KIM ENG

SELL

Initiating coverage

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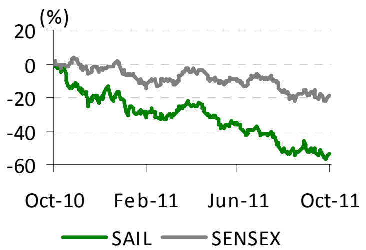
Price	**Rs107**
Target	**Rs87**
BSE Index	**16,536**

Historical Chart



Performance	1m	3m	6m
Absolute (%)	*-7*	*-24*	*-39*
Relative (%)	*-6*	*-12*	*-24*

Stock Information

Ticker code	SAIL
Market cap (US$ bn)	8.9
52-week high (Rs)	230
52-week low (Rs)	98
Shares issued (m)	4,130
6m avg d.vol (US$m)	0.8
Free float (%)	14.2
Major shareholders (%)	
Gov't of India	85.8

Statutory Auditor
T.R. Chadha & Co
Tej Raj & Pal
S.K. Mittal & Co.

Key Indicators FY12F

ROE (%)	11.0
Net gearing (%)	19.2
NTA (US$ bn)	8.2
Interest cover (x)	4.7

INDIA

Steel Authority of India (SAIL)

Not yet a smooth sailing

High coking coal prices would continue to hurt SAIL's FY12 profit. Following a 30% Y/Y fall in Q1, earnings will decline 17% in Q2. SAIL's current PER of 9.9x FY12F (sector avg is 7.6x) more than justifies its advantage over peers who face iron ore shortage and have exposure to risky int'l markets. We expect this premium to narrow and initiate with SELL rating. Our TP is Rs87/sh based on PER of 8x FY12F.

Q2 cash spread to reduce by 13% Y/Y on high coal prices
Apr-Sep coking coal prices increased 40% Y/Y to Rs14k/ton as supplies suffered due to floods in Australia. This would reduce SAIL's quarterly cash spread by 13% to Rs5.9k/ton and earnings by 17% to Rs2.2/sh. Even considering the recent decline in coking coal prices, we expect EPS to decrease 10% for the full year.

Strengthening of steel prices may be short lived
The recent ban on iron ore mining in Karnataka created shortage of iron ore, forcing many steel producers to cut production by 30%. These production cuts resulted in steel prices increasing 5% to Rs43k/ton. However, this price increase is not sufficient enough to offset high coal prices. Our FY12 steel price assumption for SAIL is Rs41k/ton.

New capacity increase to support earnings only in FY14
SAIL would add 2m ton of new capacity this year and 4.2m ton next year. Of the total CAPEX of Rs160bn, 60% would be funded thru new debt. This would increase FY12 interest cost by 30% to Rs7.4bn. New plants would be fully operational in FY14.

TP of Rs87/sh based on PER of 8x FY12F, SELL
Currently, SAIL is trading at PER of 9.9x FY12F, which is high given FY12F profit decline of 10% and mild growth in profit of 15% in FY13. Further, capacity increase at time of slowing economic growth threatens the profitability of new the plants. We initiate with SELL and TP of Rs87/sh.

Year End March 31	FY10	FY11	FY12F	FY13F	FY14F
Revenue (Rs bn)	406	428	497	547	607
Net profit (Rs bn)	68	50	45	52	59
EPS (Rs)	16.6	12.1	10.9	12.5	14.2
Growth (%)	*10*	*-27*	*-10*	*15*	*13*
D/E (x)	0.0	0.1	0.2	0.2	0.3
PER (x)	6.5	8.8	9.9	8.6	7.6
P/BV (x)	1.3	1.2	1.1	1.0	0.9
EV/EBITDA (x)	4.7	6.0	6.2	5.2	4.5

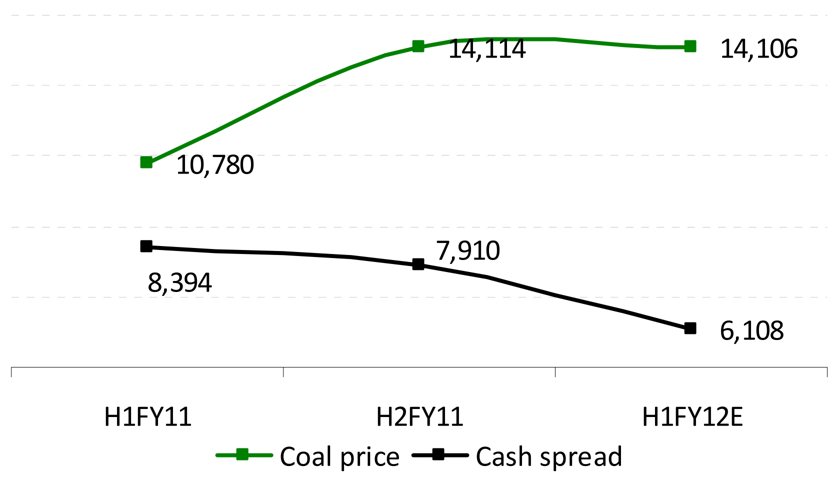
SEE APPENDIX I FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS

H1 earnings to decline 23% Y/Y on reduced coal price

H1 cash spread suffered due to high coal price

Coal cost forms 70% of SAIL's RM cost. In H1, coal prices shot up 40% to Rs14k/ton as coal supply from Australian mines came to a standstill due to floods. We expect SAIL's H1 cash spread of Rs6.1k/ton vs. avg FY11 spread of Rs8.1k/ton.

