kotak Institutional Equities

NEW RELEASE

Strategy

India

March 09, 2024

PSUs: Myth versus reality

In our view, the broad-based rally in PSU stocks is largely driven by top-down bullish sentiment for PSUs in general, rather than any major bottom-up structural fundamental developments. We see several problems with the euphoric sentiment for PSU stocks—(1) bullish short-term profitability and volume assumptions, (2) incorrect valuation methodologies and (3) unrealistic narratives.

The broad-based rally in PSU stocks is in itself a problem

(1) The strong rally in PSUs across sectors without any meaningful change in the fundamentals of or structural reforms in most sectors and (2) the massive outperformance of PSUs versus private sector peers in the same sectors highlights the inherent flaw with the rally in PSU stocks. The rally is largely driven by top-down euphoria among non-institutional investors, rather than any bottom-up structural fundamental developments. Government ownership seems to be the only common factor for the performance of PSU stocks, with disparate sector- and company-specific fundamentals.

Euphoria, incorrect valuation principles, unrealistic narratives at play

We see three broad problems with the rally in PSU stocks—(1) bullish pricing, profitability and volume assumptions, which result in over-optimistic medium-term earnings estimates, (2) incorrect valuation approaches to value earnings with unsustainable drivers and business models with questionable terminal value and (3) unrealistic narratives in several sectors related to government agenda, policies and regulations.

Investors should look to exit rather than get carried away

We would recommend investors to use the rally in the PSU stocks to exit most of their positions. Most non-financial stocks in the electric utilities, metals & mining and oil, gas & consumable fuels sectors are trading at very expensive valuations based on (1) their premium to private sector peers, despite weaker fundamentals (metals & mining) or (2) their weak business models (certain capital goods and electric utilities stocks and all oil, gas & consumable fuels stocks) in the context of mediocre FCF-to-PAT ratios, low or negative terminal value and growing risks of existential irrelevance.

Government may have to review strategy

The government's benign policies and regulations may benefit PSUs in the short term, but ironically prevent them from addressing the large disruption threats to their business models in the medium term. The government's current policies may advertently (electric utilities) or inadvertently (oil, gas and consumable fuels) boost the earnings and cash flows of PSUs. However, continued large reinvestment of cash flows by PSUs into their extant businesses (mostly sunset industries) may constrain their ability to invest in more future-proof businesses—key to their longer-term viability.

Key macro estimates

	2024E	2025E	2026E
Nifty estimates			
Earnings growth (%)	18.9	10.2	12.5
Nifty EPS (Rs)	977	1,079	1,220
Nifty P/E (X)	23.0	20.8	18.4
Macro data			
Real GDP (%)	7.6	6.6	6.5
Avg CPI inflation (%)	5.4	4.5	4.5

Source: Company data, Kotak Institutional Equities estimates

Quick Numbers

BSE PSU Index is up 102%, while Nifty-50 Index is up 30% FYTD24

19 PSU stocks have delivered more than 200% returns and 28 PSU stocks have delivered 100-200% returns FYTD24

The worst-performing central PSU (SBI) has delivered a 50% return FYTD24

Related Research

→Strategy: Nobody wants to hold these multi-
→Strategy: No fear, only greed
→Strategy: Private pricy, public priceless

Full sector coverage on KINSITE

Sanjeev Prasad
sanjeev.prasad@kotak.com
+91-22-4336-0830

Anindya Bhowmik
anindya.bhowmik@kotak.com
+91-22-4336-0897

Sunita Baldawa
sunita.baldawa@kotak.com
+91-22-4336-0896

Table of Contents

1

Overview: Myth versus reality

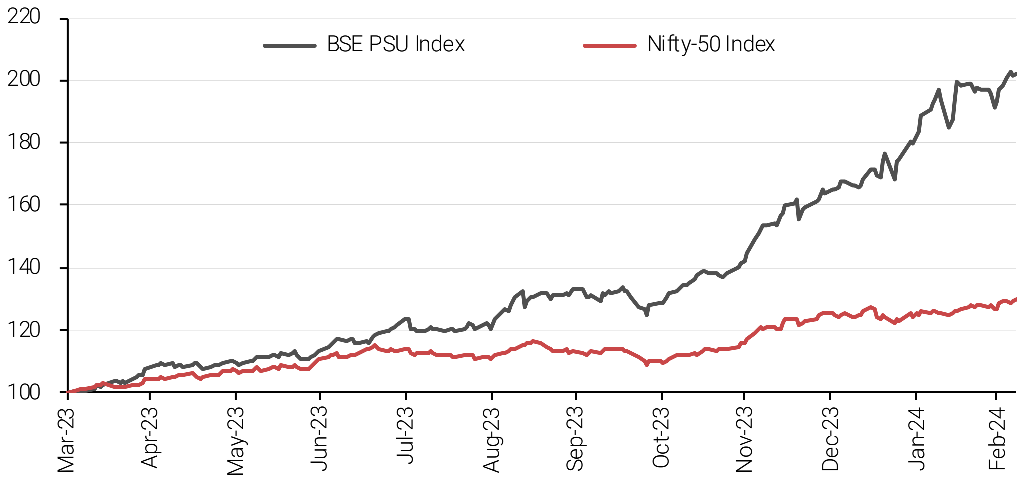
We would use the recent rally in PSU stocks to exit most positions in PSU stocks (except financials), given that the rally is largely due to general euphoria in a section of the market (non-institutional investors), rather than any meaningful change in the fundamentals of most sectors and companies. We find the *post facto* rationalization among institutional investors odd, as the arguments are based on (1) bullish assumptions on profitability and volumes, (2) incorrect valuation approaches and (3) unrealistic narratives.

Every PSU stock is up significantly and therein, lies the problem

We ascribe the strong rally in PSU stocks relative to the broad market (see Exhibit 1) to the general euphoria among a section of investors (domestic non-institutional investors) with respect to the Indian market in general and certain sectors (investment-related) and PSUs in particular. Several institutional investors have also bought (in all senses of the word) into the frenzy, either because of (1) their changed view of PSUs or (2) performance compulsions.

BSE PSU Index has given 102% return so far in FY2024 compared with 30% return of the Nifty-50 Index

Exhibit 1: Performance of BSE PSU versus Nifty (Base=100)



Source: Bloomberg, Kotak Institutional Equities

We do not see any major fundamental or structural drivers to the PSU rally for the following reasons:

- **All PSUs stocks have performed irrespective of capitalization, fundamentals and sector.** Exhibit 2 shows that the rally in PSU stocks over the past year is very broad-based, with just about every PSU stock delivering superlative returns over this period. It is obvious that the fundamentals of every PSU stock and every PSU-dominated sector has not improved dramatically. We would concede that there has been an improvement in (1) the profitability of certain PSU stocks (oil, gas & consumable fuels) and (2) order inflows and revenue visibility of others (capital goods), but these factors could turn out to be ephemeral, unless they are backed by structural reforms (for example, free pricing of automobile fuels for downstream oil companies).

PSU stocks have seen sharp increase in their prices over the past 12 months

Exhibit 2: Performance of select PSU stocks (sorted on market cap.) (%)

Company	Sector	Market cap. (Rs bn)	Performance (%) 1M	3M	6M	12M	FYTD
BSE PSU Index			**4**	**32**	**58**	**95**	**102**
Nifty Index			**4**	**7**	**13**	**27**	**30**
ONGC	Oil, Gas & Consumable Fuels	3,499	2	40	53	76	84
NTPC	Electric Utilities	3,415	7	24	50	99	101
Coal India	Oil, Gas & Consumable Fuels	2,826	1	30	67	104	115
Power Grid Corp.	Electric Utilities	2,722	9	27	52	72	73
IOCL	Oil, Gas & Consumable Fuels	2,466	(6)	44	90	120	124
Hindustan Aeronautics	Capital goods	2,219	12	23	64	145	143
Bharat Electronics	Capital goods	1,573	18	34	54	123	121
BPCL	Oil, Gas & Consumable Fuels	1,355	4	32	76	92	81
GAIL (India)	Gas Utilities	1,240	5	33	50	73	79
NHPC	Electric Utilities	905	(12)	40	67	125	124
BHEL	Capital goods	897	11	40	87	244	268
IRCTC	Commercial & Professional Services	750	(2)	24	33	52	64
HPCL	Oil, Gas & Consumable Fuels	721	(3)	33	100	131	115
NMDC	Metals & Mining	700	(2)	30	67	109	114
Oil India	Oil, Gas & Consumable Fuels	683	29	99	124	140	150
Container Corp.	Transportation	588	5	15	40	60	66
SAIL	Metals & Mining	574	(3)	40	40	59	68
Rail Vikas Nigam	Construction & Engineering	496	(15)	40	55	264	247
SJVN	Electric Utilities	480	(17)	34	93	271	268
Fertilizers & Chemicals Travancore	Fertilizers & Agricultural Chemicals	460	(10)	(9)	38	183	246
Mazagon Dock	Capital goods	421	(3)	0	(0)	185	215
MRPL	Oil, Gas & Consumable Fuels	409	15	80	145	337	344
Gujarat Gas	Gas Utilities	393	(5)	29	23	11	24
Bharat Dynamics	Capital goods	330	3	38	52	91	82
Neyveli Lignite Corp.	Electric Utilities	303	(15)	17	55	167	184
National Aluminium Co.	Metals & Mining	300	1	65	63	94	108
KIOCL	Metals & Mining	272	(6)	31	62	127	166
Hindustan Copper	Metals & Mining	271	(5)	53	72	173	185
ITI	IT services	269	(20)	(7)	120	194	211
NBCC	Construction & Engineering	229	(19)	57	116	256	259
Cochin Shipyard	Capital goods	228	(1)	35	51	266	265
IRCON International	Construction & Engineering	210	(3)	39	82	309	299
Gujarat State Petronet	Gas Utilities	206	(6)	28	30	25	38
NMDC Steel	Metals & Mining	179	(12)	33	7	59	97
RITES	Commercial & Professional Services	177	(8)	53	45	110	108
Railtel Corp.	Telecommunication Services	135	(1)	48	82	273	317
CPCL	Oil, Gas & Consumable Fuels	135	(4)	33	106	279	281
BEML	Capital goods	134	(13)	30	31	166	156
Engineers India	Construction & Engineering	127	(7)	45	43	197	203
GMDC	Oil, Gas & Consumable Fuels	126	(18)	(6)	52	184	213
MMTC	Capital goods	113	(20)	36	10	141	171
Shipping Corp.	Transportation	106	(11)	42	57	145	142
BFSI							
State Bank of India	Banks	7,033	17	29	36	40	50
LIC	Insurance	6,482	(2)	30	52	68	92
IRFC	Diversified financials	1,878	(12)	89	96	410	440
Bank of Baroda	Banks	1,457	15	33	44	63	67
Punjab National Bank	Banks	1,430	5	50	95	153	179
PFC	Diversified financials	1,418	(8)	14	98	232	254
Indian Overseas Bank	Banks	1,249	(17)	50	102	161	194
REC	Diversified financials	1,245	(7)	20	93	289	310
Union Bank	Banks	1,201	7	35	77	118	136
Canara Bank	Banks	1,085	8	37	77	96	110
IDBI Bank	Banks	919	(10)	27	22	74	90
Indian Bank	Banks	735	0	26	39	90	89
UCO Bank	Banks	687	(16)	44	67	111	137
Bank of India	Banks	664	6	28	56	80	96
GIC	Insurance	644	(9)	18	60	152	174
Central Bank of India	Banks	559	(13)	34	65	139	167
Bank of Maharashtra	Banks	438	(7)	35	46	125	150
Punjab & Sind Bank	Banks	437	(14)	47	61	127	151
New India Assurance	Insurance	425	(6)	9	91	149	165
HUDCO	Diversified financials	405	2	119	159	330	368
IREDA	Diversified financials	398	(26)	130	NA	NA	NA
J&K Bank	Banks	155	(2)	23	39	170	187
IFCI	Diversified financials	104	(39)	53	138	268	328

Source: Bloomberg, Kotak Institutional Equities

It is interesting to note that many of the smaller PSU stocks that had rallied the hardest over the past 12 months without any change in their fundamentals have corrected quite sharply over the past one month (they are still up a lot over the past 12 months). However, the large-cap. and better-quality PSUs have held up better over this period. We wonder if some froth is finally going out of the PSU stocks with some smarter non-institutional investors exiting from the low-quality names and entering better-quality stocks.

- **PSU stocks have outperformed their private sector peers across sectors and trade at a premium to their private sector counterparts.** Exhibit 3 compares the performance of PSU and private companies in certain sectors over the past 1, 3, 6 and 12 months and Exhibit 4 compares the valuations of PSU and private companies in a few sectors. The facts that (1) PSUs have massively outperformed their private sector peers irrespective of the nature of the sector and/or changes (if any) in the sector and (2) PSUs trade at a large premium to their private sector peers across sectors clearly demonstrates the point that the rally in PSU stocks is largely driven by sentiment and less by fundamentals.

Most PSU companies have outperformed their private peers

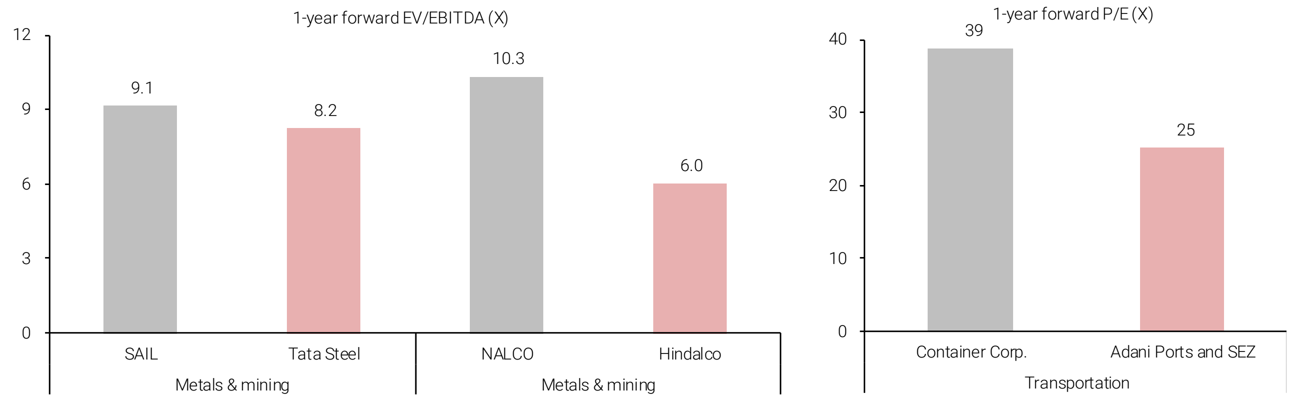
Exhibit 3: Performance of major PSUs versus private companies in select non-financial sectors (%)

		Return (%)			
	Ownership	1-month	3-months	6-months	12-months
Electric utilities					
NHPC	PSU	(12.3)	40	67	125
NTPC	PSU	6.5	24	50	99
PWGR	PSU	9.2	27	52	72
Tata Power	Private	7.6	31	61	102
Metals & mining					
Hindalco Industries	Private	(9.4)	4.0	13.0	29
National Aluminium Co.	PSU	1.3	65	63	94
SAIL	PSU	(3.1)	40	40	59
Tata Steel	Private	8.9	21	21	49
Transportation					
Adani Ports & SEZ	Private	5.6	27	64	92
Container Corp.	PSU	4.6	15	40	60

Source: Bloomberg, Kotak Institutional Equities

PSU stocks are trading at a premium to their private sector counterparts

Exhibit 4: 1-year forward valuation of PSU stocks versus their private peers (X)



Source: Kotak Institutional Equities estimates

- **Several PSUs are trading at absurd valuations.** We note that many PSU stocks are trading at completely absurd valuations. We can attribute the extreme valuations to low free float in a few cases, but we see cases of extreme valuations even in cases of PSUs with decent free floats. This again proves the point that the PSU rally is less about fundamentals and more about sentiment. We showcase three cases of rather bizarre valuations below, although this can be extended to several more PSUs.

  - Fertilizers and Chemicals Travancore (FCT) is trading at 126X FY2024E EPS (extrapolating 9MFY24 net profits; 75X FY2023 EPS) and 47X FY2023 gross block. The stock has a free float of 10% (more correctly, 1.44% with 90% ownership of the Government of India and 8.56% ownership by an investment fund of the Government of India).

  - Hindustan Copper Ltd (HINDCOPPER) is trading at 119X FY2024E EPS (extrapolating 9MFY24 net profits) and 19X FY2023 gross block (including C-WIP). The stock has a free float of 34%, with about 13.7% ownership among domestic institutional investors and 14.1% ownership among domestic retail investors. The Government of India owns a 66.1% stake in the company.

  - Indian Railways Finance Corp. (IRFC) is trading at 3.8X FY2024E BV (extrapolating 9MFY24 BV) and 4.1X FY2023 BV, at a significant premium to the best private and PSU banks and NBFCs in India. IRFC is the dedicated financing arm of the Indian Railways, and its main business is to raise funds in the form of bonds and external commercial borrowings from domestic and overseas institutional investors to finance projects of the Indian Railways. IRFC has a market capitalization of US$23 bn currently and it had 41 employees at end-FY2023.

Little merit in the ‘factors’ supporting the rally

We see three broad problems with the Street’s positive view on PSUs—(1) the Street’s assumptions on pricing, profitability and volumes are too optimistic, (2) the Street has used and is using incorrect valuation methodologies to value PSU stocks; this is true for private companies too, but this is more egregious in the case of PSU stocks and (3) the Street has created and started to believe in certain flimsy narratives across sectors and stocks.

We discuss the issues briefly below and later in more detail in the report, where we assess several PSU stocks using a framework that (1) compares the implied profitability and volumes based on the current market capitalization of a PSU with more realistic profitability and volumes based on fundamentals of the sector and the company, (2) uses appropriate valuation methodologies linked to the business models of the PSUs rather than the Street’s lenient approach of using historical and peer multiples, which do not take cognizance of the challenges to the business models of companies and (3) assesses the strength and weakness of a narrative for a PSU stock. Exhibit 5 is our summary of the differences between the market’s narratives (myth) and our view (reality) on various PSU stocks.

Bullish assumptions, incorrect valuation approaches and unrealistic narratives at play for PSUs

Exhibit 5: Summary of street assumptions versus KIE views on expensive PSU stocks

	Assumptions		Valuation methodology	
Sector	Street	KIE view	Street	KIE view
Capital goods (defense)	(1) Elevated government spending for an extended period of time, (2) increase in indigenization	Risks from (1) ordering delays and (2) elevated profitability disregarded in current high multiples	P/E	Extant elevated multiples will depend on (1) continued high growth and (2) RoEs sustaining at current high levles in a largely B2G business
Capital goods (electric equipment)	(1) Increased ordering from increase in thermal electricity demand over the next 3-5 years, (2) improvement in profitability	Optimistic assumptions on opportunity size	P/E	Limited-period opportunity should be valued on an NPV basis; high P/E multiple implies strong earnings for an extended period of time
Electric utilities	(1) Long-term transition from thermal to renewable energy, (2) medium-term increase in regulated equity base from new thermal capacity	(1) Optimistic assumptions on regulated equity base, (2) oversight of fundamental negative shift in business model, (3) cashflows from extant capacities required to fund new capacities with lower IRR and (4) questionable terminal value of thermal assets	P/E	Valuations need to be looked at on a P/B basis relative to regulated return and cost of equity. Stocks trading around 2X P/B of regulated entity
Metals & mining	(1) Increase in capacities, (2) improvement in profitability and (3) option value of new mining initiatives	(1) Optimistic assumptions on growth and profitability, (2) low probability of privatization of metal companies at current valuations	EV/EBITDA	Higher multiples assinged to (1) NACL versus private peers despite being in the cyclical upstream business, (2) SAIL versus private peers despite significantly lower profitability
Oil, gas & consumable fuels	(1) Strong near-term earnings, (2) elevated profitability on automobile fuels to sustain for an extended period of time	Low earnings predictability due to (1) large volatility in global crude prices, (2) unpredictable pricing policy of the government	P/E	Low FCF/PAT ratio renders valuation on P/E basis meaningless. GAIL and OMCs are expensive on (1) price/FCFS basis and (2) low terminal value
Transportation	(1) Privatization of CCRI, (2) sharp improvement in efficiency post-privatization	(1) Privatization has proven to be surprisingly challenging, (2) low visibility on terms of trade with government entities	P/E	(1) Low FCF/PAT ratio renders valuation on P/E basis meaningless, (2) CCRI's rich valuation may be an obstacle to privatization

Source: Kotak Institutional Equities estimates

- **Bullish assumptions on pricing, profitability and volumes.** We find the Street's assumptions on pricing, profitability and volumes quite aggressive in the case of most PSUs. The Street seems to be (1) extrapolating the current high profitability in certain sectors (high marketing margins on automotive fuels for downstream oil stocks) without taking note of inherent risks in the factors that are contributing to the current high profitability and/or (2) making aggressive assumptions on volumes in certain sectors (order inflows for capital goods, as an example) without taking cognizance of the likely market opportunity.

  The implied profitability and volume assumptions (to justify the current market capitalization) of many PSU stocks are so egregious and disconnected from reality that we cannot but wonder about the compulsions of the Street. The Street seems willing to overlook glaring inconsistencies across companies simply to rationalize its positive investment thesis for PSUs. We can only hope that the Street is not making up the numbers to retrofit into the narratives.

- **Incorrect valuation methodologies.** We note rampant misuse of valuation methodologies to value PSU stocks. We highlight three problems on the Street's incorrect valuation approach and discuss the Fair Value of companies using a more orthodox (first-principle) valuation approach. We covered some common mistakes in the valuation practices on the Street in our December 4, 2023 report titled *Sins of the past revisited*. These mistakes seem to be even more visible in the Street's valuation of PSUs.

  - **Use of P/E multiples, irrespective of the extent of conversion of PAT to FCF.** This problem is most egregious in the case of the downstream oil & gas companies (GAIL, oil marketing companies or OMCs), where the Street finds their valuations inexpensive based on P/E, but we find their valuations quite expensive on a more appropriate P/FCFS basis. We note that almost all oil, gas & consumable fuel PSUs generate very little FCF relative to PAT and they may not do so in the future too, given their aggressive capex plans in conventional energy projects.

- **Use of multiples, irrespective of the business model and terminal value of the business model.** This oversight is most prominent in the electric utilities and oil, gas and consumable fuels sectors, where the Street is willing to use multiples (P/B or P/E) to value companies without adjusting the multiples for the low or negative terminal value of the businesses. BHEL is another prominent case where the market is willing to ascribe 'high' multiples for a business that may generate profits for a few years at best. It is unlikely that India will build new coal-based thermal electricity generation capacity after the next 5-6 years.

  We note that a low-growth or ex-growth business should logically deserve a P/E multiple of around 8-10X based on the current cost of equity of around 12% in the Indian context (7% risk-free rate linked to government bond yields and 5% equity risk premium). Most PSU energy stocks have rerated to well above these multiples. We would note that even a 'low' P/E of 12-14X would imply (1) low single-digit growth in earnings/cash flows in perpetuity or (2) high growth in earnings/cash flows for a reasonable period of time, assuming negligible terminal value.

  We note that very few energy-related PSUs are making significant efforts to move to 'new' energy from 'old' energy. In fact, they continue to invest aggressively in conventional energy projects for inexplicable reasons. The continued large investment in conventional energy will constrain their ability and delay their transition to 'new' energy companies, which will raise serious concerns about the longevity of their business models and their terminal values.

- **Use of historical valuations as benchmarks to value stocks, irrespective of the changes in a sector.** This is a common mistake across sectors and companies (and not just PSUs). In our view, historical multiples may have little relevance, given the extent of ongoing and potential disruption in just about sector. We would note that the historical multiples were valid under a certain set of underlying assumptions on growth and profitability (apart from cost of capital/equity) and these multiples may not be relevant under a different set of underlying assumptions on growth and profitability.

  This is especially true for PSUs, many of whom are vulnerable to disruption and face existential challenges or even existential threats. As mentioned above, the PSUs are not making sufficient efforts to build more future-proof businesses. They continue to invest aggressively in their traditional areas, thereby depriving themselves of (1) precious capital that is required for the radical transformation of their business models and (2) valuable time that is needed to achieve the transition to newer business models; every passing year will only increase the scale of disruption, leaving the PSUs ill-prepared to overcome disruption challenges.

- **Unrealistic narratives to back investment decisions.** We find the Street's confidence in flimsy narratives (rather than solid fundamental-backed investment hypotheses) behind their decision to invest in PSUs rather puzzling. Most institutional investors had completely eliminated PSUs from their list of investable options, until recently, given their historical bad experience in investing in PSUs related to either their governance or their operations. Many index-agnostic investors continue to do so.

  The about-turn in the view of a section of the Street may reflect (1) their genuine views of positive changes in the fundamentals of PSUs and/or (2) their compulsions to invest in PSUs, given the strong outperformance of PSUs relative to benchmarks over the past 12 months. We doubt the former is true, given limited fundamental changes in the governance and operations of PSUs; the recent improvement in profitability in a few cases is more due to serendipity (happy confluence of favorable factors) rather than a concerted effort on part of the companies to improve their fundamentals. The latter (decision to invest in PSUs) may have forced investors to rationalize their investment decision in PSUs with a combination of make-belief numbers and narratives.

Government plans become important at distended valuations of PSUs

We are unsure of the government's gameplan for PSUs, even as its sharp focus on execution and strong commitment to PSUs has resulted in a marked improvement in the operations of PSUs. The government has not pursued privatization aggressively in its two past two terms. It remains to be seen if it will change track in its third term (assuming it forms the next government after the national elections in April-May 2024, as is widely expected).

Nonetheless, the government may have to do more to ensure a 'better' future for PSUs, given the rapid acceleration in disruption in certain sectors such as electric utilities and oil, gas & consumable fuels, with a large PSU presence. We discuss the options below:

- **Privatization.** We have long been advocates of privatization of almost all PSUs (barring atomic energy and defense selectively), given limited strategic value in most PSUs that operate in sectors with a large private sector presence. However, current government policy on ownership of PSUs would rule out privatization of most larger PSUs (see Exhibit 6 for a list of PSUs and their respective sectors), given the stated policy of the government to retain control over one or more PSUs in a strategic sector. Under its New Public Sector Enterprise Policy of February 2021, the government has classified certain sectors as strategic for national security, energy security, critical infrastructure and other reasons. These four broad sectors include (1) atomic energy, space and defense, (2) banking, insurance and financial services, (3) power, petroleum, coal and other minerals and (4) transport and communication.

Current government policy rules out privatization of major large PSUs

Exhibit 6: PSUs in strategic sector as per government policy

		Market Cap.		Govt holding
Company	Sector	(Rs bn)	(US$ bn)	(%)
Non-financial PSUs				
NTPC	Electric Utilities	3,415	41	51
ONGC	Oil, Gas & Consumable Fuels	3,499	42	59
Coal India	Oil, Gas & Consumable Fuels	2,826	34	63
Power Grid Corp.	Electric Utilities	2,722	33	51
Hindustan Aeronautics	Capital goods	2,219	27	72
IOCL	Oil, Gas & Consumable Fuels	2,466	30	52
Bharat Electronics	Capital goods	1,573	19	51
GAIL (India)	Gas Utilities	1,240	15	52
NHPC	Electric Utilities	905	11	71
Mazagon Dock	Capital goods	421	5	85
Bharat Dynamics	Capital goods	330	4	75
Cochin Shipyard	Capital goods	228	3	73
Financial PSUs				
State Bank of India	Banks	7,033	85	57
LIC	Insurance	6,482	78	97
PFC	Diversified financials	1,418	17	56
Bank of Baroda	Banks	1,457	18	64
Punjab National Bank	Banks	1,430	17	73
Union Bank	Banks	1,201	15	77
Canara Bank	Banks	1,085	13	63

Source: Companies, Kotak Institutional Equities

- **Strategic review of operations.** The government may need to strike the right balance between (1) strategic long-term objectives such as future-ready business models for PSUs versus (2) current tactical short-term objectives of higher investment in extant businesses to increase production volumes. In our view, the former would be critical to ensure the relevance of PSUs in the forthcoming decades, as almost all sectors that the PSUs operate in will change dramatically; the broader energy sector is a case in point. The latter is a laudable objective in light of short-term compulsions (for example, investment in new thermal electricity generation capacity to bridge a possible supply-demand gap in electricity), but excessive focus and investment in extant businesses may drain their cash flows and delay the transformation of the PSUs to more 'future-proof' businesses.

