TATA Sponge Iron Ltd

Bloomberg Code: TTSP IN

India Research - Stock Broking

BUY

Improving Macros to drive growth:

Sponge iron industry is likely to see higher capacity utilization and better price realization, amid expectations over robust growth in steel demand at a CAGR of 15% after FY17E on the back of projected GDP growth of 8.1-8.5% in the coming years.

Consistently high capacity utilization is TSIL's strength: TSIL is operating with more than 90% of its total capacity against the industry average of 53%. This is reflective positioning of TSIL's high operation efficiency. TSIL could also sell its products even though sponge iron demand was subdued in the domestic market during FY14.

Better sales realization to drive the top line: We expect sponge iron prices to bottom out which could generate better sales realization by 5-10% during FY16E and FY17E considering FY14 as base. Spurt in domestic steel demand in the backdrop of meager capacity expansion in sponge iron industry could ease the pricing pressure. We expect TSIL's EBITDA margins to be maintained at 14-15% even if coal and iron ore prices surge by 3-5% during FY16E and FY17E considering base as FY15.

Robust balance sheet, zero debt and high operating cash flow: TSIL is expected to sustain its commendable balance sheet with adequate cash for working capital and positive cash flow from its core sponge iron business.

Valuation & Outlook

We expect TSIL to sustain in terms of volume and sales realization. The positive outlook for construction, infrastructure and manufacturing sectors augurs well for the sponge iron industry. TSIL's commendable balance sheet with zero debt and high cash flows makes it a VALUE BUY. We have valued TSIL based on 1 year forward EV/EBITDA. At the CMP of Rs 604, stock is trading at 6.7x FY15 EV/EBITDA and we valued TSIL at 6.5x FY17E EV/EBITDA for a target of 762 representing an upside potential of 26%.

Key Risk

Sponge iron is dependent on the steel sector growth. Steel industry's cyclical nature could affect the growth in top line as well as profitability.

Exhibit 1: Valuation Summary (Rs. Mn)

YE Mar	FY13	FY14	FY15	FY16E	FY17E
Net Sales	7958	7822	7897	8258	8646
EBITDA	1201	1454	992	1205	1298
EBITDA Margin (%)	15.1	18.6	12.6	14.6	15.0
Adj. Net Profit	854	1012	920	942	1031
EPS (Rs.)	55.4	65.7	59.7	61.2	67.0
RoCE (%)	27.4	29.1	26.0	22.2	22.1
PE (x)*	5.4	7.7	10.1	9.9	9.0

*Source: Company, Karvy Research; * For FY13, FY14 PE multiples are on historic basis*

Recommendation (Rs.)

CMP *(as on May 12, 2015)*	604
Target Price	762
Upside (%)	26

Stock Information

Mkt Cap (Rs.mn/US$ mn)	9314 / 145
52-wk High/Low (Rs.)	1205 / 501
3M Avg. daily volume (mn)	0.7
Beta (x)	1.3
Sensex/Nifty	26824 / 8145
O/S Shares(mn)	15.4
Face Value (Rs.)	10.0

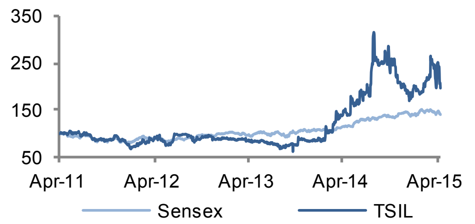
Shareholding Pattern (%)

Promoter	54.5
FIIs	4.3
DIIs	1.0
Others	40.2

Stock Performance (%)

	1M	3M	6M	12M
Absolute	(26)	(17)	(12)	8
Relative to Sensex	(20)	(10)	(8)	(4)

Relative Performance*



*Source: Bloomberg; *Index 100*

Technical View

The stock has made a Bullish Bat harmonic chart pattern on weekly charts after the recent price correction and looks well set to rally towards the 760-780 zone over the next few months. The stock is trading above its 5 day SMA at 595.15, clearly indicating that the stock is likely to surge higher in the days to come. On the downside, the stock has support around 525-480 zone and on the upside, the stock may face resistance around 670-740 levels.

Analyst Contact

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Company Financial Snapshot (Y/E Mar)

Profit & Loss (Rs.mn)

	FY15	FY16E	FY17E
Net sales	7897	8258	8646
Optg. Exp (Adj for OI)	6905	7053	7348
EBITDA	992	1205	1298
Depreciation	129	134	124
Interest	53	54	55
PBT	1365	1406	1539
Tax	445	464	508
PAT	920	942	1031

Profit & Loss Ratios

	FY15	FY16E	FY17E
EBITDA margin (%)	12.6	14.6	15.0
Net Profit margin (%)	11.6	11.4	11.9
P/E (x)	10.1	9.9	9.0
EV/EBITDA (x)	6.7	5.0	4.5
Dividend yield (%)	1.6	1.6	1.6

Source: Company, Karvy Research

Company Background

Tata Sponge Iron Ltd (TSIL) (a subsidiary of Tata Steel) is engaged in the business of manufacturing and sales of sponge iron in India. TSIL has its manufacturing facility at Bilaipada (in Joda Block of Keonjhar District in Orissa). It operates with three kilns with total capacity of 3,90,000 tons per annum of sponge iron. TISL is a coal based merchant sponge iron producer. Iron ore and coal are two important raw materials in production of sponge iron. Its iron ore requirement is met from mines of Tata Steel which are located close to its facilities and it sources coal from domestic open market and from overseas markets.

