## WHAT WILL DRIVE THE MARKETS IN 2007?

It's a simple answer to a seemingly difficult question. The same elements that drove our markets in 2006 and gave the bulls some wild jitters in May and December are likely to be at play in the Chinese year of the Pig.

While the New Year may necessitate a change in your desk calendar, there is no need to think that the rules that governed your investment decisions in 2006 are going to become obsolete overnight or stocks come with expiry dates like the medicines.

### Acquisitions will raise the bar

While earnings continue to drive stock prices in all markets, whether the Index rises in proportion to the earnings or not is function of the sentiment. The year 2006 saw the Sensex rising 46%, while the earnings rose just 20% on a trailing 12-month basis.

The determination of large MNCs to get a toe hold in the Indian companies at any price, a trend that manifested itself last year, is likely to continue and may be played with a renewed vigour this year as well. As the acquisitions are happening at rates, which look expensive from an earning perspective, they are raising the floor for the entire industry in which such deals take place.

### Cement

Holcim's fancy price of $260 per tonne paid for Gujarat Ambuja's stake in November was way above the $ 93 paid by Heidelberg in September for a pie in Mysore cement.

It all began with Lafarge taking over TISCO's cement unit for $72 a tonne in 1999 and that of Raymond's at $ 80 a tonne. The asking rate, however, remained sub $100, till Holcim entered the fray in 2005 and changed the rules of the game by offering $ 129 for a pie in cement major ACC.

### IT

Oracle paid a price of Rs 2100 per share for upping its stake in I-Flex last month. The valuation of 46 times the expected 2007 earnings makes Infosys look cheap at 31 times, expected 2007 earnings and Satyam at 22 times, a downright steal.

If Oracle pushes for a de-listing of I-Flex, the valuations could improve further.

IBM could well be the next tiger on the prowl. Having sold its personal computing business to Lenovo, Big Blue is actively looking for a large software company to shore up its delivery capability in the arena. Last week, IBM – Siemens combine bagged an order $9.3 billion from the German military.

**Telecom**

Valuations are likely to go up in the telecom space as well. Race is currently on for acquiring Hutchison Telecommunications International 's 67% stake in Hutch-Essar, the third largest player in the rapidly growing telecom arena.

Vodafone, which holds 10% stake in Bharti Airtel has bid for the entire Hutch-Essar stake of 100% for a fancy price of $ 17 billion. With an enterprise value of $ 17 billion and a subscriber base of 2.23 cr, the EV/Subscriber value of $ 762 is 18% higher than what Bharti Commands.

The deal is by no means over. Reliance is likely to be an aggressive bidder. It badly needs to shore up its GSM presence and Hutch represents just what the doctor ordered. The re-emergence of Essar as a bidder, which has the first right of refusal, has muddied the waters. Who so ever steps into the Hutch shoes is going to pay a high price and will raise the bar for the Industry. If Vodafone gets Hutch, it will have to offload it's 10% stake in Bharti. As Bharti's margins are higher by 400 basis points, Bharti's shares will change hands at even higher prices.

**Steel**

If Mittal or any other steel major buys a company in India, it could trigger a re-rating of the domestic companies as well. Companies that have access to captive mines are likely to be in demand.

If Mitsui's 51% stake in the iron ore exporter Sesa Goa were to be put under the hammer, it would surely be a benchmark price for the Industry.

**Oil and Gas**

The high issue price of Cairn Energy has put the spotlight back on ONGC. Suddenly ONGC is being seen as a value pick. New gas finds in the K.G. basin are going to result in a re-rating of the stock. Cumulative tests of GSPC, Reliance and ONGC suggest that the Mahanadi and the KG basins may be a part of the same system. At this point of time, this is merely in the realm of imagination, but subsequent tests could prove that. If that happens, it could re-rate all the operative assets in the region.

While final allotments for the NELP VI are yet to be formally announced, the next round of NELP VII is round the corner. There is talk that the Government may renegotiate some 19 blocks where the share of the Government sharply reduces in subsequent years.

While the Government can do what it wants before final allotment, revisiting the contract terms may not show the Government in a good light. Whatever Government wants to change can do it in NELP VII, which could begin in March 2007.

This makes the drilling and ancillary companies a better bet. We believe that major action would happen in the offshore business and we like Aban Lloyd in the sector.

Then there is our rail corridor study and atomic power opportunity that will flourish in 2007.

**Banking**

Strategic investors will continue to look at banks from a portfolio investment view point, till April, 2009, when RBI may allow the foreign banks to buy significant stakes in the private sector banks. Till that point of time, the portfolio funds are going to keep the seat hot for the banks to come in later.

This will ensure that the valuations don't suffer for the sector.

However, a hike in the bank rate, which we expect, is likely to mar the prospects of still better valuations in 2007. Some altitude could be lost here.

**Buoyant Tax collections**

Buoyancy in direct tax collections has given the impression that the FM may have the elbowroom to reduce the surcharge on income tax, if not altogether scrap it. Any reduction in the tax rate, however, does not seem likely, though it is doable.

| Particulars | Change % |
|---|---|
| Net Direct Tax Collection Rs. Cr. | 42.50 |
| Corporate Tax Rs. Cr. | 51.20 |
| Income Tax including FBT Rs. Cr. | 26.60 |
| Securities Transaction Tax Rs. Cr. | 96.80 |
| Corporate Advance Tax Rs. Cr. | 38.51 |
| **Corporate Advance Tax In the Dec Month Particularly** | 46.40 |
| Advance Income Tax | 26.30 |
| Advance Income Tax in the Dec Month Particularly | 38.47 |

**FII Inflows**

The net FII inflows last year were to the tune of Rs 36540 cr. A good number in it's own right, but less than Rs 47,181 cr received in 2005 and also less than Rs 38965 Cr pumped in 2004.

| Year | FII | MF |
|---|---|---|
| 2000 | 6370 | -735 |
| 2001 | 13128 | -5026 |
| 2002 | 3629 | -3018 |
| 2003 | 30459 | 403 |
| 2004 | 38965 | -1797 |
| 2005 | 47593 | 13438 |
| 2006 | 35866 | 15184 |

And despite lower FII inflow, we saw a 47% rise in the Sensex. This was partly attributable to higher MF inflows of Rs 15,183 cr as against Rs 13437Cr seen in 2005.

One of the probable reason why the Index did that better with lower inflows is that the Sensex stocks received higher inflows in terms of % of inflows. That is also probably the reason, why BSE Small Cap and BSE Mid-Cap grew 15% and 30% respectively during the period.

In Dollar terms, the inflows are much lesser. What kind of inflows can we expect this year?

If the Commerce Minister is to be believed, expect a deluge from Japan. According to the pink press, Nomura had assured Mr. Kamal Nath during his recent Japan visit, that Japan could pump in almost 10 billion dollars this year. That is more than the entire FII inflows from all countries put together in 2006.

If this is true, and assuming a lukewarm response from the rest of the world, we could still be having enough FII inflows to chase the Sensex to the moon.

The big assumption here is that the regulators will permit the current regime of PNs to continue. Any policy change here, that bars or controls PNs could seriously de-rail the markets.

**What could go wrong?**

What could go wrong? Any surge in crude, a hard landing of the US economy or sub-normal monsoon could be the party poopers. The presence of El Nino effect in the Pacific points towards that. Any control on the PNs would be a sure disaster. Most likely reason for a fall, whenever it happens, could be the derivative positions. Last week 26 new stocks were added to the derivatives list, taking permissible securities to 153. As more stocks and indices become eligible, the open interest could mount, creating periodic scares in the markets.

States of Goa, Punjab, Manipur, UP and Uttaranchal are scheduled to go to the polls any time between March–June 2007. UP is the most important. If the UPA wins UP, one could expect a preponement of the General Elections, which could pave the way for the Congress to make a come back on it's own terms. Any setback in UP could further force the UPA to take a more anti-reforms view.

Take a bottom up approach and things could work your way in 2007 as well.

## Automobile Sector – Smooth Ride Ahead

The year 2007 is expected to herald the launch of fifty new car models and Indians are going to be spoilt for choice. And the next year's party will not be limited to just cars. Between Jan and Nov 2006, more than 10 million new automobiles have hit the Indian roads, which is nearly 17% more than the number of vehicles that the automakers turned out in 2005. However the same enthusiasm was not reflected on the bourses as the automobile sector under-performed the Sensex. In the past year, while the Sensex returned 46.7%, the BSE Auto index rose just 29.7% as rising input cost rung in disappointing results across the board. Moreover, the higher base effect and continuing margin pressures are expected to strain the earnings growth in FY 2008.

**Commercial Vehicles (CV) - Zooming into 2007**

The CV segment comprising nearly 25% of the nearly 1.5 million strong four wheelers market *(Commercial & Passenger Vehicles)* has been the star performer this year. Between April and Nov 2006, the domestic CV sales grew by a robust 36% to 3.25 lakh units and exports rose by over 28% as compared to the same period last year. A significant part of the increased demand was the result of the Supreme Court ban on overloading of trucks, which came as a blessing for truck manufacturers. We expect the growth rate in demand as a result of the ban on overloading to taper off by 2008.

The adoption of the hub and spoke model by the Industry is expected to drive the demand for both high as well as low tonnage trucks at the expense of the medium category. The three wheeler segment is expected to continue its dominance in the area of last mile distribution goods on the back of the improved road network between major production centers and demand centers. The CV industry may also get slightly impacted by the increasing efficiency of the railways. The Rs 60,000 Cr dedicated rail freight corridor is not expected to be a significant threat to the road sector in the short to medium term. With the economy growing at a scorching pace and increasing availability of road network subsequent to the completion of the 'Golden Quadrilateral' and the North-South-East-West corridors, we expect the demand for CVs to be on the rise in FY 2008 as well.

**Passenger Cars – No speed breakers ahead**

Car production also crossed the one million mark between Jan and Nov 2006, driven by the nearly 19% growth Y-o-Y in the mini and compact segment. The buoyant demand and the ability to pass on the rise in costs have facilitated growth in revenues and profits of domestic passenger vehicle manufacturers in 2006 and the year 2007 is all set to continue to see similar decent growth as well. The demand growth can further accelerate if the Union Budget 2007-08 extends the concessional 16% excise duty across all cars — so far restricted to small cars.

