RESULT REVIEW

BOBCAPS
TRUST | INNOVATION | EXCELLENCE

HOLD

TP: Rs 95 | ▲ 10%

SAIL | Metals & Mining | 20 February 2023

Higher production positive but legacy issues linger

- **Q3 marks recovery in line with peers; production uptick helped SAIL partly bridge the gap with existing capacity**
- **Plugging of margin gap vis-à-vis peers requires resolution of bloated employee base and margin penalty on legacy blast furnaces**
- **We raise TP to Rs 95 (from Rs 90) on valuation rollover; maintain HOLD**

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Q3 marks recovery from lows: While SAIL's Q3FY23 EBITDA recovered from a bottom, in line with consensus, net income missed estimates on higher debt.

Production gap partly bridged: SAIL finally delivered a production pickup in Q3, achieving an annualised run-rate of 18.8mt. This is still short of its 21mt potential and further pickup is likely to be slow, contingent on utilisation improvement in structural mills at Durgapur and IISCO. We expect sales to pick up to 4.8mt in Q4 (+16% QoQ) and 17.6mt in FY24 (+12% YoY).

EBITDA constrained by legacy issues: While higher sales should help reduce per-unit fixed costs, legacy issues of a higher employee base and older blast furnaces continue to weigh on profitability. SAIL's employee cost could come in line with peers when the company implements its next wave of expansion (13mt) sans material addition to the employee base. Similarly, the US$ 80-90/t gap in EBITDA margin for legacy vs. newer blast furnaces can be closed upon modernisation of these units planned in the next wave. See **Plodding quest for growth** for details.

FY23 forecasts cut: Accounting for weaker 9MFY23 actuals and an increase in borrowings, we cut our FY23 EBITDA estimate by 23%. Factoring in slower steel margin stabilisation over FY24, we assume EBITDA margins of Rs 7.2k/t/Rs 8.0k/t for FY24/FY25 and tweak our EBITDA forecasts by -5%/-2%.

Likely to lag peers in next growth phase: SAIL plans to add 3mt of capacity via debottlenecking over the next 3-4 years and to start a 4.5mt brownfield expansion project over the next couple of years (of 13mt planned by FY31). This translates into a slower growth trajectory than peers who have put into motion capex over FY24-FY26.

Maintain HOLD: We raise our TP from Rs 90 to Rs 95 as we revise estimates and roll our valuation base forward to FY25E, continuing to value the stock at an unchanged target EV/EBITDA multiple of 4x. Retain HOLD given limited upside potential of 10%.

Key changes

Target	Rating
▲	◀ ▶

Ticker/Price	SAIL IN/Rs 86
Market cap	US$ 4.3bn
Free float	35%
3M ADV	US$ 19.5mn
52wk high/low	Rs 112/Rs 64
Promoter/FPI/DII	65%/4%/11%

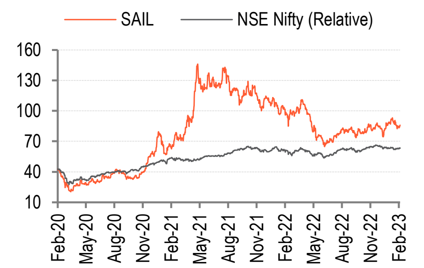
Source: NSE | Price as of 17 Feb 2023

Key financials

Y/E 31 Mar	FY22A	FY23E	FY24E
Total revenue (Rs mn)	1,035	1,042	1,061
EBITDA (Rs mn)	213	87	129
Adj. net profit (Rs mn)	122	26	58
Adj. EPS (Rs)	29.6	6.4	14.0
Consensus EPS (Rs)	29.6	5.1	11.2
Adj. ROAE (%)	24.6	4.8	10.0
Adj. P/E (x)	2.9	13.5	6.2
EV/EBITDA (x)	3.7	7.1	4.3
Adj. EPS growth (%)	195.2	(78.5)	119.9

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE

Recovery in Q3 but not out of the woods yet

While SAIL's Q3FY23 EBITDA of Rs 20.8bn was broadly in line with consensus (+2%), net profit of Rs 1.3bn fell short.