TSIL has two power plants with total capacity of 26 MW capacity (split into 7.5 MW and 18.5 MW). It produces power for its captive consumption and sells surplus to Tata Steel. It generates power from the waste heat of exit gases of its Kilns.

TSIL generates 95% of its operating revenue from sponge iron and rest from sale of surplus power and iron ore fines, coal fines etc.

Balance Sheet (Rs.mn)

	FY15	FY16E	FY17E
Total Assets	**9728**	**10817**	**11521**
Net Fixed assets	1516	1330	1263
Current assets	6085	7464	8177
Other assets	2127	2023	2081
Total Liabilities	**9728**	**10817**	**11521**
Networth	7952	8737	9538
Debt	-	-	-
Current Liabilities	1493	1809	1708
Other Liailities	283	271	275

Balance Sheet Ratios

	FY15	FY16E	FY17E
RoE (%)	12.1	11.3	11.3
RoCE (%)	26.0	22.2	22.1
Net Debt/Equity (x)	-	-	-
Equity/Total Assets (x)	0.8	0.8	0.8
P/BV (x)	1.1	1.0	0.9

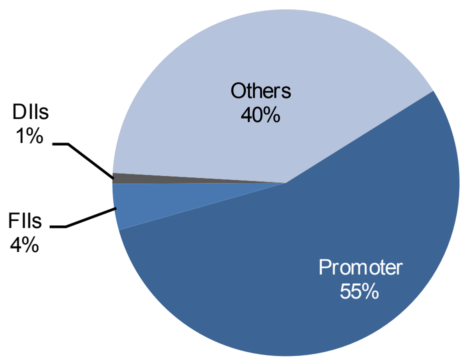
Source: Company, Karvy Research

Cash Flow (Rs.mn)

	FY15	FY16E	FY17E
PBT	1365	1406	1539
Other Income	(340)	(369)	(401)
Interest	53	54	55
Tax	(503)	(537)	(540)
Changes in WC	(645)	117	(130)
CF from Operations	**64**	**811**	**654**
Capex	0	0	0
Investment	(190)	(830)	(928)
CF from Investing	**11**	**(604)**	**(702)**
Change in Equity	0	0	0
Change in Debt	0	0	0
Dividends	(122)	(122)	(122)
CF from Financing	**(122)**	**(122)**	**(122)**
Change in Cash	(47)	85	(171)

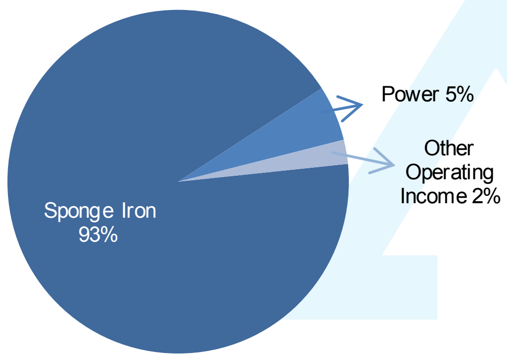
Source: Company, Karvy Research

Exhibit 2: Shareholding Pattern (%)



Source: Company, Karvy Research

Exhibit 3: Revenue Segmentation (%)



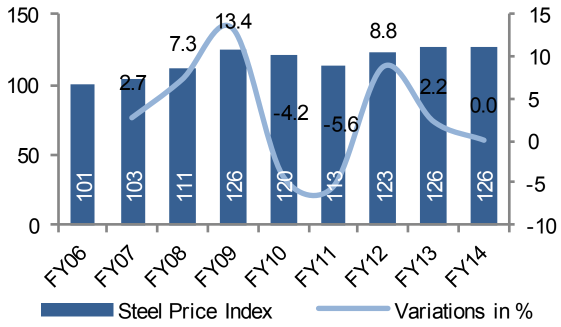
Source: Company, Karvy Research

Robust balance sheet, zero debt and high operating cash flow

TSIL has maintained a commendable balance sheet with zero debt. Over the years, it has been generating consistent operating cash flows from its core sponge iron business. TSIL could sell its entire products because of superior product quality even though sponge iron demand was subdued in the domestic market during FY14. We expect consistent earnings from its sponge iron business. It sells excess power produced from its captive power plant which also boosts the top line.