Coal price vs. cash spread (Rs/ton)



Source: Bloomberg, KESI estimates

Sensitivity analysis

Risk to earnings from rise in coal price

According to our sensitivity analysis, a 2% change in steel price affects EPS by 6% and 2% change in coal price affects EPS by 7%. However, EPS is insulated from any change in iron ore prices since SAIL sources iron ore from its own mines.

Sensitivity analysis

Sensitivity matrix (FY12F)	Change in EPS (%)
Steel price (base case of Rs41.1k/ton)	
Impact of each 2%	6
Sales volume (base case of 12.6m ton)	
Impact of each 2%	4
Coal price (base case of Rs13.2k/ton)	
Impact of each 2%	7

Source: KESI estimates

Target PER of 8x FY12F, TP of Rs87/sh

EPS decline of 10% in FY12

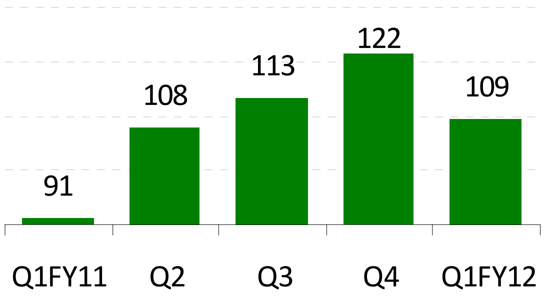
Our target PER for SAIL is 5% above sector avg. We believe this justifies the advantages it has over its peers of: 1) own iron ore mines and, 2) min. exposure to the export market - only 2% output is sold in int'l markets.

Peer comparison

		Mcap	PER (x)		P/BV (x)	
(Yr to Mar)	**Company**	**(Rs bn)**	**FY12F**	**FY13F**	**FY12F**	**FY13F**
TATA	Tata Steel	416	6.7	5.6	1.0	0.9
JSTL	JSW Steel	131	8.4	5.7	0.8	0.7
Average			**7.6**	**5.7**	**0.9**	**0.8**
SAIL		443	9.9	8.6	1.1	1.0

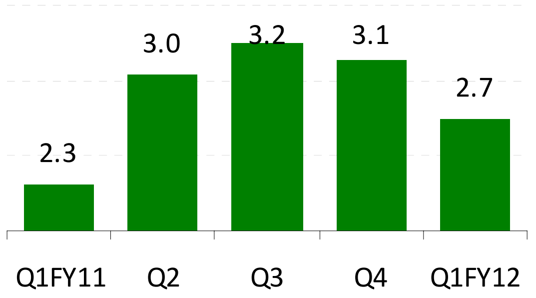
Source: Bloomberg, KESI estimates

Revenue (Rs bn)



Source: Company data

Sales volume (m ton)

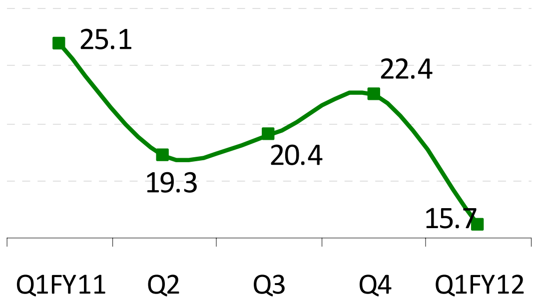


Source: Company data

Cash spread (Rs/ton)

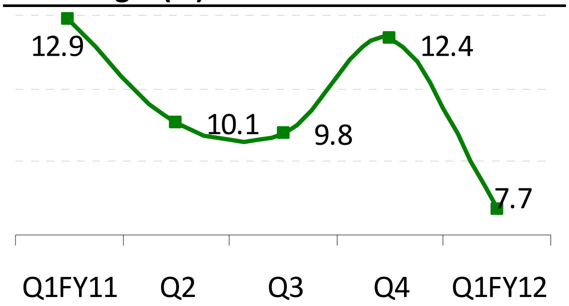
Source: Company data

GM (%)



