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Stock Update

JSW Steel Limited

Strong margin recovery; improved earnings outlook

Metal & Minning	Sharekhan code: JSWSTEEL	Result Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 321**	
Price Target: **Rs. 375**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

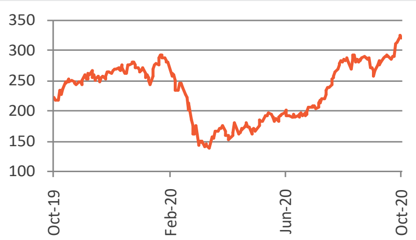
Company details

Market cap:	Rs. 77,605 cr
52-week high/low:	Rs. 327/133
NSE volume: (No of shares)	107 lakh
BSE code:	500228
NSE code:	JSWSTEEL
Free float: (No of shares)	135.2 cr

Shareholding (%)

Promoters	44.07
FII	13.34
DII	5.84
Others	36.75

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	24	57	109	44
Relative to Sensex	13	50	80	40

Sharekhan Research, Bloomberg

Summary

- JSW Steel's consolidated EBITDA at Rs. 4,186 crore (up 85% y-o-y) was significantly above our estimates, led by higher-than-expected EBITDA/tonne at Rs. 10,087/tonne (up 59% y-o-y) and strong sales volume at 4.2mt (up 16.6% y-o-y).
- Management has maintained FY2021E sales volume guidance of 15mt, which implies 5% y-o-y growth in H1FY2021E. Capacity expansion at Dolvi plant (undergoing 5mtpa capacity expansion) is on track to get commissioned by Q4FY2021.
- Higher steel price (revision in contractual steel price for the auto sector from October), improving revenue mix (with higher domestic sales), higher operating leverage, and volume growth from Dolvi expansion to drive 27% PAT CAGR over FY2020-FY2023E.
- We recommend Buy on JSW Steel with a PT of Rs. 375, given strong earnings growth outlook, decent RoE of 15%, and reasonable valuation of 6.6x its FY22E and 6x its FY23E EV/EBITDA, given an early recovery in the steel profitability cycle.

JSW Steel Limited's (JSW Steel) Q2FY2021 consolidated adjusted EBITDA at Rs. 4,186 crore (up 84.8% y-o-y; up 212% q-o-q) was significantly above our estimate of Rs. 3,641 crore. The sharp beat in EBITDA was led by: 1) higher-than-expected EBITDA/tonne at Rs. 10,087/tonne (up 58.5% y-o-y, up 109.9% q-o-q versus expectation of Rs. 9,470/tonne) backed by the recent hike in domestic steel price (11% q-o-q jump in realisations) and lower cost of production (down by 5% q-o-q) given operating leverage and lower coal price partially offset by the increase in iron ore price; and 2) beat in consolidated sales volume at 4.2 million tonne (up 16.6% y-o-y; 48.7% q-o-q) versus estimate of 3.84 million tonne. Higher-than-expected sales volume was on account of liquidation of steel inventory to the tune of 0.48 million tonne and volume mix improved towards domestic sales (share at 72% versus 43% in Q1FY2021). We have adjusted EBITDA for one-time exceptional income of Rs. 228 crore related to claim settlement and government grant received at US operations. Resultantly, consolidated adjusted PAT at Rs. 1,365 crore (versus net loss of Rs. 137 crore and Rs. 561 crore in Q2FY2020 and Q1FY2021 respectively) was also considerably above our estimate of Rs. 1,037 crore led by superior operating performance and slightly higher other income. Management has reiterated its sales volume guidance of 15 million tonne for FY2021E and is confident to achieve its volume guidance. JSW Steel has further increased the steel price in October as domestic steel price was at 4%-5% discount to international price and expect prices to remain firm given low steel inventory level in India and favourable demand-supply scenario. We believe the strong pricing environment, improving revenue mix (rise in contribution from domestic sales), higher utilisation level and Dolvi expansion to drive a 27% PAT CAGR for JSW Steel over FY2020-FY2023E. Hence, we recommend Buy on JSW Steel with a PT of Rs. 375, given strong earnings growth outlook, decent RoE of 15%, and reasonable valuation of 6.6x its FY2022E EV/EBITDA given an early recovery in steel profitability cycle.

