SSKI

INDIA RESEARCH

4 September 2007

BSE Sensex: 15465

Initiating coverage

Monnet Ispat & Energy

Rs310

OUTPERFORMER

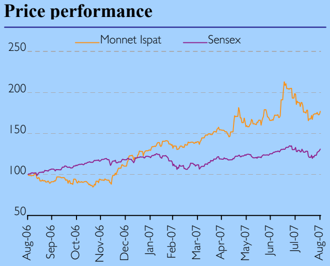
Power booster

Mkt Cap: Rs15.5bn; US$383m

Stock data

Reuters	MNET.BO
Bloomberg	MISP IN
1-yr high/low (Rs)	369/143
1-yr avg daily volumes (m)	0.02
Free float (%)	45.1

Price performance



Performance (%)

	3-mth	6-mth	1-yr	3-yr
Monnet	10.9	34.1	76.9	135.2
Sensex	5.3	18.4	30.9	195.4

Monnet Ispat & Energy (MIEL) is emerging as an integrated steel producer with a tilt towards value added engineering and long products. MIEL, besides expanding and forward integrating in the core steel business, is also setting up a 1000MW power project with captive coal mines. We believe that strong volume growth, cost reduction through economies of scale and forward integration into value added products would drive a 41% CAGR in MIEL's earnings over FY07-09. We believe the company's financial profile would remain strong even as it embarks on huge capital spending. We initiate coverage on the stock with an Outperformer rating and a price target of Rs435 per share based on our sum-of-parts valuation.

A business makeover in progress: A well laid-out business transformation plan is unfolding at MIEL. Post commissioning of its 1000MW pithead-based coal power plant by FY11E and a 90MW expansion at the existing plant to 150MW, MIEL's business mix would significantly change, largely insulating it from the volatilities of the steel business.

Highly cost-competitive in all businesses: A strong theme of cost competitiveness runs across the power and steel businesses. Thanks to an end-to-end integration, we expect MIEL to remain one of the lowest cost steel producers even as it rapidly climbs the value chain. With a pithead-based power plant fuelled from captive coalmines and utilization of residue (flue gases, coal fines, char, etc) from reduction and mining processes, MIEL would immensely benefit from lower cost of generation.

Stock attractively valued – Buy: At 8.0x FY08E earnings, valuations ignore the high-RoE power business in the parent company as also the option value of the upcoming 1000MW merchant power project. Strong volume growth, coupled with a gradual shift towards valued added products, should drive a 41% CAGR in profits over FY07-09. Initiating coverage on the stock with a price target of Rs435 per share based on our sum-of-parts valuation.

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Key financials

Year to March 31	FY05	FY06	FY07	FY08E	FY09E
Net sales (Rs m)	5,198	5,324	10,996	13,891	20,681
Adj. net profit (Rs m)	1,233	1,078	1,423	1,950	2,848
Shares in issue (m)	30	32	34	34	34
Adj. EPS (Rs)	53.0	24.7	32.6	38.9	56.9
% growth	*-*	*(53.4)*	*32.0*	*19.3*	*46.1*
PER (x)	5.8	12.5	9.5	8.0	5.5
Price/Book (x)	3.0	3.3	2.5	2.2	1.6
EV/EBITDA (x)	6.3	12.5	6.9	5.0	3.6
RoE (%)	39.8	29.9	30.0	31.2	33.7
RoCE (%)	18.6	10.6	16.2	20.4	20.5

Source: SSKI Research (--Adjusted EPS is based on fully diluted equity)*

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INVESTMENT ARGUMENT

MIEL, one of India's lowest cost coal-based sponge iron producers, is rapidly forward integrating into value added long products, viz plates and structurals. MIEL is partially backward integrated with captive raw material resources (coal and iron ore). Importantly, MIEL is slated to become a merchant power company with its upcoming 1000MW pithead-based coal plant in Angul (Orissa) expected to go on stream by FY11. Power sales would increasingly have a higher share in overall profitability, even as the capacity of core business increases 4x by FY09E. At 8.0x FY08E earnings, we believe the stock price has yet to factor in the upside slated to accrue from forward integration and the power foray. Initiating coverage with Outperformer rating and a 1-year price target of Rs435.

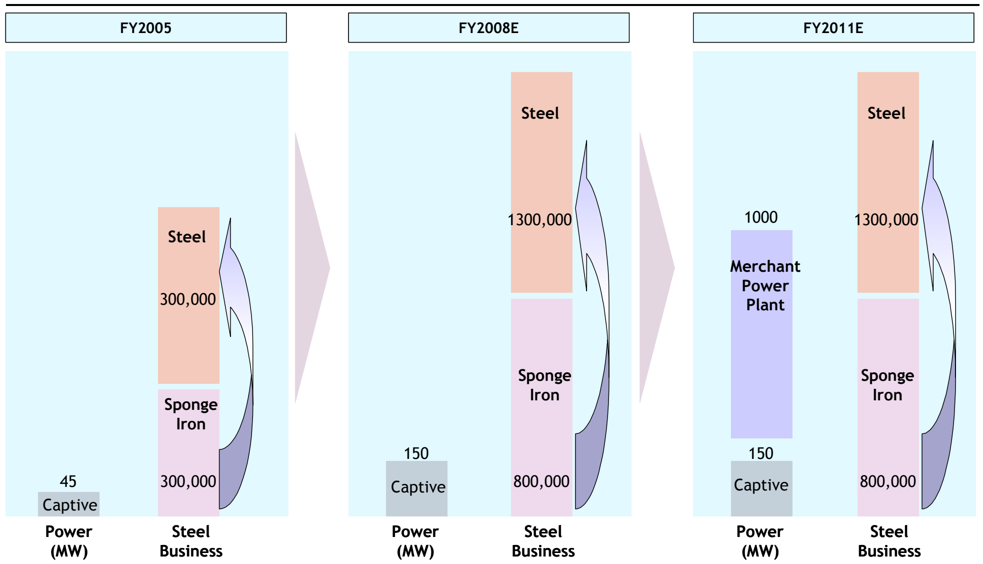
❑ A makeover is underway

MIEL among India's largest and lowest cost coal based sponge iron producers

MIEL's product portfolio comprises sponge iron, steel, ferro alloys and power generation. The company plans to increase its steel capacity 4x, to 1.3m tpa by FY09, with emphasis on forward integration into value added products. In addition, MIEL is also setting up a 1000MW thermal power plant in Orissa through its wholly-owned subsidiary Monnet Energy (MEL). The IPP would be a merchant power plant, which in the long run would insulate MIEL from cyclicality in the steel business. MEL would leverage on the captive coalmines and the residue from reduction/ mining processes, which would translate into significantly low variable cost per unit of power produced.

