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INDIA

7 April 2017

Top Research Picks

- Mastek Technologies: New management steering growth revival

Other Research

- India Economics: RBI Monetary Policy Review - RBI narrows rate corridor amid focus on liquidity
- India Energy: Q4 Preview - Structural earnings trend emerging
- India IT Services: Q4 Preview - Expect a stable quarter

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INDIA
INFORMATION TECHNOLOGY

6 April 2017

NOT RATED

Mastek Technologies

MAST IN

New management steering growth revival

We met the management of MAST and key takeaways are: (1) New CEO John Owens has overseen improved execution in recent quarters and management's focus on select verticals and markets is driving a growth recovery. (2) The TaisTech acquisition (US$ 30mn revenue) gives MAST an entry into the US and looks to be highly EPS accretive. (3) Operating leverage is high and continued revenue momentum will drive margins, even as cash flows have improved and the balance sheet remains healthy. MAST is trading at 9x trailing P/E and 1.8x P/B – inexpensive given the acquisition will fully reflect in FY18. NOT RATED.

- **New management driving execution:** MAST is a UK-centric IT services company with revenues of ~US$ 105mn (trailing twelve months including TaisTech) and a focus on three key verticals – government (primarily UK), retail and FSI. The company's historical performance has been mixed, though both organic constant-currency growth and margins have recovered over the past 3-4 quarters following the appointment of a new management team led by CEO John Owens. The UK business is seeing market share upsides from contracts driven by G-Cloud and the DOS framework, as it allows MAST to bid directly with smaller TCVs (total contract value). Additionally, the new management's clear strategy of concentrating on the key UK and US markets bodes well.
- **US acquisition large and earnings-accretive:** In Dec'16, MAST acquired TaisTech for a total consideration of ~US$ 25mn (fixed consideration of US$ 14mn with the rest in earn-outs), as it aimed to scale up business in the US, build a digital footprint and reduce its UK market concentration risk. TaisTech is a digital commerce player (and an Oracle Gold Partner) with revenues of US$ 30mn and EBITDA margins in the mid-teens. This acquisition will provide MAST with much-needed scale (adds 39% to revenues), access to the US market and a higher margin profile, leading to EPS accretion from Q4FY17 onwards.
- **Room for growth-led margin recovery, balance sheet healthy:** With growth recovering over the past three quarters and a focus on cost optimisation, MAST's EBITDA margin has surged from 1% in Q4FY16 to 11% in Q3FY17. The company has net cash of Rs 536mn on its books post the acquisition. In addition, its investment in US-based Majesco is worth Rs 1.7bn and cash and investments is 52% of current market cap. The Majesco investment is financial in nature and management will look to cash in at an opportune time. Given the limited capex requirement, cash generation will improve – this could be used for distribution and/or acquisitions.
- **Valuations:** We believe that MAST's valuations, at 9x trailing P/E (Q3FY17 annualised), are inexpensive considering that EPS accretion from the acquisition will flow in from Q4 onwards. The new management team's focused execution strategy has translated to an improved performance from MAST over the past few quarters. Further, we believe the TaisTech acquisition will be highly accretive and its successful integration along with market share gains in UK government contracts will be the key drivers of stock performance. We do not have a rating on the stock.

REPORT AUTHORS

Rumit Dugar
+91 22 6766 3444
rumit.dugar@religare.com

Akash Nainani
+91 22 6766 3466
akash.nainani@religare.com

PRICE CLOSE (05 Apr 17)
INR 179.35

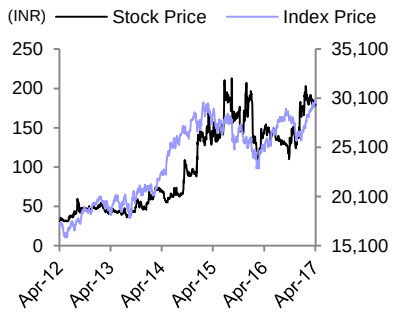
MARKET CAP
INR 4.2 bln
USD 0.06 bln

SHARES O/S
23.3 mln

FREE FLOAT
50%

3M AVG DAILY VOLUME/VALUE
0.3 mln / INR 12.3 mln

52 WK HIGH	52 WK LOW
INR 203.95	INR 109.00



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6 April 2017

RBI Monetary Policy Review

RBI narrows rate corridor amid focus on liquidity

In its first bi-monthly Monetary Policy Review for FY18, the RBI kept the repo rate unchanged at 6.25% but narrowed the policy rate corridor to +/-25bps. The reverse repo rate hike is set to push up money market rates. The RBI maintained its cautious stance on inflation with a focus on absorbing surplus liquidity. We think the rate cut cycle is over and that soaking surplus liquidity may exert some upward pressure on yields through FY18.

