Initiating Coverage August 27, 2008

MF Global

Private Client Group

Mercator Lines

BUY

CMP : Rs.80 **Target Price: Rs.130**

Mercator Lines (MLL) is the second largest private sector shipping company in India, in terms of aggregate tonnage capacity, which has risen exponentially from 3500 dwt in 1993 to nearly 3 mn dwt in 2008. MLL is on an aggressive fleet expansion spree through both owned and chartered route that will raise aggregate tonnage capacities substantially over the next couple of years. The company has diversified into dredging, offshore and coal-mining business, which we believe is a strategic fit, de-risking the business model going forward. We recommend a Buy on MLL because of its strong cash flows, increase in profitability and attractive valuations. With accelerated revenue growth of 26% over the next two years, due to the additions of new vessels and increased charter rates, we expect MLL to almost double the turnover from Rs.112.3 mn in FY07 to Rs.230.5 mn in FY10E. We initiate coverage on the stock with one-year price target of Rs.130.

Key highlights

Minimizing earning volatility – MLL employs nearly 70% of its shipping fleet in long-term time charter contracts at fixed rates, which will help reduce its earning volatility. The remaining 30% of the fleet has been deployed in the spot market to capitalize on the ruling high spot rates. The management plans to continue this ratio of 70:30 even in FY09 and FY10, as sustainability of earnings is of prior importance. Further fleet additions coming in at right time to add further momentum to its revenue growth. MLL has ordered for 1 jack up rig, 1 new VLCC, 2 dredgers and 2 new carriers which would add an incremental Rs.5.1 bn in FY10E revenues.

Contract renewals for the existing fleet at higher rates – We believe that carrier freight rates will firm up by 10-15% in 2008-09 on the back of the increase in global demand for oil, coal and iron ore largely from non-OECD nations such as India and China. This is beneficial for MLL, as not only it will benefit from higher day rates for its existing fleet but also for new additions.

De-risking of business model – The management has sought to further de-risk its possible earnings from the shipping cycle by entering into areas such as dredging, offshore and coal mining, where the earnings are much more predictable and where the margins are lucrative. It has also recently acquired two mines, one each in Indonesia and Mozambique, which would serve dual purpose i.e., revenues from coal business and secured business for its bulk carriers.

Valuations

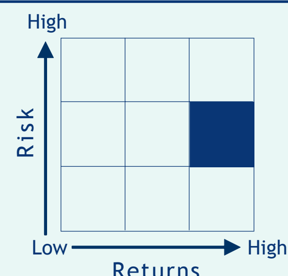
We expect MLL to scale up both its revenue and profits due to firming up of charter rates, substantial fleet additions and foray into dredging, offshore businesses and coal mining business. The prices of coal have gone by nearly 100% in the last one year, which would further boost its profits significantly. At the CMP of Rs.80, it discounts FY09E EPS of Rs.18.4 by 4.4x and FY10E EPS of Rs.27.8x by 2.9x. It trades at 88% discount to its NAV of Rs.150. We believe FY09 and FY10 will be the growth drivers for MLL. Therefore, we initiate coverage with a **BUY** on Mercator with a target price of Rs.130, which discounts average of one year forward earnings of Rs.23.1 by 5.6x.

Valuation summary

Y/E, 31st March	FY07	FY08	FY09E	FY10E
Revenues (Rs. mn)	11,228	14,549	17,379	23,842
Adj PAT (Rs. mn)	1,309	3,676	4,312	7,316
Adj EPS (Rs.)	7.0	16.9	18.4	27.8
EPS growth (%)	–	143.0	8.5	51.3
P/E (x)	11.5	4.7	4.4	2.9
Dividend yield (%)	2.5	1.4	0.6	0.6
RoCE (%)	24.6	18.5	20.3	28.7
RoNW (%)	42.9	33.3	21.7	27.9
P/BV (x)	2.4	1.1	0.9	0.7
EV/EBITDA (x)	10.8	6.8	4.5	2.7
EV/sales (x)	2.9	2.7	2.0	1.3

