



# Metals & Mining

**Disciplined capital allocation key to improving payout**

August 2021

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## METALS & MINING

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### Disciplined capital allocation key to improving payout

- Indian steel margins expected to remain elevated near term but revert to mean in longer run
- Steel companies to report robust results, albeit unlikely to beat consensus – prefer players with robust capital allocation policies
- Initiate with BUY on TATA & JSP but HOLD on JSTL & SAIL due to disproportionately higher risk from margins cooling off

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#### Global steel margins largely supported by demand-supply imbalance: H1CY21

margin strength was supported by high demand both in China and the rest of the world amid slow catch-up of supply and pass-along of elevated raw material prices due to supply chain disruptions. China's publicised intent to cut emissions from its steel industry by lowering production could further support steel prices.

**Steel margins to normalise over longer term:** The demand-supply imbalance was in part due to supply disruptions and pent-up demand. We believe both of these will ease sooner than later. We expect steel demand to moderate over the next 6 months, while it could take 12-18 months to restore iron ore supply and 6-12 months for coking coal. We, therefore, believe steel margins will soften over the next 6-12 months with steel prices easing to US\$ 650/t by FY23. If China does move to curtail steel sector emissions, the current run may be extended, which would mean another 12-24 months before the demand-supply balance is restored to mid-cycle levels.

**Sustainable profit opens up scope for meaningful increase in payout:** The Indian steel industry, unlike its Chinese counterpart, gains from higher spreads due to domestic iron ore, and has also benefitted from coking coal differentials as China moved away from traditional supplier Australia. Companies have used this windfall to deleverage and restore balance sheet health, with the FY22 net debt/EBITDA ratio estimated at 1.2x on average for our coverage vs. 2.3x in FY21. This opens up the possibility of an increase in payout, and players with a disciplined capital allocation approach will have more flexibility.

**Prefer TATA, JSP:** With the steel cycle at a peak, we would prioritise capital discipline over expansion projects. We are therefore positive on Tata Steel (TATA) and Jindal Steel & Power (JSP) who are now focusing on responsible growth. JSW Steel (JSTL) has a higher commitment to aggressive growth and will be disproportionately impacted if margins cool off. SAIL's discount to peers will continue, in our view, given its lower operational efficiency and pro-growth capital allocation policies. We initiate on TATA (TP Rs 1,755) and JSP (TP Rs 555) with BUY ratings and JSTL (TP Rs 795) and SAIL (TP Rs 150) with HOLD.

#### Recommendation snapshot

Ticker	Price	Target	Rating
TATA IN	1,462	1,755	BUY
JSTL IN	749	795	HOLD
JSP IN	424	555	BUY
SAIL IN	134	150	HOLD

Price &amp; Target in Rupees | Price as of 13 Aug 2021

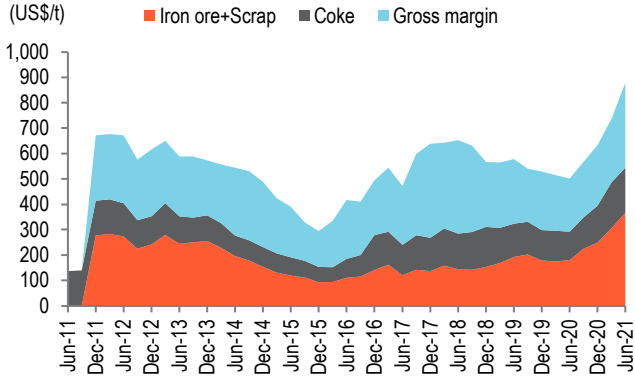


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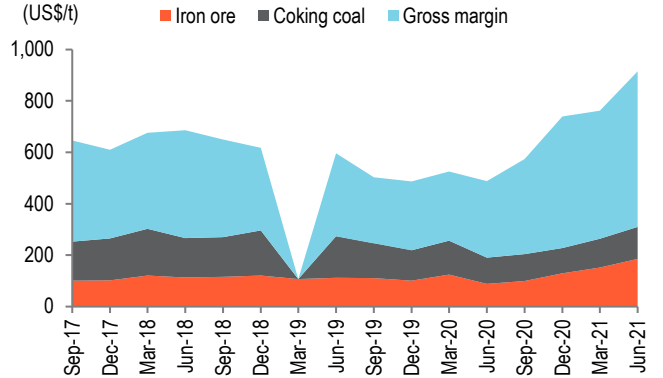
Focus charts

**Fig 1 – China HRC export price have risen with higher iron ore and coking coal prices**



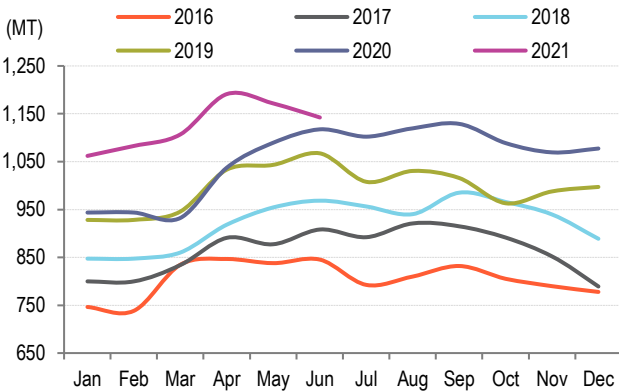
Source: Bloomberg, BOBCAPS Research

**Fig 2 – India benefitted from improvement in gross margin due to iron ore price differential**



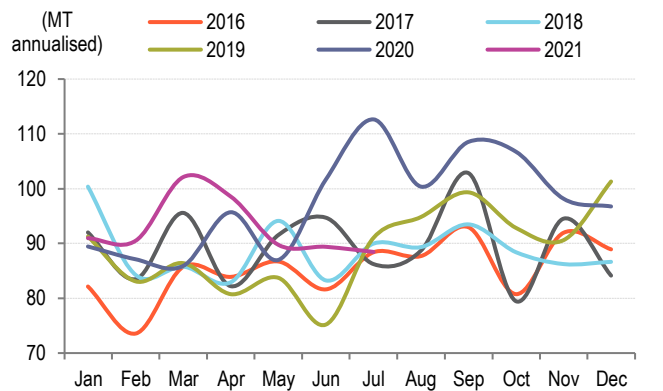
Source: Bloomberg, BOBCAPS Research

**Fig 3 – China steel production normally eases over H2 and this trend has begun**



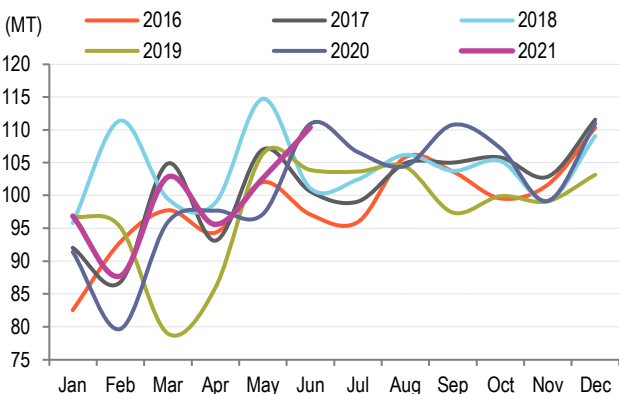
Source: Bloomberg, BOBCAPS Research

**Fig 4 – China iron ore imports have moderated over past quarter after running high for nine months**



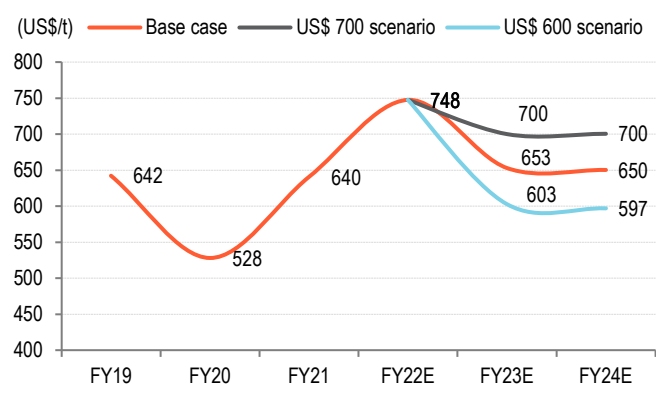
Source: Bloomberg, BOBCAPS Research

**Fig 5 – Brazil and Australia iron ore exports to improve in H2CY21**



Source: Bloomberg, BOBCAPS Research

**Fig 6 – We assume easing of steel price to US\$ 650/t in base case and test two scenarios of US\$ 700 & US\$ 600**



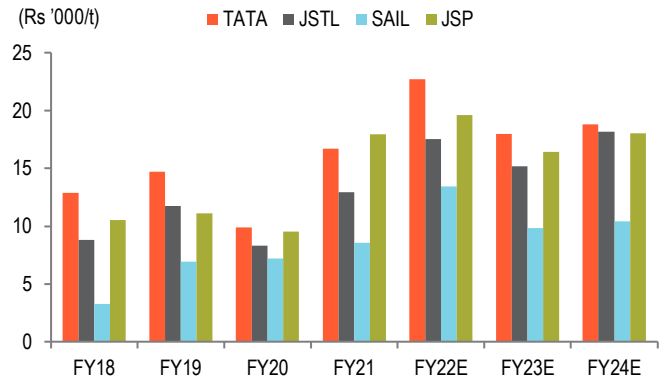
Source: BOBCAPS Research

**Fig 7 – India: Start of capex upcycle for steel industry**

Company	Capex plan (Rs tn)	Capacity expansion plan (mtpa)	Potential timeline
TATA	0.4	5.8	FY25
JSTL	0.5	13.5	FY25
JSP	0.2	6.3	FY25
AMNS India	NA	1.3	FY23
<b>Subtotal</b>	<b>1.1</b>	<b>26.9</b>	<b>-</b>
SAIL	0.7	13	FY26-28
<b>Total</b>	<b>1.8</b>	<b>40</b>	<b>-</b>

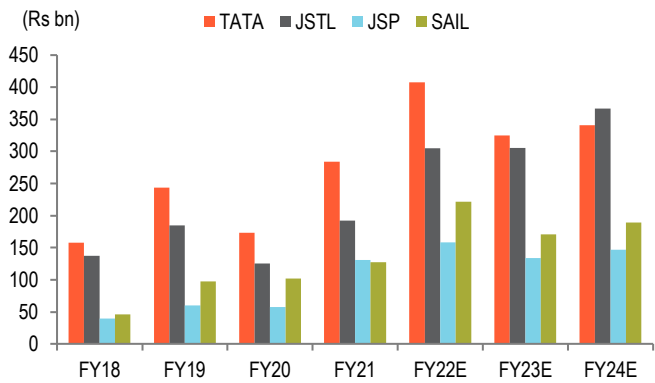
Source: Company, BOBCAPS Research

**Fig 8 – Healthy EBITDA/t**



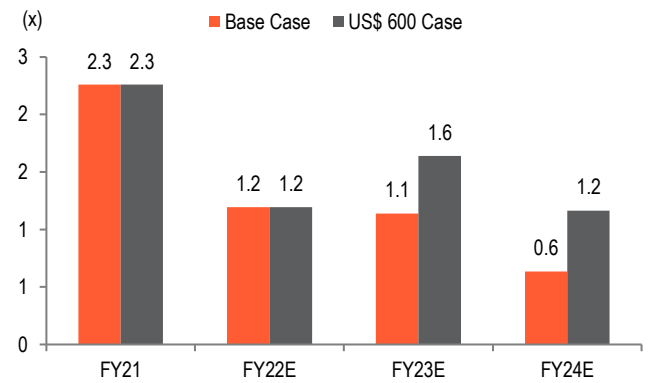
Source: Company, BOBCAPS Research

**Fig 9 – Healthy cash generation (EBITDA) to support capex upturn**



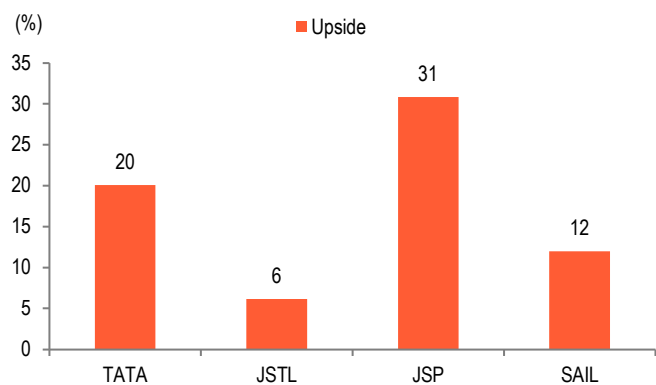
Source: Company, BOBCAPS Research

**Fig 10 – Leverage remains well under control in US\$ 650/t (base) and US\$ 600/t scenario as well**



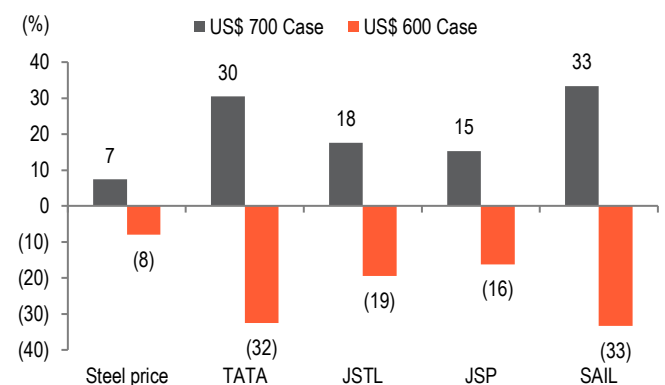
Source: Company, BOBCAPS Research

**Fig 11 – Prefer TATA and JSP over JSTL and SAIL**



Source: Bloomberg, BOBCAPS Research

**Fig 12 – Sensitivity of stock fair value to steel prices**



Source: Bloomberg, BOBCAPS Research

## Investment summary

### Steel margins to normalise but remain resilient

Most commodities go through cycles but the span of each cycle can be materially different from past ones. We expect current robust steel margins to gradually revert to mid-cycle levels over the next 1.5-2 years. However, we believe Indian steel prices will normalise at a healthy level of US\$ 650/t by FY23 and remain supported by balanced markets and global moves towards emission reduction.

The current upcycle can be attributed to post-lockdown reopening of demand centres, initially in China and then through the rest of the world, even as supply chains remained constrained in several countries. We believe the demand pull will ease as China slows down and the replenishing of inventory for steel and its end products reduces in other markets. Supply capacity has been ramped up significantly to support the tight market, which would result in gradual normalising of global steel inventories. This, in turn, would likely mean restoration of the demand-supply balance.

Ongoing Chinese efforts to lower steel sector emissions are likely to extend the cycle, in our view, as China imposes restrictions on domestic production which in turn will reduce supply for the global seaborne market. There is also a possibility of China turning net importer, albeit a low one. While global steel operating costs are expected to move up in response to greening of the production process, we expect this to happen gradually.

### High profits drive capex upcycle for Indian steel majors

Indian steel companies are actively looking at expansion projects, with large players (ex-SAIL) committing Rs 1.1tn of capex by FY25 to raise capacity by ~27metric tonne per annum (mtpa). High margins over the last several quarters have eased balance sheet pressures. While demand-supply in the Indian market is balanced, it needs additional capacity to support its growth ambitions. Given likely moderation in supply from China, we believe the demand trajectory justifies these capex projects.

Sustainability of this round of capital expenditure is significantly higher on several counts – steel majors are looking to maintain healthy leverage through the cycle, they are mainly pursuing brownfield expansion with competitive capital intensity, and nearly a third of the planned outlay is targeted at cost efficiency and downstream capacity, which will improve the resilience of earnings through the cycle.

**Fig 13 – Beginning of capex upcycle for Indian steel industry**

Company	Capex plan (Rs tn)	Capacity expansion plan (mtpa)	Potential timeline
TATA	0.4	5.8	FY25
JSTL	0.5	13.5	FY25
JSP	0.2	6.3	FY25
AMNS India	NA	1.3	FY23
<b>Subtotal</b>	<b>1.1</b>	<b>26.9</b>	
SAIL	0.7	13	FY26-28
<b>Total</b>	<b>1.8</b>	<b>40</b>	

Source: Company, BOBCAPS Research

## Prefer TATA, JSP

With the steel cycle at a peak, we prefer players with robust capital allocation policies that preserve balance sheet health through the cycle. A disciplined approach also opens up the possibility of increasing payout to shareholders once comfort levels on leverage are reached. We thus prioritise capital discipline over aggressive expansion projects. In this context, we prefer TATA and JSP over JSTL and SAIL.

**Fig 14 – Valuation summary**

(Rs bn)	CMP (Rs)	Rating	Target price (Rs)	Upside (%)	EV/Sales		EV/EBITDA		Net income		P/B (x)		P/E (x)	
					FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY21A	FY22E	FY22E	FY23E
JSP	424	BUY	555	30.8	1.2	1.3	3.7	4.3	73	57	1.4	1.1	5.9	7.7
JSTL	749	HOLD	795	6.1	1.9	1.8	6.8	6.7	179	165	3.9	2.9	10.1	11.0
SAIL	134	HOLD	150	12.0	0.9	0.9	3.7	4.6	114	80	1.2	1.0	4.9	6.9
TATA	1,462	BUY	1,755	20.1	1.2	1.2	4.6	5.5	264	189	2.4	1.8	6.7	9.3

Source: Bloomberg, BOBCAPS Research

## Outlook on Indian steel sector

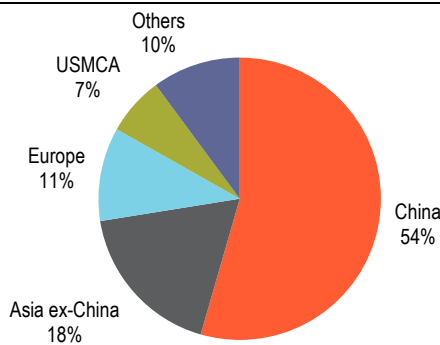
- Expect Indian steel prices to ease from current levels of US\$ 900/t and average at US\$ 748/t in FY22 and US\$ 653/t in FY23
- Strong cycle has restored balance sheet health, prompting Indian steel majors to launch new growth projects. Leverage likely to remain in check
- Despite rerating, steel companies still trade in line with or below historical multiples. Prefer TATA and JSP for their disciplined capital allocation

## Unprecedented world demand growth

While China helped arrest the decline in steel consumption in CY20, recovery outside China and particularly in the developed world has supported demand this year. The recovery is also running ahead of expectations. We expect global steel demand to grow by 6.7% in CY21 and 2.6% in CY22 as growth outside China reaches 10.9% and 4.6% in these years respectively. In our view, world demand ex-China will recover to 2019 levels this year itself.

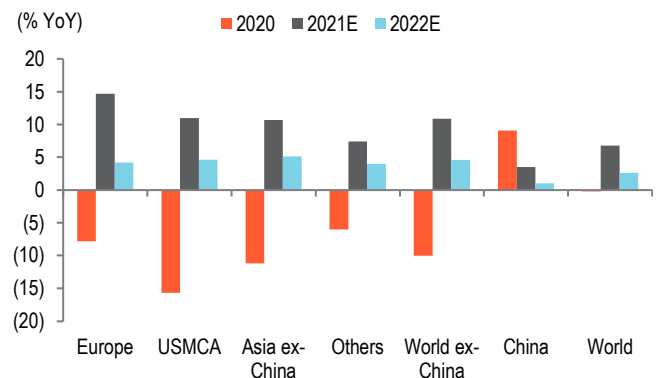
China has demonstrated strong demand growth in the first half of CY21 supported by a domestic stimulus as well as export demand, but we expect it to slow down during the second half with a domestic cool-down and reduced focus on exports due to production curtailments. We pencil in 3.5% growth in Chinese demand in CY21 and 1.0% growth in CY22.

**Fig 15 – 2021E demand break-up**



Source: World Steel Association, BOBCAPS Research

**Fig 16 – Regional demand growth forecast**



Source: World Steel Association, BOBCAPS Research



## Steel and raw material price forecasts

We expect steel demand to moderate over the next 6 months, while it could take 12-18 months to restore iron ore supply and 6-12 months for coking coal to readjust. We, therefore, believe steel margins will soften over the next 6-12 months. Under these assumptions, we expect Indian HRC price to average US\$ 748/t in FY22 (+17% YoY) and US\$ 653/t in FY23 (-13% YoY) from ~US\$ 900 currently (Fig 17).

In our view, two key drivers for steel prices over the next 6-12 months are tightness in steel trade after a reduction in exports from China and ramp-up of iron ore production by Vale and Australian majors. For iron ore, we expect tightness to persist through the first half of CY22 till the end of the wet season. At this stage, we await confirmation that Vale has secured two licenses at key mines which will pave the way for production increases.

**Fig 17 – Price forecast**

	FY19	FY20	FY21	FY22E	FY23E	FY24E
USDINR exchange rate	69.9	70.9	74.2	74.3	75.8	77.3
China HRC Export Price (US\$/t)	555	491	539	751	636	596
India HRC price (US\$/t equ)	642	528	640	748	653	650
YoY Change (%)	1.6	(17.8)	21.3	16.7	(12.7)	(0.4)
India HRC price (Rs'000/t)	44.9	37.4	47.4	55.5	49.5	50.3
YoY Change (%)	10.1	(16.7)	26.8	17.0	(10.9)	1.6
Iron ore CFR China (US\$/t)	68	91	123	170	140	115
Coking Coal Australia FOB (US\$/t)	201	165	116	172	163	150

Source: BOBCAPS Research, Bloomberg

If China does move to curtail steel sector emissions, the current bull run may be extended, which would mean another 12-24 months before the demand-supply balance is restored to mid-cycle levels. We consider this to be a 'US\$ 700 scenario' wherein Indian steel prices average at US\$ 700/t over FY23 and FY24. There is a possibility that the demand pull eases sooner than we expect and operating margins revert to the average cyclical level. Under this 'US\$ 600 scenario', we assume that steel prices will fall to US\$ 600/t levels on average over FY23 and FY24.

