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HOLD
TP: Rs 90 | ⮝ 13%

SAIL | Metals & Mining | 30 August 2022

Plodding quest for growth

- **Expect full benefits of Rs 600bn expansion to flow by FY25; doubling of capacity needed to align employee cost with peers**
- **We conservatively forecast EBITDA/t of Rs 6.8k/Rs 7.7k over FY23/FY24 factoring in our lower steel margin forecasts for the Indian industry**
- **Maintain HOLD with a TP of Rs 90 (vs. Rs 150), set at a target EV/EBITDA of 4x (vs. 5x) to reflect the global economic downturn**

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Takeaways from our recent meeting with Amit Agarwal, Head of Investor Relations, SAIL:

Triggers to realise potential: SAIL has completed its Rs 600bn expansion and modernisation plan, but is still some time away from reaping the full benefits even after a decade-long execution drive. In our view, the company has two triggers that can bridge the gap between potential (20.2mt) and targeted production (17-17.5mt of sales guided for FY23): (1) an 0.8-1mt increase in Bhilai plant production after implementation of the Caster-4 unit, and (2) a 1mt rise in output at the IISCO and Durgapur plants via better utilisation of the 1.85mt structure mills (50-55% now) as demand grows in India.

Ramp-up of the Bokaro cold rolled mill could also help bridge the gap in production (6% of product mix in FY22 vs. SAIL's target of 11%). Semi-finished steel output has decreased to 15% of the product mix in FY22 vs. 12% targeted, and further reduction will hinge on ramp-up of the structure mills.

Legacy issues continue to weigh on margins: Improvement in employee cost per tonne remains slow as SAIL's annual manpower reduction by 3,000-4,000 staff is being partly negated by cost inflation and slow production scale-up. As legacy blast furnaces earn US$ 80-90/t lower margins, the average EBITDA margin remains constrained.

Demand pullback behind our estimate cut: We now assume FY23/FY24 EBITDA/t of Rs 6.8k/Rs 7.7k. With legacy blast furnaces still operating, a higher coke rate and weak operating leverage due to a large employee base, we expect the company to earn far lower steel margins than the US$ 200/t possible for the Indian industry, assuming China's gross margin settles at US$ 250/t, a 10Y historical average. SAIL's stock is currently discounting an EBITDA/t of Rs 4.9k/Rs 5.2k based on 5Y/10Y multiples.

Maintain HOLD: We cut FY23/FY24 EBITDA estimates by 39%/29% and lower our target 1Y forward EV/EBITDA multiple to 4x (vs. 5x) to reflect global economic uncertainty. Our TP thus reduces to Rs 90 (vs. Rs 150) – we retain HOLD given the recent stock correction, following which SAIL is trading at 3.7x FY24E EV/EBITDA compared to its 5Y/10Y mean of 5.4x/5.7x.

Key changes

Target	Rating
▼	◄ ►

Ticker/Price	SAIL IN/Rs 80
Market cap	US$
Free float	35%
3M ADV	US$ 27.1mn
52wk high/low	Rs 132/Rs 64
Promoter/FPI/DII	65%/4%/9%

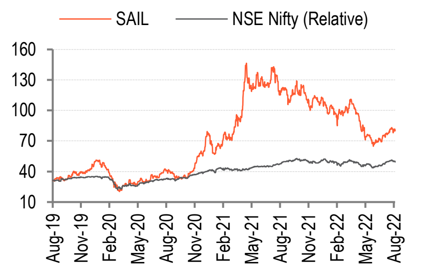
Source: NSE | Price as of 29 Aug 2022

Key financials

Y/E 31 Mar	FY22A	FY23E	FY24E
Total revenue (Rs mn)	1,035	1,024	952
EBITDA (Rs mn)	213	114	135
Adj. net profit (Rs mn)	122	49	67
Adj. EPS (Rs)	29.6	11.9	16.1
Consensus EPS (Rs)	29.6	10.5	10.1
Adj. ROAE (%)	24.6	8.8	11.2
Adj. P/E (x)	2.7	6.7	5.0
EV/EBITDA (x)	3.6	5.1	3.6
Adj. EPS growth (%)	195.0	(59.9)	35.6

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE

Key meeting takeaways

We recently hosted Amit Agarwal, Head of Investor Relations, SAIL. Key takeaways:

