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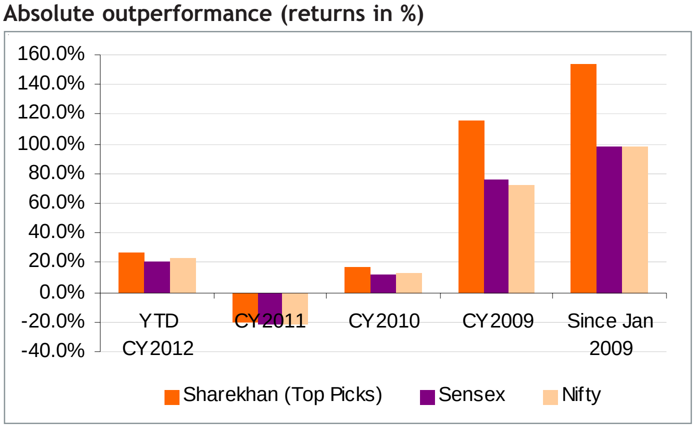
Sharekhan Top Picks

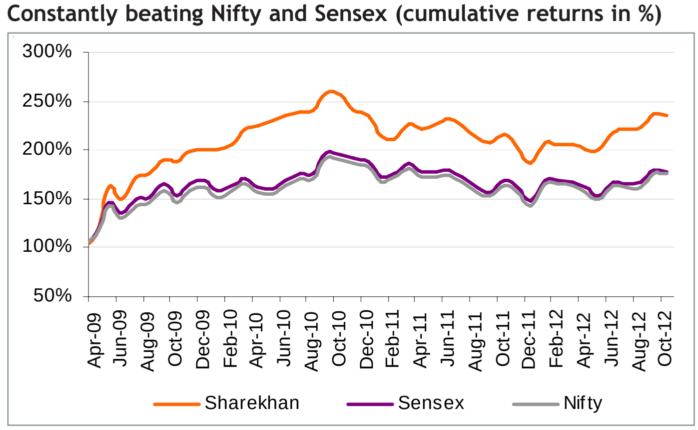
The benchmark indices moved in a very narrow range throughout the last month after rallying hard in September this year. The Nifty and the Sensex ended the month with marginal losses of 0.2% and 0.7% respectively (the data is from September 28 to October 26, 2012). Within the Top Picks basket, some of the recent entrants like Axis Bank, Persistent Systems and Godrej Consumer Products reported healthy gains of 7-10% each for the period. However, the outperformance of the Top Picks basket was limited by the unexpected controversy in IRB Infrastructure Developers (IRB) that resulted in a sharp sell-off in the stock (the stock fell by 21.5% in this period). Consequently, the Top Picks basket performed in line with the benchmark indices and reported a marginal decline of 0.5% for the period under review.

For the current month, we are making two changes in the Top Picks basket. We are introducing Mahindra and Mahindra (M&M) in place of IRB in accordance with the recent change in our automobile (auto) analyst's view on the sector (from bearish to positive). Our auto analyst believes that the volume growth would pick up in some segments of the sector, like tractors and passenger cars, from the next quarter. The removal of IRB is more of a cautionary step due to the weakening of sentiments towards the stock in the wake of two controversies related to the IRB's management in a short time. The other change is the replacing of Mcleod Russel with Relaxo Footwear. We are bringing in Relaxo Footwear because we believe it is a good proxy play on the domestic consumption story as well as a likely beneficiary of the prevailing soft rubber prices.

Absolute outperformance (returns in %)



Constantly beating Nifty and Sensex (cumulative returns in %)



