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Pricing normalised, wages overhang set to pass

Quick Note

February 1, 2012

Rating Remains	Buy
Target price Remains	INR 433
Closing price January 31, 2012	INR 327

Key overhangs (price normalisation, wage revision) playing out

Two much anticipated events for Coal India (CIL) – revision (normalisation) of notified coal prices for 1QCY12 and finalisation of the non-executive wage revision – transpired yesterday. While the potential impact of the price revision is fairly clear (broadly revenue / EPS neutral), final magnitude of the wage revision is awaited (we build in a 30% wage hike implying an outgo of Rs40bn, broadly in line with market expectations). Ceteris paribus, a 1% change in blended ASP / total employee cost would impact CIL's EPS by ~3%/1%.

Grade mix key to 'revenue neutrality' in CIL's new pricing structure

Unlike the sharp hike in prices notified on switch-over to the GCV-based coal pricing mechanism on 1 January, CIL's revised pricing structure for 1QCY12 indicates that the impact on consolidated revenues would be 'largely neutral' (in sync with the broad direction from the Ministry of Coal), albeit with negligible margin of safety in grade slippage. By our calculations, CIL's blended notified coal price could swing between -9% to +5%; offtake mix in the context of GCV-based 17-grade classification and realization via e-auctions would determine the delta in revenues.

Low GCV coal prices sporadically lowered; IPPs likely to benefit

We note that [1] Relative to the prices set on 1 January, revised price for erstwhile Grade C,D coal (~18% of output) is lowered by 40-45% and revised price for erstwhile Grade E,F coal (~two-thirds of output) is lowered by 5-35% 4-5%, [2] IPPs may get coal at lower cost as a few GCV-bands of Grade E,F coal exhibit a drop in pricing from levels pegged in the UHV-based pricing regime (effective till December 2011); a 1% change in notified coal prices would typically result in 0.25-0.4% change in cost of power, and [3] Pricing premium for non-core sectors is marginally higher at ~35% from ~30% previously.

Wage revision finalised, but is the hit Rs40bn or Rs65bn?

While official confirmation of the final wage revision (pact was to be inked yesterday) is awaited, outgoing CIL Chairman's comment that the outgo would be Rs65bn (implying a 45% wage revision) is significantly higher than our forecast (Rs40bn, implying a 30% wage revision), which is in sync with market expectations. In our view, if the effective wage hike is indeed ~45%, the scheduled price revision at the end 1QCY12 would likely neutralize the incremental impact.

Price revision post 1QCY12 is the silver lining; reiterate Buy

Arguably, the magnitude of wage revision may indeed be Rs65bn and the new pricing structure may result in lower revenues / earnings for CIL in 1QCY12. However, we believe that CIL would neutralise any negative impact from these two events in the scheduled review of the pricing structure post 1QCY12. We maintain that CIL would eventually be able to push through a nominal hike in notified coal prices for FY13. Our current earnings forecast for CIL (under review) builds-in a 3.4% hike in blended realization for FY13. On our FY13 normalised earnings forecasts for CIL, the stock trades at 12.0x P/E and 6.9x EV/EBITDA

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 1: CIL – Summary of revision in coal grading & pricing mechanism

Price hike for priority sector consumers and erstwhile Grade E,F,G coal is lower; CIL to now charge for <3,100 GCV coal

