investor's eye

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Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
ACC	10-Aug-04	260	**1,001**	1,210
Balaji Tele	9-July-07	231	**246**	303
HUL	24-Nov-05	172	**201**	280
Maruti	23-Dec-03	360	**829**	921
SBI	19-Dec-03	476	**1,650**	1,780

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Information Technology

Sector Update

Favourable policy changes

Key points

- The recent policy announcements by the government indicate its growing willingness to protect the rupee against any further appreciation. This is a positive move for the information technology (IT) service companies that have primarily an export-centric business model.
- The policy changes not only allay concerns related to further appreciation in the rupee but could also potentially result in earnings upgrades on the back of the possible weakening of the rupee. The positive impact of the same would be more pronounced in case of the mid-cap companies.
- Despite the distinct pick-up in revenues from the banking, financial services and insurance (BFSI) vertical in Q1 (after a lacklustre performance in Q4), the concerns related to a possible slowdown in demand from the BFSI vertical (in the wake of the subprime woes) would be an overhang on the tech stocks. Especially so, given the fact that the subprime crisis has affected large financial institutions from across the world.
- In terms of our top picks, we continue to prefer HCL Technologies (HCLT; given the company's strong results in the past three quarters, aggressive hedging strategy and reasonably attractive valuations) and Satyam Computer Services (Satyam; based on the distinct improvement in the company's operating metrics, its relatively lower exposure to the BFSI vertical and the strong growth momentum in its enterprise business). In the mid-cap space, we prefer 3i Infotech (purely on valuation basis and due to the company's limited exposure to the US geography).

Policy initiatives to support rupee

The recent policy initiatives highlight the central bank's intentions to support the rupee. This is done by using a two-pronged approach of curbing the foreign exchange inflow (through fresh restrictions on external commercial borrowings) and enhancing the leeway available to the central bank to intervene directly (by sucking excess liquidity by hiking the cash reserve ratio by 50 basis points and increasing the Market Stabilisation Scheme limit by Rs40,000 crore).

The policy initiatives would allay the fears related to further appreciation in the rupee (which came close to breaching the Rs40/USD mark recently), which is important for the export-centric sectors such as IT services. Especially since the rupee was recently trading below the assumption taken in the full year guidance by Infosys Technologies (Rs40.58/USD) and Satyam (Rs40.5/USD). A further rise in the rupee could potentially have led to more downgrades in the earnings estimates of the IT companies (at least for FY2008) as many analysts have assumed an exchange rate of Rs40.5 to Rs41/USD in their estimates.

Our estimates at Rs40/USD

In our estimates we have factored in an exchange rate of Rs40/USD for FY2008 and FY2009. This not only gives us a reasonable margin of safety but can also potentially result in an upside to our estimates, considering the central bank's renewed focus on supporting the rupee.

In case the rupee stays close to the current level of Rs40.5-40.6 for the rest of the year, it would result in an earnings upgrade of 1-1.6% for FY2008 and of 1.1-1.7% for FY2009 for select front-line companies. However, if the central bank intervenes aggressively in the foreign exchange market and the rupee depreciates to an average rate of Rs41/USD, the earnings upgrade would be much higher at 2.5-3.2% for FY2008 and 2.2-3.7% for FY2009 for the same companies.

Sensitivity to exchange rate

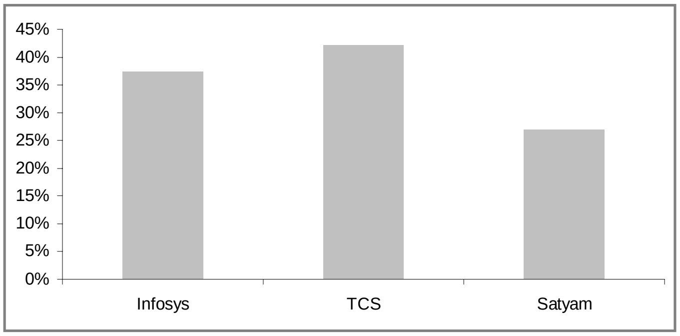
	FY2008	FY2009
Infosys		
Rs40.5	1.0%	1.1%
Rs41	2.6%	2.2%
TCS		
Rs40.5	1.2%	1.1%
Rs41	2.5%	2.4%
Satyam		
Rs40.5	1.6%	1.7%
Rs41	3.2%	3.7%

The Q1 performance clearly reflected that the impact of the rupee's appreciation was more pronounced in case of the mid-cap IT companies. Consequently, the rupee's stability (or a possible depreciation) would be much more positive for the mid-cap companies. The mid-cap companies have lost 25-30% of their market cap in the last couple of months and any reversal in the movement of the rupee could potentially boost sentiment towards the mid-cap tech stocks. We expect Tata Elxsi (negligible forex hedging) and Hexaware (relatively higher leverage to currency movement) to be among the key beneficiaries of possible weakness in the rupee.

