Indsec Securities & Finance Ltd.

Recommendation: Buy **Adhunik Metalliks Ltd** **November 28,2006**

Share Price	:Rs 33
BSE Sensex	: 13601
Nifty	: 3922
Sector	: Specialty Steel
High / Lo	: 50/26
Year end:	:March
Listed on	: BSE
Market Lot	: 1
BSE Scrip Code	: 532727
Shares in issue	: 91.23cr
Shareholding	: Sep 2006
Promoters	: 63.88%
Institutions	: 17.09%
Public & Others	: 18.22%
Foreign	: 0%

All currency in INR unless otherwise stated

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We are initiating coverage on Adhunik Metaliks Ltd. (AML) a specialty steel producer with a Buy recommendation from an 18-month investment perspective. We hold a positive view on the company based on the below mentioned reasons.

AML is the flagship company of "ADHUNIK GROUP" that was founded by the late Mahadeo Prasad Agarwal. The company's capacity consists of 250,000 TPA of alloy steel & carbon steel billets that finds application in Auto and Engineering industry. Hence 80% of the revenues are derived from the fast growing Automobile sector while the lucrative engineering sector comprises the remaining. The present sales mix is skewed more towards Billets (70%), and hence AML is decided to switch towards value added products.

It has drawn a capex program post, which the sales would be more tilted towards rolled products (70%). This will help in boosting the present average realizations from 19000/tonne to 34000/tonne. The total capex charted for this purpose is around Rs.437.36cr, which would be funded through proceeds of IPO (Rs.100cr), consortium of term loans (Rs277cr already tied up) and internal accruals (Rs.60cr).

The planned expansions would transform Adhunik into **an integrated** value chain producer having **end-to-end capabilities.** The company plans to set up the second steel melting shop with vacuum degassing plant, rolling mill, ferro alloy division, captive power plant, sinter plant, oxygen plant, a private railway siding and captive iron ore and coal mining.

Once **fully integrated** AML would be completely insulated with the fluctuations in prices of key inputs. This along with surge in the **realizations** would lead to a radical jump in margins that will end up percolating into the bottom line.

The prospects of the alloy & specialty steel industry are closely linked with automobile, auto component and engineering industry. Over-supply in the industry is now getting bridged on back of strong domestic demand coupled with India's emerging position as the sourcing hub for the world. With auto component exports expected to touch to $25 billion by 2015 (McKinsey report) prospects of **specialty steel players** including AML are promising.

At CMP of Rs.33 the stock trades at 3x FY08E earnings. Most of the players in the special and stainless steel segment are trading at a PE of 6x. Post expansion AML would be a part of the peer group of Kalyani Steel, MUSCO and Monnet Ispat. We believe despite the strong fundamentals AML is trading at low valuations. Hence we recommend a **Buy** on Adhunik Metaliks Ltd with an 18-month price **target of Rs.75.**

Earnings Table	Income (Rs mn)	Op. Profit (Rs mn)	PBT (Rs mn)	PAT (Rs mn)	EPS (Rs)	CEPS (Rs)	P/E (x)
FY2005	1300	158	106	71	1.2	2	27
FY2006	4237	734	551	338	3.7	4	9
FY2007 (P)	7665	1429	1093	706	7.7	9	4
FY2008 (P)	11633	2572	1720	1139	12.5	16	3

Company Background:

Adhunik Metaliks Ltd (AML) is the flagship company of the Adhunik Group founded by late Mahadeo Prasad Agarwal. The Agarwal family has been in the Metallurgical sector over three decades (mainly engaged in trading activities). AML was incorporated in the year 2001 and started operations in the year 2003. The Manufacturing facility is strategically located in Orissa, a hub of raw materials for steel industry. The company's current capacity consists of 250,000 TPA of alloy steel & carbon steel billets. Earlier AML was engaged in selling billets however it has now initiated sales of rolled products manufactured through third party contracts in order to meet the current requirement of rolled products in various segments.

