

Specialty Steel - Alloys

March 5, 2007

ICICIdirect Code: ADHMET

Company Profile

Corporate Office

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India

Tel: +91-33-30517100

Website: www.adhunigroup.com

Managing Director: **Manoj Kumar Agarwal**
Business Group: **Adhunik Group**

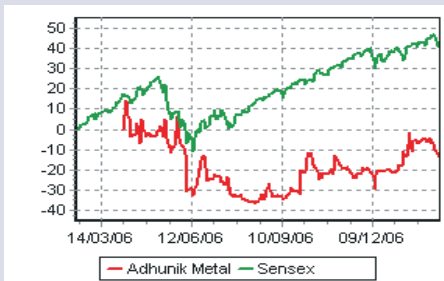
Shareholding Pattern as on 31/12/2006

Major Holer	%
Promoters	63.88
Non Promoter Corporate	11.35
Total Promoter	13.82
General Public	10.95

Stock Data

Market Cap (Rs crore)	337.56
Shares Outstanding (in crore)	9.123
52-week High (Rs)	50
52-week Low (Rs)	26
Average Volume	97461
Absolute Return 3 mth (%)	7.62
Absolute Return 12 mth (%)	34.58
Sensex Return 3 mth (%)	3.73
Sensex Return 12 mth (%)	38.53

Performance Chart



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Adhunik Metaliks

OUTPERFORMER

Price (2 Mar, 07) Rs 37	Target Price Rs 52.50
Potential upside 42%	Time Frame 9-12 mths

Adhunik Metaliks Ltd (AML), a value-added steel manufacturer, is expected to more than double its top line and quadruple its bottom line during FY06-09E on the back of capacity expansion into high-margin products along with backward integration into critical raw materials such as iron ore and coal. We believe these initiatives would result in a significant de-risking of its business model and lend stability to earnings. The stock appears attractive on various valuation parameters and we rate it an Outperformer.

INVESTMENT RATIONALE

Capex to transform business model

AML is implementing a capex programme that would change its business profile from a secondary steel manufacturer to an integrated steel player with linkages across the entire value chain from critical raw materials such as iron ore and coal to value-added steel products. Post expansion, we expect the company to emerge as one of the lowest cost integrated special steel manufacturer in the country by 2008.

Capacity to almost double

The company is executing a expansion programme which would almost double its capacity from 250,000 tonnes per annum (tpa) to 440,000 tpa by 2008. Apart from making the company more competitive, we expect the expansion would result in improved realizations from value-added products as prices in this segment are higher and more stable than those for base grades products.

Backward integration to drive profitability

AML is integrating backwards with captive ownership of critical raw materials, viz. iron ore and coal mines, which would enable it achieve a 48% reduction in iron ore costs and about 40% savings on coal resulting in annual combined savings of about Rs 50 crore annually.

VALUATIONS

We believe the current prices do not reflect the forward and backward integration benefits over a two-year investment horizon. We expect RoCE to expand from 14.58% in FY07E to 25.65% in FY09E. RoNW is expected to jump from 24.69% in FY07E to 27.54% in FY09E. Net profit margin is expected to expand by 186 basis points to 11.61% in FY09E. At the current price of Rs 37, the stock discounts its FY08E EPS of Rs 13.13 by 2.82x and FY09E EPS of Rs 15.02 by 2.46x. We believe the stock is a re-rating candidate and even at a lower P/E band of 4x FY08E earnings, it offers an upside of 42% to Rs 52.50 levels.

Exhibit 1: Key Financials

(Rs Crore)

