3rd October 2018

JSW STEEL LTD (JSTL: IN) **BUY / Target Price ₹ 435 (27% Upside)**

Industry	Iron & Steel
Sector	Materials
Recommendation	Buy
CMP (2nd Oct'18)	389.1
Target Price	435
52 Week High/Low	237.60/427.55
Nifty	11008
Sensex	36526
Key stock data	
Bloomberg code	JSTL:IN
No of shares out	2.42B
Market cap (INR)	923B
30 day avg volume	9846809
P/B	3.29
P/E	14.83
Share holding (%)	
Promotors	37.89%
DII & MF	14.37%
Others	27.25%
FII	20.49%

Source: Bloomberg

Strong results; stepping up capex buoyed by demand

Executive Summary

- JSW Steel (JSTL) has delivered very strong performance (2QFY19 consol. EBITDA of INR49.1b) driven by sharp expansion in spreads and improving domestic demand.
- JSTL has sharply increased planned capex by INR176bn to INR444bn. This will increase its steel capacity from 18mt to 24.7mt (earlier 23mt), increase its value-add product mix and further improve its raw material integration by FY20-21E.
- Domestic steel demand witnessed strong growth in FY18 after long-period of lull. Global demand outlook has also improved, while at the same time the supply side is more favourable.
- JSTL deserves higher valuation multiple for efficient opex, capex, lower volatility in margins and aggressive growth. Its balance sheet is strong with net debt/EBITDA ratio of less than ~3x. We recommend "Buy" for the stock with a Target Price of 435 per share.

KEY HIGHLIGHTS

Backward integration

The company is planning on backward integration to achieve cost reduction. In line with this aim, the company has acquired five iron ore mines in Karnataka with a total reserve of 111 million tonnes and will meet 20% of the demand at Vijayanagar Works (the company's largest plant – 66% of total installed capacity).

Increasing demand of steel

Domestic steel demand is projected to grow at 5.5% compared to global demand which will grow at 1.8% over the next year. Per capita consumption is expected to rise from 12.11 kg to 14 kg for finished steel by 2020. Policies like Food for Work Programme, Indira Awaas Yojana, Pradhan Mantri Gram Sadak Yojana and Affordable Housing will drive the demand. Higher transparency through Real Estate Regulation and Development Act will increase housing demand. Increasing demand from large scale infrastructure projects and automobile industry will provide a significant boost to the sector.

Deleveraging

One of the key strategies of JSTL was to deleverage during 2017-18. This has improved credit ratings and showed up in stronger profits. The free up cash Flow were planned to be used in expansion and in projects with accretive returns. It reduced its consolidated debt by Rs. 3529 crore on a consolidated basis in FY18-19 while diversifying sources of funding. The capex spending plan for the next 3 years of Rs. 39,715 crores will be funded by debt and internal accruals to maintain debt levels within limits of 3.75x for Net Debt/EBITDA and 1.75x for Net Debt/Equity. Its capital required stands at less than $600/MT, which is the best in the industry.

Mergers and Acquisitions

The company has been expanding aggressively through the inorganic route to gain presence in key geographies and hedge against the growing protectionist environment. They acquired a 1.5MTPA steel making plant, Monnet Ispat in Chattisgarh, a strategic move to increase footprint in eastern and central markets of India. On the international front, the company acquired Acero Holdings in USA, an integrated flat steel making facility with 3MTPA capacity. JSTL also has plans to set up a Plate & Pipe mill facility at Baytown in USA. The company has also announced plans acquiring Aferi, an Italian steelmaker with a capacity of 1.3 MTPA.

Improvement of Credit ratings

The credit rating agency CARE has revised the rating of the company's long-term bank facilities and non-convertible debentures from 'CARE AA-/Negative' to 'CARE AA-/Stable'. They also reaffirmed the ratings on short-term bank facilities and commercial paper at 'CARE A1+'.