Production finally picks up

- **Production rises in Q3…:** SAIL's crude steel production at 4.7mt in Q3 was ahead of our forecast of 4.3mt and translated into an annualised run-rate of 18.8mt, showing a clear pickup over FY23 guidance of 17.0-17.5mt.
- **…but further increase limited near term:** Despite the improvement in Q3, the production shortfall continues given 21.2mt of crude steel capacity. We believe a further increase in output is contingent upon achieving better utilisation at the 1.85mt structure mills (operating at 50-55% now), which is linked to growth in domestic demand for structural products.
- **Sales volume to increase in Q4 and FY24:** While sales were muted in Q3 at 4.2mt, management has guided for 4.8mt in Q4 on the back of better domestic demand during a seasonally peak quarter.
- **FY24 production and sales forecasts raised:** Factoring in weak 9M sales and build-up of 0.5mt of excess inventory, we cut our FY23 sales forecast by 4% to 16.2mt. Factoring in liquidation of excess inventory thereafter, we increase our sales estimate by 3% to 18.0mt in FY24.

EBITDA recovers from bottom but legacy issues persist

Lower coking coal costs aid revival in Q3

EBITDA recovered in Q3 to Rs 5.0k/t from a bottom of Rs 1.7k/t in Q2 due to a Rs 6.4k/t reduction in operating cost, which management attributed to lower coking coal consumption cost. Employee and other conversion expenses were in line with the company's historical run-rate. With the return of Bhilai and Rourkela to profit from losses in Q2, all five major plants reported operating profits in Q3. Profit levels at these plants remain quite modest compared to the surge seen in FY22 (Fig 5-8).

- While a material ramp-up in production indicates the potential addition of a caster unit at the Bhilai (Chhattisgarh) steel plant, unit profitability remains weak. We will watch performance of the Bhilai plant over the next few quarters to understand the benefits of completion of the fourth caster.
- The Durgapur and IISCO plants (West Bengal) are yet to demonstrate sustained gains from the ongoing investment plan. Ramp-up in profitability remains contingent upon better utilisation of the structural mills at these two plants. While the IISCO plant has a 0.85mtpa universal section mill, the Durgapur unit has a 1mtpa new structural mill. The Durgapur unit has seen a pickup to ~50kt per month (or 0.6mt annualised), whereas the IISCO plant has picked up to 35kt per month (0.4mt annualised) from 15-20kt a year ago. Together, both plants are operating at 50-55% utilisation, and SAIL has been working with the industry to introduce new products and garner acceptance on quality.

Expect volume-led improvement in Q4 EBITDA

Management guidance suggests that gross margins may not materially improve in Q4FY23 as the benefit of higher sales realisation (guided at +Rs 1.5-2.0k/t) is likely to be offset by increased coking coal costs for March (+Rs 4k/t). However, with a 15% recovery in volumes per management guidance, unit EBITDA per tonne is likely to improve as fixed costs decline. Management also expects additional reimbursement from the railways in Q4 for higher costs on FY21-FY22 rail sale volumes of 1.1mt.

Legacy issues continue to weigh on margins

While management has partly bridged the gap with its potential crude steel capacity of 21mt, we believe improvement in profitability remains constrained by legacy issues.

- Improvement in employee cost per tonne remains sluggish as SAIL's annual manpower reduction by 3,000-4,000 staff is being partly negated by cost inflation.
- Older legacy blast furnaces constrain the average margins for SAIL's plants. These furnaces still account for half of production and earn US$ 80-90/t lower EBITDA margins than new blast furnaces.

Product mix improvement some time away

While the share of semis in revenue has dropped to 9% in 9MFY23 from 15% in FY22, we do not see material improvement in flat or long products between FY22 and FY23. We, therefore, relate the reduction to an increase in exports of lower value semis. Management guidance implies that further improvement in the product mix will be contingent upon better utilisation of structural mills. Also, a ramp-up of the Bokaro cold rolled mill could help bridge the gap in production (6% of product mix in FY22 vs. SAIL's target of 11%).

