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UPDATE

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**India Steel—on a recovery path.** Indian steel markets started FY2017 on a weak note with muted demand (+4%) due to lower off-take from the construction sector. Trade protection measures remain effective and have largely curtailed steel dumping. The recent weakness in global steel and raw material prices has led to correction in Indian steel prices and will affect operating margins in 1QFY18, especially due to high cost coal inventories. The quarter aside, we expect earnings of steelmakers to gain from anti-dumping duties, falling raw-material prices and improving demand-supply equation in India. We maintain ADD on TATA, JSTL and BUY on JSP.

#### **FY2017 starts with subdued steel demand (+4%)—construction sector lagging behind**

The steel demand in FY2017 again started on a weak note with a growth of mere 4% for April – May 2017 (to 13.8 mn tons), after muted 2.6% growth in FY2017. Demand was weak from the construction sector as off take of bars/rods and structural were flat yoy at 6.9 mn tons—we believe this largely reflects subdued off take from the real estate sector. The off take from railways has picked up (+52% yoy) which we believe is led by higher capital outlays including those in city metro rails. The demand though has increased strongly for flat products (HR coils, CR coils, etc.) by 11% yoy to 5.5 mn tons during the period. We note that end consumption of flat products is in autos, appliances, pipe manufacturing, railways, engineering, machinery, etc. which appears to be faring better than the construction sector.

#### **Steel imports remain low on trade protection measures, exports increase on higher production**

Steel imports to India remained low in May 2017 at 604,000 tons, down 2% yoy and considerably lower than almost +1 mn tons/month before trade protection measures were put in place. Imports, especially from China, declined to 100,000-150,000 tons per month from peak of 300,000-400,000 tons per month in FY2016.

Steel exports though have risen over past few months to ~700,000 tons (per month) on rising production from Indian steelmakers and weak domestic demand. Production increased by 7% yoy for April – May 2017 due to capacity ramp-up by large names including Essar Steel, JSW Steel, Tata Steel, Jindal Steel & Power. We expect exports to remain high in FY2018E given higher production by almost all large steel makers.

#### **Prices—raw materials correct and so do steel prices; higher cost inventories to impact 1QFY18**

Spot domestic HRC prices have corrected 7-10% from 4QFY17 though rebar prices increased. We estimate ₹2,000-2,500/ton qoq decline in flat steel realization in 1QFY18 and ₹500-1000/ton increase in longs realization. The fall in flat product prices is largely on account of lower import offers while firm long prices reflects weak prices in previous quarters due to subdued demand. We believe 1QFY18 will see lower operating margins for steel names due to lower realizations while costs may increase on account of high cost carry over coal inventories.

#### **Near term weakness aside, we believe multiple tailwinds will aid earnings of steelmakers**

The decline in domestic steel prices reflects the fall in global steel prices led by lower raw material prices and passing of steel restocking phase in China. We expect earnings of domestic steel companies to benefit from three factors (1) safety net of anti-dumping duties augur well as it provides a floor to domestic steel prices as companies also benefit from falling raw-material prices (iron-ore, coal), (2) low investment in new steel projects for past three years will result in improving demand-supply balance in domestic steel markets, and (3) large companies are gaining at the expense of fragmented names with stretched balance sheets and low operating rates. We have ADD rating on Tata Steel, JSW Steel and BUY on Jindal Steel & Power.

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### Steel demand – supply scenario is improving in India

The lack of large new projects due to stretched balance sheets of most steel names may prove a blessing in disguise for the sector over the next three to five years. Save for JSW Steel's recently announced 5 mtpa capacity expansion (which is capable to catering to export markets as well given it is on a port based plant), steel capacity additions in India will remain muted over next three to four years resulting in improvement in operating utilization rates and increased ability of steelmakers to direct more steel to domestic markets (which is more profitable due to duty protection) than export markets.

We highlight that improved utilizations, especially beyond 85% will benefit steelmakers by lessening price competition—this will result in increased ability of steelmakers to command higher premium on import offers thereby adding to the bottom line.