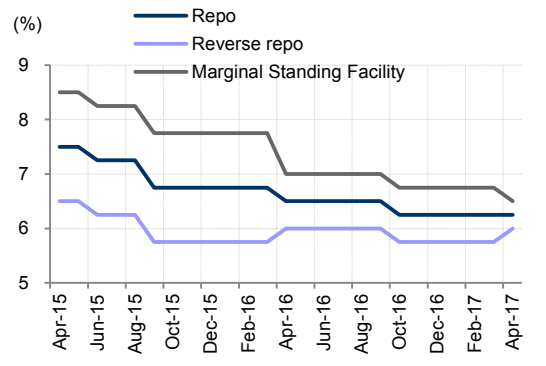
- **RBI narrows policy rate corridor:** The Monetary Policy Committee (MPC) kept the repo rate unchanged at 6.25% in its first bi-monthly Monetary Policy Review for FY18 held today. The move was along expected lines, given the sudden change in MPC's monetary policy stance from "accommodative" to "neutral" in its last meeting on 8 Feb'17. Surprisingly, it narrowed the policy rate corridor to +/-25bps from +/-50bps by hiking the reverse repo rate by 25bps (to 6%) and reducing the marginal standing facility (MSF) rate by 25bps (to 6.5%).
- **Money market rates to rise on reverse repo hike:** The move to narrow the policy rate corridor is in line with the Urjit Patel Committee's recommendations, and should help minimise volatility in the weighted average call rate (WACR; operating target of the Monetary Policy) and align it more closely with the repo rate. The WACR has averaged at ~6% over the last three months, towards the lower end of the corridor. With a 25bps hike in the reverse repo, the WACR and money market rates are likely to come under pressure, leading to an upmove at the short end of the yield curve.
- **Focus on liquidity:** As anticipated, liquidity remained the key focus of the meeting; the RBI maintained that it would progressively move to a neutral liquidity stance and steadily drain out the structural liquidity surplus created post demonetisation. Progressive remonetisation had brought down surplus liquidity in the banking system from Rs 8trn in Jan'17 to Rs 6trn in Feb'17 and further to Rs 4.8trn in Mar'17. The downtrend is set to continue in the near term as the currency in circulation expands; this in turn would help RBI gauge the extent of durable liquidity surplus before it takes any big mop-up measures.

  The RBI stated it would drain out any incremental surplus liquidity in the system with the help of variable reverse repos with a preference for long-term tenors, operations under the Market Stabilisation Scheme (MSS), OMO sales and issuance of cash management bills (CMBs). Besides, the RBI also considered introducing a Standing Deposit Facility (SDF) which would enable it to drain liquidity without providing any collateral (G-secs). However, the introduction of this measure would need amendments to the RBI Act. The interest rate on the SDF would be a key moniterable.

REPORT AUTHORS

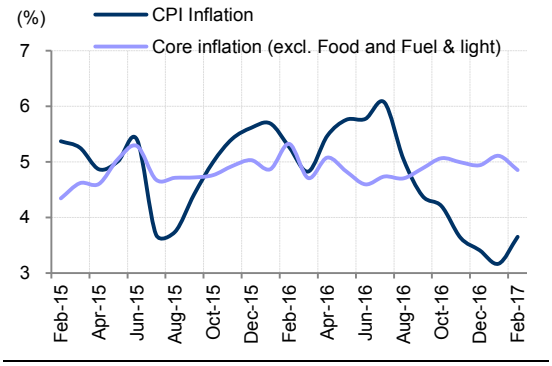
Rahul Agrawal
India Economist
+91 22 6766 3433
ag.rahul@religare.com

RBI narrows policy rate corridor



Source: RBI, RCML Research

Inflation declined sharply in the last 5 months



Source: MOSPI, RCML Research

RBI Monetary Policy Review

RBI narrows rate corridor amid focus on liquidity

Economics
INDIA

- **Cautious on inflation:** The RBI cited high upside risks to its FY18 inflation trajectory (4-4.5%/4.5-5% in H1/H2FY18) from (1) a deficient rainfall owing to the rising probability of an El Niño event and its implication on food inflation, (2) effects of implementation of the house rent allowances (HRA) under the 7th CPC, (3) GST rollout, (4) impact of farm loan waivers on the already-high general Govt. deficit and (5) a global reflation risk leading to higher commodity prices. Besides, household inflation expectations also edged higher in the Mar'17 round of the RBI's survey, with a hardening in price expectations across most product groups. The latest round of RBI's industrial outlook survey also suggests that pricing power is returning to corporates as input costs rise.