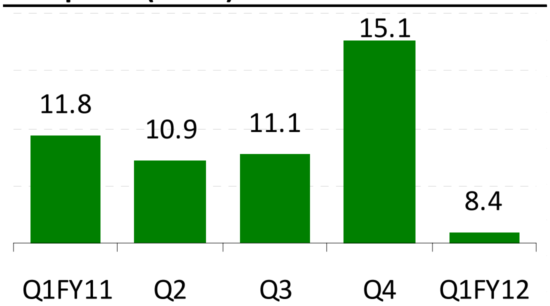
Source: Company data

Net margin (%)



Source: Company data

Net profit (Rs bn)



Source: Company data

Company description:

SAIL is country's largest steel producer with capacity of 12.5m ton. It is an integrated producer with own iron ore mines. The company has strong B/S with net D/E of 0.2x. The company is in process of increasing its capacity (mainly brownflied) to 24m ton by FY15. Total CAPEX would be Rs700bn out of which 30% has already been spent.

Investment thesis:

We initiate with SELL rating due to: 1) threat to earnings from high coal prices and, 2) slowing domestic economic growth. For FY12F, we forecast EPS to decline 10%. Further, capacity increase at time of slowing economic threatens the profitability of new the plants. Our TP is Rs87/sh based on PER of 8x FY12F (5% above sector avg).

COMPANY ONLY QUARTERLY FINANCIALS (Yr To Mar)

PROFIT & LOSS (Rs bn)	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12
Revenue	91.3	108.1	113.1	121.7	109.3
Cost of sales, ex depr	-64.9	-83.5	-86.3	-90.5	-88.4
Depreciation	-3.5	-3.7	-3.8	-3.9	-3.7
Selling, Admn. & R&D expenses	-8.0	-7.6	-8.9	-7.8	-7.8
Operating profit	**14.9**	**13.3**	**14.2**	**19.5**	**9.4**
Other income / expense	3.9	3.8	2.7	4.1	4.6
Interest expensed	-1.3	-1.1	-0.6	-1.7	-1.7
Profit before tax	**17.5**	**15.9**	**16.3**	**21.9**	**12.3**
Tax	-5.7	-5.0	-5.2	-6.8	-3.9
Recurring profit	**11.8**	**10.9**	**11.1**	**15.1**	**8.4**
Exceptional items	0.0	0.0	0.0	0.0	0.0
Net profit	**11.8**	**10.9**	**11.1**	**15.1**	**8.4**
EPS (Rs)	2.8	2.6	2.7	3.6	2.0
Recurring EPS (Rs)	2.8	2.6	2.7	3.6	2.0
Fully diluted no. of share (m)	4,132	4,132	4,132	4,132	4,132

Ratios (%)	Q1FY11	Q2FY11	Q3FY11	Q4FY11	Q1FY12
Gross margin	25.1	19.3	20.4	22.4	15.7
Operating margin	16.3	12.3	12.5	16.1	8.6
Net margin	12.9	10.1	9.8	12.4	7.7
SG&A / Sales	8.8	7.0	7.8	6.4	7.1
Effective Tax rate	32.7	31.6	31.9	31.1	31.8

Source: Company data

CONSOLIDATED YEARLY FINANCIALS (Yr To Mar)

PROFIT & LOSS (Rs bn)	FY09	FY10	FY11	FY12F	FY13F	FY14F
Revenue	432.2	405.7	428.1	497.1	547.2	606.7
Cost of sales, ex depr	-323.8	-293.0	-332.4	-400.3	-434.7	-478.2
Depreciation	-13.3	-14.3	-16.0	-17.5	-19.1	-20.8
Selling, Admn. and R&D Expenses	-23.0	-18.6	-22.1	-25.5	-27.9	-30.8
Operating profit	**72.1**	**79.9**	**57.6**	**53.8**	**65.5**	**76.9**
Other income / expense	25.9	27.8	22.1	21.0	19.9	18.9
Interest expensed	-2.6	-4.7	-5.8	-7.4	-7.8	-8.1
Profit before tax	**95.3**	**102.9**	**73.9**	**67.4**	**77.6**	**87.7**
Tax	-32.9	-34.5	-23.7	-22.4	-25.8	-29.2
Minorities	0.0	0.0	0.0	0.0	0.0	0.0
Recurring profit	**62.5**	**68.5**	**50.2**	**44.9**	**51.8**	**58.5**
Extraordinary gain	0.0	0.0	0.0	0.0	0.0	0.0
Net Profit	**62.5**	**68.5**	**50.2**	**44.9**	**51.8**	**58.5**
EPS (Rs)	15.1	16.6	12.1	10.9	12.5	14.2
Recurring EPS (Rs)	15.1	16.6	12.1	10.9	12.5	14.2
Fully diluted no. of share (m)	4,130	4,130	4,130	4,130	4,130	4,130

