investor's eye

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October 27, 2006

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
BEL	26-Sep-06	1,108	**1,138**	1,525
ICICI Bank	23-Dec-03	284	**758**	770
India Cements	28-Sep-06	220	**222**	315
ITC	12-Aug-04	69	**188**	220
TV18	23-May-05	214	**710**	*

*Target under review

Sharekhan Special

Monetary policy preview

RBI's dilemma: to hike or not to hike

We believe the Reserve Bank of India (RBI) will find it difficult to choose between *one more interest rate hike* and *a pause in the rate hike exercise* when it meets on October 31, 2006 for the mid-term review of its Annual Monetary Policy 2006-07. It would be a tough call for the apex bank for several reasons.

While the softening oil prices, the pause by the US Federal Reserve (Fed) in its interest rate hike exercise and India's wish to move to a higher growth trajectory demand a pause, the country's strong economic growth and higher inflation rate make out a case for another rate rise. Besides, with the next quarterly review of the monetary policy scheduled very close to the state elections in Uttar Pradesh and Punjab, it makes more sense for the RBI to act now rather than then.

The opinion on the streets also seems divided with the recent polls conducted amongst the capital market players and bankers showing that while some favour a pause, the others prefer a hike.

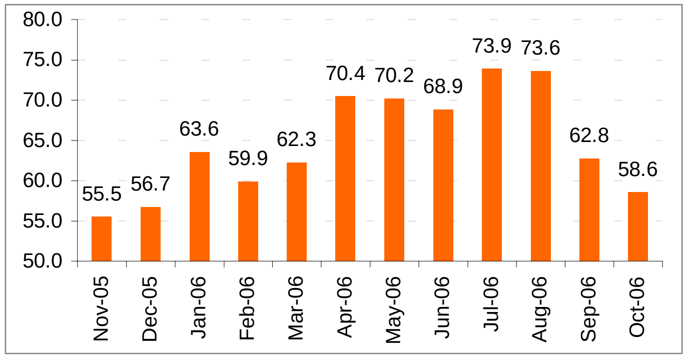
We believe that if the RBI resorts to a rate hike on October 31, it will be slightly negative for the equity markets in general and for the banking sector in particular in the short term. The short-term interest rates have already tightened over the last few weeks. In the near term, liquidity shall face more pressure, what with the October-December quarter being a festive season, when credit disbursals are high. As the longer-term yields have not moved in tandem with the short-term yields, we believe that the possibility of another rate hike has been only partly factored in by the bond market.

Global factors favour a pause

Softening oil prices

The crude oil prices have come down by 25% from their peak levels of $78.63 per barrel (bbl) in August 2006. The average Brent crude oil price for October 2006 is at $58.6 per bbl compared with that of $62.8 per bbl for September 2006 and $70+ per bbl for July and August 2006.

Brent crude oil price ($/bbl)



The RBI has recognised rising crude oil prices as one of the major threats to global as well as domestic economic growth, and the softening crude oil prices make out a case for a pause.

Fed stops its rate hike exercise

CY2006 has seen central bankers across the world tightening their interest rates and this was one of the reasons why our own apex bank went for an unexpected interest rate hike in June 2006 (see our note "RBI raises repo rates unexpectedly" dated June 09, 2006).

However, the world's largest and perhaps most influential central bank, the Fed, took a pause from its interest rate increase exercise on August 09, 2006. It has kept the target Fed fund rate unchanged at 5.25% since then.

India's wish to move to higher growth trajectory

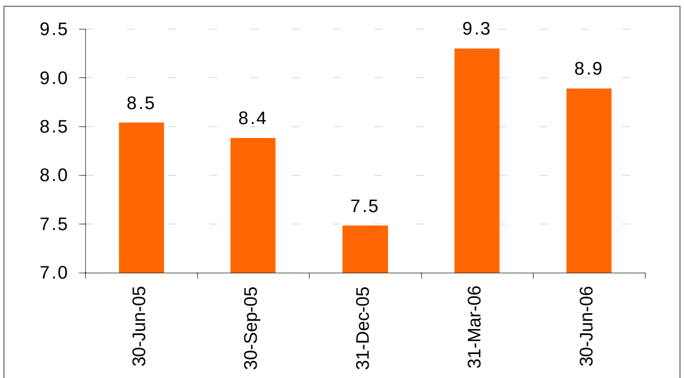
After achieving a 7.5% growth in its gross domestic product (GDP) over the last three years, India appears hungry for more. The same is evident from the Planning Commission's proposal to set the target GDP growth rate at 10% for the 11th Five-Year Plan. While the target looks ambitious, the same would require heavy investments in infrastructure (like undertaken in China) and higher interest rates would sure be an impediment to growth.

Domestic factors favour a hike

Domestic growth on a higher plane

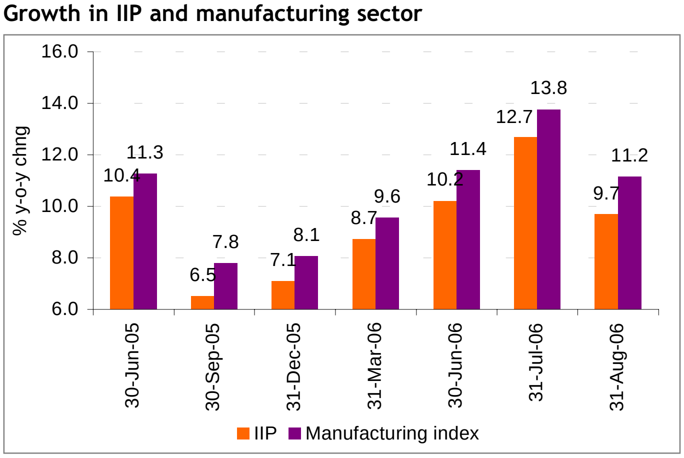
The growth in the economy is just getting better each quarter and each month. The growth in India's GDP continued unabated at 8.9% year on year (yoy) for Q1FY2007 after a robust growth of 7.9% for FY2006. The Index of Industrial Production (IIP) has seen a rise of 10.7% till August 2006 compared with an 8.7% growth in the same period last year. Amazingly, despite the floods in several parts of the country during August 2006, the IIP grew by a strong 9.7% yoy and the manufacturing sector grew at a faster clip of 11.2%.

GDP growth (% y-o-y change)



Source: MOSPI

Growth in IIP and manufacturing sector



Source: MOSPI

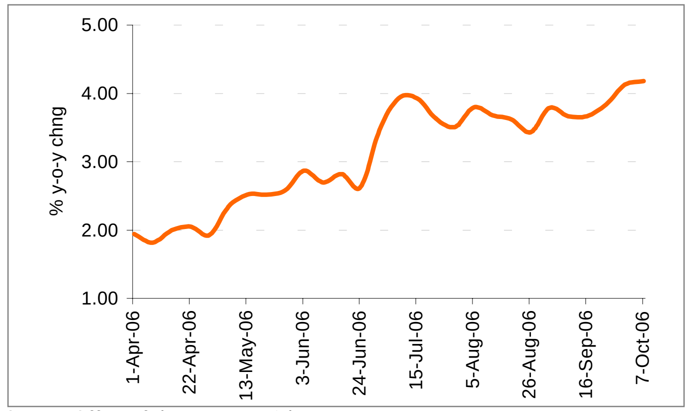
Inflation on its way up

For much part of FY2007, inflation has remained benign. However, over the past few weeks the same has moved up. All the three main components of the commodity baskets, primary articles, fuel, oil and lubricants and manufactured articles have seen an upward bias. The resulting concern is visible in the statements of the governor of the RBI:

"We are most concerned about the inflationary expectations. Unless there is a convincing reason that oil prices are easing off on a sustained basis, the inflationary expectations will not be significantly altered"

