June 7, 2017

Rating matrix

Rating	:	Hold
Target	:	₹ 275
Target Period	:	12 months
Potential Upside	:	-2%

What's Changed?

Target	:	Changed from ₹ 180 to ₹ 275
EPS FY18E	:	Changed from ₹ 6.1 to ₹ 6.5
EPS FY19E	:	Changed from ₹ 9.7 to ₹ 13.3
Rating	:	Unchanged

Quarterly Performance

	Q4FY17	Q4FY16	YoY (%)	Q3FY17	QoQ (%)
Revenue	257.8	177.3	45.4	236.6	9.0
EBITDA	29.6	10.3	188.9	29.2	1.7
EBITDA Margin (%)	11.5	5.8	571 bps	12.3	-82 bps
PAT	(3.9)	(27.1)	NA	(3.2)	NA

Key Financials

	FY16	FY17 P	FY18E	FY19E
Net Sales	827.5	860.0	1,098.0	1,213.5
EBITDA	124.5	80.6	143.4	169.7
Adjusted PAT	(15.2)	(50.1)	26.0	53.0
Adj EPS (₹)	(3.8)	(12.5)	6.5	13.3

Valuation summary

	FY16	FY17 P	FY18E	FY19E
PE (x)	NA	NA	43.0	21.1
Target PE (x)	NA	NA	42.2	20.7
EV/EBITDA (x)	14.0	22.3	11.9	9.3
P/BV (x)	1.2	1.3	1.2	1.2
RoE (%)	(1.6)	(5.7)	2.9	5.6
RoCE (%)	3.2	0.9	5.3	7.4

Stock data

Particulars	Amount
Market Capitalisation	₹ 1139 crore
Debt (FY17 P)	₹ 684 crore
Cash (FY17 P)	₹ 8 crore
EV	₹ 1815 crore
52 Week H / L (₹)	327 / 144
Equity Capital	40.0
Face Value	₹ 10

Price performance (%)

Return %	1M	3M	6M	12M
HEG	-10.9	31.1	74.7	78.8
Graphite India	-5.7	12.5	56.0	55.1

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HEG Ltd (HEG)

₹ 280

Capacity utilisation to improve, going ahead

- HEG's Q4FY17 results came in below our estimates. Topline for the quarter came in at ₹ 257.8 crore (up 45.4% YoY, 9% QoQ and below our estimate of ₹ 309.4 crore). Capacity utilisation during the quarter came in at ~80% (our estimate: 85%)
- EBITDA came in at ₹ 29.6 crore, lower than our estimate of ₹ 54.5 crore. The resultant EBITDA margin came in at 11.5% (our estimate of 17.6%, Q3FY17: 12.3%, Q4FY16: 5.2%)
- At the PAT level, the company reported a loss to the tune of ₹ 3.9 crore against our profit estimate of ₹ 16.6 crore

Models capacity utilisation of 80% for FY18E; 85% for FY19E…

After subdued capacity utilisation over the last few quarters, HEG reported healthy utilisation level for Q4FY17 (~80% in Q4FY17 compared to capacity utilisation of 75% in Q3FY17, 65% in Q2FY17 and 50% in Q1FY17). Demand for graphite electrodes has started picking up after inventory correction at the customer's end. Going forward, we have modelled capacity utilisation of 80% for FY18E and 85% for FY19E.

Improved capacity utilisation to aid margins, going forward…

During FY17, the EBITDA margin contracted to 9.4% (FY16: 15%) primarily on account of muted graphite electrode price. We believe graphite electrode prices have bottomed out and are likely to increase. With an improvement in capacity utilisation at ~80-85%, the company is likely to benefit from economics of scale. Subsequently, we expect a pick-up in capacity utilisation to aid in EBITDA margin expansion. Going forward, we have modelled EBITDA margins of 13.1% and 14.0% for FY18E and FY19E, respectively.

Demand improvement to be gradual; maintain HOLD…

HEG reported capacity utilisation of ~80% in Q4FY17. During FY17, the capacity utilisation improved to ~68% from ~56% in FY16. We have modelled capacity utilisation of 80% for FY18E (upward revised from 72% earlier) and 85% for FY19E (upward revised from 75% earlier) factoring in the pick-up witnessed in the demand scenario. On the back of consolidation in the global industry coupled with the oligopoly nature of the graphite electrode market, we value the stock on an SOTP basis. We value the core business at 8.5x FY19E EV/EBITDA (from 7x earlier) and assign a 20% discount to HEG's stake in BEL. Subsequently, we arrive at a target price of ₹ 275. We have a **HOLD** rating on the stock.

