

Spread expansion continues, downgrade to Hold

We downgrade Tata Sponge (TSIL) to Hold with a revised TP of Rs1165 as recent sharp run-up leaves limited upside on the table given the fact that surplus cash on books would be deployed as CWIP for steel plant capex over FY19-20E. TSIL's spreads in sponge iron business have continued to improve and outlook on the sustenance of the same is strong which gives confidence of smart uptick in earnings over FY18-19E. Q3 earnings were strong YoY led by better pricing and company remains on track to achieve its full year volume targets. Stock trades at FY19E EV/EBITDA of 4.9x and a five year AOCF/EV yield of 6.8% which is fair.

- Operational performance strong YoY led by solid volume growth:** TSIL's volumes were strong at 115kt, up 17.4% YoY. EBITDA rose 347% YoY and 40% QoQ to Rs481mn. Realisations improved (up 3.6% QoQ to Rs17300) and spreads (gross profit/t) were marginally higher QoQ led by better realisations partially negated by higher coal costs. EBITDA/t stood at Rs4183, up 280% YoY.
- Steel plant capex yet to be finalised but spend likely to start from FY19E:** TSIL's board had earlier approved the set-up of a steel plant of up to 1.5 mtpa in stages. Management has indicated that the likely route for plant set-up would be BF-BOF combination with an approx. size of ~0.8 MT in first phase and this would be a brownfield expansion with a competitive capex cost/t. TSIL would be foraying into long product manufacturing in the steel plant and expects to announce the plant's final set-up plans by FY18E-end. We expect TSIL to start deploying its existing cash pile and internal accruals into steel plant set-up from FY19E.
- Earnings revised higher:** We increase our volume estimates as TSIL remains on track to surpass its full year volume guidance of ~410kt. We increase our realization estimates as sponge iron prices have gone up sharply in line with upward movement in global scrap and steel prices. Coal availability in domestic market remains tight and we have factored in imports/domestic sourcing of 90%/10% for TSIL in FY18E. We revise our coal costs higher to account for higher global prices. We have revised our EBITDA estimates higher by ~18%/16% for FY18E/19E.
- Valuation and risks – Maintain Buy:** We remain positive on TSIL due to better visibility on spread improvement and its sustenance. We are also positive on the announcement of forward integration into steelmaking considering the improved outlook for the steel sector and strong parentage, but would wait for final details on capex to factor its impact on TSIL's fair value. We rollover to FY20E and value the company at 5x FY20E EV/EBITDA but value the surplus cash at 75% of its value now as this cash is expected to be deployed as CWIP for the steel plant by FY20E. We revise our TP higher to Rs1165. Downgrade to hold as recent strong rally leaves limited upside. Key risks are fall in sponge iron prices and higher coal costs.

Y/E Mar (Rs mn)	Q3FY18	Q3FY17	YoY(%)	Q2FY18	QoQ(%)	Q3FY18E	Var(%)
Net sales	2,145	1,435	49.4	1,672	28.3	1,967	9.0
Raw materials (net)	1,370	958	43.0	1,072	27.8	1,226	11.8
Employee costs	101	150	(32.7)	106	(4.3)	118	(14.3)
Other expenses	193	220	(12.3)	150	28.3	200	(3.8)
EBITDA	481	108	346.7	344	39.9	423	13.6
EBITDA margin (%)	22.4	7.5	1493 bps	20.6	186bps	21.5	90bps
Depreciation	31	32	(4.6)	31	0.7	32	(3.4)
Other income	117	86	35.6	95	23.0	100	16.5
PBT	543	153	256.1	407	33.6	487	11.5
Tax	183	43	327.5	131	40.4	156	17.6
PAT	360	110	228.2	276	30.4	331	8.6

