HINDUSTAN PETROLEUM CORPN.

INR 265

Edelweiss
Ideas create, values protect

Under recoveries take their toll

REDUCE

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Niraj Mansingka
+91-22-2286 4304
niraj.mansingka@edelcap.com

Hindustan Petroleum Corporation's (HPCL) Q3FY08 loss at INR 157 mn, on the back of accounting for receipt of oil bonds worth INR 19.0 bn for the quarter, was higher than our expectation.

Refining throughput was normal at 4.3 mmt. Blended refining margins, at USD 6.25/bbl, were higher due to higher regional refining margins and inventory gains due to increase in crude prices. Marketing gross under recoveries for Q3FY08 were at INR 45.2 bn. The government of India's (GoI) and upstream firms' share of under recoveries at 42.5% and 33.2% respectively, (for nine-month) were in line with our yearly estimates.

We have incorporated the annual numbers and have increased our crude price and refining margin assumptions, while maintaining GoI's and upstream firms' share of under recoveries at 42.7% and 33.3%, respectively. We are increasing our net revenue estimate by 6.8% and 12.9% for FY08 and FY09, respectively (mainly due to crude price increase). Our net profit estimates for FY08 and FY09 have been revised down by 3.6% and 51.2%, respectively, after factoring in inability of OMCs to pass on impact of higher crude prices to consumers.

The current environment makes it tough for the government to pass on increased crude prices to consumers. The forecasted election schedule is packed as there are elections in 14 states till the run up to central elections; these states constitute 32.8% seats in the Lok Sabha (see table 4). Moreover, with the OIL India initial public offer in sight, the chances of government increasing the share of upstream firms seems to be low. These factors increase the chances of the government choosing OMCs to bear higher share of under recoveries, which will pressurise their earnings.

On the other hand, OMCs are trading at extremely attractive asset valuations of 0.9x our FY08E/FY09E/FY10E book values. However, we believe that till we have clarity on the under recovery sharing mechanism, earnings growth for HPCL may be negative and it will henceforth trade at high earnings-based valuations. Investors are advised to book profits on every rise.

At CMP of INR 265, HPCL is trading at 20.4x and 19.6x our FY08 and FY09 EPS estimates, respectively. We are downgrading our recommendation from 'ACCUMULATE' to 'REDUCE'.

Reuters	:	HPCL.BO
Bloomberg	:	HPCL IN

Market Data

52-week range (INR)	:	405 / 218
Share in issue (mn)	:	338.6
M cap (INR bn/USD mn)	:	89.7 / 2,276.2
Avg. Daily Vol. BSE/NSE ('000)	:	1,268.6

Share Holding Pattern (%)

Promoters	:	51.1
MFs, FIs & Banks	:	24.8
FIIs	:	12.8
Others	:	11.3

Financials

Year to March	Q3FY08	Q3FY07	*Growth %*	Q2FY08	*Growth %*	FY07	FY08E
Net rev. (INR mn)	271,170	221,502	*22.4*	242,344	*11.9*	890,413	1,012,326
EBITDA (INR mn)	1,481	1,940	*(23.7)*	13,176	*(88.8)*	24,237	10,309
Net profit (INR mn)	(157)	4,073	*(103.9)*	8,530	*(101.8)*	15,792	4,417
EPS (INR)	(0.5)	12.0	*(103.9)*	25.2	*(101.8)*	46.6	13.0
P/E (x)						5.7	20.4
EV/EBITDA (x)						7.4	21.7

Edelweiss Research is also available on Bloomberg EDEL <GO>, Thomson First Call, Reuters and Factset.

