HDFC securities

INSTITUTIONAL RESEARCH

STRATEGY | 23 SEP 2015

Value picks in volatile times

World in turmoil, but India story intact

While valuations across sectors have fallen, we remain bullish on domestic stories, such as (a) power utilities like NTPC and Power Grid with their annuity cash flow, regulated ROEs and high predictability, (b) select cement companies where we see value in terms of EV/tonne plus operating leverage playing out as infrastructure build-out takes place — be it roads, railways, ports, or housing for all, (c) select PSU banks, such as SBI and BoB, because of the valuation comfort and some recent changes in the top management of the latter, and (d) a few road and real estate companies with very low leverage.

However, we recommend a cautious stance on companies that are either overvalued or overowned, and where majority of the profits come from outside India. With global growth under stress, any negative event can see outflow of foreign funds, which can cause sharp volatility in stocks where foreign ownership is high.

- *Key positives:* Drop in oil and other commodity prices have aided India's fiscal situation and CAD. Although the global slowdown has been affecting exports, the government's timely increase in excise duty on petroleum products will ensure enough room to spend heavily on infrastructure, which, in turn, will revive the capex cycle.

- The government is playing its cards right by infusing capital into PSU banks and bringing in people from the private sector to head them (for eg, Bank of Baroda, Canara Bank). It is also trying to address the issue of NPA of banks by trying to revive metals, highways and power sectors.

- The government has started increasing capital spending, which stands at 38% YTD. This is most visible in sectors such as roads, power transmission and renewable energy. We are hopeful that railways and defence will also pick up, although the impact on earnings will be visible only from FY18.

- We believe the current government will come up with innovative ways to unlock value, which was evident from Finance Minister Arun Jaitley's recent statements about IDBI Bank Ltd. The FM cited the example of Axis Bank's structure to create value. This gives hope that there may soon be innovative ways to unlock huge value of land owned by PSUs.

- Muted domestic inflation and delay in US Fed rate hike may result in rate cuts in the near future. Although news on monsoon remains mixed, the shortfall being reported has gone down from 16 to 14% after recent revival of the rains.

- *Key concerns:* The global growth slowdown led by China, a US $11 trillion economy with debt to GDP of 280%, is hurting commodity-producing countries like Brazil, Russia, etc, which, in turn, can affect global liquidity flows, thereby causing sharp volatility in equity markets. This can also create stress in the global banking system which has huge exposure to commodity producing countries.

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PREFERRED STOCKS

Large-caps	Mid-caps
Bank of Baroda	KNR Constructions
Coal India	Kolte Patil Developers
Hero Motocorp	Mangalam Cement
ICICI Bank	Oberoi Realty
NTPC	Orient Cement
Powergrid Corporation	Sanghi Industries
SBI	
Ultratech Cement	

Preferred stocks: Large-caps

BANK OF BARODA

(CMP Rs 187, MCap Rs 413bn)

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- BoB is probably the biggest beneficiary of recent government actions in the sector. These include (a) appointment of an accomplished private sector banking professional, PS Jayakumar (MD and CEO of VBHC Value Homes Pvt Ltd, also ex-Citigroup), as MD and CEO, (b) appointment of Ravi Venkatesan (currently Independent Director at Infosys) as chairman, and (c) capital infusion of Rs 17.9bn (~4.5% of net worth).
- Given its diversified loan mix and presence in fast growing states, we think BoB can surprise on growth and asset quality. It has better-than-peer CRAR position (Tier I 9.4%), better coverage ratio (65%) and lower NNPA/NW at 21%.
- We believe our loan growth (~12% CAGR over FY15-17E) and flat NIM assumptions are conservative given BoB's moderate C-D ratio of ~68%, well-capitalised B/S and diversified geographical presence. We expect PAT CAGR of ~26% over FY15-17E, factoring slippages of 1.6% during the period (vs. 2% in FY15) and credit cost of 0.8% (vs. 0.9% in FY15).
- At CMP of Rs 191, BoB trades at 1.2x FY17E ABV (excluding recently announced capital infusion). This is a well-deserved premium. Our TP implies 20% upside from current price.