Key positives

- Better-than-expected consolidated EBITDA margin at Rs. 10,087/tonne (up 58.5% y-o-y, up 109.9% q-o-q).
- Better-than-expected consolidated sales volume at 4.2mt (up 16% y-o-y) led by inventory liquidation.

Key negatives

- Continues to make EBITDA loss at overseas operations in the US and Italy in Q2FY2021.

Our Call

Valuation – Recommend Buy on JSW Steel with PT of Rs375: We have increased our FY2021-FY2023 earnings estimate to factor in higher EBITDA margin given higher-than-expected margin performance in Q2FY2021. Earnings outlook for the steel sector has improved as profitability is expected to increase, led by higher steel spreads and sharp recovery seen in domestic steel demand. Additionally, the company is on track to commission capacity expansion at Dolvi plant (undergoing 5mtpa capacity expansion) by Q4FY2021, which would ensure volume growth for JSW Steel over FY2022E-FY2023E. Thus, we expect JSW Steel's earnings to clock 27% CAGR over FY2020-FY2023E with improvement in RoE to 15% (versus 10.5% in FY2020). Hence, we recommend Buy rating on JSW Steel with PT of Rs375. JSW Steel's valuation (of 6.6x FY2022E and 6x FY2023E EV/EBITDA) seems reasonable given an early recovery in steel profitability cycle.

Key Risks

Sharp decline in steel prices and higher coking coal and iron ore price could impact profitability. Any delay in capacity expansion at Dolvi and turnaround of overseas subsidiaries could impact growth outlook.

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	84,757	73,326	72,937	83,039	90,662
OPM (%)	22.4	16.2	19.5	23.3	24.1
Adjusted PAT	7,524	3,919	3,725	6,858	8,090
% YoY growth	18.0	-47.9	-4.9	84.1	18.0
Adjusted EPS (Rs.)	31.2	16.3	15.5	28.5	33.6
P/E (x)	10.3	19.7	20.8	11.3	9.6
P/BV (x)	2.2	2.1	2.0	1.7	1.5
EV/EBITDA (x)	5.7	10.0	8.8	6.6	6.0
ROE (%)	21.8	10.5	9.4	15.1	15.5
RoCE (%)	19.1	8.5	10.0	13.5	14.0

Source: Company; Sharekhan estimates

Note: We now convert JSW Steel into a Stock Update; It was earlier a 'Viewpoint' under our coverage

Substantial beat in operating profit and PAT led by higher-than-expected margin and sales volumes

Consolidated adjusted EBITDA at Rs. 4,186 crore (up 84.8% y-o-y; up 212% q-o-q) was 15% above our estimate of Rs. 3,641 crore, led by higher-than-expected EBITDA margin at Rs. 10,087/tonne (up 58.5% y-o-y; up 109.9% q-o-q and 7% above our estimate of Rs. 9,470/tonne) and beat in volumes at 4.2 million tonne (up 16.6% y-o-y; 48.7% q-o-q and 8% above estimate of 3.84 million tonne). The beat in EBITDA margin was supported by the recent steel price hikes and superior sales mix (share at domestic volume at 72% versus 43% in Q1FY2021 and value added at 51% of total sales) while volume beat was on account of inventory liquidation of 0.48 million tonne. Volume of value added and special steel sales was at 51% of total sales in Q2FY2021 supported by an increase in sales to auto and coated products segments by 392% and 83%, respectively. Retail sales also increased by ~177% q-o-q, led by the branded sales increase of 153% q-o-q. Resultantly, consolidated adjusted PAT at Rs. 1,365 crore (versus net loss of Rs. 137 crore/Rs. 561 crore in Q2FY2020/Q1FY2021) was also considerably above our estimate of Rs. 1,037 crore, led by superior operating performance and slightly higher other income. We have adjusted EBITDA/PAT for one-time exceptional income of Rs. 228 crore related to claim settlement and government grant received at US operations.