**Exhibit 1: Steel demand growth was weak at 4% in April - May 2017; low capacity additions augur well for utilizations over next 2-3 years**  
Trend of finished steel production and consumption, March fiscal-year ends, 2011-20E (mn tons)

|                                 | 2011        | 2012        | 2013        | 2014        | 2015        | 2016        | 2017        | 2018E       | 2019E       | 2020E        | YTD            |                |            |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------|----------------|----------------|------------|
|                                 |             |             |             |             |             |             |             |             |             |              | Apr - May 2017 | Apr - May 2016 | Change (%) |
| <b>Steel capacity (crude)</b>   | 80.4        | 89.3        | 91.7        | 92.7        | 101.9       | 109.1       | 117.1       | 119.2       | 122.2       | 122.2        |                |                |            |
| <b>Finished steel capacity</b>  | 73.9        | 83.9        | 83.4        | 86.2        | 93.7        | 100.4       | 104.2       | 106.1       | 108.8       | 108.8        |                |                |            |
| Production                      | 68.6        | 75.7        | 81.7        | 85.0        | 90.7        | 91.0        | 100.7       | 103.1       | 109.2       | 113.1        | 17.5           | 16.4           | 6          |
| Less: Double counting           | 4.0         | 6.4         | 11.1        | 10.3        | 15.9        | 15.8        | 16.2        | 14.1        | 15.0        | 15.9         | 2.8            | 2.7            | 2          |
| <b>Net production</b>           | <b>64.6</b> | <b>69.3</b> | <b>70.6</b> | <b>74.8</b> | <b>74.8</b> | <b>75.2</b> | <b>84.5</b> | <b>89.0</b> | <b>94.2</b> | <b>97.2</b>  | <b>14.7</b>    | <b>13.7</b>    | <b>7</b>   |
| Add: Imports                    | 7.1         | 6.9         | 7.9         | 5.4         | 9.3         | 11.7        | 7.2         | 5.5         | 6.0         | 6.0          | 1.1            | 1.2            | (11)       |
| Less: Exports                   | 3.5         | 4.6         | 5.3         | 5.6         | 5.5         | 4.1         | 8.2         | 5.3         | 5.4         | 2.4          | 1.4            | 0.7            | 102        |
| <b>Assumed consumption</b>      | <b>68.3</b> | <b>71.6</b> | <b>73.2</b> | <b>74.6</b> | <b>78.6</b> | <b>82.8</b> | <b>83.5</b> | <b>89.3</b> | <b>94.9</b> | <b>100.8</b> | <b>14.4</b>    | <b>14.2</b>    | <b>1</b>   |
| Stock change                    | 1.9         | 0.6         | (0.3)       | 0.7         | 1.6         | 1.3         | (0.1)       | 0.5         | 0.5         | 0.5          | 0.6            | 1.0            |            |
| <b>Consumption</b>              | <b>66.4</b> | <b>71.0</b> | <b>73.5</b> | <b>73.9</b> | <b>77.0</b> | <b>81.5</b> | <b>83.7</b> | <b>88.8</b> | <b>94.4</b> | <b>100.3</b> | <b>13.8</b>    | <b>13.2</b>    | <b>4</b>   |
| <b>Capacity utilization (%)</b> | <b>87.4</b> | <b>82.6</b> | <b>84.6</b> | <b>86.7</b> | <b>79.8</b> | <b>74.9</b> | <b>81.1</b> | <b>83.9</b> | <b>86.6</b> | <b>89.4</b>  |                |                |            |
| <b>Growth (%)</b>               |             |             |             |             |             |             |             |             |             |              |                |                |            |
| Production                      | 12.5        | 7.3         | 1.8         | 6.0         | 0.0         | 0.5         | 12.4        | 5.3         | 5.8         | 3.2          |                |                |            |
| Consumption                     | 11.9        | 7.0         | 3.4         | 0.6         | 4.2         | 4.6         | 2.6         | 6.1         | 6.3         | 6.3          |                |                |            |

Source: Joint Plant Committee, Ministry of Steel, , Kotak Institutional Equities estimates

