

HINDALCO INDUSTRIES

Deleveraging key amidst volatile LME

India Equity Research | Metals and Mining



We perceive risk to the recent surge in Hindalco Industries' (Hindalco) stock price as LME aluminum price could weaken following commentary of large smelters in China looking to restart facilities coupled with commissioning of new capacities (7% of global demand). However, assuming moderation in LME prices, we believe the company can pare debt up to ~35% of current market cap, rendering the stock interesting over the medium term. Other critical positive factors for stock performance are ability to increase proportion of domestic sales and fully realign to global energy cost. Ergo, we recalibrate our SOTP, estimating target price of INR120 factoring in value of investments in listed companies and retain 'HOLD'.

Anticipated 7% additional supply to hammer LME aluminium price

At the current level of prices, we estimate an additional 3.5mt supply (~7% of global production) progressively in H2CY16 due to smelter restarts of up to 0.7mt and an additional 2.8mt of low-cost capacity expected to be added in China. This will disrupt demand-supply equilibrium, fuelling a price dip.

In 1st quartile of cost curve; could pare debt

Hindalco's cost-efficient operations and focus on value-added products are expected to ensure that the company continues to maintain its quartile 1 position in the global cost curve. On our estimates of LME at USD 1,500 and USD 1,575 we expect Hindalco to generate free cash flow of INR 76bn and INR 111bn over FY17E and FY18E, respectively. Even assuming a maintenance capex of INR10bn, the balance surplus can be utilised to cut gross debt from INR684bn to INR610bn over the forecast period.

Outlook and valuations: LME price under threat; maintain 'HOLD'

Our estimates factor in a moderation in LME prices and are below consensus. We realign our SOTP, estimating target price of INR120 (earlier INR100) factoring in value of investments in listed companies, in line with the methodology followed in Grasim and Tata Steel. We maintain 'HOLD/SP'.

Financials

(INR mn)

Year to March	FY15	FY16	FY17E	FY18E
Net revenue	1,042,811	1,000,538	1,029,537	1,087,070
EBITDA	89,446	87,240	104,177	114,132
Adjusted Profit	13,323	2,674	16,944	24,434
Diluted equity shares (mn)	2,063	2,063	2,063	2,063
Adjusted diluted EPS (INR)	6.5	1.3	8.2	11.8
EPS Growth (%)	(46.5)	(79.9)	NA	44.2
Diluted P/E (x)	18.2	90.5	14.3	9.9
EV/EBITDA (x)	9.1	9.3	7.6	6.5
ROAE (%)	1.8	0.1	4.3	6.0

EDELWEISS 4D RATINGS

Absolute Rating	HOLD
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Underweight

MARKET DATA (R: HALC.BO, B: HNDL IN)

CMP	: INR 117
Target Price	: INR 120
52-week range (INR)	: 125 / 59
Share in issue (mn)	: 2,065.0
M cap (INR bn/USD mn)	: 242 / 3,564
Avg. Daily Vol.BSE/NSE('000)	: 11,381.2

SHARE HOLDING PATTERN (%)

	Current	Q3FY16	Q2FY16
Promoters *	37.7	37.7	37.0
MF's, FI's & BK's	19.0	18.7	18.0
FII's	19.5	20.3	21.5
Others	23.8	23.4	23.6
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Metals and Mining Index
1 month	35.9	4.4	10.0
3 months	28.5	4.8	7.1
12 months	0.0	(3.3)	(12.4)

