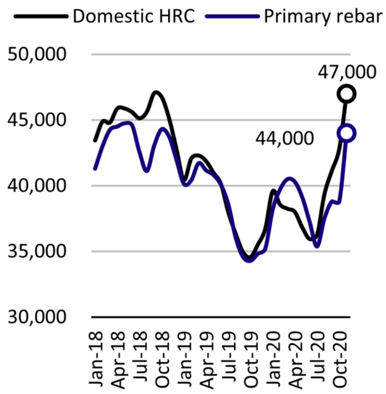
Sector Update | 26 November 2020

Metals

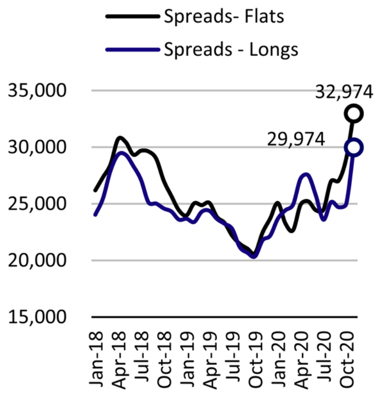
Steel spreads at a multi-year high

Raise coverage EBITDA estimates by 7-10% for FY21-22E

HRC-rebar prices at two- year highs (INR/t)



Indian steel spreads at multi-year highs (INR/t)



Indian steel spreads have risen ~25% in 3QFY21 and are at a three-year high. We expect spreads to stay strong on the back of a domestic demand recovery and higher regional prices. The improvement in EBITDA/t should be even higher on an improving sales mix (lower exports and higher value-added sales). We raise our coverage EBITDA estimates by 3-12%/5-13% for FY21E/FY22E to factor in higher spreads.

- **Steel prices in India have rallied by INR4,000-5,000/t (10-13%) MoM in Nov'20 – HRC (hot-rolled coils) by ~10% to INR47,000/t and rebar by 13% to INR44,000/t. Despite these hikes, domestic HRC prices are trading at par to the landed cost of imports from Korea (USD630/t), raising the possibility of further hikes in Dec'20.**
- **Domestic hikes are being supported by higher regional prices, which in turn are being driven by a sharp rise in Chinese domestic steel prices. China HRC/rebar prices are up 10%/11% in the last two months to USD622/599 per tonne.**
- **Contrary to rising steel prices, the raw material basket has been a mixed one. While iron ore prices are at a multi-year high, coking coal prices are at four-year low (due to restrictions on Chinese steelmakers from buying Australian coking coal, causing a supply glut). As a result, steel spreads (price – 1.7x iron ore – 0.7x coking coal) are at multi-year highs – ~INR33,000/t for HRC (flats) and ~INR30,000/t for rebar. Steel players like TATA, SAIL and JSP with captive iron ore should benefit the most from higher prices.**
- **JSP is our preferred pick in this sector followed by JSTL. Coupled with strong margins, they are also better placed to deliver higher volume growth in the medium term. JSP also has the lowest leverage in the peer growth with supportive valuations.**

Domestic steel prices are at a two-year high

Domestic HRC prices have increased by INR4,500/t in Nov'20 to INR47,000/t on a strong recovery in the demand for flat steel, backed by a demand recovery in end-use sectors like Auto, White Goods, etc. The price hikes have been well supported by higher regional steel prices. Domestic HRC prices are trading at par to the landed cost of imports from Korea. With monsoon subsiding and expected recovery in infra and construction demand after the festive season, rebar prices too have increased by INR5,000/t in Nov'20.

Improved demand has supported absorption of price hikes

India's steel demand has seen a gradual recovery over the past few months and was down just 2% YoY in Oct'20. Even net exports from India declined 354kt MoM to 186kt. We believe demand for flat steel has turned positive YoY in Oct'20, with higher YoY demand for automotive steel. Auto steel deliveries were higher by ~19% YoY in 2QFY21 for TATA and JSTL. With the monsoon subsiding and the festive season ending, long steel demand has entered a seasonally strong period (December to June). With strong demand outlook from auto, construction, infra, etc., we expect demand to remain positive in 2HFY21. We believe the price hikes have been well absorbed by the market due to strong demand.

