

India

Underweight (no change)

Highlighted Companies

Steel Authority of India

REDUCE, TP Rs54, Rs120 close

Despite having captive iron ore capacities, SAIL's operational cost/t is the highest among its steel peers. Its mining cost is rising, negating advantages

Tata Steel

REDUCE, TP Rs750, Rs1437 close

The stock looks overvalued on all parameters, in our view. European asset sales are factored into its price.

JSW Steel

REDUCE, TP Rs330, Rs689 close

We expect the company to fare well based on its value-added offerings but expect its profitability to fall, leading to a 6% EBITDA CAGR over FY21-23F.

Summary Valuation Metrics

P/E (x)	Mar21-F	Mar22-F	Mar23-F
Steel Authority of India	-75.05	1485.86	195.65
Tata Steel	20.59	5.96	17.76
JSW Steel	26.3	32.13	31.7

P/BV (x)	Mar21-F	Mar22-F	Mar23-F
Steel Authority of India	0.73	0.73	0.73
Tata Steel	2.32	1.72	1.61
JSW Steel	3.56	3.31	3.09

Dividend Yield	Mar21-F	Mar22-F	Mar23-F
Steel Authority of India	0%	0%	0%
Tata Steel	1.74%	1.74%	1.74%
JSW Steel	0.94%	0.94%	0.94%

Analyst(s)



Satish KUMAR

T (91) 9004603998
E satish.kumar@incredcapital.com

Shaily RUPARELIA

T (91) 22 4161 1556
E shaily.ruparelia@incredcapital.com

Steel

Long steel plants never enjoyed an upcycle

- For Indian long steel players, it was not a bull cycle as high raw material prices never led their profits to touch supernormal levels, like that of flat steel.
- Port congestion in key areas like China and USA provided export opportunity to Indian companies, but with congestion easing the advantage is not there.
- We maintain our UNDERWEIGHT rating on the sector. Tata Steel is our Top REDUCE.

For long steel players there was never a bull cycle

For Indian long steel companies (small plants based on electric arc furnace/induction furnace) there was never any bull run as their spreads remain well below long-term averages. On the other hand, even unintegrated flat steel producers minted money. Large steel players have cash flows which they won't have dreamt of just a few months ago, but steel stocks will still underperform from here on. If one is bullish on steel (we are not), then also don't fall into the trap of relative value, just buy large caps. Some small steel companies will cease to exist after a few years, but large caps will be there as they have survived all the booms and busts. We still may have to eat our words, and steel can rally from here because in this age of relative value, steel is still relatively much cheaper compared to other cyclicals. At least Tata Steel (REDUCE, TP Rs750) doesn't trade at 83X FY22F PAT and 31X FY22F sales (on Bloomberg consensus PAT and sales) which Clean Science & Technology (NOT RATED) does.

Flat steel survived on exports for last 12 months, but no more

Because of port congestion and container shortage, trade was disrupted globally which gave a wonderful opportunity for Indian steel companies to export. In first five months of FY22, India exported 10.5m tonnes of steel against FY21 exports of 19m tonnes. Normalisation of exports will lead to a rapid fall in flat steel prices, more so when one of the biggest users – automobile companies are witnessing production cuts.

Scrap pointed out iron ore's fall, freight is pointing to a fall in steel

As pointed out in our last report, iron ore prices have fallen to US\$100/t and now the correction in freight rates displays the easing of container congestion. We expect a fall in steel prices in coming future. Maintain UNDERWEIGHT rating on the sector. Tata Steel is our top REDUCE.

Figure 1: The steep fall in ex-Miami CFR China container freight rates indicates some easing of congestion in the US which will have a cascading impact on supply chain

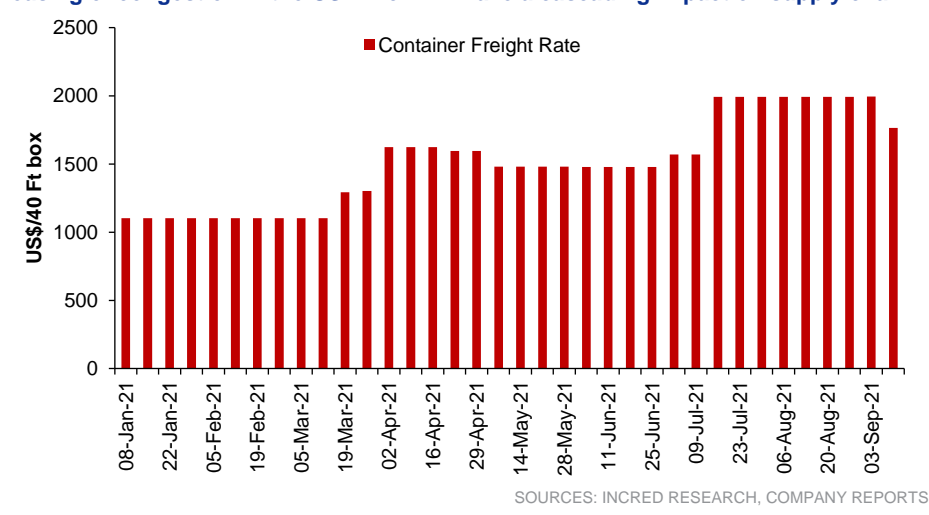
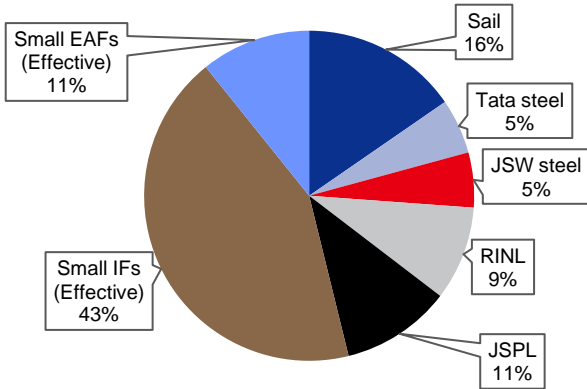
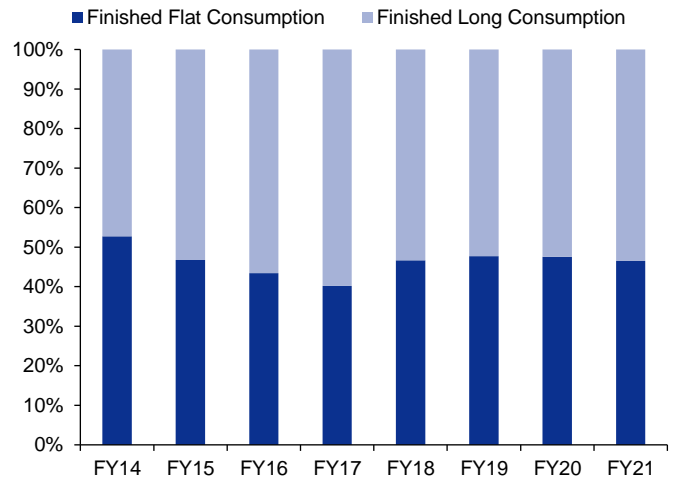


