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Morgan Stanley India Company Private Limited+

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Stock Rating
Overweight

Industry View
Attractive

Initiation

Rajesh Exports Ltd

Triple Strategy for Sparkling Earnings; Initiate at OW

Conclusion: We initiate coverage of Rajesh Exports (Rajesh) with an Overweight rating and price target of Rs1051 based on a Residual Income Model, implying 35% growth from the current price. We believe the company is at an inflection point from where its three-pronged growth strategy will lead to higher margins and earnings. We believe this growth is not fully captured in the stock price given that at current price the stock trades at 12.9 times F2009e earnings and at an attractive implied PEG of 0.60x.

India's leading jewellery exporter moving to higher-margin businesses: Rajesh is the biggest exporter of jewellery from India and now wants to shift its business mix towards the three higher-margin businesses of diamond jewellery, private label jewellery, and retailing. We believe its existing bulk export business is strong and that this, together with planned expansion in other businesses, will lead to net profit CAGR of 61% for F2007-10. The management expects that the new business mix will take the margins of the company from the current 2% to 10% by F2010, however we have estimated the operating margins to go up from 3.1% to 4.82% and net margins from 1.47% to 3.67% in the same period. The upside risk to our estimates will come from better execution by the company in its new growth businesses in the next 2 quarters.

The company has a war chest of Rs6400mn (20% of its market cap) to fund its retail plans with the recent FCCB issuance, which would be enough for it to fund its growth plans.

The key concerns for Rajesh are customer concentration, execution risk and slowdown in key consumer markets like USA and Europe.

We believe the risk-adjusted returns for Rajesh are positive and hence we have an Overweight rating with target price of Rs1051 implying 35% return.

Key Ratios and Statistics

Reuters: REXP.BO Bloomberg: RJEX IN
India Consumer

Price target	Rs1,051.00
Shr price, close (Sep 18, 2007)	Rs779.05
Mkt cap, curr (mn)	Rs33,269
52-Week Range	Rs849.95-175.00
Sh out, basic, curr (mn)	37.0
Shrs out, basic, avg (08e) (mn)	43
ROE (08e) (%)	53.6
S'hldr eqty (08e) (mn)	Rs11,296

Fiscal Year (Mar)	2007	2008e	2009e	2010e
ModelWare EPS (Rs)*	23.7	36.4	60.4	87.9
EPS, basic (Rs)	27.41	41.26	60.35	87.94
Revenue, net (Rs mn)	68,934	84,658	98,629	116,014
Op exp (Rs mn)	66,806	81,786	94,657	110,434
ModelWare net inc (Rs mn)	1,013	1,762	2,924	4,261
P/E	15.9	21.4	12.9	8.9
P/BV	4.9	3.8	2.7	2.1

*** =** Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

Rajesh Exports: Financial Summary

Rs mn; Financial Year Ending March 31

Particulars	2006	2007	2008e	2009e	2010e
Income Statement					
Income from operations	54,819	68,934	84,658	98,629	116,014
Other income	18	0	-	-	-
Total Income	54,837	68,934	84,658	98,629	116,014
Cost of Materials	53,607	65,425	80,849	93,698	109,634
Total Expenditure	53,704	66,791	81,771	94,643	110,419
Operating Profit	1,133	2,143	2,887	3,986	5,595
Interest and bank charges	417	1,086	957	793	898
Depreciation	14	15	15	15	15
PBT	702	1,042	1,915	3,179	4,682
Total tax	36	30	153	254	421
Tax as % of PBT	*5%*	*3%*	*8%*	*8%*	*9%*
Net Profit	665	1,013	1,762	2,924	4,261
EPS	18.0	27.4	36.4	60.4	87.9
Dividends	84	86	170	283	454
Period end basic shares o/s	37.0	37.0	48.5	48.5	48.5

Particulars	2006	2007	2008e	2009e	2010e
Ratios					
Growth					
Sales	29%	26%	23%	17%	18%
Op Profit	29%	89%	35%	38%	40%
Net Income	55%	52%	74%	66%	46%
Leverage					
Current Ratio	73%	115%	95%	97%	95%
LT debt / Equity	3%	1%	0%	0%	0%
Total Debt / Equity	101%	74%	26%	24%	22%
Profitability					
Gross Margins	2.1%	3.1%	3.4%	4.0%	4.8%
Net Margins	1.2%	1.5%	2.1%	3.0%	3.7%
ROCE	7.2%	5.9%	10.4%	12.1%	14.5%
ROE (Avg Equity)	34.6%	37.1%	24.8%	23.5%	27.2%
ROE (Beg Equity)	44.9%	42.9%	57.0%	26.4%	31.0%
Turnover					
Inventory (Days)	6.9	6.6	7.5	12.1	15.8
Debtors (Days)	16.2	33.7	35.0	40.0	45.0
Creditors (Days)	86.0	162.3	165.0	160.0	160.0
Valuation			1 Yr Fwd	2 Yr Fwd	3 Yr Fwd
P/E		28.4	21.4	12.9	8.9
EV/EBIDTA		16.6	12.4	8.9	6.4
EV/Sales		0.5	0.4	0.4	0.3
PEG		0.60			

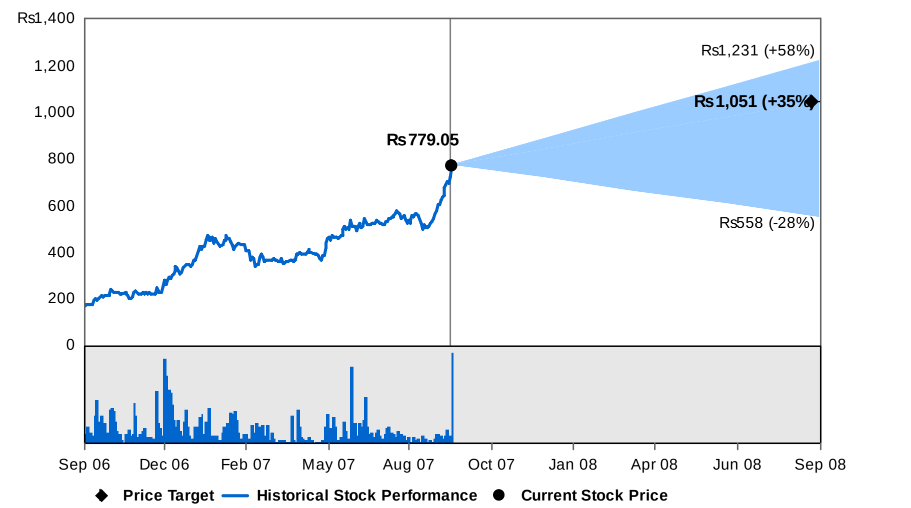
Particulars	2006	2007	2008e	2009e	2010e
Balance Sheet					
Sources Of Funds					
Share Capital	74	74	97	97	97
Total reserve	2,289	3,017	11,199	13,840	17,648
Total	2,363	3,091	11,296	13,937	17,744
Total Secured Loans	2,389	2,287	2,883	3,352	3,937
Total OD	10,741	24,046	13,356	15,650	16,984
Total Unsecured loans	314	6,900	297	172	173
Total Liabilities	15,806	36,325	27,831	33,111	38,838
Uses of Funds					
Gross block	564	616	646	676	706
Less : Depreciation	64	79	94	110	127
Net block	500	537	551	565	579
Work in progress	15	19	19	19	19
Total Fixed Assets	500	537	551	565	579
Investments	49	63	63	63	63
Current Assets					
Inventories	1,481	957	2,447	3,954	5,833
Sundry debtors	3,769	8,967	10,741	13,432	16,927
Cash & bank balances	34,104	57,647	49,026	54,559	61,865
Loans and advances	819	1,575	1,732	1,905	2,095
Total Current Assets	40,172	69,146	63,946	73,850	86,720
Total CL and Provisions	24,924	33,429	36,738	41,376	48,532
Net Current Assets	15,249	35,716	27,208	32,474	38,188
Total Assets	15,806	36,325	27,831	33,111	38,838

Particulars	2006	2007	2008e	2009e	2010e
Cash Flow Statement					
PAT	665	1,013	1,762	2,924	4,261
Add: Depreciation	14	15	15	15	15
Change in WCap					
Inventories	-	524	(1,490)	(1,507)	(1,879)
Sundry Debtors	-	(5,198)	(1,774)	(2,691)	(3,494)
Loans and Adv	-	(757)	(157)	(173)	(190)
Sundry Creditors	-	8,504	3,225	4,525	6,986
Cash Flow from Operations	673	4,103	1,663	3,207	5,868
(Incr)/Decr of Fixed Assets	-	(52)	(30)	(30)	(30)
(Incr)/decr of Investments	-	(14)	-	-	-
Cashflow from Investments	1,437	(66)	(30)	(30)	(30)
inc/(dec) of eq cap	-	-	23	-	-
Incr/(Decr) of Equities	-	-	6,392	-	-
Incr/(Decr) of ST Debt	-	19,892	(17,294)	2,170	1,335
Incr/(Decr) of LT Debt	-	(101)	596	469	585
Dividends(including Tax)	-	(86)	(170)	(283)	(454)
Cash Flow From Financing	6,853	19,506	(10,454)	2,356	1,466
Net Cash Flow	8,963	23,543	(8,820)	5,532	7,304
Opening Cash	25,141	34,104	57,647	48,827	54,359
Closing Cash	34,104	57,647	48,827	54,359	61,663

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

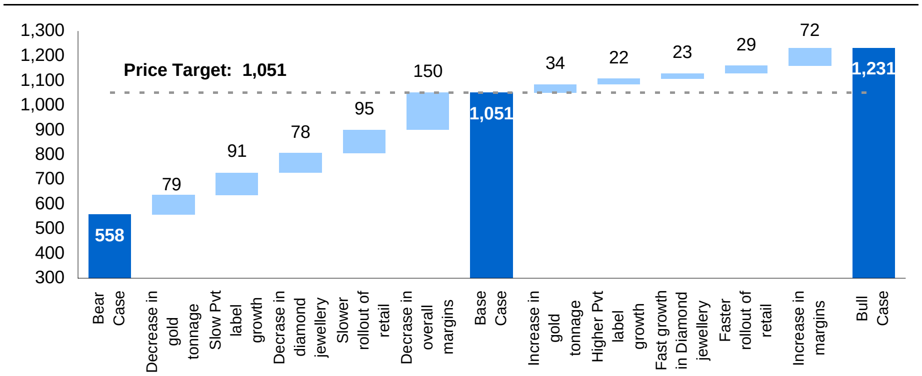
Risk-Reward Snapshot: Rajesh Exports (REXP.BO, Rs779.05, Overweight, PT Rs1051)

Triple Growth Strategy to Widen Margins in Expanding Industry



Price Target Rs1051		Please refer to Exhibit 3 for detailed assumptions.
Bull Case Rs1231	Current price is 11.5x Bull Case F2009e EPS	Our bull case assumes a greater increase in the gold tonnage in the bulk exports business, faster growth in the diamond jewellery and private label jewellery businesses, faster rollout of retail outlets and an overall increase in margins, all combining for a 68% CAGR in earnings and 21% CAGR in sales for F2007-10.
Base Case Rs1051	Current price is 13.6x Base Case F2009e EPS	Our base case assumes moderate growth in the new businesses and in gold tonnage in the bulk exports business. Margins rise from the current 3.1% to 4.65% in F2010, leading to 61% earnings CAGR for F2007-10.
Bear Case Rs558	Current price is 19.6x Bear Case 2009e EPS	Weaker growth in the gold tonnage handled in the exports business, lower acceptance of the new businesses, and a slower than expected retail rollout, together with lower margins, leading to a 34% earnings CAGR for F2007-10.

Bear to Bull: Higher-margin New Businesses Driving Value



Source: Morgan Stanley, FactSet

Investment Thesis

- **Inflection point:** We believe the company is at an inflection point from where its business strategy will lead to net profit CAGR of 61% for F2007-10.
- **Industry growth:** India's jewellery industry growth is set to accelerate because of a shift in global jewellery manufacturing to India, as well as domestic demand.
- **Three-pronged strategy:** The company has implemented a three-pronged strategy to increase margins.

Key Value Drivers

- **Diamond jewellery and private label:** We believe these two segments offer very good growth potential and could lead to higher margins for the company. We estimate 9% revenue and 22% profit contribution from these segments in F2010.
- **Domestic retail:** The domestic retail industry presents a huge untapped market, wherein Rajesh wants to open close to 250 outlets in the next two to three years.

Potential Catalysts

- **Faster acceptance** of the new diamond jewellery and private label jewellery by retailers (customers) could lead to faster-than-expected growth.
- **Retail consolidation:** The domestic retail industry is highly fragmented; we believe it could consolidate to the benefit of Rajesh.

Key Risks

- The key risks are execution risk, customer concentration, inventory risk, and gold price volatility.

Investment Summary

Summary and Conclusions

We are initiating coverage on Rajesh with an Overweight rating and a price target of Rs1051. We believe the company is well positioned to achieve a 61% net profit CAGR for F2007-10 through its new business initiatives and strength in existing business. We expect a renewed focus on margins and the favourable macro environment to help Rajesh achieve this growth.

Three-pronged Strategy

Rajesh has been a wholesale distributor of plain gold jewellery. It has achieved significant scale of operations in this business by operating at thin margins. Management now plans a three-pronged strategy to increase its margins substantially from the current 3% to double digits by F2010. To achieve this, the company plans to enter the following business segments: 1) diamond jewellery; 2) private label jewellery (white label); and 3) domestic retail. We believe the existing business is strong and that these new businesses will help Rajesh expand its margins.

Favourable Macro Environment

Demand for jewellery in India is set to increase in the positive macro environment. Income levels and the number of affluent households in India are accelerating. These factors, together with the growing middle class and India's inherent affinity for jewellery and gold, will help drive the growth. Also, we believe low-cost countries, such as India and China will attract a significant portion of the international jewellery manufacturing industry, leading to further growth in India's jewellery industry.

Organised Retail Could be a Big Story

India is one of the biggest markets for jewellery, particularly gold jewellery. India consumes close to 850 tonnes of gold per annum, more than 30% of global demand. Jewellery consumption as a percentage of disposable income is the highest in India, at 3.5%. Despite the large market, the industry is still very fragmented, with organised retail accounting for only 4% of the market. We believe this offers a significant growth opportunity in this segment. Standalone family jewellers dominate most of the market currently. They face problems because of a lack of technology in designing jewellery, low advertising spend, a shift from unbranded to branded jewellery, compulsory hallmarking, and competition. We believe these factors could lead to consolidation in the jewellery retail business, which could help companies such as Rajesh.

Competitive Advantage

Rajesh processes more than 70 tonnes of gold per annum. We believe this kind of processing ability is unmatched in the jewellery sector. This gives the company sourcing advantages, such as better credit terms and consignment facilities. It also gives the company a large customer base for such volumes. The company's export performance has also been very impressive, resulting in Rajesh receiving various government incentives.

Key Risks

We believe execution risk is the key risk for Rajesh. The company plans expansion in new, different business segments. Historically, it has operated in the wholesale jewellery segment. Now, it plans to sell its jewellery to retailers and end consumers. We believe this requires a change in mindset and the ability to adapt to different consumer tastes in different regions.

Gold price volatility, slowing developed economies, and competition from other luxury goods may also affect overall consumer jewellery demand.

Valuation

We value the company based on an RIM. We derive our price target of Rs1051 from our estimate of a 61% net profit CAGR for F2007-10. We believe the new growth strategy will help the company improve its margins from the current 3.1% to 4.82% in F2010. At the current price the stock is trading at 12.9x F2009e EPS and at an implied PEG of 0.6x.

Investment Positives

Changing Business Mix…

Rajesh has established a very large-scale jewellery operation by selling its jewellery to wholesale distributors at very low margins. This has helped the company to exponentially increase its sales, gain size and scale advantages, and build a large customer base. Rajesh is now planning to enter the business segments of high-margin private label (white label) and diamond jewellery exports and to explore the growing retail industry in India.

The company has operated at very low margins in the wholesale jewellery business and is now trying to go further up the value chain through forward integration. We believe this strategy will help the company's earnings grow at a 61% CAGR for F2007-10.

…Leading to Higher Margins

Rajesh has operated at very low margins by selling jewellery to a few large-scale distributors to use its expansive manufacturing capacity. It currently derives 100% of its revenue from the wholesale jewellery segment. We believe it will be able to generate at least 19% of its total revenue and 41% of operating profit from the new high-margin business segments by F2010. We believe Rajesh has the necessary infrastructure, research capabilities, and customer insight to deliver this margin expansion easily.

Macro Factors

In India, a combination of positive macro economic factors will lead to higher jewellery demand, in our view. These include a booming economy, high disposable income, growing middle-income class, favourable demographics, and a cultural affinity with gold. We believe all these positive factors will lead to growth of the industry in India. Also, judging by past trends, we expect some jewellery fabrication to move to low-cost manufacturing countries, such as India and China, further boosting industry growth.

