

# Lacking catalysts

## EPS cut; PO cut to Rs272 (Rs321), Reiterate Neutral

Our global team has cut zinc, aluminum and copper price forecasts to factor weak demand and rising surplus. As a result, we cut our earnings sharply by 4-33% over FY09E and FY10E. Our PO is set at a 40% discount to NPV and falls to Rs272 on account of lower earnings. This implies 6% upside potential from the current price.

## Metals outlook has worsened

Zinc has fallen 30%, ally 33% and copper 46% since Sept 08. Demand slowdown concerns and high metals surplus imply catalysts for metal prices to rebound are unlikely. We have cut our price forecasts by 5-29% for FY09E and FY10E. Our new forecasts for 2H FY09 are 5-9% higher than spot for zinc & copper, but we are 23% higher in aluminum.

## EPS cut 4-33% over FY09E and FY10E on lower metal prices

We now expect EPS to decline by 27% in FY09E to Rs45.8 and further decline in FY10E to Rs26.5. Applying spot prices to FY10E, our EPS forecast works to Rs14.6, which is a sharp 45% lower than our base case.

## Strong cash flow underpins valuation

On our base case, Sterlite is now trading at P/E of 9.7x FY10E. On spot metal prices, it is trading at 18x. We believe downside is now limited, given ~US\$3bn of cash on its balance sheet. This accounts for some three-fourth of its current market cap. We believe Sterlite is well positioned to deliver on its zinc expansion and merchant power plans. Further its low cost position implies that even on current depressed zinc prices, it earns margins of ~25%. However, sharp negative earnings momentum implies that catalysts for stock performance are missing.

## Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	45,823	44,639	32,434	18,767	22,448
EPS	82.04	63.01	45.78	26.49	31.68
EPS Change (YoY)	172.6%	-23.2%	-27.3%	-42.1%	19.6%
Dividend / Share	4.00	4.00	3.43	1.99	2.38
Free Cash Flow / Share	68.92	28.93	66.68	31.18	30.98
ADR EPS (US\$)	1.81	1.56	0.915	0.530	0.634
ADR Dividend / Share (US\$)	0.088	0.099	0.069	0.040	0.048

## Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	3.13x	4.08x	5.62x	9.71x	8.11x
Dividend Yield	1.56%	1.56%	1.34%	0.773%	0.924%
EV / EBITDA*	1.41x	1.69x	2.61x	3.99x	3.28x
Free Cash Flow Yield*	21.13%	11.25%	25.94%	12.13%	12.05%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 8.



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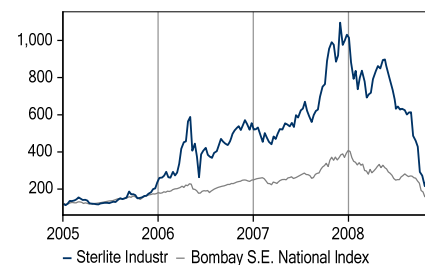
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## Stock Data

Price (Common / ADR)	Rs257.10 / US\$4.78
Price Objective	Rs321.00 to Rs272.00/ US\$6.50 to US\$5.40
Date Established	5-Dec-2008 / 5-Dec-2008
Investment Opinion	C-2-8 / C-2-8
Volatility Risk	HIGH / HIGH
52-Week Range	Rs164.50-Rs1,150
Market Value (mn)	US\$3,653
Shares Outstanding (mn)	708.5 / 708.5
Average Daily Volume	4,647,553
ML Symbol / Exchange	XTNDF / BSE
ML Symbol / Exchange	SLT / NYS
Bloomberg / Reuters	STLT IN / STRL.BO
ROE (2009E)	13.6%
Net Dbt to Eqty (Mar-2008A)	-42.2%
Est. 5-Yr EPS / DPS Growth	-10.5% / -7.5%
Free Float	40.0%



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Refer to important disclosures on page 9 to 11. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6.