KEY ASSUMPTIONS	FY09	FY10	FY11	FY12F	FY13F	FY14F
Steel volume (m ton)	11.5	12.3	11.9	12.6	13.6	15.0
Chg(%)	*-9.0*	*7.2*	*-3.5*	*6.0*	*8.1*	*10.0*
Steel price (Rs/ton)	39,931	33,840	37,416	41,158	41,981	42,400
Chg(%)	*16.3*	*-15.3*	*10.6*	*10.0*	*2.0*	*1.0*
Cash spread (Rs/ton)	9,440	9,156	8,064	7,687	8,265	8,579
Chg(%)	*-2.3*	*-3.0*	*-11.9*	*-4.7*	*7.5*	*3.8*
EBITDA margin (%)	19.8	23.2	17.2	14.3	15.5	16.1
Total debt (Rs bn)	86.9	176.4	212.6	222.6	232.6	242.6
Average interest paying debt (Rs bn)		62.9	131.6	194.5	217.6	227.6
Average interest rate	5.4	6.1	6.1	7.0	7.0	7.0
Total interest (Rs bn)	3.4	8.0	11.9	15.2	15.9	16.6
% capitalised of total interest	21.7	40.9	51.1	51.1	51.1	51.1

RATIOS (%)	FY09	FY10	FY11	FY12F	FY13F	FY14F
Gross margin	22.0	24.3	18.6	16.0	17.1	17.7
Operating margin	16.7	19.7	13.5	10.8	12.0	12.7
Net margin	14.5	16.9	11.7	9.0	9.5	9.6
SG&A / Sales	5.3	4.6	5.2	5.1	5.1	5.1
Effective tax rate	n.a.	33.5	32.1	33.3	33.3	33.3
Book value per share (Rs)	68.9	81.7	91.1	99.0	108.4	119.3
D/E (x)	-0.3	-0.2	0.1	0.2	0.2	0.3
ROA	11.2	9.7	6.4	5.3	5.6	5.8
ROE	22.0	20.3	13.3	11.0	11.6	11.9

CASHFLOW (Rs bn)	FY09	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	85.4	94.2	73.7	71.3	84.6	97.7
Current assets	-38.8	-1.2	-32.4	-33.2	-24.1	-28.6
Current liabilities	38.9	2.5	0.0	28.5	20.7	24.6
Operating cash flow	**85.5**	**95.4**	**41.2**	**66.6**	**81.2**	**93.6**
Interest expenses	-3.4	-8.0	-11.9	-15.2	-15.9	-16.6
TAX	-32.9	-34.5	-23.7	-22.4	-25.8	-29.2
Residual cash flow	**49.3**	**52.9**	**5.5**	**29.0**	**39.4**	**47.8**
CAPEX	-63.7	-112.6	-102.5	-80.0	-80.0	-80.0
Change in investments	25.9	27.7	21.9	21.0	19.9	18.9
Free cash flow	**11.4**	**-32.0**	**-75.0**	**-30.1**	**-20.7**	**-13.3**
Capital increase	0.0	0.0	0.0	0.0	0.0	1.0
Dividend payments	-12.6	-15.9	-11.6	-12.2	-12.8	-13.4
Others	-1.0	0.4	0.7	-1.0	2.3	1.2
Net change in Cashflow	**-2.1**	**-47.5**	**-85.9**	**-43.3**	**-31.2**	**-24.5**
Net Cash Beg	100.5	98.3	50.8	-35.1	-78.4	-109.6
Net Cash End	**98.3**	**50.8**	**-35.1**	**-78.4**	**-109.5**	**-134.2**

BALANCE SHEET (Rs bn)	FY09	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalent	185.2	227.2	177.5	144.2	123.0	108.4
Receivables	30.7	36.2	41.8	48.5	53.4	59.2
Inventories	102.9	91.6	115.1	133.6	147.1	163.1
Other current assets	34.3	44.5	54.0	69.7	83.6	98.9
Fixed assets (net)	126.5	151.1	166.3	188.9	209.7	229.0
Investments	0.4	0.4	0.6	0.6	0.7	0.7
Capital WIP	79.0	153.8	225.8	265.8	305.8	345.8
Total assets	**559.0**	**704.9**	**781.1**	**851.3**	**923.2**	**1,005.0**
Working capital - liabilities	174.3	176.8	176.8	205.2	225.9	250.5
Debt	86.9	176.4	212.6	222.6	232.6	242.6
Deferred tax	13.3	14.3	15.6	14.7	17.0	19.2
Minorities	0.0	0.0	0.0	0.0	0.0	0.0
Shareholders' Funds	**284.5**	**337.4**	**376.2**	**408.8**	**447.7**	**492.8**

Source: Company Data, KESI estimates

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Recommendation definitions

Our recommendation is based on the following expected price performance within 12 months:

+15% and above: BUY
-15% to +15%: HOLD
-15% or worse: SELL

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