

29 November 2010

Produced by: The Royal Bank of Scotland N.V., (India) Office

Buy

Target price
Rs201.00

Price
Rs161.95

Equity | India | Materials

Flashnote

Sterlite Industries

Management meet note

We recently met the management of Sterlite Industries and maintain our positive view on the company. We see several triggers for the stock such as i) acquisition of minority government stakes in BALCO and HZL ii) ramp-up of silver output at HZL from 150t to 500t iii) Sale of 3,870MW of power in merchant markets.

Acquisition of minority stakes

- The arbitration over the minority government stake in BALCO (49%) and HZL (29.5%) is over and the judgment is expected anytime. A favorable outcome of arbitration would see substantial value unlocking, in our view and could potentially free up US\$2.4bn of cash for the group. We believe Sterlite's valuation could rise by US\$1.5bn if it completes acquisition of government minority stakes.

Ramp-up of silver output

- Hindustan Zinc produced 87t of silver in 1HFY11 and the company guided for 170t for the full year during the 2QFY11 conference call. The company is targeting 400 plus tonnes by FY12 and 600 tonnes by FY13. The expansion in silver output will be driven by the Sindesar Khurd mine, highly rich in silver. This business will be a significant growth contributor going forward. Since it is still evolving, our current SOTP valuation considers silver to be part of the Zinc business.

Power sales to surge

- Merchant power sales at Sterlite would rise manifold to 3,870MW following the deferral of aluminum expansions at Vedanta Aluminium operations at Jharsuguda, Orissa and BALCO's operations at Korba, Chhatisgarh. Before the deferral of the aluminium expansions at these locations, power sales were expected at 1200MW, which comprised of 600MW of power from BALCO and 600MW of power from Sterlite Energy (SEL). With the change in plans, an additional 2400MW of power (1800MW additional from SEL and 600MW from BALCO) would be available for sale in merchant markets. This would lead to a sharp jump in power sold from 154MW in FY10 to an estimated 449MW in FY11 and 2200MW in FY12. We estimate that by FY13, the energy segment will contribute 10% of net revenues and 20% of EBITDA.
- SEL IPO: Sterlite is also looking at value unlocking at SEL through an IPO, which may be launched once market conditions are appropriate.

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SOTP

Entity	EBITDA (Rs bn)	Multiple (X)	Attributable	
			EV (Rs bn)	EV (Rs/share)
Bauxite and aluminium (Balco)	17	6.3	108	16
Alumina refining and aluminium smelting (VAL)				7
Copper smelting (Sterlite Inds.)	11	6.3	70	21
Copper mining (Copper mines of Tasmania)				2
Zinc mining and smelting (HZN)	72	6.3	452	87
2400MW power generation (SEL)				25
Total enterprise value				158
Less: net debt (HZN, Sterlite Inds.)				-43
Attributable market capitalization				201
Target price (Rs/share)				201

Source: RBS estimates

Important disclosures can be found in the Disclosures Appendix.

Analyst

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- Aluminium: The 325kt Korba III smelter and 1.25mt Jharsuguda II smelter projects have been deferred by 18-24 months. Balco has been exclusively allocated the Durgapur-II/Taraimar block in Chattisgarh. Balco has also got coal linkage for the first 600MW and it has applied for the remaining units.
- Copper smelting: The Supreme Court stay on the Tuticorin plant closure is effective till the next hearing which is in mid-December. We note that globally, the copper smelting business continues to be weighted down by shrinking Tc/Rc charges and we estimate a contribution of Rs21 per share of Sterlite from the copper smelting business.

Income statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	214484	244103	290346	382433	490479
Cost of sales	-163473	-182261	-207080	-254063	-332644
Operating costs	n/a	n/a	n/a	n/a	n/a
EBITDA	51011	61843	83266	128370	157835
DDA & Impairment (ex gw)	-7007	-7498	-10560	-17392	-23307
EBITA	44004	54345	72706	110978	134528
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	44004	54345	72706	110978	134528
Net interest	-3973	-3424	-8471	-11938	-10499
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	553.1	-2970	0.00	0.00	0.00
Other pre-tax items	17573	18469	17395	19899	23319
Reported PTP	58158	66420	81630	118939	147348
Taxation	-8550	-12330	-17146	-25380	-30297
Minority interests	-12671	-17241	-20028	-25746	-33443
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	-1536	587.7	216.4	3018	7233
Reported net profit	35400	37437	44672	70831	90841
Normalised Items Excl. GW	553.1	-2970	0.00	0.00	0.00
Normalised net profit	34847	40407	44672	70831	90841

