Company In-Depth

22 March 2007 | 7 pages

Hindalco Industries (HALC.BO)

Sell: Still Not Out of the Woods

Rating change ☐
Target price change ☑
Estimate change ☑

- **Improved outlook; overshadowed by inherent risks** — Our target price is being marginally tweaked to Rs142 based on our new aluminium price forecasts. We maintain our target P/E multiple at 7x FY08E as concerns for Hindalco remain – high gearing and low margins on account of Novelis' acquisition, expected weakness in copper TC/RC margins and aluminium prices. Reiterate Sell/Medium Risk.
- **Aluminium prices revised** — Our global commodity analyst, Alan Heap, has revised aluminium prices by 7% for FY08E and FY09E to $2,480/t (from US$2,315/t) and $2,425/t (from US$2,260/t), respectively. This upgrade is supported by a tightening market; demand is strong in China and holding up relatively well in the US. There is also some short-term speculative support.
- **Copper TC/RC margins could move southwards** — We already expect a fall in copper treatment and refining charges (TC/RCs) to 15c/lb in both FY08E and FY09E (versus ~27c/lb in FY07E) due to a shortage of concentrate. However TC/RCs could decline further and put pressure on Hindalco's profitability.
- **Novelis' acquisition** — Hindalco recently announced a preferential share and warrant issue to its promoters to raise about US$500m to partly finance the Novelis acquisition. However, the debt required to fund the acquisition (~US$2.5bn) will raise consolidated interest costs substantially.
- **ABML earnings lowered** — We have incorporated Aditya Birla Mineral's new earnings. Its FY08 PAT has been lowered by 8% due to delayed commissioning of equipment.

Sell/Medium Risk	3M
Price (22 Mar 07)	Rs136.00
Target price	Rs142.00
from Rs137.00	
Expected share price return	4.4%
Expected dividend yield	2.2%
Expected total return	**6.6%**
Market Cap	Rs157,661M
	US$3,643M

Price Performance (RIC: HALC.BO, BB: HNDL IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Figure 1. Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	EPS (Rs)	EPS growth (%)	P/E (x)	EPS cons (Rs)	P/E cons (x)	EV/EBITDA (x)	ROE (%)
FY05A	13,294	14.4	59%	9.4	13.8	9.8	5.2	17%
FY06A	16,556	17.7	23%	7.7	16.9	8.1	4.8	17%
FY07E	23,795	23.7	34%	5.7	23.9	5.7	3.4	20%
FY08E	20,046	17.6	-26%	7.7	18.3	7.4	4.7	13%
FY09E	19,818	15.6	-11%	8.7	16.4	8.3	5.4	11%

Source: Company Reports, DataStream and Citigroup Investment Research estimates. Prices as on March 22.

