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Q4 FY07
Result Update

JSW Steel

BUY	Rs 583	May 3, 2007

Growing volumes and improving margins

Company Details	
Market Cap:	Rs 95,578m
52-Week High/Low:	Rs 606 / 205
Bloomberg Code:	JSTL@IN
Reuters Code:	JNDL.BO / NS
Shares O/s:	164m
Average Volume (3 months):	0.1m

Price Performance

(%)	1m	3m	12m
Absolute	18.1	27.1	68.2
Relative to Sensex	12.0	28.6	53.0

Result Snapshot

JSW Steel's excellent Q4 FYO7 results far exceeded our expectations. The company reported 57% yoy sales growth to Rs 24,985.4m, though an almost flat PAT of Rs 4,133m (from the corresponding quarter last year) chiefly because of some non-recurring income in last year's figure. Excluding that, PAT has vaulted 163% yoy. The EBIDTA margin expanded by 800bp to 33%, exactly in line with our expectations.

At the CMP of Rs 583, the stock trades at 5.2x FY08E earnings and 4.2x those of FY09. It also trades at 3.7x the FY08E EBIDTA and 3.4x that of FY09. The company has "given guidance" of 26% volume growth and expects steel prices to continue at the present level.

Ahead, we expect the EBIDTA margin to improve slightly, as backward links start kicking in from FY09. We maintain a **BUY** on the stock, with a price target of Rs 740.

Q4 FY07 Result Overview

(Rs m)

Y/e March	Q4 FY07	Q4 FY06	*YoY Gr. (%)*	Q3 FY07	FY06	FY07	*YoY Gr. (%)*
Net Sales	**24,985**	**15,930**	***56.8***	**23,015**	**62,155**	**85,944**	***38.3***
Total Operating Expenditure	16,796	11,803	*42.3*	15,317	44,648	57,772	*29.4*
Raw Materials, Stores, etc.	12,300	7,928	*55.2*	10,982	29,882	40,296	*34.9*
Wages & Salaries	454	341	*33.3*	488	1,270	1,755	*38.2*
Energy (Power & Fuel)	1,009	1,148	*(12.1)*	924	4,201	3,930	*(6.5)*
Other Expenses	3,032	2,386	*27.1*	2,924	9,295	11,791	*26.9*
PBDIT	**8,190**	**4,127**	***98.4***	**7,698**	**17,507**	**28,172**	***60.9***
Other Income	807	3,794	*(78.7)*	64	3,830	1,052	*(72.5)*
Financial Charges	1,016	826	*23.1*	1,107	3,639	3,995	*9.8*
Depreciation	1,498	1,015	*47.6*	1,295	4,058	4,982	*22.8*
Misc. Exp. written off	270	156	*73.6*		618	1,090	
PBT	**6209**	**5,925**	***4.8***	**5,360**	**13,018**	**19,156**	***47.2***
Tax Provision	2,076	1,818	*14.1*	1,738	4,454	6,230	*39.9*
PAT	**4,133**	**4,107**	***0.7***	**3,622**	**8,564**	**12,926**	***50.9***

(Stock price as on April 30, 2007)

Result Analysis

Sales for Q4 FY07 grew 57.8% yoy to Rs 24,985m and for the year by 38.3% yoy to Rs 85,944m. The sales growth in the quarter came mainly from the 33% increase in volumes of saleable steel; 19% came from price increases. For the year, the yoy growth could be attributed to volumes rising 26% and prices 10%.

The EBIDTA margin for the quarter expanded by 800bp to 33% and the operating profit grew 98% yoy to Rs 8,190m. This was mainly due to the substantial reduction in power costs. In Q4 FY07, power cost fell to 6% of total cost (compared to 9.7% for the corresponding period last fiscal). This was possible because of the commissioning of the 30-MW captive generation plant during the quarter taking captive power generation to 162 MW.

At first glance it appears that PAT for Q4 FY07, at Rs 4,133m, was flat (compared to the Rs 4,107m a year ago, which included some non-recurring extra income). When that is removed and adjusted for, PAT has rocketed 163% yoy. For the full year, it registered a 50.9% jump yoy to Rs 12,926m.

