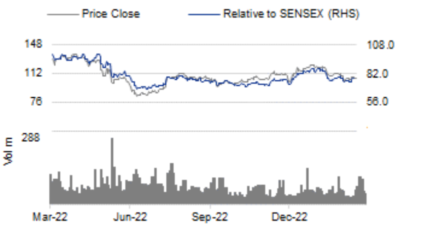
India

**REDUCE** *(no change)*

| Consensus ratings*: | Buy 24 | Hold 5 | Sell 3 |
|---|---|---|---|

| | |
|---|---|
| Current price: | Rs103 |
| Target price: | Rs70 |
| Previous target: | Rs71 |
| Up/downside: | -32.0% |
| InCred Research / Consensus: | -45.1% |
| Reuters: | TISC.NS |
| Bloomberg: | TATA IN |
| Market cap: | US$15,242m |
| | Rs1,252,730m |
| Average daily turnover: | US$67.3m |
| | Rs5532.6m |
| Current shares o/s: | 12,223.5m |
| Free float: | 66.9% |

*Source: Bloomberg*




*Source: Bloomberg*

| Price performance | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (%) | (1.4) | (8.3) | (23.2) |
| Relative (%) | 0.9 | (2.7) | (22.8) |

| Major shareholders | % held |
|---|---|
| Promoter & Promoter Group | 33.1 |
| LIC India | 9.0 |
| HDFC Trustee Company | 4.6 |

# Tata Steel

## It's never different - Europe pain to intensify

- We expect a global shortage of coking coal due to sub-par investment in Australia. Europe must rely on blast furnaces (BFs) as electric arc furnaces are unviable (even on gross profit or GP) due to higher scrap and electricity prices. On the other hand, BFs will make at least +ve gross profit in Europe.
- Pollution fears are forcing China to become a voracious user of scrap, leading to scarcity of old scrap (comes from scrapping of old steel items). Scrap prices are rising, which is a further negative for European steel-makers. Thus, production will shift to BFs, leading to higher coking coal prices.
- European power prices will rise again, which will make the production shift to BFs even more pronounced. An oversupplied steel market, rising costs and slowing demand is a recipe to buy steel names at 0.5x book value. Tata Steel is away from that. Its balance sheet will deteriorate (contrary to consensus estimate). We retain our high conviction REDUCE rating on Tata Steel.

### Cost pressure to continue for Tata Steel

Tata Steel follows a typical cycle - stock price rallies and then people get bullish on Europe, but Europe doesn't go anywhere, and India business disappoints. The same cycle will repeat this time around as well. While energy prices have fallen in Europe, however in steel production, due to high scrap prices, electric arc furnaces or EAFs won't make money even at contribution margin level. The situation will be far worse in the coming weeks as natural gas in storage will fall below last year's level by week 21-25, leading to a rise in energy prices in Europe. China's voracious appetite for scrap is leading to the shortage of old metal scrap, which is adding to EAFs' woes. Please note that Europe is primarily an EAF steel-maker and hence, as it shifts to BFs, coking coal prices skyrocket (because of supply concerns). Rising coking coal prices are bad for even India business of Tata Steel. Needless to say, steel is oversupplied and steel-makers lack pricing power. At the same time, demand is weakening, and costs are rising, which is a recipe for collapse in margins and deterioration of balance sheet.

### Balance sheet to deteriorate and capex to get delayed

We have shown in this report that deleveraging in FY22 was artificial as there was an enormous rise in current liabilities. The nature of liabilities (as shown in this report) means that they cannot be carried in perpetuity, which also means that working capital will increase in FY23F. At the same time, consensus earnings for FY23F/24F/25F are just based on a great recovery (which hasn't come after 2008). Consensus is all set to be disappointed, both on P&L and balance sheet fronts.

### Retain REDUCE rating with a target price of Rs70

In the foreseeable future, the steel market is likely to experience sustained downward pressure, resulting in no improvement in steel spreads. We value Tata Steel at 0.7x FY23F book value to arrive at a target price of Rs70. Retain REDUCE rating on it. Upside risk: Big QE by the western world, although it means that they are ready for hyperinflation.

| Financial Summary | Mar-20A | Mar-21A | Mar-22F | Mar-23F | Mar-24F |
|---|---|---|---|---|---|
| Revenue (Rsm) | 1,369,768 | 1,533,084 | 2,423,269 | 2,019,889 | 1,829,799 |
| Operating EBITDA (Rsm) | 174,631 | 304,963 | 634,900 | 313,657 | 250,269 |
| Net Profit (Rsm) | 27,196 | 81,818 | 417,493 | 126,352 | 64,356 |
| Core EPS (Rs) | 5.3 | 7.2 | 34.2 | 10.3 | 5.3 |
| Core EPS Growth | (37.5%) | 36.0% | 375.8% | (69.8%) | (49.1%) |
| FD Core P/E (x) | 46.07 | 15.31 | 3.00 | 9.92 | 19.47 |
| DPS (Rs) | 4.1 | 4.1 | 4.1 | 4.1 | 6.5 |
| Dividend Yield | 9.76% | 24.39% | 24.39% | 1.95% | 1.95% |
| EV/EBITDA (x) | 13.33 | 6.48 | 2.82 | 6.07 | 7.58 |
| P/FCFE (x) | 9.46 | 28.85 | 6.86 | 3.33 | 11.05 |
| Net Gearing | 137.7% | 89.0% | 43.7% | 49.1% | 47.0% |
| P/BV (x) | 1.70 | 1.69 | 1.09 | 1.01 | 0.97 |
| ROE | 9.1% | 11.9% | 44.4% | 10.6% | 5.1% |
| % Change In Core EPS Estimates | | | | (0.70%) | (0.87%) |
| InCred Research/Consensus EPS (x) | | | | | |

SOURCES: INCRED RESEARCH, COMPANY REPORTS

Analyst(s)

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# It's never different - Europe pain to intensify

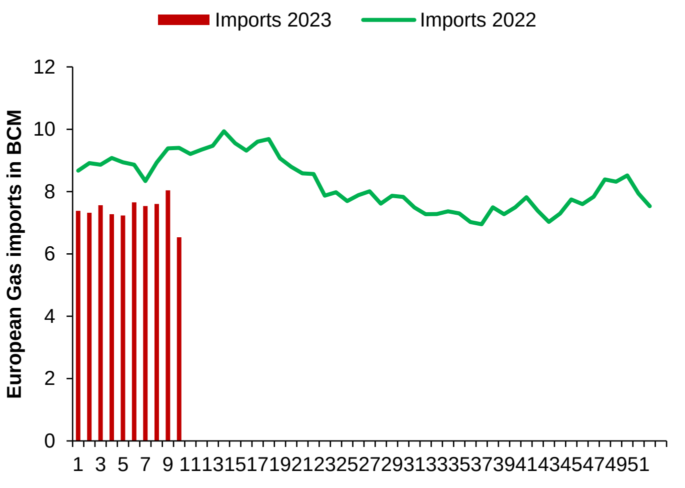
Tata Steel follows a typical cycle - stock price rallies and then people get bullish on Europe, but Europe doesn't go anywhere, and India business disappoints. The same cycle will repeat this time around as well. While buying Bhushan Steel may look attractive on a replacement cost basis, the balance sheet will become stretched as the working capital cycle will revert to its mean. Coking coal prices will fall only if steel prices collapse. Reiterate REDUCE rating on Tata Steel with a 12-month target price of Rs70.

## Europe market pain returns

Just like what we had written in Jun 2022, European pain has retuned (IN: Tata Steel - European pain to return (REDUCE - Maintained)) and it will haunt this time much more than earlier. Free money will help consumer discretionary industries, but steel will suffer the most. Higher power cost will return to bite principal industries in Europe like automotive and forging industries (IN: Ind Goods & Services - Europe's energy crisis: +ve for Indian firms). Coking coal prices will not fall and any semblance of steel demand growth will lead to a rapid rise in coking coal prices. Please see our report: IN: Steel - Rise in raw material cost & fall in steel price.

