IDFC SSKI

INDIA RESEARCH

Steel Sector Update

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Demand destruction and aggressive de-stocking are seemingly the two key factors that have put steel industry in the reverse gear. We see little possibility of demand returning in the near term despite the several fiscal stimulus packages announced globally. However, the issue pertaining to de-stocking is giving way as the unprecedented and coordinated production cuts effected globally have lowered industry steel production by a record 20% over the last few months. This, in turn, has facilitated faster inventory clearance – reflected in a marginal uptick seen in steel prices. Various lead indicators also point to the distress sale phase nearing an end. While we concede that the steel industry's woes, particularly with respect to demand destruction, are unlikely to fade in a hurry, we maintain that the renegotiated raw material contract prices (due early next year) will provide stability to steel prices. Under-utilization of capacities remains the biggest risk in our view, though Indian companies are relatively insulated. While a sharp drop in industry profitability in Q3FY09 would hardly come as a surprise to the markets, we see some uptick in stock prices with de-stocking largely behind and stability in sight. Even as we feel demand visibility will have to return to drive a sector re-rating, there exists a trading opportunity in the near term. JSPL followed by Tata Steel are our key picks in the sector.

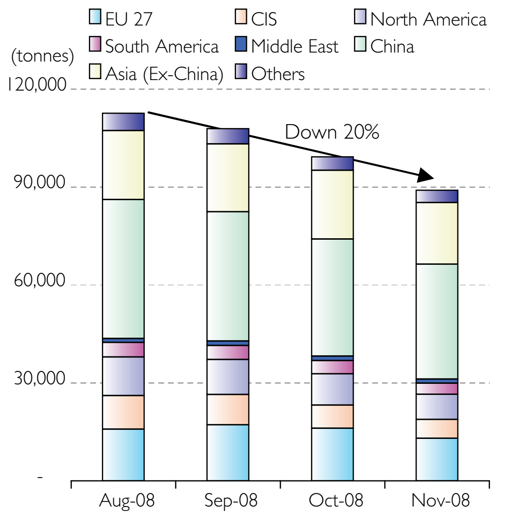
DEMAND DESTRUCTION STILL AN ISSUE BUT DE-STOCKING PHASE NEARING COMPLETION…

❑ Record production cuts to help in faster discovery of stable price levels

Even as the steel industry remains fragmented, there is a considerably high level of regional consolidation in USA, Europe and Japan. This has facilitated coordinated production cuts by major steel players across these geographies to cope with the sudden slump in demand in the last few months. Global steel production has thus dropped 20% in November 2008 from the peak scaled in August, with a further decline expected in December. These actions, we believe, would lead to faster inventory clearance and demand-supply realignment, thereby helping the commodity discover stable price levels in the near term.

"For Private Circulation only" and "Important disclosures appear at the end of this report"

Exhibit 1: Drop in production levels across geographies…major production cut announcements in the last three months



September

- Arcelor Mittal announces production cuts up to 15% in Q4CY08
- Maanshan I&S slashes light H-beam production by 75% in October

October

- Arcelor Mittal Temirtau, Kazakhstan, announces 25-30% production cut
- Nippon Steel, JFE Steel, Sumitomo Metal Industries and Kobe Steel announce plans to reduce October-March carbon steel output by a total of about 1.9mt
- BaoSteel Chairman indicated total Chinese output could decrease to 480mt in 2008 (from 490mt in 2007, and earlier production estimates of 520mt)
- Press reports indicate ~50% of all steel mills in Hubei province to have suspended production
- Maanshan Steel decides to reduce steel production by 250,000 tonnes in October; extend cut to 400,000 tonnes in November.

November

- Tata Steel, UK operations announce production cuts up to 30%
- Arcelor Mittal says it is increasing its production cuts to 30% or more in Q4
- US Steel believed to have six of its 14 working Blast furnaces idled
- JFE Steel cuts another 1m tonnes off October-March output

Source: SBB, WSA, Press reports, IDFC-SSKI Research

❑ Most players see inventory de-stocking coming to an end

We believe actual implementation of announced production cuts, and subsequently lower Chinese steel exports, has brought inventory de-stocking to its fag end. Our interactions with industry players too indicate an improving inventory situation. Corus, for example, has depleted its inventory by almost 1m tonnes in the last two months. Many international players have also gone on record with regards lower inventory piles as also improving pricing outlook. Findings of the recent SBB Steel survey also point to a similar view even as most respondents also see the risk of demand destruction still looming large. Confidence on off-take is yet to return despite monetary easing and announcements of several fiscal stimulus packages worldwide.