Improved Macros to boost steel demand

Exhibit 4: WPI Steel Price Index



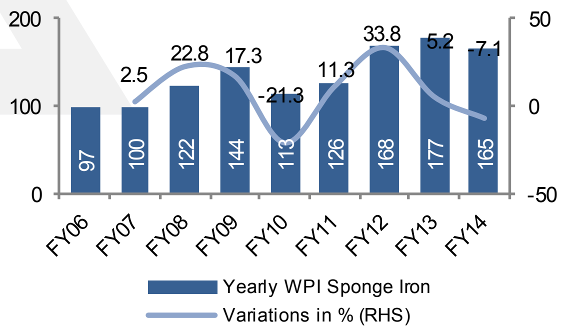
Source: Office of the Economic Advisor; Karvy Research

The implementation of policy reforms proposed in the budget are expected to help boost demand for steel in the domestic market. The demand for steel has been closely linked with the GDP growth. During FY16E, India's GDP growth rate is expected to be around 8.1-8.5% and the demand for steel is expected to clock a CAGR of 15 percent after FY17E.Steel industry is expected to witness a capacity addition of 26.4 million tons during FY15-FY17.

GoI seeks to provide an environment that attracts investment in industry and propels economic growth. The infrastructure sector accounts for close to 60 per cent of the country's total steel demand, while the automobile industry accounts for 15 per cent. The Rs.70,000 cr. earmarked for the infrastructure sector, too, augurs well for sectors such as steel and cement. India has held the position of being the 4th largest steel producing nation in the world for several years, and now is likely to take the second spot in a few years time from now. This could lead the domestic sponge iron units to pin hopes for an insurgence towards revival.

Sponge iron prices had stabilized, any improvement to stimulate growth

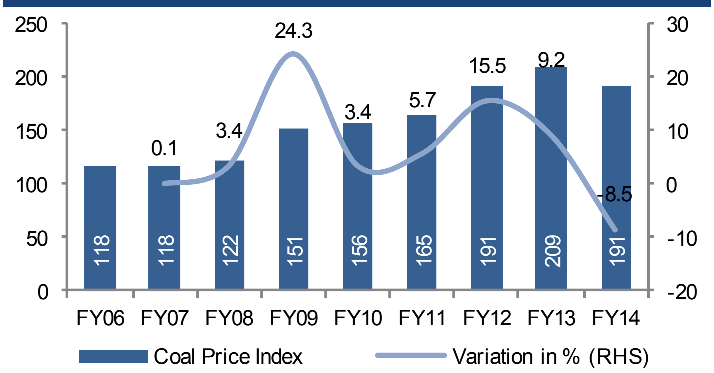
Exhibit 5: WPI Sponge Iron Price Index



Source: Office of the Economic Advisor; Karvy Research

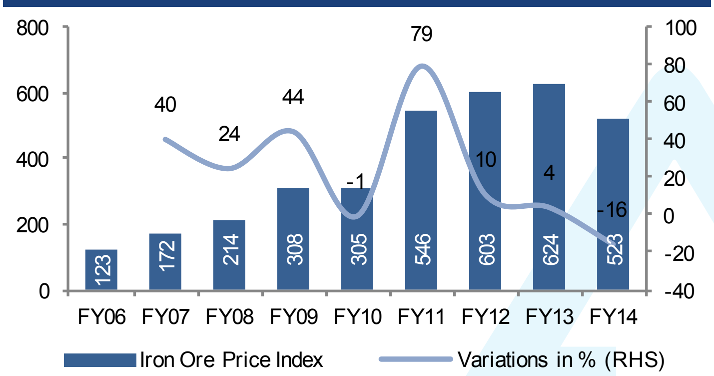
We expect the sponge iron prices to resume its uptrend to give better realizations in line with rising domestic demand for steel on the back of better outlook for the construction, infrastructure and manufacturing sectors. We expect TSIL's EBITDA margins to be maintained at 14-15% even if coal and iron ore prices surges by 3-5% FY15 during FY16E and FY17E.

Exhibit 6: WPI Coal Price Index



Source: Office of the Economic Advisor; Karvy Research

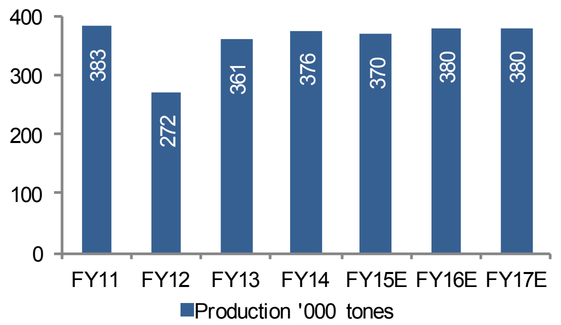
Exhibit 7: WPI Iron Ore Price Index



Source: Office of the Economic Advisor; Karvy Research

Healthy capacity utilization could lead to stable margins

Exhibit 8: TSIL Production

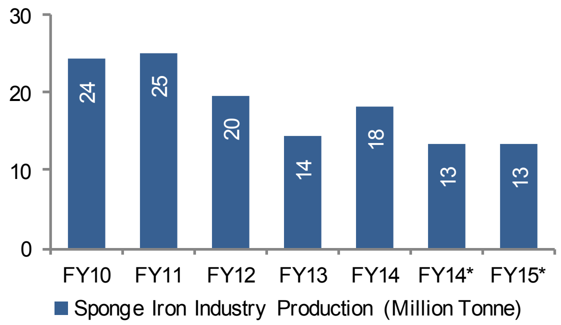


Source: Company, Karvy Research

As per Sponge Iron Manufacturers Association (SIMA) the average capacity utilization was 53% and 55% during FY13 and FY14 respectively. TSIL is operating at an average capacity utilization of 90% which enabl TSIL to maintain the return ratios. We expect it to be intact and so are the margins.