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Regional steel prices remain strong; spreads in Europe improve

China has seen a strong recovery in steel demand since Apr'20, driven by an uptick in key steel consuming sectors such as construction and auto. Domestic steel prices in China have bounced back sharply post the New Year Holiday in the first week of Oct'20. HRC and rebar prices have risen by 10-11% to USD622/t and USD599/t respectively. China's domestic HRC prices are also at a two-year high.

Supported by strong China prices, regional HRC steel prices have also gained strength. Korea and CIS HRC export prices have increased by 14% MoM in Nov'20. Domestic HRC prices in Europe have also improved by 9% MoM (13% in the last two months) to USD628/t.

Spot spreads at a multi-year high

Despite domestic iron ore prices rising to a five-year high, spot steel spreads are at a multi-year high due to higher steel prices and subdued coking coal prices. While iron ore prices from NMDC have increased by 30% YTD in FY21, imported coking coal prices have declined by ~35% YTD, keeping total raw material cost in check. As a result, domestic steel spreads are strong at INR33,000/t for flats (HRC) and INR30,000/t for longs (rebar). On an average, spot spreads are ~INR6,000/t higher than 2QFY21. Assuming spot prices sustain, spreads in 3QFY21 are expected to be higher by ~INR5,000/t for flats and ~INR3,500/t for longs, which should largely flow through to EBITDA as conversion costs have been largely unchanged.

Spot spreads in Europe have also improved by ~USD120/t over Sep'20. Assuming spot spreads sustain, we expect Europe spot steel spreads to be higher by ~USD100/t QoQ in 3QFY21, which should lead to improved profitability for Tata Steel's European operations.

Prefer longs over flats, JSP is our preferred pick followed by JSTL

- We prefer longs over flats in the steel sector as we expect India rebar prices to be strong, led by a seasonal (post-monsoon) uptick in construction activity. Our analysis of pricing trends of the past 10 years suggests that longs have outperformed flats by ~INR1,500/t on an average in the second half of the fiscal.
- JSP, with ~70% share of long products in its portfolio, is thus our preferred pick in the sector with a TP of INR307 (23% upside). Over FY20-22E, we estimate a strong 11%/12% CAGR in standalone volumes/consolidated EBITDA. This, coupled with the Oman divestment, would result in a 44% fall in consolidated net debt to INR211b. Net debt-to-EBITDA should thus decline to 2.1x, the lowest in India's steel sector.
- We rate JSTL a Buy with a TP of INR413 (15% upside). Coupled with robust margin, it offers a strong volume growth potential from its Dolvi expansion, which is slated to be commissioned in 4QFY21. Given the current strong spreads, concerns over the acquisition of Bhushan Power and Steel have significantly subsided.
- We remain Neutral on TATA with a TP of INR604 as: 1) current valuations factor in strong spreads in India and Europe, and 2) sustainability of cash flows at Tata Steel Europe remain questionable given the uncertainty over its UK operations.
- We also rate SAIL Neutral with INR49 TP as despite strong near term cash flows, leverage remains high making it vulnerable to any down cycle in margins.

Top picks – JSP, JSTL

JSP (Buy, TP: INR307)

We expect the company to achieve ~11% volume CAGR over FY20-22E, which will help drive 20% EBITDA CAGR (excl. Oman). This, coupled with lower capex and Oman divestment, should reduce net debt by 44% to INR211b over FY20-22E. Net debt-to-EBITDA is expected to decline to 2.1x in FY22E – the lowest in the steel sector. Gare Palma IV/1 coal block, if allotted, would improve Jindal Power's profitability significantly. Reiterate **Buy,** with a SoTP-based TP of INR307, based on 5x FY22E EBITDA for the Steel business and DCF valuation for the Power business. At the CMP, the stock trades at an attractive 3.9x FY22E EV/EBITDA for the Steel business.

JSTL (Buy, TP: INR413)

We like JSTL given its strong project pipeline and cost reduction initiatives. On the domestic front, we expect the company to deliver above-industry volume growth in FY22E driven by expansion. Margin should improve, aided by a better product mix. We expect JSTL's margin to remain strong on the back of higher steel prices and the commissioning of cost-saving projects. Higher margin should also keep debt in check. We expect net debt to decline by INR49b to INR590b over FY20-22E. We expect it to decline subsequently as the capex phase ends and invested projects start generating cash flows. We value JSTL at 6.5x FY22E EV/EBITDA to arrive at TP of INR413/share. Maintain **Buy**.

