Usha Martin – BUY

CMP Rs81, Target Rs102

Sector: Metals & Mining	
Sensex:	17,750
CMP (Rs):	81
Target price (Rs):	102
Upside (%):	25.2
52 Week h/l (Rs):	107 / 38
Market cap (Rscr) :	2,482
6m Avg vol ('000Nos):	1,007
No of o/s shares (mn):	305
FV (Re):	1
Bloomberg code:	USM IB
Reuters code:	USBL.BO
BSE code:	517146
NSE code:	USHAMART

Closing price as on 22 Jun, 2010

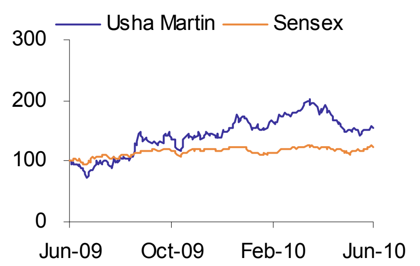
Shareholding pattern

March '10	(%)
Promoters	37.9
Institutions	58.0
Non promoter corp hold	3.8
Public & others	10.3

Performance rel. to sensex

(%)	1m	3m	1yr
Usha Martin	(2.8)	(16.2)	33.6
Godawari Power	(6.9)	(5.5)	78.4
Adhunik Metaliks	1.1	(12.6)	45.6
Prakash Industries	(13.5)	(32.1)	37.1

Share price trend



Usha Martin Ltd (UML) is well placed to reap the benefits of a massive capex undertaken over the last three years. Volumes are set to more than double over the next two years while increased raw material integration adds further value. Topline is expected to jump 55% yoy in FY11E and 25% in FY12E. With the increase in captive consumption of both metallic and raw materials, OPM for the company is set to increase 412bps yoy to 23.4% in FY11. UML trades at a P/E of 5.3x and EV/EBIDTA of 3.8x FY12E, which is at a huge discount to larger players. We recommend a BUY rating on Usha Martin for a target price of Rs102, an upside of 25%.

Volumes to double over the next two years

UML capex program of Rs21bn ends this year and will increase its crude steel making capacity by 2.5x and metallic capacity by 3x. Value-added products like wire ropes were the growth drivers for UML's topline in the past. This is set to change on account of the European crisis. We see volume growth coming from commodity steel products like rods and rolled products. While wire division sales volume are set to witness a CAGR of 14.7%, steel division would witness a CAGR of 85.7% over the next two years. Overall sales volume in FY11 is expected to increase 75.5% yoy and we see a further increase of 30.8% yoy in FY12E.

Dependence on external metallic sources to reduce sharply

UML commissioned its 0.2mtpa DRI in December 2009 and has been running at 95% utilization over the last three months. Pig iron production too has increased with the mini-blast furnace becoming operational after the refractory realignment in Q4 FY10. The new 0.4mtpa MBF will be commissioned by July '10. We believe the captive metallic production would be enough to meet UML's internal requirement and lead to a sharp reduction in external purchases.

Increase in captive resources to boost earnings

UML was able to meet its full iron ore requirement in FY10 and thermal coal requirement for the DRI over the last one quarter from its mines in Jharkhand. On account of the increase in captive resources, we expect OPM to expand 400bps yoy to 23.3% in FY11. The volume growth coupled with a rise in raw material integration will lead to earnings CAGR of 68.1% over the period FY10-12E.

