Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Equity Research

Industry: Steel
Date: May 27, 2011

STEEL AUTHORITY OF INDIA LTD.

Analyst Recommendation: Buy

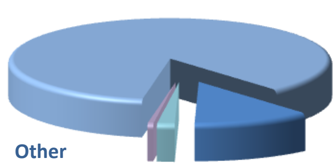
Buy | Accrue | Hold | Ease | Sell

BSE Code:	500113	NSE Code:	SAIL	Reuters:	SAIL.BO	Bloomberg Code:	SAIL:IN

CMP:	**₹144**
3 month Target:	**₹175**
SL:	**₹128**

EPS (₹)	11.9
P/E (X)	12.1
Revenue (₹mn)	434,505.7
EBITDA (₹mn)	91,623.0
EBITDA Margin (%)	20.4
EV/EBITDA (X)	6.8
Market Cap (₹mn)	593,332
Free Float Mar Cap (₹mn)	84,134.5
52 week high/low	234/138
Total Debt (₹mn) (FY10)	176,378.2
Enterprise Value (₹mn)	619,294.6
Book Value per Share	92.4
P/BV	1.6

Shareholding pattern as on March 31, 2011



Nearly doubling capacity over the next two years to augur growth

With a ₹720 billion capacity expansion plan the company is set to increase its potential output of steel to reach 23.46 million tonnes (MT) from the current level of 13.8MT.

Exploring opportunities in global arena

SAIL's expansion plan has stretched beyond India, as it indicated exploring possibilities of setting up steel plants in Mongolia and Indonesia. It has already decided to rope in a strategic partner to set up a 3MT steel plant in Afghanistan.

Shifting the burden of soaring raw material costs

SAIL has been increasing the in-house resource capacity of iron-ore and coking coal to meet the requirement of its massive expansion plans and reducing the dependencies on import. Additionally, it has consistently raisd its product prices to shift the price burden.

Better margin products growing steadily

Slowly, but steadily the better margin products are growing over the years that will help in raising the profitability of the company

Valuation

The ₹593 billion steel enterprise of India, SAIL, has reported a relatively quiet rise in its Q4FY11 revenues. Due to soaring coking coal prices, the company margins have suffered. In the long-run, the company's prospects look bright and strong under its massive expansion plan to raise its capacity to 23.5 million tonnes. Also, it marked its presence in the global market by setting up a steel plant in Afghanistan. The company has been looking to change its product mix to benefit from higher margin products. Looking at the growth prospect of SAIL in India supported by strong demand amidst government focused towards infrastructure growth; we rate the stock 'BUY' at the current market price of ₹144, at a PE of 12.1x on FY11 EPS of ₹11.9 and 9.4x on FY12E EPS of ₹15.2.

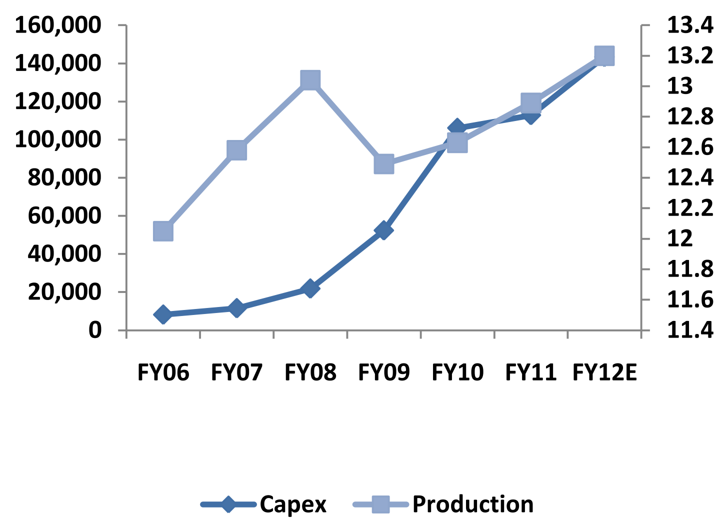
₹Million	FY09A	FY10A	FY11A	FY12E
Operating Income	437,091.8	413,565.1	434,505.7	486,646.4
EBITDA	110,173.0	119,419.9	91,623.0	113,394.8
Net Profit	62,177.3	67,907.8	49,142.9	62,822.3
Share Capital	41,304.0	41,304.0	41,304.0	41,304.0
EPS (₹)	15.1	16.4	11.9	15.2
PE (x)	9.5	8.7	12.1	9.4
P/BV (x)	2.1	1.8	1.6	1.4
EV/EBITDA (x)	4.5	4.5	6.8	5.7
ROE (%)	21.9	20.1	12.9	14.3
ROA %	16.2	12.9	8.1	8.9

