Equity Research
March 5, 2009
BSE Sensex: 8446

INDIA

Hindalco Industries

HOLD
Upgrade from SELL

Worst priced-in

Rs39

Reason for report: Recommendation change

We lower Hindalco's FY09E, FY10E & FY11E earnings estimates 3.4%, 44% & 47% due to 12%, 15% & 15% reduction respectively in aluminium price assumptions. Hindalco is still being affected by the highly-leveraged Novelis acquisition (for which it plans to write down goodwill of US$1.8bn) and back-ended expansions (~Rs280bn), leading to FY10E consolidated debt of Rs319bn. However, we believe that most negatives are factored in the current price of Rs39/share. Also, given current weak aluminium demand scenario, further potential goodwill writedowns and high cashflow risk in Novelis through mark-to-market (MTM) derivative losses (US$405mn in Q3FY09) will prevent any significant upward rerating. We upgrade Hindalco to HOLD from Sell with a new SOTP target price of Rs44/share (Rs41/share earlier) mainly on expanding global aluminium and copper multiples.

- **Novelis remains key concern.** With raw material prices (including energy costs) that follow the LME with a lag, declining aluminium prices and falling fixed-price ceiling contract volumes have not released enough cashflows for Novelis. We expect Novelis to post losses till FY11E owing to: i) declining rolled products demand (and premium) across the US and EU and ii) high interest cost burden with annual interest outflow of ~US$180-190mn resulting in depressed acquisition RoIC (3-5%) and prolonged payback (>12 years). Novelis expects ~US$580mn cash outflows relating to settlement of derivatives instruments till FY10E, including US$260mn in Q4FY09. Also, Novelis is exposed to ~US$160mn cash outflows from hedging of exposures to metal price ceiling.
- **Weak short-term aluminium price & demand outlook.** We had trimmed our CY08/FY09E, CY09E/FY10E & CY10E/FY11E aluminium price assumptions 12%, 15% & 15% respectively on account of: i) reduced Cy09E & CY10E global demand estimates to 0.3% & 2.9% (from 2.5% and 5% respectively), ii) insufficient production cutbacks so far (9-10% of global aluminium production vis-à-vis 25-30% cutback in steel and 15% in zinc), iii) rising inventory, iv) China's inability to increase demand due to weak internal consumption (with concomitant reduction in CY09E Chinese demand growth estimates to 4.5% from 7.1%).
- **Valuations.** Backended earnings outlook, increased leverage and the expensive Novelis acquisition dents short-term performance outlook for Hindalco. We expect FY10E EBITDA & EPS to decline 35% YoY each, with RoCE dipping to 3.6% in FY10E (cost of capital: 8.7%). We believe most downside risks are factored-in at current price of Rs39/share (at ~50% discount to replacement cost vis-à-vis 13% for NALCO). Upgrade to HOLD with target of Rs44/share (upside 13%; falls within the medium-risk category of the I-Sec universe).

Market Cap	Rs66.3bn/US$1.32bn
Reuters/Bloomberg	HALC.BO/HNDL IN
Shares Outstanding (mn)	1700
52-week Range (Rs)	210/37
Free Float (%)	63.9
FII (%)	10.4
Daily Volume (US$'000)	23,000
Absolute Return 3m (%)	(22.6)
Absolute Return 12m (%)	(81.4)
Sensex Return 3m (%)	(5.8)
Sensex Return 12m (%)	(48.9)

Year to March	FY08	FY09E	FY10E	FY11E
Revenue (Rs mn)	600,128	720,323	494,164	507,261
Net Income (Rs mn)	18,709	15,729	5,425	5,497
EPS (Rs)	10.7	9.0	3.1	3.1
% Chg YoY	(40.8)	(41.2)	(65.5)	1.3
P/E (x)	2.6	4.3	12.6	12.4
CEPS (Rs)	24.7	25.5	18.4	18.5
EV/E (x)	4.0	5.4	7.7	7.8
Dividend Yield	3.2	4.6	2.2	1.9
RoCE (%)	12.2	0.7	3.6	4.1
RoE (%)	10.4	3.7	3.2	3.9

