

Steel Authority of India (SAIL)

Date
01/04/2011

Sensex
19445

Nifty
5833

Sector
Metal - Steel

CMP
Rs.169.75

Face Value
Rs.10/share

Equity Capital
Rs.4134 cr.

52 Week H/L in Rs.
258.45/150

Market cap Rs. Cr.
64599

Share Holding

	Shares (Crs)	%holding
Govt	354	85
Financial Institutions	27.5	8
Banks/Mutual Fund	6	1
FII	18.5	5
Public	7.25	2
Total	413	1

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Summary

SAIL is India's leading steel maker and manufactures a variety of finished steel products which are mainly used for infrastructure and automobile industry. 58% of SAIL's overall revenue is generated from Flat products (automobile steel) and Long products (infrastructure steel) contribute 34% to the revenue. On consolidation basis, SAIL's revenue for Q3 FY2011 has grown by 4.68%, EBITDA margin has grown by 1.2% and PAT margin has gone down by 3.07% Q-O-Q. The Management is planning to expand its production capacity from the current level of 14.6 million tonnes to 26.2 million tonnes by the end of 2014 at cost of Rs.70,000 crores. Since 80% of the investment is in brown field projects, we expect that increased scale and modernization will bring about a reduction in raw materials cost and an increase in the EBITDA margins. Currently the stock is trading at P/E of 14x and 15.5x on FY2011 and FY2012 EPS respectively. The Company's Follow on Public Offer (FPO) is likely to hit the market in the next few weeks; we expect a dip in the stock price due to increased supply of shares. Considering these headwinds, the current valuations look expensive, however given the robust demand for steel products over the long term we are positive on the steel sector and SAIL being a major player, would stand to benefit. We recommend a **HOLD** on this stock.

Introduction to the Company:

Steel authority of India (SAIL) is a Government undertaking Company where GOI holds nearly 85.2% of the equity. It is one of the leading steel makers in the country, holding a market share of 20%. A fully integrated iron and steel maker, it produces both basic and special steel (value addition) for domestic construction, engineering, power, railway, automotive and defense industries. It has a strong distribution network with nearly 2500 dealers and almost 99% of the total business comes from the domestic market. It produces steel mainly from 10 of its plants under 3 different categories for other user industries.

It has three categories of products namely,

- **Semis**, which are mainly used for engineering purpose
- **Long products** which are mainly used by infrastructure companies
- **Flat products**, used by automobile and power industry.

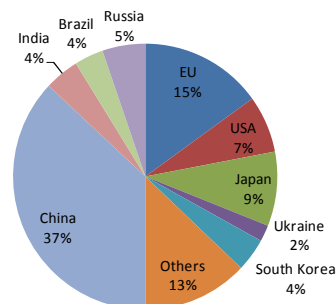
Plant Wise Revenue	Production Capacity MT	Long	Revenue 2010 (Crs)	
			Flat	Semis
Bhilai Steel Plant	4.7	2147.6	1215.4	907.5
Durgapur Steel Plant	2.088	157.1	74.4	415.6
Rourkela Steel Plant	2	0.0	1339.8	0.0
Bokaro Steel Plant	4	0.0	2060.0	22.9
IISCO Steel Plant	2.5	137.9	0.0	41.0

Global Industry Outlook

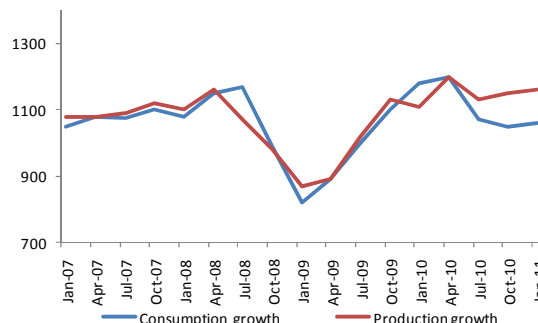
Globally, China is the world's largest producer and consumer of steel. Globally, steel is at a surplus despite increasing demand, the excess capacity is largely driven by capacity additions from China in the recent past and now India is also following suit. Currently, India is the 5th largest steel producer in the

world. It is expected to become the world's 2nd largest producer by 2020. The capacity growth is mainly driven by planned capacity additions by various international players like Posco, Arcelor Mittal, Tata Steel, etc., which are at various stages of implementation.

