J.P.Morgan

Asia Pacific Equity Research
10 May 2010

Sterlite Industries

Zinc acquisition positive, in our view; Government approval key to watch for

Overweight

STRL.BO, STLT IN

Price: Rs713.85

▲ **Price Target: Rs920.00**
Previous: Rs840.00

India
Metals

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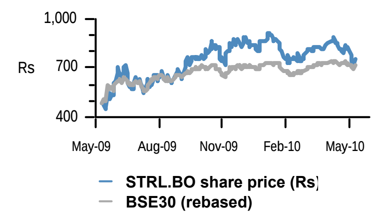
J.P. Morgan India Private Limited

Price Performance



	YTD	1m	3m	12m
Abs	-13.6%	-14.6%	-1.1%	55.6%
Rel	-12.3%	-11.2%	-9.9%	7.3%

- **Board approval from HZL awaited, Government stake at 29%:** Vedanta (VED) clarified in its conference call that the asset acquisition proposal would be put forward to Hindustan Zinc's (HZL, Not Rated) board who then would decide. The Government of India has a 29% stake in HZL and hence its approval would be required for the asset acquisition. VED mentioned in its conference call that in a hypothetical situation, if the HZL approval does not come through, it would consider Sterlite Industries (STLT) as a vehicle. The company expects to close the acquisitions (effectively three assets) over next 12 months. We would view Government approval for the acquisition as positive.
- **Gamsberg-key project among the portfolio:** On current CoP of $1080/MT and Zinc prices of $2100/MT, with 400KT Zn+Pb production, headline implied multiple of 3.3x of the acquired assets appear broadly reasonable. However, the two key mines Lisheen and Skorpion have a mine life <7 years, and the Gamsberg mine (part of Black Mountain), which accounts for two-thirds of the acquired R&R, has been under-developed for years given high manganese in the mines which has precluded development. Exxaro Resources had acquired its 26% stake in Gamsberg for $22MM in CY06. VED did not give any details on the potential capex required for Gamsberg. We do not rule out STLT increasing concentrate production at the acquired mines.
- **Strategically, the deal makes sense:** One of the biggest concerns among investors has been an over-capitalized balance sheet (the other two being a lack of bauxite mine allotment and a corporate holding structure which is perceived to be less beneficial to STLT). While the above assets are not as profitable as the existing zinc business, we continue to believe that acquiring upstream mining assets is good usage of cash from STLT shareholders' viewpoint. We believe that zinc's next leg of growth lies outside India, as finding another 'Rampura Agucha' will be very difficult.
- **Remain OW, although the overhangs of bauxite mine, inter-corporate loan to VAL to remain in the near term:** We remain OW on STLT with a revised March-11 PT of Rs920. While the stock remains cheap at 4.5x and 3.3x FY11/12E EV/EBITDA, we admit that near-term performance is likely to be muted given bauxite mine delays and investor concerns on the loan to VAL. We would be buyers of the stock on declines. We continue to like STLT's best-in-class execution, diversified earnings stream, and multiple earnings growth drivers beyond the commodity price variable.

Sterlite (Bloomberg: STLT IN; Reuters: STRL.BO)

Rs in millions, year-end March	FY09	FY10E	FY11E	FY12E	52-wk range (Rs)	929 - 442.65
Net sales	211,442	234,941	317,386	376,430	Mkt cap. (Rs MM)	635,076
Net profit (pre-exceptional)	36,936	41,428	61,747	78,353	Mkt cap. (US$ MM)	14,157
EPS (pre-exceptional) (Rs)	52.1	48.0	71.6	90.8	Avg. daily volume (MM)	2.3
Net profit growth (%)	-16%	12%	49%	27%	Average daily value (US$ MM)	40.8
ROE (%)	15%	13%	15%	17%	Shares O/S (MM)	840
P/E (x)	14.5	15.7	10.6	8.3	Index (BSE Sensex)	17,331
EV/EBITDA (x)	17.6	6.0	4.5	3.3	Exchange rate	44.9
P/BV (x)	2.1	1.7	1.5	1.3	Date of Price	10-May-09