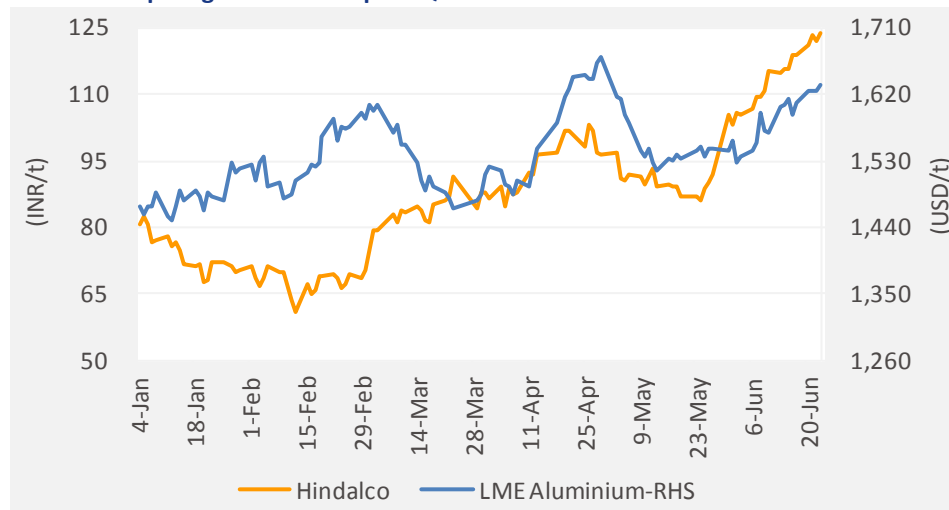
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Sharp surge in Hindalco this year

Hindalco has surged 35% YTD driven by better-than-expected Q4FY16 numbers and slight recovery in LME aluminium prices. LME Al price has been above USD 1,600 /t for a week now on the back of slower than expected smelter restarts.

Chart 1: Sharp surge in Hindalco post Q4FY16 results



Source: Edelweiss research

Sustained cost benefits due to efficient operations

We believe that the Cost of Production (COP) at both Aditya and Mahaan smelters is in the range of USD 1,450- 1,500/t (first quartile of cost curve) while for Renukoot and Hirakud operations it is in the range of USD 1,500-1,550/t (second quartile of cost curve) at ingot level. We estimate COP of Alumina at Utkal within USD 170/t (first decile of the cost curve). Captive bauxite and prevailing low price of coal in domestic market is expected to keep cost stable at the current levels.

Focus on value added products expected to keep margins stable

For domestic operations, we estimate the share of Value Added Products (VAP) to grow from 30% currently to 40% in next 24 months. The company is setting up Wire Rod Mill (WRM) of 200ktpa each at Aditya and Mahaan. Further, the company is shifting Novelis assets- 350ktpa high end plate capacity and 15ktpa ultra thin gauge capacity in India. Average premium of VAP over ingots is estimated at USD 150/t.

For Novelis, value added auto shipments are expected to account for 25% of total sales volume (~900kt) in next two years. The impact of metal price lag is also expected to be benign going forward. This is likely to keep EBITDA stable.

Balance sheet set to be deleveraged as cash flow likely to improve

Over the next two years, we expect Hindalco to consolidate its assets with capital expenditure limited to INR 10bn per annum. Hindalco has also got the debt at standalone refinanced and tenor extended until 2030. This would limit the total principal repayment to INR 10bn for next three years with an option to pre-pay. At Novelis, there is a repayment obligation of USD 1.2bn due in December 2017. The company is confident of getting the debt refinanced.

As a result, we expect free cashflow of INR 76bn and INR 111bn in FY17 and FY18 respectively. This is likely to reduce Net debt from INR 565bn in FY16 to INR 488bn in FY18.

Smelter restarts and additional capacity in China poses threat

At the current level of SHFE price of RMB 12,550/t, players with captive power were making cash margin at RMB 2,400-2,600/t on average in May, up 45-50% from the level in December. At this level of prices, capacity curtailed in February is again likely to come onboard. As per Asian Metal database, Chinese aluminium smelters will resume close to 0.7mtpa capacity in 2016. These restarts are further aided by power subsidies from the government.

Further, an additional capacity of 2.8mn tonnes is expected to come onboard during CY16. We expect this to exacerbate the fragile demand supply balance currently, pushing prices down from the current levels.

