

COMPANY UPDATE

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NALCO

PRICE: RS.77

TARGET PRICE: RS.100

RECOMMENDATION: BUY

FY20E PE: 10.0X

US sanctions on Rusal (April 2018) and alumina cost push led to ~10% rise in the aluminium prices since Feb'18 end. Besides, supply disruptions, the sanctions also restrict Rusal's ability to complete new projects or ramping up of exiting capacities (1.5-1.6MT), restricting any new supply coming into the market. This, coupled with China's emphasis on environmental sustainability should support aluminium prices in the near to medium term. As we believe that, lower supply from China, low inventory, and deficit (ex-China) will continue to support the aluminium prices. Given the recent uptick in aluminium prices, we believe, NALCO should report improvement in operating performance for its Aluminium segment from 1QFY19 onwards, provided the current LME prices sustain. Besides, this the sharp surge in Alumina prices would also boost the overall earnings for the company. We revise our earnings to Rs7.5 (earlier Rs7.0) and Rs7.7 (earlier Rs7.6) for FY19E and FY20E, respectively. While we continue to assess the development, a positive impact on aluminium and alumina is apparent in the near term. At current valuation of 5.0x/4.7x FY19E/FY20E EBITDA, the stock is trading at attractive level. We continue to maintain our BUY rating with an unchanged target price of Rs100.

Summary table

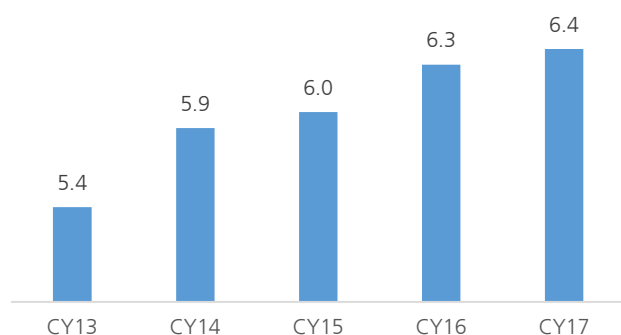
(Rs mn)	FY18E	FY19E	FY20E
Sales	92,552	101,701	103,367
Growth (%)	22.7	9.9	1.6
EBITDA	17,953	23,353	24,135
EBITDA margin (%)	19.4	23.0	23.3
PBT	16,712	21,788	22,245
Adj net profit	11,197	14,598	14,904
Adj EPS (Rs)	5.8	7.5	7.7
Growth (%)	148.5	29.5	2.8
CEPS (Rs)	8.2	10.1	10.5
BV (Rs/share)	56	59	63
Dividend / share (Rs)	5.0	4.0	4.0
ROE (%)	10.4	12.4	11.6
ROCE (%)	14.2	17.3	16.2
Net cash (debt)	34,113	32,126	35,577
EV/EBITDA (x)	6.4	5.0	4.7
EV/Sales (x)	1.2	1.1	1.1
P/E (x)	13.3	10.2	10.0
P/CEPS (x)	9.4	7.6	7.4
P/BV (x)	1.5	1.4	1.3

Source: Company, Kotak Securities – Private Client Research

Higher alumina prices to boost earnings

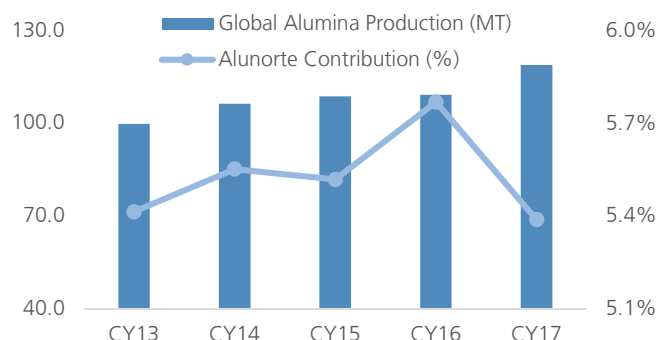
Alumina prices have risen over 70% in last 3 months, due to the partial shutdown of Alunorte refinery belonging to Norsk Hydro in Brazil since 27th Feb, 2018. Alunorte refinery is the world's largest, with a production volume of 6.7MT in CY17 (5% of global output). As per NALCO's management the alumina prices in the last one week is up by 27% and last tender has been entered at US\$601/tonne (multiyear high). Given the shortage of alumina, Brazilian aluminum smelter Albras is likely to curtail its production by 50%. This, coupled with consolidation in the alumina refiners would also augur well for the industry. We believe NALCO will be one of the key beneficiaries of the recent uptick in the alumina prices and is better placed compared to its peers owing to the higher sales of alumina, as over 75% of its EBITDA comes from alumina segment. Nalco's earning has high sensitivity to the change in alumina prices, with every \$20/tonne change in alumina prices, EPS impact will be ~6%. We believe NALCO's surplus alumina production will allow the company to sell 1.28/1.25MT of alumina in FY19/FY20E, aiding earnings. Our earnings estimates are based on alumina prices of US\$380-385/MT, as against average alumina prices of US\$300/tonne and US\$365/tonne in FY17 and FY18E respectively.

