kotak® Institutional Equities

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News Roundup

Corporate

- The proposed Reliance Power IPO will be the first to offer a discount to retail investors when the issue opens for subscription later this month. The IPO is estimated to raise about $3 billion, making it the biggest-ever in India. Sources say the company will be offering a discount of 5-6% to all retail investors participating in the IPO. (ET)
- Tata Steel and state-run SAIL, the country's two biggest makers of the alloy, are all set to form a joint venture to mine coal blocks for securing assured coking coal supply to meet their increasing production needs. (FE)
- Housing finance company HDFC said it has agreed to sell a 7.15% stake in its life insurance joint venture—HDFC Standard Life Insurance Company—to its foreign partner, Standard Life (Mauritius Holdings), at a pre-agreed price. Sources said Standard Life paid about Rs 201 crore to HDFC for the stake. (BL)

Economic and political

- Sebi on Monday barred mutual fund houses from charging entry load from investors, who buy schemes directly from funds and not through a distributor, agent or broker. The new rule is effective from January 4. (BS)
- The Department of Telecom (DoT) has mandated that while customers can buy international roaming SIM cards and global calling cards of foreign telcos in India, the same cannot be used for making or receiving calls within the country. (ET)
- India's current account deficit shrunk to $5.5 billion in July-September 2007 as remittances by non-residents offset rising oil prices, higher import bill and slower growth in software exports. The overall balance of payments rose to a record surplus $29.2 billion during the same period. (ET)

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

EQUITY MARKETS

		Change, %		
India	**31-Dec**	**1-day**	**1-mo**	**3-mo**
Sensex	20,287	0.4	4.8	17.1
Nifty	6,139	1.0	6.5	21.1
Global/Regional indices				
Dow Jones	13,265	(0.8)	(0.8)	(5.8)
Nasdaq Composite	2,652	(0.8)	(0.3)	(3.2)
FTSE	6,457	(0.3)	0.4	(0.8)
Nikkie	15,308	(1.7)	(2.4)	(8.8)
Hang Seng	27,813	1.6	(2.9)	2.5
KOSPI	1,897	(0.6)	(0.5)	(2.5)

Value traded - India

		Moving avg, Rs bn		
	31-Dec		**1-mo**	**3-mo**
Cash (NSE+BSE)	278.3		275.3	280.3
Derivatives (NSE)	504.4		862.9	570.0
Deri. open interest	1,026.1		1,114	739.9

Forex/money market

		Change, basis points		
	31-Dec	**1-day**	**1-mo**	**3-mo**
Rs/US$	39.4	0	(8)	(43)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.8	(5)	(14)	(11)

Net investment (US$mn)

	28-Dec		MTD	CYTD
FIIs	283		40	17,163
MFs	9		(340)	1,585

Top movers -3mo basis

		Change, %		
Best performers	**31-Dec**	**1-day**	**1-mo**	**3-mo**
Neyveli Lignite	257	3.5	9.1	138.3
MRF	7,221	2.3	2.1	92.2
Rashtriya Chem	118	5.0	57.3	90.2
Thomas Cook	114	(1.3)	56.9	79.3
VSNL	764	2.7	21.9	71.1
Worst performers				
i-Flex	1,511	(0.4)	0.4	(19.8)
Acc	1,025	1.6	(6.0)	(15.3)
United Phos	349	0.3	1.6	(11.8)
Glaxosmithkline	1,030	0.5	8.7	(7.5)
Container Corp	1,930	4.0	8.0	(6.9)

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Strategy

Sector coverage view	N/A

Alpha Bet: Closing IVRCL/Nagarjuna Construction/Siemens trade

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- **Closing Long IVRCL and Nagarjuna Construction, short Siemens on 14% gross return**
- **Trade 1: Long Hindalco and Sesa Goa, short Tata Steel**

Closing Long IVRCL and Nagarjuna Construction, short Siemens on 14% gross return

We had recommended this trade on the back of strong positive momentum in the businesses of IVRCL and Nagarjuna Construction Co. versus the likely continuation of margin pressures, decline in order book visibility combined with stretched valuations for Siemens. Since the inception of the trade (November 14, 2007), IVRCL and Nagarjuna Construction Co. stock has appreciated by 8.5% and 20.8%, respectively, whereas Siemens stock has remained relatively flat (0.7%), resulting in a gross return of 14%.

