27 July 2010 | 8 pages

# Sterlite Industries (India) (STRL.BO)

Equity

## 1QFY11 Benefits from Higher LME Prices; Other Income

- **1Q PAT grows 50%; but below expectations** — Consolidated PAT at Rs10bn grew 50% YoY but 17% below our estimates due to lower volumes and higher costs. The PAT rise came from a 29-40% jump in LME prices, better copper margins, higher volumes for zinc/silver/power and higher other income. PAT would have been lower by Rs1bn but for change in option fair value of Convertible Notes. Operating margin was 25% in 1QFY11 vs. 24% in 1QFY10 and 29% in 4QFY10.

- **Copper: higher margins; other income** — Copper PAT was Rs4.2bn. Operating profit jumped 185% to Rs1.7bn, and the OPM was 5.3% vs. 2.5% last year due to better TC/RC margins (13.5c/lb vs 11.9) and a 14x jump in sulphuric acid prices. Volumes fell 2% to 77kt due to maintenance shutdown. Sterlite benefited from higher other income (Rs5.6bn, +202% YoY, incl. Rs1.7bn of option value gain).

- **HZL's OPM at 51%** — HZL's PAT grew 24% to Rs8.9bn due to 1) 29-37% jump in zinc-lead prices; 2) 19% rise in zinc volumes; and 3) silver sales up 20% YoY. Margins were adversely impacted by higher wages/gratuity, higher stripping costs and hike in coal/coke costs.

- **Aluminium hit by higher costs** — Aluminium OPM (excl power) fell to 15% vs. 21% last year despite a 40% jump in LME prices. It was adversely impacted by higher alumina, power, gratuity and fixed costs relating to Balco's old smelter. Volumes fell 13% YoY (to 63,000t) as Balco's old smelter is shut, and led to higher sale of surplus power (EBITDA margin 58%).

- **Maintain Sell** — We expect a zinc surplus until 2012 keeping prices range-bound. Zinc provides ~70% of cons. EBITDA. We lack visibility on triggers like captive bauxite, stake acquisitions & possible restructuring benefits. We do not expect captive bauxite from Niyamgiri until FY13; earlier availability would raise cons. FY12 PAT by 12%.

| Sell/Medium Risk | 3M |
|---|---|
| Price (26 Jul 10) | Rs174.15 |
| Target price | Rs151.00 |
| Expected share price return | -13.3% |
| Expected dividend yield | 0.5% |
| **Expected total return** | **-12.8%** |
| Market Cap | Rs585,423M<br>US$12,478M |

**Price Performance (RIC: STRL.BO, BB: STLT IN)**


**Figure 1. Sterlite Industries – Statistical Abstract**

| YE 31 Mar | Net Profit (Rsm) | EPS (Rs) | EPS growth (%) | P/E (x) | EV/EBITDA (x) | ROE (%) |
|---|---|---|---|---|---|---|
| FY07 | 46,215 | 20.7 | 175% | 8.4 | 5.5 | 46% |
| FY08 | 43,994 | 15.5 | -25% | 11.2 | 6.1 | 20% |
| FY09 | 35,400 | 12.5 | -20% | 13.9 | 7.9 | 14% |
| FY10E | 36,224 | 10.8 | -14% | 16.2 | 8.5 | 9% |
| FY11E | 41,454 | 12.3 | 14% | 14.1 | 7.8 | 10% |
| FY12E | 61,363 | 18.3 | 48% | 9.5 | 5.3 | 15% |

Source: Company Reports and Citi Investment Research and Analysis estimates. Price as on 26 July 2010.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

