NATSONS RESEARCH

Gujarat NRE Coke Limited

Growth driven by increasing capacities

BUY

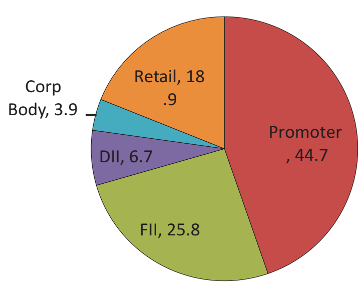
BSE code	512579
NSE code	GUJNRECOKE
Bloomberg code	GNC.IN
Current price	79
Target price	91
MCap Rs bn	38.6
MCap US$ mn	857.7
52 wk H/L	97/22
Face value	10

Financial Snapshot

Rs Mn	FY09	FY10E	FY11E
Sales	15226	13308	20530
% Ch	*75*	*-13*	*54*
OPM	3430.9	2534.0	5151.7
PAT	1072.4	925.0	2574.7
% Ch	*-38*	*-14*	*178*
EPS*	2.3	1.9	4.5
PER	34.8	41.7	17.4
EV/EBIDTA	3.2	4.0	2.7

* fully diluted EPS for FY11E

Share holding pattern



GNCL is the largest standalone coke manufacturer in India with a capacity to produce 1.25mn tonnes. It was the first Indian company to take a stake in a coking coal mine in Australia to vertically integrate itself. The mining capacity of the Australian subsidiary is 1.5mn tonnes of coking coal. GNCL is expanding its capacities of coke manufacturing in India to 4mn tonnes and is simultaneously increasing its mining capacity in Australia to 6mn tonnes over the next few years. GNCL also has a small steel division and a power division. The power division is being expanded though clean energy, wind and waste heat recovery plants.

Increasing demand of coke: India steel production is expected to increase from around 53mn tonnes at present to almost 200mn tonnes by the year 2020. Most of the steel will be manufactured through the blast furnace route. Steel manufactured through this route generates large demand for coke estimated at 140mn tonnes/ year. The demand for coke would ensure good offtake from standalone coke producers.

Prices stability expected: Coke prices are cyclical in nature and linked to the price and demand of steel. With demand for steel increasing again globally we expect demand for coke to remain firm as well. In addition China which was the largest exporter of coke globally having turned a net importer of the commodity has created a shortage of Coke, this coupled with increasing Indian demand would ensure more price stability.

Expanding capacities: GNCL has currently 1.25mn tonnes of coke manufacturing capacity located at three locations within India. It has announced expansion plans to enhance this capacity to 4mn tonnes through a mixture of brownfield and new greenfield projects. These capacities will get commissioned progressively over the next few years with final completion expected by Fy15.

Vertical integration benefits: With the purchase of coking coal mines in Australia a few years ago GNCL was the first Indian coke manufacturer to be backward integrated for raw materials. The mines are owned in a subsidiary company where GNCL has a 78% stake post the recent fund raising activities. Production from these mines is expected to gradually increase from 1.5mn tonnes in the current year to 6mn tonnes by FY15. ensuring enough coking coal for GNCL for their expanded coke facilities.

Diversifying revenues: Along with the coke division the company also has a steel manufacturing facility of 0.311 tonnes of TMT bars per annum. In addition they have set up wind energy capacity of 87.5MW, they are also setting up waste heat energy capacity of 240MW. Of the total waste energy 60MW will be fully operational by FY12, the balance capacities will get operational by FY15.

Valuations: We prefer to value GNCL on a sum of the parts basis given its subsidiary is listed on the Australian stock exchange. For the Indian Coke manufacturing, steel production and power capacities which are expected to have steady volumes growth over the next few years we prefer the P/E multiple of 12X for FY11. We currently value the listed subsidiary at the current rate traded on the Australian stock exchange. Taking these we arrive at a price target of Rs91 and recommend a BUY on GNCL with an upside of 16%.

