

# Outlook remains weak

## EPS cut; PO cut to Rs153(188), Reiterate Underperform

Our global team has cut aluminum price forecasts to factor in the weak demand, metals surplus and continuing turmoil in financial and commodity markets. As a result we cut our earnings sharply by 9-40% over FY09 and FY11. Our PO which is set at 50% discount to NPV reduces 19% to Rs153.

## EPS cut by 9-40% over FY09 and FY11

Based on our lower commodity prices, we now expect EPS to remain flat in FY09 at Rs25.5, decline 26% in FY10 to Rs18.8 and thereafter increase 13% in FY11 to Rs21.2. At spot aluminum price however, our forecasts would be significantly weaker – down 50% versus our base case.

## Dismal Aluminum outlook, Rupee provides little respite

Aluminum prices have fallen 34% since Sept, far ahead of the Rupee depreciation of 9%. High metal surplus, demand slowdown and growing fears of recession imply that near term catalysts for prices to rebound are unlikely. We have cut our aluminum forecast by 7% in FY09E, 22% in FY10 and FY11. We now expect a price of \$1951/t in 2H FY09 and FY10 and \$2067/t in FY11.

## Valuation implies further downside

Over the last 10 years, Nalco has traded at average one-year forward P/E of 8x. On our base case estimates, Nalco is currently trading at P/E of 9.1x FY10E. However, on spot aluminum prices it is trading at 19x. We expect the stock to continue to underperform on weak aluminum prices and potential for sharp earnings disappointment.

### Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	23,764	16,315	16,402	12,092	13,639
EPS	36.88	25.32	25.46	18.77	21.17
EPS Change (YoY)	50.8%	-31.3%	0.5%	-26.3%	12.8%
Dividend / Share	7.50	6.00	6.00	6.00	6.00
Free Cash Flow / Share	32.38	6.40	5.07	11.28	19.68

### Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	4.75x	6.92x	6.89x	9.34x	8.28x
Dividend Yield	4.28%	3.42%	3.42%	3.42%	3.42%
EV / EBITDA*	2.45x	3.94x	3.88x	4.90x	4.27x
Free Cash Flow Yield*	19.24%	3.81%	3.02%	6.70%	11.69%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 6.



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### Stock Data

Price	Rs175.35
Price Objective	Rs188.00 to Rs153.00
Date Established	5-Dec-2008
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs105.25-Rs566.45
Mrkt Val / Shares Out (mn)	US\$2,259 / 644.3
Average Daily Volume	1,193,317
ML Symbol / Exchange	NAUDF / BSE
Bloomberg / Reuters	NACL IN / NALU.BO
ROE (2009E)	17.4%
Net Dbt to Eqty (Mar-2008A)	-39.7%
Est. 5-Yr EPS / DPS Growth	10.0% / 0%
Free Float	12.8%



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Refer to important disclosures on page 7 to 8. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5.

*iQprofile*<sup>SM</sup> National Aluminum Co. Ltd.

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
<b>(Rs Millions)</b>					
Sales	59,103	49,888	54,843	54,586	62,349
Gross Profit	38,920	26,136	27,200	23,199	26,574
Sell General & Admin Expense	(3,562)	(4,192)	(4,878)	(5,539)	(6,313)
Operating Profit	32,187	19,133	19,303	12,774	15,024
Net Interest & Other Income	4,017	5,533	5,548	5,548	5,548
Associates	NA	NA	NA	NA	NA
Pretax Income	36,203	24,666	24,851	18,322	20,572
Tax (expense) / Benefit	(12,440)	(8,351)	(8,449)	(6,229)	(6,933)
Net Income (Adjusted)	23,764	16,315	16,402	12,092	13,639
Average Fully Diluted Shares Outstanding	644	644	644	644	644

**Key Cash Flow Statement Data**

Net Income	23,764	16,315	16,402	12,092	13,639
Depreciation & Amortization	3,171	2,811	3,019	4,886	5,236
Change in Working Capital	854	951	849	(709)	3
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	0	0	0	0	0
Cash Flow from Operations	27,789	20,077	20,270	16,270	18,878
Capital Expenditure	(6,930)	(15,950)	(17,000)	(9,000)	(6,200)
(Acquisition) / Disposal of Investments	0	0	0	0	0
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(6,930)	(15,950)	(17,000)	(9,000)	(6,200)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(5,558)	(4,523)	(4,523)	(4,523)	(4,523)
Cash Flow from Financing	(5,558)	(4,523)	(4,523)	(4,523)	(4,523)
Free Cash Flow	20,860	4,127	3,270	7,270	12,678
Net Debt	(36,865)	(35,165)	(32,354)	(35,812)	(43,887)
Change in Net Debt	(15,302)	396	1,253	(2,747)	(8,155)

