Twitter Thread by [redacted] : Advait Arora

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@WealthEnrich

Massive targets for #Tatasteel by #AmbitCapital.
Nearly 50 % upside from here.
Cmp Rs. 1440/-, Targets Rs. 2100/-

Metals & Mining

POSITIVE

SECTOR UPDATE	STEEL & IRON ORE	August 20, 2021

A structural story beckons

Chinese supply restrictions and ex-China capital starvation have finally set stage for steel supply shortfalls. OECD data suggests there is 325MT spare capacity ex-China, but most of it old, inefficient, some permanently idled or in military conflict (>30-35MT). Steel will likely undergo a similar tight supply cycle iron ore is going through since 2019. HRC conversion margins should stay in a higher, tighter range than in past. Indian steel companies are in a sweet spot. WACC is declining as companies are moving closer to optimal capital structure. There's significant brownfield potential that should generate IRR of >=25%. Returns should be less volatile, stay ahead of cost of capital. That calls for re-rating. Mid-cycle EBITDA/t and EV/EBITDA should be higher than in the past. We raise FY23 EV/EBITDA for TSL (7.4x) and JSTL (7.2x); assume 13% cost of equity for TSL & LT China HRC of $545/t (vs $520/t past 10 years). Turn BUYers on TSL with TP of Rs2,200 (Rs1,335 earlier).

Supply shortfalls forthcoming – high-cost players to balance the market

Chinese local authority directives suggest seriousness about steel production control. OECD data suggests there is 325MT spare steel capacity ex-China. But Japan and Korea are also firmly on de-carbonization path. Given current supernormal profits, EU players can restart idled capacities despite higher marginal Co2 cost. But that would entail deviating from Co2 reduction targets. Global steel cost curve would steepen on decarbonization costs for already higher-cost players. The need for higher cost, inefficient, older BFs or marginal-cost EAFs to balance the market will keep conversion margins elevated. Iron ore should decline but stay >$100/t through CY25; scrap tightness is on anvil.

India in a sweet spot

Introduction of climate-friendly policies in India will be 5-10 years behind most countries. Indian steel companies operate on low end of global cost curve, and stand to benefit from 1) stronger domestic growth and 2) higher exports to Southeast Asia. There is significant brownfield potential with major Indian players – these entail attractive payback with ROCE of >=25%. Incremental ROIC should expand. We see some similarities between current metals developments and trends in Indian specialty chemicals post 2014.

Look past the cyclicality

Lagged impact of China credit cycle should start reverberating in a few months. So would return of more sustainable durable goods orders in developed world as stimulus checks fade. But Chinese CCP in Oct'22 may limit decline. Investors can look past forthcoming cyclicality, as structural shortfalls are here to stay. Given de-carbonization trends and costs, steel prices need to stay higher for longer before incentivizing capex on capacity growth (ex-India, ASEAN).

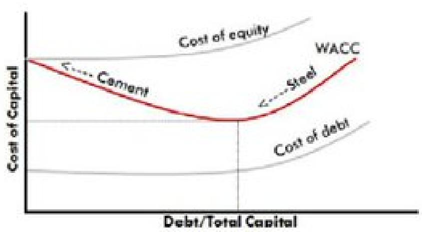
Valuation re-rating case compelling – most for TSL, least for NMDC

Metal is deep cyclical sector – price volatility, high financial leverage historically led to marked swings in ROE (often below 0). But companies are graduating to optimal capital structure. ROCE should settle higher vs WACC. Metals investors have often ascribed 15-20% cost of equity. That should come down. 6x EV/mid-cycle EBITDA implies cost of equity of >=15%, LT Chinese HRC of $500-$550/t. We lower cost of equity for TSL to 13% and keep LT China HRC at $545/t. Incremental ROCE should remain elevated on brownfield growth. Indian steel companies should trade well above replacement cost for few years. TSL has most compelling re-rating case, NMDC least. Risks: China not following through on de-carbonization commitment, an Indian export tax similar to 2008, aggressive bids for RINL, NMDC steel plants.

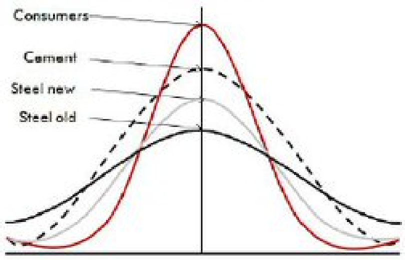
Key Recommendations

Tata Steel	**BUY**
Target Price: 2,200 Upside 47%	
JSW Steel	**SELL**
Target Price: 760 Upside: 3%	
Jindal Steel & Power	**SELL**
Target Price: 425 Upside: 4%	
NMDC	**SELL**
Target Price: 180 Upside: 8%	

Steel moving to optimal capital structure



Lower cyclicality vs past



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