INDIA RESEARCH

JSW Steel

Rs602
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs113bn; US$2.4bn

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Result: Q1FY10
Comment: Quarterly profits disappoints; core story remains intact
Last report: 7 May 2009 (Price Rs429; Recommendation: Upgrade to Outperformer)

Key financials

(Rs m)	Net Revenues	yoy chg (%)	Net Profit	EPS (Rs)	yoy chg (%)	PER (x)
FY07	85,944	39.1	12,919	69.1	50.8	8.7
FY08	124,567	44.9	16,400	87.7	26.9	6.9
FY09P^	161,047	29.3	2,427	13.0	(85.2)	46.4
FY10E^	179,970	11.7	13,072	69.9	438.5	8.6
FY11E^	234,275	30.2	19,059	101.9	45.8	5.9

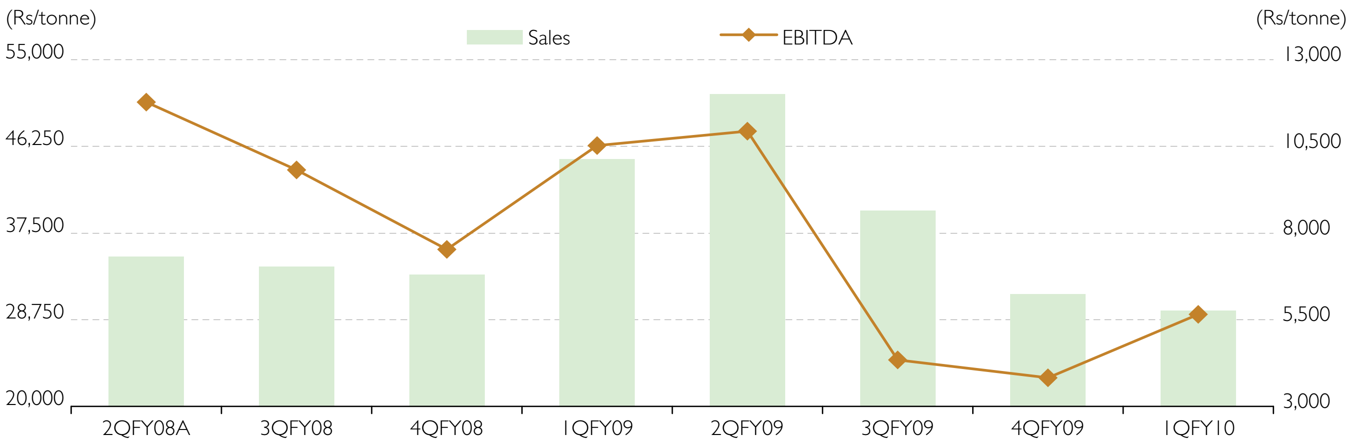
^consolidated financials

KEY RESULT HIGHLIGHTS

Standalone Operations

- Operating profit (EBITDA) in the standalone business at Rs7.5bn was lower than our estimates of Rs8.5bn
- This was led by a combination of (a) lower than estimated volumes and realizations by 2% and 3% respectively (b) higher proportion of semi-finished steel at 24% of volumes compared to 11% in Q4FY09 and (c) higher than expected impact of legacy high cost coking coal inventory used in the first two months of the quarter --raw material cost per tonne decline of 15%qoq was lower than what we expected.
- Other income for the quarter saw steep 148%qoq increase to Rs2.4bn largely on account of forex gains and gains from FCCB buyback
- Depreciation and interest costs for the quarter at Rs2.7bn and Rs2.2bn respectively were broadly in line with estimates
- Overall, net profit for the quarter at Rs3.4bn was significantly ahead of our estimates (we saw at Rs2.6bn) but largely on account of forex gains.

