

Ten for 2010

Mid Cap Ideas for the year



Foreword

Dear Investors,

As we step into the calendar year 2010, most stock market investors will heave a sigh of relief. The year gone by was akin to a roller coaster ride and brought to the fore, subtle nuances of our country and its economic system. Several factors considered hitherto as the bane of our economy, like a conservative banking system and high reliance on domestic consumption, proved to be the saving grace when the entire world was passing through a phase of unprecedented financial turmoil. The Indian populace also asserted its democratic right by delivering a clear mandate and brought in a government which, if it bites the bullet, can make tremendous difference and substantially accelerate the pace of economic development.

The markets, appreciative of the above, reacted in an extremely positive manner and posted gains of over 100% from the bottom, as the risk appetite both from domestic as well as international investors, surged. However, after the tremendous re-rating our country has had, most of the low hanging fruits seem to have been plucked and discerning investors will have to deep trawl the markets to scour for profitable investments with appropriate risk profiles.

We, at Antique, have always adhered to the philosophy that at each point of valuation curve of the markets, there exist pockets of growth as well as value mispricing. To unravel the same entails unorthodox insights. Our quest has always been, and remains, investigation of themes involving clear addressable markets, sound balance sheet and business model, backed by strong implementation skills. We believe that companies scoring high on these factors will emerge as strong and sustained value creators over a period of time despite scepticism and being classified as 'Mid-Caps'.

In conformance with the above, we have woven together several threads with the themes of 'Growth and Value' to present 10 stocks, which we are confident, will prove to be profitable investments for CY10.

Sandeep Shenoy
Head of Research

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BGR Energy Systems Ltd.

EP(i)C Warrior...



BUY

CMP: INR478

Target Price: INR640

December 22, 2009

Strictly confidential

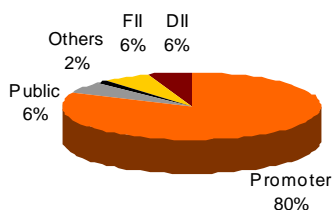
Market Data

Sector	:Engineering
Market Cap (INRbn)	: 34.4
Market Cap (USDm)	: 716.9
O/S shares (m)	: 72
Free Float (m)	: 13.5
52-wk HI/LO (INR)	: 536/107
Avg 12m Vol ('000)	: 163
Face Value (INR)	: 10
Bloomberg	: BGRL IN
Reuters	: BGR.E.BO

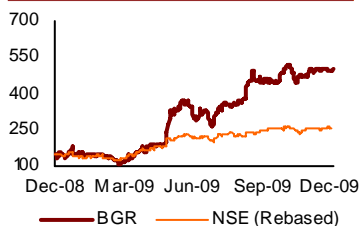
Price Performance

	1m	3m	6m	12m
Absolute	1.5	10.7	44.6	236.4
Relative	0.0	5.0	25.8	93.4

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Syed Sagheer +91 22 4031 3469
syed.sagheer@antiquelimited.com

Investment Rationale

BGR Energy Systems Ltd. (BGR), a Chennai (TN)-based company, is rapidly emerging as a player to reckon with in the power engineering space (EPC/BoP). It also has presence in verticals like oil & gas equipment, air fin coolers, electrical projects, environmental engg, infrastructure, etc.

BGR has carved out an enviable reputation in the EPC/BoP space in the domestic power industry and is now being considered as a competitor for established players like BHEL, Reliance Infra and L&T.

Post its evolution as a full-fledged EPC contractor from a parts supplier, the group has outlined a capex plan of INR25bn in the coming two years. This entails setting up a boiler manufacturing unit, thereby attaining capabilities for in-house manufacturing of critical BTG components and revamping its in house product portfolio.

At the CMP of INR478, the company is trading at a P/E of 12.8x and EV/EBIDTA 8.7x, discounting its FY11E numbers.

Valuation

Proven track record, management bandwidth, inhouse manufacturing and supportive macro headwinds should translate into accelerated growth in revenues and profits for BGR over the next few years.

At the CMP of INR478, there exists huge scope for re-rating in BGR on account of asset mispricing as well as growth prospects. We initiate coverage with a BUY recommendation and a 12-month price target of INR640, which represents a 34% upside from current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	19,303	29,022	43,375	49,921
EBITDA	2,089	3,487	5,201	5,917
EBITDA margin	10.8	12.0	12.0	11.9
EBITDA growth	34.5	66.9	49.1	13.8
PAT	1,154	1,665	2,692	3,105
PAT growth	32.2	44.3	61.6	15.3
EPS (INR)	16.0	23.1	37.4	43.1
EPS growth	32.2	44.3	61.6	15.3
P/E	29.8	20.7	12.8	11.1
P/BV	6.1	4.7	3.5	2.7
EV/EBITDA	14.7	11.9	8.7	7.6
RoE (%)	22.3	26.0	31.6	27.4

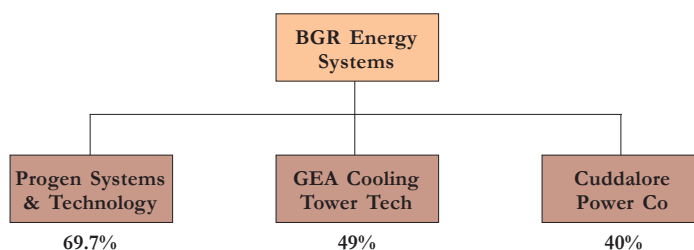
Source: Antique

Introduction

BGR Energy Systems Ltd., was promoted as *GEA Energie Systems India Pvt Ltd* in 1985, in a joint venture between Mr. B G Raghupathy and *GEA Energietechnik GmbH* of Germany. It commenced operations in 1987 manufacturing condenser tube cleaning systems, debris filters and tube cleaning balls. *GEA Energietechnik* divested its stake in 1993 to the present promoter Mr. B G Raghupathy and the name was changed to BGR Energy Systems in June 07.

BGR has gradually evolved from being a parts supplier across a spectrum of industries to a serious contender in the power engineering space. It graduated into a full scale BoP operator in 2007 after gathering expertise as a BOP component supplier for a number of years. Over the last few years, BGR made an ambitious foray in EPC and has now emerged as a full scale EPC contractor, spanning a large part of the power engineering value chain.

Holding Structure



Source: Company

Presently, it operates in six verticals viz. oil & gas equipment, air fin coolers, environmental engineering, electrical projects, infrastructure and power trading.

BGR's operations are organised in the form of various subsidiaries, associates and joint ventures in order to effect presence in different lines of business. These are:

1. **GEA BGR Energy System Ltd:** Established in 1985 as a JV with GEA Energietechnik GmbH, Germany for tube cleaning system, debris separator, cleaning balls and cleaning systems.
2. **Cuddalore Powergen Corp Ltd:** Incorporated in 1993 as an IPP developing two 660MW coal based thermal power plants, which on completion, will sell power to TNEB on a 'Take or pay' basis.
3. **Progen Systems & Technology:** Incorporated in 1994, it manufactures process equipment like heat exchangers, pressure vessels, boiler components, welded finned tubes, etc.
4. **GEA Cooling Tower Technologies:** Established in 1996 as a JV between GEA Energietechnik GmbH, Germany and the BGR group, wherein GEA provides technical expertise and the engineering license. Full range of dry cooling and wet cooling systems are manufactured here.

Business Model

BGR is present across six different verticals i.e., power (captive & regular), oil & gas equipment, air fin coolers, environmental engineering, electrical projects and infrastructure. It has entered into collaborations with various technology partners and formed subsidiaries to nurture the above competencies. We can bifurcate these verticals into two major heads i.e., projects and products.

Projects

This division comprises of mainly power projects on regular and captive side, electrical projects and infrastructure and accounted for ~92% of BGR's revenues in FY09.

Power

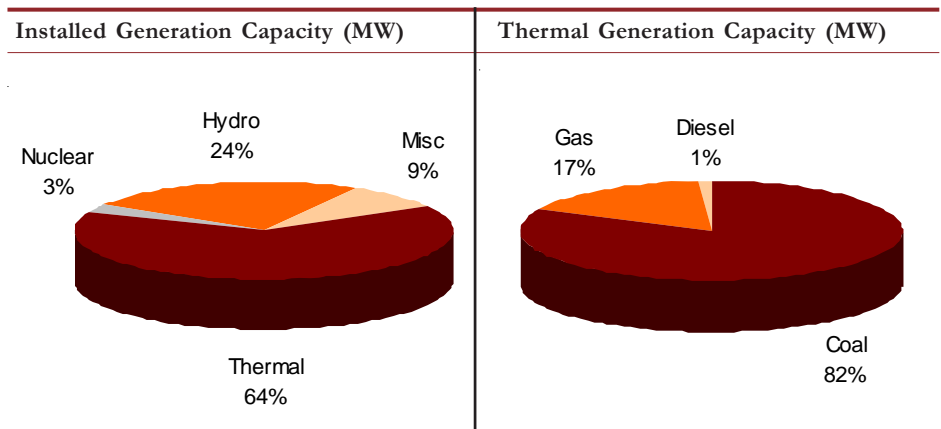
BGR started out as a part system provider in the BoP (Balance of Plant) space and now has evolved and emerged as a full scale EPC contractor. It has executed three contracts in the regular power space comprising turnkey BoPs up to 500MW and in the captive space has executed two projects comprising one BoP and one EPC. Going forward, we expect this segment to be the engine of BGR's growth as it accounts for ~95% of its current order backlog of INR121.7bn.

Industry

Globally, the installed power capacity is ~4,000GW, of which thermal power comprises 69%. India accounts for ~4% of total installed capacity (152GW), of which 64% is made up by thermal power. Going forward, as per CEA, domestic power generation capacity will double to 310GW by 2017, of which thermal power should be 142GW.

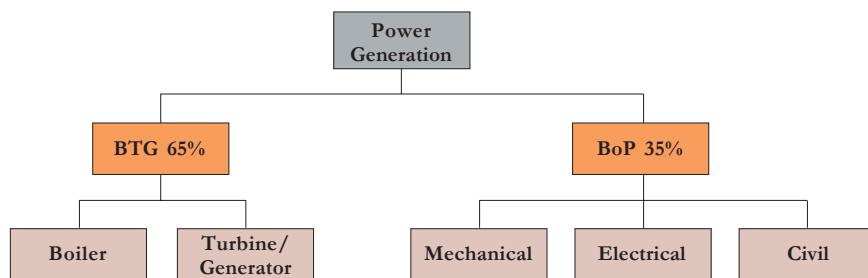
As per the XIth Plan, ~64GW of power generation capacity is expected to be added by 2014 (net of slippages). In CY10, less than 33% of the 13GW planned expansions would have been executed. Capacity addition is being undertaken by the central and state governments as well as private companies who meet the qualification criteria, with the role of the latter gaining prominence. Currently captive power accounts for ~14% of total installed capacity and this metric is expected to rise significantly going ahead. Some of the important players in the power engineering space are BHEL, Alstom Projects, L&T, BGR Energy, Thermax, etc.

BGR's customer profile in this segment would either be power plants (if they tender for EPC/BoP directly) or EPC contractors like BHEL, L&T who secure the contract and sub tender the BoP element.



Source:CEA

Power Generation Component Break-up



Source: Industry

In a thermal power plant, the power island (BTG) constitutes 65% of the total cost with the remaining 35% comprising BoP components (electrical, civil, mechanical). A power plant generally requires 4-5 years to reach its completion stage. The current domestic capacity for manufacturing BT (Boilers & Turbines) is ~19GW of which BHEL has the lion's share (15GW) and L&T comprises the rest (4GW).

BGR is pre-qualified for EPC and has an agreement with Chinese manufacturer *Dong Fang* for sourcing boilers. It has also firmed up plans to set up an inhouse manufacturing capacity for boilers and turbine generators under license from *Foster Wheeler* (US), most probably in TN. BGR group's product division manufactures many BoP components (~50%) inhouse.

BGR has an order backlog of INR115.8bn in the power segment, spread across seven projects (4 BOP, 3 EPC) with an average execution period of four years. This constitutes 6x of BGR's FY09 revenues. We believe with an uptick in thermal PP construction, BGR has a potential bid market of INR2tn.

With the execution of four BoP projects of up to 500MW and one EPC project of 120MW under its belt, BGR has demonstrated its capability in project execution. Simultaneously, it has beefed up its management bandwidth and capabilities by attracting good talent with relevant experience on the technical side. It recently roped in the ex CMD of NTPC, Mr. Sankarlingam, to take over as its MD; this should go a long way in ramping up the operations of the company.

Electrical Projects

BGR undertakes turnkey contracting for supply of electrical systems and equipment for power stations i.e., in the T&D space. It can execute turnkey solutions for substations, transmission lines and plant electricals, apart from fulfilling the electrical BoP requirements of a power plant. It has also ventured into hydro electric projects by supplying electrical BoP equipment.

Infrastructure Division

BGR deploys its existing project management know how in its infrastructure division to undertake BOT projects in roads, tunnels and other infrastructure verticals.

Equipment Division

Oil & Gas Equipment

BGR provides specialised equipment to the Oil & Gas industry including processing equipment, storage tanks, pipeline equipment, compression packaging machinery, etc. Gradually, it has expanded its scope to span most of the equipment required to transport crude from well head to end user unit. All of the projects currently under execution are for the State Company for Oil Projects (SCOP) in Iraq. With ~USD900bn of capital investment outlined for the E&P sector

in India over the next 25 years (*Source: ELA estimates*), there exists potent demand both in India and abroad for such equipment.

Air Fin Coolers

BGR provides dry cooling solutions through equipment like air cooled heat exchangers, radiators and finned tubes used in process based industries like oil & gas, power, petrochemical etc. Currently, its geographical reach extends to companies in India, M. East, S.E.Asia and North Africa.

Environmental engineering/Infrastructure

BGR's product profile includes desalination and water treatment plants and de-aerators. With the tightening of emission and effluent discharge norms, this sector offers tremendous growth potential.

Expansion Plans

BGR group is setting up a boiler manufacturing unit in Tamil Nadu to manufacture sub and super critical boilers from 100MW to 1,000MW in collaboration with *Foster Wheeler North American Corporation*, which will have a capacity of ~4,000-5,000 MW by CY12-14, at an approximate cost of INR60bn. Going forward, BGR is expected to incur a consolidated capex of INR25bn over the course of the next two years.

Competitive Analysis

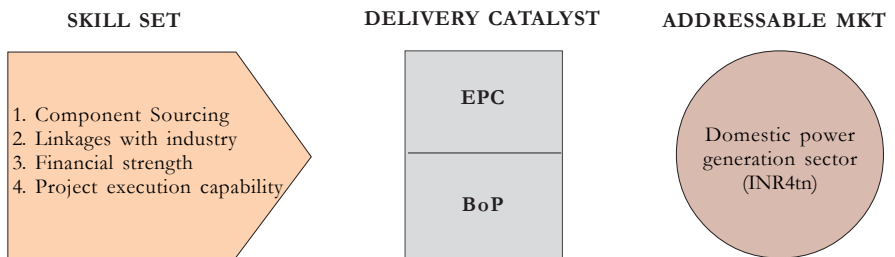
In the EPC space, BGR faces competition from the likes of *BHEL, L&T, Reliance Infra* and *Tata Projects*. In the BoP space, there are well entrenched players in specific segments like *Indure* for Ash handling plants or *Techpro* for CHPs and so on. In terms of inhouse technology, BGR is sourcing technology for super critical boilers from Foster Wheeler in order to compete with BHEL. On the BoP front, BGR is technically self sufficient with ~50% of mechanical and electrical components manufactured inhouse. We have enclosed more details on the competitive scenario in **Annexure I**.

SWOT

Strengths

- 1. Strong scale-up demonstrated:** BGR has emerged from being a mere parts supplier (rubber cleaning balls) to BoP players to a full-fledged BoP operator, and finally, a large scale EPC operator. This strong scale up has been ably demonstrated in terms of orders which it has bagged in the last one year and in terms of proven execution of 5 projects of up to 500MW.

BGR Opportunity Scenario



Source: Antique

2. **Capability and domain expertise:** BGR has grown manifold thanks to its capability in project execution and strong domain expertise built over a period of time. Its management team, some drawn from engineering giants like NTPC, L&T, has ensured that BGR has been able to absorb and implement the best practices of large project companies.
3. **Managing financial closures:** An important aspect for a project management company is its ability to garner financial closures without much difficulty. BGR has managed to achieve the same and has sourced timely finance, like in case of its 1,200MW EPC execution in Jhalawar, Rajasthan, where it managed to secure fund and non fund based facilities of INR39bn, which underlines its financial competence.
4. **Strong component base and vendor relationships:** Technical competence is an important aid in EPC contracts. It manufactures ~50% of its required components inhouse through its inhouse division, which enables it to save procurement time and gives it a slight margin cushion.

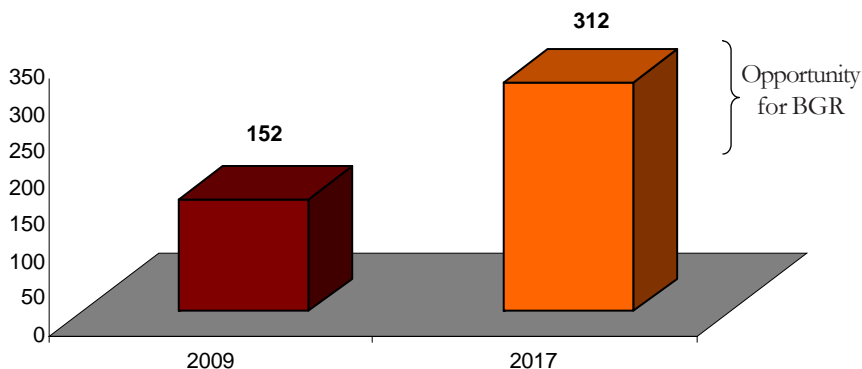
Weakness

1. BGR is a relatively new entrant in the EPC space and is head to head with larger peers like BHEL, Reliance Infra, L&T, etc. Lack of a substantial track record could prove to be a deterrent in bagging incremental EPC orders or in terms of competitive bidding.
2. Simultaneous execution of five large orders will strain BGR's balance sheet and elongate its working capital cycle. This in turn would increase its DER which could hamper earnings growth.

Opportunities

With the XIth and XIIth Plans outlining the effort to double the installed capacity from present levels to 312GW, there is a huge addressable market which can be tapped by BGR. Orders are yet to be placed for 60GW capacity which translates into a lucrative opportunity worth ~INR2tn. On the BoP front, the opportunity looks more attractive with 60% of BoP orders till XIIth plan yet to be placed. With competition booked to capacity (BHEL) and with inherent limitations (Tata projects), BGR can identify certain niche projects (IPPs and SEBs) and capture the opportunity on hand.

Estimated Installed Capacity - Indian Power Generation (GW)



Source:CEA

Threats

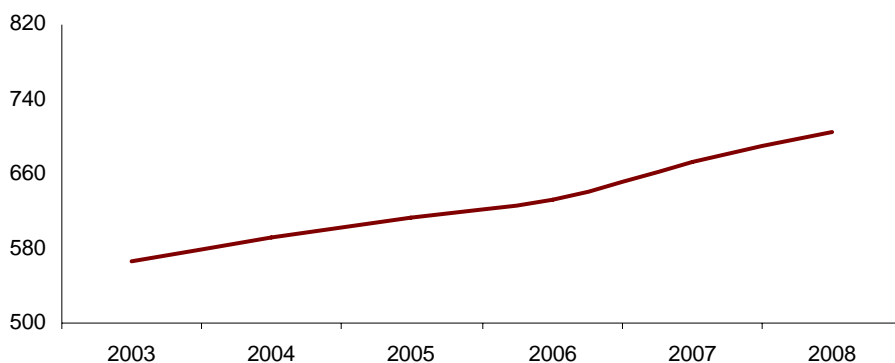
1. Slippages in project deadline dates could elongate the working capital cycle for BGR which could impact earnings going ahead. Also, since two projects comprise almost 70% of the total power project order backlog, there is an inherent concentration risk in case of slippages.
2. Strong competition from established players like BHEL, L&T and Reliance Infrastructure would be a threat for BGR as these players have deep pockets i.e. strong balance sheets which can withstand the pressure of slowdowns and/or competition undercutting.
3. Any slowdown in macro demand for power has the potential to be detrimental to BGR's earnings growth trajectory, as it may result in slow down in order intake, stretched working capital cycle and increasing cost of fund, thereby resulting in lower return ratios and earnings.

Investment Argument

Favourable macro scenario

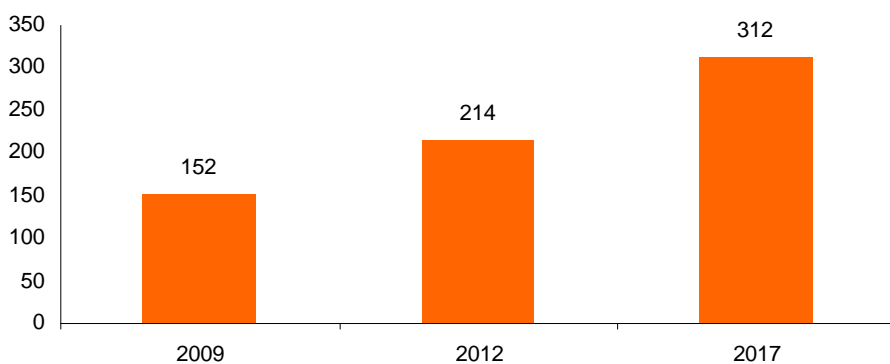
The domestic power scenario is upbeat with the proposed addition of 160GW over the XIth and XIIth plan. An incremental 60GW of orders are yet to be placed and furthermore, at least 10GW of power capacity should be added per annum beyond that. There has been a slew of orders placed by organisations in the central, state and private sectors for power plants in order to capitalise on the power demand. This translates into a large and lucrative opportunity for players like BGR who can bid for orders in the EPC/BOP space.

Domestic Consumption per capita (Kwh)



Source:CEA

Proposed Capacity Expansion under XIth & XIIth Plans (GW)



Source:CEA

Moving up the power value chain...

BGR has emerged from being a part BoP supplier to a full scale BoP player in addition to being EPC contractor wherein it undertakes entire contracts of constructing thermal power plants. This move means that BGR has limited (but quality) competition as well as large order sizes, enabling to garner incremental revenue per MW being tendered out.

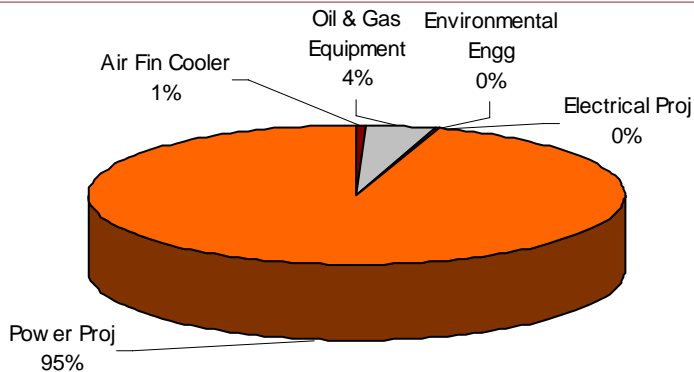
In house manufacturing...

Progen, BGR's in house subsidiary, manufactures and supplies the latter with ~50% of BoP components. This generates dual benefits of lower lead time source the materials while providing a slight margin cushion in the face of fluctuating input prices.

Burgeoning order book...

BGR's order book has grown exponentially over the last four quarters. It has a backlog of INR121.7bn of which 95% is from the power segment. This provides revenue visibility for 4.2x FY10e and 2.8x FY11e earnings, which should stand the company in good stead during turbulent times. There would be an incremental opportunity of 60GW (orders which are yet to be placed for XIIth plan) which could further strengthen the backlog along with other orders.

BGR Order Backlog Details



Source:Company

Our View

BGR has grown at a very robust pace of ~60% CAGR in revenue terms and 71% CAGR in profitability in the last four years. We estimate the company to close FY10 with a revenue growth of 50% i.e. INR29bn, with the same being driven by fresh power orders. Net profits at INR1.7bn is expected to post a 45% growth. FY11 should see revenue growth along similar lines, on back of booking of the two large scale EPC orders constituting INR80bn of its order book. Accordingly, we estimate a turnover of INR43.4bn with net profits growing at a higher rate of 62% to INR2.7bn, due to improved asset utilisation and richer margins.

For FY12, we have not factored incremental orders from the bulk tendering of NTPC or the incremental flows from 60GW worth of orders pending as per the XIIth plan in our estimates, as a result of which the growth in profits would be sedate at INR3.1bn (+16%).

BGR has made the right moves in the last 15 months and graduated into a full scale turnkey contractor in the promising domestic power engineering space. The strategic collaborations to source technology has enabled BGR to gain critical knowhow in the BTG space, while its in-house manufacturing capabilities have helped it secure a firm foothold in the BoP space. We expect the recent inductions into BGR's top management to lend their proven track record and expertise, which in turn should translate into significant order wins for the company. Furthermore, the company has strengthened its balance sheet and fine tuned its financial model to effectively manage its working capital cycle and achieve financial closures for projects. We believe that with these strategic moves and upon implementation of its proposed Boiler manufacturing facilities, its revenue share per MW of contract would be substantially enhanced from an average of INR13m/MW to ~INR32m/MW. This should enable it to attain critical mass and secure more such orders on a sustainable basis while traction in business should boost its asset sweating, enabling it to reap the benefits of operating leverage.

We believe that high profile orders in the full scale BoP and EPC space should propel BGR in the 11.5-12% plus OPM category from previous levels of 10% due to economies of scale and in house production. We have factored in a margin decline of 15bps to 11.9% in FY12 in anticipation of higher input costs and have assumed the worst case scenario for margins even though BGR has delivered close to 13% OPM in 1HFY10. Higher capital charges should continue in light of BGR's ongoing capex. We have also assumed full tax rate in our estimates.

BGR trades at PER of 12.8x and EV/EBITDA of 8.7x discounting its FY11e earnings. This compares favourably with listed peers like L&T, Punj Lloyd and BHEL. Higher asset sweating on back of heightened order execution is an additional positive. We have arrived at a target PE of 14.8x for BGR keeping in mind its superlative growth prospects and thus arrive at a target price of INR640, which provides an upside of 33% from the CMP. We initiate with a 'BUY' recommendation on the stock on an 12 month investment horizon.

Financials (INR m)

Profit and Loss Account

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	15,205	19,303	29,022	43,375	49,921
Expenses	13,652	17,214	25,535	38,174	44,004
Operating profit	1,553	2,089	3,487	5,201	5,917
Other income	52	317	288	315	410
EBIDT	1,605	2,406	3,775	5,516	6,327
Depreciation	55	75	114	175	225
Interest expense	254	579	1,125	1,240	1,365
Profit before tax	1,296	1,752	2,536	4,101	4,737
Taxes incl deferred taxation	411	596	862	1,394	1,611
Profit after tax before MI & EO Items	885	1,156	1,674	2,707	3,127
Extra ordinary Items	-	-	-	-	-
Minority Interest	11	1	9	15	22
Profit after tax	873	1,154	1,665	2,692	3,105
Diluted EPS (INR)	12.1	16.0	23.1	37.4	43.1

Balance Sheet

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	720	720	720	720	720
Reserves & Surplus	4,017	4,919	6,525	9,164	12,223
Networth	4,737	5,639	7,245	9,884	12,943
Minority Interest	27	28	37	52	74
Debt	5,027	7,090	12,663	14,400	15,400
Deferred Tax Liability	356	747	852	975	1,120
Capital Employed	10,147	13,504	20,797	25,311	29,537
Gross Fixed Assets	734	1,245	1,949	2,949	3,749
Accumulated Depreciation	206	268	382	557	782
Net Assets	527	977	1,567	2,392	2,967
Capital work in progress	11	54	50	50	50
Investments	1,514	5	2,400	2,400	2,400
Current Assets, Loans & Advances					
Inventory	150	140	375	555	705
Debtors	7,360	12,789	18,950	26,450	30,100
Cash & Bank balance	3,070	6,152	2,144	1,029	1,470
Loans & advances and others	2,749	6,610	7,975	9,795	11,250
Current Liabilities & Provisions					
Creditors	3,065	4,413	5,850	9,910	11,450
Other liabilities & provisions	2,176	8,815	6,815	7,450	7,955
Net Current Assets	8,089	12,462	16,779	20,469	24,120
Misc. Expenses	-	-	-	-	-
Application of Funds	10,141	13,498	20,797	25,311	29,537

Per share data

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	72	72	72	72	72
BVPS (INR)	65.8	78.3	100.6	137.3	179.8
CEPS (INR)	12.9	17.1	24.7	39.8	46.2
DPS (INR)	2.0	3.0	0.8	0.8	0.8

Margins (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	10.2%	10.8%	12.0%	12.0%	11.9%
EBIT	10.2%	12.1%	12.6%	12.3%	12.2%
PAT	5.7%	6.0%	5.7%	6.2%	6.2%

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	1,296	1,752	2,536	4,101	4,737
Depreciation & amortisation	55	75	114	175	225
Interest expense	254	579	1,125	1,240	1,365
Interest / Dividend Recd	(32)	(24)	(288)	(315)	(410)
Other Adjustments	21	(44)	120	138	167
(Inc)/Dec in working capital	(3,226)	(1,528)	(8,325)	(4,805)	(3,210)
Tax paid	(64)	(37)	(862)	(1,394)	(1,611)
CF from operating activities	(1,696)	773	(5,580)	(860)	1,264
Capital expenditure	(176)	(523)	(700)	(1,000)	(800)
Net Investments	(1,488)	1,466	(2,395)	-	-
Income from investments	32	24	288	315	410
CF from investing activities	(1,631)	967	(2,807)	(685)	(390)
Inc/(Dec) in share capital	3,197	-	-	-	-
Inc/(Dec) in debt	2,563	2,063	5,573	1,737	1,000
Dividends & Interest paid	(291)	(721)	(1,193)	(1,308)	(1,433)
CF from financing activities	5,469	1,342	4,380	430	(433)
Net cash flow	2,141	3,081	(4,007)	(1,116)	441
Opening balance	929	3,070	6,152	2,144	1,029
Closing balance	3,070	6,152	2,145	1,029	1,470

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	93.3	27.0	50.3	49.5	15.1
EBITDA	75.7	34.5	66.9	49.1	13.8
PAT	114.0	32.2	44.3	61.6	15.3
EPS	(67.9)	32.2	44.3	61.6	15.3

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	39.4	29.8	20.7	12.8	11.1
P/BV	7.3	6.1	4.7	3.5	2.7
EV/EBITDA	22.7	14.7	11.9	8.7	7.6
EV/Sales	2.4	1.8	1.5	1.1	1.0
Dividend Yield (%)	0.0	0.0	0.0	0.0	0.0

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	31.8	22.3	26.0	31.6	27.4
RoCE (%)	23.1	19.8	21.4	23.2	22.3
Debt/Equity (x)	1.1	1.3	1.7	1.5	1.2
EBIT/Interest (x)	6.3	4.2	3.4	4.4	4.6

Annexure-I

Coal handling plant orders

Player	Orders	Details
Elecon	5	Hissar, Sikka, Surat, Mejia & NCTPP
L&T	7	Barh, Bakreshwar, Kahalgaon, Korba, Simhadri, kodarma, Raghunathpur
TRF	2	Bhilai, Aravali
ThysenKrupp	3	Sipat, Durgapur, Harduaganj
NCPE	1	Korba
MBEL	3	Chandrapur, Barsingar, Kaparkheda
BGR	2	Kakatiya, Vijaywada
MECON	1	Neyveli
Techpro	8	Chabra, Lanco Amartak, Torangallu, Adani P 1 P2, Anpara, Jalipa, Maithon
TPL	3	Kota, Bhusawal, Giral
Indure	1	Suratgarh
REL	1	Paricha
FFE Minerals	1	Kutch Lignite
BHEL	1	Trombay
Bengal Tools	2	Budge Budge, Farakka
Techpro	2	Rosa, Raichur
Energ	1	Nagarjuna
Sunil Hitech	2	Parli, Paras
SEPCO	2	Adani power, Sterlite TPP
Punjloyd	1	Goindwal sahib
Unnamed	1	Santaldih
BSBK Engineers	1	JSW Ratnagiri
Era Const	1	Ukai TPP

Source: CEA

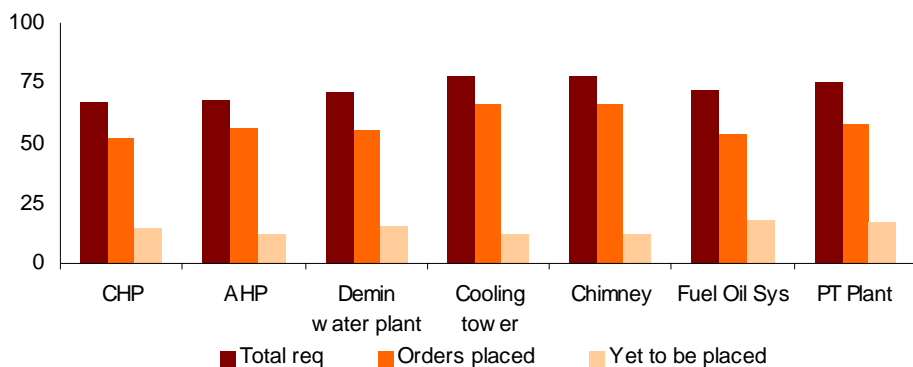
Ash handling plant orders

Player	Orders	Details
Indure Amarkantak,	12	NCTPP Dadri, Kahalgaon, Farakka, Bhilai, Bakreshwar, Lanco Simhadri STPP, Hissar TPP, Durgapur Steel, Kodarma, Raghunathpur, Vallur
DC Industrial	5	Barh, Korba, Chandrapura, Aravali, Santaldih TPP Extn
Mahindra Ash tech	3	Sipat I, Barsingpur Lignite, Nagarjuna
MBEL	3	Neyveli Expn, New Parli, Paras TPP
Mecawber Beekay Power	11	Chhabra 1&2, Suratgarh, Torangallu, Budge Budge, Korba East, Adani P1 P2, Jalipa lignite, Rayalseema, Maithon RBC, Sikka TPP
TPL	3	Kora TPS, Bhusawal TPP, Giral Lignite
RIL	1	Parichcha
UCC	1	Surat Lignite
Energ	1	Kutch Lignite
BGR	3	Kaparkheda, Kakatiya, Vijaywada
BHEL	1	Trombay
IGN	1	Mejia TPS
Techpro	4	Raichur U 8, Kothagudam, Bellary TPS II, Anpara c
UEEPL	1	Rosa TPP
SEPCO	2	Adani Power, Sterlite TPP
BSBK	1	JSW ratnagiri
Era	1	Ukai TPP
Punjloyd	1	Goindwal sahib 1 & 2
Unnamed	1	Harduaganj extn

Source: CEA

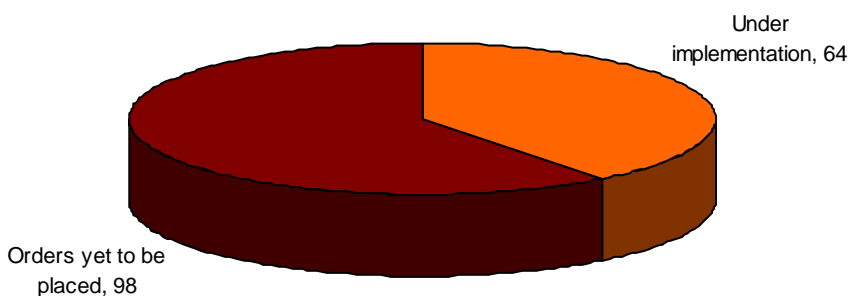
Annexure-II

Ordering status for BoP (nos)



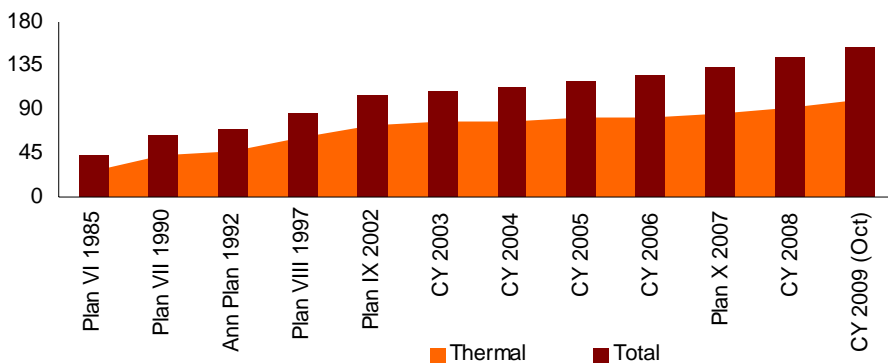
Source:CEA

Ordering status for BoP (nos)



Source:CEA

Growth in installed capacity (GW)



Source:CEA

Note

Gayatri Projects Ltd.

'Road's to Riches...



BUY

CMP: INR402

Target Price: INR494

December 22, 2009

Strictly confidential

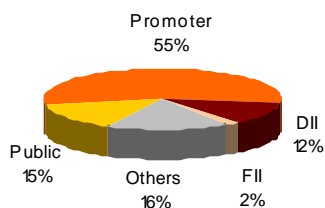
Market Data

Sector	: Construction
Market Cap (INRbn)	: 4.5
Market Cap (USDm)	: 97.9
O/S shares (m)	: 11.1
Free Float (m)	: 3.0
52-wk HI/LO (INR)	: 427/42
Avg 12m Vol ('000)	: 114
Face Value (INR)	: 10
Bloomberg	: GAYPIN
Reuters	: GAPR.BO

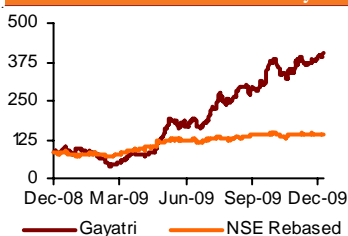
Price Performance

	1m	3m	6m	12m
Absolute	5.7	47.4	148.8	388.7
Relative	5.4	43.1	106.9	174.8

Shareholding Pattern



Price Performance vs. Nifty



Investment Rationale

Gayatri Projects Ltd. (Gayatri), incorporated in 1989 by Dr. T. Subbarami Reddy, is in the road transportation, irrigation and industrial civil construction space.

The company, through its subsidiaries, also has interests in 5 road BOT projects (4 annuity and 1 toll) which will be commissioned by FY11. It is in the early stages of commissioning 1,320MW coal based power plant at Krishnapattam (Andhra Pradesh) for which it has received all the necessary approvals/clearances. It has entered into PPA with the state grid for 70% of the generation whereas balance 30% will be available for merchant sales.

The company has an order book of INR56bn as of September 2009, executable over the next three years. The order book is well-diversified with irrigation, roads and industrial projects accounting for 68%, 27%, and 5% respectively.

At the CMP of INR402, the stock is trading at a P/E of 8.4x discounting its FY11e diluted EPS of INR47.9.

Valuation

Gayatri's robust order book and strong execution capabilities provide revenue visibility over the next three years. This coupled with stable margin scenario augurs well for the future outlook of the company. Its foray into the power segment also presents stable cash flows post commissioning of its 1,320MW power plant at Krishnapattam. We initiate coverage on the stock of the company with a BUY recommendation and with a price target of INR494 (based on SOTP valuation), presenting a potential upside of 23%.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	10,046	12,332	15,199	18,852
EBITDA	1,136	1,464	1,835	2,301
EBITDA Margin	11.3	11.9	12.1	12.2
EBITDA growth	7.3	28.9	25.3	25.4
PAT	404	573	695	937
PAT growth	5.1	23.2	36.5	34.9
EPS (INR)	28.5	35.1	47.9	64.6
EPS growth	5.1	23.2	36.5	34.9
P/E	14.1	11.5	8.4	6.2
P/BV	1.9	1.6	1.3	1.1
EV/EBITDA	5.9	5.7	5.1	4.2
RoE (%)	20.9	20.5	19.3	19.4

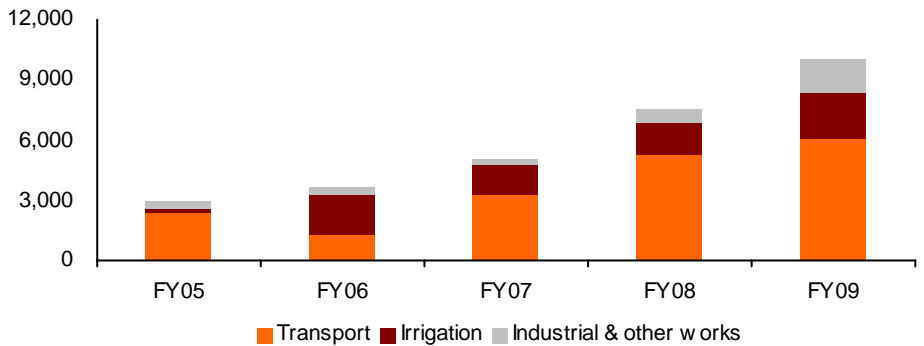
Nirav Shah +91 22 4031 3473
nirav.shah@antiquelimited.com

Source: Company, Antique

Introduction

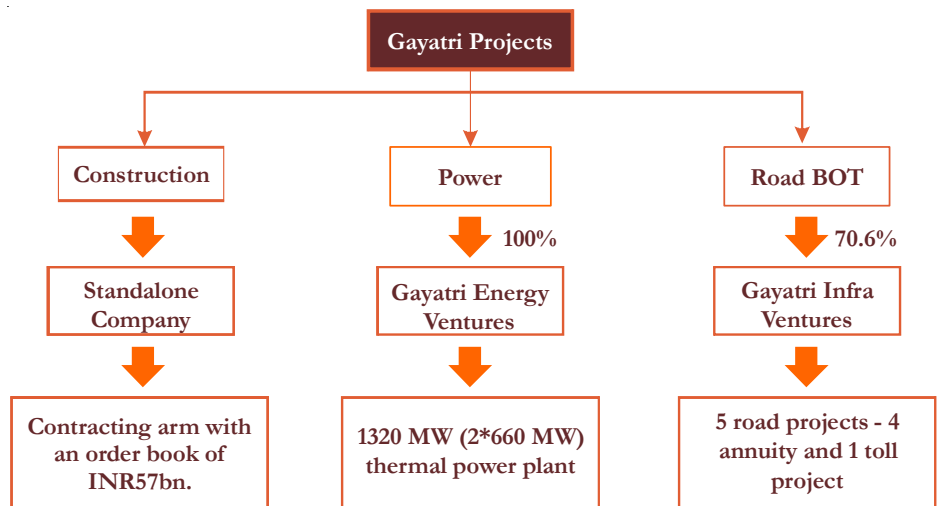
Hyderabad based Gayatri Projects Ltd. (Gayatri) commenced operations as a proprietary concern in 1963 under Dr. T Subbarami Reddy and was later incorporated in 1989 as Andhra Coastal Construction Private Ltd. to undertake construction activities in Andhra Pradesh. However, it gradually diversified its geographical operations and has currently executed projects across India in the space of road transportation, irrigation and industrial civil construction space. Its revenues and profits have grown at an impressive CAGR of 41% and 32% over the last three years. As of FY09, roads contributed 61% to total revenues whereas irrigation and industrial projects contributed 22% and 17% respectively.

Yearly Revenue Break-up (INRm)



Source: Company

Group Structure

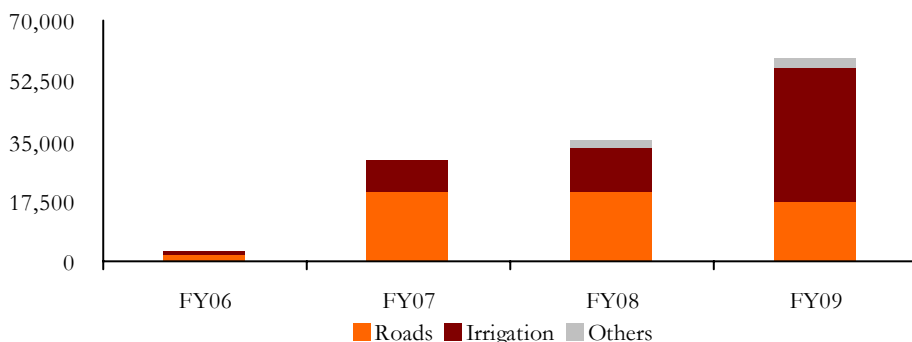


Source: Company

Apart from presence in the construction vertical, Gayatri also has interests in road BOT projects and power business through its subsidiaries Gayatri Infra Ventures Ltd. (70.6%) and Gayatri Energy Ventures (100% subsidiary). Although the existing road BOT projects are nearing completion, the power project is at a nascent stage with the company receiving all the necessary clearances and the project is yet to achieve financial closure. Gayatri has executed projects across different verticals of infrastructure like highways, irrigation, industrial civil construction, ports, airports, mass excavations, etc. Since inception as a proprietary company in 1963, it has constructed over 1,000kms of Highways, 1,200kms of irrigation canals and 9 projects for construction of dams and reservoirs.

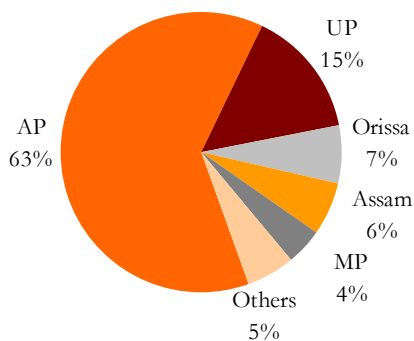
It has an order book of INR56bn as of September 2009, executable over the next three years. The order book continues to be concentrated to the A.P. state, which accounts for 63%. However, it is well diversified in terms of segment-wise break up with irrigation accounting for 68%, roads and transport for 27% and industrial projects for 5%. The order book coverage ratio stands at a comfortable 5.6x, ensuring robust growth over the next three years.

