Asia Pacific - India | Equity | Construction - Cement

NextGen India Investments

HeidelbergCement India Limited

Short term pain to realize long term gains…

29 September 2010	
Current Price (INR)	48.4
Target price (INR)	57.6
Potential return (%)	19%
52-week range (INR)	64.9/ 33.1
Bombay Stock Exchange (BSE 30)	19,956

Stock Rating
Overweight (OW)

Performance (%)	1m	3m	12m
HCIL (absolute)	-0.5	27.4	7.9
BSE 30	10.9	13.8	18.4
BSE 500	9.1	13.3	23.3
MSCI India (INR)	11.0	11.3	13.1
MSCI India (USD)	15.6	14.5	16.5

Stock statistics	
Symbol/ Exchange	HEIDELCEM/ BSE
Bloomberg	HEIM:IN
Market cap (INRbn)	1.1
Market cap (USDmn)	244.1
Shares outstanding, current (mn)	226.6
Free float (%)	31.4
Avg. daily trading volume (3 months, '000 shares)	280.3

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Initiating coverage with an Overweight (OW)

We see a further 19% potential return from the current level on this cement play. Our 1-year target price is based on capacity led revenue growth, and our expectation that pricing pressure in the industry would start easing from FY 12-13.

Strong and committed parent

HeidelbergCement Group is the third largest cement manufacturer in the world. HCIL would be benefited by rich product portfolio, technological support in manufacturing technology and parent's experience to scale up operations in emerging economies.

Trading at a discount to the acquisition price

HCIL is trading at a significant discount to the acquisition price paid by HeidelbergCement Group to acquire controlling stake in 2006. Post acquisition, the operations of HCIL have turned around and the company is now cash rich. Current price offers an attractive entry point for long term investors.

Poised to scale up

HCIL plans to double its manufacturing capacities by March 2012. We believe that post 2012; HCIL would further grow by organic and inorganic routes to become a key player in the industry. Capability to turn around acquired units and conservative capital structure are key value drivers.

Reasonable valuations

Our 1-year target price is based on USD 61.6x FY12E EV/ tonne and 7.7x FY12E EV/EBITDA. In our view, cement demand in India is at an inflection point and pricing pressure would start easing from 2012-13. We believe that HCIL would trade at a premium valuation to the medium size cement players.

Key risk factors

1) Over capacity in the cement industry. 2) Rising cost pressures. 3) Limited captive power generation capacity. 4) Rising freight costs. 5) Constraints in the availability of fly ash. These factors may impact our earnings assumptions.

Key financials & valuation

INR bn (Year ending Dec.)	2009A	2010E	2011E	2012E
Profit & loss summary				
Net Sales	9.4	9.3	9.3	14.0
EBITDA	1.6	1.5	1.0	2.2
Net Income	1.3	0.8	0.3	0.1
Cash Flow summary				
Cash from operations	1.7	0.8	0.1	1.5
Cash from investments	0.0	(1.8)	(8.7)	(0.3)
Cash from financing	(0.1)	0.0	6.5	(0.6)
Change in cash	1.6	(1.1)	(2.1)	0.5
Balance Sheet summary				
Shareholders' Capital	7.4	8.2	8.4	9.4
Minority Interest				
Operating liabilities	-	-	6.5	5.8
Deferred Tax liability	0.2			
Total Liabilities	**7.5**	**8.2**	**14.9**	**14.3**
Net Current Assets	3.8	2.3	0.0	0.5
Net Fixed Assets	3.1	3.4	5.4	13.6
Capital Work in Progress	0.6	2.5	9.5	0.3
Total Assets	**7.5**	**8.2**	**14.9**	**14.3**

Valuation

	2009A	2010E	2011E	2012E
PE (:1)	8.2	13.8	43.8	91.6
P/BV (:1)	1.5	1.3	1.3	1.4
EV/Sales (:1)	0.6	0.8	1.7	1.0
EV/EBITDA (:1)	3.8	4.6	15.3	7.2
FCF/Share (:1)	7.5	3.4	0.3	6.0
FCF Yield (%)	15.5	7.0	0.7	12.3

Per share data

INR	2009A	2010E	2011E	2012E
EPS	5.9	3.5	1.1	0.5
Book value	32.5	36.0	37.1	34.2

Quarterly trend

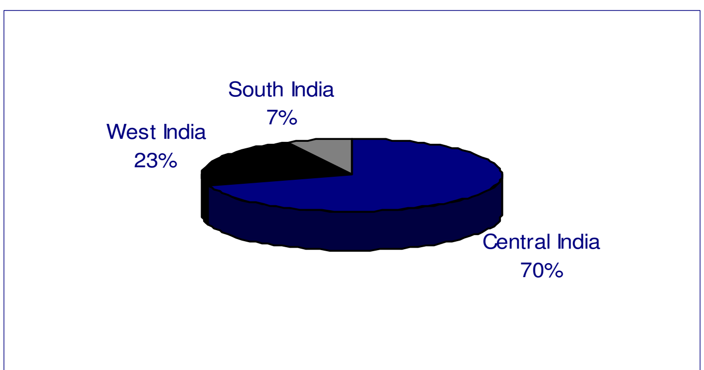
INR bn	Sep-09	Dec-09	Mar-10	Jun-10
Sales	2.3	2.3	3.0	2.8
EBITDA	0.5	0.4	0.7	0.5
Net income	0.3	0.5	0.4	0.3

Peer comparison

	EV/ tonne	P/ BV	EV/ EBITDA
HCIL	43.8	1.6	2.9
JK Lakshmi Cement	48.7	0.8	2.8
OCL India	52.5	1.0	3.1
Mangalam Cement	40.1	1.1	1.9

Ratios	2009A	2010E	2011E	2012E
EBITDA (%)	17.1	16.6	11.0	15.5
NPM (%)	14.3	8.5	2.7	0.9
Total debt/ Equity (:1)	0.4	0.4	1.1	1.2
ROE (%)	18.2	9.7	3.0	1.5

Geographical break down of revenues: FY 2009



Relative Performance: BSE Sensex

Source: Company data, NextGen India Investments Research
E: NextGen India Investments Research estimates

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Company Background

HCIL is a part of Germany based group

HeidelbergCement India Limited (HCIL) is a part of the EUR 11 billion HeidelbergCement Group. HCIL was set up in 1958 and was a part of S. K. Birla Group. In 2006, HeidelbergCement Group acquired control and changed the company's name to HeidelbergCement India Limited. HCIL operates through 5 manufacturing facilities in India. The company primarily manufactures cement, clinker and building products.

