

Analyst Contributor

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Week ended – 16 January 2009

Markets this week:

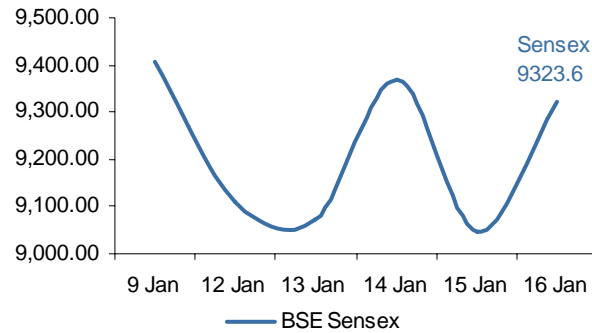
The Indian markets remained volatile during the week; the BSE Sensex closed at 9324. Selling pressure by FIIs and after effects of the Satyam fraud dragged the markets down. However, better than expected Index of Industrial Production (IIP) numbers for the month of November 2008 and impressive December 2008 quarter results by large IT companies such as Infosys and TCS helped the Sensex to recover lost ground. Towards

the end of the week, the US government announced an additional bailout package of \$825bn for the US economy and financial support to Bank of America. This and declining domestic inflation numbers (5.24%) buoyed the Indian markets. The Sensex closed the week with a marginal decline of 0.9% from the previous week's close.

The highlight of the week was the IT index. The December 2008 quarter results announced by Infosys saw the IT index rally. By mid-week the index had already gained 6% over previous week's close. These gains were however negated in the following trading session on news of Nortel filing for Chapter 11 bankruptcy protection. Nortel is a client of some listed Indian IT companies. The news of the bankruptcy filing led to a sell off in these companies, which dragged the IT index to eventually close the week only 2% above the previous week's closing. Even with this moderate gain, the IT index outperformed the Sensex.

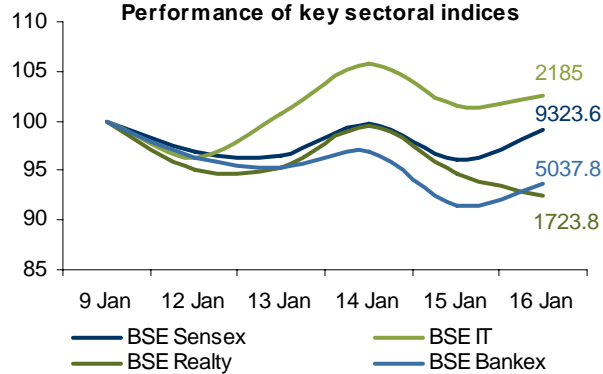
The biggest decline during the week was in the BSE Realty index and BSE Bankex, which were down 7.5% and 6.4%, respectively. FII's and Mutual funds were net sellers during the week to the tune of INR 15,578m and INR 10,116m¹, respectively.

Markets stay volatile during the week



Source: BSE

Performance of key sectoral indices

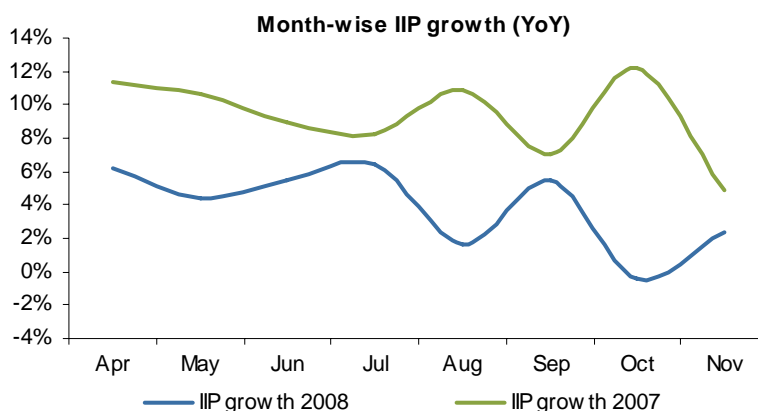


Source: BSE

¹ Data available upto 15 January 2009

Macroeconomic indicators:

Index of Industrial Production (IIP): After witnessing a decline of 0.3% in October 2008, IIP for November 2008 grew by 2.4% compared to 4.9% in November 2007. The performance was better than what the market expected. The Apr-Nov growth in 2008 was 3.9% compared to 9.2% achieved during the same period in 2007.