Alunorte Alumina production (MT)



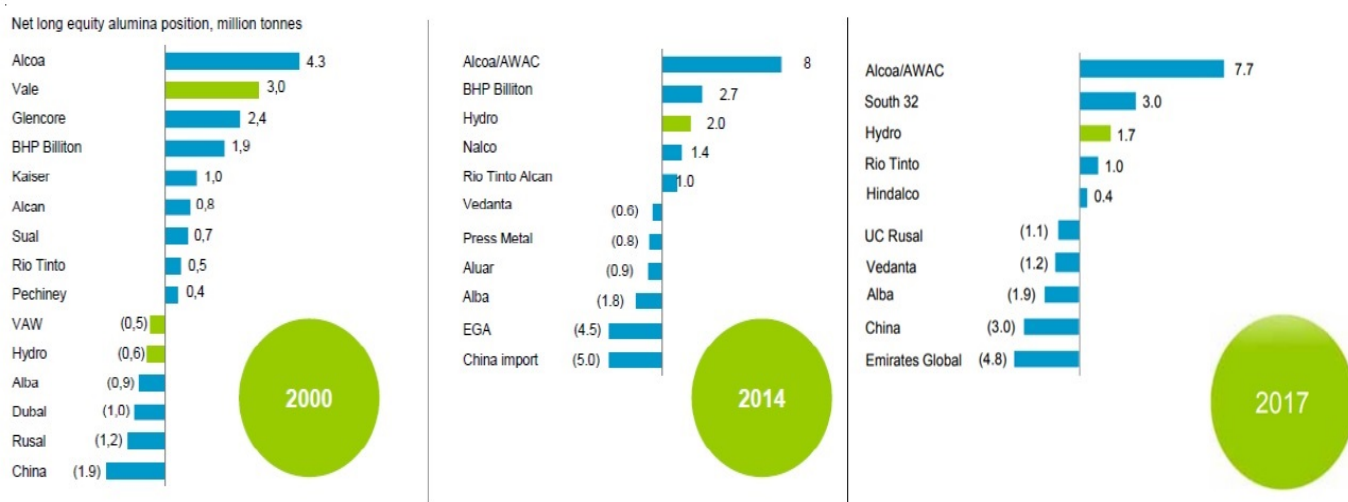
Source: Norsk Hydro presentation

Alunorte accounts for 5% of global output



Source: International Aluminium Institute; Norsk Hydro presentation

Consolidation in Alumina market



Source: CRU, Norsk Hydro

Cost push and supply disruptions to support aluminium price

United States has imposed sanctions on and frozen assets of Oleg Deripaska (Director at Rusal, Ex-President) and UC Rusal which are in the US jurisdiction. US Rusal has been designated for sanctions/asset freeze for being owned or controlled by, directly or indirectly, by Oleg Deripaska. Rusal is the world's second-largest aluminum producer and the biggest outside of China. Rusal produced 3.71MT of primary aluminum in 2017, accounting for 6% of the global output and 14% of world, ex-China supplies. Global aluminum prices and the U.S. premium rose following U.S.-imposed sanctions on Rusal. Average aluminum prices jumped 23% in 2017 after China cut supply. 2018 started with a weak momentum. However, post the sanction, the risk of rising supply increases, resulting into an uptick in global aluminium prices by 6-7%. Rusal is one of the largest exporter to US accounting for 14% of 2017 revenue, which will now have to be replaced either from other international suppliers or domestically. We believe that the sanctions will have effect on its largest customer Glencore, which accounts for 10% of its revenue (US\$2.4 bn).