Trade 1: Long Hindalco and Sesa Goa, short Tata Steel

We continue to recommend the ‘Long Hindalco and Sesa Goa, short Tata Steel’ trade to derive out-performance from (1) higher raw material prices pressurizing margins of Corus Group in FY2009E and (2) likely upward revisions to valuation of Novelis from growing visibility on reported earnings. We expect CY2008E iron ore contract prices (likely to be finalized over the next few weeks) to be significantly higher than the CY2007 average contract price. Since the inception of the trade (November 14, 2007), Hindalco Industries stock has declined 1.3%, Sesa Goa and Tata Steel stock has increased 5% and 9%, respectively, resulting in a gross negative return of 7.1%.

Alpha-Bet trades
Statistics of trades, current price, initiation price, gross expected/actual return

	Stock	Current price (Rs)	Initiation price (Rs)	Return (%)
Trade 1				
Buy	Hindalco Industries	215	218	(1.3)
Buy	Sesa Goa	3,818	3,636	5.0
Sell	Tata Steel	935	858	9.0
Current return (%)				**(7.1)**
Closed trades (14 November-31 December 2007)				
Buy	IVRCL	554	511	8.5
Buy	Nagarjuna Construction Co.	353	292	20.8
Sell	Siemens	1,893	1,881	0.7
Return (%)				**14.0**
Closed trades (14 November-29 November 2007)				
Buy	Bharti Airtel	916	860	6.5
Sell	Reliance Communications	665	725	(8.2)
Return (%)				**14.7**
Closed trades (14 November-29 November 2007)				
Buy	HCL Tech.	313	302	3.9
Sell	ZEEL	282	313	(9.9)
Return (%)				**13.8**

Source: Bloomberg, Kotak Institutional Equities estimates.

Banking

HDFC.BO, Rs2872	
Rating	REDUCE
Sector coverage view	Attractive
Target Price (Rs)	2,200
52W High -Low (Rs)	3195 - 1397
Market Cap (Rs bn)	823.6

Financials

March y/e	2007	2008E	2009E
Sales (Rs bn)	22.1	33.9	35.9
Net Profit (Rs bn)	15.7	22.6	23.8
EPS (Rs)	62.1	79.0	82.9
EPS gth	*23.6*	*27.3*	*4.9*
P/E (x)	46.3	36.4	34.7
P/B (x)	14.8	6.7	6
Div yield (%)	0.7	1.0	1.0

Shareholding, September 2007

	Pattern	% of Portfolio	Over/(under) weight
Promoters	-	-	-
FIIs	63.5	5.0	3.3
MFs	2.1	1.0	(0.7)
UTI	-	-	(1.7)
LIC	1.4	0.6	(1.1)

HDFC: Standard Life has realigned its stake in HDFC SL Insurance, retain REDUCE

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- **HDFC has sold a 7% stake in HDFC SL Insurance to SL at a pre-determined price**
- **The deal will likely drive capital gains for HDFC in 2HFY08E, may not affect our SOTP based valuation, retain REDUCE**

Standard Life (SL) has purchased 7% stake in HDFC SL Insurance from HDFC at a pre-agreed valuation. According to newspaper reports, HDFC has booked capital gains of Rs1.2 bn on the deal.

With this deal, SL's stake in the insurance company has increased to 26%. The company has highlighted that any further sale, if permitted by law, would be based on fair value. The company plans to launch an IPO by end of 2009. Our SOTP-based price target for HDFC factors value for 74% stake in the insurance company and may not be affected by the deal.