COAL INDIA

(CMP Rs 324, MCap Rs 2,044bn)

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- Coal India's despatches in April-Aug period have grown by 8.2%, a great start to the government's aim of doubling output/offtake by 2020. Although doubling of offtake maybe a tall order, we believe CIL can grow by 8-9% CAGR and deliver ~750 mT in FY20 (vs. ~500 mT in FY15).
- The strong offtake growth is a new phenomenon for consumers who are used to endless shortage of supplies from CIL. However, most of the incremental offtake has been directed towards the power (regulated) sector. This has resulted in coal stocks at the power plants rising up to the normative 21 days (as against 6 days in Aug-2014). As a result, power utilities have largely been absent from e-auctions.
- This has also coincided with low demand from steel (sponge iron) and cement sectors, which bring up a

chunk of market priced coal (sold under e-auction). While e-auction rates are affected by global prices, we believe lack of demand from non-regulated sectors and absence of power companies from the e-auction are major drivers.

- The stock has been under pressure because of overhang of OFS by the government to the tune of 10%.

We believe this is a great time to enter, here's why:

- Weakness in e-auction prices is temporary and should revert to normal levels (60-85% above FSA pricing) once power generation picks up. Coal India's EBITDA is highly sensitive to e-auction prices. For every 1% change in e-auction, the EBITDA changes by 0.6%.
- Given the higher availability of coal for non-power FSAs — priced 35% higher vs. power FSAs — blended FSA realisations will tend higher. Further, Coal India plans to auction linkages to non-regulated sector. This is likely to result in crystallisation of this opportunity.
- Given that employee costs are largely unrelated to production (~55% of production/OBR is from outsourced labour), increase in realisations/volume translate into disproportionate gains at EBITDA level.
- Dividend yield at ~6% makes the stock more attractive. We remain bullish on the stock, with a TP of Rs 450 (8x FY17 EV/EBITDA). The current weakness in e-auction pricing and OFS overhang provide decent entry points.

HERO MOTOCORP

(CMP Rs 2,389, MCap Rs 4,77bn)

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- The domestic two-wheeler market has seen a downturn led by weak rural sentiments. Weak rural wage growth and lower farm output have resulted in adverse impact on discretionary spending in the rural markets. While domestic motorcycle sales have declined by 4% YoY on YTD basis, Hero's market share in the segment has been largely intact at ~53%. Over the past few months, the company's management has brought down channel inventory levels from 6 weeks in April-15 to ~5 weeks.
- Sales in hero's scooter segment have come down by 15% YoY on YTD basis. The company is scheduled to launch 2 new scooters — Hero Maestro Edge and Hero Duet — this month. These scooters will have indigenously developed 110cc engines and would not entail any royalty payment to Honda.
- Hero's export plans are gaining momentum with the commencement of a new manufacturing facility at Colombia earlier this month. Its initial capacity is pegged at 80k units/annum, which the company plans to double in the next phase. Hero has a long-term target of taking its export volume share to ~10% of its total sales.
- Hero's operating performance saw an improvement in 1QFY16 with 160bps YoY expansion to 15.1%. Saving from its margin transformation project (est at Rs 1.75-2bn in FY16) and tailwinds from lower commodity costs could further boost margins in coming quarters.
- At current levels, the stock trades at 15x/13.2x on FY16/FY17E EPS, which is below its median valuations. We have BUY rating on the stock with a target price of Rs 2,894.

ICICI BANK

(CMP Rs 271, MCap Rs 1,571bn)

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- Over the past three years, ICICI Bank has built a granular book with sharp improvement in incremental contribution from retail loans and SA deposits.
- Incremental contribution from the retail loans has improved from ~30% in FY13 to ~67% in FY15 (highest amongst private peers). From SA deposits it has improved from ~26% to 53% during FY13-15 (also highest amongst peers). Subsequently, ICICIBC's top-20 depositors form a mere 6.4% vs. ~13% for AXSB, 26% for IIB and ~13% for YES.
- ICICIBC's contingent liability (CL) growth at 4% CAGR over FY13-15 (in line with AXSB) is substantially lower than YES (17% CAGR) and IIB (24% CAGR). Further, CL/BS stands at 1.3x, which is lower compared with IIB (1.9x) and YES (2.5x).
- Despite ~43% of its book being retail, ICICIBC's proportion of top 20 loans/exposures at 17/16% remain marginally higher than its peers, given its exposures to leveraged corporates. However, asset/stake sale by these corporates and the government's helping hand to stressed sectors such as infra and steel will ease asset quality concerns for the bank.
- At CMP, ICICBC trades at attractive valuations of 1.55x FY17E ABV. Maintain BUY with SOTP of Rs 382 (2.3x FY17E core ABV + Rs 65 subs value), implying upside of 37%.

