

Company Focus

2 November 2007 | 15 pages

Sterlite Industries (India) (STRL.BO)

 Rating change
 Target price change
 Estimate change

Buy: Raising Target Price; More Positives Expected

- More steam left** — We see more steam in Sterlite's strong stock performance on: 1) its exposure to zinc, our favored metal with strong volume growth; 2) higher ownership of its key businesses as government stake purchases of HZL and Balco should be completed soon; 3) allotment of coal blocks for Balco expected soon; and 4) 2,400MW of power commissioned Dec 09 onwards.
- Raising target multiple; EPS trimmed** — We are raising our target multiple to 12.5x from 10x incorporating the above positive expectations which appear closer and further upward sector re-rating in the last few months. Adding the power business value takes target price to Rs1,209. EPS is revised by -1 to -5% in FY09-FY10E on rupee appreciation, 1HFY08 trends, and lower costs.
- Zinc - Rumors of death exaggerated** — Zinc accounts for about 70% of total EBITDA. Although zinc prices have been weak recently, we remain bullish as we do not expect China to emerge as a major supplier to western markets, and also because of delays expected in mine production.
- 2QFY08 in line** — This was a good quarter for volume growth (up 14-30% yoy) for all businesses. However zinc EBITDA fell 19% due to rupee appreciation and copper EBITDA fell 20% due to a sharp fall in TC/RCS. Aluminium EBITDA rose 23% benefiting from 30% volume growth and lower yoy alumina costs.
- Risks** — (1) Delays in the acquiring stakes in HZL and Balco; (2) Higher acquisition price; and (3) Further rupee appreciation beyond our forecasts.

| | |
|------------------------------|--------------|
| Buy/Low Risk | 1L |
| <i>from Buy/Medium Risk</i> | |
| Price (02 Nov 07) | Rs995.00 |
| Target price | Rs1,209.00 |
| <i>from Rs949.00</i> | |
| Expected share price return | 21.5% |
| Expected dividend yield | 0.4% |
| Expected total return | 21.9% |
| Market Cap | Rs705,149M |
| | US\$17,975M |

Price Performance (RIC: STRL.BO, BB: STLT IN)



Figure 1. Sterlite Industries (India) – Statistical Abstract

| YE 31 Mar | Net Profit* | EPS | EPS growth | P/E | EV/EBITDA | ROE |
|-----------|-------------|------|------------|------|-----------|-----|
| | (Rsm) | (Rs) | (%) | (x) | (x) | (%) |
| FY06 | 16,781 | 30.0 | 153% | 34.2 | 20.1 | 32% |
| FY07 | 44,841 | 80.3 | 167% | 12.8 | 8.1 | 56% |
| FY08E | 48,084 | 67.9 | -15% | 15.1 | 9.1 | 23% |
| FY09E | 66,494 | 93.9 | 38% | 10.9 | 6.8 | 22% |
| FY10E | 44,802 | 63.2 | -33% | 16.2 | 9.3 | 15% |

Source: Company Reports, Citi Investment Research estimates.

Price as on Nov1. * Net profit is profit attributable to shareholders.

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See Appendix A-1 for Analyst Certification and important disclosures.

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¹Citigroup Global Markets India Private Limited

| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|--|----------------|----------------|----------------|-----------------|----------------|
| Valuation Ratios | | | | | |
| P/E adjusted (x) | 33.1 | 12.4 | 14.7 | 10.6 | 15.7 |
| EV/EBITDA adjusted (x) | 18.7 | 7.4 | 7.1 | 6.5 | 9.8 |
| P/BV (x) | 9.2 | 5.6 | 2.2 | 2.6 | 2.2 |
| Dividend yield (%) | 0.1 | 0.4 | 0.4 | 0.4 | 0.5 |
| Per Share Data (Rs) | | | | | |
| EPS adjusted | 30.05 | 80.29 | 67.87 | 93.85 | 63.24 |
| EPS reported | 30.05 | 80.29 | 67.87 | 93.85 | 63.24 |
| BVPS | 108.38 | 178.72 | 454.94 | 385.75 | 458.39 |
| DPS | 1.25 | 4.00 | 4.25 | 4.40 | 4.50 |
| Profit & Loss (RsM) | | | | | |
| Net sales | 131,272 | 243,868 | 265,754 | 295,398 | 246,756 |
| Operating expenses | -96,300 | -150,501 | -178,045 | -201,123 | -183,084 |
| EBIT | 34,972 | 93,367 | 87,709 | 94,275 | 63,673 |
| Net interest expense | -2,353 | -3,791 | -2,897 | -5,266 | -4,893 |
| Non-operating/exceptionals | -101 | -198 | 0 | 0 | 0 |
| Pre-tax profit | 32,518 | 89,378 | 84,813 | 89,009 | 58,780 |
| Tax | -10,165 | -24,118 | -21,080 | -20,647 | -13,284 |
| Extraord./Min.Int./Pref.div. | -5,572 | -20,420 | -15,649 | -1,869 | -694 |
| Reported net income | 16,781 | 44,841 | 48,084 | 66,494 | 44,802 |
| Adjusted earnings | 16,781 | 44,841 | 48,084 | 66,494 | 44,802 |
| Adjusted EBITDA | 40,241 | 101,406 | 96,202 | 103,073 | 72,440 |
| Growth Rates (%) | | | | | |
| Sales | 81.0 | 85.8 | 9.0 | 11.2 | -16.5 |
| EBIT adjusted | 127.5 | 167.0 | -6.1 | 7.5 | -32.5 |
| EBITDA adjusted | 119.3 | 152.0 | -5.1 | 7.1 | -29.7 |
| EPS adjusted | 153.1 | 167.2 | -15.5 | 38.3 | -32.6 |
| Cash Flow (RsM) | | | | | |
| Operating cash flow | 22,086 | 56,490 | 63,818 | 72,953 | 53,036 |
| Depreciation/amortization | 5,269 | 8,039 | 8,493 | 8,798 | 8,767 |
| Net working capital | -8,339 | -18,647 | 4,530 | -3,689 | 4,523 |
| Investing cash flow | -16,172 | -43,070 | -13,046 | -154,900 | -19,428 |
| Capital expenditure | -13,506 | -23,796 | -23,022 | -31,430 | -29,637 |
| Acquisitions/disposals | -6,009 | -26,091 | 0 | -132,316 | 0 |
| Financing cash flow | -3,103 | -13,438 | 65,731 | 50,526 | -12,162 |
| Borrowings | -320 | 217 | -11,762 | 59,387 | -3,500 |
| Dividends paid | -732 | -4,441 | -132 | -3,595 | -3,770 |
| Change in cash | 2,811 | -19 | 116,503 | -31,420 | 21,445 |
| Balance Sheet (RsM) | | | | | |
| Total assets | 170,976 | 239,990 | 464,843 | 489,407 | 541,311 |
| Cash & cash equivalent | 11,153 | 11,134 | 127,638 | 96,218 | 117,663 |
| Accounts receivable | 13,475 | 16,521 | 19,165 | 22,935 | 20,144 |
| Net fixed assets | 85,497 | 97,176 | 118,641 | 167,381 | 202,504 |
| Total liabilities | 93,279 | 103,916 | 99,349 | 165,402 | 161,093 |
| Accounts payable | 13,917 | 9,078 | 18,327 | 20,383 | 19,091 |
| Total Debt | 51,653 | 46,103 | 34,342 | 93,729 | 90,229 |
| Shareholders' funds | 77,696 | 136,074 | 365,494 | 324,005 | 380,217 |
| Profitability/Solvency Ratios (%) | | | | | |
| EBITDA margin adjusted | 30.7 | 41.6 | 36.2 | 34.9 | 29.4 |
| ROE adjusted | 32.3 | 55.9 | 22.8 | 22.3 | 15.0 |
| ROIC adjusted | 23.9 | 51.1 | 33.0 | 26.8 | 15.9 |
| Net debt to equity | 52.1 | 25.7 | -25.5 | -0.8 | -7.2 |
| Total debt to capital | 39.9 | 25.3 | 8.6 | 22.4 | 19.2 |

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Target price raised

We have been positive on Sterlite and continue to see several upside triggers for the stock price. These are now closer than expected. We are raising our target multiple to 12.5x from 10x earlier, taking our target price to Rs1,209. We maintain a Buy on the stock.

Key positives

Bullish on zinc

Sterlite offers exposure to zinc through Hindustan Zinc (HZL). Zinc is our favored metal with strong near term volume growth as HZL's capacity is expanding by 63% to 669,000 tpa by June 2008. Zinc is the biggest contributor to Sterlite's EBITDA (70% of total) and should benefit from better pricing and strong volumes over the next 2-3 quarters. Although zinc prices have been weak recently, its outlook remains fundamentally robust due to delayed mine production, low inventory levels, and strong Chinese demand. We expect tightness to persist and zinc prices to rally above US\$4,000/t in 1H08E. HZL also offers exposure to lead. Lead prices have been strong in recent months due to supply disruptions, strong demand, and speculative buying.

