Volume No. I Issue No. 168

# Hindustan Zinc Limited

April 9, 2018

**BSE Code:** 500188 | **NSE Code:** HINDZINC | **Reuters Code:** HZNC:NS | **Bloomberg Code:** HZ:IN

***Capacity Addition + Strong Price Outlook = Sustained Growth Momentum***

Hindustan Zinc Limited (HZL) is the India's largest and world's second-largest zinc miner. It caters to ~80% of zinc demand in India. The company has also the world's second largest operating zinc mine – Rampura Agucha Mine. HZL's business comprises of mining and smelting of zinc and lead along with captive power generation. It is the only integrated zinc manufacturer in India, with zinc smelting capacity of 823 ktpa and lead smelting capacity of 185 ktpa.

## Investment Rationale

**Low inventory and supply disruptions augur well for zinc prices:** Zinc inventory declined by 320KT during Jan-Nov 2017. According to the International Lead and Zinc Study Group (ILZSG), world demand for refined zinc metal is forecasted to increase by 2.5% YoY to 14.28 mn tonnes while production is expected to increase by 6% YoY to 13.78 mn tonnes in CY18. Hence, the market is expected to remain in deficit with the extent of the shortage forecasted at 223kt even in CY18. Overall, sustained deficit and decline in inventory levels will worsen the supply situation and keep LME prices firm in the coming months. We build-in LME zinc prices of US$3,186/ton for FY19E and US$3,059/ton for FY20E.

**Volume expansion to 1.5 mn MTPA on track:** Following continued deficit and limited supply in the zinc market, HZL is ramping up its metal production capacity to 1.2 mn MTPA mined metal (MM) production by FY20E from 0.9 mn MTPA as of FY17. Further, the company is on track to achieve 1.5 mn metric tonnes per annum (MTPA) MM production capacity in the medium term driven by SK and Zawar mines. Hence, we expect zinc/lead/silver sales volume to grow at a CAGR of 9.0%/12.3%/13.9%, over FY17-20E.

**Strong Balance Sheet:** Given strong operating performance, the company has built substantial cash reserves over the years, As on Q3FY17, the company's cash and cash equivalents stood at Rs19,176cr (Rs45 per share) invested in high quality debt instruments. The company is debt free. Going forward, we expect it to continue to generate strong FCF (Rs21,282 over FY17-20E). Further, we expect RoE and RoCE to stay robust at 25.8% and 35.4% in FY20E, respectively.

**Valuation:** Although, we expect strong near-term zinc prices due to tight inventories, some correction in FY20 is expected due to new supplies coming in. Therefore, we build-in LME zinc prices of US$3,186/ton for FY19E and US$3,059/ton for FY20E. We like HZL given its strong balance sheet, robust fundamentals, lower cost of production, integrated business model, debt free status and healthy dividend yield. We project the top line and EBITDA to clock a CAGR of 15.6% and 16.3%, respectively over FY17-20E driven by strong outlook on zinc and HZL's quality operations. Hence, we recommend BUY rating on the stock with a target price of Rs345 where we value the stock at its three year mean of 7x FY20E EV/EBITDA.

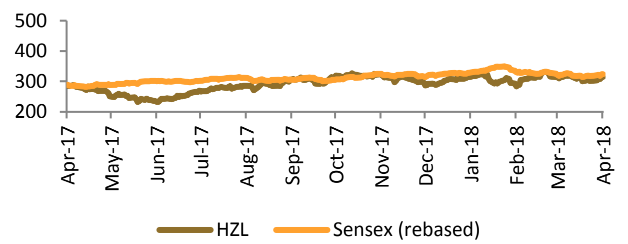
### Market Data

| | |
|---|---|
| **Rating** | **BUY** |
| **CMP (Rs.)** | 315 |
| **Target (Rs.)** | 345 |
| **Potential Upside** | 10% |
| **Duration** | Long Term |
| Face Value (Rs.) | 1.0 |
| 52 week H/L (Rs.) | 340/227 |
| Adj. all time High (Rs.) | 340 |
| Decline from 52WH (%) | 7.9 |
| Rise from 52WL (%) | 38.7 |
| Beta | 0.8 |
| Mkt. Cap (Rs.Cr) | 132,907 |