## Sterlite 1QFY11 Results

**Figure 2. Sterlite Industries – 1QFY11 Results**

| | 1Q FY11 | 1Q FY10 | % chg |
|---|---|---|---|
| **Net Sales** | **59,245** | **45,802** | **29%** |
| Operating expenses | 44,729 | 34,903 | 28% |
| **Operating Profit** | **14,516** | **10,899** | **33%** |
| **Operating Profit margin (%)** | **25%** | **24%** | |
| Other Income | 7,372 | 3,993 | 85% |
| EBITDA | 21,888 | 14,892 | 47% |
| EBITDA margin (%) | 37% | 33% | |
| Depreciation | 2,170 | 1,736 | 25% |
| EBIT | 19,718 | 13,155 | 50% |
| Interest | 1,409 | 1,612 | -13% |
| Profit before tax and extraordinary items | 18,310 | 11,544 | 59% |
| **PBT** | **18,310** | **11,544** | **59%** |
| Tax paid | 3,685 | 2,305 | 60% |
| Effective tax rate (%) | 20% | 20% | |
| Net profit after tax and extraordinary items | 14,625 | 9,239 | 58% |
| Less: Minority interest | 3,756 | 3,219 | 0% |
| Share in profit/(loss) of associates | -785 | 707 | |
| **PAT attributable to Consolidated Group** | **10,084** | **6,727** | **50%** |
| | | | |
| **Production volumes (tonnes)** | | | |
| Copper | 77,000 | 78,189 | -2% |
| Aluminium | 63,000 | 72,056 | -13% |
| Zinc | 164,519 | 139,315 | 18% |
| Lead | 14,144 | 15,218 | -7% |
| Silver (kgs) | 37,176 | 29,527 | 26% |
| Power sales (m units) | 480 | 287 | 67% |
| | | | |
| **LME prices (US$/tonne)** | | | |
| Aluminium | 2,100 | 1,495 | 40% |
| Zinc | 2,018 | 1,476 | 37% |
| Lead | 1,944 | 1,506 | 29% |
| Copper TC/RC (c/lb) | 14 | 12 | 13% |
| | | | |
| **Segmental Revenue (Rs m)** | | | |
| Copper | 29,059 | 21,760 | 34% |
| Aluminium | 6,659 | 6,386 | 4% |
| Zinc and Lead | 19,277 | 14,892 | 29% |
| Power | 2,587 | 1,986 | 30% |
| Others | 2,208 | 1,368 | 61% |
| Gross Sales | 59,790 | 46,391 | 29% |
| Less: Intersegment Revenues | 545 | 590 | |
| **Net Sales** | **59,245** | **45,802** | **29%** |
| | | | |
| **Segment PBIT (Rs m)** | | | |
| Copper | 1,878 | 1,076 | 75% |
| Aluminium | 497 | 750 | -34% |
| Zinc and Lead | 9,051 | 7,010 | 29% |
| Power | 1,175 | 835 | 41% |
| Others | 427 | -90 | |
| Other unallocable income/expenses (net) | 6,692 | 3,575 | 87% |
| **Total** | **19,718** | **13,155** | **50%** |
| Less: Interest | 1,409 | 1,612 | -13% |
| PBT | **18,310** | **11,544** | **59%** |

Source: Company Report

# Sterlite Industries (India)

## Company description

Sterlite is a non-ferrous metals major with a presence in aluminium, zinc and copper. It is a custom copper smelter (capacity 400,000 tpa) with treatment and refining charges (TC/RCs) driving profit. Sterlite is in the lowest-cost quartile of worldwide copper smelting operations. Its aluminium exposure comes from its 51% stake in Bharat Aluminium Co (Balco) and 29.5% stake in Vedanta Aluminium (VAL). Balco's aluminium capacity will rise to 570,000 tpa (from 245,000 tpa) by Sep 2011 and its power capacity will rise to 2,010MW (from 810MW) by Sep 2011. Balco has to source alumina from VAL and other external sources. Surplus power sales will remain an important source of revenue/profits for Balco. VAL will have 1.75m tpa of aluminium capacity (by mid-FY13) and 5m tpa of alumina capacity by mid-2011. VAL will need to buy its bauxite and some power from external sources during FY11-12E. Sterlite's zinc and lead revenues come from its 64.9% holding in Hindustan Zinc Ltd (HZL), an integrated zinc producer with an ~80% domestic share. It is amongst the lowest-cost zinc producers in the world largely due to the low cost of mining ore at the Rampura Agucha mine, which meets 90% of its requirement. Zinc-lead capacity is currently 964,000 tpa and will rise to 1.06m tpa by mid-2010 once its 100,000 lead expansion is completed. The 210,000 tpa zinc expansion was commissioned in March 2010, three months ahead of schedule. We have assumed that the purchase of the minority government stake in Balco (49%) and HZL (29.5%) would be completed by December 2010 and March 2011 respectively.