Source: Company reports, Bloomberg, J.P. Morgan estimates

See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

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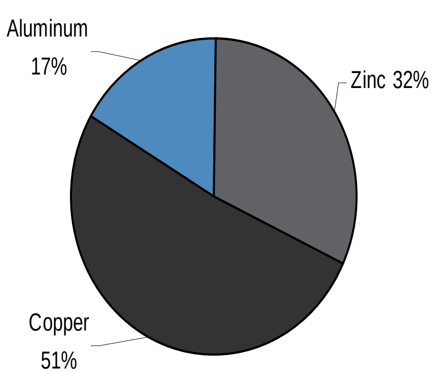
Company description

Sterlite Industries is one of the largest diversified non-ferrous metal companies in India with operations in aluminum copper and zinc. It is a subsidiary of Vedanta Group, a London-based company controlled by Anil Agarwal. The company is also expanding into the commercial power generation sector to leverage on its experience of operating captive power plants. Sterlite has significant size and scale in all the base metals. It is the third-largest aluminum company in India, second-largest in copper and the largest in zinc.

Figure 1: Sterlite—Revenue customer chart



Source: Company reports.

Table 2: EPS estimates—J.P. Morgan vs. consensus

Rs	J.P. Morgan	Consensus
FY11E	71.6	71.7
FY12E	90.8	93.9

Source: Bloomberg, J.P. Morgan.

Table 1: Sterlite—P&L sensitivity metrics

	EBITDA impact (%)	EPS impact (%)
Aluminum realization assumption		
Impact of each 1%	0.4%	0.8%
Zinc realization growth assumption		
Impact of each 1%	0.9%	0.9%
Copper realization assumption		
Impact of each 1%	0.1%	0.1%
Power costs assumption		
Impact of each 5%	1.4%	1.6%

Source: J.P. Morgan estimates.

Price target and valuation analysis

We remain OW on STLT with a revised March-11 PT of Rs920. We value the company now on earnings based methodology of EV/EBITDA from our earlier methodology of sum of the parts. We change our methodology as a) we cannot give an explicit valuation of the power subsidiary and b) we prefer to use a more conservative approach to value earnings only, given the lack of visibility on bauxite mine allocation. Our PT is based on 7x consolidated EV/EBITDA which is the high end of the past five-year trading range of Indian mining companies.

Key risks to our thesis are a) no bauxite mine allocation for VAL, and; b) delays in growth projects and corporate restructuring which is negative for minority share holders.

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Why we like the acquisition

The three biggest concerns we have heard about from investors recently regarding STLT have been:

- **An over-capitalized balance sheet with little visibility on cash usage (the recent inter-corporate loan to Vedanta Aluminum, VAL, did not help)**
- **Lack of progress on the bauxite mine allotment to VAL which impacts STLT negatively**
- **A corporate holding structure which investors perceive to be more beneficial to VED holders than STLT**

In our view the proposed acquisition of zinc assets, partially addresses the first and third issues as the acquistion provides for value enhancing use of cash, and STLT shareholders can directly participate in this (via their 65% ownership of HZL). With another Rampura Agucha becoming increasingly difficult to discover, we believe acquiring zinc assets overseas is good usage of cash.

We believe STLT’s acquisition efforts have been hampered by the lack of quality mining assets globally, particularly in copper, which remains the weakest part of its portfolio. While we do not agree with the company on coal acquisitions and believe that coal (thermal/met coal) is also a good segment to look at (admittedly coal is not a direct part of the entire group, though via its very sizeable power portfolio, it would likely have a meaningful presence in coal, as it develops its own coal mines), **we do agree with the company that the next phase of the company’s growth in mining lies overseas (particularly zinc and copper). STLT's aluminum and power portfolio growth in India remains on track, but for other metals, it has to go overseas. With HZL among the most profitable zinc assets globally with the lowest quartile CoP and significant volume growth ahead, estimated cash generation in STLT's zinc segment is considerable over the next 2-3 years with a $2000-2100/MT zinc price**. We believe the acquisition partially addresses the cash usage problem at the zinc segment (FY10 end cash balance stood at $2.6B), assuming Government approval comes through. **Admittedly the profitability of the acquired assets is not close to the current zinc business,; however, we believe comparing the two assets is not fair. Rampura Agucha, the zinc mine in Western India, is the best-in-class, lowest-quartile CoP, and such assets are difficult to replicate.**