Exhibit 2: Destoccking phase nearing completion

"*"**Inventory levels are very low"…** "if demand will start improving in Q1 or Q2, we will increase production."*

-- Mr. Mittal, Arcelor Mittal, 8 December 2008

*"**63% of respondents reported lower inventories, up from 46%**, while only 5% had higher stocks compared with the previous week … **Sentiment about prices among respondents in the US and Europe continued to be slightly more positive**. 16% of US companies expect higher prices in the next three months, up from 6%. For European companies, 19% foresee higher prices, up from 12%.*

– Extract from SBB Steel Survey, 4 December 2008

❑ We see stability returning by end-Q1CY09

We had mentioned in our earlier report that we expect some stability (*not an uptick*) in steel prices by February 2009 as (i) new raw material pricing contracts would be signed by then; (ii) distress sales by the trade channel would be over; and (iii) a new cost curve would have been established, helping buyers to take a view on future prices. Several lead indicators vindicate our view. Chinese steel exports and iron ore inventory levels have dropped considerably for four months in a row and inventory clearance phase appears to be nearing completion with average ~15% production cuts announced in the last couple of months. Also, no further production cuts have been announced in the last few days even as few larger players have announced higher contract prices for January 2009 deliveries.

Exhibit 3: Extracts from our recent reports

"As cost pressures ease and inventories increase at the margin, we expect global steel prices to soften in Q4CY08."

*IDFC-SSKI Research - **The Glass is Half Empty;** August 2008*

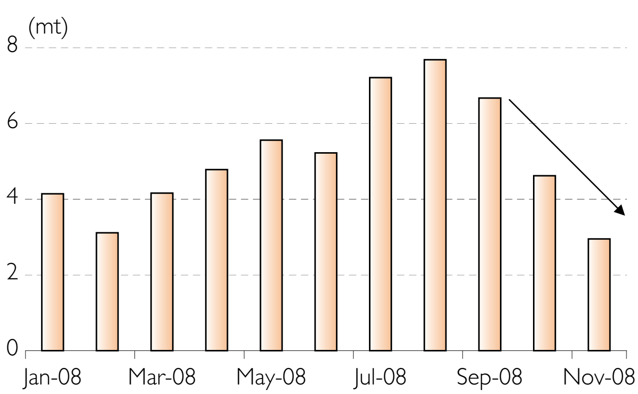
"With the demand-supply gap narrowing and cost-led price increase hypothesis giving way, we had earlier argued for softening in steel prices…. Notably, the price cuts have come despite expected production cuts by large global players. We now contemplate whether there is more to read into the spiraling Chinese steel exports and a considerable slowdown in electricity consumption in the country. (Are they early signs of an economic slowdown in China?)…."

"While the uncertain pricing environment would restrict any expansion in multiples in the short term, the renegotiated raw material contract prices (due early next year) will provide clarity on the levels at which steel prices would stabilize for FY10."

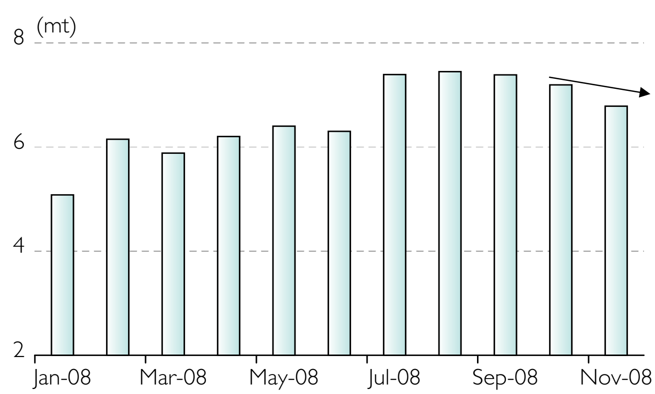
*IDFC-SSKI Research - **Last of the Best -- Steel Sector Earnings Preview;** October 2008*

Notably, raw material prices have improved marginally w-o-w basis. Indian iron ore prices and Newcastle Thermal Coal Index have both shown a marginal uptick recently. More importantly, Baltic Dry Freight Index too has seen a sharp uptrend in the last couple of weeks – the index is a lead indicator of activity in the commodities space. Our channel checks in India suggest that buying has resumed towards lower end of the price band. We see impact of monetary easing/ fiscal stimulus packages and improving liquidity triggering a revival in global steel demand, and thereby expect the next restocking phase to begin in March-April 2009.

