kotak Institutional Equities

INDIA DAILY

April 05, 2007

EQUITY MARKETS

India	4-Apr	1-day	1-mo	3-mo
		Change, %		
Sensex	12,787	1.3	3.0	(7.7)
Nifty	3,733	1.2	4.4	(6.3)
Global/Regional indices				
Dow Jones	12,530	0.2	4.0	1.1
Nasdaq Composite	2,459	0.3	5.0	1.0
FTSE	6,365	(0.0)	5.1	2.3
Nikkie	17,473	(0.4)	5.0	2.2
Hang Seng	20,210	1.0	8.3	(0.0)
KOSPI	1,482	(0.1)	7.7	7.0

Value traded - India

	4-Apr		1-mo	3-mo
			Moving avg, Rs bn	
Cash (NSE+BSE)	100.9		113.6	126.6
Derivatives (NSE)	220.7		325.3	281.5
Deri. open interest	426.9		530.1	495.7

Forex/money market

	4-Apr	1-day	1-mo	3-mo
		Change, basis points		
Rs/US$	43.1	-	(160)	(122)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	8.2	(2)	20	59

Net investment (US$mn)

	3-Apr		MTD	CYTD
FIIs	(39)		#N/A	(698)
MFs	(24)		#N/A	(301)

Top movers -3mo basis

Best performers	4-Apr	1-day	1-mo	3-mo
		Change, %		
SAIL	112	0.9	15.6	28.3
Punjab Tractors	303	0.1	(4.4)	20.7
BEL	1,581	4.5	8.3	20.7
Bharti Tele	748	1.8	8.2	17.4
Britannia	1,220	(0.5)	(5.9)	10.8
Worst performers				
Acc	714	1.4	(12.1)	(32.3)
Tvs Motor	56	(0.9)	3.8	(31.5)
Century Tex	508	0.3	7.8	(31.1)
Grasim	2,064	(1.9)	(1.8)	(27.1)
Ingersoll Rand	271	0.0	(11.7)	(27.1)

Contents

Updates

News Roundup

Corporate

- Realty major DLF Ltd has re-filed the draft prospectus for its mega initial public offering (IPO), clarifying that it was yet to get a certificate for change of use for 60 per cent of the developable land of 574mn sq ft mentioned in the document. (BS)
- The clearance of the Vodafone-Hutch deal could run into a further roadblock with the Law Ministry suggesting appointment of inspectors to investigate the actual ownership of mobile services company Hutchison Essar. (BL)

Economic and political

- Steel production in the country during the April-February period grew 10.1 per cent at 44.3mn tonnes as against 40.2mn tonnes in the corresponding period of previous fiscal. Exports during the period under review increased 9.3 per cent to 4.3mn tonnes from 3.9mn tonnes in the same period of previous fiscal. (ET)
- The Centre is well on course to achieve the revised direct tax collection target of US$52.1bn. Official sources said that the net direct taxes touched a level of US$50.3bn (for challans entered and validated by NSDL up to April 2). This last available data for fiscal 2006-07 under the online tax accounting system does not include the tax deducted at source (TDS) in the last week of March. The TDS amount is estimated at about US$1.1bn. (BL)

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

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Automobiles

ASOK.BO, Rs36	
Rating	IL
Sector coverage view	Attractive
Target Price (Rs)	47
52W High -Low (Rs)	54 - 30
Market Cap (Rs bn)	47.3

Financials

March y/e	2007E	2008E	2009E
Sales (Rs bn)	70.4	81.0	92.1
Net Profit (Rs bn)	4.3	5.1	5.9
EPS (Rs)	3.2	3.8	4.4
EPS gth	*39.2*	*19.0*	*16.3*
P/E (x)	11.1	9.3	8.0
EV/EBITDA (x)	6.4	5.4	4.4
Div yield (%)	3.8	4.4	4.4

Shareholding, December 2006

	Pattern	% of Portfolio	Over/(under) weight
Promoters	51.3	-	-
FIIs	11.8	0.1	(0.1)
MFs	7.8	0.5	0.2
UTI	-	-	(0.2)
LIC	8.6	0.5	0.3

