies for FY2009E as per the government's June 4, 2008 announcement. Alternatively, if the government keeps GAIL's share of upstream losses constant at 5.1%, then our assumed amount is adequate as long as the total loss of upstream oil companies is below Rs540 bn.

FY2010. We have revised FY2010E EPS to Rs42 (+14.8% yoy) from Rs35.7 based on (1) higher gas transportation volume at 120 mcm/d against 105 mcm/d previously, (2) weaker rupee at Rs41.5/US$ against Rs38.5/US$ previously and (3) lower subsidy loss at Rs19 bn against Rs22.5 bn previously.

Our assumed higher gas transportation volumes reflects start of two large new pipelines by September 2009—(1) new Dahej-Vijaipur-Dadri pipeline (66 mcm/d capacity) and (2) Dadri-Bawana-Nangal pipeline (31 mcm/d); Exhibit 4 gives details of GAIL's capex in FY2009-12E. GAIL's management is confident about commissioning the new pipelines before September 2009. We highlight certain factors, which may ensure timely completion of the new pipelines—(1) availability of RIL's KG D-6 gas and (2) compulsion to supply gas to certain gas-based new power plants around Delhi before start of Commonwealth Games in 2010 in Delhi.

FY2011. We model FY2011E EPS at Rs41.3, flat versus FY2010E EPS. We expect EBITDA to grow 12% to Rs62.3 bn led by growth in gas transportation volume to 143 mmc/d from 120 mcm/d in FY2010E. However, a steep increase in interest and depreciation resulting from commissioning of the above-mentioned new pipelines in FY2010E (full-year impact) and FY2011E (Chainsa-Jhajjhar-Hissar with capacity of 35 mcm/d) will likely result in flat net income.

We value GAIL stock at Rs450 per share

Sum-of-the-parts valuation of GAIL, FY2010 basis (Rs bn)

	Valuation base (Rs bn)		Multiples (X)		EV (Rs bn)		
	Replacement cost	EBITDA	EV/RC	EV/EBITDA	Replacement cost basis	EBITDA basis	EV (Rs/share)
Natural gas/LPG transportation		36		6.0		218	258
LPG production		31		4.0		123	146
Petrochemicals		7		6.0		45	53
Oil and gas upstream	17		1.00		17		21
Subsidy sharing scheme		(19)		1.0		(19)	(22)
Investments	86		0.80		69		81
ONGC shares	62		0.80		49		58
Others	24		0.80		19		23
Total		**56**				**367**	**536**
Net debt/(cash)					76	76	90
Implied value of share (Rs/share)							**446**

Source: Kotak Institutional Equities estimates.

We model strong increase in gas volumes between FY2008 and FY2012E

Key assumptions behind GAIL model, March fiscal year-ends, 2006-2012E

	2006	2007	2008E	2009E	2010E	2011E	2012E
Volumes							
Natural gas transportation, gross (mcm/day)							
HBJ pipeline	32	32	32	32	32	32	32
Dahej-Vijaypur-GREP upgradation					18	38	63
Dadri-Bawana-Nangal					6	12	24
Chainsa-Jhajjar-Hissar					0	5	15
Other pipelines	36	39	40	42	45	48	50
Regassified LNG							
Dahej-Vijaipur pipeline (transmitted and sold)	7	6	9	9	15	15	15
Dahej-Vijaipur pipeline (transmitted)	4	4	6	6	10	10	10
Dahej-Uran pipeline			6	9	12	12	12
Panvel-Dabhol pipeline			4	6	8	10	12
Elimination of double-counted volumes (a)	(1)	(3)	(15)	(18)	(26)	(39)	(63)
Total gas transmission	**79**	**77**	**82**	**86**	**120**	**143**	**170**
LPG (000 tons)							
Sold	1,039	1,037	1,039	1,100	1,100	1,100	1,100
Transported	2,228	2,490	2,754	2,800	2,800	2,800	2,800
Petrochemicals (000 tons)							
Polyethylene							
Domestic sales	271	337	381	420	420	420	420
Exports	40	10	10	—	—	—	—
Total petrochemicals	**311**	**347**	**391**	**420**	**420**	**420**	**420**
Prices							
Natural gas (Rs/cubic meter)							
Natural gas ceiling price	3.52	4.21	5.24	5.83	7.00	7.34	7.63
Regassified LNG including transportation	6.47	6.93	6.44	6.63	8.24	8.17	8.03
Transmission plus marketing charges							
HBJ pipeline, Dahej-Vijaipur pipeline (from FY2007)	1.15	0.99	0.96	0.97	0.98	0.99	1.00
Dahej-Vijaypur-GREP upgradation					1.07	1.04	1.02
Dadri-Bawana-Nangal					0.52	0.50	0.49
Chainsa-Jhajjar-Hissar					0.18	0.18	0.17
Dahej-Vijaipur, Dahej-Uran, Panvel-Dabhol pipeline	0.69	0.99	1.03	1.04	1.04	1.05	1.06
Other pipelines	0.42	0.40	0.42	0.44	0.46	0.46	0.46
LPG							
LPG (US$/ton)	510	531	702	937	814	773	773
Transmission charges (Rs/ton)							
Jamnagar-Loni	1,522	1,522	1,522	1,522	1,522	1,522	1,522
Vizag-Secunderabad	1,450	1,450	1,450	1,450	1,450	1,450	1,450
Other assumptions							
Polyethylene, HDPE (US$/ton)	1,055	1,315	1,500	1,635	1,485	1,335	1,310
Import tariff, Polyethylene	10%	5%	5%	5%	5%	5%	5%
Import tariff, LPG	0%	0%	0%	0%	0%	0%	0%
Exchange rate (Rs/US$)	44.3	45.3	40.3	42.0	41.5	41.0	40.0
Subsidy losses	10,640	14,880	13,137	27,500	19,000	15,000	14,000

Note:
(a) Gas transported through the HVJ or DV pipeline and then to smaller pipelines.

Source: Company, Kotak Institutional Equities estimates.

GAIL (India) Ltd: Profit model, balance sheet, cash model of GAIL, March fiscal year-ends, 2006-2012E (Rs mn)