International Steel Industry:

Key Highlights:

Chinese steel demand increased due to higher real estate investment:

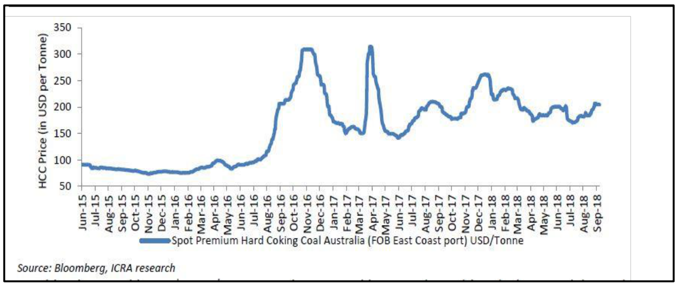
Steel consumption in China grew over 8% YOY in the first half of CY2018, against a flat growth prediction by the World Steel Association. This increase in demand is attributed to the rise in the real estate investment in China. Q2 CY2018 steel demand has grown over 7.1% y-o-y compared to the Q1 CY2018 growth which was just 5.4%. This shows that the steel demand in China has considerably increased. This has helped the worlds capacity utilization to improve to 77%. Also, overall Chinese exports stood at a lower level of 41.3MT for the 7-month period of the CY.

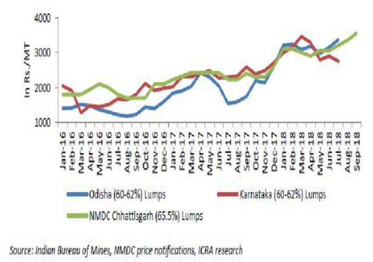
India turned a net importer in Q1 FY2019:

Steel consumption in India raised to 9.2% for Q1 209 compared to the 7.9% recorded in FY 2018. This growth in demand has been set by key consumer sectors like automobile & construction sector. Government's continuous emphasis on infrastructure will push steel usage in the coming months. Higher consumption of steel by domestic demand has decreased the exports by 33% and increased the steel imports by 11%, thus India turned a net importer of steel in Q1 2019. However, with rupee depreciating, the expectation is that imports will be muted. Due to seasonally weak demand, the domestic HRC is being priced at discount of 40$/MT against imports. This is expected to drive the domestic consumption.

Rise in raw material prices:

China raised its import demand for coking coal with the aim of increasing production before it starts the annual winter production cuts. This has led to increase in the prices to 184 $/MT in august compared to 173$/MT levels in July. Chinese imports of coking coal have increased over 23% YOY. This increase in coke prices has increased the cost of steelmaking to Rs630/MT. Once the winter shutdowns are fully implemented, moderation in the coke prices will occur.



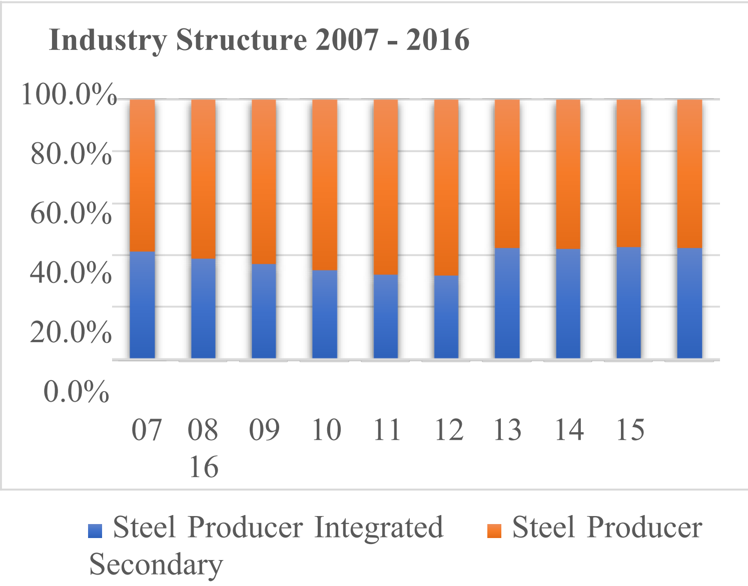


Policy Change in Winter Shutdown Policies:

China being the primary producer of steel, contributes around 50% of the worlds steel production. Steel industry is one of the primary causes of high pollution levels. With high levels of pollution, the Chinese government has decided to mandatorily shutdown production between 30%-50% of the production capacity in its northern provinces. Recently, the ministry of ecology and environment has changed the winter shutdown policy by allowing local provincial authorities to take the call on the shutdown based on local pollution levels. This can change the dynamics of the steel market as this can potentially increase the level of steel output from china thereby driving the steel prices down.