Acquisition of 29.5% stake in HZL

Sterlite has started discussions with the government to acquire their residual 29.5% stake in Hindustan Zinc. This should help smooth the transaction upon formal exercise of the call option. Sterlite expects the process to be completed soon. We now expect the purchase to be completed by March 2008 versus October 2007 earlier, and assume a small premium to market price.

Making progress on the Balco stake

The option to acquire the government's 49% stake in Balco is being worked on, and out of court mediation has started. The price initially offered was Rs11bn, but Sterlite may have to pay a premium. Both parties are keen to resolve the issue, and we assume that the transaction will get completed by March 2008.

Allocation of coal blocks

Balco had signed a 5-year contract in August 2006 with a subsidiary of Coal India to meet about 70% of its coal requirements, the remaining being purchased from the open market. Balco is in the process of being allotted coal mines. The Coal Ministry has approved coal blocks for Balco and Sterlite expects the mines should be allotted in four weeks to six weeks. The process to start mining is likely to take about 3 years after allocation and should help bring down the coal costs by about 20-25%. As full details of the mines are not available, we have not been able to incorporate its value in our estimates. However this will be a positive in terms of cost savings and we have instead accounted for this by raising the target multiple.

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Commercial Power – on track

Sterlite intends to build a pit-head thermal coal-based 3,600MW capacity power plant through its subsidiary, Sterlite Energy. Phase – I would be 2,400 MW (4 X 600MW) and Phase – II would be 1,200 MW (2 X 600MW). Unit-I is to be commissioned by Dec 2009, with the remaining 3 units to be commissioned one-per-quarter thereafter. Sterlite Energy has commenced construction of the first phase of the project. Sterlite Energy expects investments of ~ Rs76bn (US\$1.76bn) over the next three years to complete Phase – I.

Valuation multiple increased; New Target Price of Rs1,209

Upgrading multiple on several imminent positive triggers and upward re-rating for sector

We are raising our target multiple to 12.5x from 10x. This incorporates 1) positive expectations of closer acquisitions. 2) The coal blocks will help reduce costs for Balco, but as full details are not available, we are instead using a higher multiple. 3) Further upward sector re-rating in the last few months.

To put it in perspective, of Citi's global metal coverage, diversified metal stocks (such as Sterlite) trade at a forward PE of 11-13x, aluminium stocks trade at 12-13x, copper stocks at 9.0x and Zinifex at 10.1x.

Based on 12.5x P/E for FY09 we get a price of Rs 1,174/share for Sterlite. To this we add the value of the power business (at book value of the equity investment) to arrive at our target price of Rs1,209. We maintain Buy on the stock.

Risk Factors

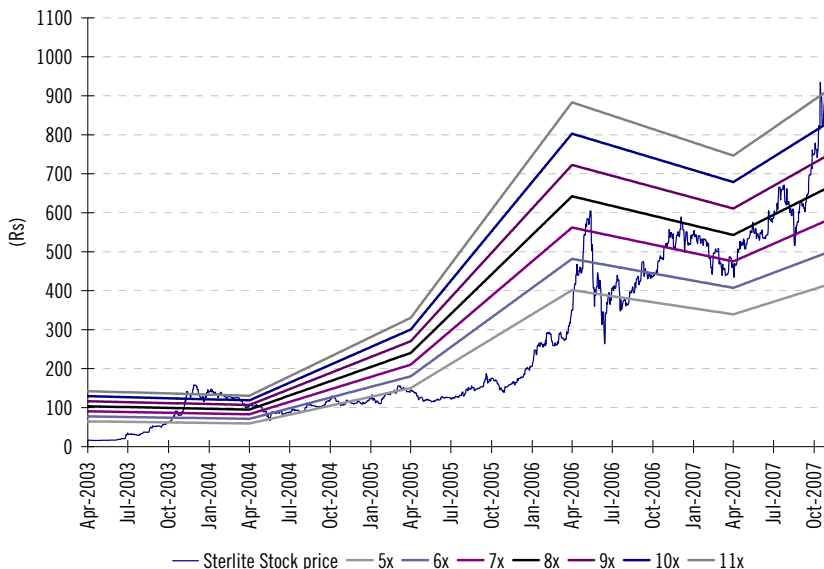
Downside risks are: 1) Delays in the acquisition of the stakes in HZL and Balco; 2) A higher price to be paid than expected; 3) Further rupee appreciation beyond our forecasts.