Variance analysis

	Q4FY17	Q4FY17E	Q4FY16	YoY (%)	Q3FY17	QoQ (%)	Comments
Total Operating Income	257.8	309.4	177.3	45.4	236.6	9.0	Topline came in below our estimates
Other Income	1.0	3.7	0.8	31.2	1.5	(32.2)	
Raw Material Expense	131.6	121.9	93.7	40.4	106.6	23.4	
Employee Expense	16.6	13.1	14.9	11.7	14.3	16.0	
Power & Fuel Expense	24.7	24.0	6.5	282.5	22.9	7.6	
Other Expenses	55.3	95.9	52.0	6.4	63.6	(13.1)	
Total Operating Expenses	228.2	254.9	167.0	36.6	207.5	10.0	
EBITDA	29.6	54.5	10.3	188.9	29.2	1.7	EBITDA came in below our estimates
EBITDA Margin (%)	11.5	17.6	5.8	571 bps	12.3	-82 bps	EBITDA margin came in below our estimates
Depreciation	18.2	20.7	20.1	(9.5)	18.3	(0.6)	
Interest	12.5	12.7	13.5	(7.6)	13.8	(9.9)	
Exceptional Items	0.0	-	-	NA	-	NA	
PBT	(0.0)	24.8	(22.6)	NA	(1.5)	NA	
Tax Outgo	3.8	8.2	4.5	(15.7)	1.7	130.1	
PAT	(3.9)	16.6	(27.1)	NA	(3.2)	NA	The company reported loss as against our estimate of a profit
Key Metrics							
Capacity Utilisation (%)	80.0	85.0	50.0		75.0		Capacity utilisation came in lower than our estimates

Source: Company, ICICIdirect.com Research

Change in estimates

(₹ Crore)	FY17 P	FY18E			FY19E			Comments
		New	Old	% Change	New	Old	% Change	
Revenue	860.0	1,098.0	1,002.4	9.5	1,213.5	1,075.0	12.9	Revised upwards for both years
EBITDA	80.6	143.4	176.1	-18.6	169.7	155.3	9.3	Revised downward for FY18E, upwards for FY19E
EBITDA Margin (%)	9.4	13.1	17.6	-451 bps	14.0	14.4	-46 bps	Revised downward for both years
PAT	-50.1	26.0	24.4	6.6	53.0	38.6	37.3	Revised upwards for both years
EPS (₹)	-12.5	6.5	6.1	6.7	13.3	9.7	36.7	Revised upwards for both years

Source: Company, ICICIdirect.com Research

Assumptions

(₹ Crore)	FY17 P	FY18E			FY19E			Comments
		New	Old	% Change	New	Old	% Change	
Capacity Utilisation (%)	68.0	80.0	72.0	800 bps	85.0	75.0	1000 bps	Estimates revised upwards

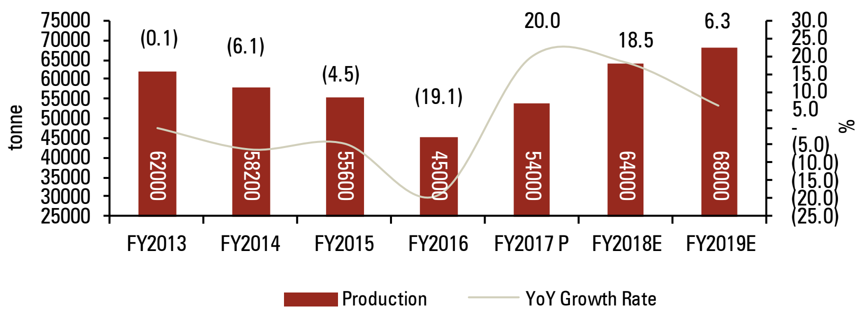
Source: Company, ICICIdirect.com Research

Company Analysis

The company is a leading manufacturer of graphite electrodes in India with an installed capacity of 80,000 tonne per annum (TPA). HEG commissioned its last capacity expansion way back in Q4FY12 (February 2012) wherein it installed a capacity of 14,000 tonne while incurring a capex of ₹ 225 crore.

We expect graphite electrodes sales volumes to increase from 54000 tonnes in FY17 to 64000 tonnes in FY18E, to 68000 tonnes in FY19E.

