19 December 2012

BUY

TP: INR 185.00
▲ 13.7%

NMDC

NMDC IN

Quality business at attractive valuations

We initiate coverage on NMDC with a BUY rating and TP of Rs 185. We like the business model given NMDC's access to high quality iron ore reserves, its low cost of production, a tightening domestic demand-supply situation and potential for a steady pricing uptick given the discount to global prices. NMDC also generates high FCF and net cash on books is ~30% of market cap. We believe current valuations at 4.2x FY14E EV/EBITDA are attractive given the volume/pricing growth potential and defensive earnings profile.

- **Iron ore demand-supply dynamics favourable:** While domestic iron ore production is expected to drop to 150mt in FY13, iron ore consumption is expected to continue to grow at an 8-9% CAGR over FY12-15E, resulting in a tight demand-supply situation in the near future. NMDC will clearly be the biggest beneficiary as it continues to operate its mines and exercise greater pricing power.
- **Production capacity to increase 50% by FY15:** Though the company has fallen short of expansion targets in the past due to regulatory issues and operations in Naxal-affected areas, we expect the planned 50% production ramp-up to proceed as scheduled by FY15 given the tightening domestic iron ore situation.
- **Pricing not at risk given discount to global prices:** NMDC's realisations are still lower than global prices – even on export parity basis. Thus, there is comfortable support for its domestic and export realisations in case of further weakness in global prices.
- **Strong balance sheet to fund future expansion:** NMDC has a strong balance sheet with net cash of Rs 220bn and FCF generation of ~Rs 150 bn in FY13-14. Thus it will be able to finance future expansion via internal cash flows.
- **Initiate with BUY:** We initiate coverage with a BUY rating and TP of Rs 185 based on 5x FY14E EV/EBITDA. Below-expected volume growth is a key risk to our call.

Financial Highlights

Y/E 31 Mar	FY10A	FY11A	FY12A	FY13E	FY14E
Revenue (INR mln)	62,226	1,12,853	1,11,676	1,11,288	1,27,585
EBITDA (INR mln)	44,115	84,494	88,304	85,564	98,482
Adjusted net profit (INR mln)	34,545	65,025	73,682	72,018	80,713
Adjusted EPS (INR)	8.7	16.4	18.5	18.2	20.4
Adjusted EPS growth (%)	(20.9)	88.2	12.5	(1.6)	12.0
ROIC (%)	22.1	33.1	26.9	20.9	20.2
Adjusted ROAE (%)	26.7	38.8	33.8	26.8	25.1
Adjusted P/E (x)	33.8	17.3	8.8	9.0	8.0
EV/EBITDA (x)	23.5	11.3	5.0	5.0	4.1
P/BV (x)	8.2	5.9	2.6	2.2	1.8

Source: Company, Bloomberg, RCML Research

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PRICE CLOSE (18 Dec 12)
INR 162.70