Source: Company, MF Global PCG Research

Risk Return Matrix



Indices

Sensex	14,482
Nifty	4,338

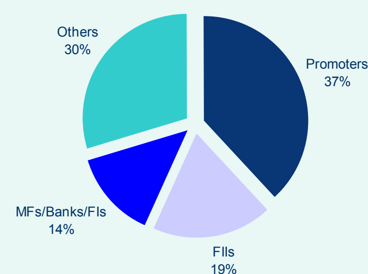
Stock Data

BSE Code	526235
NSE Code	MLL
Bloomberg	MRLN@IN
Reuters	MRCT.BO
Industry	Engineering
Shares Issued (mn)	236
Market Cap (Rs mn)	18,880
52 Wk H/L (Rs)	185/51
Face Value (Rs)	1
Avg. daily vol. (12-mths)	1,459,848

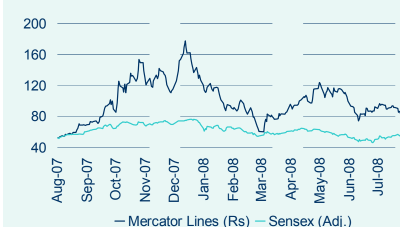
Absolute Returns (%)

	1 m	3 m	12 m
Absolute	(14.6)	(35.0)	52.5
Rel. to Sensex	(16.7)	(20.2)	51.4

Shareholding Pattern



Mercator Lines Vs Sensex (Adj)



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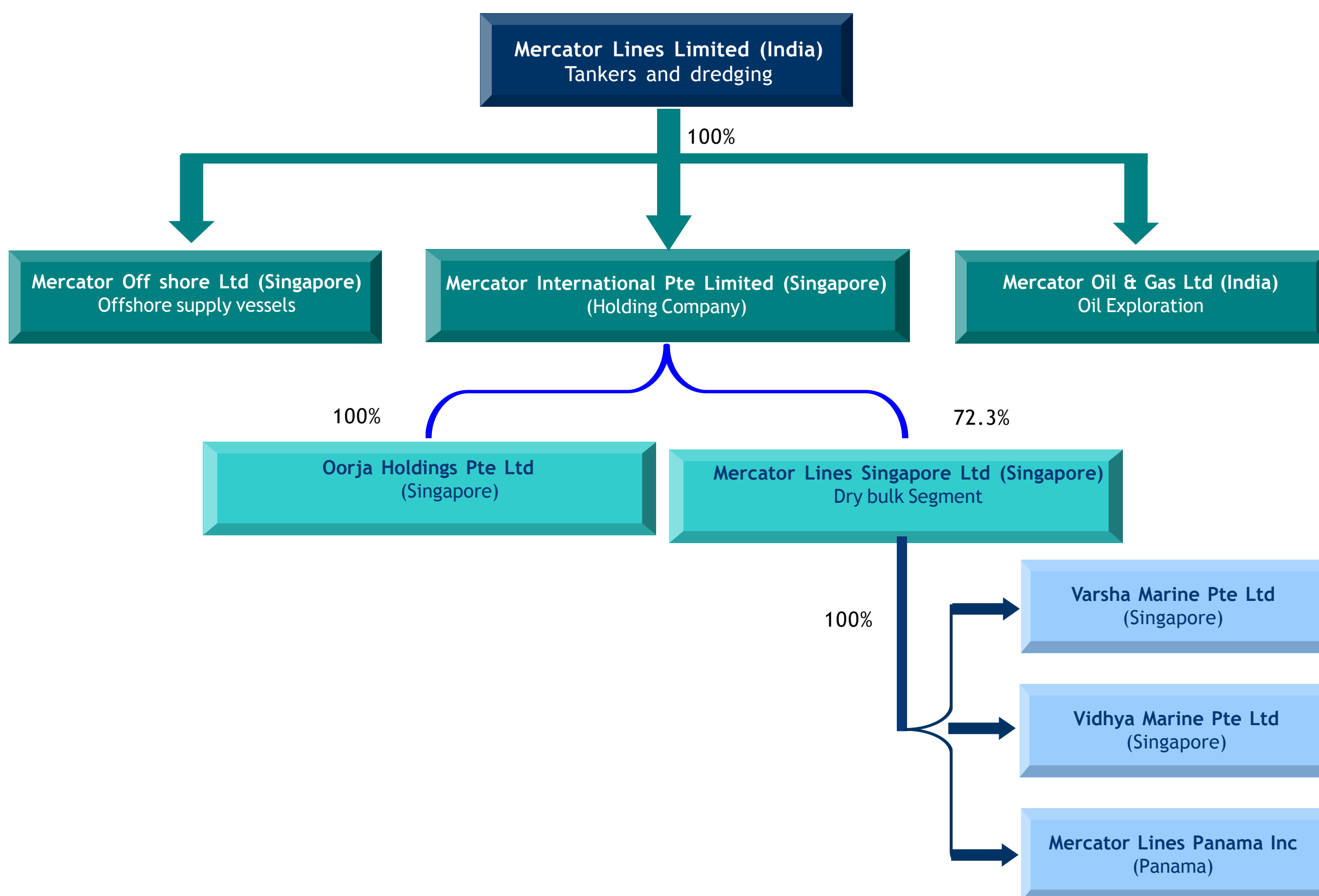
Company background