Figure 2: India's long steel capacity is fragmented (total capacity= 65m tonnes)



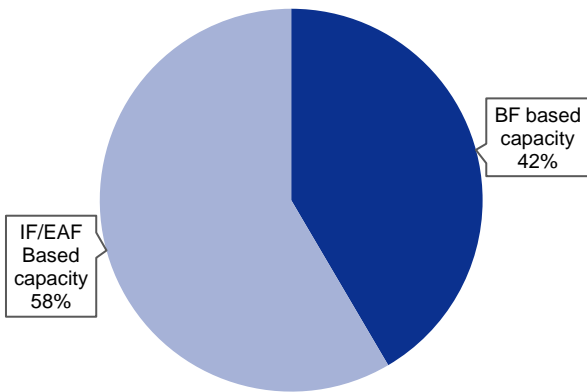
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 3: However, long steel constitutes ~57% of domestic demand



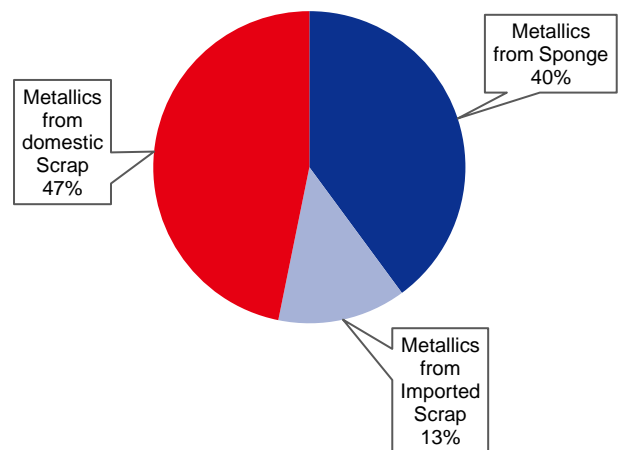
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 4: As much as 58% of long steel capacity is based on EAF/IF



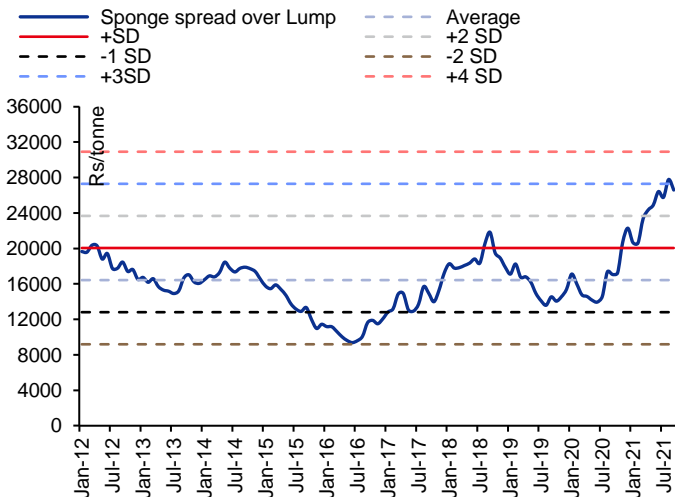
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 5: Small EAF/IF capacities' metallics requirement depends heavily on sponge iron and imported scrap



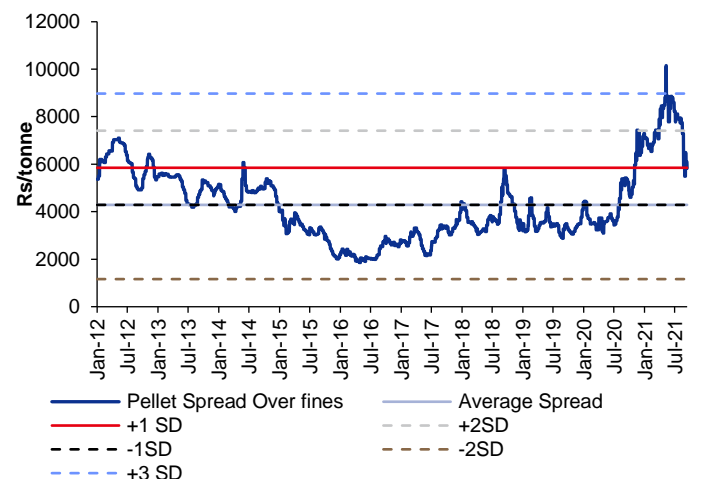
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 6: However, merchant sponge iron capacity is limited and hence, sponge profitability has risen



