Sterlite Technologies STTE.NS SOTL IN

ELECTRICAL EQUIPMENT

NOMURA EQUITY RESEARCH

Q3 result – slow but steady progress

Quick Note

January 25, 2012

Rating Remains	**Buy**
Target price Remains	INR 98
Closing price January 24, 2012	INR 37

Sterlite Technologies reported standalone sales of INR6,635mn (~14.6% y-y growth), which was in line with our expectation and ~6% below consensus. The company reported an EBITDA margin of 7.9%, an improvement of ~50bps y-y and ~80bps q-q, against our expectation of ~7.7%. Higher depreciation and interest expense (~INR650mn) on account of the merger of Sterlite Infra-Tech Limited (100% subsidiary of the company) resulted in PAT of INR95mn, which was 22% below our and 33% below consensus expectations. Sterlite Infra was EBITDA neutral YTD, and its merger was approved by the Supreme Court in Oct-11. YTD depreciation & interest of Sterlite Infra was adjusted on the Q3 P&L. So adjusting for Sterlite Infra's Q1 +Q2 loss, Sterlite Tech's net profit of ~INR128mn is in line with our expectation. Our target price and estimates are under review.

Power conductor business – margin improving but still very low

The power conductor business recorded sales growth of ~13% y-y while volume declined by ~ 3% y-y in Q3. On the positive side, EBITDA margin in this business improved ~250bps y-y and ~90bps q-q to 5.4%. However margins still haven't recovered to the 12-15% range before Q3FY11, when they touched a trough of 2.9%. The drastic drop in Q3FY11 was on account of the company bidding & executing very low-margin orders as orders from PGCIL dried up. The power conductor business order book stands at INR22bn, which represents 1.37x FY11 sales. PGCIL contributes ~ 55% of the total order book and the company is making conscious efforts to diversify its client base.

Optical fibre business – struggling with stabilization issue

The telecom business reported sales growth of ~19.4% with 2.9mn km volume in optical fibre (~32% volume growth) and 0.9mn km in the optical fibre business (18% volume decline) in Q3. EBITDA margin at 15.9% implied a ~30bp improvement q-q but remained short of margins in excess of 20% that the company has achieved in this business over the past 8-9 quarters. The margin dropped to 15.6% in Q2FY12 on account of stabilization issues post capacity expansion.

Optical fibre & power conductor - industry outlook remains positive

- Global demand for optical fibre reached 215mn fibre km (8% y-y growth) with Europe, the US, China and Brazil being biggest contributors to growth.
- Post 2010, there was speculation of a fall in China demand which resulted in pressure on fibre realization. With a demand increase in China in 2011, the price has remained stable. As per the company, fibre realization also remained stable at USD7.5–8 per km, thereby sustaining margins.
- The government approved an investment of ~ INR200bn towards broadband connectivity to panchayats, e-governance, online banking and health service indicatives. The central government also formed an

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SPV for setting up national fibre optic network. Similarly investment by private players like BSNL is also increasing.

- In the power business, orders from PGCIL also increased by 113% YTD in FY12. For details, please refer to Nomura's report "PGCIL Jul-Oct FY12 orders highest in four years" dated 22 Nov 2011. As per the company, PGCIL's order release momentum should continue in FYQ4.
- The central government also plans to provide financial assistance to state governments (such as Rajasthan, Gujarat etc) to set up a transmission network for evacuation of energy.

Company-specific issues– low-margin orders in power & stabilization issue in optical fibre remain a short-term concern

- The company continues to execute its low-margin orders booked in Q3FY11. According to management, most of the orders should get executed by FYQ4 and part might slip to Q1FY13.
- In the optical fibre business, the company continues to struggle with stabilization (integration of new capacity with old), thus yield has declined. Management has indicated that it takes around 6-9 months for stabilization, and new capacity should stabilize by the end of FYQ4. As per management, m-m yield and thus margin are improving
- On the positive side, the company is expanding capacity in power conductors from 160,000 MT to 200,000 MT, which is expected to become operational by Q4FY13. Similarly in the optical fibre business, the company is expanding capacity from 12mn km to 20mn km.

Debt to increase in FY13 – interest to be capitalized

As per management, the company will have to increase debt by ~INR1.5bn in FY13 in order to finance its BOM (built, operate & maintain) projects. On a consolidated basis, total gross debt stands at ~INR9.3bn. Debt will be raise at the project level, which will lead to interest being capitalized, according to management.