**Key Balance Sheet Data**

Property, Plant & Equipment	45,525	58,664	72,645	76,759	77,723
Other Non-Current Assets	0	0	0	0	0
Trade Receivables	12,876	15,249	17,001	16,922	19,328
Cash & Equivalents	36,865	35,165	32,354	35,812	43,887
Other Current Assets	NA	NA	NA	NA	NA
Total Assets	95,266	109,077	122,001	129,493	140,938
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	6,127	6,074	6,074	6,074	6,074
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	12,186	15,409	16,453	16,376	18,705
Total Liabilities	18,314	21,483	22,527	22,450	24,779
Total Equity	76,952	88,585	100,464	108,033	117,149
Total Equity & Liabilities	95,265	110,068	122,991	130,483	141,928

***iQmethod*<sup>SM</sup> - Bus Performance\***

Return On Capital Employed	32.0%	18.5%	16.5%	11.1%	11.6%
Return On Equity	35.0%	19.7%	17.4%	11.6%	12.1%
Operating Margin	54.5%	38.4%	35.2%	23.4%	24.1%
EBITDA Margin	59.8%	44.0%	40.7%	32.4%	32.5%

***iQmethod*<sup>SM</sup> - Quality of Earnings\***

Cash Realization Ratio	1.2x	1.2x	1.2x	1.3x	1.4x
Asset Replacement Ratio	2.2x	5.7x	5.6x	1.8x	1.2x
Tax Rate (Reported)	34.4%	33.9%	34.0%	34.0%	33.7%
Net Debt-to-Equity Ratio	-47.9%	-39.7%	-32.2%	-33.1%	-37.5%
Interest Cover	NA	NM	NA	NA	NA

**Key Metrics**

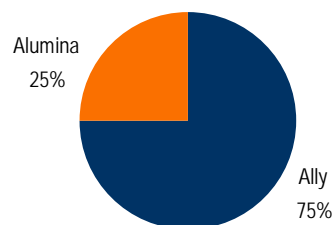
\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 6.

**Company Description**

Nalco is an integrated aluminum producer with production assets in the state of Orissa in Eastern India. It is the largest alumina manufacturer with 52% market share in India and the second largest aluminum manufacturer with 38% market share. In addition, it has captive bauxite mines and a captive power plant, and hence, has the benefits of low-cost raw materials and power.

**Investment Thesis**

We expect Nalco's earnings to peak in Sept Q of the current year. We expect FY10 to be a particularly challenging year with falling aluminum and alumina prices. We believe there are unlikely to be any catalysts near term to support higher commodity prices given the continuing turmoil in financial and commodity markets and risks to demand growth. Despite Nalco's low cost structure, the negative commodity price momentum will in our opinion lead to the stock underperforming.

**Chart 1: FY09E EBITDA mix**


Source: Nalco, Merrill Lynch Estimates

**Stock Data**

Price to Book Value

1.1x

## Weak aluminum outlook

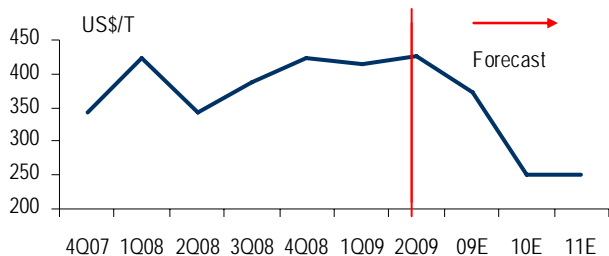
Over the last one month aluminum prices have fallen 21%. We believe slowdown in demand and growing fears of recession imply that near term catalysts for prices to rebound are unlikely. Based on these factors our global team has cut aluminum forecast by 7% in FY09E, 22% in FY10 and 22% in FY11. We now expect a price of \$1940/t in 2H FY09, US\$1951 in FY10 and \$2067/t in FY11. We note however, that spot price is far lower at \$1570/t. If the prices do not rise significantly from current levels then there could be further downside risk to our estimates.

Table 1: Commodity Price Assumptions: Whats Changed?

