Coal India Ltd

Better way to play India's booming energy demand

CMP	TARGET	RATING	RISK
Rs 343	Rs 400	BUY	HIGH

BSE	NSE	BLOOMBERG
533278	COALINDIA	COAL IN

We consider Coal India (CIL) to be the best play on the rising coal deficit in the country. Over the next three years, we expect CIL to register an 18% CAGR in EPS driven by a substantial expansion in EBIT margins from 19% in FY10 to 29% in FY13. Margin expansion will likely be led by improved realisations (5%), labour efficiency (3%), a focus on beneficiated coal (1%) and technology upgrades (1%). We value CIL at 10x FY13E EV/EBITDA, given its unique position in the country (with ~82% market share), led by a defensive business model and a strong balance sheet. Further, given its utility-type earnings profile and lower correlation with international coal prices, we believe it deserves a higher valuation multiple than a commodity stock. We initiate coverage on the company with a BUY rating and a price target of Rs 400.

Key upside risks to our estimates include cash deployment, better pricing parity with imports, and a faster-than-expected turnaround in subsidiaries (ECL and BCCL). Key downside risks are delays in land acquisition, inability to meet minimum contracted quantity (MCQ), inability to pass on higher employee costs, and transport infrastructure bottlenecks.

Net long coal a safer bet than utilities: We believe electricity units sold would likely increase in line with overall growth in the economy, but power tariffs (and ROEs) should normalise by FY15-FY16. In our view, the coal demand–supply gap for the Indian power sector could widen from 69mmt in FY11 to 137mmt by FY13, and deficit, as a percentage of demand, from 14% in FY11 to 21% in FY13.

Strong operational performance ahead: We expect CIL to deliver a robust operational performance over FY11–FY13, with sales likely to grow at a 12% CAGR (10.9% during FY06–FY10) and EBITDA margins expected to increase sharply from 22% in FY10 to 32% in FY13. Margin expansion will be supported by improved labour efficiency, subsidiary turnaround, focus on beneficiated coal and upgrades to execution technology.

Robust balance sheet but risk of volatility in earnings persists: We expect the company to report a net profit CAGR of 18% over FY11-FY13, with ROE settling in the range of 30–40% (on account of non-utilisation of cash). CIL has cash of Rs 391bn on its books which could be used for future expansion plans and international acquisitions, thereby further bolstering ROE. In addition, a net worth of Rs 258bn would qualify the company for global project bids.

Initiate with BUY, PT of Rs 400/sh: We value CIL at 10x EV/EBITDA on FY13E given its defensive business model. Global coal companies are trading in the range of 5–10x EV/EBITDA and 9–14x P/E on CY12E. Triggers for a stock re-rating include any increase in raw coal price, international acquisitions, cash deployment and faster subsidiary turnaround.

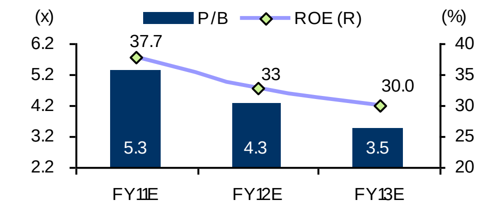
Company data

Market cap (Rs mn / US$ mn)	2,166,513 / 47,948
Outstanding equity shares (mn)	6,316
Free float (%)	10
Dividend yield (%)	-
52-week high/low (Rs)	358 / 245
2-month average daily volume	4,203,789

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Coal India	343	12.4	6.9	n/a
Sensex	18,150	(1.9)	(8.6)	(7.4)

P/B vs. ROE comparison



Valuation matrix

(x)	FY10	FY11E	FY12E	FY13E
P/E @ CMP	22.0	19.1	16.8	14.1
P/E @ Target	24.4	21.2	18.6	15.6
EV/EBITDA @ CMP	17	12.8	11.1	8.9

RHH vs consensus

Parameter	FY11E		FY12E	
	RCML	Cons	RCML	Cons
Sales (Rs mn)	497,855	511,634	559,228	586,728
EPS (Rs)	17.9	17.2	20.5	21.4

Financial highlights

(Rs mn)	FY10	FY11E	FY12E	FY13E
Revenue	473,515	497,855	559,258	624,711
Growth (%)	*15.6*	*5.1*	*12.3*	*11.7*
Adj net income	98,293	113,249	129,180	158,593
Growth (%)	*141.9*	*15.2*	*14.1*	*22.8*
FDEPS (Rs)	15.6	17.9	20.5	25.1
Growth (%)	*141.9*	*15.2*	*14.1*	*22.8*

Profitability and return ratios

(%)	FY10	FY11E	FY12E	FY13E
EBITDA margin	22	28.3	28.8	32.1
EBIT margin	19	25.3	25.8	29.1
Adj PAT margin	21	22.7	23.1	25.4
ROE	44	37.7	33.0	31.3
P/BV	7	5.3	4.3	3.4
ROCE	39	34.3	30.7	29.5

Suhas Harinarayanan *(91-22) 6766 3404* *suhas.hari@religare.in*

Sumit Maniyar *(91-22) 6766 3461* *sumit.maniyar@religare.in*

Amit Agarwal *(91-22) 6766 3449* *amit.ag@religare.in*

Investment rationale

Defensive play on India's surging energy demand

With massive generation capacity additions scheduled over the next five years, we expect India's coal shortfall to more than triple by FY15. We remain conservative on utilities and prefer a net long coal story to tap into India's rising energy demand.

91GW of capacity addition by 2015

Over 2011–15, we estimate that ~91GW of power generation capacity will be added in India, at a CAGR of 12%, led by additions from independent power producers (IIP), and supported by central and state level projects. Consequently, we estimate that India's power sector may need incremental coal supply of ~340 MT (million tonnes) over FY11-FY15. In our view, the coal shortfall for the power sector could increase from 69MT in FY11 to 160MT in FY15.

Net long coal a safer bet than utilities

We believe units sold would likely increase in line with overall growth in the economy, but power tariffs (and returns) should normalise by FY15-16. However, our long-term view on utilities is more conservative than consensus given concerns over the pattern of demand, fuel uncertainty, the mix of upcoming supply, and infeasibility of open access in distribution. Thus, we believe a net long coal story would be a more defensive way to play the boom in India's utility sector.

World's largest coal producer, catering to 42% of India's energy requirements

CIL, a state-owned company, was established in 1973 and is the largest coal producer in the world (based on raw coal output), with a dominant 82% market share. CIL also holds the world's largest coal reserves with proven resources of 52.5 billion tonnes and meets as much as 42% of India's primary commercial energy requirements.