Steel capacity to be augmented to 4x by FY09E, a 1000MW merchant power plant being set up

Exhibit 1: MIEL— changing business profile



Source: Company, SSKI Research

Expect 25% CAGR in MIEL's overall sales volumes over FY07-10

❑ Strong volume growth in steel business backed by capacity expansion

MIEL is setting up a huge greenfield capacity at Raigarh involving a capital outlay of Rs11bn and production capacities of 0.5m tpa each for sponge iron, steel plates and structural steel along with a 90MW captive power plant. We expect 25% CAGR in MIEL's overall sales volumes over FY07-10.

Exhibit 2: MIEL – expected ramp up in production capacities

(m tpa)	Existing capacity as of Mar '07	Capacities post expansion	Scheduled commissioning
Sponge iron	0.3	0.8	Commissioned
Hot metal	0.3	1.3	End of FY08
Rolling steel	0.2	0.2	
Structural		0.5	Q1FY09
Plate mill		0.5	Q1FY09
Ferro alloys	0.06	0.06	
Captive power	60 MW	150	Oct'07

Source: SSKI Research

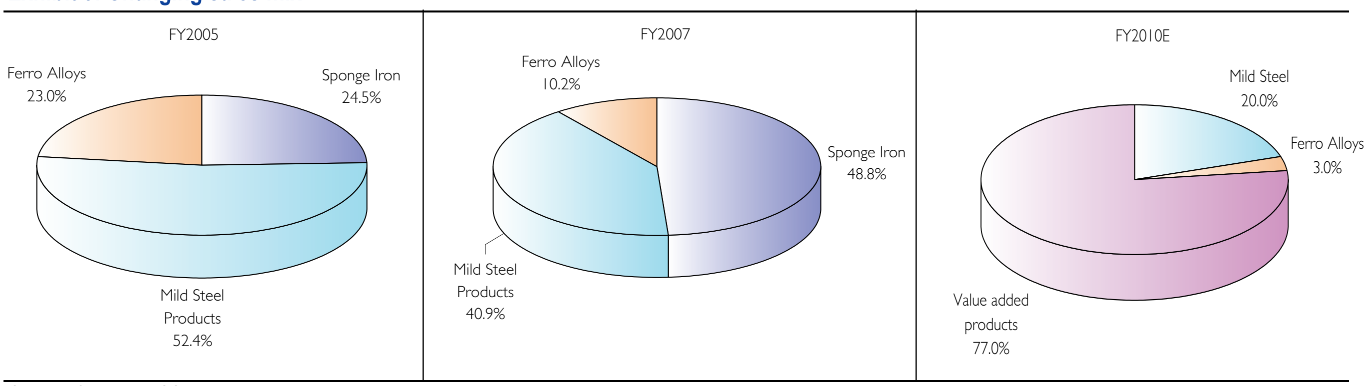
With shift towards value added products, steel realizations set to improve significantly

❑ Product profile – moving towards value added

MIEL is steadily forward integrating into manufacturing of long products. Consequently, we expect contribution from sponge iron to reduce significantly from 25% of revenues in FY05 to almost nil by FY09, as the portfolio gradually shifts towards long products. MIEL currently sells mild-steel products, which fetch far lesser realizations than long products. Steel plates would find use in the ship building/ pipe manufacturing sectors, whereas structurals are targeted at construction applications including transmission towers, bridges, etc.

As MIEL diversifies into value added products, we expect significant improvement in weighted average realizations for the steel business.

Exhibit 3: Changing sales mix



Source: Company, SSKI Research

Being a merchant power plant, the project expected to generate high returns…

❑ Power business leveraged by cost effectiveness

MIEL plans to set up a merchant power plant through MEL, a wholly-owned subsidiary, at a capital outlay of Rs42bn. This, we believe, would catapult MIEL into one of the largest and lowest cost power generators in India. We expect MEL's cost of generation to be Rs1.3/ unit with cost competitiveness stemming from its pithead-based operations and owned coalmines (that reduces transportation costs) as also lower inventory requirement. Further, being a merchant power plant, the plant falls outside the purview of regulated returns.

Exhibit 4: MEL - project commencement schedule

Commencement date	Capacity (MW)
Q1 FY11	330
Q2 FY11	330
Q3 FY11	330

Source: Company, SSKI Research

…of ~25% vis-à-vis 14% assured returns for a regulated power business

We expect MEL to generate an above average RoE of 25%, significantly higher than the 14% assured return for a regulated power business. The plant is likely to go on stream in three equal quarterly trenches of 330MW, beginning Q1FY11. While the 1000MW power plant has already achieved financial closure for a significant portion, the remaining is likely to be closed soon. With the commencement of the power project, along with an additional 90MW expansion for captive use (to 150MW), MIEL would emerge among India's largest private power generating companies.

❑ Return ratios expected to remain strong

Cost competitive steel operations and highly profitable power business to keep return ratios high

We believe the upcoming downstream facilities would lead to an improved sales mix for MIEL, in turn leading to higher blended realizations. We have conservatively assumed a 2.5% increase in blended realizations over FY07-09, primarily led by sales mix shifting towards value added long products. This, in turn, would drive a sharp 41% CAGR in MIEL's net profit over FY07-09. MIEL's cost-competitive steel operations and the highly profitable power business would translate into a high RoE (estimated at 31% for FY08).

Exhibit 5: Du Pont analysis

(Rs m)	2006	2007	2008E	2009E	2010E
PAT	1,078	1,423	1,949	2,847	3,069
Sales	5,324	10,996	13,891	20,681	21,606
PAT/Sales (A)	**20.3**	**12.9**	**14.0**	**13.8**	**14.2**
Sales	5,324	10,996	13,891	20,681	21,606
Assets	10,882	13,586	17,560	25,876	34,269
Sales/Assets(B)	**48.9**	**80.9**	**79.1**	**79.9**	**63.0**
Assets	10,882	13,586	17,560	25,876	34,269
Equity	3,601	4,726	6,227	8,427	11,188
Assets/Equity(C.)	**302.2**	**287.5**	**282.0**	**307.1**	**306.3**
ROE	**29.9**	**30.1**	**31.3**	**33.8**	**27.4**

Source: SSKI Research

❑ Initiate coverage with a price target of Rs435/share

Valuations offer ample scope for appreciation

At 8.0x FY08E earnings, we believe valuations do not capture the upside expected from the high RoE generating power business as also the option value for MIEL. We have valued the upcoming power business of MIEL by discounting the cash flows at 18%. The discounting rate is conservative considering the early status of the project and project implementation risk. Based on this, we value the power plant at Rs2.5bn (against an equity commitment of Rs12bn from MIEL).