Source: Company, Centrum Research

Y/E Mar (Rs mn)	Revenue	YoY (%)	EBITDA	EBITDA (%)	Adj. PAT	YoY (%)	EPS	RoE (%)	RoCE (%)	PE (x)	EV/EBITDA(x)
FY16	5,735	(27.4)	240	4.2	319	(65.3)	20.7	3.9	4.2	22.7	4.3
FY17	5,573	(2.8)	616	11.1	588	84.1	38.2	7.0	6.8	15.7	5.5
FY18E	8,007	43.7	1,768	22.1	1,365	132.2	88.6	14.8	13.8	12.9	5.9
FY19E	8,292	3.6	1,845	22.2	1,559	14.2	101.2	14.8	13.8	11.3	4.9
FY20E	8,163	(1.5)	1,907	23.4	1,668	7.0	108.3	13.9	13.1	10.5	4.0

Source: Company, Centrum Research Estimates; All ratios based on average mcap for year

In the interest of timeliness, this document is not edited

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Target Price		Rs1,165	Key Data	
CMP*	Rs1,140	Bloomberg Code	TTSP IN	
Upside	2.2%	Curr Shares O/S (mn)	15.4	
Previous Target	Rs1125	Diluted Shares O/S(mn)	15.4	
Previous Rating	Buy	Mkt Cap (Rsbn/USDmn)	18.2/285.4	
Price Performance (%)*		52 Wk H / L (Rs)	1240/589.6	
	1M	6M	1Yr	
TTSP IN	27.7	43.8	89.2	5 Year H / L (Rs)
Nifty	4.1	10.1	28.5	1238/217.9
			Daily Vol. (3M NSE Avg.)	347873

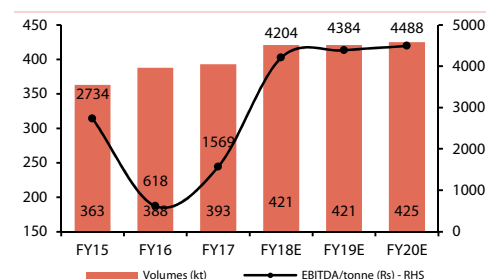
*as on 18 January 2018; Source: Bloomberg, Centrum Research

Shareholding pattern (%)*

	Dec-17	Sep-17	Jun-17	Mar-17
Promoter	54.5	54.5	54.5	54.5
FII's	8.4	7.0	8.2	8.2
Dom. Inst.	0.9	0.8	0.9	0.9
Public & Others	36.2	37.7	36.4	36.4

Source: BSE, *as on 18 January 2018

EBITDA/tonne trend



Source: Company, Centrum Research Estimates

Earnings Revision

Particulars (Rs mn)	FY18E			FY19E		
	New	Old	Chg (%)	New	Old	Chg (%)
Sales	8,007	7,356	8.8	8,292	7,460	11.1
EBITDA	1,768	1,497	18.1	1,845	1,592	15.9
EBITDA Margin (%)	22.1	20.3	173 bps	22.2	21.3	90 bps
PAT	1,365	1,326	2.9	1,559	1,454	7.2

Source: Centrum Research Estimates

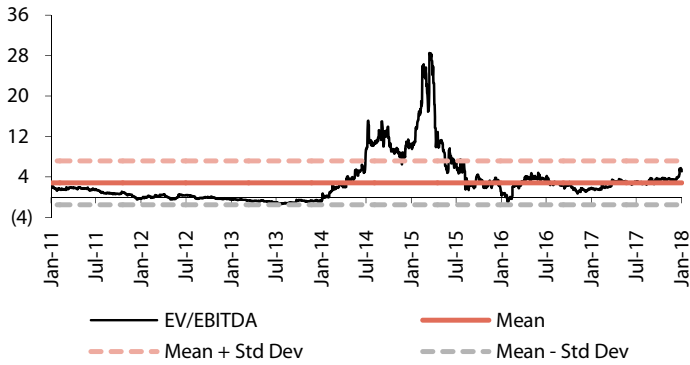
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Exhibit 1: Sensitivity Analysis (FY18E)