# iQprofile<sup>SM</sup> Sterlite Industries India Ltd.

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
<b>(Rs Millions)</b>					
Sales	243,868	247,054	203,843	178,189	202,583
Gross Profit	94,589	78,682	51,038	33,380	40,623
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	86,550	72,732	44,814	27,101	33,480
Net Interest & Other Income	3,026	12,475	12,475	12,475	12,475
Associates	NA	NA	NA	NA	NA
Pretax Income	89,576	85,207	57,289	39,576	45,955
Tax (expense) / Benefit	(24,707)	(21,935)	(10,312)	(9,894)	(11,489)
Net Income (Adjusted)	45,823	44,639	32,434	18,767	22,448
Average Fully Diluted Shares Outstanding	559	708	708	708	708

## Key Cash Flow Statement Data

Net Income	45,823	44,639	32,434	18,767	22,448
Depreciation & Amortization	8,039	5,950	6,224	6,279	7,143
Change in Working Capital	(15,668)	(874)	9,158	9,699	(12,411)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	20,018	3,920	13,126	9,044	10,472
Cash Flow from Operations	58,212	53,635	60,942	43,789	27,652
Capital Expenditure	(19,718)	(33,141)	(13,700)	(21,700)	(5,700)
(Acquisition) / Disposal of Investments	(1,314)	(15,958)	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(21,031)	(49,099)	(13,700)	(21,700)	(5,700)
Shares Issue / (Repurchase)	(1,936)	80,509	0	0	0
Cost of Dividends Paid	(2,748)	(3,442)	(2,773)	(1,605)	(1,919)
Cash Flow from Financing	(11,245)	81,709	(2,773)	(1,605)	(1,919)
Free Cash Flow	38,494	20,494	47,242	22,089	21,952
Net Debt	(14,283)	(117,806)	(162,275)	(182,654)	(202,251)
Change in Net Debt	(31,485)	(81,604)	(44,469)	(20,485)	(20,033)

## Key Balance Sheet Data

Property, Plant & Equipment	97,176	124,367	131,843	147,265	145,822
Other Non-Current Assets	2,967	18,925	18,925	18,925	18,925
Trade Receivables	16,521	15,623	14,269	11,226	14,181
Cash & Equivalents	60,387	168,551	213,020	233,399	252,997
Other Current Assets	62,939	66,476	54,018	46,329	54,697
Total Assets	239,990	393,942	432,076	457,143	486,621
Long-Term Debt	46,103	50,745	50,745	50,745	50,745
Other Non-Current Liabilities	36,411	43,996	43,996	43,996	43,996
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	21,399	19,941	15,288	14,255	13,168
Total Liabilities	103,913	114,683	110,030	108,996	107,909
Total Equity	136,076	279,259	322,046	348,253	379,254
Total Equity & Liabilities	239,990	393,942	432,076	457,249	487,163

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

Return On Capital Employed	33.8%	18.2%	9.3%	4.7%	5.5%
Return On Equity	57.1%	27.7%	13.6%	7.2%	8.0%
Operating Margin	35.5%	29.4%	22.0%	15.2%	16.5%
EBITDA Margin	38.8%	31.8%	25.0%	18.7%	20.1%

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

Cash Realization Ratio	1.3x	1.2x	1.9x	2.3x	1.2x
Asset Replacement Ratio	2.5x	5.6x	2.2x	3.5x	0.8x
Tax Rate (Reported)	27.6%	25.7%	18.0%	25.0%	25.0%
Net Debt-to-Equity Ratio	-10.5%	-42.2%	-50.4%	-52.4%	-53.3%
Interest Cover	22.8x	22.8x	14.1x	8.5x	10.5x

## Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 8.

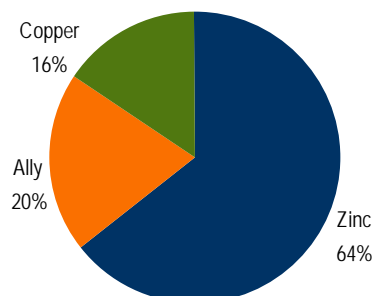
## Company Description

Sterlite is India's largest non-ferrous metals and mining company based on net sales. It is also one of India's most diversified metals company with presence in zinc, aluminum, copper and in the near future merchant power generation.

