RESULT REVIEW

BOBCAPS
TRUST | INNOVATION | EXCELLENCE

HOLD
TP: Rs 90 | ⮝ 7%

SAIL | Metals & Mining | 29 May 2023

Production gains momentum, higher debt a concern

- **Buildup of production momentum in Q4 but slower pickup in profitability on higher employee costs**
- **Increased risk of a stretched balance sheet through the next wave of expansion over FY24-FY31**
- **TP lowered to Rs 90 (vs. Rs 95) as our higher target EV/EBITDA (4.5x vs. 4x) is offset by higher debt assumptions; maintain HOLD**

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Q4 production momentum builds, debt a concern: SAIL's Q4FY23 production/ sales at 5mt/4.7mt grew 5%/13% QoQ. However, EBITDA was 13% below consensus with a slower pickup in EBITDA/t due to employee costs. Gross debt more than doubled in FY23 to Rs 308bn and poses a concern ahead of the next expansion wave.

FY24 to benefit from better operational momentum…: We currently model for 65% YoY growth in FY24 EBITDA as we factor in a 12% YoY increase in sale volumes (vs. 15% guided) and improvement in EBITDA/t to Rs 7.3k (from Rs 5.0k) in FY24 on the back of improved utilisation of existing operations.

…but legacy issues to weigh on further pickup: We believe profitability will remain constrained by the presence of legacy blast furnaces that account for nearly half of production and earn US$ 80-90/t lower EBITDA margins than new furnaces. We also expect improvement in employee cost per tonne to remain sluggish as SAIL's annual manpower reduction by 3,000-4,000 staff is being partly negated by cost inflation. We currently model for EBITDA/t of Rs 7.3k/Rs 7.6k for FY25/FY26.

Likely to lag peers in next growth phase: SAIL plans to add 3mt of capacity via debottlenecking over the next 3-4 years and deliver 13mt by way of staggered brownfield expansion over FY24-FY31. We believe the company will deliver a slower growth trajectory than peers who have put into motion capex over FY24-FY26.

Higher risk of stretched balance sheet for next expansion wave: We expect SAIL to begin the expansion drive at a net debt-to-EBITDA ratio of 1.5x if it succeeds in starting over FY25. With limited scope for operational improvement in the existing setup and the peak of capex planned over FY28-FY29, we see increased risk of a stretched balance sheet during the next capex wave.

Maintain HOLD: We lower our TP to Rs 90 (vs. Rs 95) as higher net debt assumptions more than offset the benefit of an increase in target FY25E EV/EBITDA multiple to 4.5x (vs. 4x) on improved operational momentum. Retain HOLD as we expect SAIL to lag peers in the next growth phase and face higher balance sheet risk.

Key changes

Target	Rating
▼	◀ ▶

Ticker/Price	SAIL IN/Rs 84
Market cap	US$ 4.2bn
Free float	35%
3M ADV	US$ 13.1mn
52wk high/low	Rs 94/Rs 64
Promoter/FPI/DII	65%/5%/13%

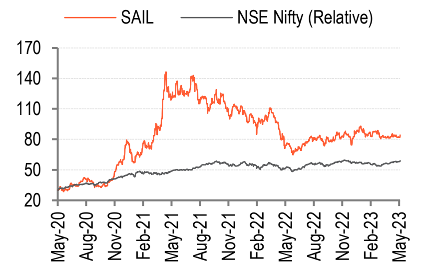
Source: NSE | Price as of 29 May 2023

Key financials

Y/E 31 Mar	FY23P	FY24E	FY25E
Total revenue (Rs mn)	1,044	1,054	993
EBITDA (Rs mn)	80	132	134
Adj. net profit (Rs mn)	22	56	57
Adj. EPS (Rs)	5.3	13.5	13.7
Consensus EPS (Rs)	5.3	10.3	10.9
Adj. ROAE (%)	4.0	9.9	9.4
Adj. P/E (x)	16.0	6.2	6.1
EV/EBITDA (x)	7.7	4.4	4.6
Adj. EPS growth (%)	(82.2)	157.0	1.5

Source: Company, Bloomberg, BOBCAPS Research | P – Provisional

Stock performance



Source: NSE

Q4 review

While SAIL's Q4FY23 results demonstrated a further buildup in operational momentum, the pickup in profit was slower than anticipated. Incremental debt is also a concern as SAIL readies for the next major wave of expansion with a capex plan of Rs 1tn over FY24-FY31.