**Fig 18 – Scenario assumptions**

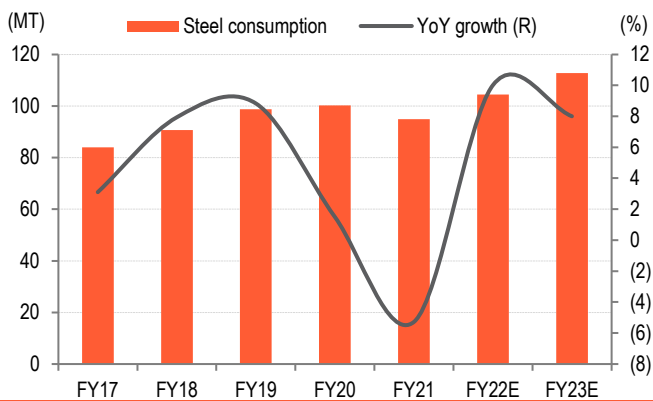
(US\$/t)	FY19	FY20	FY21	FY22E	FY23E	FY24E
Base case	642	528	640	748	653	650
US\$ 700 scenario				748	700	700
US\$ 600 scenario				748	603	597

Source: Bloomberg, BOBCAPS Research

### India: Expect demand recovery post October festive season

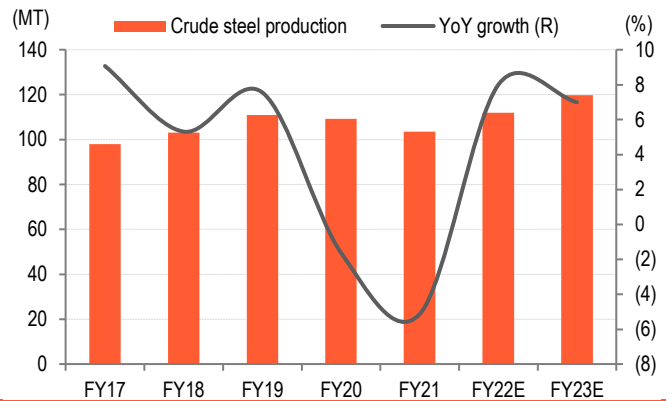
While steel demand in India has declined during the second Covid wave, the impact has been less than last year. We expect demand to recover post festive season and grow by ~10% in FY22 and 8% in FY23, supported by a significant push in infrastructure investments, offtake from the engineering and packaging segments, recovery in auto volumes, and to some extent revival in the building and construction segment. At this stage, we do not factor in material impact from a potential third pandemic wave.

**Fig 19 – India steel consumption growth**



Source: CMIE, BOBCAPS Research

**Fig 20 – India steel production growth**



Source: CMIE, BOBCAPS Research

### Crude steel production to recover

The Q1FY22 results of steel majors in India indicate that the impact of the pandemic on production has been significantly lower than on consumption. Steel majors have been taking advantage of export markets to capture higher realisations.

Factoring in ~10% recovery in production from large players and somewhat lower recovery from smaller players, we expect Indian steel crude production to grow at 8% in FY22 and 7% in FY23. With strong prices across regions, Indian steel companies have the option to export and hence utilisation levels could remain high irrespective of demand trends in India.

### Deleveraging has aided capex upcycle

With a strong steel cycle, India's steel industry has seen accelerated deleveraging and hence has taken the opportunity to launch the next wave of volume growth projects. Indian steel majors excluding SAIL have committed Rs 1.1tn of capex by FY25 to raise capacity by ~27mtpa. Some capacity additions such as JSTL's 5mtpa expansion at Dolvi is included in the 27mtpa, which is the result of earlier capital spend. In addition, SAIL has announced its intention to expand capacity by 13mt at its three plants, which could result in potential capex of Rs 0.65tn.

**Fig 21 – Beginning of capex upcycle for Indian steel industry**

Company	Capex plan (Rs tn)	Capacity expansion plan (mtpa)	Potential timeline
TATA	0.4	5.8	FY25
JSTL	0.5	13.5	FY25
JSP	0.2	6.3	FY25
AMNS India	NA	1.3	FY23
<b>Subtotal</b>	<b>1.1</b>	<b>26.9</b>	
SAIL	0.7	13	FY26-28
<b>Total</b>	<b>1.8</b>	<b>40</b>	

Source: Company, BOBCAPS Research

Sustainability of this round of capital expenditure has been significantly higher on several counts:

- **Competitive capital intensity:** JSTL and JSP are looking to add brownfield capacity at their respective Vijaynagar and Angul plants at a competitive capital intensity of US\$ 400/t. Both companies leverage available land and infrastructure, and JSTL is able to further leverage excess capacity of pellets, sinter and coke.
- **Efficiency and downstream focus:** Nearly a third of planned capex targets cost efficiency and downstream capacity, which will improve the resilience of earnings through the cycle. Cost efficiency projects entail pellet addition, coke making, improvement in iron ore mining and slurry pipelines, among others. Downstream expansion projects aim to augment value-added capacity to capture higher margins through the chain.
- **Leverage in check:** While pursuing this leg of capacity addition, steel majors are looking to maintain healthy leverage through the cycle, though the comfort level differs. On net debt/EBITDA, while JSP aims to remain below 1.5x, TATA considers 2x as a threshold and JSTL 2.75x.

Upon completion of targeted capacity addition, there is a possibility that further downstream expansion projects may follow. Also, we see scope to further expand acquired capacities. JSTL, JSP and TATA are currently pursuing improvement of operations within their acquired companies.

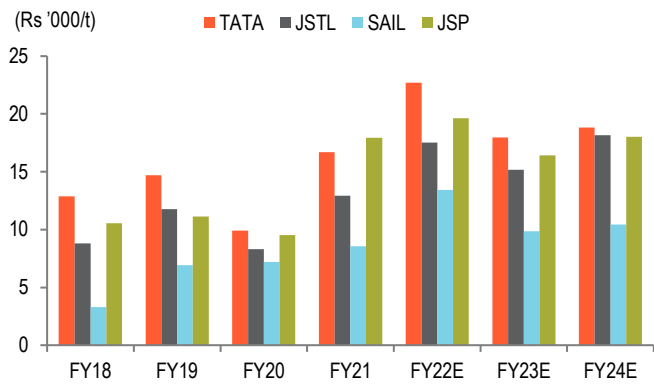
### Expect sustained profitability through FY24

Amongst our coverage companies, we expect TATA to derive the highest capex-driven earnings benefits with its backward integration into iron ore, margin capture across the chain aided by a focus on value-added sales, and efforts to drive higher margins from B2B and B2C channels.

JSTL and JSP remain in the middle of the pack with the absence of iron ore integration. JSTL emphasises on value-added products and enhancing margins from B2B and B2C channels. JSP stands to benefit more than others from its focus on structural and market gaps in long products with pickup in infrastructure capex. However, it has significantly lower exposure to flat products and a relatively higher proportion of semis.

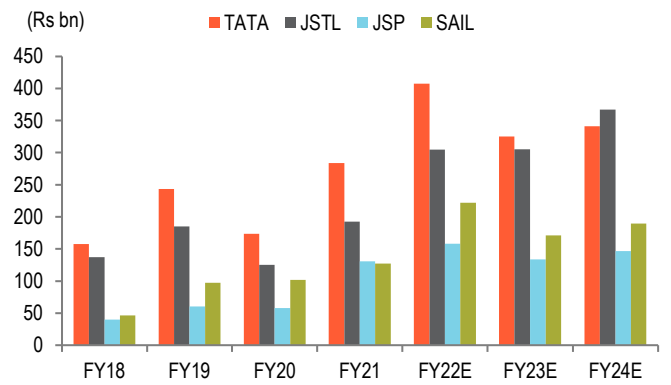
SAIL has been a clear laggard with its legacy plants and protracted expansion plan. Still, the company has substantial potential to improve margins upon plugging operational gaps in expansion plans and raising utilisation of new plants as infrastructure demand recovers.

**Fig 22 – Healthy EBITDA margin per tonne...**



Source: Company, BOBCAPS Research

**Fig 23 – ...supports sustained EBITDA generation**



Source: Company, BOBCAPS Research

### Base case earnings forecasts

For steel majors, we expect 57% YoY growth in aggregate FY22 EBITDA on the back of strong steel prices. As prices soften, we forecast aggregate EBITDA declining 16% in FY23 but then recovering to grow 11% over FY24. Earnings will likely remain resilient.

Amongst the majors, we expect JSTL to demonstrate the highest earning growth on the back of countercyclical investments toward expanding the Dolvi plant. JSP is projected to demonstrate the lowest growth given a pause on growth investments while it addressed high leverage and stabilised Angul operations.

Relative to consensus, we forecast slightly slower growth in FY22 on our conservative price assumptions and see a lower decline in FY23. We expect steel sector profit to recover part of the decline in FY23 with growth in volumes.

Fig 24 – Earnings forecasts

(Rs bn)	BOBCAPS				Consensus			Delta to consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
<b>Revenue</b>										
JSTL	781	1,203	1,232	1,246	1,231	1,264	1,232	(2.3)	(2.6)	1.1
JSP	390	439	420	432	467	442	437	(5.9)	(5.1)	(1.2)
SAIL	691	912	888	945	884	866	899	3.1	2.5	5.1
TATA	1,563	2,033	1,863	1,850	2,002	1,811	1,627	1.5	2.9	13.7
<b>Aggregate</b>	<b>3,425</b>	<b>4,586</b>	<b>4,402</b>	<b>4,472</b>	<b>4,583</b>	<b>4,383</b>	<b>4,195</b>	<b>0.1</b>	<b>0.4</b>	<b>6.6</b>
<b>YoY growth (%)</b>		<b>33.9</b>	<b>(4.0)</b>	<b>1.6</b>	<b>33.1</b>	<b>(4.4)</b>	<b>(4.3)</b>	-	-	-
<b>EBITDA</b>										
JSTL	201	340	330	392	372	332	335	(8.7)	(0.4)	16.9
JSP	144	145	123	135	156	124	113	(6.9)	(0.7)	19.0
SAIL	127	222	171	190	245	187	216	(9.6)	(8.5)	(12.1)
TATA	305	514	400	419	536	396	332	(4.1)	1.1	26.1
<b>Aggregate</b>	<b>778</b>	<b>1,221</b>	<b>1,024</b>	<b>1,136</b>	<b>1,310</b>	<b>1,038</b>	<b>997</b>	<b>(6.8)</b>	<b>(1.3)</b>	<b>13.9</b>
<b>YoY growth (%)</b>		<b>56.9</b>	<b>(16.1)</b>	<b>10.9</b>	<b>68.3</b>	<b>(20.7)</b>	<b>(4.0)</b>	-	-	-
<b>Net income adjusted</b>										
JSTL	79	179	165	211	206	175	171	(13.2)	(5.5)	23.5
JSP	53	73	57	67	76	56	41	(4.2)	0.2	62.7
SAIL	41	114	80	93	133	94	123	(14.3)	(15.3)	(24.0)
TATA	75	264	189	199	290	177	150	(8.9)	7.0	32.3
<b>Aggregate</b>	<b>248</b>	<b>630</b>	<b>490</b>	<b>570</b>	<b>705</b>	<b>502</b>	<b>485</b>	<b>(10.7)</b>	<b>(2.3)</b>	<b>17.5</b>
<b>YoY growth (%)</b>		<b>153.8</b>	<b>(22.2)</b>	<b>16.2</b>	<b>155.8</b>	<b>(28.8)</b>	<b>(3.4)</b>	-	-	-

Source: Bloomberg, BOBCAPS Research

## Capex vs. deleveraging outlook

Under our base case scenario, we estimate capex of Rs 390bn-450bn annually by our coverage companies. Despite this, net debt/EBITDA should remain well under control at 1.1-1.2x on average for the sector for FY22 and FY23 and further improve to 0.6x in FY24. Amongst our coverage, SAIL has the highest leverage but should still be well in check at ~1.1x by FY24.

While announcing capex, most steel majors have disclosed their targeted leverage through the cycle. JSP's target is sub-1.5x, TATA's is sub-2x and JSTL has a wider threshold of 2.75x (although its stated target is 3.75x). Though JSTL has lowered its threshold band in the current strong environment, it has left open the possibility of forging ahead with its aggressive growth policy even when the cycle cools down.

Though players are likely to adhere to this range with organic expansion, the impact of any inorganic acquisitions on leverage will be a key monitorable. TATA is interested in strengthening its long products franchise through inorganic expansion and has been vocal about its interest in next-door-neighbour, Neelachal Ispat Nigam. JSTL too has been actively taking advantage of interesting opportunities to expand its franchise.

From the perspective of shareholders, this wave of expansion does provide scope for free cash return and an increase in payout considering net debt is likely to drop significantly below targeted levels. However, at this point, we are seeing no clear signs from companies yet.

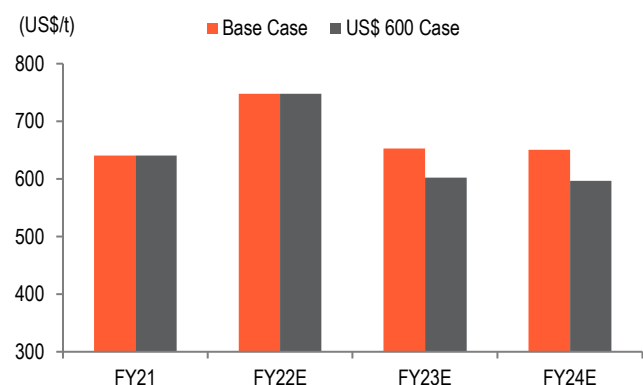
**Fig 25 – Leverage likely to be under control despite significant pick-up in capex**

(Rs bn)	BOBCAPS				Consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
<b>Capex</b>							
Jindal Steel	(94)	(185)	(180)	(125)	(181)	(178)	(118)
JSPL	(8)	(35)	(64)	(65)	(34)	(52)	(53)
SAIL	(30)	(49)	(75)	(75)	(66)	(67)	(60)
Tata Steel	(85)	(118)	(129)	(129)	(117)	(132)	(113)
<b>Aggregate</b>	<b>(216)</b>	<b>(388)</b>	<b>(447)</b>	<b>(394)</b>	<b>(399)</b>	<b>(429)</b>	<b>(344)</b>
<b>Net debt</b>							
Jindal Steel	476	496	397	195	507	468	381
JSPL	154	109	94	63	155	96	146
SAIL	365	273	238	207	258	150	(79)
Tata Steel	761	580	439	255	580	453	328
<b>Aggregate</b>	<b>1,757</b>	<b>1,458</b>	<b>1,168</b>	<b>720</b>	<b>1,501</b>	<b>1,167</b>	<b>776</b>
<b>Net debt to EBITDA (x)</b>							
Jindal Steel	2.4	1.5	1.2	0.5	1.4	1.4	1.1
JSPL	1.1	0.7	0.8	0.5	1.0	0.8	1.3
SAIL	2.9	1.2	1.4	1.1	1.1	0.8	(0.4)
Tata Steel	2.5	1.1	1.1	0.6	1.1	1.1	1.0
<b>Aggregate</b>	<b>2.3</b>	<b>1.2</b>	<b>1.1</b>	<b>0.6</b>	<b>1.1</b>	<b>1.1</b>	<b>0.8</b>

Source: Company, BOBCAPS Research

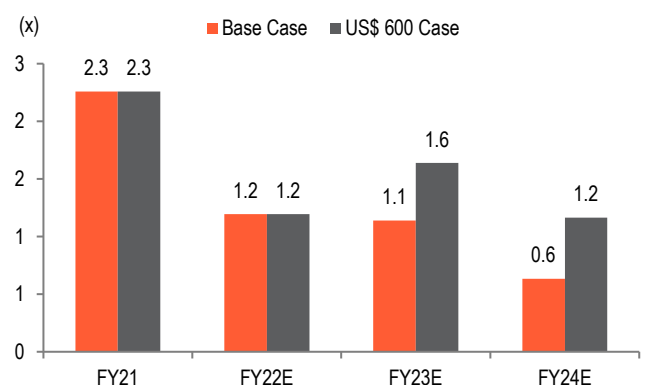
To test the downside to our assumptions, we analyse our scenario of Indian steel prices stabilising at a lower level of ~US\$ 600/t. Even in this scenario, we expect net debt/ EBITDA to remain well under control, with SAIL's leverage rising the most to 1.7x by FY24. Should steel prices remain strong for another 12-18 months, the windfall will significantly improve balance sheets and we suspect the industry would accelerate its pace of investments.

**Fig 26 – Testing downside for our coverage at price of US\$ 600/t...**



Source: BOBCAPS Research

**Fig 27 – ...shows leverage remains well under control**



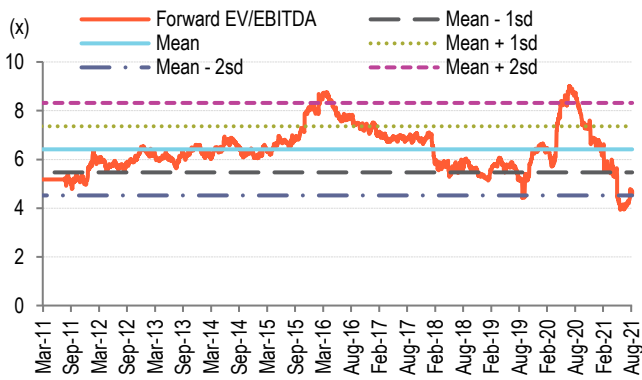
Source: BOBCAPS Research

## Valuation and Investment view

### Historical valuation trends

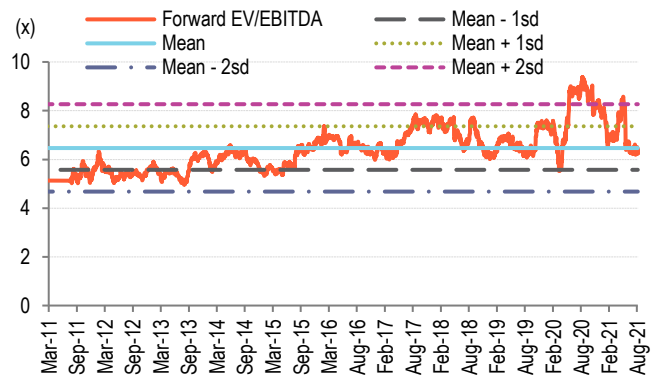
On EV/EBITDA, one-year forward indicators are not ideal as steel prices are at a peak. Looking at two-year forward multiples, JSTL is trading above its historical average, TATA is trading in line, and JSPL and SAIL are trading below the average.

**Fig 28 – EV/EBITDA 1Y forward – TATA**



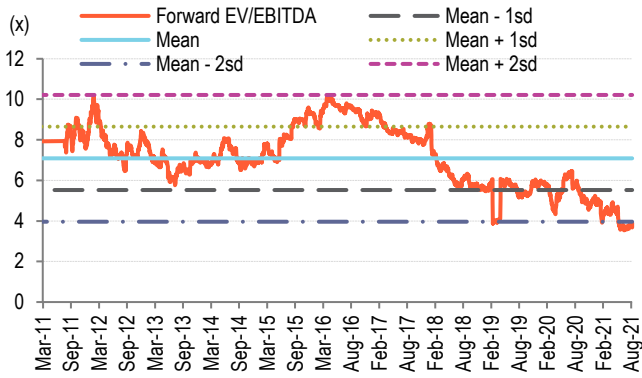
Source: Bloomberg, BOBCAPS Research

**Fig 29 – EV/EBITDA 1Y forward – JSTL**



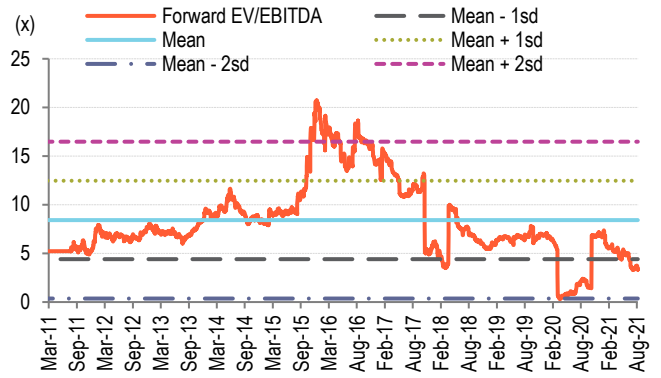
Source: Bloomberg, BOBCAPS Research

**Fig 30 – EV/EBITDA 1Y forward – JSP**



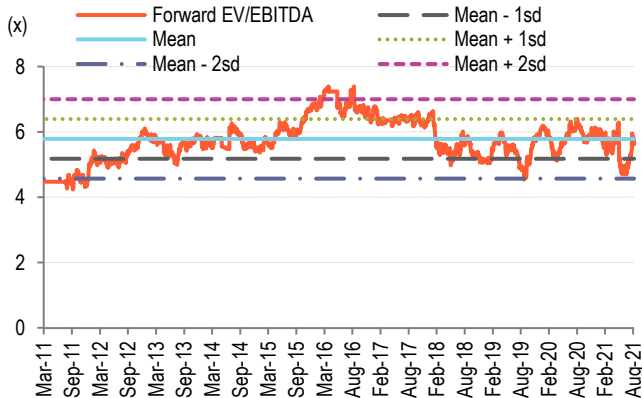
Source: Bloomberg, BOBCAPS Research

**Fig 31 – EV/EBITDA 1Y forward – SAIL**



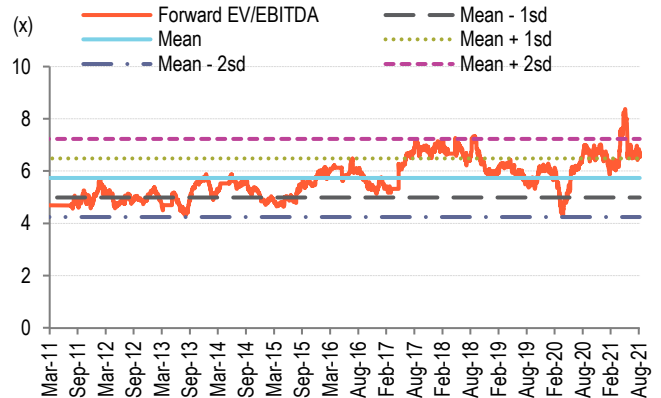
Source: Bloomberg, BOBCAPS Research

**Fig 32 – EV/EBITDA 2Y forward – TATA**



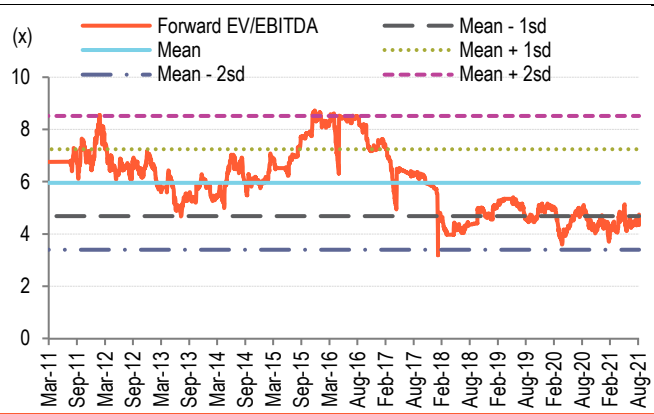
Source: Bloomberg, BOBCAPS Research

**Fig 33 – EV/EBITDA 2Y forward – JSTL**



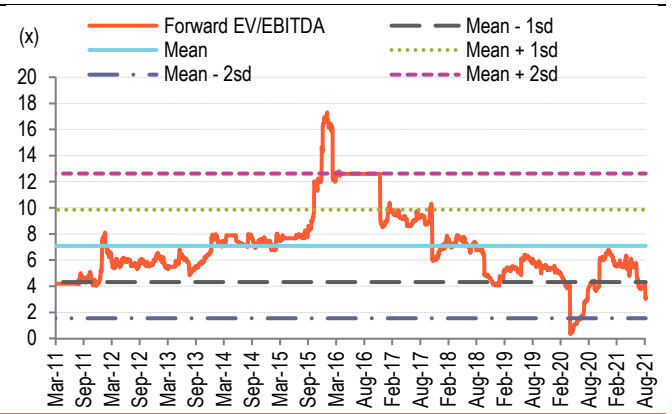
Source: Bloomberg, BOBCAPS Research

**Fig 34 – EV/EBITDA 2Y forward – JSP**



Source: Bloomberg, BOBCAPS Research

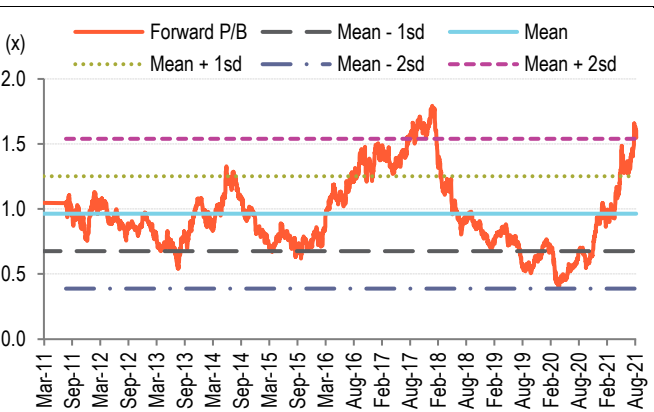
**Fig 35 – EV/EBITDA 2Y forward – SAIL**