	2006	2007	2008	2009E	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	163,513	160,472	180,082	267,787	421,255	538,941	707,028
EBITDA	**35,731**	**29,896**	**39,492**	**45,284**	**55,596**	**62,298**	**73,051**
Other income	4,555	5,450	5,564	6,056	6,159	6,416	6,416
Interest	(1,174)	(1,071)	(795)	(795)	(1,909)	(7,286)	(4,816)
Depreciation	(5,595)	(5,754)	(5,710)	(6,338)	(8,622)	(11,106)	(11,238)
Pretax profits	33,518	28,521	38,551	44,207	51,223	50,322	63,413
Tax	(9,221)	(7,941)	(12,525)	(12,245)	(6,582)	(10,498)	(16,412)
Deferred taxation	(445)	(190)	(10)	(992)	(9,096)	(4,921)	(3,489)
Net profits	**23,101**	**23,867**	**26,015**	**30,970**	**35,546**	**34,902**	**43,512**
Earnings per share (Rs)	**27.3**	**28.2**	**30.8**	**36.6**	**42.0**	**41.3**	**51.5**
Balance sheet (Rs mn)							
Total equity	99,733	113,929	130,051	150,138	172,822	194,863	223,534
Deferred taxation liability	12,997	13,187	13,197	14,189	23,284	28,205	31,695
Total borrowings	19,166	13,379	13,316	20,816	89,616	58,416	41,216
Current liabilities	37,522	45,512	42,174	54,466	76,503	93,417	117,537
Total liabilities and equity	**169,418**	**186,007**	**198,738**	**239,609**	**362,225**	**374,901**	**413,981**
Cash	44,959	26,604	15,189	15,619	14,199	15,346	15,088
Other current assets	28,309	50,851	58,388	68,963	88,699	96,523	110,289
Total fixed assets	81,716	93,913	110,523	140,388	244,689	248,394	273,966
Investments	14,434	14,638	14,638	14,638	14,638	14,638	14,638
Total assets	**169,418**	**186,007**	**198,738**	**239,609**	**362,225**	**374,901**	**413,981**
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	25,165	23,920	26,172	31,850	43,758	44,513	51,823
Working capital changes	5,950	(10,151)	(10,875)	1,717	2,300	9,090	10,354
Capital expenditure	(5,811)	(20,449)	(22,320)	(35,810)	(109,576)	(14,810)	(36,810)
Investments	(6,462)	(205)	—	—	—	—	—
Other income	3,995	3,884	5,564	6,056	6,159	6,416	6,416
Free cash flow	**22,837**	**(3,002)**	**(1,459)**	**3,813**	**(57,359)**	**45,209**	**31,782**
Ratios (%)							
Debt/equity	17.0	10.5	9.3	12.7	45.7	26.2	16.1
Net debt/equity	(22.9)	(10.4)	(1.3)	3.2	38.5	19.3	10.2
ROAE (%)	21.8	19.9	19.2	20.1	19.7	16.7	18.2
ROACE (%)	**19.7**	**15.5**	**17.9**	**18.5**	**15.7**	**14.1**	**16.2**

Source: Kotak Institutional Equities estimates.

GAIL will invest significantly to expand gas transportation capacity in FY2009-12E

Capital expenditure plan, March fiscal year-ends, 2007-2012E (Rs mn)

	Project Cost	Due date	2007	2008E	2009E	2010E	2011E	2012E
Petrochemicals								
Auraya complex expansion-Phase 2	6,470	Jun-07	2,232	3,708	—	—		
Natural gas pipelines								
Thulendi-Phulpur pipeline	1,500	May-06	300	—	—	—		
Vijaipur Kota	1,760	Sep-06	692	—	—	—		
Jagoti Pithampur (Indore)	1,948	Jul-06	1,398	—	—	—		
Dahej Uran pipeline	18,308	Mar-07	7,000	10,037	—	—		
Dabhol-Panvel	13,265	Mar-07	6,500	6,765	—	—		
Dahej-Vijapur-GREP expansion	110,000	Sep-09			30,000	80,000	—	—
Dadri-Bawana-Nangal pipeline	25,000	Sep-09	—	—	4,000	20,766	—	—
Chainsa-Gurgaon-Jhajar-Hissar	10,000	Jun-10				7,000	3,000	—
Jagdishpur-Haldia	66,000				—	—	—	5,000
Dabhol-Bangalore	35,680				—	—	5,000	20,000
Kochi-Kanjirrkod-Bangalore/Mangalore	35,000				—	—	5,000	10,000
LPG facilities and pipelines								
Others (Power/Telecom)								
Telecom			—	—	—	—	—	—
Others continuing/planned			1,800	1,800	1,800	1,800	1,800	1,800
Operating expenses capitalized			11	10	10	10	10	10
Total direct			**19,933**	**22,320**	**35,810**	**109,576**	**14,810**	**36,810**
Joint venture projects								
E&P			—	—	—	—	—	—
Others-power plants/LNG east coast			—	—	—	—	—	—
Total investments			—	—	—	—	—	—
Total			**19,933**	**22,320**	**35,810**	**109,576**	**14,810**	**36,810**

Source: Kotak Institutional Equities estimates.

Economy

Sector coverage view	N/A

Further monetary tightening imminent as inflation keeps its tryst with double-digit destiny

Mridul Saggar: mridul.saggar@kotak.com, +91-22-6634-1245

- **Inflation rises to 11.05% for the week-ended June 7 (from 8.75% in the preceding)—highest since April 8, 1995**
- **Jump this week is mainly due to fuel, fibers and oilseeds**
- **Inflation likely to plateau around 13% in early-October 2008**
- **We expect further monetary tightening in the near term—CRR hike of 50 bps on June 30 possible**

Headline inflation kept its tryst with destiny of going into double digits for the week-ended June 7, 2008 (see Exhibit). The jump was at least 1 pps above most expectations. Clearly the inflation trajectory has worsened and higher fuel prices mean further increase in general prices. We now expect headline inflation to peak at around 13% in early-October 2008. We retain our assessment that inflation could fall dramatically in 4QFY08 but revise our end-year inflation forecast upwards to 8% from 6%. We expect further monetary tightening in the near term, possibly through a CRR hike of 50 bps.

All the fiscal policy measures, as well as the monetary measures of the CRR and repo rate hikes, could not avert the inevitable double-digit inflation led by the global oil price shock. Way ahead of the street expectations, we have been stating since April 2008 that the headline inflation in India is likely to average 8% in FY2009E. In our May 16, 2008 Economy note, we had cautioned: "Current inflation is not transitory—prepare for 8% and leave the rest to the Rain Gods". We had talked of inefficacy of monetary and fiscal policy measures in face of the global transmission of commodity-price inflation.

The Rain Gods have been kind so far, but the OPEC kings have not been too kind in increasing the oil supplies. More damage has been done by fuel price rigidities in India and China. Monetary policy easing by some OECD central banks has left far too much liquidity and allowed commodity play to go on in a manner which may expose the world economy to another round of financial turmoil if the oil price bubble bursts. Meanwhile, higher global crude cause oil importing economies to continue bleeding and threaten OECD economies with possible stagflation.

Crude shock of this week

In this week's WPI data, 94% weighted contribution to the price rise has been on account of fuel price hike. The impact was larger than anticipated. The increase in prices of petroleum, diesel and LPG prices were factored in. We had estimated their direct impact as 0.9 pps increase in WPI that would have taken the inflation to about 10%. However, additional factors caused inflation to jump by another 1 pps:

- Increase in prices of some other fuels whose prices are not administered
- A 1.5% increase in prices of non-food primary articles, mainly fibers (3.5%) and oilseeds (1.4%), as also basic metal alloys and metal products (1.1%) also contributed to the price rise over the week

Inflation trajectory rises further

The impact of fuel price hike on inflation is far from over. We now see headline inflation rising to 13% by end-September or early-October and likely to plateau for a short while before dropping. Our upward revision in inflation expectations is based on the following:

1. The pass-through to domestic prices is still small. But even assuming that

administered fuel prices are not raised immediately, non-administered fuel prices would continue to see some more increases as oil companies struggle to keep their under-recoveries from rising further.

2. We expect the indirect impact of the fuel price hike already effected on June 4, 2008 to feed through to other prices and significantly impact the prices of manufactured products ahead.
3. Inflation expectations have risen and certain segments of the industry, especially in the consumption goods segment, could see aggressive price hikes in a bid to increase margins when inflation psychology is pervasive.
4. A possible small upward adjustment in fertilizer prices can not be ruled out as sharp rise in naphtha prices is already causing large under-recoveries for fertilizer firms. Another round of steel price hike is also possible in the present circumstances.

We expect the inflation rate to soften a bit in 3QFY08 if food prices fall on the back of a good harvest. We expect a sharp drop in inflation only in the 4QFY09 on account of strong base effects and some correction in mineral and metals prices.

