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India Daily Comment

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India

Sectors in this Issue

23 November 2006

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Company Update

Reliance Energy, RLEN.BO **Suhas Rema Harinarayanan** p.1

Transmitting power

Reduce 2* (Unchanged) CBE , FY07E Rs32.38, FY08E Rs34.22, PT Rs475.00 Mkt Cap Rs113bn/US$2.53bn

Industry Update

Pharmaceuticals **Prashant Vaishampayan** p.3

India pharmaceuticals update - What is driving growth in the Indian pharma market in 2006?

South Asian Focus, India: Which way for the Rupee?

Sector (See Below)

Healthcare

Utilities

Global Equity Research

India

Electric Utilities

Rating	Reduce 2* *Unchanged*
Price target	Rs475.00/US$10.61 *Unchanged*
Price	Rs532.75/US$11.90

RIC: RLEN.BO BBG: RELE IN

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First Read: Reliance Energy

Transmitting power

- **Wins the first fully private BOT transmission project**

Reliance Energy (REL) has won the bid to build, and operate 2 transmission lines in Western India. We understand that REL's bid is 25% lower than CERC set benchmark and 25% lower than 2nd lowest (L2) bidder. This could very well have been due to a) lower capital costs from either shorter routes or lower equipment costs, b) lower hurdle rates or c) higher debt-equity, though not ascertainable.

- **Transmission projects are low risk**

Transmission projects are low risk, low reward projects with little incentive to earn returns above 14% even under the cost plus tariff regime. Under competitive bidding as this one, it looks unlikely that returns could exceed 14%. They are low risk since collection ratios are high, and execution cycle is faster.

- **Finally, a project for REL**

We estimate the NPV/Investment at about 1.1x of Rs5.4bn (on project cost of Rs18bn, D:E of 70:30), contributing <1% to the overall value. Nevertheless, given the current overhang of execution related problems for REL's projects, the news of the project win is a welcome positive.

- **Valuation: Maintain Reduce 2 rating**

Our PT of Rs475 is based on a sum of the parts valuation with core power business at Rs223, Delhi distribution Rs62 and cash at Rs190. We retain Reduce 2 rating.

Highlights (Rs m)	03/05	03/06	03/07E	03/08E	03/09E
Revenues	41,454	40,335	44,766	48,461	52,294
EBIT (UBS)	3,278	4,279	4,028	4,166	4,567
Net income (UBS)	4,543	7,598	7,375	7,794	8,226
EPS (UBS, Rs)	22.12	33.36	32.38	34.22	36.12
Net DPS (UBS, Rs)	4.70	4.99	5.73	5.99	6.32

Profitability & Valuation	5-yr hist. av.	03/06	03/07E	03/08E	03/09E
EBIT margin %	10.0	10.6	9.0	8.6	8.7
ROIC (EBIT) %	12.2	11.2	8.7	9.1	9.9
EV/EBITDA x	7.7	12.8	11.8	10.1	8.3
PE (UBS) x	16.3	17.5	16.5	15.6	14.8
Net dividend yield %	1.6	0.9	1.1	1.1	1.2

Source: Company accounts, Thomson Financial, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of Rs532.75 on 21 Nov 2006 23:38 HKT

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Trading data (local/US$)

52-wk. range	Rs656.05-377.25/US$14.79-8.21
Market cap.	Rs113bn/US$2.53bn
Shares o/s	212m (ORD)
Free float	89%
Avg. daily volume ('000)	332
Avg. daily value (Rsm)	159.1

Balance sheet data 03/07E

Shareholders' equity	Rs77.2bn
P/BV (UBS)	1.6x
Net cash (debt)	Rs19.5bn

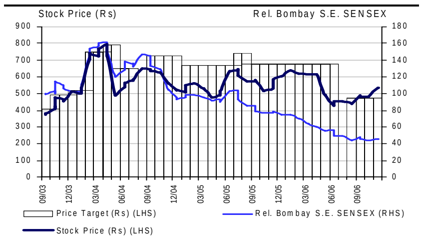
Forecast returns

Forecast price appreciation	-10.8%
Forecast dividend yield	1.1%
Forecast stock return	-9.7%
Market return assumption	12.1%
Forecast excess return	-21.8%

EPS (UBS, Rs)