Exhibit 1: JSW Steel India Operations: Trend in Realization and EBITDA/tonne

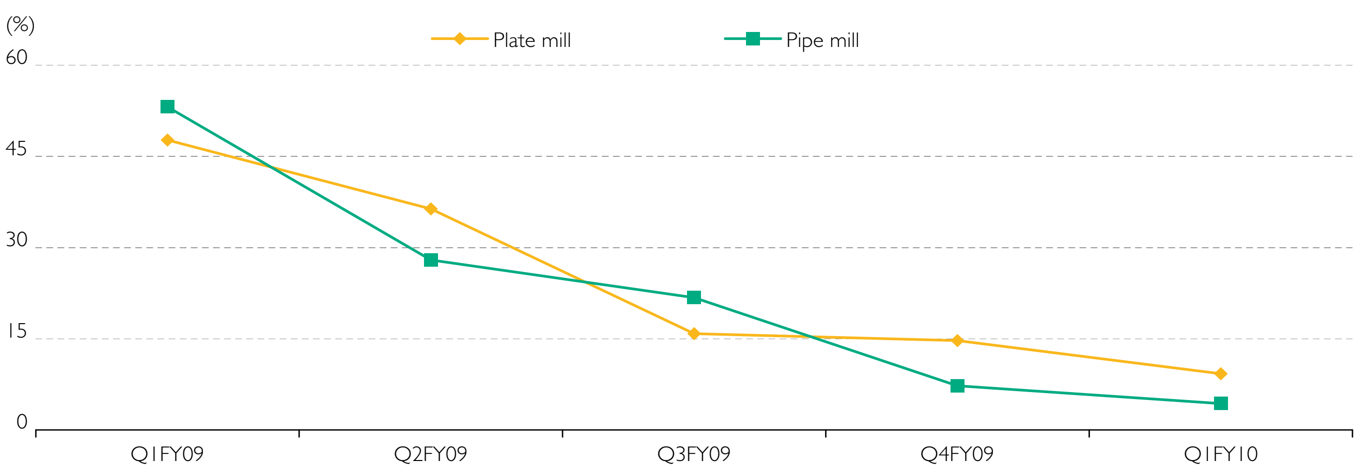


Source: IDFC-SSKI Research

❑ US operations

- US plate and pipe mill operated at ~9% and 4% capacity utilization levels, registering 27,727 and 5,432 tonnes of production respectively in Q1FY10—the plate mill utilization was considerably lower than estimates.
- JSWS US operations reported net loss of US$26m in Q1FY10, against our estimates of US$4m loss. This was largely on account of lower utilization levels coupled with negative impact of high operating leverage.