Production and sales volumes break-up

PRODUCTION *(m tons)*	**Q4 FY07**	**Q4 FY06**	***Growth*** *(%)*	**FY07**	**FY06**	***Growth*** *(%)*
Crude Steel	0.713	0.596	*20*	2.652	2.25	*18*
HR Coils / Sheets	0.653	0.553	*18*	2.155	2.148	*0*
GP / GC	0.182	0.213	*(15)*	0.714	0.78	*(8)*
HR Plates	0.058	0.037	*57*	0.182	0.086	*112*
SALES *(m tons)*						
Slabs	0.063	-		0.355	-	
HR Coils / Sheets	0.468	0.312	*50*	1.387	1.189	*17*
GP / GC	0.171	0.221	*(23)*	0.658	0.762	*(14)*
HR Plates	0.041	0.029	*41*	0.151	0.074	*104*

Investment Highlights

- Brownfield expansion of steel capacity from 3.8m tpa to 6.8m by March 2009, ultimately taking capacity to 10m tpa by October 2010.
- The furnace, down for repairs due to an accidental fire, has recommenced operations (in April) and production is expected to now rise. Besides, expansion of the CRM (cold-rolling mill) by 1m tpa is expected to be commissioned by end-Q2 FY08.
- The EBIDTA margin is expected to improve -- from the present 33% to 36% by FY09 -- following robust steel demand coupled with lower coke consumption, a less-than-proportionate rise in key raw material prices and greater efficiency.
- JSW Steel recently acquired a 100% stake in Argent Independent Steel, UK, for an EV of £3.75m (including debt of £2.1m). JSW has therefore to pay in cash only the balance of £1.65m.

Strong domestic demand

Greater spending on infrastructure and the booming economy has led to robust demand for steel. Besides, the increased use of stainless steel in the construction sector, as in some premium real estate projects in Mumbai, has boosted demand.

Acquisitions and expansion

JSW Steel has acquired a 100% stake in a UK based company, Argent Independent Steel, for an enterprise value of £3.75m. Of this £2.1m is debt; effectively, the company has to pay only £1.65m in cash.

Argent Steel has capacity to process 150,000 tpa of HR, CRCA, galvanized, colour-coated steels, etc. About 55% of the products go to the construction sector and 15% to the automobile sector. Its turnover in 2006 was £26.3m. However, it has suffered operating losses due to rising raw material prices. Because of potential synergies, in order to save on costs JSW Steel would supply Argent with hot-rolled and other coils and sheets from its Indian plant -- and smoothly turn it around.

Besides, the acquisition serves another purpose for JSW Steel. It is establishing its own steel-service centres at Gurgaon, Chennai, Bangalore, etc. These centres would cater to automobile companies such as Maruti, Ford, Toyota, etc. So the expertise and experience of Argent in this business would assist JSW Steel's foray into this business in India. This is a value-added service and the latter can expect much from this venture.

Acquisition of coal blocks

JSW Steel has been allotted the Rohne coal block in Jharkhand, with 250m tons of mineable reserves of high- and medium-grade coking coal. In this block, JSW Steel has a 69% stake; 31% lies with two other allottees. The annual capacity of the mine would be 8m tons, divided among three companies in the ratio of their stakes. Actual mining would take about two to three years.

Besides, JSW Steel has signed MOUs to take over two mining licenses in Africa. At present, it is conducting 'due diligence' over 30,000 hectares to gauge the quality and quantity of reserves.

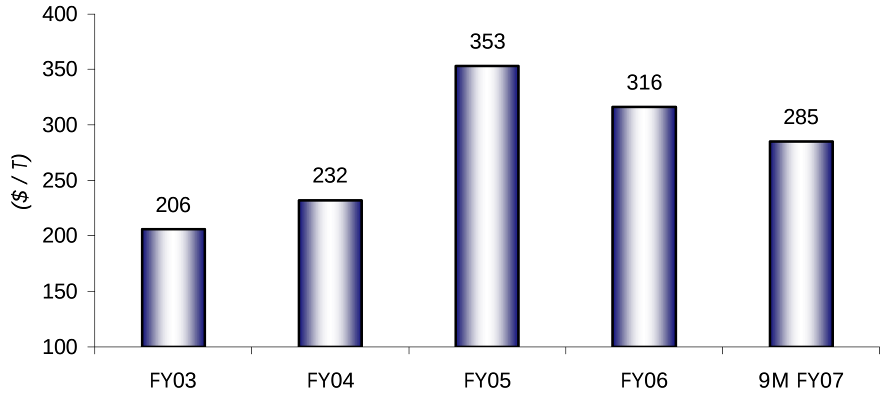
When coal mining begins in the next two or three years, the company would be 100% self sufficient in coal. This would further help it reduce its coal and coke cost (substantial at present, at about 44% of total raw material cost. In fact, coke oven batteries are expected to start operations in March-April 2008; then (by FY09), raw material cost would slide by 40% and the EBIDTA margin would expand by about 200-300bp.

