Ispat Industries

BSE code:	500305
NSE code:	ISPATIND

CMP: Rs 52 **Target: Rs 101** **BUY**

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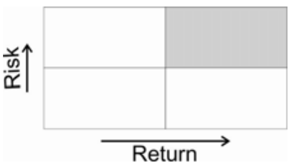
Company data

Particulars	
Market cap (Rs mn / US$ bn)	63,357/2,471
Outstanding equity shares (mn)	1218.4
52-week high/low (Rs)	55.0/10.3
2-month average daily volume (mn)	20.6

Financial snapshot

Particulars	FY07	FY08E	FY09E
Sales (Rs mn)	74,865.7	82,710.4	97,520.4
Growth (%)	-	10.5	17.9
Adj net profit (Rs mn)	(10.3)	74.2	386.0
Growth (%)	-	-	420.5
FDEPS (Rs)	(0.1)	0.6	3.2
Growth (%)	-	-	420.0
P/E (x)	-	85.4	16.4
ROE (%)	-	3.5	34.2

Risk-return profile



Shareholding pattern

(%)	Sep-07	Jun-07
Promoters	50.8	50.6
FIIs	0.8	0.6
Banks & FIs	27.3	35.3
Public	21.3	13.5

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
Ispat Industries	52	114.1	195.4	268.4
Sensex	19,738	1.7	26.4	38.5
BSE Metal	19,044	10.7	63.0	82.9

Company website	**www.ispatind.com**

Catch it young

Set to prove its mettle in the steel super cycle

Investment rationale

- A turnaround company with expected improvement in operational performance and sharp reduction in the interest cost and increasing consolidation in the steel industry to further drive the valuation going forward.
- Focus on improving backward linkages through the set up of coke and pellet plants by 2010, which would bring in substantial cost savings. Expects allotment of an iron ore mine in Maharashtra with reserves of ~30mn tonnes, with ~1mn tonnes to be mined in the first 18 months.
- Gas-based sponge iron (DRI) plant of 1.6mn-tonne capacity allows for a unique combination of DRI and hot metal feedstock in electric arc furnace (EAF) steel manufacture. This translates to substantial energy savings and offers flexibility regarding input mix.
- DRI plant set to operate at full capacity from FY09 as against sub-70% utilisation currently due to non-availability of gas supply. Contract signed with Shell for LNG supply through the Dahej-Uran pipeline would ensure availability of gas from March 2008.
- De-bottlenecking operations to increase hot rolled steel capacity to 3.6mn tonnes by October 2008, with an aggressive long-term plan to raise capacity to 5mn tonnes by 2012 and further to 10mn tonnes by 2015

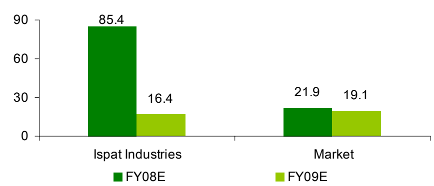
Key concerns

- Very high vulnerability to rising feedstock prices. Also, higher financial leverage exposes the company to a high risk from falling steel prices.

Valuation

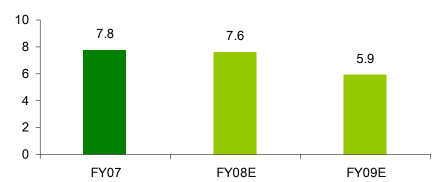
- Traditional P/E and EV/EBIDTA valuation methods are unsuitable as the company is in a turnaround phase. Using the replacement cost method, we arrive at a fair price of Rs 101/share. Buy.

P/E multiple (x)



Source: Religare Research

EV/EBITDA multiple (x)



Source: Religare Research

Company snapshot

One of the largest flat steel producers in India

Ispat Industries (IIL) is among the largest flat steel producers in India with a capacity of 3mn tonnes for hot rolled (HR) coils and a downstream capacity of 0.33mn tonnes each for galvanised sheets and cold rolled (CR) coils. The company enjoys a strong geographical advantage as it is the only steel producer in Maharashtra, with two plants located at Dolvi and Kamleshwar (near Mumbai).

