

Weak show but growth outlook strong & value intact

We maintain Buy on Tata Sponge (TSIL) with a revised TP of Rs1160. Q2 results were weak due to exceptional circumstances which led to high iron ore and maintenance cost. Overall, we expect strong operational performance during FY19-20E led by robust pricing, healthy spreads and increasing volumes as additional EC clearance of 40ktpa is expected soon. Clarity on capex towards the build-up of new steel complex is still elusive but strong cash rich balance sheet provides comfort. Valuations remain attractive at 2.3x FY20E EV/EBITDA making risk-reward favorable.

- **Volumes on expected lines:** Sponge iron volume stood at 93kt, up 1% YoY and was marginally above expectations. TSIL took maintenance shutdown of all three kilns in Q2FY19 to better manage its overall production given the seasonally weak period and intermittent disruption in iron ore sourcing due to delay in related party approval. Management guided for exceeding its full year production target of 425kt.
- **EBITDA below expectations due to high iron ore & maintenance costs:** EBITDA stood at Rs298mn, down 13% YoY and was well below our estimates due to higher maintenance cost of Rs100mn (vs Rs40mn QoQ). Iron ore cost/t increased by 15% QoQ due to intermittent outside sourcing in the wake of delay in getting related party approvals. EBITDA/t stood at Rs3206, down 14% YoY.
- **Earnings revision:** Sponge iron prices have upward bias led by better demand expectation post monsoons, increase in cost of imported scrap due to weak rupee and pressure from higher RM prices (coal & iron ore). TSIL also mentioned in Q2 call that EC clearance for additional 40ktpa sponge iron production is expected soon which would allow TSIL to ramp-up production from 425ktpa to 465ktpa. We revise our volume estimates higher to 425kt/446kt for FY19E/20E and increase our realization estimates marginally by 2%/5% for FY19E/20E. We also increase our iron ore and coal costs to factor in weak rupee and higher spot prices. Our EBITDA estimates are revised downwards by 11%/5% and PAT estimates are revised downwards by 10%/5% for FY19E/20E.
- **Valuation and risks – Maintain Buy:** We remain positive on TSIL due to better visibility of volume growth and sustenance of spread. We continue to value the company at 5x FY20E EV/EBITDA and value the surplus cash at 75% as this cash is expected to be deployed as CWIP for the steel plant over next few years. We revise our TP to Rs1160 and maintain buy. Key downside risks are fall in sponge iron prices and higher coal costs.

| Y/E Mar (Rs mn) | Q2FY19 | Q2FY18 | YoY(%) | Q1FY19 | QoQ(%) | Q2FY19E | Var(%) |
|--------------------------|--------------|--------------|-----------------|--------------|-----------------|--------------|-----------------|
| Net sales | 2,162 | 1,672 | 29.3 | 2,609 | (17.1) | 2,133 | 1.4 |
| Raw materials (net) | 1,704 | 1,072 | 59.0 | 1,709 | (0.3) | 1,404 | 21.4 |
| Employee costs | 106 | 106 | 0.0 | 102 | 3.9 | 110 | (3.8) |
| Other expenses | 254 | 150 | 69.5 | 196 | 29.9 | 162 | 57.0 |
| EBITDA | 298 | 344 | (13.3) | 603 | (50.5) | 457 | (34.8) |
| EBITDA margin (%) | 13.8 | 20.6 | (678)bps | 23.1 | (930)bps | 21.4 | (763)bps |
| Depreciation | 29 | 31 | (5.5) | 29 | 1.4 | 30 | (3.3) |
| Other income | 149 | 95 | 56.9 | 119 | 24.9 | 125 | 18.9 |
| PBT | 415 | 407 | 2.0 | 690 | (39.9) | 547 | (24.2) |
| Tax | 139 | 131 | 6.1 | 234 | (40.8) | 181 | (23.2) |
| PAT | 276 | 276 | 0.0 | 456 | (39.4) | 367 | (24.6) |