Economy

Sector coverage view	N/A

Record capital inflows in 2QFY08: FIIs not the only cause; look elsewhere for answers

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- **CAD in 2QFY08 at US$5.5 bn; invisibles sustain current account**
- **Capital flows (net) touch a record US$33.9 bn ; add US$22.9 bn to reserves**
- **Banking, other capital contribute to excessive inflows in addition to portfolio flows**

Policy dilemma accentuates as FIIs not the only drivers of strong capital inflows

2QFY08 BOP data released by the RBI on December 31, 2007 shows a departure from conventional thinking regarding capital flows into India (see Exhibit). Interest rate differential sensitive, 'banking capital' and 'other capital' are equally big contributors to the surge in capital inflows as are FII inflows. To add to the woes, short-term suppliers export credit flows have also assumed significance size at US$3.6 bn in 2QFY08. We emphasize that FII inflows explain less than half of the excessive capital story. Also, FDI inflows (driven by real estate and private equity funds) and External Commercial Borrowings (ECB, which invited forms of capital controls) contributed moderately to capital inflows. We deconstruct the story, which raises two key policy questions:

i. Are capital controls effective or permeable and futile?

ii. If capital flows are interest sensitive, what are the policy choices when an asset price bubble is seen to be building up?

Policy makers have largely seen FII investments as the root of excessive capital inflows into the Indian economy. This required curbing in the view of policy makers, which resulted in policy action such as (1) cap on P-notes and (2) hike in CRR to manage surplus liquidity. We believe that RBI apparently stopped worrying about interest rate differential. It probably thought that high interest rates were the best way to proactively prick the credit and asset price cycles. It kept its policy rate intact, in spite of a sharp drop in headline inflation rate to around 3.0% by mid-October from 6.4% in the start of FY2008.

Portfolio flow surge

Large FII inflows are of course contributing to the capital account pressures. In 1HFY08, FII inflows are placed at US$15.5 bn on BOP basis. Considering that about US$5.7 bn of FII net investments have taken place in equity and debt cash segments in 3QFY08, we retain our projection for FII inflows for FY2008 at US$23.8 bn. There are larger upside risks to this estimate than downside.

For 2QFY08, FII inflows (net) are placed at US$8.4 bn, while investments through ADRs/ GDRs are at US$2.5 bn. Unlike the 1QFY08, the RBI FII inflows (net) data is spot on with SEBI's FII investments (net) data; both at US$8.4 bn. However, the large divergence between the two in 1QFY08 (RBI data places it at US$7.1 bn while the SEBI data at US$3.3 bn) remains to be understood. This gap does not appear to tally with futures positions and FIIs are unlikely to leave billions of dollars idle.

Banking capital; other capital major surprise additional capital flow channels

Portfolio flows are not the main story behind the surge in capital flows. Flows with poorer visibility may be more important contributors. Banking capital inflows reached a high of US$6.2 bn in 2QFY08 in spite of NRI deposits adding very little to these flows. Clearly, while administered interest rates, NRI deposits have become unattractive. However, the banks themselves have been leveraging by drawing down the assets abroad or incurring fresh offshore liabilities. They are bringing in money to take advantage of the wide interest rate differential which exists in India and abroad. In terms of capital inflows, this segment needs to be closely watched for 2HFY08 and beyond. The interest rate differential is even getting wider, with the US Fed cutting 100 bps since September 18. Though FII investments in debt funds are capped, arbitrage opportunities exist for other form of capital flows.

Other capital account items added another major surprise additional component to the already large capital flows. In these items, while external assistance in 2QFY08 remained small at nearly US$0.5 bn, the unprecedented jump in "other capital" to US$10.3 bn in gross terms and US$7.1 bn in net terms in a single quarter was a surprise. Other capital inflows are coming in the form of leads and lags in exports, advances received against pending issues of FDI equity, capital receipts for derivative hedging, migrant capital transfers, etc. These flows are sensitive to exchange rate expectations and also to interest rate differentials.

Wide trade gap well financed by invisible surpluses

While we see capital flows as being excessive, they helped finance a large trade gap. 2QFY08 BOP data released by the Reserve Bank of India (RBI) yesterday confirms that India's BOP remains sustainable. The trade deficit on the BoP (realization) basis at US$ 21.7 bn was about US$4 bn more than the DGCIS data (based on customs). Transfers at US$10.1 bn were larger than US$8.3 bn in the 1QFY08 and US$5.4 bn in the 1QFY07.

