Motilal Oswal

8 February 2012

3QFY12 Results Update | Sector: Metals

Nalco

BSE SENSEX	S&P CNX
17,622	5,335
Bloomberg	NACL IN
Equity Shares (m)	2,577.2
52-Week Range (INR)	120/48
1,6,12 Rel. Perf. (%)	-2/-12/-40
M.Cap. (INR b)	157.2
M.Cap. (USD b)	3.2

CMP: INR61 TP: INR55 Neutral

Year End	Net Sales (INR m)	PAT (INR m)	EPS (INR)	EPS Gr. (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ Sales	EV/ EBITDA
3/10A	50,557	8,032	3.1	-36.3	19.6	1.5	7.7	10.6	2.3	11.7
3/11A	59,590	10,703	4.2	33.2	14.7	1.4	9.6	13.3	1.8	7.1
3/12E	65,423	7,200	2.8	-32.7	21.8	1.4	6.2	8.4	1.6	11.2
3/13E	71,598	10,504	4.1	45.9	15.0	1.3	8.5	12.6	1.6	7.4

Consolidated

- **Lower volumes, higher-than-expected costs hit PAT:** Nalco's adjusted PAT for 3QFY12 declined 69% YoY to INR786m, below our estimate of INR2.3b, due to lower- than-expected volumes and higher-than-expected costs. Reported PAT of INR512m included non-recurring provisions for wage revision of non-executives.
- **Aluminum production declines:** Aluminum production declined 11% QoQ to 93,000 tons as 120pots out of 960pots were out of operation because of shortage of domestic coal. Alumina production increased by just 6% QoQ to 413,000 tons due to a 15-day strike at refinery by contract labor.
- **Input costs, consumption rates up:** Input costs remains high due to the 50% YoY increase in cost of coal, 35% YoY increase in cost of caustic soda and 20-40% increase in cost of other inputs. Specific consumption of coal and caustic soda increased because of inferior quality of linkage coal and higher percentage of silica in bauxite.
- **Aluminum production volumes reduced:** We are cutting aluminum volume estimates by 20% for FY13 to factor in continued shutdown of 120 pots and diminishing hope of early restart due to much higher cost of production. The capex guidance of INR23b for FY13 will reduce available cash leading to lower interest income.
- **FY13 EPS estimates lowered by 30%, maintain Neutral rating:** We are cutting FY13 EPS estimates by 30% to INR4.1. We are factoring LME price of USD2,250, INR/USD of 50.1, CoP of USD2,258 for Aluminum and USD204 for Alumina in our model. The stock is trading at FY13E PE of 15.0x, EV/EBITDA of 7.4x and P/BV of 1.3x. **Neutral**.

Quarterly performance (consolidated) (INR MILLION)

Y/E MARCH	FY11				FY12				FY11	FY12E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Alumina Production ('000 tons)	363	380	398	416	400	390	413	470	1,556	1,673
Aluminium Prod. ('000 tons)	112	110	111	111	111	105	93	93	444	402
Aluminium Sales ('000 tons)	109	109	103	119	109	101	98	93	439	401
Alumina Sales ('000 tons)	100	226	164	195	197	180	163	293	685	834
Avg LME Aluminium (USD/ton)	2,150	2,110	2,357	2,531	2,618	2,450	2,115	2,250	2,287	2,358
Alumina Exports (USD/ton)	375	316	362	399	428	448	359	370	363	401
Net Sales	13,081	14,792	14,431	18,254	17,625	16,139	14,486	17,172	60,558	65,423
Change (YoY %)	39.9	25.4	1.8	12.3	34.7	9.1	0.4	-5.9	19.8	8.0
EBITDA	3,938	3,477	3,896	4,537	5,298	1,526	1,019	1,667	15,847	9,511
Change (YoY %)	135.2	145.4	31.6	-16.2	34.5	-56.1	-73.8	-63.2	59.7	-40.0
As % of Net Sales	30.1	23.5	27.0	24.9	30.1	9.5	7.0	9.7	26.2	14.5
Interest	0	0	1	0	0	0	1	0	1	1
Depreciation	916	952	1,030	1,319	1,019	1,179	1,235	1,260	4,217	4,693
Other Income	897	854	894	973	1,266	1,321	1,309	1,440	3,617	5,335
PBT (before EO Item)	3,919	3,379	3,759	4,190	5,545	1,667	1,092	1,848	15,247	10,151
Extra-ordinary Income	0	0	0	0	0	0	-380	0	0	-380
PBT (after EO Item)	3,919	3,379	3,759	4,190	5,545	1,667	712	1,848	15,247	9,771
Total Tax	1,079	1,139	1,199	1,138	1,776	274	200	591	4,554	2,841
% Tax	27.5	33.7	31.9	27.1	32.0	16.4	28.1	32.0	29.9	29.1
Reported PAT	2,841	2,240	2,560	3,053	3,768	1,393	512	1,256	10,693	6,930
Adjusted PAT	2,841	2,240	2,560	3,053	3,768	1,393	786	1,256	10,693	7,200
Change (YoY %)	124.6	40.5	64.9	-22.0	32.7	-37.8	-69.3	-58.8	33.1	-32.7

