Prabhudas Lilladher

JSW Steel

Riding on strong growth momentum

March 26, 2010

Visit Update

Rating	Accumulate
Price	Rs1,280
Target Price	Rs1,453
Implied Upside	13.5%
Sensex	17,559

(Prices as on March 25, 2010)

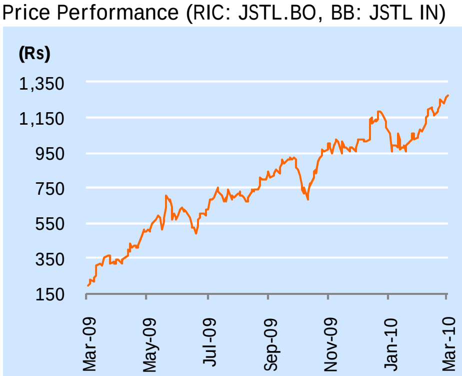
Trading Data	
Market Cap. (Rs bn)	239.4
Shares o/s (m)	187.0
Free Float	54.99%
3M Avg. Daily Vol ('000)	2,454.0
3M Avg. Daily Value (Rs m)	2,689.4

Major Shareholders	
Promoters	45.01%
Foreign	31.19%
Domestic Inst.	6.11%
Public & Others	17.69%

Stock Performance

(%)	1M	6M	12M
Absolute	20.9	59.9	538.1
Relative	13.7	54.4	462.0

Price Performance (RIC: JSTL.BO, BB: JSTL IN)



Source: Bloomberg

- **Strong demand outlook:** JSW Steel expects steel demand to remain very strong, with growth in excess of 10% for FY11. This confidence is substantiated by massive investments to the tune of US$117bn lined up by the private and public sector for FY11. The company's long product portfolio, especially *Rebar*, whose demand has been sluggish throughout the year, would get the much-needed boost on the back of the Government's reinforced thrust on infrastructure development and revival of mass housing demand.

- **Cost push of US$88 per tonne:** JSW Steel's cost of production for FY11 would go up by US$88 per tonne on account of rise of 55% and 51% in coking coal prices (impact isUS$56) and iron ore prices (impact is US$32), respectively. However, the impact of 51% increase in iron ore prices (NMDC + spot) would be reduced to 40% due to beneficiation of cheaper low-grade iron ore (59-60% Fe grade). This would result in savings of US$6 per tonne of iron ore.

- **Steady improvement in the earnings at US operations:** US operations witnessed considerable improvement in utilization rates from the level of 20% in Q3FY10 to the current level of 35-40%. Management expects EBITDA from the operations to be enough to cover up the interest cost for FY11 which is expected to be US$33m for the year.

- **Expansion program in full swing:** Company's expansion program of 3.2mtpa crude steel is progressing as per schedule, with integrated commissioning expected in March 2011. Also, Hot Strip Mill (HSM) of 3.5mtpa is likely to be operational during next week. Driven by strong iron ore prices, the company recommenced work at Chile iron mines by setting up beneficiation plant of 3mtpa at total investment of US$75m with commissioning scheduled during FY12. Company would spend Rs29bn and Rs67bn during FY10 and FY11, respectively.

- **Valuation:** Company's inability to secure captive resources diluted the volume benefit and simultaneously defied the premium valuations identical to its peers. Now, with the allocation of captive iron ore and coking coal mines, we believe that stock should attain stable and quality earnings going ahead and accordingly, valuations at par with its peers. At CMP, stock trades at P/E of 12.5x and 8.4x FY11E and FY12E, while on EV/EBITDA, it trades at 8.3x and 5.6x FY11E and FY12E, respectively. We upgrade our rating on the stock to '**Accumulate**' on the back of improved earnings quality associated with higher raw material integration and hassle-free superior volume growth, attractive returns on capital and better shaped balance sheet.

Key financials (Y/e March)	FY09	FY10E	FY11E	FY12E
Revenues (Rs m)	158,863	192,343	262,163	350,931
Growth (%)	*28.7*	*21.1*	*36.3*	*33.9*
EBITDA (Rs m)	29,333	40,498	53,995	76,173
PAT (Rs m)	8,079	12,804	19,517	28,680
EPS (Rs)	43.2	68.5	104.3	153.3
Growth (%)	*(46.8)*	*58.5*	*52.4*	*46.9*
Net DPS (Rs)	1.0	2.3	10.7	18.3

