

Company In-Depth

10 September 2007 | 8 pages

Sterlite Industries (India) (STRL.BO)

Buy: Changing Forecasts on Revised Commodity Prices

 Rating change
 Target price change
 Estimate change

- Revising forecasts, target price** — We raise our target price marginally by 4% to Rs949 on the back of global commodity price forecast revisions. While small changes have been made to most base metals, the upgrade to lead has been significant. Our EPS estimates have changed by -8%, 4% and 7% for FY08E, FY09E and FY10E respectively. Our target price is based on 10x FY09 P/E.
- Bullish on zinc and lead** — Our lead forecasts have been hiked substantially by 69-171% in FY08-10E due to supply disruptions, strong demand and speculative buying. While zinc prices have come off due to weak sentiment (our FY08E estimates cut by 13%), we remain bullish and expect prices to reach ~US\$4,000/t in 2HFY08 due to LME stock draw down and better fundamentals.
- Stable outlook for aluminium** — The aluminium price is weakening under the combined pressures of declining US demand and unwinding of speculative positions, only partially offsetting very strong Chinese demand growth. We expect the market to remain relatively close to demand-supply balance in 2008 and 2009. We have raised our forecasts by 4% for FY08E and 7% for FY09E.
- Copper TC/RCs range bound** — Our TC/RC outlook remains subdued until FY09. Our TC/RC forecasts have been cut 13% to USc13.2/lb in FY08E and raised to USc15.7/lb in FY09E. The TC/RCs are expected to rise in FY10E to USc20.7/lb.
- Reiterate Buy (1M)** — The expected purchase of the balance government stake in HZL and Balco, and buoyant zinc and lead outlook, should lead to 39% EPS growth in FY09E. We reiterate our Buy (1M).

Buy/Medium Risk	1M
Price (10 Sep 07)	Rs602.90
Target price	Rs949.00
	<i>from Rs910.00</i>
Expected share price return	57.4%
Expected dividend yield	0.7%
Expected total return	58.1%
Market Cap	Rs427,271M
	US\$10,550M

Price Performance (RIC: STRL.BO, BB: STLT IN)



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

Figure 1. Sterlite Industries (India) – Statistical Abstract

YE	Net Profit*	EPS	EPS growth	P/E	EV/EBITDA	ROE
	(Rs m)	(Rs)	(%)	(x)	(x)	(%)
31 Mar						
FY05A	6,517	11.9	-8%	50.8	31.4	15%
FY06A	16,781	30.0	153%	20.1	13.1	28%
FY07A	44,841	80.3	167%	7.5	5.1	45%
FY08E	48,229	68.1	-15%	8.9	5.7	22%
FY09E	67,233	94.9	39%	6.4	3.9	24%
FY10E	47,381	66.9	-30%	9.0	5.2	14%

Source: Company Reports and Citigroup Investment Research estimates. Prices as on Sep 10. *Net profit is profit attributable to shareholders

