Q4FY2007 earnings preview

Sensex earnings are expected to be driven by software, cement and banking sectors

Key points

- The Sensex earnings are expected to grow by 37% year on year (yoy) for Q4FY2007. However, excluding oil the earnings are expected to grow by 34% driven by the earnings in the software, cement and banking sectors. These three sectors are expected to contribute 42% of the Q4FY2007 Sensex earnings excluding oil. On a quarter-on-quarter (q-o-q) basis the expected growth is only 1.2%, which indicates expectations of some slowdown in the earnings momentum.
- Strong earnings growth is expected in the pharma sector mainly due to a very low base. On the other hand information technology (IT) earnings will be affected due to the sharp appreciation in the rupee. Auto numbers are not expected to be great due to margin pressure and a slowdown in the volumes.
- Strong year-on-year (y-o-y) earnings growth is expected from Reliance Communications, Bharti Tele, Ranbaxy, Dr Reddy's Laboratories, Grasim and Tata Steel.
- Two-wheeler majors Hero Honda and Bajaj Auto are expected to report a y-o-y decline in the profits.
- Some of the non-Sensex companies where high growth is expected are Dabur Pharma, Syndicate Bank, Polaris and India Cements.
- In the absence of any major surprises, the fourth quarter results of the Indian companies may not be a trigger for the market, but the market will keenly await the guidance on the FY2008 prospects of the corporate sectors, especially automobiles, banks and the other interest rate sensitive sectors.

Expected and implied growth for fourth quarter

We have also prepared a list of the Sensex companies for which we have the expected and implied y-o-y growth rates. The implied growth rate is arrived at after deducting the nine-month actual results from the consensus annual earnings estimates. If the expected earnings estimates are higher than the implied growth rates then it signals that the market is expecting higher earnings and hence a possibility of an earnings upgrade increases and the converse is true when the implied growth rate is higher than the expected growth rate.

The table below suggests that some earnings upgrade possibilities are there for Hindalco, Bharti and Reliance Communications, while the downgrades are likely for most IT companies, Hero Honda and ICICI Bank.

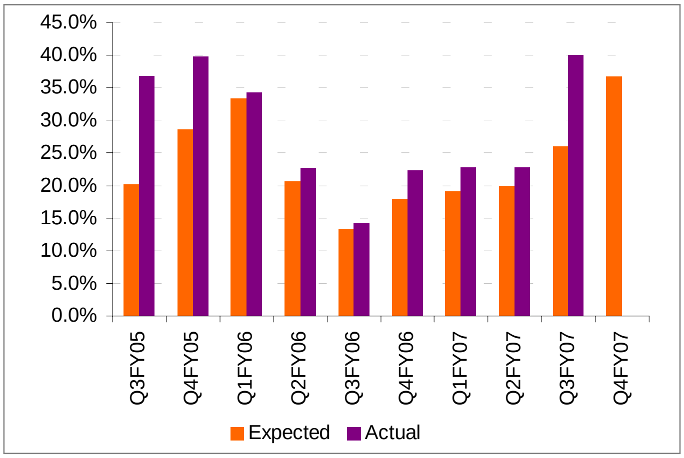
Expected and implied growth for few Sensex stocks

Company	Q4 FY07E	Q4 FY06A	% yoy Expected	% yoy Implied
Bharti Tele	1,290.0	682.4	89.0	85.0
Cipla	201.1	171.1	17.5	10.0
HDFC Bank	336.0	263.2	27.7	26.0
Hero Honda	202.4	267.2	-24.3	-19.0
Hindalco	650.7	626.3	3.9	-2.0
HDFC	513.0	426.5	20.3	21.0
ICICI	1,004.1	789.9	27.1	35.0
Infosys	1,031.3	673.0	53.2	56.0
Maruti	425.1	360.9	17.8	19.0
Rel Commn	911.7	403.4	126.0	118.0
TCS	1,170.6	800.0	46.3	50.0
Wipro	775.4	597.5	29.8	29.0

Sensex' Q4FY2007E earnings growth (%)

