

HEG Ltd (HEG)

Continues to outperform...

- HEG again reported a stellar performance in Q2FY19 marked by sustained healthy realisation, lower raw material cost. Capacity utilisation was at ~85%. Revenue from operation was at ₹ 1793.8 crore (up 338% YoY, 13% QoQ), higher than our estimate of ₹ 1589.3 crore
- The company reported a strong EBITDA of ₹ 1368.8 crore, higher than our estimate of ₹ 1017 crore. Resultant EBITDA margin was at 76.3% (vs. Q2FY18: 46.3%, Q1FY19:74.8% and our estimate of 64%)
- Reported PAT came in at ₹ 888.9 crore vs. our estimate of ₹ 665.7 crore. The company declared an interim dividend of ₹ 30/share

Reports stellar H1FY19...

Sustained healthy realisations led to HEG's stellar performance in H1FY19. It reported capacity utilisation of ~83.5%. Revenues from the operation were at ₹ 3381.2 crore, up 450% YoY. H1FY19 EBITDA was at ₹ 2556.8 crore, up 1100% YoY, implying a robust EBITDA margin of 75.6% (vs. 34.7% for H1FY18). PAT was at ₹ 1659.3 crore, up 1477% YoY.

Growing EAF production points to healthy demand prospects...

China, on account of stringent environmental norms, has shut ~155-160 million tonne (MT) of largely unaccounted induction furnace capacity along with 115 MT steelmaking capacities in 2016-17. These capacity cuts have led to a reduction in steel exports by ~40%, thus encouraging steel production in other countries (primarily EAF route). Industry sources indicate globally ~55 MT of EAF steel production was added in 2017. Given the stringent pollution control norms, China is also aiming to increase their share of EAF route of steelmaking in its total steel production and is likely to commission ~66 MT of EAF capacities in CY18.

Supply constraints to keep graphite electrodes prices elevated...

Graphite electrode prices fell to unsustainable levels in 2014-17 on account of subdued demand from EAF producers, leading to permanent shutdown of ~200000 tonne globally (ex-China). Furthermore, ~300000 tonne graphite electrode capacity was shut in China citing environmental concerns. The reduction in graphite electrodes exports from China coupled with a shutdown of global graphite electrodes capacity vacated a substantial part of the global electrode market, tilting the graphite electrode demand-supply dynamics in favour of domestic players like HEG. Demand for graphite electrodes remained healthy on account of increasing steel production through the EAF route. Even in China, steel produced through the EAF route increased sharply from ~6% in CY16 to ~9% in CY17. In the absence of any new capacity additions owing to limited supply of needle coke, we believe this demand-supply imbalance (in favour of demand) will sustain in the near to medium term keeping graphite electrode prices elevated, thereby boosting profitability.

Operating environment continues to be favourable, maintain BUY...

In addition to healthy realisations, a key highlight of HEG's Q2FY19 performance has been the access to lower cost needle coke inventory aiding a robust performance for Q2FY19. As the production process of graphite electrode is fairly long (three to six months), we expect the higher cost needle coke to come in with a lag from H2FY19 onwards. Thus, it would remain a key monitorable. We expect the EBITDA margins to moderate to ~67% in FY19 (from 75.6% in H1FY19) and further to 52% in FY20E. We continue to remain positive on the graphite electrodes space and value the company at 10x FY20E EPS of ₹ 575 thereby arriving at a target price of ₹ 5750. We maintain our **BUY** rating on the stock.

Rating matrix	
Rating	: Buy
Target	: ₹ 5750
Target Period	: 12 months
Potential Upside	: 37%

What's Changed?	
Target	: Changed from ₹5000 to ₹5750
EPS FY19E	: Changed from ₹485 to ₹750
EPS FY20E	: Changed from ₹500 to ₹575
Rating	: Unchanged

Quarterly Performance					
	Q2FY19	Q2FY18	YoY (%)	Q1FY19	QoQ (%)
Revenue	1,793.8	409.5	338.0	1,587.4	13.0
EBITDA	1,368.8	189.7	621.5	1,188.0	15.2
EBITDA (%)	76.3	46.3	2998 bps	74.8	147 bps
PAT	888.9	113.7	LP	770.4	15.4

