

Contents

Updates

Tata Motors: JLR's operational performance not too exciting; maintain SELL rating as JLR continues to be a concern

Maharashtra Seamless: Lower billet prices to benefit only in the short term, reduce TP to Rs350

Economy: Inflation stays flat this week, but could still near 13% mark in 3QFY09 on base effects and festival impact

Economy: First official crop estimates likely overstating drop in foodgrains output at 5%

Energy: Hurricane Ike caused the spike

News Roundup

Corporate

- South African phone firm **MTN Group Ltd** has approached **IBM** to provide technology support and services in a deal estimated to cost US\$2 bn and modeled on the work the US company has done for three Indian cellphone operators. A majority of the 250 engineers working on the project will be drawn from India given their expertise in such projects. (Mint)
- **Tata Motors** is learnt to have initiated talks with private equity (PE) fund to sell up to 25% stake in each of its six-profit making unlisted subsidiaries. (ET) Meanwhile, the upcoming Tata Motors rights issue will be the first in the country where existing investors will have to commit funds as soon as they apply for shares — following Sebi's decision to make the issue a pilot case for the Applications Supported by Blocked Amount (Asba) concept. (FE)
- **Raymond**, has put its loss making denim business, **Raymond UCO Denim**, on the block. Europe's **UCO Denim** holds 50% stake in the denim company, which was formed in August 2006. (BS) In other news, denim maker **Arvind Ltd's** retail chain **Megamart** has entered into a licensing pact with US-based Cherokee Inc. (Mint)
- **Indian Farmer's Fertiliser Cooperative** (IFFCO) is all set to pull out its Egyptian joint venture with El Nasr for manufacturing and importing phosphoric acid. (BL)

Economic and political

- **Malaysia** has said that Indian engineering companies are eligible to apply for investment tax allowance in specialized areas, including advanced electronics, engineering support industries and precision equipment. (Mint)

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

EQUITY MARKETS

India	Change, %			
	25-Sep	1-day	1-mo	3-mo
Sensex	13,547	(1.1)	(6.3)	(4.7)
Nifty	4,111	(1.2)	(5.2)	(3.3)

Global/Regional indices				
Dow Jones	11,022	1.8	(3.2)	(6.7)
FTSE	5,197	2.0	(5.6)	(8.3)
Nikkie	11,956	(0.4)	(6.4)	(13.5)
Hang Seng	18,934	(0.1)	(10.1)	(15.7)
KOSPI	1,483	(1.3)	(0.5)	(13.7)

Value traded - India				
	Moving avg, Rs bn			
	25-Sep	1-mo	3-mo	
Cash (NSE+BSE)	203.0	168.6	176.2	
Derivatives (NSE)	827.0	459.8	810	
Deri. open interest	960.2	838	873	

Forex/money market

	Change, basis points			
	25-Sep	1-day	1-mo	3-mo
Rs/US\$	46.0	11	220	326
6mo fwd prem, %	0.7	(25)	71	24

Net investment (US\$m)

	24-Sep	MTD	CYTD
FIs	(43)	-	(7,299)
MFs	7	-	2,501

Top movers -3mo basis

Best performers	Change, %			
	25-Sep	1-day	1-mo	3-mo
BANK OF BARODA	305	1.0	12.3	43.6
PUNJ LLOYD LIMITE	305	4.8	9.0	30.1
UNION BANK OF INDIA	145	0.4	8.2	28.6
BHARAT PETROLEUM	341	(2.4)	14.3	26.6
RELIANCE CAPITAL	1,243	0.7	(3.9)	26.1
Worst performers				
RANBAXY LABORATORIES	296	(4.9)	(42.9)	(44.5)
JSW STEEL LIMITED	581	0.0	(22.6)	(43.8)
HOUSING DEVELOPMENT FINANCE CORP	210	0.6	(29.8)	(40.0)
INDIABULLS REAL ESTATE	198	(5.3)	(31.0)	(38.5)
INFRASTRUCTURE DEVELOPMENT	76	(3.2)	(19.5)	(36.9)

Kotak Institutional Equities Research

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Automobiles**TAMO.BO, Rs384**

Rating	SELL
Sector coverage view	Cautious
Target Price (Rs)	425
52W High -Low (Rs)	815 - 339
Market Cap (Rs bn)	223.2

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	287.3	340.1	412.9
Net Profit (Rs bn)	20.3	14.6	13.0
EPS (Rs)	47.4	25.1	22.3
EPS gth	0.9	(47.1)	(10.9)
P/E (x)	8.1	15.3	17.2
EV/EBITDA (x)	7.9	9.2	9.2
Div yield (%)	2.6	3.3	3.3

Shareholding, June 2008

	% of Pattern Portfolio	Over/(under) weight
Promoters	33.4	-
FIs	29.7	0.7
MFs	2.0	0.3
UTI	-	(0.5)
LIC	10.8	1.2

Tata Motors: JLR's operational performance not too exciting; maintain SELL rating as JLR continues to be a concern

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- **JLR reports net loss of US\$383 mn for the period Jan 1-Jun 1 2008**
- **We remain concerned over risks associated with JLR; funding the acquisition continues to be a key issue**
- **Media reports suggest Tata Motors is moving equipment out of Singur plant—Nano's production schedule could be delayed**
- **Maintain SELL rating on the stock with a target price of Rs425/share**

Tata Motors, in its filing for the rights issue, reported the financial performance of JLR. JLR reports net loss of US\$ 383 mn for the period Jan 1, 2008- Jun 1, 2008. However it has reported a profit of US\$ 58 mn for the period of Jun 2, 2008- Jun 30, 2008 (28 days)—besides, the company has reported EBIT of US\$ 625 mn and US\$ 63 mn for the corresponding period. We believe that the operational performance of JLR may not be sustainable as we highlight key risks/concerns associated with JLR. The fate of Nano continues to remain under a cloud as media reports suggest that Tata Motors is moving equipment out of Singur—we believe this will delay the project and the company might have to incur losses as it shifts the mother-plant for Singur to an alternate location. We continue to maintain our SELL rating on the stock with a target price of Rs425/share.

JLR's operational performance might deteriorate

We believe that JLR's operating performance might deteriorate in the coming months on account of declining sales of luxury cars, rising fuel costs and a general slowdown in the US. JLR has been reported EBIT loss of US\$357 mn in CY2006 while it reported an EBIT of US\$650 mn in CY2007. However, it reported net loss of US\$714 mn in CY2006 and a profit of US\$1 bn in CY2007. However, for the period Jan 1-Jun 1, 2008, it reported a loss of US\$383 mn. JLR also reported a net profit of US\$58 mn for the 28-day post-acquisition period upto Jun 30, 2008. However, this does not take into account the interest cost associated with the bridge loan taken for the acquisition. Given the rising cost of fuel and the rising cost of ownership on account of higher interest rates, the sales of luxury cars will likely come off. We believe that as consumers lean towards fuel-efficient smaller cars, the sales of JLR might come off, resulting in a significant decline in operating performance despite new launches by JLR. JLR's EBIT margin for the period Jun 2-Jun 30, 2008 declined 400 bps versus the period Jan 1-Jun 1, 2008.

We remain concerned over risks associated with the JLR acquisition—await clarity on various issues

We remain concerned over quite a few risks/concerns associated with the JLR issue and are awaiting clarity over these issues. We highlight the following:

- JLR has been dependent on Ford for critical components such as engines, technology and other corporate services. There exist long-term agreements with Ford for technology sharing and joint development for power-train engineering.
- JLR has supply agreements with Ford for supply of engines for duration of 7-9 years. Any disruption/non-performance in the agreement may have an adverse impact on JLR's operations.
- JLR has an agreement with Ford Motor Credit to provide consumer and wholesale credit support to the dealers and customers for upto 12 months. We remain concerned over credit arrangements post this 12-month period.

- Tata Motors may have to face significant liability with respect to the pension funds of JLR. JLR's pension funds are likely to be re-valued in April 2009. Given current market conditions, valuation of the pension funds may have declined and Tata Motors may have to contribute significant amount to make up for the deficit in these pension funds.
- JLR had a total capital allowance of GBP2 bn as of Dec 31, 2007 of which, a minimum capital allowance pool of GBP580 mn is assured to JLR. The fate of the balance of GBP1.4 bn of capital allowance remains uncertain and depends upon possible utilization by Ford.
- Tata Motors will likely raise about US\$1 bn through rights issue of equity shares. The company intends to raise balance money for JLR funding through monetization of its investments. We believe that given the current market conditions, it might be a tough task to raise these funds.

