Nat Resources & Energy
Metals & Mining
Equity – India

Coal India Limited

Overweight (V)

Target price (INR)	**472.00**
Share price (INR)	**385.25**
Potential return (%)	**23.8**

Performance	1M	3M	12M
Absolute (%)	5.3	-0.4	
Relative^ (%)	16.1	9.6	

Index^	BOMBAY SE IDX
RIC	COAL.BO
Bloomberg	COAL IN
Market cap (USDm)	53,649
Market cap (INRm)	2,433,379
Enterprise value (INRm)	1858717
Free float (%)	10

Note: (V) = volatile (please see disclosure appendix)

17 August 2011

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Upgrade to OW(V): Beats expectations

- **Q1 results indicate COAL should significantly increase its offtake in FY12-14, despite modest production growth, as demand pressure builds**
- **We expect e-auction prices to converge with imported coal costs faster and improve average realisation for COAL**
- **Upgrade rating to OW(V) from N(V) and target to INR472 (from INR425) as we lift our EPS estimates by 10-12% for FY12-14 (now expect 27% EPS CAGR)**

Strong 1Q12 results imply better earnings for FY12: COAL reported a 63% yoy net profit increase, 11% ahead of our estimate and 14% ahead of consensus, reflecting: 1) 20% higher realisation (to INR1,365/ton, 3% ahead of our estimate); and 2) improved offtake by 5% to 106.2MT (4% ahead of our estimate), despite modest growth in production (1.2% yoy). COAL liquidated c10MT of its inventory in Q1 (a further 4.6MT in July 2011), implying strong demand-side pressure and better logistics.

Strong offtake of inventory likely to continue in FY13-14: We are now confident of COAL's ability to meet its offtake target of 454MT for FY12 through liquidation of inventory. Consequently, we increase our offtake estimates by 38MT for FY12-14. While our demand analysis suggests that upcoming power projects solely dependent on COAL will require c150MT pa of additional coal over FY12-17 (from c347MT pa to over 500MT by FY17), we continue to take a conservative approach towards production increases (incremental 130MT pa by FY17) limiting offtake volumes. See our 8 July 2011 report, *Coal India: N (V): Huge demand; will supply keep pace?*, for our detailed analysis on demand and supply.

Pricing not a factor for COAL customers: We believe the better than expected realisation in 1Q is a result of higher price realisation under e-auction on demand-side pressure. We expect this to continue and convergence with landed costs to occur earlier. We now build in a decline in the discount on e-auction prices to landed imported coal (20% by FY14 from 25% earlier). Further, we believe if the MMDR Bill were to become operational, COAL would have the flexibility to pass on the costs to its customers (requires a price hike of 8-9% to offset the cost).

Upgrade to OW(V): We raise EPS by 10-12% for FY12e-14e (now expect 27% EPS CAGR) on the back of increased offtake and realisation. Consequently, our target price rises to INR472 (from INR425). We upgrade COAL to OW(V) from Neutral (V) on the strong outlook and our increased confidence in its earnings visibility. At our new target price, the stock implies a PE of 14.5x 24M EPS (currently trading at PE of 13.2x 12M forward EPS) and 9.0x EV/EBITDA. Downside risks are lower-than-expected offtake from logistics constraints and implementation of the MMDR Bill, with COAL unable to pass on the cost to its customers.