Key Financials				
	FY17	FY18	FY19E	FY20E
Net Sales	860.0	2,750.0	6,805.0	6,477.3
EBITDA	80.6	1,721.6	4,562.7	3,357.7
Adjusted PAT	(50.1)	1,081.3	2,997.2	2,297.6
Adjusted EPS (₹)	(12.5)	270.6	750.1	575.0

Valuation summary				
	FY17	FY18	FY19E	FY20E
PE (x)	NA	15.5	5.6	7.3
Target PE (x)	NA	21.2	7.7	10.0
EV/EBITDA (x)	216.1	9.9	3.5	4.4
P/BV (x)	19.2	9.3	4.5	3.2
RoE (%)	(5.7)	59.8	79.8	43.8
RoCE (%)	0.9	78.9	121.4	66.1

Stock data	
Particulars	Amount
Market Capitalisation	₹ 16751 crore
Debt (FY18)	₹ 297 crore
Cash (FY18)	₹ 8 crore
EV	₹ 17040 crore
52 Week H / L (₹)	4950 / 1570
Equity Capital	40.0
Face Value	₹ 10

Price performance (%)				
Return %	1M	3M	6M	12M
HEG	24.9	(3.4)	45.7	138.5
Graphite India	14.6	(5.5)	37.5	78.7

Research Analyst	
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Variance analysis

	Q2FY19	Q2FY19E	Q2FY18	YoY (%)	Q1FY19	QoQ (%)	Comments
Total Operating Income	1,793.8	1,589.3	409.5	338.0	1,587.4	13.0	Topline came in better than our expectations on the back of higher-than-expected realisations
Other Income	20.4	8.3	2.6	698.8	8.0	156.2	
Raw Material Expense	217.8	349.6	122.2	78.3	205.6	5.9	Raw material costs came in lower than our estimate
Employee Expense	52.6	47.7	17.0	209.3	45.5	15.6	
Power & Fuel Expense	45.4	39.7	27.4	65.8	41.5	9.3	
Other Expenses	109.2	135.2	53.3	104.9	106.8	2.2	
Total Operating Expenses	425.0	572.3	219.8	93.3	399.4	6.4	
EBITDA	1,368.8	1,017.0	189.7	621.5	1,188.0	15.2	EBITDA came in higher than our estimate
EBITDA Margin (%)	76.3	64.0	46.3	2998 bps	74.8	147 bps	EBITDA margin came in higher than our estimate
Depreciation	18.1	20.0	18.2	(0.4)	17.6	3.2	
Interest	5.4	7.2	12.9	(58.3)	1.7	209.8	
Exceptional Items	-	-	-	-	-	-	
PBT	1,365.7	998.1	161.1	LP	1,176.6	16.1	
Tax Outgo	476.8	332.4	47.5	NA	406.2	NA	
PAT	888.9	665.7	113.7	LP	770.4	15.4	PAT came in higher than our estimate
Key Metrics							
Capacity Utilisation (%)	85	82	85		82		Capacity utilisation was lower than our estimates

Source: Company, ICICI Direct Research

Change in estimates

(₹ Crore)	FY19E			FY20E			Comments
	New	Old	% Change	New	Old	% Change	
Revenue	6,805	5,730	18.8	6,477	5,958	8.7	Upward revised estimates on all parameters for both years
EBITDA	4,563	2,954	54.5	3,358	3,000	11.9	
EBITDA Margin (%)	67.0	51.6	1550 bps	51.8	50.3	149 bps	
PAT	2,997	1,938	54.6	2,298	1,998	15.0	
EPS (₹)	750	485	54.6	575	500	15.0	