Media reports suggest Tata Motors is moving equipment out of Singur plant—Nano's production schedule could be delayed

Recent media reports suggest that Tata Motors is moving key equipment out of the Singur plant. We believe that the launch of the Nano project could be delayed if the plant were to be relocated out of Singur. This could have a negative impact on Tata Motors as relocation costs could be high. The relocation could significantly delay the launch of the Nano and would likely result in Nano's production schedule being delayed. In the event of relocation, Tata Motors would have to write off a part of its investment in Singur as bulk of the investment in the Rs15 bn project has been made. The relocation would also negatively impact the component manufacturers associated with the Nano project as they would also have to move to a different location along with Tata Motors.

We retain our SELL rating on the stock with a target price of Rs425/share.

Jaguar Land Rover, Summarized financial statement, December fiscal year-ends, (US\$ mn)

	2005	2006	2007	Jan 1, - Jun 30, 2008	Jun 2- Jun 30, 2008
Revenues	12,462	12,969	14,942	7,071	1,341
Cost of sales	(10,955)	(11,292)	(12,258)	(5,591)	(1,087)
Gross profit	1,507	1,677	2,684	1,480	254
Marketing & selling expenses	(1,112)	(1,057)	(1,069)	(480)	(86)
Research & development expenses	(821)	(683)	(829)	(382)	(74)
General & administrative expenses	(408)	(360)	(352)	(137)	(34)
Other income/(expenses)	335	66	216	144	3
EBIT	(499)	(357)	650	625	63
Special adjustments	(999)	(1,487)	1,093	(54)	-
EBIT (post adjustments)	(1,498)	(1,844)	1,743	571	63
Interest	(276)	(133)	(134)	(42)	(1)
PBT	(1,774)	(1,977)	1,609	529	62
Provision for taxes	(310)	(1,263)	(571)	(912)	(4)
Profit after taxes	(2,084)	(3,240)	1,038	(383)	58
Ratios (%)					
Gross profit to sales	12.1	12.9	18.0	20.9	18.9
EBIT margin (pre-adjustment)	(4.0)	(2.8)	4.4	8.8	4.7
PAT margin	(16.7)	(25.0)	6.9	(5.4)	4.3

Source: Rights-issue Letter of Offer, Kotak Institutional Equities

Industrials**MHSM.BO, Rs289**

Rating	BUY
Sector coverage view	Neutral
Target Price (Rs)	350
52W High -Low (Rs)	660 - 233
Market Cap (Rs bn)	20.4

Financials

March y/e	2008	2009E	2010E
Sales (Rs bn)	15.0	21.6	24.1
Net Profit (Rs bn)	2.1	2.7	3.0
EPS (Rs)	29.4	38.5	43.0
EPS <i>gth</i>	(23.5)	31.2	11.8
P/E (x)	9.9	7.5	6.7
EV/EBITDA (x)	6.3	4.9	4.3
Div yield (%)	1.7	2.0	2.2

Shareholding, June 2008

	% of	Over/(under)
	Pattern Portfolio	weight
Promoters	46.3	-
FIs	13.2	0.0
MFs	12.7	0.2
UTI	-	-
LIC	-	-

Maharashtra Seamless: Lower billet prices to offer short-term benefit only, reduce TP to Rs350

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- **Reduction in billet prices to benefit only in the short term, expect realizations to drop, but with a lag**
- **Revise our assumptions for raw material cost and realizations downwards by 1-10%**
- **Reduce target price to Rs350 (from Rs390) on account of lower target multiple, maintain BUY**

We believe the recent sharp correction of over 20% in billet prices will benefit MHS only in the short term, as we expect realizations to drop but with a lag. We expect MHS to enjoy the benefits of lower raw material prices in 4QFY09 and 1QFY10, post which we expect realizations to drop in line with lower raw material costs. MHS has tied up its raw material requirement for the current outstanding order book which is expected to be executed by 3QFY09, hence its current order book would remain immune from lower prices. We lower our revenue estimates for FY2009E and FY2010E by 1.5% and 6%, respectively on account of lower realizations. We reduce our assumptions for pipe realization and raw material cost for FY2009-10E by 1-10%. We lower our target FY2010E EV/EBITDA multiple to 5X from 5.5X on account of relative correction in multiples of global peers. We reduce our target price to Rs350 (from Rs390), maintain BUY.

Lower billet prices to benefit only in the short term, expect realization to drop, but with a lag

We believe the recent correction of over 20% in billet prices (see Exhibit 2) will benefit MHS only in the short term as we expect realizations to come down as well; but with a lag of 2-3 months. MHS has booked the raw material requirements for its current order book which is executable till 3QFY09. We expect MHS to benefit from lower billet prices only in 4QFY09 and 1QFY10, post which we expect drop in realizations to offset the lower material prices. HR coil prices have also begun cool off, with prices falling around 5% from their peak in July 2008 (see Exhibit 3). Management expects steel prices to correct further in the short term, hence is going slow on raw material procurement in order to enjoy the full benefit of lower prices. We lower our assumptions for steel prices and pipe realizations for FY2009-10E by 1-10% for the recent drop in global steel prices.

Revise estimates for lower metal prices

We revise our FY2009E and FY2010E revenue estimates downwards by 1.5% and 5.9%, respectively, on account of lower pipe realization estimates. We increase our FY2009E PAT estimates by 2.6% as we expect the company to benefit from higher margins in the latter part of the year. We lower our FY2010E PAT estimates by 3.8% as we expect drop in realizations to take effect in FY2010E. We expect the company to continue to enjoy high margins as the demand for seamless and ERW pipes remains strong. We expect E&P expenditure to remain robust supported by high crude prices and strong demand for oil and gas globally.

Annual report updates

- **Large increase in working capital.** MHS reported incremental investment of Rs1.7 bn in working capital in FY2008. The increase in working capital was largely attributable to increase in debtors/turnover days to 57 from 45 days in FY2007 and increase in inventory/turnover to 77 days from 69 days. It had started building up raw material inventory in FY2008 in light of rising steel prices leading to increase in the inventory days.

- **Forex translation loss of Rs183 mn.** MHS provided for currency translation losses amounting to Rs183 mn on account of conversion of its foreign currency deposits. The company has maintained overseas US Dollar deposits from its FCCB proceeds which are to be used for capex purposes. We believe this to be only an accounting adjustment and expect it to be reversed in the current year due to the recent appreciation in US Dollar exchange rate.
- **Backward integration project—allocated coal block in Maharashtra.** MHS was recently allocated coal blocks in Maharashtra for its proposed 500,000 tons steel billet plant. It is in the process of securing land and iron ore supplies, which the management expects to complete shortly. We do not build any benefits from the project currently, awaiting further visibility on its completion and timing.

Reduce target price to Rs350 (from Rs390) on account of lower EBITDA multiple, maintain BUY

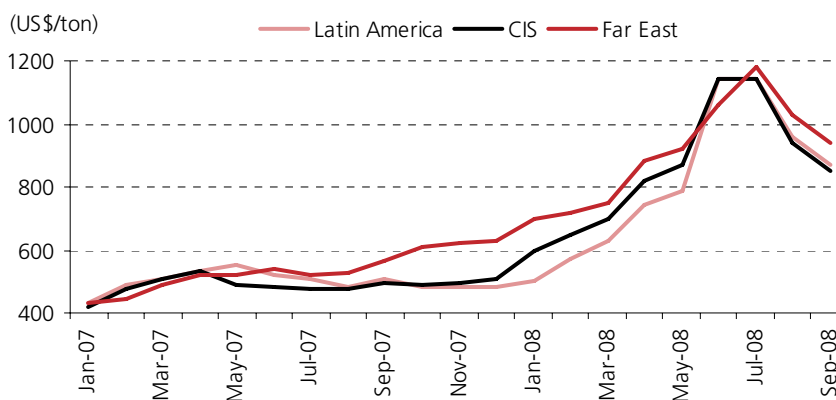
We reduce our target price to Rs350 (from Rs390) as we lower our target FY2010E EV/EBITDA multiple to 5X from 5.5X in line with recent correction in valuation of global peers (see Exhibit 4). We believe the stock currently valued at 25% discount to global peers—Tenaris and Vallourec offers and attractive opportunity in light of its comparatively higher earnings growth over the next two years (see Exhibit 5). We maintain our BUY rating on the stock.