Exhibit 1
Shareholding Pattern

Shareholder	Shareholding %
Foreign Promoters	68.5
Foreign Inst. Investors	5.4
DII's and General Public	26.1

As on June 30, 2010

Source: Bombay Stock Exchange

Investment Rational

Strong and committed management

Parent of the HCIL is among the largest cement manufacturers

Exhibit 2
Heidelberg Group global facts

Inception	1873
Consolidated Revenues (FY 2009)	EUR 11 billion
No. of employees	56,000
Competitive position	No. 1 in aggregates No. 3 in cement No. 3 in ready mix concrete
Cement capacity	107 MTPA
Manufacturing locations	2600 plants in 40 countries

Source: HeidelbergCement Global

HCIL is a 68% subsidiary of Cementrum I. B.V. (a company incorporated under the laws of The Netherlands, which is 100% controlled by Germany based HeidelbergCement AG). The parent's equity shares are part of German benchmark DAX 30 index. HeidelbergCement Group is a prominent global player to manufacture and distribute cement, concrete and downstream building products. The group was among the first to focus on transitional Eastern European economies in 1980's. The group started focusing in Asia and Africa in 1990's and has since readjusted its business focus to leverage the growth in emerging economies. The group is currently pursuing a clear dual external growth strategy: expansion of the cement business in growth markets and North America; and focus on aggregates and downstream activities in mature markets and North America. The strategy aims to leverage growth rate in emerging economies since in early stage of economic development the proportion of cement utilization in construction activities is high. The strategy also aims to consolidate group's position in mature markets by introducing value added aggregates and downstream products since industrialized economies have high degree of vertical integration.

The acquisition of Hanson in 2007 was a logical consequence of strategic reorientation. It strengthened group's position in aggregates and building products segments. It also brought extensive raw material base in important markets of North America, the United Kingdom and Australia. HCIL is expected to be benefited from extensive experience of the parent.

Parent's focus on emerging markets to benefit HCIL

Globally the group is expected to add 20MTPA cement capacity over the next two years. Emerging Asian economies such as China and India are important markets for the growth plans of the group. About 17.5% of the global capacity expansion is expected at group's Indian subsidiary (HCIL). It would increase the capacity of HCIL from 3.1 MTPA to 6.0 MTPA by March 2012.

HCIL to leverage diverse product portfolio and strong R & D of the parent

In the short run, we believe that the focus of Indian construction industry would be towards utilization of basic cement, concrete and building products. However over the long run, there would be gradual shift towards value added concrete and specialized building products segments. Rich product portfolio of the parent would benefit HCIL in launching specialized products. We feel that there would be increased awareness for natural resource conservation and environment protection. HCIL would have a competitive edge due to proprietary environment technology products of the parent.

HCIL would be in a unique position to derive benefits from parent's experience in procurement of key inputs for cement production, manufacturing technology, treatment of effluent generated from manufacturing, transportation of cement to influencing markets, institutional relationships and marketing of its products.

Exhibit 3
HeidelbergCement Group: Product portfolio

Standard cement	Used in standardized construction activities
Specialty cements	White and trass cements Sulphate resisting aquament and Portland cement for hydraulic engineering Anti sulphate for sewage work construction Fine cement for soil injection and masonry repair Depocrete and Procrete for waste dump sealing
Specific binders	Tailor made cement products for geotechnology, environmental technology and road construction
Aggregates	Raw material for ready mix concrete; used for structural fill, road base, and railway ballast
Concrete and ready mix concrete	Used in construction and construction engineering
Concrete products	Light, heavy and aerated concrete building blocks, pavers, prefabricated ceilings, walls, cellar and sewage works units
Building products	Lime and limestone products, sand lime bricks for the use in advanced construction engineering
Environmental technology	Specialty products and services for waste stabilization, landfill construction, and immobilization of toxic compounds

Source: HeidelbergCement Global

Trading at a discount to the acquisition price

Current price is at a discount to the acquisition price paid by the parent

In 2006, HeidelbergCement Group acquired shareholding from erstwhile promoters at Rs 58 per share excluding an additional non compete fee of Rs 14.5 per share. Subsequently it made a public offer to acquire additional stake. Current share price is at a substantial discount to the acquisition price. Post acquisition there has been expansion of capacities, operational restructuring and cash infusion to retire high cost debt. It led to turnaround and turned the company from distressed to cash rich. The discount to acquisition price can be attributed to the adverse industry situation. However we believe that the industry condition would improve and therefore in our view current price offers an attractive opportunity for long term investors.

Poised to scale up

HCIL plans to double the capacities by March 2012

HeidelbergCement Group plans to globally add 20 MTPA cement, aggregates and clinker capacities over the next 2 years. 17.5% of the capacities would be added in HCIL. Upon completion of the expansion in March 2012, the cement production capacity of HCIL would double to 6.0 MTPA from the current capacity of 3.1 MTPA. The timing of the completion of expansion would be a significant advantage as we believe that the impact of oversupply would start easing from FY 2012; it would reduce payback period for the expansion cost. Most of the expansion would occur in central India; traditionally the region has better price realization than the Southern market. It would maintain high operating margins for the company. We believe that in the long run, HCIL would expand more aggressively through organic and inorganic route. Strong pedigree, ability to operationally turn around the acquired units, surplus cash in the balance sheet would be significant long term advantages over competitors.