Ashok Leyland: CV sales down by 1% in March

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- **Total Mar sales decline 1% yoy**

Ashok Leyland has reported a 1% yoy decline in total sales for the month of March. Goods M&HCV sales declined 1.5% yoy while buses grew 5% yoy in March. MoM total sales growth was muted at 5%. March is typically the strongest month for Ashok Leyland and has historically witnessed 25-35% mom growth on a consistent basis. In this context, the lackluster 5% mom growth this March is a cause for concern. Our discussions with Ashok Leyland's management during March indicate that a tightening of credit by banks owing to the ongoing acute liquidity crunch had impacted sales for the month. This, in our opinion, explains only part of the underperformance and believe that March sales are an indication of softer CV growth for the company in FY08. Ashok Leyland has ended FY07 with a total volume growth of 35% driven by a 49% growth in goods M&HCVs and a 1% decline in bus sales.

Ashok Leyland's management has guided for 10-15% sales growth in FY08 versus our current estimate of 10%. However, in view of the weak sales number for March combined with the trend of weakening freight rates in recent months, we see downside risk to our 10% growth estimate for the company in FY08. We maintain our In-Line rating on the stock.

4-wheelers March 2007 sales performance

	Mar-07	Mar-06	yoy %	Feb-07	mom %	YTD, FY07	YTD, FY06	yoy %	FY2008 growth estimate
Ashok Leyland									
M&HCV	6,773	6,876	-1.5%	6,347	6.7%	67,330	45,156	49.1%	
LCV	-	79	-100.0%	18	-100.0%	303	805	-62.4%	
Total CV	**6,773**	**6,955**	**-2.6%**	**6,365**	**6.4%**	**67,633**	**45,961**	**47.2%**	
Buses	1,671	1,593	4.9%	1,671	0.0%	15,501	15,665	-1.0%	
Total	**8,444**	**8,548**	**-1.2%**	**8,036**	**5.1%**	**83,134**	**61,626**	**34.9%**	**10.0%**

Source: Company, Kotak Institutional Equities.

Technology

Sector coverage view	Attractive

Company	Rating	Price, Rs 4-Apr	Target
TCS	IL	1,197	1,275
Wipro	OP	549	660
Infosys	OP	1,993	2,200
Satyam Comp	IL	453	475
HCL Tech	IL	288	338
i-flex solutions	U	2,153	1,675
Patni	OP	390	510
Hexaware	IL	164	185
Polaris Softwa	U	171	150
Tech Mahindra	IL	1,370	1,900
Mphasis BFL	IL	276	280
iGate Global	U	370	325

Attrition and onsite wage inflation the key challenges after the H1B application window is closed in only two days

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- **Enough applications to meet the cap received on day one of window opening**
- **Implications: Onsite staffing, attrition and onsite wage inflation**
- **Maintain attractive coverage view on the sector**

The United States has stopped accepting new applications for H1B visa within two days of the opportunity window opening up. According to a release by the U.S. Citizenship and Immigration Services (USCIS), it has received enough H-1 B petitions to meet the mandated cap of 65,000 for FY2008 (fiscal year from Oct-Sep every year). USCIS will now use a random selection process for all cap-subject filings received on or before April 3, 2007 as opposed to the first come first serve selection process followed in previous years. The key implications in our view are (a) the lottery process to be followed for selection renders uncertainty around the number of H-1 B visas for the Indian IT companies and would severely impact resource planning and (b) there could be additional pressure on onsite wages and higher onsite attrition as various IT companies vie to achieve their H-1 B targets. The development is marginally negative for the sector as a whole, especially for Tier-II IT companies who have lower onsite salaries and visa inventory compared to peers. We expect companies such as Infosys and Wipro to tide over these challenges led by a strong inventory of visas and competitive onsite salaries. Maintain Attractive coverage view with Wipro and Infosys as our top picks