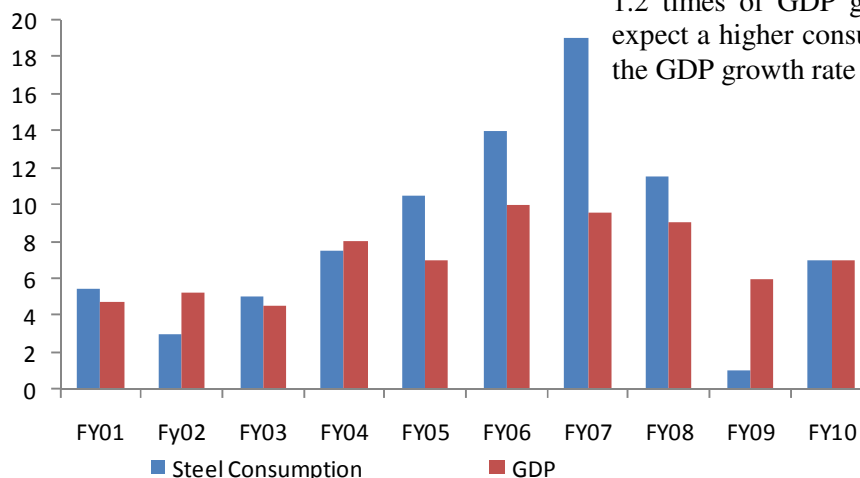
World Steel Production



Global Production/Consumption



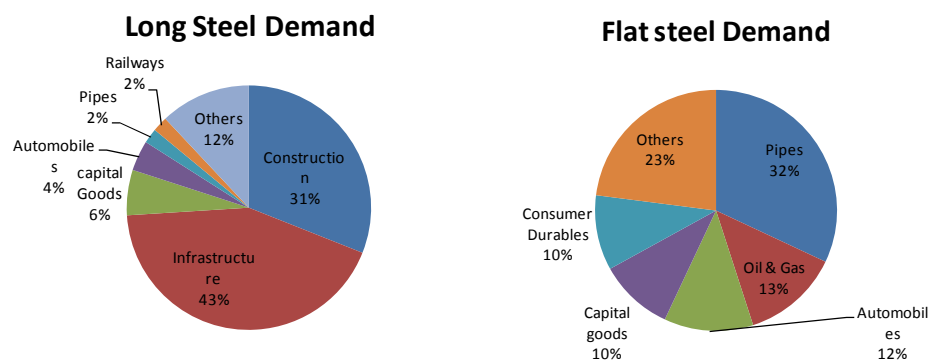
India Steel Consumption/GDP Growth Rate



India's steel consumption growth rate is 1.2 times of GDP growth rate. So, we expect a higher consumption this year as the GDP growth rate is expected at 9%.

Domestic Demand

The steel market in India is estimated to be 72 million tonnes by 2012. The industry is fully organized and integrated. Presently, India consumes 91% of its total steel production and remaining is made to serve the global demand. The industry grows at a CAGR of 10% every year. The steel consumption in Indian market for last 3 quarters is on a downtrend. This is mainly due to cheap exports from China that continued to pose threat for domestic suppliers. With excess steel capacity in the global steel industry, China dominates the trade in terms of import of raw materials and export of finished steel. WSA (World Steel Association) reports estimate that steel production in India will grow at 4.8% for next three years and steel consumption in India will grow at 9.6% due to increase in Infrastructure spending.



3QFY11 Result Analysis of SAIL

- SAIL's Q3 FY11 revenue increased by 4.68% YOY and 14.52% QOQ, aided by 7.2% YOY growth in value added steel. However, there was a sequential drop of 2% in realisation despite the Rs.500/tonne increase in steel prices. Dip in realisation was on account of liquidation of defective rails inventory.
- The quarter also saw EBITDA down by nearly 30% mainly due to increase in raw material cost. Raw materials such as coking coal which comprises 35% of total direct expenses touched its peak at \$141.94/tonne against \$96.16/tonne in the previous quarter.
- Q3, PAT was down by 33.9% to Rs 1,107 crores mainly due to SAIL's increase in capital expenditure and borrowings. It has funded its capital expenditure through borrowings. This has led to increase in depreciation and interest charges. In the coming quarters, we expect a further decrease in PAT as the Company is increasing capital expenditure, substantially.

Rs in Crores	Q3FY10	Q4FY10	Q1FY11	Q2Fy11	Q3FY11	QOQ (%)	YOY (%)
Sales	9879.1	12229.8	9133.2	10806.2	11312.0	4.7%	14.5%
Total Expenditure	6905.1	8731.4	7290.5	9111.4	9517.1	4.5%	37.8%
EBITDA	2974.0	3498.5	1842.8	1694.8	1794.9	5.9%	-39.6%
EBITDA %	30.1%	28.6%	20.2%	15.7%	15.9%		
Depreciation	339.0	338.4	350.5	368.8	379.3	2.8%	11.9%
Interest	110.1	134.7	129.6	109.0	59.2	-45.7%	-46.2%
Other Income	406.8	442.9	386.2	375.4	271.1	-27.8%	-33.4%
EBT	2931.6	3468.2	1748.8	1592.3	1627.4	2.2%	-44.5%
TAX	860.5	981.9	572.3	502.3	520.7	3.7%	-39.5%
PAT	2071.1	2486.3	1176.6	1090.0	1106.7	1.5%	-46.6%
PAT%	21.0%	20.3%	12.9%	10.1%	9.8%		