Valuation summary

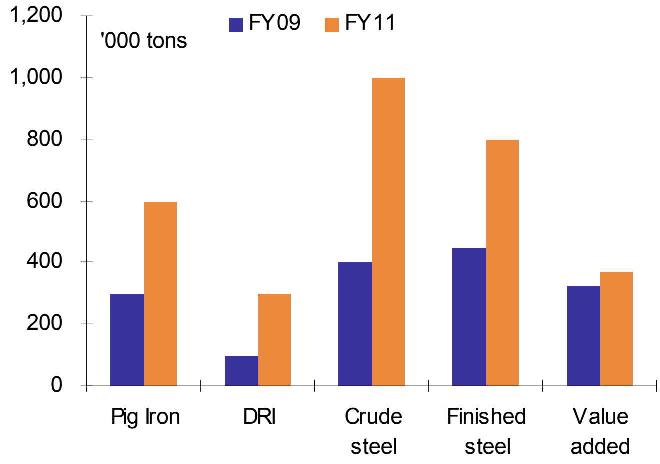
Y/e 31 Mar (Rs m)	FY09	FY10E	FY11E	FY12E
Revenues	29,498	25,344	35,640	43,484
yoy growth (%)	27.8	(14.1)	40.6	22.0
Operating profit	5,137	4,895	8,310	10,598
OPM (%)	17.4	19.3	23.3	24.4
Pre-exceptional PAT	1,853	1,686	3,324	4,762
Reported PAT	1,853	1,686	3,324	4,762
yoy growth (%)	5.7	(9.0)	97.1	43.3
EPS (Rs)	7.4	5.5	10.9	15.6
P/E (x)	11.1	14.9	7.5	5.3
Price/Book (x)	1.8	1.4	1.2	1.0
EV/EBITDA (x)	7.0	7.5	4.8	3.8
Debt/Equity (x)	1.4	0.7	0.7	0.6
RoE (%)	17.6	11.7	17.6	21.1
RoCE (%)	16.2	12.0	18.9	21.9

Source: Company, India Infoline Research

21bn capex to conclude in this year

Usha Martin's massive capex program of Rs21bn would conclude this quarter. Over the last three years, the company has managed to increase both its steel making and metallic capacity. Steel making capacity has increased by 2.5x, from 0.4mtpa in FY09 to 1mtpa with the commissioning of the 0.6mtpa SMS mill in Q3 FY10. On the metallic feed front, both the 0.1mtpa DRI plants are operational at 95% utilization. The company has guided that the production capacity will be increased from 0.3mtpa to 0.4mtpa, once the sinter and pellet plants get operational in Q2 FY11. The new mini-blast furnace (MBF) with a capacity of 0.4mtpa is expected to start trial production in July '10 and would start commercial production by August '10. The sinter plant with a capacity of 0.8mn tons is expected to be commissioned in Q3 FY11. On the finishing side, the company is increasing its capacity from 0.4mtpa to 0.8mtpa through a blooming mill of 0.25mtpa capacity and by raising the existing wire rod capacity to 0.4mtpa.

Capacity expansion plan



Source: Company, India Infoline Research

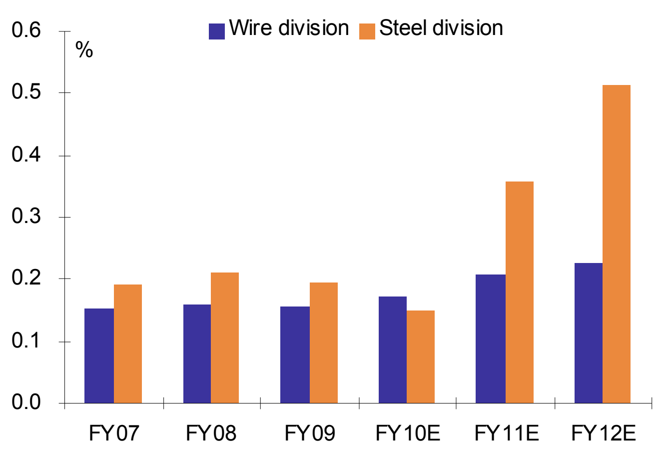
For value-added products, the company is mainly expanding its wires & wire rope and bright bar capacities. It has increased its wire, strands and wire rope capacity to 0.4mtpa. Bright Bar capacity would be expanded from 18,000tpa to 30,000tpa at Ranchi and a new plant with a capacity of 30,000tpa would be built at Chennai. It is also raising its OT wire capacity from 3,600tpa to 6,000tpa and the cord wire capacity from 2,400tpa to 4,800tpa.

To meet the increase in demand from the wire rod division and also to take advantage of the two new DRI kilns, UML is raising its power generation capacity from 73.3MW to 93.3MW. It is also raising its thermal captive power plant capacity by 20MW at Ranchi.

