

APRIL 2011 – NEWSLETTER

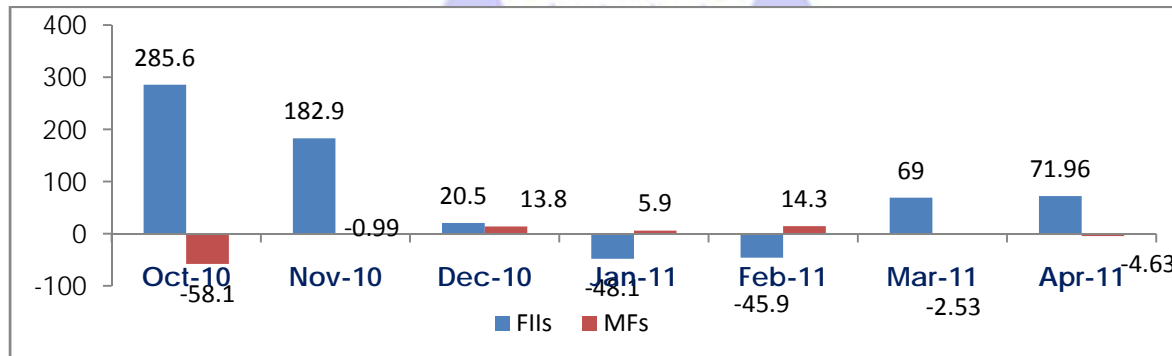
5TH MAY, 2011

The month of April, 2011 was jittery and nervous for investors due to domestic events. Key events like arrests of several high profile politicians and corporate icons in the 2G and CWG scams hampered the sentiments. The negative sentiments affected the telecom and real estate sector. In addition to this, Q4FY11 results from large caps like Infosys and Reliance were below street estimates which disappointed the markets which led to rerating of valuations. Overall Q4FY11 earnings during the month have been a mixed bag and concerns regarding inflation are still persisting.

The month also witnessed higher commodity prices leading to pressure in margins of the Capital Goods sector. Oil prices too, touched 3-month high. On the other hand Precious metals like gold recorded a new high and silver touched its 31- year peak.

Inspite negative events, good inflows were registered from global investors. FIIs bought worth Rs. 71.9bn whereas the Mutual Fund investors remained sellers and sold worth Rs. 4.6bn

Trend in FII and MF activity in equity (Rs. bn)



Source: SEBI, Money control

Monthly indices

Index	29 th April, 2011	31 st March, 2011	% change
Dow Jones	12,810.5	12,319	3.9
FTSE	6069	5,954	1.9
Hang Seng	23,720.8	23,527	0.8
Nikkei	9945.5	9,755	1.9
Nifty	5,749.5	5,834	(1.5)
Sensex	19,135.9	19,445	(1.6)
BSE -Midcap	7,094.2	6,873	3.2
BSE-500	7,427.1	7,437	(0.13)

Source: Ajcon Research

Recently RBI came out with the monetary policy on 3rd May, 2011.

Key highlights: RBI's Monetary Policy: 2011-12

In order to control inflation pressures, the Reserve Bank of India has raised key rates by a higher-than-expected 50 basis points. It has raised the repo rate, by 50 bps to 7.25%, and the reverse repo, by 50 bps to 6.25%. Bank rate and CRR has been kept unchanged at 6%

This action came in after India's headline inflation had overshot even the most pessimistic projections. With this stance too, RBI expects inflation to remain at higher levels, in the first half of 2011-12. On the basis of recommendation by Deepak Mohanty Committee for reviewing Operating Procedure of Monetary Policy, following measures have been announced effective from the fortnight beginning 07 May, 2011

- a) The **weighted average overnight call money rate will be the operating target of monetary policy** of the Reserve Bank.
- b) **There will henceforth be only one independently varying policy rate and that will be the repo rate.** The transition to a single independently varying policy rate is expected to more accurately signal the monetary policy stance.
- c) The **reverse repo rate will continue to be operative but it will be pegged at a fixed 100 basis points below the repo rate.** Hence, it will no longer be an independent rate.
- d) A new **Marginal Standing Facility (MSF)** will be instituted from which SCBs can borrow overnight up to 1% of their respective NDTL. The rate of interest on amount accessed from this facility will be 100 basis points above the repo rate. This facility is expected to contain volatility in the overnight inter-bank market.
- e) As per the above scheme, the **revised corridor will have a fixed width of 200 basis points.** The repo rate will be in the middle. The reverse repo rate will be 100 basis points below it and the MSF rate 100 basis points above it.
- f) While the width of the corridor is fixed at 200 basis points, the Reserve Bank will have the flexibility to change the corridor, should monetary conditions so warrant.

