kotak Institutional Equities

Mundra Port and SEZ (MSEZ)

Infrastructure

ADD

MARCH 05, 2010

CHANGE IN RECO.

Coverage view: Attractive

Price (Rs): 715

Target price (Rs): 725

BSE-30: 16,972

Downgrade to ADD based on recent outperformance. We downgrade MPSEZ to ADD based on its recent outperformance of 26% in last three months and 15% since mid-Jan 2010. We have already built in strong earnings growth over the next two years, which limits the potential for upside to estimates. We could see upside from strong progress in new port projects and better-than-expected SEZ land sales. Downside risks include lower-than-expected SEZ area absorption and delays in upcoming power plants.

Company data and valuation summary

Mundra Port and SEZ

Stock data			
52-week range (Rs) (high,low)			724-290
Market Cap. (Rs bn)			288.5
Shareholding pattern (%)			
Promoters			81.0
FIIs			7.4
MFs			1.5
Price performance (%)	**1M**	**3M**	**12M**
Absolute	10.6	26.1	127.7
Rel. to BSE-30	5.7	26.6	13.3

Forecasts/Valuations	2010	2011E	2012E
EPS (Rs)	15.1	24.1	35.7
EPS growth (%)	40.8	59.5	48.4
P/E (X)	47.4	29.7	20.0
Sales (Rs bn)	13.7	22.2	29.3
Net profits (Rs bn)	6.1	9.7	14.4
EBITDA (Rs bn)	8.9	14.6	19.4
EV/EBITDA (X)	35.5	21.4	15.4
ROE (%)	18.5	23.2	26.1
Div. Yield (%)	0.0	0.0	0.0

Downgrade to ADD based on recent outperformance; limited potential for upside to estimates

MPSEZ has outperformed the market (SENSEX) by about 26% in the past three months and 20% in the past six-month period. We highlight that the company has outperformed the market by about 15% since mid-January 2010. We cut our rating on the stock to ADD from BUY earlier based on limited upside to our target price of Rs725/share. We remain positive on the company based on strong growth and long-term potential to add capacity and capability but believe most of these positives are already priced in as per our valuation estimates. Our earnings estimates of Rs24.1 and Rs36 for FY2011E and FY2012E already build in strong revenue growth and margin expansion. We have built strong growth into Mundra port volumes over the next few years which leaves very little room for upside risk to our estimates (total port volumes to record CAGR of 29% over FY2009-13E to reach 102 mn tons).

Service tax revision unlikely to alter relative price dynamics among various ports

Service tax is payable by the end consumer (shipping lines) and hence is unlikely to impact the relative price dynamics among various ports. MPSEZ management cited that the company already levies service tax on 90-95% of the services provided at the port. SEZ units and developers are already exempt from service tax for services consumed within SEZs.

MPSEZ—AEL swap ratio likely to be decided by end of the month

The swap ratio for the merger of the promoter's stake in MPSEZ with Adani Enterprises is likely to be finalized by the end of this month (to be filed in the High Court by end of March). The market would look forward to this event as both are listed entities.

Key downside risks include lower-than-expected SEZ land absorption and delays in power projects

Key downside risks to our estimates are (1) delays in progress of the power projects, which would lead to lower-than-expected coal volumes, (2) slower-than-expected SEZ area absorption with competing SEZs vying for clients, and (3) removal of SEZ-related tax benefits. Key upside risks to our estimates include (1) stronger-than-expected performance of other upcoming port projects and (2) higher-than-expected SEZ land sales.

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Recent outperformance leaves little room for upside; downgrade to ADD

MPSEZ has outperformed the market (benchmark: SENSEX) by about 26% in the past three months and 20% in the past six-month period. The company has outperformed the market by about 15% since our initiation in mid-Jan 2010. The current trading level of Rs715/share provides limited upside to our target price of Rs725/share. Hence, we cut our rating on the stock from BUY to ADD given the recent stock price rise. We still maintain a positive stance on the stock based on (1) long-term potential to add capacity led by large water front, (2) asset profile advantage versus other infrastructure players, (3) growing trade volumes amidst capacity constraints, and (4) good track record of capacity and volume ramp-up. However, we believe that as most of these positives have already been priced in, the potential for outperformance remains low.