Operational momentum picks up but profit still lags

SAIL's Q4 revenue/EBITDA/net income at Rs 291bn/Rs 29.8bn/Rs 9.3bn missed Bloomberg consensus by 1%/13%/28%. The results were also marginally below our forecasts (-1%/-6%/-1%).

- **High debt a concern:** Gross debt eased only marginally (by Rs 30bn QoQ) in the absence of inventory liquidation and given the continuing high cost of coking coal. Gross debt has, in fact, more than doubled to Rs 308bn at end-FY23. Net debt at Rs 302bn was higher than the Bloomberg consensus estimate of Rs 254bn.
- **Operational momentum builds further:** Production/sales at 5mt/4.7mt were up 5%/13% QoQ, building upon momentum gained in Q3. The production run-rate at 19.8mt (annualised) shows a strong increase over the FY22 rate of 17.4mt.
- **Profit pickup still slow:** Higher production has not yet translated into material improvement in profit. Q4 gross margin and EBITDA/t recovered by Rs 1.4k and Rs 1.2k to Rs 29.1k and Rs 6.1k respectively in Q4. While conversion costs did decrease by Rs 0.5k/t QoQ with higher production, this was offset by increased employee costs (at Rs 0.7k/t QoQ) as SAIL made an additional 3.6% provision for pension (total at 6.6% of revenue for the year) and raised retirement provisions with changes to actuarial valuation.
- **Durgapur and IISCO profitability improve:** Durgapur and IISCO's Q4 operating profit stood at 103% and 178% of the average quarterly profit reported in FY22 respectively. SAIL attributed the improvement to higher utilisation of the medium structure and universal structure mills at these plants, which are collectively operating at a 0.6mt monthly run-rate from 0.35mt a year-ago.
- **Rourkela and Bokaro profitability muted relative to FY22:** Q4 operating profit at the Rourkela and Bokaro plants stood at 27% and 20% of average quarterly profit reported in FY22 respectively. SAIL attributed the apparent weakness to a higher base in FY22 when these plants benefitted from significantly wider spreads between flat and long products.

Stronger traction guided for FY24

- **FY24 sales growth guidance at 15%:** SAIL is guiding for 18.75mt of sales in FY24, including the liquidation of inventory built in FY23 (up 0.45mt to 1.05mt). This translates into 15% YoY growth. While the production momentum has continued into Apr'24 (1.3mt or 16mt annualised), management is guiding for a bulk of the growth to come through in the second half of the year.

- **Margin to soften in Q1FY24:** SAIL is experiencing a Rs 2-2.5k/t reduction in domestic steel prices in May following the decline in international prices. Against this, coking coal prices are likely to remain steady at Rs 28k/t as the company absorbs high-cost coal inventory purchased in January-February. SAIL expects the benefit of cheaper coking coal to pass through to the cost base only in the second half of June.

- **Price revision upside on rails:** SAIL guides for upside from price revision on the sale of rails in FY22 and FY23, as the railway board will approve pricing for FY22 sometime over H1FY24 (revenue has been booked at a provisional rate of Rs 67.5k/t). Further upside may also accrue if the company is successful in getting the FY23 sale price approved by the railway board earlier by end-FY24.

- **Cash tax outgo to start from FY24:** SAIL has exhausted past tax credit, and cash tax outgo is guided to commence from FY24.

- **Modest capex outgo in FY24:** Management expects capex outgo of Rs 65bn in FY24 toward maintenance, planned steel plant debottlenecking, start-up of the Tasra coking coal mine and rebuilding of coke-oven batteries. It further guides for Rs 50bn-55bn of annual capex outgo on existing plants for maintenance and normal upgrades over medium-term.

- **Commissioning of Tasra coking coal mine:** The company has floated tenders for operating the Tasra coal mine (potential production of 1.6mt), with a plan to operationalise the same in FY24. All clearances are in place.

Growth plan still under evaluation

- **Committed debottlenecking target of 3mt:** SAIL aims to add 2.5-3.0mt of capacity at existing plants over the next 3-4 years via debottlenecking. It has initiated the environmental impact assessment for increasing hot metal production by 0.2mtpa to 2.7mtpa at Durgapur and crude steel production by 0.65mtpa/ 0.35mtpa at Rourkela/Bokaro.

- **13mt expansion still under evaluation:** The company plans to add 13mt of capacity by FY31 at a total capex of Rs 1tn via staggered expansion at three plants. It has initiated a detailed feasibility report (DFR) for 4.5mt of expansion at IISCO and 3mt at Bokaro. Expansion at IISCO is scheduled to begin in FY24, Bokaro in FY25 and Durgapur in FY26.