Source: Company, Centrum Research Estimates

| Target Price | | Rs1,160 | Key Data | |
|------------------------|---------|------------------------|------------|--------------------------|
| CMP* | Rs839.1 | Bloomberg Code | TTSP IN | |
| Upside | 38.2% | Curr Shares O/S (mn) | 15.4 | |
| Previous Target | Rs1,220 | Diluted Shares O/S(mn) | 15.4 | |
| Previous Rating | Buy | Mkt Cap (Rsbn/USDmn) | 12.9/175.5 | |
| Price Performance (%)* | | 52 Wk H / L (Rs) | 1249/774 | |
| | 1M | 6M | 1Yr | |
| TTSP IN | (9.9) | (28.2) | (8.4) | 5 Year H / L (Rs) |
| Nifty | (7.9) | 0.1 | 3.7 | 1249/284 |
| | | | | Daily Vol. (3M NSE Avg.) |
| | | | | 204345 |

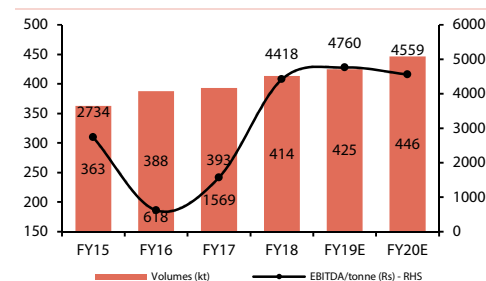
*as on 12 October 2018; Source: Bloomberg, Centrum Research

Shareholding pattern (%)*

| | Jun-18 | Mar-18 | Dec-17 | Sep-17 |
|-----------------|--------|--------|--------|--------|
| Promoter | 54.5 | 54.5 | 54.5 | 54.5 |
| FII | 8.5 | 8.7 | 8.4 | 7.0 |
| Dom. Inst. | 0.9 | 0.9 | 0.9 | 0.8 |
| Public & Others | 36.2 | 35.9 | 36.2 | 37.7 |

Source: BSE, *as on 12 October 2018

EBITDA/tonne trend



Source: Company, Centrum Research Estimates

Earnings Revision

| Particulars (Rs mn) | FY19E | | | FY20E | | |
|---------------------|--------|-------|----------|-------|-------|----------|
| | New | Old | Chg (%) | New | Old | Chg (%) |
| Sales | 10,043 | 9,764 | 2.8 | 9,915 | 9,013 | 10.0 |
| EBITDA | 2,024 | 2,276 | (11.1) | 2,035 | 2,144 | (5.1) |
| EBITDA Margin (%) | 20.2 | 23.3 | (316)bps | 20.5 | 23.8 | (326)bps |
| PAT | 1,645 | 1,820 | (9.6) | 1,713 | 1,804 | (5.0) |

Source: Centrum Research Estimates

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| 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 | 5.4 |
| FY18 | 8,002 | 43.6 | 1,827 | 22.8 | 1,409 | 139.7 | 91.5 | 15.2 | 14.2 | 10.0 | 4.7 |
| FY19E | 10,043 | 25.5 | 2,024 | 20.2 | 1,645 | 16.8 | 106.8 | 15.5 | 14.4 | 7.9 | 3.0 |
| FY20E | 9,915 | (1.3) | 2,035 | 20.5 | 1,713 | 4.1 | 111.2 | 14.2 | 13.3 | 7.5 | 2.3 |

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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Conference Call Takeaways

Operations

- Tata Sponge underwent maintenance activities for all 3 kilns in Q2FY19 as there was slowdown in demand due to monsoon. The cost for these maintenance activities was Rs 40mn in Q1FY19 and Rs100mn in Q2FY19. Maintenance guidance for Q3 and Q4 would be within the budgeted maintenance expenditure this year. No maintenance activities will be held in Q3FY19 but Q4FY19 will see minor maintenance activities taking place.
- Company's related party transaction resolutions for sourcing of iron ore got defeated in its AGM due to which they had to source iron ore from market at a higher price as compared to sourcing from Tata Steel. All the three kilns operated on iron ore sourced from markets for a period of 40 days which resulted in 15% increase of their iron ore cost. After getting the related party transactions passed in September, company has resumed the use of iron ore sourced from Tata Steel.
- Management strongly voiced that they are confident to exceed full year production target of 425kt.
- EC clearance for additional production of 40ktpa of sponge iron is expected to be received soon and management mentioned that first round of approvals has been already received.
- Power generation for the quarter was 46mn units and they exported 33 mn units.
- Sponge Iron sales this quarter clocked realisation of approx. Rs 22,000/t. Company aims to achieve a realisation of Rs 23500/t in Q3FY19. In the long run, the realisations could be in the range of Rs 21,500/t to Rs 24,000/t.
- Production and sales reported this quarter were 95kt and 93kt respectively.
- Company is not interested to acquire smaller sponge iron projects which do not meet their raw materials and quality specifications.

