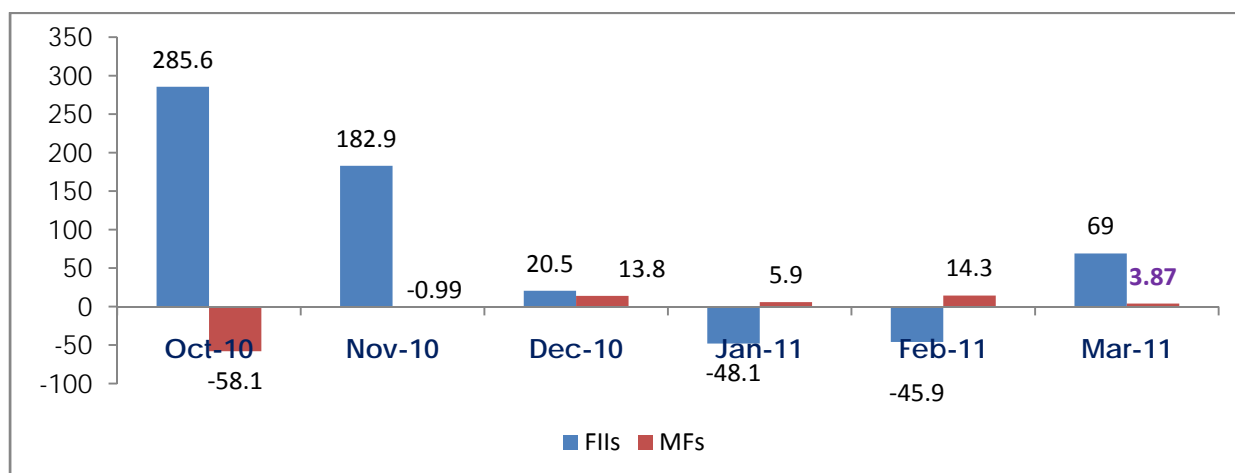


MARCH 2011 – NEWSLETTER

The month of March has been action oriented for the Indian markets due to external events. The unfortunate natural disaster in Japan depressed the sentiments of the investors, both globally and domestic. The overall impact of this mega negative event can be only ascertained over the next few months. We believe, Japan is aggressive on its rebuilding path. The government has estimated that rebuilding exercise would cost the government, approximately Yen 25 trillion (US\$298 bn) which is equivalent to ~5% of one year's Japanese GDP.

Despite this major concern in Japan and other pressures like high oil prices, and inflationary concerns, FIIs have been on a buying spree in the later part of March 2011. Total purchases by FIIs have been Rs. 69 bn, with majority of buying coming in the last eight days of March 2011.

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



Source: SEBI, Money control, Note: March, 2011 MF activity is up to 30th March, 2011

Monthly indices

| Index | 31 st March, 2011 | 28 th February, 2011 | % change |
|--------------------|------------------------------|---------------------------------|----------|
| Dow Jones | 12,319 | 12,226 | 0.76 |
| FTSE | 5,954 | 5,994 | (0.7) |
| Shanghai Composite | 2,929 | 2,905 | (0.8) |
| Hang Seng | 23,527 | 23,338 | (0.8) |
| Nikkei | 9,755 | 10,600 | (8) |
| Nifty | 5,834 | 5,334 | 9.3 |
| Sensex | 19,445 | 17,823 | 9.1 |
| BSE -Midcap | 6,873 | 6,373 | 7.9 |
| BSE-500 | 7,437 | 6,850 | 8.5 |



As the Japanese Government feared an economic derail due to this natural event, the Bank of Japan increased its asset-purchase program to US\$183.7 bn. This was based on the expectation that, increasing the purchases will help ward off any financial crisis.

We believe, the unfortunate earthquake would have limited impact on Indian companies' performance as exports to Japan are small. However, there would be an indirect impact on India's nuclear energy policy.

In the western globe, concerns of recession in US are receding as the economy has gained traction in terms of manufacturing and consumer spending. This is mainly supported by Federal Reserve's expansionary monetary policy. As far as European Financial Markets stability is concerned, there would be some near term pressure on the European Financial Stability fund. It was a second consecutive good month in terms of job growth for the US economy, when non-farm payrolls rose by 190,000, according to a Reuter's poll. This is a testimony to the improving labor market in the midst of broader economic recovery. While improving economic performance is lifting industrial demand for energy in the US, high prices at the pump are damaging consumer confidence and capping gasoline demand.

In the domestic market, we believe the sentiments have improved, post budget. We have seen a good rally of ~10% in Nifty in last 8-10 trading sessions. We feel, going ahead there would be some correction which would present opportunity for value based stock pickers in the mid caps segment. We advise investors, to enter into midcaps space post correction in Nifty/Sensex of 5-6%, as we believe there is still some value left in the midcaps space.

We remain positive on India's long term consumption story, although there may be immediate headwinds like higher inflation and volatility in oil prices. The present higher levels with Nifty going up by another 100 points, should be taken as an opportunity to book profits in short run.