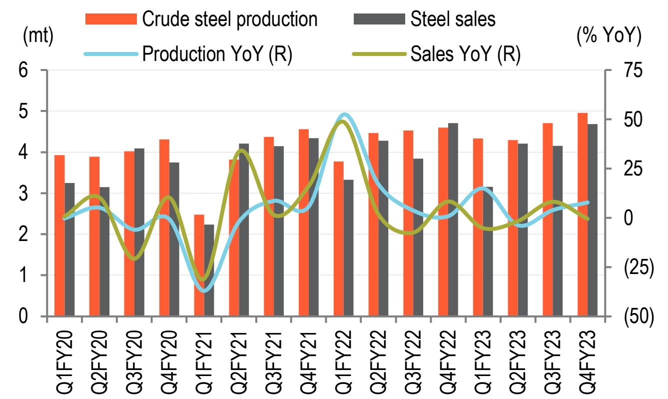
  Management aims to complete the DFR and finalise tender specifications over the next six months and seek board approval by end-FY24. At present, the company envisages a material increase in capex from H2FY25, and a peak over FY28 and FY29 when three expansion projects will run concurrently.

Fig 1 – Quarterly performance

(Rs bn)	Q4FY23	Q3FY23	QoQ (%)	Q4FY22	YoY (%)	FY23	FY22	YoY (%)
Consolidated P&L								
Revenue	291.3	250.4	16.3	307.6	(5.3)	1044.5	1034.8	0.9
EBITDA	**29.2**	**20.8**	**40.7**	**43.4**	**(32.6)**	**80.4**	**213.4**	**(62.3)**
EBIT	15.6	8.6	81.9	31.9	(51.2)	30.8	170.7	(82.0)
PBT before JV and exceptionals	13.3	3.2	321.6	31.7	(58.1)	19.9	162.3	(87.7)
PBT before exceptionals	16.0	4.3	274.8	32.7	(51.0)	26.3	166.5	(84.2)
PAT adjusted before JV	**9.3**	**1.3**	**604.8**	**23.7**	**(60.9)**	**12.7**	**121.8**	**(89.5)**
PAT adjusted	12.0	2.4	392.1	24.7	(51.4)	19.2	126.0	(84.8)
PAT reported	11.6	5.4	113.8	24.8	(53.2)	21.8	122.4	(82.2)
EPS (Rs)	2.8	1.3	114.5	6.0	(53.2)	5.3	29.6	(82.2)
Tax rate (%)	25.1	43.0		24.5		27.2	24.3	
Standalone								
Crude steel production (mt)	5.0	4.7	5.2	4.6	7.8	18.3	17.4	5.3
Steel sales (mt)	4.7	4.2	12.8	4.7	(0.5)	16.2	16.2	0.3
Realisation (Rs'000/t)	62.2	60.3	3.2	65.4	(4.8)	64.5	64.1	0.7
Gross margin (Rs'000/t)	**29.1**	**27.7**	**5.0**	**30.1**	**(3.5)**	**29.3**	**37.7**	**(22.3)**
Employee costs (Rs'000/t)	7.3	6.7	9.8	6.4	13.9	7.5	8.0	(6.4)
Other conversion costs (Rs'000/t)	15.5	16.0	(3.2)	14.5	7.0	16.9	16.5	2.2
EBITDA (Rs'000/tcs)	**6.2**	**5.0**	**24.8**	**9.2**	**(32.2)**	**5.0**	**13.2**	**(62.4)**

