JSW Steel - Ispat Deal : Steely Impact

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Abstract

This is the first of its kind and a pioneering deal in the Indian steel sector and it could, in a sense, be one of the many more to come. Although this deal will stretch JSW's balance sheet in the short-term, the deal would benefit JSW in the long-term, given the low valuations of the deal, readily available capacity and huge potential for improvement in operations. This could also be beneficial from the perspective of the shareholder (especially of Ispat) because control moves into stronger hands that will be able to rightfully justify the capacity and available resources.

Introduction

The JSW Steel and Ispat deal rightfully attracted a lot of attention, given that this is the first ever effort at M&A in the steel sector in India. Before getting into the analysis of the deal, we briefly look at the individual companies and the blueprint of the deal itself, after which the impact of the deal on the company and the steel sector at large is analyzed.

About the companies

JSW has two primary business segments, steel and power (used mainly for captive consumption). JSW has scheduled expansion plans at Vijaynagar and West Bengal and looks well-placed to cater to the increasing demand for steel. Further, in the greenfield project in West Bengal, the company has planned an outlay of Rs 16,000 cr for a 4.5 MTPA plant, which also includes investments in thermal and coking coal mines.

Ispat is primarily engaged in the business of manufacturing and sale of iron and steel products. It is an integrated steelmaker and a producer of hot rolled coils in India. The company's products include sponge iron, hot rolled coils, cold rolled coils, galvanized sheets/coils, color

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coated sheets, galvalume and pipes and tubes. Ispat is amongst the few companies in the world which have complete flexibility to choose the steel making route, be it the conventional blast furnace or the electric arc furnace. This dual technology allows Ispat the freedom to choose its raw material feed, be it pig iron, sponge iron, iron ore, scrap or any combination of various feeds. It also has total flexibility in choosing its energy source, be it electricity, coal or gas.

The Deal

JSW Steel has entered into an agreement with Ispat Industries to acquire 41.29% stake in the company. As part of the deal, Ispat will issue preferential shares worth 41% of its paid-up capital to JSW for around $500 mn. JSW Steel will also make a mandatory open offer of 20%, as per market regulator Sebi's guideline that any company buying more than 15% in another firm will have to make an offer to buy 20% additional stake.

JSW plans to finance this deal through a mix of internal accruals and debt. Post this deal, the debt equity mix of JSW would increase to 1:1. Post debt conversion, JSW will hold 39.9% stake in Ispat, while existing promoters will hold 24.5%. JSW plans to infuse Rs 7,500 cr to refinance Ispat's debt, and this attempt of debt rescheduling is expected to lower interest costs by around 200 bps, resulting in additional savings.

The Combined Strength

Parameter	JSW	Ispat
Capacity (mtpa)	11*	3.3
Operating since (year)	2000	2000
Plant Location	South/West	West
Products Range	Flat + Long	Flat
Raw Material Integration	Partial	Nil
Technology	Pioneer in COREX Technology	Pioneer in Twin Shell ConArc/ Thin Slab Casting
Markets	South/West	West/South
Logistics	Rail/Road	Port-based
Financial Status	profit making/dividend paying company	Low EBITDA/CDR case

* By March 31, 2011, current capacity 7.8 mtpa.

Source: JSW Steel

Acquisition Rationale

Although this deal will stretch JSW's balance sheet in the short-term, the deal would benefit JSW in the long-term, given the low valuations of the deal, readily available capacity and huge potential for improvement in operations. This acquisition will also enable JSW to emerge as India's largest steel player by FY2012, at 14.3 MTPA. The company cites the following as the reasons for the acquisition that it proposes to complete:

- Inorganic growth opportunity; expansion without gestation;
- Shore-based facility immediately available;
- Ability to propel JSW to become the leading player in the growing western markets;
- Attractive valuations;
- Cutting-edge technologies;
- Minimum project execution risks; and
- Complementary product basket additions.

Impact Analysis

JSW Steel has the financial strength and operational capabilities to turnaround Ispat's operations. Its first shipment of coking coal from the US mines is likely to arrive in the next two quarters. This is expected to help the company with an easing of cost pressure; this will also improve the margins over the next few quarters. Ispat's operating margins have remained under severe pressures due to raw material cost, cost of power and freight. This deal will significantly reduce the freight cost incurred by both JSW and Ispat, thereby improving the consolidated margins. JSW will pull out of the Maharashtra market for Ispat, while Ispat will vacate the southern market. This is likely to bring down freight costs for Ispat and JSW in the immediate term and thereby improve the operating margins.

Financials

All figures in Rs Cr as on Sept. 30, 2010

Particulars	JSW Steel Stand-alone	JSW Steel Consolidated	Ispat Stand-alone	JSW Steel consolidated (incl. proportionate consolidation of Ispat)
Net Sales (trailing 12 months)	20,114	20,963	8,959	24,692
EBITDA (trailing 12 months)	4,571	4,600	1,227	5,106
Net Worth	15,777	15,320	207	16,625
Gross fixed assets including CWIP	30,782	36,260	12,542	41,438
Net Debt	7,508	12,188	8,040	15,507
Net Debt/EBITDA (x)	1.64	2.65	6.55	3.04
Net Debt Equity Ratio (x)	0.48	0.80	38.78	0.93

Including impact of JFE FCD of Rs 4,800 cr and tranche II (GDRs/Equity infusion) Rs 610.

Source: JSW Steel

Shareholding Pattern

The shareholding pattern of Ispat is all set to undergo a change with the controlling stake going into the hands of JSW Steel. Here is a brief look at the anatomy of the transition.

Management Control

JSW is to have management control. Mittal brothers, Promod and Vinod Mittal, the promoter-directors of Ispat Industries, would continue on the board as non-executive directors even after the majority interest in the company goes to JSW Steel.

The deal will increase the topline by 18%; this, however, has minimal impact on the operating margin (JSW consolidated: 21.95% vs. JSW incl. Ispat: 20.68%). However, debt will increase drastically and that could be a deterrent in the short-term, given the increasing interest rate scenario.

Recent Development

Most of the lenders are not willing to forgo the right to recompense (recompense is loss incurred by lenders on Ispat account). Though lenders are yet to calculate the exact recompense amount for Ispat, recompense is estimated to be between Rs 500-600 cr. What pans out in the next few months on this score will be interesting to watch; JSW has declared that it will meet to deliberate on the issue. JSW will declare its results on January 27, 2011, a much-awaited event within the steel sector.

Conclusions

This is the first of its kind and a pioneering deal in the Indian steel sector and it could, in a sense, be one of the many more to come. JSW is likely to benefit from the same in the long-term, if they are able to transition the loss-making ISPAT to complement and add to its financial strength. Inorganic growth could be a great opportunity to crucial sectors such as Steel, Oil and Gas, Infrastructure, Power, etc. Such deals are of a rare kind and are normally aimed at overseas targets. This could also be beneficial from the perspective of the shareholder (especially of Ispat) because control moves into stronger hands that will be able to rightfully justify the capacity and available resources.