Please refer to important disclosures at the end of this report

Metals

Earnings revision

	FY09E	FY10E
Sales	↓ 5.2	↓ 11.0
EBITDA	↓ 15.9	↓ 19.4
EPS	↓ 3.3	↓ 44.3

Shareholding pattern

	Jun '08	Sep '08	Dec '08
Promoters	31.4	31.4	36.1
Institutional investors	28.1	28.2	24.6
MFs and UTI	4.4	3.8	3.2
Insurance Cos.	10.5	10.4	7.8
FIIs	12.3	12.9	10.4
Others	40.3	40.4	39.3

Source: BSE India

Price chart

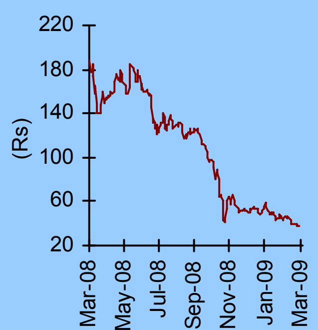

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Table 1: Earnings revision

(Rs mn, year ending March 31)

	FY09E			FY10E			FY11E		
	Old	**New**	**% Chg**	**Old**	**New**	**% Chg**	**Old**	**New**	**% Chg**
Sales	760,153	720,323	(5.2)	555,128	494,164	(11.0)	568,856	507,261	(10.8)
EBITDA	67,731	56,942	(15.9)	46,219	37,245	(19.4)	50,251	40,607	(19.2)
PAT	16,267	15,729	(3.3)	9,741	5,425	(44.3)	10,441	5,497	(47.4)

Source: Company data, I-Sec Research

Table 2: SOTP valuations

	EV (Rs mn)	Comment
Hindalco Aluminium	104,955	FY10E EV/EBITDA of 7x
Birla Copper	13,052	FY10E EV/EBITDA of 4x
ABML (51% stake)	620	Market cap at ASX
Novelis	175,030	FY10E EV/EBITDA of 8x
Total EV	293,657	
Net debt	233,884	
Equity value	59,773	
Fully-diluted no of shares	1,752	
SOTP value (Rs/share)	34	
Equity investments at 20% discount	18,605	
SOTP value (with investments)	44	

Source: Company data, I-Sec Research

Table 3: Replacement cost

(Rs mn)

	Capacity	Replacement costs (US$/unit)	Replacement costs (Rs mn)
Hindalco			
Alumina (mnte)	1.6	800	61,440
Aluminium (te)	543	2,800	72,979
Copper (te)	500	960	23,040
Power (MW)	1100	640000	35,200
Novelis			
Aluminium (te)	300	3,200	46,080
Rolling (mnte)	2.7	960	124,416
Total Replacement cost			**363,155**
Net debt			233,884
Equity value			129,271
Target price (Rs/share)			**74**

Source: Company data, I-Sec Research

Table 4: Aluminium price & demand/supply assumptions

(mnte)

	2008	2009E	2010E	2011E	2012E
Total old-capacity estimates	43.2	45.2	47.5	49.9	52.9
Total new-capacity estimates	40.2	41.9	44.0	46.2	49.0
Old production estimates	42.3	43.1	44.8	47.1	49.7
Growth YoY (%)	*13.0*	*2.0*	*4.0*	*5.0*	*5.5*
Capacity utilisation (%)	*97.8*	*95.3*	*94.4*	*94.4*	*94.0*
New production estimates	40.3	41.1	42.7	44.5	46.5
Growth YoY (%)	*7.6*	*2.0*	*4.0*	*4.1*	*4.6*
Capacity utilisation (%)	*100.1*	*98.0*	*97.1*	*96.2*	*95.0*
Old demand estimates	**41.6**	**42.6**	**44.8**	**47.2**	**50.1**
Old growth YoY (%)	*9.2*	*2.5*	*5.0*	*5.5*	*6.0*
New demand estimates	**38.9**	**39.0**	**40.1**	**42.4**	**45.0**
New growth YoY (%)	*2.1*	*0.3*	*2.9*	*5.7*	*6.3*
New surplus/deficit	1.35	2.06	2.58	2.06	1.45
Old surplus/deficit	0.69	0.49	0.09	(0.13)	(0.38)
Old aluminium price assumptions (US$/te)	2,417	2,000	2,100	NA	NA
New aluminium price assumptions (US$/te)	2,124	1,700	1,785	NA	NA
% Chg (between old and new)	(12.1)	(15.0)	(15.0)	NA	NA

Source: Company data, I-Sec Research

Weak short-term aluminium demand & price outlook

Substantial LME inventory build-up has been dominating the sentiment in the aluminium market, with the inventory rising to a record 2.68mnte, surpassing the 1994 peak. Coupled with a large supply of aluminium coming to US warehouses (primarily Detroit), Europe and Asia also saw net rise in inventory. And, although demand dwindled across the globe, producers did not commensurately cut down on supply.

