VALUE PICKS

EQUITY RESEARCH REPORT

HEG LTD	BSE CODE: 509631 NSE CODE: HEG
Sector: Electrodes & Welding	CMP: Rs. 233.10 (27/10/2012)
Market Cap: 9314.5 (Millions)	Target Price: Rs. 320
Date: Oct 27, 2012	Time Period: 12 – 18 months

Saral Gyan

Investors guide providing insight to equity market

Saral Gyan Capital Services

www.saralgyan.in

An Independent Equity Research Firm

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1. Company Background

HEG Limited
World Winning Quality

HEG Ltd, a premier company of the LNJ Bhilwara group, is today India's leading graphite electrode manufacturer. It has one of the largest integrated Graphite Electrode plants in the world**,** processing sophisticated UHP (Ultra High Power) Electrodes.

The company exports over 80% of its production to more than 25 countries of the world. The position HEG enjoys today in India and abroad is largely due to its commitment to constant upgradation of its product quality to match international standards and to meet new challenges to win and excel in all situations.

In the 1990's, Company sets its "Vision" to be: *"A vibrant globally acknowledged top league player in Graphite Electrodes and allied businesses with commitment to growth, innovation, quality and customer focus".*

In Graphite, company focus is on UHP grade electrodes and they have expanded their product range and established the same on some of the toughest furnaces of their customers. Today, HEG have years of experience supplying quality UHP grade electrodes all over the world.

The encouragement from the customers has led the company to increase production capacity and become a significant global producer of quality UHP grade electrodes for EAF application. HEG ability to source the best raw materials from sources worldwide and the skills of human resources has been the key to their growth.

With a recent Rs 4.5 billion (US$ 120 million) investment, company has now expanded their manufacturing capacity.

To maintain competitiveness, HEG have set up a Captive Power Plant totaling more than 77 MW. As a responsible graphite electrode manufacturer, HEG continue to invest in technology, development of new products and in human resources.

HEG operates with 3 divisions:

- Graphite Electrode Division
- Power Division
- Carbon Division

1. Graphite Electrode Division

The main business of HEG is graphite which accounts for 80% of the revenue. Set up in 1977, in technical and financial collaboration with Societe Des Electrodes Et Refractaires Savoie (SERS), a subsidiary of Pechiney of France, HEG is now the largest integrated graphite plant in the world. Spread over an area of about 170 acres, HEG (graphite division) has facilities for production of Graphite Electrodes and Graphite Specialities. Its plant is located at Mandideep near Bhopal (MP).

The plant has an annual capacity to make 66,000 MT of UHP grade electrodes. It has three captive power generation facilities which can together produce around 77 MW which fulfils almost the entire requirement of the graphite plant. HEG also has a dedicated R&D Set-up for Carbon and Graphite.

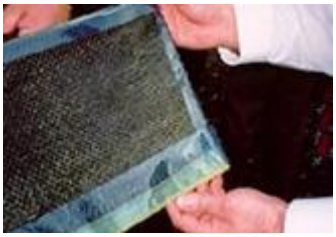
2. Power Division

One of the major bottlenecks plaguing the Indian industry has been the shortage of power. HEG management realized this as early as 1995 and overcame this problem by setting up the group's first hydropower project of 13.5 MW rated capacity in Tawanagar, district Hoshangabad (M.P.) which was commissioned in 1997. The power generated at this unit is wheeled to the graphite plant at Mandideep. This not only ramped up the efficiency of the graphite plant but also opened up a window of opportunity for company to enter the area of power generation.

Subsequently, when the Graphite Electrode capacity was increased from 30,000 tonnes / annum to 80,000 tonnes / annum, a Coal Based 25 MW captive Power Plant was also commissioned in 2005 and is running successfully. The main equipments including the Turbine were sourced from BHEL, India.

3. Carbon Division

A. Activated Carbon Fabric (ACF)



ACF is a flexible form of activated carbon. The activated carbon fabric is mechanically weak but highly porous in nature. Due to this, it possesses unique characteristics as compared to conventional activated carbon, which is commonly used in granular, palletised, powdered and moulded form. Due to a thin fibrous shape in activated carbon fabric, fast intraparticle adsorption kinetics takes place in gas and liquid phase adsorption.

