ABN·AMRO

Thursday 14 June 2007

Change of target price

Steel Authority of India

Building for sustainable growth

We believe SAIL is a key beneficiary of growth in the Indian steel industry. Its plan to add capacity and to improve product mix should accelerate earnings growth, which we estimate will ensure ROEs of above 30%. Buy, with a new target price of Rs158.

Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
Revenue (Rsm)	291705	354416	399262	458584	537201
EBITDA (Rsm)	70584.2	103319	127857▲	156218▲	198012▲
Reported net profit (Rsm)	40677.7	62615.9	76839.7▲	93229.4▲	117445▲
Normalised net profit (Rsm)[1]	40677.7	62615.9	76839.7	93229.4	117445
Normalised EPS (Rs)	9.85	15.2	18.6▲	22.6▲	28.4▲
Dividend per share (Rs)	2.00	2.90	3.80	4.50▼	5.60
Dividend yield (%)	1.53	2.22	2.91	3.44	4.29
Normalised PE (x)	13.3	8.62	7.02▼	5.79▼	4.59
EV/EBITDA (x)	7.82	4.77	3.94	3.44	2.79
Price/book value (x)	4.24	3.15	2.32	1.76	1.34
ROIC (%)	28.8	41.2	55.2	45.2	38.2

1. Post-goodwill amortisation and pre-exceptional items
Accounting Standard: Local GAAP
Source: Company data, ABN AMRO forecasts

year to Mar, fully diluted

Higher volumes and better mix through capacity expansions

Steel Authority of India (SAIL) is embarking on plans to enhance output by the end of this decade. The company aims to do this through debottlenecking of its facilities and brownfield expansions at its existing sites. We forecast a 16% CAGR in the company's sales volumes over the next three years, from 11.9m tonnes in FY07 to about 18.5m tonnes in FY10F. Capacity enhancement should also improve SAIL's product mix. As a result, we expect its price realisations to remain fairly stable in the next few years, despite continued strength in the rupee.

Outlook for the Indian steel industry remains bright

Our recent meetings with several steel producers in India suggest a more bullish outlook on demand. We concur, and so raise our demand growth projection to 12% (from 10%) pa till the end of the decade. We believe the acceleration in demand growth will be driven by corporate India adding manufacturing capacity across sectors and the government increasing its infrastructure budget. The supply side, we believe, will be met by brownfield expansions, while the large greenfield projects that have been announced in the past two years have seen slow progress in getting off the ground. This should alleviate concerns about an oversupply at the end of the decade.

Strong growth outlook warrants higher valuations

We believe SAIL, being India's largest steel producer, is a key beneficiary of growth in domestic steel demand. We forecast an increase in EBIT/tonne over the next two years, supporting an average earnings CAGR of 22% over FY07-10F. We have raised our earnings estimates by 9% for FY08 and by 15% for FY09, in view of the company's plans to step up its capacity expansion and an expected increase in price realisations (albeit offset to an extent by an increase in coal input costs). We expect ROE to remain above 30% though FY07-10 and raise our target price to Rs158 (from Rs134), based on 2.8x FY08F P/B.

Priced at close of business 13 June 2007. Use of ▲▼ indicates that the line item has changed by at least 5%.

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Buy

Absolute performance

n/a

Short term (0-60 days)

Neutral

Market relative to region

Materials

India

Price

Rs127.55

Target price

Rs158.00 (from Rs134.00)

Market capitalisation

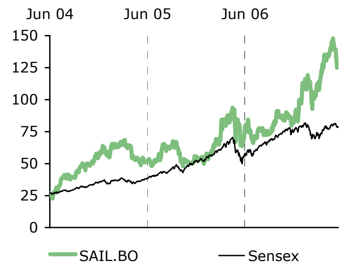
Rs539.64bn (US$13.17bn)

Avg (12mth) daily turnover

Rs238.30m (US$5.41m)

Reuters	Bloomberg
SAIL.BO	SAIL IN

Price performance	(1M)	(3M)	(12M)
Price (Rs)	135.1	105.6	64.3
Absolute %	-5.6	20.8	98.2
Rel market %	-7.0	12.0	28.3
Rel sector %	-4.6	7.4	0.3



Stock borrowing: Difficult
Volatility (30-day): 32.17%
Volatility (6-month trend): ↑
52-week range: 149.95-62.00
Sensex: 14003.03
BBG AP Steel & Others: 452.59

Source: ABN AMRO, Bloomberg

Researched by

ABN AMRO Institutional Equities Team

www.abnamrobroking.co.in

Building for sustainable growth

We expect SAIL's capacity expansion over the next few years to lead to stronger volume growth and a better product mix, allowing it to benefit from the positive momentum in India's steel industry.

Higher volumes and better mix ahead

Management is targeting a significant increase in production capacity through 2010

After achieving record sales volumes and revenues in FY07, SAIL has embarked on an expansion plan that management targets will almost double the company's production capacity by the end of the decade. These capacity targets had originally been set for 2012, but SAIL has decided to accelerate its building plans in view of the buoyant steel market in India.

