Steel Sector Update

Government toils to control prices

Steel is an essential commodity and is used in various applications like Automobiles, Construction, Transportation, etc. Soaring steel prices have increased the cost for these user industries. To protect consumers' interests and curb inflation, which is now well above the RBI's target of 5% (6.68% for the week ended March 15, 2008), the government has been trying to rein in the soaring steel prices. In February 2008, after the government's intervention, domestic players had agreed to partially roll back the price hike by Rs500-1,000/tonne. Further, despite the reduction in Excise Duty from 16% to 14% in Budget 2008-09, steel players increased the prices again in March by Rs2,000-3,000/tonne.

However, steel prices rising globally…

Globally, steel prices have been on an upward trajectory over the last few months due to a considerable increase in raw material costs like Iron Ore and Coking Coal. In tandem with this, domestic steel prices have also increased by almost 20% in the last three months. Notably, domestic players have announced price hikes thrice this year, in-line with the global trends, taking the domestic HR prices to around Rs40,000/tonne.

It must be noted that surging input costs had squeezed the third quarter profit margins of several domestic steel players that have no backward linkages to Iron Ore and Coal mines. Iron Ore is a key ingredient in making steel, spot prices of which have catapulted 150% in the last six months from US$60/tonne to US$150/tonne now. Coking Coal prices have similarly soared 100% in the last six months. Ferro Manganese has increased by 40% from Rs43,000 to Rs62,000/tonne in the same period. Recently, National Mineral Development Corp. Limited raised prices of ore fines and lumps by 47% and 22-33% respectively. Steel Scrap, used by induction and electric arc furnaces as input, has also witnessed a 36% increase in prices, while prices of Coke, obtained from Coking Coal for use in furnaces, have increased from US$290/tonne in mid-2007 to US$500/tonne now.

Government options to control prices

Overlooking these global factors, the government's focus and efforts are currently aimed at bringing inflation under control. Thus, it now plans to initiate measures to control rising steel prices. Some of the tools that the government could use to control the rising steel prices include:

- Appointment of Steel regulator to control prices
- Slapping of Export Tax to discourage exports
- Ban/Curb Exports to increase the availability of steel in the domestic market
- Removal of DEPB benefits
- Further reduction in Excise Duty on steel
- Reduction in Import duties on steel raw materials like met coke, refractory, etc.
- Export ban / Export tax on iron ore exports to increase its availability in the domestic market

Setting up a Regulator / Export Tax will send the wrong signals

We believe that setting up a Steel regulator and imposition of an Export Tax are amongst the extreme measures and the government should refrain from implementing the same. Many global investors, including the likes of Mittal Steel and Posco, are acquiring land and machinery and are signing MoUs with the State Governments for setting up steel plants in the country. Any wrong signal by the government at this stage could dampen the zeal of such investors and hamper the growth of the Steel Industry.

In fact, the point to note here is that there is a strong demand for steel in the country on the back of buoyant economic growth. At the same time, it is also true that steel prices have firmed up considerably of late. But, the way ahead to resolve the steel pricing issue is to match supply with demand. The government should encourage higher supplies at the producer's end to soften steel prices. Notably, a number of investment proposals in steel continue to remain mired by Policy inaction. What's required, without further delays, is ironing out of the Policy glitches that are

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holding back these steel capacities in the pipeline. But to attempt to douse prices by clamping down on Steel exports via a steep levy or appointing a Steel regulator is more likely to backfire, as it may discourage incremental steel capacities in the country.

Mutual understanding at reducing exports - The first step

Considering the government's concerns over rising steel prices, Steel producers have agreed to restrain exports of spot steel even as exports under long-term contracts would continue. In return, the Steel industry has urged the government to lower the Excise Duty on steel to 8% from 14% and reduce Import duties on inputs such as metcoke, refractory, ferro alloys and zinc. The industry has also urged the government to contain export of Iron Ore through physical and fiscal means.

Steel prices have been on an uptrend in the recent past mainly due to the unhindered rise in input costs. India exports 4-5 mn tonnes of steel annually. The Indian Steel producers have increased prices by Rs5,000-7,000/tonne in the last three months. **We believe that curtailing exports would have little impact on steel exporting companies like JSW Steel, SAIL and other ISA (Indian Steel Alliance) member companies. Steel demand in India is pretty strong and India, for the first time in 10 years, has become a net importer of steel. Hence, in the event of some exports being diverted into the domestic market, it would not create an over-supply scenario in the domestic market. Also, only the products which have a market in India are to be sold in the domestic market. For instance, players like JSW Steel primarily export galvanised products, the domestic supply of which is not of concern.**

Removal of DEPB benefits to have little impact

The government has also temporarily suspended the export subsidy under the Duty Entitlement Pass Book (DEPB) Scheme on some steel products. It must be noted that the DEPB benefits are capped at a certain price point depending upon the product, and thus the actual benefits of this scheme were that much lower considering that globally, steel prices have been ruling at very high levels. Thus, the impact of the DEPB withdrawal in terms of the reduction in benefit to steel players will be lower than anticipated.