Exhibit 1: Maharashtra Seamless, change in estimates, March fiscal year-ends, (Rs mn)

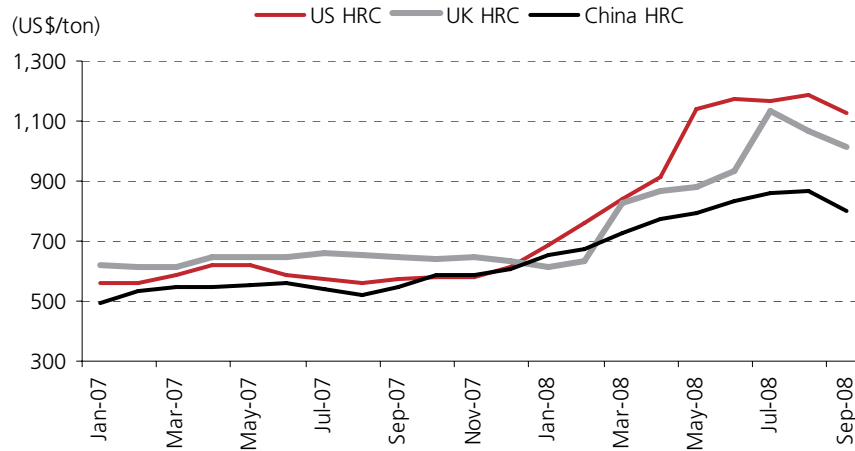
	2009E			2010E		
	New	Old	Change(%)	New	Old	Change(%)
Revenue	21,613	21,932	(1.5)	24,068	25,567	(5.9)
EBITDA	4,021	3,849	4.5	4,579	4,727	(3.1)
EBITDA margin (%)	18.6	17.5	—	19.0	18.5	—
Net profit	2,717	2,648	2.6	3,036	3,155	(3.8)
Diluted EPS	38.5	37.5	2.7	43.0	44.7	(3.7)
Realisation (Rs/ton)						
Seamless	67,359	68,701	(2.0)	60,623	65,610	(7.6)
ERW	51,563	51,563	(0.0)	50,274	50,790	(1.0)
Raw material cost (Rs/ton)						
Billets	38,171	40,079	(4.8)	33,591	37,273	(9.9)
HR Coils	36,116	36,632	(1.4)	35,033	36,083	(2.9)

Source: Kotak Institutional Equities.

Exhibit 2: Steel billet prices have corrected more than 20% from their peak three months ago



Source: CRU.

Exhibit 3: HR Coil prices have also begun to cool off

Source: CRU, Bloomberg.

Exhibit 4: We value Maharashtra Seamless at Rs350/share

FY2010E EBITDA	4,579
EV/EBITDA (X)	5.0
EV	22,897
Net debt	(1,519)
Equity value	24,416
No. of shares (mn)	71
Value per share (Rs)	346
Target price (Rs/share)	350

Source: Kotak Institutional Equities estimates.

Exhibit 5: Comparative valuation of global pipe and steel companies

Company	25-Sep-08			Mkt Cap. (US\$ mn)	EV/EBITDA (X)			PER (X)			EV/Sales (X)			CAGR (2 yr) (%)		
	Price (local)	Currency	Year-end		LFY	FY1	FY2	LFY	FY1	FY2	LFY	FY1	FY2	EPS	Revenue	EBITDA
Maharashtra Seamless (1)	286	INR	Mar	441	6.3	4.9	4.3	9.9	7.5	6.7	1.3	0.9	0.8	21.1	26.8	24.0
Vallourec	165	EUR	Dec	5,971	5.3	6.0	5.2	8.7	9.8	8.4	1.5	1.5	1.4	2.1	6.2	1.8
Tenaris	15	EUR	Dec	12,161	8.1	7.5	6.3	9.4	8.0	7.1	2.8	2.3	2.0	15.5	19.4	13.3
Ratnamani Metals & Tubes	680	INR	Mar	132	3.9	3.2	2.9	6.8	5.0	4.3	0.9	0.7	0.6	26.0	24.7	16.1
Mean - seamless [global]					5.9	5.4	4.7	8.7	7.6	6.6	1.6	1.3	1.2	16.2	19.3	13.8
Welspun-Gujarat Stahl (1)	255	INR	Mar	1,039	10.7	5.8	3.6	12.4	8.7	5.4	1.8	1.0	0.6	51.9	57.8	63.0
Jindal Saw (1)	622	INR	Dec	826	6.0	3.5	2.7	10.8	6.9	5.6	0.9	0.5	0.4	38.3	40.3	33.0
PSL (1)	254	INR	Mar	240	6.2	4.6	3.4	12.1	5.6	3.9	0.8	0.5	0.4	74.9	54.5	44.3
Man Industries	62	INR	Mar	71	4.3	3.1	2.6	4.6	4.4	4.4	0.3	0.3	0.3	2.3	10.6	27.3
Mean - linepipe [India]					6.8	4.2	3.1	10.0	6.4	4.8	1.0	0.6	0.4	41.8	40.8	41.9
Posco	466,000	KRW	Dec	35,222	6.6	4.9	4.5	9.6	8.5	7.7	1.8	1.0	0.9	11.9	40.6	21.0
Sumitomo Metal Industries	366	JPY	Mar	16,610	7.1	6.8	6.2	9.3	9.9	9.2	1.5	1.3	1.2	0.4	12.2	6.8
Severstal	13	USD	Dec	13,201	3.9	2.7	2.6	6.8	4.1	4.2	1.0	0.7	0.6	28.1	24.4	22.8
United States Steel	90	USD	Dec	10,586	8.2	3.2	2.8	12.1	4.2	3.8	0.8	0.5	0.5	78.0	31.9	72.5
Salzgitter	80	EUR	Dec	3,260	2.2	2.2	2.2	5.0	5.3	5.3	0.3	0.3	0.3	(2.8)	12.3	0.9
Voestalpine	24	EUR	Mar	2,646	NA	3.9	3.9	5.0	3.8	3.7	0.8	0.7	0.7	17.1	11.4	NA
Corinth Pipeworks	2	EUR	Dec	202	6.4	8.2	7.0	8.7	11.7	9.0	1.1	1.1	0.9	(1.8)	6.1	(4.6)
Mean - steel and pipe [global]					5.8	4.6	4.2	8.1	6.8	6.1	1.0	0.8	0.7	18.7	19.8	19.9
Mean - overall					6.1	4.7	4.0	8.8	6.9	5.9	1.2	0.9	0.8	24.2	25.3	24.4

Note: (1) Kotak Institutional Equities estimates.

Source: Bloomberg, Kotak Institutional Equities estimates.