Retail Focus With the Right Business Model

There is no major organised presence in India's retail jewellery market, despite it being the biggest in the world. Rajesh wants to tap the retail jewellery market in India through three different store types targeting different customer segments. It plans to roll out the stores from 2Q F2008. The company plans to mainly follow the associate model, under which it aims to convert existing family jewellers to company outlets and pay the jeweller sales commission. We believe this associate model is best-suited for retail jewellery in India because of the following factors: 1) it consolidates the highly fragmented retail industry; and 2) it makes use of an existing loyal customer base.

We estimate Rajesh will open at least 260 retail outlets in different formats by F2010, and that these will generate 9% of its revenue and 12% of its operating profits in that year.

Possible Retail Consolidation

Very few jewellers in India have succeeded in attracting a large customer base while remaining profitable, as a result of the high industry fragmentation and competition. Not many jewellers have been able to capture a big and loyal customer base. Therefore, we expect most of the other jewellers in India, who are just surviving on thin margins, to be sidelined, partly also because of a government move to bring in gold purity controls through compulsory hallmarking from 2008.

Such a scenario would be good for consolidation, as larger firms, such as Rajesh, would be eyeing the retail locations the smaller jewellers offer and the retailers would require financial stability. We believe Rajesh is well positioned to take advantage of this scenario by entering the retail market through the associate model.

Recent JVs

Rajesh Exports has recently entered two joint ventures. The first is with US-based Fossil Inc, one of the largest watch brands in the US. Rajesh will partner Fossil to increase its retail operations in India and to sell some of its products through Fossil's global outlets. It is also looking at using this JV to increase its white label and diamond jewellery business.

Rajesh has also teamed up with the Muthoot Group, one of the largest non-banking financial companies in India's southern states. Rajesh will be able to sell gold coins throughout the southern states, given the Muthoot Group's distribution reach.

In March 2006, Rajesh acquired all the retail outlets of Oyzterbay, a nationwide jewellery retailer. It also acquired Oyzterbay's management team, which includes people with jewellery brand-building experience.

We believe all these steps have helped Rajesh consolidate its position in the industry.

Nominated Agency Status

Rajesh has recently been awarded nominated agency status, meaning it is now able to import gold, without the help of banks, for domestic operations. Rajesh is the only Indian non-bank company to be awarded such status. We believe this will save costs, as the company will save commission costs on buying gold. This also reinforces the faith the government has in the company's export performance.

Size and Sourcing Ability

Rajesh has the largest jewellery manufacturing plant in Asia, which can process 250 tonnes of gold per annum. The company currently processes around 70 tonnes of gold annually to manufacture jewellery and coins. This is about 7-8% of the gold imports in India. We believe this kind of scale is unmatched in the industry. This gives the company tremendous advantage in terms of sourcing ability. Using only one source gives Rajesh pricing power and logistic support from the supplier. The company has secured favourable credit lines and consignment stocks from its supplier. We expect Rajesh to secure even better credit terms, which would unlock some working capital.

Exploring Real Estate Potential

Rajesh owns some land, which it plans to develop with the help of a developer. It has formed a subsidiary, Bangalore Infra Ltd, for this purpose. We believe there could be upside from the option value of this venture. However, we have not yet modelled real estate potential into our valuation.

Company Description

Rajesh Exports Ltd is the largest exporter of Gold Jewellery in India. It is a Bangalore based company with exports all across the globe. Recently the company has announced a JV in India with Fossil Inc. and also acquired the retail chain of Oyzterbay. The company has plans to get in to the domestic retail markets through franchisee outlets under three different brands catering to different customer segments. The company is a five star trading house and has received nominated agency status in India to import gold.

India Consumer

Industry View: Attractive

The industry outlook remains attractive with most consumer companies witnessing significant revenue growth. While the input cost pressures remain severe, pricing environment has improved and price increases have been sufficient to offset cost pressures albeit with a lag. If the cost pressures were to alleviate consumer companies in India could witness steady gross margin expansion over the next few quarters.

MSCI Country: India

Asia Strategist's Recommended Weight: 2.2%
MSCI Asia/Pac All Country Ex Jp Weight: 6.8%

Investment Negatives

Execution Risk
Rajesh plans an aggressive roll-out in the retail segment. We believe the incremental roll-out will depend on the following factors:

- Success of recently launched stores
- The pace of opening of new stores
- The terms and conditions for the jewellers under the associate model
- The company's ability to streamline the operations of the stores with good logistics and advertising support

In India, the successful retail format for the jewellery segment is an unknown because of the dearth of organised retail chains. Rajesh has no prior retail experience. Therefore, we believe it faces significant execution risk.

Slowdown in Key Markets
The key jewellery consumer markets are the US, Europe, and Japan. The slowing economic growth in these regions may affect demand for jewellery, which may affect the company's bulk export business.

Gold Price Volatility
Empirical evidence suggests an increase in gold price volatility inversely affects demand for gold. Any increase in gold price volatility, as a result of financial market instability or otherwise, may lead to a decline in jewellery demand, which may also affect the company's bulk export business.

Customer Concentration
Rajesh makes around 90% of its sales to one party, that is, Excel Goldsmiths. Excel acts as a distributor and in turn sells the products to other distributors. We believe this skewed concentration of sales and lack of transparency on Excel's customers is a very big concern for Rajesh.

From Wholesale to Retail Requires Change in Mindset
Rajesh has so far worked in the wholesale jewellery business, which is a high-volume, low-margin operation. We believe the company's foray in diamond jewellery, white label jewellery, and retailing will require the following factors:

- An understanding of consumer tastes
- The creation of strong brands
- The creation of trust among customers
- The ability to sell the best designs at the best prices

We believe Rajesh will have to completely change its mindset from wholesale to retail to succeed in this business.

Managing Inventory Costs
The move into retail comes with its own set of problems. We believe the company's strategy of owning the inventory may lead to funding requirements to meet inventory costs. So far, Rajesh has had higher inventory turnover because of lower turnaround time for the finished goods. However, for the retail operations, the inventory days will increase, putting pressure on the balance sheet.

Removal of USP in the US
The US government has recently lifted the US Generalised System of Preferences benefits, under which India was able to export jewellery to the US at 0% duty. Now, there is an additional 6% duty levied on the imports. We believe this will affect overall jewellery exports to the US.

Competition from Other Luxury Goods
The jewellery sector competes with other luxury goods, such as watches, leather goods, electronic gadgets etc. Most of these competitive products have very good advertising and branding support. We believe this may lead to consumers spending a greater proportion of their disposable income on these other products than on jewellery. Also, we think diamond jewellery poses a significant threat to pure gold jewellery.

Rupee Appreciation
Most of the company's revenue comes from exports. The rupee has appreciated almost 17% against the US dollar in the past 12 months and this could affect the overall competitive cost advantage of Indian Jewellery vis-à-vis other exporters.

Valuation

We value Rajesh using an RIM. Our 12-month price target of Rs1051 implies 24.9x F2008e earnings and 15.9x F2009e earnings. We believe the company is well poised to achieve good earnings growth for the next few years based on favourable industry macro factors and its three-pronged growth strategy. The company has changed its focus from revenue growth to margin expansion. In our RIM, we discount the residual income using the spread in returns over cost of equity.

Exhibit 1

RIM Details

	2007	2008e	2009e	2010e	2011e	2012e	2013e	2014e	2015e	2016e	2017e
Inputs											
Book Value	3,091	11,098	13,739	17,546	22,157	28,269	35,198	42,861	51,864	62,443	74,080
Net Income	1,013	1,762	2,924	4,261	5,177	6,793	8,152	9,578	11,254	13,224	14,546
ROE (%)	37.1	57.0	26.4	31.0	29.5	30.7	28.8	27.2	26.3	25.5	23.3
Dividends	86	170	283	454	567	680	1,223	1,916	2,251	2,645	2,909
CoE (%)	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9	14.9
Spread (%)	22.2	42.1	11.5	16.1	14.6	15.8	13.9	12.3	11.4	10.6	8.4
RI	688	4,673	1,573	2,827	3,236	4,455	4,905	5,277	5,891	6,617	6,219
PV of RI	-	4,067	1,192	1,864	1,857	2,225	2,132	1,996	1,939	1,896	16,630

e = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Explicit horizon

Beyond explicit horizon

Terminal value

Exhibit 2

RIM Summary

Summary	Rs mn
Starting Book Value	3,091
PV of RI in period 1	11,204
PV if RI in period 2	7,963
PV of TV	16,630
Total value	38,888
Value rolled fwd for Sep08	**47,895**
g (%)	5%
No. of shares (mn)	46
Value per share (Rs)	**1,051**

Source: Company data, Morgan Stanley Research

RIM Assumptions

We calculate residual income for two periods: the forecast period and beyond the forecast period until the stable state. We forecast earnings until 2012 and use expected earnings growth for the following five years. We assume 5% long-term growth. We assume 20% payout in the terminal year.

ROE: Our ROE assumptions are driven by our earnings growth estimates, of a 43% CAGR during the explicit horizon period and a 16.5% CAGR for 2013-17. Our ROE assumptions taper down from 57% now to 23% in the terminal year. Our earnings growth projections are driven by margin expansion as a result of change in business mix and better industry fundamentals.

COE: We assume 14.9% cost of equity based on a risk-free rate of 8% and 6% risk premium. We use beta of 1.15 to reach the COE of 14.9%. The spread between ROE and COE decreases as our ROE tapers down because of a higher increase in the book value.

Our price target of Rs1051 implies 35% upside from current levels. At the current price, the stock is trading at 12.9x F2009e P/E and 8.9x EV/EBITDA. At our price target, the stock would be reasonably valued at 17.4x F2009e EPS, given the higher potential for earnings growth. The implied PEG is a comfortable 0.6x.

Exhibit 3

Details of our Assumptions in our Base, Bull, and Bear Cases for Each Business Segment

BASE CASE – 12-month Price Target of Rs1051

BUSINESS	KEY ASSUMPTIONS	EFFECT ON FINANCIALS
Bulk Exports	We assume **6%** growth in gold volumes and an average **6.5%** growth in manufacturing charges for F2008-12. Rajesh's gold volumes have risen at an 11.5% CAGR over the past three years and manufacturing charges have risen rapidly, as evident in the margin widening from 2% to 3%.	Rs91,964 mn revenue and Rs3,143 mn operating profit from this segment, that is, contribution of 79% and 56%, respectively, for F2010e.
Private Label	We assume this business will start contributing revenue from F2008 and will grow at a CAGR of **38%** for F2009-12. The margins are higher for this segment, but it is a new venture, so we assume **5%** margins in first year and an increase to **10%** by F2010.	Rs7,613 mn revenue and Rs761 mn operating profit from this segment, that is, contribution of 7% and 14%, respectively, for F2010e.
Diamond Jewellery	We assume this business will start contributing revenue from F2008 and will grow at a CAGR of **36%** for F2009-12. We assume margins stabilise at **15%** in F2012.	Rs5,775 mn revenue and Rs722 mn operating profit from this segment, that is, contribution of 5% and 13%, respectively, for F2010e.
Retail	We assumed Rajesh will open **50** Shubh outlets, **five** Laabh outlets, and **10** Oyzterbay outlets this year and that, by the end of F2010, it will have **200** Shubh, **50** Laabh, and **30** Oyzterbay outlets. We assume the average annual sales per store at Rs**20-30** mn, depending on the format, and same store growth of 10-12%.	Rs10,663 mn revenue and Rs969mn operating profit with a 9% margin in F2010e. Our margin assumption is low for this segment, given the start-up costs and uncertainty of retail execution.

BULL CASE – Rs1231

BUSINESS	KEY ASSUMPTIONS	EFFECT ON FINANCIALS
Bulk Exports	We assume **8%** growth in gold volumes and an average **7%** growth in manufacturing charges for F2008-12.	77% of sales and 55% of operating profit in F2010e.
Private Label	A revenue CAGR of **42%** for F2009-12 through higher acceptance of Rajesh's jewellery by European customers and faster distribution reach to different geographies.	8% of sales and 15% of operating profit in F2010e.
Diamond Jewellery	A revenue CAGR of **38%** for F2009-12 on the basis of demand growth in international markets.	5.5% of sales and 14% of operating profit in F2010e.
Retail	Faster rollout than expected because of more franchisee requests and success of earlier rollout. Close to **100** more outlets than in the base case by F2010.	9.5% of sales and 16% of operating profit in F2010e.

BEAR CASE – Rs558

BUSINESS	KEY ASSUMPTIONS	EFFECT ON FINANCIALS
Bulk Exports	We assume **2%** growth in gold volumes and an average **4%** growth in manufacturing charges for F2008-12.	85% of sales and 79% of operating profit in F2010e.
Private Label	A revenue CAGR of **20%** for F2009-12 through lower-than-expected acceptance of Rajesh's jewellery by European customers.	4% of sales and 5% of operating profit in F2010e.
Diamond Jewellery	A revenue CAGR of **17%** F2009-12 on the basis of lower demand in international markets and higher competition in this segment.	4% of sales and 8% of operating profit in F2010e.
Retail	Execution delays and lower profitability leading to fewer franchisee requests and a slow rollout of retail plans. Around **75** fewer outlets than in the base case by F2010.	7% of sales and 7% of operating profit in F2010e.

Source: Company data, Morgan Stanley Research

We do not think there are many comparable companies in India for Rajesh because most of the listed jewellery companies are either involved in diamond processing and jewellery or in retailing. Rajesh is the only pure gold jewellery export company with domestic retail plans. Also, most of the international listed jewellery firms are more focused on retail than manufacturing. Therefore, we value Rajesh using an RIM. Rajesh has a stable bulk export business and very good plans for retail development in India. We do not have consensus estimates to compare, as the stock is not widely covered.

Exhibit 4

International Comparison

Name of the company	Country	Price (Local Currency)	Market Cap (mn$)	1 Yr forward PE	2 Yr forward PE	1 Yr fwd EV/EBIDTA	2 Yr fwd EV/EBIDTA
Gems TV Holding	Singapore	0.6	406	45.2	12.9	22	8
Egana Goldfeil	Hong Kong	2.2	408	6.2	4.9	5	4
Chow Sang Sang hld	Hong Kong	8.6	660	14.7	12.0	13	10
Gitanjali Gems	India	291.5	421	18.6	18.1	NA	NA
Titan Industries	India	1,242.3	1,349	27.2	17.5	21	15
Pranda Jewellery	Thailand	8.9	107	8.2	7.0	NA	NA
Signet Group*	UK	0.9	3,256	12.4	11.7	7	6
Fossil Inc	Unites States	33.5	2,287	20.5	17.0	NA	NA
Movado Group	Unites States	29.5	765	16.5	14.4	NA	NA
Tiffany and Co	Unites States	51.3	7,019	22.9	20.1	11	10
Zale Corp	Unites States	22.5	1,102	17.3	16.7	6	6
Blue Nile Inc	Unites States	84.4	1,341	84.2	66.9	44	34
Finlay Enterprises	Unites States	3.2	29	NA	11.3	NA	NA
Average				**24.5**	**17.7**	**15.9**	**11.8**

* under Morgan Stanley coverage
Source: Factset, Morgan Stanley Research

Exhibit 5

Indian Companies Comparison

Name	Price	Market Cap	P/B	P/E	P/Sales	Net Margins (%)	EV/EBIDTA
Titan Industries	1,501	1,537	19.7	66.5	3.2	4.8	29.8
Rajesh Exports	779	666	9.7	34.9	0.5	1.3	13.1
Gitanjali Gems	291	415	2.3	24.1	0.5	2.1	19.0
Vaibham Gems	208	140	0.9	5.4	0.6	11.9	6.7
Suashish Diamonds	191	98	0.9	14.1	0.5	3.5	NA
Classic Diamonds	480	83	2.1	21.3	0.5	2.5	13.8
Goldiam Intenational	84	54	1.2	12.8	0.7	5.7	7.7
Asian Star	1,319	347	5.3	53.4	1.2	2.3	25.0
Su-Raj Diamonds	59	56	0.4	6.0	0.2	3.1	6.9

Note: We do not have estimates for these companies, so we have used data for the year ending March 2007.
Source: Factset, Morgan Stanley Research

Option Value from Real Estate Development

We have not taken into consideration the option value that may arise from real estate development. Rajesh has 32 properties in and around Bangalore, of which it plans to develop five. Management estimates the total saleable area from these properties at 1.4 mn sq ft.

Business Strategy – Bulk Exports

We need to look back to understand the significance of Rajesh's current strategy. Up until 2003, the company had installed capacity of six tonnes per annum (tpa) for gold fabrication. In 2002, the company received land from the state government of Karnataka to start its jewellery exports operations as an export-oriented unit. In 2003, it took a major step and built a manufacturing facility with 250tpa capacity. This became the biggest jewellery manufacturing plant in India. The next task was to find customers that could buy such large quantities of jewellery.