Debt has risen again

SAIL's gross debt has risen from a low of Rs 134bn as at Mar'22 to Rs 293bn at end-Dec'22 owing to a significant increase in working capital driven by higher inventory levels (from 0.6mt to 1.2mt) and coking coal costs. Though management aims to lower debt by Rs 30bn-40bn, SAIL is still likely to end FY23 at Rs 240bn-250bn.

Next wave of capex at least a couple of years away

Management is rightly focused on lowering debt before undertaking the next wave of projects. Thus, capital spend is likely to remain in check with guidance of Rs 55bn for FY23 and Rs 60bn for FY24.

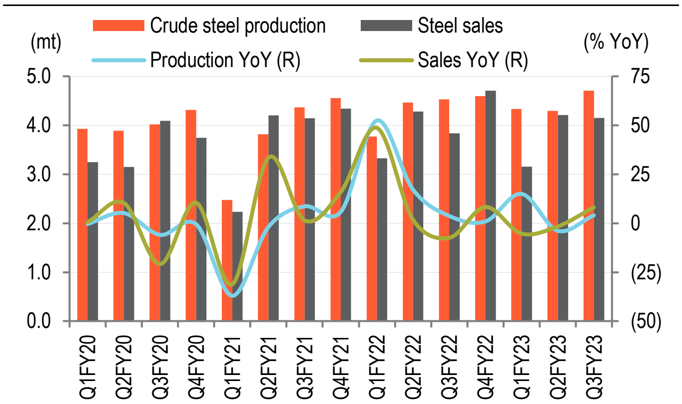
Management aims to expand crude steel capacity by 3mt over the next 3-4 years with debottlenecking at existing plants. SAIL has initiated environmental impact assessment for increasing hot metal production by 0.2mtpa to 2.7mtpa at Durgapur and crude steel production by 0.65mtpa/0.35mtpa at Rourkela/Bokaro. Management also aims to initiate the first 4.5mt expansion project at one of the existing sites over the next 12-24 months after completion of a detailed feasibility report. The plan is to expand steel production by 13mtpa by FY31 in a staggered manner.

Fig 1 – Quarterly performance

(Rs bn)	Q3FY23	Q2FY23	QoQ (%)	Q3FY22	YoY (%)	9MFY23	9MFY22	YoY (%)
Consolidated P&L								
Revenue	250.4	262.5	(4.6)	252.5	(0.8)	753.2	727.2	3.6
EBITDA	**20.8**	**7.4**	**182.7**	**34.0**	**(38.9)**	**51.2**	**170.0**	**(69.9)**
EBIT	8.6	(4.5)	291.2	23.5	(63.6)	15.2	138.7	(89.1)
PBT before JV and exceptionals	3.2	(5.6)	156.4	21.9	(85.6)	6.6	130.6	(94.9)
PBT before exceptionals	4.3	(4.4)	196.6	23.7	(82.0)	10.3	133.8	(92.3)
PAT adjusted before JV	**1.3**	**(4.5)**	**129.5**	**17.1**	**(92.3)**	**3.5**	**98.1**	**(96.5)**
PAT adjusted	2.4	(3.3)	174.0	18.9	(87.1)	7.2	101.3	(92.9)
PAT reported	5.4	(3.3)	264.6	15.3	(64.5)	10.2	97.6	(89.6)
EPS (Rs)	1.3	(0.8)	263.8	3.7	(64.6)	2.5	23.6	(89.6)
Tax rate (%)	43.0	25.6	-	20.1	-	30.4	24.3	-
Standalone								
Crude steel production (mt)	4.7	4.3	9.6	4.5	3.9	13.3	12.8	4.4
Steel sales (mt)	4.2	4.2	(1.4)	3.8	8.1	11.5	11.4	0.6
Realisation (Rs'000/t)	60.3	62.3	(3.2)	65.7	(8.2)	65.4	63.5	3.0
Gross margin (Rs'000/t)	**27.7**	**23.3**	**19.0**	**36.5**	**(24.1)**	**29.4**	**40.8**	**(28.0)**
Employee costs (Rs'000/t)	6.7	6.7	(0.7)	9.7	(30.9)	7.5	8.6	(12.7)
Other conversion costs (Rs'000/t)	16.0	14.8	8.1	17.9	(10.8)	17.4	17.3	0.4
EBITDA (Rs'000/tcs)	**5.0**	**1.7**	**186.8**	**8.9**	**(43.5)**	**4.4**	**14.9**	**(70.1)**

