

A case for re-rating – Revise Target to Rs410

24th July 2007

BUY

Price Target Price

Rs243 Rs410

Sensex – 15,732

Price Performance

(%)	1M	3M	6M	12M
Absolute	45	42	39	126
Rel. to Sensex	34	25	25	45

Source: Bloomberg

Stock Details

Sector	Metals
Reuters	HEGL.BO
Bloomberg	HEG@IN
Equity Capital (Rs mn)	403
Face Value (Rs)	10
52 Week H/L (Rs)	247/99
Market Cap (Rs bn)	9.8
Daily Avg Vol (No of shares)	213380
Daily Avg Turnover (USD mn)	1.1

Shareholding Pattern (%)

(30th Jun.'07)

Promoters	56.5
FII/NRI	7.9
Institutions	14.7
Private Corp.	6.6
Public	14.3

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HEG reported strong 1QFY08 results. The net sales were Rs2248mn (yoy up 22%, qoq down 8%), EBITDA was Rs473mn (yoy up 28%, qoq down 16%), EBITDA margin was 21% (yoy up 229bps, qoq down 82bps), PAT was Rs285mn (yoy up 157%, qoq down 4.5%) and net margin was 12.7% (yoy up 336bps, qoq down 285bps). For 1QFY08, HEG reported FDEPS of Rs6.07 (yoy up 153%, qoq down 4.6%). HEG has hived off its steel division for an all cash consideration of Rs1.2bn to Jai Balaji Industries Ltd. (JBIL), The company has secured 20-22% hike in realization for 80% of its graphite electrode capacity that has already been pre-booked for FY08. Further, it plans to increase the graphite electrode capacity from 52,000t to 57,000t by 4QFY08. Currently the company has around Rs8bn debt on its balance sheet which includes Rs1.2bn FCCB and Rs3.5bn in long term debt. With the proceeds from steel division sale used to repay long term debt and conversion of FCCB (conversion price set at Rs192), we expect the net debt to equity of the company to come down from ~2x to less than 1x. Given the strong demand for graphite electrodes and margin expansion that the company will witness following the sale of its steel division, we upgrade our earnings for FY08 by 24.4%. We expect the company to report net sales of Rs8.8bn for FY08 and Rs10.4bn for FY09. We believe the company will likely report PAT of Rs1.3bn for FY08 and Rs1.6bn for FY09. At CMP of Rs243, the stock is trading at 6.9x our FY09 FDEPS estimate of Rs34.4 and EV/EBITDA of 4.2x FY09 estimates. We maintain a BUY with a revised target price of Rs410.

Graphite electrode division - robust performance

HEG's graphite division reported an increase of 46% yoy in revenues aided by strong volume growth of 27.7% and realization growth of 14.5% yoy. On sequential basis the company reported volume growth of 3.7% and realization growth of 1.2% resulting in overall sequential revenue growth of 4.9%.

	1QFY08	1QFY07	% yoy	4QFY07	% qoq
Volumes (t)	12,200	9,550	27.7%	11,761	3.7%
Revenues (Rs mn)	2,037	1,393	46.2%	1,941	4.9%
Average Realization (Rs/t)	166,967	145,864	14.5%	165,037	1.2%

Source: Company and Emkay Research

Steel division hived off- margins to expand

HEG has formally announced its decision to hive off its steel division along with 13MW WHRP to JBIL at a consideration of Rs1.2bn. The de-merger will be effective from Aug 1, 2007. We believe with this de-merger, HEG will witness margin expansion as the billet division had very low contribution at EBITDA level during FY07. For 1QFY08, HEG's graphite division generated EBIT margin of 20%, while the steel business generated EBIT margin of 9%.