2

Institutional investors struggling, retail investors strutting for now

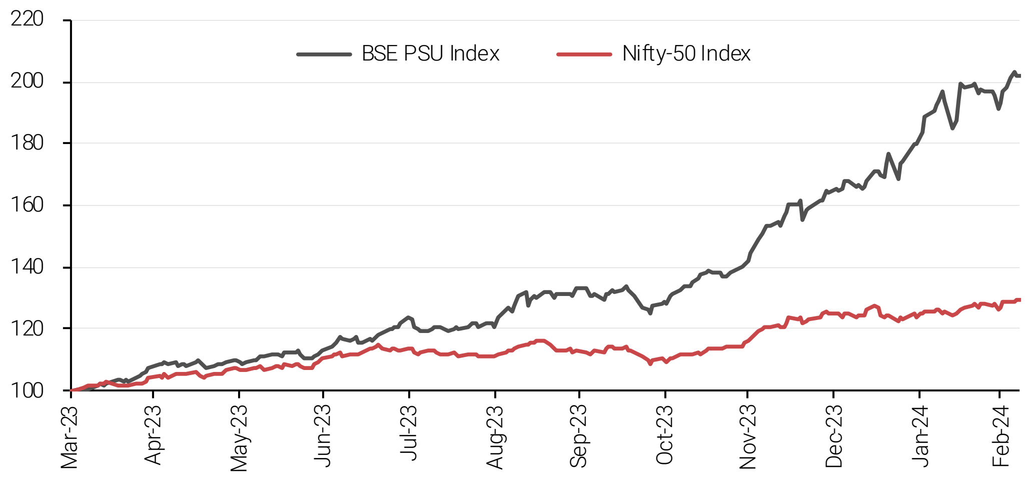
The strong performance of PSU stocks is in sharp contrast with the low ownership of most PSU stocks among institutional investors, especially FPI investors. Institutional investors seem to be quite cautious, whereas non-institutional investors (domestic HNI and retail investors) seem to be very positive on the fortunes of PSUs. The latter's enthusiasm may stem from (1) renewed faith in the government's ability to rejuvenate PSUs and/or (2) rampant surge in stock prices of PSUs.

The PSU tag is enough these days for massive performance

The BSE PSU index has surged 102% in the past 12 months compared with a 30% rally in the Nifty Index (see Exhibit 7). PSU-led sectors such as (1) capital goods (including defense), (2) electric utilities and (3) oil, gas & consumable fuels and (4) PSU banks have been the leaders in the ongoing market rally. These sectors are up 73%, 89%, 64% and 98% FYTD24 (see Exhibit 8). PSU stocks have generated incredible returns in FYTD24, with as many as 19 stocks climbing over 200% and 28 stocks up between 100% and 200%. It is interesting to note that not a single PSU stock has given negative returns in this period (see Exhibit 9); the worst-performing central government PSU stock has also delivered a return of 24%.

BSE PSU Index has given 102% return so far in FY2024 compared with 30% return of the Nifty-50 Index

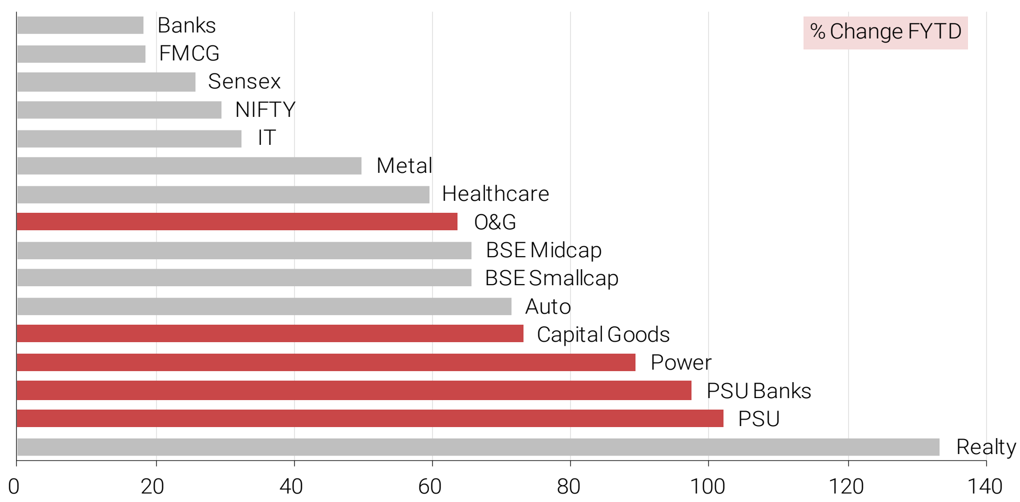
Exhibit 7: Performance of BSE PSU versus Nifty (Base=100)



Source: Bloomberg, Kotak Institutional Equities

PSUs and PSU-led sectors are the leaders in the ongoing market rally

Exhibit 8: Performance of various sectors since April 2023 (%)



Source: Bloomberg, Kotak Institutional Equities

PSU stocks have seen sharp increase in their prices over the past 12 months

Exhibit 9: Performance of select PSU stocks (sorted on market cap.) (%)

		Market cap.	Performance (%)				
Company	Sector	(Rs bn)	1M	3M	6M	12M	FYTD
BSE PSU Index			**4**	**32**	**58**	**95**	**102**
Nifty Index			**4**	**7**	**13**	**27**	**30**
ONGC	Oil, Gas & Consumable Fuels	3,499	2	40	53	76	84
NTPC	Electric Utilities	3,415	7	24	50	99	101
Coal India	Oil, Gas & Consumable Fuels	2,826	1	30	67	104	115
Power Grid Corp.	Electric Utilities	2,722	9	27	52	72	73
IOCL	Oil, Gas & Consumable Fuels	2,466	(6)	44	90	120	124
Hindustan Aeronautics	Capital goods	2,219	12	23	64	145	143
Bharat Electronics	Capital goods	1,573	18	34	54	123	121
BPCL	Oil, Gas & Consumable Fuels	1,355	4	32	76	92	81
GAIL (India)	Gas Utilities	1,240	5	33	50	73	79
NHPC	Electric Utilities	905	(12)	40	67	125	124
BHEL	Capital goods	897	11	40	87	244	268
IRCTC	Commercial & Professional Services	750	(2)	24	33	52	64
HPCL	Oil, Gas & Consumable Fuels	721	(3)	33	100	131	115
NMDC	Metals & Mining	700	(2)	30	67	109	114
Oil India	Oil, Gas & Consumable Fuels	683	29	99	124	140	150
Container Corp.	Transportation	588	5	15	40	60	66
SAIL	Metals & Mining	574	(3)	40	40	59	68
Rail Vikas Nigam	Construction & Engineering	496	(15)	40	55	264	247
SJVN	Electric Utilities	480	(17)	34	93	271	268
Fertilizers & Chemicals Travancore	Fertilizers & Agricultural Chemicals	460	(10)	(9)	38	183	246
Mazagon Dock	Capital goods	421	(3)	0	(0)	185	215
MRPL	Oil, Gas & Consumable Fuels	409	15	80	145	337	344
Gujarat Gas	Gas Utilities	393	(5)	29	23	11	24
Bharat Dynamics	Capital goods	330	3	38	52	91	82
Neyveli Lignite Corp.	Electric Utilities	303	(15)	17	55	167	184
National Aluminium Co.	Metals & Mining	300	1	65	63	94	108
KIOCL	Metals & Mining	272	(6)	31	62	127	166
ITI	IT services	269	(20)	(7)	120	194	211
Hindustan Copper	Metals & Mining	271	(5)	53	72	173	185
NBCC	Construction & Engineering	229	(19)	57	116	256	259
Cochin Shipyard	Capital goods	228	(1)	35	51	266	265
IRCON International	Construction & Engineering	210	(3)	39	82	309	299
Gujarat State Petronet	Gas Utilities	206	(6)	28	30	25	38
NMDC Steel	Metals & Mining	179	(12)	33	7	59	97
RITES	Commercial & Professional Services	177	(8)	53	45	110	108
CPCL	Oil, Gas & Consumable Fuels	135	(4)	33	106	279	281
Railtel Corp.	Telecommunication Services	135	(1)	48	82	273	317
BEML	Capital goods	134	(13)	30	31	166	156
Engineers India	Construction & Engineering	127	(7)	45	43	197	203
GMDC	Oil, Gas & Consumable Fuels	126	(18)	(6)	52	184	213
MMTC	Capital goods	113	(20)	36	10	141	171
Shipping Corp.	Transportation	106	(11)	42	57	145	142
BFSI							
State Bank of India	Banks	7,033	17	29	36	40	50
LIC	Insurance	6,482	(2)	30	52	68	92
IRFC	Diversified financials	1,878	(12)	89	96	410	440
Bank of Baroda	Banks	1,457	15	33	44	63	67
Punjab National Bank	Banks	1,430	5	50	95	153	179
PFC	Diversified financials	1,418	(8)	14	98	232	254
Indian Overseas Bank	Banks	1,249	(17)	50	102	161	194
REC	Diversified financials	1,245	(7)	20	93	289	310
Union Bank	Banks	1,201	7	35	77	118	136
Canara Bank	Banks	1,085	8	37	77	96	110
IDBI Bank	Banks	919	(10)	27	22	74	90
Indian Bank	Banks	735	0	26	39	90	89
UCO Bank	Banks	687	(16)	44	67	111	137
Bank of India	Banks	664	6	28	56	80	96
GIC	Insurance	644	(9)	18	60	152	174
Central Bank of India	Banks	559	(13)	34	65	139	167
Bank of Maharashtra	Banks	438	(7)	35	46	125	150
Punjab & Sind Bank	Banks	437	(14)	47	61	127	151
New India Assurance	Insurance	425	(6)	9	91	149	165
HUDCO	Diversified financials	405	2	119	159	330	368
IREDA	Diversified financials	398	(26)	130	NA	NA	NA
J&K Bank	Banks	155	(2)	23	39	170	187
IFCI	Diversified financials	104	(39)	53	138	268	328

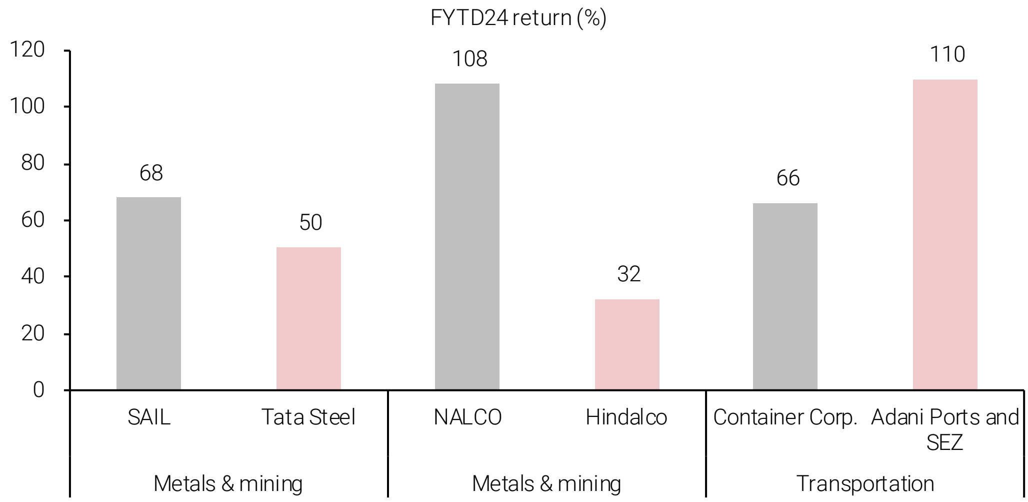
Source: Bloomberg, Kotak Institutional Equities

We would note that the rally in PSU stocks has been quite broad-based (across sectors and capitalization), which would suggest that the rally in PSU stocks is driven by top-down positive change in sentiment for PSUs in general, rather than major bottom-up positive fundamental changes in sectors with a large PSU presence. A few sectors such as oil, gas & consumable fuels have seen positive developments, although the sustainability of positive factors (current benign pricing and regulatory environment in the case of downstream oil PSUs) is quite uncertain.

In our view, government ownership seems to be a common denominator for the rally in PSUs, as PSU stocks have rallied, irrespective of sector fundamentals. The excitement for PSU stocks can be seen by the facts that (1) PSUs have meaningfully outperformed their private-sector counterparts in the same sector (see Exhibit 10) in the past 12 months, even though sector fundamentals have not really improved; ADSEZ's outperformance of CCRI reflects its rebound from low levels of March 2023 and (2) many PSU stocks trade at a large premium to their private sector peers (see Exhibit 11), which is in marked contrast to historical trends.

PSU stocks have outperformed their private sector counterparts

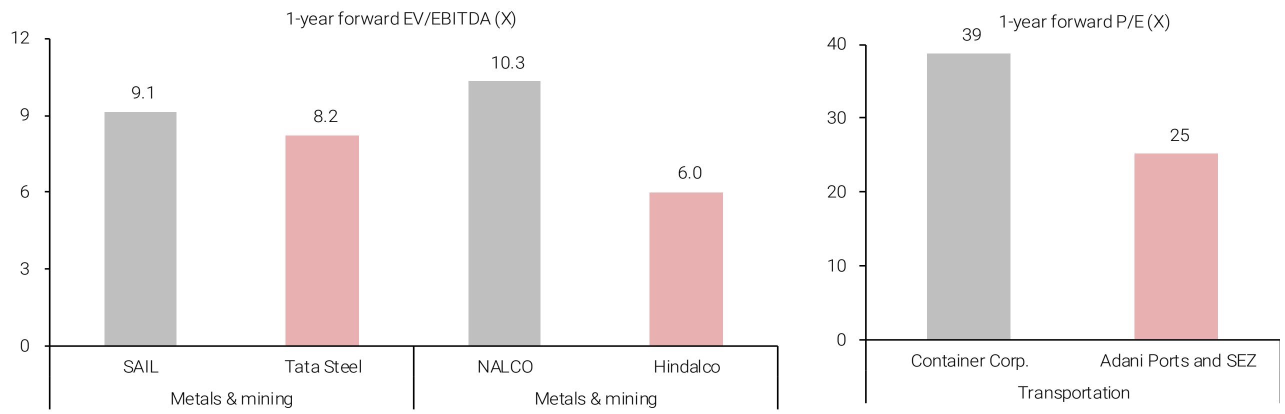
Exhibit 10: FYTD24 return of PSU stocks versus their private sector peers (%)



Source: FactSet, Kotak Institutional Equities

PSU stocks are trading at a premium to their private sector counterparts

Exhibit 11: 1-year forward valuation of PSU stocks versus their private peers (X)



Source: Kotak Institutional Equities estimates

Not preferred by institutional investors

Institutional investors, especially FPIs, have not participated meaningfully in the sharp rally in PSU stocks over the past 12 months. FPIs have remained underweight on PSU stocks throughout. MFs have been modestly overweight, but that reflects concentrated positions in a few MFs in their large-cap. portfolios. They have trimmed their overweight position in certain PSU stocks in the ongoing rally. Lastly, their mid-cap. and small-cap. funds have struggled to outperform their respective benchmark indices, given the massive rally in several under-owned mid-cap. and small-cap. PSU stocks. Exhibits 12-13 show that most top-performing stocks in the mid- and small-cap. indices are PSUs.

Steep increase in stock prices of several mid-cap. stocks; PSUs dominate the top quartile

Exhibit 12: 1M, 3M, 6M and 12M performance of stocks in Nifty Midcap Index (sorted on 12M basis)

			Performance (%)			
	Company Name	**GICS sector**	**1M**	**3M**	**6M**	**12M**
	NSE Midcap 100 Index		**(1)**	**10**	**21**	**58**
1	IRFC	Financials	(12)	89	96	410
2	REC	Financials	(7)	20	93	289
3	Rail Vikas	Industrials	(15)	40	55	264
4	BHEL	Industrials	11	40	87	244
5	PFC	Financials	(8)	14	98	232
6	Adani Power	Utilities	(1)	1	58	219
7	Prestige Estates	Real Estate	(4)	5	87	194
8	Mazagon Dock	Industrials	(3)	0	(0)	185
9	FACT	Materials	(10)	(9)	38	183
10	Lupin	Health Care	5	34	47	152
11	Oil India	Energy	29	99	124	140
12	Dixon Technologies	Consumer Discretionary	13	19	40	139
13	Macrotech Developers	Real Estate	4	31	58	137
14	HPCL	Energy	(3)	33	100	131
15	Aurobindo Pharma	Health Care	6	3	23	127
16	NHPC	Utilities	(12)	40	67	125
17	Torrent Power	Utilities	(0)	14	59	120
18	Union Bank (I)	Financials	7	35	77	118
19	Godrej Properties	Real Estate	7	27	49	111
20	NMDC	Materials	(2)	30	67	109
21	HDFC AMC	Financials	3	25	48	108
22	Vodafone Idea	Communication Services	(5)	8	36	105
23	JSW Energy	Utilities	4	12	35	91
24	Bharat Dynamics	Industrials	3	38	52	91
25	Indian Bank	Financials	0	26	39	90
26	PB Fintech	Financials	20	32	43	85
27	Indian Hotels Co	Consumer Discretionary	12	33	38	84
28	Bank of India	Financials	6	28	56	80
29	KPIT Technologies	Information Technology	(10)	3	28	79
30	L&T Finance Holdings	Financials	(8)	5	25	77
31	LIC Housing Finance	Financials	(1)	23	41	77
32	Max Healthcare	Health Care	(10)	12	24	74
33	Persistent System	Information Technology	(3)	33	41	72
34	Cummins India	Industrials	16	42	60	71
35	Tata Communications	Communication Services	19	18	6	66
36	MRF	Consumer Discretionary	1	23	32	66
37	Alkem Lab	Health Care	0	5	41	63
38	Apollo Tyres	Consumer Discretionary	(6)	14	34	62
39	Container Corp.	Industrials	5	15	40	60
40	Polycab India	Industrials	11	(10)	(6)	60
41	SAIL	Materials	(3)	40	40	59
42	Oberoi Realty	Real Estate	5	(6)	19	56
43	Indus Towers	Communication Services	13	32	39	54
44	CG Power	Industrials	5	0	2	53
45	Patanjali Foods	Consumer Staples	(6)	(4)	19	52
46	Sona BLW	Consumer Discretionary	9	19	17	49
47	Ipca Lab	Health Care	(3)	5	32	48
48	Astral	Industrials	11	7	10	46
49	Poonawalla Fin	Financials	(12)	3	11	46
50	Coforge	Information Technology	(5)	10	11	44
51	L&T Technology	Industrials	(5)	8	14	43
52	Bharat Forge	Consumer Discretionary	(8)	1	7	42
53	Sun TV Network	Communication Services	(3)	(8)	1	42
54	Fortis Healthcare	Health Care	(12)	3	18	42
55	Escorts Kubota	Industrials	(3)	(12)	(9)	42
56	ACC	Materials	5	23	29	41
57	IDFC First Bank	Financials	(3)	(8)	(16)	41
58	Yes Bank	Financials	(20)	19	29	41
59	Max Financial	Financials	2	(5)	4	40
60	Gland Pharma	Health Care	(14)	0	4	38
61	Delhivery	Industrials	(2)	19	4	36
62	Motherson Wiring	Consumer Discretionary	(4)	11	3	36
63	Laurus Labs	Health Care	6	8	4	31
64	Tata Chemicals	Materials	33	29	21	31
65	Petronet LNG	Energy	(0)	32	18	30
66	APL Apollo Tubes	Materials	14	(0)	(8)	27
67	Tube Investments	Consumer Discretionary	(3)	3	8	27
68	Biocon	Health Care	(3)	16	5	25
69	Tata Elxsi	Information Technology	(1)	(8)	4	23
70	Deepak Nitrite	Materials	(1)	(2)	(6)	20
71	Coromandel International	Materials	3	(10)	(2)	19
72	Voltas	Industrials	4	25	21	18
73	Syngene International	Health Care	(8)	(5)	(18)	18
74	Ashok Leyland	Industrials	(4)	(4)	(6)	17
75	Mphasis	Information Technology	(4)	4	1	17
76	Federal Bank	Financials	5	1	8	17
77	Aditya Birla Cap	Financials	(3)	9	(3)	17
78	United Breweries	Consumer Staples	(5)	(2)	2	16
79	Piramal Enterprises	Financials	(3)	(3)	(17)	15
80	MMFSL	Financials	(3)	5	(4)	12
81	Gujarat Gas	Utilities	(5)	29	23	11
82	The Ramco Cement	Materials	(19)	(21)	(10)	11
83	Dr Lal Pathlabs	Health Care	(13)	(19)	(3)	11
84	Balkrishna Industries	Consumer Discretionary	(4)	(13)	(6)	10
85	Gujarat Fluoroch	Materials	(2)	24	17	9
86	Dalmia Bharat	Materials	(10)	(17)	(14)	7
87	FSN E-Commerce	Consumer Discretionary	0	(10)	8	5
88	Devyani International	Consumer Discretionary	1	(17)	(31)	2
89	Bata India	Consumer Discretionary	2	(13)	(16)	2
90	Jubilant Food.	Consumer Discretionary	(5)	(19)	(15)	1
91	Indraprastha Gas	Utilities	(4)	5	(10)	(3)
92	Page Industries	Consumer Discretionary	(1)	(4)	(15)	(4)
93	Aditya Birla Fashion	Consumer Discretionary	(14)	(6)	(3)	(5)
94	Crompton Greaves Consumer	Consumer Discretionary	1	(4)	(7)	(8)
95	AU Small Finance	Financials	(8)	(24)	(21)	(9)
96	Bandhan Bank	Financials	(10)	(18)	(18)	(16)
97	Zee Entertainment	Communication Services	(12)	(41)	(43)	(18)
98	Navin Fluorine	Materials	(1)	(19)	(35)	(28)
99	One 97	Financials	(19)	(39)	(55)	(36)

Source: Bloomberg, Kotak Institutional Equities

Steep increase in stock prices of several small-cap. stocks; PSUs dominate the top quartile

Exhibit 13: 1M, 3M, 6M and 12M performance of stocks in Nifty Small-cap Index (sorted on 12M basis)

			Performance (%)							Performance (%)			
	Company Name	GICS sector	1M	3M	6M	12M		Company Name	GICS sector	1M	3M	6M	12M
	NSE Smallcap 100 Index		**(5)**	**8**	**23**	**66**							
1	Suzlon Energy	Industrials	(18)	4	68	372	51	HFCL	Communication Services	(3)	46	32	51
2	BSE	Financials	(10)	(9)	79	367	52	Amara Raja Energy & Mobility	Industrials	(2)	14	31	51
3	MRPL	Energy	15	80	145	337	53	KEC International	Industrials	7	11	4	50
4	HUDCO	Financials	2	119	159	330	54	Tanla Platforms	Information Technology	(4)	3	(10)	48
5	SJVN	Utilities	(17)	34	93	271	55	Elgi Equipments	Industrials	8	35	41	47
6	Cochin Shipyard	Industrials	(1)	35	51	266	56	Bikaji Foods	Consumer Staples	(5)	2	4	46
7	NBCC	Industrials	(19)	57	116	256	57	CreditAccess Gramin	Financials	(14)	(19)	(3)	46
8	Kalyan Jewellers	Consumer Discretionary	21	27	69	249	58	Triveni Turbine	Industrials	3	17	20	45
9	JBM Auto	Consumer Discretionary	(5)	48	29	229	59	PNB Housing	Financials	(14)	(11)	5	44
10	Hindustan Copper	Materials	(5)	53	72	173	60	IDFC	Financials	(3)	(6)	(10)	44
11	Birlasoft	Information Technology	(7)	18	51	168	61	Praj Industries	Industrials	(0)	(18)	(3)	44
12	NLC India	Utilities	(15)	17	55	167	62	Can Fin Homes	Financials	(8)	(1)	2	38
13	Apar Industries	Industrials	(5)	13	25	163	63	Latent View	Industrials	(8)	5	9	36
14	IOB	Financials	(17)	50	102	161	64	Raymond	Consumer Discretionary	2	4	(18)	35
15	Multi Commodity Exchange	Financials	(5)	9	102	148	65	UTI AMC	Financials	(3)	7	12	34
16	Global Health	Health Care	2	34	81	144	66	Mahanagar Gas	Utilities	(11)	13	25	33
17	Angel One	Financials	(18)	(11)	49	144	67	Tata Tele	Communication Services	(6)	(3)	(5)	32
18	Century Textiles	Materials	5	15	42	141	68	Equitas Small Finance Bank	Financials	(6)	2	15	32
19	Intellect Design	Information Technology	8	46	49	140	69	Radico Khaitan	Consumer Staples	(10)	(3)	23	29
20	Central Bank	Financials	(13)	34	65	139	70	JK Lakshmi Cement	Materials	(4)	(0)	30	29
21	Glenmark Pharma.	Health Care	9	16	20	127	71	Chambal Fertilisers	Materials	(1)	7	30	28
22	Jyothy Labs	Consumer Staples	(13)	(8)	19	126	72	Anupam Rasayan	Materials	3	(11)	(6)	26
23	Graphite India	Industrials	5	24	33	114	73	CAMS Services	Industrials	2	3	19	26
24	Welspun Living	Consumer Discretionary	(2)	(5)	18	113	74	Tejas Networks	Information Technology	1	(8)	(14)	25
25	BLS International	Industrials	(12)	23	17	112	75	Metropolis Healthcare	Health Care	(7)	(2)	14	24
26	UCO Bank	Financials	(16)	44	67	111	76	Route Mobile	Information Technology	(2)	2	2	20
27	Zensar Technologies	Information Technology	(0)	12	7	111	77	Redington	Information Technology	6	22	23	19
28	Rites	Industrials	(8)	53	45	110	78	Aegis Logistics	Energy	15	16	22	16
29	Data Pattern	Industrials	43	33	23	109	79	Finolex Cables	Industrials	(20)	(13)	(19)	15
30	Cyient	Information Technology	(12)	(0)	9	108	80	GNFC	Materials	(10)	(14)	(3)	13
31	IRB Infra	Industrials	(11)	59	86	100	81	Jubilant Ingrevia	Materials	6	3	(9)	8
32	KEI Industries	Industrials	3	12	33	98	82	CIE Automotive	Consumer Discretionary	(9)	(9)	(11)	7
33	National Aluminium	Materials	1	65	63	94	83	Indiamart	Industrials	(2)	(4)	(19)	5
34	CEAT	Consumer Discretionary	1	21	25	93	84	Balaji Amines	Materials	3	(0)	4	5
35	Sonata Software	Information Technology	(2)	9	43	92	85	Affle India	Communication Services	(7)	(4)	(2)	5
36	CDSL	Financials	(7)	(3)	52	80	86	Indian Energy Exchange	Financials	2	(6)	7	1
37	Exide Industries	Consumer Discretionary	(5)	11	20	80	87	Balrampur Chini	Consumer Staples	(6)	(7)	(9)	1
38	Amber Enterprises	Consumer Discretionary	(17)	18	20	80	88	Medplus Healthcare	Consumer Staples	8	(6)	(14)	(2)
39	CESC	Utilities	(10)	3	38	79	89	Happiest Minds	Information Technology	(4)	(4)	(10)	(3)
40	Natco Pharma	Health Care	18	30	11	79	90	City Union Bank	Financials	4	(11)	4	(4)
41	IDBI Bank	Financials	(10)	27	22	74	91	Shree Renuka Sugar	Consumer Staples	(14)	(5)	(14)	(4)
42	Birla Corp.	Materials	1	9	24	72	92	Easy Trip	Consumer Discretionary	(10)	22	21	(5)
43	Karur Vysya Bank	Financials	(4)	14	36	71	93	Laxmi Organic	Materials	(6)	(12)	(20)	(6)
44	Firstsour.Solu.	Industrials	(4)	14	19	71	94	IIFL Finance	Financials	(31)	(34)	(29)	(7)
45	Piramal Pharma	Health Care	(9)	0	18	66	95	PVR Inox	Communication Services	1	(19)	(23)	(10)
46	J B Chemicals	Health Care	(12)	6	14	63	96	VIP Industries	Consumer Discretionary	(2)	(11)	(26)	(13)
47	NMDC Steel	Materials	(12)	33	7	59	97	KRBL	Consumer Staples	(17)	(17)	(35)	(15)
48	Granules India	Health Care	5	16	45	58	98	Deepak Fertilizers	Materials	(4)	(22)	(22)	(21)
49	Manappuram Finance	Financials	(9)	4	19	56	99	AAVAS Financiers	Financials	(2)	(6)	(15)	(23)
50	RBL Bank	Financials	(2)	(0)	9	54	100	Campus Activewe.	Consumer Discretionary	(4)	(11)	(18)	(39)

Source: Bloomberg, Kotak Institutional Equities

The cautious view of institutional investors is in sharp contrast to the exuberance among non-institutional investors. Institutional investors perhaps do not see any major shift in the governance and operations of PSUs, whereas non-institutional investors expect a new paradigm for PSU companies. We would agree with the view of institutional investors and discuss the reasons for our more cautious stance in the next section.