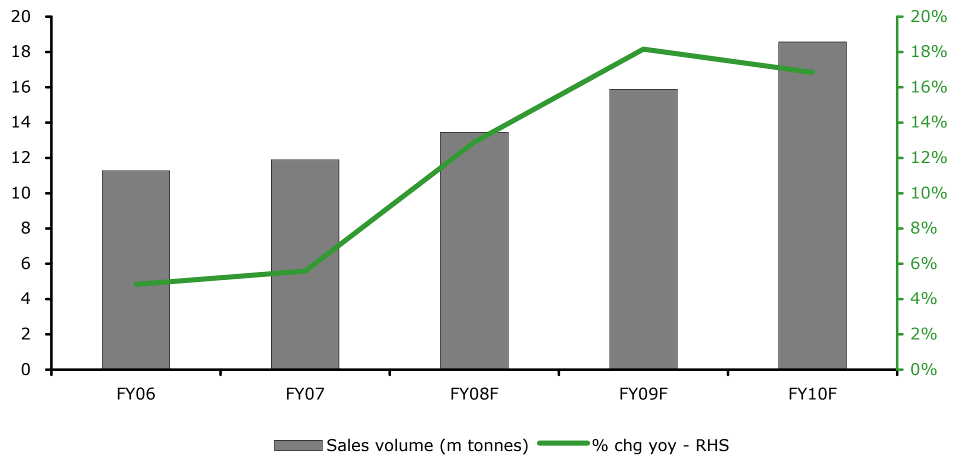
Table 1 : SAIL's expansion plan

(m tonnes)	2006-07 (Actual)	2010 (Plan)
Hot metal	14.6	25
Crude steel	13.5	24
Saleable steel	12.6	23

Source: Company data

The company aims to achieve the capacity enhancement through debottlenecking of its current facilities and brownfield expansions at its existing sites. In the next 12 months, we expect the debottlenecking efforts to add 2m tonnes of hot metal capacity. The impact from the brownfield expansions, we believe, will be more evident from FY09/10. We estimate the brisk growth in domestic demand and the proposed expansion will accelerate SAIL's sales volumes from 11.9m tonnes in FY07 to 18.5m tonnes in FY10, representing a CAGR of 16% vs only a 3.7% CAGR over FY04-07.

Chart 1 : SAIL's sales volumes



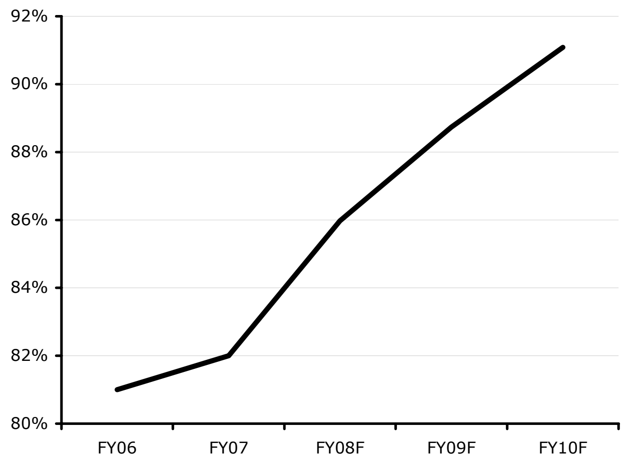
Source: Company data, ABN AMRO forecasts

The capacity expansion plans are targeted at improving the product mix, for example, by increasing the output of higher-value products and reducing the sales proportion of semi-finished products.

Improved product mix should help SAIL maintain price realisations at attractive levels

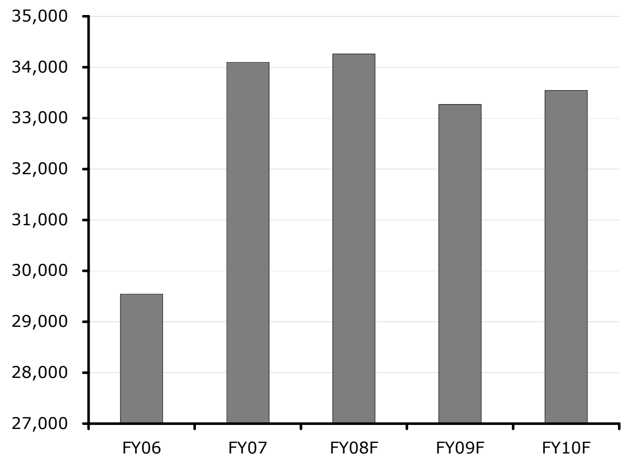
As a result, we expect SAIL's steel price realisation to improve further in FY08 and maintain it at attractive levels, though the strengthening rupee and the government's close watch on inflation may limit the extent of steel price increases in India.