NTPC

(CMP Rs 121, MCap Rs 997bn)

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- Prime Minister Narendra Modi's vision of 24x7 power augurs well for NTPC, which generates 25% of the total power produced in the country. Despite issues such as coal availability and power lifting, we see a great opportunity to buy this stock at 1.1x FY17E book value till this overhang remains.
- NTPC's regulated business model, wherein it is guaranteed 15.5% post-tax ROE (at project level) plus incentives linked to demand uptick, implies 1% higher PLF to drive 1% higher EPS. Also, falling interest rate promises to be a boon for the utility company.
- An installed capacity of ~45GW and project under construction of 24GW makes NTPC one of the largest power generating companies not only in India, but also globally. With all its capacity locked-in for PPA and assured fuel supply, its business model is largely immune to issues of fuel availability, demand off-take and payment from SEBs (FY15 cons. debtors of Rs 92bn on sales of Rs 806bn implies no payment issue from SEBs).
- The management has been making efforts to boost RoE through (a) bonus debenture (D/E improved from sub 1x to 1.2 between FY14 and FY15), (b) solar capacity addition of 3GW by FY19E, leading to 7.4% increase in EPS, and (c) inorganic growth through acquisition of SEB plants (already acquired 770MW and under 5GW under consideration), most of which are write-offs, wherein land and infrastructure availability can assist in faster capacity addition.

- Attractive valuations: While the CERC tariff order (2014-19) has led to sharp cut in returns on operating projects from 23-24% to 16-17%, it has largely been factored in stock prices and earnings estimate. With FY15 cons. operating cash flow (post-interest) of Rs 112bn and current market capitalisation of Rs 1000bn, the operating cash flow yield is attractive at 11%. We expect the current project pipeline to translate into ~10% earnings CAGR between FY18 and FY21E, making NTPC lucrative at current valuations. Stock currently trades 1.1x and 10.3x FY17 BV & P/E, respectively. We recommend a BUY with a target price of Rs 145/share.
- Near-term overhang: The government plans to divest 5% stake of NTPC.

POWER GRID

(CMP Rs 131, MCap Rs 685bn)

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- Investments in the underinvested transmission sector are expected to stay strong and PGCIL will continue receiving large projects on nomination basis through its regulated tariff mechanism (8 transmission projects worth Rs 362.6bn). Decline in competitive intensity in tariff-based bidding further improves our growth visibility beyond FY17.
- Working under a regulated return regime, wherein it is guaranteed 15.5% post-tax ROE on equity investments made in transmission assets, Power Grid offers healthy earnings growth (18.5% over FY15-17E) in large-cap power space with no cyclicality in earnings and better return ratios. Also, with FY15 cons. operating cash flow (post-interest) of Rs 117bn and current market capitalisation of Rs 667bn, the operating cash flow yield is attractive at 18% with an assured growth of 15-18%.
- With Agra-Assam HVDC project (TPC ~Rs 75bn) and Champa-Kurukshetra HVDC Pole-I (TPC ~Rs50bn) to be completed soon, PGCIL is set to deliver capitalisation of Rs 280bn-Rs 300bn vs. capex of ~Rs225bn in FY16, thereby reversing the trend of piling CWIP and fear of dilution.
- PGCIL is trading at an attractive valuation with FY17E P/E of 9.1x, P/BV of 1.4x and RoE of 15.6%. Also, falling risk-free rates will support rerating of the stock (10-year G-Sec yield slipped ~1pps to 7.8% in past 1 year). We assign Buy recommendation with target price of Rs 190/share (offers ~50% upside).
- Huge impetus to the renewable energy sector by the current government will drive growth for PGCIL, as it will only execute green corridor projects.