Further, this adverse impact may be mitigated to some extent by allowing steel players other benefits like duty drawbacks.

Exports Tax - a 'What if' analysis!

While imposition of an Export Tax is a far-fetched possibility in our view, nonetheless, we have assumed a hypothetical situation of a 10% Export Tax scenario and the impact of this on the profitability of steel companies.

Clearly, if the government does impose an export tax of 10% on finished steel, profitability of steel players will be negatively impacted, especially that of JSW Steel, which has a higher export revenues share in total revenues. In case of JSW Steel, 30% of its revenues can be attributed to exports, while export revenues of SAIL and Tata Steel account for 3.5% and 10% of their total revenues, respectively.

Below is a Sensitivity Analysis of steel companies' earnings at different export tax scenarios.

JSW Steel's Earnings are highly sensitive to export tax as it contributes almost 30% to its total revenues. It can be seen in the table below that in the worst case scenario, if the company opts to continue its exports without passing on the additional burden onto customers, a 10% imposition of export tax would hit JSW Steel's EBIDTA by Rs500cr and Net profit by Rs335cr (15% reduction from base case) in FY2009 and Rs696cr and Rs466cr respectively in FY2010.

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Exhibit 1: JSW Steel - Sensitivity Analysis

		Export Tax		
FY2009E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	4,965	4,715	4,590	4,465
Net Profit (Rs cr)	2,210	2,042	1,958	1,875
EPS (Rs)	110.0	102.0	98.0	93.0
		Export Tax		
FY2010E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	6,073	5,725	5,551	5,377
Net Profit (Rs cr)	2,770	2,537	2,420	2,304
EPS (Rs)	138.0	126.0	121.0	115.0
Target Price (Rs)	**1,170**	**1,074**	**1,026**	**978**

Source: Angel Research, Note: Numbers are consolidated

On the contrary, we believe that the export tax impact would be low on SAIL as exports contribute only 3.5% of its total revenues.**We maintain our Neutral view on SAIL.**

Exhibit 2: SAIL - Sensitivity Analysis

		Export Tax		
FY2009E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	10,396	10,311	10,269	10,228
Net Profit (Rs cr)	7,004	6,948	6,920	6,893
EPS (Rs)	17.0	16.8	16.7	16.6
		Export Tax		
FY2010E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	10,030	9,946	9,904	9,861
Net Profit (Rs cr)	6,708	6,653	6,625	6,597
EPS (Rs)	16.2	16.1	16.0	15.9

Source: Angel Research

Further, the impact would be minimal for Tata Steel as the company's exports constitute less than 2% of its total consolidated Revenues. We believe that Tata Steel, to some extent, is insulated from any moves by the government to control the domestic prices due to its acquisition of Corus, which contributes more than 75% to its consolidated Revenues. **We maintain our Neutral view on Tata Steel.**

Exhibit 3: Tata Steel - Sensitivity Analysis

		Export Tax		
FY2009E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	21,093	20,948	20,875	20,803
Net Profit (Rs cr)	8,653	8,555	8,507	8,485
EPS (Rs)	102.0	100.9	100.4	99.8
		Export Tax		
FY2010E	**Base case**	**5%**	**7.5%**	**10%**
EBIDTA (Rs cr)	21,263	21,118	21,046	20,975
Net Profit (Rs cr)	8,779	8,682	8,634	8,585
EPS (Rs)	104.0	102.5	101.9	101.3

Source: Angel Research, Note: Numbers are consolidated

Having considered the various scenarios and their varying impact on 3 large domestic steel players, we would like to re-iterate that the possibility of above materialising is very low and it assumes that steel players will continue to export at the same pace despite the export tax without passing on the additional burden to the customers.

Also, as we understand, in the event of an export tax on steel, the government would also have to ban export of Iron Ore or hike the export tax on Iron Ore, as iron ore exports from India are more than 60% compared to just 10% of steel export. This would effectively mitigate the impact of export tax on the steel players.

Thus, considering the latest developments in the sector and the probability of more stringent measures materialising being low, **we maintain our Buy on JSW Steel with the Target Price of Rs1,170.**

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