Chart 2 : Increasing proportion of finished steel



Source: Company data, ABN AMRO forecasts

Chart 3 : Average revenue per tonne (Rs/tonne)



Source: Company data, ABN AMRO forecasts

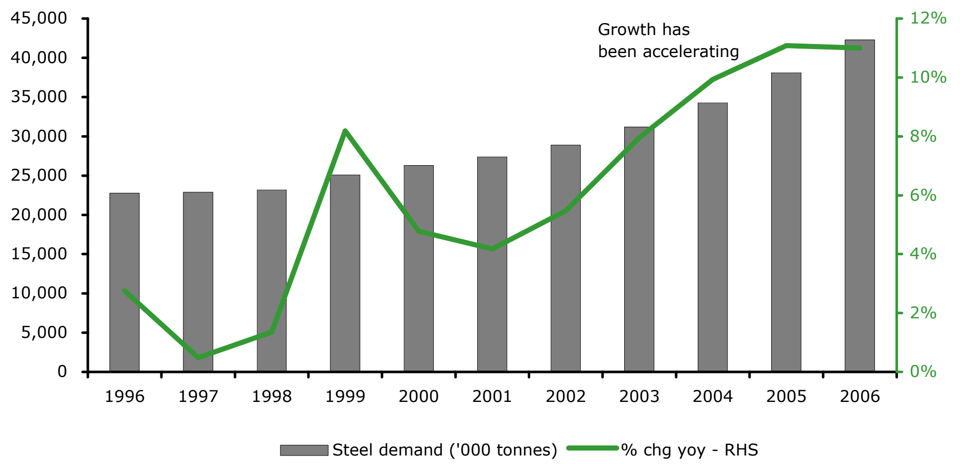
A key beneficiary of strong Indian demand

As India's largest steel producer, with about one-third of total domestic production, we believe SAIL is well-positioned to benefit from the acceleration in demand growth that we project in India.

Domestic steel demand is accelerating

The domestic steel consumption growth has accelerated to 11% in 2005 and 2006, after averaging 6.4% over the last decade. We expect the growth to accelerate further to average 12% pa through 2010, driven by the corporate sector's capacity addition in various sectors (such as power equipment, autos and construction) and the government's plans to increase infrastructure spending on roads, railways and ports to support economic growth.

Chart 4 : Apparent steel consumption in India

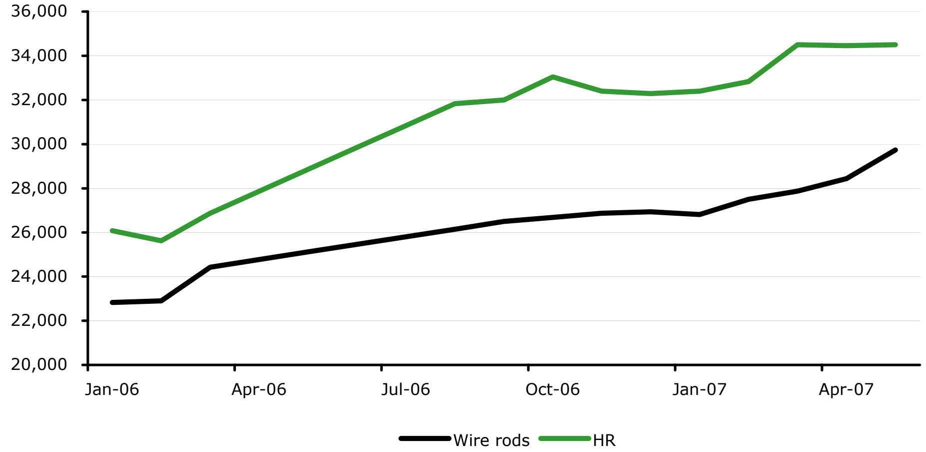


Source: IISI, ABN AMRO

Prices are still firm and we expect them to remain so

There is no formal price control on steel in India, but concerns about inflation had prompted the government to ask steel producers to roll back the price increases they had announced in April. However, strong demand and a slight moderation in inflation saw price increases resuming in May. SAIL, for instance, raised prices by about Rs1,000-1,500/tonne in May, after keeping prices stable in March and April.

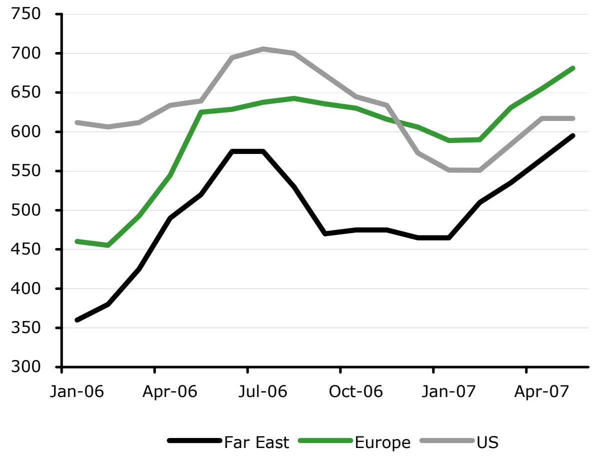
Chart 5 : Indian steel prices (Rs/tonne)