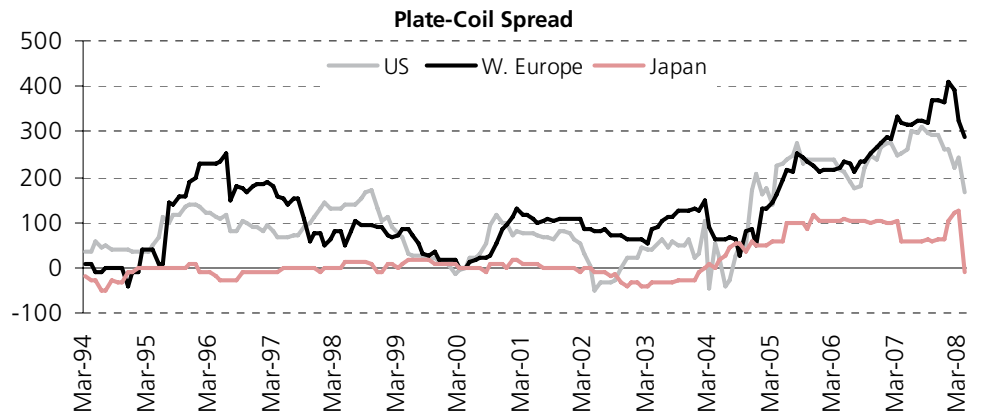
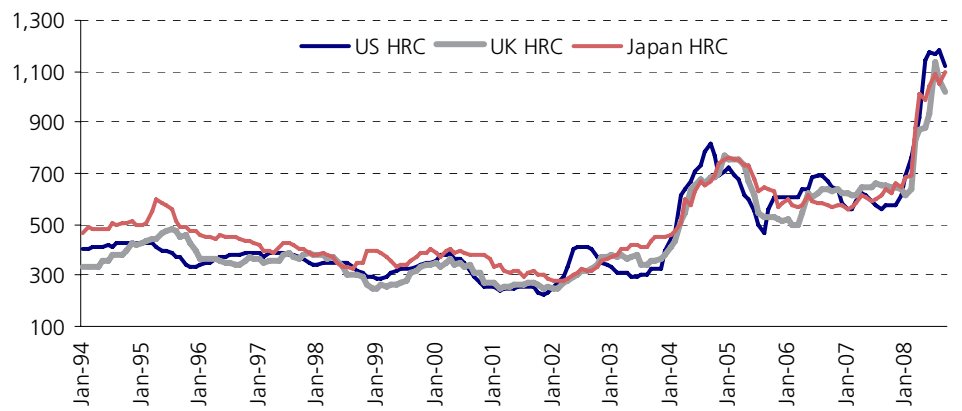
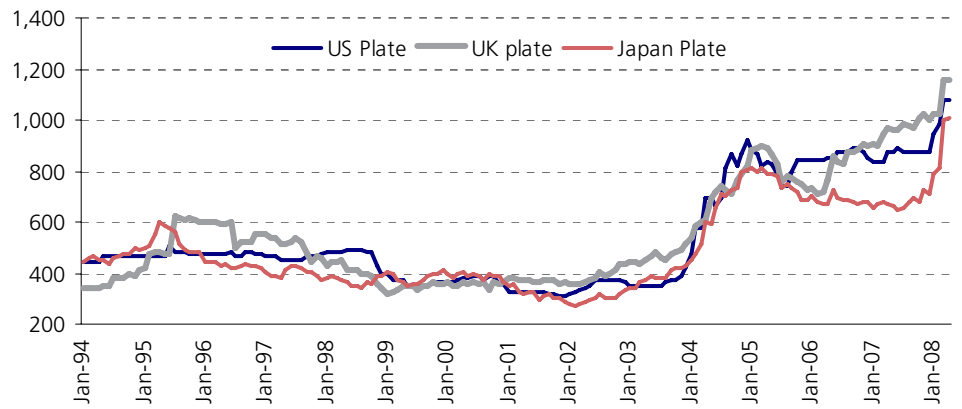
Exhibit 6: Operating assumptions for Maharashtra Seamless, March fiscal year-ends, 2008-2011E

	2008	2009E	2010E	2011E
Capacity (tons)				
Seamless	350,000	350,000	400,000	700,000
ERW	200,000	200,000	200,000	200,000
Despatch (tons)				
Seamless	237,965	258,057	320,000	397,500
ERW	105,432	113,838	135,000	140,000
Average realisation (Rs/ton)				
Seamless	50,003	67,359	60,623	58,805
ERW	37,390	51,563	50,274	49,771
Raw materials (tons)				
Billets	263,900	284,694	356,947	443,395
HR Coil	110,212	120,595	141,059	146,283
Raw material cost (Rs/ton)				
Billets	26,131	38,171	33,591	32,751
HR Coil	28,396	36,116	35,033	34,682

Source: Company, Kotak Institutional Equities estimates.

Exhibit 7: Profit model, balance sheet, cash model for Maharashtra Seamless 2007-2011E, March fiscal year-ends (Rs mn)

	2007	2008	2009E	2010E	2011E
Profit model					
Net revenues	13,900	14,976	21,613	24,068	27,809
EBITDA	3,416	2,976	4,021	4,579	5,282
Other income	314	437	243	193	247
Interest (expense)/income	(35)	(38)	(21)	(21)	(19)
Depreciation	(163)	(174)	(188)	(220)	(312)
Adjusted pretax profits	3,532	3,202	4,055	4,531	5,198
Extraordinary items	(5)	(183)	—	—	—
Reported PBT	3,527	3,019	4,055	4,531	5,198
Tax	(1,166)	(1,059)	(1,298)	(1,359)	(1,351)
Deferred taxation	(23)	(8)	(41)	(136)	(364)
Reported PAT	2,338	1,952	2,717	3,036	3,483
Adjusted PAT	2,342	2,070	2,717	3,036	3,483
Diluted Earnings per share (Rs)	38.4	29.4	38.5	43.0	49.4
Balance sheet					
Total equity	9,241	10,934	13,243	15,824	18,680
Deferred taxation liability	411	420	460	596	960
Total borrowings	1,082	1,022	1,022	1,022	1,022
Current liabilities	797	1,924	1,991	2,062	2,303
Total liabilities and equity	11,531	14,300	16,716	19,503	22,964
Cash	3,232	2,549	1,861	1,756	3,545
Other current assets	4,903	7,483	9,275	9,887	11,270
Total fixed assets	2,858	3,375	4,686	6,966	7,255
Investments	538	894	894	894	894
Total assets	11,531	14,300	16,716	19,503	22,964
Free cash flow					
Operating cash flow, excl working capital	2,374	1,893	2,702	3,199	3,911
Working capital changes	(859)	(1,732)	(1,725)	(541)	(1,143)
Capital expenditure	(213)	(691)	(1,500)	(2,500)	(600)
Investments	(325)	(342)	—	—	—
Other income	249	231	243	193	247
Free cash flow	1,226	(640)	(280)	350	2,416
Ratios (%)					
EBITDA margin	24.6	19.9	18.6	19.0	19.0
Debt/equity	11.7	9.3	7.7	6.5	5.5
Net debt/equity	(23.3)	(14.0)	(6.3)	(4.6)	(13.5)
RoAE	33.0	19.7	21.7	20.2	19.3
RoACE	23.4	18.1	20.2	19.0	18.3



Economy

Sector coverage view

N/A

Inflation stays flat this week, but could still near 13% mark in 3QFY09 on base effects and festival impact

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- **Headline inflation and price level stays flat for the week-ended Sep 13, 2008**
- **We expect inflation rate to stay flat next week as well with modest price rise**
- **Diwali (festival of lights) impact likely to take inflation rate to over 12.5% in October**
- **Inflation likely to stay in 11.5-13% range in 3QFY09 and fall sharply in 4QFY09 to around 9.0% by end-FY2009**

Headline inflation at 12.14% and price level (at WPI of 241.1) for the week-ended September 13, 2008 stayed unchanged from the preceding week. We consider this as encouraging for the following reasons (1) base effects suggested that inflation rate could rise to 12.26% this week, (2) market polls suggested an inflation rate of 12.23% this week and actual inflation turned out to be less than expected, (3) inflation rate remained stable despite 5-15% price cuts by steel firms in early September not getting captured in the WPI data of last week or this week and (4) prices of manufacturing products declined for the second straight week, reaffirming that current inflation is primarily supply-side and not demand-side driven.

In our Economy note dated September 19, 2008, "*Inflation exhibiting hysteresis on agro-supply bottlenecks and statistical reasons*", we had explained that inflation would have dropped to 11.93% had steel prices dropped by just 5% in WPI. While we continue to believe that a price fall is not getting adequately factored in for statistical reporting reasons, we note that the price rise in primary articles was a meager 0.1% this week, with energy and manufacturing prices remaining unchanged.

