Steel Authority of India (SAIL.BO)

Equity

Sell: PAT Declines 35%; Better Outlook But Stock Expensive

- **1QFY10 marginally better** — SAIL's reported PAT came in at Rs13.3bn, down 28% yoy. Adjusting for the wage provision write back, recurring PAT was Rs11.9bn, down 35% yoy (4% above our estimate). EBITDA margin (incl other income) was 25% vs 29% last year (20% in 4QFY09). The fall in profits was on account of lower realizations despite an overall reduction in per tonne costs.
- **Volumes grow in line with industry** — Sales rose 5% to 2.8m tonnes and output rose 4% to 3.1m tonnes. SAIL focused its efforts on special steels/value added products (+21% yoy) and better productivity norms in 1Q. Overall capacity utilisation was 111%. SAIL's volume growth in 1Q (+5%) is low vs Tata Steel (+22%) and JSW Steel (+62%) as most of SAIL's expansions are likely by FY12.
- **Weaker realizations** — Avg realizations fell 20% yoy to ~Rs32,600/t, but flat qoq. Going forward, flat product prices could improve on strong demand. However, long product prices (35% of volumes) are weakening due to sluggish seasonal demand and are only likely to recover post the monsoons in 3QFY10.
- **Overall costs decline** — Overall costs per tonne fell 13% yoy with declines across all heads. Raw materials were the exception with costs rising 13% yoy due to high cost coking coal inventory. Input costs should fall in the coming quarters on lower cost imported coking coal and increased captive coal output.
- **Sell** — While SAIL would benefit from an improved price environment, we believe that the positives are already priced in and it is expensive relative to history. The stock has run up 127% YTD, outperforming the Sensex by 67%.

Sell/Medium Risk	**3M**
Price (30 Jul 09)	Rs174.30
Target price	Rs132.00
Expected share price return	-24.3%
Expected dividend yield	1.3%
Expected total return	**-23.0%**
Market Cap	Rs719,929M
	US$14,913M

Price Performance (RIC: SAIL.BO, BB: SAIL IN)

Figure 1. SAIL – Statistical Abstract

YE 31 Mar	Net Profit (Rsm)	EPS (Rs)	EPS growth (%)	P/E (x)	EV/EBITDA (x)	ROE (%)
FY06	40,130	9.7	-41%	18.1	9.6	32%
FY07	62,023	15.0	55%	11.7	6.1	36%
FY08	75,368	18.2	22%	9.6	4.8	33%
FY09E	62,705	15.2	-17%	11.6	5.7	22%
FY10E	42,850	10.4	-32%	16.9	8.5	14%
FY11E	53,643	13.0	25%	13.5	7.7	15%
FY12E	57,788	14.0	8%	12.6	7.9	15%

Source: Company Reports and Citi Investment Research and Analysis. Priced as at 30 July 2009.

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See Appendix A-1 for Analyst Certification and important disclosures.

1QFY10 Results

Figure 2. SAIL – 1QFY10 Results

(Rs m)	1QFY10	1QFY09	% change
Gross sales	100,620	124,907	-19%
Less: Excise duty	7,961	14,612	-46%
Net sales	**92,659**	**110,294**	**-16%**
Operating costs	75,222	82,559	-9%
Operating profit	17,436	27,736	-37%
Operating profit margin (%)	19%	25%	
Total other income	5,400	3,926	38%
EBITDA	**22,836**	**31,661**	**-28%**
EBITDA margin (%)	**25%**	**29%**	
Depreciation	3,269	3,165	3%
EBIT	19,567	28,496	-31%
Interest	828	568	46%
PBT	18,740	27,928	-33%
Total tax	6,798	9,577	-29%
Tax rate (%)	36%	34%	
PAT	**11,941**	**18,352**	**-35%**

Source: Company Reports and Citi Investment Research and Analysis

Steel Authority of India

Company description

Steel Authority of India (SAIL) is India's largest integrated steel producer with hot metal capacity of 15mtpa and crude steel capacity of 13mtpa. It has five integrated steel plants and three special steel plants, mostly located in eastern and central India, near its own iron ore, limestone and dolomite mines. SAIL is a Public Sector Undertaking (PSU) in which the Government of India owns 85.8%. It plans to expand its capacity gradually, taking its hot metal capacity to 26mtpa and saleable steel capacity to 23m tpa by 2012 at a total capex of Rs540bn. SAIL also plans to increase its iron ore mining capacity and power capacity (through JVs) to match its expansion plans. SAIL makes both flat (52% of sales) and long (36%) products. It also makes value added products such as pipes, plates and coated products. Alloys and special steels make up about 6% of sales. Most of SAIL's output is sold within India and exports account for only 3% of sales. SAIL's planned capex will also help reduce costs as existing facilities are being modernized and upgraded. Once the capex is complete, SAIL will move to 100% continuous casting, no longer produce any steel using the twin hearth process and not need to sell any semi-finished steel.