**Exhibit 2 : The long product demand remains weak while flat segment is faring better**  
Product wise steel consumption in India, 2016- 2017 ('000 tons)

|                         | Apr- May 2017 | Apr- May 2016 | Change (%) |
|-------------------------|---------------|---------------|------------|
| Bars & rods             | 5,691         | 5,654         | 1          |
| Structurals             | 1,225         | 1,244         | (2)        |
| Railway materials       | 179           | 118           | 52         |
| <b>Sub-total--longs</b> | <b>7,095</b>  | <b>7,016</b>  | <b>1</b>   |
| HR coils & sheets       | 2,642         | 2,171         | 22         |
| Plates                  | 638           | 637           | 0          |
| Others                  | 2,254         | 2,194         | 3          |
| <b>Sub-total flats</b>  | <b>5,534</b>  | <b>5,002</b>  | <b>11</b>  |
| Alloy steel             | 1,166         | 1,217         | (4)        |
| <b>Total</b>            | <b>13,795</b> | <b>13,235</b> | <b>4</b>   |

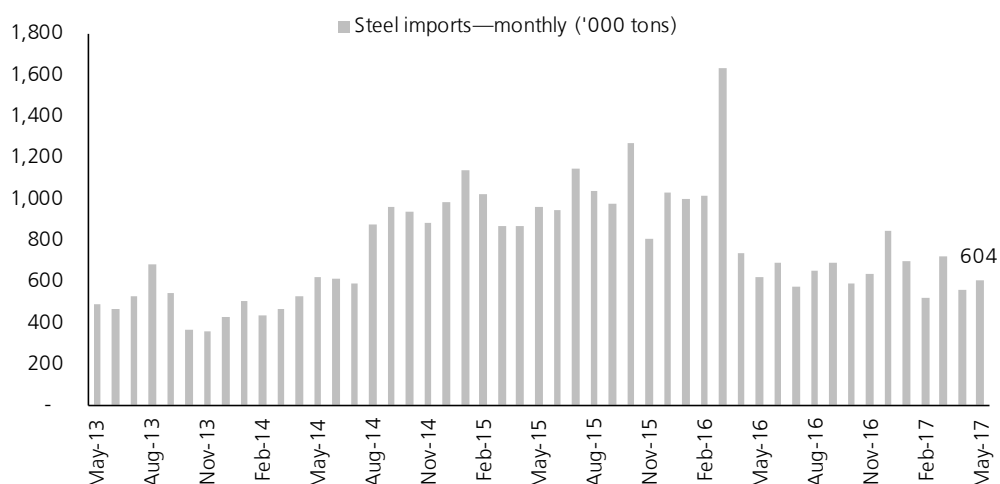
Source: JPC, Kotak Institutional Equities estimates

**Exhibit 3: Steel imports in India remained at low levels (500-600 kt per month) post imposition of trade protection measures**  
 India's steel production, consumption and trade volumes, March fiscal year-ends, 2016-17 ('000 tons)

|                 | Apr-16     | May-16     | Jun-16     | Jul-16     | Aug-16     | Sep-16     | Oct-16     | Nov-16     | Dec-16     | Jan - Feb 2017 | Mar-17     | Apr-17     | May-17     | YTD Change (%) |
|-----------------|------------|------------|------------|------------|------------|------------|------------|------------|------------|----------------|------------|------------|------------|----------------|
| China           | 205        | 146        | 159        | 196        | 175        | 200        | 144        | 179        | 300        | 368            | 92         | 99         | 144        | (2)            |
| Japan           | 118        | 51         | 136        | 96         | 112        | 51         | 84         | 87         | 102        | 159            | 147        | 85         | 82         | 63             |
| Korea           | 209        | 124        | 194        | 151        | 155        | 224        | 161        | 219        | 245        | 310            | 178        | 193        | 180        | 44             |
| Russia          | 53         | 76         | 40         | 15         | 6          | 25         | 2          | 7          | 5          | 45             | 15         | 20         | 35         | (54)           |
| Other countries | 148        | 221        | 164        | 119        | 199        | 189        | 195        | 143        | 189        | 335            | 288        | 164        | 163        | (26)           |
| <b>Total</b>    | <b>733</b> | <b>618</b> | <b>693</b> | <b>576</b> | <b>648</b> | <b>690</b> | <b>587</b> | <b>634</b> | <b>841</b> | <b>1,218</b>   | <b>720</b> | <b>561</b> | <b>604</b> | <b>(2)</b>     |