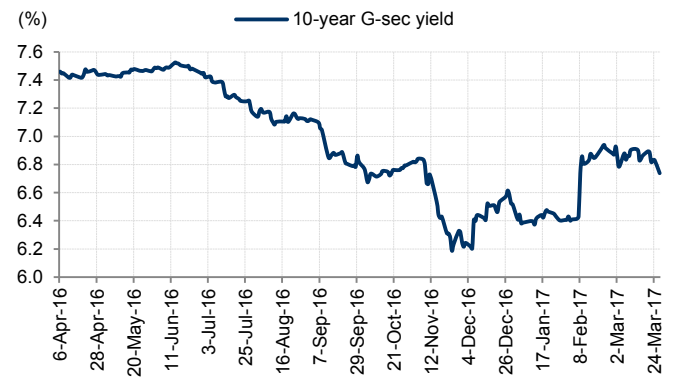
  On the downside, the recent fall in crude oil prices, sharp appreciation in the INR vs. the dollar and record food production should alleviate pressure on the headline inflation number.

- **Expect status quo on policy rates, focus on liquidity in FY18:** We believe upside risks to the RBI's inflation trajectory are significant and would constrain monetary easing through FY18. The RBI is yet to build in HRA hikes into its inflation projections, which alone should add 100-150bps to the headline number as per its own estimates. While the impact of HRA hikes and GST implementation would largely be temporary, we believe the RBI would wait for these events to play out before taking any action on rates. The "formalisation effect" stemming from the GST rollout and demonetisation could possibly exert an upward pressure on prices in FY18.

  Given the significant upside risks to inflation, the recent change in the monetary policy stance to "neutral" from ''accommodative'', and the continued focus on moving towards the 4% inflation target on a durable basis, we believe India is at the end of the rate cut cycle. The RBI would likely maintain its focus on (1) liquidity management with a move towards a neutral liquidity stance and (2) fuller transmission of the 175bps repo rate cuts already taken since the beginning of the easing cycle.

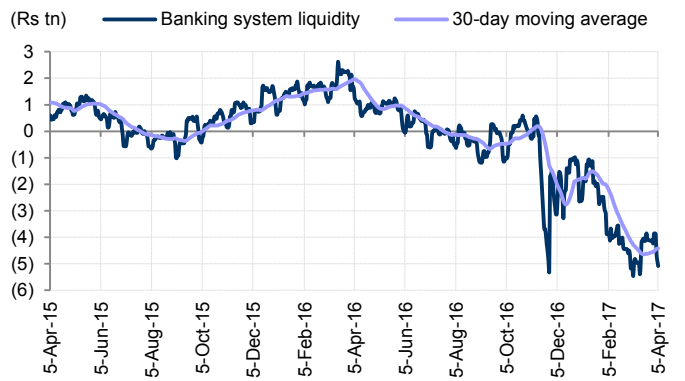
  Draining of surplus liquidity through FY18 is likely to exert upward pressure on the yield curve in the absence of policy rate cuts. The differential between interest rates on small savings schemes and bank deposit rates has widened, which is likely to impede monetary transmission. Rationalisation of interest rates on small savings schemes followed by deposit rate cuts could enable greater transmission of policy rates to bank lending rates.

Fig 1 - Yields have risen post last monetary policy meeting



Source: Bloomberg, RCML Research

Fig 2 - Banking system liquidity in surplus mode



Source: Bloomberg, RCML Research

7 April 2017

India Energy

Q4 Preview: Structural earnings trend emerging

We expect favourable macro trends to benefit both upstream and downstream energy players in Q4FY17. While oil prices have increased, GRMs and petchem margins have remained stable QoQ. Inventory losses of OMCs would be neutralised by a transient surge in marketing margins (in Mar'17) amid no changes in product prices during the state elections. Gas utilities would continue to see stable margins, while GAIL would be in focus due to improved petchem volumes. CGDs IGL and MAHGL would deliver robust earnings. Top picks: GAIL, IOCL, RIL and IGL.

- **GRMs to remain stable:** While headline Singapore GRMs have declined to US$ 6.4/bbl (-5% QoQ), high complex GRMs (RIL, IOCL's Paradip refinery) may remain flat on better light-heavy crude spreads. Refineries with high distillate yields would gain from a decline in fuel oil (FO) spreads and an improvement in petrol/ diesel (MS/HSD) spreads.