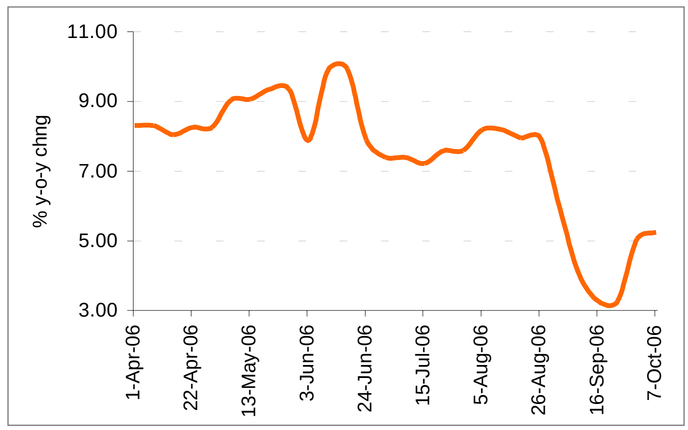
- YV Reddy, Governor, RBI

Inflation ups ante—manufactured articles



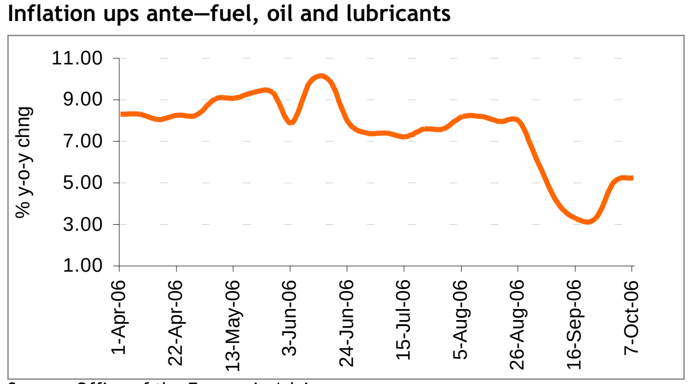
Source: Office of the Economic Adviser

Inflation ups ante—primary articles



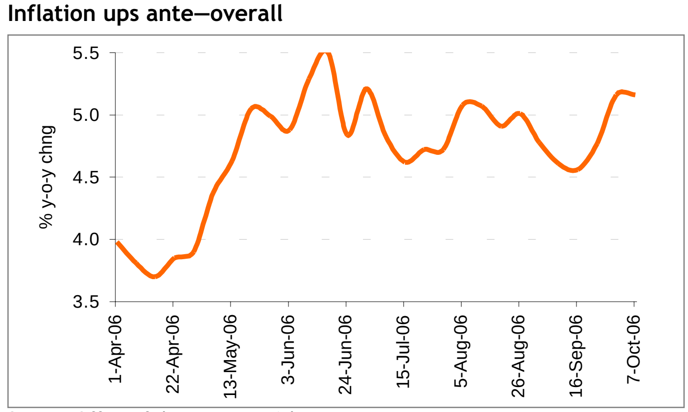
Source: Office of the Economic Adviser

Inflation ups ante—fuel, oil and lubricants



Source: Office of the Economic Adviser

Inflation ups ante—overall

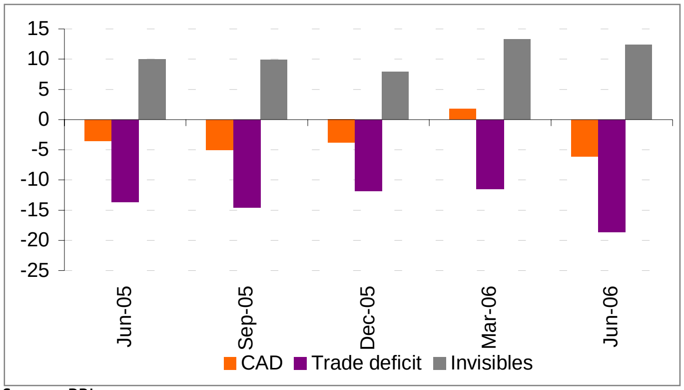


Source: Office of the Economic Adviser

Current account deficit has moved up

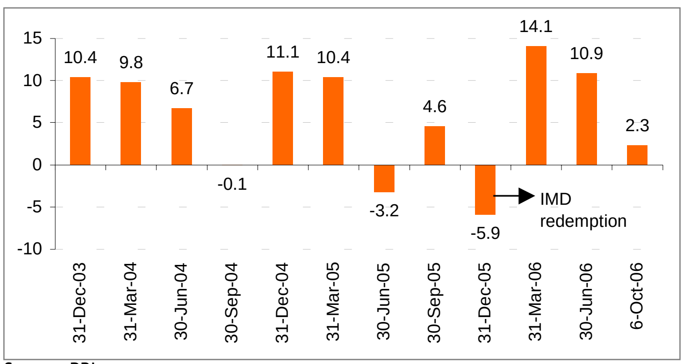
India's current account deficit widened to $6.1 billion in Q1FY2007 from $3.5 billion in Q1FY2006, far ahead of our and consensus expectations. The deterioration of the current account has more than offset the gains made on the capital account front, thereby slowing down the accretion to the foreign exchange (forex) reserves of the country.

Current account deficit widens for Q1FY2007 (US$ billion)



Source: RBI

Accretion to forex reserves slowing down (US$ bn)



Source: RBI

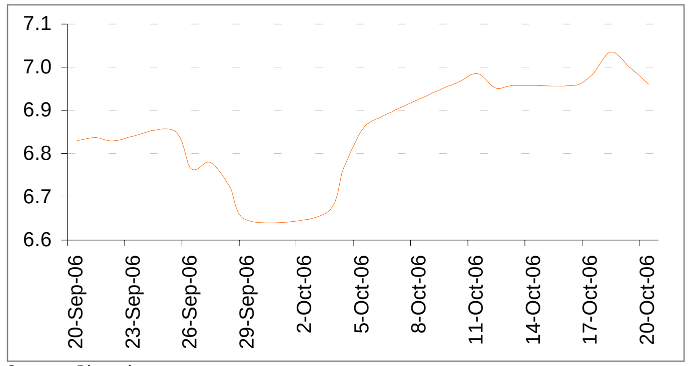
State elections may prompt a move now

State elections are lined up in several states like Uttar Pradesh, Punjab and Uttaranchal in early CY2007. The RBI's next quarterly review of the Annual Monetary Policy 2006-07 is scheduled on January 30, 2007 which would be very near to the election dates. For obvious reasons the central government would want the RBI to make a move now rather than during the elections.

Yields up but rise may be seasonal

The short-term bond yields have already moved up by 31 basis points from their recent bottom of 6.645% on September 29, 2006.

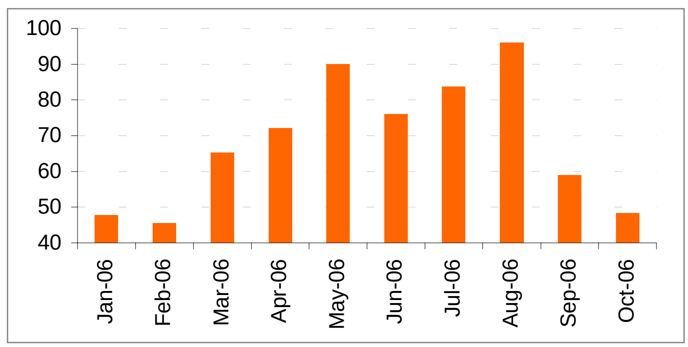
Short-term yields moving up—one-yr bond yield (%)



Source: Bloomberg

The yields may have increased partly because the bond market participants are likely to have started factoring in another rate hike. However the other reason could be that traditionally yields tend to tighten during festive seasons like *Diwali* and Christmas when loan disbursals are higher and liquidity tight. The excess liquidity in the system has come down dramatically, thereby exerting pressure on the short-term interest rates. As the longer-term interest rates haven't moved up much in tandem, another rate hike seems to have been factored in by the bond market only in part.

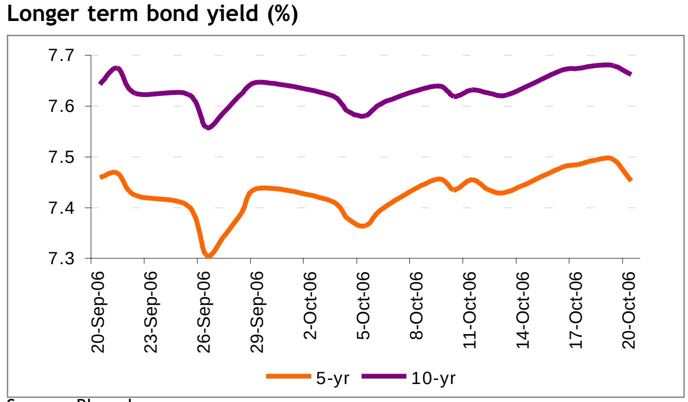
Tightening excess liquidity (Rs'000 crore)



Source: RBI

Note: Excess liquidity includes the central government balances, market stabilisation bonds and balances under liquidity adjustment facility.

Longer term bond yield (%)



Source: Bloomberg

Esab India

Vulture's Pick

Stock Update

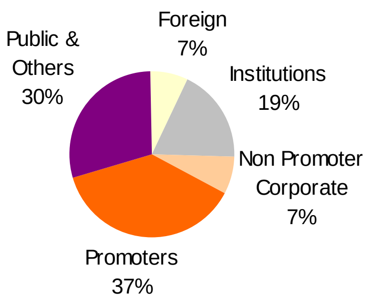
Impressive numbers

Buy; CMP: Rs360

Company details

Price target:	Rs575
Market cap:	Rs554 cr
52 week high/low:	Rs553/237
NSE volume: (No of shares)	20,396
BSE code:	500133
NSE code:	ESABINDIA
Sharekhan code:	ESAB
Free float: (No of shares)	96 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	5.8	11.8	-26.0	5.3
Relative to Sensex	2.6	-6.8	-31.3	-34.8

Result highlights

- Esab India's Q3CY2006 results are good and in line with our expectations. In the quarter the company achieved the much-needed top line growth aided by both its businesses, ie equipment and consumables.
- The top line for the quarter grew by a handsome 26% year on year (yoy) to Rs81 crore, driven by a 24.3% growth in the consumable segment and a 30.7% growth in the equipment segment.
- The operating profit for the quarter grew by a decent 24% to Rs20.33 crore, driven by a 29.5% growth in the earnings before interest and tax (EBIT) of the consumable segment.
- The overall operating profit margin (OPM) declined by 40 basis points primarily because of a 420-basis-point decline in the EBIT margin of the equipment division. The division incurred significant overheads in expanding its capacity during the quarter. The new unit has just started operations and gradually as the revenues of the division begin to move up as a result of the additional capacity, the margins would improve again.
- However the EBIT margin of the consumable division improved by 120 basis points and stood at 30.1%, the highest in the last 10-12 quarters.
- The other income for the quarter grew by 200% to Rs1.23 crore primarily because of the commission earned from its parent Esab AB, Sweden, on an ISRO order secured earlier this year.
- With the depreciation charge remaining flat yoy (an increase of 14% sequentially because of the commissioning of the new equipment plant), the net profit for the quarter grew by an impressive 26.7%.

Result table Rs (cr)

Particulars	Q3CY06	Q3CY05	% yoy	M9CY06	M9CY05	% yoy
Net sales	81.0	64.3	26.0	208.5	178.8	16.7
Stocks	1.6	-4.3		0.6	-9.1	
RM consumed	38.3	32.3		98.7	89.1	
Purchases-FG	7.4	7.3		20.9	17.3	
Staff cost	4.4	3.2		12.0	10.9	
Other expenditure	8.9	9.4		26.5	26.8	
Total expenditure	60.6	47.9	26.7	158.8	135.2	17.5
Operating profits	20.3	16.4	24.0	49.8	43.6	14.2
Other income	1.2	0.4	200.0	3.6	2.3	56.7
EBIDTA	21.6	16.8	28.3	53.4	45.9	16.3
Interest	0.1	-0.5	-123.4	0.4	-1.1	-134.3
Depreciation	1.2	1.2	4.3	3.3	3.4	-3.5
EBT	20.2	16.1	25.5	49.7	43.5	14.2
Tax	7.0	5.7	23.4	17.1	15.6	10.0
EAT	13.2	10.4	26.7	32.6	28.0	16.5
Extraordinary items	0.0	4.5		0.0	4.5	
Tax on extraordinary items	0.0	1.0		0.0	1.0	
Profit after extraordinary items	13.2	13.9		13.2	31.5	
Operating margins (%)	25.1	25.5		23.9	24.4	
EATM (%)	16.3	16.2		15.6	15.6	

Esab's Q3CY2006 results are in line with our expectations. The top line of both the businesses, ie the consumable and equipment divisions, saw an impressive growth during the quarter. The growth was driven by the hectic activity in India's core infrastructure sectors, like roads, ports, airports and construction, and the industrial sectors. Also, the company is showing a strong improvement in its profitability with the margin of the consumable division at a two-year high and that of the equipment division all set to improve.