TATA (Neutral, TP: INR604)

The outlook for its India operations has improved significantly, led by better domestic demand and prices. While EBITDA growth should be strong in 2HFY21, we forecast an expansion in working capital and capex to limit FCF growth. We expect Tata Steel Europe's EBITDA to turn positive in 2HFY21. While the potential sale of the company's profitable operations in the Netherlands could lower debt, retention of the loss-making UK business would remain an overhang on the stock. With TATA already on track to meet its debt reduction plan of USD1b for FY21, concerns on leverage are abating. We expect net debt to decline by INR150b (INR131/share) to INR921b over FY20-22E. At the CMP, the stock trades at 5.8x FY22E EV/EBITDA. Maintain Neutral with a TP of INR604/share based on FY22E EV/EBITDA of 6x for its Indian operations and 5x for Europe.

SAIL (Neutral, TP: INR49)

With improved pricing, lower coking coal costs, and better operating leverage, we expect SAIL to record an EBITDA/t in excess of INR7,500 in 2HFY21. We expect it to post a 6% volume CAGR and 32% EBITDA CAGR over FY20-22E. Despite an expected reduction in net debt by INR84b to INR449b over FY20–22E, net debt-to-EBITDA would stay elevated ~5.9x in FY21E and 4.5x in FY22E. This remains a key concern as it makes the company vulnerable in the event of a downcycle in steel prices. We value the stock at 6.5x FY22E EV/EBITDA of INR49/share. Maintain **Neutral**.

Exhibit 1: Valuation summary

	M-cap (USD m)	CMP (INR)	TP (INR)	Rating	P/E (x)		EV/EBITDA (x)		P/B (x)		Net debt-to-EBITDA		
					FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY20	FY21E	FY22E
Steel													
JSTL	11,657	359	413	Buy	15.0	8.9	8.8	6.0	2.1	1.7	5.7	3.7	2.4
TATA	7,422	569	604	Neutral	22.3	7.6	7.2	5.8	0.9	0.9	6.1	4.3	3.4
JSP	3,067	250	307	Buy	7.7	11.8	4.4	4.7	0.9	0.8	4.8	2.2	2.1
SAIL	2,582	47	49	Neutral	14.5	7.4	8.3	6.4	0.4	0.4	9.3	5.9	4.5

Source: MOFSL

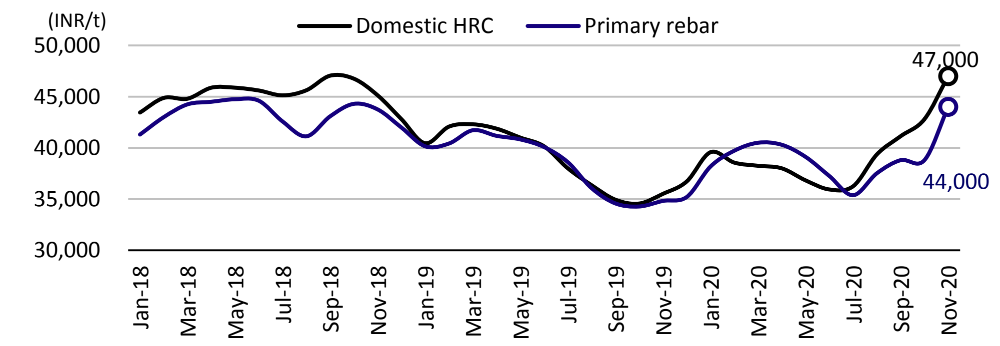
Exhibit 2: Change in estimates

		Revised		Old		Change (%)	
		FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
JSTL							
EBITDA/t	INR	11,123	12,192	10,128	10,964	9.8	11.2
EBITDA	INR m	1,67,817	2,41,739	1,52,361	2,14,197	10.1	12.9
PAT	INR m	57,484	97,348	47,036	78,442	22.2	24.1
Target price	**INR**		**413**		**372**		11.1
TATA							
EBITDA/t - India	INR	13,794	14,629	13,594	13,990	1.5	4.6
EBITDA	INR m	2,25,221	2,73,388	2,18,601	2,46,780	3.0	10.8
PAT	INR m	29,216	85,692	24,668	66,084	18.4	29.7
Target price	**INR**		**604**		**456**		32.6
JSP							
S/A steel EBITDA/t	INR	14,659	12,198	13,522	11,430	8.4	6.7
EBITDA	INR m	1,16,029	98,733	1,07,070	92,991	8.4	6.2
PAT	INR m	32,890	21,555	26,146	16,181	25.8	33.2
Target price	**INR**		**307**		**261**		17.6
SAIL							
EBITDA/t	INR	5,365	6,252	4,802	6,009	11.7	4.0
EBITDA	INR m	79,261	1,00,071	70,960	95,398	11.7	4.9
PAT	INR m	13,218	26,035	7,037	22,177	87.8	17.4
Target price	**INR**		**49**		**39**		23.6

