Welspun Corp (WGSR.BO)

Core Business Strong, but WMSL to Be a Drag

- Company Update
- Target Price Change
- Estimate Change

- **Factoring in the Apollo dilution** — We have revised our estimates and target price for WLCO as we now take into account the Rs13bn equity infusion (in the form of GDR and CCD) by Apollo Group into WLCO and the resultant 25% equity dilution. In addition, with WLCO now acquiring an 87.5% stake in WMSL (Welspun Maxsteel – a 0.9MMT sponge iron producer) for Rs8bn, we take a closer look at WMSL's operations.

- **WLCO's core business remains strong...** — As per mgmt, WLCO's core pipe business remains strong, with robust demand being seen globally. As before, WLCO continues to focus on the more lucrative North American and Middle East markets, besides targeting new markets such as Latam. Consequently, the company's plants in the US and the Middle East are seeing strong utilization, and are completely booked for the next 6-9 months, with the overall order book stable at US$1.1bn.

- **...But WMSL to be a drag** — WMSL uses natural gas as a raw material in its sponge iron (DRI) plant. Its operations have been significantly impacted in the last 2-3 months with the reduction in KG gas supply (WMSL's peak gas requirement is ~0.85 mmscmd of which 0.36-0.37 mmscmd of KG supply is now down to nil). This, in our view, would lead to a <50% utilization in FY12E vs. a normalized utilization of 94% in FY11 (WMSL's PAT breakeven is at a 50% utilization), with any turnaround contingent on additional gas supplies.

- **Revise TP to Rs160** — We have reduced our estimates as we now factor in 1) ~25% equity dilution impact of the Apollo Deal, and 2) reduced sales forecasts given shutdown in 1Q and slower ramp-up of the Anjar mill. Our TP of Rs160 (from Rs236) is based on 6.5x FY13E P/E (7.5x Sep-12E earlier), with the cut in the multiple reflecting concerns on global slowdown. We currently ascribe no value to WLCO's stake in WMSL, as we expect the gas supply situation for the latter to remain challenging, with no immediate solution in sight. However, we continue to be positive on WLCO's core pipe business, and expect order win announcements to be a key trigger for the stock.

Buy/High Risk	**1H**
Price (30 Sep 11)	Rs114.30
Target price	Rs160.00
from Rs236.00	
Expected share price return	40.0%
Expected dividend yield	1.7%
Expected total return	**41.7%**
Market Cap	Rs23,403M
	US$478M

Price Performance
(RIC: WGSR.BO, BB: WLCO IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2010A	6,104	26.74	133.5	4.3	0.8	27.4	1.7
2011A	6,330	27.68	3.5	4.1	0.7	19.9	1.7
2012E	6,359	22.18	-19.9	5.2	0.6	15.8	2.2
2013E	7,122	24.84	12.0	4.6	0.5	13.5	2.6
2014E	8,296	28.94	16.5	3.9	0.4	13.1	2.6