Mercator Lines (MLL), was incorporated in 1983 as a private limited company, it was converted into a public limited company in 1984. The present promoters of the company, Mr. H K Mittal and Mr. Atul Agarwal, took over the company's reins in 1988, making it one of the fastest growing shipping companies. Over the years, MLL has transformed itself from being a mere wet and dry bulk cargo shipping company into a complete logistics solutions provider. MLL has also recently forayed into dredging, offshore businesses and coal mining business through the acquisition of coalmines in Indonesia and Mozambique.

Holding structure



Source: Company

Investment rationale

Fastest growing shipping company – MLL, over the years, has transformed itself from a bulk cargo shipping company into a complete logistics solution provider and has also emerged as the fastest growing shipping company by expanding aggregate tonnage capacity exponentially, from a meager 3500 dwt in 1993 to over 3 mn dwt in 2008. MLL is on an aggressive fleet expansion spree through both owned and chartered assets that will further raise aggregate tonnage capacities substantially over the next couple of years.

Expanded aggregate tonnage capacity exponentially, from a meager 3500 dwt in 1993 to over 3 mn dwt in 2008

Contract renewals for fleet at higher rates – MLL currently employs nearly 70% of its fleet on time charter contracts at fixed rates and has successfully negotiated with large clients like Tata Power & Arcelor Mittal (an upward revision of 10-15%) for higher fixed rates for next 2 years. Firming up of bulk freight rates in 2008 and

Company to benefit from increased charter rates across all vessels

its significant fleet expansion program (at a capex of over Rs.10 bn) over the next 2 years will help the company to scale up both its revenue and profits going forward. The remaining 30% of its fleet is deployed in the spot market to take advantage of prevailing high spot market rates. The company plans to maintain the same ratio going forward, which would give more revenue visibility especially at the time when it is embarking on a major fleet expansion program. This strategy will also help in case of the correction in the Baltic freight index as its maximum assets would be locked in at fixed price contracts, which are 15-20% lower than the spot prices.

Demand for vessels to remain buoyant – We expect shipping companies to boost healthy cash flows due to:

The current scenario of economic slow down is only a blip and would not be a dampner

- Tanker demand is seen strong on soaring oil prices & expansion of refinery capacities. Nearly 10-mbpd capacities of refineries is expected to come up in Asia of which half being in India, would result in greater inflow and outflow of petroleum products, thereby boosting the demand for crude tankers. Nearly half of the world's energy requirement is met through oil, and the International Energy Agency (IEA) forecasts global oil demand to go up.