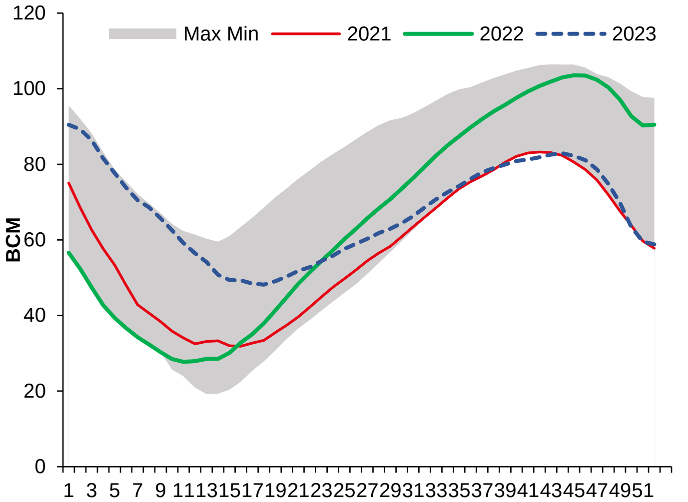
### It's a temporary reprieve in Europe's energy situation

**Figure 1: An unusually mild winter is leading to lower import of natural gas in Europe**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

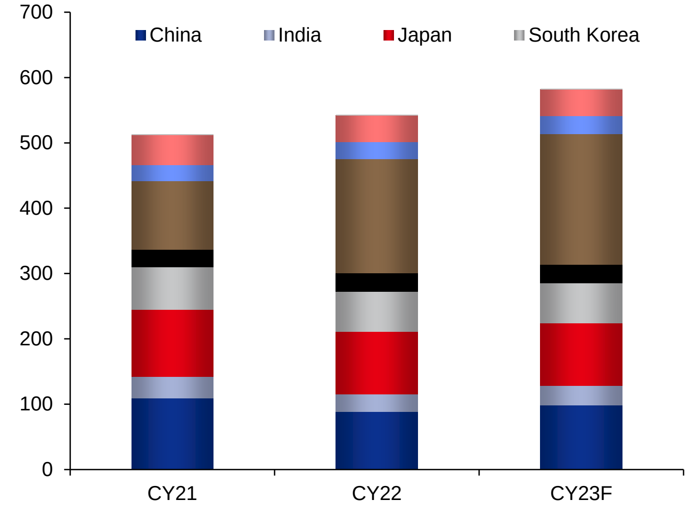
**Figure 2: Assuming normal consumption during the summer season, gas inventory will fall below last year's level ~ week 20-25**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

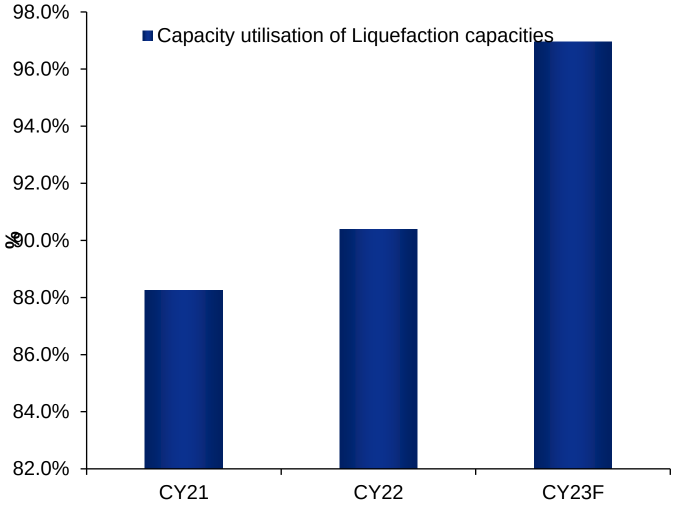
## Please note that LNG global liquefaction capacity is barely matching demand and hence, spot LNG prices are bound to rise ➤

**Figure 3: We expect China's LNG demand to rise moderately over last year's level, but to remain well below 2021 level**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

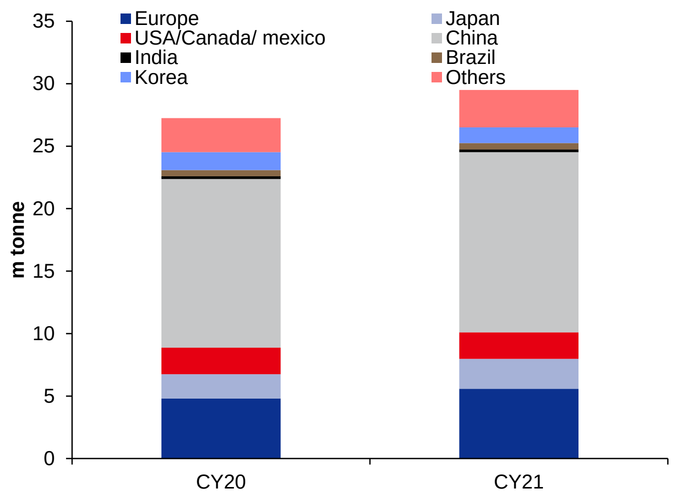
**Figure 4: Utilization of liquefaction capacities across the world needs to be higher than 97% - a very difficult proposition to sustain continuously**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

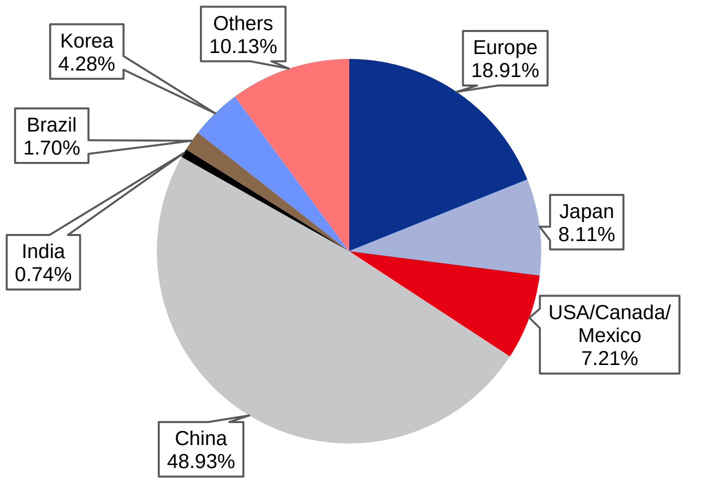
## Energy prices will rise, leading to a slowdown in energy-intensive industries like forgings ➤

**Figure 5: Europe produced nearly 5.6mt forgings per annum**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

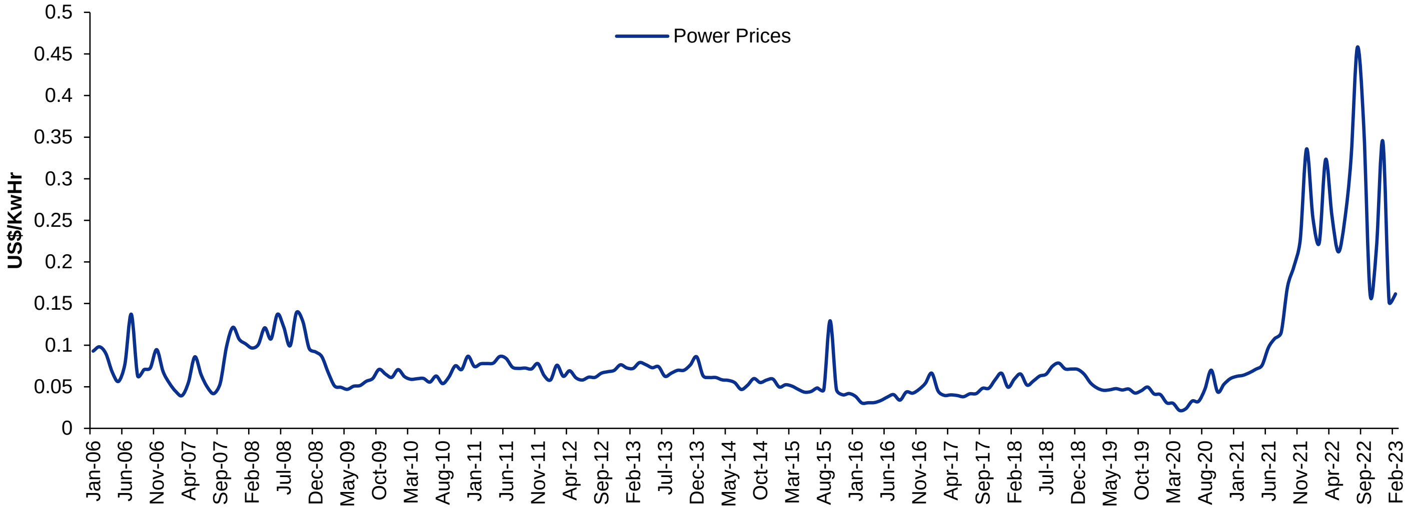
**Figure 6: Europe's market share in global forgings market is 19% whereas that of India is below 1%**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

