Analyst Details

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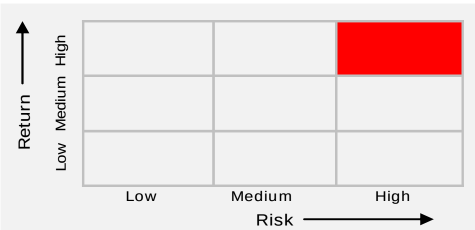
Closing Price (as on 7 June 10)	58.6
Target Price	75.6
Upside %	29%

Source: NSE, HISL Advisory

Risk Return Matrix



Source: Company Data, HISL Advisory

Company Data	
BSE Code	512579
NSE Code	GUJNRECOKE
Equity Capital (Rs mn)	4981.9
Face Value (Rs)	10
Market Cap (Rs bn)	29.2
Avg Daily Volume (Qtly)	5,540,940
52 week H/L (Rs)	97.9/35

Source: Capitaline, NSE

Financial Snapshot (Rs mn)

Particulars	FY10E	FY11E	FY12E
Net Sales	14399	21466	25648
EBITDA	1126	8538	13045
EBITDA (%)	7.8	39.8	50.9
Net Profit	204	3171	5394
EPS (Rs)	0.4	5.6	9.4
RoE (%)	1.7	20.3	25.8
P/E (x)		10.6	6.2
EV/EBITDA (x)		6.0	3.9
P/BV (x)		2.1	1.6
Net Debt/ Equity (x)		1.1	0.9

Source: NSE, HISL Advisory

Shareholding (%)

Holders	31 Mar 2010
Promoters	46.5
FIIs	26.9
MFs/banks	5.9
Corporate Holding	3.9
Public & Others	16.8

Source: NSE, Capitaline

Gujarat NRE Coke Ltd: Moving up the ladder through backward integration

BUY

Gujarat NRE Coke Limited (GNCL), promoted by Mr Arun Kumar Jagatramka, has transformed into an integrated metallurgical coke producer from being present only in the conversion business of metallurgical coal into metallurgical coke. Through this backward integration into coking coal mining, GNCL has entered the profitable part of the value chain in metallurgical coke production. Going forward, GNCL is likely to increasingly derive a major part of its earnings from mining. GNCL is poised for a turnaround from FY11 as its coking coal subsidiary in Australia (with ~75% stake)––**Gujarat NRE Coking Coal Ltd (earlier known as Gujarat NRE Minerals)**––is likely to turn profitable, benefiting from soaring coking coal prices and increased coking coal mining output. We believe that value unlocking in its large coking coal resources would result in higher RoE and growth for it over the medium- to long-term. Towards this, GNCL is undertaking a capex of AUD 500mn for mine development which will take its annual coking coal output from ~1.1.mn tonnes in FY10 to ~6mn tonnes in FY15 and help lower its operating cost from present AUD 105/tonne to AUD 39/tonne. We initiate coverage on GNCL with a **BUY** rating. Our target price for GNCL is **Rs 75.6**, implying a potential return of ~29**%**.

Investment Arguments

- **Large coking coal reserves:** Gujarat NRE Coking Coal Ltd (GNCCL) has two underground coking coal mines––**NRE No.1** and **NRE Wongawilli**––with a combined Joint Ore Reserves Committee (JORC) resource of 574mn tonnes. GNCL is the only company in India to play on the highly profitable coking coal sector.
- **Strong coking coal prices:** We believe that supply constraints, strong demand and high bargaining power of coking coal suppliers will keep coking coal prices strong. The HSBC global metals and mining team has forecast coking coal prices per tonne at USD 237.5 and USD 250 for CY10E and CY11E respectively.
- **Turnaround in coking coal business:** Increased mining output from 1mn tonnes to 2.1mn tonnes in FY11 combined with strong coking coal prices in FY11 is expected to turn GNCCL profitable. We expect GNCCL to post an EBITDA and PAT of Rs 4.8bn and Rs 2.4bn respectively in FY11.
- **Capex of AUD 500mn for mine development to unlock the value of its most prized possession––coking coal mines:** A capex of AUD 500mn for mine development in GNCCL is expected to increase its present coking coal output from 1.1.mn tonnes to 6mn tonnes in FY15, and lower its operating cost from present AUD 105/tonne to AUD 39/tonne.
- **Largest independent metcoke producer in India with strong expansion plans:** GNCL, the parent entity has a metcoke capacity of 1.25mn tonnes which it plans to expand to 4mn tonnes by FY15. We expect the increased production to help the standalone domestic operations of metcoke post a PAT of Rs 1.4bn and Rs 1.7bn in FY10 and FY11 respectively.
- **DVR shares trading at a sizeable discount:** GNCL's 'B' class of equity shares (NSE code: GUJNREDVR), which enjoys lower voting rights, is trading at a discount of 33% to its normal equity share. An attractive arbitrage opportunity lies here as the average discount of such shares is ~10-20%.
- **Attractive valuations:** We expect GNCL to post a **consolidated EPS of Rs 9.44 in FY12**. Given strong long term growth prospects on account of its large coking coal resources, turnaround of its coking coal business in FY11 and it being the only available coking coal play in India, we have valued GNCL at a P/E of 8x FY12E to arrive at a value of Rs75.6. This implies a potential return of ~29%. We, thus, recommend a BUY on Gujarat NRE Coke.