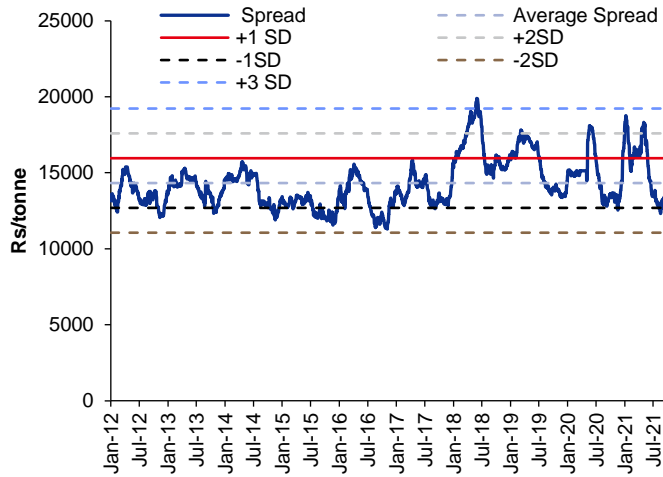
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 7: Higher demand from China had elevated pellet prices in India, and thus even standalone pellet makers were making money



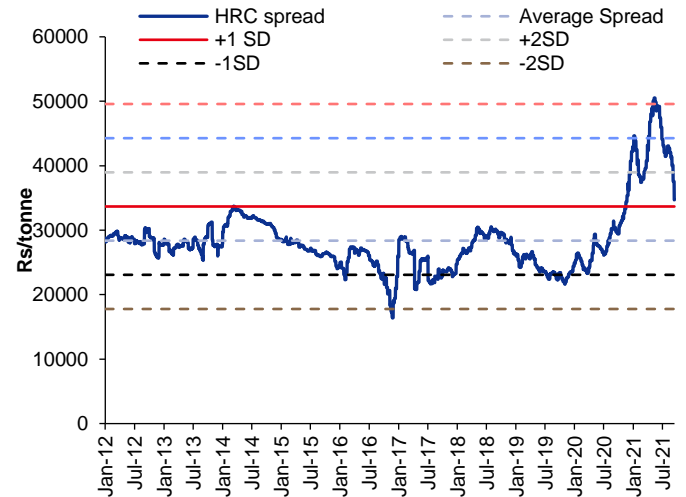
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 8: Standalone rebar makers could never avail the advantage of the bull cycle in steel



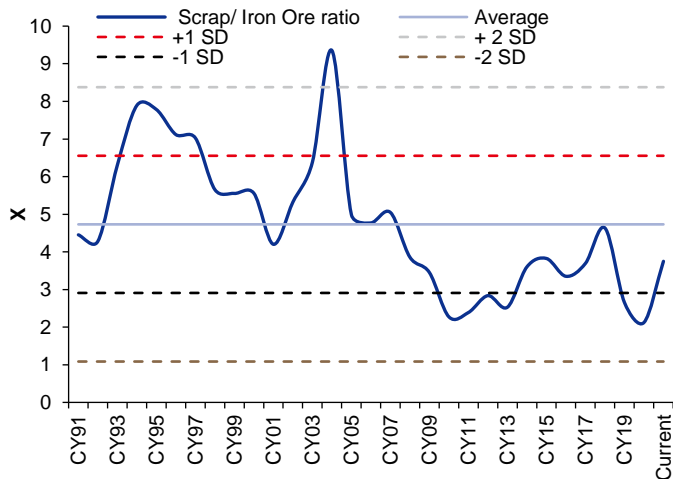
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 9: Unlike unintegrated long steel makers, unintegrated flat steel makers minted money



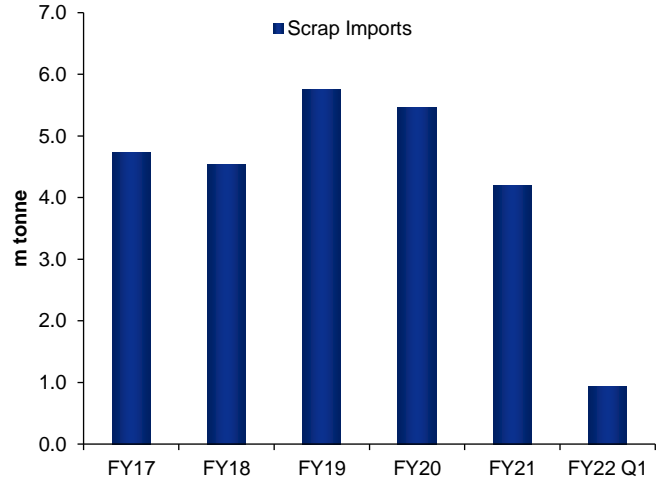
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 10: Scrap-to-iron ore ratio was near its all-time low, but India didn't import higher scrap quantities in in FY21



