sharekhan top picks

Visit us at www.sharekhan.com September 01, 2014

Sharekhan Top Picks

After taking a breather in July, the equity market surged ahead again in August to scale new heights. As highlighted by us in the last month's editorial of ValueGuide, it is not the right strategy to wait for corrections to enter the market. It is better to start investing in a systematic and phased manner especially if one is looking to play the rally that is expected in the domestic equity market over the next two to three years.

The benchmark indices, Nifty and Sensex, have appreciated by 5.1% and 5.3% respectively since our revision in the Top Picks basket last month whereas the CNX Mid-cap Index has also moved up by 5.3% in the same period. The Top Picks basket has comfortably outperformed the benchmark indices with superlative returns of 10.6% in the same period.

Two stocks added during the last revision, PTC India Financial Services and TVS Motor Company, have appreciated by well over 25% each in the past one month. The only underperformer has been Zee Entertainment Enterprises (down 1.5% in the same period) where the sentiment was dented by the further extension of the deadline for phases III and IV of the digitisation of cable television services. However, we believe it is only a temporary setback and Zee Entertainment Enterprises is our preferred pick in the media sector. It is slated to get inducted in the Nifty in the forthcoming round of changes in the index composition.

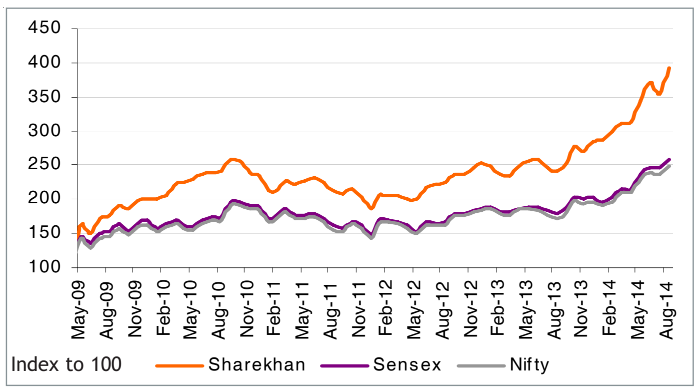
This month, we are making three changes and adding another stock to the portfolio. We are booking profit in TVS Motor Company (a gain of 27% in a month) and PTC India Financial Services (a return of 31.4% in a month); and replacing these with Maruti Suzuki and Axis Bank as part of the churn within the auto and financial sectors respectively.

The third change in the Top Picks folio is the proposed replacement of UltraTech Cement with Reliance Industries Ltd (RIL). The bellwether RIL has underperformed in the past few months and could catch up with the benchmark indices on the back of some favourable policy announcement and the commissioning of its expansion project in both the refining and the petrochemical business. We see scope for the doubling of its earnings over the next four years if the petrochemical cycle improves in line with our expectations and the realisations in its upstream business are revised upwards after the deliberations by the new government at the centre. Lastly, we are adding an engineering company, Salzer Electronics (which is under our soft coverage) to the Top Picks folio. It is a well managed company (26% stake held by Larsen and Toubro [L&T]) with a wide product portfolio and marquee clients like L&T, Schneider Electric and General Electric among others and could be an early gainer of an improving macro scenario along with its increased focus on the overseas business.

Absolute returns (Top Picks Vs Benchmark indices) %

	Sharekhan (Top Picks)	Sensex	Nifty	CNX MIDCAP
CY2014	38.1	27.1	26.9	39.7
CY2013	12.4	8.5	6.4	-5.6
CY2012	35.1	26.2	29.0	36.0
CY2011	-20.5	-21.2	-21.7	-25.0
CY2010	16.8	11.5	12.9	11.5
CY2009	116.1	76.1	72.0	114.0
Since Inception (Jan 2009)	287.7	168.2	163.3	212.9