Yearly Trend in Order Book



Source: Company

Region-wise Order Book Break-up



Source: Company

Segment-wise Analysis

Irrigation

Over the last few years, Gayatri has increased its focus on irrigation segment, which is also visible in the sharp rise in the segment's order-book. Order-backlog, which stood at INR9.2bn in FY07 (30.9% of total order-book), has surged to the present INR38.1bn (68% of total order-book). The company is currently executing orders in AP, Orissa and Madhya Pradesh with AP accounting for over 90% of the total orders.

Projects under execution and key projects executed

Scope of work	Contract Value (INRm)
Projects completed	
Construction of Upper Krishna Project, (AP)	1,308
Construction of Narmada main canal reach (Gujarat)	1,334
Rehabilitation and modernisation of Kakatiya canal	1,300
Excavation and concrete lining of K.C. canal (AP)	940
Projects under execution	
Velugonda Project (AP)	3,333
Polavaram Irrigation Canal (AP)	3,013
Rajiv Sagar Lift Irrigation Project (AP)	2,816
Sriram Sagar Flood Flow Canal (AP)	1,870

Source: Company

Roads

Gayatri has constructed projects worth over INR30bn in the roads and highways segment over the last three decades. It plans to leverage its experience and expand its operations in pre-qualifications by participating in bids for more complex projects. Gayatri is also the EPC contractor for some of the road BOT projects of its subsidiary, Gayatri Infra Ventures Ltd. Of the five existing BOT projects, Gayatri is the EPC contractor for Hyderabad Expressway, Gayatri Lalitpur and Gayatri Jhansi projects. Thus, further order inflow can be expected in case the subsidiary successfully bids for more BOT road projects.

Projects under execution and key projects executed

Scope of work	Contract Value (INRm)
Projects completed	
Widening and upgrading of the existing 2 lane road (Ongole - Chilakaluripet) on NH No 5, A.P	2,312
Widening and strengthening of Tallada - Devarapalli road	1,428
Upgradation of Road from Hungund to Belgaum	1,401
Widening and Strengthening of Warangal – Khammam Road and Khammam – Tallada Road	1,362
Projects under execution	
Design, construction, development, finance, operation and maintenance of Hyderabad ORR	3,620
Design, construction, development, finance, operation and maintenance of NH No 25/26	3,450
Hyderabad ORR (Patancheru - Shamirpet and Mallampet - Dundigal)	3,240
Upgradation of Naranpur - Pandapada - Harichandanpur - Bramhanipal - Duburi Road, Orissa	3,119
Design, construction, development, finance, operation and maintenance of NH No 26	2,530

Source: Company

The segment has been a key contributor to the revenues, with a share of around 61%. However, the share of roads (including BOT) to total order-book has declined from around 68% in FY07 to 27% as on October 2009, on back of robust inflows from the irrigation segment.

Industrial Projects

In the industrial projects space, Gayatri's client list includes marquee names like Nagarjuna Fertilisers, Reliance Petroleum, Visakhapatnam Steel, Jindal Vijaynagar, Tata Steel, etc. Its scope of operations includes site preparation and grading, construction of roads, ponds, reservoirs and industrial structures. It has also executed projects for Indian Railways (construction of railway line for Koraput - Rayagada line), Kakinada Sea Ports Ltd. (construction of approach berth and back-up area) and Airport Authority (extension and strengthening of runway). The company is also likely to be awarded the EPC work for the 1,320MW power plant from its subsidiary Gayatri Energy Ventures. The segment accounts for 5% and 17% of the total order-book (September 2009) and revenues (FY09).

Subsidiaries Details

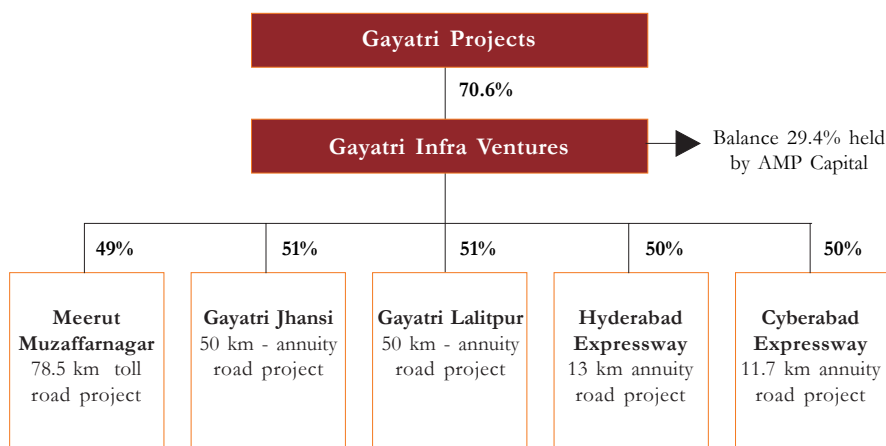
Gayatri Infra Ventures Ltd.

Gayatri Infra Ventures Ltd. (GIVL) was incorporated in January 2008 as a wholly owned subsidiary to execute infrastructure projects related to construction, operation and maintenance of roads, highways, toll roads, vehicular tunnels and bridges.

In August 2008, it raised INR1bn (with an option to raise another INR1bn) by divesting 29.4% stake to AMP Capital Finance Mauritius Ltd. The funds raised were utilized to meet the working capital requirements of the existing projects as well as future bids and concessions undertaken by GIVL.

The company currently has a portfolio of five BOT projects under execution of which four projects are on annuity basis and one on toll basis. Additionally, it is L1 in an INR20bn road BOT project. Thus, it may exercise its option to raise an additional INR1bn from AMP Capital, however ensuring that its stake does not fall below 51%.

Structure of Gayatri Infra Ventures



Source: Company

Western UP Tollway Ltd (WUPTL)

The project, to construct a 78.5km highway on National Highway (NH)-59, was awarded to the SPV consortium of Gayatri (40%), Nagarjuna Construction (30%) and Maytas Infra Pvt. Ltd. (30%). Post exit of Maytas Infra from the SPV, Gayatri and Nagarjuna Construction increased their stake to the present 49% and 51% respectively. The scope of project includes improvement, operation and maintenance of Rehabilitation and strengthening of existing 2-lane and widening to 4-lane dividing highway on the Meerut - Muzaffarnagar section in UP.

Meerut - Muzaffarnagar Toll Project Details

	INRm
Length of the project (kms)	78.5
EPC cost per km	70.2
Cost of the project	
EPC cost	5,510
Preliminary and other expenses	259
Design and supervision fees	59
Interest during construction	785
Contingency	56
Total	6,670
Equity share capital	936
Preference share capital	618
Term Loans	4,552
NHAI grant	564
Total	6,670

Source: Company

The total cost of 78.5km stretch is estimated at INR6.67bn, funded in the D:E ratio of 2.9x, which excludes a grant of INR564m received from NHAI. The agreement was signed on September 2005 with a concession period of 20 years (excluding construction duration of 30 months). The project is expected to be completed by June 2010.

Gayatri Lalitpur Roadways Ltd. (GLRL)

GLRL, a jointly promoted SPV by Gayatri and Infrastructure Development Finance Company (IDFC) (51:49 share), was awarded the project to design, develop, construct, operate and maintain 50km stretch between Jhansi and Lalitpur on NH-26. The project was awarded under the National Highway Development Program (NHDP)-II. The scope of work involves strengthening and widening of the existing 2-lane highway to 4-lane. While Gayatri will be responsible for the construction, operation and maintenance of the stretch, IDFC will be the financial partner.

The total cost of the project is estimated at INR3.1bn funded in the D:E of 4.2x with Gayatri's equity contribution at INR306m. The SPV has a 20 year concession period with NHAI, which includes the construction period, along with a semi-annual annuity payment of INR239.5m.

Gayatri Jhansi Roadways Ltd. (GJRL)

GJRL, a jointly promoted SPV by Gayatri and IDFC (51:49 share), was awarded the project to design, develop, construct, operate and maintain 50km stretch between Jhansi and Lalitpur on NH-25/26. The project was awarded under the NHDP-II. The scope of work involves strengthening and widening of the existing 2-lane highway to 4-lane. While Gayatri will be responsible for the construction, operation and maintenance of the stretch, IDFC will be the financial partner.

The total cost of the project is estimated at INR4.2bn funded in the D:E of 4.3x with Gayatri's equity contribution at INR408m. The SPV has a 20 year concession period with NHAI, which includes the construction period, along with a semi-annual annuity payment of INR299.5m.

GLRL and GJRL Project Details

INR m	GLRL	GJRL	Total
Length of the road (kms)	50	50	100
EPC cost per km	51	69	
Project Cost Snapshot			
EPC costs	2,530	3,450	5,980
Preliminary expenses	13	17	30
Consultant fees	19	26	45
Finance fees	17	23	40
Interest during construction	188	258	445
Contingency	60	86	146
Working capital	300	350	650
Total project cost	3,126	4,210	7,336
Financing mix			
Equity	600	800	1,400
Subordinate debt	190	250	440
Senior debt	2,336	3,160	5,496
Total	3,126	4,210	7,336

Source: Company

Hyderabad Expressway Pvt. Ltd. (HEPL)

Maytas-Gayatri consortium, a 50:50 Joint Venture (JV) promoted by Maytas Infrastructure and Gayatri, bagged the INR5bn project from Hyderabad Urban Development Authority (HUDA) for constructing, developing, financing, operating and maintaining 13km 8-lane expressway under Phase-II program of the Hyderabad outer ring road (ORR) from Bongulur to Tukkuguda. The project, awarded on an annuity basis with semi-annual annuity of INR310m, has a concession period of 15 years including construction period of 2.5 years.

Cyberabad Expressway Pvt. Ltd. (CEPL)

Maytas-Gayatri consortium, a 50:50 JV promoted by Maytas Infrastructure and Gayatri bagged the INR4.3bn project from Hyderabad Urban Development Authority (HUDA) for constructing, developing, financing, operating and maintaining 11.7km 8-lane expressway under Phase-II program of the Hyderabad outer ring road (ORR) from Kollur to Patancheru.

The project, awarded on an annuity basis with semi-annual annuity of INR395m, has a concession period of 15 years including construction period of 2.5 years.

HEPL and CEPL Project Details

	HEPL	CEPL	Total
Project Cost Snapshot			
EPC and directly related costs	3,620	4,150	7,770
Preliminary and pre-operative expenses	197	227	424
Interest during construction	333	434	766
Interest upto first annuity payment	160	207	367
Total project cost	4,310	5,018	9,327
Financing mix			
Equity	682	447	1,129
Grant	719	807	1,526
Debt	2,909	3,763	6,672
Total	4,310	5,018	9,327

Source: Company

The management expects HEPL and CEPL to receive COD (Commercial Operation Date) by March 2010 and June 2010 respectively. Commencing operations ahead the schedule will make the JV and the EPC contractor eligible for a bonus of one annuity i.e. INR700m (INR305m for HEPL and INR395m for CEPL). Of the total bonus, 50% will be shared by the EPC contractor and the balance by the consortium. Thus, Gayatri will receive INR152m for being the EPC contractor for HEPL, Maytas will receive INR198m for being the EPC contractor for CEPL and the Maytas-Gayatri consortium will receive the balance INR350m. We have not factored in any benefits from the above bonus while arriving at our estimates.

Gayatri Energy Ventures (GEV)

GEV, a wholly-owned subsidiary of Gayatri, was incorporated to capitalise on the opportunities in the power sector. GEV is setting up a 1,320MW coal based power plant at Krishnapattam, Andhra Pradesh. Expected to cost INR70bn, the project will be funded in the D/E ratio of 3x. It has received all the necessary clearances viz. land, water and environment and plans to complete the financial closure by March 2010.

GEV has also signed a power purchase agreement (PPA) with the Andhra Pradesh State Grid for 70% of the generation with balance power generated will be available for sale on a merchant basis. It has also been allocated coal linkages from Mahanadi Coalfields Ltd for 70% of the requirement. However, it will rely on imported coal from Indonesia for meeting the coal requirement for the balance 30% generation.

Of the total equity component of INR17.3bn, Gayatri has already infused INR1.5bn as on November 2009. It is looking for inducting a strategic investor by diluting not more than 50% stake in the project. Gayatri is also likely to secure the EPC work contract estimated at INR10bn.

SWOT Analysis

Strengths

- 1) **Strong track record:** Gayatri has successfully demonstrated strong execution capabilities in completing projects in the roads, irrigation and industrial projects segment within the stipulated time and in a cost competitive manner. Execution of road projects in excess of INR30bn has enabled the company to pre-qualify for some most of the projects.
- 2) **Robust order-book:** At 5.6x its FY09 revenues, the company has one of the highest order-book coverage ratios in the industry. This presents high degree of revenue visibility over the next 36 months.
- 3) **Diversified order-book:** The company's order-book is well diversified with roads, irrigation and industrial projects accounting for 27%, 68% and 5% respectively. Such diversification enables it to reduce its dependence on any particular sector.
- 4) **Joint Ventures:** Gayatri has entered into JV's with companies like DLF, Jaiprakash Associates, etc which helps the company meet the net worth criteria for qualifying for large projects announced by NHAI. It has also entered into Joint Ventures for securing and executing various projects in the irrigation segment.

Weakness

- 1) **Concentration of order-book:** Gayatri has a high concentration of order book in the Andhra Pradesh region, with the state accounting for over 63% of total order book and over 90% of the irrigation segment. This exposes the company to political risk in an event of change in policy/government.
- 2) **High share of government orders:** Around 95% of the order book relates to projects sponsored by either government or governmental sponsored agencies. Higher share of such orders can potentially extend the working capital cycle of the company and negatively impact its profitability.

Opportunities

- 1) **Government spend on irrigation:** With improvement of irrigation infrastructure being a high priority for states like Maharashtra, Andhra Pradesh, Madhya Pradesh, etc., robust spends by the respective state governments are expected for the construction of dams, canals, lift irrigation, urban infrastructure, etc. This provides a large addressable market to players like Gayatri.
- 2) **Robust spend on road infrastructure:** Gayatri can capitalise on the robust spend on improving the road infrastructure either through BOT or EPC basis. With over 35,000 kms of road projects up for bidding, there exists enough revenue visibility for players present in the segment.

Threat

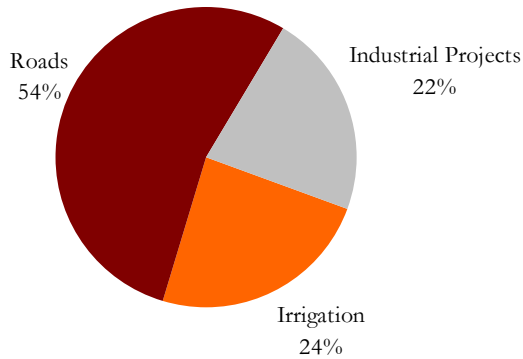
- 1) **Competition from established players:** Gayatri faces stiff competition from players like Larson & Tubro, Patel Engineering, IVRCL, Nagarjuna, for securing big ticket orders in the road transportation and irrigation segment.
- 2) **Competitive bidding may impact margins:** With intensifying competition and entry of foreign players, companies may bid aggressively in order to secure orders. This may have a negative impact on the margins of the company and impact its profitability.
- 3) **Hardening of interest rates:** Rise in interest rates can significantly impact the profitability as infrastructure projects are funded with higher debt levels.

Our View

Gayatri has established its presence in the roads segment and would like to consolidate its position with a focus on large sized orders. In the irrigation segment, it will focus on timely execution of the orders in hand and strengthen its presence. Further order inflows are expected to remain robust considering orders from new BOT road projects and 1,320MW power plant.

We expect Gayatri to post net sales of INR12.3bn and INR15.2bn in FY10e and FY11e, a growth of 22.8% and 23.2% respectively. Margins are expected to remain stable at 11.9% and 12.1% in FY10e and FY11e. Capital charges should increase by 22% and 13% to INR687m and INR774m, as a result of capex and higher requirement of working capital due to increased project execution. With tax rate of 34%, we expect net profits to grow by 23% and 37% in FY10e and FY11e to INR509m and INR695m, respectively.

Revenue Break-up (FY11e)



Source: Antique

Valuation and Recommendation

At the CMP of INR370, the stock is trading at a P/E of 8.4x discounting its FY11e EPS of INR47.9. It is trading at an EV/Sales and EV/EBIDTA of 0.6x and 1.1x its FY11e respectively.

Gayatri's robust order-book and strong execution capabilities provides revenue visibility over the next 3 years. Strong revenue growth coupled with stable margin scenario augurs well for the future outlook of the company. Its foray into the power segment also presents stable cash flows post commissioning of its 1,320MW power plant at Krishnapattam. We initiate coverage on the stock of the company with a BUY recommendation and with a price target of INR494 (based on SOTP valuation), presenting a potential upside of 23%.

SOTP Valuation

Standalone Valuation		INR / Share
FY11 EPS		48
Target Multiple		6.5
Fair Value		311
Subsidiary Valuation	Method	
Gayatri Infra Ventures Ltd.		
Western UP Tollway Limited	NPV	17
Gayatri Lalitpur Roadways Ltd.	NPV	10
Gayatri Jhansi Roadways Ltd.	NPV	6
Hyderabad Expressways Pvt Ltd.	NPV	11
Cyberabad Expressways Pvt Ltd.	NPV	14
Gayatri Energy Ventures	20% premium to equity	124
Target Price		494

Source: Antique

Key Concerns

- 1) The 40:60 JV with IJM Corporation Berhad (Malaysia), which was formed to execute road projects in AP, has accumulated losses of INR1.3bn due to contract failures on part of the employer. The JV has also raised claims of INR3.1bn on NHAI and AP government which are pending in the various platforms of the courts. In an event where the entire claim amount is rejected, Gayatri will have to provide for its share of INR538m in losses.
- 2) Gayatri's 50:50 JV with ECI Engineers for executing road projects in Assam has accumulated losses of INR296m. It has not provided for its share of INR148m in losses as the execution of the projects (AS-10, AS-11 and AS-27) has been impacted by law and order problems in the state. However, the company is confident of recovering the costs upon successful execution of the projects.
- 3) The ongoing political situation in AP relating to demands for a separate state (Telangana) can result in a delay in disbursements of dues. This can increase the short term working capital requirements of the company, thereby impacting profitability.

Financials (INRm)

Profit and Loss Account

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	7,524	10,046	12,332	15,199	18,852
Expenses	6,465	8,910	10,868	13,364	16,551
Operating Profit	1,058	1,136	1,464	1,835	2,301
Other income	33	54	64	-	-
EBIDT	1,092	1,190	1,528	1,835	2,301
Depreciation	164	197	247	324	381
Interest expense	337	369	440	450	490
Profit before tax	591	625	841	1,061	1,431
Taxes incl deferred taxation	219	221	268	366	494
Profit after tax before MI & EO Items	372	404	573	695	937
Extra ordinary Items	-	-	-	-	-
Profit after tax	372	404	573	695	937
Diluted EPS (INR)	27.1	28.5	35.1	47.9	64.6

Balance Sheet

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	101	101	111	145	145
Reserves & Surplus	1,691	2,056	2,688	4,251	5,111
Networth	1,792	2,158	2,799	4,396	5,256
Debt	3,102	3,608	4,400	4,094	4,450
Deferred Tax Liability	187	186	186	186	186
Capital Employed	5,080	5,951	7,385	8,675	9,892
Gross Fixed Assets	2,573	2,748	3,298	3,998	4,698
Accumulated Depreciation	944	1,141	1,389	1,712	2,093
Net Assets	1,629	1,607	1,909	2,286	2,605
Capital work in progress	-	-	-	-	-
Investments	662	1,283	1,283	1,283	1,283
Current Assets, Loans & Advances					
Inventory	386	604	652	802	993
Debtors	1,680	2,239	2,898	3,572	4,430
Cash & Bank balance	756	588	550	591	620
Loans & advances and others	2,371	2,765	3,405	4,187	4,942
Current Liabilities & Provisions					
Creditors	2,299	3,015	3,192	3,925	4,861
Other liabilities & provisions	104	120	120	120	120
Net Current Assets	2,789	3,061	4,192	5,106	6,004
Misc. Expenses	-	-	-	-	-
Application of Funds	5,080	5,951	7,385	8,675	9,892

Per share data

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	10.1	10.1	11.1	14.5	14.5
BVPS (INR)	177.3	213.5	252.1	303.1	362.5
CEPS (INR)	53.0	59.4	73.9	70.2	90.9
DPS (INR)	2.5	4.0	4.0	4.5	4.5

Margins (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	14.1	11.3	11.9	12.1	12.2
EBIT	12.3	9.9	10.4	9.9	10.2
PAT	4.9	4.0	4.6	4.6	5.0

Financials (INRm)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	612	634	777	1,061	1,431
Depreciation & amortisation	164	197	247	324	381
Interest expense	337	369	440	450	490
Interest / Dividend Recd	-	-	-	-	-
Other Adjustments	(7)	(3)	-	-	-
(Inc)/Dec in working capital	(306)	(488)	(1,169)	(872)	(869)
Tax paid	(202)	(219)	(268)	(366)	(494)
CF from operating activities	598	490	27	596	938
Capital expenditure	(508)	(175)	(550)	(700)	(700)
Net Investments	(304)	(621)	-	-	-
Income from investments	-	-	-	-	-
CF from investing activities	(812)	(796)	(550)	(700)	(700)
Inc/(Dec) in share capital	-	-	185	978	-
Inc/(Dec) in debt	1,027	506	792	(306)	356
Dividends & Interest paid	(337)	(369)	(492)	(527)	(566)
CF from financing activities	690	137	485	145	(210)
Net cash flow	476	(168)	(38)	42	28
Opening balance	280	756	588	550	591
Closing balance	756	588	550	591	620

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	49.8	33.5	22.8	23.2	24.0
EBITDA	40.2	7.3	28.9	25.3	25.4
PAT	66.8	5.1	23.2	36.5	34.9
EPS	27.7	5.1	23.2	36.5	34.9

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	14.8	14.1	11.5	8.4	6.2
P/BV	2.3	1.9	1.6	1.3	1.1
EV/EBITDA	5.8	5.9	5.7	5.1	4.2
EV/Sales	0.9	0.7	0.7	0.6	0.5
Dividend Yield (%)	0.6	1.0	1.0	1.1	1.1

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	24.6	20.9	20.5	19.3	19.4
RoCE (%)	19.9	18.2	18.3	18.8	20.7
Debt/Equity (x)	1.3	1.4	1.4	0.8	0.7
EBIT/Interest (x)	2.8	2.7	2.8	3.4	3.9

Note

Great Eastern Shipping Co. Ltd.

On full steam...



BUY

CMP: INR272

Target Price: INR330

December 22, 2009

Strictly confidential

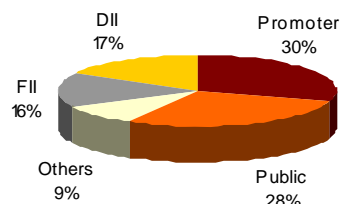
Market Data

Sector	: Shipping
Market Cap (INRbn)	: 41.4
Market Cap (USDm)	: 862.6
O/S shares (m)	: 152.3
Free Float (m)	: 42.6
52-wk HI/LO (INR)	: 316/142
Avg 12m Vol ('000)	: 975
Face Value (INR)	: 10
Bloomberg	: GESCO IN
Reuters	: GESC.BO

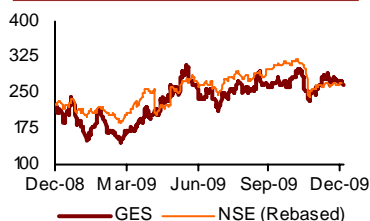
Price Performance

	1m	3m	6m	12m
Absolute	3.2	1.6	1.0	18.5
Relative	1.7	(3.6)	(12.1)	(31.9)

Shareholding Pattern



Price Performance vs. Nifty



Investment Rationale

Great Eastern Shipping Ltd. (GES), a Mumbai based company, is India's largest private sector shipping company. It commenced operations as an inhouse entity for the Mulji (Sheth) and Bhiwandiwalla family with one ship to expand their trading business in 1948.

Over the last sixty years, the company has not only expanded its fleet to include bulk, tanker and offshore segments, but also has demonstrated an enviable track record in procuring and disposing of shipping assets at the most opportune times.

Its present fleet comprises of 31 tankers, 6 bulk carriers and 14 offshore assets. GES will add 7 shipping vessels and 12 offshore vessels to its fleet over the next two years.

At CMP of INR272, the company is trading at a P/E of 3.9x & EV/sales of 2.3x, discounting its FY11e numbers.

Valuation

GES, by virtue of being the largest shipping company domestically and having a diversified vessel profile has withstood the protracted downturn in the shipping markets. It has an optimum mix of time and spot charters and also with a growing offshore vertical, seems poised to emerge out of this bloodbath unscathed.

On a SOTP basis, we have valued the shipping business at a 30% discount to its present NAV of INR230 i.e a value of Rs160. The offshore business, which is more stable, has been assigned a PER of 5.5x FY11 estimates which gives it a value of Rs170. Thus we believe the fair value of GES stands at INR330, giving a potential upside of 23%.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	37,916	26,465	35,793	38,761
EBITDA	15,404	12,270	18,892	20,983
EBITDA margin	40.6	46.4	52.8	54.1
EBITDA growth	13.0	(20.3)	54.0	11.1
PAT	14,090	6,358	10,493	11,812
PAT growth	12.0	(54.9)	65.0	12.6
EPS (INR)	87.3	41.8	68.9	77.6
EPS growth	6.4	(52.5)	65.0	12.6
P/E	3.1	6.5	3.9	3.5
P/BV	0.8	0.7	0.6	0.5
EV/EBITDA	2.9	4.9	4.0	3.7
RoE (%)	28.0	11.5	16.9	16.6

Syed Sagheer +91 22 4031 3469
syed.sagheer@antiquelimited.com

Source: Antique

Introduction

Great Eastern Shipping (GES), is India's largest private sector shipping company based out of Mumbai and has been in operation since 1948. It commenced operations as an inhouse entity for the Mulji (Sheth) and Bhiwandiwalla family with one ship to expand their trading business. Over the last sixty years, its has expanded its fleet to include bulk, tanker and offshore segments. Its present fleet comprises of 31 tankers, 6 bulk carriers and 14 offshore assets. GES will add 7 shipping vessels (5 bulk, 2 tanker) and 12 offshore vessels to its fleet over the next two years.

Business Model

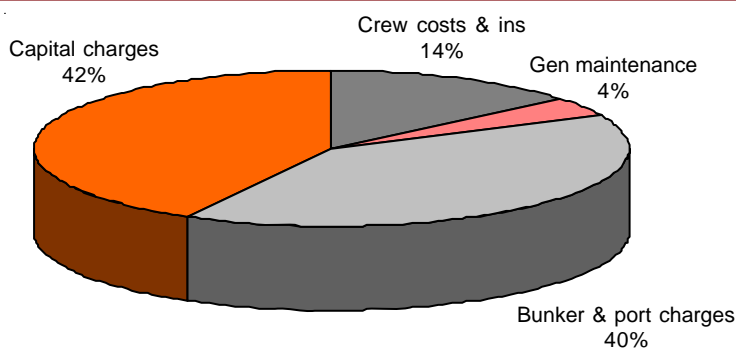
Revenue Model

Shipping lines derive revenues by letting out their ships for hire for a specific time period, voyage or other means of measurement. The charges vary depending on the type of contract. Primarily, contracts are of four types i.e. time charter, voyage (spot), contract of affreightment (COA) and bareboat charter. Time charter is when a vessel is chartered for a specific time period locked in at a fixed day rate, while voyage charter rates are determined as per the market rates existing on that day or week. COA type of contract would mean that the shipping line is paid on a per ton or a similar measure basis i.e. on basis of output delivered for that particular time period. COA agreements generally have a certain minimum gurantee of volumes. Bareboat charter is letting out only the vessel to a third party for a certain day rate without any additional manpower to service that vessel.

Expense Model

Expenses for a shipping vessel largely consists of voyage costs and capital charges in an equal measure. Total expenses in a shipping line comprises of 14% opex (crew and upkeep), 4% maintenance, 40% voyage costs (bunker, port charges) and 42% capital costs (interest & depreciation). In case of a time charter, voyage costs i.e. bunker and port charges are borne by the charterer, while in case of voyage charter the voyage costs are borne by shipping line itself. For bareboat chartering, all charges are borne by charter party.

Shipping cost break up



Source: Industry

Fleet Profile

1. GES has an existing fleet of 37 shipping vessels and 14 offshore vessels.
2. Six bulk carriers include one cape size, panamax, handymax, handysize and 2 supramaxes with an average age of ~13 years and gross asset value (as per our calculations) of USD150m.
3. 31 tanker segment vessels comprise of six suezmaxes, six aframaxs, four long range tankers, nine medium range, five general purpose and one LPG carrier with a gross asset value of USD1bn and an average age of 10yrs.
4. In the offshore segment in its wholly owned subsidiary Greatship (India), GES has 14 vessels which include 8 AHTSVs, 5 PSVs and one Jack up rig
5. On an incharter basis, GES has one jack up rig, one PSV, one suezmax and 2 supramaxes

SWOT

Strength

1. **Astute management:** The top management with Mr Bharath Sheth at the helm currently, is an experienced team and have passed through many shipping cycles in the past four decades. Their experience in this regard is expected to stand in good stead in the current cycle much better than their peers.
2. **Diversified fleet:** GES has an active fleet of 31 tankers, 6 bulk carriers and 14 offshore vessels. This has gone a long way in diversify its revenues in the current scenario by ensuring low dependence on any one segment. This strategy will help insulate its earnings from fluctuations to a large extent.
3. **Emerging offshore division:** GES divested its inhouse offshore division into Great Offshore in CY06. Post that, it started another offshore subsidiary viz. Greatship (India) which houses its offshore assets. Greatship has a fleet of 14 vessels consisting of 8 Anchor Handling Tugs cum Supply Vessels (AHTSV), 5 Platform Supply Vessels (PSV) and one Jack up rig. It also has inchartered one Jack up rig from Mercator Lines. It plans to add 12 more vessels over the next two years. This division will drive growth in incremental earnings for the company and will overtake shipping earnings over the next 18ms.
4. **Stellar financials:** GES has consolidated cash to the tune of INR32bn and a comfortable DER of 0.5x. This would help it cushion the vagaries of the sector and yet have enough reserves to capitalise on any potential acquisitions in a distressed market.
5. **Optimum mix of time and spot charters:** GES has always timed the market well i.e. positioned more vessels in the spot markets while markets were on a blitzkreig to capitalise on the upsurge in day rates and vice versa. In this depressed scenario however, GES has largely tried to keep its vessels on spot (after they come out of contract) so as to not lock in assets at low day rates for an extended time frame. This pro active approach to time and spot mix will help GES minimise losses on its shipping revenues.

Weakness

1. **Skew in exposure to tanker segment:** Though GES is a integrated marine services operator with exposure across all segments, historically it has always been biased towards the tanker market. While the tanker segment has lesser competition due to its inherent complexity, the shifting demand dynamics due to the recession has affected demand for tankers as can be witnessed with the 60% QoQ drop in TCY earnings for tankers (however they have staged a smart recovery subsequently). With order book to total fleet for tankers standing relatively high, there could be further pressure on day rates which could act as a weakness for GES.

Opportunities

1. Energy security is the prime driver of the domestic E&P sector. Sovereign players having deep pockets and long-term strategic outlook, lend visibility to revenues of service providers in this sector. This would help GES' offshore services business post incremental earnings growth.
2. With a comfortable cash reserve of INR32bn, GES has the opportunity to buy distressed assets as opportunities arise. It can also look at smaller companies for inorganic acquisitions.
3. With the intent of deploying vessels coming out of contracts in the spot market, GES has left the leeway for getting these vessels on lucrative time charters as and when conditions improve. In other words, there is plenty of scope for upward revision in earnings.
4. GES can look at value unlocking of the offshore subsidiary by way of private equity infusion or a full fledged IPO once most of the vessels have joined the fleet and have spent reasonable time in operating conditions.

Threats

1. A prolonged slump in day rates of vessels in segments like tanker and dry bulk could have a higher than anticipated adverse impact on earnings. It can also slow down plans to expand organically and inorganically.
2. GES competes on a global basis with majors like Teekay Corp, Dry Ships etc. It can face increased competition due to non existence of a level playing field in terms of excess and double taxation, paucity of resources and reach.

Investment Rationale

We believe that the current market scenario does not make economic sense for shipping lines to operate in. The TCY for product tankers is barely at break even levels and crude tankers are making net losses. Even bulk carriers, post the improvement in day rates are having elongated pay back period. For things to improve, there should be an improvement in the demand aspect i.e. increase in ton mile demand as well as supply contraction by way of order book slippages and scrapping of vessels should occur.

Hence, we believe that the shipping cycle across segments has hit its trough and day rates from here on should improve, albeit with a lag of two quarters, on back of sporadic demand for iron ore/coal from China as well as increase in grain trade contributing to period demand from Europe. On the tanker side, demand should remain stagnant whilst day rates should improve due to increased scrapping of single hull tankers, which comprise 13% of the fleet as well as increased order book slippages.

The offshore segment day rates remain steady barring few supply side pressures on jack up rigs in spot markets like North Sea and Gulf of Mexico. We believe that the current day rates are sufficient to throw up enough free cash to fund other segments or further expansion. Long term contracts should provide visibility to revenues.

GES remains our top pick in the shipping sector for the following reasons

1. **Burgeoning offshore division to drive valuations:** GES' offshore division should overtake revenues from the standalone shipping business in two years. With a fully funded expansion plan underway, Greatship India should have an offshore vessel asset base of 25 high end support vessels and two jack up rigs in its fleet, making it one of the largest offshore services company domestically. We believe value unlocking from this aspect should trigger a re-rating for GES.

2. **Stellar financials:** With a low leverage and comfortable cash reserve, GES is in an enviable position to capture any asset mispricing in terms of organic or inorganic acquisitions which would give it an upside to current earnings.
3. **Astute management at helm:** An experienced set of professionals who have seen many such cycles in the past should be able to guide GES through this current turmoil
4. **Upside to current shipping earnings:** The shipping sector is at its trough of the cycle with earnings at historic lows. Even a slight improvement in the macro scenario can provide a fillip to our earning estimates. GES with an optimum mix of time and spot charters spread across a decent mix of tanker and bulk segment should capture any possible upsides, if any.

Our View

GES should post consolidated revenues of INR26.5bn and INR35.8bn in FY10e and FY11e, respectively on back of increasing exposure to the offshore segment. Consolidated OPM should improve by 580bps to 46.4% in FY10 and a further 640bps to 52.8% in FY11 on back of increasing share of offshore earnings to the mix, which has higher profitability. Thus, net profits should surge to INR6.4bn and INR10.5bn in FY10e and FY11e, respectively.

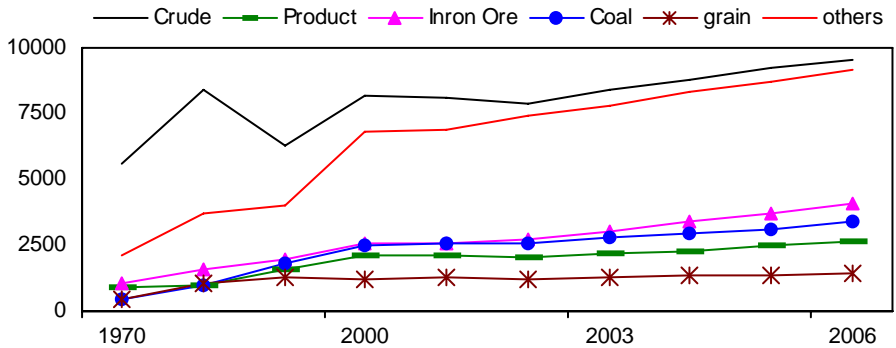
At the CMP of INR272, GES is trading at a P/E of 3.9x and EV/EBITDA of 4x, discounting its FY11e numbers. We have valued GES on a SOTP basis assigning INR160 to the shipping entity based on a 30% discount to its standalone NAV of INR230 and INR170 to offshore division based on a target PE of 5.5x FY11 estimates. Thus we arrive at a consolidated value of INR330.

Hence, we initiate coverage with a BUY recommendation and a target price of INR330, which represents a 23% upside from current levels.

Industry

Shipping is a cyclical industry and has followed many cycles in the past. Demand and supply are determined by myriad factors and are different for different segments. It plays an important part in global trade. For instance, >60% of global trade in crude oil happens through maritime mode and one third of iron ore/coal trade happens via shipping. For India, ~90% of its overall export trade happens through this mode.

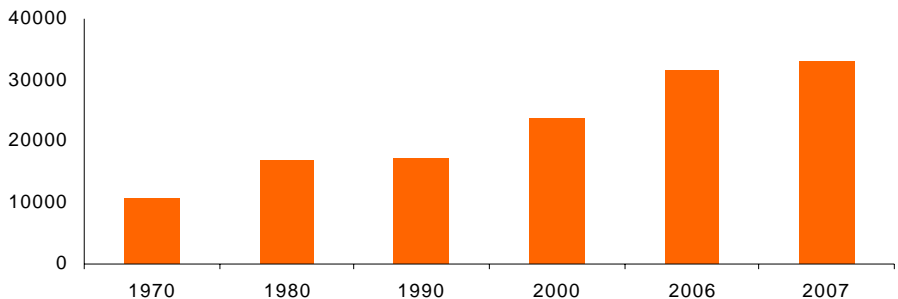
Commodity wise ton mile growth (bn ton miles)



Source: Fearnley's Review

Crude oil, iron ore and coal are globally heavy weight commodities transported largely via the marine route i.e. shipping as can be seen from the aforementioned chart. Crude oil ton miles have grown at a CAGR of 1.5% in the last 36 years and 2.6% in the last six years. Refined products have grown at a higher rate of 3.1% in the last 36 yrs. In dry bulk, coal has had the fastest growth trajectory (5.6% CAGR) followed by iron ore (3.8%) due to explosion in Chinese demand and increase in ton miles as the route elongated to areas like Brazil and Australia as supply sources.

Global ton miles Carried (bn ton miles)



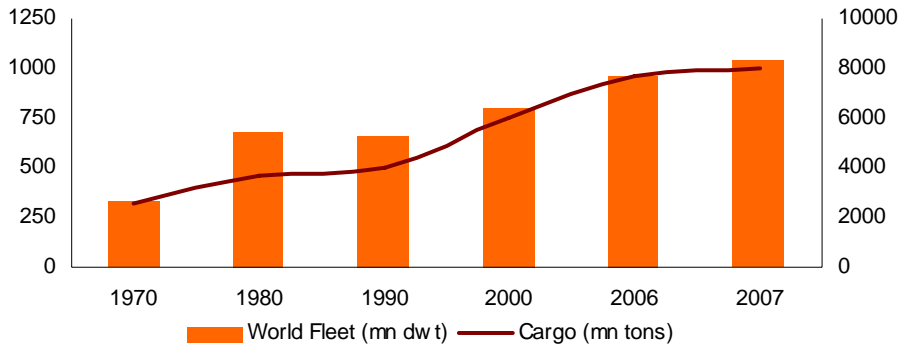
Source: Fearnley's Review

Volume carried is determined by two factors i.e. capacity and length. Capacity is determined by the supply of vessels as well as utilisation of the same. Tons carried per dwt has largely remained the same in the last three decades while ton miles performed per dwt has shown some increase thanks to changing centers of production and consumption resulting in longer routes. Global ton miles have also charted a consistent growth path in the last decade as can be seen in the following charts.

Going forward, the increase in demand should largely be led by ton miles performed per dwt as against tons carried per dwt. This is because vessels are already operating at optimum capacity per dwt as can be gleaned from the below mentioned chart. The growth in ton miles performed per dwt should increase due to changing centers of production i.e. in case of iron ore/coal, centers like Brazil and Australia should increase ton mile demand as the primary consumption center, China, falls in a longer route.

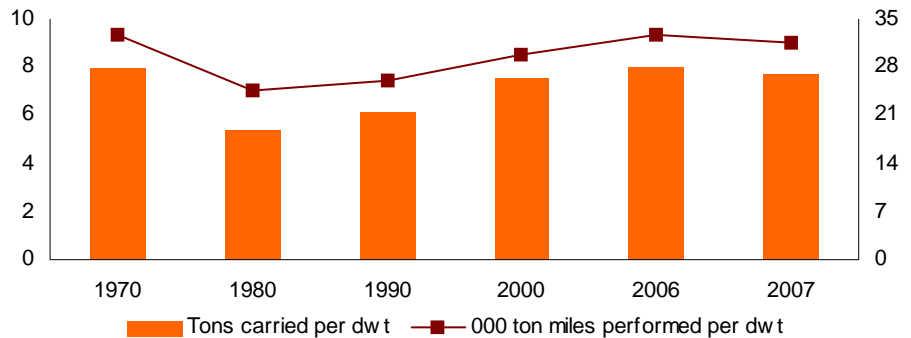
Also in case of crude oil, with refineries sprouting up in multiple and newer locations, and production also in newer centers, there should be an increase in ton mile demand.

Global Fleet and Cargo Growth



Source: Fearnley's Review

Ton Mile Performance



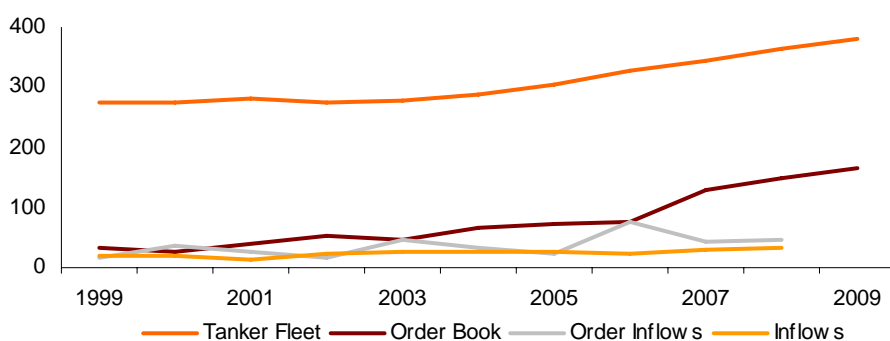
Source: Fearnley's Review

We can classify shipping industry into three major segments i.e. dry bulk, tanker and containers. Offshore services is a separate segment as it does not come under the ambit of maritime transport but that of oil exploration and allied activities and hence the demand supply dynamics are different.

Tanker Segment

This segment of shipping essentially transports crude oil and refined products. Demand depends on transportation of the same. Thus, if crude oil prices are on the rise, inventory builds up as sellers anticipate higher prices if they sell forward. Also, if crude prices are depressed for a long time, inventories build up due to lack of demand. The build up of inventory has an inverse effect on freight rates i.e. rates rise when inventories are low (more oil being transported) and vice versa.

Tanker Order Backlog Details (m dwt)



Source: Platon

The tanker market of late has seen a massive correction due to tankers used for storage joining the active fleet, demand destruction overall as well as lack of winter demand from developed countries. Hence, we saw a 60% QoQ decline in day rates and a 90% YoY decline in 2QFY10. However, day rates have recovered from their October 2009 lows and TCY's of large tankers are hovering ~USD25-30k.

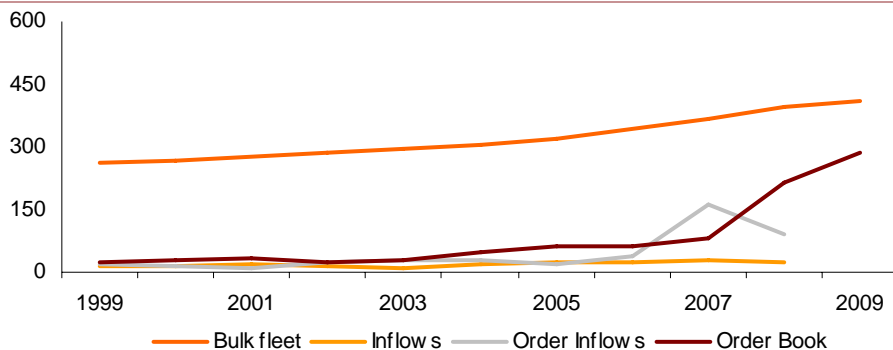
The order book to total fleet of tankers is also at a all time high of 40% whilst historically it has been in the 12-20% range. This can provide further pressure to day rates. However, some minor succor can be sought from the fact that there will be slippages in execution of the backlog as well as reduction in fleet as IMO guidelines mandate scrapping of single hull tankers which contribute ~13% of the fleet. Scrapping of single hull tankers has gathered steam with China and Fujairah also framing rules to disallow single hull carriers to dock at their ports. Also, since single hull tankers garner lower realisation as compared to their double hulled peers, there will be an increased impetus to scrap single hull tankers.

Dry bulk segment

This segment of shipping transports commodities like iron ore, coal and grains. Bulk carrier day rates are heavily influenced by demand emanating from China for iron ore/steel/coke. Another factor which also plays a major part is the ton mile demand. Changing trade patterns can have an effect on ton mile demand either positively or negatively depending on the circumstances.

Bulk freight rates touched their historic lows during December 2008 when the Baltic dry index collapsed from ~13k levels at peak to 830 points. The index staged a recovery in mid CY09 only to have a slump. But in the last quarter, there has been a slow and steady rise in the index thanks to coal demand emanating from China and period demand from Europe. TCY of Capesize ships which at peak were ~USD100k/day had collapsed to USD1,000/day and now are back to a fairly healthy USD30k levels.