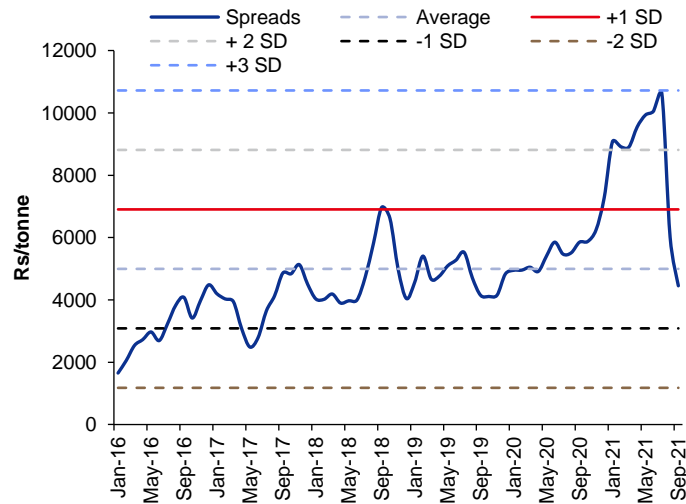
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 11: Indian scrap imports remained at a comparatively low level in FY21



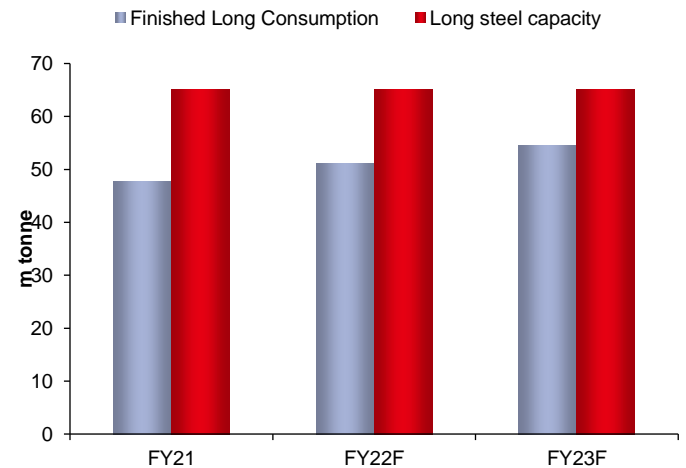
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 12: With the fall in pellet export prices currently, pellet exports are hardly profitable which will exert stress on local iron ore



SOURCES: COMPANY REPORTS, INCRED RESEARCH

Figure 13: However, given the overcapacity and sluggish demand, don't expect a revival in profitability for long steel



SOURCES: COMPANY REPORTS, INCRED RESEARCH

Indian long steel makers: No bull cycle

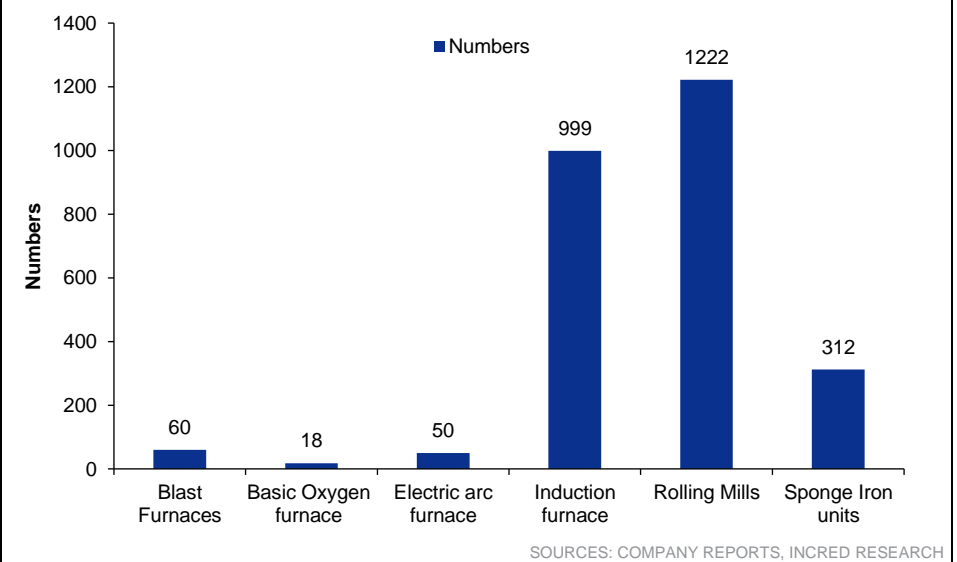
High iron ore prices killed the bull cycle before it even started for long-steel makers

For Indian long steel makers (most of them are small and unintegrated), the bull market never came. For a better part of the bull market, raw material producers made money, be it merchant iron ore sellers or sponge iron makers. Most of their furnaces are old and they won't have the luxury to change the 100% feed material from sponge to scrap and vice versa. Hence, despite low scrap prices compared to sponge, long-steel makers could not take advantage of the same. However, the party for raw material producers appears to be coming to an end and converters can get a breather, but balance sheets remain leveraged