Implications—Onsite staffing to become more challenging, attrition rates may increase and onsite wage inflation could have a negative surprise: While the visa demand reflects the strong demand environment and shortage of skills (can reflect in higher pricing) in US, we believe the Indian companies may face the following challenges

1. Random application selection process (versus first come first serve policy) creates uncertainty on availability of visas and matching of skill sets.
2. The number of applications reflects the inadequacy of the present visa limit and can potentially reflect in higher onsite wage increase and/ or attrition. Already onsite attrition is higher than offshore attrition for most companies.
3. Companies with low onsite wages are most vulnerable on wage inflation as well as attrition. Onsite wage inflation may turn out to be higher for the industry as a whole compared to the current expectations of 3-4%. Infosys has the highest compensation in US among Indian IT services companies and is the best placed to manage this challenge followed by Wipro. Satyam may be more vulnerable than peers.
4. Project staffing has to be met with local recruitments, which comes at a higher cost and may reduce flexibility on managing utilization rates. Infosys has actively started recruiting from US campuses, though the number is small at present.

Cap-exempt quota yet to be filled up: Under the H-1B Visa Reform Act of 2004, visa application from US-earned masters' or higher degrees are exempt from the above cap of 65,0000. The current limit for such applications is 20,000 per annum. However this limit has not been fully utilized in the past.

Record number of petitions on the first day of application window: The USCIS has announced that it had received 150,000 applications for H-1 B visa (well above the mandated cap of 65,000) as of April 2, 2007 and that it has set the final receipt date as April 3, 2007. The H-1 B cap for FY2006 and FY2007 was reached on August 10, 2005 and May 26, 2006 respectively. We highlight other key details below

1. USCIS will reject all petitions received on or after April 4, 2007
2. All applications received on or before April 3, 2007 will be subject to a computer-generated random selection process (a lottery); we note that the USCIS followed a first come first serve policy for petition selection in the previous years
3. USCIS will reject and return along with the filing fee(s) all cap-subject H-1 B petitions that are not randomly selected
4. The next round of applications will begin on April 1, 2008 for the fiscal year 2009 (unless the Congress increases the cap for FY2008 in the immigration bill under consideration, unlikely in our view)

Cost of processing a new H1B visa

	Amount (US$)	Comments
Visa Application		
Processing fees	185	
AICWA fees	1,500	US$ 750 for organizations with less than 25 full time employees
Fraud prevention fees	500	
Degree evaluation fees	200-300	
Attorney cost	500-1000	
Total application fee	**2900-3500**	
Post Approval		
Stamping fee	100	
Travel & Miscallenous	100-900	Travel to visa interview, etc.

Source: USCIS, Kotak Institutional Equities

Economy

Sector coverage view	N/A

India's Rupee: Banks distress sale forex as the RBI 'fights' inflation

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- **Rupee at Rs43.09/USD, as banks to distress sell forex for Rupee liquidity**
- **Why? Anti-inflationary measures: monetary tightening, higher metals/oil prices**
- **Why do we expect the Rupee to soften? Liquidity, REER, US Fed**
- **Retain FY08 Rupee forecast at Rs44/USD, assuming Euro/USD at 1.34.**

We continue to expect the Rupee to retrace back towards Rs44/USD levels once the RBI's monetary policy 'normalizes' - presumably as base effects pull down inflation ahead. Monetary tightening has forced private and foreign banks to distress sell forex. Since these banks do not have surplus gilts to furnish at the RBI's 7.75% repo ' cash for gilts - window, the alternative would have been to borrow in a volatile call market, where rates are swinging between 4-80%. We do not see how the Rupee can appreciate for long. First, the RBI will still likely need to buy US$15 bn in this fiscal to fund domestic liquidity as banks' hit minimum SLR, shutting down the RBI's repo window. Second, the Rupee's real effective exchange rate likely crossed the 108 levels at which the central normally intervenes.

Why a softer - Rs44/USD - Rupee? Liquidity, REER. We expect the Rupee to retrace to Rs44/USD in FY2008E as monetary policy normalizes in the coming months with a likely inflation top off in 1QFY08E.