Single hull vessels to be phased out

- Further we believe that supply of assets to remain tight due to the pressure from the International Maritime Organization's (IMO) for phasing out single-hull tankers by 2010. The present shipyards being full with orders, the delivery schedules have a waiting period of about 2-years for a new vessel.

Huge capacities of steel production set-up in India and China have increased the ton-mile demand

- Bulk cargo includes iron ore, steel, grain, coal, agricultural products, cement, forest products, scrap etc. Nearly 63% of the dry bulk trade comprises of iron ore and coal. With the increase in demand for power and steel huge capacities have been set up by the Asian countries especially India and China, who have been major importers of iron ore and coal. This would increase the ton-mile demand for the bulk carriers significantly in the coming years.

Other streams of revenue to directly add to the bottomline

Diversified into new business streams – MLL has forayed into dredging, offshore businesses and coal mining business all of which hold robust outlook at present. By doing this MLL will de-risk its earnings volatility. It has presently forayed into:

Going by estimates India would require Rs.70 bn expenditure on ports to handle traffic, which throws open huge oppotunity for dredging segment

- **Dredging –** Dredging mainly comprises of maintenance of channel depth (maintenance dredging) and during construction of new ports (capital dredging). India has around 18 major ports and 30 non-major and private ports situated along its long coastline of over 7,500 km. The government's National Maritime Development Programme (NMDP) report suggests that the total volume of traffic handled by all the Indian ports will double by 2013-14 and the expenditure required for this would be over Rs.70 bn. If dredging takes in 10% of the cost to develop the ports, it throws open a Rs.7 bn opportunity for this sector and there are not enough dredgers to explore this opportunity. Secondly the day rates for dredgers have gone up 25% due to demand supply mismatch. MLL India already owns three dredgers that are employed with the Dredging Corporation of India. It took possession of a fourth dredger recently, and this dredger has already been contracted. In the next 2 years, the company plans to further increase the number of dredgers. The daily charter rate for dredgers is $25,000-30,000 per day, while the operating cost is $7,000-8,000 per day, giving dredger margins of $18,000-23,000 per day. We believe that the dredging business will be a major revenue driver for the company in the next few years. These new businesses will de-risk the company's earnings from the cyclicality associated with shipping freight revenues.

Agencies estimates that $3.6trillion would be required for oil & gas exploration

- **Offshore Business –** With crude oil prices hitting new highs, low global inventories of oil and lack of new major discoveries in the last few years, there has been a dramatic increase in exploration and production activity by

the oil and gas industry. With depleting oil reserves world over, this momentum is expected to gather further steam in the years ahead. But globally fleet supply for offshore assets mainly Rigs, AHTSVs, PSVs, MSVs, DSVs etc have not kept pace with demand. Further, nearly 50% of the total supply vessels are estimated to be around 20 years old. In India, the government under NELP VII has offered nearly 57 blocks for exploration, nearly half of which are offshore projects. This opens up a huge market for exploratory drilling in the country.

We believe that the offshore supply market offers tremendous potential over the next few years in terms of demand for rigs, AHTSV, PSV and other support vessels. Offshore vessels day rates have remained firm in both 2006 and 2007 and are expected to remain robust over the next few years. In the offshore business, MLL is building a 350 feet jack-up rig at Keppel Fels, Singapore. The rig, whose cost is estimated at over $200 million and is expected to be delivered to the group's Singapore subsidiary, Mercator Offshore, in March 2009. The rig has already been reportedly contracted for 3 years at a charter rate of $95,000 per day. In the spot market, rig charter rates are as high as $150,000 per day. Rig operating costs are estimated at $30,000-35,000 per day and would give operating margins of approximately 60%. MLL is also contemplating acquiring second hand offshore vessels, which offers it value for money.