The company's capital expenditure (capex) plan to set up an equipment factory has been completed. On a fully operation a basis this new plant can contribute Rs60 crore to the top line. Further, the company plans to launch certain high-end consumables, with technological help from its parent. The company expects the new products to contribute approximately 10% to its top line.

The new product launches and the additional equipment capacity would help the company maintain the growth momentum in its earnings. At the current market price of Rs360 the stock is discounting its CY2007E earnings by 9.3x and CY2006 earnings before interest, depreciation, tax and amortisation (EBIDTA) by 4.8x. We maintain our Buy recommendation on the stock with a price target of Rs575.

Top line growth picks up in Q3

In the second quarter Esab had delivered a dull performance with only a 7% growth in its top line and a 4% growth in its bottom line. In our earlier update on Esab, dated August 3, 2006, we had mentioned that the commissioning of the new equipment plant as well as the introduction of new products with technological help from the parent would help the company to register a decent top line growth so imperative for a good earnings growth. And so the top line grew by a good 26% in the third quarter to Rs81 crore. The growth was achieved on the back of a 24.3% increase in the revenues of the consumable division and a 30.7% growth in the revenues of the equipment division. The commissioning of the new equipment-manufacturing unit at Chennai drove the growth of the equipment business.

Segmental results

Particulars	Q3CY06	Q3CY05	% yoy chg
Revenue			
Consumables	59.3	47.7	24.3
Equipment	21.7	16.6	30.7
Net revenue	81.0	64.3	26.0
EBIT			
Consumables	17.8	13.8	29.5
Equipment	3.6	3.5	4.6
EBIT margins (%)			
Consumables	30.1	28.9	
Equipment	16.7	20.9	
Total	0.0	0.0	

Consumable division's EBIT up 29.5%

With the top line for the quarter registering a decent growth, the operating profit increased by a healthy 24% to Rs20.33 crore. The profit growth was driven by a 29.5% growth in the EBIT of the consumable segment whose EBIT margin improved by 120 basis points to 30.1%, the highest in the last 10-12 quarters. However, the overall OPM declined by 40 basis points primarily because of a 420-basis-point decline in the EBIT margin of the equipment division. The division incurred significant overheads in expanding its capacity during the quarter. The new unit has just started operations and gradually as the revenues of the division begin to move up as a result of the additional capacity, the margins would improve again.

Net earnings surge 26.7%

The other income for the quarter grew by 200% to Rs1.23 crore primarily because of the commission earned from its parent Esab AB, Sweden, on an order secured by the Swedish company from the Indian Space Research Organisation (ISRO) earlier this year. With the depreciation charge remaining flat, the net profit for the quarter grew by an impressive 26.7%.

Valuation and view

Esab's Q3CY2006 results are in line with our expectations. The top line of both the businesses, ie the consumable and equipment divisions, saw an impressive growth during the quarter. The growth was driven by the hectic activity in India's core infrastructure sectors, like roads, ports, airports and construction, and the industrial sectors. Also, the company is showing a strong improvement in its profitability with the margin of the consumable division at a two-year high and that of the equipment division all set to improve.

The new product launches and the additional equipment capacity would help the company maintain the growth momentum in its earnings. At the current market price of Rs360 the stock is discounting its CY2007E earnings by 9.3x and CY2007E EBIDTA by 4.8x. We maintain our Buy recommendation on the stock with a price target of Rs575.

Earnings table

Particulars	CY03	CY04	CY05	CY06E	CY07E
Net profit (Rs cr)	0.7	20.4	36.2	45.8	59.9
Shares in issue (cr)	1.54	1.54	1.54	1.54	1.54
EPS (Rs)	0.5	13.2	23.5	29.7	38.9
% y-o-y growth	*-106.0*	*2807.0*	*78.0*	*27.0*	*31.0*
PER (x)	792.0	27.2	15.3	12.1	9.3
Book value (Rs)	12.8	26.0	23.5	53.3	92.2
P/BV (Rs)	28.1	26.0	11.2	6.8	3.9
EV/EBIDTA (x)	123.9	16.7	10.5	7.1	4.8

Selan Exploration Technology

Ugly Duckling

Stock Update

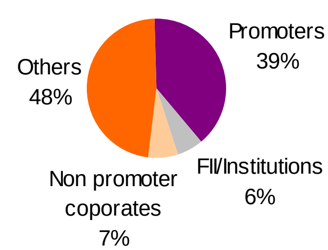
Growth driven by higher realisations

Buy; CMP: Rs73.5

Company details

Price target:	Rs94
Market cap:	Rs106 cr
52 week high/low:	Rs114/44
NSE volume: (No of shares)	55,237
BSE code:	530075
NSE code:	SELAN
Sharekhan code:	SELAEXP
Free float: (No of shares)	0.9 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-6.9	25.3	-17.9	48.7
Relative to Sensex	-9.7	4.5	-23.7	-7.9

Result highlights

- Selan Exploration Technology (Selan) reported a 30.7% year-on-year (y-o-y) growth in its net revenues to Rs6.3 crore during the second quarter ended September 2006. The revenue growth was driven by the cumulative impact of the incremental volumes from the commercialisation of two new wells in the first half (one in June 2006 and the second well in September 2006) and relatively higher realisations.
- The operating profit margin (OPM) at 65.8% was higher than 65.3% reported in Q2FY2006. This is despite the higher provisioning for the development of hydrocarbon properties (Rs0.94 crore as compared with Rs0.35 crore in Q2FY2006) during the quarter. The operating profit grew 31.6% to Rs4.1 crore.
- The earnings of Rs2.7 crore grew by 47.5% year on year (yoy) but were slightly below our estimates due to the higher provisioning for the development of hydrocarbon reserves in Q2FY2007.
- On a sequential basis, the revenues grew by 3.8% and the earnings were largely flat (a growth of 0.8%). The decline in the OPM on a sequential basis was largely due to the higher provisioning for the development of hydrocarbon reserves.
- In terms of the outlook, the revenue growth is likely to be driven largely by the growth in volumes. The production volume would be boosted by the full impact of the incremental volumes from the two new wells already commercialised in the first half of FY2007. Moreover, the planned commercialisation of two more wells in the second half of the fiscal would further aid the overall growth in revenues. On the other hand, the lower realisation is likely to limit the growth in the third quarter.
- At the current price the stock trades at 13x FY2007E and 6x FY2008E earnings. In terms of the enterprise value (EV) by proven and probable (2P) barrel of oil & oil equivalents (boe) reserves, Selan trades at an attractive valuation of $0.9 per boe (as compared to the global benchmark of around $8 per boe). We maintain our Buy recommendation on the stock with the price target of Rs94.

Result table Rs (cr)

Particulars	Q2FY07	Q2FY06	Q1FY07	% yoy	% qoq
Net sales	**6.3**	**4.8**	**6.0**	**30.7**	**3.8**
Total expenditure	2.1	1.7	2.0	28.9	6.5
Operating profit	4.1	3.1	4.0	31.6	2.5
Other income	0.2	0.2	0.3	25.0	-25.9
Interest	0.2	0.0	0.2	-	-5.6
Depreciation	0.2	0.2	0.2	6.7	0.0
PBT	4.0	3.1	4.0	27.1	1.0
Tax	1.3	1.3	1.3	-0.8	1.5
RPAT	**2.7**	**1.8**	**2.7**	**47.5**	**0.8**
Equity cap (Rs cr)	14.4	13.4	14.4		
EPS (Rs)	1.85	1.35	1.84		
Margins (%)					
OPM	65.8	65.3	66.7		
NPM	42.7	37.8	43.9		

Better realisations boosted revenue growth

The revenue growth of 30.7% yoy was contributed by an increase of 10.4% in the volumes and around 20.3% increase in the price realisations. The incremental production of around 2,200 barrel of oil from the recently commissioned oil wells in Bakrol contributed to the growth in volumes.

On a half yearly basis, the company produced 43,300 barrel of oil, around 11% higher than the 39,000 barrel produced in the first half of FY2006. The average price realisation of Rs2,840 per barrel of oil in H1FY2007 is 30% higher compared with that in the corresponding period of last fiscal. The higher realisation was contributed by the firm crude oil prices and successful negotiations for a price hike from the government nominee, Indian Oil Corporation.

Margins to remain firm

The OPM at 65.8% was also quite healthy and improved marginally from 65.3% reported in Q2FY2006. This is despite the higher provisioning for the development of the hydrocarbon properties (Rs0.94 crore as compared with Rs0.35 crore in Q2FY2006) during the quarter. Even after the recent decline in the crude oil prices, the management expects to maintain the OPM at over 60% level in the second half of FY2007.

Development of the Bakrol oilfield

The management indicated that the efforts taken to monetise (through development of additional oil wells) the Bakrol oilfield (situated in Cambay Basin) are on schedule. It has commercialised two oil wells in the first two quarters and is confident of commercialising two additional wells in the second half of the current fiscal. Consequently, the production volumes are likely to cross the one-lakh-barrel mark in the current year.

