STEEL AUTHORITY OF INDIA LTD.

Q3 FY 2008 update SELL

PINC RESEARCH

Sector Metals I CMP Rs 221

STOCK DATA

Market Cap	Rs 913 bn.
Book Value per share	Rs 41.9
Eq Shares O/S (F.V. Rs.10)	47.1 mn.
Median Vol (12 mths)	11 mn (BSE+NSE)
52 Week High/Low	Rs 293 / 92
Bloomberg Code	SAIL@IN
Reuters Code	SAIL.BO

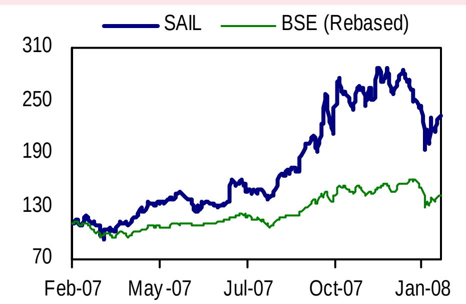
SHAREHOLDING PATTERN (%)

Qtr. Ended	Jun-07	Sep-07	Dec-07
Promoters	85.8	85.8	85.8
MFs/FIs	5.3	5.3	5.5
FIIs	6.4	6.7	6.2
PCBs	0.5	0.5	0.6
Indian Public	2.0	1.7	1.9

STOCK PERFORMANCE (%)

	1M	3M	12M
Absolute	(15.2)	(9.0)	108.8
Relative	(6.0)	(4.5)	(62.4)

STOCK PRICE PERFORMANCE



KEY HIGHLIGHTS

SAIL's Q3FY08 results were above expectations as it shrugged off adverse effects of higher raw material prices (faced by the industry) with improved sales mix. This resulted in net sales registering a 12% YoY growth to Rs95.3bn.

SAIL reported record production volumes as hot metal production rose 3.5% YoY while saleable steel volumes increased ~1.4% YoY due to improved performance at Durgapur and Bokaro.

- **Substantial rise in wage expenses**

Adherence to AS-15 resulted in SAIL's wage bill inflating by more than 39% to Rs17bn. Moreover, the company has indicated that it would take an additional Rs3bn hit of similar nature in Q4FY08.

- **Higher capacity utilisation led to increased production**

The average capacity utilisation of SAIL's furnaces continue to breach their rated capacity and hence hot metal production rose 3.5% to 3.96mn mt while crude steel production was 3.66 mn mt (Capacity utilisation of ~108%). Saleable steel production was 3.4mn mt (at 115% capacity utilisation).

- **OPM expansion due to higher value added product sales**

The quarter saw a 280bps jump in OPM to ~31.3% mainly due to higher sale of high margin value added products (production in excess of 1mn mt) and increase in operational efficiencies like higher production through concast route and lower coke consumption.

- **Coking coal contract renewals at higher prices**

SAIL's coking coal contracts are expected to be renewed at ~50% higher rates in Jul'08. With steel prices already having hiked, we expect the higher coking coal prices to impact margins. Also, higher wage bill due to the Sixth Pay Commission will further impact margins.

VALUATIONS AND RECOMMENDATION

At the CMP of Rs221, the stock trades at a P/E of 13.9x and EV/EBIDTA of 7.2x discounting its FY09 estimates. These are rich valuations as compared to peers like Tata Steel and JSW Steel. Even on EV/mt of crude steel production basis, it is expensive vis-a-vis peers. Thus, we recommend a 'SELL' on the stock.