Source: Bloomberg, BOBCAPS Research

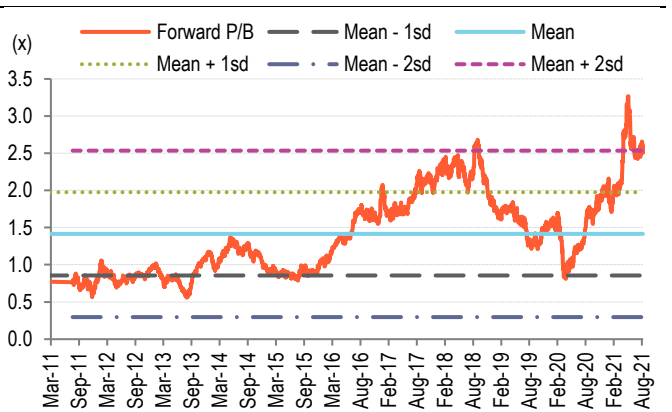
On P/B, all companies except JSPL are trading well above the historical range. This is probably the result of a significant restoration of balance sheet aided by the current strong steel cycle.

**Fig 36 – P/B 1Y forward – TATA**



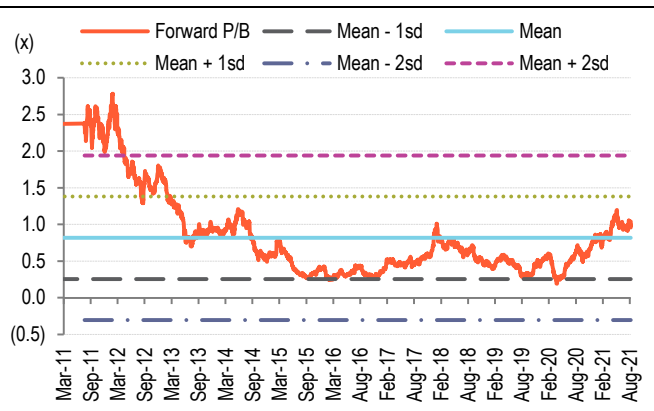
Source: Bloomberg, BOBCAPS Research

**Fig 37 – P/B 1Y forward – JSTL**



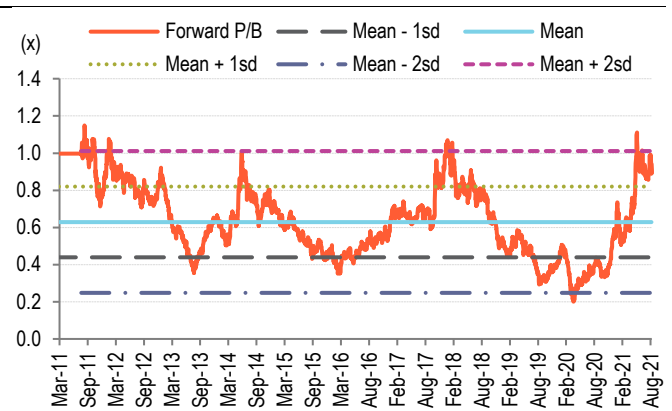
Source: Bloomberg, BOBCAPS Research

**Fig 38 – P/B 1Y forward – JSP**



Source: Bloomberg, BOBCAPS Research

**Fig 39 – P/B 1Y forward – SAIL**



Source: Bloomberg, BOBCAPS Research



## Investment view

We have BUY ratings on TATA and JSP. We like TATA for its disciplined investment approach even through the peak of the cycle. While JSP has seen a rerating on resolving its high leverage, we think the company has scope to further bridge the valuation gap to peers if it continues to demonstrate disciplined investment and credible progress on growth.

JSTL is positioned to benefit the most through this upcycle with completion of Dolvi expansion aided by a countercyclical investment policy, but we think valuations already price this in. The company has also consummated the Rs 190bn acquisition of Bhushan Power and Steel through its parent group during FY21 and marked it as an affiliate. We remain wary of JSTL's aggressive growth policy which could pose a risk if the commodity cycle takes a turn.

SAIL trades at a discount to the sector, partly because of the overhang of its decade-long expansion. The company needs to achieve production potential (for both crude steel and value-added products) and demonstrate margin benefits from the expansion. While SAIL is working to close operational gaps at plants and waiting for demand recovery to improve utilisation of new downstream plants, we do not have good visibility on timelines for the same.

**Fig 40 – Valuation and rating**

Company	Rating	CMP	Target Price	Upside (%)
TATA	BUY	1,462	1,755	20.1
JSTL	HOLD	749	795	6.1
JSP	BUY	424	555	30.8
SAIL	HOLD	134	150	12.0

Source: BOBCAPS Research

We run two steel price scenarios comprising the US\$ 600 case and the US\$ 700 case. Amongst our coverage stocks, TATA and SAIL exhibit higher sensitivity to change in steel prices. With 100% dependence on captive iron ore, they do not benefit from the reduction in iron ore prices in a lower steel price environment.

**Fig 41 – Sensitivity of target price to steel price**

(Rs)	Steel price (US\$/t)	TATA	JSTL	JSP	SAIL
US\$ 600 Case	600	1,185	640	465	100
Base Case	652	1,755	795	555	150
US\$ 700 Case	600	2,290	935	640	200
<b>Change from Base Case</b>					
US\$ 600 Case	(8)	(32)	(19)	(16)	(33)
US\$ 700 Case	(8)	30	18	15	33

Source: BOBCAPS Research

## Steel industry price trends

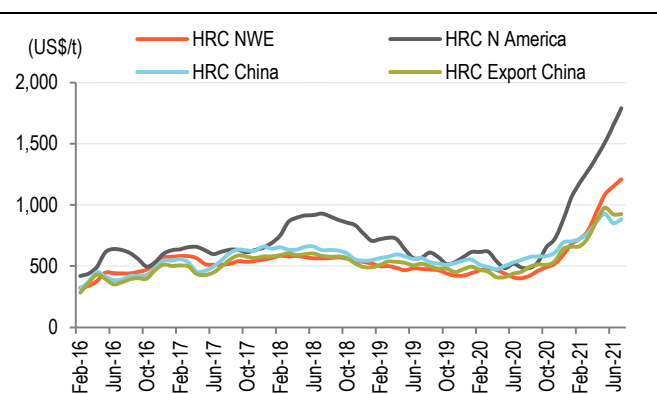
- Steel prices reflect tighter demand-supply balance rather than greening of the production process
- Expect steel demand to moderate over 6 months; iron ore supply to be restored in 12-18 months and coking coal in 6-12 months
- Steel prices forecast to soften over 6-12 months but to remain resilient

### Steel prices

#### Tight demand-supply dynamics

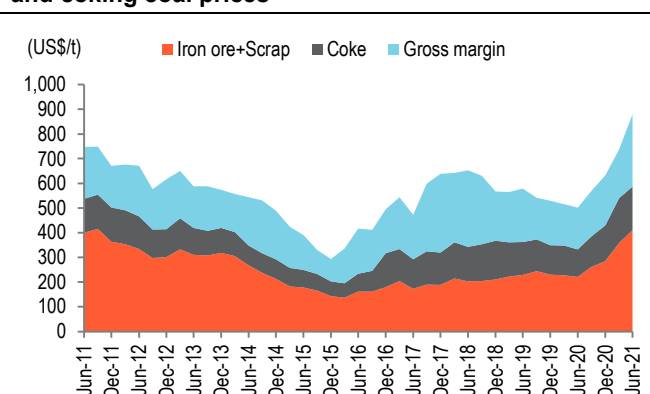
The recent upswing in global steel prices is a result of higher costs and constrained supply while demand surged. Historically, China prices are driven primarily by cost given adequate domestic capacity while prices in Europe and the US tend to be above cost and respond to export netback. Note that the cost of greening is yet to seep into prices as companies have not begun to invest meaningfully here. We now expect a combination of softening iron ore prices and gradual build-up of inventories with a meaningful ramp-up of supply to bear on global steel prices.

**Fig 42 – Regional prices reflect domestic tightness**



Source: Bloomberg, BOBCAPS Research

**Fig 43 – China HRC export price reflects higher iron ore and coking coal prices**



Source: Bloomberg, BOBCAPS Research

#### Strong demand in H1 likely to moderate

H1CY21 demand strength in China was fuelled by a large stimulus, sustained robustness of steel-containing goods exports, and front-loaded steel purchases on the expectation of production cuts in H2. Outside China, recovery from Covid-19 led to replenishing of inventory in the system (steel products and end products using steel), which bolstered demand.

**Fig 44 – Demand strength visible in recent revision by AMNS (published Jul'21)**

Market	Steel demand, YoY growth (%)			Index with 2019 as 100		
	2020	2021 new	2021 old	2020	2021 New	2021 old
China	9.0	3.0-5.0	1.0-3.0	109.0	112.3-114.5	110.1-112.3
Ex-China	(11.0)	12.0-13.0	8.5-9.5	89.0	99.7-100.6	96.6-97.5
Global	(1.0)	7.5-8.5	4.5-5.5	99.0	106.4-107.4	103.5-104.4

Source: AMNS, BOBCAPS Research

Demand is already showing early signs of seasonal adjustment but remains above previous year levels. Chinese demand was high partly due to continuing traction in exports of products containing steel. We expect seasonal weakness to be reflected in the coming months albeit with some delay due to pent-up demand. Beyond CY21, the World Steel Association forecasts that growth will moderate in CY22 and thereafter revert to trend level. Faster growth in CY21 means that easing would occur earlier in CY22.

**Fig 45 – World Steel Association (published Apr’21)**

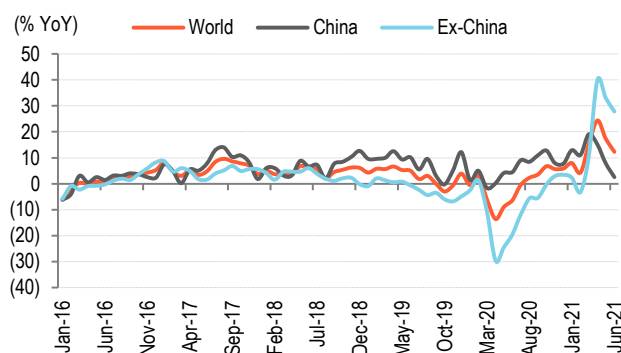
Market	Steel demand, YoY growth (%)			Index with 2019 as 100		
	2020	2021	2022	2020	2021	2022
China	9.1	3.0	1.0	109.1	112.4	113.5
Ex-China	(10.0)	9.30	4.70	90.0	98.4	103.0
Developed	(12.7)	8.20	4.20	87.3	94.5	98.4
Developing	(7.8)	10.20	5.20	92.2	101.6	106.9
Global	(0.2)	5.80	2.70	99.8	105.6	108.4

Source: World Steel Association, BOBCAPS Research

### China begins production cuts...

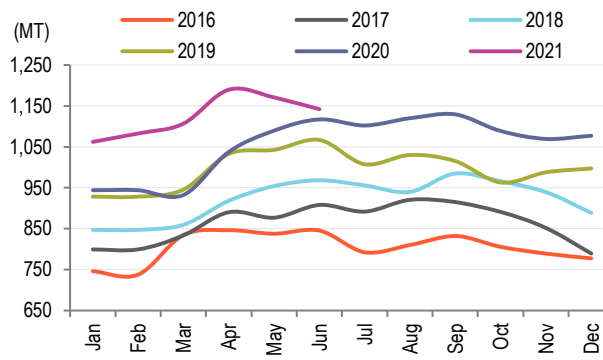
Crude steel production has responded to higher price signals both in and outside China, but nearly 20% of global capacity still remains constrained. China steel production normally eases over H2 and this trend has already begun. Authorities are further looking to curb production to control emissions. Steel production ex-China also reduces in the second half with summer and Christmas breaks.

**Fig 46 – Crude steel production has responded to higher prices both in and outside China**



Source: Bloomberg, BOBCAPS Research

**Fig 47 – China steel production normally eases over H2 and this trend has begun**

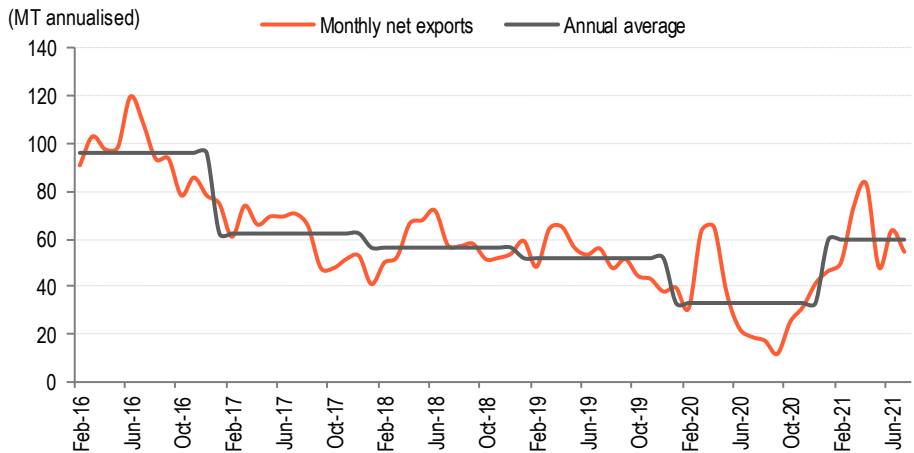


Source: Bloomberg, BOBCAPS Research

CRU estimates a 48mt production cut in China in H2CY21 (vs. 64mt higher production in H1). CRU highlights that hot metal production will fall at a lower rate of 28mt in H2, further extending good margin levels. In our view, hot metal production will fall faster in Q4CY21 due to expectations of regular “winter heating season” restrictions. Chinese provinces that have started to implement informal cuts include Jiangsu, Gansu (West China), Anhui (Central China), Shandong (East China), Hubei, and major steelmaking groups in Hebei, Liaoning, Fujian and Inner Mongolia.

We believe EAF production cuts are likely to be higher due to a combination of power shortages, higher margins for flat vs. long products, and cost disadvantages of scrap-based production given a young Chinese economy. A fall in China’s production could lower the country’s exports from the H1 run rate of 60mt annualised.

**Fig 48 – China’s exports have been bridging the gap in rest of world**



Source: Bloomberg, BOBCAPS Research

**...but other suppliers need to bridge the gap**

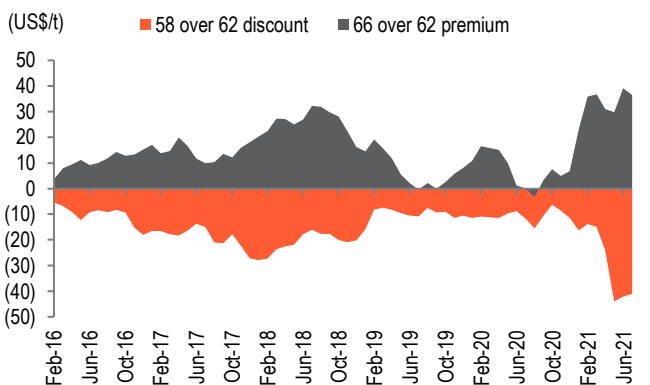
Over the medium term, we expect continuing support for the demand-supply balance as production cuts would be at a slower pace. As per CRU, China will likely close only obsolete capacities but not new ones. Note that China allows for swaps, so even when there is a production cut, effective utilisation of operating capacity can still be robust. Also, as China hints at withdrawing from the export market, we are witnessing a spate of new capacity from India. Russia and Turkey also has potential to meet some of the incremental export needs.

**Iron ore prices**

**Steady uptick from H2CY20**

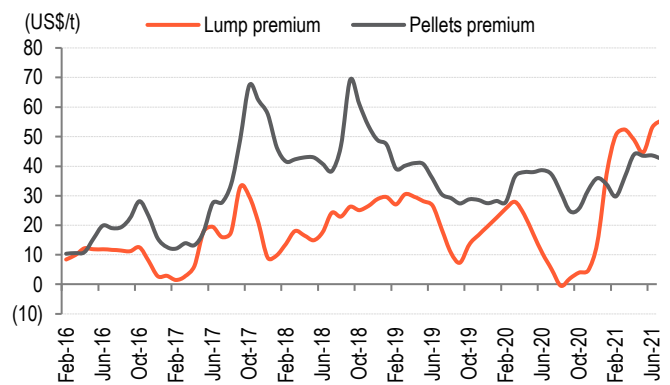
Iron ore prices increased during H2CY20 driven by a broader commodity rally, China’s demand strength (seaborne market share 75%) and inability of suppliers to respond quickly to the pickup in demand. Grade premia ore (66% over 62%) rose too and the discount (58% over 62%) widened. Lump and pellet premia also widened. Note that higher grade fines, lumps and pellets help lower the heat cycle and thereby improve productivity of a blast furnace, which means higher steel throughput.

**Fig 49 – Wide iron ore grade premia/discounts and...**



Source: Bloomberg, BOBCAPS Research

**Fig 50 – ...lump and pellet premia indicates tightness**



Source: Bloomberg, BOBCAPS Research

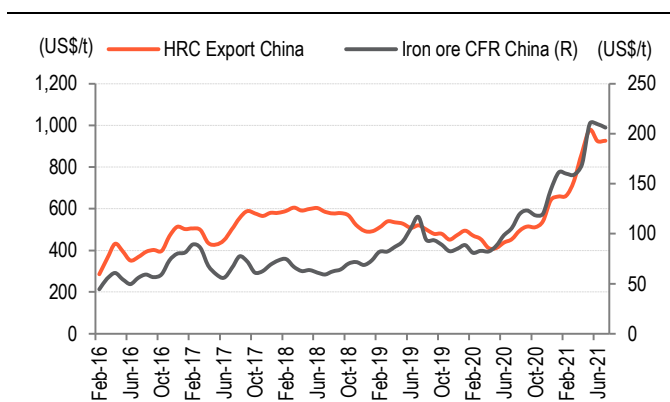
Premia for pellets at US\$ 55/t increased above 2019 levels. European steelmakers are battling severe pellet shortage due to lower supply from Brazil and strikes in Canada. However, once the supply-side catches up and demand moderates, we hope to see higher utilisation of lower grades, which in turn could help narrow the discount between 58% and 62% grades of iron ore. The spread is a key variable in our view. Similarly, lower demand for higher grade ore could result in lower premium.

**Expect gradual correction over CY22**

Steel demand has eased from a seasonal peak in Q2CY21 and iron ore supply has also recovered from the wet season in H1. However, H2CY21 prices remain elevated due to supply constraints. Note that Australian iron ore exports have picked up following the wet season but are still delivering only a constrained ramp-up. In H1, supply from global majors rose by just 1% YoY (vs. a 5% YoY rise in demand).

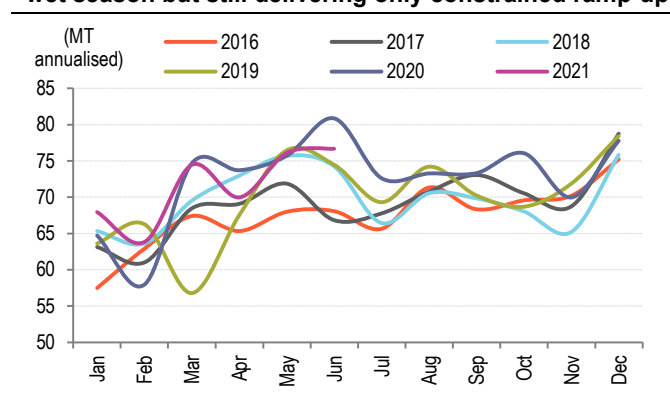
Overall, as we move close to Q4CY21, we expect Chinese demand to moderate alongside gradual recovery in Australian supply. Both lump and pellet premia are also expected to moderate, which would further support lower iron ore prices. Prices have already started to correct from US\$ 220/t levels in late July to US\$ 160/t levels in early August. However, substantial correction beyond this level is dependent upon renewal of Vale’s licenses (due in Q4). At this juncture, we do not assume renewal in Q4 and hence expect deeper price correction only towards H2CY22.

