JSW Steel Limited

High steel margin cycle to sustain on tight supply

Metal & Mining	Sharekhan code: JSWSTEEL	Company Update

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

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 438**	
Price Target: **Rs. 500**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

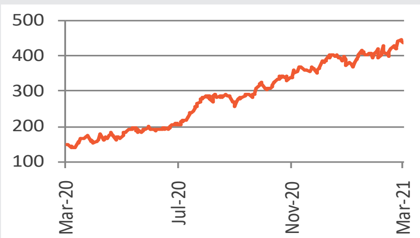
Company details

Market cap:	Rs. 105,886 cr
52-week high/low:	Rs.449/133
NSE volume: (No of shares)	77.0 lakh
BSE code:	500228
NSE code:	JSWSTEEL
Free float: (No of shares)	135.2 cr

Shareholding (%)

Promoters	44.1
FII	13.3
DII	6.3
Others	36.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	11	13	58	193
Relative to Sensex	12	11	31	131

Sharekhan Research, Bloomberg

Summary

- We retain Buy on JSW Steel with a revised PT of Rs. 500 as the high steel margin cycle is likely to sustain over FY2022-FY2023, led by higher international price (given supply constraints in China) and tight domestic supply amid strong demand. Valuation of 6.5x its FY2023E EV/EBITDA is reasonable and below historical average of 7x.
- We have increased our FY2021/FY2022/FY2023 earnings estimates by 11%/33%/21% to factor higher steel price (sustained EBITDA margin of Rs. 13,500-14,000/tonne) and volume growth (expect 7% CAGR over FY2021E-FY2023E, which is conservative in our view).
- Volume growth is likely to be driven by Dolvi expansion from 5mtpa to 10mtpa (expected to be completed by Q1FY2022); higher profitability could result in early turnaround of overseas subsidiaries in US and Italy.
- Strong earnings growth (expect PAT CAGR of 15% over FY2021E-FY2023E) to improve cash flows over the next two years and drive balance sheet deleveraging; and we expect JSW Steel's net debt/EBITDA to decline to 2.2x by FY2023 (versus 3.5x in 9MFY2021).

We expect domestic steel producers to witness sustained steel margin upcycle (expect EBITDA/tonne of Rs. 13,500-14,000/tonne) over FY2022-FY2023, given: 1) strength in China HRC export price (up by ~16% to $740/mt versus price in early February 2021), as China's steel demand growth is expected to outpace production growth rate (given production cuts amid measures to curb pollution); and 2) tight demand-supply scenario in the domestic market, as exports become lucrative (export price are at premium of Rs. 6,000-7,000/tonne to domestic prices). Moreover, domestic steel producers could further increase steel price by Rs. 2,000-3,000/tonne, which would improve profitability and lead to upgrade in consensus earnings estimate for domestic steel players. We believe JSW Steel is well placed to benefit from favourable margin environment and is likely to report best earnings growth among domestic players with strong volume growth outlook (expect a 7% volume CAGR over FY2021E-FY2023E, which is conservative in our view). Capacity expansion at Dolvi from 5mtpa to 10mtpa (expected to get completed by Q1FY2022) is coming at right margin cycle and would drive volume growth for JSW Steel. Moreover, improved cash flow generation over the next two years would drive balance sheet deleveraging, and we expect JSW Steel's net debt/EBITDA to decline to 2.2x by FY2023 (versus 3.5x in 9MFY2021). JSW Steel's valuation of 6.5x its FY2023E EV/EBITDA seems reasonable, given our expectation of strong 15% PAT CAGR over FY2021E-FY2023E, improving RoE to 16.8% by FY20223E and likely balance sheet deleveraging. Also, sustained high profitability would result in early turnaround of loss-making overseas subsidiaries. Hence, we maintain our Buy rating on JSW Steel with a revised PT of Rs. 500.

Our Call

Valuation – Maintain Buy on JSW Steel with a revised PT of Rs. 500: We have increased our FY2021-FY2023 earnings estimate to factor in higher EBITDA margin (as we expect steel margin upcycle to sustain on tight supply) and higher volume assumption as Dolvi expansion is nearing completion and steel demand is expected to remain strong. We expect JSW Steel's earnings to register a 15% CAGR over FY2021E-FY2023E with improvement in RoE to 16.8% (versus 10.5% in FY2020). Hence, we maintain our Buy rating on JSW Steel with a revised PT of Rs. 500 (increase in PT reflects upwards revision in earnings estimates). JSW Steel's valuation of 6.5x FY2023E its EV/EBITDA (below historical average one-year forward EV/EBITDA multiple of 7x) is reasonable given expectation of sustained steel margin upcycle.