Valuation

Table 1: Target price revised to INR120(INR100 earlier)

	FY18E
Novelis	
Applicable multiple (x)	7.0
EBITDA (USD mn)	987
Enterprise value (USD mn)	6,911
Enterprise value (INR mn)	463,037
Less: debt (INR mn)	288,974
Equity valuation (INR)	174,063
Equity valuation/share (INR) - NOVELIS	84
Copper	
Applicable multiple (x)	6.0
EBITDA (INR mn)	15,981
Enterprise value (INR mn)	95,884
Aluminium	
Applicable multiple (x)	6.0
EBITDA (INR mn)	32,003
Enterprise value (INR mn)	192,020
Total Enterprise value (INR mn)	287,904
Less: Debt (INR mn)	255,660
Equity value (INR mn)	32,244
Equity valuation/share (INR) - INDIA/EX-NOVELIS	16
Add: Value of listed investments (at 30% discount)*	40,435
Investments/share (INR)	20
Company equity valuation (INR mn)	246,742
Company equity valuation/ share (INR)	120
Current market price (INR)	117
No. of shares (mn)	2,063
Upside (%)	2

Source: Edelweiss research

* Includes investments in Idea, Nalco, AB Nuvo, Grasim and Ultratech.

Company Description

Hindalco is one of the largest aluminium producers in India with 0.5mtpa of upstream aluminium facility/capacity and backward linkage in alumina (1.5 mtpa) and bauxite (reserves of 65 mn tonnes). It also operates India's largest copper smelter with a capacity of 500,000 tonnes at Dahej with a captive power plant, jetty, and ~15% backward linkage in copper concentrate through Aditya Birla Mineral (a 51% subsidiary). In February 2007, Hindalco acquired Novelis, a 3.0 mtpa aluminium rolled-products producer, for enterprise value of USD 6.1 bn. Novelis has 33 operating plants and 3 research facilities in 11 countries, across 4 continents. The company has increased its alumina capacity to 3.0 mtpa (from 1.5 mtpa currently) and aluminium capacity to 1.3 mtpa, with total capital outlay of INR300bn. These green field projects have been ramped up in FY16.

Investment Theme

We have a cautious outlook on aluminium due the possibility of supply discipline getting routed. Hindalco's standalone business is robust with competitive cost of producing aluminium (~USD 1,500/tonne at ingot level currently) and value-added aluminium products, which constitute over 50% of the volume mix. The company manufactures special grade alumina that commands a premium of up to ~USD 250/tonne over the regular variety. We expect EBITDA growth in Novelis led by ramp up of auto-lines in USA and improved product-mix.

Key Risks

Aluminium LME prices sustaining below USD1,500/t with no increase in premiums

Higher- than- expected increase in input costs

Lower –than- expected margin expansion at Novelis

Financial Statements

Key Assumptions

Year to March	FY15	FY16	FY17E	FY18E
Macro				
GDP(Y-o-Y %)	7.2	7.4	7.9	8.3
Inflation (Avg)	5.9	4.8	5.0	5.2
Repo rate (exit rate)	7.5	6.8	6.0	6.0
USD/INR (Avg)	61.1	65.0	67.5	67.0
Sector				
Aluminium LME (USD/t)	1,890.0	1,600.0	1,500.0	1,575.0
Copper Tc/Rc (USD/t)	19.0	22.0	22.0	22.0
Company				
Volumes (tonnes)				
Alumina prodn	2,220,000	2,520,000	2,782,000	2,916,200
Alumina sales	625,255	372,395	239,495	373,695
Aluminium sales	831,120	1,107,550	1,305,000	1,305,000
Copper Sales	368,300	388,300	388,300	388,300
Cost per tonne (INR)	-	-	-	1
Bauxite	3,600	2,310	2,310	2,310
Caustic soda	32,400	25,000	29,000	29,000
Calcined Petroleum Coke	31,502	23,000	23,000	23,000
Staff costs (INR mn)	13,578	16,981	17,490	18,015
Novelis	-	-	-	1
Total shipments (ktpa)	3,374	3,325	3,605	3,705
Blended Realisation(USD)	3,304	2,969	2,789	2,932
EBITDA (USD mn)	902	791	973	987
Blended EBITDA/t (USD)	267	238	270	266
Avg. Interest rate (%)	6.4	7.4	7.4	7.4
Depreciation rate (%)	4.9	4.6	4.0	3.9
Tax rate (%)	75.4	30.0	30.0	30.0
Dividend payout (%)	42.4	91.7	19.3	13.1
Net borrowings (INR mn)	564,761	565,552	544,634	488,386
Capex (INR mn)	73,550	44,500	10,000	10,000
Debtor days	32	32	32	32
Inventory days	98	109	115	115
Payable days	79	92	98	98
Cash conversion cycle	51	49	49	49