Geographical reach of the manufacturing units and limestone mine arrangement

Reach of manufacturing facilities to support in scaling up the operations

Exhibit 4
Geographical reach of the manufacturing facilities

Units	Influencing markets
Damoh and Jhansi	Uttar Pradesh, Madhya Pradesh, Chhattisgarh, Haryana, Rajasthan, Delhi, Uttarakhand
Raigad	Maharastra
Ammasandra	Karnataka, Andhra Pradesh, Tamil Nadu, Kerala

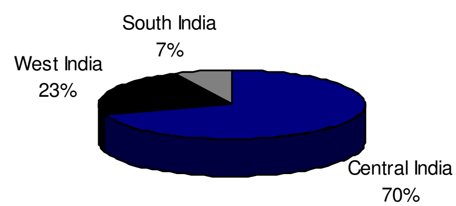
Source: Company data, NextGen India Investments Research

As per industry estimates freight and distribution cost accounts for 12-18% of the revenues in the cement industry. The cost depends on lead distance to markets, freight mix between road, rail and sea, and proximity of manufacturing units to the sources of raw material. Optimizing these costs is important to gain operating margins. HCIL have 5 manufacturing locations. These locations enable the company to focus on Northern, Central, and Southern part of the country. Maharashtra unit of the company mainly caters to high growth markets such as Mumbai and Pune. Only a few mid size cement players have pan India focus and manufacturing reach. In the long run it would enable the HCIL management to undertake capacity expansion in areas where potential is high.

Focus on North and Central India to moderate oversupply pressure

We believe that in the long run HCIL would be a key player in the Indian cement industry. Such advantage would provide the company to leverage synergies among units located in different geographical locations, rationalize costs and focus on institutional segment of the construction industry. Traditionally, North and central India have witnessed better pricing of cement. HCIL is expected to benefit from the trend since it derives most of the revenues from central India. South India is currently witnessing acute oversupply situation, since this region accounts for 7% of the total revenues of HCIL, the impact on the company would be relatively moderate. In the past, cement companies in India have witnessed considerable delays in commissioning expanded capacities. Most delays have occurred due to problems in getting license for limestone mining, environmental clearances, and acquiring land. HCIL have obtained these approvals from the government and we expect that the expanded facilities would commence commercial production as scheduled from March 2012.

Exhibit 5
Geographical break down of revenues (2009)



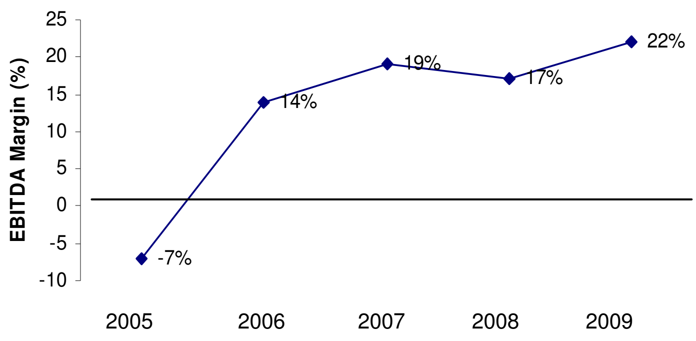
Source: Company data

The company currently has a market share of 8.6% in Madhya Pradesh and 6.2% in Uttar Pradesh. Since majority of the capacity expansion is planned in manufacturing facilities located in central India, company's market share is expected to increase to 9.0% in Madhya Pradesh and 7.3% in Uttar Pradesh by 2015. These two states are among the most populous regions and have high growth potential; consolidation of market position in central India would provide strategic advantage to HCIL.

Capability to acquire, integrate and turn around:

Demonstrated capability to turn around acquired units

Exhibit 6
Post acquisition: Operational turnaround



Source: Company data, NextGen India Investments Research

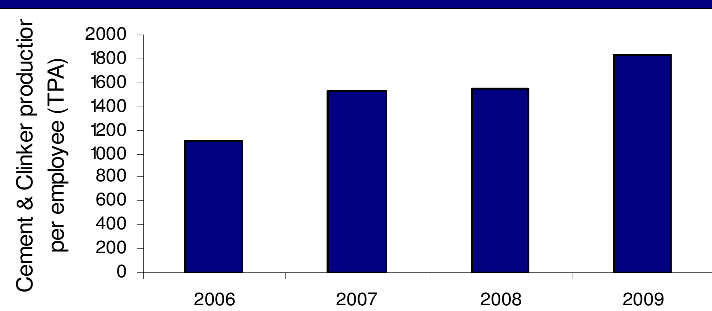
HeidelbergCement Group acquired management control of HCIL in August 2006. Subsequently, HCIL acquired Indo Rama Cement in April 2008. Post acquisitions there has been considerable improvement in operating margins of the acquired units. HCIL has reduced bottlenecks in the production process to enhance capacity utilization and reduce break down time.

By increasing the proportion of road dispatches, HCIL has reduced freight and transportation costs. HCIL also entered into long term arrangements with key raw material suppliers to optimize the procurement costs and ensure regular supply of inputs. Focus on marketing efforts in proximity to manufacturing facilities of the company led to further reduction in transportation costs.

Increased productivity by rationalizing manpower and optimizing use of inputs

By negotiating settlement with labor unions, the company rationalized its workforce to 2183 employees in 2009 from 2926 employees in 2005.
During this period cement production increased by 27%. It indicates enhancement in productivity of employees. Modernization and debottlenecking initiatives led to enhancement in the productivity of key inputs. Cost cutting initiatives led to operational turnaround and expansion in EBITDA margins.
In a raw material intensive industry like cement, making the cost structure more efficient reduces volatility in earnings during downturn, increases operational cash flow and improves return ratios.

Exhibit 7
Increase in employee productivity



Source: Company data, NextGen India Investments Research

Balance sheet restructuring

Retired long term debt and reduced working capital requirement

HCIL restructured its balance sheet to improve return ratios. The company reduced receivables to 8.3 days and managed payables at 31 days in FY 2009-10. This reduced working capital requirement and improved return on capital. High cost debt has been retired. The company is now debt free and holds surplus cash of Rs 4.9 billion as on December 31, 2009.

The ability of the management to pay conservative price for acquisitions, restructure and turn around loss making units into profitable units would be key value drivers for the shareholders of HCIL.