Buy with a price target of Rs435 per share

We assign a 1-year price target of Rs 435/ share for MIEL based on our sum-of-parts valuation. Our valuation methodology assumes an average industry target PE multiple (1-year forward) of 6x for steel and 10x for power profits. To this, we have added current NPV of MEL to arrive at a justified market capitalization for MIEL (see exhibit below). Our SOTP value of Rs22bn for MIEL works out to Rs435/share on a fully diluted basis. We believe there is significant value creation possibility as the power plant nears completion and project implementation risk reduces.

Exhibit 6: MEIL – sum-of-parts valuation

Particulars	Net profit - FY09E (Rs m)	Justified multiple (x)	Justified market cap (Rs m)
Profit from steel business	2,301	6	13,808
Profit from power business	547	10	5,470
Discounted value of MEL @ 18%			2,526
Justified market capitalization*			21,804
Current market capitalization*			15,531
Potential upside (%)			40

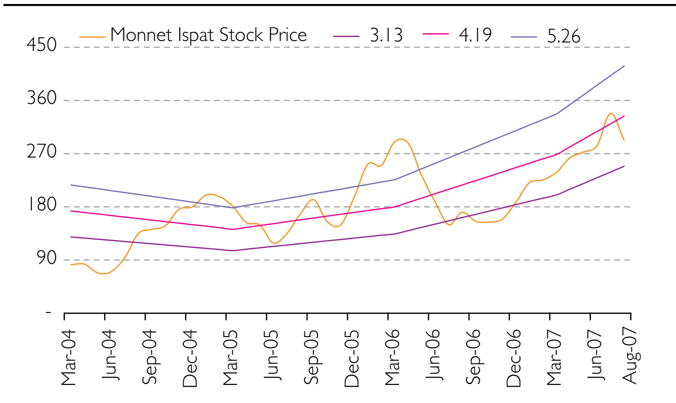
Source: SSKI Research (-- Market capitalization is based on fully diluted equity)*

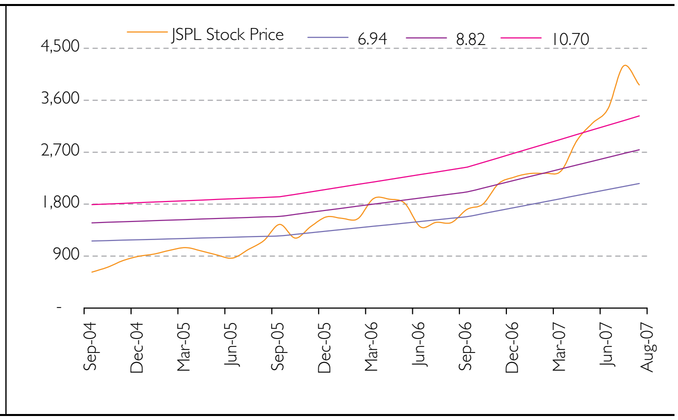
❑ Correlation exists between Jindal Steel & Power and MIEL

As power plant achieves financial closure and new steel capacity comes on stream, we expect MIEL to get re-rated

We believe MIEL, currently trading at 8.0x FY08E earnings, would see multiple re-rating going forward as the power plant achieves financial closure. MIEL could follow a re-rating trend as displayed by Jindal Steel & Power (currently trading at 12.7x FY08E earnings), which shares a similar business structure. As can be seen from the exhibit below, JSPL's stock price has got steadily re-rated with emerging visibility on cash flows, improving sales mix in the steel business, scalability and, last but not least, successful execution of its large power project.

Exhibit 7: MIEL – a case for multiple re-rating, a la Jindal Steel & Power





Source: SSKI Research

MIEL: Changing business mix

MIEL is one of India's lowest cost coal-based sponge iron producers. The company is expanding capacity and further forward integrating into value added long products used by infrastructure, energy and real estate sectors. Post the expansion, there would be a marked change in MIEL's business mix with value added products contributing a substantial 75% to revenues by FY08E. MIEL is also increasing its power generation capacity by 90MW (to 150MW) meant for captive use with plans also in place to set a 1000MW IPP (a dedicated merchant power plant) at Angul, Orissa.

Steel business: Achieving scale with vertical integration

MIEL India's lowest cost sponge iron producers

MIEL has recently commissioned its greenfield sponge iron capacity at Raigarh. With this, MIEL has emerged as one of the largest producers of sponge iron in the country with an installed capacity of 1.3m tpa. MIEL's sponge iron operations are extremely cost competitive, attributable to partial backward integration achieved in coal and iron ore. Further cost efficiency has been realized from recovery of waste heat (flue gases) from the reduction process and lower transportation cost with pithead-based operations. Besides insulating MIEL from volatility in raw material prices, captive resources have enabled MIEL to control both cost and quality. At a production cost of US$155/ tonne, MIEL is one of the lowest cost sponge iron producers in India.

❑ MIEL's cost-competitiveness looks set to improve further…

Given its integrated business structure and focus on backward integration, MIEL's cost competitiveness is expected to improve from here. Captive coalmines with high grade coal and proximity to the plants ensure low inventory and transportation costs, thereby rendering lower cost per tonne of coal.

Exhibit 8: Cost analysis per tonne of sponge iron produced

Ingredients	Consumption norm*	Assumed cost (Rs/ tonne)	Mode of purchase	% breakup	Cost (Rs/tonne)
Iron ore (In tonnes)	1.7	1,800	captive	30	891
		3,100	open market	70	3,580
Dolomite (In tonnes)	0.02	800	open market	100	16
Coal (In tonnes)	1.1	800	captive	100	880
		2,200	open market	0	
Power (in units)	80	3.9	captive	100	313
Others					600
Cost (Rs/ tonne) for sponge iron					6,281

*Source: SSKI Research (Note: Cost of power is assumed at market linked transfer pricing basis); *-- expected consumption per tonne of sponge iron*

MIEL has persistently strived to maintain backward integration by looking for new coal and iron ore mines. MIEL has also entered into off-take agreements for iron ore, which are sufficient to meet ~30% of its iron ore requirement. We believe iron ore costs from the off-take agreement would be significantly lower (~55%) than the market linked iron ore prices. MIEL is also actively scouting for captive iron-ore mines.