BFSI vertical, concerns rising again

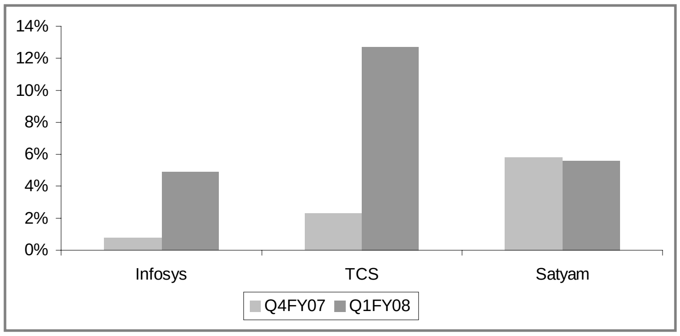
In addition to the appreciating rupee, the growing concerns related to the subprime lending crisis and its possible impact on the large financial institution/banks globally have also been an overhang on the IT stocks. That's because on an average the BFSI vertical contributes around 30-35% of the revenues of the Indian IT service companies.

High dependence on BFSI vertical (% contribution to FY2007 revenues)



After the subdued growth in the BFSI vertical in Q4FY2007, the strong performance by the leading vendors in terms of a pick-up in the sequential growth in Q1FY2008 was comforting. Moreover, the management of most companies indicated that their exposure to the US-based mortgage companies (especially subprime mortgage companies) is minimal or close to zero. There are exceptions such as iGate Global Services, which has close to 10% exposure to mortgage clients and consequently has witnessed a steep decline in revenues from the said vertical.

Improving sequential growth in revenues from BFSI vertical



However, the subprime woes are threatening to engulf and dent many large and leading global financial institutions across geographies; eg Bear Stearns Cos. (USA), Macquarie Bank (Australia) and BNP Paribas (Europe). Consequently, the crisis has the potential to considerably affect the client base of the Indian vendors in the BFSI vertical and would act as an overhang on the IT stocks.

Valuation

In terms of our top picks, we continue to prefer HCLT (given the company's strong results in the past three quarters, aggressive hedging strategy and reasonably attractive valuations) and Satyam (based on the distinct improvement in the company's operating metrics, its relatively lower exposure to the BFSI vertical and the strong growth momentum in its enterprise business). In the mid-cap space, we prefer 3i Infotech (purely on valuation basis and due to the company's limited exposure to the US geography).

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

Banking

Sector Update

RBI modifies ECB guidelines

ECB guidelines curbed

The government has finally decided to curb the external commercial borrowing (ECB) route, which has been one of the main routes through which overseas money has been entering into India. We had expected a similar announcement during the first quarter monetary policy review. The modifications done to moderate the capital inflows through the ECB route are stated below:

- ECBs of more than US$20 million per borrower company per financial year would be allowed only if expenditure (for permissible end-uses) is in foreign currency; funds raised will need to be parked overseas and cannot be remitted into India.
- While ECBs of less than US$20 million can be raised for rupee expenditure as well, this will need prior approval from the Reserve Bank of India (RBI). Funds raised will need to be parked overseas until actual requirement in India.
- All other aspects of the policy such as the limit of US$500 million per company per year under the automatic route, definition of eligible borrower etc remain unchanged.
- The revised guidelines do not apply to borrowers who have already entered into loan agreements and obtained loan registration numbers from the RBI.

The move is aimed at controlling the dollar inflows via the ECB route as companies have been accessing this route purely to play the interest rate arbitrage mainly for domestic working capital purpose. Some of these borrowings are also getting converted into domestic deposits to exploit the arbitrage that exists between overseas borrowing rates and domestic deposit rates.

