

INITIATING COVERAGE

Sterlite Industries Ltd

Buy

Share Data

Market Cap	Rs. 411.14 bn
Price	Rs. 580.3
BSE Sensex	14501.08
Reuters	STRL.BO
Bloomberg	STLT IN
Avg. Volume (52 Week)	0.6 mn
52-Week High/Low	Rs. 612.4/331
Shares Outstanding	708.49 mn

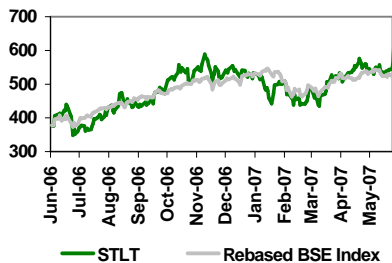
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	59.3	60.3
+/- (%)	-13.9%	1.7%
PER (x)	9.8x	9.6x
EV/ Sales (x)	1.4x	1.4x
EV/ EBITDA (x)	3.8x	3.7x

Shareholding Pattern (%)

Promoters	79
FII's	7
Institutions	4
Public & Others	9

Relative Performance



Consolidating market positions

Sterlite Industries (India) Ltd (Sterlite) is India's largest non-ferrous metals and mining company. Sterlite is currently riding a high in base metals prices; zinc has tripled in price since the start of 2005 and has remained at this level for the past year while copper is at approximately double its 2005 level. The company now looks to consolidate by acquiring the remaining government stake in its high margin subsidiary, Hindustan Zinc Ltd (HZL). This will be funded by the recently completed ADS issue of over \$2.0 bn (Rs. 82.2 bn) which also funds Sterlite's foray into the commercial energy business. The current market valuation seems low given Sterlite's advantages.

Key Figures

Year to March	FY05	FY06	FY07	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data) (FY07-09E)						
Net Sales	72,525	131,272	243,868	260,543	267,951	4.8%
EBITDA	15,377	36,878	94,589	98,360	99,816	2.7%
Net Profit	4,402	12,990	38,150	39,810	40,480	3.0%
Margins(%)						
EBITDA	21.2%	28.1%	38.8%	37.8%	37.3%	
NPM	5.8%	9.6%	15.2%	14.9%	14.7%	
Per Share Data (Rs.)						
Normalised EPS	9.7	23.5	68.9	59.3	60.3	-6.5%
PER (x)	60.1x	24.7x	8.4x	9.8x	9.6x	

- We expect growth for Sterlite to slow down from the high level of FY07 as metal prices begin to stabilise and ease down; margins are expected to be impacted somewhat by declining Tc/Rc rates.
- At the current price of Rs. 580.3, the stock is trading at a forward PE of 9.8x FY08E and 9.6x FY08E. This is at the low end of the company's historical PE band and represents a good buy opportunity.
- Our 12 month price target price of Rs. 670 is based on applying a target EV/EBITDA ratio of 4.4x to our FY08E EBITDA estimate of Rs. 98.4 bn. The target price takes into account the effect of the recent ADS issue. We have not factored in acquisition of a further stake in HZL as the timing is uncertain. This will further add value to the stock. We initiate coverage with a **Buy**.

Investment Rationale

Exposure to three base metals

Diverse exposure to base metals

Sterlite is active in copper, zinc and aluminium, providing investors with simultaneous exposure to several metals, thereby reducing cyclical risk, as the cyclical timings of the metals are not fully synchronous.

In the medium term we expect copper and zinc prices to ease off, while aluminium prices should hold firm during FY08.

Government stakes in HZL and BALCO

Increasing stake in Zinc and Aluminium

Sterlite currently owns a 51% stake in Bharat Aluminium Company Ltd India (BALCO), and is pursuing the Government of India (GOI)'s remaining stake of 49%. Sterlite also owns a 65.9% of Hindustan Zinc Ltd (HZL) and has a call option to purchase the GOI's 29.5% stake in HZL. Such moves would increase Sterlite's stake in its consolidated zinc and aluminium operations, which are currently the highest margin business segments, and de-skew the company's metals exposure away from copper, which currently contributes 45% of consolidated revenues. As these companies operate their own mines, an increased Sterlite stake would significantly strengthen Sterlite's position in the current low Tc/Rc environment.

Some protection from Tc/Rc decline

An integrated player

Sterlite's wholly owned subsidiary, Copper Mines of Tasmania, supplies around 9% of the total concentrate requirements of Sterlite's Indian copper smelting operations, thereby offering some protection against the current harsh Tc/Rc environment for smelters. Sterlite's operating subsidiaries too have protection from movements in input prices; HZL is the only integrated Zinc producer in India and owns captive zinc mines that supply all of HZL's zinc concentrate requirements for its smelters. This enables it to fully profit from current high zinc prices as its input prices remain fixed rather than correlating with the price of zinc. BALCO operates its own Bauxite mines and alumina refinery which partially supply its aluminium smelting operations.

