CRISIL IER IndependentEquityResearch

MSP Steel & Power Ltd

Detailed Report

Enhancing investment decisions

Explanation of CRISIL Fundamental and Valuation (CFV) matrix

The CFV Matrix (CRISIL Fundamental and Valuation Matrix) addresses the two important analysis of an investment making process – Analysis of Fundamentals (addressed through Fundamental Grade) and Analysis of Returns (Valuation Grade) The fundamental grade is assigned on a five-point scale from grade 5 (indicating Excellent fundamentals) to grade 1 (Poor fundamentals) The valuation grade is assigned on a five-point scale from grade 5 (indicating strong upside from the current market price (CMP)) to grade 1 (strong downside from the CMP).

CRISIL Fundamental Grade	Assessment	CRISIL Valuation Grade	Assessment
5/5	Excellent fundamentals	5/5	Strong upside (>25% from CMP)
4/5	Superior fundamentals	4/5	Upside (10-25% from CMP)
3/5	Good fundamentals	3/5	Align (+-10% from CMP)
2/5	Moderate fundamentals	2/5	Downside (negative 10-25% from CMP)
1/5	Poor fundamentals	1/5	Strong downside (<-25% from CMP)

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About CRISIL Research

CRISIL Research is India's largest independent and integrated research house. We provide insights, opinions, and analysis on the Indian economy, industries, capital markets and companies. We are India's most credible provider of economy and industry research. Our industry research covers 70 sectors and is known for its rich insights and perspectives. Our analysis is supported by inputs from our network of more than 4,500 primary sources, including industry experts, industry associations, and trade channels. We play a key role in India's fixed income markets. We are India's largest provider of valuations of fixed income securities, serving the mutual fund, insurance, and banking industries. We are the sole provider of debt and hybrid indices to India's mutual fund and life insurance industries. We pioneered independent equity research in India, and are today India's largest independent equity research house. Our defining trait is the ability to convert information and data into expert judgments and forecasts with complete objectivity. We leverage our deep understanding of the macroeconomy and our extensive sector coverage to provide unique insights on micromacro and cross-sectoral linkages. We deliver our research through an innovative web-based research platform. Our talent pool comprises economists, sector experts, company analysts, and information management specialists.

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Last updated: April 30, 2012

Analyst Disclosure

Each member of the team involved in the preparation of the grading report, hereby affirms that there exists no conflict of interest that can bias the grading recommendation of the company.

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MSP Steel & Power Ltd

Pellet to drive profitability

Fundamental Grade	**2/5 (Moderate fundamentals)**
Valuation Grade	**4/5 (CMP has upside)**
Industry	**Metals and Mining**

October 15, 2012

Fair Value	**Rs 39**
CMP	**Rs 33**

Mid-sized non-integrated steel player MSP Steel & Power Ltd (MSP) has survived the current challenging scenario – supply constraint-led scaling raw material prices – courtesy of its pellet plant. The recently expanded pellet capacity is expected to support both top and bottom lines. However, overall profitability is expected to remain low as sponge and steel segments are likely to remain under pressure due to high raw material prices. The company is in the process of expanding its steel capacity (to be completed by FY13-end), which will drive PAT growth over the next two years. However, working capital is expected to be tight. We lower our earnings estimates for FY13 and FY14, and maintain the fundamental grade of 2/5, indicating that its fundamentals are moderate relative to other listed securities in India.

Expansion in pellet and steel to drive growth over FY13 and FY14

MSP has expanded its pellet capacity from 0.3 mn MTPA to 0.9 mn MTPA; the initial capacity catered to 80-85% of MSP's iron ore requirement. The excess capacity will allow MSP to sell pellets in the market, which is expected to boost both top and bottom lines over the next two years. Players with pellet capacity at present earn 25-35% EBITDA margin. Going forward, we expect margins in pellet to normalise with the expected increase in supply. MSP is expected to generate Rs 2,223 mn and Rs 1,889 mn sales in FY13 and FY14 from sale of pellets. Further, MSP is expanding its steel capacity to 0.27 mn MTPA by FY13-end. This would integrate its operations as MSP has excess sponge capacity; it will also increase the share of value-added products in sales.

But key segments, steel and sponge, under pressure; overall profitability to remain low

The profitability of MSP's key segments – sponge and steel – has deteriorated in the past one and a half years due to increasing raw material prices and the producers' inability to pass on price hike completely. We expect profitability in these segments to remain under pressure in FY13 as we expect raw material prices to stay firm and demand to remain sluggish. However, profitability is expected to improve slightly in FY14 once raw material prices cool off; PAT margin estimated to remain low at 4-6% vs 9-10% it enjoyed during FY07 to FY11.

Tight working capital deteriorates debt servicing capability

MSP's interest coverage ratio is expected to remain low, in the range of 1.5x-2.0x, over FY13-FY14. The balance sheet is highly leveraged (debt: equity ratio is 3x as of FY12) due to debt-funded capex and tight working capital.

Adjusted PAT to grow at 72% CAGR over the next two years

Driven by capacity expansion in pellet and steel, MSP's adjusted PAT is expected to grow to Rs 773 mn in FY14. EBITDA margin is also expected to improve from FY12 levels but higher capital cost will arrest the expansion in PAT margins. RoE is estimated to improve to 19% in FY14. MSP is expected to report EPS of Rs 7.0 in FY13 and Rs 11.3 in FY14.

Valuations: Current market price has upside

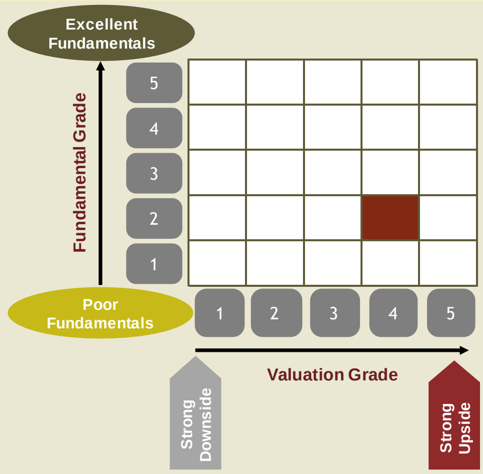
We continue to value MSP by assigning an EV/EBITDA multiple of 5x FY14E EBITDA. We factor in the stress in the working capital and lower our fair value estimate from Rs 49 per share to Rs 39 per share. At the current market price of Rs 33, our valuation grade is **4/5**.

KEY FORECAST

(Rs mn)	FY10	FY11	FY12	FY13E	FY14E
Operating income	4,021	5,079	6,993	9,952	11,245
EBITDA	774	1,068	1,184	2,045	2,381
Adj Net income	387	496	261	479	773
Adj EPS-Rs	6.7	8.5	4.5	7.0	11.3
EPS growth (%)	35.6	28.3	(47.4)	56.5	61.5
Dividend Yield (%)	-	3.1	1.0	1.5	2.1
RoCE (%)	11.5	10.7	8.3	12.6	15.3
RoE (%)	19.7	21.2	9.6	14.4	19.4
PE (x)	5.0	3.9	7.4	4.7	2.9
P/BV (x)	0.9	0.8	0.6	0.6	0.5
EV/EBITDA (x)	7.5	8.3	9.2	5.3	4.1

Source: Company, CRISIL Research estimates

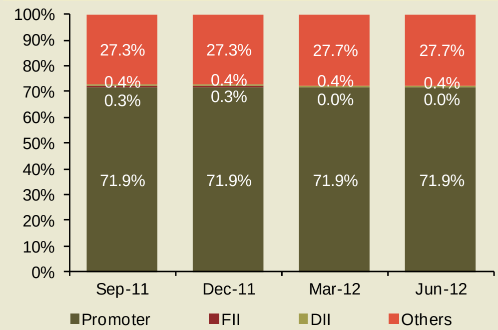
CFV MATRIX



KEY STOCK STATISTICS

NIFTY/SENSEX	5687/18714
NSE/BSE ticker	MSPL / MSPSTEEL
Face value (Rs per share)	10
Shares outstanding (mn)	68
Market cap (Rs mn)/(US$ mn)	2,258/42
Enterprise value (Rs mn)/(US$ mn)	12,151/229
52-week range (Rs)/(H/L)	45/26
Beta	1.4
Free float (%)	28%
Avg daily volumes (30-days)	53,596
Avg daily value (30-days) (Rs mn)	1.6

SHAREHOLDING PATTERN



PERFORMANCE VIS-À-VIS MARKET

	Returns			
	1-m	3-m	6-m	12-m
MSP	7%	-10%	-4%	-31%
NIFTY	5%	8%	8%	11%

ANALYTICAL CONTACT

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Table 1: MSP - Business environment

	Sponge	Steel products	Pellets	Power
Revenue contribution (FY12)	20%	77%	1%	2%
Revenue contribution (FY13)	17%	52%	24%	7%
Revenue contribution (FY14)	1%	79%	18%	2%
End-market	Billets/ ingots manufacturers	Infrastructure and construction sector	Sponge iron producers	State electricity boards (SEBs) and other industrial customers
Market position	Small player in a highly fragmented industry with a large number of unorganised players	Small player in a highly fragmented industry with a large number of unorganised players	One of the few secondary steel players	Insignificant
Industry growth expectations	■ Domestic steel demand growth to slow down to 3-5% in FY13. Of this, demand for flat products is estimated to grow by 5-7% during the year, while that of long products is likely to grow by 2-4% ■ In FY14, domestic demand is expected to grow at 4-6%. Demand for flat steel is expected to grow at 6-8% while demand for long is expected to grow at 3-4% ■ In the long term, demand is expected to grow at 7-9% CAGR over FY14-FY17			
Sales growth (FY09-FY12 – 3-yr CAGR)	34%	14%	NA	158%
Sales forecast (FY12-FY14 – 2-yr CAGR	-78%*	31%	409%	22%
Demand drivers	■ Growth in end-user industry such as automobiles, oil & gas, irrigation, railways ■ Infrastructure investments, industrial constructions			
Key competitors	Adhunik Metaliks, Bihar Sponge Iron, Jai Balaji Sponge Ltd, Monnet Ispat, Jindal Steel & Power, TATA Sponge Iron Ltd TATA Steel, SAIL, RINL, JSW			
Key risks	■ Availability and prices of iron ore lumps and fine ■ Reduced demand from the infrastructure and construction sectors			

* Expected to consume internally to produce steel

Source: Company, CRISIL Research

Grading Rationale

MSP survives industry-wide headwinds

During the past one and a half years, the steel industry faced multiple headwinds. Increasing raw material prices, sluggish demand and high interest costs eroded non-integrated steel producers' profitability and forced them to shut down their plants. Though MSP, a mid-sized steel producer, managed to withstand the pressure, its bottom line did weaken; PAT margin deteriorated significantly from 8-10% over FY07-FY11 to 4% in FY12.