Sensitivity to key variables	% change	% impact on EBITDA	% impact on EPS
Sales volume	1	4.2	3.2
Realization	1	4.8	4.0
Iron ore cost increase	1	(2.1)	(1.8)

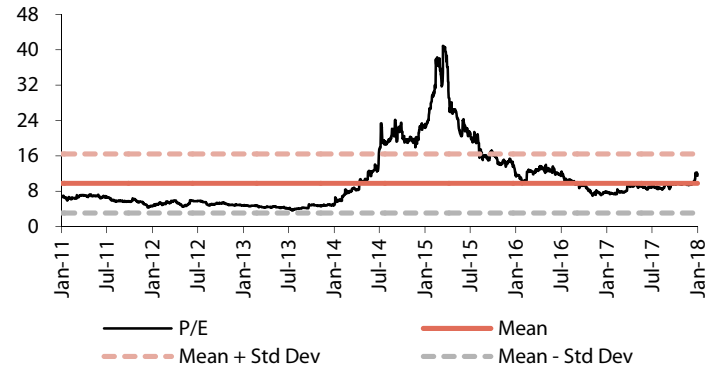
Source: Company, Centrum Research Estimates

Exhibit 2: 1 year forward EV/EBITDA chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 3: 1 year forward P/E chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 4: Valuations

(Rsmn)	Mar'20E
EBITDA	1,907
Justified EV/EBITDA (x)	5.0
EV	9,537
Net Cash	9,964
Add: Net Cash (@75%)	7,473
Add: Coal block investment (@50%)	900
Fair Value Mkt Cap	17,910
No. of Shares (mn)	15.4
Fair value/share (Rs)	1,163

Quarterly financials, operating metrics and key performance indicators

Exhibit 5: Quarterly Financials

Particulars (Rs mn)	Q4FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
Net Sales	1,404	1,077	1,380	1,435	1,672	1,750	1,672	2,145
Other operating income	0	3	7	1	0	0	0	0
Total Income	1,404	1,079	1,387	1,435	1,672	1,750	1,672	2,145
(Accretion)/Decretion of stock	8	-97	48	-4	85	-209	62	78
Cost of Raw Materials consumed	857	813	897	962	1,025	1,263	1,010	1,292
Staff Cost	100	101	97	150	114	98	106	101
Other Operational expenses	291	180	175	220	189	212	150	193
Operating Profit (Core EBITDA)	147	82	169	108	258	386	344	481
Depreciation	31	31	33	32	32	32	31	31
EBIT	117	51	137	75	226	354	313	450
Interest	37	6	6	9	5	5	1	23
Other Revenue/Income	109	96	93	86	96	103	95	117
Other Exceptional Items	0	0	0	0	0	0	0	0
Profit Before Tax	189	141	224	153	318	452	407	543
Tax	61	36	63	43	106	147	131	183
<i>Tax rate (%)</i>	<i>32.3</i>	<i>25.3</i>	<i>28.2</i>	<i>28.1</i>	<i>33.2</i>	<i>32.4</i>	<i>32.1</i>	<i>33.8</i>
Profit After Tax	128	105	161	110	212	306	276	360
Growth (%)								
<i>Net Sales</i>	<i>(12.2)</i>	<i>(24.1)</i>	<i>(8.4)</i>	<i>3.4</i>	<i>19.1</i>	<i>62.6</i>	<i>21.1</i>	<i>49.5</i>
<i>EBITDA</i>	<i>(946.6)</i>	<i>101.2</i>	<i>1,265.3</i>	<i>362.2</i>	<i>75.1</i>	<i>373.6</i>	<i>103.2</i>	<i>346.7</i>
<i>Adj. PAT</i>	<i>49.6</i>	<i>47.9</i>	<i>182.2</i>	<i>109.4</i>	<i>65.4</i>	<i>190.3</i>	<i>71.9</i>	<i>228.2</i>
Margin (%)								
<i>EBITDA</i>	<i>10.5</i>	<i>7.6</i>	<i>12.2</i>	<i>7.5</i>	<i>15.4</i>	<i>22.1</i>	<i>20.6</i>	<i>22.4</i>
<i>EBIT</i>	<i>8.3</i>	<i>4.7</i>	<i>9.9</i>	<i>5.2</i>	<i>13.5</i>	<i>20.2</i>	<i>18.7</i>	<i>21.0</i>
<i>PAT (reported bef minority interest)</i>	<i>9.1</i>	<i>9.8</i>	<i>11.6</i>	<i>7.6</i>	<i>12.7</i>	<i>17.5</i>	<i>16.5</i>	<i>16.8</i>
Key Drivers								
Sponge Iron Sales (kt)	100.0	84.4	108.5	97.9	101.9	98.5	92.0	115.0
Net Sales realizations - Sponge Iron (Rs/t)	12,288	11,386	11,500	13,470	15,152	16,282	16,895	17,330
EBITDA/t (Rs)	1,473	966	1,560	1,100	2,530	3,919	3,739	4,183