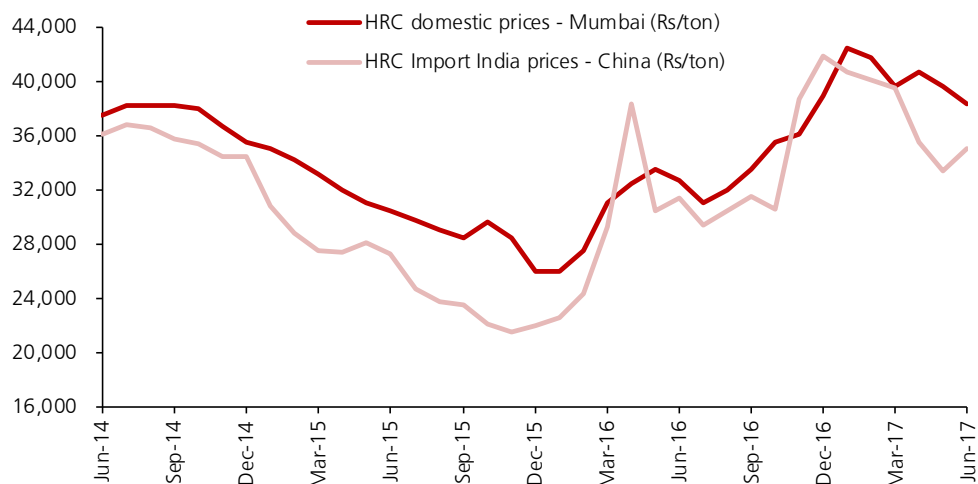
Source: JPC, Kotak Institutional Equities estimates

**Exhibit 4: Steel imports in India has declined to ~600 kt per month now**  
 Monthly steel imports in India from various countries, 2013 - 2017 ('000 tons)



Source: JPC, Kotak Institutional Equities estimates

**Exhibit 5: Domestic HRC prices have corrected by 7-10% in June 2017 from previous quarter**  
 Comparison of domestic HRC steel prices and CIF prices from China, Calendar year-ends, 2014-17



Source: CRU, Bloomberg, Kotak Institutional Equities estimates

### Anti-dumping duties to provide floor to domestic steel prices; lower coking coal prices are beneficial for Indian companies

The anti-dumping duties set a floor for domestic steel prices as the difference between the (1) landed cost of imports (CIF value and basic custom duty of 12.5%) , and (2) anti-dumping duty price of US\$474-489/ton (for HR coils) will be payable to the government as anti-dumping duty amount. This essentially means that domestic prices will be above the floor of US\$474-489/ton (and cost of local freight & domestic premia).

Given the duty structure freezes the floor to the steel prices (for flat products), the lower raw-material cost is beneficial for domestic steel companies and vice versa. The recent fall in coking coal prices augurs well for domestic steelmakers.

**Exhibit 6: Steel margins of steelmakers will be protected even if China prices fall; low coking coal prices is beneficial for Indian companies**  
Changes in domestic steel post anti-dumping duty & coking coal prices and impact on steel spreads (US\$/ton, Rs/ton)

