ENAM **ENAM Securities**
India Research

Rs.211
Target Price: Rs.285
Potential Upside: 35%

VISIT NOTE

Nalco

Relative to sector: **Neutral**

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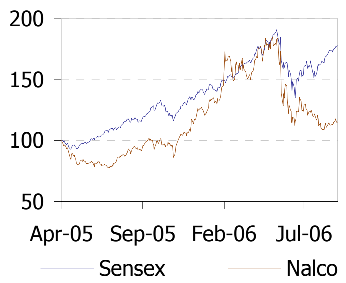
Relative Performance



Source: Bloomberg, ENAM Research

Stock data

No. of shares	: 644mn
Market cap	: Rs.136bn
52 week high/low	: Rs.335/ Rs.152
Avg. daily vol. (6mth)	: 1.1mn shares
Bloomberg code	: NACL IN
Reuters code	: NALU.BO

Shareholding (%)		Jun-06	QoQ chg
Promoters	:	87.2	0.0
FIIs	:	2.9	0.0
MFs / UTI	:	1.0	(0.8)
Banks / FIs	:	4.5	0.4
Others	:	4.5	0.4

WELL PLACED IN VOLATILE ALUMINA MARKET

Our recent interaction with the management of Nalco suggests that the company is well placed despite lower spot prices, given its low operating cost in alumina of around USD100 per ton. As regards contract pricing, the company has entered into an alumina tender contract (120,000 tonnes from Sept 2006 to Aug 2007) at 11.5% of LME aluminium price, which is significantly lower than the earlier contract price of 23% of LME aluminium price.

Highlights:

- Spot alumina now accounts for 60% of surplus alumina sales, while annual contract sales account for balance 40%. Currently, spot prices are at USD 275 per ton. Cost pressures are evident in fuel, caustic soda and calcined petroleum coke.
- The alumina & aluminium expansion projects are now expected to be fully operational in FY10.The expansion project is likely to see a minor cost overrun. The cash outflow on account of this project would be Rs 14 bn in FY08 and Rs 25 bn in FY09.

The recent fall in alumina prices to USD 275 per ton has brought prices at a level close to cash cost of Chinese alumina production (using captive as well as imported bauxite). As a result, we believe that spot alumina prices would rebound and would trade in the band of USD 330-380 per ton. We believe Nalco would be able to report higher profits on relatively higher alumina prices (for the first five months of FY07) and higher aluminium prices for the most of FY07. However lower alumina and aluminium prices would reduce earnings in FY08. To adjust for the lower alumina prices, we have revised our earnings downward for FY07 to Rs 32.9 (down by 7% from previous forecast) and to Rs 28.5 for FY08 (down by 5%). At CMP (Rs.211), the stock trades 6.4x FY07E earnings. We have revised our price target to Rs.285 based on 10x FY08E earnings. We believe the stock would trade at a discount, due to higher exposure to volatile spot alumina prices, and absence of volume growth over the next three years. *We maintain our sector **Neutral** recommendation as we believe, there are other compelling Outperformers in the non ferrous sector.*

Financial summary

Y/E Mar	Sales (Rs.mn)	PAT (Rs. mn)	Consensus EPS* (Rs.)	EPS (Rs.)	Change YoY (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBIDTA (x)	DPS (Rs.)
2005	42,362	11,896	-	18.5	64	9.4	28.1	41.4	4.6	4.5
2006	49,940	15,647	-	24.3	32	12.1	29.5	45.9	6.2	5.0
2007E	59,401	21,185	32.5	32.9	35	6.4	31.3	47.6	2.9	6.0
2008E	54,689	18,374	22.3	28.5	(13)	7.4	22.0	33.3	3.2	6.0

Source: *Consensus broker estimates, Company, ENAM estimates

Alumina

- **Spot vs Contract:** Nalco has entered into a one year alumina contract of 120,000 tonnes, starting 1st September06 at 11.5% of LME aluminium. This is sharply lower than the one-year contract pricing of 23% of LME aluminium struck at the beginning of the year. With the signing of the new contract, contract sales of alumina would now account for 40% of total alumina sales as opposed to earlier 30%. The previously contracted alumina volume (30%) is locked in at higher 23% of LME aluminium prices till December 2006. Given the volatile spot prices, Nalco plans to wait before entering into any fresh yearly contracts.