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	4.3	4.2	5.2	4.6	4.0
EV/EBITDA adjusted (x)	2.7	2.9	2.9	2.0	1.4
P/BV (x)	0.8	0.7	0.6	0.5	0.5
Dividend yield (%)	1.7	1.7	2.2	2.6	2.6
Per Share Data (Rs)					
EPS adjusted	26.74	27.68	22.08	24.77	28.82
EPS reported	26.74	27.68	22.08	24.77	28.82
BVPS	141.99	169.52	200.00	226.85	254.79
DPS	2.00	2.00	2.50	3.00	3.00
Profit & Loss (RsM)					
Net sales	73,503	80,236	83,548	95,020	101,302
Operating expenses	-62,377	-69,845	-73,085	-83,308	-88,111
EBIT	**11,126**	**10,391**	**10,463**	**11,711**	**13,191**
Net interest expense	-2,071	-1,471	-1,746	-1,858	-1,724
Non-operating/exceptionals	185	184	661	743	863
Pre-tax profit	**9,240**	**9,104**	**9,377**	**10,596**	**12,329**
Tax	-3,136	-2,871	-3,048	-3,497	-4,069
Extraord./Min.Int./Pref.div.	0	97	0	0	0
Reported net income	**6,104**	**6,330**	**6,330**	**7,099**	**8,261**
Adjusted earnings	6,104	6,330	6,330	7,099	8,261
Adjusted EBITDA	13,186	12,831	13,566	15,580	17,398
Growth Rates (%)					
Sales	28.1	9.2	4.1	13.7	6.6
EBIT adjusted	126.4	-6.6	0.7	11.9	12.6
EBITDA adjusted	107.7	-2.7	5.7	14.9	11.7
EPS adjusted	133.5	3.5	-20.2	12.2	16.4
Cash Flow (RsM)					
Operating cash flow	**4,055**	**3,938**	**8,024**	**8,338**	**10,887**
Depreciation/amortization	2,061	2,440	3,103	3,869	4,207
Net working capital	-4,110	-4,735	-1,408	-2,631	-1,581
Investing cash flow	**-3,115**	**-3,372**	**1,600**	**-6,500**	**-6,500**
Capital expenditure	-3,571	-16,182	-7,950	-6,500	-6,500
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**4,339**	**13,099**	**8,500**	**-1,243**	**-1,294**
Borrowings	-1,062	12,584	2,777	-9,600	-2,000
Dividends paid	-478	-479	-666	-922	-922
Change in cash	**5,279**	**13,664**	**18,124**	**595**	**3,093**
Balance Sheet (RsM)					
Total assets	**91,425**	**110,428**	**125,581**	**133,363**	**141,244**
Cash & cash equivalent	17,028	7,532	6,515	7,110	10,202
Accounts receivable	8,077	12,915	13,734	15,620	16,652
Net fixed assets	38,333	51,560	56,407	59,038	61,330
Total liabilities	**62,414**	**73,709**	**78,028**	**71,753**	**72,295**
Accounts payable	9,356	11,683	12,166	13,836	14,751
Total Debt	25,476	38,060	40,836	31,236	29,236
Shareholders' funds	**29,011**	**36,719**	**47,553**	**61,610**	**68,949**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.9	16.0	16.2	16.4	17.2
ROE adjusted	27.4	19.9	15.8	13.5	13.1
ROIC adjusted	21.4	15.2	12.1	12.2	12.7
Net debt to equity	29.1	83.1	72.2	39.2	27.6
Total debt to capital	46.8	50.9	46.2	33.6	29.8

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Core Business Strong, but WMSL to Be a Drag

Figure 1. WLCO-Apollo Deal: Current Status

Infusion by	Infusion into	Amount	Comments
Apollo Global	WLCO	Rs13bn	Transaction complete (Rs7.9bn of CCD + Rs5.2bn of GDR) – Post CCD conversion, Apollo will have a 22% stake in WLCO
WLCO	WMSL	Rs8bn	Transaction complete – WMSL is now a subsidiary of WLCO (WLCO has a 87.5% stake in WMSL)
Apollo Global	WMSL	Rs1.4bn	Transaction complete – Apollo has a 12.5% stake in WMSL

Source: Citi Investment Research and Analysis

Value accretion from Welspun Maxsteel (WMSL) likely to be delayed

- Post the Apollo transaction, WLCO bought out a majority (87.5%) stake in WMSL at a trailing normalized EV/EBITDA of ~8x, which, as highlighted earlier in our report (Welspun Corp (WGSR.BO) - PE Deal with Apollo – Valued Up, but Does it Add Value?), made it a pricey acquisition for WLCO.
- WMSL's operations have been significantly impacted in the last 2-3 months with the reduction in KG gas supply (its peak gas requirement is ~0.85 mmscmd of which 0.36-0.37 mmscmd of KG supply is now down to nil). This, in our view, would lead to a ~50% utilization in FY12E vs. a normalized utilization of 94% in FY11. Utilizations could remain impacted for the time being, given that LNG, at current price levels, remains uneconomical and KG ramp-up may not happen in the near-term. We estimate PAT break-even for the company at 50% utilization levels.
- WMSL has a 0.9 MMT sponge-iron (DRI) capacity, which it planned to expand to 1.7 MMTPA in the next 2 years (estimated capex of Rs3-4bn). However, with current operations under pressure owing to reduced gas supplies, the company has now put its capex plans on hold. This, in our view, is a positive for WLCO as further investments into WMSL's expansion plans will now likely be deferred.