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	9.5	7.9	6.6	8.9	9.0
EV/EBITDA adjusted (x)	6.1	5.8	4.0	4.4	4.3
P/BV (x)	1.6	1.4	1.2	1.1	1.0
Dividend yield (%)	1.5	1.6	2.2	1.8	1.8
Per Share Data (Rs)					
EPS adjusted	14.33	17.30	20.53	15.34	15.16
EPS reported	14.33	17.30	20.53	15.34	15.16
BVPS	82.63	97.46	116.89	129.39	141.89
DPS	2.00	2.20	3.00	2.50	2.50
Profit & Loss (RsM)					
Net sales	95,233	113,965	177,424	199,626	188,553
Operating expenses	-74,400	-90,642	-142,056	-169,652	-158,891
EBIT	**20,832**	**23,323**	**35,368**	**29,974**	**29,662**
Net interest expense	-1,700	-2,252	-2,547	-2,700	-2,700
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**19,133**	**21,071**	**32,821**	**27,274**	**26,963**
Tax	-5,748	-4,501	-9,026	-7,228	-7,145
Extraord./Min.Int./Pref.div.	-91	-14	0	0	0
Reported net income	**13,294**	**16,556**	**23,795**	**20,046**	**19,818**
Adjusted earnings	13,294	16,556	23,795	20,046	19,818
Adjusted EBITDA	25,465	28,490	41,561	35,935	36,023
Growth Rates (%)					
Sales	53.4	19.7	55.7	12.5	-5.5
EBIT adjusted	46.4	12.0	51.6	-15.3	-1.0
EBITDA adjusted	46.3	11.9	45.9	-13.5	0.2
EPS adjusted	57.9	20.8	18.6	-25.3	-1.1
Cash Flow (RsM)					
Operating cash flow	**17,609**	**7,101**	**28,793**	**26,706**	**26,186**
Depreciation/amortization	4,633	5,167	6,193	5,962	6,361
Net working capital	-6,258	-17,434	-3,216	2,744	-293
Investing cash flow	**-19,840**	**-13,519**	**-22,475**	**-31,518**	**-36,791**
Capital expenditure	-11,205	-11,554	-25,086	-34,130	-39,154
Acquisitions/disposals	-24,744	-4,109	-500	19,390	-500
Financing cash flow	**3,961**	**11,582**	**-4,463**	**44**	**-869**
Borrowings	12,354	11,034	-5,000	-5,000	5,000
Dividends paid	-1,725	-2,116	-2,472	-3,437	-3,249
Change in cash	**1,731**	**5,163**	**1,856**	**-4,768**	**-11,474**
Balance Sheet (RsM)					
Total assets	**151,145**	**188,958**	**220,607**	**255,142**	**283,886**
Cash & cash equivalent	4,010	9,173	11,029	15,035	13,961
Accounts receivable	7,874	12,484	17,668	17,928	16,854
Net fixed assets	69,265	76,157	95,050	123,219	156,012
Total liabilities	**74,479**	**92,895**	**98,630**	**96,412**	**98,469**
Accounts payable	14,574	19,745	26,799	31,103	27,135
Total Debt	38,000	49,034	44,034	39,034	44,034
Shareholders' funds	**76,666**	**96,063**	**121,977**	**158,730**	**185,417**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	26.7	25.0	23.4	18.0	19.1
ROE adjusted	18.3	19.2	21.8	14.3	11.5
ROIC adjusted	18.5	17.9	20.5	14.9	12.4
Net debt to equity	44.3	41.5	27.1	15.1	16.2
Total debt to capital	33.1	33.8	26.5	19.7	19.2

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Figure 2. Hindalco – Estimate changes, FY07-09

	FY07			FY08			FY09		
	Old	New	% change	Old	New	% change	Old	New	% change
Aluminium price (US$/t)	2,680	2,658	-1%	2,315	2,480	7%	2,260	2,425	7%
Import duty (%)	7.1%	7.1%	0%	5.0%	5.0%	0%	5.0%	5.0%	0%
Net sales (Rs bn)	177.5	177.4	0%	201.1	199.6	-1%	183.8	188.6	3%
EBITDA (Rs bn)	42.1	41.6	-1%	33.6	35.9	7%	33.2	36.0	8%
Net profit (Rs bn)	24.2	23.8	-2%	18.4	20.0	9%	17.8	19.8	12%
EPS (Rs)	24.0	23.7	-2%	17.1	17.6	3%	15.3	15.6	2%
Consolidated profit (Rs bn)	24.9	24.0	-3%	18.9	20.8	10%	19.3	20.8	8%
Consolidated EPS (Rs)	24.8	23.9	-3%	17.6	18.3	4%	16.7	16.4	-2%

Source: Citigroup Investment Research estimates

Hindalco Industries

Company description

Hindalco is a low-cost integrated aluminum producer (455,000 tpa) with access to captive power and bauxite. It also operates India's largest copper smelter (500,000 tpa, 35-40% market share). The aluminum division accounted for 52% of FY06 sales and 99% of EBIT. In aluminum, Hindalco has a strong domestic market share with a dominant 60-65% share in sheet products. It plans to quadruple its alumina capacity and triple its aluminum capacity in the next 4-5 years. Hindalco owns copper mines in Australia through its 51% subsidiary, Aditya Birla Minerals, which will meet about 15-20% of its requirement when fully ramped up. Hindalco is in the process of acquiring Novelis, which controls about 19% of the world’s aluminium sheet market. Novelis reported revenues of US$7.4bn and a net loss of US$170mn for 9mCY06.