In July 2011, the domestic supply of iron ore took a hit as: a) the Supreme Court banned mining in Bellary, a key iron ore-rich region in Karnataka, and extended it to other regions such as Tumkur and Chitradurga; and b) the Odisha government launched a drive to curb illegal mining in the state. Poor supply exerted pressure on prices. Steel producers increased the prices of finished steel to pass on the increase in cost, but were unable to do so completely due to sluggish demand and, hence, their profitability suffered. High interest costs worsened the scenario.

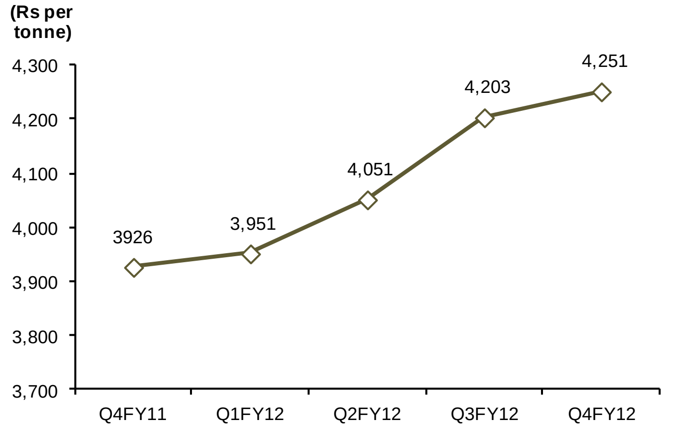
Pellet capacity makes its operations viable; negates price risk

MSP escaped the adverse effect of rising prices of iron ore lumps as it sources most of its iron ore requirement from its pellet plant. This makes operations viable in the current scenario of high iron ore lumps prices, though it remains exposed to fluctuations in the prices of iron ore fines. MSP's 0.3-mn MTPA pellet capacity, set up in FY10, helped the company save Rs 650 mn (9% of the operating income) in FY12. During the same year, it reported 16.9% EBITDA margin. It required close to 0.32 mn MTPA iron ore in FY12 (at 67% capacity utilisation of the sponge iron plant), out of which 80-85% was provided by the pellet plant.

Cost saving through pellet capacity

Per tonne	Lumps	Fines
Cost	7,500	2,000
Fines required for pellet	NA	1.4
Conversion cost	NA	2200
Cost of lumps/pellet	7,500	5,000
Total saving per tonne		**2,500**

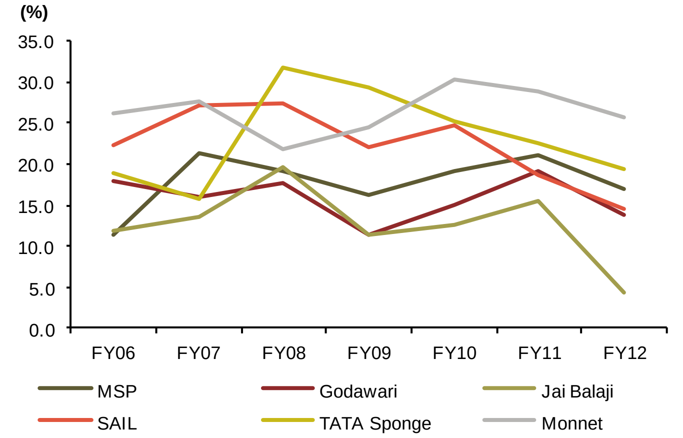
Figure 1: Increase in raw material prices...



-Ex-mine prices of 62% fe grade, 10-40 mm sized iron ore (Barbil, Odisha)

Source: Company, CRISIL Research

Figure 2: ... Deteriorated the profitability of steel players



EBITDA margins

Source: Company, CRISIL Research

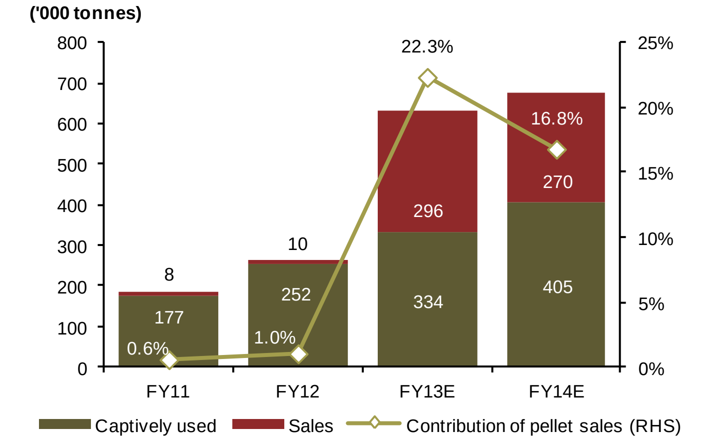
A pellet plant is used to convert iron ore fines to pellets which can be used as a substitute for sized iron ore (lumps). Given the low demand for iron ore fines due to limited pellet capacity in India and high demand for iron ore lumps, the price differential between pellets (processed using fines) and lumps is large. Hence, a steel player with pellet capacity saves Rs 3,000 -4,000 per tonne (16% of sales price of sponge iron) in the cost of iron ore.

Expanded pellet capacity to support profitability

We expect MSP's EBITDA margin to improve in the next two years from 16.9% in FY12 to 20.6% in FY13 and 21.2% in FY14 driven by increased sales of high-margin pellets. MSP's pre-emptive decision to set up the pellet capacity in order to diversify its raw material source has played well for it in the past two years. To tap the opportunity in the pellet business, it recently tripled its pellet capacity from 0.3 mn MTPA to 0.9 mn MTPA in Q1FY13. So far, MSP has used most of the pellets captively. Going ahead, with increase in capacity, it plans to sell the incremental pellets in the domestic market.

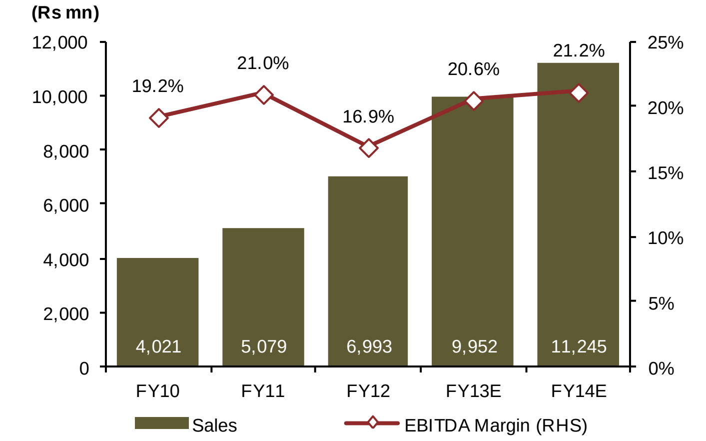
MSP is expected to sell 0.30 mn MTPA and 0.27 mn MTPA pellets in FY13 and FY14, respectively. This is expected to generate Rs 2,223 mn (assuming realisation of Rs 7,500 per tonne) and Rs 1,889 mn (assuming realisation of Rs 7000 per tonne) sales in FY13 and FY14, respectively, and expected to contribute Rs 459 mn and Rs 420 mn to the total EBITDA.

Figure 3: Higher sales of pellets in the market...



Source: Company, CRISIL Research

Figure 4: ... Will boost margins



Source: Company, CRISIL Research

But margins in pellet will normalise once supply kicks in

We expect margins in pellet sales to normalise post FY14 with the increase in iron ore fine prices and decline in iron ore lumps prices. Many players have linked up capacity expansion plans to set up pellet capacity which will fuel the demand for iron ore fines and pull the prices up. On the other hand, dependency on iron ores lumps will reduce and, hence, prices will come down. Further, increased production from mines in Karnataka and Odisha will also help iron ore prices to cool off. MSP procures iron ore fines from Odisha.

Many players have lined up large expansion in pellets

CRISIL Research expects India's pellet capacity to increase from 42 mn MTPA in FY12 to around 85 mn MTPA by FY16. Besides steelmakers, miners are also planning to set up pellet plants to better use their reserves of fines as a recent duty imposed by the government renders exports unviable. In the Union Budget 2012-13, the government has increased the export duty on iron ore to 30% from 20% to conserve supply for domestic steel makers. Steel players are expected to account for nearly 80% of the incremental capacity additions, while miners are expected to account for 10%. The remainder will be contributed by the standalone merchant pellet plants.