MARKET CAP
INR 6,45,057 mln
USD 11,760 mln

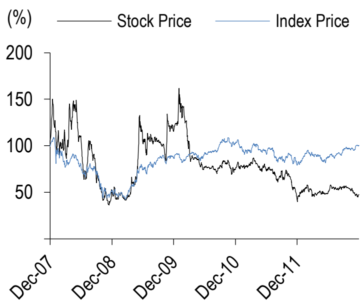
SHARES O/S
3,964.7 mln

FREE FLOAT
20.0%

3M AVG DAILY VOLUME./VALUE
2.6 mln/ USD 7.7 mln

52 WK HIGH
INR 199.40

52 WK LOW
INR 136.95



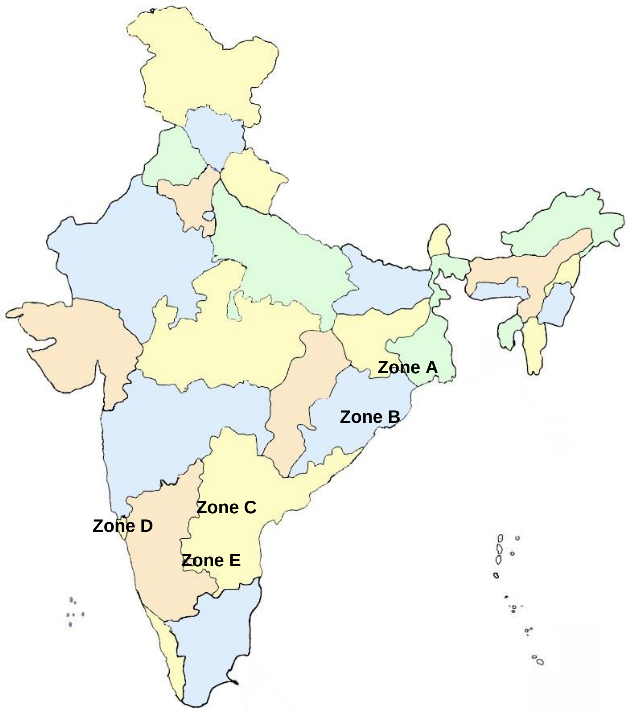
Domestic iron ore dynamics

High ore reserves

According to the UN Framework Classification (UNFC), India's iron ore resources stood at 28.5bn tonnes in 2010, of which 17.8bn tonnes are haematite resources and 10.6bn tonnes are magnetite resources. About 59% of hematite ore deposits are found in the eastern region while ~92% of magnetite deposits occur in the southern region, especially Karnataka. About 10% of global iron ore reserves are in India and India has traditionally been a major producer/exporter of iron ore.

India's iron ore resources stood at 28.5bn tonnes in 2010 – ~10% of global reserves

Fig 1 - Iron ore distribution in India



Zone A: Chiriya, Noamundi, Kiriburu, Meghataburu, Thakurani, Bolani, Gua, Malangtoli, Gandhamardhan, Daitri

Zone B: Bailadila, Dalli, Rajhara, Rowghat, Mahamaya, Aridongri, Surajgharh

Zone C: Donimalai, Ramandurg, Kumaraswamy, NEB Range, Ettinahatti, Tunti, Belegal

Zone D: N.Goa, Redi

Zone E: Kudremukh, Bababudan, Kudachari

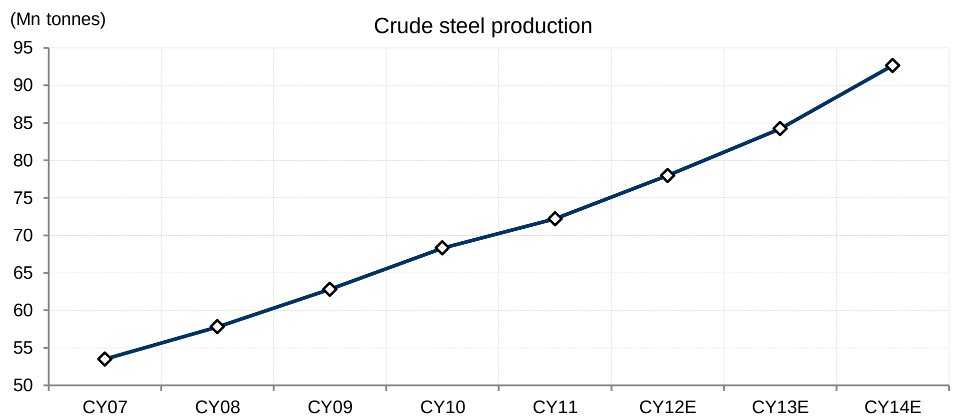
Source: RCML Research, Company

Domestic iron ore consumption to grow at 8-9%

Demand for iron ore in India is driven by the steel industry (~58%) followed by the sponge iron industry (~41%). Domestic iron ore consumption has grown at a 9.4% CAGR in the last two years as domestic crude steel production grew 8.7% over CY08-CY12.

Steel industry accounts for 58% of domestic iron ore demand

Fig 2 - Domestic crude steel production



Source: RCML Research, Company

Fig 3 - Domestic iron ore consumption break-up

Iron ore (mt)	2009	2010	2011	2012	2013E	2014E	2015E
Alloy Steel	0	0	0	0	0	0	0
Cement	1	1	1	1	1	1	1
Coal washery	0	0	0	0	0	0	0
Ferro-alloys	0	0	0	0	0	0	0
Iron & Steel	52	56	60	67	73	80	88
Sponge iron	34	39	43	48	52	58	63
Others	0	0	0	0	0	0	0
All Industries	**87**	**97**	**104**	**116**	**126**	**139**	**153**