Exhibit 2: JSW Steel US Operations: Utilization rates continue to decline



Source: IDFC-SSKI Research, Company

Exhibit 3: Financial performance US operations

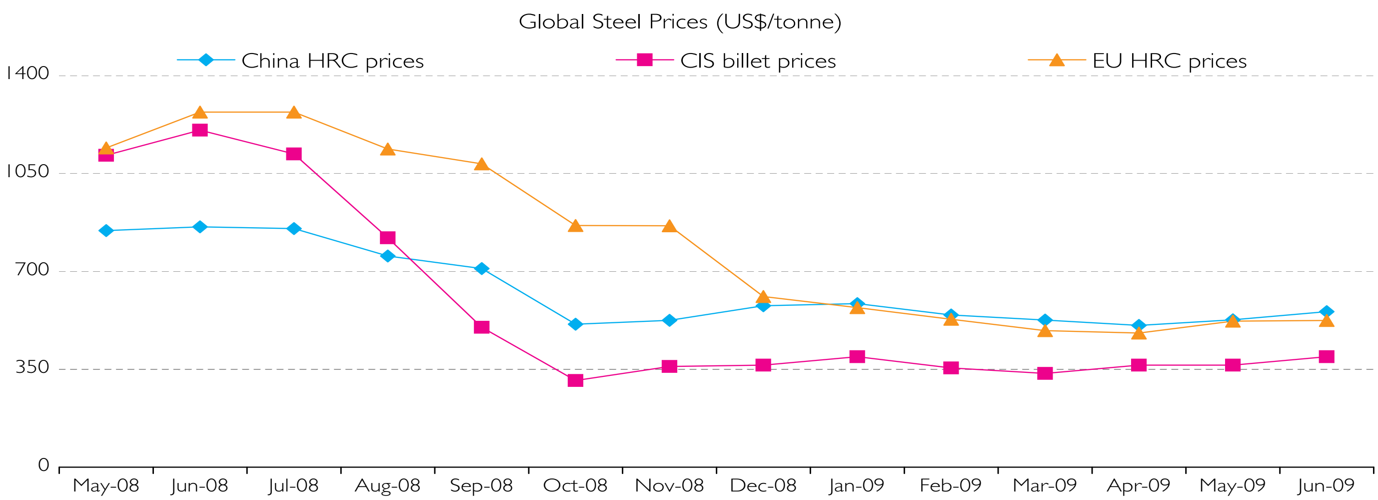
Particulars (US$ m)	Q1FY10	Q1FY09
Sales revenues	17.9	217.5
EBITDA + Other income	(13.7)	44.9
Profit Before Tax	(32.1)	25.6
Profit After Tax	(21.0)	17.7

Source: IDFC-SSKI Research

❑ Global steel prices have increased by US$40-60/ tonne

Even as sustainability could be argued, global steel prices have moved up by US$40-60/tonne, i.e. 10-12%, in the last two months. Unprecedented and coordinated production cuts effected globally over the last 6-9 months, we believe, have gone a long way in arresting (and supporting) the decline in steel prices in the wake of rapid inventory de-stocking. Our interaction with industry professionals leads us to conclude that inventory stocks at steel mills as well as distributor level are at minimum levels. Next, we also believe that the recent spurt in steel prices in Asia has been on account of stronger demand owing to the impact of fiscal stimuli packages and re-stocking of inventories. However, given that the global steel industry is still operating at sub-optimal utilization levels and the underlying demand in developed economies also remains weak, we believe that continuation of 'supply discipline' would be the key factor determining steel price stability going forward. A weakness could indeed set in case the global market is flooded with cheaper Chinese steel products going forwards, particularly considering the local government has recently extended steel export rebates of up to 14%.

Exhibit 4: Global Steel prices on uptrend



Source: Bloomberg, IDFC-SSKI Research

❑ Domestic prices hold firm; though premium over landed cost has narrowed

In Q1FY10, Indian steel prices traded at a significant premium to the landed cost, partly attributable to the protectionist measures adopted by the Indian government. The most prominent factor in our view is the fact that allotment of import licenses has been restricted to the minimal. This, coupled with longer lead times for import, kept steel importers on the sidelines. Notably, the import premium has now shrunk drastically with global prices moving up by 5-10% recently. This, we believe, reduces the risk of a sharp fall in domestic steel prices in the near term.

Exhibit 5: Domestic price premium over landed cost of imports has narrowed considerably…