Dry Bulk Order Backlog Details (m dwt)



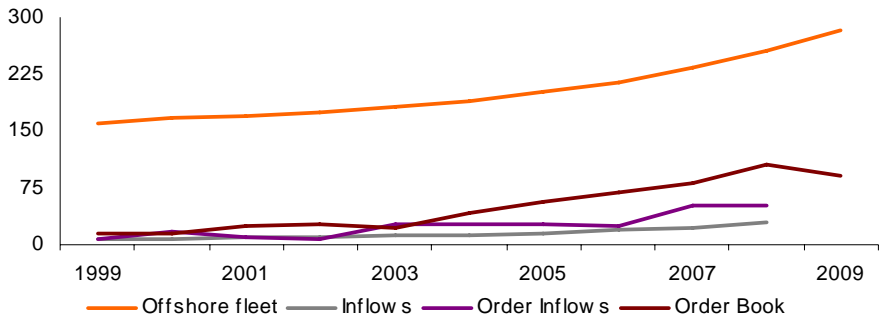
Source: Company, Antique

Historically, order book to total fleet for this segment has been ~10% for the last decade. However, post the insatiable demand from China which resulted in huge commodity spikes, there has been a rush to order bulk carriers from all shipping lines. Hence, order book to fleet stands at a historic high of ~70%. Also, this seems more worrisome in the light of trade versus fleet growth. Historically, global trade growth has always been ~4% while fleet growth was ~3%. Going ahead fleet growth (even factoring slippages in order backlog) would be ~15% while trade growth would be <4%. We expect bulk freight rates to exhibit spikes during the next 2 quarters and there is a strong possibility of rate correction with incremental supply coming in unless there is a demand revival. We draw succour from the fact that lot more slippages have been witnessed in this segment compared to the tanker market as most of the yards building dry bulk vessels are start ups, centered in China and south east asia. ~30% of the order book fleet is yet to commence execution and thus slippages could be higher in the backdrop of economic uncertainty.

Offshore segment

Offshore services includes provision of rigs, support vessels and/or ancillary equipment for the purpose of offshore oilfield drilling. This market is relatively more stable than the shipping market as can be seen from the past, wherein day rates have not fluctuated wildly. Offshore services depend on hydrocarbons i.e. exploration of crude oil which is done by government run oil companies and large private oil majors. Offshore drilling is more complex than onshore and hence the break even price of oil is higher in the former's case. Thus, when demand for oil picks up at a reasonable price band, there exists demand for drilling vessels and allied support activities. Capex in offshore services is drawn up based on a longer time frame and hence, investment committed for a particular project in a particular time frame does not follow the fluctuations in oil prices. Thus, day rates are largely stable as compared to shipping.

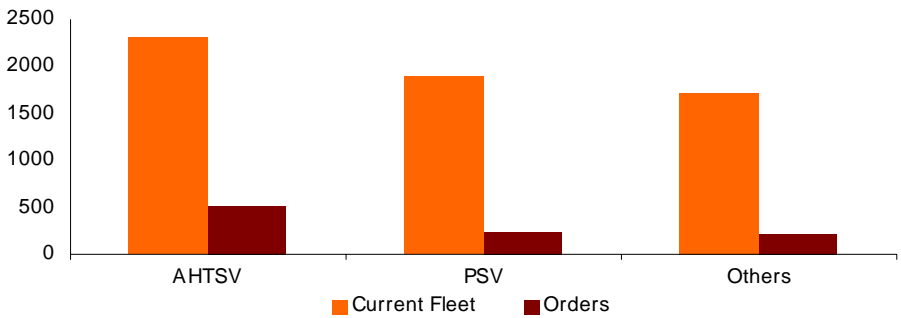
Offshore order backlog details (m dwt)



Source: Platou

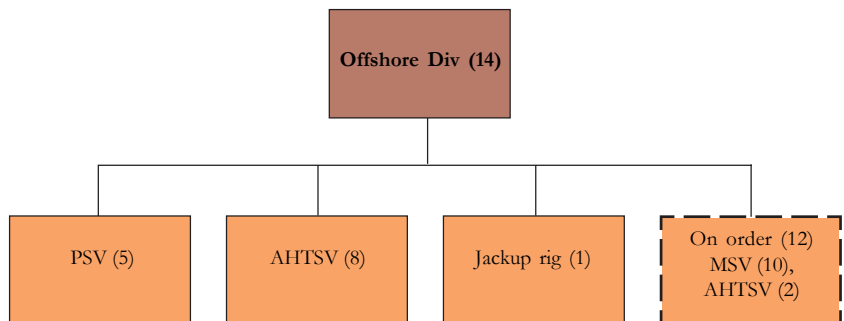
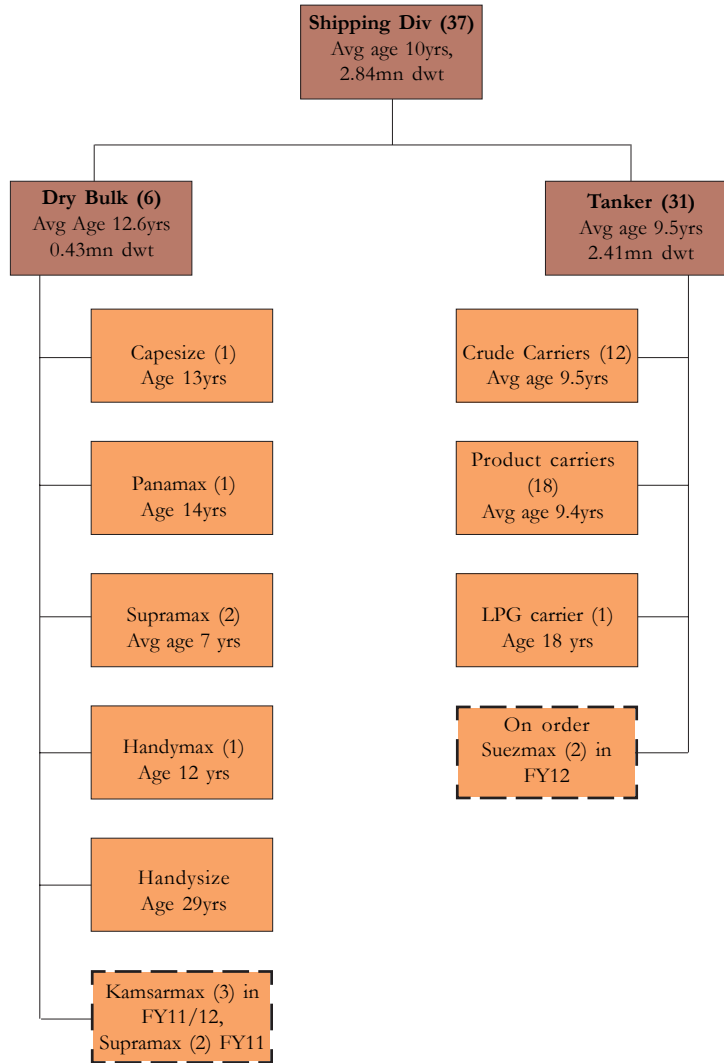
Day rates for offshore vessels are a function of demand and supply. Demand is derived from demand for crude oil whilst supply comes from new built orders placed at various ship yards. Another factor influencing supplies is the scrapping of older vessels from existing fleet due to age and technological requirements. The present order backlog of offshore segment is ~35-40% of fleet size. It is noticeably lower in the supply vessel segment wherein, as depicted below, order book to fleet is 22% in case of AHTSVs and 13% in case of PSVs.

Support Vessel Order Backlog Details (m dwt)



Source: Industry

Annexure- GE Shipping Fleet Details



Financials (INRm)

Profit and Loss Account

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	31,084	37,916	26,465	35,793	38,761
Expenses	17,452	22,512	14,195	16,901	17,778
Operating profit	13,632	15,404	12,270	18,892	20,983
Other income	4,593	4,827	2,198	1,500	1,501
EBIDT	18,224	20,231	14,467	20,392	22,484
Depreciation	3,551	3,840	4,970	5,910	6,607
Interest expense	1,616	1,847	2,897	3,465	3,465
Profit before tax	13,057	14,544	6,600	11,017	12,412
Taxes incl deferred taxation	474	454	242	523	600
Profit after tax before MI & EO Items	12,584	14,090	6,358	10,493	11,812
Extra ordinary Items	1,950	788	-	-	-
Profit after tax	10,634	13,302	6,358	10,493	11,812
Diluted EPS (INR)	69.8	87.3	41.8	68.9	77.6

Balance Sheet

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	1,523	1,523	1,523	1,523	1,523
Reserves & Surplus	41,794	50,798	56,312	64,963	74,703
Networth	43,317	52,321	57,834	66,486	76,225
Debt	27,469	42,659	50,813	55,813	50,813
Capital Employed	70,786	94,980	108,647	122,299	127,038
Gross Fixed Assets	65,897	75,148	101,848	129,198	153,304
Accumulated Depreciation	17,470	18,529	23,499	29,408	36,015
Net Assets	48,427	56,619	78,349	99,789	117,289
Capital work in progress	8,378	19,181	14,181	7,181	-
Investments	65	76	76	76	76
Current Assets, Loans & Advances					
Inventory	612	731	473	657	691
Debtors	1,497	2,284	1,588	2,505	2,713
Cash & Bank balance	15,472	25,125	20,678	15,342	9,616
Loans & advances and others	1,323	1,942	1,323	2,327	2,519
Current Liabilities & Provisions					
Current Liabilities	4,612	9,487	7,098	5,070	5,333
Provisions	376	1,489	923	507	533
Net Current Assets	13,916	19,105	16,042	15,253	9,674
Misc. Expenses	-	-	-	-	-
Application of Funds	70,786	94,980	108,647	122,299	127,038

Per share data

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	152	152	152	152	152
BVPS (INR)	284.5	343.6	379.8	436.6	500.6
CEPS (INR)	118.8	122.9	74.4	107.7	121.0
DPS (INR)	2.0	3.0	0.8	0.8	0.8

Margins (%)

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	43.9%	40.6%	46.4%	52.8%	54.1%
EBIT	47.2%	43.2%	35.9%	40.5%	41.0%
PAT	46.8%	39.2%	24.0%	29.3%	30.5%

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	13,057	14,544	6,600	11,017	12,412
Depreciation & amortisation	3,551	3,840	4,970	5,910	6,607
Interest expense	1,616	1,847	2,897	3,465	3,465
Interest / Dividend Recd	(1,147)	(1,445)	(1,598)	(1,500)	(1,501)
Other Adjustments	(2,490)	(662)	(600)	-	-
(Inc)/Dec in working capital	997	389	(1,383)	(4,548)	(146)
Tax paid	(496)	(469)	(242)	(523)	(600)
CF from operating activities	15,089	18,044	10,644	13,820	20,238
Capital expenditure	(19,723)	(19,711)	(21,700)	(20,350)	(16,926)
Net Investments	(2,291)	1,098	-	-	-
Income from investments	4,819	4,619	2,198	1,500	1,501
CF from investing activities	(17,194)	(13,995)	(19,503)	(18,850)	(15,425)
Inc/(Dec) in share capital	219	33	-	-	-
Inc/(Dec) in debt	6,358	9,178	8,154	5,000	(5,000)
Dividends & Interest paid	(3,754)	(4,100)	(3,641)	(5,307)	(5,538)
CF from financing activities	2,823	5,112	4,513	(307)	(10,538)
Net cash flow	719	9,161	(4,346)	(5,337)	(5,725)
Opening balance	11,885	13,016	22,177	17,678	12,342
Closing balance	12,603	22,177	17,831	12,341	6,616

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	43.5	22.0	(30.2)	35.2	8.3
EBITDA	27.7	13.0	(20.3)	54.0	11.1
PAT	38.9	12.0	(54.9)	65.0	12.6
EPS	38.9	6.4	(52.5)	65.0	12.6

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	3.3	3.1	6.5	3.9	3.5
P/BV	1.0	0.8	0.7	0.6	0.5
EV/EBITDA	2.9	2.9	4.9	4.0	3.7
EV/Sales	1.7	1.6	2.7	2.3	2.1
Dividend Yield (%)	5.5	2.9	1.5	3.8	4.3

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	33.7	28.0	11.5	16.9	16.6
RoCE (%)	25.9	23.7	11.2	13.8	13.1
Debt/Equity (x)	0.3	0.3	0.5	0.6	0.5
EBIT/Interest (x)	9.1	8.9	3.3	4.2	4.6

Note

HEG Ltd.

Electrifying prospects...

BUY

CMP: INR385

Target Price: INR601



December 22, 2009

Strictly confidential

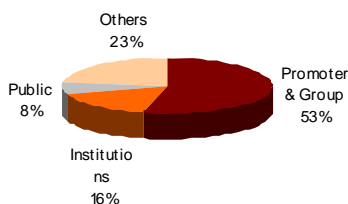
Market Data

Sector	:	Metals
Market Cap (INRbn)	:	16.3
Market Cap (USDm)	:	335
O/S shares (m)	:	41
Free Float (m)	:	25
52-wk HI/LO (INR)	:	411/94
Avg 12m Vol ('000)	:	354
Bloomberg	:	HEG IN
Reuters	:	HEGL.BO

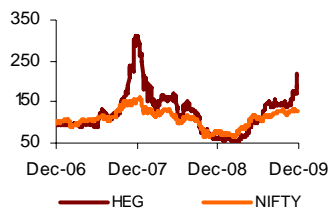
Price Performance

	1m	3m	6m	12m
Absolute	50	49	118	258
Relative	53	51	87	113

Shareholding Pattern



Price Performance vs. Nifty



Sumeet Singhania

+91 22 4031 3431

sumeet@antiquelimited.com

Investment Rationale

HEG Ltd. (HEG), a LNJ Bhilwara group company, is engaged in manufacturing of graphite electrodes with an installed capacity of 66,000tpa, backed by a captive power generation capacity of 77MW.

It is the leader in UHP(Ultra High Power) Graphite Electrodes (GE) which command significant premium over normal electrodes. Superior product mix coupled with technological competence and cost efficiency has enabled it to enjoy highest OPM in the industry. HEG is considering to scale up its capacity to 80,000tpa, wherein it will account for ~10% of the global supply of GE.

Power constitutes over 20% of the total operational cost in GE manufacturing, and hence, HEG's self-sufficiency in power on account of its captive facilities affords its significant cost benefits. It recently received coal linkages (for its thermal power plants) which will reduce power generation costs thereby boosting its OPM. The company also has surplus power capacities (~15MW) which it sells in the lucrative merchant markets, thereby generating additional profits.

We believe disproportionately larger part of the new steel capacities in the next decade will be based on Electric Arc Furnace (EAF) route due to rising environmental concerns and scrap generation in China. The capacity via this route is expected to register a CAGR of 5% to surpass the 500mt mark by CY12, thus increasing the demand for graphite electrodes. The industry has high entry barriers due to significant consolidation, which places HEG in an advantageous position. We are positive on the stock and initiate coverage with a 'BUY' recommendation and a 12-month price target of INR601, and a 56% upside from the current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	11,021	11,304	13,800	15,638
EBITDA	2,747	3,914	4,945	6,117
Margin	24.9	34.6	35.8	39.1
EBITDA growth (%)	-10	42	26	24
PAT	1,851	1,810	2,502	3,306
EPS (INR)	25.1	44.3	61.3	81.0
EPS growth (%)	-11	76	38	32
P/E	5.7	8.7	6.3	4.8
P/BV	1.2	2.0	1.5	1.2
EV/EBITDA	4.6	5.6	4.4	3.6
RoE (%)	31	23	24	24

Source: Antique

Introduction

HEG Limited, the flagship company of LNJ Bhilwara Group, commenced operation in 1977 as a manufacturer of graphite electrodes with a capacity of 24,000tpa. Beginning with technology sourced from SERS (a subsidiary of Pechiney, France), it soon scaled up its operations and now owns and operates one of the largest single-sited Graphite Electrodes (GE) plants in South East Asia, at Mandideep, MP. Strong manufacturing capabilities, captive power source and economies of scale has enabled it to emerge as a leading producer of high quality GE's on the global arena.

Currently, HEG has an installed capacity of 66,000tpa of graphite electrodes backed by 77mw of power plant capacity. It has also moved up the complexity chain and is now one of most cost competitive producer of UHP electrodes in the world.

Production Facilities

Facility	Location	Capacity	Units	Status
Graphite Electrodes	Mandideep, MP	66,000	Tonnes	Operating
Hydel Power	Tawa, MP	13.5	MW	Operating
Thermal Power plant - I	Mandideep, MP	30	MW	Operating
Thermal Power plant - II	Mandideep, MP	33	MW	Operating

Source: : Company, Antique research

Graphite electrodes - applications

Graphite electrodes find their largest industrial use as a consumable in EAFs, used in steel plants to melt steel scrap. Demand for graphite electrodes is therefore sensitive to steel production volumes (not necessarily to steel prices). Manufacturers of graphite electrodes require a high degree of operational competence and expertise, as it is a technology intensive process that involves heat-treating non-graphitic carbon to temperatures up to 3,000°C, with quality of output being a key differentiating factor.

Core competencies

HEG owns and operates the world's largest single location facility, and accounts for ~7% of the global market share. Its UHP GE, which is the latest technology, has found customer acceptance in sophisticated EAF producers in the developed economies, within three years of launch.

Its current installed capacity is 66,000tpa (~75% being earmarked for UHP) and the company has been consistently increasing output through improvements in quality and operational efficiency. The presence an in-house R&D centre focused towards innovation and excellence in the field of conventional carbon products and advanced carbon materials/ products has afforded it strong competitive advantages.

We believe with its sizeable scale and technological superiority, HEG is well geared to leverage the superior quality of its products to garner market share in the expanding global GE market.

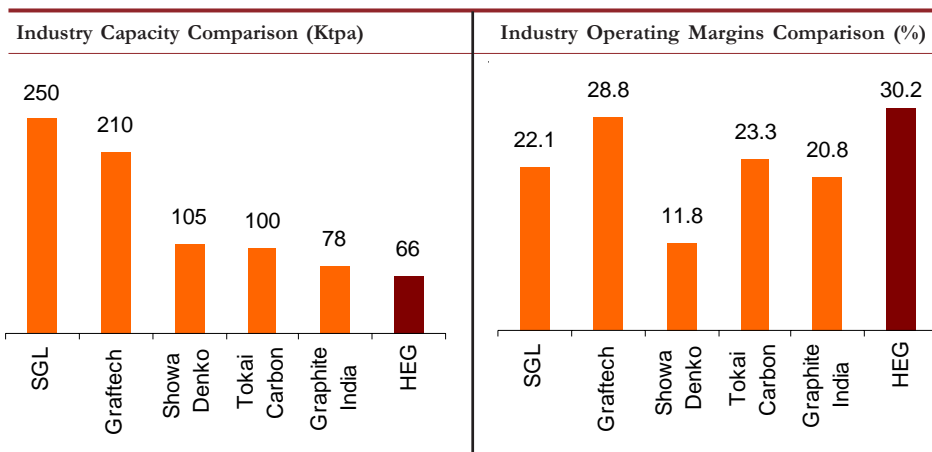
Industry Snapshot

The global GE industry has consolidated significantly over the last few years. Two of the largest manufacturers (SGL Carbon of Germany & GrafTech International Limited of US) control over 50% of global production and the top five players account for 75% of the market.

Consolidation in the industry has brought in pricing discipline and contained sharp swings in the end product prices, as it has enabled manufacturers to pass on gyrations in raw material prices. Thus, manufacturers have been able to report stability in operating margins even during periods of sharp swings in needle coke prices (key raw material) in the last two years.

Highest Margin Safety

HEG, though relatively smaller in size compared to the global giants, enjoys highest operating margins on account of its product range (high margin, value added UHP GE), superior technology and low production cost.



Source: Antique Research

Customer Portfolio

Being one of the leading suppliers of value-added UHP GE's; it boasts of a diverse customer base across the globe including markets like the Americas, Europe, South East Asia and South Africa among others. Most of the largest manufacturers of steel through EAF route both in international and domestic market are HEG's customer namely Arcelor Mittal, Nucor, Thyssen Kruppe, Posco, US Steel, Esaar Steel, Ispat Industries and Jindal Steel and Power.

Sales Mechanism

HEG's exports sales accounts for nearly 75% of the total revenues as its major customers are international steel producers (EAF). China and India, two of the fastest growing steel markets in the world employ the traditional Blast Furnace (BF) route, and hence, markets for GE in these economies has not expanded in pace with the west.

Usually, the company enters into annual contracts with its customers. However, the recent financial crisis changed the contractual mechanism significantly as the steel producers in two of its largest markets reduced their utilisation rates by over 50% on account of demand uncertainty. The scenario has been stabilising off late and has brought in some sort of demand visibility. Thus, HEG's current order book has limited visibility of a few months, unlike the year long visibility that it enjoyed in the pre-crisis period. Going ahead, we expect a robust order booking in FY11 led by continuous improvement in steel production level in the developed economies.

Order Book Flow

Particulars	Capacity (kt)	Expected utilization rate (%)
3QFY10	60	80
4QFY10	60	85
1QFY11	66	90
2QFY11	66	90

Source: Company, Antique Research

Raw Material Sourcing

The key raw materials and the consumption norm required to produce one tonne of GE are as mentioned.

Raw Material Matrix

Particulars	Units	Consumption norm
Needle Coke/CPC	Tonnes	1.0
Pitch	Tonnes	0.50-52
Fuel oil	Kilo Liters	0.40-0.425
Power	Kwh	5,800-6,000

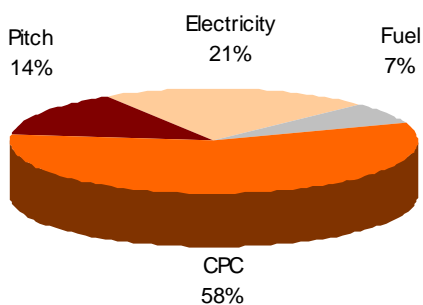
Source: Company, Antique Research

Needle coke, the key raw material, is manufactured by very few companies worldwide and is a by-product of oil refinery. As nearly 70% of the global production is controlled by a US based oil major, the supply is highly concentrated, thereby posing a risk of sharp swing in prices as well as uncertainty of delivery schedule and quantity. To mitigate some of these risks, electrode manufacturers normally lock their yearly requirement prior to the beginning of New Year, by getting into a full year volume contract with prices being fixed on a consignment basis.

As needle coke constitutes over 50% of the total raw material cost, any spike in the prices of same has the potential to significantly impact the margins of the electrode manufacturer.

Needle coke prices have been on a continuous uptrend for the past few years, driven by rising oil prices and changing demand supply dynamics. Prices of the same have increased by ~20% YoY in 2009 and the current prices are hovering around USD1,800/t. However, average cost for HEG is ~USD1500, as it uses a blend of imported needle coke (for UHP electrode) and domestic needle coke for nonUHP electrodes. Some of its product ranges also entail use of CPC, which is substantially cheaper.

Raw material cost composition



Source: Company, Antique Research

As can be inferred from the above, players like HEG do not have much bargaining power on the raw material front on account of limited supplies. Nevertheless, with UHP graphite electrode industry being itself concentrated, the manufacturers are able to pass on the increase in raw material costs to a large extent, albeit with a lag. To cite an example, the recent increase in needle coke prices (+20%) has been in excess of the increase in electrode realisations (+15%).

Captive power provides an upper hand in cost competency

Power constitutes ~20% of operational costs in manufacturing graphite electrodes as 1 tonne of GE typically consumes ~5,800-6,000 units of power. As power is probably the only variable which a manufacturer can control, HEG has been consistently focussed on the same and set up captive power generation facilities. Its current installed capacity is 77MW (13.5MW Hydel power plant at TAWA (MP), 30MW thermal power plant in Mandideep (MP) and recently commissioned 33MW in Mandideep (MP)

The recently commissioned 33MW (May 2009) was set up in order to support the proposed increase in electrode capacity from 60ktpa to 80ktpa. However, the global downturn resulted the electrode expansion plan was put on hold. The resultant surplus of power has proved to be a boon in disguise as HEG now sells the same in the lucrative merchant market, boosting its earnings. It plans to continue with this practice till the expansion of electrodes capacity fructifies.

Surplus power sales to boost earnings for next 3-5 years

HEG Limited has an installed capacity of 77MW (63MW thermal and 13.5MW Hydel) captive power plant. Its electrodes division, at a CUF of 75% consumes around 270m units (55% of total generation) leaving a surplus of ~230m units to be sold in the merchant market. However, in case CUF increases, this surplus could drop significantly.

As of now, there is no clarity on the expansion of electrodes capacity from 66,000tpa to 80,000tpa, and hence, we believe HEG will have some surplus power which could help generate additional revenues.

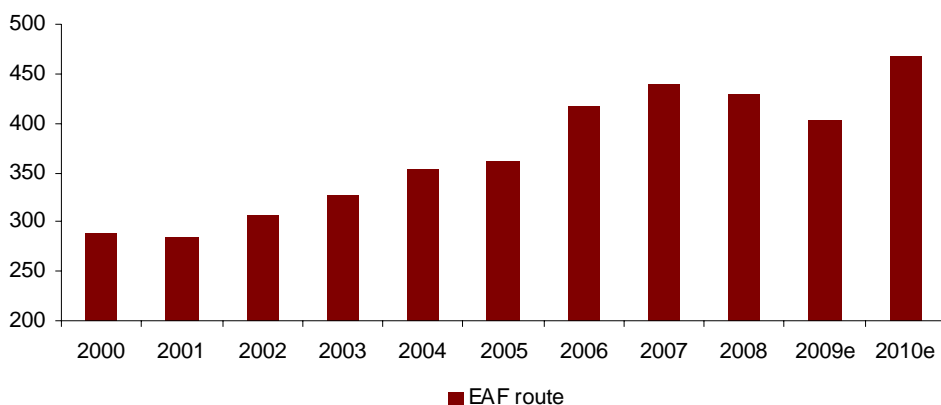
Generation cost to decline with coal linkages for power plants in place

Until now, HEG was operating its power plants on merchant coal with an average landed price of INR3,100/mt. However, it has received coal linkages for its 33MW thermal power plant which will reduce its landed coal costs. Accordingly, its generation cost is expected to come down from current INR3.5/unit to INR2.75-3.0/unit. Its hydro power plant in Tawa, MP is 15 years old and fully depreciated, with nil debt and hence, no finance cost. The total generation cost of this plant is ~INR1/kwh, however dependence on rainfall impacts the utilisation rates thus capping any substantial gains from low cost generation. All the power generated from this plant is utilised for captive consumption.

Industry Outlook

EAF steel output has been rising globally, and from 296MT in 2001, it increased to 365MT in 2006 and is expected to touch 410MT by 2010. China is producing ~15% of its steel through the EAF route, while in the US the same is >50%. Considering that quality iron ore supply is depleting globally and coking coal (needed for steel making through blast furnace route) is becoming scarce, the EAF process will gain preference from a long-term perspective.

Global EAF production trend (MT)



Source: Industry, Antique

As Indian steel firms still use for the conventional steel production method, given the higher iron ore reserves in the country, the demand for graphite electrodes is primarily overseas, especially from the US, South America, Europe, Japan, and China. Not surprisingly, HEG exports over 80% of its graphite production.

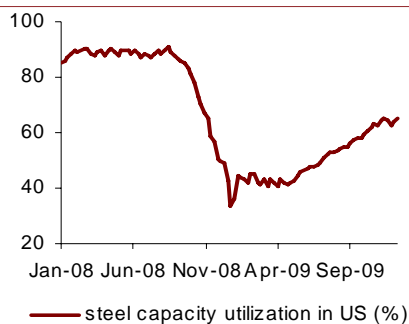
Utilisation rates to pick up with recovery in global steel sector

GEs are primarily used to produce steel from scrap by EAF technology vis-à-vis the conventional iron ore based process that uses the Basic Oxygen Furnace route. From the lows in 2HFY09, the global steel industry has posted some meaningful recovery driven by emerging economies like India and China. America and Europe, two of the largest markets for HEG have seen the capacity utilisation rates of their domestic steel industry recovering from the low of 40% to 60% presently.

Global Steel Capacity Utilisation Trend

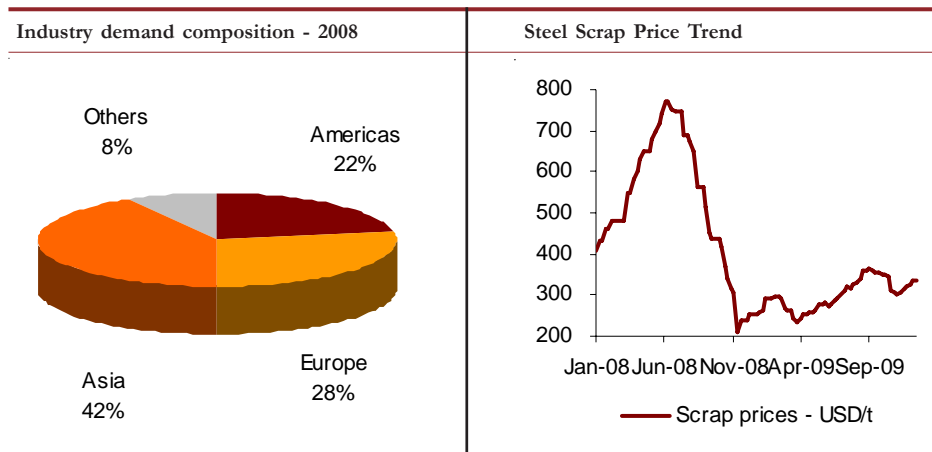


US Steel Capacity Utilization Trend



Source: Company, Antique

World Steel Association has forecasted a 9% increase in global steel apparent consumption in 2010. While China is expected to lead the show, India with its ongoing economic expansion, consumer demand growth and infrastructure building, should further aid the growth rates. Construction steel demand in Saudi Arabia is expected to remain strong as the country develops good employment prospects for its population. Despite healthy recovery in 2010, we believe 2007 demand levels will not be revisited before 2012 as the European construction sector continues to suffer residential and commercial property oversupply. Although the World Steel Association is forecasting a 12.4% increase in European consumption in 2010, we believe industry in this region still faces a number of challenges as government embarks on reduced spending.



Source: Antique, Research, Bloomberg

EAF technology to gain preference; growth trigger for HEG

It has been projected that disproportionately larger part of the new steel capacities in the next 10-15 years will be set up relying on EAF route, thus increasing the demand for GE. As increasing amount of scrap becomes available in countries like China and India and the world starts taking cognisance of serious environmental issues relating to carbon dioxide emissions (blast furnace emits 3 to 4 times more carbon dioxide versus EAF), EAF will be increasingly preferred as a route to produce steel.

Why will EAF route gain preference

China to add incremental EAF's with rising scrap generation

In the last five years, practically all the new capacities globally have been added in China, which still produces ~90% steel through the blast furnace route. Usage of EAF route is dependent on availability of scrap and level of economic development in a country. China witnessed one of the strongest economic growths in the last decade, however EAF route could not gain prominence as there was not enough scrap available to meet the Chinese demand. It normally takes 15 years for an industrialised and economically developed country to start generating scrap. We believe China has now reached a stage where industrialisation and development, which started about 15-20 years ago, should start generating enough scrap. Availability of scrap should incentivise China to add incremental capacities through the EAF route. It is estimated that China will add ~40mt of EAF capacities in next 5 to 10 years, thus setting the trigger for a big wave of electrodes demand in the medium to long term.

Environmental issues to discourage further blast furnace capacities

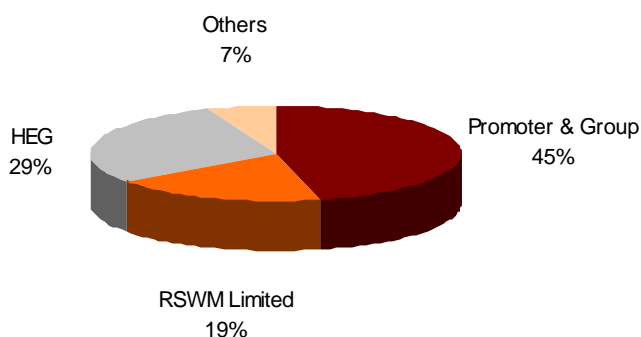
Environment protection has become a bone of contention in many developed countries. Globally, blast furnaces are three to four times more polluting than EAF. This has been the primary reason for the increased preference of the EAF route, whereby steel from the EAF route as a percentage of total steel produced has increased from 50% to over 60% in the US in the last five years. In Europe the same has increased from 30-32% to 43-45% within the same time frame.

Another notable fact is that most of the blast furnaces have a large production capacity i.e 2-5mtpa. In case of any slackness of demand or softening of prices, these would be the first to be mothballed as blast furnaces are akin to continuous process plants, whereas EAF are more like batch processing.

Bhilwara Energy

Bhilwara Energy Limited (BEL) is the flagship company for the group's power business with HEG holding ~29% stake. (The holding has reduced from 36% in 1QFY10 due to conversion of warrants). BEL is one of the emerging players in the hydroelectric power space in India and has 51% stake in Malana Power Company Limited (MPCL), which operates a 86MW Hydro power plant. MPCL is in the process of implementing additional 192MW of hydro electric power, which is expected to commence operation in 1QCY10. BEL expects to achieve ~2,600MW of hydro power capacity by 2017.

Shareholding structure



Source: Company

Project update

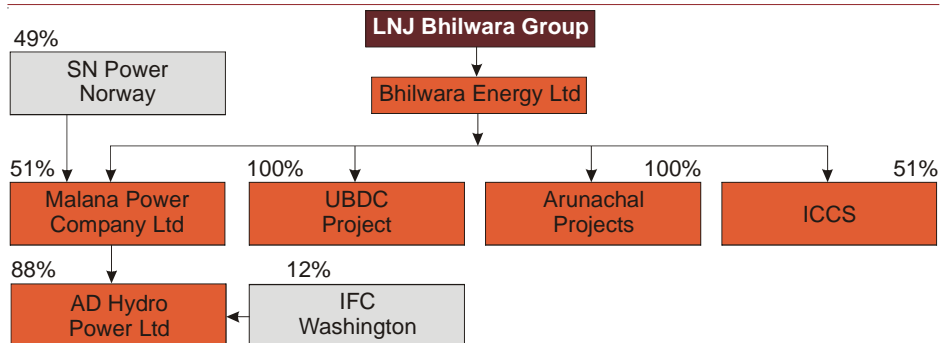
The ongoing 192MW hydro project under MPL has witnessed significant costs-overrun, and accordingly, the revised estimated capex stands at INR20.2bn, against previous estimates of INR11bn. The project has achieved financial closure and is funded through a debt equity mix of 70:30. We do not expect any further equity contribution by HEG on the above projects as all the equity requirement on revised capex is expected to be funded through internal accruals of Malana Power.

Project details

Projects	BEL's stake (%)	Other holders	Capacity	Location	Cost of project (INRbn)	Proposed/ Existing Selling mechanism	Expected commencement
Malana Power Company	51	S.N power, Norway	86MW	Kullu, HP	3.3	Short/Med term PPA	Operational
Allain Duhangan Hydro Power Limited	44.9	IFC Washington	192 MW	Kullu, HP	20.2	Short/Med term PPA	1QCY10
UBDC Stage III Hydroelectric Project	100	None	15 MW	Punjab	7.9	LTA with PSEB for 30 years at a fixed rate of 2.49/unit	CY13
Nyamjang Chhu Hydro Electric Power	100	None	900 MW	Tawang, AP	72	Short/Med term PPA	CY15

Source: Company, Antique

Holding structure



Source: Company

BEL is set to achieve a capacity of ~2,600MW of power capacity, which are under various stages of implementation. The same are expected to be completed by 2017 at an estimated capital outlay of INR200bn. In a past transaction, the company raised INR1.1bn through a 7% equity dilution to Mauritius based New York Life Investment Management India Fund II and Wachovia Investment Holdings LLC (WIH).

Valuation and Risk Factors

Despite being relatively smaller than global majors, HEG enjoys the highest operating margins in the industry on account of superior product mix and cost-efficient production process. Its bottom-line will also be strengthened by the sale of surplus power over the next two years, until completion of capacity expansion from current 66,000tpa to 80,000tpa.

Thus, we estimate revenues and net profits to post a CAGR of 11% and 22% over 2010-12, respectively. While higher utilisation on the current capacity (66,000t) will boost revenues, lower costs, on back of savings in power costs from linkage coal and higher economies of scale will expand operating margins. Earnings will be further boosted by high margin merchant sales surplus power.

HEG's earnings are highly sensitive to finished product prices and needle coke prices. Since the needle coke market is relatively more consolidated than the electrodes market, the entire rise in needle coke prices is not passed on to the customer, resulting into margin compression.

Sensitivity Analysis

		Average realisation				
		4,750	5,000	5,250	5,500	5,750
Needle coke prices	1,400	47	57	67	78	88
	1,500	44	54	64	75	85
	1,600	41	51	61	72	82
	1,700	38	48	58	68	79
	1,800	35	45	55	65	76

Source: Antique

We have valued this stock using SOTP method. The core business has been valued at 5.5x of FY11 EBITDA. We have separately valued the merchant power business which commands a higher valuation under the current business environment. HEG's stake in the flagship Bhilwara Energy Limited (BEL) has been valued at INR15bn (The power firm recently raised INR1.1bn by placing 7% stake with a clutch of foreign investors, valuing the company at around INR15bn).

Valuation

Particulars	Unit	Amount	Multiples	Amount
Core business EBITDA	INRm	4,745	5.5	26,194
Power EBITDA	INRm	200	8	1,600
Implied EV	INRm			27,794
Net debt	INRm			6,175
Implied Mcap	INRm			21,175
Value per share				521
BEL	INRm	15,000		
HEG's stake in BEL	%	29%		
Value	INRm	4,050		
Discount		25%		
Per share value	INR			80
HEG's value per share			601	

Source: Antique

At the CMP of INR 385, HEG trades at P/E of 6.1x and EV/EBITDA of 4.2x discounting its FY11 estimates. We have valued the core business and power business using EV/EBITDA multiple of 5.5x and 8x respectively. Accordingly we have arrived at a fair value price of INR521 per share. HEG's 29% stake in BEL comes at ~INR4.3bn, which we have discounted by 25% making it to INR80 per share. We initiate coverage on this stock with a 'BUY' recommendation and a 12-month price target of INR601, representing a potential upside of 56% from the current levels.

Peer comparison

Valuation matrix

	Last price	M.Cap USDm	EV USDm	PE		EV/EBITDA		P/BV 2011e	RoE 2011e
				FY10e	FY11e	FY10e	FY11e		
HEG	356	312	497	8.7	6.3	5.7	4.5	1.7	26
Graphite	76	277	367	6.8	5.6	6.1	5.8	1.2	22
SGL	22	2,067	2,515	34.6	20.3	9.9	8.2	1.6	7
Graftech	16	1,937	1,940	29.5	12.9	15.3	8.2	2.6	15
Tokai	446	1,119	1,305	60	21	9.4	6.5	0.9	5
Showa Denko	177	2,902	7,390	Loss	32	15.3	8.3	1.2	4

Source: Bloomberg

Price performance

	Last Price	52 w		Absolute Change				Relative Change			
		High	Low	1m	3m	6m	12m	1m	3m	6m	12m
HEG	356	366	94	36	36	104	216	37	36	73	89
Graphite	76	79	20	14	24	90	113	15	23	60	27
SGL	22	31	15	(8)	(15)	(6)	(1)	(9)	(17)	(23)	(19)
Graftech	16	17	5	7	1	43	107	8	(1)	20	67
Tokai	446	563	286	14	1	(15)	33	9	6	(13)	25
Showa Denko	177	218	108	20	(13)	9	38	14	(9)	11	30

Source: Bloomberg

Risk Factors

Exchange risk: HEG's revenues majorly accrue through exports, and hence, are subject to the vagaries of volatility in the exchange rate.

Technological innovation reducing demand: Better technology and improved quality of graphite electrodes have led to a decline in GE consumption per tonne of steel produced, as it came down from 4.5 to 2.5kg per tonne in the last two decades. If this consumption goes down any further, it will erode a significant demand created by the EAF industry, thereby affecting the GE manufacturers badly.

Technological shift to shrink markets: The conversion of existing AC current EAFs to DC current EAFs poses a threat as the latter consumes less GE, refractories and power. Additionally, the equipment needed for DC melting has the same configuration as that of conventional AC furnace and an addition of a DC reactor, rectifier and bottom electrode (anode). Therefore, a technological shift in production of steel is a major concern for GE players.

Raw material constraints: Other major concern pertains to the supply shortage of basic raw material i.e. needle coke as it could hamper the growth potential of the company.

Competition: Low quality Chinese GE producers also pose a threat to other companies as they may gain technology to produce UHP GEs.

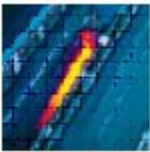
Manufacturing Process



Mixing and extrusion: Raw materials (primarily coke and binder pitch) are mixed together at an elevated temperature in order to create a homogeneous mass which is then extruded into the shape and size of the required end products.



Baking, impregnation and re-baking: The baking process "cokes-out" the binder pitch, removing most of the volatiles and leaving a solid, non-deformable carbon body (amorphous carbon). It is followed by further impregnation and subsequent re-baking to improve density and other properties.

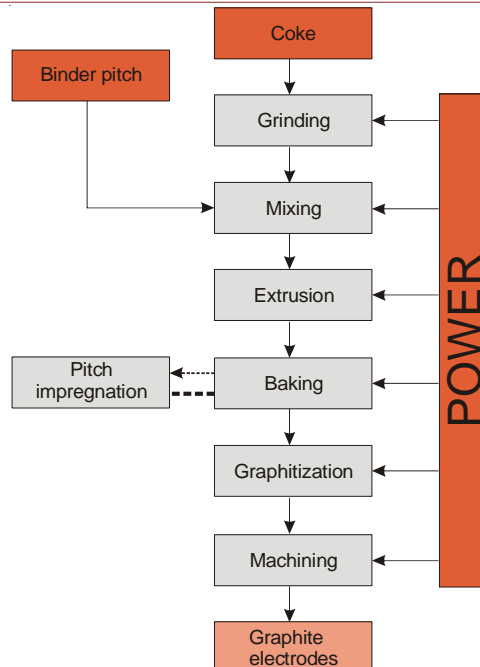


Graphitization: This step heats the carbon body to a temperature of approx. 3,000°C (+5,400°F) which induces the formation of the crystalline graphite structure.



Machining: The electrodes are machined within well-defined tolerances on length and diameter. The nipples and sockets are threaded to assure optimal electrode-nipple joining.

Manufacturing process



Source: Company

Financials (INR m)

Profit and Loss Account

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	10,017	11,021	11,304	13,800	15,638
Expenses	6,978	8,274	7,390	8,855	9,521
EBITDA	3,039	2,747	3,914	4,945	6,117
Depreciation & amortisation	461	466	495	514	521
EBIT	2,578	2,281	3,419	4,432	5,596
Interest expense	506	667	690	658	610
Other income	-	-	-	-	-
Profit before tax	2,072	1,614	2,729	3,774	4,986
Taxes incl deferred taxation	608	544	920	1,272	1,680
Reported PAT	1,464	1,070	1,810	2,502	3,306
Adjusted profit after tax	1,625	1,851	1,810	2,502	3,306
Recurring EPS (INR)	28.2	25.1	44.3	61.3	81.0

Balance Sheet

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	443	426	416	416	416
Reserves & Surplus	4,985	5,496	7,305	9,807	13,113
Networth	5,428	5,921	7,721	10,223	13,529
Debt	7,118	8,820	8,620	8,220	7,620
Capital Employed	12,546	14,742	16,341	18,443	21,149
Gross Fixed Assets	8,590	8,535	9,897	10,275	10,425
Accumulated Depreciation	3,103	2,894	3,389	3,903	4,424
Net Assets	5,488	5,640	6,508	6,372	6,001
Capital work in progress	565	1,342	-	-	-
Investments	303	835	835	3,335	6,835
Other non current assets	-	-	-	-	-
Current Assets, Loans & Advances					
Inventory	2,734	4,097	3,097	3,781	4,284
Debtors	2,884	3,285	2,787	3,403	3,856
Cash & Bank balance	432	64	3,155	1,697	354
Loans & advances and others	2,120	1,627	1,627	1,627	1,627
Current Liabilities & Provisions					
Creditors	889	895	413	517	555
Other liabilities & provisions	355	504	504	504	504
Net Current Assets	6,927	7,674	9,748	9,486	9,063
Deferred tax assets/(liabilities)	736	750	750	750	750
Application of Funds	12,546	14,742	16,341	18,444	21,149

Per share data

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	44	43	41	41	41
BVPS (INR)	105	139	189	250	331
CEPS (INR)	47	54	56	74	94
DPS (INR)	3.1	6.5	6.5	6.5	6.5

Margins (%)

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
EBITDA	30	25	35	36	39
EBIT	26	21	30	32	36
PAT	16	17	16	18	21

Financials (INR m)

Key Assumptions

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Capacity - Kt	60.0	60.0	60.0	66.0	66.0
UHP Prices (USD/t)	-	-	5,500	5,500	6,000
Non UHP prices (USD/t)	-	-	4,500	4,500	4,700
Needle Coke (USD/t)	-	-	1,600	1,600	1,600
CPC - USD/t	1,093	989	1,200	1,300	1,400
Binder Pitch - (USD/t)	715	762	750	750	750
USD~INR	40	45	47	45	45

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIT	2,578	2,281	3,419	4,432	5,596
Depreciation & amortisation	461	466	495	514	521
Interest expense	506	667	690	658	610
(Inc)/Dec in working capital	(1,224)	(1,424)	1,017	(1,196)	(919)
Tax paid	(707)	(530)	(920)	(1,272)	(1,680)
Cash flow from operating activities	892	675	4,011	2,477	3,517
Capital expenditure	(474)	(1,393)	(150)	(378)	(150)
Inc/(Dec) in investments	262	(550)	-	(2,500)	(3,500)
Income from investments	-	-	-	-	-
Cash flow from investing activities	414	(1,550)	(150)	(2,878)	(3,650)
Inc/(Dec) in share capital	-	(205)	-	-	-
Inc/(Dec) in debt	954	1,099	(200)	(400)	(600)
Dividends paid	(512)	(321)	-	-	-
Cash flow from financing activities	(1,906)	507	(890)	(1,058)	(1,210)
Net cash flow	(601)	(368)	3,101	(1,458)	(1,342)
Opening balance	1,033	432	64	3,165	1,707
Closing balance	432	64	3,165	1,707	364

Growth Indicators (%)

Yearended 31st March	2009a	2010e	2011e	2012e
Revenue	10	3	22	13
EBITDA	-10	42	26	24
PAT	14	-2	38	32
EPS	-11	76	38	32

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	7.2	5.7	8.7	6.3	4.8
P/BV	1.9	1.2	2.0	1.5	1.2
EV/EBITDA	6.6	4.6	5.6	4.4	3.6
EV/Sales	1.9	1.6	1.9	1.6	1.4
Dividend Yield (%)	1.3	2.6	1.7	1.7	1.7

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	30	31	23	24	24
RoCE (%)	21	15	8	10	11
Debt/Equity (x)	1.3	1.5	1.1	0.8	0.6
EBIT/Interest (x)	5.1	3.4	5.0	6.7	9.2

Mahindra Holidays & Resorts (I) Ltd.