Recent outperformance caps potential upside; downgrade to ADD
MPSEZ's absolute and relative performance (%)

	1M	3M	6M	12M	From 15-Jan-2010
Absolute performance	9.6	24.8	30.8	133.1	11.7
SENSEX performance	3.1	(1.1)	10.4	101.7	(3.5)
Relative performance	**6.5**	**25.9**	**20.4**	**31.3**	**15.2**

Source: BSE

Already build in strong growth over next few years – 100 mn tons by FY2013E

We estimate Mundra to report very strong earnings growth of 40-50% over the next two years. We estimate consolidated earnings of Rs24.1 and Rs36 for FY2011E and FY2012E, respectively, which builds in strong revenue growth as well as margin expansion across the various assets of the company.

100-mn-ton port by FY2013E

We have already built in strong growth in the Mundra port volumes over the next few years. We estimate the total port volumes to grow at a strong CAGR of 29% over the next four years i.e. FY2009-13E led by (1) 28% CAGR of bulk cargo volumes, (2) container cargo to grow at a CAGR of 23% and (3) 39% CAGR for crude volumes. Hence, we believe that there is very limited upside risk to our volume estimates.

We expect the port to have a capacity of 100 mn tons by FY2013E, including bulk, container and crude volumes led by (1) 22 MMT of coal cargo for the two upcoming power plants (Adani Power and Tata Power), (2) increase in HPCL crude volumes for the upcoming Bhatinda refinery to 9 MMT, (3) increase in IOCL crude volumes to about 11 MMT from 4.8 MMT in FY2009 (led by increased capacity of Panipat refinery), (4) ramp-up in container volumes to about 1.8 mn TEUs (about 24 MMT, from 0.8 mn TEUs in FY2009) and (5) bulk volumes of about 30 MMT (excluding coal for Adani and Tata power plants) versus current levels of 19 MMT in FY2009.

Potential to become a 100 mn tons port in FY2013E; present port capacity expansions sufficient to support over 100 MMT of cargo
Expected port capacity, volume and utilization of Mundra port, March fiscal year-ends, 2010E and 2013E

Cargo type	FY2010E-end capacity (MMT)	FY2010E volumes (MMT)	FY2013E-end capacity (MMT)	FY2013E volumes (MMT)
Container	24	12	33	24
(mn TEUs)	3	1.0	3	1.8
Coal cargo	—	9	50	35
Other bulk	25	14	25	17
POL	20	8	40	25
Total	**69**	**42**	**148**	**102**

Container volume growth aided by spill-over traffic from over-capacitated west-coast ports

Coal requirements of about 22 mn tons in FY2013E for Adani and Tata Power thermal plants

Strong growth in POL volumes led by start of Bhatinda refinery and capacity expansion at Panipat

45-50 mtpa coal terminal likely to be commissioned by Oct-2010E

HPCL's SPM to increase the port's POL capacity to rise to 40 mtpa from current 20 mtpa

Source: Company, Kotak Institutional Equities estimates

Downside risks: Lower-than-expected SEZ land sales, delays in power projects

Key risks to the company's performance are (1) delays in progress of the power projects which would lead to lower-than-expected coal volumes, (2) slower-than-expected SEZ area absorption with competing SEZs vying for clients, and (3) lifting of SEZ-related tax benefits. Other risks include (1) lower-than-expected economic growth and potential competition which would affect volumes, (2) near-term cash-burn by the logistics business, (3) delays and/or cost escalation in planned capital expenditure, (4) removal of SEZ-related tax benefits, (5) unavailability of revenue break-up which impedes understanding and (6) inability to sustain tariffs at current/projected levels.

Upside could arise from better-than-expected progress in other port projects, large SEZ land parcel sales

The key sources of upside to our estimates could arise from (1) stronger-than-expected performance from the other upcoming port projects (Dahej, Mormugao and Hazira) in terms of progress in projects and initial volumes and (2) set-up of a large manufacturing plant (such as a steel plant) at the Mundra SEZ, which would lead to higher-than-expected land sales. We have built strong growth into Mundra port earnings in terms of volumes as well as margin expansion and hence the potential for upside remains limited.