Figure 2. Global Valuations

| Company Name | Reuters Code | Rating | Market Cap USD \$m | Ccy | Share | | | P/E (x) | | | EV/EBITDA (x) | | |
|--------------------------------------|--------------|--------|--------------------|-----|--------|--------|--------|------------|-------------|-------------|---------------|------------|------------|
| | | | | | Price | Target | Upside | 2006A | 2007E | 2008E | 2006A | 2007E | 2008E |
| Diversified | | | | | | | | | | | | | |
| Mitsubishi Materials | 5711.T | 1M | 7,346 | JPY | 675.0 | 900.0 | 33% | 9.6 | 10.5 | 10.7 | 8.1 | 7.9 | 7.4 |
| Anglo American PLC | AAL.L | 2M | 89,028 | GBP | 32.62 | 32.50 | (0%) | 11.7 | 13.2 | 12.5 | 6.7 | 6.9 | 7.2 |
| Banpu | BANP.BK | 1M | 4,028 | THB | 468.0 | 353.0 | (25%) | 11.1 | 13.9 | 16.9 | 4.6 | 8.9 | 9.9 |
| BHP Billiton PLC | BLT.L | 2M | 229,437 | GBP | 18.23 | 18.50 | 1% | 9.0 | 10.6 | 12.6 | 6.2 | 6.8 | 7.8 |
| Hindustan Zinc | HZNC.BO | 1M | 9,324 | INR | 868.2 | 1,128 | 30% | 7.1 | 7.4 | 8.0 | 4.4 | 4.2 | 4.4 |
| Rio Tinto PLC | RIO.L | 2M | 119,967 | GBP | 43.99 | 47.00 | 7% | 9.2 | 12.5 | 11.1 | 5.8 | 8.4 | 7.0 |
| Sally Malay Mining Ltd | SMY.AX | 1H | 1,037 | AUD | 5.94 | 5.70 | (4%) | 4.5 | 9.2 | 12.5 | 1.9 | 4.4 | 6.0 |
| Sterlite Industries (India) | STRL.BO | 1L | 18,398 | INR | 1,021 | 1,209 | 18% | 12.7 | 15.0 | 10.9 | 8.1 | 9.0 | 6.8 |
| Teck Cominco Ltd | TCKb.TO | 1H | 21,310 | CAD | 47.10 | 60.00 | 27% | 7.1 | 9.3 | 9.1 | 3.6 | 5.0 | 5.4 |
| Companhia Vale do Rio Doce Preferred | RIO_p.N | 1M | 150,094 | USD | 31.06 | 37.00 | 19% | 7.6 | 9.0 | 12.5 | 7.1 | 7.2 | 8.3 |
| Vedanta Resources Plc | VED.L | 2H | 12,643 | GBP | 21.29 | 23.50 | 10% | 8.4 | 8.9 | 9.0 | 3.4 | 3.6 | 3.5 |
| Western Areas NL | WSA.AX | 3H | 849 | AUD | 5.53 | 5.10 | (8%) | (45.8) | (172.6) | 39.3 | (35.6) | (1371.2) | 20.0 |
| Xstrata PLC | XTA.L | 1M | 69,976 | GBP | 34.90 | 40.00 | 15% | 6.8 | 9.0 | 8.1 | 3.7 | 5.8 | 4.9 |
| Aluminium | | | | | | | | | | | | | |
| ALCOA Inc | AA.N | 1M | 33,688 | USD | 39.72 | 52.00 | 31% | 10.6 | 12.6 | 10.7 | 5.8 | 5.3 | 5.9 |
| Alumina Ltd | AWC.AX | 1M | 7,260 | AUD | 6.74 | 7.70 | 14% | 15.5 | 18.2 | 14.4 | 12.3 | 13.9 | 10.0 |
| Hindalco Industries | HALC.BO | 3M | 6,026 | INR | 193.2 | 142.0 | (27%) | 8.8 | 9.9 | 12.7 | 5.4 | 5.3 | 6.5 |
| National Aluminium | NALU.BO | 3M | 5,205 | INR | 317.9 | 231.0 | (27%) | 7.1 | 8.8 | 12.1 | 3.6 | 4.5 | 6.6 |
| Norsk Hydro ASA | NHY.OL | 1M | 18,491 | NOK | 79.20 | 95.00 | 20% | 10.8 | 8.8 | 10.8 | 18.3 | 13.9 | 5.6 |
| Copper | | | | | | | | | | | | | |
| Antofagasta PLC | ANTO.L | 2M | 16,989 | GBP | 8.35 | 8.00 | (4%) | 6.0 | 8.7 | 10.4 | 2.6 | 3.9 | 4.5 |
| Freeport McMoran Copper & Gold Inc | FCX.N | 1H | 44,387 | USD | 116.3 | 122.0 | 5% | 8.3 | 8.6 | 9.8 | 4.0 | 4.5 | 4.4 |
| First Quantum Minerals Ltd | FQM.L | 1M | 6,748 | GBP | 49.30 | 65.00 | 32% | 7.3 | 9.9 | 7.1 | 4.3 | 5.5 | 4.1 |