IIL has a gas-based sponge iron (DRI) plant at Dolvi with a capacity of 1.6mn tonnes, and a thin slab casting & compact strip process plant, giving it the ability to produce thin gauge steel. In addition, it is aggressively looking at increasing its backward linkages through the set up of coke and pellet plants, which are expected to bring in significant cost savings. The company also has a long-term supply agreement for iron ore, a key raw material for steel manufacturing, with the National Mineral Development Corp (NMDC).

IIL has a strong presence in LPG and oil & gas pipeline applications as well as roofing & panelling, drums, barrels and tubing products. Further, it has long-term contracts with OEMs in the automobile and white goods segments.

Production capacity

Plant	Capacity (mn tonnes)
Dolvi, Maharashtra	
HR coils	3.0
Sponge iron (DRI)	1.6
Blast furnace	2.0
Sinter plant	2.2
Oxygen plant (tpd)	1,260
Kamleshwar, Maharashtra	
Galvanised sheets	0.3
CR coils	0.3
Colour coated sheets	0.05

Source: Company

Investment rationale

Market leader in Maharashtra

IIL is the market leader in Maharashtra with 55% of its products sold within a 100km radius of its plants at Dolvi and Kamleshwar, and 75% of revenues derived from western India. This allows the company substantial freight advantages as compared to its peers. It is also eligible for a deferred VAT credit for sales within Maharashtra.

Unique combination of twin shell EAF with gas-based DRI

Dual use of DRI and hot metal offers raw material flexibility and energy cost savings

IIL's 3mn-tonne HR coil plant houses the latest steel-making technology, namely the Conarc process and the Twin Shell Electric Arc Furnace (EAF) process. The company has combined the usage of DRI and hot metal as raw material for its twin shell EAF, resulting in energy savings and giving it flexibility regarding the input mix.

IIL currently employs a mix of ~60% hot metal, 35% DRI and 5% scrap for steel-making. Since the price of scrap metal is very high, the company intends to raise the proportion of DRI, which is manufactured in-house, in its feedstock mix.

DRI (sponge iron) the preferred route for steel making

In India, the two prominent steel-making routes are BF+BOF (blast furnace + basic oxygen furnace) and DRI+EAF. Since a majority of the coal available in India is of an inferior quality, steel players are compelled to import high-cost coking coal. We believe the dependency on coking coal will increase going forward due to the rise in steel-making capacity across the industry.

IIL and Essar Steel are the only two players in India to have gas-based DRI plants as they are in the vicinity of ports, with proximity to sources of gas. Gas-based DRI is of a superior quality and is mainly used in the manufacture of flat steel products, whereas coal-based DRI is used for producing billets and other long products.

Contract with Shell for LNG supply to increase DRI production

At present, IIL's DRI plant is operating at low capacity utilisation levels (below 70%) due to a shortage of natural gas supply. However, we expect this situation to improve now that IIL has signed a contract with Shell for the supply of LNG through GAIL's Dahej-Uran pipeline, which is scheduled to commence by March 2008. This would allow the DRI plant to run at full capacity, enabling IIL to replace the expensive metallic feed with sponge iron.

Large gas finds to increase availability: There have been significant natural gas discoveries on the eastern coast of India in the past three to four years, with the most prominent being Reliance Industries' Krishna Godavari Basin and Cairn India's find on the Rajasthan belt. These discoveries would improve the availability of natural gas for end consumers. Further, the expansion of LNG terminals at Dahej, Dabhol and Kochi at an estimated investment of Rs 36bn over the next five years will improve the connectivity of gas to end users.

Continuous casting method enables product customisation

IIL is one of the few companies to have the thin slab casting technology, which allows it to process thin gauge steel of 65mm thickness as against the conventional 225–250mm thickness. This in turn enables the company to earn better realisations on its products.