Source: JPC, ABN AMRO

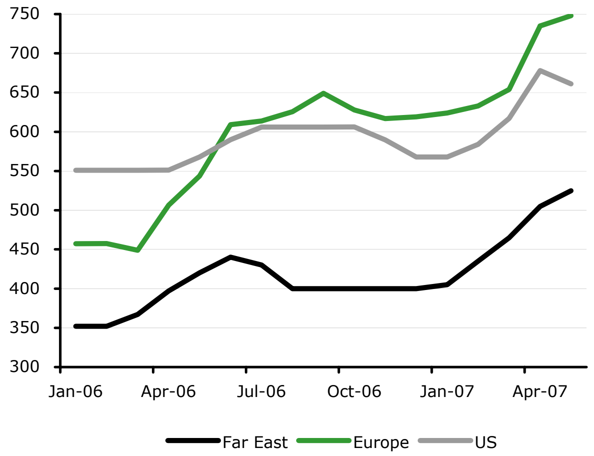
Our economists point out that inflationary pressure, as measured by the WPI, peaked in March, and the WPI fell to 5.7% yoy in April, or 6.1% yoy on 3mma. We believe the authorities are likely to remain watchful for inflationary pressures, limiting price increases by Indian steel producers. We also believe the strengthening rupee could constrain price increases by domestic producers. That said, we do believe that current prices already afford attractive margins for Indian producers. We also see little reason for price cuts, given the strength of domestic demand and the rising price trend across Asia, Europe and the US. As such, we forecast steel prices in India will be maintained close to current levels for FY08.

Chart 6 : Flat-product prices by region (US$/tonne)



Source: CRU

Chart 7 : Long-product prices by region (US$/tonne)



Source: CRU

Strong growth outlook warrants higher valuations

Our more bullish outlook on the Indian steel industry, and our expectation that product mix improvements will support SAIL's average realisations, prompt us to increase our price realisation forecasts by 2-3% for the next two years. These upward revisions and a potential acceleration in capacity addition lead to an increase in our earnings estimates, by 9% for FY08 and by 15% for FY09.

Table 2 : Key earnings drivers

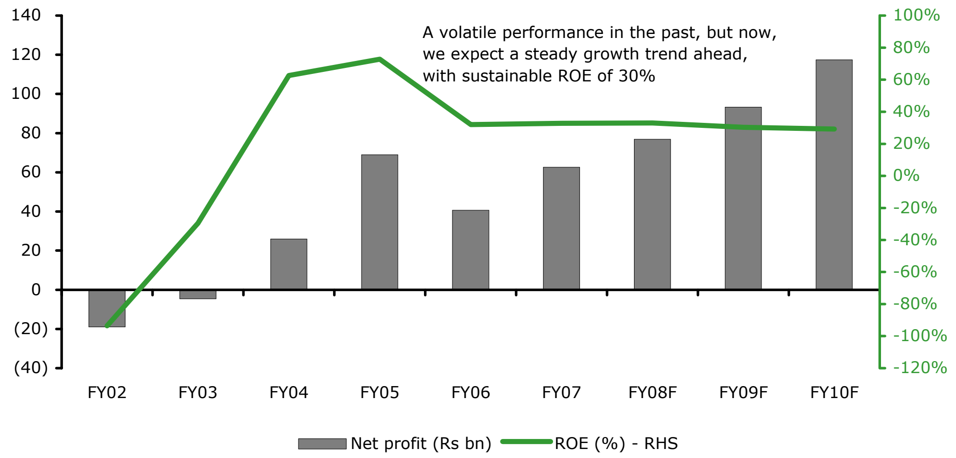
	FY06A	FY07A	FY08F	FY09F	FY10F
Crude steel production (m tonnes)	13.5	13.5	15.4	18.2	21.5
Sales volume (m tonnes)	11.3	11.9	13.4	15.8	18.4
Average selling price (Rs/tonne)	29,546	34,099	34,262	33,269	33,543
Average selling price (US/tonne)	668	754	848	862	883
Average Rs/US$	44.2	45.2	40.4	38.6	38.0
EBIT per tonne (US$/tonne)	141	192	237	256	283
Net profit (Rs bn)	40.7	62.6	76.8	93.2	117.4
% chg yoy	-41%	54%	23%	21%	26%

Source: Company data, ABN AMRO forecasts

We believe strong earnings growth over FY07-10 will enable SAIL to maintain its ROE at around 30%, making returns markedly less volatile than in the early part of this decade.