	03/07E		03/06
	UBS	Cons.	Actual
Q1E	7.75	-	6.88
Q2E	8.21	-	7.01
Q3E	8.21	-	7.23
Q4E	8.21	-	7.44
03/07E	32.38	*32.69*	
03/08E	34.22	*34.22*	

Performance (Rs)



Source: UBS

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SEE REQUIRED DISCLOSURES SECTION AT END OF NOTES

*Exception to core rating bands

■ Reliance Energy

Reliance Energy is the electricity distributor for South Mumbai, and East and Central Delhi. Reliance Energy owns a 500MW coal-fired plant at Dahanu and plans to build a 5,600MW gas-based power plant at Dadri, Uttar Pradesh. Additional investments via joint venture include a 165MW liquid-fuel plant at Kerala (85% net); a 220MW naphtha plant in Andhra Pradesh (70%); and a 250MW lignite-fired plant in Tamil Nadu (67%). Reliance Energy has also diversified into distribution in resource-rich Orissa State (three distribution licences), a coal washery, and manufacture of electrical meters.

■ Statement of Risk

Timing of the sealing of the gas supply agreement for Dadri project and state government's allocation of new distribution licence areas impacts REL's future growth.The delay in implementing the Electricity Act gives incentives or leeway to some of the errant states to delay unbundling of their distribution networks. This is reflected in our predictability level of '2'.

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India pharmaceuticals update

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Pharmaceuticals

Sector Comment

22 November 2006

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What is driving growth in the Indian pharma market in 2006?

- **Volume growth coming back**

In the 12 months ending June, the Indian pharma market grew 19% YoY driven by a strong reversal in volume growth. After declining for three consecutive half-years, 9% volume growth has driven growth in 1H06. Price declines have stopped from 2005 and added 2% to growth. New product introduction was the dominant growth driver in 2004-05 but is fast losing importance.

- **Rural markets are driving the volume revival**

Rural India, with 36% growth, is the new growth engine. Three other segments of the market grew an uninspiring 10-13%. We think increased distribution focus from companies will continue, but income levels in rural India could change annually. This makes growth forecasts for 2007 even more difficult. Our base-case assumption is for 12-14% growth in 2007.

- **Growth is well diversified across therapeutic segments**

In 2005, there was only one segment – cardiac – that grew in double digits, whereas in 2006 every single segment among the top 10 is growing in double digits. The top segments accounting for 29% of the Indian pharma market are growing faster than the market average and pulling up the growth rate.

- **Company-specific performance comments**

Companies with a higher focus on acute illnesses and better rural market penetration have gained the most in this rebound. Ranbaxy and Nicholas Piramal lead the pack, while Cipla grew less than the market.

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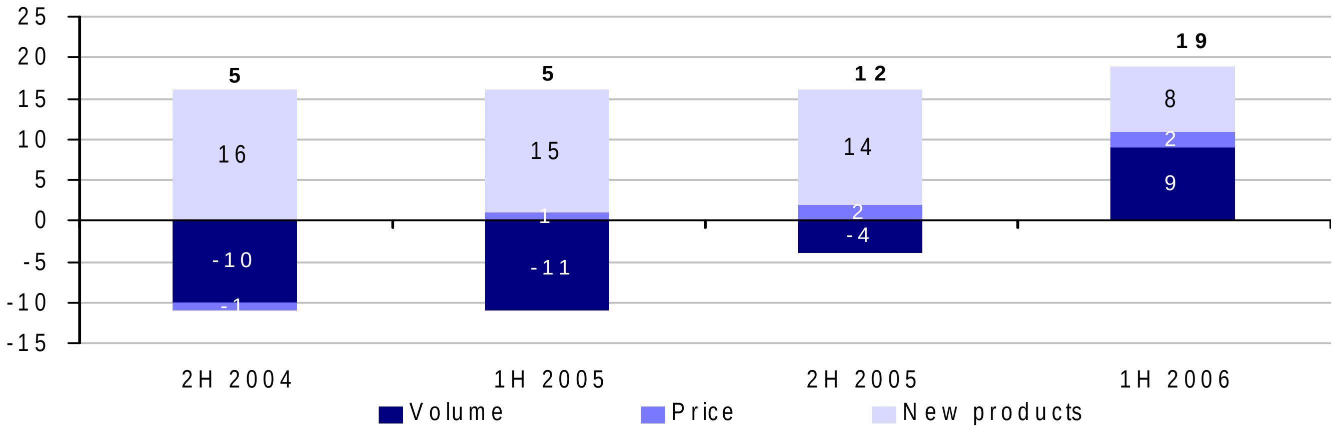
What is driving the revival of the Indian market?