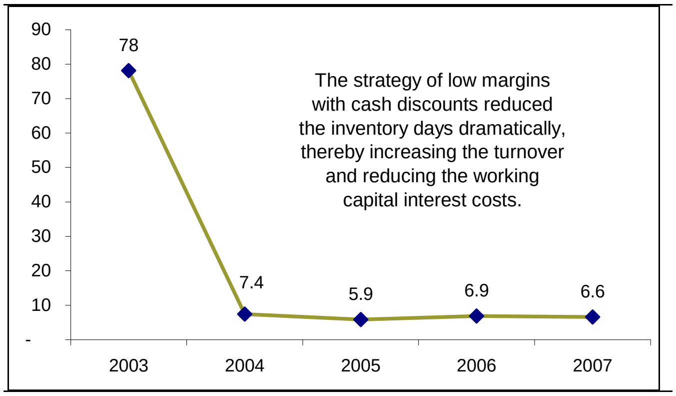
Manufacturing the jewellery is the easier part; the difficult part is to manage the working capital. The manufacture of large quantities of jewellery requires the handling of lots of gold and arranging funds.

Developments in 2004

To overcome this situation, the company adopted a strategy to sell jewellery at very low margins but for cash payments, without a credit period. It gave a very large discount for cash payment on delivery and thereby reduced its working capital cycle. It was able to attract more customers, with such low margins and high quality jewellery. This helped the company post very high revenue of Rs30,150 mn in F2004, 13.5x higher than in F2003.

Exhibit 6

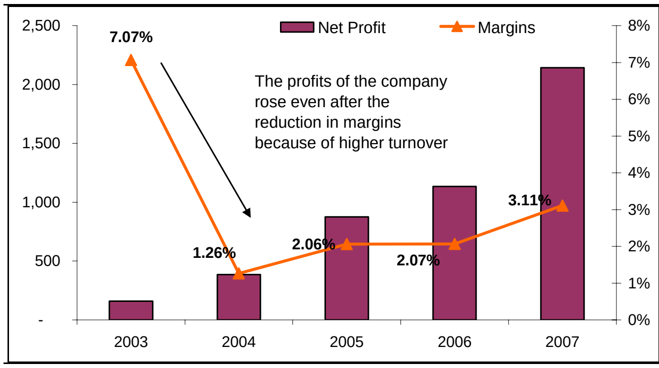
Drastic Reduction in Inventory Days



Source: Company data, Morgan Stanley Research

Exhibit 7

Higher Profits Despite Margin Reduction



Source: Company data, Morgan Stanley Research

This strategy helped the company increase revenues and earnings. It also gave the company some unique competitive advantage, in terms of:

- Handling very large volumes of gold, which gives it sourcing advantages
- Being the world's largest private gold importer
- Developing a large portfolio of jewellery designs
- Emerging as the lowest-cost jewellery producer

Bulk Exports Business – Key Revenue Contributor for the Company

In F2007 the company earned 100% of its revenues from the bulk exports business. We have estimated that by F2010 this segment will contribute 79% of total sales and 56% of total operating profits. The company over the past four years has built a strong bulk export business by selling the jewellery at very low margins and getting higher volumes. We believe this business is robust and will continue to provide stable margins to the company. The company sells its jewellery as well as coins and medallions in bulk exports. According to management the mix is currently 55% coins and medallions and the rest jewellery.

As per our calculations the making charges on its entire portfolio of coins and jewellery are around Rs29/gm in F2007. The making charges on jewellery are higher than that of medallions and coins. We have assumed a 6% increase in the making charges for the company going forward. We believe any change in the product mix towards higher percentage of jewellery than coins will lead to higher making charges, thereby increasing the margins in this business.

We have performed a scenario analysis to understand the impact of higher making charges due to a change in product mix to the overall financials as well as total value.

Exhibit 8

Sensitivity Analysis – The Impact of Change in Making Charges in Bulk Exports

Making Charges (Rs/gm)	Sales	Operating profits	Total Value
25	-0.8%	-24.0%	-14.5%
30	-0.3%	-8.8%	-5.3%
35	0.2%	6.4%	4.0%
40	0.7%	21.6%	13.4%
45	1.2%	36.8%	22.8%

Source: Morgan Stanley Research (Note: the change in Sales, Operating Profits and The value of the company is with respect to the year F2009e)

Strong Growth Expected in Jewellery Segment

We expect global demand for gold will 6-7% annually, led by growth in developing countries, such as India and China, along with Turkey, Russia, and parts of the Middle East. We expect around 20% gold demand growth in India annually in dollar terms. The growth in India in 1H07 was a strong 24% and we expect it will easily meet, or even surpass, our full-year 2007 target of 20%.

The demand for gold for jewellery consumption globally has actually decreased in tonnage terms, at a 4.5% CAGR for the past seven years. However, in value terms, it has risen at a CAGR of 4.5% for the same period. Global gold demand was really strong in 1H07, rising 11% YoY in tonnage terms and 24% YoY in dollar terms. This was mainly driven by demand in India, where demand for gold rose 72% YoY in tonnage terms, from 307 tonnes to 527 tonnes. The increase was much steeper in case of Q207 at 91%.

The effects of the increase in gold prices in 2005 appear to be behind us. People have accepted higher gold prices and appear willing to invest in jewellery and gold, as indicated by the stability in gold prices and increase in demand. This was evident in the growth in 2Q07, as shown below.

Exhibit 9

Record 2Q Gold Demand in India

Consumer demand (tonnes)	Q206	Q207	YoY Change
India	**166**	**317**	**91%**
Greater China	67	86	29%
Indonesia	11	14	22%
Vietnam	21	26	26%
Middle East	81	98	20%
Turkey	65	73	11%
Russia	16	20	27%
USA	63	52	-18%
Italy	14	13	-11%
UK	8	8	-2%
Total above	501	700	40%
Other	110	109	-1%
World total	**611**	**808**	**32%**

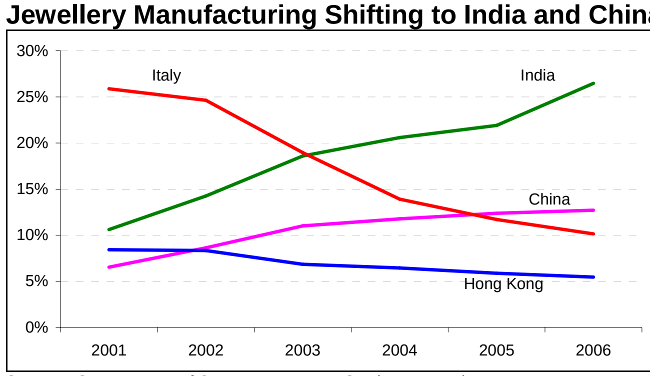
Source: World Gold Council, Company data, Morgan Stanley Research

Jewellery Fabrication May Move to Low-cost Countries

We believe industry participants are now looking at the competitive advantages of each country. The US and European markets are known for higher consumption of higher-priced jewellery, while the Indian market is well known for diamond processing and jewellery fabrication. The Italian industry, until recently, was renowned for its jewellery fabrication skills. But, with increased mechanisation and more value being added at the retail level, these countries will focus more on brand positioning and marketing than fabrication.

Exhibit 10

Jewellery Manufacturing Shifting to India and China



Source: US Department of Commerce, Morgan Stanley Research

We believe low-cost countries, such as India, China, Turkey, and Israel, will take more fabrication and processing work from the US and Europe. The proportion of US imports of fabricated jewellery from India has risen from 11% to 26% from 2001 to 2006, while that from Italy has declined from 26% to 10%. US jewellery imports have risen at a CAGR of 11% in 2002-06, whereas India's jewellery exports to the US have risen at a 34% CAGR in the same period.

Exhibit 11

Healthy Growth in Recent Quarters – Global Gold Demand

Identifiable gold demand (US$ mn)	2005	2006	Q106	Q206	Q107	Q207	Q1 Chg YoY	Q2 Chg YoY	H1 Chg YoY
Jewellery consumption	**38,684**	**44,242**	**8,692**	**10,549**	**11,739**	**14,474**	**35%**	**37%**	**36%**
Industrial and dental	**6,104**	**8,774**	**1,975**	**2,296**	**2,374**	**2,498**	**20%**	**9%**	**14%**
Electronics	3,990	5,908	1,332	1,560	1,596	1,698	20%	9%	14%
Other industrial	1,223	1,687	370	428	470	488	27%	14%	20%
Dentistry	892	1,179	273	308	308	312	13%	1%	7%
Identifiable investment	**8,472**	**12,483**	**3,517**	**2,765**	**3,068**	**2,795**	**-13%**	**1%**	**-7%**
Net retail investment	5,498	7,433	1,505	1,778	2,308	2,850	53%	60%	57%
Bar hoarding	3,763	4,327	761	866	1,425	1,828	87%	111%	100%
Official coin	1,585	2,507	597	859	713	747	19%	-13%	0%
Medals/imitation coins	528	1,144	209	221	442	578	111%	162%	137%
Other identified retail investment*	-378	-544	-61	-168	-273	-304	348%	81%	152%
ETFs and similar products	2,973	5,050	2,011	986	760	-55	-62%	-106%	-76%
Total identifiable demand	**53,260**	**65,498**	**14,183**	**15,610**	**17,181**	**19,767**	**21%**	**27%**	**24%**

Source: World Gold Council, Company data, Morgan Stanley Research (*Note: The Other identified retail investments section represents activites inThe negative figure is because of net selling of the retail stock or currency and gold price adjustments.

The Way Forward – Growth Engines

Rajesh believes its current bulk exports business is stable. It has concrete plans to increase margins. It plans to do so through three new growth engines.

Growth Engines

Rajesh wants to shift its business from being predominantly in the bulk exports business, catering to high volume demand from distributors at thin margins, to the high-value jewellery and retail business. It plans to increase its net margins from the current 2% to 10% in three to four years. Its growth engines are the following:

1) **Diamond jewellery** – This offers higher margins because people buy it for its aesthetic appeal rather than as an investment, as in case of gold.

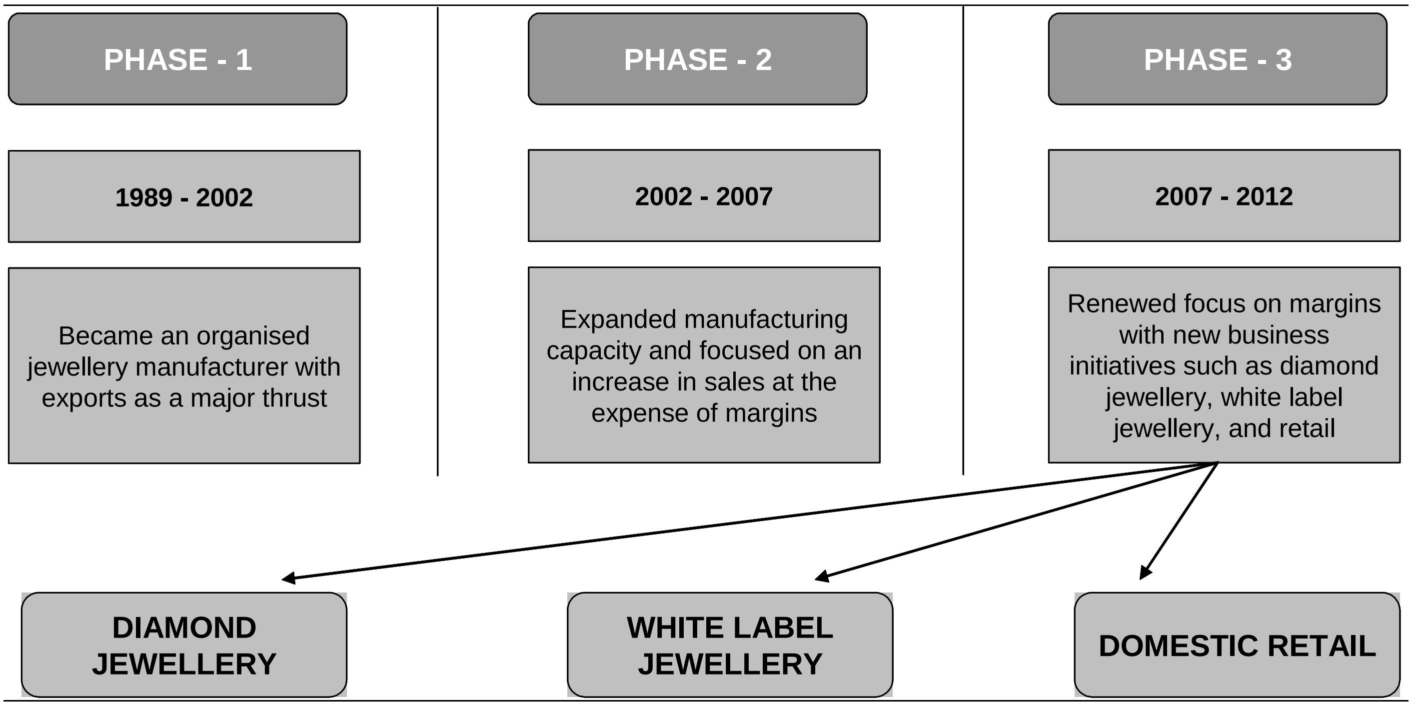
2) **White Label Jewellery** – The company wants to expand its presence across the value chain by selling its products directly to retailers.

3) **Domestic Retail** – The company wants to target India's large retail market for jewellery, which should lead to higher margins.

We believe Rajesh will be able to deliver on these planned growth strategies, given its strong track record.

Exhibit 12

Entering the Growth Phase



Source. Company data, Morgan Stanley Research

Diamond Jewellery

The value addition for plain gold jewellery is limited and customers are not willing to pay in excess of the price of the gold. Diamond jewellery targets completely different customers and markets. The pricing is based on design and not on a cost-plus basis. Rajesh plans to launch its diamond jewellery designs in 2H F2008.

The demand for diamond jewellery internationally is higher than for gold jewellery. The current global market for diamond jewellery is around US$68 bn annually, according to various industry reports. This demand in this segment has risen at a 5% CAGR over the past five years, with growth in India being above 10%. The US market is the biggest market in terms of consumption, followed by Japan and then Europe. Also, there is a growing shift to diamond jewellery from plain gold jewellery in India's urban markets. We believe this sector has growth potential that Rajesh can tap.

The company has finalised more than 700 designs for this segment. It will sell the jewellery under its own brands, for which it is finalising names. The company's unique selling point for diamond jewellery is global designs with honest pricing. The company will use its low-cost advantage and design capabilities to deliver this. Rajesh expects to easily generate margins of 15-20% in this business. We believe this is possible, based on our discussions with industry participants. However, we estimate lower-than-industry
-average margins for the company in this segment because of the following factors:

- It has no track record for diamond jewellery
- It does not have very good diamond sourcing ability
- It is yet to establish customers in this segment

Rajesh will use its own distribution network as well as tap new customers for its diamond jewellery business. It also plans to use the Fossil network to sell its products.

We estimate this segment will contribute roughly 4% of revenue and 8% of operating profit in F2010. The risks to our assumptions include competition in the diamond jewellery industry and the presence of established firms in India. However, we believe the industry is large enough to accommodate new participants, such as Rajesh.

White Label Jewellery

Rajesh wants to tap the high-value European and US markets through this segment. It is making jewellery taking the tastes of European customers into consideration. This is low-carat jewellery (eight-12 carats) with exclusive designs, of which Rajesh has finalised around 1,300.

Rajesh has identified customers and formed a team to target them. It will sell mainly to top retailers in identified countries and distribute directly to them. It will also use its JV with Fossil to sell its products.

We estimate this segment will contribute close to 5% of revenue and 12% of operating profit in F2010. Management has indicated that the increase in margins in the past two quarters has come partly from contribution from this segment.

Domestic Retailing

Huge Opportunity

In India, organised retailers account for only 4% of the jewellery retail market because Indians have historically preferred buying jewellery from family jewellers. Many standalone jewellers in the country make jewellery with the help of an in-house goldsmith. The designs are traditional and the jewellery is made more for investment than fashion purposes.

However, there is a growing trend in India for branded and designer jewellery. Customer preferences are shifting because people are looking at branded, designer, and diamond jewellery. Consumers appear ready to buy jewellery for all occasions and to pay premiums for good designs.

We believe there could be a huge opportunity for the domestic retail industry to organise and consolidate. The industry fragmentation leads to competition, but the standalone family jewellers have not been able to make the latest trendy jewellery designs because of: 1) a lack of mechanisation and technology; 2) a lack of funds to promote good designs; and 3) failure to understand customer preferences. We believe this provides a considerable gap in terms of understanding the customer and fulfilling their needs.

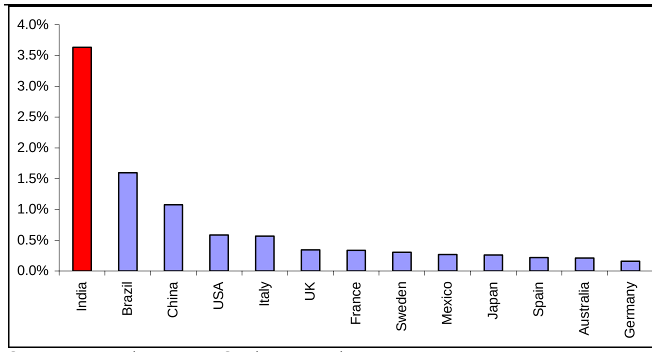
Titan and Gitanjali Gems are the only jewellery firms in India that have successfully built retail brands. Each has different formats. Gitanjali has been a pioneer in jewellery brands and has six major brands and various sub brands. It sells jewellery through other retail shops and its own few stores. Titan has *Tanishq* as its jewellery store brand and sells its jewellery only through its own stores. Titan and Gitanjali both target the upper segment of the market.