We still expect inflation to near 13% mark in 3QFY09

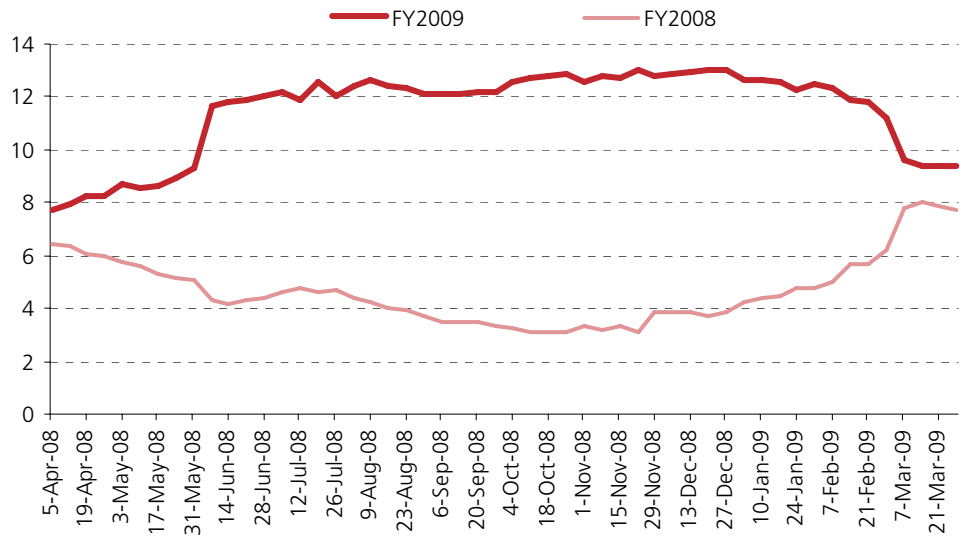
We stay with our call that headline inflation rate may stay in the 11.5-13.0% range in 3QFY09, but drop to around 9% by the end of FY2009 (see Exhibit). We now see a 12-13% range more likely unless commodity prices decline. While factoring in the inflation path ahead, we take note of the fact:

1. Inflation rate likely to stay flat next week also (for the week-ended September 20) as the base effects are not strong and moderate increase in primary prices can be offset by expected 0.33% fall in fuel price (mineral oils) index as a result of reduction in naphtha and furnace oil prices.
2. Festival season ahead could put some temporary upward pressure on prices. The Diwali festival this year falls on October 28, compared with November 9 last year. Last year, the price level shot up by 0.51% in the three weeks prior to the week of the festival, due mainly to 1.4% jump in manufactured food prices. This impact could now start from early October instead of mid-October last year, but these prices could moderate faster in November.
3. We see inflation rate in >12.5 and <13.0% band during October as a result of festival impact and inflation rate could stay at those high levels in November and December as a result of adverse base effects, unless there is marked fall in commodity prices during the period.
4. Favorable base effects kick in a big way only in 4QFY09 and can see inflation fall to around 9.0% by the end of FY2009.

Rupee depreciation of over 13% in FY2008 so far is likely to put upward pressure on inflation rate in 3QFY09 offsetting most of the impact of a sharp fall in global non-fuel commodity prices (fuel prices are anyway mostly fixed) by about 10% after July.

Expect inflation to touch 13% in 3QFY09; fall sharply in 4QFY09

Headline inflation rate, FY2008 and FY2009E (actual till September 13, 2008; estimates thereafter) (%)



Source: GOI, Kotak Institutional Equities estimates

Economy

Sector coverage view

N/A

First official crop estimates likely overstating drop in foodgrains output at 5%

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- **Official estimates show Kharif foodgrains output lower by 5.6 mt or 4.7%**
- **Kharif rice production at a new high of 83.3 mt**
- **Sugarcane production drop of about 14% may pressure prices**
- **We believe overall agricultural growth could drop to below 2.0% in FY2009**

Ministry of Agriculture released its first official estimates of Kharif crop. When compared with last year's Kharif estimates, it shows a fall of 4.7% in foodgrains output, with a similar alarming fall in oilseeds (-9.5%), cotton (-7.4%) and sugarcane (-13.5%). However, in our view, the fall is overstated and there is no cause to panic on the agricultural front. The data released are the First Advance Estimates and four more estimates would follow before the final data is known. When compared with the similar first estimate last year, foodgrains output is higher (+2.8%) (see Exhibit 1). In our view, the data release reaffirms our view that agricultural growth could drop to below 2.0% in FY2009, but stay positive.

In our recent updates, we noted that cotton crop prospects have improved, but anticipated that agricultural growth could stay below 2% with falls in coarse cereals, pulses, sugarcane and jute & mesta production. The First Advance Estimates released by Ministry of Agriculture yesterday appear to be in line with our assessment.

Pulses, sugarcane likely to pressure pricing

Key takeaways from the data released are as follows:

1. Sugarcane and pulses are likely to exert pressure on pricing in the rest of FY2009. Since the monsoon began, wholesale pulses prices have already shot up by about 10%, while sugar prices have risen by nearly 9%. In view of likely crop shortage, these could rise further.
2. Though official data show a nearly 10% drop in oilseeds, the supply shortages may not turn out to be large as area under the crop has not declined and official output estimates can get revised upwards later. Rabi oilseeds output and imports could also bridge the gap.
3. Though the data released shows a drop in cotton crop of over 7%, we believe that crop size may turn out to be in line with last year's record crop. With cotton and cotton textile prices already having risen in recent months, we do not expect further price pressures in these commodities.

Rabi crop now critical to agricultural fortune in FY2009

With the Kharif crop getting impacted by poor rainfall during the crop sowing period, the Rabi crop would be critical in shoring up agricultural output. The downside risks to agricultural growth in FY2009 have increased. However, on the positive side: (1) the overall monsoon in 2008 has been normal; (2) 34 out of 36 sub-divisions have received normal/excess rainfall, the best in five years (see Exhibit 2). Only the North East and West Madhya Pradesh have received deficient rainfall.

Storage in top 81 reservoirs up until the week-ended September 18, 2008 was 70% of the live capacity. While this is 6.5% higher than the past 10-year average, the levels are 10.5% less than last year when the reservoirs were at 78.2% at this stage. While the reservoir levels are a wee bit shorter than comfortable, they should not significantly impact the rabi crop. Furthermore, it should be possible to increase the overall area sown during Rabi, especially if adequate post flood management measures in the affected areas are taken.

Exhibit 1: Kharif foodgrains fall of 4.8% is still +2.8% growth compared with 1st advance estimate

output of major foodgrains and cash crops (mn tons; except cotton and jute & mesta

cotton in mn bales of 170 kgs each; jute & mesta in mn bales of 180 kgs each), July-June agriculture year

	Last 5-yr Kharif average	2008			2009E		
		Kharif-1AE	Kharif-4AE	Rabi	Kharif-1AE	% (4AE)	%(1AE)
1 Rice	74.5	80.2	82.8	13.6	83.3	0.5	3.9
2 Jowar	4.2	3.6	4.1	3.6	3.1	-25.4	-14.2
3 Bajra	8.2	8.0	9.8	..	9.2	-6.3	15.1
4 Maize	11.4	13.1	15.2	4.2	13.0	-13.9	-0.2
5 Other kharif cereals	2.4	1.9	2.6	..	2.1	-21.4	6.2
6 Total coarse cereals (2 to 5)	26.2	26.6	31.7	9.0	27.4	-13.7	2.9
7 Total cereals (1+6)	100.7	106.7	114.5	101.1	110.6	-3.4	3.6
8 Arhar (tur)	2.4	2.7	3.1	..	2.4	-23.3	-12.2
9 Other kharif pulses	2.6	2.8	3.4	..	2.4	-30.1	-16.4
10 Total pulses (8+9)	4.9	5.5	6.5	8.7	4.7	-26.8	-14.3
11 TOTAL FOODGRAINS (7+10)	105.6	112.2	121.0	109.7	115.3	-4.7	2.8
12 Groundnut	5.0	5.2	7.5	1.9	6.1	-18.4	17.8
13 Soyabean	7.3	9.0	10.0	..	9.9	-0.5	10.0
14 Other kharif oilseeds	1.9	1.9	2.4	..	1.9	-19.4	0.0
15 Total nine oilseeds (12 to 14)	14.1	16.1	19.8	9.0	18.0	-9.5	11.3
16 Cotton	16.0	22.9	25.8	..	23.9	-7.4	4.2
17 Jute	10.0	10.4	10.2	..	10.3	1.4	-0.9
18 Mesta	0.9	0.9	1.0	..	0.8	-17.2	-7.9
19 Sugarcane	279.0	345.6	340.6	..	294.7	-13.5	-14.7

Note: (1) Percentage change in output for 2009 are calculated from both the 1st Advance Estimate (1AE) and 4th Advance Estimate (4AE)

(2) crop season for cotton spans across Kharif and Rabi

Source: Ministry of agriculture; Kotak institutional equities

Exhibit 2: Monsoon one of the best ever in spatial-distribution

Rainfall till September 24, 2008 during the monsoon season (June 1-September 30)

Rainfall	2004	2005	2006	2007	2008	2009
Normal/Excess	33	23	31	26	30	34
Excess	4	0	9	6	12	2
Normal/Excess	29	23	22	20	18	32
Deficient/Scanty	3	13	5	10	6	2
Deficient	3	13	5	10	6	2
Scanty	0	0	0	0	0	0
Total	36	36	36	36	36	36
Foodgrains output (in mt)	213.2	198.4	208.6	217.3	230.7	236.5E
Foodgrains growth (%)	22.0	-7.0	5.2	4.2	5.5	2.4E
Agricultural growth (%)	21.7	-3.1	8.1	2.9	6.0	1.5E