Exhibit 4: Chinese steel exports on the decline

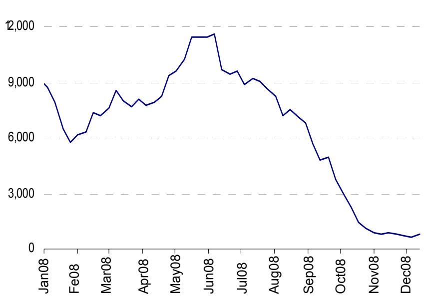


China Iron ore inventory levels dcreeasing

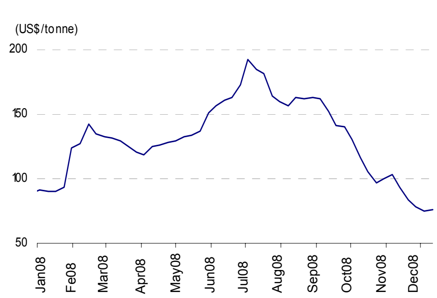


Source: IDFC-SSKI Research, Bloomberg

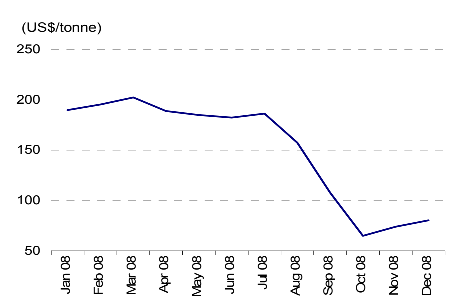
Baltic Freight Index – U shaped recovery



Newcastle Thermal Coal prices



Indian iron ore, CFR China

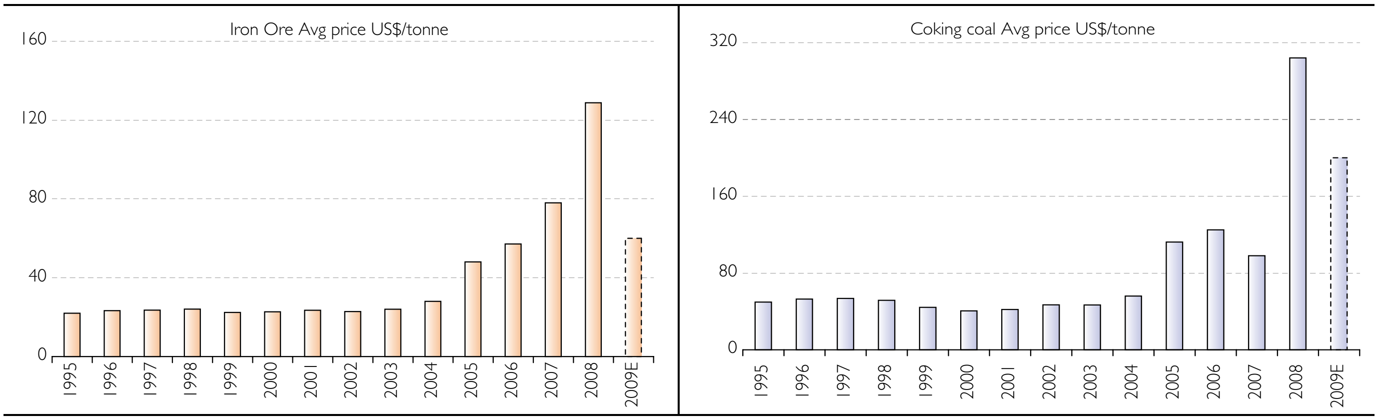


Source: IDFC-SSKI Research, Bloomberg

❑ 2009 will be a year of deflation for steel industry…

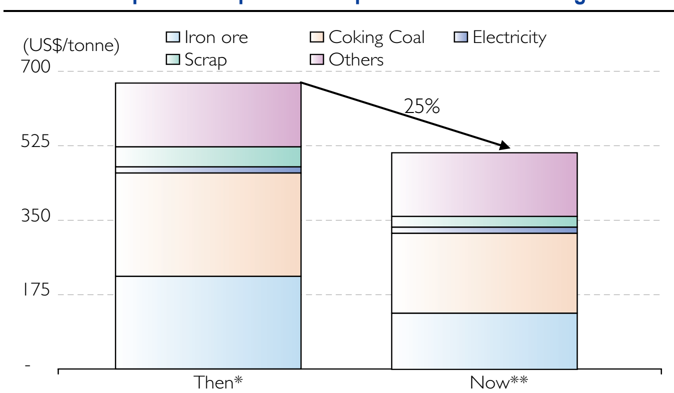
With spot raw material prices (iron ore, coking coal and thermal coal) quoting at a 55-65% discount to annual contract prices for two consecutive months now (refer to the following exhibit), we expect annual raw material contracts for 2009 to be struck at substantially lower price points. China Iron and Steel Association (CISA) has also begun negotiations with Australian and Brazilian miners for aligning 2008 annual iron ore contract rates to lower steel realizations. Further, Chinese mills have indicated their inclination to peg iron ore prices to an index though there is lack of financial tools available to achieve the same. In the prevailing scenario, we expect significantly lower rates for the upcoming annual raw material contracts, even as our estimates already factor in 40% drop in iron ore and coking coal prices.

