

Equities

10 January 2011 | 8 pages

India Coking Coal Update

Alert: Coking Coal Under Water

- **Queensland: ~55-60% of global exports** — The unprecedented rains and floods have led to nearly all Queensland coal producers declaring force majeure. All but one rail system in the region has been impacted. Queensland accounts for ~55-60% of the global seaborne coking coal market (~250mt in 2010E). While the extent and period of disruption are hard to quantify at this point, our global commodities team believes that Citi's 18mt deficit forecast for 2011 is likely to be much higher once damage to mines/rail infrastructure is taken into account.
- **Coking coal inventories** — Major coking coal importing countries are Japan (26%), India (17%), China (14%), South Korea (11%), Taiwan (2%), Europe (15%), Brazil (6%). Most steel producers have ~40-60 days inventory and are not worried yet. The Japanese blast furnaces have ~2 months inventory and would be willing to buy coal from North America if higher steel prices justify the same. Korean steel mills have 40-60 days inventory and can source coal from China and Canada. The Indian producers have ~2 months inventory; European producers ~4 weeks.
- **Coking coal prices moving north** — While steel producers globally appear less concerned near term, longer-term uncertainty remains. Spot coking coal prices have moved to ~ US\$260/t from ~225/t at the end of December. If damage to the Queensland rail system is substantial, quarterly contract prices could move beyond \$300/t.
- **Impact on the Indian steel producers** — The coking coal price hike will have an impact on margins of all the major steel companies if they are not able to pass on the cost hike as Indian steel companies have hardly any captive coking coal. The range of integration is ~0-15% for the major steel players. Jindal Steel and Power would be least impacted as it has 100% captive thermal coal and its overall coal integration is ~55-60%. JSW Steel's profits would be most sensitive to coking coal price changes.

■ Industry Overview

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Jindal Steel and Power

Valuation

We value JSPL's power business using a discounted cash flow approach as power plants generate largely predictable cash flows for fixed time periods. While applying DCF one can choose free cash flow to the firm (FCF) or free cash flow to equity (FCFE). We prefer FCFE as individual projects are highly geared and gearing changes as debt is rapidly paid off.

We value JSPL's steel business at 7x FY12 EV/EBITDA - at a discount to Tata Steel India's target EV/EBITDA multiple of 7.5x. We use a discount given (1) Tata Steel India's scale of operations at 6.8mtpa vs 2.4mtpa for JSPL, (2) Tata Steel India's 100% captive iron ore vs. 50-60% for JSPL and 3) Tata Steel's product mix being largely high end relative to JSPL. Both companies have ~55-60% of captive coal. Tata Steel has 55-60% coking coal. JSPL has 100% thermal coal, but no coking coal.

If we assume JSPL executes all its power projects in line with our assumptions, we arrive at a value of Rs676/share. This includes Rs204 for the steel business, Rs19 for Bolivia, Rs325 for Jindal Power, Rs86 for 1,350MW captive power plants and Rs40 for excess power purchased from JPL at fixed prices. At our target price the stock would trade at a P/E of 11x and EV/EBITDA of 9.2x FY12E.

Risks

Our quantitative risk-rating system, which tracks 260-day historical share price volatility, assigns a Low Risk rating to JSPL.

Downside risks include: fuel supply risk, coal mining risk, execution risk, merchant tariff risks, financial closure risk, receivables risk, regulatory risk, R&R, land acquisition and environmental clearance risk and lower than expected operating parameters. Upside risks include: better-than-expected operating parameters; faster-than-expected execution and additional project wins; higher-than-expected merchant tariffs; higher steel prices and rupee depreciation. These upside and downside risks could impede the stock from achieving our target price.

JSW Steel

Valuation

EV/EBITDA is our preferred valuation metric for JSTL due to its high debt-equity levels. Our target price of Rs1,450 is based on SOTP. We continue to value the standalone business at 6.5x EV/EBITDA (roll forward to Jun11 from Mar11) - in-line with its 3-yr average and captures more recent valuation trends - giving a value of Rs1,437/share. We value the other businesses (mainly represented by its US pipe and plate operations) at 3x EV/sales. We use 3x EV/sales as utilization levels at its US business are quite low at 30-35% in FY11-12. This gives a value of Rs13/share - resulting in a net target price of Rs1,450/share. At our target price, the stock would trade at a consolidated June11 EV/EBITDA of 7x and P/E of 10.3x.

Risks

We rate JSTL Medium Risk as opposed to the High Risk rating suggested by our quantitative risk-rating system, which tracks 260-day historical share price volatility. JSTL's exposure to the Indian market, strong volume growth, EBITDA/t at US\$186/t during FY11-12 and greater value addition warrant a Medium Risk, in our view. Possible downside risk factors to our target price are: 1) weaker steel prices than we forecast; 2) higher raw material costs; 3) lower volumes than we expect; and 4) FX trends.