Holidaying in style...



BUY

CMP: INR444

Target Price: INR507

December 22, 2009

Strictly confidential

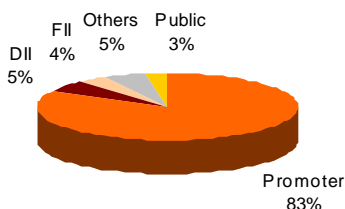
Market Data

Sector	:	Leisure
Market Cap (INRbn)	:	33
Market Cap (USDm)	:	696
O/S shares (m)	:	83
Free Float (m)	:	1.4
52-wk HI/LO (INR)	:	468/300
Avg 12m Vol ('000)	:	N.A.
Face Value (INR)	:	10
Bloomberg	:	MHRL IN
Reuters	:	MAHH.BO

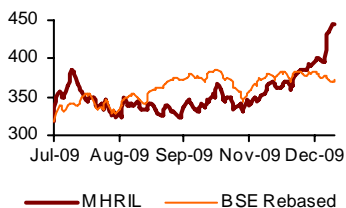
Price Performance

	1m	3m	6m	12m
Absolute	22	37	-	-
Relative	23	35	-	-

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Amol Rao +91 22 4031 3435
amol.rao@antiquelimited.com

Investment Rationale

Mahindra Holidays & Resorts India Ltd. (MHRIL) is India's premier provider of timeshare holidays, with a well rounded product profile positioned at several price points. With more than 100,000 members and 1,300 rooms, the company is identified as a provider 'Family Holidays' to the country's burgeoning middle class.

It has aggressively scaled up its inventory and member base over the past couple of years (five year CAGR of 23% and 35% respectively) and managed to expand its revenues and profits at a CAGR of 140% and 178%, respectively. MHRIL intends to maintain the current tempo of member acquisition, and hence, went in for an IPO in Jun'09, with the aim of garnering funds to ramp up its inventory, in terms of number of rooms and variety of destinations.

At the CMP of INR452, MHRIL is trading at a PER of 16x and EV/EBIDTA of 7.8x, discounting its FY11e numbers.

Valuation

MHRIL's business model is structured around optimisation of cash flows. The steady flow of new members, coupled with the holiday entitlement offered, generates significant float, insulating revenues and cash flows from cyclicality. A combination of scale, float, robust business model and comfortable valuations, in the backdrop of high foreseeable growth in both revenues and profits, makes for a compelling case for investment at the CMP of INR444. Hence, we initiate coverage on the company with a BUY recommendation and a price target of INR507, an upside potential of 14%.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	3,931	4,796	6,012	7,160
EBITDA	1,044	1,668	2,568	3,424
EBITDA Margin	26.6	34.8	42.7	47.8
EBITDA growth	(11.8)	59.8	54.0	33.3
PAT	834	1,419	2,072	2,840
PAT growth	0.0	0.7	0.5	0.4
EPS (INR)	10.0	17.1	24.9	34.1
EPS growth	3.5	70.2	46.1	37.0
P/E	41.0	26.0	17.8	13.0
P/BV	17.3	7.7	5.8	4.2
EV/EBITDA	21.9	13.7	8.8	5.6
RoE (%)	49.1	42.0	37.0	37.4

Source: Antique

Introduction

Mahindra Holidays and Resorts (India) Ltd. (MHRIL), promoted by the Mahindra Group of companies, was incorporated in 1996 to tap the opportunities spawned by the burgeoning hospitality services sector and capitalise on the changing demographic profile of Indian populace. Over the years it has built and fine tuned a unique business model to tap the vacation ownership (VO) / timeshare segment in India and carved out a niche for itself. Beginning with a resort at Munnar, Kerala, in 1998, it now boasts of an inventory of 1,349 rooms across 35 properties, largely owned, with some being leasehold (both long and short term).

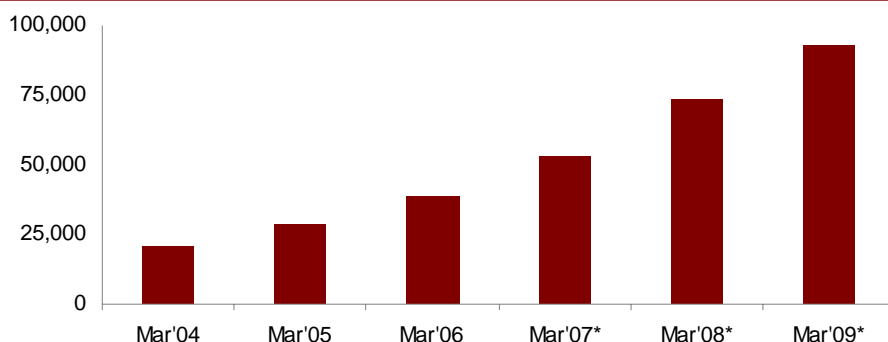
List of Properties

Club Mahindra				Zest	
Property	Rooms	Property	Rooms	Property	Rooms
Ashtamudi	26	Munnar	112	Kodaikanal	11
Atuli	10	Mussoorie	19	Masinagudi	20
Bangkok (i)	6	Naukutichiataal	31	Ooty	15
Bangkok (ii)	6	Pattaya	6	Puducherry	125
Binsar	36	Poovar	20		
Coorg	188	Shimla	67		
Corbett	24	Thekkady	32		
Dharamshala	23	Yercaud	40		
Gangtok	32	Corbett	6		
Goa (i)	205	Kodaikanal	16		
Goa (ii)	24	Mahableshwar	10		
Kodaikanal	6	Manipur Villa	22		
Kumbalgarh	68	Ooty	90		
Manali	33	Panchgini	20		

Source: Company, Antique

The growth in the initial years was slow and the company could only manage a membership count of ~20,500 towards the end of FY04. However, since then it has exhibited strong traction in membership enrollment and ended FY09 with 92,825 members, a CAGR of 35% over the previous five years. This robust growth can be attributed to the spread of properties it has built and its competitive product offerings namely *Club Mahindra Holidays*, *Zest*, *Club Mahindra Fundays*, *Mahindra Homestays* etc., which now span a wide spread of the addressable markets.

MHRIL: Membership Trend



Source: Company, Antique * Inclusive of Zest

Product Offerings

MHRIL offers its members non-deeded vacation ownerships i.e. the member has the right of usage, but not the ownership. This is mutually beneficial for both, the company and the members on account of the following reasons:

1. The responsibility of resort maintenance lies with the company, not with the members. This ensures timely and appropriate upkeep of properties and maintenance of standards.
2. Due to the absence of ownership, members are not tied down to any particular resort and thereby have a wide variety of holiday destinations to choose from.

MHRIL's product offerings are as follows:

Club Mahindra Holidays: This is the company's flagship product, which was launched in 1997. Its membership entitles the member to stay and holiday at the company's resorts for seven days a year, in the eligible season, for twenty five years, across 28 destinations. The classification of seasons is enclosed below and the pricing of membership is dependent on the season opted for.

Season Classifications for Club Mahindra Holidays

Purple	Holiday at any time of the year
Red	Can holiday in Red, Purple, White and Blue season
White	Can holiday in Red and Blue season
Blue	Can holiday in White season

Source: Company, Antique

The tenements available under this scheme are in the following configurations: Double bedroom, single bedroom and studio apartment, so as to cater to the diverse customer profile and needs.

Zest: Launched in 2006, this product is targeted at young urban families desirous of taking short breaks, typically over the weekend. It entitles members to six days of holidays in a year, in the relevant season, for a period of ten years. Seasons are classified as under:

Season Classifications for Zest

Verve	Holiday at any time of the year
Buzz	Can holiday in Pep season
Pep	Can holiday in Buzz season

Source: Company, Antique

This product offers one type of apartment and the resorts are typically located within driving distance of major metros. As mentioned earlier, the company has 171 rooms across 5 destinations.

Club Mahindra Fundays: Launched in 2006, this product targets those corporate houses who reward their employees with holidays at MHRIL's resorts. These holidays can be utilised at both *Club Mahindra* and *Zest* resorts. The primary reason behind the same was to improve utilisation rates of existing resorts.

Travel Business: Most of the holiday spends usually entail 20-25% of the supplementary spends outside the holiday locations on travel, ticketing, sight-seeing, leisure, F&B, etc. In order to capture a larger share of this supplementary spend, which would be a low hanging fruit, MHRIL launched a travel website 'www.clubmahindra.travel', in 2008, aimed at providing an integrated platform for holiday planning, ticketing, travel related services, etc.

Mahindra Homestays: This product was launched on a pilot basis in 2008 with the idea of promoting Indian homestays for international travellers. Initially there was a huge effort involved in selling this concept, as homestays in an environment not connected to friends and relatives was alien in India, as a result, the product was offered only to inbound overseas travellers. However, the success of the same has now prompted MHRIL to extend this product offering to Indian customers as well. Beginning with affiliations at ~26 homes across Rajasthan, Delhi and Kerala, the company's homestay offerings now extend to ~71 locations across the country.

Initial Public Offering (IPO)

In order to strengthen its capital base, enable valuation discovery, increase inventory and bolster marketing reach, MHRIL went in for an IPO in Jun'09. In this, it issued ~5.9m new equity shares and ~3.4m shares on an offer for sale basis by the promoters @INR300/share. The paid up equity capital after the issue stood at 8.3m shares of FV INR10 each.

The objects of the IPO and the tentative deployment of the same are as below:

Schedule of Deployment of IPO Proceeds

	FY10	FY11	FY12	Total
Tungi	605	200	-	805
Ashtamudi	237	95	-	332
Coorg (Phase IV)	34	129	-	163
Ooty	83	-	-	83
Theog	159	510	58	727
Total	1,118	934	58	2,110

Source: Company

Vacation Ownership Industry

The vacation ownership industry can be said to have evolved in Europe in 1960s, as a fallout of the changing demographic profile of its populace, onset of the culture of overseas annual holidays and last but not the least, the surge in buying power. Most of the European holiday travellers used to vector on to the Mediterranean coastal areas as holiday spots or had holiday homes (especially the richer class). By late 60s, this resulted in holiday costs rising disproportionately, while ‘Location Fatigue’ had also set in. Consequently, holiday providers started seeking newer avenues at competitive costs. Thus, the timeshare industry emerged as an alternative to conventional holiday options, because of the attractive alternative of booking a week or two at a resort every year or purchasing a holiday property outright.

Timeshares initially offered the rights of occupancy in a property for a set period/time. It also enabled members to utilise their entitled holidays in the way they saw fit i.e. they could use it themselves, pass it out to friends/relatives, rent it out, etc. Commencing from single location resorts, slowly the industry evolved into offering options of multiple locations on account of changing consumer (member) demand. Many of these companies entered into reciprocal arrangements, which enabled their members to use each-others resorts, thereby increasing the holidaying options manifold.

The next stage of evolution was in late 70s, when ‘Exchanges’ and ‘Clearing houses’ emerged, wherein time share members could exchange their holiday entitlements with other members, within the same time share provider or with any other. Timeshare owners today have the option to holiday in numerous resorts, spread across the world, if their membership is affiliated to an exchange company. Amongst the existing exchange companies, *Resort Condominiums International* (RCI) and *Interval International* (II) are the major players, with the former controlling ~85% of the timeshares exchanged globally.

The success of this industry attracted large and well-capitalised hospitality players from late 80s onwards as majority wanted to increase their asset sweating and capitalise on the locational advantages of their resorts. Today, many large international companies like *Hilton Grand Vacation Company*, *Marriott Ownership Resorts*, *Disney*, *Starwood Vacation Ownership*, *Wyndham Vacation Ownership*, are serious global players. This ensured that after taking almost two decades to achieve a size of USD2bn till the mid 80s, the industry multiplied five fold over the next two decades to attain proportions of USD10bn by 2005.

The global timeshare/ Vacation Ownership (VO) market was estimated at USD16bn in 2008, with almost 85% revenues being accounted for in the US and Europe. This is largely on account of the fact that a significant portion of working population in both geographies is inclined towards taking periodic holidays. The industry has also expanded on account of large hospitality companies venturing into the VO space, as these players were able to impart credibility to projects and deliver superior levels of service quality.

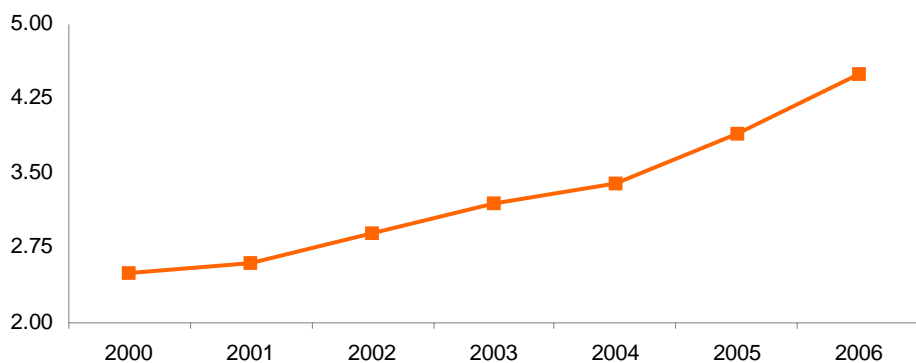
On the resort locations front, industry experts opine that the US and Europe account for almost 55% of the resort locations, with Asia accounting for 15%. However, the growth in both VO members as well as resorts is expected to be the sharpest in Asia and Africa in the coming years.

The development and performance of this industry in India have been influenced by the changes in the demographics of the country and spending patterns of the population. Till the previous decade, the leisure and recreation space was dominated by large hospitality chains, which catered exclusively to the niche high end customers, and consisted of super luxury business and leisure travellers.

The mid-market and affordable vacationing segment was hitherto underdeveloped; whereby middle and upper-middle class consumers had to choose from stand-alone resorts and various state government-operated properties.

However, the growing incidence of urbanisation over the past decade (1995-2005) coupled with the demographics tilting in favour of a working population of 25-55 years have provided a fertile background for the growth of the VO industry. This segment of population has displayed an increasing propensity to spend, albeit with an emphasis on quality service and brand preference. This has resulted in a window of opportunity for the vacation timeshare industry.

Numbers of Holiday Takers in India



Source: Min. of Tourism, GoI

The timeshare industry in the country kicked off in the 1990s and several companies mushroomed to capitalise on the benefits of the float generated by the business. However, lack of management experience, poor execution skills and low resort rollouts along with teething problems resulted in extremely bad experiences for members who expectantly had gone to the resorts to enjoy their vacations. This was compounded by timeshare scams, whereby many investors were duped of their membership fees by fly by night operators as there was no enforcement/ regulatory authority.

At present, the Indian VO industry is estimated to have 40 timeshare companies offering ~80 resorts, which include apartments, villa, spas, yachts etc. Going forward, an improvement in the macroeconomic scenario in conjunction with the following factors is expected to contribute to the development of the domestic VO industry:

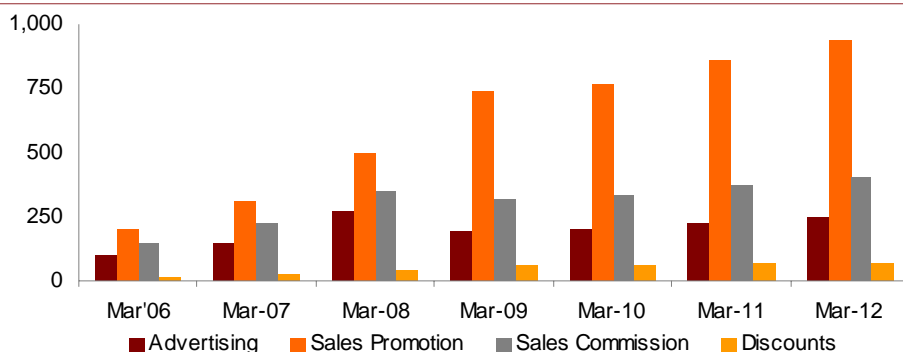
1. Rapid urbanisation and changing demographics - Rising incidence of urbanisation is expected to contribute to a tenfold increase in the size of the middle class from 50m to 583m people by 2025, resulting in India becoming the fifth largest consumer market, globally. This would form a very attractive addressable market, which remains under-served and under-penetrated today.
2. Number of high networth individuals in India (Individuals with more than USD1m in financial assets) in India has grown 1.4x from 2004 to ~100,000 individuals today. The possibility of owning a holiday home through a timeshare, at a fraction of the cost of a second home, should fuel the propensity to holiday amongst these individuals.
3. Improvement in infrastructure and connectivity: The advent of Low Cost Carriers (LCCs), development of roads and highways and the corresponding improvement in domestic connectivity, has resulted in the country's 461m strong population of domestic tourists registering a CAGR of 13% since 2000. This growing trend could provide opportunities for the VO industry in the form of new products viz. heritage, spiritual, medical tourism etc.

Business Summary

MHRIL's operational activities can broadly be categorised under three heads viz. marketing, membership enrollment and holiday delivery. Each activity has a specific impact on the revenues and cash flows of the company with makings of a unique business model.

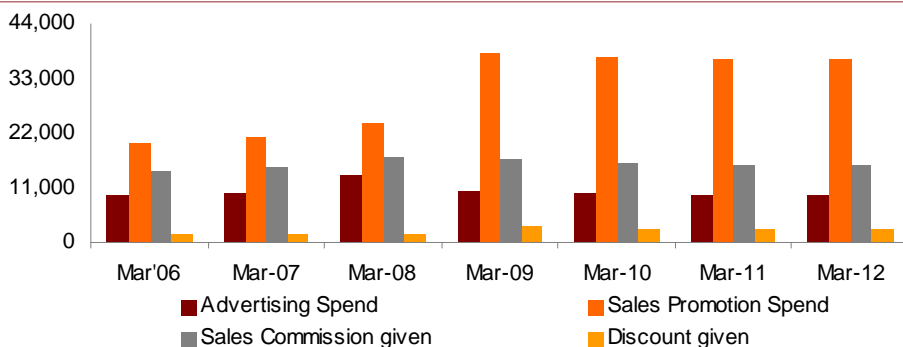
Marketing: Despite being the market leader by a wide margin, MHRIL has to undertake strong efforts to reach out to its addressable audience, as the general malaise of the timeshare vacations ranges from low awareness to downright skepticism on account of the numerous scams of mid 90s. It currently operates 19 branches and 61 retail outlets across the country (45 owned and 16 franchises), in addition to a network of ~165 franchisee sales agents. This network is utilised to not only enrol prospective clients but also to increase awareness about timeshare holidays, and thereby, increase the brand equity of the company. Historically, expenditure attributable to client acquisition and incurred under the various heads of advertising, sales promotion, commissions and discounts has accounted for ~30-33% of revenues.

MHRIL: Marketing Expenses (INRm)



Source: Company, Antique

MHRIL: Marketing Spend (INR/member)



Source: Company, Antique

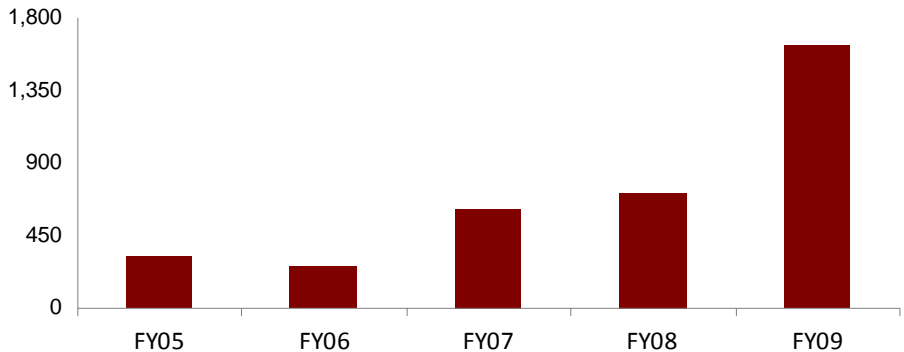
Going forward, with heightened awareness about the product and high brand equity of the company, we expect these expenses to decline (as a % of sales and on a per member basis), thereby providing operating leverage.

Membership Enrollment: MHRIL's marketing efforts are primarily geared towards converting prospective customers/referrals into firm enrollments for Club Mahindra/Zest. Upon enrollment, the company receives a downpayment of 10% of the total value of the timeshare package from the new member. Considering the discretionary nature of the purchase, MHRIL offers an option to pay the remaining 90% over 12-60 months, thereby, financing the purchase and earning interest on the transaction.

On an average, over 80% of new members opt to pay the remaining 90% of the amount within 24 months of signing up. These new members get 2 days of free holidays, with their holiday entitlement commencing after ~12-14 monthly installments. This is the reason why most new members tend to opt for payment within 24 months, despite the option of paying in installments over 60 months.

The company also follows a policy of securitising a part of its receivables (with full recourse to its balance sheet), utilising the funds to build up strengthen the marketing effort or beef up its inventory. However, for the purpose of our projections, we have ignored this stream of potential income as it is usually one off and not predictable in nature.

MHRIL: Trend of Securitised Revenues (INR m)



Source: Company

Holiday Delivery: As mentioned earlier, 80% of new members become eligible for holidays within 12-14 months of enrollment. This involves seven days for members of *Club Mahindra* and six days for members of *Zest*.

Numerically, at the current level of 1,349 rooms, the company would be facing a shortfall of room nights to service its members with. However, most members under-utilise their eligibility (~4 nights per annum) or simply accumulate the same with the intention to redeem their holiday at an international destination. MHRIL has a tie-up with RCI, enabling the same. The company has ~10-15% of free inventory which it sells to non-members at prevailing market rates.

Another factor which has a bearing on the inventory utilisation is that many members opt to accumulate the holiday entitlements to a substantial level and utilise the exchange network like RCI, to holiday abroad in the network resorts. This not only generates fee income for MHRIL, but also frees up inventory for the company as the members would have exhausted their entitlements, but at the same time not impacted the room night availability of MHRIL's assets in India.

This is fairly convenient as the outward flow of exchanges is higher than inward flow i.e. the numbers of RCI members from international VO companies opting to holiday in India in MHRIL resorts is much lower.

On the flip side, as membership enrollment gathers pace, MHRIL has to add new inventory and destinations in order to service new members, who would become eligible for holidays after 12-14 months. This is where the float generation plays a crucial part, enabling the company to choose between leasing a property or going in for greenfield development.

Revenue recognition policy: MHRIL currently accounts for 60% of membership fees (classified as non-refundable admission fees) as revenues in the year in which the membership is signed. The balance 40% (classified as entitlement fees) is recognised as revenues over the residual life of the membership i.e., 24 years.

On an annuity basis, as long as the membership term is in enforcement, each member is required to pay an Annual Subscription Fee (ASF); this fee is indexed and rises in accordance with inflation. ASF is booked as revenues as and when it becomes due for each member.

Other resort-linked income like room rentals, F&B income, facilities fees etc. are booked as income as and when they are incurred/rendered.

MHRIL also derives other income from securitisation of receivables and interest from installment sales of membership. While the latter is recognised on an accrual basis, the former is booked (profit or loss) as per the difference between the book value of the receivable and the transfer consideration. The company has now stopped securitising its receivables preferring to enrol of the members through the EMI mode, as it has substantial liquidity in its book and income from interest is quite considerable.

SWOT

Strength

Product Profile: The company has a diversified product basket which is customised to various price points and customer preferences. Its formidable marketing reach helps monetise the product basket in the form of an increasing member base.

Non-deeded Vacation Ownership: Unlike conventional deeded VO that are prevalent abroad, MHRIL's VO scheme is non-deeded in nature and entitles the member to use the property, while the ownership title of the same is retained by the company. Consequently, the responsibility of maintenance and quality standards of the various properties rests with the company, thereby ensuring consistency.

Float Generation: The membership enrollment process generates significant float for the company in the first 12-14 months. Additionally, with cash flows from membership fees accruing within 24 months on an average, the company has adequate head room to expand inventory, boost marketing efforts or pay out dividend to shareholders. Lastly, it can deploy its float as a treasury instrument, thereby generating additional income.

High Asset Sweating: The company's business model facilitates high utilisation i.e. occupancy ratio compared to conventional hotel chains. As vacation ownerships are usually sold in 'Seasons' (four) of the member's choice, there is adequate occupancy throughout the year. The same would be limited only by utilisation and seasonal mix of the membership pool. Thus, many of the properties usually can be occupied for up to 50 weeks in a year, assuming that two weeks a year are reserved for maintenance.

Another fact that enables high asset sweating is low capital and operational outlay for the asset. This is largely driven by the fact that the cost to set up a room is less than 40% than for a conventional hotel property, on account of the resorts being in offbeat locations, and so is the operating expenditure.

Usage Pattern: The terms and conditions of the membership entitle members to the vacations only upon achievement of certain milestones in payment of fees. E.g.: A member will be eligible to utilise his vacation entitlement once 50% of the membership fees is paid. It has been observed that usually ~10% of the members opt for complete payment, while the remaining go in for 'Deferred Payment' or 'EMI payment' schemes. Thus, the number of members eligible for holiday entitlements is much lower than the existing membership count. Additionally, most of the member usually utilise ~4 days of their entitlement (as opposed to eligibility of 7 days p.a.). Since members can accumulate up to 21 days of entitled vacations, many members opt for the same and subsequently swap/ exchange the same through the mechanism available (i.e. RCI) so as to enjoy their vacations overseas.

Strong Parentage: MHRIL is promoted by the Mahindra Group, one of the largest industrial conglomerates in India today. The group has operations spread across automobiles, information technology, metals, financial services etc. and is one of the most reputable brands in the country. The brand inspires customer confidence, which makes it relatively easier while enrolling customers.

Weakness

Sales cost/Marketing expenses: As mentioned earlier, the incidence of sales and marketing costs is high for MHRIL. This is due to the low levels of awareness about the timeshare concept and the company's brand. However, as membership enrollment gathers pace, we expect the cost of membership acquisition to come down significantly, thereby providing operating leverage to the company.

Possibility of member defaults on financed purchases: Since most members opt for paying fees over a period of 24 months, the chance of default on payment is likely. However, this risk is mitigated in case the receivables from the defaulting member are securitised and sold, as the company replaces the same with a new compliant member.

Opportunities

Operating leverage: MHRIL's business model is structured in a way that fixed costs like operating expenditure in resorts and client acquisition costs like sales promotion and marketing are high in incidence. These account for ~22% of the company's expenditure outflow. However, by virtue of being fixed in nature, these costs provide the backdrop for generation of operating leverage for MHRIL, as the new enrollments generate revenues.

Incidental services can provide upside to earnings: The low utilisation rate results in unoccupied rooms during the year, which MHRIL can monetise by selling to non-members at the prevailing market rate for the destination. Additionally, the off-beat locations of MHRIL's properties lend themselves to heightened F&B spend by patrons on account of lack of other options. This could translate into higher revenues and improved margins for the company.

Pricing: MHRIL has been able to slowly and steady monetise brand premium and translated the same into pricing power. The trend in pricing of the membership can be ascertained from the charts before, whereby the rebased trend demonstrates the company's ability to steadily pass on an increase in the product price on back of higher acceptability.

MHRIL: Re-based rates for 1 BR and Studio Apt. across Seasons



Source: Company, Antique

Penetration: Despite India having twice the number of public holidays vis-a-vis US and UK (viz 44 days vs. 25 days), the composition of leisure holiday travellers in the country is abysmally low and estimated at ~5% of the total populous. This compares unfavourably against 84% for the US and 66% for the UK (*Source: Euromonitor International, CIA Factbook*). While a pickup in this number is imminent, players like MHRIL, who have a 'First Mover Advantage', should be able to reap the benefits of the same.

Newer Products: There is a huge potential of further segmentation in the addressable market for MHRIL. While it has been targeting the Indian middle class with Club Mahindra and corporate vacations by Fundays and Zest (expand), it has also now firmed up plans to mine the corporate sector deeper by offering services and products for corporate training and offsite. The first of these locations is expected to be operational in Mahableshwar, which would have strong catchment areas for corporates i.e., Mumbai and Pune. This not only has the potential to be a corporate training centre, but also to emerge as a mid week holiday location, as most of the corporate training workshops are usually towards weekends.

Threats

Delicate state of economy: Given the current state of the macroeconomic environment, any downturn could seriously impair MHRIL's ability to increase the pace of member enrollments. This could play out in the form of lower generation of monetary float for the company and delay any of expansion plans.

Uptrend in usage could lead to inventory mismatch: At current levels of 1,349 rooms and ~4.5 days of utilisation/member, MHRIL is comfortably placed in terms of spare inventory to service eligible members. However, the inability to add more inventory from current levels or any sudden surge in the utilisation rate of eligible members or a combination of both would lead an inventory mismatch, with the company being unable to provide eligible members with their rightful entitlement, thereby generating negative brand equity for the company.

Competition: Currently, the VO space in India is relatively uncluttered, with no large conventional hospitality players (domestic or international) or international VO players present in the space. However, commencement of operations by any of these players may dent the member enrollment and consequently affect the float generation of the company.

Legal Threat: Most of MHRIL's resorts are in remote locations which are generally ecologically and environmentally sensitive viz. beaches, jungles, hill stations, sanctuaries etc. Any adverse change in the land usage rules has the potential to render some of the resorts unusable. MHRIL currently has some litigations with the Government over its resort in Munnar (considered to be its flagship property) and the matter is sub judice. Any adverse ruling on the same has the ability to substantially impact the business model of the company.

Capex funding: MHRIL's per room cost is significantly lower in comparison to hospitality players (INR3m vs. INR10m for conventional hotel players). However, any move by the company to build more opulently and move into the 'Super-Luxury' category like conventional hospitality players could seriously impair the float generated by its member enrollment.

Our View

MHRIL's existing clientele consists of the rapidly expanding Indian middle class. In the backdrop of current levels of disposable income, this segment of the populous is under-served with limited outlets available for leisure spending and travel in particular. While MHRIL doesn't have a 'First Mover' tag to its credit, its lineage and product array have catapulted it to the top of the VO market in the country.

We believe that the company's current bouquet of products is designed to cater to this large, addressable market, with interesting variations adding a flavour of customisation, thereby satisfying the diverse vacationing requirements of its target market. The funds garnered from its recent IPO will afford the company plenty of elbow room to expand its existing inventory aggressively (organically/ inorganically), whereby it will be able to meet the room requirements of its enhanced member base 3-5 years down the line. While an augmentation of the current inventory will generate an option value of revenues from external sales to non-members, we believe that the availability of inventory, with which to service existing clients, will prove to be a big USP during client acquisition and membership referrals.

We expect MHRIL to maintain its present momentum in marketing activities over the next 12-24 months. This should impart dual benefits of addition of critical mass to its member base, thereby generating sizeable float for the company in addition to driving down the fixed overheads (marketing costs) per member.

We have assumed an addition of 20,500 and 23,000 members and expect MHRIL to clock revenues of INR4.7bn and INR6bn in FY10e and FY11e, respectively. We estimate operating profits to settle at INR1.8bn and INR2.6bn, with net profits of INR1.4bn and INR2bn in FY10e and FY11e, respectively. Lastly, MHRIL should generate cash and cash equivalents of ~INR2.9bn and INR5.5bn in FY10e and FY11e, respectively. This generates numerous possibilities for the company viz. expansion of current inventory through the organic or inorganic routes, dividend payouts to shareholders etc.

At the CMP of INR444, MHRIL is trading at a PER and EV/EBIDTA of 14.3x and 6.8x, discounting its FY11e numbers. The company's unique business model, cash generating abilities and aggressive marketing and expansion plans make for an interesting play, given the backdrop of the Indian middle class and the change in its spending patterns. MHRIL's operations are similar to but do not replicate that of a hotel's. Hence, it is difficult to ascribe a peerset valuation to the company.

We have used the DCF method to arrive at the valuation of the company, considering the cash generating capabilities of its business model. We have arrived at a DCF based price of INR507 for the company and initiate coverage with a BUY recommendation.

Key Assumptions

Risk Free Return (%)	7.5	Topping out Year	2017e
Market Premium (%)	5	Membership count	253,825
Beta (x)	1.3	Peak Utilisation	4.8
Cost of Equity (%)	14	Room Inventory	2,873
Terminal Growth (%)	5		
Total NPV (INR m)	42,154		
O/s Shares (m)	83		
Value/share (INR)	507		

Source: Antique

Financials (INRm)

Profit and Loss Account

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	3,527	3,931	4,796	6,012	7,160
Expenses	2,345	2,887	3,129	3,443	3,736
Operating Profit	1,183	1,044	1,668	2,568	3,424
Other income	223	513	821	1,018	1,440
EBIDT	1,406	1,556	2,489	3,586	4,864
Depreciation	113	166	195	264	327
Interest expense	33	70	47	40	38
Profit before tax	1,260	1,320	2,248	3,283	4,499
Taxes incl deferred taxation	455	487	829	1,210	1,659
Profit after tax	805	834	1,419	2,072	2,840
Diluted EPS (INR)	9.7	10.0	17.1	24.9	34.1

Balance Sheet

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	764	770	832	832	832
Reserves & Surplus	651	1,210	3,949	5,584	7,937
Networth	1,416	1,980	4,781	6,415	8,769
Debt	201	247	200	180	180
Deferred Income	4,789	6,368	8,183	10,441	13,088
Deferred Tax Liability	236	295	295	295	295
Capital Employed	6,641	8,890	13,458	17,331	22,332
Gross Fixed Assets	2,734	4,221	5,340	6,274	6,334
Accumulated Depreciation	479	640	834	1,098	1,425
Net Assets	2,255	3,582	4,505	5,176	4,909
Capital work in progress	450	512	500	200	140
Investments	2	6	1,756	4,256	7,756
Current Assets, Loans & Advances					
Inventory	35	52	61	67	73
Debtors	4,034	4,842	6,351	7,573	8,872
Cash & Bank balance	68	320	1,173	1,288	2,178
Loans & advances and others	576	735	1,180	1,344	1,535
Current Liabilities & Provisions					
Creditors	591	828	850	924	984
Other liabilities & provisions	189	332	1,218	1,649	2,148
Net Current Assets	3,934	4,789	6,696	7,698	9,526
Application of Funds	6,641	8,890	13,458	17,331	22,332

Per share data

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	76	77	83	83	83
BVPS (INR)	18.5	25.7	57.5	77.1	105.4
CEPS (INR)	12.0	13.0	19.4	28.1	38.1
DPS (INR)	1.0	1.3	1.5	1.7	2.0

Margins (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	33.5	26.6	34.8	42.7	47.8
EBIT	36.7	35.4	47.8	55.3	63.4
PAT	22.8	21.2	29.6	34.5	39.7

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	1,262	1,320	2,248	3,283	4,499
Depreciation & amortisation	113	167	195	264	327
Interest expense	33	70	47	40	38
Interest / Dividend Recd	(9)	(15)	(165)	(375)	(665)
Other Adjustments	21	(22)	-	-	-
Interest from securitisation	(197)	(372)	-	-	-
Interest on instalment sales	(12)	(100)	(656)	(643)	(775)
(Inc)/Dec in working capital	(303)	863	760	1,371	1,710
Tax paid	(440)	(395)	(829)	(1,210)	(1,659)
CF from operating activities	469	1,518	1,599	2,729	3,475
Capital expenditure	(711)	(1,559)	(1,106)	(634)	-
(Purchase) / Sale of Investments	(1)	(4)	(1,750)	(2,500)	(3,500)
Interest received	9	9	165	375	665
Interest on Instalment sales	197	372	656	643	775
Income from securitisation	12	100	-	-	-
CF from investing activities	(494)	(1,083)	(2,035)	(2,116)	(2,060)
Inc/(Dec) in share capital	3	4	1,772	-	-
Inc/(Dec) in debt	141	46	(47)	(20)	-
Dividends & Interest paid	(135)	(234)	(436)	(478)	(524)
CF from financing activities	9	(183)	1,289	(498)	(524)
Net cash flow	(16)	252	853	115	890
Opening balance	84	68	320	1,173	1,288
Closing balance	68	320	1,173	1,288	2,179

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	51.8	11.4	22.0	25.3	19.1
EBITDA	67.5	(11.8)	59.8	54.0	33.3
PAT	90.8	3.5	70.2	46.1	37.0
EPS	90.8	3.5	70.2	46.1	37.0

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	42.1	41.0	26.0	17.8	13.0
P/BV	24.0	17.3	7.7	5.8	4.2
EV/EBITDA	24.2	21.9	13.7	8.8	5.6
EV/Sales	9.7	8.7	7.1	5.2	3.8
Dividend Yield (%)	0.4	0.7	0.9	1.0	1.1

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)RoE (%)	74.2	49.1	42.0	37.0	37.4
RoCE (%)	24.8	18.9	21.4	22.1	23.1
Debt/Equity (x)	0.1	0.1	0.0	0.0	0.0
EBIT/Interest (x)	39.2	19.8	48.9	83.3	120.0

Note

Opto Circuits (India) Ltd.

A consi'Stent' performer...



BUY

CMP: INR229

Target Price: INR295

December 22, 2009

Strictly confidential

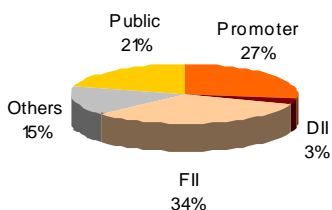
Market Data

Sector	: Medical Devices
Market Cap (INRbn):	43
Market Cap (USDm):	906
O/S shares (m)	: 183
Free Float (m)	: 117
52-wk HI/LO (INR):	230/70
Avg 12m Vol ('000)	: 1,325
Face Value (INR)	: 10
Bloomberg	: OPTC IN
Reuters	: OPTO.BO

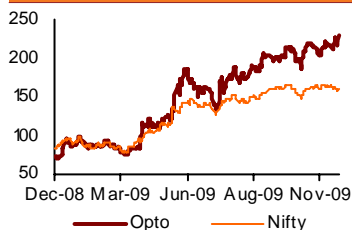
Price Performance

	1m	3m	6m	12m
Absolute	6	15	47	158
Relative	6	12	22	45

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Amol Rao +91 22 4031 3435
amol.rao@antiquelimited.com

Investment Rationale

Opto Circuits (I) Ltd. (OCIL) is a manufacturer of invasive and non-invasive medical devices, with strong brand equity and proven track record of pioneering products, rooted in proprietary technology.

The consistent ramp up in revenues and profits over the years (3 year CAGR of 80% and 70%, respectively), brought about by organic and inorganic growth, underscores the management bandwidth, technology assimilation and implementation skills.

OCIL is focussing on improving the monetisation of its base of proprietary technology in the patient monitoring (Criticare) and invasive cardiac (Eurocor) segments, with a marked thrust on increasing profitability of operations.

Its marquee products (viz. patient monitors and stents) are making significant inroads at home and abroad, as is apparent from the sales volumes and geographical distribution of revenues.

At the CMP of INR229, OCIL is trading at a PER of 8.7x and EV/EBIDTA of 7x, discounting its FY11e numbers.

Valuation

OCIL is currently mainly focussed on developing cost-effective and technologically superior products, while simultaneously expanding its reach in domestic and international markets through appropriate products at suitable price points. In the backdrop of increasing non-discretionary healthcare spend and greater product acceptance, the company is interestingly poised, in terms of revenue and profit growth. Hence, we have a BUY recommendation on the stock and a price target of INR295, which represents an upside of 29% from current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	8,185	11,060	14,408	18,663
EBITDA	2,591	3,518	4,721	6,268
EBITDA Margin	31.6	31.8	32.8	33.6
EBITDA growth	88.8	35.8	34.2	32.8
PAT	2,087	3,112	4,447	5,816
PAT growth	59.7	49.1	42.9	30.8
EPS (INR)	11.1	16.5	23.5	30.8
EPS growth	59.7	49.1	42.9	30.8
P/E	17.7	12.4	8.7	6.7
P/BV	7.2	3.1	2.5	1.9
EV/EBITDA	14.4	9.7	7.0	5.3
RoE (%)	49.2	35.4	31.6	32.5

Source: Antique

Introduction

Opto Circuits (I) Ltd. (OCIL) was started in 1992 by a first generation entrepreneur, Mr. Vinod Ramnani, along with two technocrats, Mr. Thomas Dietiker and Mr. Jayesh Patel. It commenced operations by manufacturing sensors for Original Equipment Manufacturers (OEM). Starting with one product, namely *Pulse Oximetry Sensors*, it has consistently scaled up its product range and has emerged as a player to reckon with in the medical equipment space.

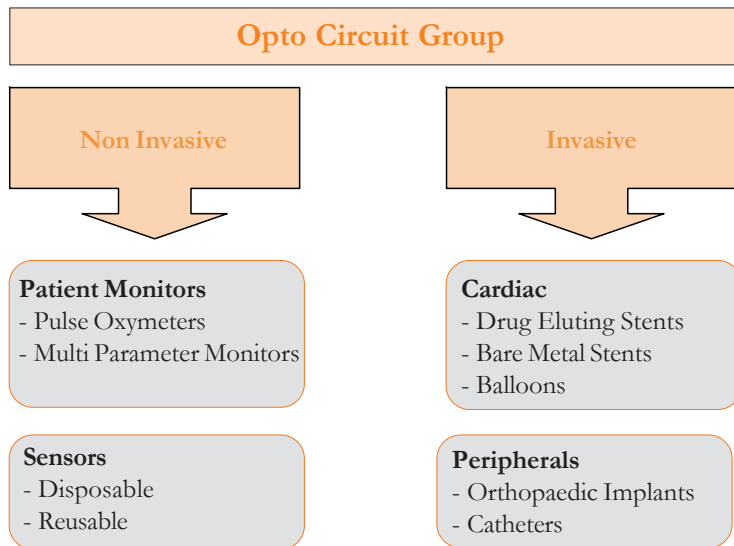
Over the years, it has built up vibrant relationships with global medical equipments majors as a reliable OEM supplier. After building up strong domain expertise and skill sets, OCIL ramped up its scale of operations and expanded its product profile, both organically as well as through a series of acquisitions. This has enabled it garner a larger share of the spend of the healthcare providers it has been targeting in developed as well as developing countries.

It has emerged as the largest player in the domestic medical equipments space and has also managed to carve out a formidable reputation globally on account of its product range, technological innovation and IPRs, and currently has rights over 35 product patents, with 28 applications pending.

Its product profile consists of ~ 90 products spread across the non-invasive and invasive segments of medical devices and it also provides ancillary and complementary services for its patient monitoring devices. With manufacturing operations located in India, Germany and U.S., and marketing presence in ~56 countries, it has emerged as a player to reckon with on the global arena.

It went in for a QIP in 2QFY10 raising INR4bn by issuing 21.4m shares at a rate of INR186.65/share. The company utilised the funds to repay INR2bn of debt taken on the books at the time of the Criticare acquisition. Of the remaining funds, INR1bn has been pumped back into the business while INR1bn is yet to be deployed

Business Verticals of the Group



Source: Company, Antique

Manufacturing Locations

The manufacturing facilities of the company are located in India and the US, with a design and development centre located in Germany.

The main manufacturing facilities in India are located in Bengaluru (Karnataka) in Electronic City and the same has US FDA registration and CE certification for vital signs monitor, SpO2 sensors (disposable as well as reusable) and thermometers. It is a registered 100% EOU (Export Oriented Unit) and is thus eligible for tax concessions from export sales till Mar'11. [U.S. FDA and C.E. approvals are required to sell medical equipment in the U.S. and Europe respectively.]

Its other facilities in India are at : Parwanoo (Himachal Pradesh), for manufacturing catheters and stents for urology, gastroenterology, gynecology and radiology uses; Chennai (Tamil Nadu), for manufacturing surgical implants and at Vishakapatnam (Andhra Pradesh) which is an SEZ facility.