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Investment Rationale

Rising demand for coke

Coke is one of the key raw materials used in the manufacturing of steel through the blast furnace route. This route of steel making is the preferred globally with over 75% of all steel manufactured this way. Going forward too most of the capacity coming up in the emerging markets is through the blast furnace. To manufacture 1 tonne of steel the requirement is for 0.7mn tonnes of coke, hence with the rising production capacities of steel in India the requirements for coke are expected to continue to remain buoyant.

Rising international demand: Just a few years ago china was the largest exporter of coke globally, however in china the capacity of steel production has been rising and is in excess of 500mn tonnes per annum. Catering to this large capacity has made china turn a net importer of coke increasing global demand. In addition following the slowdown in the developed markets, when steel production was cut to ensure pricing power, the demand for steel has risen again in turn increasing the demand for coke. The global recovery is facing a few hiccups however it is widely believed that the recovery is well under way. We believe the demand for steel will continue to grow over the next few years with demand coming from most emerging markets.

Capacity Increases in India to drive coke demand: The current installed capacity of steel in India is about 55mn tonnes. The demand for steel is expected to rise at over 8% per annum over the next few years as India develops its infrastructure. In an attempt to cater to this demand many steel manufacturers large and small have announced capacity expansions. We have also seen keen interest of global manufacturers to enter the Indian markets. Expectations are of steel production reaching close to 200mn tonnes by the year 2020. With steel production expected to grow 3 folds we can expect the domestic demand of coke to rise at the same pace over the period of time. India unfortunately does not have coking coal reserves to match this demand that would be generated. This would lead to further demand from global markets.

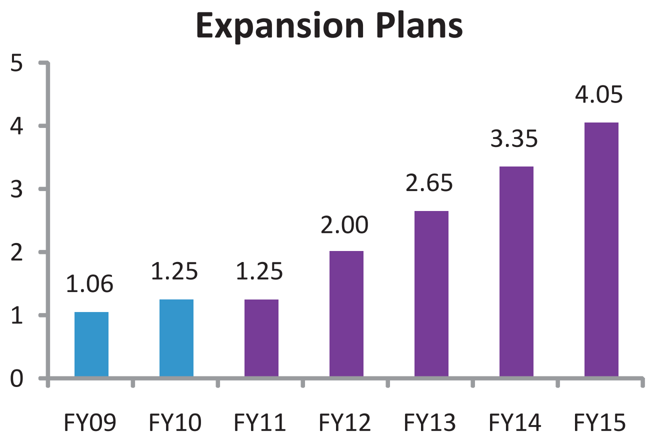
Coke Prices to remain Buoyant

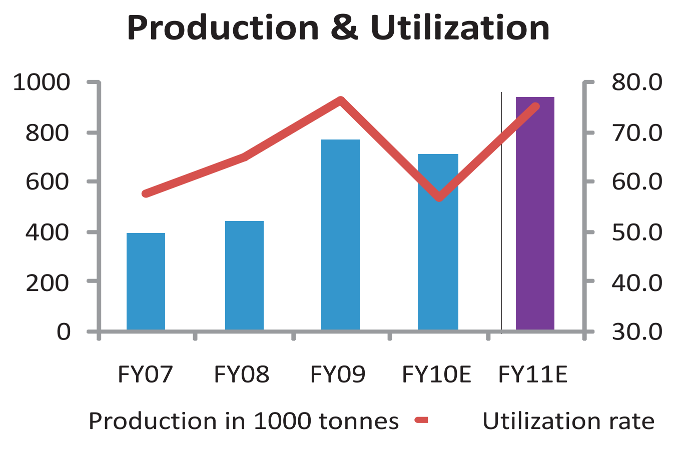
Coke prices usually move in line with the price of steel as the demand of coke is linked to the demand for steel. In the recent past China controlled the pricing of coke as they were one of the largest exporters of the commodity. As mentioned China has now become a net importer of coke and this has caused coke prices to stabilize and rise over the past few quarters. With further demand expected from china and increased demand from India prices of coke are expected to remain firm above $300 per tonne. Coke prices could witness a further upside over the next few quarters as steel production keeps increasing in both the developed and the emerging markets.