|  | 4QFY17  | Spot markets | Other scenarios |        |        |
|--|---------|--------------|-----------------|--------|--------|
| China HRC export prices (US\$/ton)                               | 504     | 450          | 430             | 400    | 385    |
| Add: Freight & other import costs (US\$/ton)                     | 22      | 21           | 20              | 19     | 19     |
| Add: Custom duty @ 12.5% (US\$/ton)                              | 68      | 61           | 58              | 54     | 52     |
| Landed cost of imports (US\$/ton)                                | 594     | 531          | 508             | 473    | 455    |
| Add: Anti-dumping duty (US\$/ton)                                | —       | —            | —               | 16     | 34     |
| Steel price as per anti-dumping duty notification (US\$/ton) (A) | 489     | 489          | 489             | 489    | 489    |
| Other import costs/premium                                       | 15      | 15           | 15              | 15     | 15     |
| Landed cost of imports (US\$/ton) (B)                            | 504     | 504          | 504             | 504    | 504    |
| INR:USD  | 67      | 64.5         | 64.5            | 64.5   | 64.5   |
| Cost of steel imports -HRC (Rs/ton) - higher of A or B           | 39,724  | 34,250       | 32,750          | 32,508 | 32,508 |
| Domestic Steel prices (C)  | 38,100  | 35,000       | 34,254          | 34,000 | 34,000 |
| Premium of domestic prices over imports (Rs/ton)                 | (1,624) | 751          | 1,504           | 1,492  | 1,492  |
| Coking coal costs for steelmakers (US\$/ton)                     | 200     | 142          | 140             | 125    | 100    |
| Consumption factor (X)   | 0.70    | 0.70         | 0.70            | 0.70   | 0.70   |
| Cost of coking coal at steel mills (Rs/ton) (D)                  | 9,366   | 6,411        | 6,321           | 5,644  | 4,515  |
| Spread between steel prices and coking coal (C-D)                | 28,734  | 28,589       | 27,933          | 28,356 | 29,485 |
| Difference   | —       | (145)        | (801)           | (378)  | 751    |

Source: CRU, Bloomberg, Kotak Institutional Equities estimates

**Exhibit 7: Our estimates factor steady EBITDA/ton for steel names over FY2018-2020E**

Profitability estimate of steel names under our coverage, March year-ends, 2016 - 2020E (mn tons, Rs/ton)

|                                 | FY2016 | FY2017 | 4QFY17 | FY2018E | FY2019E | FY2020E |
|---------------------------------|--------|--------|--------|---------|---------|---------|
| <b>Tata Steel</b>               |        |        |        |         |         |         |
| India volumes (mn tons)         | 9.5    | 11.0   | 3.2    | 12.3    | 12.5    | 12.5    |
| EBITDA/ton (Rs)                 | 7,976  | 10,826 | 13,586 | 11,143  | 11,328  | 11,575  |
| Europe volumes (mn tons)        | 14     | 10     | 3      | 10      | 10      | 10      |
| EBITDA/ton (US\$)               | (35)   | 71     | 103    | 65      | 70      | 70      |
| <b>JSW Steel</b>                |        |        |        |         |         |         |
| India volumes (mn tons)         | 12.1   | 14.8   | 4.0    | 15.5    | 16.1    | 16.6    |
| EBITDA/ton (Rs)                 | 5,252  | 7,813  | 7,586  | 8,284   | 8,284   | 8,383   |
| <b>Jindal Steel &amp; Power</b> |        |        |        |         |         |         |
| India volumes (mn tons)         | 3.3    | 3.4    | 0.9    | 4.8     | 6.4     | 6.8     |
| EBITDA/ton (Rs)                 | 7,455  | 8,532  | 9,929  | 8,670   | 8,717   | 8,891   |