Sector	Expected	
	% y-o-y chng	% q-o-q chng
Auto	5.3	2.6
Banking & finance	33.7	18.8
Capital goods	23.0	61.3
Cement	57.2	6.6
FMCG	22.4	-12.2
IT	41.4	5.1
Metal	31.1	4.4
Oil and gas	43.5	-4.9
Pharma	124.3	-40.5
Power	1.1	-23.8
Telecom	102.8	11.9
Total	36.7	1.2
Total - ex oil	34.2	3.8

Sensex earnings expected to grow by 36.7%



Source: Sharekhan Research

Auto—margin pressure concerns

Automobile sales numbers rendered a mixed performance in Q4FY2007. The four-wheeler growth rate outpaced the growth rate in the two-wheelers. The operating profit margins are expected to remain under pressure for the whole sector due to the high raw material prices. The margin pressure would be higher in the two-wheeler segment due to the intensified competition, various sales promotion activities and discounts being offered by the major players.

Banking—asset quality issue remains a concern

The business growth is likely to remain robust in the banking sector with credit and deposits growing by 30% and 24% yoy respectively for FY2007. However, two lending rate hikes coupled with the interest income on the cash reserve ratio (CRR) with retrospective effect will help banks counter the increase in the deposit costs and higher provisioning requirements. The asset quality will be an important factor to watch.

The net interest margins for banks may not be impacted in this quarter, as the full quarter impact of the increase in the deposit costs will start reflecting only from Q1FY2008 when we may see some margin pressure. The increase in the bond yields by 37 basis points would also keep the marked-to-marked provisions high for some public sector banks like Canara Bank, Punjab National Bank and Oriental Bank of Commerce.

Our estimates for SBI are ahead of the market estimates, as we believe that the one-time CRR income plus the PLR hikes would be more than enough to negate the increase in the deposit costs.

Cement—no major concerns in this quarter

During the quarter the cement industry witnessed a 22.5% yoy and a 3-4% q-o-q increase in the prices. The realisations for the companies in our coverage will see a 19.2% year on year growth.

The volumes for Gujarat Ambuja and the AV Birla group cumulatively increased by 13% yoy. ACC witnessed a 1.1% y-o-y decline in the volumes mainly on account of maintenance and shutdown exercise at its various facilities. We expect the cement stocks under our coverage to post a 31.2% y-o-y growth in sales and an 85.9% y-o-y growth in the profit after tax (PAT).

Capital goods—healthy growth

We expect a more than 40% y-o-y top line growth for the capital goods companies and around a 35% bottom line growth. The operating margins are expected to improve as new priced orders come in for execution and the operating leverage comes into play. However the rising interest rates will have some negative impact at the net margins level.

As per the recent report of the Working Group on Power for the 11th Five-Year Plan, a capacity addition 69,000 megawatt (MW) in power generation is envisaged for the 11th Five-Year Plan and another 86,000MW for the 12th Five-Year Plan, which we believe will keep the momentum going for the power equipment companies.

FMCG—benefits likely from price hikes

We expect the market leader in the fast moving consumer goods (FMCG) segment, Hindustan Lever Ltd's (HLL) profits to grow by 18.8% yoy backed by the strong growth in the HPC segment and the price increases in the key product segments. We expect the margin to improve from 11.8% in Q1CY2006 to 12.8% in Q1CY2007, which would be primarily due to the price hikes undertaken in many of the company's products. We also expect the margins in the soaps and detergent segment to get slightly affected by the strong palm oil prices.

ITC's profits are expected to grow by a strong 24% yoy. We expect the growth to be broad-based with the magnitude of losses in the non-FMCG business coming down. A 12.5% value-added tax (VAT) getting implemented would result in lower growth or no growth in the cigarette volumes. The company has gone for a price increase of 10-25% across all segments. We believe the stock would continue to underperform till clarity emerges on how the subsequent price hike would affect the company's volumes. But looking at the rising disposable income and addictive nature of cigarette consumption, we believe the volumes will not fall drastically. The VAT is having a dampening effect but we believe any decline is a good opportunity to buy.

Telecom services—high growth on a low base

Despite the re-verification of the pre-paid customers and lesser number of days in the month of February, the subscriber additions continued to show a strong growth momentum during the fourth quarter. The industry added around 19 million subscribers in Q4, which is a tad lower than the 19.8 million subscribers added in the previous quarter.

