kotak Institutional Equities

Coal India (COAL)

Metals & Mining

BUY

JULY 12, 2011

UPDATE

Coverage view: Attractive

Price (Rs): 365

Target price (Rs): 460

BSE-30: 18,412

Mining tax—assessing the worst-case, a probable case and an optimistic scenario. Coal India's FY2013E earnings could be impacted by a maximum of 21%, if the full impact of the mining tax comes through without any offsetting benefits in the form of (1) tax deductibility, (2) reduction in extant CSR expenses, and (3) price increase to compensate for the impact of mining tax, which could potentially reduce the impact to as low as 2%. In our view, the CMP of CIL offers a favorable risk-reward balance even after factoring potential dilution of earnings from the draft of the mining tax.

Company data and valuation summary
Coal India

Stock data			
52-week range (Rs) (high,low)			422-245
Market Cap. (Rs bn)			2,304.8
Shareholding pattern (%)			
Promoters			90.0
FIIs			6.1
MFs			1.2
Price performance (%)	1M	3M	12M
Absolute	(10.0)	2.0	0.0
Rel. to BSE-30	(10.7)	6.8	0.0

Forecasts/Valuations	2011	2012E	2013E
EPS (Rs)	17.3	24.5	28.6
EPS growth (%)	13.6	41.7	16.8
P/E (X)	21.1	14.9	12.7
Sales (Rs bn)	551.8	634.4	692.1
Net profits (Rs bn)	109.3	154.8	180.8
EBITDA (Rs bn)	162.8	199.0	222.8
EV/EBITDA (X)	11.4	8.8	7.3
ROE (%)	35.1	38.9	35.8
Div. Yield (%)	1.4	2.0	2.4

Earnings could be impacted by as much as 21%, without any offsetting benefits

If the draft mining bill is passed in its current avatar and 26% of mining profits are to be set aside as a mining tax, the impact on reported EPS could be as high as 21.4% for FY2013E while our fair value estimate will fall to Rs375/share (4.2% above the CMP). If the mining tax is based on the profits of the previous year, the impact could be reduced to 19% owing to 17% earning growth factored. We note that the draft bill is currently with the Cabinet for its approval and will then be placed before the parliament, and has found critics from sections of the opposition as well as industry participants.

Tax deductibility of the mining tax, as envisaged for non-coal royalty-based computation, could further restrict the impact to 16% on FY2013E EPS and 14% on our fair value estimate. We would be of the opinion that 'mining tax' would likely be classified as a tax deductible expense carrying benefits as per normal business expenditure.

Trimming CSR expense—CIL currently incurs 20% of PAT under social overhead

CIL incurred Rs22.3 bn (20% of PAT) under Social Overhead expenses in FY2011, which included a combination of employee as well as local community welfare expenses. Even if CIL does not have the liberty of doing away entirely with its CSR commitments—a 25% reduction in social overhead expenses (along with tax deductibility allowed) could reduce the impact of the mining tax to 13% of FY2013E EPS.

Pricing power remains, could be the final offsetting tool

Imposition of the mining tax strengthens the case for a judicious price increase in FY2013E. Mining bill, if passed in its current form (even if applicable by FY2013E), will strengthen CIL's case to increase prices for the power sector, which has not seen a price increase since October 2009. A price increase of 8% (if tax deduction is not allowed) and 5.7% (if tax deduction is allowed) will suffice to compensate for the entire impact of the mining tax.

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Our current estimates build a modest 3.6% yoy increase in prices in FY2013E, primarily from a favorable sales mix and better market-driven coal realizations. The CIL management has already stated its intent of compensating any incidence of the mining bill through a price hike. This is aligned with CIL's pricing policy of maintaining margins by taking price increases to offset any incremental cost incidence.

Levers exist to offset the impact. Maintain BUY

We maintain our BUY rating and target price of Rs460/share. Our target price is based on 13X FY2013E EPS adjusted for overburden removal and interest income and implies an EV/EBITDA of 9.4X on FY2013E EBITDA (adjusted for overburden removal). CIL currently trades at 10X FY2013E EPS (adjusted) and 7X FY2013E EBITDA (adjusted).