**Fig 51 – Iron ore prices have eased from a peak**



Source: Bloomberg, BOBCAPS Research

**Fig 52 – Australian iron ore exports have picked up post wet season but still delivering only constrained ramp-up**



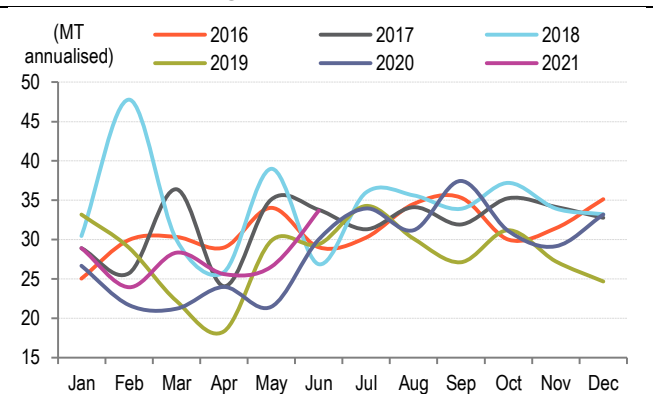
Source: Bloomberg, BOBCAPS Research

**Supply remains constrained at present...**

- Production from Australian majors has declined slightly, with exports down 2% YoY or by 8mt in H1CY21. Production issues and maintenance are capping Rio Tinto’s exports while FMG and Roy Hill have managed to increase exports YoY. Iron Bridge production is due only after a couple of years, which will add another 20mt from FMG. In CY21, an additional 10mt will come to market from smaller producers, mostly in H2.
- Brazilian output is recovering post wet season but a faster ramp-up remains challenging. Key Brazilian suppliers in CY21 are Vale (76%), CSN (7%), Minas Rio (5%), Samarco (2%), and others (10%).

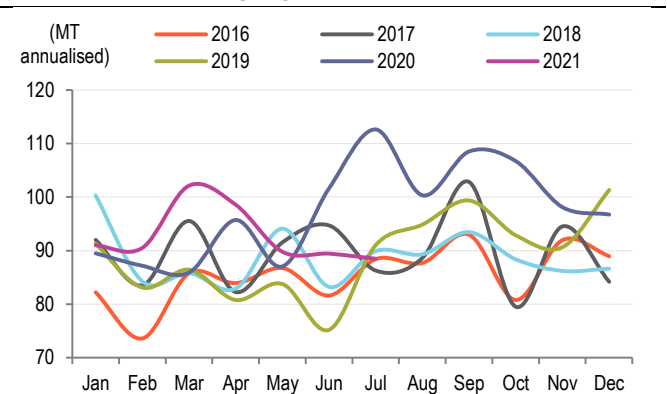
- Exports from northern Brazil increased 7% YoY in H1 led by a strong performance from producers in Minas Gerais (up 44% YoY or 18mt). Total Brazilian exports rose 23% but comprised largely of low-grade ore while pellet sales remained weak. Pellet feed supply remains a key issue as it produces tailings.
- Vale’s Southern and Southeastern System are exporting more low-grade ore. Vale could produce 330mt this year but we could see more lower grade supply. The company is seeking licenses for two mines (Itabira complex, Itaburucu mine) in Q4. These will be an important source for pellet feed. Vale was forced to interrupt production at Timbopeba and part of Alegria in June after prosecutors ordered evacuation of the area near the Xingu dam; the closures reduced production by 40ktpd (~15mtpa).
- Chinese iron ore production is increasing marginally while Indian exports declined despite higher prices. Canada, South Africa and Peru are gradually returning to normal, and new supply from smaller producers in various parts of the world is gradually looking up.
- Chinese iron ore producers are facing challenges on account of environmental norms and licenses. Many tailings dams in the country are upstream. As China upgrades low-grade ore with processing and beneficiation, it generates a high quantum of tailings.
- Indian exports remain low due to strong domestic demand and logistics constraints in Odisha.

**Fig 53 – Brazilian iron ore output is recovering post wet season but challenges ahead for ramp-up**



Source: Bloomberg, BOBCAPS Research

**Fig 54 – China iron ore imports have eased over past quarter after running high for nine months**



Source: Bloomberg, BOBCAPS Research

**...but ramp-up on the cards**

Looking at the revised guidance from five global iron ore majors, production is targeted to rise by 5-56mt HoH in H2CY21. However, the wide range indicates the uncertainty associated with this ramp-up.

**Fig 55 – Wide guidance range from iron ore majors for supply increase in H2CY21**

(MT)	CY20	H1CY21	Implied H2CY21		Guidance range CY21	
			Lower range	Upper range	Lower range	Upper range
VALE3	255	144	171	191	315	335
RIO	331	154	171	186	325	340
BHP	253	140	138	148	278	288
FMG	196	108	70	74	178	182
AAL	70	32	33	35	65	67
<b>Total supply from 5 majors</b>	<b>1,105</b>	<b>578</b>	<b>583</b>	<b>634</b>	<b>1,161</b>	<b>1,212</b>

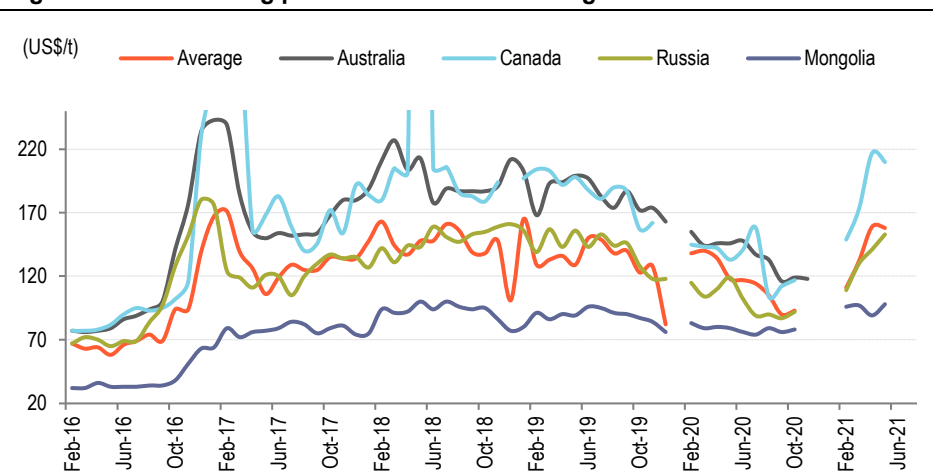
Source: Company, Bloomberg, BOBCAPS Research

## Coking coal prices also support steel prices

### Australia coal ban hits China

Following the ban on Australian coal, coking coal import prices in China have risen as it hasn't been able to fully replace Australia as a supplier. Imports have declined 31% YoY since Oct'20 and 43% YoY over Jan-May'21. While supply from Canada and Russia increased 78% YoY to 2.4mt each, imports from Mongolia are a concern, having dropped 41% YoY due to Covid-19 control measures. Also, domestic Chinese coking coal production was limited by inspection checks over the summer months.

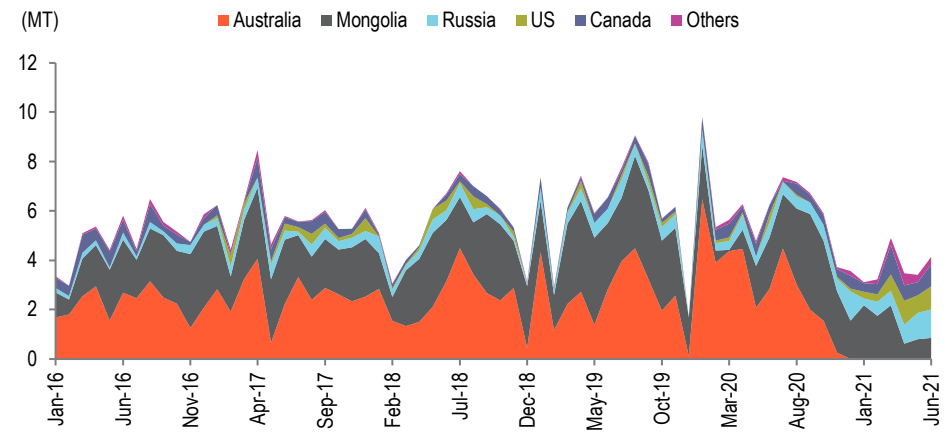
**Fig 56 – China is facing price escalations on coking coal from most sources**



Source: Bloomberg, BOBCAPS Research

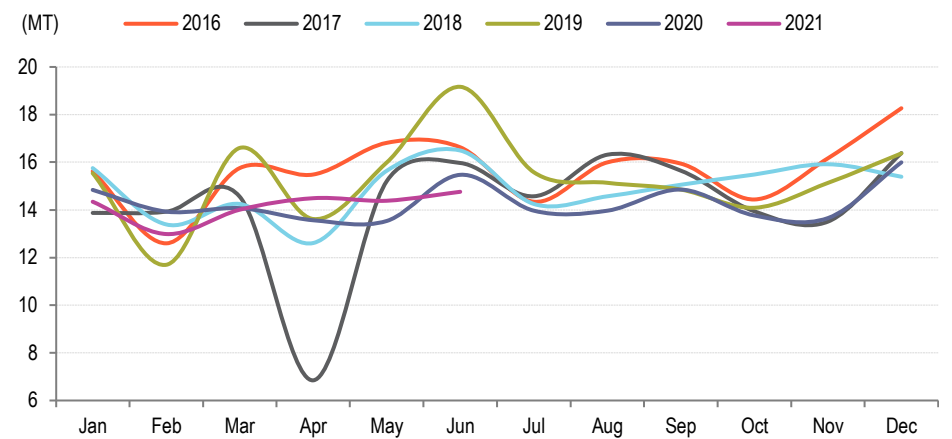
Non-Australian coking coal has been slow to change destination to China due to contractual commitments. Moreover, such a shift carries additional China policy risks and relationship risks with existing customers. The US is a marginal swing producer with high spot supply pulled into China by high prices. Mongolian and Russian supply face Covid-19 restrictions and logistics constraints in the near term.

**Fig 57 – China has not fully replaced Australian coking coal supply and also faces issues with Mongolia**



Source: Bloomberg, BOBCAPS Research

**Fig 58 – Despite Chinese ban, coking coal exports from Australia have only reduced 3%**



Source: Bloomberg, BOBCAPS Research

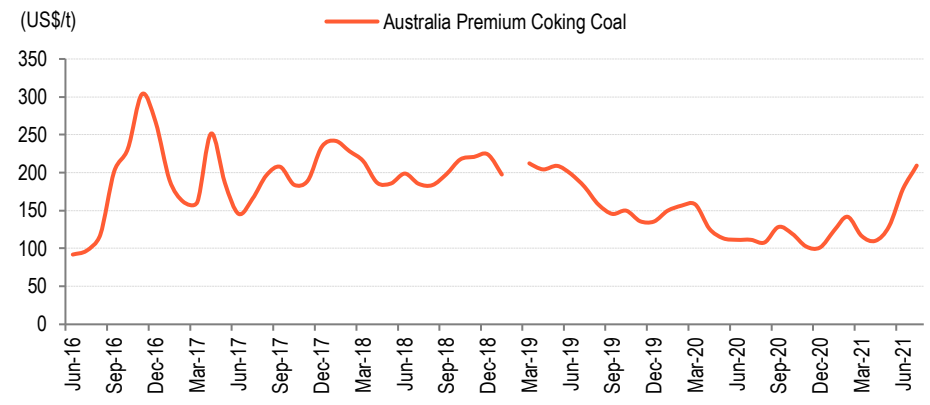
**Spot price volatility has increased**

Following the ban, volatility in Australian coking coal spot prices has increased. Due to tighter July/August supply, traders are taking bullish forward positions, further boosting prices. Glencore has settled the JFY annual benchmark price with Tohoku at US\$ 110/t from July onwards, up 59% YoY.

We expect a return to normal regional price differentials over CY22. We also expect China price differentials to narrow to historical levels over next couple of years. Key drivers will be increased coking coal exports from Russia and Mongolia to China, and a backing down of US and Canadian exports.



**Fig 59 – Australia premium coking coal**



Source: Bloomberg, BOBCAPS Research

**Long-term ban implications**

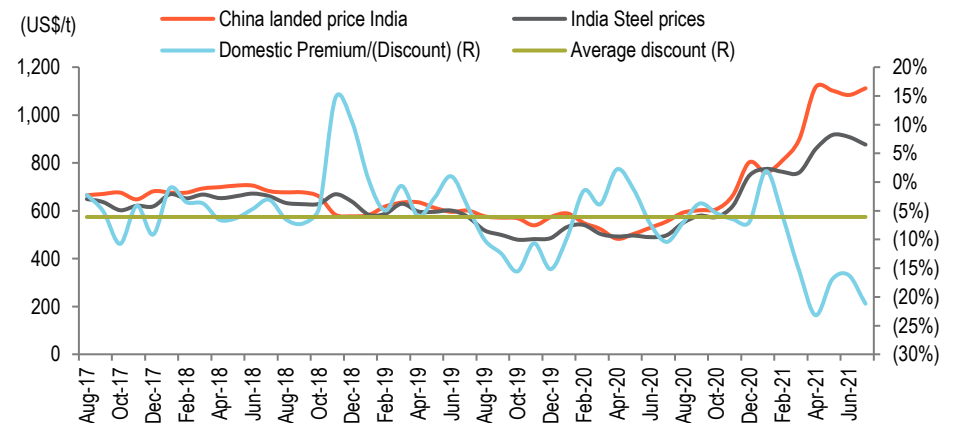
Over the longer term, we look at two scenarios: (1) no ban in 2025 and (2) the ban continuing even in 2025. Under the no-ban scenario, Mongolia, Australia and Russia will likely dominate exports to China. If the ban remains in place in 2025, Russian exports will likely be redirected to China from Atlantic and other Asian markets, with Australian coal switching to Asia and other Atlantic markets. This would mean all producers will maintain their production level and only trade flow will shift, with the price adjusting to new netbacks.

**Benefits of higher steel prices for Indian producers**

**Improved gross margin**

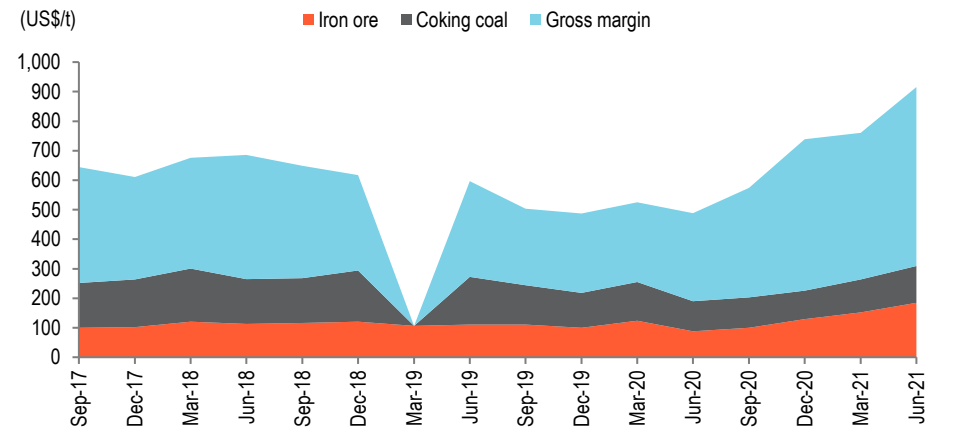
Indian steel prices are at a discount to Chinese landed prices. We expect some form of discount to continue over the longer term. Despite the discount, India gross margin trends have improved vis-à-vis historical levels thank to a robust pickup in global margins.

**Fig 60 – Indian steel prices are at a discount to Chinese landed price**



Source: Bloomberg, CMIE, SteelMint, BOBCAPS Research

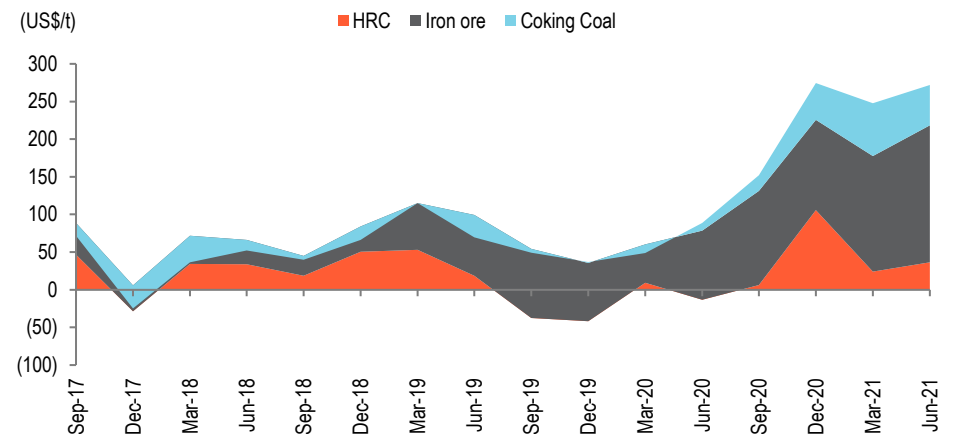
**Fig 61 – India gross margin trend has improved vis-à-vis historical trend**



Source: Bloomberg, CMIE, SteelMint, BOBCAPS Research

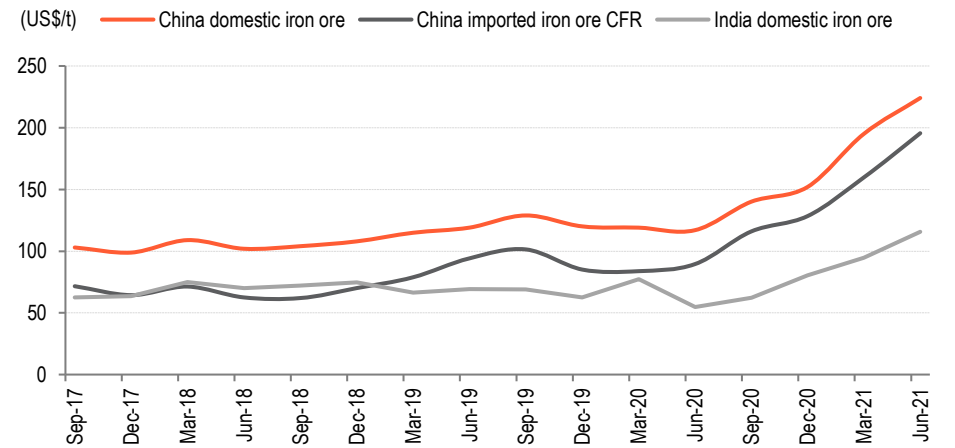
Due to relatively higher availability of local iron ore, the input price differential has been a key element of stronger gross margins for the Indian industry relative to China.

**Fig 62 – Indian producers benefit from iron ore price differential with China**



Source: Bloomberg, BOBCAPS Research

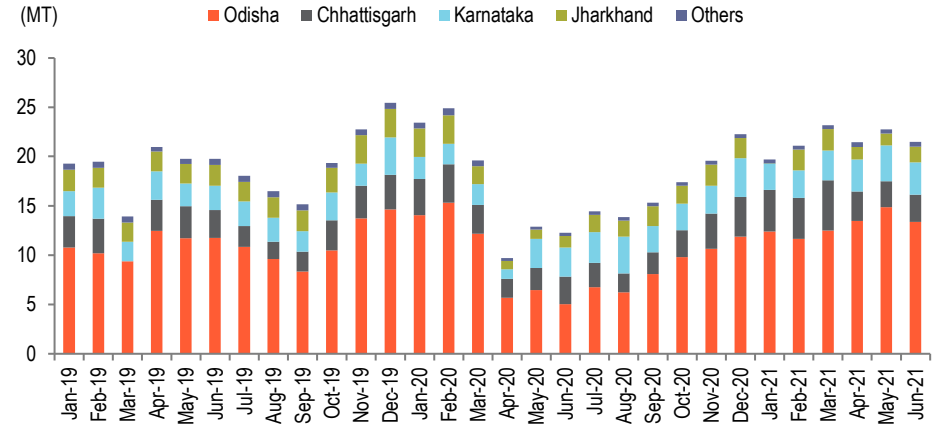
**Fig 63 – Iron ore price differential between India and imported CFR vs. domestic China prices**



Source: Bloomberg, CMIE, BOBCAPS Research

With ramp-up of auctioned mines, iron ore production in the country has recovered further, alleviating tightness in domestic prices and helping margins of Indian producers.

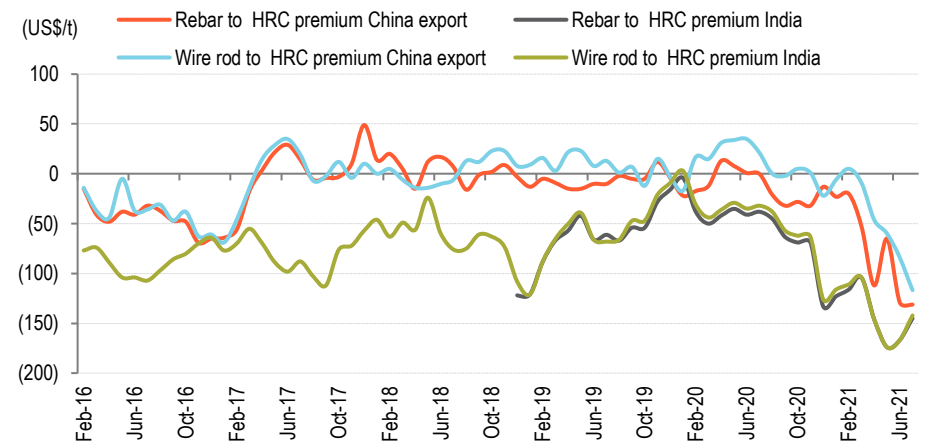
**Fig 64 – Iron ore production state-wise**



Source: SteelMint, BOBCAPS Research

Individual Indian companies with a higher percentage of HRC have fared better on margins than long producers, a trend likely to continue near term till demand for steel from the infrastructure sector improves.