Name	CMP* (Rs)	PER (x) FY12	PER (x) FY13E	PER (x) FY14E	RoE (%) FY12	RoE (%) FY13E	RoE (%) FY14E	Price target	Upside (%)
Axis Bank	1,231	12.0	10.7	9.0	20.3	19.2	19.5	1,370	11
BHEL	243	8.4	9.0	9.4	27.7	22.2	18.5	260	7
Cadila Healthcare	871	23.2	18.3	13.9	17.8	26.2	28.3	1,064	22
Dishman Pharma	92	13.2	8.6	5.4	9.0	10.2	13.2	135	46
GCPL	708	42.1	30.0	24.4	26.3	27.3	27.4	726	3
ICICI Bank	1,077	19.2	16.0	14.3	6.6	8.5	8.2	1,230	14
Larsen & Toubro	1,707	24.6	21.7	19.4	18.1	17.7	17.3	1,788	5
M&M	877	19.5	16.9	17.6	22.8	22.1	18.4	949	8
Persistent Systems	471	13.3	10.5	8.7	17.9	19.7	20.1	552	17
Relaxo Footwear	726	21.8	17.4	12.3	20.2	19.4	20.2	885	22
Reliance Industries	802	13.1	13.0	12.3	11.5	10.4	9.9	915	14

* CMP as on October 26, 2012

Sharekhan
Your guide to the financial jungle

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Name	CMP (Rs)	PER (x) FY12	PER (x) FY13E	PER (x) FY14E	RoE (%) FY12	RoE (%) FY13E	RoE (%) FY14E	Price target	Upside (%)
Axis Bank	1,231	12.0	10.7	9.0	20.3	19.2	19.5	1,370	11

Remarks:

- Axis Bank's net interest margin (NIM) improved to 3.46% in Q2FY2013 due to a decline in the cost of deposits. The bank's strong growth in the retail segment is likely to support the margin in the coming period. Going ahead, the management expects to maintain the margin in the 3.3-3.5% range.
- The bank aims to expand its loan book by 3-5% higher than the industry rate (~20% for FY2013). Moreover, the bank has shifted its focus towards the retail segment (currently corporate loans form ~55% of the book) and aims to expand the retail mix to 30% of the book by FY2015.
- Axis Bank continues to maintain a strong liability base (the current and savings account [CASA] ratio is 40.5%) and expects a healthy growth in deposits. The average CASA balance remains healthy, which will give stability to the margins.
- While the asset quality scenario remains challenging, the bank's non-performing asset (NPA) ratio (gross NPAs at 1.1%, net NPAs at 0.33%) is better than that of its comparable peers. Going ahead, any asset quality deterioration will be within manageable levels (ie gross stressed loan additions at ~Rs1,000 crore per quarter) and the management has guided for a credit cost of 75-80 basis points of advances. Further, the higher provision coverage (~80%) adds comfort on the asset quality front.
- Axis Bank is attractively valued as it trades at 1.6x FY2014 book value against a five-year mean valuation of 2.2x. We expect the bank to deliver return on equity (RoE) of ~19% and return on asset (RoA) of 1.5% by FY2014. We recommend a Buy on Axis Bank with a price target of Rs1,370.

Name	CMP (Rs)	PER (x) FY12	PER (x) FY13E	PER (x) FY14E	RoE (%) FY12	RoE (%) FY13E	RoE (%) FY14E	Price target	Upside (%)
BHEL	243	8.4	9.0	9.4	27.7	22.2	18.5	260	7

Remarks:

- Bharat Heavy Electricals Ltd (BHEL) is a premier power generation equipment manufacturer and a leading engineering, procurement and construction company.
- BHEL has witnessed a severe downgrade in its valuation multiples in the last couple of years on account of policy inaction-driven slowdown in the demand environment. However, the proposed initiatives to restructure the debt on the books of the state electricity boards would kick-start the reforms in the power sector.
- In terms of the existing order book, we believe that the concern over the cancellation of the orders from the private power developers seems overplayed as the Inter Ministerial Group hasn't de-allocated any coal mine of BHEL's private clients after scrutinising 29 coal mines.
- The company is also focusing on the non-BTG segments, like railways, logistics, and transmission and distribution (T&D), that have a significant growth potential.
- The relatively lower order intake in recent years would reflect on its revenue growth and result in a marginal decline in the earnings over the next two years. However, a lot of negatives are reflected in the serious de-rating of the stock over the last two years. Therefore, we have included BHEL in our Top Picks basket.