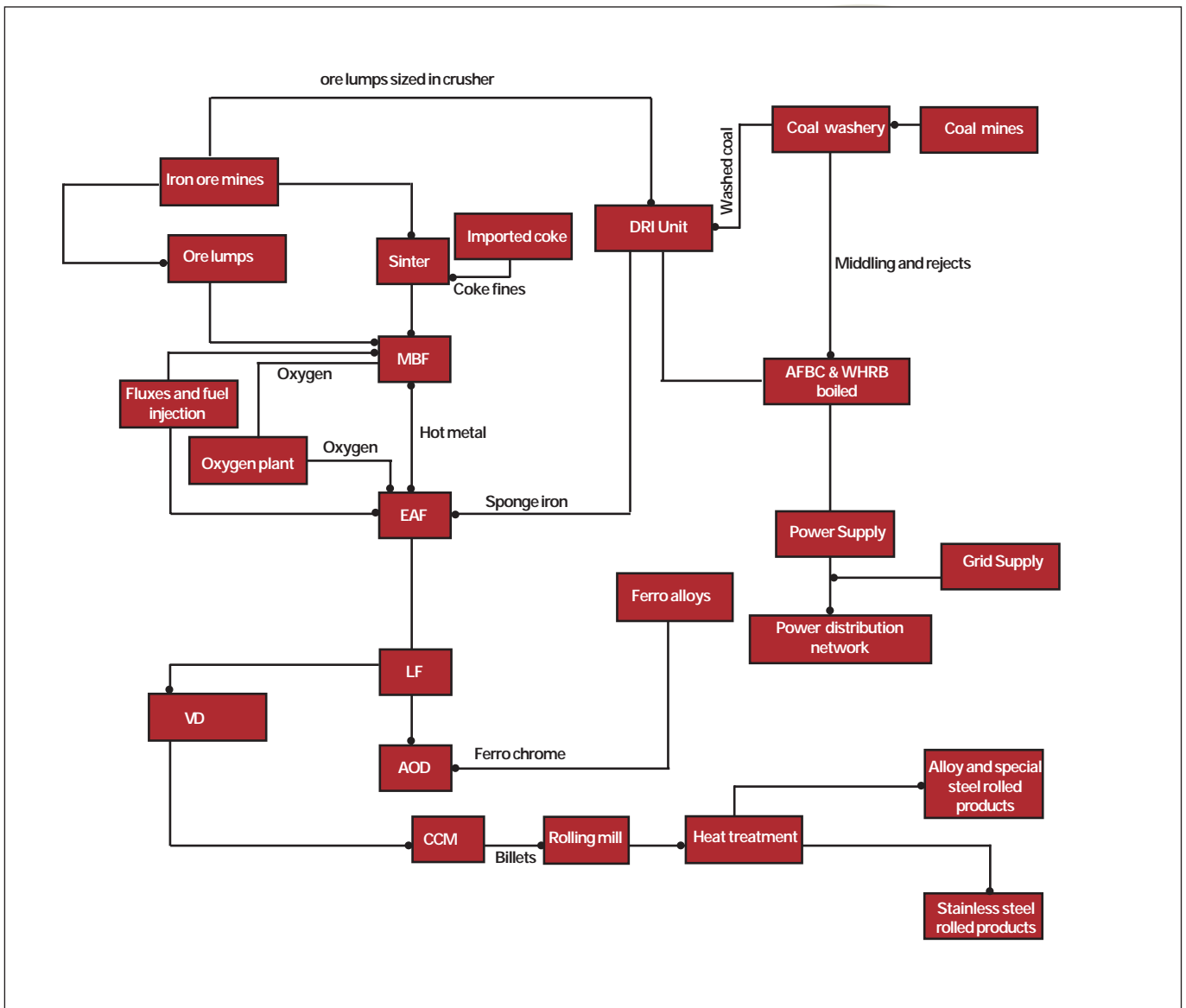
Year to March 31	FY06	FY07E	FY08E	FY09E
Net Profit (Rs crore)	33.71	68.42	119.77	137.00
Shares in issue (in cr.)	9.123	9.123	9.123	9.123
EPS (Rs)	3.7	7.5	13.13	15.02
% Growth		103	75	14
P/E (x)	10.01	4.93	2.82	2.46
Price / Book (x)	1.54	1.22	0.87	0.68
EV/EBIDTA (x)	5.93	6.56	3.42	2.59
RoNW(%)	15.39	24.69	30.99	27.54

Source: ICICIdirect Research

COMPANY BACKGROUND

Adhunik Metaliks Ltd (AML) is the flagship company of Rs 1,000 crore Adhunik Group based in Kolkata with manufacturing facilities at Rourkela, Orissa. The company began operations as a sponge iron manufacturer in FY04 and set up a pig iron and steel-making facility in FY06. The company is undertaking an expansion that would fully integrate it over the entire value chain. At present, the company has a capacity of 250,000 tonnes per annum (tpa) with sponge and pig iron capacities of 150,000 tpa and 187,500 tpa respectively, and carbon and alloy billet capacity of 250,000 tpa.