✻ Refining throughput higher by 1% Q-o-Q; GRMs higher at USD 6.35/bbl

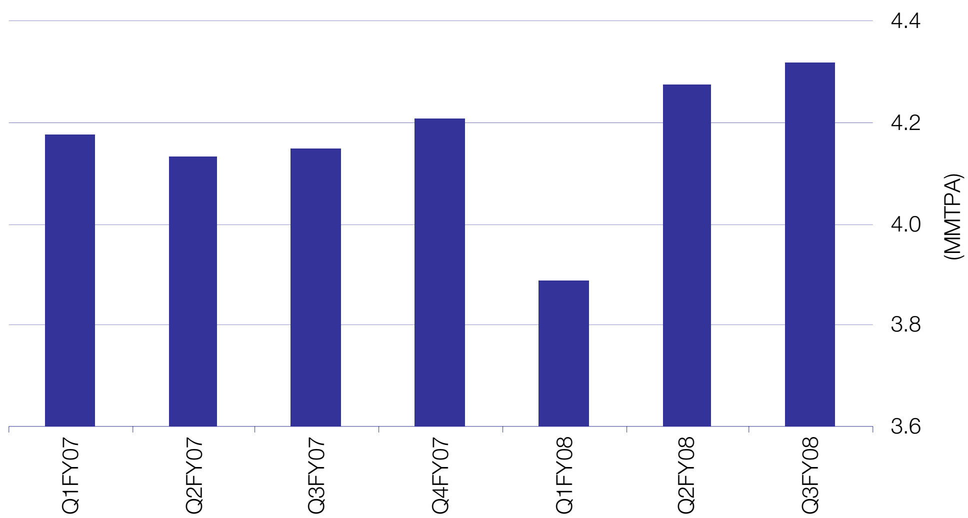
Refinery throughput increased 1.0% Q-o-Q and 4.1% Y-o-Y to 4.3 mmt due to absence of any planned/unplanned shutdown (see chart 1). HPCL's Q3FY08 blended refining margins at USD 6.35/bbl increased 51% Q-o-Q and 157% Y-o-Y (see table 1). Refining margins increased due to: (a) Higher regional refining margins, which increased 107% Y-o-Y and 40% Q-o-Q.

(b) Higher increase in crude prices by 51.3% Y-o-Y. Higher crude prices imply higher protection to refining margins.

(c) Inventory gains, which added ~USD 1.5/bbl to refining margins.

Increase in refining margins were partially offset by 12.2% Y-o-Y appreciation of the rupee and higher outgo towards octroi (increase by ~USD 0.16/bbl).

Chart 1: Refining throughput has remained stable



Source: Company, Edelweiss research

Table 1: Break-up of HPCL's refining margins

	Q1FY07	Q2FY07	Q3FY07	Q4FY07	Q1FY08	Q2FY08	Q3FY08
Average estimated GRMs of two refineries (USD/bbl)	7.6	2.1	2.5	4.2	8.3	4.2	6.4
Estimated inventory gains (USD/bbl)	1.6	(1.5)	(0.3)	(0.4)	0.6	2.0	1.5
Estimated discounts to marketers (USD/bbl)	0.7	0.7	(1.4)	0.0	-	0.0	0.0
Estimated core GRMs (USD/bbl)	**6.7**	**4.3**	**1.3**	**4.7**	**7.8**	**2.2**	**4.8**

Source: Company, Edelweiss research

✻ GoI bonds and upstream firms shared 75.6% of nine-month under recoveries

HPCL booked oil bonds of INR 19.0 bn from GoI in the quarter and upstream discount receipts of INR 14.8 bn. This resulted in the company reporting net under recovery of INR 11.4 bn. Nine-month upstream firms' and GoI oil bonds' share of under-recovery were at 33.2% and 42.5%, respectively (see table 2). This is in line with our estimates.

Domestic marketing sales at 5.72 mmt were higher 14% Y-o-Y and 15% sequentially. Most of the increase was due to increased sales of auto fuels (MS/HSD); exports increased 17% Q-o-Q and Y-o-Y.