Maintain earning estimates

Given the robust performance in the first half and the firm crude prices, the company is likely to comfortably surpass our earnings estimate of Rs8.1 crore for the current fiscal. However, we are not upgrading the earnings estimate, as the earnings could be dented by possible one-time expenses related to the expected commercialisation of the additional oil wells in the second half of the fiscal.

Valuation

At the current price, the stock trades at 13x FY2007E and 6x FY2008E earnings. In terms of EV/oil (2P) reserves, Selan trades at an attractive valuation of $0.9 per boe (as compared with the global benchmark of around $7-8 per boe). We maintain our Buy recommendation on the stock with the price target of Rs94.

Earnings table

Particulars	FY2005	FY2006	FY2007E	FY2008E
Adj net profit (Rs cr)	1.2	6.6	8.1	17.6
No of shares (cr)	1.3	1.4	1.4	1.4
EPS (Rs)	0.9	4.6	5.6	12.2
% y-o-y chg		*412.1*	*23.6*	*116.6*
PER (x)	82.6	16.0	13.0	6.0
Price/BV (x)	4.2	3.1	2.5	1.8
EV/EBIDTA(x)	33.9	7.5	7.6	3.7
EV/Sales (x)	8.2	5.4	4.6	2.5
RoCE (%)	6.7	26.0	20.7	35.1
RoNW (%)	5.1	19.5	19.3	29.6

The author doesn't hold any investment in any of the companies mentioned in the article.

Wockhardt

Ugly Duckling

Stock Update

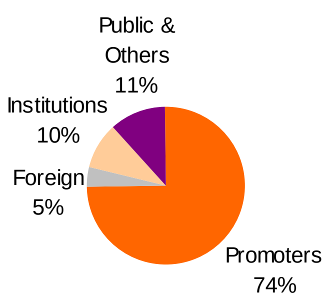
Margins remain under pressure

Buy; CMP: Rs394

Company details

Price target:	Rs552
Market cap:	Rs4,378 cr
52 week high/low:	Rs562/316
NSE volume: (No of shares)	2.0 lakh
BSE code:	532300
NSE code:	WOCKPHARMA
Sharekhan code:	WOCKLTD
Free float: (No of shares)	2.9 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-3.7	15.0	-12.5	1.0
Relative to Sensex	-6.6	-4.1	-18.7	-37.5

Result highlights

- Wockhardt's net sales increased by 21.8% to Rs437.7crore in Q3CY2006. The growth came on the back of a 38.5% growth in the domestic business and a 10.4% growth in the international business.
- The sales in the European market grew by 9.7%. The European sales were buoyed by the strong performance of the UK business. The sales in the US market grew by 19.6%, showing a substantial turnaround from the previous quarter.
- Wockhardt's operating profit margin (OPM) shrank by 220 basis points to 22.2% in Q3CY2006. The contraction in the margin was on account of an increase in the staff cost as the company increased its domestic field force. The decline in the margin was also attributed to the acquisition of the lower-margin Dumex business and the commissioning of the company's biotech facility (which raised the other expenditure by 460 basis points). Consequently, the company's operating profit (OP) increased by 10.8% to Rs97.1 crore in the quarter.
- The company's margins have been clouded by the capitalisation of ANDA development costs, which would have been otherwise added to the operating expenses. Adjusting for the capitalised costs, the company's OPM stands at 18.3% for the quarter (a decline of 610 basis points), whereas the OP shows a decline of 8.6% to Rs80.1 crore.
- Wockhardt's net profit rose by 13.7% to Rs74 crore. The growth in the net profit was aided by a higher other income (which doubled in the quarter). A higher tax outgo of 17.4% as compared to 12.7% in Q3CY2005 restricted the company's net profit growth. The tax outgo was higher on account of an increase in the minimum alternative tax (MAT) rate effected in the previous quarter.

Result table Rs (cr)

Particulars	Q3CY06	Q3CY05	% chg	9MCY06	9MCY05	% chg
Net sales	437.7	359.5	21.8	1201.4	1046.2	14.8
Pre-R&D expenditure	323.7	251.8	28.6	878.6	750.6	17.1
EBITDR	114.0	107.7	5.8	322.8	295.6	9.2
R&D expense	16.9	20.1	-15.9	67.1	52.2	28.5
Operating profit	97.1	87.6	10.8	255.7	243.4	5.1
Other income	6.1	2.9	110.3	11.2	15.3	-26.8
EBITDA	103.2	90.5	14.0	266.9	258.7	3.2
Interest	-0.5	4.1	-112.2	-8.8	14.5	-160.7
Depreciation	14.1	11.8	19.5	41.8	32.8	27.4
PBT	89.6	74.6	20.1	233.9	211.4	10.6
Taxes	15.6	9.5	64.2	39.8	27.1	46.9
PAT	74.0	65.1	13.7	194.1	184.3	5.3
Extra-ordinary Items	0.0	0.0	-	-60.4	0.0	-
Net profit	74.0	65.1	13.7	133.7	184.3	-27.5
EPS (Rs)	6.6	6.0	11.4	17.4	16.9	3.2
EBITDR margin (%)	26.0	30.0		26.9	28.3	
OPM (%)	22.2	24.4		21.3	23.3	
EBIDTA margin (%)	23.6	25.2		22.2	24.7	
Net profit margin (%)	16.9	18.1		11.1	17.6	

- Wockhardt recently acquired Pinewood Laboratories, an Irish generic firm, for $150 million. The acquisition is expected to be complementary to Wockhardt's existing business in Europe and add marginally to its earnings.
- At the current price of Rs394, Wockhardt is quoting at 14.2x its CY2007 estimated earnings on a fully diluted basis. We reiterate our Buy recommendation on Wockhardt, with a price target of Rs552.

Wockhardt's net sales grew by 21.8% to Rs437.7 crore in Q3CY2006, led by a 38.5% growth in its domestic business and a 10.4% growth in its international business. The sales growth was above our expectations. The formulation sales rose by 25.7% whereas the sales of active pharmaceutical ingredients (APIs) declined by 4.7%. The decline in the API sales was on account of a greater captive consumption of APIs by the company. However, the company's operating performance was affected by a sharp rise in the staff cost and the other expenditure. Moreover, the company started capitalising the cost incurred to develop abbreviated new drug applications (ANDAs) in the quarter instead of expensing them, causing the research and development (R&D) costs to decline substantially. Despite the decline in the R&D costs, the company's margins remained under pressure. The company reported an OP of Rs97.1 crore, a growth of 10.8% year on year (yoy). Despite a higher other income (which more than doubled in the quarter), the net profit grew by only 13.7% to Rs74 crore in Q3CY2006. The net profit was affected by an increase in the tax provision for the quarter due to an increase in the MAT rate.

Sales break-up Rs crore

Particulars	Q3 CY06	Q3 CY05	% chg	9M CY06	9M CY05	% chg
Formulations	**392.6**	**312.4**	**25.7**	**1074.4**	**915.7**	**17.3**
- India formulations	192.8	141.7	36.1	491.8	378.6	29.9
- EU formulations	145.0	128.0	13.3	430.9	391.9	10.0
- US formulations	34.9	28.8	21.2	90.0	83.7	7.5
- ROW formulations	19.9	13.9	43.2	61.7	61.5	0.3
API	**45.0**	**47.2**	**-4.7**	**126.7**	**130.6**	**-3.0**
- India API	7.4	2.9	155.2	17.4	12.2	42.6
- EU API	4.1	7.9	-48.1	13.0	23.6	-44.9
- US API	19.4	16.6	16.9	45.2	38.9	16.2
- ROW API	14.1	19.8	-28.8	51.1	55.9	-8.6
Total	**437.6**	**359.6**	**21.7**	**1201.1**	**1046.3**	**14.8**

Domestic business grows by 38.5%—a key growth driver

Wockhardt's domestic sales increased by 38.5% to Rs200.2 crore in the quarter. The sales of formulations in the domestic market increased by 36.1% whereas that of APIs grew by a staggering 155.2%. The overall growth in the domestic business was substantially higher than the industry growth of approximately 17%. The overall growth was driven largely by high-end niche therapeutic segments, power brands and new product launches. Apart from the inorganic growth, Wockhardt's domestic revenues were also boosted by a Rs15-crore contribution from the recent Dumex acquisition. Wockhardt's focus therapeutic segments of diabetology and nephrology, which account for close to 60-70% of its domestic sales, grew by an impressive 27% and 43% respectively in M9CY2006. Wockhardt's products, Zedex and BroZedex, entered the league of top 300 products as per ORG-IMS MAT data for August 2006.

US business recovers but still substantially lower than estimates

Wockhardt's US sales increased by 19.6% to Rs54.3 crore in Q2CY2006. This was led by a 21.1% growth in the sales of formulations and a 16.9% growth in the sales of APIs in the US market. Wockhardt's performance in the US business has improved compared to the previous quarter as the company completed its transition from the partner product distribution system to its own distribution network. However, the year-to-date growth of 10.3% in the US business yet remains substantially below the company's guidance of 50% growth for CY2006. While the business does seem to be coming back on track, there is not much visibility of a dramatic turnaround in the US business over the next few quarters.

Wockhardt received one ANDA approval in the quarter, taking the total number of product approvals to six in the current year. It is currently marketing 14 products in the US market.

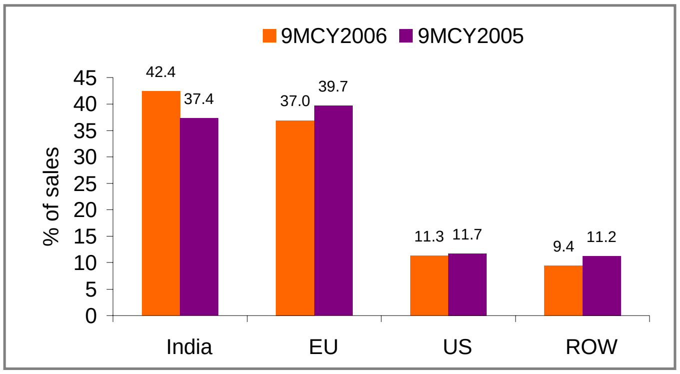
UK business drives European market growth of 9.7%

Wockhardt has continued its strong performance in the European markets, which account for the largest chunk of its international business. It has registered a growth of 9.7% in Europe. The growth was driven primarily by the UK business, which is a large component of Wockhardt's European business.