Exhibit 5: Prices of both finished steel and raw materials are expected to come off sharply in 2009

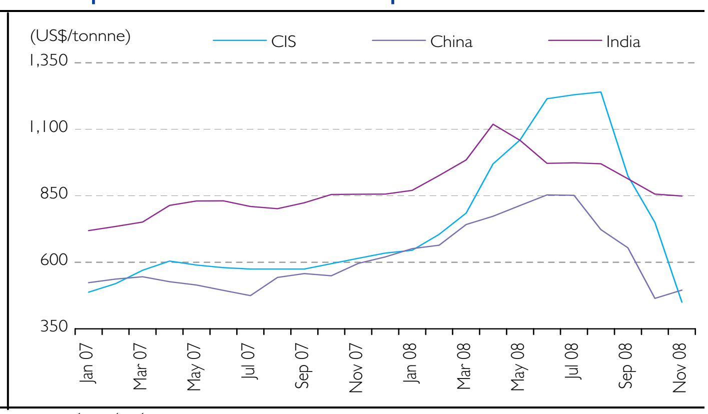


Source: IDFC-SSKI Research, Industry

Exhibit 6: Expected drop in cost of production at the margin



Sharp fall seen in benchmark HRC prices



*Source: IDFC-SSKI Research, SBB, *based on 2008 annual contract prices, ** based on current spot rates*

❑ …leading to huge working capital release across companies

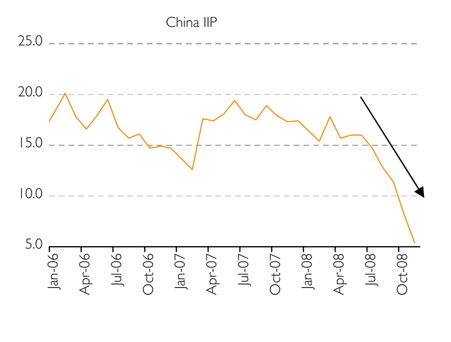
We see a combination of inventory clearance and sharp drop in raw material and end-product prices leading to significant working capital release (cumulative $1.8bn for FY09 and $870m for FY10) across companies under our coverage. The key beneficiaries would obviously be convertors rather than integrated players. Within our commodities universe, we see Tata Steel, UK being the largest beneficiary as liquidation of its finished goods inventory alone yields $700m-900m by March 2009. The company would further realize benefits from lower contracted raw material values. We expect Tata Steel's consolidated operations to have a working capital release of ~$1.5bn from the peak levels seen in September 2008; and the quantum could be higher depending on the negotiated annual raw material contract rates for 2009.

VOLUMES, NOT PRICES, THE BIGGEST RISK FOR FY10

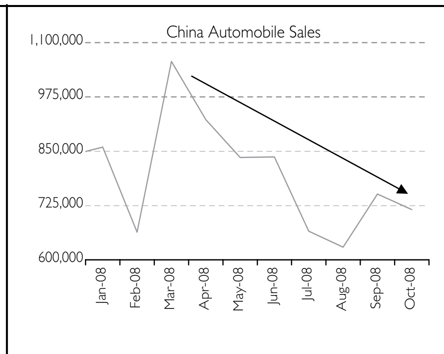
❑ Revival packages yet to stimulate demand; further slowdown in China remains key risk

The global financial turmoil and concerns over a prolonged recession have led to a slump in steel demand from end-user industries in the last few months. Auto and construction – two key user industries – are in dire straits with no visibility on revenues. A sharp drop in automobile sales across USA, Europe and Japan (exhibit below) and rising consumer durable inventory levels signify slowing demand for flat products. Slowing Chinese IIP growth and contracting ISM index (USA) also underpin the demand slowdown