Molecules/atoms of pollutants have an affinity towards activated carbon fabric surface by physical adsorption at low temperatures.

In physical adsorption there is a Van Der Waals interaction, having a long range, but weak forces. Molecules of pollutant bouncing across the activated carbon fabric surface gradually loses its energy and finally comes to rest on it. Due to weak bonds in the physical adsorption molecules can be removed from the activated carbon fabric surface by giving heat energy. This property is utilised in regenerating activated carbon fabric

Features of ACF:

It is of minimum 90% pure form of activated carbon and is soft and easy to handle.

It has a BET surface area (SBET) of the range from 1,000 to 2,500 m2 g-1 with a high degree of adsorption and desorption characteristics. Effective adsorption is several hundred times higher than that of GAC, PAC or palletized activated carbon

ACF is made up of filament yarn, due to which ACF is electrically conductive and hence it can be regenerated by passing a low voltage current across the ACF surface or by heating ACF at 100 ^{o}C for 15 to 30 minutes. The distribution of pore size is in narrow range < 10 nm.

Usage:

- ACF is used in Air-conditioner filters, Air purifying filters, Clean rooms and all other types of pollution control filters.
- Anti pollution masks - for personal protection against gaseous vapours / fumes and bad odours.
- Refrigerator deodouriser - to arrest odours in refrigerators
- Cigarette filters - to trap harmful chemicals present in cigarette smoke.

B. Carbon Blocks

HEG also makes Fine Grain Carbon Blocks for various applications on special orders. These blocks are used by the customers to make value added products like Heat Exchangers, etc.

C. Graphite Specialities

HEG has a small graphite Speciality division to cater to the requirements of customers who need Graphite Products in specific sizes and shapes. These are manufactured to individual customer requirements as per specs and requirements

Achievement

- Awarded ISO 9001:2008 & ISO 14001:2004 Certifications.
- Awarded 'Rajiv Gandhi National Quality Commendation Award 2001 for Quality" by the Bureau of Indian Standards, Government of India.
- HEG Ltd bagged the prestigious National Export Award instituted by the Ministry of Commerce, Government of India, for outstanding export performace for the year 1997-98. HEG has also won the country's top export award instituted by the Chemical & Allied Products Export Promotion Council (CAPEXIL) for outstanding exports for 18 consecutive years. For 2001-02, HEG was awarded the "Highest" Export Award.
- HEG has the largest Integrated Graphite Electrodes manufacturing plant in South Asia and the Middle East. It is also the second largest in the world.
- HEG has been regularly exporting electrodes since 1981 and today exports more than 80% of its production.
- HEG's graphite electrodes are exported to 25 countries around the world, including developed countries like USA, Canada, Germany, France, Italy, South Korea, Australia etc. - a reward for our commitment to World winning Quality and Performance.

Research & Development

HEG R&D Center for carbon science and technology have strong applied research and development focus in the field of conventional carbon products and advanced carbon materials/ products such as carbon nanotubes/fibers.

It will push the technology envelope and shall establish a strong cooperative research effort (Industry / Government / University) to improve energy efficiency, process productivity and quality control of carbon products with environmentally responsible approach both in its operations and in its products that purify the environment. It shall develop new secure sources of high quality carbon feed stocks that can be used by a number of different carbon manufacturing processes and new carbon and graphite based products.

Keeping in view the Vision & the Strategic Fit, the R&D Center is working on the following areas

- Advanced Materials/ Products
- Process Technology
- Carbon Specialities
- Material characterization
- Technical Library/ Archives

Infrastructure

A Separate R&D set up has been established by the company wherein the Scientists are working on the Developmental projects as well as the projects to sustain & improve the competitiveness of the company. Frequent Structured interactions are held between the Process Personnel & the R&D scientists to maintain the pace & momentum of the activities. The HEG R&D center has also entered into collaborations with reputed agencies like IIT (Indian Institute of Technology) Kanpur, RRL (Regional Research Laboratory, CSIR) Bhopal, CEFES (Center for Environment, Fire and Explosive Safety), New Delhi etc.