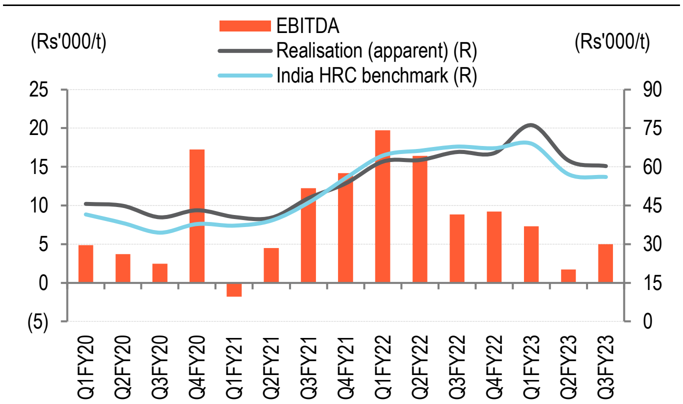
Source: Company, BOBCAPS Research

Fig 2 – Surprise pickup in production but sales muted



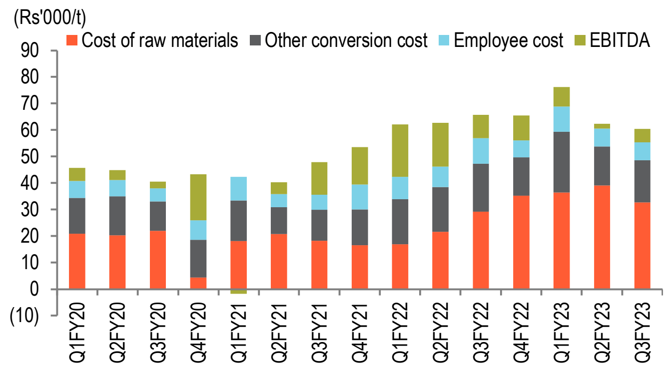
Source: Company, BOBCAPS Research

Fig 3 – EBITDA recovered from the bottom seen in Q2...



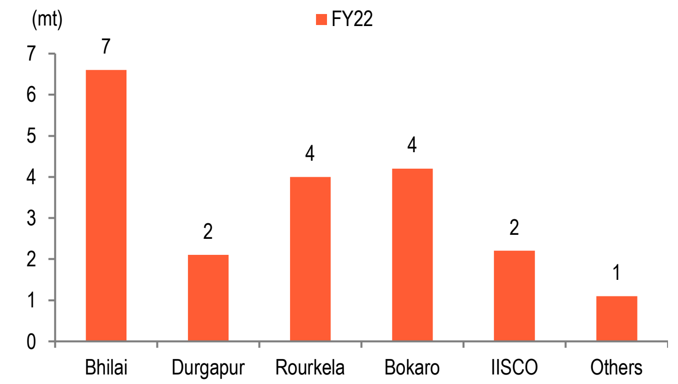
Source: Company, BOBCAPS Research

Fig 4 – …with recovery driven primarily by reduction in coking coal consumption costs