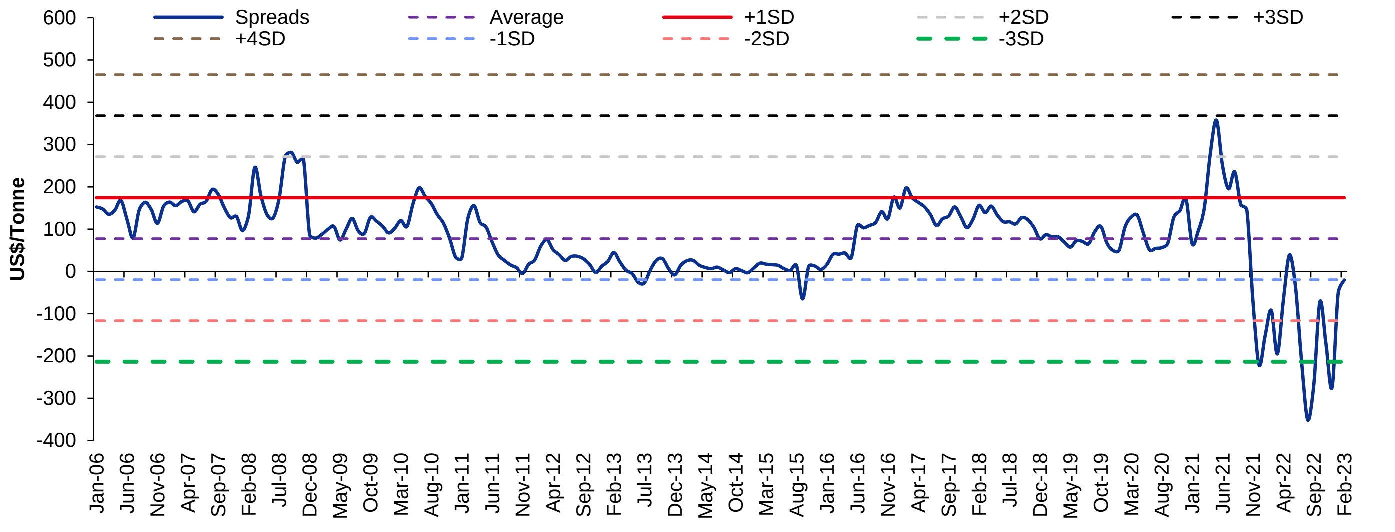
## As of now, even steel-making through the scrap route is not viable, forget forgings

**Figure 7: Power prices in Europe have come down significantly, but are still way above the historical average**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

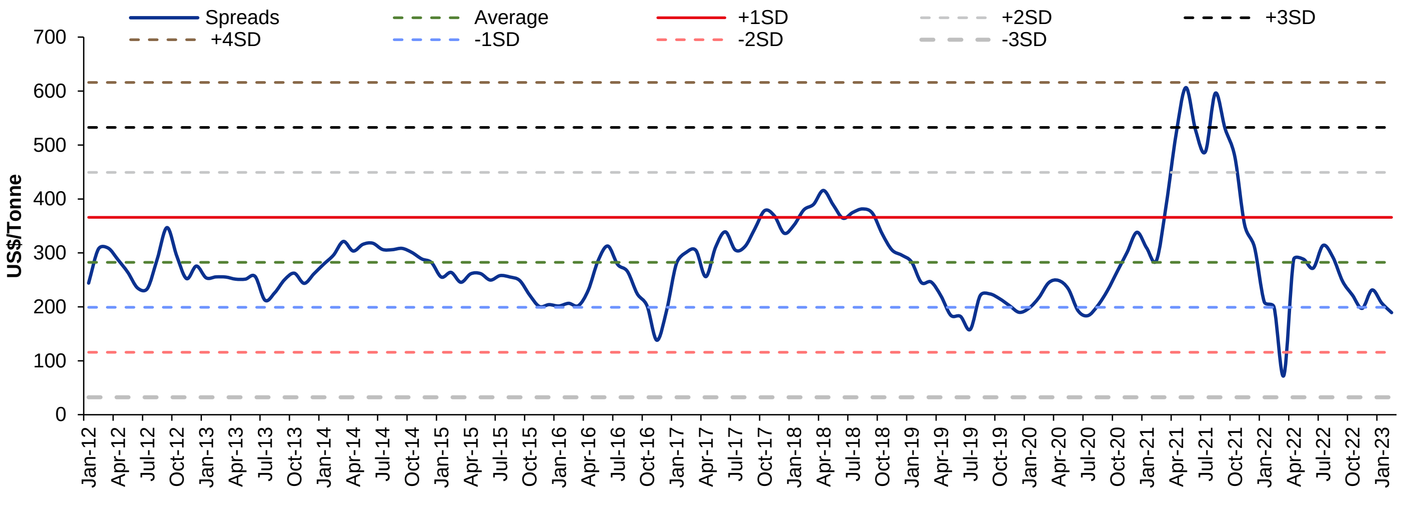
**Figure 8: The ensuing bearish industrial scenario in Europe means steel prices are depressed and EAFs are not viable**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Interstingly, blast furnaces are viable despite high coking coal prices ➤

**Figure 9: Interestingly, despite high coking coal prices, blast furnaces are viable (at least +ve spreads), which is leading to a higher usage of blast furnaces and hence, higher coking coal demand**

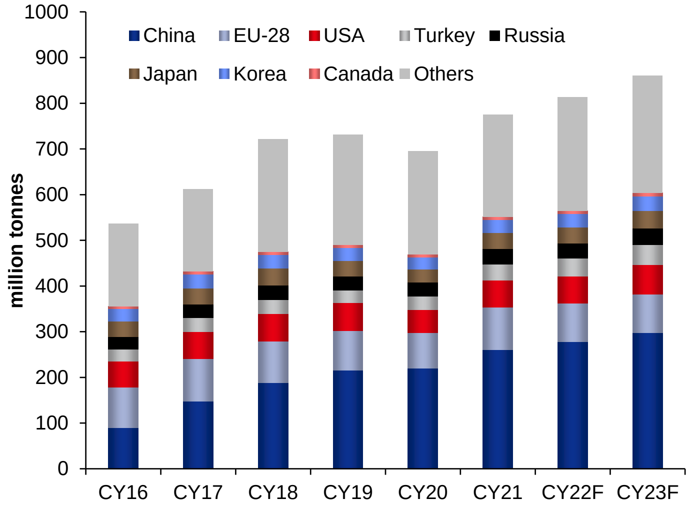



SOURCE: INCRED RESEARCH, COMPANY REPORTS

## High scrap prices in Europe can stay for long ➤

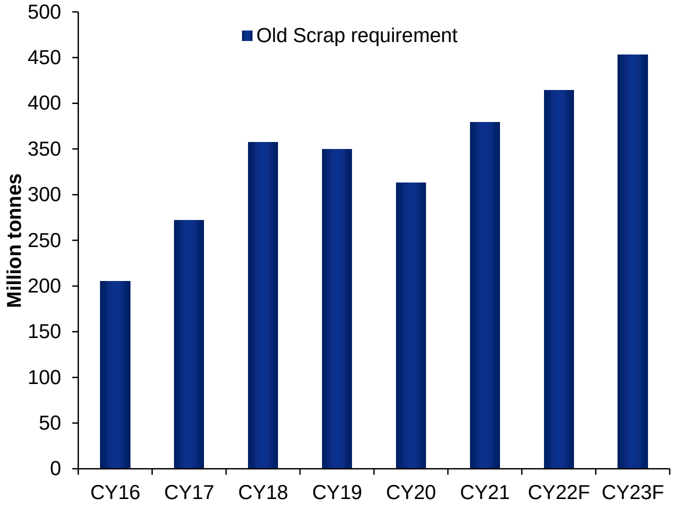
Even if Europe's scrap demand goes down because of high power prices, rising demand from China will keep scrap prices elevated.