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.

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenues	84,757	73,326	77,313	89,548	97,075
OPM (%)	22.4	16.2	23.7	26.6	25.5
Adjusted PAT	7,524	3,919	6,568	9,961	10,105
% YoY growth	18.0	-47.9	67.6	51.7	1.4
Adjusted EPS (Rs.)	31.2	16.3	27.3	41.3	41.9
P/E (x)	14.0	26.9	16.1	10.6	10.4
P/BV (x)	3.0	2.9	2.5	2.1	1.8
EV/EBITDA (x)	7.2	12.4	8.4	6.6	6.5
ROE (%)	21.8	10.5	15.4	19.4	16.8
RoCE (%)	19.1	8.5	13.8	16.7	15.4

Source: Company; Sharekhan estimates

Domestic steel margin upcycle to sustain, led by higher steel price and improving demand

Indian steel producers have witnessed sharp improvement in profitability over Q2FY2021-Q3FY2021, led by steep price hikes (Rs. 10,500-12,250/tonne), given cost push (higher iron ore price) and improving demand environment (visible in sharp improvement in the steel industry's utilisation rate to 85%-90%).

We expect the steel margin upcycle for domestic players to sustain over FY2022-FY2023, led by 1): expectation of higher China steel price as steel demand supply to remain tight given demand growth would outpace production growth (due to production cuts and shutdown of steel plants in China given strict compliance of pollution norms), 2) lower production in China would mean lower export volume in Asian markets and 3) V-shaped demand recovery in the indian market, given improved demand from the auto sector and higher government spending on infrastructure activities. We highlight here that China HRC exports price are up 10% m-o-m to average of $727/tonne in March 2021 till date and is currently hovering at $740/tonne and the trend is expected to sustain as China's steel demand growth is expected to outpace production growth rate in coming years. We believe higher international steel price would mean Indian steel producers would focus on the export market; and thus, keeping domestic demand-supply situation tight over FY2022E-FY2023E. Thus, we expect high EBITDA margin of ~Rs. 13,500-14,000/tonne to sustain for domestic steel producers over FY2022-FY2023 and support current steel profitability upcycle.

China HRC export prices up 10% to average of $727/mt in March 2021 till date and is currently hovering at $740/tonne