Product range:

AML's product profile comprises of carbon alloy steel and stainless steel with 65% of the revenues coming from former and balance from the later. The product that AML manufactures finds application in auto ancillaries and engineering & construction industry. AML generates bulk of its business from automobile industry i.e. 80% while the rest comprises of engineering & construction. **The carbon and alloy division** manufactures auto grade steel including gearing steel, spring flat steel and free cutting & non-hardened and tempered steel that are mainly used for crankshaft, shaft, connecting rod and front beam etc. It also offers Ball Bearing quality steel, which is an important element in mechanical driving process. Further the **stainless steel division** is again bifurcated in 300 series and 200 series. 300 series is supplied to Auto and engineering sector while the later is targeted to the general industry.

Previously AML operations were limited to manufacturing of carbon alloy billets. However in order to move higher in the value chain it has started processing further its billets into rolled products through third party contracts. AML has also planned to set up its captive rolling mill by April 2007. This strategy will help the company from upgrading itself from being a supplier to Tier II vendor to Tier I vendor. Management is quite confident of getting approval as a Tier I vendor soon once it has its Vacuum Degassing Plant (VDP: high quality steel) upstream by Nov 2006.This move will help AML to build a client base so that post commencement of its captive rolling mills the demand for its product would have already geared up. At present AML's holds a reputed client list such as J.M.T Auto, Amtek Auto, Magnum, Kec International, Mahindra Sona, Ramkrishna Forgings and Talbros Auto Corporation. AML is also targeting the Railways and the Defense sector and revenues from these are expected to kick in within a year.

Industry Background:

The auto grade alloy steel is a combination of carbon-based steel and chromium/cobalt/copper manganese/nickel/tungsten/vanadium, providing the product greater strength and durability. It is premium steel used in high-performance applications requiring strength and resistance to corrosion. Apart from Auto it finds applications in drilling & mining equipment, train engines and the aviation industry.

The alloy steel industry had witnessed tough times in the past on account of excessive capacity additions leading to unbridled growth in the production of special steel. The total installed capacity was roughly around 3.52 MT. However post the shutdown of few large plants the operational capacity now stands slightly above 3 MT. The demand that had fallen in the previous years has now regained to roughly around 3MT and is expected to grow at around 15-17% going ahead.

Auto boom to keep demand in check:

The alloy & specialty steel industry prospects are closely linked with automobile, auto component and engineering industry. Thus the buoyancy in these sectors has brought back the momentum in the specialty steel industry. The Indian auto component industry witnessed a CAGR of 20% during 2000-2005 and is expected to grow by 17% CAGR during 2005-2014. The growth was primarily driven by strong domestic demand coupled with India's emerging position as the sourcing hub for the world. India has been able to create a distinguished image for itself owing to its low cost manufacturing ability along with Full Service Supply capability. Hence we believe that the Indian auto component industry has a long way to go. It is also important to note that McKinsey report envisages exports to touch $25 billion by 2015 from the present $1.8 billion. Thus anticipating a strong demand from the user Industry, the prospects of specialty steel players including AML are promising.

Expansion and Project Highlights:

AML intends to focus more on the value added products rather than playing the volume game. And hence one needs to be fully integrated in order to command higher value for its products. To take advantage of this AML has chalked out an ambitious plan, post which the company would be a fully integrated end – to – end manufacturer of auto grade alloy steel. The facility is likely to come on stream in phases from Q4 - FY07 to Q1 - FY08. The company has also secured captive mining rights for iron ore, which would commence supplies by March-April 2007. Similarly AML has been identified as a joint allottee for coalmines and is optimistic to commence mining by Q3 ' FY08. The total capex charted by AML for this purpose is around Rs.437.36cr. This project would be funded through proceeds of IPO (Rs.100cr), consortium of term loans (Rs277cr already tied up) and internal accruals (Rs.60cr).

Expansions that will place AML as a fully integrated end – to – end manufacturer of auto grade alloy steel.