Even though coke prices may rise this may not lead to expanding margins of GNCL as the raw material, coking coal, prices too have been on the rise. Overall tough the higher prices would benefit GNCL as they get most of their requirement of coking coal from their Australian subsidiary. The higher prices of coking coal would benefit the Australian subsidiary in turn benefitting GNCL consolidated earnings.

Increasing capacities

GNCL currently has plants at 3 locations in India, Khambalia and Bhachau in Gujarat and in Dharwad in Karnataka. The current installed capacity is 1.25mn tonnes of coke manufacturing. It has planned to increase this capacity to 4mn tonnes through a mix of brown field expansions and new plants in Andhra Pradesh and Gujarat. These expansions will come on stream gradually starting from FY12 over the next few years and will be fully operational by the year FY15. These new capacities will enable them to have higher volumes in the respective years and increase the overall profitability.





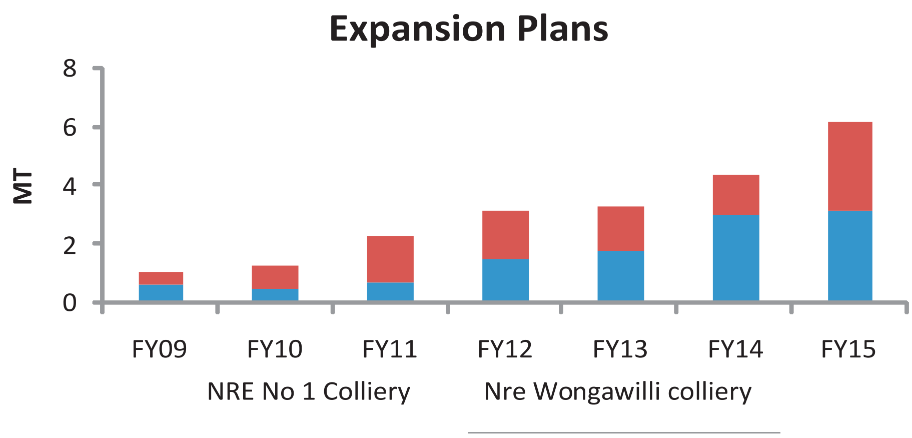
Source: Natverlal & Sons, Company

In addition the management has indicated they would be looking to increasing utilization of its existing plants in FY11 to 80% from the rate of near 60% expected in FY10. We do believe it would be possible for them to increase the utilization from FY10 to around 75% and we would see some amount of volumes growth in the FY11 as well.

Expansions of Australian mines: GNCL was the first Indian coke manufacturer to acquire coking coal mines in Australia. They identified the growing need for coke in the domestic industry, taking a leap of faith it acquire 2 mines in Australia. Both the mines are located in the southern coalfields of New South Wales, with close proximity from port Kemba. The mines are not directly held by GNCL but through its 100% subsidiary which owns a75.6% stake in Gujarat NRE Minerals (GNM). GNM is listed on the Australian stock exchange, which in turns own 100% in both the mines. The current production from both the mines is 1.5mn tonnes of raw coking coal, the plan is to expand the total production of these mines to a total of 6mn tonnes by the end of FY15E. GNCL has entered into a contract with GNM to purchase all the unwashed coking coal at 60% of the price of the coking coal price contracts reached for during the quarter.

NRE no.1 colliery: This is the first of the two mines owned 100% by GNM, located in southern coal fields of NSW, is about 20 km from the terminal of port Kemba, it has proven reserves of 18.5mn tonnes and has resources of 315.6mn tonnes of premium hard coking coal. This mine is currently generating 0.65mn tpa and is expected to produce 3.2mn tpa by the year FY15. This far GNM has invested Approximately Australian $160mn and they would further invest $300mn over the next few years to enable them to reach their target production.