Source: Ministry of Statistics

Increases in the production of consumer goods and consumer durables by 4.4% and 7.3% respectively, were the primary drivers for growth in the index during November 2008. It also reflects a positive outlook for demand in consumer goods in the months to follow. However, the consensus market estimate of IIP growth for the month of December continues to be negative. IIP performance in November notwithstanding, the trend in the coming months is expected to remain negative.

Inflation: Annual Inflation rate for the first week of January 2009 fell by 67 basis points to 5.24% compared to the previous week. Inflation rate has been declining since August 2008 when it touched a high of 12.9%. On a week-on-week basis, all three components (Primary articles, Power, fuel, light & lubricants, and Manufacturing products) witnessed a fall during the week; the biggest fall was in Food Articles (0.6%).

However, despite the fall in inflation, concerns remain over the high annual inflation rate in Primary articles, particularly Food Articles. Annual inflation rates of Primary articles, and its sub-group, Food Articles were 10.85% and 9.52%, respectively. In the coming week, inflation is expected to rise as the Trucker's strike has resulted in spikes in prices of certain commodities. Overall, fall in inflation has created room for RBI to cut interest rates further.

Policy Updates:

Income Tax exemption norms for SEZ: The government is planning to amend certain provisions of the Income Tax Act, which will benefit some entities operating in Special Economic Zones (SEZs). The SEZ Act states that entire profits earned by SEZ units from exports will be exempt from tax. Section 10AA of the Income tax act prescribes a formula for calculating such profits. As per the formula, the ratio of export turnover to total turnover determines the export profits. For example if export

Particulars	INR m	
Total turnover of the company	150	
Total turnover of the SEZ unit	100	
Export turnover of the SEZ unit	80	
Total profit of the SEZ unit	20	
Scenarios	Current	Proposed
Ratio of export turnover to total turnover	53%	80%
Profits exempt from tax	11	16

Source: ValueNotes Research

turnover of an entity is 80% of the total turnover, then 80% of total profits will be treated as export profits and

be exempt from tax. There exists an anomaly in the definition of 'total turnover', which affects an entity that has both a SEZ as well as a non-SEZ entity. 'Total turnover' is defined as total turnover of the company as a whole and not total turnover of the SEZ unit, as intended by the SEZ Act. This anomaly affects the ratio for computing the export profits (see table above). The proposed amendment intends to change the definition of 'total turnover' to include the total turnover of only the SEZ unit of the company. This change is expected to significantly benefit a number of IT companies who have units registered in both, SEZ and non-SEZ locations. The change, when effected, will correct the anomaly and facilitate computation of exempt profits commensurate with the spirit of the SEZ Act.

Sale of Surplus Coal: The government has decided to amend coal-mining norms applicable to captive units. The change will allow power companies to supply surplus coal from their captive units to other projects. This will be allowed only to projects awarded on tariff-based bidding after government approval. Currently, only government-based agencies are authorized to undertake coal trading. Coal is used as an input for generating ~65% of the total power in India. There is a significant gap between the supply and demand for coal, and the policy change will narrow this gap. Assured supply is expected to soften coal prices and translate into better financial performance of power companies.

Feature: Fuel pricing deregulation

Presently, the government controls prices of fuel via the Administered Price Mechanism (APM). This means that the retail fuel selling prices that public sector Oil Marketing Companies (OMCs) charge is determined by the Government. While APM may be useful to keep a check on inflation (given that fuel prices have a cascading effect on other prices related to consumption), it puts pressure on margins of OMCs in a scenario of rising crude oil prices. To compensate the OMCs, the government issues oil bonds; this in turn affects its planned deficit targets (revenue and fiscal). Moreover, retail prices of fuel under the APM regime are not a true indicator its market prices. To address this systemic issue the government is planning to deregulate the pricing of fuel and align it to international fuel prices.