One of the lowest-cost producers

JSW has consistently tried to reduce its costs; for 9M FY07 the cost of its hot-rolled coils was just $285 a ton, marginally higher than Tata Steel's $279, the world's lowest-cost steel producer.

This is highly commendable, given that the Tata Steel has captive iron and coal mines, providing full backward links to key raw materials -- in contrast with JSW Steel's partial backward links.

HR Coil Production Cost Trend



Source: Company

Being approved for carbon trading

Recently (in March 2007), JSW Steel obtained approval for carbon trading. It generates about 7,500 tons a day of waste, utilized to generate power. This way it would be able to reduce 7.67m units of CER (carbon emission reduction) over ten years. At the CMP of about €15.5 per unit of CER, it could gain over €118m over the ten years. This could provide additional income of over Rs 700m each year. Further, it is expanding its capacity to 10m tpa by 2010. This could further raise income from carbon trading.

Expansion Projects under Implementation

Project	Capacity (m tpa)	Expected Completion Date	Cost (Rs m)	Debt (Rs m)
CRM	1	Q2 FY08	10,000	6,000
2.8m tpa	2.8	Mar.'09	53,000	30,000
New HSM	2	Sep.'09	20,000	12,000
BF-1 Upgrade	0.3	FY09	1,500	-
HSM Phase II	0.7	FY08	750	
Galvalume	-	Mar.'08	1,090	1,250
CPP-30	30 MW	Mar.'08	970	
Phase 2 expansion of steel making capacity from 6.8m tpa to 10m tpa	3.2m tpa	Oct.'10	70,000	30,000
Capacity	6.8m tpa	FY10		
Total	**10m tpa**	**FY11**	**157,310**	**79,250**

Contrasting Strategies - JSW Steel and Tata Steel

JSW Steel	Tata Steel
Focused on demand growth at home. So less sensitive to international demand-supply dynamics.	Focused on spreading its wings outside India. Hence, more sensitive to international demand-supply dynamics
Securing access to key raw materials abroad	Securing access to markets abroad
Focused on cost efficiency	Focused on value-addition
Cost-conscious approach standing good in turbulent times	In turbulent times aggressive approach generally boomerangs

Export duty on iron ore – double boost for Indian steel companies

In the recent budget, the GoI levied a duty of Rs 300 a ton on exports of iron ore. On one hand, exports of iron ore have become more expensive as the duty amounts to an almost 40% rise in cost. (This is supposed to help Indian steel manufacturers secure precious raw material resources.)

On the other, Chinese steel producers, who were importing vast inexpensive ore from India, have been affected, as this has turned the ore costlier and rendered steel production unviable. As a result, Chinese steel production would contract and turn out to be very good for the steel industry globally. In the long run, this would benefit the steel industry as a whole because many uneconomical and unviable steel plants in China, which thrived on an artificially low cost of production, would close down. Production would slide and help keep steel prices firm, provided demand continues robust.

Steel prices - Has the peak been reached?

Though the price of steel started moving up from August 2006 and has since appreciated by 25% from its low, it has yet to touch its June 2005 peak. **If we take the peak as Mt. Everest, a good 18-20% price appreciation is still possible from the level now.**

High Prices – Are they good for the economy?

Generally, high prices mean high profits and so on. However, over a long time if prices continue high, demand might slacken as commodities turn price sensitive and price elasticity is high. In the context of the real-time economy, where demand-supply dynamics prevail, prices are taken care of by slackening demand.