NRE Wongawilli colliery: The second of the two mines owned 100% by GNM also located in the southern coal fields of NSW. This mine too is located only 20km from port Kemba. The mine was an amalgamation of Eloura colliery (previously owned by BHP) Avondale colliery and Huntley colliery. The Mine has proven reserves of 7.8mn tonnes and resources of 258mn tonnes. It currently produces 0.8mn tpa and is gradually expected to reach 3mn tap by FY15. This far GNM has invested A$80mn and is expected to invest an additional A$200mn over the next few years to expand its mining facility.



source: Natverlal & Sons, Company

Diversifying of business model to reduce cyclicality

Although the coke business would be the main driver of growth for GNCL, they are diversifying their revenue and profit steams towards steel manufacturing and power. They already have a steel plant and are expanding power capacities by setting up clean energy sources.

Exisiting steel unit: The steel is manufactured using scrap as the raw material, this division has been generating a good return for it over the past couple years. We expect this business to continue to generate decent returns for it. However at the moment there are no expansion plans to the steel business. This however would be the next step in forward integration for GNCL and we shall wait to see if they expand here.

Entering power and expanding capacities: Recently GNCL entered the power generation business by installing 87.5MW of wind energy turbines. It has also decided to set up waste heat recovery power plants at its existing coke facilities. The current plans are to install 60MW of waste heat recovery by the end of FY12. The first 15 units will come on stream by Dec 2011 and subsequently addition 15 units each will get commissioned by June, September and December 2011 respectively. The full benefit of the 60MW will be seen in FY13. The eventual plan is to take the waste heat power capacity to 240MW, this is likely to happen when all its new coke units will be fully functional.

Equity Dilution to fund expansions: Given the large capex plans of GNCL we can expect there to be further equity dilution for both the Indian operations as well as the Australian operations. The management has already announced placing warrants of Rs2.5bn at a conversion of Rs120. This would further dilute the equity going forward. we have not factored this into equity at the moment as the target price is below the conversion price.

Valuations:

Since GNCL would derive quite some value from its mining subsidiary in Australia, we prefer valuing it on the SOTP. We will use the P/E multiple of 12X to value the Indian operations. We believe this is justified given the growth over the next few years through volumes. However we are not looking to give it a higher valuation at the time as we are still in some uncertain economic times, in addition the business is cyclical in nature. Based on 12X for FY11E, which is a 1 year forward we arrive at a price of Rs55.

We have chosen to value the mining operations at the market traded rate on the Australian Stock Exchange. Currently GNCL has a 75.6% stake in the Australian subsidiary GNM. The current market cap of GNM is A$664.85mn, at the current price of A$0.75, this equals Rs36 per share for GNCL. At the current Market cap, GNM coal reserves and resources are being valued at A$1.2 per tonne. We see further upside possibility looking at the low valuations and expect GNM stock price to rise. This would mean further upside for GNCL with the rising value of GNM.

Adding up the values of the domestic operations and the mining operations we arrive at a price target of Rs91. We see further upside over the longer term once more of its mines and coke capacities get commissioned. We recommend to BUY Gujarat NRE Coke Limited with an upside potential of 16% from its current levels.

Risks

Slowdown of the global recovery affecting steel demand and prices

The global economy went into a slump in the year 2008, impacting the demand for many products including steel. Lower steel demand caused the demand for coke to dry up during the period which led to the decline in the prices of coke. Now the recovery is underway, this has led to prices of coke bouncing back with the increase in demand. If the recovery was to be impacted and we see another slowdown in demand, this would affect the prices of steel and coke again bringing the profitability of the GNCL below our estimates and in turn affect prices.

Developments of new mines that would lead to an oversupply

With demand for coke increasing we have seen many steel majors global and Indian look to invest in coking coal mines. If they these steel majors were to be given mining permission and develop mines for captive consumption the overall pricing power of coke would be reduced. Even though this could happen it would not affect demand in the near term as developing these mines would take time. In addition smaller steel manufacturers would not be in a position to acquire mines and would have to continue to buy from standalone coke manufacturers such as GNCL.

High debt levels used for funding expansion

Funding the expansions in Indian and Australia to its target is going to require large quantum's of funds. Some part of this funding will be done by internal accruals and equity dilutions. However the balance would have to be funded by debt. In a bid to increase production the debt levels are expected to rise for GNCL and this would increase interest costs and in turn profitability. It would be important to see that GNCL does not over leverage itself in an attempt to grow rapidly.