Source: Company, ICICI Direct Research

Assumptions

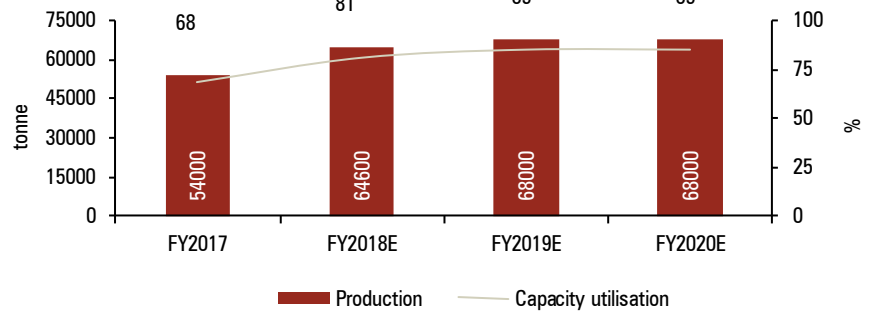
(₹ Crore)	FY19E			FY20E			Comments
	New	Old	% Change	New	Old	% Change	
Capacity Utilisation (%)	85.0	85.0	0 bps	85.0	85.0	0 bps	Maintained estimates

Source: Company, ICICI Direct Research

Company Analysis

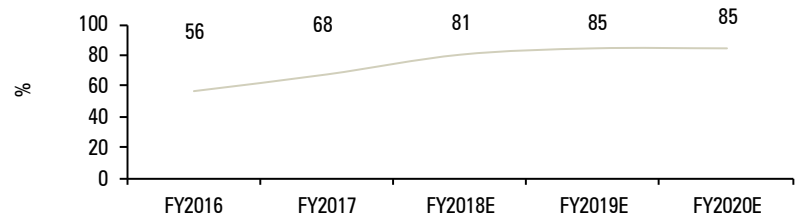
The company is a leading manufacturer of graphite electrodes in India with an installed capacity of 80,000 tonnes per annum (TPA). HEG commissioned its last capacity expansion way back in Q4FY12 (February 2012) wherein it installed a capacity of 14,000 tonnes while incurring a capex of ₹ 225 crore.

Exhibit 1: Graphite electrode production & growth rate



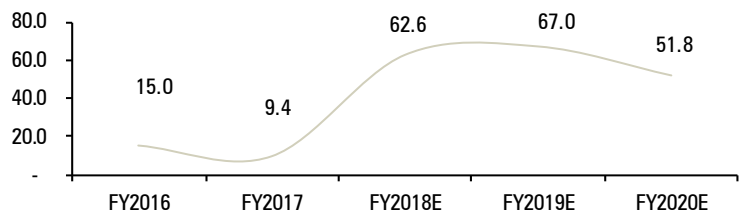
Source: Company, ICICI Direct Research, FY12, FY13 and FY14 numbers have been assumed on basis of capacity utilisation rates

Exhibit 2: Capacity utilisation



Source: Company, ICICI Direct Research

Exhibit 3: EBITDA margins



Source: Company, ICICI Direct Research

EBITDA margin in FY20E is expected to mellow on account of increase in prices of key raw material (needle coke)

Key takeaways from conference call...

- World crude steel production during January-September 2018 was at 1347 million tonne (MT), up 4.7% YoY. Chinese crude steel production during the year was up 6.1% YoY to 699 MT. World crude steel production (ex-China) was up 3.3% YoY to 648 MT
- Chinese exports are expected to keep falling in the near term. During January-September 2018, steel exports from China were down 11% YoY
- Realisations during Q2FY19 were higher vs. Q1FY19. The depreciating rupee was favourable as the graphite electrode business is a net exporting segment
- The management indicated that EAF steel production outside China continues to grow at 8-9% per annum
- The company is considering expansion by 20000 tonne through de-bottlenecking (thereby plans are to take the cumulative graphite electrode capacity to 100000 tonnes). The specific details regarding capex, etc would be communicated over the near term
- The management indicated the company will maintain the payout ratio of 35%
- The company has treasury to the tune of ₹ 700-800 crore. The average income on the same is ~8%
- Q3FY19 capacity utilisation is likely to be in closer to ~90%

Outlook and Valuation

In addition to healthy realisations, a key highlight of HEG's Q2FY19 performance has been access to lower cost needle coke aiding a robust performance for Q2FY19. As the production process of graphite electrode is fairly long (three to six months), we expect the higher cost needle coke to come in with a lag from H2FY19 onwards. Thus, it would remain a key monitorable. We expect EBITDA margins to moderate to ~67% in FY19 (from 75.6% in H1FY19) and further to 52% in FY20E.