| Grupo Mexico SAB de CV | GMEXICOB.MX | 1H | 23,171 | MXN | 96.00 | 101.7 | 6% | 5.2 | 8.4 | 8.8 | 2.6 | 3.8 | 4.1 |
| Kazakhmys Plc | KAZ.L | 2H | 14,463 | GBP | 14.92 | 16.50 | 11% | 5.6 | 7.4 | 8.1 | 3.2 | 3.9 | 4.1 |
| KGHM Polska Miedz SA | KGHM.WA | 3H | 10,898 | PLN | 136.8 | 119.0 | (13%) | 5.7 | 6.4 | 6.8 | 3.3 | 3.9 | 4.3 |
| Southern Copper Corp | PCU.N | 2H | 41,219 | USD | 140.0 | 125.0 | (11%) | 6.6 | 11.2 | 11.9 | 4.0 | 6.8 | 7.4 |
| Gold & Precious Metals | | | | | | | | | | | | | |
| Barrick Gold Corp | ABX.N | 1H | 37,455 | USD | 43.26 | 48.00 | 11% | 20.4 | 18.8 | 17.6 | 10.7 | 12.2 | 9.7 |
| Anglo Platinum Ltd | AMSJ.J | 3M | 38,966 | ZAR | 1,080 | 950.0 | (12%) | 12.5 | 16.5 | 15.1 | 7.8 | 9.7 | 9.5 |
| Aquarius Platinum Ltd | AQP.L | 1M | 3,282 | GBP | 18.60 | 18.00 | (3%) | 9.6 | 13.6 | 15.6 | 3.7 | 5.4 | 6.0 |
| Compania de Minas Buenaventura SA | BVN.N | 1H | 6,943 | USD | 54.57 | 64.00 | 17% | 8.2 | 17.2 | 12.0 | 7.1 | 9.4 | 8.8 |
| Hochschild Mining Plc | HOCM.L | 1M | 2,932 | GBP | 4.62 | 4.25 | (8%) | 59.9 | 29.3 | 18.4 | 21.6 | 15.6 | 9.7 |
| Impala Platinum Holdings Ltd | IMPJ.J | 3M | 22,926 | ZAR | 237.8 | 206.0 | (13%) | 14.8 | 13.6 | 12.8 | 6.7 | 7.9 | 8.3 |
| Lihir Gold Ltd | LGL.AX | 2H | 7,217 | AUD | 4.11 | 4.20 | 2% | 45.9 | 41.7 | 26.0 | 21.5 | 20.4 | 15.0 |
| Lonmin PLC | LMI.L | 2M | 10,791 | GBP | 33.49 | 37.00 | 10% | 15.8 | 22.7 | 20.0 | 8.7 | 12.2 | 10.2 |
| Newcrest Mining Ltd | NCM.AX | 2H | 13,064 | AUD | 31.30 | 33.00 | 5% | 42.0 | 26.0 | 24.6 | 8.7 | 9.8 | 13.0 |
| Newmont Mining Corp (Holding Co) | NEM.N | 1H | 20,178 | USD | 46.74 | 54.00 | 16% | 32.4 | 33.5 | 22.6 | 11.9 | 10.2 | 7.9 |
| NovaGold Resources Inc | NG.A | 1S | 2,054 | USD | 19.63 | 23.00 | 17% | (112.5) | (139.1) | 321.7 | (36.6) | (83.7) | 205.2 |
| Northam Platinum Ltd | NHMJ.J | 3H | 1,696 | ZAR | 46.74 | 38.95 | (17%) | 8.2 | 10.3 | 12.6 | 4.5 | 5.5 | 5.8 |
| Oxiana Ltd | OXR.AX | 1H | 5,736 | AUD | 4.03 | 4.60 | 14% | 7.0 | 13.4 | 12.4 | 4.9 | 7.0 | 7.1 |
| Peter Hambro Mining PLC | POG.L | 1H | 2,326 | GBP | 13.89 | 18.00 | 30% | 41.0 | 31.4 | 17.9 | 23.2 | 20.4 | 12.5 |
| Nickel | | | | | | | | | | | | | |
| Aneka Tambang | ANTM.JK | 3M | 3,487 | IDR | 3,325 | 1,700 | (49%) | 6.5 | 6.8 | 11.7 | 3.7 | 4.0 | 6.5 |
| Norilsk Nickel | GMKN.RTS | 1M | 54,424 | USD | 285.5 | 260.0 | (9%) | 4.6 | 5.5 | 11.2 | 2.9 | 3.4 | 6.9 |
| PT Inco | INCO.JK | 3L | 9,559 | IDR | 87,500 | 45,000 | (49%) | 4.4 | 6.7 | 18.1 | 2.4 | 4.0 | 11.0 |
| Jubilee Mines NL | JBM.AX | 2H | 2,823 | AUD | 23.45 | 16.70 | (29%) | 7.8 | 15.9 | 28.2 | 4.3 | 9.5 | 16.2 |
| Minara Resources Ltd | MRE.AX | 3H | 2,791 | AUD | 6.51 | 5.30 | (19%) | 4.4 | 10.6 | 15.7 | 3.1 | 7.2 | 9.8 |
| Metals & Mining | | | | | | | | 9.1 | 12.0 | 13.1 | 5.4 | 7.2 | 7.3 |