## Investment Thesis

Assessing risk reward for Sterlite we conclude negative news is likely priced in but positive catalysts are unlikely in the near term. Probability of minority stake buyout in zinc has reduced materially owing to political compulsions, Hence we expect earnings decline in FY09. Secondly, zinc prices have fallen sharply but are likely bottoming out with spot now significantly below marginal cost of production.

## Chart 1: Sterlite EBITDA mix (FY09E)



Source: Sterlite, Merrill Lynch Estimates

## Stock Data

Shares / ADR	1.00
Price to Book Value	0.7x

## Weak metal price outlook

Metal prices have fallen sharply since Sept 2008 - zinc down 30%, aluminum down 33% and copper down 46%. This is much higher than the Rupee depreciation of 9%. We believe slowdown in demand, recession concerns and rising metals surplus imply that near term catalysts for prices to rebound are unlikely. Based on these factors, our global team has cut metal price forecasts as follows:

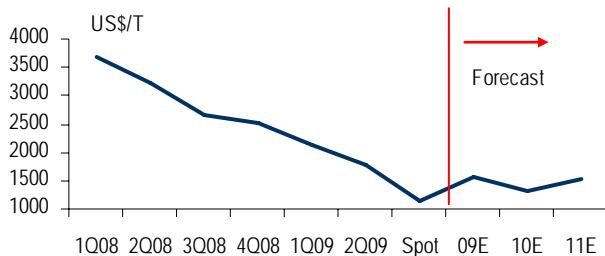
- **Zinc** - increase by 2% in FY09E, cut by 17% in FY10 and 14% in FY11. We now expect a price of \$1576/t in FY09 and \$1323/t in FY10. We note however, that spot price is far lower at \$1150/t.
- **Aluminum** - by 7% in FY09E, 22% in FY10 and in FY11. We now expect a price of \$1969/t in 2H FY09 and \$1951/t in FY10. We note however, that spot price is far lower at \$1570/t.
- **Copper** - by 5% in FY09E, 20% in FY10 and 21% in FY11. We now expect a price of \$5905/t in FY09 and \$4300/t in FY10. We note however, that spot price is far lower at \$3423/t.

Table 1: Metal Price Forecasts

	FY09			FY10		
	Old	New	%chg	Old	New	%chg
Re/US\$	45	46.0	2.2%	45	48.5	7.8%
Zinc prices - US\$/T	1551	1576	1.6%	1599	1323	-17.2%
Aluminum prices - US\$/T	2564	2395	-6.6%	2508	1951	-22.2%
Copper prices - US\$/T	6185	5905	-4.5%	5402	4300	-20.4%