	FY09E			FY10E		
	Old	New	%chg	Old	New	%chg
Aluminum prices - US\$/T	2564	2395	-6.6%	2508	1951	-22.2%
Alumina Spot prices - US\$/T	391	372	-4.9%	360	250	-30.6%
Re/US\$	45.0	46.0	2.2%	43.0	48.5	12.8%

Source: Merrill Lynch Estimates

Chart 2: Alumina Spot price trends



Source: NALCO, ML Estimates

Chart 3: Aluminum price trends



Source: Bloomberg, ML Estimates

Table 2: EPS Sensitivity

A 1% change in:	Change in EPS
Aluminum	2.6%
Alumina	0.2%
Rupee	3.0%

Source: ML Estimates

## EPS cut on lower commodity prices

We have cut our EPS estimates by 8.7% for FY09E and by 29.4% for FY10E. The cut essentially reflects the lower commodity price expectations. Based on our lower commodity prices, we now expect EPS to remain flat in FY09 at Rs25.5 and decline 26.3% in FY10 to Rs18.8. We believe earnings have peaked in Sept Q as aluminum prices have declined sharply over the last 6-8 weeks. At spot aluminum, we forecast FY10 EPS of Rs9.2, a decline of 51% vs. our base case.

Table 3: Aluminum: Key assumptions and forecasts

	FY 08A	FY 09E	FY 10E	FY 11E
Aluminum LME (US\$ / ton)	2,593	2,395	1,951	2,067
Sales volume (tons)	353,334	360,000	414,000	478,800
Aluminum Avg Realisation - Rs/t	109,953	114,146	99,225	98,119
Aluminum EBITDA - Rsm	20,230	19,577	16,896	19,592

Source: NALCO, Merrill Lynch Estimates

**Table 4: Alumina: Key assumptions and forecasts**

Alumina	FY 08A	FY 09E	FY 10E	FY 11E
Aluminum LME (US\$ / ton)*	2,593	2,395	1,951	2,067
Alumina Contract - As % of LME	9.4%	13.1%	13.0%	13.0%
Alumina spot price - US\$/t	385	372	250	250
Alumina volume sales - tons	883,179	896,000	1,103,400	1,272,530
Alumina Avg Realisation - Rs/t	12,498	15,347	12,241	12,078
Alumina EBITDA - Rsm	1,714	2,744	765	669

Source: NALCO, Merrill Lynch Estimates

**Table 5: Summarized earnings changes**

	FY09			FY10		
	Old	New	%chg	Old	New	%chg
<b>Turnover</b>	57212	54843	-4%	64552	54586	-15%
- Aluminum	42911	41093	-4%	48466	41079	-15%
- Alumina	14301	13751	-4%	16087	13507	-16%
<b>Total Operating Costs</b>	32522	32522	0%	39256	36926	-6%
- Aluminum	21515	21515	0%	25214	24183	-4%
- Alumina	11006	11006	0%	14042	12742	-9%
<b>EBITDA</b>	24690	22322	-10%	25296	17660	-30%
<b>EBITDA Margin</b>	43.2%	40.7%	-2%	39.2%	32.4%	-7%
<b>EBIT</b>	21672	19303	-11%	20410	12774	-37%
<b>Profit bef Tax</b>	27219	24851	-9%	25958	18322	-29%
<b>Tax</b>	9255	8449	-9%	8826	6229	-29%
<b>Net Profit</b>	17965	16402	-9%	17132	12092	-29%
<b>EPS</b>	27.9	25.5	-9%	26.6	18.77	-29%

Source: NALCO, Merrill Lynch Estimates

## PO cut by 19% to Rs153

We have cut our PO from Rs188 to Rs153 owing to lower earnings forecasts. Our new PO implies a 13% downside to the current stock price. Our PO is set at a 40% discount to NPV. We believe Nalco will trade at a discount to DCF because of substantial downside risk to our aluminum price forecasts in our model. Our model currently builds an aluminum price of US\$1951/t for FY10 versus spot at US\$1570/t.

## Price objective basis & risk

### NALCO (NAUDF)

Our PO of Rs153 is based on 40% discount to our DCF valuation (WACC of 13.7%, terminal growth rate of 0%). Our DCF currently assumes aluminum prices of US\$2395/t in FY09E, US\$1951/t in FY10E and long term price of US\$2646/t. However, we believe there is downside risk to our forecasts in the medium term given rising metals surplus and continuing turmoil in financial and commodity market and risks to demand growth. Hence, we expect Nalco to trade at a discount to DCF. Upside risks: Higher aluminum and alumina prices. Downside risks: Lower aluminum prices, execution risks and delays in capacity expansions.