Profitability in pellets to normalise with increase in pellet capacities

At present, players with pellet capacity earn 25-35% EBITDA margin as they purchase low-cost iron ore fines and sell pellets at high prices. After the commissioning of large pellet capacities and resumption of the production in Karnataka mines, the iron ore industry's dynamics will change. The Supreme Court of India has permitted some category 'A' mines in Karnataka to resume extraction once they fulfil the conditions laid down by it.

However, sponge and steel businesses remain under pressure

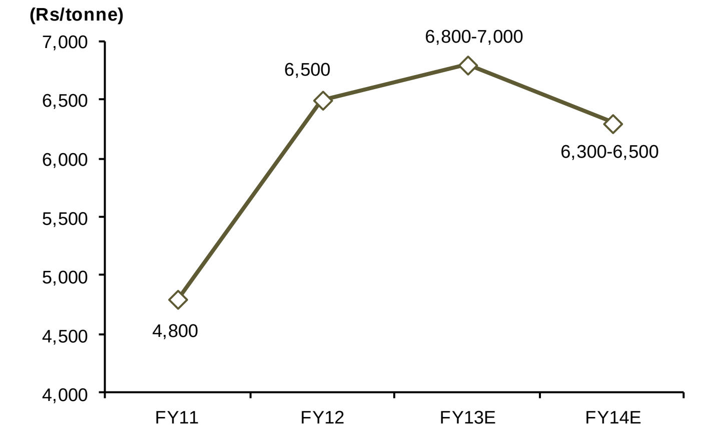
Although higher pellet sales will support MSP's bottom line, profitability in steel and sponge, the major contributors to total sales, is expected to remain under pressure in FY13. However, improvement is expected in FY14. Operating margins of all domestic players are likely to remain under stress owing to firmness in raw material costs (especially that of iron ore), moderate demand and a fall in steel prices. We expect MSP's profitability to remain much lower at 4-6% as compared to 9-10% it enjoyed during FY07 to FY11.

A) Raw material prices to continue to exert pressure on margins

Raw material price pressure to continue to impact profitability

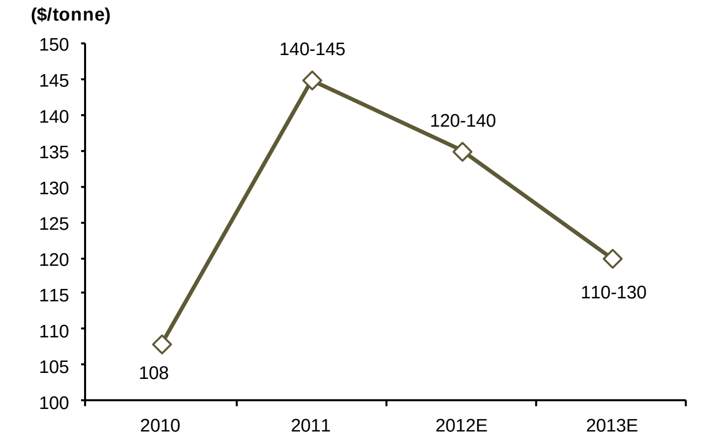
Although global iron ore prices have started declining on account of slowdown in steel production in China, domestic iron ore prices are still on an uptrend. Recently, considering the current demand-supply mismatch scenario in the domestic market, National Mineral Development Corporation Ltd (NMDC) increased the contract price of iron ore by 8-13% for the July-September period. The average contract price of iron ore is likely to decline from US$140-150 per tonne in 2011 to US$120-140 per tonne in 2012 and further to US$110-130 per tonne in 2013. However, domestic prices are expected to remain firm due to supply constraints on account of a mining ban in Karnataka and the government's drive to close illegal mines. Prices are expected to fall in FY14 as we expect supply to improve only after FY13.

Figure 5: Domestic lump prices to remain firm...



Source: Company, CRISIL Research

Figure 6: ... Despite global iron ore contract prices cooling



Source: Company, CRISIL Research

For blast furnace players, the expected fall in coking coal prices will be largely offset by the y-o-y depreciation in rupee in FY13. Contract prices are expected to decline and average between US$210 and US$230 per tonne in 2012 and decline further to US$190-210 per tonne in 2013 due to subdued demand from China coupled with robust supply from Australia and Mongolia.

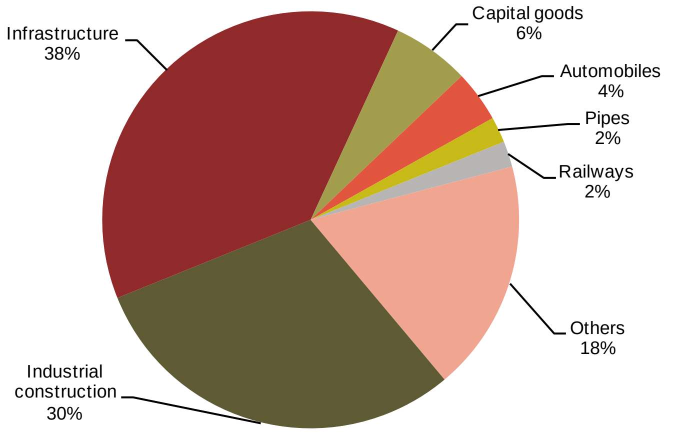
B) Demand outlook subdued for next two years, steady for long term

Domestic demand for steel has been affected by macroeconomic concerns, persistent inflation, high interest rates and their effect on end-user demand. With the rise in cost of finance and execution delays owing to environment clearances, many construction and infrastructure projects are in limbo, as expected, translating to lower demand for steel. Recently, CRISIL Research revised India's GDP growth forecast for FY13 to 5.5% from 6.5%.

Demand for long steel to grow at 2-4% in FY13 and 3-4% in FY14

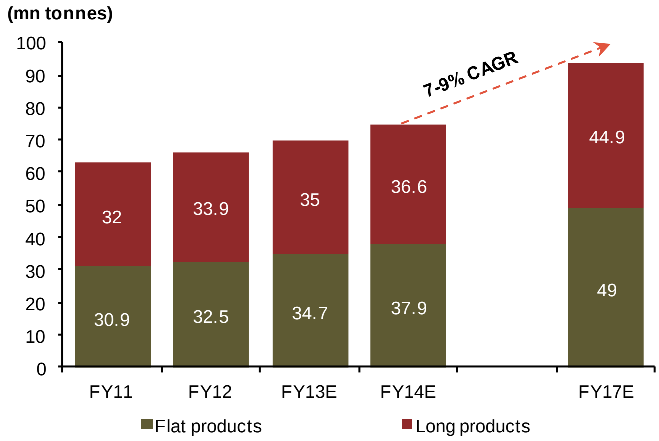
CRISIL Research estimates domestic demand for steel to grow at 3-5% in FY13 and 4-6% in FY14. Demand is expected to pick up in FY14 with the expected revival in demand from key end-user sectors such as construction, infrastructure and automobile. CRISIL Research estimates domestic steel demand to post a CAGR of 7-9% between FY14 and FY16. MSP primarily sells long products; hence, its fortune depends on construction and infrastructure sectors. CRISIL Research expects demand for long steel to grow at 2-4% in FY13 and 3-4% in FY14.

Figure 7: Consumption pie of long products (FY12)



Source: CRISIL Research

Figure 8: Demand to pick up in FY14



Source: CRISIL Research

C) Steel prices to remain flat in FY13, to fall in FY14

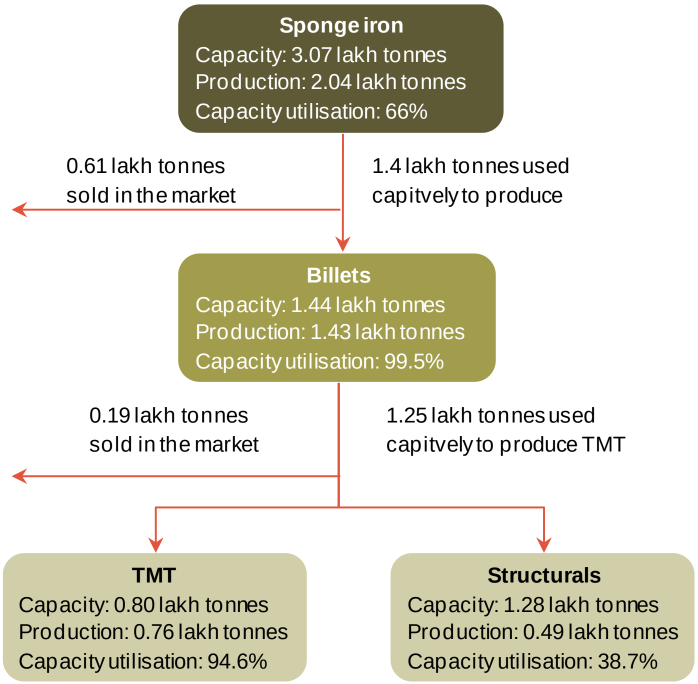
Due to sluggish demand, we believe steel players will be able to pass on the increase in raw material costs only partially, thereby taking a knock on their profitability in FY13. In FY14, the decline in raw material cost will support profitability of the players but the benefit will remain capped as players will have to reduce steel prices factoring in the expected appreciation in the rupee; domestic steel prices follow landed cost of global prices.

