



**INDIA**

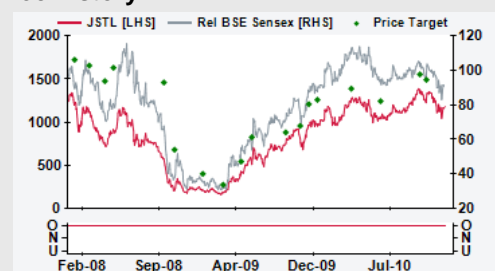
**JSTL IN** Outperform  
Price 20 Dec 10 Rs1,185.55

**12-month target** Rs 1,492.00  
**Upside/Downside** % 25.8  
**Valuation** Rs 1,492.00  
- Sum of Parts  
**GICS sector** Materials  
**Market cap** Rsm 259,699  
**30-day avg turnover** US\$m 41  
**Market cap** US\$m 5,711  
**Number shares on issue** m 219.1

**Investment fundamentals**

Year end 31 Mar		2010A	2011E	2012E	2013E
Revenue	bn	189.0	255.5	339.3	350.3
EBITDA	bn	40.1	51.8	70.6	85.8
EBITDA growth	%	36.8	29.1	36.2	21.4
Reported profit	bn	14.8	21.7	33.9	40.6
EPS rep	Rs	79.22	91.27	132.82	158.90
EPS rep growth	%	496.2	15.2	45.5	19.6
EPS adj	Rs	79.22	91.27	132.82	158.90
EPS adj growth	%	84.1	15.2	45.5	19.6
Total DPS	Rs	9.50	9.70	9.90	10.10
Total div yield	%	0.8	0.8	0.8	0.9
ROA	%	7.8	9.0	10.3	11.5
ROE	%	17.4	14.8	15.7	16.2
EV/EBITDA	x	7.8	7.6	5.6	4.6
Net debt/equity	%	165.2	45.0	13.8	-8.9
P/BV	x	2.4	1.5	1.3	1.1

**JSTL IN rel BSE Sensex performance, & rec history**



Note: Recommendation timeline - if not a continuous line, then there was no Macquarie coverage at the time or there was an embargo period.

Source: FactSet, Macquarie Research, December 2010  
(all figures in INR unless noted)

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21 December 2010

# JSW Steel

## Attractive deal, maybe a bit too early

### Event

- **JSW to acquire 45.5% Ispat Industries:** JSW Steel announced today that it will be acquiring a 45.5% stake in Ispat Industries for a consideration of US\$480m. This deal values Ispat Industries at close to US\$2.5bn, or US\$712/t, which is a 30% discount to the replacement cost. While we have doubts about the timing of the deal, given that JSW recently reduced its leverage and needed to consolidate, we find the deal valuations are attractive.

### Impact

- **The assets – near the consumer and high on potential:** Ispat Industries owns a 3.3mtpa steel plant near Mumbai, close to consumers (autos and re-roller). It includes a 1.6mt gas-based DRI, a 2mt blast furnace and a 3.3mt hot strip mill. It also owns a 12mtpa captive port. With additional investment of US\$500m in CPP, coke oven and pellets, we estimate the EBITDA margins can be improved from the current US\$70–80/t to US\$110–120/t.
- **Deal attractively valued and can be easily funded:** On a replacement cost basis, the deal does look attractive to us at just US\$712/t of steel capacity. JSW is sitting on cash of US\$680m and won't need to raise further debt to fund this purchase. However, the debt on Ispat Industries will have to be refinanced and would increase JSW's debt/equity to 1.37x from 0.8x, by our estimates.
- **EPS dilutive at first glance:** Based on our assumptions (EBITDA for Ispat at US\$80/t), the deal would lead to 10% EPS dilution in FY12E. It needs US\$150/t of EBITDA for an EPS breakeven, which looks difficult to us as JSW itself is doing close to a US\$125/t EBITDA margin currently.
- **Open offer for a further 20% stake:** As per the SEBI's guidelines, JSW will have to make an open offer for an additional 20% stake on expanded equity at Rs20.7/sh. The acceptance ratio will need to be 78% of the free float, assuming existing promoters do not subscribe. However, given the current stock price is higher than the open offer price, and considering that Ispat Industries actually will be in much better shape, many investors may not subscribe to this offer. Hence, we consider JSW might limit its holding to 51%.

### Earnings and target price revision

- No changes.

### Price catalyst

- 12-month price target: Rs1,492.00 based on a sum-of-the-parts methodology.
- Catalyst: Increasing steel prices in India and synergies from this deal.

### Action and recommendation

- **Maintain Outperform; accumulate on dips:** JSW's growth profile remains robust but we think the oversupply in the global steel market and pressure from raw material prices will keep margins muted. Also, the increased risk profile could lead to a PER de-rating in the near term. Hence, we would advise waiting for an earnings downgrade to enter this stock.

