

JSW Steel

3 September 2012

JSW Ispat Merger Expected, But Timing Surprises

JSW Steel has announced the merger of its 47%-owned associate company JSW Ispat with itself, effective 1 July 2012. The company will issue 1 equity share in lieu of 72 equity shares of JSW Ispat. We are surprised about the timing of the merger as JSW Steel maintained in the past that it would turn around JSW Ispat before merging it. But, the merger was a logical event in order to avail the benefit of accumulated tax losses. In a separate set of events, the apex court is likely to give its judgment today on resuming iron ore mining operations in Karnataka. The verdict is likely to be positive, thereby easing the current tight iron ore supply situation in Karnataka. We retain our Sell rating on JSW Steel with a revised TP of Rs600 (2% higher than our earlier TP of Rs586).

Benefit of accumulated losses at JSW Ispat: The company has indicated that JSW Ispat's accumulated losses as per income tax calculations at the end of June 2012 stood at Rs97bn compared to Rs43bn as per reported numbers. This helps the company to achieve tax savings of Rs32bn, although it loses some of the existing Section 80IA benefits to the tune of Rs10bn in the merger process, leading to a net gain of Rs22bn. JSW Ispat's merger was a logical move, as otherwise a portion of the accumulated losses would have lapsed and it would have taken a longer time to turn profitable at the PAT level, thereby losing the time value of money.

Transaction details: The merger would increase its equity capital from Rs2,231mn to Rs2,417mn, a dilution of 7.7% on the expanded capital. It will also issue 485mn 0.01% non-convertible cumulative preference shares in lieu of existing preference shares. As part of the merger scheme, downstream operations at Vasind and Tarapur of JSW Steel and Kalmeshwar operations of JSW Ispat would be transferred to a wholly-owned subsidiary of JSW Steel in order to take the advantage of VAT benefit available to JSW Ispat.

Other highlights: JSW Steel has indicated the merger of JSW Ispat would result in substantial costs savings, to the tune of Rs3,500mn-Rs5,000mn due to economies of scale and lower interest costs as JSW Ispat's weighted average interest costs are almost 350bps higher compared to the former. Debt-equity ratio of the combined entity would stand at 1.6x at the end of FY14 compared to 1.1x for the existing JSW Steel.

Valuation: At the beginning of the iron ore crisis, we had cut our target multiple from 5.0x to 3.5x, which was revised upwards to 4.0x last year based on the company's strong performance. We have now upgraded our target multiple further from 4.0x to 4.5x as there is a fair amount of visibility on the iron ore supply situation easing. Nonetheless, it is still 10% lower compared to our ferrous sector universe. We have cut our FY13 EBITDA and PAT estimates by 2% and 5%, respectively, due to the new price assumptions based on the current trend, but we have raised our FY14 EBITDA and PAT estimates by 3% and 7%, respectively, as the drop in raw material price assumptions is much more when compared to steel prices.

Y/E March (Rsmn)	FY10	FY11	FY12	FY13E	FY14E
Revenue	190,738	241,161	343,681	391,508	404,480
YoY (%)	17.7	26.4	42.5	13.9	3.3
EBITDA	41,658	47,795	60,333	68,939	79,103
EBITDA margin (%)	21.8	19.8	17.6	17.6	19.6
PAT	15,976	17,540	5,377	13,276	23,973
EPS (Rs)	85.4	78.6	24.1	59.5	107.4
YoY (%)	481.1	(8.0)	(69.3)	146.9	80.6
RoE (%)	17.5	11.0	3.1	7.8	12.8
RoCE (%)	8.5	7.0	8.6	8.2	9.2
P/E (x)	8.1	8.8	28.9	11.7	6.5
EV/ EBITDA (x)	5.6	5.9	5.5	5.3	4.6

Source: Company, Nirmal Bang Institutional Equities Research

SELL

Sector: Steel

CMP: Rs695

Target Price: Rs600

Downside: 14%

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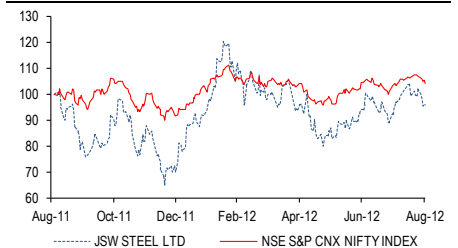
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Key Data

Current Shares O/S (mn)	223.1
Mkt Cap (Rsbn/US\$bn)	154.8/2.8
52 Wk H / L (Rs)	886/462
Daily Vol. (3M NSE Avg.)	1,911,342

Share holding (%)	3QFY12	4QFY12	1QFY13
Promoter	37.7	37.9	38.1
FII	41.5	41.7	41.3
DII	4.7	4.4	4.7
Corporate	4.8	4.6	4.9
General Public	0.6	0.6	0.6

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
JSW Steel	(0.8)	(11.9)	(4.0)
Nifty Index	0.8	(1.9)	4.3

Source: Bloomberg

Exhibit 1: Change in our estimates at JSW Steel (excluding JSW Ispat)

Description (Rsmn)	Earlier assumptions		New assumptions		Change (%)	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Operational data						
Production (mt)	8.42	9.12	8.42	9.12	0.0	0.0
Volume (mt)	8.68	9.50	8.68	9.50	0.0	0.0
Realisation (Rs/tn)	42,437	41,112	41,069	38,363	(3.2)	(6.7)
Cost (Rs/tn)	34,995	33,544	33,806	30,544	(3.4)	(8.9)
EBITDA (Rs/tn)	7,658	7,568	7,479	7,819	(2.3)	3.3
Std financials (Rsmn)						
Net sales	368,159	390,582	356,294	364,461	(3.2)	(6.7)
EBITDA	66,436	71,901	64,885	74,280	(2.3)	3.3
PAT	17,683	23,016	16,628	24,634	(6.0)	7.0
Consol. financials (Rsmn)						
Net sales	403,373	430,601	391,508	404,480	(2.9)	(6.1)
EBITDA	70,490	76,724	68,939	79,103	(2.2)	3.1
PAT after MI	14,045	22,473	13,276	23,973	(5.5)	6.7