The strong performance in the UK was partially offset by a decline in the German business, which was adversely affected by pricing pressures arising out of the recently introduced pricing legislation in Germany.

Wockhardt has recently implemented a four-fold increase in the capacity of its UK plant to manufacture Byetta cartridges, an injectable medicine used to control blood sugar in diabetes patients. The expanded capacity went on stream in September 2006.

Geographical sales break-up



Pinewood to add marginally to earnings, increase European exposure

Wockhardt recently announced the acquisition of Pinewood Laboratories, an Ireland-based generic company, for an all-cash consideration of $150 million. Pinewood Laboratories is the largest and fastest growing generic company in Ireland, with a compounded annual growth rate of 20% and earnings before interest, depreciation, tax and amortisation (EBIDTA) margin of 20%. Pinewood Laboratories reported sales of $70 million for the year ended June 2006. The company comes with a manufacturing facility in Ireland, an employee headcount of 350 and over 200 marketing authorisations in various countries.

The acquisition seems fairly priced at 2.1x sales and approximately 10x EBIDTA. The acquisition of Pinewood will provide Wockhardt with a larger footprint in Europe spread over the UK, Ireland and Germany. The acquisition is a strategic fit for Wockhardt UK as the Irish company's liquid and cream business complements Wockhardt UK's strengths in injectable and solid dosages. Hence, Wockhardt will be able to introduce Wockhardt UK's products in the Irish market and vice versa. Going forward, Wockhardt plans to rationalise Pinewood Laboratories' manufacturing costs by transferring some of the manufacturing to its Indian facilities.

Based on our back-of-the-envelope calculations, we estimate the Pinewood acquisition to be marginally earnings accretive for Wockhardt. Moreover, after the acquisition, Wockhardt's revenues from Europe are expected to exceed $200 million. Europe, which currently contributes 37% to Wockhardt's revenues, will form close to 50% of its overall sales post-acquisition.

Margins remain under pressure, clouded by capitalisation of ANDA R&D costs

Wockhardt's OPM slid by 220 basis points to 22.2% in Q3CY2006. The margin dropped on account of a 33.7% rise in the employee expenses and a 56.9% rise in the other expenses. Wockhardt's employee expenses, which formed 12.4% of sales in Q3CY2005, constituted 13.6% of sales in Q3CY2006, as the company strengthened its domestic field force. Wockhardt's other expenses as a percentage of sales also rose by a sharp 460 basis points in the quarter as the company incurred additional expenses related to the new biotech facility. Further, the acquisition of the low-margin Dumex business also affected Wockhardt's margins. Consequently, the company's OP grew by 10.8% to Rs97.1 crore in Q3CY2006.

Wockhardt's management has adopted a new R&D accounting policy wherein R&D expenses incurred on account of ANDAs are capitalised. Consequently, it has capitalised Rs17 crore of R&D costs for the quarter, which would have otherwise been expensed in the profit and loss account. This new policy is unlike the accounting policies being followed by the pharma companies across the industry, wherein the entire R&D costs are being expensed. If we include these R&D costs as part of the company's operating expenses, the OPM stands at 18.3%, a decline of 610 basis points yoy, while the company's OP actually shows a decline of 8.6% to Rs80.1 crore in the quarter. The new policy seems a management effort to shore up the near-term profitability and distort the company's true financial performance.

Cost break-up

Particulars	Q3CY06	Q3CY05	% change
Material cost	173.5	149.5	16.1
% of sales	*39.6*	*41.6*	
Employee Expenses	59.5	44.5	33.7
% of sales	*13.6*	*12.4*	
Other Expenses	90.7	57.8	56.9
% of sales	*20.7*	*16.1*	
R&D expense	16.9	20.1	-15.9
% of sales	*3.9*	*5.6*	

Higher tax outgo affects performance at net level

Wockhardt's net profit stood at Rs74 crore in the quarter, growing by 13.7% yoy. Despite recording a substantially higher other income (which more than doubled in the quarter), the net profit growth was affected by an increase in the tax provision. The company incurred a tax rate of 17.4% in the quarter as compared with 12.7% in the corresponding quarter of the previous year due to an increase in the MAT rate. The earnings for the quarter stood at Rs6.6 per share.

The net profit received an upward boost of Rs11.3 crore due to the change in the accounting treatment of the R&D costs. On adjusting for this, the net profit stood at Rs62.7 crore, a decline of 3.7% yoy.

New developments:

- Wockhardt has recently signed a memorandum of understanding with the Maharashtra Industrial Development Corporation to establish a special economic zone (SEZ) in Aurangabad. Wockhardt plans to invest Rs700 crore over three to four years to establish a pharmaceutical manufacturing and research facility at the SEZ.
- Wockhardt has got the approval from the US Food & Drug Administration for manufacturing and marketing Cefotaxime 1gram injections in the US market. Cefotaxime sodium is the generic version of Sanofi Aventis Claforan injection and is a broad-spectrum antibiotic used in treating a variety of infections. The market size for this product is estimated at $545 million.

Valuation and view

Even though Wockhardt's performance on the revenue front has been encouraging and above expectations, the company continues to face challenges on the margin and profitability fronts. Although the performance in the US market has improved as compared to the previous quarter, yet the same remains substantially lower than the company's target. Moreover, the results do not reflect the company's true financial picture, as the numbers have been clouded by the capitalisation of the ANDA development costs. Adjusting for this capitalisation, the margin and profitability pictures seem even more dismal.

However, with the growing synergies between Wockhardt and its recent acquisitions, Pinewood Laboratories and Dumex, the company's financial picture is likely to improve going forward. Further, Wockhardt's performance in the domestic market has been commendable, and is expected to remain strong in the future, aided by the increase in its domestic field force. Wockhardt's US business also seems to be back on track, and with a strong R&D pipeline and further product approvals, it is expected to grow steadily in the future.

The growing synergies in Europe and the new product launches in the European market (the company has a pipeline of ten new product launches planned in the UK and six in Germany) will continue to fuel growth in the European markets. Further, the UK Byetta cartridge business is expected to add to the growth with the expansion of capacities.

We are in the process of reviewing our earnings estimates for Wockhardt, in order to factor in the contributions from the Dumex and Pinewood acquisitions. We will come out with an update shortly. For now, we maintain our estimates for CY2006 and CY2007. At the current market price of Rs394, Wockhardt is quoting at 14.2x its CY2007 estimated earnings, on a fully diluted basis. We maintain our Buy recommendation on Wockhardt, with a price target of Rs552.

Valuation table (consolidated)

Particulars	CY2004	CY2005	CY2006E	CY2007E
Net sales	1251.6	1412.1	1578.4	1838.1
Net profit	213.5	257.1	279.7	330.0
Shares in issue (cr)	10.9	10.9	11.9	11.9
EPS (Rs)	19.6	23.5	23.4	27.6
PER (x)	20.1	16.7	16.8	14.2
Cash EPS (Rs)	23.0	27.4	28.0	32.6
Cash PER (x)	17.1	14.3	14.0	12.1
Book value (Rs/share)	56.6	79.9	96.6	124.2
Price/BV (x)	6.9	4.9	4.1	3.2
EV/EBITDA (x)	14.9	12.6	11.8	9.7

The author doesn't hold any investment in any of the companies mentioned in the article.

Mahindra & Mahindra

Apple Green

Stock Update

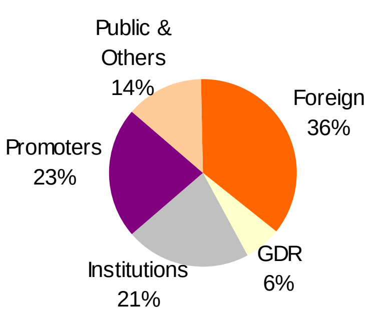
Price target revised to Rs870

Buy; CMP: Rs762

Company details

Price target:	Rs870
Market cap:	Rs18,357 cr
52 week high/low:	Rs768/351
NSE volume: (No of shares)	8.1 lakh
BSE code:	500520
NSE code:	M&M
Sharekhan code:	M&M
Free float: (No of shares)	17.1 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	9.9	29.8	15.3	105.6
Relative to Sensex	6.6	8.2	7.1	27.3

Result highlights

- The Q2FY2007 results of Mahindra and Mahindra (M&M) are way ahead of our expectations. The stand-alone net sales grew by 30.1% to Rs2,490.5 crore. The strong growth was led by the brilliant performance of the farm equipment division (FED) and higher margins of the automotive division due to an improved product mix.
- On a segmental basis, the automotive revenues rose by 21.7% to Rs1,556.5 crore. The FED reported a stellar performance, marking a revenue growth of 45.1%. The profit before interest and tax (PBIT) margin of the automotive segment improved by a whopping 470 basis points to 14.9% while that of the FED rose by 240 basis points to 14.3% in Q2FY2007. Consequently, the overall operating profit margin (OPM) grew by 345 basis points to 14.8% and the operating profit rose by 69.4% year on year (yoy) to Rs369.6 crore.
- A higher interest income aided the pre-extraordinary net profit to grow by 54.6% to Rs245.4 crore. If you consider the special dividend received from Tech Mahindra, the profit on the sale of the stake in Tech Mahindra and an octroi refund received during the quarter, the reported profit after tax (PAT) grew by 146% to Rs386.5 crore.
- M&M's Q2FY2007 consolidated revenues were also strong and grew by 46% to Rs4,617.6 crore. The consolidated PAT after minority interest rose by 133% to Rs510 crore.