Source: MOFSL

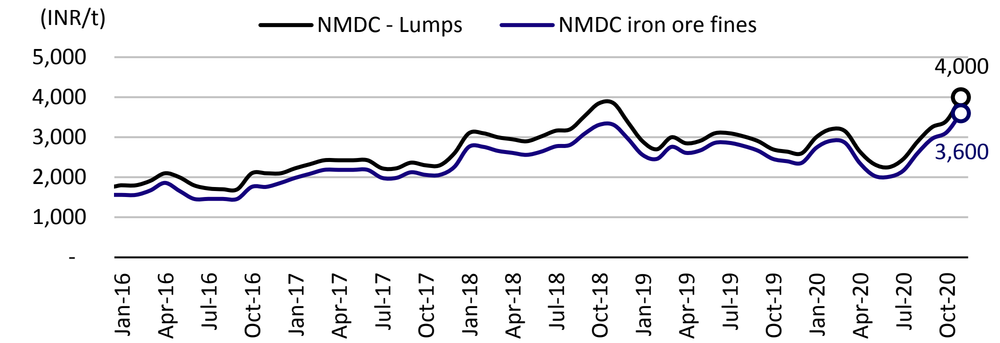
Story in Charts

Exhibit 3: HRC-rebar prices at two- year highs



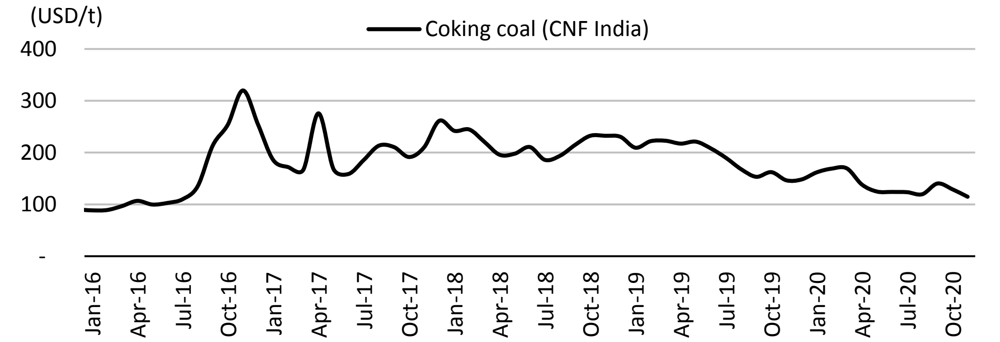
Source: SteelMint, MOFSL

Exhibit 4: Iron ore prices at five-year highs,…



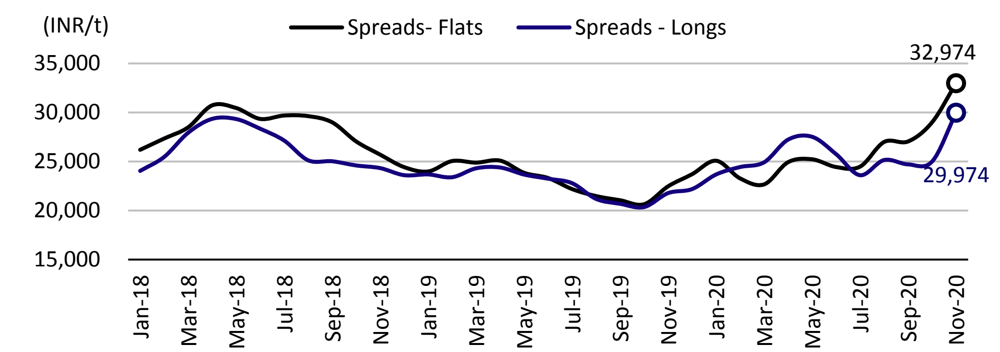
Source: Company, MOFSL