Monetary Projections:

- a) FY12 baseline GDP growth expected to be around 8%, but range decided at 7.4-8.5%.
- b) Baseline WPI inflation target for March 2012 is at 6%. However, expectation is of inflation remaining elevated in H1FY12 (~9% factoring in fuel price hikes) before it starts to gradually cool down in second half.
- c) FY12 Money Supply growth estimated at 16.0%
- d) Credit growth at 19%
- e) Deposit growth at 17%

Regulatory Measures:

- 1) Savings Bank Deposit Rate has been hiked by 50bps to 4.0% currently, till further clarity over the process of savings bank rate deregulation emerges

2) Enhancement of Rates of Provisioning for Non-Performing and Restructured Assets which would have a negative impact on the NIMs

- a) Advances classified as “sub-standard” will attract a provision of 15% versus 10% currently (the “unsecured exposures” classified as sub-standard assets will attract an additional provision of 10%, i.e., a total of 25% as against the existing 20%)
- b) The secured portion of advances which have remained in “doubtful” category up to one year will attract a provision of 25% versus 20% currently
- c) The secured portion of advances which have remained in “doubtful” category for more than one year but upto three years will attract a provision of 40% versus 30% currently
- d) Restructured accounts classified as standard advances will attract a provision of 2% in the first two years from the date of restructuring, or in cases of moratorium on payment of interest/principal after restructuring, for the period covering moratorium and 2 years thereafter (as against existing provision of 0.25-1.00%, depending upon the category of advances); and
- e) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2% in the first year from the date of upgradation (as against existing provision of 0.25-1.00%, depending upon the category of advances).

Outlook

We believe that this stance has been to control the inflationary pressures. This would affect growth in the short term. RBI's action of increase in the savings bank rate and provisioning requirements for non-performing and restructured assets could have a huge bearing on the earnings of public as well as private sector banks. This action would ***is likely to put pressure on the bottomline of banks, especially for PSU banks who have larger portfolio of the restructured assets as compared with the private banks.***

Ajcon's view on equity markets

We believe that there would be major headwinds like inflationary concerns in the domestic economy which would pressurize the earnings of companies due to hike in interest rates. We expect sectors like Banking, Real Estate, Infrastructure and Auto to remain under pressure in H1FY12. However, we also do believe that every fall below 5500 Nifty levels should be considered as an opportunity to pick some top stocks.

In this newsletter, we have touched upon the Shipping Sector on the macro level. Please find a brief study on the shipping sector below:

Shipping Industry

The shipping industry provides a base to international trade, as it is the only cost effective mode of transporting large volumes of many essential commodities and finished goods.

In 2008, total annual world seaborne trade amounted to 8.7 billion tonnes of goods (loaded). Dry cargo, including bulk, break bulk and containerized cargo, accounted for the largest share of

goods loaded (66.3%) while oil and related products made up the balance (*Source: International Shipping and World Trade - facts and figures - IMO*).

The United Nations Conference on Trade and Development (UNCTAD) estimates that the operation of merchant ships contributes about US\$380 billion (Rs. 17,069.60 billion) in freight rates within the global economy, equivalent to about 5% of total world trade.

World Seaborne Trade: Maritime transport has generally been associated with the carriage of high-volume, low-value goods such as iron ore and coal. However, over recent years the share of low-volume, high-value goods such as manufactured goods carried by sea has been growing. This shift is a function of global and regional GDP growth and a growing dislocation between the locations of resources, manufacturing bases and key areas of consumption.

World seaborne trade has grown almost continuously since the 1970s. The growth in world seaborne trade is strongly influenced by any changes in global industrial and economic development trends (*Source: Review of Maritime Transport, 2008, UNCTAD (UNCTAD/RMT/2008)*). During the past three decades, the annual average growth rate of world seaborne trade is estimated to have been 3.1% per annum. At this rate of growth, UNCTAD expects global seaborne trade to increase by 44% in 2020 and double by 2031, potentially reaching 11.5 billion tonnes and 16.04 billion tonnes, respectively (*Source: Review of Maritime Transport, 2008, UNCTAD (UNCTAD/RMT/2008)*).

World Merchant Fleet: As of January, 2009, the world merchant shipping fleet reached 1.19 billion DWT in the aggregate, representing 6.7% growth over the last year (*Source: Review of Maritime Transport, 2009, UNCTAD (UNCTAD/RMT/2009)*).