Constantly beating Nifty and Sensex (cumulative returns) since April 2009



Name	CMP* (Rs)	PER (x) FY14	FY15E	FY16E	RoE (%) FY14	FY15E	FY16E	Price target (Rs)#	Upside (%)
Apollo Tyres	179	8.7	8.7	7.7	26.4	20.7	19.3	**210**	17
Axis Bank	406	15.3	13.4	11.5	17.4	17.3	17.5	**476**	17
Federal Bank	124	12.7	10.9	9.0	12.6	13.3	14.5	**142**	14
Gateway Distriparks	260	19.9	18.2	15.8	17.5	18.1	20.0	**310**	19
ICICI Bank	1,599	18.8	16.8	14.1	14.0	14.5	15.7	**1,723**	8
Larsen & Toubro	1,578	29.8	26.3	21.7	15.6	15.6	17.1	**1,840**	17
Lupin	1,289	31.4	22.7	19.8	26.5	27.7	24.4	**	-
Maruti Suzuki	2,916	31.6	25.3	19.1	14.1	15.5	17.8	**3,500**	20
Persistent Systems	1,301	20.9	16.8	14.3	22.3	23.1	22.7	**1,400**	8
Reliance Industries	1,014	14.6	13.7	12.3	11.3	10.9	11.0	**1,190**	17
Salzer Electronics	137	16.7	10.6	7.4	9.0	13.1	16.7	**175**	28
Zee Entertainment Enterprises	285	30.6	28.8	21.9	20.6	19.1	22.3	**367**	29

*CMP as on September 01, 2014 **# Price target for next 6-12 months** ** Under review

Sharekhan
Your guide to the financial jungle

Regd Add: **Sharekhan Limited,** 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Fax: 67481899; E-mail: publishing@sharekhan.com; Website: www.sharekhan.com; CIN: U99999MH1995PLC087498. Sharekhan Ltd.: SEBI Regn. Nos. BSE- INB/INF011073351 ; CD-INE011073351; NSE- INB/INF231073330 ; CD-INE231073330; MCX Stock Exchange- INB/INF261073333 ; CD-INE261073330; DP-NSDL-IN-DP-NSDL-233-2003 ; CDSL-IN-DP-CDSL-271-2004 ; PMS-INP000000662 ; Mutual Fund-ARN 20669 ; Commodity trading through Sharekhan Commodities Pvt. Ltd.: MCX-10080 ; (MCX/TCM/CORP/0425) ; NCDEX-00132 ; (NCDEX/TCM/CORP/0142) ; NCDEX SPOT-NCDEXSPOT/116/CO/11/20626; For any complaints email at igc@sharekhan.com ; Disclaimer: Client should read the Risk Disclosure Document issued by SEBI & relevant exchanges and Do's & Don'ts by MCX & NCDEX and the T & C on www.sharekhan.com before investing.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target (Rs)	Upside (%)
		FY14	FY15E	FY16E	FY14	FY15E	FY16E		
Apollo Tyres	**179**	8.7	8.7	7.7	26.4	20.7	19.3	**210**	17

Remarks:

- Apollo Tyres is a leading player in the domestic passenger car and truck tyre segments. The tyre industry's volume has been subdued given the weak macro environment. We expect the demand to improve in H2FY2015 with a pick-up in the economy.
- The profitability of the tyre companies has improved given the soft natural rubber prices and this benefit is expected to continue in FY2015-16 as global supply of natural rubber is expected to outstrip demand.
- Its European operations too have reported a strong performance with a strong volume growth and high profitability. The company will be investing EUR200 million for setting up a greenfield facility in Eastern Europe which will start production in Q4FY2017 and cater to the long-term growth in Europe. Additionally, it will invest Rs2,000 crore in its Indian operations for capacity expansion.
- We like the stock for its consistent performance and long-term growth prospects (expansion in Europe and Chennai). We have a Buy recommendation on the stock with a price target of Rs210.

Axis Bank	**406**	15.3	13.4	11.5	17.4	17.3	17.5	**476**	17

Remarks:

- Axis Bank continues to report a strong growth in profits led by an improved operating performance. With a strong focus on raising the CASA ratio and reducing dependence on wholesale funds, the bank has been able to narrow the gap vis-à-vis its peers (ICICI Bank, HDFC Bank) in terms of liability franchise. This should help sustain the net interest margin at healthy levels going ahead.
- With gross NPAs of 1.3%, the asset quality of the bank remains among the best in the system. The provision coverage of about 80% further adds to the comfort on the bank's asset quality. The strategy of diversifying the loan book in favour of the retail segment is shaping well as retail loans constitute over 30% of its loan book.
- Axis Bank is among the best capitalised bank and is likely to benefit from a recovery in the economy. An increase in investment activity will boost its fee income and add to its profitability. Considering high visibility of the earnings growth and the healthy asset quality, the stock trades at a reasonable valuation (1.9x FY2016E book value [BV]). We have a Buy rating on it with a price target of Rs476.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target (Rs)	Upside (%)
		FY14	FY15E	FY16E	FY14	FY15E	FY16E		
Federal Bank	**124**	12.7	10.9	9.0	12.6	13.3	14.5	**142**	14