Acquisition of further iron-ore mines can drive significant cost savings

We believe significant cost savings are possible with higher captive iron ore consumption. For example, if MIEL were to increase its captive iron ore consumption by another 20% (to 50%) and 70% (100%), it could lead to ~7% and ~25% savings respectively in cost per tonne.

Exhibit 9: Scenario analysis for captive iron ore mines

Ingredients	Captive (%)	Open market (%)	Cost of sponge iron (Rs/ tonne)	Total cost (Rs/ tonne)
Iron ore	0	100	5,115	6,924
	30	**70**	**4,471**	**6,281**
	50	50	4,042	5,851
	100	0	2,970	4,779
Dolomite	0	100	16	
Coal	100	0	880	
Power	100	0	313	
Others			600	

Source: SSKI Research

MIEL also leverages its savings from captive power plants which operate on flue gases, char and coal fines – residue from the reduction and mining process. MIEL's strategically located plants ensure easy and uninterrupted availability of raw material as also proximity to secondary steel manufacturers and re-rollers. Proximity to eastern ports would further bring down MIEL's transportation and distribution cost.

Exhibit 10: Cost analysis per tonne of steel produced

Ingredients	Consumption norm	Cost (Rs/tonne)	Mode of purchase	% breakup	Cost (Rs/ tonne)
Sponge Iron	0.90	11,600	captive	100.0	10,440
		open market	-		
Power	815 units	2.8	captive	100.0	2,282
Scrap	0.25	(Rs/unit)	open market	0.0	
		11,600	captive	100.0	2,900
Others					800
Cost (Rs/ tonne) for steel				16,422	

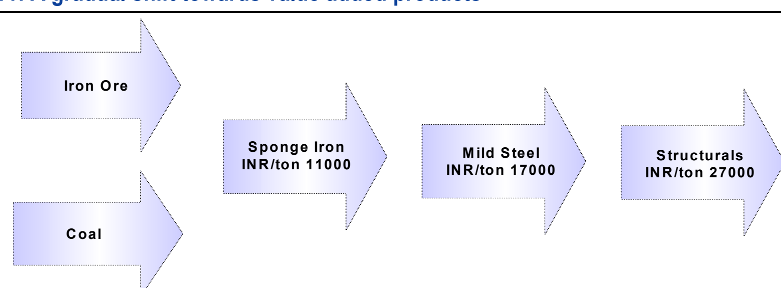
Source: SSKI Research (Note: Cost of Sponge Iron is assumed at market linked transfer pricing basis)

Moving up the value chain; realizations to improve substantially

❑ Business mix in for a complete makeover by FY10E

MIEL is forward integrating into manufacturing of structurals and rolled products, and value added engineering products. This would help the company diversify its mix towards products targeted at energy, infrastructure and real estate sectors. We believe the upcoming facilities of plate mill and structurals would help MIEL cater to shipbuilding, piping and infrastructure industries, which would eventually lead to higher realizations.

Exhibit 11: A gradual shift towards value added products



Source: Company, SSKI Research

Contribution of sponge iron expected to drop from 25% of total volumes to almost nil by FY10

MIEL has been consistently moving up the value chain with focus on value added products. Importantly, the company has retained focus on the core business while insulating its bottomline (given the cyclical nature of the business). MIEL now plans to set up an IPP (1000MW) in Orissa. We believe the IPP would be a profitable proposition as it would be a merchant power plant with attractive operating margins and RoE of at least 25% on full commissioning. We expect revenues from the sponge iron business to drop from 25% of the total revenues in FY05 to nil in FY10 due to the changing product mix and increased internal consumption.

Exhibit 12: Changing sales mix

Products (% of total vol.)	FY05	FY06	FY07	FY08E	FY09E	FY10E
Sponge Iron	24.4	19.7	48.7	16.2	0.0	0.0
Mild Steel Products	52.1	67.4	40.8	32.3	21.6	20.7
Value added products	0.0	0.0	0.0	44.8	76.5	77.5
Ferro Alloys	22.9	12.2	10.2	6.5	3.9	3.7

Source: SSKI Research

❑ Expansion to accelerate the integration process

A Rs11bn greenfield capacity being set up, which would augment capacity to 4x

MIEL is setting up a huge greenfield facility at Raigarh, Chhattisgarh involving a capital outlay of Rs11bn with production capacity of 0.5m tpa each for sponge iron, steel plates and structural steel (used in construction applications including transmission towers, bridges, etc) as also a 90MW power plant for captive consumption. This ~4x increase in capacity, to 1.3m tpa by FY08E, would drive an estimated 37% CAGR in MIEL's total sales volumes over FY07-09. Further, we expect an impressive 540bp increase in operating margins with focus on backward integration and a shift in sales mix towards value added products.

MIEL: 'POWER'FUL GROWTH

MIEL is setting up a mega 1000MW integrated power plant (under a wholly owned subsidiary – MEL) at a capital investment of Rs42bn. MIEL, by virtue of it being a merchant power plant, would fall outside the purview of regulated returns and thus fetch an above average RoE of 25%. We expect the plant to generate significantly higher returns compared to a regulated power plant. Also, the generation cost for the pithead-based coal plant is likely to be highly competitive. By FY11, when the plant becomes fully operational, power business would contribute 40% to MIEL's consolidated profits at the EBIT level.

❑ MIEL setting up a 1000MW power plant

The power plant expected to generate above average RoE of 25% against 14% for a regulated plant

MIEL has laid out massive expansion plans for power generation by setting up an IPP through a wholly-owned subsidiary at a capital investment of Rs42bn. MIEL would then become one of the largest and lowest cost power generators in India. The company would generate power at Rs1.3/unit—significantly lower than the industry average. MIEL derives its cost competitiveness from its pithead-based operations with owned coalmines (that reduce transportation costs) and lower inventory requirements. Further, being a merchant power plant, it would be outside the purview of regulated returns. We expect MIEL to generate an above average RoE of 25%, significantly higher than the 14% assured return for a regulated power business.