- We expect the RBI to buy US$15 bn of forex in order to balance money market liquidity in FY2008 especially given the fact that the repo window will likely shut down as banks hit their 25% SLR regulatory minimum (Exhibit 1).
- This is consistent with our balance of payments estimates which suggest that the RBI will likely be able to buy up US$18 bn assuming that international crude prices settle at US$60/bbl (Exhibit 2).
- Governor Reddy has, in fact, naturally preferred to frontload his forex buying in the past two years. We thus expect the RBI to likely try to buy up as much of the additional US$20 bn needed to maintain FY2009E liquidity. This assumes that the government spends the surplus cash with the RBI to foot the 6th Pay Commission bill.
- A stronger Rupee also clashes with a natural policy preference for export promotion (especialcially IT, especially at a time of a US slowdown). The Rupee's real effective exchange rate has certainly crossed the 108 benchmark at which the RBI has intervened in the past (Exhibit 3).
- Finally, the RBI's anti-inflationary 'compulsion' of high 7.75%+ short-term interest rates will increasingly clash with the exchange rate objective of a softer Rupee to maintain export competitiveness as expectations about a US Fed cut strengthen in the months ahead.
- In our Rupee projections, we have priced the US Dollar at 1.34/Euro factoring in 50bps cut in the US federal funds rate and a 25bp hike by the European Central Bank.

Why did the RBI push up the Rupee? Inflation 'expectations', high oil prices. The RBI is trying to keep a tight rein on liquidity in order to anchor inflation 'expectations' at a time of 6%+ inflation.

- Private and foreign banks are not able to access the RBI's 7.75% repo window to meet rising reserve requirements (150 bps since November) since they do not possess surplus gilts (beyond the 25% regulatory minimum).
- Although March is usually a month in which seasonality favors exports over imports, the RBI has not bought forex because of its objective of tighter Rupee liquidity.
- These banks are therefore liquidating their forex balances to avoid borrowing on call from PSU banks. Inter-bank rates have actually been swinging between 4-70% during the past month depending on the monetary measure – repo rate increase, CRR hike, Market Stabilization Scheme, LAF reverse repo limit - that catches the RBI's fancy.
- Matters have also been complicated by large-scale advance tax payments and a threat of a PSU bank strike during end-March which spooked private and foreign banks which typically borrow from PSU banks.
- Media reports suggest that the government has also allowed the RBI to appreciate the Rupee as an anti-inflationary measure at a time of rising oil prices. A stronger Rupee also contains 'imported' inflation from rising international metal prices.
- The RBI may have also desisted from intervening in the forex market at a time of volatility in the stock market. Its US$15 bn forex intervention had run into the May 2006 meltdown last year and pulled the Rupee beyond Rs46/USD levels.

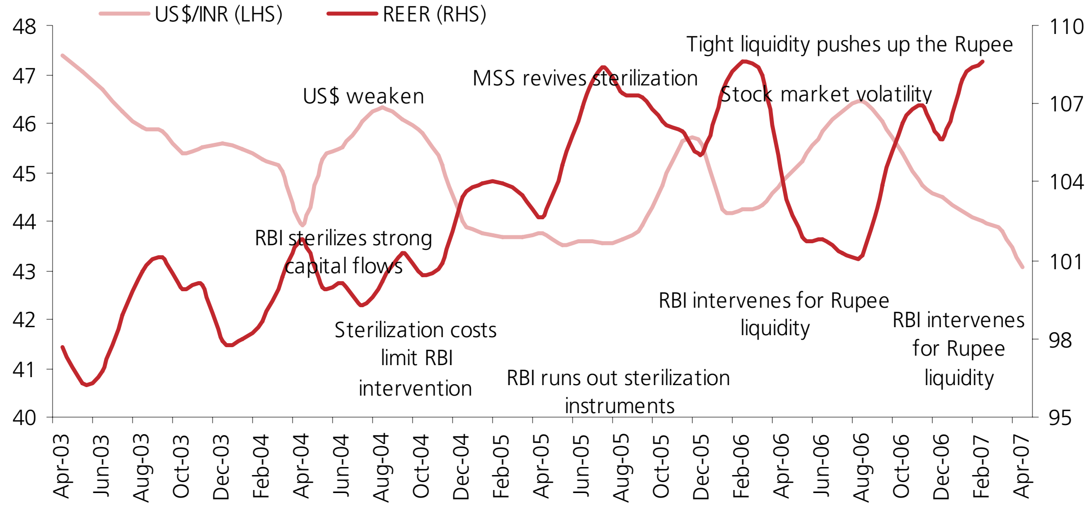
Exhibit 1: RBI will need to buy US$33 bn by March 2009