Source: India Meteorological Department; Ministry of Agriculture; KIE estimates

Energy

Sector coverage view

Cautious

Company	Rating	Price, Rs	
		25-Sep	Target
Reliance Inds	RS	2,026	-
IOC	REDUCE	390	500
BPCL	REDUCE	341	360
HPCL	REDUCE	232	260
RPL	REDUCE	151	150

Hurricane Ike caused the spike

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- Refining margins bounce back led by shutdown of US refining capacity caused by Hurricane Ike
- Expect the spike in margins to revert once capacity comes back onstream
- Large capacity additions from 2HCY08 plus demand weakness will keep margins under pressure

Refining margins bounced back in September 2008 led by shutdown of US refining capacity caused by Hurricane Ike. We compute Singapore complex gross refining margins at US\$6.2/bbl in the latest week and US\$3.7/bbl for September 2008 versus -US\$1.9/bbl in August 2008. The expansion in product cracks and thus refining margins was led by (1) a sharp decline in operating rates and (2) low product inventories. However, we expect margins to decline from the current high levels given the limited damage caused by Hurricane Ike which should ensure that shut refining capacity is restarted quickly. Nevertheless, we would focus less on the short-term volatility in refining margins and more on the likely deterioration in supply-demand balance of refined products from 2HCY08. We expect margins to remain under pressure given (1) demand weakness in CY2008E and CY2009E and (2) significant refining capacity addition from 2HCY08.

Refining margins bounce back but unlikely to sustain at current levels. Refining margins have improved sharply in the recent month led by (1) a shutdown of US refining capacity due to Hurricane Ike resulting in very low operating rates and (2) low product inventories. We compute Singapore complex gross refining margins at US\$6.2/bbl in the latest week and US\$3.7/bbl for September 2008 versus -US\$1.9/bbl in August 2008 (Exhibit 1). The spike in refining margins was caused by a shutdown of large refining capacity (16 refineries) in the US due to Hurricane Ike which resulted in operating rates declining to 67% in the most recent week, which is significantly lower than the 10-year range (Exhibit 2).

The shutdown of refining capacity resulted in large drawdown of product inventories, (Exhibit 3) which helped in expansion of product cracks and thus, refining margins. Product cracks have improved significantly but are still below the high levels seen in 2QCY08. Diesel cracks were at US\$27/bbl in the recent week versus US\$38.1/bbl in 2QCY08 (see Exhibit 4). However, gasoline cracks have improved to US\$15.1/bbl versus US\$13.2/bbl in 2QCY08.

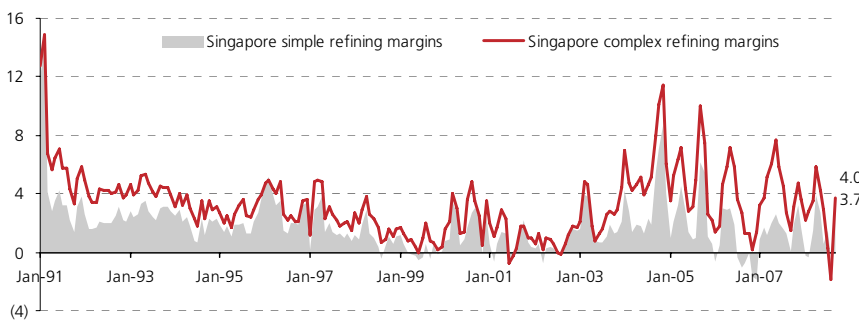
However, we expect margins to decline from the current high levels as Hurricane Ike caused less-than-anticipated damage and will enable the shut refineries to start operations earlier. This should help improve the operating rates and thus, product inventory levels. However, we would focus less on short-term volatility in refining margins and more on the likely deterioration in supply-demand balance of refined products from 2HCY08.

Large global capacity addition from 2HCY08 is a given. We see significant refining capacity coming addition from 2HCY08, which includes capacity addition of 0.9 mb/d in China and RPET's 580,000 b/d refinery (Exhibit 5). We expect refining capacity addition of 1.6 mb/d, 1.6 mb/d and 1.7 mb/d in CY2008E, CY2009E and CY2010E, respectively (see Exhibit 6). In addition, we note supply of natural gas liquids (NGLs) would increase by 0.3 mb/d, 0.7 mb/d and 0.6 mb/d in CY2008E, CY2009E and CY2010E as would supply of bio-fuels (0.43 mn b/d in CY2008E).

Demand continues to weaken, particularly in 'free' markets. We expect incremental global demand (see Exhibit 7) to be meaningfully lower than incremental global supply of refined products, NGLs and bio-fuels. IEA's September 2008 publication has cut CY2008E global oil demand to 0.7 mn b/d from 1.42 mn b/d in April 2008 and 2 mn b/d in January 2008. The IEA now projects OECD demand to decline 0.8 mn b/d in CY2008E versus +0.5 mn b/d in January 2008. 1QCY08 OECD demand has fallen by 0.9 mn b/d (-2% yoy) due to the impact of high gasoline and other product prices (see Exhibit 6). However, non-OECD demand is relatively unchanged at 1.4 mn b/d against 1.5 mn b/d in January 2008 given that users in countries such as China, India and the Middle East are relatively insulated from high crude prices.

Refining margins have bounced back from very low levels in August

Singapore refining margins (US\$/bbl)



Simple refining margins, March fiscal year-ends (US\$/bbl)										
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 YTD
1Q	(0.32)	1.29	0.51	0.30	1.05	1.69	3.02	2.52	2.25	2.40
2Q	(0.08)	2.47	0.45	0.07	1.20	3.13	2.78	(0.70)	0.99	1.72
3Q	0.14	1.74	1.06	1.44	1.57	6.46	2.22	(1.25)	2.32	
4Q	1.86	0.21	(0.03)	2.98	2.88	2.08	1.09	1.25	0.25	
Average	0.40	1.43	0.50	1.20	1.67	3.34	2.28	0.45	1.45	2.06

Weekly margins				
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk
5.40	2.68	1.84	0.69	(1.51)

Singapore refining margins, March fiscal year-ends (US\$/bbl)										
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 YTD
Simple	0.40	1.43	0.50	1.20	1.67	3.34	2.28	0.45	1.45	2.06
Complex	0.43	1.86	1.34	0.79	1.24	4.57	4.93	3.45	4.05	2.49

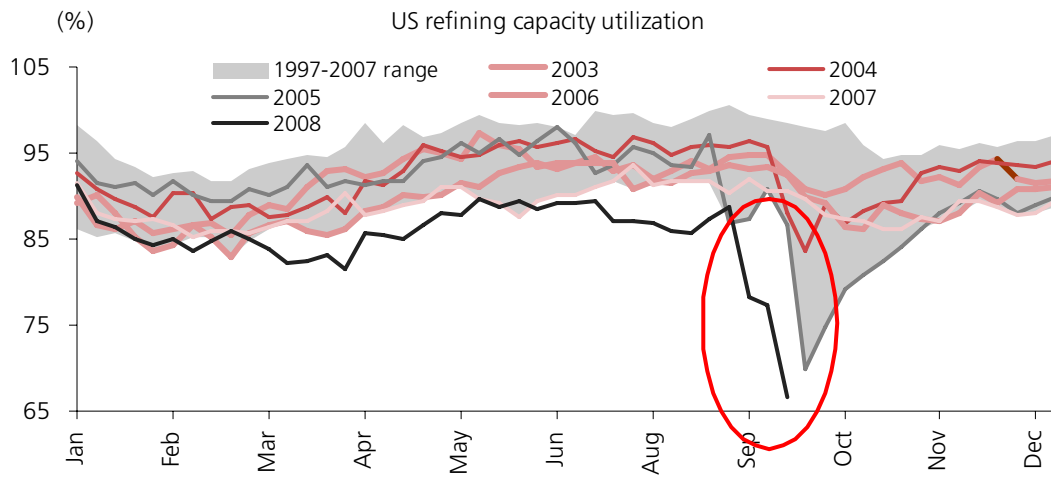
Source: Bloomberg.