Peer comparison

Trading at a discount to peers

HCIL is currently trading at an EV/tonne of USD 48.4. The valuation is at a steep discount to other similar sized cement players in India. We believe that the management strength and pan India location of manufacturing facilities are the unique advantages of HCIL over its competitors. HCIL has one of the most ambitious expansion plans among mid sized cement players. Strong execution capabilities and conservative financial policies of the management ideally position it to leverage long term opportunities in infrastructure sector. The current cost structure of HCIL leaves scope for improvement. By attainting backward linkages for coal and power supply there would be further reduction in costs. It would lead to accretion in operating margins.

In our opinion, the current uncertain situation in the industry offers an attractive opportunity to enter in HCIL.

Exhibit 8: HCIL trading at a reasonable valuation

	HCIL	JK Lakshmi	OCL India	Mangalam
Share price	48.4	65.5	138.4	157.5
PE	8.3	3.5	5.3	4.0
P/BV	1.6	0.8	1.0	1.1
EV/Sales	0.6	0.6	0.8	0.6
EV/EBITDA	2.9	2.8	3.1	1.9
EV/ tonne (USD)	43.8	48.7	52.5	40.1

Based on trailing 12 months results

Source: Bombay Stock Exchange, NextGen India Investments Research

Financial projections

Capacity expansion to be funded by internal accruals and debt

Surplus cash to be utilized for expansion

Conservative debt equity ratio to reduce risk during uncertain industry conditions

The total cost of expansion is Rs 12.0 billion. It includes earmarking of Rs 9.5 billion for capacity expansion and Rs 2.5 billion for the modernization and debottlenecking of manufacturing facilities. We expect the company to fund the expansion by the combination of debt and equity. The debt equity ratio for the expansion is expected at 1.2:1. We have projected a funding of Rs 6.4 billion from debt and Rs 5.6 billion from internal accruals. As on December 31, 2009, the company held a surplus cash of Rs 4.9 billion. We expect that despite recessionary conditions in the industry, HCIL would generate sufficient cash from operations to partially fund the cost of expansion. Conservative debt equity ratio for the expansion would reduce risk from financial leverage during uncertain times.

Exhibit 9
Capacity expansion details

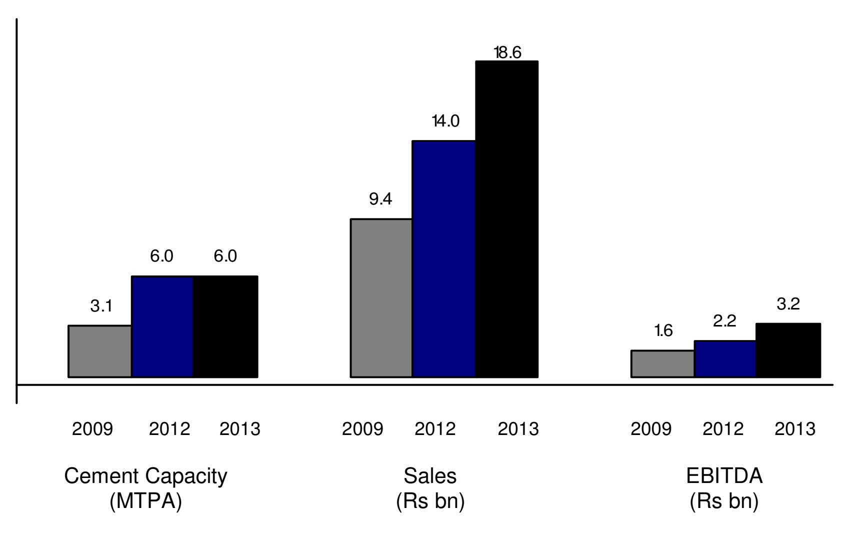
Product	Location	Current (MTPA)	Proposed (MTPA)
Clinker Manufacturing	Narsingarh, District: Damoh, Madhya Pradesh	1.2	3.1
Cement Grinding	Imlai, District: Damoh, Madhya Pradesh	1.0	2.0
Cement Grinding	Jhansi, Uttar Pradesh	0.8	2.7

Source: Company data

The company has recently placed orders to acquire certain equipments and we believe that at the end of the first quarter of calendar year 2011, there would be need to do the fresh borrowing for the expansion. Civil work for the construction is expected to start from July 2011. Expanded facilities are scheduled to commence commercial production from March 2012.

Full benefits of capacity expansion from FY 2013

Exhibit 10
Impact of capacity expansion on financials



Source: NextGen India Investments Research

Since the proportion of internal accrual for the expansion is high, it would keep the financial leverage of HCIL low. We expect the total debt to equity ratio to reach at a peak level of 1.2:1 in FY 2012; this would be the time when expanded facilities of HCIL would commence commercial production. FY 2013 would be the first full year of commercial production of expanded capacities; from this year sales and EBITDA of HCIL are expected to substantially increase. Higher operational cash flow generation is expected to improve debt servicing capacity of the company. We expect that increased level of operations, easing of pricing pressure and improvement in cost efficiency would lead to shorter payback period for the expenses incurred on expansion.

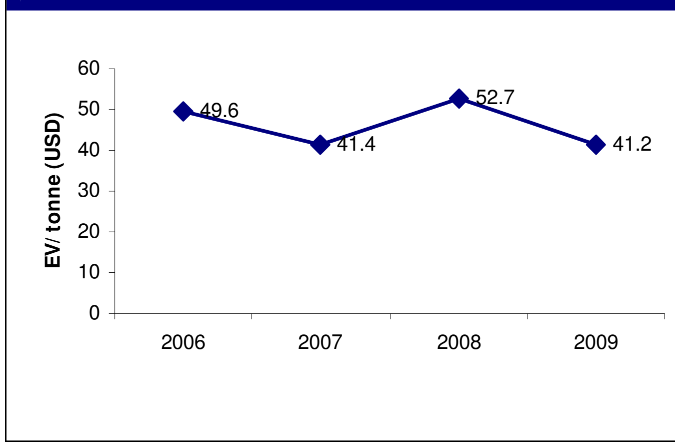
Initiating coverage with an overweight

Asset based valuation suitable for the industry

We believe that for the cement industry, asset based matrix is more applicable. During the cyclical downturns, earnings are more volatile, therefore asset base valuation matrix offers more stability to the valuation process. During industry downturn, while smaller players trade at a steep discount to the replacement cost of their assets, cash rich and acquisitive players explore opportunities to inorganically grow by acquiring assets trading at a discount to the replacement cost.