Fig. 1: Q3FY12 performance – higher depreciation & interest expense impacts profit

INR mn

INR mn	Q3FY11	Q2FY12	Q3FY12				
			Actual	Nomura	Difference(%)	Consensus	Difference(%)
Sales	5,791	7,073	6,635	6,538	1%	7024	-6%
- growth	*-33.2%*	*38.8%*	*14.6%*	*12.9%*		*21.3%*	
EBITDA	431	504	522	501	4%	553.5	-6%
- Margin	*7.4%*	*7.1%*	*7.9%*	*7.7%*		*7.9%*	
PAT	171	127	95	122	-22%	142	-33%
Adj EPS	0.48	0.32	0.24	0.31	-22%	0.3	-20%

Source: Company data, Bloomberg, Nomura estimates

Fig. 2: Segmental Performance – margin improving in power business

Power Transmission business	Q3FY11	Q2FY12	Q3FY12
Sales	4,219	5,147	4,757
- growth	*0.7%*	*55.8%*	*12.8%*
EBITDA	122	236	257
- Margin	*2.9%*	*4.6%*	*5.4%*
Telecom products & solutions			
Sales	1,573	1,926	1,878
- growth	*-64.9%*	*7.6%*	*19.4%*
EBITDA	380	300	298
- Margin	*24.2%*	*15.6%*	*15.9%*

Source: Company data, Bloomberg, Nomura research

Fig. 3: Ordering activity by PGCIL has picked up since Aug-2011

Month	FY09	FY10	FY11	FY12
Apr	4	0	5	0
May	9	11	--	1
Jun	1	1	5	2
Jul	8	9	11	7
Aug	8	6	5	12
Sep	11	3	2	17
Oct	25	6	0	41
Nov	2	5	6	10
Dec	9	13	19	23
Jan	7	8	13	NA
Feb	11	25	17	NA
Mar	49	34	100	NA
Total	144	120	183	112

Source: PGCIL, Nomura research

Appendix A-1

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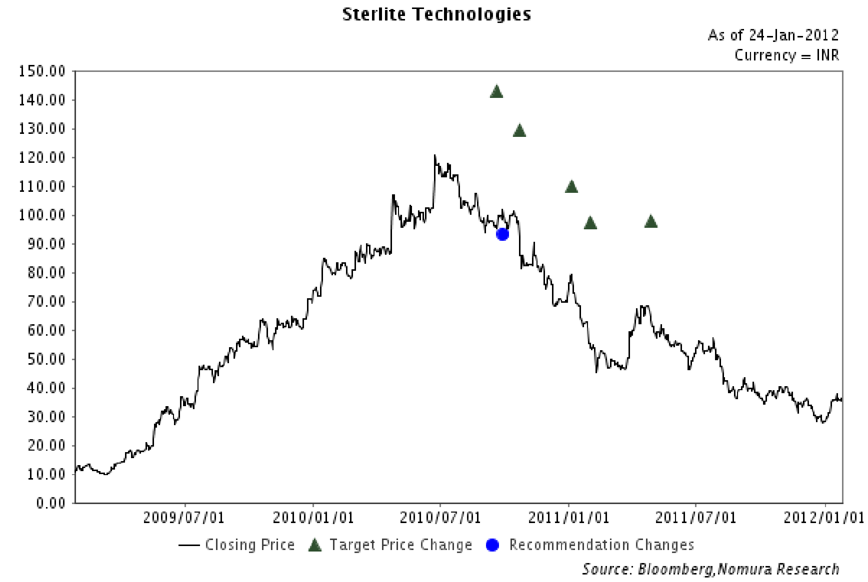
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Sterlite Technologies	SOTL IN	INR 37	24-Jan-2012	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Sterlite Technologies	Not Rated	20-Sep-2010

Sterlite Technologies (SOTL IN) **INR 37 (24-Jan-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
28-Apr-11		98.00	63.50
31-Jan-11		97.50	53.85
05-Jan-11		110.10	77.60
22-Oct-10		129.30	85.85
20-Sep-10	Buy		95.35
20-Sep-10		143.00	95.35

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We like the company's business model and strong competitive positioning. Our target price of INR98 is based on 12x one-year forward EPS (FY13 EPS of INR8.2).

Risks that may impede the achievement of the target price Delay in pick-up of capex cycle: demand for optical fibre and cables is dependent on growth in the number of telecom subscribers, 3G and broadband services. Therefore, any economic shock to the global economy could have a negative impact on the growth of these demand drivers. Also, revenues of the power conductor business could be affected if transmission capex in India is delayed.

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STOCKS

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