Appendix A-1

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Jindal Steel and Power (JNSP.BO)

Ratings and Target Price History Fundamental Research

Analyst: Atul Tiwari, CFA
Covered since December 2 2010

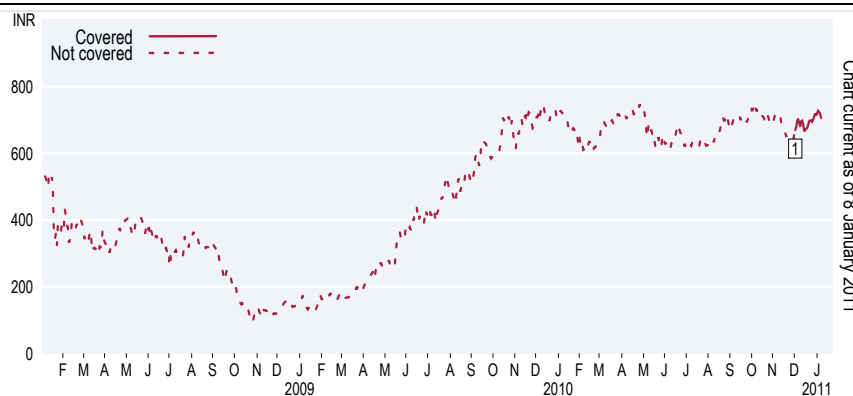


Chart current as of 8 January 2011

	Date	Rating	Target Price	Closing Price
1	2-Dec-10	*2L	*676.00	669.40

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Jindal Steel and Power (JNSP.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Atul Tiwari, CFA
Covered since December 2 2010

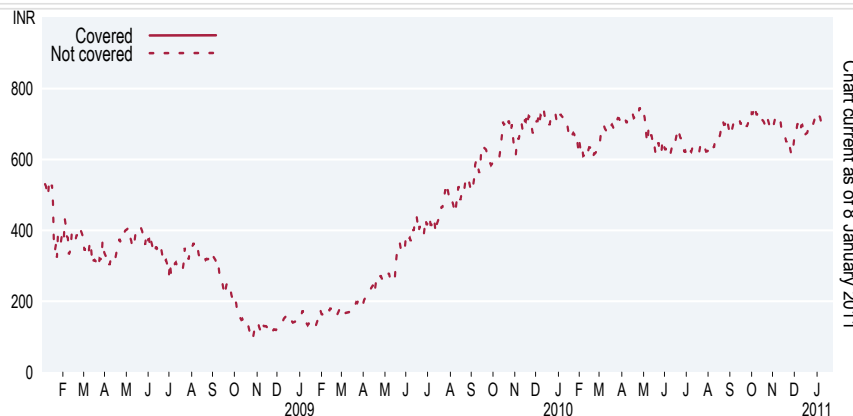


Chart current as of 8 January 2011

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

JSW Steel (JSTL.BO)
Ratings and Target Price History
Fundamental Research

Analyst: Pradeep Mahtani



Chart current as of 8 January 2011

	Date	Rating	Target Price	Closing Price
1	10-Apr-08	1M	*995.00	723.90
2	21-Nov-08	*3H	*190.00	204.40

	Date	Rating	Target Price	Closing Price
3	16-Feb-09	3H	*185.00	215.05
4	6-Jul-09	*1M	*756.00	576.60

	Date	Rating	Target Price	Closing Price
5	25-Oct-09	1M	*1,027.00	852.40
6	17-May-10	1M	*1,450.00	1,170.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

JSW Steel (JSTL.BO)
Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Pradeep Mahtani

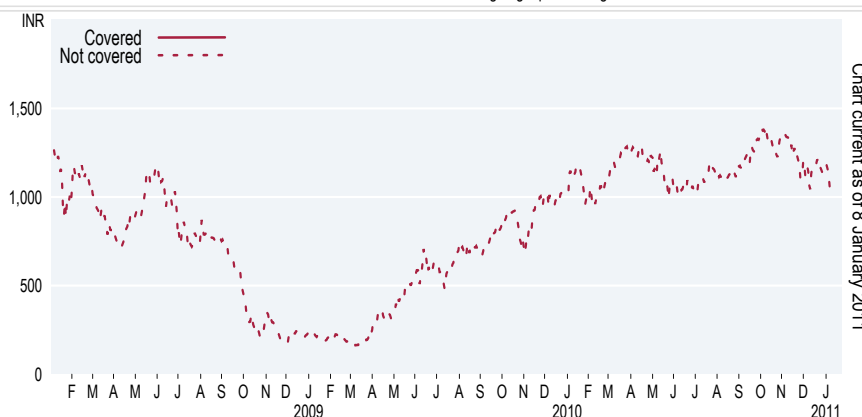


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Citi Investment Research & Analysis Global Fundamental Coverage

% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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45%	44%	40%	0%	44%	0%

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