



Hindalco

STOCK INFO. BLOOMBERG
BSE SENSEX: 14,428 HNDL IN
REUTERS CODE
S&P CNX: 4,209 HALC.BO

20 August 2007

Neutral

Previous Recommendation: Under Review

Rs142

Equity Shares (m)	1,306.8
52-Week Range	193/125
1,6,12 Rel. Perf. (%)	-14/-6/-38
M.Cap. (Rs b)	185.2
M.Cap. (US\$ b)	4.6

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/07A	199,548	28,006	24.2	77.5	5.9	1.3	22.8	18.8	1.0	4.4
3/08E	684,913	13,247	10.1	-58.0	14.0	1.2	8.7	7.0	0.7	7.6
3/09E	735,973	21,415	16.4	61.7	8.7	1.0	11.6	8.8	0.6	6.1

Neutral with target price of Rs156

We recently met with the management of Hindalco. Key takeaways: We understand that Novelis has a technological edge and strong market position and operates in a business with significant entry barriers. However, it suffers operationally due to unfavorable industry structure. Price ceiling contracts (10% of product portfolio) and lack of effecting hedging has resulted in its poor financial performance. Novelis reported 1QFY08 results that were operationally better but the non recurring items resulted in a loss of US\$151m. Though Novelis is working on reducing its exposure to price ceiling contracts, we remain concerned due to the unfavorable industry structure. Hindalco has aggressive growth plan to increase its Aluminium capacity ~3x to 1.5mtpa in next five years. However, the benefits will accrue FY11 onwards. We rate the stock **Neutral** with target price of Rs156.

Strong market positioning of Novelis driven by technology and quality

Novelis is the world leader in flat rolled products (FRP) and has market share of 19% (total market size of 16.4m tons). The product portfolio is dominated by beverage cans (comprising 45%) followed by construction/industrial (18%), packaging (17%), automobile (9%), and litho (3%). The company's growth is driven by technology, quality and new products and caters to blue chip customers, e.g. for beverage cans (Coke, Rexam, Can & Closure, Ball & Crown cork & seal), for automobiles (Audi, BMW, Ford etc), for printing litho (AGFA, Kodak, Polychrome etc.), packaging (Pactiv, Alfa Tetra) and for industrial (Ryerson,

Velux etc). Novelis has recently introduced a new product technology called Fusion, which can produce multi metal sheets to provide best of both strength and functionality.

Significant entry barriers in FRP business

Significant entry barriers exist in the aluminum rolled products industry due to large capital cost, long lead times to install cost competitive plants and technological requirements. There exists premium on 'know how' due to rising service, quality and efficiency demands of large global customers.

Unfavorable market structure, little pricing power with Novelis

The global FRP market is dominated by five players who have combined market share of 52%. These five players have been fully integrated historically and have grown their business inorganically. The integrated players have offered fixed price contracts to their blue chip customers as they have control over costs, which played against the standalone FRP business. Novelis was carved out of Alcan in 2005 after its merger with Pacheiny. Aleris too is a spin off from Corus. Hydro, Alcan and Alcoa are the three integrated players who have a combined market share of 28%. There are three customers who have 70% share of global market of beverage cans. Novelis' product portfolio is dominated by beverage cans, where the customers are highly consolidated, and there is intense competition from integrated players which leaves very little pricing power with Novelis.

Will the market structure change for better?

Alcan has already shown interest in spinning off its FRP business. Post merger with Alcan, Rio Tinto, who is a commodity player, would also like to spin off its non core business to partly fund the acquisition and unlock value for its shareholders. Similarly, if Alcoa and Hydro too follow the trend to unlock value for their shareholders, the margins would substantially improve for standalone FRP players like Novelis. However, at the moment, this remains a question mark.

Novelis' 1QFY08 results are operationally better

Novelis reported 1QFY08 results with loss of US\$151m after minority interest, which included non recurring expenditures totaling US\$96m.

- ✍ US\$45m of stock compensation expense triggered by sale of Novelis
- ✍ US\$32m for sale transaction costs
- ✍ US\$19m(net) for purchase accounting

Net sales increased 10% YoY, primarily driven by higher prices of metal while the shipments of 755,000 tons remained flat YoY against 753,000 tons. EBITDA increased by 16.3% YoY to US\$114m and EBITDA margin improved 20bp to 4%. The losses on account of price ceiling contracts net of hedges were lower by US\$27m YoY.