## Ispat Industries' assets

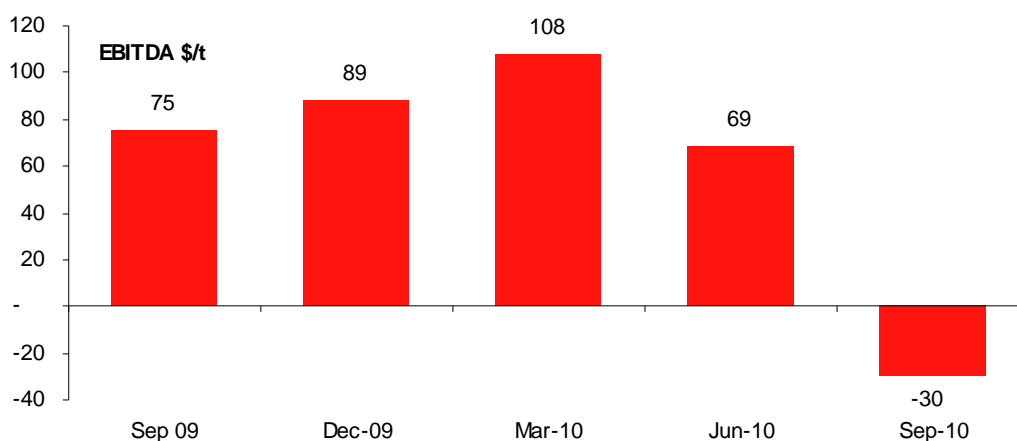
**Fig 1 Ispat Industries capacity (June 2010)**

Product	tons
Direct Reduced Iron	1,600,000
Pig Iron/Hot Metal	2,000,000
Hot Rolled Coils	3,300,000
Cold Rolled Steel Coils/Sheets	330,000
Galvanised Coils/Sheets	225,000
Galvalume Coils/Sheets	100,000
PVC Coated Sheets	60,000
Tubes & Pipes	56,000

Source: Company data, Macquarie Research, December 2010

## Margins under pressure due to lack of raw material integration

**Fig 2 EBITDA/t – unable to gain from price increases**



Source: Company data, Macquarie Research, December 2010

## Ispat – can benefit through cost-saving projects

**Fig 3 Cost saving strategies for Ispat Industries**

Facility	Capacity	Savings assumptions	Investment	Timeline
<b>Increasing capacity</b>				
Captive power plant	110mw	\$69m	\$109m	18 months
Coke oven battery	1mtpa	\$40m	\$250m	24 months
Pellet Plant	2mtpa	\$38m	\$133m	21 months
<b>Raw material integration strategy</b>				
Granted PL for Iron ore mine at Damkodwadvi, with reserves of 101mt and production of 2mtpa				24 months

Source: Company data, Macquarie Research, December 2010

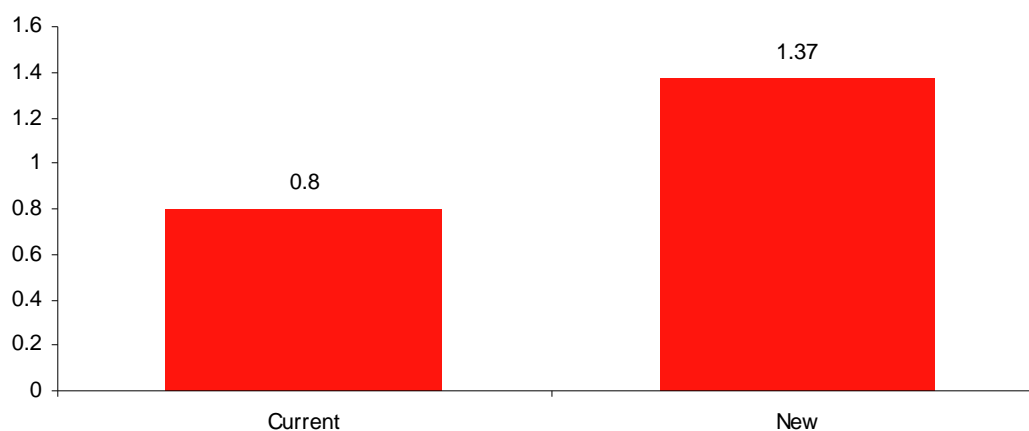
**Fig 4 Deal details – at replacement cost**

<b>Implied market cap at Rs19.85</b>	<b>Rs m</b>	<b>55,472</b>
Debt	Rs m	50,289
EV	Rs m	105,761
Capacity at 3.3mtpa	\$/t	712
Capacity at 4.2mtpa	\$/t	560

Source: Macquarie Research, December 2010

## JSW's debt to equity will expand on consolidated basis at 51% stake

Fig 5 D/E – using cash to finance the deal



Source: JSW presentations, Macquarie Research, December 2010

## We expect Ispat to be profitable only in FY13

Fig 6 ISPAT P&L – assumptions

		FY12	FY13	FY14	FY15	FY16
Capacity	mt	3.3	3.3	4.2	4.2	4.2
Utilisation	%	85%	85%	80%	85%	85%
Production	mt	2.8	2.8	3.4	3.6	3.6
EBITDA/t	\$/t	80	95	107	117	121
Synergies						
Power plant	\$m		69	69	69	69
Pellet plant	\$m			38	38	38
Coke Oven	\$m				40	40
EBITDA	\$m	224	266	360	416	432
USD/INR		45	45	45	45	45
EBITDA	Rs m	10098	11961	16214	18725	19445
Depreciation	Rs m	6200	6200	6200	6200	6200
Interest	Rs m	5186	5186	5186	5186	5186
PBT	Rs m	-1304	559	4812	7323	8043
PAT	Rs m	-913	391	3368	5126	5630
Minority interest	Rs m	-447	192	1650	2512	2759