	All divisions combined FY07 (a)	Steel Division (b)	All Divisions ex-steel (a-b)	Change in margin
Net Sales	8,179	1,740	6,439	
EBIT	1,259	-46	1,305	
EBIT margin %	15.4%	-2.6%	20.3%	490bps

Source: Company and Emkay Research

Debt to be reduced substantially

HEG expects to receive Rs1.2bn from the sale of its steel division. The management has mentioned that the proceeds will be utilized to pay off a portion of their long term debt. Further, we expect the FCCB to be converted as the current market price is around 24% premium to the conversion price of Rs192. Currently, the company has around Rs8bn of debt on their balance sheet which includes Rs1.2bn of FCCB and Rs3.5bn in long term debt. We expect the debt to reduce by Rs2.2bn by end of FY08 (Rs1.2bn by way of FCCB conversion and Rs1bn through repayment of long term debt).

Likely savings in the subsequent quarters for FY08

Benefit source	Amount	Rationale
Additional DEPB benefits	Rs180mn	DEPB rates increased from 5% to 8%. Additional DEPB benefits not accounted for in 1QFY08.
Reduction in pre-shipment credit interest rate	Rs30mn	Secured a reduction of 2% on pre-shipment loan
Saving in interest cost	Rs45mn	Proceeds of steel division sale off to be used for reduction in long term debts
Total Savings	Rs255mn	

Source: Emkay Research

Hydel power plant restarts ahead of schedule

Hydro power plant at Tawa, being seasonal in nature, was not operational during 1QFY08, which resulted in lower revenues in the power division. However, the plant restarted on July 13, ahead of its schedule, due to better monsoons. This will likely result in generation of additional 10mn units during FY08.

80% of the capacity is pre-booked at 20-22% higher realization

HEG has already booked around 80% of its annual capacity of graphite electrodes at 20%-22% higher price as compared to last year. Balance 20% has been left for sale on spot market. We believe this strategy will have a positive impact on the margins.

Inventory of 1,600t still available for sale

HEG has an inventory of 1,600t of graphite electrodes, which is carried forward from the last quarter. In the current rising price scenario, the company expects to benefit from sale of this inventory at higher prices during the second half of the year.

Low capex of Rs800mn for 33MW CPP

HEG is investing Rs800mn to construct a 33MW captive thermal power plant. The cost of the project is significantly lower than the industry benchmark of Rs40mn/MW. Earlier when HEG had set-up 30MW CPP, it had created the infrastructure related to land, coal handling and ancillary infrastructure to accommodate 60MW. In the current round of expansion, HEG has benefited from the earlier infrastructure that it had already set-up, resulting in lower specific cost per MW. The management expects the power plant to be commissioned by 1QFY09.

Needle coke supplies 90% already secured

HEG has secured 90% of the needle coke requirements for FY08, at a 40%-45% price hike. Globally there are few suppliers of needle coke, of which ConocoPhillips (USA) controls 70% market share. We expect the company to secure balance 10% of needle coke supplies during the year.

Binder pitch prices – trends lower

In 1QFY08, binder Pitch prices have softened. The reducing trend is expected to continue in the near future.

FCCB conversion - to dilute equity by 16.4%

HEG has issued Rs1.2bn FCCB at a conversion price of Rs192. With the CMP at Rs243, we expect FCCBs to be converted, resulting in 16.4% dilution of equity.

Expansion projects on schedule

HEG will invest Rs350mn to expand its graphite electrode capacity from 52,000t to 57,000t through de-bottle necking. HEG expects the additional 5,000t to be operational by 4QFY08. Further, work on the 33MW CPP is also on track. HEG expects the power plant to commence its operations by 1QFY09. The funding for entire capex of Rs1.15bn has already been tied up. We do not expect any further dilution for this capex.

Change in assumptions

We have made the following changes in our assumptions post our discussion with the management.