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

Fertilizer Industry

Indian fertilizer industry provides for three primary nutrients: nitrogen-N, phosphate-P2O5 and potash- K2O. The industry also manufactures complex fertilizers (N:P:K), which are a combination of three nutrients. Urea (46% N), ammonium sulphate or AS (20.6% N), calcium ammonium nitrate or CAN (25% N), ammonium chloride or ACI (25% N) are the straight nitrogenous N-fertilizers manufactured. The complex fertilizers comprise a combination of two or three nutrients and are referred to as NP or NPK fertilizers. These include 16:20:20, 20:20:0, 14:28:14, 14:35:14, 17:17:17, 19:19:19, 16:20:0, 15:15:15, 20.8:20.8, 23:23:0, 10:26:26, 12:32:16 and 20:0:10.

India imports ~90% of its phosphatic fertilizer requirement and imports its entire requirement of muriate potash.



Indian fertilizer industry have high barriers to entry in the form of a) high capital costs, b)delays in subsidy payments, c)high working capital requirement and d) government approval for setting up a urea plant.

Feedstock is a major cost component for the fertilizer companies. However, Government's subsidy mechanism largely insulates companies from input cost volatility, as agricultural subsidies are disbursed primarily through input subsidies, which have proved beneficial to increase the yield of crops. The government also provides output-rice support. It is in the form of assured returns to the companies through concession schemes.

Nutrient Based Subsidy Policy

Under this policy, the government fixes subsidy on basic nutrients, i.e nitrogen, phosphorous, potash, sulphur based on the proportion of these nutrients. This will incentivize farmers and fertilizer companies to use more complex fertilizers.

In the past, for all non urea fertilizers, MRP was fixed by the government for sale of fertilizers to farmers and fertilizer companies were compensated for the difference between the cost of production and MRP. However under the NBS, fertilizer companies can decide the selling prices as the subsidy portion is fixed.

The government recently revised nutrient subsidy rates to mitigate the effects of increase in feedstock prices. We believe, revision in subsidy rates would be beneficial to complex fertilizer manufacturers as it would help them to maintain their profitability. The policy aims at increasing the efficiency in procurement of raw materials and operations which would result in higher margins. With this policy, we believe there would be gradual reduction in subsidy outflow as there would be an increase of farm gate fertilizer prices.

The revision in 2011-12 rates is higher than the rates notified in November 2010 and also higher as compared to 2010 -11

| Nutrients | Subsidy per nutrient | | |
|-----------------|----------------------|---------|------------|
| | 2011-12 | 2010-11 | Change (%) |
| Nitrogen (N) | 27.5 | 23.2 | 18.3 |
| Phosphorous (P) | 29.4 | 26.3 | 11.9 |
| Potassium (K) | 24.6 | 24.5 | 0.6 |
| Sulphur (S) | 1.7 | 1.8 | (5.2) |

Source: Department of Fertilisers

With the current revision in nutrient rates (and comparative benchmark rates), it would be difficult for players to contract import volumes as the new rates are at a discount to current landed prices.

For eg: The total realization (sum of subsidy and retail price) at the revised benchmark rate for Di Ammonium Phosphate (DAP) amounts to about US\$630 per ton, while international prices are

currently about US\$690 per ton(landed cost), which results into a loss of US\$ 60 per ton in the current subsidy dispensation.

| Benchmark US\$/ton | FY12 (Revised) | FY11 | %change |
|--------------------|----------------|------|---------|
| Urea | 350 | 310 | 12.9 |
| DAP | 580 | 500 | 16 |
| MOP | 390 | 370 | 5.4 |
| Sulphur | 180 | 190 | (5.3) |

Source: ICRA

Total budgeted subsidy amount fertilizer sector is Rs. 630 bn. FY12 subsidy requirement would be over ~Rs.700bn. Earlier in FY11, revised estimates pegged fertilizer subsidy at Rs. 550 bn.

Major players present in this sector

| Fertiliser | Major Players |
|---------------------|---|
| Urea | IFFCO, RCF, Chambal Fertilizers, National Fertilizers, Nagarjuna Fertilizers, Tata Chemicals, Kribhco |
| DAP | IFFCO, Coromandel International, GSFC, Paradeep Phosphates, Tata Chemicals, Zuari Industries |
| MOP | Zuari Industries, Coromandel International, Tata Chemicals |
| Complex Fertilizers | Coromandel International, Zuari Industries, GSFC |

Steps taken by the government in the past budget:

- FY11 budgeted fertilizer subsidy of Rs. 500 bn, was lower than subsidy of Rs. 530 bn in FY10. The government had assured of disbursing all subsidy in cash as against partial payment in bonds in previous years.
- It also introduced Nutrient Based Subsidy scheme on DAP/complex fertilizers resulting in fixed subsidy – floating price regime – enabling all complex fertilizer companies to charge their own prices to the farmers.
- With effect from April 2010, Urea prices were increased by 10% to the farmers
- Excise duty was rolled back from 8% to 10%

The following were the expectations of the industry in this year's budget:

Industry had expected, Urea to be brought under the preview of NBS, to reward efficient players. Gas based players can be compensated through gas pooling arrangements while non-gas based players should be compensated for their high input cost, until adequate infrastructure is in place.