Domestic Steel Industry:

Introduction:



Integrated Steel Producers are firms which are present throughout the value chain of the industry.

Secondary Steel producers, either use sponge iron and scrap steel as their inputs and produce finished products. Till 2012 the growth of the secondary steel producers has been phenomenal, and they have contributed to 68% of the steel production. But the aftermath of the 2012 coal scam created a lot of uncertainties which led to the production growth from the integrated players as they could cope up with the uncertainties. Currently integrated steel producers contribute to over 42% of the steel production.

Integrated Steel plants are present right from iron ore mining to intermediate crude steel production till the production of the finished steel. Some of the integrated steel producers in India include Tata Steel, JSW Steel, SAIL, RINL etc.

Demand Outlook:

Steel sector demand drivers have been mainly associated with the following industries:

(1) Infrastructure
(2) Engineering and Fabrication
(3) Automotive

Infrastructure:

The union budget of 2018-19 has allocated INR 5.94 Lakh Crore for infrastructure. This is 20.9% higher than the 2017-18 infrastructure budget of INR 4.97 Lakh crore. Construction GVA has improved in the last few quarters, with the last quarter growing over 11% is a good sign of the boom in the infrastructure space. With the value of new projects launches reducing, the one important factor which shows signs of revival is the reduction in the value of the stalled projects. With increased government spending in the year before the general elections, we can expect the infrastructure sector to grow.

Source: CSO, ICRA research

(Rs. trillion)	Sep-17	Dec-17	Mar-18	Jun-18
New projects	1.32	1.52	3.44	2.33
Completed projects	1.26	1.16	1.57	0.93
Stalled projects	0.69	0.88	3.44	0.31
Revived projects	0.34	0.24	0.27	0.28
Implementation stalled projects	0.78	0.71	1.92	0.04

Source: CMIE, ICRA research

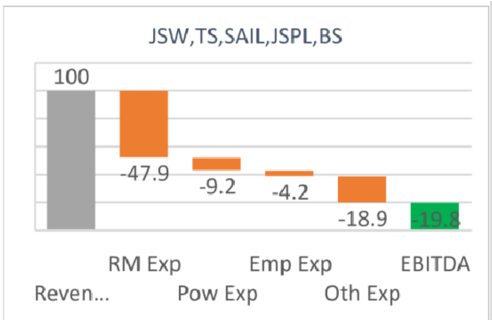
Engineering & Fabrication:

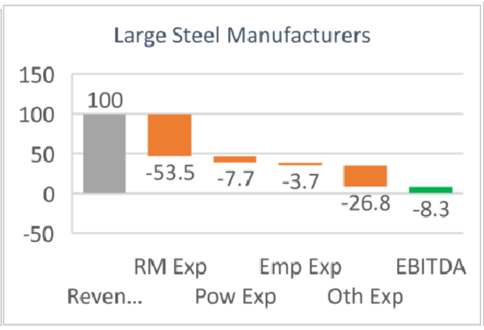
The sector which comes under this section comprises of capital goods, consumer durables, electrical goods & defense systems. Galvanized steels & HRC are used in bulk in these sections. CARE ratings predict that this section will grow somewhere between 6.5% to 8.5% y-o-y because of the expected increase in the domestic consumption. The growth in the capital goods sector improved to 9.7% in June from 6.7% from march levels which also shows good signs of improvement. Over 30% of the steel demand is being driven by this section and hence we can expect the steel sector to grow. The growth in the capital goods sector improved to 9.7% in June from 6.7% from march levels.

