

August 30, 2012

Rating
 Remains **Neutral**
Target price
 Remains INR 766

Closing price
 August 29, 2012 INR 689

Research analysts

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How negative is the merger of JSWISPAT?

Quick Note

News reports of merger of JSW Steel and JSW ISPAT; the company has denied the news

There have been news reports suggesting that JSW ISPAT (JSWI IN, not rated) might be merged into JSW Steel in next few weeks (Source: *business today*, August 29, 2012). Earlier, management had guided that the merger would happen once JSWI turns profitable. The company has said that these are media rumours and asked us to ignore it. However, we present below our view on the merger, if it happens.

A negative development if the merger takes place...

We believe this merger at current levels would be negative for JSW Steel given JSWISPAT shares would ideally get a negative value owing to low profitability and high debt. Though JSW Steel already holds close to a 49.3% stake in JSWISPAT, it didn't get a negative value on account of this stake given JSW ISPAT was a listed company.

Impact on valuation: we expect -INR45/share impact on JSW Steel

Post merger, JSW Steel would have total consolidated EBITDA of INR75bn in FY13F and INR82bn in FY14F. At 5x FY14F EV/EBITDA, the merged entity will have EV of INR408bn and equity value of INR158bn.

However, JSW Steel would benefit from JSWI's deferred tax assets of INR20.9bn. We estimate JSW Steel can use this over next six years and hence ascribe an NPV of INR12.9bn to the deferred tax assets. As a result, we estimate JSW Steel on a consolidated basis would have value of INR721/share, compared with our current target price of INR766.

Fig. 1: JSW Steel: valuation comparison

	Post merger	Pre merger
Consolidated EBITDA (FY14F) (INR mn)	81,612	71,198
EV/EBITDA (x)	5	5
EV (INR mn)	408,058	355,991
Net debt (FY12) (INR mn)	249,992	187,983
Equity value (INR mn)	158,066	168,007
Benefit of Deferred tax assets (INR mn)	12,915	-
Total value (INR mn)	170,981	168,007
Per share (INR)	709	753
Value of stakes in JSW Energy (INR)	13	13
Target price (INR)	721	766

Source: Company data, Nomura estimates

Limited equity dilution for JSW Steel...

We would expect equity dilution of 7.5-8.1% for JSW Steel on account of the merger. JSW Steel already holds a 49.3% stake in JSWI. So to

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

acquire the remaining shares, JSW Steel would have to issue 16.9-18.2mn shares, which be 7.5-8.1% dilution.

As per news reports, the merger ratio would be in the range of 1 share of JSW Steel per 70-75 shares of JSW ISPAT. JSW Steel currently has 223mn shares, which would go up to 241.2mn shares (assuming merger at a ratio of 1:70).

Fig. 2: JSW Steel EBITDA post JSWI merger

(INR mn)

	FY13F	FY14F
JSW Steel Ex ISPAT	64,979	71,198
JSW ISPAT	10,111	10,414
Total EBITDA	75,090	81,612

Source: Company data, Nomura estimates

Fig. 3: JSW Steel net profit post JSWI merger

(INR mn)

	FY13F	FY14F
JSW Steel Ex ISPAT	17,007	20,353
JSW ISPAT	-3,012	-2,458
Total Profit	13,995	17,895

Source: Company data, Nomura estimates * JSWI: we have built in tax credits on losses

Leverage to increase significantly for the consolidate entity

More than impact on the P&L account, JSW Steel's balance sheet would see major deterioration on account of this merger, in our view. We estimate that JSW Steel's total consolidated net debt would go up to INR250bn (from current INR175bn) and D/E ratio would also increase from 1.03 currently to 1.4.

Please note that we have treated preferential capital of INR6.4bn (which JSWI reports under shareholder's capital) as debt in the below calculations.

Fig. 4: JSW Steel's leverage to increase post merger

(as per FY12 reported numbers)

Net debt (INR mn)

JSW Steel	174,344
JSW ISPAT	75,648
Total net debt (INR mn)	249,992

Shareholders capital (INR mn)

JSW Steel	169,672
JSW ISPAT	9,725
Total capital (INR mn)	179,397

Interest cost (INR mn)

JSW Steel	14,273
JSW ISPAT	10,891
Total interest (INR mn)	25,164

D/E	1.4
EBITDA/Interest	3.0

Source: Company data, Nomura estimates

There could be some synergy benefits from lower interest costs

We believe this merger could result in lower interest cost for JSW ISPAT debt. Currently average cost of debt for JSW ISPAT is close to 15%, while the same for JSW Steel is close to 7.5%. This could result in savings of close to INR3.5bn and an increase in net profit of INR2.5bn, assuming interest cost on debt of JSW ISPAT comes down to 10%.