India's Inherent Jewellery Affinity

The Indian people have an inherent cultural affinity for the yellow metal. India's per capita spend on jewellery, as a percentage of total disposable income, is very high 3.5% compared to China at 1.0% and the US at 0.5%. India's disposable income has increased at a CAGR of 11% in the past decade (Exhibit 53). It is expected that the income will increase at a faster rate along with the increase in the total affluent population. We believe that with higher disposable income the total spend on jewellery will increase going forward.

Exhibit 13

Expenditure on Jewellery out of Disposable Income



Source: Euromonitor, Morgan Stanley Research

Jewellery Retail Formats in India

India has a large and growing domestic jewellery market worth around US$16-18 bn. Jewellery retailing in India is undergoing a transformation from a largely unorganised sector to a more organised one. The family owned jewellery store remains the predominant retail format, but new formats, such as boutiques, supermarkets, and gold souks, are emerging for jewellery retailing. Branded jewellery is a recent phenomenon, wherein products are sold under a brand name either through dedicated showrooms or through the shop-in-shop format in shopping malls.

Rajesh's Strategy in This Segment

As mentioned, Rajesh has bought the Oyzterbay chain and has incorporated its management team. This team was instrumental in building the *Oyzterbay* brand and had prior experience building the *Tanishq* brand for Titan.

Rajesh has split the retail market into three distinct segments based on customer profiles, and plans to launch brands to cater to each. These brands are *Shubh*, *Laabh*, and *Oyzterbay*.

Business Model

Rajesh wants to start off with an "*Associate model*". It has sought applications from existing jewellers to become associates (similar to franchisees, but here Rajesh will own the inventory). We believe this could be a good model because it does not require investment in real estate and Rajesh will have good locations and target existing customers. Rajesh will fill the shops with its own inventory and be responsible for the related advertising.

Shubh Jewellers

Rajesh plans to launch Shubh Jewellers, positioned as a dependable family jeweller, offering better quality, value, and designs than the standalone stores, which have a 96% share of the US$18 bn Indian jewellery market.

Rajesh plans to open many Shubh Jewellers stores across India in urban, semi-urban, and rural areas. It has 5,000 exclusive jewellery designs for this brand to suit local tastes, with high quality finishes and gold purity guarantees.

Rajesh plans to open the first Shubh stores in India's four southern states. These states account for around 40% of gold jewellery demand in the country. Rajesh would launch these stores under the associate model; it would acquire existing retail jewellers and convert them to Shubh stores. The original owners would then manage the stores as associates. Rajesh expects to start the operations with 100 stores in the next couple of years.

Laabh Jewellers

Laabh will be Rajesh's urban-centric format. The company has converted Oyzterbay stores to Laabh stores. The Laabh stores will be slightly larger and house 3,000 designs covering a complete range of jewellery.

Oyzterbay

The Oyzterbay brand will be youth centric and will have fashion jewellery and accessories. The Oyzterbay brand will be launched with the help of Fossil. The outlets will be opened in retail malls and as shops-in-shops. Rajesh plans to open 50 stores across prominent Indian cities.

Our Assumptions vis-à-vis Management Estimates

We have assumed the store rollout plan very conservatively because of the lack of visibility in the business model and the execution risk. Our assumptions are 50-70% less than the management plans. We believe there is an upside risk to our assumptions as the rollout takes place in the next few quarters.

Exhibit 14

Retail Stores Rollout Plan Assumptions

Our Assumptions (No of Outlets)			
	Shubh	**Laabh**	**Oyzterbay**
2008	50	35	10
2009	125	45	20
2010	200	55	30
Company Estimates (No of outlets)			
	Shubh	Laabh	Oyzterbay
2008	100	50	20
2009	250	100	40
2010	450	150	60
Diff. in our assumptions in 2010e v/s Management	56%	63%	50%

Source: Company data, Morgan Stanley Research
e =Morgan Stanley Estimates, p = Management plan estimates

Global and Domestic Retailers Experiencing Some Pain is a Concern

Macro factors, such as lower economic growth, the credit crunch, and higher borrowing costs, have led to lower jewellery sales in the US. Also, the housing market drag is affecting consumer demand. Many retailers are now focusing on controlling expenses. Earnings at Zale, which operates 2,300 retail outlets in the US and elsewhere, were flat in 2006, with a fall in the last quarter. The company's same store sales decreased 0.5% in 2006. Same store sales at Signet Group, which operates 1,900 stores in the US and elsewhere, rose just 3% in 2006. At constant exchange rates, the growth was even lower. We believe this trend will affect the export market and lead to a further squeeze on export companies.

At the domestic level, higher rentals and borrowing costs and a lack of new designs from traditional standalone jewellers are putting pressure on margins, leading to consolidation.

Financials

We forecast sales growth of 19% for F2007-10. We expect this growth to come mainly from: 1) an increase in gold volumes in the bulk exports business; and 2) revenue from the new business initiatives. We estimate a 5-7% annual increase in gold volumes handled by the bulk exports business. We estimate the company to derive 21% of its revenue from the high value-added businesses (new businesses and retail) by F2010. We believe Rajesh will stabilise its operations in these business segments during the next two to three years. We expect these segments to drive sales and earnings growth.

For F2007-10, we estimate CAGRs of 61% for net income and 47% for EPS, the difference being because of equity dilution from issuance of a foreign currency convertible bond (FCCB).

We expect earnings growth to be driven by margin expansion as a result of the following factors:

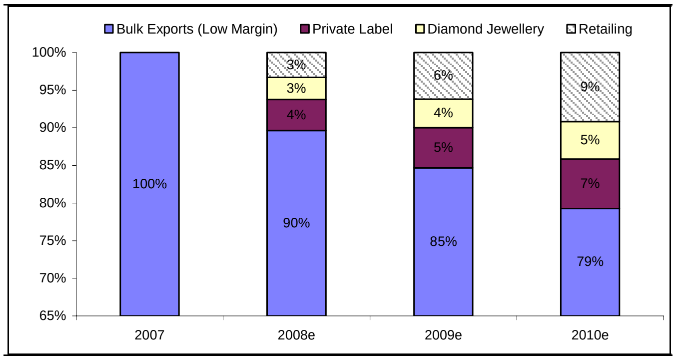
- Extending the value chain through presence in the domestic retail format
- Moving from plain jewellery to higher-margin exotic diamond jewellery
- Distributing directly to retailers
- Using size advantage to improve credit lines and supply terms

Sales and Profit Breakdown

Rajesh currently derives all its profits from bulk exports. We estimate bulk exports will contribute 79% of consolidated revenue in F2010, with the rest coming from the new higher-margin segments – diamond jewellery, private label jewellery, and domestic retails – which we term high-value segments.

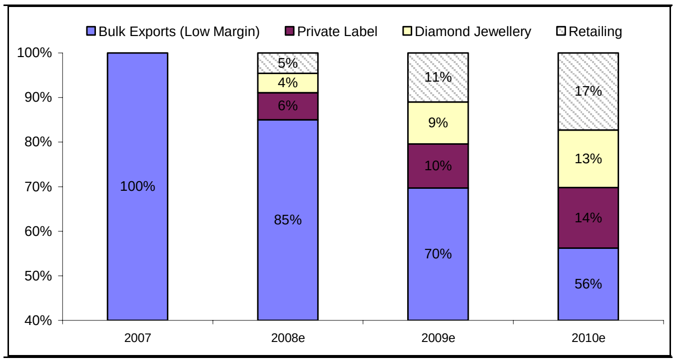
We estimate the high-value segments will contribute 44% of consolidated operating profit in F2010. We conservatively estimate the change in business mix will result in the company's margins rising from the current 3.1% to 4.82% in F2010.

Exhibit 15
Sales Breakdown



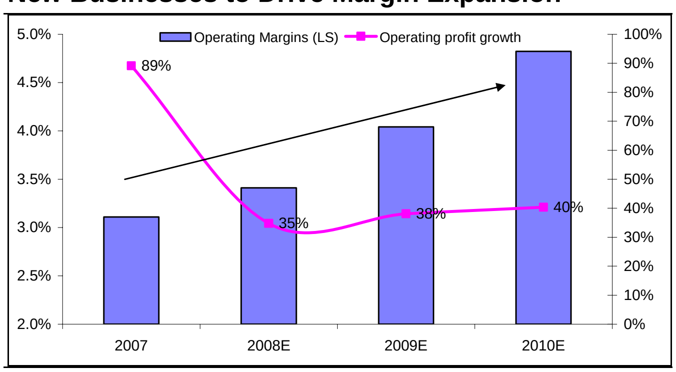
e=Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Exhibit 16
Operating Profits Breakdown



e=Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

Exhibit 17
New Businesses to Drive Margin Expansion



e=Morgan Stanley Research Estimates
Source: Company data, Morgan Stanley Research

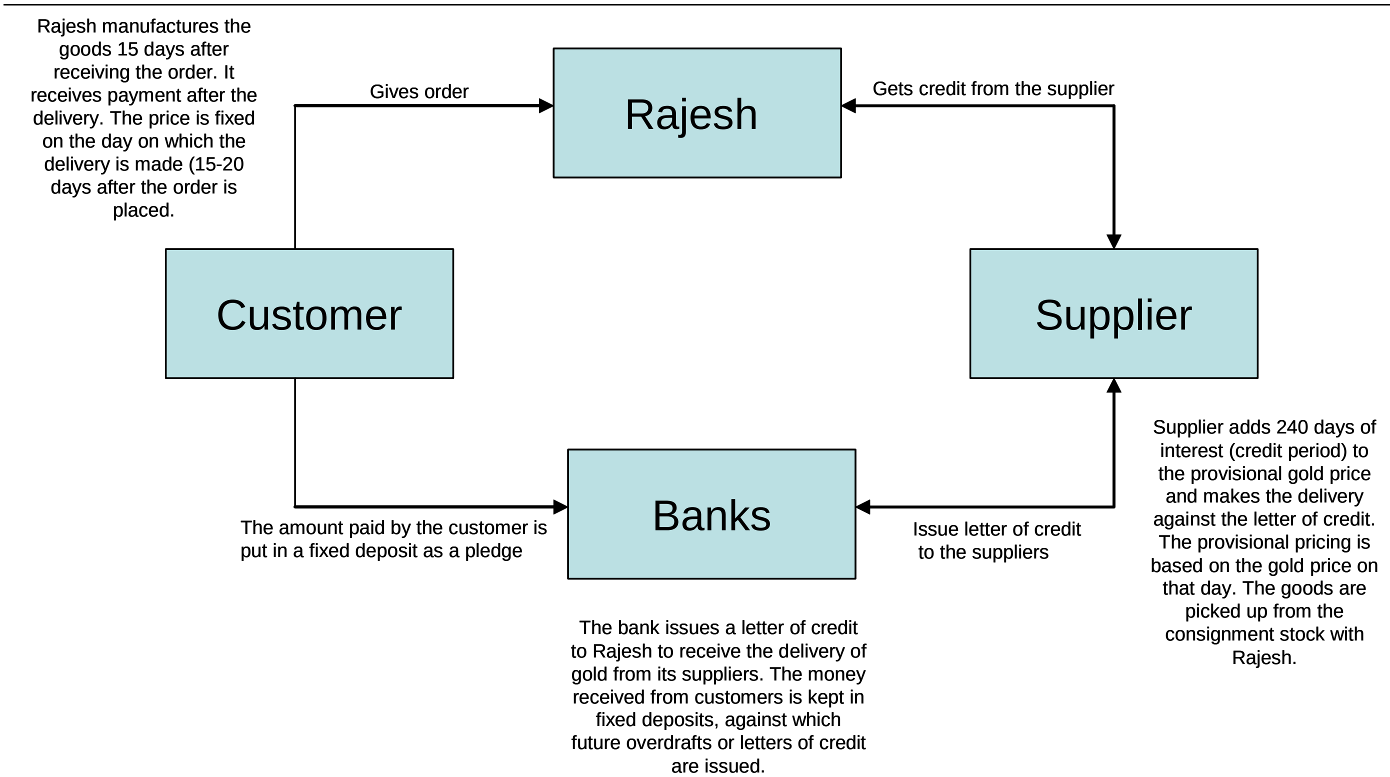
Management of Working Capital Requirements Leads to Creation of Fixed Deposits
Rajesh's business model makes the financial statements look a little odd, in our view. At the end of F2007, the company had Rs57,647 mn as cash, a Rs24,026 mn overdraft, and Rs33,429 mn as current liabilities. To explain this situation, we have to look at the company's working cycle.

The company receives an order from its customers with a specified future date on which the gold price has to be fixed for the quantity of gold in the order. The company informs its suppliers to supply the same quantity with a request to the supplier to fix the price of the gold at the London AM fix of the date specified by the buyer. The supplier sends a provisional invoice based on the gold price on the day the quantity was booked, along with 240 days of interest (credit period) for the stocks picked up by the company from the consignment.

The company establishes a stand-by letter of credit from a prime Indian bank for the provisional value. It manufactures and exports the required product within eight-15 days, depending on the order. It raises a provisional export invoice for the goods based on that day's price plus the manufacturing charges. The payment for the value of the provisional invoice is made against delivery by the supplier and the entire production and sales transaction is completed in approximately 15-20 days.

This cash received from the customer after delivery is available to Rajesh for about 210-230 days, as it gets 240 days credit from its supplier and receives the money in 15-20 days from customers. Rajesh recovers the interest paid on purchase by placing this surplus cash as deposits with the bank for eight or nine months, depending on the interest rate offered. The fixed deposit so made is offered as 100% margin to the bank to establish further letters of credit, against which raw material is again taken on credit, processed, and exported, thereby generating further surplus cash. This cycle is repeated, resulting in approximately 200 days of the sales realisation being kept as fixed deposits with the banks. Therefore, these fixed deposits are actually the funds to be paid to the supplier when the credit period expires.

Exhibit 18
Fixed Deposit Creation Cycle



Source: Company data, Morgan Stanley research

Quarterly Performance

Rajesh's margin has improved significantly YoY in the past two quarters, to 6.3% in 1Q F2008 and 4.8% in 2Q F2008, because of contribution from private label jewellery and the change in product mix in the bulk exports business, leading to higher manufacturing charges.

Normally, the first two quarters of the fiscal year are weaker. However, the company's margin and revenue growth performances have been strong in 1H F2008.

Rajesh has not officially given the segmental breakdown, but we believe the growth is because of revenue from the private label and retail operations. We expect revenues from the diamond jewellery business and the rollout of new retail outlets in the next few quarters. Therefore, further similar growth could have a positive effect on our estimates.

Exhibit 19

Quarterly Financials: Evident Margin Improvement

Particulars	QE Mar-06	QE Mar-07	QE Jun-06	QE Jun-07
Net Sales	17,831	17,965	15,122	20,302
QoQ Growth	*38%*	*-4%*	*-15%*	*13%*
YoY Growth	*25%*	*1%*	*29%*	*34%*
RM Consumption	18,070	15,563	14,430	18,677
% of sales	*98.4%*	*87.3%*	*98.0%*	*91.6%*
Expenditure	17,552	16,815	14,833	19,335
% of sales	*98.5%*	*93.7%*	*98.1%*	*95.2%*
QoQ Growth	*38%*	*-8%*	*-15%*	*15%*
YoY Growth	*28%*	*4%*	*30%*	*30%*
Operating Profit	272	1,132	295	967
% of sales	*1.5%*	***6.3%***	*1.9%*	***4.8%***
Interest	83	765	104	542
Gross Profit	190	367	190	425
% of Sales	*1.1%*	*2.0%*	*1.3%*	*2.1%*
QoQ Growth	*4%*	*29%*	*0%*	*16%*
YoY Growth	*-3%*	*94%*	*11%*	*123%*
Depreciation	4	4	4	4
Profit before Tax	186	363	187	421
Profit after Tax	149	333	187	421
% of Sales	*0.8%*	*1.9%*	*1.2%*	*2.1%*
QoQ Growth	*-16%*	*19%*	*25%*	*26%*
YoY Growth	*-25%*	***123%***	*11%*	***126%***
Equity Capital	74	74	74	74
EPS (As reported)	4.04	9.02	5.05	11.40

Source: Company data, Morgan Stanley Research

Recent FCCB Issue

Rajesh recently issued an FCCB amounting to US$150 mn. The issue was subscribed successfully, along with the greenshoe option. The company had wanted to raise money from three sources for its capex plans, and the FCCB was one of them. The conversion for this FCCB to equity is due any time before 2012, when it will be compulsorily redeemed. The conversion price is fixed at Rs575. We assume these bonds will get converted to equity at the conversion price in F2008 itself. This will lead to increase in the number of shares outstanding by 11.5 mn, in turn leading to 31% equity dilution. As a result, Rajesh's share capital would increase from Rs73.91 mn to Rs96.91 mn. The company will use the cash to fund its retail and new business ventures.