In our assessment:

- the year-end headline inflation rate could be around 8%
- the average WPI inflation rate for FY2009E is likely to be 9%
- headline inflation rate could touch 11.2% in next week's data release

Further monetary tightening in the near term likely

In our assessment, a further tightening of monetary policy in the near term is likely. Non-food credit growth is again picking up and is now at 25.5% yoy (up from 22% yoy at end-December 2007). While many believe it is on account of oil companies borrowing from banks, we have anecdotal evidence to suggest that genuine industrial offtake has been large and is not restricted to oil companies in any way.

a) **50 bps CRR hike likely at end-June**

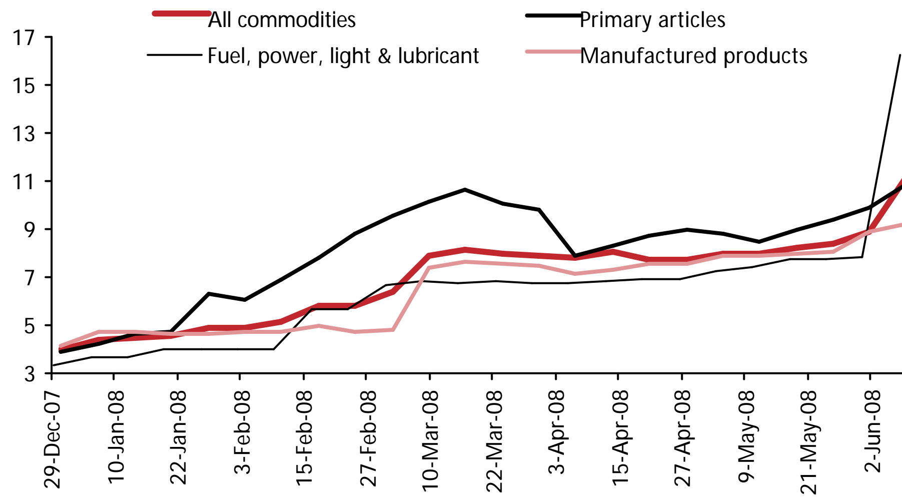
We had already stated in our Economy note of June 12, 2008, *Repo rate hike may have a sequel in July*, that we expect RBI to raise CRR by 50 bps on or before July 29—the scheduled policy review date. As stated, this was because, "we expect surplus liquidity to return to the money markets as the last week of June and early July sees large government spending". Trends in daily LAF numbers indicate that money markets would have surplus liquidity by end-June. Therefore, we anticipate that RBI may at close of markets on June 30 hike CRR by 50 bps. The impact of the hike on bank balance sheets would then spill over to the next quarter, giving them space to make adjustments through hikes in lending rates as a follow-up of increase in deposit rates.

b) **25 bps repo rate hike possible on July 29**

If the CRR hike occurs at end-June and credit growth remains high while liquidity remains ample, RBI may hike repo rate by another 25 bps on the scheduled policy date of July 29.

Exhibit: Fuel price hike takes Inflation to 11%

WPI inflation rate for major groups (yoy %)



Source: Office of the Economic Advisor, Ministry of Commerce & Industry, Government of India

Banking

Sector coverage view			Neutral
		Price, Rs	
Company	Rating	20-Jun	Target
SBI	ADD	1,249	1,800
HDFC	ADD	2,173	2,700
HDFC Bank	BUY	1,098	1,500
ICICI Bank	ADD	733	933
Corp Bk	ADD	284	375
BoB	ADD	225	335
PNB	BUY	431	650
OBC	ADD	155	210
Canara Bk	SELL	195	200
LIC Housing	REDUCE	277	330
Axis Bank	REDUCE	704	850
IOB	REDUCE	104	145
Shriram Trans|	REDUCE	307	330
SREI	BUY	112	175
MMFSL	REDUCE	257	230
Andhra	REDUCE	64	81
IDFC	ADD	119	170
PFC	REDUCE	116	150
Centurion Bank	REDUCE	41	45
Federal Bank	BUY	199	310
J&K Bank	ADD	581	750
India Infoline	ADD	596	1,225
Indian Bank	ADD	115	150
Union Bank	BUY	124	210
Central Bank o	SELL	74	85

Higher inflation may lead to higher rates

Tabassum Inamdar : tabassum.inamdar@kotak.com, +91-22-6634-1252

Ramnath Venkateswaran : ramnath.venkateswaran@kotak.com, +91-22-6634-1240

- **Finance Ministry is likely less averse to banks raising their lending and deposit rates**
- **Expect this increase in lending rates to stem the margin pressure at banks**
- **HDFC Bank and ICICI Bank amongst private banks, PNB, Union Bank and BoB amongst public banks are our preferred picks**

Given recent data on inflation it now appears the government will be in favor of monetary tightening in line with RBI's thinking. A hardening of rates in the credit market is also in line with our calculations, which was published in the morning note of June 17, 2008. We expect public banks to hike their lending rates and deposit rates by 50 bps and 25 bps shortly. We believe this will help these companies stem their decline in margins and maintain them at close to FY2008 levels. The rise in interest rates and moderation in economic growth will likely lead to higher credit costs for banks. Higher policy rates by RBI is also likely to increase the cost of equity (discount rate) demanded by investors. We believe most of these negative developments are already reflected in the stock prices and fundamentals do not warrant further downside from the current price levels (see Exhibits 1 and 2). However, we expect the volatility in prices to continue and a sustainable reversal to occur only once concerns on oil prices and inflation recede. In this challenging environment, banks with strong liability profile and/ or banks with significant freedom to price their credit products will likely fare better and are therefore our preferred picks i.e. HDFC Bank and ICICI Bank. Within public banks we prefer PNB, Union Bank and BoB.

Exhibit 1: Earnings carry significant risk under stress-case scenario

EPS, BVPS, ABVPS of stocks under various scenarios, March fiscal year-ends, 2009E (Rs)

	Current estimates 2009			Margin compression by 50 bps	20% increase in gross NPLs and 50 bps higher provisions		10 year Gsec at 8.5%	MTM hit on exposure to forex	Cummulative impact		% change	
	EPS	BVPS	ABVPS	EPS	EPS	ABVPS	EPS	BVPS	EPS	ABVPS	EPS	ABVPS
Public banks												
Andhra Bank	12.0	75	71	8.0	9.5	69	11.2	NA	4.7	62	(61)	(13)
BoB	35.8	294	279	19.7	25.3	269	33.6	NA	7.1	242	**(80)**	(13)
Canara Bank	26.6	271	206	12.0	17.5	197	24.2	NA	0.6	173	**(98)**	(16)
Central Bank	10.8	74	62	0.9	4.6	56	10.0	NA	(6.1)	40	**(156)**	**(36)**
Corporation Bank	44.6	329	313	28.7	35.2	304	41.9	NA	16.6	279	(63)	(11)
Indian Bank	21.8	125	121	16.3	18.5	117	19.7	NA	10.9	109	(50)	(10)
IOB	20.9	105	95	14.3	16.9	92	20.3	NA	9.8	81	(53)	(15)
OBC	28.4	252	241	16.0	20.6	233	23.8	NA	3.6	213	**(88)**	(12)
PNB	67.4	386	363	46.7	54.0	350	64.8	358	30.7	311	(55)	(14)
SBI (standalone)	96.6	782	732	59.3	72.9	710	93.4	727	32.4	644	(66)	(12)
Union Bank	25.3	132	127	16.8	19.9	122	23.2	NA	9.3	108	(63)	(15)
Old private banks												
Federal Bank	27.8	251	246	21.4	23.8	242	NA	NA	17.4	231	(37)	**(6)**
J&K Bank	74.7	529	496	51.4	60.7	482	NA	NA	37.4	445	(50)	(10)
New private banks												
Axis Bank	40.8	277	277	29.2	34.1	271	NA	275	22.6	250	(45)	**(10)**
HDFC Bank	54.3	436	436	42.4	48.0	443	NA	426	36.1	414	(33)	**(5)**
ICICI Bank (standalone)	29.5	364	364	19.7	23.6	360	NA	357	13.8	337	(53)	**(7)**

- BoB, Canara Bank, Central Bank, OBC are affected the most on earnings.