70% Capacity Expansion and modernisation plan supported by massive Capex; driving its topline in a phased manner

Capacity Expansion to drive growth

The steel major is nearing the end of its ₹720 billion modernisation drive that will see its production capacity to reach 23.46MT from the current 13.8MT by March 2013. The company is focusing its capacity extension to meet the increasing steel demand and boost the per capita steel consumption in India, which is amongst the lowest in the world. During FY11, SAIL has invested a capex of ₹113 billion and its likely push the capex for FY12 upwards by 25% to ₹143 billion. For the planned expansion expenditure 70% of it will be funded by internal accruals and the remaining through borrowings. The capital crunch will not be an issue for the company as it is likely to raise ₹35,000 million from the FPO and low debt burden will enable for further borrowings. Previously, SAIL borrowed ₹36,500 billion more from the markets to fund its increasing investments. Post expansion the share of value added steel products will grow by 37% to around 45%, boosting the company's margins.

Capital expenditure (₹million) & production trend (MT)



Present Scenario of modernization and expansion plan (in MT)

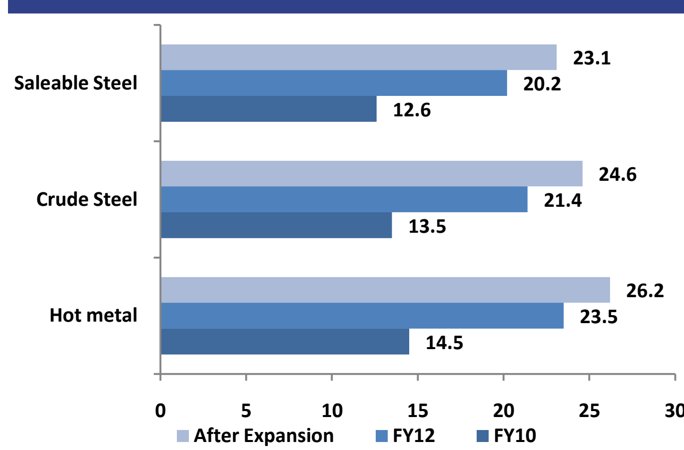
Plants	Hot Metal	Crude	Saleable Steel	date of commission
IISCO Steel Plant	2.7	2.5	2.39	Sep'11
Bokaro Steel Plant	5.77	4.61	4.18	Dec'11
Bhilai Steel Plant	4.08	3.93	3.15	Dec'12-Mar'13
Rourkela Steel Plant	2	1.9	1.67	Dec'12-Mar'13
Durgapur Steel Plant	2.09	1.8	1.59	Dec'12

Salem Steel Plant	Already commissioned Electric Arc Furnace, AOD Converter, Ladle Furnace, Single Strand Slab Caster and Roll Grinder in Sep'10

Growing beyond India

SAIL's expansion till now has been entirely within India, but the next round of growth could be overseas as well. The company had indicated that it is exploring possibilities of setting up steel plants in Mongolia, Indonesia and also Afghanistan. The company has already decided to rope in a strategic partner to spearhead its plan to set up a 3MT steel plant in Afghanistan. It is forming a consortium of 15 Indian mining and steel companies to make foray into the iron ore mines sector in Afghanistan.

