ULJK GROUP

Initiating Coverage

Mercator Lines Ltd

June 18, 2008

CMP:Rs.109 | Target Price:Rs.152 | Recommendation: Accumlate

BSE Code	526235
NSE Symbol	MLL
Bloomberg code	MRLN@IN
Reuters code	MRCT.BO
ISIN	INE934B01028

Key Data

Sensex	15474
52 week H/L	184 / 31
Outstanding Shares (mln)	234.9
Avg. Wkly Volumes (shrs)	1695177
Market Cap (Rs mln)	25615.3
Face value Rs	1

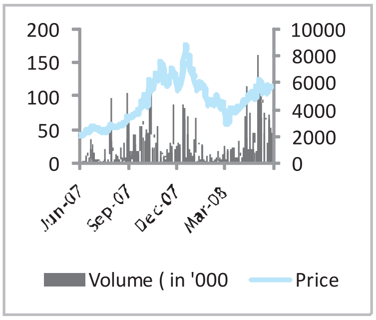
Source: Capitaline

Share Holding Pattern (%)

Promoters	38.11
Institutions	13.69
FIIs/NRI's	19.38
Public & Others	28.82
Total	100.00

Source: Company

Price Volume Analysis



Source: Capitaline

Company Report

Mercator Lines Limited, (MLL) is India's second largest private-sector shipping company. It operates a fleet of 12 dry carriers, 13 tankers and 4 dredgers. It services large thermal-based power plants, steel companies, refineries and has established strong relationships with its customers, including names such as Arcelor Mittal group, Tata Power, IOC and MRPL.

Investment Rationale

In the shipping segment, increased demand for shipping vessels will keep the rates buoyant in the dry bulk segment. MLL renewed its 4-year contract with Tata Power, a contract worth US$320 million. This revision validates our view of firm dry bulk rates in the near future, which will have a positive impact on the profitability of the company. The fundamentals of the shipping business are strong, with China driving the demand for iron ore and India for coal imports.

MLL is also looking for more assets in dredging, offshore and shipping business.The new streams will give better visibility of their earnings, as they are not subject to volatility like the shipping freight rates. This will translate into a strong operational and financial performance of the company in FY'09 and FY'10. Sales is expected grow at a CAGR of 38% and profit is expected to grow at 40% CAGR in FY'08-FY'10. The company has a strong cash flow position and the profitability ratios are also expected to show improvement with a return on equity envisioned at over 35% in FY'10. The company's debt: equity ratio is at a four-year low and the company has scope to further leverage.

Valuation

The stock is trading at a PE of 7.6x its FY'09 earnings of Rs 15.2 and PE of 4.9x its FY'10 earnings of Rs 23.4. We initiate coverage on MLL with a price target of Rs 152. At this price, the stock will discount FY'09 and FY'10 earnings of Rs 15.2 and Rs 23.3 by 10x and 6.5 times respectively. Increased revenue streams in FY'10 make the stock more attractive at a PE of 4.9x its FY'10 EPS of Rs 23.3. On replacement price per share works out to Rs 166. The stock is trading at a discount of over 50% of its NAV. We believe that going forward, the discount will narrow down to a fair discount of about 10% after which the stock should trade at Rs 149. We recommend an accumulate rating on the stock.

Financial Summary

Year	Sales (Rs mn)	% growth	PAT(Rs mn)	%growth	PER	P/BV
2007	11228	36	1345	-32	15	3.6
2008	14549	30	4003	137	8	1.6
2009E	20881	44	4814	28	7	1.9
2010E	27568	32	7909	54	5	1.4

Source: Company,ULJK Research

ULJK Research

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Email:research@uljk.in

Background:

Mercator Lines Ltd was incorporated on 24th November, 1983, as a private limited company. It was converted into a public limited company on 3rd April, 1984. Mr. H. K. Mittal, the promoter of the company, took it over in the year 1988. Under his vision and leadership, today, the company has acquired the position of becoming the second-largest private sector shipping company in India. Its tonnage has risen from 4000 DWT in 1994 to about 2646365 DWT in 2008. Today, MLL operates a fleet of 12 dry carriers, 13 tankers and 4 dredgers. It services large thermal-based power plants, steel companies, refineries and has established strong relationships with its customers, including names such as the Arcelor Mittal group, Tata Power, IOC and MRPL.