Source: Company data, RBS forecasts

year to Mar

Balance sheet

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
Cash & market secs (1)	55048	33378	28833	76859	134228
Other current assets	61312	141737	175028	189274	209740
Tangible fixed assets	172104	233500	316917	316811	301451
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	162061	203045	217648	252648	277556
Total assets	450526	611659	738427	835592	922975
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	42051	49319	50254	56460	66242
Long term debt (3)	70135	92600	131298	131603	100005
Oth non-current liab	14078	15526	17772	21872	25963
Total liabilities	126264	157445	199325	209935	192209
Total equity (incl min)	324262	454214	539102	625658	730766
Total liab & sh equity	450526	611659	738427	835592	922975
Net debt	15087	59222	102465	54744	-34224

Source: Company data, RBS forecasts

year ended Mar

Cash flow statement

Rsm	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA	51011	61843	83266	128370	157835
Change in working capital	13636	-8487	-16143	-3181	-9701
Net interest (pd) / rec	12801	12279	0.00	0.00	0.00
Taxes paid	-8522	-11549	-14360	-22071	-25056
Other oper cash items	-1835	-5459	-9594	17528	14492
Cash flow from ops (1)	67090	48627	43169	120646	137570
Capex (2)	-40095	-61819	-81027	-29823	-10500
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-4227	-102169	-30100	-35100	-30100
Cash flow from invest (3)	-44322	-163989	-111127	-64923	-40600
Incr / (decr) in equity	0.00	76248	31262	0.00	0.00
Incr / (decr) in debt	12762	21795	38698	305.1	-31598
Ordinary dividend paid	-3938	-4352	-6547	-8002	-8002
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from fin (5)	8824	93691	63413	-7697	-39601
Forex & disc ops (6)	-1080	0.00	0.00	0.00	0.00
Incr/(decr) cash (1+3+5+6)	30513	-21671	-4544	48026	57369
Equity FCF (1+2+4)	26996	-13193	-37858	90823	127070

Lines in bold can be derived from the immediately preceding lines.
Source: Company data, RBS forecasts

year to Mar

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy implies upside in excess of 20%, a Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 29 Nov 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	710 (0)	446 (0)
Add	0 (0)	0 (0)
Hold	445 (0)	243 (0)
Reduce	0 (0)	0 (0)
Sell	111 (0)	69 (0)
Total (IB%)	1266 (0)	758 (0)

Source: RBS

Trading recommendations (as at 29 Nov 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	1 (0)	1 (0)
Trading Sell	0 (0)	0 (0)
Total (IB%)	1 (0)	1 (0)

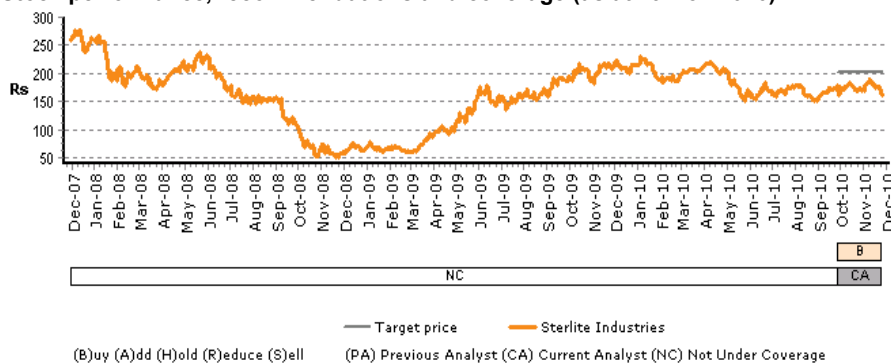
Source: RBS

Valuation and risks to target price

Sterlite Industries (RIC: STRL.BO, Rec: Buy, CP: Rs161.95, TP: Rs201.00): We value Sterlite based on a sum-of-the-parts valuation methodology. We value the individual assets separately, valuing the base metals business on an EV/EBITDA multiple, based on average peer group valuations, and the power business power business on a DCF. Key risks would be delays in project commissioning, an unfavourable arbitration outcome to Sterlite's bid to acquire minority government holdings and a weakening in base metal prices.

Sterlite Industries coverage data (STRL.BO, STLT IN)

Stock performance, recommendations and coverage (as at 29 Nov 2010)



Rahul Jain started covering this stock on 24 Sep 10. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

Trading recommendation history

Date	Rec	Analyst
n/a	n/a	n/a

Source: RBS

Price perf (at Close 29 Nov 2010)

	(1M)	(3M)	(12M)
Price (Rs)	168.6	152.1	207.7
Absolute (%)	-4.0	6.5	-22.0
Rel market (%)	-0.9	-1.2	-33.2
Rel sector (%)	-1.4	0.0	-17.7

Source: Bloomberg
Market: Sensex
Sector: Nonferrous Metals

Regulatory disclosures

None

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