Source: Company, Centrum Research

Exhibit 6: Key Performance Indicators

	FY15	FY16	FY17	FY18E	FY19E	FY20E
Sponge Iron						
Sales Volumes (kt)	363	388	393	421	421	425
YoY %	(3.3)	6.9	1.3	7.1	0.1	1.0
Net Realizations (Rs/t)	19,805	15,046	14,345	17,720	18,500	18,000
YoY%	3.5	(24.0)	(4.7)	23.5	4.4	(2.7)
Power						
Sales Volumes (mn units)	121	113	132	142	137	139
YoY %	(13.8)	(6.7)	16.8	7.6	(3.3)	1.1
Realizations (Rs/unit)	3.8	4.2	3.8	4.3	3.7	3.7
YoY%	19.5	11.2	(10.5)	12.8	(13.4)	0.0

Source: Company, Centrum Research Estimates

Financials

Exhibit 7: Income Statement

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Revenues	5,735	5,573	8,007	8,292	8,163
Materials cost	4,269	3,729	5,062	5,149	4,904
% of revenues	74.4	66.9	63.2	62.1	60.1
Employee cost	340	463	415	457	502
% of revenues	5.9	8.3	5.2	5.5	6.2
Others	887	764	762	842	850
% of revenues	15.5	13.7	9.5	10.1	10.4
EBITDA	240	616	1,768	1,845	1,907
EBITDA margin (%)	4.2	11.1	22.1	22.2	23.4
Depreciation & Amortisation	129	128	125	131	134
EBIT	111	489	1,643	1,714	1,773
Interest expenses	54	24	34	25	25
PBT from operations	57	464	1,608	1,689	1,748
Other income	377	371	426	638	743
PBT	434	835	2,034	2,326	2,489
Taxes	115	247	669	768	822
Effective tax rate (%)	26.4	29.6	32.9	33.0	33.0
Adjusted PAT	319	588	1,365	1,559	1,668