Cautiously positive H2FY23 market outlook

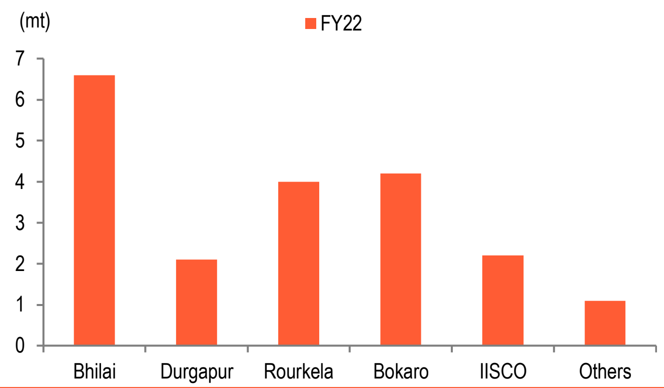
- **Prices have stabilised at a lower level:** SAIL highlighted initial signs of demand improvement with its sales run-rate improving 30% over the monthly average in Q1FY23 to 1.3-1.4mt in July. The company is now targeting record sales in August. The decline in the hot rolled (HR) coil segment has been arrested, with prices settling at Rs 55k/t from Rs 74-75k/t in April. Long product prices have corrected less due to a relatively higher cost of production for secondary manufacturers amid steep thermal coal prices.
- **Prices could improve in H2FY23 with demand pickup:** Construction demand seasonally improves in the second half of the fiscal year following the festive period. The government's infrastructure push should also help.

Triggers to realise growth potential

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. Looking through the operating history of the company's five integrated steel plants, we note that the Rourkela (Odisha) and Bokaro (Jharkhand) facilities have captured relatively greater benefits from the investment plan.

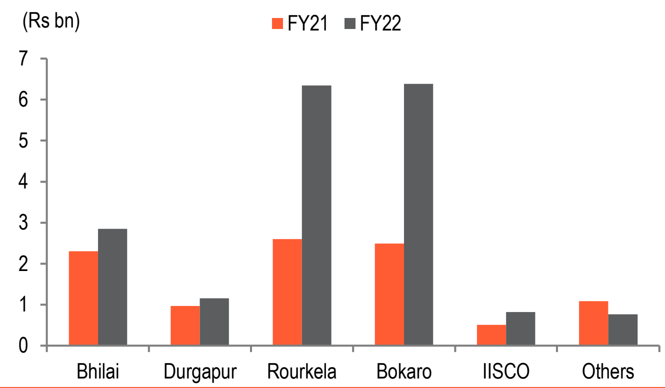
Bhilai (Chhattisgarh) has seen the addition of a new blast furnace, rail mill and other upgrades but needs an additional caster unit to achieve full potential. The Durgapur and IISCO plants (West Bengal) are yet to demonstrate sustained gains from the investment plan. Per management, efforts are underway to bridge the capacity gap, spur mix improvements and narrow the employee productivity gap with peers.

Fig 1 – Plant-wise capacity



Source: Company, BOBCAPS Research

Fig 2 – Plant-wise operating profit



Source: Company, BOBCAPS Research

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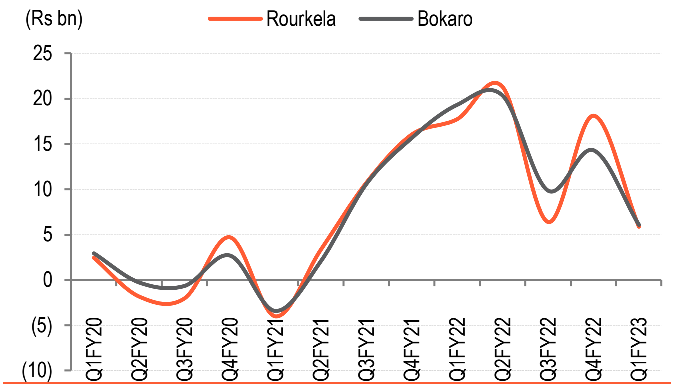
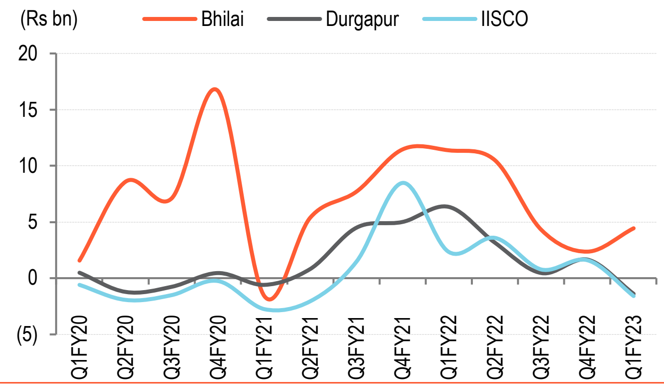
Fig 3 – Operating profit trend at Bokaro and Rourkela plants