Result table Rs (cr)

Particulars	Q2FY07	Q2FY06	% yoy chg
Net sales	2,490.5	1,914.8	30.1
Total expenditure	2,120.9	1,696.6	25.0
Raw material consumed	1,853.2	1,418.8	30.6
Stock adjustment	-231.9	-89.6	
Employee expenses	164.2	126.3	30.0
Provisions & write-offs	-0.1	1.3	
Other expenses	335.6	239.9	39.9
PBIDT	369.6	218.2	69.4
Interest gross	-15.5	6.9	
PBDT	385.1	211.3	82.3
Depreciation	50.1	46.6	
Other income	47.8	41.1	16.1
PBT	382.8	205.8	86.0
Tax	137.4	47.2	
Adj PAT	245.4	158.7	54.6
Extraordinary items +	141.1	-1.5	-9569.1
Reported PAT	386.5	157.2	145.8
EPS-reported	10.4	8.7	
OPM (%)	14.8	11.4	

- Considering the growth in the various business segments, higher realisations and higher OPM for Q2FY2007, we have upgraded our FY2007 earnings estimates (consolidated) for M&M by 5% to Rs57.8. We have maintained our FY2008 earnings estimates at Rs64.1.
- Using the sum-of-parts model, we have valued M&M's core business at Rs607 (14x FY2008E earnings) and its subsidiaries at Rs263, arriving at a higher price target of Rs870.

Volume growth, better product mix drive the top line

M&M's Q2FY2007 net sales grew by 30.1% to Rs2,490.5 crore. The strong top line growth was driven mainly by a 29.7% growth in the tractor volumes and a 21% growth in the automotive volumes. The revenues also include an amount of Rs40.4 crore received by the company as octroi refund for the earlier years.

Automotive division: The division reported a sales growth of 21% driven mainly by the sales of *Scorpio* and three-wheelers. The sales of *Scorpio* have picked up since the launch of its new version. During the quarter the company also introduced the all-new *Scorpio* in some of the export markets such as Sri Lanka and Kenya. The three-wheeler segment has been performing brilliantly for the company and the quarter marked a growth of 68.7% yoy because of the strong performance of the *Champion Alfa* model. The company managed to significantly increase its market share in the three-wheeler and light commercial vehicle (LCV) segments. Its share in the LCV market, for instance, improved from 18.4% in H1FY2006 to 19.4% in H1FY2007. The market share in the large three-wheeler category improved by 310 basis points to 46.4% while that in the smaller three-wheeler category rose to 10.8% from 0.6% last year.

Automotive division sales

	Q2 FY07	Q2 FY06	% yoy chg	H1 FY07	H1 FY06	% yoy chg
Utility vehicles	29,449	26,601	10.7	54665	51446	6.3
Scorpio	9,893	8,248	19.9	17986	15154	18.7
UVs w/o *Scorpio*	19,556	18,353	6.6	36679	36292	1.0
LCVs	1,991	1,883	5.7	3920	3691	6.2
Three-wheelers	8,887	5,269	68.7	15469	9023	71.4
Total domestic	**40,383**	**33,753**	**19.6**	**74054**	**64160**	**15.4**
Exports	2,761	1,822	51.5	4090	2678	52.7
Total	43,144	35,575	21.3	78144	66838	16.9

FED: Led by normal monsoons, good *kharif* production and strong growth in farm credit, tractor sales remained buoyant, growing by 29.7% during the quarter. The company maintained its leadership position in the tractor segment with a market share of 30%. The tractor segment continued to register a strong growth in exports with its global presence increasing to include countries such as the USA, China, Gambia, Iran and Turkey.

FED sales

	Q2 FY07	Q2 FY06	% yoy chg	H1 FY07	H1 FY06	% yoy chg
Tractors						
domestic	21800	17096	27.5	46842	36109	30
Exports	1764	1075	64.1	4080	3262	25
Total sales	23,564	18,171	29.7	50922	39371	29

Segmental profitability

A look at the segmental performance and profitability now. The revenues of the automotive business grew by 21.7% to Rs1,556.5 crore. The PBIT of the automotive segment improved by 77% to Rs232.4 crore as the segment's PBIT margin improved by 466 basis points to 14.3%.

The FED reported a stellar performance as its revenues grew by 45.1% to Rs883.3 crore. The PBIT for the quarter improved by a whopping 74% to Rs126.4 crore as the PBIT margin improved significantly by 240 basis points to 14.3%.

Segmental analysis

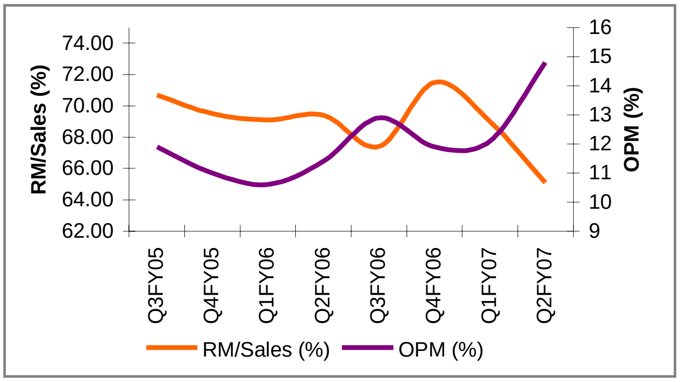
(In crore)	Q2FY07	Q2FY06	% change
Revenues			
Automotive	1556.5	1279.3	21.7
FED	883.3	608.8	45.1
Others	115.1	74.5	54.5
PBIT			
Automotive	232.4	131.4	76.8
FED	126.4	72.5	74.3
Others	3.9	2.9	32.7
Margins (%)			
Automotive	14.9	10.3	
FED	14.3	11.9	
Others	6.1	6.2	

Higher volumes, rising efficiencies aid margin growth

The strong volume growth and improved product mix led to an improvement in the margins during the quarter. The margins in the tractor segment improved impressively as a result of the rising efficiencies due to higher volumes. Over the years, the company has consistently managed to improve its productivity with the number of tractors per employee rising to 19 from 12 in FY2004 and 18 in FY2006.

The better product mix and strong volume growth resulted in a sharp fall in the raw material to sales ratio, which reduced to 65.1% from 69.4% last year. Consequently, the overall OPM improved by 345 basis points to 14.8%. As a result, the operating profit for the quarter rose by 69.4% to Rs369.6 crore.

Lowering material costs boost margins



The OPM improved due to the efficiencies resulting from the higher volumes and the company's effort to increase its operational efficiencies. M&M has set up a separate sourcing division, which looks after the raw material procurement. Moreover, cost-control and value-engineering initiatives helped the company to increase its efficiencies and improve the margins.

A higher interest income caused the PAT before extraordinary items to grow by 55% to Rs245 crore. The extraordinary items pertain to an octroi refund of Rs40.39 crore, a special dividend of Rs25.13 crore from Tech Mahindra and a profit of Rs117.45 crore on the sale of the stake in Tech Mahindra. As a consequence, the PAT after exceptional items grew by 146% to Rs386.5 crore.

Consolidated performance

M&M's Q2FY2007 consolidated results too are very strong. The consolidated gross revenues (including the other income) grew by 46% to Rs4,617.6 crore. The consolidated PAT after minority interest rose by 133% to Rs510 crore.

New product launches

The company has recently launched two small cargo vehicles, *MaXX* MAXI truck and "Bolero" Pik Up. In the tractor segment, towards the end of September it launched a multi-utility tractor *Shaan*, which is expected to boost growth in the segment. Going forward, M&M expects to launch two new utility vehicle (UV) variants in the current fiscal. In the next two years, the company plans to launch *Logan*, *Ingenio* and more new commercial vehicles (CV). The company has maintained that its two joint ventures, one with Renault and the other with International Tractors, are progressing as per schedule. The *Logan* would be launched in H1FY2007 and the heavy commercial vehicles would be launched in FY2008.

For new product development and capacity expansions, the company has earmarked a capital expenditure of Rs300 crore. The company would enhance its vehicle capacity by 25% at its existing plants as well as set up a greenfield plant as part of the capex plan.

Outlook and upgrading our earnings estimates

We expect the double-digit growth to continue in the UV segment. The growth in the FED is expected to slow down. The management has indicated that the pressure of non-performing assets on banks in states like Madhya Pradesh, Uttar Pradesh and Bihar is rising for tractor loans. Though the dealer stock for M&M stands at 23 days, the same for the industry is higher at 45-50 days. We estimate a growth of 10% in the UV segment and that of 15% in the tractor segment (FY2007; 12% for FY2008).

Considering the growth in the various business segments, higher realisations and higher OPM for Q2FY2007, we have upgraded our FY2007 earnings estimates (consolidated) for M&M by 5% to Rs57.8. We have maintained our FY2008 earnings estimates at Rs64.1.

Valuation and view

Using the sum-of-parts model, we have valued M&M's core business at Rs607 (14x FY2008E earnings) and its subsidiaries at Rs263, arriving at a higher price target of Rs870.

Sum-of-parts valuation

M&M stand-alone (14x on FY2008 EPS)	607
Value of subsidiaries (20% discount to Market Price)	263
Target price	870

We maintain our Buy recommendation on the stock with the revised price target of Rs870.