  As a result, for CY2006, the company would sell 0.6 mn tonnes of alumina in the spot market and the balance ~0.3 mn tonnes through annual contracts. The pricing of spot alumina sales is obtained through tenders to its registered buyers on monthly basis. The company has the flexibility to switch to contracts as and when it chooses in the future. However, for the current year, the company is prepared to be in the volatile spot market.

- **Pricing:** The sharp fall in recent annual contract pricing is on account of continuous drop in spot alumina prices, which is currently at USD 275 per ton. The spot price of alumina had hit a high of over USD 600 per ton recently, and has since steadily declined over the last few months. The decline is due to the lower purchases by the Chinese aluminium producers who have switched partly to Chinese alumina production, which rose sharply in FY07.

- **Volume:** We believe, the volume of alumina production/ sales is likely to remain flat for the next two years.

- **Cost of production:** The operating cost of alumina production has increased to more than USD 100 per ton, up some USD 20 per ton a couple of years ago. Cost of production including the fixed cost of capital and depreciation will be USD 150 per ton.

(Please refer to page 4 for alumina price trend, Chinese alumina production trend, bauxite import trends and cost of alumina production)

Aluminium

- **Domestic Vs International mix:** The Company now sells more aluminum in the domestic market vis-à-vis exports as the domestic market has been growing rapidly. Also, demand from the electrical sector is rising and the company expects to sell higher volumes of wire rods over the next couple of years.

- **Volume:** The Company is operating at more than its rated capacity of 345,000 tpa. The company does not expect a significant rise in volume over the next couple of years.

- **Product Mix:** The product mix is likely to improve gradually as the company is yet to stabilize the operation of the new rolling mill as tight schedules of the technical experts of the machinery supplier continue to result in delays.

Cost pressure – Fuel and caustic soda remain firm

- **Power/ Coal:** Domestic pricing of coal remains unchanged, as abundant coal supplies are being made available to Nalco's captive power plant and alumina refinery.
- **Captive Coal Mining:** The company is awaiting regulatory clearance on the coal project. The Company plans to develop its own captive coalmines on the coal blocks that are allotted to it. The captive coalmines are located 40 Kms away as against 14 Kms from the existing coal mines. The captive mining from the coalmine would coincide with the expansion of aluminium smelter and power plant.
- **Calcined Pet Coke:** The cost of calcined pet coke continues to remain firm, in line with higher crude oil prices.
- **Caustic Soda:** The caustic soda prices is expected to be higher by 15% in FY07 at around Rs.18,000 per ton. The company expects caustic soda prices to remain firm for the next couple of years.
- **Fuel Oil:** Fuel oil too witnessed higher pricing trend, in line with the rise in crude oil prices. Fuel oil prices are likely to remain at higher levels.
- **CT Pitch:** Coal Tar pitch prices have almost doubled as a result of shortage of coke derivatives from the steel plants.
- **Employee expenses:** Employee expenses are likely to rise at a normal pace this year. In FY 08, however employee cost could rise on account of pay revision.

Expansion plan – Full operational in FY10

The company now expects the expansion projects to be fully operational by FY10. The company plans to raise the alumina capacity by 0.5 mn tpa to 2.1 mn tpa and that of aluminium capacity by 115,000 tonnes pa to 460,000 tpa. The estimated capital expenditure is around Rs. 41 bn.