Higher dispatches and coal prices to boost sales

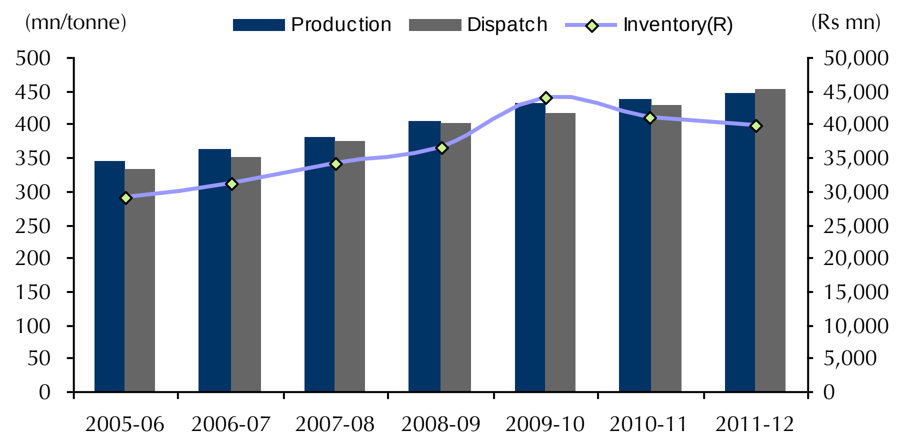
We expect 12% revenue CAGR over FY11-FY13 driven by the management's focus on dispatch growth and given the recent hikes in coal prices.

Sales likely to grow at a CAGR of 12% over FY11-FY13

Focus on increasing dispatches

CIL aims to increase its dispatch-to-production ratio to 101% in FY12 from 96% in FY10. It is also working to clear inventory before focusing on production growth. However, once the level of coal inventory winds down we expect the ratio to settle at 98%. The lack of adequate transportation facilities (road and rail) is proving a hurdle to dispatch growth. We assume a 4.4% CAGR in dispatches over FY10-FY12.

Fig 1 - Production-dispatch ratio and inventory



Source: CIL DRHP

We expect raw coal prices to increase further during FY11-FY13

Higher coal prices

CIL has increased the prices of different grades of coking and non-coking coal with effect from 28 February 2011. Grade A and B coal prices stand increased by 100% with a 30% hike for C to F grades (used by the power sector). Power utilities, IPPs, and the fertiliser and defence sectors are being exempted from an outright, across-the-board increase, while a 30% hike will become effective for all other sectors whose products enjoy market-driven prices. Furthermore, coal procured under e-auction would see a price hike of 30% (in floor pricing).

For the power sector, this price increase would not affect existing fuel supply agreements (FSA) except those tied up with CIL's subsidiary, Mahanadi Coalfields (MCL). The notified prices of coal produced by the subsidiary would be hiked by 15–17%. Based on the above, we expect additional revenue of Rs 6.4bn and Rs 62bn for CIL in FY11 and FY12 respectively.

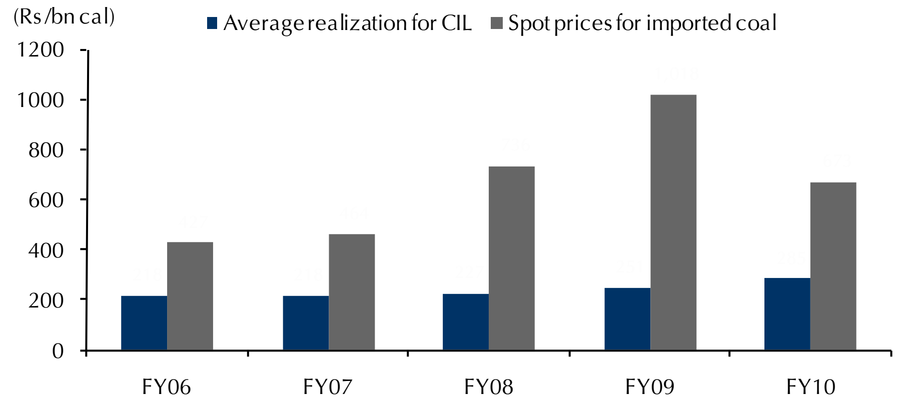
Fig 2 - Coal pricing trend

Date	Rise in coal price (%)
January 2001	8.5
June 2004	16.2
December 2007	10.0
October 2009	11.0
28 February 2011	30*

Source: CIL DRHP **Differential pricing mechanism*

While CIL's average realisations have remained historically lower than international coal prices, we note that the company is less susceptible to fluctuations in coal prices in international markets.

Fig 3 - CIL coal prices have remained less volatile historically



Source: RCML Research, Bloomberg

Strong margin outlook

Margins likely to improve sharply over the next three years

CIL has delivered operating margins in the range of 6.4–23.9% during FY06-FY10. We expect an expansion in EBIT margins to 28–30% levels over FY11-FY13 on the back of lower employee costs (led by manpower reduction and higher labour productivity), a focus on coal beneficiation, and efficiencies arising out of technological upgrades.

Reduction in employee cost

At the end of FY10, CIL's employee base stood at ~397,000, a 7% decline from FY08. Its subsidiaries, Eastern Coal Field (ECL) and Bharat Coking Coal (BCCL), which accounted for 22.3% and 18.8% of total employees in FY08 now form a lower share of 21.5% and 18.5% respectively. Similarly, employee cost for these two subsidiaries combined has declined from 39.4% of sales in FY08 to 36.3% in FY10. We believe CIL is working to improve labour efficiency by both, downsizing its workforce and introducing technological upgrades. Led by these initiatives, output per man-shift has risen to 4.48t in FY10 as against 3.79t in FY08 and we see room for further improvement.