	FY08E Earlier	FY08E Revised	Change	Remarks
Graphite Electrode division				
Volume (t)	53,000	52,000	-1000	
Realization (\$/t)	3,650	3,950	+300	Management guidance
CPC cost/t	\$1,250	\$1,350	+\$100	Strong demand, limited availability
Pitch cost/t	\$800	\$600	-\$200	Falling Pitch prices (Mgt. estimates pitch prices are currently down by 40%. We have assumed 25% decline)
Total cost/t	\$2,651	\$2,865	+\$214	
Steel Div Revenue (Rs mn)	2,029	434	-1595	Steel business hived off
Interest cost (Rs mn)	580	478	-102	Reduction in debt due to repayment of Rs1bn + pre-shipment loan cost reduction
Depreciation (Rs mn)	530	500	-30	Lower, as billet division is hived off
Other income (Rs mn)	50+70	450+70	+400	Forex gains + additional DEPB benefit of 3%. Consultancy fee from Iran project assumed at Rs70mn as earlier
PAT (Rs mn)	1,072	1,334	+262	

Source: Emkay research estimates

Further, we also introduce FY09 estimates and now assign valuation based on our FY09 estimates.

Key products and assumptions

	FY08E	FY09E
Graphite electrode		
Volume (t)	52,000	57,000
Realization/t	\$3,950	\$4,444
Power		
Total capacity	30MW	63MW
Surplus units sold (mn)	31.11	90.83
Avg. cost/unit	2.6	2.6
Realization/unit	3.1	3.1

Source: Company, Emkay research estimates

Outlook and Valuation

We expect the company to report FDEPS of Rs28.4 for FY08 and Rs34.7 for FY09. We value HEG at Rs410/sh on SOTP basis.

We believe HEG deserves a premium valuation over the commodity stocks (as detailed in our reported dated No 1, 2006) for the following reasons:

Unlike commodity stocks, Graphite electrodes is a highly technology intensive business with strong entry barriers. China does not possess the technical expertise to manufacture graphite electrodes, as the technology has not been shared by the existing players. Further, unlike volatility in commodity prices, graphite electrodes have seen secular growth in realizations. The demand for graphite electrodes is not linked to the price of steel, but the volume growth in steel manufactured through the EAF route, which continues to expand, resulting in significant growth in its demand. Unlike fragmented steel industry, the supply of graphite electrodes is highly consolidated.

Valuation

	Per share Rs	Rationale	Remarks
Core business	312	9x our FY09 FDEPS estimate of Rs34.7	We expect the stock to command a premium over commodity stocks owing to the huge technology barrier in setting up a Graphite electrode plant
Investment in group company	98	40% stake in group company Bhilwara Energy Limited (BEL), based on last deal	(BEL) has recently placed 8% of its equity through private placement that has pegged the equity valuation of BEL at Rs11.5bn. HEG's 40% stake will therefore be valued at Rs4.6bn. Based on existing capital of 46.9mn shares on fully diluted basis, the investment value will be Rs98/sh
Fair Value per share	410		

With the billet division now hived off, we believe the stock is poised for re-rating. At the CMP of Rs243, the stock is trading at 8.6x our FY08 estimated FDEPS of Rs28.4 and at 6.9x our FY09 estimated FDEPS of Rs34.4. The stock is trading at 5.9x EV/EBITDA of FY08E and at 4.2x EV/EBITDA of FY09E. We maintain BUY on the stock with a revised target price of Rs410, implying an upside of 69% from the current level.

Quarterly results summary

	1QFY08	1QFY07	% yoy	4QFY07	% qoq
Net Sales	2,248	1,844	21.9%	2,444	-8.0%
Expenditure					
Consumption of raw material	1,091	1,029	6.1%	952	14.6%
Change in stock	-63	-146	-56.7%	239	-126.5%
Total cost of goods sold	1,028	883	16.5%	1,191	-13.7%
Gross profit	1,220	961	26.9%	1,253	-2.6%
Gross margin	54.3%	52.1%	-395 bps	51.3%	300bps
Personnel exp	98	88	12.1%	91	7.8%
Power and fuel	219	173	26.7%	157	39.7%
Other exp	431	333	29.4%	441	-2.5%
Total operating exp	747	593	26.0%	689	8.5%
EBITDA	473	368	28.4%	564	-16.2%
Ebitda margin	21.0%	20.0%	229 bps	23.1%	-204bps
Depreciation & amortization	126	117	7.5%	130	-3.0%
EBIT	347	251	38.2%	434	-20.1%
EBIT margin	15.4%	13.6%	325bps	17.8%	-233bps
Interest Expense	144	131	9.7%	121	19.2%
Other income	203	31	558.4%	106	92.2%
PBT	406	151	169.3%	419	-3.1%
Provision for tax	121	40	203.3%	120	0.7%
ETR %	29.8%	26.5%	110bps	28.7%	330bps
- Current tax	114	32	259.1%	73	55.8%
- Deferred tax liability	6	11	-45.3%	46	-87.4%
- Fringe benefit tax	1	0		1	
- Earlier Years		-3			
PAT	285	111	157.0%	299	-4.6%
Net margin	12.7%	6.0%	336 bps	12.2%	45bps
Equity capital (basic)	403	403		403	
Equity capital (Fully diluted)	469	469		469	
Reported EPS					
- Basic	7.07	2.75	157.0%	7.41	-4.6%
- Diluted	6.07	2.40	153.0%	6.37	-4.6%