Brief Summary of Our Projections

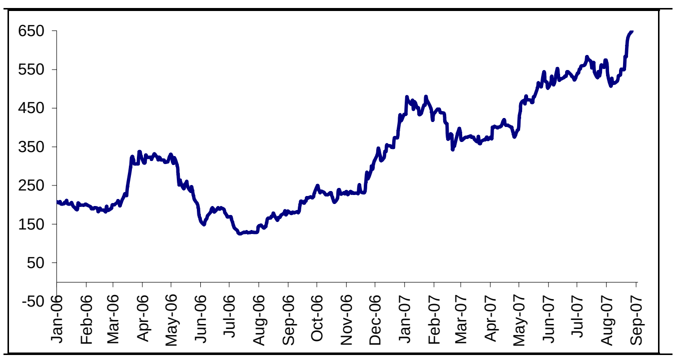
We believe Rajesh can maintain its current growth track for the next three to five years. We estimate its sales will rise from Rs68,934 mn in F2007 to Rs116,014 mn in F2010. We estimate sales growth based on an increase in the tonnage of gold with a moderate increase in gold prices. Gold prices can have a significant effect on the company's revenue, but we do not think they will have a major effect on operating profits because manufacturing charges are based on weight. We assume 7% and 5% revenue contribution and 14% and 13% operating profit contribution from diamond jewellery and private label jewellery, respectively, in F2010. On the retail side, we estimated 9% revenue contribution and 17% operating profit contribution for F2010. We estimates overall operating profit of 5,595 mn in F2010, against Rs2,143 mn in F2007.

Price Performance

The stock has already performed well, generating 50% absolute returns in the past three months. The stock has been the steadiest and best performer among listed Indian jewellery stocks. We believe the stock could rise further, despite the recent superior performance. The stock has given the best returns among these peers and we believe it will continue to do so.

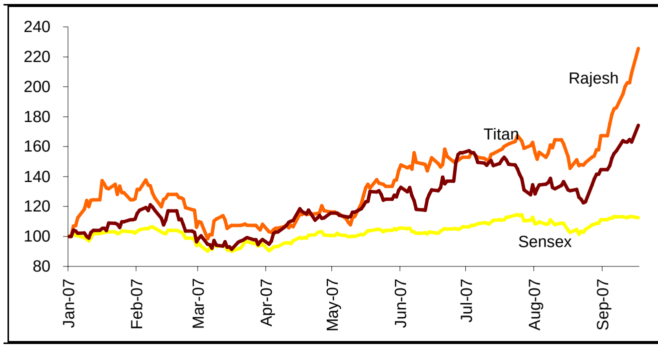
Exhibit 20

Share Price Performance



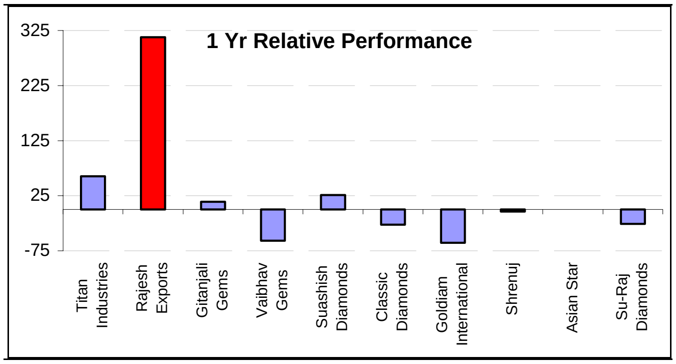
Note: Values in Rs per share
Source: Factset, Morgan Stanley Research

Exhibit 21
Rajesh Has Outperformed the Sensex (YTD)



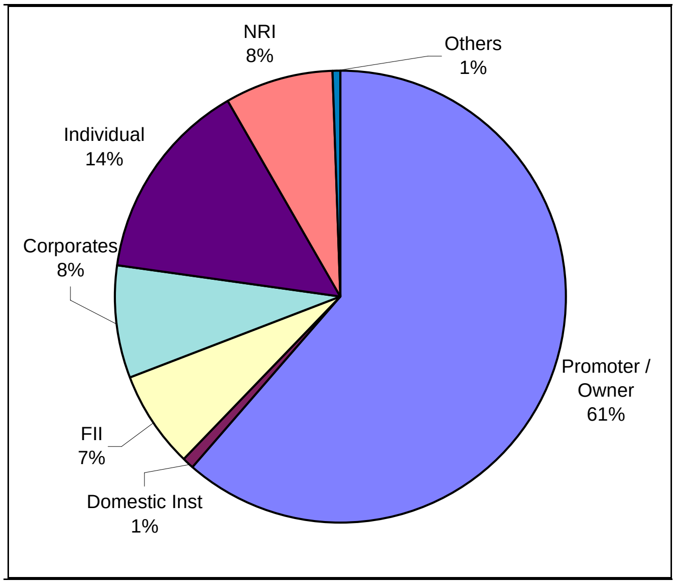
Source: Factset, Morgan Stanley Research

Exhibit 22
Relative Performance



Source: Factset, Morgan Stanley Research

Exhibit 23
Shareholder Breakdown (1Q F2007)



Source: Company data, Morgan Stanley Research

Rajesh Exports – Company Background

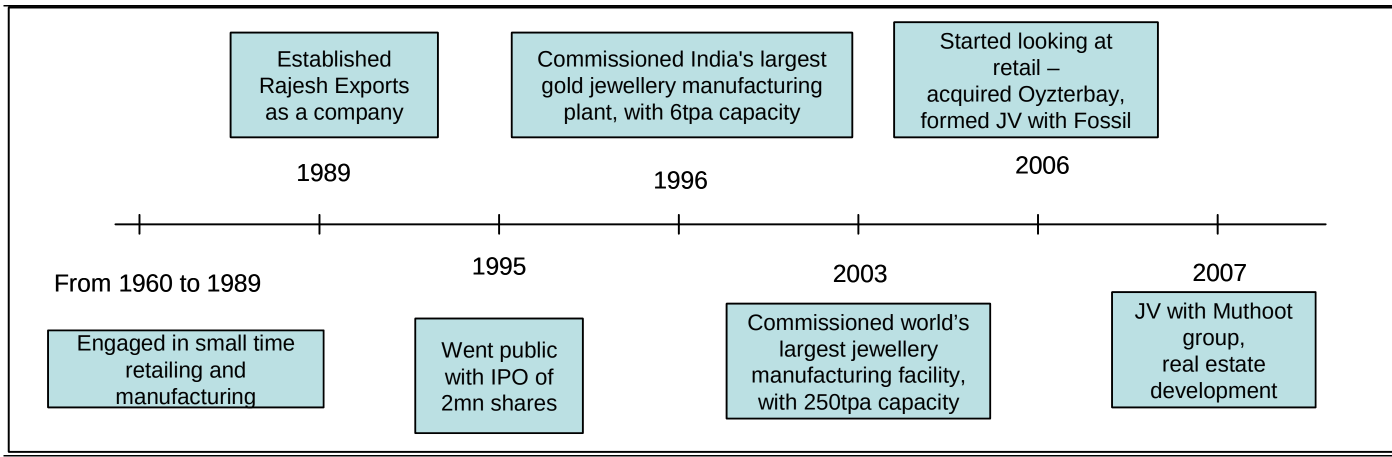
Rajesh is a Bangalore-based gold jewellery manufacturer and exporter. It is the largest gold jewellery exporter in India, accounting for more than 25% of gold jewellery exports. It sells its jewellery mainly to distributors across the globe, with a major focus on the Gulf and US markets. It aims to become a fully integrated jewellery company with presence across the jewellery value chain.

Company History

In 1989, brothers Rajesh Mehta and Prashant Mehta joined the family jewellery business. In 1990, they established the first organised jewellery manufacturing facility in India. They predominantly catered to the export market. By 1994, they were the largest exporters of jewellery in India. In 2003, they started commercial production from the biggest jewellery manufacturing plant in India, with processing capacity of 250tpa. Simultaneously, the company invested in R&D for different designs for different markets. It now has a collection of 29,000 jewellery designs.

Exhibit 24

Company Development Timeline



Source: Company data, Morgan Stanley Research

Manufacturing Process

Rajesh's manufacturing starts from gold bullion sourced from Australia. This is 99.9% pure gold. It is heated at high temperatures and mixed with special alloys to make it 22, 20, or 18 carats, as required. The heated gold is cast into rods, which are then made into jewellery. Coins and medallions are made directly from the pure gold.

The production process can be divided into three broad divisions: machine made, handmade, and fusion jewellery. The primary raw material for manufacture of gold jewellery is gold bullion, which is easily available in India following the liberalisation of imports.

Machine-made chains: These are manufactured in a semi-automatic process, wherein gold rods are first drawn into thin wire. The wire is spooled and the spools are mounted on automatic chain-linking machines, which link the wire into different chain designs in a fully automated process. The chain is faceted and cut into required sizes. Loops and hooks are fixed to the chain, which is then sent for final polishing and to the quality control department before delivery.

Handmade jewellery: Different shapes of jewellery designs are made using dyes and casts. This is the old way of making jewellery, in which each piece was manufactured separately and then soldered. At Rajesh, only some parts are made using the manual stamping process and some are made using machines.

Cast jewellery: This is the standard process used by many manufacturing units. It is called lost wax investment casting. A metal master piece is made from which a wax model is created. The wax model is put in a liquid investment powder, akin to plaster of Paris. After this powder is set, the wax is taken out and a cast is created. The required gold shape of the design can be obtained by pouring gold in the cast.

Rajesh has various designs that are combinations of chains, handmade jewellery, and cast jewellery. These combinations are sometimes called fusion jewellery. Rajesh can also make diamond jewellery through the casting process.

Management

Rajesh is a family business run by Rajesh Mehta and Prashant Mehta. Each has over 20 years' experience in the jewellery business. Rajesh Mehta is responsible for the overall functioning of the company, as well as being specifically in charge of the finance and marketing functions. He is a member of the export trade advisory committee of the Bangalore Jewellers Association. He is the president of the Karnataka Jewellery Exports Association and the director of the Handloom and Handicrafts Export Corporation of India. Prashant Mehta, the company's managing director, is in charge of the day-to-day functioning and specifically in charge of the production unit.

Through acquisition of Oyzterbay, Vasant Nangia and Vipin Sharma joined Rajesh's retail team. Each has good and unique experience of brand building in the jewellery industry. They were the founding partners of Oyzterbay and have prior experience with Titan's *Tanishq* brand.

Exhibit 25

Management

Rajesh Mehta *Executive Chairman*	Experience of over 20 years in the jewellery industry Pioneer in organising jewellery trade in India Director, Handloom & Handicrafts Exports Promotion Corp President, Jewellery Exporters Association of Karnataka
Prashant Mehta *Managing Director*	Experience of over 22 years in jewellery manufacturing Expert on global best practices in jewellery manufacturing and technology.
Vasant Nangia *CEO (Retailing)*	Experience of over 15 years Pioneer in creation of retail jewellery brand in India Founder-promoter of Oyzterbay
Vipin Sharma *Director (Laabh)*	Experience of over 12 years in brand building & jewellery retailing Part of the Oyzterbay promoter-group
John Verghese *Chief GM (Shubh)*	Experience of over 15 years in branding and retailing of jewellery Part of the Oyzterbay promoter-group
Kalpesh Sagar *CEO (Banglore Infra)*	Experience of 10 years in real estate and construction Ex-CEO of mid-sized real estate development company

Source: Company data, Morgan Stanley Research

Infrastructure

Rajesh set up a futuristic jewellery manufacturing facility at White Field, Bangalore in 2003. It is the largest jewellery manufacturing facility in the world. It is on an area of 12 acres, and covers approximately 0.5 mn sq ft, providing a good working environment for the company's craftspeople. The facility can accommodate 10,000 workers. It has an innovative R&D wing and can achieve a peak output of 250 tonnes of world-class jewellery annually from basic raw material.

Distribution Network

Rajesh's global distribution network is spread across North America, Europe, Asia, and Australia. The company has set up a wholesale distribution network in New York, Chicago, Dallas, Toronto, London, Paris, Zurich, Dubai, Sharjah, Muscat, Kuwait, Singapore, Kuala Lumpur, and Sydney. It supplies products in bulk to large jewellery distributors in these cities, who in turn wholesale the products. Rajesh has built strong relationships with these distributors over the past 15 years. This arrangement ensures steady volume business.

Rajesh has built a domestic distribution network across the whole of India. It supplies jewellery to about 5,000 retail showrooms across India. It has divided the showrooms into various zones, each headed by a zonal general manager, responsible for distribution and promotion of products.

Marketing Team

Rajesh has a well-experienced marketing team for the global and domestic markets. It has developed an extensive global marketing network through leading wholesalers with which the company has exclusive marketing arrangements to ensure continuous and growing business. Rajesh exports its jewellery to the USA, the UK, the UAE, Kuwait, Muscat, and Singapore, among other places. It has maintained good relations with most of the overseas buyers since it began exporting. These buyers are basically wholesalers who in turn supply jewellers and semi-wholesalers. Rajesh's entire operation is computerised and the company has set credit limits for each export and local wholesale party. It has a strong credit policy; Rajesh does not take exposure to a single party for more than 15% of the estimated worth of the party. The credit limits are allotted to the parties after thorough research and discussions.

Very Low Gold Wastage

Rajesh has a very low percentage of gold wastage, as it has taken measures to recover and recycle gold. These measures include: 1) very high security (physical checking); 2) factory design (high walls with no windows); 3) recycling the floor mats; 4) recycling human body waste; and 5) recycling wastewater.

Employees

Rajesh has a strong managerial team and specialised artisan workforce, drawn from different parts of India. It has sophisticated machinery and has invested heavily in technology and process controls. The entire production process is controlled by a customised ERP package.

Industry Undercurrents

Consolidation at the Retail Level
We expect consolidation and corporatisation of India's very fragmented retail jewellery industry, as it will be difficult for standalone jewellers to survive with high borrowing costs and increasing rentals. More people are now looking at jewellery as aspirational products rather than investment products, so the standalone family jewellers have to revamp their product portfolios. People are also looking at jewellery as fashion and status products, in our view. Also, the family jewellers are not able to make contemporary designs that appeal to the younger generations. We expect these factors to lead to dwindling sales for the local standalone jewellers.

Strong Macro factors
In India, a combination of positive factors should lead to increased jewellery demand. These include a booming economy, high disposable incomes, favourable demographics, and a cultural affinity with gold. We believe the greater promotional activities during traditional gold buying seasons, such as for weddings or festivals, will lead to higher sales. The increasing number of working women and rising rural incomes may also lead to higher gold demand.

India is an Important Cog in the Global Jewellery Wheel
India has historically been an important market for gems and the jewellery industry. There is an underlying traditional demand for gold in India, backed by the cultural and social fabric of the country. India has been an important centre for diamond processing for years. Ten out of every 11 processed diamonds in the world pass through India. India has been the biggest gold consumption market for years. More than 30% of global gold demand comes from India. The country has a lot of goldsmiths, craftsmen, and retail jewellers. We believe India will remain a key market in the jewellery industry as a consumer and manufacturer.

Reduced Gold Price Volatility Leading to Higher Consumption
In 2006, increased gold price volatility had a negative effect on global gold demand. Gold is a unique commodity used as a monetary asset as well as an investment. Higher gold price volatility normally dampens demand. However, in the past three months, gold price volatility has decreased to a new low. The increase in demand in 1H07 has been due to this reduced volatility. We believe people have accepted gold prices of above US$600 per ounce and that there will be renewed interest in gold consumption.

Indians Abroad
There is a very large, still-growing, non-resident Indian community spread across the globe. Most of the Indian jewellery exports to the Gulf and the US cater to the Indian communities there.

Subdued Demand in Developed Countries
Growth in the jewellery markets in the US and Europe has continued to slow in recent years. Also, growth in the Japanese market has not been normal. We believe this is a clear negative for the industry, as these are the biggest jewellery markets. Slower overall economic growth, coupled with alternative luxury products, could be causing this slower jewellery market growth, in our view. High gold prices, together with slowing economic growth and retail sales, have taken a toll on mass-market items. High and volatile gold prices have affected the supply chain of retail jewellers. However, with reduced volatility recently, retailers have been able to plan their purchases better. We believe that, for the jewellery industry to prosper, growth in the jewellery markets in the US, Europe, and Japan will need to increase.

Competition from Other Luxury Products
We believe jewellery products face tough competition from other luxury products, such as luxury consumer durables, foreign vacations, new gadgets, fashion and branded apparel, and watches. Most consumer durables or electronic gadgets have very good marketing support that can give the consumer a 'first to have' feeling. This segment has significant potential to take spending away from the jewellery segment, in our view.

Competition from China
China has a similar low-cost advantage as India. There could be a shift in jewellery fabrication and processing to China. We believe India has the major share of this industry because of the presence of skilled craftsman, processing skills, and experience. However, China could pose a competitive threat, particularly if jewellery production becomes more mechanised.

The Structure of the Industry in India
As mentioned, India's jewellery industry is fragmented and uncontrolled and lacks branding. Numerous standalone jewellers with in-house goldsmiths produce jewellery. Also, assaying and hallmarking is still voluntary. The unorganised market is very large and there are very few groups that have actually corporatised the business. We believe this structure hampers growth because of a lack of access to higher capital, a lack of ability to advertise, and failure to create demand pull.