Only partial recovery in global trade; correlation to port may be low

The Baltic Dry Index has witnessed some recovery in the recent past post steep decline in October 2008. This could be a reflection of some pick-up in global trading volumes. However, this recovery is only partial and the levels still remain significantly below their peaks. The Baltic Dry Index has picked up significantly from its low of 663 in December 2008 to 2,911 but is still considerably lower than the peak of 11,793 in May 2008.

Exhibit 68: Only partial recovery in Baltic Dry Index post steep decline in October 2008
Daily Baltic dry index, January 2008 - Mar 2010

Source: Bloomberg

We believe the correlation of Mundra's port volumes to global trade volumes is relatively low as a bulk of its cargo is led by import requirements of the country. Only the container volumes of the port are likely to be dependant on the global volumes. The energy and food related imports at the port (cargo such as coal, crude/POL, edible oil etc.) are dependent on the requirements of the country and hence are relatively inflexible to global trade volumes. These commodities are likely to contribute to about 68-70% of the total port volumes handled in FY2013E.

Share-swap ratio of MPSEZ and AEL to be finalized by end-March

The MPSEZ management said that the request for the merger of MPSEZ's promoter stake with AEL is likely to be filed with the High Court by the end of this month (March 2010). Hence, the share-swap ratio of MPSEZ and AEL is likely to be finalized by then. The market would look forward to this event as both are listed entities. The company has already appointed PWC and Bank of America as the consultants for arriving at a swap ratio. Post the filing, the ruling of the high court and completion of the merger could take about 120-150 days.

Service tax revision unlikely to impact relative price dynamics among ports

Service tax is payable by the end consumer (shipping lines) and is hence unlikely to impact the relative price dynamics among various ports. MPSEZ's management said that the company already levies service tax on 90-95% of the services provided at the port including value added services such as blending/bagging of cargo etc. Recent revision to service tax for ports in the 2011 budget is only a definition change to include a broader range of services which would be taxable. The budget redefined the term port services to mean "any service rendered within a port or other port, in any manner" (hitherto "any service rendered by a port or any person authorized by the port, in any manner, in relation to a vessel or goods").

Positive on long-term potential of the port but valuations already price it in

We remain positive on the long-term potential of the company based on (1) long-term potential to add capacity at Mundra port led by availability of large waterfront, (2) asset profile that has several advantages versus other infrastructure peers, (3) suitably placed to benefit from expected growth in Indian trade volumes led by capacity-constrained major ports and lack of visible progress in port's capacity addition on the west coast, and (5) good historical track record in terms of capacity and volume ramp-up.

SOTP-based target price of Rs725/share

Our SOTP-based target price of Rs725/share is comprised of (1) Rs521/share from the Mundra port business (Sept-11E-based DCF valuation), (2) Rs150/share from the SEZ business (Sept-11E-based FCFE valuation), (3) Rs15.5/share from Dahej port value, (4) Rs4/share from Mormugao port, (5) Rs14/share from Hazira port value and (6) Rs9/share from book value of investments in Adani Logistics.

We arrive at an SOTP-based target price of Rs725/share for MPSEZ
FY2011E-based Sum-Of-Total-Parts valuation of Mundra Port and SEZ

	Valuation (Rs mn)	P/B multiple (X)	MPSEZ stake (%)	Value of MPSEZ stake (Rs mn)	Per share value (Rs)	Method of valuation
Mundra port	210,160		100	210,160	520.9	Sept-11E-based DCF
SEZ	60,537		100	60,537	150.0	Sept-11E-based DCF
Dahej port	8,437		74	6,243	15.5	Sept-11E-based DCF
Mormugao port	1,644		100	1,644	4.1	Sept-11E-based DCF
Hazira port	5,749		100	5,749	14.2	Sept-11E-based DCF
Adani Logistics		2.0		3,500	8.7	2.0X book value
Total				**287,833**	**713**	