Software services retain momentum in spite of rupee appreciation

Software imports maintained momentum and provided net receipts of US$7.2 bn, which was only slightly less than in 1QFY08 but was more than US$6.7 bn in 2QFY07. Maintenance of software receipts is impressive when seen in relation to 9.3% rupee appreciation in 1HFY08. Nearly 75% of the trade gap in 1Q & 2Q of FY08 was covered by invisibles surplus

BOP remains sustainable, but capital account management has limits

We believe that the new data reaffirms that India's balance of payments remains sustainable. Based on the latest information, we project CAD/GDP and trade deficit ratios lower at below 1.5% and 7.5% of GDP, respectively. The key lesson of the new data release is that capital account management has its limits and may require further liberalization of outflows and not just restrictions on inflows. Also interest rate differentials require a closer attention ahead.

Large Capital Inflows in 2QFY08 leave a record overall balance in BOP

India's quarterly balance of payments (US$bn)

Item	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	1HFY07	1HFY08	FY2007	FY2008E
Current Account	**(4.1)**	**(6.3)**	**(2.8)**	**2.6**	**(5.2)**	**(5.5)**	**(10.3)**	**(10.7)**	**(9.8)**	**(13.9)**
Trade balance	(17.0)	(16.8)	(16.9)	(15.2)	(20.7)	(21.7)	(33.8)	(42.4)	(63.2)	(85.3)
- Exports	29.6	31.8	30.7	34.1	35.8	37.9	61.5	73.7	126.2	156.7
- Imports	46.6	48.6	47.5	49.3	56.5	59.6	95.2	116.1	192.0	242.1
o/w Oil imports	13.7	15.7	14.0	13.2	17.0	17.2	29.4	34.2	57.3	70.1
Invisibles (net)	13.0	10.5	14.1	17.8	15.5	16.2	23.4	31.7	53.4	71.5
- Software	6.6	6.7	6.9	8.9	7.9	7.2	13.3	15.1	29.0	34.3
- transfers	6.9	5.4	7.8	8.7	8.3	10.1	12.3	18.4	28.2	36.3
- other invisibles	(0.5)	(1.6)	(0.6)	0.3	(0.7)	(1.1)	(2.2)	(1.9)	(3.8)	0.9
Capital Account	**10.4**	**8.8**	**10.5**	**17.1**	**16.5**	**33.9**	**19.2**	**50.4**	**44.9**	**88.7**
Foreign investment	1.1	5.1	6.1	3.9	9.2	13.0	6.1	22.2	15.5	43.1
- FDI	1.6	2.9	2.6	2.0	1.7	2.1	4.5	3.9	8.4	13.5
- FII	(1.8)	1.7	3.4	(0.0)	7.2	8.4	(0.1)	15.5	3.2	24.8
- ADRs/GDRs	1.3	0.5	0.2	1.8	0.3	2.5	1.7	2.8	3.8	4.8
Banking capital	5.1	(1.7)	(3.3)	2.3	(0.9)	6.2	3.3	5.3	2.1	8.0
- NRI deposits	1.3	0.9	1.2	0.6	(0.4)	0.4	2.2	(0.1)	3.9	0.7
Short term credit	1.2	2.7	(0.3)	1.6	2.2	3.6	3.9	5.7	3.3	8.4
ECBs	4.0	1.8	4.0	6.7	7.0	3.6	5.7	10.6	16.1	18.2
Other capital account items	(0.9)	1.0	4.0	2.7	(0.9)	7.6	0.1	6.7	8.0	11.0
E&O	0.4	(0.2)	(0.2)	0.8	(0.1)	0.9	0.2	0.7	1.3	3.3
Overall balance	**6.7**	**2.3**	**7.5**	**20.5**	**11.2**	**29.2**	**9.0**	**40.4**	**36.4**	**78.2**
Memo										
RBI's net forex purchases	**4.8**	**0.0**	**5.0**	**17.0**	**9.7**	**25.1**	**4.8**	**34.8**	**26.8**	**64.3**

Note: (1) Data for 3Q & 4Q of FY08 has been slightly revised but not disseminated by RBI as yet. So quarterly data does not eaxctly add up to FY2007 data.
(2) Similar is the case with export, import figures for FY2007.
(3) FY2008E are Kotak Institutional Equities estimates.