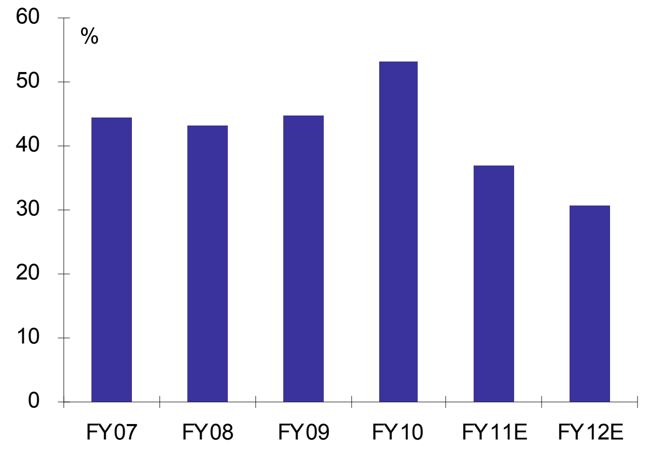
Volumes to surge 129% over the next two years

In FY10, UML's sales volume declined 9% on account of the slowdown in the European region and lower demand for steel in H1 FY10. European region has been a major export destination for UML over the last few years. We believe that sales to Europe will remain subdued over the next two years and hence most of the growth in volumes will be led by the strong domestic consumption. We expect growth in sales of value-added products like wire ropes and strands to remain flat in the export market. On the other hand, in the domestic market, demand for wire and wire ropes are expected to pick up on account of the increase in spending in mining, oil exploration and rise in demand for engineering equipment sales. With the commissioning of the blooming mill and the increase in capacity of wire rods, we expect sales growth to be led by the steel division in FY11 and FY12. The domestic consumption for long products is expected to remain strong on account of the huge infrastructure spending to be witnessed over the next few years. Also, the buoyancy in the domestic automobile and auto ancillary sector will lead to a higher demand for wire rods and straight bars.

Volume growth to be led by steel division



Share of VAP to decrease sharply in FY11E



Source: Company, India Infoline Research

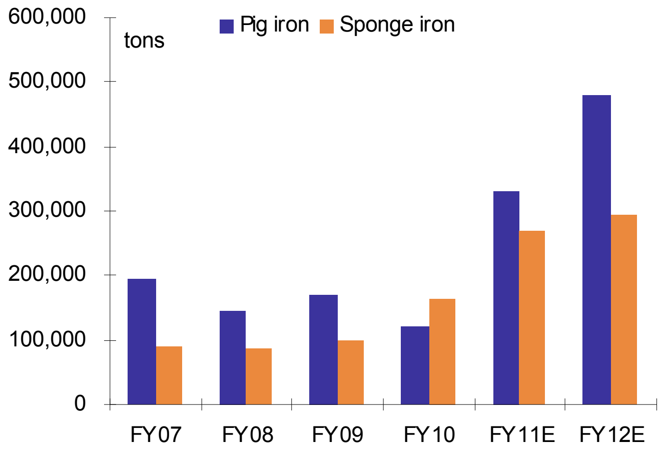
We expect wire division sales volume to witness a CAGR of 14.7% to 0.2mn tons and steel division volumes to witness a CAGR of 85.7% to 0.51mn tons in FY12. Total sales volume in FY11 is expected to be 0.56mn tons, an increase of 75.5% yoy and a further increase of 30.8% yoy to 0.74mn tons.

Dependence on external metallic and scrap to reduce

In the past, UML's steel making capacity has been higher than its metallic capacity. On account of this, the company had to buy metallic or scrap from outside at a much higher rate than its cost of production. Raw material costs for the company in Q4 FY10 jumped sharply on a qoq basis as it had to consume high cost metallic. The mini blast furnace during the quarter was shutdown for maintenance and as a result the hot metal supply declined 50%. UML in FY10 had bought ~120,000 tons of external scrap and metallic. Raw material costs as a percentage of sales rose sharply from 32.1% in Q3 FY10 to 44.5% in Q4 FY10 even though its captive coal mine was operational and sponge iron plant production was higher on a qoq basis.

Over the last two months, UML has been able to meet its metallic requirement through its internal facilities. The new sponge iron facilities, which were commissioned in Q3 FY10, are operating at 90-95% capacity utilization rates in Q1 FY11 and the mini-blast furnace, which had a maintenance shutdown in Q4 FY10, has been ramped up in Q1 FY11. With the complete raw material integration in place for thermal coal and iron ore requirement for the sponge iron plant, we believe that the proportion of sponge iron in the feed to the Electric Arc Furnace (EAF) will increase. In addition, the mini-blast furnace consumes coking coal, wherein prices are expected to remain high globally. As a result of the high coking coal prices, we expect that external purchase of scrap and metallic to reduce during the next two years.