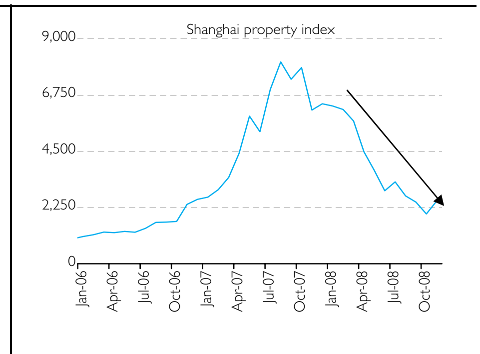
Exhibit 7: China IIP growth



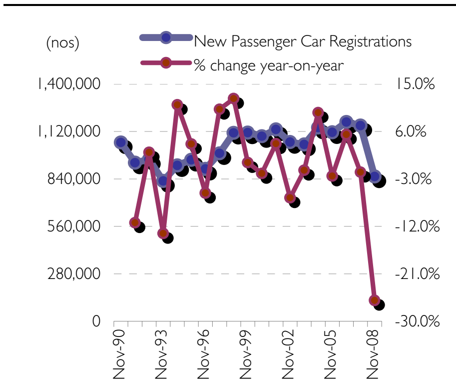
China automobile sales



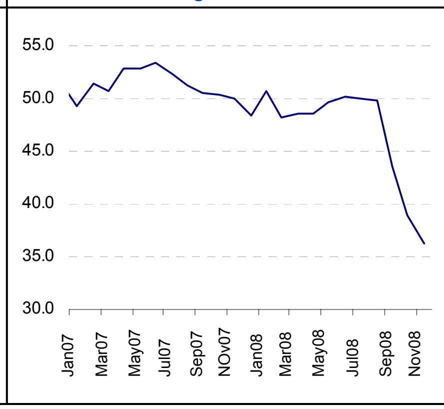
Shanghai property index



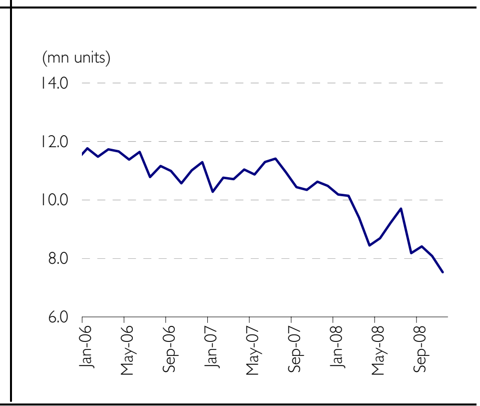
New passenger car registrations – Europe



ISM Manufcaturing Index – USA



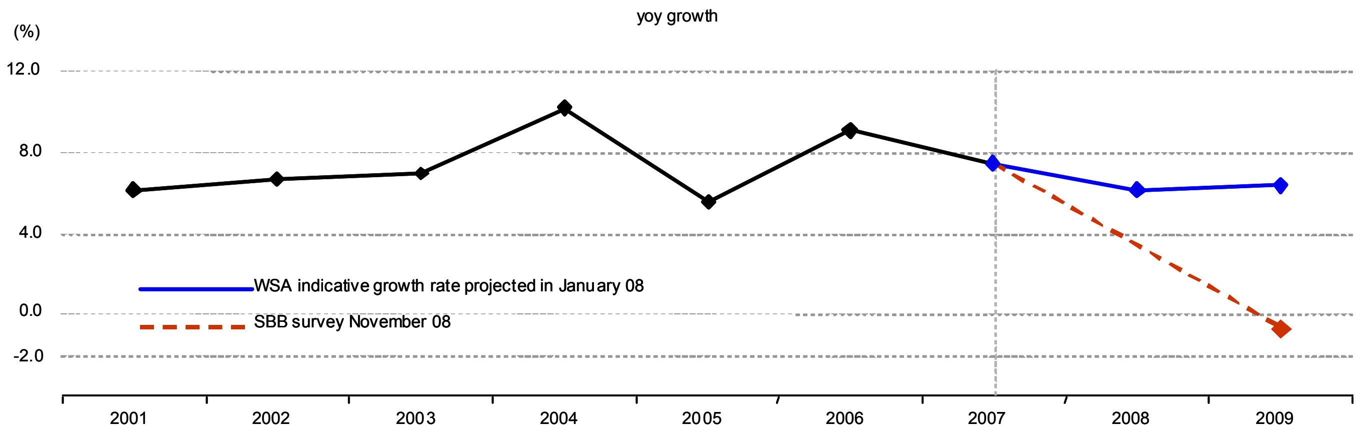
Gross motor vehicle assembiles – USA



Source: IDFC-SSKI Research, Bloomberg

While governments world over have announced fiscal stimulus and monetary softening measures to boost demand, we see a considerable lag before the benefits actually start accruing. The Rs500bn package announced by the Indian government to fund priority infra projects would also take at least two quarters to generate any demand for steel. The same holds true for pump-priming measures by other economies including the US $580bn fiscal stimulus package announced by China. Also, global GDP forecasts have been revised to the slowest growth rate in the last three decades. In developing countries, steel demand typically shows a high correlation (1-1.5x) to GDP. While the recent production cuts would indeed help absorb supply in the short term, demand rebound from user industries is imperative for stability in production volumes. Chinese domestic demand (and thereby exports), accounting for ~1/3rd of global steel demand, remains the key variable going forward, and a rebound in Chinese IIP and power consumption would be lead indicators to revival of steel demand.