Earnings table

Particulars	FY04	FY05	FY06	FY07E	FY08E
Stand-alone					
Net sales (Rs cr)	4873.8	6511.0	7977.2	10,272.0	11,805.0
(%) y-o-y change		*33.6*	*22.5*	*28.8*	*14.9*
Net profit (Rs cr)	322.5	499.5	647.9	866.7	1,012.7
Shares in issue (cr)	23.34	23.34	23.36	23.36	23.36
EPS (Rs)	13.8	21.4	27.7	37.1	43.4
(%) y-o-y change		54.9	29.6	33.8	16.8
PER (x)	55.1	35.6	27.4	20.5	17.6
Consolidated					
Net profit (Rs cr)	398.3	711.0	1050.0	1351.2	1553.9
Shares in issue (cr)	23.34	23.34	23.36	23.36	23.36
EPS (Rs)	17.1	30.5	44.9	57.8	66.5
(%) y-o-y change		*78.5*	*47.6*	*28.7*	*15.0*
PER (x)	44.6	25.0	16.9	13.2	11.4

ICI India

Ugly Duckling

Stock Update

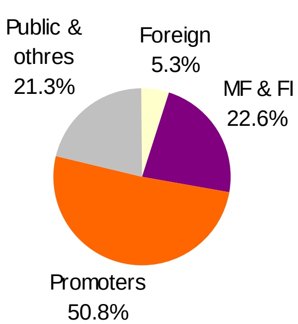
Price target revised to Rs430

Buy; CMP: Rs342

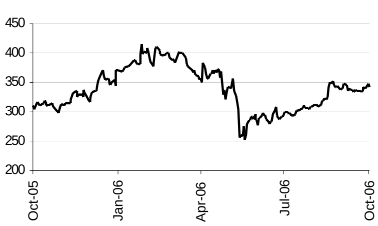
Company details

Price target:	Rs430
Market cap:	Rs1,423 cr
52 week high/low:	Rs421/243
NSE volume: (No of shares)	10,622
BSE code:	500710
NSE code:	ICI
Sharekhan code:	ICI
Free float: (No of shares)	2.0 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.9	18.0	0.1	14.4
Relative to Sensex	-0.2	-1.2	7.0	-29.2

Result highlights

- ICI India's Q2FY2007 net profit (adjusted for extraordinary items) at Rs19.2 crore is in line with our expectations. The net profit has grown by 23.7% year on year (yoy).
- The net revenues have grown by 6.1% yoy to Rs244 crore due to the discontinuation of the rubber chemical and surfactant businesses.
- The paint business has grown by 27% yoy to Rs217.2 crore. The continued chemical business has grown by 28.4% yoy to Rs33.7 crore.
- The profit before interest and tax (PBIT) in the paint business has grown by 54% yoy with a 157-basis-point expansion in the margin. The PBIT margin in the residual chemical business has risen by 52% yoy with a 200-basis-point expansion in the margin.
- The overall operating profit (including all businesses) grew by 12.4% yoy with a 73-basis-point expansion in the operating profit margin (OPM).
- With a higher other income and stable depreciation charge, the net profit grew by 23.7% yoy to Rs19.2 crore.
- We have upgraded our earnings per share (EPS) estimates for the stock for FY2007 and FY2008, from Rs17.4 and Rs23.2 to Rs18.3 (5.5%) and Rs24.2 (4.3%) respectively, to take into account the better-than-expected margins in the paint business. Accordingly we have revised our price target on the stock to Rs430.
- At the current market price of Rs342, the stock is quoting at 15.1x its FY2008E EPS and 5.9x FY2008E enterprise value (EV)/earnings before interest depreciation tax and amortisation (EBIDTA). We maintain our Buy recommendation on the stock with the revised price target of Rs430.

Result table Rs (cr)

Particulars	H1FY07	H1FY06	% yoy chg	Q2FY07	Q2FY06	% yoy chg
Net sales	473.9	445.1	6.5	243.8	229.7	6.1
Other income	10.5	9.6	8.8	3.9	2.5	56.0
Total income	484.4	454.7	6.5	247.7	232.2	6.7
Total expenditure	416.7	394.8	5.5	212.0	201.5	5.2
Operation profit	57.3	50.2	14.0	31.8	28.3	12.4
Interest	1.4	1.8	-20.6	0.8	1.2	-36.7
Depreciation	11.4	10.8	5.7	5.8	5.6	3.8
Profit before tax and extraordinary items	44.5	37.7	18.0	25.2	21.5	17.4
Extraordinary items	2.0	-0.4		2.1	0.4	
Profit before tax	56.9	47.0	21.2	31.3	24.4	28.4
Total tax	18.4	15.4	19.3	10.7	8.7	
Profit after tax	38.6	31.6	22.2	20.6	15.7	30.7
Adjusted profit after tax	37.2	31.8	17.0	19.2	15.5	23.7

Sales from continued businesses grow by 27.3%

ICI's revenues grew by 27.3% on a like-to-like basis on the back of a 25%+ growth in both its businesses, ie paints and chemicals. However, ICI's reported net revenues for Q2FY2007 grew by 6.1% yoy to Rs244 crore as it had sold off:

- its rubber chemical business to a joint venture with the US-based PMC Group International in Q3FY2006 (see our report "Sale of rubber chemicals business" dated November 09, 2006); and
- its surfactant business to the Croda Group, UK with effect from September 02, 2006 (see our report "Exiting surfactant business" dated June 30, 2006).

Segmental sales (gross) (Rs crore)

Particulars	H1 FY07	H1 FY06	% yoy chg	Q2 FY07	Q2 FY06	% yoy chg
Paints	406.0	326.2	24.4	217.2	170.8	27.2
Chemicals	106.8	87.0	22.8	33.7	26.3	28.4
Total (continued businesses)	512.8	413.2	24.1	251.0	197.1	27.3
Discontinued business	26.2	90.3	-71.0	26.2	64.2	-59.2
Total revenues	538.9	502.4	7.3	277.1	260.2	6.5

Sales from continued businesses grow by 53.9%

The PBIT from the continued businesses for the quarter grew by 53.5% on the back of an expansion in the PBIT margin of both its businesses. In the paint business, the PBIT margin expanded by 150 basis points. The PBIT margin in the chemical business expanded by 200 basis points. On a reported basis (including the discontinued businesses), the PBIT grew by 25.7%.

PBIT (Rs crore)

Particulars	H1 FY07	H1 FY06	% yoy chg	Q2 FY07	Q2 FY06	% yoy chg
Paints	30.4	20.7	47.3	19.0	12.3	53.9
PBIT margins (%)	*7.5*	*6.3*		*8.7*	*7.2*	
Chemicals	14.4	11.1	29.3	4.3	2.8	51.9
PBIT margins (%)	*13.5*	*12.8*		*12.8*	*10.8*	
Total (continued businesses)	44.8	31.8	41.0	23.3	15.2	53.5
Discontinued business	4.8	7.8	-38.3	4.8	7.2	-33.1
Total PBIT	49.6	39.6	25.4	28.1	22.4	25.7

The operating profit for the quarter under review grew by 12.4% yoy due to an increase in the unallocable expenses on account of sales and promotions.

Operating profit grows 16.8%

Particulars	Q2FY2007	Q2FY2006	% yoy chg
Reported PBIT	28.1	22.4	25.7
Less: Unallocable expenses	1.8	0.1	-
Add: Depreciation	5.8	5.6	3.8
Operating profit	31.8	28.3	12.4
OPM (%)	13.0	12.3	73 bps

With a higher other income and stable depreciation charge the net profit grew by 23.7% to Rs19.2 crore.

Sale of surfactant business

In Q1FY2007, ICI decided to sell off its surfactant business to the Croda group, a specialty chemical group based in the UK, for a total consideration of Rs260 crore. ICI's decision to sell the business is in line with the strategic decision of ICI Plc (ICI's parent company) to divest its surfactant business. The transfer of the business has been completed with effect from September 02, 2006. However, the consideration for the sale will be received in Q3FY2007 following the completion of some legal formalities.

Cash to be utilised to buy back and grow inorganically

At the end of March 2006, ICI had Rs350 crore of investments on the book. With an additional cash inflow of Rs260 crore from the sale of the surfactant business, ICI has announced the buy-back of its shares during July 2006 using Rs125 crore. It would buy the shares through market operations with the maximum price limit of Rs350 per share. However, with the current market price ruling around Rs343, we do not expect the company to garner much of the equity.

ICI might also look at the inorganic growth option in paints and starch businesses as it has ample liquid cash on its books.

To sell auto-refinish business only if gets right price

Recently there have been press articles suggesting that ICI intends to sell off its auto-refinish paint business to PPG Industries of USA. ICI's auto-refinish paint business consists of two parts:

- conventional refinish paints that are sold under the *Duco* brand and
- polyurethane (PU) based paints inlicenced from PPG Industries with the licence likely to expire in 2009.

With PPG Industries planning to set up its own 100% subsidiary in India (the US company has obtained the necessary approvals) for manufacturing and marketing automotive paints, it would make sense for ICI to sell off the PU-based auto-refinish paint business. ICI would sell the business only if it gets the right price. In any case, the business contributes less than 10% to ICI's revenues. Also, since the company first imports and then sells the auto-refinish paints, we believe the margins are not high in the business. Hence the impact of the disposal of the business on the net profit would also be lower.

Valuations

We have upgraded our EPS estimates for the stock for FY2007 and FY2008, from Rs17.4 and Rs23.2 to Rs18.3 (up 5.5%) and Rs24.2 (up 4.3%) respectively, to take into account the better-than-expected margins in the paint business. Accordingly we have revised our price target on the stock to Rs430.

At the current market price of Rs342, the stock trades at 15.1x its FY2008E core EPS and 5.9x FY2008E EV/EBIDTA. We also expect ICI to have investments worth Rs162 per share at the end of FY2008. We maintain our Buy recommendation on the stock with the price target of Rs430.

Valuation table (consolidated numbers)

Year to 31 March	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs crore)	42.6	53.7	74.9	98.8
Shares in issue (crore)	4.1	4.1	4.1	4.1
EPS (Rs)	10.4	13.1	18.3	24.2
% y-o-y change	*-12.0*	*26.0*	*39.5*	*31.8*
P/E (x)	33.6	26.6	19.1	14.5
Core E P S (Rs)	5.8	8.4	13.0	18.1
P/Core EPS (x)	46.9	31.1	15.7	10.3
Book value (Rs)	128.0	133.0	182.2	200.1
P/BV (x)	2.7	2.6	1.9	1.7
EV/Sales (x)	1.3	1.1	1.1	1.0
EV/EBITDA (x)	12.8	9.8	9.0	7.2
RoNW (%)	8.2	10.1	11.6	12.6
RoCE (%)	8.7	11.5	10.6	13.5

The author doesn't hold any investment in any of the companies mentioned in the article.