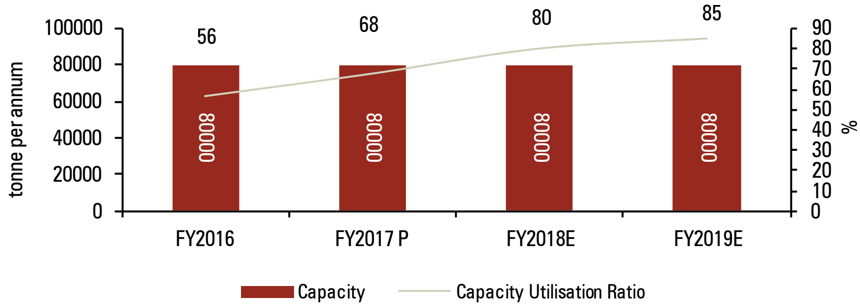
Exhibit 1: Graphite electrode production & growth rate



Source: Company, ICICIdirect.com Research, FY12, FY13 and FY14 numbers have been assumed on basis of capacity utilisation rates

We have assumed a capacity utilisation of 80% for FY18E and 85% for FY19E

Exhibit 2: Capacity & utilisation rates

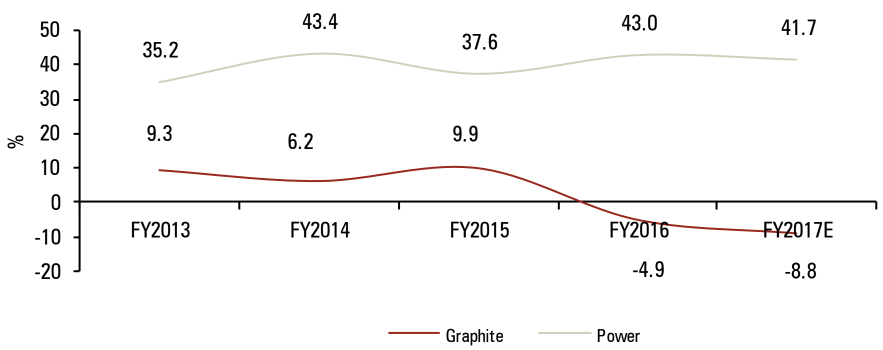


Source: Company, ICICIdirect.com Research

Segmental performance

Apart from operating the graphite electrode facility, the company also operates captive power plants with capacity of 77 MW. Out of the 77 MW, 13.5 MW capacity is hydel. For Q4FY17 EBIT margins for graphite electrodes segment came in at 2.2% while that for the power segment was 48.2%.

Exhibit 3: Segment wise EBIT performance



Source: Company, ICICIdirect.com Research

Conference call highlights

- The World Steel Association (WSA) forecasts global steel production will increase 1.3% to 1535.2 million tonne (MT) in 2017 and 0.9% to 1548.5 MT in 2018. Chinese steel demand is expected to remain flat in 2017 and then decline 2% in 2018
- In China, in the beginning of 2017, the government identified some major industries as high pollutant and directed the closure of these industries including sizable number of induction furnace based steel units
- The environment crackdown in China has also affected graphite producers leading to closures creating a shortage of electrodes within Chinese markets
- During the year, the company improved the working capital cycle while the overall debt position reduced by ~₹ 100 crore. As on March 31, 2017, the debt was at ₹ 684 crore comprising ₹ 272 crore of term loan and ₹ 412 crore of working capital loans
- The management indicated consolidation in the graphite electrode industry is likely to result in an improvement in capacity utilisation levels in the industry. The electrode market is likely to stabilise at higher utilisation levels in 2017 compared to 2016. The graphite electrode market has witnessed a shutdown of ~200000 tonnes of capacity in the last 36 months
- As an industry practice, by February the company more or less books ~65-75% of the order book for the year. The order book is largely split between 60% UHP and 40% HP
- The management guided a capacity utilisation of ~75-80% in FY18. As per the management, the margins are likely to be higher than that witnessed in FY17. The company's exports of graphite electrodes will remain in the range of ~60% in FY18
- Suppliers of needle coke have shifted contracts from a yearly basis to half yearly (six months) contracts
- The management indicated the debt repayment during the year FY18 was at ~₹ 150 crore
- During the quarter, the company recognised other operating income of ~₹ 10 crore. The same pertains to export incentives received, which were clubbed under raw material expenses in preceding quarters. The change in recognition is due to adoption of Ind-As