KEY FINANCIALS (STANDALONE)

Rs mn	Quarter Ended			Yr Ended (March)				
	Jun-07	Sep-07	Dec-07	2005	2006	2007	2008E	2009E
Net Sales	80,395	91,635	95,333	285,228	278,603	344,680	367,672	414,306
YoY Gr. (%)	*6.3*	*7.3*	*11.7*	*29.7*	*(2.3)*	*19.1*	*8.4*	*12.7*
Op. Profits	23,829	26,291	29,834	99,149	58,326	95,689	108,443	96,511
Op. Marg. (%)	*29.6*	*28.7*	*31.3*	*34.8*	*20.9*	*27.8*	*29.5*	*23.3*
Net Profits	15,251	17,002	19,347	60,525	40,130	62,023	70,747	65,825
Eq Capital	41,304	41,304	41,304	41,304	41,304	41,304	41,304	41,304

KEY RATIOS

	Yr Ended (March)				
	2005	2006	2007	2008E	2009E
Dil. EPS (Rs)	14.7	9.7	15.0	17.1	15.9
ROACE (%)	58.7	35.2	49.7	46.2	35.7
ROANW (%)	78.9	35.0	41.5	35.1	25.7
P/E (x)	15.1	22.7	14.7	12.9	13.9
EV/Sales (x)	3.2	3.2	2.5	2.2	1.9
EV/EBDIT (x)	8.9	12.1	7.6	6.7	7.2

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PERFORMANCE OVERVIEW

SAIL posted a 12%YoY net sales growth in Q3FY08 mainly on back of increased realisations and improved sales mix. However, incremental revenues can be attributed to the contribution from *Bhilai & Durgapur* steel plants and exceptional performance of the Alloy steel plant. While revenues from Bhilai & Durgapur were up 4% & 7% respectively at Rs33.7bn and Rs12.7bn, revenues from Alloy steel plant surged 37% to Rs2.6bn. Overall, 1/3rd of net sales accrued from Bhilai whereas 26% was contributed by Bokaro. Other two ISPs (at Durgapur & Rourkela) contributed 13% & 15% of total revenues respectively.

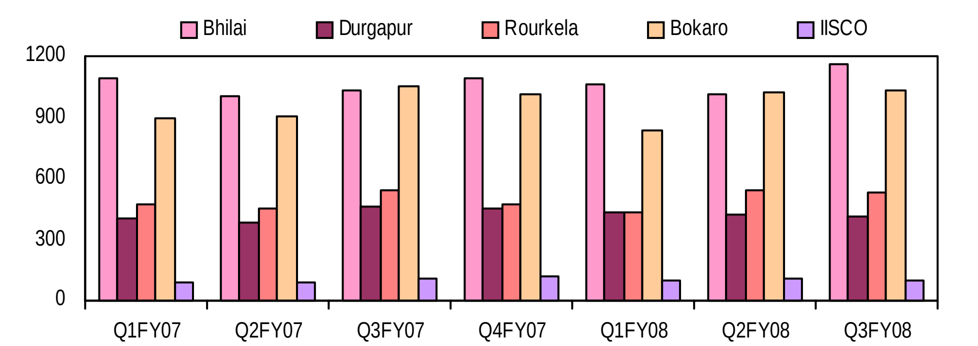
Blast furnace throughputs in excess of rated capacities

Higher capacity utilisations resulted in record steel production in Q3FY08 …

Throughput of all blast furnaces continues to expand and run beyond rated capacities, thereby enhancing hot metal production by ~3.5% to 3.96mn mt (annualised run rate of ~16 mn mt against rated capacity of ~14.6mn mt). Higher hot metal production also accelerated crude and saleable steel production, which rose ~2% & 1% respectively.

A major chunk of incremental production of saleable steel came from Bhilai steel plant, which recorded a commendable 13% increase in saleable steel production to ~1.2 mn mt. However, the stand-out performance was on special & alloy steel front where production increased more than 30%. Citing strong demand, SAIL was able to increase production of TMT bars (+32%), plates (+13%), structurals (+11%) and other high value special steel products like LPG grade steel, wheels & axles and rails. Total sales volume was stagnant at 3 mn mt with increased contribution from value added products, which command higher margins and realisations.