Source: Company, BOBCAPS Research

Fig 4 – Operating profit trend at Bhilai, Durgapur and IISCO plants



Source: Company, BOBCAPS Research

Bridging the capacity gap

SAIL has previously guided for sales of 17-17.5mt in FY23 against potential production of 20.2mt after completion of expansion. Most plants have scope for improvement in capacity utilisation, except for Rourkela which has been operating at 90-95%. We believe two key developments will help the company achieve full production potential:

- Implementation of the fourth caster at the Bhilai steel plant will allow for an additional 0.8-1mt of output. SAIL aims to complete this by Q1FY24.
- Improvement in utilisation of structure mills at the IISCO and Durgapur plants from the current level of 50-55% will augment steel output by another ~1mt. SAIL is working to develop market demand for new structural products in Asia so as to improve utilisation.

Improving the product mix

- **Higher production of cold rolled/galvanised flat products:** SAIL's Q1FY23 production mix included 7% CR coils/sheets, 1% galvanised products and 27% HR plates/coils and sheets. This compares with a potential mix of 11%, 3% and 16% respectively post expansion. While some of the gap between actual and potential mix can be attributed to a commercial decision to prioritise HR products, SAIL expects improvement as the CR mill at the Bokaro steel plant ramps up.
- **Improvement in structure products at IISCO and Durgapur:** SAIL has a 0.85mtpa universal section mill at IISCO and a 1mtpa new structure mill at Durgapur. The company has ramped up utilisation to 50-55% so far and has been working with industry to introduce new products and garner acceptance on quality.
- **Margin expansion on rail products from Bhilai:** While the 1.2mtpa universal rail mill at Bhilai is operating at good utilisation levels, there is an opportunity to further improve margins via the inclusion of head-hardened rails in the sale mix. SAIL has been working with the railways to get its head-hardened rails accepted.

Bridging the employee productivity gap with peers

- SAIL's employee cost per tonne at ~Rs 7,000/t is almost double that of peers.
- Over the next three years or so, the company's productivity can improve marginally as it gradually closes the 15% capacity gap and brings about a 15% reduction in employee base (3,000-4,000 annual retirees) to ~50,000, partially offset by inflation-driven increases in employee costs.
- More material improvement in productivity will be realised when SAIL is able to double its output using the same manpower. The company's goal is to double output by 2030 in the next phase of growth.

Legacy furnaces to remain a drag on average profitability

SAIL has implemented 2.7-2.8mtpa of blast furnaces at three of its plants (Bhilai, IISCO and Rourkela) and upgraded the blast furnace at Bokaro during its modernisation plan. However, its older legacy blast furnaces still account for half of production and earn US$ 80-90/t lower EBITDA margins than new blast furnaces. This constrains the average margins for SAIL's plants.

Other takeaways

No plans to increase coking coal inventory

Despite the risk of rising prices during Australia's wet season starting Nov'22, SAIL highlighted that it is not planning to build coking coal inventory in the near term. The company's internal policy does not allow for significant inventory buildup due to deterioration in coking property during storage.

Contours for next wave of growth yet to be defined

In FY22, SAIL launched the next wave of expansion and modernisation at three plants (IISCO, Bokaro and Rourkela), aiming to double its capacity by 2030. The company has appointed a consultant to identify a product mix based on market needs and then work through the plant configuration. The process to define the contours of plant expansion could take 12-18 months, and the company plans to stagger implementation to limit debt. In the interim, SAIL is targeting a capex budget of Rs 80bn to implement schemes that will debottleneck capacities and enhance efficiencies.

Valuation methodology

Accounting for Q1FY23 actuals and the global economic downturn, we lower our FY23/FY24 standalone EBITDA/t estimates by 50%/22%% to Rs 6.8k/Rs 7.7k. This results in a 39%/29% cut in our EBITDA estimates.