The Indian pharmaceutical market showed an outstanding bounce back in growth from 5% in 1H 2005 to 19% in 1H 2006. The reasons for this change were not immediately apparent to us. However, a new report from the market research agency ORG-IMS has given an insight into what has changed in the Indian market in the past 12 months. The short answer is that the growth driver has been volume growth coming from the rural market.

Chart 1: Contributors to growth in the Indian pharma market (%)



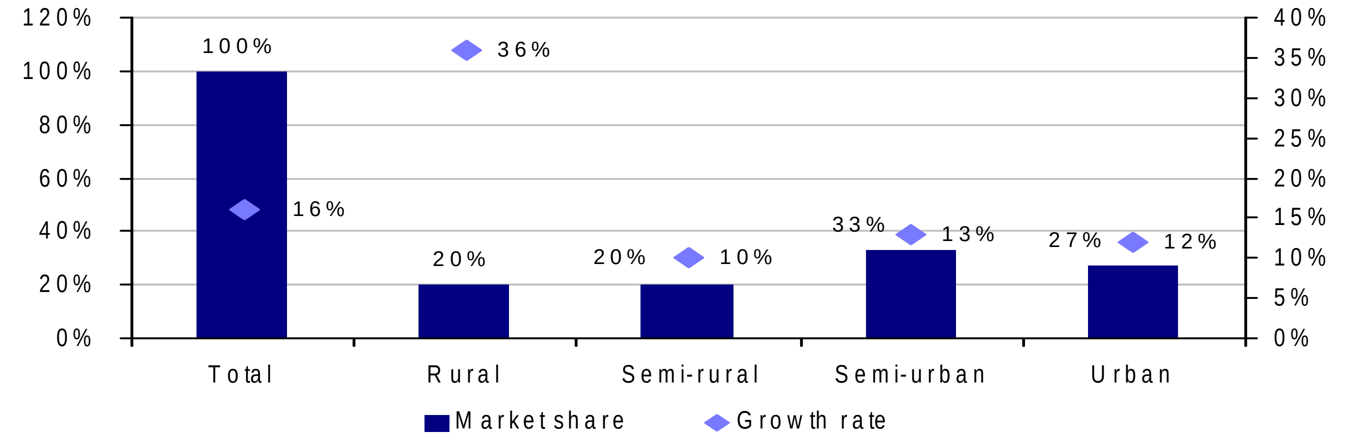
Source: ORG IMS SSA Jun06 MAT

Chart 1 clearly highlights that volume decline seen since 2H04 has been the key change in 1H06. Volumes declined for three consecutive half-years before reversing direction. The price decline seen in 2H04 changed to a price increase in 2005 and it has continued with this trend in 1H06 with 2% growth. New product introduction was the main growth driver historically, but its importance has declined, reflecting weak R&D pipelines globally and changes in patent law implemented in India in 2005. We expect new product introductions to decline further in 2007.

Rural markets are driving the growth in 2006

Some 60% of the Indian pharmaceutical market is in urban and semi-urban areas, while the remaining 40% of the market is located in rural and semi-rural areas. Chart 2 shows that the rural market segment grew 36% but all other segments have managed a modest 10-13% growth. This has important implications for the next year’s forecast. We think that rural demand growth is coming from two factors: (1) an increase in companies’ distribution capabilities through new marketing divisions focussed on rural markets and (2) increasing levels of income in rural India. It is essential but impossible to separate the impact of these two factors to estimate growth rates for 2007 and beyond. While companies will likely continue to focus on rural India, income levels in rural India may remain difficult to predict and are linked to weather patterns. Should this segment show a slowdown in 2007, the overall growth rate of the Indian pharmaceutical market is bound to suffer.