**Fig 65 – Long products trade at a significant discount to HRC**

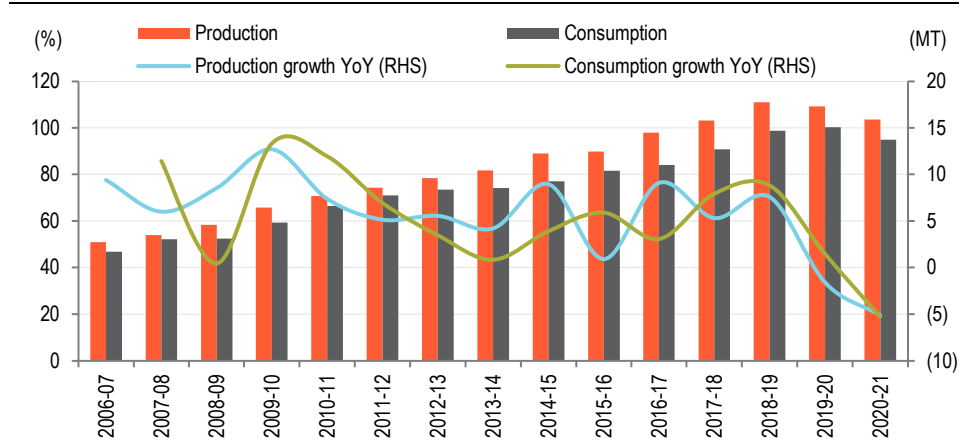


Source: Bloomberg, BOBCAPS Research

### India demand trends

Steel demand in India has remained robust. Indian companies, therefore, do not face volume risk but mainly margin risk. As long as margins remain elevated, companies will be able to fully exploit the same.

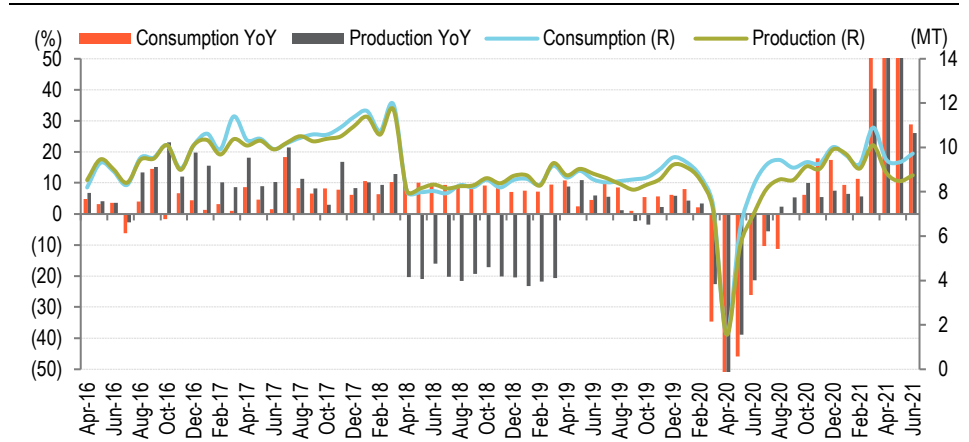
**Fig 66 – India long-term steel production vs. consumption**



Source: Bloomberg, BOBCAPS Research

India's medium-term steel production vs. consumption indicates that the country will soon need to expand its steel producing capacity to avoid turning into a meaningful net importer.

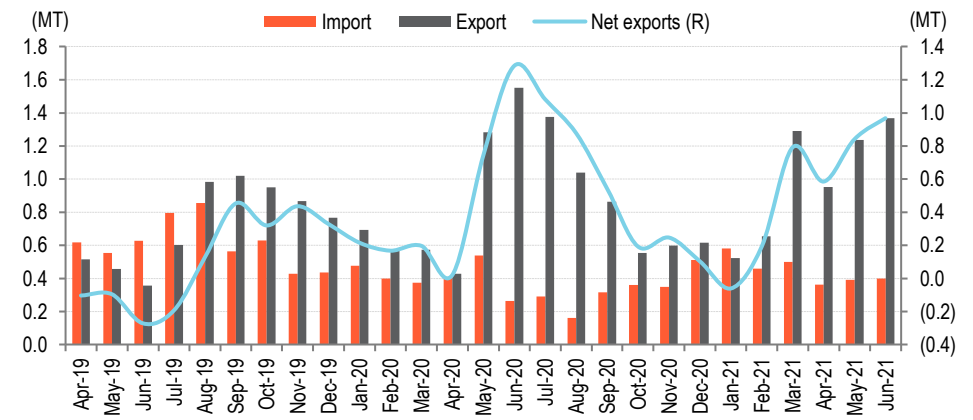
**Fig 67 – India medium-term steel production vs. consumption**



Source: Bloomberg, BOBCAPS Research

In the near term, however, due to muted domestic demand amid Covid lockdowns, Indian producers were able to earn higher prices by exporting more.

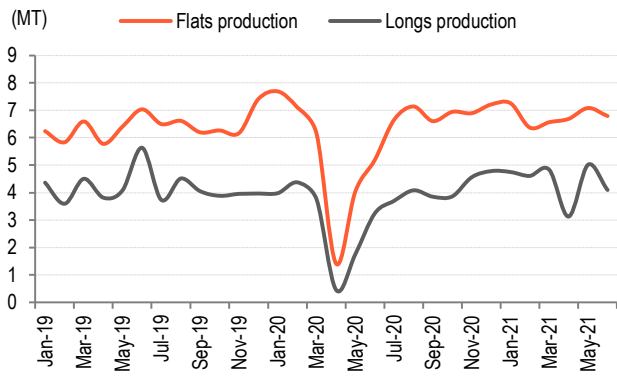
**Fig 68 – With muted domestic demand, exports have increased**



Source: Bloomberg, BOBCAPS Research

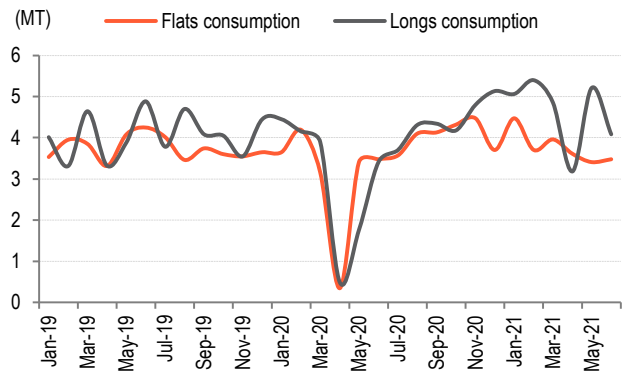
The Indian market is almost equally split between flat and long products.

**Fig 69 – Production**



Source: Bloomberg, BOBCAPS Research

**Fig 70 – Consumption**



Source: Bloomberg, BOBCAPS Research



Companies

**BUY**

TP: Rs 1,755 | ▲ 20%

**TATA STEEL**

| Metals &amp; Mining

| 16 August 2021

## Steady ship with disciplined approach – initiate with BUY

- We like TATA's disciplined approach to investment even during the peak of cycle
- Key stock catalysts include likely deleveraging, better viability of European operations and timely delivery on capital projects
- Initiate with BUY and a Sep'22 TP of Rs 1,755

**Kirtan Mehta, CFA**

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**Investment thesis:** While the recent steel margin upsurge has helped restore TATA's balance sheet, we believe it is important for cyclical companies to manage a healthy balance sheet through the cycle. This can be delivered by appropriate capital allocation, particularly during the peak of the cycle. We like TATA's approach of disciplined capital allocation towards growth that includes a combination of deleveraging, organic and inorganic growth options.

Thanks to better integration all the way to iron ore, its Indian operations are resilient through the cycle and generate leading margins in the domestic steel sector. TATA is working on improving the viability of its European operations via better cost control and production optimisation.

**Key growth catalysts:** (a) Meaningful debt reduction through FY22, (b) adherence to disciplined capital allocation, (c) demonstration of sustainability of European operations, (d) timely delivery on the pellet plant and CRM expansion at Kalinganagar, (e) completion of realignment across four identified verticals to simplify group structure.

**Sharp deleveraging in FY22:** We forecast 69% YoY growth in FY22 EBITDA riding on strong steel margins and higher utilisation at both Indian and European operations. With robust cash flow, we expect net debt/EBITDA to reduce to 1.1x in FY22, well below the company's target of 2.0x. Note, we expect TATA's EBITDA to decline by 22% in FY23 (+5% over FY24) as steel margins ease from the peak.

In the base case scenario, TATA's net debt/EBITDA is projected to drop to 0.6x by FY24. Even in our US\$ 600/t steel price scenario, we expect this metric to remain at 1.4x.

**Initiate with BUY:** We value TATA at 6.5x Sep'22E EBITDA, a premium to the sector multiple of 6.0x, to arrive at a Sep'22 TP of Rs 1,755. At the current price, the stock offers 20% upside.

Ticker/Price	TATA IN/Rs 1,462
Market cap	US\$ 23.7bn
Free float	66%
3M ADV	US\$ 229.7mn
52wk high/low	Rs 1,482/Rs 343
Promoter/FPI/DII	34%/22%/19%

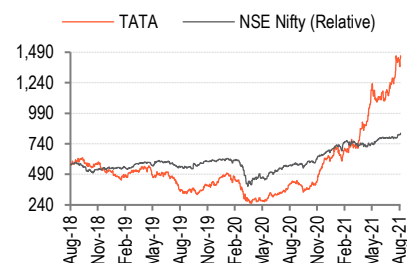
Source: NSE | Price as of 13 Aug 2021

### Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs bn)	1,563	2,033	1,863
EBITDA (Rs bn)	305	514	400
Adj. net profit (Rs bn)	75	264	189
Adj. EPS (Rs)	62.2	219.2	156.9
Consensus EPS (Rs)	70.0	235.1	153.0
Adj. ROAE (%)	10.1	30.3	17.3
Adj. P/E (x)	23.5	6.7	9.3
EV/EBITDA (x)	8.9	5.2	6.1
Adj. EPS growth (%)	175.4	252.4	(28.4)

Source: Company, Bloomberg, BOBCAPS Research

### Stock performance



Source: NSE

## Investment thesis

### Disciplined capex approach

TATA aims to maintain net debt/EBITDA below 2x and EBITDA/interest coverage under 4x through the cycle. After planned gross debt reduction of US\$ 2bn in FY22, the company aims to allocate US\$ 1bn annually to reduce debt prior to allocation for organic growth over the medium term.

Management has demonstrated this philosophy by deferring TSK (Tata Steel Kalinganagar) expansion in FY20 and following a gradual, phased implementation of this project to keep capital commitments in line with cash flow generation. TATA has also focused on running European operations on its own cash flow generation ability and has been minimising additional commitments from India operations.

### Reasonable capex commitments

The company aims to manage annual capex at Rs 100bn-120bn (US\$ 1.3bn-1.6bn). For FY22, it plans to allocate Rs 75bn for Indian operations and GBP 350mn for European operations. The main capex commitment includes Rs 170bn for TSK expansion and Rs 40bn for expansion of iron ore mines by ~15mtpa to cater to the increased requirements for Tata Steel BSL (TSBSL) and the TSK expansion.

### Balance sheet resilience through the cycle

Even after meeting planned capex commitments, we expect the company's net debt/EBITDA to fall to 0.6x by FY24. Even in the US\$ 600 steel price scenario, we expect net debt/EBITDA to remain at ~1.4x by FY24.

### Multiple growth drivers

With deferral of the Kalinganagar expansion in FY20, near-term earnings growth will now be driven by volume recovery of 1mt each in Indian and European operations in FY22, and completion of margin enhancement projects in FY23. At its Kalinganagar plant, the company is targeting completion of the pellet unit to lower steel production cost and a cold roll mill to improve margins. The next phase of volume growth will be from FY25 as it completes 5mtpa of expansion at the Kalinganagar plant to raise total Indian capacity to 25mtpa.

TATA is open to pursuing inorganic growth for building up its long products franchise. The company is interested in pursuing Neelachal Ispat Nigam (NIL: 1.1mtpa steel capacity) as and when it is available for divestment. NIL has an incomplete long products facility located adjacent to TATA's plant.

Beyond 2025, management has laid out its vision to expand capacity by another 15mtpa to 40mtpa through a mix of the organic and inorganic routes. This may include development of steel recycling units.



### **Leading margins**

TATA earned an EBITDA margin of Rs 16.7k/t in FY21, which was close to the top end of the Rs 8.5k-17.9k/t range of India's four steel majors. We expect its margin to improve to Rs 22.7k/t over FY22 with stronger steel prices. TATA's Indian operations deliver leading operating margins amongst Indian steel companies. The company benefits from captive iron ore mines, a skew towards flat products and high downstream integration to capture value-add margins. It focuses on branded products to enhance margins from the B2C sales channel and also offers B2B services and solutions to cater to medium and small enterprises.

TATA's Europe margins have recovered following a reduction of EUR 200mn of cost overheads and improvement in benchmark steel margins. The company is pursuing separation of its Netherlands and UK operations to further deepen cost initiatives and improve its resilience through the cycle.

### **ESG alignment**

TATA is focusing on a steel recycling unit as a step towards improving its carbon footprint. After stabilising operations of a 0.5mtpa EAF plant at Rohtak (Haryana), it is looking to develop a 5mtpa domestic scrap-based EAF capacity to cater to requirements for long products within the region. The company further plans to set up a demonstration plant deploying Hisarna technology and will then test the same on commercial scale at its Netherlands operations. TATA is also working with the local government in the Netherlands for potential carbon capture and storage.

## Valuation methodology

### Forecasts

We forecast 69% YoY growth in FY22 EBITDA with strong steel margins and improved utilisation in Indian and European operations. Robust cash flow should aid reduction in net debt/EBITDA to 1.1x, well below the company's target of 2x.

As margins ease from the peak level, we expect a 22% YoY decline in FY23 EBITDA (+5% in FY24). TATA will likely face a higher decline in earnings than peers in the absence of near-term volume growth. Its capex-driven earnings growth is limited to the addition of a pellet plant and CRM plant at TSK operations.

**Fig 1 – TATA: Earnings forecasts**

(Rs bn)	Actual	Expected			Consensus			Delta to Consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	1,563	2,033	1,863	1,850	2,002	1,811	1,627	1.5	2.9	13.7
EBITDA	305	514	400	419	536	396	332	(4.1)	1.1	26.1
Net income	75	264	189	199	290	177	150	(8.9)	7.0	32.3

Source: Company, Bloomberg, BOBCAPS Research

**Fig 2 – Key assumptions**

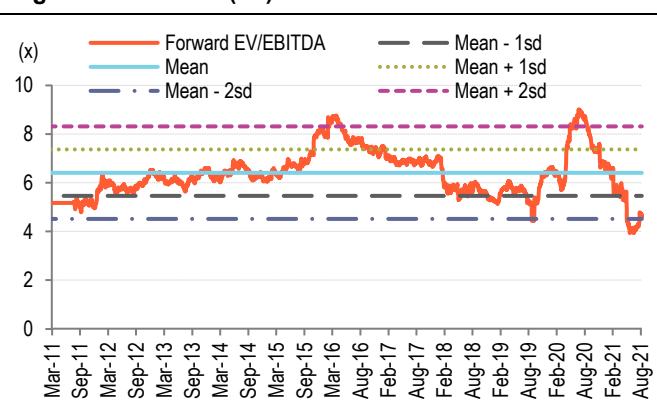
Parameter	FY21	FY22E	FY23E	FY24E
Sales India (mt)	7.3	8.1	8.2	8.2
Sales Europe (mt)	8.8	9.6	9.6	9.6
HRC Price India (US\$/t)	640	748	653	650
EBITDA Standalone (Rs '000/t)	18.1	23.6	18.5	18.6

Source: Company, BOBCAPS Research

### Valuation relative to history

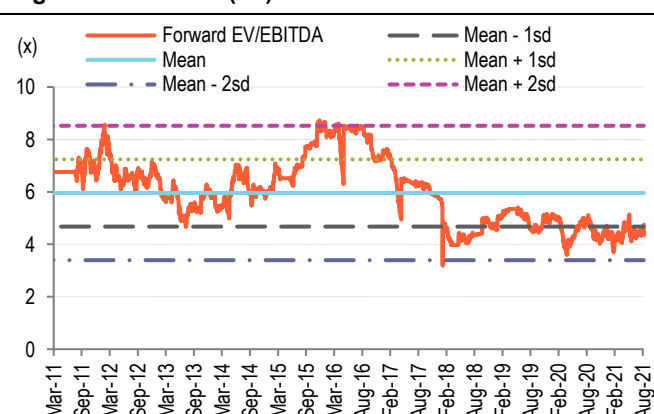
TATA is trading at 4.7x 1Y EBITDA and 5.8x 2Y EBITDA on consensus estimates. While the 1Y EV/EBITDA multiple appears low on peak earnings, the 2Y multiple is in line with the historical range of 6.0-6.5x over a 5-10-year period.

**Fig 3 – EV/EBITDA (1Y) band**



Source: Bloomberg, BOBCAPS Research

**Fig 4 – EV/EBITDA (2Y) band**



Source: Bloomberg, BOBCAPS Research

## Initiate with BUY

We initiate coverage on TATA with a BUY rating and a Sep'22 TP of Rs 1,755. We value the stock at a one-year forward EV/EBITDA multiple of 6.5x, a premium to our target multiple of 6.0x for the Indian steel sector and in line with the stock's historical trading average over the past 5-10 years. We use Sep'23E EBITDA as the base year for valuation and apply a one-year forward multiple.

**Fig 5 – Valuation summary**

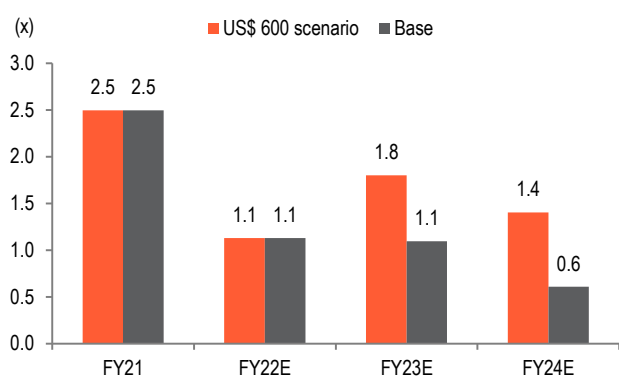
(Rs bn)	Value
Sep'23E EBITDA	409
Target EV/EBITDA multiple	6.5
<b>EV</b>	<b>2,662</b>
Net debt FY22E	580
KPO Phase II CWIP at 50%	35
<b>Equity value</b>	<b>2,116</b>
Fair value per share (Rs)	1,757
<b>Target price Sep'22 (Rs) (rounded to nearest Rs 5)</b>	<b>1,755</b>

Source: BOBCAPS Research

## Sensitivity to steel prices

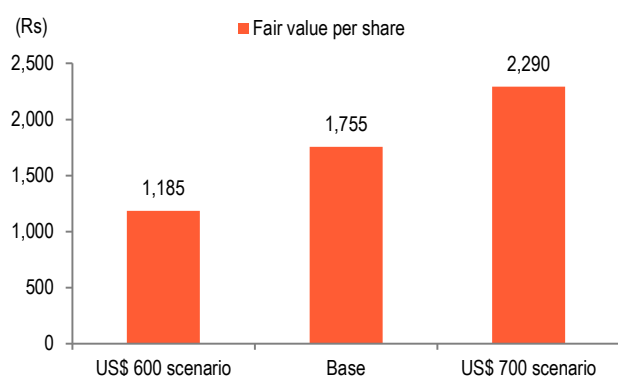
Our base case assumes Indian steel prices at US\$ 652/t over FY23-FY24. To test the downside to our assumptions, we analyse a scenario where prices stabilise at ~US\$ 600/t. Even if this happens, we expect TATA's net debt/EBITDA to remain well under control. The company exhibits high sensitivity to changes in steel price with no offset from changes in iron price against steel as it uses entirely captive production. We highlight below the fair value per share for a US\$ 600 and a US\$ 700 scenario.

**Fig 6 – TATA's leverage remains under control**



Source: Company, BOBCAPS Research

**Fig 7 – TATA has higher sensitivity to steel prices**



Source: Company, BOBCAPS Research

## Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Steel prices have been supported by sharp demand recovery in China and the rest of the world, as well as raw material inflation supported by supply issues. Key downside risks to our estimates are slower recovery in the global economy, or an unfavourable change in global demand-supply balance for steel and its raw materials, leading to lower prices than our assumptions.

## Company-specific risks

- TATA is exposed to risk of delay in implementation of its capital investment plan including expansion, which could impact its earnings growth.