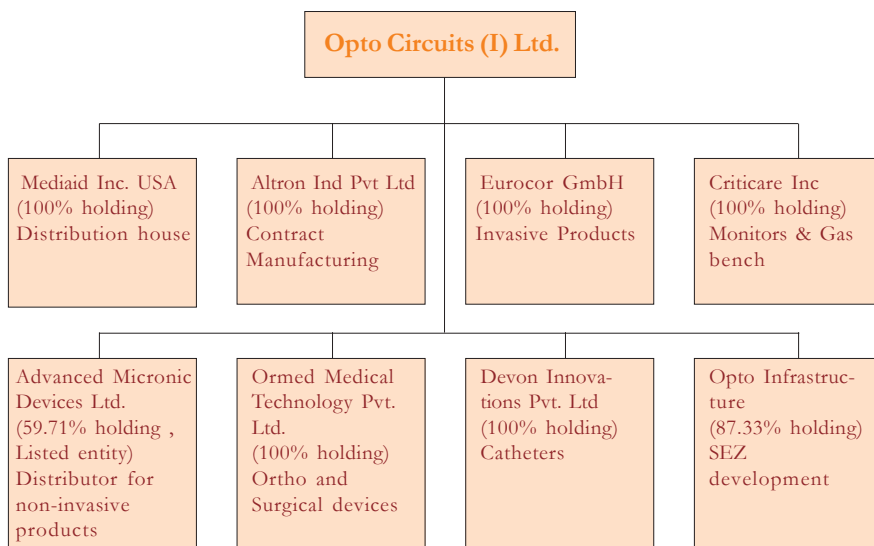
The SEZ facility was set up by OCIL to ensure that it will have the advantage of a tax shelter, in case the concessions available at its Bengaluru facilities are not extended beyond Mar'11.

The company has also set up a subsidiary, *Opto Infrastructure* (87.33% holding) through which it intends to set up an SEZ in Hassan, Karnataka, so that it retains its costing advantage on the manufacturing front on account of tax concession, in the years to come.

The facility in US at Wisconsin manufactures US FDA approved patient monitoring systems. It came into OCIL's fold post its acquisition of Criticare. The headcount at this facility is 25.

The *Eurocor* facility in Bonn, Germany designs and develops Coronary stents, Balloons, Catheters and allied devices, which are later CE certified. This came into the company's fold in Jan'06, post its acquisition of Eurocor. The head count here is 29 and the same would be a key differentiating factor in the company's thrust in the Invasive segment as design and product innovation is a key separator.

Holding Structure of Opto Circuits Group



Source: Antique

Marketing setup

In order to obtain critical customer reach, OCIL has continuously scaled up its operations and managed to build a strong marketing network at home as well as abroad.

Its distributor strength in India is ~380 and the same is being serviced by a 100 member strong sales team. The overseas marketing structure of over 800 distributors spans almost 56 countries and is serviced by a team of 30 sales personnel.

Despite being an OEM supplier to many global majors for sensors, OCIL has taken considerable efforts to tap the demand from the replacement and after sales market where public domain design sensors / compatible sensors are used.

The company also participates in the tender business, but not to a large extent, as the dynamics of that business are distinctly different from the distribution model. However, this is largely to sovereign entities in India and large scale procurement organisations in developed countries viz. GPO etc. As a derisking measure, the company limits its exposure to institutional buyers to ~10% of its sales. The average ticket size of sales for the company is ~USD5,000 -10,000 and in case of institutional sales it ranges around USD150,000-200,000.

As part of a brand building and market penetration exercise, the company regularly sponsors trade shows, seminars etc. where not only its products are show cased, but also case papers on its usage presented. Its efforts to carve out a distinctive brand equity for its products and safeguard the same have yielded 29 trademarks registrations, with 8 applications pending.

The company has managed to set up a strong marketing, distribution and receivable collection system. This, along with the fact that no distributor accounts for over 5% of its net sales, has ensured that its receivables have never exceeded 180 days and delinquencies have been negligible.

After Sales service setup

In the critical care medical equipment market, a strong after sales service backup is just as important as brand equity and marketing reach. A well crafted after sales service strategy, along with a point of presence in places normally overlooked by large competitors who chase big ticket sales, can ensure that companies like OCIL make strong inroads into markets which are usually not serviced by global majors.

In India, OCIL has an after sales service team of ~100 and supports installations directly as well as through distributors and the network is adequately stocked with spares. While this could strain the working capital of the company on account of inventory carrying costs, the assurance of minimal downtime is probably the best brand equity builder in this segment.

In international markets, the after sales service is provided directly in some areas, and through distributors in majority of the locations. Its personnel strength in the same is ~30 and OCIL has points of presence in locations across Europe and the US.

Product Profile

Non-invasive Devices

Patient Monitors: A non-invasive patient monitor is a medical device that displays two or more vital signs or parameters which indicate the patient's condition, thereby enabling treatment options. The company develops, manufactures and distributes ~30 variants of proprietary technology based single-parameter, multi-parameter and vital signs monitors on both, singular and modular platforms. These are used in doctors' clinics, surgery centres, ICUs, operating rooms and emergency rooms.

Sensors: Sensors are the crucial interface between the patient and the monitoring systems. The company has a comprehensive range of, which are classified as reusable or disposable sensors. Reusable sensors can be reused a number of times before being replaced. Currently reusable sensors are widely used, especially in developing markets. However, due to hygiene reasons and growing healthcare awareness, the market is shifting towards disposable sensors.

Disposable sensors are one time use sensors and have wide acceptance, especially in developed markets. Since a disposable sensor is used on one patient and only once, the risk of cross-contamination is eliminated. Developed markets such as the United States have gradually transitioned to disposable sensors as compared to developing countries that use reusable sensors due to cost considerations. Reusable sensors usually cost around USD110-150 while the disposable one cost around USD4-10.

In FY09, ~40% and 35% of OCIL's revenues accrued from patient monitors and sensors respectively. These products are manufactured through the company's proprietary technology and are CE and US FDA certified. They are sold under the brand names of *Mediaid* and *Criticare* and are distributed in most of the developed markets of the world.

Invasive Products

Cardiac implants: This vertical comprises of products like Drug eluting stents, Bare Metal stents and Balloons. Coronary stents are implanted in heart vessels when they get blocked due to arteriosclerosis. A coronary artery stent is a small, metal mesh tube that expands inside a coronary artery and keeps the arteries open, even after surgical treatment.

Stents can broadly be divided into two types:

Bare Metal Stents (BMS): These are the earliest developed form of stents of early 1990s vintage. BMS have a plain metal body mesh and are usually made of stainless steel, cobalt-chromium etc.

Drug Eluting Stents (DES): These are an evolved form of BMS and are used to release drugs in the artery gradually over a period of two to three months. This is done to prevent the recurrence of blockage and are currently preferred by cardiologists over BMS.

Drug Eluting Balloons (DEB): These deliver the drug during the surgery in a more effective manner, thus preventing blockage of the artery. OCIL has pioneered the use of this product and is currently aggressively marketing the same amongst cardiologists.

The cardiac implants manufactured are CE certified. The company is awaiting FDA certification for its BMS product line, which is marketed under the *Eurocor* brand and distributed in most of the developed markets of the world, except US, Canada and Japan.

Orthopedic Implants: Orthopedic implants are used to surgically replace damaged or troubled joints. These are constructed from titanium alloys for strength and lined with plastic to act as artificial cartilage.

The invasive products contributed ~22% to the company's revenues in FY09 and we estimate this proportion to ramp up significantly in the coming years with increased marketing efforts of the company and increasing acceptance of the product range.

Industry Overview

Medical devices form a crucial healthcare part of the present health and healthcare sector. The sector covers ~ 8,000 types of products, covering a wide spectrum, from bandages and spectacles, implantable devices, screening and diagnostic equipment etc. (Source: European Commission).

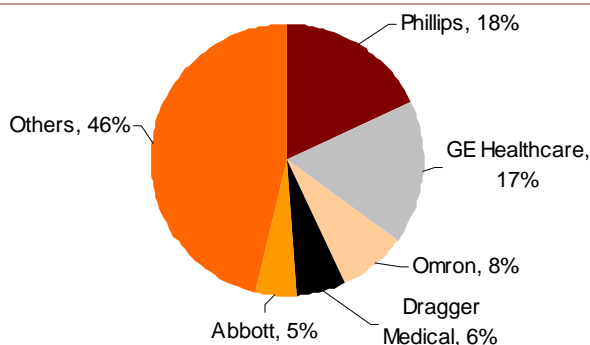
The medical devices industry can be broadly classified into non-invasive (including patient monitors and sensors) and invasive devices (including implants and stent systems).

Non-invasive Devices

OCIL's non-invasive devices viz. patient monitoring devices, sensors, etc. form a part of the non-invasive healthcare devices market. Globally, this market is estimated to grow to USD5.7bn by 2011, with multi-parameter patient monitors accounting for over 40% of the market.

Furthermore, the North American market is expected to grow at a CAGR of over 8% and account for 56% of the worldwide market for patient monitors by 2011. Interestingly, remote patient monitoring is expected to grow the fastest at a CAGR of over 10%. This augurs well for OCIL as it has just commercialised a state-of-the-art 'Remote Patient Monitoring Module' through its *Criticare* brand, which it is marketing aggressively.

Competitive Scenario: Global Market Scenario: Patient Monitoring Devices



Source: Antique

Growth Drivers for Non-Invasive Devices

Increasing outlay on healthcare by governments: The GoI has budgeted significant amounts for mobile health care delivery service through programs such as the National Rural Health Mission (NRHM). This includes coverage of upto INR30,000 for diseases that require hospitalization. (Source: www.rsby.in). The US Government is also planning healthcare reforms to introduce significant budgetary and legislative initiatives in order to expand healthcare coverage and increase expenditure on healthcare institutes while controlling rising health care costs. (Source: www.healthreform.gov)

Improvements in technology: The trend in patient monitoring devices is steadily veering towards modularisation and compatibility, with emphasis on miniaturisation and making them more suitable for ambulatory purposes. OCIL is well poised to tap this demand on back of recently developed products like its miniature gas bench and modular patient monitor.

Compatibility of equipment and technology: Currently, most sensors used are patient monitor specific and incompatible with monitors of other OEMs, resulting in a bundling of sensors with the patient monitors and limiting the end users' choice, thereby reducing cost effectiveness. The emerging trend in the industry is the development of sensors that are compatible with a range of patient monitors, which may lead to the market for sensors opening up further.

There is also a distinct shift in medical treatment patterns and with costing being a prime driver and institutional insurance coverage becoming scarce, individual are now opting for cost effective treatments in centres which can emerge as value for money options. A brief table on costing of medical treatment and surgeries across geographies is given in the table overleaf

While one of the key differentiators for cheaper medical treatments is manpower i.e. doctor and nursing costs, there has been a concerted efforts on part of medical/hospital service providers to keep their capital costs as well as operational cost low, thus spawning up demand for technologically innovative players like OCIL who are carving a niche for themselves.

Procedure costs in US, UK, India, Thailand, Singapore, (USD), 2008

Procedure Costs	US	UK	India	Thailand	Singapore
Heart bypass surgery	24,000	20,000	6,500	8,000	10,500
Hear valve replacement surgery	200,000	90,000	8,500	10,000	12,500
Spinal fusion	20,000	10,000	2,000	3,500	4,500
Cosmetic surgery	62,000	50,000	5,500	7,000	9,000

Source: Planning Commission of India and Global Markets Direct

Invasive Products

The global market for coronary stents is expected to grow to ~USD7bn by the end of 2015 from USD6bn in 2008 (CAGR of 3.4%). Of this, the market for DES market is expected to touch ~USD4bn by 2010.

Competitive Scenario

The Indian stent market is currently dominated by *J&J* and *Medtronic*. However, smaller companies like OCIL, *Translumina* and *Sabajanand* are making inroads by selling products at a lower price band and enhanced marketing activities.

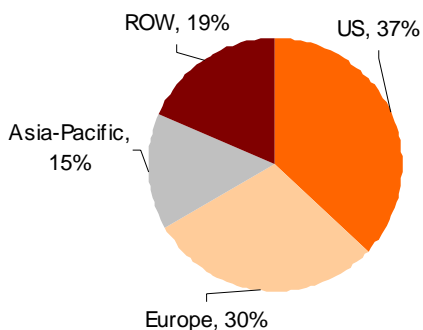
Growth Drivers for Invasive Devices

Increasing occurrence of lifestyle diseases: Globally, there has been a rise in the incidence of lifestyle related diseases such as diabetes, obesity, high blood pressure and high cholesterol, providing growth impetus for advanced cardiovascular care.

Shift in demographics: A growing number of people aged over sixty in the US and the developed world is expected to lead to an increase in the occurrence of age-related diseases, including cardiovascular diseases since its prevalence rate increases with age.

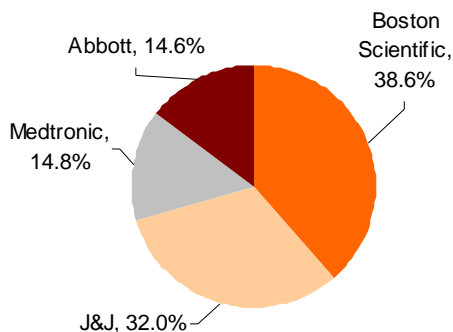
Increasing acceptance of minimally invasive surgery: Stents form the largest product segment of the minimally invasive surgery segment. Their acceptance is growing rapidly on account of better clinical performance, faster patient recovery time and fewer medical complications. Additionally, technological advances in stent design and cost effectiveness of the same vis-a-vis bypass surgery is fuelling the demand for coronary stents.

Geographical break-up of Global DES market



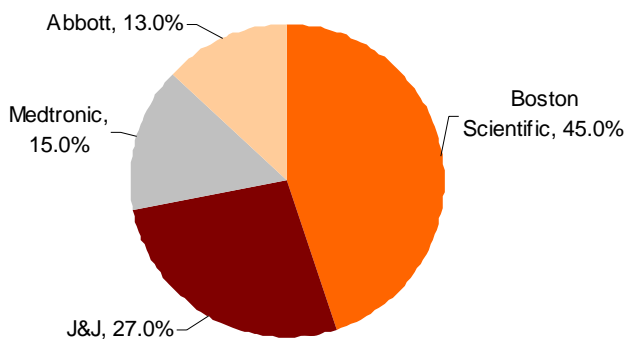
Source: Industry estimates

Market share of Global DES market



Source: Industry estimates

Competitive Scenario: US DES Market



Source: Industry estimates

Inorganic Growth

OCIL commenced operations in 1992 by manufacturing pulse oximetry sensors for OEMs. Since then, the management has effected a series of acquisitions in order to fuel growth. The common thread that OCIL maintained throughout these acquisitions for the same was:

1. Achievement of growth through synergies of OCIL’s product line and that of the target company
2. The existing product line of the acquired company had to be rooted in proprietary technology, which would drive pricing power, profitability and future growth.
3. The manufacturing process had the potential of being migrated to India.

A brief summary of the same is enclosed in the table below.

Chronology and Details of Inorganic Growth

Acquisiton	Date	Shareholding	Product/ Service Profile Acquired	Consideration
AMDL	CY01	59.71	Vast domestic distribution network	INR50m
Mediaid	CY02	100%	Development of non-invasive devices alongwith global dealership network	USD1m
Altron	CY04	100%	Manuf. facilities of non-invasive devices	INR5m
Eurocor	CY06	100%	Invasive products viz. BMS, DES & DBS	Euro4.31m (Shares to promoters) + Euro1.5m (Earn & Payout)
Devon	CY07	100%	Invasive products, catheters	
Ormed	CY07	100%	Orthopaedic implants	
Criticare	CY08	100%	Patient Monitors	USD68m

Source: Company, Antique

Strength

Product Range and value chain presence

The company has built up a formidable range of product offerings for a player of its size. Beginning operations as a OEM supplier of sensors for pulse oxymeters sensors, it capitalized on the opportunity which emerged on account of the product going off patent in 2002, emerging as a sensor supplier of choice not only in the OE segment, but also in the replacement segment.

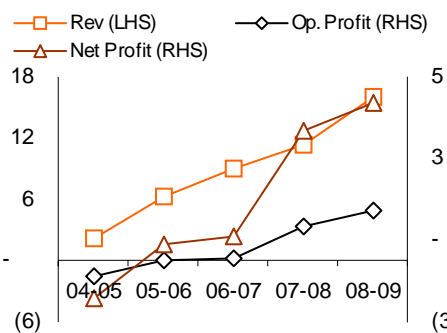
Its subsequent acquisitions in the patient monitoring and multi parameter monitoring arenas have enabled it to tackle competitive pressures and practices as its presence over a larger value chain enables it to garner a large share of spend of the capital expenditure (largely by service providers like hospitals and clinics, which form a highly cost sensitive segment) as well as the operating expenditure (largely by patients, who form the least sensitive segment to pricing vagaries).

OCIL has simultaneously nurtured a skill set which has enabled it to develop innovative modular products like the gas bench, networked multi parameter monitors etc. which are not only cost effective, but also offer high usage convenience.

Proven capability of successful inorganic growth

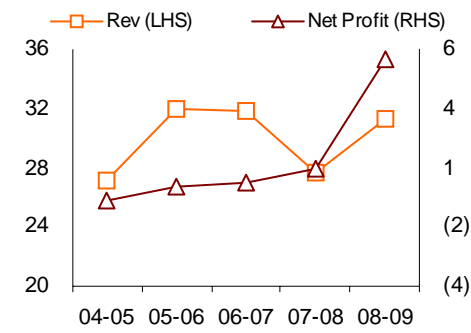
In its endeavor to capture a larger part of the capital and operational expenditure spends, OCIL has institutionalized the process of not only identifying and consummating acquisitions, but also scaling up and turning around of the same in a short period of time. The same can be inferred from the table below when the positive traction in operational metrics can be seen.

Financial Performance of Eurocor (Euro m)



Source: Company

Financial Performance of Criticare (USD m)



Source: Company

Strong positioning as a cost-effective, technology player

Over the past few years, the company has refined its ability to spot niches and conceive and develop practical solution for the same. It has managed to accomplish the same in a cost effective manner while simultaneously nurturing the domain expertise of its acquisitions like Criticare and Eurocor in critical functions like front end engineering, since the same cannot be achieved in India in a cost-effective manner. However, it has always succeeded in fanning out operational functions like design, engineering, circuitry, modularisation etc to India, which like the Indian IT sector, generates benefits on fronts like product costing and turnaround time.

Emphasis on development of proprietary technology through R&D

Availability of skilled pool of manpower at an effective price point has been a traditional advantage of the Indian engineering and technology sector. OCIL has managed to capitalise on this to not only set up cost effective operations, but also secure an advantage on the lifecycle management. This has resulted in a lower designing and development costs for products and lower lead time to commercialise and market products. Its spend on R&D for the FY07, FY08 and FY09 has been INR92m, INR600m, INR 1.05bn, constituting 3.6%, 1.3% and 12.3% of revenues respectively.

Derisked revenue streams:

OCIL's revenue streams are diversified, from the product as well as geographical perspectives. The same can be seen from the table below.

This has de-risked it from any threat emanating from periodic uncertainties which could emerge due to tariff, non-tariff as well as legal and statutory glitches on the geographical front.

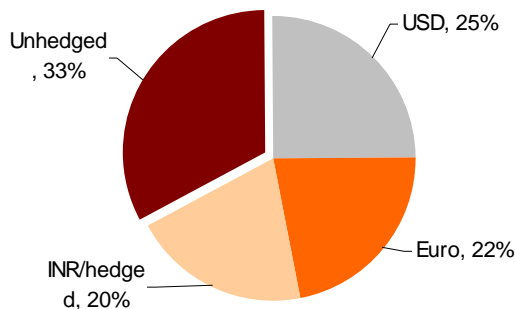
Additionally, as the product and revenue streams have broadened over the past few years, on account of the traction being exhibited by acquisitions like *Eurocor* and *Criticare*, the company is well placed to tide over any unforeseen factors which could impact a particular range of products or geography.

Weakness

Multi currency revenue streams

OCIL's revenues accrue from various geographies viz. US, Europe and Asia. Its domestic/ INR denominated revenues are miniscule. Almost half of its revenues originating from overseas entities have natural hedges as income and expenses are both in same currency. Of the balance, ~20% is backed by commensurate imports i.e. largely raw materials. The rest i.e. 30% of the revenues are technically exposed to currency gyrations. Furthermore, any unforeseen currency divergence between the USD and Euro could adversely impact revenues and cash flows. However the company has a strong mechanism in place to tackle the same.

Currency Profile of OCIL's revenues (FY09)



Source: Company

Balance sheet

OCIL has to incur markedly high expenses whenever it enters new markets, on account of setting up marketing infrastructure. Another aspect is the line of credit extended to various channels and incentives provided for increasing product usage. These factors serve as significant challenges for entry and growth for many players. As the company is in initial stages of growth it will have to effectively manage its balance sheet for not only seeding and penetrating markets, but also to ensure that its primary growth engine viz. its innovation capability does not get stifled by inadequate allocation of scarce capital.

OEM tie ups could stifle innovation:

OCIL had started out as an OE supplier to dominant players in the medical equipments sector. It subsequently capitalized on the shift in the industry trend and built up skill sets and emerged as a player to reckon with in many segments of healthcare. While OEM supply and becoming a replacement requirement supplier is an easy business with relatively lower time for operational stabilisation, the ease of business operations could end up stifling innovation. While the company has crossed critical inflection points in its lifecycle and its innovation ability has not been stifled, going forward, the company would have to avoid the pitfall of capital scarcity, which could result in lack of focus on innovation and ultimately impact its growth prospects.

Brand equity: yet in a nascent stage.

Though the medical equipments business is cost competitive, it is highly brand conscious, more so in case of the invasive segment. In order for OCIL to ramp up significantly to tap the burgeoning addressable, it will have to simultaneously be at the forefront of technological innovation and considerably fortify and develop strong brand equity and recognition.

This could prove to be a challenge, especially in developed economies, as it would entail innovative marketing and judicious capital allocation. While the company has demonstrated strong skills in managing such challenges in several geographies, it could be tested as it forays into more mature markets.

Opportunities

US markets to open up post FDA approval.

The US is the largest market for healthcare services and products and is accessible to players having the inclination and capability to cater to it. However, stringent guidelines relating to manufacturing, quality, design and approvals are a formidable entry barrier.

The total market for all invasive products is estimated at USD10.5bn (2008), of which the US accounts for ~60%. This market is not only huge but also insensitive to pricing pressure as most of the treatment costs are borne by insurance companies and not by patients themselves.

While OCIL currently has CE certification for its entire range of stents, it is pursuing FDA approval and does not have any presence in the sizeable and lucrative US market. Fructification of the same would not only boost sales volumes of this product line, but also serve to improve the per unit realizations. US FDA approval generally entails an expense of ~USD12-15m and could take ~30-36 months to secure.

Indian markets hold promise

India currently undertakes around 90,000 cardiac bypass surgeries and a similar amount of invasive surgeries per annum. While the average cost of a bypass surgery used to be ~INR0.3m and entail hospitalization of 12-21 days a decade ago, the same has now slid to INR0.1m with hospitalization of 7-10 days. This, coupled with the healthy distribution of superior quality tertiary care hospitals across Indian metros has brought cardiac care within the reach of ~4m patients.

While there is global consensus that India will emerge as a country having the largest number of the cardiac patients by 2015, the number of people requiring critical treatments would be ~1.5-2m a year, there by spawning a huge addressable market for a player like OCIL which offers competitively priced products which are also at the forefront of technological innovation.

Emergence as a disruptive player

The stent markets has evolved considerably, from bare metal stents, to drug eluting stents, to biodegradable to drug eluting balloons. OCIL has consistently taken efforts to secure breakthrough in the drug eluting stents and balloons, with the latter being a cost effective innovation for cardiac care as well as post operative care (since it drastically reduces post treatment medicinal ingestion). Going forward, OCIL can capitalise on these capabilities to emerge as a player which can have disruptive effect in the most cost competitive segments of cardiac care.

Threats

Global players can play a predatory pricing game.

Global giants in medical equipments (Phillips, Tyco, Siemens etc) and invasive cardiac care (J&J, Boston Scientific, Abbot etc) have multi billion dollar balance sheets and tremendous brand equity. Their marketing strength and reach could prove to be a tough deterrent for a new player with the potential to emerge as sizeable competition.

Till lately, OCIL was a fringe player and an OE supplier (for medical equipments and devices), however, it has scaled up its product profile to encompass a larger part of the consumption/ value chain. It also has been taking firm steps to emerge as a cost competitive player offering contemporary technological options in the cardiac care invasive market. While OCIL has not made a foray into the home turf of the large players i.e. US, it would do so upon securing the FDA approval in the coming years. This has the potential to bring it in direct confrontation with well entrenched players who have the requisite strength to fight a long drawn marketing war and indulge in predatory pricing game.

While there has been no indication of the same, but the possibility of the same cannot be ignored. In case the same materialises, OCIL could be seriously impacted on the operational as well as the balance sheet front.

Technological shifts

Medical science is one of the most dynamic streams of science wherein there has been constant endeavor by committed participants to invent and innovate both on almost all fronts, especially since capital is not a constraint in most developed countries.

While obesity, diabetes and genetic predispositions have been the prime reasons for the upsurge in cardiac care cases (especially in India and the Far East), there has been a multitude of efforts to discover cures and treatments for cardiac afflictions, despite best efforts to adopt preventive life-style practices. This is proving to be a addressable market for players like OCIL.

However, any discoveries of drugs or treatments which could reduce chances of cardiac afflictions (like a vaccine) or cure diabetes and hypertension, would ensure that the above addressable market would shrink. In case of any disruptive treatment discovery (like polio or small pox vaccine) the impact on companies like OCIL and many other could be substantial. While there is no inkling of any such discoveries or innovation, history has been replete with instances of medical science spawning groundbreaking treatment and discoveries when least expected. Thus despite best efforts at desrisking, no company in this sector can be truly said to be insulated from any technological discoveries and innovation.

Impact of non tariff barriers, duties, ad spends

While technological capability and innovation serve as strong barriers, players like OCIL have managed to build a strong and enviable product range by virtue of their focus on developing cost effective technological options in an innovative manner. While the current deterrent could be the size and deep pockets of its competitors, equal danger could emanate from non traffic barriers which could emerge in some of the countries.

Usually high statutory duties and anti dumping duties are imposed in many sectors by developed countries when large incumbents express reservations about overseas and foreign upstarts foraying into their markets. While these incidents have not occurred, the possibility of the same cannot be ruled out. In such case, critical resources like management bandwidth and financial strength would get utilized in an extremely wasteful manner thereby impairing the profitability as well as the growth prospects of the company.

Our View

OCIL posted net sales of INR8bn with an OPM of 32% and operating profits of INR2.6bn in FY09. Its revenues and operating profit CAGR for the past 3 years has been 80% and 77% respectively. While a substantial part of this growth could be attributed to acquisitions, the company's skill in identifying niche acquisitions, integrating the same in a reasonable short time frame is what has set it apart from others.

The geographical quality of revenues has also improved as despite the net sales scaling up over 325%, the share of highly developed, most quality conscious and competitive markets namely US and EU has increased from 36% and 8% in FY07 to 46% and 15% in FY09 respectively. This underscores not only the acceptance of its technological skills in these markets, but also emphasise the success of its marketing strategy.

On the products front, OCIL's 'bread and butter' product i.e. sensors constituted only 35% of its revenues in FY09, as opposed to 49% in FY07. While sensors enjoyed high OPM sustained for an extended period of time, the successful assimilation of acquisitions like *Palco* (now *MediAid*), *Criticare* and *Eurocor* have ensured that the high complexity and realization segments like Monitors and Invasives now account for almost 62% of revenues in FY09, as against 41% in FY07. Viewed in the backdrop of revenues itself getting scaled up from INR2.5bn to INR8bn, it conveys the tremendous traction successfully exhibited by these high complexity acquisitions.

Considering the acceptance of its monitor as well as invasive products, the revenue ramp up potential is still high for these product ranges. OCIL has not been focussing on the large healthcare service providers/ hospital chains in the developed countries, as the global majors drive down prices by bundling in several products together. The majors have strong balance sheets and usually adopt the policy of offering soft terms of purchase for capital equipments but manage to draw a large annuity stream from the consumables and spares supply. However, their ability to service installations is limited as they restrict themselves to high density agglomerations and are not too keen to tap low density areas. This has resulted in them ignoring almost 35% of the market, thereby providing a window of opportunity for upstarts like OCIL.

Penetrating these markets and moving into least competitive market segments in metro agglomerations has the potential to offer huge growth opportunity for OCIL. As it has got the marketing framework and infrastructure in place, the operating leverage is extremely high. Thus we estimate the company to post revenues of INR11bn in FY10 and INR14bn in FY11, a growth of 35% and 30% respectively.

The OPM during these years is expected to be maintained at 31% levels. Our assumption accounts for the constraint of not being able to foray into the most lucrative market for Stents i.e. US for the next two years. However, this growth will also entail enhanced requirement of working capital.

Over FY10 and FY11, we expect the company to report net profits of INR2.8bn and INR3.9bn respectively, a growth of 34% and 41% respectively

At a CMP of INR229, the stock is ruling at an EV/EBIDTA of 7x and PER of 8.7x its FY11e numbers. Considering the peerset valuations, elaborated in the table below, these metrics are

at the lower end of the spectrum, despite considering the size differential. Extrapolating a PE multiple of 12.5x, we arrive at a fair price of INR295 for the company based on FY11e earnings. Hence, we recommend a buy with a price target of INR295, which represents an upside of 29% from current levels.

Peerset Comparison of Medical Equipment Players

	Biosensors International	Terumo Corp.	Becton Dickinson	Medtronic Corporation	Johnson & Johnson	Baxter
USDm	FY11	FY11	Sep-11	Apr-11	Dec'10	Dec'10
Revenues	164	3,807	8,053	16,703	64,065	13,507
EBITDA	24	1,040	2,399	6,285	21,090	4,067
Net Profit	21	518	1,340	3,837	13,668	2,599
P/E(x)	19.0	23.3	13.7	10.5	10.7	11.2
EV/EBITDA(x)	27.8	12.3	7.5	8.6	8.3	9.1
Market Cap(USD bn)	0.6	12.5	18.1	48.1	177.5	35.2

Source: Bloomberg

Financials (INR m)

Profit and Loss Account

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	4,681	8,185	11,060	14,408	18,663
Expenses	3,309	5,595	7,542	9,688	12,395
Operating Profit	1,372	2,591	3,518	4,721	6,268
Other income	171	288	313	524	567
EBIDT	1,543	2,878	3,831	5,245	6,835
Depreciation	63	138	245	340	400
Interest expense	109	537	355	288	398
Profit before tax	1,371	2,203	3,231	4,617	6,037
Taxes incl deferred taxation	38	75	113	162	211
Profit after tax before MI & EO Items	1,333	2,128	3,118	4,455	5,825
Extra ordinary Items	(20)	(35)	-	-	-
Minority Interest	7	6	7	8	10
Profit after tax	1,307	2,087	3,112	4,447	5,816
Diluted EPS (INR)	6.9	11.1	16.5	23.5	30.8

Balance Sheet

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	942	1,615	1,889	1,889	1,889
Reserves & Surplus	2,404	3,551	10,543	13,885	18,154
Networth	3,346	5,166	12,432	15,774	20,043
Minority Interest	79	134	141	149	158
Debt	1,012	5,379	2,508	3,252	4,716
Deferred Tax Liability	5	3	3	3	3
Capital Employed	4,442	10,682	15,084	19,178	24,921
Gross Fixed Assets	778	2,660	4,460	5,860	7,060
Accumulated Depreciation	222	666	911	1,251	1,651
Net Assets	556	1,995	3,550	4,610	5,410
Capital work in progress	17	172	600	600	400
Goodwill	431	2,374	2,374	2,374	2,374
Investments	3	3	3	3	3
Current Assets, Loans & Advances					
Inventory	1,456	2,305	2,200	2,826	4,132
Debtors	2,376	4,060	4,915	6,404	9,331
Cash & Bank balance	686	913	3,914	5,240	7,091
Loans & advances and others	558	2,565	628	807	1,033
Current Liabilities & Provisions					
Creditors	1,100	2,510	1,885	2,422	3,099
Other liabilities & provisions	801	1,198	1,218	1,267	1,758
Net Current Assets	3,174	6,134	8,554	11,588	16,730
Misc. Expenses	261	3	3	3	3
Application of Funds	4,442	10,682	15,084	19,178	24,921

Per share data

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	94	161	189	189	189
BVPS (INR)	35.5	32.0	65.8	83.5	106.1
CEPS (INR)	14.5	13.8	17.8	25.3	32.9
DPS (INR)	1.0	4.0	5.0	5.0	7.0

Margins (%)

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	29.3%	31.6%	31.8%	32.8%	33.6%
EBIT	31.6%	33.5%	32.4%	34.0%	34.5%
PAT	27.9%	25.5%	28.1%	30.9%	31.2%

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	1,371	2,203	3,225	4,609	6,027
Depreciation & amortisation	63	138	245	340	400
Interest expense	85	516	355	288	398
Interest / Dividend Recd	(3)	(0)	(313)	(524)	(567)
Other Adjustments	18	323	-	-	-
Minority Interest	7	49	7	8	10
(Inc)/Dec in working capital	(1,093)	(1,953)	581	(1,708)	(3,291)
Tax paid	(38)	(75)	(113)	(162)	(211)
CF from operating activities	409	1,202	3,986	2,851	2,766
Capital expenditure	(211)	(2,672)	(1,328)	(500)	(100)
Goodwill & Product Development Exp	(320)	(1,572)	(900)	(900)	(900)
Income from investments	26	21	313	524	567
CF from investing activities	(505)	(4,224)	(1,915)	(876)	(433)
Inc/(Dec) in share capital	459	175	5,260	-	-
Inc/(Dec) in debt	367	4,367	(2,871)	744	1,464
Dividends & Interest paid	(429)	(1,292)	(1,460)	(1,393)	(1,945)
CF from financing activities	397	3,250	929	(649)	(482)
Net cash flow	301	228	3,000	1,326	1,851
Opening balance	384	686	913	3,913	5,240
Closing balance	686	913	3,913	5,240	7,091

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	86.1	74.9	35.1	30.3	29.5
EBITDA	66.3	88.8	35.8	34.2	32.8
PAT	78.9	59.7	49.1	42.9	30.8
EPS	78.9	59.7	49.1	42.9	30.8

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	16.5	17.7	12.4	8.7	6.7
P/BV	6.4	7.2	3.1	2.5	1.9
EV/EBITDA	14.2	14.4	9.7	7.0	5.3
EV/Sales	4.7	5.1	3.4	2.5	1.9
Dividend Yield (%)	0.4	1.7	2.2	2.2	3.1

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	48.0	49.2	35.4	31.6	32.5
RoCE (%)	40.8	36.7	28.7	29.7	29.9
Debt/Equity (x)	0.3	1.0	0.2	0.2	0.2
EBIT/Interest (x)	13.7	5.2	10.5	17.7	16.6

Note

Prakash Industries Ltd.

A 'structural' growth story...



BUY

CMP: INR183

Target Price: INR432

December 22, 2009

Strictly confidential

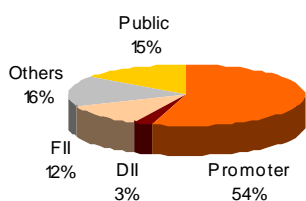
Market Data

Sector	:	Metals
Market Cap (INRbn)	:	21.6
Market Cap (USDm)	:	460.7
O/S shares (m)	:	115.5
Free Float (m)	:	52.0
52-wk HI/LO (INR)	:	191/32
Avg 12m Vol ('000)	:	1692
Face Value (INR)	:	10
Bloomberg	:	PKI IN
Reuters	:	PRKI.BO

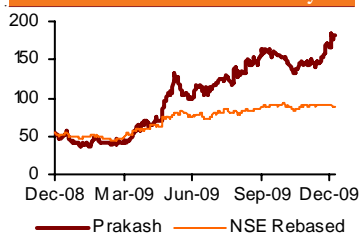
Price Performance

	1m	3m	6m	12m
Absolute	28.3	16.2	88.8	257.7
Relative	27.9	12.8	57.0	101.1

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Nirav Shah +91 22 4031 3473
nirav.shah@antiquelimited.com

Investment Rationale

Prakash Industries Ltd. (Prakash) is a New Delhi based company with majority of revenues accruing from steel and ferro alloys. Its steel capacity of 0.65mtpa, located at Champa (Chhattisgarh), is backed by a sponge iron capacity (0.6mtpa) and complemented by a finishing capacity of wire rods (0.45mtpa) and structurals/TMT (0.3mtpa). It also operates a ferro alloy plant (48k tpa) and has a power facility of 100MW (25MW WHRS, 75MW coal based CPP).

Prakash is in the midst of a INR8bn capex which would enhance its sponge iron capacity to 1.2mtpa, steel smelting to 1mtpa and mine development. To monetise its coal mines, it is also foraying into power generation and plans to set up a 650MW power plants (600MW coal based and 50MW WHRS) at an outlay of INR25bn.

At the CMP of INR183, the company is trading at a P/E of 5.5x and EV/Sales 1.2x, discounting its FY11e numbers.

Valuation

Stable steel pricing environment, strong control over key raw material (coal and iron ore) and predictability of revenues from its proposed merchant power plant places Prakash in an enviable position. Moreover, scaling up in operations and captive linkages for both iron ore (FY10 onwards) and coal would result in substantial topline and net profits growth. Thus at the CMP, there is a huge scope for re-rating due to asset mis-pricing, as well as growth prospects. Hence, we initiate coverage with a BUY recommendation with a 24-month price target of INR432 (based on SOTP valuation), which represents a 136% upside from current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	15,256	17,053	19,965	26,070
EBITDA	3,004	3,681	6,534	8,850
EBITDA Margin (%)	19.7	21.6	32.7	33.9
EBITDA growth (%)	1.3	22.5	77.5	35.4
PAT	1,980	1,955	4,139	5,134
PAT growth (%)	2.7	(4.3)	111.8	24.0
EPS (INR)	17.2	15.6	33.0	40.9
EPS growth (%)	2.7	(11.9)	111.8	24.0
P/E	11.2	11.7	5.5	4.5
P/BV	2.4	2.0	1.5	1.2
EV/EBITDA	7.7	6.1	3.5	3.0
RoE (%)	19.4	14.7	23.8	22.8

Source: Antique

Introduction

Prakash Industries Ltd. (Prakash), promoted by Mr. B. D. Agarwal in 1982, has interests in steel, ferro alloys, power and PVC pipes. While steel accounts for a lion's share of its revenues, around 15% of its revenues for FY09 were accounted for by its PVC pipes (capacity - 15ktpa) and ferro alloys (~48k tpa capacity) divisions.

It was one of the earliest entrants into sponge iron manufacturing and in 1991 set up a 500 tpd kiln at Champa (Chhattisgarh) based on Lurgi Technology. Since then, it has focussed on scaling up its steel business and its capacities currently are as following:

While its sponge iron, steel melting shop (SMS) and ferro alloy facilities are located at Champa, the finishing facilities i.e. structurals/TMT and Wire rod mills are located at Raipur (Chhattisgarh).

Product	Existing
Sponge Iron	0.6m tpa
SMS (Steel melting)	0.65m tpa
Structurals/TMT	0.3m tpa
Wire Rods	0.45m tpa
Ferro Alloy	0.048m tpa
Coal Mining	1m tpa
Power	2 X 12.5MW WHRS 75 MW coal based CPP

Source: Company

Business Model

Prakash manufactures sponge iron and operates a capacity of 0.6mtpa, including the recently commissioned kiln with a capacity to 0.2mtpa. The company also has a WHRS power capacity of 25MW.

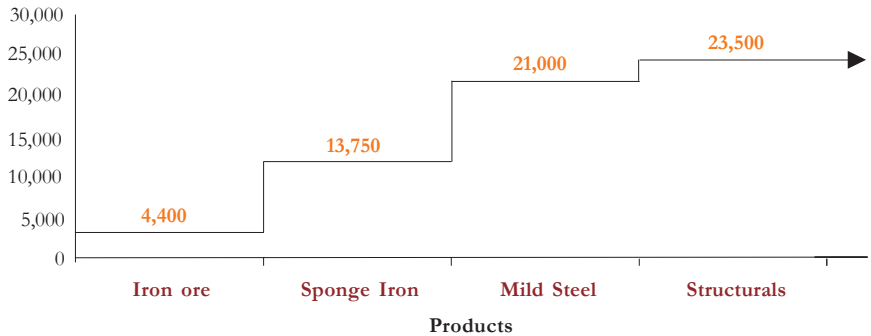
Its steel making (SMS) capacity stands at 0.65mtpa and the company uses the induction furnace route. In this method, sponge iron constitutes 80-85% of chargeable material (balance being scrap/pig iron). Thus, for its current steel capacity, the captive sponge iron suffices ~70-80% of its requirements, necessitating open market purchases of metallics.

Its steel production is captively consumed to manufacture higher value added products like structurals/TMT and wire rods, where its capacity stands at 0.3mtpa and 0.45mtpa respectively. Wire rods and structural command a realisation of INR25,000/tn and INR23,500/tn, as opposed to sponge iron and billet realisation of ~INR13,750/tn and ~INR 21,000/tn respectively, enabling the company to not only improve its sales realisation per tonne, but also improve margins.

Currently, there is a mismatch in its SMS and finishing lines which again entail external purchases of billets of requisite grade.

A brief illustration of the value chain is elaborated below:

Realisation Scale-up Chart (INR/tn)



Source: Antique

Prakash also has Ferro alloy capacity of 48k tpa, a crucial raw material for steel manufacturing. While a portion of the production (~30%) is captively consumed for steel making, the balance is sold in the open market to other steel players on long term or spot basis.

The company's current power generation capacity is 100MW, split into 25MW of waste heat recovery system (WHRS) and 75MW of coal based. Peak power requirement of ferro alloy production would be ~25MW, with the balance being consumed by the steel melting shop and finishing mills.

At the current scale of operations, the power consumption would be marginally more than captive generation. Prakash has grid dependence for ~20MW. While the scale up in sponge iron will ensure a commensurate rise in WHRS based power plant, there will also be a matching scale up in steel melting capacity. Thus, the company will need to have some grid dependence till the first phase of its 600MW power project becomes operational.

As the company presently has a mismatch in metallics, it is susceptible to volatility in sponge iron and scrap prices. To alleviate this mismatch, reduce volatility in raw material and derive benefits of scale, Prakash has outlined a capital expansion of INR8bn to scale up its metallics and melting shop capacities.

Operational Costing

The key raw materials for sponge iron manufacturing are iron ore and coal, with the standard consumption norm being ~1.6tn of iron ore and ~1.2-1.3tn of coal for every ton of sponge iron. Prakash is self sufficient in coal as a result of which its landed coal cost is INR800-900/tn (vs market price of INR1,800/tn).

The company's captive coal mine is located at Chotia (Chhattisgarh) with reserves of ~50m tn. The extraction capability at this mine (1mtpa) can cater not only to the requirements of its sponge iron division, but also for its 75MW captive power plant.

However in case of iron ore, the company does not have captive mines and incurs a landed cost of ~INR4,400/tn, for procuring the same from Orissa. Thus, it is exposed to market forces. It has been allotted the Kawardha iron ore mine in Chhattisgarh, with estimated reserves of ~75m tn containing high grade iron ore (+66% Fe) and this is expected to be operationalised by 2QFY11. Upon commencement of mining, the mine head cost of CLO (Calibrated ore) is expected to be INR1,000/tn while the landed cost would work out to INR1,500/tn. On a normative basis, this would entail a raw material saving of INR4,000/tn of sponge iron manufactured, affording huge costing advantage to Prakash and buoy its profits significantly. The costing matrices of a sponge iron manufacturer who has to procure all the raw material externally, vis-à-vis a player who has a degree of control over the same is elaborated in the table below. It can be seen that the costing advantage of a player with captive coal and iron ore mines along with WHRS system is almost INR5,000-5,500/tn of sponge iron manufactured. At the current realisations of INR13,750/tn, the advantage accruing from control over resources would prove to be a key operating profit/tn differentiator.

The indirect advantages in later stages for an integrated or a value added player like Prakash could be inferred from the fact that its cost of power generation is around INR 0.7/unit and the production cost/consumption parameters are ~3,800-4,000 units/tn of ferro alloys and ~800-1,000 units/tn for steel melting and 120-200 units/tn for rolling and drawing. Thus, the benefits of a CPP would be significantly evident in the steel making and finishing.

Operational Costing for Manufacturing 1tn of Sponge Iron

Component	Qty	W/o Raw material Linkages		With captive coal		With captive coal and iron ore	
		Rate	Total	Rate	Total	Rate	Total
Iron ore	1.6tn	4,400	7,040	4,400	7,040	1,500	2,400
Coal	1.3tn	1,800	2,340	820	1,066	820	1,066
Flux		800	800	800	800	800	800
Manpower		750	750	750	750	750	750
Power	90units	3	270	1	90	1	90
Total			11,200		9,746		5,106

Source: Industry, Antique

Existing Capacities

Sponge Iron/Steel

In 1991, PIL set up a 1x500tpd sponge iron kiln at Champa (Chhattisgarh) in technical collaboration with Lurgi. The same was doubled in 1995 and the performance of the kilns has been satisfactory with utilisation levels ~90%. To move up the value chain, Prakash set up a steel melting shop of 0.55mtpa which was expanded to 0.65mtpa in 3QFY10. However, as its current sponge iron capacity is not capable of catering to its metallics requirements, it has to procure sponge iron/scrap from the spot market. The output of the steel melting shop i.e. billets/blooms is further processed at its finishing plant at Raipur, to make value added products such as structurals and wire rods.

