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Visit Note

Monnet Ispat

Buy

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Rs 42.15

We met the management of Monnet Ispat to know about the company's future prospects. Key takeaways of the meeting are as under:

Monnet Ispat is into coal-based sponge iron (present capacity – 2.30 lakh MTPA) production and forward integration into steel billets / ingots production (present capacity – 0.50 lakh MTPA). Monnet's sponge iron and steel plant is situated at Raipur in Chhattisgarh. Sponge iron is substitute for melting steel scrap through the secondary route – electric and induction arc furnace. Associate company Monnet Power presently has 7.5MW power plant that uses waste heat generated during sponge iron production. Thus, there is no fuel cost for power generation. Monnet Power also operates a ferro alloy plant (present capacity – 12,000 MTPA). Presently, the entire power generated at Monnet Power is consumed by the company's ferro alloy unit itself. The company's evolving model is almost resembling that of Jindal Steel and Power.

This was on account of Monnet initially opting for Jindal Steel's competitive technology and later improving on it through in-house efforts. The company now no more depends on Jindal Steel for technology. The company has also mastered the steel-making technology through its in-house efforts.

High Operating efficiencies

Monnet Ispat has a good track record of operating efficiency. The company's plants have been operating at more than 85% capacity utilisation consistently.

Sponge Iron on positive track

- Outlook for sponge iron continues to be positive. Sponge iron prices that started firming up from October-November 2002 from Rs5500-6000/mt levels (excluding excise) touching a high of Rs7500/mt (excluding excise) in Q4FY03 are currently hovering in the Rs7200-7500 (excluding excise) region.
- Sponge iron prices chiefly trail landed cost of steel scrap. Presently, the landed cost of steel scarp is in the range of Rs9500-10500/MT on the back of world scrap prices rising from a low of USD 90/MT CIF to USD 150/MT CIF. In the past, sponge iron prices trailed the scrap prices by an average of 15%. This has now increased to around 20% leaving further scope for firming up of prices of sponge iron.
- Globally, there is a major shortage of steel scrap due to increasing use of sophisticated technology in steel making, the prime source of scarp generation and increasing use of scrap for making steel through the EAF route. Going forward, this trend is not expected to get reversed resulting in further tightening of scrap. Hence, the present price levels are expected to sustain in the short to medium term.
- To bridge this gap, the industry estimates additional sponge iron capacity of more than 4mn MTPA in the coming 3-4 years. However, only 4-5 of the existing sponge iron producers such as Monnet Ispat, Jindal Steel and Tata Sponge Iron are in a position to expand their capacities. Players like Sunflag Iron, Prakash Industries, Gold Star, Bihar Sponge, etc., due to poor financials are not in a position to expand their capacities in the short to medium term.
- Institutions are also increasingly looking at funding those expansion/new projects that have captive coal and iron ore facilities and which are not easy to come by. So some small capacities are coming in, which of course run the risk of economies of scale but which isn't perceived as a threat.

- While there is no major scope for export of sponge iron, equally there is no major import threat from the same.

Monnet Ispat recently went in for expansion of its sponge iron capacity by 70,000mtpa to 3 lakh mtpa and its steel capacity by 2.50 lakh mtpa to 3 lakh mtpa. Benefits of this expansion should start getting reflected from Q2FY04. This expansion has been done at a competitive cost of Rs300mn for sponge iron and Rs250mn for steel, in all Rs550mn.

In the medium term, besides the above expansion, Monnet Ispat is setting up a greenfield sponge iron plant of 4.50 lakh mtpa capacity at Raigarh, which is 180kms away from Raipur in Chhattisgarh at a cost of Rs2.25bn. This plant would be commercialised by December 2004. This project would be funded through a debt of Rs1.5bn and a mix of internal accruals and equity of Rs0.75bn. Performance of this plant would be reflected in Q4FY05.

Monnet Power's expansion moves
Concurrently, the company has expanded its power generation capacity by 37MW based on coal and coal rejects for Rs1.30bn. Post expansion, power capacity would be 45MW. This expansion has been commercialised in July 2003. Monnet Power has contracted to meet Monnet Ispat's entire power requirement for its sponge iron and steel production at Rs2.65 per unit. Currently, Monnet Ispat meets its entire power requirement from the grid and other private suppliers at an average price of Rs3 per unit. Also, Monnet Power has increased the capacity of its ferro alloys from 12000mtpa to 36000mtpa.

Monnet Ispat and Monnet Power merger: A Positive
Eventually, the management is looking at merging Monnet Power with Monnet Ispat. Presently, various modalities are being contemplated without any specifics actually decided. Nevertheless, despite the impeding equity dilution, the merger would positively impact the working from hereon.