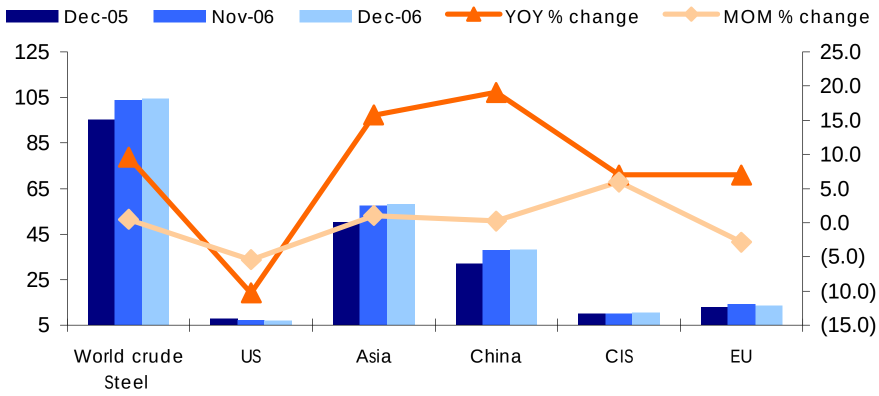
India has reached the inflection point and there is no way growth would come down. In the near to medium term though, we might see signs of a slowing down due to tightening measures by the RBI. However, this would only strengthen the long-term growth foundation.

Global demand-capacity ratio to remain stable

Globally, the demand-capacity ratio, which was about 89% during 2006, is expected to continue during 2007. This would hold prices in the same range as in 2006. As steel is an international commodity, domestic prices would follow suit.

Globally, about 53m tons of fresh capacity is expected in 2007. Of this, about 52% will come in the China and Russian region. On global capacity of over 1,200m tons, 53m tons makes little significant impact. In India too huge capacity additions are expected from FY09, which is still a little away. As such, in India the demand-capacity ratio would be stable, though with a higher bias.

Crude Steel Production Trend



Source: IISI

Globally, production of crude steel has risen to 1,217.3m tons in 2006, increasing about 9% from the previous year.

Investment Concerns

Price volatility

The largest concern for any steel company or, for that matter, a metals company is volatility in prices. Steel particularly being an international commodity, prices are linked to international prices and steel companies' earnings growth or slowdown are also linked to price appreciation or softening of prices.

But this volatility would stabilize following consolidation in the steel industry. Though, in the near term, volatility will continue, in the long term it would definitely be greatly subdued, giving way to price stabilization.

Government intervention

This could be a major concern for Indian steel companies. Though misguided, yet, in a bid to check inflation, the government could force the steel industry to keep prices artificially down and compel it to delink prices from international price movements. How much this can actually help control inflation though is still not understood.

Slowdown in Chinese economy

There is concern in the global community about the slowing down of Chinese growth, post-2008 Olympics. This may release excess steel from China, which might find its way into the international market. On the other hand, growth in demand for steel arose mainly from the voracious consumption of China and any slowdown in Chinese demand would definitely affect global steel prices as demand-supply dynamics might tilt on the supply side. The actual effect of this, though, may depend on the degree of consolidation and its effect on global steel dynamics.

Rising Interest rates

In a bid to cool down the over-heated economy and curb inflationary growth, the RBI has tightened its monetary policy thrice in the last three months by raising the CRR (credit-reserve ratio) and the repo/ reverse repo rates. This would certainly have a significant impact on the bottom line of the company as it is in a major expansion mode and is planning to raise Rs 79,000m in debt in the next two to three years.

International Peer Comparison *(x)*

	PE	EV / EBIDTA	P / BV	P / Sales
Arcelor Mittal	9.7	4.4	1.2	0.9
Nucor	11.6	6.3	4.1	1.4
Nippon	23.9	12.6	4.1	2.1
Posco	4.0	2.0	0.8	0.6

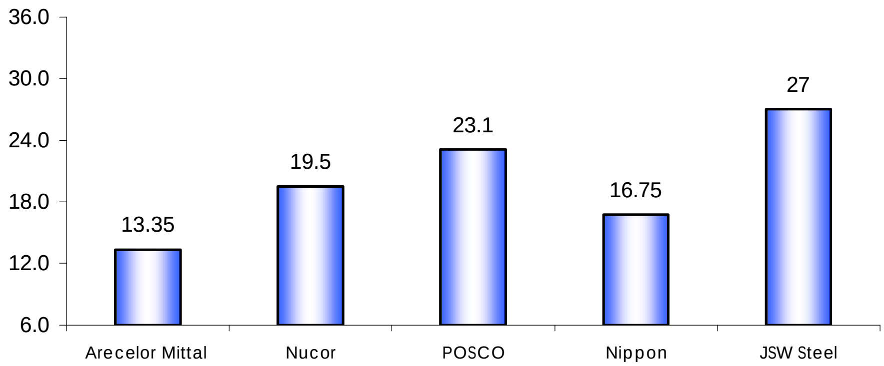
Source: Bloomberg, PL Research

Domestic Peer Comparison *(x)*

	PE	EV / EBIDTA	P / BV	P / Sales
Tata Steel	6.1	4.2	2.4	1.4
SAIL	8.7	4.4	3.7	1.7
Essar	4.5	5.8	1.9	1.2
Ispat	-	8.0	1.7	0.2