Exhibit 14 shows that FPIs have stayed underweight PSUs through FY2024. They are significantly underweight heavyweight PSUs in capital goods, electric utilities (except PWGR) and oil, gas & consumable fuels sectors. They were relatively better-positioned in PSU banks. FPIs are underweight PSU-led sectors such as (1) capital goods, (2) oil, gas & consumable fuels and (3) PSU banks (see Exhibit 15).

FPIs remain underweight on PSU stocks

Exhibit 14: Over/under ownership of FPIs in PSU stocks with respect to Nifty-50, MSCI India, BSE-200 indices (%)

	% of portfolio		Over/under ownership versus BSE-200 (%)		Over/under ownership versus MSCI India (%)		Over/under ownership versus Nifty-50 (%)	
Company	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**
NTPC	0.59	0.84	(0.23)	(0.26)	(0.38)	(0.54)	(0.50)	(0.72)
Bharat Electronics	0.26	0.39	(0.06)	(0.10)	(0.25)	(0.29)	0.26	0.39
ONGC	0.34	0.39	(0.24)	(0.21)	(0.20)	(0.27)	(0.43)	(0.45)
Coal India	0.23	0.32	(0.21)	(0.31)	(0.24)	(0.26)	(0.36)	(0.58)
PFC	0.15	0.37	(0.03)	(0.05)	0.15	(0.21)	0.15	0.37
REC	0.15	0.37	0.00	(0.01)	0.15	(0.19)	0.15	0.37
Hindustan Aeronautics	0.19	0.40	(0.04)	0.00	0.19	(0.18)	0.19	0.40
IRCTC	0.07	0.08	(0.10)	(0.12)	(0.13)	(0.13)	0.07	0.08
BPCL	0.21	0.23	(0.11)	(0.09)	(0.22)	(0.12)	(0.22)	(0.23)
GAIL (India)	0.26	0.26	(0.01)	(0.07)	(0.08)	(0.12)	0.26	0.26
IOCL	0.17	0.26	(0.12)	(0.10)	(0.14)	(0.11)	0.17	0.26
HPCL	0.11	0.13	(0.04)	(0.06)	(0.11)	(0.10)	0.11	0.13
Container Corp.	0.18	0.17	0.02	(0.01)	(0.05)	(0.07)	0.18	0.17
State Bank of India	1.13	1.10	(0.80)	(0.73)	(0.21)	(0.06)	(1.51)	(1.49)
Power Grid Corp.	1.14	1.10	0.38	0.29	0.13	(0.02)	0.13	(0.04)
Bank of Baroda	0.21	0.24	(0.09)	(0.08)	(0.04)	(0.00)	0.21	0.24
MMTC	0.00	—	0.00	—	0.00	—	0.00	—
Punjab & Sind Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
UCO Bank	0.00	0.00	0.00	(0.02)	0.00	0.00	0.00	0.00
Indian Overseas Bank	0.00	0.00	(0.02)	(0.02)	0.00	0.00	0.00	0.00
ITI	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Central Bank of India	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fertilizers & Chemicals Trava	—	0.00	—	0.00	—	0.00	—	0.00
Bank of Maharashtra	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
IFCI	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Railtel Corp.	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
GMDC	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
IDBI Bank	0.00	0.00	(0.02)	(0.02)	0.00	0.00	0.00	0.00
Shipping Corp.	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
New India Assurance	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
HUDCO	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
LIC	0.01	0.01	(0.09)	(0.11)	0.01	0.01	0.01	0.01
RITES	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Neyveli Lignite Corp.	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
GIC	0.00	0.01	(0.03)	(0.05)	0.00	0.01	0.00	0.01
IREDA		0.01	-	0.01	-	0.01	-	0.01
Hindustan Copper	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
MRPL	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
SJVN	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
NMDC Steel	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
NBCC	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
IRCON International	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
Cochin Shipyard	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Engineers India	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
J&K Bank	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
Bharat Dynamics	0.01	0.02	0.01	0.02	0.01	0.02	0.01	0.02
Rail Vikas Nigam	0.00	0.02	0.00	0.02	0.00	0.02	0.00	0.02
Gujarat Gas	0.03	0.02	(0.05)	(0.04)	0.03	0.02	0.03	0.02
BEML	0.01	0.02	0.01	0.02	0.01	0.02	0.01	0.02
IRFC	0.01	0.02	(0.04)	(0.11)	0.01	0.02	0.01	0.02
CPCL	0.01	0.02	0.01	0.02	0.01	0.02	0.01	0.02
Mazagon Dock	0.01	0.02	0.01	0.02	0.01	0.02	0.01	0.02
Bank of India	0.02	0.04	(0.04)	(0.07)	0.02	0.04	0.02	0.04
SAIL	0.04	0.04	(0.08)	(0.10)	0.04	0.04	0.04	0.04
Gujarat State Petronet	0.06	0.05	0.06	0.05	0.06	0.05	0.06	0.05
National Aluminium Co.	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Punjab National Bank	0.02	0.05	(0.12)	(0.16)	0.02	0.05	0.02	0.05
Indian Bank	0.03	0.05	0.03	(0.06)	0.03	0.05	0.03	0.05
Union Bank	0.02	0.06	(0.06)	(0.09)	0.02	0.06	0.02	0.06
Oil India	0.07	0.07	(0.02)	(0.03)	0.07	0.07	0.07	0.07
BHEL	0.05	0.08	0.05	(0.11)	0.05	0.08	0.05	0.08
NHPC	0.07	0.08	(0.05)	(0.05)	0.07	0.08	0.07	0.08
NMDC	0.05	0.10	0.05	(0.08)	0.05	0.10	0.05	0.10
Canara Bank	0.10	0.15	(0.08)	(0.07)	0.10	0.15	0.10	0.15
Total	**6.13**	**7.74**	**(2.06)**	**(2.75)**	**(0.69)**	**(1.58)**	**(0.41)**	**0.26**

Source: BSE, NSE, Prime Infobase, Kotak Institutional Equities

FPIs underweight PSU-led sectors and PSU banks

Exhibit 15: Over/under ownership structure for FPIs across different sectors with respect to BSE-200 Index, December 2023 (%)

Source: BSE, NSE, Prime Infobase, Kotak Institutional Equities

Exhibit 16 shows that MFs have trimmed their overweight position in PSU stocks in FY2024. Their top-three overweight positions of MFs are in NTPC, Bharat Electronics and SBI, whereas they have an underweight position in IOCL. MFs are overweight PSU-led sectors (see Exhibit 17). Their underweight position in the oil, gas & consumable fuels sector reflects their large underweight position in RIL.

MFs have trimmed their overweight position in PSU stocks

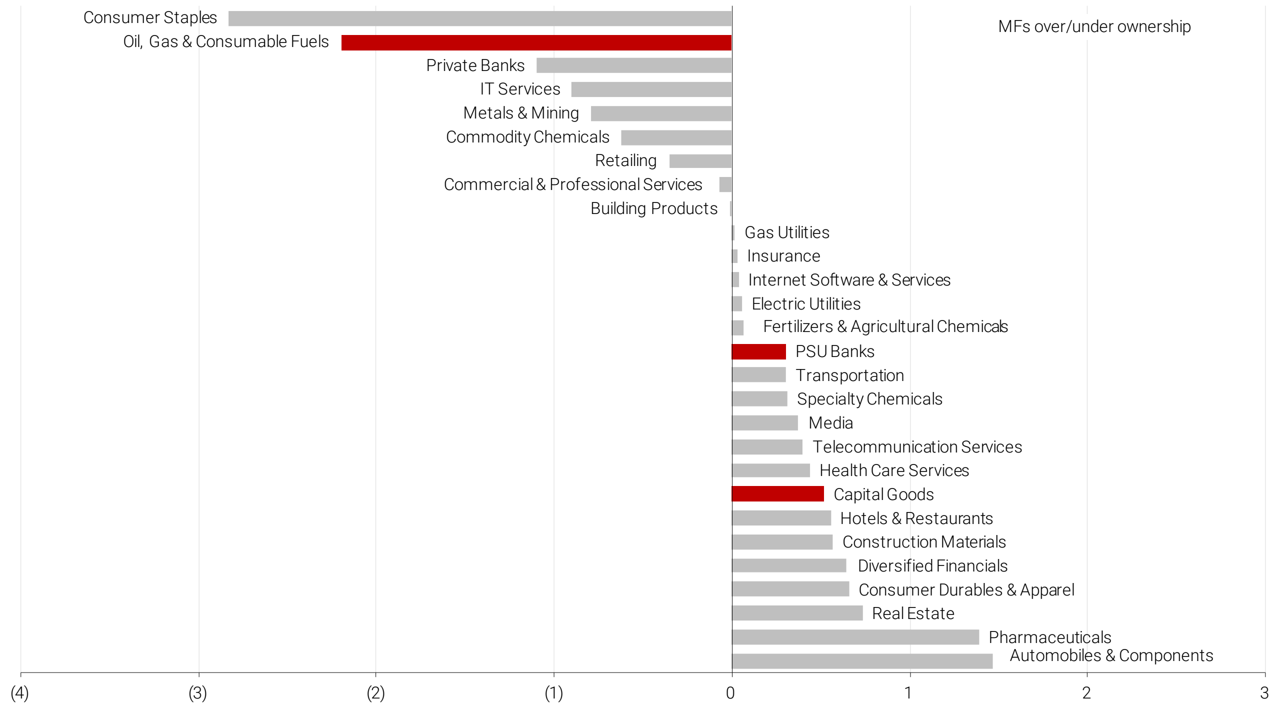
Exhibit 16: Over/under ownership of MFs in PSU stocks with respect to Nifty-50, MSCI India, BSE-200 indices (%)

	% of portfolio		Over/under ownership versus BSE-200 (%)		Over/under ownership versus MSCI India (%)		Over/under ownership versus Nifty-50 (%)	
Company	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**	**Mar-23**	**Dec-23**
NTPC	1.52	1.83	0.70	0.73	0.55	0.45	0.43	0.27
Bharat Electronics	0.64	0.78	0.32	0.29	0.14	0.10	0.64	0.78
State Bank of India	2.72	2.11	0.79	0.28	1.38	0.95	0.08	(0.48)
Coal India	0.52	0.76	0.07	0.12	0.05	0.17	(0.07)	(0.14)
Gujarat State Petronet	0.15	0.12	0.15	0.12	0.15	0.12	0.15	0.12
National Aluminium Co.	0.06	0.10	0.06	0.10	0.06	0.10	0.06	0.10
Bharat Dynamics	0.07	0.09	0.07	0.09	0.07	0.09	0.07	0.09
Indian Bank	0.13	0.19	0.13	0.08	0.13	0.19	0.13	0.19
BEML	0.04	0.06	0.04	0.06	0.04	0.06	0.04	0.06
HPCL	0.20	0.25	0.05	0.06	(0.02)	0.02	0.20	0.25
Neyveli Lignite Corp.	0.02	0.06	0.02	0.06	0.02	0.06	0.02	0.06
Hindustan Copper	0.02	0.05	0.02	0.05	0.02	0.05	0.02	0.05
PFC	0.22	0.47	0.05	0.05	0.22	(0.11)	0.22	0.47
SJVN	0.02	0.05	0.02	0.05	0.02	0.05	0.02	0.05
Container Corp.	0.20	0.22	0.04	0.04	(0.03)	(0.02)	0.20	0.22
NHPC	0.17	0.17	0.05	0.04	0.17	0.17	0.17	0.17
Engineers India	0.01	0.03	0.01	0.03	0.01	0.03	0.01	0.03
IREDA		0.03	-	0.03	-	0.03	-	0.03
ONGC	0.75	0.62	0.17	0.02	0.20	(0.04)	(0.03)	(0.22)
HUDCO	0.00	0.02	0.00	0.02	0.00	0.02	0.00	0.02
J&K Bank	0.00	0.02	0.00	0.02	0.00	0.02	0.00	0.02
RITES	0.03	0.02	0.03	0.02	0.03	0.02	0.03	0.02
GAIL (India)	0.26	0.34	(0.02)	0.02	(0.08)	(0.04)	0.26	0.34
NMDC Steel	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
NBCC	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
LIC	0.10	0.13	(0.00)	0.01	0.10	0.13	0.10	0.13
Cochin Shipyard	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Railtel Corp.	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
MRPL	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
Shipping Corp.	—	0.01	—	0.01	—	0.01	—	0.01
Gujarat Gas	0.14	0.07	0.06	0.01	0.14	0.07	0.14	0.07
Hindustan Aeronautics	0.36	0.40	0.14	0.01	0.36	(0.17)	0.36	0.40
Bank of Baroda	0.40	0.33	0.09	0.01	0.15	0.08	0.40	0.33
Mazagon Dock	0.00	0.01	0.00	0.01	0.00	0.01	0.00	0.01
Bank of Maharashtra	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
IRCON International	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Rail Vikas Nigam	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Central Bank of India	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
CPCL	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
MMTC	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
New India Assurance	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Fertilizers & Chemicals Trava	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Punjab & Sind Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
ITI	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
GMDC	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
IFCI	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
NMDC	0.09	0.17	0.09	(0.01)	0.09	0.17	0.09	0.17
BPCL	0.32	0.31	(0.00)	(0.01)	(0.11)	(0.04)	(0.11)	(0.15)
Oil India	0.05	0.09	(0.05)	(0.01)	0.05	0.09	0.05	0.09
UCO Bank	0.00	0.00	0.00	(0.02)	0.00	0.00	0.00	0.00
Indian Overseas Bank	0.00	0.00	(0.02)	(0.02)	0.00	0.00	0.00	0.00
IDBI Bank	0.00	0.00	(0.02)	(0.03)	0.00	0.00	0.00	0.00
Bank of India	0.02	0.07	(0.04)	(0.03)	0.02	0.07	0.02	0.07
SAIL	0.07	0.08	(0.05)	(0.05)	0.07	0.08	0.07	0.08
Punjab National Bank	0.11	0.16	(0.03)	(0.05)	0.11	0.16	0.11	0.16
BHEL	0.04	0.13	0.04	(0.05)	0.04	0.13	0.04	0.13
GIC	0.00	0.00	(0.03)	(0.05)	0.00	0.00	0.00	0.00
Union Bank	0.05	0.09	(0.03)	(0.06)	0.05	0.09	0.05	0.09
Power Grid Corp.	0.65	0.73	(0.11)	(0.07)	(0.37)	(0.39)	(0.37)	(0.40)
Canara Bank	0.11	0.13	(0.08)	(0.09)	0.11	0.13	0.11	0.13
REC	0.10	0.29	(0.04)	(0.09)	0.10	(0.27)	0.10	0.29
IRFC	0.02	0.02	(0.03)	(0.12)	0.02	0.02	0.02	0.02
IRCTC	0.02	0.05	(0.15)	(0.15)	(0.18)	(0.16)	0.02	0.05
IOCL	0.11	0.10	(0.18)	(0.27)	(0.20)	(0.27)	0.11	0.10
Total	**10.54**	**11.82**	**2.35**	**1.32**	**3.72**	**2.50**	**4.01**	**4.34**

Source: BSE, NSE, Prime Infobase, Kotak Institutional Equities

MFs overweight PSU-led sectors and PSU banks; underweight in oil, gas & consumable fuels sector reflects underweight on RIL

Exhibit 17: Over/under ownership structure for FPIs across different sectors with respect to BSE-200 Index, December 2023 (%)

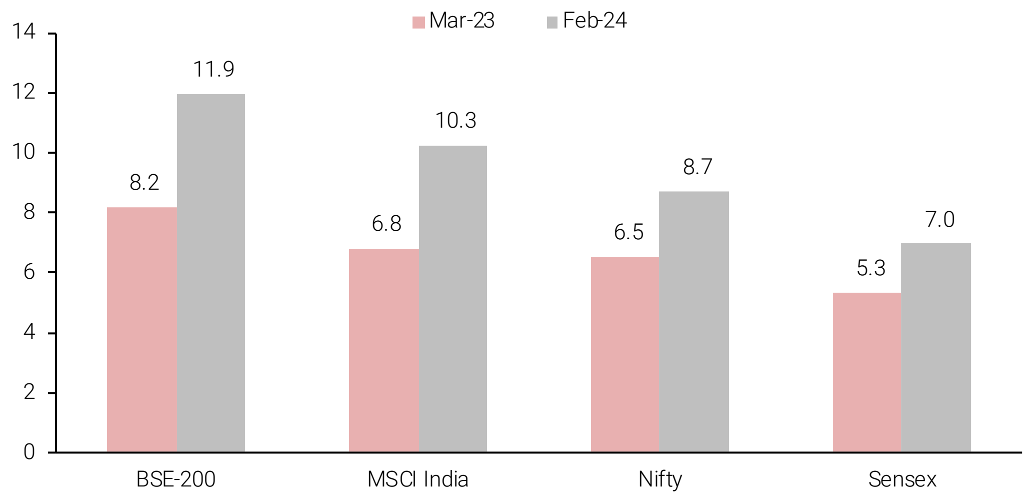


Source: BSE, NSE, Prime Infobase, Kotak Institutional Equities

The under-ownership position of FPIs and low over-ownership of MFs in several PSU stocks would have hurt the overall portfolio performance of FPIs and MFs over the past few months, given the unabated rally in PSU stocks. The dilemma for institutional investors has increased with the sharp rally in prices of PSU stocks, resulting in a major increase in the weight of PSU stocks in major indices (see Exhibit 18). PSU stocks account for 11.9%, 10.3%, 8.7% and 7% weights in BSE-200, MSCI India, Nifty-50 and BSE-30 Indices, respectively compared with 8.2%, 6.8%, 6.5% and 5.3% weights, respectively, in March 2023.

Weight of PSU stocks in various indices has increased sharply in the past few months

Exhibit 18: Weights of PSU stocks in BSE-200, MSCI India, Nifty and Sensex, March fiscal year-ends, 2023-24 (%)



Source: BSE, NSE, Bloomberg, Kotak Institutional Equities

Revered by non-institutional investors

Non-institutional investors have benefited significantly from the rally in PSU stocks, as they are the largest shareholders in many PSU stocks, after the Indian government. Exhibit 19 shows the latest shareholding pattern of PSU stocks, along with the past 12 months' performance. Some PSU stocks with high retail holding (with comparatively lower market cap.) have delivered exponential returns (see Exhibit 20). HUDCO, IFCI, IRFC and MRPL are the major gainers and are up 368%, 328%, 440% and 344%, respectively, in the past 12 months. In fact, there seems to be an inverse correlation between free float and performance with PSU stocks, with very low free floats delivering outsized returns compared with PSU having higher free floats (see Exhibit 21).

Stocks with high retail holding have delivered very high returns in this rally

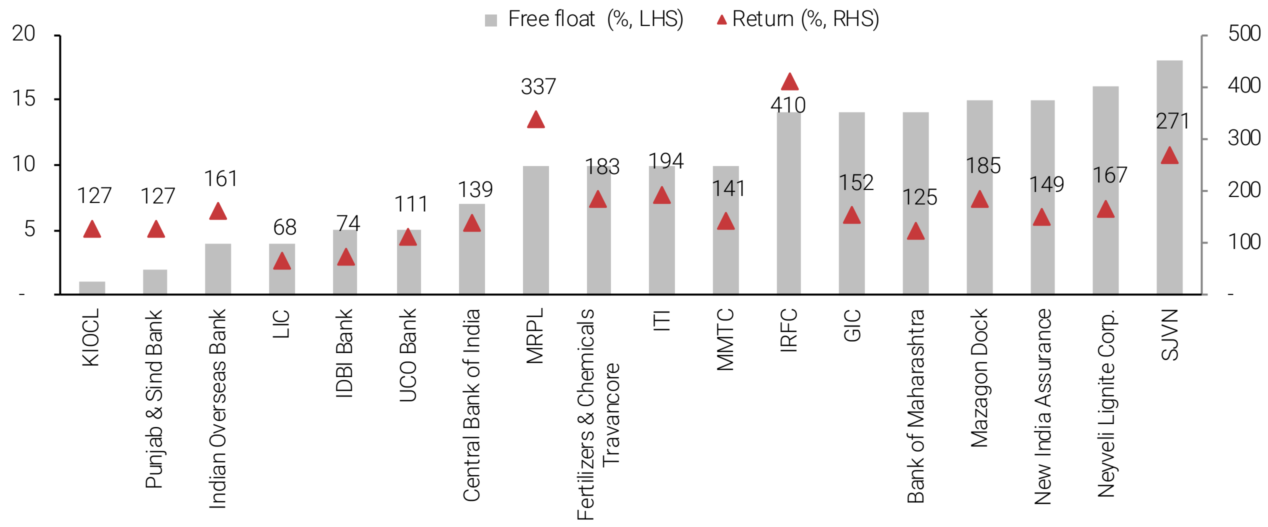
Exhibit 19: Shareholding data of PSU stocks, as of December 2023 (%)

	Market cap.	Perf-FYTD24	Shareholding pattern (%)						
Company	(Rs bn)	(%)	Promoters	FPIs	MFs	BFIs	Retail	Other	LIC
ONGC	3,499	76	58.9	9.2	7.6	10.7	2.5	11.2	9.7
NTPC	3,415	99	51.1	17.0	19.1	7.6	2.3	2.8	4.6
Coal India	2,826	104	63.1	8.6	10.4	12.2	3.8	1.9	10.6
Power Grid Corp.	2,722	72	51.3	30.5	10.5	3.5	2.9	1.3	2.1
IOCL	2,466	120	51.5	8.8	1.8	7.9	6.8	23.2	7.0
Hindustan Aeronautics	2,219	145	71.6	12.9	6.7	1.9	5.3	1.5	1.6
Bharat Electronics	1,573	123	51.1	17.8	18.3	3.6	6.8	2.4	–
BPCL	1,355	92	53.0	14.2	9.9	11.0	7.2	4.7	–
GAIL (India)	1,240	73	51.5	14.9	10.1	9.1	5.4	9.0	7.5
NHPC	905	125	71.0	7.4	8.2	4.6	5.8	3.1	2.9
BHEL	897	244	63.2	7.1	6.3	10.9	10.3	2.3	9.6
IRCTC	750	52	62.4	7.3	2.4	9.4	17.0	1.4	9.0
HPCL	721	131	54.9	14.3	14.1	6.7	7.5	2.6	4.5
NMDC	700	109	60.8	9.9	8.7	8.4	9.6	2.5	6.9
Oil India	683	140	56.7	11.0	6.7	9.2	5.6	10.9	8.3
Container Corp.	588	60	54.8	19.6	13.1	8.5	2.2	1.9	5.9
SAIL	574	59	65.0	4.3	5.2	10.3	13.0	2.3	9.2
Rail Vikas Nigam	496	264	72.8	2.6	0.1	5.9	17.0	1.5	5.9
SJVN	480	271	81.9	1.7	4.3	1.7	8.8	1.7	1.4
Fertilizers & Chemicals Travancore	460	183	90.0	0.1	0.0	0.0	0.8	9.1	–
Mazagon Dock	421	185	84.8	3.3	0.4	0.1	9.4	2.1	–
MRPL	409	337	88.6	2.6	1.3	0.2	5.7	1.7	–
Gujarat Gas	393	11	60.9	3.3	6.6	7.4	6.3	15.5	6.1
Bharat Dynamics	330	91	74.9	3.1	9.3	3.6	7.3	1.9	1.0
Neyveli Lignite Corp.	303	167	79.2	1.2	5.3	2.0	5.5	6.8	1.1
National Aluminium Co.	300	94	51.3	11.6	13.4	5.4	14.6	3.8	3.3
KIOCL	272	127	99.0	–	–	0.1	0.8	0.1	–
Hindustan Copper	271	173	66.1	2.1	6.2	7.4	14.1	4.1	6.9
ITI	269	194	90.3	0.1	0.0	–	1.9	7.7	–
NBCC	229	256	61.8	4.5	3.2	7.2	19.4	4.0	6.6
Cochin Shipyard	228	266	72.9	4.1	1.9	0.3	16.9	4.0	–
IRCON International	210	309	65.2	4.1	0.5	0.3	24.5	5.4	–
Gujarat State Petronet	206	25	37.6	16.0	22.3	2.2	7.2	14.7	–
NMDC Steel	179	59	60.8	4.3	3.2	15.9	13.7	2.1	14.2
RITES	177	110	72.2	3.2	4.8	7.5	9.4	3.0	6.3
Railtel Corp.	135	273	72.8	1.5	3.0	0.4	18.1	4.3	–
CPCL	135	279	67.3	14.7	0.3	0.8	13.8	3.2	–
BEML	134	166	54.0	9.1	17.3	1.3	14.5	3.9	–
Engineers India	127	197	51.3	7.6	9.6	5.8	21.0	4.7	2.9
GMDC	126	184	74.0	1.8	0.0	0.9	19.9	3.4	–
MMTC	113	141	89.9	–	0.3	2.1	7.0	0.6	2.0
Shipping Corp.	106	145	63.8	3.3	3.3	4.7	19.7	5.3	3.3
BFSI									
State Bank of India	7,033	40	56.9	11.8	11.6	10.4	6.3	2.9	8.9
LIC	6,482	68	96.5	0.1	0.8	0.2	2.0	0.5	-
IRFC	1,878	410	86.4	1.2	0.4	0.8	10.6	0.8	-
Bank of Baroda	1,457	63	64.0	12.3	8.6	5.6	6.6	3.0	5.1
Punjab National Bank	1,430	153	73.2	3.1	4.8	8.9	8.8	1.3	8.3
PFC	1,418	232	56.0	17.9	11.6	5.3	6.8	2.4	2.1
Indian Overseas Bank	1,249	161	96.4	0.0	0.1	1.2	1.9	0.5	1.2
REC	1,245	289	52.6	20.6	8.3	4.7	10.1	3.7	–
Union Bank	1,201	118	77.0	4.0	3.1	9.0	6.0	0.9	6.0
Canara Bank	1,085	96	62.9	11.2	5.2	7.9	10.2	2.6	6.3
IDBI Bank	919	74	94.7	0.3	0.0	0.1	4.0	0.8	49.2
Indian Bank	735	90	73.8	5.9	10.5	4.8	3.1	1.8	2.9
UCO Bank	687	111	95.4	0.0	0.1	1.2	3.0	0.3	1.2
Bank of India	664	80	73.4	4.3	4.3	10.0	6.0	2.0	6.6
GIC	644	152	85.8	1.0	0.2	10.9	1.6	0.6	8.7
Central Bank of India	559	139	93.1	0.1	0.1	2.7	3.6	0.5	2.6
Bank of Maharashtra	438	125	86.5	0.5	0.4	4.3	7.5	0.9	4.1
Punjab & Sind Bank	437	127	98.3	0.0	0.0	0.6	1.0	0.1	–
New India Assurance	425	149	85.4	0.8	0.0	11.7	1.3	0.8	8.7
HUDCO	405	330	75.2	1.2	2.7	9.1	9.2	2.6	8.9
IREDA	398	NA	75.0	1.9	2.9	1.4	17.6	1.2	–
J&K Bank	155	170	59.4	5.8	5.0	2.4	21.5	6.0	1.3
IFCI	104	268	70.3	2.1	0.0	2.0	19.4	6.2	2.0