A more stable growth outlook

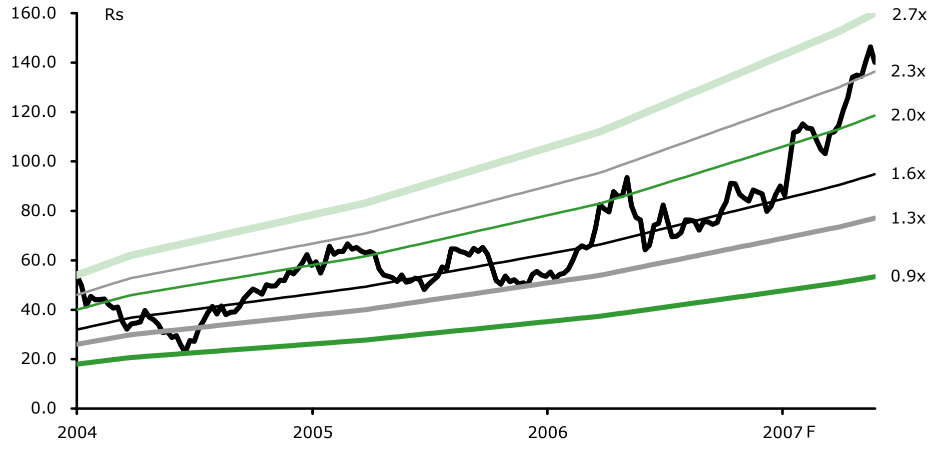
Chart 8 : Earnings and returns



Source: Company data, ABN AMRO forecasts

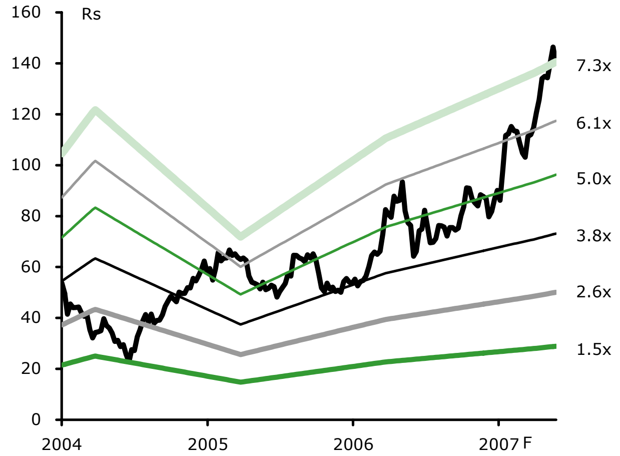
On the back of our higher earnings forecasts, we upgrade our target price to Rs158, based on 2.8x FY08F P/BV, as the company is able to generate ROAE significantly above its cost of equity (13.4%). At our target price, the stock would trade at a PE of 8.5x and EV/EBITDA of 5x on FY08F numbers. These multiples would be historical peaks for the stock, but they would still be at discounts to regional peers and the domestic market's valuations.

Chart 9 : P/B band



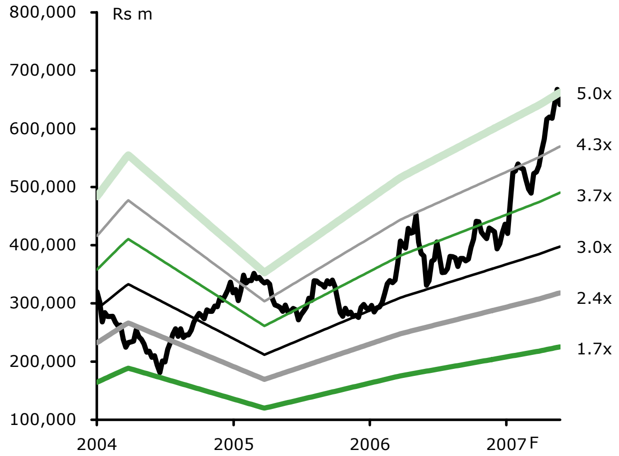
Source: Datastream, ABN AMRO forecasts

Chart 10 : SAIL – PE band



Source: Datastream, ABN AMRO forecasts

Chart 11 : SAIL – EV/EBITDA band



Source: Datastream, ABN AMRO forecasts

Key assumptions and sensitivities

Table 3 : SAIL – Key earnings drivers

	FY06	FY07	FY08F	FY09F	FY10F
Sales volumes ('000 tonnes)					
HR	3,337	3,437	3,850	4,389	5,047
Plates	1,478	1,567	1,802	2,073	2,487
CR	1,009	1,069	1,198	1,377	1,653
Coated products	340	354	396	456	638
Structurals	655	738	879	1,172	1,465
Rounds & bars	792	905	1,091	2,014	2,517
Railway materials	869	912	1,022	1,175	1,351
Semis	1,714	1,800	1,890	1,795	1,651
Average realised price (Rs/tonne)	29,546	34,099	34,262	33,269	33,543
Raw material prices (US$/tonne)					
Iron ore	12.61	13.56	15.94	17.53	18.69
Coking coal	128.49	120.52	122.93	119.49	117.10
Avg INR:USD	44.23	45.23	40.40	38.58	38.00
Y/E INR:USD	44.57	43.47	40.00	38.00	38.00