Metallic volumes to surge in FY11



Source: India Infoline Research

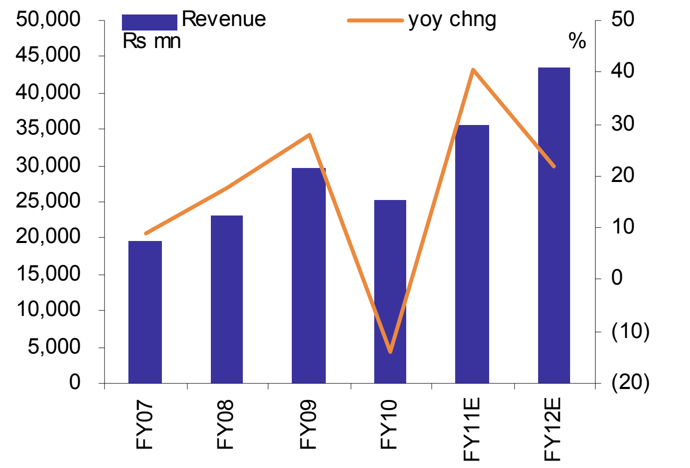
Volume growth to lead to topline CAGR of 33.1% over FY-12E

Steel prices globally have declined sharply over the past one month. Concerns over demand from the European region and expectations of demand growth to slowdown in China on account of the rate tightening measures have led to the slide in prices. HRC export prices from China and CIS countries have been trading at sub-US$600/ton level. We believe that steel prices will gain from the current levels as prices of raw material and coking coal have not declined significantly along with the slide in steel prices. We expect the Chinese government's plan to reduce the export rebates on various steel products and the revaluation of the Yuan against the Dollar will lead to an increase in steel prices. We expect HRC prices to average US$650/ton in FY11 from US$515/ton in FY10.

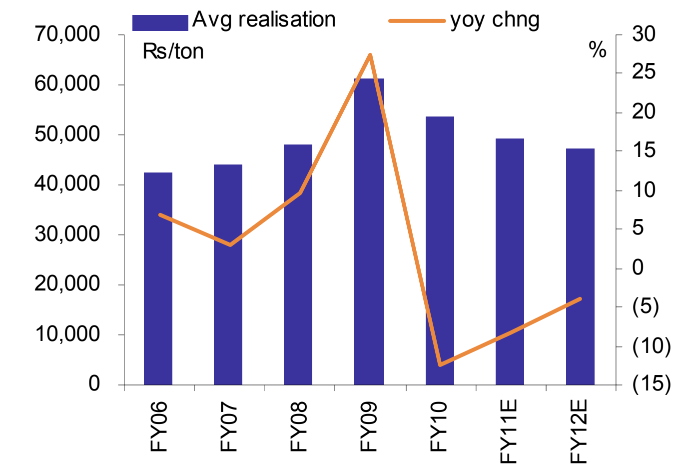
For UML, we do not foresee any significant increase in prices of wire ropes and bright bars as demand in global markets remains weak. However, for the steel products, we expect prices to increase ~10% yoy. Since the growth in volumes over the next two years will be led by steel products, average realisations for the company is expected to decline on a yoy basis. We expect average realisations to decline by 8% yoy to Rs49,154/ton in FY11 and a further 4% yoy decline in FY12 to Rs47,245/ton.

We expect UML's standalone topline to jump 55% yoy to Rs28.9bn on account of the 75.5% yoy jump in volume in FY11. In FY12, we expect topline to increase by 25% yoy to Rs36.2bn due to the 30.8% increase in volume.

Revenue to jump 40% yoy in FY11



... Despite a 3% yoy decline in realisations



Source: Company, India Infoline Research

Captive coal mine to increase raw material integration

UML has been able to meet its complete iron ore requirement through its captive mines since H2 FY09. The company was allotted the iron ore mine named Vijay II in the Barajamada District of Jharkhand and it has been operational since October ' 05. The mine is just ~160kms away from the plant and has an estimated reserve of 80-100mn tons with high grade deposits of 62-64% Fe content. The discovered reserves are sufficient to meet ~50 years of UML's requirement at the expanded capacity. The company has all the facilities in place at the mine and uses railway sliding to transport the ore from the mine to the plant. The landed cost of iron ore at the plant would be ~1,100/ton. UML has received approval to raise its output to 2.5mtpa, of which it was able to extract 1.3mn tons in FY10 from 0.65mn tons in FY09.