Coking coal market––attractive fundamentals: Supply constraints, strong demand and high bargaining power of coking coal suppliers likely to keep coking coal prices strong

In 2009, China became a significant importer of coking coal at spot prices on account of (1) increased demand from rising domestic steel production resulting from its government's infrastructure focused, stimulus-led boom and (2) reduced supply from closure of small domestic coking coal mines due to pollution and safety reasons. China is reported to have imported ~34mn tonnes of coking coal in 2009 as compared to about 6–7mn tonnes from 2004–2008. This led to spot coking coal prices rising to ~USD 220–225 per tonne in early 2010 from the annual contract price of USD 129/tonne in 2009. The tightness of the coking coal market combined with the strong bargaining power of the coking coal suppliers encouraged them to pressurise steel producers to switch to quarterly pricing contracts from annual pricing. In view of the high spot coking coal prices, coking coal contracts for the April–June 2010 quarter were settled at USD 200/tonne, a rise of 55% YoY.

Table 1: Australian monopoly of global coking coal trade

Particulars	2004	2005	2006	2007	2008
Australian coking coal exports (mn tonnes)	117	125	124	138	135
Global coking coal exports (mn tonnes)	214	227	222	227	233
Australia's share of global coking coal exports (%)	55	55	56	61	58

Source: ABARE, WCI

Chart 1: Contract coking coal prices per tonne (FOB)

Source: HISL Advisory, HSBC global metals and mining team

Going forward, global demand for coking coal is expected to continue to be strong in 2010 on account of steel capacity restarts from Europe and Japan––the two biggest coking coal importers––and continued growth in steel production in China. European and Japanese steel production in January–April'10 has grown 44.3% YoY and 52.2% YoY to 58mn tonnes and 35.5mn tonnes respectively as the developed economies recovered from the Great Recession. Continued impetus from the Chinese government's infrastructure focused, stimulus-led boom helped Chinese steel production to grow 25.4% YoY to 213.9mn tonnes during January–April'10. China recorded its highest ever steel production in April'10 at 55.4mn tonnes, a 27% rise YoY and 0.8% MoM. The HSBC global metals and mining team expects Chinese steel production to grow 8% YoY to 613mn tonnes in 2010. On the other hand, the supply of coking coal has been constrained on account of (1) lack of spare production capacity and new supply, (2) reduced output of coking coal in China on account of closure of small coking coal mines (3) logistical issues in Australia as inclement weather and planned shutdowns for maintenance have disrupted the supply of coking coal from the Hay Point coal terminal (which handles ~28% of Australian coking coal exports) and (4) mining accidents. Bargaining power of the coking coal suppliers is high on account of Australian monopoly in global trade of coking coal. Australia controls ~55%–60% of the global coking coal exports (See Chart-1). **Thus, supply constraints, strong demand and high bargaining power of coking coal suppliers makes the coking coal market very attractive from the supplier's perspective.** The shift to quarterly pricing contracts from complete annual contract pricing is thus expected to make coking coal prices volatile in favour of the supplier. The HSBC global metals and mining team has forecast coking coal prices at USD 237.5 and USD 250 for CY10 and CY11 respectively.