Imposition of higher duty on import of scrap iron to favor Indian sponge iron industry

Exhibit 9: Sponge Iron Industry Production

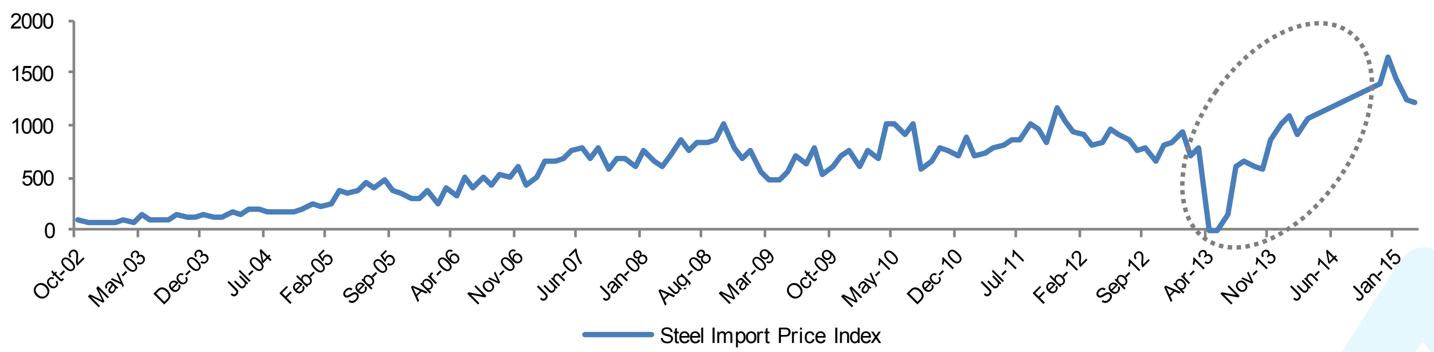


*Source: Ministry of Steel (GoI); Karvy Research; * FY14 & FY15 Apr-Dec*

The 2.5% import duty on scrap iron imposed by the India's finance ministry on May 8, 2013 was a positive move for the sponge iron sector. Until May 8, 2013 India levied no import duty for scrap iron. This move by GoI was to boost the sponge iron industry which is alternative to scrap iron as a raw material for various steel products. As per Sponge Iron Manufacturers Association (SIMA) with 37 million tonnes is the total installed capacity India is one of the largest producers of sponge iron in the world.

GoI's contemplation to impose anti dumping duty on China steel imports could be positive for Indian sponge iron industry: To safeguard the interests of the domestic steel industry, GoI mulls anti-dumping duty steel imports from China. The domestic steel makers are under threat against rising imports from China which might curtail the domestic production. Any imposition of anti dumping duty could boost the domestic steel production, which in turn can uplift the demand for the domestic steel ancillary industries such as sponge iron. With this, demand for sponge iron could increase and and is likely to help in maintaining its sales realisation.

Exhibit 10: Steel Import Price Index



Source: Bloomberg, Karvy Research

Captive power plant and mines near to factory can keep costs low

TSIL purchases iron ore directly from the mines of Tata Steel (holding company) which are located closely to its plant at Joda, Odisha. This provides an advantage towards uninterrupted supply of iron ore to its plant and at less freight cost. TSIL has captive power plants with a combined generation capacity of 26 MW, which helps in keeping overall power cost at low and such supply of uninterrupted power.

Allocation of coal block could be a trigger point

Coal forms 50% of raw material cost of TSIL. The captive coal block could certainly help to reduce the raw material cost and dependency on imported coal. TSIL purchases coal from Central Coalfields, South Eastern Coalfields & Mahanadi Coalfields, imports coal from South Africa and purchases washed coal.