Fig 5 – Revised estimates

(Rs bn)	Actual	New			Old		Change (%)	
	FY22	FY23E	FY24E	FY25E	FY23E	FY24E	FY23E	FY24E
Revenue	1,035	1,013	952	952	888	945	14.1	0.8
EBITDA	213	104	135	145	171	190	(39.4)	(28.6)
EBITDA growth (%)	67.5	(51.5)	30.8	7.2	(23.0)	11.0	-	-
Net income	122	41	67	74	80	93	(48.6)	(28.7)

Source: Company, BOBCAPS Research

Our FY23/FY24 EBITDA forecasts are 24%/56% ahead of consensus estimates. We attribute this to our higher EBITDA/t assumption of Rs 7.7k/t in FY24 (+13% YoY) as steel margins stabilise.

Fig 6 – Estimates vs. Consensus

(Rs bn)	BOBCAPS			Consensus			Delta to Consensus (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	1,013	952	952	971	953	813	5.4	(0.1)	17.0
EBITDA	104	135	145	108	110	93	5.6	23.5	56.0
Net income	41	67	74	72	66	34	(31.8)	0.9	118.3

Source: Company, BOBCAPS Research

Fig 7 – Key assumptions

Parameter	FY22	FY23E	FY24E	FY25E
Sales (mt)	16.2	16.9	17.6	18.1
India HRC (US$/t)	891	746	642	612
Realisation (Rs'000/t)	64.1	60.5	54.2	52.7
EBITDA/ton (Rs'000/t)	13.2	6.8	7.7	8.0

Source: Company, BOBCAPS Research

Maintain HOLD, TP lowered to Rs 90

We lower our TP to Rs 90 (from Rs 150) – this factors in our revised estimates and reduction in our target one-year forward EV/EBITDA multiple to 4x (from 5x) to account for increased uncertainty due to a slower-than-anticipated recovery in China and risks to global demand from the inflationary impact of the Russia-Ukraine war.

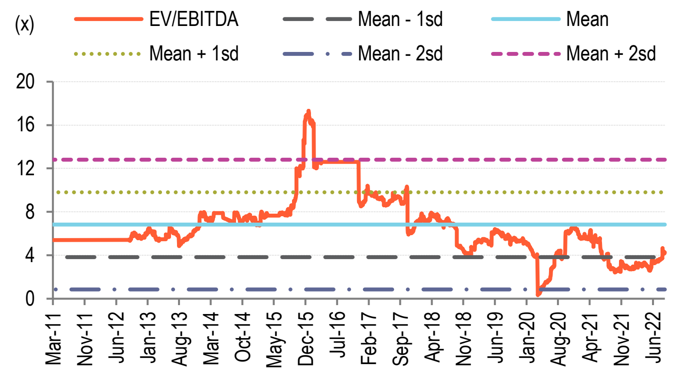
Our valuation multiple of 4x for SAIL is below our target 6x mid-cycle multiple for the Indian steel sector and reflects increased economic uncertainty. The target multiple is also below the stock's historical trading average of 5.4x/5.7x over the past five/ten-year period. The stock has corrected 28% over the past five months, leading us to maintain our HOLD rating.

Fig 8 – Valuation summary

Particulars	Value (Rs bn)
FY24E EBITDA	135
Target EV/EBITDA multiple (x)	4
EV	542
Net debt FY23E	164
Market Value	**377**
Fair value per share (Rs)	91
Target price Sep'22 (rounded to nearest Rs 5)	**90**