STATE BANK OF INDIA

(CMP Rs 238, MCap Rs 1,800bn)

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- SBIN is our top PSB pick and remains a broad proxy for revival in the Indian economy with presence across segments, sectors and geographies. We believe it is coming off a sluggish phase (in line with recent macros) and may hold several positive surprises if the NPA cycle reverses.
- The bank has enough capital (Tier I ~9.6%), along with lowest net impaired assets (6.6% of loans and 21% of NW), and highest PCR of ~69.5% among PSBs.

- Additional positions are: diversified loan book, superior liability franchise (~40% CASA) and relatively superior return ratios (amongst PSB peers).
- After factoring fairly high slippages of ~2% (vs. 2.3% in FY15) and LLP of ~1.2% (vs. 1.3% in FY15), we expect PAT CAGR of ~25% over FY15-17E for SBI.
- **At CMP, SBIN trades at 1.1x FY17E core ABV, Maintain BUY with an SOTP of Rs 344 (1.7x FY17E core ABV + Rs 66 subs value). Our TP implies 40% upside.**

ULTRATECH CEMENT

(CMP Rs 2,809, MCap Rs 771bn)

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- UltraTech is a pan-India cement company with presence in every region, especially after its acquisition of JPA's Satna assets concludes. Given the large extant capacity (71.65 mTPA by FY17 exit) vs. current volumes (46.5 mT LTM), UTCEM will benefit from the expected demand revival.
- Despite its industry-leading capacity and aggressive addition, UT remains underleveraged (we expect FY18 d/e to fall to under 0.2), which provides further a safety net.
- At CMP, the stock trades at 13.6x/10.5x FY16/17 EV/EBITDA and US$ 200/t.

Preferred stocks: Mid-caps

KNR CONSTRUCTIONS

(CMP Rs 547, MCap Rs 15bn)

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- KNR is a domestic infra play. Its FY15-18E order book is expected to grow ~6x, largely driven by NHAI and state EPC road projects. During 1QFY16E, KNRC has announced three orders, amounting to Rs 23.3bn (resulting in order book multiplying 2.8x FY15 to Rs 36.4bn). We expect new orders of Rs 17bn for the rest of 9MFY16E.
- With the recent ramp up of the order book, revenue growth will be back on track with FY15-18E (revenue CAGR of 32.5%). Further, limited incremental capex on BOTs (Kerala BOT is ~95% complete and partial COD has been achieved) will help keep the balance sheet healthy.
- We expect strong order intake to deliver 32.5%/29.2% FY15-18E sales/net profit CAGR. With no exposure to foreign debt, KNR remains resilient to currency headwinds. We maintain BUY with SOTP-based target price of Rs 665/share (standalone business at 15x FY17E EPS, Kerala BOT at 1x P/BV), 25% upside potential.

KOLTE PATIL

(CMP Rs 161, MCap Rs 12bn)

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- During 1QFY16, KPDL achieved 0.5mn sqft new pre-sales with Corolla being the only project under launch. With 87% of the launch pipeline (9.2 mn sqft) planned for rest of 9MFY16E, the pre-sales momentum will pick up.

- Pune property prices have corrected ~10%, providing better affordability. With ~80% of launch pipeline being sub-Rs10mn, KPDL will witness healthy pickup. During 1QFY16, gross/net debt increased by Rs220/170mn to Rs3.3/1.6bn QoQ. The 1QFY16 Net D/E stood at 0.19x (vs. 0.17x 4QFY15), adjusted for debentures (Rs1,160 mn).
- KPDL expects to have a fully approved launch pipeline of ~20.1mn sqft by FY17E (of which ~9.2mn sqft approvals are already in place). This lends visibility to KPDL FY15-17E cumulative pre-sales guidance of 12mn sqft at an average realisation of Rs6,000/sqft. The icing on the cake is that the launches are from existing paid land inventory and the company doesn't need to acquire any new land parcels during FY16E.
- We maintain our positive stance on KPDL with a BUY and NAV-based TP of Rs260/sh (0.85x end FY16E NAV). Key triggers are (1) townships FSI increase and (2) successful Mumbai foray. At CMP, KPDL trades at 8.3x FY17E EPS.