Based on the last 2 industry cycles from 1994 to 2009, we have assumed that the asset based valuation multiples during the previous downturn in the year 2000 provide a floor to the implied stock values. The multiples during the upturn in FY 1994-1995 and FY 2008-09 would be the cap and can be used for exit. We believe that since the cost of setting up a cement plant has substantially increased over the last 10 years, the floor arrived on the basis of downturn in the year 2000 by asset based valuation indicators would be reliable. Profitability of Indian cement companies have also substantially improved from the levels of downturn in the year 2000. Post acquisition by the German parent, HCIL has traded at an EV/tonne band of USD 41 and USD 53.

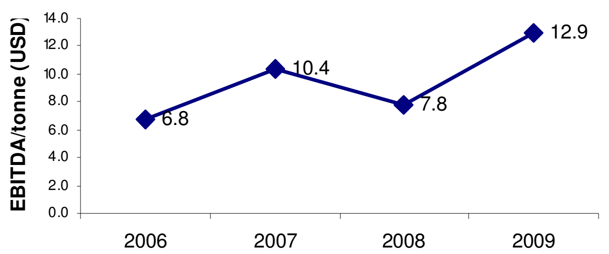
Exhibit 11
Historical EV/ tonne trend: HCIL



Source: NextGen India Investments Research

Valuations to stay above the previous downturn

Exhibit 12
Historical EBITDA/ tonne trend: HCIL



Source: Company data, NextGen India Investments Research

Over the last 4 years, HCIL has traded at a per tonne EBITDA band of 6 and 13. Last 4 years have largely been considered upturn in the cement industry therefore we considered valuation multiples of previous industry cycle. Year 2012 would be the early stage recovery period for cement industry. During early cyclical upturn, mid sized cement players have traded at an EV/ tonne band of USD 45 and USD 65. At our target price HCIL would trade at a USD 61.6x FY12E EV/ tonne and 7.7x FY 12E EV/EBITDA. We assign overweight (OW) rating to the stock.

The projections for FY 12-13 consider production of only 6 months from the expanded capacities, therefore earning based multiples appear to be on the higher side. FY 2013-14 would be the first full year of production from expanded capacities. We believe that due to strong parent and sound capacity growth plans post FY 2012, HCIL would trade at a premium valuation to mid size cement players. In our view, cement industry in India is at an inflection point. One of the lowest per capita consumption in the world and emphasis of government on infrastructure creation would lead to demand surge and expansion in multiples of well capitalized cement companies.

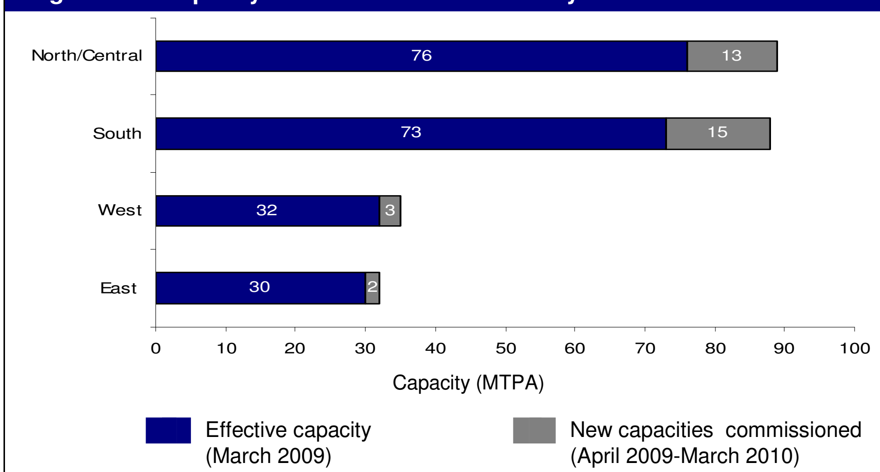
Risks and concerns

Overcapacity in the cement industry

Oversupply to keep the prices subdued

Substantial capacity expansions in the last 3 years have led to overcapacity in the industry. HCIL operates in Central, Northern and Southern markets. These regions have currently been going through over capacity. Capacity expansion in the industry has led to surplus and correction in prices. We believe that surplus situation and subdued pricing would continue till FY 2012. While North and Central parts have added major capacities, in our view these would be the first to maintain demand supply balance once the industry starts recovering. During the period of oversupply while the prices are expected to stay above variable cost of cement firms, there would be substantial reduction in operating margins. The players with efficient manufacturing operations and strong balance sheet are likely to outperform other companies in the sector.

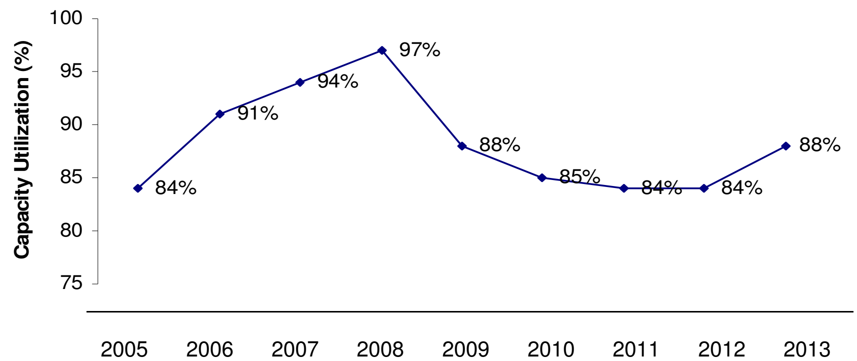
Exhibit 13
Region wise capacity addition over the last one year



Source: Cement Manufacturers' Association of India (CMA)

Pricing pressure to ease from 2012-13

Exhibit 14
Capacity utilization to bottom out in FY 2011-12



Source: Cement Manufacturers' Association of India (CMA)

We expect revenues and realizations of HCIL to adversely get impacted by the downturn. While adverse industry situation would lead to contraction in EBITDA margins, the company would continue to generate free cash from operations due to better working capital management and improved operational efficiency. We expect that the capacity surplus situation in the industry would start easing from FY 12-13, this would be the time when HCIL would start getting benefits of the capacity expansion.