Expected rise in production after expansion and modernization (MT)



Post expansion benefit

- ✓ Production through twin-hearth furnace route to be replaced by BOF–LD Converter route and through Ingot-teeming route to be replaced with Continuous cast production route.
- ✓ Enhancement of production capacity by addition of 3 new 4060m³ BlastFurnace.
- ✓ Increase in market share and world class technology and products along with improved product mix/proportion of value added products to increase.
- ✓ Complete elimination of Semi-finished steel and enhanced pollution control measures, with environmental conservation.

Tepid growth during Q4FY11

During the fourth quarter ended March 2011, SAIL reported a fractional fall of 0.5% operating income on yoy while a growth of 7.5% on qoq on due to better-than expected realisations sequentially. However, the overall margins of 12% (Q4FY10: 16.5%) was lower due to pressure from soaring coking coal prices and hike in the wages. Net profit advanced qoq by 36.1% while incurred a major drop of 27.7% yoy to ₹15,071 million.

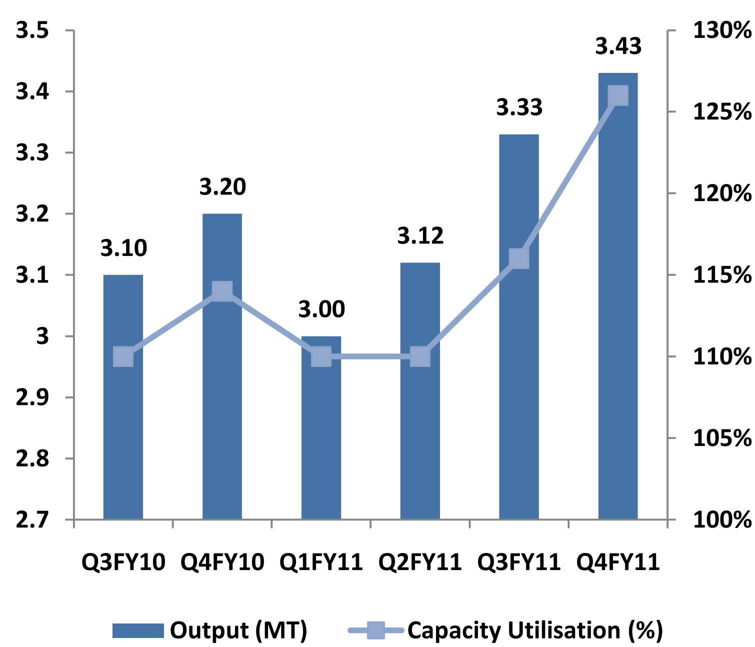
SAIL likely to raise ₹ 35 billion through FPO: Supporting its massive capital expenditure

The government controlled steel giant is coming up with a Follow-on Public Offer (FPO) is the next month, which is likely to raise a whooping ₹35,000 million. SAIL's board members have already approved the Red Herring Prospectus that will be filed in due course of time. The company is planning to issue 5% of its existing share capital and another 5% for a share sale from the government's stake. The FPO is tentatively scheduled within this fiscal. This is the phase-I of the capital raising plan, further in phase II, another 10% stake sale would be undertaken by SAIL through the FPO route. Besides, stake sell is a part of a plan of Indian government to dispose stakes in roughly 60 state-run companies over the next few years. Total proceeds from the share sale would be about ₹7000 crore, with half of it going to the Indian government. SAIL will be supporting its expansion plan of about $15 billion by 2013 through this IPO. The company will be using 70% of the capex plan from internal accruals and the rest will be financed from borrowings. SAIL is expanding its capacity to 20 million tonnes a year by next March, and to 24 million tonnes by March 2013.

