EQUITY RESEARCH **July 06, 2007**

INITIATING COVERAGE

Nalco Limited — Hold

Share Data

Market Cap	Rs. 167.07 bn
Price	Rs. 259.3
BSE Sensex	14964.12
Reuters	NALU.BO
Bloomberg	NACL IN
Avg. Volume (52 Week)	0.13 mn
52-Week High/Low	Rs. 267/185
Shares Outstanding	644.31 mn

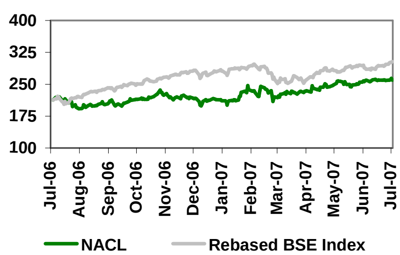
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	31.4	27.1
+/- (%)	(15.0)%	(13.9)%
PER (x)	8.3x	9.6x
EV/ Sales (x)	2.5x	2.7x
EV/ EBITDA (x)	4.4x	5.1x

Shareholding Pattern (%)

Promoters	87
FIIs	2
Institutions	7
Public & Others	4

Relative Performance



Sales under pressure

National Aluminium Company Limited (Nalco) is the largest producer of alumina and the second largest producer of aluminium in India. Owing to lower alumina prices in the global market, and a slow down in aluminium price growth, we expect short term pressures on sales growth. With major capacity expansions not expected to be complete for another 2 years, developments in alumina and aluminium prices will impact the company directly. Sales will also be impacted by the recent strike over the Government's decision to divest a 10% stake in Nalco. We believe that Nalco has limited growth potential in the next one year because of lower London metal exchange (LME) alumina prices and increasing competition from other companies such as Vedanta & Hindalco.

Key Figures

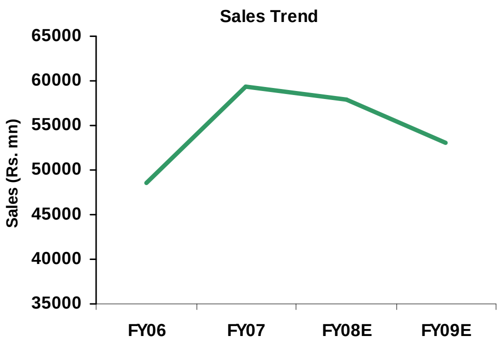
Year to March	FY05	FY06	FY07	FY08E	FY09E	CAGR (%)
(Figures in Rs. mn, except per share data)						(FY07-09E)
Net Sales	41,195	48,604	59,425	57,891	52,988	(5.6)%
EBITDA	23,195	26,514	35,344	32,731	28,660	(10.0)%
Net Profit	12,356	15,449	23,809	20,244	17,433	(14.4)%
Margins(%)						
EBITDA	54.2%	53.5%	59.5%	56.5%	54.1%	
NPM	28.9%	31.2%	40.1%	35.0%	32.9%	
Per Share Data (Rs.)						
Normalised EPS	19.2	24.0	37.0	31.4	27.1	(14.4)%
PER (x)	13.5x	10.8x	7.0x	8.3x	9.6x	

- We expect Nalco's revenues to go down from Rs. 59.4 bn in FY07 to Rs. 53 bn in FY09E, reflecting a decline of 5.6%, because of strained LME alumina prices and slow down in production.
- EBITDA margins and net profit margins are expected to go down by 540 bps and 720 bps respectively from FY07 to FY09E due to lower realizations coupled with rising power cost.
- At the current market price of Rs. 259.3, the stock is trading at 4.4x FY08E and 5.1x FY09E EV/EBITDA. We value Nalco at Rs. 245 per share based on FY08E EBITDA of Rs. 32.7 bn, in line with sector multiple. Since we do not foresee any significant upside from current levels hence, we initiate coverage with Hold.