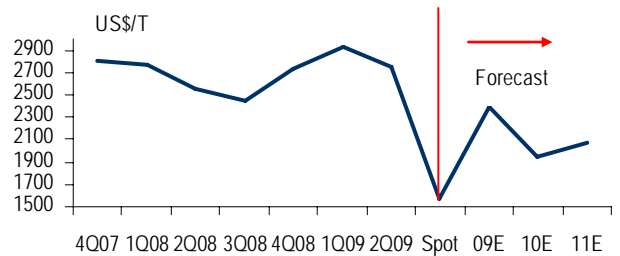
Source: ML Estimates

Chart 2: Zinc spot price trends



Source: Bloomberg, ML Estimates

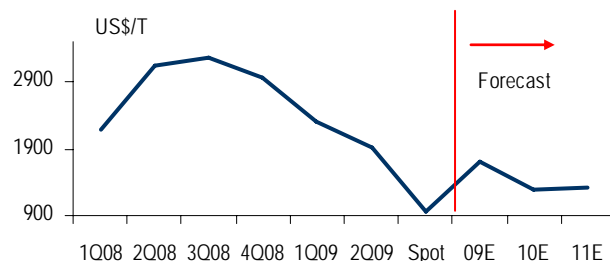
Chart 3: Aluminum spot price trends



Source: Bloomberg, ML Estimates

**Chart 4: Copper spot price trends**


Source: Bloomberg, ML Estimates

**Chart 5: Lead spot price trends**


Source: Bloomberg, ML Estimates

## EPS cut on lower commodity prices

We have cut our EPS estimates by 3.6% for FY09E and by 33% for FY10E. The cut essentially reflects the lower commodity price expectations. Based on our lower commodity prices, we now expect EPS to decline 27% in FY09 to Rs45.8 and further decline 42% in FY10 to Rs26.5. Applying spot prices to FY10, our EPS forecast works to Rs14.6, which is a sharp 45% lower than our base case.

**Table 3: Key forecast and assumptions**

Rs in Mn	FY08A	FY09E	FY10E	FY11E
<b>Aluminum</b>				
LME US\$/t	2,593	2,395	1,951	2,067
Volume (Kt)	359	369	389	409
<b>Zinc</b>				
LME US\$/t	3,044	1,576	1,323	1,516
Volume (Kt)	426	614	636	762
<b>Copper</b>				
TCRC - c/lb	21	12	12	12
Volume (Kt)	339	345	381	381

Source: Sterlite, ML Estimates

**Table 4: Summarized changes in earning estimates**

	FY09			FY10		
	Old	New	%chg	Old	New	%chg
<b>Net Turnover</b>	<b>206863</b>	<b>203843</b>	<b>-1%</b>	<b>205578</b>	<b>178188.5</b>	<b>-13%</b>
Copper	102787	100417	-2%	99335	85686	-14%
Ally	48117	46078	-4%	48713	41066	-16%
Zinc	53761	55336	3%	55619	50493	-9%
Others	2199	7607	246%	1911	5839	206%
<b>EBITDA</b>	<b>50928</b>	<b>51038</b>	<b>0%</b>	<b>46728</b>	<b>33380</b>	<b>-29%</b>
EBITDA Margin	24.6%	25.0%	1.8%	22.7%	18.7%	-17.5%
Copper	5921	5257	-11%	3562	3501	-2%
Ally	13367	13521	1%	12977	7346	-43%
Zinc	29874	31330	5%	30314	23731	-22%
Others	1766	930	-47%	-125	-1199	859%
<b>EBIT</b>	<b>44704</b>	<b>44814</b>	<b>0%</b>	<b>40449</b>	<b>27101</b>	<b>-33%</b>
Interest Costs	3186	3186	0%	3186	3186	0%
Pre-tax profit	57179	57289	0%	52924	39576	-25%
Profit After Tax	46887	46977	0%	39693	29682	-25%
Minority Interest	-12700	-13126	3%	-12662	-9044	-29%
Share of associates	-543	-1417	161%	977	-1871	-291%
Net Profit after Minority Interest	33644	32434	-4%	28008	18767	-33%
<b>EPS</b>	<b>47.5</b>	<b>45.8</b>	<b>-4%</b>	<b>39.5</b>	<b>26.5</b>	<b>-33%</b>

Source: Sterlite, ML Estimates

**Table 2: EPS Sensitivity**

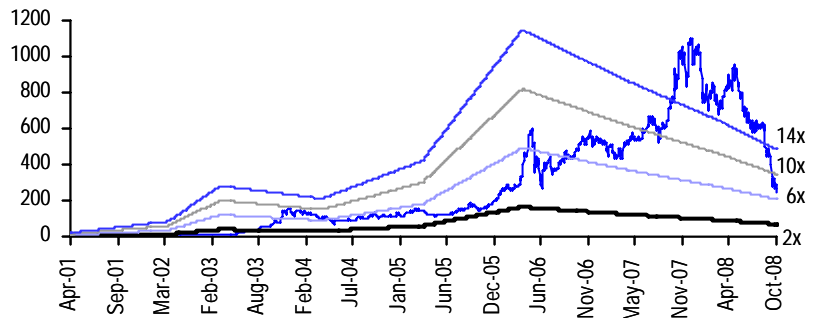
A 1% change in:	Change in EPS
Zinc	1.0%
Aluminum	1.2%
Copper	0.3%
Re	1.8%