INVESTMENT RATIONALE

Strong FY'08 Numbers

For the year FY'08, the company registered net sales of Rs 14548 million, up 30% compared with Rs 11227 million in FY'07. Its operating profit was up at Rs 7824.4 million from Rs 3953 million in FY'07. Its net profit stood at Rs_3276.5 million from Rs 1348.5 million in FY'07. During the same period, both operating as well as net profit margins have shown a significant rise. The other income of the company was significantly higher at Rs 1341 million, which is over 9% of its net sales as compared to Rs 272 million, nearly 2.5% of net sales last year. Depreciation was up 61% at Rs 1674 million from Rs 1038 million, on account of acquisition of new assets.

Operational Matrices for FY'08

Shipping business will be the main source of revenue for the company. In FY'08, MLL operated a fleet of 12 dry carriers and 13 tankers. MLL's own fleet grew from 13 to 20 during the year ended 31st March 2008. Its own fleet now comprises 9 tankers with a combined capacity of 1044273 DWT and11 dry bulkers with a combined capacity of 829057 DWT.

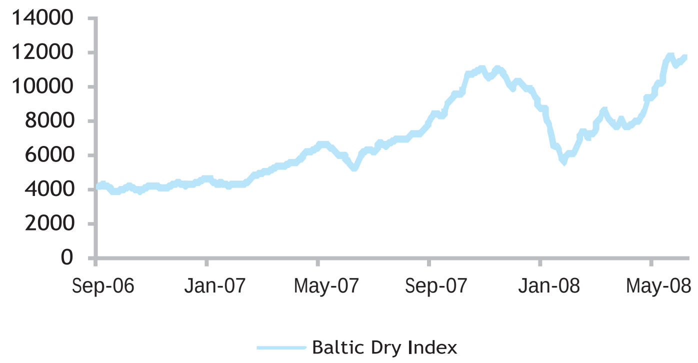
The Time Charter Equivalent (TCE) rate per vessel per day increased by 57% to USD38,322 and the total number of vessel-operating days increased by 19% to 3820 days for dry carriers, for FY'08. In the tankers segment, the TCE rate per vessel per day reduced by 8% to US$ 24,467 and the total number of vessel-operating days increased by 16% to 5589 days. The company's fleet utilization in dry bulk was 99% and its overall utilization was over 95% in FY'08. MLL has adopted a 70:30 strategy of long-term versus short-term charters, which gives the company an opportunity to take advantage of rates in the spot market and also gives visibility to its future earnings.

Betting Big on Dry Bulk Market

In the shipping business until FY'08, wet bulk has been the major contributor but the company will now focus on the dry bulk segment as it gives higher margins and the rates have proved to remain firm.MLL operates a young fleet of 11 dry bulk vessels comprising geared and gearless Panamaxes and Kamsarmaxes, with an aggregate capacity of 829057 DWT. It owns seven vessels averaging around two years of age and four other chartered-in vessels at an average of less than nine years of age. The average age of the global dry bulk fleet is approximately fifteen years.

The company has seen significant increase in rates in the dry bulk segment on account of a demand-supply mismatch. Commodities like coal and iron ore constitute a significant portion of the dry bulk segment. China and India are the major players in the dry bulk market. Going ahead, the addition of new steel capacity combined with the increased demand for iron ore are keeping the bulk market prices firm. The company is betting on the dry bulk segment as it has ordered two carriers in the segment. One was delivered in the month of May'08 and the other will be delivered in September'08.

Baltic Dry Index
The Baltic dry index, which is an indicator of the strength of the dry bulk segment, is strong. As seen in the graph shown below, the rates have almost doubled since June 2007. The index is trading near its all-time high and going ahead, the rates in the segment are expected to be buoyant.



Source: Bloomberg

Stable Wet Bulk Rates
Apart from the dry bulk and the wet bulk segments, the global crude oil demand growth forecast is now at 1m b/d, or 1.2%, in 2008 YOY, which will keep the tanker rates stable. The company is looking at adding a couple of tankers in FY'09. The rates of the tankers are expected to be stable during the year as demand and supply seem to be evenly balanced in the VLCC segment.

De Risking the Business Model
During the fourth quarter of FY'08, the company saw revenues coming in from the dredging business. Apart from dredging, the company has also forayed into coal mines and has acquired economic interests in two coal licenses in Indonesia and one license in Mozambique.

MLL is also becoming an integrated supply chain and logistics player. It will provide end-to-end services for the power plants at a time when all power players are looking at major expansions. The company has forayed into the offshore sector with the objective of getting exploration and production acreage and providing drilling services.