Other Developments

- HR coil that contributes 35% of total revenue has seen a downtrend in realisation post Quarter 2. The prices have come down by 9% from the last Quarter. It is presently trading at \$667/tonne.
- SAIL has plans to diversify its business by increasing the market share of Long products, as these comprise 60% of the total steel consumption. Long products contribute 34% of its present revenue and the Management plans to expand it to 42% in next 4 years. These Long products have the lowest realisation value in the domestic market. So, we expect a downtrend in SAIL's EBITDA in the coming quarters due to a shift in product mix towards low margin products.

- Under the current long term capital expenditure, the Company has commissioned Guillotine Shear in the plate mill of Bhilai Steel Plant, and coal dust injection system in blast furnaces 2 & 3 in Bokaro Steel Plant. These will help in cost reduction and efficiency increases over the medium to long term.

Budget Impact

The Union budget 2011 has been a positive one for the steel industry.

- The Government has increased the infrastructure spending to Rs.214000 crores, which will directly enhance the demand for steel, beyond the current expectation of 9.6%. SAIL will have an edge over competition, as the Infrastructure sector is the major customer for SAIL's specialized value added steel. Much of infrastructure spending will be driven by the Government sector and SAIL being a PSU could be a preferred supplier.
- Hike in iron ore export duty to 20% is also a positive sign for the industry as it will divert the export towards the domestic industry, thereby easing price pressures on iron ore which is a key input.

Risks for SAIL and Steel Industry

- Inflation in India is in double digits and is a cause for concern. We expect a tighter monetary policy and restrictive fiscal policy to maintain fiscal deficit impacting the steel demand in domestic market.
- Steel making is a raw material intensive process. Each tonne of finished steel involves transportation of 4 tonnes of materials. Infrastructure cost in India is higher than global benchmark. To have internationally competitive steel industry, it is essential that the infrastructure costs come down.
- Coking Coal continues to be a critical input for producing steel, SAIL needs to develop new technologies to make the indigenous coal suitable for use in the steel mills and reduce the dependence on imported coking coal, whose prices are highly volatile.

Future Plans

As the market share of SAIL in domestic steel market has decreased from 30% to 20% over the last decade, it has plans to diversify its business. The Company aims for 25% non-steel revenue in its portfolio by 2020 through diversification.

- It has planned initiatives in sectors such as mining, power generation and railway transport in coming years. This requires a capital expenditure of nearly Rs.59,905 crores for brown field projects, to raise production capacity to 24 million tonnes by 2013 from the present production capacity of 14.6 million tonnes. Apart from the domestic capital expenditure, the Company has also plans to set up steel plants overseas in joint ventures, estimated at a total investment of Rs.45,000 crores in future.
- SAIL has plans to set up a separate company called SAIL Natural Resources for mining resources which will be its subsidiary. It also plans to set up power generation plants with generating capacity of 1,500 MW with an investment of around Rs.7,000 crores. Out of this, 1,000 MW capacity is proposed to be set up at its Jagadishpur plant in Uttar Pradesh, the remaining 500 MW will be set up at Sindri in Dhanbad. The Company plans to use 450 MW of the total capacity for its own consumption and the rest will be sold in the domestic market as merchant power.
- SAIL has signed an in-principle agreement with Department of Fertilizers to set up an integrated steel and power plant along with urea manufacturing facility with annual production capacity of 1.1mt of urea in Sindri unit. It has plans to set up two joint ventures with NTPC Ltd. and Damodar Valley Corporation in coming years.

Comparison with Peers

Tata Steel, the 7th largest steel producer of the world, is SAIL's main domestic competitor. Although global capacity of Tata Steel is much higher than that of SAIL, it acts as a market follower to SAIL in the domestic market. However, we believe that Tata Steel is much better placed than SAIL due to its higher efficiencies and low cost manufacturing; in fact this is also exemplified by its superior performance post recession compared to SAIL.