Chart 2: Geographical breakdown of the market

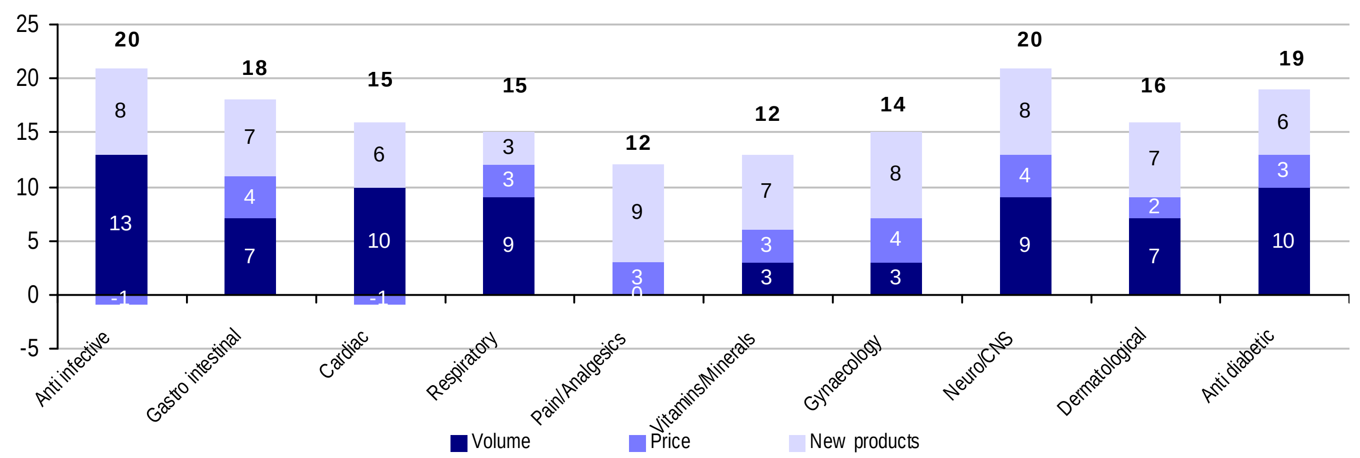


Source: ORG IMS SSA Jun06 MAT

Growth is well diversified across therapeutic segments

Data for the moving annual total for 12 months ending June06 shows that most of the top 10 segments have shown a better-than-market growth rate. Only three segments – pain & analgesic, vitamin & minerals and gynaecology – performed worse than the market average growth rate of 16%. In 2H06, we expect to see an increase in growth rates for pain & analgesic, vitamin & minerals as there was large scale prevalence of illnesses such as malaria, dengue and chickengunya following a good monsoon season and warm weather.

Chart 3: Performance of top 10 therapeutic segments (%)



Source: ORG IMS SSA Jun06 MAT

Table 1 highlights the revival in growth across the therapeutic segments. In 2005, there was only one segment – cardiac – that grew in double digits, while in 2006 every single segment among the top 10 is growing in double digits. The top segments, accounting for 29% of the Indian pharma market, are growing faster than the market average and pulling up the growth rate.

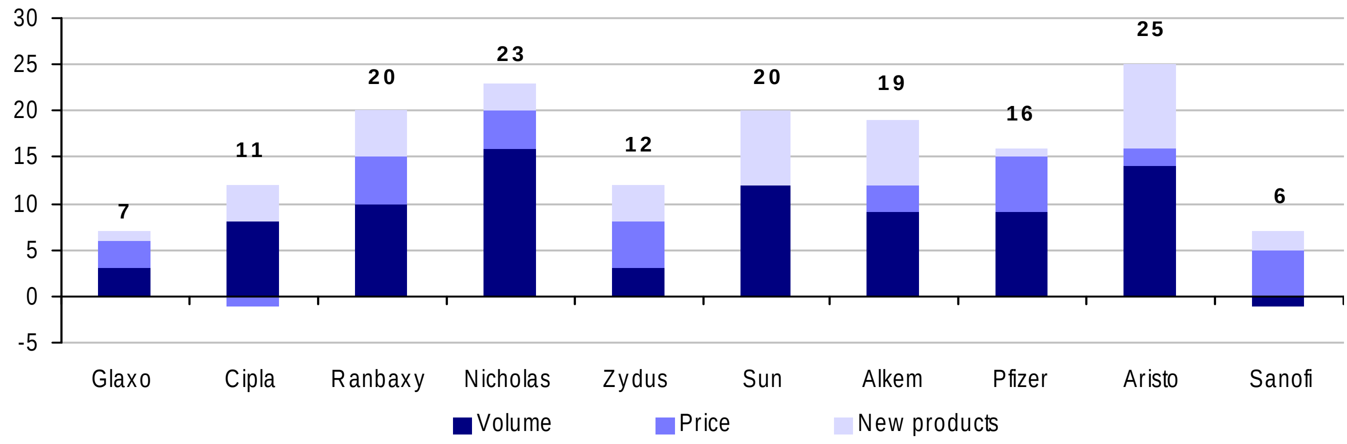
Table 1: Performance of top 10 therapeutic segments