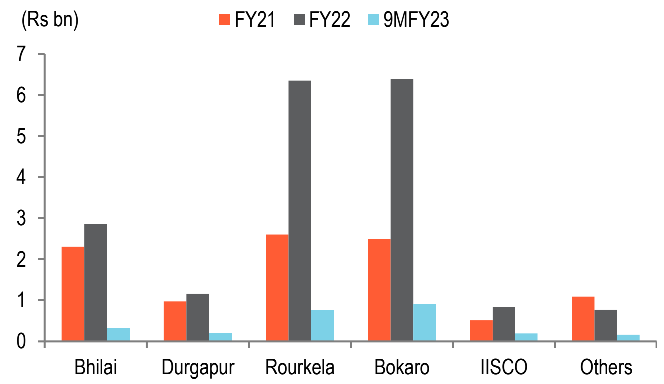
Source: Company, BOBCAPS Research

Fig 5 – Plant-wise capacity currently totals 20mt



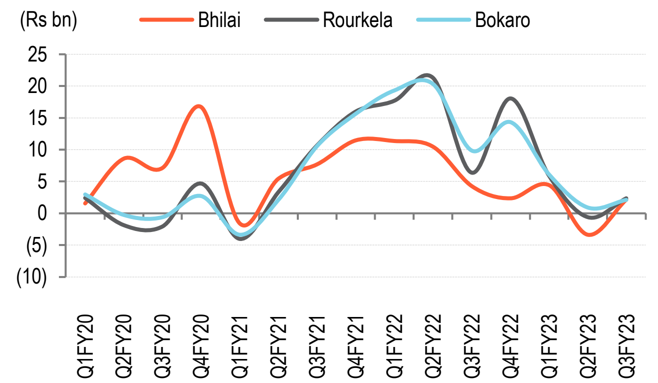
Source: Company, BOBCAPS Research

Fig 6 – Plant-wise operating profit has plummeted in 9M



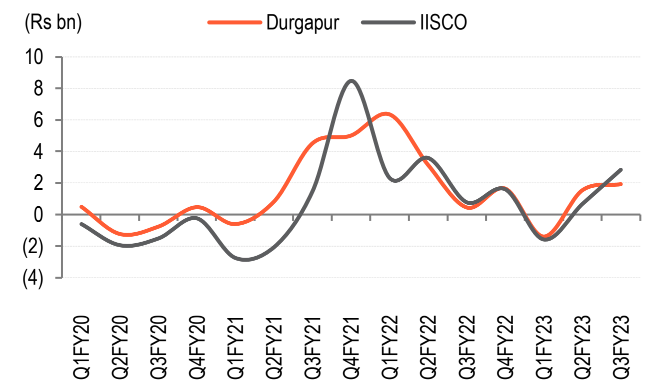
Source: Company, BOBCAPS Research

Fig 7 – Operating profit at larger plants significantly lower than the surge seen in FY22



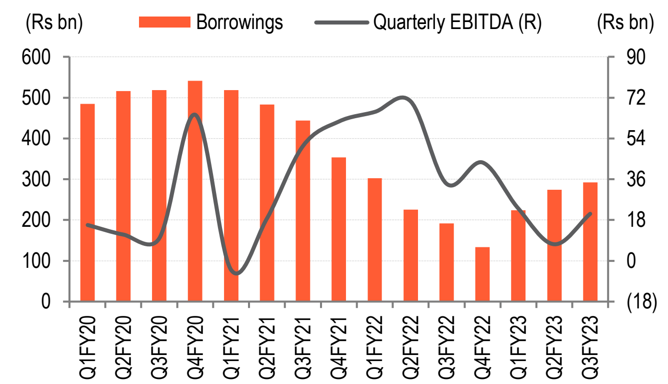
Source: Company, BOBCAPS Research

Fig 8 – Operating profit trends at smaller plants shows a recovery but on a smaller base



Source: Company, BOBCAPS Research

Fig 9 – Borrowings picked up again from a low in FY22



Source: Company, BOBCAPS Research

Valuation methodology

Accounting for weaker 9MFY23 actuals and an increase in borrowings, we cut our FY23 EBITDA and net profit estimates by 23% and 47% respectively. Factoring in our assumption of slower steel margin stabilisation over FY24, we cut unit EBITDA margin forecasts by 7%/0% over FY24/FY25 to Rs 7.2/Rs 8k/t and marginally lower our EBITDA estimates by 5%/2%. Our forecasts assume a continued production gap versus capacity and the negative impact of legacy blast furnaces on average margins for SAIL.

Fig 10 – Revised estimates

(Rs bn)	Actual	New			Old			Change (%)		
	FY22	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	1,035	1,042	1,061	992	1,024	952	952	1.7	11.4	4.3
EBITDA	213	87	129	142	114	135	145	(23.4)	(4.6)	(2.4)
EBITDA growth (%)	67.5	(59.0)	47.7	9.7	(46.5)	18.6	7	-	-	-
Net income	122	26	58	67	49	67	74	(46.5)	(13.2)	(9.5)

Source: Company, BOBCAPS Research

We are ahead of consensus EBITDA over FY23-FY25, likely on assumptions of stronger recovery in EBITDA margin on a lower base. Note that our margin assumptions are for a modest recovery to Rs 7.2/Rs 8k/t in FY24/FY25.