There are four main segments in the shipping industry: bulk carriers, which transport such raw materials as coal and grains; tankers, which transport commodities like crude oil, petroleum products and chemicals; container vessels, which transport freight shipped in containers; and gas tankers which transport mostly liquefied petroleum gas (or "LPG") and LNG.

The size of vessels that comprise the world merchant shipping fleet has grown over time. According to UNCTAD, as of January, 2009, 57.2% of such vessels were more than 20 years old. On the other hand, only 23.8% of vessel tonnage is more than 20 years old. Younger vessels thus contribute more total DWT to the world merchant shipping fleet (*Source: Review of Maritime Transport, 2009, UNCTAD (UNCTAD/RMT/2009)*).

Baltic Dry Index

The Baltic Dry Index (BDI), which tracks global international shipping prices of various dry bulk cargoes, has fallen almost 50% in the past six months due to vessel oversupply. While the BDI represents a more global picture, the Indian scenario is not much different with most local shipping companies seeing dry-bulk and tanker rates staying distressed.

Among Indian shipping firms, Essar Shipping, Shipping Corporation of India (SCI), Mercator Lines and GE Shipping have presence both in the tanker and dry-bulk segments. SCI and GE both

have around 60% of its dry-bulk fleet on spot rates, while Mercator has 15% to 20%, according to the data with company sources. On the tanker side, SCI has a dynamic exposure, with around one-third capacity deployed on spot rates. Rates for vessels in the spot markets are determined on a daily average basis based on the market conditions.

Outlook

We believe, 2011 would be a difficult year for shipping because the excess supply (of tonnage) will continue to put pressure on freight rates. 2010 was a record year for delivery (of new ships). 2011 will be closely following that, and thereafter it will drop. On the demand side, there will be growth despite the financial difficulties in the Euro region and in the US. While the global fleet for dry-bulk is expected to grow at around 13% in 2011, trade is expected to grow only by 8%, resulting in a demand-supply gap of around 5%. The tanker segment is facing a much worse situation.

The year 2010 witnessed good demand growth. Dry bulk segment registered a growth of 10 per cent and tanker segment clocked 3.4-4 percent growth. This growth is attributed to the low base of 2009, when global trade had actually plummeted. But supply growth has been higher than demand growth and that put pressure on freight rates, which remained subdued. Despite the severe winter, the energy demand has not reached the expected level and the tanker rates have not gone up. The impact of excess supply (of ships) is expected to continue till early 2012.

Thereafter, there will be a reasonable chance for a decent revival in rates. This is because 2009 was a historic low for new ship orders and therefore delivery of new ships will be very limited in 2012. But the growth in demand will continue following the expected global economic recovery. So, there will be demand supply equilibrium by 2012.

Although there is supply pressure in the shipping sector, our top pick from the shipping sector is Mercator Lines on account of factors like:

Diversified revenue stream, b) long term charter contracts, c) favorable debt: equity ratio of 1.44x as on H1FY11 d) value unlocking tin coal business through expected demerger, e) dynamic management and f) cheap valuations.

Key extracts of the interview with the management of Mercator Lines Ltd.:

The company is facing pressure in the shipping industry especially in the tanker segment where margins have severely deteriorated. The company attributes the downturn in the performance due to global slowdown in shipping industry. Since, 2007, it believes that there has been an increase of ship fleet by 25%. According to the management, it would take another two quarters to absorb oversupply. Turnaround in the shipping segment would be on demand recovery in America.

As the shipping business, is linked to commodity prices, the management attributes the current high commodity prices to be speculative as compared to prices of commodity in 2007, which

were backed by actual demand, being the culprit of the global slowdown in the shipping industry. However, the dredgers of the company are fully occupied (100% occupancy) for the next two quarters (Q1FY12 and Q2FY12). It is also optimistic in the offshore business; it is concentrating on scaling up its floating production and storage business where it has long term charter contracts as against jack up rig segment where it has exited.

The management is very bullish on its coal business which contributed 50% of the total revenues in Q3FY11 and 21.4% of 9MFY11 revenues. According the management, the coal business would unlock value for its shareholders on demerger. It expects demerger to be completed in a year's time. It may be noted, its just a thought that company plans to unleash and no formalities have been started yet. In volume terms in coal business, the company has done 5 mn tones in FY11 (1 mn – Mining and 4mn tones for Procurement and Logistics). Going forward, it targets 7 mn tones (1.5 mn tones – Mining and 6.5 mn tones: Procurement and logistics) in FY12 and 10 mn tones (3mn tones: Mining, 7 mn tones: Coal Procurement) by FY13. 70% of coal is sold in India whereas the balance is exported to countries like Pakistan, China, Sri Lanka and Thailand.