Exhibit 2: Integrated steel model



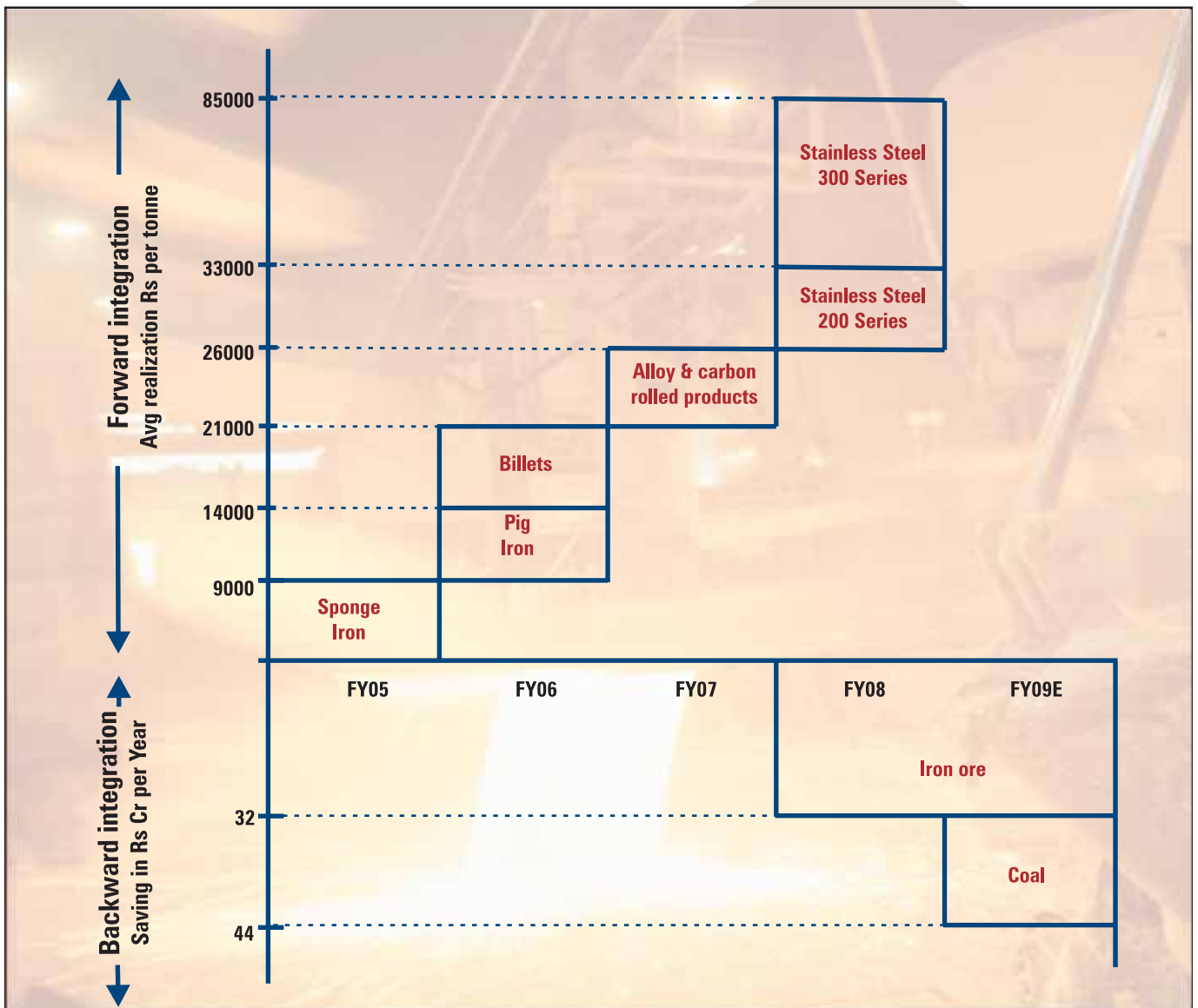
Source: Company, ICICIDirect Research

INVESTMENT RATIONAL

1) On threshold of becoming integrated steel player

AML is implementing a capex programme that would change its business profile from a secondary steel manufacturer to an integrated steel player with linkages across the entire value chain from critical raw materials such as iron ore and coal to value-added steel products. The fragmented nature of steel industry has meant that domestic players have little say in prices of final products and raw materials. Thus the key critical factor is to keep costs under check through backward linkages, besides other parameters such as technology, operational efficiency, etc. AML is creating an integrated business model that would give it more control over critical raw materials like iron ore and coal. It is also integrating forward in an effort to lower earnings sensitivity due to product prices.