Bharti Airtel (BAL) continues to lead the growth in subscriber additions and it added around 5.07 million subscribers (not adjusting for any churn due to the re-verification process) in Q4, higher than the 4.9 million subscribers added in Q3FY2007. Consequently, we expect BAL's revenues to grow by 12.8% quarter on quarter (qoq) and 62.4% yoy to Rs5,541 crore. The consolidated earnings are estimated to grow by 6% qoq and 89% yoy to Rs1,290 crore. Our earning estimates are ahead of the consensus estimates of around Rs1,246 crore.

IT services—rupee appreciation to take its toll

The steep appreciation of the rupee has further added to the seasonal weakness in Q4, which would result in limiting the revenue growth in the front-line IT services companies to 5-6.6% on a sequential basis. The margins would be under pressure, especially in case of Wipro (relatively lower forward cover and the impact of annual salary hikes to its onsite employees in Q4) and Satyam (due to the incremental cost of $4.5 million related to stock-based compensation). The earnings growth is expected to vary substantially among the various companies with a wide range of 1.3% to 6% sequentially.

Our earnings estimates are more or less in line with the consensus estimates. The only exception is Tata Consultancy Services (TCS) where our earnings estimates are a bit conservative at Rs1,170 crore as compared to the consensus estimates of Rs1,208 crore.

More than the quarterly performance, the guidance for FY2008 would be an important factor. The street expectations have toned down considerably with most analysts expecting Infosys to give an earnings guidance of 22-24% in the rupee terms. It is much lower than the 26.5-28.5% earnings growth guidance at the beginning of FY2007 and implies a less than 5% sequential growth in the earnings over the four quarters.

Metals—better numbers expected

The price cut in aluminium could see Hindalco's realisations getting reduced while Tata Steel is expected to see high volume growth.

Oil & gas—better numbers expected

The oil & gas sector is expected to report a good y-o-y growth on the back of an improvement in the crude oil prices, higher refining margins, rupee appreciation etc. The high fuel marketing under recoveries will continue to impact the bottom line of the government oil marketing companies. However, the likely issue of the oil bonds by the government will provide some cushion.

Pharma—high growth on a low base

We remain positive on the Indian pharmaceutical sector on the back of the continued domestic growth, steady contributions from exports and synergies arising out of integration of acquisitions. Further, the increased focus towards drug discovery and collaborative research with the global players enhances the medium term earnings visibility for the sector.

In line with the business trend, the domestic market growth moderated to around 9% in Q4FY2007 from more than 15% in the last couple of quarters. But the formulation exports continue to be robust and the successful integration of acquisitions (Like Ranbaxy's Terapia, Wockhardt's Pinewood, Nicholas' Morpeth etc) will drive the revenue growth for the sector. We expect the pharmaceutical companies under our coverage to report a revenue growth of 20.3% for Q4FY2007.

With increasing competition in the generics segment,US and European generics markets continue to remain challenging for most of the players. But thanks to the cost-cutting efforts, improvement in the product mix and larger thrust on branded formulation business by the local players ensures higher margins. The pharmaceutical companies under our coverage are expected to report a 420-basis-point expansion in the operating profit margin (OPM), leading to a 30% growth in their net profit in Q4FY2007. Ranbaxy and Nicholas are expected to report the highest growth rates during the quarter.

Annexure-I

Stocks where the earnings growth is expected to be high

Company	Q4FY07E	Q4FY06A	% yoy chg
Rel. Commn	911.7	403.4	126.0
Bharti Tele	1,290.0	682.4	89.0
Ranbaxy	131.0	71.8	82.5
Grasim	443.0	258.6	71.3
TISCO	1,167.5	760.1	53.6

Stocks where lower earnings growth/decline is likely

Company	Q4FY07E	Q4FY06A	% yoy chg
Hero Honda	202.4	267.2	-24.3
Bajaj Auto	276.3	321.8	-14.1
Reliance Energy	159.2	169.5	-6.1

Annexure-II

Non-Sensex companies where high yoy growth is expected

Company	Q4FY07E	Q4FY06A	% yoy chg
Dabur Pharma	8.7	0.2	4042.9
Syndicate bank	168.7	10.3	1536.0
Polaris	31.3	4.8	553.0
India Cements	109.2	24.3	348.8

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