All fig. in Rs mn except for % and per share data

Common size ratios

	1QFY08	1QFY07	% yoy	4QFY07	% qoq
Net Sales	100.0%	100.0%	-	100.0%	-
Raw material cost	48.5%	55.8%	-730bps	39.0%	950bps
Change in stock	-2.8%	-7.9%	510bps	9.8%	-1260bps
Cost of goods sold	45.7%	47.9%	-220bps	48.7%	-300bps
Personal expenses	4.4%	4.8%	-40bps	3.7%	70bps
Power cost	9.7%	9.4%	30bps	6.4%	330bps
Other expenses	19.2%	18.1%	110bps	18.0%	120bps
EBITDA	21.0%	20.0%	229bps	23.1%	-204bps
Depreciation	5.6%	6.3%	-70bps	5.3%	30bps
Interest expense	6.4%	7.1%	-70bps	5.0%	140bps
Other income	9.0%	1.7%	730bps	4.3%	470bps
PAT	12.7%	6.0%	336bps	12.2%	45bps

Segmental Results

	1QFY08	1QFY07	% yoy	4QFY07	% qoq
Segment Revenue					
Graphite	2,037	1,393	46%	1,941	5%
Steel	365	456	-20%	499	-27%
Power	239	247	-3%	325	-27%
Others	36	23	58%	82	-56%
Less: inter-segment sales	-227	-244	-7%	-299	-24%
Less: Other Income Included in sales	-203	-31	558%	-106	92%
Total Revenue	2,248	1,844	22%	2,444	-8%
Segment EBIT					
Graphite	444	219	103%	273	63%
Steel	34	-12	-379%	11	213%
Power	47	60	-22%	137	-66%
Others	25	15	63%	58	-58%
Less: Interest and Finance Charges	-144	-131	10%	-60	140%
Total	406	151	169%	419	-3%
Segment Capital Employed					
Graphite	5,559	4,829	15%	5,162	8%
Steel	777	742	5%	722	8%
Power	1,455	1,502	-3%	1,506	-3%
Others	1,042	1,580	-34%	1,351	-23%
Total	8,832	8,653	2%	8,741	1%