❑ Current status of the project

The power plant to be commissioned in three equal stages of 330MW each beginning FY11

The project has achieved 65% financial closure with land acquired for the plant. The company has estimated overall cost of Rs42bn for the project, likely to be funded at a debt equity ratio of 70:30. MIEL would contribute Rs12bn as equity for its stake in the company with the remaining proposed to be funded through debt. The power plant would be commissioned in three equal stages, beginning first quarter of FY11 and increasing by 330MW each in the following two quarters.

Exhibit 13: Project commencement schedule

Commencement date	Capacity (MW)
Q1 FY11	330
Q2 FY11	330
Q3 FY11	330

Source: Company, SSKI Research

❑ Project expected to be extremely cost-competitive

Cost competitive steel operations and highly profitable power business to drive strong RoE

The project is possibly among the first few private sector power plants to be laid in India with pithead-based captive coalmines. Pithead-based coal power plants generate the cheapest power as they entail reduced transportation costs and lower coal inventories. MIEL is also in the process of leasing a coalmine at Angul (Orissa) with 115m tonnes of recoverable reserves (total capacity 126m tonnes), which would ensure complete backward integration. MIEL would be among India's first few merchant power plants. A combination of higher realizations and high cost competitiveness is expected to yield significantly higher RoE of 25% for the plant.

FINANCIAL ANALYSIS

We expect a 41% CAGR in MIEL's net profit over FY07-09 driven by a complete shift in business mix towards value added products and strong volume growth on the back of capacity expansion. We have taken a conservative stand with flat realizations on sponge iron and a marginal 2.5% increase in weighted average realizations of finished steel products over FY07-09. We expect return ratios to remain strong owing to MIEL's cost competitiveness and high profitability of the power business.

❑ Strong volume growth and value addition to drive revenue growth

Expect a strong 37% CAGR in revenues over FY07-09

We expect MIEL's (standalone) revenues to witness a CAGR of ~37% over FY07-09, driven by a distinct shift towards value added products, and expansion in structurals and rolled products capacity. We expect value added products to contribute 75% of MIEL's revenues by FY08 and 95% by FY10. Despite our assumption of falling steel prices, we expect weighted average realizations to improve as the sales mix shifts towards value added products.

Exhibit 14: MIEL - summarized financials

Year-end Mar 31 (Rs m)	FY06	FY07	FY08E	FY09E	FY10E
Gross revenues	6,181	12,355	15,608	23,313	24,353
Excise duty & ST	(857)	(1,359)	(1,717)	(2,564)	(2,679)
Net revenue	5,324	10,996	13,891	20,749	21,674
Cost of goods sold	(3,646)	(8,085)	(9,344)	(14,145)	(14,167)
Gross profit	1,677	2,911	4,547	6,603	7,508
Selling, general and administrative	(276)	(303)	(394)	(513)	(536)
EBITDA	1,402	2,608	4,152	6,091	6,972
Depreciation and amortization	(249)	(440)	(568)	(696)	(824)
Operating profit (EBIT)	1,153	2,168	3,585	5,395	6,149
Interest (expense)	(3)	(490)	(482)	(704)	(947)
Interest & dividend income	-	1	2	3	3
Other income/(expense)	97	65	65	65	65
Pre-tax profit	1,246	1,744	3,170	4,759	5,269
Deferred income tax provision	(165)	(262)	(571)	(857)	(949)
Income tax	(3)	(87)	(475)	(571)	(316)
Net profit	1,078	1,395	2,124	3,331	4,005

Source: SSKI Research

❑ Expansion capex to push up gearing in the short term

Gearing expected to settle at reasonable levels as steel business starts generating cash

MILE has raised US $120m though FCCB (two FCCBs - US$60m each raised at a conversion rate of Rs237 and Rs317) for the ongoing greenfield project at Raigarh. On the back of capex plans, we believe steel business will start generating positive cash flows and subsequently bring down the debt equity ratio to a comfortable range by FY11E.

Exhibit 15: Gearing expected to improve

	2006	2007	2008E	2009E	2010E	2011
Gearing (x)	1.00	0.84	1.22	1.33	1.37	1.06
Operating cash flow (Rs m)	1,430	2,097	2,994	3,871	3,968	4,127

Source: Company, SSKI Research

Better realizations and strong volume growth to prop return ratios

❑ Return ratios to remain attractive

We expect MIEL's return ratios to remain at attractive levels, attributable mainly to a sharp rise in realizations (from Rs11,000 per tonne for sponge iron to Rs27,000 per tonne for long products) with focus on value added products and strong volume growth on the back of capacity expansion.

Exhibit 16: Du Pont analysis

(Rs m)	2,006	2,007	2008E	2009E	2010E
PAT	1,078	1,423	1,949	2,847	3,069
Sales	5,324	10,996	13,891	20,681	21,606
PAT/Sales (A)	**20.3**	**12.9**	**14.0**	**13.8**	**14.2**
Sales	5,324	10,996	13,891	20,681	21,606
Assets	10,882	13,586	17,560	25,876	34,269
Sales/Assets(B)	**48.9**	**80.9**	**79.1**	**79.9**	**63.0**
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Equity	3,601	4,726	6,227	8,427	11,188
Assets/Equity(C.)	**302.2**	**287.5**	**282.0**	**307.1**	**306.3**
ROE	**29.9**	**30.1**	**31.3**	**33.8**	**27.4**

Source: SSKI Research

Our estimates are subject to smooth execution of new steel project and tying up of funds for power plant

❑ Project execution – the key risk

Our estimates factor in smooth execution of the new 1mtpa capacity in steel by FY09 and ramp-up in capacity utilization of the recently commissioned sponge iron capacity. Any delay on these fronts is a key risk to our estimates. Similarly, any delay in tying up funds for the upcoming power plant and a consequent delay in commissioning of the project could impact valuations.

VALUATIONS AND VIEW

We assign a price target of Rs435 per share to MIEL based on our sum-of-parts valuation, which assumes a target PE multiple for steel and power profits, and an NPV for MIEL's 1000MW power plant. We have assumed a discount rate of 18% on MEL (Monnet Energy) NPV to account for early stage status of the project and the implementation risk. At 8.0x FY08E earnings, we believe valuations do not factor in the high RoE generating power business and the option value for MIEL.

❑ MEL – DCF valuation pegs fair value at Rs50 per share

We have assumed an 18% discounting rate for valuing MEL

We assign an NPV of Rs2.5bn or Rs50 per share for MEL assuming an 18% discount rate to cash flows. We believe the discounting rate is quite conservative as MEL has already achieved significant financial closure. We would cut our discounting rate as the project implementation risk declines progressively over a period of time. The exhibit below provides NPV value of MEL.