Rationale

Negative sales growth as aluminium and alumina prices ease

Growth is expected to slow down in Nalco's aluminium business as aluminium prices will not continue with the same upward trend of the last two years. The average price of aluminium increased by 31% from FY06 to FY07, leading Nalco's 22% sales growth over the period. The current spot price of LME aluminium is USD 2743.5/tonne, already higher than the FY07 average price of USD 2660.4/tonne. Prices are expected to remain steady for the next year, and we predict an increase in the average price prevailing for the current financial year of 4.5%.



At the same time alumina prices are expected to fall over the next year due to production increases in China, Brazil and Australia. We expect the average price of alumina to be USD 320/tonne in FY08E, a decline of 15.7% from the FY07 level.

Decline in the average LME alumina price combined with a steadying of aluminium prices will lead to lower average realisations in FY08E. This coupled with a slow down in production due to the recent strike over the Government's decision to divest part of its stake in the company results in our forecast of negative sales growth.

Capacity expansion plans only for long term

Significant capacity expansions with investment of Rs. 51 bn in long term

Nalco has been pursuing plans of continuous expansion of production capacity to strengthen business and to increase market share. After the completion of the 1st phase expansion, the company has now launched its 2nd phase expansion involving additional investments of Rs. 51 bn. Though the significant capacity additions will only be for long term.

As per management schedule, the present capacity of bauxite mines will go up from 4.8 mn tonnes to 6.3 mn tonnes, aluminium refinery from 1.6 mn tonnes to 2.1 mn tonnes, aluminium smelter from 0.4 mn tonnes to 0.5 mn tonnes and captive power plant from 960 MW to 1,200 MW. However, this target will be reached in the next 2-3 years.

Possibility of setting up joint ventures abroad for producing aluminium

As per schedule, once the 2nd phase expansion is complete, company will have surplus alumina to the tune of 1.2 mn tonnes. Nalco could explore the possibilities of setting up joint ventures abroad for producing aluminium based on surplus alumina. This would increase the footprint of Nalco in the overseas market in long run.

Lowest cost manufacturing could improve earnings

Nalco is among the lowest cost producers of alumina and aluminium in the world. The company produces alumina at USD 282/tonne against a world average of USD 330/tonne and aluminium at USD 900/tonne against a world average of USD 1,180/tonne. This low cost manufacturing could increase the earnings of the company in future.

Significant potential for aluminium consumption

Low per capita consumption of aluminium in India at less than 1.5 kg

The per capita consumption of aluminium in India is very low at less than 1.5 kg as against nearly 25-30 kg in the US and Europe, 15 kg in Japan, 10 kg in Taiwan and 3 kg in China. The key consumer industries in India are power, transportation, consumer durables, packaging and construction. Of this power is the biggest consumer (about 44% of total) followed by infrastructure (17%) and transportation (about 10%-12%). Thus, there is huge growth potential in the Indian market. We believe that Nalco has a significant opportunity to garner a substantial chunk of the domestic market share.

Key Risks

Industrial action

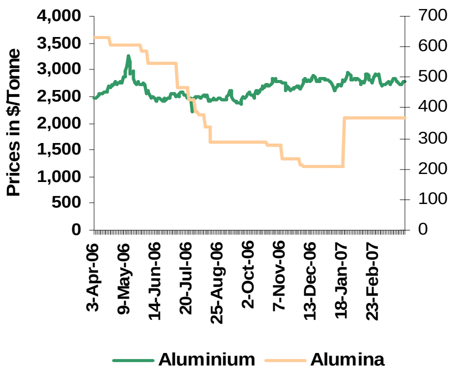
Strike at Angul smelter

The Government of India recently decided to divest to divest a 10% in Nalco (it currently holds 87.5% of the company's shares). This is vigorously opposed by trade unions and opposition political parties, and resulted in a 12-hour strike on June 23, 2007 at the Angul smelter, halting metal production. If the dispute intensifies volumes and sales would be further adversely impacted and could affect our rating.