Indian long steel industry is still fragmented

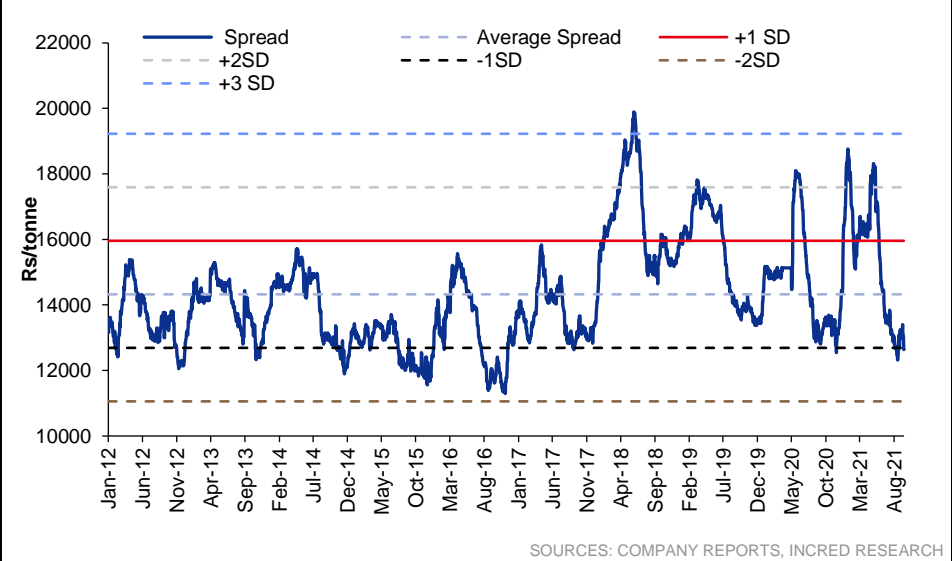
India's long steel capacity is around 65m tonnes, out of which 54% is accounted for by small EAF and IF. Mostly these furnaces are standalone and survive only on bought-out iron ore/sponge iron/pellets to make steel.

Figure 14: Most of the independent rolling mills and induction furnaces make long steel



Pure conversion margins for long-steel producers was never near to the historical average in last six months ➤

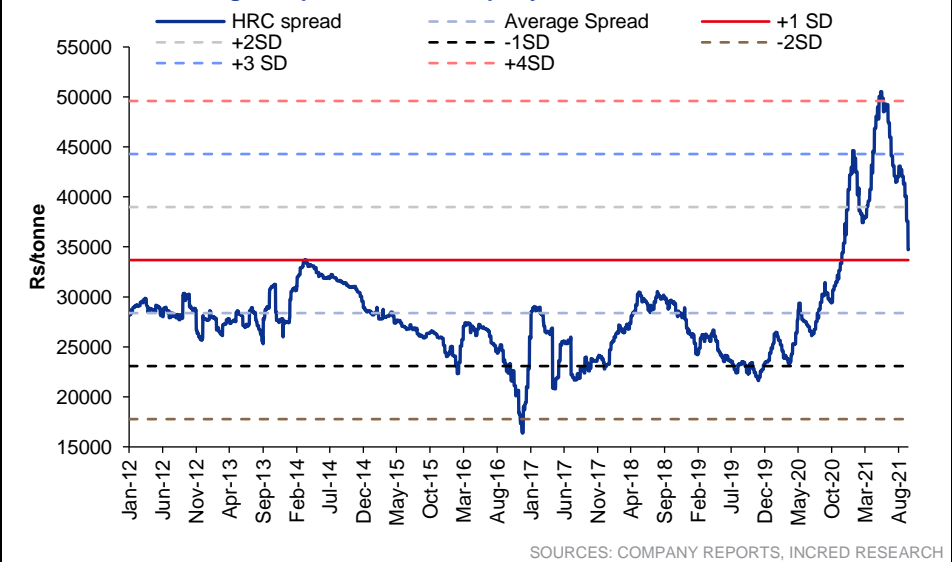
Figure 15: During last few months, an average unintegrated rebar maker's profitability has been below the historical average



Flat steel makers had a completely different story to tell - they have minted money in last six to nine months ➤

The difference in stories of small, long steel and unintegrated flat steel is because they could buy iron ore and make sponge iron on their own. Sponge iron was the bottleneck in the system which was leading to sub-optimal margins for long steel makers. However, high coking coal prices are ending the party for flat steel makers as well.

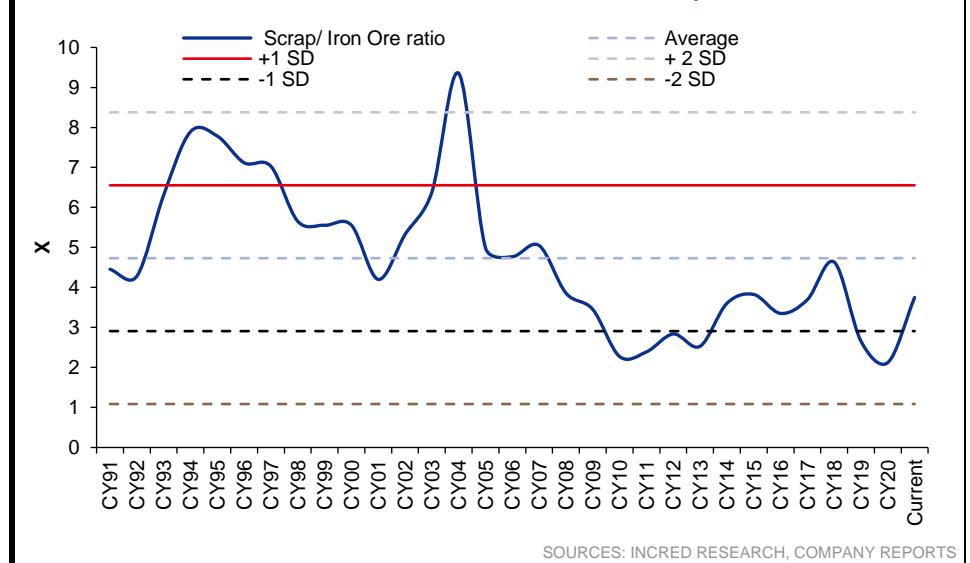
Figure 16: Flat steel makers with pellet capacity and small blast furnaces were ruling the market till roaring coal prices ended the party



The party can continue for scrap users, but alas not all furnaces in India can use 100% scrap ➤

As pointed out in our report on steel scrap (like here), scrap prices are on the downswing structurally and hence, steel makers who can use it will be winners in coming few years.