**Figure 10: European demand for scrap is likely to go down because of high power prices**




SOURCES: INCRED RESEARCH, COMPANY REPORTS

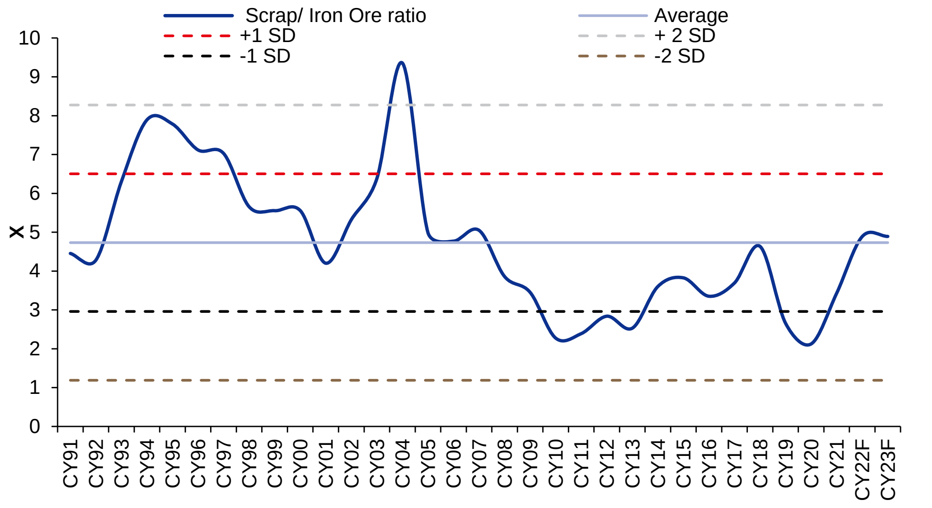
**Figure 11: Old scrap requirement is increasing fast, which means that scrap prices can remain elevated for a long time**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Scrap-to-iron-ore ratio will rise

Figure 12: Scrap-to-iron ore ratio will rise, which means scrap will become costlier with respect to iron ore




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## This will lead to more usage of iron ore and coking coal, but their capacity is limited

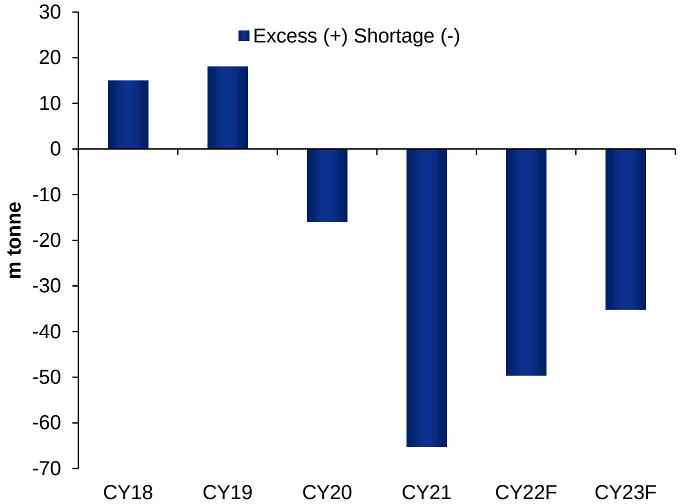
While the demand for iron ore and coking coal will rise, there has been little investment in mining over the past few years.

## Coking coal prices unlikely to come down

Sub-par investment in coking coal assets in Australia is leading to global shortage of coking coal. While Mongolia has raised its production level, it won't be sufficient to cover the replacement of steel production in Europe through the EAF route with the blast furnace production route and hence, demand for coking coal will rise.

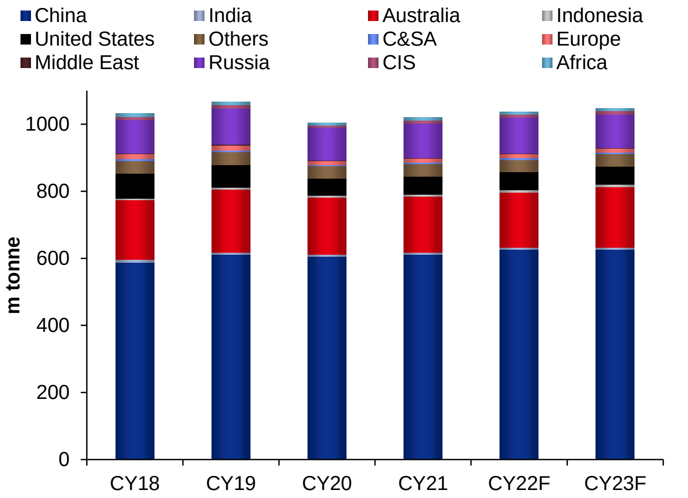
## Coking coal to remain in short supply as Australian production may disappoint once again in CY23F

Figure 13: We expect coking coal to remain in short supply in the coming years




SOURCE: INCRED RESEARCH, COMPANY REPORTS

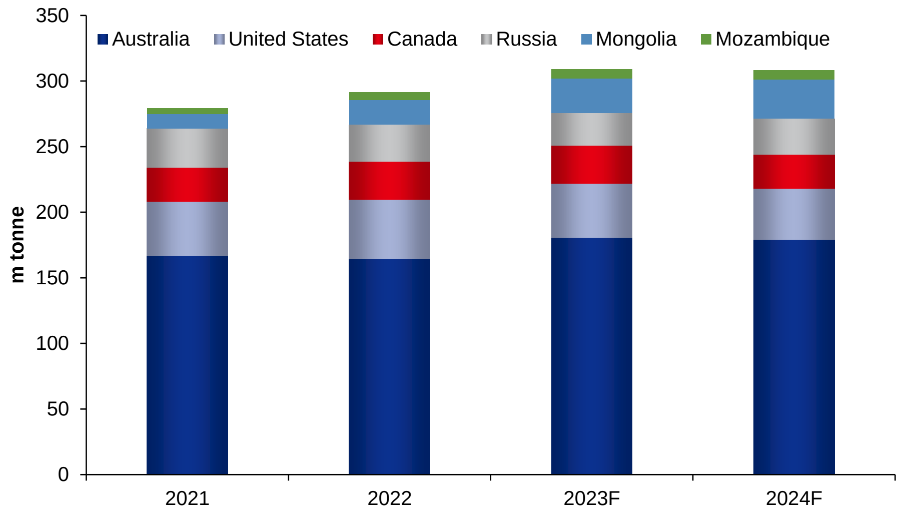
Figure 14: Australia's coking coal production is likely to disappoint in CY23F as well




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Australia is projected to export 181mt of coking coal in CY23F, but it appears to be a tall task

**Figure 15: In the past few years, Australia has consistently missed its coking coal export targets; in CY23F, Australian government projects exports of 181mt**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Europe will have to depend on blast furnaces for its steel production, thereby raising the demand for coking coal

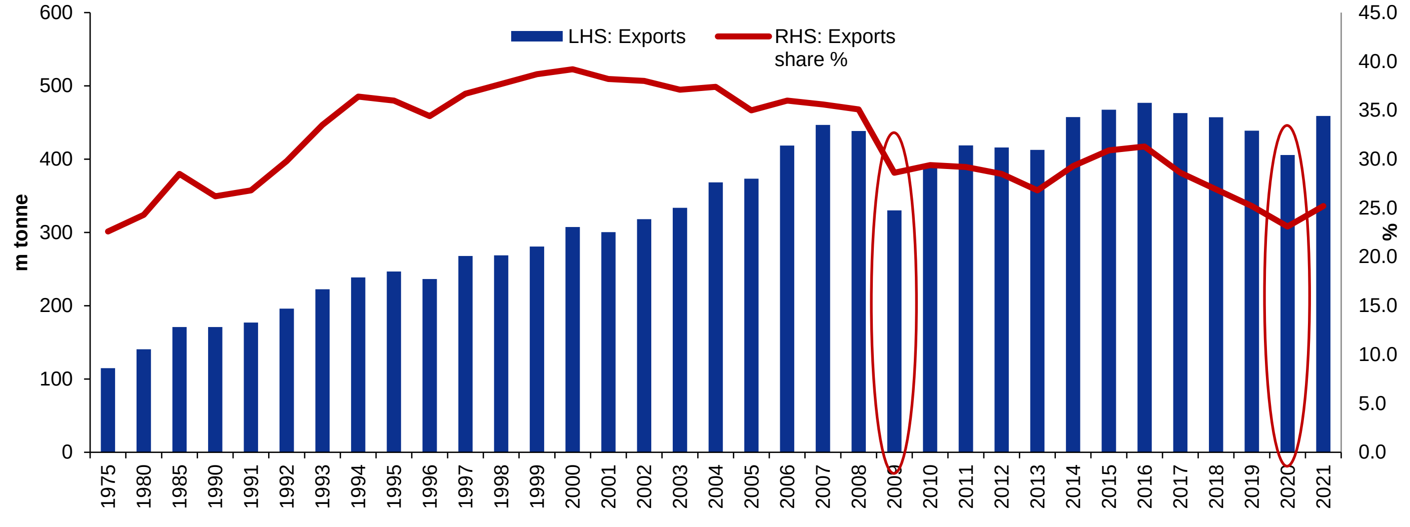
At current steel, scrap, and power prices in Europe, it will be difficult for EAFs to make any operational profit. Naturally, for steel production, European countries will have to depend on blast furnaces, which need coking coal. Hence, although coking coal demand is muted currently, because of cannibalization of steel supply from EAFs to blast furnaces, coking coal demand will increase. Hence, our projection of coking coal deficit may aggravate further, pushing up coking coal prices.