Source: RCML Research, Indian Bureau of Mines

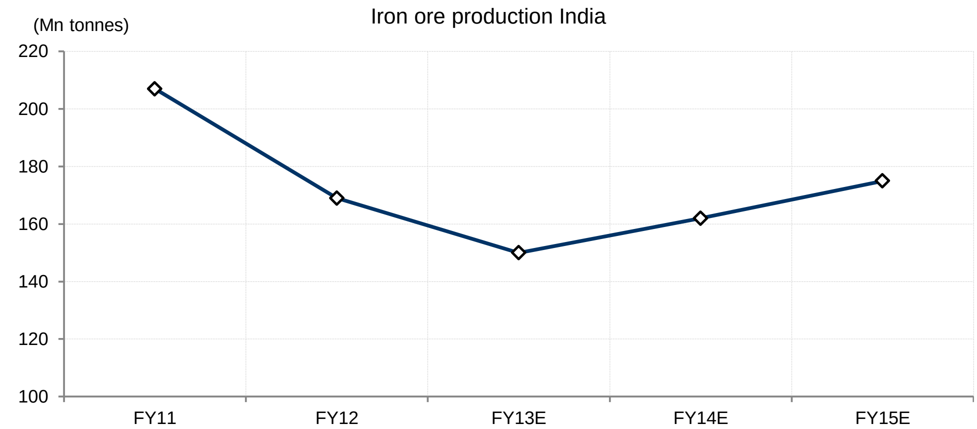
Per capita steel consumption in India is still very low. In the medium term, we expect a revival in the capex cycle to boost steel demand by 8–10% (CAGR) in the foreseeable future. With significant expansion in the iron and steel industry, we expect domestic iron ore consumption to continue to grow at an 8-9% CAGR in FY12-15E.

Likely revival in capex cycle to drive 8-10% growth in steel demand

Domestic iron ore production to bottom out at 150mtpa

After reaching a high of 210mt in FY10, India's iron ore production fell 5% to 201mt in FY11, further plunging 20% to 170mt in FY12 post the mining ban in Karnataka. With the recent mining ban in Goa, iron ore production is expected to drop to 150mt in FY13. We expect production to remain at this level in the short term till regulatory clarity on mining emerges. But given the needs of the domestic steel industry, we believe production is likely to return to 8% growth rates in the medium term.

Fig 4 - Iron ore production to fall to 150mtpa in FY13E



Source: RCML Research, Company

Mining bans in Karnataka and Goa have dented production

Exports under increasing pressure

With the increase in export duty on fines and higher rail tariffs, the viability of export of fines continues to decline. This is further exacerbated by lower production due to the mining ban and weaker demand from China. After peaking at 107mt in CY09, iron ore exports have drastically reduced to ~45mt in CY12E and are expected to fall further.

Iron ore exports down from 107mt in CY09 to ~45mt in CY12E

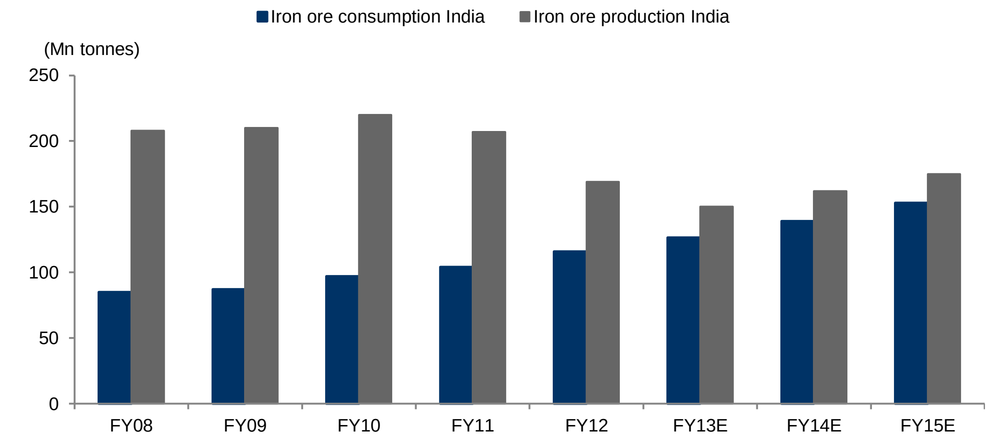
Investment rationale

Tightening domestic iron ore demand-supply

India has traditionally been an exporter of iron ore. However, with ongoing regulatory travails leading to mining bans in Karnataka and Goa, iron ore production has dropped 20% YoY to 170mt in FY12 and is expected to decline further to 150mt by FY13E. At the same time, iron ore consumption has grown at a 9.4% CAGR over FY09-FY13E, reaching 116mt in FY12. With increasing domestic crude steel capacity, iron ore consumption should continue to grow at an 8-9% CAGR, resulting in a tight demand-supply situation in the near future. NMDC will clearly be the biggest beneficiary as it continues to operate its mines and exercise greater pricing power.