Equity dilution larger than expected

We mentioned fund requirements would be high for both GNCL in India and GNM in Australia. GNCL has already got some outstanding FCCB's and Warrants, in an attempt to keep debt in check both entities might look to raise capital through equity dilution. It would be important to see what equity dilution happens as that would affect the EPS for GNCL. In GNM, GNCL has a stake of 75% the management has indicated to raise capacities they may look to dilute stake there. However they have also said they would not let the stake fall below 51%. This too however needs to be looked at as the lower the stake the lower value derived for GNCL.

Change in mining policy in Australia

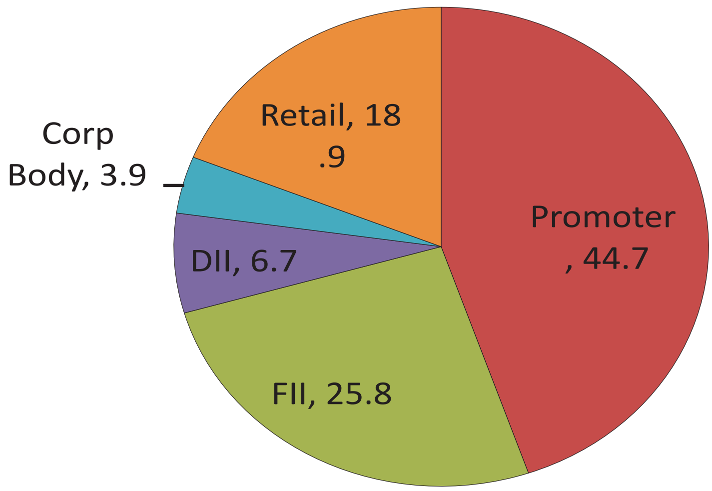
The Australian governments has recently proposed to increase the tax liability on mining companies in Australia to 40%. If this proposal was to be passed, it would negatively affect the cash flows of the Australian subsidiary. This would put some pressure on price of the Australian subsidiary in turn putting pressure on the value of GNCL

Company background

GNCL is the largest indipedent producer of Met Coke in India. It is one of the only companies to have invested in mining capacity in Australia for coking coal. In addition it has interest in steel manufacturing and power generation in India. It was promoted by the Jagatramka family, the current chairman of the board is Mr. Girdharilal Jagatramka, while the MD is Mr. Arun Kumar Jagatramka under who the company has grown rapidly over the past few years.

Recently GNCL has given a bonus issue of shares of differential voting rights. 100 shares would have 1 vote, even though this does help the management in keeping better control on the company, the equity does get diluted by the similar amount.

Share holding pattern



Financials

Profit & Loss

In Rs million	FY08	FY09	FY010E	FY011E
Net sales	8,721.5	15,226.0	13,307.9	20,529.9
YoY (%)	*69.9*	*74.6*	*(12.6)*	*54.3*
Total expenses	6,359.0	11,795.1	10,773.9	15,378.2
EBIDTA	2,362.5	3,430.9	2,534.0	5,151.7
YoY (%)	*139.3*	*45.2*	*(26.1)*	*103.3*
EBIDTA (%)	27.1	22.5	19.0	25.1
Other income	467.4	139.2	282.4	282.4
PBIDT	2,829.9	3,570.1	2,816.4	5,434.1
Depreciation	233.5	393.5	459.8	483.8
PBIT	2,596.4	3,176.6	2,356.6	4,950.3
Interest	329.1	647.5	1,035.2	1,272.1
PBT	2,267.3	2,529.1	1,321.4	3,678.2
(-) Tax	538.5	309.5	396.4	1,103.5
Current Tax	322.9	129.8	392.5	1,092.4
Deferred Tax	214.5	177.9	4.0	11.0
Fringe benefir tax	1.1	1.8	0.0	0.0
Tax/ PBT	23.8	12.2	30.0	30.0
PAT	1,728.8	2,219.6	925.0	2,574.7
Extra-ordinary expenses	0.0	1,147.2	0.0	0.0
Net Profit	1,728.8	1,072.4	925.0	2,574.7
YoY (%)	210.2	(38.0)	(13.7)	178.4