Exhibit 3 : Going up the value chain



Source: Company, ICICIDirect Research

The proposed expansion would help the company move up the value chain with focus on special steel along with a substantial reduction in raw material costs due to its access to captive iron ore and coal mines. **Post expansion, we expect AML to emerge as one of the lowest cost integrated special steel manufacturer in the country by 2008.**

II) Capacity to almost double post expansion

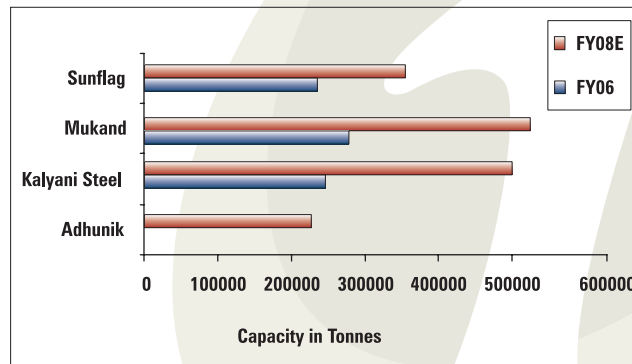
AML is executing a capex programme that would almost double its capacity from 250,000 tpa to 440,000 tpa by 2008. It has already completed phase I of the expansion at a cost of Rs 250 crore. It set up a sponge and pig iron capacity of 150,000 tpa and 187,500 tpa respectively, along with a continuous casting unit for manufacturing billets (alloy steel). It completed the phase I in Nov 2005 and is currently executing phase II entailing a capex of Rs 437 crore which would go on-stream by FY08.

Exhibit 4 : Capacity expansion (in tonnes)

	FY06	FY07	FY08	FY09
Sponge Iron (DRI Division)	150,000	150,000	150,000	150,000
Pig Iron (MBF Division)	178,000	187,500	214,000	214,000
Sinter Plant	-	-	102,000	102,000
Ferro Alloys	-	-	33,760	33,760
Steel Melting Shop (SMS I)	250,000	250,000	250,000	250,000
Steel Melting Shop (SMS II)	-	-	156,300	156,300
Rolling Capacity of Carbon & Alloy Steel	-	-	100,000	100,000
Rolling Capacity of Stainless Steel	-	-	120,000	120,000
Stainless Steel	-	-	119,000	119,000
Power Plant (MW)	17	17	35	35

Source: Company, ICICIdirect Research

Exhibit 5 : Peer rolling capacity comparison



Source: Company, ICICIdirect Research

We expect AML to become more competitive post expansion. We believe the expansion would result in improved realizations from value-added products, as prices in this segment are higher and more stable than for base grades products. (See exhibit 14)

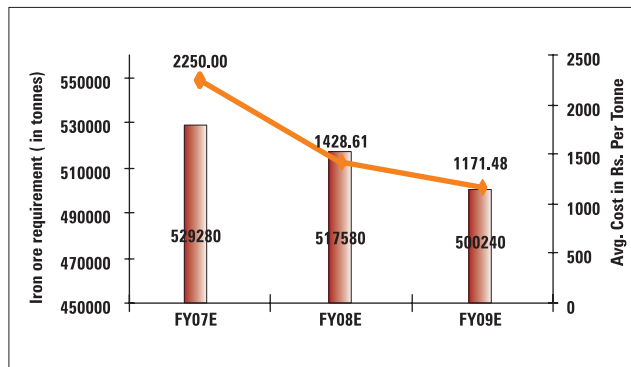
III) Backward integration to drive profitability

AML is integrating backwards with captive ownership of critical raw materials, viz. iron ore and coal mines which would enable it to withstand pricing pressures and face competition better compared to its peers. It would insulate the company from a sustained upward pressure on iron ore & coal prices. In addition, it is setting up a power plant, which would lower its dependence on the grid power.

a) Iron ore

AML has recently been allotted iron ore mines at Kulum in Keonjhar district of Orissa which would provide significant benefits to the company in terms of assured raw material supply at very low cost. The mines are situated about 125 km away from its plant in Rourkela and have a rich ferrous content of over 64%. We expect the mines to start producing iron ore from Q2FY08 and would see a full year impact on bottomline in FY09 only. We expect the company to achieve about 48% reduction in per tonne iron ore cost which would help it to save about Rs 38 crore annually after the commencement of iron ore supplies from newly allocated mines.