Source: Bloomberg, Kotak Institutional Equities

PSU stocks with low free floats generated 68-410% returns over the past 12 months

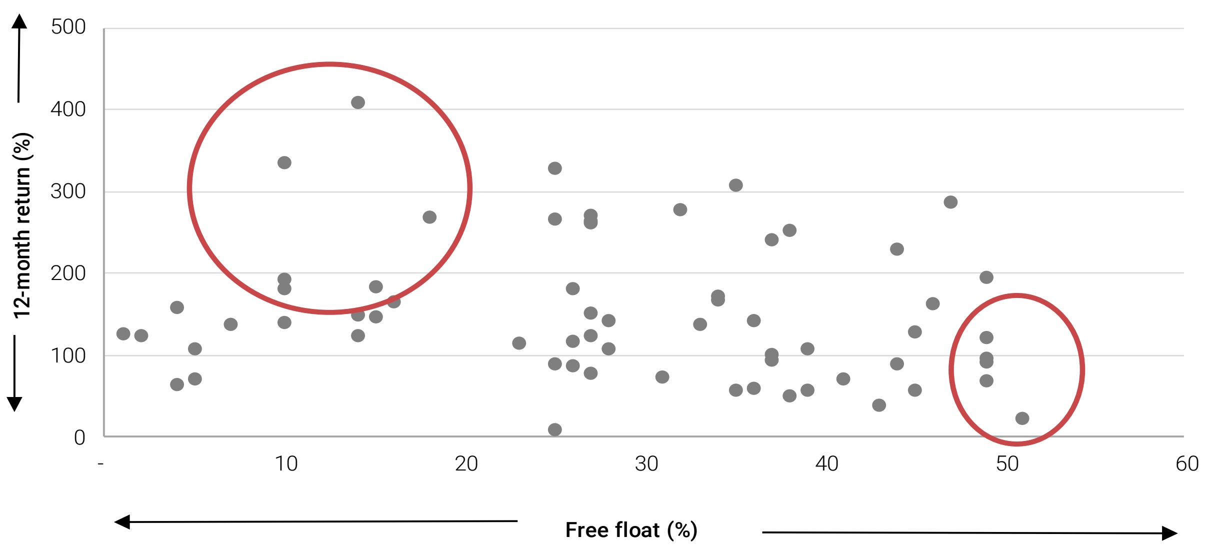
Exhibit 20: 12-month return versus free float of PSU stocks (%)



Source: Bloomberg, Kotak Institutional Equities

PSU stocks with low free floats generated significantly higher returns compared with ones having higher free floats

Exhibit 21: 12-month return versus free float of PSU stocks, March 2024



Source: Bloomberg, Kotak Institutional Equities

3

Reality is different from myth

We find the market narratives to justify the high valuations of non-financial PSU stocks quite superficial. These narratives (1) reflect unrealistic optimism on future opportunities, (2) build in elevated, but unsustainable profitability, (3) ignore long-term business viability issues and (4) overlook low FCF in the context of continued large investment in low-return projects, with high technological obsolescence. Thus, we see large risks of value erosion in most PSU stocks.

We see stark divergence between the narratives and realities surrounding the future of a number of PSU companies. The market seems to have found a plethora of narratives to justify the elevated extant valuations of PSU companies. In our view, these narratives appear to be quite disconnected from reality and simply reflect top-down irrational exuberance among a set of investors, as discussed in the previous section.

Capital goods may at least have a story; others seem like fables

We discuss the major PSUs under coverage and analyze the reality of their business models and valuations versus the narratives supporting their current expensive valuations.

- **Capital goods (defense).** The Indian defense sector has witnessed a sharp rerating and delivered massive returns over the past 6-12 months (see Exhibit 22) on (1) expectations of large spending by the government for an extended period of time and (2) steady increase in indigenization. The large deal wins of companies in FY2024 boosted investor sentiment.

Defense stocks have seen sharp rally in their stock prices in the past one year

Exhibit 22: Performance of major defense stocks in India, March 2024 (%)

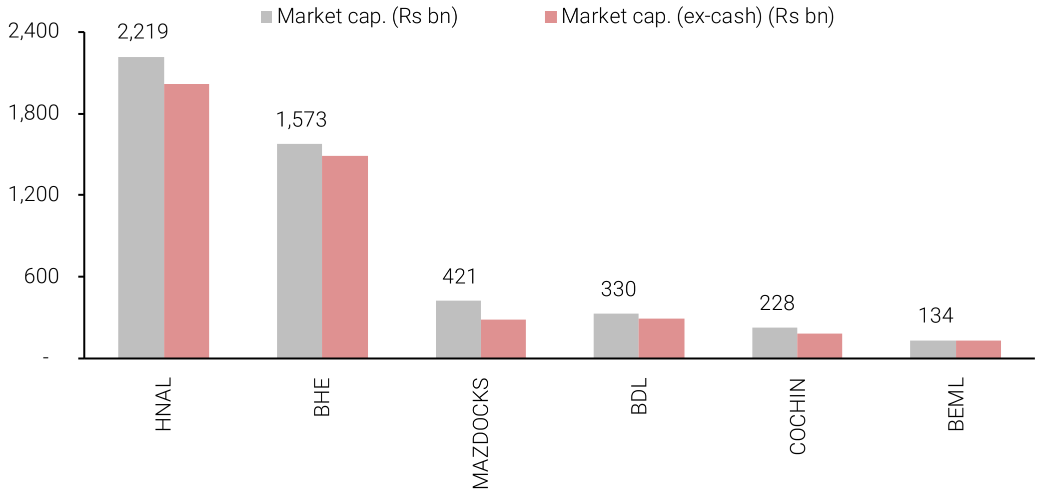
	Return (%)		
	3-month	6-month	1-year
BEML	30	31	166
Bharat Dynamics	38	52	91
Bharat Electronics	34	54	123
Cochin Shipyard	35	51	266
Hindustan Aeronautics	23	64	145
Mazagon Dock Shipbuilders	0	(0)	185
Nifty Midcap-100 Index	**10**	**21**	**58**
Nifty Smallcap-100 Index	**8**	**23**	**66**

Source: Bloomberg, Kotak Institutional Equities

However, markets may have run ahead of reality, as current valuations suggest a massive upturn in ordering and execution for defense companies. Our reverse valuation analysis of a basket of major defense PSU stocks suggests that these companies will need to execute around Rs1.9 tn of defense orders annually to justify their current market capitalization, assuming they maintain their current margin profiles (see Exhibits 23-24). For context, these companies had combined revenues of Rs612 bn in FY2023 versus Rs1.5 tn of government capex in defense (see Exhibits 25-26). Taking into account the pace of indigenization and strong growth rate, we model the FY2026 defense opportunity at Rs1.6 tn (see Exhibit 27). As such, defense PSUs will need to capture an even higher share of the government's defense capex to justify their valuations.

Total market cap. of major defense PSUs in India currently at Rs5 tn

Exhibit 23: Market cap. of defense stocks, March 2024 (Rs bn)



Source: Bloomberg, Capitaline, Kotak Institutional Equities

Current valuations imply the major defense companies, generating Rs1.8-2.3 tn of annual revenues

Exhibit 24: Implied annual sales to be generated by a set of defense stocks (Rs bn)

	P/E (X)		
	15	18	20
Current market capitalization (Rs bn)	4,904		
Implied PAT (Rs bn)	327	272	245
Assumed PAT margin (%)	14.0	14.0	14.0
Implied annual sales (Rs bn)	**2,335**	**1,946**	**1,751**

Source: Bloomberg, Capitaline, Kotak Institutional Equities estimates

Revenues increased at a paltry CAGR of 7.5% over FY2017-23 for a basket of defense stocks

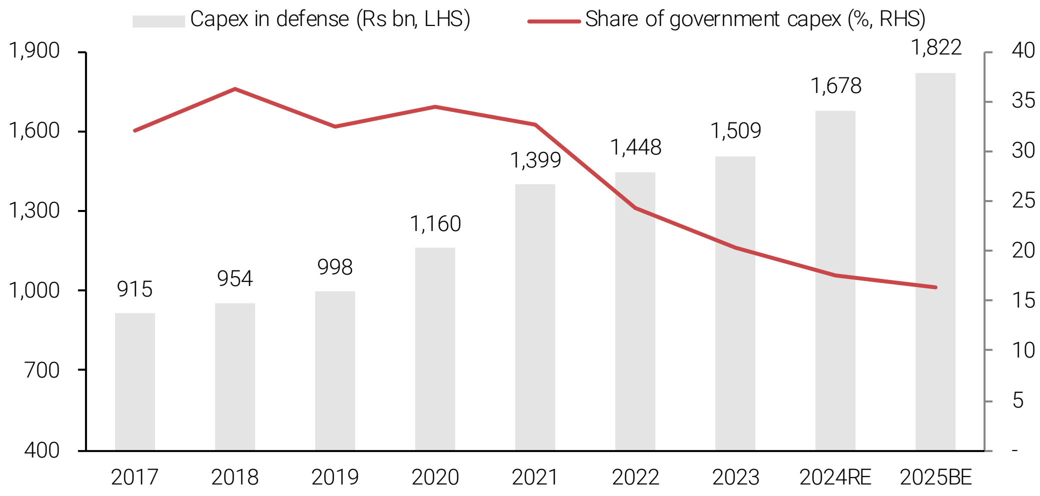
Exhibit 25: Revenues of major defense stocks, March fiscal year-ends, 2017-23 (Rs bn)

	2017	2018	2019	2020	2021	2022	2023	CAGR (%) 2017-23
BEML	25	32	35	30	36	43	39	8
Bharat Dynamics	49	46	31	31	19	28	25	(11)
Bharat Electronics	87	104	122	130	141	154	177	13
Cochin Shipyard	21	24	30	34	28	32	24	2
Hindustan Aeronautics	179	185	200	214	229	246	269	7
Mazagon Dock Shipbuilders	35	45	46	49	40	57	78	14
Total	**396**	**436**	**463**	**489**	**494**	**561**	**612**	**7.5**

Source: Capitaline, Kotak Institutional Equities

Government capex in defense increased at a CAGR of 9% over FY2017-25BE

Exhibit 26: Government capex in defense, March fiscal year-ends, 2017-25BE (Rs bn)



Source: Union Budget, Kotak Institutional Equities

We project government budget for domestic defense procurement at Rs1.6 tn in FY2026

Exhibit 27: Annual spending of government in defense, March fiscal year-ends, 2018-27E (Rs tn)

	2018	2019	2020	2021	2022	2023	2024RE	2025BE	2026E	2027E
Defense capex (Rs tn)	0.95	1.00	1.16	1.40	1.45	1.51	1.68	1.82	2.02	2.24
Yoy growth in spending (%)		4.6	16.3	20.6	3.5	4.2	11.2	8.6	11.0	11.0
Estimated imports (Rs tn)	0.31	0.38	0.40	0.71	0.58	0.48	0.46	0.44	0.42	0.40
Yoy growth (%)		24.5	5.8	77.4	(18.3)	(18.6)	(2.6)	(5.0)	(5.0)	(5.0)
Estimated opportunity for domestic companies (Rs tn)	**0.65**	**0.62**	**0.76**	**0.68**	**0.86**	**1.03**	**1.22**	**1.38**	**1.60**	**1.85**

Notes:
(a) Imports data over FY2018-24RE is based on government data on imports and domestic procurement. We assume steady decline over FY2025-27E.

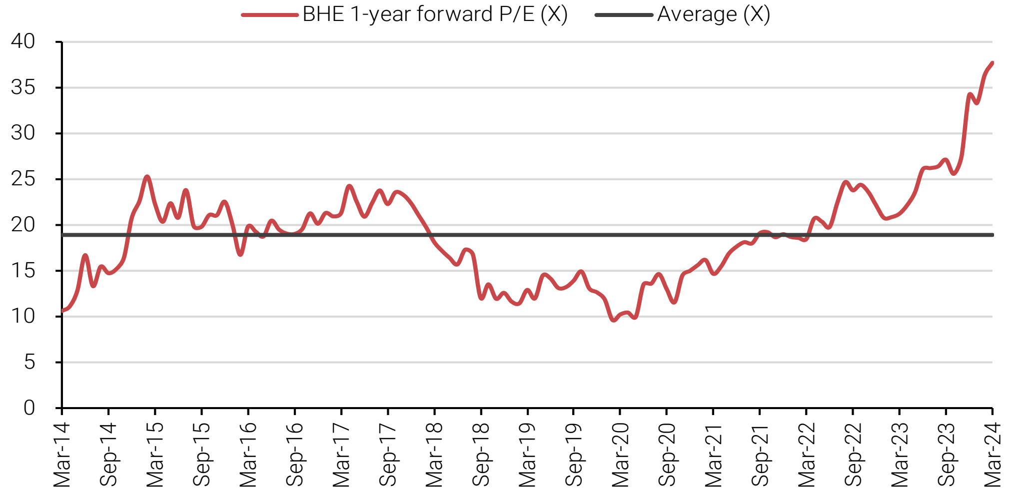
Source: PIB, Union Budget, Ministry of Defence, Kotak Institutional Equities estimates

We believe in the long growth runway for the sector over the medium to long term, but we see downside risks due to (1) potential delays in ordering (lumpy in nature) and (2) possible risks to extant elevated profitability. We discuss our views on individual defense stocks below:

- **Bharat Electronics.** BHE stock is trading at 41X FY2025E EPS and 29X FY2025E EBITDA; it is currently trading at a large premium to its historical trading range (see Exhibit 28). We agree with the market's assessment about the stock being one of the major beneficiaries of the government's thrust on domestic defense manufacturing and procurement. BHE has a strong order book. However, we note that BHE may see a flattening of its order book, as the government had fast-tracked certain medium-sized orders in FY2024, suggesting that there may be a slowdown in new order wins in FY2025-26E (see Exhibits 29-30).

BHE is currently trading at a large premium to its historical valuations

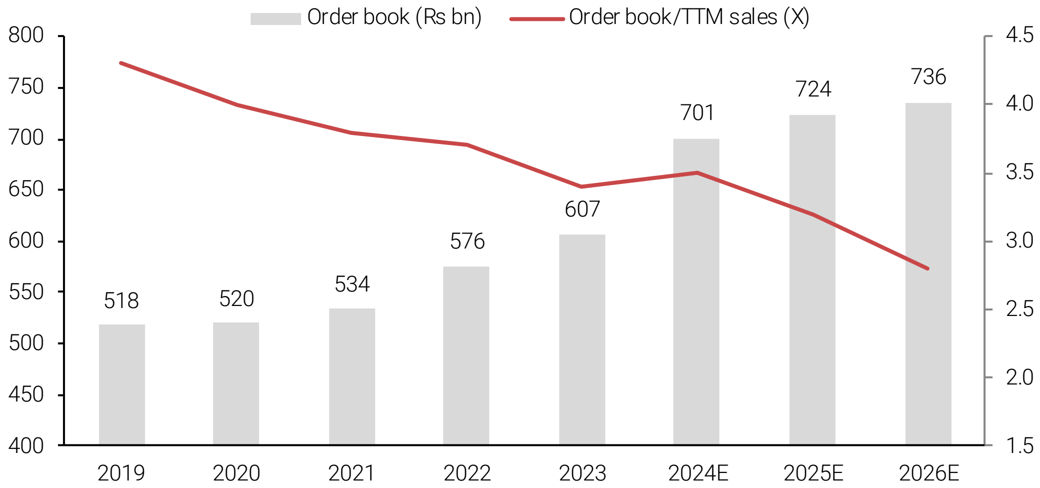
Exhibit 28: 1-year forward P/E of Bharat Electronics, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

BHE witnessed sharp increase in its order book in FY2024, driven by fast-tracking of certain medium-sized orders

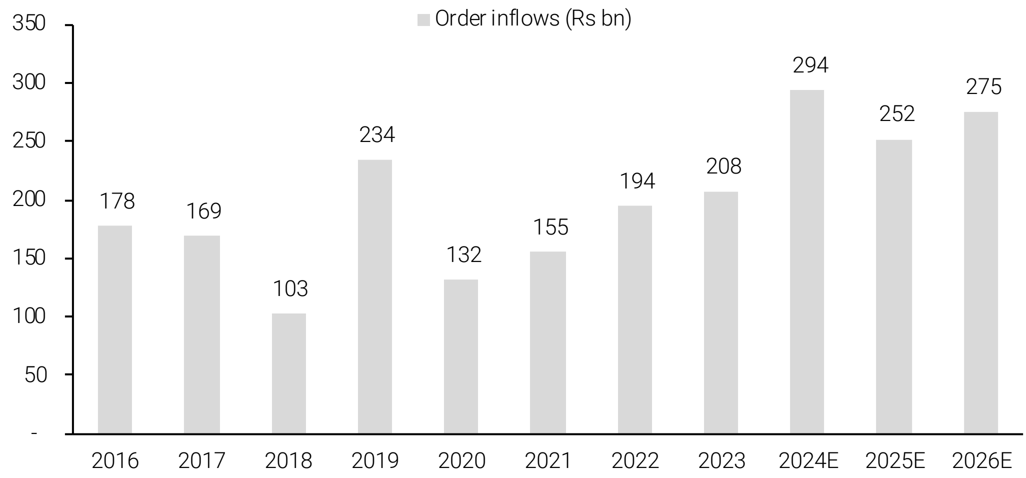
Exhibit 29: Order book of Bharat Electronics and order book/trailing 12m sales, March fiscal year-ends, 2019-26



Source: Company, Kotak Institutional Equities estimates

BHE's order inflows have been patchy historically; order inflows to be likely lower over FY2025-26E versus FY2024 levels

Exhibit 30: Order inflows of Bharat Electronics, March fiscal year-ends, 2019-26 (Rs bn)

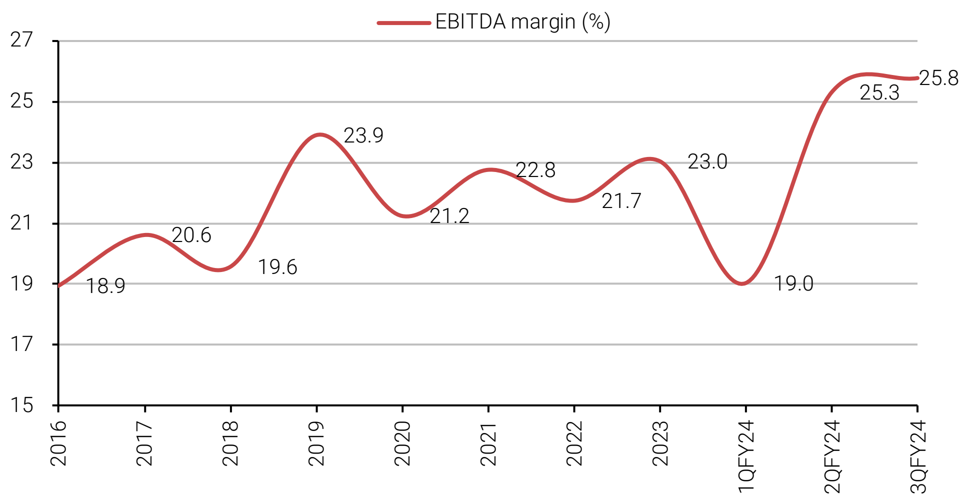


Source: Company, Kotak Institutional Equities estimates

BHE's medium-term margins may moderate as (1) its margins are at historical peak levels (see Exhibit 31) and (2) the share of higher-profitability non-defense revenues will likely decline in the coming years (see Exhibit 32). The company's high multiples imply that its profitability will sustain at current high levels (or increase further) and government pricing policy for incremental orders will remain suitably benign. However, the government's three-in-one role of buyer, owner and policy-maker/regulator adds a degree of uncertainty to the company's future earnings and returns.

BHE's margins are at historical highs

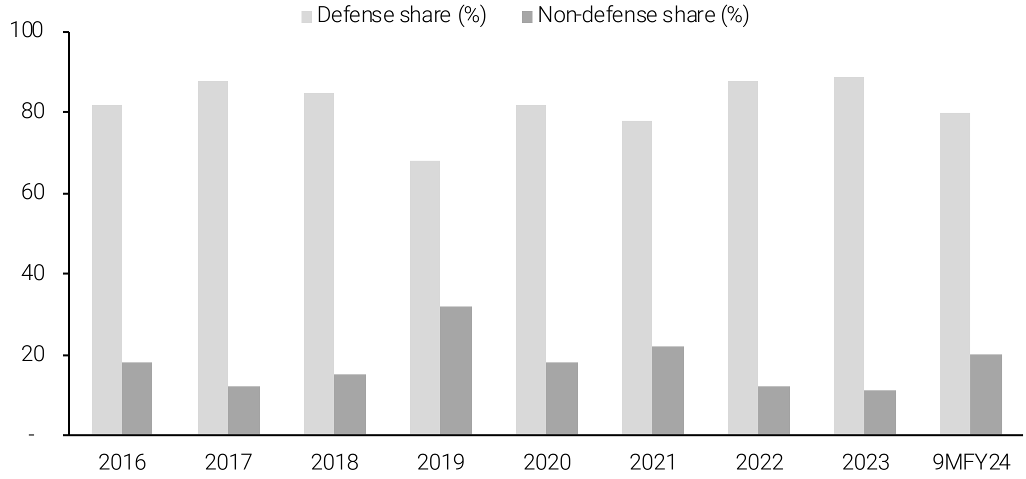
Exhibit 31: EBITDA margin of Bharat Electronics, March fiscal year-ends, 2016-24 (%)



Source: Company, Kotak Institutional Equities

Contribution of non-defense revenues expected to decline, as impact of EVM and VVPAT machines are behind

Exhibit 32: Split of defense and non-defense revenues of Bharat Electronics, March fiscal year-ends, 2016-24 (%)

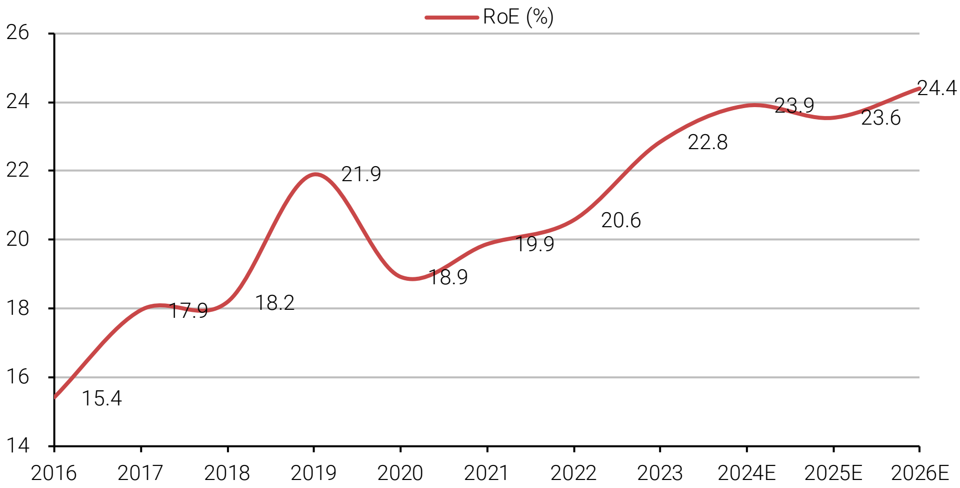


Source: Company, Kotak Institutional Equities estimates

We note that BHE's RoE has been around 20-23% (excluding FY2020's 18.6%, affected by the Covid-19 pandemic) over FY2019-23. We model the FY2024-26E RoE at 22-23% (see Exhibit 33). It remains to be seen if BHE's RoE will sustain at such 'high' levels in the future, given the business-to-government (B2G) nature of its business. That is possible, but it is hard to be fully confident about the same, as this would largely depend on government policy. The timing of new orders and timelines of execution are rather sketchy, given the nature of the business.

BHE's financial returns are at historical highs

Exhibit 33: RoE of Bharat Electronics, March fiscal year-ends, 2016-26E (%)

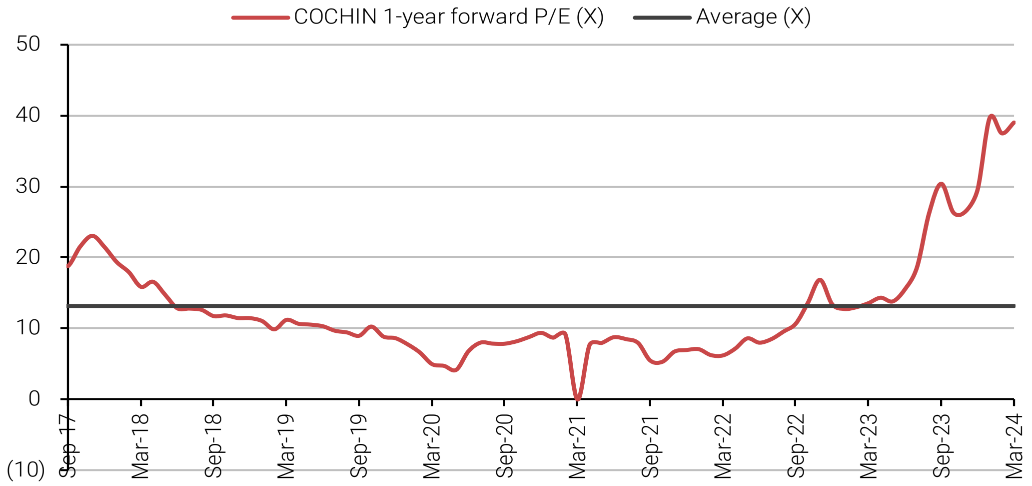


Source: Company, Kotak Institutional Equities estimates

- **Cochin Shipyard.** COCHIN stock is currently trading at 37X FY2025E EPS and 23X FY2025E EBITDA, which is at a significant premium to its historical trading range (see Exhibit 34). COCHIN trades at 4.3X FY2025E BVPS, which appears quite high in the context of its reported RoE (average of 13.5% over FY2018-23, although FY2023 RoE was pulled down by some accounting issues; we model 13-15% over FY2024-26E).