Structurals

To move up the value chain, Prakash commissioned a 0.15mtpa structural mill (in FY01), which was enhanced to 0.3mtpa in FY08. This facility, at Raipur, manufactures a wide range of products like channels, beams and angles which are largely utilised in the infrastructure and construction sectors.

Wire Rods

With capacities of 0.55mtpa for steel (expanded to 0.65mtpa in Q3FY10) and 0.3mtpa for structurals, Prakash was selling billets in the open market. In order to utilise this excess billet production and improve realisations and evolve a stronger product mix, the company set up a wire rod mill of 0.45mtpa in FY08 at Raipur.

Power

Prakash was one of the first companies to tap waste gases from sponge iron kilns for power generation. The company currently operates 25MW captive power plant based on this technology. Over and above this, in order to have strong control over its costing in SMS, Prakash set up a 75MW captive power plant (each tonne of steel entails power consumption of 800-1,000 units). This generated significant cost savings for Prakash, as it was generating power at ~INR 0.7/unit instead of purchasing from the grid at INR 3.75/unit.

Ferro Alloys

The company operates four furnaces to manufacture ferro alloys and their combined capacity is 48,000 tpa. Its product portfolio consists of silico manganese, ferro manganese and ferro chrome and over 30% of its production is consumed captively, while the rest is sold outside.

Expansion Plans

Prakash is expanding capacities in both steel and power. While steel capacity will not be increased by a large extent, majority of the capex entails enhancing its power capacities. All the capacities in power and steel will be implemented in a phased manner till FY15. The outlay for steel capacity expansion is ~INR7bn, while the proposed power capacity of 650MW will entail a capex of INR25bn. Additionally, an expenditure of INR1bn is envisaged for development of iron ore and coal mines and normal capital expenditure.

Outlays

Sponge Iron Division

The company has expanded its current sponge iron capacity from 0.4mtpa to 0.6mtpa. It plans to further augment this capacity to 1m tpa by the end of FY12 and 1.2mtpa by the end FY13. The outlay for the entire exercise of capital expansion is estimated at INR5.3bn.

Steel Division

Plans are afoot to expand the capacity of the SMS from the current levels of 0.65mtpa to 1mtpa by Q3FY11. The company envisages an outlay of INR1bn for this expansion.

Mining Division

Prakash also plans to expand its existing mining capacities in order to ensure that coal extraction reaches levels of 1.1m tpa in FY10, 1.5m tpa in FY11 and 2.5m tpa in FY12. This would fulfill its captive demand for steel and power operations.

In the iron ore mines, the scale up will be in the Kawardha mines initially, so that captive ore production would cater to at least 50-60% of the demand of the sponge iron units. The ramp up in Sirkaguttu mine would be in tandem with the scale up in sponge iron capacities. The total outlay for the ramp up in all mines is estimated to be ~INR1bn.

Product	Existing	Expansion	Timeline	Cost
Sponge Iron	0.4mtpa	1 X 500 tpd (0.2mtpa) 1 X 500 tpd (0.2mtpa) 1 X 500 tpd (0.2mtpa) 1 X 500 tpd (0.2mtpa)	Completed FY11 FY12 FY13	INR 5.8bn
SMS Steel melting	0.55mtpa	0.1m tpa 0.35m tpa	Completed FY11	INR 1bn
Structural	0.3mtpa	Modernisation	FY10	INR 0.2bn
Wire Rods	0.45mtpa			
Ferro Alloy	0.048mtpa			
Mining				INR 1bn
Power	2 X 12.5MW WHRS 75 MW coal based CPP	650MW (50MW WHRS and 600MW Coal based)	FY15	INR 25bn
Total Capex				INR 33bn

Source: Company

Value Addition Division

Prakash does not sell any intermediary products since its entire production of mild steel is converted to value added products like structurals and wire rods. Its structurals/TMT capacity currently stands at 0.3mtpa and its wire rod capacity stands at 0.45mtpa and this would suffice a large part of its enhanced steel capacity.

Power Division

In addition to the capex plans outlined in the steel division, the company plans to place strong emphasis in monetising its coal reserves by enhancing its power capacity substantially.

Despite its current power generation capacity of 100MW, Prakash has to procure ~20MW power from the grid. With a view to bridge the power deficit (even on an enhanced capacity) and generate a predictable revenues stream, Prakash plans to set up a 650MW power plant at an estimated outlay of ~INR25bn.

Of the above, ~50MW would be through the WHRS route as each of the proposed 500tpd kilns is capable of supporting a 12.5MW power plant. The balance 600MW would be set up in a modular format of 6 X 100MW. Prakash has adequate land for the proposed power plant and will not incur expenses for land acquisition. There would also be substantial savings as the proposed power project is located close to the CSEB distribution station and Prakash would not have to incur much expenditure to set up an evacuation facility. The project is likely to be commissioned in phases by FY15 as outlined in capacity expansion table. The company has not signed a PPA and plans to resort to merchant sales under the appropriate licensing norm.

Captive Linkages

PIL has been allocated three Coal mines and two iron ore mines for captive consumption. While the iron ore mines are located in Orissa and Chhattisgarh, all three coal mines are located in Chhattisgarh.

State	Location	Ore	Reserves	Remarks
Chattisgarh	Kawardha	Iron ore (66-67gr Fe)	75m tns	Est operational date July 10
	Chotia	Coal	50m tns	Operational since July 06 Extraction rate 1m tpa
	Madanpur	Coal (C/D grade)	50m tns	Est operational date September 10 (consortium allocation)
	Fatehpur	Coal (E/F grade)	45m tns	Earmarked for power project Est operational date FY13
Orissa	Sirkaguttu	Iron ore (63-65gr Fe)	10m tns	Est operational date April 10

Source: Company

One of the coal mines, viz. Chotia coal mine, has been operational since July 2006 and has reserves of ~50m tns. The current extraction of ~1m tpa suffices both its steel and power requirement (75MW). The mines are located at a distance of ~80kms from its manufacturing facilities.

The Madanpur mine has ~50m tns of coal reserves (C & D grade) and is a consortium allocation along with six other companies. Operations at this mine is expected to commence by the end of 2QFY11. The recently allotted Fatehpur coal mine has reserves of ~45m tns but its reserves are of inferior grade (E & F) grade. These mines have been allocated for captive consumption and company intends to utilise the superior grade coal to manufacture sponge iron manufacturing while using the inferior grade for power generation.

On the iron ore front, Prakash has been granted the Kawardha mines in Chhattisgarh, which is ~140kms from the plant. The same has high quality grade of iron ore (+66% Fe content) with total reserves of ~75m tns. This mine is scheduled for commissioning by 2QFY11 as environmental and forest clearances are awaited. Upon commissioning, this mine should result in savings of ~INR0.5bn in FY10 and ~INR1bn FY11 onwards (considering an estimated sponge iron production of ~0.35m tpa and 0.46m tpa for those years respectively) as opposed to sourcing from the spot market.

Apart from the above iron ore mine, Prakash has also been allocated the Sirkaguttu mine in Orissa (reserves of 10m tns of 65% Fe grade). Expected to be operational by 1QFY11, the mine would complement the Kawardha mine, resulting in a significant cost reduction.

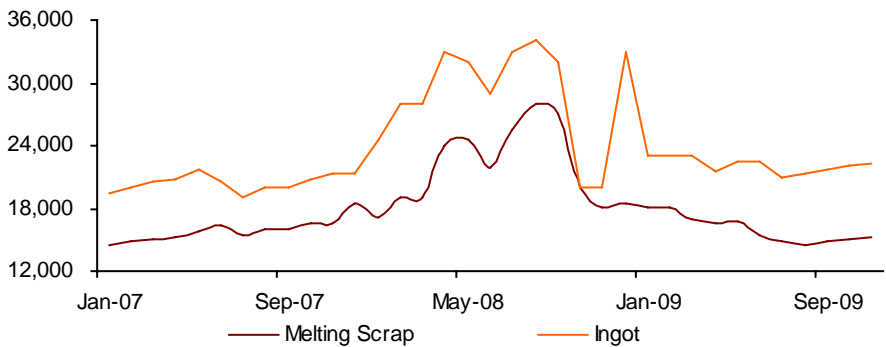
Healthy steel industry scenario...

The outlook for the steel sector is buoyant backed by both demand pull and cost push pressures. With the Indian GDP set to grow at ~7%, steel consumption which currently stands at ~54mtpa, is set to follow track.

With increased demand emanating from the construction and infrastructure sectors, demand for long products (constituting ~40% of the market) is expected to increase sharply at 20% CAGR. Additionally, with the recent spike in prices of crucial inputs like iron ore, coke and coal, we expect steel prices to be stable, if not harden. The current scenario places all integrated steel companies in a favourable position to capitalise upon.

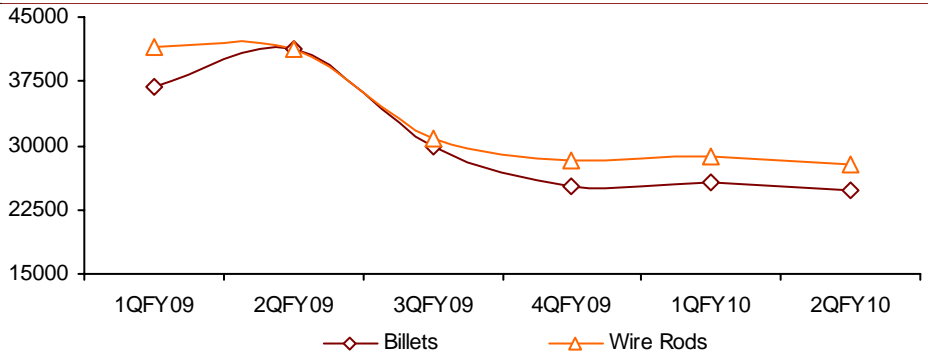
While the price trend in steel has been volatile for the last six quarters, off late there has been stability in valued added steel products like wire rods etc. Commodity products like pig iron, scrap and sponge iron have still to exhibit signs of stabilisation, as can be inferred from the graph below. In such a business environment, players with a high degree of operational integration and those who straddle a large part of the value chain would benefit.

Price Trend for Melting Scrap and Ingots (INR/tn)



Source: Industry

Price Trend for Billets and Wire Rods (INR/tn)



Source: Industry

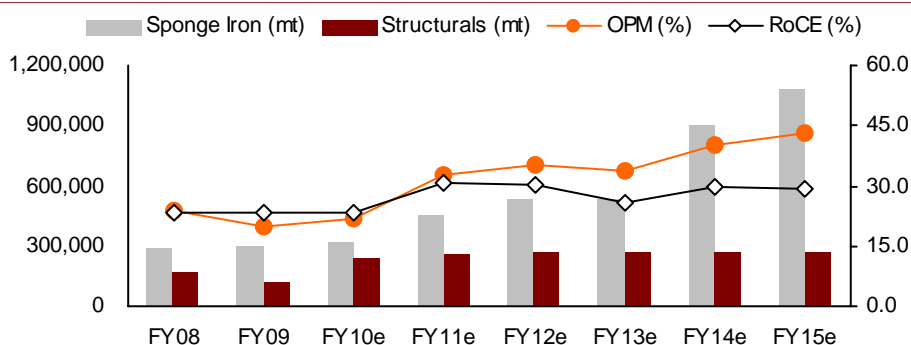
Capacity expansion to boost revenues...

With the ongoing expansion, the company will benefit from incremental volumes that are set to flow in a phased manner from FY10. Moreover, as Prakash does not intend to sell any intermediate products like billets; its entire production is set for value addition, which will result in higher and stable realisations.

Captive mineral linkages to boost steel business margins...

With ~85m tns of iron ore and ~145m tns of coal reserves, company's margins are set to improve as a result of significant cost savings flowing through these captive linkages. From current levels of 20% (FY09), OPM should touch ~34% in FY12, enabling Prakash to transform into one of the lowest cost producers of steel in the country.

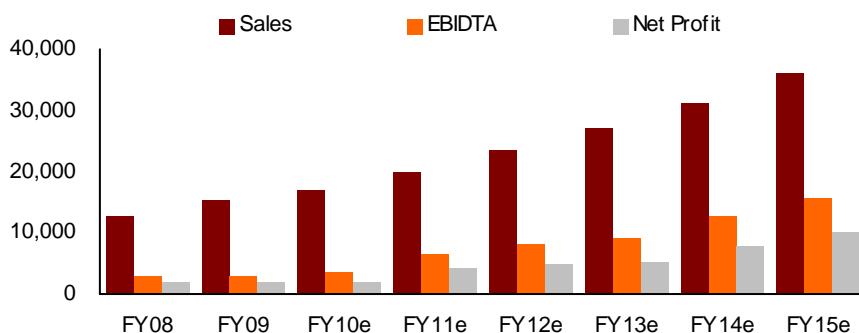
Operational Matrix & Profitability Trend



Source: Antique

Post commissioning of 650MW power project, Prakash's power capacity would stand at 750MW. Of this, ~35% would be consumed captively in the steel manufacturing process, while the rest would be earmarked to be sold through the merchant route. The company has not entered into a PPA agreement and will review the same upon completion of the project. Moreover, with in-house linkage of coal and no debt on the books for the project, the cost of production would not exceed ~INR1/unit.

Operational Matrix & Profitability Trend



Source: Antique

Our View

For FY09, Prakash reported net sales of INR 15.3bn (+22%) and exhibited an OPM of 19.7%. This was despite a challenging environment where the volatility in raw material prices and soft realisations impacted margins of most players. Going forward, we estimate the company to post a net sales growth of 12%, 17% and 31% for FY10e, FY11e and FY12e respectively while the operating profit growth for the same period is estimated to be 23%, 78% and 35%. The reason for this disproportionate growth in operating profits is scaling up of operations and higher percentage of captive sources in raw material.

We believe that Prakash is well poised to reap benefits of the increasing demand for structurals and wire rods from the construction and infrastructure sectors, which has a higher degree of insularity from the volatility in commodity grade steel.

It would be able to post strong growth in revenues and profits and also shake off the cyclicality of the steel business and volatile raw material costs. Moreover, the power business will aid in improving operational parameters in the form of reduced cost, assured revenues and higher RoCE.

Since the company has a strong presence in steel and is scaling up presence in power, we have valued the company on a SOTP basis. The steel business valuation according to the benchmark valuation metrics of peer steel companies, at an EV/EBITDA of 4x, on an estimated EBITDA of INR 6.5bn for FY11e, works out to INR 188/share.

The power business, on a WACC of 16%, and an average unit realisation of INR3/unit, works out to INR326/share. Applying a 25% discount, the value accretion of the power project works out to INR245/share. The fair value of the company thus works out to INR432/share. At the CMP of INR183, it leaves scope for an upside of 136%. Hence, we recommend a BUY on the stock with a 24 month price target of INR432/share.

Sum-of-the-Parts Valuation		
Steel business (INRm)		Amount
FY11e EBITDA		6,534
EV/EBITDA multiple (x)		4
Enterprise value		26,137
Net debt		2,593
Implied market cap		23,544
Value per share (INR)		188
Particulars (INR/share)	Method	Value
Steel business	EV/EBITDA	188
600 MW power plant (25% discount to DCF)	DCF	245
Total SOTP Value	INR	432

Source: Antique

600MW Power Project Synopsis (INRm)

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Asset cost	4,625	9,250	13,875	18,500	23,125	23,125	23,125	23,125	23,125	23,125
Debt	3,238	6,475	9,713	12,950	16,188	14,188	11,188	8,188	5,188	2,188
Equity	1,388	2,775	4,163	5,550	6,938	6,938	6,938	6,938	6,938	6,938
Reserves	-	2,327	5,918	10,773	16,892	23,178	29,718	36,512	43,560	50,861
RoE (%)	76.6	45.6	35.6	29.7	25.7	20.9	17.8	15.6	14.0	12.6
RoCE (%)	31.9	27.6	24.8	22.7	20.9	19.3	18.5	17.8	17.0	16.3

Revenue Statement (INRm)

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Net sales	2,594	5,188	7,782	10,376	12,970	12,970	12,970	12,970	12,970	12,970
Op. Exp	777	1,311	1,846	2,381	2,916	2,924	2,933	2,942	2,951	2,961
Fuel Cost	397	794	1,191	1,588	1,985	1,985	1,985	1,985	1,985	1,985
O&M	130	260	390	520	650	650	650	650	650	650
Staff	250	258	265	273	281	290	299	307	317	326
Op Profit	1,817	3,877	5,936	7,995	10,054	10,046	10,037	10,028	10,019	10,009
Interest	340	680	1,020	1,360	1,700	1,490	1,175	860	545	230
Depreciation	197	393	590	786	983	983	983	983	983	983
PBT	1,281	2,804	4,327	5,849	7,372	7,573	7,880	8,186	8,491	8,797
Tax	218	477	736	994	1,253	1,287	1,340	1,392	1,444	1,495
PAT	1,063	2,327	3,591	4,855	6,119	6,286	6,540	6,794	7,048	7,301

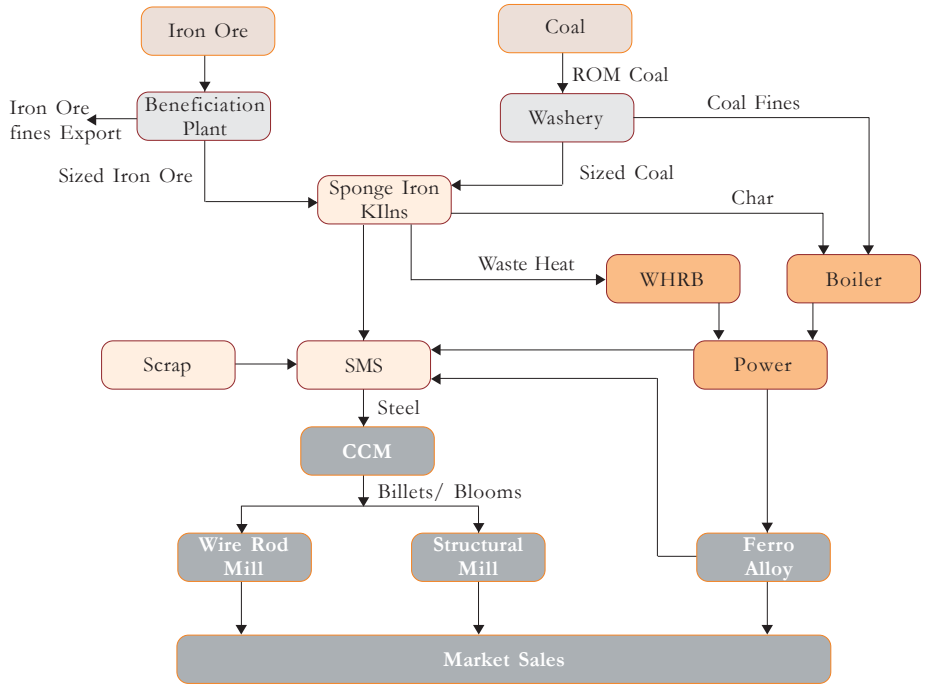
Cash Flows (INRm)

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
PBT	1,281	2,804	4,327	5,849	7,372	7,573	7,880	8,186	8,491	8,797
Add: Dep	197	393	590	786	983	983	983	983	983	983
Add: Interest	340	680	1,020	1,360	1,700	1,490	1,175	860	545	230
Less: Tax paid	218	477	736	994	1,253	1,287	1,340	1,392	1,444	1,495
Net CF from op	1,817	3,877	5,936	7,995	10,054	10,046	10,037	10,028	10,019	10,009
CF from Fin/ Inv	(340)	(680)	2,218	1,878	1,538	(3,490)	(4,175)	(3,860)	(3,545)	(3,230)
Net cash flows	1,477	3,197	8,154	9,873	11,592	6,556	5,862	6,168	6,474	6,780
WACC @ 16%	0.86	0.74	0.64	0.55	0.48	0.41	0.35	0.31	0.26	0.23
Discounted CF	1,273	2,376	5,224	5,453	5,519	2,691	2,074	1,882	1,702	1,537
Terminal value	11,197	O/S shares post dilution - 125.5mn WACC - 16% Terminal Growth rate - 2%, PLF - 90%, Sales Realisations - INR3 / unit								
Total Future CF	40,928									
Value / share	326									

Sensitivity Analysis - Power Business

WACC/ Term. grwth.	0.5%	1.0%	1.5%	2.0%	2.5%	3.0%
14%	367	372	377	382	388	395
15%	340	344	348	352	357	362
16%	316	319	323	326	330	334
17%	296	298	301	304	307	310
18%	277	279	281	284	286	289

Manufacturing Process Flowchart



Source: Company, Antique

Financials (INRm)

Profit and Loss Account

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	12,537	15,256	17,053	19,965	26,070
Expenses	9,572	12,253	13,372	13,430	17,219
EBIDTA	2,965	3,004	3,681	6,534	8,850
Depreciation	477	425	561	870	1,325
EBIT	2,488	2,579	3,120	5,664	7,525
Interest expense	440	632	467	389	651
Other income	38	40	100	100	100
Profit before tax	2,086	1,987	2,753	5,375	6,974
Taxes	4	6	798	1,236	1,840
Adj Profit after tax	2,081	1,980	1,955	4,139	5,134
Reported profit after tax	1,987	2,042	1,955	4,139	5,134
Recurring EPS (INR)	18.0	17.2	15.6	33.0	40.9

Balance Sheet

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	1,155	1,155	1,255	1,255	1,255
Reserves & Surplus	8,284	9,350	12,015	16,154	21,288
Networth	9,439	10,505	13,270	17,409	22,542
Debt	3,631	2,593	2,593	2,593	5,831
Deferred Tax Liability	-	702	1,033	1,651	2,306
Capital Employed	13,070	13,801	16,896	21,653	30,679
Gross Fixed Assets	13,836	15,242	18,600	23,896	33,949
Accumulated Depreciation	6,067	6,370	6,931	7,801	9,126
Net Assets	7,769	8,872	11,669	16,096	24,823
Capital work in progress	1,760	2,413	530	543	688
Investments	1	22	22	22	22
Current Assets, Loans & Advances					
Inventory	986	820	895	899	1,195
Debtors	1,148	1,085	1,213	1,420	1,996
Cash & Bank balance	845	313	2,368	2,479	2,032
Loans & advances	1,658	1,935	1,935	1,935	1,986
Current Liabilities & Provisions					
Creditors	596	842	919	923	1,248
Other liabilities	708	1,008	1,008	1,008	1,008
Net Current Assets	3,333	2,303	4,483	4,801	4,954
Misc. Expenses	207	191	191	191	191
Application of Funds	13,070	13,801	16,896	21,653	30,679

Per share Data

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	115	115	125	125	125
BVPS (INR)	81.7	91.0	105.8	138.7	179.7
CEPS (INR)	22.2	20.8	20.0	39.9	51.5
DPS (INR)	-	-	-	-	-

Margins (%)

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	23.7	19.7	21.6	32.7	33.9
EBIT	19.8	16.9	18.3	28.4	28.9
PAT	16.6	13.0	11.5	20.7	19.7

Financials (INRm)

Key Assumptions

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Sponge Iron Production (Tn)	284,150	296,299	320,000	460,000	540,000
Steel Production (Tn)	394,061	445,805	440,000	557,500	810,000
Wire Rods Production (Tn)	168,737	208,709	360,000	382,500	405,000
Structurals Production (Tn)	169,479	120,241	240,000	255,000	270,000
Wire Rods Sales (Tn)	168,187	209,997	360,000	382,500	405,000
Structurals Sales (Tn)	161,089	120,713	240,000	255,000	270,000

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIT	,992	2,048	2,753	5,375	6,974
Depreciation & amortisation	477	425	561	870	1,325
Interest expense	415	605	467	389	651
Interest/Dividend Recd	(33)	(33)	(100)	(100)	(101)
Other Adj	129	(20)	-	-	-
(Inc)/Dec in working capital	(107)	308	(126)	(207)	(600)
Tax paid	(248)	(9)	(468)	(618)	(1,186)
CF from operating activities	2,624	3,324	3,087	5,709	7,064
Capital expenditure	(1,706)	(2,340)	(1,475)	(5,309)	(10,198)
Inc/(Dec) in investments	1	7	-	-	(0)
Income from investments	33	32	100	100	100
CF from investing activities	(1,672)	(2,301)	(1,375)	(5,209)	(10,098)
Inc/(Dec) in share capital	1,650	-	810	-	-
Inc/(Dec) in debt	(957)	(921)	-	-	3,238
Dividends & Interest paid	(895)	(634)	(467)	(389)	(651)
CF from financing activities	(202)	(1,555)	343	(389)	2,586
Net cash flow	751	(532)	2,055	111	(448)
Opening balance	94	845	313	2,368	2,479
Closing balance	845	313	2,368	2,479	2,031

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	34.5	21.7	11.8	17.1	30.6
EBITDA	48.1	1.3	22.5	77.5	35.4
PAT	49.6	2.7	(4.3)	111.8	24.0
EPS	27.4	2.7	(11.9)	111.8	24.0

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	11.6	11.2	11.7	5.5	4.5
P/BV	2.9	2.4	2.0	1.5	1.2
EV/EBITDA	8.0	7.7	6.1	3.5	3.0
EV/Sales	1.9	1.5	1.4	1.2	1.0
Dividend Yield (%)	-	-	-	-	-

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	21.1	19.4	14.7	23.8	22.8
RoCE (%)	19.0	18.7	18.5	26.2	24.5
Debt/Equity (x)	0.4	0.2	0.2	0.1	0.3
EBIT/Interest (x)	5.7	4.1	6.7	14.6	11.6

Note

Sterlite Technologies Ltd.

'Cable'ing up scale ...



BUY

CMP: INR321

Target Price: INR405

December 22, 2009

Strictly confidential

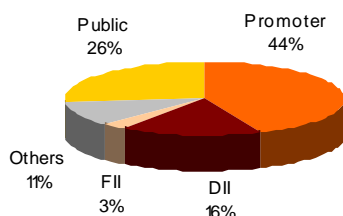
Market Data

Sector	:	Cables
Market Cap (INRbn)	:	23
Market Cap (USDm)	:	476
O/S shares (m)	:	65
Free Float (m)	:	30
52-wk HI/LO (INR)	:	335/44
Avg 12m Vol ('000)	:	205
Face Value (INR)	:	5
Bloomberg	:	SOTL IN
Reuters	:	STTE.BO

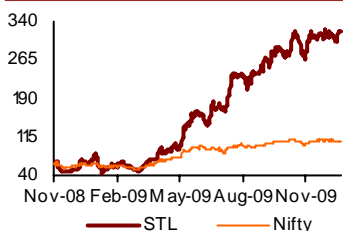
Price Performance

	1m	3m	6m	12m
Absolute	4	12	121	366
Relative	7	13	93	183

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Amol Rao +91 22 4031 3435
amol.rao@antiquelimited.com

Investment Rationale

Sterlite Technologies Ltd. (STL), India's premier manufacturer of cables with market leadership in the Optic Fiber, Fiber Optic Cable and Power Conductors segments is counted amongst Top Five global manufacturers in both the segments. It has scaled up revenues and operating profits commendably over the past three years (CAGR of 61% and 54% respectively), on back of healthy growth in sales to the power and telecom segments.

STL is ramping up its capacities in both verticals to capitalise on the lucrative opportunities, spawned by the imminent capital inflows in the power and telecommunication sectors. Simultaneously, it is endeavouring to increase its presence in international markets to not only boost its sales but also geographically de-risk its revenue mix.

STL is currently trading at a PER of 8.9x and EV/EBIDTA of 5.4x, discounting its FY11e numbers.

Valuation

STL has adopted a broad flanked approach for growth by meshing its technological prowess in developing superior products, with its scalable manufacturing capabilities. Simultaneously, it is seeding international markets, to boost the offtake of its proven products. A combination of scale, technological superiority, astute management and low valuations (relative to its global peers), in the backdrop of high foreseeable growth in both revenues and profits, make a compelling case for investment at the CMP of INR321. Hence, we have a BUY recommendation on the company and a price target of INR405, an upside potential of 26% from current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	22,892	25,006	29,990	35,195
EBITDA	2,342	3,805	4,593	5,913
EBITDA margin	10.2	15.2	15.3	16.8
EBITDA growth	21.2	62.5	20.7	28.7
PAT	901	2,146	2,564	3,345
PAT growth	(10.5)	138.1	19.5	30.5
EPS (INR)	12.7	30.2	36.1	47.1
EPS growth	(10.5)	138.1	19.5	30.5
P/E	23.0	9.7	8.9	6.8
P/BV	3.3	2.5	2.1	1.6
EV/EBITDA	10.1	6.3	5.4	3.8
RoE (%)	15.5	29.5	26.4	26.4

Source: Antique

Introduction

Sterlite Technologies Ltd. (STL), as an entity, was born out of the demerger of the telecom cable division of *Sterlite Industries (I) Ltd.* in 2000. The underlying logic of the demerger was to enable both companies to focus on their core operations, viz. telecom products and non-ferrous metals, respectively, as *Sterlite Industries (I) Ltd.* had firmed up ambitious plans to scale up its operations in the non-ferrous space.

Following the demerger, the equity capital of the company stood at INR280m, which over a period of time, got enhanced to INR323m, following a preferential allotment of shares (2.8m shares of F.V. INR10 at a premium of INR95) and a series of Employee Stock Option schemes.

Subsequently, in FY06, STL acquired the Power Transmission Conductors Business from *Sterlite Industries (I) Ltd.* This was largely on account of the latter emerging as a large domestic player in base metals (non-ferrous) and its clear defined strategy to focus on the metals and power sectors and emerge as a player of international size and scale. Another reason for the acquisition was STL's intention to broaden its product basket and diversify revenue streams (away from telecommunications) by leveraging its customer reach to drive overall business growth.

After having identified the high growth potential of two core sectors of the domestic economy, viz. telecom and power, STL is ramping up capacities in both verticals. It is funding this ramp up through a judicious mix of internal accruals and equity infusion by promoters, who have been allotted 6.45m warrants (F.V. INR5 at a premium of INR60) in Apr 09. The company has made tentative forays into international markets, seeding both developed countries which are characterised by low growth and enormous opportunity, as well as LDCs (Less Developed Countries) which are exhibiting strong growth, on back of poor penetration and low base. Thus STL is poised to emerge as a derisked player, on both, the product range as well geographical concentration.

Product Verticals

STL is India's premier manufacturer of cable products. It commands market leadership position in telecom and power cables and has a comprehensive product profile which includes-

1. **Telecom cables** viz. Optic Fiber Cables (OFC) and Copper Telecom Cables (CTC), related intermediate products like Optical fiber (OF), structured data cables and other equipment which form a critical part of the telecommunication sector.

In FY09, sale of telecom cables and associated services stood at INR8.4bn, representing ~35% of the company's gross revenues.

2. **Power conductors** wherein the company manufactures conductors in various specifications ranging from 1.1-110KV in the distribution segment and 132KV-800KV in the transmission segment.

In FY09, STL's revenues from power conductors stood at INR15bn, accounting for ~65% of gross revenues.

Telecom Cables

Telecom cables (also referred to as telecommunication channels) are used for connecting multiple voice or data lines and are one of the five principal components in any network environment (others being networking terminals, processors, software and operating equipment).

The most widely used varieties of telecom cables are CTCs and OFCs. The latter are made from Optical fibers (OF), which are long, thin strands of very pure glass about the diameter of a human hair. They are arranged in bundles called OFCs and are used to transmit signals in the form of light, over long distances and are primarily used for communications and signalling purposes. Presently, they have replaced the conventional CTC in long distance infrastructure.

Advantages of OFC over CTC

Costing - In the initial stages, OFCs, belonging to a different genre of technology, were substantially costlier than conventional copper cables which were ruling the roost in telecom technology till as late as mid-nineties. However, the phenomenal improvement on technological curve has ensured that the costing of OFCs is now comparable to the copper cables, albeit with the former's operational capacity being multifold.

Bandwidth - As the data transmission in OFCs is through the medium of light (as opposed to electrical signals in CTC), they can transmit enormous amounts of data. This is because the frequency range of light is wider than analog signals and each fibre can carry multiple channels of data, thereby enhancing the carrying capacity multifold.

Dimensions - OFCs can be drawn into smaller diameters than copper wire and multiple fibres can be bundled to form a cable. This dimensional difference multiplied by the high bandwidth capacity of OFCs ensures substantially higher carrying capacity of OFC vis-a-vis conventional CTC.

Signal fidelity - Unlike electrical signals in CTC, light signals from one fiber can be carried for much longer distance without amplification or 'Boosting'. These signals do not interfere with signals travelling in other fibers in the same cable, thereby ensuring high clarity and low disturbance transmission over longer distances, which are essential requirements for intensive applications like voice and video transmissions.

Low power - Since signals in OFCs degrade less, lower-power transmitters can be used instead of the high-voltage electrical transmitters needed for copper wires, thus entailing lower operational and maintenance costs.

Digital signals - OFCs are ideally suited for carrying high amounts of digital information at high speeds, which is especially useful in data (computer) networks. Currently, data transmission is one of the largest components of the communication network due to the explosive proliferation of Internet, as a result of which OFCs have emerged as the backbone of the same.

Trends in Telecom Industry

The global telecommunications industry has witnessed dramatic changes over the past decade. The current decade has seen consumers shift from fixed line to wireless in the telephony space with mobile technology evolving to such levels where it has nearly converged with the Internet, blurring the segmentation between Internet and telephone based applications.

The transformation in the Internet/Broadband segment is more stark, as browsing speeds have vaulted exponentially and newer applications like e-commerce, music downloads, file sharing (both audio and video), on-line gaming etc. are spurring on improvements in the field.

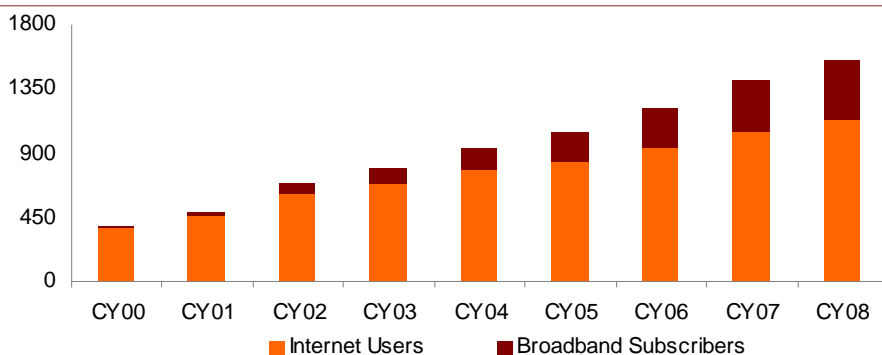
The following are the salient developments in the sector over the past decade:-

- Increasing penetration across geographies, which is borne out by the increasing teledensity and number of Internet connections.
- Continuous lowering of capital and operating costs on an individual user level.
- Increasing availability of bandwidth with consistent slide in price points. .
- Widening scope of technology (e.g: 3G services) to encompass new applications like data streaming, e-transactions across platforms, video telephony etc.
- Heavier voice and data traffic across media.
- Convergence of Internet and telephony.

Nowhere is this more aptly reflected than in India, which has moved from 3.6m Internet connections (including 0.01m Broadband) in Mar 03 to 13.7m Internet connections (including 6.1m Broadband) in Mar 09. This represents a six year CAGR of 25% in Internet connections and 203% in Broadband connections.

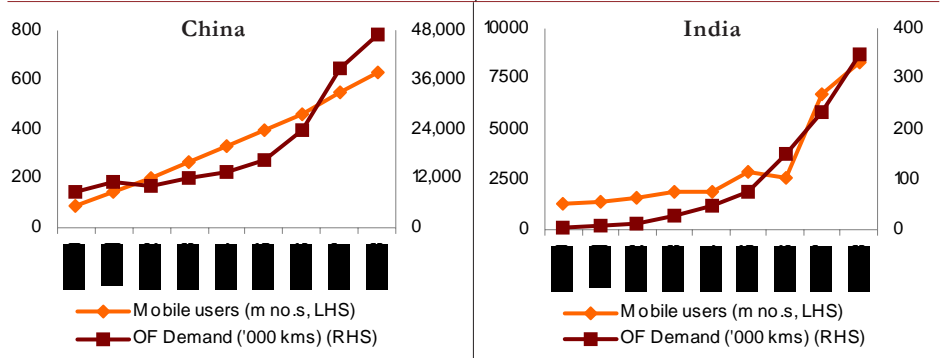
A noteworthy fact is that the penetration of Broadband globally is 6.1% (usage base of ~410m) as compared to Internet penetration of 24% (usage base of 1.6bn globally), implying that there is tremendous scope for upswing in bandwidth demand on account of the switch from conventional Internet to Broadband.

Global Internet & Broadband Users (m no.s)



Source: ITU, Point-Topic

Wireless Users in China and India

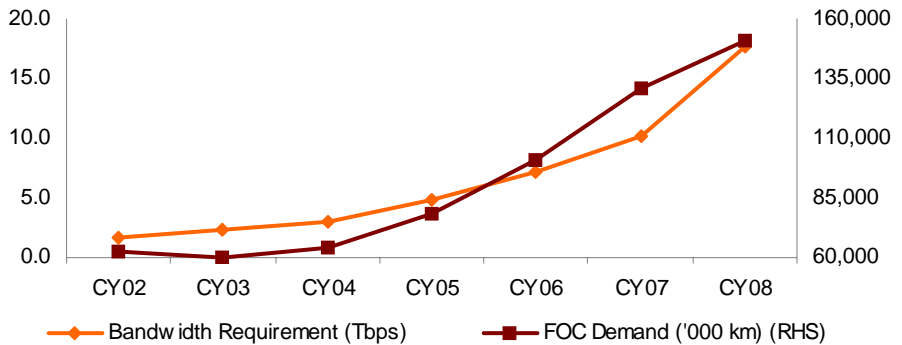


Source: ITU, TRAI

Future Outlook

While positive developments in telecommunications trigger the need for further improvements, these changes have been nurtured by a commensurate ramping up of infrastructure at the cross-continental, national and local levels. Technological advances in conjunction with change in demographics and consumer spends have propelled the growth of the addressable markets, in developed and developing economies of the world. Historically, any increase in telecommunication (both telephonic and Internet) usage has been accompanied by an increase in demand for OFC.

Global Demand for Bandwidth and OFC



Source: Telegeography, CRU

On the international front, it is estimated that demand will be generated on account of the following:

- Increasing bandwidth requirement to fulfill demand from newer applications like video-on-demand, video telephony, music downloading, etc.
- Push towards increasing last mile connectivity or 'Fibre-to-Home'.
- Increasing penetration in geographies where telephone and Internet usage was absent or extremely low.

On the domestic front, we expect higher OFC offtake on account of the following factors-

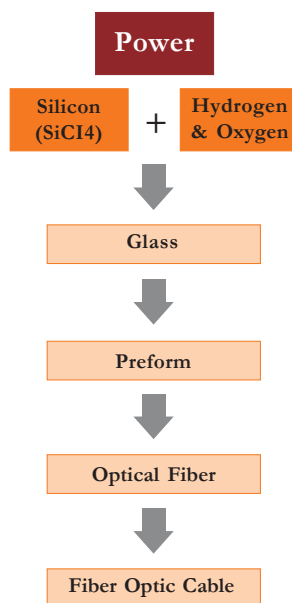
- Increasing teledensity on account of GOI's thrust on improving national teledensity (through wire and wireless connections). This will require telecom networks to set up optical backbones for their networks, before venturing into the market place to tap customers.
- Lower capital and operational costs for connectivity.

With the Indian Broadband industry still in investment mode, the asset turnover ratio currently hovers around ~1:1 ratio, since the critical penetration, usage and locational density has still not been achieved in most of the clusters. The investment in the industry can typically be broken up into:

- 30% on the backbone (OFC network).
- 20% back end networking equipment (Switches, servers, VSAT equipment, etc).
- 35% end use network gear (ADSL equipment/modems at consumer end, CTC for last mile connectivity, etc).
- 15% as incidental establishment expenses (Digging and laying of OFC, etc).

Hence, on an estimated spend of INR115bn in CY10, we expect an opportunity of INR40bn to be generated for OFC.

OFC Manufacturing Process



Source: Company, Antique

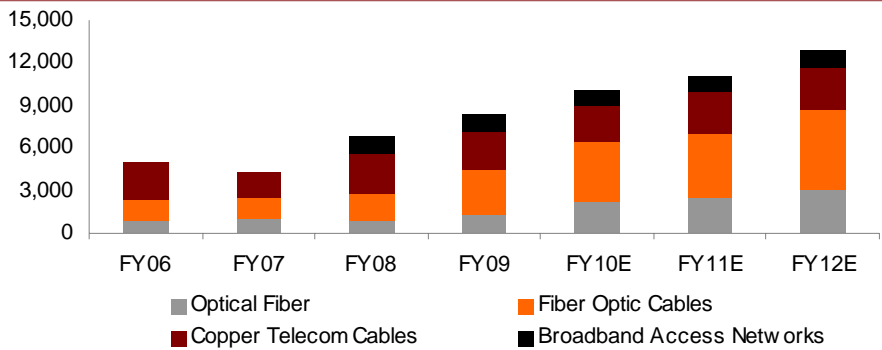
Business Model (Telecom Cables)

A large number of manufacturers globally source glass preform from global giants like *Shin Etsu* and *Furukawa*, which they then draw into optical fiber (OF), post which it is bundled into cables. STL's operations in the OFC segment are completely integrated from production of the glass core rod to bundling of fiber into cable. Depending on the competitiveness of silica prices, it domestically sources or imports this raw material for manufacturing glass preforms.

This helps it keep a tight lid on raw material costs and simultaneously maintain control over the quality of intermediate and final products, resulting in low rejection and workover costs. STL captively consumes 35-40% of its optical fiber production, while the rest is sold to various third party OFC manufacturers in Africa, S.E. Asia and S. Asia.

In addition to manufacturing OF, OFC and CTC, STL is also engaged in integration of Broadband systems for its clients. While still in a nascent stage, the Broadband solutions business involves setting and maintaining the Broadband and access networks for its telecom clients. This forms an essential extension of the telecom cables business, as it strengthens the company's case as a 'One-Stop-Shop' or solutions' provider and also helps STL leverage its position as an existing supplier to increase revenues.

Telecom Revenues over the years (INRm)



Source: Company, Antique

Power Conductors

STL's power conductor cables are utilised in overhead transmission and distribution lines. Its product basket comprises of the following types of cables, which have specific applications:-

- **AL:** Aluminium Conductors
- **AAAC:** All Aluminium Alloy Conductors - AAAC cables offer better sag performance due to the high strength to weight ratio provided by the alloy. Additionally, they also provide higher corrosion resistance than ACSR conductors.
- **ACSR:** Aluminium Conductor Steel Reinforced - ACSR conductors provide are designed for performance under adverse weather conditions. The combination of the aluminum and steel in the conductor design provides efficient conductivity and high tensile strength, making it an economical solution for overhead power transmission and distribution projects.
- **AACSR:** Aluminium Alloy Conductor Steel Reinforced

Trends in Domestic Power Sector

The economic transformation of the previous decade has witnessed a huge surge in energy demand in India. While domestic power generating capacity has been scaled up significantly in the past few years, the same has been outpaced by growth in demand, as a result of which we still have a peak power deficit of 13%. India's per capita power consumption is estimated to be ~606 units and is expected grow at 8-9% pa and top out at 1,000 units by CY12.

Given the sheer geographical spread of the country, most of the power generation capacity is concentrated in clusters in central and eastern India, usually in close proximity to the coal rich belts. A large part of the power generation capacity of India is thermal based, with new capacities retaining the same dependence. A large majority of the hinterland power generation capacity is dependent on domestic coal and only recently have coast based thermal power projects taken off, which would be largely rely on imported coal.

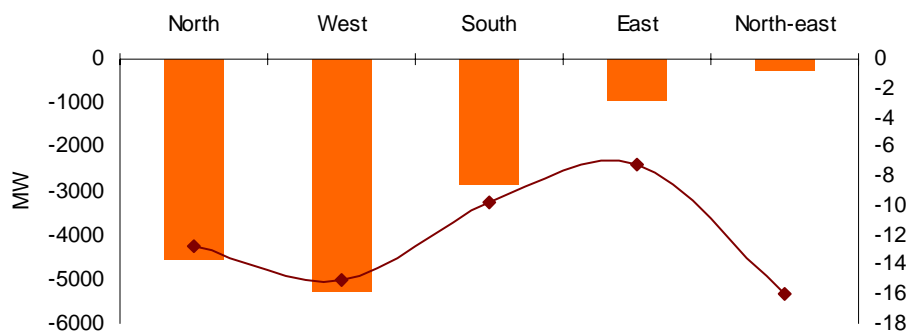
The extent of clustering of power generation capacity can be seen from the fact that the Singrauli region of Madhya Pradesh, accounts for almost 10,500MW of generation capacity; while Mundra in Gujarat is set to emerge on an equally large scale. However, the demand centres are largely urban centric with west and north India being the largest consumers since these regions have high urban agglomerations, coupled with sizeable industrial activity.

Thus, transmission of power over long distances in an efficient and reliable manner is critical for the economic growth of the country. Contemporary transmission and distribution systems generally consist of transmission lines, substations, switching yards, transformer stations and last mile distribution lines. There is a high correlation between power generation capacity and transmission line capacity (and also distribution capacity). Globally the ratio of spend on T&D as compared to generation is 1:1, however in India it is ~1.1:1, on account of prevailing inefficiencies.