Lower production due to mining bans and strong demand to keep iron ore supply tight

Fig 5 - Iron ore demand-supply



Source: RCML Research, Company

NMDC has sizeable quality reserves

NMDC has access to high quality iron ore reserves (> 64% Fe content), totaling 1,160mt with mine life of ~35 years at the current production rate.

NMDC's reserves total 1,160mt with a mine life of 35 years

Fig 6 - NMDC reserves/resources base

Mn tonnes	Reserves	Resources	Reserves + Resources
Deposit - 5	221	0	221
Deposit -10 p	140	56.5	197
Deposit -11	140	17	157
Deposit - 14	130	19.5	150
Deposit -14 NMZ	61	3	64
Deposit - 4	0	105	105
Deposit - 13	320	0	320
Sub-total - Chhattisgarh	**1,012**	**201**	**1,213**
Donimalai	18	0	18
Kumaraswamy	130	0	130
Sub-total - Karnataka	**148**	**0**	**148**
GRAND TOTAL	**1,160**	**201**	**1,361**

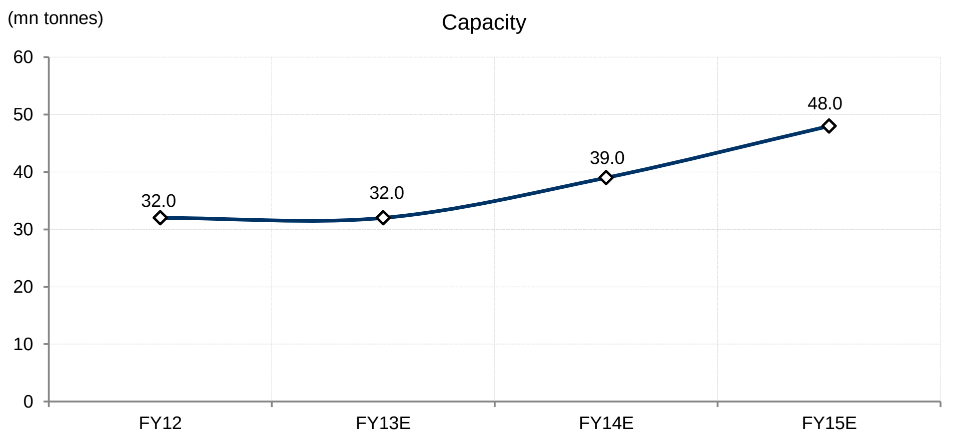
Source: Company, RCML Research

Production likely to expand 50% by FY15

Despite past hiccups on expansion goals, tight supply should lend impetus to planned 50% expansion

NMDC plans to ramp up capacity to 48mt from the current 32mt by FY15 with organic expansion at its Bailadila Deposit 11B mine (+7 mtpa), Kumaraswamy (+7 mtpa) and Deposits 10 & 11A (+5 mtpa). Expansion at Bailadila is expected to be completed by March'13 while Kumaraswamy will be completed by FY14. Though the company has fallen short of production ramp-up expectations in the past due to regulatory issues and operations in Naxal-affected areas, we expect the ramp-up to materialise over the next 2-3 years given the tightening domestic iron ore situation.

Fig 7 - Capacity expansion on cards



Source: RCML Research, Company

The company also plans to set up a 1.2 mtpa pellet plant in Donimalai and 2 mtpa pellet plant in Nagarnar. NMDC plans to set up a 3mtpa steel plant in Chattisgarh. We believe this forward integration project will negatively affect its strong EBITDA margins and also tie up capital in case of expansion delays.

Downside support to sales realisations

NMDC's sales realisations are still lower than global iron ore prices

NMDC's sales realisations are still lower than global iron ore prices – even on an export parity basis. Hence, we believe there is comfortable downside support for the company's domestic as well as export realisations in the event of further weakness in global iron ore prices.