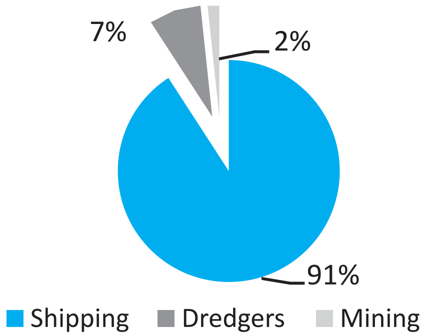
Dredging
Dredging and offshore businesses will give some stability to the revenues as going ahead, their contribution will be significant. The dredgers contributed US$ 5 million to its revenues in FY'08. The revenues are expected to be significantly higher this year, to the tune of Rs 1215 million, contracted at the rate of US$ 25000 per day. The company added one more dredger in May'08. Looking at the demand-supply scenario, the company wants to increase the total number of dredgers to nearly eight by FY'10. This will contribute over Rs 2268 million to the total revenues or to 10% of the total operating profit.

Mining Operations
The company has forayed into coal mines through its network of subsidiaries. It has acquired economic interests in two coal licences in Indonesia and one licence in Mozambique. The coal resources in Indonesia are about 15 million tonnes and about 3 billion tonnes in Mozambique. The company will start its mining operations in Indonesia and will start generating revenues from the month of July'08. The company intends to sell 1 million tonnes of coal annually. The Mozambique mines will take another two to five years to be operational due to lack of infrastructure.

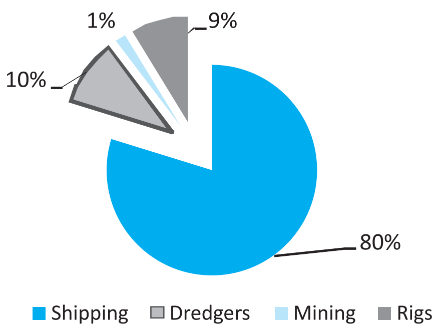
Offshore

Offshore industry is a logical offshoot of the shipping industry. MLL is building one jack-up rig at Keppel in Singapore and is looking at outright purchases to acquire more. The delivery of the jack-up rig is scheduled for March '09. It has fixed the employment of the rig for a tenure of 3 years at the rate of US$ 93000 per day. The business will start contributing over Rs 1357 million, i.e. nearly 9% of the total operating profit in FY'10.

Break up of FYO9 EBIDTA



Break up of FY10 EBIDTA



(Source: ULJK Research, Company)

Hungry for Assets

MLL intends to expand its fleet size further with suitable acquisitions of dry bulk carriers. It recently purchased two chartered-in vessels. The company is also looking at adding a couple of tankers in India. It will also add one dredger in the current year. The company has a capex of over USD 450 million for FY09. MLL has signed a deal to acquire a modern double-hull, very large crude carrier (VLCC). The said vessel is expected to join the company's fleet in June'08. This will bring the fleet of VLCCs controlled by the company to 3. In addition, during 2008-09, Mercator has signed an MOA to acquire 2 Panamax-sized dry cargo vessels, as also one THSD dredger. Going ahead a similar volume growth is expected in FY'10, in the vessel fleet. However, in the dredger segment, the company is expected to double its capacity in FY'10 to 8 dredgers.

Name	FY08	FY09E
Tanker		
VLCC	1	3
Suezmax	1	1
Aframax	5	5
MRTanker	2	2
Chartered by Subsidiaries		
VLCC	1	1
Aframax	1	1
ChemicalTanker	1	1
Dry Bulk		
Panamax	1	1
Panamax-(Owned by Subsidiaries)	4	6
Kamsarmaxes(Owned by Subsidiaries)	3	3
CharteredbySubsidiaries		
Panamax	4	4
	12	14
Total vessels	24	28
Dredgers	3	4

Source: ULJK Research, Company

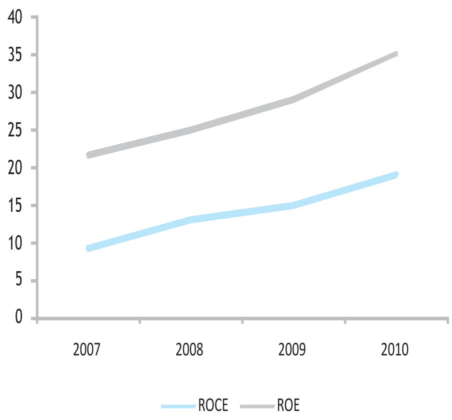
Debt/Equity Ratio at Four-Year Low; Higher Profitability and Strong Cash Flow Position

The company's debt:equity ratio is less than 1, which is the lowest in the past four years. In FY'08, the company retired debt worth Rs 2500 million and its net debt stood at Rs 12500 million. Its debt/equity ratio is at 0.78:1 and the company has the capacity to leverage further for buying more assets. Its debt:equity was 2.39:1 last year. This gives it an opportunity to increase its capital-gearing ratio and going ahead, acquire more assets. The company is looking at funding its assets with a debt/equity ratio of 80:20.