Financials

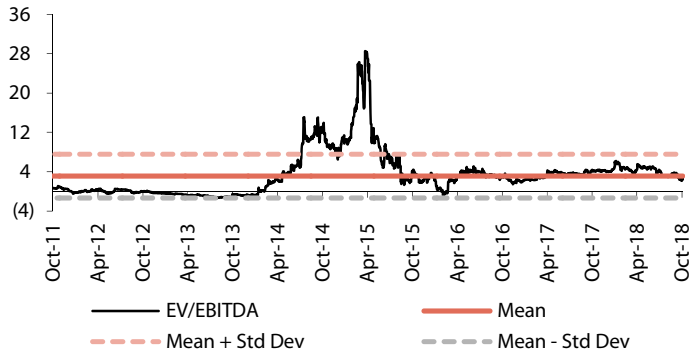
- Coal cost along with USDINR has not affected the EBITDA this quarter as they had older low cost inventory which has been fully utilised. Coal cost pressure will be seen in third quarter and the management guided a 5-7% increase in coal cost compared to the present quarter.
- Raw material costing for this quarter was Rs 16500/t of sponge iron. Splits: Coal cost – Rs 8500/t, Iron ore – Rs 7500/t and Dolomite – Rs 500/t.
- Net cash as of Sept'18 was Rs7bn.
- Capex guidance stands at sustenance capex of Rs150mn for the sponge iron plant. Steel plant capex is yet to be finalised but could be in the range of Rs25bn which would be spent over a period of time.

Exhibit 1: Sensitivity Analysis (FY19E)

| Sensitivity to key variables | % change | % impact on EBITDA | % impact on EPS |
|------------------------------|----------|--------------------|-----------------|
| Sales volume | 1 | 3.6 | 2.8 |
| Realization | 1 | 4.0 | 3.2 |
| Iron ore cost increase | 1 | (1.0) | (0.8) |

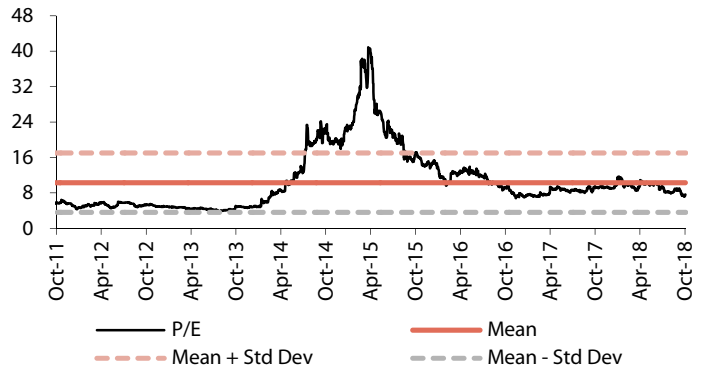
Source: Company, Centrum Research Estimates

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 | 2,035 |
| Justified EV/EBITDA (x) | 5.0 |
| EV | 10,175 |
| Net Cash | 9,022 |
| Add: Net Cash (@75%) | 6,767 |
| Add: Coal block investment (@50%) | 900 |
| Fair Value Mkt Cap | 17,842 |
| No. of Shares (mn) | 15.4 |
| Fair value/share (Rs) | 1,160 |