Table 2: Marketing—GoI and upstream firms shared 42.5% and 33.2% of nine-month gross under recoveries

	Q1FY07	Q2FY07	Q3FY07	Q4FY07	Q1FY08	Q2FY08	Q3FY08
Reported gross under-recoveries (INR bn)	34.9	32.8	16.6	16.1	27.1	27.9	45.2
Discounts from the upstream companies (INR bn)	12.4	12.3	5.5	11.4	9.0	9.4	14.8
Estimated discounts from the refiners (INR bn)	3.2	1.3	(2.3)	0.0	0.0	0.0	0.0
GOI Bonds (INR bn)	0.0	29.1	10.3	10.0	0.0	23.6	19.0
Net under-recovery (INR bn)	**19.3**	**-9.8**	**3.0**	**-5.3**	**18.0**	**-5.0**	**11.4**
Upstream share (% YTD)	35.4	36.4	35.8	41.4	33.3	33.4	33.2
Refiners share (% YTD)	9.2	6.7	2.7	2.2	0.0	0.0	0.0
GOI bonds share (% YTD)	0.0	42.9	46.7	49.2	0.0	42.9	42.5
Share of HPCL (% YTD)	55.4	14.0	14.8	7.2	66.7	23.7	24.4

Source: Company, Edelweiss research

Adjusting earnings to increased crude price assumptions; introducing FY10E EPS at INR 25.9

We are revising our crude price assumptions upwards (refer note *Increasing long-term crude prices by 17%*, dated *January 9, 2008*) to USD 80/bbl in FY08E (from USD 70/bbl) and USD 85/bbl in FY09E (from USD 65/bbl) due to higher prevailing crude prices and long term crude price assumption to USD 70/bbl (from USD 60/bbl).

Pursuant to these macro changes and increase in refining margin estimates, we have increased our net revenue estimate by 6.8% and 12.9% for FY08 and FY09, respectively (mainly due to crude price increase). Our net profit estimates for FY08 and FY09 have been revised down by 3.6% and 51.2%, respectively, after factoring in inability of OMCs to pass on impact of higher crude prices to consumers. The reduction in FY09E and FY10E marketing margins were marginally offset by our assumption of lower under-recoveries for petrol and diesel by INR 1.0/lt and INR 0.5/lt, respectively.

Table 3: Revision in assumptions and estimates

	Revised estimates		Previous estimates		(% change)		Comments
	FY08	FY09	FY08	FY09	FY08	FY09	
Assumptions							
WTI (USD/bbl)	80.0	85.0	70.0	65.0	14.3	30.8	Increase in crude prices due to higher current prices and increased OPEC discipline
Indian Simple GRMs (USD/bbl)	5.3	5.3	5.3	5.0	-	5.0	Increase in GRMs due to delays in the new refining capacities
Estimates							
Revenues (INR bn)	1,012	1,025	947.6	907.5	6.8	12.9	Due to crude price increase negated to some extent by rupee appreciation and capped retail realisations
EBITDA (INR bn)	10.3	10.0	10.6	18.6	(2.4)	(46.3)	Impact of higher crude prices and maintained GoI and upstream share t 42.7% and 33.33%, respectively
Net profit (INR bn)	4.4	4.6	4.6	9.4	(3.6)	(51.2)	

Source: Edelweiss research

✻ Outlook and valuations: Long term upside; downgrade to 'REDUCE'

The current environment makes it tough for the government to pass on the increased crude prices to consumers. The forecasted election schedule is packed as there are elections in 14 states till the run up to central elections and these states constitute 32.8% seats in the Lok Sabha (see table 4). Moreover, with the OIL India initial public offer in sight, the chances of government increasing the share of upstream firms seems to be low. These factors increase the chances of the government choosing OMCs to bear higher share of under recoveries, which will pressurise their earnings.