Sponge expansion delayed; expanding steel capacity instead

MSP is integrating its operations

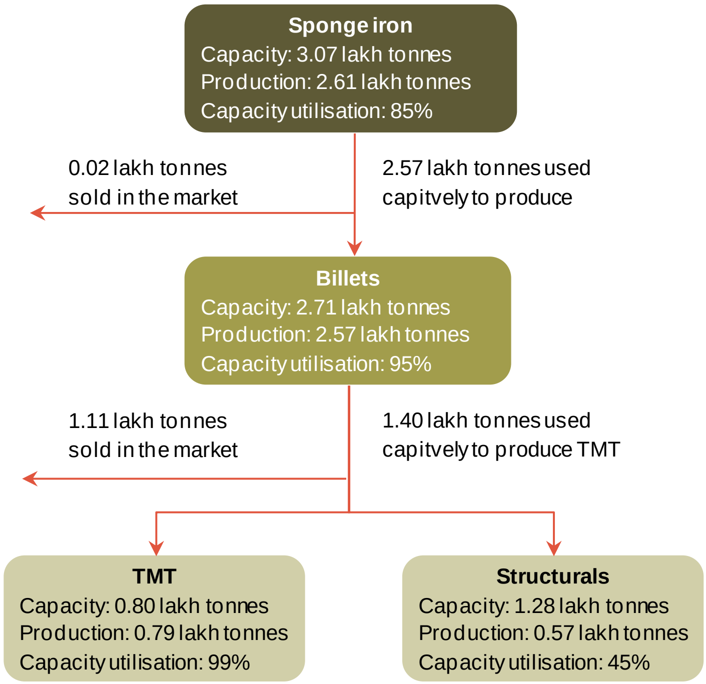
MSP has postponed the expansion of sponge iron capacity, which was initially planned as the company expected the allocated iron ore and coal mines to get operational. But as the approvals have been pending for a long time, the company has postponed the expansion of sponge iron capacity. Instead, it has initiated the integration of its operations by expanding its steel capacity by 1.3 lakh MTPA. The company is expected to commission the 1.3 lakh MTPA steel capacity by FY13-end. In FY14, it is expected to consume 98% of the total sponge iron production to produce steel which will increase its EBITDA per tonne. We believe the strategy is sound and value accretive.

Figure 9: Production chain as of FY12



Source: Company, CRISIL Research

Figure 10: Production chain after the integration (FY14E)



Source: Company, CRISIL Research

The company has spent Rs 500 mn till March 2012 for the expansion of sponge iron capacity. Now that it is planning to expand steel capacity, it has transferred Rs 410 mn from sponge capex to steel capex as some of the products such as structural steel and conveyor bell are common in usage and will be used in the steel plant. The remaining Rs 90 mn has been written off in the income statement in Q1FY13. The total capex required for steel expansion is Rs 1,650 mn which will be funded through a mix of debt and equity at 65:35.

Increased power capacity to support incremental steel plant

In Q1FY13, MSP commissioned a 34-MW power plant, increasing its total capacity to 76 MW. In FY14, after the commissioning of steel capacity, MSP will require 400 mn units of power. It generated 233 mn units by operating the 42-MW power plant at 73% rate in FY12. Hence, the incremental capacity of 34 MW will fulfil the requirement. This will help in reducing the cost of steel production and support margins.

Strategic investment in AA ESS for cost rationalisation

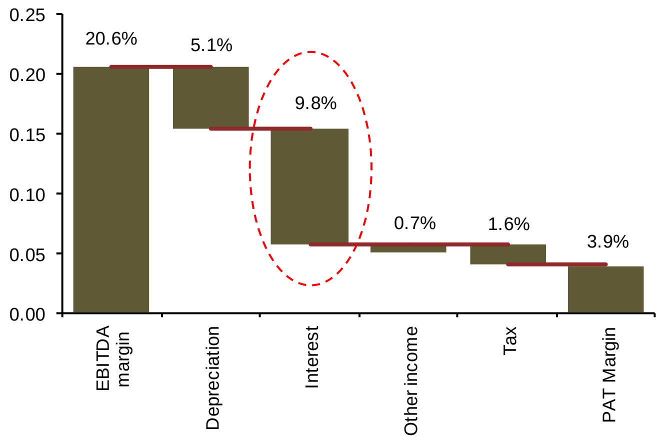
Access to railway sliding to lower the cost of iron ore

MSP has invested Rs 250 mn to acquire a 51% stake in AA ESS Tradelinks Pvt. Ltd in FY12. This company has 50% usage rights of the railway siding which will be set up by Durgapur Mining Company in Barbil, Odisha – an iron ore rich area. Currently, large miners charge a premium as they deliver iron ore fines to the railway depot via their own railways siding. Access to railway siding will enable MSP to purchase iron ore fines from small miners at a discounted price as compared to large traders, which will reduce the cost of iron ore by an average 250-300 per tonne and improve profitability. As per the management, the company has rights to transfer 30 rakes per month; each rake can carry 3,000-3,500 tonnes of ore. The siding will become operational in FY14-end.

Stretched balance sheet; debt servicing capability is low

MSP's interest coverage ratio has deteriorated from 3.5x in FY11 to 1.5x currently on account of a decline in operating margins and high interest cost due to increase in debt. The company's capital expansion is largely funded through debt. Further, steel players have to dole out cash upfront to purchase the raw materials. They also have to keep some amount as advance with the traders who purchase raw materials for the company. These strategies ensure a regular supply of raw materials but at the cost of a stretched working capital. The debt to equity ratio is 3x as of FY12. With the increase in profitability the interest coverage ratio is expected to improve but will remain below the comfort level. Due to high volatility in earnings and low interest coverage ratio, MSP's debt servicing capability remains a key monitorable.

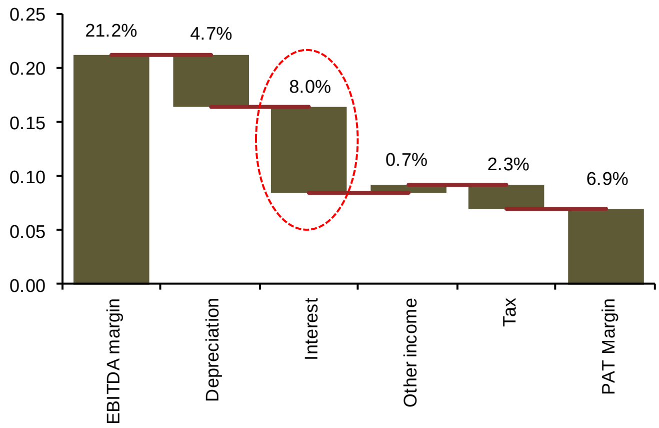
Figure 11: Profitability break-down for FY13E…



As a % of sales

Source: Company, CRISIL Research

Figure 12: ... And for FY14E



As a % of sales

Source: Company, CRISIL Research

Changes client profile to manage working capital effectively

MSP has strategically consolidated its client list from a large number of small traders to a few large clients. Top 10 clients contributed 71% to total operating income in FY12 as compared to 46% two years ago. This has helped MSP to reduce its receivables and manage its working capital more effectively in the current scenario where steel manufacturers have to purchase raw materials by paying cash up-front.

Key Risks

Exposed to cyclicality of end-user industries

End-user industries such as construction and infrastructure are highly susceptible to economic cycles, changes in interest rates and varying demand patterns. Any slowdown in the economic activity can hamper the consumers' ability to spend or result in postponement of consumption. This has a negative impact on the business (revenues) of industries such as real estate, construction and infrastructure, which in turn impacts steel manufacturers like MSP.

Exposed to fluctuations in input costs

MSP procures iron ore fines from the open market for production of sponge iron, which exposes it to fluctuations in prices of iron ore fines. With the upcoming pellet capacities, we expect demand for iron ore fines to increase significantly which will impact the profitability of the company. Further, MSP is exposed to market prices of coal which comprises 30-35% of its total cost. The increase in coal prices in the past one year has affected its profitability. Although a coal block in Chhattisgarh has been allocated to the company, the approval process is at a nascent stage. We don't expect the mine to get operational before FY14.

Redemption price of preferential shares is not fixed

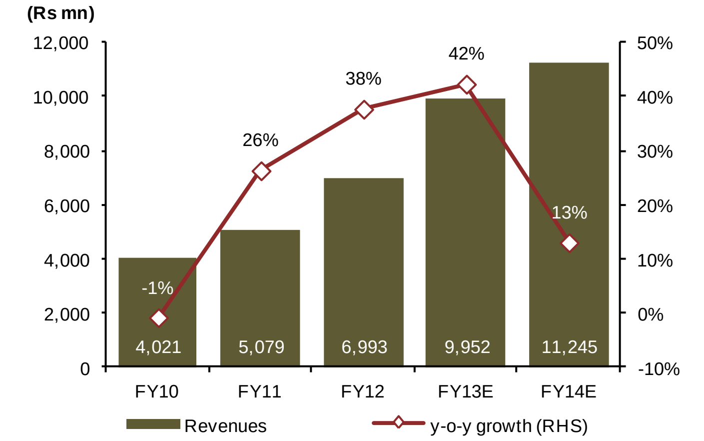
MSP has issued 7.5 lakh and 1.3 lakh 6% non-cumulative redeemable preference shares of Rs 10 each with a premium of Rs 90 per share in FY11 and FY12, respectively. These preference shares are redeemable within 20 years from the date of allotment at a price to be decided by the board of directors at the time of redemption.