Table 5: Daily average production rate (ex China)

(000' te)

	Jul-08	Aug-08	Sep-08	Oct-08	Nov-08	Dec-08
Daily average production	70.0	70.2	70.3	70.5	69.4	68.7
% Chg (MoM)	(0.6)	0.3	0.1	0.3	(1.6)	(1.0)

Source: International Aluminium Institute (IAI), I-Sec Research

Even after factoring in the announced aluminium-production cuts, global production could be slightly higher in Q1CY09E at 40.3mtpa versus 40.0mtpa in Q4CY08 on a day-adjusted basis. This is unsustainable against the backdrop of weakening demand, growing inventories and falling aluminium prices; however, this could happen since China is starting new smelting capacity, even as the old, high-cost capacities are shut down – this is also a global trend. At present, India is ramping up ~575,000tpa capacity and Oman is adding 350,000tpa, which offsets most of the 1.2-mnte non-China production-cut announced. While this has led to reasonable alumina demand, it has depressed LME aluminium prices, which, through their linkage with alumina prices, have jeopardised viability of some high-cost alumina refineries. The market has responded by pushing down LME aluminium prices below US$1,300/te, levels not seen since H1CY1999, when inventories touched multi-year highs.

At the current market price, over 90% of global smelting capacity is unviable, albeit, reluctance to cut capacity (due to high entry & exit loads) and falling raw material prices are key reasons for the muted industry response.

Table 6: Announced capacity closure insufficient

Company	Announced cut-back (te) – Annualised
Chinese smelters	2,940,000
Century Aluminium	42,500
Alcoa	615,000
MALCO	40,000
BALCO	25,000
Norsk Hydro	120,000
UC Rusal	113,000
Total capacity shutdown	**3,895,500**

Source: Industry, I-Sec Research

Chinese demand growth expected to fall further to 4.5% in '09E

We are lowering CY09E Chinese demand growth estimates to 4.5% from 7.1% (Table 7) with possible downside due to weak automotive and construction demand (70% of aluminium demand). The declining demand is evident in rising inventories in Mainland (Chart 1).

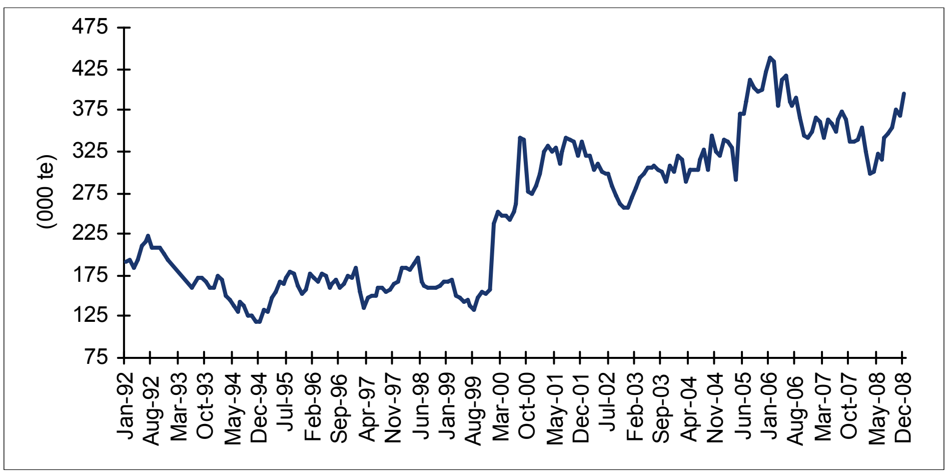
Table 7: Lowering Chinese aluminium demand estimates