Fig 8 - Sales realisations

(Rs/tonne)	FY11	FY12	FY13E	FY14E
Avg realization- Domestic	4,107	4,048	4,074	4,074
Computed- Export parity basis	7,385	8,111	5,824	5,824
Computed- Import parity basis	9,102	9,573	7,540	7,540
Discount to export parity prices	-3,279	-4,063	-1,750	-1,750
Avg realization- Exports	5,975	7,089	5,364	5,365
Computed	8,206	8,866	6,864	6,864
Discount to global prices	-2,230	-1,777	-1,500	-1,499

Source: RCML Research, Company

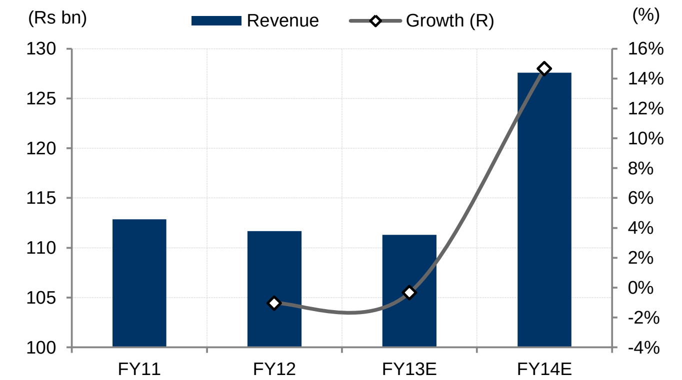
Financial overview

Revenue growth driven by volume expansion

We expect NMDC to clock a revenue CAGR of 7% over FY12-FY14E driven by volume expansion of 7% CAGR during this period.

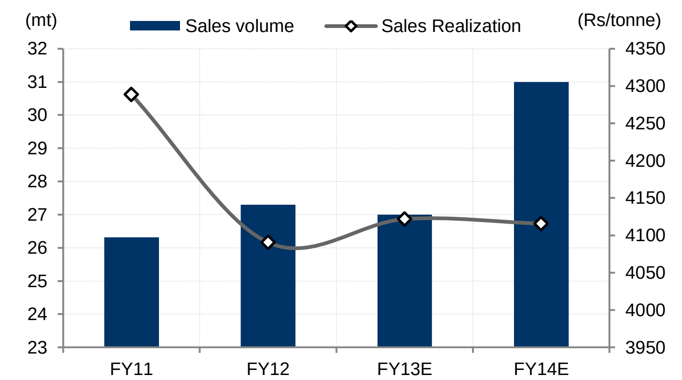
Revenue CAGR of 7% over FY12-FY14E

Fig 9 - Trend in sales revenue



Source: RCML Research, Company

Fig 10 - Sales volume and realisation

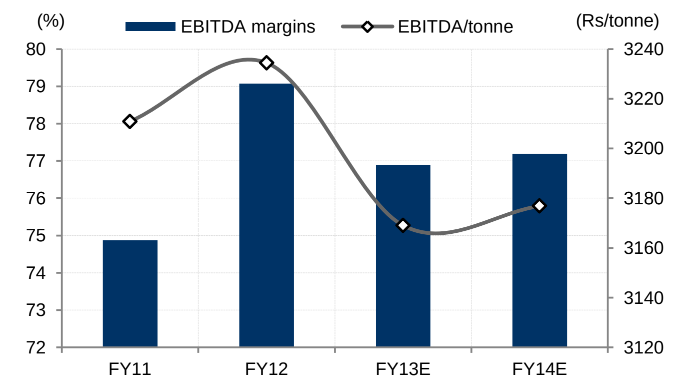


Source: RCML Research, Company

High EBITDA margins of ~77% likely sustained in FY13E/FY14E

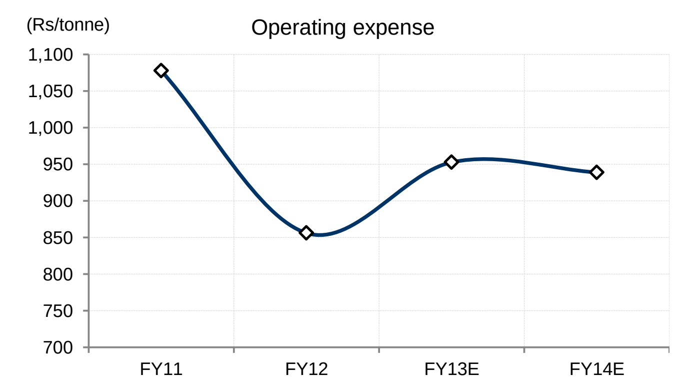
In spite of the global fall in iron ore prices, we expect the company to maintain its EBITDA margins at ~77% in FY13E/FY14E with only a modest increase in operational expenses.