Funding of Novelis

Hindalco paid an enterprise value of ~US\$6b, which included the existing debt on the books. The amount paid towards buying out the equity was US\$3.4b which is funded through bridge loan of US\$3.1b (recourse to Hindalco's balance sheet) and issue of preference and warrants to promoters amounting to Rs25.6b, which has diluted the equity base by 11.3% to Rs1,307m (face value of Rs1).

We are modeling the US\$3.1b bridge loan on the balance sheet of Hindalco and factoring interest expenses thereon @7.5% pa.

Challenges ahead for Novelis

Novelis' exposure to price ceiling contracts is now down to 10% of the product portfolio. The company has internal hedge mechanism through recycling of scrap and primary production of aluminium in Brazil. The net exposure for remaining FY08 is 50,000 tons, which the company plans to reduce to 20,000tons by the year end. We understand that it will take few years before the company comes out of fixed price contracts completely. Though LME prices of metal are pass-through on remaining 90% of its product portfolio, yet they are fixed for the short duration of contract. The company tries to mitigate the risk through hedging on

QUARTERLY PERFORMANCE (NOVELIS)										(USD MILLION)	
Y/E MARCH	FY07				FY08				FY07	FY08E	FY09E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE			
Net Sales	2,564	2,494	2,472	2,630	2,828	2,800	2,814	2,871	10,160	11,312	11,617
Change (YoY %)	18.0	21.5	22.0	13.4	10.3	12.3	13.8	9.1	18.6	11.3	2.7
EBITDA	98	-47	-24	53	114	113	113	116	80	456	653
Change (YoY %)	-11.7	-130.5	-109.5	-60.4	16.3	-340.1	-572.6	118.3	-87.7	470.0	43.2
As % of Net Sales	3.8	-1.9	-1.0	2.0	4.0	4.0	4.0	4.0	0.8	4.0	5.6
Interest	49	52	57	50	51	48	48	49	208	195	200
Depreciation	59	57	59	58	81	79	79	81	233	320	315
Other Income											
PBT (before EO item)	-10	-156	-140	-55	-18	-14	-14	-14	-361	-59	138
Extra-ordinary Income	-	-	-	-	-96	-	-	-		-96	
PBT (after EO item)	-10	-156	-140	-55	-114	-14	-14	-14	-361	-155	138
Total Tax	-20	-52	-34	7	40	-26	-26	-27	-99	-39	34
% Tax	200.0	33.3	24.3	-12.7	-35.1	192.1	192.1	192.1	27.4	25.0	25.0
Reported PAT	10	-104	-106	-62	-154	12	13	13	-262	-116	103
Minority interest	4	-2	-1	2	-3	-3	-3	-3			
Preference Dividend											
Adjusted PAT	6	-102	-105	-64	-21	15	16	16	-262	-44	103
Change (YoY %)		-1,800	-216	-14	-455	-115	-115	-125	-2,207	-83	-334

E: MOST Estimates

LME contracts, yet the task is challenging due to multi currency operations.

Novelis operates in four continents and the outlook for North American (39% by volumes) and Asian market (16% by volumes) is not very encouraging. North American market is stagnant and the competition is intense. Asian market is fast growing but the aggressive exports from China are putting pressure on margins. The outlook is positive for European and Brazilian markets. We believe that Novelis will continue to face challenges in the coming years due to unfavorable industry structure and will find it difficult to generate return on capital employed, which now has got further inflated due to sale of the company.

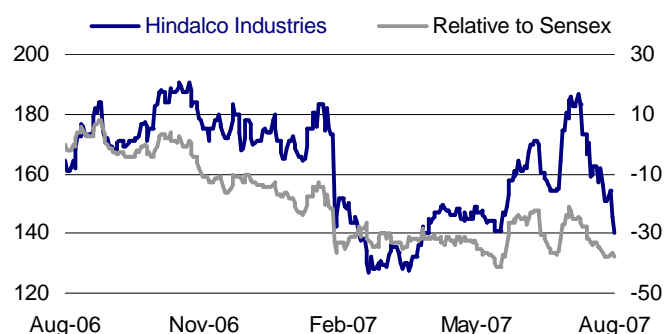
Resume coverage on Hindalco with Neutral rating

We expect the consolidated EPS of Hindalco to decline sharply to Rs10.1 per share in FY08 as Novelis will continue to report losses. The performance of Novelis is expected to improve substantially in FY09 when the exposure to fixed price contracts is reduced and the new management puts

in play effective hedging mechanism. Hindalco's standalone earnings will grow due to growth in primary metal on account of expansion at HiraKud. Therefore, the consolidated EPS will grow substantially by 62% YoY in FY09.