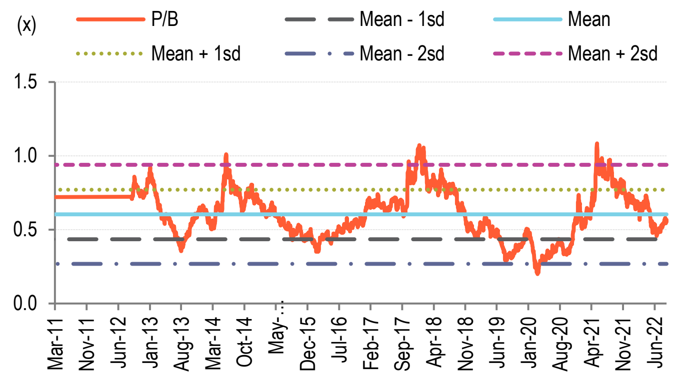
Source: Company, BOBCAPS Research

Fig 9 – EV/EBITDA 2Y forward



Source: Bloomberg, BOBCAPS Research

Fig 10 – P/B 1Y forward



Source: Bloomberg, BOBCAPS Research

Fig 11 – Peer comparison

Ticker	CMP (Rs)	Rating	Target (Rs)	Upside (%)	EV/Sales (x)		EV/EBITDA (x)		Net income (Rs bn)		P/B (x)		P/E (x)	
					FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
TATA IN	105	BUY	140	33.5	0.8	0.9	4.1	4.2	221	190	1.1	0.8	5.7	6.7
JSTL IN	650	HOLD	655	0.8	1.3	1.3	7.6	5.8	122	175	2.3	1.7	12.8	9.0
JSP IN	416	BUY	460	10.6	0.9	0.9	4.4	4.0	53	59	1.2	0.9	8.1	7.2
SAIL IN	80	HOLD	90	12.6	0.5	0.5	4.8	3.5	80	93	0.6	0.5	8.0	5.2

Source: BOBCAPS Research

Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Key upside/downside risks to our estimates are changes in global demand-supply balance for steel and its raw materials, leading to higher/lower prices and margins than our assumptions.
- Faster/slower ramp-up of crude steel and value-added production than our expectations represent upside/downside risks to our earnings forecasts.

Sector recommendation snapshot

Company	Ticker	Market Cap (US$ bn)	Price (Rs)	Target (Rs)	Rating
Jindal Steel & Power	JSP IN	5.3	416	460	BUY
JSW Steel	JSTL IN	19.6	650	655	HOLD
SAIL	SAIL IN	4.1	80	90	HOLD
Tata Steel	TATA IN	15.9	105	140	BUY

Source: BOBCAPS Research, NSE | Price as of 29 Aug 2022

Financials

Income Statement

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Total revenue	**691**	**1,035**	**1,024**	**952**	**952**
EBITDA	127	213	114	135	145
Depreciation	(41)	(43)	(45)	(47)	(50)
EBIT	86	171	69	88	95
Net interest inc./(exp.)	(28)	(17)	(15)	(11)	(8)
Other inc./(exp.)	9	9	7	7	7
Exceptional items	1	(4)	0	0	0
EBT	72	163	66	89	99
Income taxes	(31)	(40)	(17)	(22)	(25)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	5	4	5	5	5
Reported net profit	**41**	**122**	**49**	**67**	**74**
Adjustments	0	0	0	0	0
Adjusted net profit	**41**	**122**	**49**	**67**	**74**

Balance Sheet

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Accounts payables	70	169	162	145	144
Other current liabilities	216	157	157	157	157
Provisions	20	12	20	19	19
Debt funds	356	173	170	133	98
Other liabilities	76	148	158	156	158
Equity capital	41	41	41	41	41
Reserves & surplus	413	501	530	577	629
Shareholders' fund	454	542	572	618	670
Total liab. and equities	**1,192**	**1,201**	**1,239**	**1,228**	**1,246**
Cash and cash eq.	8	8	10	14	14
Accounts receivables	72	48	56	52	52
Inventories	153	196	199	179	177
Other current assets	89	37	41	38	38
Investments	0	0	0	0	0
Net fixed assets	641	684	689	702	712
CWIP	89	40	50	60	70
Intangible assets	14	15	15	15	15
Deferred tax assets, net	0	0	0	0	0
Other assets	126	174	178	167	167
Total assets	**1,192**	**1,201**	**1,239**	**1,228**	**1,246**

Cash Flows

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Cash flow from operations	**244**	**295**	**105**	**132**	**135**
Capital expenditures	(30)	(37)	(61)	(71)	(71)
Change in investments	0	0	0	0	0
Other investing cash flows	(24)	(47)	(5)	11	1
Cash flow from investing	**(54)**	**(84)**	**(65)**	**(60)**	**(70)**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(156)	(183)	(3)	(38)	(35)
Interest expenses	(28)	(17)	(15)	(11)	(8)
Dividends paid	(12)	(36)	(20)	(20)	(22)
Other financing cash flows	9	25	0	0	0
Cash flow from financing	**(187)**	**(211)**	**(37)**	**(68)**	**(65)**
Chg in cash & cash eq.	**4**	**0**	**2**	**4**	**0**
Closing cash & cash eq.	**8**	**8**	**10**	**14**	**14**

Per Share

Y/E 31 Mar (Rs)	FY21A	FY22A	FY23E	FY24E	FY25E
Reported EPS	10.0	29.6	11.9	16.1	18.0
Adjusted EPS	10.0	29.6	11.9	16.1	18.0
Dividend per share	2.8	8.7	4.8	4.8	5.4
Book value per share	109.9	131.2	138.4	149.7	162.2