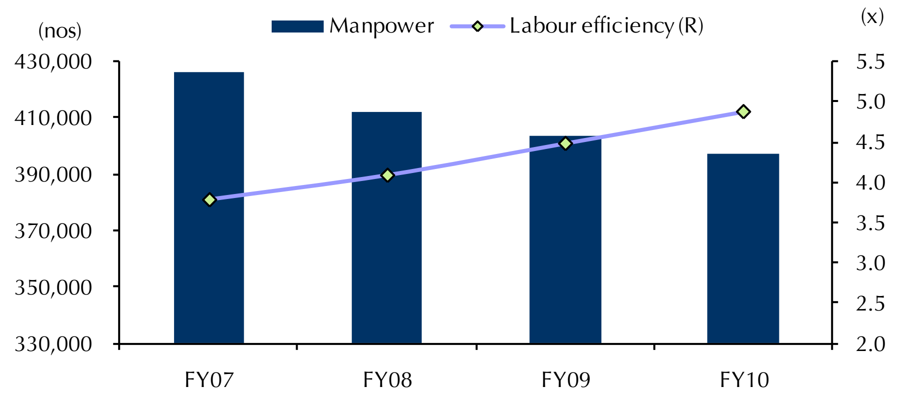
Shedding of excess manpower has helped lower employee costs

Fig 4 - Decline in CIL's employee base

Year	CIL	ECL share	BCCL share
FY07	439,343	22.5%	19.0%
FY08	426,077	22.3%	18.8%
FY09	412,350	21.9%	18.5%
FY10	397,138	21.5%	18.5%

Source: CIL, Annual Report

Fig 5 - Improving labour efficiency



Source: RCML Research

Focus on coal beneficiation

Beneficiation improves the quality and hence sale value of coal

CIL currently has 17 coal beneficiation facilities with a total capacity of 39.4mt. The management expects to add 20 new facilities in the 12th five year plan, raising its capacity to 111mt at a total expenditure of Rs 23bn. Further, the company intends to equip all new open-cast mining projects that have coal production capacities greater than 2.5mtpa (not linked to pithead customers) with dedicated coal beneficiation facilities. Beneficiation increases the quality and gross calorific value (GCV) of coal so that it is comparable with imports, thereby enabling margin improvement.

Fig 6 - Beneficiated coal

(mt)	FY07	FY08	FY09	FY10
Beneficiated Non-coking Coal	10.31	10.46	11.28	11.62
Beneficiated Coking Coal	3.81	3.83	3.68	2.97

Source: CIL

Turnaround in key subsidiaries

After turning around at the PAT level in FY10, we expect two of CIL's key coal production subsidiaries, ECL and BCCL, to turn net worth positive in FY15.

Operating metrics of ECL, BCCL improving

ECL and BCCL together accounted for 13.5% of CIL's total production in FY10

CIL has 11 direct and indirect subsidiaries of which 9 are associated with coal production. ECL and BCCL, two key direct subsidiaries of the company, were making losses and had been referred to the BIFR (Board for Industrial & Financial Reconstruction). The BIFR has approved their revival plans and we note that both companies have turned around at the net profit level in FY10. We expect a stronger operating performance from these subsidiaries considering that employee costs have been reined in and labour productivity ramped up. ECL and BCCL together accounted for 13.5% of CIL's total production in FY10.

Net worth positive in FY15

Both companies reported a significant increase in employee cost in FY09, largely on account of higher provisions made towards an expected retrospective increase in employee remuneration and benefits. These subsidiaries are now focused on improving cost efficiency. The ECL management expects to turn net worth positive in FY15 (we expect the same from BCCL as well), which will strengthen CIL's financial potential.

Fig 7 - Financial performance of ECL and BCCL

(Rs mn)	Accumulated losses		Net worth		PAT		Employees cost as % of sales	
Subsidiary	March '10	March '09	March '10	March '09	March '10	March '09	March '10	March '09
ECL	(82,340)	(86,332)	(60,156)	(64,147)	3,334	(21,029)	65%	112%
BCCL	(75,209)	(83,561)	(54,029)	(62,381)	7,942	(13,805)	74%	43%

Source: Annual Report

Eyeing overseas acquisitions

Considering the coal supply shortage in India, CIL is exploring the acquisition of overseas coal assets. The company has taken several key initiatives in this regards which we believe would open up access to additional coal resources and enhance its value.

Potential acquisition of overseas coal assets to drive long-term growth

Key initiatives

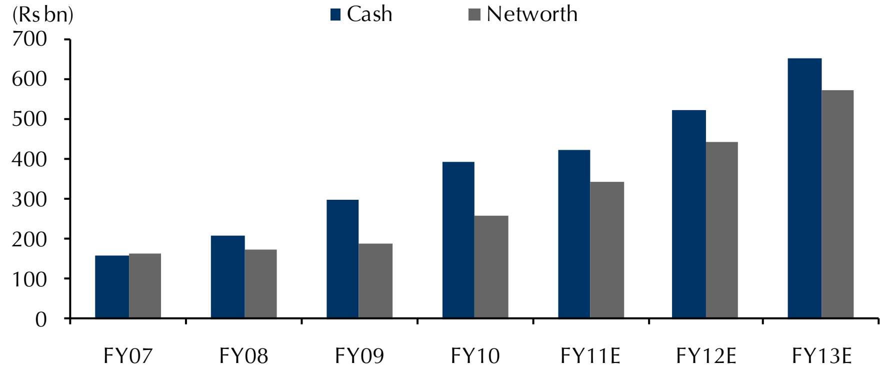
- Acquired prospecting licences for two coal blocks in Mozambique in 2009 with plans to enter into strategic JVs for development of the same over a period of five years (CIAL set up to carry on mining activities)
- Begun scouting for strategic partnerships for the acquisition of coal assets in Australia, the US, and Indonesia with a sum of Rs 60bn earmarked for the same
- Formed a JV called International Coal Venture (ICVL, 28.7% stake) with SAIL, NTPC, NMDC and Rashtriya Ispat Nigam (RINL) for acquiring coal assets outside India.

Strong balance sheet

Capex of Rs 38bn–46bn over the next two years can be comfortably funded

CIL has a net worth of Rs 258bn and a net cash balance of Rs 391bn which will more than suffice to finance its growth plans. In the past, the company has incurred capex of less than Rs 20bn per annum. For FY11 and FY12, however, it has outlined expenditure of Rs 38bn and Rs 46bn respectively. Considering the cash-rich balance sheet and the fact that CIL generates strong operating cash flows, we believe the company would comfortably finance its capex and overseas acquisition plans without recourse to external funding.