Outlook and valuation

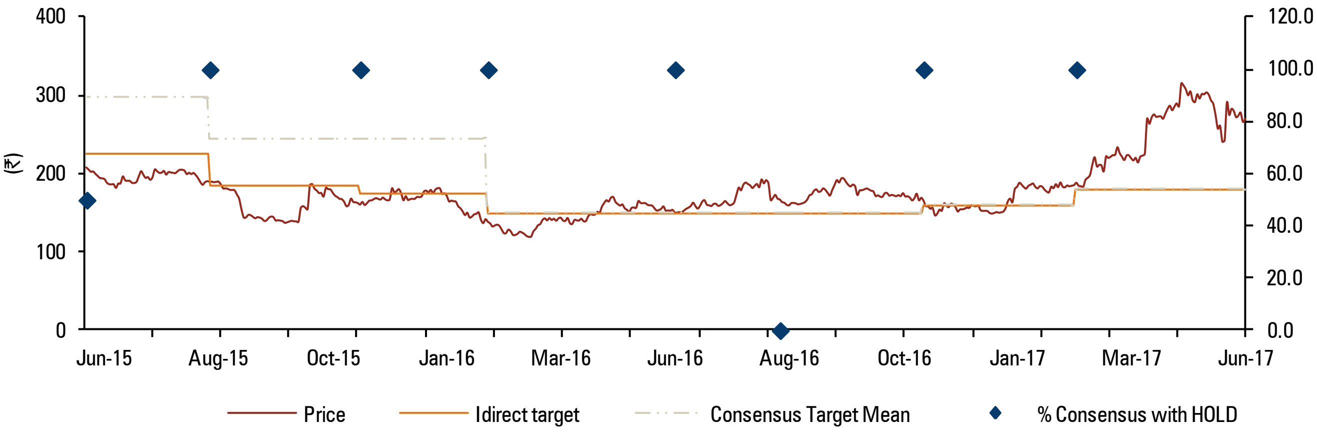
HEG reported capacity utilisation of ~80% in Q4FY17. During FY17, the capacity utilisation improved to ~68% from ~56% in FY16. We have modelled capacity utilisation of 80% for FY18E (upward revised from 72% earlier) and 85% for FY19E (upward revised from 75% earlier) factoring in the pick-up witnessed in the demand scenario. On the back of consolidation in the global industry coupled with the oligopoly nature of the graphite electrode market, we value the stock on an SOTP basis. We value the core business at 8.5x FY19E EV/EBITDA (from 7x earlier) and assign a 20% discount to HEG's stake in BEL. Subsequently, we arrive at a target price of ₹ 275. We have a **HOLD** recommendation on the stock.

Exhibit 4: Valuation matrix

	Sales (₹ Crore)	Growth (%)	EPS (₹)	Growth (%)	PE (x)	EV/EBIDTA (x)	P/ BV (x)	RoE (%)	RoCE (%)
FY15	1,233.1	(15.9)	9.8	(65.2)	29.2	10.8	1.2	4.1	6.9
FY16	827.5	(32.9)	(3.8)	(138.8)	NA	14.2	1.2	(1.6)	3.2
FY17 P	860.0	3.9	(12.5)	(230.7)	NA	22.5	1.3	(5.7)	0.9
FY18E	1,098.0	27.7	6.5	LP	LP	12.0	1.3	2.9	5.3
FY19E	1,213.5	10.5	13.3	LP	LP	9.4	1.2	5.6	7.4

Source: Company, ICICIdirect.com Research

Recommendation history vs. consensus estimate



Source: Bloomberg, Company, ICICIdirect.com Research

Key events

Date	Event
Aug-08	Board approves buyback of equity shares (10% of paid up capital) at a price exceeding ₹350/share
Mar-10	HEG embarks upon its expansion plan of increasing the capacity from 66000 TPA to 80000 TPA
Jul-10	Bhilwara Energy (BEL) raises ₹230 crore (US$50 million) by selling 10.8% stake to Washington-based IFC and India Clean Energy Fund. Transaction results in dilution of HEG's stake in BEL from 28.9% to 25.5%
Dec-10	European Union renews tariffs on graphite electrodes from India (tariff at 9.4%)
Mar-11	Board approves buyback of 10% of equity capital of the company at a price not exceeding ₹ 350 per share
Dec-11	Fitch (credit rating agency) revises HEG's outlook from neutral to negative
Mar-12	Commissions new facility; capacity reaches 80000 TPA
Sep-12	Company's international peer Graftech expected to hike electrode prices for 2013 contracts
Nov-13	Global players announce production cuts to support graphite electrode prices
Feb-15	GoI imposes antidumping duty on graphite electrodes (all diameters) originating in or exported from China. The amount of anti-dumping duty ranges from US$278.19 per MT to US$922.03 per MT, depending on the Chinese producer/exporter
Nov-15	India Rating & Research (Ind-Ra) assigns 'IND A1+' rating for ₹ 80 crore commercial paper programme.