New Classification				Old Classification				Price Revision			
Grade	GCV	Priority (INR/ton) [A]	Other (INR/ton) [B]	Grade	GCV	Priority (INR/ton) [C]	Other (INR/ton) [D]	Priority (INR/ton) [A/C (mid)]	Priority (INR/ton) [A/C (low)]	Other (INR/ton) [B/D (mid)]	Other (INR/ton) [B/D (low)]
I	>7000	*	*	**A**	>6,401	3,690-4,100	3,690-4,100	NA	NA	NA	NA
II	6,700-7,000	4,870	4,870	**A**	>6,401	3,690-4,100	3,690-4,100	25%	32%	25%	32%
III	6,400-6,700	4,420	4,420	**A**	>6,401	3,690-4,100	3,690-4,100	13%	20%	13%	20%
IV	6,100-6,400	3,970	3,970	**B**	5,800-6,401	3,590-3,990	3,590-3,990	5%	11%	5%	11%
V	5,800-6,100	2,800	2,800	**B**	5,800-6,401	3,590-3,990	3,590-3,990	-26%	-22%	-26%	-22%
VI	5,500-5,800	1,450	1,960	**C**	5,400-5,801	1,050-1,860	1,370-2,420	0%	38%	3%	43%
VII	5,200-5,500	1,270	1,720	**C**	5,400-5,801	1,050-1,860	1,370-2,420	-13%	21%	-9%	26%
				D	4,800-5,401	880-1,610	1,140-2,090	2%	44%	7%	51%
VIII	4,900-5,200	1,140	1,540	**D**	4,800-5,401	880-1,610	1,140-2,090	-8%	30%	-5%	35%
IX	4,600-4,900	880	1,180	**D**	4,800-5,401	880-1,610	1,140-2,090	-29%	0%	-27%	4%
				E	4,200-4,801	730-1,090	950-1,420	-3%	21%	0%	24%
X	4,300-4,600	780	1,050	**E**	4,200-4,801	730-1,090	950-1,420	-14%	7%	-11%	11%
XI	4,000-4,300	640	870	**E**	4,200-4,801	730-1,090	950-1,420	-30%	-12%	-27%	-8%
				F	3,600-4,201	570-870	740-1,030	-11%	12%	-7%	18%
XII	3,700-4,000	600	810	**F**	3,600-4,201	570-870	740-1,030	-17%	5%	-13%	9%
XIII	3,400-3,700	550	740	**F**	3,600-4,201	570-870	740-1,030	-24%	-4%	-21%	0%
				G	3,200-3,601	430-700	560-910	-3%	28%	1%	32%
XIV	3,100-3,400	500	680	**G**	3,200-3,601	430-700	560-910	-12%	16%	-7%	21%
XV	2,800-3,100	460	620	**-**	NA	NA	NA	NA	NA	NA	NA
XVI	2,500-2,800	410	550	**-**	NA	NA	NA	NA	NA	NA	NA
XVII	2,200-2,500	360	490	**-**	NA	NA	NA	NA	NA	NA	NA

Notes: (1) Priority Sectors = power utilities (incl. IPPs), fertilizers and defence; (2) For WCL, there shall be a 10% add on over and above the price mentioned above for GCV bands not exceeding 5800 Kcal/Kg; (*) For GCV exceeding 7000 Kcal/Kg, the price shall increase by Rs150/ton over and above the price applicable for GCV band exceeding 6700Kcal/kg but less than 7000 Kcal/kg, for every 100 Kcal/Kg increase in GCV. Source: Company data, Nomura research

Fig. 2: CIL – Gauging effective price hike assuming production mix skewed at the low-end of pricing slabs

Weighted-average notified price realisation would fall by ~9%; product mix and grade slippage are the key swing factors