Fig 8 - Cash and Net worth



Source: CIL DRHP, RCML Research

Financial performance

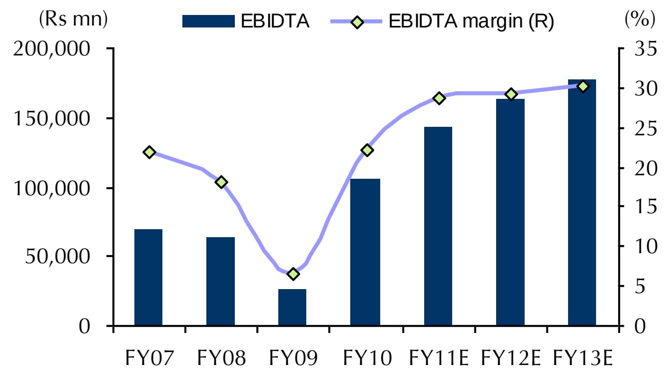
Wage provisions in FY09 dented an otherwise consistent margin uptick

Steady increase in EBITDA margins

Going forward, we expect EBITDA margins to improve from 22% in FY10 to 32% in FY13 driven by (1) price hikes; (2) labour efficiency from both, downsizing the workforce and introducing technological upgrades; and (3) increased sales from beneficiation of coal. However, we expect employee costs to increase by 10% in FY12 due to wage revision.

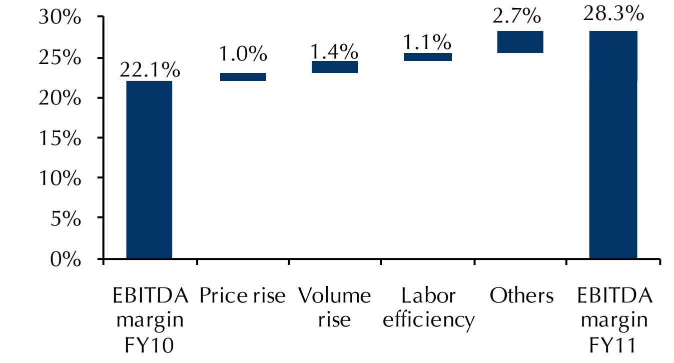
With the exception of FY09, CIL's EBITDA margins have inched up steadily from 21.8% in FY07 to 22.1% in FY10. In FY09, though, a significant increase in employee costs due to implementation of the National Coal Wage Agreement (NCWA-VIII) led to a steep drop in margin to 6.4%.

Fig 9 - EBITDA margin trend



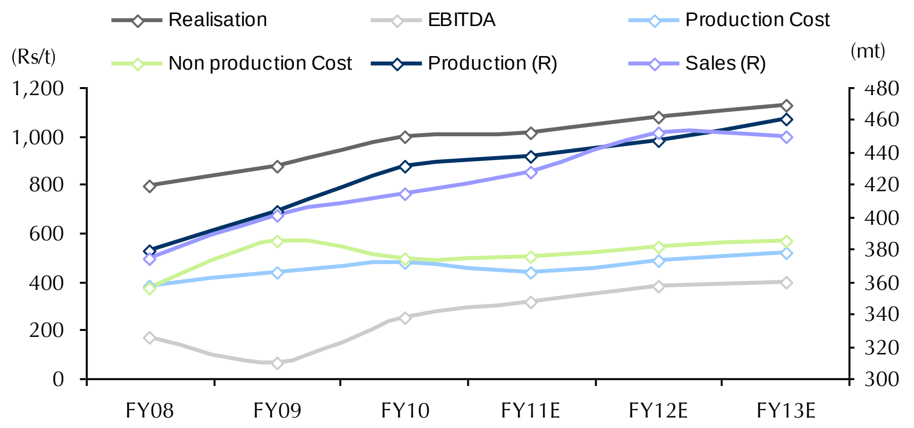
Source: CIL DRHP, RCML Research

Fig 10 - Margin expansion in FY11E to be led by multiple factors



Source: CIL DRHP, RCML Research

Fig 11 - Realisation and Cost variables



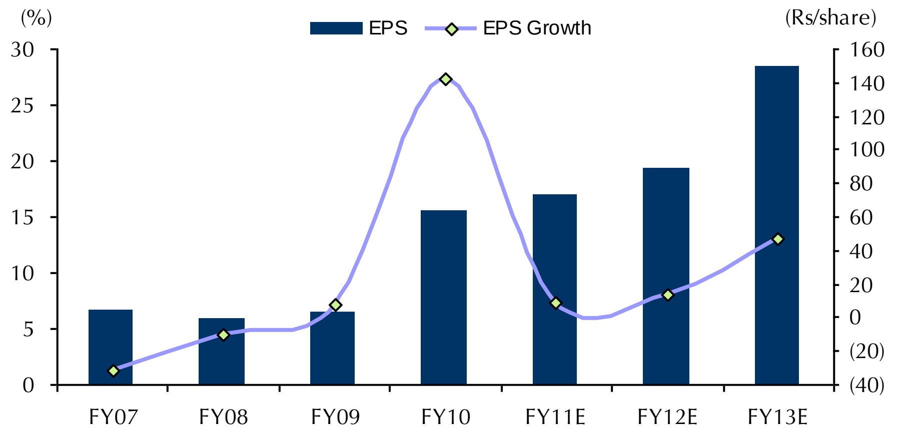
Source: RCML Research

EPS growth to remain strong

We expect EPS to grow at a CAGR of 18% during FY11-FY13 on the back of volume and pricing growth, partly offset by wage increases. The benefits of CIL's recent coal price hike would be partly eroded by the revision in wages—NCWA-IX, due from 1 July 2011.

Restating of accounts mitigated impact of wage provisions on EPS

Fig 12 - EPS growth trend



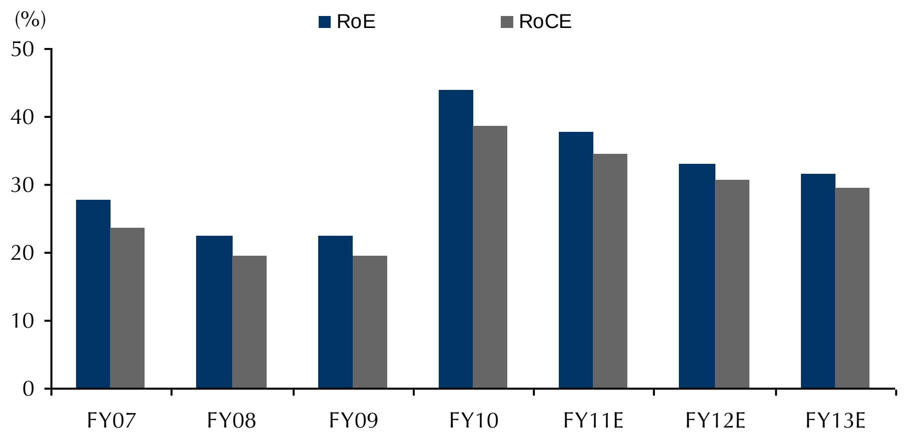
Source: CIL DRHP, RCML Research

ROE and ROCE likely to remain robust

We expect ROE and ROCE to remain strong over FY11-FY13, in the range of 30–36% and 30–33% respectively, albeit lower than FY10 mainly on account of excess cash lying in the balance sheet. Utilisation of cash for capex or for international acquisitions will further bolster return ratios.