	% to total		Value growth (%)	
	Jun-05	Jun-06	Jun-05	Jun-06
Anti-infective	17	18	4	20
Gastro intestinal	11	11	3	18
Cardiac	10	10	11	15
Respiratory	9	9	-1	15
Pain/analgesics	9	9	3	12
Vitamins/minerals	9	9	2	12
Gynaecology	6	5	6	14
Neuro/CNS	5	5	7	20
Dermatological	5	5	5	16
Anti-diabetic	4	4	9	19
Indian market	100	100	5	16

Source: ORG IMS SSA Jun06 MAT

Companies' performance is linked to the portfolio constitution. Companies with a higher focus on acute illnesses and better rural market penetration have gained the most in this rebound. Nicholas is the best-performing company with a strong volume-led momentum. Ranbaxy has achieved 20% growth as a price increase and new product introduction complemented the 10% volume growth achieved. Despite being focused on chronic segments, Sun pharma achieved 20% growth. This is remarkable since there was no accompanying price increase. It has the best new product introduction record among the top 10 companies. Cipla delivered a poor performance with growth lower than the market average. It faced a price decline of 1% while most others gained from price hikes.

Chart 4: Performance of top 10 companies (%)



Source: ORG IMS SSA Jun06 MAT

■ Statement of Risk

We believe general risks include regulatory, timing of approval, competition from rival drug therapies, litigation (including the appeals process), accounting/disclosure, product liabilities, execution and product pricing from generic competition. Severe pricing pressure in the US generics market occurred in 2005, a result of increased competition, and this might continue in 2006. In the generics industry, competition usually surfaces without warning.

We base our predictability level of 2 on our view that pharmaceutical revenues are very difficult to forecast in terms of timing of revenues from quarter to quarter. Lumpiness of customer orders, price erosion in the generics industry and delays in regulatory approval can make quarterly profits very volatile. Another growing risk is higher R&D costs.

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South Asian Focus

India: Which way for the Rupee?

22 November 2006

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After having underperformed most regional currencies in the first half of the year, the Rupee is regaining strength. What explains this renewed strength and what the future direction may be, we examine in this Focus. We think that a number of factors including a slowdown in portfolio flows, high oil prices and most of all, an expansionary monetary policy aimed at augmenting liquidity in the system had weighed on the Rupee. These factors have now either reversed or mitigated substantially. The INR appreciation story is here to stay.

The convergence of weak portfolio inflows and rising oil prices had resulted in a sharp weakening of the INR from May 2006. Portfolio capital flows have tended to be the single most important influence on the INR. RBI's policy actions complicated the situation further. The central bank did not expend its formidable stock of external reserves to stabilise the INR. In fact, it intervened in the currency markets on an unsterilised basis i.e. replaced its foreign currency purchases with INR liquidity. This policy action only weakened the INR further. We think this rather surprising policy action was motivated by two factors: (1) money markets had tightened considerably after the redemption of the India Millennium bonds and (2) the Rupee was substantially overvalued by approximately 7% on a real effective exchange rate (REER) basis. While there is no specified tolerance level for REER over/undervaluation, we think the 5% level is viewed as key. The recently released report on capital account convertibility has recommended central bank intervention whenever, the currency deviates from fair value by 5%.