Figure 17: Scrap is becoming cheaper relative to iron ore and the same situation can remain for some time and hence, furnaces which can use scrap will benefit



It's the era of scrap: Users of scrap will benefit

At least for some years, scrap users will benefit vis-à-vis iron ore users as scrap will remain cheap vis-à-vis iron ore. It will take time for furnaces across the world to change their feed structure with the changing times.

As of now, pure scrap user mills are either in the US or Europe ➤

Europe and the US industrialised much before Asia and hence, they have a good scrap pool available to them. This is why Europe, and the US were always scrap exporters for a long period of time

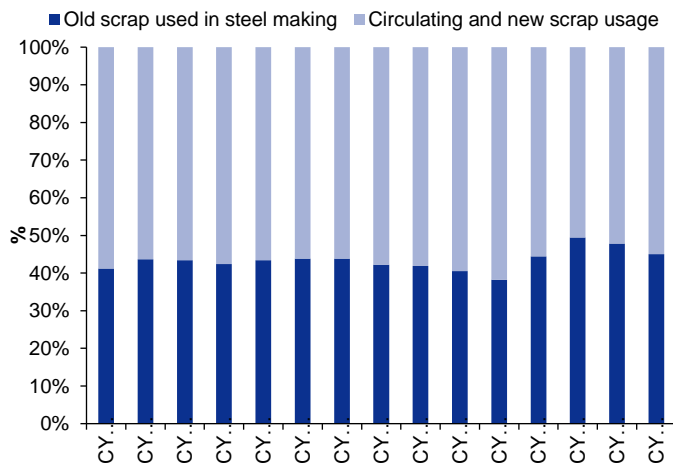
Rise in scrap usage is structural as it is less polluting, capex is lower and land requirement is lesser ➤

Scrap is less polluting (as disclosed in earlier paragraphs) and scrap-based furnaces are easy to switch on and off, which makes them ideal in the current world order where no one knows how sustainable the current demand pattern is. EAF have lower capital cost, they require less area and manpower costs are also lower. Also, at current carbon credit prices they are straightaway saving at least US\$40/t of crude steel.

Old scrap generation declined in CY20 because of Covid-related lockdowns ➤

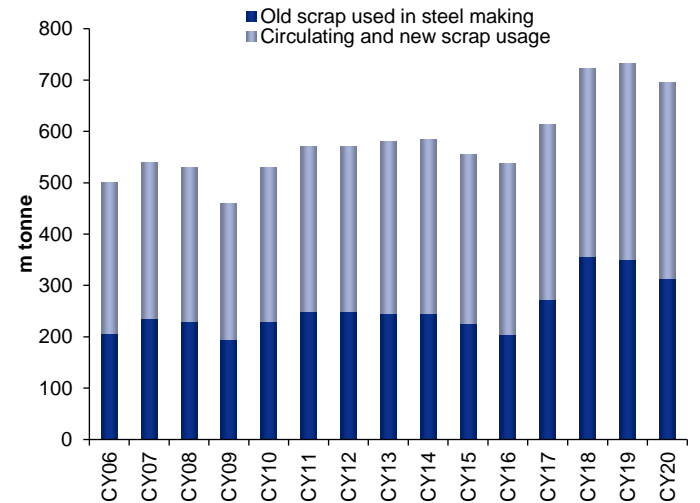
Steel scrap can be divided into two categories: 1) Circulating and new scrap. 2) Old scrap. Circulating and new scrap is generated during the steel production process, while old scrap is generated by scrapping old structures, machines, buildings, automobiles etc. Old scrap generation is a function of the used metal pool available in the world.

Figure 18: Old scrap still accounts for around 42% of overall scrap usage by the steel industry



SOURCES: COMPANY REPORTS, INCRED RESEARCH

Figure 19: CY20 saw a decline in old scrap usage because of Covid-led collection difficulty

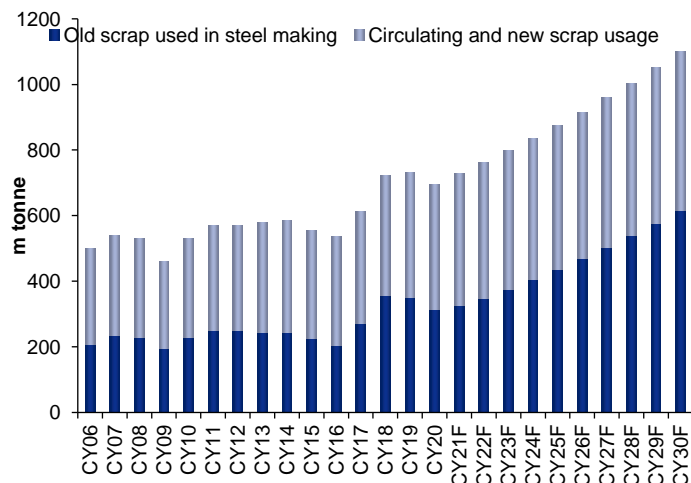


SOURCES: COMPANY REPORTS, INCRED RESEARCH

World has enough old scrap to feed 100m tonnes of new electric arc furnaces over next three years - China to lead this boom ➤