Appendix A-1

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JSW Steel	JSTL IN	INR 689	29-Aug-2012	Neutral	Not rated	A4,A5

A4 A Nomura Group Company had an investment banking services client relationship with the issuer during the past 12 months.

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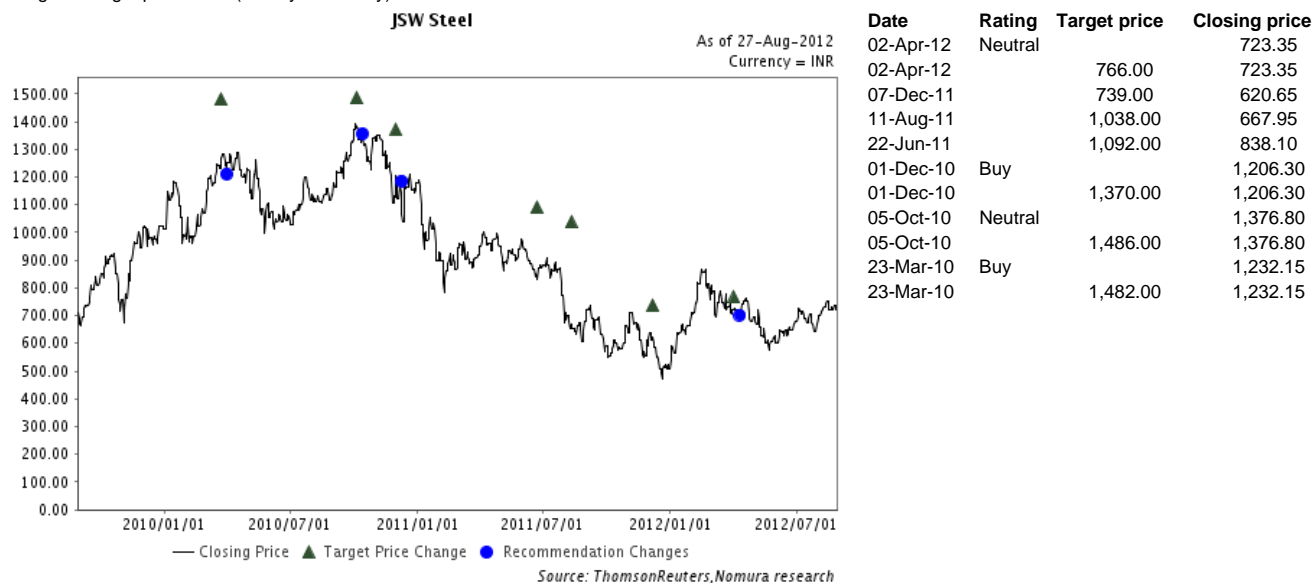
Previous Rating

Issuer name	Previous Rating	Date of change
JSW Steel	Buy	02-Apr-2012

JSW Steel (JSTL IN)

INR 689 (29-Aug-2012) Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price is INR766, based on sum of the parts valuation. We value JSW Steel at 5.5x FY13F consolidated EV/EBITDA at INR754/share and valued its 49.3% stake in JSW ISPAT at INR2/share (JSW ISPAT valued at 5x FY13F EV/EBITDA) and 4.75% stake in JSW Energy at INR10/share (JSW Energy valued at INR60.5bn).

Risks that may impede the achievement of the target price Upside risks include: 1) Stronger-than-expected steel prices: We expect steel prices to come down by 5-8% in India. In case of stronger prices, there is an upside risk to our estimates. 2) Weaker-than-expected raw material prices: we expect iron ore prices to fall by 8-10% and coking coal prices to fall by INR 2-3%, in case prices are weaker than expected, there could be a risk to estimates. Downside risks include: 1) Risks of JSW ISPAT merger with JSW Steel: JSW ISPAT remains a loss making company and if merged with JSW Steel would be a downside risk in our view. 2) Iron ore situation worsens in Karnataka: Karnataka has seen frequent delays in restarting of mining and in case of further delay, product could be hampered.

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Explanation of Nomura's equity research rating system in Japan and Asia ex-Japan

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