China	2008	2009E	2010E	2011E	2012E
Old demand estimates	**14.1**	**15.1**	**16.1**	**17.7**	**19.5**
Old growth YoY (%)	*14.6*	*7.1*	*6.6*	*9.9*	*10.2*
New demand estimates	**13.3**	**13.9**	**14.8**	**16.3**	**17.9**
New growth YoY (%)	*8.1*	*4.5*	*6.6*	*9.9*	*10.2*
% Change	(5.7)	(7.9)	(8.0)	(8.0)	(8.0)

Source: Industry data, I-Sec Research

The slowdown in construction threatens revenues for local Governments (as leasing of land accounts for as much as 40% of revenues) and Government spending is responsible for funding bulk infrastructure development (some estimates imply contribution by local Government being as high as 75%).

Chart 1: Rising Asian inventory (mainly China) at 10-year highs



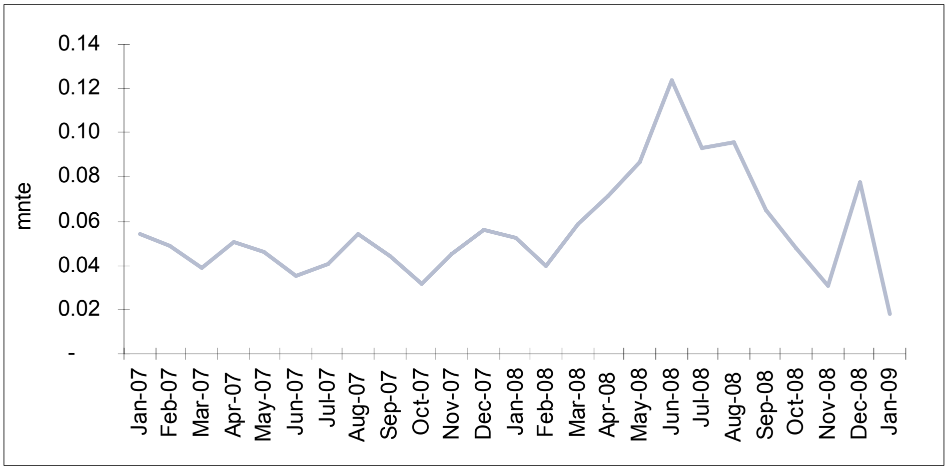
Source: IAI, I-Sec Research

Exports unlikely to replace domestic consumption

Post introducing 15% export tax on aluminium alloy to stem the flow of alloy exports, the Chinese Government is attempting to boost exports as waning domestic demand takes toll. China has reduced export tax on aluminium rods and bars (with circumference of <210mm) to 5% from 15% and increased tax rebates on aluminium sheet & strip to 9% from 5% and to 3% from 1% respectively, as of December 1, '08.

Also, there are high expectations on 15% export tax on primary metal to be cut to 5% or removed altogether to restrict flow of metal to the domestic market. Such cuts would lead to increased incentive to export to South Korea and Asia (sharp export spike was seen over November-December '08; Chart 2), but the extent of exports (as expected by the Government) is not likely to be attained.

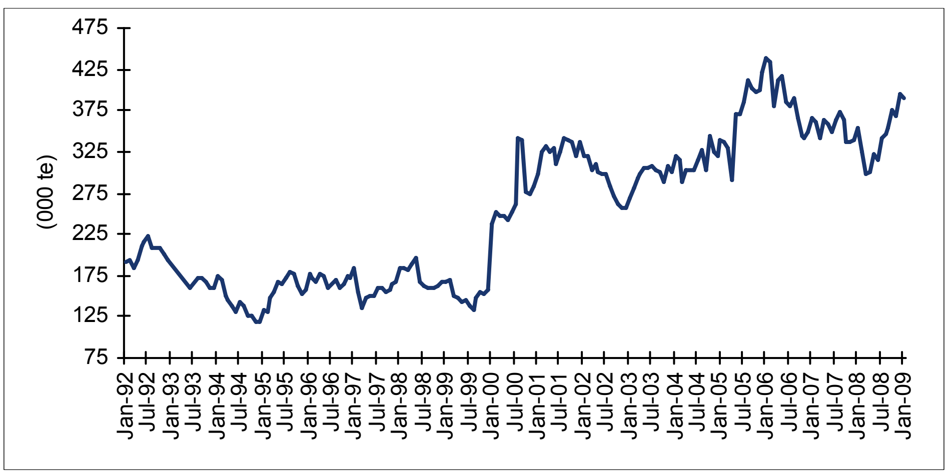
Chart 2: Chinese unwrought-aluminium exports