Fig 11 – Estimates vs. Consensus

(Rs bn)	BOBCAPS			Consensus			Delta to Consensus (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	1,042	1,061	992	1,029	1,007	1,018	1.2	5.3	(2.5)
EBITDA	87	129	142	84	121	127	4.0	6.5	11.5
Net income	26	58	67	22	49	51	21.7	17.2	30.8

Source: Company, BOBCAPS Research

Fig 12 – Key assumptions

Parameter	FY22	FY23E	FY24E	FY25E
Sales (mt)	16.2	16.2	18.0	17.6
India HRC (US$/t)	891	748	670	642
Realisation (Rs'000/t)	64.1	64.3	58.8	56.3
EBITDA/ton (Rs'000/t)	13.2	5.4	7.2	8.0

Source: Company, BOBCAPS Research

Maintain HOLD, TP increased to Rs 95

We raise our TP from Rs 90 to Rs 95 as we revise estimates and roll our valuation base forward to FY25E, continuing to value the stock at an unchanged target EV/EBITDA multiple of 4x. We maintain our HOLD rating given 10% upside potential.

Our valuation multiple of 4x for SAIL is below our target 6x mid-cycle multiple for the Indian steel sector and reflects weaker profitability of the company's operations and a pause in its capex programme. We believe that steel margins will stabilise in FY24 aided by supportive government policies in China aimed at rebooting the economy.

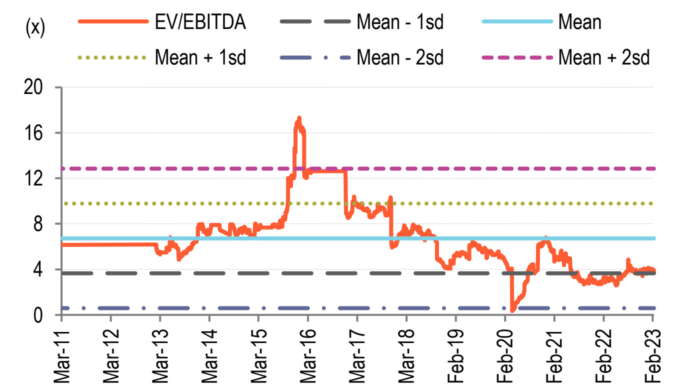
Fig 13 – Valuation summary

(Rs bn)	Value (Rs bn)
FY25E EBITDA	142
Target EV/EBITDA multiple (x)	4.0
EV	567
Net debt FY24E	166
Market Value	401
Fair value per share (Rs)	97
Target price Mar'23 (rounded to nearest Rs 5)	95

Source: Company, BOBCAPS Research

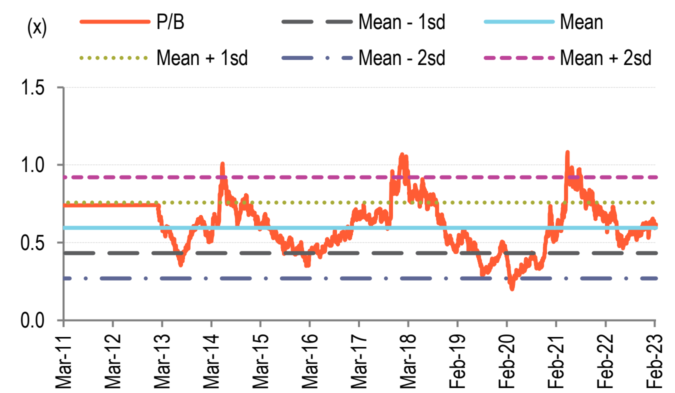
Our target multiple is lower than the stock's historical trading average of 4.6x/6.7x over the past five-year/ten-year period.