HEG Ltd. has set up HEG Technology Center as a separate unit at Mandideep, to focus exclusively on Technical Services & Consultancy in the Engineering sector. The unit is awarded 100% EOU status by Govt. of India.

The Center is having a team of experts and technicians in the field of Design & Engineering. HEG Technology Center is helping HEG to participate in a number of bids involving supply of technical know-how including supply of Drawings, and Engineering.

The above has been initiated in line with the trend world-over has been to outsource processes so that the top management of the enterprises can remain free to focus on the crucial task of providing vision and direction in the light of changing world economy.

This Center will co-ordinate in the following activities:

- Engineering and design consultancy through supply of drawings and deputation of expert personnel
- Training of manpower at clients location or own premises etc
- Engineering study of plants with a view to suggesting changes in the manufacturing processes in the light of emerging technologies
- Execution of turnkey Engineering and Design Drawings

2. Recent Development

i) Value addition

HEG has recently commissioned new capacity (14,000 TPA) has widened the product basket towards value-added products opening new windows of opportunity for the Company.

ii) Increase in Promoters share holding

Promoters of the company are hiking their stake very aggressively through open market purchases. In last 1 year, promoters have increased their stake from 55.30% to 57.82% which shows confidence of management to achieve decent revenue and bottom line growth in coming quarters.

iii) Dividend payout

Company has paid dividend of Rs. 5 per share in Sept 2012 compared to Rs. 10 in 2010 and 2011; less dividend payout was on account of decrease in net profits due to capacity expansion & increase in raw material prices. With robust performance during first half of this year, we expect dividend payout of Rs. 10 or more for FY 2012-13, hence dividend yield (for next year) at stock current market price with 1 year time horizon will be above 4%.

iv) Geographic diversification

Company expects to strengthen their presence in new and growing EAF markets of BRIC nations and other Asian economies and benefit from emerging opportunities in those geographies.

v) Strengthening relationships with suppliers

Company is taking all required measures for building up their relationships with existing suppliers besides bringing new supplier sources for key raw materials.

3. Financial Performance

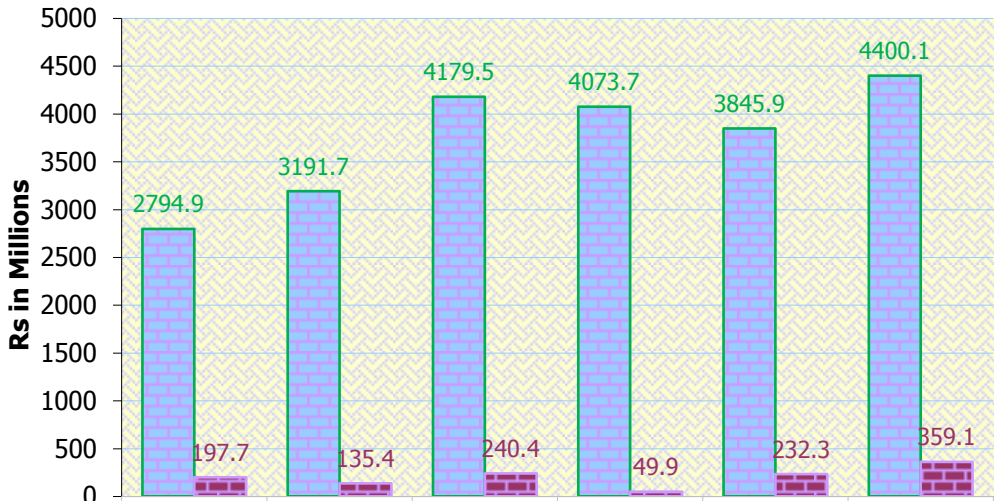
HEG net profit rises 165.21% in the September 2012 quarter

HEG net profit rose 165.2% to Rs 359.1 million in the quarter ended September 2012 as against Rs 135.4 million during the previous quarter ended September 2011. Sales rose 37.8% to Rs 4400.1 million in the quarter ended September 2012 as against Rs 3191.7 million during the previous quarter ended September 2011.