Q2FY2021 results - Conference call highlights

- **Sales and production volume guidance:** Management has reiterated its sales volume guidance of 15 million tonne for FY2021E and is confident to achieve the sales guidance. Production target of 16 million tonne could witness some short fall as there was production loss of close to 1.2 million tonne in Q1FY2021. Management has indicated that there has been strong recovery in domestic steel demand in the recent months and same is expected to continue in H2FY2021.

- **Improving utilisation rate:** The company's plants are operated at 86% utilisation rate in Q2FY2021 as compared to only 66% in Q1FY2021. Utilisation could have further improved if there was no shortage of iron ore supplies in India.

- **Steel price and spread outlook:** Domestic steel prices were at 4%-5% discount to that of international prices at the end of September 2020 and thus, the company has taken steel price hike with effect from October 1, 2020. Contractual price revision (which is done on half-yearly and quarterly basis) would be implemented for auto and other sectors from October 1, 2020, and should increase steel price by 10%-12% on the existing prices. Moreover, India's steel inventory levels have declined in the last few months and there has been improvement in demand across sectors. Thus, demand-supply situation should remain favourable and should benefit steel prices. Management has indicated steel spread should sustain in the near term, given healthy pricing and coking coal price expected to remain flat at $120/mt in the near term. However, iron ore price needs to be monitored as there is supply constrains for iron ore given lower production and higher exports.

- **Dolvi expansion update:** Expansion of the steel capacity at Dolvi plant (from 5 mtpa to 10 mtpa) is on schedule to get commissioned in Q4FY2021. Management has indicated that labour availability has improved with ~14,000 people working currently as compared to 4,900 workers in Q1FY2021.

- **Pellet plant update:** Management indicated that 8 mtpa pellet plant and the wire rod mill at Vijayanagar are expected to be commissioned in Q3FY2021. The CRMl complex capacity expansion at Vijayanagar from 0.85 mtpa to 1.80 mtpa is expected to be commissioned progressively over 3Q and 4Q of FY2021.

- **Capex guidance:** The company has spent Rs. 4,411 crore for capital expenditure in H1FY2021 and has maintained its FY2021E capex guidance of Rs. 9,000 crore.

- **Bhushan Power & Steel Limited (BPSL):** Management indicated that final hearing on BPSL is scheduled on November 3, 2020; and if there would be favourable judgment, then JSW Steel would like to close the acquisition. BSPL has steel production capacity of 3 million tonne.

- **Net Debt and D/E**: Net debt stood at Rs. 52,892 crore as of September 2020 as compared to Rs. 54,527 crore as on June 30, 2020. The company's consolidated net debt to equity stood at 1.43x (versus 1.54 x in Q1FY2021) and net debt to EBITDA stood at 4.73x (as against 5.74x in Q1FY2021). The company targets to bring down net debt to EBITDA ratio to 3.75x.

