

<p><b>NAME</b> <b>BUSINESS LINE</b></p>	<p><b>PLACE</b> New Delhi</p>	<p><b>DATE</b> 18 APR 2010</p>
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**HEG**

# Grip on profits

With signs of bounce back in steel production, increased demand for graphite electrodes augurs well the company's prospects.

**BUY**

**Vidya Bala**

Investments can be considered in the stock of graphite electrode producer HEG. With a clear sign of bounce back in steel production, besides expansion plans in the sector, increased demand from the steel industry for graphite electrodes can only follow.

Among the two graphite electrode players in India, HEG's superior profit margins and timely expansion plans are likely to ensure that it is a key beneficiary of the demand revival.

At the current market price of Rs 354, the stock trades at seven times its estimated per share earnings for the financial year 2012. Any significant fund raising through issue of equity can weigh on the stock in the near term until the expanded capacities come on stream by mid-2012. Investors with a two-year perspective can consider limited exposure to the stock.

**DEMAND DRIVER**

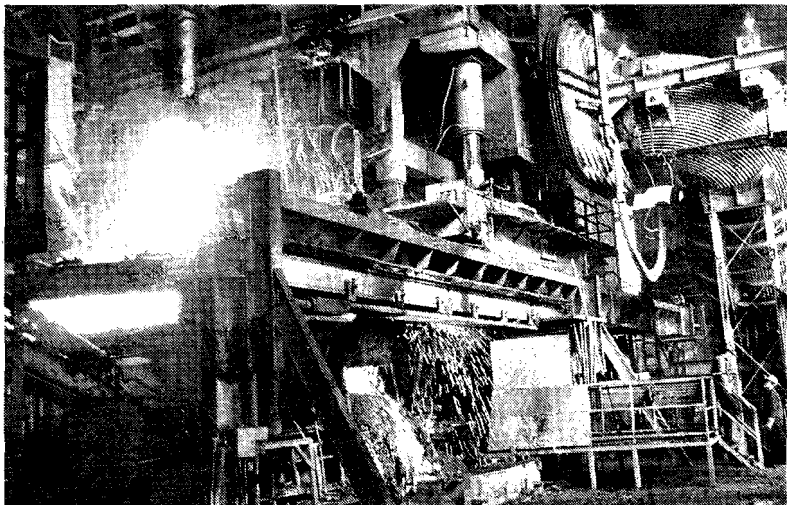
Graphite electrodes are consumed while producing steel through the electric arc furnace route (EAF). According to industry data, steel produced through the EAF route accounts for 31 per cent of the total production globally.

Steel produced through this route has been growing globally, especially in North and South America and West Asia, as a result of higher availability of steel scrap (key input in EAF process), higher productivity and flexible product mix.

Demand for steel, availability and price of key raw material needle coke, managing cost efficiencies and price contracts with customers are the key factors that determine the fortunes of the seven or eight graphite players globally. Among these factors, India players score on the manpower and power cost front.

**STEEL PRODUCTION**

HEG's improving prospects are visible from its capacity utilisation over the three quarters ending December 2009.



**Graphite electrodes** are consumed while producing steel through the electric arc furnace route.

From a 57 per cent utilisation level in the June quarter, the company operated at a 75 per cent rate by December. It can be expected to reach its pre-downturn operating levels of over 80-90 per cent as steel producers bring their idled capacities back on stream.

Besides, the World Steel Association has forecast an 11 per cent increase in steel production in 2010 (world crude steel production was 1.22 billion tonnes in 2009).

HEG plans to increase its capacity from the current 66,000 million tonnes (mt) to 80,000 mt to cater to anticipated demand. While HEG had put on hold these plans last year, the current surge in activity in steel has revived the expansion.

**SECURE SUPPLIES**

Needle coke, a key and scarce raw material used to produce graphite electrode, plays a significant role in determining profit margins for graphite players.

HEG has stated that it has booked its needle coke requirement for the current year at prices similar to the financial year 2010. The prices of needle coke rose by 35-40 per cent last year and are currently at \$1,650-\$1,800 a tonne.

The freezing of supply and price of the raw material is expected to provide stability to margins.

Besides, given an anticipated supply-demand mismatch on the back of graphite production not keeping up with increase in steel produced, the company is likely to ensure that the electrode realisations make up for input cost hikes.

Realisation of electrodes increased by

11 per cent year-on-year for the quarter ended December, reinforce the above.

HEG scores over its Indian peer Graphite India on account of managing its power needs captively with 77MW of generation capability.

The company has also managed to sell its surplus power at Rs 2.95 a unit in the December quarter. This has led to the company enjoying operating profit margins of 32 per cent compared with its peer which on an average operates at 20-25 per cent.

Superior profitability has ensured better return on equity of about 32 per cent (FY-09) compared with about 22 per cent for Graphite India.

Sales for the nine-months ending the financial year 2010 stood at Rs 811 crore and net profits at Rs 131 crore. Exports accounted for 75 per cent of revenues.

Earnings for the last three years grew annually at 40 per cent. HEG's superior operating metrics has traditionally helped it command a premium over Graphite India.

**RISKS**

The graphite electrode industry is fraught with risk due to volatility in demand (as a result of cyclical nature of user industry- steel) and raw material cost and energy costs.

While Indian players have done well on the cost front, limited pricing power with steel majors such as Arcelor Mittal and POSCO and the availability of needle coke supplies, remains a sector risk.

It is for this reason that the Indian players in the graphite sector trade at a discount to global peers.