## Financials

### Income Statement

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Total revenue</b>	<b>1,490</b>	<b>1,563</b>	<b>2,033</b>	<b>1,863</b>	<b>1,850</b>
EBITDA	178	305	514	400	419
Depreciation	(87)	(92)	(93)	(97)	(101)
EBIT	91	213	421	303	318
Net interest inc./(exp.)	(76)	(76)	(50)	(41)	(30)
Other inc./(exp.)	18	9	11	10	10
Exceptional items	(49)	(10)	0	0	0
EBT	(14)	138	385	275	301
Income taxes	26	(57)	(96)	(69)	(84)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	2	3	3	3	3
<b>Reported net profit</b>	<b>27</b>	<b>75</b>	<b>264</b>	<b>189</b>	<b>199</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>27</b>	<b>75</b>	<b>264</b>	<b>189</b>	<b>199</b>

### Balance Sheet

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	214	260	291	240	235
Other current liabilities	194	307	305	279	277
Provisions	17	47	56	51	51
Debt funds	1,133	819	671	548	400
Other liabilities	185	247	264	242	240
Equity capital	11	12	12	12	12
Reserves & surplus	724	730	988	1,172	1,365
Shareholders' fund	762	775	1,058	1,259	1,470
<b>Total liab. and equities</b>	<b>2,504</b>	<b>2,455</b>	<b>2,645</b>	<b>2,619</b>	<b>2,674</b>
Cash and cash eq.	81	58	90	109	145
Accounts receivables	79	95	124	102	101
Inventories	311	333	402	361	353
Other current assets	117	116	150	138	137
Investments	35	43	43	43	43
Net fixed assets	1,195	1,190	1,150	1,157	1,111
CWIP	189	181	241	261	331
Intangible assets	24	30	35	40	44
Deferred tax assets, net	0	0	0	0	0
Other assets	509	452	452	452	452
<b>Total assets</b>	<b>2,504</b>	<b>2,455</b>	<b>2,645</b>	<b>2,619</b>	<b>2,674</b>

### Cash Flows

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Cash flow from operations</b>	<b>130</b>	<b>397</b>	<b>321</b>	<b>326</b>	<b>339</b>
Capital expenditures	(111)	(85)	(118)	(129)	(129)
Change in investments	4	(9)	0	0	0
Other investing cash flows	(133)	75	11	10	10
<b>Cash flow from investing</b>	<b>(240)</b>	<b>(19)</b>	<b>(108)</b>	<b>(118)</b>	<b>(119)</b>
Equities issued/Others	0	1	0	0	0
Debt raised/repaid	221	(314)	(148)	(123)	(148)
Interest expenses	(76)	(76)	(50)	(41)	(30)
Dividends paid	(11)	(30)	(26)	(19)	(20)
Other financing cash flows	22	19	48	(1)	17
<b>Cash flow from financing</b>	<b>157</b>	<b>(401)</b>	<b>(181)</b>	<b>(189)</b>	<b>(185)</b>
<b>Chg in cash &amp; cash eq.</b>	<b>47</b>	<b>(23)</b>	<b>33</b>	<b>19</b>	<b>36</b>
<b>Closing cash &amp; cash eq.</b>	<b>81</b>	<b>58</b>	<b>90</b>	<b>109</b>	<b>145</b>

### Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	22.6	62.2	219.2	156.9	164.9
Adjusted EPS	22.6	62.2	219.2	156.9	164.9
Dividend per share	9.5	24.9	21.2	16.1	16.6
Book value per share	611.0	616.5	830.8	982.9	1,143.2

### Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	1.7	1.7	1.3	1.3	1.2
EV/EBITDA	14.6	8.9	5.2	6.1	5.4
Adjusted P/E	64.7	23.5	6.7	9.3	8.9
P/BV	2.4	2.4	1.8	1.5	1.3

### DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	76.6	50.3	68.6	68.6	65.8
Interest burden (PBT/EBIT)	38.9	70.0	91.3	90.8	94.8
EBIT margin (EBIT/Revenue)	6.1	13.6	20.7	16.3	17.2
Asset turnover (Rev./Avg TA)	61.6	63.0	79.7	70.8	69.9
Leverage (Avg TA/Avg Equity)	3.4	3.4	2.9	2.4	2.1
Adjusted ROAE	3.8	10.1	30.3	17.3	15.5

### Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
<b>YoY growth (%)</b>					
Revenue	(3.7)	4.9	30.1	(8.4)	(0.7)
EBITDA	(39.3)	71.1	68.6	(22.2)	4.7
Adjusted EPS	(73.6)	175.4	252.4	(28.4)	5.1
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	12.0	19.5	25.3	21.5	22.6
EBIT margin	6.1	13.6	20.7	16.3	17.2
Adjusted profit margin	1.8	4.8	13.0	10.1	10.7
Adjusted ROAE	3.8	10.1	30.3	17.3	15.5
ROCE	5.6	11.3	22.5	15.5	15.8
<b>Working capital days (days)</b>					
Receivables	19	22	22	20	20
Inventory	76	78	72	71	70
Payables	60	75	70	60	60
<b>Ratios (x)</b>					
Gross asset turnover	0.6	0.6	0.8	0.7	0.7
Current ratio	1.0	0.8	1.0	1.1	1.1
Net interest coverage ratio	1.2	2.8	8.4	7.4	10.6
Adjusted debt/equity	1.4	1.0	0.5	0.3	0.2

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**HOLD**

TP: Rs 795 | ▲ 6%

**JSW STEEL**

| Metals &amp; Mining

| 16 August 2021

## Aggressive approach a cyclical risk – initiate with HOLD

- Countercyclical investment will drive highest earnings growth for JSTL during this upcycle but approach not sustainable through the cycle
- Delivery on timely ramp-up of Dolvi expansion a key stock catalyst but appears priced in
- Initiate with HOLD and a Sep'22 TP of Rs 795

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**Investment thesis:** JSTL is positioned well to benefit from completion of the Dolvi plant in FY22 through its countercyclical investment approach. Further, in line with its aggressive growth policy, the company has launched another 5mtpa Vijaynagar expansion project to take its domestic capacity to more than 30mtpa (equivalent to 20% of Indian capacity) by FY25. While an ambitious growth policy offers benefits during this upcycle, we remain concerned about the risk it poses to the balance sheet should the cycle turn. For cyclical commodity companies, it is important to manage a healthy balance sheet through the cycle.

At current valuations, we believe the stock captures benefits of the Dolvi expansion. Also, the launch of another mega expansion plan (Vijaynagar) defers free cash flow returns to shareholders.

**Key growth catalysts:** (a) Ramp-up of Dolvi expansion over H2FY22 and FY23, (b) integration and ramp-up of downstream facilities, (c) extension of a stronger steel cycle poses higher benefits whereas a sharper downturn poses higher risks for JSTL than peers due to its ambitious growth policy.

**Volume growth to cushion margins in FY23:** We forecast 69% YoY growth in FY22 EBITDA with strong steel margins and volume recovery, further aided by ramp-up of Dolvi expansion in H2FY22. Given robust cash flow, we expect net debt/EBITDA to reduce to 1.5x, well below the company's current target of 2.75x. As the expected easing of margins will be partly offset by volume growth, EBITDA is likely to see only a modest decline of 3% in FY23 (+19% in FY24).

Despite an annual capex commitment of Rs 160bn on average over the next three years, net debt/EBITDA is projected to reduce to 0.5x by FY24. Even in our US\$ 600 steel price scenario, we expect leverage to rise only to 0.8x.

**Initiate with HOLD:** We value JSTL at 6.5x Sep'23E EV/EBITDA, a premium to the 6x target multiple for the steel sector, and arrive at a Sep'22 TP of Rs 795. At the current price, the stock offers 6% upside.

Ticker/Price	JSTL IN/Rs 749
Market cap	US\$ 24.4bn
Free float	56%
3M ADV	US\$ 86.2mn
52wk high/low	Rs 777/Rs 258
Promoter/FPI/DII	44%/13%/7%

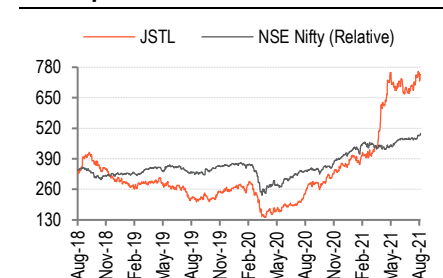
Source: NSE | Price as of 13 Aug 2021

### Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs bn)	781	1,203	1,232
EBITDA (Rs bn)	201	340	330
Adj. net profit (Rs bn)	79	179	165
Adj. EPS (Rs)	32.7	74.1	68.2
Consensus EPS (Rs)	32.9	87.1	71.9
Adj. ROAE (%)	19.0	32.8	23.6
Adj. P/E (x)	22.9	10.1	11.0
EV/EBITDA (x)	6.8	3.8	4.0
Adj. EPS growth (%)	96.3	126.3	(7.9)

Source: Company, Bloomberg, BOBCAPS Research

### Stock performance



Source: NSE

## Investment thesis

### Aggressive, countercyclical growth policy

JSTL's focus remains on pursuing growth. This was demonstrated through continuation of its 5mtpa Dolvi (Maharashtra) expansion through the Covid wave, which is now scheduled for an integration run in Sep'21. This policy has positioned the company to reap the benefits of volume growth while the cycle remains on an upturn. Stronger margins have also helped deleverage the balance sheet. JSTL has further launched a 5mtpa brownfield expansion at its Vijaynagar (Karnataka) plant to raise total capacity to more than 30mtpa by FY25.

The company also zealously pursues inorganic growth options. It has completed the Rs 190bn acquisition of Bhushan Power and Steel in FY21 and is pursuing an operational improvement capex plan within the scope of its balance sheet.

### Capital allocation driven by ambitious growth policy

JSTL's ambitious growth policy carries a significantly higher through-the-cycle threshold of 3.75x net debt/EBITDA (though the current target is 2.75x). To manage the leverage for its listed entity, the company is open to aligning its inorganic acquisitions in the metal space with other group entities. A recent example is Bhushan Power and Steel wherein JSTL has limited its equity stake to 49% and treats the acquired entity as an affiliate of the listed company.

While this aggressive approach works well through the upcycle, it poses balance sheet risk during a sudden downturn. For cyclical commodity companies, we believe that managing balance sheet risk over the entire cycle is a more prudent approach.

### Heavy capex commitments

JSTL has committed capex of Rs 475bn over FY22-FY24 including Rs 251bn to expand the Vijaynagar plant and to improve operations of its captive iron ore mines. This amounts to an average annual capex spend of ~Rs 160bn over the next three years. The brownfield expansion is quite competitive with capital intensity of ~US\$ 400/t as it leverages the surplus of pellets, sinter and coke as well as existing infrastructure. The planned outlay does not yet include further downstream expansion to cater to the larger capacity.

### Resilient balance sheet, risks only if cycle turns

We expect JSTL's net debt/EBITDA to fall to 1.5x by end-FY22, well below its current target of 2.75x. Despite high capex outgo planned for FY23-FY24, leverage is likely to improve over FY23-FY24 to 0.5x. Even under our US\$ 600/t steel price scenario, leverage remains well under control at ~0.8x by FY24. While the aggressive expansion plan is well covered during this upcycle, this approach poses a risk if the cycle turns.

Besides its consolidated net debt of ~Rs 475bn as of FY21, JSTL also has exposure to another Rs 130bn of debt within its two affiliates – Bhushan Power and Steel and JSW Ispat Special Products (erstwhile Monet Steel). The proportionate share of net debt at these two entities works out to Rs 60bn.

### Healthy margins

JSTL earned an EBITDA margin of Rs 12.9k/t in FY21, which falls in the middle of the Rs 8.5k-17.9k/t range for peers. We expect its margin to improve to Rs 17.5k/t/ Rs 15.2k/t in FY22/FY23 driven by better steel prices and full utilisation of its downstream capacities.

The company has been able to maintain healthy margins despite non-availability of low-cost captive iron ore. This is because JSTL has one of the lowest conversion costs in India and also captures margin from value-added and special products (FY21 share at 52%). Even after the Dolvi expansion, value-added product share is likely to remain around 50% as its downstream capacity has grown to ~12mtpa following the acquisition of ACCL (Asia Colour Coated).

On raw materials, JSTL has 100% integration for its coke requirements although it imports coking coal. Iron ore integration has risen to 42% as of Q1FY22 with the ramp-up of nine mines in Karnataka and four in Odisha. However, as a high premium of 80-130% is applicable on iron ore from Odisha mines, these acquisitions do not improve the company's cost structure but result in better operation control in steel manufacturing alongside consistent grade and quality of ore.



## Valuation methodology

### Forecasts

We forecast 69% YoY growth in FY22 EBITDA with strong steel margins and volume recovery from existing operations as well as ramp-up of the Dolvi plant through H2. Given robust cash flow, we expect net debt/EBITDA to reduce to 1.5x, well below the company’s current target of 2.75x.

As margins come off their peak, EBITDA is forecast to decline modestly by 3% YoY in FY23 but again grow by 19% in FY24. Owing to the significant volume ramp-up ahead, JSTL will likely face the lowest decline amongst its peers.

**Fig 1 – JSTL: Earnings forecasts**

(Rs bn)	Actual	Expected			Consensus			Delta to Consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	781	1,203	1,232	1,246	1,231	1,264	1,232	(2.3)	(2.6)	1.1
EBITDA	201	340	330	392	372	332	335	(8.7)	(0.4)	16.9
Net income	79	179	165	211	206	175	171	(13.5)	(5.5)	23.5

Source: Company, Bloomberg, BOBCAPS Research

**Fig 2 – Key assumptions**

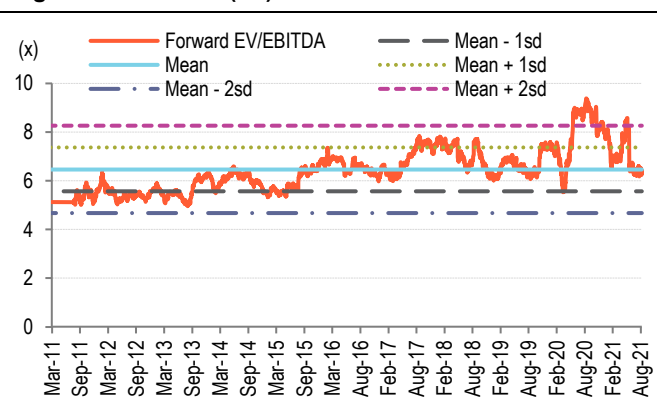
Parameter	FY21	FY22E	FY23E	FY24E
Crude steel production (mt)	18.5	21.0	21.2	23.7
India HRC (US\$/t)	640	748	653	650
Realisation standalone (Rs '000/t)	43.9	58.4	53.1	53.8
EBITDA standalone (Rs '000/t)	12.9	17.5	15.2	18.2

Source: Company, BOBCAPS Research

### Valuation relative to history

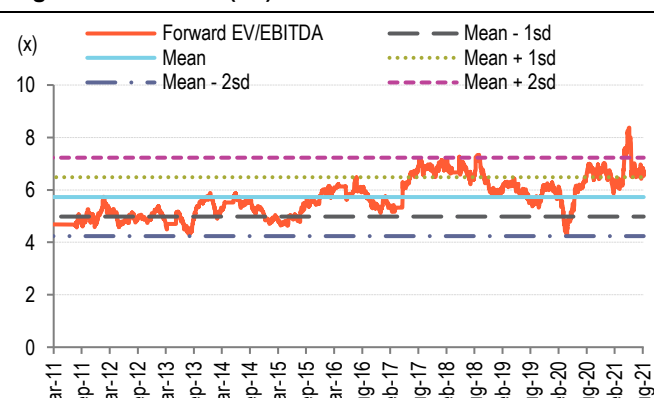
JSTL is trading at 6.4x 1Y EBITDA and 6.7x 2Y EBITDA on consensus estimates. These multiples are in line with the stock’s historical 6.5-7x multiple over a 5-10-year period, which reflects the company’s success in commanding a premium to peers.

**Fig 3 – EV/EBITDA (1Y) band**



Source: Bloomberg, BOBCAPS Research

**Fig 4 – EV/EBITDA (2Y) band**



Source: Bloomberg, BOBCAPS Research

**Initiate with HOLD**

We initiate coverage on JSTL with a HOLD rating and a Sep’22 TP of Rs 795. We value the stock at a one-year forward EV/EBITDA multiple of 6.5x, a premium to our target multiple of 6x for the Indian steel sector to reflect its healthy margin and growth profile. The multiple is below the stock’s historical trading average over the past 5-10 years as we are cognizant of risks that cyclical companies undertake while pursuing an aggressive growth policy. We use Sep’23E EBITDA as the base year for valuation and apply a one-year forward multiple.

**Fig 5 – Valuation summary**

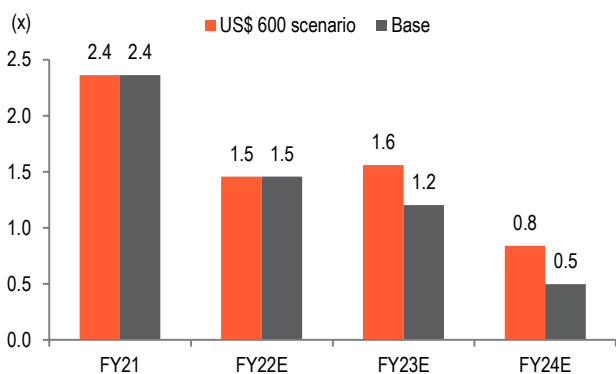
(Rs bn)	Value
Sep’23E EBITDA	361
Target EV/EBITDA multiple	6.5
<b>EV</b>	<b>2,347</b>
Net debt FY22E	496
Equity investments	65
<b>Equity value</b>	<b>1,916</b>
Fair value per share (Rs)	793
<b>Target price Sep’22 (Rs) (rounded to nearest Rs 5)</b>	<b>795</b>

Source: BOBCAPS Research

**Sensitivity to steel prices**

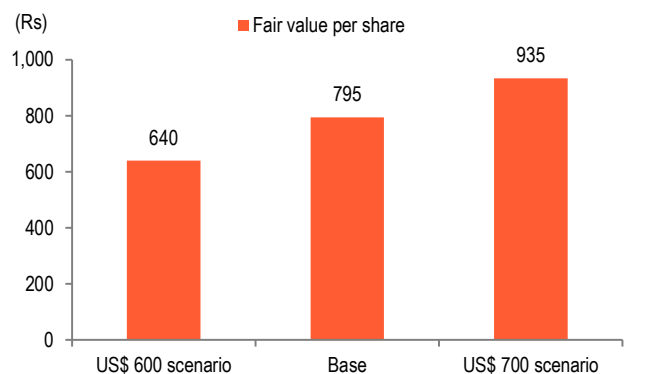
Our base case assumes Indian steel prices at US\$ 652/t over FY23-FY24. To test the downside to our assumptions, we analyse a scenario where prices stabilise at ~US\$ 600/t. Even if this happens, we expect JSTL’s net debt/EBITDA to remain well under control. The company exhibits moderate sensitivity to changes in steel price with partial offset from changes in iron price against steel. We highlight below the fair value per share for a US\$ 600 and a US\$ 700 scenario.

**Fig 6 – JSTL’s leverage remains under control**



Source: Company, BOBCAPS Research

**Fig 7 – JSTL has moderate sensitivity to steel prices**



Source: Company, BOBCAPS Research

## Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Steel prices have been supported by sharp demand recovery in China and the rest of the world, as well as raw material inflation supported by supply issues. Key downside risks to our estimates are slower recovery in the global economy, or an unfavourable change in global demand-supply balance for steel and its raw materials, leading to lower prices than our assumptions.

## Company-specific risks

- JSTL is exposed to risk of delays in ramping up its aggressive capital investment plan, which could impact earnings growth. The company is targeting an integration run for Dolvi expansion by Sep'21 and capacity expansion to 30mtpa by FY25.
- Considering its aggressive growth policy and large capital investment plan over FY22-FY24, the company is relatively more vulnerable than peers should the steel cycle turn.

## Financials

### Income Statement

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Total revenue</b>	711	781	1,203	1,232	1,246
EBITDA	119	201	340	330	392
Depreciation	(42)	(47)	(52)	(58)	(57)
EBIT	76	155	288	272	335
Net interest inc./(exp.)	(43)	(40)	(39)	(37)	(35)
Other inc./(exp.)	5	6	6	1	4
Exceptional items	(8)	(1)	0	0	0
EBT	30	120	254	236	303
Income taxes	9	(41)	(76)	(71)	(91)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	(1)	0	(1)	(1)	(1)
<b>Reported net profit</b>	<b>40</b>	<b>79</b>	<b>179</b>	<b>165</b>	<b>211</b>
Adjustments	0	0	1	0	0
<b>Adjusted net profit</b>	<b>40</b>	<b>79</b>	<b>179</b>	<b>165</b>	<b>211</b>

### Balance Sheet

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	179	152	274	278	256
Other current liabilities	56	190	171	175	177
Provisions	2	3	4	4	4
Debt funds	550	541	516	486	456
Other liabilities	57	72	109	139	176
Equity capital	3	3	3	3	3
Reserves & surplus	363	465	622	767	954
Shareholders' fund	360	461	618	764	951
<b>Total liab. and equities</b>	<b>1,318</b>	<b>1,483</b>	<b>1,692</b>	<b>1,845</b>	<b>2,020</b>
Cash and cash eq.	120	128	20	88	260
Accounts receivables	45	45	82	84	85
Inventories	138	142	219	222	205
Other current assets	62	43	60	61	60
Investments	0	0	0	0	0
Net fixed assets	611	591	661	655	649
CWIP	269	324	389	519	594
Intangible assets	7	18	16	14	13
Deferred tax assets, net	0	0	0	0	0
Other assets	67	191	244	200	153
<b>Total assets</b>	<b>1,318</b>	<b>1,483</b>	<b>1,692</b>	<b>1,845</b>	<b>2,020</b>

### Cash Flows

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Cash flow from operations</b>	<b>62</b>	<b>306</b>	<b>262</b>	<b>290</b>	<b>335</b>
Capital expenditures	(192)	(94)	(185)	(180)	(125)
Change in investments	0	0	0	0	0
Other investing cash flows	10	(119)	(46)	45	52
<b>Cash flow from investing</b>	<b>(182)</b>	<b>(213)</b>	<b>(231)</b>	<b>(135)</b>	<b>(73)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	250	(60)	(89)	(30)	(30)
Interest expenses	(43)	(40)	(39)	(37)	(35)
Dividends paid	(5)	(5)	(18)	(16)	(21)
Other financing cash flows	(23)	21	10	1	0
<b>Cash flow from financing</b>	<b>178</b>	<b>(85)</b>	<b>(139)</b>	<b>(86)</b>	<b>(90)</b>
<b>Chg in cash &amp; cash eq.</b>	<b>58</b>	<b>8</b>	<b>(109)</b>	<b>69</b>	<b>172</b>
<b>Closing cash &amp; cash eq.</b>	<b>120</b>	<b>128</b>	<b>20</b>	<b>88</b>	<b>260</b>

### Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	16.7	32.7	73.8	68.2	87.3
Adjusted EPS	16.7	32.7	74.1	68.2	87.3
Dividend per share	2.0	2.0	7.4	6.8	8.7
Book value per share	151.4	193.5	258.6	318.8	395.8

### Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	2.0	1.7	1.1	1.1	1.1
EV/EBITDA	12.1	6.8	3.8	4.0	3.5
Adjusted P/E	44.9	22.9	10.1	11.0	8.6
P/BV	4.9	3.9	2.9	2.3	1.9

### DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	105.6	65.4	70.4	70.0	69.7
Interest burden (PBT/EBIT)	50.1	78.2	88.3	86.5	90.5
EBIT margin (EBIT/Revenue)	10.7	19.8	24.0	22.1	26.9
Asset turnover (Rev./Avg TA)	57.6	55.7	75.7	69.6	64.5
Leverage (Avg TA/Avg Equity)	3.5	3.4	2.9	2.5	2.2
<b>Adjusted ROAE</b>	<b>11.3</b>	<b>19.0</b>	<b>32.8</b>	<b>23.6</b>	<b>24.4</b>

### Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
<b>YoY growth (%)</b>					
Revenue	(13.8)	9.8	54.1	2.4	1.1
EBITDA	(37.4)	69.6	68.8	(2.9)	18.8
Adjusted EPS	(47.2)	96.3	126.3	(7.9)	28.1
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	16.7	25.8	28.3	26.8	31.5
EBIT margin	10.7	19.8	24.0	22.1	26.9
Adjusted profit margin	5.7	10.1	14.9	13.4	16.9
Adjusted ROAE	11.3	19.0	32.8	23.6	24.4
ROCE	8.5	14.5	24.7	20.8	22.8
<b>Working capital days (days)</b>					
Receivables	23	21	25	25	25
Inventory	71	67	67	66	60
Payables	106	93	113	110	107
<b>Ratios (x)</b>					
Gross asset turnover	0.6	0.6	0.8	0.7	0.6
Current ratio	0.8	0.8	0.8	0.9	1.3
Net interest coverage ratio	1.8	3.9	7.3	7.3	9.5
<b>Adjusted debt/equity</b>	<b>1.5</b>	<b>1.0</b>	<b>0.8</b>	<b>0.5</b>	<b>0.2</b>

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**BUY**

TP: Rs 555 | ▲ 31%

**JINDAL STEEL & POWER** | Metals & Mining

16 August 2021

**Further scope for rerating – initiate with BUY**

- **Lowest debt level among peers aided by transfer of non-core assets to parent and self-imposed discipline**
- **Key stock catalysts include balance sheet deleveraging and resumption of measured growth**
- **Initiate with BUY and a Sep'22 TP of Rs 555**

**Kirtan Mehta, CFA**

researchreport@bobcaps.in

**Investment thesis:** JSP has successfully achieved the lowest net debt amongst steel majors following transfer of its stakes in the Oman arm and Jindal Power to its parent. However, this has come at the cost of slower growth. Armed with an improved balance sheet, the company aims to restart growth investments in its core steel operations at a measured pace while keeping net debt/EBITDA below 1.5x at all times. Though divestment of non-core capacity has aided a stock rerating, JSP continues to trade at a discount to peers. Amongst our coverage, JSP stands to benefit the most from the ongoing ramp-up in infrastructure investments in India, given its focus on long and structured products.