All fig. in Rs mn except for %

Financials

Income Statement					Balance Sheet				
	Rs mn					Rs mn			
	FY06	FY07	FY08E	FY09E		FY06	FY07E	FY08E	FY09E
Gross Sales	5,642.9	8,675.3	9,331.8	11,045.5	Equity Capital	403	403	469	469
Less: Excise	(351.3)	(496.5)	(534.1)	(632.1)	Reserves & Surplus	2,802	3,406	5,658	6,999
Net Sales	5,291.6	8,178.8	8,797.7	10,413.3	Networth	3,205	3,809	6,127	7,468
Other Income	60.2	202.0	520.0	170.0	Total Debts	8,050	8,045	5,885	5,485
Total Income	5,351.7	8,380.8	9,317.7	10,583.3	Preference Shares	0	0	0	0
Raw Material Consumption	2,153.3	3,737.7	3,948.3	4,749.0	Net deferred liability	695	835	891	960
As a % to Net Sales (%)	40.7	45.7	44.9	45.6	Capital Employed	11,950	12,689	12,903	13,913
Power & Fuel	1,035.8	660.3	757.6	769.5	Gross Block	8,492	9,222	8,572	9,372
Staff Cost	326.8	351.6	364.7	351.8	Less Depreciation	-2,214	-2,703	-2,953	-3,503
Other Expenses	621.5	1,682.9	1,380.3	1,500.0	CWIP	357	0	500	0
As a % to Net Sales	11.7	20.6	15.7	14.4	Net Fixed Assets	6,635	6,520	6,120	5,870
Total Exp	4,137.4	6,432.5	6,450.9	7,370.3	Investments	301	302	302	302
EBIDTA	1,214.3	1,948.3	2,866.8	3,213.0	Inventory	2,141	2,241	2,892	3,424
EBIDTA (%)	22.9	23.8	32.6	30.9	Debtors	1,240	1,905	2,049	2,425
Depreciation	396.2	486.9	500.0	550.0	Cash and Bank	1,305	674	787	1,118
EBIT	818.1	1,461.4	2,366.8	2,663.0	Loans & Advances	1,125	2,318	2,308	2,573
Interest	288.1	460.6	467.9	355.0	Other Current Assets	0	0	0	0
Misc. W/offs and E/O items	0.0	0.0	0.0	0.0	Total Cur. Assets	5,811	7,137	8,036	9,540
PBT	530.0	1,000.8	1,898.9	2,308.0	Current Liabilities	660	1,120	1,326	1,569
Tax	140.8	262.3	557.5	692.4	Provisions	183	195	274	274
ETR (%)	26.6	26.2	29.4	30.0	Total Curr. Liabi. & Prov.	843	1,315	1,600	1,843
A PAT	389.2	738.5	1,341.4	1,615.6	Net Current Assets	4,968	5,822	6,436	7,696
Pref. Div.	0.0	0.0	0.0	0.0	Misc. Assets	-45	-45	-45	-45
Net Income to Equity holders	389.2	738.5	1,341.4	1,615.6	Total Assets	11,950	12,689	12,903	13,913

Cash Flow Statement					Ratios				
	Rs mn								
	FY06E	FY07E	FY08E	FY09E		FY06	FY07E	FY08E	FY09E
PBT	530	1,001	1,899	2,308	EBIDTA margin (%)	21.8	21.4	26.7	29.2
Depreciation	396	487	500	550	EBIT margin (%)	14.3	15.4	21.0	23.9
Net Chg in WC	-1,827	-1,496	-580	-930	NPM (%)	7.4	9.0	15.2	15.5
Others	-59	-123	-502	-623	Adj ROCE (%)	6.4	9.3	14.6	15.9
CFO	-959	-131	1,317	1,305	Adj ROE (%)	12.7	21.3	27.2	23.9
Capex	-1,250	-371	-100	-300	ROIC (%)	6.1	8.3	10.9	14.1
Net Investments made	1	-1	0	0	Adj EPS	9.7	18.3	28.6	34.4
Others Investing Activities	0	0	0	0	Cash EPS	19.5	30.4	39.3	46.2
CFI	-1,249	-372	-100	-300	Book Value	78.4	93.4	129.7	158.3
Change in Share capital	-45	0	1,251	0	DPS	3.0	4.3	5.0	5.00
Change in Debts	3,501	-5	-2,160	-400	Payout (%)	31.1	23.5	17.5	14.5
Div. & Div Tax	-145	-183	-195	-274	Net Debt to Equity (%)	213.4	195.9	83.8	58.8
Others	0	0	0	0	PE (x)	24.7	13.0	8.3	6.9
CFF	3,312	-187	-1,104	-674	P/BV (x)	3.0	2.6	1.8	1.5
Total Cash Generated	1,103	-691	113	331	EV/Sales (x)	2.3	1.6	1.6	1.2
Cash Opening Balance	203	1,305	674	787	EV/EBITDA (x)	10.7	7.7	5.9	4.2
Cash Closing Balance	1,305	674	787	1,118	Div Yield (%)	1.3	1.8	2.1	2.1

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