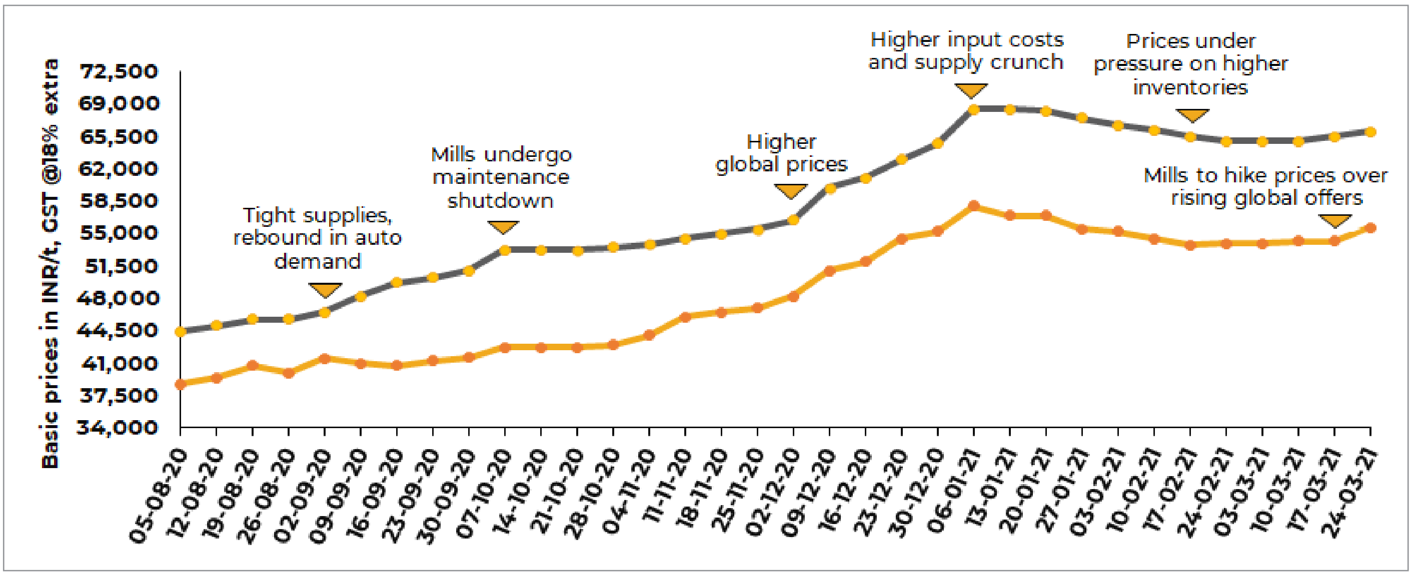
Source: Bloomberg

Landed HRC price from China and Japan at premium to domestic HRC prices

Particulars	China	Japan
CIF ($/mt)	770	810
BCD (%)	7.5%	0%
CIF + BCD ($/mt)	828	810
Port handling charges ($/mt)	20	20
Other cost ($/mt)	5	5
Landed HRC price ($/mt)	853	835
Landed HRC price (Rs./tonne)	61,910	60,621
Domestic HRC price (Rs./tonne)	55,500	55,500
Premium (International price over domestic price) – Rs./tonne	6,410	5,121