De-bottlenecking operations to raise HR steel capacity

HR coil capacity being raised to 3.6mn tonnes by October 2008

The company is increasing its HR coil capacity from 3mn tonnes to 3.6mn tonnes by October 2008 through de-bottlenecking initiatives. It is also setting up additional support infrastructure in the form of a 0.65mn-tonne blast furnace and a 0.2mn-tonne sponge iron capacity. The 45km Dahej-Uran pipeline connection to Dolvi will ensure an adequate supply of natural gas to raise DRI production.

As a long-term growth plan, IIL aims to increase its HR coil capacity to 5mn tonnes by 2012 and further to 10mn tonnes by 2015. It also has plans to set up an additional 150MW power plant to feed the expanded capacity.

Backward integration would enhance operational efficiency

- **Coke plant to be set up jointly with Stemcor:** IIL has entered into a joint venture with Stemcor for setting up a 1mn tonne coke plant, with a 26% share in the JV. The plant is expected to be commissioned by January 2010 and will have a total capital outlay of Rs 9bn. The management expects raw material cost savings of ~Rs 6.4bn p.a. from the captive coke facility.

Captive coke and pellet plants would save close to Rs 11bn p.a. from 2010

- **New 4.5mn tonne pellet plant at Vizag:** IIL is also setting up a 4.5mn tonne pellet plant at Vizag at a cost of Rs 7.7bn. This would ensure high-quality pellet feed into the sponge iron plant and blast furnace. The project is expected to be commissioned by June 2010 and should translate to raw material savings of Rs 4.3bn per year. IIL has already signed a contract with NMDC for leasing out iron ore mines to meet the feedstock requirements of its pellet plant.

- **Iron ore mine allotment in Maharashtra:** The company expects to be allotted an iron ore prospecting lease for ~30mn tonnes in Maharashtra shortly. Of this, at least 1mn tonne is likely to be mined in the first 18 months of operation.

- **110MW captive power plant to come onstream in Oct '08:** Subsidiary company, Ispat Energy, is setting up a 110MW captive power plant which will cater to 30% of IIL's requirements. This plant will operate on blast furnace waste gas and is expected to reduce the company's annual power costs by ~Rs 1.5bn. Financial closure for the project has been completed after being held up for more than a year and commissioning is scheduled for October 2008.

In a restructuring mode

IIL is a part of Global Steel Holding promoted by Pramod Mittal and Vinod Mittal, which has a steel capacity of 14mn tonnes spread across the world. Most of this capacity has been built up in the last four years through the acquisition route. Global Steel has a strong resource base with interests in coke, coal, iron ore and chrome mining, energy, infrastructure, ferro alloys, forged steel rolls, refractories and mining.

Apart from strong parent company backing, IIL is currently in a restructuring mode and plans to repay its high-cost debt through FCCBs or the private equity route. The company witnessed a significant setback last year on account of a fire at the ONGC High oilfield, which led to a halt in gas supply to the DRI plant for four months. It also witnessed considerable flooding during the monsoons which resulted in a shutdown of the blast furnace. However, significant steps have been taken to safeguard against such natural calamities, including the tie-up with Shell and an arrangement with GAIL for natural gas.

The company is currently in the corporate debt restructuring scheme and has managed to decrease the interest cost by 37% till H1FY08 and is expected to reduce its interest cost by 80% till FY09. We believe with improvement in operational performance and infusion of fresh capital the company will be able to reduce it loan book. We remain extremely bullish on the steel super cycle and believe the consolidation in the industry will drive the valuation going forward.

Global Steel Holding – geographical presence

Country	Facility	Capacity (mn tonnes)
Bulgaria	Steel	2.2
Bosnia	Coke	1.4
Serbia	Refractories	0.2
India	Steel & Others	3.0
Nigeria	Steel & Iron ore	3.6
Libya	Steel	1.8
Kosovo	Steel	0.2
Philippines	Steel	3.0

Source: Company

Key concerns

- The company will remain vulnerable to rising feedstock prices, raising the cost of steel production.

- Also, higher financial leverage exposes IIL to a high risk from falling steel prices.