Fig 14 – EV/EBITDA 2Y forward



Source: Bloomberg, BOBCAPS Research

Fig 15 – P/B 1Y forward



Source: Bloomberg, BOBCAPS Research

Fig 16 – Peer comparison

Ticker	CMP (Rs)	Rating	Target Price (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	112	BUY	140	24.7	0.9	0.8	5.8	4.6	89	126	1.2	1.0	10.7	7.5
JSTL IN	728	HOLD	715	(1.8)	1.5	1.4	7.4	5.9	39	135	2.5	1.8	13.0	9.5
JSP IN	590	BUY	670	13.5	1.3	1.2	5.8	4.3	38	56	1.5	1.2	10.7	7.8
SAIL IN	86	HOLD	95	10.3	0.5	0.5	4.0	3.4	49	67	0.6	0.6	6.2	5.3

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 and implementation of efficiency measures 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	7.3	590	670	BUY
JSW Steel	JSTL IN	21.3	728	715	HOLD
SAIL	SAIL IN	4.3	86	95	HOLD
Tata Steel	TATA IN	16.6	112	140	BUY

Source: BOBCAPS Research, NSE | Price as of 17 Feb 2023

Financials

Income Statement

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Total revenue	**691**	**1,035**	**1,042**	**1,061**	**992**
EBITDA	127	213	87	129	142
Depreciation	(41)	(43)	(48)	(50)	(52)
EBIT	86	171	39	79	90
Net interest inc./(exp.)	(28)	(17)	(18)	(14)	(12)
Other inc./(exp.)	9	9	7	7	7
Exceptional items	1	(4)	3	0	0
EBT	72	163	36	77	90
Income taxes	(31)	(40)	(10)	(19)	(23)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	5	4	5	5	5
Reported net profit	**41**	**122**	**26**	**58**	**67**
Adjustments	0	0	0	0	0
Adjusted net profit	**41**	**122**	**26**	**58**	**67**

Balance Sheet

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Accounts payables	80	169	144	140	128
Other current liabilities	170	157	157	157	157
Provisions	20	12	21	21	20
Debt funds	377	173	243	180	145
Other liabilities	76	148	158	161	159
Equity capital	41	41	41	41	41
Reserves & surplus	413	501	518	558	605
Shareholders' fund	454	542	559	600	647
Total liab. and equities	**1,178**	**1,201**	**1,282**	**1,260**	**1,256**
Cash and cash eq.	8	8	7	15	23
Accounts receivables	82	48	63	64	60
Inventories	153	196	248	204	186
Other current assets	65	37	42	43	40
Investments	0	0	0	0	0
Net fixed assets	641	684	681	682	690
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	176	177	172
Total assets	**1,178**	**1,201**	**1,282**	**1,260**	**1,256**

Cash Flows

Y/E 31 Mar (Rs bn)	FY21A	FY22A	FY23E	FY24E	FY25E
Cash flow from operations	**223**	**316**	**14**	**164**	**140**
Capital expenditures	(30)	(37)	(56)	(61)	(71)
Change in investments	0	0	0	0	0
Other investing cash flows	(24)	(47)	(2)	(2)	6
Cash flow from investing	**(54)**	**(84)**	**(58)**	**(62)**	**(65)**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(135)	(204)	70	(63)	(35)
Interest expenses	(28)	(17)	(18)	(14)	(12)
Dividends paid	(12)	(36)	(9)	(17)	(20)
Other financing cash flows	9	25	0	0	0
Cash flow from financing	**(166)**	**(232)**	**43**	**(94)**	**(67)**
Chg in cash & cash eq.	**4**	**0**	**(1)**	**8**	**8**
Closing cash & cash eq.	**8**	**8**	**7**	**15**	**23**

Per Share

Y/E 31 Mar (Rs)	FY21A	FY22A	FY23E	FY24E	FY25E
Reported EPS	10.0	29.6	6.4	14.0	16.3
Adjusted EPS	10.0	29.6	6.4	14.0	16.3
Dividend per share	2.8	8.7	2.2	4.2	4.9
Book value per share	109.9	131.2	135.4	145.2	156.6