- Central Bank, Union Bank and IOB are most impacted on BVPS given their relatively low capital base

- New private banks and Federal Bank carry low downside risk to BVPS under stress case

Source: Kotak Institutional Equities estimates.

Exhibit 2: Most banking stocks do not hold downside risk in our extreme stress-case scenario

Valuation of companies under stress case and potential downside from the current price, March fiscal year-ends

	Current price	Target price	Book value 2008E	Value for the growth stage	Terminal value	Impact on fair value: EPS decline in 2009	Impact on fair value: BVPS impact in 2009	Revised fair value		Potential downside to price from current level	Cost of equity
	(Rs)	(Rs)	(Rs)	(Rs)	(Rs)	(Rs)	(Rs)	(Rs)	% impact	(%)	(%)
Public banks											
Andhra Bank	64	86	63	17	7	(6)	(8)	72	16.6	—	14.0
BoB	225	316	245	32	38	(25)	(33)	258	18.3	—	13.5
Canara Bank	195	197	175	16	6	(23)	(29)	145	26.2	(25.7)	13.8
Central Bank	74	87	51	27	10	(15)	(20)	52	39.9	(29.1)	12.5
Corporation Bank	284	403	278	66	58	(25)	(30)	348	13.6	—	14.0
Indian Bank	115	139	101	26	11	(10)	(11)	118	14.6	—	14.0
IOB	104	151	76	61	14	(10)	(13)	128	14.9	—	14.0
OBC	155	216	198	8	10	(22)	(25)	170	21.5	—	13.5
PNB	431	601	297	201	103	(32)	(46)	522	13.1	—	13.3
SBI (standalone)	740	1,285	707	228	350	(57)	(78)	1,151	10.5	—	13.0
Union Bank	124	214	106	80	29	(14)	(17)	183	14.5	—	13.5
Old private banks											
Federal Bank	199	286	225	11	50	(9)	(13)	264	7.7	—	13.5
J&K Bank	473	655	434	87	134	(33)	(45)	577	11.9	—	13.5
New private banks											
Axis Bank	704	845	229	196	421	(16)	(24)	805	4.7	—	12.5
HDFC Bank	1,098	1,454	324	284	846	(16)	(20)	1,418	2.5	—	11.8
ICICI Bank (standalone)	336	585	355	50	123	(14)	(23)	548	6.4	—	13.5

Source: Bloomberg, Kotak Institutional Equities estimates.

Mid-cap Radar

Scalable Opportunities conference

Nitin Bhasin : nitin.bhasin@kotak.com, +91-22-6634-1395

Augustya Somani : augustya.somani@kotak.com, +91-22-6634-1328

We recently held our Scalable Opportunities conference wherein we showcased corporates from varied business segments with the common theme—'well managed company with scalable business models.' We believe these companies signify the vast amount of investment opportunity from the Indian investible space from where we could see many more leaders emerging. We present briefly the key takeaways from this corporate-investor interface in the following pages.

List of companies

Balrampur Chini (Unrated)

Everonn Systems (Unrated)

HT Media (BUY, Target price: Rs185)

Jai Balaji Industries (Unrated)

JSW Steel (ADD, Target price: Rs1,040)

Lupin (Unrated)

NIIT Limited (Unrated)

OnMobile (Unrated)

Opto Circuits (Unrated)

Tulip Telecom (Unrated)

Balrampur Chini

Background

Balrampur Chini Mills Limited (BCML) is one of the largest integrated sugar companies in India. The allied businesses of the company comprise distillery operations, cogeneration of power and manufacturing of bio-compost. The company has nine sugar factories located in Uttar Pradesh (India) having an aggregate sugarcane crushing capacity of 73,000 TCD, distillery and cogeneration operations of 320 KLPD and 126 MW (saleable), respectively.

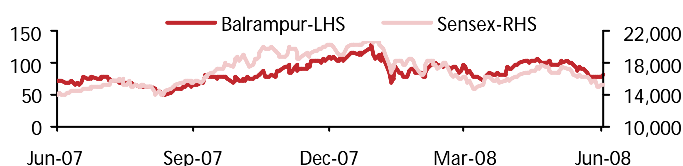
Strategy

BCML expects better inter-plant synergies and utilization of byproducts to result in substantial value addition and greater hedge against sugar cycle for the company's earnings. The company enjoys extremely good relationship with farmers in its command area and with the installation of latest technology and machinery it expects to achieve the highest operational result through production of finest quality sugar and alcohol. With key expansions already executed across all its business segments, BCML feels confident about achieving an economic rate of return on its investments, which will be largely supported by the integrated nature of operations. During SY2008-09, the company expects power and alcohol businesses to contribute most of the profits; it expects sugar to be profitable too.

Sugar industry

The company expects improvement in sugar business in the coming quarters on a sequential basis due to comparatively better realizations and lower sugarcane costs. However, the cane price issue still remains unresolved, but hopes that the judicial system will arrive at a solution in a short time which will benefit all stakeholders. Furthermore, the company expects sugar prices to rise Rs1-2 per kg next season as production will be lower at 23-24 MT in SY2008-09 from 26 MT in SY2007-08. Lower production and marginal higher consumption will reduce the closing inventory to 5-6 MT at end of SY2008-09 from 7.5 MT last year. Reduction in inventories and resultant higher sugar prices should improve sugar business earnings for the sector.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	21,565	502
Price	84	Free float (%)	63	
12 month high	128	Share outstanding (#)	256	
12 month low	50	Performance 1m (%)	(16)	ADTV($ mn)
Reuters code	BACH BO	Performance 3m (%)	10	10.4
Bloomberg code	BRCM IB	Performance 12m (%)	24	

Everonn

Background

Everonn is one of the pioneers in computer education at schools and colleges, and has partnered with various state governments to bring the computer and computer-aided education to schools and colleges. The company has set up Virtual and Interactive Learning classroom networks across India, delivering quality and affordable education. The company develops integrated content for the Indian and global audience for schools, colleges, corporate and retail segments.

Business segments

ViTELS: The Company expects the Virtual and Technology Enabled Learning Solutions

(ViTELS) business segment to be the key growth driver in the future. Currently, ViTELS has presence across 450 schools, colleges and retail points. Increase in number of studios from current seven to twenty over the next three years will enable the company further expand its reach in the country. Everonn has a major presence in South India under ViTELS. The company has a capability of opening one center per day and expects to double its capability over the next couple of years. Everonn expects to have 10,000 points of presence in next five years from current 450. The company currently has a 120 member team in this business.