We arrive at a sum of the parts one year valuation of Rs156 per share (an upside of 10% from current levels). The stock is trading at P/E of 8.7x FY09E and EV/EBITDA of 6.1x FY09E and P/B of 1x FY09E (RoE of only 11.6% despite D/E ratio of 2x). We believe that the stock is fully valued and resume our coverage with **Neutral** rating.

RELATIVE TO SENSEX (1 YEAR)



SUM OF THE PARTS VALUATION

	(RS M)	EQUITY VALUE	
		(RS M)	(RS/SHARE)
Standalone business			
PAT (FY09)	15,930		
Target Multiple (x)	8		
Equity Value (a)		127,436	97.5
Novelis (Rs m)			
EBITDA (FY09)	26,767		
Target Multiple (x)	4.5		
Target EV	120,453		
Less: Net debt	92,285		
Residual Equity Value (b)		28,168	21.6
QUOTED INVESTMENTS			
	SHARES	CMP	
	(M)	(RS/SHARE)	
IDEA (10.11% stake)	228.3	113.4	25,894
ABML, Australia	159.8	94.8	15,150
Aditya Birla Nuvo	7.7	1,345.5	10,311
Grasim	2.3	2,776	6,382
Bihar Caustic & Chemicals Ltd.	12.0	50.6	607
NALCO	8.4	256.0	2,145
			60,489
			46.3
Discount for Locked Value	20%		12,044
Net Value of Investments (c)			48,391
Sum of the Parts (a+b+c)			156.1

Source: Motilal Oswal Securities

INCOME STATEMENT						(RS MILLION)				
Y/E MARCH	2005	2006	2007	2008E	2009E					
Net sales	101,053	120,362	199,548	684,913	735,973					
Change (%)	18.5	19.1	65.8	243.2	7.5					
Total Expenses	76,748	91,913	153,542	624,472	662,688					
EBITDA	24,306	28,449	46,006	60,441	73,285					
% of Net Sales	24.1	23.6	23.1	8.8	10.0					
Depn. & Amortization	6,325	7,959	8,404	21,723	21,665					
EBIT	17,981	20,490	37,602	38,718	51,620					
Net Interest	2,459	3,014	3,174	20,646	21,241					
Other income	2,779	2,805	4,101	4,246	3,700					
PBT before EO	18,600	20,281	38,529	22,319	34,080					
EO income	585	24	-1,377	-3,936						
PBT after EO	19,186	20,305	37,152	18,383	34,080					
Current tax	5,419	3,424	9,603	7,320	11,564					
Deferred tax	809	980								
Tax	6,228	4,403	9,603	7,320	11,564					
Rate (%)	32.5	21.7	25.8	39.8	33.9					
Reported PAT	12,958	15,902	27,549	11,063	22,516					
Minority interests	110	106	564	185	1,101					
Adjusted PAT	12,452	15,777	28,006	13,247	21,415					
Change (%)	25.2	26.7	77.5	-52.7	61.7					