Exhibit 8: Steel - projected demand growth…now and then

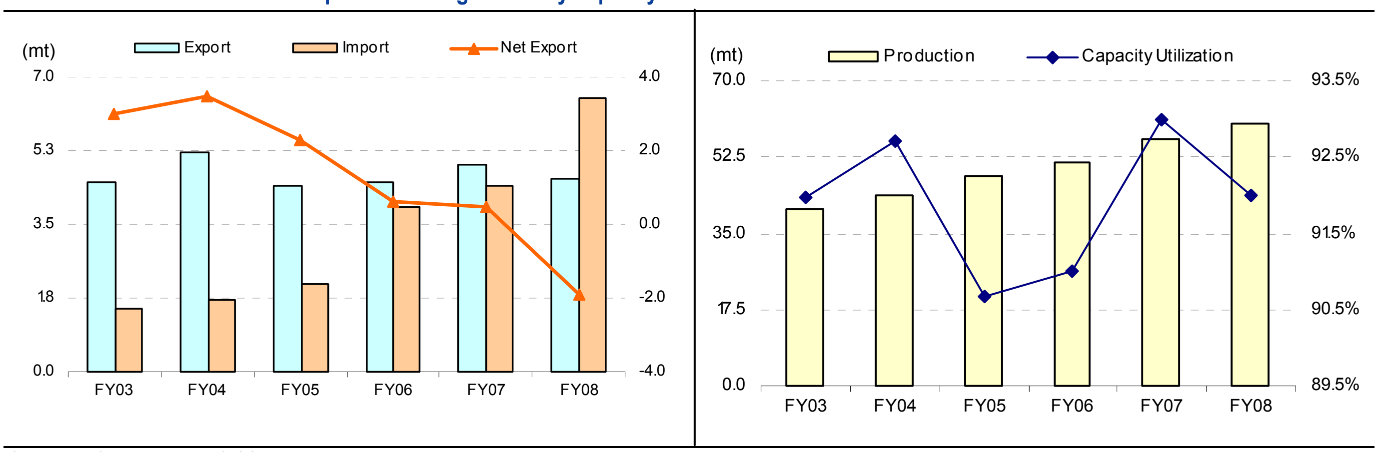


Source: IDFC-SSKI Research, SBB, WSA

❑ India relatively insulated; but sensitivity of volume drop to earnings is high

We expect India to remain a net importer of steel even as ~6m tonnes of capacity is expected to be added by March 2009. Unlike China and developed countries, the Indian steel industry does not face overcapacity concerns and capacity utilization has remained high (averaging 92% for the last five years; 84% YTD capability utilization for USA, AISI – and higher than for China). In this backdrop, we expect production growth to moderate considerably against 8.2% CAGR witnessed over the last five years. Further, a depreciating rupee (up 6% vis-à-vis the USD in last three months) and regulatory intervention (particularly a hike in import duty rates) would check dumping of cheaper steel imports, thereby supporting domestic utilization rates.

Exhibit 9: India remains a net importer with high industry capacity utilization rates



Source: JPC, Industry, IDFC-SSKI Research

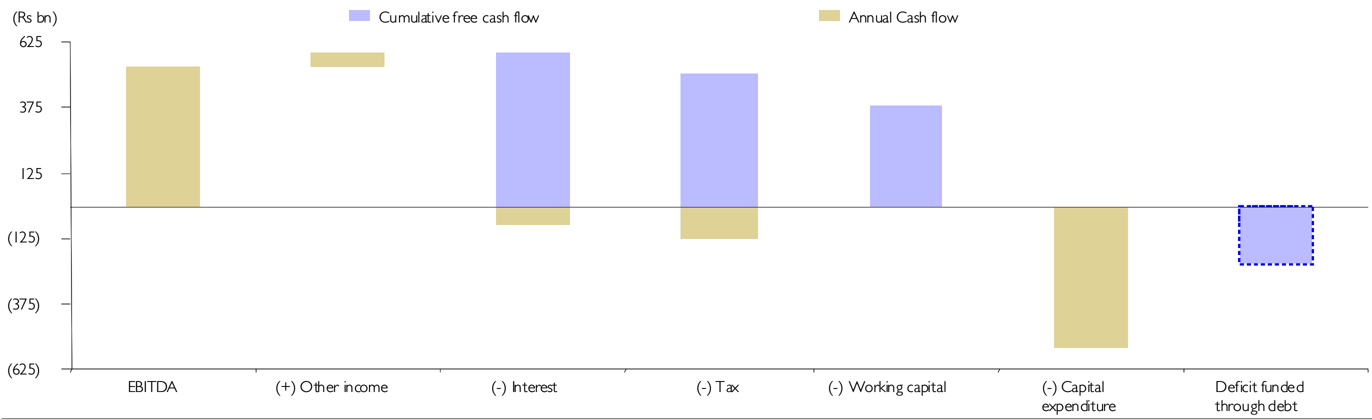
❑ Balance sheet strength has assumed center-stage