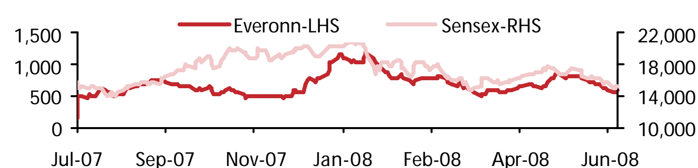
ICT: Everonn is the second largest player in the country for provision of computer education in government schools after Educomp. Everonn currently has about 17.5% share in the organized sector under ICT schools and expects to add another 2,000-3,000 schools annually over the next two years. Company expects the margins of this business to remain at current levels as increasing competition keeps margins under check. However, the company indicated that it is looking at proposals to tie-up with governments and financial institutions so as to provide only content without any initial investments, which should favorably impact cash flows. The company expects 28,000 schools to come up for tender this year and then 50,000 schools in FY2010.

iSchools: Everonn has recently acquired computer-based digital content from Aban group and is using this content to launch its offering iSchool—blended format of curriculum delivery to school which includes server based content supported by live sessions through the VSAT platform. Everonn currently has 48 K-12 schools under this format and expects to grow these at more than 100% over next two years. iSchool format will be not only utilise for curriculum teaching in schools but also coaching for entrance exams like IIT entrance after school hours

Financials

Revenues and PAT of the company grew at 100% and 200% in FY2007-08 and the company expects to maintain the same growth rate in revenues and PAT in FY2009. However, the mix in revenues and PAT will shift towards ViTELS contributing nearly 60% of earnings compared to 40% in the last fiscal. The company expects EBITDA margins to improve with the increasing share of ViTELS segment revenues. The company expects to invest Rs2.5 bn in FY2009 with Rs1.25 bn for ViTELS segment, Rs625 mn for ICT business and another Rs625 mn for Vocational training business.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	7,732	180
Price	558	Free float (%)	57	
12 month high	1,236	Share outstanding (#)	14	
12 month low	140	Performance 1m (%)	(32)	ADTV($ mn)
Reuters code	EVSI BO	Performance 3m (%)	(2)	3.0
Bloomberg code	ESIL IB	Performance 12m (%)	NA	

HT Media

Company description

HT Media is India's second largest print media company in terms of circulation of daily newspapers and the brand 'Hindustan Times' is one of India's most well recognized media brands. The company has two daily newspapers, i.e. Hindustan Times in English and Hindustan in Hindi. In addition, the company has recently launched a business newspaper in partnership with the Wall Street Journal. The company has also forayed into the emerging radio space.

Revenue Drivers

HTML management was confident of maintaining the robust ad revenue growth in the core print business with contributions from (1) recovery in the real estate ad spending in HT Delhi, (2) robust ad revenue growth in HT Mumbai and (3) expansion of Hindustan. The company expects real estate ad spending to recover in FY2009E with the launch of new projects in the NCR region. HT Mumbai is growing satisfactorily and classifieds advertising, which reflects a newspaper's position in the local ad market, has been growing at 25-30%.

HT Media plans to scale up its Hindi daily, Hindustan, with new editions in Dehradun, Bareilly and Allahabad. The company is looking to bundle copies of Hindustan Times and Hindustan for subscribers as well as distributors in these markets to drive circulation and develop consumer loyalty for the brands. The management appeared confident of maintaining 30-35% growth rate in Hindi ad revenues. The company plans to demerge the Hindi business in a subsidiary and start separate financial reporting of the English and Hindi businesses from 1QFY09E.

Newsprint Prices

HT Media management expects newsprint prices increases in India to stay at current high levels for another six months and start moderating with the restoration of newsprint supply from China after the close of Olympics in August, 2007. HTML has largely been insulated from the newsprint price increase till date since it had increased its inventory of newsprint to five months. The management reiterated its guidance of 12-15% effective newsprint price increase for HTML in FY2009E and noted a number of levers—(1) lower basis weight newsprint (43 gsm versus 45 gsm), (2) improved efficiency in circulation and (3) lower pagination levels—likely to come into play if newsprint prices increase further or stay at current levels for an extended period of time.

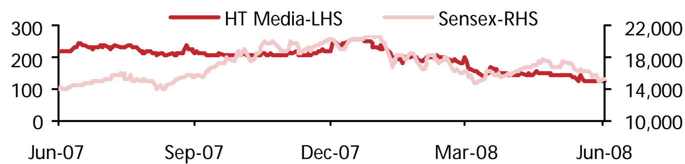
New Media Ventures

HTML management noted continued traction in Mint business newspaper with launches in Chandigarh and Bangalore recently; the company is planning to expand Mint into Chennai, Kolkata and Hyderabad. Fever FM, HTML's radio station, has achieved a sustained number two position in listenership in Delhi. Following its success in Delhi, HTML is targeting the number two position in Mumbai and Bangalore and expects revenues of Rs500 mn in FY2009E. HTML is looking to expand its presence on the internet with classifieds websites (jobs, reality, matrimonial and auto).

Financials

HTML earnings are likely to remain flat in FY2009E despite a robust 22% revenue growth over FY2008E given (1) rising newsprint prices and (2) continued losses in new media initiatives. However, we expect EBITDA to grow 60% CAGR during FY2009E-2011E driven by (1) continued strong ad revenue growth, (2) falling newsprint prices and (3) new media ventures starting to contribute to profits. We expect the consolidated EBITDA margin for the company to increase to 24.7% in FY2011E from 14.1% in FY2008.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	BUY	Market cap	26,444	615
Price	113	Free float (%)	22	
12 month high	266	Share outstanding (#)	234	
12 month low	111	Performance 1m (%)	(20)	ADTV($ mn)
Reuters code	HTML BO	Performance 3m (%)	(24)	0.6
Bloomberg code	HTML IB	Performance 12m (%)	(49)	

Jai Balaji Industries

Background

Jai Balaji Industries, based out of West Bengal, is the fifth-largest steel manufacturer with an installed capacity of 1.2 mtpa. Its product profile comprises TMT bars, alloy steel (for auto, engineering and defense purposes), ductile pipes (for water transportation) and ferro alloys.

Expansion plans

Jai Balaji is undertaking capacity expansion plans with a total capital spend of Rs16.7 bn. This includes setting up a sinter plant with a capacity of 608,000 tons, ferro alloy plant of 433,000 tons, coke oven plant of 400,000 tons and captive power of 40MW. The company is setting up an integrated steel manufacturing facility with a capacity of 5 mtpa of steel. The total capex for the greenfield project will be Rs160 bn and the estimated time for completion would be 36-40 months. Jai Balaji has signed an MOA with the West Bengal government for setting up this project at Purulia and will include 3 mtpa of cement and 1,250 MW of captive power.

Strategy

Jai Balaji's management highlighted the following key areas for its growth:

1) **Raw material costs**: The management highlighted cost of raw materials as one of the major concerns for the steel industry. In terms of non-coking coal, Jai Balaji plans to start mining within the next eight months at Dumri coal block, Jharkhand. Jai Balaji is looking to capture coke mines in Rohne coal block in Jharkhand. In terms of iron ore, the company does not yet have iron ore mines; however, it is setting up a pellet and sinter plant so as to reduce costs by using lower grade iron ore.

2) **Cost of energy**: Jai Balaji benefits from low energy cost and a stable supply of power. The company currently has captive power capacity of 65MW and it intends to add another 40 MW. It would be using waste gases/solid waste for generating power resulting in low cost of power per unit—power cost for Jai Balaji would be Re0.50/unit versus grid cost of Rs2.8/unit. The captive generated is used for ferro alloy production.