## Analyst Certification

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Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Banpu Pcl	BPULF	BANPU TB	Komsun Suksumrun
	China Shenhua-H	CJAEF	1088 HK	Alexander Latzer
	PT Adaro Energy Tbk	XPDRF	ADRO IJ	Daisy Suryo
	PT Bayan Resources Tbk	XBAYF	BYAN IJ	Daisy Suryo
	Tambang Batubara	PBATF	PTBA IJ	Daisy Suryo
<b>NEUTRAL</b>				
	Hindalco	HNDFF	HNDL IN	Vandana Luthra
	Intl Nickel In	PTNDF	INCO IJ	Daisy Suryo
	Sterlite Industr	XTNDF	STLT IN	Vandana Luthra
	Sterlite Industries India Limited	SLT	SLT US	Vandana Luthra

05 December 2008

**APR - Metals & Mining Coverage Cluster**

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
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	Yanzhou Coal -A	YZC	YZC US	Alexander Latzer
<b>UNDERPERFORM</b>				
	Aneka Tambang	XANEF	ANTM IJ	Daisy Suryo
	Angang	ANGGF	347 HK	Alexander Latzer
	Baosteel	BAOSF	600019 CH	Alexander Latzer
	Bumi Resources	PBMRF	BUMI IJ	Daisy Suryo
	Chalco	ACH	ACH US	Alexander Latzer
	Chalco	ALMMF	2600 HK	Alexander Latzer
	China Steel	CISXF	CISXF US	Albert Hsu
	China Steel Corp	CISEF	2002 TT	Albert Hsu
	Gloria Material	GLMTF	5009 TT	Albert Hsu
	Jiangxi Copper-A	JIXAY	JIXAY US	Alexander Latzer
	Jiangxi Copper-H	JIAXF	358 HK	Alexander Latzer
	Jindal Steel and Power Limited	XJDLF	JSP IN	Bhaskar.N.Basu,CFA
	JSW Steel	XJWJF	JSTL IN	Bhaskar.N.Basu,CFA
	Maanshan I & S-H	MAANF	323 HK	Alexander Latzer
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	POSCO	PKXFF	005490 KS	Alexander Latzer
	POSCO -A	PKX	PKX US	Alexander Latzer

**iQmethod<sup>SM</sup> Measures Definitions**

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

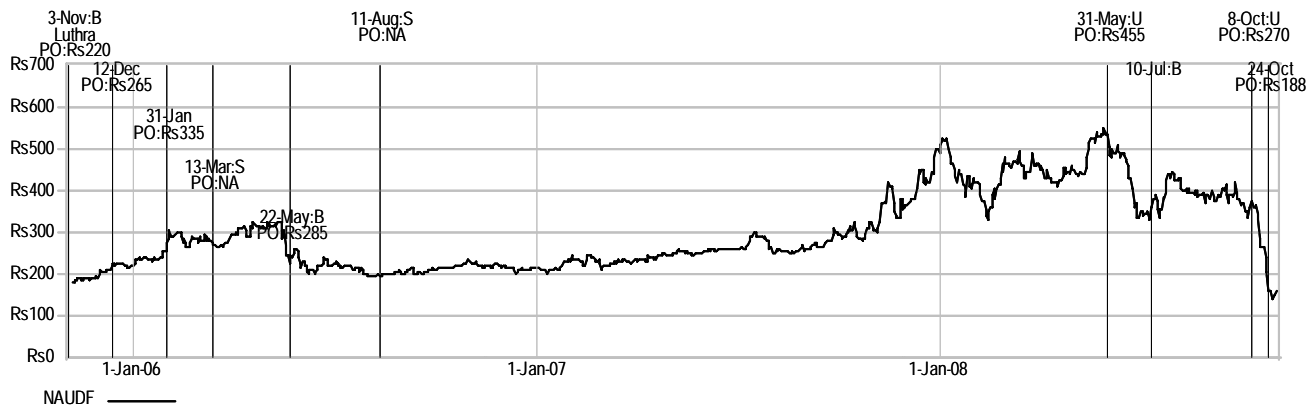
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### NAUDF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of October 31, 2008 or such later date as indicated.

### Investment Rating Distribution: Non-Ferrous Metals/Mining & Minerals Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	80	56.74%	Buy	15	21.13%
Neutral	32	22.70%	Neutral	11	44.00%
Sell	29	20.57%	Sell	6	27.27%

### Investment Rating Distribution: Global Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1647	45.31%	Buy	429	28.83%
Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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