**Two Wheelers - Volumes to crowd the Indian Street**

We expect two-wheeler companies to maintain their earnings growth as their key drivers viz. economic growth, soaring disposable incomes and improving demographics remain intact. We estimate a 14% CAGR in two-wheeler volumes over FY07-10E, while we expect the motorcycle volumes to record a 17% CAGR over FY07-10E. The ramping up of manufacturing in tax-free zones and the relatively lower Capex are key factors favorable to the two-wheeler sector in FY 2008.

**Tax Savings to boost revenues and profitability**

The majority of the automobile manufacturers are setting up new facilities in the tax free zones in the states of Uttaranchal and Himachal Pradesh and would be enjoying excise duty exemption *(currently 16%)* for a period of 10 years and 100% income tax exemption for the first five years from the year in which commercial production starts. We expect the resulting tax benefits to be passed on to the customers, which is likely to boost volumes and revenue growth.

**Major Expansions in the Pipeline**

- ✓ Tata Motors and Fiat are expected to invest over Rs 4,000 Cr in a joint venture to make cars and engines, and they may expand it to produce trucks as well. The annual capacity is likely to be more than 100,000 cars and 200,000 engines & transmissions and the production is expected to start from the beginning of 2008 at the Fiat plant at Ranjangaon in Maharashtra.

- ✓ Ashok Leyland has also lined up investment worth Rs 5,250 Cr to enhance its production capacity by 1,40,000 units over a period of next four to five years. Ashok Leyland is expected to set up a bus assembly unit at Ras Al Khaimal, UAE with an initial investment of USD 50 million. The new facility is expected to build 1,000 buses of international styling, manufacture and quality.

- ✓ Bajaj Auto is in the process of investing Rs 1,500 Cr over the next three years for a range of projects, including enhancement of manufacturing capacity from the current 3.5 million vehicles per annum to 5.1 million. Bajaj Auto is also likely to invest US$ 50 million for setting up a motorcycle plant in Indonesia and expects to sell 100,000 vehicles in south East Asia’s largest Economy in the next two years.

- ✓ Hero Honda, along with its ancillary companies, is set to invest Rs 1,900 Cr to set up a new bike plant in Uttaranchal. The proposed plant will have an initial capacity of 5 lakh bikes and later ramped upto 1.5 million bikes by 2010.

- ✓ TVS Motors Co. also plans to invest upto USD 100 million in Indonesia over the next three years to set up a manufacturing facility of 300,000 motorcycles a year to cater to Southeast Asia.

**Investment Concerns**

- ✓ The automobile sector is expected to encounter cost pressures on the back of rising input costs, especially aluminium, copper, steel and rubber. The average price of natural rubber increased by 48% between April and November of 2006, while aluminium rose 44% between July 2005 and October 2006 and steel has risen by 15-20% since October 2006. Any further rise in the price of raw materials coupled with the inability to pass it to the customers is expected to dent the EBIDTA margins.

- ✓ The rising interest rate is an area of concern as 75-80% of the car and two wheeler purchases are made through bank loans. With a strong growth in the disposable incomes, a meager rise in the EMIs is not likely to have a major impact on the demand.

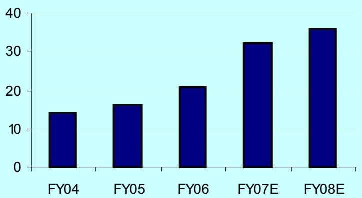
**Valuation of some Automobile companies:**

| Company | Net Profit (Rs in Crore) | | | EPS (In Rs) | | | P/E Ratio | | | CMP |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY 06 | FY 07E | FY 08E | FY 06 | FY 07E | FY 08E | FY 06 | FY 07E | FY 08E | |
| Tata Motors | 1,564 | 2,300 | 2,700 | 42 | 59 | 70 | 21 | 15 | 13 | 900 |
| Ashok Leyland | 327 | 350 | 450 | 2.5 | 2.7 | 3.4 | 18 | 17 | 13 | 45 |
| Maruti Udyog | 1,220 | 1,500 | 1,800 | 42 | 52 | 62 | 22 | 18 | 15 | 927 |
| Bajaj Auto | 1,070 | 1,250 | 1,500 | 100 | 123 | 148 | 26 | 21 | 18 | 2,618 |
| Hero Honda | 971 | 975 | 1,150 | 48 | 48 | 58 | 16 | 16 | 13 | 762 |

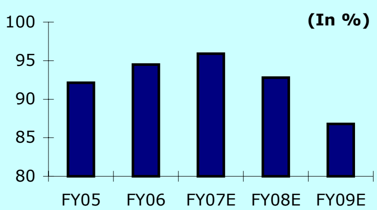
## Cement Sector Update

| Company | Market Cap (Rs Cr) |
|---|---|
| ACC | 20201 |
| Guj. Ambuja | 21751 |
| Ultra Tech | 13975 |
| Grasim | 25769 |
| Shree Cem | 5034 |
| India Cement | 5158 |

**Increasing EBIDTAM%**




**Optimum Capacity utilization:**




The Indian cement industry comprises of 129 large cement plants which are owned by 54 large companies and 300 mini-cement plants, with installed capacities of 160.2 Mn TPA and 11.1 Mn TPA, respectively. The cement industry accounts for approximately 1.3% of GDP and employs over 0.14 mn people. The Industry had started the year 2006 with robust demand growth of more than 10% driven by growth in the housing sector, increasing spending on infrastructure projects across the sectors and corporate cap-ex. It is well supported by robust GDP growth rate, macro factors and limited supply that has resulted the improved price realization coupled with optimum capacity utilization.

**Increasing realization has improved the margin matrix:** During the year, the realization has gone up by more than 25%, driven by robust demand growth coupled with limited supply, consolidation in the industry and operating efficiency. The continuous improvement in the realization has beaten the market expectations and has improved the margin matrix. We believe the growth momentum in prices will be sustained in future till mid-FY09 when a large number of capacities would be getting operational.

**Optimum capacity utilization for next two years:** Most of the companies have already announced capacity additions, but we expect delay in project implementation due to overbooked order book of equipment supplier, government clearances, availability of limestone, infrastructural bottlenecks, logistics factors, tying up with financial resources etc. So actual capacity addition would be lower than that announced, which will lead to optimum capacity utilization for FY07 and FY08, despite fresh capacity additions.

**Continued momentum in demand growth:** The cement industry has witnessed a growth rate of more than 10% on account of drivers like higher disposable income, lower EMIs and fiscal incentives, increased infrastructure spending, proposed SEZs and capital spending by corporate. So going forward, the demand for the industry continues to look positive and we can expect that the 10% YoY growth rate will be maintained for next two years. On the other hand, we expect the supply to grow at a CAGR of 9% for the next two years driven by increasing capacities by different players and increased blending potential.

**Valuation Table:**

| | | EPS | | P/E | | EV/EBIDTA | |
|---|---|---|---|---|---|---|---|
| | CMP | FY07E | FY08E | FY07E | FY08E | FY07E | FY08E |
| **ACC** | 1079.0 | 64.3 | 76.4 | 16.8 | 14.1 | 9.9 | 10.4 |
| **GACL** | 143.5 | 9.8 | 11.9 | 14.6 | 12.1 | 10.4 | 10.7 |
| **Grasim** | 2811.1 | 195.4 | 234.5 | 14.4 | 12.2 | 6.4 | 4.9 |
| **UltraTech** | 1122.4 | 56.8 | 74.3 | 19.8 | 15.6 | 10.8 | 8.4 |
| **Shree Cem** | 1445.0 | 102.5 | 134.6 | 14.1 | 10.7 | 8.3 | 6.3 |

**Demand-supply mismatch:**

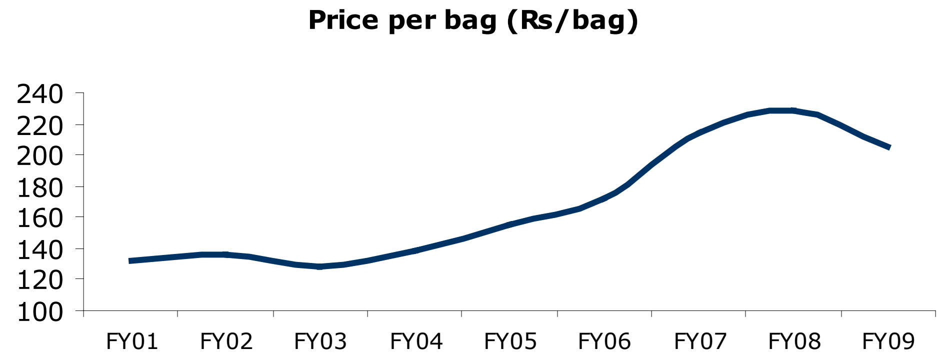
Limited capacity addition in next two years would be insufficient to feed the strong demand and will lead to rise in cement prices.

| Demand Supply Status | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| Annual Installed Cap. | 151.6 | 160.2 | 170.3 | 189.9 | 232.5 |
| Idle Cap. | 7 | 7 | 7 | 5 | 5 |
| Cement Effective Cap* | 144.6 | 153.2 | 163.3 | 184.9 | 215.5 |
| Cement Domestic Demand | 123.1 | 135.6 | 149.8 | 165.1 | 181.6 |
| YonY% Change | | 10.2 | 10.5 | 10.2 | 10.0 |
| Cement & Clinker Export | 10.1 | 9.2 | 6.8 | 6.5 | 5.5 |
| Total Cement Demand | 133.2 | 144.8 | 156.6 | 171.6 | 187.1 |
| **Req. Utilization Rate %** | **92.1** | **94.5** | **95.9** | **92.8** | **86.8** |

***Cement effective capacity exclusive of idle capacity and delayed projects**

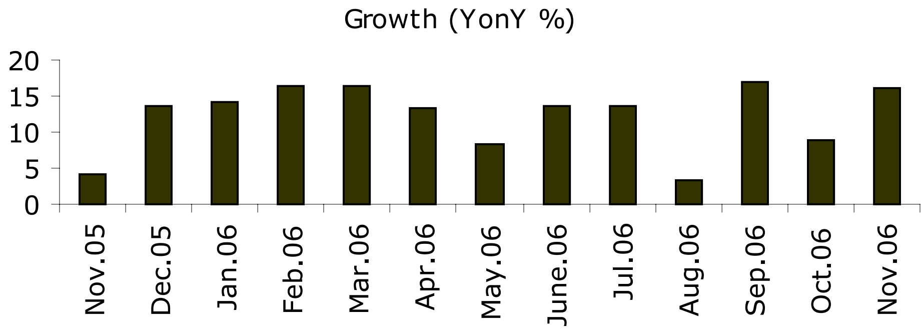
**Firm price realization:**

We expect the cement prices will move up by 12-14% in next 12-15 months, driven by higher volume growth and limited supply.




