

Sterlite Technologies

Cost pressures drive down profitability

Sterlite Technologies (SOTL) reported Q2FY12 numbers significantly below our estimates. While volumes during the quarter was in line with our forecasts, increased cost pressures (segment wise detail below) led to lower than expected EBITDA and PAT. Expecting these issues to persist for some time, we downgrade our EPS estimates by 17% and 11% for FY12E and FY13E respectively. Our interaction with PGCIL (not rated) suggests a positive view on its capex plans for FY12E and FY13E, thereby benefitting SOTL. Fibre prices have stabilised over the last two quarters and CRU data suggests CY11 to be the best year for fibre demand on back of planned investments in telecom infrastructure across the globe. Hence the key business drivers for SOTL remain intact. Our downgrade stems from company-specific issues which we expect to recede over next two quarters. We still see 58% upside on our revised FV of Rs60 per share (down from Rs71) and maintain our BUY.

Power segment EBITDA/ ton at c.Rs6,000

The power segment reported volumes of 36,500 MT in the quarter, which was in line with our estimates, but EBITDA/ton at Rs6,000 was well below our expectation of Rs7,000. Management attributed this to aggressive bidding it undertook on account of lumpy order flows from PGCIL in FY11. Additionally, profitability was impacted by an increase in furnace oil prices leading to higher conversion costs. Hence we have revised our FY12E EBITDA/ton estimate to Rs9,000 from Rs10,500.

Telecom segment also impacted with rising costs...

Fiber volumes of 2.8 mn kms and cable volumes of 0.8 fkm were line with our estimates, and fiber realisations at Rs350 per km also remained stable QoQ. However cost pressures due to higher power/ crude prices and delay in stabilisation of the new fibre plant has increased costs, leading to a sequential decline in margins of 800bps to 15.6% against our expectation of 22%. While we maintain our revenue estimates, we have built in higher other expenses (up 100bps as a percentage of sales to 17% for FY11, as the new facility is likely to take about 2-3 quarters to stabilise its operations).

Higher interest expenses bite as working capital worsens

The working capital cycle worsened from c.80 days by FY11 end to 110 days H1FY12 end, primarily on account of higher inventory due to volatility in commodity prices. This has led to an increase in debt by Rs2 bn to Rs8 bn at H1FY12 end. We factor in increased working capital requirement and debt levels leading to higher interest expense for FY13E (coupled with marginally higher cost structure for the Telecom business) leading to a 11% decline in our EPS estimate to Rs5 per share.

Reduce FV to Rs60; recovery slower than expected

We've been pointing to a challenging H1FY12 for SOTL given the low margin orders the company had in its order book. Albeit lower than expected, the Power segment EBITDA/ ton has improved sequentially from Rs2,600 to Rs6,000 in Q2FY12. The fundamental reasons for us to be positive on SOTL's business remain unchanged. PGCIL, the key customer for SOTL, continues its capex plans and the progress so far in H1FY12 (orders worth c.Rs40 bn) looks encouraging. As per CRU, investments in telecom infrastructure continue to grow across all leading markets (viz. China, US and EU) and the industry is expected to cross 200mn kms in CY11. Fiber optic prices have remained firm at \$7.5-8 per km over the last two quarters. Whilst cost pressures are likely to persist for a couple of quarters, the medium term macro scenario and valuation look attractive (FY13E P/E of 7.6x). Our revised FV of Rs60 per share (down from Rs71 earlier) based on triangulation of DCF and P/E based valuation (10x 1-yr forward), implies 58% upside from current levels. We maintain our BUY rating, though we recognise that there are no obvious near-term catalysts for a re-rating of the stock.