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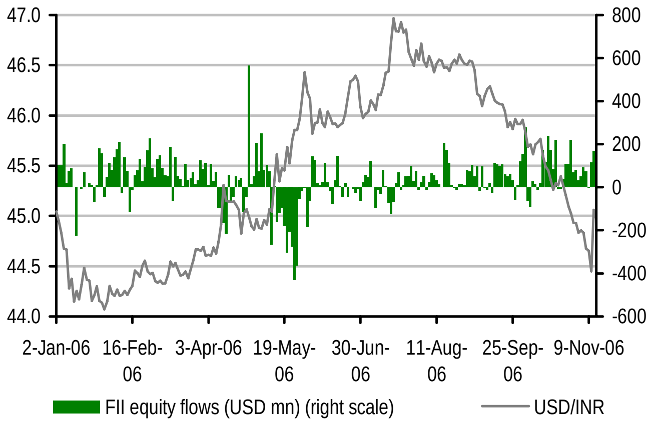
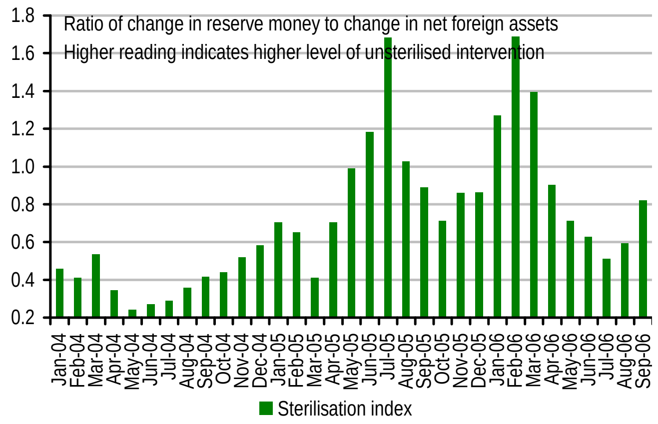
Chart 1: The impact of FII flows on USD/INR



Source: CEIC

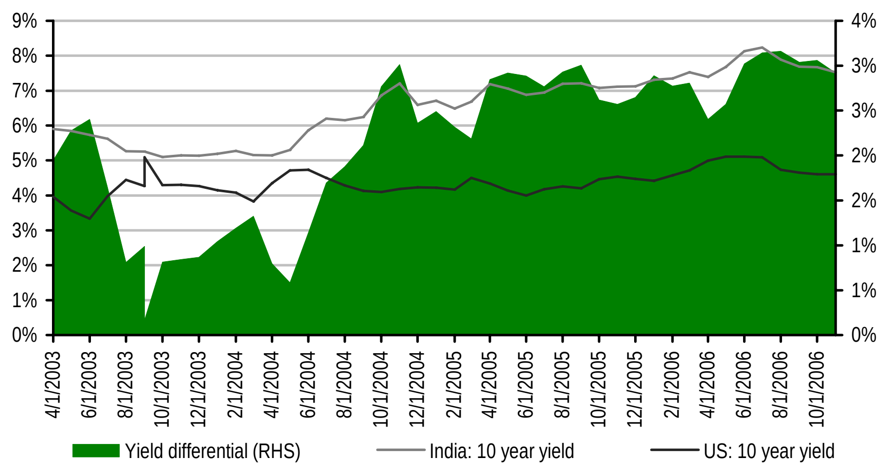
Chart 2: Level of unsterilised intervention



Source: CEIC, UBS estimates

The situation is significantly different now. The fall in oil prices has been significant and although, the trade accounts have not benefited significantly, the problem of lumpy payments for oil purchases has receded. More importantly, portfolio flows are once again averaging USD1bn each month, although this is lower than levels seen in Q1 06. Although no firm estimates are available, anecdotally it appears that overseas corporate borrowings have picked up in recent months. We think this pick-up is here to stay and foreign currency borrowings could exceed the USD17.3bn level in FY06. Both demand and supply side factors are supportive of higher overseas borrowings. On the demand side, India is in the midst of a capex cycle and with domestic yields hardening, scope for external borrowings is significant. The RBI has also eased norms for overseas borrowings in the October monetary policy review – corporates can now borrow USD250mn (in a single year) without prior approval, if the maturity of the loan is 10 years or more. This is over and above the previous annual limit of USD500mn.