MANGALAM CEMENT

(CMP Rs 232, MCap Rs 6bn)

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- Despite recent weak profitability numbers (EBITDA loss in 1QFY16), continuous improvement in costs (even accounting for cheaper fuel cost) is encouraging.
- Further reductions will put Mangalam squarely in the league of cost leaders (already sub-Rs 3,500/t).
- The upcoming expansion in Aligarh will help address a key market (West UP) more efficiently, while freeing up volumes from Morak GUs for higher VAT exemption in Rajasthan. We maintain our positive stance with a target price of Rs 340 (4.5x June 17 EV/EBITDA, US$ 55/t), implying 45% upside from CMP.

OBEROI REALTY

(CMP Rs 244, MCap Rs 83bn)

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- ORL is gearing up for a busy 2HFY16E with launches in Borivali, Worli and Mulund (additional inventory release).
- New launches and ready inventory monetisation are key tailwinds for the company. The new projects will be a mix of luxury and affordable luxury product, and our channel checks suggest a strong undercurrent for ORL in the macro market.
- ORL is facing inventory liquidation headwinds as it currently has ~Rs 40mn+ ticket size. The new launches will fill in the ticket-size gap in Rs 20-40mn range. However, annuity assets provide comfort on volatile residential demand, with residential (devco) and commercial (rentco) segments contributing 56% and 42% to our NAV, respectively. Unlike peers, in case of slowing residential sales, the cash flows from commercial projects lend visibility to earnings.
- ORL remains largely insulated from currency headwinds, although corrections in commodity prices will benefit margins. Maintain BUY with SOTP-based target price of Rs 339/share (40pc upside).

ORIENT CEMENT

(CMP Rs 155, MCap Rs 32bn)

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- With its industry-beating cost structure and upcoming capacity expansion of 3 MTPA, Orient Cement remains the best bet on resurgent cement demand in South/West. It currently trades at a huge discount to Ramco, which we believe is not justified.

- At CMP, Orient Cement trades at 15.8/7.8x FY17/18 EV/EBITDA and US $87/t vs. Ramco, which trades at ~US$ 130/t. We have a BUY with a TP of Rs 210 (32% upside).

SANGHI INDUSTRIES

(CMP Rs 54, MCap Rs 12bn)

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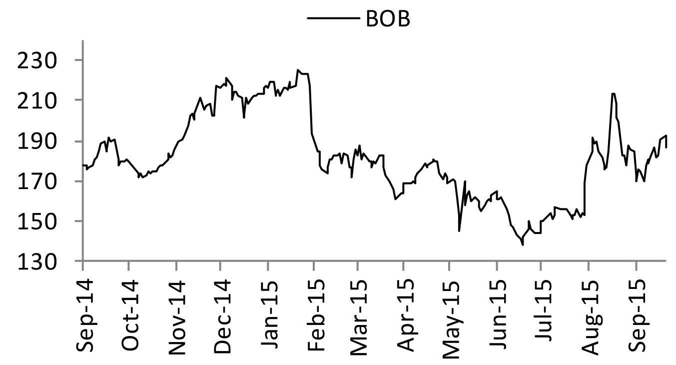
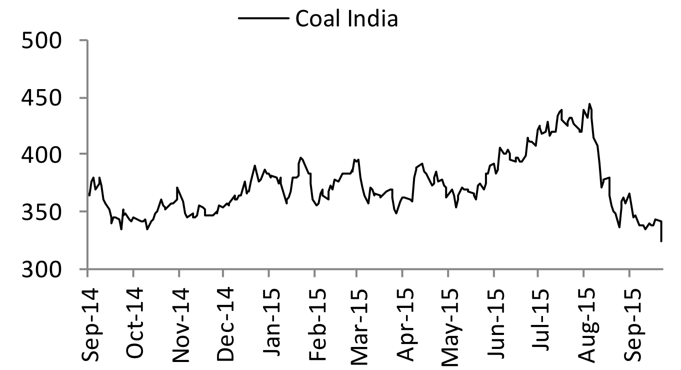
- Sanghi Industries has multiple profitability levers in place such as (a) additional volumes from the new grinding unit, (b) improving PPC in the mix, which will reduce P&F costs further, (c) increasing share of coastal dispatches, which will reduce cost of freight, and (d) operating leverage as new capacity is coming up in the same location.
- Given this, profitability is expected to weather any weakness in cement prices.
- Reduction in debt (0.56x D/E at FY14-end) from strong operational cash flows will help support future expansions at its current plant, which has adequate limestone reserves and land. We have a BUY with a TP of 85/sh (5.5x FY17E EV/EBITDA, US$85/t), implying 66% upside from CMP.