**Robust demand growth:**

We can expect that the 10% growth rate will be maintained YoY for next two years.




We continue to remain positive on the growth prospects of the cement sector for next 12-18 months.

**Future Outlook:** We expect the industry will continue its stellar performance for next two years on account of the government's continued thrust on infrastructure and strong demand from the housing sector. High capacity utilization, consolidation and mismatch in demand-supply situation will ensure that the cement prices move up by ~12-14% in the next one year. We continue to remain positive on the growth prospects of the cement sector for next 12-18 months.

## Pharmaceutical Sector

We have a positive stance on the Pharma sector in the next year propelled by topline and bottom line growth from the companies under our coverage primarily led by Ranbaxy, Cipla, Nicholas Piramal, and Glaxo Pharma.

Global Pharma Industry is estimated at US$ 4.5 bn (approx. Rs 202,500 Cr) while the Indian Pharma industry represents 8% of the Global Industry in volume terms & 13% in terms of value i.e. Rs 23,040 Cr. The industry has been growing consistently between 8-10% p.a. In 2005, it grew by 9% in value terms. We expect the trend to continue in the coming year as well, accompanied by significant growth during the 180-day exclusivity period for the new generics in the US market.

**Investment Arguments:**

**Domestic formulations on a steady growth path:** Domestic formulation business is expected to grow in double-digit range for FY07 and FY08. However, the growth will continue to be impacted by finalization of issues under Pharmaceutical Policy 2006. Various issues – inclusion of additional 354 drugs under the policy, use of regulatory framework to control the fluctuation of prices – continue to loom large over the Domestic pharma industry, despite hectic discussions between the Pharma Industry and the Ministry of Chemicals and Fertilizers. A tentative report has been submitted to the Government on November 30th, 2006. These issues need to be resolved at the earliest for the growth of the industry.

**US generics continue to face stiff competition on pricing & volumes fronts:** The pricing pressure in the US generics business is expected to continue even in 2007. Price erosion of 60-90% is common among the new launches. This is due to increasing number of players for new launches in the US. For example, in case of 'Meloxicam' launch in Q1FY07, there were more than 10 players, which resulted in the erosion of prices by 95%. Besides, Chinese players are steadily gaining momentum in API filings in the USA aided by large API capacity & compliance to International standards. This is going to impact companies focused in the US business like Ranbaxy and Sun Pharma.

**Outsourcing to gain momentum in the coming years:** Innovator Pharma players will continue to outsource more as they focus on core competencies. The pressure from declining R&D productivity, increased generic competition, patent expiries, increasing cost of drug development and fewer blockbuster drugs is likely to force them to outsource more in the coming years. The global outsourcing opportunity is expected to double its current size of US$ 27 bn to US$ 55 bn by 2010. This would include US$ 30 bn in contract manufacturing and US$ 20 bn of Contract research involving Custom chemical synthesis (CCS) and clinical trials. India offers a unique combination of skilled labour (at low cost), international regulatory compliance, IPR protection, and presence across the CRAMS value chain and good quality. China and other countries are not expected to pose major threat, as they don't provide same combination of skills and costs. Given the high entry barriers in this space, we expect the already established players: Jubilant Organosys, Nicholas Piramal, Shasun Chemicals, Matrix Labs and Divi's Labs to get a significant share of outsourcing business. However, Indian players have to look beyond cost advantage to grab a bigger pie.

**Biopharmaceuticals, fast picking up:** Globally, biotechnology approvals are outpacing pharmaceuticals gradually and Asia-Pacific region is registering faster growth. Australia, Singapore, China and India have a significant share in the sector. Spending on biopharmaceuticals has been growing in the US at a rate of 20-50% annually. It grew from US$ 42 bn in 2004 to US$ 69 bn in 2005. Considering the market growth & the demand potential, several Indian companies are strengthening their position. Wockhardt, Biocon, Bharat Biotech, Dr Reddy's are some of the prominent companies working in this area and therefore, these companies are expected to show good topline growth in FY08 and FY09.

**Mergers & acquisitions to gain momentum:** In the last 2 years, the Indian Pharma companies have been at the forefront of mergers & acquisitions. Dr. Reddy's acquired Betapharm in Germany and Roche's API division, Ranbaxy acquired Terapia, Ethimed and Allen SPA in Europe and Nicholas Piramal acquired Avecia pharma. This is due to intense competition for getting market share by various pharma players in different geographies. There are more companies like Sun Pharma (Rs 2,050 Cr) and Jubilant Organosys (Rs 900 Cr), which have sufficient cash to acquire appropriate companies at the right valuations. However, considering the pricey premium and lengthier payback period, Indian companies should look for strategic fit for their businesses. There is also a possibility where Indian companies may become a target of global players, as it happened in the case of Matrix Labs, which is acquired by Mylan Labs. We believe this consolidation in the Pharma sector is expected to continue in 2007 as well as in the coming years.

**Investment Concerns:**

**Pharma companies catering to US market can be hit by legislative battles:** There are many legislations waiting for changes by the Congress, which can change the dynamics of the market. Most important are:

- Medicare reform: It would remove the clause that prevents the US government from negotiating directly with the drug firms and therefore could allow the government to lower drug prices.
- Drug importation: The law would allow import of cheap drugs from Canada, which would force companies to revise their strategies for North America.

**Competition from Chinese players to emerge strongly, especially in the US generics business:** In the US generics space, Chinese companies are steadily gaining ground in the API filings with US FDA. China has huge API capacities and most of it is underutilized. In the next 1-3 years, Indian companies will start facing heat from the Chinese companies, which will force Indian players to revise their strategies in these markets.

Valuation of some Pharma companies:

| Company | Net profit (Rs Cr) | | | EPS (Rs) | | | P/E ratio | | | Market price (Rs) |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | |
| Ranbaxy* | 516.5 | 651.4 | 839.0 | 13.9 | 17.5 | 22.5 | 28.6 | 22.7 | 17.6 | 397 |
| Dr Reddy | 146.7 | 738.7 | 654.5 | 9.6 | 44.0 | 39.0 | 84.5 | 18.4 | 20.7 | 808 |
| Cipla | 607.6 | 770.9 | 969.1 | 7.8 | 9.9 | 12.5 | 33.3 | 26.2 | 20.9 | 260 |
| Glaxo Pharma* | 364.8 | 421.8 | 484.0 | 43.1 | 49.8 | 57.1 | 27.2 | 23.5 | 20.5 | 1170 |
| Pfizer India* | 115.8 | 135.5 | 159.8 | 38.8 | 45.4 | 53.5 | 19.6 | 16.8 | 14.2 | 762 |

*Ranbaxy, Glaxo: Fiscal Dec-ending (FY06 is Estimated Dec-06 figures)
Pfizer: Fiscal Nov-ending (FY06 is Estimated Nov-06 figures)

## Information Technology Sector

We have a positive stance on the Technology Sector in the next year, as the companies continue to expand existing relationships and clinch major deals. Large players along with niche players would lead the growth in the IT sector: Infosys, TCS, Satyam Computers, Mphasis BFL, Sasken and Tech Mahindra.

International Data Corporation (IDC) projects that worldwide IT (including hardware, software and services) and related business service spends would grow by 9.8% CAGR from US$ 1,479 bn in CY05 to US$ 1,964 bn in CY09. Given the significant cost advantage, offshoring of IT services would continue to rise and India would be a key beneficiary of it. The Indian IT industry is on a roll with large companies guiding a growth of 25-35% for FY07 despite higher base. Volume growth has been steady or accelerated for most of the large companies on a QoQ basis. Customer additions have been strong and have not witnessed any slowdown in the last one year. We believe this growth rate (around 10% globally & 25%+ in the Indian Industry) to be maintained in the next 2 years.

**Investment Arguments:**

**IT spending with Offshoring continues to gain momentum:** Global IT services spend is estimated to grow at CAGR of 5.7% over 2005-10 to US$ 589 bn, according to International Data Corporation (IDC). With increased acceptance of IT offshoring, it is expected to grow at a faster pace of 25-30% CAGR over next 3 to 5 years. Given the significant cost advantage that India has, it would be a key beneficiary of this growth. So far, there has been no indication of slowdown in client addition in any quarter for Indian companies despite fears of slowdown in the US. This robust demand environment would also trickle down to mid-size players especially niche service providers and product companies. Large players are: Infosys, TCS, Wipro & Satyam computers. Mid-size companies are: Mphasis BFL, 3i Infotech, Hexaware Technologies, Tech Mahindra and InfoTech Enterprise.

**Larger number of small deals to benefit smaller players:** TPI (a sourcing advisory company) estimates that nearly US$ 100 bn in total contract value in IT services is due to come up for renewal over CY06-07. TPI reveals that 325 deals are due for renewal during CY06 and CY07, representing over 1/5th of active contracts. It observes a trend towards a larger number of smaller deals – 293 deals were signed in CY05, of which 70% were small to medium sized contracts (US$ 50-200 mn), up from 65% in CY04 and 61% in CY03. The trend towards a larger number of smaller contracts represents an opportunity for smaller, niche players.

**New verticals to show robust growth:** New verticals like Consulting, Testing and Infrastructure management will be the growth drivers in the coming years. For most companies, the consulting business is in the nascent stage with negative or no contribution to the bottom line. For example, the consulting arm of Infosys has revenue of Rs 29 Cr and a loss of Rs 15 Cr in Q2FY07. But the management believes it will become marginally positive this fiscal. Once in full flow, consulting will turn into a high margin vertical. It will drive downstream IT work, which can be delivered through the global delivery model. Consulting and IT services, together, can yield margins higher than that obtained on just IT services. As a result, this would favour companies like Infosys, TCS. Wipro gets almost 17% of its revenues from Testing and Infrastructure space and is growing in excess of 50%.

**Pricing trend showing upward bias:** Pricing environment for IT services have been improving for major contracts with upward bias of 5% on new contracts and 2-3% for existing contracts. However, pricing for emerging areas of IT consulting, Testing and Infrastructure space is robust and these spaces would continue to be a focus for many players.

**Investment Concerns:**

**Competition from Global players gaining ground:** Large Indian players are facing stiff competition from Global players like Accenture, IBM and EDS. Due to this, now Indian players need to invest more in the client facing area to remain competitive and generate incremental work from existing client base. Also, companies need to look beyond low cost area to revise their strategies. This competition can put pressure on the margins in the coming years.