Effective cash deployment could further boost return ratios

Fig 13 - ROE and ROCE



Source: CIL DRHP, RCML Research

Valuation

We value CIL at an EV/EBITDA of 10x on FY13E

Valued at 10x FY13E EV/EBITDA; initiate with BUY

Overseas coal players are trading in the range of 5–10x EV/EBITDA and 9-14x P/E on CY12E. We believe CIL merits an EV/EBITDA multiple of 10x on FY13E, translating to a target price of Rs 400/sh (including cash). In our view, EV/EBITDA is the best valuation methodology for coal companies rather than EV/Reserve or EV/Tonne, as an accurate comparison using the latter proves difficult on account of (a) differing grades of produced coal which warrants a different price point for each grade, and (b) divergence in the timelines for exploiting coal reserves due to disparate technologies and mine categories (open-cast or underground).

Fig 14 - Global valuation summary

Company	CMP LC	MCap	P/E (x)			EV/EBITDA (x)		
		($ mn)	CY10E	CY11E	CY12E	CY10E	CY11E	CY12E
Yanzhou Coal Mining Co-H	24	13,348	17.1	14.4	13.4	9.5	8.0	7.4
China Coal Energy Co-H	11	20,681	14.4	12.0	9.9	6.5	5.4	4.4
China Shenhua Energy Co - H	34	73,444	14.6	12.6	11.2	6.9	6.1	5.3
Peabody Energy Corp	65	13,647	22.3	13.3	10.7	10.4	7.7	6.3
Macarthur Coal Ltd	11	3,831	17.0	11.1	9.6	9.8	6.6	5.6
Whitehaven Coal Ltd	7	3,171	38.1	15.4	10.9	19.7	9.3	6.8
Adaro Energy Tbk Pt	2,375	7,349	28.7	14.3	10.7	10.1	6.5	5.0
Tambang Batubara Bukit Asam	20,600	5,229	22.1	13.1	11.1	15.9	8.9	7.4
Bumi Resources Tbk Pt	3,025	5,180	25.8	13.8	10.3	8.2	7.1	5.2
Indo Tambangraya Megah Pt	47,250	5,470	19.8	11.8	9.6	10.1	9.9	6.8
United Tractors Tbk Pt	22,150	7,830	18.5	15.0	12.6	10.1	8.2	7.1
Coal India	2,166,513	47,948	19.1	16.8	13.7	12.8	11.1	8.9

Source: Bloomberg

Fig 15 - Share price sensitivity to coal price & volumes at 10x EV/EBITDA (Rs 400/sh)

Price (%)	Volume sensitivity (%)				
	-20	-10	0	10	20
-20	-31	-19	-6	6	19
-10	-31	-17	-3	11	25
0	-32	-16	0	15	31
10	-32	-15	2	20	37
20	-32	-13	5	24	43

Source: RCML Research

Key risks

CIL has been able to acquire only a tenth of the land required to meet its targets over 2007–12

Land acquisition – a bottleneck for mining operations

CIL is required to acquire the land and associated surface rights overlying coal reserves prior to commencing mining activities. In the past, the company has faced challenges to acquiring land in a timely manner, particularly with respect to property owned by private parties and forest land, resulting in delays in mining operations. Of the total land requirement of 62,000ha in the 11th plan period (2007–12), its subsidiaries have been able to acquire only~6,000ha (9.7%) during the first three years of the plan period. Key bottlenecks in this regard are:

- Prolonged procedural delays in obtaining forestry and environment clearances
- Tenanted land and related resettlement and rehabilitation (R&R) issues
    - Unavailability of proper records with the state government for identification of land ownership
    - R&R issues for tenanted land acquisition—high rates are offered by private parties (without provision for employment), complicating the problem further
- Lack of support from the local government and administration.

We have observed severe land-related hurdles in subsidiaries where growth potential is the highest (SECL, MCL and CCL) and hence, delays in this context may hamper productivity.

Fig 16 - Subsidiaries facing land acquisition delays

Coal Mines	Capacity(mn)	Scheduled date of completion	Anticipated date of completion	Time overrun (Years)
ECL				
Kottadih, open cast mine, Pandeshwar area	1	Mar'10	Mar'11	1
CCL				
Bokaro Bermo Seam, open cast mine, B& K area	0.8	Mar'00	Mar'14	14
Karo, open cast mine, B&K area	3.5	Mar'10	Mar'12	2
NCL				
Krishnasila, open cast mine, Krishnasila area	4	Mar'10	Mar'13	3
WCL				
Gondegaon Extn., open cast mine, Nagpur area	0.75	Mar'10	Mar'12	2
Gouri Deep, open cast mine, Ballarpur area	0.4	Mar'10	Mar'12	2
Bhatadih Expn, open cast mine, Chandrapur	0.65	Mar'10	Mar'12	2
SECL				
Mahan (RPR), open cast mine, Bhatgaon area	0.36	Mar'09	Mar'12	3
Amera, open cast mine, Bisrampur area	1	Mar'08	Mar'11	3
Rani Atari, underground mine, Chirimiri area	0.48	Mar'08	Mar'11	4
MCL				
Bharatpur Phase, open cast mine, Bharatpur area	9	Mar'10	Mar'11	1*
Balaram Extension, open cast mine, Hingula	8	Mar'10	Mar'11	1
HBI(Aug), underground mine, Orient area	0.9	Mar'10	Mar'11	1#
Nataraj, underground mine, Talcher area	0.64	Mar'08	Mar'17	9

Source: CIL RHP **Delay in obtaining forest clearance and due to rehabilitation #Delay in obtaining environment clearances*

Average 7-year wait for forest clearances

Delays in grant of forest and environment clearances

When forest land is involved, the mining lease can be executed only after forest clearances have been obtained from the ministry of environment & forests (MoEF). In addition, any project involving an area greater than 5ha may commence operations only after the receipt of environmental clearances from the MoEF. The average time required for final clearance of forest land is ~7 years which delays mining operations. Apart from forest clearance, the SPCB (State Pollution Control Board) must also issue 'consent to establish' and 'consent to operate' certificates for environment clearance, which too is a protracted process. Each expansion project requires a separate environment clearance for the expanded capacity, further delaying the process.