Production Update

For the fourth quarter ended 31 Mar'11, SAIL's output stood at 3.43 million tonnes of saleable steel, increasing 5% yoy on higher capacity utilisation of 126%. For the year ended 31 Mar'11 its production grew 2% at 12.89 million tonnes as compared to 12.63 million tonnes in FY10. Maintaining its thrust on production of value-added and special steels, SAIL achieved highest-ever Q4 production of value-added products at 1.26 million tonnes, a growth of 6% yoy, as well as best-ever annual production of these high-value items at 4.8 million tonnes, showing a growth of 3% over FY '10. Growth was recorded in production of items such as electrode quality wire rods (37%), high tensile plates (29%), TMT-HCR wire rods & rounds (34%), LPG HR coils/sheets (12%), SAILCOR HR/CR products (69%), 90-UTS rails (2%) etc, signifying a change in the product mix favouring high margin special products. SAIL is expected to increase its saleable steel production capacity from 12.5 million tonnes to 23.1 million tonnes by FY15.

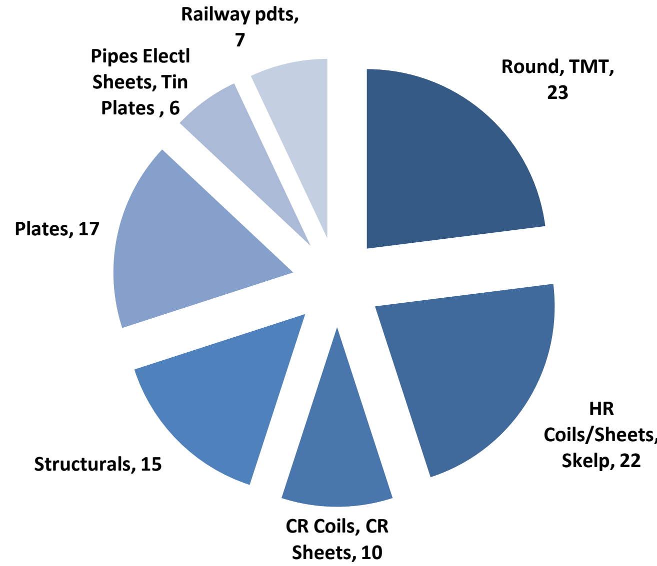
Quarterly production output and capacity utilisation



Product mix to improve

After the major expansion and modernisation of the steel producer, it will benefit from the improvement in its product mix. The company has decided to cut down the sale of semis to nil that hold 20% of its portfolio as on FY10. On the other hand, contribution of structural steel is expected to improve to 15% from 4.5% in FY10. The company is going to gain further as rise in the high-margin special products is set to grow post expansion.

SAIL product mix post expansion (%)



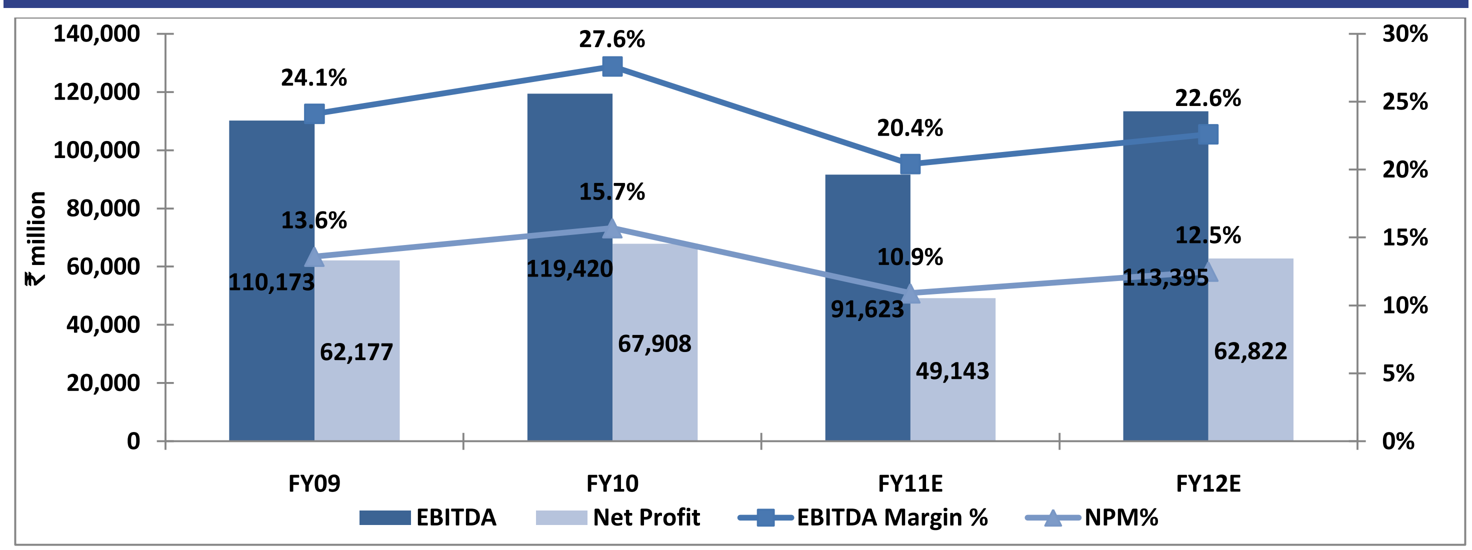
SAIL to increase captive resources for raw materials

