HSBC Global Research

Nat Resources & Energy
Metals & Mining
Equity – India

Coal India Limited (COAL IN)

Overweight (V)

Target price (INR)	469.00
Share price (INR)	322.55
Potential return (%)	46.9

Performance	1M	3M	12M
Absolute (%)	-14.9	-11.8	-
Relative^ (%)	-15.7	-4.2	-

Index^	BOMBAY SE SENSITIVE INDEX
RIC	COAL.BO
Bloomberg	COAL IN
Market cap (USDm)	41,613
Market cap (INRm)	2,037,343
Enterprise value (INRm)	1,471,940
Free float (%)	10

Note: (V) = volatile (please see disclosure appendix)

18 October 2011

Arun Kumar Singh*
Senior Analyst, Indian Power Utilities
HSBC Securities and Capital Markets (India) Private Limited
+9122 22681778
arun4kumar@hsbc.co.in

Jigar Mistry*, CFA
Analyst, Indian Metals and Mining
HSBC Securities and Capital Markets (India) Private Limited
+9122 22681079
jigarmistry@hsbc.co.in

Murtuza Zakiuddin*
Associate
Bangalore

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OW (V): Current price offers attractive entry level

- **We think COAL's stock price correction on negative newsflow in the past few months provides a good entry level**
- **Current indications do not suggest any meaningful earnings loss for the company, even considering a pessimistic scenario**
- **Assuming a 50% probability of all the negatives currently in the news occurring, we see only 13% cut to our TP, still offering significant upside. Maintain OW (V) rating and INR469 TP**

COAL's stock price has reacted sharply to negative newsflow (Exhibit 1): we, however, believe the company's fundamentals remain strong and most market fears have, in effect, only very small downside potential to our estimates.

Power companies, including NTPC, know that the cost of imported coal would be too high and are not interested in lobbying for lower prices from COAL but higher quantity (Exhibit 2): power companies are already divided into haves and have-nots (coal linkage), and any FSA coal price cut or prioritisation will further distort the difference. We expect coal prices to rise owing to higher cost and a push for more production, benefiting COAL.

E-auctions process is institutionalised and a number of smaller end-users transporting coal by road depend on them: we do not think lobbying will permanently stop e-auction sales and assume the proportion of coal sold in this way will remain at 11% for the next few years, the risk is only on the upside (sales in 1HFY12 are 12.6% of offtake).

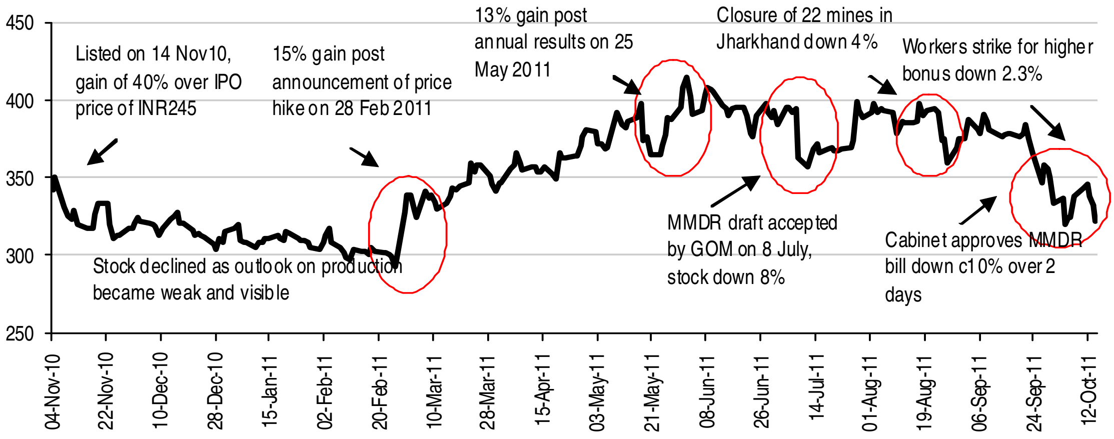
The government is unlikely to seek further discounts from COAL to address SEB losses, which are because of poor management, lower consumer tariffs and high AT&C losses. Recent tightening of bank lending to SEBs – which primarily funded the losses – indicates the realisation that any form of indirect subsidy could lead to new complications.