Source: Company data, ABN AMRO forecasts

Table 4 : Forecast revisions

	New forecasts			Previous forecasts	
	FY08F	FY09F	FY10F	FY08F	FY09F
Net profit (Rs m)	76,840	93,229	117,445	70,753	81,200
EPS (Rs)	18.6	22.6	28.4	17.1	19.7

Source: ABN AMRO forecasts

Table 5 : Sensitivity analysis

Impact on FY08F earnings	1%	-1%
Long product price	0.8%	-0.8%
Flat product price	1.8%	-1.8%
Iron ore cost	-0.1%	0.1%
Coking coal cost	-0.6%	0.6%

Source: ABN AMRO forecasts

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STEEL AUTHORITY OF INDIA: KEY FINANCIAL DATA

Income statement

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
Revenue	291705	354416	399262	458584	537201
Cost of sales	-193783	-223019	-240519	-269936	-305138
Operating costs	-27338	-28078	-30886	-32430	-34052
EBITDA	**70584.2**	**103319**	**127857**	**156218**	**198012**
DDA & Impairment (ex gw)	-12571	-12382	-14749	-17412	-21140
EBITA	**58013.4**	**90937.1**	**113107**	**138806**	**176871**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**58013.4**	**90937.1**	**113107**	**138806**	**176871**
Net interest	-227.0	4082.4	3316.3	2450.7	1076.1
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	0.00	0.00	0.00	0.00	0.00
Other pre-tax items	0.00	0.00	0.00	0.02	0.00
Reported PTP	**57786.4**	**95019.5**	**116424**	**141257**	**177947**
Taxation	-17109	-32404	-39584	-48027	-60502
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.01	0.00	0.00
Reported net profit	**40677.7**	**62615.9**	**76839.7**	**93229.4**	**117445**
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	**40677.7**	**62615.9**	**76839.7**	**93229.4**	**117445**

Source: Company data, ABN AMRO forecasts ***year to Mar***

Balance sheet

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
Cash & market secs (1)	62434.7	113220	99533.0	62936.6	57317.9
Other current assets	114267	100836	115193	132332	155053
Tangible fixed assets	135228	146810	212061	314649	413509
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	2369.9	3500.0	3500.0	3500.0	3500.0
Total assets	**314300**	**364366**	**430287**	**513418**	**629379**
Short term debt (2)	23695.8	29192.1	33348.6	38310.4	44888.0
Trade & oth current liab	102416	114142	122963	134388	149457
Long term debt (3)	46161.3	30920.8	22720.3	14820.8	14820.8
Oth non-current liab	14784.6	18627.3	18627.3	18627.3	18627.3
Total liabilities	**187058**	**192882**	**197659**	**206147**	**227793**
Total equity (incl min)	127241	171484	232628	307271	401586
Total liab & sh equity	**314300**	**364366**	**430287**	**513418**	**629379**
Net debt (2+3-1)	12573.8	-46760	-36214	-1476.7	12149.6

Source: Company data, ABN AMRO forecasts ***year ended Mar***

Cash flow statement

Rsm	FY06A	FY07A	FY08F	FY09F	FY10F
EBITDA	70584.2	103319	127857	156218	198012
Change in working capital	-29099	12642.5	-5381.3	-6423.9	-8515.9
Net interest (pd) / rec	-6378.3	-3854.1	-2682.1	-1877.1	-1482.1
Taxes paid	-7496.6	-28962	-39584	-48027	-60502
Other oper cash items	11792.4	10000.0	10000.0	10000.0	10000.0
Cash flow from ops (1)	**39402.7**	**93145.2**	**90209.3**	**109890**	**137512**
Capex (2)	-10511	-15141	-80000	-120000	-120000
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	n/a	n/a	n/a	n/a	n/a
Cash flow from invest (3)	**-10511**	**-15141**	**-80000**	**-120000**	**-120000**
Incr / (decr) in equity	n/a	n/a	n/a	n/a	n/a
Incr / (decr) in debt	n/a	n/a	n/a	n/a	n/a
Ordinary dividend paid	-12730	-11978	-15696	-18587	-23130
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	-17431	-15241	-8200.5	-7899.5	0.00
Cash flow from fin (5)	**-30161**	**-27219**	**-23896**	**-26486**	**-23130**
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	**-1268.4**	**50785.0**	**-13687**	**-36596**	**-5618.7**
Equity FCF (1+2+4)	28892.2	78003.8	10209.3	-10110	17511.5

Lines in bold can be derived from the immediately preceding lines. ***year to Mar***
Source: Company data, ABN AMRO forecasts