Investment strategy

We rate SAIL Sell/Medium Risk (3M). We were earlier more conservative on the steel outlook and expected a decline in international HRC prices (from US$550/t in FY10 to US$450/t in FY11). We are now more positive on the international steel price outlook and expect a yoy uptrend in FY11 prices. While SAIL also benefits from rising prices, we believe that the positives are largely priced as the stock has run up 98% YTD, outperforming the Sensex by 47%. As steel cycle improves, SAIL is likely to underperform JSW Steel and Tata Steel, which are more leveraged. While the stock was earlier inexpensive on a relative basis, it is no longer cheap vs. JSW Steel and Tata Steel on almost all valuation parameters. The stock is also expensive relative to its historical EV/EBITDA and no longer at the bottom on P/B ratio. We expect sales volumes to rise by 7% yoy in FY10E and 12% in FY11E which continues to be the lowest volume growth among the three majors.

Valuation

We use EV/EBITDA as our preferred valuation metric for the Indian steel companies given the high debt-equity levels for two of the three steel majors under coverage. SAIL has traditionally traded at a discount to both Tata Steel and JSW Steel based on its history, status as a government company and lower rate of volume growth. Our Rs132 target price is based on Sept10E EV/EBITDA of 6x, at a discount to JSTL's (standalone) target multiple of 6.5x and a small premium to TSL's target multiple (consolidated) of 5.9x. SAIL offers lower volume growth than JSTL and has a PSU-tag, although both offer largely domestic exposure. The premium to TSL accounts for TSL's 70%+ European exposure. SAIL's target EV/EBITDA multiple is at a premium to its 3-year average EV/EBITDA of 4.3x but lower than its highs of 7-9x since April 2006. At our target price, the stock would trade at a P/E of 11.3x.

Risks

We rate SAIL Medium Risk as opposed to the Speculative Risk rating suggested by our quantitative risk-rating system, which tracks 260-day historical share price volatility. SAIL's exposure to the Indian market, net cash position and potential for cost cutting warrant a Medium Risk, in our view. Possible upside risk factors to our target price are: 1) better steel prices than we expect; 2) higher import duties on steel; 3) sharper decline in raw material prices than we expect; 4) disinvestment.

Appendix A-1

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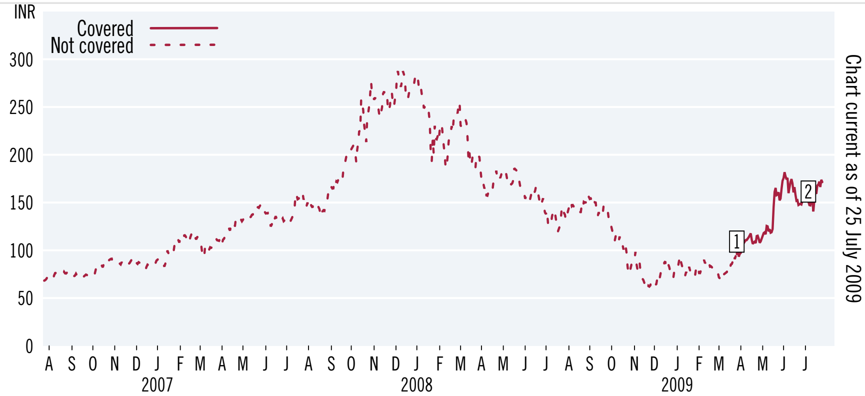
Steel Authority of India (SAIL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Pradeep Mahtani
Covered since March 26 2009



	Date	Rating	Target Price	Closing Price
1	26-Mar-09	*1M	*116.00	96.10
2	6-Jul-09	*3M	*132.00	151.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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