Exhibit 17: MIEL - net present value of Rs50 per share of MEL

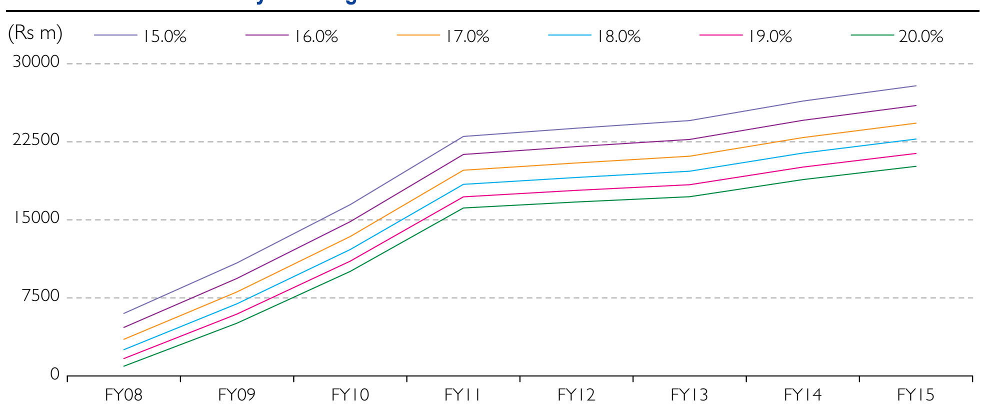
Cash flows (Rs m)	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
EBIT				4,859	6,720	7,304	7,190	7,071
EBIT after tax				4,495	6,216	6,756	6,650	6,540
EBIT after tax + Depn				4,895	8,540	9,114	9,050	8,981
Less: Regular capex				-	(500)	(750)	(750)	(750)
Less; WC				-	(2,500)	(1,000)	(500)	(500)
Funds inflow	(13,860)	(13,860)	(14,280)		-	-		
Free cash flow	(13,860)	(13,860)	(14,280)	4,895	5,540	7,364	7,800	7,731
Less: Interest				2,241	2,700	2,565	2,295	2,025
Less: Debt repayment	(9,900)	(9,900)	(10,200)	-	-	3,000	3,000	3,000
Net equity cash flow	(3,960)	(3,960)	(4,080)	2,654	2,840	1,799	2,505	2,706
Discounting rate (%)		18						
NPV	2526	6,940	12,150	18,417	19,078	19,673	21,415	22,764
Value for MEL (Rs/ share)	50	139	243	368	381	393	427	454

Source: SSKI Research

As project implementation risk narrows, we see significant value creation in MEL

The following exhibit depicts a scenario analysis for MIEL's proposed IPP using net equity cash flows at various discounting rates. We see significant value creation possibility as the power plant nears completion and the project implementation risk narrows. On completion, we have valued the project in line with a similar asset of JSPL, discounting at 13%.

Exhibit 18: Scenario analysis using different discount rates



Source: SSKI Research

Our target price assumes a 6x and 10x multiple on steel and power profits respectively NPV of MEL added to it

❑ MIEL – sum-of-parts value at Rs 435/share

We value MIEL on sum-of-parts basis to arrive at a fair price target for the stock. We have assigned 6x and 10x multiple on steel and power profits respectively – in line with 1-year forward industry valuations. This effectively translates into a PE target of 8.0x FY08E earnings for MIEL. To this, we add current NPV of MEL (Rs2.5bn) to arrive at a justified market capitalization for the stock. Our sum-of-parts valuation gives us a fair value of Rs435/share – a significant upside of 40% from the current market price.

Exhibit 19: MIEL – sum-of-parts valuation

Particulars	Net profit - FY09E (Rs m)	Justified multiple (x)	Justified market cap (Rs m)
Profit from steel business	2,311	6	13,808
Profit from power business	547	10	5,470
Discounted value of Monnet Energy @ 18%			2,526
Justified market capitalization			21,804
Current market capitalization*			15,531
Potential upside (%)			40

*Source: SSKI Research; *Note: Based on fully diluted basis*

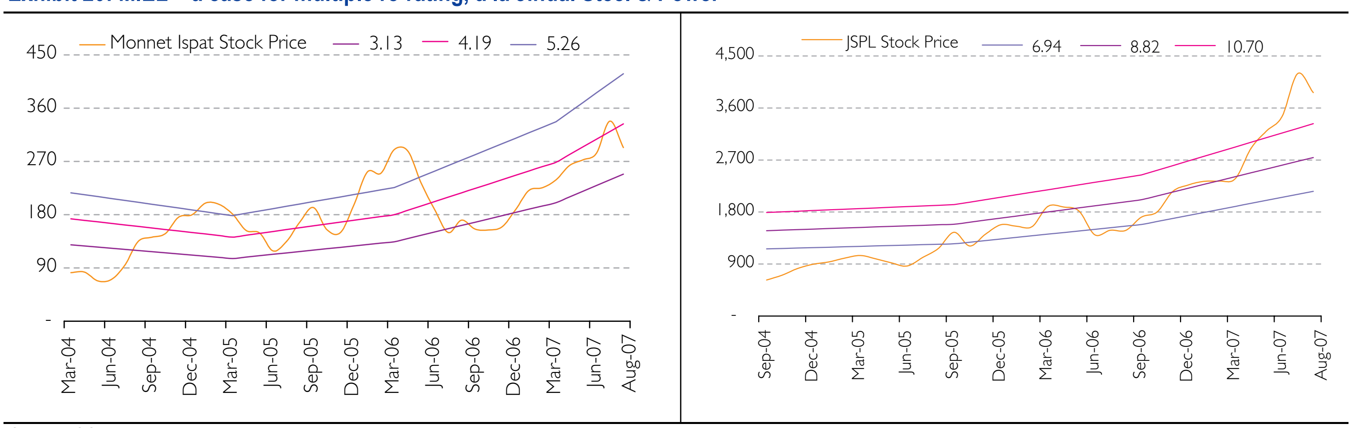
While the power division is likely to account for an estimated 40% of the total EBIT by FY11, valuation multiple of 8.0x FY08E earnings ignores the high RoE generating power business. With strong volume growth and vertical integration in steel business, and profitability rapidly shifting towards the stable power business, we believe there is a strong case for re-rating of the stock.