Copper segment to drive top line growth in FY08...

Increased volumes in copper driving top line growth during FY08

Following the debottlenecking of the Tutiricon smelter, copper cathode production for FY08 should be at 400,000 TPA, a 28% increase over FY07 volumes. Copper prices, at \$7,312 per tonne, are currently higher than the average for FY07, but the market is in backwardation, with the 15 month LME future at \$6,645 per tonne. We see a similar average price prevailing during FY08 as over FY07.

...but margins to decline because of short supply of copper concentrate

Tc/Rc rates, which act as profit margin for smelting operations, have been falling substantially over the last few months as a result of 500,000 tonnes of deficit of copper concentrate in CY07. We see the Tc/Rc rate remaining at current depressed levels in the medium term as the copper concentrate market remains in deficit.

HZL – Stable growth, high margins

World zinc prices have shot up since 2005, and the current high prices make this a high margin business as HZL supplies all its zinc concentrate requirements from its own mines. The FY07 price-led growth in revenues of over 100% will not be repeated, as Zinc prices are expected to fall over the next year; the current LME spot price is \$3,440 per tonne, while the 15 month future is at \$3,123 per tonne. However, the recent ramp-up of the new 170,000 TPA Chanderiya zinc hydro smelter to full capacity will provide volume led growth in FY08.

Capacity expansion plans ahead of schedule

A second 170,000 TPA zinc hydro smelter is currently being built in Chanderiya along with a 77 MW captive power plant. Progress on this project has been good and it is expected to be commissioned in 4Q07, 3 months ahead of the earlier declared schedule. The total cost of the project, including a +1m TPA mine expansion, comes to \$300 mn.

Continued volume growth in zinc business

Volume growth in FY09

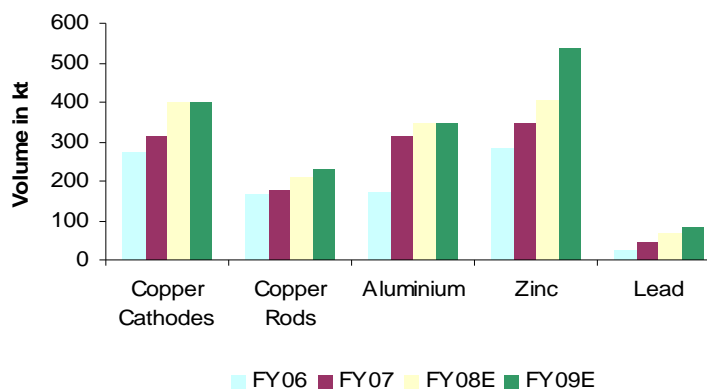
HZL is also carrying out a debottlenecking project to increase capacity by 88,000 TPA and building a new captive power plant of 80 MW at Zavar at a total cost of \$170. These initiatives are scheduled for completion in early 2008, providing scope for volume led growth in FY09.

Lead smelting ramps up

Although lead prices are set to decline over the coming year, HZL's lead operations will show some growth, as the 50,000 TPA Ausmelt smelting plant is expected to reach its rated capacity by the end of 2Q07. The lead operation, however, only contributes about 10% of HZL's revenues.

Aluminium smelting at full capacity

BALCO completed the full ramp of its new smelter at Korba during FY07. It is now functioning at its rated capacity of 245,000 TPA. This will deliver some volume growth in FY08 over FY07. Aluminium prices should remain firm over the medium term as the market is currently contango.

Production Overview**Rs. 82.2 bn raised through the ADS issue****ADS issue raises new capital**

On June 19 Sterlite raised over \$2.0 bn (Rs. 82.2 bn) through an initial public offering of 150 mn of its equity shares in the form of ADS at a price of \$13.44 (Rs. 548) per ADS. Sterlite now has 708 mn equity shares outstanding. The Green Shoe option of 19,560,000 shares in the form of ADS was fully exercised.

Moving into the commercial energy business

New capital funds investment in energy generation,...

Sterlite plans to invest the amount raised from this ADS issue to build a 2,400 MW green field thermal coal power facility in Orissa at an estimated cost of \$1.9 bn (Rs. 78 bn). The power generated will be sold to the State Electricity Board and power trading companies in India. Progressive commissioning is expected from December 2009. India needs to add about 70,000 MW of capacity by 2012 to meet predicted power demand and keep up with the country's economic growth, so power will be sharply in demand. As Sterlite only plans to generate, it is not directly subject to the transmission and distribution difficulties that trouble the sector generally, and this project should provide strong returns.

Exercising the call on HZL

...the consolidation of the HZL stake, and debt reduction

The company may use the proceeds of this offering to exercise the call option on the remaining 29.5 per cent ownership interest of the government in Hindustan Zinc. As mentioned earlier, this would give Sterlite increased protection from worrying recent Tc/Rc trends, and increase its exposure to its highest margin segment. The ADS proceeds may also be used for reduction of debt of up to Rs. 689.3 crore (\$169 mn).