Source: DataCentral, Citi Investment Research estimates. Prices as on Oct 29.

Figure 3. Sterlite Industries – Rolling P/E Band



Source: DataStream, Citi Investment Research

Figure 4. Sterlite Industries – Rolling EV/EBITDA



Source: DataStream, Citi Investment Research

EPS revised; Attributable EPS to grow 38% in FY09

We have revised our consolidated attributable EPS -1% to -5% in FY09-FY10E. This is on largely the back of foreign exchange changes which reduced earnings. However we have now accounted for lower costs and marginal changes in volumes based on trends seen in 1HFY08 and also based on our recent site visits to Sterlite's various plants.

We expect Sterlite's attributable net income to rise 38% yoy in FY09E due to higher profits in zinc and flattish profits in aluminium and the completion of the acquisition of the government stake in Hindustan Zinc (29.5%) and Balco (49%) by end-FY08.

Figure 5. Sterlite Industries (India) – Estimate Changes, FY08E-10E

| | FY08E | | | FY09E | | | FY10E | | |
|--|-------------|-------------|--------------|-------------|-------------|------------|-------------|-------------|------------|
| | Old | New | % chg | Old | New | % chg | Old | New | % chg |
| Average Copper LME (US\$/t) | 7,378 | 7,410 | 0% | 7,441 | 7,441 | 0% | 6,614 | 6,614 | 0% |
| Average Zinc LME (US\$/t) | 3,684 | 3,667 | 0% | 3,417 | 3,417 | 0% | 2,315 | 2,315 | 0% |
| Average Lead LME (US\$/t) | 2,649 | 2,679 | 1% | 2,260 | 2,260 | 0% | 2,315 | 2,315 | 0% |
| Average Aluminium LME (US\$/t) | 2,606 | 2,605 | 0% | 2,590 | 2,590 | 0% | 2,315 | 2,315 | 0% |
| Copper TC/RC LME (USc/lb) | 13.2 | 17.6 | 33% | 15.7 | 16.0 | 2% | 20.7 | 20.7 | 0% |
| Rs/US\$ rate | 41.8 | 40.2 | | 40.0 | 38.0 | | 39.0 | 36.0 | |
| Net sales (Rs bn) | 267 | 266 | 0% | 295 | 295 | 0% | 249 | 247 | -1% |
| EBITDA (Rs bn) | 95 | 96 | 2% | 105 | 103 | -1% | 76 | 72 | -5% |
| Profit available to shareholders (Rs bn) | 48 | 48 | -0.3% | 67 | 66 | -1% | 47 | 45 | -5% |
| EPS (Rs) | 68.1 | 67.9 | -0.3% | 94.9 | 93.9 | -1% | 66.9 | 63.2 | -5% |