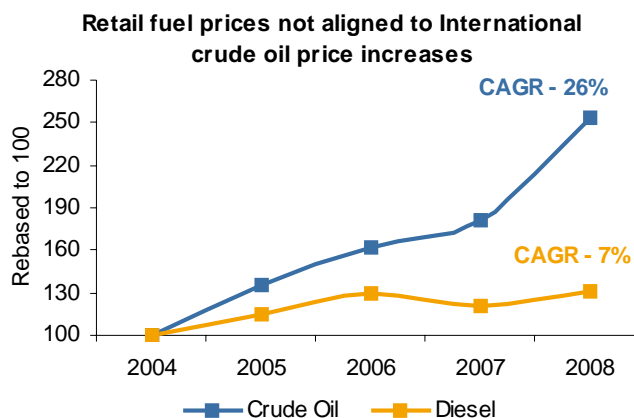
Fuel pricing structure under the APM regime

The largest component of the retail fuel price is the price of crude oil. Since India meets ~80% of its total crude oil requirement through imports, the price that India pays for such imports largely represent international prices of crude. Other components include refining costs, distribution costs, excise duties, sales tax, other local levies and the marketing margin (profit of the OMC). The government alters the marketing margin to determine the retail fuel price charged to the consumer.

Impact of APM

- Under-recoveries for OMCs

Under the APM regime, retail fuel prices in India have not been aligned with the prices of crude oil. For example, while international



Source: Indian Oil corporation, ValueNotes research

crude oil prices grew at a CAGR of 26% over the past four years, retail prices of diesel in India grew by only 7%. The widening gap between the crude oil prices and prices of retail fuel in India directly impacts the operating margins and more importantly, the cash flow management of OMCs.

To ease the burden, government periodically issues bonds to the OMCs, which can be traded in the secondary markets to generate liquidity. However, oil bonds have not been very popular with banks and FIs (financial institutions) primarily because such bonds cannot be considered as a part of their statutory liquidity requirement (SLR). Secondly, the bonds do not qualify for refinance from Reserve Bank of India. Inability to trade the bonds and a need to ensure adequate funding for day to day activities have forced the OMCs to borrow funds, which in turn has increased leverage and interest cost.

A portion of under-recoveries is also shared by oil drilling companies by reducing the price of crude oil charged to OMCs. The table below indicates the distribution of under-recoveries for the past four years:

(all figures in INR bn)	2005-06	2006-07	2007-08	Apr-Sep'08
Crude Oil (Indian basket) \$ per barrel	55.7	62.5	79.3	108.1
Under-recovery	400.0	493.9	771.2	928.5
Burden Sharing of the Under-recovery				
Sharing by upstream companies	140.0	205.1	257.1	259.3
Oil Bonds	115.0	241.2	352.9	449.7
Absorbed by OMCs	145.0	47.6	161.3	219.8

Source: Ministry of Petroleum and Natural Gas

- Budget deficit

Total oil subsidies in 2007-08 were estimated to be ~2-3% of GDP. However, if the under-recoveries borne by the OMCs are considered, they account for a whopping 6% of GDP.

- Uneven playing field for private players

Private companies are outside the APM regime and can independently determine the retail selling price of fuel. However, in order to compete with OMCs, the private players are compelled to sell fuel at prices that are similar to those of OMCs. At those prices, private players have suffered significant losses. Unlike OMCs, private players are not compensated by the government for under-recoveries, thus rendering their operations unviable. Mounting operating losses forced Reliance Industries (RIL) to discontinue its retail fuel operations and close down ~1,400 of its filling stations.

New Pricing Structure - Moving band structure in the APM:

Under the new structure, Government has formulated a price band for select (auto) fuels such as petrol and diesel. The OMCs will be permitted to revise prices within that price band. The "moving price band" will be based on the average of the global prices in the immediate past three months and the past one year. OMCs will have the limited freedom to revise prices (both upwards and downwards) up to 10% of this mean price.

Impact Analysis and conclusion

Selective decontrol will enable the OMCs to sell the fuel at prices that are better aligned to international prices or fuel. This is expected to not only improve margins but also ease the pressure on working capital. Private players can look forward to a level playing field and revive their operations to effectively compete with OMCs.

The Government, in 2002, had partially deregulated the fuel prices. However, a sharp rise in crude prices and increased political pressure had forced the Government to roll back the deregulation and resort to APM.

Though partial deregulation is a step in the right direction, previous attempts to deregulate the fuel prices were plagued by a lack of political consensus and vested interests, particularly when crude prices increased. The possibility of it happening this time around cannot be overruled. The benefits to OMCs will ensue only if the government resists the temptation to control prices when crude prices rise.

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