Exhibit 5: …however, coking coal prices are at four-year lows,…



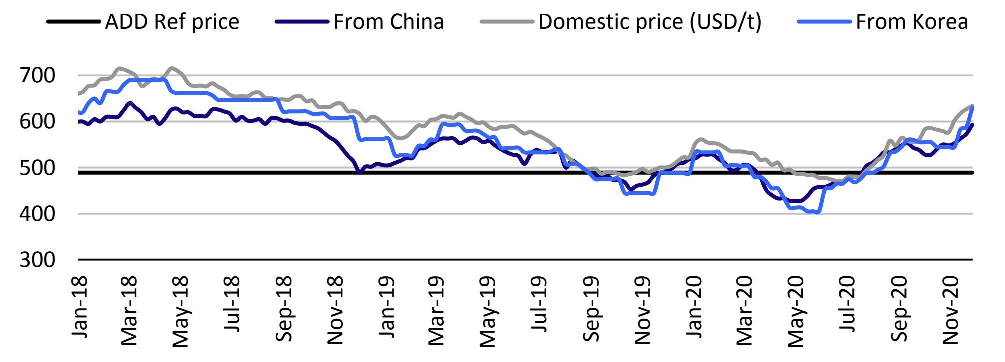
Source: MOFSL, SteelMint

Exhibit 6: Indian steel spreads at multi-year highs



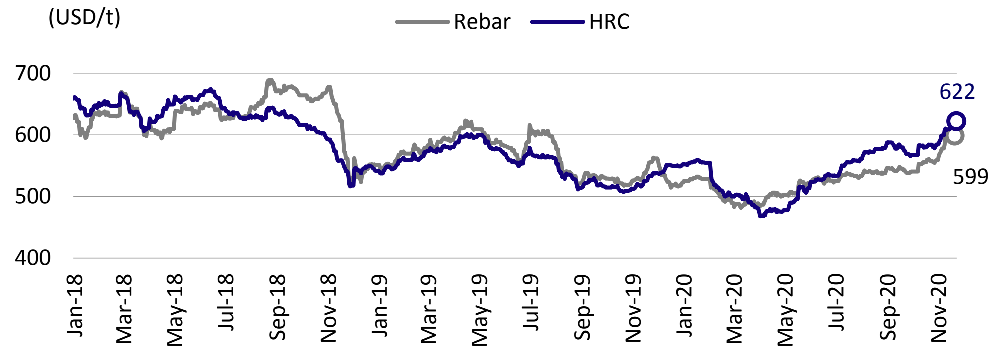
Source: MOFSL

Exhibit 7: Domestic steel prices trading at par with the landed cost of imports from Korea



