

Rights issue dilution exceeds expectations

EPS cut 6-8% on higher dilution; cut PO by 7% to Rs168; Buy

We now forecast weighted average fully diluted EPS to decline 15% in FY09 to Rs13.3 and grow 4% in FY10 to Rs13.9. While the Rights dilution exceeds our expectations, there is no change in the underlying business fundamentals. At P/E of 10x FY09E and 9.5x FY10E, Hindalco ranks among the cheapest aluminum stocks globally. Hence we maintain our Buy rating with reduced PO of Rs168.

Rights issue dilution now at 43% vs. 33% earlier

Hindalco now proposes to issue Rights at 3:7 at Rs96/share vs. our earlier expectation of 1:3 at Rs120. The total quantum of funds raised remains largely unchanged at US\$1.2bn but the share count rises. We forecast net profit to rise 17% in FY09E and 19% in FY10E. Key growth driver is higher aluminum EBITDA – higher sales realization and lower cost increases owing to high degree of integration. However the Rights dilution leads to EPS declining in FY09E.

Gearing levels unchanged post the revised Rights Issue

There is no change to our net gearing forecasts – 64% in FY09E and rising to 89% by FY11E to fund the proposed greenfield capex of trebling both alumina and aluminum capacities. We expect the capacities to come on line earliest FY11-12 onwards.

Aluminum outlook - positive newsflow at the margin

Ally spot prices are US\$2730/t, down 16% from its recent peak in July due to recent macro concerns. We believe aluminum prices are well supported at current levels owing to production cuts in China and rising energy prices. The recent export tax on Chinese aluminum alloys is an additional small positive. We believe these issues also support our long term aluminum price of US\$2650/t.

Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	27,722	18,551	21,506	25,514	22,346
EPS	26.08	15.82	13.33	13.92	12.19
EPS Change (YoY)	55.0%	-39.4%	-15.7%	4.5%	-12.4%
Dividend / Share	1.67	1.85	1.90	2.00	1.97
Free Cash Flow / Share	9.62	(98.69)	(0.373)	(17.48)	(33.21)

Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	4.97x	8.19x	9.72x	9.31x	10.62x
Dividend Yield	1.29%	1.43%	1.47%	1.54%	1.52%
EV / EBITDA*	8.76x	5.85x	5.31x	4.95x	5.08x
Free Cash Flow Yield*	4.89%	-55.38%	-0.288%	-15.33%	-29.11%

* For full definitions of *iQmethod*SM measures, see page 5.

Equity | India | Non-Ferrous-Aluminum & Light Metals
18 August 2008



Merrill Lynch

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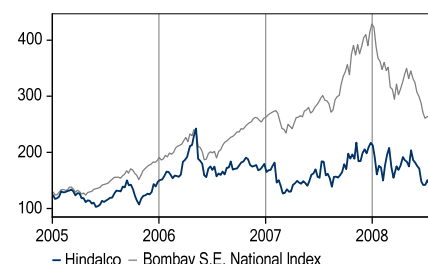
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Stock Data

Price	Rs129.55
Price Objective	Rs180.00 to Rs168.00
Date Established	18-Aug-2008
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs128.50-Rs240.00
Mkt Val / Shares Out (mn)	US\$4,861 / 1,613.6
Average Daily Volume	3,052,127
ML Symbol / Exchange	HNDF / BSE
Bloomberg / Reuters	HNDF IN / HALC.BO
ROE (2009E)	10.0%
Net Dbt to Eqty (Mar-2008A)	117.7%
Est. 5-Yr EPS / DPS Growth	10.0% / 10.0%
Free Float	74.0%



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*iQprofile*SM Hindalco

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
(Rs Millions)					
Sales	193,161	600,128	675,095	696,254	664,730
Gross Profit	44,306	66,351	73,051	78,457	76,402
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	36,513	41,786	46,725	51,060	47,918
Net Interest & Other Income	951	(12,090)	(13,009)	(11,619)	(13,003)
Associates	5	159	159	159	159
Pretax Income	37,469	29,855	33,875	39,599	35,074
Tax (expense) / Benefit	(9,585)	(9,098)	(10,162)	(11,879)	(10,522)
Net Income (Adjusted)	27,722	18,551	21,506	25,514	22,346
Average Fully Diluted Shares Outstanding	1,063	1,173	1,614	1,833	1,833