Acquisition price appears broadly reasonable

The proposed acquisition essentially consists of two mature assets with a mine life <7 years (Skorpio in Namibia and Lisheen in Ireland) and a mostly under/undeveloped asset with Black Mountain in South Africa. VED mentioned current CoP of $1080/MT for the above portfolio of assets, implying a consolidated EV/EBITDA of 3.3x on potentially peak profitability and 6.3x on trailing 2009 EBITDA of $213MM. We find deal valuations to be broadly reasonable, given that a deal premium to get asset ownership also needs to be factored in.

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Table 3: Deal Implied valuations

$ MM

	2009
EBITDA	213
EV	1,338
EV/EBITDA	6.3
	Current
Current CoP $/MT	1,080
Current Zinc Price $/MT	2,100
EBITDA/MT $/MT	1,020
Zn+Pb production KT	400
Total EBITDA $mn	408
EV/EBITDA	3.3

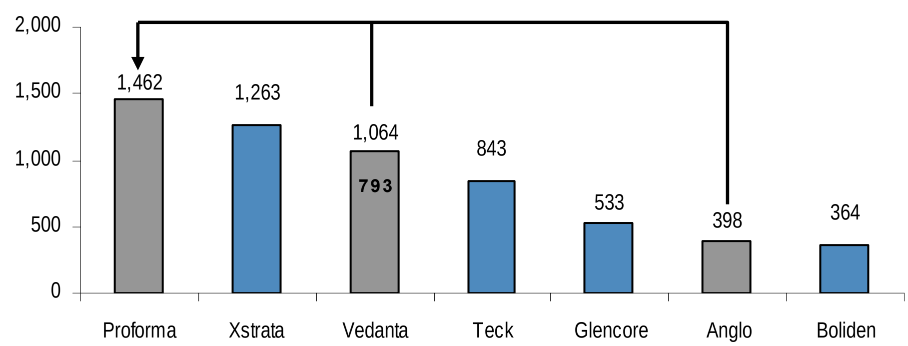
Source: Company reports and J.P. Morgan estimates.

According to the company, "The transaction is subject to customary regulatory approvals as well as competition clearance in the relevant jurisdictions. In addition, Exxaro Resources Limited ("Exxaro"), Anglo American's black economic empowerment partner in Black Mountain Mining, holds a 26% interest in the company and has a pre-emptive right to match Vedanta's offer in respect of this asset. Completion of the transaction is expected to be in stages, with separate completion dates for Skorpion, Lisheen and Black Mountain Mining. Vedanta expects to have completed the acquisition of all three companies within the next 12 months."

Asset overview: Gamsberg development remains key in the long term

Of the asset portfolio, we believe Gamsberg remains the key longer-term asset to watch for. The Namibia and Ireland assets are essentially mature assets and we suspect would likely be used to fund development of the Gamsberg deposit. VED did not disclose the potential investment required in Gamsberg deposit, saying it was early days. However J.P. Morgan Cazenove analyst, Amos Fletcher, has highlighted that over the last few years, the high level of manganese in the deposit has precluded development of the mine. Of the acquisition price, $332MM has been attributed to Anglo's 74% stake in Gamsberg (Exxaro owns the remaining 26%, which it had purchased for $22mn in CY06). We do not rule out STLT increasing concentrate production at the existing mines in order to maximize near term cash flows.