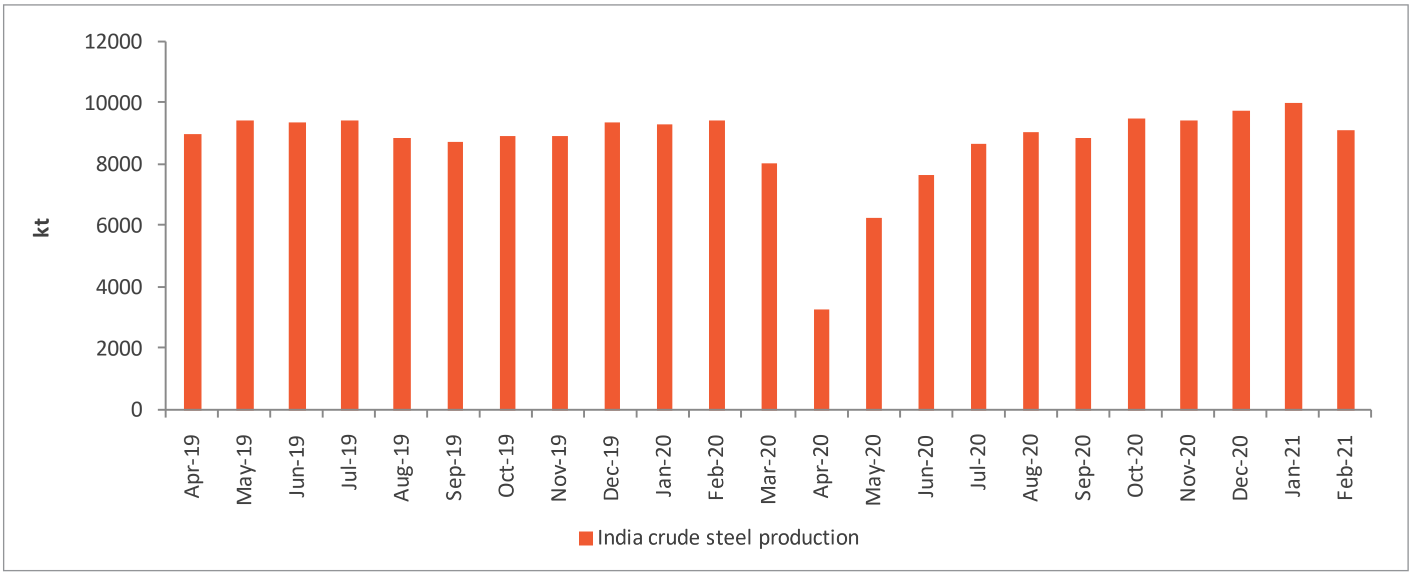
Source: Industry; Sharekhan Research

Indian HRC and CRC price



Source: Steel Mint; media articles

India steel production recovered sharply from COVID-19 disruption

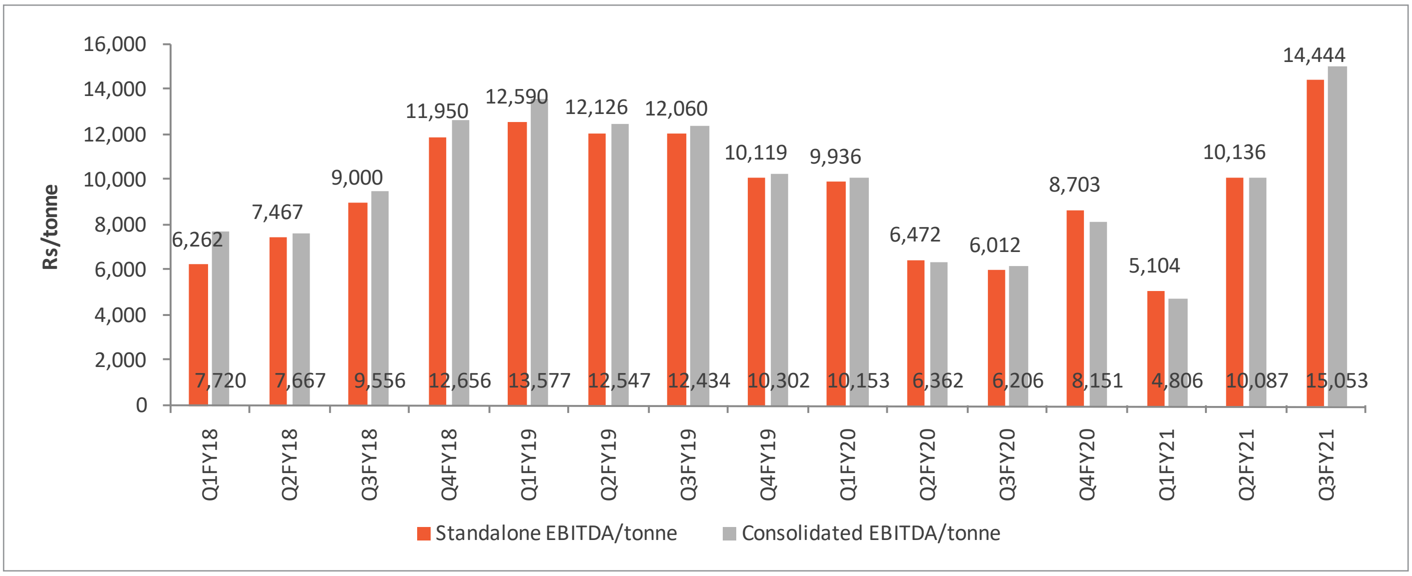


Source: Bloomberg

JSW Steel – High steel spreads and robust volume growth (Dolvi expansion nearing completion) to sustain strong earnings growth over FY2022-FY2023