HEG net profit rises 17.50% in the June 2012 quarter

HEG net profit rose 17.50% to Rs 232.3 million in the quarter ended June 2012 as against Rs 197.7 million during the previous quarter ended June 2011. Sales rose 37.5% to Rs 3845.9 million in the quarter ended June 2012 as against Rs 2794.9 million during the previous quarter ended June 2011.

Last 6 Quarters Net Sales & Profit



	1	2	3	4	5	6
Net Sales	2794.9	3191.7	4179.5	4073.7	3845.9	4400.1
Net Profit	197.7	135.4	240.4	49.9	232.3	359.1
	Jun 11	**Sep 11**	**Dec 11**	**Mar 12**	**Jun 12**	**Sep 12**

Current & Expected Earnings:

QUARTERLY RESULTS	Dec '11	Mar '12	Jun '12	Sep '12	Dec'12E	Mar'13E
Net Sales	4179.5	4073.7	3845.9	4400.1	4968.5	4917.9
Total Expenditure	3328.7	3349.9	2814.9	3719	3956.7	4011.5
PBIDT (Excl OI)	**850.8**	**723.8**	**1031**	**681.1**	**1011.8**	**906.4**
Other Income	59.9	44.8	23.5	30.5	42.1	46.4
Operating Profit	910.7	768.6	1054.5	711.6	1053.9	952.8
Interest	136.5	128.8	156.3	157.3	159.5	144.6
Exceptional Items	-355	-481.6	-484.2	36.1	14.4	10.1
PBDT	419.2	158.2	414	590.4	908.8	818.3
Depreciation	146.1	155.4	160.0	157.0	163.0	165.4
Profit Before Tax	273.1	2.8	254	433.4	745.8	652.9
Tax	32.7	-47.1	21.7	74.3	128.6	112.7
Provisions and contingencies	0	0	0	0	0	0
Profit After Tax	240.4	49.9	232.3	359.1	617.2	540.2
Extraordinary Items	0	0	0	0	0	0
Prior Period Expenses	0	0	0	0	0	0
Other Adjustments	0	0	0	0	0	0
Net Profit	**240.4**	**49.9**	**232.3**	**359.1**	**617.2**	**540.2**
Equity Capital	399.6	399.6	399.6	399.6	399.6	399.6
Face Value (IN RS)	10	10	10	10	10	10
Reserves						
Calculated EPS	**6.02**	**1.25**	**5.81**	**8.99**	**15.45**	**13.52**
Calculated EPS (Annualised)	24.06	4.99	23.25	35.95	61.80	54.08
No of Public Share Holdings	17493410	17273684	17120425	16855206	--	--
% of Public Share Holdings	43.78	43.23	42.84	42.18	--	--

In Q2 FY2013, profit before tax increased by 197.9% at 433 million as compared to 146 million in Q2 FY2012. The Company's Net Profit was higher by 165.2% at 359 million in Q2 FY2013 as compared to 135 million in Q2 FY2012. The Net Profit gave a basic EPS of 8.99 for Q2 FY2013 as compared to 3.29 of Q2 FY2012.

EBIDTA was higher by 48.4% at 712 million in Q2 FY2013 from 479 million in Q2 FY2012. PBIT of the graphite division rose by 55.6% in Q2 FY2013 at 313 million from 201 million and PBIT for the power division was increased by 87.9% at 231 million from 123 million.

Company has delivered robust second quarter results and is expected to perform better with realisation of higher income and profitability in coming quarters.

4. Investment Rationale

i) Expect Growth in Graphite Electrode Demand

As per World Steel Association, global steel use will increase by 3.6% to 1,422mt in 2012. The world steel demand in 2013 is expected to grow by 4.5% to around 1,486mt. The major contributing region to the growth includes the US (~growth of 5.7% in 2012 & 5.6% in 2013), Central and South America (~growth of 6.8% in 2012 & 6.7% in 2013) and MENA region (~ growth of 5.7% in 2012 and 8.4% in 2013). The company is a leading exporter of graphite electrodes with footprint across 35 countries including the US, Europe, Russia, Middle East, South East Asia, South America and Africa. Thus, we expect continued growth trajectory for graphite electrodes demand in the long run.