E: MOSL Esitmates

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Volumes disappoints due to strike at refinery and continued shutdown of 120pots

- Net Sales declined 10% QoQ to INR14.5b. Aluminum production was down 11% QoQ to 93kt. Metal sales were little higher at 98kt due to liquidation of inventory.
- Although LME average declined 14% QoQ, the realization of aluminum decreased just 4% QoQ to INR115,545/ton due to weakening of INR against USD.
- Alumina production increased 6% QoQ to 413kt while realization decreased 10% to INR18,263/ton.
- Alumina sales tonnage declined 14% QoQ to 163,000 tons because dispatches were hurt due to contract worker strike for 15 days.

EBITDA decline 33% QoQ; input costs increases of 20-50% and deteriorating quality of coal and bauxite escalating cost of production

- Aluminum segment (on full integration basis) reported EBIT loss of INR1.1b implying EBIT per ton loss of INR10,964 v/s loss of only INR868 in 2QFY12.
- Aluminum cost of production (CoP, incl. depreciation) increased 4% QoQ to INR126,509/ton. In USD, the CoP declined 7% QoQ to USD2,490/ton, according to our calculations. CoP also increased due to higher staff cost at INR3b and higher fixed charges as part of capacity remained unutilized.
- Input cost remains high due to 50% YoY increase in cost of coal, 35% YoY increase in cost of caustic soda and 20-40% increase in other inputs. Further, the specific consumption of coal has increased because of inferior quality of linkage coal, and caustic soda because of higher presence of silica in bauxite.
- Non-executive wage revision increased staff cost by INR1.3b of which non-recurring INR380m was on account of new pension liability shortfall.

Concall highlights

- 120 out of 960 pots remained closed due to shortage of coal. Since the availability of domestic coal is limited, for incremental metal production, Nalco needs to import coal. At current LME, metal production based on imported coal is not viable.
- Aluminum production was 93kt and sales were 98kt due to de-stocking. Quarterly metal production is unlikely to rise unless LME improves significantly.
- Alumina production was 413kt and sales were 163kt in 3QFY12. Of this, 154kt of alumina was exported. This implies inventory build-up of 65kt during the quarter. Alumina production suffered due to 15-day contract labor strike.
- Alumina capacity expansion to 2.1mtpa has now been stabilized and is expected to achieve 100% CU in FY13. Alumina production is expected to be 500kt and 2.1m tons for 4QFY12 and FY13 respectively.
- Specific consumption of coal has increased due to lower quality coal and caustic soda due to higher silica contents in bauxite.

Inputs costs are galloping (INR per ton)

Inputs	3QFY11	3QFY12	Remarks
Caustic Soda	19,000	26,000	
Coal	1,355	2,000	10% imports, 15% E-Auction, 75% from linkage
CPC	22,000	27,000	
CT Pitch	26,000	30,000	
Heavy Furnace Oil	26,000	35,000	
Aluminum Fluoride	54,000	70,000	

Source: Company

Project updates

- Capex guidance: INR7b in 9MFY12, INR6b in 4QFY12 and INR23b in FY13.
- NPCIL equity contribution 24% i.e. INR9b of which INR3b will be paid in 4QFY12.
- Wind power project: Phase 1 of 50.4MW for INR3.3b is expected to be commissioned by March 2012 and Phase II of 50.4MW at the end of FY13.
- 4th stream of alumina will increase capacity by 175ktpa by March 2013 at capex of INR5b.
- 5th stream to improve alumina capacity by 1mtpa in 3 years at capex of INR50b.
- Uktal coal mine is expected by end of FY13. The planned capex is INR3.4b.
- 220KVA rating (i.e. upgrade of pots rating) will improve capacity and reduce power consumption.

Cutting EPS by 30% to factor rising costs and lower production guidance

- We are cutting FY13 aluminum volumes by 20% to factor continued shutdown of 120 pots and diminishing hope of early restart due to much higher cost of production.
- Also, FY13 capex guidance of INR23b will reduce available cash leading to lower interest income. As a result, we are cutting FY13 EPS by 30% to INR4.1.
- The stock is trading at FY13E PE of 15.0x, EV/EBITDA of 7.4x and P/BV of 1.3x. Maintain **Neutral**.