Jewellery Industry Overview

Global Markets

Background

The jewellery industry is part of the value chain of the entire gems and jewellery industry. The jewellery industry is the intermediate stage of the chain, which includes mining, manufacturing, and retailing. This is one of the oldest industries in the world. Gold is a unique commodity because most gold mined so far has been above ground and has been recycled to produce various forms of products. The supply of gold is limited to certain countries, but the consumption is global. Jewellery is the major demand driver for gold, with more than 70% of demand coming from this sector.

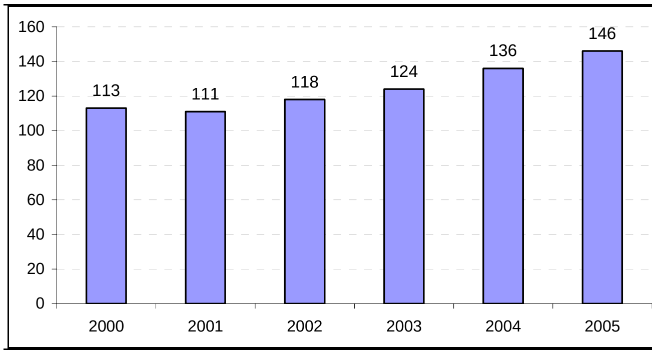
The global markets are divided based on the competitive or natural advantage each has. The mining of gold and diamonds is focused in Australia, South Africa, other nations in Africa, and in parts of Russia. For diamond processing, India, Israel, and Turkey are key countries. For jewellery fabrication, India and Italy are among the prominent markets. For jewellery consumption, the USA, India, Europe, the Middle East, and now China are important markets. Aspects such as design, size, and purity, are different for different countries.

Market Size and Trends

There are various estimates on the total size of the jewellery industry. Industry sales were worth close to US$150 bn in 2005, according to KPMG. Most of these sales were in the US. We believe this is because retailing accounts for the majority of the market. Retailing is widespread and mature in developed markets, such as the US and Europe. In India, China, and the Middle East, standalone retailers still dominate the fragmented retail market. Industry sales as a whole have increased at a CAGR of 5% since 2000.

Exhibit 26

Jewellery Industry Growth



Source: KPMG Report (Note: figures in bn$)

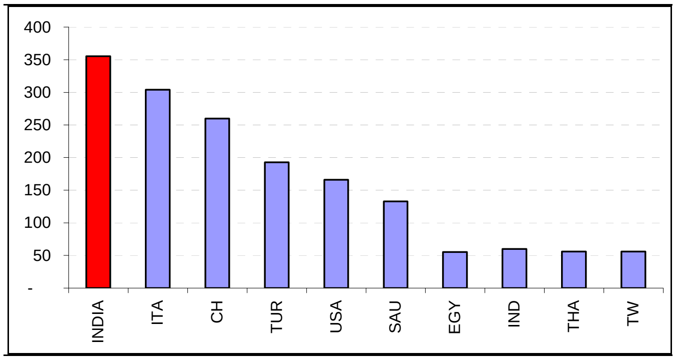
India has the highest gold consumption in terms of tonnage in the world. Global jewellery industry sales are likely to grow, led by growth in countries such as India and China. India is, and historically has been, the largest centre for processing raw diamonds. Processing involves cutting and polishing the raw diamond to give it a final shape. The processing involves a lot of labour costs. We expect processing to remain in low-cost countries, such as India and China, which offer competitive labour rates. For larger diamonds, Antwerp in Belgium and Israel are the key centres.

Jewellery

Gold jewellery and diamond-studded jewellery are the two main segments of the industry. Together, they account for more than an 85% share of the jewellery industry. The remainder is accounted for by other metals, such as silver, platinum, and palladium, and gemstones. Jewellery fabrication and precious metals form the next biggest chunk of the jewellery value chain after retail. Gold and diamonds are synonymous with jewellery and have historically been used for this purpose, along with the investment value for gold.

Exhibit 27

India No.1 in Gold Jewellery Fabrication

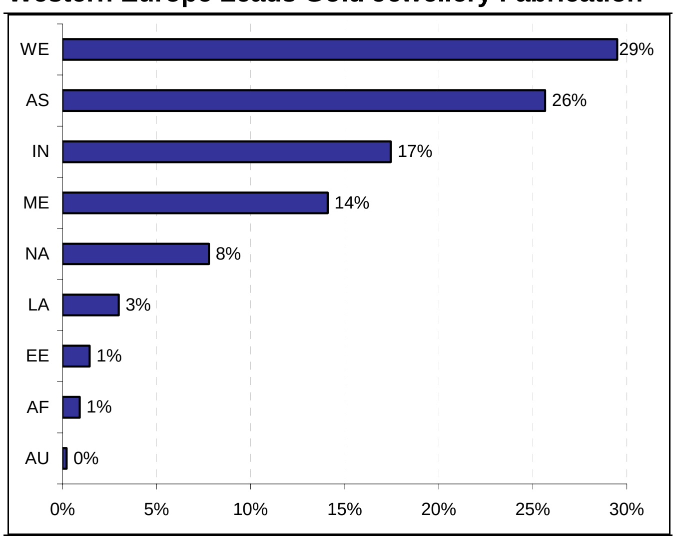


The figures exclude recycled gold, values are in tonnage terms for 2006
Source: Virtual Metals, Yellow Book, Company data, Morgan Stanley Research.

The jewellery fabrication industry has developed across the world, with certain geographic areas specialising in different forms of jewellery. Each area has a distinct identity based on design specialisation, choice of fabrication material, use of technology, method of production (handmade versus machine made), quality, and finish of the final product. Italy, Thailand, and the US have developed as fabrication centres, while India has emerged as the largest centre for manufacturing. Western Europe is still the main area for jewellery fabrication, while emerging centres include Turkey and China.

Exhibit 28

Western Europe Leads Gold Jewellery Fabrication

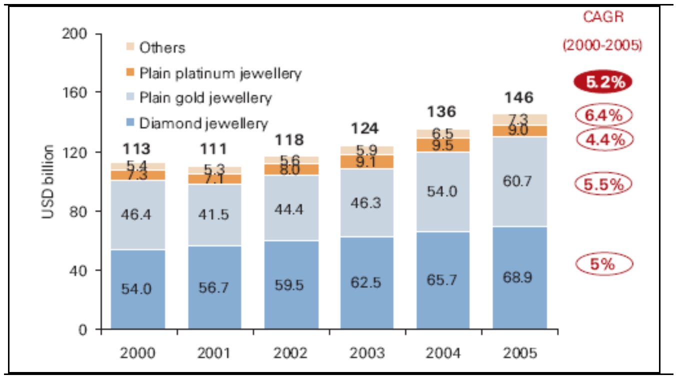


Note: values for year 2006. WE – Western Europe, AS- Asia, IN-Indian subcontinent, ME-Middle East, NA-North America, LA-Latin America, EE- Eastern Europe, AF-Africa, AU-Australia.
Source: Virtual Metals, Yellow Book, Company data, Morgan Stanley Research

KPMG data for 2005 indicates US$69 bn in jewellery sales came from diamond-studded jewellery and US$61 bn came from plain gold jewellery. Sales of plain gold jewellery accelerated, while sales of platinum jewellery ate into sales of diamond-studded jewellery, as illustrated below.

Exhibit 29

Higher Growth of Plain Gold Jewellery Sales



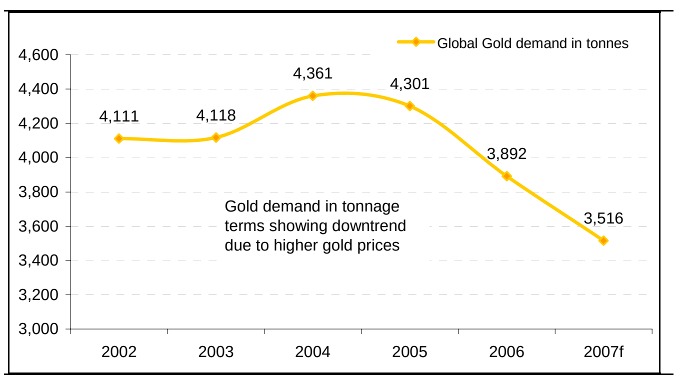
Source: KPMG and GJEPC Report

World Demand Drivers for Gold and Diamonds

The primary demand for gold and diamonds comes from the jewellery segment. The rise in the price of gold resulted in a reduction in the usage of gold in jewellery from 3,200 tonnes in 2000 to 2,300 tonnes in 2006. However, in terms of value, the usage increased 35% over the same period as gold prices increased. The overall demand for gold declined only marginally, from 4,100 tonnes in 2002 to 3,900 tonnes in 2006, because of increased demand from industrial applications and retail investment.

Exhibit 30

Gold Demand



f = Virtual Metals forecast
Source: Virtual Metals, Company data, Morgan Stanley Research

Exhibit 31

Jewellery Gold Demand Proportion Decreasing

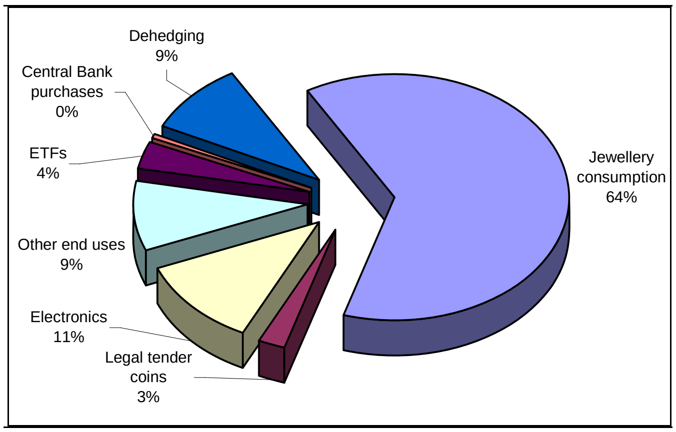
Year	Jewellery Demand (tones)	Total Gold Demand (tones)	Jewellery %
1999	3,139	3,910	80%
2000	3,204	3,821	84%
2001	3,008	3,728	81%
2002	2,660	3,360	79%
2003	2,482	3,194	78%
2004	2,614	3,496	75%
2005	2,707	3,727	73%
2006	2,279	3,374	68%

Source: WGC, Morgan Stanley Research

The demand for gold from the jewellery industry as a proportion of overall demand for gold is decreasing. The proportion of demand from exchange traded funds (ETFs) and industrial applications is increasing. The other demand drivers for gold are industrial, dental, and investment purposes.

Exhibit 32

Gold Demand Breakdown, 2006



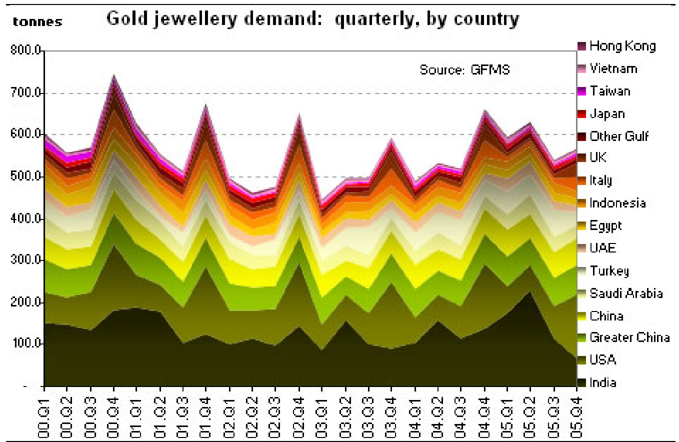
Source: Virtual Metals, Morgan Stanley Research

Jewellery Consumption

Jewellery buying patterns are different in different countries. Jewellery buying is often linked to special occasions, which vary according to culture. Common occasions include weddings and festivals. This leads to seasonality in the jewellery sales. The demand tends to peak in 4Q, largely because of end-of-year religious festivals and the wedding season in the first and last quarter of the calendar year. However, retailers promote the sale of jewellery as gifts throughout the year, in an attempt to reduce such seasonality.

Exhibit 33

Seasonality in Jewellery Demand

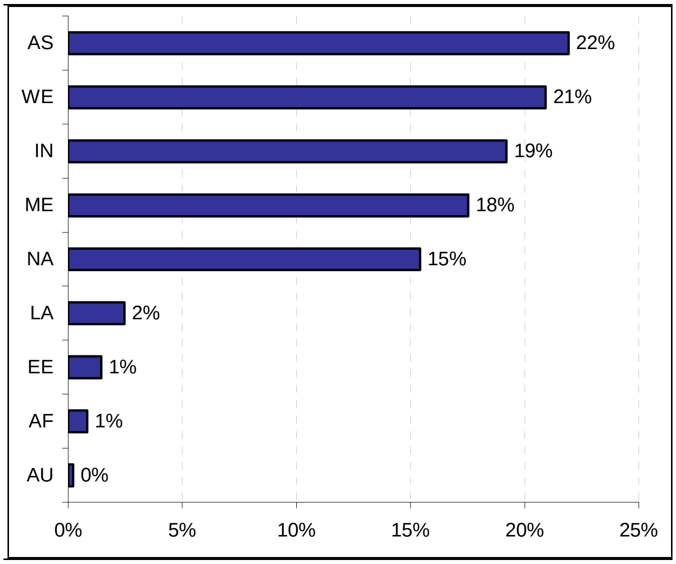


Source. GFMS, WGC, Morgan Stanley Research

The US accounts for over 30% of global jewellery consumption. In Europe, the UK and Italy account for over an 8% combined share of the world market. India and China are emerging centres of jewellery consumption and each accounts for more than an 8% market share.

India is the largest consumer of gold in tonnage terms, but still accounts for a relatively low share of global jewellery consumption. This is partly because most gold demand in India is for investment and the pricing of jewellery is still on a weight-plus-fabrication-cost basis. Therefore, it is difficult to charge a high premium above the price of gold. However, with higher per capita income, we believe the consumption of jewellery in India will increase. KPMG estimates jewellery consumption in both India and China will be the same as in the US by 2015.

Exhibit 34
Gold Jewellery Consumption Highest in Asia



Note: values for year 2006. WE – Western Europe, AS- Asia, IN-Indian subcontinent, ME-Middle east, NA-North America, LA-Latin America, EE- Eastern Europe, AF-Africa, AU-Australia.
Source: Virtual Metals, Morgan Stanley Research

Consumer Tastes in Terms of Gold Purity

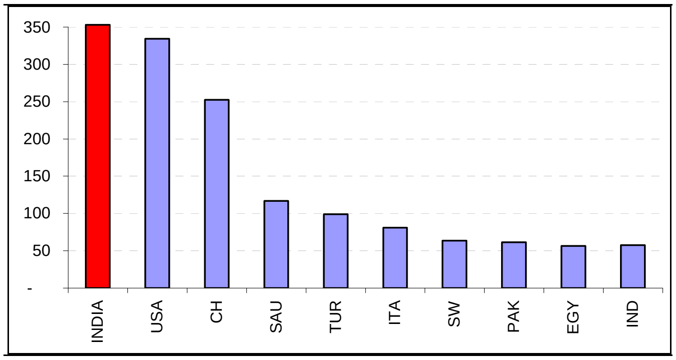
Gold jewellery can be segmented according to the amount of gold in the alloy from which the jewellery is made. Pure gold is very ductile and malleable. Jewellery cannot be made from pure gold, as it is not suitable. Therefore, gold is mixed with other metals to make an alloy with suitable strength and ductility to be made into fine jewellery. Consumer taste in terms of gold purity differs across countries.