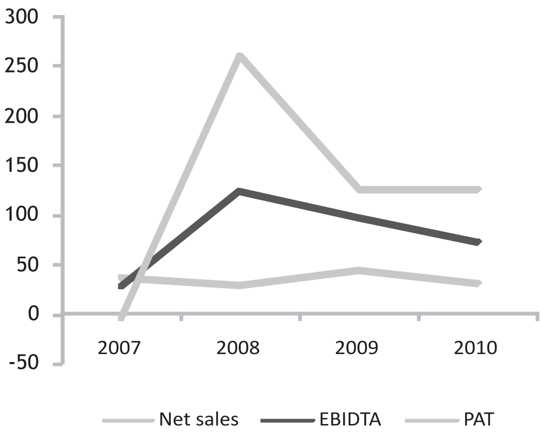
Year	2004-05	2005-06	2006-07	2007-08
Debt Equity Ratio	1.53	1.92	2.39	0.78

The sales growth of CAGR is expected to be 38% in the next two years and its profit will grow at 40% CAGR in FY'08-FY'10. Its operating margins will also be higher as not only are the freight rates expected to remain firm but also because the new businesses of dredging, mining and offshore have higher margins.

Growth Estimates for ROCE, ROE



Estimates for Sales, EBIDTA, PAT



Source: Company, ULJK Research

The company has a strong cash flow position and the profitability ratios are also expected to improve with return on equity expected to be over 35% in FY'10.

Business Outlook

The underlying trend in the increasing demand for shipping is mainly driven by the strength of the global economy and global trade. The tanker segment or even the offshore segment are further driven by the demand for oil while the dry bulk segment is influenced by commodity demand, primarily iron ore and coal. According to the Drewry, global demand for iron ore is expected to increase by 5.5% to 828.5 million tonnes while the demand for coking coal is expected to reach 236 million tonnes in 2008. The demand for steam coal is expected to reach 569.2 million tonnes in 2008. According to CISA, China's crude steel output is expected to grow in the range of 6.3% and 10.4% YOY while rolled steel output is expected to grow by 7% to 12.3%.Iron ore is the main raw material for making steel. China, which accounted for 49% of seaborne iron ore imports in 2007, is set to maintain its position as a major importer. This is because China's share of seaborne iron ore imports is expected to increase to around 55% by 2012.

China imported a total of 153.49 million tones of iron ore in the first four months of the year 2008, up 15.2% year-on-year. The annual import volume will reach 463 million tonnes this year, up 80 million tons, and far more than the demand from China's steel production.

In addition to India's growing position as a major coal importer, its "Power for All" mission by 2012 will also greatly boost dry bulk demand. Demand for coal in India over the next few years is at a rise; the incremental demand for coal is seen to be anywhere between 100-150 million tons.

The dredging business is looking upbeat with there being limited players in the industry and a strong demand for dredgers in the port industry. The outlook for rigs is also positive with crude oil having breached the US$ 139 mark. This will encourage more exploration ventures and initiatives. Day rates are seen to be firm on account of long gestation periods for new assets and rig deficits accompanied by the increasing number of rigs set for replacement due to ageing factor.

Concerns

The shipping industry is cyclical in nature. A fall in freight rates will affect the profitability of the company. Secondly, the fuel cost is a major factor in the company's operational expenses. A surge in oil prices will increase the operational expenses.

Valuation

The stock is trading at a PE of 7.6x its FY'09 earnings of Rs 15.2 and PE of 4.9x its FY'10 earnings of Rs 23.4. We initiate coverage on MLL with a price target of Rs 152. At this price, the stock will discount FY'09 and FY'10 earnings of Rs 15.2 and Rs 23.4 by 10 times and 6.5 times respectively. Increased revenue streams in FY'10 make the stock more attractive at a PE of 4.9X its FY'10 EPS of Rs 22.5. The company is trading at EV/EBIDTA of 5.07X and 3.77X its FY'08 and FY'09 EBIDTA of Rs 8858 million and Rs 12451 million respectively. Even with a replacement cost method, the company is trading at a significant discount. NAV for the shipping business is US$ 1.2 billion (USD 700 million for the Singapore subsidiary and over US$ 650 million for the Indian operations).