Corporation Bank

Apple Green

Stock Update

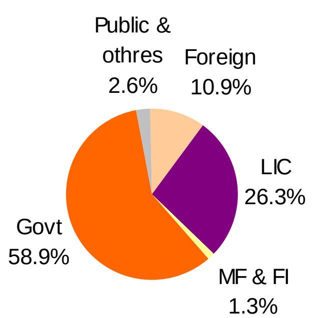
Price target revised to Rs425

Buy; CMP: Rs402

Company details

Price target:	Rs425
Market cap:	Rs5,749 cr
52 week high/low:	Rs445/205
NSE volume: (No of shares)	1.2 lakh
BSE code:	532179
NSE code:	CORPBANK
Sharekhan code:	CORPBANK
Free float: (No of shares)	2.1 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	0.0	71.0	18.0	17.0
Relative to Sensex	-3.0	42.6	9.6	-27.6

Result highlights

- Corporation Bank's Q2F2007 net profit at Rs127 crore is up 20.3% year on year (yoy) and is below our expectations.
- The net interest income (NII) grew by a modest 3.3% yoy to Rs316.7 crore due to a 69-basis-point fall in the net interest margin (NIM), even as the advances grew by 38.5% yoy.
- The fall in the NIM was due to a lower yield on investments (down 27 basis points) and a higher cost of funds (up 88 basis points; mainly on account of a sharp rise of 77 basis points in the deposit costs).
- The other income declined by 18.1% yoy to Rs113.1 crore due to losses on treasury operation and a sedate 11.4% growth in the fee and other incomes.
- With the net income declining by 3.3% yoy and the operating expenses increasing by 7.4%, the operating profit declined by 10.7% yoy to Rs235.7 crore.
- With a significant fall in the provisioning requirement the net profit grew by 20.3% to Rs127 crore. The provisioning requirement for the non-performing assets (NPAs) declined due to a fall in the gross NPAs on account of higher recoveries and upgradations as well as a write-back of investment depreciation.
- Going forward, we expect the bank's NIM to remain stable or show some marginal improvement over Q2FY2007, as some of its high-priced deposits are likely to mature over the coming fortnight and some of its low-yielding advances are due for re-pricing.
- We have revised our earnings per share (EPS) estimates for FY2007 and FY2008 from Rs35.1 and Rs43.1 to Rs36.7 and Rs46.5 respectively to take into account the lower provisioning requirement and stable NIMs going forward.
- At the current market price of Rs402, the stock is quoting at 8.7x its FY2008E EPS, 4.3x pre-provision profit (PPP) and 1.3x book value (BV).

Result table Rs (cr)

Particulars	H1FY07	H1FY06	% yoy	Q2FY07	Q2FY06	% yoy	% qoq
Net interest income	641.5	587.4	9.2	316.7	306.5	3.3	-2.5
Other income	300.6	307.6	-35.7	113.1	138.0	-18.1	-39.7
Other income (excl treasury)	*226.4*	*196.9*	*15.0*	*118.4*	*106.3*	*11.4*	*9.7*
Treasury income	*74.2*	*110.7*	*-33.0*	*-5.4*	*31.7*	*PL*	*PL*
Net income	942.0	895.0	5.3	429.7	444.5	-3.3	-16.1
Operating expenses	382.3	354.1	8.0	194.1	180.6	7.4	3.1
Operating profit	559.7	540.9	3.5	235.7	263.9	-10.7	-27.3
Provisions	144.9	177.3	-18.3	38.7	96.0	-59.7	-63.6
Tax	143.5	134.5	6.7	70.0	62.3	12.4	-4.8
Net profit	271.3	229.1	18.4	127.0	105.6	20.3	-12.0

PL: profit to loss

- Although the upside to the current market price is limited, the same could come from a better-than-expected improvement in the NIM. Further, Corporation Bank is best placed to leverage its balance sheet due to its high Tier-I capital adequacy ratio (CAR) of 13.3%. It is also the best bank in the industry to implement the Basel II norms due to its high Tier-I CAR and would not require an equity dilution. We would like to wait and watch the improvement in the NIM before factoring the same into our numbers. We maintain our Buy recommendation on the stock with price target of Rs425.

NII grows by modest 3.3%

Corporation Bank's Q2FY2007 NII grew by a modest 3.3% yoy which is below our expectations of a 10.5% growth. Although the advances book has grown by a robust 38.5%, yet the NII growth remained muted, as the bank sacrificed margins to grow its assets. The sedate growth was on account of a 54-basis-point decline in the NIM owing to a 27-basis-point drop in the yield on investment and a steep rise of 88 basis points in the cost of funds. The cost of funds increased mainly because of a 77-basis-point rise in the deposit cost. The deposit cost rose sharply on a y-o-y basis because the share of the total demand deposits in the total deposits decreased from 33.1% to 29.9% and the term deposit costs were higher.

Other income down due to treasury loss

The other income decreased by 18.1% yoy to Rs113.1 crore mainly due to a Rs5.4-crore trading loss reported in Q2FY2007 compared with a gain of Rs31.7 crore in Q2FY2006. Excluding the treasury income, the other income increased by 11.4% and included bad debt recovery of Rs28.2 crore compared with Rs18.5 crore in Q2FY2006.

Other income (Rs crore)

Particulars	Q2Y07	Q2FY06	% yoy chg	% qoq chg
Other income (excl. treasury)	118.4	106.3	11.4	9.2
Treasury income	-5.4	31.7	PL	PL
Total	113.1	138.0	-18.1	-39.7

Source: Company, Sharekhan Research
PL: profit to loss

Operating expenses up 7.4%

The operating expenses grew by 7.4% yoy to Rs194.1 crore with the staff cost rising marginally by 1.7% yoy to Rs91.2 crore.

Operating expenses (Rs crore)

Particulars	Q2Y07	Q2FY06	% yoy chg	% qoq chg
Employee cost	91.2	88.7	2.9	1.7
Other operating expenses	102.8	92.0	11.8	4.4
Total operating expenses	194.1	180.6	7.4	3.1

Provisions down 59.7%

The provisioning requirement for the NPA declined due to a fall in the gross NPAs on account of higher recoveries and upgradations. A further write-back for investment depreciation of Rs6.3 crore resulted in a 59.7% fall in the total provisions yoy to Rs38.7 crore from Rs96 crore in Q2FY2006.

Break-up of provisions

Particulars	Q2FY07	Q2FY06	% yoy chg
Provisions & Contingencies	38.7	96.0	-59.7
Amortisation and others	10.7	36.0	-70.4
NPA	28.0	60.0	-53.3

Asset quality remains good

The gross NPAs reduced to Rs616.3 crore (2.16%) at the end of September 2006 from Rs688.8 crore (3.33%) at the end of September 2005 due to higher upgradations and recoveries. The net NPAs reduced to 0.48% of the net advance at the end of September 2006 from 0.98% at the end of September 2005.

Strategic alliance

Corporation Bank has entered into a strategic alliance with Indian Bank and Oriental Bank of Commerce to increase income streams, achieve cost efficiency by sharing technology platforms, automated teller machine networks etc. Although the managements of these three banks are working together to identify operational plans to achieve such synergies, yet they have not yet finalised the cost

Yield assessment (%)

	H1FY07	H1FY06	yoy chg (in bps)	Q2FY07	Q2FY06	Q1FY07	yoy chg (in bps)	qoq chg (in bps)
Yield on advances	8.69	8.30	39.0	8.52	8.11	8.14	41.8	38.9
Yield on investments	7.61	7.87	-26.0	7.33	7.60	7.19	-27.5	14.0
Yield on assets	7.79	7.54	25.0	7.54	7.20	7.08	33.9	46.5
Cost of deposits	5.02	4.54	48.0	5.23	4.45	4.48	77.2	74.3
Cost of funds	4.59	3.98	61.0	4.67	3.79	3.93	88.1	74.4
NIM	3.20	3.56	-36.0	2.87	3.41	3.15	-54.2	-27.9

Source: Sharekhan Research
Quarterly figures are calculated based on opening and closing balances
Half-yearly numbers are as reported by the bank

income sharing formulae. We believe that since the model is still in its infancy, the financial benefits of the strategic alliance would accrue only in the next three to four quarters.

Valuation and view

We have revised our EPS estimates for FY2007 and FY2008 from Rs35.1 and Rs43.1 to Rs36.7 and Rs46.5 respectively to take into account the lower provisioning requirement and stable NIMs going forward.

At the current market price of Rs402, the stock is quoting at 8.7x its FY2008E EPS, 4.3x PPP and 1.3x BV. Although the upside to the current market price is limited, yet the same could come from a better-than-expected improvement in the NIM. Further, Corporation Bank is best placed to leverage its balance sheet due to its high Tier-I CAR of 13.3%. It is also the best bank in the industry to implement the Basel II norms due to its high Tier-I CAR and would not require an equity dilution. We would like to wait and watch the improvement in the NIM before factoring the same in our numbers. We maintain our Buy recommendation on the stock with price target of Rs425.

Earnings table

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	402.2	444.5	524.9	664.6
Shares in issue (cr)	14.3	14.3	14.3	14.3
EPS (Rs)	28.1	31.1	36.7	46.5
% y-o-y change	*-20.2*	*10.5*	*18.1*	*26.6*
PE (x)	14.4	13.0	11.0	8.7
P/PPP (x)	5.6	5.5	5.1	4.3
Book value (Rs)	213.0	236.0	264.1	301.5
P/BV (x)	1.9	1.7	1.5	1.3
Adj book value (Rs)	199.2	225.3	256.1	294.5
P/ABV (x)	2.0	1.8	1.6	1.4
RONW (%)	13.8	13.8	14.7	16.4

The author doesn't hold any investment in any of the companies mentioned in the article.

Sharekhan Stock Ideas

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
ACC
Bajaj Auto
Balrampur Chini Mills
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Electronics
Bharat Heavy Electricals
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Godrej Consumer Products
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
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Marico Industries
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Satyam Computer Services
SKF India
State Bank of India
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Tata Motors
Tata Tea
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Wipro

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Shree Cement
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Thermax
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KEI Industries
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Selan Exploration Technology
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UltraTech Cement
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