Mining tax—assessing the reasonableness, and past experiences

The purpose of the mining tax is to compensate project-affected people and facilitate speedier land-acquisition. Imposing a mining tax on all coal mines may be questionable given that some of these mines have been operational for decades, with enough potential to continue in the foreseeable future.

We note that the money collected as 'mining tax' will likely be used for only 3% of the total number of districts in India which highlights the skewed distribution of the amount proposed to be generated from the new arrangement.

We also highlight below two cases where similar such measures were attempted but could not be implemented.

- **Attempt made by Gujarat faced stiff opposition.** The Gujarat government had recommended a provision of 30% of PBT for all companies owned by the state for the purpose of socio-economic development of the state. The move, however, faced stiff resistance from the minority shareholders and did not eventually see the light of day.

- **Australian Super-Profit Tax.** The Australian Government, in May 2010, announced the imposition of 'resource super profits' tax on mining, oil and gas, geothermal and other resource extraction companies. The proposal was to levy a 40% tax on these entities from July 2012. However, the proposal has since then been significantly diluted. As per recent media reports, the Australian Government has agreed to reduce the headline tax rate from 40% to 30% and reduce the number of companies under the ambit of 'super tax' from 2,500 to 320.

Exhibit 1: Worst case already factored in stock price
EPS and valuation impact under different scenarios

		FY2013E EPS (Rs/share)	Impact (%)	Fair value (Rs/share)	Impact (%)
Case I - Tax deductions on "mining tax" not allowed					
[A]	Worst case - 26% proft sharing without setoff, tax benefit and price hike	22.49	(21.4)	375	(18.5)
[B]	26% profit sharing on previous year profit	23.22	(18.9)	385	(16.3)
Case II - Tax deductions on "mining tax" allowed					
[C]	No offset in social overhead expenses	24.11	(15.8)	397	(13.7)
[D]	25% reduction in social overhead expenses	24.81	(13.3)	406	(11.7)
[E]	50% reduction in social overhead expenses	25.51	(10.9)	416	(9.6)
Case II - Tax deductions along with price hikes					
[F]	2.5% price hike in FY2013E with 25% reduction in social overhead expenses	27.47	(4.0)	442	(3.9)
[G]	5% price hike in FY2013E without any reduction in social overhead expenses	28.04	(2.0)	450	(2.2)

Note:
Impact on EPS and fair value are calculated based on our current estimate of Rs28.6/share and Rs460/share

Source: Kotak Institutional Equities estimates

Exhibit 2: Our target price is based on 13X FY2013E adjusted-EPS
Computation of CIL's target price

EBITDA (Rs bn)	**205**
OBR (Rs bn)	29
Adjusted EBITDA (Rs bn)	234
Interest income (Rs bn)	43
PAT (Rs bn)	181
Adjusted PAT (Rs bn)	**170**
EPS (Rs/share)	29
Adjusted EPS (Rs/share)	27
P/E on FY2013E adjusted PAT (X)	**13**
Value of coal business (Rs bn)	2,219
Cash (Rs bn)	684
Market Cap (Rs bn)	2,903
Target price	**460**

Notes.
(1) Adjusted EBITDA is calculated after removing the effect OBR adjustment.
(2) Adjusted PAT is calculating after removing the effect of
OBR adjustment and interest income net of taxes.

Source: Kotak Institutional Equities estimates

Exhibit 3: Profit model, balance sheet, cash model of CIL, March fiscal year-ends, 2009-15E (Rs mn)