Qtrly plantwise production volumes ('000 Mt)



Improving average realisations boost margins

Higher contribution of value added products led to higher realisations …

Consequent to the above, average realisations crossed Rs31k/mt. This, coupled with cost reduction measures (reduction in coke rate and power consumption per mt) negated the impact of higher employee cost (+39%). OPM as a result expanded 280bps to 31.3%. Operating profits increased 23% to Rs30bn with operating profit per mt rising 23% to ~Rs10k/mt on sales volumes of 3mn mt. The Bhilai steel plant was a significant contributor with its PBIT margins rising by 1,100bps to ~39% while margins of Durgapur steel plant increased by ~600bps to xx%.

AS-15 provisioning impacts staff cost

AS-15 required SAIL to provide for Rs3-4bn as a liability against retirement benefits and charge it to P&L. This inflated the wage bill by 39% to Rs17bn. A similar liability will also need to be accounted for in Q4FY08 which will impact profitability. The 6th Pay Commission recommendations are expected to be implemented by Q3FY08 and can impact staff costs in H2FY09.

Capex Plans

As per its *Corporate Plan-2012*, SAIL has announced a capex of ~Rs530bn (~USD13.3bn) to expand production from current 13.5mn mt to ~25mn mt. Towards this, capex is estimated at ~Rs20bn in FY08. Majority of its capex is expected to be funded via internal accruals as SAIL is expected to generate cash profits of >Rs250bn in the next five years.

Corporate Plan - 2012

Corp. plan-2012	2007	2010	Plant wise	2007	2010	Product wise	2007	2010
Hot Metal (Mn mt)	14.6	26.0	Bhilai	4.2	6.5	HRC	24.1	22.1
Crude Steel (Mn mt)	13.5	24.5	Durgapur	1.6	2.8	Plates	19.8	16.4
Saleable Steel (Mn mt)	12.6	23.0	Rourkela	1.9	3.8	CR Coils	8.7	10.4
BOF	78%	100%	Bokaro	3.8	6.5	Railways	8.0	7.4
Continuous Casters	62%	100%	IISCO	0.4	2.4	Structrals	6.7	15.0
Total Capex		**Rs530bn**	Others	2.7	4.0	Rounds/Bars	10.2	23.3
Capex 2008		**Rs20bn**	**Total**	**14.6**	**26.0**	Others incl.Semis	22.5	5.4

Source: Company

High sensitivity to steel prices

SAIL has a high sensitivity to steel prices and with buoyancy in prices over the last 2 years, it has consistently enjoyed high profitability. This is largely on account of captive iron ore mines and annual fixed price coking coal contracts. This ensures a stable cost of production even in a rising raw material prices scenario. Thus, when steel prices move up in tandem with raw material, incremental revenues flow directly to operating profits while reversing in a vice-versa scenario.

Renewal of coking coal contracts to impact margins

Substantial increase in coking coal price expected for FY08-09 contracts...

Prices of key raw material (Iron ore, Coal & Coke) have appreciated significantly over past six months and are now exerting pressure on steel prices. Consequently, steel prices have started spiking and benchmark HR Coil prices have jumped to ~USD720/mt in Jan'08 from ~USD575-600/mt levels for CY07. This scenario places SAIL in an enviable position upto Jun'08.

SAIL's coking coal contracts are due for renewal in Jun-Jul'08. With spot coking coal prices having doubled in the past six months, we expect FY08-09 contracts to be at much higher levels as compared to ~USD100/mt price (FY07-08 contract price). Hence, SAIL would face pressure on raw material front from Q2FY09 onwards.

OUTLOOK

We estimate SAIL to post net sales of Rs414bn in FY09. However, OPM could contract 600bps due to higher coking coal prices and higher wage bill post 6th Pay Commission recommendations. We have assumed a one-time hit (2 years arrears) of ~Rs20bn, which would be routed through the P/L. Thus, we expect the company to take a 600bps hit on OPM, which would hover ~23-24% (28% ignoring wage arrears). We estimate net profits of ~Rs 67bn.