Domestic cement demand is at an inflection point

We believe that this downturn offers an attractive opportunity to enter in fundamentally sound cement stocks. In the long run, Indian construction sector is expected emerge as one of largest construction markets in the world. Relatively lower level of existing infrastructure facilities, increased government emphasis on planned spending and infrastructure development, higher foreign direct investment in sectors such as port, road, real estate and housing are expected to drive demand for companies operating in infrastructure sensitive sectors. Cement companies would be direct beneficiary of increased spending on infrastructure. In our view, due to increased emphasis of the parent in emerging markets, HCIL would be in a strong position to leverage the opportunity. Company's experience in managing organic as well as inorganic growth would lead to substantially scale up its operations in the long run.

Exhibit 15
Global construction outlook

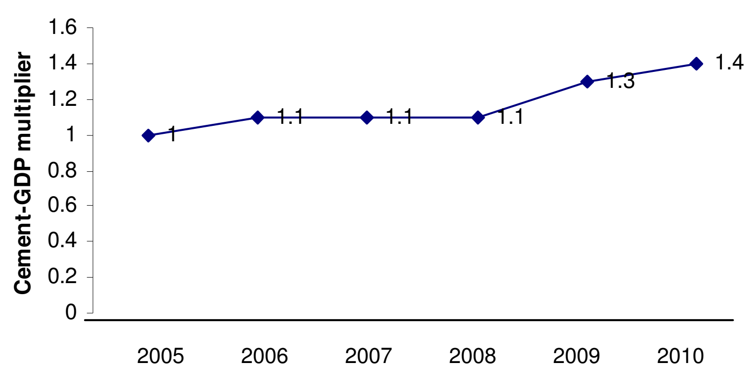
Largest construction markets 2009		Largest construction markets 2015E	
Country	**Global ranking**	**Country**	**Global ranking**
USA	1	China	1
China	2	USA	2
Japan	3	India	3
Germany	4	Japan	4
Spain	5	South Korea	5
France	6	Germany	6
Italy	7	Spain	7
South Korea	8	Russia	8
India	9	UK	9
UK	10	Canada	10
Canada	11	France	11
Brazil	12	Italy	12
Australia	13	Indonesia	13
Russia	14	Brazil	14
Indonesia	15	Australia	15

Source: Global construction perspective, Oxford Economics

Cement demand to witness strong correlation with the GDP growth

Historically GDP growth has a multiplier effect between 1.0 and 1.3 times on cement demand. However we believe that in the coming years the multiplier would move higher, since there would be increased emphasis on infrastructure development to support higher economic growth rate. Such increased multiplier would lead to relatively shorter period for balancing oversupply with increased demand. We also expect that cement prices would settle at a higher level than the bottom of prices in the previous down turn in the cement industry. Commissioning of newer capacity in the cement industry is a time intensive process, it often causes demand supply mismatch. During the period of demand exceeding supply, cement companies post higher operating margins. The current situation in the industry would lead to consolidation and emergence of stronger players.

Exhibit 16
Cement demand and GDP multiplier

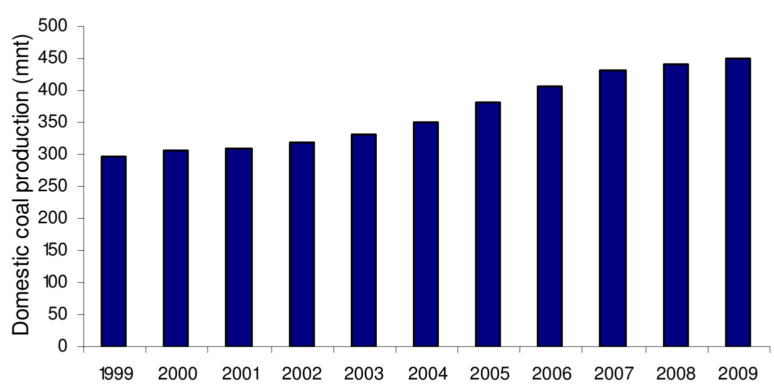


Source: Ministry of Finance, NextGen India Investments Research

Cost pressures on the rise

Constraints in domestic coal production to adversely impact cement producers

Exhibit 17
Domestic coal production has grown at a slower pace



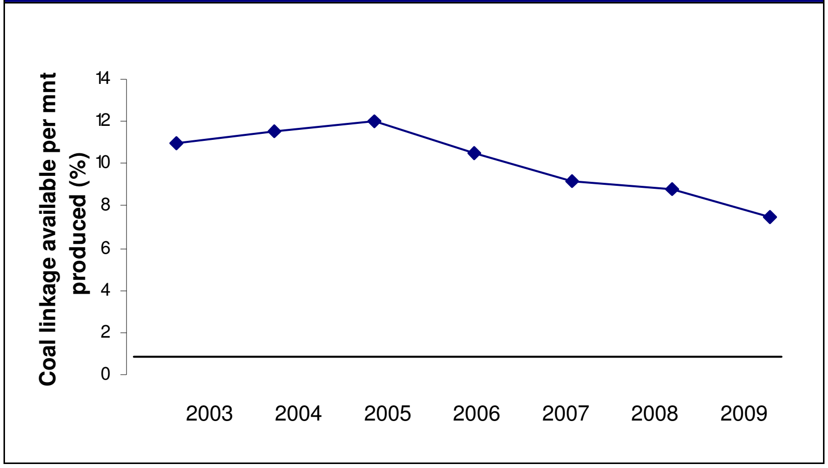
Source: Planning commission, NextGen India Investments Research

Power and fuel costs constitute 18-22% of the total revenues of Cement companies. Fuel is primarily used in kilns and captive power plants. Cement plants located near coastal areas use imported coal as it is cheaper than the domestic coal and has high calorific value. However landed cost of imported coal sometimes become higher than the domestic coal if international freight rates are high. In such situation, coastal cement plants procure coal from domestic sources. About 45% of the cement capacities in India are located inland, making the usage of imported coal difficult due to domestic transportation lead time and congestion of the transportation network. Domestic coal production has recorded a slower growth than the growth in cement cement production over the last decade.