Table 4: Election schedule in India

State	Lok Sabha seats (#)	% Seats (%)	Last election date	Expected next election date
Tripura	2	0.4%	1-Jan-03	23-Feb-08
Nagaland	1	0.2%	1-Jan-03	5-Mar-08
Meghalaya	2	0.4%	1-Jan-03	7-Mar-08
J&K	6	1.1%	16-Sep-02	2008
Mizoram	1	0.2%	20-Nov-03	19-Nov-08
Chattisgarh	11	2.0%	4-Dec-03	2-Dec-08
Delhi	7	1.3%	4-Dec-03	2-Dec-08
Rajasthan	25	4.6%	4-Dec-03	2-Dec-08
Madhya Pradesh	29	5.3%	4-Dec-03	3-Dec-08
Andhra Pradesh	42	7.7%	13-May-04	12-May-09
Arunachal Pradesh	2	0.4%	13-May-04	12-May-09
Karnataka	28	5.2%	13-May-04	12-May-09
Orissa	21	3.9%	13-May-04	12-May-09
Sikkim	1	0.2%	13-May-04	12-May-09
TOTAL SEATS	178	32.8%		

Source: Edelweiss research, Elections commission

On the other hand, OMCs trade at extremely attractive asset valuations of 0.9x our FY08E/FY09E/FY10E book values. However, we believe till we have clarity on the under-recovery sharing mechanism, earnings growth for HPCL may be negative and will henceforth trade at high earnings-based valuations. Investors are advised to book profits on every rise. At CMP of INR 265, HPCL is trading at 20.4x and 19.6x our FY08 and FY09 EPS estimates respectively. We are downgrading our recommendation from 'ACCUMULATE' to 'REDUCE'.

Financials snapshot								(INR mn)
Year to March	Q3FY08	Q3FY07	*Growth %*	Q2FY08	*Growth %*	FY07	FY08E	FY09E
Net revenues	271,170	221,502	*22.4*	242,344	*11.9*	890,413	1,012,326	1,024,593
Raw material costs	257,661	211,646	*21.7*	214,820	*19.9*	824,235	959,834	971,764
Gross profit	13,509	9,856	*37.1*	27,525	*(50.9)*	66,178	52,492	52,829
Other expenses	9,854	5,987	*64.6*	12,282	*(19.8)*	34,647	34,305	34,322
Employee expenses	2,174	1,930	*12.6*	2,067	*5.2*	7,294	7,878	8,508
Operating expenses	12,028	7,917	*51.9*	14,349	*(16.2)*	41,941	42,183	42,830
EBITDA	1,481	1,940	*(23.7)*	13,176	*(88.8)*	24,237	10,309	9,998
Interest	2,184	1,046	*108.8*	1,399	*56.1*	4,230	6,258	7,012
Depreciation	2,161	1,733	*24.7*	2,017	*7.1*	7,040	9,173	11,110
Other income	2,645	2,466	*7.2*	2,808	*(5.8)*	6,845	7,017	9,911
Profit before tax	(219)	1,627	*NA*	12,568	*NA*	19,812	1,895	1,787
Current taxes	(1,026)	456	*NA*	2,034	*NA*	6,527	878	525
Deferred taxes	1,942	23	*8,235.6*	1,974	*(1.6)*	365	(234)	83
Excess/short prov for tax/refund	(1,008)	(3,030)	*NA*	0	*NA*			
Fringe benefit tax (FBT)	30	105	*(71.3)*	30	*0.0*	(2,931)	(3,166)	(3,419)
Total tax	(61)	(2,446)	*NA*	4,037	*NA*	3,960	(2,522)	(2,812)
Net profit	(157)	4,073	*NA*	8,530	*NA*	15,792	4,417	4,599
No. of shares (mn)	339	339	*0.0*	339	*0.0*	339	339	339
EPS (INR/share)	(0.5)	12.0	*NA*	25.2	*NA*	46.6	13.0	13.6
P/E (x)						5.7	20.4	19.6
as % of net revenues								
Direct costs	95.0	95.6	*NA*	88.6	*NA*	92.6	94.8	94.8
Gross profit	5.0	4.4	*NA*	11.4	*NA*	7.4	5.2	5.2
Employee expenses	0.8	0.9	*NA*	0.9	*NA*	0.8	0.8	0.8
SG&A	3.6	2.7	*NA*	5.1	*NA*	3.9	3.4	3.3
EBITDA	0.5	0.9	*NA*	5.4	*NA*	2.7	1.0	1.0
Profit before tax	(0.1)	0.7	*NA*	5.2	*NA*	2.2	0.2	0.2
Net profit	(0.1)	1.8	*NA*	3.5	*NA*	1.8	0.4	0.4
Tax rate (as a % of PBT)	28.0	(150.3)	*NA*	32.1	*NA*	20.0	(133.1)	(157.3)