After meeting its captive requirement, the company managed to sell 0.6mn tons of iron ore fines in FY10 and generated revenue of Rs950mn from sales of iron ore fines. However, the management has indicated that it will no longer sell iron ore in H1 FY11 and will build up inventory before the commissioning of the new pellet plant. We have not factored in any iron ore sales over the next two years as we believe that the management will be focused on its core area of steel making.

UML has been allotted a coal mine situated at Daltenganj in Jharkhand. The coal mine has an estimated reserve of 40mn tons and is located 250km away from the plant. Majority of the deposits at the mine are A, B and C grades having calorific value of ~6,500 Kcal/kg. These mines were supposed to be operational in FY09 itself, but got delayed on account of problems related to local rehabilitation. The management was able to restart mining by Q4 FY10 and has been able to extract ~40,000-45,000 tons of coal from this mine over the last three months. The current coal production will be able to meet 100% coal requirement for the sponge iron plant through its captive mines. We expect the complete coal requirement for the sponge iron plant (DRI) to be met through captive resources over the next two years.

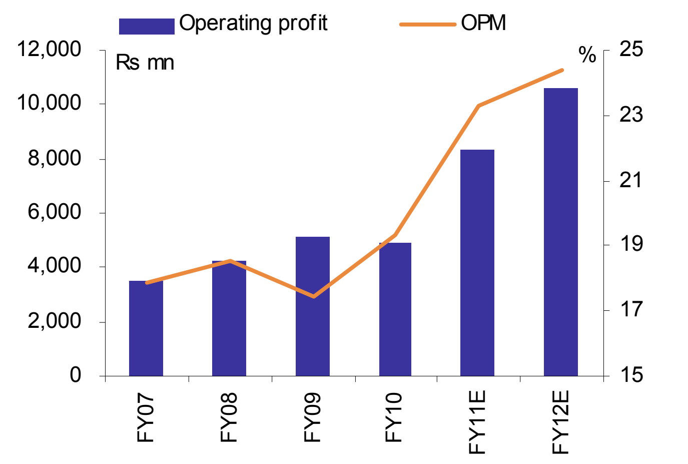
Operating margin to expand despite lower realisations

In FY10, UML managed to increase its OPM by 190bps yoy to 19.3% even though its performance was hampered by the shutdown of blast furnace in Q4 FY10 and prices of wire ropes remained largely flat on a qoq basis. During Q4 FY10, OPM declined 379bps qoq to 18.5% from 22.3% in Q3 FY10 on account of a jump in raw material costs. With the company consuming metaliks from external sources, raw material costs as a % of sales increased by 1,239bps qoq to 44.5% in Q4 FY10. This was on account of the maintenance shutdown in the company's mini-blast furnace.

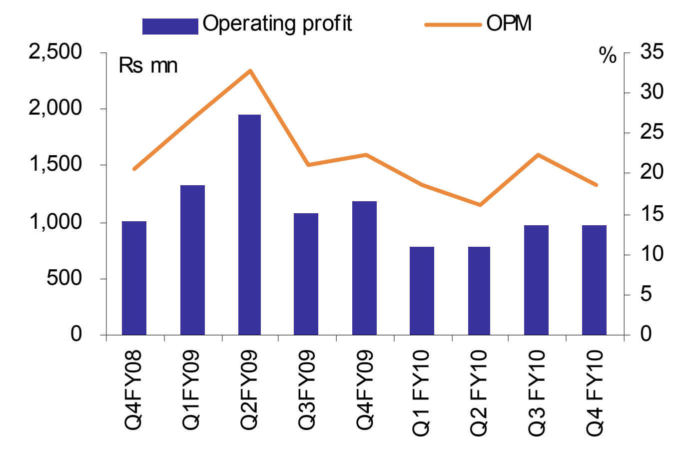
However, in FY11 we believe that the company will not largely purchase metallic and scrap as its capacity will be enough to meet its internal requirement. The thermal coal mine has been able to meet the company's coal requirement for the DRI over the last three months. We expect this to continue and see huge cost savings as the landed cost of thermal coal to its plant is ~1,400/ton against the Rs4,000/ton it had paid in Q4 FY10. Realisations for most of the products except wire ropes is expected to increase on a yoy basis and will be higher than the increase in coking coal prices. The company's performance in FY11 will be impacted on account of the jump in coking coal prices. Coking coal contract prices for Q1 FY11 were agreed at US$200/ton, up from US$128/ton in FY10. We expect coking coal prices to be US$220/ton for FY11 and see it increasing 5% yoy in FY12.