Exhibit 6 : Iron ore cost set to decline

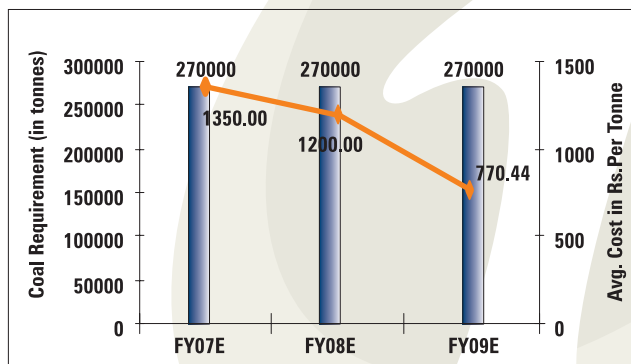


Source: Company, ICICIdirect Research

b) Coal

The company has also been able to secure availability of coal after the allotment of coal mines at Patrapara (Talcher district) in 2006. The mines are located about 230 km from its existing facilities and would be able to meet its captive requirement for over 30 years on expanded capacity base. The mines are likely to be commissioned during Q1FY09 and would lower its coal cost from Rs 1,350 per tonne to about Rs 770 per tonne. We expect the company to rake in annual savings of about Rs 12-15 crore from FY09 onwards as there would be about 40% reduction in per tonne cost of coal.

Exhibit 7 : Coal cost to decline



Source: Company, ICICIdirect Research

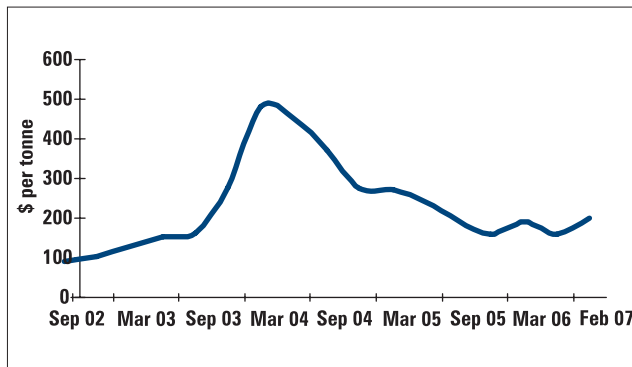
c) Power

The company is also taking steps to lower its power cost which constitutes about 6.5-7% of total expenses. It is setting up a 17 MW captive power plant, which would lower its power cost to Rs 1.7-1.80 per unit as compared to Rs 3.8 per unit for grid power. It also plans to add another 18 MW captive power plant by October 2007, which would further lower its dependence on grid power.

d) Coke

Coke is another important raw material used in the production of pig iron, forming about 43% of raw material cost by value in FY07. The company would require 120,000 to 130,000 tonnes of imported coke on an expanded capacity. Coke prices globally witnessed an appreciation of over 150% in the past two years due to jump in steel production (via the blast furnace route). We expect coke prices will remain stable at current levels of \$180-200 per tonne as incremental capacities to the tune of 20.6 million tonnes are expected to come up in China in 2006, while incremental demand would be around 22.0 million tonnes. Also coke production facilities are likely to come up in other countries such as Korea, India and Brazil, which could prevent any sharp appreciation in prices, if not a fall.

Exhibit 8 : Coke prices to stabilize



Source: Company, ICICIdirect Research

IV) Inorganic route to strengthen value-added pie

The company further plans to move up the value chain through a foray into the forgings business, either through an overseas acquisition or a joint venture. The company is likely to incur a cost of Rs 30-70 crore for the acquisition and intends to move into both automobile and engineering forgings with a capacity of 100,000 tpa.

The company has already acquired Unistar Galvanising and Fabrication Ltd, a Kolkata-based transmission tower manufacturing company, for a consideration of Rs 4.5 crore. Unistar is engaged in the production of electrical and telecom towers and is likely to be merged with Neepaz Tubes Ltd, a group company involved in manufacturing and galvanizing of steel tubes. AML also plans to invest around Rs 25 crore in the merged entity and would leverage on Unistar's strength in the power sector as it has necessary approvals from NTPC, Power Grid Corporation of India, BHEL, Grid Corporation of India, etc. We believe the inorganic growth strategy of AML would result in de-risking of its business model through forward integration along with boosting top line and bottom line growth on improved margins.

V) Demand outlook buoyant

Post expansion in FY08, AML would be well positioned to capture opportunities emerging in the user industries mainly auto & auto-ancillary industries, stainless steel and power transmission sector.

a) Auto sector to lend buoyance to alloy & steel demand

Alloy & special steel are increasingly used in two and four-wheelers to make the vehicles lighter and more fuel-efficient. The total capacity of alloy & special steel is around 2.8 million tpa, of which demand for auto grade special steel was about 2 million tpa. The forging sector is one of the largest consumers of alloy & special steel, which finds application in auto and auto-ancillary sector.