STEEL AUTHORITY OF INDIA: PERFORMANCE AND VALUATION

Standard ratios

	SAIL					Tata Steel			POSCO		
Performance	**FY06A**	**FY07A**	**FY08F**	**FY09F**	**FY10F**	**FY08F**	**FY09F**	**FY10F**	**FY06F**	**FY07F**	**FY08F**
Sales growth (%)	-2.86	21.7	12.6	14.9	17.2	363.7	1.33	3.65	-2.37	13.1	3.26
EBITDA growth (%)	-36.5	46.4	23.7	22.2	26.8	126.8	10.8	15.0	-22.6	16.6	21.4
EBIT growth (%)	-41.4	56.8	24.4	22.7	27.4	103.7	12.6	16.7	-28.9	19.6	27.5
Normalised EPS growth (%)	-41.5	53.9	22.7	21.3	26.0	26.5	18.4	24.1	-23.3	23.3	25.5
EBITDA margin (%)	24.3	29.2	32.1	34.2	37.0	15.3	16.7	18.6	23.2	23.9	28.1
EBIT margin (%)	20.0	25.7	28.4	30.4	33.0	12.0	13.3	15.0	16.9	17.8	22.0
Net profit margin (%)	14.0	17.7	19.3	20.4	21.9	6.85	8.00	9.58	12.5	13.6	16.6
Return on avg assets (%)	13.5	17.6	18.8	19.4	20.4	15.5	11.0	12.4	11.4	11.9	12.9
Return on avg equity (%)	36.6	41.9	38.0	34.5	33.1	34.8	26.9	26.6	15.5	16.9	18.3
ROIC (%)	28.8	41.2	55.2	45.2	38.2	61.0	16.0	18.2	16.6	18.4	18.1
ROIC - WACC (%)	17.0	29.4	43.5	33.4	26.4	50.4	5.42	7.62	5.72	7.47	7.23
					year to Mar			*year to Mar*			*year to Dec*
Valuation											
EV/sales (x)	1.90	1.39	1.26	1.18	1.03	0.63	0.57	0.48	1.37	1.31	1.29
EV/EBITDA (x)	7.82	4.77	3.94	3.44	2.79	4.10	3.39	2.58	5.90	5.47	4.58
EV/EBITDA @ tgt price (x)	9.42	5.86	4.82	4.17	3.36	4.46	3.71	2.86	5.36	5.00	4.20
EV/EBIT (x)	9.52	5.42	4.45	3.88	3.12	5.24	4.26	3.19	8.12	7.34	5.85
EV/invested capital (x)	3.57	3.44	2.34	1.66	1.28	1.05	0.94	0.80	1.69	1.41	1.22
Price/book value (x)	4.24	3.15	2.32	1.76	1.34	1.62	1.30	1.04	1.68	1.46	1.25
Equity FCF yield (%)	5.35	14.5	1.89	-1.87	3.25	2.99	14.4	19.3	3.69	-5.95	0.32
Normalised PE (x)	13.3	8.62	7.02	5.79	4.59	6.38	5.39	4.34	11.5	9.30	7.41
Norm PE @tgt price (x)	16.0	10.4	8.49	7.00	5.56	7.50	6.34	5.11	10.5	8.48	6.76
Dividend yield (%)	1.53	2.22	2.91	3.44	4.29	2.69	3.02	3.36	1.76	1.98	2.20
					year to Mar			*year to Mar*			*year to Dec*

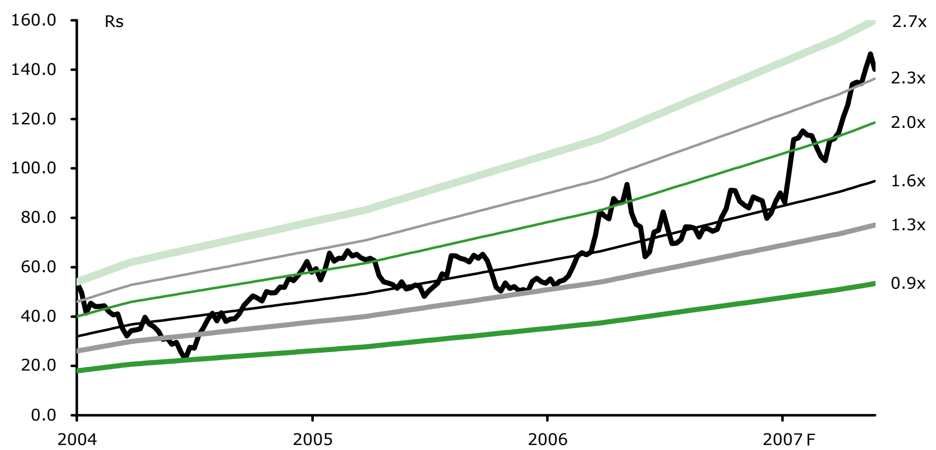
Per share data	FY06A	FY07A	FY08F	FY09F	FY10F
Tot adj dil sh, ave (m)	4130.4	4130.4	4130.4	4130.4	4130.4
Reported EPS (INR)	9.85	15.2	18.6	22.6	28.4
Normalised EPS (INR)	9.85	15.2	18.6	22.6	28.4
Dividend per share (INR)	2.00	2.90	3.80	4.50	5.60
Equity FCF per share (INR)	7.00	18.9	2.47	-2.45	4.24
Book value per sh (INR)	30.8	41.5	56.3	74.4	97.2
					year to Mar