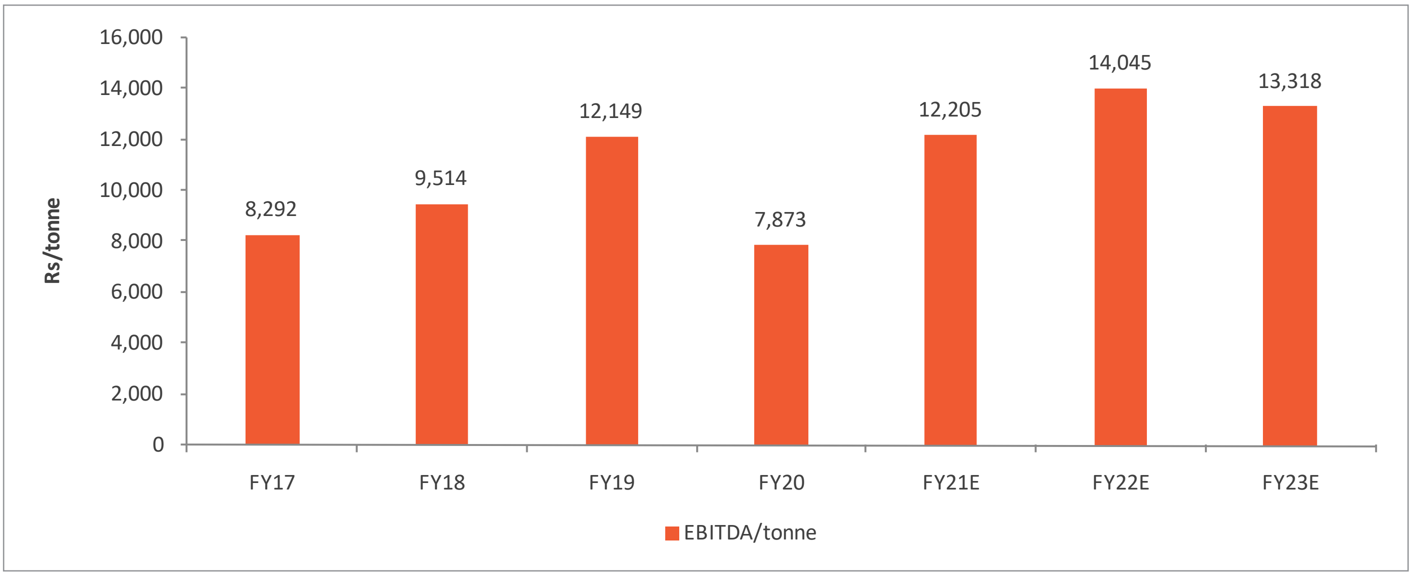
We expect JSW Steel's EBITDA margin to improve to Rs. 14,045/tonne in FY2022E and normalise at Rs. 13,318 in FY2023E as compared to only Rs. 7,873/tonne in FY2020 and average of Rs. 9,457/tonne over FY2017-FY2020. The sharp improvement in profitability would be driven by sustained higher domestic steel price (upward of Rs. 55,000/tonne), cost-saving initiatives, and efficient iron ore sourcing. We mention here that JSW Steel is focused to increase captive iron ore sourcing (49% of iron ore requirement was met through captive sources in Q3FY2021). Moreover, the company is implementing cost-saving projects such as pellet plant and coke ovens.

JSW Steel's quarterly EBITDA trend



Source: Company; Sharekhan Research

JSW Steel's EBITDA margin to remain strong over FY2022E-FY2023E



Source: Company; Sharekhan estimates

JSW steel production cost break-up – Declined by 8% in 9MFY2021 versus FY2020 cost

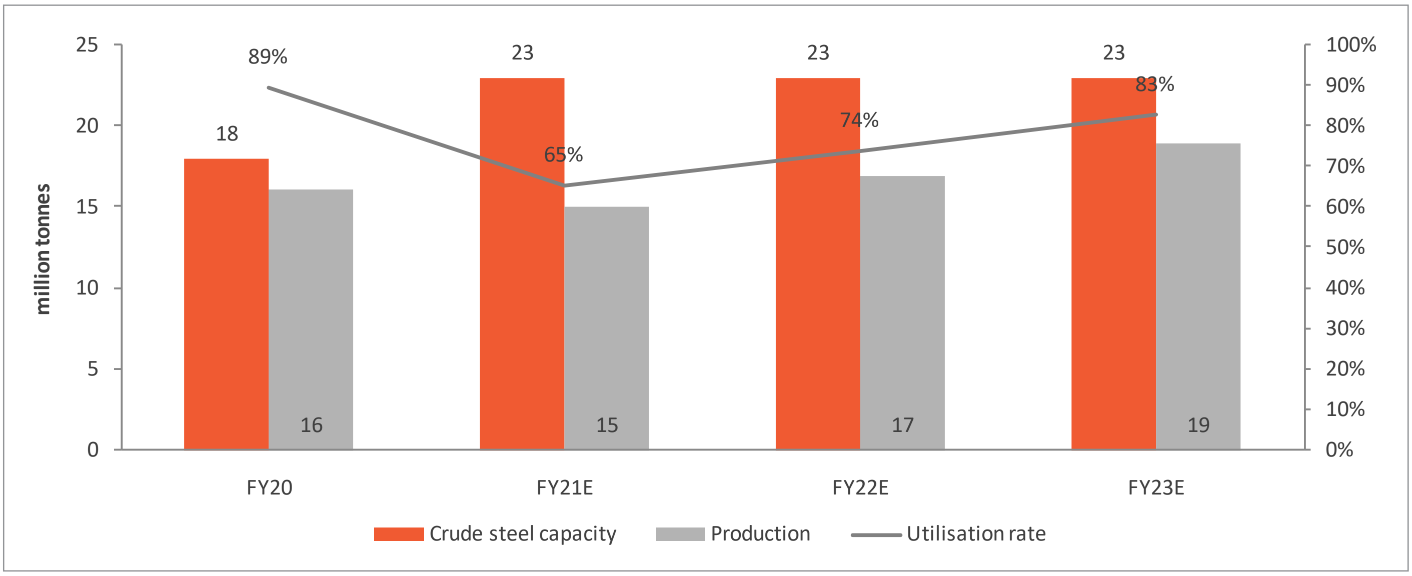
Rs. per tonne basis	FY20	9MFY20	Cost saving
RM cost	25,993	21,613	-17%
Employee cost	1,905	1,702	-11%
Power and Fuel	4,209	3,802	-10%
Others	9,136	10,720	17%
Overall production cost	**41,244**	**37,837**	**-8%**