## Global steel prices to remain under pressure

Global steel prices will remain under pressure for some time and hence, we don't expect any revival in steel spreads.

### COVID-19 pandemic led to a decline in global steel trade and hence, steel supply was scarce ➤

Figure 16: 2021 witnessed lowest steel exports as a % of overall steel consumption since 1975 - this led to widespread steel scarcity and the perception of a steel supercycle



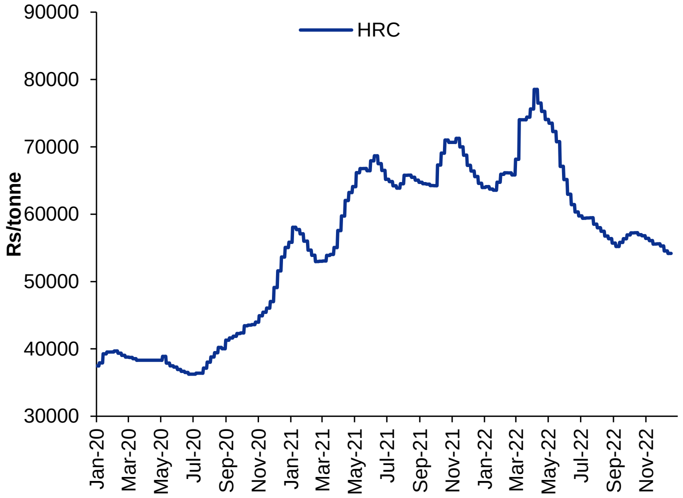

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Please note that we had pointed out this phenomenon, although without any concrete data (as data is not available in real time) multiple times during 2021. Please see some of our reports detailed below:

1. IN: Steel - Irrational enthusiasm
2. IN: Steel - Recent market exuberance close to its end

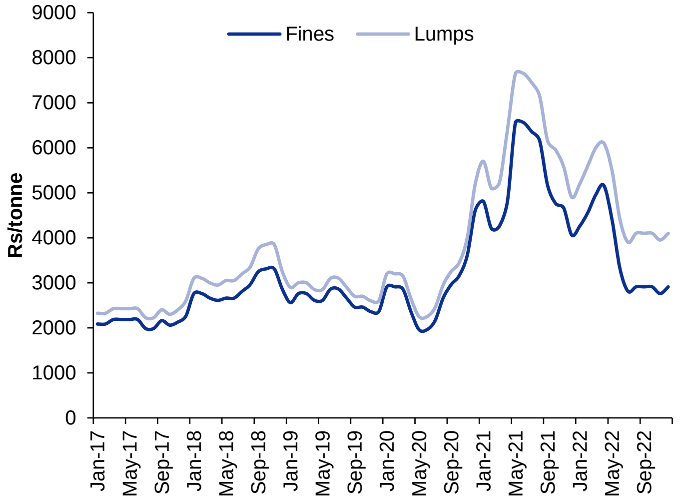
### Normalization of supply chain led to a rapid decline in steel prices ➤

Figure 17: Indian hot rolled coil or HRC prices touched Rs80,000/t in 2021, but have since then corrected to Rs54,000/t




SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 18: However, iron ore prices are not correcting as there are structural tailwinds

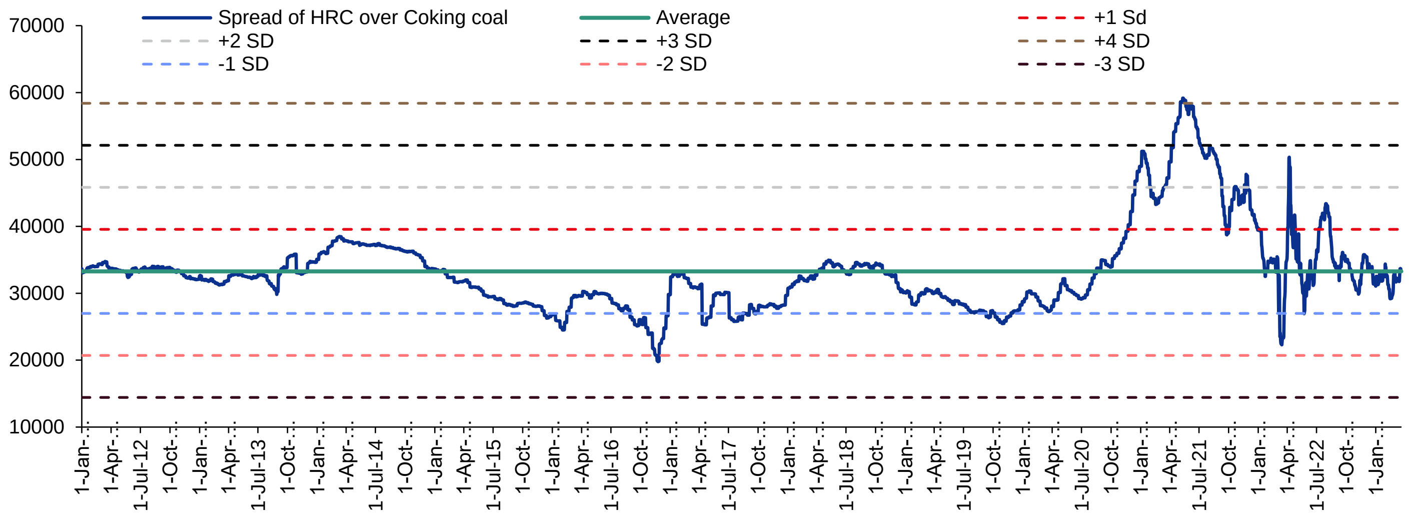



SOURCE: INCRED RESEARCH, COMPANY REPORTS

As highlighted earlier, we don't expect coking coal prices to fall in the global market.

## Hence, Indian steel spreads have fallen to their historical mean level

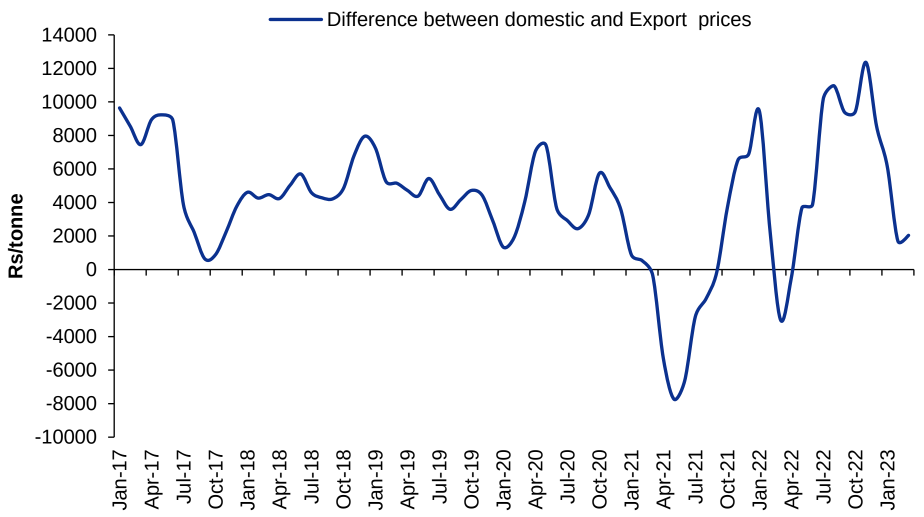
**Figure 19: Indian domestic HRC spreads over coking coal have fallen to historical mean level; we believe that as coking coal prices rise, they will fall to-1 SD level**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## However, Indian export prices are still at a significant discount to domestic prices