### Fiscal Year Ended

| Y/E | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| Net sales (Rs.Cr) | 17,046 | 21,443 | 24,493 | 26,304 |
| Adj. profit (Rs.Cr) | 8,316 | 8,811 | 10,635 | 11,395 |
| EPS (Rs.) | 19.7 | 20.9 | 25.2 | 27.0 |
| P/E (x) | 16.0 | 15.1 | 12.5 | 11.7 |
| EV/EBITDA (x) | 13.6 | 11.0 | 9.3 | 8.5 |
| ROE (%) | 24.4 | 26.6 | 27.7 | 25.8 |

### One year Price Chart



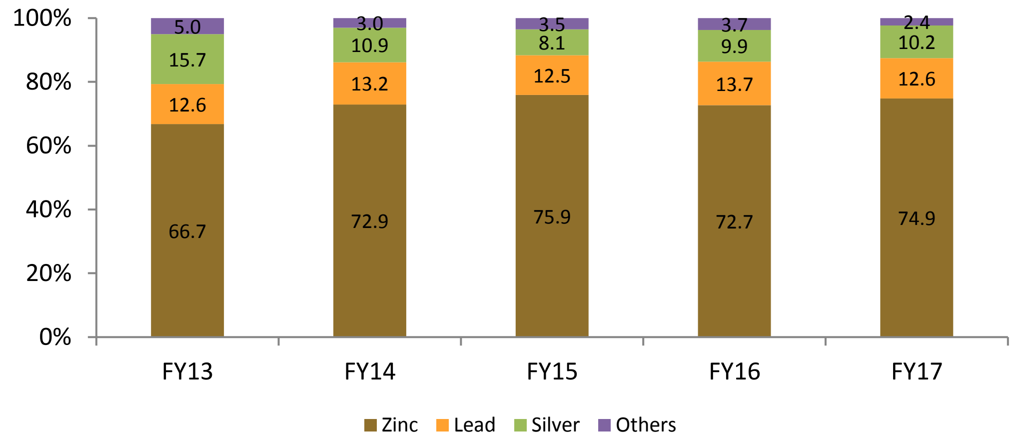

| Shareholding Pattern | Dec-17 | Sep-17 | Chg. |
|---|---|---|---|
| Promoters (%) | 64.9 | 64.9 | - |
| Public (%) | 35.1 | 35.1 | - |

## Company Overview

HZL (erstwhile Metal Corporation of India) was incorporated in 1966 as a public-sector undertaking (PSU). In April 2002, Vedanta acquired 46% stake in the company through a divestment program undertaken by the GOI (26% from the GOI and the remaining portion from an open offer). Post this, the group acquired an additional 18.9% in the company in 2003 taking the holding to 64.9%. Currently Government of India (GOI) holds 29.5% stake in the company as of Q3FY18.

Hindustan Zinc Limited (HZL) the India's largest and world's second-largest zinc miner. It caters to ~80% of zinc demand in India. It the only company in the country with three mines rated as 'Five Star' by Indian Bureau of Mines. The company has also the world's second largest operating zinc mine – Rampura Agucha Mine. It is also one of the lowest cost zinc producers in the world. Notably, the company derives almost 75% of its total revenues from zinc.

**Trend in Business Revenue Mix**




*Source: Company, In-house research*

HZL's business comprises of mining and smelting of zinc and lead along with captive power generation. It is the only integrated zinc manufacturer in India, with zinc smelting capacity of 823 ktpa and lead smelting capacity of 185 ktpa. The company's fully-integrated zinc operations include three lead-zinc mines, two zinc smelters, a lead smelter, and one lead-zinc smelter in Rajasthan. HZL's mines supply most of its concentrate requirements. In addition, the company also recover silver and cadmium as by products.

HZL also own 474 MW of coal based thermal captive power plants in Rajasthan to support its metallurgical operations. In addition, the company's power generation includes 274 MW of wind energy, 16 MW of solar power and 35.4 MW from waste heat generation.