Source: Company, Centrum Research Estimates

Exhibit 8: Key Ratios

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Growth Ratio (%)					
Revenue	(27.4)	(2.8)	43.7	3.6	(1.5)
EBITDA	(75.9)	157.3	186.8	4.3	3.4
Adjusted PAT	(65.3)	84.1	132.2	14.2	7.0
Margin Ratios (%)					
EBITDA	4.2	11.1	22.1	22.2	23.4
PBT from operations	1.0	8.3	20.1	20.4	21.4
Adjusted PAT	5.6	10.5	17.0	18.8	20.4
Return Ratios (%)					
ROE	3.9	7.0	14.8	14.8	13.9
ROCE	4.2	6.8	13.8	13.8	13.1
ROIC	3.6	11.5	37.9	39.6	40.5
Turnover Ratios (days)					
Gross block turnover ratio (x)	1.5	1.4	2.0	2.0	1.9
Debtors	19	23	20	20	20
Inventory	21	32	30	30	30
Creditors	26	34	30	30	30
Cash conversion cycle	13	21	20	20	20
Solvency Ratio (x)					
Net debt-equity	(0.8)	(0.7)	(0.7)	(0.8)	(0.8)
Debt-equity	0.0	0.0	0.0	0.0	0.0
Interest coverage ratio	0.5	0.0	0.0	0.0	0.0
Gross debt/EBITDA	0.0	0.0	0.0	0.0	0.0
Current Ratio	4.6	4.5	4.3	4.8	5.6
Per share Ratios (Rs)					
Adjusted EPS	20.7	38.2	88.6	101.2	108.3
BVPS	536.4	561.7	638.6	728.1	824.8
CEPS	29.1	46.5	96.8	109.7	117.0
DPS	10.0	11.0	10.0	10.0	10.0
Dividend payout %	48.2	28.8	11.3	9.9	9.2
Valuation (x)*					
P/E (adjusted)	22.7	15.7	12.9	11.3	10.5
P/BV	0.9	1.1	1.8	1.6	1.4
EV/EBITDA	4.3	5.5	5.9	4.9	4.0
Dividend yield %	2.1	1.8	0.9	0.9	0.9
5 Yr Avg AOCF/EV yield %	57.5	15.0	5.5	6.8	11.4

Source: Company, Centrum Research Estimates; * All ratios based on average mcap for year

Exhibit 9: Balance Sheet

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Equity Share Capital	154	154	154	154	154
Reserves & surplus	8,106	8,496	9,681	11,059	12,548
Shareholders' fund	8,260	8,650	9,835	11,213	12,702
Def tax liab. (net)	217	191	191	191	191
Total Liabilities	8,478	8,841	10,025	11,404	12,893
Gross Block	3,992	4,027	4,147	4,267	4,387
Less: Acc. Depreciation	2,355	2,483	2,608	2,739	2,873
Net Block	1,637	1,544	1,539	1,528	1,514
Capital WIP	92	100	130	160	190
Net Fixed Assets	1,729	1,645	1,669	1,689	1,704
Investments	2,854	2,634	2,634	2,634	2,634
Inventories	324	491	658	682	671
Sundry debtors	294	358	439	454	447
Cash	2,521	3,026	4,489	5,880	7,339
Loans & Advances	2,113	2,232	2,264	2,269	2,266
Other assets	39	73	66	68	67
Total Current Asset	5,291	6,181	7,915	9,353	10,790
Trade payables	407	525	658	682	671
Other current Liab.	425	488	548	568	559
Provisions	565	606	987	1,022	1,006
Net Current Assets	3,894	4,562	5,722	7,081	8,554
Total Assets	8,478	8,841	10,025	11,404	12,893

Source: Company, Centrum Research Estimates

Exhibit 10: Cash Flow

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Operating profit bef WC	258	616	1,768	1,845	1,907
Changes in working capital	603	(189)	302	32	(14)
Cash flow from operations	736	180	1,401	1,109	1,071
Adj. OCF (OCF - Interest)	682	156	1,367	1,084	1,046
Net Capex	173	43	150	150	150
Adj. FCF	509	113	1,217	934	896
Cash flow from investments	(530)	548	276	488	593
Cash flow from financing	(185)	(223)	(214)	(205)	(205)
Net change in cash	20	506	1,463	1,391	1,458

Source: Company, Centrum Research Estimates

Appendix A

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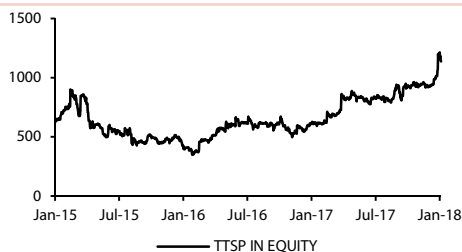
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Tata Sponge price chart



Source: Bloomberg, Centrum Research

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Hold	Upside between -20% to +20%	Upside between -15% to +15%	Upside between -10% to +10%
Sell	Downside > 20%	Downside > 15%	Downside > 10%

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