Accounting & corporate governance	GREEN
Franchise Strength	GREEN
Earnings Momentum	AMBER

BUY 58% upside

Fair Value (Rs) 60

Bloomberg Code	SOTI IN Equity
Share Price (Rs)	38
Market Cap (Rs bn / \$ m)	Rs14.9bn / \$0.3bn
Free Float / FII holding	39% / 2%
ADV (Rs mn/ \$ mn)	Rs 34m / \$0.7m

Key Financials (Year ending March)

Rs mn	2010	2011	2012E	2013E
Revenue	24,316	22,626	25,736	30,782
EBITDA	3,810	2,656	3,021	3,941
PAT	2,461	1,405	1,437	1,957
EPS (Rs)	6.9	3.9	3.7	5.0
DPS (Rs)	0.5	0.6	0.5	0.5

Valuation	2010	2011	2012E	2013E
EV/ EBITDA (x)	3.6	5.4	5.7	3.8
P/E(x)	5.5	9.6	10.4	7.6
P/BV (x)	1.5	1.3	1.3	1.1
ROE (%)	32%	14%	13%	16%
Dividend yield	1.3%	1.5%	1.3%	1.3%

Source: Company, Espirito Santo Investment Bank Research for estimates

Historical share price performance



Source: Bloomberg

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Changes to estimates and valuation

Our revenue estimate for FY12E and FY13E remains intact. However our EBITDA estimates are down by 13% and 6% for FY12E and FY13E on account of higher costs relating to power/ crude prices and new facility stabilisation-related issues. Additionally in FY13E we have increased our working capital and debt levels, thereby leading to higher interest costs. Hence our FY13E PAT estimates are downgraded by 11%. (see table 1)

Table 1 Key revision in estimates (Rs m)

(Rs m)	Old estimates		New estimates		% change	
	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E
Revenue	25,722	30,783	25,736	30,782	0.1%	0.0%
EBITDA	3,482	4,180	3,021	3,941	-13.2%	-5.7%
<i>EBITDA margin (%)</i>	13.5%	13.6%	11.7%	12.8%		
PAT	1,731	2,195	1,437	1,957	-17.0%	-10.9%
<i>PAT margin (%)</i>	6.7%	7.1%	5.6%	6.4%		

Source: Espirito Santo Investment Bank Research for estimates

We value SOTL based on triangulation of a DCF and P/E based valuation (10x 1-yr forward) and arrive at a FV of Rs 60 per share (from Rs71 per share earlier), implying 58% upside from current levels. Our key assumptions are given in the table below:

Table 2 Key valuation assumptions (Rs m)

Key assumptions	
Risk free rate	8.5%
Risk premium	6.0%
Beta	1.2
COE	15.7%
Cost of Debt	11.0%
D/E	0.7
WACC	12.4%
DCF based valuation	68
P/E based valuation	53
Fair value	60

Source: Espirito Santo Investment Bank Research for estimates

Key risks and concerns

Decline in global broadband investments: Significant decline in telecom investments in key markets like China (42% of industry demand) could drive down fiber prices and thereby profitability for SOTL.

Lower order flows from PGCIL: SOTL commands a c.35% market share in PGCIL orders. Lower order flows from PGCIL would likely lead to lower capacity utilisation for SOTL and thereby a possible decline in profitability

Table 3 Quarterly financials (Rs m)

Rs mn	Q2FY12	Q2FY11	YoY (%)	Q1FY12	QoQ (%)
Net sales	7,073	5,094	39%	5,473	29%
Raw Material Consumed	5,059	3,172	59%	3,835	32%
Employee Expenses	252	208	21%	213	18%
Other Expenses	1,258	808	56%	1,124	12%
Total expenditure	6,569	4,189	57%	5,171	27%
EBITDA	504	906	-44%	302	67%
Depreciation	156	133	17%	146	7%
EBIT	348	772	-55%	156	124%
Interest expense	208	92	125%	219	-5%
Other income	32	33	-4%	138	NA
PBT	172	713	-76%	75	129%
Tax expense	45	137	-67%	23	99%
Reported PAT	127	576	-78%	52	142%
as % of sales (%)					
Operating expenses	71.5%	62.3%		70.1%	
Personnel expenses	3.6%	4.1%		3.9%	
Admin and other expenses	17.8%	15.9%		20.5%	
EBITDA	7.1%	17.8%		5.5%	
Adjusted PAT	1.8%	11.3%		1.0%	