Valuation

We believe India's steel industry is set for take-off with a lower threat of cyclicality due to increasing diversity of the global economy as regards steel consumption. Demand from developing countries, which now account for ~50% of the world GDP, is fuelling growth of the industry.

We prefer a replacement cost valuation as IIL is in a turnaround phase

Replacement cost valuation yields target of Rs 101

We believe that traditional P/E and EV/EBIDTA valuation methods are inappropriate for IIL as the company is in a turnaround phase. We have therefore adopted the replacement cost method, which yields a fair price of Rs 101/share for the company. In order to cross-check our assessment, we have also used the EV/Sales valuation approach. This yields a fair value of Rs 105/share for the company.

Replacement cost analysis

Particulars	Capacity (mn tonnes)	Value per unit	Total (Rs bn)
Dolvi, Maharashtra			
Upstream facility	3.6	1100 $	154,836
Kamleshwar Maharashtra			
Downstream facility	0.33		30,000
Investment in Ispat energy (power plant)	110 MW		4950
Total replacement cost			189,786
Less: Expected Debt as on FY09			69,655
Add: Cash & Cash equivalent			2649.7
Implied Mcap			122,781
No of shares			1218.4
Fair value			101

Source: Religare Research

EV to Sales

	FY09
EV/Sales Multiple (x)	2
Target EV	195,041
Less: Expected Debt as on FY09	69,655
Add: Cash & Cash equivalent	2,650
Implied Mcap	128,036
No of shares	1,218
Fair value	**105**

Source: Religare Research

Under the replacement cost method, we have valued the upstream facility at Dolvi at US$ 1,100/tonne, whereas the downstream facility at Kamleshwar has been valued at Rs 30bn. We have arrived at a value of US$ 1,100mn for the Dolvi unit based on the investment cost required for the HR coil rolling mill, the gas-based DRI plant of midrex technology, the blast furnace, the sinter and the oxygen plant. The downstream capacity contains a 50,000-tonne colour coated sheet facility and a galvanised and CR coil plant of 0.3mn tonnes each.

Initiate coverage with a target of Rs 101; Buy

Initiate coverage with Buy

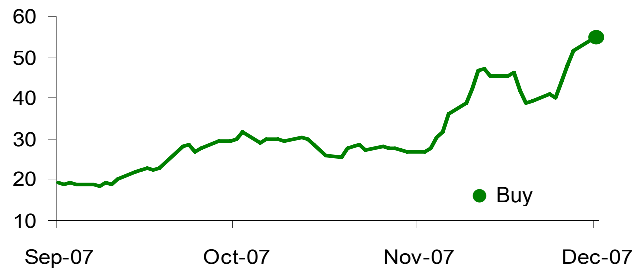
We have followed an asset-driven valuation approach as against an earnings-based approach, as we believe in the current long-term steel up-cycle. We recommend a Buy rating on the stock with a target price of Rs 101.

Recommendation history

Date	Event	Reco price	Tgt price	Reco
04-Dec-07	Initiating Coverage	52	101	Buy

Source: Religare Research

Stock performance



Source: Religare Research

Consolidated financials

Profit and Loss statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Revenues	49,587	74,866	82,710	97,520
Growth (%)	-	51.0	10.5	17.9
EBITDA	2,782	15,086	15,715	21,454
Growth (%)	-	442.2	4.2	36.5
Depreciation	5,714.3	6,238.3	7,324.6	7,544.6
EBIT	(2,932.2)	8,847.5	8,390.4	13,909.9
Growth (%)	-		(5.2)	65.8
Interest	9,568.3	9,908.7	7,565.5	6,617.2
Other income	519.9	1,087.7	2,400.0	750.0
EBT	(2,412.3)	9,935.2	10,790.4	14,659.9
Growth (%)	-	-	8.6	35.9
Tax	228.8	129.1	2,483.2	4,182.2
Effective tax rate (%)	-	-	-	-
Adj net income	(12,209.4)	(10.3)	74.2	386.0
Growth (%)	-	-	-	420.5
Shares outstanding (mn)	1,218.4	1,218.4	1,218.4	1,218.4
FDEPS (Rs)	(10.0)	(0.1)	0.6	3.2
DPS (Rs)	-	-	-	-
CEPS (Rs)	(5.3)	5.0	6.6	9.4