Contribution from WMSL is significantly dependent on utilizations and gas supplies

Figure 2. WMSL – Sensitivity to Utilization

		FY11	FY12E			
Utilization	%	94%	25%	50%	75%	100%
EBITDA	Rsm	1,500	401	801	1,202	1,602
EBITDA/ton*	US$/T	39	39	39	39	39

Source: Citi Investment Research and Analysis estimates *Assuming EBITDA/ton remains in line with FY11

Estimates revisions

We revise our earnings estimates mainly on the back of the following:

- We now base our EPS assumptions on the new diluted share count, post the Apollo deal. Thus, while the share count has increased by 25%, we are not building in any contribution from WMSL going forward, leading to the sharp EPS cut.
- Our FY12E PAT revision is largely on account of a cut in production estimates to factor in the shutdown in 1Q, as well as slower than expected production ramp-up of the new Anjar mill. We have cut production estimates for FY13/14 also as we now expect slower ramp-up of new capacities.

Figure 3. WLCO – Estimates Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2012E	6,608	6,359	28.90	22.18	-23.2%	2.5	2.5
2013E	7,779	7,122	34.02	24.84	-27.0%	3.0	3.0
2014E	9,170	8,296	40.10	28.94	-27.8%	3.0	3.0

Source: Citi Investment Research and Analysis estimates

Figure 4. WLCO – Key Assumptions

WLCO	Units	FY11	FY12E	FY13E	FY14E
Pipe sales	000 MT	909	1,004	1,129	1,205
Pipe capacity	000 MT	1,900	2,250	2,250	2,250
Pipe capacity utilization	*%*	*48%*	*45%*	*50%*	*54%*
Plate/Coil Sales	000 MT	377	510	660	660
Plate capacity	000 MT	1,500	1,500	1,500	1,500
Plate capacity utilization	*%*	*25%*	*34%*	*44%*	*44%*

Source: Citi Investment Research and Analysis estimates

Welspun Corp

Company description

Welspun Corp (WLCO) is a line-pipe manufacturer with an installed pipe capacity of 2.25 MMTPA. The company produces three types of pipes: HSAW, LSAW and ERW, primarily used in the oil & gas industry. It has also expanded its operations by backward integrating its pipe business with the manufacture of steel coils and plates. Its domestic operations are based out of Anjar and Dahej (in Gujarat) and Mandeya (in Karnataka), while it also has pipe mills in the US and Saudi Arabia. Currently, WLCO has an order book of ~US$1.1bn, a significant proportion of which are export orders. WLCO has also acquired a majority stake in Welspun Maxsteel (WMSL), 0.9 MMTPA sponge-iron producer.

Investment strategy

We have a Buy / High Risk (1H) rating on Welspun shares. We remain positive on WLCO's core pipe business, given its high-quality product offerings, accreditations with key customers, and expanding capacities at a time when crude prices are high and global pipe demand is strong. WLCO's leverage to higher-margin international markets (exports are ~80% of its order book) is a key positive. WLCO has capacities in the US, where demand should remain strong (+150% yoy growth), and the Middle East, where pipeline capex is rising despite political concerns. New order wins should be a positive catalyst for the stock, driving capacity utilizations and earnings going forward. However, we are cautious on WLCO's acquisition of Welspun Maxsteel, as we expect the gas supply situation for the latter to remain challenging, with no immediate solution in sight.

Valuation

We cut our target price to Rs160 (from Rs236) on a lower target multiple and lower estimates, with the cut in the multiple reflecting concerns on global slowdown.