Financial Outlook

Revenues are expected to grow at 27% CAGR over FY12-FY14

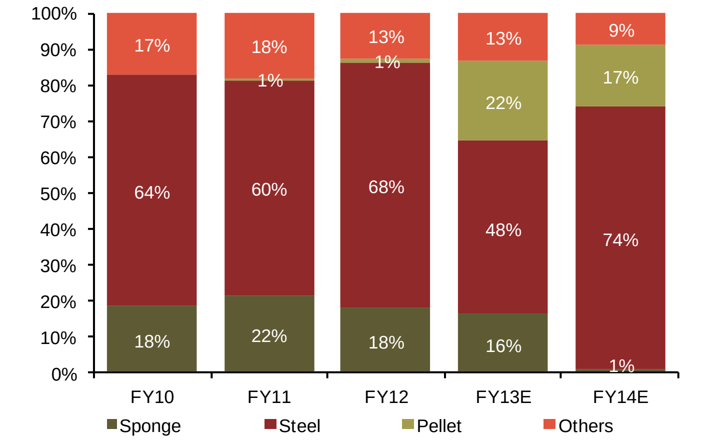
Fuelled by capacity expansion, MSP's top line is expected to cross the Rs 10 bn mark in FY14. It is expected to grow at 27% CAGR to Rs 11,245 mn in FY14. The expansion in pellet and steel capacities will fuel this growth. In Q1FY13, MSP tripled its pellet capacity from 0.3 mn MTPA to 0.9 mn MTPA. It is now in the process of expanding its steel capacity from 0.14 mn MTPA to 0.27 mn MTPA by FY13-end. It is expected to sell excess pellets in the market. Further, higher steel sales will push per tonne realisations up and boost revenues. We expect prices of sponge and steel to decline in FY14.

Figure 13: Revenues to grow y-o-y



Source: Company, CRISIL Research

Figure 14: Change in the product mix

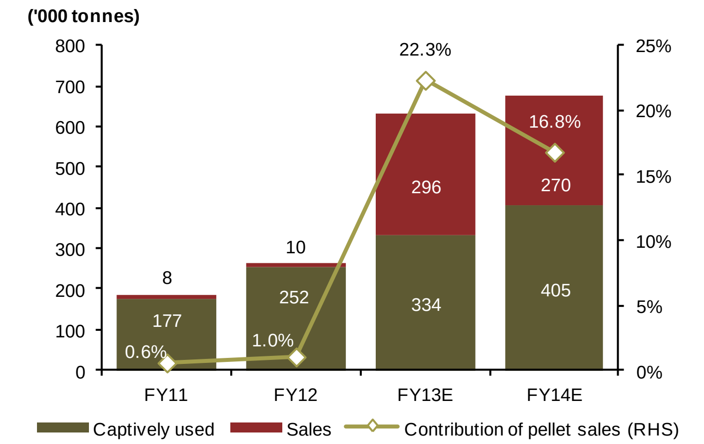


Source: Company, CRISIL Research

EBITDA margin is expected to improve; supported by pellets

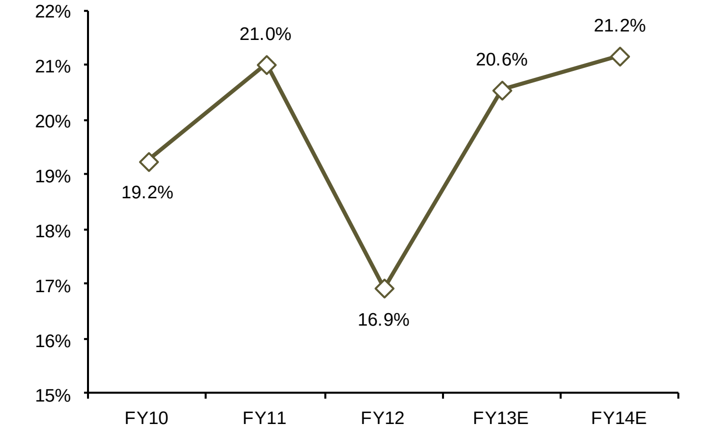
We expect EBITDA margin to improve by 362 bps to 20.6% in FY13 from 16.9% in FY12. The increase in contribution of high-margin pellet sales to total sales will improve margins. In FY14, margin will further expand by 62 bps mainly on account of improvement in sponge and steel business' profitability since we expect fall in the prices of raw materials will be higher than fall in the prices of end products.

Figure 15: Higher sales of pellets in the market...



Source: Company, CRISIL Research

Figure 16: ... Will boost margins



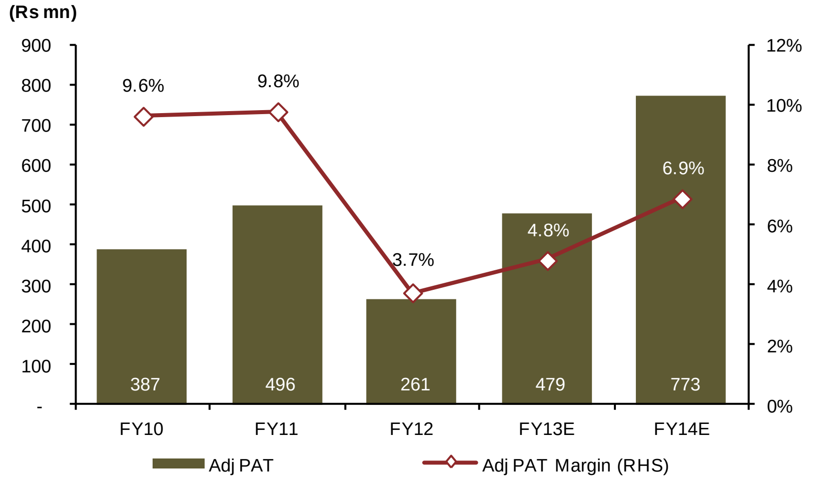
Source: Company, CRISIL Research

Profitability to improve, but will remain low

Following the improvement in operating performance, MSP's adjusted PAT margin is expected to improve from 3.7% in FY12 to 4.8% in FY13 and 6.9% in FY14. The improvement in profitability is lower than the improvement in operating performance on account of higher capital costs. The company is expected to incur Rs 972 mn and Rs 899 mn interest expenses in FY13 and FY14, respectively, as compared to Rs 607 mn in FY12. We have also adjusted our FY13 PAT estimates to factor in Rs 90 mn exceptional expense which the company reported in Q1FY13. MSP charged off capitalised borrowing and other costs pertaining to the abandoned sponge iron project.

The higher interest cost is on account of increase in debt due to the capacity expansion and stretched working capital. MSP has funded a large part of capex through debt. Further, steel players have to dole out cash upfront to purchase iron ore, which stretches their working capital. We now factor in the same in our assumptions because of which MSP's interest cost has increased from our earlier estimates.

Figure 17: PAT and PAT margin



Source: Company, CRISIL Research

Gearing to remain high; RoE to improve

MSP's D/E ratio is expected to improve but will remain high at 2.6x in FY13 and 1.9 x in FY14. Debt will increase as the debt component in steel capex is close to Rs 1,000 mn. The company's RoE is expected to increase to 14.4% in FY13 and further to 19.4% in FY14 as compared to 9.6% in FY12. It is expected to report EPS of Rs 7.0 and Rs 11.3 in FY13 and FY14, respectively.

Management Overview

CRISIL's fundamental grading methodology includes a broad assessment of management quality, apart from other key factors such as industry and business prospects, and financial performance.

Family-driven business

MSP has an experienced management headed by Mr Puran Mal Agarwal (chairman) and his brother Mr Suresh Kumar Agarwal (managing director). They are first generation entrepreneurs and have more than two decades of experience in the steel sector. Their sons are also on the board and are actively involved in the business.

Mr Manish Agarwal, Mr Puran Mal Agarwal's son, is a commerce graduate and holds an MBA degree from IMI Delhi. He has been taking an active interest in the business for the past seven years. He is responsible for iron ore procurement, mining activities and operations of the power plant and steel melting plant.

MSP has an experienced management, quick in identifying new opportunities

Mr Saket Agarwal, Mr Suresh Kumar Agarwal's son, is also a commerce graduate and holds an MBA degree from IMI Delhi. He has been involved in the business for the past seven years. He looks after sponge iron, rolling, mills, structural rolling mill and marketing and commercial activities.

Promoters have been quick to identify growth opportunities

Promoters have proactively focussed on integration (both backward and forward) to strengthen the value chain. They set up a pellet plant in Raigarh to reap the cost advantage and to hedge price volatility in iron ore prices. The benefits of the same were visible in the recent past (FY11 and CY11); while peers were struggling to cover costs, MSP's margin expanded q-o-q. For future growth, the company has outlined huge capacity additions. The strengthening of backward integration – with added sponge iron capacity, captive power plant, pelletisation plant and coal washery – is a positive. The company has implemented the phase 1 expansion six months ahead of schedule with the commissioning of the 0.115 MTPA sponge iron plant in Q3FY11.

Second line of management

MSP has an experienced second line of management with adequate domain expertise backed by an experience of 12 to 26 years in respective fields. Most of the second line personnel have been with the company for more than five-six years. The company has inducted various professionals from the industry at the senior and mid management levels to prepare for the next level of growth.

Corporate Governance

CRISIL's fundamental grading methodology includes a broad assessment of corporate governance and management quality, apart from other key factors such as industry and business prospects, and financial performance. In this context, CRISIL Research analyses the shareholding structure, board composition, typical board processes, disclosure standards and related-party transactions. Any qualifications by regulators or auditors also serve as useful inputs while assessing a company's corporate governance.

Corporate governance at MSP meets the regulatory requirement - it has reasonably good board practices and an independent board.