COCHIN is currently trading at a large premium to its historical valuations

Exhibit 34: 1-year forward P/E of Cochin Shipyard, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

COCHIN's market capitalization has increased by Rs138 bn (US$1.7 bn) since the middle of August 2023 for two plausible reasons—(1) the market has started discounting the prospects of COCHIN being awarded a contract for a new aircraft carrier (IAC-2) by the Indian Navy and (2) the market has started assuming plentiful ex-IAC defense and non-defense orders for COCHIN.

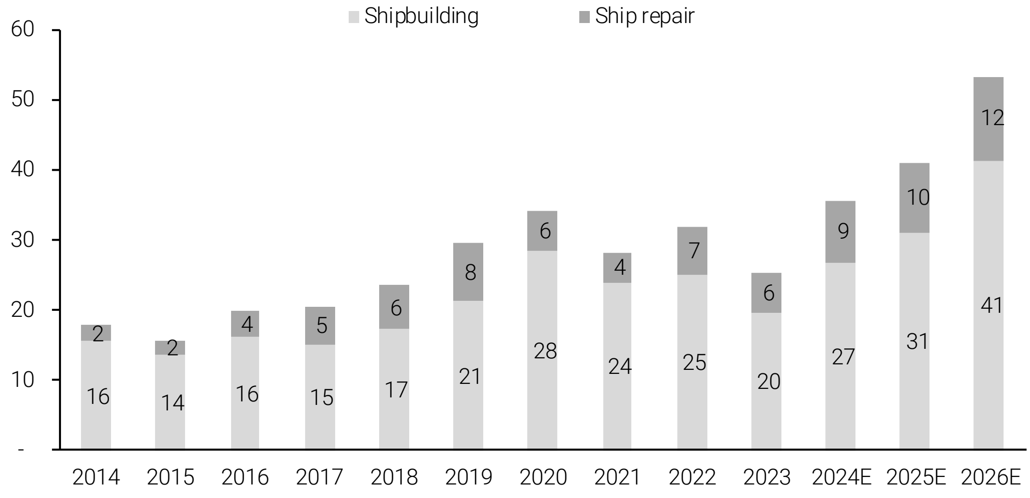
We see issues with both the abovementioned 'factors', which underpin the market's optimism view of COCHIN.

- **IAC order.** We would note that there is no clarity on the size and timing of the contract, even assuming that COCHIN would get to execute the contract. The market believes that the new order would be of a significantly higher value of Rs400 bn compared with the order value of Rs200 bn for the previous aircraft carrier. In our view, it may not be prudent to assume a large increase in order value, until it is confirmed by the defense acquisition council.

- **Ex-IAC and defense non-defense orders.** We would note that the pipeline of new contracts (ex-IAC-2) has seen a steady decline from Rs160 bn in 1QFY24 to Rs90 bn in 3QFY24, suggesting a decline in ordering and revenue visibility. The company has lost three recent contracts (fast patrol vessels, ocean research vessel and NG offshore patrol vessels) to other shipyards. As such, COCHIN will need to diversify its operations beyond government orders, which may not be as profitable as government orders though. We are already building in stronger revenue growth for COCHIN compared with its rather modest growth rate in the recent past (see Exhibit 35).

We expect COCHIN to increase its revenues at CAGR of 14% over FY2023-26; its revenues grew at 7.5% over FY2014-22

Exhibit 35: Split of COCHIN's revenues between shipbuilding and ship repair, March fiscal year-ends, 2014-26E (Rs bn)

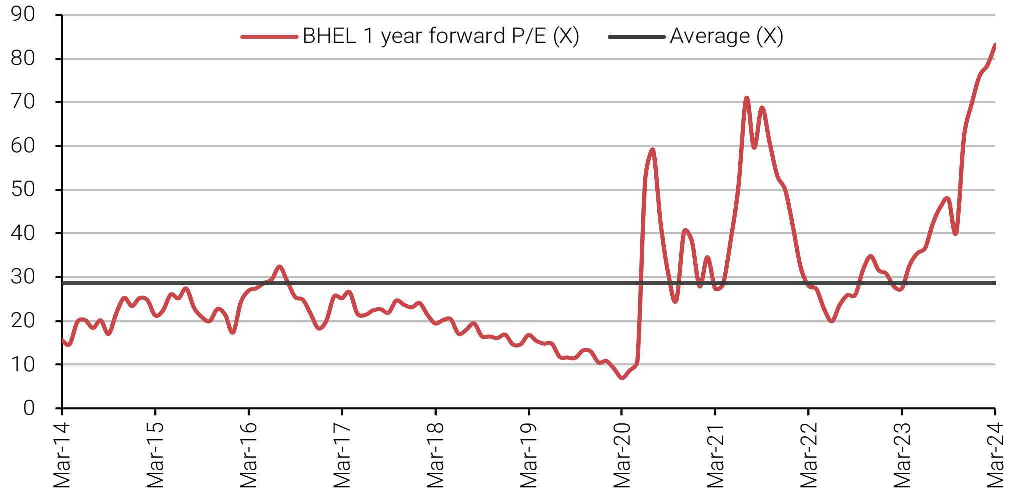


Source: Company, Kotak Institutional Equities estimates

- **Capital goods (electric equipment).** BHEL has seen a sharp rally in its stock price and delivered a 244% return in the past one year. The stock has seen a massive rerating (see Exhibit 36) on expectations of (1) a sharp pick-up in thermal electricity generation orders for the next 3-5 years, given possible electricity demand-supply imbalance, (2) related increase in order inflows for BHEL's BTG (boiler, turbine, generator) equipment and (3) pick-up in BHEL's revenues and profits, which have collapsed over the past few years.

BHEL is currently trading at a massive premium to its historical valuations

Exhibit 36: 1-year forward P/E of BHEL, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

We disagree with the market's bullish view, given (1) wildly optimistic assumptions on order inflows, revenues and profits and (2) incorrect valuation methodology being used to value the stock.

- **Optimistic assumptions.** BHEL's current market capitalization implies that it would need to deliver BTG equipment corresponding to 31 GW of new thermal generation capacity every year in perpetuity (see Exhibit 37). This is clearly absurd, as the incremental addition of thermal electricity generation is likely to be restricted to a limited amount and for a limited period of time only. We expect progress in storage technology to address the current problem of intermittency associated with solar electricity generation. This would cap BHEL's revenues and profits to a finite number and for a finite period.

Current market cap. of BHEL implies 25-37 GW of annual BTG sales

Exhibit 37: Implied annual thermal electricity generation capacity to be supplied by BHEL (GW)

	P/E (X)		
	10	**12**	**15**
Current market cap. (Rs bn)	897		
Implied PAT (Rs bn)	90	75	60
Assumed PAT margin (%)	4.0	4.0	4.0
Implied annual sales (Rs bn)	2,242	1,868	1,494
Revenue/GW (Rs bn)	60	60	60
Implied annual sales (GW)	**37**	**31**	**25**

Notes:
(a) BHEL derives a portion of its revenues from industrial sales. However, the implied BTG numbers are so large that we can ignore the same in this exercise.

Source: Company, Kotak Institutional Equities estimates

- **Incorrect valuation methodology.** The market's use of P/E multiple to value BHEL's near-term earnings arising from the aforementioned limited-opportunity business is conceptually incorrect. Even a moderate P/E multiple (say, 12-15X) implicitly assumes strong growth in earnings for a very long period of time. In our view, BHEL's limited-opportunity business should be valued based on the NPV of future cash flows.

  The difference between an NPV approach (fair value of cash flows) and a P/E approach (current market capitalization) is quite vast, as can be seen in Exhibit 38. Even in the best-case scenario, BHEL's cumulative profits will be significantly lower than its current market capitalization. The discounted value of the net profits will be even lower. We compute BHEL's hypothetical profits under various combinations of (1) cumulative thermal capacity addition in India over the next few years (and no more additions beyond the next 5-6 years), (2) BHEL's market share of the new thermal electricity generation capacity and (3) net profit margin assumptions.

BHEL's likely cumulative profits from new thermal capacity addition is well below its current market capitalization

Exhibit 38: Potential size of limited opportunity for BHEL from thermal capacity addition

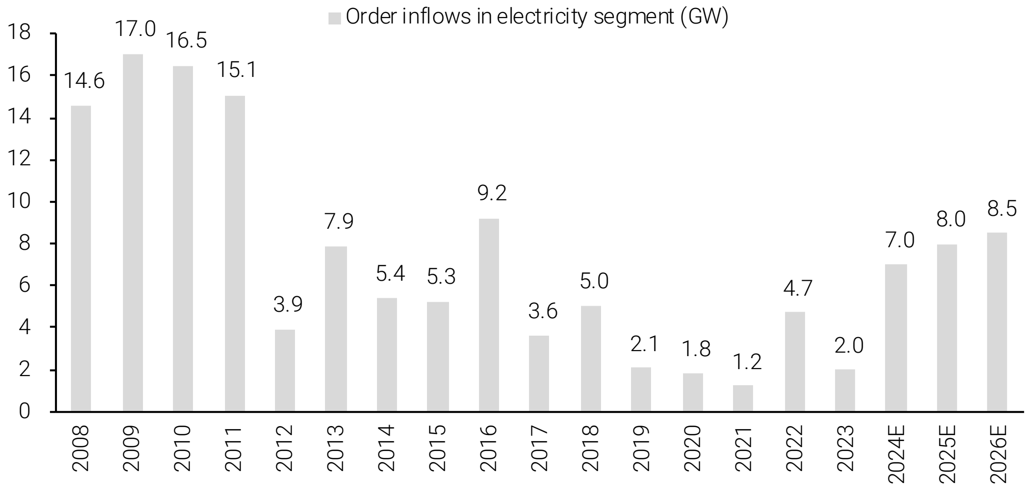
	Total thermal capacity addition (GW)			
	50	**60**	**70**	**80**
Revenue/GW (Rs bn)	60	60	60	60
Industry revenue pool (Rs bn)	3,000	3,600	4,200	4,800
BHEL's assumed market share (%)	60	60	60	60
BHEL's revenue opportunity (Rs bn)	1,800	2,160	2,520	2,880
Cumulative PAT @ 2.5% PAT margin (Rs bn)	45	54	63	72
Cumulative PAT @ 5% PAT margin (Rs bn)	90	108	126	144
Cumulative PAT @ 7.5% PAT margin (Rs bn)	**136**	**163**	**190**	**216**

Source: Kotak Institutional Equities estimates

Exhibit 39 shows the trend in BHEL's order inflows in its thermal electricity BTG segment. We expect BHEL to witness a strong recovery in new order wins over FY2024-26E, which should also support a pick-up in margins. BHEL had seen a sharp deterioration of its margin profile in the past decade (see Exhibit 40). We note that BHEL's margins will increase gradually linked to the pick-up in its revenues, which in turn, will follow the schedules of projects being executed by BHEL. A typical new thermal electricity generation projection will take at least 4-5 years to complete and BHEL's revenues would accordingly be quite back-ended. The market seems to be baking in a sharper recovery in profitability.

We expect strong recovery in BTG orders of BHEL over FY2024-26E

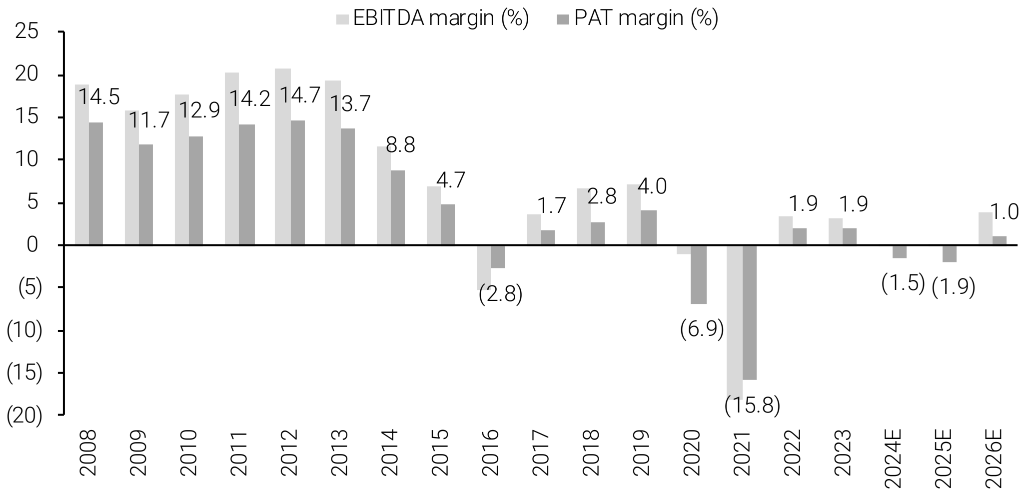
Exhibit 39: Order inflows of BHEL in the electricity segment, March fiscal year-ends, 2008-26E (GW)



Source: Company, Kotak Institutional Equities

BHEL has seen weak margins over FY2014-23; we expect gradual recovery over FY2024-26E

Exhibit 40: EBITDA margin and PAT margin of BHEL, March fiscal year-ends, 2008-26E (%)



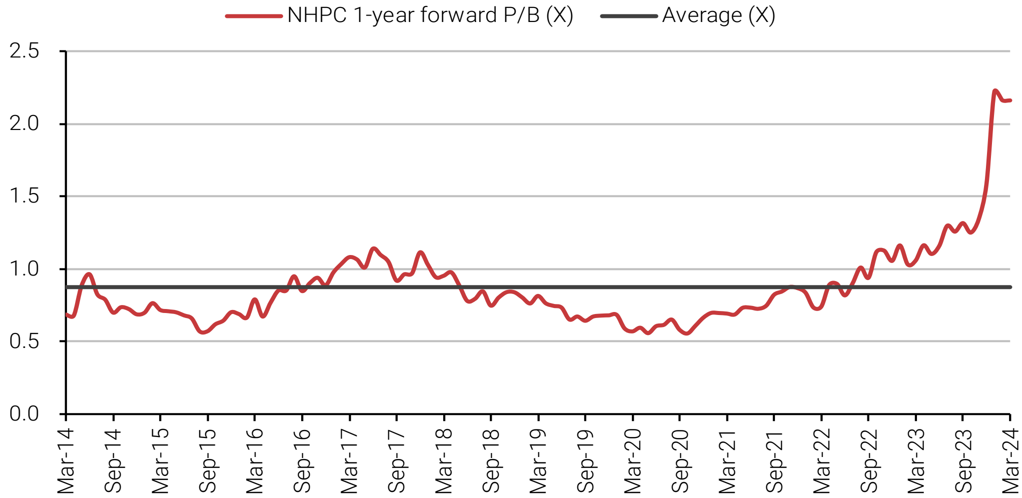
Source: Company, Kotak Institutional Equities

- **Electric utilities.** Electric utilities stocks have seen a sharp rerating in their multiples in the past one year and are currently trading at a large premium to their historical multiples. The stocks currently bake in much better future prospects compared with a year ago.

  - **NHPC.** The NHPC stock has seen a sharp rerating over the past year and is currently trading at expensive valuations on a P/B basis (see Exhibit 41). The market seems to be justifying the expensive valuations of the stock under the assumptions of (1) significant increase in regulated equity base over the medium term and (2) timely achievement of NHPC's ambitious long-term capacity targets. The narrative surrounding the stock also seem to bake in growth opportunities from renewables and pumped hydro storage.

NHPC is currently trading at a large premium to its historical valuations

Exhibit 41: 1-year forward P/B of NHPC, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

The current market capitalization of NHPC at Rs905 bn implies a regulated equity base of Rs566 bn by FY2025E (see Exhibit 42). This is far higher than NHPC's likely regulated equity base of Rs246 bn by FY2026E, comprising (1) operational standalone regulated entity of Rs129 bn, (2) incremental Rs97 bn regulated equity from likely commissioning of Parbati II and Subansiri Lower and (3) incremental Rs20 bn regulated equity from NHDC. This assumes timely completion of ongoing projects. We note that NHPC historically has had a dubious track record on project completion. In fact, Subansiri and Parbati II, likely to be commissioned by FY2026, were originally targeted for completion by FY2012.

NHPC's CMP implies sharp jump in regulated equity base

Exhibit 42: Implied regulated equity base of NHPC, March fiscal year-end, 2025E (Rs bn)

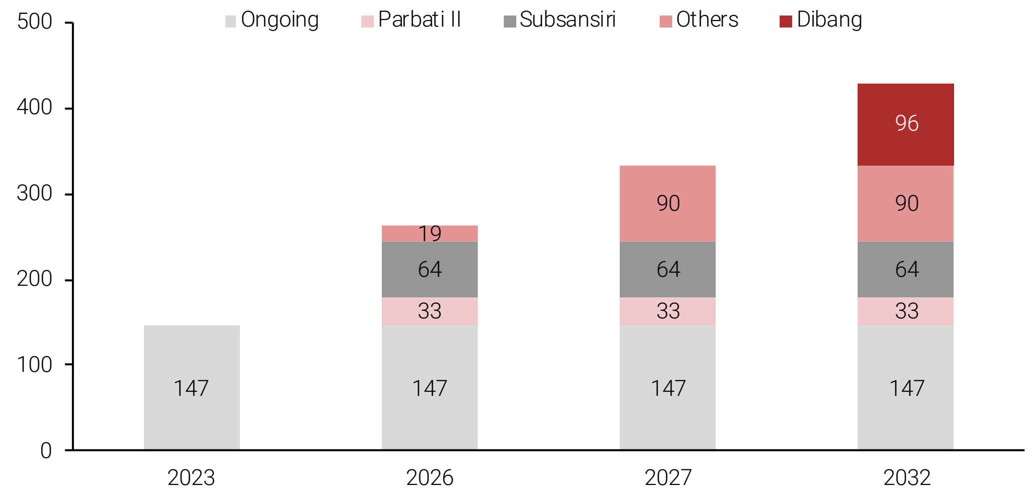
Current market capitalization (A)	905
FY2025E cash and investments (B)	55
Book value of operational projects	225
Value of operational projects @1.5X P/B (C)	337
Implied value of incremental projects (A-B-C)	512
Implied incremental regulated equity base @1.5X P/B	**341**

Source: Company, Kotak Institutional Equities estimates

Exhibits 43-44 show the growth in NHPC's regulated equity base linked to the status of projects under construction. NHPC has plans to add another 7.6 GW capacity that would add Rs186 bn to its regulated equity by FY2032. We note that NHPC earns 15.5% regulated return on equity + incentives, which should effectively result in a Fair Value of 1.5X BV on project completion and potential 0.5X BV of incremental value addition. This also assumes that the government will not change its current regulatory framework for regulated assets. The current regulated framework is distinctly benign in the context of about 12% cost of equity prevalent in India.

NHPC's regulated equity base is expected to be around Rs263 bn by FY2026

Exhibit 43: Estimated value of regulated equity of NHPC, March fiscal year-ends, 2023-32 (Rs bn)



Source: Company, Kotak Institutional Equities

NHPC has ambitious plans to add new renewable electricity generation capacity; timely completion key

Exhibit 44: Status of projects under construction for NHPC

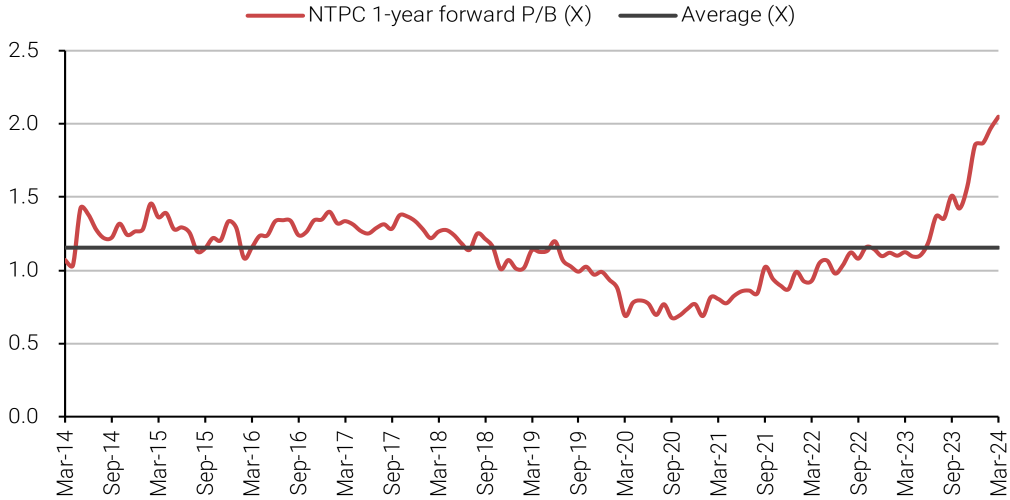
	Capacity	Cost (Rs bn)				
Project	**(MW)**	**Total**	**Incurred**	**(%)**	**Commissioning**	**Tariff**
Subansiri Lower (8X250)	2,000	212	200	94	1QFY26	
Parbati II (4X200)	800	111	109	99	2QFY25	
Dibang (12X240)	2,880	319	23	7	4QFY32	
CPSU Scheme (Solar, GJ)	600	43			2026	2.45
CPSU Scheme (Solar, RJ)	300	17			2025	2.45
CPSU Scheme (Solar, AP)	100	6			2025	2.45
Standalone	**6,680**	**708**	**332**			
Pakal Dul, JK (4X250)	1,000	81	132	163	2QFY27	
Kiru, JK (4X156)	624	43	38	88	4QFY26	
Kwar, JK (4x135)	540	45	15	33	3QFY27	
Kalpi	39	3	6		2024	2.68
Omakreshwar	88	6			2024	3.22
Sanchi	8	1			2024	3.22
JV	**2,299**	**179**	**190**			
Teesta VI, Sikkim (4X125)	500	57	31	53	2QFY27	
Rangit IV, Sikkim (3X40)	120	9	9	95	2QFY25	
Ratle, JK (4X205+30)	850	53	6	11	1QFY27	
Subsidiary	**1,470**	**120**	**45**			
Consolidated	**10,449**	**1,006**	**567**			
Hydro	9,314	931	562	60		
Renewable	1,135	76	6	7		

Source: Company, Kotak Institutional Equities

- **NTPC.** NTPC's stock has seen a steep rerating over the past year and is currently trading at expensive valuations on a P/B basis (see Exhibit 45), even though its P/E valuations look 'moderate'. The market perhaps finds NTPC's valuation inexpensive in the context of multiples of the broader market valuations and other PSUs. The market seems to believe that NTPC will see the twin benefits of (1) a long-term transition from thermal to renewable electricity and (2) medium-term increase in regulated equity base from the start of the new thermal electricity plants. In our view, the market may be overestimating value creation from these two factors.

NTPC is currently trading at a large premium to its historical valuations

Exhibit 45: 1-year forward P/B of NTPC, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

NTPC's market capitalization has increased Rs1.1 tn over the past six months, which would imply that the market is already giving value for 40 GW of new thermal generation capacity (assuming 1.5X BV value for new capacity). Exhibit 46 shows the implied incremental thermal capacity added by the company. This is far ahead of NTPC's own targets by 2030. NTPC expects to add another 20 GW of thermal electricity capacity over the next 6-7 years.

NTPC has already added 60-80 GW of incremental thermal capacity, according to the market

Exhibit 46: Implied capacity of NTPC, March fiscal year-end, 2025E (GW)

	P/B for regulated equity (X)		
	1	1.25	1.5
Current market cap. (Rs bn)	**3,415**	**3,415**	**3,415**
FY2025E cash and investments (Rs bn)	317	317	317
FY2025E value of subsidiaries	172	195	234
FY2025E regulated equity (Rs bn)	887	887	887
Value of extant assets @ 1, 1.25 or 1.5X regulated equity	887	1,108	1,330
Fair value of extant business, cash and investments	**1,375**	**1,620**	**1,881**
Implied market capitalization of new capacities (Rs bn)	**2,040**	**1,795**	**1,534**
Cost/GW of new thermal capacity (Rs bn)	60	60	60
Implied new thermal capacity @ 70:30 debt/equity (GW)	**113**	**80**	**57**

Source: Company, Kotak Institutional Equities estimates

We see several issues with the market's optimistic view regarding NTPC's prospects.

- **Valuations are expensive in the context of the nature of NTPC's business.** NTPC's current valuation at FY2025E 2X BV (BV including cash and investments) and 3.9X regulated equity book (without cash and investments) are meaningfully higher than the logical 1.25-1.5X P/B for extant coal-based assets based on regulated return and CoE, even assuming the generation assets generate the same amount of profits and RoE in perpetuity. This assumption is clearly optimistic in that India has aggressive plans to transition to renewable energy over a period of time. It is very likely that at least some of NTPC's extant thermal electricity generation capacity will become stranded assets after 15-20 years.

- **Valuations ignore a fundamental negative shift in business.** NTPC's valuations ignore a likely decline in its return profile in the longer term. We expect NTPC's return profile to progressively worsen, as it will pursue more renewable electricity capacity. We note that solar electricity generation has a far weaker return profile (see Exhibit 47) compared with the guaranteed 15.5% (plus incentives) for NTPC's regulated thermal assets.

Low RoE of solar plants under current operating conditions

Exhibit 47: Estimated RoE of a solar power plant operated by a public developer (%)

	ROEs at different solar tariffs (%)		
Capacity (MW)	100	100	100
Cost (Rs mn/MW)	40	40	40
PLF (%)	22	22	22
Generation (MU)	193	193	193
Tariff (Rs/kWh)	2.8	3.0	3.2
O&M (Rs mn/MW)	0.5	0.5	0.5
Interest rate (%)	8.5	8.5	8.5
Leverage (%)	70	70	70
Income statement (Rs mn)			
Revenues	540	578	617
O&M	(50)	(50)	(50)
EBITDA	**490**	**528**	**567**
Depreciation	(114)	(114)	(114)
Interest	(238)	(238)	(238)
PBT	**137**	**176**	**214**
Tax	(27)	(35)	(43)
PAT	**110**	**141**	**172**
RoIC (%)	**12.2**	**13.2**	**14.2**
RoE (%)	**9.2**	**11.7**	**14.3**

Source: Kotak Institutional Equities estimates

Renewable electricity generation is a very competitive business, with many companies vying to grow their portfolios. NTPC has a moderate presence in the renewable electricity generation space, unlike its dominant presence in the thermal electricity generation sector. Exhibit 48 shows the large number of renewable electricity generation companies in India, their current and contracted capacities and their major investors. We note that a few of them have (1) larger renewable portfolios versus NTPC's and (2) strong investors who would provide the requisite capital to their respective companies to grow aggressively.