ii) Addition Capacity to Improve Revenues

HEG has expanded its graphite electrode manufacturing facility from 66,000 tonnes to 80,000 tonnes, making it the largest single site plant in the world. The company's capacity utilization in the 1st quarter was around 70% and is improved to 85% currently. The demand outlook for graphite electrodes looks stable on the back of strong demand from steel producers. We therefore expect this factor to drive graphite electrodes sales volume.

iii) Aggressive Increase in Stake by Promoters

In 2009, the promoters bought back almost about 33 lakh shares at an average price of Rs 150 pumping in Rs 48 crore. In 2011, the management bought back 29 lakh shares at an average price of about Rs 233 and they have bought 29 lakh shares at an average price of Rs 233 pumping in Rs 68 crore. During this year, promoters increased their stake by 1.6% from 56.22 (Dec 2011) to 57.82% in Sept 2012. So when management is buying back in a matter of three years, we think it certainly gives you a feel that at these levels there is nothing much to lose from here and the upside could be very decent.

iv) Increase in Revenues, Net Profits & Operating Margins

Q2 FY2013 Net Revenues increased by 37.8% at 440.0 crore as compared to 319.3 crore in Q2 FY2012. Revenues in graphite electrode division were higher by 37.4% at 430.2 crore in Q2 FY2013 as compared to 313.0 crore in Q2 FY2012. Revenues in the Power division rose by 19.5% at 67.7 crore from 56.7 crore. EBIDTA was higher by 48.4% at 71.2 crore in Q2 FY2013 from 47.9 crore in Q2 FY2012. PBIT of the graphite division rose by 55.6% in Q2 FY2013 at 31.3 crore from 20.1 crore and PBIT for the power division was increased by 87.9% at 23.1 crore from 12.3 crore. We expect company will continue to deliver robust performance like that of Q2 FY12-13.

In Q2 FY2013, profit before tax increased by 197.9% at 43.3 crore as compared to 14.6 crore in Q2 FY2012. The Company's Net Profit was higher by 165.2% at 35.9 crore in Q2 FY2013 as compared to 13.5 crore in Q2 FY2012. The Net Profit gave a basic EPS of 8.99 for Q2 FY2013 as compared to 3.29 of Q2 FY2012.

5. Peer Group Comparison

PEER GROUP	HEG LTD.	GRAPHITE INDIA LTD.
CMP	233.10	84.15
52 W H/L	256.95/141.00	99.90/65.45
Market Cap	9314.48	16411.55
Results (in Million)	Sep-12	Jun-12
Sales	4400.10	4175.30
PAT	359.10	405.50
Equity	399.60	390.80
EPS	22.07	12.36
P/E	10.56	6.79

We are comparing HEG with another market player Graphite India Ltd (GIL), which is the largest producer of graphite electrodes in India. Besides graphite, the company is also engaged in the business of high speed steel, power and pipe & tanks. The company has 4 plants with a combined manufacturing capacity of 78,000 tonnes per annum. GIL exports around 65% of its production to over 50 countries, with no single client contributing of more than 6% of revenue. Region wise, India contributes to 29% of total electrodes volumes of GIL followed by Middle East and Europe contributing 25% each. The management of the company looks more focused towards sustainable revenue growth by growing capacity and exploring opportunities in other low cost location. The company also targets to grow equipment and speciality products into a global business.

On the other hand HEG has one of the largest integrated Graphite Electrode plants in the world with a capacity of 80,000 tonnes per annum. It exports 85% of its production to more than 35 countries across the world. The company is more likely to benefit from recent expansion capacity to enhance revenue. After completing a major portion of their order bookings in the first quarter of the current fiscal, the company is more focused towards better cost management. Needle coke stock procured last year at lower prices has now been exhausted and company has started operating with needle coke which was procured in the current year at higher but competitive rates.

6. Risk & Concerns

- The first and foremost risk for any commodity is the demand & supply and steel is no exception. The steel industry has grown moderately over the quarter under review and revised forecasts indicate lower but sustainable growth rates.

- The current macro-economic situation is defined by problems in the European markets and sluggish growth in USA. Overall volatile market conditions continue to impact most sectors unfavorably.