Exhibit 9 : Auto Sector to drive alloy steel demand

Vehicle	Average consumption per vehicle (kg)
M&HCV	650-800
Passenger cars	
Large cars	80
Medium cars	75
Small cars	55
Multi Utility Vehicles	200
Two-wheelers	
Scooters	18
Motorcycle	8
Mopeds	5
Tractors	400

Source: Company, ICICIdirect Research

The Indian automobile industry has witnessed an impressive CAGR in double digits in the past five years and is likely to sustain the growth momentum on the back of rising disposable income, easier financing and new launches. In addition, initiatives backed by government would help the industry achieve global scale and would lead to double digit CAGR growth in cars, utility vehicles, commercial vehicles and two-wheelers ranging from 10-16% on an expanded base during 2006- 2011 period.

Exhibit 10 : Buoyancy in auto sector to continue

Past growth rates, projected growth rates of volume sales		
(%)	CAGR from 2001-06	Projected CAGR from 2006 - 11
Cars and utility vehicles	13%	16%
Commercial vehicles	21%	10%
Two-wheelers	15%	12%
Tractors	5%	5-7%

Source: CRISIL Research, ICICIDirect Research

Besides auto industry, other end users of alloy steel include railways, defense, agriculture and industrial equipment. These segments are also likely to do well on the back of buoyancy in country's economic growth, along with government-aided initiatives.

b) Stainless steel industry

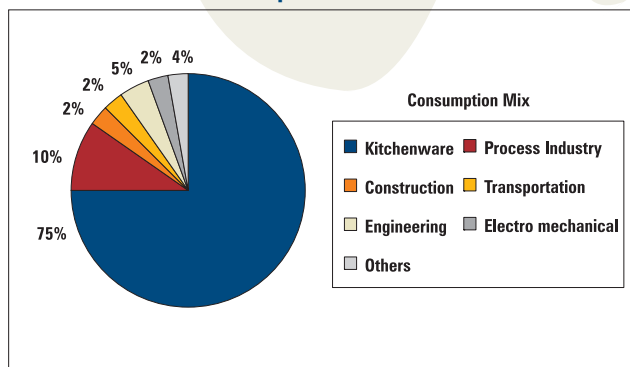
Indian stainless industry is on a high-growth trajectory growing around at a CAGR of 15% during the past 25 years compared to world's average CAGR growth of 11%. The country produced about 1.7 million tonne of stainless steel in 2005 with domestic consumption contributing 70% to total demand, while the balance 30% was exported.

Exhibit 11 : Stainless steel demand to stay robust

Production (in million tonnes)			
Year	1980	2005	CAGR
Domestic	1	15	14.57%
Global	2	24.03	11.18%

Source: CRISIL Research, ICICIDirect Research

Exhibit 12 : Consumption mix



Source: Company, ICICIDirect Research

We expect Indian stainless steel demand to grow by 12% annually on the back of higher sustainable GDP growth of 7% and new demand avenues arising from investments in railways, airports, refinery & petrochemicals sector, power sector, malls, hospitals, hotels and housing, etc. About 70% of the stainless steel demand would be for stainless steel 200 series, which is used in kitchenware, and the rest would be for stainless steel 300 series used for industrial purposes. The growth optimism also stems from the fact that India's per capita consumption of stainless steel is still low at 1.1 kg against 4 kg in China and 15-20 kg in the developed countries.

RISK & CONCERNS

Steel Price

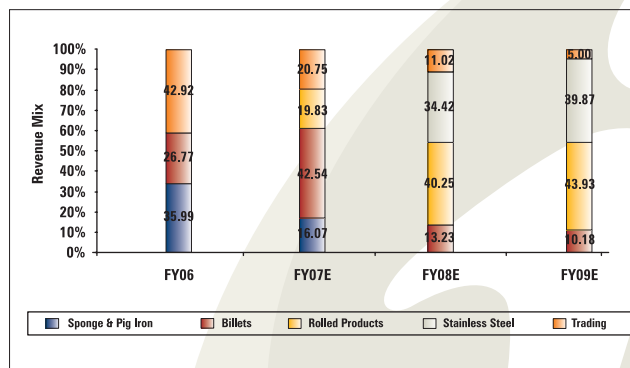
Steel being a commodity is subject to price fluctuations and in the last eighteen months, the global steel prices have come off their top. Global steel prices may soften further due to lower Chinese steel consumption, post-2008 Olympics which would have an adverse impact on company's earnings and valuation as well.

FINANCIALS

Sales to jump exponentially

We expect AML's sales to grow at a CAGR of 40.70% during FY06-09E to Rs 1,180.37 crore from Rs 423.78 crore on the back jump in volumes along with better realizations from value-added products. In line with industry trends, we expect capacity utilization levels to remain relatively high, ranging between 75-85%, over the next two to three years. We expect the company to generate 43.93% and 39.87% of its FY09 revenues from rolled products and stainless steel against 62% from sponge, pig iron and billets, and 42.92% from trading in FY06.