There have been concerted efforts by both, central and state governments, to shore up the power transmission networks/grid. Of late, the private sector has also been roped in on a partnership basis. The ultimate aim of the central government is to have a national grid, which would consist of five regional grids viz. northern, western, eastern, southern and north eastern, in order to minimise and manage the imbalances in power and optimise the evacuation of power. This is imperative as the demand supply dynamics keep on changing on account of multiple reasons viz. industrial activity, seasonal changes, usage pattern variances etc. Optimum grid management ensures that disruptions are contained in a localised area and any sudden spurts in demand are fed from far flung generation areas, thereby ensuring load parity.

Despite establishment of the same, the regional peak deficit can be seen from the graphic below:

Absolute power deficit and % deficit in India



Source: Industry

Thus, one can say that the rapid scale up in generation capacity will necessitate large investment in setting up and managing a national grid.

The Indian grid is undergoing an unprecedented scale up and could add ~60,000Ckm by CY12. This is expected to facilitate an evacuation of ~95,000MW power generated, which would be ~60% of the total power generated in India at that time.

Domestic inter-regional power transfer capacity, which stands at ~8,500MW, is also expected to be scaled up to >37,500MW by CY12 as regional imbalances will have to be ironed out in order to maintain grid parity, since ~28,000MW power capacity is being set up in eastern India while the largest load centres would be in western and northern India.

Going forward, India's current infrastructure, which is largely 400KV AC and 500KV HVDC, will not be able to support such heavy evacuation loads unless switched over to Ultra High Voltage (UHV) networks of 765KV/1200KV AC or 800KV DC. These will serve the dual purposes of not only reducing current levels of transmission losses by 50% but also entail lower land and RoW (Right of Way) requirements (by over 50%) as opposed to conventional Extra High Tension (EHT) lines.

Towards this, India has set up six operational 765KV lines, the first one being the Sipat (Chandigarh) – Seoni (MP) line, set up in Apr'07. India has also experimented with the 1,200KV lines. Some instances of such implementation/testing are the Raipur-Wardha-Aurangabad-Pune line and the Pune-Sholapur-Raichur-Kurnool line, with the evacuation capability of the latter estimated at 6,000MW. Additionally, the north eastern hydel projects are being connected on 800KV HVDC lines which could run from Assam to Agra. This line of 1,815km is expected to evacuate 6,000MW of power. This underscores the magnitude of investments flowing into the sector and the spawning opportunities for ancilliary industries like STL.

Growth of Indian Transmission Network

	X Plan (Actual)	XI Plan
Transmission Line (CKM)	198,410	293,372
Substations (MVA)	249,439	42,800
HVDC (MW)	8,200	14,200

Source: CEA, Antique

The flow of investments into this sector has been enabled by multiple programs like *Accelerated Power Development & Reform Program* (APDRP) which envisages T&D losses to be brought down to sub 10% from the current all India level of 21%, and simultaneously increase reliability and quality of power supply in the country. Additionally, the *Rajiv Gandhi Gramin Vidyutikaran Yojana* (RGGVY) aims to provide access to electricity to all villages by CY12 and has electrified over 490,000 villages (almost 83% of inhabited villages) of India. The former has got an allocation of INR20bn in Budget FY10 and the latter garnered INR70bn.

In order to generate a conducive investment climate for power transmission, the *National Electricity Policy* was set up in 2003, which allowed 100% FDI in the transmission sector. The policy also allowed private companies to enter into Joint Ventures to the extent of 74:26 with State Electricity Boards (SEBs) as well as central undertakings. This has spawned multiple ventures, details of which are below:

Transmission Projects

Project	Partners	Holding Ratio	Cost (INR bn)
Tala Transmission	Tatapower : PGCIL	51:49	35.0
Sugen	Torrent Power: PGCIL	74:26	3.2
Hazira Power	Essar Power: PGCIL	74:26	6.9
Karcham Wangtoo	Jaiprakash : PGCIL	79:21	79.0

Source: CEA, Antique

Power Grid Corporation's proposed expenditure outlay for the XIth plan is estimated to be ~INR550bn. The game plan of the government is to implement a national grid in the XIth plan and have a interregional power evacuation capacity of over 37,500MW.

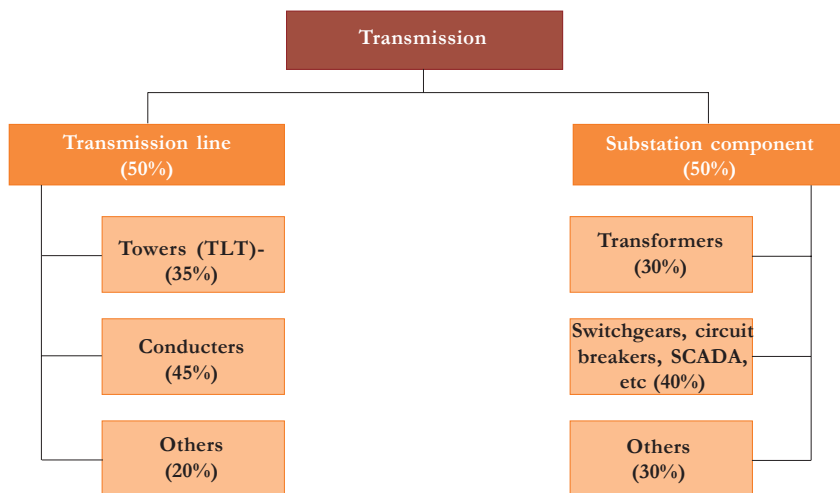
Investments Planned in Transmission (INRbn)

	X Plan (Actual)	XI Plan
National + Regional Grid	207	740
State Grid	289	560
Additional spend for N.East		60
Total	496	1,360

Source: CEA, Antique

Thus, the addressable demand for power conductor can be inferred from the split in the T&D as per the graphic enclosed below:

Break-up of Spend on Transmission Segment



Source: CEA, Antique

The consistent scale up of the T&D infrastructure has generated huge demand for power conductors as there are at least five conductors in case of HVAC and three in case of HVDC. The average weight/km of transmission conductors ranges from 1.8MT/km-2.1MT/km and in case of distribution lines the same ranges from 90kgs/km-120 kgs/km. This implies that an incremental transmission line demand of 75,000kms p.a. would translate into conductor demand of 675,000m MT (75,000 X.5 X 1.8), while on the distribution side, an incremental network addition of 85,000Ckms works out to 42,500MT (85,000 x 5 x 0.1) over the plan period.

Enclosed below are the CEA estimates for aluminium demand on account of the Transmission sector (which is largely on account of conductors) for the XIth Plan. This sustenance in demand is underscored by the fact that similar demand is expected in the XIIth Plan.

Requirement for Aluminium and Steel in XIth plan

Voltage	MT/ Ckm		Ckt Km Planned	Aluminium	Steel
	Aluminium	Steel			
765	23.0	4.7	3,200	73,600	14,880
500 (HVDC)	15.5	3.5	5,400	83,700	18,900
400	8.9	4.5	44,400	395,160	199,800
220	3.6	1.8	23,000	82,800	41,400
132	1.8	1.7	20,000	36,000	33,000
			96,000	671,260	307,980

Source: CEA, Antique

As per industry sources, the technical life of a transmission line is ~35 years. However, most of the time, the replacement cycle gets compressed as the growth in power demand outpaces the wheeling capacity of existing transmission facilities. This, coupled with development of newer technology for evacuation of heavier loads has resulted in the replacement cycle for transmission lines being crunched down to ~12-15 years.

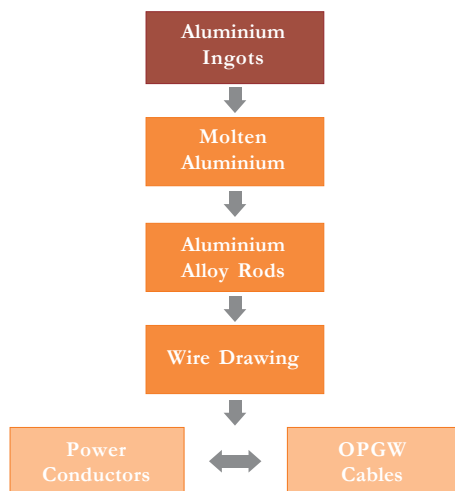
Growth of Transmission and Distribution Sector

Year	Generation (MW)	Transmission Line (Ckm)	Increment (Ckm)	Dist Lines (Ckm)	Increment (Ckm)
2004-2005	119,354	2,617,367	72,283	3,953,456	83,952
2005-2006	124,287	2,713,843	96,476	4,064,516	111,060
2006-2007	132,329	2,789,606	75,763	4,149,923	85,407

Source: CEA, Antique

Business Model (Power Conductors)

Power Conductors Manufacturing Operations



Source: Industry

As is the case in its telecom business, STL has a completely integrated model for its power conductors business. With a rated capacity of 115,000MT, STL is currently the third largest manufacturer of power conductors globally.

Over the years, STL has continuously ramped up its scale of operations, thereby becoming more competitive while sourcing raw material and lowering conversion costs on account of economies of scale. This has enabled it to boost profitability per MT as well emerge as a 'Price-Warrior', whereby it can garner market share on its terms.

The company sources its raw materials viz. aluminium or steel, in ingot form, on LME benchmarked prices, through imports or domestic purchases. In order to maintain visibility of operational profitability, it maintains raw material inventory of ~4 weeks. Business in this vertical is largely a tender based, whereby it participates in bids floated by organisations like PGCIL, REC, various SEBs, etc.

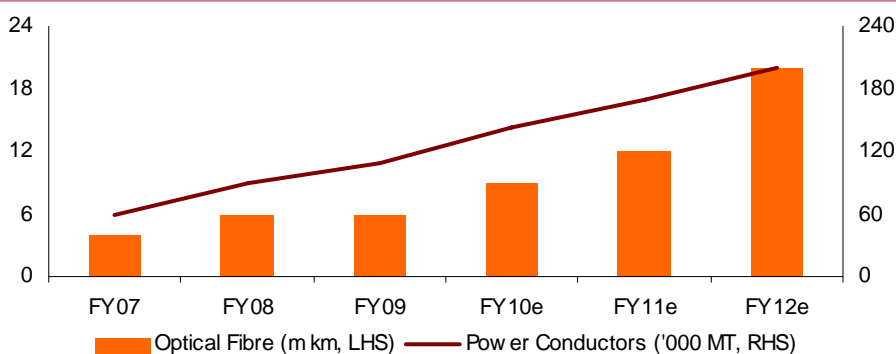
Currently, STL has an unexecuted order book of ~INR21bn. This consists of INR15bn of orders for the power conductors segment, which is to be executed over the next 9-10 months.

Strength

Product range: Currently, STL has one of the widest possible product ranges in power conductors and OFC. While in the 765KV conductor it is one of the only two domestic manufacturers, in the UHT range (800KV and 1220KV), it is the sole manufacturer. Thus, it is not only able to compete with smaller players in the lower voltage range (which is large commoditised), but also able to derive strong positioning advantage at the top end of the conductor business i.e HVDC and UHT where grid expansion on back of budgetary allocation offer excellent revenue visibility.

Size and scale: STL has built an enviable scale in both its businesses. In power conductors, it accounts for ~50% of domestic capacity and is the third largest global player. Its domestic market share is ~ 25%, with a sizeable portion of the National Grid (~25%) set up using its conductors. It has 14% market share in the power conductor market in Africa. In the OF and OFC segments, STL has 50% market share in India, (fourth largest market globally), 7% in China and 4% in CIS. It is currently amongst the top five global players and upon expansion to 20m km and 9.5m Fkm in the OF and OFC segments respectively, it is set to become one of the top three global players.

Ramp up in OF and Power Conductors Capacities



Source: Company, Antique

Manufacturing expertise: STL has built up strong manufacturing expertise in the OFC as well as the power conductor businesses. While it is amongst the cheapest manufacturers in the power conductor business, it is also in the lowest decile of cost competitiveness in the OFC business. This is largely because of its ability to manufacture key raw materials i.e viz. glass preforms and OF.

Technology: Technology is a key separator in both, the power conductors and telecom cables segments. There is constant endeavor by players to keep abreast with technology, thereby feeding the process of invention/innovation. This not only offers a vital 'First Mover' advantage, but also ensures a brief time frame to monetise the technological advantage resulting from the same. Companies usually utilise this time to recover their developmental or technology assimilation costs and also align their manufacturing costing with the realisation curve which falls sharply once the technology becomes commoditised (usually in 2-4 years). STL has managed to fine tune the technology to manufacture OF, the key raw material for OFC and has stabilised the same. Going forward, this will ensure that it has a strong advantage on the opex front vis-a-vis its domestic competitors and also keep it on par with its global peers, thereby enabling it to tap global markets. Its efforts to fine tune the 1,200KV technology in the power conductors business are an effort in this direction and should result in a lucrative opportunity at the time of monetisation.

Weakness

PSU dominated order book: A significant portion of its order book in the both, the telecom cables and power conductors businesses, is from Indian PSUs. *BSNL* remains one the largest buyers of OFC in India, despite the recent sharp scale up undertaken by its private sector competitors. Several other PSUs like *PGCIL*, *KRC*, *Indian Railways*, *GAIL* etc have also implemented or in the process of implementing their own OFC network as they capitalize on the most critical requirement i.e. right of way. Even in the power conductors vertical, a significant portion of STL's orders are from government bodies like *PGCIL*, *REC* and *SEBs*. Most of these orders are tender based and sporadic in nature. While STL has been competing for and a large part of these orders over the past few years, this imparts lumpiness in revenues as orders or execution are generally skewed towards March end. This also results in stretched receivables as direct supply to PSUs usually results in a credit extension of 120 days.

Increasing commoditisation of business: Mindful of the trend of exponential demand growth of for OFC and power conductors over the past few years, production capacities are being added across these industries. While innovation has helped STL develop new products across both verticals and catapulted it to the leadership position, several of its older products have become commoditised, with competitors having achieved critical mass for production of the same. (~40% of STL's current product profile falls under this category). Going forward, we feel that this could drive down realisations and profitability of these products. However, STL's increasing scale of operations should help it sustain margins at current levels as it benefits from operating leverage and lower manufacturing costs, to tide over lower realisations.

Opportunities

Market explosion: STL is strategically poised in two of the sectors which are poised for a dramatic scale up, despite the robust growth demonstrated over the past few years. In telecommunications, the prime drivers of growth are technological changes, convergence, sliding bandwidth charges, increasing penetration and rapid adoption of Internet as an enabling tool by general public. Simultaneously growth in the sector is being fanned by strong capital flows from the private sector. India is expected to be one of the markets exhibiting strongest growth in telecom and the spillover to back end equipment, and consequently to OFC, is expected to be strong.

In the power sector, the flow of private sector capital along with slow privatisation of distribution and implementation of programs like *APDRP* has ensured strong growth in demand for power conductors, with India now emerging as the second largest market globally (Estimates for total domestic capacity expansion outlined for the sector over next 5 years stand at INR2.2tn). Given its dominant presence in India in both these segments, we expect STL to garner a lion's share of the growth opportunities, especially in light of the imminent ramp up in its capacities.

Exports: Currently, STL is looking to tap demand in the under penetrated, yet promising, markets in Africa and M. East. Additionally, it has recently ventured into the European markets, where the replacement demand is enormous, where the outlay for augmenting and upgrading the existing grid infrastructure is pegged at ~USD9bn over the next two years. Going forward, we expect this demand to translate into an addressable market for the company as its power conductors find increasing acceptance in European markets.

Threats

Technological swings: Both sectors in which the company operates are at the forefront of technological evolution. In telecom, given the speed at which technology becomes commoditised and its impact on the realisation/pricing curve, any wrong move in adoption of a particular technology can result in huge write offs. STL has managed to commendably ride out the cost curve while transitioning its OFC product from being technology intensive product to a commodity, however there is no guarantee that it would be able to replicate its success while riding the next technological wave.

In power conductors, it is developing manufacturing skillset in product ranges where it does not have a presence i.e 800KV, 1200KV etc. In case it does so successfully, it would be able to 'skim' the market when this technological advantage can be monetised, failing which it will have to compete only on scale and not on technology

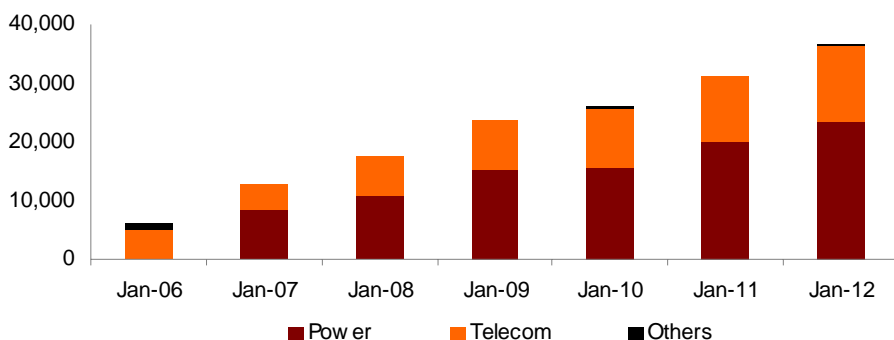
Dumping: The market for OFC is global, with no barriers. Since domestic custom duties and costing metrics are low, any misalignment in the duty structure or irrational dumping by overseas players has the potential to impact STL's operating margins and profitability. While such an untoward incident has yet to occur globally and the possibility of the same is scant, it cannot be ruled out.

Excise litigation: Since FY02, STL is having a pending demand of INR1.8bn from the Indian Central Excise authorities. In FY09, it managed to get a court order and discharged some these liabilities (To the tune of ~INR500m). The matter is pending in the Supreme Court and could be resolved in the coming months. While STL is confident of getting the same resolved in its favour, any adverse ruling would not only impact the profitability of the company, but also its net worth, which currently stands at INR6.5bn. While most of its tender based supplies do not require a networth criteria, a negative outcome of the matter could probably impact the debt rating of the company.

Our View

STL posted net revenues of INR22.8bn in FY09 (+36%), with an OPM of 10.2% and operating profits of INR2.3bn. Its revenues and operating profit have registered a CAGR of 61% and 54% respectively, over the past 3 years. A substantial part of this growth has emanated on account of the company's creditable ramp up of its Power Conductor business, where it has managed to double its revenues from FY07 to FY09. This has been on back of its aggressive sales strategy in India and foray into under-penetrated, yet lucrative, markets like Africa and M. East. Another noteworthy aspect of its performance has been the maintenance of operating profitability, which has consistently hovered between 10-11%.

Revenue break-up (INR m)



Source: Antique

On the telecom products front, we believe that its integrated operations, comprehensive range of OFC products coupled with network integration servicing capabilities generate the potential for revenue ramp up in this vertical. We feel that STL's impending capacity expansion in the OFC space will facilitate its monetisation of the dual domestic opportunities of rollout of wireless services and increasing Internet penetration. Additionally, its increasing penetration in the OF space in the high growth market of China holds the promise of higher capacity utilisation, thereby generating operating scale leverage and positively impacting operating metrics.

On the power conductors' front, STL's 'First-Mover' advantage in the sunrise product line of 800KV and 1,220KV, coupled with its all inclusive product profile should help it maintain its current position as the preferred supplier for large electrification projects. The impending capex of INR2.2tn envisaged for the T&D sector in the XIth Plan generates a large window of opportunity for STL, which is aggressively ramping up its power conductors' capacity. This expansion will also enable the company to ramp up its presence in geographies like M. East and Africa, where it has ~10-14% market share.

With the requisite marketing network to back its technological prowess and manufacturing scale, we estimate STL to clock revenues of ~INR25bn and INR30bn in FY10 and FY11 respectively, a growth of 10% and 20% respectively. We feel the ramp up in revenues will be gradual as the company expands capacities in the OFC and power conductors' business, with the full effect of the same being visible in FY11. We expect the OPM to be ~15% as the benefits of scale in conjunction with a benign raw material play out to impact the company positively. We estimate the company's net profits to settle at INR2.1bn and INR2.6bn in FY10 and FY11 respectively.

At a CMP of INR321, the stock is ruling at an EV/EBIDTA of 5.4x and PER of 8.9x, discounting its FY11e numbers. Mindful of its peerset valuations (enclosed below), ongoing capacity expansion and prudent cost of the same, we feel that current valuations are at the lower end of the spectrum. Lastly, the management's proven track record of identifying opportunities and aggressively pursuing the same to fruition, inspires confidence in the company's prospects. Extrapolating an EV/EBIDTA multiple of 7.5x, which would still keep it at the bottom end of its peerset, we recommend a BUY on the stock, with a price target of INR405, which represents an upside of 26% from current levels.

International Peerset Valuations (x)

	1 Year Forward			2 Year Forward		
	P/E	EV/EBIDTA	Year Ended	P/E	EV/EBIDTA	Year Ended
Corning Inc	13.9	19.6	Dec-09	11.5	14.5	Dec-10
Furukawa Electric	81.3	11.9	Mar-10	19.4	9.0	Mar-11
Draka	14.8	8.5	Dec-09	11.9	7.6	Dec-10
Prysmian	10.4	7.1	Dec-09	10.1	6.7	Dec-10
Sterlite Tech	9.7	6.3	Mar-10	8.9	5.4	Mar-11

Source: Bloomberg, Antique

Financials (INRm)

Profit and Loss Account

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	16,858	22,892	25,006	29,990	35,195
Expenses	14,926	20,551	21,201	25,397	29,282
Operating profit	1,932	2,342	3,805	4,593	5,913
Other income	41	37	80	80	80
EBIDT	1,973	2,378	3,885	4,673	5,993
Depreciation	372	425	515	745	1,046
Interest expense	360	880	509	509	486
Profit before tax	1,241	1,073	2,862	3,419	4,460
Taxes incl deferred taxation	297	172	715	855	1,115
Extra ordinary Items	(63)	-	-	-	-
Profit after tax	1,007	901	2,146	2,564	3,345
Diluted EPS (INR)	14.2	12.7	30.2	36.1	47.1

Balance Sheet

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	322	323	323	355	355
Reserves & Surplus	5,073	5,887	8,002	10,728	13,907
Networth	5,395	6,209	8,325	11,083	14,262
Debt	6,632	4,966	4,733	4,521	4,322
Deferred Tax Liability	381	560	560	560	560
Capital Employed	12,408	11,735	13,617	16,163	19,143
Gross Fixed Assets	9,189	9,762	11,924	13,584	14,584
Accumulated Depreciation	3,950	4,309	4,824	5,569	6,615
Net Assets	5,239	5,453	7,100	8,015	7,969
Capital work in progress	362	1,114	1,260	600	200
Investments	60	920	169	200	250
Current Assets, Loans & Advances					
Inventory	2,194	1,004	2,650	3,175	3,660
Debtors	5,191	5,459	6,072	7,368	8,647
Cash & Bank balance	891	779	719	1,718	4,290
Loans & advances and others	1,689	2,012	1,566	1,691	1,803
Current Liabilities & Provisions					
Creditors	2,347	2,679	2,945	3,175	3,660
Other liabilities & provisions	871	2,326	2,975	3,430	4,016
Net Current Assets	6,747	4,248	5,088	7,348	10,724
Application of Funds	12,408	11,735	13,617	16,163	19,143

Per share data

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	64	65	65	71	71
BVPS (INR)	83.7	96.2	129.0	156.1	200.9
CEPS (INR)	21.4	20.6	41.2	46.6	61.9
DPS (INR)	1.0	1.3	1.5	1.7	2.0

Margins (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	11.5	10.2	15.2	15.3	16.8
EBIT	9.5	8.5	13.5	13.1	14.1
PAT	6.0	3.9	8.6	8.6	9.5

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	1,304	1,073	2,862	3,419	4,460
Depreciation & amortisation	372	425	515	745	1,046
Interest expense	360	880	509	509	486
Interest / Dividend Recd	-	(5)	(80)	(80)	(80)
Other Adjustments	42	144	-	-	-
(Inc)/Dec in working capital	(1,418)	2,383	(899)	(1,262)	(805)
Tax paid	(80)	(144)	(715)	(855)	(1,115)
CF from operating activities	580	4,755	2,191	2,477	3,993
Capital expenditure	(1,101)	(1,372)	(2,308)	(1,000)	(600)
(Purchase) / Sale of Investments	28	(752)	751	(31)	(50)
Income from investments	(208)	71	79	80	80
CF from investing activities	(1,281)	(2,053)	(1,478)	(951)	(570)
Inc/(Dec) in share capital	252	0	84	335	-
Inc/(Dec) in debt	765	(1,702)	(233)	(212)	(199)
Dividends & Interest paid	(423)	(1,005)	(624)	(650)	(652)
CF from financing activities	595	(2,707)	(773)	(527)	(852)
Net cash flow	(106)	(4)	(60)	999	2,572
Opening balance	131	24	20	(40)	959
Closing balance	24	20	(40)	959	3,530

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	40.7	35.8	9.2	19.9	17.4
EBITDA	75.3	21.2	62.5	20.7	28.7
PAT	98.1	(10.5)	138.1	19.5	30.5
EPS	98.1	(10.5)	138.1	19.5	30.5

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	20.6	23.0	9.7	8.9	6.8
P/BV	3.8	3.3	2.5	2.1	1.6
EV/EBITDA	13.4	10.1	6.3	5.4	3.8
EV/Sales	1.5	1.0	0.9	0.8	0.6
Dividend Yield (%)	0.3	0.4	0.5	0.5	0.6

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	21.1	15.5	29.5	26.4	26.4
RoCE (%)	14.8	17.2	29.3	28.1	28.7
Debt/Equity (x)	1.2	0.8	0.6	0.4	0.3
EBIT/Interest (x)	4.4	2.2	6.6	7.7	10.2

Note

Shiv Vani Oil & Gas Exploration Services Ltd.

Drilling for 'profit'...



BUY

CMP: INR337

Target Price: INR445

December 22, 2009

Strictly confidential

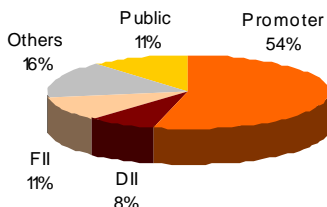
Market Data

Sector	: Oilfield Services
Market Cap (INRbn):	14
Market Cap (USDm):	310
O/S shares (m)	: 44
Free Float (m)	: 34
52-wk HI/LO (INR):	395/88
Avg 12m Vol ('000)	: 161
Face Value (INR)	: 10
Bloomberg	: SVOG IN
Reuters	: SHVD.BO

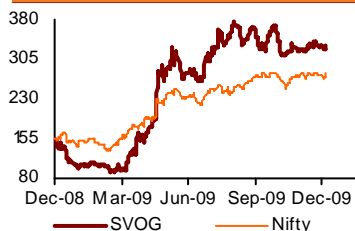
Price Performance

	1m	3m	6m	12m
Absolute	3	(5)	23	99
Relative	5	(5)	7	21

Shareholding Pattern



Price Performance vs. Nifty



Sandeep Shenoy +91 22 4031 3436
sandeep.shenoy@antiquelimited.com

Amol Rao +91 22 4031 3435
amol.rao@antiquelimited.com

Investment Rationale

Shiv Vani Oil and Gas Exploration Services Ltd. (SVOG) is India's leading provider of oilfield services, with a portfolio spanning across the entire value chain in the oil and gas arena. It has recently completed the ramping up of its fleet of onshore rigs. The deployment of the same is almost complete.

The company is an aggregator of oilfield services and is concentrating on capturing a lion's share of business outsourced by sovereign Indian players like ONGC, OIL, etc. With an imminent jump in exploration and production (E&P) activity in the domestic hydrocarbon arena, SVOG is focussing on improving asset utilisation and boost operational cash flows, with the aim of de-leveraging its balance sheet.

In the backdrop of uncertainty in the global E&P space, the buoyancy of the sovereign players in the domestic market provides strong visibility of cash flows.

At the CMP of INR337, SVOG is trading at a PER of 5.3x and EV/EBIDTA of 4.4x, discounting its FY11e numbers.

Valuation

SVOG is currently focusing on ramping up the utilisation rates of its existing asset base. The emphasis on energy security by domestic E&P players forms the perfect backdrop for the company, whereby margin of safety coupled with predictability of revenues facilitate repayment of debt. On back of its strong asset base and unique business model, SVOG is interestingly poised in terms of revenue and profit growth. Hence, we have a BUY recommendation and a price target of INR445, which represents an upside of 32% from current levels.

Key financials

INRm	2009a	2010e	2011e	2012e
Revenues	8,713	12,954	13,981	14,393
EBITDA	3,522	5,296	5,869	6,064
EBITDA margin	40.4	40.9	42.0	42.1
EBITDA growth	59.3	50.4	10.8	3.3
PAT	1,927	2,397	2,779	3,348
PAT growth	108.9	25.5	14.9	20.5
EPS (INR)	43.9	55.1	63.3	76.3
EPS growth	108.9	25.5	14.9	20.5
P/E				
P/BV				
EV/EBITDA				
RoE (%)	24.0	23.8	21.9	21.3

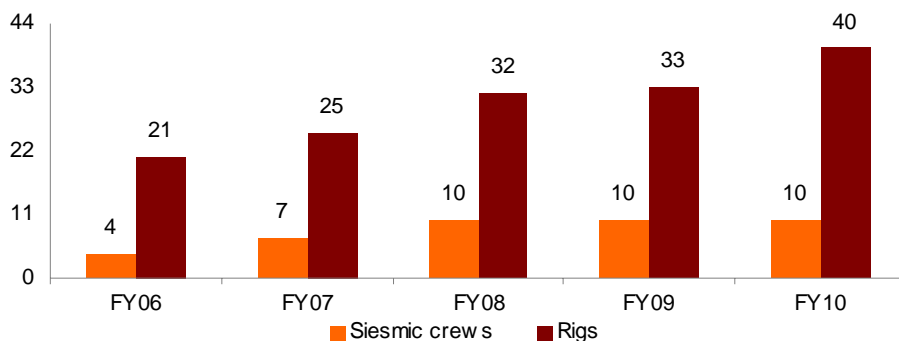
Source: Antique

Introduction

Shiv Vani Oil & Gas Exploration Services Ltd. (SVOG), promoted by Mr. Padam Singhee, a first-generation entrepreneur, was incorporated in CY89 and commenced operations by providing mudlogging services to ONGC.

Over the years, it has consistently expanded its range of services, evolving into an oilfield services provider, with a wide range of offerings for the domestic hydrocarbon industry. Apart from owning and operating a formidable fleet of onshore rigs, it has also diversified into areas such as seismic surveys, directional drilling, gas compression, CBM solutions and offshore logistics.

SVOG: Asset Base



Source: Company, Antique

Service Profile

The company has an impressive array of oilfield services including:

Drilling and make-over services: SVOG provides and operates onshore gas drilling rigs. It has 36 rigs currently operational in India and 40 worldwide, which encompass a wide range of technical capability. In most locations, SVOG provides the rig as well as the operating crew.

The company also offers work over services for servicing onshore oil and gas wells. These are required during the exploration, developmental and production stages of drilling.

CBM services: In the CBM space, SVOG provides end-to-end services in drilling, operating, extraction, compression and dispatch of gas, and is equipped with an impressive fleet of gas compressors.

2D/3D seismic services: The company has 10 crew sets, which provide 2D and 3D seismic services. It is currently the largest service provider in the private sector. It has a distinct advantage over its peers like Alpha Geo (4 crews) and Asian Oil Field Services (3 crews), as it has its own shothole drilling facilities, which form a substantial cost component of seismic surveys.

Directional drilling, mudlogging and cementing: SVOG also provides directional drilling services, whereby it helps enhance recovery from oil wells and drill in complex angles as opposed to conventional vertical drilling techniques. Additionally, it provides vital services like cementing oil wells, which is required to hold casing pipes in place as well seal exhausted wells.

Transportation and logistical services: The company is testing the waters in the logistical services segment by providing support services in the offshore segment. While this does not constitute any worthwhile revenues, the same is scalable and has the potential to emerge as a growth area in the coming years.

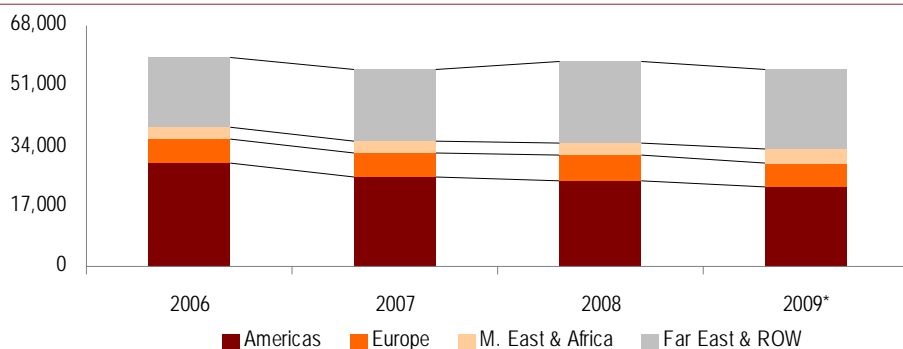
Industry Overview

The market for service providers like SVOG is highly dependent on investments in E&P, oil well development and crude oil production. Globally, these spends are usually proportional to the crude oil price and consumption. The unprecedented rally in crude oil prices from USD45 to USD147 between Sep'04 and July '08 could be attributed to the following factors:

- Strong global economic growth.
- Geopolitical events, namely, unrest in the Middle East.
- Demand-supply balance tilting in favour of suppliers.
- Poor reserve accretion.

These triggered an unprecedented rise in the E&P spend of global oil majors during the period. Simultaneously, emerging economies such as China and India have made energy security their top priority and increased the E&P spend of state-controlled petroleum undertakings.

Wells Drilled Globally



Source: www.worldoil.com

Domestic demand scenario

Despite the recent correction in international crude oil prices, domestic demand for oilfield support and allied services has not shrunk. This has been borne out by the number of wells drilled, which has shown an uptrend over the past five years. The same has been sustained in CY08, despite the softening of crude oil demand and prices.

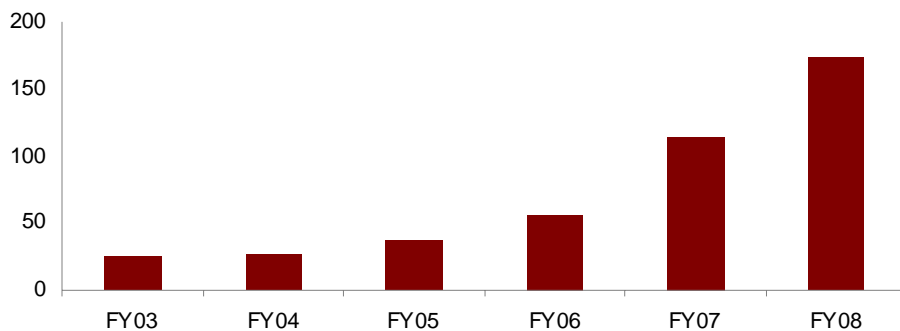
This is largely due to the fact that profitability is not the only driver for E&P activity. In many countries, including India and China, the same is dictated by political and strategic compulsions.

Domestic oil consumption has increased from 120 million metric tonnes (mmt) in FY05 to 157mmt currently (CAGR of 6%), outpacing the growth rate of demand from OECD countries, which posted a CAGR of 2% during the same period.

Simultaneously, domestic production has not kept pace with consumption, and around 74% of crude oil requirements are met through imports. Of the total domestic crude oil production of 34mmt in FY08, ONGC accounted for 76%. The demand-supply situation is not likely to change significantly in the foreseeable future, despite the capex being undertaken.

In the next two years, despite IEA estimates of global crude oil demand posting a negative growth, Indian consumption is expected to grow by a CAGR of 12%.

Trend of Total E&P Spend in India (INRbn)

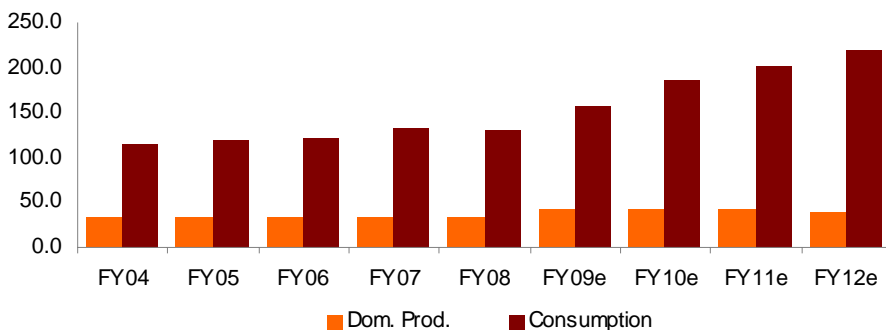


Source: Petroleum Min, GoI

Buoyant Domestic E&P Scenario

India's crude and natural gas reserves are estimated at 725mmt and 1,055bn cubic metres, respectively. Of India's nearly 1,700boe hydrocarbon reserves, almost 36% is estimated to be onshore. Only 30% of the country's 1.4m sq km of sedimentary basin has been effectively explored, underscoring the need for a sharp scale up in the industry. Despite consistent capex by PSUs, reserve accretion has been quite low. Mindful of this, the Government of India (GoI) came out with the NELP policy to tap the private sector expertise and FDI capital for E&P.

Oil: Demand-supply Gap in India (m mt)

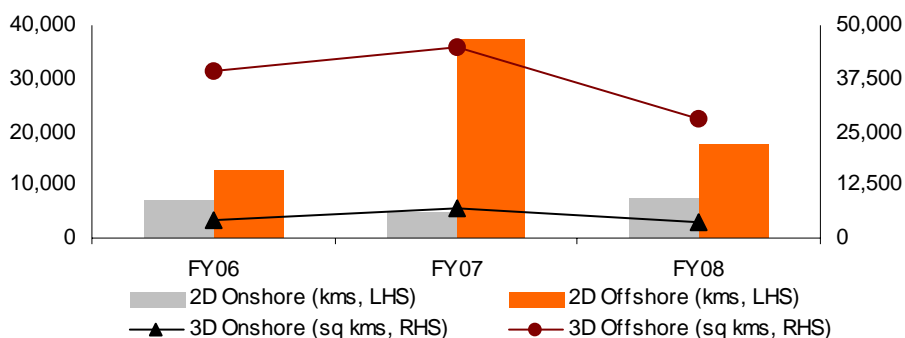


Source: Petroleum Min, GoI

In the last seven NELP awards, over 219 blocks have been awarded, of which, private sector players have garnered a sizeable number of blocks. Currently, onshore drilling constitutes almost 75% of the total drilling in the country.

Domestic E&P activity is expected to register a sharp uptick on account of NELP-VII, as 57 blocks were awarded and none have been operationalised to date.

Seismic Surveys in India: Offshore and Onshore



Source: DGH, GoI

Till recently, most investments have been by PSUs, who continue to dominate the sector, either on a stand-alone or consortium basis. Despite this, the gap between the number of wells committed and drilled remains large.

The pace of data gathering from 2D and 3D surveys points towards a build up in momentum towards drilling activity, especially onshore. This is borne out from the fact that of 526 exploratory and 734 developmental wells drilled in India from FY06-08, 914 were onshore and 346 offshore.

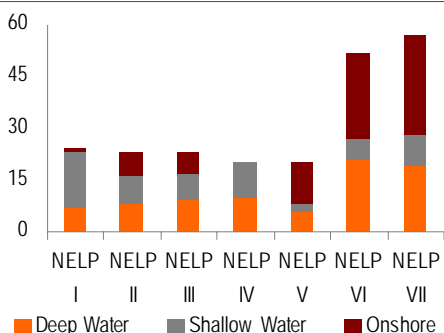
The DGH is now moving towards a regime, wherein a minimum committed capex and operational activity would be laid down at the time of awarding the block. This, along with the easing of capital flow towards private sector players, could ensure their adequate capitalisation and provide a fillip to E&P activities.

As most of the blocks awarded are onshore, the trend towards onshore E&P is gathering momentum, thanks to lower costs and higher commensurate benefits. At the same time, the strike rate in Rajasthan and Arunachal Pradesh is infusing confidence.

The government has now begun to tap marginal oil and gas fields via a public-private partnership model. This will channelise investments into areas, which were previously considered small and unviable by large PSUs.

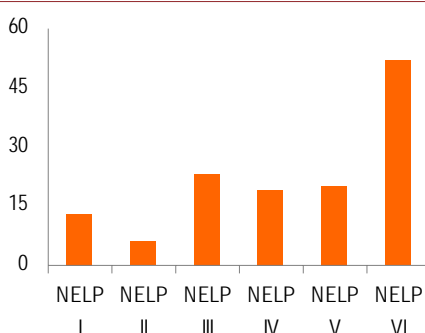
Though a commitment of USD10bn has been made on account of NELPs I to VI, the deployment of the same has been slow.

Allocation of blocks under NELPs (I-VII)



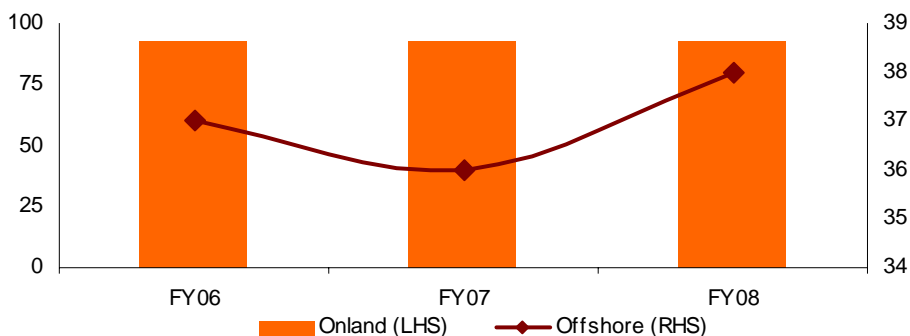
Source: DGH, GoI

Wells operationalised under NELPs (I-VI)



Source: DGH, GoI

Rigs Deployed in India (x)

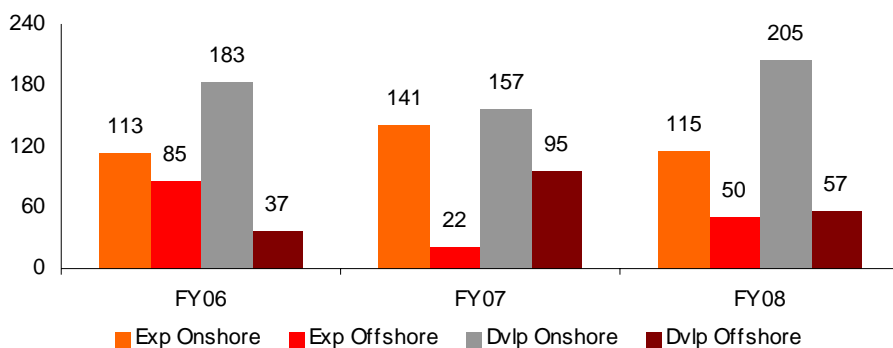


Source: DGH, GoI

With the imminent implementation of NELP-VII, investments in the sector are expected to pick up in the coming years, and the E&P capex is expected to be around USD2bn over the next two years.

Additionally, the actual number of wells drilled as compared with the commitment (minimum number of wells to be drilled by the operator) is quite low. However, policy changes would now ensure commencement of activity on the E&P front, especially by private sector players.

Number of Wells Drilled in India



Source: DGH, GoI

Coal Bed Methane - Additional Demand Driver for Oilfield Services

CBM is emerging as a key focus area in the domestic energy space. It entails drilling into coal beds/seams, and extracting methane and allied gases for energy use. Of India's coal reserves of 253bn mt, around 160mnt is estimated to be capable of emerging as a source of methane of about 800bn cubic metres.

Till date, 26 CBM blocks have been awarded in India, with 23 under CBM I, II and III bidding. Initial estimates indicate 6tn cubic feet of gas reserves. The first commercial production of CBM commenced in July'07, with extraction of 72,000 cubic metre/day, thereby catapulting India into the league of CBM producing nations.

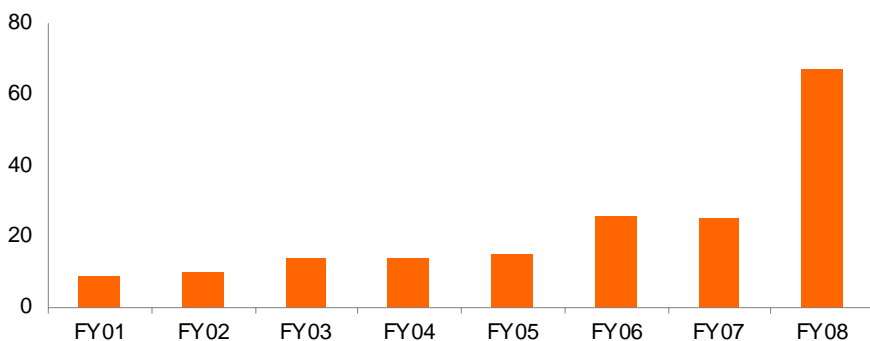
The average cost to operationalise a CBM site is estimated to be USD150-200m. As multiple wells have to be drilled usually, directional drilling equipment is often required. Upon striking gas, gathering and compression facilities, along with logistical support systems, have to be set up.

On the costing front, the largest component for a CBM is obviously well drilling. With an estimated cost of ~USD1.5m/well and ambitious rollout plans of block holders (one player has announced its intention to drill 100 wells at an outlay of USD180m), the opportunity for service providers could rival the size of oil E&P segment in India.

The business model in the CBM space is evolving, as operators are exploring all opportunities to ensure stability in revenues by inking predictable and long-term offtake for gas. While the power sector is an obvious consumer, domestic piped gas and industrial consumers are also being tapped aggressively.