Complex refining margins, March fiscal year-ends (US\$/bbl)											
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 YTD	
1Q	0.43	1.86	1.34	0.79	1.24	4.57	4.93	6.24	6.58	4.31	
2Q	1.19	3.96	0.58	0.14	2.35	5.80	6.11	2.46	2.91	0.67	
3Q	0.41	2.25	1.22	1.56	3.23	9.04	3.94	0.98	3.91		
4Q	2.64	1.60	0.65	3.70	5.44	5.02	2.77	4.11	2.78		
Average	1.17	2.42	0.95	1.55	3.06	6.10	4.44	3.45	4.05	2.49	

Weekly margins				
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk
6.15	5.80	2.43	0.32	(1.00)

Operating rates have declined significantly due to shutdown of refining capacity caused by Hurricane Ike

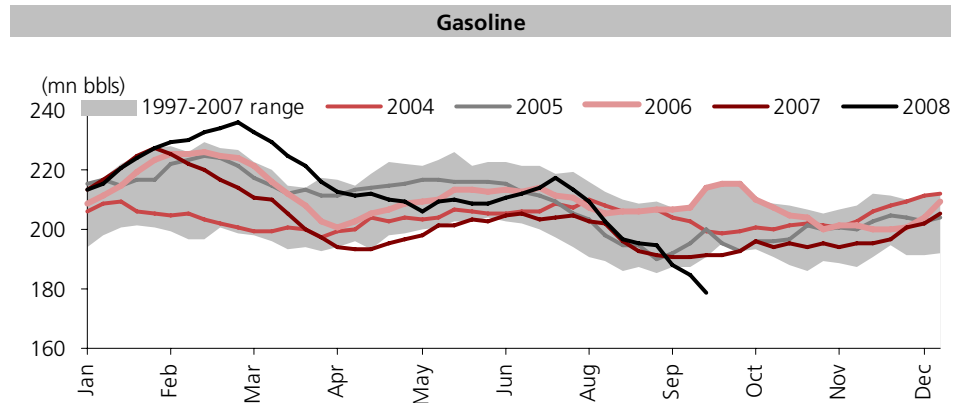
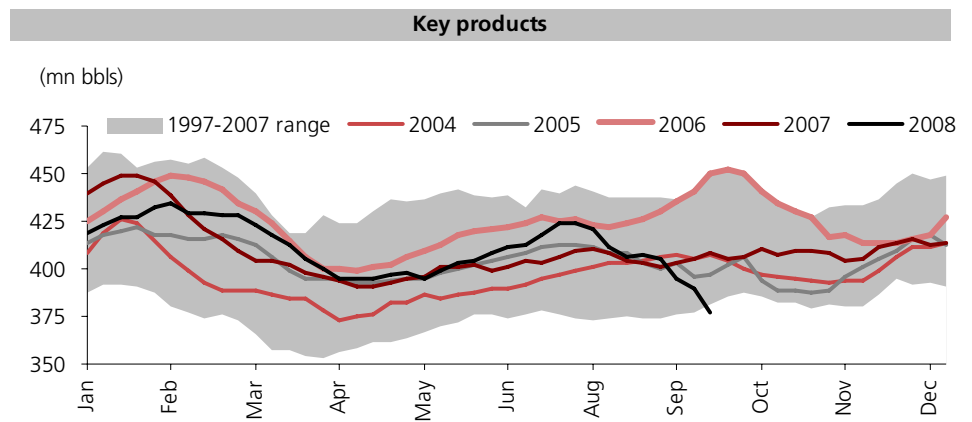
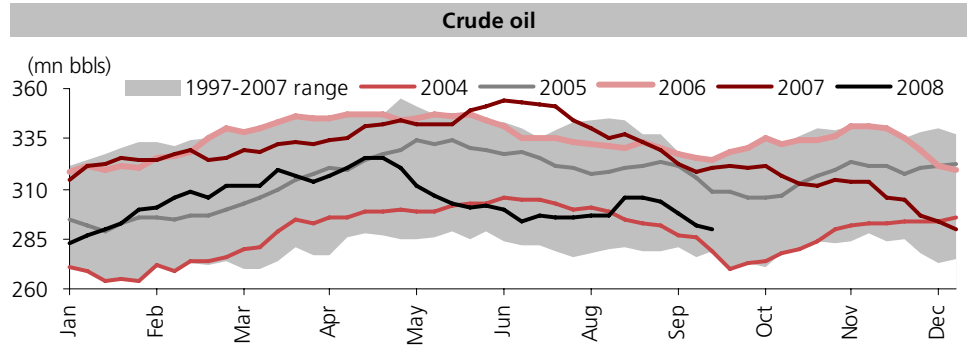
US refining capacity utilization rates (%)



Source: EIA, Kotak Institutional Equities

Sharp decline in inventory levels following shutdown of refining capacity in US

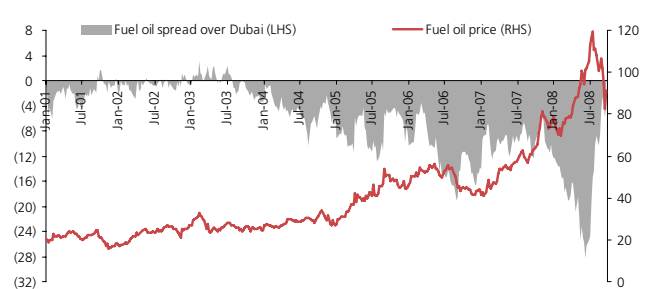
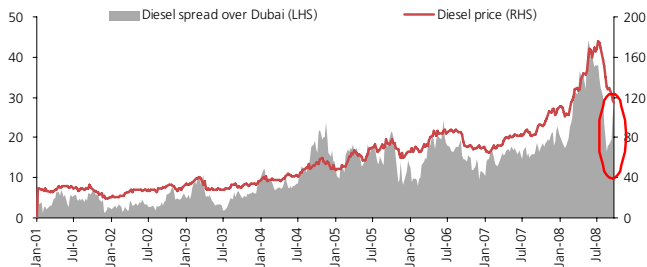
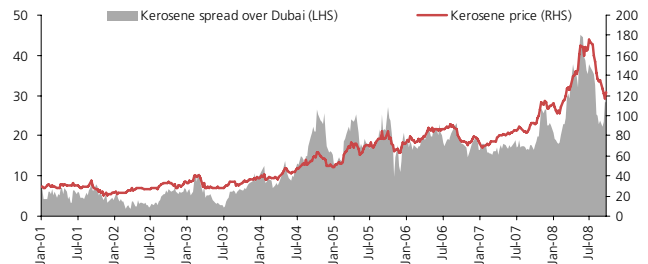
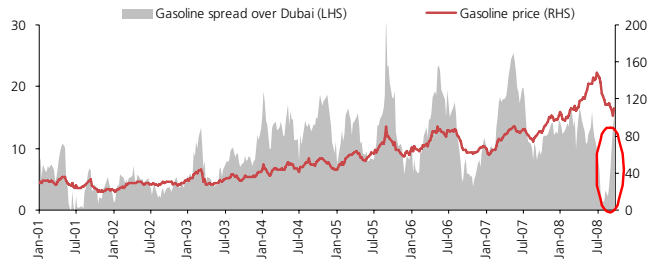
U.S. (DOE) crude oil and refined product statistics



Source: DOE, Kotak Institutional Equities

Product cracks have improved in the recent month

Spread between Arab Gulf product prices and Dubai crude (US\$/bbl)