Hightened activity of exploration has led to a shortage of supply vessels

- **Coal Mining –** With Indian wanting to expand its power generation capacity and crude oil prices shooting through the roof over the last few years, coal has become a precious commodity. India and China are emerging as major coal importers to meet their power requirements. India is expected to add nearly 40,000-45,000 MW of coal-fired power generation capacity by 2012. MLL, by acquiring a coalmine in Indonesia and Mozambique, has the potential to get twin benefits firstly from revenues from sale of coal in the domestic market & International market and secondly by securing its assets for the trans-shipment of the coal production through its own ships. MLL has 50% stake in both the mines at Indonesia and Mozambique. This is a form of backward integration for the company. The Indonesian mine has reserves of 15 mn ton and Mozambique which is under prospecting could have a potential reserves of 3 bn. This mining asset could prove to be a significant investment, if the estimated reserves turn to be realistic. Mining in Indonesia has already commenced in the month of August.

With rise in oil prices, coal has become a precious commodity

On asset based valuation the per share price is higher then the current market price – We have arrived at Rs.150 per share on asset valuation basis. MLL has 28 vessels with aggregate market value of Rs.352.6 bn, which translate into Rs.150 per share, which is 87% higher than the current market price.

NAV of existing fleet stands at Rs.150 per share

Present fleet size and expansion – At present the company has a total fleet size of 28 vessels, comprising 9 owned and 2-chartered tankers, 10 owned and 3-chartered dry bulk carriers and 4 dredgers. The group's tanker and dredging business are enlisted under MLL India, the Singapore subsidiary focuses on the dry bulk carrier segment. The average age of the company's dry bulk fleet is 3, making it one of the youngest globally. It also has ambitious fleet expansion program on the anvil with an outlined capex of over Rs.2 bn in the next two years across various business segments. MLL Singapore is acquiring a very large crude carrier (VLCC) and two dry bulk carriers in FY09. It is also acquiring one new tanker. The VLCC is expected to be delivered in first quarter of FY09 while the bulk carriers and tankers are expected in the subsequent quarter. MLL is building a 350 feet jack-up rig at Keppel Fels, Singapore. The rig, whose cost is estimated at over $200 million and is expected to be delivered to the group's Singapore subsidiary, Mercator Offshore, in March 2009.

New vessels to bring in additional revenues and lower down average fleet age

Financials

The company reported net profit of Rs.4 bn on sales of Rs.14.5 bn in FY08. The net profit was up due to an increase in the other income (due to forex gains and treasury income). In Q1 FY09 the revenue was up 83% YoY at Rs.4,929 mn as compared to Rs.2,698 mn last year due to increased charter rates. But however the operating expense was up 115.6% at Rs.2,867.4 mn as the company had incurred dry-docking expenses. Net profit was up by only 8% at Rs.759 mn as the company had to report forex loss (non cash transaction) as per AS-11 norms. In FY09E we expect the company to report sales of Rs.17.1 bn and net profit of Rs.4.2 bn. There would be an improvement in the margins going forward due to new vessels getting deployed at higher charter rates with the fixed expenses remaining the same. We expect operating profit margin to improve to around 45% in FY09 from current levels of 40% in FY08. Given the robust demand and the capex undertaken by the company to expand its base, we expect MLL to grow at CAGR of 26% in revenues by FY10E to Rs.23 bn. During the same period we expect the OPM to improve by 700 bps. Net profit is expected to grow at CAGR of 37% by FY10E. We expect the momentum to continue with the addition of new vessels by FY10E and thus revenues will continue to grow.

The net profit was subdued due to dry-docking expense incurred by the company

(Rs. Mn)	Q1 FY09	Q1 FY08	% yoy	FY08	FY07	% yoy
Sales	4,929	2,698	82.7	14,549	11,228	29.6
Expenditure	2,867	1,742	64.6	8,675	8,198	5.8
Operating profit	2,062	956	115.6	5,874	3,030	93.9
Interest	300	253	18.5	1,446	808	79.1
Depreciation	493	306	60.8	1,675	1,038	61.4
Other income	(207)	317	(165.4)	1,341	199	573.5
PBT	1,062	713	48.9	4,094	1,383	195.9
Minority interest	277	–	–	–	–	–
Tax	26	11	142.0	90	34	165.0
Net profit	759	703	8.0	4,003	1,349	196.7
Adj net profit	759	703	8.0	4,003	1,349	196.7