Remarks:

- Federal Bank undertook structural changes in the balance sheet, viz increasing the proportion of the better rated assets and improving the retail deposit base, and is thus better prepared to ride the recovery cycle. As the economy is gradually showing signs of a revival, the bank is much better capitalised (tier-1 capital adequacy ratio of ~15%) compared with its peer banks to expand the balance sheet.
- The a sset quality has improved substantially over the past three to four quarters and is likely to improve further in the coming period. Higher provision coverage of over 80% and a possibility of recovery from one large-ticket account (likely in the next two to three quarters) would further increase the comfort on asset quality.
- The valuation of 1.3x FY2016E BV is attractive when compared with the regional banks and other old private banks. The expansion in the return on equity (RoE) led by a better than industry growth (FY2014-16) will lead to an expansion in the valuation multiple. We have a Buy rating on the stock with a price target of Rs142.

Name	CMP (Rs)	PER FY14	PER FY15E	PER FY16E	RoE FY14	RoE FY15E	RoE FY16E	Price target (Rs)	Upside (%)
Gateway Distriparks	**260**	19.9	18.2	15.8	17.5	18.1	20.0	**310**	19

Remarks:

- An improvement in exim trade along with a rise in port traffic at the major ports signals an improving business environment for the logistic companies. Gateway Distriparks being a major player in the CFS and rail logistic segments is expected to witness an improvement in the volumes of its CFS and rail divisions going ahead.
- The improving trend in the rail freight and cold chain subsidiaries would sustain on account of the recent efforts to control costs and improve utilisation.
- We continue to have faith in the company's long-term growth story based on the expansion of each of its three business segments, ie CFS, rail transportation and cold storage infrastructure segments. First, we believe the listing of Snowman Logistics will unlock the inherent value and the potential of the cold chain operations. Second, the coming on stream of the Faridabad facility and the strong operational performance will further enhance the performance of the rail operations. Third, the expected turnaround in the global trade should have a positive impact on the CFS operations. We maintain our Buy rating on the stock.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target (Rs)	Upside (%)
		FY14	FY15E	FY16E	FY14	FY15E	FY16E		
ICICI Bank	**1,599**	18.8	16.8	14.1	14.0	14.5	15.7	**1,723**	8

Remarks:

- With an improvement in the liability profile, ICICI Bank is better positioned to expand its market share especially in the retail segment. We expect its advances to grow at ~19% compound annual growth rate (CAGR) over FY2014-16 leading to a CAGR of 17.0% in the net interest income.
- ICICI Bank's asset quality has stabilised and fresh non-performing asset (NPA) additions are within manageable limits. We believe the strong operating profits should help the bank to absorb the stress which anyway is expected to recede due to an uptick in the economy.
- Led by a pick-up in the advance growth and a significant improvement in the margin, the RoE is likely to expand to ~16% by FY2016 while the return on assets (RoA) is likely to improve to 1.8%. This would be driven by a 15.3% growth (CAGR) in the profit over FY2014-16.
- The stock trades at 2.1x FY2016E BV. Moreover, given the improvement in the profitability led by lower NPA provisions, a healthy growth in the core income and improved operating metrics, we recommend a Buy with a price target of Rs1,723.