HSBC

Financials & valuation

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Profit & loss summary (INRm)				
Revenue	528,958	675,651	740,945	791,041
EBITDA	161,410	250,490	276,142	302,627
Depreciation & amortisation	-16,729	-18,226	-19,844	-21,256
Operating profit/EBIT	144,681	232,264	256,298	281,371
Net interest	18,963	32,169	40,628	52,345
PBT	164,626	266,018	298,510	335,300
HSBC PBT	165,228	266,018	298,510	335,300
Taxation	-55,954	-87,516	-98,294	-110,491
Net profit	108,673	178,502	200,216	224,809
HSBC net profit	109,275	178,502	200,216	224,809
Cash flow summary (INRm)				
Cash flow from operations	128,224	203,974	249,251	276,734
Capex	-24,750	-40,000	-30,000	-31,094
Cash flow from investment	-22,566	-38,000	-28,000	-29,094
Dividends	-33,995	-42,712	-51,428	-60,145
Change in net debt	-73,178	-123,262	-169,822	-187,494
FCF equity	76,306	134,207	186,299	209,604
Balance sheet summary (INRm)				
Intangible fixed assets	0	0	0	0
Tangible fixed assets	150,611	172,385	182,541	192,379
Current assets	643,960	777,357	956,480	1,151,111
Cash & others	458,623	581,885	751,707	939,202
Total assets	813,973	967,144	1,154,423	1,356,891
Operating liabilities	408,178	430,558	474,050	511,854
Gross debt	15,536	15,536	15,536	15,536
Net debt	-443,087	-566,349	-736,172	-923,666
Shareholders funds	333,172	468,963	617,750	782,415
Invested capital	-72,230	-62,701	-86,736	-107,566

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
Y-o-y % change				
Revenue	12.6	27.7	9.7	6.8
EBITDA	23.5	55.2	10.2	9.6
Operating profit	23.2	60.5	10.3	9.8
PBT	14.1	61.6	12.2	12.3
HSBC EPS	11.2	63.4	12.2	12.3
Ratios (%)				
Revenue/IC (x)	-8.6	-10.0	-9.9	-8.1
ROIC	-154.7	-231.0	-230.1	-194.2
ROE	36.9	44.5	36.8	32.1
ROA	14.3	20.1	18.9	17.9
EBITDA margin	30.5	37.1	37.3	38.3
Operating profit margin	27.4	34.4	34.6	35.6
EBITDA/net interest (x)				
Net debt/equity	-132.9	-120.7	-119.1	-118.0
Net debt/EBITDA (x)	-2.7	-2.3	-2.7	-3.1
CF from operations/net debt				
Per share data (INR)				
EPS reported (fully diluted)	17.20	28.26	31.70	35.59
HSBC EPS (fully diluted)	17.30	28.26	31.70	35.59
DPS	3.90	4.90	5.90	6.90
Book value	52.75	74.25	97.80	123.87

Key forecast drivers

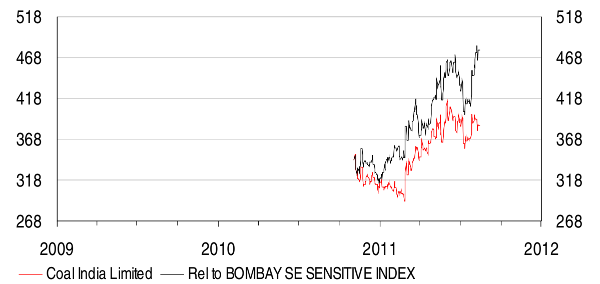
Year to	03/2011a	03/2012e	03/2013e	03/2014e
Production (MT)	431	442	469	490
Sales (MT)	424	453	471	490
ASP (INR/t)	1,178	1,410	1,487	1,525

Valuation data

Year to	03/2011a	03/2012e	03/2013e	03/2014e
EV/sales	3.7	2.8	2.3	1.9
EV/EBITDA	12.3	7.4	6.1	5.0
EV/IC				
PE*	22.3	13.6	12.2	10.8
P/Book value	7.3	5.2	3.9	3.1
FCF yield (%)	3.1	5.5	7.7	8.6
Dividend yield (%)	1.0	1.3	1.5	1.8

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 15 Aug 2011

Strong 1Q12 results imply better earnings for FY12

1Q results highlights: Coal India reported net profit of INR41.3bn (up 63% yoy), 11% ahead of our estimate and 14% ahead of consensus, driven by 1) increased realisation by 20% yoy to INR1,365/ton (3% ahead of our estimate) and 2) increase in offtake by 5% yoy to 106.2MT (4% ahead of our estimate). Offtake was better despite only modest growth in production of 1.2% yoy (to 96.3MT) as COAL liquidated c10MT of its inventory in 1Q. EBITDA margins grew to 36.4% (700bp improvement), driven by better realisation and lower employee cost to sales (34% to sales in 1Q versus 40% last year), which is in line with our estimates. A lower than expected effective tax rate at 30.5% (versus our estimate of 33.9%) further boosted net profit growth. Exhibit 1 provides a summary of COAL's quarterly earnings.