Rising Input costs

The rising prices of fuel oil, coal and other input materials are a cause of concern for the Indian aluminium industry. A more than expected rise in crude oil prices in the global markets could significantly impact the cost of production of aluminium and thereby, our estimates.

Fluctuation in metals prices to affect rating



Revenues of Nalco are highly sensitive to aluminium and alumina price movements. The average LME aluminium price during FY07 was USD 2,660/tonne, whilst that of alumina was USD 380/tonne. Moreover, the current 15 months aluminium future price is USD 2,768/tonne, which is slightly higher than the current spot price of USD 2,743.5/tonne. We therefore, expect aluminium prices to remain firm in the near future but, an unexpected rise or fall in it could significantly affect our rating.

Availability of substitute products

Availability of substitutes poses threat to aluminium

The current high prices of aluminium may drive consumers to alternative sources such as plastics, steel, wood, copper, fibres and other alloys. The relatively low per tonne cost of steel, the higher aesthetic appeal of wood and the higher conductivity of copper are some factors favouring the use of substitutes. Nalco would be adversely affected from such substitution and this could have a significant impact on rating.

Threat to low cost manufacturing

The Indian aluminium sector is characterised by large integrated players such as Hindalco and Balco. Vedanta plans to expand its aluminium business with the aim of becoming India's lowest cost producer. Thus, it could challenge Nalco's position as the cost leader and the company can face a set-back in revenues in long run.

Outlook

The consumption of aluminium in India is expected to grow in the annual range of 6%-8% on the strength of an encouraging outlook for end-user segments such as construction, automotives, packaging, electrical appliances and consumer durables. Moreover, India has large untapped demand potential for aluminium, as evidenced by the country's low per capita consumption of metal. The Indian producers such as Nalco are likely to benefit from a rise in demand.

Nalco's sales are likely to go down in the near future as we expect alumina prices to decline on account of the global market continuing in surplus. Moreover, we are assuming no significant change in sales volume for FY08E as the capacity expansion plans are only for the long term. Nalco has plans to produce a higher quantity of rolled products and sell them in the domestic market and later on to launch them in the overseas market. But, this is also a long term consideration.

We expect Nalco's revenues to go down from Rs. 59.4 bn in FY07 to Rs. 53.0 bn in FY09E, reflecting a decline of 5.6%, due to lower alumina realizations and slow down in production. EBITDA and net profit margins are expected to go down by 540 bps and 720 bps respectively from FY07 to FY09E. At the current market price of Rs. 259.3, the stock is trading at 4.4x FY08E and 5.1x FY09E EV/EBITDA. We believe that the company has limited growth potential. Hence, we initiate coverage with a Hold.

Industrial disputes over the Government of India's partial privatisation of the company pose a risk to the uninterrupted flow of metal output.

Company Background

National Aluminium Company Limited (Nalco), an 87% government owned company, was incorporated in 1981 in the public sector, to exploit large deposits of bauxite discovered in the east coast of India. Nalco is currently the largest producer of alumina and the second largest producer of aluminium in India. The company is a fully integrated producer with operations encompassing bauxite mining, alumina refining, power generation, aluminium smelting & casting. It operates in two segments: Chemicals and Aluminium.

- Chemicals: Chemicals include calcined alumina, alumina hydrate and other related products.
- Aluminium: Aluminium includes aluminium ingots, wire rods, billets, strips and other related products.

Nalco Ltd is headquartered in Bhubneswar, Orissa. The company is backward integrated with captive bauxite mines and a coal based power plant of 960 MW. It is among the lowest cost producers of alumina and aluminium globally. The company currently exports to about 30 countries across South East Asia, the Far East, the Indian Sub-continent, China and the USA.

The main production units of Nalco are at Damanjodi and Nalconagar-Angul. The refinery complex for producing bauxite is located at Damanjodi. The smelter unit is located in Nalconagar, Angul.

The company has received numerous awards such as the Indira Priyadarshini Vrikshamitra award from the Government of India for contribution in the field of afforestation and wasteland development.

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