As project moves towards completion, we would progressively reduce discounting rate, in line with that of JSPL

❑ Correlation exists between Jindal Steel & Power and MIEL

We believe MIEL, currently trading at 8.0x FY08E earnings, would see multiple re-rating going forward as it achieves financial closure of its power plant. MIEL could follow a re-rating trend as displayed by Jindal Steel & Power (currently trading at 12.7x FY08E earnings), which shares a similar business structure. As can be seen from the exhibit below, JSPL's stock price has got steadily re-rated with emerging visibility on cash flows, improving sales mix in the steel business, scalability and, last but not the least, successful execution of its large power project.

Exhibit 20: MIEL – a case for multiple re-rating, a la Jindal Steel & Power



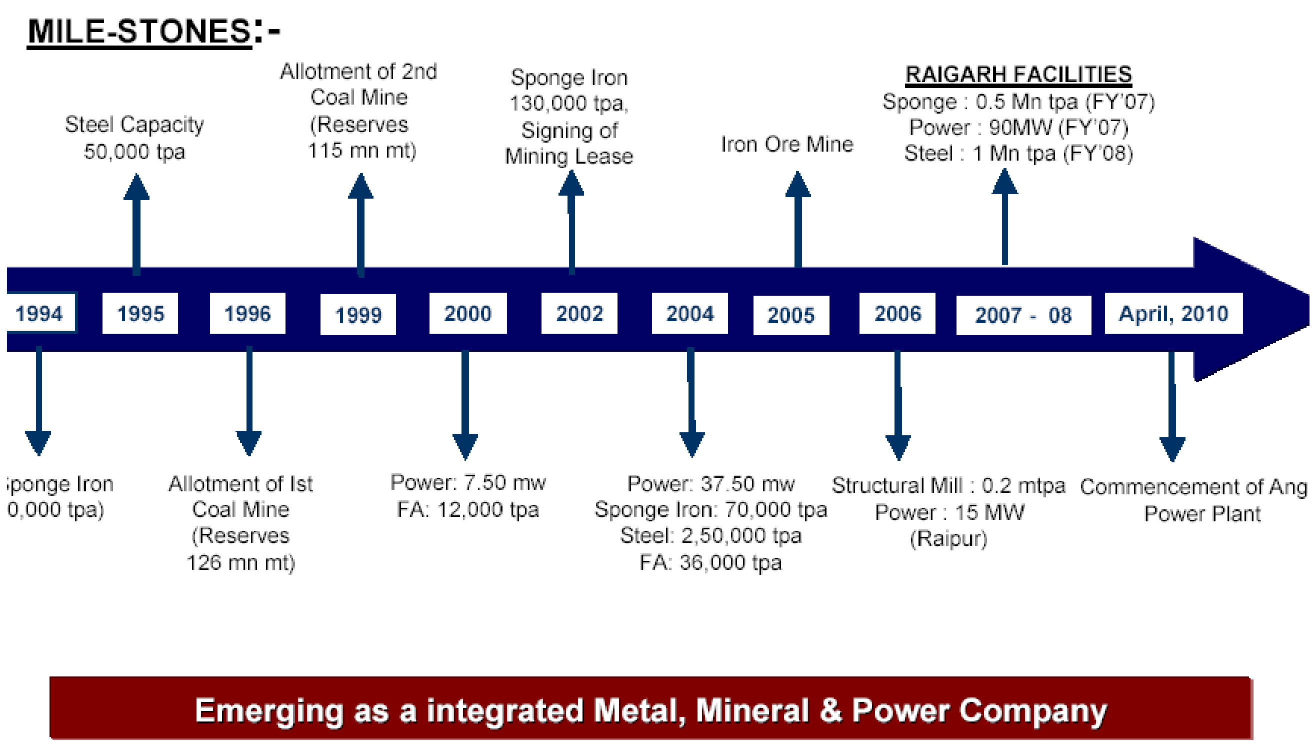
Source: SSKI Research

ANNEXURE

❑ Monnet Ispat & Energy – Group profile

MIEL, promoted by the Jajodia family, was formed through the merger of Monnet Ispat (MIL) with Monnet Power, another Jajodia family owned company, in 2004. MIEL is one of the India's largest and lowest cost coal-based sponge iron producers. MIEL also currently manufactures mild steel and ferro alloys with partial backward integration into captive resources of raw materials, viz coal, iron ore and power.

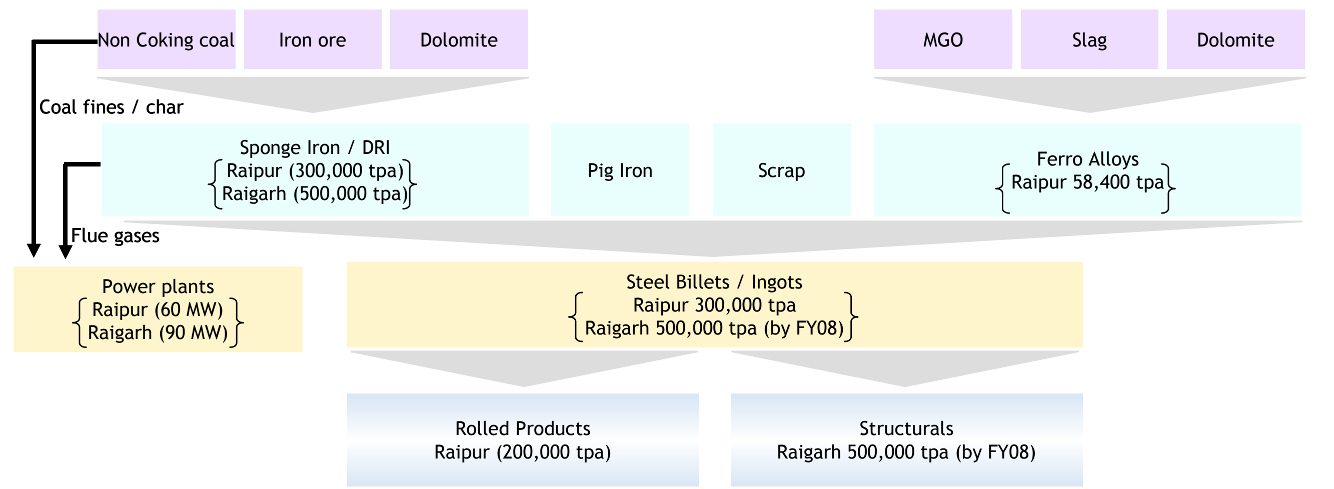
Exhibit 21: Progression timeline for MIEL