Valuations Ratios

Y/E 31 Mar (x)	FY21A	FY22A	FY23E	FY24E	FY25E
EV/Sales	1.2	0.8	0.6	0.5	0.6
EV/EBITDA	6.4	3.7	7.1	4.3	3.9
Adjusted P/E	8.6	2.9	13.5	6.2	5.3
P/BV	0.8	0.7	0.6	0.6	0.6

DuPont Analysis

Y/E 31 Mar (%)	FY21A	FY22A	FY23E	FY24E	FY25E
Tax burden (Net profit/PBT)	58.0	73.6	78.4	74.8	74.8
Interest burden (PBT/EBIT)	82.8	97.5	85.0	97.5	100.4
EBIT margin (EBIT/Revenue)	12.5	16.5	3.8	7.5	9.0
Asset turnover (Rev./Avg TA)	56.5	87.0	83.9	83.5	78.9
Leverage (Avg TA/Avg Equity)	2.8	2.4	2.3	2.2	2.0
Adjusted ROAE	9.5	24.6	4.8	10.0	10.8

Ratio Analysis

Y/E 31 Mar	FY21A	FY22A	FY23E	FY24E	FY25E
YoY growth (%)					
Revenue	12.1	49.7	0.7	1.9	(6.5)
EBITDA	24.7	67.5	(59.0)	47.7	9.7
Adjusted EPS	95.6	195.2	(78.5)	119.9	16.3
Profitability & Return ratios (%)					
EBITDA margin	18.4	20.6	8.4	12.2	14.3
EBIT margin	12.5	16.5	3.8	7.5	9.0
Adjusted profit margin	6.0	11.8	2.5	5.4	6.8
Adjusted ROAE	9.5	24.6	4.8	10.0	10.8
ROCE	10.0	20.3	5.1	9.1	10.2
Working capital days (days)					
Receivables	43	17	22	22	22
Inventory	81	69	87	70	69
Payables	52	75	55	55	55
Ratios (x)					
Gross asset turnover	0.6	0.9	0.8	0.8	0.8
Current ratio	0.7	0.7	0.8	0.7	0.7
Net interest coverage ratio	3.1	10.1	2.2	5.5	7.7
Adjusted debt/equity	0.8	0.3	0.4	0.3	0.2

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

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

BUY – Expected return >+15%

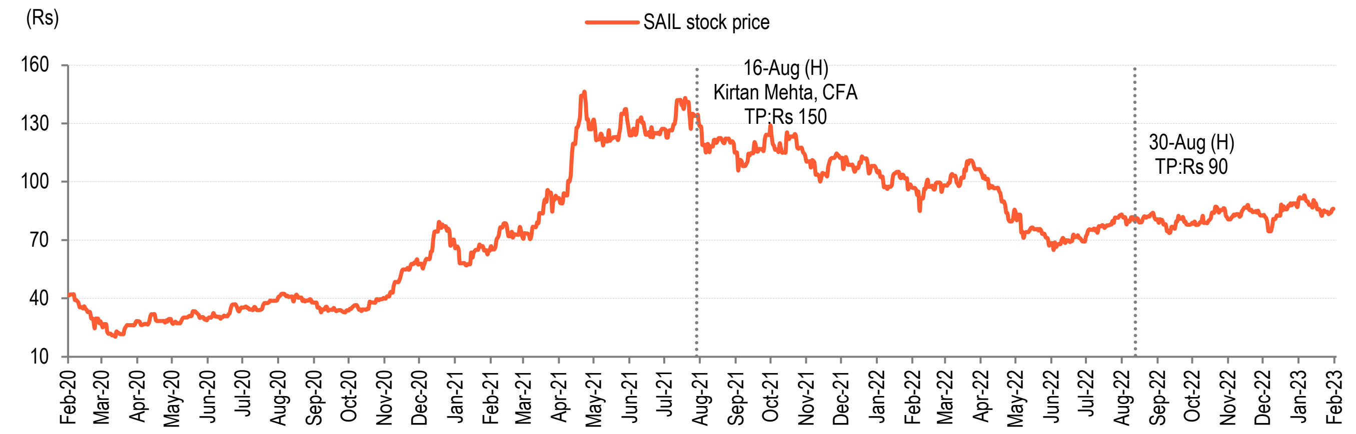
HOLD – Expected return from -6% to +15%

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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