Exhibit 1: Coal India consolidated quarterly earnings summary

(INRm)	1QFY12	yoy%	HSBC 1QFY12	% Var	1QFY11	2QFY11	3QFY11	4QFY11
Production (MT)	96.3	1.2%	97.0	-0.7%	95.2	90.5	113.9	131.8
Offtake (MT)	106.3	5.1%	102.0	4.2%	101.1	98.4	110.5	115.3
Realisation (INR/ton)	1,365	20.6%	1,330	2.6%	1,132	1,127	1,148	1,302
Sales*	152,181	27.9%	142,850	6.5%	118,985	114,863	132,919	162,193
EBITDA*	55,429	58.7%	52,580	5.4%	34,936	22,553	39,804	64,122
Margin %	36.4%	706	36.8%	(38)	29%	20%	30%	40%
PBT	59,423	58.9%	56,177	5.8%	37,406	26,289	42,214	59,325
Tax	-18,115	50.0%	-19,035	-4.8%	-12,077	-9,377	-15,796	-18,710
Tax %	30.5%		33.9%		32.3%	35.7%	37.4%	31.5%
Net profit (adjusted)	41,308	63.1%	37,142	11.2%	25,329	16,912	26,419	40,616
Net profit (reported)	41,439	64.3%			25,218	14,944	26,261	40,786

Note: *HSBC reclassifies Sales and EBITDA to include income from recovery of transportation and loading charges from customers which COAL reports as other income.
Source: Company data, HSBC estimates

Strong offtake of inventory likely to continue in FY13-14

COAL liquidated c14.6MT of its inventory in April-July 2011 of the 69.2MT inventory at end March 2011; we expect this to continue given the demand-side pressures. Consequently, we increase our offtake estimates by 38MT for FY12-14 and expect COAL to meet its target of 454MT for FY12.

Our demand analysis for incremental power projects over FY12-17 depending solely on COAL supplies suggests c150MT pa of additional demand (from c347MT pa to over 500MT by FY17). But we continue to take a conservative approach towards long-term production increases (incremental 130MT pa by FY17), thus limiting offtake volumes. See our 8 July 2011 report, *Coal India: N(V): Huge demand; will supply keep pace?*, for our detailed analysis on demand and supply.

Pricing is not a factor for COAL customers

We believe the better than expected realisation in 1Q is a result of higher price realisation under E-Auction. COAL currently sells 11.6% of its coal through e-auctions. While we expect the proportion of e-auction sales to remain stable over the next few years, prices should increase and ultimately converge with the landed cost (which is the opportunity cost of acquiring coal through alternate sources). We now build in a faster decline in the discount on e-auction prices to landed cost of imported coal (from 47% in FY11e to 20% by FY14e). Exhibit 2 shows our analysis of the discount on e-auction prices to the landed price of imported coal.

Further, we believe if the Metals and Mining (Development and Regulation), or MMDR, Bill were to become operational, COAL should have the flexibility to pass on the additional burden to its customers (COAL would require price hikes of 8-9% to compensate for the additional cost burden from the MMDR bill). See our 8 July 2011 report, *Coal India: N (V): Huge demand; will supply keep pace?*, for our detailed analysis of the impact of the MMDR bill.