**Smelting, Refining and Power Generation Capacity (FY17)**

**Smelting and Power Summary**

| | |
|---|---|
| Zinc Smelting | : 833,000 tpa |
| Lead Smelting | : 185,000 tpa |
| Silver Refining | : 518 tpa |
| Captive Power | : 474 MW |
| Wind Power | : 274 MW |
| Solar Power | : 16.2 MW |
| WHRB Power | : 35.4 MW |

*Source: Company, In-house research*

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## Low inventory and supply disruptions augur well for zinc prices

Zinc inventory declined by 320KT during Jan-Nov 2017. According to the International Lead and Zinc Study Group (ILZSG), world demand for refined zinc metal is forecasted to increase by 2.5% YoY to 14.28 mn tonnes while production is expected to increase by 6% YoY to 13.78 mn tonnes in CY18. Hence, the market is expected to remain in deficit with the extent of the shortage forecasted at 223kt even in CY18. Overall, sustained deficit and decline in inventory levels will worsen the supply situation and keep LME prices firm in the coming months. We build-in LME zinc prices of US$3,186/ton for FY19E and US$3,059/ton for FY20E.

**Zinc Monthly Price Trend - US Dollars per Metric Ton**


*Source: Company, In-house research*

## Best in class portfolio of operational mines

HZL's strategy to maintain a portfolio of five mines with predominantly long life and low cost of operations enables viability across various stages of demand supply cycle. Besides, forward integration with smelting and refining leads to value addition.

## Volume expansion to 1.5 mn MTPA on track

HZL is on track to achieve 1.5 mn Metric tonnes per annum (MTPA) MM production capacity in the medium term, while 1.2 mn MTPA of mined metal (MM) production by FY20E is firmly in sight. Though FY18 would be the last year of production from Rampura Agucha (RA) open-cast mine, production ramp-up at underground mines have been impressive with 85% contribution in 9MFY18. Notably, the SK mine reached 4.5 mn MT production in Q3FY18. The RA underground mine shaft is expected to start ore production from Q3FY19, enabling HZ to reach 1.2 mn MTPA mined metal production in FY20. The SK mine is also in the process of taking regulatory approvals to increase ore mining capacity to 6 mn MT. Growth beyond 1.2 mn MTPA would be primarily driven by SK and Zawar mines. Ore production capacity at SK mines is expected to increase to 8 mn MT from 4 mn MT, while production at Zawar mines is also expected to double to 4 mn MT. Besides, the company is also planning to increase the silver capacity to 650 MT over the medium term with higher production from Sindesar Khurd mine and enhanced recoveries from the fumer project with peak production of 750-800 MT.

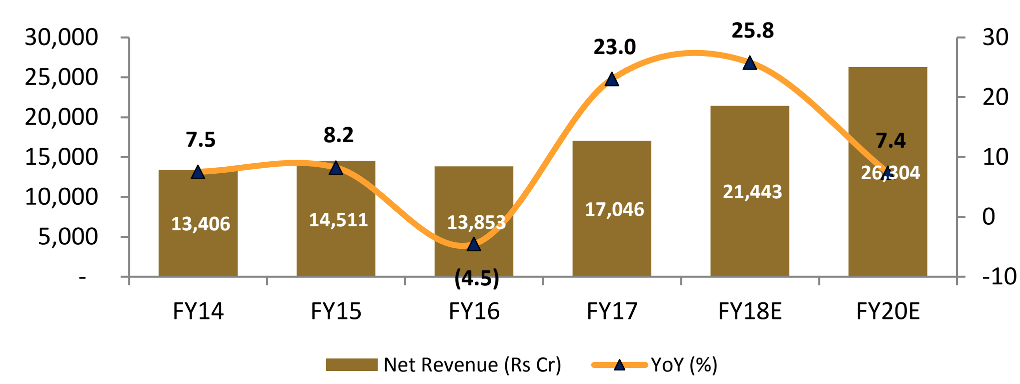
## Adequate resources lead to long term visibility

HZL has strong focus on enhancing reserves and resources (R&R). Exploration activities are intensifying further, encouraged by the findings so far. The company is further strengthening its exploration team. Exploratory drilling is likely to increase from 70km in FY17 to 200km in FY19. R&R has increased from 146 mn MT in FY04 to 404 mn MT in FY17 and the plan is to increase it to 550 mn MT. Strong focus on enhancing resources has ensured mine life of more than 30 years at any time despite 10-fold increase in production in the last 12-13 years.