Liquidity projections in Rsbn

	Liquidity indicator	FY2007E	FY2008E	FY2009E
1.0	Bank CRR demand	521	465	346
2.0	Autonomous liquidity position (2.1+2.2+2.3-2.4)	265	67	257
2.1	RBI's loans to government	-100	200	400
2.2	RBI's market net foreign currency purchases	1125	675	772
	in USD	25.0	15.3	17.7
2.3	Others	0	0	0
2.4	Currency	760	808	915
3.0	Net liquidity (2-1)	-256	-398	-89
4.0	Policy position (4.1+4.2+4.3)	22	398	-89
4.1	Net LAF repos	363	-42	-249
	Outstanding LAF repos	291	249	0
4.2	Market Stabilization Scheme	-391	440	160
4.3	OMO (net outright sales)	50	0	0
5.0	Excess Reserves (3+4)	-234	0	0
	Memo items			
	CRR (1st round hikes)	270	155	

Source: RBI, Kotak Institutional Equities.

Exhibit 2: how long will the RBI live with an overvalued Rupee?
US$/INR, real effective exchange rate of the Rupee



Source: RBI, x-rates.com

Exhibit 3: RBI will likely be able to buy US$18 bn in FY2008E
India's balance of payments (US$bn)

Item	FY2007E	FY2008E
Current Account	**(14.0)**	**(10.0)**
% of GDP	(1.6)	(1.0)
Trade balance	(68.0)	(70.0)
- Exports	125.0	144.0
- Imports	193.0	214.0
o/w Oil imports	56.0	56.0
Invisibles	54.0	60.0
o/w income from forex reserves	7.5	10.0
Capital Account	**47.5**	**39.0**
Foreign investment	16.0	18.0
- FDI	8.0	10.0
- FII+	8.0	8.0
Banking capital	8.0	6.0
- NRI deposits	5.0	3.5
Short term credit	3.0	3.0
ECBs	12.5	10.0
Others	8.0	2.0
Overall balance	**33.5**	**29.0**
Memo		
RBI's net forex purchases	**25.0**	**18.0**

Source: RBI, Kotak Institutional Equities.

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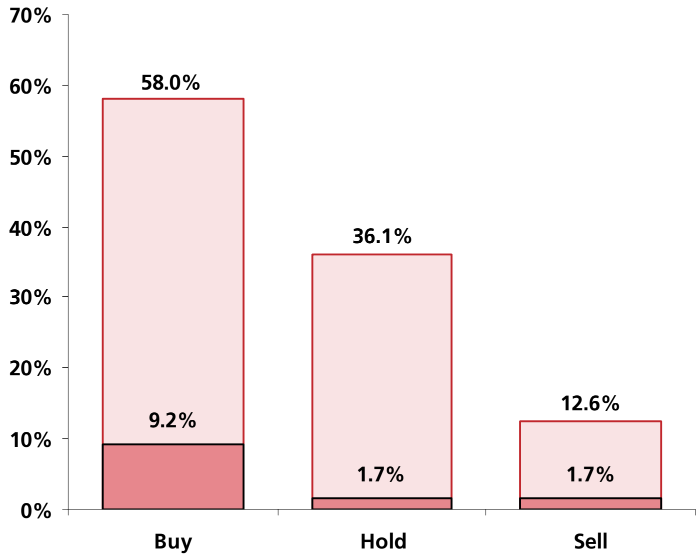

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Source: Kotak Institutional Equities. *As of December 31, 2006*

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