On account of the rise in integration, on both metallic and raw material, OPM for the company is expected to increase 412bps qoq to 23.4% in FY11. We expect steel prices to stay flat on a yoy basis in FY12 and on the other hand expect raw material prices to rise marginally by 5-10%. We expect OPM to increase 110bps yoy in FY12 due to higher capacity utilization rates.

OPM to expand in FY10E & FY11E



Quarterly OPM trend



Source: Company, India Infoline Research

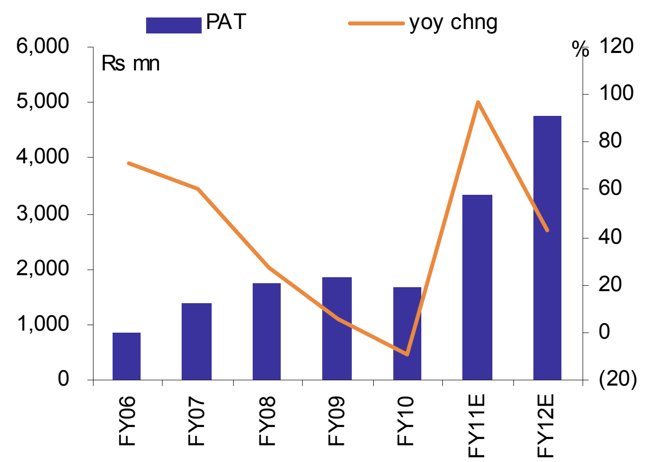
Time to reap benefits, earnings CAGR of 68% over FY10-12E

UML is well placed to reap the benefits of a massive capex undertaken over the last three years. Volumes are set to more than double over the next two years while improvement in raw material integration would add further value.

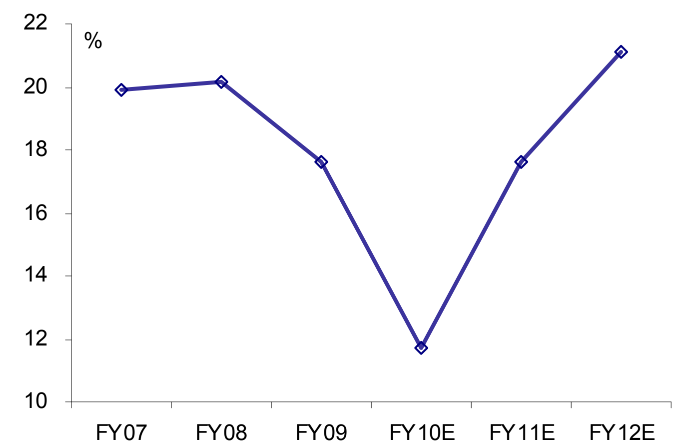
We expect UML to witness a volume growth of 75.5% yoy to 0.56mn tons in FY11 and a further 30.8% yoy to 0.73mn tons in FY12. With steady steel prices globally, we expect topline to jump 55% yoy to Rs28.9bn in FY11 and thereafter 25% yoy to Rs36.2bn in FY12. With the increase in captive consumption of both metallic and raw materials like iron ore and thermal coal, OPM for the company is expected to increase 412bps yoy to 23.4% in FY11. The company's balance sheet is set to improve following the successful QIP issue in FY10 and the steady cash flows expected over the next two years. Debt/Equity ratio is expected to remain flat at 0.7x as the company has announced a further capex of Rs12bn over the next three years.

At the CMP of Rs81, the stock trades at a P/E of 5.3x and an EV/EBIDTA of 3.8x FY12E, which is at a huge discount to the larger players. We believe that the valuation gap will reduce and recommend a BUY rating on Usha Martin for a target price of Rs102, an upside of 25%.