Source: Company, MF Global PCG Research

Concerns

Correction in the Baltic freight index – Baltic dry index is one of the leading indicators, which helps to track shipping freight rates. Of lately the index has corrected to the extent of 30%, which signals fall in crude and lower demand for commodities due to which there is a fall in charter rates for the vessels. We however believe that this is a temporary phase due to onset of Olympics in China. China directly and indirectly controls 30% of global traffic and most of the industries in China have been closed due to Olympics to curb pollution levels. Post Olympics the industrial activity in China is set to resume again which would lead to an upswing in the Baltic index.

Drop in baltic index indicates downturn in the commodity cycle

Slowdown in global economy would result in lower material movement – The fear of recession in the global markets would lead to a sharp decline in the commodity demand. Inflationary pressure would leave less purchasing power in the hands of people, thus less industrial investments. As a result demand would taper off leading to slow industrial activity so lower movement of material.

Slowdown would reduce ton-mile demand

Fall in crude prices could lower E&P spending – A fall in oil price, would reduce the E&P spend by the oil giants globally, as a result of which the long term contract rates of oil drilling rigs, OSV's and tankers would decline.

Sustainability of long term contracts with new vessel supply coming on-stream – Rising rates of long-term contracts is due to the sustained rise in global commodities. Any down turn in the commodity cycle with addition of new vessels will impact the freight rates. The company needs to show its diligence by continuously securing new long-term orders and that too at higher rates.

Falling commodity prices would have cascading effect on vessel charter rates

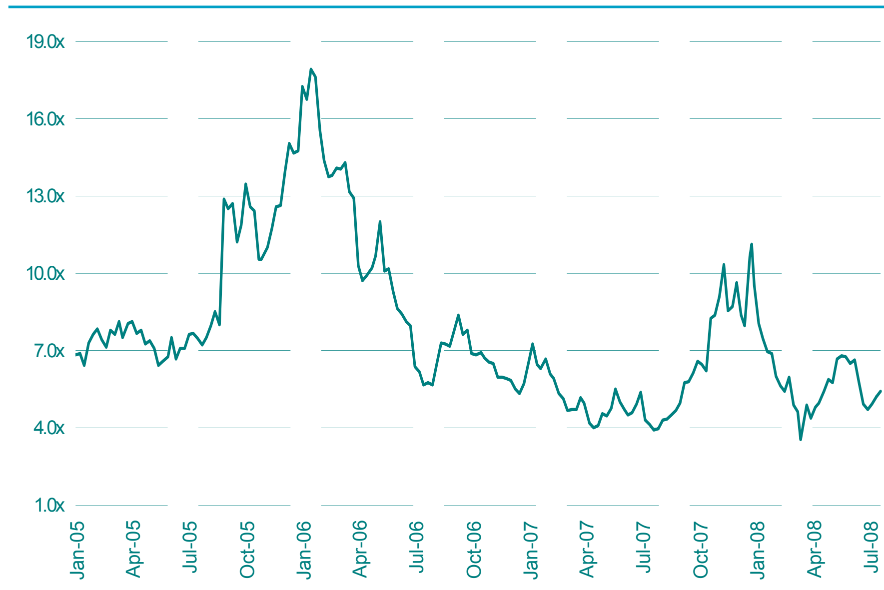
Appreciation in Indian rupee against the US dollar – Since day rates are quoted largely in US dollars, fluctuation in the INR-USD exchange rate poses some risk to its earnings. The company benefits from a declining Indian rupee, but has a downside risk to its earnings in case the rupee appreciates.