The major expansion plan of SAIL will also raise the raw material requirement higher in coming times. Besides, the company meets 100% of its iron ore, 30% of its coking coal and 70% of its power requirements by captive resources while it imports 70% of coking coal requirements. After the expansion the iron ore requirement will go up to 40-43 million tonnes that will be meet by the capacity expansion in existing mines at Kiriburu, Meghataburu, Bolani, Gua & Barsua. Also, new pellet plant of 4 mtpa capacity has being planned for better utilisation of Iron Ore fines. SAIL has an existing captive mine coking coal mine of about 0.5 mtpa. There will be a rise from 13.8 mtpa of coking coal requirement to 23 mtpa, post expansion. This will be meet by Tasra captive coal block by developing it to produce 4 mtpa of ROM (2 mtpa washed coal) along with Sitanala coal block which will also be developed for production of 0.75 mtpa of ROM (0.4 mtpa of washed coal). Further, it is currently in talks for acquiring stakes in potential coal properties in Indonesia, South Africa, Mongolia, Mozambique and Australia through International Coal Ventures Ltd to reduce the import dependency of the coal.

Business Summary

SAIL is the largest government owned steel plant in India, with nearly around 30% market share. The company operates mainly through its six manufacturing plants with a capacity of 14 million tonnes of steel and will reach to 23.5 million tonnes post expansion. SAIL is self sufficient in iron-ore through its captive mines while it imports nearly 70% of coking coal. Soon, government will be disposing 5% stake through FPO after the market conditions improve. The company offers wide range of products and is a large producer of special steel.

Rise in capacity and increasing captive resources to improve both sales and margins



Indian Steel Industry

India is currently the 5th largest producer of crude steel in the world and is expected to become the 2nd largest producer of crude steel in the world by 2015-16. As per official estimates, the Iron and Steel Industry contributes around 2% of the Gross Domestic Product (GDP) and its weight in the Index of Industrial Production (IIP) is 7.3%. India is also a leading producer of sponge iron with a host of coal based units, located in the mineral-rich states of the country. Per capital consumption of steel in India is at 44~48 kgs as against an average of 190kgs of the world. As India is a developing country, most of industries still need to cover a long distance to attain maturity level. Thus, steel consumption rate in domestic market is poised to grow. Capitalizing on the high degree of domestic dependency, low credit leverage and debt exposure and the Government's thrust on infrastructure creation the steel industry is expected to accelerate the Indian economy.