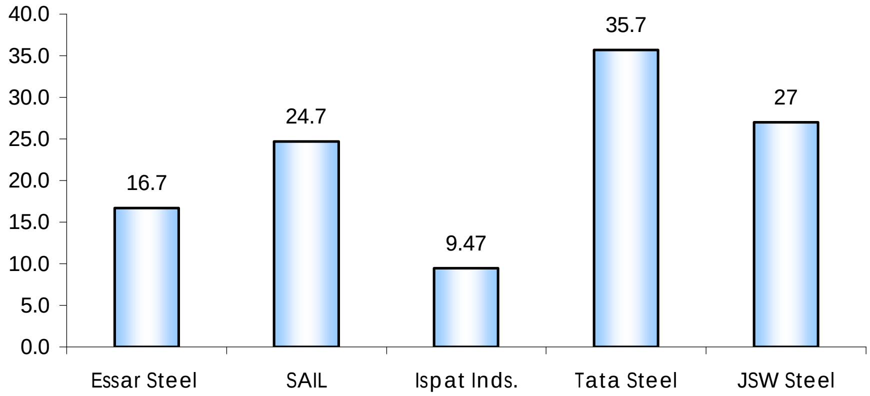
Source: Bloomberg, PL Research

EBIT (%) Margin -- JSW Steel vs. International Peers



Source: PL Research

EBIT (%) Margin -- JSW Steel vs. Domestic Peers



Source: PL Research

Steel Price Sensitivity analysis

	Revenue *(Rs m)*	**EBIDTA** *(Rs m)*	**PAT** *(Rs m)*	**EPS** *(Rs)*
FY08E				
Prices remaining constant	114,591	38,879	18,501	113
Prices appreciating by 5%	118,582	42,870	21,859	133
Prices declining by 5%	107,288	31,576	13,673	83
FY09E				
Prices remaining constant	139,206	50,104	22,139	135
Prices appreciating by 5%	146,166	57,064	27,461	167
Prices declining by 10%	125,285	36,183	12,938	79

Valuation and Recommendation

At the CMP, the stock trades at 5.2x FY08E and 4.3x FY09E earnings, at a significant discount to the average industry PER of 5.5. Also, on an EV/EBIDTA basis, the stock trades at 3.7x FY08 and 3.4x FY09 estimates against the industry average of 5.5x.

Though it is difficult to predict steel price movements and correspondingly the earnings of the company, we have conducted a price-sensitivity analysis taking different scenarios into consideration (like the price declining by 5% or remaining constant at current level or rising by 5% and so on). Through this sensitivity analysis, we have concluded that the most probable scenario would be that steel prices would be stable and the FY08 and FY09 estimated EPS would be Rs 113 and Rs 135 respectively.

Since most of the capacity expansion would come from FY10-11 onwards, significant growth can be expected in the long term. Some intermediate blips, if at all, on account of the softening of prices, cannot be ruled out.

We maintain a **BUY** on JSW Steel, with a target price of 740, implying a 27% appreciation from the level now.

Key Figures

Y/e March		FY06	FY07E	FY08E	FY09E
Revenues	*(Rs m)*	62,155	85,944	114,591	139,206
EBITDA	*(Rs m)*	17,505	28,172	38,879	50,104
Margins	*(%)*	*28.2*	*32.8*	*33.9*	*36.0*
PAT	*(Rs m)*	8,565	12,926	18,501	22,139
EPS	*(Rs)*	17.2	78.8	112.8	135.0
PER	*(x)*	33.8	7.4	5.2	4.3
EV / E	*(x)*	18.9	4.9	3.7	3.4
EV / Sales	*(x)*	5.3	1.6	1.2	1.2
RoCE	*(%)*	*15.2*	*24.0*	*28.0*	*29.0*
RoE	*(%)*	*19.7*	*25.4*	*27.2*	*34.5*