Previous							Current						
Grade	Priority Mid [A]	Priority Low [B]	Other Mid [C]	Other Low [D]	Blended Mid [E]	Blended Low [F]	Grade	Blended Price [G]	Price Hike Mid [X]=G/E	Price Hike Low [Y] =G/F	Product [Z]	W. Avg Price Mid X*Z	W. Avg Price Low Y*Z
A	3,895	3,690	3,895	3,690	3,895	3,690	**I**	*	NA	NA			
A	3,895	3,690	3,895	3,690	3,895	3,690	**II**	4,870	25.0%	32.0%			
A	3,895	3,690	3,895	3,690	3,895	3,690	**III**	4,420	13.5%	19.8%	1.1%	0.1%	0.2%
B	3,790	3,590	3,790	3,590	3,790	3,590	**IV**	3,970	4.7%	10.6%			
B	3,790	3,590	3,790	3,590	3,790	3,590	**V**	2,800	-26.1%	-22.0%	5.5%	-1.4%	-1.2%
C	1,455	1,050	1,895	1,370	1,587	1,146	**VI**	1,603	1.0%	39.9%			
C	1,455	1,050	1,895	1,370	1,587	1,146	**VII**	1,405	-11.5%	22.6%	10.3%	-1.2%	2.3%
D	1,245	880	1,615	1,140	1,356	958		1,405	3.6%	46.7%			
D	1,245	880	1,615	1,140	1,356	958	**VIII**	1,260	-7.1%	31.5%			
D	1,245	880	1,615	1,140	1,356	958	**IX**	970	-28.5%	1.3%	8.1%	-2.3%	0.1%
E	910	730	1,185	950	993	796		970	-2.3%	21.9%			
E	910	730	1,185	950	993	796	**X**	861	-13.2%	8.2%			
E	910	730	1,185	950	993	796	**XI**	709	-28.6%	-10.9%	22.5%	-6.4%	-2.5%
F	720	570	935	740	785	621		709	-9.6%	14.2%			
F	720	570	935	740	785	621	**XII**	663	-15.5%	6.8%			
F	720	570	935	740	785	621	**XIII**	607	-22.6%	-2.3%	44.5%	-10.1%	-1.0%
G	565	430	735	560	616	469		607	-1.5%	29.4%			
G	565	430	735	560	616	469	**XIV**	554	-10.1%	18.1%			
Coking Coal											8.0%	-	-
Effective Price Hike										**-8.8%**		**-21.3%**	**-2.0%**

Note (1): Prices are in INR/ton; (2) Blended price = (70% x priority sector price) + (30% x other sector price); (3): Product mix as of FY2010 is used as a proxy; (4) Overall price hike = (35% x Effective hike at mid price) + (65% x Effective hike at low price). (*) For GCV exceeding 7000 Kcal/Kg, the price shall increase by Rs150/ton over and above the price applicable for GCV band exceeding 6700Kcal/kg but less than 7000 Kcal/kg, for every 100 Kcal/Kg increase in GCV. Source: Company data, Nomura research

Fig. 3: CIL – Gauging effective price hike assuming production mix skewed towards 'middle' pricing slabs

Weighted-average notified price realisation would rise by ~5%

	Previous						Revised						
Grade	Priority Sectors		Other Sectors		Blended Price		Grade	Blended Price	Price Hike		Product Mix	W. Avg Price Hike	
	Mid	Low	Mid	Low	Mid	Low			Mid	Low		Mid	Low
	[A]	[B]	[C]	[D]	[E]	[F]		[G]	[X]=G/E	[Y] =G/F	[Z]	X*Z	Y*Z
A	3,895	3,690	3,895	3,690	3,895	3,690	**I**	*	NA	NA			
A	3,895	3,690	3,895	3,690	3,895	3,690	**II**	4,870	25.0%	32.0%	1.1%	0.3%	0.4%
A	3,895	3,690	3,895	3,690	3,895	3,690	**III**	4,420	13.5%	19.8%			
B	3,790	3,590	3,790	3,590	3,790	3,590	**IV**	3,970	4.7%	10.6%	5.5%	0.3%	0.6%
B	3,790	3,590	3,790	3,590	3,790	3,590	**V**	2,800	-26.1%	-22.0%			
C	1,455	1,050	1,895	1,370	1,587	1,146	**VI**	1,603	1.0%	39.9%	10.3%	0.1%	4.1%
C	1,455	1,050	1,895	1,370	1,587	1,146	**VII**	1,405	-11.5%	22.6%			
D	1,245	880	1,615	1,140	1,356	958		1,405	3.6%	46.7%			
D	1,245	880	1,615	1,140	1,356	958	**VIII**	1,260	-7.1%	31.5%	8.1%	-0.6%	2.6%
D	1,245	880	1,615	1,140	1,356	958	**IX**	970	-28.5%	1.3%			
E	910	730	1,185	950	993	796		970	-2.3%	21.9%			
E	910	730	1,185	950	993	796	**X**	861	-13.2%	8.2%	22.5%	-3.0%	1.8%
E	910	730	1,185	950	993	796	**XI**	709	-28.6%	-10.9%			
F	720	570	935	740	785	621		709	-9.6%	14.2%			
F	720	570	935	740	785	621	**XII**	663	-15.5%	6.8%	44.5%	-6.9%	3.0%
F	720	570	935	740	785	621	**XIII**	607	-22.6%	-2.3%			
G	565	430	735	560	616	469		607	-1.5%	29.4%			
G	565	430	735	560	616	469	**XIV**	554	-10.1%	18.1%			
Coking Coal											8.0%	-	-
Effective Price Hike										**4.7%**		**-9.8%**	**12.4%**