Exhibit 2: Coal prices under e-auction are at a discount to international coal prices, but we now expect the discount to fall faster

E-auction	FY10	FY11e	FY12e	FY13e	FY14e
Thermal coal (Newcastle)					
Landed cost (USD/ton)	92	121	145	138	124
GCV (Kcal/kg)	6,672	6,672	6,672	6,672	6,672
Landed Cost (INR/ton)	4,140	5,465	6,655	6,331	5,722
COAL's e-auction Coal					
GCV (Kcal/kg)	4,361	4,361	4,361	4,361	4,361
Landed Cost (INR/ton)	1,583	1,899	2,610	2,897	2,992
Cost of Indian coal (GCV adjusted basis)	2,706	3,572	4,349	4,138	3,740
% Discount	**-42%**	**-47%**	**-40%**	**-30%**	**-20%**

Source: HSBC estimates

E-auction quantity could be lower, but not likely in our view: There are investor concerns that the government could reduce the proportion of coal production allowed to be sold under e-auction since COAL is unable to meet its contractual supply obligations mainly to the power sector (Ministry of Power is already putting on pressure). However, we believe this concern is untenable as there are large numbers of small customers (other than power with no linkages) dependent purely on e-auction coal. On our analysis, even if we assume the absolute quantity of coal under e-auction remains stagnant at c48MT (FY11 level) over the next 2-3 years, which is unlikely, this would lower our FY13e EPS by 2.5%, target price by 1.6% and average selling price by INR15-20/ton for FY13-14.

Raise our EPS estimates by 10-12% for FY12-14

We raise our EPS estimates by 10-12% for FY12-14 on the back of a) increase in offtake for FY12-14 by c38MT, by 2-3% of volumes, and b) increase in average selling prices by c2% over FY12-14 from higher prices realised through e-auction. See Exhibit 3 for summary of changes to our estimates for FY12-14.

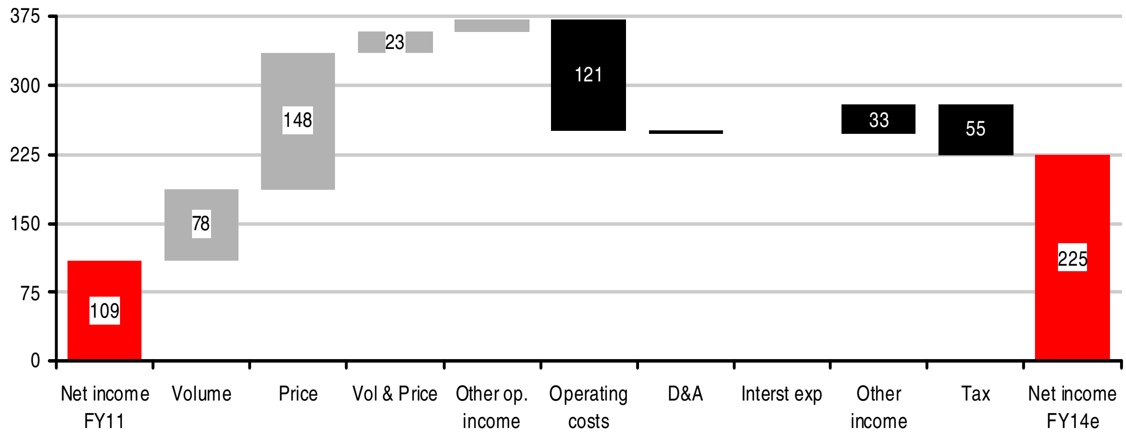
Exhibit 3: Coal India – changes to HSBC estimates

INRm	New			Old			Diff		
	FY12e	FY13e	FY14e	FY12e	FY13e	FY14e	FY12e	FY13e	FY14e
Production (MT)	442	469	490	440	466	490	0%	0%	0%
Offtake (MT)	453	471	490	440	458	478	3%	3%	2%
Average selling price (INR/ton)	1,410	1,487	1,525	1,387	1,465	1,505	2%	2%	1%
Revenue	675,651	740,945	791,041	645,965	709,214	761,774	5%	4%	4%
EBITDA	250,490	276,142	302,627	225,738	249,820	278,310	11%	11%	9%
Margin %	*37.1%*	*37.3%*	*38.3%*	*34.9%*	*35.2%*	*36.5%*	*213*	*204*	*172*
PBT	266,018	298,510	335,300	241,266	271,128	308,458	10%	10%	9%
Tax	87,516	98,294	110,491	81,752	91,963	104,713	7%	7%	6%
% tax rate	*32.9%*	*32.9%*	*33.0%*	*33.9%*	*33.9%*	*33.9%*	*-99*	*-99*	*-99*
Net profit	178,502	200,216	224,809	159,514	179,165	203,745	12%	12%	10%
EPS (INR)	28.3	31.7	35.6	25.3	28.4	32.3	12%	12%	10%