Source: ML Estimates

## PO cut by 15% to Rs272

We have cut our PO by 15% from Rs321 to Rs272 owing to lower earnings. Our PO is set at a 40% discount to NPV. We believe Sterlite will trade at a discount to DCF because of substantial downside risk to our metal price forecasts in our model. Our model currently builds a zinc price of US\$1323/t for FY10 versus spot at US\$1150/t, aluminum price of US\$1951/t for FY10 versus spot at US\$1570/t and copper price of US\$4300/t for FY10 versus spot at US\$3423/t.

Chart 6: Sterlite: 1 Year Forward P/E Bands



Source: Bloomberg, Merrill Lynch Estimates

## Price objective basis & risk

### Sterlite Industr (XTNDF / SLT)

Our PO of Rs272 (USD5.4) is based on sum of the parts for the metals and merchant power business. We value the metals business at Rs238/share, at a 40% discount to 12 month DCF value of Rs397. The discount emanates from continuing weak metal prices and hence the significant downside risk to our earnings estimates. We value the merchant power business at Rs34/share.

Our DCF valuation for the metals business builds in long term metal prices from FY16E onwards and we take a WACC of 13.7% and perpetuity growth of 0%. We forecast long term zinc prices of \$1657/t and long term aluminum prices of \$2646/ton. Near term our zinc price forecast is \$1576/t for FY09E and \$1323/t for FY10E. Our valuation of the power business is based on capacity of 2400MW by FY11, capex of \$1.9bn and gearing of 70%.

Upside risks to our PO are higher than forecast metal prices and higher than forecast power capacity over the next two years. Downside risks are lower metals prices and continuing hurdles in minority stake increase.

## Analyst Certification

I, Vandana Luthra, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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05 December 2008

**APR - Metals & Mining Coverage Cluster**

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Banpu Pcl	BPULF	BANPU TB	Komsun Suksumrun
	China Shenhua-H	CUAEF	1088 HK	Alexander Latzer
	Intl Nickel In	PTNDF	INCO IJ	Daisy Suryo
	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
	Yanzhou Coal	YZCHF	1171 HK	Alexander Latzer
	Yanzhou Coal -A	YZC	YZC US	Alexander Latzer
	Zijin Mining - H	ZIJMF	2899 HK	Alexander Latzer
<b>NEUTRAL</b>				
	Chalco	ACH	ACH US	Alexander Latzer
	Chalco	ALMMF	2600 HK	Alexander Latzer
	Hindalco	HNDFF	HNDL IN	Vandana Luthra
	Jiangxi Copper-A	JIXAY	JIXAY US	Alexander Latzer
	Jiangxi Copper-H	JIAXF	358 HK	Alexander Latzer
	Sterlite Industr	XTNDF	STLT IN	Vandana Luthra
	Sterlite Industries India Limited	SLT	SLT US	Vandana Luthra
<b>UNDERPERFORM</b>				
	Aneka Tambang	XANEF	ANTM IJ	Daisy Suryo
	Angang	ANGGF	347 HK	Alexander Latzer
	Baosteel	BAOSF	600019 CH	Alexander Latzer
	China Steel	CISXF	CISXF US	Albert Hsu
	China Steel Corp	CISEF	2002 TT	Albert Hsu
	Gloria Material	GLMTF	5009 TT	Albert Hsu
	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
	NALCO	NAUDF	NACL IN	Vandana Luthra
	Steel Authority	SLAUF	SAIL IN	Vandana Luthra
	Tata Steel	TAEUF	TATA IN	Vandana Luthra
	Wuhan Steel	WHNIF	600005 CH	Alexander Latzer
<b>REVIEW</b>				
	China Oriental	CUGCF	581 HK	Alexander Latzer
	POSCO	PKXFF	005490 KS	Alexander Latzer
	POSCO -A	PKX	PKX US	Alexander Latzer