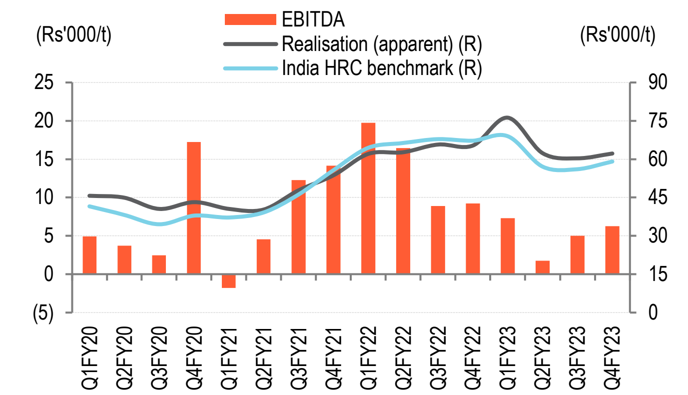
Source: Company, BOBCAPS Research

Fig 2 – Production momentum builds on Q3 pickup



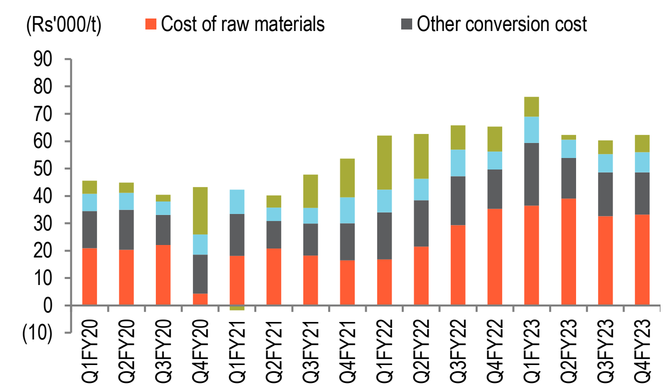
Source: Company, BOBCAPS Research

Fig 3 – EBITDA recovery still slow…



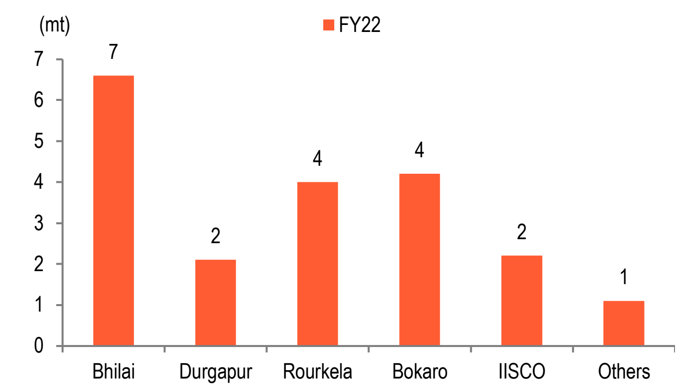
Source: Company, BOBCAPS Research

Fig 4 – …as reduction in unit conversion cost per tonne was offset by higher employee cost



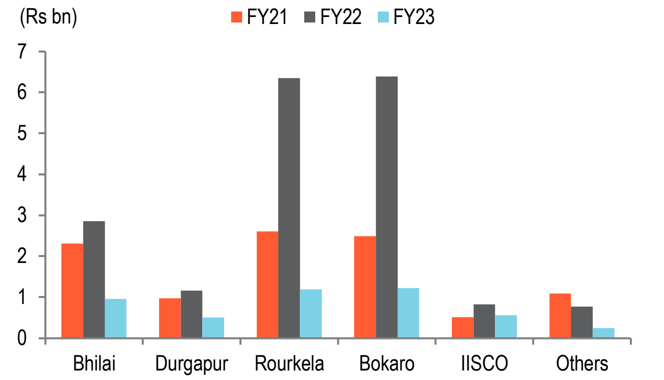
Source: Company, BOBCAPS Research

Fig 5 – Plant-wise capacity currently totals 20mt



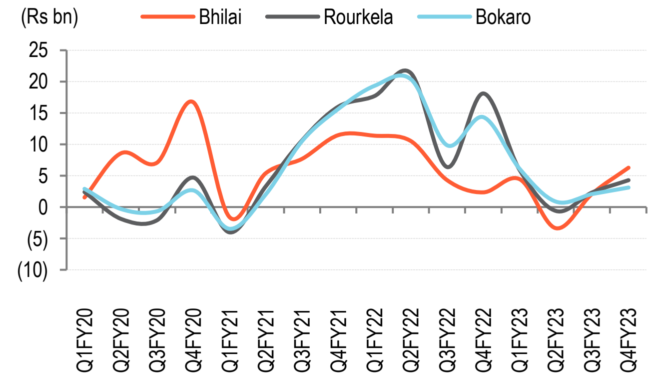
Source: Company, BOBCAPS Research

Fig 6 – Plant-wise operating profit remains muted



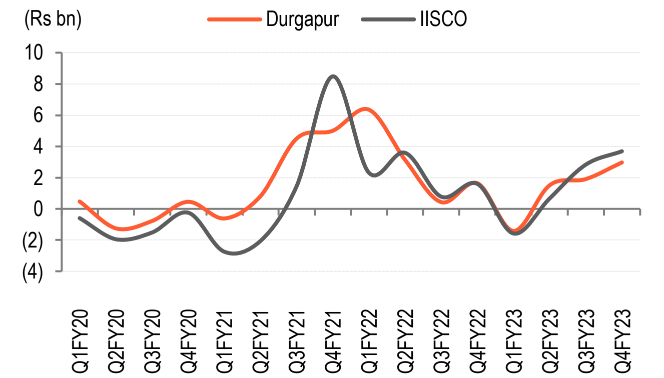
Source: Company, BOBCAPS Research

Fig 7 – Operating profit at larger plants below FY22 levels on compression in flat to long spreads