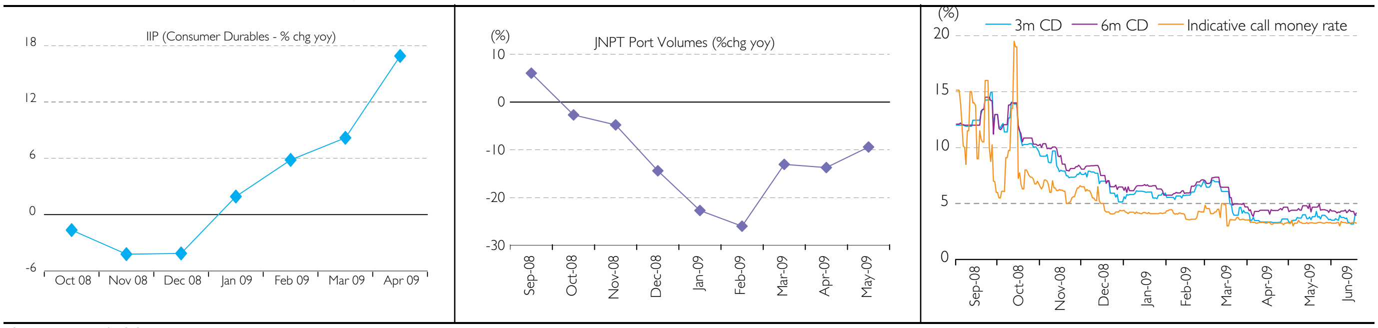
Particulars	Unit	Mar'09	May'09	July'09
HRC Price, FoB Russian port	US$	380	410	470
Freight cost	US$	20	15	15
Total Cost	US$	400	425	485
Import duty, C&F charges	US$	23	23	27
Total	US$	423	448	512
Inward freight differential	US$	10	10	10
HR Cost at plant	US$	433	458	522
HR Cost at plant (In Rs)	Rs	21,650	22,900	24,519
Domestic Steel prices (In Rs)	Rs	25,500	25,500	25,900
% difference in domestic prices over imports	%	18%	11%	6%

Source: IDFC-SSKI Research

❑ Domestic steel demand has improved considerably

Domestic steel demand has grown 5.4% in the April-June quarter--improving consumer durable and capital goods indices (IIP contributors), rising port throughput, higher automobile sales and a drop in short-term interest rates indicate improving economic outlook. Further, with the UPA-led government returning to power and the extensive thrust on infrastructure projects in the recent budget, we expect swift improvement in visibility on steel demand (particularly long products). Inventory re-stocking at distributor level supports our view of an upward trend.

Exhibit 6: Macro indicators pointing towards economic revival



Source: IDFC-SSKI Research, Bloomberg, Industry

❑ Scalability story for JSWS to regain momentum

JSWS had earlier decided to defer part of the expansion plans given the cash flow constraints and its stretched balance sheet. In that regard, the 3.2m tpa expansion to increase capacity to 11m tpa was delayed by a year and other greenfield projects too were kept on hold. However, JSWS has once again earmarked a higher capex of Rs30bn and Rs70bn in FY10 and FY11 respectively. Our earlier estimates expected JSWS to incur only ~50% of the envisaged capex. With increased cashflow visibility, we believe JSWS would have enough cash flows to meet 70% of its capex plans and the balance is likely to be funded through incremental debt. With successful execution of its expansion plans by FY11E, JSWS is set to emerge as the second largest steel player in India (after SAIL).