Nalco: an investment profile

Company

NACL is a fully integrated producer of aluminum and alumina. Aluminum contributes ~70% and alumina ~30% of revenue. Its aluminum smelter (0.46mtpa) sources alumina and power from its captive refinery in Damanjodi and captive power plant located in Angul. Coal for power generation is sourced from the state-owned Coal India; hence, the cost of power generated is low. The alumina refinery, which has a capacity 2.1mtpa, is located in Damanjodi (Orissa) close to captive bauxite mines at Panchpatmalli. The bauxite from these mines is of superior quality and consumes low energy in the crushing and digestion process during conversion to alumina. Therefore, NACL's cost of production is the lowest in the world.

Key investment arguments

- NACL has increased its capacity for aluminum smelting from 345ktpa to 460ktpa, for alumina refining from 1.6mtpa to 2.1mtpa, and for captive power from 960MW to 1,200MW.
- The company has been allotted a coal block, Utkal-E, which has coal reserves of ~70m tons, which will insulate the company from input price risk.

Key investment risks

- Unexpected fall in alumina or aluminum prices may adversely impact profitability.

Recent developments

- Mr N R Mohanty has assumed the charge of Director (Project & Technical) of **Nalco** from 1 February, 2012.

Valuation and view

- The stock is trading at FY13E PE of 15.0x, EV/EBITDA of 7.4x and P/BV of 1.3x. Maintain **Neutral**.

Sector view

- Aluminium prices after declining sharply over the last few weeks have started to recover. Recent shutdown announced by Aluminium majors has positive impact on Aluminium prices. Higher energy costs for Aluminium will continue to support prices, as cost of production of marginal players continues to be high. However slowing demand in China and high inventory at LME will limit potential upside due to cost side pressure.

Comparative valuations

		Nalco	Hindalco	Sterlite
P/E (x)	FY12E	21.8	8.7	7.1
	FY13E	15.0	7.4	7.6
P/BV (x)	FY12E	1.4	1.6	0.9
	FY13E	1.3	1.3	0.8
EV/Sales (x)	FY12E	1.6	0.7	0.8
	FY13E	1.6	0.6	0.7
EV/EBITDA (x)	FY12E	11.2	6.2	4.2
	FY13E	7.4	5.3	3.2

EPS: MOSL forecast v/s consensus (INR)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY11	2.8	3.9	-28.0
FY12	4.0	4.5	-10.2

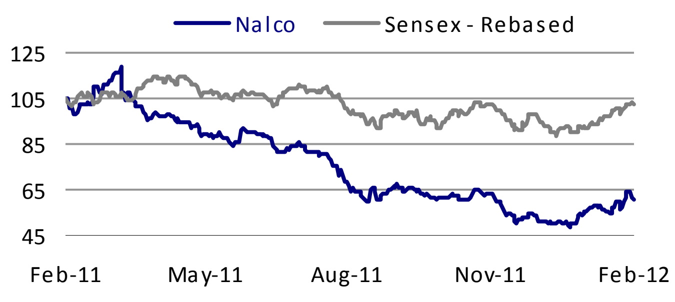
Target price and recommendation

Current Price (INR)	Target Price (INR)	Upside (%)	Reco.
61	55	-9.4	Neutral

Shareholding pattern (%)

	Dec-11	Sep-11	Dec-10
Promoter	87.2	87.2	87.2
Domestic Inst	5.2	5.2	5.4
Foreign	4.2	4.3	4.4
Others	3.4	3.4	3.1

Stock performance (1 year)



Financials and Valuation

Income Statement (INR Million)

Y/E MARCH	2009	2010	2011	2012E	2013E
Net Sales	50,945	50,557	59,590	65,423	71,598
Change (%)	2.1	-0.8	17.9	9.8	9.4
Total Expenses	34,038	40,635	44,558	55,912	55,824
EBITDA	16,907	9,922	15,032	9,511	15,774
% of Net Sales	33.2	19.6	25.2	14.5	22.0
Depn. & Amortizati	2,724	3,194	4,301	4,693	4,771
EBIT	14,182	6,728	10,732	4,817	11,003
Net Interest	40	23	1	1	0
Other income	4,958	4,688	4,530	5,335	4,912
PBT before EO	19,101	11,392	15,261	10,151	15,915
EO income	170	156	-14	-380	0
PBT after EO	19,272	11,549	15,247	9,771	15,915
Tax	6,549	3,406	4,554	2,841	5,411
Rate (%)	34.0	29.5	29.9	29.1	34.0
Reported PAT	12,723	8,142	10,693	6,930	10,504
Adjusted PAT	12,610	8,032	10,703	7,200	10,504
Change (%)	-23.5	-36.3	33.2	-32.7	45.9