Source: Bloomberg, I-Sec Research

Further, with LME prices lower than Shanghai prices (Chart 3), there remains little room for Chinese producers to export; also, oversupplied export markets are not likely to buy. Earlier, overseas buyers would place orders through October-November for delivery in the following quarter. In Q4CY08, producers reported marginal order accretion for Q1CY09. Buyers have been deferring Q4CY08 shipments to Q1CY09 and will be using these deferrals vis-à-vis placing new orders.

Chart 3: Rising SHFE-LME spread in aluminium prices



Source: Bloomberg, I-Sec Research

Stockpiling aluminium, unviable proposition

With many State/local Government-owned non-ferrous producers posting losses and local producers being hit hard by the slowdown in market activity, the Government may use the State Reserve Bureau to build inventory in a bid to boost sentiment and help local producers. We believe stockpiling aluminium to boost domestic demand in the short term is unviable due to: i) inventory being already high, with commercial/non-SHFE stocks reportedly growing rapidly and ii) with metal prices having declined swiftly in the past month and estimated to stay low for some time, the stockpile of metal will need to be financed.

Surplus aluminium stock to continue till CY12E

We had raised our CY09E estimates for surplus aluminium stocks to 2.1mnte from 0.5mnte on the back of: i) reduced CY09E demand estimate to 0.3% from 2%, ii) insufficient production cut-backs witnessed till date (9-10% of global aluminium production vis-à-vis 25-30% cutback in steel and 15% in zinc), iii) rising inventory (globally and in China) and iv) China's inability to increase demand on account of weak internal consumption. We also lowered our CY08/FY09E, CY09/FY10E & CY10/FY11E aluminium price assumptions 12%, 15% & 15% respectively.

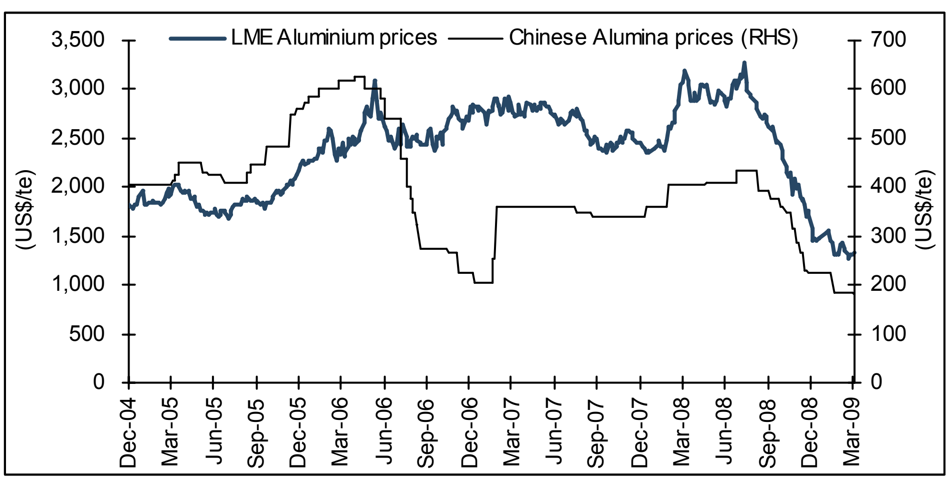
Table 8: Inventory surplus to be prolonged

(mnte)