Exhibit 35
Typical Gold Purity in Jewellery

Region	Purity (carat)	Gold %
Indian Subcontinent	22	91.7%
China and Hong Kong	22 - 24	99.0%
U.S.A.	8 - 10	33.3%
Northern Europe	18	75.0%
Middle East	21	87.5%
Southern Europe	18	75.0%

Source: Company data, Morgan Stanley Research

Exhibit 36
Gold Jewellery Consuming Countries

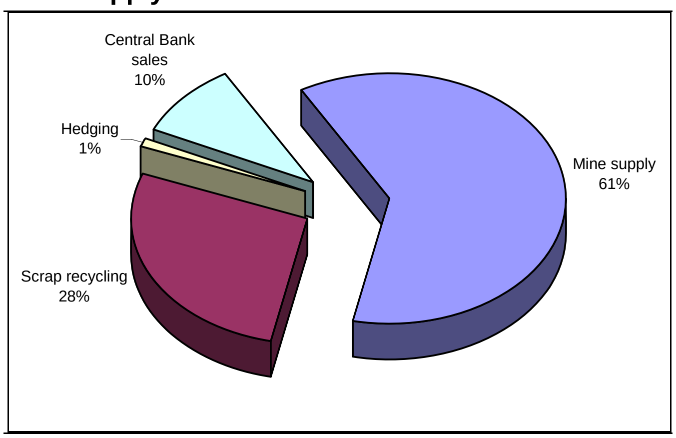


Excluding recycled gold, values in tonnage terms for 2006
Source: Virtual Metals, Morgan Stanley Research

World Supply of Gold and Diamonds

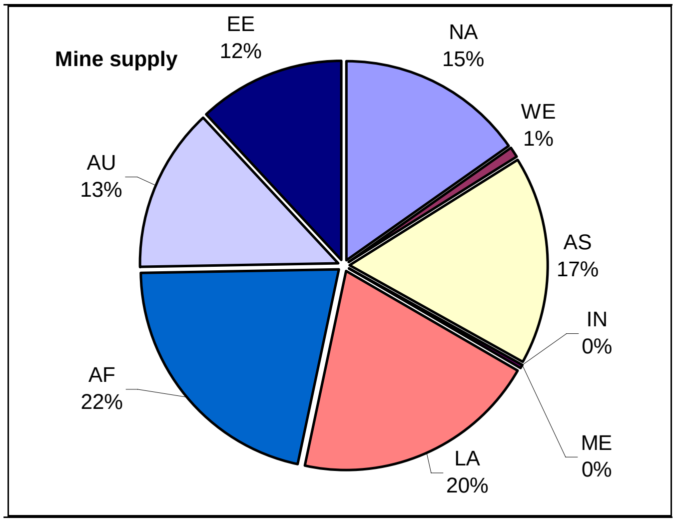
The supply of gold comes from mine supply, scrap recycling, and World Bank sales. Most of the gold mined so far is still available in some form because of the non-destructive nature of gold and its high value. In 2006, 61% of gold supply came from mines and almost 28% came from scrap recycling. India imports most of the gold it requires.

Exhibit 37
Gold Supply Breakdown



Source: Virtual Metals, Morgan Stanley Research

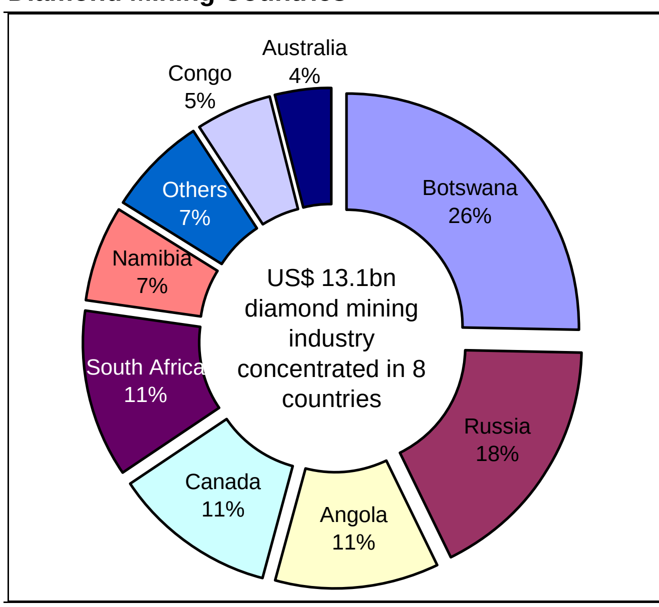
Exhibit 38
Gold Supply from Mines



WE – Western Europe, AS- Asia, IN-Indian subcontinent, ME-Middle east, NA-North America, LA-Latin America, EE- Eastern Europe, AF-Africa, AU-Australia.
Source: Virtual Metals, Yellow Book, Morgan Stanley Research

Seven key mining countries produce 88% of the world's diamonds. Between 2002 and 2005, the global production of rough diamonds rough rose 31% in volume terms and over 70% in value terms.

Exhibit 39
Diamond Mining Countries



Source: DeBeers, Morgan Stanley Research

Rough diamonds are distributed through a central distribution system and then cut and polished.

Diamond Cutting and Polishing

This takes place in 30 countries, but is concentrated in five locations: Antwerp, Johannesburg, Mumbai, New York, and Tel Aviv. India processes 55% of the world's diamonds by value. China and Thailand are increasingly active centres for diamond cutting and polishing.

Diamond cutting is a great skill. The natural form of a diamond will determine the shape of the final polished diamond. A standard round brilliant cut, with 57 or 58 polished facets, is based on the original shape of an octahedral crystal.

Gem quality diamonds are usually distributed to one of the main diamond cutting and trading centres. Experts, known as *diamantaires*, cut and polish the rough diamonds into shapes, such as the round brilliant, the oval, the pear, the heart, and the emerald.

Polishing follows cutting, before the diamonds are again classified by their cut, colour, clarity and carat weight – also known as the 'Four Cs'. These diamonds are typically sold to diamond wholesalers or diamond jewellery manufacturers in one of the 24 registered diamond exchanges across the world.

Indian Market

The gems and jewellery industry has an important position in the Indian economy. Gold jewellery accounts for around 80% of the Indian jewellery market, with the balance comprising fabricated studded jewellery, which includes diamond-studded and gemstone-studded jewellery. The majority of gold jewellery manufactured in India is consumed domestically. However, the majority of rough, uncut diamonds processed in India are exported, either as polished diamonds or in finished diamond jewellery.

Besides being the world's largest consumer of gold, India is also the leading diamond-cutting nation. The Indian gems and jewellery industry is competitive because of its low cost of production and availability of skilled labour. Also, the industry has a worldwide distribution network. Indian companies have set up more than 3,000 offices worldwide to promote and market Indian diamonds. The large overseas Indian populations facilitate the exports of jewellery from India.

India has the world's largest diamond cutting and polishing industry, employing around 800,000 people (constituting 94% of global diamond industry workers) with more than 500 hi-tech laser machines. The industry is well supported by government policies and the banking sector – around 50 banks provide nearly US$3 bn credit to India's diamond industry. Ten out of every 11 diamonds in the world are cut and polished in India. India is therefore a significant part of the world gems and jewellery market, both as a source of processed diamonds and a large consumer market.

Background

India is the world's largest consumer of gold. In 2006, India consumed almost 850 tonnes of gold, excluding recycled gold. Indians have traditionally used gold as a form of saving. Historically, an average India citizen only had two forms of asset: land and gold. The banking system in India was not always reliable so people used to keep their wealth as gold.

Gold has a very strong position in Indian culture and is a part of the social fabric. Gold is used extensively in weddings and festivals. Even today, family status can be gauged by the gold being worn by a bride. It is considered auspicious to buy gold during certain festivals, such as *Dhanteres* (*Diwali*) and *Akshaytritiya*. Estimates vary, but we believe there is at least 13,000 tonnes of gold in India. Gold mining is negligible in India, so most gold is imported.

Changes from 1947

Before India's independence, gold could be freely moved out of the country. In 1947, the import and export of gold was banned in India. In 1962, the Gold Control Act came in to existence. The government banned the holding of more than 100 grammes of gold per person. This changed the whole dynamics of the business in India. Domestic gold production was non-existent, so people relied on gold smuggling. This became a very professional business and gold was usually associated with smuggling.

Deregulation in India

In 1991, the government abolished the Gold Control Act. Two years later, the government permitted non-resident Indians to bring 5kg of gold into the country twice, on payment of a subsidised import duty. The allowance was raised to 10kg per trip in January 1997. Also in 1997, the government allowed five banks and entities to import gold. Over the years, these banks and non-resident Indians visiting India have acted as consignees for overseas suppliers and sold gold to domestic wholesale traders and fabricators, boosting supply.

The deregulation has brought about a dramatic change. Taking advantage of the new regulatory regime, and the growing appetite for gold products, many banks/mutual funds are now devising schemes for issuing gold-backed paper. For example, the State Bank of India takes local gold deposits and issues interest-bearing gold term deposits in return.

Why India Has So Much Gold

There is around 13-15,000 tonnes of gold in India. A combination of factors is responsible for this. Some are cultural and others are business related. In India, farmers have long viewed gold as a very good way of storing wealth. The inheritance laws, through which the wealth of a dead person was vested to the government, helped increase gold accumulation, as it was easier to transfer gold to heirs. For centuries, the gifting of gold to the bride by her parents was common, since women did not inherit family wealth. Gold was easy to mortgage and was a relatively liquid instrument to use to obtain cash. These factors are still at play in India, but with the difference that people now buy designer jewellery instead of gold.

Market Characteristics in India

There are about 450,000 gold artisans spread throughout the country. India was one of the first countries to start making fine jewellery from minerals and metals and, even today, India makes some of the finest jewellery in the world; most of the jewellery made in India is handmade. There are more than 500,000 jewellery stores in India.

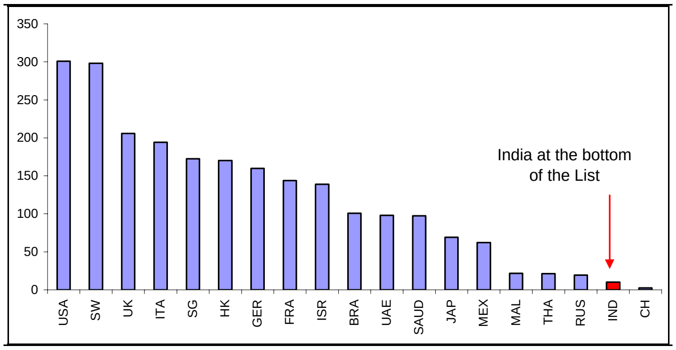
There are more than 6,000 companies in the domestic diamond processing industry. The low gestation period, coupled with low capital cost, allows easy entry into the sector. This has led to the large number of small-scale firms. However, just as in the jewellery industry, the share of the organised sector has increased significantly in recent years because of an increase in demand for better and finer quality finished goods. Also, certain companies have good access to raw diamonds by having sightholder status from the Diamond Trading Corporation, which helps them lower sourcing costs.

In the market for jewellery, consumer protection is still not assured, although this issue has received much policy attention in the past few years. It is customary even now for affluent Indians to buy jewellery items abroad for better quality assurance. Claiming a higher purity of gold is used in jewellery than is actually the case is widespread in India. In April 2000, the government introduced voluntary hallmarking of gold jewellery through the Bureau of Indian Standards. However, the progress in this regard has been slow so far, with very few jewellers having accepted the necessary certification, and most having only partial stocks of their jewellery hallmarked. Also, there are very few assaying and hallmarking centres in the country. From January 2008, hallmarking in India will be compulsory. However, there is a strong opposition from retailers to this, citing the lack of infrastructure as a major reason.

The per capita spend on luxury items in India is low, as it is a developing country in which a high percentage of the population lives below the poverty line. However, there are two classes of consumers that actually have an effect on the total per capita spend in India. There is a growing middle class and there has been a significant increase in India's rich population. We believe these classes will increase the per capita spend on luxury items through higher disposable income. Gold is likely to attract the majority of discretionary spending, in our view. The affinity of Indians with jewellery is evident from the high spend on jewellery as a percentage of total disposable income.

Exhibit 40

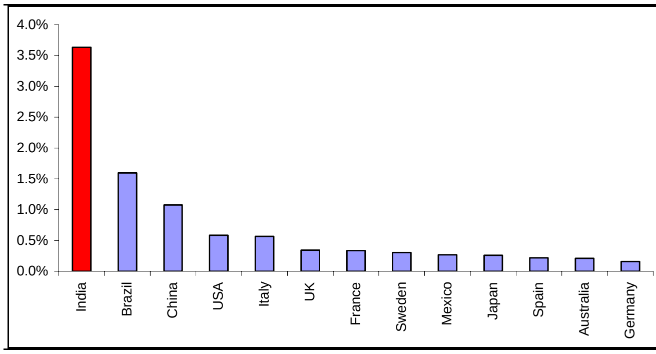
Per Capita Spend on Luxury Items



Source: Euromonitor, Morgan Stanley Research

Exhibit 41

Expenditure on Jewellery out of Disposable Income



Source: Euromonitor, Morgan Stanley Research

Jewellery Retail Formats in India

India has a large and growing domestic jewellery market worth around US$16-18 bn. Jewellery retailing in India is undergoing a transformation from a largely unorganised sector to a more organised one. The family owned jewellery store remains the predominant retail format, but new formats, such as boutiques, supermarkets, and gold souks, are emerging for jewellery retailing. Branded jewellery is a recent phenomenon, wherein products are sold under a brand name either through dedicated showrooms or through the shop-in-shop format in shopping malls.

In the past few years, urban Indian consumers have shown a rising preference for branded and more aesthetic jewellery. Younger customers are looking at jewellery as a fashion statement rather than an investment. There has been significant growth in the gifting market and growth in sales of lower-priced jewellery. We believe there will be a very large increase in the number of branded jewellery stores in urban India in shopping malls and theme malls. Traditional family jewellers will find it increasingly difficult to do business in the face of growing competition from brands, leading to industry consolidation.

Impressive Performance of the Indian Jewellery Industry in 1H07

World Gold Council (WGC) data indicates global gold demand increased to a record figure of US$14.5 bn in 2Q07, up 37% QoQ. This was not due solely to the increase in the value of gold. In tonnage terms, gold demand increased 19% QoQ and gold demand for jewellery increased by 29%.

This impressive growth in the global gold industry is driven by the large demand from India, which consumed more than half of the world's goldmine output in 2Q07. This is surprising, as 2Q is not usually the strongest quarter for gold demand. There have been similar growth trends in Turkey and China.

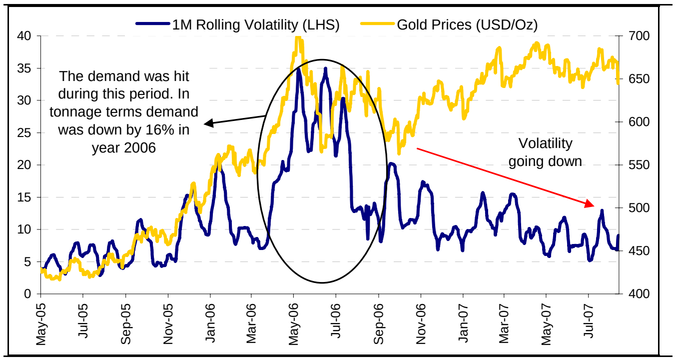
The WGC cites three factors leading to the increase in demand:

- Favourable economic conditions in India and China
- Lower gold price volatility; see Exhibit 42
- Positive effect of ongoing promotions and better quality of the final product

In tonnage terms, demand for gold in India for jewellery increased 89% QoQ in 2Q07 and demand for retail investments increased 99% QoQ. Overall demand for gold in India increased to 317 tonnes, from 166 tonnes in 1Q07. Jewellery accounted for 240 tonnes and net retail investments accounted for 77 tonnes. Gold demand in the Middle East, comprising for this purpose Saudi Arabia, Egypt, UAE, and other Gulf nations, was 97.5 tonnes. For 1H07, consumer demand for gold was up 72% YoY and 10% over 1H05. We expect strong 2Q demand in years ahead because of better promotion of a festival in India, *Akshaythritiya*. It is considered auspicious to buy gold during this festival, particularly in southern India.

Exhibit 42

Gold Prices and Volatility



Source: Bloomberg, Morgan Stanley Research

Gold prices have declined from recent peaks and consensus opinion is for gold prices to stabilise at current levels. This has helped boost investment demand. WGC data shows most demand for gold for jewellery in 2Q07 was not for recycled gold, which means stable prices have helped generate new demand.

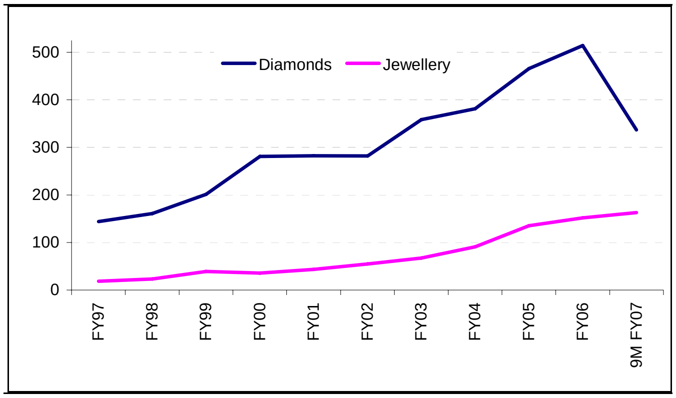
Price volatility, which was particularly pronounced in the first eight months of 2006, had the most severe effect on tonnage demand in India and the Middle East. This is because much of the jewellery in these regions is sold by weight at a price which varies according to movements in the market price of gold, and with only a small mark-up. This makes any change in the market price of gold visible very quickly at the retail level. We believe the overall demand for gold in India, even at high prices, was not affected during this period of volatility, as there was an increase in demand for gold for investment purposes.

We expect demand for gold to remain strong because of the combination of favourable factors in India, such as a booming economy, high disposable income, lower gold price volatility, the underlying traditional affinity with gold, and demand related to festivals.

India's Trade in Jewellery

India consumes most of the gold it imports and exports most of the polished diamonds it processes. However, lately, India's exports of diamonds have been on a clear downtrend, while the country's exports of gold jewellery have risen.