Source: Company, Centrum Research Estimates

Quarterly financials, operating metrics and key performance indicators

Exhibit 5: Quarterly Financials

| Particulars (Rs mn) | Q3FY17 | Q4FY17 | Q1FY18 | Q2FY18 | Q3FY18 | Q4FY18 | Q1FY19 | Q2FY19 |
|---|--------------|--------------|--------------|--------------|--------------|--------------|--------------|---------------|
| Net Sales | 1,435 | 1,672 | 1,750 | 1,672 | 2,145 | 2,435 | 2,609 | 2,162 |
| Other operating income | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Total Income | 1,435 | 1,672 | 1,750 | 1,672 | 2,145 | 2,435 | 2,609 | 2,162 |
| (Accretion)/Decretion of stock | (4) | 85 | (209) | 62 | 78 | 22 | (34) | (40) |
| Cost of Raw Materials consumed | 962 | 1,025 | 1,263 | 1,010 | 1,292 | 1,441 | 1,744 | 1,543 |
| Staff Cost | 150 | 114 | 98 | 106 | 101 | 113 | 102 | 106 |
| Other Operational expenses | 220 | 189 | 212 | 150 | 193 | 244 | 196 | 254 |
| Operating Profit (Core EBITDA) | 108 | 258 | 386 | 344 | 481 | 616 | 603 | 298 |
| Depreciation | 32 | 32 | 32 | 31 | 31 | 30 | 29 | 29 |
| EBIT | 75 | 226 | 354 | 313 | 450 | 586 | 574 | 269 |
| Interest | 9 | 5 | 5 | 1 | 23 | 3 | 3 | 3 |
| Other Revenue/Income | 86 | 96 | 103 | 95 | 117 | 117 | 119 | 149 |
| Other Exceptional Items | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Profit Before Tax | 153 | 318 | 452 | 407 | 543 | 700 | 690 | 415 |
| Tax | 43 | 106 | 147 | 131 | 183 | 233 | 234 | 139 |
| <i>Tax rate (%)</i> | <i>28.1</i> | <i>33.2</i> | <i>32.4</i> | <i>32.1</i> | <i>33.8</i> | <i>33.3</i> | <i>34.0</i> | <i>33.4</i> |
| Profit After Tax | 110 | 212 | 306 | 276 | 360 | 467 | 456 | 276 |
| Growth (%) | | | | | | | | |
| <i>Net Sales</i> | <i>3.4</i> | <i>19.1</i> | <i>62.6</i> | <i>21.1</i> | <i>49.5</i> | <i>45.7</i> | <i>49.1</i> | <i>29.3</i> |
| <i>EBITDA</i> | <i>362.2</i> | <i>75.1</i> | <i>373.6</i> | <i>103.2</i> | <i>346.7</i> | <i>138.8</i> | <i>56.1</i> | <i>(13.3)</i> |
| <i>Adj. PAT</i> | <i>109.4</i> | <i>65.4</i> | <i>190.3</i> | <i>71.9</i> | <i>228.2</i> | <i>120.2</i> | <i>49.0</i> | <i>0.0</i> |
| Margin (%) | | | | | | | | |
| <i>EBITDA</i> | <i>7.5</i> | <i>15.4</i> | <i>22.1</i> | <i>20.6</i> | <i>22.4</i> | <i>25.3</i> | <i>23.1</i> | <i>13.8</i> |
| <i>EBIT</i> | <i>5.2</i> | <i>13.5</i> | <i>20.2</i> | <i>18.7</i> | <i>21.0</i> | <i>24.1</i> | <i>22.0</i> | <i>12.5</i> |
| <i>PAT (reported bef minority interest)</i> | <i>7.6</i> | <i>12.7</i> | <i>17.5</i> | <i>16.5</i> | <i>16.8</i> | <i>19.2</i> | <i>17.5</i> | <i>12.8</i> |
| Key Drivers | | | | | | | | |
| Sponge Iron Sales (kt) | 97.9 | 101.9 | 98.5 | 92.0 | 115.0 | 108.0 | 115.0 | 93.0 |
| Net Sales realizations - Sponge Iron (Rs/t) | 13,470 | 15,152 | 16,282 | 16,895 | 17,330 | 21,263 | 21,384 | 22,047 |
| EBITDA/t (Rs) | 1,100 | 2,530 | 3,919 | 3,739 | 4,183 | 5,703 | 5,239 | 3,206 |

Source: Company, Centrum Research

Exhibit 6: Key Performance Indicators

| | FY15 | FY16 | FY17 | FY18 | FY19E | FY20E |
|--------------------------|--------|--------|--------|--------|--------|--------|
| Sponge Iron | | | | | | |
| Sales Volumes (kt) | 363 | 388 | 393 | 414 | 425 | 446 |
| YoY % | (3.3) | 6.9 | 1.3 | 5.3 | 2.8 | 5.0 |
| Net Realizations (Rs/t) | 19,805 | 15,046 | 14,345 | 18,011 | 22,347 | 21,000 |
| YoY% | 3.5 | (24.0) | (4.7) | 25.6 | 24.1 | (6.0) |
| Power | | | | | | |
| Sales Volumes (mn units) | 121 | 113 | 132 | 144 | 139 | 146 |
| YoY % | (13.8) | (6.7) | 16.8 | 9.1 | (3.6) | 5.4 |
| Realizations (Rs/unit) | 3.8 | 4.2 | 3.8 | 3.8 | 3.7 | 3.7 |
| YoY% | 19.5 | 11.2 | (10.5) | 1.5 | (3.9) | 0.0 |