Source: HSBC estimates

We now expect COAL EPS to grow at 27% CAGR over FY12-14 (from 23% CAGR earlier), driven by volume growth (5%), price hike (9%) and EBITDA margin improvement of 775bp (from 30.5% in FY11 to c38% by FY14) based on a reduction in employee cost as a percentage of sales (major cost for COAL). We expect employee costs as % of sales to fall from 38.6% in FY11 to 34.3% in FY14e, despite our expectation of a 30% wage hike in 2QFY12. We continue to expect COAL to revise prices of D, E & F category coal by 10% in 2HFY12 to compensate for the wage cost increase. See Exhibit 4 for a summary of our earnings reconciliation of net income for FY12-14. Our EPS estimates for FY12-14 are 18-20% above consensus, which we expect to move upwards post the factoring in of 1Q results.

Exhibit 4: Reconciliation between net income of FY11 and FY14e (INRbn)



Source: HSBC estimates

Raise target price to INR472 and upgrade to Overweight (V)

We value COAL based on a combination of a DCF and an earnings multiple based valuation (see Exhibits 5-5C). For our DCF, we discount the cash flows assuming an unchanged WACC of 11.3% (cost of equity of 11.8%, cost of debt of 7.5% and beta of 0.95) to arrive at our value of INR462 per share. We value COAL at 15x 24M forward EPS and 9x 24M forward EV/EBITDA. Our new target price of INR472 is based on an unchanged weighted-average of DCF, PE and EV/EBITDA, to which we assign a weight of 50%, 25% and 25%, respectively.

Our target price rises to INR472 (from INR425) based on the increase in our EPS estimates for FY12-14 (by 10-12%) and the rolling forward of our valuation to the June quarter. At our new target price, the stock implies a PE of 14.5x 24M EPS (currently trading at PE of 13.2x 12M forward EPS) and 9.0x EV/EBITDA.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for Indian stocks of 11%. COAL is classified as a volatile stock in our research model, which implies a Neutral band of 1-21%. We upgrade to Overweight (V) rating as the potential return of 23.8% (including the dividend yield) falls above the Neutral band.

Exhibit 5: Calculation of 12-month target price

Method	Weight	INR/Share
DCF	0.50	462
PE	0.25	490
EV/EBITDA	0.25	472
Target price		**472**

Source: HSBC estimates

Exhibit 5A: COAL India – DCF summary table

Particulars	INRm	INR/Share
Enterprise value	**2,485,463**	**393**
Less: Gross Debt	15,536	2
Add: Cash & Bank excluding OBR provision	441,990	70
Add: Investments	8,137	1
Less: Minorities	326	0
Equity value	**2,919,728**	**462**

Source: HSBC estimates, OBR= Overburden Removal

Exhibit 5B: COAL India – PE-based valuation

	INR
PE multiple (x)	15.0
EPS (24M fwd) – June 2013	32.7
Value per share	**490**

Source: HSBC estimates

Exhibit 5C: COAL India – EV/EBITDA-based valuation

	INRm	INR/Share
EV/EBITDA multiple (x)	**9.0**	
EBITDA (24M fwd)	282,763	
Enterprise value	**2,544,867**	**403**
Less: Gross Debt	15,536	2
Add: Cash & bank adj for OBR	441,990	70
Add: Investments	8,137	1
Less: Minorities	326	0
Equity value	**2,979,133**	**472**

Source: HSBC estimates

We upgrade COAL to Overweight (V) from Neutral (V) given its strong outlook and our increased confidence in its earnings visibility (EPS CAGR of 27% over FY12-14). COAL is likely to benefit from a surge in coal demand in India, but we would watch its ability to increase production, which could limit volume growth in the long term. Despite the strong price movement since its IPO (up c58% while the Sensex is down 18%), we believe the stock is still reasonably valued at a PE of 13.2x (12M forward EPS) and EV/EBITDA of 7.1x (12M forward EBITDA) supported by the strong earnings outlook.