Company Description

HPCL is the third-largest refining company in India. It has a market share of around 16.6% in total sales of petroleum products in India. The company owns and operates two refineries—Mumbai refinery with a capacity 7.9 MMTPA and Vizag refinery with a capacity of 8.3 MMTPA. It has a 16.95% equity stake in MRPL (a subsidiary of ONGC) with an operable capacity of around 11.0 MMTPA. It has a 6,667-strong nation-wide retail outlet network, the third largest in India after IOC and BPCL.

Investment Theme

HPCL is an integrated refining and marketing play with high share in metros giving it an advantage of higher margins, higher growth rate, and lower competition. HPCL's pipelines capacity is set to increase three times by FY08. We estimate the pipeline's EBITDA to increase at a CAGR of 37% in three years .Addition of a new 9-MMTPA Bhatinda refinery in north India by FY10 will remove the marketing skew of the company. With gradual phasing out of the auto-fuel subsidies and continued government support in the form of oil bonds would help reduce the under-recovery of the oil marketing companies.

Key Risks

Increase in crude prices would increase the under recovery for the oil marketing companies.

Any regulatory or policy change in the form of reduction in duty protection, reduction in quantum of Oil Bonds or retail prices cut would impact HPCL's earnings.

Competition from private players in the auto fuel marketing may result in reduction in market share.

Financial Statements

Income statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Adjusted net revenues	710,379	890,413	1,012,326	1,024,593	984,429
Cost of goods sold	663,513	824,235	959,834	971,764	927,996
Gross profit	46,866	66,178	52,492	52,829	56,433
Employee expenses	6,415	7,294	7,878	8,508	9,189
Other expenses	32,309	34,647	34,305	34,322	34,536
Operating expenses	38,724	41,941	42,183	42,830	43,724
EBITDA	8,142	24,237	10,309	9,998	12,708
Depreciation & amortisation	6,890	7,040	9,173	11,110	11,843
EBIT	1,252	17,197	1,136	(1,112)	866
Other income	3,285	6,845	7,017	9,911	13,152
Interest	1,587	4,230	6,258	7,012	6,288
Extraord. items / Prior period exp.	0	(61)	0	0	0
Profit before tax (PBT)	2,949	19,752	1,895	1,787	7,730
Current tax	785	6,527	878	525	2,519
Deferred tax	97	365	(234)	83	109
Other taxes	(2,087)	(2,931)	(3,166)	(3,419)	(3,693)
Tax	(1,205)	3,960	(2,522)	(2,812)	(1,065)
Profit after tax (PAT)	4,154	15,792	4,417	4,599	8,796
Equity shares outstanding (mn)	339.3	339.0	339.3	339.3	339.3
EPS (INR)	12.2	46.6	13.0	13.6	25.9
Dividend per share (INR)	3.0	18.0	1.3	1.2	5.3
Dividend payout (%)	24.5	38.7	9.9	9.0	20.3

Common size metrics (% sales)					(% of Net sales)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Cost of goods sold	93.4	92.6	94.8	94.8	94.3
Operating expenses	5.5	4.7	4.2	4.2	4.4
EBITDA	1.1	2.7	1.0	1.0	1.3
Depreciation & amortisation	1.0	0.8	0.9	1.1	1.2
Interest	0.2	0.5	0.6	0.7	0.6
Net profit	0.6	1.8	0.4	0.4	0.9