Source: Company Data; PL Research

Profitability & valuation	FY09	FY10E	FY11E	FY12E
EBITDA margin (%)	*18.5*	*21.1*	*20.6*	*21.7*
RoE (%)	*3.2*	*15.3*	*20.0*	*24.5*
RoCE (%)	*7.1*	*7.6*	*9.3*	*12.0*
EV / sales (x)	2.6	2.1	1.7	1.2
EV / EBITDA (x)	13.8	10.1	8.3	5.6
PE (x)	30.9	19.2	12.5	8.4
P / BV (x)	3.6	3.0	2.5	1.9
Net dividend yield (%)	*0.1*	*0.2*	*0.8*	*1.4*

Source: Company Data; PL Research

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Cost of production to rise by US$88

JSW Steel's cost of production in FY11 would escalate by US$88 per tonne due to 55% increase in coking coal contract prices and 51% rise in iron ore price. Company is currently procuring 63% Fe and 59% grade iron ore in the spot market at Rs3,000 (US$66) and Rs1,200 (US$26), respectively. Supplies from NMDC are currently at Rs2,186 (US$48) and management expects NMDC to increase prices by 40% for FY11 supplies to Rs2,960 (US$65).

Iron Ore Mix **(m tonnes)**

Y/e March	FY10E	FY11E	FY12E
Captive	2.0	2.0	4.0
NMDC	4.0	4.0	4.0
Third Party			
High grade (63% Fe)	5.9	3.0	0.0
Low grade (58-60% Fe)	0.0	6.5	15.5

Source: PL Research

With the commencement of beneficiation plant, we expect savings of Rs262 (US$6) per tonne of equivalent 63% Fe grade assuming 65% capacity utilisation, 75% yield and beneficiation cost of Rs225 per tonne of beneficiated ore. However, we have not assumed any contribution from new mines for FY11. While for FY12, we have assumed contribution of 2m tonnes from the new mines.

Source-wise cost break-up

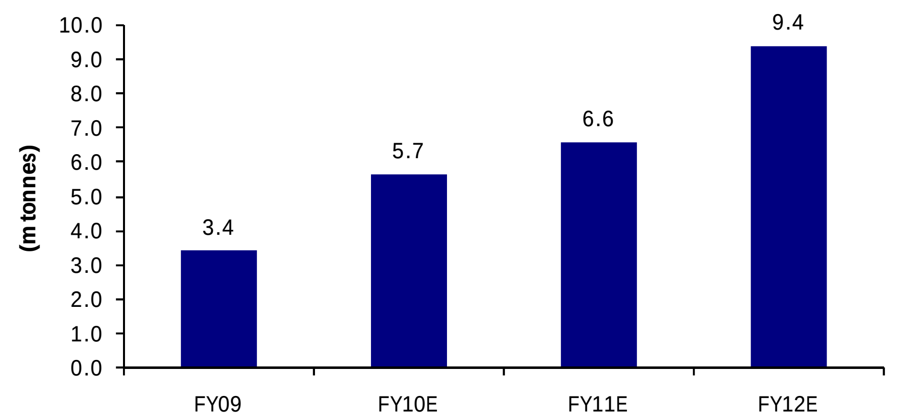
Y/e March	FY10E	FY11E	FY12E
Captive	600	660	700
NMDC	1,923	2,960	2,960
Third Party			
High grade (63% Fe)	2,124	3,238	3,238
Low grade (58-60% Fe)	-	1,700	1,700
Beneficiation cost / tonne of beneficiated output	-	225	225
Average cost per tonne of 63% Fe grade	1,800	2,524	2,222

Source: PL Research

Expansions on track

Integrated commissioning of 3.2mtpa expansion in flat products segment is progressing as per schedule of March 2011. The total outlay envisaged for expansion is Rs74bn and would include 1.9mtpa coke over battery and 300MW thermal coal based CPP. Expansion would enable the company to post growth of 43% in the volume for FY12.

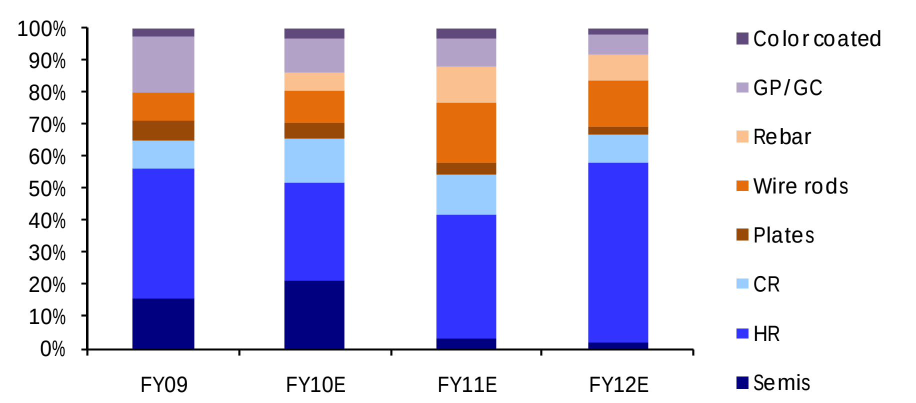
Volumes on rise



Source: Company, PL Research

Company's 3.5mtpa HSM is expected to commission during next week. Post commissioning of HSM, semis volume would be replaced by better margin hot rolled sheets/coils. Accordingly, share of semis would come down from 21% in FY10 to 3% in FY11, with incremental EBITDA of Rs1,000 (US$22) per tonne of steel.