❑ JSWS to report fastest volume growth over FY11E

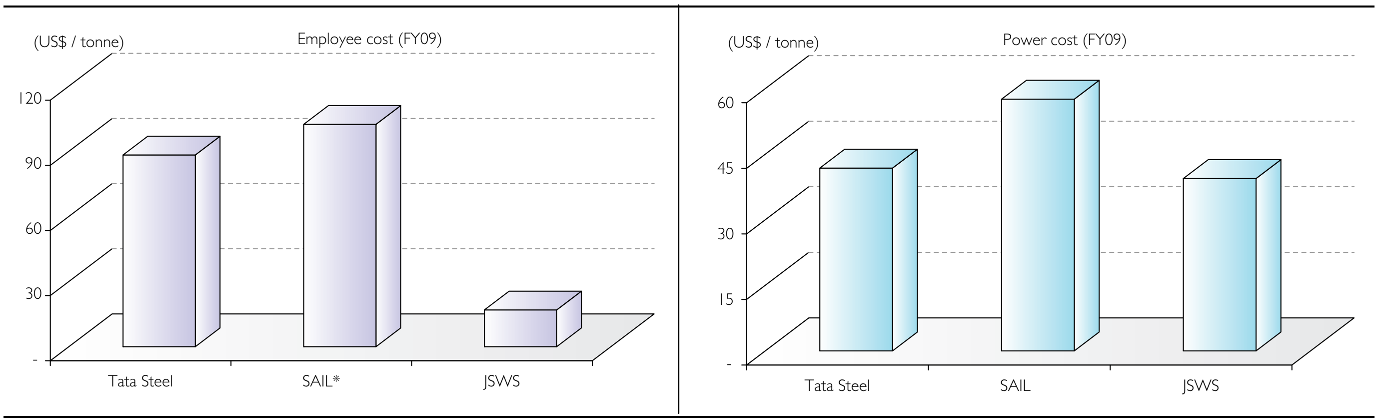
JSWS is poised for spectacular volume growth over FY09-11 (the highest among Indian steel players) with capacity slated to increase ~3x over FY08-11E. The on-going 3.2m tpa expansion project would take JSWS's consolidated installed capacity to 11m tpa by FY11, higher volume growth would likely be supported by an improved product mix. We like JSWS's well-crafted marketing strategy, under which it has increased its domestic market share to compensate for the slowing export demand. JSWS now targets to sell 87% of its sales volumes in the domestic market in FY10. JSWS plans to follow a three-pronged strategy to increase its market share in the Indian market – (a) target import substitution business; (b) focus on supplies to government-funded infrastructure projects; and (c) increase share in the rural infrastructure space. Factoring in an improvement in real demand, JSWS's favorable product mix (~30% from long products) and judicious marketing strategy, we increase our sales volume estimate for JSWS from 5.8m to 6m tonnes for FY10. Our volume assumptions are based on the following:

- Value-added flat products and slabs constitute 72% of flat product(s) installed capacity, wherein we see JSWS better placed vis-à-vis peers as the identified target markets are niche and clearly demarked.
- Our channel checks indicate that the newly commissioned wire-rods mill (50,000 tonnes capacity) has received a good response in the market. With a much stronger technological advantage, JSWS is gaining market share in this segment from secondary producers.
- A big chunk (88%) of JSWS's capacity would be utilized to service domestic markets with the remaining targeting exports – wherein we have assumed substantially lower volume off-take.

❑ JSWS ideally placed in a deflationary raw material price scenario

In a scenario of lower raw material (iron ore, coking coal) costs/ contract prices, we expect JSWS to be the key beneficiary owing to the non-integrated nature of its business operations. Lower raw material prices significantly narrow the cost differential between integrated and non-integrated players, and offer an operating margin expansion opportunity to the latter set of producer's vis-à-vis their integrated counterparts. JSWS procures 16% of its iron ore requirement through its JV (with Vijaynagar Minerals Pvt. Ltd) and the remaining from NMDC/ private miners as also through spot purchase. We estimate JSWS to procure coking coal at a relatively higher blended cost of US$167/tonne CIF for FY10, as it has to lift 8% of volumes at 2008 contract rates.

Exhibit 7: JSWS- Far efficient on conversion costs



*Source: Company, IDFC-SSKI Research, *adjusted for Sixth Pay Commission*

Even as JSWS coking coal costs would be relatively higher than peers in FY10, we expect its cost of production among the lowest, primarily owing to lower conversion costs. JSWS is a far more efficient player than Indian peers in terms of pure conversion costs (total operating cost minus raw material cost) based on several factors including lower employee cost per tonne of steel produced, usage of a combination of COREX and blast furnace (BF) technology, and persistent focus on technical parameters (coke rate, energy consumption, etc). We estimate JSWS's conversion costs to be 35% lower than Tata Steel's Indian operations.