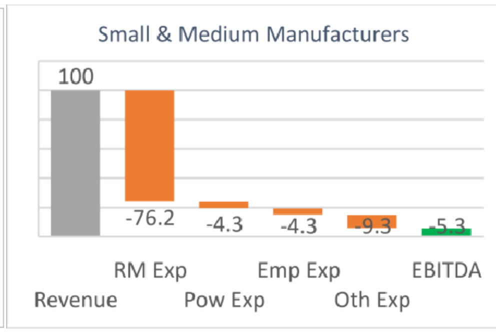
Automotive:

Flat steel segment is primarily consumed in the automotive sector. Steel forms one of the highest cost components for the auto sector. Flat steel like HRC finds its use in the wheel disc segment and other flat steel segments like CRC & galvanized coils finds its use in body, roof & door. Strong growth reported cross the two-wheeler, three-wheeler & commercial vehicle segments resulted in the total vehicle sales growth increasing to 16.9% in 4 MFY 2019 from 14.5% in FY 2018. It is expected that the two-wheeler segment sales will grow between 17-19%, passenger vehicle & commercial vehicle segments will grow in the range of 8-10% & 18-20% respectively. Thus, we can expect that the auto sector will drive the steel segment. Considering the individual demand driver segment growths for the year 2018-19, we expect the Steel segment to grow between 6-8% in FY2019.

Cost structure of the industry:







The analysis of the cost structure clearly indicates that economies of scale has a major impact and integrated players outperform others.

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Company overview:

Healthy product mix

Flat products comprise 71% of the revenues of which hot rolled contribute 39%, cold rolled 17% and galvanized steel comprise the rest. 45% growth in sales of flat products is attributed to growth in automobile sector. JSM is taking multiple initiatives in brand building of its TMT bars as JSW Neosteel, JSM Coluron + (Color Coated) and JSW Everglow (Color Coated). JSW Colouron+ continues to be the leading colour coated brand in India with considerable market share. JSW's long products comprise remaining part of the revenues. Their trademark product JSW Neosteel TMT bars has a huge market and is used in major projects like railways, aerospace, defense, expressways and highways. The company has recently launched JSW Everglow, a new product in steel roofing segment, also providing a 10-year paint warranty. Color coated products constitute 4% of their product portfolio but it saw an increase in 26% in sales.

Tech and R&D

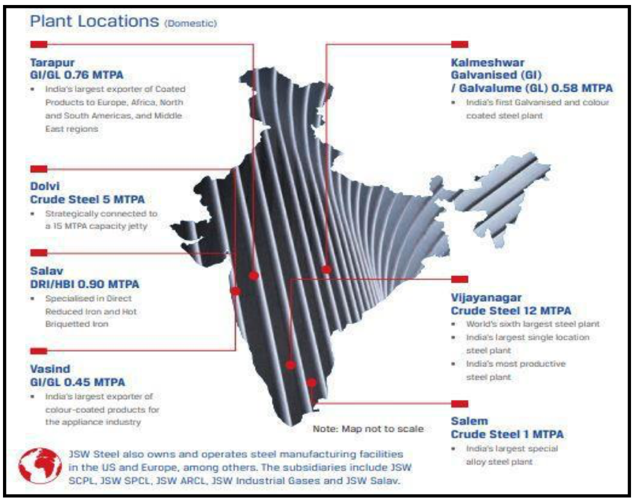
At JSW's Dolvi Works, India's first CONARC (CONverter ARChing) process was implemented. JSW is the first company to get the license for using this technology from BIEC International, USA. It has also entered into technological collaboration with JFE Steel Corp, Japan to manufacture advanced high-strength steel for automobile sector and JV with Marubeni-Itochu Steel Inc., Japan to set up contemporary steel processing centres. It has developed or customized 73 new grades with an expenditure of Rs. 41 crore R&D and a total of 16 patents were filed during the year FY17-18. The company also actively focusses on Industry-Institute partnership, it's R&D department is actively involved in research projects in collaboration with IIT-Bombay/Madras/Kanpur, NMDC and NITK-Surathkal.