Name	CMP (Rs)	PER FY14	PER FY15E	PER FY16E	RoE FY14	RoE FY15E	RoE FY16E	Price target (Rs)	Upside (%)
Larsen & Toubro	**1,578**	29.8	26.3	21.7	15.6	15.6	17.1	**1,840**	17

Remarks:

- Larsen & Toubro (L&T), the largest engineering and construction company in India, is a direct beneficiary of the strong domestic infrastructure development and industrial capital expenditure (capex) revival now.
- L&T continues to impress us with its order inflow growth achievement and good execution skills even in a slowdown. Now it is looking at better days ahead with the domestic environment improving. We believe in such a situation, L&T would be a major beneficiary as it is placed much ahead of its peers with a strong balance sheet. Moreover, monetisation of various assets (including listing of subsidiary) would help the company to improve the RoE.
- Owing to poor results in its hydrocarbon subsidiary, L&T reported weak Q1FY2015 results and the stock corrected significantly. We recommend investors to consider this as an opportunity of lower entry point as L&T is one of the best bets to play the cyclical (revival benefit yet to reflect in numbers) and as the management expects the performance of hydrocarbon business to improve in future.

Name	CMP	PER (x)			RoE (%)			Price	Upside
	(Rs)	FY14	FY15E	FY16E	FY14	FY15E	FY16E	target (Rs)	(%)
Lupin	**1,289**	31.4	22.7	19.8	26.5	27.7	24.4	**	-

Remarks:

- A vast geographical presence, focus on niche segments like oral contraceptives, ophthalmic products, para-IV filings and branded business in the USA are the key elements of growth for Lupin. The company has remarkably improved its brand equity in the domestic and international generic markets to occupy a significant position in the branded formulation business. Its inorganic growth strategy has seen a stupendous success in the past. The company is now debt-free and that enhances the scope for inorganic initiatives.
- The company has shown a sharp improvement in the base business' margin in Q1FY2015 on the back of cost rationalisation measures and better product mix. The management has given a guidance to sustain the operating profit margin (OPM) at 27% to 28% in FY2015 (vs 25% in FY2014), which especially impress us.
- The company is expected to see stronger traction in the US business on the back of the key generic launches in recent months and a strong pipeline in the US generic business (over 97 abbreviated new drug approvals pending approval including 86 first-to-files) to ensure the future growth. The key products that are going to provide a lucrative generic opportunity for the company include Nexium (market size of $2.2 billion), Lunesta (market size of $800 million) and Namenda (market size of $1.75 billion) that will be going out of patent protection in FY2015. We expect revenue and profit CAGR of 21% and 26% respectively over FY2014-16.

Maruti Suzuki	**2,916**	31.6	25.3	19.1	14.1	15.5	17.8	**3,500**	20

Remarks:

- Maruti Suzuki India Ltd (MSIL) is the market leader in the domestic passenger vehicle industry. In FY2014, as against an industry decline of 6.6%, MSIL was able to retain volumes at the previous year's levels and in the process expanded market share by 270BPS to 42.1%.
- It has further strengthened its sales and service network. Additionally, the drive by the company's management to tap the potential in rural areas paid rich dividends in difficult times for the industry and against rising competitive intensity; this reaffirms the resilience of MSIL's positioning and business model.
- The recent launch of *Celerio* has been well received by the market and the new automatic manual transmission facility has especially enthused the market. MSIL has a pipeline of new launches over the next few years with the most important being the entry into the compact utility vehicle and light commercial vehicle segments.
- We expect customer sentiment to improve on the back of a strong government at the centre. Additionally, the passenger vehicle segment is expected to benefit from the pent-up demand over the past two years due to deferred purchases. MSIL will benefit the most due to its high market share in the entry-level segment. We remain positive on the stock with a price target of Rs3,500.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target (Rs)	Upside (%)
		FY14	FY15E	FY16E	FY14	FY15E	FY16E		
Persistent Systems	1,301	20.9	16.8	14.3	22.3	23.1	22.7	1,400	8

Remarks:

- Persistent Systems Ltd (PSL) has proven expertise and an early movers advantage in the digital technologies (Social, Mobile Analytics and Cloud; SMAC). Additionally, strength to improve its IP base and the best-in-the-class margin profile set it apart from the other mid-cap IT companies.
- The distinctive advantage of PSL's lies in its SMAC-oriented business model (a big growth area), strong balance sheet (Rs663 crore, at 41% of the balance sheet size) and good corporate governance.
- Despite trading at a valuation (trading at 14.3x FY2016E earnings) that is closer to that of the large-cap IT companies after a steep re-rating in the last six months, PSL continues to attract investors' interest (FIIs have increased the stake in the company from 20.6% in March 2014 to 27.4% in June 2014). Given the huge potential in the SMAC space, we see PSL as a long-term value creator for investors.