## Investment strategy

We rate Sterlite as Sell/Medium Risk (3M) with a target price of Rs151. The stock is well diversified with strong growth plans in its various businesses. However we maintain Sell as we believe there is limited visibility on or upside from potential triggers such as captive bauxite for VAL, acquisition of the minority government stakes in Balco and HZL and likely benefits from re-structuring. We would await a stock correction to enter. Hindustan Zinc (HZL) is the biggest contributor to Sterlite's EBITDA (~65-70%). We expect a zinc surplus until 2012 keeping prices range bound. We expect zinc-lead volumes to rise 34% in FY11 and 10% in FY12 and forecast zinc LME prices of US$1,911/t in FY11 and US$2,000/t in FY12. Balco is expected to contribute ~14-20% to Sterlite's consolidated EBITDA. Aluminium is one of our preferred metals with limited downside. Key positives: 1) a modest deficit in 2011 and 2012; 2) at current prices about 30% of aluminium production is sub-economic; 3) production cuts in China (high end of cost curve) due to falling prices and government measures (capacity closures and higher power tariffs); 4) Inventory levels are high but there is good potential for physically backed aluminium ETF. We forecast average prices of $2,090/t for FY11 and $2,273/t for FY12. In copper, we expect TC/RC margins to remain sluggish at US$13.8c/lb in FY11, but improve to US20.6c/lb in FY12. Commercial production of the first phase of the power project by the Sterlite Group is now expected to begin in Sep 2010 and be completed by 2H 2011, a bit delayed from the original timetable (*Source: Company Announcement*).

## Valuation

We value Sterlite using sum-of-the-parts (SOTP). For the zinc business (HZL), we apply a P/E of 5.2x (its 5-year average) to its June 2011E core earnings. Adding on the HZL cash gives us a target price of Rs895 for HZL. This translates into a value of Rs81 per Sterlite share. We value the non-zinc businesses using P/E and P/B in line with or lower than domestic peers. The non-zinc value works out to Rs70 per Sterlite share resulting in a target price of Rs151. At our target price, the stock would trade at an adjusted Jun11 P/E of 10.9x and EV/EBITDA of 6.2x. Our valuations assume that the acquisition of the minority stake of Balco and HZL are completed by December 2010 and March 2011 respectively.

## Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, suggests a Medium Risk rating for Sterlite shares. We feel this is appropriate based on its diversified business lines and low cost of production in both zinc and copper. Upside risks that could cause the shares to continue to trade above our target price include: (1) Stronger-than-expected commodity prices or TC/RC margins; (2) Quicker acquisition of minority stakes in Hindustan Zinc and Balco than we assumed; (3) Higher capacity utilization than we assume; (4) Trends in exchange rates/import duties for non-ferrous metals; (5) Faster availability of captive bauxite for VAL.

# Appendix A-1

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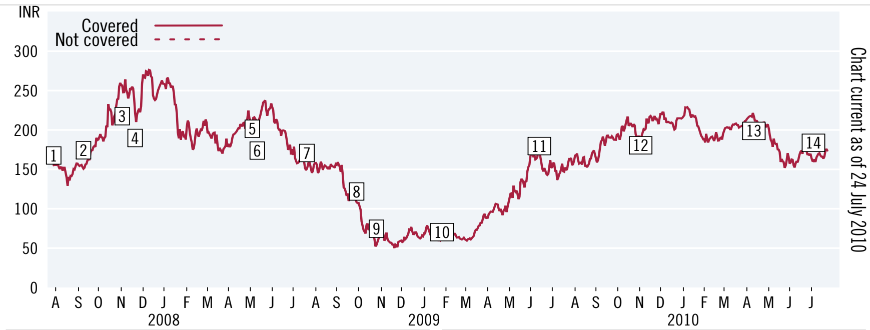
**Fundamental Research**

Analyst: Pradeep Mahtani
Covered since July 31 2007




| | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1 | 30-Jul-07 | *1M | *227.50 | 155.10 |
| 2 | 10-Sep-07 | 1M | *237.25 | 150.73 |
| 3 | 2-Nov-07 | *1L | *302.25 | 256.64 |
| 4 | 21-Nov-07 | 1L | *280.75 | 221.38 |
| 5 | 5-May-08 | 1L | *243.50 | 205.21 |
| 6 | 12-May-08 | 1L | *263.25 | 212.03 |
| 7 | 21-Jul-08 | 1L | *194.25 | 150.86 |
| 8 | 29-Sep-08 | *1M | *141.50 | 108.21 |
| 9 | 27-Oct-08 | 1M | *86.25 | 53.94 |
| 10 | 27-Jan-09 | *3M | *58.75 | 66.95 |
| 11 | 12-Jun-09 | 3M | *145.25 | 179.53 |
| 12 | 3-Nov-09 | 3M | *166.25 | 180.54 |
| 13 | 11-Apr-10 | 3M | *180.75 | 221.54 |
| 14 | 4-Jul-10 | 3M | *151.00 | 160.65 |

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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