Product mix



Source: Company, PL Research

Earnings to grow at 2-year CAGR of 50% (FY10-12E)

JSW Steel's consolidated earnings would grow at a 2-year CAGR of 50% for FY10-FY12E. Almost 58% of the growth would be contributed by volume growth, while rest of the growth would come from US operations which went into abnormal losses in FY10.

EBITDA per tonne is expected to remain near US$175 per tonne for FY11E and FY12E.

Key Operating Metrics

Y/e March	FY09	FY10E	FY11E	FY12E
Exchange Rate (Rs/USD)	45.9	47.5	45.0	45.0
Sales volume	3.4	5.7	6.6	9.4
% Growth	*0.4*	*65.4*	*16.5*	*42.7*
Realisation (Rs/Tonne)	45,373	29,456	33,020	31,953
in $	988	621	734	710
Coking coal (Rs/Tonne)	12,257	7,599	9,545	9,662
in $	267	160	212	215
Iron ore (Rs/tonne)	2,275	1,800	2,524	2,222
in $	50	38	56	49
EBITDA per tonne (Rs)	8,140	7,498	7,966	7,875
in $	177	158	177	175
EBITDA break-up (Rs m)				
Domestic	27,845	42,421	52,492	74,035
US operations	562	(1,923)	1,503	2,138
Total	**28,407**	**40,498**	**53,995**	**76,173**

Source: Company Data, PL Research

Most likely scenario for earnings stand at combination of benchmark HRC price of US$700 and exchange rate of Rs45/US$. Now, with the quarterly raw material contracts, downside /upside risk to the earnings would be capped.

EPS Sensitivity Analysis

	FY11	Ex-factory HRC price				
		600	**650**	**700**	**750**	**800**
Exchange Rate	43	-17.1	34.6	86.2	137.9	189.6
	44	-10.4	42.4	95.3	148.1	201.0
	45	-3.8	50.3	**104.3**	158.4	212.5
	46	2.9	58.1	113.4	168.7	223.9
	47	9.5	66.0	122.4	178.9	235.4

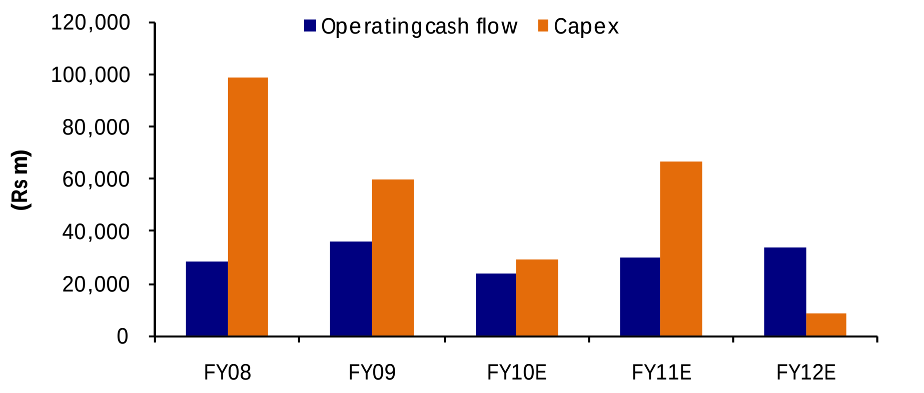
	FY12	Ex-factory HRC price				
		586	**636**	**686**	**736**	**786**
Exchange Rate	43	-20.1	53.6	127.3	201.0	274.7
	44	-10.5	64.9	140.3	215.7	291.2
	45	-0.9	76.2	**153.3**	230.5	307.6
	46	8.6	87.5	166.3	245.2	324.0
	47	18.2	98.8	179.3	259.9	340.4

Source: PL Research

Capex at peak in FY11E with leverage under control

JSW Steel's capex would peak out in FY11E, with total outlay of Rs67bn during the year associated with 3.2mtpa expansion, HSM-II of 1.5mtpa, blooming mill of 0.5mtpa and CPP of 300MW. Company would have to raise Rs47bn through debt to cover up for the shortage of operating cash flows (OCF) after providing for debt repayment of Rs9bn during the year. This would translate in to D/E ratio of 70:30 which seems reasonable.