Fig 11 - EBITDA margins to remain stable



Source: RCML Research, Company

Fig 12 - Modest increase in operating expenses



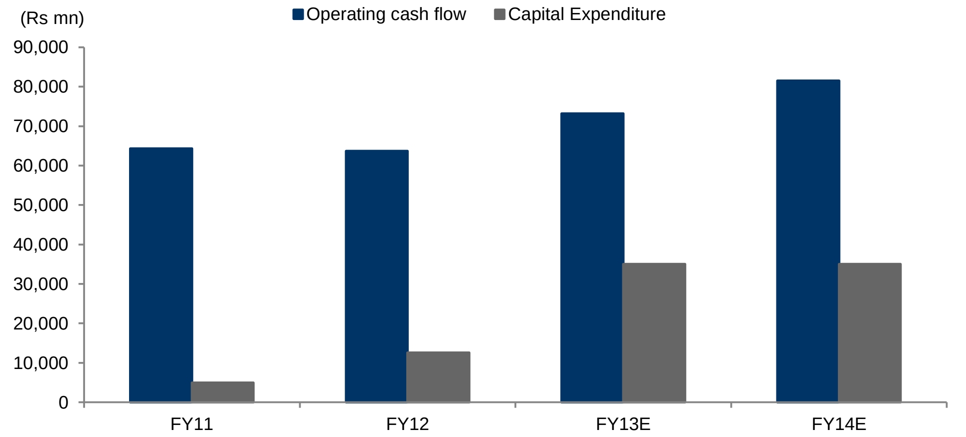
Source: RCML Research, Company

Strong balance sheet with net cash of Rs 220bn

With expansion in the iron ore business and plans for forward integration, NMDC aims to invest Rs 300bn in the next five years. The company has a cash pile of Rs 220bn and should be able to comfortably finance its expansion activities via internal cash flow generation.

Internal cash flows sufficient to fund expansion capex

Fig 13 - Strong operating cash flow



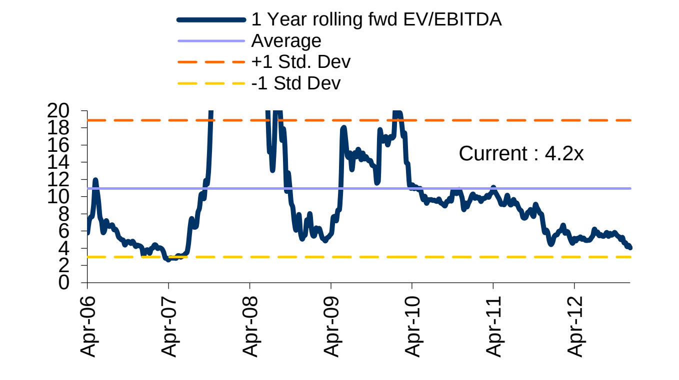
Source: RCML Research, Company

Valuation

We initiate coverage on NMDC with a BUY rating and TP of Rs 185 as we like the volume expansion potential of its high-quality iron ore operations and feel the stock is undervalued at current levels. We assign a 5x FY14E EV/EBITDA multiple to the stock. With dividend yield of ~3.5% and the current inexpensive valuations, we believe the risk-reward is clearly favourable.

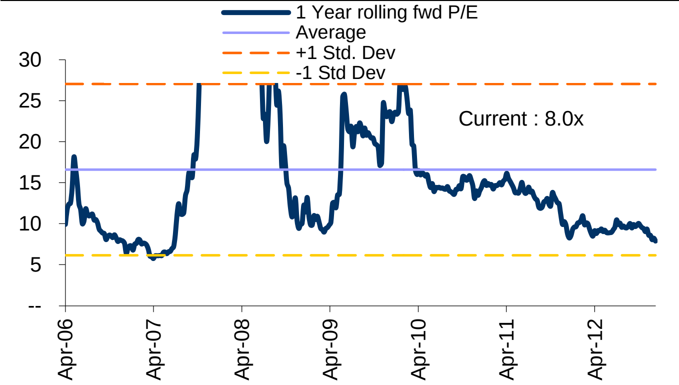
Stock undervalued at current levels; initiate with BUY