Wage negotiations and additional bonus payouts are unlikely to result in major downside to COAL's earnings (Exhibit 3). COAL is treated like a cost-plus company by the government and hence any increase in its costs will be passed on to consumers.

COAL will be allowed to pass on the MMDR burden: chairman reported to have quantified this at INR20-22bn, calling for 3.0-3.5% price rises, which we think it should be able to pass on.

Reiterate OW(V) and TP of INR469: we value COAL on a combination of DCF and earnings multiples. Our TP implies a PE of 14.4x 24m EPS (current PE 11.7x)**. Downside risks** are lower-than-expected offtake from logistics constraints and implementation of the MMDR Bill, with COAL unable to pass on the cost to its customers.

Exhibit 1: COAL's share price performance since listing – factoring in a lot of negatives in the past few months



Source: Thomson Reuters Datastream, HSBC

Exhibit 2: COAL's pricing under FSA is a steep discount to landed imported coal prices even after adjusting for low-grade coal

CIF price	5,500 kcal coal at USD110
% Discount for plant located at 500kms from coast	
- Under FSA	-68%
- Under E-Auction	-32%
% Discount for plant located at coast	
- Under FSA	-62%
- Under E-Auction	-19%

Note: We assume GCV of 4000kcal/kg for Indian domestic coal
Source: HSBC estimates

Exhibit 3: Summary of sensitivity to various factors not accounted for in our valuation and earnings forecast

Factor	Base case	Potential upside/ (downside)	Probability	Impact on FY13 EPS	Impact on HSBC TP
Upside					
Production for FY13e is higher than anticipated if classification of No-Go area is dispensed off	469 MT	Incremental 20mt	Very low	7.8%	8.0%
Downside – Worst case impact					
MMDR bill clears in its current form – if the impact is assumed at INR20-22bn per company	COAL will pass the entire burden	No pass through	Low to medium	-11.0%	-11.0%
Price hike for DEFG coal in 2HFY12 is more than expected by us	10% hike expected in Q1FY13	Less hike at 5%	Low to medium	-6.7%	-6.9%
Bonus paid is higher than expected	INR17,000 per employee	at INR25,000 per employee	Low to medium	-1.2%	0.1%
Wage cost higher than expected	+30% in 2QFY12	Hiked by another 10%	Low to medium	-6.8%	-6.6%
MoC fixes quantity of coal through E-Auction at current levels of c48MT over next 2-3 years	51 to 54MT over FY12-14	Lower by 3-6MT over FY12-14	Low to medium	-2.3%	-1.1%
Total downside				**-28.0%**	**-25.6%**
Realistic downside (assume 50% of the above)				*-14.0%*	*-12.8%*

Source: HSBC estimates

Financials & valuation

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	528,958	656,999	740,899	790,992
EBITDA	161,410	232,705	276,098	302,580
Depreciation & amortisation	-16,729	-18,226	-19,844	-21,256
Operating profit/EBIT	144,681	214,479	256,254	281,324
Net interest	18,963	32,169	39,979	51,479
PBT	164,626	248,233	297,818	334,387
HSBC PBT	165,228	248,233	297,818	334,387
Taxation	-55,954	-81,646	-98,066	-110,190
Net profit	108,673	166,586	199,752	224,198
HSBC net profit	109,275	166,586	199,752	224,198
Cash flow summary (INRm)				
Cash flow from operations	128,224	194,715	246,137	276,122
Capex	-24,750	-40,000	-30,000	-31,094
Cash flow from investment	-22,566	-38,000	-28,000	-29,094
Dividends	-33,995	-42,712	-51,428	-60,145
Change in net debt	-73,178	-114,003	-166,708	-186,883
FCF equity	76,306	124,947	183,185	208,993
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	150,611	172,385	182,541	192,379
Current assets	643,960	765,441	944,101	1,138,119
Cash & others	458,623	572,626	739,334	926,217
Total assets	813,973	955,227	1,142,043	1,343,900
Operating liabilities	408,178	430,558	474,050	511,854
Gross debt	15,536	15,536	15,536	15,536
Net debt	-443,087	-557,090	-723,798	-910,681
Shareholders' funds	333,172	457,047	605,371	769,423
Invested capital	-72,230	-65,358	-86,743	-107,573