NTPC has stiffer competition in the renewable space compared with the thermal space

Exhibit 48: Major renewable generation companies in India and their commissioned capacity, March fiscal year-end, 2024 (GW)

Company	Promoter/ Investors	Commissioned capacity (GW)
Adani Green	Adani Group	9.5
Renew Power	ADIA, CPPIB, Goldman Sachs	8.3
Greenko	ADIA, GIC, Orix Group	7.2
Tata Power	Tata Group	4.7
Avaada Energy	Airtel, Brookfield Renewable Partners, Global Power Synergy, KFW DEG	4.0
NTPC	PSU	3.3
ACME	APG Asset Management, Piramal Finance, REC (debt financing)	3.1
Azure Power	CDPQ, Ontario Municipal Employees Retirement System	3.0
Sembcorp India	Temasek	2.3
JSW Energy	JSW Group	2.3
O2 Power	EQT, Temasek Holdings	0.5
SJVN	PSU	0.3
NHPC	PSU, Foundation Capital	0.1

Source: SECI, SERC, media articles, Kotak Institutional Equities

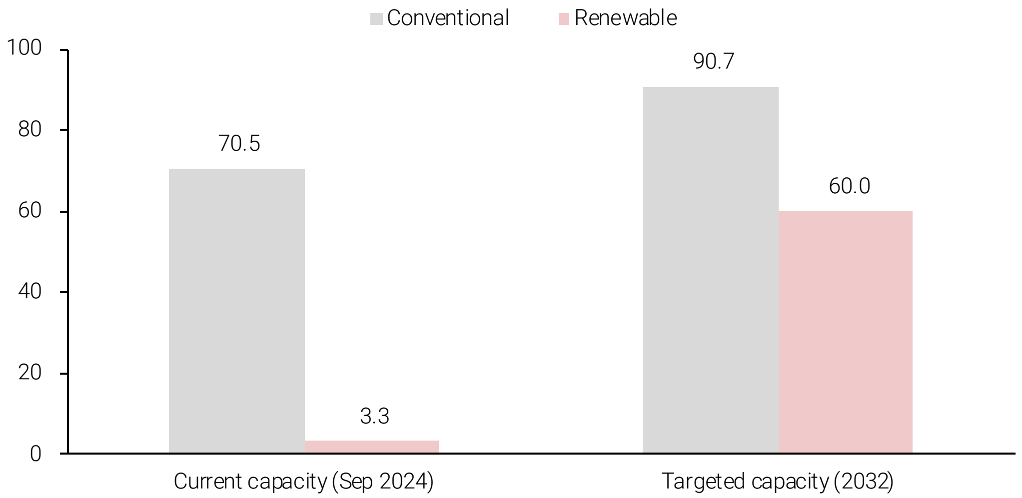
- **Shareholders may not see much benefit of cash flow generation from extant thermal capacity.** We expect the bulk of operating cash flows from NTPC's extant thermal electricity plants to fund new renewable electricity capacity (with a lower return profile as discussed above) over the next several years. NTPC may have to add renewable capacity to (1) meet incremental electricity demand and (2) replace old thermal electricity capacity, as and when they are phased out for environmental reasons. We would note that NTPC would need to spend about 2X the capex for new thermal capacity to replace an equivalent quantity of thermal electricity capacity.

- **Questionable terminal value of new and old thermal capacity.** The new thermal capacities will enjoy decent regulated returns (15.5% RoE), but will have questionable terminal value in the context of 'finite' life of any new thermal electricity plant. We are not sure if a new thermal electricity plant being commissioned by 2030 will be required 20 years later.

  NTPC is implementing the government's revised policy to install new thermal electricity plants to meet temporary electricity supply-demand mismatch, while no private company is doing so. The private sector perhaps does not find new thermal electricity generation capacity to be commercially viable in the long run (from a project IRR perspective). This also shows the difference in commercial orientation of private companies and PSUs. A section of the Street is excited about the increase in NTPC's regulated equity base and earnings from commissioning of new projects. However, we would note that the incremental investment in coal-based thermal capacities will further delay NTPC's transition to a renewables-based electricity generation company from a largely coal-based generation company currently. NTPC aspires to increase its renewable capacity from about 3.5 GW in FY2024 to 60 GW in FY2032. Exhibit 49 shows the current targets of NTPC.

NTPC's current portfolio largely comprises thermal assets with questionable terminal value

Exhibit 49: Current and targeted conventional and renewable portfolio of NTPC, March fiscal year-end, 2024 (GW)

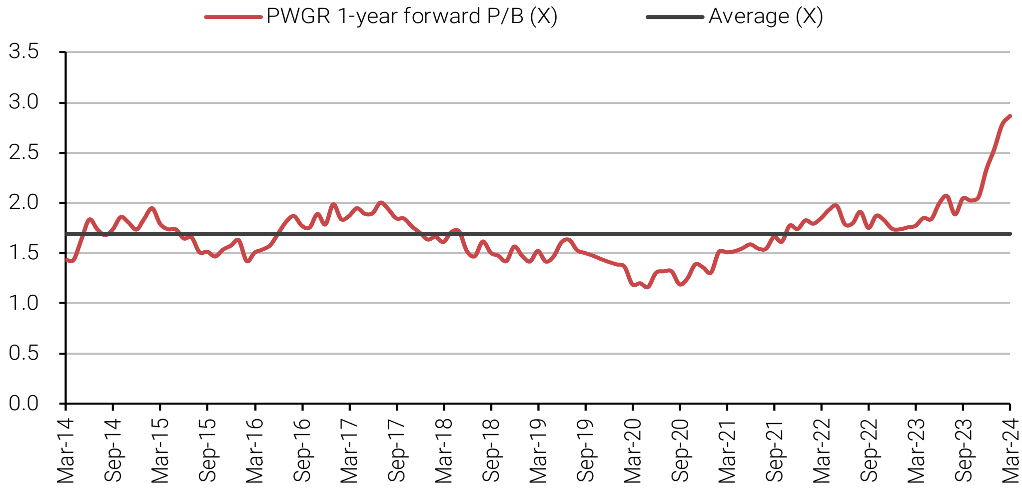


Source: Company, Kotak Institutional Equities

- **PWGR.** PWGR's stock has delivered strong returns (72% over the past year) and has seen a sharp rerating in its multiples over the past year (see Exhibit 50). The stock is currently trading at 2.6X FY2026E BV, which may not look expensive in the context of multiples of the broader market and other PSUs.

PWGR is currently trading at a large premium to its historical valuations

Exhibit 50: 1-year forward P/B of PWGR, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

However, we see issues with the market's assessment of PWGR's valuations and growth prospects.

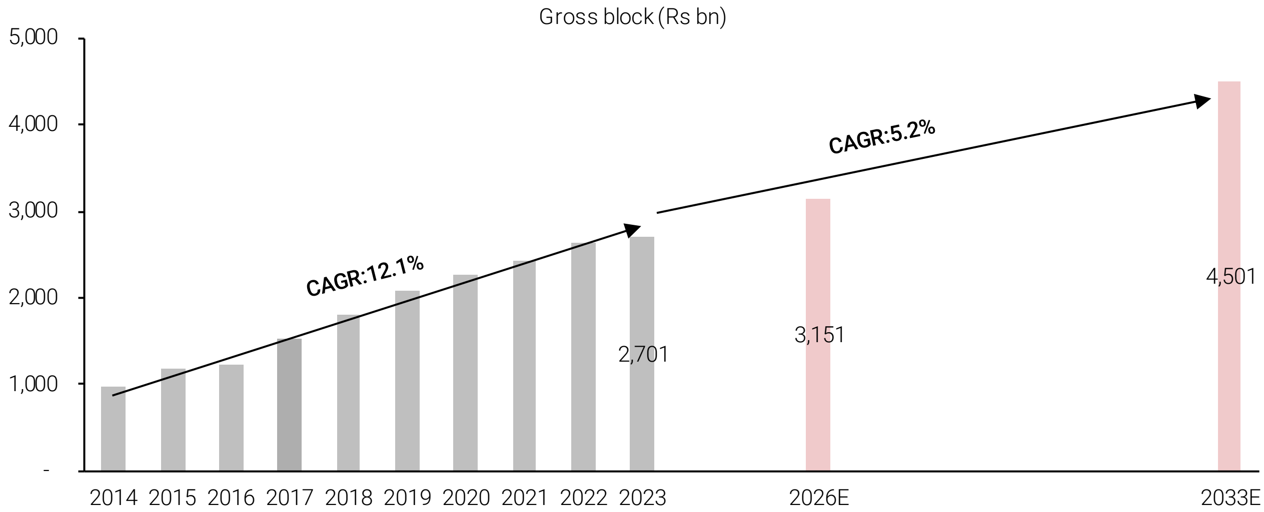
- **Valuations are expensive, contrary to what the market believes.** PWGR's current valuation at 2.8X FY2025E BV (BV including cash and investments) and 3.4X FY2025E regulated equity book (without cash and investments) is meaningfully higher than the logical 1.5X P/B for extant assets based on regulated return and CoE.

  PWGR's return profile may progressively deteriorate, as the share of tariff-based competitive bidding (TBCB) projects increases over time. We note that TBCB projects generally have a lower RoE compared with nominated projects, which earn a guaranteed regulated return on equity (15.5% plus incentives).

- **High implied growth rates may not be achievable.** PWGR's current 'high' valuations imply a significant increase in its growth opportunity over the next few years. This remains to be seen. In fact, PWGR's current targets imply a more moderate growth trajectory over FY2026-33E versus FY2014-24E (see Exhibit 51).

PWGR's management appears to be less optimistic than the market on its growth prospects

Exhibit 51: Historical and estimated gross block of PWGR, according to the company, March fiscal year-ends, 2014-33E (Rs bn)

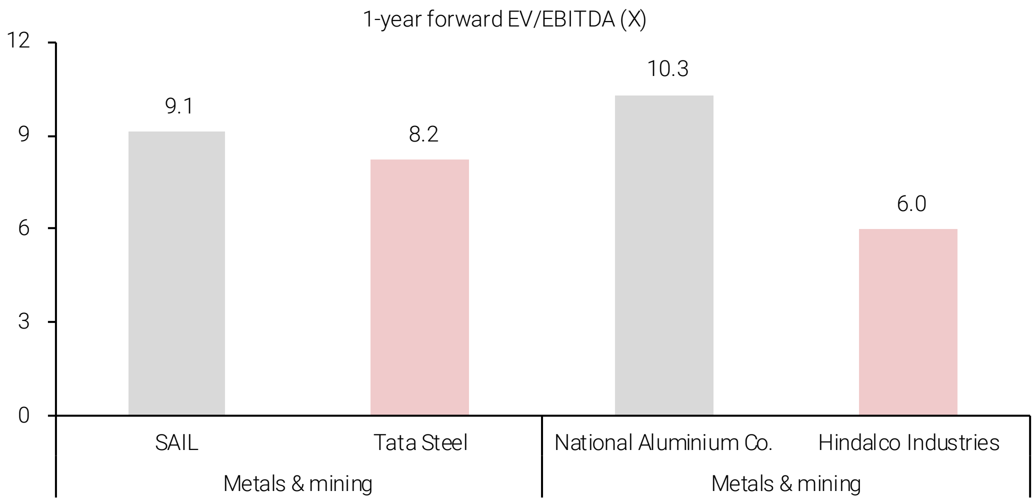


Source: Company, Kotak Institutional Equities

- **Metals & mining.** PSU metal companies have seen a sharp rerating in their valuation multiples and are currently trading at a significant premium to their private peers (see Exhibit 52). The rerating of PSU stocks is quite surprising, as there is no meaningful change in the fundamentals of (1) the sector and/or (2) the companies. Private sector companies have broadly performed in line with the large-cap. Indices, except for TATA, which has seen a sharp rally recently on expectations of value-unlocking from a potential listing of TATA Sons, the major holding company for Tata Group companies. TATA owns 3.1% in Tata Sons.

PSU metal companies are trading at a premium to their private peers

Exhibit 52: 1-year forward EV/EBITDA of PSU stocks versus their private peers, March 2024 (X)

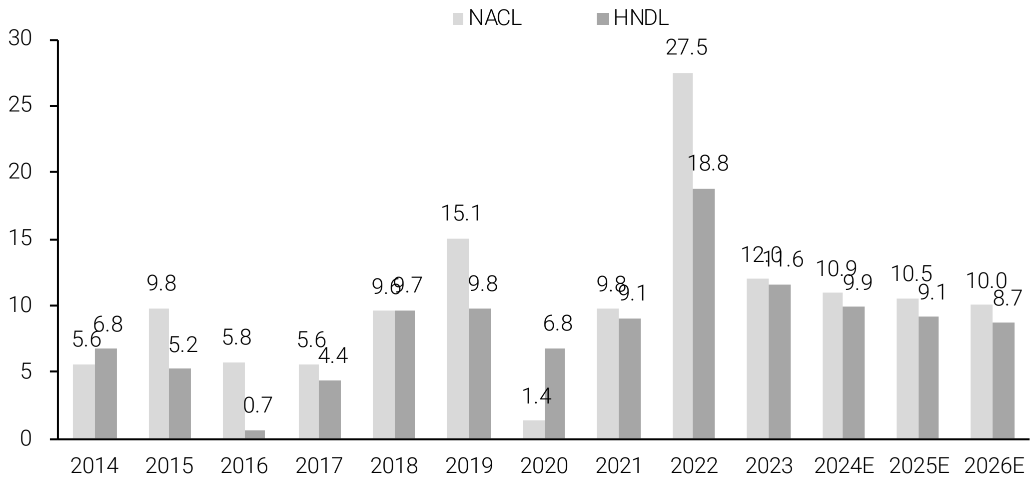


Source: FactSet, Kotak Institutional Equities estimates

- **NACL.** NACL's stock is trading at 10.3X FY2025E EBITDA versus HNDL stock at 6X FY2025E EBITDA. It is trading at 2X FY2025E BV and will deliver RoE of 10.5% for FY2025E, which is well below its cost of equity of around 12%. HNDL stock is trading at 1.1X FY2025E BV and will deliver RoE of 9.1% for FY2025E. Exhibit 53 compares the return profiles of HNDL and NACL.

NACL's RoE profile has been slightly superior to HNDL's in recent years, but will be below its CoE

Exhibit 53: RoE of NACL versus HNDL, March fiscal year-ends, 2014-26E (%)



Source: Company, Kotak Institutional Equities estimates

- **Benign assumptions to justify NACL's premium valuation to HNDL.** The market seems to be assigning higher multiples to NACL versus HNDL on (1) higher alumina sales after commissioning of its 1 mtpa refinery, (2) possible improvement in profitability through backward integration into coal production and (3) option value of lithium exploration through its KABIL JV (with other Indian PSUs).

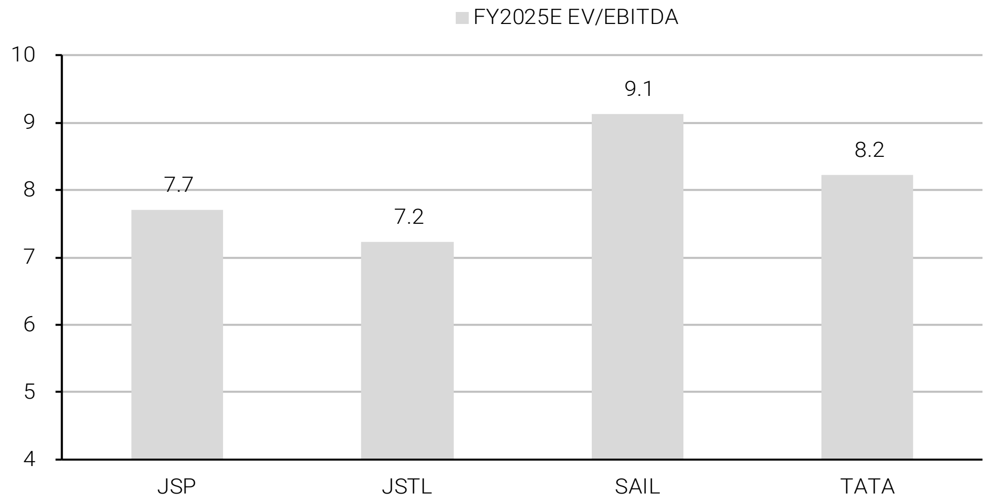
- **Incorrect valuation multiples, given difference in underlying business models of HNDL and NACL.** In our view, the aluminum downstream business should logically trade at a higher multiple versus the upstream smelting business, given (1) higher returns (higher RoIC due to lower capex intensity of the business) and (2) lower risks (cyclicality) of the upstream business, given its linkage to steadier downstream businesses such as automobiles and beverage cans. The upstream aluminum smelting business is a highly capex-intensive, cyclical and commodity business. HNDL enjoys strong global competitive positions in both the automotive components and beverage cans businesses, with a high market share in both downstream segments.

  We also note greater risks to NACL's earnings from weaker-than-expected metal prices. NACL's earnings have higher sensitivity to aluminum prices compared with HNDL's, given the higher share of the upstream business of NACL compared with HNDL's. We assume FY2025E aluminum price (LME basis) at US$2,350/ton for both HNDL and NACL versus an average price of US$2,150/ton over FY2018-23.

- **SAIL.** SAIL stock is trading at 9.1X FY2025E EBITDA, at a meaningful premium to JSP, JSTL and TATA (see Exhibit 54). SAIL's market capitalization is about Rs574 bn and it has delivered average annual net profit of Rs30 bn over FY2018-23.

SAIL is trading at a large premium to its peers

Exhibit 54: FY2025E EV/EBITDA of steel companies under coverage (X)



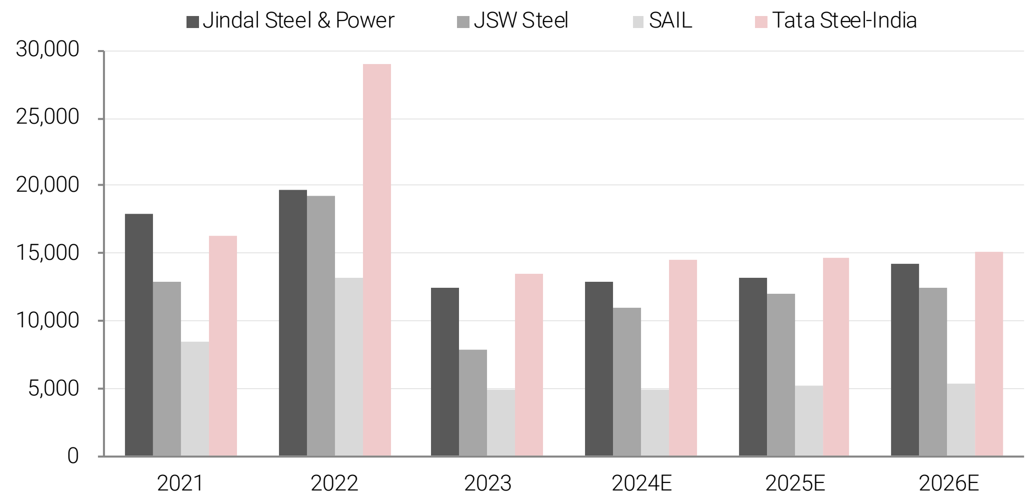
Source: Company, Kotak Institutional Equities estimates

The market perhaps believes that the company (1) can deliver strong operational improvement and achieve higher profitability versus current and historical depressed levels, (2) has high growth potential and (3) may be a privatization candidate. In our view, the market's optimism is not backed by fundamentals.

- **Low scope for a sharp and sudden improvement in SAIL's profitability.** SAIL's profitability has been well below the profitability of its peers historically. Its average profitability (EBITDA/ton) over FY2018-23 was Rs6.6K, despite FY2022's exceptional profitability of Rs13.2K. FY2023 EBITDA/ton was a low Rs5K. Exhibit 55 shows the profitability of SAIL versus its peers. We model FY2025E EBITDA/ton at Rs5.1K per ton versus Rs12.8K for JSP, Rs12.5K for JSTL and Rs14.5K for TATA for their domestic steel operations.

SAIL has significantly lower profitability compared with private peers

Exhibit 55: EBITDA/ton of steel companies under coverage, March fiscal year-ends, 2021-26E (Rs/ton)

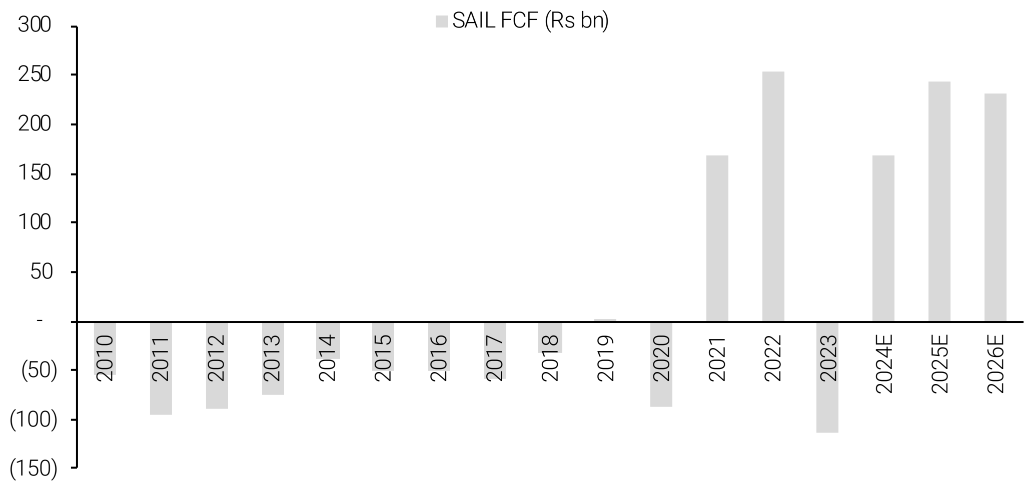


Source: Companies, Kotak Institutional Equities estimates

- **Increase in volumes may not come through on expected lines.** SAIL has announced ambitious plans to increase capacity by around 15 mtpa to 35 mtpa by FY2031. However, it has not provided any specific timelines. Additionally, we do not expect any major capacity increases over the next three years, given limited progress on ongoing projects. Lastly, any large expansion program could sharply increase capex and net debt over the next 3-5 years. During its previous expansion phase over FY2010-20, SAIL saw negative FCF in nine of the 10 years, resulting in its net debt rising to Rs534 bn in FY2020 from net cash of Rs60 bn in FY2010 (see Exhibit 56).

SAIL's FCF has turned positive in recent years; future expansion plans may result in weaker cash generation in future

Exhibit 56: FCF of SAIL, March fiscal year-ends, 2010-26E (Rs bn)



Source: Companies, Kotak Institutional Equities estimates

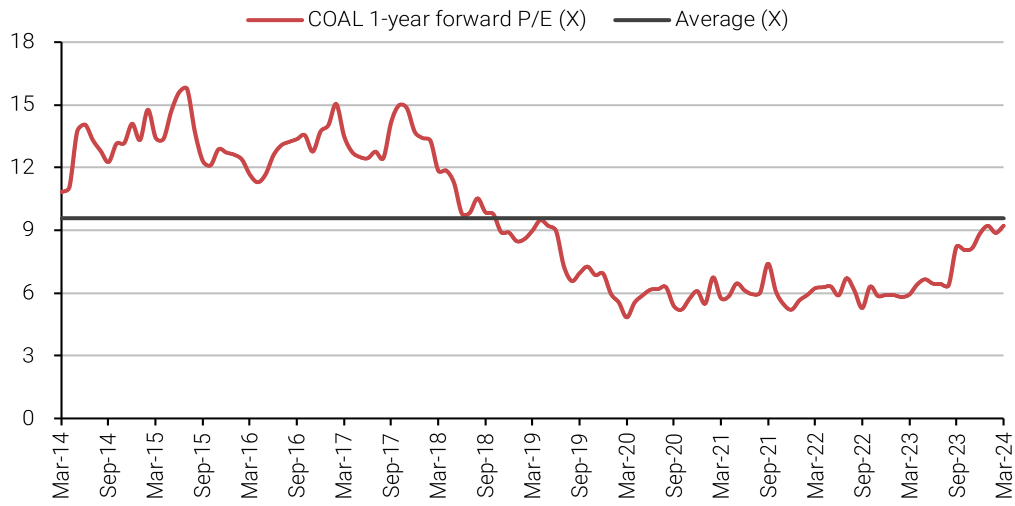
- **Privatization may be difficult at current valuations.** We doubt any private sector company would be keen to purchase a majority stake in SAIL at its current high valuations. We are not even sure if the government has any plans to privatize SAIL, although as it does not fall under the definition of a strategic sector, as defined under the government's New Public Sector Enterprise Policy of February 2021.

- **Oil, gas & consumable fuels.** Oil, gas & consumable stocks have seen a strong rerating in their multiples in the past year and almost all of them are currently trading at expensive valuations on a 'first-principle' valuation basis. The market seems to be justifying these valuations on hopes of (1) strong near-term earnings, led by historical-high profitability and (2) elevated near-term profitability sustaining in perpetuity. However, the market seems to be conveniently ignoring large risks to the durability of the companies' business models.

  - **Coal India.** COAL's stock has delivered 104% return in the past year, driven by strong rerating in its multiples (see Exhibit 57). We assume the market likes COAL's (1) 'cheap' valuations in the context of near-term growth (13X FY2025E EPS) and (2) likely strong increase in volume growth over the next few years.

COAL's stock has seen large rerating in recent months

Exhibit 57: 1-year forward P/E of COAL, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

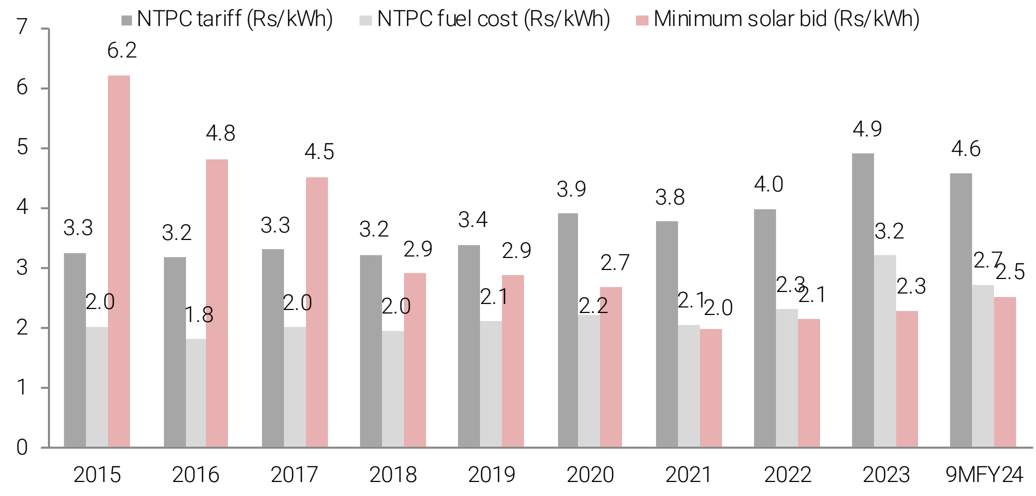
- **Incorrect valuation methodology being used to value COAL's stock.** In our view, COAL's P/E multiple needs to be viewed in the context of longevity of COAL's business model. COAL's current P/E multiple of 13X FY2025E EPS implies (1) decent growth in EPS and FCF in perpetuity—about 5% or so assuming cost of equity of 12% or (2) very high growth in EPS and FCF in the short term, followed by a gradual decline in earnings and FCF. Both these assumptions implicitly assume that COAL's current high profitability and returns will stay intact for a long period of time.

- **Volume growth—near-term growth versus eventual decline in volumes.** We expect COAL's volumes to likely peak over the next few years, as most of the new coal-based electricity generation capacities under construction will start operations by FY2028-30. It is unlikely that India will add coal-based electricity generation capacity beyond FY2030. COAL's volumes may stay stable over the next decade (after FY2030) and decline afterward.

  The pace of decline in COAL's volumes would depend on (1) a pick-up in renewable generation capacity; renewable electricity tariff is already far cheaper than the coal-based thermal electricity tariff (see Exhibit 58), (2) pace of availability of storage capacity to address the issue of intermittency in the case of renewable electricity and (3) the government's energy policy and pace of transition to clean energy from dirty energy.