Fig 14 - EV/EBITDA band



Source: RCML Research, Company

Fig 15 - P/E band



Source: RCML Research, Company

Fig 16 - Gobal iron ore comps

Ticker	Company	Price	Market Cap	ROE (%)			EV/EBITDA		
		local	$ mn	LFY	FY1	FY2	LFY	FY1	FY2
AGO AU equity	ATLAS IRON LTD	1.7	1,475	(6)	4	7	10.1	6.1	3.8
CLF US equity	CLIFFS NATURAL RESOURCES INC	35.3	5,033	15	10	7	3.6	7.5	8.0
FMG AU equity	FORTESCUE METALS GROUP LTD	4.7	13,800	50	27	31	7.6	7.3	5.0
GBG AU equity	GINDALBIE METALS LTD	0.2	321	(4)	1	4	-30.9	189.2	5.1
GRR AU equity	GRANGE RESOURCES LTD	0.3	319	31	6	3	1.4	2.7	3.6
LIM CN equity	LABRADOR IRON MINES HOLDINGS	0.9	89	(16)	(18)	(3)	-5.7	-3.2	9.6
MGX AU equity	MOUNT GIBSON IRON LTD	0.8	835	14	15	12	1.6	2.0	2.5
MMXM3 BZ equity	MMX MINERACAO E METALICOS SA	4.3	1,999	(14)	(11)	2	40.4	72.0	20.0
NFE AU equity	NORTHERN IRON LTD	0.6	260	5	1	16	10.5	12.5	3.5
SESA IN equity	SESA GOA LTD	198	3,154	19	17	17	5.9	13.8	10.1
NMDC IN equity	NMDC LTD	163	11,821	34	27	25	5.0	5.0	4.1
Global Diversified									
BHP AU EQUITY	BHP BILLITON LTD	37.1	1,80,838	25	19	20	6.9	7.5	6.4
BLT LN Equity	BHP BILLITON PLC	2,174.0	75,314	25	19	20	6.6	7.5	6.4
ENRC LN Equity	EURASIAN NATURAL RESOURCES	277.6	2,194	12	6	7	2.9	4.9	4.4
EXX SJ Equity	EXXARO RESOURCES LTD	16,510.0	6,957	37	25	22	17.5	14.2	15.3
RIO AU Equity	RIO TINTO LTD	65.7	1,02,102	7	17	16	5.2	7.6	6.2
VALE US equity	VALE SA-SP ADR	20.5	1,08,173	16	14	14			

Source: RCML Research, Company

Key risks

Delay in expansion of iron ore project

There could be further delays in expansion of NMDC's iron ore projects. Post its Q2FY13 results, the company announced that expansion at 11B, Chhattisgarh is running five months behind schedule and is now expected to be completed by March'13. Also, the mechanisation of Kumarswamy is running three months behind schedule and is now expected by December'13.

Geographically remote project locations

The company's remote project locations may act as a deterrent to attracting and retaining talent and providing supplies and services. Also, disturbances due to Maoist group activities in the Bailadila area can hinder operations. Delays in forest, environmental and other clearances may affect time schedules for the opening and commissioning of new mines and affect investment plans.

Per Share Data

Y/E 31 Mar (INR)	FY10A	FY11A	FY12A	FY13E	FY14E
Reported EPS	8.7	16.4	18.5	18.2	20.4
Adjusted EPS	8.7	16.4	18.5	18.2	20.4
BVPS	36.0	48.5	61.6	74.2	88.0

Valuation Ratios

Y/E 31 Mar (x)	FY10A	FY11A	FY12A	FY13E	FY14E
EV/Sales	16.7	8.5	3.9	3.8	3.2
EV/EBITDA	23.5	11.3	5.0	5.0	4.1
Adjusted P/E	33.8	17.3	8.8	9.0	8.0
P/BV	8.2	5.9	2.6	2.2	1.8

Financial Ratios

Y/E 31 Mar	FY10A	FY11A	FY12A	FY13E	FY14E
Profitability & Return Ratios (%)					
EBITDA margin	70.9	74.9	79.1	76.9	77.2
EBIT margin	69.7	73.8	77.9	75.8	76.3
Adjusted profit margin	55.5	57.6	66.0	64.7	63.3
Adjusted ROAE	26.7	38.8	33.8	26.8	25.1
ROCE	22.2	33.2	27.1	21.0	20.3
YoY Growth (%)					
Revenue	(17.7)	81.4	(1.0)	(0.3)	14.6
EBITDA	(24.3)	91.5	4.5	(3.1)	15.1
Adjusted EPS	(20.9)	88.2	12.5	(1.6)	12.0
Invested capital	22.9	34.5	26.9	20.4	18.6
Working Capital & Liquidity Ratios					
Receivables (days)	43	15	20	24	23
Inventory (days)	61	46	68	65	62
Payables (days)	136	104	132	134	127
Current ratio (x)	10.6	11.1	11.3	12.1	12.3
Quick ratio (x)	10.4	10.8	11.0	11.8	12.1
Turnover & Leverage Ratios (x)					
Gross asset turnover	3.6	5.6	4.8	4.7	5.3
Total asset turnover	0.4	0.6	0.5	0.4	0.4
Net interest coverage ratio	n.a.	n.a.	n.a.	n.a.	n.a.
Adjusted debt/equity	0.0	0.0	0.0	0.0	0.0

