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STEEL........A STEAL???

Current scenario: Government may impose import duty to avoid dumping by China..

Import duty on steel was removed and export duty was levied in April 08 to rein in inflationary pressures. Consequently, steel imports between April 08 and September 08 rose by 50% to about 3 mt as prices in China, Thailand and Ukraine were ruling below domestic prices. With competitive pricing and slowdown in domestic demand, China's total steel exports globally rose to a record 7.8 mt in August 08. However, as international steel prices subsided, landed cost of imported Chinese steel dropped to $700/ton in India as against the domestic price of $750. China-based steel producers, backed by cheaper operating costs in met coal and power, have a significant price advantage over the domestic players. There is a difference of $150 between Chinese and Indian domestic and export prices (Chinese domestic price is $600 and export price is $700, whereas Indian domestic and export prices are $750 and $850 respectively). Facing an overall economic slowdown, consumers are opting for cheaper Chinese steel, whose share in India's steel import basket surged from 10% in April 08 to about 48% in August 08. To avoid large-scale dumping and protect domestic players, the government, responding to industry demands, may levy import duty to 15%, remove export duty (currently 15%) and reduce excise duty from 14.4% to 8%. There has been no capacity expansion in the past quarter with key players including JSW delaying the commissioning of their plants by over two months owing to current market conditions. Indian steel makers may have to cut production by 30% and continue to postpone expansion projects if the government does not act.

Key Highlights

		Tata Steel *	Tata Steel	SAIL	JSW Steel	Comments
Backward integration						
	- iron ore	100%	20%	100%	20%	Iron ore prices have fallen significantly over the past quarter (21% fall in April 08 to September 08 period) with a sharp correction in the previous fortnight (43% fall from April 08 till date). The price reduction will largely benefit non-integrated players such as JSW Steel with margin pressures easing off in the coming quarters
	- coking coal	65%	14%	0%	0%	Met coal has also witnessed a downward movement in rates with prices dropping by 14% in April 08 to September 08 period. Except for Tata Steel, which sources significant portion from captive mines, the price reduction is welcome news for most players in the domestic market
Import of raw material						
	- iron ore	0%	30%	0%	0%	With large iron ore reserves in India, domestic companies primarily source their requirement from local market except for Corus that has production facilities in UK and Netherlands. Drop in freight rates (Baltic dry index has fallen by 88% to 1,438 from high of 11,933 in May 08) is likely to benefit Tata Steel as a consolidated entity as Corus imports raw material from Brazil, Australia, Canada and South Africa

		Tata Steel *	Tata Steel	SAIL	JSW Steel	Comments
	- coking coal	30%	80%	70%	100%	While India is endowed with plenty of iron ore reserves, the low grade coal available makes it necessary for companies to import their requirement from neighbouring countries and Australia. Met coal is the largest component in raw material cost (Met coal comprises 25% of total RM cost, 9% of operating cost and 5% of net sales; and iron ore comprises 20% of total RM cost, 7% of operating cost and 4% of net sales) and though reduction in freight rates coupled with drop in prices will benefit all industry players, depreciating rupee will add to the landed cost
Export (as a % of sales)		12%	17%	6%	25%	Rising inventory levels and increasing industry concerns on expansion plans have prompted the government to rethink on export duties that were earlier imposed as an anti-inflationary measure to meet rising domestic demand. Any cut or roll-back will benefit players such as JSW Steel who market a significant portion of the output overseas
FCCBs						
	Amount outstanding	$875 mn	$875 mn	-	$324 mn	Steel industry being capital-intensive, players accessed cheaper credit in the international markets to fund expansion plans. However, adverse movements in foreign exchange rates has increased the MTM provisioning for unhedged exposures. Tata Steel and JSW Steel, with major foreign currency exposures, is expected to be hit by higher provisions on account of rupee depreciating by over 10% in Q2FY09
	Conversion price	Rs. 758.1	Rs. 758.1	-	953.4	
	Maturity date	05-Sep-12	05-Sep-12	-	21-Jun-12	
MTM losses due to rupee depreciation (Q2FY09E) **		Rs. 3.9 bn	Rs. 3.9 bn	-	Rs. 4 bn	
Realisation growth (% YoY) (Q2FY09E)		30%	33%	26%	41%	While we expect robust growth in topline, the impact on bottomline is weak driven by higher interest costs and extraordinary items such as MTM provisioning of external borrowings pulling down earnings. Further, steel prices have corrected sharply from the previous highs but the corresponding reduction in raw material prices has been delayed impacting the bottomline adversely in Q2FY09
Volume growth (% YoY) (Q2FY09E)		5%	6%	2%	23%	
Net sales growth (% YoY) (Q2FY09E)		38%	42%	30%	73%	
Net profit growth (% YoY) (Q2FY09E) ***		45%	-9%	18%	-55%	