1-YR PRICE CHARTS

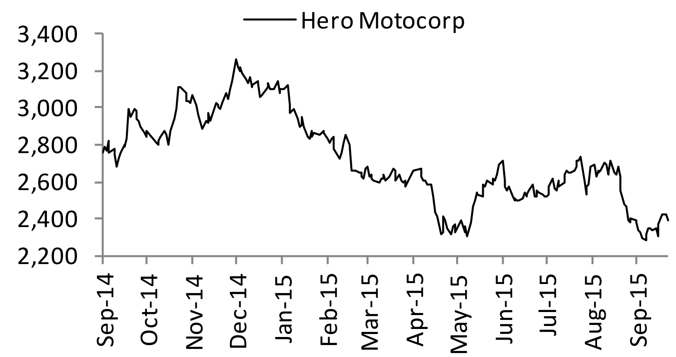
BOB



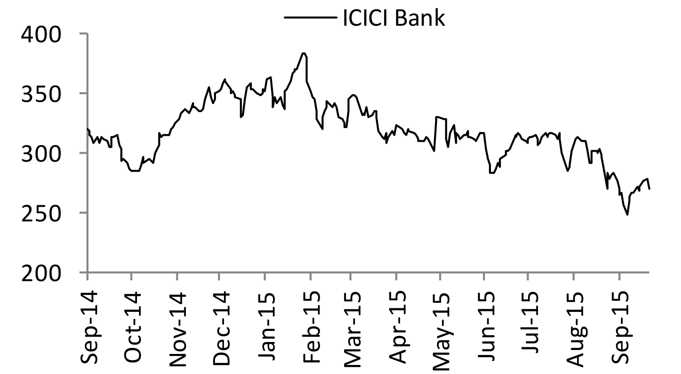
Coal India



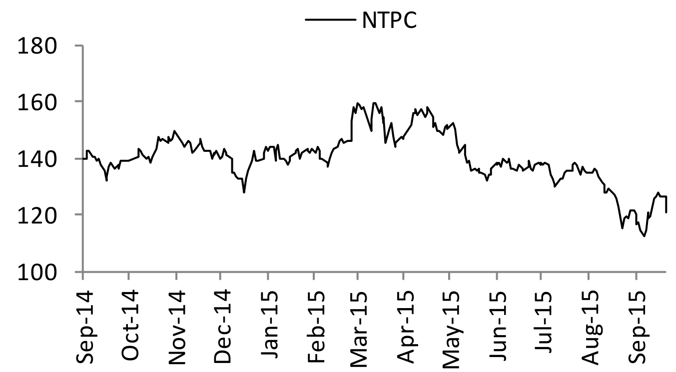
Hero Motocorp



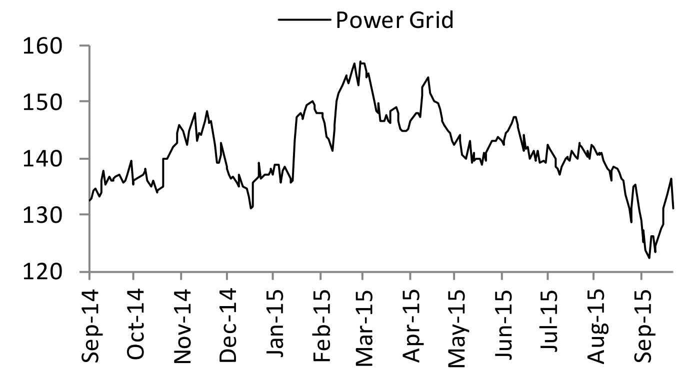
ICICI Bank



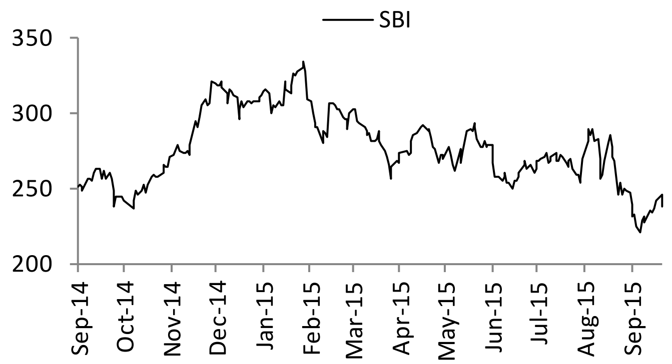
NTPC



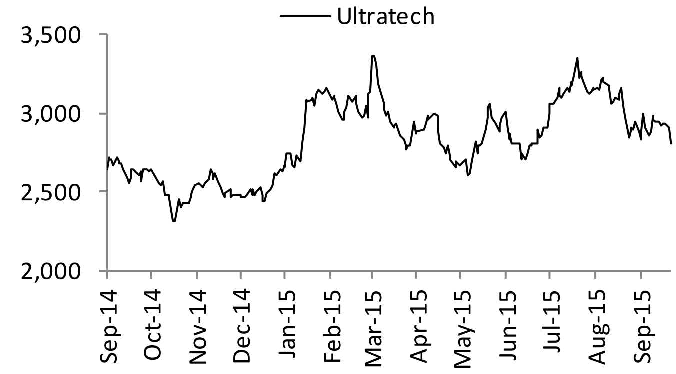
Power Grid



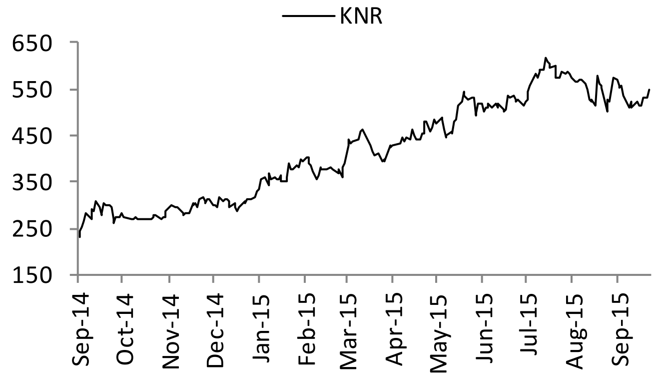
SBI



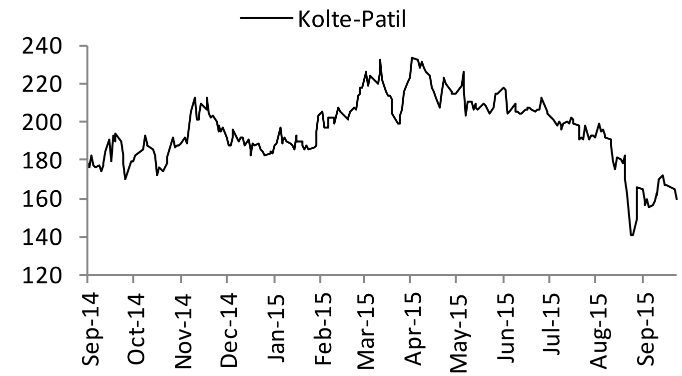
Ultratech Cement



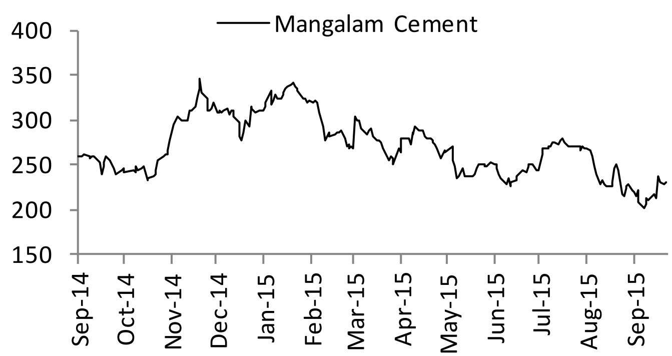
KNR Constructions



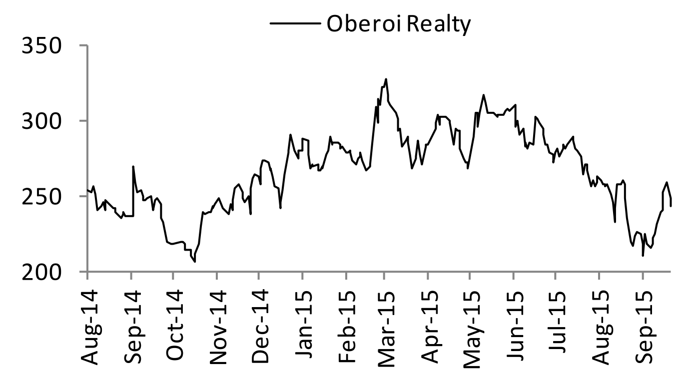