- **Petrochemicals cracks robust:** Polyester chain deltas improved during Q4FY17 led by PX and MEG, while polymers remained robust. Petchem margins for RIL and IOCL should marginally improve during the quarter. RIL's new capacity addition in PX (~0.8mmtpa) would be earnings accretive in Q4FY17 on improved PX spreads.

- **Gains for utilities on improving gas consumption:** We expect gas consumption to improve 2% YoY to 141-142mmscmd in Q4 on higher domestic gas supplies. CGD segment consumption has picked up as LNG prices retraced to US$ 5/mmbtu levels from a high of ~US$ 9/mmbtu in Jan'17. Note that PLNG and CGD companies are direct beneficiaries of low LNG prices; we expect LNG consumption to expand by another 4mmscmd from Q1FY18. GAIL would additionally gain from improved petchem volumes and higher LPG prices.

- **INR appreciation negative for cyclicals and upstream:** USD/INR reduction to sub-Rs 65 levels (if sustained over FY18/F19) threatens an earnings erosion of 2-8% across downstream and upstream companies. Earnings for ONGC (-8.1% for FY18/ FY19 at USD/INR of Rs 65), RIL (-6.8%), HPCL (-4.6%), BPCL (-3.2%) and OINL (-5.5%) are most sensitive to USD/INR movement. IOCL (diversified business model that includes pipelines) and gas utilities are least impacted.

- **Production to trend up for upstream companies:** OINL's production is likely to improve by 2.8% YoY to 1.54mmtoe, driven by a sharp increase in oil production (+6.3% YoY to 0.83mmt) and flat gas production (0.71bcm). ONGC's production is likely to remain flat (YoY) at 11.6mmtoe, as a 10% decline in oil production is neutralised by a 13.5% increase in gas production. However, INR appreciation and another cut in domestic gas prices could dent the outlook on earnings.

REPORT AUTHORS

Rohit Ahuja
+91 22 6766 3437
ahuja.rohit@religare.com

Akshay Mane
+91 22 6766 3438
akshay.mane@religare.com

RCML Energy universe

Company	Ticker	Rating
Reliance Industries	RIL IN	BUY
Indian Oil Corp	IOCL IN	BUY
Bharat Petroleum Corp	BPCL IN	SELL
Hindustan Petroleum Corp	HPCL IN	HOLD
Oil & Natural Gas Corp	ONGC IN	HOLD
Oil India	OINL IN	HOLD
GAIL (India)	GAIL IN	BUY
Petronet LNG	PLNG IN	BUY
Indraprastha Gas	IGL IN	BUY
Mahanagar Gas	MAHGL IN	HOLD
Gujarat State Petronet	GUJS IN	BUY
Gujarat Gas	GUJGA IN	HOLD

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6 April 2017

India IT Services

Q4 Preview: Expect a stable quarter

We expect a steady quarter for our IT coverage universe in Q4FY17, with large-caps likely to report US$ revenue growth of 1-3% QoQ and range-bound margins. TCS and HCLT are poised to lead organic growth among large-caps. We expect a mixed quarter for mid-cap IT services with 0-2.5% QoQ US$ revenue growth. The INR has appreciated against the US$ on a period-end basis and will affect other income QoQ. With improving global macro data, the focus will remain on INFO's FY18 guidance. While a strong INR remains a risk, we continue to believe that the core earnings downgrade cycle has bottomed.

- **Expect a stable Q4:** We expect stable US$ revenue growth of 1.4%/3.1%/1.5%/ 2.7% QoQ for large-caps INFO/TCS/WPRO/HCLT in Q4FY17 with limited cross-currency headwinds on an average basis. We build in EPS growth of -1.6%/7.9%/ -1.5%/9.9% YoY for these companies on expectations of flattish margins and lower other income.
- **INFO's FY18 revenue guidance key:** Given the FY17 experience of guidance cuts through the year coupled with a challenging industry landscape, we expect INFO to be conservative with its FY18 guidance. We expect FY18 US$ revenue growth guidance of 6-8%, implying a CQGR of 1.8-2.5%. The focus will also be on capital allocation. WPRO's Q1FY18 revenue growth guidance should come in at 1-3% QoQ.
- **Mixed performance from mid-caps:** We expect IT service mid-caps under our coverage to deliver mixed US$ revenue growth, in the range of 0-2.5% QoQ. MTCL and FSOL are expected to see a soft quarter while NITEC should post sequential growth and a margin recovery in Q4.
- **View:** Overall, we expect a steady quarter from the sector on a sequential basis despite a low base in Q3. Indian IT has underperformed the Sensex by 7.6% this quarter. With the INR retracing from its lows against the USD, earnings upgrades will be the key to outperformance from here on. While growth expectations from the sector have moderated, an upgrade cycle is key to a re-rating. We remain selective and retain INFO and HCLT as top picks.