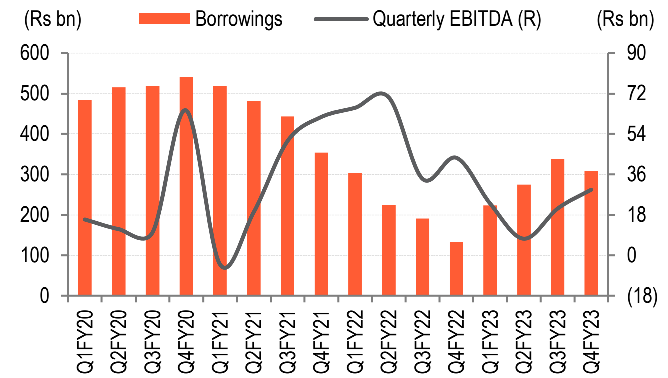
Source: Company, BOBCAPS Research

Fig 8 – Operating profit trends at smaller plants recovered on improved utilisation of structure mills



Source: Company, BOBCAPS Research

Fig 9 – Borrowings remained high at end-FY23



Source: Company, BOBCAPS Research

Valuation methodology

Estimates revised

Accounting for stronger operational momentum, we raise our FY24 EBITDA estimate by 2.4%, but assuming a slower pickup in profitability post FY24, we lower FY25 EBITDA by 5.7%. We also roll forward our forecasts to FY26.

- **Conservative sales forecasts:** We are now factoring in 12% YoY growth in FY24 sales to 18.1mt including liquidation of inventories. Our sales forecasts are conservative compared to management guidance of 15% YoY growth to 18.75mt considering SAIL's history of slower sales ramp-up than management guidance. At this stage, we are also not building in the potential 2.5-3.0mt increase in capacity planned over the next 3-4 years through debottlenecking as we await clearances and clear implementation timelines.
- **Improved profitability baked in for FY24:** Given the improved operational momentum in H2FY23, we estimate that EBITDA/t will rise from Rs 5.0k in FY23 to Rs 7.3k/Rs 7.3k/Rs 7.6k over FY24/FY25/FY26.
- **Legacy blast furnace to weigh on profits:** Our forecasts assume a negative impact of legacy blast furnaces on average margins for SAIL. These furnaces still account for half of production and earn US$ 80-90/t lower EBITDA margins than new blast furnaces.
- **Employee cost per tonne to improve only gradually:** We expect improvement in employee cost per tonne to remain sluggish as SAIL's annual manpower reduction by 3,000-4,000 staff is being partly negated by cost inflation.

Fig 10 – Revised estimates

(Rs bn)	Actual	New			Old		Change (%)	
	FY23P	FY24E	FY25E	FY26E	FY24E	FY25E	FY24E	FY25E
Revenue	1,044	1,054	993	1,016	1,061	992	(0.6)	0.1
EBITDA	80	132	134	139	129	142	2.4	(5.7)
EBITDA growth (%)	(62.3)	64.6	1.0	3.9	47.7	9.7	-	-
Net income	22	56	57	59	58	67	(3.2)	(15.5)

Source: Company, BOBCAPS Research

Fig 11 – Key assumptions

Parameter	FY23P	FY24E	FY25E	FY26E
Sales (mt)	16.2	18.1	18.2	18.3
India HRC (US$/t)	891	751	641	599
Realisation (Rs'000/t)	64.5	58.2	54.6	55.6
EBITDA/t (Rs'000/t)	5.0	7.3	7.3	7.6

Source: Company, BOBCAPS Research

We are ahead of consensus EBITDA for FY24-FY25, likely on assumptions of stronger recovery in EBITDA margin on a lower base. Note, our margin assumptions are for a modest recovery to Rs 7.3k/t in each of these two years.