VALUATIONS

At the CMP of Rs 221, SAIL is trading at a P/E of 13.9x and EV/EBIDT of 7.2x discounting its FY09E EPS of Rs16. Considering the current industry scenario, SAIL's high exposure to external sources for coking coal and Ferro Alloys would take its toll on the company's profitability in FY09 and erode margins despite higher realisations. Moreover, the company is in midst of a huge capex and any slippage in implementation could significantly impact profitability. Further, it trades at a premium to peers like Tata Steel and JSW Steel. Thus, we recommend a 'SELL' based on valuations.

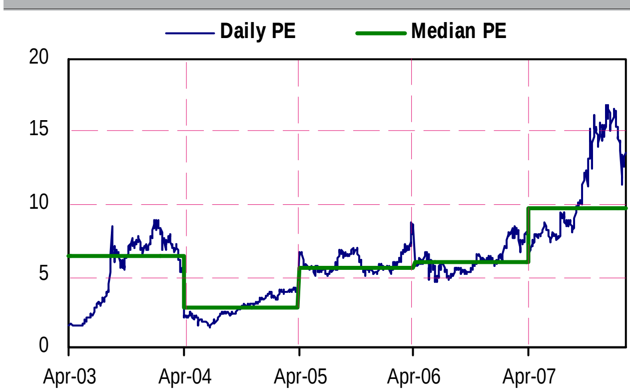
Company description

SAIL is India' largest steel manufacturer with steel making capacity of ~13 mn mt. Its with main plants located at Bhilai, Durgapur, Bokaro and Rourkela. It has undertaken a massive expansion plan to double its capacity to ~25mn mt (by end of FY10) at an estimated capex of Rs530bn.

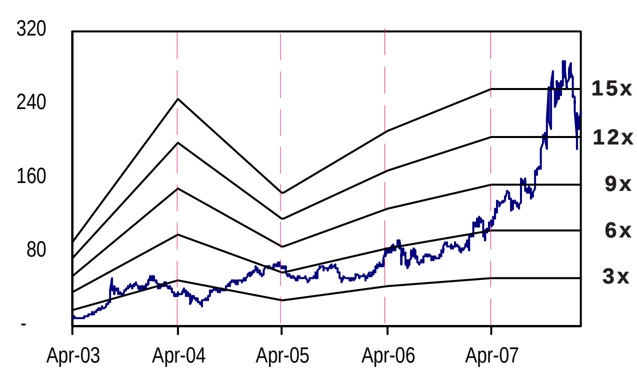
Financial Results for the quarter & nine months ended 31 December 2007