**Key growth catalysts:** (a) Closure of JPL divestment which is largely in the stock price, (b) timely delivery on the next wave of expansion, (c) adherence to disciplined capital allocation while developing further downstream units and pursuing inorganic expansion.

**Sharp deleveraging in FY22:** We forecast flattish growth in FY22 EBITDA as modest recovery in volumes and long product realisation is offset by loss of JPL earnings after its sale to promoter. However, we expect JSP to demonstrate sharp deleveraging, reducing net debt below Rs 110bn and net debt/EBITDA below 1x on divestment of JPL. EBITDA is projected to decline by 15% in FY23 (+10% in FY24) as steel prices ease off their peak. The quantum of easing would be lower for long products due to the current high discount to flat products.

Under our base case scenario, we expect JSP's net debt/EBITDA to retract to 0.5x by FY24 even during the expansion phase. In the US\$ 600 steel price scenario as well, leverage is likely to remain below 1x – below JSP's target.

**Initiate with BUY:** We value the stock at 5x Sep'23E EV/EBITDA, a discount to the sector multiple of 6x to reflect lower near-term capex-driven growth. We arrive at a Sep'22 TP of Rs 555, which implies 31% upside. JSP has seen a significant rerating relative to peers post divestment of the Oman unit in FY21 and JPL in FY22. We see further scope for catch-up.

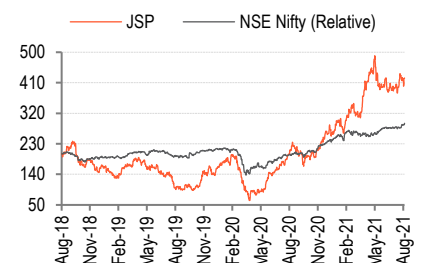
Ticker/Price	JSP IN/Rs 424
Market cap	US\$ 5.8bn
Free float	40%
3M ADV	US\$ 65.7mn
52wk high/low	Rs 502/Rs 160
Promoter/FPI/DII	60%/11%/15%

Source: NSE | Price as of 13 Aug 2021

**Key financials**

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs mn)	3,89,886	4,38,974	4,19,583
EBITDA (Rs mn)	1,44,443	1,45,194	1,23,214
Adj. net profit (Rs mn)	52,721	73,215	56,555
Adj. EPS (Rs)	51.7	71.8	55.4
Consensus EPS (Rs)	71.9	73.2	55.6
Adj. ROAE (%)	16.5	20.6	13.5
Adj. P/E (x)	8.2	5.9	7.7
EV/EBITDA (x)	5.2	4.5	4.6
Adj. EPS growth (%)	nm	38.9	(22.8)

Source: Company, Bloomberg, BOBCAPS Research

**Stock performance**

Source: NSE

## Investment thesis

### Moving to a disciplined investment approach

JSP did halt incremental investments till it stabilised Angul (Odisha) operations over the past couple of years and has addressed market concerns on leverage by transferring non-core investments – Oman unit and JPL – to its parent group. With restoration of the balance sheet, JSP has restarted investments to expand its core steel operations in India. In phase 1, it will focus on crude steel expansion and setup of a hot-strip mill to balance its product mix by increasing exposure to flat products.

Capital intensity is competitive at US\$ 400/t as the company uses available land and infrastructure and aims to repeat the proven design of already implemented units to reduce execution uncertainty.

### Capex commitments in check

Management has announced a Rs 180bn capex plan with 63% of the outlay planned for expansion of crude steel & flat product capacity and the balance for improving margins. While the FY22 expansion-capex commitment is modest at Rs 25bn, this would pick up to an annual commitment of Rs 41bn-47bn over FY23-FY25. The outlay remains in line with cash generation abilities. To maintain a measured investment pace, JSP has deferred development of downstream flat products to FY23 and beyond.

### Balance sheet resilience through the cycle

With the divestment of JPL, JSP's net debt has come down to ~Rs 130bn, accounting for potential payment of Rs 30bn for equity upon closure. The company further aims to lower this below Rs 100bn by end-FY22, which will reduce net debt/EBITDA below 1x. With a measured pace of expansion, we expect JSP's net debt to reduce to 0.5x by FY24. Even under the US\$ 600 scenario, we expect leverage to remain around 1x.

### Capacity expansion, long product exposure to drive growth

JSP plans to augment steel capacity by 1mtpa to 9.6mtpa at the Angul plant and has guided for 8.0-8.5mtpa of production for FY22. Thereafter, the company intends to raise capacity by 6.6mtpa to 16mtpa in two steps – complete a 3.3mtpa BOF in FY24 and a 3mtpa EAF in FY25. To increase flat product exposure, JSP will expand hot strip mill capacity by 5.5mtpa in two phases to 7.7mtpa by Sep'23. To improve margins, it will raise iron ore pellet capacity in two tranches of 6mt each, in tandem with crude steel expansion.

Amongst Indian steel majors, JSP's product slate is geared towards long and structural products serving the infrastructure market and could see relatively higher pickup in realisation and margins as infrastructure investments in India accelerate.

### Healthy margins

JSP earned an EBITDA margin of Rs 17.9k/t in FY21, which stands at the top end of the Rs 8.5k-17.9k/t range for the four majors. Margins were aided by the use of low-cost iron ore from the Sarda mines. We expect JSP's margin to improve only modestly to Rs 19.6k/t over FY22 given muted long steel prices (relative to flat steel prices) and a higher cost of iron ore.

Despite the absence of captive ore mines and its focus on long products, JSP's operating margin profile has been healthy. This is because it benefits from proximity to mines in Odisha and is able to secure stable supply at a lower cost than steel plants in Western and Southern India. The company also improves its margin by focusing on value-added long products and specific gaps in the segment. For instance, JSP supplies 1080-grade steel for metro rail, 1175-grade for Indian rail, and structures for transmission towers above 230kV.

## Valuation methodology

### Forecasts

We forecast flattish FY22 EBITDA as modest recovery in volumes and long product realisation is offset by loss of JPL earnings after its sale to promoter. Given divestment of JPL and a smaller capex plan for FY22, we expect net debt/EBITDA to reduce to 0.7x. As margins come off from their peak, EBITDA is estimated to decline 15% YoY in FY23 (+10% YoY In FY24). We believe the discount on realisation of long products will narrow as infrastructure investments in the country gather pace, partly offsetting the decline in benchmark steel prices.

**Fig 1 – JSP: Earnings forecasts**

(Rs bn)	Actual	Expected			Consensus			Delta to Consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	390	439	420	432	467	442	437	(5.9)	(5.1)	(1.2)
EBITDA	144	145	123	135	156	124	113	(6.9)	(0.7)	19.0
Net income	53	73	57	67	76	56	41	(4.2)	0.2	62.7

Source: Company, Bloomberg, BOBCAPS Research

**Fig 2 – Key assumptions**

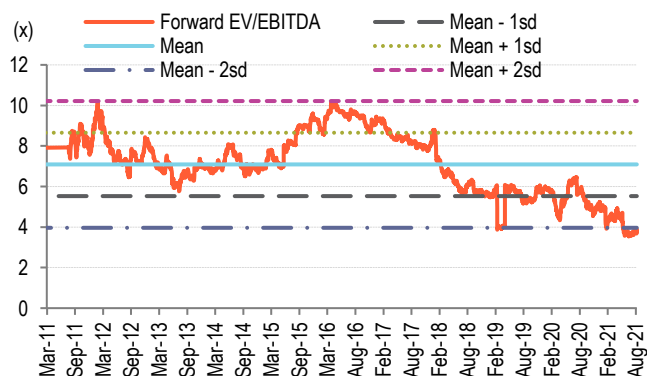
Parameter	FY21	FY22E	FY23E	FY24E
Sales (mt)	7.3	8.1	8.2	8.2
India HRC (US\$/t)	640	748	653	650
Realisation (Rs '000/t)	42.9	52.1	49.1	50.6
EBITDA (Rs '000/t)	17.9	19.6	16.4	18.0

Source: Company, BOBCAPS Research

### Valuation relative to history

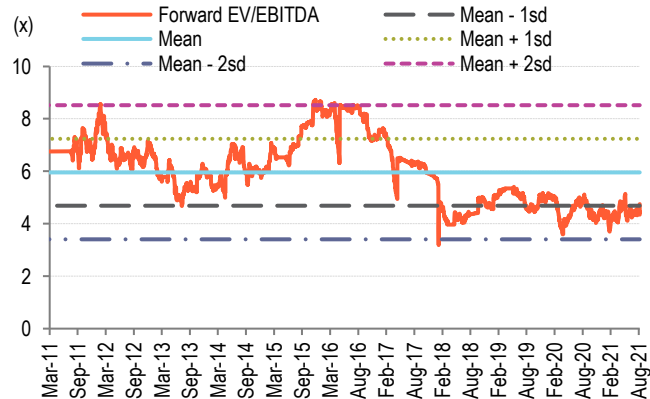
JSP is trading at 3.9x 1Y EBITDA and 4.8x 2Y EBITDA on consensus estimates. This is below the company's historical 5.5-6x 12M EBITDA multiple over a 5-10-year range. With divestment of non-core investments to the parent group, the stock has seen a rerating relative to peers.

**Fig 3 – EV/EBITDA (1Y) band**



Source: Bloomberg, BOBCAPS Research

**Fig 4 – EV/EBITDA (2Y) band**



Source: Bloomberg, BOBCAPS Research



### Initiate with BUY

We initiate coverage on JSP with a BUY rating and a Sep'22 TP of Rs 555. We value the stock at a one-year forward EV/EBITDA multiple of 5x, a discount to our target multiple of 6x for the Indian steel sector (and to the stock's historical trading average over the past 5-10 years) to reflect slower growth in the recent past. We use Sep'23E EBITDA as the base year for valuation and apply a one-year forward multiple.

**Fig 5 – Valuation summary**

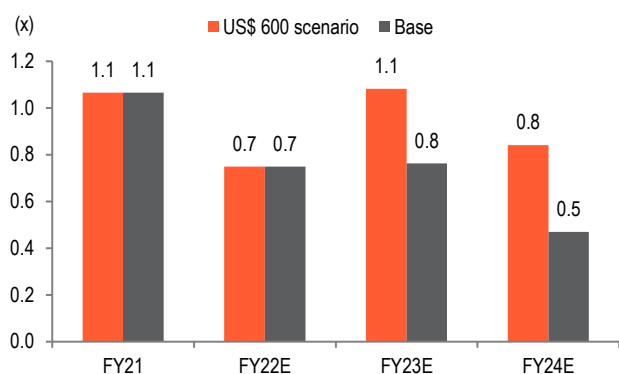
(Rs bn)	Value
Sep'23E EBITDA	129
Target EV/EBITDA multiple	5
<b>EV</b>	<b>645</b>
Net debt FY22E	109
Equity value JPL	30
<b>Equity value</b>	<b>567</b>
Fair value per share (Rs)	556
<b>Target price Sep'22 (Rs) (rounded to nearest Rs 5)</b>	<b>555</b>

Source: BOBCAPS Research

### Sensitivity to steel prices

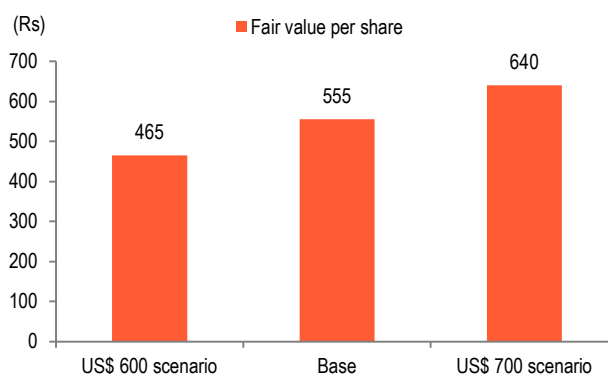
Our base case assumes Indian steel prices at US\$ 652/t over FY23-FY24. To test the downside to our assumptions, we analyse a scenario where prices stabilise at ~US\$ 600/t. Even if this happens, we expect JSP's net debt/EBITDA to remain well under control. The company exhibits moderate sensitivity to changes in steel price with partial offset from changes in iron price against steel. We highlight below the fair value per share for a US\$ 600 and a US\$ 700 scenario.

**Fig 6 – JSP's leverage remains under control**



Source: Company, BOBCAPS Research

**Fig 7 – JSP exhibits moderate sensitivity to steel prices**



Source: Company, BOBCAPS Research

## Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Steel prices have been supported by sharp recovery of demand in China and the rest of the world, as well as raw material inflation supported by supply issues. Key downside risks to our estimates are slower recovery in the global economy, or an unfavourable change in global demand-supply balance for steel and its raw materials, leading to lower prices than our assumptions.

### Company-specific risks

- JSP is exposed to risk of delays in implementation of its capital investment plan, which could impact earnings growth. To lower the risk and reduce execution uncertainties, it is planning to replicate the setup of previous units. The plan also does not involve a syngas unit or coal washery, which had faced execution delays in the last round of investment.

## Financials

### Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Total revenue</b>	<b>3,69,175</b>	<b>3,89,886</b>	<b>4,38,974</b>	<b>4,19,583</b>	<b>4,31,772</b>
EBITDA	78,539	1,44,443	1,45,194	1,23,214	1,34,945
Depreciation	(38,672)	(34,534)	(23,012)	(23,705)	(24,895)
EBIT	39,867	1,09,909	1,22,183	99,509	1,10,050
Net interest inc./(exp.)	(42,071)	(31,364)	(25,885)	(25,885)	(22,882)
Other inc./(exp.)	840	5,820	2,320	2,552	2,524
Exceptional items	(1,094)	(11,409)	0	0	0
EBT	(2,458)	72,956	98,618	76,177	89,692
Income taxes	(1,539)	(17,687)	(23,908)	(18,468)	(21,744)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	0	0	0	0	0
<b>Reported net profit</b>	<b>(1,092)</b>	<b>52,721</b>	<b>73,215</b>	<b>56,555</b>	<b>66,589</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>(1,092)</b>	<b>52,721</b>	<b>73,215</b>	<b>56,555</b>	<b>66,589</b>

### Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	55,671	40,383	48,293	48,718	48,793
Other current liabilities	1,47,996	1,38,382	1,55,805	1,48,922	1,53,249
Provisions	976	822	925	884	910
Debt funds	3,06,754	2,15,512	2,15,512	1,90,512	1,65,512
Other liabilities	72,416	73,936	79,726	79,016	80,545
Equity capital	1,020	1,020	1,020	1,020	1,020
Reserves & surplus	3,20,351	3,17,127	3,90,342	4,46,897	5,13,486
Shareholders' fund	3,13,607	3,09,370	3,84,079	4,41,788	5,09,736
<b>Total liab. and equities</b>	<b>8,97,420</b>	<b>7,78,404</b>	<b>8,84,340</b>	<b>9,09,841</b>	<b>9,58,745</b>
Cash and cash eq.	9,062	61,522	1,06,738	96,621	1,02,200
Accounts receivables	35,493	27,944	48,107	45,982	47,317
Inventories	63,687	59,426	80,488	81,197	81,322
Other current assets	51,667	54,299	60,525	58,065	59,611
Investments	0	0	0	0	0
Net fixed assets	6,72,186	5,18,747	5,10,735	5,30,735	5,80,735
CWIP	19,745	8,903	28,903	48,903	38,903
Intangible assets	27,038	27,957	27,957	27,957	27,957
Deferred tax assets, net	0	0	0	0	0
Other assets	18,542	19,607	20,888	20,382	20,700
<b>Total assets</b>	<b>8,97,420</b>	<b>7,78,404</b>	<b>8,84,340</b>	<b>9,09,841</b>	<b>9,58,745</b>

### Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Cash flow from operations</b>	<b>1,05,640</b>	<b>1,11,293</b>	<b>1,09,184</b>	<b>1,00,437</b>	<b>1,18,296</b>
Capital expenditures	(33,198)	1,28,829	(35,000)	(63,705)	(64,895)
Change in investments	0	0	0	0	0
Other investing cash flows	4,501	(634)	(611)	1,481	583
<b>Cash flow from investing</b>	<b>(28,697)</b>	<b>1,28,194</b>	<b>(35,611)</b>	<b>(62,224)</b>	<b>(64,313)</b>
Equities issued/Others	52	0	0	0	0
Debt raised/repaid	(40,907)	(91,242)	0	(25,000)	(25,000)
Interest expenses	(42,071)	(31,364)	(25,885)	(25,885)	(22,882)
Dividends paid	0	0	0	0	0
Other financing cash flows	10,830	(64,422)	(2,473)	2,554	(523)
<b>Cash flow from financing</b>	<b>(72,096)</b>	<b>(1,87,028)</b>	<b>(28,357)</b>	<b>(48,330)</b>	<b>(48,405)</b>
<b>Chg in cash &amp; cash eq.</b>	<b>4,846</b>	<b>52,460</b>	<b>45,216</b>	<b>(10,117)</b>	<b>5,579</b>
<b>Closing cash &amp; cash eq.</b>	<b>4,216</b>	<b>9,062</b>	<b>61,522</b>	<b>1,06,738</b>	<b>96,621</b>

### Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	(1.1)	51.7	71.8	55.4	65.3
Adjusted EPS	(1.1)	51.7	71.8	55.4	65.3
Dividend per share	0.0	0.0	0.0	0.0	0.0
Book value per share	315.1	311.9	383.7	439.1	504.4

### Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	2.2	1.9	1.5	1.3	1.2
EV/EBITDA	10.2	5.2	4.5	4.6	4.0
Adjusted P/E	(396.4)	8.2	5.9	7.7	6.5
P/BV	1.3	1.4	1.1	1.0	0.8

### DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	80.0	62.5	74.2	74.2	74.2
Interest burden (PBT/EBIT)	(3.4)	76.8	80.7	76.6	81.5
EBIT margin (EBIT/Revenue)	10.8	28.2	27.8	23.7	25.5
Asset turnover (Rev./Avg TA)	41.3	46.5	52.8	46.8	46.2
Leverage (Avg TA/Avg Equity)	2.8	2.6	2.3	2.1	1.9
Adjusted ROAE	(0.3)	16.5	20.6	13.5	13.8

### Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
<b>YoY growth (%)</b>					
Revenue	(6.2)	5.6	12.6	(4.4)	2.9
EBITDA	(6.6)	83.9	0.5	(15.1)	9.5
Adjusted EPS	(93.7)	nm	38.9	(22.8)	17.7
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	21.3	37.0	33.1	29.4	31.3
EBIT margin	10.8	28.2	27.8	23.7	25.5
Adjusted profit margin	(0.3)	13.5	16.7	13.5	15.4
Adjusted ROAE	(0.3)	16.5	20.6	13.5	13.8
ROCE	5.7	17.9	19.5	14.7	15.3
<b>Working capital days (days)</b>					
Receivables	35	26	40	40	40
Inventory	63	56	67	71	69
Payables	(70)	(60)	(60)	(60)	(60)
<b>Ratios (x)</b>					
Gross asset turnover	0.4	0.5	0.5	0.5	0.5
Current ratio	0.7	1.1	1.4	1.3	1.3
Net interest coverage ratio	0.9	3.5	4.7	3.8	4.8
Adjusted debt/equity	0.9	0.5	0.3	0.2	0.1

Source: Company, BOBCAPS Research | Note: TA = Total Assets

**HOLD**

TP: Rs 150 | ▲ 12%

**SAIL**

| Metals &amp; Mining

| 16 August 2021

## Mega expansion slow to yield benefits; initiate with HOLD

- Large capex projects complete but benefits to gradually materialise; execution of upcoming phase-2 expansion a concern
- Key stock catalysts include full utilisation of crude steel and value-added product capacity
- Initiate with HOLD and a Sep'22 TP of Rs 150

Kirtan Mehta, CFA

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**Investment thesis:** While SAIL has completed its Rs 600bn expansion and modernisation plan, it is still some time away from reaping the full benefits even after a decade-long execution drive. Recent strong steel margins have helped the company lower leverage levels, but plans are already afoot for the next wave of investment towards another 60% capacity increase. Though the start of implementation is at least 18 months away, we remain wary of execution and the consequent stock overhang. On a positive note, SAIL has higher exposure to long products (50% of mix) than peers (ex-JSP) and will thus benefit from revival in India's infrastructure investments.

**Key growth catalysts:** (a) Ramp-up of steel production to a potential level of 20.2mtpa of saleable steel, (b) reduction of semis production from the current level of ~25% to the targeted 12% post expansion, (c) significant reduction in leverage before the next leg of investment begins.

**Benefits from completed capex to gradually materialise:** We forecast 74% YoY growth in FY22 EBITDA with strong steel margins and a 11% YoY increase in sales volume. Healthy cash flow should aid reduction in net debt/EBITDA to 1.2x. For FY23, we expect EBITDA to decline by 23% YoY (+11% YoY in FY24) as steel margins come of peaks but are partly offset by improvement in volumes. Under our base case scenario, we estimate that net debt/EBITDA will remain at 1.1x by FY24. Even in a US\$ 600/t steel price scenario, leverage is forecast to remain below 2x.

**Initiate with HOLD:** We value SAIL at 5x one-year forward EV/EBITDA, a discount to our 6x target multiple for the steel sector, and arrive at a Sep'22 TP of Rs 150. At the current price, the stock trades at a discount to steel majors, reflecting concerns on execution, in our view. Key upside risks to our rating are faster ramp-up of production and margins than assumed. Key downside risk is faster normalisation of steel margin than expected.