Capex focus are on capacity expansion, cost saving and value addition downstream projects:

JSW Steel has a planned capex of Rs. 44,415 crores for its domestic operations. The focus areas are capacity expansion and modernization of downstream business. Of this planned capex, Rs. 4700 crores has already been incurred in 2018-19. Rs. 21,700 is planned on upstream projects, completion of which will enhance the overall crude steel production to 24.7 MTPA, from current capacity of 18 MTPA by FY2020. Also, 5292 crores were earmarked for downstream. Completion of downstream expansion will increase value added capacity to 8.7 MT form a current capacity of 5.5 MT. Multiple cost savings projects have also been taken up like 8MTPA pellet plant to reduce dependency on more expensive iron ore, captive power plants, coke ovens and pipe conveyor, amounting to INR 12069 Crores.

The Groups' units at Dolvi and Vijayanagar are eligible for VAT/CST deferral/refund scheme and have accounted for government grant on ICICI Securities Ltd | Retail Equity Research Page 7 basis of SGST rates instead of VAT rates in accordance with the notification issued by the two states post implementation of GST. The group has recognised grant income of |309 crore and |618 crore respectively for Q2FY19 and H1FY19.

Plant Location:



Capacity expansion roadmaps and key projects:

PARTICULARS	CURRENT CAPACITY (MTPA)	TARGETED CAPACITY (MTPA)	TIMELINE
Ramp up total capacity	12	13	December – 2019
Product-category wise break-up			
Flat Products	8.2	8.8	December – 2019
Long Products	2.8	4.0	July – 2019
CRM1 complex capacity expansion	0.85	1.8	December – 2019
Colour Coating line	-	0.3	October - 2019

Financials:

JSW Steel has strong sales and EBITDA growth showing a positive trend (in the last 15 years) with consistent performance through economic cycles

	FY2002	FY2010	FY2017	
Capacity (MTPA)	1.6	7.8	18.0	CAGR FY2002–FY2017: 18% Capacity increased to 18MTPA in Mar 2016
Production (MTPA)	1.3	6.0	15.8	CAGR FY2002–FY2017: 18%
Revenue (USD mn)	268	3,006	9,336	CAGR FY2002–FY2017: 27%
EBITDA (USD mn)	43	641	1,878	CAGR FY2002–FY2017: 29%
EBITDA/ton[1] (USD/ton)	34	112	128	CAGR FY2002–FY2017: 9%
Market Cap (USD mn)	81	3,565	7,016	Significant value creation with 86x increase in market value[2]
Technology	Corex	Corex, BF	Corex, BF, DRI	Combination of industry leading technologies
Product Mix	Flats	Flats, long, special steel and value added	Flat, long, special steel & high value-added auto, electrical grade	Continuously expanding product canvas with focus on high-end value-added products

Figure 4: Company Financials Table; Source: Investor Report Feb 2018

The market cap has grown significantly over the past 15 years from 81mn to 7016mn USD creating long term wealth for the investors. It has focused its efforts on R&D to continuously update its product mix and produce value added steels which in turn contributes to higher margins. Exports contribute 10% to the total revenue mix for the company.

The company has achieved significant growth in terms of volume of sales, revenue, PAT, EBITDA over the years