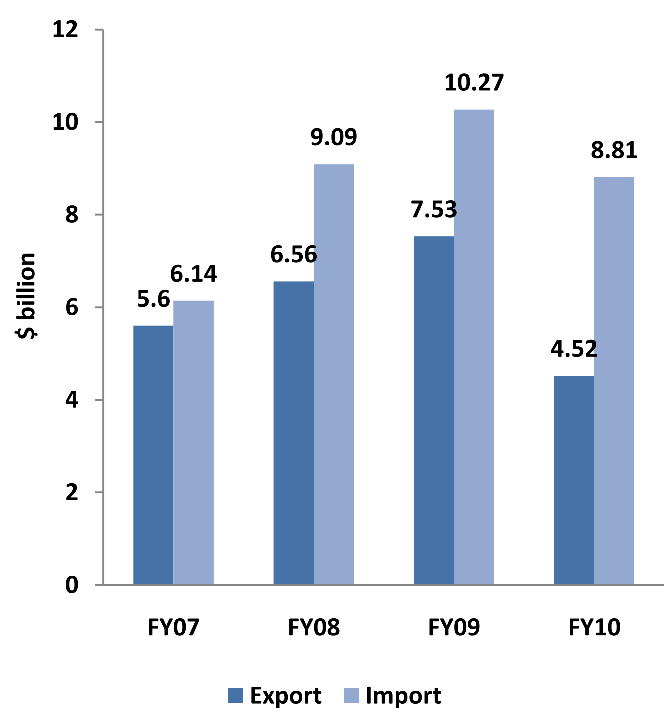
Indian Steel Industry to double the capacity

The Indian steel industry has withstood the global economic turmoil as against the global steel industry due to its resilience during the downturn. While World crude steel production for the 66 countries reporting to the World Steel Association (world steel) was 114 million metric tons (mmt) in November 2010. Further the domestic steel demand is growing at a faster pace than production, as the demand during Q1FY11 grew by 12% as against the production that grew by 3% during the same period last year. The sluggish growth of the real estate and housing sector was compensated by sustained growth in sectors like infrastructure, manufacturing and automobile. Government's intervention in the form of fiscal stimulus helped to propel growth in the end user industry. Currently India is the 5th largest producer of steel in the world; however as per Steel Minister, Mr Virbhadra Singh, the Indian Steel industry is expected to become the 2nd largest by 2012 on the back of doubling the capacity to 124 million tonnes. India is also the world's largest producer of DRI with ~21 million tonnes of production during 2009-10. India's per capita steel consumption was 48 kg in F.Y. 2009-10 far below the world's average of 190 kg and China's 250 kg. Within the country, the semi-urban and rural sector has significant growth opportunities due to its low per capita consumption as compared to urban area.

Buoyant steel growth supported by massive consumption

A robust growth in production is likely to decrease the country's reliance on imports. From 38% in 2009-10, CMIE expects the growth in steel imports to come down to 25% in 2010-11 and further down to 17.9% and 10% in FY12 and FY13, respectively. Major capacity additions of 40.1 million tonnes scheduled during 2011-13 are also expected to augment production and push up sales of the steel companies. Steel prices are expected to rise by 7-8% during 2011-13, as companies try to pass on the input cost burden to the consumer. Steel production growth is expected to accelerate further because of a pickup in demand and fresh capacity additions. Demand from other user industries such as automobile and machinery is also expected to remain buoyant. As per CMIE steel consumption is expected to grow by 9.5% to 61.8 million tonnes in 2010-11. This will augur a 6.5% growth in finished steel production for the year 2010-11, to 12.5% in 2011- 12 and further to 17.5% in 2012-13. The industry is expected to maintain a healthy sales growth of 21.4% in 2011-12 and 17.9% in 2012-13. Strong demand for steel and huge capacity additions are expected to push up sales volumes by 12- 14%. Net profits of the industry would grow by a healthy 24.1% in 2011-12.