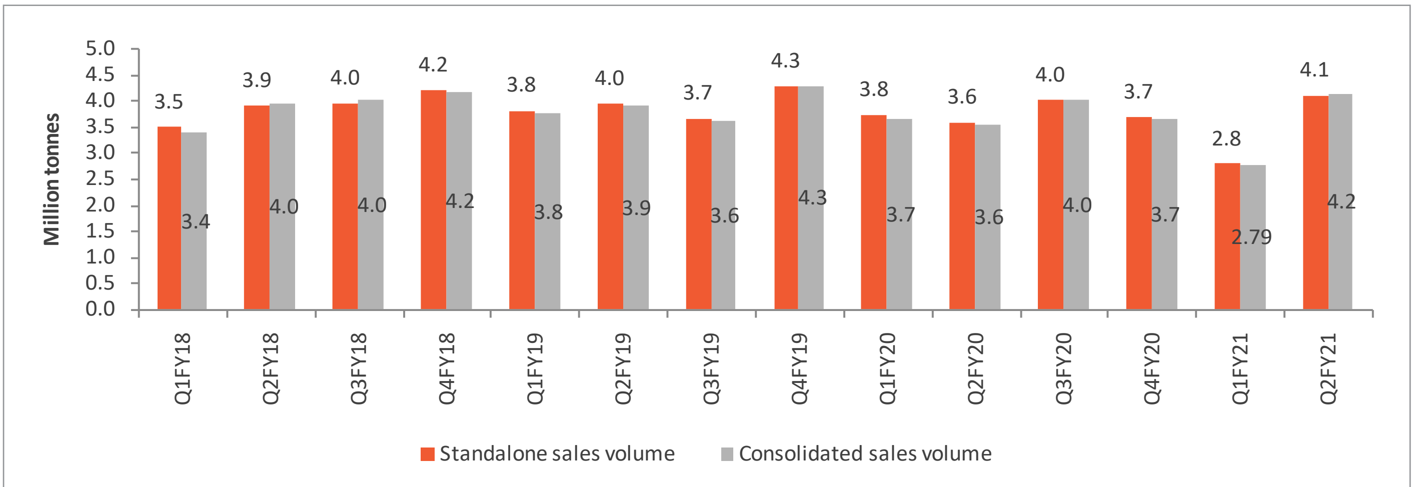
- In terms of overseas subsidiaries, US-based, Acero Junction reported EBITDA loss of $10.5 million in Q2FY2021 as against EBITDA loss of $12.5 million in Q1FY2021. Italy-based Aferpi reported EBITDA loss of Euro12.6 million in Q1FY2021 versus EBITDA loss of Euro7 million in Q1FY2021. The management indicated that shutdown of Mingo Junction (US) would continue till March 2021 and improvement in EBITDA would be witnessed from Q1FY2022. Operations at Italy are expected to improve gradually over Q3FY2021-4QFY2021.

Results (Consolidated) Rs cr

Particulars	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Revenue	19,264	17,572	9.6%	11,782	63.5%
Reported operating profit	4,414	2,731	61.6%	1,341	229.2%
Adjusted operating profit	**4,186**	**2,265**	**84.8%**	**1,341**	**212.2%**
Other Income	152	156	-2.6%	132	15.2%
Interest	959	1,127	-14.9%	1,016	-5.6%
Depreciation	1,149	1,057	8.7%	1,047	9.7%
Reported PBT	2,458	703	249.6%	(590)	NA
Adjusted PBT	**2,230**	**237**	**840.9%**	**(590)**	**NA**
Tax	910	(1,848)	NA	(61)	NA
EO	228	(2,673)	NA	-	NA
Reported PAT	1,593	2,536	-37.2%	(561)	NA
Adj. PAT	**1,365**	**(137)**	**NA**	**(561)**	**NA**
Adj. EPS (Rs.)	5.7	(0.6)	NA	(2.3)	NA
Margin			**BPS**		**BPS**
OPM (%)	21.7	12.9	884	11.4	1,035
NPM (%)	7.1	(0.8)	NA	(4.8)	NA
Tax rate	37.0	(262.9)	NA	10.3	2,668