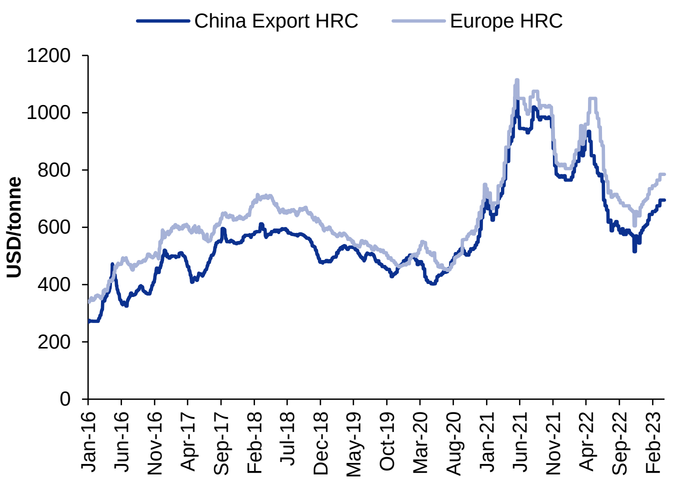
**Figure 20: Domestic steel prices are still at one of their highest levels vis-à-vis export prices**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Global steel prices are showing slight volatility, but no big revival as such ➤

**Figure 21: After a steep decline, global HRC prices have shown a minor uptick**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

**Figure 22: However, iron ore prices have also moved up, thereby negating all the advantages.**

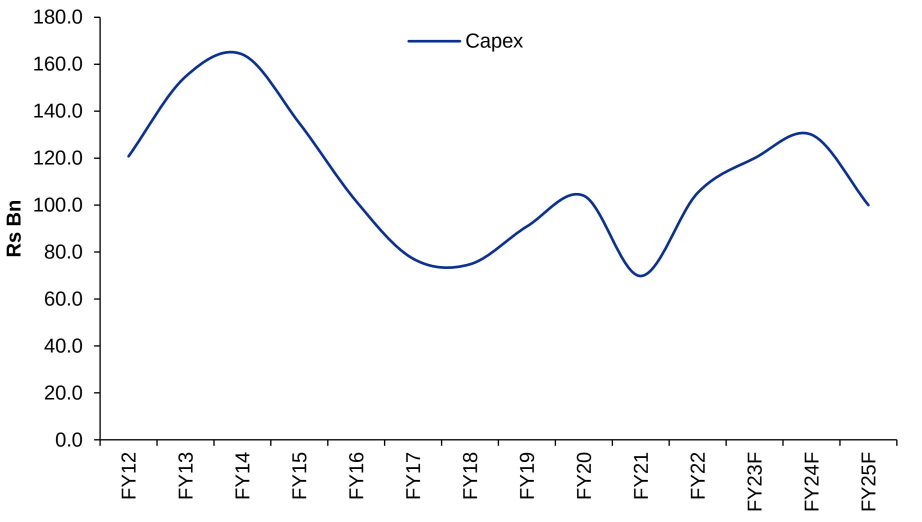

SOURCE: INCRED RESEARCH, COMPANY REPORTS

## We expect a delay in capex by Tata Steel, but its debt won't come down

Tata Steel had announced Rs 500-600bn capex over the next four years to expand its steel and iron ore capacity. Please click the link to our report here: (New Paper Link). However, as the cash flow will deteriorate, capex will also taper down. We don't expect a very high capex in the next few years.

## Tata Steel will delay its capex plan as cash flow constraints come to the fore ➤

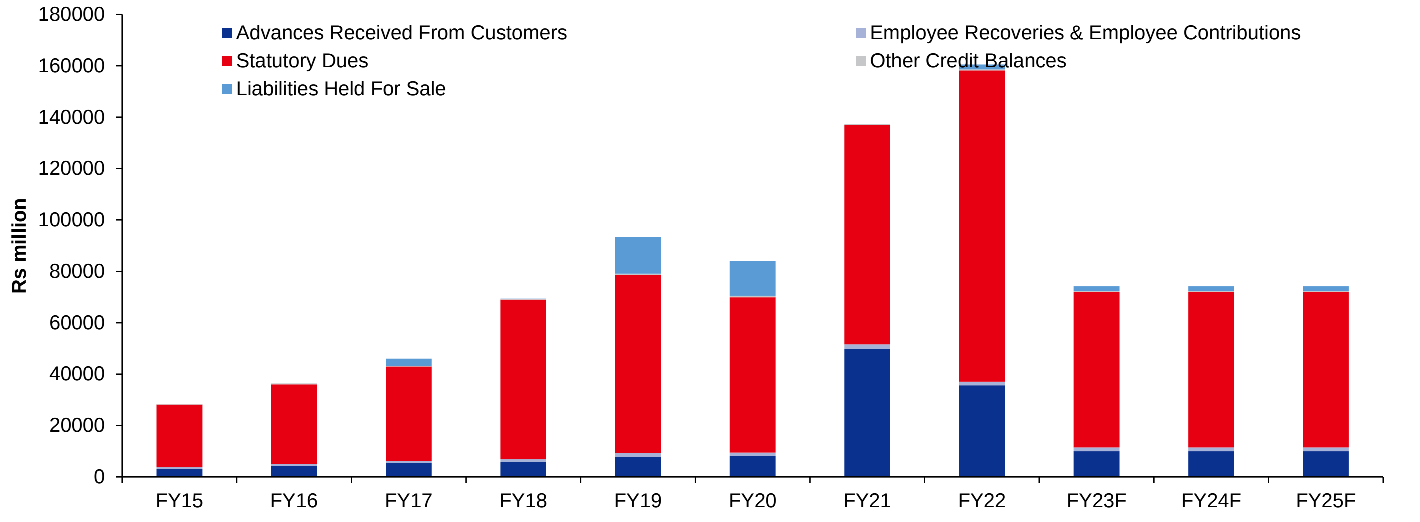
**Figure 23: We expect capex to be delayed as cash flow will come under risk**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## Current liabilities to go down after hitting their peak in FY22

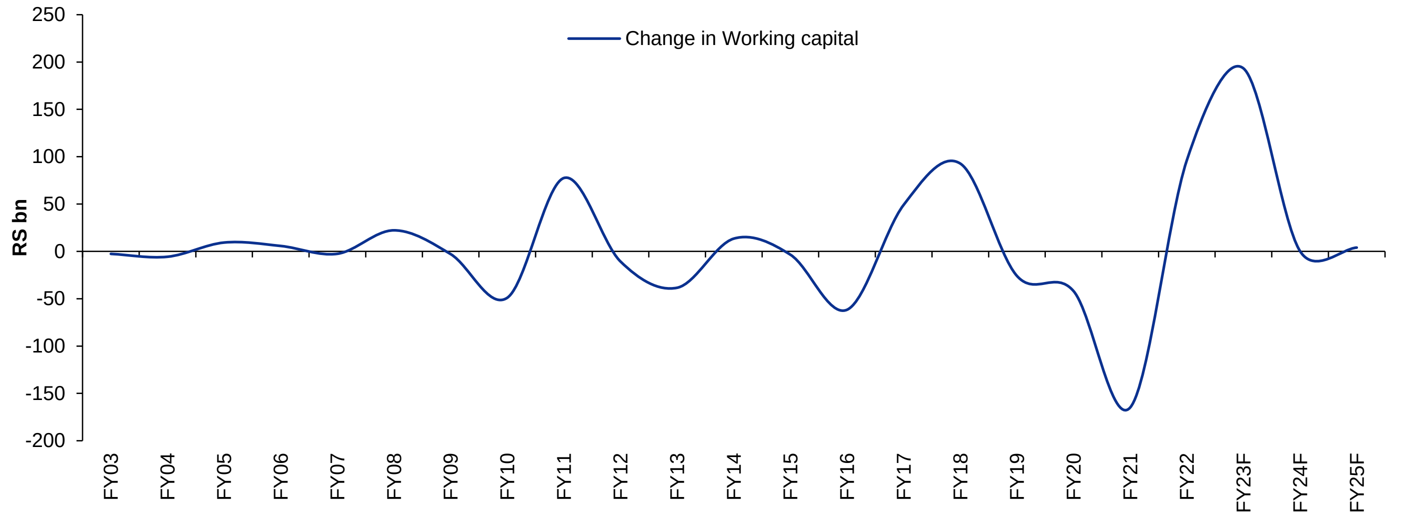
**Figure 24: Current liabilities will go down after hitting their peak in FY22; the extent of supply chain fears can be gauged from customer advances in Tata Steel's balance sheet**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## This will lead to a rise in working capital requirement in FY23F and onwards