Source: Espirito Santo Investment Bank Research for estimates

Traffic Lights

Table 4 Traffic lights: criteria for judgement

Parameter	Traffic signal	Reasons
Accounting & governance	GREEN	SOTL follows sound and consistent accounting practice. While disclosure standards are satisfactory, more detailed information on its BOOT project would be appreciated.
Franchise strength	GREEN	SOTL enjoy leadership position in the domestic power conductor and the optic fibre industry. Additionally, it is amongst top 5 global manufacturers and enjoys strong brand recall in the optic fibre industry.
Earnings momentum	AMBER	Earning momentum for SOTL is likely to be moderate and we don't expect any significant upgrades in consensus estimates for FY12E and FY13E.

Source: Bloomberg, Espirito Santo Investment Bank Research for estimates

Summary Financials (All figures in Rs m unless stated. Year-end is March)

Sterlite Technologies

Recommendation: **BUY**

Fair Value: **INR 60**

Share Price: **INR 38**

Upside / Downside: **57.9%**

3 Month ADV (\$m): **3**

Free Float: **38.5%**

52 Week High / Low: **INR 101 - 34**

Bloomberg: **SOTL IN**

Model Published On: **21 October 2011**

Shares In Issue (mm): **393**

Market Cap (\$mm / Rs bn): **\$302mn/ Rs15bn**

Net Debt: **7,226**

Enterprise Value (\$mm / Rs bn): **\$448mn/ Rs22bn**

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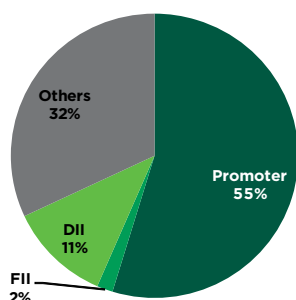
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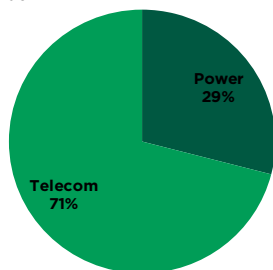
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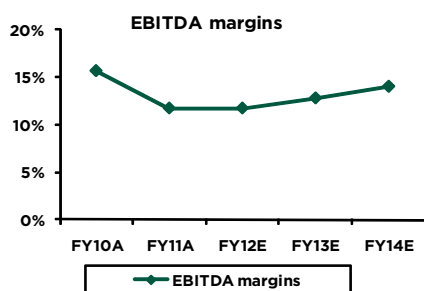
Shareholding Pattern



Revenue breakdown



Margin Trends



Valuation Metrics	2010	2011	2012E	2013E	2014E
Adjusted P/E	5.5	9.6	10.4	7.6	5.3
Adjusted P/B	1.5	1.3	1.3	1.1	0.9
EV / Sales	0.9	1.0	0.9	0.7	0.6
EV / EBITDA	18.3	21.3	20.1	18.0	13.3
Dividend yield	1.3%	1.5%	1.3%	1.3%	1.3%

Key ratios	2010	2011	2012E	2013E	2014E
EBITDA margin	15.7%	11.7%	11.7%	12.8%	14.0%
Capex / Revenue	2.6%	10.6%	5.8%	0.8%	0.7%
Capex / Depreciation	1.33	4.28	2.21	0.34	0.33
Net Debt / EBITDA	0.4	1.8	2.4	1.4	0.7
EBITDA / Net Interest	10.0	5.6	4.3	5.4	8.2
ROE	4%	2%	-11%	0%	5%