Growth metrics (%)					(%)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Net revenues	18.8	25.3	13.7	1.2	(3.9)
EBITDA	(60.3)	197.7	(57.5)	(3.0)	27.1
PBT	(82.0)	569.8	(90.4)	(5.7)	332.6
Net profit	(67.5)	280.1	(72.0)	4.1	91.3
EPS	(67.5)	280.1	(72.0)	4.1	91.3

Balance sheet					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Equity capital	3,389	3,390	3,390	3,390	3,390
Reserves and surplus	83,968	92,597	93,336	94,032	97,046
Shareholder's equity (A)	87,357	95,987	96,725	97,422	100,435
Secured loans	14,862	10,055	3,000	3,000	3,000
Unsecured loans	51,777	95,121	145,694	184,778	200,150
Total debt (B)	66,638	105,175	148,694	187,778	203,150
Net deferred tax liability (C)	13,844	14,209	13,975	14,058	14,166
Capital employed (A+B+C)	167,840	215,371	259,395	299,258	317,752
Accounts payable	73,947	88,918	106,648	107,974	103,111
Provisions	5,602	12,277	15,185	15,369	14,766
Current liabilities & provisions (D)	79,549	101,195	121,833	123,343	117,877
Total liabilities (A+B+C+D)	247,389	316,566	381,228	422,600	435,629
Gross fixed assets	134,793	156,385	210,545	233,855	239,855
Accumulated depreciation	61,419	68,176	77,350	88,460	100,302
Net fixed assets	73,374	88,208	133,195	145,395	139,552
Capital WIP	23,639	42,436	12,776	(2,034)	(2,034)
Total fixed assets (A)	97,013	130,644	145,971	143,361	137,518
Investments (B)	40,276	71,275	108,034	150,521	174,464
Inventories	78,103	80,984	92,039	93,183	88,986
Accounts receivables	13,923	15,778	17,057	17,264	16,587
Cash and cash equivalents	426	868	1,012	1,025	984
Loans and advances	17,535	16,094	16,913	17,042	16,893
Other current assets	114	923	202	205	197
Current assets (C)	110,100	114,647	127,223	128,718	123,647
Total assets (A+B+C+D)	247,389	316,566	381,228	422,600	435,629

Cash flow statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Ope. cash flow before wkg cap. ch.	11,096	23,119	10,190	12,373	17,054
(Incr)/Decr in working capital	(7,005)	17,541	8,206	27	(435)
Cash flow from operations (A)	4,091	40,660	18,396	12,399	16,619
Net purchase of fixed assets	(26,598)	(40,671)	(24,500)	(8,500)	(6,000)
Net purchase of investments	(22,708)	(30,998)	(36,759)	(42,488)	(23,942)
Net cash flow from investing (B)	(49,306)	(71,669)	(61,259)	(50,988)	(29,942)
Net incr./(decr.) in debt	44,785	38,537	43,519	39,083	15,372
Dividends paid	(1,161)	(7,086)	(512)	(483)	(2,090)
Cash flow from financing (C)	43,624	31,452	43,007	38,600	13,283
Net incr./(decr.) in cash (A+B+C)	(1,590)	442	144	12	(40)

Valuation parameters

Year to March	FY06	FY07	FY08E	FY09E	FY10E
EPS (INR)	12.2	46.6	13.0	13.6	25.9
EPS Y-o-Y growth (%)	(67.5)	280.5	(72.1)	4.1	91.3
CEPS (INR)	32.5	67.4	40.0	46.3	60.8
P/E (x)	21.6	5.7	20.4	19.6	10.2
Book value per share (INR)	257.4	283.2	285.0	287.1	296.0
P/BV (x)	1.0	0.9	0.9	0.9	0.9
EV/Sales (x)	0.2	0.2	0.2	0.3	0.3
EV/EBITDA (x)	17.4	7.4	21.7	26.3	21.9
Dividend yield (%)	1.1	6.8	0.5	0.5	2.0