Captive Coal block: A reality
Monnet is the only other company after Jindal Steel to get a coal block for captive consumption. Coalmines have very good quality sponge iron grade coal with mineable reserves of 65mn mt. The mines are located around 30kms away from the upcoming Raigarh sponge iron plant and around 210kms away from the Raipur plant. The company would have the capacity to mine 10 lakh mtpa of coal initially. This project costing Rs0.50bn would be commercialised in January 2004. The project would entail net savings of Rs600/mt of coal consumed with the quantity of coal consumed also reducing, nearly 40% saving over the cost of coal consumed in FY03.

Captive Iron Ore mines to follow
The company is actively negotiating for good quality iron ore mines in Orissa. This is expected to be completed in FY04. When completed, it would mean a net saving of Rs300/mt of iron ore, nearly 20-22% saving over the cost of iron ore consumed in FY03.

Valuation and View
All the above initiatives would put Monnet Ispat in the big league in the medium term characterised by the feature of becoming an integrated steel player with economies of scale from captive coal, iron ore and power (as inputs entail risk over input cost to intermediate sponge iron both for captive as well as outside sales to finished steel as measure of value addition). In the long-term, Monnet Ispat looks forward to making long steel products at Raigarh backed by captive power generation. This is not withstanding impeding equity dilution the timing of which is presently not certain but which overall will be EPS positive. At the current price level of Rs42.15, Monnet trades at 2.5x FY04E fully diluted earnings of Rs17.09 and at 2.6x FY05E EPS of Rs16.12 on an assumed fully diluted equity of Rs283.9mn for funding the greenfield sponge iron plant at Raigarh.

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With the major capacity expansion in place, forward integration into steel, backward integration into major input – coal getting crystallised (only other company after Jindal Steel to have this advantage), which would reduce input costs as well as impart very low input price volatility and above all, the present strong trends in the industry is expected to continue for next 12-15 months, we recommend **BUY** the stock with a target price of Rs65-70 in 6-8 months.

Financials **Rs Million**

	FY02	FY03	Change(%)	FY04E	Growth	FY05E	Growth(%)
Sales (Incl. Excise)	1323.4	2166.2	63.7%	3899.1	80%	5068.8	30.0%
EBITDA	188.9	375.6	98.9%	713.5	90%	978.3	37.1%
Interest and Finance Charges	74.2	115.5	55.6%	173.4	50%	309.9	78.7%
Gross Profit	114.7	260.2	126.8%	540.1	108%	668.4	23.7%
Depreciation	35.9	55.4	54.2%	90.2	63%	167.2	85.4%
PBT (Ex. OI and EI)	78.8	204.7	159.9%	449.9	120%	501.2	11.4%
OI	9.8	7.2	-26.5%	7.2	0%	7.2	0.0%
Extraordinary Income / (Expense)	0.00	(30.0)	N. A.	0.00	N. A.	0.00	
PBT (Incl. OI and EI)	88.6	181.9	105.4%	457.1	151%	508.4	11.2%
Total Tax	31.1	31.2	0.1%	91.4	193%	50.8	-44.4%
Current	6.8	14.4	111.8%				
Deferred	24.3	16.8	-31.1%				
PAT	57.4	150.8	162.5%	365.7	143%	457.6	25.1%
OPM (Ex OI)	14.3%	17.3%		18.3%		19.3%	
NPM	4.3%	6.9%		9.4%		9.0%	
Tax Rate	35.1%	17.1%		20.0%		10.0%	
Equity (FV Rs10/-)	19.09	19.09		21.39		28.39	
EPS (Rs)	3.01	7.90	162.5%	17.09	116%	16.12	-5.7%

Equity dilution in FY04 is due to share application money received from the promoters during FY03 for allotment of shares at Rs30 premium. Pursuant to this, the promoters' stake in the company would increase to 59%.

Though the issue price of shares for funding the greenfield sponge iron project at Raigarh has not be fixed, considering the company's prospects and valuation, the issue price has been conservatively assumed at Rs50 per share. So, in all Monnet will fund the new project through an equity issue of Rs350mn.

Shareholding Pattern (YE March 2003)

Promoters	54.03%
UTI and MFs	0.06%
Banks / FIs / Insurance Cos.	0.01%
Public	33.82%
PCBs	12.08%

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Stock Ratings Absolute Returns

Buy	:	> 25%
Out Performer	:	16 - 25%
Market Performer	:	0 - 15%
Under Performer	:	< 0%

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