3) **Cost of logistics:** The company has already acquired four rakes under the Wagon Investment Scheme (WIS). Besides, by supplying rakes to the Railways under the WIS, it is able to obtain discounts on freight movement and assured allotment of rakes. Jai Balaji has outlined a capex of Rs1,250 mn to be spent on logistics which will likely result in annual savings of Rs1,875 mn thereby leading to a payback period of less than one year.

4) **Product profile:** Jai Balaji highlighted that it has a diversified product profile enabling it to have a derisked product portfolio. Its products include TMT bars, ductile pipes, ferro alloys and alloy steel. It aims to produce long products to the extent of 30%, alloy steel products of 45% and ductile pipes to the extent of 25%.

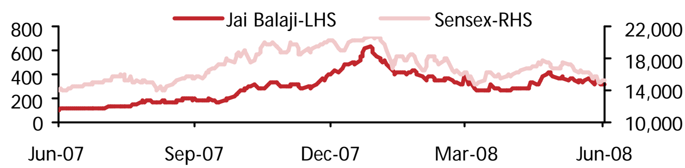
Other takeaways

1) Jai Balaji has 30% lower capex cost than most others. It has completed expansion of 0.5 mtpa of steel manufacturing capacity in 10 months.

2) Jai Balaji aims to bring about total savings in raw material costs of Rs140 bn annually once it is able to able to start production at its coking/non-coking coal mines and completes the acquisition of iron ore mines.

3) The company recently acquired the steel division of HEG Ltd. having facilities of sponge iron, captive power and railway siding. It also acquired Nilachal Iron & Power Ltd, which has been allotted coal mining facilities.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	13,806	321
Price	293	Free float (%)	NA	
12 month high	668	Share outstanding (#)	47	
12 month low	97	Performance 1m (%)	(17)	ADTV($ mn)
Reuters code	JAIB BO	Performance 3m (%)	6	0.2
Bloomberg code	JBIL IB	Performance 12m (%)	191	

JSW Steel

Background

JSW is the second-largest steel producer in the private sector in the country having a capacity of 4.8 mtpa. This will be ramped up to 7.8 mtpa by mid-FY2009 as JSW is in the process of adding 3 mtpa capacity at its Vijaynagar plant. It recently acquired Southern Iron and Steel Company (SISCOL) having a capacity of 0.5 mtpa which is being ramped up to 1 mtpa. JSW also acquired iron ore mines in Chile and coal mines in Mozambique in order to reduce dependence on external sources of raw materials.

Expansion plans

JSW is in the process of expanding its capacity from 7.8 mtpa to 32 mtpa by FY2020. The current capacity at Vijaynagar is being expanded to 10 mtpa (from 6.8) and this will be completed by FY2010 taking total capacity up to 11 mn tons. JSW is also setting up two greenfield projects of 10 mtpa each—one in West Bengal and the other in Jharkhand. Both these projects are likely to be fully commissioned by FY2020 resulting in a total capacity of 32 mtpa by FY2020. Phase-1 of the West Bengal project of 6 mtpa is expected to be operational by FY2012. The company has already acquired 4,068 acres of land in West Bengal and has acquired coal mines in West Bengal. The land acquisition has been made by way of providing stake to the land owners, cash as well as employment to one member of each family.

Raw Material integration

JSW plans to increase captive sourcing of iron ore and coking/thermal coal. JSW has acquired iron ore mines in Chile in order to increase its raw material integration. The Chile mines were acquired for US$252 mn and have estimated iron ore reserves of 500-800 mn tons of post beneficiation. JSW intends to use the output at Chile mines as a hedge against its domestic iron ore purchases. It intends to start mining by FY2010—the mine output will be increased from 4 mtpa in FY2010 to 20 mtpa over three years. JSW will have to incur a capex of US$150 mn at Chile to upgrade the capacity to 6 mtpa by FY2010. Besides it will be incurring another US$50 mn for upgradation of port and rail facilities.

Besides iron ore, JSW intends to secure a large part of its coking and non-coking coal requirements from mine allocated in Mozambique. The Mozambique mine has estimated coking coal reserves of 188 mn tons. Additional coking coal supplies are expected in FY2011-12 from mines allocated in Jharkhand and West Bengal. respectively.

Funding

The company would not need to raise additional funds for completing its expansion program upto 11 mtpa of capacity. The management has also indicated that the debt-equity ratio would not exceed 1.5X.

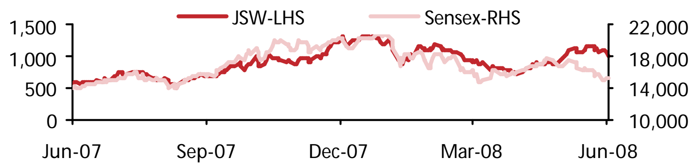
Positives

The management has indicated that value accretion from the iron ore mines in Chile could be a huge positive for JSW Steel. It intends to list JSW Steel or its subsidiary at the London Stock Exchange. Besides, listing of its other subsidiaries (JSW Bengal, Jharkhand subsidiary) could also be positive triggers for the company.

Challenges

The key challenge is the raw material integration. Mining approvals from the government may take time and this may upset the resource integration plans. Besides, till the time approvals are in place and operations commence, JSW remains dependent on external sources for its raw material requirements. The timely completion of the various capacity expansion projects being undertaken and government intervention in determining steel prices remains a challenge for JSW.

Share price performance



Company data	
Stock rating	ADD
Price	995
12 month high	1,390
12 month low	506
Reuters code	JSTL BO
Bloomberg code	JSTL IB

Capitalization	(Rs mn)	(US$ mn)
Market cap	186,027	4,330
Free float (%)	65	
Share outstanding (#)	187	
Performance 1m (%)	(13)	ADTV($ mn)
Performance 3m (%)	11	25.5
Performance 12m (%)	64	

Lupin

Background

Lupin, promoted by Dr D.B. Gupta, is one of the leading pharmaceutical companies in India and is one of the world's largest manufacturers of Cephalosporins and anti-TB drugs. Exports comprise 55% of sales and formulations form 70% of total revenue. The major therapeutic segments the company operates in are: Cephalosporins (45% of sales); cardiovascular-prils and statins (16% of sales); anti-TB (12% of sales). US is the largest international market for Lupin with revenues at US$180 mn (around 25% of sales). Lupin recently entered the second largest pharmaceutical market in the world, Japan through the acquisition of Kyowa (90% stake).

Strategy

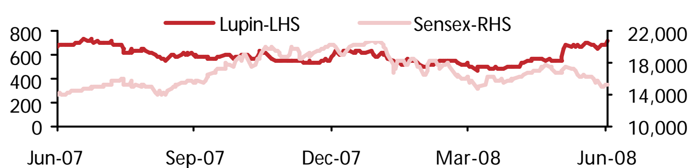
Lupin has shifted focus from being a bulk drug supplier to a formulations-led generics company. Going forward, the company wants to move from generics to an innovation-led branded company. In addition to generics, the company has a presence in the US through its branded drug, Suprax, which has grown over 50% yoy. It launched oral tablets for Suprax recently and plans to launch further line extensions to grow this franchise. Lupin plans to step up its presence in other developed and emerging markets through alliances in European markets, expanding revenues through its subsidiary in Australia and expanding sales force in CIS to increase market penetration. India formulations comprise 35% of sales. The company will add new therapies and in-license new products in hospital, critical care segment, oncology and women's healthcare. It aims at increasing revenues by increasing market penetration in rural areas. Lupin made two significant acquisitions over the last financial year. It acquired 90% in Kyowa which would provide it with an entry into the fast expanding Japanese markets. It also acquired Rubamin to enter the CRAMS segment.