## Revenue to grow at a healthy CAGR of 16% over FY17-20E

The company reported a CAGR of 8% in revenue over the last four years. We expect the company to clock a healthy CAGR of 16% in revenue over FY17-20E led by higher mined and refined production coupled with steady zinc and lead realizations. We expect zinc/lead/silver sales volume to grow at a CAGR of 9.0%/12.3%/13.9% over FY17-20E.

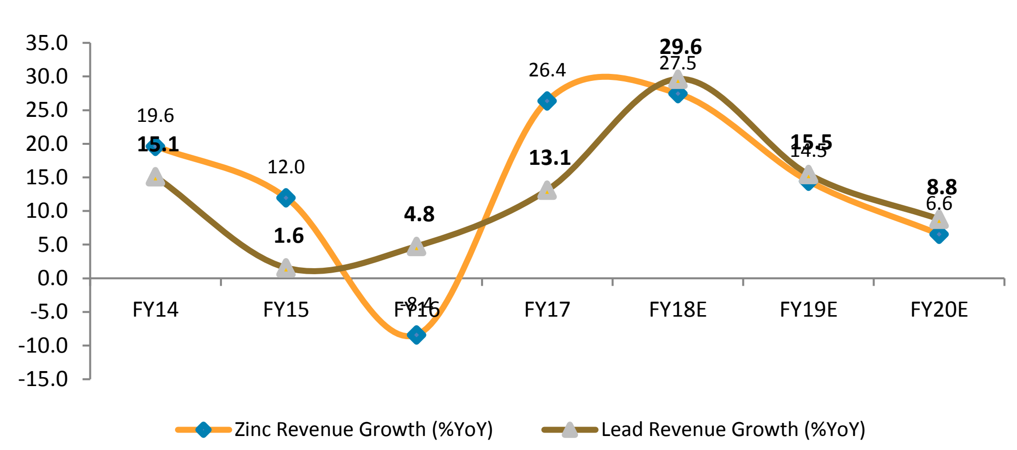
**Net revenue to grow at 16% CAGR over FY17-20E**




*Source: Company, In-house research*

We expect zinc and lead revenues to grow at a CAGR of 16% and 18% over FY17-20E, respectively primarily driven by increase in mined metal production, and hence refined metal production. Firming up of LME prices with a widening deficit situation is also expected to boost revenues. We expect silver revenues to grow at a CAGR of 15% over FY17-20E driven by higher production volumes.

**Zinc/Lead revenue to grow at 16%/18% CAGR over FY17-20E**




*Source: Company, In-house research*

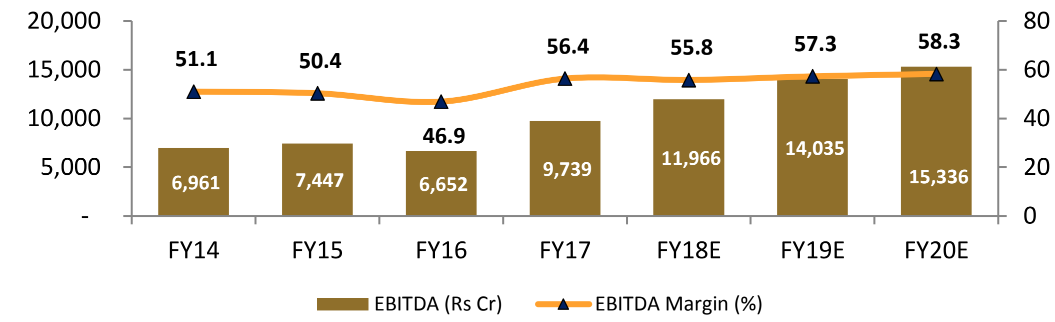
## Focus on cost reduction

The company expects production costs to further decline to US$850/ton from US$950-975/ton led by (1) lower coal costs due to increased sourcing from Coal India. (cost differential being 30-35% as compared to imported coal), (2) USD20-30/ton savings led by ore hauling from production shafts and (3) operating leverage led by higher mined metal volumes given a large fixed cost base in mining—this can save close to USD40/ton. Besides, management also highlighted other instances of savings such as purchase of clinker instead of cement (utilizing internal slag to make cement). It will lead to reduction in overall cost as cement is used for back filling in underground mines.