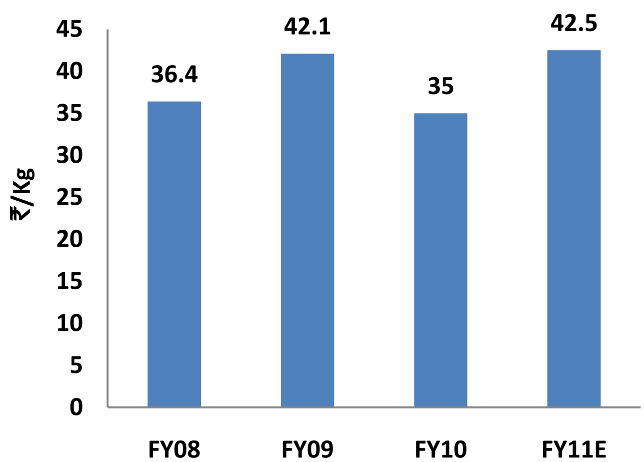
Import-Export scenario



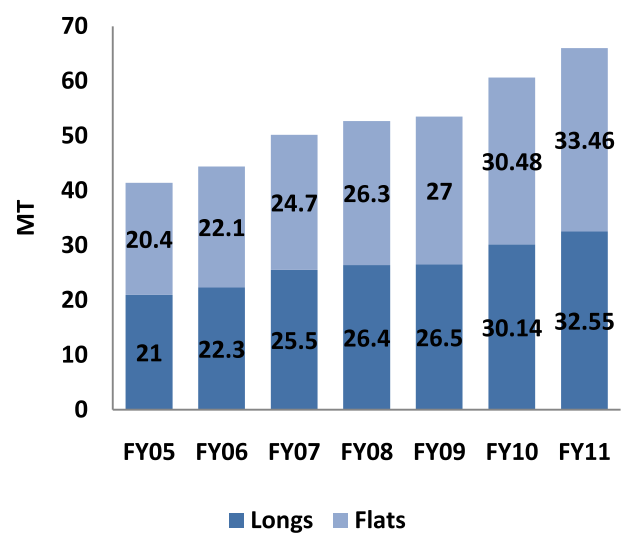
Price hike scenario

Indian domestic steel prices recorded marginal increases in recent period. However, there is growing resistance amongst consumers regarding any additional advances in selling values. According to MEPS International, purchasing activity has been quite slow during the last few weeks. Inventories are being run down ahead of the monsoon season and no large orders have been placed. As such, mills are facing difficulties due to steel price hikes. Also, lower raw material expenditure is likely to exert downward price pressure in the short term. The demand from the construction and infrastructure segments has been weaker due to price hike. The prices of steel are expected to be fairly stable in June and then fall, modestly, over the summer period. The steel companies hiked prices to pass on the input cost rise to the consumers. Most of the steel companies source their raw materials from the overseas market and the global miners raised prices of iron ore and coking coal in January 2011. The contract prices of iron ore were hiked by 4-5% to $137 per tonnes for the March 2011 quarter compared to the prices prevailing in the December 2010 quarter. Coking coal prices too were hiked by eight% to $225 per tonnes. State-run NMDC recently raised iron ore prices by 5.22% for the January-March quarter. The hike comes after prices fell by about ₹700-1,000 a tonnes in November last year amid softening global prices and appreciation of the rupee against the dollar. The steel companies are unlikely to meet with any resistance to the price hike as the demand for steel in the domestic market remains robust.

Yearly realisation from steel



Indian Steel Production of long and flat products



Future Outlook

Indian steel industry plays a significant role in the country's economic growth. The major contribution directs the attention that steel is having a stronghold in the traditional sectors, such as infrastructure & constructions, automobile, transportation, industrial applications etc. Moreover, steel variant stainless steel is finding innovative applications due to its corrosion resistive property. India is the fifth largest steel producer at the global front and struggling to become the second largest producer in the coming years.

The country has acquired a central position on the global steel map with its giant steel mills, acquisition of global scale capacities by players, continuous modernization & up gradation of old plants, improving energy efficiency, and backward integration into global raw material sources. Global steel giants from across the world have shown interest in the industry due to its phenomenal performance. For instance – the crude steel production in India registered a year-on-year growth of 6.4% in 2010 and reached 66.8 Million Metric Tons.