Valuations Ratios

Y/E 31 Mar (x)	FY21A	FY22A	FY23E	FY24E	FY25E
EV/Sales	1.1	0.7	0.6	0.5	0.5
EV/EBITDA	6.2	3.6	5.1	3.6	3.2
Adjusted P/E	8.0	2.7	6.7	5.0	4.4
P/BV	0.7	0.6	0.6	0.5	0.5

DuPont Analysis

Y/E 31 Mar (%)	FY21A	FY22A	FY23E	FY24E	FY25E
Tax burden (Net profit/PBT)	58.0	73.5	74.8	74.8	74.8
Interest burden (PBT/EBIT)	82.8	97.5	95.4	101.2	104.0
EBIT margin (EBIT/Revenue)	12.5	16.5	6.7	9.2	10.0
Asset turnover (Rev./Avg TA)	56.2	86.5	83.9	77.2	76.9
Leverage (Avg TA/Avg Equity)	2.8	2.4	2.2	2.1	1.9
Adjusted ROAE	9.5	24.6	8.8	11.2	11.5

Ratio Analysis

Y/E 31 Mar	FY21A	FY22A	FY23E	FY24E	FY25E
YoY growth (%)					
Revenue	12.1	49.7	(1.1)	(7.0)	(0.1)
EBITDA	24.7	67.5	(46.5)	18.6	7.2
Adjusted EPS	95.6	195.0	(59.9)	35.6	11.5
Profitability & Return ratios (%)					
EBITDA margin	18.4	20.6	11.2	14.2	15.2
EBIT margin	12.5	16.5	6.7	9.2	10.0
Adjusted profit margin	6.0	11.8	4.8	7.0	7.8
Adjusted ROAE	9.5	24.6	8.8	11.2	11.5
ROCE	10.1	20.5	8.6	10.5	11.1
Working capital days (days)					
Receivables	38	17	20	20	20
Inventory	81	69	71	69	68
Payables	45	75	65	65	65
Ratios (x)					
Gross asset turnover	0.6	0.9	0.8	0.8	0.8
Current ratio	0.7	0.7	0.7	0.7	0.7
Net interest coverage ratio	3.1	10.1	4.5	8.3	12.2
Adjusted debt/equity	0.8	0.3	0.3	0.2	0.1

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

Disclaimer

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

BUY – Expected return >+15%

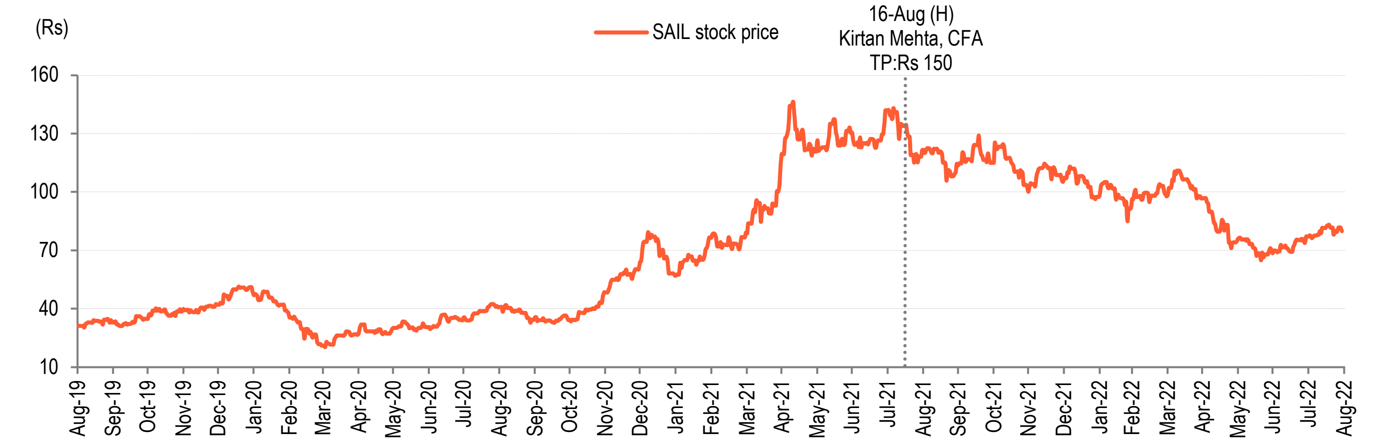
HOLD – Expected return from -6% to +15%

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): SAIL (SAIL IN)



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

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