Solar tariffs have declined sharply and are currently lower than thermal tariffs in India

Exhibit 58: Average thermal tariff of NTPC and solar bids in India, March fiscal year-ends, 2015-24 (Rs/kWh)

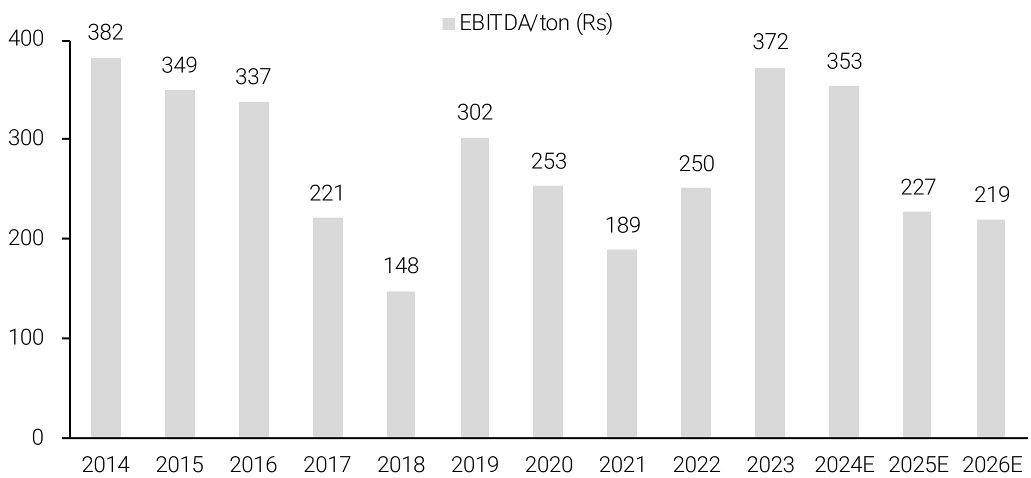


Source: Source: CEA, Kotak Institutional Equities

- **Pricing and profitability of COAL entirely dependent on government.** We see downside risks to the current high profitability of COAL over the medium to long term (see Exhibit 59). The Street perhaps believes that COAL's coal realization and profitability are reasonable, given that its raw coal price is lower than the import parity price of coal.

COAL has seen sharp increase in profitability over FY2023-24E; we expect a sharp fall over FY2025-26E

Exhibit 59: Profitability of COAL, March fiscal year-ends, 2014-26E (Rs/ton)

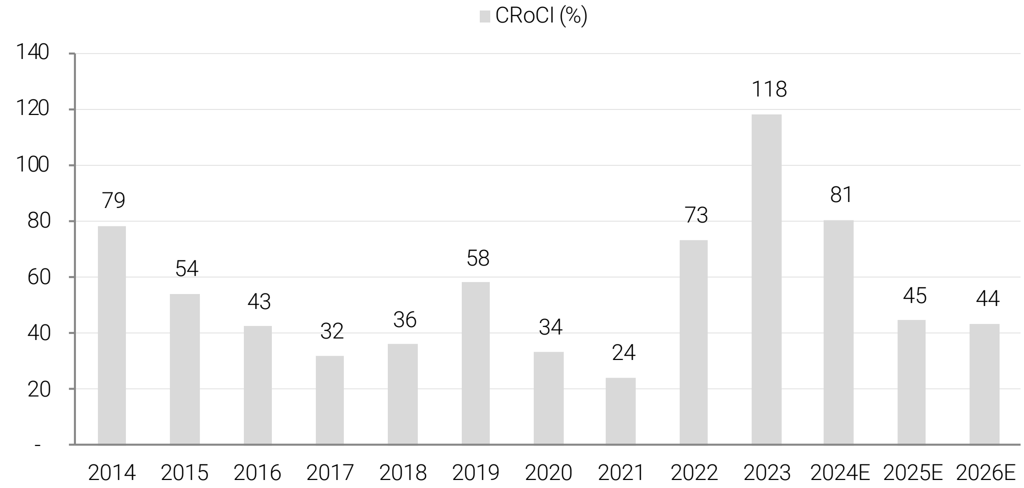


Source: Company, Kotak Institutional Equities estimates

However, COAL's 'low' coal realizations need to be viewed in the context of its very high returns. COAL's CRoCI has averaged 62% over FY2019-23, astonishingly high for a commodity business (see Exhibit 60). We note that the high profitability and returns of COAL are due to the government's (1) favorable pricing policy for raw coal in the form of low royalty relative to price of coal, as COAL's coal blocks were allocated based on nominations without a bidding process and (2) benevolent approach to the steep increase in employee expenses of COAL; COAL has managed to pass on the rapid escalation in its employee costs through higher coal prices.

Coal India has consistently enjoyed high cash returns owing to low capital investments

Exhibit 60: CRoCI for Coal India, March fiscal year-ends, 2014-26E (%)

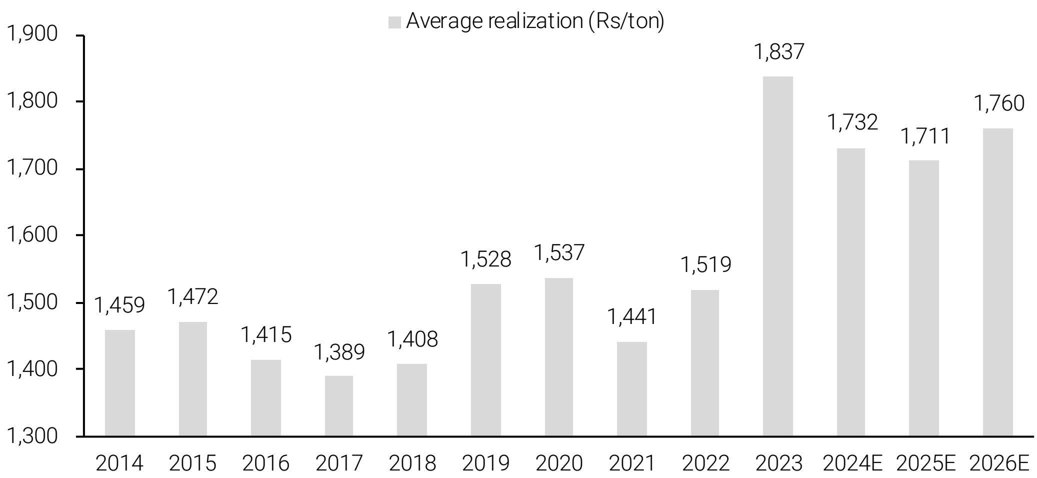


Source: Company, Kotak Institutional Equities estimates

The government may or may not review the price of or royalty on coal, but the high profitability and returns of the company does raise concerns about potential risks from any 'unfavorable' change in government policy. COAL has steadily raised prices of the fuel supply agreement (FSA) coal (see Exhibit 61) to pass on higher employee costs to customers (thermal electricity generation companies). COAL's average employee costs have increased at a CAGR of 10.1% over the past 10 years (see Exhibit 62). We note that the next price revision on FSA coal is due in FY2027, coinciding with the next round of wage revision.

COAL's realizations jumped over FY2023-24E, led by higher global coal prices

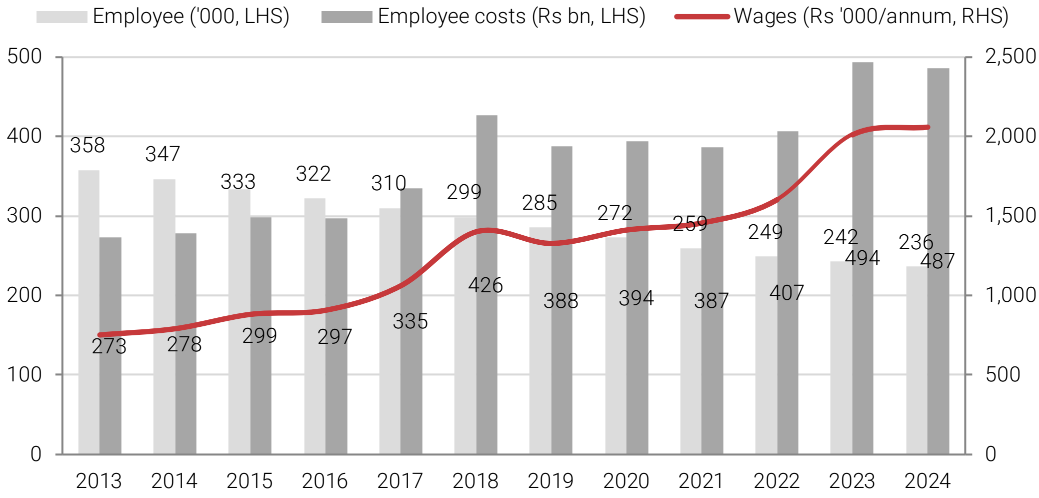
Exhibit 61: Average realizations of COAL, March fiscal year-ends, 2014-26E (Rs/ton)



Source: Company, Kotak Institutional Equities estimates

Average employee wages have increased at CAGR of 10% over the past decade

Exhibit 62: Employee headcount, cost and wages, March fiscal year-ends, 2013-24 ('000, Rs bn, Rs/annum)



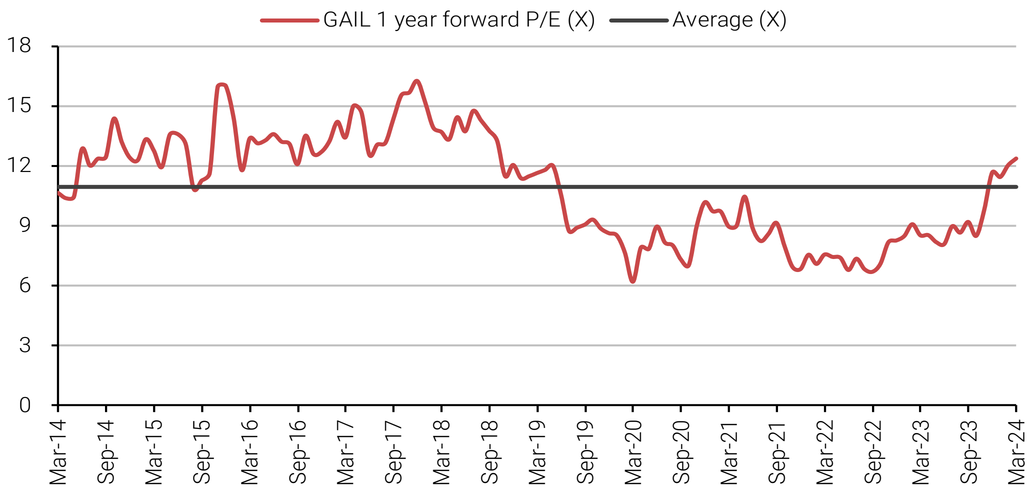
Source: Company, Kotak Institutional Equities

We expect COAL's profitability to decline over FY2024-26E from high levels of FY2023-24E, led by (1) steady coal realizations and (2) continued increase in employee costs. We expect higher raw coal price and lower e-auction prices to broadly balance out in FY2025-26E, resulting in broadly stable realizations. Global coal prices have declined from elevated levels of FY2023-1HFY24; high global coal prices had propelled COAL's e-auction prices, overall realizations and profitability in FY2023-24E.

- **GAIL.** GAIL's stock has seen a strong rerating (see Exhibit 63) and has delivered 73% return in the past year. It currently trades at 13X FY2025E EPS and 1.9X FY2025 BPS. The recent excitement around GAIL's stock reflects (1) euphoria among non-institutional investors for PSU stocks in general and (2) earnings upgrades in the case of GAIL, largely due to an upward revision to marketing margins on its traded gas volumes.

GAIL's stock has seen a large rerating in recent months

Exhibit 63: 1-year forward P/E of GAIL, March fiscal year-ends, 2014-24 (X)



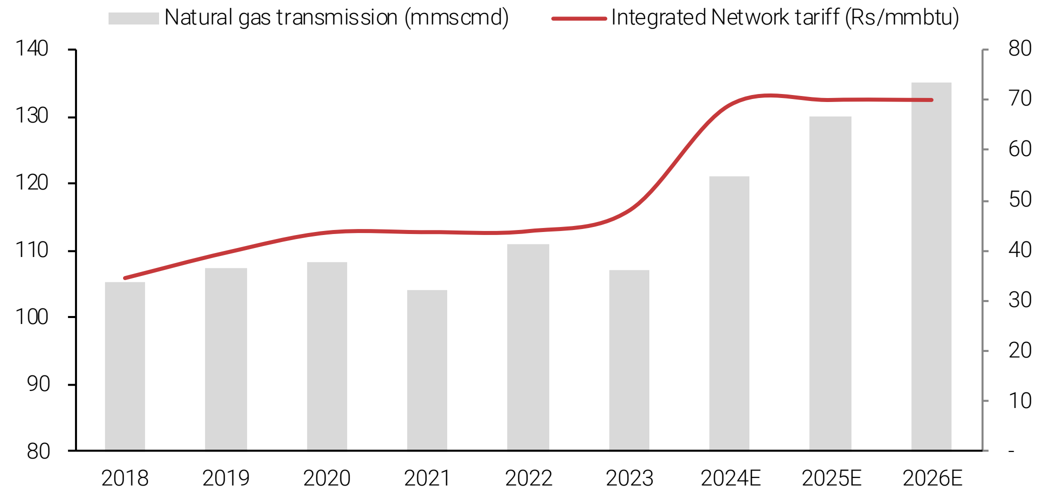
Source: FactSet, Kotak Institutional Equities

We believe the optimism around GAIL's stock may be misplaced due to (1) downside risks to earnings, given optimistic assumptions regarding GAIL's two key businesses (gas transmission, gas marketing) and (2) inadequate appreciation of the challenges of its business model, which results in a large disconnect between the Street's valuation approach and GAIL's business model.

- **Optimistic assumptions.** We bake in fairly optimistic assumptions (see Exhibit 64) for GAIL's mainstay gas transmission business over FY2024-26E. We assume (1) decent growth in gas transmission volumes over FY2024-26E due to softer spot LNG prices; however, weak CGD demand and limited new capacities in the crucial electricity and fertilizer segments will likely result in modest growth in gas transmission volumes in the future—FY2024E volumes will be boosted by a ramp-up in capacity utilization at three new urea fertilizer plants and (2) steady network tariffs at current elevated levels, which are 18-19% higher than the approved tariff of Rs58.6/mmbtu.

Our transmission volume and tariff assumptions for GAIL are optimistic

Exhibit 64: Key assumptions for GAIL's transmission business, March fiscal year-ends, 2018-24E



Source: Company, Kotak Institutional Equities estimates

- **Incorrect valuation approach.** GAIL's stock may not look expensive on a P/E or P/B basis, but its valuation must be seen in the context of its (1) mediocre business model (low growth, low FCF-to-PAT ratio, high share of trading segment in overall EBIT) and (2) weak medium-term prospects (acceleration in electrification of the economy, which will hurt CGD volumes) of the company.

  We project GAIL's EPS to be flat (at around Rs14.5) over FY2024-26E, despite assuming high marketing margins for FY2025-26E versus historical levels (see Exhibit 65) and related large contribution to earnings of the gas trading segment. GAIL's gas marketing segment (accounting for 35% of EBIT over FY2025-26E; see Exhibit 66 for breakdown of EBIT by segments) has low earnings visibility (it has been quite volatile in the past) and should trade at low multiples compared with other businesses of GAIL.

We model gas marketing margins at elevated levels over FY2024-26E compared with history

Exhibit 65: Key assumptions behind GAIL's model, March fiscal year-ends, 2017-26E

	2017	2018	2019	2020	2021	2022	2023	2024E	2025E	2026E
Transmission										
Natural gas transmission (mmscmd)	100	105	107	108	104	111	107	121	130	135
Integrated Network tariff (Rs/mmbtu)	33	34	39	43	44	44	48	69	70	70
yoy tariff change %	(3)	3	15	10	0	0	9	44	1	—
Other pipelines	33	34	36	26	25	27	25	24	22	22
Blended tariffs (Rs/mmbtu)	**33**	**34**	**39**	**42**	**42**	**42**	**45**	**64**	**64**	**65**
Blended tariffs (Rs/scm)	1.26	1.30	1.47	1.57	1.57	1.58	1.70	2.40	2.43	2.44
LPG transmission ('000 tons)	3,363	3,721	3,975	3,909	4,163	4,199	4,335	4,360	4,385	4,410
Transmission tariff(Rs/kg)	1.5	1.5	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7
Gas marketing										
Natural gas sales (mmscmd)	81	85	97	96	89	96	95	102	108	114
Blended margins (Rs/scm)	**0.5**	**0.4**	**0.8**	**0.6**	**(0.2)**	**1.5**	**1.0**	**1.7**	**1.3**	**1.2**
LPG/LHC ('000 tons)										
Production ('000 tons)	1,082	1,276	1,341	1,264	1,137	1,004	929	975	1,000	1,000
LPG price (US$/ton)	415	528	542	473	390	649	746	639	715	665
LPG price (Rs/kg)	30	34	38	33	29	48	60	53	59	56
Petrochemicals ('000 tons)										
Total petrochemicals	578	673	735	738	872	792	400	760	810	810
Polyethylene, HDPE (US$/ton)	1,131	1,148	1,108	863	894	1,063	998	947	980	1,000
PE realisation (Rs/kg)	98	87	91	74	81	108	123	102	105	115
Other assumptions										
Exchange rate (Rs/US$)	67.1	64.5	69.9	70.8	74.3	74.7	80.4	82.8	83.0	84.0
APM gas price (GCV, US$/mmbtu)	**2.8**	**2.7**	**3.2**	**3.5**	**2.1**	**2.4**	**7.4**	**6.5**	**6.5**	**6.8**

Source: Company, Kotak Institutional Equities estimates

Sharp increase in EBIT contribution from the gas marketing business over FY2022-26E

Exhibit 66: Segment breakdown of GAIL's EBIT, March fiscal year-ends, 2018-24E (Rs mn)

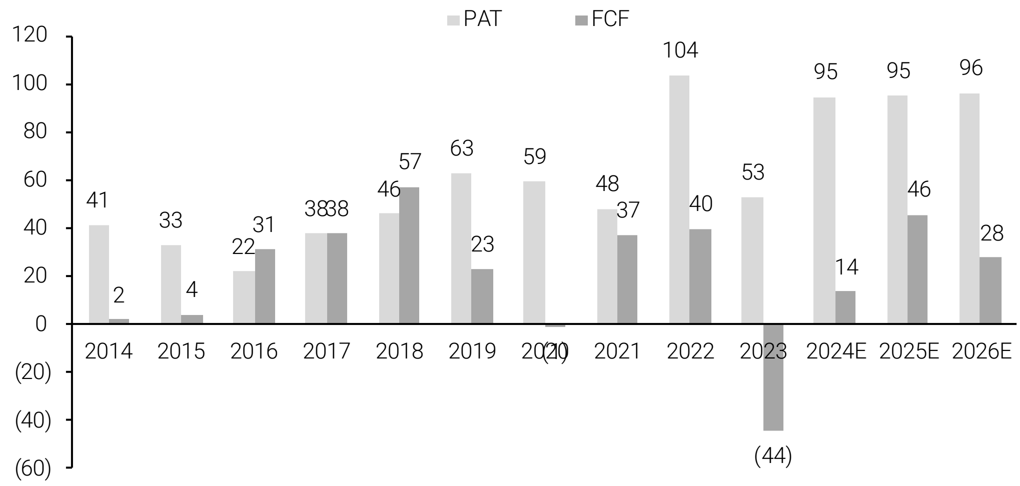
	2018	2019	2020	2021	2022	2023	2024E	2025E	2026E
EBIT (Rs bn)									
Gas transportation	30,009	32,539	37,258	35,819	38,058	19,197	46,162	54,530	56,577
LPG transportation	2,726	3,014	3,309	3,514	3,350	3,687	3,406	3,478	3,549
Gas marketing	12,561	28,591	21,562	(7,023)	49,322	30,788	63,115	50,005	50,003
LPG production	23,043	25,465	15,806	13,035	28,997	12,284	7,404	14,077	8,694
Petrochemicals	2,667	3,849	(2,455)	10,649	12,453	(10,609)	(1,408)	6,924	13,721
Others / unallocable	1,330	(1,224)	6,898	8,463	5,468	13,608	12,533	11,104	10,931
Total	**72,335**	**92,234**	**82,379**	**64,457**	**137,647**	**68,955**	**131,213**	**140,118**	**143,474**
Share (%)									
Gas transportation	41	35	45	56	28	28	35	39	39
LPG transportation	4	3	4	5	2	5	3	2	2
Gas marketing	17	31	26	(11)	36	45	48	36	35
LPG production	32	28	19	20	21	18	6	10	6
Petrochemicals	4	4	(3)	17	9	(15)	(1)	5	10
Others / unallocable	2	(1)	8	13	4	20	10	8	8

Source: Company, Kotak Institutional Equities estimates

We expect GAIL's FCF to stay low relative to PAT in the future too, as it will likely continue to invest in capex-intensive projects, despite possible low IRRs of such projects. We model GAIL's cumulative FCF at Rs87 bn versus cumulative net profit of Rs286 bn over FY2024-26E. GAIL's cumulative FCF was Rs112 bn versus cumulative net profit of Rs373 bn over FY2018-23. We believe GAIL's low FCF-to-PAT ratio (see Exhibit 67) should logically result in a lower multiple for the stock.

GAIL's PAT to FCF conversion was quite low at 37% over FY2014-23

Exhibit 67: PAT and FCF of GAIL, March fiscal year-ends, 2014-26E (Rs bn)

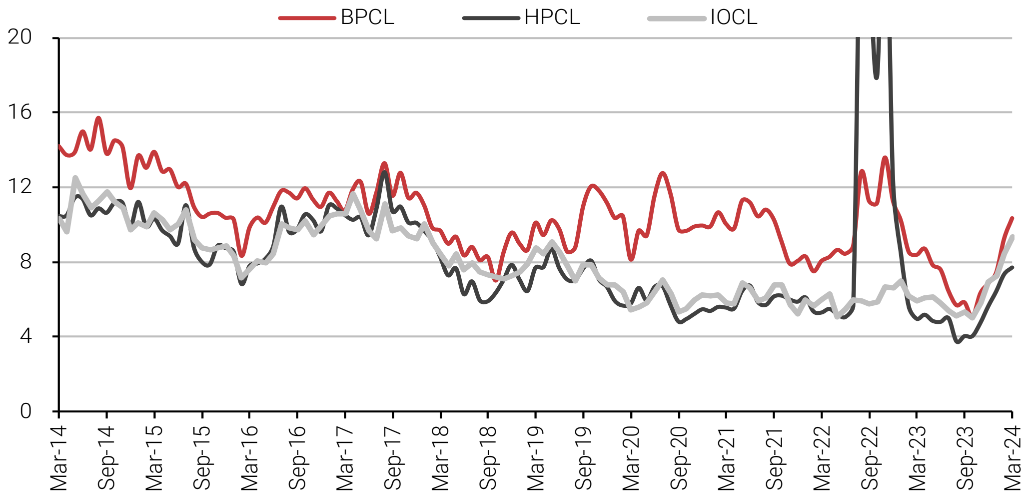


Source: Company, Kotak Institutional Equities estimates

- **Oil marketing companies (OMCs—BPCL, HPCL, IOCL).** OMCs have seen a sharp rerating in their multiples over the past year (see Exhibit 68**)** based on the Street's benign view of the current high marketing margins on automobile fuels sustaining for a long period of time. The marketing margins on diesel and gasoline of the OMCs had expanded significantly in 2HFY24, led by favorable relative movement in retail prices of retail automobile fuels (stable) and global prices of crude oil (down).

OMCs' multiples have seen a sharp rerating in the past year

Exhibit 68: 1-year forward P/E of OMCs, March fiscal year-ends, 2014-24 (X)



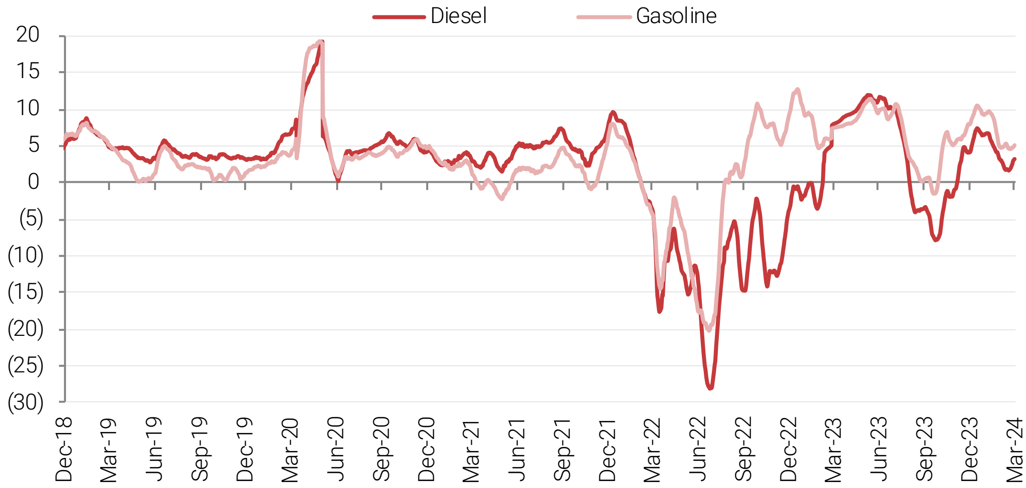
Source: FactSet, Kotak Institutional Equities

We find the market's new-found confidence in the high profitability of downstream oil, gas & consumable fuels quite puzzling, as discussed below.

- **Difficult-to-forecast earnings.** It is pretty much impossible to forecast the earnings of the downstream oil companies, given the government's pricing policy on retail automobile fuels. OMCs have not changed retail prices of diesel and gasoline since May 2022, which has resulted in huge volatility in the marketing margins (see Exhibit 69) and profits of the OMCs in the past two years. The market's new-found confidence may reflect high marketing margins on automobile fuels in 2HFY24, but this is more of a case of serendipity rather than design. Marketing margins were hugely negative just a few months ago and could turn negative in case crude oil prices were to increase from current levels.

Large volatility in marketing margins of auto fuels

Exhibit 69: Marketing margins on diesel and gasoline, calendar year-ends, 2019-24 (Rs/liter)



Source: PPAC, Kotak Institutional Equities estimates

We would note that the marketing margins on automobile fuels (bulk of OMCs' overall sales volumes) will largely depend on (1) the level of crude prices and (2) government policy on pricing of automotive retail fuels—both of which are quite difficult to forecast. Earnings of OMCs have very high sensitivity to marketing margin assumptions (see Exhibit 70), which makes their earnings overly reliant on hard-to-forecast drivers.

Downstream companies' earnings have high sensitivity to automobile marketing margin assumptions

Exhibit 70: Sensitivity of EPS of downstream oil companies to automobile marketing margins, March fiscal year-ends, 2024E-26E (Rs)

	2024E			2025E			2026E		
	BPCL	HPCL	IOCL	BPCL	HPCL	IOCL	BPCL	HPCL	IOCL
Sensitivity to marketing margin									
Marketing margin on auto fuels (Rs/liter)	5.4	5.2	5.2	4.0	4.0	4.0	4.0	4.0	4.0
Current EPS estimates	**128**	**103**	**30**	**55**	**69**	**17**	**57**	**66**	**16**
Marketing margin lower by Rs0.5/liter	121	94	28	47	58	15	49	56	14
Change (%)	(6)	(10)	(6)	(14)	(15)	(11)	(14)	(16)	(12)
Marketing margin higher by Rs0.5/liter	136	113	31	63	79	19	65	77	18
Change (%)	6	10	6	14	15	11	14	16	12

Source: Kotak Institutional Equities estimates

We see downside risks to our earnings assumptions, as our profitability assumptions are much higher than historic levels (see Exhibit 71), with limited visibility on (1) crude price levels and (2) the government's pricing policy on retail automobile fuels.