Exhibit 43
Clear Downtrend in Diamonds Exports; Steady Growth in Jewellery Exports



Source: Department of Commerce, India. Morgan Stanley Research (Rs bn)

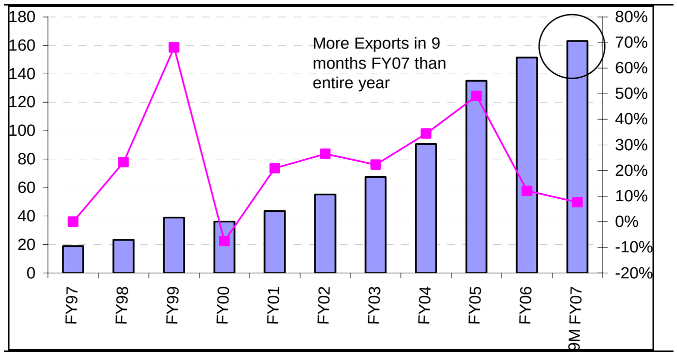
Indian gold jewellery has slowly gained global acceptance mainly because of a better understanding of global customers, a combination of traditional craftwork and increased mechanisation, and more aesthetic designs. This is why jewellery exports have slowly picked up. Price volatility hampered jewellery export growth in 2006. However, this growth has picked up once again in 2007.

Exhibit 44
Growth in Diamond and Jewellery Exports

Source: Department of Commerce, India. Morgan Stanley Research

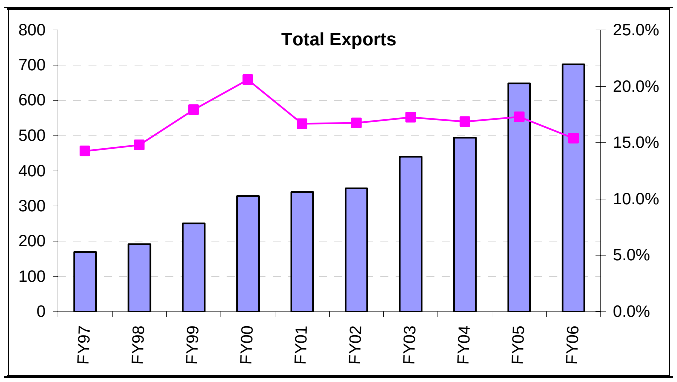
India's jewellery exports for the first nine months of F2007 exceeded the total for the whole of F2006.

Exhibit 45
Jewellery Exports Increasing Rapidly



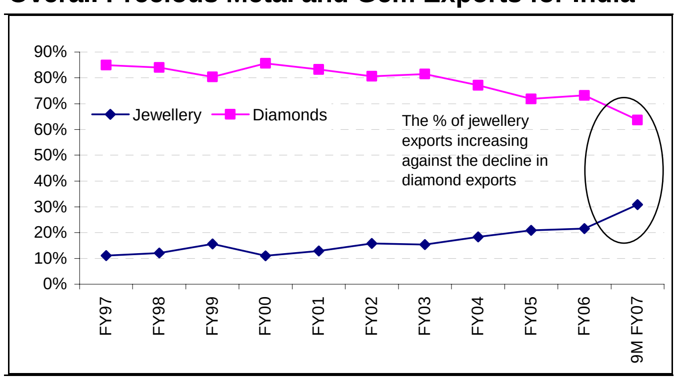
Note: Figures in Rs bn
Source: Department of Commerce, India. Morgan Stanley Research

Exhibit 46
Steady Growth in Exports of Diamonds and Precious Metals, Raw and Fabricated



Note: Figures in Rs bn
Source: Department of Commerce, India. Morgan Stanley Research

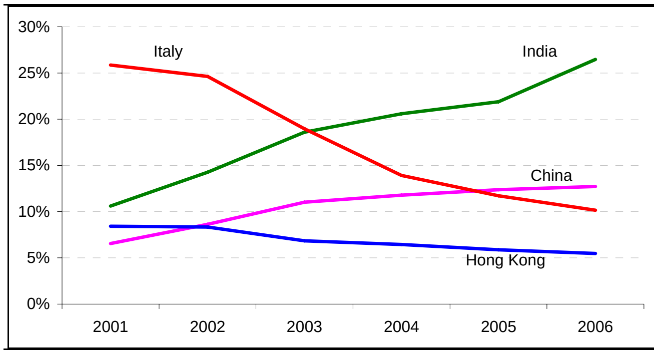
Exhibit 47
Proportion of Diamond and Jewellery Exports in Overall Precious Metal and Gem Exports for India



Source: Department of Commerce, India. Morgan Stanley Research

US imports of jewellery from India have increased, at the expense of imports from Italy. The US imports the majority of its jewellery requirements. We believe the US's share of jewellery fabrication will decline and most of the work will be outsourced to India and China. India has a long history of producing quality jewellery at cheaper rates, so we expect most of the work to flow there. Exhibit 48 illustrates this trend.

Exhibit 48
US Imports of Jewellery by Source Region



Source: US Department of commerce, Morgan Stanley Research

India's Demographics and Income

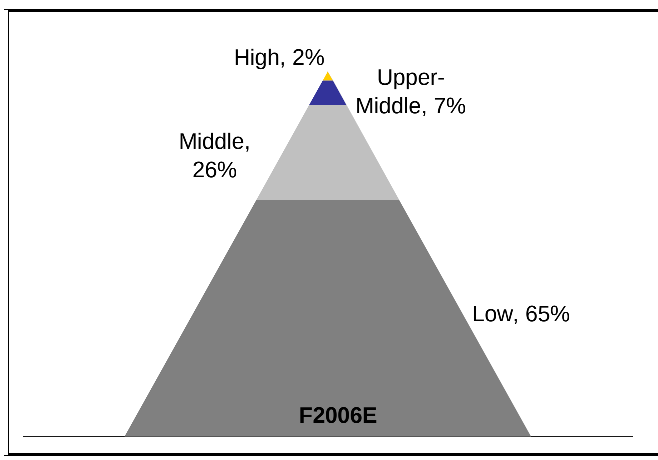
India's economy has grown strongly since liberalisation in 1990. As a result, individuals' spending power has increased. Per capita disposable income has doubled during the past decade. If India continues on its growth path, consumption could triple in the next two decades, making the country the world's fifth-largest consumer market. We believe a new middle class, with relatively high spending power and different spending patterns, has emerged, and will drive the future of the country's jewellery industry. More women are working, increasing household incomes and influencing spending decisions. Also, around 10m marriages take place in India each year, inducing more spending on jewellery. We expect this number to edge higher because of favourable demographics.

Rise of India's Middle Class

Data from the National Council of Applied and Economic Research (NCAER) indicates India's income earning population will expand 8.6% from F2006 to F2010. The data suggests the proportion in the middle class will increase from the current 26% to 34% in F2010 as the total income earning population expands and the proportion in the lower earnings bracket increases. We believe this structure will change further in 2015, with a reduction in the lower income category and a substantial increase in the middle and upper-middle income categories.

Exhibit 49

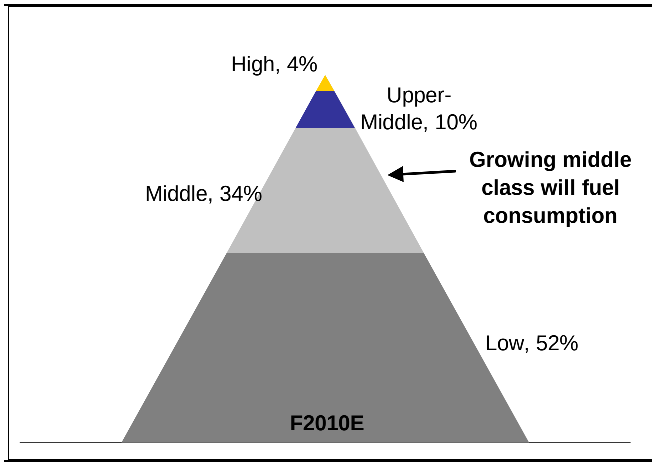
Income Distribution 2006…



Source: NCAER, Morgan Stanley Research

Exhibit 50

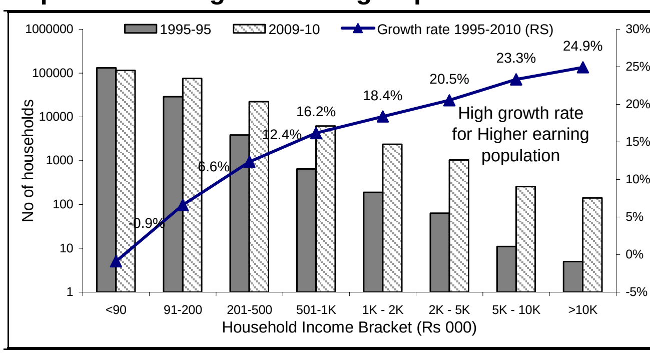
…Income Distribution in 2010e



Source: NCAER, Morgan Stanley Research

Exhibit 51

Expansion of Higher-earning Population Tranche



Note: The Y axis on the right-hand side is an exponential scale.
Source: NCAER, Morgan Stanley Research

More Affluent Households

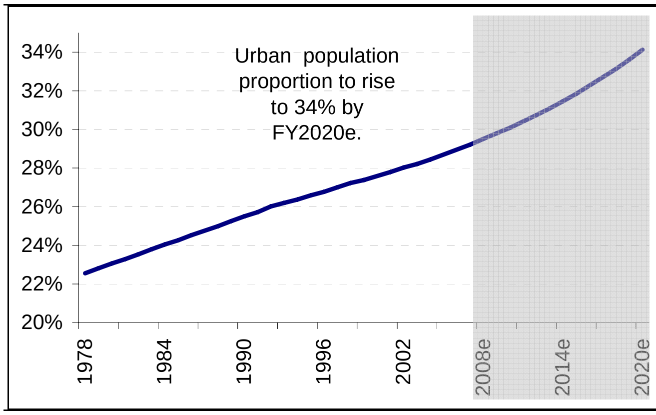
The growth of the number of affluent people in India is accelerating. We believe there will be a much larger proportion of the population with greater spending power in India within the next decade. This bodes well for the jewellery industry.

Increasing Urban Population

We believe the migration of the rural population towards urban centres will increase. We expect the urban population to account for 34% of India's overall population by 2019; this is a positive sign for consumer markets.

Exhibit 52

Growing Urban Population

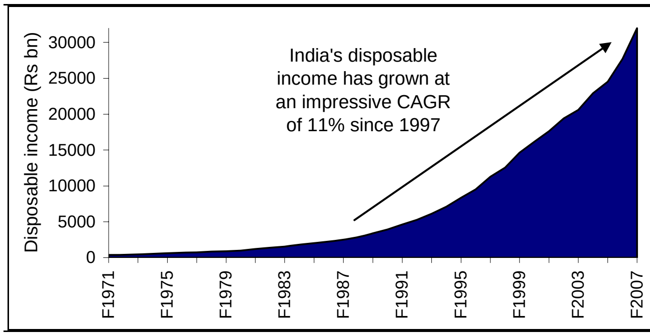


e = Euromonitor estimates
Source: Euromonitor, Morgan Stanley Research

Disposable income in India has risen at a CAGR of 11% since 1997. We believe this offers significant growth potential for the jewellery market, particularly if the trend continues. Also, we expect India's population of young bachelors to increase in the next decade, driving wedding-related expenditure on jewellery.

Exhibit 53

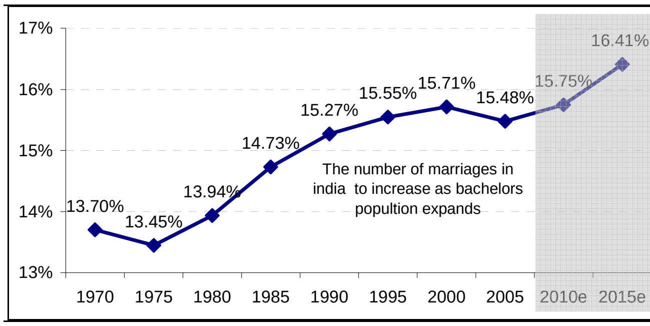
Disposable Income in India



Source: CEIC, NCAER, Morgan Stanley Research

Exhibit 54

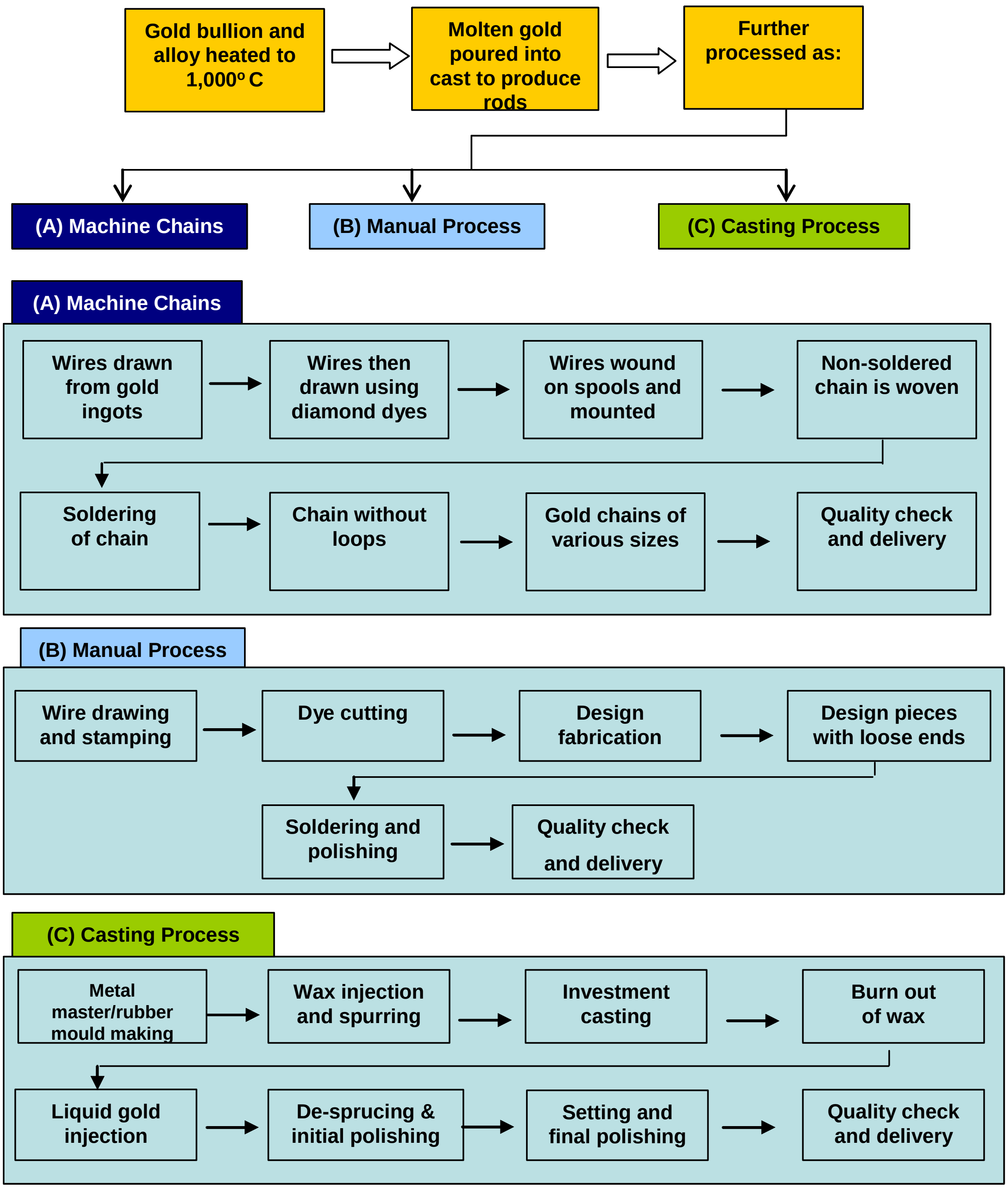
Young Bachelors (Aged 20-30) as a Percentage of the Overall Population



e = United Nations Estimates
Source: CEIC data, Morgan Stanley Research

Exhibit 55

Manufacturing Process



Source. Company Data, Morgan Stanley Research

MORGAN STANLEY ModelWare	**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of August 31, 2007)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**934**	**41%**	**321**	**43%**	**34%**
Equal-weight/Hold	**1015**	**44%**	**328**	**44%**	**32%**
Underweight/Sell	**333**	**15%**	**92**	**12%**	**28%**
Total	**2,282**		**741**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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Industry Coverage:India Consumer

Company (Ticker)	Rating (as of)	Price (09/18/2007)
Mangesh Bhadang		
Rajesh Exports Ltd (REXP.BO)	O (09/19/2007)	Rs779.05
Hozefa Topiwalla		
Colgate-Palmolive India (COLG.BO)	O (01/10/2005)	Rs393
Dabur India (DABU.BO)	O (10/18/2006)	Rs107.75
Godrej Consumer Products Limited (GOCP.BO)	O (07/24/2006)	Rs136.85
Hindustan Unilever (HLL.BO)	E (07/11/2007)	Rs214.3
ITC Ltd. (ITC.BO)	E (03/12/2007)	Rs180.15
Marico Limited (MRCO.BO)	O (07/06/2007)	Rs58.45
Nestle India (NEST.BO)	O (05/02/2002)	Rs1,315.8
Tata Tea (TTTE.BO)	E (09/04/2006)	Rs794.3

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