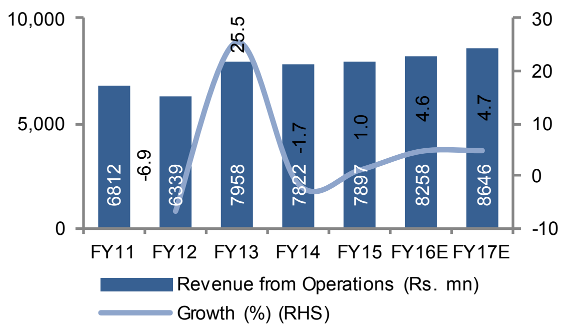
Exhibit 11: Business Assumptions

Y/E Mar (Rs. Mn)	FY14	FY15E	FY16E	FY17E	Comments
India Business					
Revenue	7822	7897	8258	8646	We have assumed that TSIL's capacity utilization could increase by 1% and to remain same during the next couple of years. The unit realization for sponge iron price are likely to increase by 5-10 percent in the next couple of years with respect to FY14 on the back of higher domestic steel demand.
Revenue Growth (%)	(1.7)	1.0	4.6	4.7	
EBITDA	1454	992	1205	1298	Iron ore prices and coal prices had declined during FY14. The cost of these two basic raw materials to increase by 5-7 percent in the next couple of years.
EBITDA Margins (%)	18.6	12.6	14.6	15.0	We expect that EBITDA margins to improve marginally even after increase of the raw material prices by 5-7%.
PAT (normalized)	1012	920	942	1031	We expect sponge iron prices could move up on the back of improved outlook on infrastructure sector and domestic steel sector.
EPS	65.7	59.7	61.2	67.0	
Net CFO (FY15-Expected)	1006	568	1348	1194	Better realization in sponge iron prices with marginal improvement in capacity utilization could help in maintaining healthy cash flow.
Net Debt	-	-	-	-	The company is debt free. It is a cash rich company and we expect all its capex to be met through cash reserves.
Free Cash Flow (FY15-Expected)	1006	568	1348	1194	Huge capex incurred during FY12 and FY13. We are not expecting any huge capital outlay during the next couple of years except for coal block, if at all allocated. We have not considered allocation of coal block while projecting numbers.

Source: Company, Karvy Research

Consistent Growth, Strong Financials & Healthy Cash flow

Exhibit 12: Revenue & Growth



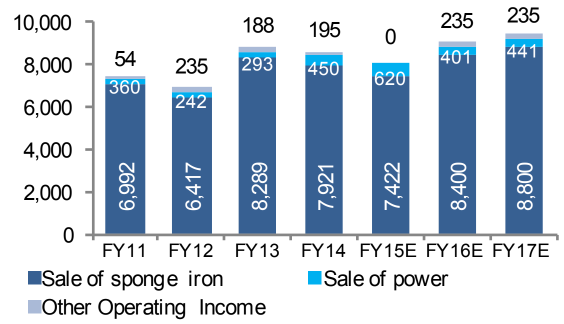
Source: Company, Karvy Research

TSIL has registered a steady growth of CAGR at 7.2% over FY11-14. We expect a 4-5 percent revenue growth on y-o-y basis during FY16E and FY17E compared to FY15 with marginal increase of capacity utilization and better realization of sponge iron prices.

We expect sponge iron prices to bottom out. With exoectations over enhancement in demand on the back of positive outlook for domestic macro economy.

TSIL reported dismal numbers during the last quarter of FY15 on the back of general sluggishness in the steel market. It is also expected that there could be planned shut down during the first quarter of FY16 where the volumes might affect. Further, TSIL could not benefit from the decline in iron ore prices during February and March 2015 because of piling of closing stock during Q3FY15. We expect to see the effect of decline in iron ore prices during the first two quarters of FY16E.

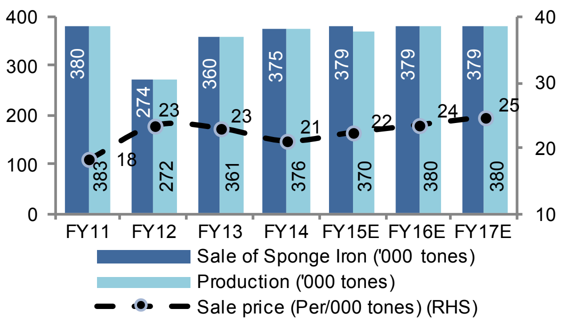
Exhibit 13: Gross Revenue from Operation (Rs.mn)



Source: Company, Karvy Research

TSIL's more than 90% of its revenue comes from sale of its core product, sponge iron. It has captive power plant and sells the surplus power which boosts the revenue. TSIL was able to sell its products because of its superior product quality even though sponge iron demand was subdued in the domestic market during FY14. We expect consistent earnings from its sponge iron business.

Exhibit 14: Sponge Iron Production/ Sales and per unit Realization



Source: Company, Karvy Research

The demand for steel is expected to climb steadily over the next few years on the back of high growth in infrastructure and auto industry .

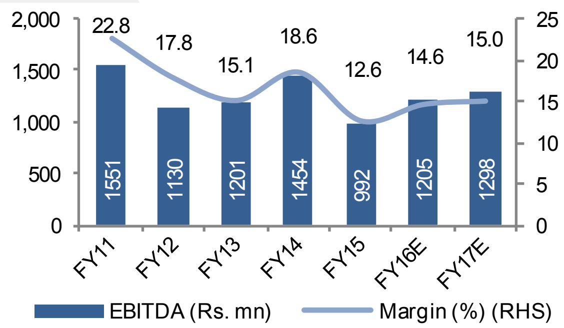
The positive statements in the budget with regards to infrastructure and Make in India are likely to have positive effect on usage of iron and steel. With that, we can expect an increase in demand for sponge iron.

At present, the capacity utilization of the company is at 96.5%. We expect a marginal increase in capacity utilization.

The maximum capacity of the unit is 3.9 Lacks MT. However, capacity utilization will be a hurdle to achieve the required sales volume in case of higher demand.

We expect marginal high realization for Sponge iron prices in FY16E and during the next couple of years.