Source: Company, Nirmal Bang Institutional Equities Research

Pro-forma financials
Exhibit 2: Profit & Loss account

Description (Rsmn)	JSW Steel		JSW Ispat		Combined financials	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Net sales (*)	391,508	404,480	102,972	94,983	475,922	482,736
Total expenditure (*)	322,569	325,377	92,016	85,766	392,227	390,616
EBITDA	68,939	79,103	14,756	13,017	83,695	92,121
EBITDA margin (%)	17.7	19.7	14.4	13.7	17.6	19.1
Depreciation	22,121	24,329	6,400	6,400	28,521	30,729
Other income	611	400	200	200	811	600
PBIT	47,428	55,175	8,356	6,617	55,785	61,792
Interest & finance charges	17,927	18,326	9,600	9,000	27,527	27,326
Exchange loss/(gain)	5,948	-	3,388	-	9,336	-
PBT	23,553	36,849	(4,631)	(2,383)	18,922	34,466
Total tax	8,190	11,780	-	-	6,244	11,374
Net PAT	15,363	25,069	(4,631)	(2,383)	12,677	23,092
Minority interest	(85)	(22)	-	-	(85)	(22)
Profit/(losses) of associates	(2,172)	(1,118)	-	-	-	-
PAT after MI	13,276	23,973	(4,631)	(2,383)	12,762	23,114
Equity share capital	2,231	2,231	-	-	2,417	2,417
EPS	59.5	107.4	-	-	52.8	95.6

(*) – inter-segment transfer has been excluded in revenue and costs

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 3: Balance Sheet

Description (Rsmn)	JSW Steel		JSW Ispat		Combined financials	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Shareholders' funds						
Equity share capital	2,842	2,842	25,162	25,162	3,028	3,028
Preference share capital	2,790	2,790	4,854	4,854	7,644	7,644
Reserves and surplus	164,787	184,583	(23,016)	(25,398)	152,870	171,401
Net worth	170,418	190,215	7,000	4,617	163,542	182,073
Non-current liabilities						
Long-term borrowing	135,263	145,263	63,736	63,736	198,999	208,999
Deferred tax liability - net	27,250	27,250	(20,879)	(20,879)	6,370	6,370
Other long-term liabilities	4,722	4,722	89	89	4,811	4,811
Long-term provisions	350	350	443	443	793	793
Total non-current liabilities	167,585	177,585	43,388	43,388	210,973	220,973
Current liabilities						
Short-term borrowings	13,758	13,758	1,810	1,810	15,567	15,567
Trade payables	98,383	100,520	35,605	33,187	133,988	133,706
Other current liabilities	95,129	95,129	9,067	9,067	104,197	104,197
Short-term provisions	3,353	3,548	66	66	3,418	3,614
Total current liabilities	210,623	212,955	46,548	44,130	257,170	257,084
Minority interest	2,092	2,070	-	-	2,092	2,070
Total liabilities	550,719	582,825	96,936	92,135	633,778	662,201
Application of funds						
Total fixed assets	397,877	423,548	64,658	59,258	462,535	482,806
Goodwill on consolidation	12,440	12,440	311	311	12,751	12,751
Non-current investment	16,684	15,566	1,610	1,610	4,417	4,417
Long-term loans and advances	23,829	21,629	1,891	1,891	25,720	23,520
Other current assets	144	144	823	823	967	967
Total non-current assets	450,973	473,326	69,294	63,894	506,390	524,461
Current assets, loans and advances :						
Current investment	2,040	2,040	-	-	2,040	2,040
Inventories	56,176	58,043	18,345	17,047	74,522	75,090
Sundry debtors	15,150	15,910	3,177	2,952	18,327	18,862
Cash and bank balances	2,379	7,506	2,684	5,020	5,063	12,527
Loans and advances	24,000	26,000	3,436	3,221	27,436	29,221
Total current assets	99,746	109,499	27,642	28,241	127,388	137,740
Total assets	550,719	582,825	96,936	92,135	633,778	662,201

Source: Company, Nirmal Bang Institutional Equities Research

Other highlights

- JSW Steel's management has indicated that there is huge potential to undertake brownfield expansion, to the tune of additional 4mt at JSW Ispat's existing location due to large availability of land. This was not possible for JSW Ispat earlier due to its poor balance sheet. However, the benefits of all this would accrue only in the medium to long-term.
- As against market expectations, JSW Steel's management has indicated that the tax rate would remain in the range of 33% for the combined entity, although the proportion of deferred tax will increase to the tune of 13% of overall PBT.
- The merger process is likely to be completed by the end of March 2013.

Ratings track

Date	Rating	Market price (Rs)	Target price (Rs)
24 June 2011	Buy	833	1,172
27 July 2011	Buy	870	1,153
1 August 2011	Hold	690	725
16 August 2011	Sell	656	570
27 September 2011	Sell	618	514
7 October 2011	Sell	553	530
24 October 2011	Sell	580	545
9 January 2012	Sell	570	500
23 January 2012	Sell	648	543
15 May 2012	Sell	620	570
27 July 2012	Sell	643	586
3 September 2012	Sell	695	600

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

HOLD 0-15%

SELL < 0%

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