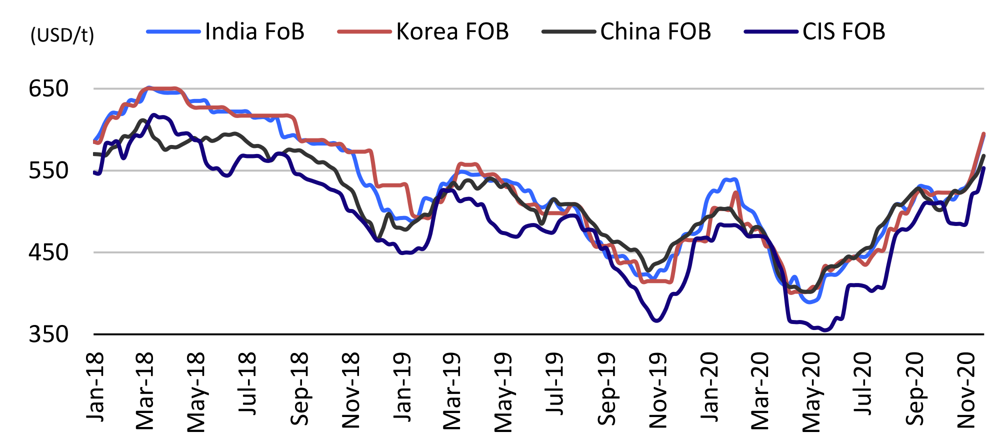
Source: SteelMint, MOFSL

Exhibit 8: China domestic steel prices rise 10-11% in the last two months



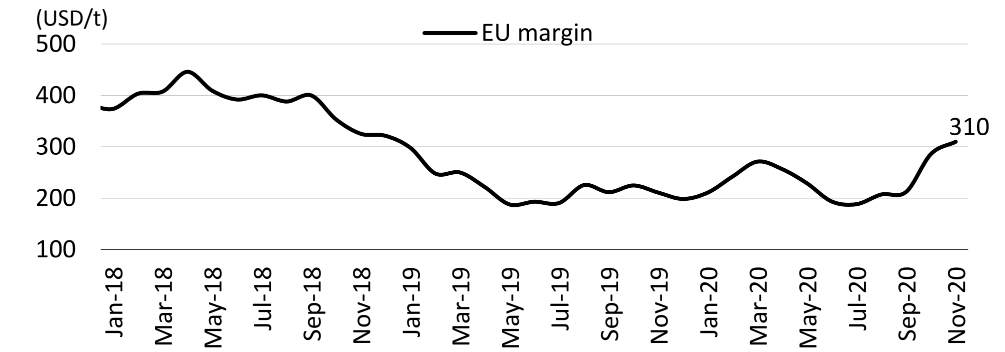
Source: SteelMint, MOFSL

Exhibit 9: Regional steel export prices rise to two-year highs



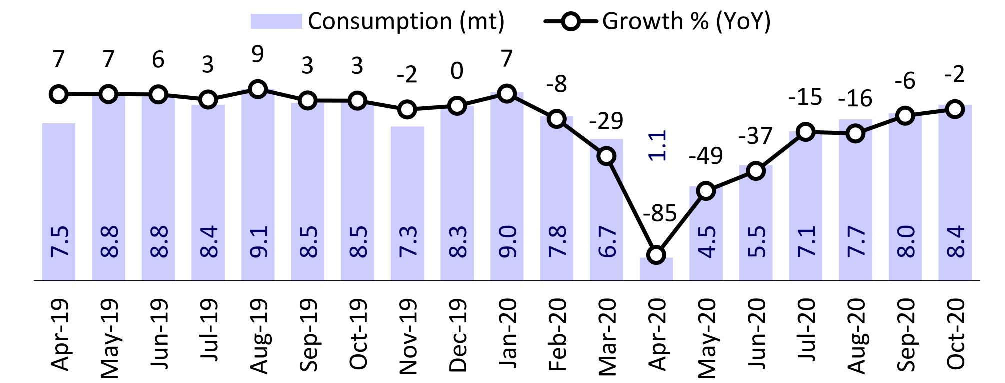
Source: SteelMint, MOFSL

Exhibit 10: Europe steel spreads improves by USD120/t to USD310/t, a two-year high



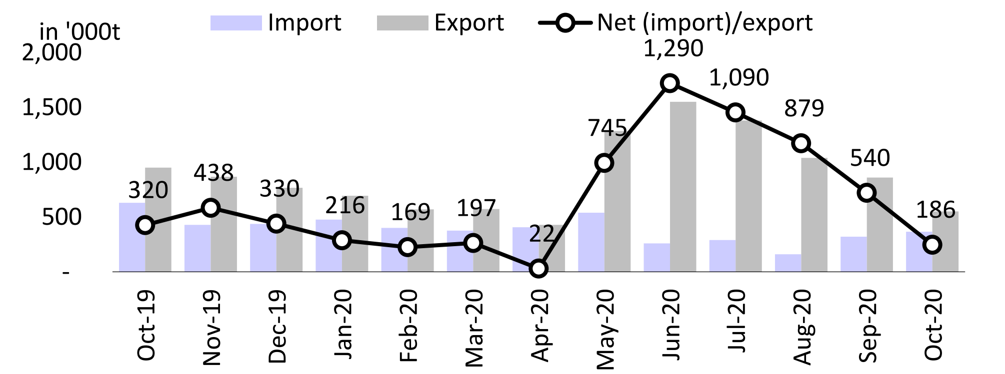
Source: Bloomberg, MOFSL

Exhibit 11: India steel consumption down by ~2% YoY to 8.4mt in Oct'20



Source: Ministry of Steel, MOFSL

Exhibit 12: India net steel exports at 186kt in Oct'20, the lowest in the last six months



Source: Ministry of Steel, MOFSL

NOTES

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SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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