Source: Company; Sharekhan Research

Capacity expansion at Dolvi plant to support volume growth over FY2022E-FY2023E

JSW Steel is expanding capacity at its Dolvi plant by 5 mtpa to 10 mtpa and the same is expected to get commissioned by Q1FY2022. Capacity expansion would increase JSW Steel's domestic capacity to 23 mtpa from 18 mtpa and drive volume growth over FY2022E-FY2023E. We model 7% volume CAGR over FY2021E-FY2023E, which we believe is conservative and could surprise on the upside. Expanded capacity would come at the right time of steel demand upcycle along with higher EBITDA/tonne.

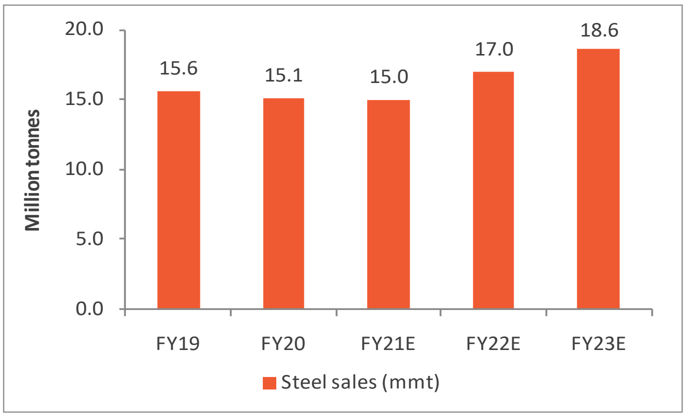
JSW Steel's capacity to increase by 28% to 23 mtpa as Dolvi expansion is nearing completion; utilisation to remain strong led by high demand