Note (1): Prices are in INR/ton; (2) Blended price = (70% x priority sector price) + (30% x other sector price); (3): Product mix as of FY2010 is used as a proxy; (4) Overall price hike = (35% x Effective hike at mid price) + (65% x Effective hike at low price). (*) For GCV exceeding 7000 Kcal/Kg, the price shall increase by Rs150/ton over and above the price applicable for GCV band exceeding 6700Kcal/kg but less than 7000 Kcal/kg, for every 100 Kcal/Kg increase in GCV. Source: Company data, Nomura research

Appendix A-1

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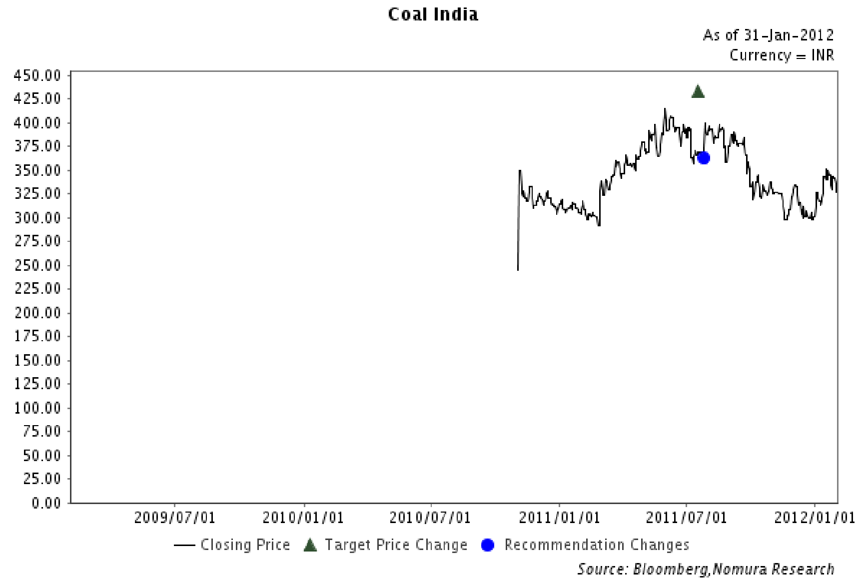
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Coal India	COAL IN	INR 327	31-1-2012	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Coal India	Not Rated	18-7-2011

Coal India (COAL IN) **INR 327 (31-1-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
18-Jul-11	Buy		368.90
18-Jul-11		433.00	368.90

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We arrive at our INR433/share 12-month target price for CIL using a sum-of-the-parts method: 1) FCFF-based methodology to value the cash flows from its 10.6bn tons of proven reserves, and 2) EV/ton based value of CIL's probable reserves (8.3bn tons) and remaining resources (45.5bn tons) as per the Australasian Joint Ore Reserves Committee Code (JORC) Code.

Risks that may impede the achievement of the target price Key risks: 1) Regulatory uncertainty particularly around pricing flexibility, environmental/forest clearance and restriction on e-auction coal sales; 2) lower-than-expected coal despatch due to lower rake availability; 3) delays in land acquisition/possession; and 4) wage revision of non-executives is higher than our expectation of a 30% increase.

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A rating of '**Buy**', indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months. A rating of '**Neutral**', indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months. A rating of '**Reduce**', indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months. A rating of '**Suspended**', indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including, but not limited to, when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.
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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

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A '**Buy**' recommendation indicates that potential upside is 15% or more. A '**Neutral**' recommendation indicates that potential upside is less than 15% or downside is less than 5%. A '**Reduce**' recommendation indicates that potential downside is 5% or more. A rating of '**Suspended**' indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.
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Target Price

A Target Price, if discussed, reflect in part the analyst's estimates for the company's earnings. The achievement of any target price may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings differ from estimates.

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