126 coal blocks currently fall in the 'no go' area

Delays in resolution of go/no-go issue

The MoEF has divided mining areas into 'go' and 'no-go' areas. 'Go' areas would be those where, prima facie, the statutory Forest Advisory Committee in the environment ministry would consider proposals for diversion of forest land for coal mining purposes. 'No-go' areas would be those with rich forest cover and bio-diversity where applications would not be entertained for forest land diversion. This demarcation could lead to further delays and may hamper CIL's production. As per CIL, the coal ministry and the MoEF are currently working to resolve this issue.

According to the MoEF, of the nine coalfields where 203 blocks, or 48% of the reserves, were declared no-go by the environment ministry, the boundaries of mines in eight of these coalfields have been tweaked to bring 77 blocks out of the barred list, leaving 126 blocks in the no-go area. The eight coalfields comprise Talcher (Orissa), the IB-Valley (Orissa), Mand-Raigarh (Chhattisgarh), Sohagpur (MP), the Wardha Valley (Maharashtra), Singrauli (Andhra), North Karanpura (Jharkhand), and West Bokaro (Jharkhand).

Fig 17 - Major coalfields in India

Source: RCML Research

Infrastructure bottlenecks

Coal is mostly produced in the central and eastern parts of India, while its consumption is distributed across the country, implying the need for transportation over long distances. In India, coal is typically transported using rail, road and sea routes, of which rail accounts for a 46.3% share. Domestic rail transport comprises a single-rake system that contains 58 wagons, each with a carrying capacity of 58t of coal and hence a total capacity of 3,364t. In comparison, in the US, one rake has 125 wagons with a per wagon capacity of 100t (total capacity of 12,500t), while Australia has an average capacity of 9,600t.

Low rake capacity a hurdle to clearing of inventory

Non-availability of a sufficient number of wagons at the rail sidings as well as constraints of road transportation to sidings over long distances are leading to a pile up of coal inventory with CIL's subsidiaries (CCL, BCCL and MCL) and raising the turnaround time for dispatch. We therefore believe that CIL may lower the growth target for production and focus on clearing existing inventory.

Fig 18 - Rise in inventory

Subsidiary (mt)	March'07	March'08	March'09	March'10
CCL	11.37	13.93	13.23	16.10
MCL	7.97	12.35	17.4	18.72
BCCL	3.96	5.02	5.92	9.93
Total	**23.3**	**31.3**	**36.55**	**45.18**

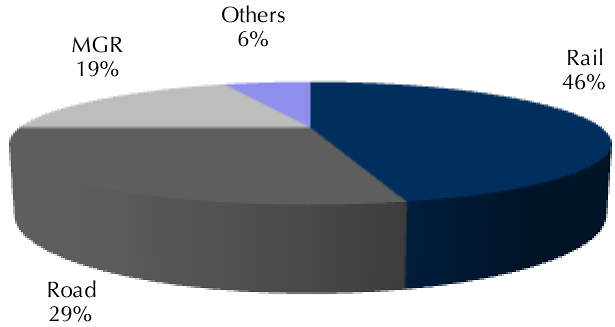
Source: CIL, RCML Research

Fig 19 - Shortfall in rakes

Particulars (nos)	2007-08	2008-09	2009-10
Target	155.7	163.4	164.5
Availability	152.5	155.7	154.5
Shortfall	3.2	7.6	10
Equivalent to Mt	4.41	10.59	12.74

Source: CIL

Fig 20 - Mode-wise share



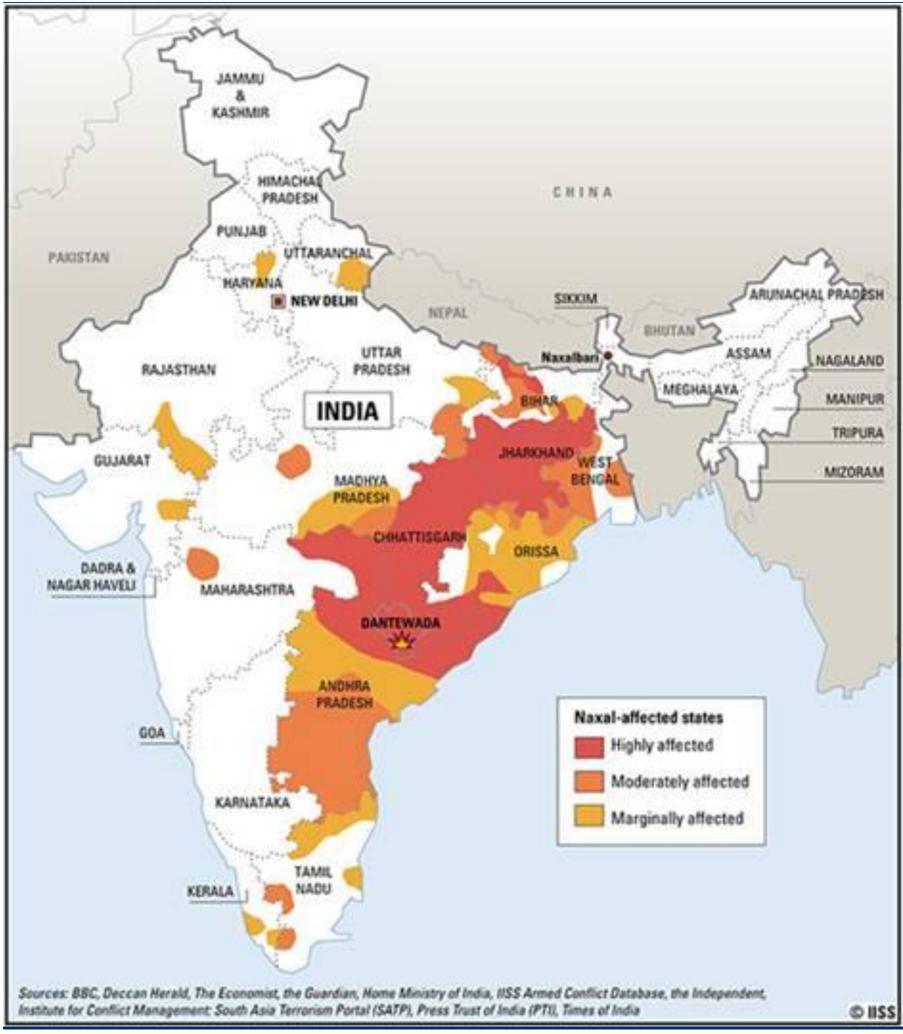
Source: CIL RHP

Operational disruptions due to Naxalite violence

Interruption of operations due to Naxal violence further raises operating costs

In the past, CIL's operations in certain parts of the country were disrupted by Naxalite violence as the authorities restricted services on state-owned railway lines due to security concerns. Future disruptions of this kind could affect the availability of adequate transportation capacities for coal offtake, raising inventory levels. Also, operating costs could rise due to the inability to complete night-loading schedules in case of suspension of night trains or other means of transport, as well as the recruitment of added security personnel in affected areas.