Comparison of SAIL and Tata Steel

	Revenue Growth	Q3 EBITDA %	PAT %	Revenue Growth	Q2 EBITDA %	PAT %
SAIL	14.5%	15.9%	9.8%	7.6%	15.7%	10.1%
Tata Steel	16.1%	37.5%	20.7%	25.0%	36.4%	29.3%

Currently, Tata Steel's domestic capacity is 6.8mtpa which it plans to expand to 11mtpa by the end of 2016. Keeping in mind the operational parameters and growth potential growing forward, we believe that Tata Steel could be better placed than SAIL in the short to medium term. *(At the moment we do not have a formal recommendation on Tata Steel, we will initiate coverage shortly)*

Valuation

Rs in Crores	FY 10	FY11E	FY 12E
Sales	43238.1	44783.6	48763.9
EBDITA	11870.5	9330.9	9845.2
EBDITA %	27%	21%	20%
PAT	8058.1	5002.2	5107.4
PAT%	19%	11%	10%
No of outstanding shares	413.0	413.0	465.8
EPS	19.5	12.1	11.0
Price	169.8	169.8	169.8
P/E x	8.7	14.0	15.5
EV/EBITDA x	5.4	6.9	7.1

On a consolidated basis, SAIL's revenue is expected to be Rs.47149 crores for FY11E whole year against the current 9-month revenue of Rs.32,000 crores. Therefore, we expect 4QFY11 revenues to be around Rs.15000 odd crore. The current trends also lead us to believe that raw material costs may come down due to increase in excise duty for iron ore as well as due to the impact of the Japanese natural disaster.

In the long term, we believe that the sector has bright prospects driven by inherent demand for steel, and SAIL, with its ongoing capacity expansion and diversification plans is well positioned to reap the benefits. The Company is investing in its organic expansion plans and also implementing its backward integration plans to shore up its margins going forward. It also has plans for a FPO in 2012 to fund its capex programs and also as a part of Government's disinvestment. Considering the current stretched valuations as compared to its peers and expected supply of shares, we believe that investors have ample opportunity to accumulate the stock over the next 12 – 14 months. Since the long term potential of the sector and Company remain bright, especially given the fact that the Company is aiming for a 25% of non-steel revenue by 2020 through diversification, we recommend a **HOLD**.

Comparative Valuation

Company	CMP	Mkt Cap (Rs Bn)	P/E		EV/EBITDA		ROE %		ROCE %	
			FY11 E	FY12 E	FY11 E	FY12 E	FY11 E	FY12 E	FY11 E	FY12 E
SAIL	160	660	13.2	14.6	6.5	6.7	13.7%	10.8%	16.4%	11.6%
TATA Steel (Stnd alone)	594	583.8	9.5	7.1	6.5	5.4	20.7	20.4	5.5	13.4
JSW Steel	890	173.6	16	8	8.3	5	9.7	13.7	12.4	9.7

Projected Financials

Rs in Cr	FY 10	FY 11E	FY 12E	Balance Sheet	FY 10	FY 11E	FY 12E
Net Sales	43238.1	44783.6	48763.9	Paid up Capital	4130.4	4130.4	4658.2
Growth %		3.6%	8.9%	Reserves & Surplus	29159.4	32284.0	42844.6
Total Expenditure	31367.7	35452.7	38918.7	Total Shareholders Equity	33289.8	36414.4	47502.8
EBITDA	11870.5	9330.9	9845.2	Total Debt	16511.3	26903.7	36925.5
Growth %		-21.4%	5.5%	Total Liabilities	51242.9	63454.3	84477.2
Depreciation	1337.2	1496.9	1694.3	Net Fixed assets	13615.3	15744.9	18225.1
EBIT	10533.3	7834.0	8150.8	Capital work in progress	15026.1	24916.5	36301.8
Interest	402.3	469.9	640.0	Investments	668.8	685.6	754.1
Current Tax	4972.9	2361.8	2403.5	Total Current assets	39081.2	37884.1	43395.1
PAT	8058.1	5002.2	5107.4	Total Current Liabilities	17148.5	15776.6	14199.0
Growth %		-37.9%	2.1%	Net Current Assets	21932.6	22107.4	29196.1
				Total Assets	51242.9	63454.3	84477.2
Key Ratios	FY 10	FY 11E	FY 12E	Operating Ratios	FY 10	FY 11E	FY 12E
EBITDA %	27.5%	20.8%	20.2%	Sales/Gross FA	1.22	1.15	1.13
EBIT %	24.4%	17.5%	16.7%	Sales/Net FA	3.18	2.84	2.68
PAT %	15.6%	11.2%	10.5%	Debtor days	29	31	33
ROE %	20.3%	13.7%	10.8%	Creditor days	52	47	39
ROCE %	20.3%	13.7%	10.8%	Inventory days	76	82	86
EPS	19.5	12.1	11.0	Depreciation/GFA	0.04	0.04	0.04
P/E x	8.7	14.0	15.5	Depreciation/NFA	0.10	0.10	0.09
EV/EBITDA	5.4	6.9	7.1				

Our Team

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