❑ US business improving at the margin

A deteriorating macro-environment and lack of clarity on incremental order book position are clearly reflected in a visible drop in capacity utilization as JSWS's US operations. Capacity utilization for plate and pipe mill has dropped for the last five consecutive quarters with plate and pipe mill operating at sub-15% utilization levels. JSWS has cut the temporary workforce and also recently halved its workforce on the rolls at the unit. However, the unit is recently witnessing revival in demand and flow of orders at the margin. According to the company, the US mill has recently received orders worth 5,000 tonnes and discussions for another 25,000 tonnes are in the final stages. Overall, even as visibility on plate mill utilization remains hazy given the near-halt in ship-building activity and expected oversupply (up to 20%) in ocean freight carriers, we reduce our operating loss estimate for the US operations from US$60m to US$25m for FY10.

❑ Overseas mining assets – no near-term upside

On account of the sharp slide in raw material (iron ore and coking coal) spot prices, JSWS has put on hold its iron ore and coal mining projects in Chile and Mozambique respectively. JSWS has incurred a capex of US$25m on Chilean operations until now, apart from an upfront payment of US$252m to acquire the mines. JSWS has so far carried out exploration activities on part of these mines to gauge the quality of reserves, and has completed initial drilling and surveying of the first concession at Mozambique. Test results pertaining to quality and quantity of reserves of other concessions are awaited, and the company would consider further investments post review of the same. With no substantial cash expected to be generated from the overseas mining assets, we believe these operations would need capital infusion to service the outstanding debt and meet debt repayment obligations (a minimum cash outgo of US$157m in FY10E). Our estimates do not factor in any cash flow from either Chilean iron ore mines or Mozambique coal assets.

❑ Expect 87% CAGR in EPS over FY09-11E; JSWS preferred pick in our universe

Among our steel coverage universe, we maintain that JSWS is best placed given its high visibility on volumes, competitive conversion costs as also strong operating and financial leverage. With cash flow concerns now dissipating and strong growth visibility, we expect strong operating performance largely offset gearing concerns. Even as we reduce our FY10E estimates by 6%, we expect JSWS to report a strong 87% CAGR in EPS over FY09-11E. Our estimates build in a 6.1mtpa sales volumes for FY10 (vs management guidance of 6.4mtpa). We expect significant improvement in operating profit going forward largely reflecting improving volumes, raw material cost savings and improvement in pricing. Maintain Outperformer with a revised price target of Rs713/share based on 6.5x FY11E EV/ EBITDA.

Exhibit 8: Quarterly results

(Consol.)	1QFY09	2QFY09	3QFY09	4QFY09	FY09	1QFY10	1QFY10
Net Sales	**36,715**	**43,091**	**28,267**	**33,288**	**141,584**	**39,168**	**40,138**
yoy chg (%)	*53.9*	*72.8*	*10*	*(21)*	*24*	*7*	*(10)*
Operating profit	**8,594**	**9,152**	**3,087**	**4,061**	**29,902**	**7,467**	**6,884**
yoy chg (%)	*11.0*	*9.5*	*(58)*	*(57)*		*(13)*	*(34)*
Other income	(1,993)	(503)	(532)	973	1,024	2,414	2,397
Interest	1,531	1,960	2,333	2,149	7,973	2,206	2,983
Depreciation	1,852	1,975	2,141	2,309	8,277	2,718	3,166
Exceptional items				178	(7,901)		
PBT	**3,217**	**4,714**	**(1,919)**	**755**	**6,776**	**4,957**	**3,132**
Tax rate (%)	*32*	*33*	*32.9*	*34.9*	*32.3*	*31.4*	*31.0*
Misc. Expenditure written off							
Tax	1,024	1,536	(632)	263	2,191	1,556	970
Reported Profit	**2,193**	**3,178**	**(1,287)**	**492**	**4,584**	**3,400**	**2,162**
yoy chg (%)	*(53.2)*	*(37.8)*	*(139)*	*(89)*	*21*	*55*	*(51)*
Adjusted Net profit	4,454	3,708	(747)	492	23,404	3,400	2,341

Source: IDFCSSKI Research

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