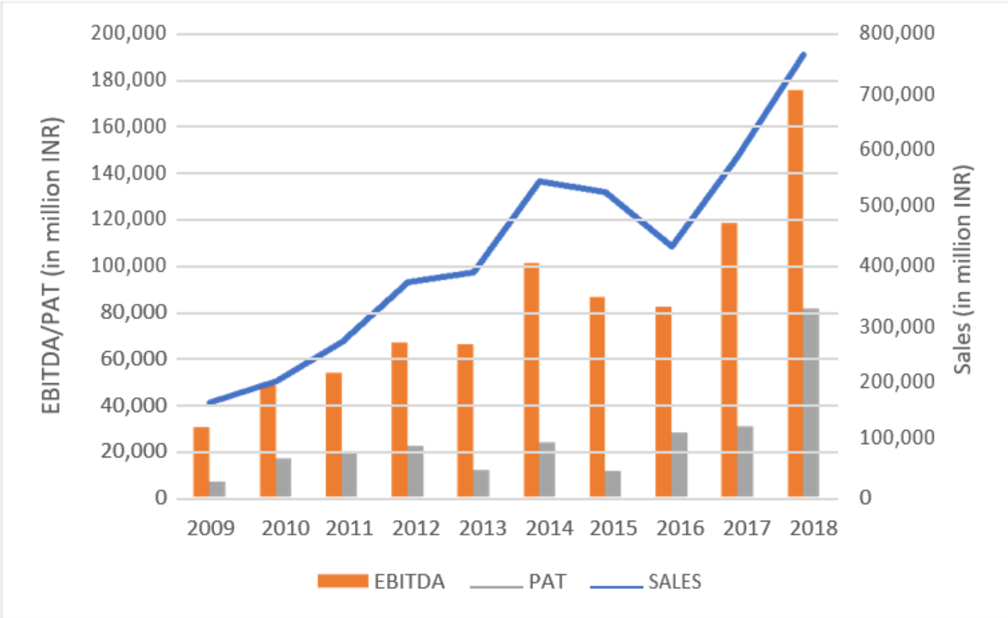


Figure 5: Sales, EBITDA, PAT. Source: EquityLevers

It has healthy return ratios with a long-term average ROE of 17%; consistently above the ROE of other peers

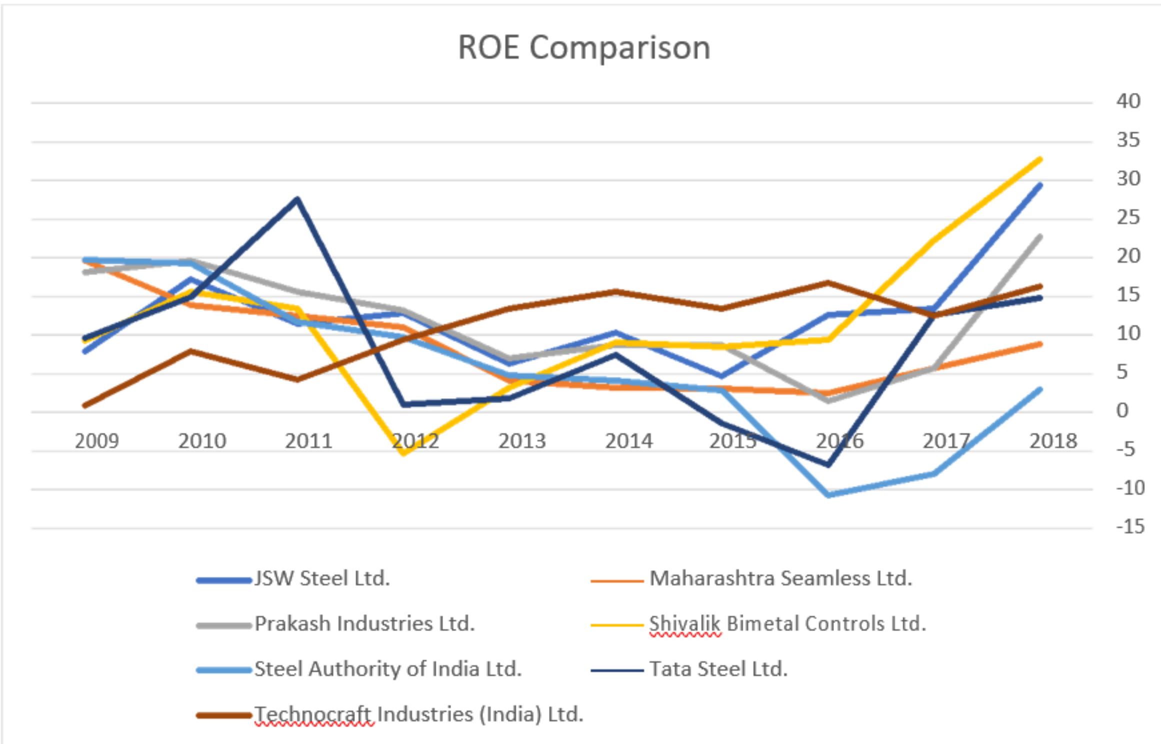


Figure 6: ROE Comparison with peers, Source: EquityLevers

Valuation:

JSW Steel Ltd.	Latest Quarter: Mar'18		All values in Rs. Millions unless mentioned			
Particulars	**2021E**	**2020E**	**2019E**	**2018**	**2017**	**2016**
Revenue	889,904	855,677	807,243	701,950	567,824	427,176
Sales Growth (YoY)	*4.0%*	*6.0%*	*15.0%*	*23.6%*	*32.9%*	*-19.4%*
EBITDA	177,981	171,135	169,521	149,610	124,119	65,815
Ebitda Margin	*20.0%*	*20.0%*	*21.0%*	*21.3%*	*21.9%*	*15.4%*
Interest	41,250	38,500	35,750	37,010	37,681	36,012
Depreciation	38,279	37,003	35,089	33,870	35,154	33,226
Profit Before Tax	98,452	95,633	98,682	78,730	51,284	(3,423)
Tax	32,095	31,176	32,170	15,380	16,743	(19,662)
Adj Profit After Tax	66,357	64,456	66,512	63,770	34,673	16,447
Profit Margin	*7.5%*	*7.5%*	*8.2%*	*9.1%*	*6.1%*	*3.9%*
Profit Growth (YoY)	*2.9%*	*-3.1%*	*4.3%*	*83.9%*	*110.8%*	*-5.9%*
Earnings Per Share (In Rs)	27.5	26.7	27.5	26.4	14.3	6.8
Valuation & Other Ratios						
PE (x)	12.1	12.5	12.1	12.8	14.4	19.3
PB (x)	1.8	2.0	2.4	3.0	2.2	1.5
PS (x)	0.9	0.9	1.0	1.2	0.9	0.7
EV/Ebitda (x)	6.3	6.6	6.6	7.6	6.9	10.0
ROE	14.5%	16.3%	19.8%	23.2%	15.5%	7.6%

Methodology

We followed a conservative approach in valuing the stock, the growth projections for 2019 are estimated to be 15%. Then the growth has been toned down to 6.0% and 4.0% further keeping in mind the volatility of the steel demand and the prices. The capex plan of 44400 crores is spread over FY18-21. The total interest cost assumed to be 11.0% in line with the expectations that interest rates may rise. We have considered the dollar value of debt, as can be observed in the table above. Company is reducing its debt from the cash flow, we projected interest costs to rise due to rupee depreciation. The EBIDTA margins are estimated to be 20% as the company is taking up various initiatives to bring down the cost by the way of acquiring captive mines of Iron ore and coking coal domestically and internationally, streamlining the procurement activities, adopting new technologies to reduce the input costs. Despite the conservative approach, we find that the stock has a potential upside of 27%

The stock has outperformed Nifty Index and Nifty Metal Index consistently from 2016