Earnings to jump 97% yoy in FY11E



RoE to improve sharply over FY10-12E



Source: Company, India Infoline Research

Financials

Income statement

Y/e 31 Mar (Rs m)	FY09	FY10	FY11E	FY12E
Revenue	29,498	25,344	35,640	43,484
Operating profit	**5,137**	**4,895**	**8,310**	**10,598**
Depreciation	(1,086)	(1,295)	(1,908)	(1,993)
Interest expense	(1,422)	(1,255)	(1,534)	(1,630)
Other income	176	55	62	71
Profit before tax	**2,806**	**2,401**	**4,930**	**7,046**
Taxes	(922)	(685)	(1,578)	(2,255)
Minorities and other	(30)	(29)	(29)	(29)
Net profit	**1,853**	**1,686**	**3,324**	**4,762**

Balance sheet

Y/e 31 Mar (Rs m)	FY09	FY10E	FY11E	FY12E
Equity capital	250	305	305	305
Reserves	11,105	17,065	20,031	24,435
Net worth	**11,355**	**17,371**	**20,336**	**24,740**
Minority interest	168	168	168	168
Debt	16,713	12,315	15,053	15,997
Def tax liab (net)	1,306	1,449	1,449	1,449
Total liabilities	**29,541**	**31,302**	**37,006**	**42,354**
Fixed assets	26,232	30,101	32,593	35,600
Investments	4	4	4	4
Net working capital	**2,217**	**718**	**4,090**	**5,969**
Inventories	6,513	6,524	8,781	10,713
Sundry debtors	4,264	3,663	5,151	6,285
Other current assets	3,118	2,697	3,686	4,438
Sundry creditors	(10,875)	(11,354)	(12,492)	(14,253)
Other current liab	(802)	(813)	(1,035)	(1,215)
Cash	1,088	480	319	782
Total assets	**29,541**	**31,302**	**37,006**	**42,354**

Cash flow statement

Y/e 31 Mar (Rs m)	FY09	FY10E	FY11E	FY12E
Profit before tax	2,806	2,401	4,930	7,046
Depreciation	1,086	1,295	1,908	1,993
Tax paid	(922)	(685)	(1,578)	(2,255)
Working capital ∆	2,350	1,499	(3,373)	(1,878)
Operating cashflow	5,320	4,509	1,888	4,906
Capital expenditure	(9,909)	(5,163)	(4,400)	(5,000)
Free cash flow	**(4,589)**	**(654)**	**(2,512)**	**(94)**
Equity raised	122	4,687	-	-
Debt financing/disposal	5,338	(4,398)	2,738	943
Dividends paid	(294)	(358)	(358)	(358)
Other items	(211)	114	(29)	(29)
Net ∆ in cash	**367**	**(608)**	**(161)**	**463**
Profit before tax	2,806	2,401	4,930	7,046

Key ratios

Y/e 31 Mar	FY09	FY10E	FY11E	FY12E
Growth matrix (%)				
Revenue growth	27.8	(14.1)	40.6	22.0
Op profit growth	20.1	(4.7)	69.8	27.5
EBIT growth	21.7	(13.5)	76.8	34.2
Net profit growth	5.7	(9.0)	97.1	43.3
Profitability ratios (%)				
OPM	17.4	19.3	23.3	24.4
EBIT margin	14.3	14.4	18.1	20.0
Net profit margin	6.3	6.7	9.3	11.0
RoCE	16.2	12.0	18.9	21.9
RoNW	17.6	11.7	17.6	21.1
RoA	5.0	4.0	7.1	8.8
Per share ratios				
EPS	7.4	5.5	10.9	15.6
Dividend per share	1.0	1.0	1.0	1.0
Cash EPS	11.7	9.8	17.1	22.1
BVPS	45.4	56.9	66.6	81.0
Valuation ratios (x)				
P/E	11.1	14.9	7.5	5.3
P/CEPS	7.0	8.4	4.8	3.7
P/B	1.8	1.4	1.2	1.0
EV/EBIDTA	7.0	7.5	4.8	3.8
Payout (%)				
Dividend payout	15.9	21.2	10.8	7.5
Tax payout	32.9	28.5	32.0	32.0
Liquidity ratios				
Debtor days	53	53	53	53
Inventory days	81	94	90	90
Creditor days	135	164	128	120
Leverage ratios				
Interest coverage	3.0	2.9	4.2	5.3
Net debt / equity	1.4	0.7	0.7	0.6
Net debt / op. profit	3.0	2.4	1.8	1.4

Du-Pont Analysis

Y/e 31 Mar	FY09	FY10E	FY11E	FY12E
Tax burden (x)	0.7	0.7	0.7	0.7
Interest burden (x)	0.7	0.7	0.8	0.8
EBIT margin (x)	0.1	0.1	0.2	0.2
Asset turnover (x)	0.8	0.6	0.8	0.8
Financial leverage (x)	3.5	2.9	2.5	2.4
RoE (%)	**17.6**	**11.7**	**17.6**	**21.1**

Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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