Thus, integrated service providers for CBM have a strong potential, as their model would entail long-term operations in a single location. This holds potential of revenue visibility, high asset utilisation and margin predictability, as most CBM operators now tend to sign long-term integrated service contracts.

Oil Well Discoveries in India



Source: DGH, GoI

SWOT

Strength

Unique positioning: The E&P outlay in India has not been trimmed, as the largest players are National Oil Companies/PSUs, and are driven by compulsions of national energy security, rather than prevailing oil prices and operational profitability. As a result, the industry is on a strong growth trajectory and is likely to result in a buoyant addressable market for domestic players like SVOG.

Capitalising on the outsourcing trend: Currently, the largest incumbent players in the Indian E&P space are outsourcing non-core and manpower-intensive operations like seismic surveys, gas compression and rig workover, focusing on reserve accretion and optimising production. Players like SVOG are best placed in such a situation, due to their wide range of service offerings and ability to emerge as aggregators of services that are not in their baskets.

Asset base: The business model in the E&P industry is changing in favour of asset-owning companies, as reliability is of prime importance to E&P players. This imparts predictability on both, the revenue and operating margin fronts, for players like SVOG. Having the largest asset base amongst private sector players, SVOG is set to reap the benefits of scale.

Manpower base: The industry, being service-oriented, has a high reliance on experienced professionals and skilled operators. Each rig entails a deployment of 40 personnel/shift, and each seismic crew deployment requires a personnel strength of 500. SVOG has a strong technical team strength of over 1,200, which would stand in good stead when it scales up operations.

Track record: The company has executed over USD300m of complex projects/services in overseas markets. This would definitely prove advantageous when it makes a foray into end-to-end projects, entailing integrated services.

Weakness

Over dependence on sovereign operators: Almost 90% of SVOG's revenues originate from two players, ONGC and OIL. This offers a margin of safety with regards to receivables, and revenue flows on account of them being sovereign players. However, despite SVOG not accounting for a large part of the order outflow of these players, there could be some downsides as operational directives of these companies may not be on pure commercial terms, that is, in case these players decide to spread their orders across 2-3 players to de-risk themselves. While there has been no indication of the same, it has the potential to adversely impact SVOG's revenues and profits.

Highly leveraged balance sheet: SVOG's gross debt currently stands at INR18bn and its gearing stands at 2x. While the average cost of debt is below 10%, and quite a large part of the debt is overseas and USD-denominated, the company could be susceptible to interest rate shocks and exchange rate swings, despite a large part of its revenues being USD-denominated.

Working capital cycle: The company is slowly migrating towards an integrated services and services aggregation model. While this could impart strong economies of scale and transport it into the global league of players, the same could result in elongation of the receivables cycle, which it is presently not capable of withstanding. This has the potential to impede its movement across the value-chain of services.

Opportunity

Energy security focus: Energy security is the prime driver of the domestic E&P sector. Sovereign players having deep pockets and long-term strategic outlook, lend visibility to revenues of service providers in this sector. While the bulk of investments made till date in the Indian E&P space have been by PSUs, the same is considerably low in view of the consumption and demand growth of the country. The total number of wells drilled in India is abysmally low and has the potential to double in the coming two years, as private sector starts investing. This can provide a strong revenues upside to oilfield service providers.

Service aggregation: The industry-wide trend has been to outsource manpower-intensive operations and oilfield services contracts are now being tendered in an integrated manner. With its wide service offerings, SVOG is poised to benefit, as it has demonstrated its ability to aggregate services that it does not render.

Overseas opportunity: Currently, onshore rig rates in some clusters like the Middle East, CIS and the Far East are higher than those in India. Additionally, the global cutback in E&P spend has resulted in a few assets and operations being put on the block in these clusters. While SVOG's technical expertise could enable it to scale up by in-chartering in a more cost-effective manner, opportunities for asset acquisition are also attractive. The company also has the potential to offer operational services to manage assets in some clusters where such a trend is emerging.

CBM: Though ~26 blocks of CBM have been awarded, the operationalisation of the same has been slow, and only three entities have commenced operations. This sector is evolving, both on the operational and business model front, and offers immense potential to players offering integrated services like SVOG, as industry estimates for this opportunity is at USD25m per annum per operational block at the least.

Marginal oil and gas fields: PSUs have now started hiving off marginal oil and gas fields in a PPP (public-private partnership) manner. This has huge potential, as over 103 fields are expected to become operational in the coming 4-5 years, generating a large addressable opportunity for players like SVOG.

Newer services offering: SVOG is exploring avenues to increase its service offering like shot hole drilling and offshore support, among others, as these are complementary to its current offerings and would mesh well with its strategy to emerge as an integrated services player.

Threat

The slump in the major global energy markets could see E&P services providers like Haliburton and Schlumberger venturing into India, as they seek to explore newer markets for growth. While there would be practical difficulties for major overseas players to make headway in India on account of huge logistical roadblocks, this remains a distinct possibility and has the potential to adversely impact the market share of incumbent domestic players.

Domestic competitors like Dewanchand Ramsaran Industries (P) Ltd. and John Energy Ltd. ramped up their asset bases a few quarters ago through private equity infusions. The weakening capital markets and tightening liquidity could have derailed their expansions as capital (equity / debt) is a key requisite for scale enhancement. A revival in the ability to raise capital would enable these players to emerge as a force to reckon with in domestic markets, as assets are now available globally at competitive rates and deployment in India is within their domain expertise.

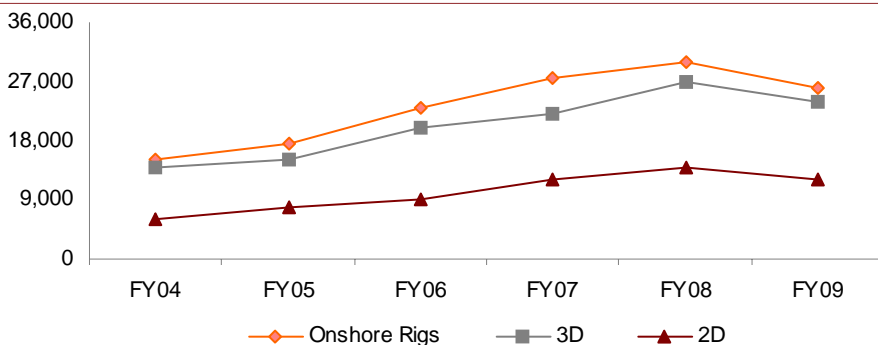
PSUs like ONGC and OIL also have onshore rigs (103 and 13 rigs respectively) on their books. The utilisation ratio remains low as they currently outsource manpower-intensive work. This has spelt opportunity for players like SVOG, as PSUs still constitute the largest market. Any reversal in this policy by PSUs has the potential to seriously impair the fortunes of SVOG.

Our View

E&P activity in India has been on the upswing for the past six years, even during the economic downturn of FY08. This generates a robust addressable market for players like SVOG.

Rig rates, which had been on a continuous uptrend from CY04-08, have currently stabilised at USD22,000-24,000/day. However, day rates have stabilised at current levels due to the clustering of onshore rig markets and stiff entry barriers (on account of logistical reasons since moving an onshore rig would require about 120 containers). There exists strong potential for upside in day rates going forward, upon renewed participation of private sector in E&P resumes.

Day rates for Onshore Rigs

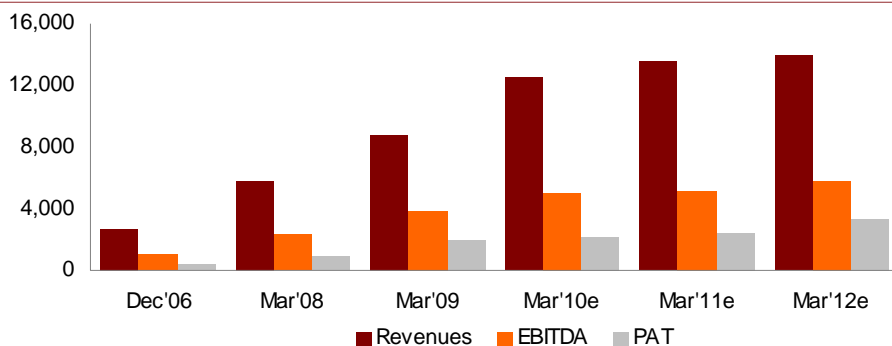


Source: www.worldoil.com

The enforcement of minimum work and capex commitment (within four years of the awarding of a block) under the NELP will ensure that a stable market emerges for seismic surveys and onshore rigs in the coming years. Strong capital flows on the CBM front will generate opportunities for players like SVOG, with the market estimated to be USD300m p.a. Currently, only three players have commenced large-scale outsourcing operations. With its ability to offer integrated services, SVOG is a strong contender for the above.

We make our case for investment in SVOG on the following basis:

- Ramp-up in asset base and revenue visibility:** SVOG has ramped up its fleet to 40 rigs in FY10, in a staggered manner. With a sizeable part of this fleet being contracted out on a time charter basis to sovereign players like ONGC and OIL, there exists strong visibility of revenues and profits. Additionally, a useful lifespan of 20-25 years, scheduled maintenance haul-up every three years (cost ~USD1m, with a downtime of three months), and high rig utilisation ensure minimal disruption in revenue flows. Lastly, factors like stabilisation of billing rates in 2D/3D seismic surveys and the enforcement of minimum work commitments afford predictability of revenue streams.
- Upside from new revenue streams:** A foray into newer service areas like shothole blasting and integrated drilling services has the potential to boost revenues and margins, while simultaneously improving asset sweating.
- Margin of safety:** The continuing robustness of the domestic E&P sector is in sharp contrast to the ongoing slowdown in the global E&P space. While this could have resulted in international oilfield service providers shifting to India, the same is not feasible due to logistical challenges (mobilisation and shifting of onshore rigs would necessitate the movement of ~120 containers of equipment). This acts as an entry barrier for such players, thereby insulating revenue streams of domestic operators like SVOG.

SVOG: Earnings Trend (INRm)


Source: Antique

We estimate the company to post revenues of INR13bn and INR14bn in FY10e and FY11e, respectively. We expect SVOG to move up the value-chain through its wide range of service offerings. This, coupled with high asset utilisation, would ensure a margin of safety. We estimate the OPM to stabilise at around 40% for the above period with net profits settling at INR2.4bn and INR2.8bn in FY10e and FY11e, respectively.

At the CMP of INR337, SVOG is trading at a P/E of 5.3x and EV/EBITDA of 4.4x, discounting its FY11e numbers. While valuations global peers may not be appropriate, we feel that the completion of capital expansion, coupled with scalability of operations, revenue visibility and margin stability justify a premium. Moreover, the slowdown in the global E&P space is in sharp contrast to the buoyant domestic scenario, which imparts a high margin of safety to our assumptions.

Hence, extrapolating a P/E multiple of 7x, we have a BUY recommendation and a target price of INR445, which represents a 32% upside from current levels.

International Peerset Comparison

USDm	Geokinetics USA		Dawson Geophysical		REM Offshore		Pioneer Drilling		Precision Drilling	
	CY09	CY10	Sep-09	Sep-10	CY09	CY10	CY09	CY10	CY09	CY10
Revenue	503	603	325	205	115	72	318	380	1,213	1,390
EBITDA	90	105	81	23	80	40	69	73	412	450
Net Profit	8	14	35	(23)	121	22	(29)	(35)	170	172
P/E(x)	76.5	23.8	23.3	N.A.	4.9	6.9	N.A.	N.A.	11.3	12.3
EV/EBITDA(x)	2.8	2.4	3.4	5.2	4.4	8.2	9.1	8.5	3.8	3.0
Mkt Cap(USDm)	100		185		285		420		992	

Source: Bloomberg

Financials (INRm)

Profit and Loss Account

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Revenues	5,745	8,713	12,954	13,981	14,393
Expenses	3,534	5,191	7,658	8,112	8,329
Operating profit	2,211	3,522	5,296	5,869	6,064
Other income	90	307	50	100	100
EBIDT	2,301	3,829	5,346	5,969	6,164
Depreciation	429	502	1,000	1,000	1,000
Interest expense	674	845	1,400	1,330	996
Profit before tax	1,198	2,482	2,946	3,639	4,168
Taxes incl deferred taxation	276	517	526	860	820
Profit after tax before MI & EO Items	923	1,965	2,419	2,779	3,348
Extra ordinary Items	-	(37)	(22)	-	-
Profit after tax	923	1,927	2,397	2,779	3,348
Diluted EPS (INR)	16.8	43.9	55.1	63.3	76.3

Balance Sheet

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
Share Capital	439	439	439	439	439
Reserves & Surplus	6,663	8,539	10,908	13,637	16,934
Networth	7,102	8,978	11,347	14,076	17,373
Debt	7,700	18,000	17,000	14,000	10,482
Deferred Tax Liability	247	533	533	743	943
Capital Employed	15,049	27,511	28,880	28,818	28,798
Gross Fixed Assets	8,646	12,367	24,367	24,867	25,367
Accumulated Depreciation	1,493	1,995	2,995	3,995	4,995
Net Assets	7,153	10,372	21,372	20,872	20,372
Capital work in progress	3,221	4,500	500	500	500
Goodwill	0	0	0	0	0
Investments	15	15	15	15	15
Current Assets, Loans & Advances					
Inventory	239	1,695	2,628	2,777	2,825
Debtors	3,917	3,630	5,397	5,437	5,597
Cash & Bank balance	635	1,576	1,812	2,379	2,662
Loans & advances and others	1,252	8,000	500	500	500
Current Liabilities & Provisions					
Creditors	1,175	1,921	2,979	2,962	3,014
Other liabilities & provisions	368	517	526	860	820
Net Current Assets	4,500	12,464	6,833	7,271	7,751
Misc. Expenses	161	161	161	161	161
Application of Funds	15,049	27,511	28,880	28,818	28,798

Per share Data

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
No. of shares (m)	44	44	44	44	44
BVPS (INR)	161.8	204.5	258.5	320.6	395.7
CEPS (INR)	30.8	55.3	77.4	86.1	99.0
DPS (INR)	-	1.0	1.0	1.0	1.0

Margins (%)

Year ended 31st March	2008a	2009a	2010e	2011e	2012e
EBIDTA	38.5%	40.4%	40.9%	42.0%	42.1%
EBIT	32.6%	38.2%	33.5%	35.5%	35.9%
PAT	16.1%	22.1%	18.5%	19.9%	23.3%

Financials (INR m)

Cash Flow Statement

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
EBT	1,198	2,444	2,924	3,639	4,168
Depreciation & amortisation	429	502	1,000	1,000	1,000
Interest expense	674	845	1,400	1,330	996
Interest / Dividend Recd	(54)	(307)	(50)	(100)	(100)
Other Adjustments	23	(0)	22	-	-
(Inc)/Dec in working capital	(1,750)	(7,022)	5,866	129	(197)
Tax paid	(266)	(232)	(526)	(650)	(620)
CF from operating activities	254	(3,770)	10,636	5,348	5,247
Capital expenditure	(5,809)	(5,000)	(8,000)	(500)	(500)
(Purchase)/Sales of Investments	(4)	-	-	-	-
Income from investments	54	307	50	100	100
CF from investing activities	(5,759)	(4,693)	(7,950)	(400)	(400)
Inc/(Dec) in share capital	3,528	-	-	-	-
Inc/(Dec) in debt	2,100	10,300	(1,000)	(3,000)	(3,518)
Dividends & Interest paid	(411)	(896)	(1,450)	(1,380)	(1,046)
CF from financing activities	5,217	9,404	(2,450)	(4,380)	(4,564)
Net cash flow	(288)	941	235	567	282
Opening balance	923	635	1,576	1,812	2,379
Closing balance	635	1,576	1,812	2,379	2,662

Growth Indicators (%)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
Revenue	66.1	51.6	48.7	7.9	2.9
EBITDA	82.7	59.3	50.4	10.8	3.3
PAT	98.7	108.9	25.5	14.9	20.5
EPS	98.7	108.9	25.5	14.9	20.5

Valuation (x)

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
PE	19.5	7.5	6.0	5.2	4.3
P/BV	2.0	1.6	1.3	1.0	0.8
EV/EBITDA	9.3	8.0	5.5	4.4	3.6
EV/Sales	3.7	3.5	2.3	1.9	1.5
Dividend Yield (%)	0.0	0.3	0.3	0.3	0.3

Financial Ratios

Yearended 31st March	2008a	2009a	2010e	2011e	2012e
RoE (%)	10.4	24.0	23.8	21.9	21.3
RoCE (%)	15.6	19.1	16.9	17.5	18.2
Debt/Equity (x)	1.1	2.0	1.5	1.0	0.6
EBIT/Interest (x)	2.8	3.9	3.1	3.7	5.2

Note

Triveni Engineering & Industries Ltd.

'Sweet' Success...



BUY

CMP: INR105

Target Price: INR134

December 22, 2009

Strictly confidential

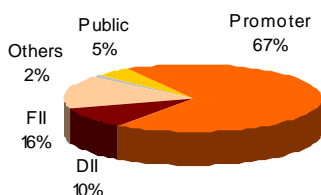
Market Data

Sector	: Diversified
Market Cap (INRbn)	: 27
Market Cap (USDm)	: 584
O/S shares (m)	: 258
Free Float (m)	: 155
52-wk HI/LO (INR)	: 125/32
Avg 12m Vol ('000)	: 753
Face Value (INR)	: 1
Bloomberg	: TRE IN
Reuters	: TREI.BO

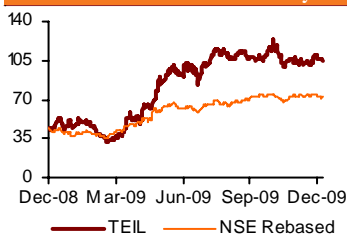
Price Performance

	1m	3m	6m	12m
Absolute	4.1	0.9	16.0	145.2
Relative	6.5	0.4	(1.1)	41.4

Shareholding Pattern



Price Performance vs. Nifty



Investment Rationale

Triveni Engineering and Industries Ltd. (TEIL) is the third largest sugar manufacturing company (in terms of capacity) in India with an operational capacity of 61,000TCD. It also has a presence in the engineering segment which comprises of steam turbines (up to 30MW range), high speed gears and waste water treatment.

TEIL has imported 90,000mt of raw sugar from Brazil for processing and selling in FY10. With rise in domestic sugar prices, the company is expected to substantially benefit from the sale of refined sugar.

The engineering segment has a total order-book of INR7.5bn (steam turbines - INR4.95bn, high speed gears - INR545m and waste water treatment - INR2bn) as on September 2009.

Absence of any capex would result in the cash flows being utilised for debt repayments, which would further strengthen its balance sheet.

At the CMP of INR105, TEIL is trading at a P/E of 10.1x discounting its FY10e EPS of INR10.4. It trades at an EV/EBIDTA and EV/Sales of 5.9x and 1.4x its FY10e.

Valuation

We believe that TEIL could significantly benefit from the current buoyancy in sugar realisations. The improving scenario for the engineering division could also add some stability to margins and profits of the company. We maintain our BUY recommendation and a target price of INR134, which represents an upside of 28% from the current levels.

Key financials

INRm	2008a	2009a	2010e	2011e
Revenues	16,368	19,186	23,272	25,080
EBITDA	3,208	4,401	5,389	6,075
EBITDA Margin	19.6	22.9	23.2	24.2
EBITDA growth	111.0	37.2	22.5	12.7
PAT	1,220	1,744	2,669	3,261
PAT growth	168.5	42.9	53.1	22.2
EPS (INR)	4.7	6.8	10.4	12.6
EPS growth	168.5	42.9	53.1	22.2
P/E	22.2	15.0	10.1	8.3
P/BV	3.3	2.8	2.3	1.9
EV/EBIDTA	11.6	7.7	5.9	4.8
RoE (%)	16.1	19.8	25.0	24.7

Nirav Shah +91 22 4031 3473
nirav.shah@antiquelimited.com

Source: Antique

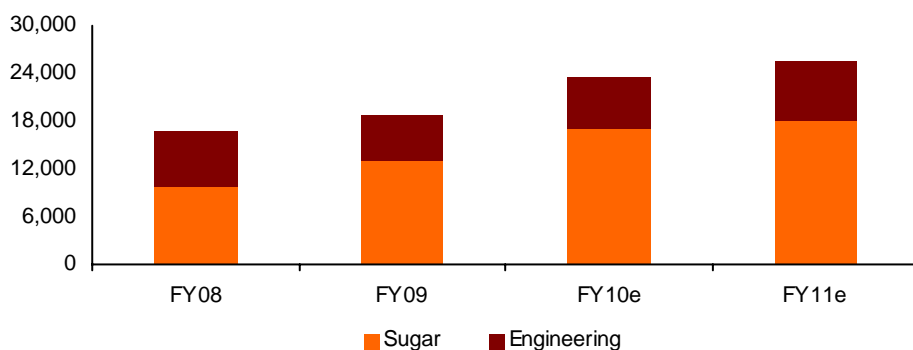
Introduction

Triveni Engineering and Industries Ltd. (TEIL) is the third largest sugar manufacturing company in India in terms of capacity. Presently, it has a sugarcane crushing capacity of 61,000TCD operational across seven units in Uttar Pradesh. To integrate its sugar operations, it also has a 160KLPD distillery and a 45MW (saleable) cogeneration power capacity.

Apart from sugar operations, it also has a presence in the engineering segment which comprises of steam turbines (up to 30MW range), high speed gears and waste water treatment. Contribution from stable engineering segment has enabled the company to minimise the cyclical nature of sugar division as well as ensuring stable cash flows.

As a percentage to total revenues, engineering segment contributed 32% whereas sugar segment (including cogen and distillery) contributed the rest. However, in terms of contribution to PBIT, the same stood at 40% and 60% for engineering and sugar respectively.

Yearly Revenue Break-up (INRm)



Source: Company, Antique

Segment-wise Details

Sugar

With a sugarcane crushing capacity of 61,000TCD, TEIL has the third largest capacity in India after Bajaj Hindustan (136,000TCD) and Balrampur Chini (73,500TCD). It has seven operational units with three in western UP (Khatauli, Deoband and Sabitgarh), three in central UP (Rani Nangal, Chandanpur and Milak Narayanpur) and one in eastern UP (Ramkola).

Capacity Details

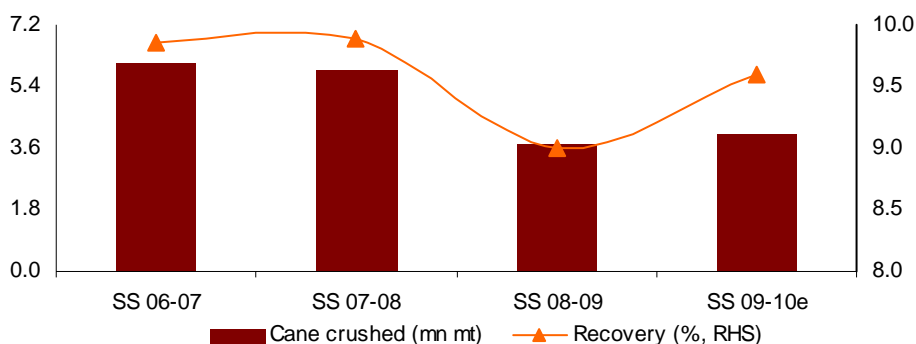
	Capacity
Sugar (TCD)	
Khatauli	16,000
Deoband	14,000
Ramkola	6,500
Sabitgarh	7,000
Chandanpur	5,500
Rani Nangal	6,000
Milak Narayanpur	6,000
Total	61,000
Cogen (MW)	45
Distillery (KLPD)	160

Source: Company

The company completed its capacity expansion from 40,500TCD to 61,000TCD in FY07. However, the ramp up in crushing was not visible as the three new units (Rani Nangal, Chandanpur and Milak Narayanpur) were in areas where sugarcane coverage was relatively less with the scope for increasing the area under cultivation.

TEIL's sugarcane crushing in SS 08-09 declined 36% to 3.7m mt on account of lower yields and diversion to alternate sweetener manufacturers. However, sugar production declined at a faster pace of 42% on back of a 90bps fall in recovery rates. With improvement in yields coupled with lower diversion to alternate sweetener manufacturers, sugarcane availability is expected to increase. Thus, we expect TEIL to post a 7% rise in crushing to 4m mt in SS 09-10. With improvement in recovery rates, we expect sugar production to increase at a faster pace of 14% to 383,568 mt.

Yearly Operational Details



Source: Company, Antique

Unlike Maharashtra and Karnataka, where sugarcane prices are linked to sugar prices subject to the floor of SMP (now being replaced by FRP), prices in UP are announced by the state government. Thus, earnings cycle of companies is more volatile. This was visible in FY07, where mills in UP posted losses on account of average sugar prices falling to INR14,500/mt against sugarcane costs of INR125/quintal leading to buildup in arrears to farmers.

Fair and Remunerative Price (FRP)

In October 2009, the central government promulgated an ordinance by making amendments to The Essential Commodities Act, 1955 where it replaced SMP with FRP. The central government announced the FRP for SS 09-10 at INR129.84/quintal for a base recovery of 9.5% with an additional payment of INR13.7/quintal for every 1% change in recovery rates.

With FRP, the burden of difference in State Advised Price (SAP) over and above the FRP was on the state government. However, the bill was passed in the parliament with the removal of clause 3(b), which relates to the state government bearing the subsidy burden.

For the current season, the UP government has announced SAP of INR165/quintal in SS 09-10 from INR140/quintal in SS 08-09. However, given the sharp surge in sugar prices in UP (ex-mill prices of around INR33,000/mt), farmers agreed to supply sugarcane at a negotiated rate of INR195/quintal. We believe intense competition for sugarcane coupled with firm sugar prices will lead to mills paying further incentives to farmers.

The company has imported 90,000mt of raw sugar from Brazil for processing and selling in FY10. Sales of processed raw sugar will help partly offset the benefits of inventory liquidation enjoyed in FY09. With the rise in domestic prices and imports of raw sugar at competitive rates, we expect the company to benefit from the sales of refined sugar.

Cogeneration

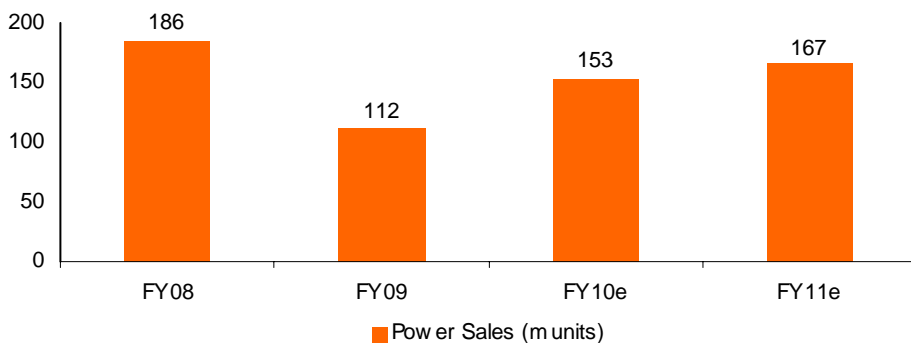
TEIL has a total exportable cogen capacity of 45MW (Khatauli - 23MW and Deoband - 22MW) saleable to UP Power Corporation Ltd. (UPPCL) under long term Power Purchase Agreement (PPA). Profits from cogen, being a renewable source of energy, are eligible for a tax holiday for a period of 10 years.

Recently, UPERC has upward revised the PPA rates for power generated from non-conventional sources with the same increasing from around INR3.1/unit to around INR3.9/unit for power generated from bagasse. This should benefit sugar mills with surplus power capacity as the incremental rates will be directly added to the PBT.

TEIL's cogen units are eligible for carbon credits of around 200,000 units p.a (Khatauli: 125,000 and Deoband: 75,000). With current carbon credit rates of USD12, the potential revenues from sale can be in the region INR110m. However, we have not factored any income from the sale of carbon credits in our estimates.

On back of shortage of bagasse availability, the operating duration of the cogen plants also reduced from 200 days in FY08 to 127 days in FY09. Accordingly, the net power sales to the grid also declined to 111.8m units from 186m units in FY08.

Yearly Power Sales



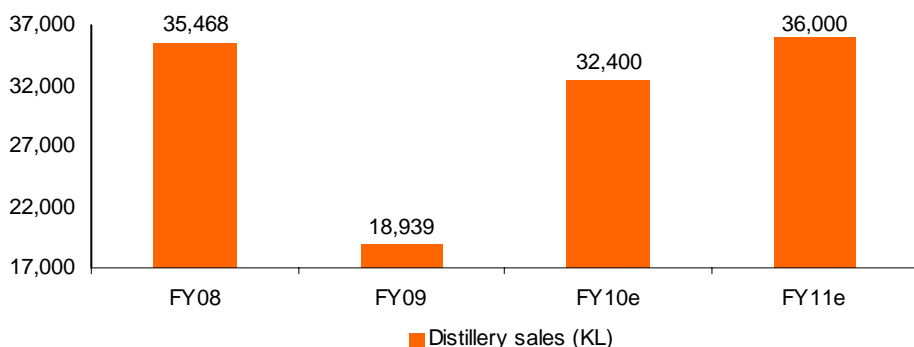
Source: Company, Antique

Distillery

TEIL commissioned its 160KLPD distillery at Muzaffarnagar (between Khatauli and Deoband unit) in April 2007 at a cost of INR900m. It manufactures rectified spirit, Extra Neutral Alcohol (ENA) and Special Denatured Spirit (SDS) and had no contractual obligation to sell ethanol to OMCs. The key customers of the division are United Spirits, Jagatjit Industries, Indian Oil Corporation and Jubilant Organosys.

It did not participate in the first ethanol tender announced in October 2006 as the distillery was not operational. This benefited the company as it fetched a higher realisations selling rectified spirit and ENA compared with the ethanol contract rate of INR21,500/KL. However, it has participated in new ethanol tenders from OMCs at a higher rate.

Yearly Distillery Sales



Source: Company, Antique

Lower molasses availability resulted in the distillery being operational for only 141 days in FY09 against 231 days in FY08. However, given the molasses inventory levels of 70,464mt coupled with increased availability due to rise in sugarcane crushing, we expect distillery production to increase to 32,400KL in FY10e. In FY11e, we expect a further improvement in production to 36,000KL on back of 14% increase in sugarcane crushing.

Improved ethanol offtake from OMCs will also result in rectified spirit/ENA prices remaining firm at the current levels of around INR30,000/KL.

Steam Turbines

TEIL is the market leader in the sub-15MW turbines with a dominant share of 75%, whereas its market share stands at ~20% for turbines in the 15-30MW range. It caters to various user industries like sugar, textiles, sponge iron, metals, textiles, paper and independent power producers. Such diversification across various sectors also helps the division to reduce its dependence on a particular sector.

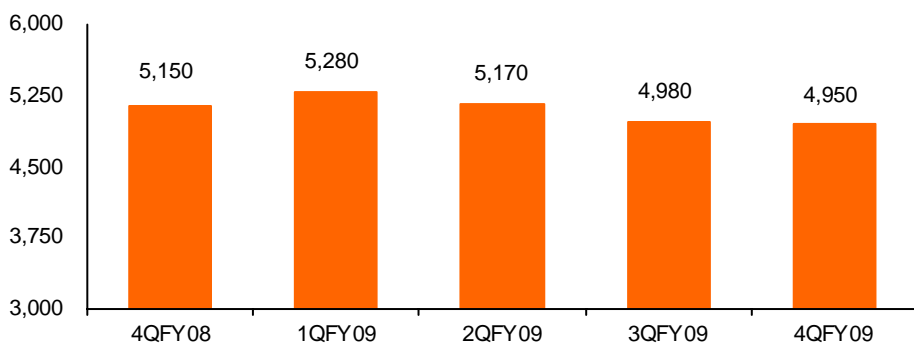
To expand its addressable market, it has entered into an agreement with BZD (China) to sell turbines up to 330MW. However, this segment is characterised by intense competition from BHEL, Siemens and other Chinese manufacturers.

For servicing turbines, the company's range expands up to 150MW capacity against its manufacturing range of up to 30MW. With increasing turbine sales, the contribution from spares and servicing has also increased to 16% in FY09 from 12% in FY08. This also enables the division to improve its profitability as margins in spares and refurbishments are better than margins on turbine sales.

Revenues of the division declined by 7% in FY09 to INR4.8bn as it was impacted by deferment of turbine deliveries in 1HFY09 by certain clients due to lack of credit availability. However, with better liquidity conditions and improving economic scenario, turbine despatches have rose by 32% in 2HFY09 over 1HFY09.

The division has an order backlog of INR4.95bn (759MW) as on September 2009, executable over the next 3-4 quarters.

Quarterly Order book Trend (INRm)



Source: Company

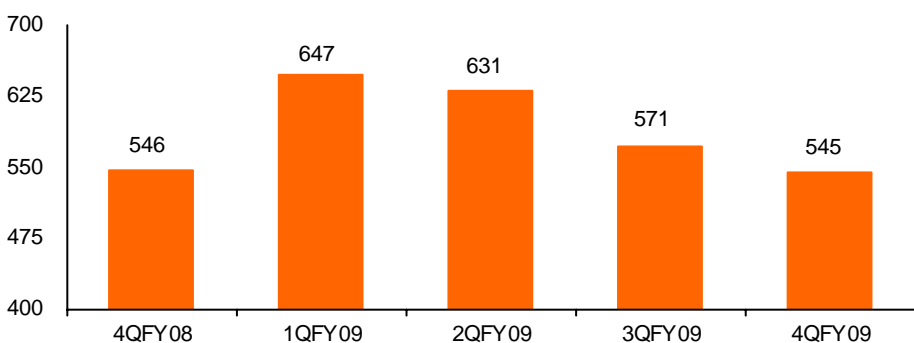
High Speed Gears and Gear Boxes

The division manufactures high speed gears and gear boxes up to 70MW capacity and 70,000rpm. Gears with a capacity of less than 7.5MW are manufactured using in-house technology, whereas for power rating >7.5MW, it manufactures gears using technology licensed from Lufkin (US). It commands a dominant share of 85% for gear boxes in the sub 7.5MW range.

Apart from meeting in-house requirements of the turbine division, the division also supplies gears to other turbine manufacturers like BHEL, Siemens, Sulzer, KSB, L&T among others. The division also offers AMCs, overhauling of gear boxes, gear unit inspections, replacement of spare parts and technical assistance. The contribution to revenues from spares and servicing has increased to 42% from 40% in FY08.

The division has an order backlog of INR545m as on September 2009, executable over the next 2-3 quarters.

Quarterly Order Book Trend (INRm)



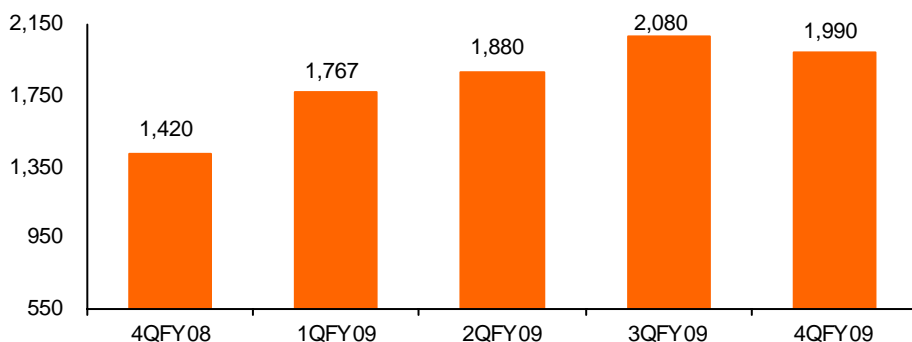
Source: Company

Waste Water Treatment

The company provides products and services for municipal as well as industrial applications, with the former accounting for a major part of revenues as well as the order book. It provides products in the field of industrial process water and waste water treatment, desalination, municipal waste water treatment, etc. The division has a technology tie-up with the US Filter (part of Siemens group) for high value water treatment equipment. It has posted an impressive five-year CAGR of 87% in revenues.

The company has forayed into the providing effluent treatments for small-medium size thermal power plants, coal and steel sector. The division has an order backlog of INR2bn as on September 2009, executable over the next 5-6 quarters.

Quarterly Order Book Trend (INRm)



Source: Company

Our View

Despite a 42% drop in sugar production in FY09, TEIL was able to post a volume growth of 4% on back of inventory liquidation. Lower production resulted in inventory declining to 65,986mt against 257,339mt in FY08. Benefits from inventory liquidation also helped boost profits in 1HFY09 as it sold at an average price of INR18,470/mt against costing of INR14,203/mt.

With inventory levels at an all time low and production in the current season estimated to grow by only 14%, sale of manufactured sugar is expected to decline by 37% in FY10e to 383,568mt. However, the impact of lower sales of manufactured sugar will be partly compensated by processing of 90,000mt of imported raw sugar.

The division is expected to post revenues of INR15bn with an average selling price of INR30,750/mt for manufactured sugar and INR33,000/mt for raw sugar sales. The reason for higher realisation for refined sugar is the obligation to sell 20% of production as levy applies on manufactured sugar and not on refined sugar. Although the levy rate for FY10e has not been announced, we have assumed the same at INR17,000/mt.

Revenues from cogen should grow by 60% to INR584m on back of 37% increase in grid sales to 153m units and a 25% improvement in realisations to INR3.81/unit. A volume growth of 71% to 32,400KL coupled with stable realisations should aid the division's revenues to grow by 73% to INR930m.

We expect engineering division (including steam turbines, high speed gears and waste water treatment) to post revenue growth of 11% to INR6.5bn as a result of the resumption of investment cycle.

We expect the company to post a revenue growth of 20% in FY10e on back of healthy growth in sales of sugar division. Revenue growth in FY11e is expected at 8% on back of stable growth in engineering division. Higher sugar prices should result in FY10e sales mix tilt in favour of the sugar segment.

Operating margins in FY10e are expected to expand by 30bps on back of profits on sale of raw sugar coupled with increase in power rates for sales to the UP grid. Absence of capex coupled with debt repayments should help capital charges decline by 16% and 14% to INR1.7bn and INR1.4bn in FY10e and FY11e respectively.

Net profits are expected to grow by 53% and 22% to INR2.7bn and INR3.3bn respectively. We have not factored any benefits from sales of carbon credits while arriving at our estimates.

Valuation and Recommendation

At the CMP of INR105, TEIL is trading at a P/E of 10.1x discounting its FY10e EPS of INR10.4. It trades at an EV/EBIDTA and EV/Sales of 5.9x and 1.4x its FY10e.

We believe that TEIL could significantly benefit from the current buoyancy in sugar realisations. The improving scenario for the engineering division could also add some stability to margins and profits of the company. We maintain our BUY recommendation and a target price of INR134, which represents an upside of 28% from the current levels.

Key Concerns

1) Acute shortage of sugarcane in SS 2008-09 resulted in mills paying an additional incentive of INR15/quintal over the SAP of INR140/quintal from February 2009 onwards. With sugar price increasing to current ex-mill levels of around INR33,000/mt in the State and expected to remain firm, any further increase in sugarcane price over and above the negotiated price of INR195/quintal would impact its profitability. Although, we have factored in a price of INR215/quintal, we remain cautious on the quantum of any further rise in sugarcane cost from these levels.

2) Decline in cane crushing from our target levels can not only impact the performance of sugar division but also affect the utilisation of cogen and distillery plants, thereby impacting the profitability. We expect the recovery rate to improve to 9.6% in SS 2009-10 from 9% in SS 2008-09, which would partly offset the rise in cane costs. Any slip-up in achieving the target recovery rate could pose a downside risk to our FY10 profit estimates.

3) Any intervention from the government to control domestic prices can negatively impact our profit estimates.

Key Assumptions

	FY09	FY10e	FY11e
Sugarcane crushing (mt)	3,736,892	3,995,500	4,547,550
Recovery (%)	9.00	9.60	9.80
Sugarcane cost (INR/quintal)	1,516	2,150	2,200
Sugar production (mt)	336,331	383,568	445,660
Sugar sales (mt)	526,608	383,568	445,660
Sugar realisation (INR/mt)	21,685	30,750	31,000
Opening stock (mt)	257,339	65,986	65,986
Closing stock (mt)	65,986	65,986	65,986
Distillery sales (KL)	18,939	32,400	36,000
Distillery realisations (INR/KL)	28,448	28,704	25,972
Power sales (m units)	112	153	167
Power realisation (INR/unit)	3.06	3.81	3.89
Raw sugar processed (mt)	-	90,000	60,000
Processed sugar price (INR/mt)	-	33,000	33,000

Source: Company, Antique

Financials (INR m)

Profit and Loss Account

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
Revenues	19,282	16,368	19,186	23,272	25,080
Expenses	17,001	13,160	14,785	17,883	19,004
Operating Profit	2,281	3,208	4,401	5,389	6,075
Other income	53	83	112	80	80
EBIDT	2,334	3,292	4,513	5,469	6,155
Depreciation	867	844	822	796	779
Interest expense	733	998	1,159	860	650
Profit before tax	734	1,450	2,532	3,813	4,726
Taxes incl deferred taxation	31	230	733	1,144	1,465
Profit after tax before EO Items	703	1,220	1,799	2,669	3,261
Extra ordinary Items	21	-	56	-	-
Profit after tax	681	1,220	1,744	2,669	3,261
Diluted EPS (INR)	2.6	4.7	6.8	10.4	12.6

Balance Sheet

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
Share Capital	258	258	258	258	258
Reserves & Surplus	6,811	7,832	9,271	11,563	14,371
Networth	7,068	8,090	9,528	11,821	14,629
Debt	9,995	11,688	8,338	6,464	4,030
Deferred Tax Liability	402	607	933	1,238	1,332
Capital Employed	17,466	20,384	18,799	19,523	19,992
Gross Fixed Assets	15,145	15,709	16,523	16,690	17,060
Accumulated Depreciation	2,293	3,082	3,861	4,657	5,436
Net Assets	12,852	12,626	12,662	12,033	11,624
Capital work in progress	211	424	189	400	400
Investments	331	432	609	609	609
Current Assets, Loans & Advances					
Inventory	4,254	5,475	4,596	4,503	4,686
Debtors	941	2,135	2,431	2,949	3,257
Cash & Bank balance	268	200	278	496	708
Loans & advances and others	3,323	3,681	4,105	4,497	4,781
Current Liabilities & Provisions					
Creditors	4,221	3,762	5,110	5,417	5,525
Other liabilities & provisions	516	845	974	561	561
Net Current Assets	4,049	6,883	5,326	6,468	7,346
Misc. Expenses	22	19	13	13	13
Application of Funds	17,466	20,384	18,799	19,523	19,992

Per share data

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
No. of shares (m)	258	258	258	258	258
BVPS (INR)	27.4	31.4	36.9	45.8	56.7
CEPS (INR)	6.0	8.0	9.9	13.4	15.7
DPS (INR)	0.6	0.6	1.0	1.3	1.5

Margins (%)

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
EBIDTA	11.8	19.6	22.9	23.2	24.2
EBIT	7.6	15.0	19.2	20.1	21.4
PAT	3.5	7.5	9.1	11.5	13.0

Financials (INR m)

Cash Flow Statement

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
EBT	712	1,450	2,476	3,813	4,726
Depreciation & amortisation	869	844	822	796	779
Interest expense	741	1,100	1,159	860	650
Interest / Dividend Recd	(14)	(113)	-	(80)	(80)
Other Adjustments	(15)	(197)	(237)	-	-
(Inc)/Dec in working capital	751	(2,907)	1,481	(923)	(666)
Tax paid	(146)	(155)	(324)	(839)	(1,371)
CF from operating activities	2,898	21	5,378	3,627	4,039
Capital expenditure	(7,767)	(811)	(613)	(378)	(370)
Net Investments	(89)	101	17	-	-
Income from investments	19	56	74	80	80
CF from investing activities	(7,837)	(654)	(521)	(298)	(290)
Inc/(Dec) in share capital	-	-	-	-	-
Inc/(Dec) in debt	5,992	1,687	(3,343)	(1,874)	(2,434)
Dividends & Interest paid	(1,042)	(1,125)	(1,428)	(1,237)	(1,103)
CF from financing activities	4,950	562	(4,771)	(3,111)	(3,537)
Net cash flow	11	(70)	85	218	212
Opening balance	259	268	200	278	496
Closing balance	270	197	285	496	708

Growth Indicators (%)

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
Revenue	7.8	27.3	17.2	21.3	7.8
EBITDA	(26.4)	111.0	37.2	22.5	12.7
PAT	(65.5)	168.5	42.9	53.1	22.2
EPS	(65.5)	168.5	42.9	53.1	22.2

Valuation (x)

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
PE	39.7	22.2	15.0	10.1	8.3
P/BV	3.8	3.3	2.8	2.3	1.9
EV/EBITDA	23.4	11.6	7.7	5.9	4.8
EV/Sales	2.8	2.3	1.8	1.4	1.2
Dividend Yield (%)	0.6	0.6	1.0	1.2	1.4

Financial Ratios

Yearended 30th September	2007a	2008a	2009a	2010e	2011e
RoE (%)	7.3	16.1	19.8	25.0	24.7
RoCE (%)	7.3	13.2	19.0	24.9	27.8
Debt/Equity (x)	1.4	1.4	0.9	0.5	0.3
EBIT/Interest (x)	2.0	2.5	3.2	5.4	8.3

Note

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Antique Stock Broking Limited

Nirmal, 2nd Floor, Nariman Point, Mumbai 400 021.

Tel. : +91 22 4031 3444 • Fax : +91 22 4031 3445

www.antiquelimited.com