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	12.6	24.2	12.8	6.8
EBITDA	23.5	44.2	18.6	9.6
Operating profit	23.2	48.2	19.5	9.8
PBT	14.1	50.8	20.0	12.3
HSBC EPS	11.2	52.4	19.9	12.2
Ratios (%)				
Revenue/IC (x)	-8.6	-9.6	-9.7	-8.1
ROIC	-154.7	-209.2	-226.0	-194.1
ROE	36.9	42.2	37.6	32.6
ROA	14.3	18.9	19.1	18.1
EBITDA margin	30.5	35.4	37.3	38.3
Operating profit margin	27.4	32.6	34.6	35.6
EBITDA/net interest (x)				
Net debt/equity	-132.9	-121.8	-119.5	-118.3
Net debt/EBITDA (x)	-2.7	-2.4	-2.6	-3.0
CF from operations/net debt				
Per share data (INR)				
EPS reported (fully diluted)	17.20	26.37	31.62	35.49
HSBC EPS (fully diluted)	17.30	26.37	31.62	35.49
DPS	3.90	4.90	5.90	6.90
Book value	52.75	72.36	95.84	121.81

Key forecast drivers

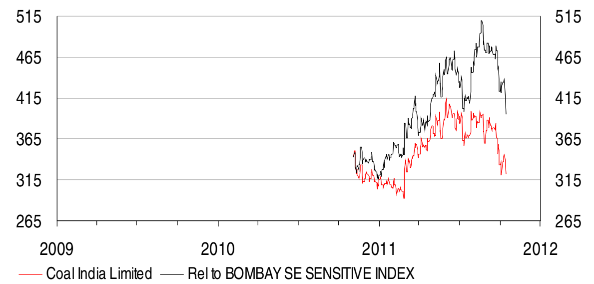
Year to	03/2011a	03/2012e	03/2013e	03/2014e
Production (MT)	431	442	469	490
Sales (MT)	424	453	471	490
ASP (INR/t)	1,178	1,371	1,487	1,524

Valuation data

Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	3.0	2.2	1.8	1.4
EV/EBITDA	9.8	6.3	4.7	3.7
EV/IC				
PE*	18.6	12.2	10.2	9.1
P/Book value	6.1	4.5	3.4	2.6
FCF yield (%)	3.8	6.2	9.0	10.3
Dividend yield (%)	1.2	1.5	1.8	2.1

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 14 Oct 2011

COAL's growth – central to India's growth story

COAL has been a volatile stock and its price has reacted sharply to negative newsflow, but the company's fundamentals remain in good shape (Exhibit 1). We think the problem is primarily because COAL does not have a share price history and, hence, is often compared with other public sector companies. Given this, the prevailing negative newsflow has led the market to think the worst in recent months. We, however, believe that COAL's production increase is central to the growth of the power sector in India and, hence, India's overall growth story. We think that given COAL's status as a monopoly coal supplier selling at c68% average discount to alternate sources of supply (imports), we do not find anything fundamentally wrong with the company and believe that despite the short-term price correction, the stock provides a good potential return for investors.

The Power Ministry has no control over COAL's pricing, although being the largest end user, it has the ability to lobby for a higher quantity of supply. COAL is expected to sell 77% (347MT) of its FY12 production to power companies through FSA and also a large part of its 50MT e-auction coal to various power companies. However, demand from power companies that depend on COAL is expected to increase at c9.4% CAGR over FY11-14 and there is significant shortfall in terms of what was originally committed and what is available. Given that international coal prices are at an all-time high (5,500 Kcal Indonesian coal CIF USD110/ton at East Coast) and further given the difficulty and cost (INR1,500 to 2,000 per MT) of transporting coal from ports to inland power stations, power companies, including NTPC, are lobbying for a higher supply of domestic coal and not for lower prices from COAL. Hence, when the situation turned critical in October (48 power stations with critical supplies), COAL committed sale on priority basis to the power sector.