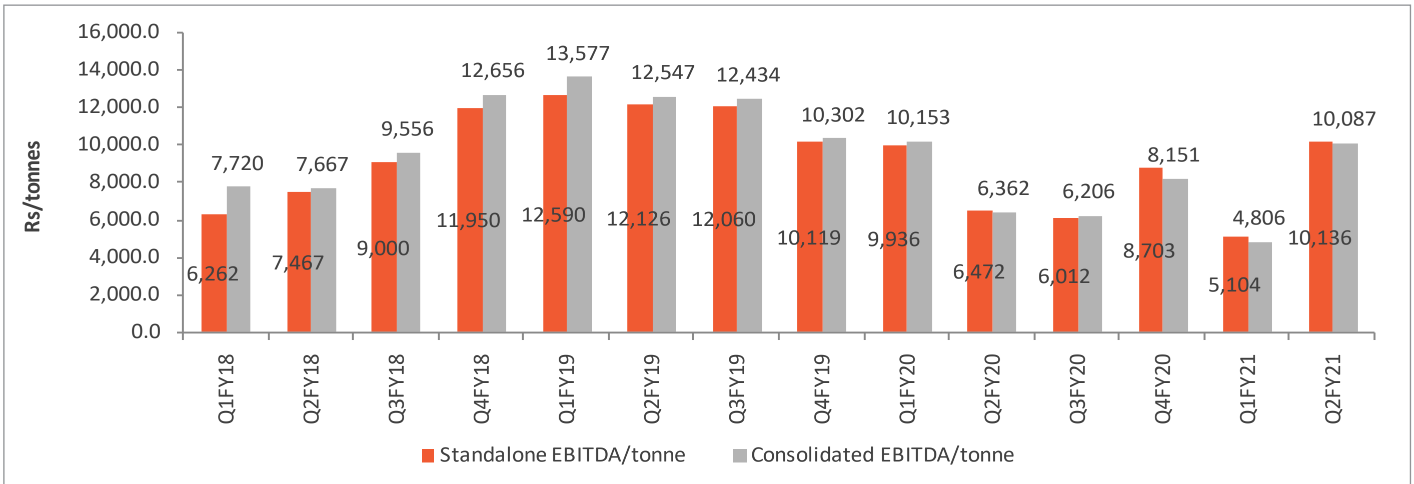
Source: Company

Standalone and consolidated steel sales volume



Source: Company

Standalone and consolidated EBITDA/tonne



Source: Company; Sharekhan Research

Outlook and Valuation

■ **Sector view - Sharp improvement in sector profitability on back of consecutive price hikes and volume recovery**

In-line with higher international steel prices, domestic steel manufacturers have also taken a cumulative steel price increase of Rs. 6,000-7,000/tonne since end-July 2020. Moreover, domestic steel demand remains strong and is expected to further improve with recovery in the overall economy and restart of stalled infrastructure projects. Potential improvement in domestic demand would improve the revenue mix, which would lead to better blended realisation in H2FY2021E for steel players. With the recent price hikes and benefit of operating leverage, we expect sector profitability to improve considerably to ~Rs. 11,000-12,000/tonne in H2FY2021E versus recent lows of Rs. 4,000-5,000/tonne in Q1FY2021.

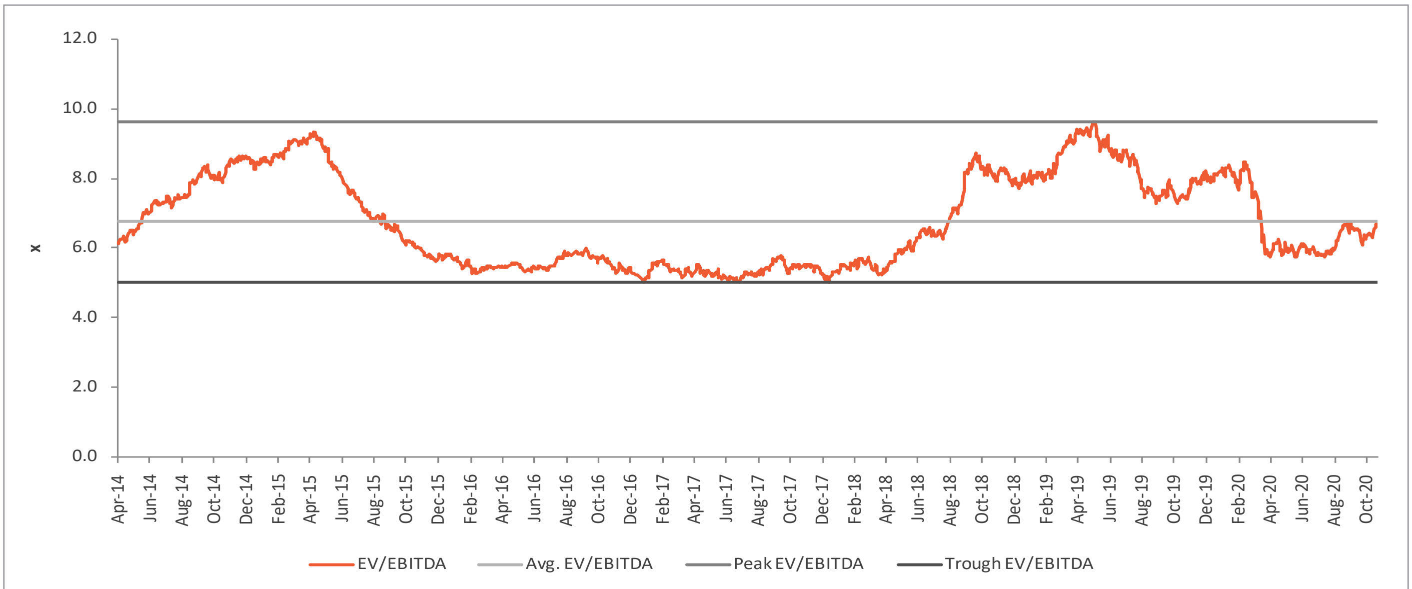
■ **Company outlook - Potential higher steel prices and volume recovery to aid revival in earnings**