	2009	2010	2011	2012E	2013E	2014E	2015E
Profit model							
Net sales	**387,888**	**446,153**	**502,336**	**589,465**	**642,696**	**700,661**	**756,664**
Coal issued for other purpose	20,220	20,690	23,969	29,103	32,826	35,666	38,587
Transport and loading recovery	14,698	12,260	12,920	13,554	14,275	14,914	15,461
Total income	**424,142**	**485,774**	**551,758**	**634,356**	**692,061**	**753,092**	**811,714**
EBITDA	**39,309**	**114,735**	**147,711**	**181,533**	**205,359**	**235,003**	**261,119**
Interest income	28,447	26,940	19,925	32,267	43,232	55,523	69,999
Other Income (ex transport, interest)	8,051	13,209	15,118	17,447	17,447	17,447	17,447
Interest expense	(1,789)	(1,560)	(791)	(1,293)	(1,193)	(1,134)	(1,118)
Depreciation	(16,909)	(13,138)	(16,729)	(17,437)	(19,159)	(20,523)	(21,537)
Pretax profits	**57,110**	**140,186**	**165,234**	**212,518**	**245,686**	**286,316**	**325,910**
Tax	(36,336)	(43,996)	(55,959)	(57,691)	(64,899)	(81,859)	(94,824)
Net income	**20,774**	**96,190**	**109,275**	**154,827**	**180,787**	**204,457**	**231,085**
Extraordinary items	13	35	(602)	—	—	—	—
Reported profit	20,787	96,224	108,674	154,827	180,787	204,457	231,085
Earnings per share (Rs)	**3**	**15**	**17**	**25**	**29**	**32**	**37**
Balance sheet							
Paid-up common stock	63,164	63,164	63,164	63,164	63,164	63,164	63,164
Total shareholders' equity	**191,651**	**257,952**	**333,172**	**427,617**	**537,897**	**662,615**	**803,577**
Minority interest	19	236	326	326	326	326	326
Total borrowings	21,485	20,869	15,536	15,469	13,148	12,540	12,140
Shifting and rehab fund	12,238	14,774	16,214	19,528	24,251	29,765	36,001
Total liabilities and equity	**225,393**	**293,831**	**365,247**	**462,940**	**575,622**	**705,246**	**852,044**
Net fixed assets	110,212	120,354	115,252	145,597	163,862	172,265	169,803
Capital work-in progress	19,195	22,107	35,357	52,601	52,477	48,958	45,430
Investments	15,052	12,823	10,637	10,637	10,637	10,637	10,637
Cash	296,950	390,778	458,623	559,258	683,844	841,825	1,031,337
Current assets (excl. cash)	174,009	152,466	185,337	200,765	218,276	236,626	253,642
Current liabilities and provisions	399,293	414,316	448,725	514,100	561,253	611,950	665,134
Deferred tax asset	9,268	9,604	8,732	8,182	7,778	6,884	6,328
Misc. expenditure	—	15	34	—	—	—	—
Total assets	**225,393**	**293,831**	**365,248**	**462,940**	**575,622**	**705,246**	**852,044**
Free cash flow							
Operating cash flow, excl. working capital	39,616	106,073	125,248	172,815	200,349	225,874	253,178
Working capital changes	77,708	22,856	1,538	49,947	29,642	32,347	36,168
Capital expenditure	(18,758)	(19,804)	(24,878)	(65,025)	(37,299)	(25,408)	(15,547)
Free cash flow	**98,567**	**109,125**	**101,908**	**157,737**	**192,692**	**232,813**	**273,799**
Ratios							
Net debt/equity (%)	(143.7)	(143.4)	(133.0)	(127.2)	(124.7)	(125.2)	(126.8)
Return on equity (%)	11	43	37	42	37	34	31
Book value per share (Rs)	30	41	53	68	86	105	128
ROCE (%)	**11**	**43**	**38**	**43**	**39**	**36**	**33**

Source: Company, Kotak Institutional Equities estimates

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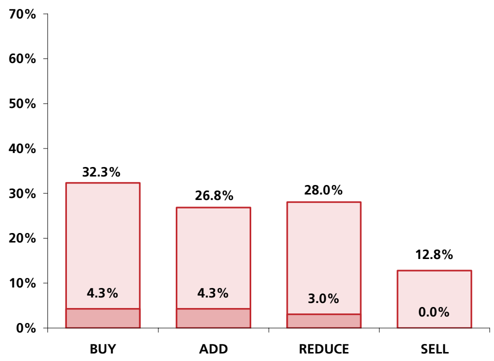

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Source: Kotak Institutional Equities

As of March 31, 2011

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