COAL has already made a c28MT e-auction sale in 1HFY12. We believe the company should not have any difficulty meetings its annual 50MT e-auction target. Further, in the previous quarter, NTPC agreed to pay a INR800/mt premium for an additional 2.5MT of coal, which we think demonstrates power companies' priorities.

E-auctions process is institutionalised and a number of smaller end-users transporting coal by road depend on them. We do not think any amount of lobbying could permanently stop this process and assume the proportion of coal sold in this way will remain at 11% of offtake for the next few years. The risk is only on the upside as was evident during 1HFY12 when the company expected to sell 26.4MT, 12.6% of offtake (it had sold 23.1MT by end August 2011).

COAL sells it FSA coal to power companies at c68% discount to the landed cost of international coal and even its e-auction coal is at c32% discount; hence, the company has price flexibility to absorb additional cost increases. We believe that COAL will be allowed to pass on any additional cost burden to its end users. If COAL were to sell entire offtake under FSA (386MT in FY12) at international prices, it would have earned an additional INR718bn, which can be called a notional discount to its end users, hence we do not expect COAL to be burdened more.

Wage negotiations and additional bonus payouts are unlikely to result in major downside to earnings.

- COAL has clarified that it would raise prices once wage negotiations are complete, we factor in a 35% wage increase on the gross worker salary cost, which translates into around 75-80% increase on the base level. If it is higher by another 10% at the gross level (say 20% at the base level), then it could result in lower net profits by c6.8% for FY13.

- We have further factored in a 10% increase in E&F category coal with a lag in FY13, post wage negotiations being completed, which in our view is reasonable. We do not see more than 5% downside risk to our estimate if, for some reason, the 10% increase is only half.
- Additional bonus demand from workers (workers demand INR25,000 versus management's commitment of INR17,000) could have a maximum impact of INR3bn, which is only 1.2% of FY12 net profit.
- Our view is that as COAL is treated by the government as a cost-plus company, it will be given the flexibility of passing on any cost increase to consumers.

COAL will also have the flexibility of passing on the MMDR burden to end consumers. Implementing the MMDR act may take more than a year since operational issues are still being worked out, even if they are passed during the winter session.

- The media reported (*Press Trust of India*, 02 October 2011) a statement attributed to COAL's chairman saying the additional burden because of the MMDR obligation would amount to INR20-22bn, and to recover this the company will need to increase coal prices across all categories by c3.0-3.5%, which we view as feasible.

Another concern that USD10bn of COAL's cash will be taken away by the government has no basis and does not match the experience of companies like NTPC, which have been sitting on large cash piles for a long time without the government taking any away. Legally, there are not many options open to take the cash other than by paying a good dividend, which would be good for minority shareholders.

The central government will not try to address the SEB losses issue via discounts from COAL similar to ONGC. We do not believe that SEB financial losses will be addressed via discounts from COAL. In the past few years, states have used PSU bank financing to meet the short-term losses of SEB and, hence, chose not to focus on tariff revision or control of AT&C losses, which led to a further deterioration of SEB losses. Realising recently that indirect subsidies only complicate the problem, as its origin lies elsewhere, the central government has impressed upon banks to tighten their lending to SEB. We do not believe that further subsidies from COAL could in anyway contain SEB losses; this would only complicate the problem. In addition, any transfer of money from COAL to meet SEB losses would, in effect, mean a transfer of central government income to states, which we think is unlikely to happen.

April-August FY12 data make us confident about COAL meeting its sales and recovery targets for FY12-13. Based on available data for the first five months of the current year, we are of the view that COAL will be able to meet its offtake target even if there is slight production slack through partial offloading of its inventory. Further, cost recovery on e-auction coal in the first five months is already at INR2600/Mt, which is our estimate for the full year. It is quite possible that COAL will be able to get a higher recovery rate than this for the full year and, hence, we believe it will be able to meet our projections of the full year FY12.

Our mine-level analysis further suggests that COAL will be able to reach production of 560MT by FY17, from the FY11 level of 431MT. We believe that it could produce at higher levels if more pressure were applied by the power companies and the GOI facilitates faster approvals.