**High attrition rates:** There has been increasing wage inflation and fluctuating utilization levels due to higher attrition rates in the industry. The trend is expected to continue, which would impact the margins in the coming years.

Valuation of some IT companies:

| Company | Net profit (Rs Cr) | | | EPS (Rs) | | | P/E ratio | | | Market price (Rs.) |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | |
| Infosys | 2458.0 | 3897.2 | 5162.5 | 44.2 | 70.1 | 92.9 | 49.7 | 31.4 | 23.7 | 2200 |
| TCS | 2966.7 | 4086.5 | 5329.9 | 30.3 | 41.8 | 54.5 | 39.6 | 28.7 | 22.0 | 1200 |
| Satyam | 1141.7 | 1463.3 | 1783.6 | 17.4 | 22.3 | 27.2 | 27.6 | 21.5 | 17.7 | 480 |
| Mphasis | 149.9 | 119.4 | 218.8 | 9.3 | 5.8 | 10.7 | 31.2 | 49.8 | 27.1 | 290 |
| Sasken | 28.1 | 45.1 | 85.6 | 9.9 | 15.9 | 30.2 | 53.7 | 33.5 | 17.6 | 532 |

## Power Sector

Power sector companies are expected to witness strong growth driven by the various initiatives & reform measures undertaken by the Government to increase the generation capacities. The ground realities that were plaguing the power companies for years are changing fast on the back of various reforms measures. Huge Capex plans of the generation companies, improving health of the SEBs, good progress on the ultra mega power projects etc. give strong evidence of the exciting times ahead.

**Investment Arguments**

- The Indian economy is going through a period of rapid economic expansion and to power the GDP growth rate of over 8%, the economy would require a 10% CAGR in power generation. India's per capita consumption of electricity is also expected to substantially rise from the present 606 KWh to over 1000 KWh per annum by 2012. This, when compared to the world average of around 3,000 KWh and over 10,000 KWh in the developed countries, highlights the need for a massive step-up in energy generation to reach anywhere near the global levels.

- Some important proposals were made in the 2006 budget for the benefit of the power industry as a whole, like proposals for addition of Ultra Mega Power Projects, electrification of villages, de-blocking of the coal reserves for the power sector & reduction of customs duty show the Government's thrust on improving the power sector. As per the rural electrification programme, the government has planned to electrify 1.25 lakh villages and 23 million households in the next five years, under the Rajeev Gandhi Grameen Vidyutikaran Yojana.

- The recent Indo-US civilian nuclear deal allowing India to access nuclear fuel and advanced reactors from the US and other countries is expected to give a shot in the arm to India's nuclear power generation programme.

- The first two ultra mega power projects (UMPP) at Sasan and Mundhra were won by Lanco and Tata Power respectively. Both the companies have bid aggressively by offering a levelised tariff of Rs 1.19 (Lanco) & Rs 2.26 (Tata Power) per unit of power. Encouraged by the response to these first two UMPPs, the government plans to award three more UMPPs in 2007. The first of these projects, Krishnapatnam in Andhra Pradesh, is targeted for award in April '07, another one in May-June '07 and one more by the end of 2007.

- While India's installed power generation capacity presently stands at 127,673 MW, the country still needs an additional 78,327 MW to meet the growing demand for electricity over the next 5 years to achieve Government's target of 206,000 MW (Power for All) by 2012. We expect the capacity additions in the X$^{th}$ plan (2002-2007) to be at about 75% (~30,641 MW) of the targeted 41,110 MW, which is a significant improvement considering the fact that India managed to achieve only 47% of the target in the previous plan period. We also expect a shortfall (~10,300 MW) of the X$^{th}$ plan to spill over to the next plan period in addition to the planned investment under the XI$^{th}$ Plan of about 72,000 MW. With the improvement in implementation ratio in X$^{th}$ plan period and increased private participation on the back of Electricity Bill 2003, we expect the future for power companies including the equipment manufacturers to remain bright for the next 5–7 years.

**Investment Concerns**

**Attracting private sector investments in generation**

Large investments are required in generation to meet the target of 'power for all by 2012'. Over the years, we have seen that assured RoE has been reduced from 16% in the past to the present 14%. The present 14% post-tax RoE commences from the date of commercial operation of the plant. It normally takes around 36 months to construct a coal-based thermal power plant and 24-28 months for a combined open cycle plant. In the interim period, no returns are provided on the capital work in progress. Thus, the 14% RoE actually becomes 11-12%. In view of the above, we believe that returns from the power sector should be competitive with other sectors to attract private sector investments.

**Privatisation of the distribution business**

In view of the current sorry state of affairs on the distribution front, few private sector players are willing to enter this industry because of the huge risk perceived. Though the government has successfully implemented the APDRP Programme in some circles, in establishing the financial viability of the distribution business, but much more is yet to be done. The successful privatisation of the Orissa and Delhi distribution business should be extended to other states also. Above all, the government should reinstate confidence among the private players about the payment security and other related issues, so that the private parties willingly come forward to invest in the T&D sector.

**Slowdown in the reform process**

Since returns on regulatory assets are based on a fixed RoE (14%) formula, the key concern pertains to the regulatory nature of the business and viability of the sector. Any adverse news flow or policy decision impacting the pace of reforms would be a setback for the growth plans of the companies in the sector.

## Outlook

In a developing country like India, to support a GDP growth rate of 8%, the rate of growth of power supply needs to be over 10% annually. With the precarious state of demand-supply gap that exists in the country, the power sector is now poised to witness a fresh bout of investments over the next 5 years on the back of substantial regulatory progress. We observe that companies like NTPC, Reliance Energy, Tata Power etc. are going ahead with the capex addition program in power generation, driven by improved cash flows and payment security mechanism. Over the years, stocks belonging to Indian Power Sector have outperformed the indices by a good margin. We expect this out-performance to continue for at least next 2-3 years on the back of reforms initiatives and huge investments in the sector.

| Company | PAT (Rs Crore) | | | EPS (Rs) | | | P/E Ratio | | | CMP (Rs) |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | |
| NTPC | 5820.2 | 6590.4 | 7506.7 | 7.1 | 7.9 | 8.9 | 19.2 | 17.3 | 15.3 | 136.5 |
| Tata Power | 610.5 | 628.8 | 656.5 | 30.9 | 32.4 | 33.9 | 18.1 | 17.3 | 16.5 | 560.5 |
| Reliance Energy | 730.9 | 828.5 | 939.4 | 35.9 | 38.7 | 43.9 | 14.5 | 13.4 | 11.8 | 520.1 |
| CESC | 179.0 | 211.7 | 233.6 | 21.1 | 25.5 | 27.9 | 15.1 | 12.5 | 11.4 | 317.7 |

## Capital Goods Sector – To remain in the limelight

The capital goods sector came out with flying colors in 2006 and registered a remarkable improvement in turnover and profitability. The sector has been posting a scorching performance for the past three years and has been increasing at an accelerated pace every year. The sector is expected to continue its strong growth momentum in the forthcoming year as well, given the strong order book position and sustaining consumption led demand growth in the Indian economy. The strong industrial growth, pick-up in investment, modest inflation in spite of spiraling global oil prices and the rapid growth in exports and imports have been the significant dimensions of this dynamic economic growth. Production of capital goods, which is a barometer for domestic investment activity, accelerated its growth on the back of resilient industrial activity and strong Capex cycle. Going into 2007, the Planning Commission in its approach paper to the 11th Plan (2007-12) has targeted growth to accelerate to 9% and subsequently to 10%. Going by the expansion plans of various corporate, the year 2007 is also expected to witness high capacity additions thereby sustaining high investment cycle. The power sector is also set to witness massive capacity additions in 2007, which is the terminal year of the $X^{th}$ Five year plan.

Backed by splurge in investment in the infrastructure and industrial sector, the order intake is expected to be brisk despite speedy execution of contracts leading to strong order book and higher sales. The strong domestic demand driven by accelerated infrastructure development and capacity additions along with the emerging opportunities in the overseas markets such as Middle East, Africa, Asia etc., augurs well for the globally competitive home grown players such as BHEL, L&T, Thermax etc.,

Indian power equipment industry is expected to continue riding high on the back of the ongoing investment splurge happening in the power sector in India. With improvement in implementation ratio in the Xth plan period and the increased private participation on the back of Electricity Bill 2003, we expect the demand for power generation equipment to remain strong not only in the short to medium term, but also in the longer term over the eleventh five year plan period. Post the commissioning of the proposed ultra mega power plants and super critical thermal power plants, the demand for high capacity equipments and transformers is also likely to expand. The modernization and upgradation of existing transmission networks, rural electrification and the setting up of interregional grid by Power Grid etc., is also expected to trigger strong demand for electrical equipment industry.

With the rising crude oil prices, we expect the oil companies to go ahead for increased drilling activities. Material handling equipment including wagon, turbines (steam/hydro), boilers, control panels/boards and furnaces are also expected to register a rise in the production.

**Investment Concerns**

Recent spates of increase in steel and non-ferrous metal prices have the potential to dent the bullish growth and are likely to put pressure on margin of industry players. Despite the spurt in non-ferrous metal prices and up trend in steel prices, the players are expected to maintain or better their margins, thanks to the price escalation clause, which insulates them from swings in metal prices. However, sustained rise in metal prices can impact demand as well, which can lead to deceleration in the pace of growth in order book.

Any substantial hike in interest rates could have a depressing effect on the internal demand in sectors such as construction as well as manufacturing Capex, which have had major contribution to overall growth of the economy in recent years.

**Outlook**

Despite concerns regarding rising interest rates and mounting pressure on profit margin, the capital goods sector is expected to continue its growth momentum in 2007 as well, given the strong order book position, sustaining robustness in the economy, the positive spin off from the capacity building drive of the industrial sector and emphasis on infrastructure development. Strategic investments in capacity augmentation and technology by industry majors are expected to result in speedy execution of orders and expanded sales. Moreover, the perceptible shift of global manufacturing activity towards low cost destination especially India and China have enhanced the opportunities for Indian engineering majors. Similarly the Indian subsidiaries of MNC parents are also expected to thrive on strong outsourcing demand, apart from strong domestic demand. Domestic engineering majors and subsidiaries of overseas majors are all gearing up with strategic investment in capacity creation to meet the incremental demand.