Capex Details

	Current Capacity	Addition	Final Capacity	Project Cost
Refineries				
Bauxite	4.8 mn tpa	1.5 mn tpa	6.3 mn tpa	-
Alumina	1.6 mn tpa	0.5 mn tpa	2.1 mn tpa	Rs.15bn
Smelter				
Aluminium (tonne)	345,000	115,000	460,000	Rs.18bn
Power	920 MW	240 MW	1,160 MW	Rs.8bn
Total				**Rs.41bn**

Source: ENAM Research

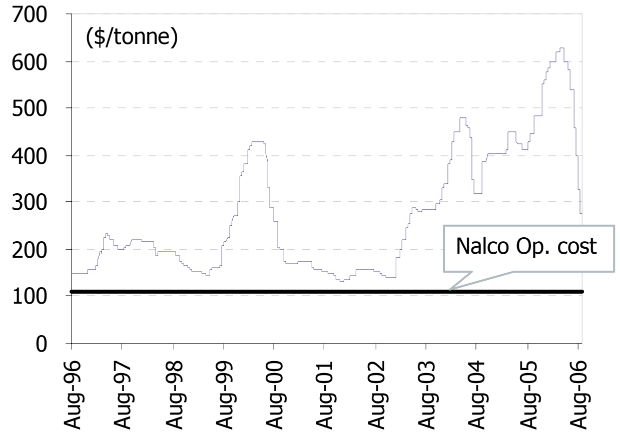
While capital expenditure estimates are as of 26th October 2004, we believe there is bound to be marginal escalation in the project cost on account of rising cost of inputs. The cost over run is likely to be in the range of 5-8%.

Financials and Cash flow: The proposed capex outlay (including over-run) for FY07 is Rs6.5 bn, Rs.14-15 bn in FY08 and the balance Rs 25 bn in FY09. As of 31st March 2006, the company had close to Rs 22 bn of cash & cash equivalents. Given the Q1FY07 PAT of Rs 6.2bn, the cash & cash equivalents, as on 30th June 2006, stands at ~ Rs 29 bn.

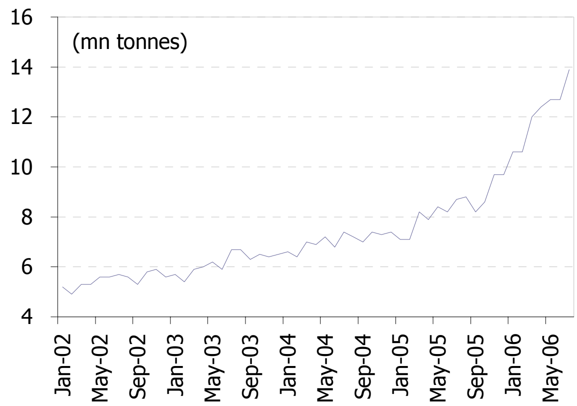
The company deposits the surplus cash with banks at market driven interest rates on short maturity. The current short-term deposit rates from the banks range from 8 to 8.5% p.a.

Alumina industry overview:

Alumina: Spot prices



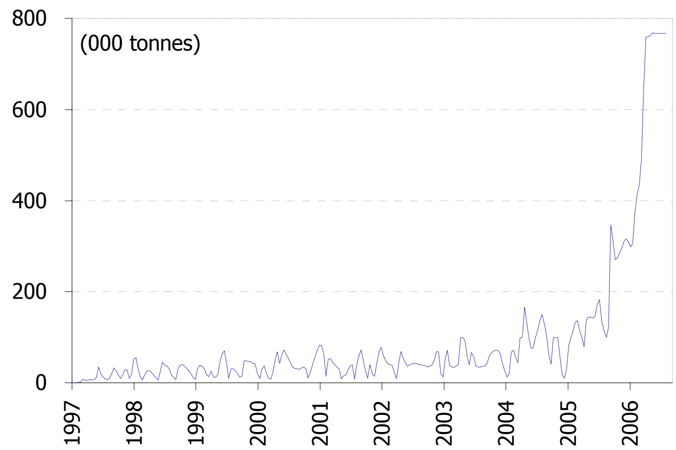
Chinese Alumina Supply: Annualized Production



Source: Bloomberg, ENAM Research, China National Statistics

As a result of higher production of alumina, China is now importing bauxite on a large scale.

China's bauxite imports are climbing rapidly.



Source: China Customs Statistics

China: Operating cost alumina

($/ton)	Imported bauxite Cost per ton of alumina	Domestic bauxite Cost per ton of alumina
Bauxite	180	100
Chemical	30	90
Fuel	50	50
Overhead	25	25
TOTAL	**285**	**265**

Source: Company, ENAM Research