Our target price for WLCO of Rs160 is based on a Mar-13E P/E of 6.5x (previously Sep-12E P/E of 7.5x). We set our target multiple at the lower end of WLCO's 5-year trading band of 5-10x, as we factor in lingering market concerns related to the sector and company-specific issues. Our fair-value P/E looks undemanding in light of WLCO's reasonable growth profile (EPS CAGR of 14% over FY12-14E). We believe a P/E methodology is appropriate given that WLCO operates in a cyclical industry.

Risks

We rate WLCO shares High Risk, as opposed to Medium Risk suggested by our quantitative risk-rating system, given that the resolution of the corporate-governance issue could take time. We see the main downside risks which could prevent the shares from reaching our target price as being:

Decline in crude prices - A sharp decline in crude prices would negatively affect exploration activities, delaying investments in fresh pipe infrastructure.

Economic downturn - Development of new pipeline infrastructure is contingent on sustained economic growth. Slower growth and/or a global downturn would impact new order wins and growth prospects for WLCO.

Execution delays - WLCO has undertaken new projects to expand its capacity; any execution delays would be a negative for the company.

Sourcing of raw material - WLCO is dependent to a large extent on external suppliers for the sourcing of raw materials for its pipe and plate mills. While it manages to lock-in raw material prices once it wins an order, any sharp volatility in steel prices could pose a risk.

Exchange rate fluctuation - Even though there exists a natural hedge between WLCO's revenues and expenses, a sharp currency fluctuation could adversely hit the company.

Reputational risk - Most of WLCO's key clients are in quality-conscious markets such as the US and Canada. Any quality issues arising from products supplied by Welspun could hamper its reputation in the global markets.

Further dilution and/or value destructive acquisitions - Any further dilution or unrelated diversification would be negative for WLCO's FCF generation.

Appendix A-1

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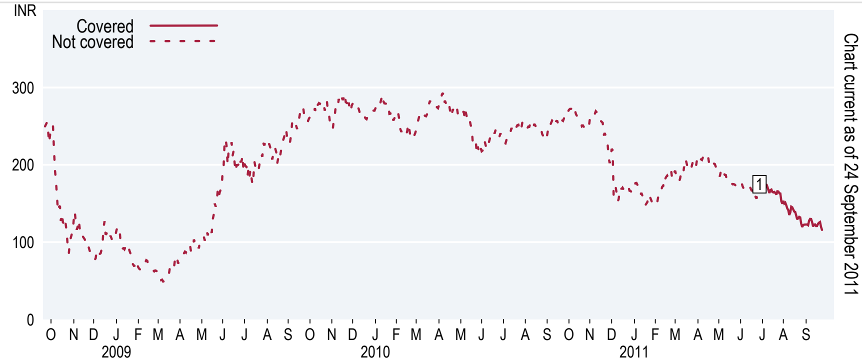
Welspun Corp (WGSR.BO)
Ratings and Target Price History
Fundamental Research
Analyst: Garima Mishra
Covered since June 28 2011



	Date	Rating	Target Price	Closing Price
1	28-Jun-11	*1H	*236.00	169.20

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Welspun Corp (WGSR.BO)

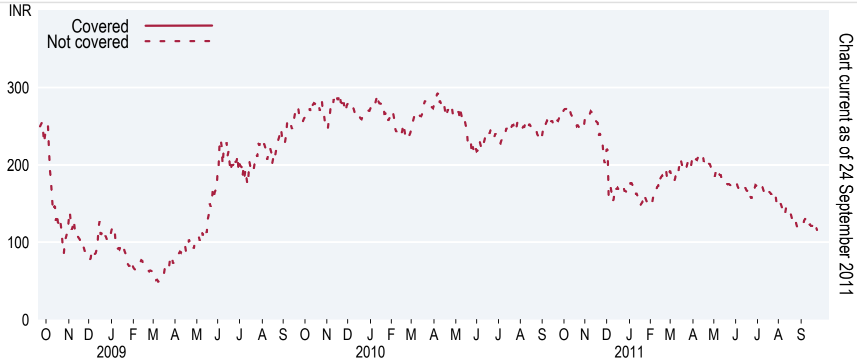
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Garima Mishra

Covered since June 28 2011



* Indicates change

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