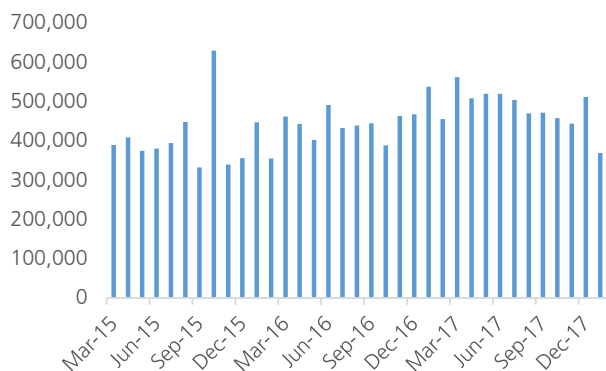
Top 8 producers accounts for ~45% of global output

Company	Aluminium Output (MT)	% of total
China Hongqiao	7.1	11.2%
UC Rusal	3.7	5.9%
Chalco	3.6	5.7%
Rio Tinto Alcan	3.6	5.6%
Shandong Xinfa	3.5	5.5%
EGA	2.5	3.9%
Alcoa	2.3	3.7%
State Power Investment Corp	2.3	3.6%

Source: Bloomberg

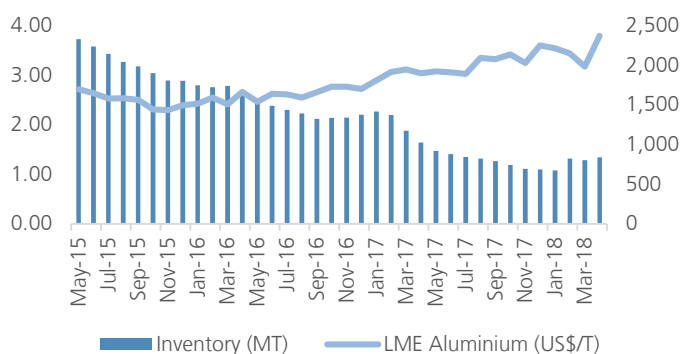
UC Rusal accounts for ~6% of the global output and ~14% world ex-China supplies

North America Aluminium imports ('000 T)



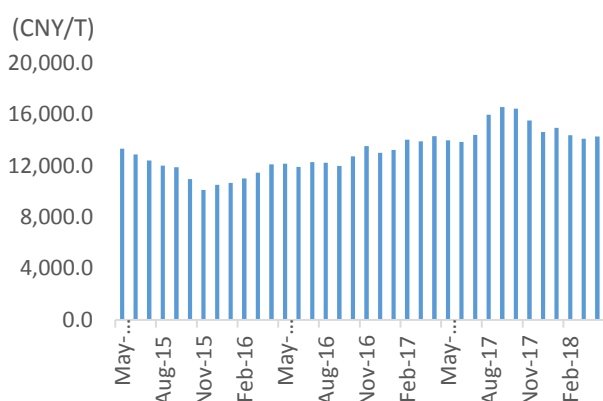
Source: Bloomberg

Aluminium inventory and price trend



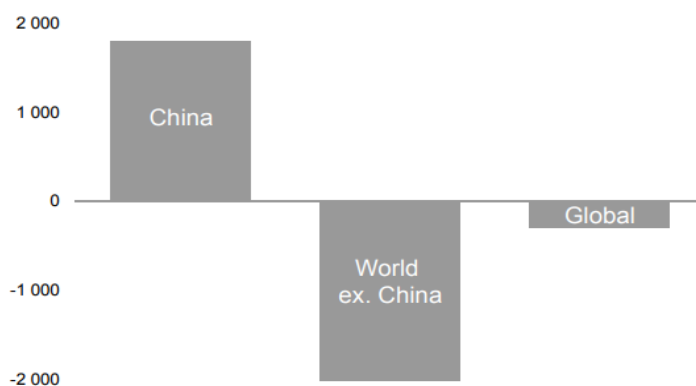
Source: Bloomberg

Chinese smelter cost curve YTD up 4% YoY



Source: Bloomberg

Global market to remain in deficit in 2018 ('000 T)

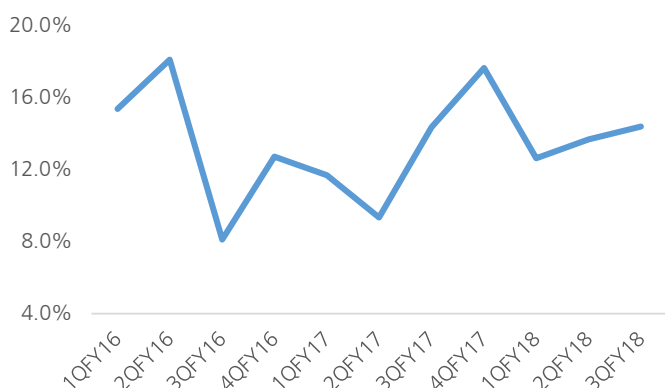


Source: Norsk Hydro

Margin to remain healthy

Given the uptick in the alumina and aluminium prices, we believe the company's operating margin is likely to remain strong. Given the strong surge in aluminium prices, the management believes that aluminium segment will be EBITDA positive given the sustainability of the current prices. In Q4FY18, we believe the company would be at breakeven point in aluminium segment. We believe that, the current prices of alumina is not sustainable over the long term, but, given the supply disruptions in the aluminium, LME aluminium prices is likely to remain strong in the near term.