Balance Sheet

In Rs million	FY08	FY09	FY010E	FY011E
Equity capital	3,760.2	5,109.2	5,026.2	6,294.9
Reserves	7,710.2	6,719.7	8,385.3	11,371.8
Net worth	11,470.4	11,828.9	13,411.5	17,666.7
Total borrowings	6,326.5	13,285.3	16,291.8	15,510.3
Deferred tax	990.1	1,168.0	1,172.0	1,183.0
Total liabilities	**18,787.0**	**26,282.2**	**30,875.3**	**34,360.0**
Net block	5,307.0	8,267.9	8,308.1	8,324.2
CWIP	891.8	1,179.8	4,179.8	3,000.0
Investments	6,571.7	8,068.3	8,068.3	8,068.3
Current assets	10,252.5	17,004.7	16,178.7	21,875.2
Inventories	2,276.7	9,586.5	7,292.0	7,874.5
Debtors	2,459.5	2,631.9	3,281.4	5,062.2
Cash	2,173.1	1,172.3	1,105.2	3,938.6
Loans and advances	3,343.2	3,614.0	4,500.0	5,000.0
Current liabilities	2,447.0	6,783.4	4,427.6	5,055.8
Provisions	1,875.1	1,499.1	1,475.9	1,895.9
Net current assets	5,930.4	8,722.2	10,275.1	14,923.4
Misc expenses	86.1	44.0	44.0	44.0
Total assets	**18,787.0**	**26,282.2**	**30,875.3**	**34,360.0**

Cash Flow

In Rs million	FY08	FY09	FY010E	FY011E
Net profit	1,728.8	1,072.4	925.0	2,574.7
Depn and w/o	233.5	393.5	459.8	483.8
Deferred tax	214.5	177.9	4.0	11.0
Change in wrkg cap	(986.8)	(3,792.6)	(1,620.0)	(1,815.0)
Other income	(467.4)	(139.2)	(282.4)	(282.4)
Operating cash flow	**1,657.4**	**(2,009.6)**	**51.1**	**1,537.1**
Other income	(467.4)	(139.2)	(282.4)	(282.4)
Capex	(2,216.6)	(3,642.1)	(3,500.0)	679.8
Investments	(454.9)	(1,496.6)	0.0	0.0
Investing cash flow	**(3,138.9)**	**(5,277.9)**	**(3,782.4)**	**397.4**
Dividend	(1,037.9)	(552.3)	(571.6)	(571.6)
Equity	931.1	1,349.0	166.4	784.2
Debt	(1,328.7)	6,958.8	3,006.5	(781.6)
Financing cash flow	**(1,435.5)**	**7,755.5**	**2,601.3**	**(568.9)**
Others	0.0	0.0	0.0	0.0
Net change in cash	**(2,917.0)**	**468.0**	**(1,129.9)**	**1,365.5**

Key Ratios

	FY06	FY09	FY010E	FY011E
EPS (Rs)	5.1	2.3	1.9	4.5
CEPS (Rs)	6.5	3.5	2.8	5.4
Book value (Rs)	34.0	25.1	27.5	31.2
DPS (Rs)	2.5	1.0	1.0	1.0
Debt-equity (x)	0.6	1.1	1.2	0.9
ROCE	16.8	14.8	8.6	15.7
ROE	20.3	9.2	7.3	16.6
Valuations				
PE (x)	15.4	34.8	41.7	17.4
Cash PE (x)	12.2	22.7	27.8	14.6
Price/book value (x)	2.3	3.2	2.9	2.5
Dividend yield	3.2	1.3	1.3	1.3
Market cap/sales	3.1	2.4	2.9	2.2
EV/sales (x)	3.5	3.2	4.0	2.7
EV/EBDITA (x)	13.0	14.4	21.2	10.9

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