* Standalone
** Based on our interaction with the management in some cases
*** After deducting MTM losses on FCCBs due to rupee depreciation

International steel prices rose sharply by 50-60% in the first half of 2008 but prices in the domestic market was reigned in by the government in an attempt to check inflationary pressures and ensure adequate supply. As a result, domestic steel prices went up by around 25% only in the corresponding period. Therefore, as we witness steep correction in international steel prices by 25% (from $1200 to $900), we do not expect similar declines in domestic prices that have fallen by 16% to $750 but rather stabilize in the coming quarters. In our view, Q3FY09E and Q4FY09E results will be better as raw material prices will come down further and long term contracts will be re-negotiated at lower rates in December. While rupee depreciation in Q2FY09 has resulted in increasing import cost and negative MTM provisioning on unhedged foreign currency exposures, falling freight rates and expected rupee appreciation will positively impact the bottomline in the coming quarters.

Scenario analysis: Impact of government policy in steel sector

	Import Duty	Export Duty	Excise Duty	Positive impact on steel sector earnings
Base case scenario	From nil to 5%	From 15% to 0%	From 14% to 10%	5-10%
Optimistic scenario	From nil to 15%	From 15% to 0%	From 14% to 8%	15-20%
Pessimistic scenario (status quo)	Nil	At 15%	At 14%	Nil

Summary

Key Positives	Key Negatives
Expected changes in the government policies, such as export duty cut, imposition of import duty and reduction in excise duty, as proposed by industry players, will benefit the domestic producers. Export duty cut - positive for JSW Steel Import duty imposition - positive for all domestic players, esp. JSW Steel Excise duty cut - positive for all domestic players	Rupee depreciation of over 10% in the past quarter has increased the MTM provisioning for unhedged exposures. Negative for Tata Steel and JSW Steel
Domestic demand for steel is expected to sustain a growth rate of 12% as against the production growth rate of 6% in FY09E. There continues to exist a 6% lag in production over demand that would support domestic prices to stabilise in the coming quarters.	IMF has revised its forecast for US, Europe and Japan from 1.0 - 1.5% to 0.1 - 0.5%. Due to the global economic slowdown, world demand for steel is expected to slowdown to 5.5% in FY09E from 7.5% in FY08. Demand contraction in overseas market is likely to have an adverse impact on domestic steel as well.
Global steel players have decided to cut their output by 20-30%, which will provide some cushion to the falling steel prices in view of changing demand-supply dynamics.	

In the light of above factors, we believe SAIL to be the top pick among peers and are reviewing our rating on other stocks. SAIL is most favourably positioned, especially in the current volatile market scenario, with 100% iron ore linkage, ~94% domestic revenue contribution and is one of the least levered company with debt equity ratio of 0.1. Further, higher employee expenses in Q1FY09 due to provisioning for Sixth Pay Commission report was a one-time event and not expected to recur in the coming quarters. With elections around the corner, recent statements of Union Minister for Steel Ram Vilas Paswan, suggest that the government would protect the domestic steel producers from the global turmoil and ensure their competitiveness. Thus, government activism which was a vice earlier may actually prove to be a virtue going forward for SAIL.

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