Source: Company, Centrum Research Estimates

Financials

Exhibit 7: Income Statement

| Y/E March (Rs mn) | FY16 | FY17 | FY18 | FY19E | FY20E |
|-----------------------------|--------------|--------------|--------------|---------------|--------------|
| Revenues | 5,735 | 5,573 | 8,002 | 10,043 | 9,915 |
| Materials cost | 4,269 | 3,729 | 4,958 | 6,713 | 6,500 |
| % of revenues | 74.4 | 66.9 | 62.0 | 66.8 | 65.6 |
| Employee cost | 340 | 463 | 418 | 443 | 488 |
| % of revenues | 5.9 | 8.3 | 5.2 | 4.4 | 4.9 |
| Others | 887 | 764 | 798 | 863 | 893 |
| % of revenues | 15.5 | 13.7 | 10.0 | 8.6 | 9.0 |
| EBITDA | 240 | 616 | 1,827 | 2,024 | 2,035 |
| EBITDA margin (%) | 4.2 | 11.1 | 22.8 | 20.2 | 20.5 |
| Depreciation & Amortisation | 129 | 128 | 123 | 118 | 127 |
| EBIT | 111 | 489 | 1,704 | 1,906 | 1,908 |
| Interest expenses | 54 | 24 | 32 | 16 | 25 |
| PBT from operations | 57 | 464 | 1,671 | 1,890 | 1,883 |
| Other income | 377 | 371 | 431 | 578 | 675 |
| PBT | 434 | 835 | 2,102 | 2,467 | 2,557 |
| Taxes | 115 | 247 | 693 | 823 | 844 |
| Effective tax rate (%) | 26.4 | 29.6 | 33.0 | 33.3 | 33.0 |
| Adjusted PAT | 319 | 588 | 1,409 | 1,645 | 1,713 |

Source: Company, Centrum Research Estimates

Exhibit 8: Key Ratios

| Y/E March | FY16 | FY17 | FY18 | FY19E | FY20E |
|--------------------------------|--------|-------|-------|-------|-------|
| Growth Ratio (%) | | | | | |
| Revenue | (27.4) | (2.8) | 43.6 | 25.5 | (1.3) |
| EBITDA | (75.9) | 157.3 | 196.4 | 10.8 | 0.6 |
| Adjusted PAT | (65.3) | 84.1 | 139.7 | 16.8 | 4.1 |
| Margin Ratios (%) | | | | | |
| EBITDA | 4.2 | 11.1 | 22.8 | 20.2 | 20.5 |
| PBT from operations | 1.0 | 8.3 | 20.9 | 18.8 | 19.0 |
| Adjusted PAT | 5.6 | 10.5 | 17.6 | 16.4 | 17.3 |
| Return Ratios (%) | | | | | |
| ROE | 3.9 | 7.0 | 15.2 | 15.5 | 14.2 |
| ROCE | 4.2 | 6.8 | 14.2 | 14.4 | 13.3 |
| ROIC | 3.6 | 11.7 | 25.1 | 26.8 | 27.0 |
| Turnover Ratios (days) | | | | | |
| Gross block turnover ratio (x) | 3.6 | 3.3 | 4.6 | 5.5 | 5.1 |
| Debtors | 19 | 23 | 27 | 25 | 25 |
| Inventory | 21 | 32 | 38 | 35 | 35 |
| Creditors | 26 | 34 | 31 | 30 | 30 |
| Cash conversion cycle | 13 | 21 | 35 | 30 | 30 |
| Solvency Ratio (x) | | | | | |
| Net debt-equity | (0.8) | (0.7) | (0.6) | (0.6) | (0.6) |
| 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 | 3.6 | 3.4 | 4.1 |
| Per share Ratios (Rs) | | | | | |
| Adjusted EPS | 20.7 | 38.2 | 91.5 | 106.8 | 111.2 |
| BVPS | 536.4 | 561.6 | 640.6 | 735.7 | 835.3 |
| CEPS | 29.1 | 46.5 | 99.5 | 114.5 | 119.5 |
| DPS | 10.0 | 11.0 | 20.0 | 10.0 | 10.0 |
| Dividend payout % | 48.2 | 28.8 | 21.9 | 9.4 | 9.0 |
| Valuation (x)* | | | | | |
| P/E (adjusted) | 22.7 | 15.7 | 10.0 | 7.9 | 7.5 |
| P/BV | 0.9 | 1.1 | 1.4 | 1.1 | 1.0 |
| EV/EBITDA | 4.3 | 5.4 | 4.7 | 3.0 | 2.3 |
| Dividend yield % | 2.1 | 1.8 | 2.2 | 1.2 | 1.2 |
| 5 Yr Avg AOCF/EV yield % | 58.2 | 15.5 | 4.5 | 6.7 | 15.1 |