Liquidity ratios

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Current ratio	1.5	1.3	1.2	1.2	1.2
Quick ratio	0.4	0.4	0.3	0.3	0.3
Cash ratio	0.0	0.0	0.0	0.0	0.0
Receivable turnover (x)	58.2	60.0	61.7	59.7	58.2
Inventory turnover (x)	9.8	10.4	11.1	10.5	10.2
Payables turnover (x)	9.8	10.1	9.8	9.1	8.8
Receivables (days)	6	6	6	6	6
Inventory (days)	37	35	33	35	36
Payables (days)	37	36	37	40	42
Cash conversion cycle (days)	6	5	2	1	1

Operating ratios (x)

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Total asset turnover	3.2	3.2	2.9	2.5	2.3
Fixed asset turnover	9.9	11.0	9.1	7.4	6.9
Equity turnover	8.3	9.7	10.5	10.6	10.0

Profitability ratios (%)

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Gross profit margin	6.6	7.4	5.2	5.2	5.7
EBITDA margin	1.1	2.7	1.0	1.0	1.3
ROCE	3.6	9.7	3.6	3.3	4.2
ROE	4.8	17.2	4.6	4.7	8.9
ROA	2.4	6.6	2.4	2.3	3.0

Financial ratios

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Debt-equity (x)	0.7	1.2	1.7	2.1	2.3
Long term debt / Capital emp.(%)	39.7	48.8	57.3	62.7	63.9
Total debt / Capital employed (%)	95.3	102.4	109.7	108.7	105.5
Interest coverage (x)	2.9	5.7	1.3	1.3	2.2

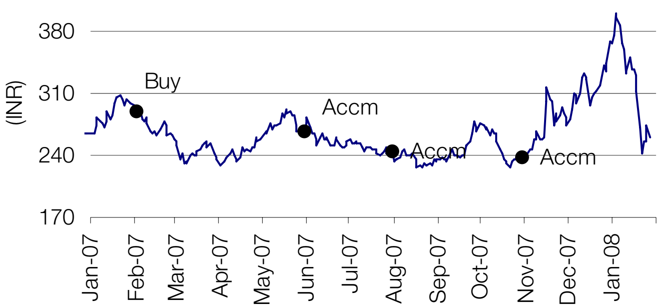
Edelweiss Securities Limited, 14th Floor, Express Towers, Nariman Point, Mumbai – 400 021, Board: (91-22) 2286 4400, Email: research@edelcap.com

Naresh Kothari	Co-Head Institutional Equities	naresh.kothari@edelcap.com	+91 22 2286 4246
Vikas Khemani	Co-Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Shriram Iyer	Head Research	shriram.iyer@edelcap.com	+91 22 2286 4256

Coverage group(s) of stocks by primary analyst(s): Oil & Gas, Petrochemicals

Bharat Petroleum Corporation, Cairn India, Chennai Petroleum Corp., Engineers India, Finolex Industries, Hindustan Petroleum Corporation, Indian Oil Corporation, Indraprastha Gas, ONGC, PSL, Reliance Industries

HPCL



Recent Research

Date	Company	Title	Price (INR)	Recos
23-Jan-08	Finolex Industries	Volumes increase offsets margins decrease; *Result Update*	79	Reduce
23-Jan-08	CPCL	Lower throughput due to *Result Update*	290	Buy
17-Jan-08	Reliance Industries	Gas from MA-1 fields a positive; *Result Update*	2,996	Accum.
9-Jan-08	Oil & Gas	Increasing long-term Crude prices by 17%; *Sector Update*		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	108	44	16	3	188

* 12 stocks under review / 5 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	103	66	19

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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