Figure 2: Acquisition to make Vedanta the largest Zinc+Lead Producer (kt)



Source: Company reports. Note: Actual production at Vedanta was 793kt in FY10. Anglo production is adjusted for 26% ownership of Exarro in Black Mountain Mining5

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Table 4: Mine Quality of Anglo's Zinc Assets

Mine	R&R (Mt)	R&R Grade Zn %	Pb %
Lisheen	8.7	11.9%	1.9%
Skorpion	8.3	11.3%	
Black Mountain(1)	51.7	1.5%	2.9%
Gamsberg	137.6	6.9%	0.4%
Total-Anglo's Zinc assets	206.3		

Source: Company reports. Note: Black Mountain is adjusted for 26% ownership of Exarro in Black Mountain Mining5

Table 5: Summary of Anglo's Zinc Assets Acquired by Vedanta

	Location	R&R	OG/UG	CoP $/MT	EBITDA $MM	EBITDA %	EV $MM	Production Zn (kt)	Pb (kt)
Lisheen	Ireland	8.7	UG	1,287	72	24%	308	172	19
Skorpion	Namibia	8.3	Opencast	902	100	42%	698	150	
Black Mountain(1)	South Africa	51.7	UG	1,237	41	31%	332	21	36
Gamsberg	South Africa	137.6							

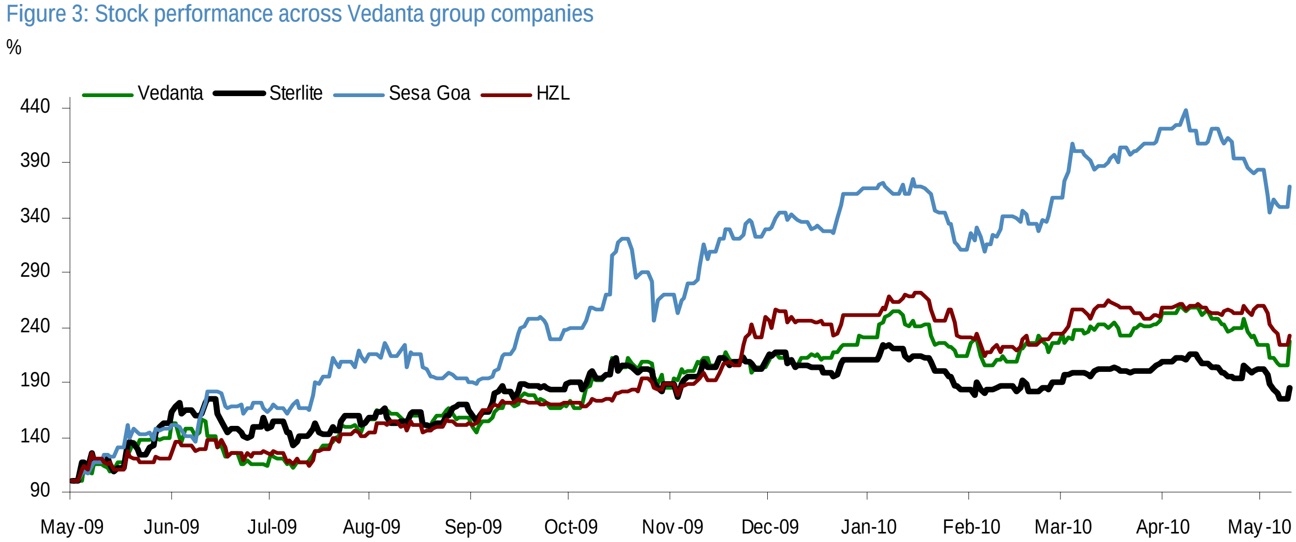
Source: Company reports. Note: Black Mountain is adjusted for 26% ownership of Exarro in Black Mountain Mining5

We remain OW on STLT; returns likely back-ended

We remain OW on STLT with a revised March-11 PT of Rs920. We value the company now on earnings-based methodology of EV/EBITDA rather than our earlier methodology of Sum of the Parts. We change our methodology as a) we cannot give an explicit valuation of the power subsidiary and b) we prefer to use a more conservative approach to value earnings only, given the lack of visibility on bauxite mine allocation. Our PT is based on 7x consolidated EV/EBITDA which is at the high end of the past five-year trading range of Indian mining companies.

While FY11E is likely to benefit from new zinc smelters, we believe FY12E is likely to benefit from volume growth in both aluminum and power segments. We expect BALCO to remain substantially surplus power even posts the 325KT smelter as the 1200MW power plant is commissioned in Q3FY11E.

Figure 3: Stock performance across Vedanta group companies



Source: Company reports and J.P. Morgan estimates.