Coal linkages to cement sector have shown declining trend

Coal linkages to the cement sector have also steadily declined. Recently Ministry of Coal has removed cement as a priority sector for the distribution of coal. These factors make HCIL vulnerable to the volatility in coal prices and availability of coal. However HCIL produces majority of its production from Damoh and Jhansi plants. These plants are located near coal mines and sources of proven coal reserves. It ensures regular supply and minimizes transportation costs of coal. Company's manufacturing units located in Maharashtra and Karnataka produce about 27% of the production and are vulnerable to increase in coal transportation cost. There has been increased emphasis by government to increase coal production. We expect Coal India Limited to increase coal output. Private sector thermal power producers are also expected to explore sources of coal in other countries. In the long run, these factors would offset demand supply imbalances for coal.

Exhibit 18
Decline in coal linkages available for the cement sector

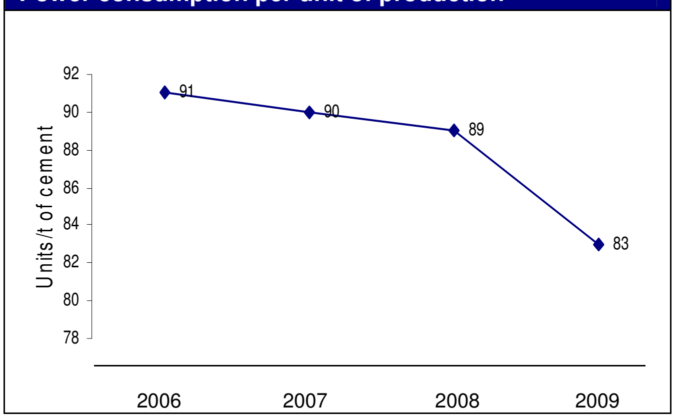


Source: Planning commission, NextGen India Investments Research

Limited captive power generation capacity

Limited captive power generation capacity to keep the cost structure high for HCIL

Exhibit 19
Power consumption per unit of production



Source: Company data, NextGen India Investments Research

For FY 2009-10, HCIL used 18% captive power. The company has 13MW coal based captive power plant. Depending upon tariff rates set up by utilities, the cost of power from utilities is 25% to 30% higher than the captive power. It exposes HCIL to power cuts and increase in power tariffs by utilities. The company has been rationalizing its production process to reduce power consumption per unit of cement production. HCIL reduced power consumption per unit of cement production by 9% over the last 4 years. Since cement is a raw material and power intensive industry, gaining operational efficiency is the key to ensure margins during cyclical downturn. However, we believe that less availability of power is a constraint to eliminate inefficiencies from the cost structure. In the long run, if the management takes steps to increase captive power capacity or enters into long term arrangement to procure power at a competitive cost, then it would an important value driver for the shareholders.

Increase in freight cost

Freight costs account for 12-18% of the revenues of cement companies. The proportion depends on freight mix between road, rail and sea, proximity to the sources of raw material such as fly ash, and lead distance to the market. In view of the price deregulation in oil sector, diesel costs have increased. We believe that once diesel prices are fully linked to the market prices, there would be further increase in freight costs. However in our view, all players in the industry would be subject to such price increase and cement companies would pass the cost increase by way of increasing the prices.

Post 2006, HCIL has shifted its fright mix towards road and that led to reduction in freight costs. We believe the gradual shift towards road transportation network to continue rationalizing freight costs. The company has been concentrating in marketing the cement in proximity to the manufacturing units to minimize freight costs. For Damoh and Jhansi units, the company is planning to use conveyor belts for transporting limestone from quarry to the plant. It would be extended to existing as well as incremental production over the next 2 years. We believe that it would further optimize freight costs. The company has applied for certain tax benefits to the government of Madhya Pradesh for incremental capacities and upon approval the return on expansion projects would improve. While in the short run, diesel cost would adversely impact HCIL; over the long run the company's business model would evolve towards more efficient freight cost structure to minimize the impact of such cost increases.

Oil sector deregulation to impact industry margins

Constraints in the availability of fly ash

It is estimated that India has about 12% of the global coal reserves. While Indian coal is low in sulphur it is high in ash content. Fly ash is derived from burning coal. It is an environmental hazard. Coal based power plants primarily generate fly ash.

Availability of fly ash may become uncertain

Cement producers have gradually adopted the use of fly ash in producing additional volume of cement by blending. When clinker and gypsum are added to fly ash, it produces cement that is superior to ordinary cement without fly ash. However the cement with fly ash takes more time for initial setting therefore requires marketing. To balance marketing efforts, cement producers offer discount on blended cement. Reasonable discount on blended cement leads to better profit margins than the ordinary cement.

It is estimated that about a third of fly ash produced by coal based power plants can be used by cement companies. Off late fly ash was readily available since it was easier for power plants to supply fly ash to cement companies than to dispose it off in environment friendly way. However, due to delay in the commissioning of new power capacities there is uncertainty of regular supply of fly ash for cement industry. In addition to it, to comply with environment norms, there has been additional investment in setting up coal washeries. It would reduce fly ash content in the coal used by power plants. We believe that this trend is significant since Coal India has devised ambitious plan to step up the investment in setting up coal washeries. There has been shift towards use of washed and imported coal by state electricity boards as this has higher calorific value and less fly ash. It would further constrain the supply of fly ash available for the cement industry.

One of the reasons for improved margins for HCIL over the last 3 years was improvement in blending ratio. We believe that constraints in the availability of fly ash would adversely impact company's operating margins.

In our opinion potential constraint of fly ash availability is an industry risk and in such case all players in the industry would shift their production for manufacturing ordinary cement. Further, land acquisition for setting up coal washeries would be a long process to ensure the availability of fly ash for relatively longer period. Government regulation would give further impetus for the use of fly ash for cement industry. For achieving higher environment sustainable compliance, Ministry of Environment and Forests have been devising regulations to improve the use of fly ash produced by coal based power plants. We believe that in future the scope of these regulations would further increase and it would ensure the increase in proportion of recycling the fly ash produced by power plants for the cement industry.