Source: Citi Investment Research estimates

Quarterly Results for Sterlite

Figure 6. Sterlite Industries (India) – 2Q FY08

| (Rs m, Y/E March 31) | 2QFY08 | 2QFY07 | % chg |
|---|---------------|---------------|-------------|
| Net Sales | 65,671 | 67,180 | -2% |
| Total operating expenses | 46,013 | 41,434 | 11% |
| Operating Profit | 19,658 | 25,746 | -24% |
| Other Income | 3,233 | 1,112 | 191% |
| EBITDA | 22,891 | 26,858 | -15% |
| EBITDA margin (%) | 35% | 40% | |
| Depreciation | 2,046 | 1,871 | |
| EBIT | 20,845 | 24,988 | -17% |
| Interest | 643 | 1,163 | |
| Profit before tax and extraordinary | 20,202 | 23,825 | -15% |
| Extraordinary items | | 1,362 | |
| PBT | 20,202 | 22,463 | -10% |
| Tax paid | 4,465 | 6,862 | -35% |
| Effective tax rate | 22% | 31% | |
| Net profit after tax and extraordinary | 15,737 | 15,600 | 1% |
| Minority interest | 4,911 | 4,890 | |
| Share in profit/(loss) of associates | 1 | 0 | |
| PAT attributable to Consolidated Group | 10,827 | 10,710 | 1% |
| Exceptional items (adjusted for tax) | | 940 | |
| Inc attributable to Consolidated group | 10,827 | 11,650 | -7% |
| Divisional Break-up | | | |
| Revenues | | | |
| Copper | 35,370 | 33,070 | 7% |
| Aluminium | 10,460 | 9,690 | 8% |
| HZL | 19,840 | 24,420 | -19% |
| Total (net) | 65,671 | 67,180 | -2% |
| EBITDA | | | |
| Copper | 4,010 | 5,030 | -20% |
| Aluminium | 3,260 | 2,640 | 23% |
| HZL | 15,620 | 19,190 | -19% |
| Total | 22,890 | 26,860 | |
| EBITDA margin | | | |
| Copper | 11% | 15% | |
| Aluminium | 31% | 27% | |
| HZL | 79% | 79% | |
| Total | 35% | 40% | |

Source: Company Reports, Citi Investment Research

On a standalone basis, Sterlite reported a PAT of Rs2.1bn (in line) for 2Q FY08, 21% lower yoy. Net sales grew 7% yoy to Rs35.4bn (in line) due to higher copper volumes. However EBITDA fell 24% yoy due to lower TC/RC margins. TC/RC margins during the quarter were around US18c/lb versus an average of US34c/lb during 2QFY07. On a consolidated basis, attributable adjusted PAT for 2QFY08 fell 7% yoy to Rs10.8bn. Consolidated net sales fell 2% yoy to Rs65.7bn. EBITDA for the quarter fell 15% yoy to Rs22.9bn. This was a good quarter for volume growth (up 14-30% yoy) for all businesses. However zinc EBITDA fell 19% due to rupee appreciation and copper EBITDA fell 20% due to a sharp fall in TC/RCS. Aluminium EBITDA rose 23% benefiting from 30% volume growth and lower yoy alumina costs. Interest on surplus cash (from ADR) helped PAT reach Rs10.8bn.

Quarterly Results for Hindustan Zinc

Hindustan Zinc is a 64.9% subsidiary of Sterlite and accounts for ~70% of Sterlite's EBITDA. Hence we give below details of its recently announced quarterly results.

Figure 7. Hindustan Zinc – 2Q FY08 Results

| (Rs m, Y/E March 31) | 2QFY08 | 2QFY07 | % chg |
|--|---------------|---------------|-------------|
| Net Sales | 19,840 | 24,460 | -19% |
| Total operating expenses | 5,650 | 5,850 | -3% |
| EBITDA (excl other income) | 14,190 | 18,560 | -24% |
| Other income -recurring | 1,230 | 460 | 167% |
| Other income -non-recurring | 210 | - | |
| Total other Income | 1,440 | 460 | 213% |
| EBITDA | 15,630 | 19,020 | -18% |
| EBITDA margin (%) | 78.8% | 77.8% | |
| Depreciation | 490 | 370 | 32% |
| EBIT | 15,140 | 18,650 | -19% |
| Interest | 60 | 100 | -40% |
| PBT | 15,080 | 18,550 | -19% |
| Total Tax* | 4,400 | 5,570 | -21% |
| Tax rate (%) | 29.2% | 30.0% | |
| PAT | 10,680 | 12,980 | -18% |
| Adjusted PAT | 10,470 | 12,980 | -19% |
| Adjusted EPS (Rs) | 27.8 | 30.7 | -19% |
| Operating Data | | | |
| LME Zinc (US\$ / tonne) | 3,238 | 3,363 | -4% |
| LME Lead (US\$ / tonne) | 3,141 | 1,189 | 164% |
| Rs/US\$ rate | 40.54 | 46.41 | |
| Production - Refined Metal (tonnes) | | | |
| Zinc | 94,108 | 78,444 | 20% |
| Lead | 13,081 | 9,479 | 38% |

Source: Company Reports, Citi Investment Research. * Note – Tax in 2QFY08 has been adjusted for Rs800m of tax write back netted off in the reported numbers.