Source: Macquarie Research, December 2010

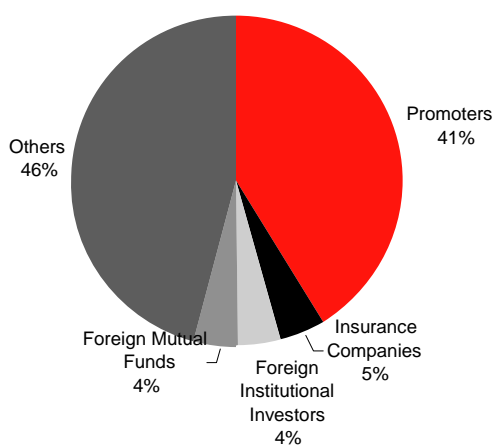
### Deal looks EPS dilutive for JSW at first glance

**Fig 7 We expect a 10% dilution in FY12 at 51% stake**

		FY12	FY13	FY14	FY15
JSW current PAT estimate	Rs m	33,935	40,597	38,301	26,175
Interest expense on new debt	Rs m	2829	2829	2829	2829
Earnings from Ispat	Rs m	-465	200	1718	2614
JSW PAT consol	Rs m	30,641	37,967	37,189	25,960
<b>Dilution</b>	<b>%</b>	<b>-10%</b>	<b>-6%</b>	<b>-3%</b>	<b>-1%</b>

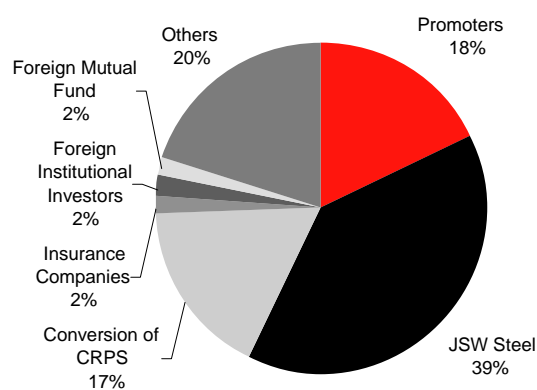
Source: Macquarie Research, December 2010

**Fig 8 Shareholding for Ispat industries (Sept 2010)**



Source: BSE, Macquarie Research, December 2010

**Fig 9 New shareholding after the deal**



Source: BSE, Macquarie Research, December 2010



## Important disclosures:

## Recommendation definitions

**Macquarie - Australia/New Zealand**

Outperform – return >3% in excess of benchmark return  
 Neutral – return within 3% of benchmark return  
 Underperform – return >3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

**Macquarie – Asia/Europe**

Outperform – expected return >+10%  
 Neutral – expected return from -10% to +10%  
 Underperform – expected return <-10%

**Macquarie First South - South Africa**

Outperform – expected return >+10%  
 Neutral – expected return from -10% to +10%  
 Underperform – expected return <-10%

**Macquarie - Canada**

Outperform – return >5% in excess of benchmark return  
 Neutral – return within 5% of benchmark return  
 Underperform – return >5% below benchmark return

**Macquarie - USA**

Outperform (Buy) – return >5% in excess of Russell 3000 index return  
 Neutral (Hold) – return within 5% of Russell 3000 index return  
 Underperform (Sell) – return >5% below Russell 3000 index return

## Volatility index definition\*

This is calculated from the volatility of historical price movements.

**Very high-highest risk** – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

**High** – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

**Medium** – stock should be expected to move up or down at least 30–40% in a year.

**Low-medium** – stock should be expected to move up or down at least 25–30% in a year.

**Low** – stock should be expected to move up or down at least 15–25% in a year.

\* Applicable to Australian/NZ/Canada stocks only

**Recommendations** – 12 months

**Note:** Quant recommendations may differ from Fundamental Analyst recommendations

## Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense  
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

**EPS** = adjusted net profit / epowa\*

**ROA** = adjusted ebit / average total assets

**ROA Banks/Insurance** = adjusted net profit / average total assets

**ROE** = adjusted net profit / average shareholders funds

**Gross cashflow** = adjusted net profit + depreciation

\*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

## Recommendation proportions – For quarter ending 30 September 2010

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	51.06%	64.41%	55.07%	46.58%	66.99%	50.00%	(for US coverage by MCUSA, 13.73% of stocks covered are investment banking clients)
Neutral	34.15%	17.31%	36.23%	48.40%	28.71%	36.81%	(for US coverage by MCUSA, 11.76% of stocks covered are investment banking clients)
Underperform	14.79%	18.28%	8.70%	5.02%	4.31%	13.19%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)

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