Source: Company: Sharekhan Research

Financials in charts

Volume growth to recover over FY2022E-FY2023E

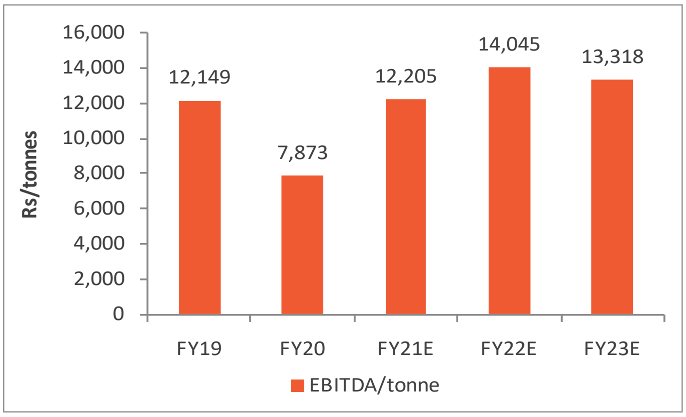


Source: Company, Sharekhan Research

Recovery in steel prices to improve profitability

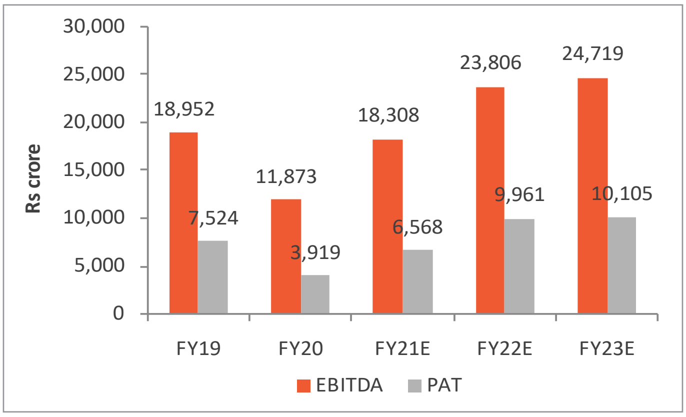
Source: Company, Sharekhan Research

High EBITDA/tonne to sustain



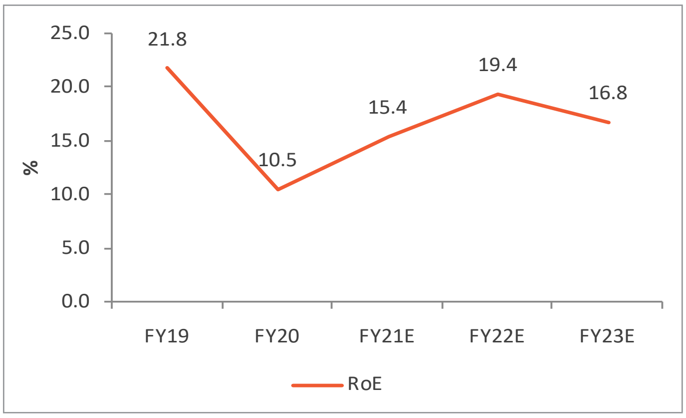
Source: Company, Sharekhan Research

EBITDA/PAT CAGR of 11%/15% over FY2021E-FY2023E



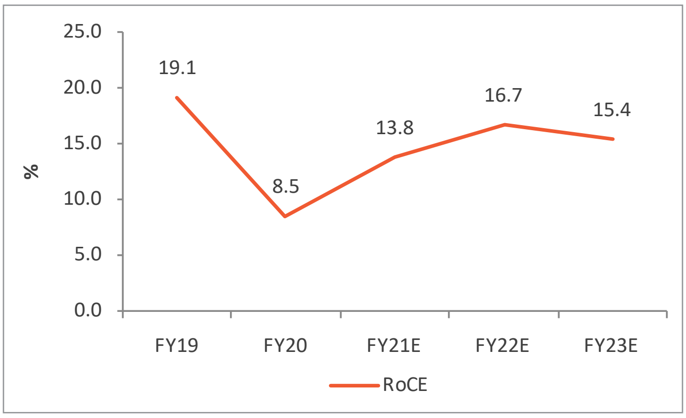
Source: Company, Sharekhan Research

RoE Trend



Source: Company, Sharekhan Research

RoCE Trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector view - Sharp improvement in sector profitability because 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. 10,500-12,250/tonne since end-July 2020. Moreover, domestic steel demand remains strong and is expected to further improve with recovery in overall economy and improvement in infrastructure/construction projects. Potential improvement in domestic demand and higher realisation bodes well fro earnings growth for domestic steel companies. We see scope of further hike in the domestic steel price given recent strength seen in China HRC export price and tight domestic demand supply situation.

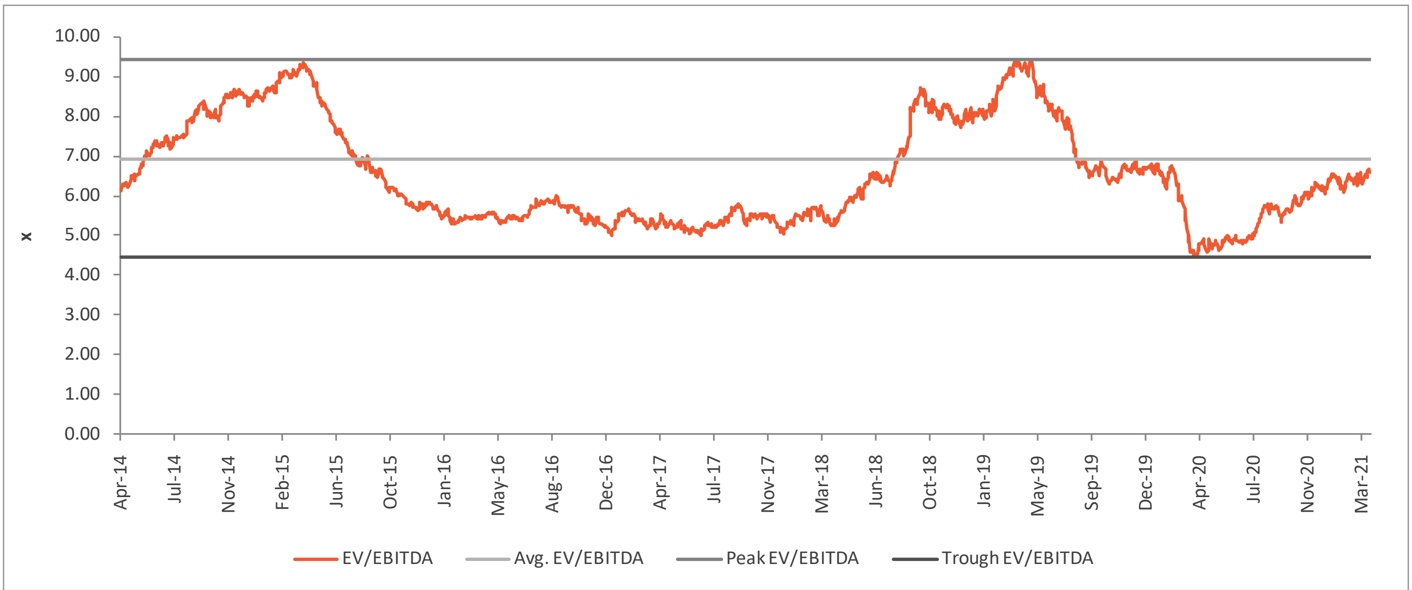
■ **Company outlook - Volume recovery and sustained high margin to aid in earnings growth**