Corporate governance practices meet regulatory requirements

Board composition

MSP's board comprises eight members, of whom four are independent directors which meets SEBI's listing guidelines under Clause 49. The directors are highly qualified and have strong and relevant industry experience. Given the background of directors, we believe the board is well experienced. The independent directors have a fairly good understanding of the company's business and its processes.

Board's processes

MSP's disclosure level is good judged by the level of information and details furnished in the annual report, websites and other publicly available data. The company has all the necessary committees – audit, remuneration, nomination and investor grievance – in place to support corporate governance practices. The audit committee is chaired by an independent director, Mr Arvind Saraf.

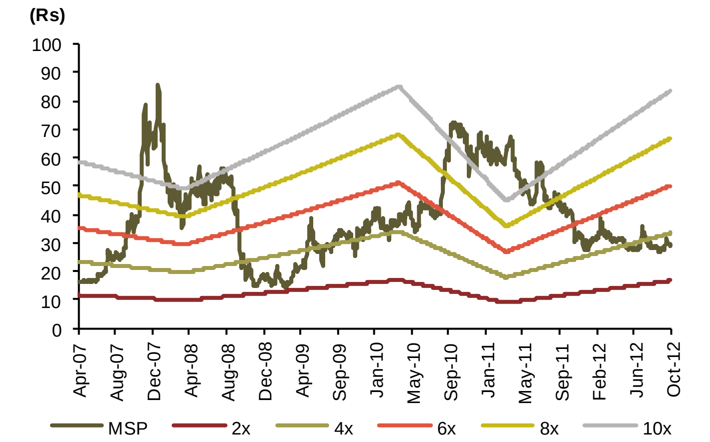
Valuation Grade: 4/5

Considering the commoditised segment and volatility in earnings, we continue to value MSP at 5x EV/EBITDA. However, we have revisited our working capital assumptions to factor in the current scenario of stretched working capital. Consequently, we have decreased our assumption of creditor days and increased the assumption of loans and advances.

Based on our FY14 EBITDA estimate of Rs 2,381 mn, and factoring in the changes in the working capital we arrive at a price of Rs 35 per share. Further, we have valued Rs 250 mn investment in AAESS Tradelinks Pvt Ltd at the book value, which translates into value of Rs 4 per share. Consequently, we lower our fair value from Rs 49 to Rs 39 per share. The stock is currently trading at Rs 33 per share. Consequently, our valuation grade is 4**/5,** indicating that the market price has 'upside' from the current levels.

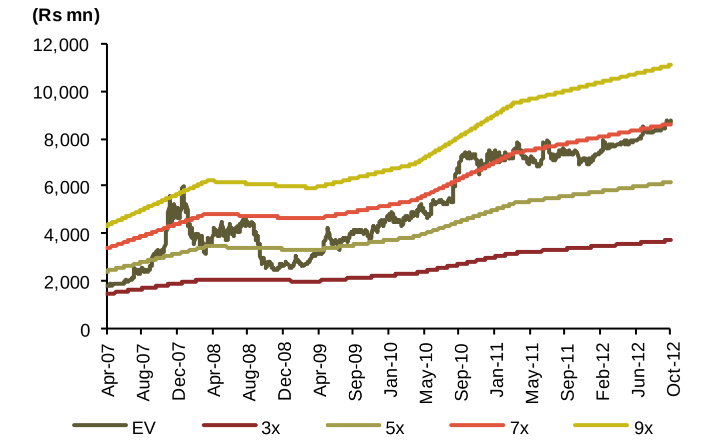
We have lowered the fair value from Rs 49 to Rs 39 per share

One-year forward P/E band



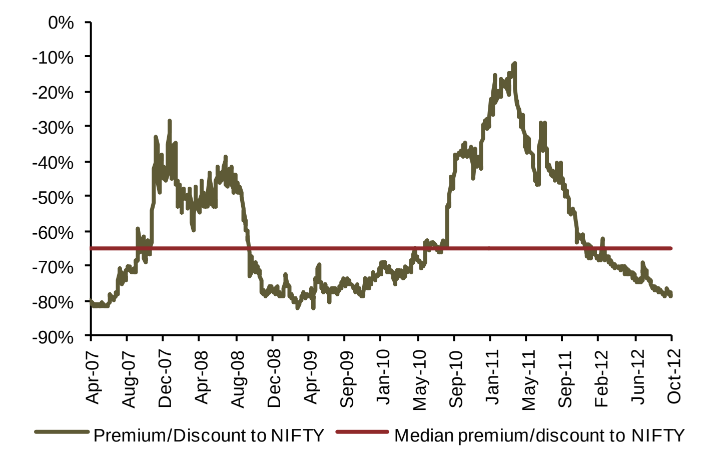
Source: NSE, CRISIL Research

One-year forward EV/EBITDA band



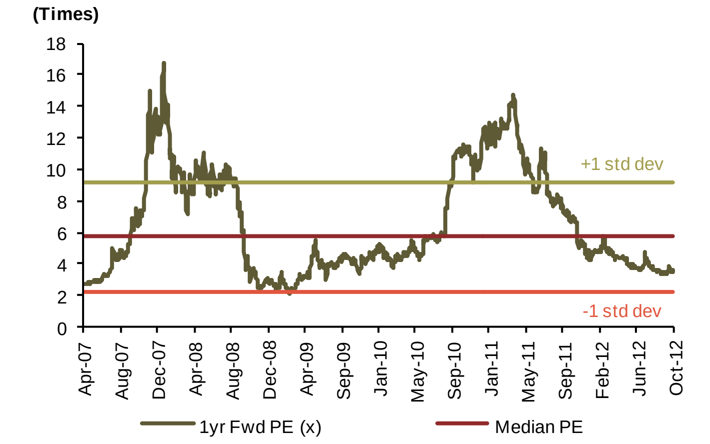
Source: NSE, CRISIL Research

P/E – premium / discount to NIFTY



Source: NSE, CRISIL Research

P/E movement



Source: NSE, CRISIL Research

Peer comparison

Companies	M.cap (Rs mn)	Price/earnings (x) FY12	FY13E	FY14E	EBITDA margin (%) FY12	FY13E	FY14E	EV/EBITDA (x) FY12	FY13E	FY14E	RoE (%) FY12	FY13E	FY14E
MSP	**2,258**	**6.2**	**4.3**	**2.9**	**16.9**	**20.6**	**21.2**	**9.0**	**5.5**	**4.5**	**9.6**	**13.3**	**16.9**
Jai Balaji	2,484	NM	16.0	NA	16.7	8.4	12.9	9.7	5.9	NA	-12.3	2.2	NA
Monnet Ispat	18,884	6.5	6.3	4.5	25.6	24.5	27.7	10.4	7.3	5.4	13.1	11.9	14.7
Bhushan Steel	106,848	9.8	9.0	7.9	31.1	28.9	28.4	9.8	8.2	6.9	14.7	14.1	14.1
Godawari Power	3,844	4.3	2.9	2.7	13.7	16.1	17.4	4.4	3.3	2.9	13.1	16.4	16.1
TATA Sponge	5,092	6.1	4.7	4.7	22.3	16.4	15.8	1.8	1.8	1.9	14.1	15.9	14.4

Source: Industry sources, CRISIL Research

CRISIL IER reports released on MSP Steel & Power Ltd

Date	Nature of report	Fundamental grade	Fair value	Valuation grade	CMP (on the date of report)
29-Jul-10	Initiating coverage	2/5	Rs 44	3/5	Rs 40
01-Dec-10	Q2FY11 result update	2/5	Rs 57	3/5	Rs 61
03-Feb-11	Q3FY11 result update	2/5	Rs 75	4/5	Rs 62
21-Jun-11	Q4FY11 result update	2/5	Rs 75	5/5	Rs 45
12-Aug-11	Q1FY12 result update	2/5	Rs 75	5/5	Rs 47
02-Nov-11	Detailed report	2/5	Rs 70	5/5	Rs 42
19-Dec-11	Q2FY12 result update	2/5	Rs 55	5/5	Rs 30
21-Feb-12	Q3FY12 result update	2/5	Rs 55	5/5	Rs 38
20-June-12	Q4FY12 result update	2/5	Rs 49	5/5	Rs 28
06-Aug-12	Q1FY13 result update	2/5	Rs 49	5/5	Rs 28
15-Oct-12	Detailed report	2/5	Rs 39	4/5	Rs 33

Company Overview

MSP, a leading operating entity of the MSP group, is a mid-size non-integrated steel manufacturer in eastern India. MSP's pellet plant has helped it backward integrate towards iron ore. The company manufactures sponge iron and long products. In the long segment, it offers a wide range of products such as billets, TMT, structurals, angles, channel, plate and beam. It has also set up a captive power plant to support its operations. The manufacturing facilities are located in Jamgaon and Raigarh in Chhattisgarh.

MSP is in the process of integrating its capacities by expanding steel capacity to 2.7 lakh MTPA from 1.4 lakh MTPA currently. In Q1FY13, it scaled its pellet and power capacity to 0.9 mn MTPA from 0.3 mn MTPA and 76 MW from 42 MW, respectively.