In case of constraints in the availability of fly ash, HCIL would be less impacted than other cement producers as most of the coal based power plants are located in Northern and Central India. These locations are in proximity to Jhansi and Damoh plants of HCIL. Since the cost of transporting fly ash is costly and has environmental implications, company's cement plants at Jhansi and Damoh would be in a position to have regular supply of fly ash. Expansion plans of HCIL include expanding grinding facilities at Jhansi unit. We believe that it would be an important value driver since setting up split grinding units closer to fly ash sources assists in achieving savings in freight as transportation of clinker is cheaper than that of the cement.

To leverage attractive prospects of Indian market, the parent may delist

Open offer and delisting

HeidelberCement Group holds 68.5% in HCIL. While the management has not indicated, we believe that delisting HCIL is a possibility. In the case of delisting, minority shareholders would not be able to participate in the growth that HCIL has to offer. However in our opinion, in the case of delisting the price for open offer would be substantially higher than the market price prevailing at that time.

Exhibit 20
Peer Comparison: Key financials

(Rs billion)

Operating indicators	HCIL	JK Lakshmi	OCL India	Mangalam Cement
Sales	10.4	16.2	15.4	6.4
EBITDA	2.0	3.7	4.1	1.9
EBITDA margin (%)	19.7	22.8	26.3	28.9
Firm's value				
Market Capitalization	11.0	8.0	7.9	4.2
Total Debt	0.0	9.2	8.2	0.1
Cash	4.9	6.9	3.5	0.7
Enterprise value	6.0	10.3	12.6	3.6
Valuation				
Share price (INR)	48.4	65.5	138.4	157.5
PE (:1)	8.3	3.5	5.3	4.0
P/ BV (:1)	1.6	0.8	1.0	1.1
EV/ Sales (:1)	0.6	0.6	0.8	0.6
EV/ EBITDA (:1)	2.9	2.8	3.1	1.9
EV/tonne (:1)	43.8	48.7	52.5	40.1

(based on trailing 12 months results: From June 2009 to June 2010)

Source: Bombay Stock Exchange, NextGen India Investments Research

Exhibit 21
Summary: Financial Statements (Consolidated)

Income Statement (Year ending December 31) INR bn	2009A	2010E	2011E	2012E	2013E
Net Sales	9.4	9.3	9.3	14.0	18.6
EBITDA	1.6	1.5	1.0	2.2	3.2
Interest	0.0	0.0	0.1	0.7	0.6
Depreciation	0.3	0.3	0.5	1.3	1.2
Non operating income	0.5	-	-	-	-
Tax	(0.4)	0.4	0.1	0.1	0.5
Net Income	**1.3**	**0.8**	**0.3**	**0.1**	**0.9**

Peak pricing pressure in FY 11-12

Cash Flow (Year ending December 31) INR bn	2009A	2010E	2011E	2012E	2013E
Opening cash	3.4	4.9	3.9	1.7	2.3
Cash from operations	1.7	0.8	0.1	1.5	2.6
Cash from investments	0.0	(1.8)	(8.7)	(0.3)	(0.3)
Cash from financing	(0.1)	0.0	6.5	(0.6)	(1.2)
Change in cash during the year	1.6	(1.1)	(2.1)	0.5	1.1
Closing cash	**4.9**	**3.9**	**1.7**	**2.3**	**3.4**

Utilization of surplus cash for expansion

Balance Sheet (As on December 31) INR bn	2009A	2010E	2011E	2012E	2013E
Issued Capital	2.4	2.4	2.4	2.4	2.4
Reserves	5.0	5.8	6.0	6.1	7.0
Secured loans	0.0	0.0	6.5	5.8	4.6
Deferred Tax liability	0.2	0.0	0.0	0.0	0.0
Total Liabilities	**7.5**	**8.2**	**14.9**	**14.3**	**14.1**
Net Current Assets	3.8	2.3	0.0	0.5	0.8
Net Fixed Assets	3.1	3.4	5.4	13.6	13.0
Capital Work in Progress	0.6	2.5	9.5	0.3	0.3
Total Assets	**7.5**	**8.2**	**14.9**	**14.3**	**14.1**

Source: Company data, NextGen India Investments Research
E: NextGen India Investments Research estimates

Exhibit 22
Financial ratios

	2009A	2010E	2011E	2012E	2013E
EBITDA margins (%)	17.1	16.6	11.0	15.5	17.0
NPM (%)	14.3	8.5	2.7	0.9	4.9
Total debt/ EBITDA (:1)	1.9	1.9	9.2	4.7	3.3
Total debt/ Equity (:1)	0.4	0.4	1.1	1.2	1.1
ROE (%)	18.2	9.7	3.0	1.5	9.6
EV/ Sales (:1)	0.6	0.8	1.7	1.0	0.7
EV/ EBITDA (:1)	3.8	4.6	15.3	7.2	4.2
PE (:1)	8.2	13.8	43.8	91.6	13.3
P/ BV (:1)	1.5	1.3	1.3	1.4	1.3
FCF/Share (:1)	7.5	3.4	0.3	6.0	10.4
FCF yield (%)	15.5	7.0	0.7	12.3	21.4

Source: Company data, NextGen India Investments Research
E: NextGen India Investments Research estimates

APPENDIX I

Disclosure Section

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Equity rating key for long-term investment opportunities

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Neutral (N) – The stock's total return is expected to be in line with the total return of the MSCI India Total Return Index, on a risk adjusted basis over the next 12-24 months

Underweight (UW) – The stock's total return is expected to be below the total return of the MSCI India Total Return Index, on a risk adjusted basis over the next 12-24 months

Not-Rated (NR) – Currently we do not have adequate conviction about the stock's total return relative to the MSCI India Total Return Index, on a risk adjusted basis over the next 12-24 months

Unless otherwise specified, the time frame for price targets included in NextGen India Investments Research is 12 to 24 months.

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