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

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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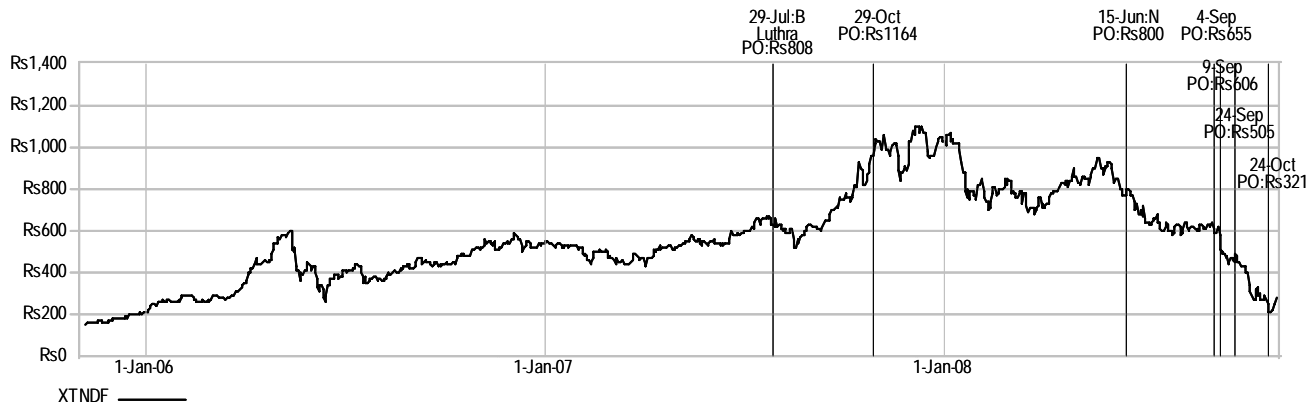
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## Important Disclosures

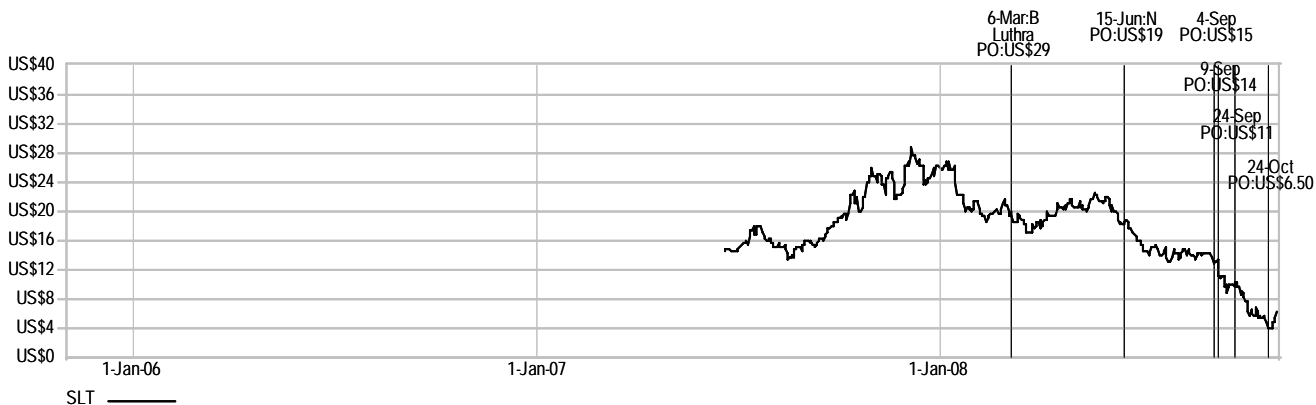
### XTNDF Price Chart



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.

### SLT 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%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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

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