Table 6: Stock performance

%

	1-mth	3-mths	6-mths	12-mths
Vedanta	-12.2%	7.6%	6.8%	97.1%
Sterlite	-14.6%	-0.1%	-11.9%	54.1%
Sesa Goa	-12.3%	14.1%	16.6%	214.8%
HZL	-10.1%	3.6%	16.9%	92.1%

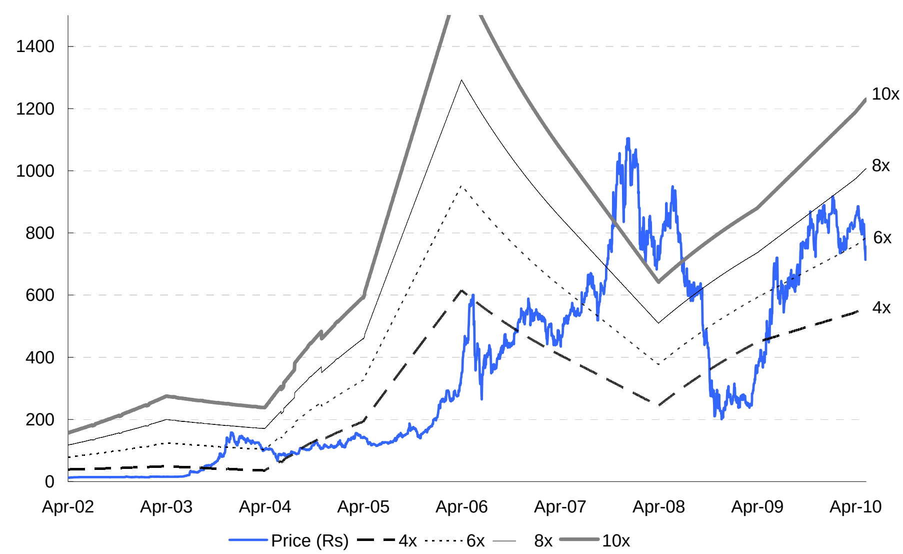
Source: Company reports and J.P. Morgan estimates.

STLT has sharply underperformed the other listed entities in the group, in our view driven by the lack of meaningful usage of existing cash balance. The lack of bauxite mine allocation to VAL and the subsequent Inter Corporate Loan to VAL, in our view has also dragged stock performance. **We remain positive on STLT and would recommend building positions on declines given: a) valuations are among the cheapest globally; b) earnings growth is driven by volumes and dependent on underlying commodity prices; c) diversified earnings stream across segments; and d) best-in-class execution.**

Key risks to our thesis are: a) no bauxite mine allocation for VAL; and b) delays in growth projects and corporate restructuring which is negative for minority share holders.

Figure 4: STLT EV/EBITDA Band Chart

Rs



Source: Company reports, Bloomberg and J.P. Morgan estimates.

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Sterlite Industries: Summary of financials

Profit and Loss statement Rs in millions, year-end Mar	FY09	FY10E	FY11E	FY12E
Revenues	211,442	234,941	317,386	376,430
% change Y/Y	-14%	11%	35%	19%
EBITDA	47,041	61,886	92,624	123,718
% change Y/Y	-40%	32%	50%	34%
EBITDA Margin (%)	22%	26%	29%	33%
EBIT	40,035	53,859	81,941	111,065
% change Y/Y	-45%	35%	52%	36%
EBIT Margin (%)	19%	23%	26%	30%
Net Interest	3,973	4,480	9,018	15,973
Earnings before tax	57,604	71,651	99,845	121,232
% change Y/Y	-32%	24%	39%	21%
Tax	8,550	12,990	21,810	27,647
as % of EBT	15%	18%	22%	23%
Net Income (Pre Exceptional)	36,936	41,428	61,747	78,353
% change Y/Y	-16%	12%	49%	27%
Shares Outstanding	708	863	863	863
EPS (pre exceptional)	52.1	48.0	71.6	90.8
% change Y/Y	-16%	-8%	49%	27%