Investment thesis

We rate Hindalco as Sell/Medium Risk (3M). The key reasons for our Sell rating are: 1) Hindalco has paid a high valuation for Novelis whose profits are not expected to improve substantially over the next couple of years. Hence the profits will not be able to compensate for Hindalco’s high interest outgo, resulting in an earnings dilution. 2) We expect a YoY downside in FY08-09 for copper and aluminum. In copper, TC/RC margins averaged US37c/lb in 1H FY07, largely benefiting from higher copper prices and price participation. But these are already trending down and are expected to average US15c/lb in FY08 and FY09. For a copper smelter like Hindalco, profits are determined largely by TC/RCs rather than copper prices. For aluminum, we expect average prices to decline 7% YoY in FY08 to US$2,480/t and remain around that level in FY09.

Valuation

Our target price of Rs142 is based on: (1) 7x FY08E earnings (Rs128); and (2) adding the value of Hindalco's investment holding in associate companies and discounting it by 25%. We use P/E because stocks such as Hindalco are largely driven by commodity price tends, which translate into earnings momentum. The stock has largely been moving in line with international aluminum prices since October 2002 and has been trading in a P/E band of 7x and 9x over the last four years. We have de-rated our target multiple from the mid point (8x) to the low end of this trading range. The proposed acquisition of Novelis raises its risk profile, increases gearing and reduces consolidated margins. Based on consensus earnings and our own preliminary analysis, we see no substantial improvement in Novelis' earnings in 2007 and 2008. Additionally we do not see any upside trigger to the stock price based on our outlook of falling international prices in aluminum and substantial declines in copper TC/RCs.

Risks

We rate Hindalco Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Possible upside risks to our target price include: 1) commodity prices (aluminum and alumina) surpassing our forecasts; 2) copper TC/RC margins exceeding our forecasts; 3) depreciation in the rupee versus our forecast of an appreciating rupee in FY08 and FY09; and 4) Novelis' operational performance surpassing forecasts.

Appendix A-1

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Hindalco Industries (HALC.BO)

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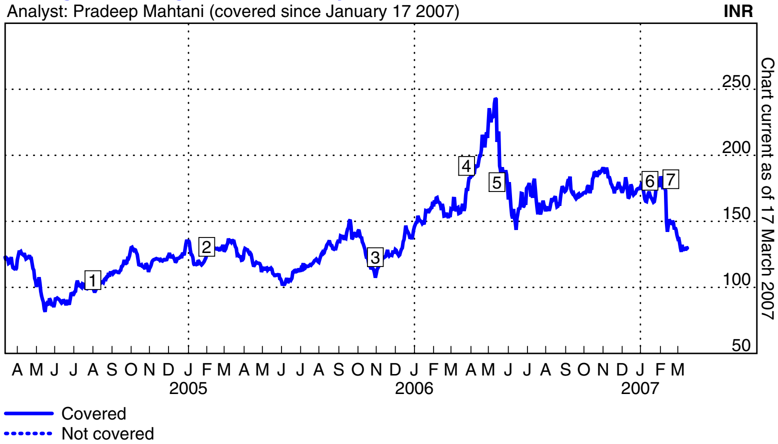
Analyst: Pradeep Mahtani (covered since January 17 2007)



#	Date	Rating	Target Price	Closing Price
1:	2 Aug 04	1L	*139.42	100.36
2:	1 Feb 05	1L	*150.14	125.24
3:	30 Oct 05	1L	*146.75	107.33
4:	26 Mar 06	1L	*196.00	175.15
5:	14 May 06	1L	*278.00	210.15
6:	16 Jan 07	*3M	*174.00	169.95
7:	18 Feb 07	3M	*137.00	148.60

*Indicates change.

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