Chart 3: Trends in bond yield spreads (India/US)



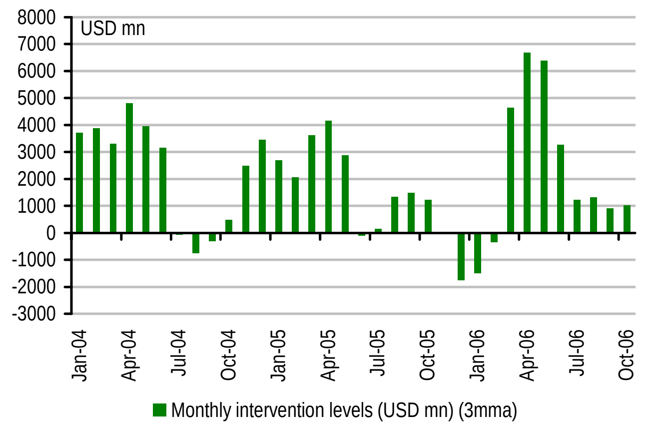
Source: CEIC

We do not think this scenario is likely to change. As we have discussed in previous Focus articles, India's monetary cycle is likely to remain divergent with the rest of the world. The October monetary policy review was clearly hawkish in our view: the hectic pace of credit expansion, risk of the emergence of demand pull inflation and elevated asset prices were key concerns cited by the RBI. We think that unlike say, Korea or Thailand, monetary easing will not be in line with that of the Fed. This would likely widen interest rate differentials and motivate recourse to overseas funding. The RBI is also winding down on unsterilised intervention although there has been an increase of late. In our view, this is at best temporary in nature as monetary growth of close to 19% in annual terms, is quite disconcerting. Continuation with this level of growth is likely to accentuate demand pull inflationary pressures.

What are the risks to this scenario? The principle risk is that funding India's current account deficit of around 3% of GDP will become problematic. We have always been cautious with the portfolio flow dominated nature of India's capital account. Foreign direct investment has been improving on a gross basis, but on a net basis, it remains low, due to aggressive overseas asset acquisition by Indian corporates. Clearly, should risk aversion rise, portfolio/debt flows would become constrictive and we should not overlook this outcome. Nonetheless, assuming a more neutral scenario associated with our call for a soft landing in the US economy, we think that funding is unlikely to be a problem.

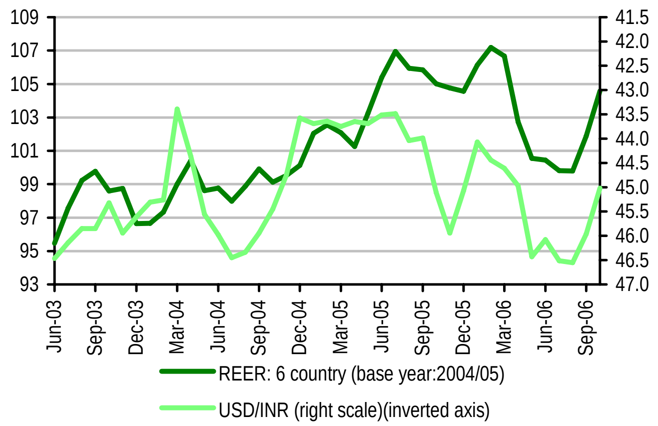
In a neutral scenario, we think the main risk becomes that of the RBI becoming less tolerant towards INR strength. This has not been the case over the past three months - intervention as measured by the change in foreign currency reserves (net of valuation effects) has come off significantly. This is shown in Chart 4. Nonetheless, the INR is now also close to being overvalued by close to 5% and as mentioned at the outset, we are probably close to the tolerance level of the RBI. Therefore, in the short term, it is possible that intervention is stepped up. Further out, it would be difficult for the RBI to be able to manage a tightening monetary policy and cap the strength of the INR.

Chart 4: Level of intervention in FX market



Source: CEIC, UBS estimates

Chart 5: Trends in real effective exchange rate and USD/INR



Source: CEIC, Reserve Bank of India

Based on this possible intervention, we think USD/INR would close 2006 at 45. This was our original forecast. Nonetheless, for end-2007, we are revising our forecast from 44 to 43. Undoubtedly, this will be a bumpy ride, interrupted by bouts of intervention, but the broad trend should be one of Rupee appreciation.