Solvency	FY06A	FY07A	FY08F	FY09F	FY10F
Net debt to equity (%)	9.88	-27.3	-15.6	-0.48	3.03
Net debt to tot ass (%)	4.00	-12.8	-8.42	-0.29	1.93
Net debt to EBITDA	0.18	-0.45	-0.28	-0.01	0.06
Current ratio (x)	1.40	1.49	1.37	1.13	1.09
Operating CF int cov (x)	8.35	32.7	49.4	85.1	134.6
Dividend cover (x)	4.92	4.89	4.90	5.02	5.08
					year to Mar

Priced as follows: SAIL.BO - Rs127.55; TISC.BO - Rs595.20; 005490.KS - W455000.00
Source: Company data, ABN AMRO forecasts

STEEL AUTHORITY OF INDIA: VALUATION METHODOLOGY

Chart 12 : Price-to-book band



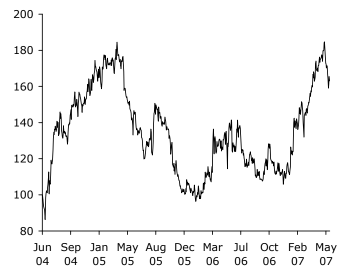
Source: Datastream, ABN AMRO forecasts

Steel Authority of India

Company description — Buy

Steel Authority of India is the largest steel maker in India (and 15th-largest in the world) with a saleable steel capacity of about 13 mtpa, with a varied product mix. It works on the BF-BOF route for steel making and is notable for a high level of vertical integration with captive mines for iron ore and limestone. The company has about 30% share in the domestic market and has products in a large number of categories in the flat as well as long products segments.

Price relative to country



Strategic analysis — Average SWOT company score: 3

Strengths — 3
Large size of operations, with a high level of vertical integration (has access to good-quality iron ore at a low cost) and a good product mix.

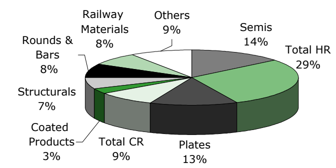
Weaknesses — 2
Lack of coking coal mines, market perception about product quality, relatively high production costs because of process inefficiency.

Opportunities — 4
Good growth in the Indian steel market. Proximity to the lucrative markets of the Middle East and Far East Asia. It can reduce operational inefficiencies through its strong cash flow.

Threats — 2
Larger-than-expected capacity additions in the Asian region could dampen the supply-demand dynamics for the sector, thereby threatening prices.

Scoring range is 1-5 (high score is good)

Revenue breakdown, FY08F



Source: ABN AMRO forecasts

Market data

Headquarters
Ispat Bhawan, Lodi Road, New Delhi 110 003, India

Website
www.sail.co.in

Shares in issue
4130.4m

Freefloat
14%

Majority shareholders
Govt. of India (86%), Financial institutions (8%)

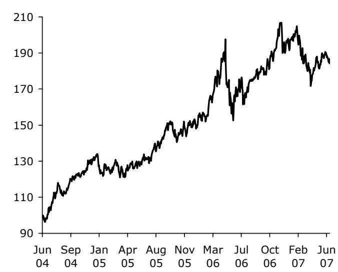
India

Country view — Neutral

The ABN AMRO Indian PMI suggests the economy is still powering ahead despite the global headwinds, thanks to its domestically-oriented economic structure. Moreover inflationary pressure has eased with the recent rate hikes by the RBI. At the sector level, we still like autos (commercial vehicles), software and construction-related stocks as infrastructure spending should be a growth driver in FY08.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific



Competitive position — Average competitive score: 3-

Supplier power — 2-
Due to the tight market, the bargaining power of global coking coal miners has risen. For domestic suppliers, we see no material change, especially for SAIL because it is a public sector company.

Barriers to entry — 3-
High capital cost is the most significant entry barrier for the steel industry. The cyclicality of steel prices and technological barriers are other factors that discourage many potential entrants.

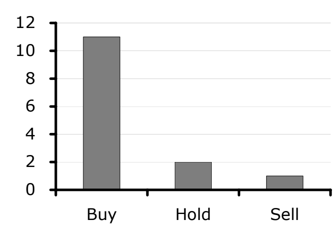
Customer power — 3+
Tight steel market globally as well as domestically and small number of integrated steel makers have caused the bargaining power to shift away from customers.

Substitute products — 3-
Aluminium, copper, plastics and wood are the main products that compete with steel in applications such as automobiles, construction and industry. In India, aluminium is a key substitute.

Rivalry — 3-
Scope for differentiation being low, a large number of product ranges and a small number of market players ensure that competitive rivalry is not too high.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source: Bloomberg