**Figure 25: Working capital follows a cycle; after a big cash release in FY21 and FY22, a big increase in working capital is inevitable (-ve number means release of working capital and =ve number means increase in working capital)**

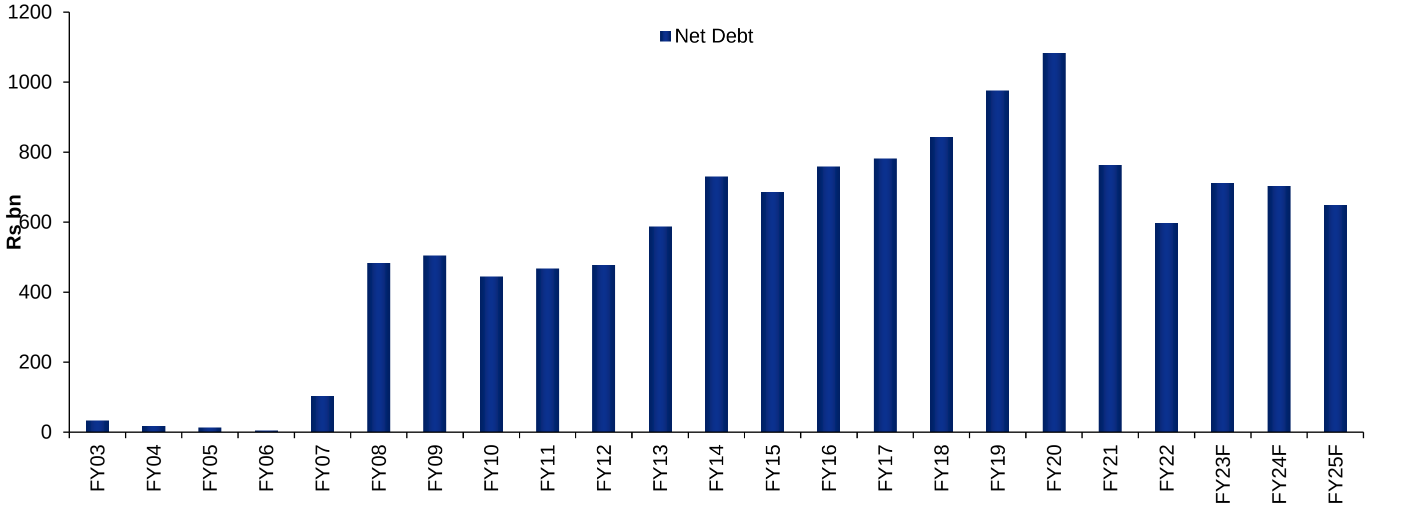



SOURCE: INCRED RESEARCH, COMPANY REPORTS

InCred Equities

## Consequently, consensus net debt estimate stands understated on two accounts: 1) assuming working capital release in perpetuity, and 2) high EBITDA estimates

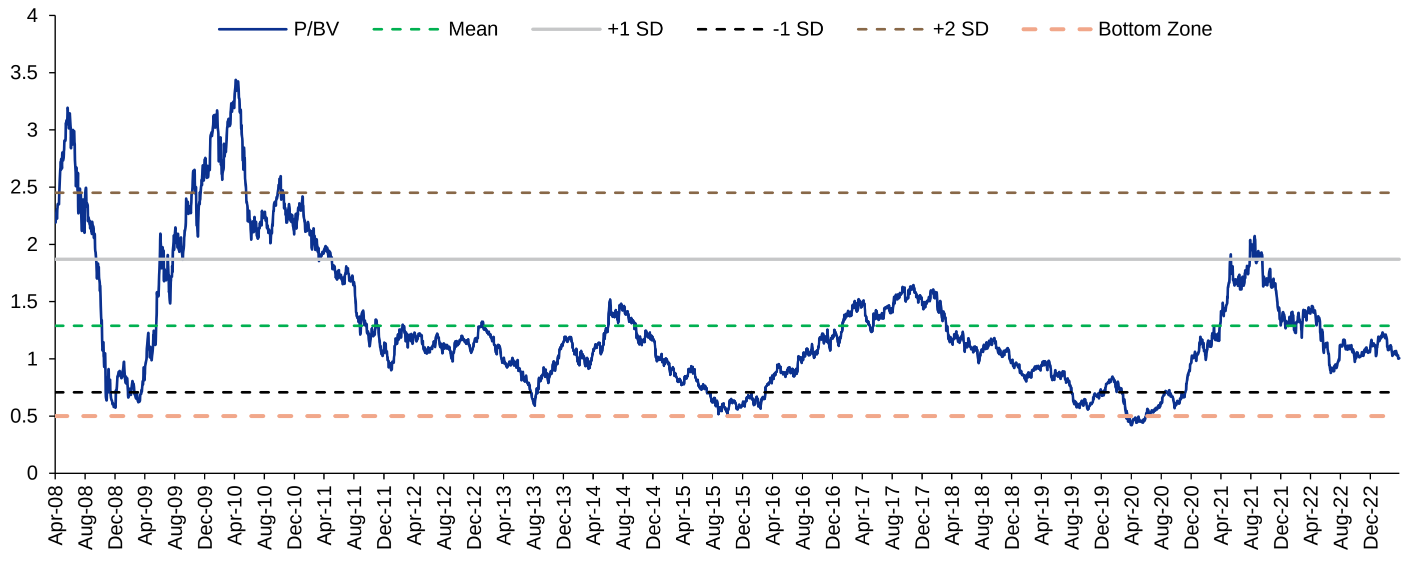
**Figure 26: Consensus estimates of a dramatic debt reduction will not come true**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

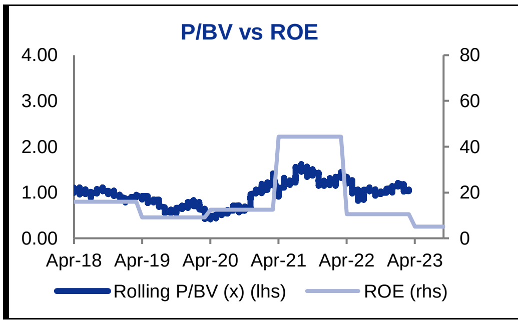
## Valuation still too high for comfort

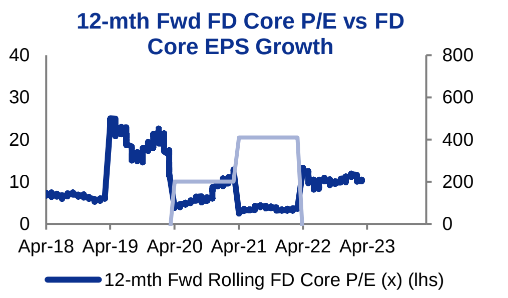
**Figure 27: Valuation of Tata Steel is still not in the buy zone; It should fall to at least near 0.7x P/BV for buying**