## EBITDA margin to improve further

The company reported a healthy EBITDA margin of ~50%+ over the last four years (except FY16). Going forward, we expect EBITDA margin to improve to 58.3% in FY20E from 56.4% in FY17 owing to decline in costs coupled with firm zinc and lead prices.

**EBITDA margin to improve to 58.3% by FY20E**




*Source: Company, In-house research*

## Outlook and Valuation

The closure of several zinc mines across the world bodes well for zinc prices in the medium term and widens opportunities for strong players in the industry. Although, we expect strong near-term zinc prices due to tight inventories, some correction in FY20 is expected due to new supplies coming in. Therefore, we build-in LME zinc prices of US$3,186/ton for FY19E and US$3,059/ton for FY20E. We like HZL given its strong balance sheet, robust fundamentals, lower cost of production, integrated business model, debt free status and healthy dividend yield. Further, we expect the company to continue to generate strong FCF going forward (Rs21,282 over FY17-20E). We project the top line and EBITDA to clock a CAGR of 15.6% and 16.3%, respectively over FY17-20E driven by strong outlook on zinc and HZL's quality operations. Hence, we recommend BUY rating on the stock with a target price of Rs345 where we value the stock at its three year mean of 7x FY20E EV/EBITDA.

## Key Risks:

- **Development of New Mines:** We have incorporated a gradual rise in zinc prices owing to the deficit situation. However, if the new mines commence operations earlier than anticipated, it will enhance the supply thereby putting downward pressure on prices and impacting our revenue forecasts.
- **Inability to achieve estimated production:** HZL is increasing its ore capacities and aims to achieve a mined metal production of 1.2 Mn MT by FY20E. Inability to meet the estimated production and ramp up of its smelter capacity for the same, could impact its profitability and cash generating abilities.
- **Slowdown in domestic economy:** Domestic sales form ~80% of HZL's revenues. The realizations are also relatively higher than that of export markets. Hence, a slower than anticipated recovery in domestic economy will hit the demand for zinc, lead and silver, HZL's primary products.
- **Inability to generate higher yield on investments:** HZL currently generates substantial investment income from its investments parked in mutual funds, bonds and other high-quality debt instruments. A lower than anticipated yield on investments will impact our profit estimates.

## Profit & Loss Account (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| **Total operating Income** | **17,046** | **21,443** | **24,493** | **26,304** |
| Raw Material cost | -314 | -395 | -451 | -485 |
| Employee cost | 722 | 908 | 1001 | 1048 |
| Other operating expenses | 7126 | 8964 | 9909 | 10405 |
| **EBITDA** | **9,739** | **11,966** | **14,035** | **15,336** |
| Depreciation | 1,811 | 1,768 | 1,899 | 2,030 |
| **EBIT** | **7,928** | **10,197** | **12,136** | **13,306** |
| Interest cost | 202 | 250 | - | - |
| Other Income | 2,474 | 1,778 | 2,032 | 2,309 |
| **Profit before tax** | **10,200** | **11,726** | **14,168** | **15,616** |
| Tax | 1,884 | 2,915 | 3,534 | 4,221 |
| **Profit after tax** | 8,316 | 9,102 | 10,635 | 11,395 |
| Minority Interests | - | - | - | - |
| P/L from Associates | - | - | - | - |
| **Adjusted PAT** | **8,316** | **8,811** | **10,635** | **11,395** |
| E/o income / (Expense) | - | 291 | - | - |
| **Reported PAT** | **8,316** | **9,102** | **10,635** | **11,395** |

## Balance Sheet (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| Paid up capital | 845 | 845 | 845 | 845 |
| Reserves and Surplus | 29,960 | 34,715 | 40,280 | 46,351 |
| **Net worth** | **30,805** | **35,560** | **41,125** | **47,196** |
| Minority interest | - | - | - | - |
| Total Debt | 7,908 | - | - | - |
| Other non-current liabilities | 760 | 760 | 760 | 760 |
| **Total Liabilities** | **39,473** | **36,320** | **41,885** | **47,956** |
| Total fixed assets | 9,993 | 10,596 | 10,197 | 9,667 |
| Capital WIP | 3,071 | 3,000 | 3,000 | 3,000 |
| Goodwill | - | - | - | - |
| Investments | 23,783 | 23,783 | 28,783 | 33,783 |
| Net Current assets | (1,456) | (2,705) | (2,053) | (765) |
| Deferred tax assets (net) | 2,748 | 312 | 624 | 936 |
| Other non-current assets | 1,334 | 1,334 | 1,334 | 1,334 |
| **Total Assets** | **39,473** | **36,320** | **41,885** | **47,956** |