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Buy 2	FSR is > 6% above the MRA, lower degree of predictability			
Neutral 1	FSR is between -6% and 6% of the MRA, higher degree of predictability	**Hold/Neutral**	38%	32%
Neutral 2	FSR is between -6% and 6% of the MRA, lower degree of predictability			
Reduce 1	FSR is > 6% below the MRA, higher degree of predictability	**Sell**	12%	27%
Reduce 2	FSR is > 6% below the MRA, lower degree of predictability			

1: Percentage of companies under coverage globally within this rating category.
2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.
Source: UBS. Ratings allocations are as of 30 September 2006.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.
UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE): Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned or Company Disclosure table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price	Price date/time
Aurobindo Pharma Ltd[20]	ARBN.BO	Reduce 2 (CBE)	Rs593.20	21 Nov 2006 23:38 HKT
Cipla[20]	CIPL.BO	Buy 2 (CBE)	Rs258.05	21 Nov 2006 23:38 HKT
Dr. Reddy's Labs[13,16,20]	REDY.BO	Neutral 2 (CBE)	Rs730.75	21 Nov 2006 23:38 HKT
Glenmark[20]	GLEN.BO	Buy 2 (CBE)	Rs545.50	21 Nov 2006 23:38 HKT
NPIL[4,5,6,20]	NICH.BO	Buy 2 (CBE)	Rs230.55	21 Nov 2006 23:38 HKT
Ranbaxy[2,4,20,23]	RANB.BO	Buy 2 (CBE)	Rs381.50	21 Nov 2006 23:38 HKT
Reliance Energy[13,20]	RLEN.BO	Reduce 2 (CBE)	Rs532.75	21 Nov 2006 23:38 HKT
Sun Pharma[20]	SUN.BO	Buy 2 (CBE)	Rs975.70	21 Nov 2006 23:38 HKT
Wockhardt[20]	WCKH.BO	Buy 2 (CBE)	Rs400.45	21 Nov 2006 23:38 HKT

Source: UBS. AEDT: Australian eastern daylight time; AEST: Australian eastern standard time; BST: British summer time; EDT: Eastern daylight time; EST: Eastern standard time; GMT: Greenwich mean time; HKT: Hong Kong time; JST: Japanese standard time.

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
6. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and investment banking services are being, or have been, provided.
13. UBS AG, its affiliates or subsidiaries beneficially owned 1% or more of a class of this company`s common equity securities as of last month`s end (or the prior month`s end if this report is dated less than 10 days after the most recent month`s end).
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.
20. Because UBS believes this security presents significantly higher-than-normal risk, its rating is deemed Buy if the FSR exceeds the MRA by 10% (compared with 6% under the normal rating system).
23. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month`s end (or the prior month`s end if this report is dated less than 10 working days after the most recent month`s end).

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

ANALYST CERTIFICATION

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Reliance Energy

Performance (Rs)

Date	Price	Price target	Rating
Sep-29-2003	375.55	407	Buy 1
Oct-07-2003	406.85	-	No Rating
Oct-16-2003	419.2	490	Neutral 1
Jan-21-2004	499.8	520	Neutral 1
Feb-24-2004	703.85	-	No Rating
Feb-25-2004	702.8	750	Neutral 1
Apr-19-2004	762.5	790	Neutral 1
Jun-02-2004	537.7	650	Buy 2
Jul-22-2004	586	-	No Rating
Sep-01-2004	646.5	725	Neutral 2
Dec-21-2004	524.55	-	No Rating
Jan-21-2005	505.25	670	Buy 2
Jul-06-2005	648.15	-	No Rating
Jul-21-2005	634.9	740	Neutral 2
Sep-01-2005	573.75	675	Neutral 2
Nov-03-2005	527.5	-	No Rating
Nov-17-2005	567.25	675	Neutral 2
Jun-15-2006	436.4	-	No Rating
Aug-31-2006	439.4	475	Neutral 2
Sep-10-2006	488.1	475	Reduce 2

Source: UBS; as of 21 Nov 2006

Note: On September 9, 2006, UBS adopted new percentage band criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details). Between October 13, 2003 and September 9, 2006 the percentage band criteria used in the rating system was 10%. Prior to October 13, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential >15%, smaller range around price target; Buy 2: Excess return potential >15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Excess return is defined as the difference between the FSR and the one-year local market interest rate.

Global Disclaimer

UBS