Impact on the bond and foreign exchange market

The 10-year yield jumped up by 9 basis points on the opening of the bond market on August 8, 2007 while the rupee declined by almost 35 paise in the early hours of trade to Rs40.72 from its previous close of Rs40.37. However by the end of the day the bond yield closed at 7.90% up 7 basis points and rupee closed at Rs40.58 up 21 paise. The bond yileds have further firmed upto 7.98% after the hike in MSS ceiling as on August 9, 2007.

RBI hikes MSS ceiling by Rs40,000 crore

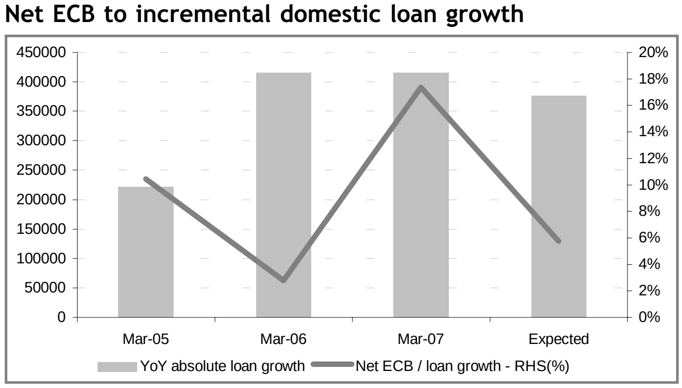
The RBI has also hiked its Market Stabilisation Scheme (MSS) ceiling for FY2008 by Rs40,000 crore to Rs150,000 crore from Rs110,000 crore earlier. The threshold at which the ceiling will be reviewed in future is now at Rs135,000 crore. After today's MSS auction, the MSS outstanding will be at Rs98,970 crore, which will be higher than the existing review limit of Rs95,000 crore that required a hike in the MSS ceiling as there was very little headroom available to the RBI. The MSS hike also indicates that the RBI expects higher inflows in the future.

Impact of the above measures on...

Banking sector

- *Higher credit demand to keep loan yields stable:* Since Indian corporates would now have to finance their rupee expenditures from domestic borrowings, it would translate into higher credit demand for domestic banks. Although year to date the credit demand has been marginally negative, yet things can change from Q2/ Q3 of FY2008. Higher demand for credit would delay the cut in lending rates and keep loan yields stable. Banks' margins are likley to remian stable going forward.
- Net ECB borrowings (at Rs72,207 crore) as a percentage of incremental domestic loans stood at 17% in FY2007. Assuming that 20% of the net ECB amount was opportunistic and 50% remains offshore, the shift in loan demand would be 30% or Rs 21,662 crore. Assuming a credit growth of 20% for FY2008, it would translate into an increase of 5-6% in the domestic loan demand due to the change in the ECB policy.

Net ECB to incremental domestic loan growth



Source: Sharekhan Research

Deposit rates unlikely to fall: The curb on ECB flows will lead to lower money supply and deposit growth. Again a higher domestic loan demand would keep the interest rates firm and would make deposit rate cuts unlikely, going forward.

Overall economy

Borrowing costs likely to show some upward bias: Due to the US subprime mortgage crisis, credit spreads across the world has moved up sharply. The benchmark LIBOR for overseas borrowings is currently at over 6%. At present it has become very difficult to borrow in the international markets due to higher pricing of credit risks. Hence, we feel the incremental borrowing costs would not have provided a significant advantage to the borrowers on a fully hedged basis. However, incremental borrowing costs would have an upward bias.

Liquidity and money supply: Net ECB flows in FY2007 accounted for 36% of the total capital flows. The restriction on the ECB inflows would help the RBI in tackling the surging foreign fund inflows. We expect that the recent CRR hike, the removal of the cap on the reverse repo rate and the hike in the MSS ceiling would go a long way in tackling the problem of liquidity. The money supply growth is expected to moderate below its current level of 21.7% going forward.

Balance of payments

After the change in the ECB guidelines we expect the net contribution of ECBs to the total capital flows to decline to 20% in FY2008 from 36% in FY2007. However, due to the strong foreign direct investments as well as portfolio and banking capital flows, we expect the capital account to show an 11.8% year-on-year increase to $50.3 billion in FY2008 from $44.9 billion in FY2007.