- Needle coke stock procured last year at lower prices has now been exhausted and company has started operating with needle coke which was procured in the current year at higher but competitive rates, any further increase in prices of needle coke will impact the profit margins of the company.

7. Future Outlook

- World crude steel production for nine months of 2012 was 1,149 Mt, a marginal increase of 0.6% compared to the same period of 2011 July - September 2012 production was higher as compared to the corresponding period (Source: World Steel Association)

- Global apparent steel use expected to increase by 2.1% in 2012, following growth of 6.2% in 2011. World steel demand in 2013 is expected to grow further by 3.2 % to a record high of 1,455 Mt (Source: World Steel Association)Graphite Electrodes demand based on steel produced via the EAF route is expected to improve going forward. An increase in steel-making through the EAF route will catalyse the next round of growth of the global graphite electrode sector.

- EAF route for steel making is preferred over the blast furnace route which is beset with volatile commodity prices and environmental considerations.

- The cost of energy (critical in EAF steel making) is relatively low in developed economies; the unit cost of energy in the US is US$0.06 and in the EU is US$0.08.

- The EAF route comprises more than 60% of all steel produced in the US and over 40% of all steel manufactured in Western Europe – approximately a third of the world''s steel production. Credible sources suggest that the EAF steel production will continue to grow in developed and fast-developing nations namely Middle East, Russia and China marked by affordable power and growing private consumption, auguring favourably for the global graphite electrode sector.

- India also provides an interesting opportunity for graphite electrode manufacturers. Indian ISPs are adding EAF units to their blast furnace facilities to strengthen their competitive advantage. Besides, increased private consumption over the last decade catalysed domestic scrap generation, reducing a dependence on imported scrap and making this route increasingly cost-effective. India is expected to add 10 MT steel making capacity through the EAF route over the next five years.

8. Saral Gyan Recommendation

- In Q2 FY 2012-13, company has delivered robust operational and financial performance for both graphite electrode and power divisions. Capacity utilisation of graphite electrodes has shown remarkable improvement. HEG is continuously working towards enhancing productivity whilst focusing on cost efficiencies.

- HEG has grown at a CAGR of 11% during the period 2008-12. Growth was driven by uptrend in the steel industry, which drove production of EAFs, increasing the demand for graphite electrodes. In Q2FY13, the capacity utilization is increased at 85%. Sales of the company registered a growth of 38% Y-o-Y from Rs 319.2 crore to Rs 440 crores. The EBITDA registered significant growth of 48.4%.

- The order book is steadily firming up in the current sustainable EAF environment. The power division has been performing well supported by linkage coal for the thermal plants and resumption of operations of the hydel power plant. Going forward, HEG aims at further optimizing its earnings and enhancing furtheroperational efficiencies.

- As per our estimates, HEG can deliver total sales of Rs 1813 crores and PAT of Rs 175 crores, resulting in EPS of Rs 44 in FY 2012-13. This translates to an expected PE multiple of 5.3 times based on FY 2012-13 earnings. Dividend payout for next year is expected to be Rs. 10 per share on conservative basis, which brings dividend yield at CMP above 4% and makes HEG a safe equity investment.

- We expect HEG Ltd net profit margin will improve to 8-9%. HEG operating margins is expected to improve considering better utilization of capacity expansion of graphite electrode division and increase in income from power division.

- HEG Ltd has declared excellent numbers in second quarter of current financial year registering sales growth of 38% and profit growth of 165% compared to same quarter - last year and is expected to perform better in coming quarters.

- On equity of Rs. 39.96 crores the estimated annualized EPS for FY 12-13 works out to Rs. 44 and the Book Value per share is Rs. 212.12. At a CMP of Rs. 233.10, price to book value is 1.1. Currently, the scrip is trading at 5.3X FY 2012-13 and 3.7X FY 2013-14 estimated earnings which make HEG an attractive bet at CMP.

Saral Gyan Team recommends "BUY" for HEG Ltd at current market price of 233.10 for a target of Rs. 320 over a period of 12-18 months.

Buying Strategy:

- 80% at current market price of 233.10
- 20% at price range of 210-215 (If stock price falls during market correction)

9. Disclaimer

Important Notice: Saral Gyan Capital Services is an Independent Equity Research Company.