Actual outcome in current budget Government is actively considering extension of the NBS regime to cover urea, to move towards direct transfer of cash subsidy to people living below poverty line in a phased manner for better delivery of fertilizers.

Outlook on Fertilizer Sector

We believe, domestic demand for fertilizers would continue to remain high. This would result in higher imports, leading to low off take risks for domestic manufacturers as their entire production is likely to find ready buyers. The government has already declared its intention to continue with its nutrient-based subsidy (NBS) in FY12 for phosphate-based and potassium-based fertilizers (P and K), albeit at reduced rates. The adequacy of these rates will depend upon the international prices of relevant commodities and the industry's ability to secure these commodities at competitive rates. The NBS has received an enthusiastic response from the industry since its introduction in FY11. The next step for the government would be the inclusion of urea under the NBS.

We at Ajcon believe, higher NBS rates would be positive for fertilizer companies like **GSFC**, RCF, Tata Chemicals, Coromandel international, Zuari Industries and Deepak Fertilisers. Higher NBS rates would also benefit companies like Chambal and Nagarjuna Fertilizers who are engaged in fertilizers importing. Our top pick in this space is GSFC. The detailed recommendation on GSFC is given below.

| AJCON'S INVESTMENT PICK IN FERTILIZER SPACE - GSFC | | 31 ST MARCH, 2011 |
|---|------------------|------------------------------|
| Company | GSFC Ltd. | |
| BSE Code | 500690 | |
| FV | Rs. 10 | |
| Equity Capital (Rs in mn) | 797 | |
| Reserves (Rs in mn) | 23,800 | |
| Book Value | Rs. 299 | |
| Market Capitalization (Rs in mn) | 27,337 | |
| CMP | Rs. 343 | |
| Target Price | Rs. 455 | |
| Upside | 33% | |

A) About the company

Background

The company was incorporated in 1962 by government of Gujarat. Currently, it holds 38% stake in the company. It is engaged in manufacturing of fertilizers like Urea, Di – Ammonium Phosphate(DAP) and other complex fertilizers. The company also manufactures industrial products like caprolactam, nylon 6 and other chemicals. GSFC has four manufacturing units located at Baroda, Surat and Jamnagar.

Investment Rationale

- 1) **Beneficiary of Nutrient Based Policy (NBS):** Previous subsidy scheme was not favorable to GSFC as subsidies were based on actual cost of production of ammonia irrespective of global ammonia prices. With the introduction of NBS, the company has been



gaining from lower cost of ammonia as compared to players who are dependent on imported ammonia. DAP contributes ~71% of the fertilizer revenues. OPM of the company has improved after NBS policy too. EBIT margin witnessed improvement in the first two quarters in H1FY11. EBIT margin touched 13% in Q1FY11, 19.7% in Q2FY11 and in Q3 FY11. Going ahead, we believe the company is set to benefit significantly, owing to growth in complex fertilizers which is likely to be higher in the next two years.

- 2) **Market leader in Caprolactum:** The company is a leader in the manufacturing of caprolactum with a capacity of 70,000 tons per annum. The other player in this space is FACT with a capacity of 50,000 tons.

Usage: Caprolactum is used in manufacturing of nylon 6 for textiles, tyre chord, moulding, engineering components and other extrusion profiles.

Contribution to revenues: On an average, caprolactum contributed 16% of total revenue over the last five years. In addition, spread between its raw material benzene required for producing caprolactum has widened. The spread had increased to US\$1,825/mt as against US\$1,200/mt in FY10. Despite 500 bps increase in Benzene prices, caprolactum prices have increased by 32% since January, 2010 to touch US\$ 2,850/mt till December, 2010. The segment witnessed good EBIT margins of 40% in Q3FY11 as compared to 19.4%/32.4% in FY10/9MFY11.

We believe, caprolactum prices are being driven due to supply side pressures. This is mainly on account of maintenance shut down of various plants and stocking in China and rising input costs.

- 3) **JV formation to result in DAP plant running at full capacity:** The company has formed JV with Tunisian companies like Groupe Chimique Tunisien (GCT) and Compagnie des Phosphates de Gafsa (CPG) and with domestic player - Coromandel Fertilizers Ltd. (CFL). Tunisian Indian Fertilizers (TIFERT - JV company) will produce 360,000 tons of phosphoric acid per annum. This will result in GSFC running DAP plant at full capacity since the production will be divided equally between GSFC and CFL. The project is expected to be operational in Q1FY12.
- 4) **Outlook and Valuation:** With due consideration to factors like a) well established brands, b) leadership in caprolactum, c) beneficiary of NBS policy, d) strong performance in 9MFY11, d) cheap valuations, we recommend a 'BUY' with a target price of Rs.455 (5x at annualized 9MFY11 EPS of Rs. 91) for investors with a 6-9 months horizon.



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