Details of installed capacities and utilisation rate

	Installed capacity				Utilisation rate			
	FY10	FY11	FY12	Q1FY13	FY09	FY10	FY11	Q1FY13
Sponge iron (MT)	192,000	307,500	307,500	307,500	81%	63%	66%	66%
Steel billets (MT)	144,109	144,109	144,109	144,109	75%	71%	99%	99%
TMT (construction bars)	80,000	80,000	80,000	80,000	85%	62%	95%	95%
Structurals	128,000	128,000	128,000	128,000	1%*	42%	39%	39%
Pellet	300,000	300,000	300,000	900,000	48%	62%	87%	49%
CPP/thermal power plant (MW)	22	42	42	76	72%	85%	58%	63%

*Commenced in FY09-end

Source: Company, CRISIL Research

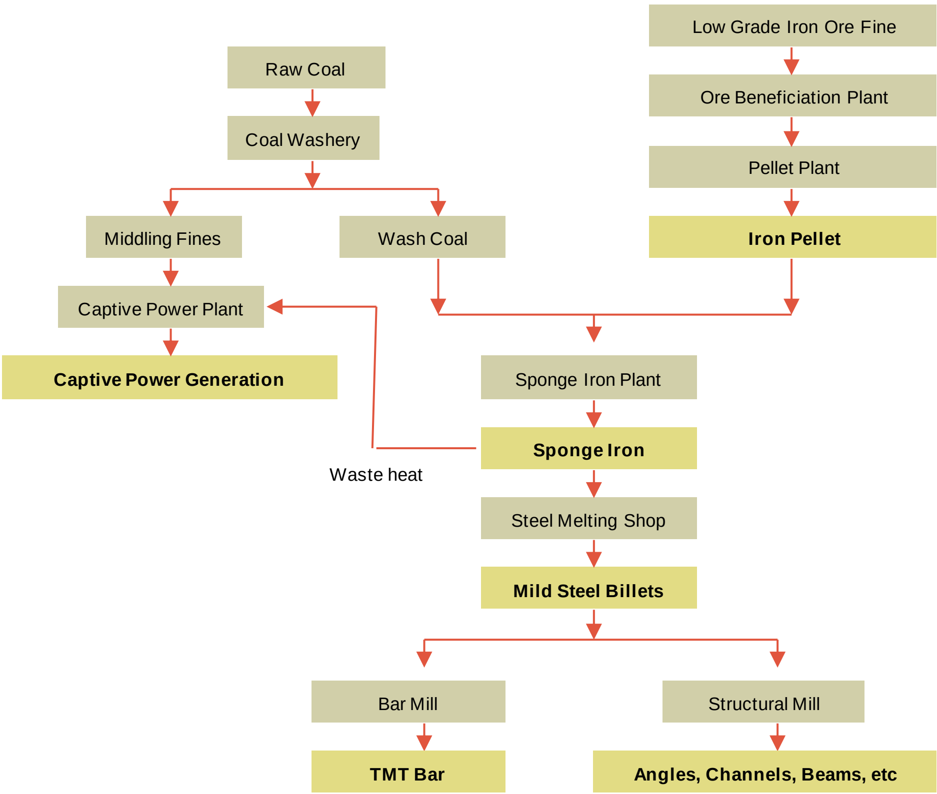
Subsidiary details

- MSP's wholly owned subsidiary company – MSP Group International Singapore (PTE) Ltd – is a dormant company.
- MSP has recently acquired 52.55% stake in AA ESS Tradelink Pvt. Ltd for Rs 250 mn. AA ESS has the rights to use the railway siding in Odisha. Thus, the move will ensure smooth flow of raw materials with increased availability of wagons and rakes.

Production flow chart

The following chart shows the long value chain present right from pelletisation and coal washery to TMT bar and structural production.

Production flow chart



Source: Company, CRISIL Research

About MSP group

The group has nine operational companies – they manufacture steel intermediaries, steel products, ferro alloys, power, cement and industrial and medical oxygen. There are no evident overlaps in the business concentration due to geographical distances and different customer markets. Though there is mutual business understanding among the companies, there is no formal agreement in that regard. None of the companies have any holding-subsidiary relationship and have insignificant cross holdings.

Group companies	Production facilities	Installed capacity (MT)	Location
MSP Metallics Ltd	Sponge iron	*256,000*	Jharsuguda, Odisha
	SMS	*263,000*	
	Pig iron	*294,000*	
	Pellets	*600,000*	
	LAM coke	*250,000*	
	Sinter plant	*416,000*	
	Captive power plant	*27 MW*	
	Railway siding	*5 Km*	
Chaman Metallics Private Ltd	Sponge iron	*94,000*	Chandrapur, Maharashtra
Howrah Gases Ltd	Sponge iron	*60,000*	Burdwan, West Bengal
	SMS	*50,000*	
MSP Sponge Iron Ltd	Sponge iron	*78,000*	Keonjhar and Raigarh, Chhattisgarh
	SMS	*50,000*	
	Re-rolling mill	*48,000*	
	Ferro alloys	*26,657*	
	Captive power plant	*12 MW*	
MSP Rolling Mills Private Ltd	TMT	*48,000*	Howrah, West Bengal
Adhunik Cement Ltd	Integrated cement plant	*1.5 MTPA*	Meghalaya
	Captive power plant	*25MW*	
Ashirwad Steels & Industries Ltd	Sponge iron	*0.15 MTPA*	Jamshedpur, Hyderabad
MSP Steel Private Ltd	Billets/ingots	*0.05 MTPA*	Keonjhar, Odisha
	TMT	*0.05 MTPA*	

Source: Company, CRISIL Research

Milestones

1968	Incorporated
2003	0.10 MTPA DRI plant commissioned in Raigarh, Chhattisgarh
2005	■ DRI capacity expanded to 0.19 MTPA ■ Set up billet capacity of 0.10 MTPA
2007	Emerged as a mini-integrated steel player. Commenced commercial production of TMT bars, a coal washery and a captive power plant with installed capacities of 0.08 MTPA, 0.35 MTPA and 24 MW, respectively
2008	Total installed capacity of billets increased to 0.14 MTPA
2009	Pellet plant set up with an installed capacity of 0.30 MTPA
2010	Operationalised greenfield structural rolling mill of capacity 0.13 MTPA
2011	Operationalised 18 MW power plant and 0.12 MTPA DRI plant
2012	Commissioned 0.6 mn MTPA pellet capacity and 34 MW power plant and 3.3 mn MTPA coal washery

Annexure: Financials

Income statement

(Rs mn)	FY10	FY11	FY12	FY13E	FY14E
Operating income	**4,021**	**5,079**	**6,993**	**9,952**	**11,245**
EBITDA	**774**	**1,068**	**1,184**	**2,045**	**2,381**
EBITDA margin	**19.2%**	**21.0%**	**16.9%**	**20.6%**	**21.2%**
Depreciation	127	193	291	505	531
EBIT	**646**	**874**	**893**	**1,540**	**1,850**
Interest	205	248	607	972	899
Operating PBT	**442**	**627**	**286**	**568**	**951**
Other income	7	39	52	70	79
Exceptional inc/(exp)	(5)	6	(1)	(90)	-
PBT	**444**	**671**	**337**	**548**	**1,030**
Tax provision	62	169	77	160	258
Minority interest	-	-	-	-	-
PAT (Reported)	**382**	**502**	**260**	**389**	**773**
Less: Exceptionals	(5)	6	(1)	(90)	-
Adjusted PAT	**387**	**496**	**261**	**479**	**773**

Ratios

	FY10	FY11	FY12	FY13E	FY14E
Growth					
Operating income (%)	(0.9)	26.3	37.7	42.3	13.0
EBITDA (%)	17.3	38.0	10.9	72.8	16.4
Adj PAT (%)	35.6	28.3	(47.4)	83.4	61.5
Adj EPS (%)	35.6	28.3	(47.4)	56.5	61.5
Profitability					
EBITDA margin (%)	19.2	21.0	16.9	20.6	21.2
Adj PAT Margin (%)	9.6	9.8	3.7	4.8	6.9
RoE (%)	19.7	21.2	9.6	14.4	19.4
RoCE (%)	11.5	10.7	8.3	12.6	15.3
RoIC (%)	11.3	10.0	8.8	12.9	15.0
Valuations					
Price-earnings (x)	5.0	3.9	7.3	4.7	2.9
Price-book (x)	0.9	0.8	0.6	0.6	0.5
EV/EBITDA (x)	7.5	8.3	9.2	5.3	4.1
EV/Sales (x)	1.5	1.9	1.6	1.1	0.9
Dividend payout ratio (%)	-	11.8	7.4	8.8	6.2
Dividend yield (%)	-	3.1	1.0	1.5	2.1
B/S ratios					
Inventory days	79	114	139	119	114
Creditors days	72	60	75	49	43
Debtor days	61	30	25	21	21
Working capital days	108	142	134	95	88
Gross asset turnover (x)	1.5	1.2	1.2	1.3	1.0
Net asset turnover (x)	1.7	1.3	1.4	1.5	1.2
Sales/operating assets (x)	1.0	0.8	0.8	1.0	1.1
Current ratio (x)	3.2	3.0	2.7	2.7	2.7
Debt-equity (x)	2.1	3.2	3.3	2.6	1.9
Net debt/equity (x)	1.7	3.2	3.3	2.6	1.9
Interest coverage	3.2	3.5	1.5	1.6	2.1

Per share

	FY10	FY11	FY12	FY13E	FY14E
Adj EPS (Rs)	6.7	8.5	4.5	7.0	11.3
CEPS	8.9	11.9	9.5	14.4	19.1
Book value	38.5	42.1	51.7	53.3	63.9
Dividend (Rs)	-	1.0	0.3	0.5	0.7
Actual o/s shares (mn)	58.1	58.1	58.1	68.1	68.1