We model higher-than-historical refining and marketing margins for OMCs over FY2025-26E

Exhibit 71: Refining and marketing margins of downstream oil companies, March fiscal year-ends, 2017-26E

	Refining margins (US$/bbl)										Marketing margins (Rs/liter)									
	2017	2018	2019	2020	2021	2022	2023	2024E	2025E	2026E	2017	2018	2019	2020	2021	2022	2023	2024E	2025E	2026E
BPCL	5.3	6.9	4.6	2.5	4.1	9.1	20.2	14.0	9.0	9.0	1.8	1.8	2.8	2.7	5.0	3.0	(4.2)	5.4	4.0	4.0
HPCL	6.2	7.4	5.0	1.0	3.9	7.0	12.1	9.8	9.0	9.0	1.8	1.7	2.7	2.6	5.0	2.9	(4.1)	5.2	4.0	4.0
IOCL	7.8	8.5	5.4	0.1	5.6	11.3	19.5	12.4	9.0	9.0	1.8	1.7	2.7	2.7	5.0	3.1	(4.7)	5.3	4.0	4.0

Source: Companies, Kotak Institutional Equities estimates

- **Expensive valuations on correct valuation framework.** We do not concur with the market's view on 'inexpensive' valuations of the OMCs. The valuations of the OMCs may look low on a P/E basis, but the use of P/E valuation framework is rather meaningless in the case of the OMCs. In fact, the current valuations of the OMCs are quite expensive, given (1) low FCF-to-PAT ratio (see Exhibit 72) and (2) low or negative terminal value of the OMCs. In our view, FCF and FCF multiple should be more relevant for shareholders, especially in cases with large and persistent gap between FCF and PAT.

Low FCF-to-PAT ratios of OMCs render P/E-based valuation redundant

Exhibit 72: FCF and PAT of OMCs, March fiscal year-ends, 2016-26E (Rs bn)

	2016	2017	2018	2019	2020	2021	2022	2023	2024E	2025E	2026E	2016-22	2016-26E
BPCL													
PAT	71	84	79	71	21	141	88	30	273	117	121	555	1,097
FCF	14	(30)	34	(10)	(42)	210	112	13	193	28	133	287	655
FCF/PAT (%)	**20**	**(36)**	**43**	**(14)**	**(205)**	**149**	**126**	**43**	**71**	**24**	**110**	**52**	**60**
HPCL													
PAT	37	66	64	60	11	113	63	(90)	147	97	94	413	662
FCF	20	42	32	(22)	(99)	34	13	(177)	118	(36)	20	19	(55)
FCF/PAT (%)	**54**	**63**	**50**	**(37)**	**(913)**	**30**	**21**	**197**	**80**	**(37)**	**22**	**5**	**(8)**
IOCL													
PAT	107	264	195	170	(36)	237	242	82	417	242	224	1,178	2,144
FCF	70	88	78	(132)	(242)	215	(38)	(114)	444	52	92	38	512
FCF/PAT (%)	**65**	**33**	**40**	**(78)**	**669**	**91**	**(16)**	**(139)**	**106**	**22**	**41**	**3**	**24**

Source: Companies, Kotak Institutional Equities estimates

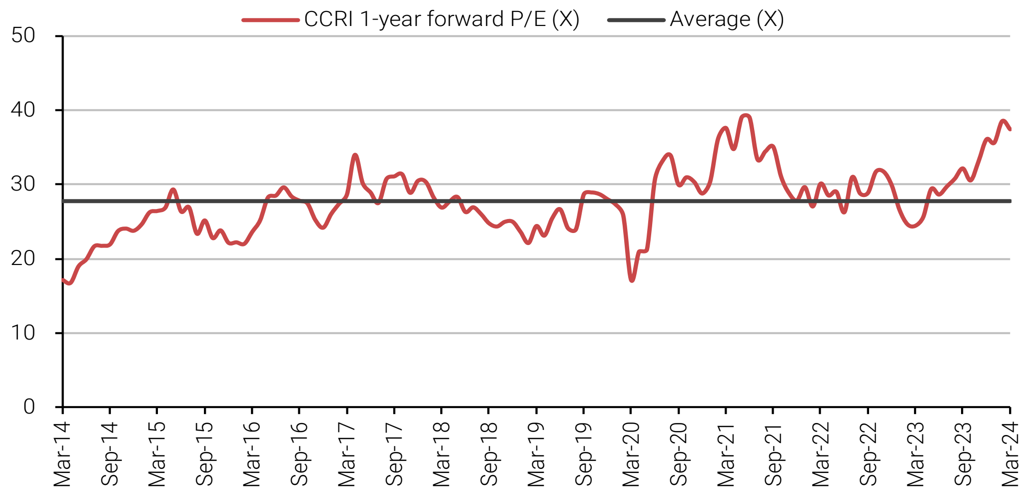
In our view, OMCs will likely continue to generate weak FCF in the future, also given their propensity to invest in capex-intensive projects. They have generated very low FCF relative to PAT for the past several years, as they have invested aggressively in refining and marketing assets. We would not rule out possible pressure on refining margins over the next few years, even assuming their marketing margins were to sustain at current high levels. Global oil demand will likely peak over the next few years, which could result in downward pressure on global refining margins, unless commensurate refining capacity was to exit the system; we note that global refining capacity will increase by 3.5 mn b/d over CY2024-27E.

The refining and marketing businesses of OMCs may have limited terminal value, given the ongoing energy transition of the global energy economy. These companies have made no efforts to transition from 'old' energy to 'new' energy using their extant cash flows. We note that OMCs continue to invest in 'old' energy projects (Rajasthan refinery of HPCL is a case in point), which raises concerns about the use of cash flows of the companies in the medium term and their viability in the long term.

- **Transportation.** CCRI's stock has seen a sharp rerating in the past year and trades at 39X FY2025E EPS and 24X FY2025E EBITDA—a large premium to ADSEZ (see Exhibits 73-74). We find CCRI's premium over ADSEZ rather surprising, given the superior nature of ADSEZ's business model. We find issues with the Street's (1) valuation approach for CCRI and (2) optimistic assumptions with respect to potential privatization of CCRI.

CCRI is trading at a large premium to its historical valuations

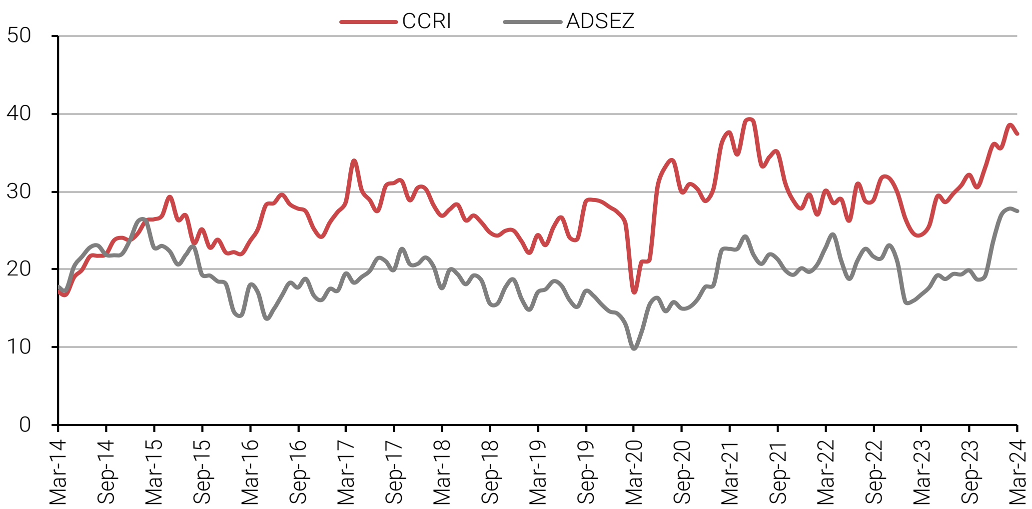
Exhibit 73: 1-year forward P/E of CCRI, March fiscal year-ends, 2014-24 (X)



Source: FactSet, Kotak Institutional Equities

CCRI is trading at a significant premium to ADSEZ

Exhibit 74: 1-year forward P/E of CCRI versus ADSEZ, March fiscal year-ends, 2014-24 (X)

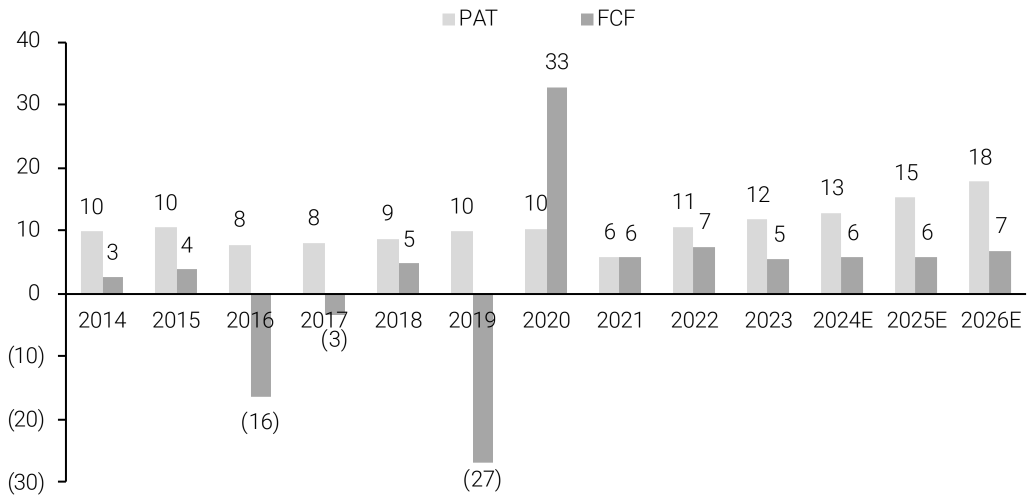


Source: FactSet, Kotak Institutional Equities

- **Disconnect between valuation approach and business model.** We struggle to justify the high multiples of CCRI's stock, given (1) low FCF-to-PAT ratio and (2) low RoE of CCRI. CCRI has generated very low FCF relative to PAT for the past several years, given the capital-intensive nature of its growth. It has generated cumulative FCF of Rs9.5 bn versus cumulative adjusted PAT of Rs73 bn (reported PAT is higher as it included export incentive benefits) over FY2016-23 (see Exhibit 75). We model cumulative FCF of Rs16.8 bn versus cumulative PAT of Rs44.5 bn over FY2024-26E. CCRI has had a fairly mediocre RoE profile historically (at around 10% for the past 10 years; see Exhibit 76), which makes it 4.7X FY025E BVPS rather unfathomable.

CCRI's PAT to FCF conversion is quite low at 17% over FY2014-23

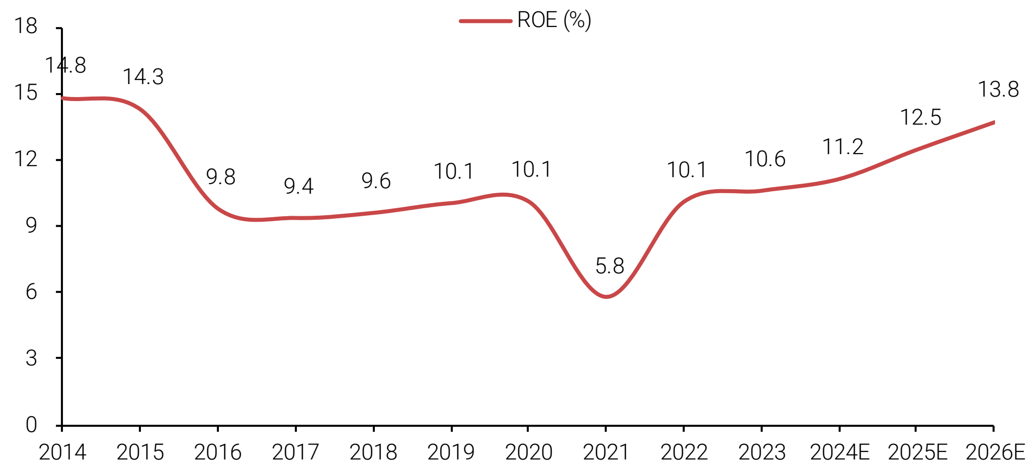
Exhibit 75: PAT and FCF of CCRI, March fiscal year-ends, 2014-26E (Rs bn)



Source: Company, Kotak Institutional Equities estimates

CCRI's RoE averaged 10.5% over FY2014-23

Exhibit 76: RoE of CCRI, March fiscal year-ends, 2014-26E (%)



Source: Companies, Kotak Institutional Equities estimates

- **Privatization is possible, but premium valuations may deter strategic investors.** The market is probably assigning a high probability to CCRI's privatization at a healthy premium to its CMP. However, it is hard to use this as a sole investment thesis for two reasons.

  There has been very little progress on the privatization of CCRI, despite the government having started the process of privatization of CCRI a few years ago. The government had to rework several agreements between CCRI and Indian Railways (see Exhibit 77) to enable the privatization of CCRI. We note that CCRI will continue to rely on the Indian Railways' rail infrastructure even after privatization, which would mean that a potential bidder of CCRI would probably require greater confidence on the relationship between CCRI and IR for it to be in a position to assess the Fair Value of CCRI's business model.

Several hurdles had to be overcome to enable privatization of CCRI

Exhibit 77: Key events in the timeline of proposed divestment of stake in Concor

	Event	Impact
Mar-20	Ministry of Railways decided to levy land license fee (LLF) at 6% of market value and 7% annual inflation	Land license fee (LLF) for Concor increased manifold, lowering the cost disadvantage for its peers in the private sector
Nov-20	Concor's results release suggests Indian Railways' demand of LLF of Rs7.6 bn for two terminals against Rs2 bn of LLF payment Concor made for all its terminals in the previous year	The formula for calculating market value of land in select terminals became a matter of discussion between Concor and Indian Railways
Sep-22	Ministry of Railways decided to (1) give option to Concor to lower land license fee to 1.5% from 6% in lieu of it letting the concession to be rebid on parameter of terminal charges (out of handling income earned from customers), (2) follow a process of bidding incremental concessions of railway land on similar terms	The endeavour was to enable Concor's peers to bid for incremental concessions. Concor decided to hold on to most terminals to start with. However, it let go of the key Tughlakabad terminal in Delhi while setting a substitute facility to cater to related traffic

Source: Industry reports, Kotak Institutional Equities

In our view, the expensive valuations of CCRI may also act as a deterrent for potential strategic investors. CCRI stock has gone up 40% in the past six months in the general euphoria surrounding PSU stocks, although there has been no meaningful change in its fundamentals. A potential bidder may have various strategic reasons to bid for CCRI, but the 40% increase in market capitalization (and payout) and its very expensive valuations would certainly test the resolve of any interested bidder.

"Each of the analysts named below hereby certifies that, with respect to each subject company and its securities for which the analyst is responsible in this report, (1) all of the views expressed in this report accurately reflect his or her personal views about the subject companies and securities, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report: Sanjeev Prasad, Anindya Bhowmik, Sunita Baldawa."

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to deliver more than 15% returns over the next 12 months.

ADD. We expect this stock to deliver 5-15% returns over the next 12 months.

REDUCE. We expect this stock to deliver -5-+5% returns over the next 12 months.

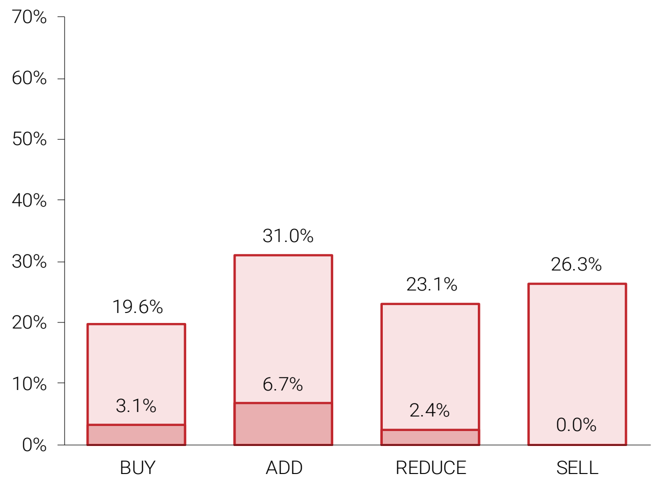
SELL. We expect this stock to deliver <-5% returns over the next 12 months.

Our Fair Value estimates are also on a 12-month horizon basis.

Our Ratings System does not take into account short-term volatility in stock prices related to movements in the market. Hence, a particular Rating may not strictly be in accordance with the Rating System at all times.

Distribution of ratings/investment banking relationships

Kotak Institutional Equities Research coverage universe



Percentage of companies covered by Kotak Institutional Equities, within the specified category.

Percentage of companies within each category for which Kotak Institutional Equities and or its affiliates has provided investment banking services within the previous 12 months.

* The above categories are defined as follows: Buy = We expect this stock to deliver more than 15% returns over the next 12 months; Add = We expect this stock to deliver 5-15% returns over the next 12 months; Reduce = We expect this stock to deliver -5-+5% returns over the next 12 months; Sell = We expect this stock to deliver less than -5% returns over the next 12 months. Our target prices are also on a 12-month horizon basis. These ratings are used illustratively to comply with applicable regulations. As of 31/12/2023 Kotak Institutional Equities Investment Research had investment ratings on 255 equity securities.

Source: Kotak Institutional Equities

As of December 31, 2023

Coverage view

The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and fair value, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.

NC = Not Covered. Kotak Securities does not cover this company.

RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and fair value, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or fair value. The previous investment rating and fair value, if any, are no longer in effect for this stock and should not be relied upon.

NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
27 BKC, Plot No. C-27, "G Block" Bandra Kurla Complex, Bandra (E) Mumbai 400 051, India
Tel: +91-22-43360000

Overseas Affiliates

Kotak Mahindra (UK) Ltd
8th Floor, Portsoken House
155-157 Minories, London EC3N 1LS
Tel: +44-20-7977-6900

Kotak Mahindra Inc
PENN 1,1 Pennsylvania Plaza,
Suite 1720, New York, NY 10119, USA
Tel: +1-212-600-8858

The Kotak Institutional Equities research report is solely a product of Kotak Securities Limited and may be used for general information only. The legal entity preparing this research report is not registered as a broker-dealer in the United States and, therefore, is not subject to US rules regarding the preparation of research reports and/or the independence of research analysts.

1. Note that the research analysts contributing to this report are residents outside the United States and are not associates, employees, registered or qualified as research analysts with FINRA or a US-regulated broker dealer; and
2. Such research analysts may not be associated persons of Kotak Mahindra Inc. and therefore, may not be subject to FINRA Rule 2241 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst.
3. Kotak Mahindra Inc. does not accept or receive any compensation of any kind directly from US institutional investors for the dissemination of the Kotak Securities Limited research reports. However, Kotak Securities Limited has entered into an agreement with Kotak Mahindra Inc. which includes payment for sourcing new major US institutional investors and service existing clients based out of the US.
4. In the United States, this research report is available solely for distribution to major US institutional investors, as defined in Rule 15a – 6 under the Securities Exchange Act of 1934. This research report is distributed in the United States by Kotak Mahindra Inc., a US-registered broker and dealer and a member of FINRA. Kotak Mahindra Inc., a US-registered broker-dealer, accepts responsibility for this research report and its dissemination in the United States.
5. This Kotak Securities Limited research report is not intended for any other persons in the United States. All major US institutional investors or persons outside the United States, having received this Kotak Securities Limited research report shall neither distribute the original nor a copy to any other person in the United States. Any US recipient of the research who wishes to effect a transaction in any security covered by the report should do so with or through Kotak Mahindra Inc. Please contact a US-registered representative; Vinay Goenka, Kotak Mahindra Inc., PENN 1,1 Pennsylvania Plaza, Suite 1720, New York, NY 10119, Direct +1 212 600 8858, vinay.goenka@kotak.com.
6. This document does not constitute an offer of, or an invitation by or on behalf of Kotak Securities Limited or its affiliates or any other company to any person, to buy or sell any security. The information contained herein has been obtained from published information and other sources, which Kotak Securities Limited or its affiliates consider to be reliable. None of Kotak Securities Limited accepts any liability or responsibility whatsoever for the accuracy or completeness of any such information. All estimates, expressions of opinion and other subjective judgments contained herein are made as of the date of this document. Emerging securities markets may be subject to risks significantly higher than more established markets. In particular, the political and economic environment, company practices and market prices and volumes may be subject to significant variations. The ability to assess such risks may also be limited due to significantly lower information quantity and quality. By accepting this document, you agree to be bound by all the foregoing provisions.

This report is distributed in Singapore by Kotak Mahindra (UK) Limited (Singapore Branch) to institutional investors, accredited investors or expert investors only as defined under the Securities and Futures Act. Recipients of this analysis /report are to contact Kotak Mahindra (UK) Limited (Singapore Branch) (16 Raffles Quay, #35-02/03, Hong Leong Building, Singapore 048581) in respect of any matters arising from, or in connection with, this analysis/report. Kotak Mahindra (UK) Limited (Singapore Branch) is regulated by the Monetary Authority of Singapore.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which includes earnings from investment banking and other businesses. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advise to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment. Certain transactions – including those involving futures, options, and other derivatives as well as non-investment-grade securities – give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. Kotak Securities Limited and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, affectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

Kotak Securities Limited established in 1994, is a subsidiary of Kotak Mahindra Bank Limited.

Kotak Securities Limited is a corporate trading and clearing member of BSE Limited (BSE), National Stock Exchange of India Limited (NSE), Metropolitan Stock Exchange of India Limited (MSE), National Commodity and Derivatives Exchange (NCDEX) and Multi Commodity Exchange (MCX). Our businesses include stock broking, services rendered in connection with distribution of primary market issues and financial products like mutual funds and fixed deposits, depository services and portfolio management.

Kotak Securities Limited is also a Depository Participant with National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL). Kotak Securities Limited is also registered with Insurance Regulatory and Development Authority and having composite license acts as Corporate Agent of Kotak Mahindra Life Insurance Company Limited and Kotak Mahindra General Insurance Company Limited and is also a Mutual Fund Advisor registered with Association of Mutual Funds in India (AMFI). Kotak Securities Limited is registered as a Research Analyst under SEBI (Research Analyst) Regulations, 2014.

We hereby declare that our activities were neither suspended nor we have defaulted with any stock exchange authority with whom we are registered in last five years. However, SEBI, Exchanges and Depositories have conducted the routine inspection and based on their observations have issued advise letters or levied minor penalty on KSL for certain operational deviations. We have not been debarred from doing business by any stock exchange/SEBI or any other authorities, nor has our certificate of registration been cancelled by SEBI at any point of time.

We offer our research services to primarily institutional investors and their employees, directors, fund managers, advisors who are registered with us. Details of Associates are available on website, i.e. www.kotak.com and https://www.kotak.com/en/investor-relations/governance/subsidiaries.html.

Research Analyst has served as an officer, director or employee of subject company(ies): No.

We or our associates may have received compensation from the subject company(ies) in the past 12 months.

We or our associates have managed or co-managed public offering of securities for the subject company(ies) or acted as a market maker in the financial instruments of the subject company/company (ies) discussed herein in the past 12 months. YES. Visit our website for more details https://kie.kotak.com.

We or our associates may have received compensation for investment banking or merchant banking or brokerage services from the subject company(ies) in the past 12 months. We or our associates may have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company(ies) in the past 12 months. We or our associates may have received compensation or other benefits from the subject company(ies) or third party in connection with the research report.

Our associates may have financial interest in the subject company(ies).

Research Analyst or his/her relative's financial interest in the subject company(ies): No

Kotak Securities Limited has financial interest in the subject company(ies) at the end of the week immediately preceding the date of publication of Research Report: YES.
Nature of Financial interest: Holding equity shares or derivatives of the subject company.

Our associates may have actual/beneficial ownership of 1% or more securities of the subject company(ies) at the end of the month immediately preceding the date of publication of Research Report.

Research Analyst or his/her relatives have actual/beneficial ownership of 1% or more securities of the subject company(ies) at the end of the month immediately preceding the date of publication of Research Report: No.

Kotak Securities Limited has actual/beneficial ownership of 1% or more securities of the subject company(ies) at the end of the month immediately preceding the date of publication of Research Report: No

Subject company(ies) may have been client during twelve months preceding the date of distribution of the research report.

A graph of daily closing prices of securities is available at https://www.moneycontrol.com/india/stockpricequote/ and http://economictimes.indiatimes.com/markets/stocks/stock-quotes. (Choose a company from the list on the browser and select the "three years" icon in the price chart).

First Cut notes published on this site are for information purposes only. They represent early notations and responses by analysts to recent events. Data in the notes may not have been verified by us and investors should not act upon any data or views in these notes. Most First Cut notes, but not necessarily all, will be followed by final research reports on the subject.

There could be variance between the First Cut note and the final research note on any subject, in which case the contents of the final research note would prevail. We accept no liability of the First Cut Notes.

Analyst Certification

The analyst(s) authoring this research report hereby certifies that the views expressed in this research report accurately reflect such research analyst's personal views about the subject securities and issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of Firm. Firm Research is disseminated and available primarily electronically, and, in some cases, in printed form.

Additional information on recommended securities is available on request.

Our research should not be considered as an advertisement or advice, professional or otherwise. The investor is requested to take into consideration all the risk factors including their financial condition, suitability to risk return profile and the like and take professional advice before investing.

Investments in securities market are subject to market risks. Read all the related documents carefully before investing.
Registration granted by SEBI and certification from NISM in no way guarantee performance of the intermediary or provide any assurance of returns to investors.

Derivatives are a sophisticated investment device. The investor is requested to take into consideration all the risk factors before actually trading in derivative contracts. Compliance Officer Details: Mr. Hiren Thakkar. Call: 022 - 4285 8484, or Email: ks.compliance@kotak.com.

Kotak Securities Limited. Registered Office: 27 BKC, C 27, G Block, Bandra Kurla Complex, Bandra (E), Mumbai 400051. CIN: U99999MH1994PLC134051, Telephone No.: +22 43360000, Fax No.: +22 67132430. Website: www.kotak.com / www.kotaksecurities.com. Correspondence Address: Infinity IT Park, Bldg. No 21, Opp. Film City Road, A K Vaidya Marg, Malad (East), Mumbai 400097. Telephone No: 42856825. SEBI Registration No: INZ000200137(Member of NSE, BSE, MSE, MCX & NCDEX), AMFI ARN 0164, PMS INP000000258 and Research Analyst INH000000586. NSDL/CDSL: IN-DP-629-2021. Compliance Officer Details: Mr. Hiren Thakkar. Call: 022 - 4285 8484, or Email: ks.compliance@kotak.com

Details of	Contact Person	Address	Contact No.	Email ID
Customer Care/ Complaints	Mr. Ritesh Shah	Kotak Towers, 8th Floor, Building No.21, Infinity Park, Off Western Express Highway, Malad (East), Mumbai, Maharashtra - 400097	18002099393	ks.escalation@kotak.com
Head of Customer Care	Mr. Tabrez Anwar		022-42858208	ks.servicehead@kotak.com
Compliance Officer	Mr. Hiren Thakkar		022-42858484	ks.compliance@kotak.com
CEO	Mr. Jaideep Hansraj		022-42858301	ceo.ks@kotak.com

In absence of response/complaint not addressed to your satisfaction, you may lodge a complaint with SEBI at SEBI, NSE, BSE, Investor Service Center | NCDEX, MCX. Please quote your Service Ticket/Complaint Ref No. while raising your complaint at SEBI SCORES/Exchange portal. Kindly refer https://www.kotaksecurities.com/contact-us/