Name	CMP	PER (x)			RoE (%)			Price	Upside
	(Rs)	FY12	FY13E	FY14E	FY12	FY13E	FY14E	target	(%)
Cadila Healthcare	**871**	23.2	18.3	13.9	17.8	26.2	28.3	**1,064**	22

Remarks:

- A weak performance during the past few quarters due to a series of acquisitions and a warning letter by USFDA to its Moraiya plant had spawned the negative sentiment, widening the valuation discount. However, the valuation discount is set to shrink on the recent clearance of the Moraiya plant by the USFDA and a strong growth in the domestic market.
- It acquired three entities during FY2012, namely Nesher Pharma (USA), Bremer Pharma (Germany) and Biochem Pharma (India), which caused the re-organisation of business across segments. These entities are in the process of settling down which will lead to better synergies going forward.
- Better synergies and a favourable change in the product mix due to the focus on niche segments are set to lead the margin expansion by 310 basis points and 100 basis points to 23.6% and 24.7% in FY2013 and FY2014 respectively.
- However, patent litigation, forex and competition remain the key risks for the company.
- We expect revenue compounded annual growth rate (CAGR) of 18.6% and profit CAGR of 25.6% over FY2012-14. The stock is currently trading at 13.9x FY2014E earning per share (EPS), which is a 19% discount to Lupin. We believe the valuation discount should narrow further. We value the stock at 17x FY2014E EPS to arrive at a price target of Rs1,064.

Dishman Pharma	**92**	13.2	8.6	5.4	9.0	10.2	13.2	**135**	46

Remarks:

- After four years of lull, Dishman is all set to capitalise on its capabilities in the contract, manufacturing and research services (CRAMS) space and the marketable molecules (MM) business, thanks to its enhanced capacities and the up cycle in the CRAMS business.
- In Q1FY2013, the net revenues of Dishman jumped by 33% YoY to Rs315 crore on the back of a 24% Y-o-Y rise in the CRAMS business and a 51% jump in the MM business (which includes the vitamin-D business). The oprating profit margin (OPM) improved by 800 basis points YoY to 26.5% which led the net profit to jump by 156% YoY to Rs38.7 crore during the quarter.
- The up cycle in the CRAMS business and the enhanced capacities (it commercialised three new units in Q3FY2012) will help achieve a 16% revenue CAGR over FY2012-14. We expect an improvement in the operating profit margin and a reduction in the fixed costs during this period, which should lead the profit after tax (PAT) to grow at a CAGR of 55% over FY2012-14. Strong cash flows are likely to help reduce its debts significantly. We expect the debt/equity ratio to reduce to 0.5x in FY2014 from 0.9x in FY2012.
- Being an export-oriented player and having a substantial portion of foreign debts on its balance sheet Dishman is vulnerable to foreign exchange fluctuations. The chequered past performance and the management's inability to meet the stated guidance in the past are also causes for concern in the prevailing market where management quality and transparency carry a premium.
- The stock is currently trading at 5.4x FY2014E EPS, which is a 60% discount to its five-year average P/E multiple and close to a 68% discount to Divi's Laboratories. We expect the valuation gap to narrow on a strong operating performance and an improved financial health. We recommend a Buy on the stock with a price target of Rs135 (8x FY2014E EPS).

Name	CMP (Rs)	PER (x)			RoE (%)			Price target	Upside (%)
		FY12	FY13E	FY14E	FY12	FY13E	FY14E		
GCPL	**708**	42.1	30.0	24.4	26.3	27.3	27.4	**726**	3

Remarks:

- Godrej Consumer Products Ltd (GCPL) is a major player in the Indian fast-moving consumer goods (FMCG) market with a strong presence in the personal care, hair care and home care segments in India. The recent acquisitions (in line with the 3x3 strategy) have immensely improved the long-term growth prospects of the company.
- On the back of strong distribution network, and advertising and promotional support, we expect GCPL to sustain the market share in its core categories of soap and hair colour in the domestic market. On the other hand, continuing its strong growth momentum, the household insecticide business is expected to grow by ~20% YoY.
- In the international markets, the Indonesian and Argentine businesses are expected to achieve a CAGR of around 20% and 35% respectively over FY2012-14. This along with the recently acquired Darling Group would help GCPL to post a top-line CAGR of ~23% over FY2012-14.
- Due to the recent domestic and international acquisitions, the company's business has transformed from a commodities soap business into the business of value-added personal care and home care products. Therefore, we expect its OPM to be in the range of 16-18% in the coming years. Overall, we expect GCPL's bottom line to grow at a CAGR of about 32.4% over FY2012-14.
- We believe the increased competitive activity in the personal care and hair care segments and the impact of high food inflation on the demand for its products are the key risks to the company's profitability.
- At the current market price, the stock trades at 30.0x its FY2013E EPS of Rs23.6 and 24.4x its FY2014E EPS of Rs29.0.