Source: Company

MIEL's production facilities are located in the mineral rich belt of Central India – Raipur and Raigarh (Chhattisgarh). This ensures easy access and steady supply of raw materials to the company as well as proximity to vendors. Both these plants are located at a distance of 400kms from each other. For the Raipur plant non-coking coal is sourced from Milupara mines (Chhattisgarh) & iron ore is being sourced from mines in Orissa. Sponge iron is manufactured at both Raipur and Raigarh facilities through the coal-based process. MIEL has downstream facilities for rolled steel at Raipur and structural steel at Raigarh. Rolled steel is produced using steel billet or ingot as a feedstock, re-heating it in a blast furnace and shaping it into the desired form for industrial application. MIEL now also has 150MW captive power capacity and these capacities run on the residue from reduction/ mining process with coal requirements sourced from nearby mines.

Exhibit 22: Work flow diagram



Source: SSKI Research

Income statement

Year to Mar 31 (Rs m)	FY05	FY06	FY07	FY08E	FY09E
Net sales	**5,198**	**5,324**	**10,996**	**13,891**	**20,681**
% growth	*110.4*	*2.4*	*106.5*	*26.3*	*48.9*
Operating expenses	3,397	3,922	8,388	9,739	14,658
EBITDA	**1,801**	**1,401**	**2,608**	**4,152**	**6,023**
% growth	*158.7*	*(22.2)*	*86.1*	*59.2*	*45.0*
Other income	49	97	65	3	3
Net interest	(294)	(3)	(489)	(681)	(1,348)
Depreciation	216	249	406	564	722
Pre-tax profit	**1,340**	**1,246**	**1,778**	**2,910**	**3,956**
Deferred Tax	104	165	267	524	316
Current Tax	3	3	89	437	791
Profit after tax	1,233	1,078	1,423	1,950	2,848
Preference dividend	-	-	-	-	-
Minorities	-	-	-	-	-
Non-recurring items	-	-	-	-	-
Net profit after non-recurring items	**1,233**	**1,078**	**1,423**	**1,950**	**2,848**
% growth	*337.8*	*(12.6)*	*32.0*	*37.0*	*46.1*

Balance sheet

Year to Mar 31 (Rs m)	FY05	FY06	FY07P	FY08E	FY09E
Paid-up capital	315	325	343	343	343
Preference share capital	-	-	-	-	-
Reserves & surplus	2,786	3,776	5,026	6,779	9,429
Total shareholders' equity	3,101	4,101	5,369	7,122	9,772
Total current liabilities	807	846	2,028	2,386	3,497
Total Debt	4,961	8,657	7,774	12,793	19,164
Deferred tax liabilities	442	502	769	1,292	1,609
Other non-current liabilities	-	-	-	-	-
Total liabilities	6,210	10,005	10,571	16,471	24,270
Total equity & liabilities	**9,311**	**14,105**	**15,940**	**23,592**	**34,042**
Net fixed assets	4,487	6,822	8,091	10,402	12,555
Investments	90	185	-	3,500	7,000
Total current assets	4,734	7,100	7,849	9,690	14,487
Deferred tax assets	-	-	-	-	-
Other non-current assets	-	-	-	-	-
Working capital	3,927	6,255	5,821	7,304	10,990
Total assets	**9,311**	**14,107**	**15,940**	**23,592**	**34,042**

P=projected

Cash flow statement

Year to March 31 (Rs m)	FY05	FY06	FY07	FY08E	FY09E
Pre-tax profit	1,340	1,246	1,778	2,910	3,956
Depreciation	216	249	406	564	722
chg in Working capital	(638)	(462)	(931)	(640)	(1,649)
Total tax paid	(3)	(3)	(89)	(437)	(791)
Ext ord. Items	0	0	0	0	0
Operating cash Inflow	914	1,030	1,165	2,397	2,238
Capital expenditure	(918)	(2,584)	(1,675)	(2,875)	(2,875)
Free cash flow (a+b)	(3)	(1,553)	(510)	(478)	(637)
Chg in investments	(83)	(95	185	(3,500)	(3,500)
Debt raised/(repaid)	2,319	3,696	(883)	5,018	6,372
Capital raised/(repaid)	481	120	18	0	0
Dividend (incl. tax)	(36)	(231	(52)	(172)	(198)
Misc	(80)	(130)	0	0	0
Net chg in cash	2,597	1,808	(1,242)	869	2,037

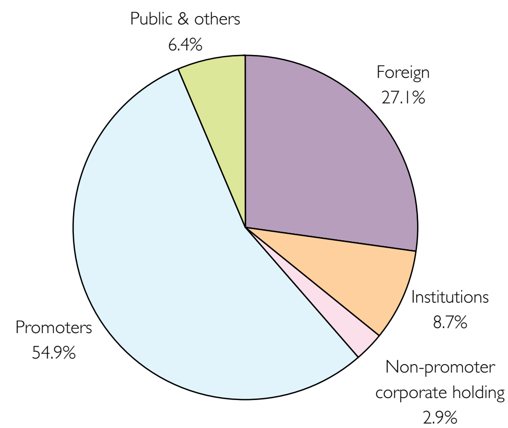
Key ratios

Year to March 31	FY05	FY06	FY07	FY08E	FY09E
EBITDA margin (%)	34.6	26.3	23.7	29.9	29.1
EBIT margin (%)	30.5	21.7	20.0	25.8	25.6
PAT margin (%)	23.7	20.3	12.9	14.0	13.8
RoE (%)	39.8	29.9	30.0	31.2	33.7
RoCE (%)	18.6	10.6	16.2	20.4	20.5
Gearing (x)	0.7	1.0	0.8	1.2	1.3

Valuations

Year to March 31	FY05	FY06	FY07	FY08E	FY09E
Fully diluted EPS (Rs)	53.0	24.7	32.6	38.9	56.9
PER (x)	5.8	12.5	9.5	8.0	5.5
Price/Book (x)	3.0	3.3	2.5	2.2	1.6
EV/Net sales (x)	2.2	3.3	1.6	1.5	1.0
EV/EBITDA (x)	6.3	12.5	6.9	5.0	3.6
EV/CE (x)	1.3	1.3	1.3	1.0	0.7

Shareholding pattern



As of June 2007

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