Source: Companies, Kotak Institutional Equities estimates

## Exhibit 8: Metals comparative valuation

| Company                | Market cap.<br>(US\$ mn) | CMP (Rs)<br>22-Jun | Target<br>price (Rs) | Rating | EPS (Rs) |        |       |       | P/E (X) |      |       |       |
|------------------------|--------------------------|--------------------|----------------------|--------|----------|--------|-------|-------|---------|------|-------|-------|
|                        |                          |                    |                      |        | 2016     | 2017   | 2018E | 2019E | 2016    | 2017 | 2018E | 2019E |
| NMDC                   | 5,460                    | 109                | 105                  | SELL   | 7.2      | 8.2    | 9.3   | 9.6   | 15      | 13   | 12    | 11    |
| Hindustan Zinc         | 16,276                   | 253                | 265                  | REDUCE | 19.4     | 19.7   | 22.2  | 23.9  | 13      | 13   | 11    | 11    |
| Jindal Steel and Power | 1,767                    | 122                | 165                  | BUY    | (29.8)   | (24.9) | (7.4) | 7.0   | NM      | NM   | NM    | 16    |
| JSW Steel              | 7,495                    | 197                | 225                  | ADD    | (1.1)    | 14.6   | 19.1  | 20.6  | NM      | 14   | 10    | 10    |
| National Aluminium Co. | 1,890                    | 63                 | 50                   | SELL   | 2.9      | 3.7    | 3.5   | 4.1   | 22      | 17   | 18    | 15    |
| Vedanta                | 13,740                   | 234                | 300                  | ADD    | 7.6      | 19.7   | 29.9  | 36.8  | 31      | 12   | 8     | 6     |
| Tata Steel             | 7,789                    | 514                | 525                  | ADD    | (20.1)   | 41.4   | 51.3  | 60.9  | NM      | 12   | 10    | 8     |
| Hindalco Industries    | 6,831                    | 191                | 220                  | ADD    | 1.3      | 8.6    | 17.4  | 19.8  | NM      | 22   | 11    | 10    |

| Company                | EV/EBITDA (X) |      |       |       | Price/BV (X) |      |       |       | RoE (%) |      |       |       |
|------------------------|---------------|------|-------|-------|--------------|------|-------|-------|---------|------|-------|-------|
|                        | 2016          | 2017 | 2018E | 2019E | 2016         | 2017 | 2018E | 2019E | 2016    | 2017 | 2018E | 2019E |
| NMDC                   | 8.0           | 8.3  | 7.7   | 7.7   | 1.5          | 1.5  | 1.5   | 1.4   | 9       | 10   | 13    | 13    |
| Hindustan Zinc         | 10.5          | 9.1  | 6.8   | 5.6   | 2.9          | 3.8  | 3.1   | 2.5   | 20      | 25   | 30    | 26    |
| Jindal Steel and Power | 16.9          | 12.3 | 8.7   | 6.6   | 0.3          | 0.4  | 0.4   | 0.4   | (10)    | (6)  | (2)   | 2     |
| JSW Steel              | 14.0          | 7.4  | 6.7   | 6.5   | 2.5          | 2.1  | 1.8   | 1.5   | (1)     | 17   | 19    | 17    |
| National Aluminium Co. | 6.5           | 8.4  | 7.0   | 5.8   | 1.2          | 1.2  | 1.1   | 1.1   | 6       | 6    | 6     | 7     |
| Vedanta                | 9.5           | 6.9  | 5.2   | 4.2   | 1.6          | 1.5  | 1.4   | 1.2   | 6       | 14   | 18    | 20    |
| Tata Steel             | 15.4          | 7.3  | 7.0   | 6.4   | 1.2          | 1.4  | 1.4   | 1.3   | (5)     | 10   | 14    | 16    |
| Hindalco Industries    | 11.2          | 7.3  | 6.5   | 5.9   | 1.0          | 0.9  | 0.8   | 0.8   | 1       | 4    | 8     | 8     |

Notes:

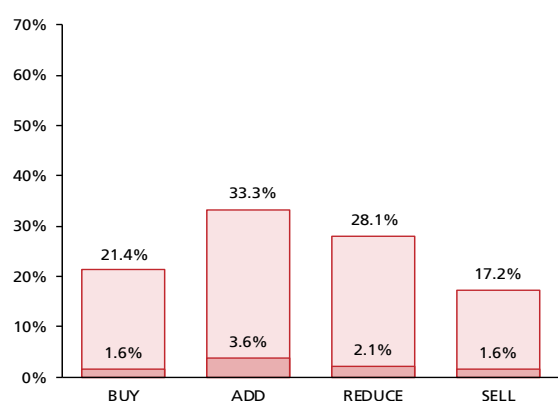
(a) EV/EBITDA for Vedanta is on attributable basis.

Source: Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of March 31, 2017

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