BALANCE SHEET						(RS MILLION)				
Y/E MARCH	2005	2006	2007	2008E	2009E					
Share Capital	928	986	1,044	1,307	1,307					
Reserves	75,098	92,296	121,602	151,266	182,630					
Net Worth	76,026	93,282	122,646	152,573	183,937					
Minority Interest	858	1,295	1,859	8,153	9,254					
Total Loans	49,796	63,278	63,278	307,597	307,597					
Deferred Tax Liability	11,342	12,281	12,281	87,352	87,352					
Capital Employed	138,023	170,137	200,065	555,676	588,141					
Gross Block	109,532	134,433	154,433	456,880	490,980					
Less: Accum. Deprn.	39,065	46,002	54,406	76,129	97,794					
Net Fixed Assets	70,467	88,431	100,027	380,751	393,186					
Capital WIP	16,387	10,403	10,403	10,403	10,403					
Investments	29,559	31,632	31,632	62,710	62,710					
Curr. Assets	49,521	78,781	108,944	259,964	286,470					
Inventory	26,970	44,975	48,223	117,799	125,085					
Account Receivables	8,404	13,057	17,649	79,873	82,625					
Cash and Bank Balance	4,730	10,423	25,586	35,560	49,195					
Others	9,416	10,326	17,485	26,732	29,565					
Curr. Liability & Pro	27,911	39,111	50,942	158,152	164,629					
Account Payables	18,812	28,861	39,987	112,301	118,778					
Provisions & Others	9,099	10,250	10,955	45,851	45,851					
Net Current Assets	21,610	39,671	58,002	101,811	121,841					
Appl. of Funds	138,023	170,137	200,065	555,676	588,141					

E: Most Estimates

RATIOS					
Y/E MARCH	2005	2006	2007	2008E	2009E
Basic (Rs)					
EPS	13.4	13.6	24.2	10.1	16.4
Cash EPS	20.8	20.6	31.0	25.1	33.8
BV/Share	81.9	80.5	105.8	116.8	140.8
DPS	2.0	1.9	2.4	2.6	2.6
Payout (%)	17.0	15.7	11.3	29.3	18.1
Valuation (x)					
P/E	10.6	10.4	5.9	14.0	8.7
Cash P/E	6.8	6.9	4.6	5.6	4.2
P/BV	1.7	1.8	1.3	1.2	1.0
EV/Sales	1.7	1.8	1.0	0.7	0.6
EV/EBITDA	7.3	7.6	4.4	7.6	6.1
Dividend Yield (%)	14	13	17	18	18
Return Ratios (%)					
RoE	16.4	16.9	22.8	8.7	11.6
RoCE	13.0	12.0	18.8	7.0	8.8
RoIC	13.9	13.6	21.1	5.2	7.3
Working Capital Ratios					
Asset Turnover (x)	0.7	0.7	1.0	1.2	1.3
Debtor (Days)	30.4	39.6	32.3	42.6	41.0
Inventory (Days)	26.7	37.4	24.2	17.2	17.0
Working Capital Turnov	16.7	24.3	16.2	9.7	9.9
Leverage Ratio (x)					
Current Ratio	1.8	2.0	2.1	1.6	1.7
Interest Cover Ratio	8.3	6.8	11.8	1.9	2.4
Debt/Equity	0.7	0.7	0.5	2.0	1.7

CASHFLOW STATEMENT						(RS MILLION)				
Y/E MARCH	2005	2006	2007	2008E	2009E					
Pre-tax Profit	19,076	20,199	36,588	18,198	32,979					
Depreciation	6,325	7,959	8,404	21,723	21,665					
(Inc)/Dec in Wkg. Cap.	-868	-12,367	-3,169	-33,835	-6,396					
Tax Paid	-5,419	-3,424	-9,603	-7,320	-11,564					
CF from Op. Activiti	19,114	12,368	32,220	-1,234	36,684					
(Inc)/Dec in FA + CWIP	-54,657	-18,917	-20,000	-302,447	-34,100					
(Pur)/Sale of Investmer	4,213	-2,074		-31,078						
CF from Inv. Activiti	-50,444	-20,991	-20,000	-333,525	-34,100					
Equity raised/(repaid)	3	58	58	263						
Chg in minorities	858	437	564	6,294	1,101					
Debt raised/(repaid)	24,150	13,482		244,319						
Dividend (incl. tax)	-2,120	-2,473	-3,177	-3,880	-3,880					
Other financing activitie	10,855	2,811	5,499	97,737	13,830					
CF from Fin. Activiti	33,747	14,316	2,943	344,733	11,050					
(Inc)/Dec in Cash	2,417	5,693	15,163	9,974	13,634					
Add: opening Balance	2,314	4,730	10,423	25,586	35,560					
Closing Balance	4,730	10,423	25,586	35,560	49,195					

N O T E S



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Disclosure of Interest Statement	Hindalco
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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