Ticker/Price	SAIL IN/Rs 134
Market cap	US\$ 7.5bn
Free float	35%
3M ADV	US\$ 107.7mn
52wk high/low	Rs 151/Rs 33
Promoter/FPI/DII	65%/5%/16%

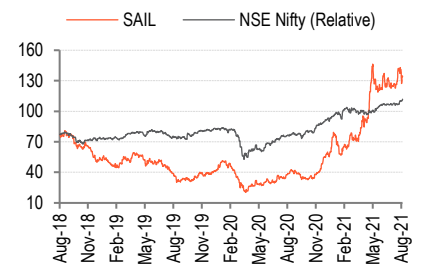
Source: NSE | Price as of 13 Aug 2021

### Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs bn)	691	912	888
EBITDA (Rs bn)	127	222	171
Adj. net profit (Rs bn)	41	114	80
Adj. EPS (Rs)	10.0	27.6	19.3
Consensus EPS (Rs)	9.9	34.6	23.5
Adj. ROAE (%)	9.5	22.8	13.8
Adj. P/E (x)	13.3	4.9	6.9
EV/EBITDA (x)	8.1	4.5	5.1
Adj. EPS growth (%)	95.6	174.4	(29.8)

Source: Company, Bloomberg, BOBCAPS Research

### Stock performance



Source: NSE

## Investment thesis

### Modernisation benefits to gradually materialise

While SAIL has completed its Rs 600bn expansion and modernisation plan, it is still some time away from reaping the full benefits even after a decade-long execution drive. Management's guidance of 16.0-16.5mt of sales (both crude steel and value-added products) during FY22 indicates a gap against its potential of 20mt of saleable steel production. We assume 10% annual growth in production over FY22-FY24.

### Concerns on ramp-up of margin from value-added products

Although ramp-up of value-added products has significant potential to improve realisation and margin, we remain conservative on benefits at this stage due to concerns over execution. Semis production still remains at ~25% of total volumes against the target of 12% post expansion as some projects remain incomplete, such as the HSM strip mill at RSP, the head hardened rail at Bhilai (Chhattisgarh), and Castor-4 at Bhilai, besides the need to resolve sinter plant issues at Bhilai and Bokaro (Jharkhand).

Reduction in semis is also dependent on recovery in demand from the infrastructure segment, and consequent improvement in demand for bars, rods and structural products, leading to better utilisation of the new medium section mill at Durgapur and universal section mill at IISCO (West Bengal).

### Margins lag peers

SAIL's FY21 EBITDA margin at Rs 8.5k/t was at the bottom end of the range of Rs 8.5k-17.9k/t earned by the four Indian steel majors. With stronger steel prices, we expect its margin to improve to Rs 13.4k/t in FY22.

SAIL has historically earned a lower steel operating margin than peers due to a higher proportion of semis, higher exposure to long products (~50%), negligible exposure to the auto segment for flat products, constraints from its legacy plants and lower productivity due to a high employee ratio. As an example, coke consumption per tonne of steel at ~450kg is higher than peers but remains constrained by its older blast furnaces. Though the company has the potential to raise the CDI rate to 100-110kg/tcs, it has not been able to go past 80kg/tcs.

These negatives are partly mitigated by benefits of low-cost iron ore from captive mines. To cater to its higher ore needs (39mtpa post expansion), SAIL is developing the Rowghat and Taldih mines. The rise in production volumes will also help lower fixed cost per tonne.

### Next wave of capex from FY24; execution risk persists

SAIL has completed its modernisation and expansion plan and is looking at a modest Rs 60bn-80bn capex investment in FY22 and a somewhat higher outlay in FY23. With encouragement from the government, the company is working towards accelerating plant improvement projects.

It has also launched the next wave of expansion and modernisation at three plants (IISCO, Bokaro and Rourkela) at a planned capex investment of Rs 650bn. This has the potential to add 13mtpa at a thumb-rule outlay of Rs 50bn/t. SAIL would take at least 18 months to finalise the plan and launch tenders; thus, any material capex commitment from this programme is likely to start from FY24.

Implementation will be staggered to keep leverage under control and can only add to volume growth over FY26-FY28, in our view. Though the start of this leg of capex is some time away, we remain wary of execution and the consequent stock overhang.

### **Leverage to remain in check**

With completion of its decade-long investment drive and a modest capex plan over the next two years, we estimate that free cash flow will help reduce SAIL's leverage to below Rs 250bn by the end of FY23. Net debt/EBITDA is forecast to remain at 1.1x by FY24 in the base case and 1.7x in the US\$ 600/t steel price scenario.

## Valuation methodology

### Forecasts

We forecast 74% YoY growth in FY22 EBITDA with robust steel margins and a 13% YoY increase in sales volume. Strong cash flow should aid reduction in net debt/ EBITDA to 1.2x by the year-end

As margins come off their peak, we expect a 23% YoY decline in EBITDA in FY23 but growth of 11% YoY in FY24. Though we assume further volume ramp-up of 5% per annum in FY23 and FY24, we do not yet pencil in much margin expansion on account of the planned reduction in semis production.

**Fig 1 – SAIL: Earnings forecasts**

(Rs bn)	Actual	Expected			Consensus			Delta to Consensus		
	FY21	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenue	691	912	888	945	884	866	899	3.1	2.5	5.1
EBITDA	127	222	171	190	245	187	216	(9.6)	(8.5)	(12.1)
Net income	41	114	80	93	133	94	123	(14.3)	(15.3)	(24.0)

Source: Company, Bloomberg, BOBCAPS Research

**Fig 2 – Key assumptions**

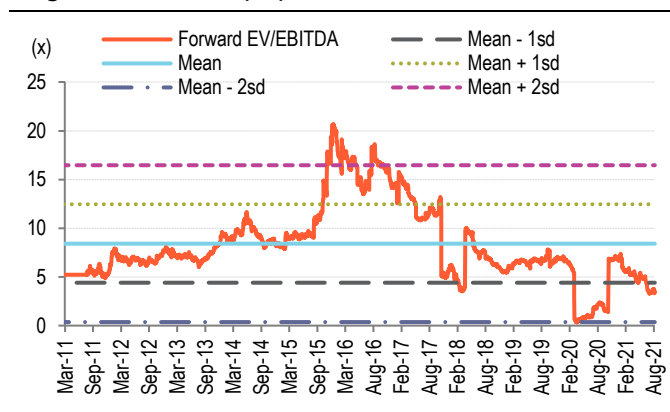
Parameter	FY21	FY22E	FY23E	FY24E
Sales	14.9	16.5	17.3	18.2
India HRC (US\$/t)	640	748	653	650
Realisation (Rs '000/t)	45.6	54.4	50.4	51.1
EBITDA (Rs '000/t)	8.5	13.4	9.9	10.4

Source: Company, BOBCAPS Research

### Valuation relative to history

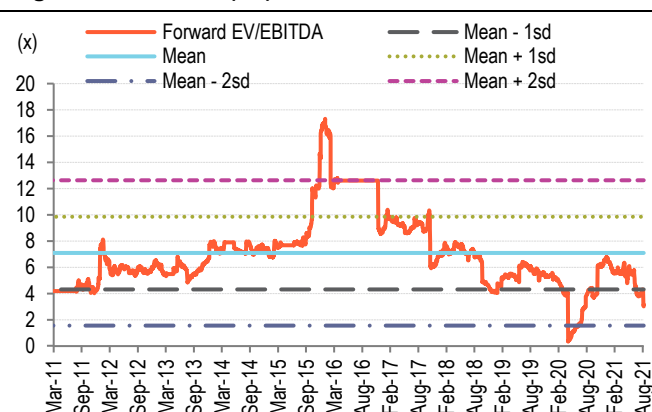
SAIL is trading at 3.5x 1Y EBITDA and 3.2x 2Y EBITDA on consensus estimates, against the 5.0-8.5x average over the last three-year, five-year and ten-year periods. The current multiple appears low on peak earnings and the 2Y multiple is also below the historical range, reflecting lower confidence on improvement in earnings from completion of its expansion and modernisation programme.

**Fig 3 – EV/EBITDA (1Y) band**



Source: Bloomberg, BOBCAPS Research

**Fig 4 – EV/EBITDA (2Y) band**



Source: Bloomberg, BOBCAPS Research

## Valuation

We initiate coverage on SAIL with a HOLD rating and a Sep'22 TP of Rs 150. We value the stock at a one-year forward EV/EBITDA multiple of 5x, a discount to our target multiple of 6x for the Indian steel sector as we remain concerned about the company's execution capabilities and ability to reap the full benefit on margins. The multiple is at the lower end of the stock's historical trading average over the past 5-10 years. We use Sep'23E EBITDA as the base year for valuation and apply a one-year forward multiple.

**Fig 5 – Valuation summary**

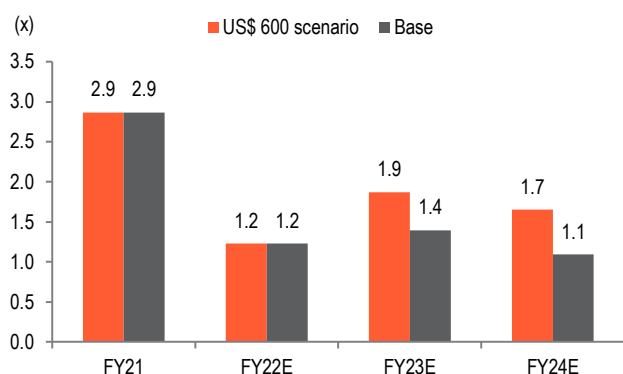
(Rs bn)	Value
Sep'23E EBITDA	180
Target EV/EBITDA multiple	5.0x
<b>EV</b>	<b>901</b>
Net debt FY22E	273
<b>Market value</b>	<b>628</b>
Fair value per share (Rs)	152
<b>Target price Sep'22 (Rs) (rounded to nearest Rs 5)</b>	<b>150</b>

Source: BOBCAPS Research

## Sensitivity to steel prices

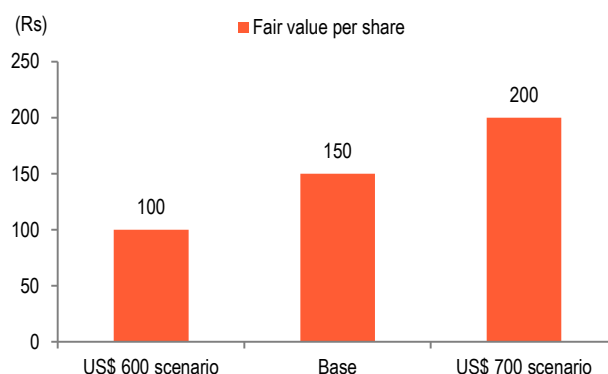
Our base case assumes Indian steel prices at US\$ 652/t over FY23-FY24. To test the downside to our assumptions, we analyse a scenario where prices stabilise at ~US\$ 600/t. Even if this happens, we expect SAIL's net debt/EBITDA to remain well under control. The company exhibits high sensitivity to changes in steel price with no offset from changes in iron price against steel as it uses entirely captive production. We highlight below the fair value per share for a US\$ 600 and a US\$ 700 scenario.

**Fig 6 – SAIL's leverage remains under control**



Source: Company, BOBCAPS Research

**Fig 7 – SAIL has higher sensitivity to steel prices**



Source: Company, BOBCAPS Research



## Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Steel prices have been supported by sharp demand recovery in China and the rest of the world, as well as raw material inflation supported by supply issues. Key downside risks to our estimates are slower recovery in the global economy, or an unfavourable change in global demand-supply balance for steel and its raw materials, leading to lower prices than our assumptions.

### Company-specific risks

- Faster/slower ramp-up of crude steel and value-added products than expected represents upside/downside risks to our earnings forecasts.

## Financials

### Income Statement

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Total revenue</b>	<b>617</b>	<b>691</b>	<b>912</b>	<b>888</b>	<b>945</b>
EBITDA	102	127	222	171	190
Depreciation	(38)	(41)	(43)	(45)	(47)
EBIT	65	86	179	126	142
Net interest inc./(exp.)	(35)	(28)	(19)	(17)	(14)
Other inc./(exp.)	9	9	7	7	8
Exceptional items	(8)	1	0	0	0
EBT	33	72	172	121	141
Income taxes	(12)	(31)	(58)	(41)	(48)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	2	5	5	5	5
<b>Reported net profit</b>	<b>21</b>	<b>41</b>	<b>114</b>	<b>80</b>	<b>93</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>21</b>	<b>41</b>	<b>114</b>	<b>80</b>	<b>93</b>

### Balance Sheet

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	63	70	85	88	93
Other current liabilities	196	216	216	216	216
Provisions	24	20	27	26	28
Debt funds	530	373	278	248	198
Other liabilities	41	59	64	62	66
Equity capital	41	41	41	41	41
Reserves & surplus	374	413	504	568	642
Shareholders' fund	415	454	545	609	684
<b>Total liab. and equities</b>	<b>1,269</b>	<b>1,192</b>	<b>1,215</b>	<b>1,250</b>	<b>1,285</b>
Cash and cash eq.	4	8	5	10	(9)
Accounts receivables	88	72	87	85	91
Inventories	238	153	142	147	155
Other current assets	80	89	117	114	121
Investments	0	0	0	0	0
Net fixed assets	654	641	656	677	695
CWIP	88	89	81	91	101
Intangible assets	14	14	14	14	14
Deferred tax assets, net	0	0	0	0	0
Other assets	102	126	112	112	117
<b>Total assets</b>	<b>1,269</b>	<b>1,192</b>	<b>1,215</b>	<b>1,250</b>	<b>1,285</b>

### Cash Flows

Y/E 31 Mar (Rs bn)	FY20A	FY21A	FY22E	FY23E	FY24E
<b>Cash flow from operations</b>	<b>(21)</b>	<b>244</b>	<b>170</b>	<b>143</b>	<b>144</b>
Capital expenditures	(20)	(30)	(49)	(75)	(75)
Change in investments	0	0	0	0	0
Other investing cash flows	(20)	(24)	14	1	(6)
<b>Cash flow from investing</b>	<b>(40)</b>	<b>(54)</b>	<b>(35)</b>	<b>(75)</b>	<b>(81)</b>
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	100	(157)	(95)	(30)	(50)
Interest expenses	(35)	(28)	(19)	(17)	(14)
Dividends paid	0	(4)	(23)	(16)	(19)
Other financing cash flows	(3)	2	0	0	0
<b>Cash flow from financing</b>	<b>62</b>	<b>(187)</b>	<b>(137)</b>	<b>(63)</b>	<b>(83)</b>
<b>Chg in cash &amp; cash eq.</b>	<b>2</b>	<b>4</b>	<b>(3)</b>	<b>5</b>	<b>(19)</b>
<b>Closing cash &amp; cash eq.</b>	<b>4</b>	<b>8</b>	<b>5</b>	<b>10</b>	<b>(9)</b>

### Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	5.1	10.0	27.6	19.3	22.6
Adjusted EPS	5.1	10.0	27.6	19.3	22.6
Dividend per share	0.0	1.0	5.5	3.9	4.5
Book value per share	100.5	109.9	132.0	147.4	165.5

### Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	1.6	1.5	1.1	1.0	0.9
EV/EBITDA	9.6	8.1	4.5	5.1	4.3
Adjusted P/E	26.1	13.3	4.9	6.9	5.9
P/BV	1.3	1.2	1.0	0.9	0.8

### DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	52.1	58.0	66.2	66.2	66.2
Interest burden (PBT/EBIT)	63.1	82.8	96.0	95.8	99.1
EBIT margin (EBIT/Revenue)	10.5	12.5	19.6	14.2	15.1
Asset turnover (Rev./Avg TA)	50.4	56.2	75.7	72.0	74.5
Leverage (Avg TA/Avg Equity)	3.0	2.8	2.4	2.1	2.0
<b>Adjusted ROAE</b>	<b>5.2</b>	<b>9.5</b>	<b>22.8</b>	<b>13.8</b>	<b>14.4</b>

### Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
<b>YoY growth (%)</b>					
Revenue	(7.9)	12.1	31.9	(2.6)	6.4
EBITDA	4.7	24.7	74.0	(23.0)	11.0
Adjusted EPS	(9.7)	95.6	174.4	(29.8)	16.9
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	16.6	18.4	24.3	19.2	20.1
EBIT margin	10.5	12.5	19.6	14.2	15.1
Adjusted profit margin	3.4	6.0	12.5	9.0	9.9
Adjusted ROAE	5.2	9.5	22.8	13.8	14.4
ROCE	7.9	10.1	21.0	14.7	16.1
<b>Working capital days (days)</b>					
Receivables	52	38	35	35	35
Inventory	141	81	57	61	60
Payables	45	45	45	45	45
<b>Ratios (x)</b>					
Gross asset turnover	0.5	0.6	0.8	0.7	0.7
Current ratio	0.9	0.7	0.8	0.8	0.9
Net interest coverage ratio	1.9	3.1	9.2	7.2	10.3
<b>Adjusted debt/equity</b>	<b>1.3</b>	<b>0.8</b>	<b>0.5</b>	<b>0.4</b>	<b>0.3</b>

Source: Company, BOBCAPS Research | Note: TA = Total Assets

## Disclaimer

### Recommendation scale: Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

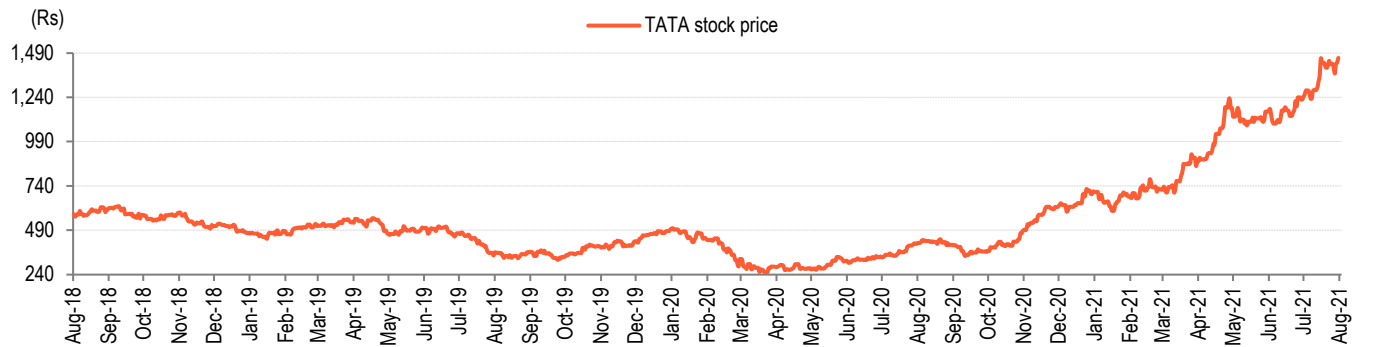
**HOLD** – Expected return from -6% to +15%

**SELL** – Expected return <-6%

**Note:** Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

### Ratings and Target Price (3-year history): TATA STEEL (TATA IN)



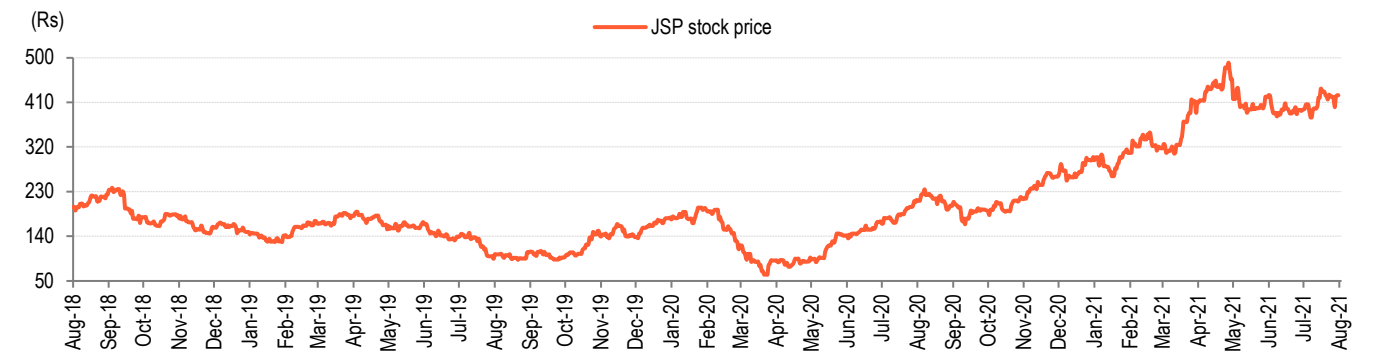
B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

### Ratings and Target Price (3-year history): JSW STEEL (JSTL IN)

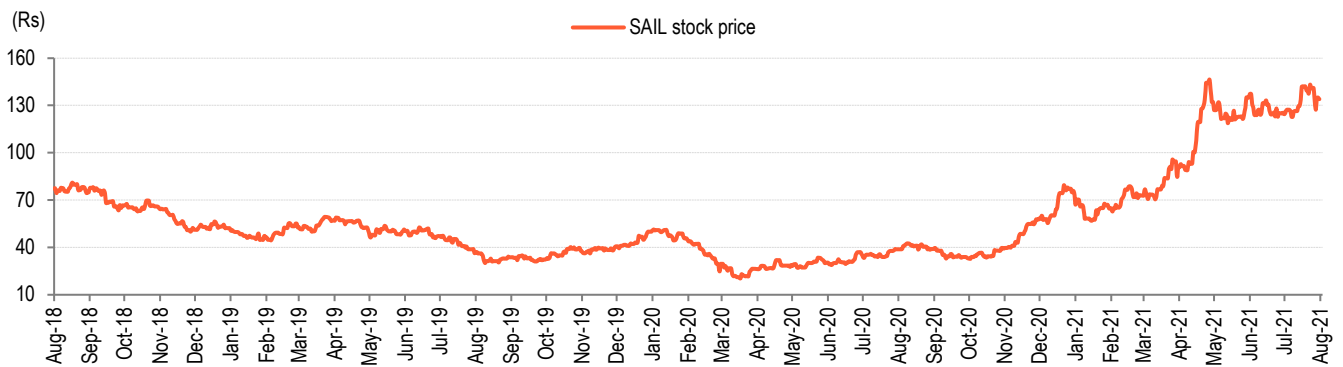


B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

### Ratings and Target Price (3-year history): JINDAL STEEL & POWER (JSP IN)



B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

**Ratings and Target Price (3-year history): SAIL (SAIL IN)**


B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

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