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	20.1	7.5	8.9	6.4	9.0
EV/EBITDA adjusted (x)	11.8	4.7	4.9	4.2	5.5
P/BV (x)	5.6	3.4	1.9	1.5	1.3
Dividend yield (%)	0.2	0.7	0.7	0.7	0.7
Per Share Data (Rs)					
EPS adjusted	30.05	80.29	68.07	94.89	66.88
EPS reported	30.05	80.29	68.07	94.89	66.88
BVPS	108.38	178.72	309.41	401.79	478.17
DPS	1.25	4.00	4.25	4.40	4.50
Profit & Loss (RsM)					
Net sales	131,272	243,868	266,556	294,850	248,798
Operating expenses	-96,300	-150,501	-180,347	-199,134	-181,392
EBIT	34,972	93,367	86,208	95,717	67,406
Net interest expense	-2,353	-3,791	-3,447	-4,624	-4,618
Non-operating/exceptionals	-101	-198	0	0	0
Pre-tax profit	32,518	89,378	82,762	91,093	62,788
Tax	-10,165	-24,118	-20,243	-21,463	-14,451
Extraord./Min.Int./Pref.div.	-5,572	-20,420	-14,289	-2,398	-955
Reported net income	16,781	44,841	48,229	67,233	47,381
Adjusted earnings	16,781	44,841	48,229	67,233	47,381
Adjusted EBITDA	40,241	101,406	94,701	104,629	76,307
Growth Rates (%)					
Sales	81.0	85.8	9.3	10.6	-15.6
EBIT adjusted	127.5	167.0	-7.7	11.0	-29.6
EBITDA adjusted	119.3	152.0	-6.6	10.5	-27.1
EPS adjusted	153.1	167.2	-15.2	39.4	-29.5
Cash Flow (RsM)					
Operating cash flow	22,086	56,490	66,341	75,067	58,209
Depreciation/amortization	5,269	8,039	8,493	8,912	8,902
Net working capital	-8,339	-18,647	4,336	-3,390	4,220
Investing cash flow	-16,172	-43,070	-118,603	-47,131	-17,246
Capital expenditure	-13,506	-23,796	-24,707	-34,044	-25,468
Acquisitions/disposals	-6,009	-26,091	-99,836	-20,000	0
Financing cash flow	-3,103	-13,438	90,181	22,169	-8,833
Borrowings	-320	217	13,238	30,387	-500
Dividends paid	-732	-4,441	-132	-3,595	-3,716
Change in cash	2,811	-19	37,920	50,105	32,130
Balance Sheet (RsM)					
Total assets	170,976	239,990	385,908	495,084	554,251
Cash & cash equivalent	11,153	11,134	49,055	99,159	131,289
Accounts receivable	13,475	16,521	19,266	22,981	20,473
Net fixed assets	85,497	97,176	118,641	171,067	202,315
Total liabilities	93,279	103,916	122,787	158,644	158,323
Accounts payable	13,917	9,078	17,780	19,536	18,395
Total Debt	51,653	46,103	59,342	89,729	89,229
Shareholders' funds	77,696	136,074	263,121	336,439	395,928
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	30.7	41.6	35.5	35.5	30.7
ROE adjusted	32.3	55.9	30.2	26.7	15.2
ROIC adjusted	23.9	51.1	32.7	26.8	16.6
Net debt to equity	52.1	25.7	3.9	-2.8	-10.6
Total debt to capital	39.9	25.3	18.4	21.1	18.4

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Figure 2. Sterlite Industries (India) – Change in forecasts

	FY08E			FY09E			FY10E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Aluminium LME (US\$/t)	2,509	2,606	4%	2,425	2,590	7%	2,315	2,315	0%
Copper LME (US\$/t)	7,145	7,378	3%	7,441	7,441	0%	6,614	6,614	0%
Lead LME (US\$/t)	1,565	2,649	69%	1,047	2,260	116%	854	2,315	171%
Zinc LME (US\$/t)	4,224	3,684	-13%	3,417	3,417	0%	2,315	2,315	0%
Copper TC/RC (USc/lb)	15.0	13.2	-12%	14.0	15.7	12%	15.0	20.7	38%
Net sales (Rs bn)	269	267	-1%	289	295	2%	244	249	2%
EBITDA (Rs bn)	101	95	-7%	101	105	4%	72	76	6%
Net profit attributable to shareholders (Rs bn)	52	48	-8%	64	67	4%	44	47	7%
EPS (Rs)	73.9	68.1	-8%	91.0	94.9	4%	62.3	66.9	7%

Source: Citigroup Investment Research estimates

Sterlite Industries (India)

Company description

Sterlite is a non-ferrous metals major with a presence in aluminium, zinc and copper. Sterlite is a custom copper smelter (capacity 400,000 tpa) for which the key profit driver is treatment and refining charges (TC/RCs). According to Brook Hunt, Sterlite is in the lowest-cost quartile of all copper smelting operations worldwide. Sterlite's aluminium revenues and profits comes from its 51% ownership of Bharat Aluminium Co (Balco), Balco's smelter capacity of 345,000 tpa has access to 810MW power, which is the most important cost component in the aluminium manufacturing process. Sterlite's zinc and lead revenues come from its 64.9% holding in Hindustan Zinc Ltd (HZL), an integrated zinc producer with a 60% domestic share. It is among the lowest-cost producers in the world largely due to the low cost of mining ore at the Rampura Agucha mine which meets about 90% of its requirement. HZL is expanding its zinc capacity by 63% to 669,000 tpa by 1Q FY09, accompanied by expansion in captive power capacity by 83% to 346MW. Sterlite is in the process of buying out the minority government stake in both HZL (29.5%) and Balco (49%).