We expect the topline, EBITDA and PAT to increase 53%, 40% and 46%, respectively, during FY18-20E.

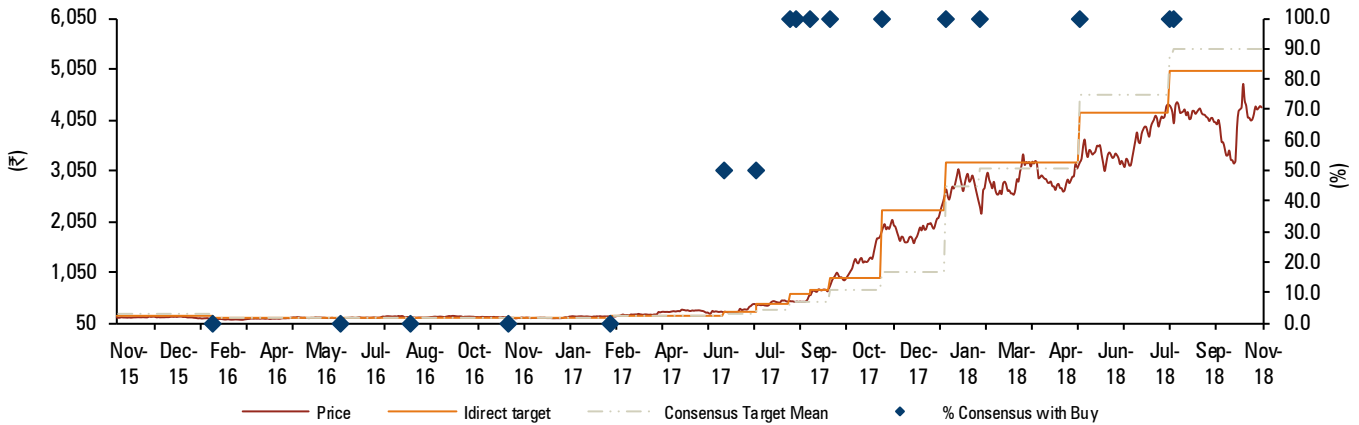
We continue to value the company at 10x FY20E EPS of ₹ 575 thereby arriving at a target price of ₹ 5750. We maintain our **BUY** rating on the stock. A healthy dividend payout of ~30-35% also augurs well.

Exhibit 4: Valuation matrix

	Sales (₹ Crore)	Growth (%)	EPS (₹)	Growth (%)	PE (x)	EV/EBITDA (x)	P/ BV (x)	RoE (%)	RoCE (%)
FY16	827.5	(32.9)	(3.8)	(138.8)	NA	139.6	18.2	(1.6)	3.2
FY17	860.0	3.9	(12.5)	(230.7)	NA	216.1	19.2	(5.7)	0.9
FY18	2,750.0	219.8	270.6	LP	15.5	9.9	9.3	59.8	78.9
FY19E	6,805.0	147.5	750.1	177.2	5.6	3.5	4.5	79.8	121.4
FY20E	6,477.3	(4.8)	575.0	(23.3)	7.3	4.4	3.2	43.8	66.1

Source: Company, ICICI Direct Research

Recommendation history vs. consensus estimate



Source: Bloomberg, Company, ICICI Direct Research

Key events

Date	Event
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	Gol 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.
Apr-18	India Rating & Research (Ind-Ra) upgraded the long term issue rating to 'IND AA' from 'IND A+' with a Stable outlook.