Fig 21 - Naxal-affected areas in India



Source: RCML Research

Risk to profits from new mining policy

Unfavourable profit sharing proposal in new mining policy draft could lower FY12/FY13 EPS by9-10%

The draft Mines and Minerals (Development and Regulation) Bill, 2010 proposes that mining companies share 26% of their profits with local inhabitants and persons displaced by mining activity. If this provision is enacted into law, it is likely to impact our FY12/FY13 EPS estimates by 9-10%. CIL currently spends about 17% of its profit in social welfare activities.

Financial and accounting risks

Gratuity liability may dent cash position

Based on the actuary's valuation, as on March '10, the closing liability with respect to employee remuneration and benefits (gratuity + settlement allowances + LTC+ personal accident and others) totals Rs 108bn, of which the gratuity amount lying in the balance sheet is Rs 59bn (net of funds with LIC). Once this liability becomes due for payment, the cash in the balance sheet will be run down to that extent.

Wage hike a significant risk to estimates

Wage hike next year a risk unless CIL raises raw coal prices

CIL is due for a wage hike next year. If implemented, our estimates for FY12 and FY13 could be affected in the event the company does not hike raw coal prices. If employee costs are 10% higher than our expectations, EPS could decrease by 14%/12%, in FY12/FY13, respectively.

Dues from power companies and utilities a concern

A majority of the coal produced by CIL is sold to public sector thermal power companies and utilities. Coal sold to government-owned/controlled power generation companies and utilities contributed 67.7% and 65.1% of total sales respectively in FY08-FY10 and 64.1% and 64.3% respectively for the June '10 quarter. There are delays associated with collection of receivables from government-owned or controlled entities, including from customers that are power utilities. To ensure continuous supply of coal, power utilities have started providing bonds to CIL which are accounted for as cash in our opinion. As per the RHP, ~35% of CIL's debts are considered doubtful.

Contingent liability

The company has ~Rs 111bn of contingent liability as on June '10 which is not being provided for. Any contingency, if transferred to actual liability, will impact our estimates and the company's bottom-line in future years.

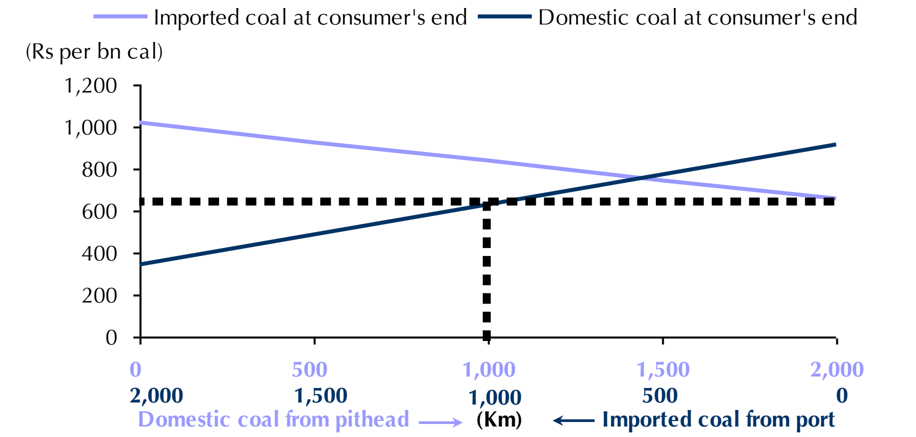
Appendix

Case study: Importance of domestic coal supply over imported coal

India's domestic coal supply to the power sector comprises predominantly of grades E and F with an average calorific value of 3,500kg/kcal, as against 5,500kg/kcal for imported coal. We have compared domestic and imported coal in terms of cost per billion calories of delivered heat value at the consumer end.

Indian coal cheaper than imported coal when delivered to a distance of <1,000km

Fig 22 - Delivered cost of domestic and imported thermal coal



Source: RCML Research

We find that the delivered cost of power-grade domestic coal is less than the cost of imported coal at port when delivered to consumers within 1,000km. Moreover, Indian coal remains a cheaper option when imported coal has to cover more than 500km and domestic coal has to cover less than 1,400km.

Our case study compares domestic coal supply to imported coal; if we were to compare captive coal (which is cheaper than imports), the distance to which domestic coal can be delivered economically could be even higher.

Case study assumptions

- Domestic coal from mine to consumer and imported coal from port to consumer are being transported by rail
- Landed CIF price of US$ 80/mmt for imported coal with a gross calorific value of 5,500kcal/kg
- Exchange rate of Rs 45/US$
- Domestic coal price includes weighted average notified price of coal for the respective grades, royalty, stowing, excise duty, transportation charges from mine to railway siding, central sales tax and rail freight.

Landed price of imported coal at port includes all applicable taxes and duties. However, the cost of handling imported coal at the Indian port and transporting it to the railway siding for inland transportation is not included. If included, the distance to which imported coal can be economically transported inland will reduce further.

Consolidated financials

Profit and Loss statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Revenues	**473,515**	**497,855**	**559,258**	**624,711**
Growth (%)	*15.6*	*5.1*	*12.3*	*11.7*
EBITDA	**104,724**	**140,891**	**161,309**	**200,776**
Growth (%)	*297.1*	*34.5*	*14.5*	*24.5*
Depreciation & amortisation	13,295	15,030	16,790	18,726
EBIT	9,460	91,429	125,861	144,518
Growth (%)	-	*866.5*	*37.7*	*14.8*
Interest	1,560	1,120	1,120	1,120
Other income	50,315	44,287	49,407	55,776
EBT	139,648	169,028	192,805	236,706
Income taxes	43,425	55,779	63,626	78,113
Effective tax rate (%)	*31.1*	*33.0*	*33.0*	*33.0*
Extraordinary items	-	-	-	-
Min into / inc from associates	-	-	-	-
Reported net income	96,223	113,249	129,180	158,593
Adjustments	2,070	-	-	-
Adjusted net income	**98,293**	**113,249**	**129,180**	**158,593**
Growth (%)	*141.9*	*15.2*	*14.1*	*22.8*
Shares outstanding (mn)	6,316.4	6,316.4	6,316.4	6,316.4
FDEPS (Rs) (adj)	**15.6**	**17.9**	**20.5**	**25.1**
Growth (%)	*141.9*	*15.2*	*14.1*	*22.8*
DPS (Rs)	-	4	4	4