- Captive Iron ore (Keonjhar District in Orissa) supplies are expected by April 2007, which would reduce the manufacturing cost of billet for AML from the present **15000-15500/tonne** to around **12500-13000/tonne**.
- Similarly Captive coal (Talcher District in Orissa) supplies are expected by April 2008 and this would further reduce the manufacturing cost to around **11000/tonne**.
- Setting up of 2nd SMS with Vacuum Degassing (VD) Plant will increase the auto grade steel manufacturing capacity from **2.5Lac TPA to 4.5Lac TPA**. Also the VDA plant would enable AML to produce clean specialty steel for targeted **OEM market segment**, which in turn would improve margins.
- The most important stride that AML has taken is to set up rolling mill that would use the in-house alloy billets to manufacture rolled products. This will drastically improve the average realizations from roughly around **Rs. 19000/tone (alloy billets) to around Rs. 34000/tone (Rolled products).** Also the present sales mix of **Billets: Rolled (70:30)** would twist towards **Billets: Rolled (30:70)** post expansion.
- The rolling mill will run on **gas generated in the blast furnace** and will replace/reduce the consumption of expensive petroleum fuel thereby reducing the cost of production.
- **Captive power plant:** For the expanded capacities AML would require close to 65-70 MW of power for their manufacturing processes. The Phase I of captive power plant of 17MW is expected to come on stream by Dec 2006. The Phase II would see another addition of 18MW by Sep' 2007.

Both these plants will use waste heat generated from the DRI plant thereby reducing the use of coal and in turn curbing the manufacturing cost. The power that the company currently buys from the grid costs around Rs.2.4 per unit and the captive generation would cost around Rs.1.5 per unit. Thus the captive production of 35MW would bring in **savings** to the tune of **Rs.30cr p.a.**

- Finally AML is to set capacity for in-house production of **Oxygen and Ferro alloy** which are key inputs in the manufacturing process. AML will also be setting up Railway Siding, which will substitute the present road movement of raw material and finished products.

Investment rationale: Steel is a volume as well as a value driven commodity. However alloy & specialty steel is more of a value-based product where the fluctuation in prices of end products is limited compared to base metal. This is largely because of the fact that, it is the auto components (end products) that are normally imported rather than specialty steel (inputs). This restricts the dumping which in turn cut down huge fluctuations in prices. AML promoters have been engaged in trading activities (steel) in the past, however with the inception of AML they have initiated manufacturing activities. Now they intend to integrate the operations so that AML with its end-to-end manufacturing capabilities would be in a position to reap the benefits of such flattering environment.

The planned expansion will put the company in the peer group of Kalyani Steel, MUSCO and Monnet Ispat. Factoring the risk of project implementation delays we discount AML at 6 times which is at par with the sector PE. We expect the company to post an EPS of Rs.12.5 for FY08. This puts our target price on Adhunik Metaliks Ltd **at Rs.75 with an 18-month** investment perspective.

Earning Summary for Adhunik Metalliks Ltd.
(Rs mn)

	Q1-FY2007	Q2-FY2007	QoQ	ExFY2007	ExFY2008
	3 mths	3 mths	%	12 mths	12 mths
Income from operations	1708	1764	3%	7665	11633
Other Income	14	15		25	3
Op. Profit	262	326	24%	1429	2527
Interest	47	60		211	495
Gross Profit	215	266	24%	1218	2077
Depreciation	27	29		126	357
PBT	188	238	26%	1093	1720
Tax	33	36		387	580
Profit (Excluding extraordinary items)	156	202	30%	706	1140
Equity capital	912.3	912.3		912.3	912.3
OPM (%)	15%	19%		19%	22%
GPM (%)	13%	15%		16%	18%
NPM (%)	9%	11%		9%	10%
EPS (Rs - Ann)	6.8	8.9		7.7	12.5
CEPS (Rs -Ann)	8	10		9.1	16.4

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