Income statement

(INR mn)

Year to March	FY15	FY16	FY17E	FY18E
Net revenue	1,042,811	1,000,538	1,029,537	1,087,070
Materials costs	656,913	586,392	605,725	650,875
Accretion to stock	(12,379)	12,543	-	-
Employee costs	79,912	81,381	81,891	82,416
Total SG&A expenses	144,767	140,107	140,683	141,868
Other Expenses	71,772	105,417	97,061	97,779
Power and Freight	83,786	92,874	97,061	97,779
EBITDA	89,446	87,240	104,177	114,132
Depreciation	35,906	41,961	42,269	42,990
EBIT	53,540	45,279	61,908	71,142
Add: Other income	11,047	12,113	11,623	11,798
Less: Interest Expense	41,784	50,467	52,488	52,328
Add: Exceptional items	(19,401)	(1,711)	-	-
Profit Before Tax	3,402	5,214	21,042	30,612
Less: Provision for Tax	2,564	5,148	6,312	9,184
Less: Minority Interest	(5,957)	(2,378)	-	-
Associate profit share	1,747	1,749	2,214	3,006
Profit- Discontinued Ops	-	(1,560)	-	-
Profit- Discontinued Ops	-	(20)	-	-
Reported Profit	8,542	2,633	16,944	24,434
Exceptional Items	(4,781)	(22)	-	-
Adjusted Profit	13,323	2,674	16,944	24,434
Shares o/s (mn)	2,063	2,063	2,063	2,063
Adjusted Basic EPS	6.5	1.3	8.2	11.8
Diluted shares o/s (mn)	2,063	2,063	2,063	2,063
Adjusted Diluted EPS	6.5	1.3	8.2	11.8
Adjusted Cash EPS	23.9	21.6	28.7	32.7
Dividend per share (DPS)	1.5	1.0	1.0	1.0
Dividend Payout Ratio(%)	42.4	91.7	19.3	13.1

Common size metrics

Year to March	FY15	FY16	FY17E	FY18E
Operating expenses	91.4	91.3	89.9	89.5
Depreciation	3.4	4.2	4.1	4.0
Interest Expense	4.0	5.0	5.1	4.8
EBITDA margins	8.6	8.7	10.1	10.5
Net Profit margins	0.7	-	1.6	2.2

Growth ratios (%)

Year to March	FY15	FY16	FY17E	FY18E
Revenues	18.9	(4.1)	2.9	5.6
EBITDA	7.9	(2.5)	19.4	9.6
PBT	(87.2)	53.3	303.6	45.5
Adjusted Profit	(46.5)	(79.9)	533.5	44.2
EPS	(46.5)	(79.9)	533.5	44.2