However, all is not that well on the current account front. We expect the current account deficit (CAD) to worsen to 3.8% of GDP from 1.1% at present. The deterioration in the current account is expected due to lower exports and invisibles growth while non-oil imports continue to rise at a robust pace. The year to date (April to June 2007) merchandise trade deficit (MTD) stood at $20.6 billion in FY2008 compared with $11.8 billion for the corresponding period in the previous year. The MTD is primarily driven by higher non-oil imports (up 49% year on year) and lower exports (up 18% year on year).

We expect the export growth to be around 12% in FY2008, the invisible growth to moderate to 20% in FY2008 from 30% in FY2007 and the total imports to grow by 29% in FY2008. All this would translate into a CAD of around $38.9 billion, up from $9.6 billion in FY2007. The net accretion to foreign exchange reserves for FY2008 is expected to be $12.8 billion and the latest RBI data shows that we had roughly achieved the entire amount expected for FY2008 by the end of July 2007. Hence, going forward, accretion to reserves would be marginal on a full year basis. Thus we feel the pressure on the interest rates and the rupee is likely to remain, however the bias on further appreciation in the rupee from the current levels has moderated with the RBI undertaking policy changes and liquidity management measures to support the rupee.

Our estimates are based on the current situation regarding lower export growth due to a strong rupee and continued rise in imports. If in reality the overall balance of payments situation deteriorates significantly, as we feel can happen, the RBI would intervene to improve the liquidity and overall external sector.

Conclusion

We maintain our stance that the interest rates are likely to have peaked out; however moderation in rates is not expected soon. Banks stand to gain due to higher credit demand and stable interest rate scenario. Our top picks in the banking sector remain State Bank of India, Bank of Baroda and Union Bank in the public sector and, ICICI Bank and HDFC Bank in the private sector.

Balance of payments

Particulars ($billion)	FY04	FY05	FY06	FY07	FY08E
A. Current account (1+2)	14.1	-2.5	-9.2	-9.6	-38.9
Exports	66.3	85.2	105.2	127.1	142.2
Imports	80.0	118.9	157.0	192.0	247.5
1. Trade balance	-13.7	-33.7	-51.8	-64.9	-105.3
2. Invisibles	27.8	31.2	42.7	55.3	66.3
CAB* as % of GDP	2.3	-0.8	-1.3	-1.1	-3.8
B. Capital account	16.7	28.0	23.4	44.9	50.3
Foreign investment	13.7	13.0	17.2	15.5	25.0
Loans (including ECBs)	-4.4	10.9	6.1	21.1	15.6
Banking capital net	6.0	3.9	1.4	2.1	6.3
Other capital	1.7	0.7	-0.7	6.4	4.0
Rupee debt service	-0.4	-0.4	-0.6	-0.2	-0.6
C. Errors & omissions	0.6	0.5	0.8	1.3	1.5
Overall BOP (A+B+C)	31.4	26.1	15.1	36.6	12.8

* CAB: Current account balance

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
Apollo Tyres
Bajaj Auto
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Electronics
Bharat Heavy Electricals
Bharti Airtel
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Grasim Industries
HCL Technologies
Hindustan Unilever
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico
Maruti Udyog
Lupin
Nicholas Piramal India
Ranbaxy Laboratories
Satyam Computer Services
SKF India
State Bank of India
Sundaram Clayton
Tata Motors
Tata Tea
Unichem Laboratories
Wipro

Cannonball

Allahabad Bank
Andhra Bank
Gateway Distriparks
International Combustion (India)
JK Cement
Madras Cement
Shree Cement
Tourism Finance Corporation of India
Transport Corporation of India

Emerging Star

3i Infotech
Aban Offshore
Alphageo India
Axis Bank (UTI Bank)
Balaji Telefilms
Cadila Healthcare
Federal-Mogul Goetze (India)
KSB Pumps
Marksans Pharma
Navneet Publications (India)
Network 18 Fincap
Nucleus Software Exports
Orchid Chemicals & Pharmaceuticals
ORG Informatics
Tata Elxsi
Television Eighteen India
Thermax

Ugly Duckling

Ahmednagar Forgings
Ashok Leyland
Aurobindo Pharma
BASF India
Ceat
Deepak Fertilisers & Petrochemicals Corporation
Genus Power Infrastructures
Hexaware Technologies
ICI India
India Cements
Indo Tech Transformers
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
South East Asia Marine Engineering & Construction
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Vulture's Pick

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