Significant refining capacity to come onstream in China and India from 2H CY08

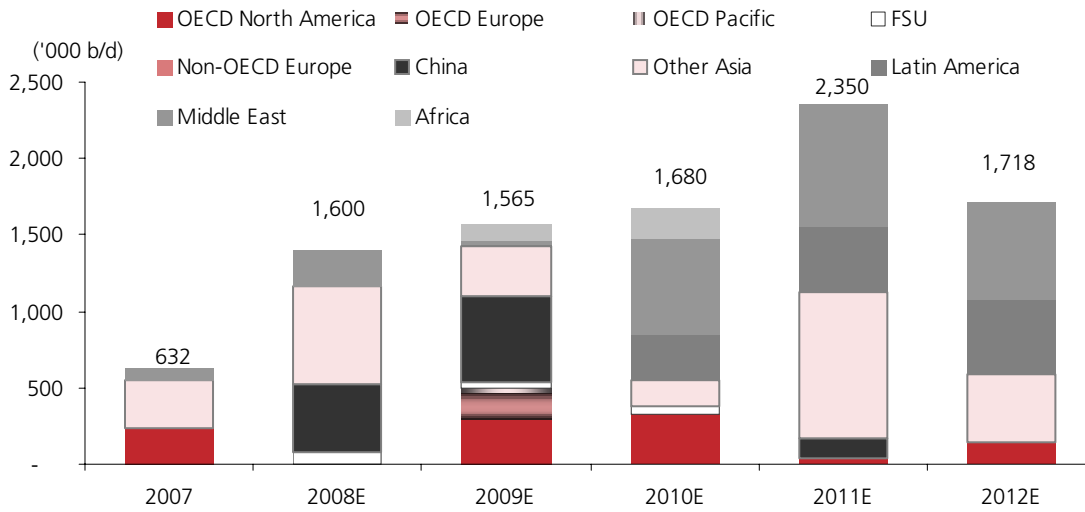
Upcoming refining capacity addition (b/d)

Company	Location	Capacity addition (b/d)	Expected completion
Reliance Petroleum	Jamnagar, India	580,000	3QCY08
CNOOC	Daya Bay, Huizhou, Guangdong, China	240,000	3QCY08
Sinopec	Qingdao, China	200,000	4QCY08
Fujian Petrochemical	Quangang, Quanzhou City, China	160,000	1QCY09
Sinopec	Tianjin, China	150,000	1QCY09
Petrochina	Dagang, Quinzhou, China	200,000	1QCY09
Petrovietnam	Dung Quat, Vietnam	121,000	1QCY09
Total capacity addition		1,651,000	

Source: Oil & Gas journal, Kotak Institutional Equities estimates

Significant supply additions to global refining capacity

Global refinery capacity addition, calendar year ends, 2007-2012E ('000 b/d)



Source: IEA, Kotak Institutional Equities estimates

Expect high crude prices to sustain backed by strong demand growth

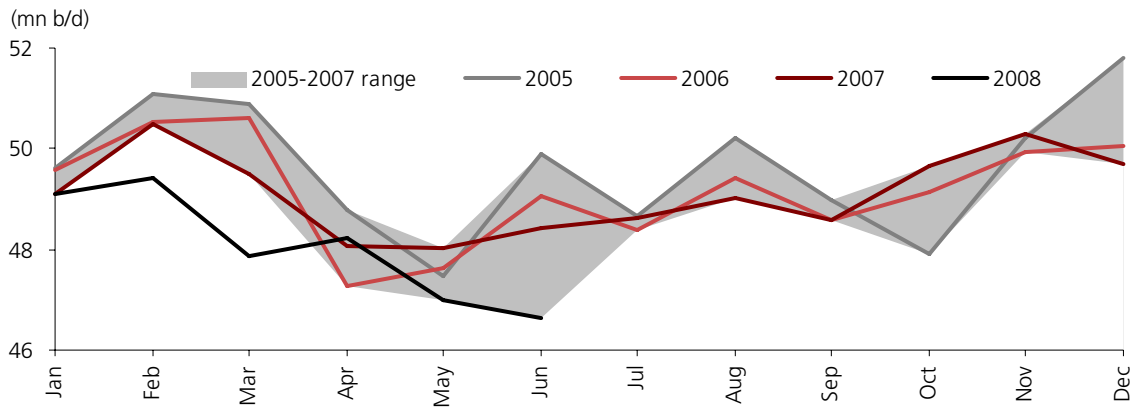
Estimated global crude demand, supply and prices, Calendar year-ends

	2004	2005	2006	2007	2008E	2009E	2010E	2011E	2012E	2013E
Demand (mb/d)										
Total demand	82.5	84.0	85.1	86.1	86.8	87.6	88.8	90.0	91.5	93.1
Yoy growth	3.3	1.5	1.1	1.0	0.7	0.8	1.2	1.2	1.5	1.6
Supply (mb/d)										
Non-OPEC	48.8	48.7	49.2	49.6	49.9	50.7	50.9	51.0	51.0	51.4
Yoy growth	0.6	(0.1)	0.5	0.4	0.3	0.8	0.2	0.1	0.0	0.4
OPEC										
Crude	29.5	30.8	31.3	31.7	31.8	31.1	31.5	32.5	33.7	34.8
NGLs	4.2	4.5	4.6	4.8	5.1	5.8	6.4	6.5	6.8	6.9
Total OPEC	33.7	35.3	35.9	36.5	36.9	36.9	37.9	39.0	40.5	41.7
Total supply	83.4	84.7	85.5	86.1	86.8	87.6	88.8	90.0	91.5	93.1
Total stock change	1.0	0.7	0.8							
OPEC crude capacity				34.4	35.3	36.4	37.4	37.3	37.6	37.9
Implied OPEC spare capacity				2.7	3.6	5.3	5.9	4.8	3.9	3.1
Demand growth (yoy, %)										
	4.2	1.8	1.3	1.2	0.8	0.9	1.4	1.4	1.7	1.7
Supply growth (yoy, %)										
Non-OPEC	1.2	(0.2)	1.0	0.8	0.6	1.6	0.4	0.2	0.0	0.8
OPEC	8.4	4.6	1.9	1.5	1.2	(0.0)	2.7	2.9	3.8	3.0
Total	4.4	1.6	0.9	0.7	0.8	0.9	1.4	1.4	1.7	1.7
Dated Brent (US\$/bbl)										
	38.3	54.4	65.8	72.7	110.0	95.0	90.0	90.0	90.0	75.0

Source: IEA, BP Statistical Review of World Energy, and various government and industry sources

OECD demand has fallen due to the impact of high gasoline and other product prices

OECD demand (mn b/d)

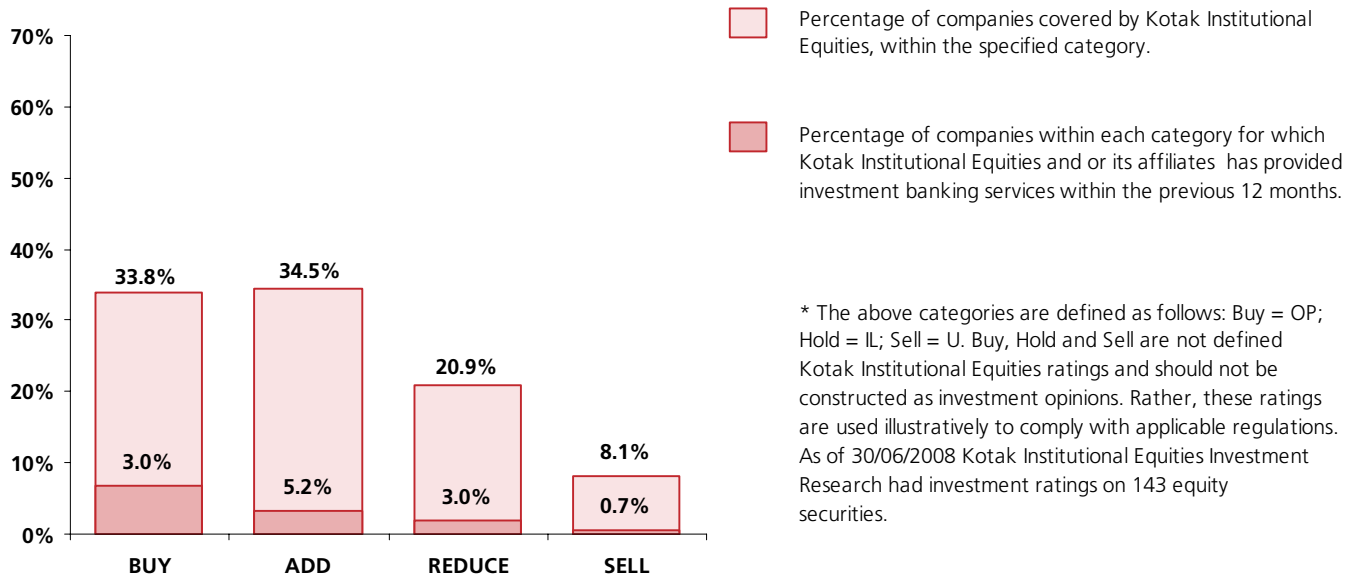


Source: IEA, Kotak Institutional Equities.

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Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2008

Ratings and other definitions/identifiers

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 Sensex by more than 10% 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).

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