ICICI Bank	**1,077**	19.2	16.0	14.3	6.6	8.5	8.2	1,230	14

Remarks:

- ICICI Bank continues to report strong growth in advances (up 17.6% YoY in Q2FY2013) with stable margins of 3.0%. We expect the advances of the bank to grow by 20% CAGR over FY2012-14. This should lead to a 13% CAGR growth in the net interest income in the same period.
- ICICI Bank's asset quality has shown a turnaround as its NPAs have continued to decline over the last eight quarters led by contraction in slippages. This has led to a sharp reduction in the provisions and an increase in the profitability. Going forward, we expect the NPAs to decline further which will lead to lower NPA provisions and hence aid the profit growth.
- Led by a pick-up in the business growth and an improvement in the margins the RoEs are likely to expand to about 13% over the by 13% in FY14 (consolidated RoE ~15%) while the RoA would improve to 1.5%. This would be driven by a 16% CAGR in profits over FY2012-14.
- The stock trades at 1.7x FY2014E book value. We expect the stock to re-rate, given the improvement in the profitability led by lower NPA provisions, a healthy growth in the core income and improved operating metrics. We recommend Buy with a price target of Rs1,230.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target	Upside (%)
		FY12	FY13E	FY14E	FY12	FY13E	FY14E		
Larsen & Toubro	**1,707**	24.6	21.7	19.4	18.1	17.7	17.3	**1,788**	5

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) boom.
- L&T continues to impress us with its good execution skills, reporting decent numbers throughout this year despite the slowdown in the industrial capex cycle. While there has been a growth of 11% YoY in its order backlog to Rs158,528 crore, the order inflow remained rather muted (excluding spill-over orders) in Q2FY2013.
- Despite challenges like deferral of award decisions and stiff competition, the company has given robust guidance of 15-20% in revenue and order inflow for FY2013. While this seems an uphill task, it instills confidence amongst the investors.
- Though the company reported overall decent results for the quarter, but the order inflow guidance would be highly subjective to an uptick in the infrastructure development activities in the country and in the Middle East region.
- Sound execution track record, bulging order book and strong performance of its subsidiaries reinforce our faith in L&T. With the company entering new verticals, namely solar and nuclear power, railways, and defence, there appears a huge scope for growth.
- At the current market price, the stock is trading at 19.4x its FY2014E stand-alone earnings and at an EV/EBIDTA of 11x.

Name	CMP (Rs)	PER FY12	PER FY13E	PER FY14E	RoE FY12	RoE FY13E	RoE FY14E	Price target	Upside (%)
M&M	**877**	19.5	16.9	17.6	22.8	22.1	18.4	**949**	8

Remarks:

- Mahindra & Mahindra (M&M) is a strong rural India story benefiting from the rising agriculture incomes. The farm equipment sector is estimated to grow by 5-8% in H2FY2013 as compared with a decline in H1FY2013. Continued farm mechanisation following labour shortages and increasing non-agri uses would support the demand for tractors in the long term.
- The automotive sector is expected to grow by 10-12% in FY2013. The new launches, such as *Qunato* and *Rexton*, have expanded the existing UV portfolio. The pick-ups portfolio has benefited from the shift towards large pick-ups where M&M has a higher market share.
- The company's pricing power is better compared with the other OEMs because of its strong brand equity. It took price hikes aggressively to maintain the margins in both the automotive and the farm equipment division. The company is expected to launch *Reva* electric *NXR* and sub-four meter *Verito* in H2FY2013.
- Our SOTP-based price target for M&M is Rs949 per share as we value the core business at Rs721 a share and the subsidiaries at Rs228 a share. We recommend Buy on the stock.