Key risks

Key downside risks to our rating are 1) lower-than-expected offtake because of logistics constraints, and 2) implementation of the MMDR Bill. In our view, COAL would have to raise product prices by 8-9% to offset the costs from implementation of the MMDR Bill. Exhibit 6 sets out some of the downside risks to our forecasts and likely upside factors.

Exhibit 6: Summary of sensitivity to various factors not accounted for in our valuation and earnings forecast

Factor	Base case	Potential upside/ (downside)	Probability	Impact on FY13e EPS	Impact on 12M target price
Upside					
Production for FY13e is higher than anticipated if classification of No-Go area is dispensed off	469MT	Incremental 20MT	Very low	7.6%	7.4%
Downside					
Price hike for DEFG coal in 2HFY12 is less than we expect	10% hike in Q3FY12	No hike	Low to Medium	-13.6%	-14.2%
Wage cost increase is higher than expected	+30% in 2QFY12	Hiked by another 10%	Low	-6.8%	-6.5%
Government lowers proportion of coal production sold through e-auction and fixes the quantity at current levels of c48MT over next 2-3 years	51 to 54MT over FY12-14	Lower by 3-6MT over FY12-14	Low to Medium	-2.5%	-1.6%

Source: HSBC estimates

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Arun Singh and Jigar Mistry.

Important disclosures

Stock ratings and basis for financial analysis

HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website at www.hsbcnet.com/research. Details of these short-term investment opportunities can be found under the Reports section of this website.

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings and other considerations. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations. Investors should carefully read the definitions of the ratings used in each research report. In addition, because research reports contain more complete information concerning the analysts' views, investors should carefully read the entire research report and should not infer its contents from the rating. In any case, ratings should not be used or relied on in isolation as investment advice.

Rating definitions for long-term investment opportunities

Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

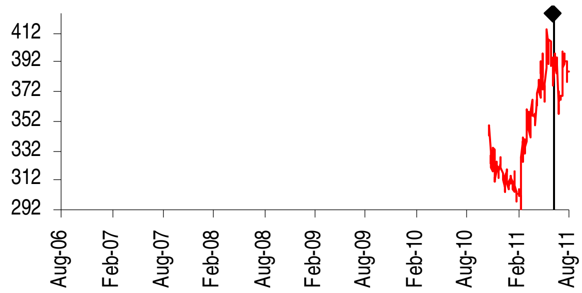
Rating distribution for long-term investment opportunities

As of 16 August 2011, the distribution of all ratings published is as follows:

Overweight (Buy)	52%	(27% of these provided with Investment Banking Services)
Neutral (Hold)	37%	(20% of these provided with Investment Banking Services)
Underweight (Sell)	11%	(19% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Coal India Limited (COAL.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Neutral (V)	21 June 2011
Target Price	**Value**	**Date**
Price 1	425.00	21 June 2011

Source: HSBC

HSBC & Analyst disclosures

None of the below disclosures applies to any of the stocks featured in this report.

1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.
3 At the time of publication of this report, HSBC Securities (USA) Inc. is a Market Maker in securities issued by this company.
4 As of 31 July 2011 HSBC beneficially owned 1% or more of a class of common equity securities of this company.
5 As of 30 June 2011, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of investment banking services.
6 As of 30 June 2011, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-investment banking-securities related services.
7 As of 30 June 2011, this company was a client of HSBC or had during the preceding 12 month period been a client of and/or paid compensation to HSBC in respect of non-securities services.
8 A covering analyst/s has received compensation from this company in the past 12 months.
9 A covering analyst/s or a member of his/her household has a financial interest in the securities of this company, as detailed below.
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