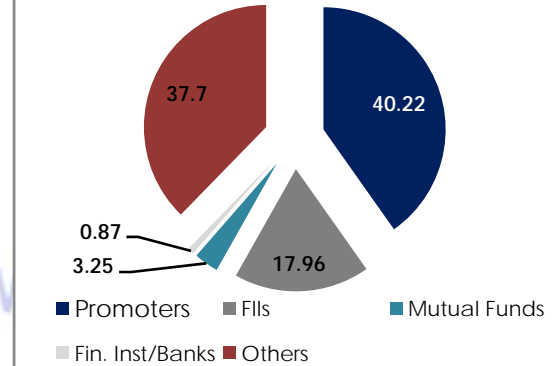
Please find below the detailed note on Mercator Lines.



TOP PICK IN SHIPPING SPACE – Mercator Lines Ltd.

COMPANY	MERCATOR LINES LTD.
Industry	Shipping
NSE Code	MLL
BSE Code	526235
FV	Re.1
Equity Capital (Rs in mn)	236
Market Capitalization (Rs in mn)	9,224
CMP	Rs. 39
Target Price	Rs. 55
Upside	41%

Shareholding pattern (%) as on March, 2011



FINANCIAL SUMMARY

INCOME STATEMENT (Rs. in mn.)

Particulars	FY09	FY10	FY11E*	FY12E*
Net sales	22,105	18,087	27,500	36,500
Operating Profit	9,493	6,449	6,650	7,300
OPM (%)	42.9	35.7	24.2	20
Reported PAT	3,789	533	1,155	1,825
PAT (%)	21.2	5.8	4.2	5
EPS	16.1	2.27	4.9	7.7
P/E(x)	2.4	17	8	5
P/BV(x)	0.47	0.50	0.47	0.45
ROE(%)	16.7	2.5	5	7.5
ROCE(%)	13.9	5.7	7	8.5

Source: Company, Ajcon Research, *Note: Projected figures for FY11E and FY12E are street estimates

ABOUT THE COMPANY

Background

Incorporated in 1983, the company has evolved from a lighter age operator to a fully integrated shipping company. Today, it is the second largest private sector company in India (by aggregate fleet tonnage capacity with global presence through its subsidiaries). It was in 1989, that the current promoter of the company took charge of the operations and entered into the tanker and dry bulk segments. The company along with its subsidiaries has diversified interests in Tankers, Bulk Carriers, Dredgers, Offshore drilling, Coal Mines and Logistics. Its current fleet

comprises of 30 vessels, which includes 17 dry bulk carriers, seven crude/product tankers, four dredgers and two floating storage units. The company's consolidated shipping fleet capacity was ~3.47 mn DWT (dead weight tones) as on March 2010.

The company also owns coalmines in Indoneasia and Mozambique. The group caters to Indian/International oil majors, large thermal based power plants and steel companies. The group has established relationships with its reputed end user customers such as Indian Oil Corporation, BG Exploration and Production, Major Ports in India, Vale, Tata Power, Arcelor Mittal Group, COSCO group and Afren PLC.

Employing a large part of its fleet on long term contracts, specifically time charters and contracts of affreightment ("COAs")/consecutive voyage ("CV") has been the group's strategy. Its long term fixed rate contracts, ranging from 11 months to five years and above, ensures revenue visibility and cash flow stability.

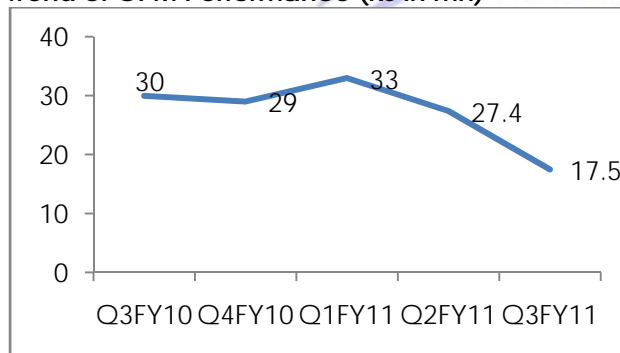
INVESTMENT RATIONALE

Q3FY11 Result update

On a yoy basis, revenues of the company witnessed yoy growth of 65.8% to touch Rs. 7,754mn. This was mainly on account of coal division contributing more than 50% of topline in Q3FY11. Coal division witnessed a yoy increase of 171% and 52% on qoq basis to touch Rs. 4,212 mn.