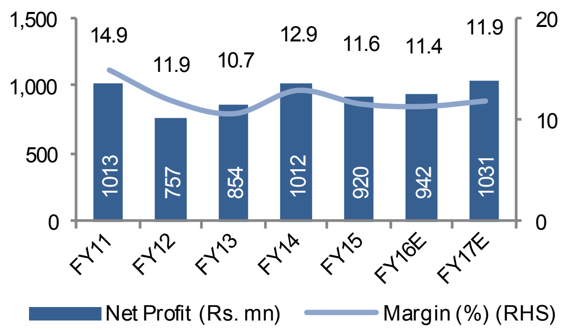
Exhibit 15: EBITDA and Margins



Source: Company, Karvy Research

TSIL has maintained consistent profitability margins over several years. The business cycle of the company features excellent business economics with higher returns every year. The major source of raw material like iron ore is from its parent company (from captive mines) that ensures uninterrupted supply of iron ore and also has genuine competitive advantage from the "TATA" brand.

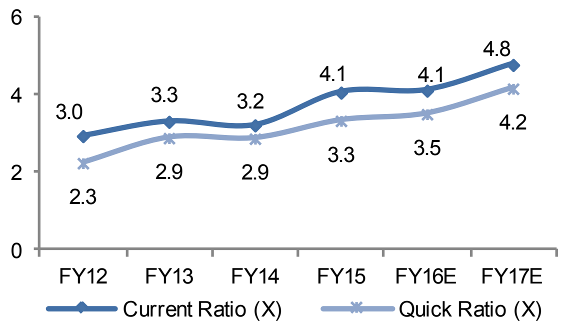
Exhibit 16: PAT and Margins



Source: Company, Karvy Research

We expect net profit to register a growth of 9.5% CAGR during FY14-FY17E. Current net profit margin is 5% and is expected to maintain the same.

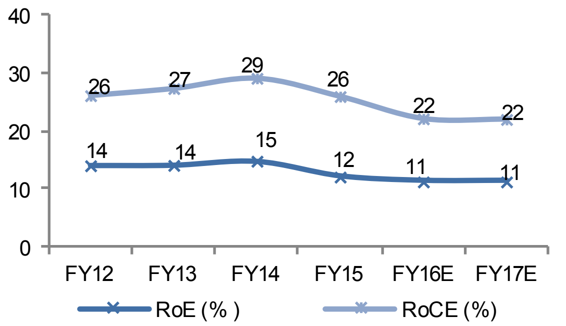
Exhibit 17: Current Ratio and Quick Ratio



Source: Company, Karvy Research

TSIL's average current ratio and quick ratio in the last four financial years are 3.2x and 2.7x respectively. During the next financial year we are expecting average current ratio of 4.5x and a quick ratio of 4.1x which indicate an overall good working capital management for the company

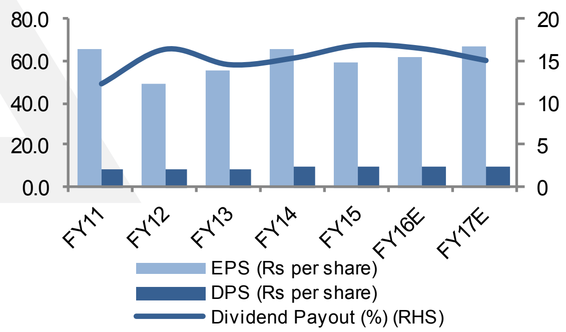
Exhibit 18: RoE (%) vs RoCE (%)



Source: Company, Karvy Research

Historically, TSIL's return on equity and return on capital employed have always been consistently strong. During FY15, these ratios have contracted and we expect that there won't be any further downside in the coming years.

Exhibit 19: Dividend



Source: Company, Karvy Research

Over the years, TSIL has consistently distributed stable dividends with higher payout ratios. We believe that the company is likely to continue its high dividend payout policy.

Sensitivity Analysis

Exhibit 20: EBITDA% sensitivty with raw material prices

	Base	Change in Raw Material Price		
		(2%)	2%	5%
EBITDA margin (%)				
FY16E	14.6	16.0	13.2	11.0
FY17E	15.0	16.4	13.6	11.5
EPS (Rs.)				
FY16E	61.2	69.3	58.5	50.4
FY17E	67.0	75.5	64.5	56.2

Source: Company, Karvy Research

Exhibit 21: EBITDA% sensitivity with sponge iron prices

	Base	Change in sponge iron price from our assumption		
		-2%	2%	4%
EBITDA margin (%)				
FY16E	14.6	12.8	16.3	17.9
FY17E	15.0	13.3	16.7	18.3
EPS (Rs.)				
FY16E	61.2	56.4	71.4	78.9
FY17E	67.0	62.1	77.8	85.7

Source: Company, Karvy Research

Exhibit 22: Company Snapshot (Ratings)

	Low				High
	1	2	3	4	5
Quality of Earnings			✓		
Domestic Sales				✓	
Exports	✓				
Net Debt/Equity				✓	
Working Capital requirement				✓	
Quality of Management				✓	
Depth of Management				✓	
Promoter				✓	
Corporate Governance				✓	