GNCCL––Turnaround in the making and value unlocking in its coking coal assets underway

GNCCL has 100% interest in two underground coking coal mines––**NRE No.1** and **NRE Wongawilli.** NRE No.1 mine has JORC resources of 316mn tonnes while NRE Wongawilli has JORC resources of 258mn tonnes. In order to unlock the value of its coking coal assets, GCCL is undertaking a capex of AUD 500mn for mine development. It has placed a USD 90mn order with Joy Manufacturing Company, which comprises new longwall equipment at its NRE No.1 mine and upgradation of equipment at its NRE Wongawilli mine. NRE No.1 mine currently employs the board and pillar method of mining which extracts lower quantity of coking coal. The longwall method will enable GNCCL to extract higher quantity of coking coal from the NRE No.1 mine and reduce fixed cost per tonne. NRE Wongawilli already employs the longwall method; however, it would require an upgradation, which the capex would cater to. The capex is expected to take GNCCL's annual ROM coking coal output of ~1.1.mn tonnes in FY10 to ~6mn tonnes and help lower its operating cost from present AUD 105/tonne to AUD 39/tonne by FY15. This capex will be financed through debt, internal accruals and raising of additional equity capital. In FY10, GNCCL has already raised AUD 50mn through a QIP and USD 50mn through a long-term loan facility.

GNCCL's entire ROM coking coal production has been sold to GNCL for captive use to produce metallurgical coke. The pricing is on commercial terms, determined through a market formula based on (1) FOB coking coal price based on the JSM BHP Goonyella benchmark and (2) adjustments for yield, additional transport costs required to ship ROM coal (as against washed coal) to India, estimated coal washing costs and the cost of emplacement of rejects in Australia. Additionally, GNCL has guaranteed GNCCL that the price for ROM coal received will not be less than USD 55 per tonne. Since the commencement of production, the ROM coal price received has been between 52%–60% of the benchmark coking coal price. Going forward into FY11 and FY12, higher benchmark coking coal prices would mean higher realizations and profits for GNCCL. On the back of strong coking coal prices and higher coking coal output, we expect GNCCL to post an EBITDA of Rs 4.8bn and Rs 8.5bn in FY11 and FY12 respectively. We have assumed the HSBC global metals and mining team's forecast of CY10 and CY11 benchmark coking coal price per tonne of USD 237.5 and USD250 respectively. We expect GNCCL's coking coal output at 2.1mn tonnes and 3mn tonnes for FY11 and FY12 respectively. We estimate GNCCL to post a PAT of Rs 2.4bn and Rs 5.0bn in FY11 and FY12 respectively.

From table No. 2 we can clearly see that going forward, GNCL is expected to increasingly derive a major part of its earnings from mining. We estimate the share of profits from mining at 57% and 69% of GNCL's consolidated profits in FY11 and FY12 respectively.

Table 2: Financial snapshot of GNCCL

Particulars (Rs mn)	FY11E	FY12E
EBITDA	4,767	8,541
PAT	2,397	4,950
PAT less minority interest	1,798	3,712
Share of profits from mining (%)	57	69
Benchmark coking coal prices (USD per tonne)	237.5	250.0
Coking coal output (in mn tonnes)	2.1	3.0

Source: HISL Advisory estimates

Standalone metcoke business––steady growth through volume expansion

GNCL is the largest independent producer of metallurgical coke in India with a capacity of 1.25mn tpa. It has two coke plants in Gujarat and two in Karnataka, one of which is on a leased basis. It plans to expand its capacity to 4mn tpa by FY15 through brown-field/green-field expansions. GNCL is expected to commission about 0.4–0.5mn tpa in FY12. It has a coal washing facility of ~1.5mn tpa, which it is currently expanding to 2.4mn tpa. GNCL also has a windmill power capacity of 87.5MW which operates at an utilisation of 20%. To utilize the waste heat gases from its metcoke plants to generate power, it is constructing four units of 15MW each of waste heat recovery power (WHRP). GNCL also has a rolled steel facility of 0.311mn tonnes.

The capacity profile of GNCL is as follows:

Table 3: Capacity profile of standalone business

Particulars	FY10E	FY12E
Metallurgical coke (mn tpa)	**1.256**	**1.706**
-Khambalia, Gujarat	0.358	0.358
-Bhachau, Gujarat	0.324	0.774
-Dharwad, Karnataka	0.574	0.574
Coal Washing (mn tpa)	**1.5**	**2.4**
Rolled steel (mn tpa)	**0.311**	**0.311**
Captive power generation (MW)	**87.5**	**147.5**
-Windpower	87.5	87.5
Waste Heat Recovery Power		60

Source: Company data, HISL advisory

Going forward, we expect steady growth through volume expansion. We expect GNCL to produce 0.95mn tonnes and 1.15mn tonnes of metcoke in FY11 and FY12 respectively, a CAGR of 27.8% over FY10-FY12. We expect coke prices to be firm on account of rising cost of coking coal, relative absence of Chinese coke supply in the export markets due to a 40% export tax and strong domestic demand from growth in domestic steel production. We have assumed metcoke per tonne realizations of Rs 19,543 and Rs 19,838 for FY11 and FY12 respectively. We estimate GNCL to post a standalone PAT of Rs 1.4bn and Rs 1.7bn respectively.