Balance sheet				(INR mn)
As on 31st March	FY15	FY16	FY17E	FY18E
Share capital	2,065	2,065	2,065	2,065
Reserves & Surplus	381,220	384,333	394,434	410,443
Shareholders' funds	383,285	386,398	396,499	412,507
Minority Interest	9,561	6,119	6,119	6,119
Short term borrowings	130,188	102,394	102,394	102,394
Long term borrowings	553,862	581,762	551,906	508,041
Total Borrowings	684,050	684,156	654,300	610,435
Long Term Liabilities	73,773	81,541	81,541	81,541
Def. Tax Liability (net)	39,481	33,303	33,303	33,303
Sources of funds	1,190,151	1,191,516	1,171,762	1,143,905
Gross Block	796,817	956,817	976,817	986,817
Net Block	566,725	666,215	643,946	610,956
Capital work in progress	162,373	46,873	36,873	36,873
Intangible Assets	131,602	139,852	139,852	139,852
Total Fixed Assets	860,700	852,940	820,671	787,681
Non current investments	74,484	87,174	87,174	87,174
Cash and Equivalents	119,289	118,603	109,666	122,048
Inventories	184,511	166,940	214,750	195,391
Sundry Debtors	91,864	81,995	96,903	91,992
Loans & Advances	75,730	63,500	63,500	63,500
Other Current Assets	24,810	38,525	38,525	38,525
Current Assets (ex cash)	376,915	350,960	413,678	389,408
Trade payable	155,005	142,000	183,266	166,245
Other Current Liab	86,233	76,161	76,161	76,161
Total Current Liab	241,238	218,161	259,427	242,406
Net Curr Assets-ex cash	135,678	132,799	154,251	147,002
Uses of funds	1,190,151	1,191,516	1,171,762	1,143,905
BVPS (INR)	185.7	187.3	192.2	199.9

Free cash flow				(INR mn)
Year to March	FY15	FY16	FY17E	FY18E
Reported Profit	8,542	2,633	16,944	24,434
Add: Depreciation	35,906	41,961	42,269	42,990
Interest (Net of Tax)	10,298	637	36,743	36,630
Others	25,530	49,011	11,317	9,687
Less: Changes in WC	(7,588)	8,577	21,452	(7,249)
Operating cash flow	87,863	85,666	85,820	120,991
Less: Capex	73,550	44,500	10,000	10,000
Free Cash Flow	14,313	41,166	75,820	110,991

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
Hindalco Industries	3,564	14.3	9.9	7.6	6.5	4.3	6.0
Hindustan Zinc	10,547	10.8	9.6	6.9	5.2	16.8	16.7
Korea Zinc Co Ltd	7,946	14.0	12.8	7.0	6.5	12.1	12.3
National Aluminium Co Ltd	1,579	14.4		6.4		5.8	
United Co RUSAL PLC	4,248	5.9	5.2	8.7	8.4	32.0	22.6
Vedanta	5,141	10.7	5.0	5.6	4.1	5.0	9.4

Source: Edelweiss research

Cash flow metrics				
Year to March	FY15	FY16	FY17E	FY18E
Operating cash flow	87,863	85,666	85,820	120,991
Investing cash flow	(77,525)	(57,190)	(10,000)	(10,000)
Financing cash flow	18,365	(72,801)	(84,758)	(98,608)
Net cash Flow	28,704	(44,325)	(8,938)	12,383
Capex	(73,550)	(44,500)	(10,000)	(10,000)
Dividend paid	(3,623)	(2,414)	(2,414)	(2,414)

Profitability and efficiency ratios

Year to March	FY15	FY16	FY17E	FY18E
ROAE (%)	1.8	0.1	4.3	6.0
ROACE (%)	6.0	5.3	6.9	8.0
Inventory Days	99	107	115	115
Debtors Days	32	32	32	32
Payable Days	81	90	98	98
Cash Conversion Cycle	51	48	49	49
Current Ratio	2.1	2.2	2.0	2.1
Gross Debt/EBITDA	7.6	7.8	6.3	5.3
Gross Debt/Equity	1.7	1.7	1.6	1.5
Adjusted Debt/Equity	1.7	1.7	1.6	1.5
Net Debt/Equity	1.4	1.4	1.4	1.2
Interest Coverage Ratio	1.3	0.9	1.2	1.4

Operating ratios

Year to March	FY15	FY16	FY17E	FY18E
Total Asset Turnover	0.9	0.8	0.9	0.9
Fixed Asset Turnover	1.6	1.3	1.3	1.4
Equity Turnover	2.6	2.5	2.6	2.6