The MMDR Act and new Land Acquisition Act, if implemented, will help COAL ramp up production faster and beat our production estimate for FY17.

Maintain target price of INR469 and Overweight(V) rating

We value COAL based on a combination of a DCF and an earnings multiple based valuation (see Exhibits 4a-4d). For DCF, we discount the cash flows assuming unchanged WACC of 11.3% (cost of equity 11.8%, cost of debt 7.5% and beta of 0.95) to arrive at INR459 per share. We value COAL at 15x 24m forward EPS and 9x 24-month forward EV/EBITDA. Our target price of INR469 (unchanged) is based on the weighted-average of DCF, PE and EV/EBITDA, to which we assign weights of 50%, 25% and 25%, respectively. At our target price, the stock implies a PE of 14.4x 24m EPS and 9.0x EV/EBITDA (it is currently trading at a PE of 11.7x 12m forward EPS).

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 11%. COAL is classified as a volatile stock in our research model, which implies a Neutral band of 1-21%. We maintain our Overweight(V) rating as the potential return of 46.9% (including dividend yield) falls above the Neutral band.

Exhibit 4a: Calculation of 12-month target price

Method	Weight	INR/share
DCF	0.50	459
PE	0.25	489
EV/EBITDA	0.25	470
Target price		**469**

Source: HSBC estimates

Exhibit 4b: COAL – DCF summary table

Particulars	INRm	INR/share
Enterprise value	**2,473,297**	392
Less: Gross Debt	15,536	2
Add: Cash & Bank excl OBR provision	431,952	68
Add: Investments	8,137	1
Less: Minorities	326	0
Equity value	**2,897,525**	**459**

Source: HSBC estimates, OBR= Overburden Removal

Exhibit 4c: COAL – PE-based valuation

	INR
PE multiple (x)	15.0
EPS (24M fwd) – June 2013	32.6
Value per share	**489**

Source: HSBC estimates

Exhibit 4d: COAL – EV/EBITDA-based valuation

	INRm	INR/share
EV/EBITDA multiple (x)	9.0	
EBITDA (24M fwd)	282,718	
Enterprise value	**2,544,466**	403
Less: Gross Debt	15,536	2
Add: Cash & bank adj for OBR	431,952	68
Add: Investments	8,137	1
Less: Minorities	326	0
Equity value	**2,968,693**	**470**

Source: HSBC estimates

Key risks

Key downside risks to our rating are: 1) lower-than-expected offtake because of logistics constraints; and 2) implementation of the MMDR Bill. In our view, COAL would have to raise product prices by 3.0-3.5% to offset the implementation cost of the MMDR Bill. Exhibit 3 sets out some of the downside risks to our forecasts and the likely catalysts.

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Disclosure appendix

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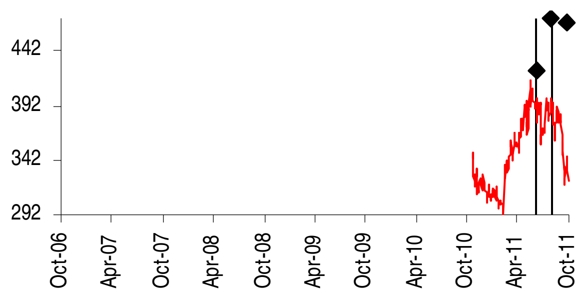
Overweight (Buy)	55%	(27% of these provided with Investment Banking Services)
Neutral (Hold)	35%	(21% of these provided with Investment Banking Services)
Underweight (Sell)	10%	(14% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Coal India Limited (COAL.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral (V)	21 June 2011
Neutral (V)	Overweight (V)	16 August 2011
Target Price	**Value**	**Date**
Price 1	425.00	21 June 2011
Price 2	472.00	16 August 2011
Price 3	469.00	10 October 2011

Source: HSBC

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2 All market data included in this report are dated as at close 14 October 2011, unless otherwise indicated in the report.
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HSBC Securities and Capital Markets (India) Private Limited
Registered Office
52/60 Mahatma Gandhi Road
Fort, Mumbai 400 001, India
Telephone: +91 22 2267 4921
Fax: +91 22 2263 1983
Website: www.research.hsbc.com

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