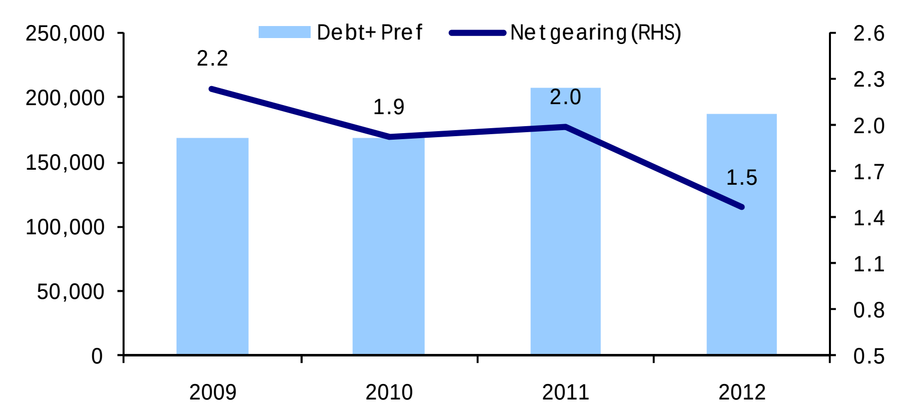
Operating cash flow and capex (Rs m)



Source: Company, PL Research

Company's overall gearing would rise marginally to 2x in FY11E from 1.9x in FY10E. However, the gearing would decline in FY12 on the back of reduced level of capital spending and strong free cash flows.

Movement in debt and net gearing



Source: Company, PL Research

Valuation

Stock's valuation witnessed significant re-rating on the back of strong visibility on the volume expansion, higher raw material integration and focussed domestic play. Positive development in these key drivers would reflect in considerable expansion in returns on capital and better shaped balance sheet.

At CMP, stock trades at P/E of 12.5x and 8.4x FY11E and FY12E, while on EV/EBITDA, it trades at 8.3x and 5.6x FY11E and FY12E, respectively. We value the stock at an EV/EBITDA of 6x FY12E EBITDA at a considerable discount to identical historical forward valuation ahead of its 3mtpa capacity expansion which got disturbed due to sharp economic meltdown. We believe the valuations are justified on the premise of its pure domestic play, likely financial restructuring to further improve the balance sheet and higher raw material integration. Hence, we upgrade our rating on the stock to '**Accumulate**'.

Valuations placed in attractive territory with advantage of pure domestic play and superior volume growth.

Relative Peer Comparison **(x)**

Company Name	P/BV		EV/EBITDA		PER	
	FY11	FY12	FY11	FY12	FY11	FY12
India						
SAIL	2.5	2.2	10.5	9.6	14.0	13.0
Tata Steel	3.1	2.3	6.4	5.4	8.7	7.4
JSW Steel	2.5	1.9	8.3	5.6	12.5	8.4
Jindal Steel and Power	4.1	3.1	9.9	9.1	14.0	12.9
Asia Ex India						
China Steel Corp	1.6	1.6	9.2	10.1	10.9	11.8
POSCO	1.2	1.0	5.2	5.1	8.5	8.5
Nippon Steel	1.2	1.1	6.8	6.8	12.5	10.2
Baoshan Iron & Steel Co	1.3	1.2	5.9	5.4	12.8	10.7
Kobe Steel	1.1	1.0	5.5	5.6	15.8	12.5
JFE Holdings Inc	1.3	1.2	5.9	6.3	11.7	9.7
US & Europe						
Arcelor Mittal	1.0	0.9	6.2	5.3	10.3	8.3
ThyssenKrupp AG	1.3	1.1	4.4	3.4	11.8	7.2
United States Steel Corp	1.6	1.4	5.2	5.1	11.6	11.6
AK Steel Holding Corp	2.1	1.7	4.0	3.3	10.2	8.1
Nucor Corp	1.7	1.5	6.0	4.7	12.7	8.9

Source: Company Data, Bloomberg, PL Research

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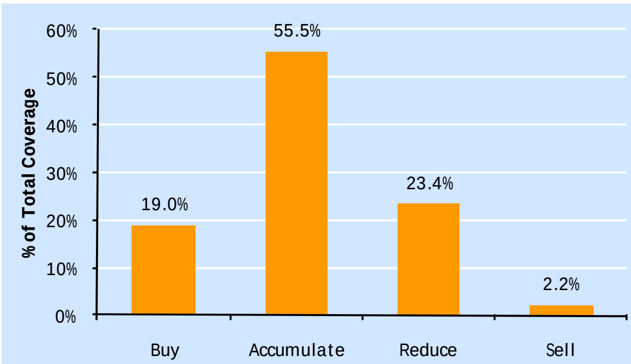
Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly

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