P&L Summary	2010	2011	2012E	2013E	2014E
Revenue	24,316	22,626	25,736	30,782	36,706
% change	6.2%	-7.0%	13.7%	19.6%	19.2%
EBITDA	3,810	2,656	3,021	3,941	5,147
% change	62.7%	-30.3%	13.7%	30.4%	30.6%
% margin	15.7%	11.7%	11.7%	12.8%	14.0%
Depreciation & Amortisation	-483	-560	-679	-739	-752
EBIT	3,327	2,096	2,343	3,201	4,396
% change	73.6%	-37.0%	11.7%	36.7%	37.3%
% margin	13.7%	9.3%	9.1%	10.4%	12.0%
Associates	0	0	0	0	0
Operating Profit	3,327	2,096	2,343	3,201	4,396
Net Financials	-381	-474	-702	-732	-625
Other Pre-tax Income	229	160	250	175	180
Pre Tax Profit	3,175	1,782	1,891	2,644	3,950
Income Tax Expense	-714	-377	-454	-687	-1,106
Minority Interests	0	0	0	0	0
Adjusted Net Income	2,461	1,405	1,437	1,957	2,844
Reported Net Income	2,461	1,405	1,437	1,957	2,844
Adjusted EPS	6.92	3.94	3.66	4.98	7.24
DPS	0.50	0.55	0.50	0.50	0.50
Payout Ratio	7.2%	14.0%	13.7%	10.0%	6.9%
Shares In Issue (Less Treasury)	356	356	393	393	393

Cash Flow Summary	2010	2011	2012E	2013E	2014E
EBITDA	3,810	2,656	3,021	3,941	5,147
Taxes Paid	-692	-377	-454	-687	-1,106
Interest Paid / Received	-381	-474	-702	-732	-625
Change in Working Capital	118	-2,807	-2,715	-596	-983
Associate & Minority Dividends	0	0	0	0	0
Other Operating Cash Flow	105	181	250	175	180
Operating cash flow	2,959	-821	-599	2,100	2,613
Capital Expenditure	-640	-2,395	-1,500	-250	-250
Free Cash Flow	2,319	-3,216	-2,099	1,850	2,363
Investments	-141	-27	0	0	0
Dividends Paid To Shareholders	-208	-228	-230	-230	-230
Equity Raised / Bought Back	690	0	0	0	0
Other Financing Cash Flow	-1,342	2,675	2,000	-1,750	0
Net Cash Flow	1,318	-797	-329	-130	2,133

Balance Sheet Summary	2010	2011	2012E	2013E	2014E
Cash & Equivalents	2,097	1,301	972	842	2,976
Tangible Fixed Assets	6,726	8,555	9,370	8,871	8,349
Goodwill & Intangibles	109	114	120	130	150
Associates & Financial Investments	1,061	1,088	1,088	1,088	1,088
Other Assets	9,565	14,082	17,275	19,397	22,124
Total Assets	19,558	25,141	28,825	30,328	34,687
Interest Bearing Debt	3,582	6,198	8,198	6,448	6,448
Other Liabilities	6,816	8,584	9,061	10,587	12,332
Total Liabilities	10,397	14,782	17,259	17,035	18,780
Shareholders' Equity	711	713	984	984	984
Minority Interests	8,449	9,646	10,582	12,309	14,923
Total Equity	9,160	10,359	11,566	13,293	15,907
Net Debt	1,485	4,897	7,226	5,606	3,472

Source: Company, Bloomberg, Espirito Santo Investment Bank Research for estimates

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NB Valuation methodology and risk factors can be found in the body of the report.

Sterlite Technologies

SOTL IN



Report Date	Recommendation	Target Price (INR)
30-Jun-11	Buy	INR 71.00

Source: Bloomberg, Espirito Santo Investment Bank Research

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SELL	Analyst expects at least 10% downside potential to fair value, which should be realized in the next 12 months

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SELL	68	16.2%	1	2.1%	0.2%
RESTRICTED	4	1.0%	1	2.1%	0.2%
TOTAL	420	100%	47	100%	

As at end September 2011	Total ESIB Research		Total Investment Banking Clients (IBC)		
Recommendation	Count	% of Total	Count	% of IBC	% of Total
SHORT TERM POSITIVE	0	0%	0	0%	0%
SHORT TERM NEGATIVE	0	0%	0	0%	0%
TOTAL	0	0%	0	0%	

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