On the margin front, OPM witnessed a decline of 1,270 bps to touch 17.5% in Q3FY11, while on qoq basis OPMs registered a decline of 993 bps. This was mainly attributable to increase in operating expenses and higher vessel charges.

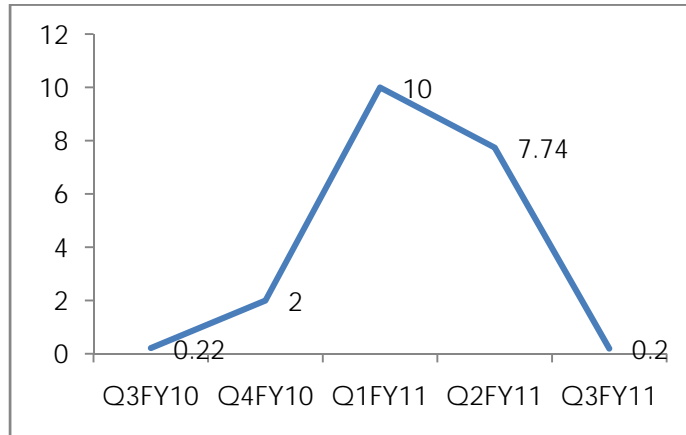
Trend of OPM Performance (Rs in mn)



Source: Company, Ajcon Research

PAT witnessed yoy growth of 56% to touch Rs. 16 mn, whereas on qoq basis, PAT registered a decline of 97%. PAT margin was under pressure and registered a decline of 759 bps on qoq basis to touch 0.2% in Q3FY11.

Trend in PAT margin (in %)



Source: Company, Ajcon Research

Key development in Q3FY11

It has contracted to sell its jack up rig to Greatship Ltd., which is a subsidiary of GE shipping. With this event, the company has completely exited the offshore business as it intends to focus and scale up its floating production and storage business.

Inherent advantages

a) Diversified revenue stream

Segment	Contribution to revenues (FY10)	Activities	Clients	Operating days (FY10)	Time charter equivalent (FY10)
Dry Bulk Segment	37%	Transportation of Coal	Vale, Arcelor Mittal, Tata Power, COSCO	5,038	US\$26,310
Coal Segment	24%	Coal Mining, Coal Trading, Coal transportation and logistics for Thermal Power Stations	BSES	-	-
Tankers Segment	25%	Transportation of Crude and Oil Products	IOC, MRPL, Reliance, British Gas, Chevron	3,541	US\$14,684
Dredging Segment	5%	-	-	1,090	US\$13,557
Offshore Drilling	9%	-	-	-	-

Source: Company

Segment contribution in Q3FY11 and 9MFY11

Segment	Contribution to revenues (Q3FY11)	Contribution to revenues (9MFY11)	EBIT Margin (%) Q3FY11	EBIT Margin (%) 9MFY11
Shipping	41.1	70.6	(0.28)	15.5
Offshore	4.9	8	74.3	74.3
Coal	54	21.4	8.85	20.6

Source: Company

Long term charter contracts

The company has long term contracts in the dry bulk segment thus insulating it from any volatility in the dry bulk rates.

Coal business to drive growth

The company expects to trade ~10 MTPA of coal in FY12E as compared to 4MTPA in FY10. The coal division contributed 54.3% in Q3FY11 with an EBIT margin of 8.85%.

Key concern

Promoters have pledged 33.4% of their stake in the company

OUTLOOK AND VALUATION

At the CMP, the stock is valued at 5x at consensus estimated FY12 EPS. As per consensus estimates, the company is expected to witness revenue CAGR of 42% and earnings CAGR of 85% over the period FY10-12E.

We believe freight rates to be volatile given the uncertainty in global oil demand after the recent quake in Japan, which would affect the operating performance of the tanker division. Considering rising oil prices due to political tensions in MENA (Middle East -North Africa) region, its OPM would be affected due to higher bunker costs. As evident from Q3FY11 results, the company has increased its focus on low margin coal trading and mining activities, which would lead to decline in overall margin of the company in the next few years. However, the operating cashflows are positive and are expected to remain so.

With due consideration to factors like a) diversified revenue stream, b) long term contracts, c) favorable debt: equity ratio of 1.44x as on H1FY11 and d) positive operating cashflows and cheap valuation, we recommend **'BUY'** with a target price of Rs. 55(0.6x estimated FY12 Book Value) for investors with a horizon of 6-9 months.

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