Exhibit 13 : Revenue quality to improve



Source: Company, ICICIdirect Research

We expect average realizations to surge from as low as Rs 9,000 per tonne in sponge iron and Rs 13,000 tonne for pig iron in FY06 to Rs 21,000-26,500 per tonne for rolled products and Rs 35,000-85,000 for stainless steel in FY09E. Also the quality of earnings are set to improve as the income from trading would come down from 42.92% in FY06 to about 5% in FY09E.

Exhibit 14 : Price Realization per tonne

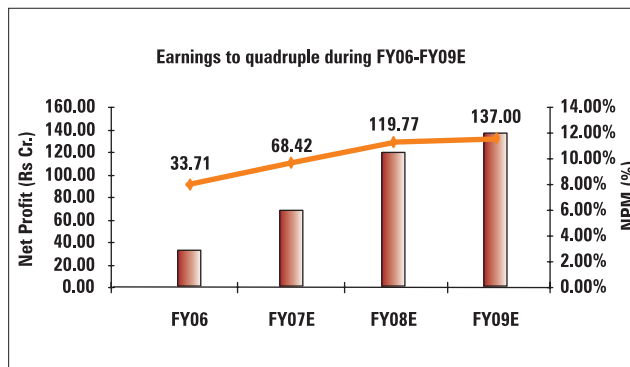
	FY06	FY07E	FY08E	FY09E
Sponge Iron	9,500	9,000	9,500	9,500
Pig Iron	13,000	14,000	14,500	14,500
Carbon Steel Billets	20,000	17,500	18,500	18,500
Alloy Steel Billets	22,000	19,500	21,000	21,000
Alloy Steel Rolled Products	-	25,500	26,500	26,500
Carbon Steel Rolled Products	-	23,500	23,300	23,300
Stainless Rolled Products (SS 200 Series)	-	-	35,000	35,000
Stainless Rolled Products (SS 300 Series)	-	-	85,000	85,000

Source: Company, ICICIDirect Research

Bottom line to quadruple during FY06-09

AML's bottom line is set to grow at an impressive CAGR of 59.58% during FY06-09E to Rs 137.00 crores from Rs 33.71 crore as the complete benefits of backward integration would become visible in FY09. We expect the company to rake in annual saving to the tune of about Rs 50 crores due to captive availability of iron ore and coal. In addition, the share of high-margin products would lend stability to earnings and expand EBIDTA margins by a hefty 701 basis points to 24.35% in FY09.

Exhibit 15 : Profitability on a high-growth trajectory



Source: Company, ICICIDirect Research

VALUATIONS

AML is expected to more than double its top line and quadruple its bottom line during FY06-09E period on the back of capacity expansion into high margin value added products along with backward integration into critical raw material such as iron ore & coal. We believe these initiatives would result in significant de-risking of its business model as it would emerge **as one of the lowest cost integrated special steel manufacturer** along with lowering its earning sensitivity as product prices volatility is much lower in value added products.

Exhibit 16 : Attractively valued among peers (Trailing 12 months)

	Sunflag Iron & Steel	Mukand	Kalyani Steel	Adhunik Metaliks
Price Earning (P/E)	9.21	6.57	23.59	4.12
Price to Book Value (P/BV)	0.91	1.26	4.98	1.37
EV/EBIDTA	3.81	6.07	14.28	3.14
Market Cap/Sales	0.22	0.32	1.84	0.37
NPM* (%)	3.76	4.23	9.78	7.31
ROE* (%)	13.57	17.92	25.57	23.15
ROCE* (%)	15.31	15.15	27.51	22.4

* - FY06

Source: CLINE, ICICIDirect Research

The stock comparable favorably among peers and is attractive even at current levels. We believe the current prices do not reflect the forward and backward integration benefits over a two-year investment horizon. We expect RoCE to expand from 14.58% in FY07E to 25.65% in FY09E. RoNW is expected to jump from 24.69% in FY07E to 27.54% in FY09E. Net profit margins are expected to expand by 186 basis points to 11.61% in FY09E. At the current price of Rs 37, the stock discounts its FY08E EPS of Rs 13.13 by 2.82x and FY09E EPS of Rs 15.02 by 2.46x. We believe the stock is a re-rating candidate and even at a lower P/E band of 4x FY08E earnings, it offers an upside of 42% to Rs 52.50 levels.