**Valuation of some Capital Goods companies:**

| Company | Net Profit (Rs in Crore) | | | EPS (In Rs) | | | P/E Ratio | | | CMP |
|---|---|---|---|---|---|---|---|---|---|---|
| | FY 06 | FY 07E | FY 08E | FY 06 | FY 07E | FY 08E | FY 06 | FY 07E | FY 08E | |
| L & T | 1,012 | 1,150 | 1,450 | 36 | 41 | 52 | 40 | 35 | 28 | 1,443 |
| BHEL | 1,679 | 2,300 | 2,900 | 69 | 94 | 118 | 33 | 24 | 19 | 2,298 |
| ABB | 218 | 450 | 650 | 51 | 106 | 153 | 73 | 35 | 24 | 3,711 |
| Cromp. Greaves | 163 | 275 | 450 | 5 | 8 | 12 | 42 | 26 | 17 | 208 |
| Thermax | 123 | 175 | 250 | 10 | 15 | 21 | 39 | 26 | 18 | 387 |

# NEW YEAR SPECIAL

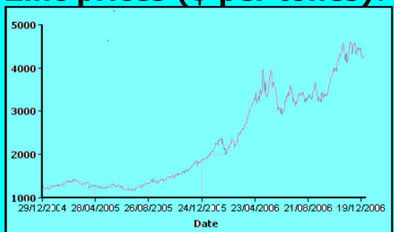
**January 02, 2007**

## Zinc Sector Update

**Segment-wise consumption:**

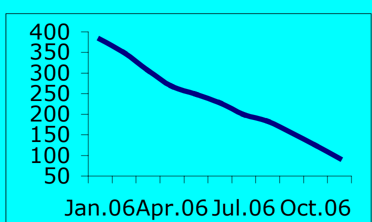
| Segment | % Use |
|---|---|
| Galvanizing | 47% |
| Brass | 19% |
| Zinc Alloy | 14% |
| Chemical | 9% |
| Misc. | 11% |

**Zinc prices ($ per tones):**




Source: LME

**Inventory Level:**
**(In '000 tones)**




Source: LME

The year 2006 was a sparkling one for base metals prices, owing to depleting inventories and higher demand from all corners amid numerous infrastructure growth plans. Zinc ranks fourth in world metal consumption behind iron, aluminum and copper. It is primarily used in protection against corrosion to building structures, vehicles, machinery and household equipment. About 50 per cent of the global zinc production is consumed by the galvanized steel industry. It is also used in pharmaceuticals, cosmetic products and agriculture sector. Robust global demand, coupled with falling inventory has resulted in tremendous growth in the price.

**Zinc prices**: The rising global demand from consumer industry and boom n industry coupled with falling inventory has given sharp rise in the prices e up by 175% to $4309 per tonne from $1570 in the Jan. 2006.

**Depleting inventory level:** The total inventory in the LME-registered warehouses fell to 88,955 tonne from 393300 in Jan. 2006, which is not equivalent to more than two days of global consumption. The global deficit of refined zinc supplies has reached around 5 lakh tonne by the end of CY06 as compared with 3.40 lakh tonne at the end of CY05, largely owing to strong Chinese imports of the non-ferrous metal.

**Chinese demand remain firm:** China represents 46% of the world zinc demand, which is expected to grow at the average rate of 7.5% Y-o-Y due to the demand from galvanized steel makers. We can expect firm demand in near future on account of robust growth in Chinese galvanized steel industry, whose capacity was approximately 2-2.5 million tonne in CY02, and has grown to about 9 million tonne currently.

**Outlook:**
We expect the prices could be firm in next year on account of depleting inventory level of LME stock, increasing demand of galvanized steel, and limited capacity addition. The zinc prices may touch a new high of $5000 per tones in FY07 and continue to remain firm during the year. Domestic market will also be buoyant in next year, which is growing at a rate of 8%, and the consumption has reached 455,000 tonnes, which is well ahead of the domestic production.

**Valuation Table:**

| Hindustan Zinc | Net Sales | Operating Profit | Net Profit | OPM% | NPM% | EPS | PE |
|---|---|---|---|---|---|---|---|
| FY06 (Rs. Cr) | 3877.0 | 2301.0 | 1472.0 | 59.3 | 37.9 | 34.8 | 23.7 |
| FY07E (Rs. Cr) | 8521.0 | 6782.0 | 4436.0 | 79.6 | 52.1 | 104.9 | 7.9 |

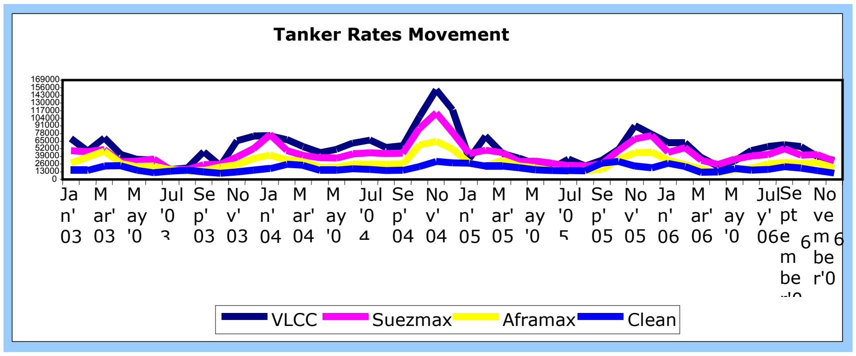
**Anagram StockBroking Ltd:** C-10, Laxmi Towers, Bandra Kurla Complex, Bandra (E), Mumbai 400 051
Regd. Office: Anagram House, Nr Commerce Roads Circle, Navrangpura, Ahmedabad – 380 009.

A Member of Lalbhai Group.

## Shipping & Associate Sector

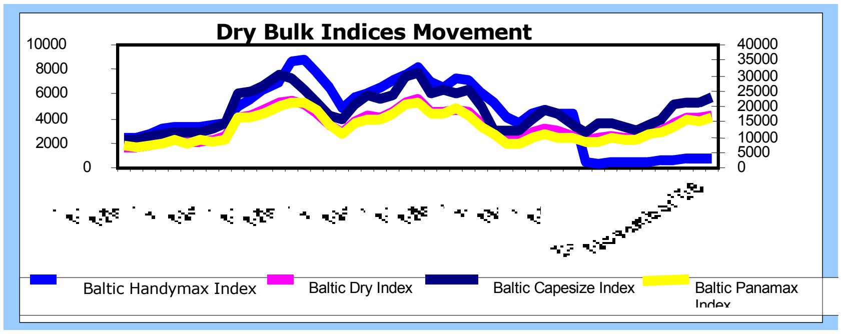
- **Dependent on Freight Rates**

  Shipping is a complex industry in character. Shipping companies' earnings are largely dependent on the freight rate. Freight rates have declined and we believe it to remain firm in the near term. For FY07 we see the earnings of shipping companies to be below our expectation but revenue may increase as new vessels will be added or sale of old vessels will add to other income, thus showing an increase in its total income. Dry-docking repairs of the vessels, which is periodically carried out every 2.5 years may also affect the revenue.




- **Dry Bulk segment looks promising**

  In Q2FY07, asset prices had moved up quite significantly but moved up much more in dry bulk to that in tankers, when compared to the end of Q2FY06 and current quarter of this year; across different asset classes. We believe the dry bulk markets to remain buoyant and will remain strong in the next two-three quarters on back of sustained growth in China. Also the shift in trade pattern towards BRIC countries is expected to positively influence the ton-mile demand. Currently the tanker rates are weak due to OPEC's decision to curb production, slowdown in the US and its comfortable inventory, but we believe it to pick up from December onwards.



**Offshore market**

- **Spurt in E&P activity**
  With surge in exploration and production activities (E&P), shipping companies have found an alternative course to beat the bearish sentiment of on-going global freight market. Shipping companies are set to make a foot in the off-shore oil exploration activity and are diverting their investments from ships to rigs, drill ships & supply vessels, which can command high day rate charges. Offshore business provides more higher visibility and lower volatility. Margins coming out of offshore would be better than that in marine sector. Perhaps that explains why there is heavy rush towards services development activities.
- **Aging fleet of Rigs**
  Oil companies are ramping up exploration and development activities that made little economic sense in the past. There is also a need to replace an aging fleet of rigs, as nearly 80% of them are more than 20 years old. To explore benefits from this increasing demand for rigs, the shipping companies have recently entered in offshore segment. Thus with the ever-increasing demand for energy all over the world, offshore exploration for oil and gas will remain an important activity for offshore and marine businesses.

**Shipbuilding**

- **Single Hull phase out plan - 2010**
  Phasing out of the single-hull vessels has been accelerated to 2010 from 2015, despite protest from a number of nations such as US and Japan. The gradual phase out of the single-hull is likely to keep the demand for shipbuilding strong hence we will see good rise in sales and profitability. Yards in India and worldwide have huge order backlogs at higher prices.
- **Poised for growth**
  Although Indian shipbuilding sector manufactures a fraction of the global output, we believe it is poised for growth and have gained a strong foothold in the niche offshore segment. We see the private players to build bigger conventional ships in future. There is a huge order book accompanied with capacity expansion simultaneously. Technology along with cheap conversion cost i.e. labour, yard etc. will enhance productivity and will bring down cost helping in timely and quality delivery which will then further give impetus to its order book and gain reputation.

**Investment concerns**

- Revenue of shipping companies are exposed to the volatility and cyclical nature of the industry. Further profitability in the shipping industry varies within different sectors on the industry.
- Offshore segment is capital-intensive. Companies servicing offshore sector are getting sidelined by foreign ships which are able to offer much lower rates since they can pick up cargo from offshore installations while on their way to other ports.
- Delay in capacity expansion/execution from the manufacturers side may hamper the production and may have to pay delay penalty.
- Earnings in US Dollar may be affected if the dollar depreciates, thus any weakening will impact the earnings.

| Company | Net profit (Rs Cr) | EPS (Rs) | P/E ratio | CMP |
|---|---|---|---|---|

| | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | (Rs) |
|---|---|---|---|---|---|---|---|---|---|---|
| Mercator Lines Ltd. | 178.2 | 192.7 | 204.0 | 9.4 | 9.8 | 9.5 | 3.6 | 3.5 | 3.6 | 34 |
| ABG Shipyard | 83.7 | 103.5 | 123.7 | 16.4 | 20.3 | 24.3 | 15.9 | 12.8 | 10.7 | 260 |
| Bharati Shipyard | 51.1 | 65.5 | 112.0 | 16.0 | 20.5 | 35.1 | 22.9 | 17.9 | 10.4 | 366 |

## Banking Sector

" *The RBI has raised repo and reverse repo rates by 75 bps and 50 bps, respectively, in the current financial year and is likely to continue with its "tightening" stance given the trends in monetary growth and inflationary expectations. It is expected to use various combinations of "CRR & policy rate hikes" to control the liquidity overhang in the system."*

- **Surprise move by RBI to hike the CRR**

Reserve Bank of India (RBI) has surprised the markets with 50 bps Cash Reserve Ration hike (CRR) hike from 5.0% to 5.5% planned in two stages, sucking out Rs 13,500 Cr from the banking system. The first hike has come in effect from 23rd December 2006 (that drained out Rs 6700 Cr from the banking system making Call rates zoom to 12.75%) and the second phase of the hike due on 6th January 2007. This RBI's decision was taken with the following objective in mind: -

1) **Inflation a growing Macro Concern:**
Curb down inflation. (y-o-y WPI inflation has risen from 4.1% at end-March 2006 to 5.3% as on November 25, 2006 higher than 4.5% per cent a year ago. Finance ministry says all possible measures will be taken as and when required to moderate inflation below 5% and towards 4%.