Source: Company, Religare Research

Balance sheet

(Rs mn)	FY06	FY07	FY08E	FY09E
Cash and cash eq	1,289	3,298	1,541	2,650
Accounts receivable	5,941	6,450	7,025	8,015
Inventories	9,856	10,562	11,557	13,359
Others current assets	3,086	4,809	5,313	6,265
Current assets	20,172	25,119	25,436	30,289
LT investments	18	20	20	20
Net fixed assets	99,660	102,988	96,738	93,294
CWIP	6,283	6,236	3,817	(204)
Total assets	126,132.7	134,363.1	126,011.6	123,398.5
Payables	22,901	21,511	20,224	20,038
Others	125	289	315	359
Current liabilities	23,026	21,800	20,539	20,397
LT debt	82,611	83,155	75,655	69,655
Other liabilities	-	-	-	-
Equity capital	12,184	12,184	12,184	12,184
Reserves	(2,391)	6,521	7,262	11,123
Net Worth	9,793	18,705	19,446	23,307
Total liabilities	126,132.7	134,363.1	126,011.6	123,398.5
BVPS (Rs)	8.0	15.4	16.0	19.1

Source: Company, Religare Research

Cash flow statement

(Rs mn)	FY06	FY07	FY08E	FY09E
Net income	(12,209)	(103)	742	3,860
Depreciation	5,714	6,238	7,325	7,545
Other adjustments	6,977	11,952	-	-
Changes in WC	7,789	(4,163)	(3,335)	(3,886)
Operating cash flow	8,271	13,925	4,732	7,519
Capital expenditure	(31,318)	(10,226)	(1,075)	(4,100)
Investments	(1)	(3)	-	-
Other investing inc/(exp)	29,222	8,128	-	-
Investing cash flow	(2,095)	(2,095)	(1,075)	(4,100)
Free cash flow	(23,047)	3,699	3,657	3,419
Issue of equity	6,192	0	(332)	(332)
Issue/repay debt	24,289	544	(7,500)	(6,000)
Dividends paid	-	-	-	-
Others	(6,371)	47	2,419	4,021
Financing cash flow	(6,271)	(9,576)	(5,413)	(2,311)
Beg. cash & cash eq	1,226	1,289	3,298	1,541
Chg in cash & cash eq	(95)	2,253	(1,756)	1,109
Closing cash & cash eq	1,289	3,298	1,541	2,650

Source: Company, Religare Research

Financial ratios

	FY06	FY07	FY08E	FY09E
EBITDA margin (%)	6.7	21.6	21.9	22.8
EBIT margin (%)	(5.9)	11.8	10.1	14.3
Net profit margin (%)	(24.6)	(0.1)	0.9	4.0
FDEPS growth (%)	-	-	-	420.5
Receivables (days)	43.7	31.4	31.0	30.0
Inventory (days)	126.8	105.0	100.0	100.0
Payables (days)	294.7	213.8	175.0	150.0
Current ratio (x)	0.9	1.2	1.2	1.5
Interest coverage (x)	0.3	1.6	2.4	3.4
Debt/equity ratio (x)	8.4	4.4	3.9	3.0
ROE (%)	(85.7)	(0.5)	3.5	34.2
ROCE (%)	4.2	19.5	22.1	26.8
EV/Sales (x)	2.6	1.7	1.7	1.3
EV/EBITDA (x)	38.6	7.8	7.6	5.9
P/E (x)	(3.8)	(451.3)	85.4	16.4
P/BV (x)	4.7	2.5	3.3	2.7
P/CEPS (x)	(7.1)	7.5	7.9	5.6

Source: Company, Religare Research

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Recommendation parameters

Large-caps*	> 10%	< - 5%	Absolute Returns
	BUY	SELL	
Mid-caps**	> 25%	< 10%	

**Market cap over US$ 1bn **Market cap less than US$ 1bn*

Religare Securities

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