Source: Company, ICICI Direct Research

Top 10 Shareholders

Rank	Name	Latest Filing Date	% O/S	Position	Change
1	Norbury Investments, Ltd.	30-Sep-2018	0.1	5.36M	0
2	Microlight Investments, Ltd.	30-Sep-2018	0.1	4.67M	0
3	Life Insurance Corporation of India	30-Sep-2018	0.1	3.33M	0
4	Bharat Investments Growth, Ltd.	30-Sep-2018	0.1	2.61M	0
5	Mekima Corporation	30-Sep-2018	0.0	1.79M	0
6	Purvi Vanijya Niyojan, Ltd.	30-Sep-2018	0.0	1.75M	0
7	Raghav Commercial, Ltd.	30-Sep-2018	0.0	1.53M	0
8	LNJ Financial Services, Ltd.	30-Sep-2018	0.0	1.43M	0
9	LNJ Bhilwara Group	30-Sep-2018	0.0	0.98M	0
10	Shashi Commercial Co., Ltd.	30-Sep-2018	0.0	0.72M	0

Source: Reuters, ICICI Direct Research

Shareholding Pattern

(in %)	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Promoter	61.0	61.0	61.0	61.0	61.0
FII	2.7	3.1	4.0	5.4	8.2
DII	12.1	12.0	11.8	11.7	10.9
Others	24.2	23.9	23.2	22.0	19.8

Recent Activity

Buys			Sells		
Investor name	Value (M)	Shares (M)	Investor name	Value (M)	Shares (M)
APG Asset Management	10.67	0.23	L&T Investment Management Limited	(14.72)	(0.25)
AllianceBernstein L.P.	3.15	0.05	The New India Assurance Co. Ltd.	(3.65)	(0.08)
JPMorgan Asset Management U.K. Limited	2.77	0.05	IDFC Asset Management Company Private Limited	(2.69)	(0.05)
Nuveen LLC	1.83	0.04	State Street Global Advisors (US)	(0.54)	(0.01)
Copper Rock Capital Partners LLC	2.15	0.03	Motilal Oswal Asset Management Company Ltd.	(0.41)	(0.01)

Source: Reuters, ICICI Direct Research

Financial summary

Profit and loss statement				
	₹ Crore			
(Year-end March)	FY17	FY18	FY19E	FY20E
Total Operating Income	860.0	2,750.0	6,805.0	6,477.3
Growth (%)	3.9	219.8	147.5	(4.8)
Raw Material Expenses	443.9	478.0	1,252.2	2,080.3
Employee Expenses	58.9	112.6	243.5	259.1
Other expenses	276.6	437.9	746.6	780.3
Total Operating Expenditure	779.4	1,028.5	2,242.3	3,119.6
EBITDA	80.6	1,721.6	4,562.7	3,357.7
Growth (%)	(35.2)	2,034.9	165.0	(26.4)
Depreciation	73.9	72.6	74.7	80.8
Interest	54.7	56.7	17.9	10.8
Other Income	7.1	12.4	69.1	192.2
PBT	(40.9)	1,604.7	4,539.2	3,458.2
Exceptional Item	-	-	-	-
Total Tax	9.2	523.4	1,541.9	1,160.6
Reported PAT	(50.1)	1,081.3	2,997.2	2,297.6
Adjusted PAT	(50.1)	1,081.3	2,997.2	2,297.6
Growth (%)	230.7	LP	177.2	(23.3)
EPS (₹)	(12.5)	270.6	750.1	575.0

Source: Company, ICICI Direct Research

Balance sheet				
	₹ Crore			
(Year-end March)	FY17	FY18	FY19E	FY20E
Liabilities				
Equity Capital	40.0	40.0	40.0	40.0
Reserve and Surplus	831.8	1,768.7	3,713.9	5,205.0
Total Shareholders funds	871.8	1,808.6	3,753.8	5,245.0
Total Debt	684.0	297.5	0.0	0.0
Deferred Tax Liability	60.9	119.2	116.7	104.2
Non Current Liabilities	4.7	5.9	6.4	4.4
Total Liabilities	1,621.3	2,231.2	3,877.0	5,353.6
Assets				
Gross Block	1,672.5	1,693.4	1,768.4	1,843.4
Less: Acc Depreciation	787.5	860.0	934.7	1,015.5
Net Block	885.0	833.4	833.7	827.8
Capital WIP	1.2	1.6	76.7	196.7
Total Fixed Assets	886.2	835.0	910.3	1,024.6
Investments	149.8	149.3	149.3	399.3
Inventory	257.8	511.5	829.3	1,196.6
Debtors	360.8	972.7	1,864.4	1,952.1
Loans and Advances	31.9	36.4	29.9	38.4
Other Current Assets	76.9	123.2	116.2	120.2
Cash	8.3	7.6	577.3	1,524.7
Total Current Assets	735.7	1,651.3	3,417.2	4,831.9
Creditors	86.5	246.4	411.7	683.9
Other Current Liabilities (incl Pr	63.9	158.0	188.1	218.2
Current Liabilities & Prov	150.4	404.4	599.8	902.1
Net Current Assets	585.3	1,246.9	2,817.4	3,929.8
Others	-	-	-	-
Application of Funds	1,621.3	2,231.2	3,877.0	5,353.6