Financials

For the financial year ended March 2008, Lupin's revenues and PAT were Rs27,730 mn (US$ 694 mn) and Rs4,083 mn (US$102 mn) registering growth of 34% and 32%, respectively. Exports grew 52% with domestic business growing at 16%.

Lupin is targeting revenues of US$1 bn in FY2009 with sales growth of over 40%. About 90% of the targeted revenues will come from organic initiatives while the remaining 10% will come through acquisitions.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	56,612	1,318
Price	690	Free float (%)	58	
12 month high	745	Share outstanding (#)	82	
12 month low	430	Performance 1m (%)	4	ADTV($ mn)
Reuters code	LUPN BO	Performance 3m (%)	40	4.9
Bloomberg code	LPC IB	Performance 12m (%)	0	

NIIT

Background

NIIT is the leading IT training provider in India and amongst the top 20 IT education providers globally. With the acquisition of Element K—a leading learning solutions provider in the US—it now has the second largest content library globally and more than 1,500 clients in 32 countries. The company operates in five key segments— (1) individual learning—offering IT training programs to individuals, (2) school learning—turnkey computer training at government schools, (3) corporate learning—providing custom content development, learning delivery and platform technology, (4) Element K— US-based learning solutions provider and (5) new businesses—NIIT-IFBI to offer training in the banking, insurance and financial services field and NIIT- Imperia offering management education in tie-up with the IIMs.

Strategy

NIIT is focusing on becoming a global talent development center from being only an IT training provider. Its recent initiatives are aimed to diversify its business mix towards non-IT skill development for sectors requiring large manpower training. NIIT has also started two new initiatives—(1) NIPE—a 75:25 JV with Genpact to impart BPO training which is expected to start by Q3FY09 and (2) acquisition of Evolv Services—a company engaged in delivering communication and other soft skills training.

It continues to expand its dominance in the domestic IT training segment through launch of new centers and curriculum. NIIT is also focusing on international opportunities and is swiftly expanding into countries like China and other South-East Asian countries. It plans to leverage Element-K acquisition to use its large content library to scale up its corporate learning business in other countries as well. The company continues to seek acquisition opportunities globally to expand its geographical reach as well as diversify its service offering.

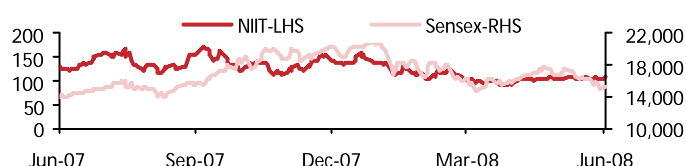
Competition

There is strong competition in the education space in India; however with large untapped opportunity there is still significant market yet to be serviced, providing large growth opportunity for all the players. NIIT is the leader in the IT training market in India; however its nearest competitor in this segment is Aptech. Other competitors in education training include Educomp and Everonn.

Financials

Revenues and PAT have grown at a CAGR of 36% and 27%, respectively over FY2005-08. Individual Learning Solutions contributed to 51% and 61% of system wide revenues and EBITDA respectively. Corporate leaning (including Element K) contributed 39% and 26% to system wide revenues and EBITDA respectively. Company expects to improve the overall margin with cost saving at Element-K and increasing contribution from the new businesses.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	16,775	390
Price	102	Free float (%)	63	
12 month high	172	Share outstanding (#)	165	
12 month low	85	Performance 1m (%)	(8)	ADTV($ mn)
Reuters code	NIIT BO	Performance 3m (%)	2	1.7
Bloomberg code	NIIT IB	Performance 12m (%)	(18)	

OnMobile

Background

OnMobile is a leading provider of telecommunications value-added services (VAS) in India with an expanding international presence, particularly in the emerging markets of Asia. Its products are targeted at end-users with an increasing focus on capitalising on the convergence between wireless and wireline telecommunications services, media content distribution, internet, mobile marketing and mobile commerce.

Its products include ringback tones, voice portals, ringtone downloads, subscription manager, contests, music messaging, on-device client software, mobile radio, dynamic voicemail, voice short messaging service and missed call alerts which enable subscribers to personalise their mobile phones and thereby enhance user experience.

Strategy

Future growth is targeted through expansion in other emerging markets in Asia as well as expanding the reach to other users of VAS like media and internet companies. The company actively pursues new growth and acquisition opportunities in its existing line of business as well as related businesses to expand its geographic presence, service offerings, carrier relationships and technological expertise.

OnMobile plans to utilize its leading market position in India to launch, test and develop innovative applications and services with existing carrier customers, thereby expanding the breadth of services offered, as well as export these new applications and services in new international markets as they become commercially viable.

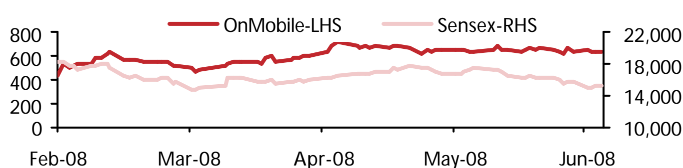
Competition

OnMobile is the leading VAS provider in India with a target reach of 98% of the mobile population in India. It has service contracts with all the leading mobile carriers except Spice. The main competitors for OnMobile in the VAS space are Bharti Telesoft, Celebrum and IMI Mobile.

Financials

Revenues and PAT have grown at a CAGR of 97% and 93%, respectively, over FY2004-08. Ring back tones currently contribute to 60% of the revenues while voice portal contributes the balance 40%. Its top three customers contributed to 59% of the revenues in FY2008.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	33,393	777
Price	582	Free float (%)	34	
12 month high	745	Share outstanding (#)	57	
12 month low	421	Performance 1m (%)	(10)	ADTV($ mn)
Reuters code	ONMO BO	Performance 3m (%)	20	12.2
Bloomberg code	ONMB IB	Performance 12m (%)	NA	

Opto Circuits

Background

Bangalore-based Opto Circuits is a leading Indian medical devices company and offers a wide range of electronic devices and monitoring products in the healthcare segment such as digital thermometers, pulse oximeter, pulse oximeter sensors, fluid warmers, cholesterol monitors and stents. It is one of the major suppliers to original equipment manufacturers (OEMs) in the medical electronics field.

Strategy

Opto Circuits' acquisitions and product innovations have provided the company with a diversified portfolio and a widespread presence in the EU, South Asia and the USA. Opto has recently acquired Criticare Systems Inc, USA, which develops, markets and distributes a wide range of patient monitoring devices—anesthetic gas monitoring, vital signs monitoring, gas and agent analysis and central station monitoring systems. These complement Opto's gas monitoring business which earlier comprised only of oxygen monitoring; Criticare provides access to nitrogen and carbon dioxide. Earlier acquisition of Eurocor (for US$13mn), has made Opto a potential global player for stents as this acquisition would help to penetrate into most of the developed markets. Post USFDA approval in the next 18-24 months, Opto plans to sell stents in the US, which is a US$4.5-bn market. Globally, there are four large players in Stents, with Johnson & Johnson and Boston Scientific being the two players controlling the US market. Opto Circuits plans to leverage the capabilities of Eurocor to garner a 5% share in the European stents market.

Strong marketing for well-built research products

Opto expects to continue its growth momentum on the back of its increasing sales of disposable sensors and stents with the help of strong global distribution network, customer focused business strategies and expansion of product portfolio. Currently, Opto has over 200 distributors across the globe with nearly 160 in the US alone. Moreover, Opto has been organizing conferences, seminars and workshops in different countries to promote its stents. Opto, through its subsidiary Eurocor, is planning to invest heavily in developing second and third generation stents.