Key Cash Flow Statement Data

Net Income (Reported)	27,722	18,551	21,506	25,514	22,346
Depreciation & Amortization	7,793	24,565	26,326	27,397	28,484
Change in Working Capital	(3,080)	(28)	(1,400)	(1,058)	(5,071)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(691)	7,687	2,206	2,204	2,204
Cash Flow from Operations	31,745	50,775	48,639	54,057	47,963
Capital Expenditure	(21,524)	(166,540)	(49,240)	(86,096)	(108,826)
(Acquisition) / Disposal of Investments	1,144	(48,920)	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(20,381)	(215,460)	(49,240)	(86,096)	(108,826)
Shares Issue / (Repurchase)	58	183	606	0	0
Cost of Dividends Paid	(2,022)	(2,655)	(3,501)	(4,186)	(4,121)
Cash Flow from Financing	29,711	297,199	11,757	(4,186)	34,305
Free Cash Flow	10,220	(115,765)	(601)	(32,038)	(60,862)
Net Debt	(4,569)	223,175	162,952	199,175	264,159
Change in Net Debt	(19,830)	106,483	(60,224)	36,224	64,983

Key Balance Sheet Data

Property, Plant & Equipment	112,565	254,540	277,454	336,152	416,493
Other Non-Current Assets	0	175,420	175,420	175,420	175,420
Trade Receivables	NA	NA	NA	NA	NA
Cash & Equivalents	89,092	100,345	111,500	75,277	48,719
Other Current Assets	76,340	96,334	108,015	111,401	106,357
Total Assets	277,997	626,639	672,390	698,249	746,989
Long-Term Debt	84,523	323,520	274,452	274,452	312,878
Other Non-Current Liabilities	11,715	49,510	49,510	49,510	49,510
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	44,013	63,979	74,260	76,588	66,473
Total Liabilities	140,250	437,009	398,222	400,550	428,861
Total Equity	137,747	189,630	274,167	297,699	318,129
Total Equity & Liabilities	277,997	626,639	672,390	698,249	746,989

*iQmethod*SM - Bus Performance*

Return On Capital Employed	13.4%	7.3%	5.6%	5.9%	5.2%
Return On Equity	24.9%	12.3%	10.0%	9.6%	7.8%
Operating Margin	18.9%	7.0%	6.9%	7.3%	7.2%
EBITDA Margin	22.9%	11.1%	10.8%	11.3%	11.5%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	1.1x	2.7x	2.3x	2.1x	2.1x
Asset Replacement Ratio	2.8x	6.8x	1.9x	3.1x	3.8x
Tax Rate (Reported)	25.6%	30.5%	30.0%	30.0%	30.0%
Net Debt-to-Equity Ratio	-3.3%	117.7%	59.4%	66.9%	83.0%
Interest Cover	11.6x	2.3x	2.4x	2.8x	2.5x

Key Metrics

* For full definitions of *iQmethod*SM measures, see page 5.

Company Description

Hindalco is India's largest producer of aluminum and copper, promoted by Aditya Birla Group. It has an integrated capacity of 425,000 tons of aluminum that accounts for 37% of capacity in India. In copper, Hindalco operates a 500,000-ton smelter, which accounts for 60% of domestic capacity. It also owns two copper mines (capacity 110,000 tons) in Australia. Hindalco ranks as one of the lowest-cost producers of aluminum globally.

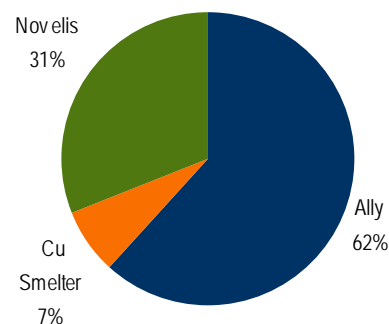
Investment Thesis

We remain positive on the aluminum outlook. We expect Chinese gov't's attempt to reduce power availability for aluminum smelters will support global aluminum prices in the near term. Also rising cost of production in China is likely to underpin aluminum prices. Hindalco ranks among the cheapest aluminum stocks globally. In addition, Hindalco is well positioned given its high integration and hence lower cost structure. Hence our Buy rating.