Valuation parameters

Year to March	FY15	FY16	FY17E	FY18E
Adj. Diluted EPS (INR)	6.5	1.3	8.2	11.8
Y-o-Y growth (%)	(46.5)	(79.9)	533.5	44.2
Adjusted Cash EPS (INR)	23.9	21.6	28.7	32.7
Diluted P/E (x)	18.2	90.5	14.3	9.9
P/B (x)	0.6	0.6	0.6	0.6
EV / Sales (x)	0.8	0.8	0.8	0.7
EV / EBITDA (x)	9.1	9.3	7.6	6.5
Dividend Yield (%)	1.3	0.9	0.9	0.9

Additional Data

Directors Data

Kumar Mangalam Birla	Chairman	D Bhattacharya	Managing Director
Rajashree Birla	Director	M M Bhagat	Director
K N Bhandari	Director	N J Jhaveri	Director
AK Agarwala	Director	Ram Charan	Director
Jagdish Khattar	Director	Satish Pai	Deputy Managing Director

Auditors - Singhi & Co

**as per last annual report*

Holding – Top10

	Perc. Holding		Perc. Holding
Igh holdings pvt ltd	16.95	Life insurance corp	14.77
Turquoise investment	6.01	Trapti trading and i	4.51
Grasim industries lt	2.64	Blackrock	1.62
Aditya birla nuvo lt	1.62	Dimensional fund adv	1.44
Pilani investment &	1.41	Umang commercial co	1.32

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Coal India	BUY	SO	M	Hindalco Industries	HOLD	SP	M
Hindustan Zinc	BUY	SO	L	Jindal Steel & Power	HOLD	SP	M
JSW Steel	REDUCE	SP	H	NMDC	HOLD	SP	M
Steel Authority of India	REDUCE	SU	M	Tata Steel	REDUCE	SU	M
Vedanta	HOLD	SP	M				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect



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Coverage group(s) of stocks by primary analyst(s): Metals and Mining

Coal India, Hindalco Industries, Hindustan Zinc, Jindal Steel & Power, JSW Steel, NMDC, Steel Authority of India, Tata Steel, Vedanta

Recent Research

Date	Company	Title	Price (INR)	Recos
16-Jun-16	Tata Steel	Challenging times ahead; <i>Visit Note</i>	330	Reduce
09-Jun-16	Metals & Mining	Q4FY16: Price decline trumps volume growth; <i>Sector Update</i>		
08-Jun-16	NMDC	Board approves buyback; minimal impact on earnings; <i>EdelFlash</i>	91	Hold

Distribution of Ratings / Market Cap

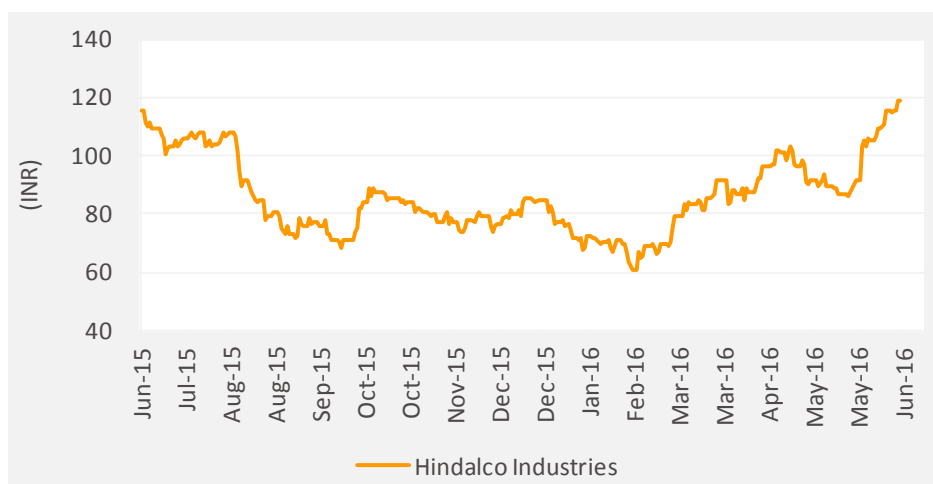
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	158	59	12	229
* - stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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