Fig 12 – Estimates vs. Consensus

(Rs bn)	Actuals	Forecasts			Consensus		Delta to Consensus (%)	
	FY23P	FY24E	FY25E	FY26E	FY24E	FY25E	FY24E	FY25E
Revenue	1,044	1,054	993	1,016	1,028	1,050	2.6	(5.4)
EBITDA	80	132	134	139	119	125	11.1	6.9
Net income	22	56	57	59	46	49	22.9	16.3

Source: Bloomberg, BOBCAPS Research

Maintain HOLD, TP lowered to Rs 90

While we raise our target FY25E EV/EBITDA multiple to 4.5x (from 4x) acknowledging the improvement in operational momentum, the benefit is offset by a higher net debt assumption for FY24, which leads to a revised TP of Rs 90 (from Rs 95). We maintain our HOLD rating as we expect SAIL to lag peers in the next growth phase and also face higher balance sheet risk.

Our assumptions bake in a net debt-to-EBITDA ratio of 1.5x for FY25 assuming SAIL succeeds in starting its expansion drive that year. With limited scope for operational improvement in the existing setup and the peak of capex planned over FY27-FY28, we see increased risk of a stretched balance sheet during the next wave.

Our revised valuation multiple of 4.5x for SAIL remains below our target 6x mid-cycle multiple for the Indian steel sector to reflect weaker profitability of the company's operations and a pause in its capex programme over past three years to stabilise the operations after previous modernization program. We believe that steel margins will stabilise in FY24 aided by supportive government policies in China aimed at rebooting the Chinese economy.

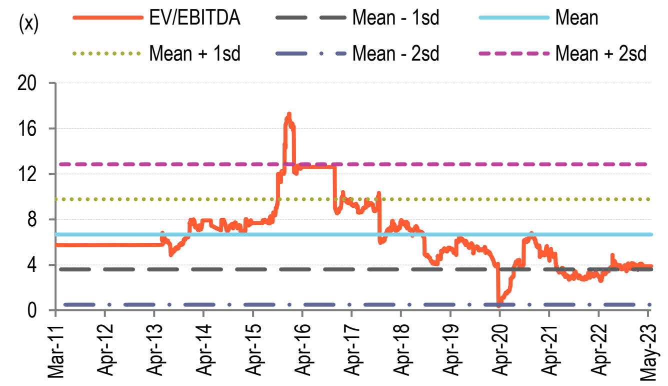
Fig 13 – Valuation summary

(Rs bn)	Value (Rs bn)
FY25E EBITDA	134
Target EV/EBITDA multiple (x)	4.5
EV	602
Net debt FY24E	230
Market Value	371
Fair value per share (Rs)	90
Target price Mar'23 (rounded to nearest Rs 5)	**90**

Source: Company, BOBCAPS Research

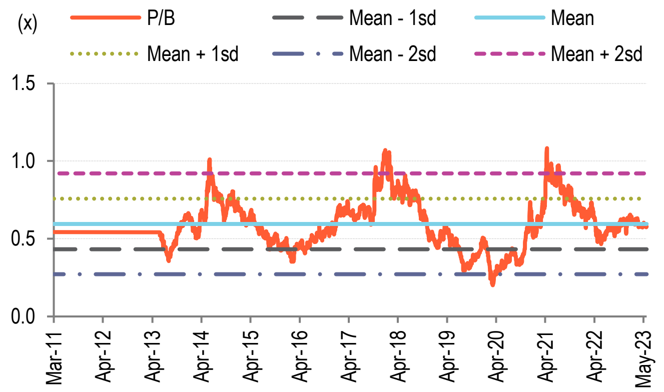
Our target multiple is broadly in line with the stock's historical trading average of 4.4x over the past five years but lower than the 6.7x seen over the past ten-year period.

Fig 14 – EV/EBITDA 2Y forward



Source: Bloomberg, BOBCAPS Research

Fig 15 – P/B 1Y forward



Source: Bloomberg, BOBCAPS Research

Fig 16 – Peer comparison

Ticker	CMP (Rs)	Rating	Target Price (Rs)	Upside (%)	EV/Sales (x)		EV/EBITDA (x)		Net income (Rs bn)		P/B (x)		P/E (x)	
					FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
TATA IN	106	BUY	140	31.6	0.9	0.8	5.8	4.7	88	123	1.3	1.0	10.5	7.4
JSTL IN	702	HOLD	715	1.9	1.5	1.3	7.2	5.8	39	135	2.4	1.8	12.5	9.1
JSP IN	520	BUY	625	20.1	1.2	1.0	5.5	4.3	32	54	1.4	1.1	9.8	7.6
SAIL IN	82	HOLD	90	9.6	0.5	0.5	4.3	4.1	26	58	0.6	0.5	6.1	6.0

Source: BOBCAPS Research

Key risks

- Steel producer valuations are highly sensitive to product and raw material prices. Key upside/downside risks to our estimates are changes in global demand-supply balance for steel and its raw materials, leading to higher/lower prices and margins than our assumptions.
- Faster/slower ramp-up of crude steel and value-added production and implementation of efficiency measures than our expectations represent upside/ downside risks to our earnings forecasts.