Kolte-Patil Developers



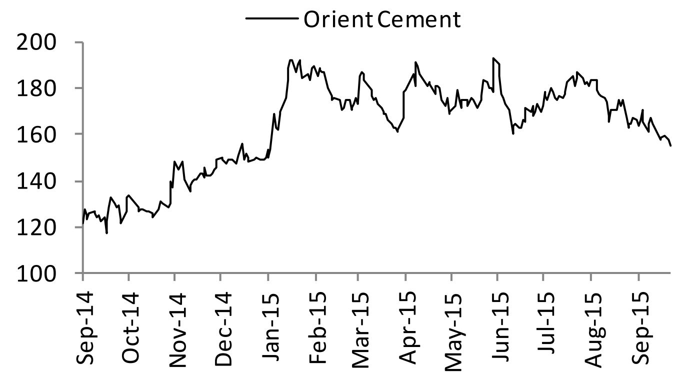
Mangalam Cement



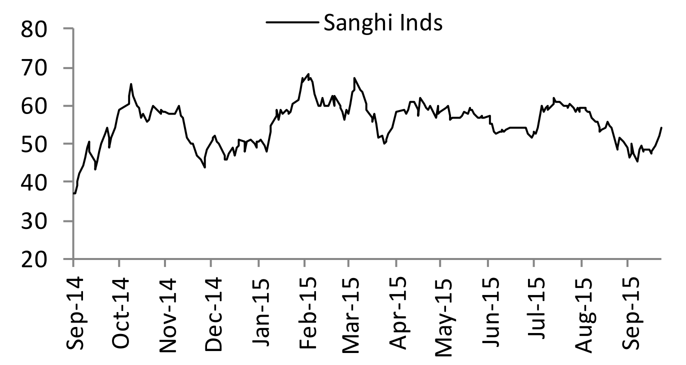
Oberoi Realty



Orient Cement



Sanghi Industries



Disclosure:

Analyst	Stock	Holding
Darpin Shah, Siji Philip	Bank of Baroda	No
Ankur Kulshrestha	Coal India	No
Navin Matta	Hero Motocorp	No
Darpin Shah, Siji Philip	ICICI Bank	No
Prabhat Anantharaman	NTPC	No
Prabhat Anantharaman	Power Grid	No
Darpin Shah, Siji Philip	State Bank of India	No
Ankur Kulshrestha	Ultratech Cement	No
Parikshit Kandpal	KNR Constructions	No
Parikshit Kandpal	Kolte-Patil Developers	No
Ankur Kulshrestha	Mangalam Cement	No
Parikshit Kandpal	Oberoi Realty	No
Ankur Kulshrestha	Orient Cement	No
Ankur Kulshrestha	Sanghi Industries	No

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Rating Definitions

BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period
NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period
SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period

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