ADS issue dilutes FY08E EPS

ADS issue is dilutive to our pre-issue target price

As our valuation for Sterlite pre-offering is higher than the Rs. 548 per share raised by the issue, we find the issue to dilute the per share value. Our pre-offering target price of Rs. 702 is lowered to Rs. 670, and our FY08E EPS is diluted by 17%.

Key Risks

Volatility in metals prices

An unexpected rise or fall in the prices of copper, zinc or aluminium would have a corresponding effect on Sterlite's top line.

*Bids from Sterlite for other metals players rumoured**Potential acquisition*

Recently takeover speculation has been rife in the Indian non-ferrous metals space. There have been rumours that Sterlite, through its parent Vedanta Resources Ltd, may partner Rio Tinto Group to bid for Alcan. There has also been the rumour that Sterlite may team up with Alcan to bid for Hindalco. Should any such bids materialise they would have significant impact on the value of Sterlite and in such a case our rating may not hold.

Thus far Sterlite itself has not been rumoured to be a takeover target.

Delay in use of funds from ADS

The GOI may delay Sterlite from exercising its call option on the HZL stake for political reasons. This would destroy value as the cash for exercise would be sitting as a liquid investment earning low yields.

Outlook

Sterlite gives exposure to a range of non-ferrous metals and is a low cost operator. This allows Sterlite to ride a downturn in the cycle in any one commodity, giving strong earnings growth during a reversal of the cycle.

In the medium term we expect Copper and Zinc prices to ease off, though volume expansions continue to drive top line growth. Aluminium prices should hold firm during FY08, and modest volume expansions in this segment also contribute to the top line trend.

HZL consolidation would boost margins

Margins come under pressure as Tc/Rc rates decline globally due to lack of copper concentrate. However, Sterlite has a measure of protection against this through its subsidiaries, and the likely acquisition of the remaining stake in HZL would increase Sterlite's exposure to a high margin business protected from Tc/Rc rate movements.

The long term prospects for the copper operations of Sterlite are positive. With India's economy growing at more than 9 per cent annually, usage of copper in telecommunication lines, power cables, house wiring and industrial equipment

is expected to surge. India's annual copper consumption is around 500,000 tonnes, of which 25,000 to 30,000 tonnes are imported.

India is predicted to become a net importer of copper in the next five years with domestic demand likely to double and exports to decline.

Our valuation derives from applying a target EV/EBITDA ratio of 4.4x to our FY08 forecast consolidated EBITDA of Rs. 98.4 bn.

We have factored in the recent ADS issue to our per share valuation while arriving at the final target price of Rs. 670. This represents an upside of 15.4% over the current price.

We have not modelled in the exercise of the call option on the GOI's 29% stake in HZL as the timing on this is uncertain. Exercise of this option will give room to further upside, as HZL's zinc operations are Sterlite's highest margin business.

Target price represents an upside of 15.4% over the current price

Company Background

Sterlite Industries (India) Ltd (Sterlite) is one of India's leading diversified metals and mining companies with interests and operations in aluminium, copper and zinc and lead. It is the principal subsidiary of the Anil Agarwal controlled, London-based Vedanta Resources Group.

The company's main operating subsidiaries are **Hindustan Zinc Ltd** for its zinc and lead operations; **Copper Mines of Tasmania Pty Ltd** for its copper operations in Australia; and **Bharat Aluminium Company Ltd** for its aluminium operations.

India's leading non-ferrous metals and mining company

Copper Business: Sterlite is involved in the smelting of copper concentrate into copper anode, the refinery of copper anode into cathode, and the drawing of copper cathode into copper rods. The company also produces sulphuric and phosphoric acid. Installed capacities are as follows: 400,000 TPA of copper anode, 400,000 TPA of copper cathode, 240,000 TPA of copper rod, 1,300,000 TPA of sulphuric acid, and 180,000 TPA of phosphoric acid.

Sterlite also owns and operates the Mount Lyell mining facility in Tasmania, through its wholly owned subsidiary Copper Mines of Tasmania Pty Ltd.

Reserves are approximately 14.2 mn tonnes of ore, with an average grade of 1.3% copper.

Zinc and Lead Business: Sterlite owns and operates zinc and lead mining and smelting facilities, through its operating subsidiary, Hindustan Zinc Ltd. Installed capacities are as follows: 411,000 TPA of zinc ingots, 85,000 TPA of lead ingots, 687,196 TPA of sulphuric acid, 74 TPA of silver ingots, and lead-zinc reserves of 68.6mn tonnes with an average grade of 11.2% zinc and 2% lead.

Aluminium Business: Sterlite operates in the aluminium segment through its operating subsidiary Bharat Aluminium Company Limited, a partially integrated aluminium company with captive bauxite mines, refineries and smelters. Installed capacities are: 345,000 TPA of aluminium, 200,000 TPA alumina, and bauxite reserves of 11.6 mn tonnes with an average grade of 46.9% oxide.

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