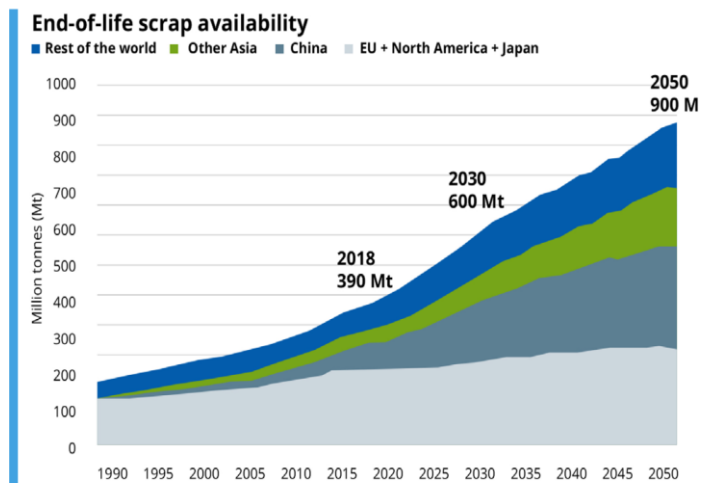
World Steel Association (WSA) forecasts that globally the total availability of old scrap pool stood at ~400m tonnes in CY20. However, please do note that it forecasts old scrap availability in China at 50-60m tonnes whereas our calculation (based on 220m tonnes scrap usage by China in CY20) indicates that old scrap availability in China was at least 100m tonnes in CY20 alone. So, as of now, old scrap availability globally is at 430m tonnes whereas demand is only for 315m tonnes. So, the world can accommodate 100m tonnes extra EAF capacity over the next three years. Please note that most of these capacities are likely to come in China at the expense of old polluting capacity, as most of the incremental scrap generation will happen in that country.

Figure 20: Given the global thrust on clean steel, most of the incremental demand for steel will be fulfilled by scrap



SOURCES: INCRED RESEARCH, WORLD STEEL ASSOCIATION

Figure 21: WSA is underestimating scrap availability in China by at least 50m tonnes in CY20

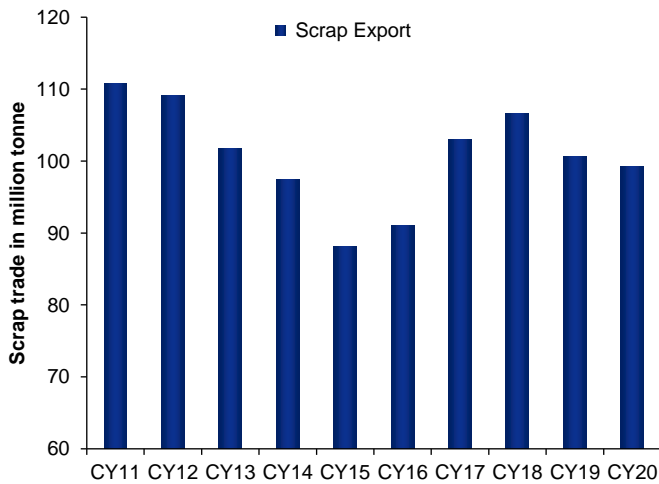


SOURCES: INCRED RESEARCH, WORLD STEEL ASSOCIATION FACT SHEET ON STEEL SCRAP

Developing economies are generating home scrap at highest-ever levels ➤

The best proof of the same is declining seaborne trade despite rising steel production globally.

Figure 22: Global scrap trade is at the same level what it was in 2016



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 23: Scrap usage in China has more than doubled in last five years

STEEL SCRAP USE FOR STEELMAKING IN KEY COUNTRIES AND REGIONS (MILLION TONNES)

	2016	2017	2018	2019	2020	% 2020/2019
China	90.1	147.9	187.8	215.9	220.3	+2.0
EU-28	88.4	93.3	90.939	86.473	77.539	-10.3
USA	56.7	58.8	60.1	60.7	50.0	-17.6
Turkey	25.9	30.27	31.317	27.900	30.077	+7.8
Russia	27.8	29.34	31.776	30.173	29.929	-0.8
Japan	33.57	35.77	36.513	33.682	29.179	-13.4
Republic of Korea	27.4	30.67	29.956	28.601	25.831	-9.7
Canada	*	6.29	6.67	6.28	*	

*Not available at editorial deadline

Source: EUROFER, CAMU, USGS/ISRI-calculations, Japan Ministry of Economy, RUSLOM, KOSA, TCUD, CARI

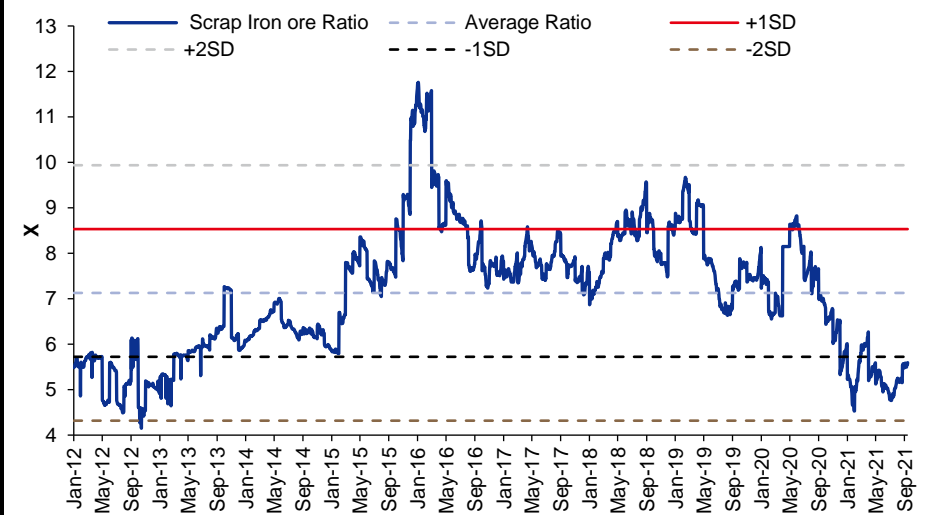
SOURCES: INCRED RESEARCH, COMPANY REPORTS

New wave of capex can be in EAF/IF furnaces as they have multiple advantages ➤

The new wave of capex in steel industry has to be in scrap-based furnaces as:

- Prices of scrap are unlikely to be volatile as that of iron ore.
- Supply source of raw material will not be limited to a few countries like Australia and Brazil.
- Inland transportation of scrap is much cheaper compared to iron ore and the wastage is also low.
- It's much cleaner technology and hence, manufacturers can get carbon credit as well.