Hindustan Zinc (HZL) reported adj PAT of Rs10.5bn, (-19% yoy) due to lower LME and rupee appreciation. Sales fell 19% yoy to Rs19.8bn on the combined impact of lower LME (-4% yoy to US\$3,238/t) and the Rs/US\$ rate appreciating from 46.4 to 40.5. The impact of falling prices was reduced by higher volumes of zinc (+20%) and lead (+38%). Sales also included around 85,000 tonnes of surplus zinc and 10,000 tonnes of lead concentrate. EBITDA (excluding other income) for the quarter was Rs 14.2bn (-24% yoy) and the margin was 71.5% (-440bps yoy). HZL's reported PAT was Rs11.5bn for 2Q FY08. We have adjusted this for (1) non-recurring income of Rs210m and (2) tax write back of Rs800m.

Sterlite Industries (India)

Company description

Sterlite is a non-ferrous metals major with a presence in aluminium, zinc and copper. Sterlite is a custom copper smelter (capacity 400,000 tpa) for which the key profit driver is treatment and refining charges (TC/RCs). According to Brook Hunt, Sterlite is in the lowest-cost quartile of all copper smelting operations worldwide. Sterlite's aluminium revenues and profits comes from its 51% ownership of Bharat Aluminium Co (Balco), Balco's smelter capacity of 345,000 tpa has access to 810MW power, which is the most important cost component in the aluminium manufacturing process. Sterlite's zinc and lead revenues come from its 64.9% holding in Hindustan Zinc Ltd (HZL), an integrated zinc producer with a 60% domestic share. It is among the lowest-cost producers in the world largely due to the low cost of mining ore at the Rampura Agucha mine which meets about 90% of its requirement. HZL is expanding its zinc capacity by 63% to 669,000 tpa by 1Q FY09, accompanied by expansion in captive power capacity by 85% to 349MW. Sterlite is in the process of buying out the minority government stake in both HZL (29.5%) and Balco (49%).

Investment strategy

We rate Sterlite shares Buy / Low Risk (1L). Zinc (Hindustan Zinc) is the biggest contributor to Sterlite's EBITDA (70% of total) and should continue to benefit from robust pricing and strong volume growth. Sterlite is expected to soon raise its holding in HZL to 94.4% and hence can be considered as an alternate investment vehicle for investors looking to participate in the zinc story. Sterlite is also 4x more liquid than HZL. In the aluminium business (Balco), lower costs and some volume growth should help compensate for lower domestic prices in FY08. Sterlite's shareholding in Balco is also expected to soon reach 100%. Copper has a difficult outlook due to the lower TC/RC margins expected in FY08-FY09 vs. FY07. We expect Sterlite's attributable net income to rise 38% yoy in FY09E due to higher profits in zinc and aluminium and the completion of the minority stake acquisition of Hindustan Zinc (29.5%) and Balco (49%) from the government by the end of FY08. In addition Sterlite is in the process of being allotted coal mines for Balco, which are likely to result in cost savings in the long term. The commissioning of the first phase of the power project being set up by Sterlite Energy from Dec 2009 onwards, is on track.

Valuation

Since April 2006, the stock has been substantially re-rated to a P/E range of 6-8x due to the positive trends in all its three major businesses. We expect this re-rating process to continue based on our robust outlook for zinc and steady profits in aluminium, with triggers coming from progress in acquiring the balance minority stakes from HZL and Balco, and the allotment of coal mines for Balco. Based on this and the further upward sector re-rating in the last few months, we are upgrading our target multiple to 12.5x from 10x. Based on 12.5x PE for FY09 we get a price of Rs 1,174/share. To this we add the value of the power business (at book value of the equity investment) to arrive at our

target price of Rs1,209. The stock has also crossed its 4-year average EV/EBITDA of 3.6x in the last few months, largely driven by the above factors. Based on the triggers stated above, we expect the EV/EBITDA upside to continue. At our target price, the stock would trade at an EV/EBITDA of 8.0x.

Risks

Risk factors that could prevent the shares from reaching our target price include: (1) Any delays in completion of Hindustan Zinc minority stake acquisition; (2) Any delays in acquisition of Balco minority stake; (3) Weaker-than-expected commodity prices or TC/RC margins; (4) Delays in expansion plans for zinc and power; (5) Substantial dependence on the Rampura Agucha mines in case of zinc; (6) Trends in exchange rates.

Appendix A-1

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IMPORTANT DISCLOSURES

Sterlite Industries (India) (STRL.BO) Ratings and Target Price History - Fundamental Research

Analyst: Pradeep Mahtani (covered since July 31 2007)



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Sterlite Industries (India) (STRL.BO)

2 November 2007

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