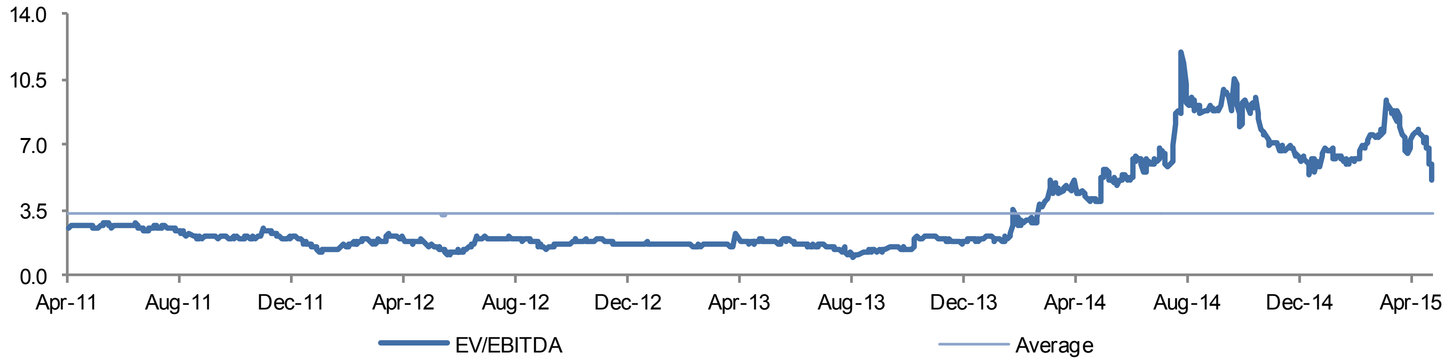
Source: Company, Karvy Research

- TSIL's maximum revenue comes from sale of its core product sponge iron. It has captive power plant and sells the surplus power which in turn boosts the revenue. It appears that it sells all its products in the domestic market. Its business model is a raw material intensive model where its profit margins are heavily dependant on the raw material prices.
- TSIL is operating at 96 percent of its total installed capacity against the industry average of 53% which is commendable.
- The maximum capacity of the unit is 3.9 Lacks MT. But with regards to constrains, capacity utilization will be the hurdle for growth in sales volume.
- Tata Sponge Iron Ltd has consistent profitable margins over several years. Returns were consistent every year except FY15. TATA Brand gives it a competitive advantage even if there are any sluggishness is the sponge iron Industry.
- Debt free company and maintains high cash balances. We expect TSIL to meet the working capital requirement from its cash balances.
- TSIL is a subsidiary of Tata Steel which holds 54.5% of total shares.

Valuation & Outlook

TSIL's business model is highly cyclical in nature, depends highly on steel industry and is raw material intensive. Historically, its core business has good fundamentals and generates positive free cash flows. The company has traded between 1x to 12x one year forward EV/EBIDTA. We value the company at 6.5x FY17E EV/EBIDTA with a target price of Rs.762.

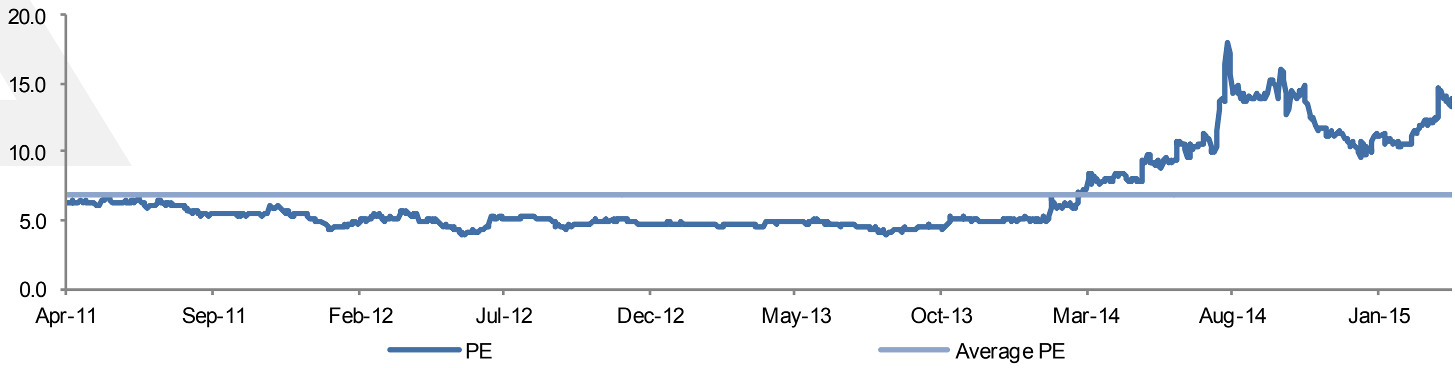
Exhibit 23: 1-Yr Fwd EV/EBITDA



Source: Company, Karvy Research

TSIL is well set to witness a growth phase on the back of healthy economic developments in the country in terms of development in domestic steel industry which could lead to better consumption of sponge iron. At CMP of Rs.604, TSIL is trading at PE of 9x FY17E EPS, we recommend a buy with a target price of Rs. 762 representing 11.3x FY17E EPS, representing an upside potential of 26%.