Name	CMP	PER (x)			RoE (%)			Price	Upside
	(Rs)	FY12	FY13E	FY14E	FY12	FY13E	FY14E	target	(%)
Persistent Systems	**471**	13.3	10.5	8.7	17.9	19.7	20.1	**552**	17

Remarks:

- Persistent Systems Ltd (PSL) is a niche player in the highly under-penetrated outsourced product development (OPD) market. PSL has helped its customers develop over 3,000 products over the last five years. With strong domain expertise and years of experience in the OPD business, PSL is well placed to garner the incremental spending taking place in the global R&D space.
- PSL has consistently invested in the areas of innovative technologies (cloud computing, analytics, collaboration and mobility) to penetrate deeper into clients' wallet and the expertise that it has built in these areas over the years has started reflecting in its numbers. In the last two years, these four areas have contributed close to 40% of the total revenues and their combined contribution is poised to increase in the coming years with the increasing size of the funnel of orders in these segments.
- PSL continues to invest in acquiring and building intellectual property (IP) to gain a foothold in the non-linear side of the business. Its IP-led revenues have grown from 1.5% of total FY2007 revenues to 8.8% of total FY2012 revenues. Going forward, the management is aiming to earn 20% of its revenues from the non-linear space in the next three to four years. This, we believe, will differentiate the company from the rest and help improve its margin in the coming years.
- Its earnings are expected to grow at a CAGR of 23.5% over FY2012-14. At the current market price, the stock trades at 10.5x and 8.7x FY2013 and FY2014 earnings estimates respectively.

Name	CMP	PER (x)			RoE (%)			Price	Upside
Relaxo Footwear	**726**	21.8	17.4	12.3	20.2	19.4	20.2	**885**	22

Remarks:

- Relaxo Footwear is present in the Indian organised footwear market and is involved in the manufacturing and trading of footwear through its retail and wholesale networks. The company's top brands, namely Hawaii, Sparx, Flite and Schoolmate, have an established presence among their respective segments.
- The company has displayed an impressive growth rate in its top line and bottom line in the last couple of years and is expected to maintain the performance going forward.
- With an established distribution set-up and aggressive plans of opening own retail outlets called "Relaxo Retail Shoppe", the company should be able to gain market share in the coming years.
- The softening rubber prices should provide a boost to the company's margins and profitability.
- We believe a rise in the raw material prices and a continuous slowdown in the discretionary spending remain the key risks to our volume and profitability estimates.
- At the current market price, the stock trades at 17.4x its FY2013E EPS of Rs41.7 and 12.3x its FY2014E EPS of Rs59.2.

Name	CMP (Rs)	PER (x)			RoE (%)			Price target	Upside (%)
		FY12	FY13E	FY14E	FY12	FY13E	FY14E		
Reliance Industries	**802**	13.1	13.0	12.3	11.5	10.4	9.9	**915**	14

Remarks:

- Reliance Industries Ltd (RIL) has a strong presence in the refining, petrochemical and upstream exploration business. The refining division of the company is the highest contributor to the company's 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 field has fallen significantly in the past one year. With the government approval for additional capex, we believe production will improve going ahead.
- In case of refining, the GRM, which had corrected sharply in Q1FY2013, showed signs of improvement in Q2FY2013. We believe the GRM is likely to sustain in the coming quarters.
- In the petrochemical business, the company's margins are close to bottoming out (with a sharp correction in Q1FY2013). In H2FY2013, we could see an improvement in the margin that will support the overall profitability of the company.
- In case of the upstream exploration business, the company has recently got the nod for further investments in exploration at the Krishna-Godavari basin, which augurs well for the company and could address the issue of falling gas output.
- The key concern remains in terms of a lower than expected GRM, profitability of the petrochemical division and the company's inability to address the issue of falling gas output in the near term.
- At the current market price the stock is trading at PE of 12.3x its FY2014E EPS.

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