## Cash Flow Statement (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| **Pretax profit** | **10,200** | **11,726** | **14,168** | **15,616** |
| Depreciation | 1,811 | 1,768 | 1,899 | 2,030 |
| Chg. in Working Capital | 198 | (3,652) | (262) | (171) |
| Others | (2,294) | (1,528) | (2,032) | (2,309) |
| Tax paid | (2,338) | (2,915) | (3,534) | (4,221) |
| **Cash flow from operating activities** | **7,577** | **5,398** | **10,240** | **10,944** |
| Capital expenditure | (2,008) | (2,300) | (1,500) | (1,500) |
| Chg. in investments | 13,665 | - | (5,000) | (5,000) |
| Other investing cashflow | (7,841) | 1,778 | 2,032 | 2,309 |
| **Cash flow from investing activities** | **3,816** | **(522)** | **(4,468)** | **(4,191)** |
| Equity raised/(repaid) | - | - | - | - |
| Debt raised/(repaid) | 7,900 | (7,908) | - | - |
| Dividend paid | (18,972) | (4,056) | (5,070) | (5,324) |
| Other financing activities | (183) | (250) | - | - |
| **Cash flow from financing activities** | **(11,255)** | **(12,214)** | **(5,070)** | **(5,324)** |
| Net chg in cash | 138 | (7,337) | 702 | 1,430 |

## Key Ratios (Consolidated)

| Y/E | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| **Growth (%)** | | | | |
| Net Sales | 23.0% | 25.8% | 14.2% | 7.4% |
| EBITDA | 46.4% | 22.9% | 17.3% | 9.3% |
| Net profit | 1.4% | 5.9% | 20.7% | 7.1% |
| **Margin (%)** | | | | |
| EBITDA | 56.4 | 55.8 | 57.3 | 58.3 |
| EBIT | 45.9 | 47.6 | 49.5 | 50.6 |
| NPM | 48.1 | 41.1 | 43.4 | 43.3 |
| **Return Ratios (%)** | | | | |
| RoE | 24.4 | 26.6 | 27.7 | 25.8 |
| RoCE | 27.3 | 32.2 | 37.0 | 35.4 |
| **Per share data (Rs.)** | | | | |
| EPS | 19.7 | 20.9 | 25.2 | 27.0 |
| DPS | 29.4 | 8.0 | 10.0 | 10.5 |
| **Valuation(x)** | | | | |
| P/E | 16.0 | 15.1 | 12.5 | 11.7 |
| EV/EBITDA | 13.6 | 11.0 | 9.3 | 8.5 |
| EV/Net Sales | 7.8 | 6.1 | 5.4 | 4.9 |
| P/B | 4.3 | 3.7 | 3.2 | 2.8 |
| **Turnover Ratios (x)** | | | | |
| Net Sales/GFA | 1.0 | 1.1 | 1.2 | 1.2 |
| Sales/Total Assets | 0.3 | 0.5 | 0.5 | 0.5 |

**Rating Criteria**

| Large Cap. | Return | Mid/Small Cap. | Return |
|---|---|---|---|
| **Buy** | More than equal to 10% | **Buy** | More than equal to 15% |
| **Hold** | Upside or downside is less than 10% | **Accumulate*** | Upside between 10% & 15% |
| **Reduce** | Less than equal to -10% | **Hold** | Between 0% & 10% |
| | | **Reduce/sell** | Less than 0% |

***** To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

***** HZL Ltd. is a large-cap company.

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**Contact Us:**

**Funds India**
Uttam Building, Third Floor|
No. 38 & 39| Whites Road|
Royapettah|Chennai – 600014|
**T:** +91 7667 166 166
**Email:** contact@fundsindia.com

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