Source: Company, ICICIdirect.com Research

Top 10 Shareholders

Rank	Name	Latest Filing Date	% O/S	Position	Change
1	Norbury Investments, Ltd.	31-Mar-2017	13.4	5.36M	0
2	Microlight Investments, Ltd.	31-Mar-2017	11.7	4.67M	0
3	Life Insurance Corporation of India	31-Mar-2017	8.3	3.33M	0
4	GPC Mauritius II, L.L.C.	31-Mar-2017	7.2	2.89M	0
5	Bharat Investments Growth, Ltd.	31-Mar-2017	6.5	2.61M	0
6	Mekima Corporation	31-Mar-2017	4.5	1.79M	0
7	Purvi Vanijya Niyojan, Ltd.	31-Mar-2017	4.4	1.75M	0
8	Raghav Commercial, Ltd.	31-Mar-2017	3.8	1.53M	0
9	LNJ Financial Services, Ltd.	31-Mar-2017	3.3	1.31M	0
10	LNJ Bhilwara Group	31-Mar-2017	2.4	0.98M	0

Source: Reuters, ICICIdirect.com Research

Shareholding Pattern

(in %)	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Promoter	58.8	58.8	58.8	58.8	58.8
FII	0.8	0.8	0.7	0.7	0.7
DII	10.7	10.7	10.7	10.1	9.9
Others	29.7	29.8	29.9	30.4	30.7

Financial summary

Profit and loss statement ₹ Crore

(Year-end March)	FY16	FY17 P	FY18E	FY19E
Total Operating Income	827.5	860.0	1,098.0	1,213.5
Growth (%)	(32.9)	3.9	27.7	10.5
Raw Material Expenses	366.9	443.9	520.9	573.6
Employee Expenses	63.2	58.9	71.4	88.0
Other expenses	273.0	276.6	362.3	382.3
Total Operating Expenditure	703.1	779.4	954.6	1,043.8
EBITDA	124.5	80.6	143.4	169.7
Growth (%)	(31.5)	(35.2)	77.8	18.4
Depreciation	79.2	73.9	75.6	76.4
Interest	59.9	54.7	44.6	37.2
Other Income	4.2	7.1	10.5	12.7
PBT	(10.5)	(40.9)	33.7	68.8
Exceptional Item	-	-	-	-
Total Tax	4.6	9.2	7.7	15.8
Reported PAT	(15.2)	(50.1)	26.0	53.0
Adjusted PAT	(15.2)	(50.1)	26.0	53.0
Growth (%)	(138.8)	230.7	LP	103.8
EPS (₹)	(3.8)	(12.5)	6.5	13.3

Source: Company, ICICIdirect.com Research

Cash flow statement ₹ Crore

(Year-end March)	FY16	FY17 P	FY18E	FY19E
Profit/(Loss) after taxation	(15.2)	(50.1)	26.0	53.0
Add: Depreciation & Amortization	79.2	73.9	75.6	76.4
Net Increase in Current Assets	239.7	38.0	(33.3)	(37.4)
Net Increase in Current Liabilities	(76.3)	(75.8)	35.6	50.4
CF from operating activities	227.4	(14.0)	103.9	142.4
(Inc)/dec in Investments	-	(0.3)	-	-
(Inc)/dec in Fixed Assets	(27.1)	2.0	(15.1)	(20.1)
Others	-	-	-	-
CF from investing activities	(27.1)	1.7	(15.1)	(20.1)
Inc / (Dec) in Equity Capital	-	-	-	-
Inc / (Dec) in Loan	(198.0)	53.7	(95.0)	(115.0)
Dividend & Dividend Tax	(14.0)	-	(4.7)	(7.0)
Others	12.7	(38.2)	10.2	5.0
CF from financing activities	(199.3)	15.4	(89.5)	(117.0)
Net Cash flow	1.1	3.2	(0.7)	5.3
Opening Cash	4.1	5.1	8.3	7.6
Closing Cash	5.1	8.3	7.6	12.9