STOCK PRICE

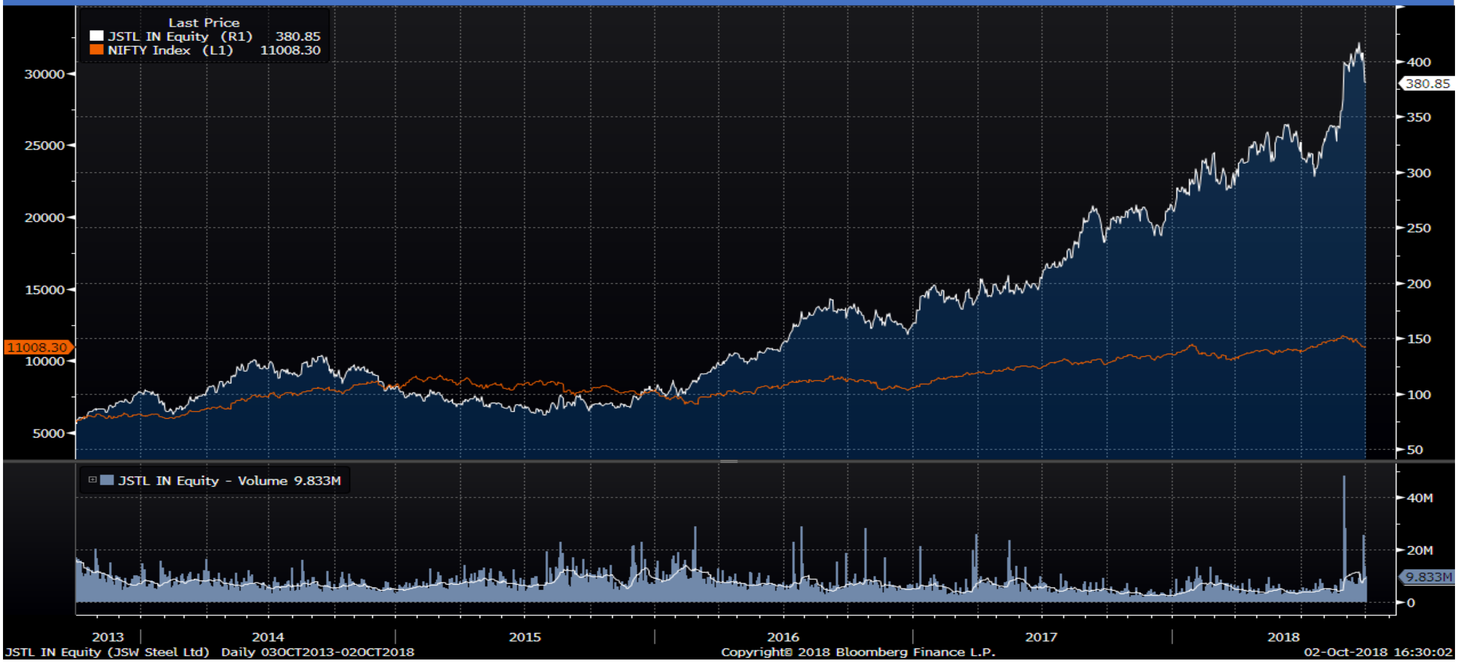


Figure 7: Stock Price JSW vs. Nifty; Source: Bloomberg

Recommendation

Latest Price	342.75	
Market Cap (in Cr)	92300	
Valuation Method	DCF	EV/EBITDA
Target Price	435	441
Upside	26.91%	28.66%

RISKS

Challenges:

Rise in trade barriers due to increase in protectionist trade

Trade barriers are increasing globally due to increase in protectionist trade measures taken up by governments worldwide to safeguard their domestic industries. India has now 53 trade actions on iron and steel with US imposing 25% duty on steel imports. To shield itself from losing these trades, JSW entered into accretive acquisition in overseas market to adopt the low-cost capital model to curtail the higher operating costs. However, the concern remains that although India's export constitutes just 2% in this industry, increase in imports, mainly through the Free Trade Agreements might hurt the domestic steel companies given the high price disparity i.e. an impact of 15% on domestic ex-mills prices.

Geopolitical risk

JSW has reduced exports from 26% in FY17 to 23% in FY18 to reduce geopolitical risk and focus on the domestic market. They have also reduced dependence on imports of coking coal and are using a state-of-the-art blend management system to use low grade coals instead of premium coking coal.

Cyclicality: Steel industry being a cyclical industry, the demand rises and falls over time. It is very hard to sustain continuous profit over a long-time horizon in this industry.

Interest rate and currency depreciation:

The upward trend in the global interest rate cycle combined with rupee depreciation could hurt the profitability and cash flows of the company.