Management's guidance of 15 million tonne of sales volume for FY2021 implies strong 5% y-o-y volume growth in H2FY2021E. The sharp recovery in plant utilisation to 86%, lower coking coal price, and other cost-reduction initiatives (related to ferro alloys, gas cost, and spares) bode well for higher profitability and would aid in earnings recovery for JSW Steel. Expansion of Dolvi plant to 10mmt (from 5mmt) would add to volume growth over FY2022E-FY2023E.

■ **Valuation - Recommend Buy on JSW Steel with a PT of Rs. 375**

We have increased our FY2021-FY2023 earnings estimate to factor in higher EBITDA margin given higher-than-expected margin performance in Q2FY2021. Earnings outlook for the steel sector has improved as profitability is expected to increase, led by higher steel spreads and sharp recovery seen in domestic steel demand. Additionally, the company is on track to commission capacity expansion at Dolvi plant (undergoing 5mtpa capacity expansion) by Q4FY2021, which would ensure volume growth for JSW Steel over FY2022E-FY2023E. Thus, we expect JSW Steel's earnings to clock 27% CAGR over FY2020-FY2023E with improvement in RoE to 15% (versus 10.4% in FY2020). Hence, we recommend Buy rating on JSW Steel with PT of Rs375. JSW Steel's valuation (of 6.6x FY2022E and 6x FY2023E EV/EBITDA) seems reasonable given an early recovery in steel profitability cycle.

One-year forward EV/EBITDA (x) band



Source: Sharekhan Research

About company

JSW Steel is an integrated steel company and is the flagship company of JSW Group. JSW Steel specialises in producing different types of steel products such as hot rolled steel, galvanised steel, cold rolled steel, and pre-painted galvanised steel products. JSW Steel has steel plants located at Karnataka, Tamil Nadu, and Maharashtra with total installed capacity of 18mmt.

Investment theme

Improvement in plant utilisation with recovery in domestic demand and higher steel prices are likely to help in earnings recovery for JSW Steel from Q2FY2021E. Capacity expansion at Dolvi plant to 10mmt (from 5mmt) would add to volume growth in FY2022E-FY2023E.

Key Risks

- Sharp fall in steel prices and increase in coking coal prices could impact earnings outlook.
- Any weakness in steel demand could impact volume growth outlook.
- Delay in capacity expansion at Dolvi plant.

Additional Data

Key management personnel

Sajjan Jindal	Chairman & Managing Director
Seshagiri Rao M.V.S.	Joint Managing Director & CFO
Vinod Nowal	Deputy Managing Director
Jayant Acharya	Director - Commercial & Marketing

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	JFE Steel International Europe BV	15.0
2	THELEME MASTER FUND LTD	2.5
3	Gagandeep Credit Capital Pvt Ltd	2.1
4	Vanguard Group Inc/The	1.5
5	APMS Investment Fund Ltd	1.3
6	Enam Securities Pvt Ltd	1.2
7	SHAMYAK INV PVT LTD	1.1
8	NEMISH S SHAH	1.0
9	BlackRock Inc	1.0
10	Republic of India	0.9

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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