Cash flow statement

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Net income + Depreciation	100,612	129,399	147,090	178,439
Non-cash adjustments	(11,869)	22,064	(21,714)	(15,073)
Changes in working capital	22,183	(73,087)	24,153	3,195
Cash flow from operations	110,926	78,376	149,530	166,561
Capital expenditure	(17,573)	(36,802)	(46,000)	(38,059)
Change in investments	-	-	-	-
Other investing cash flow	-	-	-	-
Cash flow from investing	(17,573)	(36,802)	(46,000)	(38,059)
Issue of equity	(616)	(4,869)	-	-
Issue/repay debt	1,091	(1,120)	(1,120)	(1,120)
Dividends paid	-	2	-	-
Other financing cash flow	-	(4,465)	-	-
Change in cash & cash eq	93,828	31,122	102,410	127,382
Closing cash & cash eq	390,778	421,900	524,310	651,692

Balance sheet

Y/E March (Rs mn)	FY10	FY11E	FY12E	FY13E
Cash and cash eq	390,778	421,900	524,310	651,692
Accounts receivable	21,686	23,188	26,048	29,096
Inventories	44,018	40,920	39,838	34,231
Other current assets	86,762	116,169	113,916	149,669
Investments	12,821	10,821	9,821	8,821
Gross fixed assets	349,453	370,362	408,362	454,362
Net fixed assets	120,313	130,420	151,630	178,903
CWIP	22,107	38,000	46,000	38,059
Intangible assets	-	-	-	-
Deferred tax assets, net	9,658		-	-
Other assets	-	-	-	-
Total assets	**708,143**	**781,418**	**911,562**	**1,090,471**
Accounts payable	7,725	8,000	8,000	8,000
Other current liabilities	323,704	316,100	351,220	371,629
Provisions	82,396	85,340	93,186	107,674
Debt funds	20,869	16,000	16,000	16,000
Other liabilities	14,997	13,835	15,416	16,374
Equity capital	63,164	63,164	63,164	63,164
Reserves & surplus	195,289	278,980	378,599	507,631
Shareholder's funds	258,453	342,143	441,762	570,795
Total liabilities	**708,143**	**781,418**	**925,585**	**1,090,471**
BVPS (Rs)	51	64.2	79.9	100.4

Financial ratios

Y/E March	FY10	FY11E	FY12E	FY13E
Profitability & Return ratios (%)				
EBITDA margin	22	28.3	28.8	32.1
EBIT margin	19	25.3	25.8	29.1
Net profit margin	21	22.7	23.1	25.4
ROE	44	37.7	33.0	31.3
ROCE	39	34.3	30.7	29.5
Working Capital & Liquidity ratios				
Receivables (days)	15	16	16	16
Inventory (days)	170	170	142	123
Payables (days)	35	32	28	27
Current ratio (x)	2	1.9	2.0	2.3
Quick ratio (x)	1	0.1	0.1	0.1
Turnover & Leverage ratios (x)				
Gross asset turnover	1	1.4	1.4	1.4
Total asset turnover	1	0.7	0.7	0.6
Interest coverage ratio	59	112.4	129.0	162.5
Adjusted debt/equity	0	0.1	0.0	0.0
Valuation ratios (x)				
EV/Sales	4	3.6	3.2	2.9
EV/EBITDA	17	12.8	11.1	8.9
P/E	22	19.1	16.8	13.7
P/BV	7	5.3	4.3	3.4

DuPont analysis

(%)	FY09	FY10	FY11E	FY12E	FY13E
Tax burden (Net income/PBT)	70.8	70.4	67.0	67.0	67.0
Interest burden (PBT/EBIT)	606.6	152.7	137.8	137.3	133.9
EBIT margin (EBIT/Revenues)	2.3	19.3	25.3	25.8	29.1
Asset turnover (Revenues/Avg TA)	72.5	71.1	66.7	65.6	61.7
Leverage (Avg TA/Avg equtiy)	311.9	296.8	247.5	215.0	196.4
Return on equity	**22.4**	**43.8**	**38.5**	**33.5**	**31.7**

Company profile

CIL, a state-owned company, was established in 1973 and is the largest coal producer in the world (based on raw coal output), with a dominant 82% market share. CIL also holds the world's largest coal reserves with proven resources of 52.5 billion tonnes and meets as much as 42% of India's primary commercial energy requirements.

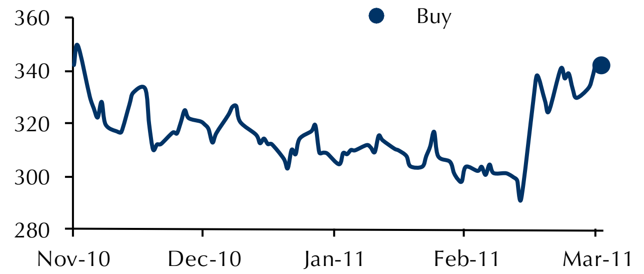
Shareholding pattern

(%)	Oct-10	Dec-10
Promoters	90.0	90.0
FIIs	3.3	5.6
Banks & FIs	1.6	1.6
Public	5.1	2.8

Recommendation history

Date	Event	Reco price	Tgt price	Reco
18-Mar-11	Initiating Coverage	343	400	Buy

Stock performance



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Recommendation Interpretation

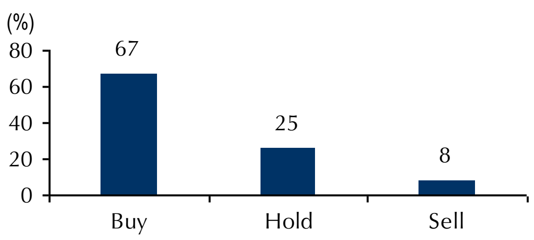
Recommendation	**Expected absolute returns (%) over 12 months**
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

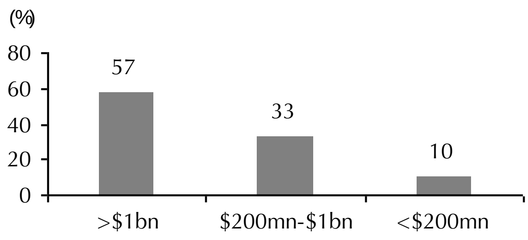
Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst’s discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

Global Coverage Profile

By recommendation



By market cap



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