Sector recommendation snapshot

Company	Ticker	Market Cap (US$ bn)	Price (Rs)	Target (Rs)	Rating
Jindal Steel & Power	JSP IN	6.6	532	625	BUY
JSW Steel	JSTL IN	20.7	702	715	HOLD
SAIL	SAIL IN	4.2	84	90	HOLD
Tata Steel	TATA IN	16.0	108	140	BUY

Source: BOBCAPS Research, NSE | Price as of 29 May 2023

Financials

Income Statement

Y/E 31 Mar (Rs bn)	FY22A	FY23P	FY24E	FY25E	FY26E
Total revenue	**1,035**	**1,044**	**1,054**	**993**	**1,016**
EBITDA	213	80	132	134	139
Depreciation	(43)	(50)	(52)	(54)	(56)
EBIT	171	31	80	80	83
Net interest inc./(exp.)	(17)	(20)	(19)	(17)	(17)
Other inc./(exp.)	9	10	9	8	9
Exceptional items	(4)	3	0	0	0
EBT	163	29	75	76	79
Income taxes	(40)	(7)	(19)	(19)	(20)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	4	6	5	5	5
Reported net profit	**122**	**22**	**56**	**57**	**59**
Adjustments	0	0	0	0	0
Adjusted net profit	**122**	**22**	**56**	**57**	**59**

Balance Sheet

Y/E 31 Mar (Rs bn)	FY22A	FY23P	FY24E	FY25E	FY26E
Accounts payables	169	143	136	124	127
Other current liabilities	157	137	137	137	137
Provisions	12	14	16	15	15
Debt funds	173	308	243	213	218
Other liabilities	148	156	158	157	160
Equity capital	41	41	41	41	41
Reserves & surplus	501	506	545	585	626
Shareholders' fund	542	547	587	626	668
Total liab. and equities	**1,201**	**1,305**	**1,276**	**1,271**	**1,324**
Cash and cash eq.	8	6	12	8	8
Accounts receivables	48	54	52	49	50
Inventories	196	278	227	212	216
Other current assets	37	43	44	41	42
Investments	0	0	0	0	0
Net fixed assets	684	671	669	666	660
CWIP	40	49	64	94	144
Intangible assets	15	15	15	16	16
Deferred tax assets, net	0	0	0	0	0
Other assets	174	190	191	185	187
Total assets	**1,201**	**1,305**	**1,276**	**1,271**	**1,324**

Cash Flows

Y/E 31 Mar (Rs bn)	FY22A	FY23P	FY24E	FY25E	FY26E
Cash flow from operations	**316**	**(38)**	**175**	**135**	**133**
Capital expenditures	(37)	(46)	(66)	(81)	(101)
Change in investments	0	0	0	0	0
Other investing cash flows	(47)	(16)	(2)	6	(2)
Cash flow from investing	**(84)**	**(62)**	**(67)**	**(75)**	**(103)**
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(204)	135	(65)	(30)	5
Interest expenses	(17)	(20)	(19)	(17)	(17)
Dividends paid	(36)	(13)	(17)	(17)	(18)
Other financing cash flows	25	(3)	0	0	0
Cash flow from financing	**(232)**	**98**	**(101)**	**(64)**	**(30)**
Chg in cash & cash eq.	**0**	**(2)**	**7**	**(4)**	**0**
Closing cash & cash eq.	**8**	**6**	**12**	**8**	**8**

Per Share

Y/E 31 Mar (Rs)	FY22A	FY23P	FY24E	FY25E	FY26E
Reported EPS	29.6	5.3	13.5	13.7	14.3
Adjusted EPS	29.6	5.3	13.5	13.7	14.3
Dividend per share	8.7	3.2	4.1	4.1	4.3
Book value per share	131.2	132.5	142.0	151.6	161.6