Investment thesis

We rate Sterlite shares Buy / Medium Risk (1M). Zinc (Hindustan Zinc) is the biggest contributor to Sterlite's EBITDA (70% of total) and should continue to benefit from robust pricing and strong volume growth. Sterlite is expected to soon raise its holding in HZL to 94.4% and hence can be considered as an alternate investment vehicle for investors looking to participate in the zinc story. Sterlite is also 4x more liquid than HZL. In the aluminium business (Balco), lower costs and some volume growth should help compensate for lower domestic prices in FY08. Sterlite's shareholding in Balco is also expected to soon reach 100%. Copper has a difficult outlook due to the lower TC/RC margins expected in FY08-FY09 vs. FY07. We expect Sterlite's attributable net income to rise 39% yoy in FY09E due to higher profits in zinc and aluminium and the completion of the minority stake acquisition of Hindustan Zinc (29.5%) and Balco (49%) from the government during FY08.

Valuation

Since April 2006, the stock has been substantially re-rated to a P/E range of 6-8x due to the positive trends in all its three major businesses. We expect this re-rating process to continue based on our robust outlook for zinc and steady profits in aluminium, with triggers coming from progress in acquiring the balance minority stakes from HZL and Balco. Our target price of Rs949 is arrived at by applying a P/E of 10x to FY09E earnings. This appears justified as Sterlite's earnings are substantially driven by zinc's robust outlook, and the sector re-rating following recent M&A activity. The stock has also crossed its 4-year average EV/EBITDA of 3.7x in the last few months, largely driven by zinc and lead prices. Based on our zinc outlook, we expect the EV/EBITDA upside to continue. At our target price, the stock would trade at an EV/EBITDA of 6.6x.

We also examine the value for Sterlite using sum-of-the-parts by applying P/E ratios of 6x to 10x for FY09E for its various businesses. We also add to this value the book value of investments in Sterlite Energy at the end of FY09E. This method gives a value of Rs904 per share.

Risks

We rate Sterlite shares as Medium Risk based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Risk factors that could prevent the shares from reaching our target price include: (1) Any delays in completion of Hindustan Zinc minority stake acquisition; (2) Any delays in acquisition of Balco minority stake; (3) Weaker-than-expected commodity prices or TC/RC margins; (4) Delays in expansion plans for zinc and power; (5) Substantial dependence on the Rampura Agucha mines in case of zinc; (6) Trends in exchange rates.

Appendix A-1

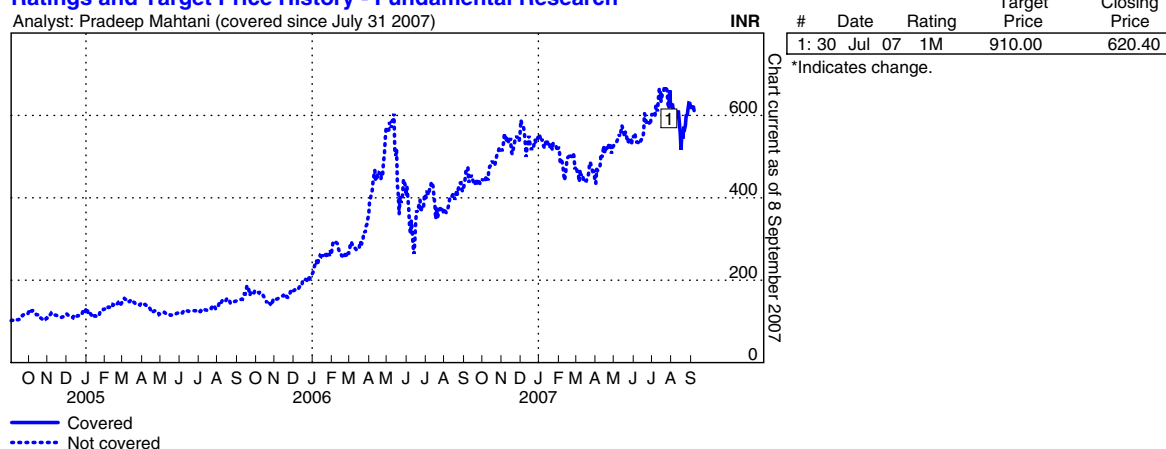
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Analyst: Pradeep Mahtani (covered since July 31 2007)



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