2) **Excess M3 also a growing concern:**
Moderating money supply and credit growth is a key task, where MS grew at 19.4% y-o-y against RBI's projection of 15%. YoY increase in non-food bank credit is 30.1% on November 24, 2006 on top of an increase of 31.1% a year ago. RBI's intervention in the forex market is the key reason for higher money supply growth.

3) **Stable GDP growth targeted:**
Maintaining condition of stability to support high GDP growth is the key objective of RBI. The real GDP growth rate rose to 9.2% during July-September 2006 and 9.1% in the first half of 2006-07.

***Effects on CRR hike a negative move for the banking sector:***

1) **Reduction in NIMs:**
This step is likely to affect the profitability of the banks by 4-5 bps, as excess deployment over 3% does not carry any interest rates.

2) **Upward pressure on interest rate:**
Moreover, this move has put upward pressure on banks' deposit rates (due to tightening of liquidity) and if banks do not pass on this increase in funding costs in the form of higher lending rates, it would put further pressure on the bank's NIMs. Pressure on liquidity is a key concern area as we may see interest rates rising (increase in yields) and slow down of the overall growth in the banking sector.

- **State bank of India Amendment bill introduced**

Finance Minister, P. Chidambaram introduced the State Bank of India (amendment) Bill, 2006, which proposes to: -

1) Allow SBI to issue preference and bonus shares. Although SBI can access the capital market by issuing equity shares or bonds, or by both equity share and bonds, there is currently no express provision under the SBI Act to enable SBI to issue preference shares and bonus shares.
2) Lower RBI's holding in SBI from 55% to 51%. Also to facilitate reduction of SBI's holding in its seven subsidiaries in a phased manner first to 55% and later to 51% thus enabling them to raise resources from markets.
3) Increasing the authorized capital of SBI to Rs 5,000 Cr, the Bill also proposes to enable the bank to increase issued capital by preferential allotment or private placement of equity or preference shares.

- **Deposit growth unable to keep pace with the on-going credit growth**

The deposit growth of the banking system is unable to keep pace with the ever-expanding demand for credit. The household sector, which contributes almost 75% of the gross domestic savings of the economy, remains the key source of deposits.

There will be competing claims for bank credit from sectors as diverse as infrastructure, housing, consumer credit, and retail besides the normal and expanding demand from industry, trade and agriculture.

- **Summary of S & P's Outlook for Indian Banking Sector for 2007**

1) ***Stable outlook for the Indian banking sector – on positive outlook***

2) **Continuation of strong economic growth – Credit Growth opportunities to remain**
   - Consumer credit continue to be key driver – housing loan growth in certain overheated markets to slowdown
   - Corporate credit growth to be maintained

3) **Consolidation to remain insignificant** – no progress on mergers among government owned banks

4) **Financial profile to be stable**
   - Absolute NPA to rise – seasoning effect on previous 3 years' growth
   - Capital raising to support growth and Basel II – hybrids to be favorites
   - Risk Management – work in progress

" *We see 2007 positive for banks due to high growth momentum, strong BV/EPS and attractive valuations* "

| S.no | Company | Net profit (Rs Cr) | | | ABV (Rs) | | | P/ABV ratio | | | CMP (Rs) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | FY06 | FY07E | FY08E | |
| 1 | State Bank of India | 4406.7 | 4571.6 | 5399.0 | 432.0 | 519.5 | 613.5 | 2.9 | 2.4 | 2.0 | 1246 |
| 2 | ICICI Bank Ltd. | 2540.1 | 3169.5 | 3840.3 | 237.5 | 263.2 | 295.0 | 3.7 | 3.4 | 3.0 | 889 |
| 3 | Bank of Baroda | 827.0 | 1002.4 | 1248.3 | 217.0 | 239.0 | 264 | 1.1 | 1.0 | 0.9 | 240 |
| 4 | Dena Bank | 73.0 | 151.0 | 176.7 | 32.0 | 39.0 | 44.0 | 1.2 | 0.9 | 0.8 | 37 |
| 5 | Karnataka Bank | 176.0 | 204.0 | 238.4 | 84.1 | 96.5 | 110 | 1.8 | 1.6 | 1.4 | 152 |

**Denso India Ltd (DIL)**
**CMP: Rs 96**
**Recommendation: Accumulate**

## Background and Business

DIL, a joint subsidiary of three Japanese companies, Denso Corporation *(47.93%)*, Sumitomo Corporation *(10.27%)* and Asmo Co Ltd *(5%)*, is into manufacturing electrical automotive equipment. The company manufactures alternators, motors (starters, wiper, fan, blower), CDIs and magnetos at its plant located in Uttar Pradesh. A zero debt company, DIL has a 35-40% market share. Its largest client in the auto industry is Maruti Udyog, which contributes to almost 50% of the company's total revenue. Maruti Udyog also has a 10.27% equity stake in the company.

## Investment Positives

- **Growth in customers' business:**
  DIL supplies its products mainly to domestic OEMs in the four- and two-wheeler segments, deriving 60% of its revenues from the four-wheeler segment and the balance from the two-wheelers. DIL's major customers in the four-wheeler segment include Maruti Udyog and Toyota. In the two-wheeler segment, DIL caters mainly to Hero Honda and Honda Motorcycles & Scooters, India. Overall, DIL derives 75-80% of its sales from Maruti Udyog and Hero Honda. Both these companies have chalked out ambitious cap-ex plans to increase their production capacities, which are expected to result in higher sales for DIL.

- **Japanese Investments to expand revenues:**
  India is being increasingly looked upon by Japan as a low cost manufacturing base. Bullish on their Indian operations, a majority of Japanese companies in India are planning to step up their investments in their Indian subsidiaries. Numerous Japanese companies in India are planning to expand their production capacities, enhance their product portfolio, target new consumer segments and increase market share in India. Going by the number of Japanese delegation visits to India in the near past, India now figures as a significant spot on the Japanese investment radar. The largest Japanese inflows have been in the auto sector with Maruti's US$ 700 mn, Toyota's US$ 128 mn and Honda Motorcycles' US$ 107 mn. Japanese automobile manufacturers Nissan and Suzuki of Japan have also announced a total investment of US$ 700-800 mn over the next three years.

  The Suzuki-Nissan deal to manufacture small cars of Nissan at Maruti Udyog's plant clearly displays the initiative towards a larger game plan. We believe these developments would work in favour of companies such as DIL, which is expected to capitalize on its established relationship with customers such as Maruti Udyog and other auto majors having substantial Japanese stakeholding.

- **Strong balance sheet and stable margins:**
  DIL is virtually a Zero Debt company. With a gearing ratio of 0.05x the company has tremendous opportunity to scale up by leveraging. On the operating front, the company has maintained its margins and has not suffered any major erosion even in the era of high raw material prices. Low gearing and strong cash flows have enabled the company to pay dividend consistently for several years now.

### Investment concerns

- **Intense competition among OEMs to put pressure on margins:**
  Competition among the OEMs is expected to intensify resulting in margin pressure. However, the demand for four-wheelers and two-wheelers is expected to continue to show an upward trend and the increasing volumes along with aggressive cost control initiatives are likely to offset the margin contraction.

- **Small Customer Base:**
  DIL's vulnerability to the fortunes of a single client (Maruti Udyog) is also a cause for concern. Added to this is the fact that Denso Corporation, Japan has four other subsidiaries in India — Denso Haryana, Denso Kirloskar, Denso Sales India and Denso Faridabad.

### Valuation

DIL is one of the cheapest MNC auto ancillary stock and trades at Rs 96 levels, which discounts its FY07 earnings by just around 10x. The outlook for the automotive-electrical parts sector looks bright as the parts are increasingly being used in motor vehicles. DIL, with a strong backing from its parent, is well positioned to take advantage of the emerging opportunities in the auto component space. DIL is virtually a zero debt company with a book value of Rs 50. We believe that the company's long-term growth prospects are sound and recommend an Accumulate rating on the stock with long-term perspective.

**Financial Snapshot:**

| Rs Cr | Q2FY07 | Q2FY06 | YoY (%) | Q1FY07 | QoQ (%) |
|---|---|---|---|---|---|
| Net Sales | 107.1 | 88.7 | 20.8 | 95.2 | 20.8 |
| Total Expenditure | 94.0 | 79.8 | 17.9 | 87.7 | 17.9 |
| Op. Profit | 13.1 | 8.9 | 47.2 | 7.6 | 47.2 |
| Other Income | 2.1 | 1.4 | 54.7 | 1.5 | 54.7 |
| PBIDT | 15.2 | 10.3 | 48.2 | 9.1 | 48.2 |
| Interest | 0.1 | 0.1 | -7.7 | 0.1 | -7.7 |
| PBDT | 15.1 | 10.1 | 49.0 | 9.0 | 49.0 |
| Depreciation | 3.3 | 3.4 | -5.5 | 3.3 | -5.5 |
| Tax | 4.2 | 2.4 | 76.1 | 2.0 | 76.1 |
| PAT | 7.7 | 4.3 | 77.5 | 3.6 | 77.5 |
| | | | | | |
| EPS (in Rs) | 2.7 | 1.5 | 77.5 | 1.3 | 77.5 |
| Equity | 27.9 | 27.9 | 0.0 | 27.9 | |
| Face Value | 10.0 | 10.0 | | 10.0 | |
| | | | | | |
| **Margins (%)** | | | | | |
| OPM | 12.2 | 10.0 | | 7.9 | |
| NPM | 7.1 | 4.9 | | 3.8 | |

**BOC India Ltd.**
**CMP: Rs 166**
**Recommendation: Accumulate**

BOC India, the largest industrial gas producing and engineering company in India is a 54.8% subsidiary of the US$ 6 bn BOC Group Plc, UK, the second largest industrial gases company in the world, and Linde Group. The steel sector contributes to more than 70% of the revenue of the company and the rest comes from industries such as fertilizers, refinery, pharmaceutical, automobiles, agriculture, chemicals, medical and food processing.

