

Industry Flash

1 November 2007 | 7 pages

India Sugar

Joker In The Pack Turns Out A Dud

- UP cane price announced** – The UP govt. today announced the cane price to be paid to farmers in FY08. As expected, the cane price has been left unchanged at last year's price of Rs1250/tonne. Recent expectations of switch over to a much lower central govt. set price (Rs900/tonne) have been defied.
- Court hearing on cane prices soon** – Currently there is litigation in the UP courts challenging last year's cane price of Rs1250/tonne. According to our discussion with the sugar cos, this hearing is likely to conclude in the next few days. Outcome of the hearing still leaves some scope for a potential reduction in cane prices for FY08.
- No sugar margins at Rs1250** – At a cane cost of Rs1250/tonne, UP-based sugar margins will be negative in FY08E, though mitigated to some extent by ancillary businesses such as alcohol, power and MDF. In addition, at this cane price, direct sugar conversion to ethanol will not be viable for UP-based sugar mills.
- Stalemate to continue** – With continuing cash losses in sugar business, we expect cane arrears to farmers in UP to mount and also see chances of sugar cos delaying the start of cane crushing. We still can't predict the endgame but as things stand currently, we expect margin squeeze for BJH and BRCM continuing. We maintain our replacement based price targets of Rs195 and Rs75 for BJH and BRCM, respectively.

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Figure 1. Replacement Cost per Share

Ticker	Rating	Price on 31 Oct 07	Asset Replacement Cost	Debt	Discount	Replacement Cost per share after discount
		(Rs)	(RsM)	(RsM)	(%)	(Rs)
Bajaj Hindusthan	1M	184.20	49,840	17,500	15%	185
Balrampur Chini	2M	79.95	26,330	4,500	15%	75

Source: Citi Investment Research

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

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Bajaj Hindusthan

Valuation

Our target price of Rs195 is based on replacement cost analysis, to which we apply a 15% discount, given that the company is making cash losses. We no longer use a P/E-based valuation methodology given sharp sugar price downcycle and uncertainty over UP state government sugar subsidies that could significantly alter our earnings estimates. In this uncertain environment, we believe that asset replacement cost (net of debt) provides base valuations to the stock. We value its sugar assets at Rs300,000 per TCD, which for 136,000TCD gives a value of Rs40.8bn. We value the 800KLPD alcohol assets at Rs3.5m per KLPD, arriving at a value of Rs2.8bn for the assets. We value the co-generation assets at Rs3.8bn, based on Rs40m per MW valuation. Stripped of total debt of Rs17.5bn, the net asset valuation of BJH is Rs32.3bn or Rs229 per share. Applying a 15% discount, we arrive at our price target of Rs195.

Risks

Although our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk to the stock, we rate it as Medium Risk given it has finished its first phase of capacity expansion. The sugar industry in general and BHL in particular, faces significant risks, some of which are structural. Key downside risks are: 1) regulations and the possibility of government intervention in an industry with little pricing power; (2) sugarcane output is governed by agro-climatic factors; an adverse climate could lead to crop failures, affecting raw-material availability; and 3) specific to BJH is execution risk, as the company is aggressively expanding capacity. If the impact of these risks is greater than we expect, the share price will likely have difficulty reaching our target price. The key upside risk would be UP government's planned new sugar policy being more favorable than the earlier policy, which could significantly alter sentiment and drive stock price beyond our price target.

Balrampur Chini Mills

Valuation

Our target price of Rs75 is based on a 15% discount to the replacement cost of assets. We apply a 15% discount to reflect cash losses of the sugar business, which we believe will continue for the next 3-4 quarters. We believe that a discount to the replacement cost is warranted till the time cash losses continue. We were earlier using a P/E-based valuation methodology, which we believe is no longer relevant as a sharp sugar price down cycle as well as uncertainty over UP state government sugar subsidies could significantly alter our earnings estimates. In such an uncertain environment, we believe that asset replacement cost (net of debt) will provide the base valuations to the stock. Our replacement cost analysis for BRCM is shown below.

We value the sugar assets of BRCM at Rs300,000 per TCD, which for 73,000TCD gives a value of Rs21.9bn. We value the 420KLPD alcohol assets at Rs3.5m per KLPD, arriving at a value of Rs1.47bn for the assets. We value the

74MW surplus power co-generation assets at Rs2.96bn, based on Rs40m per MW valuation. Stripping off the total debt of Rs4.5bn, the net asset valuation of BRCM in our view is Rs21.83bn or Rs88 per share. Applying a 15% discount to this yields a per share price of Rs75.

Risks

Although our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a High Risk to the stock, we rate BRCM as Medium Risk given that the company has successfully completed part of its capacity expansion and has raised capital for the remaining capex. We believe execution and financial risks stand mitigated to a large extent. The following risks could impede the stock from reaching our target price:

- Regulations and the possibility of government intervention in pricing in an industry that has little pricing power.
- Sugarcane output is governed by various agro-climatic factors. An adverse climate could lead to crop failures, affecting raw-material availability.
- The company is aggressively expanding capacity and any delay could hurt its near-term profitability.
- BRCM is looking at investing in power generation, which is a highly regulated industry. Any changes in government regulations could hurt business prospects.

The key upside risk would be if the UP government's planned new sugar policy is more favorable than the earlier policy, which could significantly alter sentiment and drive the stock price beyond our price target.

Appendix A-1

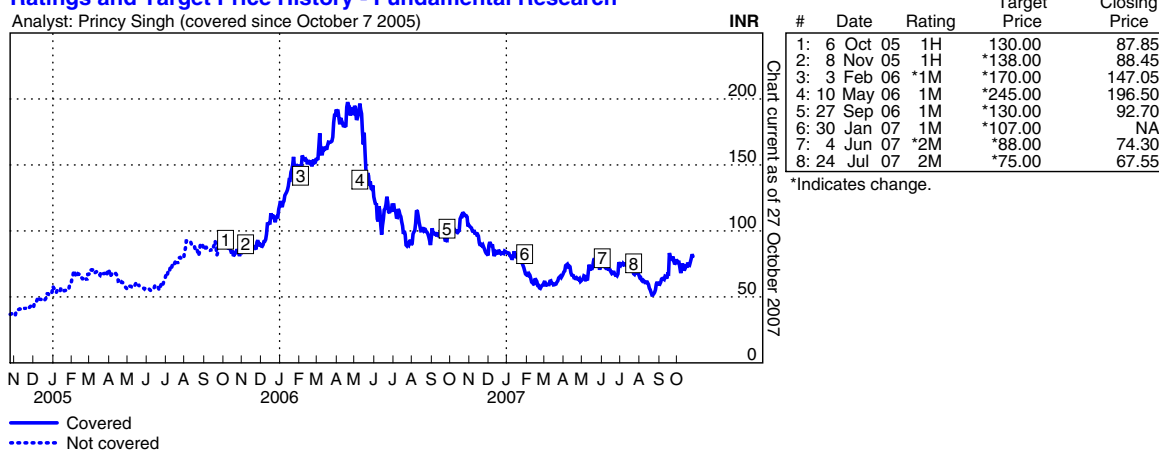
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Analyst: Princy Singh (covered since October 7 2005)



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