DuPont Analysis

Y/E 31 Mar (%)	FY10A	FY11A	FY12A	FY13E	FY14E
Tax burden (Net income/PBT)	66.2	66.8	67.8	67.0	67.0
Interest burden (PBT/EBIT)	120.2	116.8	124.9	127.4	123.8
EBIT margin (EBIT/Revenue)	69.7	73.8	77.9	75.8	76.3
Asset turnover (Revenue/Avg TA)	43.8	61.6	47.0	38.3	37.1
Leverage (Avg TA/Avg equities)	109.7	109.3	109.0	108.0	106.9
Adjusted ROAE	26.7	38.8	33.8	26.8	25.1

Income Statement

Y/E 31 Mar (INR mln)	FY10A	FY11A	FY12A	FY13E	FY14E
Total revenue	**62,226**	**1,12,853**	**1,11,676**	**1,11,288**	**1,27,585**
EBITDA	44,115	84,494	88,304	85,564	98,482
EBIT	43,383	83,279	87,002	84,370	97,288
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	8,763	14,025	21,108	23,119	23,180
Exceptional items	0	0	513	0	0
EBT	52,146	97,304	1,08,623	1,07,490	1,20,468
Income taxes	(17,601)	(32,280)	(34,942)	(35,472)	(39,754)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	**34,545**	**65,025**	**73,682**	**72,018**	**80,713**
Adjustments	0	0	0	0	0
Adjusted net profit	**34,545**	**65,025**	**73,682**	**72,018**	**80,713**

Balance Sheet

Y/E 31 Mar (INR mln)	FY10A	FY11A	FY12A	FY13E	FY14E
Accounts payables	8,676	7,498	9,470	9,437	10,819
Other current liabilities	4,801	9,939	11,582	11,582	11,582
Provisions	0	0	0	0	0
Debt funds	0	0	0	0	0
Other liabilities	0	0	0	0	0
Equity capital	396	396	396	396	396
Reserves & surplus	1,42,328	1,91,749	2,43,667	2,93,720	3,48,605
Shareholders' fund	1,42,724	1,92,145	2,44,064	2,94,116	3,49,001
Total liabilities and equities	**1,56,201**	**2,09,582**	**2,65,115**	**3,15,135**	**3,71,402**
Cash and cash eq.	1,28,549	1,72,281	2,02,646	2,18,901	2,39,617
Accounts receivables	4,270	4,854	7,370	7,345	8,420
Inventories	2,988	4,154	4,589	4,573	5,243
Other current assets	6,997	11,666	22,572	22,572	22,572
Investments	761	1,357	2,478	2,478	2,478
Net fixed assets	7,872	10,993	11,888	10,694	9,500
CWIP	5,613	5,677	14,942	49,942	84,942
Intangible assets	0	0	0	0	0
Deferred tax assets, net	(849)	(1,029)	(1,001)	(1,001)	(1,001)
Other assets	0	0	0	0	0
Total assets	**1,56,201**	**2,09,952**	**2,65,484**	**3,15,503**	**3,71,770**

Cash Flow Statement

Y/E 31 Mar (INR mln)	FY10A	FY11A	FY12A	FY13E	FY14E
Net income + Depreciation	35,277	66,240	74,983	73,212	81,908
Interest expenses	0	0	0	0	0
Non-cash adjustments	0	0	0	0	0
Changes in working capital	8,006	(2,089)	(10,244)	9	(363)
Other operating cash flows	263	180	(28)	0	0
Cash flow from operations	**43,546**	**64,331**	**64,711**	**73,221**	**81,544**
Capital expenditures	(4,255)	(4,400)	(11,462)	(35,000)	(35,000)
Change in investments	(53)	(595)	(1,121)	0	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	**(4,308)**	**(4,996)**	**(12,583)**	**(35,000)**	**(35,000)**
Equities issued	0	0	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	(1,160)	(2,520)	(2,896)	0	0
Dividends paid	(6,938)	(13,084)	(17,841)	(20,819)	(23,530)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	**(8,098)**	**(15,604)**	**(20,737)**	**(20,819)**	**(23,530)**
Changes in cash and cash eq	**31,140**	**43,731**	**31,391**	**17,402**	**23,014**
Closing cash and cash eq	**1,28,550**	**1,72,281**	**2,02,646**	**2,18,901**	**2,39,617**

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