**Capex up-cycle poised to drive the growth:** The domestic as well as foreign companies have proposed to invest more than Rs 4 lakh Cr over the years in Indian steel sector. As the steel industry is the major consumer of gas, BOC will witness a sustained rise in demand going forward. The company has also specialization in setting up air separation units (ASUs), which are an integral part of any large steel project, offering it direct upside from the accelerated Capex up-cycle in the steel sector.

**Long-term contract with JSW Steel:** BOCI had set up a special purpose vehicle, Bellary Oxygen Company Pvt. Ltd, for implementing and operating long-term gas supply of 855 tonnes per day to JSW Steel. The company has also signed a long-term gas supply contract with JSW Steel Ltd. for supply of over 3,000 tonnes per day of gaseous oxygen, nitrogen and argon to meet JSW Steel's demand for gases arising from the expansion of their steel making capacity at Bellary. For this purpose and to cater to the growing south Indian market, the Company will be setting up an on-site Air Separation Unit at JSW Steel works at Bellary, which will be commissioned in 2008.

BOC India also commissioned a state-of-the-art liquid compression facility at a greenfield site in Pune. A special gases manufacturing facility was also commissioned at the new site in Taloja keeping in mind the growing demand of such gases in the country.

**Synergy of global parents:** BOC India is now a member of Linde Group after the acquisition of BOC group. Linde group is the world leader in industrial gases and engineering with more than 53,000 employees working in 70 countries worldwide and BOC group is the second largest industrial gases company in the world. So the strong global parents will provide synergy and better opportunity for growth.

**Open offer:** Post acquisition of BOC group as per SEBI, Linde AG will have to make a mandatory 20 per cent open offer to the public as it will own and control BOC Group Plc's 54.8 per cent Indian subsidiary - BOC India.

**Opportunity in Project engineering division:** The project engineering division has shown a growth of 107% in sales to Rs 207 Cr during FY06. The company has bid for large projects in the steel and petrochemicals sector and we would expect materialization of some of the projects, which will drive the future growth of this division.

**Valuation:** At the CMP of Rs 167, the scrip is trading at the PER of 12.8x its FY07E earnings. Looking at the investment in cap-ex of steel sector, synergy of global parents, long-term contracts and opportunity in project engineering division, we expect the company, as the largest gas producing and engineering company in India, will provide good investment opportunity in the long term. So we would give a BUY rating for the stock with a long-term perspective.

**Financial Snapshot:**

| Rs Cr | FY06 | FY05 | % Change | HY1FY07 | HY1FY06 | %Change |
|---|---|---|---|---|---|---|
| Net Sales | 522.2 | 384.7 | 35.7 | 233.1 | 199.8 | 16.7 |
| Other Income | 59.0 | 6.6 | | 31.7 | 48.3 | |
| PBIDT | 150.3 | 75.8 | 98.4 | 72.5 | 88.4 | -18.0 |
| Operating Profit | 91.4 | 69.2 | 32.1 | 40.8 | 40.0 | 1.9 |
| RPAT | 78.6 | 28.0 | 181.1 | 40.3 | 52.4 | -23.0 |
| Adj. PAT | 51.7 | 26.8 | 92.7 | 23.5 | 18.9 | 24.5 |
| EPS | 16.0 | 5.7 | 181.1 | 8.2 | 10.7 | -23.0 |
| Adj. EPS | 10.5 | 5.5 | 92.7 | 4.8 | 3.9 | 24.5 |
| **Margin** | | | | | | |
| OPM% | 17.5 | 18.0 | | 17.5 | 20.0 | |
| NPM% | 9.9 | 7.0 | | 10.1 | 9.5 | |

**Zuari Industries Ltd.**
**CMP: Rs 182**
**Recommendation: Accumulate**

**Zuari** draws its name from the river Zuari that flows near its plant before mingling with the muddied but relatively quite waters of the Arabian Sea. Apart from this location in Goa, the company also operates the Paradeep Phosphates plant in Orissa. ZIL holds 51% in Zuari Maroc Phosphates Ltd (ZMPL), which in turn holds 80% in Paradeep Phosphates. ZIL and ZMPL together make DAP, Ammonia, Urea and NPK fertilizers.

On the face of it, ZIL is fairly valued. Currently it trades at 14.5 times its trailing twelve month earnings of Rs 12 per share, which is much more than what a fertiliser company should command. Dig a little deeper and you would know why Zuari is a value buy at current levels.

ZIL sold its share in the 2.1 million tonne plant of Zuari Cements for a consideration of Rs 600 Cr in June this year. Assuming a worst case of scenario where the company pays tax at the highest rate of 33.6% on the profit of Rs 386 Cr the tax out go will be Rs 130 Cr and we would be left with cash of Rs 470 Cr, which means cash per share of Rs 157.

Then ZIL holds 538.39 lakh shares in Chambal Fertilisers and 3.4 lakh shares in Texmaco, both group companies. At Dec 27 valuations, these investments adds up to Rs 80 per share.

Similarly, Zuari Investments, which is a 50% subsidiary of ZIL holds, 28.96 lakh shares of Texmaco, which are valued at Rs 332 Cr. ZIL's 50% share comes to Rs 186 Cr, which would mean Rs 55 per share of investments.

The investments come to Rs 80+55=Rs 135 per share. Prudence demands that these be valued at 50%, which gives you Rs 66 per share. Add to that the Rs 157 per share cash and you have Rs 157 + Rs 66 = Rs 223 per share of cash or cash equivalents.

There are host of other subsidiaries too. Indian Furniture Products Ltd, Zuari Seeds Ltd, Simon India Ltd, Zuari Indian Oil Tanking Ltd and Style SPA Furniture Ltd. Style SPA has around 90 branches in the country. We have not valued these companies at all in our investment argument.

Both the plants, Zuari and Paradeep come with good locations. Paradeep Phosphates is located in the port town of the same name in coastal Orissa, with a sprawling 2200-acre campus, where it also has a private jetty.

ZIL's main plant is strategically located near the Zuari river, just 5 km away from the Goa Airport. Of the 1100 acre land, the plant occupies around 130 acres and the Birla Institute of Technology and Science (BITS) Goa campus uses some portion.

What are the negatives? Zuari's plant is based on Naphtha, which is not so cost effective. The stock lacks continued liquidity.

ZIL is essentially an under owned stock, with the MFs holding at 4.8% and FIIs holding at 0.69%. This augurs well.

With around more than Rs 220 per share in terms of cash or cash equivalents, the stock is a value buy for the long-term investor, as the two plants with huge tracts of unused land and many subsidiaries come for free at the current price of Rs 174.

**Financial Snapshot:**

| (Rs Cr) | Q2FY07 | Q2FY06 | YoY (%) | Q1FY07 | QoQ (%) |
|---|---|---|---|---|---|
| Net Sales | 767.2 | 644.3 | 19.1 | 519.4 | 47.7 |
| Total Exp. | 729.7 | 608.1 | 20.0 | 499.8 | 46.0 |
| Operating Profit | 37.4 | 36.2 | 3.5 | 19.5 | 91.9 |
| Other Income | 12.5 | 12.8 | -2.7 | 360.4 | -96.5 |
| EBIDTA | 49.9 | 49.0 | 1.9 | 379.9 | -86.9 |
| Interest | 7.8 | 10.8 | -27.2 | 14.7 | -46.7 |
| PBDT | 42.1 | 38.2 | 10.0 | 365.2 | -88.5 |
| Depreciation | 4.3 | 4.0 | 7.8 | 4.3 | 0.0 |
| Tax | 1.1 | 0.5 | 109.6 | 11.6 | -90.6 |
| RPAT | 38.6 | 33.7 | 14.7 | 349.3 | -88.9 |
| Extra-ordinary Item | 0.0 | 0.0 | | 345.1 | - |
| APAT | 38.6 | 33.7 | 14.7 | 4.2 | 820.0 |
| EPS (ann.) | 52.5 | 45.8 | | 5.7 | |
| Margins (%) | | | | | |
| OPM | 4.9 | 5.6 | | 3.8 | |
| NPM | 5.0 | 5.2 | | 0.8 | |

**Hitachi Home & Life Solutions (I) Ltd.**
**CMP: Rs 94**
**Recommendation: Accumulate**

- Hitachi Home & Life Solutions (I) Limited (HHIL) is a leading manufacturer of air-conditioners, refrigerators and other durables. It has a technical collaboration with ***'Hitachi Japan'*** that holds 69.9% equity in the venture. Japanese major Hitachi has successfully turned around the ailing Indian subsidiary by cutting costs; hiking sales through new product launch and by improved marketing initiatives.

- HHIL offers home & commercial air conditioners, refrigerators and washing machines. The company has turnaround in FY05 supported by a change in business mix by rising share of traded AC in overall sales mix. Globally, Hitachi group is reorganizing its business divisions to merge air conditioning and electronic business with an aim to mainly capture growth in BRIC countries, other parts of Asia and Europe.

- HHIL is positive about India's growth potential and is amongst the fastest growing markets especially for Hitachi products and is aiming to increase its business significantly by expanding its reach in 2006. It believes that with an increasing awareness about technology, Indian consumers will move to the premium products segment. With increasing disposal incomes, AC is recognized as a necessity also with increasing focus on power supply, easy finance and hot summers, the Rs 5000 Cr Indian AC industry (room & central approx. as on June, 2006) has entered into a high growth trajectory, which is expected to grow at 15-20% over the next few years.

- In Q2FY07, the HHIL's sales was Rs 61.2 Cr against Rs 46.1 Cr in the same quarter last year, up by 33%. Net Profit rose 802% to Rs 3.1 Cr from Rs 0.3 Cr in Q2FY06. For H1FY07, net sales stood at Rs 177.2 Cr vis-à-vis Rs 145.8 Cr in the corresponding half of the previous year. Net Profit rose 25.8% to Rs 11.9 Cr from Rs 9.49 Cr in H1FY06.