FINANCIAL SUMMARY

Profit and Loss Account

(Rs crore)

	(Year-end March)	FY06	FY07E	FY08E	FY09E
<i>Sales to grow at CAGR of 40.70% over FY06-FY09E</i>					
Net Sales		423.78	702.21	1061.06	1180.37
% Growth			65.70%	51.10%	11.24%
Other Income	2.77	2.5	0.25	0	
<i>Backward integration benefits to lower cost</i>					
Raw Materials	276.63	453.69	561.74	550.08	
Employee Exp.	3.79	6.94	12.7	13.34	
Sell. & Adm.Exp	21.07	47.22	90.8	106.56	
Total Exp.	350.31	583.29	815	893.48	
% Growth			66.51%	39.72%	9.63%
EBDITA	73.47	119	246.14	287.37	
Depreciation	6.88	12.56	35.68	34.22	
Interest	11.48	23.66	68.15	59.21	
PBT	55.11	82.7	142.23	193.46	
Tax	21.4	14.28	22.46	56.46	
Net Profit		33.71	68.42	119.77	137
% Growth			102.98%	75.05%	14.38%
Equity	91.23	91.23	91.23	91.23	
Face Value	10	10	10	10	
Dividend %	5	10	10	25	
EPS	3.7	7.5	13.13	15.02	
<i>Net profit to grow at CAGR of 59.58% over FY06-FY09E</i>					

Balance Sheet

(Rs crore)

(Year-end March)	FY06	FY07E	FY08E	FY09E
Share Capital	91.23	91.23	91.23	91.23
Reserves & Sur.	127.88	185.98	295.43	406.86
Secured Loans	174	427.36	526.81	447.62
Unsec. Loans	41.94	25	40	40
Deferred Tax Liability	21.89	21.89	21.89	21.89
Total Liabilities	456.95	751.47	975.37	1007.65
Net Block	203.63	463.96	625.28	611.05
Capital Work in Progress	47.89	80	0	0
Investments	0.08	0.08	0.08	0.08
Inventories	78.6	134.16	187.45	196.56
Sundry Debtors	96.43	161.08	243.41	270.85
Cash & Bank	117.88	9.25	61.42	80.91
Loans & Adv.	33.59	51.54	73.02	81.26
Current Assets	326.57	363.44	564.58	626.72
CL & Prov.	121.22	156	214.56	230.2
Net Curr. Assets	205.35	207.44	350.02	396.52
Total Assets	456.95	751.47	975.37	1007.65

Cash Flow Statement

(Rs crore)

(Year-end March)	FY06	FY07E	FY08E	FY09E
Opening Cash	5.87	117.88	9.25	61.42
Profit after Tax	33.71	68.42	119.77	137
Dividend Paid	5.2	10.4	10.4	26.01
Depreciation	6.88	12.56	35.68	34.22
Cash Profit	52.1	70.54	143.33	146.18
Changes In WC				
Net Increase in CL	94.84	34.78	58.56	15.64
Net Increase in CA	164.22	145.37	147.17	43.14
CF after changes in WC	-17.28	-40.05	54.72	118.68
Cash Flow from Inv. Act.				
Purchase of FA	105.67	305	117	20
Cash from Financing Act.				
Inc. /(Dec.) in Loan/Eq Funds	234.95	236.42	114.45	-79.19
Closing Cash	117.88	9.25	61.42	80.91

Ratios

	FY06	FY07E	FY08E	FY09E
EPS(Rs)	3.7	7.5	13.13	15.02
Cash EPS(Rs)	4.45	8.88	17.04	18.77
Book Value(Rs)	24.02	30.38	42.37	54.53
Operating Margin (%)	17.34%	16.95%	23.20%	24.35%
Net Profit Margin (%)	7.95%	9.74%	11.29%	11.61%
RONW	15.39%	24.69%	30.99%	27.54%
ROCE	15.31%	14.58%	22.07%	25.65%
Debt/Equity	0.99	1.63	1.47	0.98
FA Turnover Ratio	1.62	1.24	1.55	1.68
Enterprise Value (EV)	435.61	780.66	842.94	744.26
EV/EBIDTA	5.93	6.56	3.42	2.59
Sales to Equity	1.93	2.53	2.75	2.37
Market Cap(Rs cr)	337.55	337.55	337.55	337.55
Market Cap to Sales	0.8	0.48	0.32	0.29
Price to Book Value	1.54	1.22	0.87	0.68

Return ratios to improve substantially

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and recommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;

Performer: Between 10% and 20%;

Hold: \pm 10% return;

Underperformer: -10% or more.

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