	2008	2009E	2010E	2011E	2012E
Total old capacity estimates	43.2	45.2	47.5	49.9	52.9
Total new capacity estimates	40.2	41.9	44.0	46.2	49.0
Old production estimates	42.3	43.1	44.8	47.1	49.7
Growth YoY (%)	*13.0*	*2.0*	*4.0*	*5.0*	*5.5*
Capacity utilisation (%)	*97.8*	*95.3*	*94.4*	*94.4*	*94.0*
New production estimates	40.3	41.1	42.7	44.5	46.5
Growth YoY (%)	*7.6*	*2.0*	*4.0*	*4.1*	*4.6*
Capacity utilisation (%)	*100.1*	*98.0*	*97.1*	*96.2*	*95.0*
Old demand estimates	**41.6**	**42.6**	**44.8**	**47.2**	**50.1**
Old growth YoY (%)	*9.2*	*2.5*	*5.0*	*5.5*	*6.0*
New demand estimates	**38.9**	**39.0**	**40.1**	**42.4**	**45.0**
New growth YoY (%)	*2.1*	*0.3*	*2.9*	*5.7*	*6.3*
New surplus/deficit	1.35	2.06	2.58	2.06	1.45
Old surplus/deficit	0.69	0.49	0.09	(0.13)	(0.38)
Old aluminium price assumptions (US$/te)	2,417	2,000	2,100	NA	NA
New aluminium price assumptions (US$/te)	2,124	1,700	1,785	NA	NA
% Chg (between old and new)	(12.1)	(15.0)	(15.0)	NA	NA

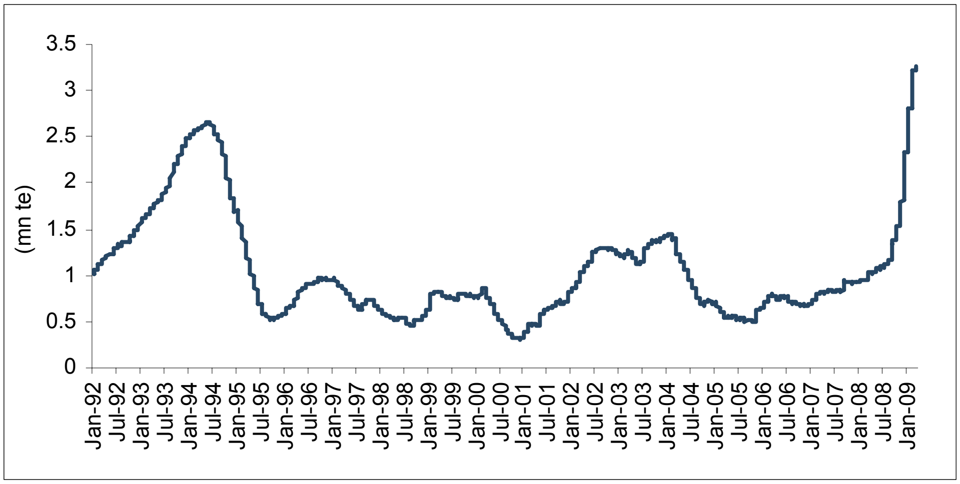
Source: Industry data, I-Sec Research

Chart 4: Aluminium versus alumina prices



Source: Bloomberg, I-Sec Research

Chart 5: LME aluminium inventories at historic highs



Source: Bloomberg, I-Sec Research

Summary financials

Table 9: Profit & Loss statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Income (Sales)	**600,128**	**720,323**	**494,164**	**507,261**
Operating Expenses	**533,778**	**675,884**	**460,255**	**468,545**
EBITDA	**66,351**	**46,555**	**35,889**	**40,607**
EBITDA (ADJ for metal ceilings)	**66,351**	**56,942**	**37,245**	**40,607**
% margins	11.1	7.9	7.5	8.0
Depreciation & Amortisation	24,565	28,993	26,797	26,910
Gross Interest	18,491	18,341	14,697	16,310
Other Income	6,560	(24,197)	8,145	7,709
PBT	**29,855**	**(14,590)**	**3,897**	**5,096**
Add: Extraordinaries	5,407	20,210	-	-
Less: Taxes	9,098	(10,000)	38	739
Net Income (Reported)	26,164	(4,590)	3,859	4,357
Recurring Net Income	**18,709**	**15,729**	**5,425**	**5,497**