After the minority interest, its NAV stands at approximately Rs 39000 million and per share value works out to Rs 166. The company is trading at a discount of over 50% of its NAV. We believe that going forward, the discount will narrow down to a fair discount of about 10% after which the stock should trade at Rs 149. We recommend an accumulate rating on the stock.

Financials :Mercator Lines Ltd

Income Statement				Rs million
Particulars	FY2007	FY2008	FY2009E	FY2010E
Net Sales	11227.7	14548.7	20881.3	27568.1
Other Income	159.6	1341.1	0.0	0.0
Employee Expenses	148.2	299.4	574.2	827.0
S&A Expenses	102.4	188.4	375.0	551.0
Dry Docking expenses	548.2	421.1	530.0	690.3
Operating Expenses	7398.9	7766.1	10353.1	12818.7
Total Op Expenses	8197.7	8674.9	11832.3	14887.0
EBIDTA	3030.0	5873.8	9049.0	12681.1
Interest	814.2	1446.4	1656.0	1782.5
Depreciation	1038.0	1675.0	2275.0	2575.0
Profit beforeTax	1379.2	3665.7	5118.0	8323.6
Provision for Tax	34.1	90.2	113.3	186.1
PAT	1345.1	4003.3	4814.0	7907.0
Minority Interest	0.8	298.8	819.0	1703.0
Extra-Ordinary Income	40.1	427.9	0.0	0.0
Net Profit	1384.4	3276.7	4185.7	6434.5

Ratios	FY2007	FY2008	FY2009E	FY2010E
EBIDTA Margin	27.0	40.4	43.3	46.0
NPM	12.3	22.5	20.0	23.3
RoCE	9.3	13.2	14.7	18.8
ROE	21.6	25.0	29.2	35.3
Debt:Equity	2.2	0.8	0.9	0.7
Interest coverage ratio	2.7	3.5	4.1	5.7

Per Share Data (Rs)	FY2007	FY2008	FY2009E	FY2010E
EPS	7.3	13.9	15.2	23.4
Cash EPS	12.8	21.1	23.5	32.8
PCE	8.7	5.3	4.7	3.4

Key Valuation Ratios (x)	FY2007	FY2008	FY2009E	FY2010E
Enterprise value	21022.8	26098.9	30554.2	30560.3
EV/EBIDTA	6.9	4.4	3.4	2.4
EV/Net Sales	1.9	1.8	1.5	1.1
P/BV	3.4	1.6	1.9	1.4
PE	15.2	8.0	7.3	4.7

Balance Sheet				Rs million
Sources of Fund	FY2007	FY2008	FY2009E	FY2010E
Equity Share Capital	189.2	234.9	275	275
Preference share	400	0	0	0
Total Share Capital	589.2	234.9	275	275
Reserves & Surplus	5645.6	15805.2	16209.1	22098.6
Networth	6234.8	16040.1	16484.1	22373.6
Secured Loan	11405.5	19883.2	27883.2	28883.2
Unsecured Loan	3326.5	1228.1	2478.1	3228.1
Total Loan Fund	18347.4	21111.3	30361.3	32111.3
Total Liabilities	24582.2	38866.4	46845.4	54484.9
Uses of Funds				
Gross Block	18944.6	31419.6	43419.6	47419.6
Less:Depreciation	2054.7	3528.7	4128.7	4428.7
Net Block	16889.9	27890.9	39290.9	42990.9
Ship under acqusition	958.6	4510.1	958.6	958.6
Investments	870.7	42.5	870.7	870.7
Inventories	250.0	270.5	459.4	605.9
Sundry Debtors	1859.3	2079.6	2505.8	2753.9
Cash & Bank Balance	3787.7	8531.4	10227.7	14556.4
Loans & Advances	2087.9	4195.6	2346.7	3315.4
Current Assets	7984.9	15077.0	15539.5	21231.6
Current Liabilities				
Current Liabilities	1897.2	8312.6	9396.6	11015.6
Provision	224.7	341.5	417.6	550.8
Total Current Liabilities	2121.9	8654.2	9814.2	11566.4
Net Current Assets	5863.0	6422.9	5725.3	9665.2
Total Assets	24582.2	38866.4	46845.4	54484.9

Growth Metrix %	FY2007	FY2008	FY2009E	FY2010E
Net sales	35.9	29.6	43.5	32.0
EBIDTA	-8.3	93.9	54.1	40.1
PAT	-31.9	136.7	27.7	53.7
EPS	2.4	90.4	9.5	53.7

Source: Company.ULJK Research

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