Exhibit 24: 1-Yr Fwd PE



Source: Company, Karvy Research

Financials

Exhibit 25: Income Statement

YE Mar (Rs. Million)	FY13	FY14	FY15E	FY16E	FY17E
Revenues	7958	7822	7897	8258	8646
Growth (%)	25.5	(1.7)	1.0	4.6	4.7
Operating Expenses	6757	6369	6905	7053	7348
EBITDA	1201	1454	992	1205	1298
Growth (%)	6	21	(32)	21	8
Depreciation & Amortization	179	178	129	134	124
Other Income	316	354	555	389	420
EBIT	1337	1630	1418	1460	1594
Interest Expenses	79	132	53	54	55
PBT	1258	1498	1365	1406	1539
Tax	405	486	445	464	508
Adjusted PAT	854	1012	920	942	1031
Growth (%)	12.8	18.5	(9.1)	2.4	9.5

Source: Company, Karvy Research

Exhibit 26: Balance Sheet

YE Mar (Rs. Million)	FY13	FY14	FY15E	FY16E	FY17E
Cash & Bank	2345	2693	2515	3176	3309
Sundry Debtors	204	261	88	263	282
Inventory	586	619	1084	1093	1045
Loans & Advances	210	1947	2180	2013	2083
Investments	1277	2046	2080	2729	3326
Gross Block	3675	3670	3787	3846	3902
Net Block	1616	1503	1516	1330	1263
CWIP	156	162	160	159	160
Miscellaneous	1754	63	105	53	53
Total Assets	**8148**	**9293**	**9728**	**10817**	**11521**
Current Liabilities & Provisions	1401	1802	1493	1809	1708
Debt	0.15	-	-	-	-
Other Liabilities	353	265	283	271	275
Total Liabilities	1754	2067	1776	2080	1983
Shareholders Equity	154	154	154	154	154
Reserves & Surplus	6241	7072	7798	8583	9384
Total Networth	**6395**	**7226**	**7952**	**8737**	**9538**
Minority Interest	-	-	-	-	-
Total Networth & Liabilities	**8148**	**9293**	**9728**	**10817**	**11521**

Source: Company, Karvy Research

Exhibit 27: Cash Flow Statement

YE Mar (Rs. Million)	FY13	FY14	FY15E	FY16E	FY17E
PBT	1258	1498	1365	1406	1539
Depreciation	179	178	129	134	124
Interest	80	132	53	54	55
Tax Paid	(528)	(580)	(503)	(537)	(540)
Inc/dec in Net WC	413	107	(645)	117	(130)
Other Income	(298)	(332)	(340)	(369)	(401)
Other non cash items	16	3	5	6	6
Cash flow from operating activities	**1120**	**1006**	**64**	**811**	**654**
Inc/dec in capital expenditure	(126)	(83)	0	0	0
Inc/dec in investments	(5405)	(3922)	(190)	(830)	(928)
Others	4636	3111	202	226	226
Cash flow from investing activities	**(895)**	**(894)**	**11**	**(604)**	**(702)**
Inc/dec in borrowings	0	0	-	-	-
Issuance of equity	0	0	-	-	-
Dividend paid	(122)	(122)	(122)	(122)	(122)
Interest paid	(10)	0	0	0	0
Others	0	0	-	-	-
Cash flow from financing activities	**(132)**	**(122)**	**(122)**	**(122)**	**(122)**
Net change in cash	93	(10)	(47)	85	(171)

Source: Company, Karvy Research

Exhibit 28 Key Ratios

YE Mar (%)	FY13	FY14	FY15E	FY16E	FY17E
EBITDA Margin (%)	15.1	18.6	12.6	14.6	15.0
EBIT Margin (%)	16.8	20.8	18.0	17.7	18.4
Net Profit Margin (%)	10.7	12.9	11.6	11.4	11.9
Dividend Payout Ratio (%)	14.4	15.2	16.7	16.4	14.9
Net Debt/Equity	-	-	-	-	-
RoE (%)	14.1	14.9	12.1	11.3	11.3
RoCE (%)	27.4	29.1	26.0	22.2	22.1

Source: Company, Karvy Research

Exhibit 29: Valuation Parameters

YE Mar	FY13	FY14	FY15E	FY16E	FY17E
EPS (Rs.)	55.4	65.7	59.7	61.2	67.0
DPS (Rs.)	8.0	10.0	10.0	10.0	10.0
BV (Rs.)	415.2	469.2	516.4	567.4	619.3
PE (x)*	5.4	7.7	10.1	9.9	9.0
P/BV (x)*	0.7	1.1	1.1	1.0	0.9
EV/EBITDA (x)*	1.9	3.5	6.7	5.0	4.5
EV/Sales (x)*	0.3	0.7	0.8	0.7	0.7

*Source: Company, Karvy Research; *Represents multiples for FY13 & FY14 are based on historic market price*

Stock Ratings		Absolute Returns
Buy	:	> 15%
Hold	:	5-15%
Sell	:	<5%

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