Source: Company data, I-Sec Research

Table 10: Balance sheet

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Assets				
Total Current Assets	214742	262828	210409	226840
of which cash & cash eqv.	*17169*	*29018*	*28507*	*42022*
Total Current Liabilities & Provisions	172037	180001	149333	154215
Net Current Assets	**42706**	**82826**	**61076**	**72625**
Investments	**107924**	**108276**	**83174**	**39037**
of which				
Strategic/Group	*5744*	*5744*	*5744*	*5744*
Other Marketable	*102180*	*102532*	*77430*	*33293*
Net Fixed Assets	**292708**	**298980**	**348238**	**399492**
of which				
Intangibles				
Capital Work-in-Progress	*24571*	*55358*	*122531*	*148925*
Goodwill	**119,327**	**27,448**	**25,696**	**24,528**
Total Assets	**562,664**	**517,531**	**518,184**	**535,682**
Liabilities				
Borrowings	323524	318050	319895	330243
Deferred Tax Liability	49514	34117	35385	38876
Minority Interest	16166	16215	14808	13827
Equity Share Capital	1226	1752	1752	1752
No of shares (mn)	*1226*	*1752*	*1752*	*1752*
Reserve s and Surplus	172235	228836	232234	242882
Net Worth	**173,461**	**149,150**	**148,096**	**152,736**
Total Liabilities	**562,664**	**517,531**	**518,184**	**535,682**

*excluding revaluation reserves; # = not written off
Source: Company data, I-Sec Research

Table 11: Cashflow statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Cash flow	**67,928**	**73,733**	**25,345**	**28,189**
Working Capital Changes	6,693	(28,272)	21,240	1,966
Capital Commitments	(323,889)	25,616	(74,303)	(76,996)
Free Cash Flow	**(249,268)**	**71,077**	**(27,718)**	**(46,842)**
Cash flow from Investing Activities	**(22,623)**	**(24,550)**	**33,248**	**51,847**
Issue of Share Capital	183	526	-	-
Buyback of shares	-	-	-	-
Inc (Dec) in Borrowings	239,095	(5,474)	1,845	10,348
Dividend paid	(2,676)	(3,900)	(1,847)	(1,642)
Extraordinary Items	**-**	**-**	**-**	**-**
Chg. in Cash & Bank balance	**6,824**	**11,849**	**(511)**	**13,514**

Source: Company data, I-Sec Research

Table 12: Key ratios

(Year ending March 31)

	FY08	FY09E	FY10E	FY11E
Per Share Data (in Rs.)				
EPS(Basic Recurring)	15.3	9.0	3.1	3.1
Diluted Recurring EPS	10.7	9.0	3.1	3.1
Recurring Cash EPS	24.7	25.5	18.4	18.5
Dividend per share (DPS)	1.3	1.9	0.9	0.8
Book Value per share (BV)	99.0	38.6	35.5	34.7
Growth Ratios (%)				
Operating Income	210.7	20.0	(31.4)	2.7
EBITDA	49.8	(29.8)	(22.9)	13.1
Recurring Net Income	(23.2)	(24.7)	(75.3)	12.9
Diluted Recurring EPS	(40.8)	(41.2)	(65.5)	1.3
Diluted Recurring CEPS	21.8	3.3	(28.0)	0.6
Valuation Ratios (x)				
P/E	2.6	4.3	12.6	12.4
P/CEPS	1.6	1.5	2.1	2.1
P/BV	0.4	1.0	1.1	1.1
EV / EBITDA	4.0	5.4	7.7	7.8
EV / Operating Income	0.4	0.3	0.6	0.6
EV / Operating FCF	3.9	3.4	10.9	11.3
Operating Ratio (%)				
Raw Material/Sales	70.1	76.2	75.2	74.7
SG&A/Sales	5.9	3.2	4.0	3.8
Other Income / PBT	22.0	165.9	209.0	151.3
Effective Tax Rate	25.8	68.5	1.0	14.5
NWC / Total Assets	4.5	10.4	6.3	5.7
Inventory Turnover (days)	58.9	63.5	81.1	69.2
Receivables (days)	25.3	34.9	46.7	40.7
Payables (days)	73.9	95.1	130.6	118.2
D/E Ratio (x)	2.2	2.4	2.4	2.4
Return/Profitability Ratio (%)				
Recurring Net Income Margins	3.4	2.2	0.8	0.8
RoCE	12.2	0.7	3.6	4.1
RoNW	10.4	3.7	3.2	3.9
Dividend Payout Ratio	8.5	21.2	29.1	25.5
Dividend Yield	3.2	4.6	2.2	1.9
EBITDA Margins	11.1	6.5	7.3	8.0

Source: Company data, I-Sec Research

ANALYST CERTIFICATION

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