SOURCE: INCRED RESEARCH, COMPANY REPORTS

## BY THE NUMBERS




### Profit & Loss

| (Rs mn) | Mar-20A | Mar-21A | Mar-22F | Mar-23F | Mar-24F |
|---|---|---|---|---|---|
| **Total Net Revenues** | **1,398,167** | **1,562,942** | **2,439,592** | **2,019,889** | **1,829,799** |
| **Gross Profit** | **1,398,167** | **1,562,942** | **2,439,592** | **2,019,889** | **1,829,799** |
| **Operating EBITDA** | **174,631** | **304,963** | **634,900** | **313,657** | **250,269** |
| Depreciation And Amortisation | (84,407) | (92,336) | (91,009) | (97,253) | (97,482) |
| **Operating EBIT** | **90,223** | **212,626** | **543,891** | **216,405** | **152,787** |
| Financial Income/(Expense) | (75,335) | (76,067) | (54,622) | (66,314) | (80,191) |
| Pretax Income/(Loss) from Assoc. | 1,880 | 3,273 | 6,492 | | |
| Non-Operating Income/(Expense) | 18,435 | 8,956 | 7,849 | 7,849 | 7,849 |
| **Profit Before Tax (pre-EI)** | **35,203** | **148,789** | **503,609** | **157,940** | **80,445** |
| Exceptional Items | (37,521) | (10,432) | (1,341) | | |
| **Pre-tax Profit** | **(2,317)** | **138,357** | **502,269** | **157,940** | **80,445** |
| Taxation | 25,684 | (56,539) | (84,776) | (31,588) | (16,089) |
| Exceptional Income - post-tax | | | | | |
| **Profit After Tax** | **23,367** | **81,818** | **417,493** | **126,352** | **64,356** |
| Minority Interests | 3,829 | | | | |
| Preferred Dividends | | | | | |
| FX Gain/(Loss) - post tax | | | | | |
| Other Adjustments - post-tax | | | | | |
| **Net Profit** | **27,196** | **81,818** | **417,493** | **126,352** | **64,356** |
| Recurring Net Profit | 64,716 | 87,987 | 418,608 | 126,352 | 64,356 |
| **Fully Diluted Recurring Net Profit** | **64,716** | **87,987** | **418,608** | **126,352** | **64,356** |

### Cash Flow

| (Rs mn) | Mar-20A | Mar-21A | Mar-22F | Mar-23F | Mar-24F |
|---|---|---|---|---|---|
| EBITDA | 174,631 | 304,963 | 634,900 | 313,657 | 250,269 |
| Cash Flow from Invt. & Assoc. | | | | | |
| Change In Working Capital | 41,962 | 164,913 | (96,177) | (193,296) | (164) |
| (Incr)/Decr in Total Provisions | | | | | |
| Other Non-Cash (Income)/Expense | 31,705 | (21,444) | 11,105 | | 1,535 |
| Other Operating Cashflow | 8,138 | 63,859 | (170,412) | 10,987 | 55,862 |
| Net Interest (Paid)/Received | (75,807) | (76,067) | (54,622) | (66,314) | (80,191) |
| Tax Paid | 21,059 | 7,043 | 119,017 | 31,588 | 16,089 |
| **Cashflow From Operations** | **201,687** | **443,267** | **443,810** | **96,623** | **243,400** |
| Capex | (100,123) | (65,340) | (99,527) | (120,000) | (130,000) |
| Disposals Of FAs/subsidiaries | | | | | |
| Acq. Of Subsidiaries/investments | | | | | |
| Other Investing Cashflow | (45,181) | (27,889) | (9,285) | | |
| **Cash Flow From Investing** | **(145,304)** | **(93,229)** | **(108,812)** | **(120,000)** | **(130,000)** |
| Debt Raised/(repaid) | 76,073 | (306,606) | (152,307) | 400,000 | |
| Proceeds From Issue Of Shares | 1,875 | 32,390 | 3,257 | 12 | |
| Shares Repurchased | | | | | |
| Dividends Paid | (18,152) | (11,505) | (30,201) | (24,446) | (24,446) |
| Preferred Dividends | | | | | |
| Other Financing Cashflow | (76,742) | (85,175) | (54,760) | (66,314) | (80,191) |
| **Cash Flow From Financing** | **(16,946)** | **(370,897)** | **(234,011)** | **309,252** | **(104,637)** |
| Total Cash Generated | 39,438 | (20,859) | 100,987 | 285,874 | 8,762 |
| **Free Cashflow To Equity** | **132,457** | **43,432** | **182,690** | **376,623** | **113,400** |
| **Free Cashflow To Firm** | **132,191** | **426,105** | **389,620** | **42,937** | **193,591** |

SOURCES: INCRED RESEARCH, COMPANY REPORTS

## BY THE NUMBERS…cont'd

### Balance Sheet

| (Rs mn) | Mar-20A | Mar-21A | Mar-22F | Mar-23F | Mar-24F |
|---|---|---|---|---|---|
| Total Cash And Equivalents | 114,866 | 130,011 | 244,234 | 530,108 | 538,870 |
| Total Debtors | 78,849 | 95,398 | 122,464 | 182,620 | 175,460 |
| Inventories | 310,687 | 332,764 | 488,244 | 427,884 | 409,170 |
| Total Other Current Assets | 82,925 | 43,946 | 70,624 | 70,624 | 70,624 |
| **Total Current Assets** | **587,327** | **602,119** | **925,566** | **1,211,237** | **1,194,125** |
| Fixed Assets | 1,499,930 | 1,453,912 | 1,510,222 | 1,532,969 | 1,565,487 |
| Total Investments | 28,533 | 34,630 | 58,254 | 58,254 | 58,254 |
| Intangible Assets | 40,545 | 43,447 | 43,112 | 43,112 | 43,112 |
| Total Other Non-Current Assets | 347,859 | 270,297 | 317,302 | 317,302 | 317,302 |
| **Total Non-current Assets** | **1,916,867** | **1,802,287** | **1,928,890** | **1,951,637** | **1,984,155** |
| Short-term Debt | 191,845 | 94,921 | 251,008 | 451,008 | 451,008 |
| Current Portion of Long-Term Debt | | | | | |
| Total Creditors | 213,809 | 259,675 | 367,649 | 276,697 | 250,657 |
| Other Current Liabilities | 180,568 | 354,075 | 287,223 | 184,675 | 184,676 |
| **Total Current Liabilities** | **586,222** | **708,671** | **905,880** | **912,381** | **886,342** |
| Total Long-term Debt | 971,437 | 724,802 | 504,709 | 704,709 | 704,709 |
| Hybrid Debt - Debt Component | | | | | |
| Total Other Non-Current Liabilities | 13,960 | 106,981 | 101,365 | 101,365 | 101,365 |
| **Total Non-current Liabilities** | **985,398** | **831,783** | **606,074** | **806,074** | **806,074** |
| Total Provisions | 170,946 | 139,333 | 171,518 | 171,518 | 173,052 |
| **Total Liabilities** | **1,742,566** | **1,679,788** | **1,683,471** | **1,889,972** | **1,865,468** |
| Shareholders Equity | 735,763 | 742,388 | 1,144,430 | 1,246,348 | 1,286,258 |
| Minority Interests | 25,866 | 32,697 | 26,554 | 26,554 | 26,554 |
| **Total Equity** | **761,629** | **775,085** | **1,170,985** | **1,272,902** | **1,312,812** |

### Key Ratios

| | Mar-20A | Mar-21A | Mar-22F | Mar-23F | Mar-24F |
|---|---|---|---|---|---|
| Revenue Growth | (11.5%) | 11.9% | 58.1% | (16.6%) | (9.4%) |
| Operating EBITDA Growth | (40.6%) | 74.6% | 108.2% | (50.6%) | (20.2%) |
| Operating EBITDA Margin | 12.7% | 19.9% | 26.2% | 15.5% | 13.7% |
| Net Cash Per Share (Rs) | (85.77) | (56.43) | (41.85) | (51.18) | (50.47) |
| BVPS (Rs) | 60.19 | 60.74 | 93.63 | 101.97 | 105.23 |
| Gross Interest Cover | 1.20 | 2.80 | 9.96 | 3.26 | 1.91 |
| Effective Tax Rate | | 40.9% | 16.9% | 20.0% | 20.0% |
| Net Dividend Payout Ratio | 188.9% | 331.2% | 73.0% | 19.3% | 38.0% |
| Accounts Receivables Days | 25.71 | 20.35 | 16.30 | 27.56 | 35.71 |
| Inventory Days | nm | nm | nm | nm | nm |
| Accounts Payables Days | nm | nm | nm | nm | nm |
| ROIC (%) | (23.5%) | 7.6% | 23.8% | 8.2% | 5.7% |
| ROCE (%) | 4.7% | 11.5% | 29.1% | 9.4% | 5.9% |
| Return On Average Assets | (13.4%) | 5.6% | 17.7% | 6.0% | 4.1% |

SOURCES: INCRED RESEARCH, COMPANY REPORTS

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