Source: Company, Kotak Institutional Equities estimates

Consolidated financials of Mundra port and SEZ, March fiscal year-ends, 2008-13E (Rs mn)

	2008	2009	2010E	2011E	2012E	2013E
Income statement						
Net sales	**8,170**	**11,949**	**13,695**	**22,161**	**29,251**	**38,685**
Total operating costs	(2,813)	(4,393)	(4,742)	(5,578)	(7,281)	(9,365)
Operational costs	(1,836)	(3,195)	(3,344)	(3,993)	(5,372)	(7,048)
Employees	(266)	(404)	(538)	(697)	(979)	(1,336)
Selling & admin.	(711)	(794)	(850)	(890)	(935)	(1,004)
EBITDA	**5,357**	**7,557**	**8,908**	**14,627**	**19,413**	**25,668**
Other income	279	446	1,459	1,357	2,037	3,258
Depreciation	(1,023)	(1,468)	(1,661)	(3,051)	(3,445)	(3,609)
Financial charges	(1,079)	(1,459)	(2,143)	(2,546)	(2,640)	(2,515)
Pre-tax profit	**3,535**	**5,075**	**6,556**	**10,163**	**15,058**	**22,213**
Taxation	(1,534)	(533)	(450)	(409)	(593)	(981)
Adjusted PAT	**2,001**	**4,542**	**6,090**	**9,713**	**14,418**	**21,170**
Extraordinary items, net of tax	104	(217)	—	—	—	—
Reported PAT	**2,104**	**4,325**	**6,090**	**9,713**	**14,418**	**21,170**
EPS (Rs)	**5.2**	**10.7**	**15.1**	**24.1**	**35.7**	**52.5**
Balance sheet						
Shareholders funds	**26,216**	**29,306**	**35,938**	**46,477**	**62,327**	**84,485**
Share capital	4,035	4,035	4,035	4,035	4,035	4,035
Reserves and surplus	22,164	25,261	31,903	42,442	58,292	80,450
Minority interest	17	93	509	640	855	908
Loan funds	**20,680**	**28,957**	**30,112**	**35,512**	**25,962**	**24,862**
Amt received under LT lease	6,568	6,505	6,367	6,216	6,065	5,914
Deferred tax liability (net)	1,771	2,296	2,297	2,297	2,297	2,297
Total sources of funds	**55,252**	**67,156**	**75,230**	**91,149**	**97,513**	**118,473**
Net block	**29,739**	**35,597**	**33,009**	**64,915**	**64,993**	**66,604**
Capital WIP	6,934	16,195	30,866	6,914	8,714	8,514
Total fixed assets	**36,673**	**51,792**	**63,863**	**71,816**	**73,695**	**75,105**
Investments	8,886	2,072	3,949	3,949	3,949	3,949
Cash and bank balance	9,029	12,951	7,373	15,454	19,849	39,117
Net current assets excl. cash	**663**	**321**	**(44)**	**(159)**	**(68)**	**212**
Total application of funds	**55,252**	**67,156**	**75,230**	**91,149**	**97,513**	**118,473**
Key ratios						
Debt/equity (X)	0.8	1.0	0.8	0.8	0.4	0.3
Net debt/equity (X)	0.4	0.5	0.6	0.4	0.1	(0.2)
RoAE (%)	12.5	15.6	18.7	23.6	26.5	28.8
RoACE (%)	6.5	9.2	11.4	14.6	18.0	21.8

Source: Company, Kotak Institutional Equities estimates

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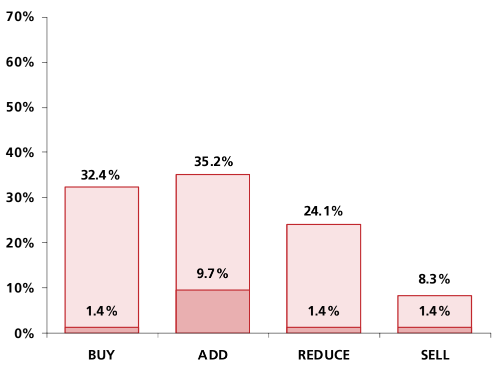

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