

Equities

3 January 2012 | 7 pages

Coal India (COAL.BO)

Alert: UHV to GCV Pricing – A Positive Surprise

- **GCV mechanism results in higher prices** — Coal India (CIL) has changed the pricing mechanism of non-coking coal from Useful Heat Value (UHV) based grading system to Gross Caloric Value (GCV) based wef 1Jan12. Our calculations suggest CIL's realizations could rise by 13-15% with an upside bias (provided grade slippage is in control). Citi estimates incorporate a 2% increase in FY13 notified prices. According to our sensitivity analysis, a 1% increase in realizations results in 2.3% higher PAT (FY13, including higher e-auction prices). While the hike, if implemented, is positive for CIL; we expect some pushback from end consumers. Part of the increase is likely to be offset by higher wages (Citi estimates 50% higher wages through FY12 and FY13).
- **Most grades benefit** — Under the new GCV grading, coal would be classified under 17 slabs (300kcal each) from 2,200-7,000kcal and above 7,000kcal. This compares to the earlier UHV classification into 7 grades (based on ash and moisture). Based on the pricing data, we believe that the weighted increase in realisation (for FSA/A and B' grades) could be 13-15% (1) Prices of 'C' and 'D' grades are likely to benefit the most with a 50-55% hike (18% of volumes); (2) Floor pricing for E-auction coal (10-12% of volumes) has been changed to 20% above notified price (from 30%); (3) The premium of non-power coal to power coal has been changed from 30% earlier to 17-60% across bands (4) The revised structure does not impact coking coal (8-10% of volumes).
- **Eastern Coalfields (ECL) levy 6% more** — While the new system ensures uniform pricing for the same coal grade across collieries/subsidiaries, CIL will levy an additional 6% above the revised prices on coal from ECL as it is a sick subsidiary listed with the Board for Industrial & Financial Restructuring. ECL accounts for ~7% of CIL's volumes, mostly 'D' and 'F' grades.
- **CIL lowers FY12 production target** — On a separate note, CIL has lowered its FY12 production target from 452mt to 440mt due to the monsoon impact in Aug and Sep11 (assuming 100% capacity utilization for 4Q). CIL's FY13 production target is 464mt (+5.5% yoy). Citi estimate: FY12 – production 417mt (-3% yoy), despatches 430mt (+1%); FY13 – production 447mt (+7%), despatches 451mt (5%).
- **Buy** — Coal India's (CIL) stock has underperformed the Sensex by 3% in the last three months due to headwinds: wage provisioning; concerns on pricing flexibility; draft mining bill; uncertainty on the use of cash (\$11bn). The stock trades at 11x FY13E PE (excluding OBR adjustment) without considering the impact of the just announced pricing structure (global peers trade at 6-11x). With most concerns largely priced in and the expected impact of the new pricing mechanism, we believe the stock is attractive at current levels.

Company Update

| | |
|------------------------------|--------------|
| Buy | 1 |
| Price (02 Jan 12) | Rs311.70 |
| Target price | Rs380.00 |
| Expected share price return | 21.9% |
| Expected dividend yield | 1.8% |
| Expected total return | 23.7% |
| Market Cap | Rs1,968,811M |
| | US\$36,935M |

Price Performance (RIC: COAL.BO, BB: COAL IN)



Raashi Chopra, CFA

+91-22-6631-9862
 raashi.chopra@citi.com

Pradeep Mahtani

+91-22-6631-9882
 pradeep.mahtani@citi.com

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Coal India

Valuation

Our TP incorporates a 25% wage hike per employee in FY12, 20% hike in FY13 and 2% raw coal price hike in FY13. We believe the proposed 26% profit-sharing burden is likely to be lower but unlikely to be zero. Hence our TP is derived using a combination of two scenarios: #1 assumes no profit sharing - derived price Rs393; #2 assumes 26% profit sharing in FY14 and beyond (based on our interactions with the Secretary, Ministry of Mines) - derived price Rs367; with a 50:50 weighting. CIL does not have a long valuation history since it listed in Nov 2010. We arrive at our TP of Rs380 using: (1) a valuation based on DCF+30% premium (Rs491) and (2) 9x FY13 PE based valuation (Rs213); with a 60/40 weighting. The 9x multiple lies within the current trading range (7-10x) of the Indonesian and Chinese coal producers.

Risks

Key downside risks to our investment thesis on CIL are: risks of restrictions imposed by regulators related to forest clearance and environmental safeguards; difficulties in obtaining reserves/resources; a proposed 26% profit-sharing requirement contained in the New Mining Bill; land acquisition; ban on e-auction coal; logistical constraints including rail transport bottlenecks; restricted ability to raise coal prices; higher wages than anticipated; unrelated investments; disruption of operations in politically unstable areas; auction for future reserves; and non-availability of critical equipment. If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Appendix A-1

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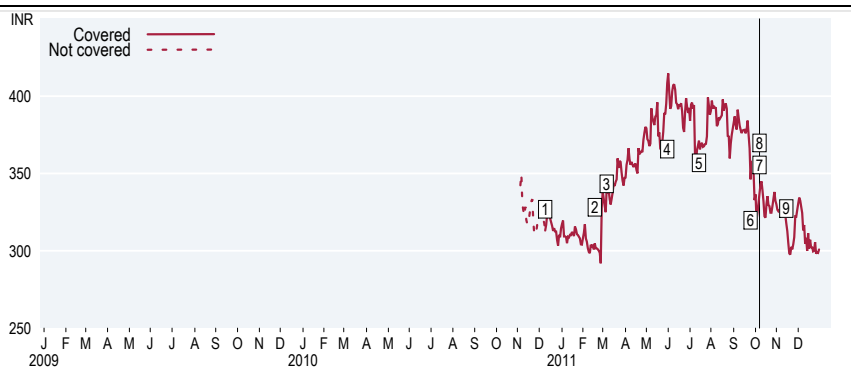
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Coal India (COAL.BO)

Ratings and Target Price History Fundamental Research

Analyst: Raashi Chopra, CFA
Covered since December 9 2010



| Date | Rating | Target Price | Closing Price |
|-------------|--------|--------------|---------------|
| 1 9-Dec-10 | *1L | *358.00 | 313.10 |
| 2 17-Feb-11 | 1L | *350.00 | 304.80 |
| 3 7-Mar-11 | 1L | *395.00 | 340.95 |

| Date | Rating | Target Price | Closing Price |
|-------------|--------|--------------|---------------|
| 4 31-May-11 | 1L | *471.00 | 408.45 |
| 5 14-Jul-11 | 1L | *430.00 | 371.20 |
| 6 26-Sep-11 | 1L | *418.00 | 346.20 |

| Date | Rating | Target Price | Closing Price |
|-------------|-----------------------------|--------------|---------------|
| 7 7-Oct-11 | Stock rating system changed | | |
| 8 7-Oct-11 | *1 | 418.00 | 337.25 |
| 9 15-Nov-11 | 1 | *380.00 | 317.60 |

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Coal India (COAL.BO)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Raashi Chopra, CFA

Covered since December 9 2010



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|---|-----------------|------|------|-----------------|------|------|
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