Since billing is in dollars company is vunerable to forex fluctuations

Valuations

We expect the company to report consistent growth every quarter over the next couple of years due to additions of new vessels to the fleet, contracts renewals and coal mining from Indonesia. The stock at current price of Rs.80 is trading at 4.4x FY09E and 2.9 FY10E earnings. Historically the stock has traded in the 7x-10x P/E band. Going forward we see all round improvement in performance parameters such as operating margins, RoCE and RoNW. Hence we expect a re-–rating in the stock and the trading range going up to 7-10x forward earnings in future. We recommend a **BUY** on the stock with minimal downside risk of 9-10% while has potential of giving 60% returns. Our one-year price target of Rs.130 discounts average of one year forward earnings of Rs.23.1 by 5.6x. The Net asset based valuation of the stock stands at Rs.150 which stands at a 88% discount to the current market price.

1-year forward P/E multiple



Financials (Consolidated)

Income statement (Rs mn)	FY07	FY08	FY09E	FY10E
Net sales	11,228	14,549	17,379	23,842
Raw material expenses	7,947	8,187	7,994	10,610
Employee expenses	103	191	243	334
Other exp	148	297	1,321	1,627
Op. profit	3,030	5,874	7,820	11,271
OPM (%)	*27.0*	*40.4*	*45.0*	*47.3*
Other income	159	1,013	428	36
Depreciation	1,038	1,675	2,156	2,649
Interest	808	1,446	1,684	1,170
PBT	1,343	3,766	4,409	7,489
Taxes	34	90	97	172
PAT	1,309	3,676	4,312	7,316
Extraordinary items	–	–	–	–
Adjusted PAT	1,309	3,676	4,312	7,316
NPM (%)	*11.7*	*25.3*	*24.8*	*30.7*

Balance sheet (Rs mn)	FY07	FY08	FY09E	FY10E
Equity capital	189	235	235	263
Reserves (incl. pref shares)	6,094	15,972	17,685	23,400
Networth	6,284	16,207	17,920	23,663
Total debt	18,347	21,111	16,310	9,700
Minority interest	–	1,548	4,012	6,936
Total liabilities	24,631	38,866	38,242	40,299
Gross fixed assets	18,945	31,420	35,930	40,130
Less: Cumulative depn.	2,055	3,529	5,684	8,333
Net fixed assets	16,890	27,891	30,245	31,797
Capital W.I.P.	959	4,510	2,700	1,500
Investments	871	42	42	42
Net current assets	5,912	6,423	5,254	6,959
Total assets	24,631	38,866	38,242	40,299

Cash flow (Rs mn)	FY07	FY08	FY09E	FY10E
PBT & extraord. items	1,383	4,094	4,409	7,489
Add: Int, depn. & other exp.	1,846	3,121	3,840	3,819
Cash flow from operations	3,229	7,215	8,248	11,308
Net chg in w.cap, tax, int.	3,025	(2,669)	8,761	3,145
Net cash flow from op.	204	9,884	(513)	8,162
Capital expenditure	19,903	16,027	2,700	3,000
Sale / purchase of inv.	871	(828)	–	–
Net cash from inv.	(20,774)	(15,198)	(2,700)	(3,000)
Issue of equity & debt	24,524	10,378	(4,801)	(5,109)
Dividend paid	189	296	117	132
Net cash from financing	24,335	10,081	(4,919)	(5,241)
Net chg in cash	3,765	4,767	(8,132)	(79)
Op. cash bal	–	3,765	8,531	400
Cl. cash bal	3,765	8,531	400	321

Ratios	FY07	FY08	FY09E	FY10E
Growth (%)				
Net sales	–	29.6	19.5	37.2
Adj PAT	–	180.7	17.3	69.7
Adj EPS	–	143.0	8.5	51.3
Per Share Data (Rs)				
Adj EPS	7.0	16.9	18.4	27.8
Book value	33.2	75.6	93.4	116.2
DPS	2.0	1.1	0.5	0.5
Valuation (x)				
P/E	11.5	4.7	4.4	2.9
P/BV	2.4	1.1	0.9	0.7
EV/EBIDTA	10.8	6.8	4.5	2.7
Performance (%)				
RoCE	24.6	18.5	20.3	28.7
RoNW	42.9	33.3	21.7	27.9

BUY : > 20%	HOLD : > 5-20%	SELL : < 5%

Note: Ratings based on expected returns from current market price (on absolute basis).

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