Balance Sheet (INR Million)

Y/E MARCH	2009	2010	2011	2012E	2013E
Share Capital	6,443	6,443	12,886	12,886	12,886
Reserves	91,255	97,513	98,760	102,675	110,163
Net Worth	97,698	103,956	111,646	115,561	123,050
Minority Interest					
Total Loans	0	0	149	149	149
Deferred Tax Liabil	6,214	6,606	6,935	6,935	6,935
Capital Employed	103,912	110,562	118,730	122,644	130,133
Gross Block	98,998	110,180	120,762	135,762	158,762
Less: Accum. Deprn	58,673	61,817	65,826	70,519	75,291
Net Fixed Assets	40,325	48,363	54,935	65,242	83,471
Capital WIP	28,671	22,434	17,435	15,435	15,435
Investments	8,959	9,868	13,317	13,317	13,317
Curr. Assets	45,288	52,096	60,452	62,326	51,199
Inventories	8,419	9,449	10,585	11,924	11,770
Account Receivable	265	1,818	1,124	1,987	1,962
Cash and Bank Bal	28,690	31,524	37,952	37,624	26,677
Others	7,914	9,306	10,791	10,791	10,791
Curr. Liability & Prov.	19,332	22,199	27,410	33,675	33,289
Account Payables	16,034	18,500	23,545	29,810	29,424
Provisions & Other:	3,298	3,700	3,865	3,865	3,865
Net Curr. Assets	25,956	29,897	33,042	28,650	17,910
Appl. of Funds	103,912	110,562	118,730	122,644	130,133

E: MOSL Estimates

Ratios

Y/E MARCH	2009	2010	2011	2012E	2013E
Basic (Rs)					
EPS	4.9	3.1	4.2	2.8	4.1
Cash EPS	6.0	4.4	5.8	4.5	5.9
BV/Share	37.9	40.3	43.3	44.8	47.7
DPS	1.3	0.6	1.0	1.0	1.0
Payout (%)	29.6	23.1	28.1	43.5	28.7
Valuation (x)					
P/E			14.7	21.8	15.0
Cash P/E			10.5	13.5	10.3
P/BV			1.4	1.4	1.3
EV/Sales			1.8	1.6	1.6
EV/EBITDA			7.1	11.2	7.4
Dividend Yield (%)			1.6	1.6	1.6
Return Ratios (%)					
RoE	12.9	7.7	9.6	6.2	8.5
RoCE (pre-tax)	19.3	10.6	13.3	8.4	12.6
RoIC (pre-tax)	39.0	16.0	22.2	9.1	16.8
Working Capital Ratios					
Fixed Asset Turnov	0.5	0.5	0.5	0.5	0.5
Asset Turnover (x)	0.5	0.5	0.5	0.5	0.6
Debtor (Days)	2	13	7	11	10
Inventory (Days)	17	19	18	18	16
Leverage Ratio (x)					
Current Ratio	2.3	2.3	2.2	1.9	1.5

Cashflow Statement (INR Million)

Y/E MARCH	2009	2010	2011	2012E	2013E
Pre-tax profit	19,272	11,549	15,247	9,771	15,915
Depreciation	2,724	3,194	4,301	4,693	4,771
(Inc)/Dec in Wkg. C	2,575	-1,108	3,284	4,063	-206
Tax paid	-6,410	-3,014	-4,225	-2,841	-5,411
Other operating ac	-1	-50	-6,734	0	0
CF from Op. Activity	18,160	10,570	11,872	15,687	15,069
(Inc)/Dec in FA + CV	-12,951	-4,944	-5,583	-13,000	-23,000
(Pur)/Sale of Invest	-7,809	-908	-3,449	0	0
Others					
CF from Inv. Activity	-20,760	-5,852	-9,032	-13,000	-23,000
Equity raised/(repa	0	0	6,443	0	0
Debt raised/(repai	0	0	149	0	0
Dividend (incl. tax)	-3,769	-1,885	-3,003	-3,015	-3,015
CF from Fin. Activity	-3,874	-1,885	3,589	-3,015	-3,015
(Inc)/Dec in Cash	-6,474	2,833	6,429	-329	-10,946
Add: opening Balai	35,165	28,690	31,524	37,952	37,624
Closing Balance	28,690	31,523	37,952	37,624	26,677

E: MOSL Estimates

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