Table 4: Standalone Financial snapshot

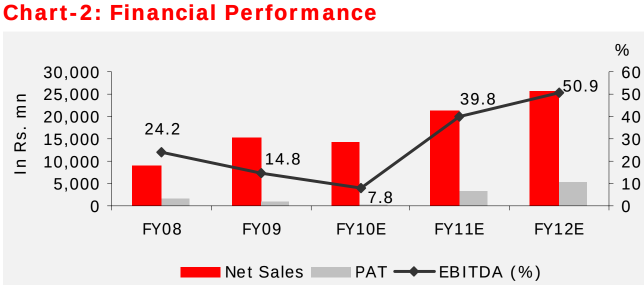
Particulars (Rs mn)	FY11E	FY12E
EBITDA	3,771	4,504
PAT	1,374	1,682
Metallurgical coke prices (Rs per tonne)	19,543	19,838
Metallurgical coke output (in mn tonnes)	0.95	1.15

Source: HISL Advisory estimates

Attractive Valuations

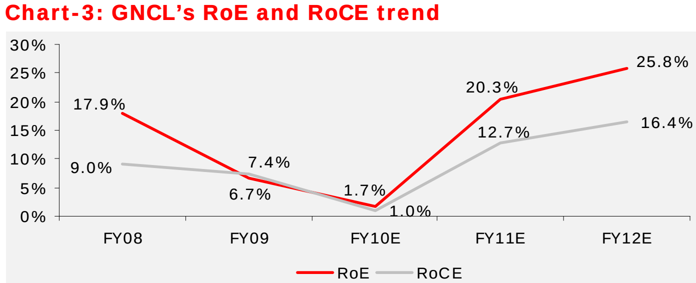
We expect GNCL to post a **consolidated EPS of Rs 9.44 in FY12**. Given strong long term growth prospects on account of its large coking coal resources, turnaround of its coking coal business in FY11 and it being the only available coking coal play in India, we have valued GNCL at a P/E of 8x FY12E to arrive at a value of Rs 75.6. This implies a potential return of 29%. In the short term, with China showing signs of overheating and Europe under the threat of a slowdown, commodity and midcap stocks, both of which characterize Gujarat NRE Coke, are likely to see risk-aversion. However, we believe that there is long term value in Gujarat NRE Coke. We, thus, recommend a BUY on Gujarat NRE Coke.

Chart-2: Financial Performance



Source: HISL Advisory estimates, company data

Chart-3: GNCL's RoE and RoCE trend



Source: HISL Advisory estimates, company data

GNCL's Key Financial Extract (Consolidated)

Profit & Loss A/c				
In Rs million	**FY09**	**FY10E**	**FY11E**	**FY12E**
Net sales	**15,220**	**14,399**	**21,466**	**25,648**
Opex	12,962	13,273	12,927	12,603
EBITDA	**2,258**	**1,126**	**8,538**	**13,045**
D&A	529	1,195	1,256	1,453
Interest Expense	1,276	1,559	2,099	2,383
Other Income (Net)	398	2,108	203	265
PBT	**851**	**480**	**5,387**	**9,473**
Extraordinary Items	(111)	0	0	0
Tax	55	413	1,616	2,842
PAT after MI	**873**	**204**	**3,171**	**5,394**
Adjustments	(105)	0	0	0
Adjusted net profit	**768**	**204**	**3,171**	**5,394**

Balance Sheet				
In Rs million	**FY09E**	**FY10E**	**FY11E**	**FY12E**
Equity capital	4,719	4,982	5,711	5,711
Other Shareholder Funds	10,229	11,216	14,183	18,920
Net worth	**14,948**	**16,198**	**19,894**	**24,631**
Total Debt	16,283	19,718	25,194	26,277
Other Liabilities	2,892	2,857	3,456	4,694
Total liabilities	**34,123**	**38,773**	**48,545**	**55,601**
Asset block (incl intangibles)	20,012	25,163	33,961	38,837
Investments	3,784	3,784	3,784	3,784
Net Current Assets (ex cash)	5,349	2,700	3,627	3,817
Cash	1,236	3,384	3,431	5,421
Other Assets	3,742	3,742	3,742	3,742
Total assets	**34,123**	**38,773**	**48,545**	**55,601**

Source: HISL Advisory estimates, company data

Risk Factors

- Weak global economic conditions leading to a prolonged slump in metallurgical coal and coke demand and prices
- Lower metallurgical coal and coke output
- Australian dollar and rupee appreciation