Source: Reserve Bank of India; Kotak Institutional Equities

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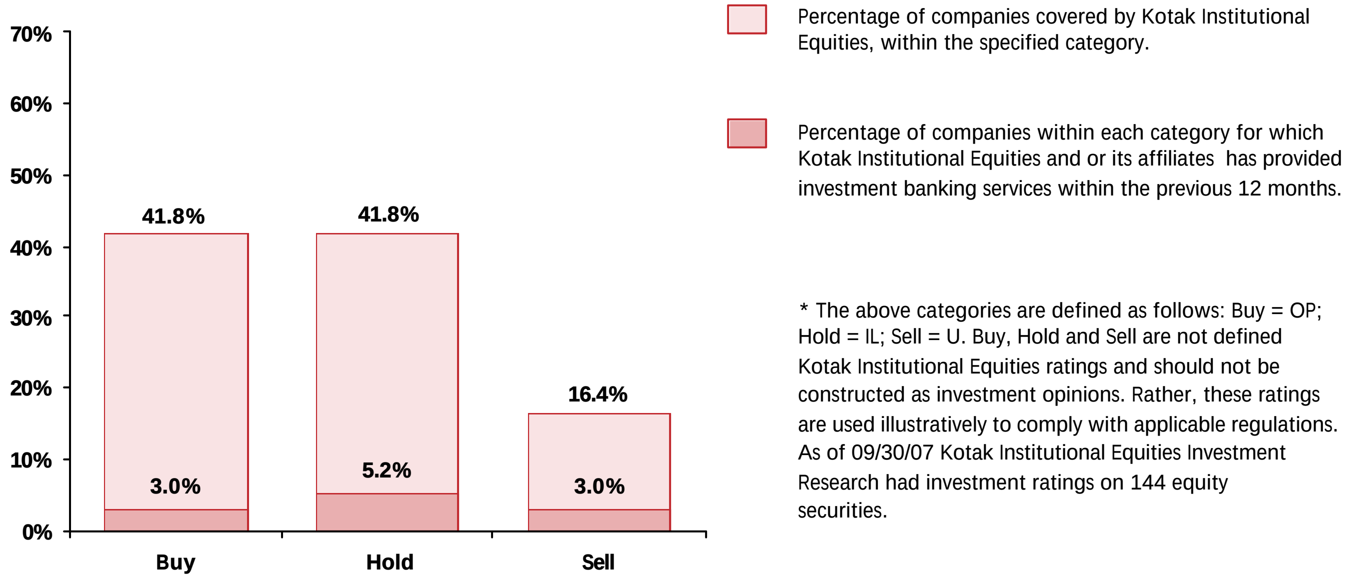

* The above categories are defined as follows: Buy = OP; Hold = IL; Sell = U. Buy, Hold and Sell are not defined Kotak Institutional Equities ratings and should not be constructed as investment opinions. Rather, these ratings are used illustratively to comply with applicable regulations. As of 09/30/07 Kotak Institutional Equities Investment Research had investment ratings on 144 equity securities.

Source: Kotak Institutional Equities. As of September 30, 2007

Ratings and other definitions/identifiers

New rating system

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.
ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.
REDUCE: We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.
SELL: We expect this stock to underperform the BSE Sensexby more than 10% over the next 12 months.

Old rating system

Definitions of ratings

OP = Outperform. We expect this stock to outperform the BSE Sensex over the next 12 months.
IL = In-Line. We expect this stock to perform in line with the BSE Sensex over the next 12 months.
U = Underperform. We expect this stock to underperform the BSE Sensex over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

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