Source: Company, ICICIdirect.com Research

Balance sheet ₹ Crore

(Year-end March)	FY16	FY17 P	FY18E	FY19E
Liabilities				
Equity Capital	40.0	40.0	40.0	40.0
Reserve and Surplus	882.7	831.8	857.8	910.8
Total Shareholders funds	922.6	871.8	897.8	950.8
Total Debt	630.3	684.0	589.0	474.0
Deferred Tax Liability	99.2	60.9	65.9	63.4
Non Current Liabilities	3.9	4.7	5.2	5.7
Total Liabilities	1,656.0	1,621.3	1,557.8	1,493.8
Assets				
Gross Block	1,646.3	1,672.5	1,687.5	1,707.5
Less: Acc Depreciation	713.5	787.5	863.1	939.4
Net Block	932.8	885.0	824.4	768.0
Capital WIP	29.4	1.2	1.3	1.3
Total Fixed Assets	962.1	886.2	825.7	769.3
Investments	149.6	149.8	149.8	149.8
Inventory	322.2	257.8	300.8	300.3
Debtors	324.9	360.8	421.1	465.5
Loans and Advances	81.6	31.9	16.9	10.4
Other Current Assets	36.6	76.9	21.9	22.0
Cash	5.1	8.3	7.6	12.9
Total Current Assets	770.5	735.7	768.3	811.0
Creditors	51.7	86.5	107.0	127.3
Other Current Liabilities (incl Provisi	174.5	63.9	79.0	109.1
Current Liabilities & Prov	226.2	150.4	186.0	236.4
Net Current Assets	544.3	585.3	582.3	574.7
Others	-	-	-	-
Application of Funds	1,656.0	1,621.3	1,557.8	1,493.8

Source: Company, ICICIdirect.com Research

Key ratios

(Year-end March)	FY16	FY17 P	FY18E	FY19E
Per share data (₹)				
EPS	-3.8	-12.5	6.5	13.3
Cash EPS	56.9	-3.5	26.0	35.6
BV	230.9	218.2	224.7	237.9
DPS	3.0	0.0	1.0	1.5
Cash Per Share	1.3	2.1	1.9	3.2
Operating Ratios (%)				
EBITDA margins	15.0	9.4	13.1	14.0
PBT margins	-1.3	-4.8	3.1	5.7
Net Profit margins	-1.8	-5.8	2.4	4.4
Inventory days	167	121	115	105
Debtor days	143	153	140	140
Creditor days	51	71	75	81
Return Ratios (%)				
RoE	-1.6	-5.7	2.9	5.6
RoCE	3.2	0.9	5.3	7.4
RoIC	-1.0	-3.2	1.7	3.7
Valuation Ratios (x)				
P/E	NA	NA	43.0	21.1
EV / EBITDA	14.0	22.3	11.9	9.3
EV / Revenues	2.1	2.1	1.5	1.3
Market Cap / Revenues	1.4	1.3	1.0	0.9
Price to Book Value	1.2	1.3	1.2	1.2
Solvency Ratios				
Debt / Equity	0.7	0.8	0.7	0.5
Debt/EBITDA	5.1	8.5	4.1	2.8
Current Ratio	3.4	4.9	4.1	3.4
Quick Ratio	2.0	3.2	2.5	2.2

Source: Company, ICICIdirect.com Research

ICICIdirect.com coverage universe (Graphite steel electrodes)

Sector/Company	CMP (₹)	TP (₹)	Rating	M Cap (₹ Cr)	EPS (₹) FY17	EPS (₹) FY18E	EPS (₹) FY19E	P/E (x) FY17	P/E (x) FY18E	P/E (x) FY19E	EV/EBITDA (x) FY17	EV/EBITDA (x) FY18E	EV/EBITDA (x) FY19E	ROCE(%) FY17	ROCE(%) FY18E	ROCE(%) FY19E	ROE(%) FY17	ROE(%) FY18E	ROE(%) FY19E
Graphite India	110	105	Hold	2149	3.1	3.6	5.4	35.0	30.5	20.3	14.5	43.6	14.5	4.4	-0.3	3.4	3.5	3.8	5.9
HEG	285	275	Hold	1140	-3.5	26.0	35.6	22.5	12.0	9.4	2.1	1.6	1.3	-3.2	1.7	3.7	0.9	5.3	7.4

Source: Company, ICICIdirect.com Research

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Strong Buy: >15%/20% for large caps/midcaps, respectively, with high conviction;
Buy: >10%/15% for large caps/midcaps, respectively;
Hold: Up to +/-10%;
Sell: -10% or more;

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