Particulars (Rs mn)	Quarter Ended			Nine Months Ended			Year Ended
	31/12/07	31/12/06	Gr %	31/12/07	31/12/06	Gr %	31/03/07
Gross Sales	**110,144**	**98,417**	**11.9**	**308,044**	**277,984**	**10.8**	**397,336**
Less: Excise Duty	14,811	13,046	13.5	40,682	37,154	9.5	52,655
Net Sales	**95,333**	**85,371**	**11.7**	**267,363**	**240,830**	**11.0**	**344,680**
Total Expenditure	**65,499**	**61,054**	**7.3**	**187,409**	**175,377**	**6.9**	**248,992**
(Inc.) / Dec. Stock-in-trade	(5,540)	(2,274)		(13,429)	(7,401)		(2,465)
Consumption of Materials	32,521	31,660		92,066	90,876		122,621
Staff Cost	17,097	12,273	39.3	46,489	34,560	34.5	50,874
Stores & Spares	6,724	6,638	1.3	20,845	19,279	8.1	26,055
Power & Fuel	7,125	6,536	9.0	20,754	19,233	7.9	25,788
Other expenditure	7,572	6,222	21.7	20,684	18,830	9.8	26,119
Operating profit	**29,834**	**24,316**	**22.7**	**79,953**	**65,453**	**22.2**	**95,689**
Interest earned	2,955	1,923	53.7	8,695	5,376	61.7	7,526
Other Income	189	308	(38.7)	561	629	(10.8)	866
PBDIT	**32,977**	**26,547**	**37.6**	**89,209**	**71,457**	**24.8**	**104,081**
Interest	598	906	(34.0)	1,988	2,767	(28.2)	3,321
Depreciation	3,160	3,299	(4.2)	9,184	9,293	(1.2)	12,115
PBT & extra-ordinary items	**29,219**	**22,342**	**30.8**	**78,037**	**59,398**	**31.4**	**88,645**
Provision for current tax	9,700	6,816	42.3	26,030	22,629	15.0	32,965
Provision for deferred tax	110	753	(85.4)	210	(836)	(125.1)	(1,027)
Provision for fringe benefit tax	62	61	1.6	197	183	7.7	265
Net profits	**19,347**	**14,712**	**31.5**	**51,600**	**37,422**	**37.9**	**62,023**
Equity Capital	41,304	41,304		41,304	41,304		41,304
Reserves (excl. rev. res.)	-	-		-	-		131,828
EPS for the period (Rs)	**4.7**	**3.6**	**31.5**	**12.5**	**9.1**	**37.9**	**15.0**
Book Value (Rs)	-	-		-	-		10.0
OPM (%)	**31.3**	**28.5**		**29.9**	**27.2**		**27.8**
NPM (%)	20.3	17.2		19.3	15.5		18.0
Exp. (% of Net Sales)							
Raw materials (adj.)	28.3	34.4		29.4	34.7		34.9
Staff Cost	17.9	14.4		17.4	14.4		14.8
Stores & Spares	7.1	7.8		7.8	8.0		7.6
Power & Fuel	7.5	7.7		7.8	8.0		7.5
Other expenditure	7.9	7.3		7.7	7.8		7.6
Production Volumes (MT)							
Hot Metal	3.9	3.8	2.9	11.3	10.8	4.6	10.8
Crude Steel	3.6	3.5	2.5	10.4	10.0	3.9	10.0
Saleable Steel	3.4	3.3	1.4	9.6	9.3	2.9	12.6
Sales Volumes	**3.0**	**3.0**	**-**	**8.5**	**8.4**	**1.4**	**11.9**
Effective Net Realisations (Rs/MT)	31,778	28,100	13.1	31,347	28,633	9.5	28,965
Operating Profit (Rs/MT)	9,945	8,068	23.3	9,374	7,782	20.5	8,041

Median PE v/s Daily PE



PE Band



Year Ended March (Figures in Rs mn)

Income Statement	2005	2006	2007	2008E	2009E
Revenues	**285,228**	**278,603**	**344,680**	**367,672**	**414,306**
Growth (%)	*29.7*	*(2.3)*	*19.9*	*8.4*	*12.7*
Total Expenditure	**186,080**	**220,277**	**248,992**	**259,230**	**317,795**
Operating Profit	**99,149**	**58,326**	**95,689**	**108,443**	**96,511**
Growth (%)	*120.6*	*(41.2)*	*54.0*	*20.7*	*(11.0)*
Interest & dividend income	2,873	15,589	8,392	12,750	14,025
EBIDT	**102,022**	**73,915**	**104,081**	**121,193**	**110,536**
(-) Interest	6,051	4,678	3,321	2,600	2,500
(-) Depreciation	11,270	12,073	12,115	13,000	14,000
PBT & extraordinary items	**84,702**	**57,164**	**88,645**	**105,593**	**94,036**
(-) Tax provision	25,924	16,928	32,203	34,846	28,211
Net Profits	**60,525**	**40,130**	**62,023**	**70,747**	**65,825**
Growth (%)	*140.9*	*(33.7)*	*54.6*	*14.1*	*(7.0)*
Fully diluted Eq. sh. O/s (mn no)	4,130	4,130	4,130	4,130	4,130
Book Value (Rs)	25	31	42	56	68
Basic EPS (Rs)	14.7	9.7	15.0	17.1	15.9
Diluted EPS (Rs)	**14.7**	**9.7**	**15.0**	**17.1**	**15.9**