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

Exhibit 9: Balance Sheet

| Y/E March (Rs mn) | FY16 | FY17 | FY18 | FY19E | FY20E |
|--------------------------|--------------|--------------|---------------|---------------|---------------|
| Equity Share Capital | 154 | 154 | 154 | 154 | 154 |
| Reserves & surplus | 8,106 | 8,495 | 9,711 | 11,176 | 12,710 |
| Shareholders' fund | 8,260 | 8,649 | 9,865 | 11,330 | 12,864 |
| Def tax liab. (net) | 217 | 191 | 180 | 180 | 180 |
| Total Liabilities | 8,478 | 8,840 | 10,045 | 11,510 | 13,045 |
| Gross Block | 1,686 | 1,722 | 1,782 | 1,902 | 2,022 |
| Less: Acc. Depreciation | 49 | 175 | 292 | 409 | 536 |
| Net Block | 1,637 | 1,547 | 1,490 | 1,492 | 1,486 |
| Capital WIP | 92 | 56 | 58 | 88 | 118 |
| Net Fixed Assets | 1,730 | 1,603 | 1,548 | 1,581 | 1,604 |
| Investments | 2,854 | 2,634 | 1,997 | 1,997 | 1,997 |
| Inventories | 324 | 491 | 841 | 963 | 951 |
| Sundry debtors | 294 | 358 | 588 | 688 | 679 |
| Cash | 2,521 | 3,068 | 4,216 | 5,484 | 7,025 |
| Loans & Advances | 2,113 | 2,232 | 2,790 | 3,467 | 3,423 |
| Other assets | 39 | 73 | 163 | 83 | 81 |
| Total Current Asset | 5,291 | 6,222 | 8,598 | 10,684 | 12,159 |
| Trade payables | 407 | 525 | 669 | 825 | 815 |
| Other current Liab. | 424 | 488 | 798 | 880 | 869 |
| Provisions | 565 | 606 | 631 | 1,046 | 1,032 |
| Net Current Assets | 3,895 | 4,603 | 6,500 | 7,932 | 9,443 |
| Total Assets | 8,478 | 8,840 | 10,045 | 11,510 | 13,045 |

Source: Company, Centrum Research Estimates

Exhibit 10: Cash Flow

| Y/E March (Rs mn) | FY16 | FY17 | FY18 | FY19E | FY20E |
|-----------------------------------|--------------|--------------|----------------|--------------|--------------|
| Operating profit bef WC | 257 | 631 | 1,852 | 2,024 | 2,035 |
| Changes in working capital | 638 | (252) | (947) | (165) | 31 |
| Cash flow from operations | 771 | 195 | 411 | 1,036 | 1,222 |
| Adj. OCF (OCF - Interest) | 717 | 170 | 378 | 1,020 | 1,197 |
| Net Capex | 172 | 38 | 68 | 150 | 150 |
| Adj. FCF | 545 | 132 | 310 | 870 | 1,047 |
| Cash flow from investments | (584) | 536 | (2,131) | 428 | 525 |
| Cash flow from financing | (183) | (185) | (202) | (196) | (205) |
| Net change in cash | 3 | 546 | (1,922) | 1,267 | 1,542 |

Source: Company, Centrum Research Estimates

Appendix A

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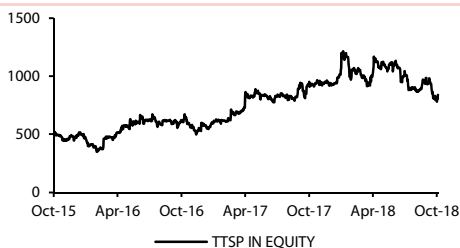
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Tata Sponge price chart



Source: Bloomberg

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|--------|-----------------------------|---------------------------------|-----------------------------|
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