We maintain that valuations of some companies not only reflect the earnings drop ahead but also market concerns that they may not be able to survive the downturn; in this context, balance sheet health assumes center-stage. Adjusting for mark-to-market losses, redemption reserves, goodwill as also convertible instruments, gearing of some companies has reached alarming levels – and has raised concerns that the profit drop may trigger debt covenant penalties. Given the sharp currency depreciation, we also see risk on high foreign currency liabilities. Thus, gearing – and not earnings – is what matters for now and for corporate, we believe the focus has clearly shifted from profit maximization to debt minimization. Even in that case, we expect improvement in overall balance sheet ratios by end-FY10 for our coverage universe, aided by working capital release and deferment of expansion plans.

❑ Industry cash flows only 2/3rd of earlier estimates; capex plans to be impacted

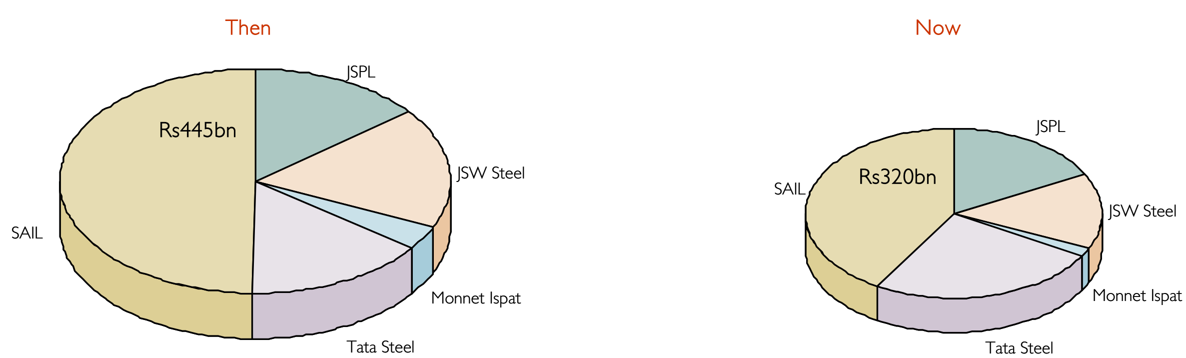
Even as we believe that domestic demand would be restored by 2HFY10, falling profitability would lead to lower operating cash flows in FY09-10. Our estimates build in a 33% drop in cumulative operating cash flows to Rs320bn over FY09-10 against our earlier expectation of Rs450bn. The following exhibit shows the cumulative gap in capex funding expected to be funded through debt (Rs230bn), which could potentially expand in case of a higher-than-expected drop in profitability.

Exhibit 10: Cumulative cash flow of steel coverage universe over FY09-10E



Source: IDFC-SSKI Research

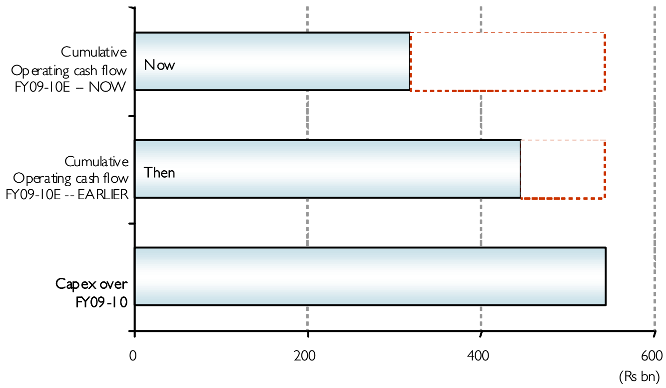
Exhibit 11: Gross operating cash flow over FY09-10E - then and now



Source: IDFC-SSKI Research

Though we expect domestic utilization rates to remain high on the back of reviving domestic demand and curb on cheaper steel imports, we expect domestic steel manufacturers to take a judicious view on their greenfield expansion plans. With investor focus shifting to balance sheet ratios and equity window for raising capital almost shut, steel majors under our coverage (JSW Steel, Tata Steel and Monnet Ispat) would most likely defer their long-term expansion plans and rather focus on deleveraging their balance sheets. We expect balance sheets of Indian steel companies to be in better health by FY10 as they utilize the released working capital towards debt reduction. However, SAIL and JSPL are comfortably placed to execute announced expansion plans backed cumulatively by cash reserves and operating cashflows.