Valuations Ratios

Y/E 31 Mar (x)	FY22A	FY23P	FY24E	FY25E	FY26E
EV/Sales	0.8	0.6	0.6	0.6	0.6
EV/EBITDA	3.7	7.7	4.4	4.6	4.1
Adjusted P/E	2.8	16.0	6.2	6.1	5.9
P/BV	0.6	0.6	0.6	0.6	0.5

DuPont Analysis

Y/E 31 Mar (%)	FY22A	FY23P	FY24E	FY25E	FY26E
Tax burden (Net profit/PBT)	73.6	82.6	74.8	74.8	74.8
Interest burden (PBT/EBIT)	97.5	85.6	93.2	95.5	95.4
EBIT margin (EBIT/Revenue)	16.5	2.9	7.6	8.0	8.1
Asset turnover (Rev./Avg TA)	87.0	83.4	81.7	78.0	78.3
Leverage (Avg TA/Avg Equity)	2.4	2.3	2.3	2.1	2.0
Adjusted ROAE	24.6	4.0	9.9	9.4	9.1

Ratio Analysis

Y/E 31 Mar	FY22A	FY23P	FY24E	FY25E	FY26E
YoY growth (%)					
Revenue	49.7	0.9	0.9	(5.8)	2.3
EBITDA	67.5	(62.3)	64.6	1.0	3.9
Adjusted EPS	195.2	(82.2)	157.0	1.5	3.9
Profitability & Return ratios (%)					
EBITDA margin	20.6	7.7	12.5	13.5	13.7
EBIT margin	16.5	2.9	7.6	8.0	8.1
Adjusted profit margin	11.8	2.1	5.3	5.7	5.8
Adjusted ROAE	24.6	4.0	9.9	9.4	9.1
ROCE	20.3	4.3	8.9	8.9	8.9
Working capital days (days)					
Receivables	17	19	18	18	18
Inventory	69	97	79	78	78
Payables	75	54	54	53	53
Ratios (x)					
Gross asset turnover	0.9	0.8	0.8	0.8	0.8
Current ratio	0.7	0.8	0.8	0.8	0.8
Net interest coverage ratio	10.1	1.5	4.1	4.7	4.7
Adjusted debt/equity	0.3	0.6	0.4	0.3	0.3

Source: Company, BOBCAPS Research | Note: TA = Total Assets

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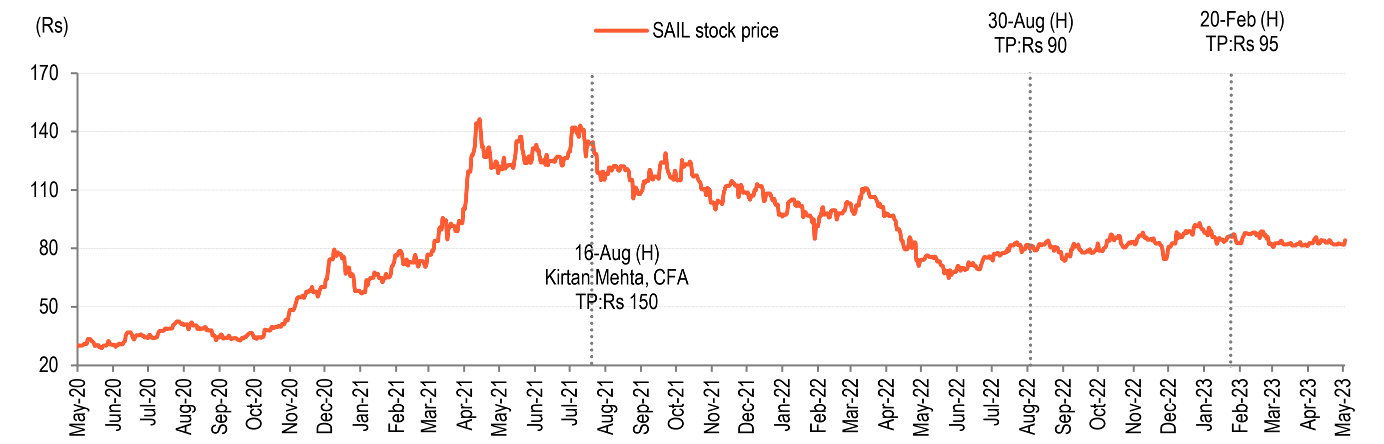
BUY – Expected return >+15%
HOLD – Expected return from -6% to +15%
SELL – Expected return <-6%
Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Ratings and Target Price (3-year history): SAIL (SAIL IN)



B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

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