REPORT AUTHORS

Rumit Dugar
+91 22 6766 3444
rumit.dugar@religare.com

Akash Nainani
+91 22 6766 3466
akash.nainani@religare.com

Valuation snapshot

Company	Ticker	CMP (Rs)	TP (Rs)	Rating
TCS	TCS IN	2,402	2,300	HOLD
Infosys	INFO IN	1,000	1,150	BUY
Wipro	WPRO IN	509	470	HOLD
HCL Tech	HCLT IN	858	925	BUY
Tech Mahindra	TECHM IN	451	510	HOLD
OFSS	OFSS IN	3,852	4,000	HOLD
Mphasis	MPHL IN	568	580	HOLD
Mindtree	MTCL IN	456	425	SELL
KPIT Tech	KPIT IN	130	135	SELL
NIIT Tech	NITEC IN	433	530	BUY
Redington	REDI IN	112	140	BUY
Firstsource	FSOL IN	44	50	HOLD
Hinduja Global	HGSL IN	595	575	HOLD

Fig 1 - Q4FY17: IT preview

(Rs mn)	Results date	Sales	QoQ (%)	YoY (%)	EBIT	QoQ (%)	Margins (%)	PAT	QoQ (%)	YoY (%)	EPS (Rs)
TCS	18-Apr-17	304,044	2.3	6.9	79,741	3.1	26.2	68,808	1.5	8.5	34.7
Infosys	13-Apr-17	173,495	0.5	4.7	43,469	0.3	25.1	35,504	(4.1)	(1.6)	15.5
Wipro	25-Apr-17	140,762	2.8	3.3	24,496	5.4	17.4	22,006	4.3	(1.5)	8.9
HCL Tech (HCLT)	4th week of Apr	120,285	1.7	12.9	24,613	2.0	20.5	21,024	1.3	9.9	14.9

Source: Company, RCML Research

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RESEARCH TEAM

ANALYST	SECTOR	EMAIL	TELEPHONE
Varun Lohchab (Head – India Research)	Consumer, Strategy	varun.lohchab@religare.com	+91 22 6766 3470
Siddharth Vora, CFA	Auto, Auto Ancillaries, Cement	siddharth.vora@religare.com	+91 22 6766 3435
Navin Sahadeo	Cement, Auto, Auto Ancillaries	navin.sahadeo@religare.com	+91 22 6766 3439
Aman Chaplot	Cement, Auto, Auto Ancillaries	aman.chaplot@religare.com	+91 22 6766 3459
Prashant Tiwari, CFA	Capital Goods, Infrastructure, Utilities	prashant.tiwari@religare.com	+91 22 6766 3485
Manish Poddar	Consumer	manish.poddar@religare.com	+91 22 6766 3468
Rohit Ahuja	Energy	ahuja.rohit@religare.com	+91 22 6766 3437
Akshay Mane	Energy	akshay.mane@religare.com	+91 22 6766 3438
Parag Jariwala, CFA	Financials	parag.jariwala@religare.com	+91 22 6766 3442
Vikesh Mehta	Financials	vikesh.mehta@religare.com	+91 22 6766 3474
Akash Nainani	Financials	akash.nainani@religare.com	+91 22 6766 3466
Rumit Dugar	IT, Telecom, Media	rumit.dugar@religare.com	+91 22 6766 3444
Pritesh Jani	Metals	pritesh.jani@religare.com	+91 22 6766 3467
Arun Baid	Mid-caps	arun.baid@religare.com	+91 22 6766 3446
Manish Mahawar	Mid-caps	manish.mahawar@religare.com	+91 22 6766 3471
Saurabh Rathi	Mid-caps	saurabh.rathi@religare.com	+91 22 6766 3451
Praful Bohra	Pharmaceuticals	praful.bohra@religare.com	+91 22 6766 3463
Aarti Rao	Pharmaceuticals	aarti.rao@religare.com	+91 22 6766 3436
Rahul Agrawal	Economics & Strategy	ag.rahul@religare.com	+91 22 6766 3433

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