Quarterly EBITDA margin trend (%)

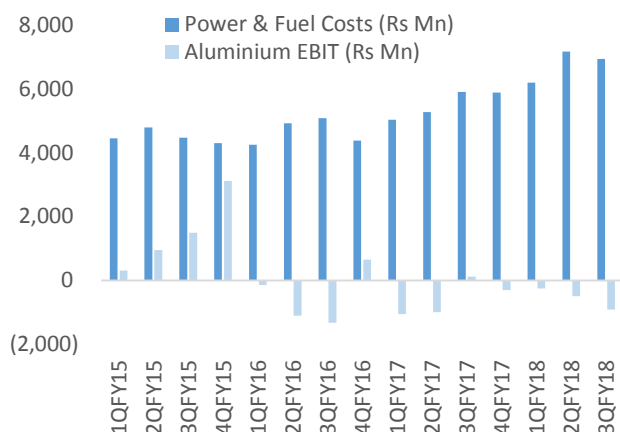


Strong realisation to support margin (%)

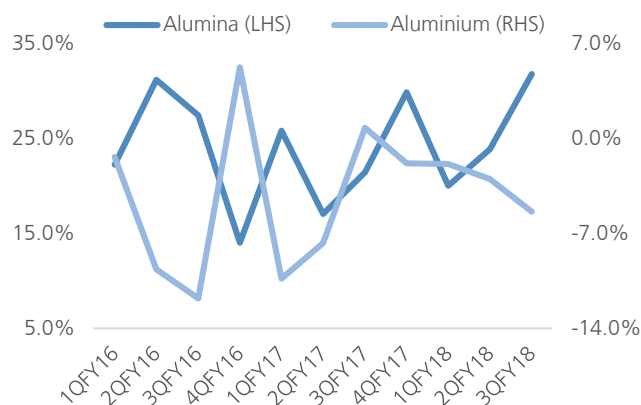


Source: Company, Kotak Securities – Private Client Research

Quarterly aluminium performance



Segmental EBIT margin



Source: Company, Kotak Securities – Private Client Research

4QFY18 result expectations

We expect Nalco's EBITDA to increase by 50% QoQ to Rs5.3 bn in 4QFY18 led by higher alumina sales (14 shipments) and a respite from the higher availability of coal will be partially offset by lower alumina realizations. The company on an average does 9-10 alumina shipments quarterly, with annual sales in the range of 1.2-1.3MT. The increase in alumina segment in 4QFY18 is supported by destocking given the lower sales in 9MFY18. Aluminium sales volume is likely to remain flat at 104KT. 3QFY18 operating performance was impacted by higher power & fuel costs and lower realisation.

Maintain BUY

Increase in cost curve for the Chinese smelters and US imposition of sanction on Russian entity shall support the prices in the short. Near term earnings is likely to remain strong for integrated players and the company who is long on Alumina, will benefit to a large extent. As per the media reports, Brazilian aluminum smelter Albras (produces 460,000 mt/year) will curtail 50% of its production due to lack of alumina supply from Alunorte, which would further lend support to the aluminium prices in the near term. Hence, we continue to maintain our positive view on NALCO, and at current valuation of 5.0x/4.7x FY19E/FY20E EBITDA, we believe stock offers decent upside. We reiterate our BUY rating, with a target price of Rs100.

We maintain BUY on
NALCO with a price
target of Rs.100

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- BUY** – We expect the stock to deliver more than 12% returns over the next 12 months
- ACCUMULATE** – We expect the stock to deliver 5% - 12% returns over the next 12 months
- REDUCE** – We expect the stock to deliver 0% - 5% returns over the next 12 months
- SELL** – We expect the stock to deliver negative returns over the next 12 months
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- NA** – **Not Available or Not Applicable.** The information is not available for display or is not applicable
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- NOTE** – Our target prices are with a 9-month perspective. Returns stated in the rating scale are our internal benchmark.

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