Stock Data

Price to Book Value 0.8x

Chart 1: Hindalco FY09E EBIT Mix



Source: Hindalco, Merrill Lynch Estimates

Revised Rights Issue terms

Hindalco has set the issue price for the proposed rights issue at Rs96 per share. It has also revised the ratio of rights issuance to three equity shares for seven equity shares instead of one share for three equity shares. We now expect issuance of 525.9mn shares on account of rights issue. This compares with our previous forecast of 409mn shares based on 1:3 rights issuance.

Table 1: Earnings Forecast: What's Changed?

	FY09E			FY10E		
	New	Old	% chg	New	Old	% chg
Sales	675,095	675,095	0%	696,253	696,253	0%
EBITDA	73,051	73,051	0%	78,456	78,456	0%
yoy change	10%	10%		7%	7%	
Depreciation	26326	26326	0%	27397	27397	0%
Interest	19410	19410	0%	18021	18021	0%
Other Income	6560	6560	0%	6560	6560	0%
PBT	33875	33875	0%	39597	39597	0%
Tax	10162	10162	0%	11879	11879	0%
Minority Interest	2206	2206	0%	2206	2206	0%
Share of profit of associates	159	159	0%	159	159	0%
Net Income	21,506	21,506	0%	25,512	25,512	0%
Weighted Avg diluted shares	1,614	1477	9%	1,833	1,716	7%
EPS	13.3	14.5	-8%	13.9	14.9	-6%
EPS Change (YoY)	-15%	-7%		4%	2%	

Source: Hindalco, Merrill Lynch Estimates

Price objective basis & risk

Hindalco (HNDFF)

Our PO of Rs168 is set at FY09 DCF valuation. At our PO, the stock would trade at 12.6x FY09 EPS and 12.1x FY10 EPS. Our DCF incorporates WACC of 11.1% and perpetuity growth of 0%. We assume aluminium prices of US\$2960/t in FY09E, US\$2949/t in FY10E and long term price of US\$2646/t. Downside risks to our PO: lower aluminum prices, further deterioration in Novelis performance due to US slowdown and inability to refinance the acquisition debt.

Analyst Certification

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	Bumi Resources	PBMRF	BUMI IJ	Daisy Suryo
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APR - Metals & Mining Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
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	Chalco	ALMMF	2600 HK	Alexander Latzer
	China Shenhua-H	CUAEF	1088 HK	Alexander Latzer
	JSW Steel	XJWJF	JSTL IN	Bhaskar.N.Basu,CFA
	Steel Authority	SLAUF	SAIL IN	Vandana Luthra
	Sterlite Industr	XTNDF	STLT IN	Vandana Luthra
	Sterlite Industries India Limited	SLT	SLT US	Vandana Luthra
UNDERPERFORM				
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	Angang	ANGGF	347 HK	Alexander Latzer
	Baosteel	BAOSF	600019 CH	Alexander Latzer
	China Steel	CISXF	CISXF US	Albert Hsu
	China Steel Corp	CISEF	2002 TT	Albert Hsu
	Dongkuk Steel	DKUSF	001230 KS	Chris Kim
	Maanshan I & S-H	MISCF	323 HK	Alexander Latzer
	Wuhan Steel	WHNIF	600005 CH	Alexander Latzer
	Yanzhou Coal	YZCHF	1171 HK	Alexander Latzer
	Yanzhou Coal -A	YZC	YZC US	Alexander Latzer
REVIEW				
	Guangzhou Ship	GSHIF	317 HK	Irene Ye

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Investment Rating Distribution: Non-Ferrous Metals/Mining & Minerals Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	71	52.99%	Buy	13	20.63%
Neutral	30	22.39%	Neutral	9	39.13%
Sell	33	24.63%	Sell	5	19.23%

Investment Rating Distribution: Global Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1664	47.42%	Buy	441	29.46%
Neutral	803	22.88%	Neutral	224	31.46%
Sell	1042	29.70%	Sell	217	22.84%

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