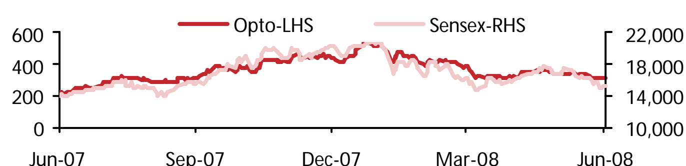
Financials

Opto expects to grow its stents revenues at about a CAGR of 80% over the next 2-3 years with USFDA approval expected in CY2010 to provide a fillip to revenue growth. The other two businesses—sensors and patient monitoring systems—are expected to collectively grow at 30% in the next 2-3 years. Company expects EBITDA margins to remain around 30% in FY2009 but to reduce in FY2010 as Criticare revenues are accounted for the full fiscal. The company expects consolidated revenues to increase at 50% in FY2009 with Criticare accounting for US$50 mn revenues in the July '08-June '09 period.

Subsidiaries

Opto Circuits has its international operations in the USA, Germany and Dubai, through its wholly-owned subsidiary, Mediaid Inc; and in France, Germany and Poland through another wholly-owned subsidiary, Eurocor. It also has a 60% stake in Advanced Micronic Devices Limited, a Bangalore-based company dealing in cardiac care and other healthcare equipment.

Share price performance



Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	29,353	683
Price	312	Free float (%)	56	
12 month high	581	Share outstanding (#)	94	
12 month low	225	Performance 1m (%)	(8)	ADTV($ mn)
Reuters code	OPTO BO	Performance 3m (%)	(4)	1.2
Bloomberg code	OPTC IB	Performance 12m (%)	37	

Tulip Telecom

Background

Tulip Telecom is a domestic telecom data services provider operating in the enterprise space. The company started as a software products vendor in 1992 and took the present shape in 2001 when it entered the network integration market. The company operates in two main segments—(1) Network integration (about 60% of FY2007 revenues) and (2) virtual private network (VPN) services for corporates (about 40% of FY2007 revenues, growing much faster than the NI segment). The company is also expanding into new service lines like Data Centers and managed network services. The company's USP is its last-mile wireless data network with an ability to provide the same in 1,100+ locations across India.

Strategy

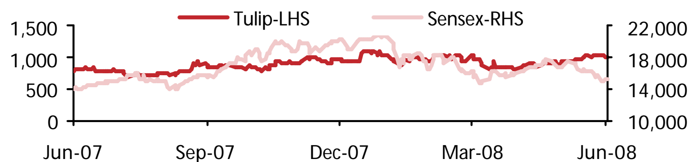
Tulip intends to maintain its market leadership position in the fast growing IP VPN segment in the country. The IP VPN is expected to grow at a 20% CAGR over the next four years to reach Rs20 bn by FY2012E. Tulip is banking on utilizing its largest reach in the market (Tulip's last-mile network reaches 1,100+ cities in the country, much larger than any of its competitors). We highlight that a larger proportion of companies are opting for IP VPN technology for their intranet/extranet needs.

In addition to its staple network integration business (where Tulip is among the top five players in the country), Tulip is also focusing on (1) State-Wide Area Networks and Common Service Centers—the Central and various state governments have substantial spends planned in this area and (2) Data Center business including co-location, hosting, and managed services; the company is building data center capabilities in Delhi (partially operational) and Mumbai.

Competition

Tulip competes with Sify, VSNL, Bharti, RCOM etc. in the enterprise data connectivity market. Wipro is its biggest competitor in the domestic network integration market.

Share price performance

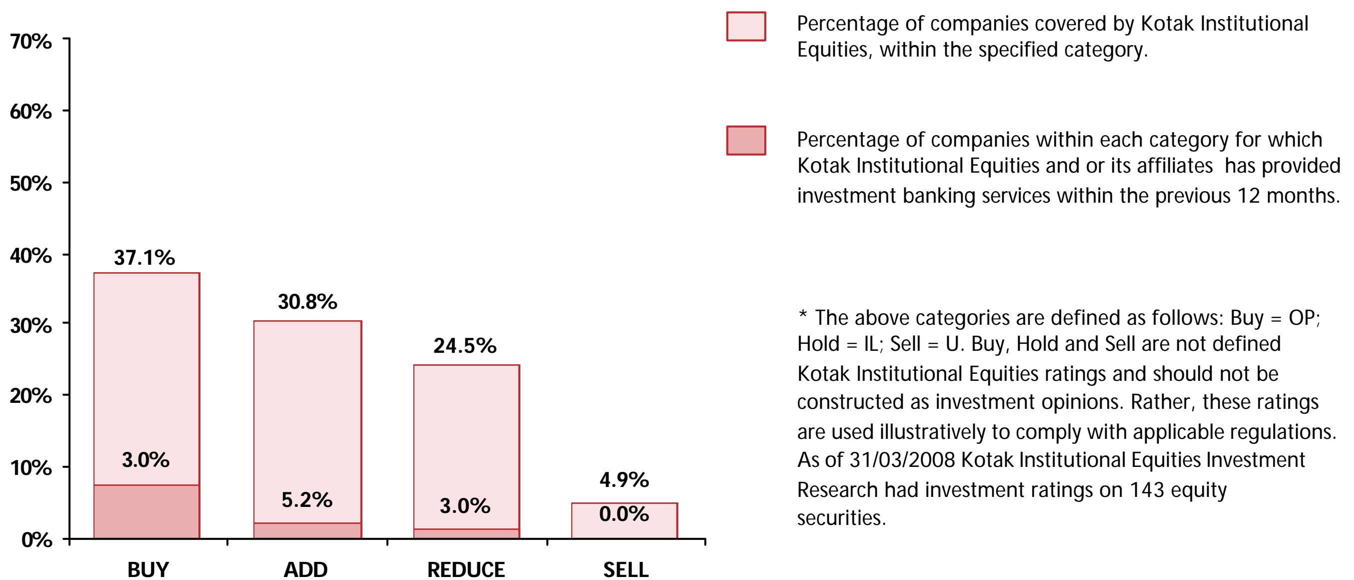


Company data		Capitalization	(Rs mn)	(US$ mn)
Stock rating	NA	Market cap	31,933	743
Price	1,101	Free float (%)	27	
12 month high	1,225	Share outstanding (#)	29	
12 month low	651	Performance 1m (%)	16	ADTV($ mn)
Reuters code	TULP BO	Performance 3m (%)	27	1.0
Bloomberg code	TTSL IB	Performance 12m (%)	30	

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Amit Agarwal, Lokesh Garg, Sanjeev Prasad, Mridul Saggar, Tabassum Inamdar, Nitin Bhasin."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities. As of March 31, 2008

Ratings and other definitions/identifiers

New rating system

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.
ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.
REDUCE: We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.
SELL: We expect this stock to underperform the BSE Sensexby more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.
IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.
U = Underperform. We expect this stock to underperform the BSE Sensex over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: Attractive (A), Neutral (N), Cautious (C).

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.
CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.
NC = Not Covered. Kotak Securities does not cover this company.
RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
NA = Not Available or Not Applicable. The information is not available for display or is not applicable.
NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office
Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices
Kotak Mahindra (UK) Ltd.
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc.
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel: +1-914-997-6120

Copyright 2008 Kotak Institutional Equities (Kotak Securities Limited). All rights reserved.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advise to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund.Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition , investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.