- **Valuation:** Hitachi Home & Life Solutions Limited is a niche player in the Indian AC industry having technology based innovative products. The company has turnaround in FY05 supported by a change in business mix by raising share of traded AC in the overall sales mix. Globally, Hitachi group is reorganizing mainly to capture growth in BRIC countries, other parts of Asia and Europe.

Global reorganization of Hitachi group, transfer of technology and cost efficiencies will lead to further improvement in margins. At the CMP of Rs 94/- the stock is trading at 9.0x its H1FY07 annualized earnings, which is quite attractive on a peer group comparison. We recommend an accumulate rating on the stock with a long-term perspective.

**Financial Snapshot:**

| Rs Cr | Q2FY07 | Q2FY06 | YoY (%) | Q1FY07 | QoQ (%) |
|---|---|---|---|---|---|
| Net Sales | 61.2 | 46.1 | 32.8 | 116.1 | -47.3 |
| Total Expenditure | 57.6 | 44.9 | 28.5 | 105.2 | -45.2 |
| Operating Profit | 3.5 | 1.2 | 196.6 | 10.9 | -67.6 |
| Other Income | 1.7 | 0.8 | 100.0 | 1.3 | 30.7 |
| PBIDT | 5.2 | 2.0 | 156.9 | 12.2 | -57.3 |
| Interest | 0.6 | 0.6 | -3.1 | 0.8 | -20.5 |
| PBDT | 4.6 | 1.4 | 231.2 | 11.4 | -59.8 |
| Depreciation | 1.0 | 1.0 | 6.3 | 1.3 | -20.9 |
| Tax | 0.4 | 0.0 | - | 1.1 | -65.2 |
| Fringe Benefit Tax | 0.1 | 0.1 | 12.5 | 0.1 | 0.0 |
| RPAT | 3.1 | 0.3 | 802.9 | 8.9 | -65.4 |
| Equity | 22.96 | 22.96 | | 22.96 | |
| EPS (Rs annual) | 5.3 | 0.6 | | 15.5 | |
| **Margins (%)** | | | | | |
| OPM | 5.8% | 2.6% | | 9.4% | |
| NPM | 5.0% | 0.7% | | 7.6% | |

**Satyam Computer Services**
**CMP: Rs 490**
**Recommendation: Accumulate**

Satyam is a leading global and IT services company, having excellent domain competencies in verticals such as Automotives, Banking & Financial Services, Insurance & Healthcare, Manufacturing, Telecom – Infrastructure – Media –Entertainment - Semiconductors (TIMES).

**Industry dynamics for IT/ITES to favour the company:** As per NASSCOMM Review Report 2006, total addressable market for global offshoring in IT/ITES space is approximately US$ 300 bn, of which US$ 110 bn will be offshored by 2010. India has the potential to capture more than 50% of this opportunity. IT solutions space is expected to grow by 25% CAGR to US$ 35 bn by 2010 and ITES space is likely to grow by 37% CAGR to US$ 25 bn by 2010. Thus, offshoring business is on a growth trajectory and major IT players like Satyam Computers, which are present across the IT value chain, would capture this opportunity.

**Dominant presence in the Enterprise solutions space:** Satyam derives 40% of its revenues from Enterprise solutions space compared to 17% for Infosys, 12% for TCS and 11% for Wipro. The spending in this space will continue due to cost advantages. Thus the revenue visibility in this space is intact and Satyam plans to target 85 clients by 2010 from 55 clients currently. This practice would have nearly 10,000 employees by 2010 from 3,400 at present.

**Improving performance of subsidiaries:** Performance of Satyam's BPO subsidiary (Nipuna) is improving. In Q2FY07, it showed a net loss of Rs 4.77 Cr compared to loss of Rs 6.15 Cr in Q1FY07 and loss of Rs 10.63 Cr in Q2FY06. It continues to enhance its portfolio of services, and therefore it is estimated to improve significantly. All other subsidiaries are showing steady growth.

The total active clients have increased to 504 (489 in Q1FY07). Pricing environment remains to be firm with new deals coming at slightly higher billing rates. The company is also expanding its services in China, which will act as a near shore set up for its clients based out of Hong Kong & Japan. Thus, the business momentum is expected to continue on the back of new clients addition and expected deals in the coming quarters associated with increased billing rates.

The EPS for FY07 and FY08 is estimated to be Rs 22 & Rs 27 respectively. At the current price of Rs 490, the stock trades at 22x its FY07E EPS and 18x its FY08E EPS, which is attractively priced. Considering the growth potential from new verticals, we recommend an Accumulate rating on the stock.

**Financial Snapshot:**

| (Rs Cr) | Q2FY07 | Q2FY06 | YoY (%) | Q1FY07 | QoQ (%) |
|---|---|---|---|---|---|
| Net Sales | 1601.9 | 1155.0 | 27.9 | 1442.9 | 9.9 |
| Other income | 28.2 | 31.6 | -11.8 | 74.5 | -163.8 |
| Total exp | 1239.4 | 880.5 | 29.0 | 1087.9 | 12.2 |
| Operating profit | 362.5 | 274.4 | 24.3 | 355.0 | 2.1 |
| PBIDT | 390.7 | 306.0 | 21.7 | 429.5 | -5.3 |
| Interest | 2.7 | 0.8 | 71.7 | 2.6 | 6.3 |
| PBDT | 388.0 | 305.2 | 21.3 | 426.9 | -11.6 |
| Depreciation | 37.5 | 34.7 | 7.5 | 36.2 | 3.6 |
| PBT | 350.5 | 270.5 | 22.8 | 390.8 | -11.5 |
| Tax | 43.2 | 33.3 | 23.0 | 36.8 | 14.9 |
| Adj. PAT | 319.8 | 237.3 | 25.8 | 354.1 | -10.7 |
| EPS (Rs) | 4.9 | 3.6 | | 5.4 | |
| Equity | 131.4 | 131.4 | | 131.4 | |
| | | | | | |
| Margins (%) | | | | | |
| OPM | 22.6 | 23.8 | | 24.6 | |
| NPM | 20.0 | 20.5 | | 24.5 | |

**Bayer Cropscience**
**CMP: Rs 264**
**Recommendation: Accumulate**

Bayer CropScience Limited, erstwhile Bayer (India) Limited, an Indian subsidiary of Bayer Germany, is into manufacturing of crop protection products and environmental science. Bayer CropScience is divided into 3 business groups: Crop Protection, Environmental Science and Bioscience. The company has production facilities in Thane, Himmatnagar and Ankleshwar. With the acquisition of Aventis Crop Science by Bayer Group in October 2001, the company was renamed as Bayer CropScience. With this acquisition Bayer CropScience is the largest agro-chemical company in India covering a wide span of crop protection activities.

Recently, the Bayer group decided to integrate the seeds business under Bayer CropScience. Initially, the integration will be in the area of sales and general administration. The seeds business has been growing tremendously in India. The company intends to more intensively exploit the long-term potential for growth in the global agriculture market. With a view to this objective, the company plans to increase its commitment to Research & Development and the dynamically growing seed business. The company estimates that the expanding business with commercial seeds will be one of the strongest growth drivers in the global agriculture market.

The company's seed business and seed treatment products are already benefiting from the growth of the commercial seeds market. In the future, the company intends to foster strong growth by gaining access to new geographical markets and extending its seed business to include new crops, such as oilseeds, food and feed crops.

Bayer has decided to cease production at its Thane Plant in the course of 2007 and shift it to the facilities at Ankleshwar. The land at Thane is spread across 112 acres with Bayer occupying near 75% of the land, which could be valued at a minimum of Rs 10-12 bn (approx Rs 250 – 300 per share). Bayer's Thane Plant is located in a residential belt, which makes it unfeasible to continue the operation, which may lead to possible sale of land in 2007. If land sale happens it will provide huge cushion to investors.

During last year, the Company obtained registration of 3 new products, viz. "Calypso", "Drado" & "Protega", and full registration of "Atlantis", which was previously under provisional registration. These products have been successfully launched and are expected to provide steady growth to overall business performance in the coming years.

Bayer CropScience AG is divesting its products and investing into higher margins business. Recently it sold its herbicide Asulam and insecticides Trichlorofon and Oxydementon to United Phosphorus. The combined purchase prices totalled 43.5 million EUR (approx Rs 250 Cr) including inventories. Bayer CropScience has retained certain rights related to non-agricultural uses in strategic markets.

## Valuations

At CMP of Rs 264, the stock is trading at 24x its TTM EPS of Rs 11. We expect the company to garner better market share due to new product launches with the help of strong R&D of the parent. The pesticides usage is on an increasing trend in India. Further, with increased usage of herbicides, which gives higher margins vis-à-vis insecticides, the company is expected to witness better margins. Integration of seed business into the company will also result into robust operational performance going ahead. The land sale will also be a next key trigger whenever the deal gets materializes.

**Financial Snapshot:**

| **PARTICULARS** | **Q3CY07** | **Q3CY06** | **YoY (%)** | **Q2CY07** | **QoQ (%)** |
|---|---|---|---|---|---|
| Net Sales | 261.6 | 216.7 | 20.7 | 146.1 | 79.1 |
| Total Expenditure | 213.2 | 186.7 | 14.2 | 135.5 | 57.3 |
| Operating Profit | 48.4 | 30.0 | 61.4 | 10.6 | 357.6 |
| Depreciation | 5.5 | 5.8 | | 5.5 | |
| PBIT | 42.9 | 24.2 | 77.2 | 5.1 | 741.0 |
| Interest | 2.3 | 1.7 | | 1.9 | |
| PBT | 40.6 | 22.5 | 80.1 | 3.2 | 1172.1 |
| Other Income | 6.8 | 17.4 | -60.9 | 11.1 | -38.8 |
| PBT + OI | 47.4 | 39.9 | | 14.3 | |
| Tax | 16.8 | 13.9 | | 5.1 | |
| PAT | 30.6 | 26.0 | 17.6 | 9.2 | 232.0 |
| Equity | 39.5 | 39.5 | | 39.5 | |
| EPS (Ann) | 31.0 | 26.3 | | 9.3 | |
| | | | | | |
| **MARGINS (%)** | | | | | |
| OPM | 18.5 | 13.8 | | 7.2 | |
| NPM | 11.7 | 12.0 | | 6.3 | |

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**RATING INTERPRETATION**
**Buy** Expected to appreciate more than 20% over a 12-month period
**Accumulate** Expected to appreciate up to 20% over a 12-month period
**Hold** Expected to remain in a narrow range
**Avoid** Expected to depreciate up to 10% over a 12-month period
**Exit** Expected to depreciate more than 10% over a 12-month period

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