Exhibit 12: Widening funding deficit



Cumulative capex vs operating cash flows

Particulars (Rs bn) over FY09-10E	Cumulative Operating cash flow	Cumulative capital expenditure
JSPL	45.8	37.4
JSW Steel	55.4	251.7
Monnet Ispat	11.3	17.4*
Tata Steel^	47.8	60.0
SAIL	158.8	225.0
Total	**319.1**	**584.6**

*Source: IDFC-SSKI Research, *investments in Monnet Power business up to Rs12bn, ^standalone operations*

Exhibit 13: Status on expansion plans

Key projects	Comments
Tata Steel	
2.9m t brownfield expansion, Jamshedpur	Expansion on track, expected to be commissioned by FY11
6m t Kalinganagar project, Orissa	Land acquisition and rehabilitation process is on
	No considerable progress expected over next 2-3 quarters
Other projects	Other projects in early stages – working towards land acquisition and obtaining mining leases
JSPL	
1.5m t plate mill, Orissa	Expansion on track, progressing on schedule
2m t DRI plant, Orissa	On track, progressing on schedule
2,640MW Jindal Power	Tenders placed, final orders to be placed soon; full commissioning expected by 2013
JSW Steel	
3mtpa integrated plant (3.8m to 6.8m tpa)	Expected to be commissioned by Feb 2009
3.2mtpa integrated plant (6.8mtpa to 10mtpa)	On hold
20m t beneficiation plant	On hold
JSW Steel, Bengal	Land acquisition in progress; yet to achieve financial closure
JSW Steel, Jharkhand	In early stages
SAIL	Orders worth Rs340bn already placed; total estimated capex of Rs530bn
	Expect execution delays in order placements

Source: Company, IDFC – SSKI Research

❑ A bad Q3FY09 is discounted by the market

As expected, Q2FY09 was indeed last of the best for the steel industry. We expect Q3FY09 to be one of the worst quarters for the steel industry over the last 10 quarters as producers face the double whammy of substantially lower steel prices and raw material costs pegged to 2008 contracted rates (higher). Performance would also be hit due to inventory write-downs, mark-to-market losses on outstanding foreign currency liabilities and lower volumes. Financial and operating leverage, earlier a boon, will now turn into a bane for the sector. We expect ~36%yoy and ~55%qoq drop *(like to like comparison)* in earnings for our steel universe. We, however, believe that the dismal performance of Q3FY09 is already discounted in the current valuations and the announced numbers would hardly come as a surprise. The focus, in all probability, would now shift from current quarter earnings to demand visibility.

Expect some upside in stocks in the near term; demand visibility needed to drive sector re-rating

While we concede that the steel industry's woes, particularly with respect to demand destruction, are unlikely to fade in a hurry, we believe some of the earlier concerns are giving way. We believe the renegotiated raw material contract prices (due early next year) will provide stability to steel prices. The regulatory support in terms of import duty imposition (to just 5%) has fallen much short of industry expectations and we expect progressive hikes as inflation numbers cool off—which can eventually translate into higher prices for steel manufacturers. With the de-stocking phase nearing completion and lead indicators signaling demand revival in a quarter or so, we expect some upside in stock prices in the near term. However, we maintain that demand visibility will have to return to drive a sector re-rating. JSPL followed by Tata Steel are our key picks in the sector. Our structural bullish view on JSPL remains on the back of a strong business model both in the steel and the power business, healthy balance sheet, robust operating cashflows. A significant chunk of profitability expected from power business (US$300m in FY10) lends strong cushion to valuations. For Tata Steel we expect huge working capital release backed by drop in inventory levels and drop in raw material prices effectively leading to significant debt-reduction. Further, Q3FY09 we believe, would potentially surprise market expectations on the upside. The stock is trading at attractive ~3.5x EV/ sustainable EBTIDA.

Exhibit 14: Comparative valuations and target price

Particulars	Unit	Tata Steel	JSW Steel**	JSPL	SAIL
CMP	Rs/ share	218	221	844	75
No. of shares	In m	831	187	154	4,130
Mkt Cap	Rs bn	181	41	130	310
Net Debt--FY10E	Rs bn	353	165	50	(44)
Enterprise value	Rs bn	443	198	178	455
EBITDA--I*	Rs bn	69	41	29	81
EBITDA--II**	Rs bn	60	5	21	0
Total EBITDA (I+II)	Rs bn	128	46	49	81
EV / EBITDA	x	3.5	4.3	3.6	5.6
EV / tonnes	Rs bn/ m tonne	16.5	29.2	28.0	35.8
Target price	Rs / share	269	223	1,104	99

**--Indian operations for Tata Steel, steel business for JSPL, **--Overseas operations for Tata Steel, power operations for JSPL*
Target price based on 4.5x EV/ EBITDA for steel business and 2.5x P/BV multiple for power business

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