Name	CMP (Rs)	PER FY14	PER FY15E	PER FY16E	RoE FY14	RoE FY15E	RoE FY16E	Price target (Rs)	Upside (%)
Reliance Industries	1,014	14.6	13.7	12.3	11.3	10.9	11.0	1,190	17

Remarks:

- Reliance Industries Ltd (RIL) has a strong presence in the refining, petrochemical and upstream exploration businesses. The refining division of the company is the highest contributor to its earnings and is operating efficiently with a better gross refining margin (GRM) compared with its peers in the domestic market due to the ability of its plant to refine more of heavier crude. However, the gas production from the Krishna-Godavari-D6 (KG-D6) field has fallen significantly in the last two years. With the government approval for additional capex in its allocated gas fields, we believe, the production will improve going ahead.
- Though there is uncertainty prevailing on gas production and pricing of gas from the KG-D6 field, but the traction in volume from shale gas assets is playing positively for the company. Moreover, the upcoming incremental capacities in the petrochemical and refinery businesses are going to drive the future earnings growth as the downstream businesses are on the driving seat and contributing the lion's share of the profitability and cash flow. Hence, the uncertainty related to the domestic gas production and pricing is having a limited material impact.
- In recent past there have been signs of improvement in the benchmark GRM which suggests that there could be a healthy improvement in the GRM of RIL too. The stock is available at a price/earnings of 12.3x its FY2016E earnings per share, which is attractive considering the size, strong balance sheet and cash flow generating ability of the company.

Name	CMP	PER (x)			RoE (%)			Price	Upside
	(Rs)	FY14	FY15E	FY16E	FY14	FY15E	FY16E	target (Rs)	(%)
Salzer Electronics	**137**	16.7	10.6	7.4	9.0	13.1	16.7	**175**	28

Remarks:

- Salzer Electronics Ltd (SEL) was established in 1985 as an electrical installation product manufacturer having more than 15 different products. SEL is a market leader in rotary switches, toroidal transformers and wire ducts. Larsen and Tuobro (L&T) is the single largest shareholder of the company with a 26% stake and two directors on the company's board. Further, SEL has a marketing tie-up with L&T and derives around 40% of its total revenues through the L&T channel. The other big clients of the company include General Electric and Schneider Electric.
- With a gradual revival in the domestic capex cycle in the key industries and improvement in project spending, the management expects a strong growth (a CAGR of over 20%) in the earnings in the next two to three years. Apart from the top line growth, we expect the margin to expand as well as the operating leverage to kick in over the coming years. After stagnant earnings during FY2012-14, the company is well poised to deliver around 50% CAGR over FY2014-16.
- At the current market price of Rs137, the stock trades at 10.6x and 7.4x FY2015E and FY2016E based on our quick earnings estimates. SEL is a consistent dividend paying company with a pay-out of around 20% (the company maintained the pay-out ratio even when the earnings growth was muted). Given the significant improvement in the earnings and the fact that L&T is its the largest shareholder and marketing partner, we believe SEL deserves a better valuation multiple.

Name	CMP (Rs)	PER FY14	PER FY15E	PER FY16E	RoE FY14	RoE FY15E	RoE FY16E	Price target (Rs)	Upside (%)
Zee Entertainment	**285**	30.6	28.8	21.9	20.6	19.1	22.3	**367**	29

Remarks:

- Among the key stakeholders of the domestic TV industry, we expect the broadcasters to be the prime beneficiary of the mandatory digitisation process initiated by the government. The broadcasters would benefit from higher subscription revenues at the least incremental capex as the subscriber declaration improves in the cable industry.
- The management maintains that the advertisement spending will continue to grow in double digits going ahead and ZEEL will be able to outperform the same. The growth in the advertisement spending will be driven by an improvement in the macro-economic factors and the fact the ZEEL is well placed to capture the emerging opportunities being a leader in terms of market share.
- ZEEL is well placed to benefit from the ongoing digitisation theme and the overall recovery in the macro economy. Also, the phase-wise rate hikes in the channel rates would augur well for the subscription revenues. We maintain our Buy rating on the stock with a price target of Rs367.

Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a position in the companies mentioned in the article.