Source: Company, ICICI Direct Research

Cash flow statement				
	₹ Crore			
(Year-end March)	FY17	FY18	FY19E	FY20E
Profit/(Loss) after taxation	(50.1)	1,081.3	2,997.2	2,297.6
Add: Depreciation & Amortization	73.9	72.6	74.7	80.8
Net Increase in Current Assets	38.0	(916.3)	(1,196.1)	(467.4)
Net Increase in Current Liabilities	(75.8)	254.0	195.3	302.3
CF from operating activities	(14.0)	491.6	2,071.2	2,213.4
(Inc)/dec in Investments	(0.3)	0.6	-	(250.0)
(Inc)/dec in Fixed Assets	2.0	(21.3)	(150.1)	(195.1)
Others	-	-	-	-
CF from investing activities	1.7	(20.7)	(150.1)	(445.1)
Inc / (Dec) in Equity Capital	-	-	-	-
Inc / (Dec) in Loan	53.7	(386.6)	(297.4)	-
Dividend & Dividend Tax	-	(374.0)	(1,052.0)	(806.5)
Others	(38.2)	289.1	(2.0)	(14.5)
CF from financing activities	15.4	(471.5)	(1,351.4)	(821.0)
Net Cash flow	3.2	(0.7)	569.7	947.4
Opening Cash	5.1	8.3	7.6	577.3
Closing Cash	8.3	7.6	577.3	1,524.7

Source: Company, ICICI Direct Research

Key ratios				
(Year-end March)	FY17	FY18	FY19E	FY20E
Per share data (₹)				
EPS	-13	271	750	575
BV	218	453	939	1,313
DPS	0	80	225	172
Cash Per Share	2	2	144	382
Operating Ratios (%)				
EBITDA margins	9.4	62.6	67.0	51.8
PBT margins	-4.8	58.4	66.7	53.4
Net Profit margins	-5.8	39.3	44.0	35.5
Inventory days	121	182	135	140
Debtor days	153	129	100	110
Creditor days	71	188	120	120
Return Ratios (%)				
RoE	-5.7	59.8	79.8	43.8
RoCE	0.9	78.9	121.4	66.1
RoIC	0.4	78.6	141.3	88.1
Valuation Ratios (x)				
P/E	NA	15.5	5.6	7.3
EV / EBITDA	216.1	9.9	3.5	4.4
EV / Revenues	20.3	6.2	2.4	2.4
Market Cap / Revenues	19.5	6.1	2.5	2.6
Price to Book Value	19.2	9.3	4.5	3.2
Solvency Ratios				
Debt / Equity	0.8	0.2	0.0	0.0
Debt/EBITDA	8.5	0.2	0.0	0.0
Current Ratio	4.9	4.1	5.7	5.4
Quick Ratio	3.2	2.8	4.3	4.0

Source: Company, ICICI Direct Research

ICICIdirect.com coverage universe (Graphite steel electrodes)

Company	CMP			M Cap (₹ Cr)	EPS (₹)			P/E (x)			EV/EBITDA (x)			ROCE(%)			ROE(%)		
	(₹)	TP (₹)	Rating		FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
Graphite India	997	1,400	Buy	19,481	52.8	180.0	140.0	18.9	5.5	7.1	12.8	3.5	4.1	47.1	116.7	69.2	37.8	82.4	47.8
HEG	4192	5750	Buy	16,768	270.6	750.1	575.0	15.5	5.6	7.3	9.9	3.5	4.4	78.9	121.4	66.1	59.8	79.8	43.8

Source: Company, ICICI Direct 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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