Figure 24: Like in global market, scrap prices underperformed iron ore in a big way in Indian market as well

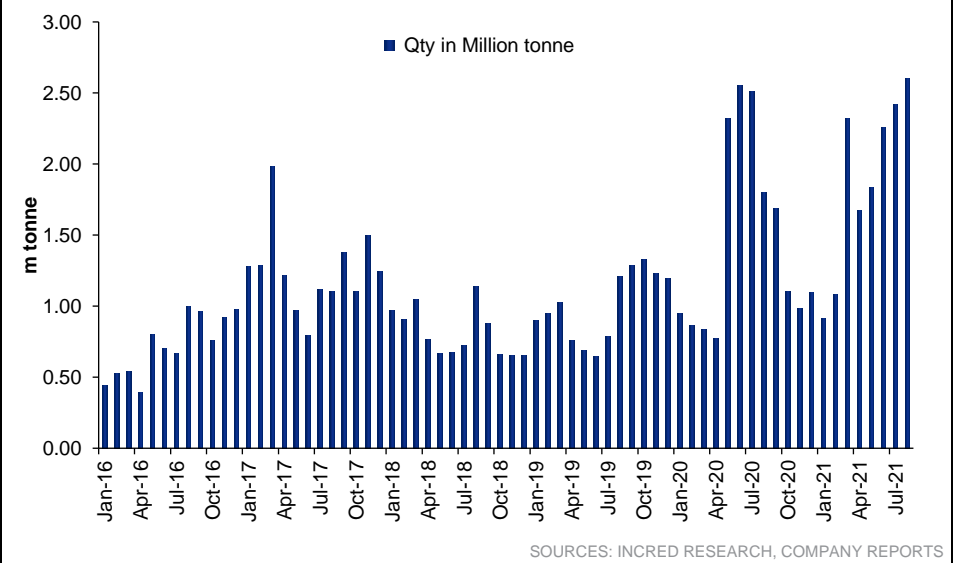


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Covid-19 is a lesson for all steel makers/users to depend on nearby sources of raw materials ➤

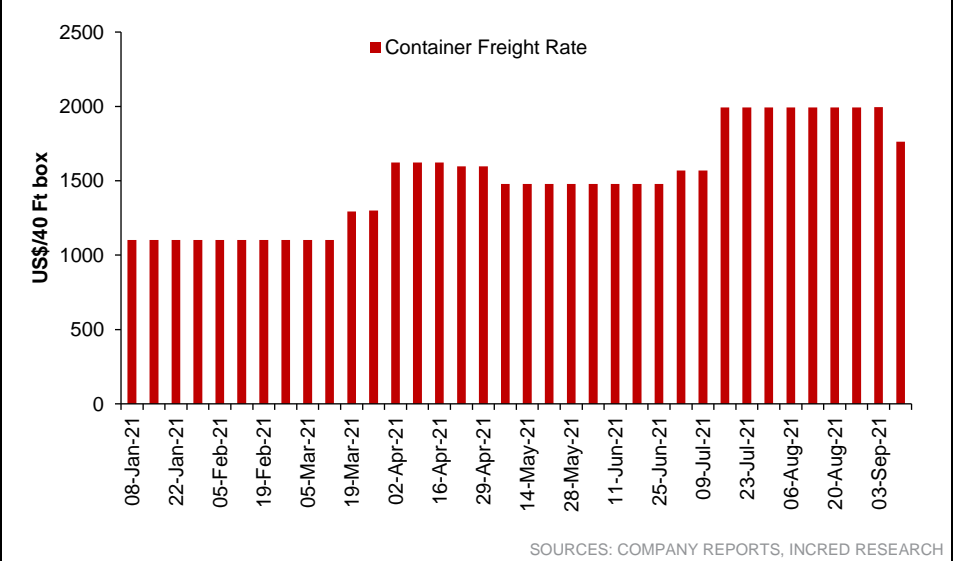
The supply chain crisis because of the Covid-19 pandemic has taught one lesson very clear to all steel makers - keep raw material sources close to you. At the same time, it is also clear for steel users that they cannot depend on long-drawn supply chains for materials. Indian steel companies had a big advantage in last few months because of port congestion in China which allowed Indian steel makers to export highest-ever quantities to various countries.

Figure 25: Steel exports from India have picked up and Indian steel makers, who would have captured the market, were devoid of steel - courtesy port congestion in China



Falling container freight rates is not good news for Indian steel exporters as it indicates easing of port congestion ➤

Figure 26: The steep fall in ex-Miami CFR China container freight rates indicates some easing of port congestion in the US, which will have a cascading impact on supply chain



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Corporate Governance Report of Thai Listed Companies (CGR). CG Rating by the Thai Institute of Directors Association (Thai IOD) in 2020, Anti-Corruption 2020

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Definition:

Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

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Definition:

Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings

Definition:

Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.