Cash flow statement Rs in millions,	FY09	FY10E	FY11E	FY12E
Net Income	49,054	58,662	78,035	93,585
Add: Depreciation	7,007	8,027	10,683	12,653
Workg. Cap change	12,437	(14,384)	(30,758)	9,613
Operational CF	68,498	52,304	57,960	115,851
Net Capex	(54,744)	(49,131)	(66,667)	(59,817)
Free cash flow	13,754	3,173	(8,707)	56,034
Equity	(12,856)	77,776	(24,045)	(42,800)
Debt raised/ (repaid)	19,390	(2,135)	42,510	25,833
Dividends paid	(3,093)	(1,475)	(1,475)	(1,475)
Beginning cash	24,536	55,048	207,557	209,596
Ending cash	55,048	207,557	209,596	252,504
DPS	3.50	1.50	1.50	1.50

Balance sheet Rs in millions, year-end Mar	FY09	FY10E	FY11E	FY12E
Inventories	24,432	29,252	40,016	35,510
Debtors	8,383	13,940	18,232	19,046
Cash and bank balances	55,048	207,557	209,596	252,504
Other Current Assets	0	0	0	0
Loans and advances	27,961	28,521	51,000	56,000
Investments	162,062	97,457	124,457	142,451
Net fixed assets	102,319	113,842	179,258	268,623
Total assets	450,526	589,935	712,491	821,866
Liabilities				
Sundry Creditors	18,519	13,078	16,855	20,077
Others	10,397	24,990	27,990	35,690
Total current liabilities	42,051	38,068	44,844	55,766
Total debt	70,135	68,000	110,510	136,343
Other liabilities	68,132	81,922	102,677	125,988
Total liabilities	194,394	198,841	268,883	328,948
Shareholders' equity	256,132	391,094	443,608	492,918
BVPS	361.5	453.3	514.2	571.3

Ratio Analysis %, year-end Mar	FY09	FY10E	FY11E	FY12E
EBITDA margin	21%	26%	29%	33%
Operating margin	19%	23%	26%	30%
Net profit margin	17%	18%	19%	21%
Sales growth	-14%	11%	35%	19%
Net profit growth	-16%	12%	49%	27%
EPS growth	-16%	-8%	49%	27%
Interest coverage (x)				
Net debt/total capital	6%	-55%	-29%	-31%
Net debt to equity	6%	-36%	-22%	-24%
Sales/assets	50%	45%	49%	49%
Assets/equity (x)	1.8	1.6	1.6	1.6
ROE	15%	13%	15%	17%
ROCE	15%	16%	17%	18%

Source: Company reports, Bloomberg, J.P. Morgan estimates

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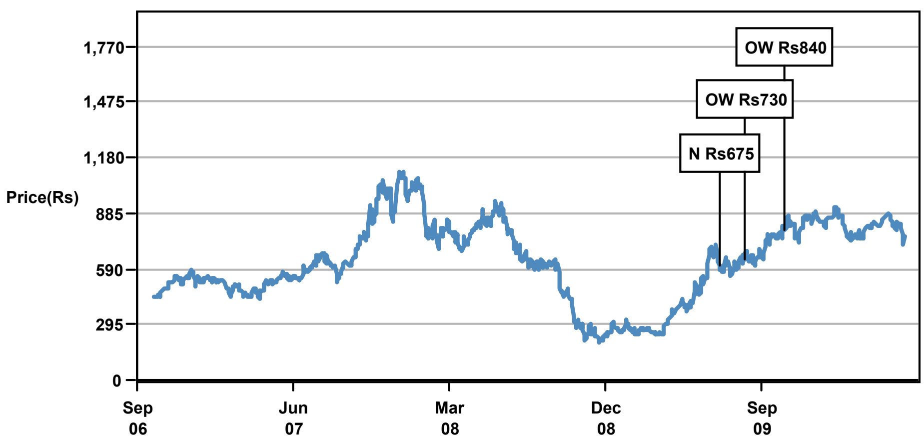
Sterlite Industries (STRL.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
18-Jun-09	N	603.10	675.00
03-Aug-09	OW	644.95	730.00
11-Oct-09	OW	791.90	840.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jun 18, 2009. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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