Balance Sheet (Consolidated)

(₹million)	FY09A	FY10A	FY11E	FY12E
Share Capital	41,304.0	41,304.0	41,304.0	41,304.0
Reserve and surplus	243,146.2	296,085.7	340,314.3	396,854.3
Net Worth	284,450.2	337,389.7	381,618.3	438,158.3
Minority Interest	7.0	10.2	12.6	15.1
Loan funds	86,905.1	176,378.2	211,025.0	255,220.0
Deferred Tax Liability	13,252.0	14,301.3	15,550.0	16,050.0
Capital Employed	**384,614.3**	**528,079.4**	**608,205.9**	**709,443.4**
Gross fixed assets	336,351.9	374,194.4	386,480.5	409,170.0
Less: accumulated depreciation	209,840.5	223,104.3	237,972.8	254,625.5
Net Fixed assets	126,511.4	151,090.1	148,507.7	154,544.5
Capital Work in Progress	79,027.0	153,821.6	225,550.0	295,000.0
Total Fixed Assets	205,538.4	304,911.7	374,057.7	449,544.5
Investment	369.9	446.7	500.0	600.0
Net Current Assets	178,705.0	222,716.9	233,644.2	259,295.0
Miscellaneous Exp	1.0	4.1	4.0	4.0
Capital Deployed	**384,614.3**	**528,079.4**	**608,205.9**	**709,443.5**

Profit & Loss Account (Consolidated)

(₹million)	FY09A	FY10A	FY11A	FY12E
Operating Income	437,091.8	413,565.1	434,505.7	486,646.4
Growth in %	8.9	(5.4)	5.1	12.0
Other Income	19,386.9	19,515.5	14,800.1	16,065.5
Total Income	**456,478.7**	**433,080.6**	**449,305.8**	**502,711.9**
Expenses	346,305.7	313,660.7	357,682.8	389,317.1
% of Sales	79.2	75.8	82.3	80.0
EBITDA	**110,173.0**	**119,419.9**	**91,623.0**	**113,394.8**
% Growth	(19.8)	8.4	(23.3)	23.8
EBITDA Margin %	*24.1*	*27.6*	*20.4*	*22.6*
Depreciation/Amortisation	12,899.6	13,397.2	14,868.5	16,652.7
EBIT	97,273.4	106,022.7	76,754.5	96,742.1
% Growth	(17.9)	9.0	(27.6)	26.0
EBIT Margin %	*21.3*	*24.5*	*17.1*	*19.2*
Interest	2,596.7	4,021.9	4,727.4	5,794.7
Profit before Tax	94,676.7	102,000.8	72,027.1	90,947.4
Tax	32,496.7	34,089.8	22,881.8	28,127.6
Minority Interest	2.7	3.2	2.4	2.5
Net Profit	**62,177.3**	**67,907.8**	**49,142.9**	**62,822.3**
% Growth	(18.1)	9.2	(27.6)	27.8
NPM %	*13.6%*	*15.7%*	*10.9%*	*12.5%*

Key Ratios & Valuations (Consolidated)

	FY09A	FY10A	FY11E	FY12E
EBITDA Margin (%)	24.1	27.6	20.4	22.6
EBIT Margin (%)	21.3	24.5	17.1	19.2
NPM (%)	13.6	15.7	10.9	12.5
ROCE (%)	25.3	20.1	12.6	13.6
ROE (%)	21.9	20.1	12.9	14.3
ROA (%)	16.2	12.9	8.1	8.9
Interest Coverage (x)	(0.3)	(0.2)	0.1	0.1
EPS (₹)	63.6	17.7	23.9	27.5
Cash EPS (₹)	44.8	55.0	44.8	50.2
P/E (x)	9.5	8.7	12.1	9.4
BVPS	68.9	81.7	92.4	106.1
P/BVPS (x)	2.1	1.8	1.6	1.4
EV/Operating Income (x)	1.1	1.3	1.4	1.3
EV/EBITDA (x)	4.5	4.5	6.8	5.7
EV/EBIT (x)	5.1	5.1	8.1	6.6

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