Management's guidance of 15 million tonne of sales volume for FY2021 implies strong 12.6% y-o-y volume growth in Q4FY2021E. With high steel spreads expected to sustain, we believe JSW Steel's EBITDA margin would also see improvement and sustain at high level, led by potential further price hikes. This coupled with sharp recovery in plant utilisation to 93% and cost-reduction initiatives (related to ferro alloys, gas cost, and spares) bode well for higher earnings for JSW Steel. Expansion of Dolvi plant to 10 mmt (from 5 mmt) would add to volume growth over FY2022E-FY2023E.

■ **Valuation - Maintain Buy on JSW Steel with a revised PT of Rs. 500**

We have increased our FY2021-FY2023 earnings estimate to factor in higher EBITDA margin (as we expect steel margin upcycle to sustain on tight supply) and higher volume assumption as Dolvi expansion is nearing completion and steel demand is expected to remain strong. We expect JSW Steel's earnings to register a 15% CAGR over FY2021E-FY2023E with improvement in RoE to 16.8% (versus 10.5% in FY2020). Hence, we maintain our Buy rating on JSW Steel with a revised PT of Rs. 500 (increase in PT reflects upwards revision in earnings estimates). JSW Steel's valuation of 6.5x FY2023E its EV/EBITDA (below historical average one-year forward EV/EBITDA multiple of 7x) is reasonable given expectation of sustained steel margin upcycle.

One-year forward EV/EBITDA (x) band



Source: Sharekhan Research

Peer Comparison

Particulars	P/E (x)			EV/EBITDA (x)			P/BV (x)		
	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E	FY21E	FY22E	FY23E
JSW Steel	16.1	10.6	10.4	8.4	6.6	6.5	2.5	2.1	1.8
Tata Steel#	11.9	7.5	8.1	6.8	5.9	6.1	1.1	1.0	0.9
SAIL#	6.8	7.2	7.8	6.0	6.0	6.4	0.7	0.6	0.6
Jindal Steel and Power#	6.2	8.1	9.3	4.1	4.7	5.1	0.9	0.8	0.7

Source: Company, Sharekhan estimates

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 18 mmt.

Investment theme

Improvement in plant utilisation with recovery in domestic demand and higher steel prices is likely to help in earnings recovery for JSW Steel over FY2021E-FY2023E. We expect high steel margin cycle to sustain over next two years given supply situation in China and strong demand environment in India and could lead to earnings upgrade got JSW Steel. Capacity expansion at Dolvi plant to 10 mmt (from 5 mmt) would add to volume growth in FY2022E-FY2023E.

Key Risks

- Sharp fall in steel prices and increased 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: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	JFE Steel International Europe BV	15.0
2	Gagandeep Credit Capital Pvt Ltd	2.1
3	Vanguard Group Inc/The	1.5
4	Enam Securities Pvt Ltd	1.2
5	BlackRock Inc	1.1
6	SHAMYAK INVEST	1.1
7	Republic of India	0.9
8	Dimensional Fund Advisors LP	0.7
9	SBI Funds Management Pvt Ltd	0.7
10	Investor Education & Protection Fund	0.3

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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