Balance Sheet

(Rs mn)	FY10	FY11	FY12	FY13E	FY14E
Liabilities					
Equity share capital	581	581	581	681	681
Reserves	1,432	1,865	2,103	2,952	3,669
Shares application money pending allotment	222	-	318	-	-
Minorities	-	-	-	-	-
Net worth	**2,235**	**2,446**	**3,002**	**3,633**	**4,350**
Preference shares	-	754	879	879	879
Other debt	4,611	7,055	9,063	8,703	7,503
Total debt	**4,611**	**7,809**	**9,943**	**9,582**	**8,382**
Deferred tax liability (net)	199	334	381	484	652
Total liabilities	**7,044**	**10,588**	**13,325**	**13,699**	**13,383**
Assets					
Net fixed assets	2,559	4,999	4,958	8,753	9,922
Capital WIP	2,454	3,419	5,224	1,724	104
Total fixed assets	**5,013**	**8,418**	**10,183**	**10,477**	**10,026**
Investments	70	74	354	354	354
Current assets					
Inventory	683	1,209	2,101	2,454	2,619
Sundry debtors	685	424	517	626	708
Loans and advances	712	1,429	1,807	1,393	1,349
Cash & bank balance	379	103	49	98	102
Marketable securities	380	-	-	-	-
Total current assets	**2,840**	**3,164**	**4,473**	**4,571**	**4,778**
Total current liabilities	**878**	**1,068**	**1,685**	**1,704**	**1,775**
Net current assets	**1,962**	**2,097**	**2,789**	**2,868**	**3,003**
Intangibles/Misc. expenditure	**-**	**-**	**-**	**-**	**-**
Total assets	**7,044**	**10,588**	**13,325**	**13,699**	**13,383**

Cash flow

(Rs mn)	FY10	FY11	FY12	FY13E	FY14E
Pre-tax profit	448	665	338	638	1,030
Total tax paid	(21)	(34)	(29)	(56)	(90)
Depreciation	127	193	291	505	531
Working capital changes	(212)	(790)	(747)	(30)	(131)
Net cash from operations	**343**	**35**	**(148)**	**1,058**	**1,340**
Cash from investments					
Capital expenditure	(1,816)	(3,598)	(2,056)	(800)	(80)
Investments and others	(382)	376	(280)	-	-
Net cash from investments	**(2,198)**	**(3,222)**	**(2,336)**	**(800)**	**(80)**
Cash from financing					
Equity raised/(repaid)	-	679	113	600	-
Debt raised/(repaid)	1,884	3,198	2,134	(361)	(1,200)
Dividend (incl. tax)	-	(69)	(22)	(40)	(56)
Others (incl extraordinaries)	156	(216)	317	(408)	-
Net cash from financing	**2,040**	**3,591**	**2,542**	**(209)**	**(1,256)**
Change in cash position	185	403	58	49	5
Closing cash	379	103	49	98	102

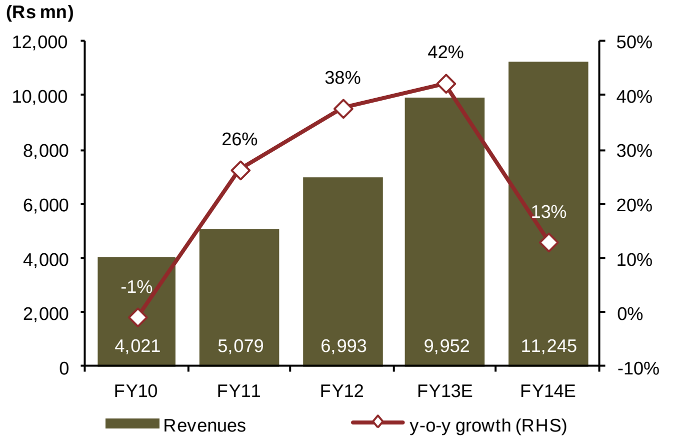
Quarterly financials

(Rs mn)	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13
Net Sales	**1,733**	**1,610**	**1,749**	**1,864**	**2,189**
Change (q-o-q)	9%	-7%	9%	7%	17%
EBITDA	**344**	**211**	**267**	**341**	**394**
Change (q-o-q)	31%	-39%	27%	28%	16%
EBITDA margin	**20%**	**13%**	**15%**	**18%**	**18.0%**
PAT	114	23	51	72	102
Adj PAT	**114**	**23**	**51**	**72**	**167**
Change (q-o-q)	0%	-79%	117%	42%	131%
Adj PAT margin	**7%**	**1%**	**3%**	**4%**	**7.6%**
Adj EPS	**2.0**	**0.4**	**0.9**	**1.2**	**1.8**

Source: CRISIL Research

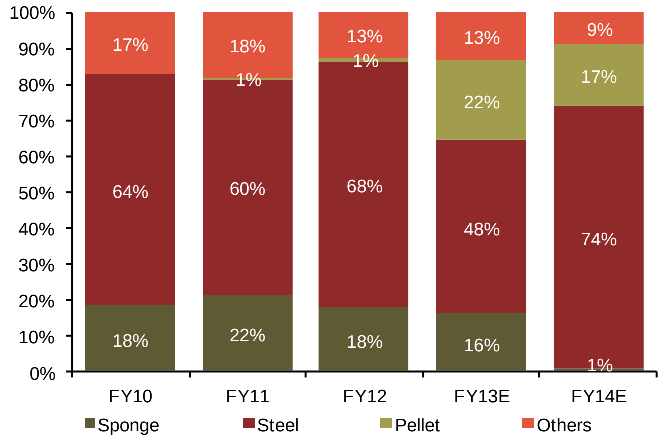
Focus Charts

Revenue growth on the back of expansion...



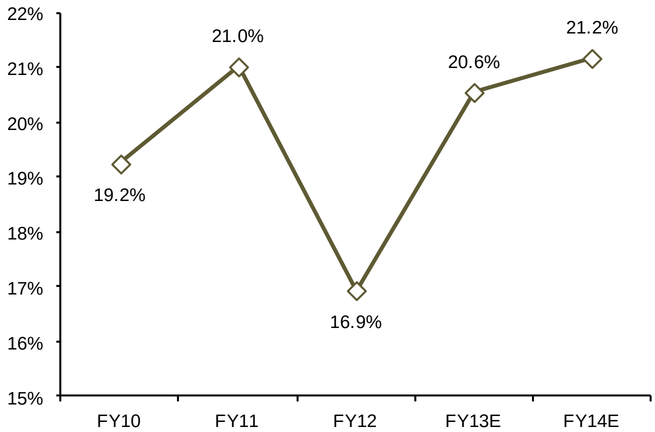
Source: Company, CRISIL Research

...With a better product mix



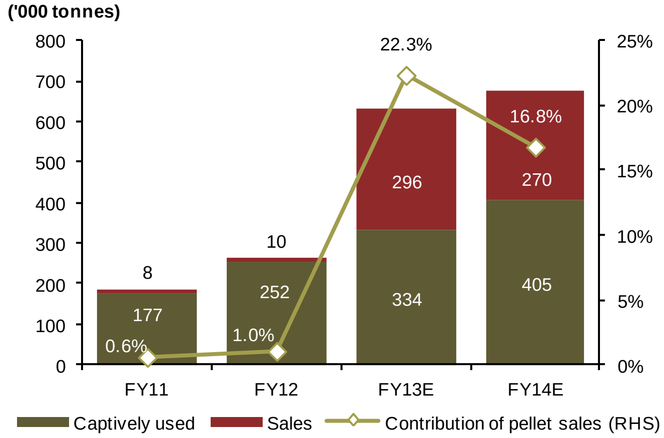
Source: Company, CRISIL Research

EBITDA margins to improve...



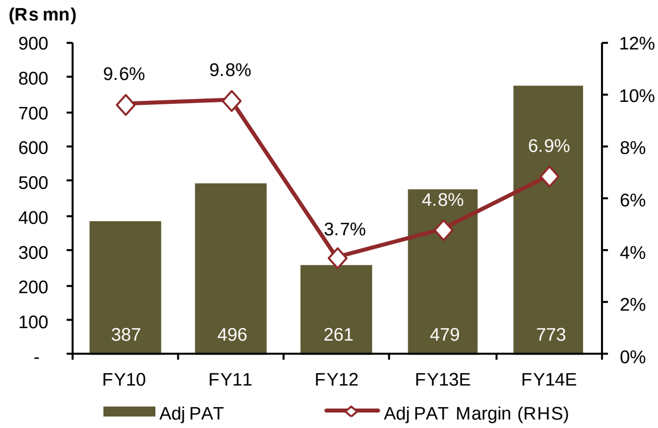
Source: Company, CRISIL Research

...With the help of high-margin pellet sales



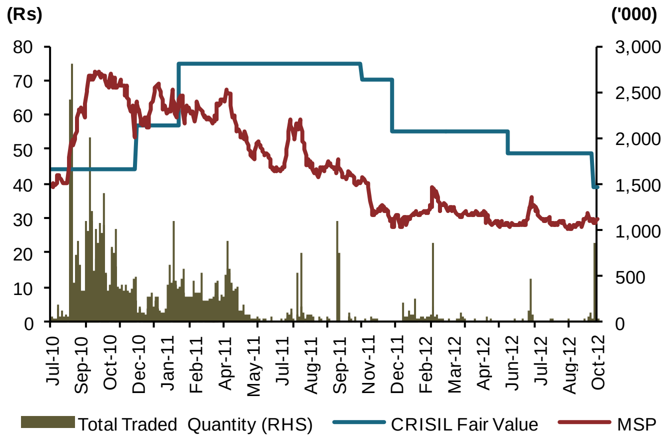
Source: Company, CRISIL Research

Profitability to improve but still remain lower



Source: Company, CRISIL Research

Fair value movement since initiation



Source: Company, CRISIL Research

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