Balance Sheet	2005	2006	2007	2008E	2009E
Equity Share Capital	41,304	41,304	41,304	41,304	41,304
Reserves & Surplus	61,763	84,710	131,828	188,696	240,643
Net worth	**103,067**	**126,014**	**173,132**	**230,000**	**281,947**
Total Debt	57,698	42,976	41,805	25,420	20,420
Deferred Tax liability	18,443	14,845	14,127	14,627	18,827
Capital Employed	**179,208**	**183,835**	**229,063**	**270,047**	**321,194**
Fixed Assets	128,516	129,201	128,338	140,984	171,984
Net current assets	41,676	49,556	94,296	100,741	86,446
Investments	6,067	2,920	5,138	27,930	62,764
Misc exp.	2,949	2,158	1,292	392	-
Total Assets	**179,208**	**183,835**	**229,063**	**270,047**	**321,194**

Year Ended March (Figures in Rs mn)

Cash Flow Statement	2005	2006	2007	2008E	2009E
PBT & Extraord. items	**86,448**	**57,057**	**94,226**	**105,593**	**94,036**
Depreciation	11,922	12,174	12,368	13,000	14,000
Interest & dividend inc.	(2,762)	(4,752)	(7,699)	(12,750)	(14,025)
Interest paid	6,051	4,678	2,153	2,600	2,500
Misc Exp W/off	1,583	1,841	1,273	900	392
Tax paid	(7,779)	(7,465)	(34,273)	(34,346)	(24,011)
(Inc/Dec in working capital	(7,410)	(28,838)	(9,763)	(472)	(10,647)
Cash from operations	**88,053**	**34,696**	**58,284**	**74,525**	**62,244**
Net capital expenditure	(5,276)	(8,967)	(11,377)	(25,647)	(45,000)
Net investments	(400)	(602)	(2,250)	(22,792)	(34,834)
Interest recd	2,202	5,312	7,283	12,750	14,025
Cash from investing activities	**(3,474)**	**(4,257)**	**(6,344)**	**(35,689)**	**(65,809)**
Issue of eq. shares	3	2	24	-	-
Change in debt	(29,451)	(15,156)	(1,115)	(16,385)	(5,000)
Dividend paid	(7,005)	(14,365)	(11,067)	(13,878)	(13,878)
Interest paid	(9,172)	(6,216)	(3,923)	(2,600)	(2,500)
Cash from financing activities	**(45,625)**	**(35,734)**	**(16,082)**	**(32,863)**	**(21,378)**
Inc/Dec. in cash	**38,954**	**(5,295)**	**35,859**	**5,973**	**(24,943)**

Key Ratios	2005	2006	2007	2008E	2009E
EBIDTA (%)	34.8	20.9	27.8	29.5	23.3
ROACE (%)	58.7	35.2	49.7	46.2	35.7
ROANW (%)	78.9	35.0	41.5	35.1	25.7
Sales/Total Assets (x)	1.8	1.8	1.7	1.6	1.5
Debt:Equity (x)	0.6	0.3	0.2	0.1	0.1
Current Ratio (x)	1.4	1.5	1.9	1.8	1.6
Debtors (days)	21.9	21.3	21.6	38.3	40.9
Inventory (days)	82.8	102.9	97.3	80.3	80.3
Net working capital (days)	47.8	56.0	87.8	87.5	66.6
EV/Sales (x)	3.2	3.2	2.5	2.2	1.9
EV/EBIDT (x)	8.9	12.1	7.6	6.7	7.2
P/E (x)	15.1	22.7	14.7	12.9	13.9
P/BV (x)	8.9	7.2	5.3	4.0	3.2

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