May, 04, 2017

First Capital Research

Mughal Iron & Steel Industries Ltd.

Powering Ahead! (Initiation Report)

PAKISTAN
ENGINEERING

Research Entity Number: REP-015

We initiate coverage on Mughal Iron & Steel Industries Ltd. (MUGHAL), a long rolled steel manufacturer, with a 'Buy' rating. Key themes central to Mughal's investment case include i) improving local steel demand courtesy the China-Pakistan Economic Corridor (CPEC) with Mughal's topline depicting a 5 year topline CAGR of 16% and ii) improved margins with GMs increasing to 16% by FY19 from current 11% consequent to heightened vertical integration (imported billet substitution). Implementation of anti-dumping may potentially be a double edged sword as benefits of dumping duty on rebar may be offset by duty implementation on billets. While positives outweigh negatives, international scrap prices remain a key caveat to profitability. Our DCF-based target price of PkR86/sh provides an upside of 25% with a PEG of 0.33x for FY18F – Buy!

Steel demand set to rise further! Mughal's volumetric sales are set to achieve new highs where we forecast the company depicting a 5 year topline CAGR of 16% backed by increasing steel demand. In this regard, impetus to overall steel demand will be three pronged with i) demand generation from the USD56bn CPEC complemented by ii) increased PSDP spending and iii) higher housing demand given elevated earning levels. Mughal's ideal location in the demand centric Northern territory, low utilization (63% of available capacity in FY16) with bottlenecks being addressed, higher grade steel production and existing GoP contracts are further sweeteners.

Margin accretion the key: With topline on the up, Mughal will also benefit from improved margins with GM increasing to 16% by FY19 compared to current 11%. Margin accretion will be achieved through a combination of i) billet substitution with inhouse production where Mughal has leased two furnaces with cumulative capacity of 96k tons and ii) enhancement of current power capacity to 27.9MW (gas based) from previous 9.3MW – enough to bring an additional furnace online and fulfill the requirement for rebars after expansion. At the same time, the company is conducting a BMR on its existing rolling mill, enhancing capacity by ~270k tons. The mentioned steps will contribute a cumulative ~PKR4.5/sh to Mughal's bottomline by FY19.

Anti-dumping – Bane or boon? Cases related to anti-dumping on both billets (input) and rebars (final product) are currently underway with ~32% dumping duty being touted for billets. If implemented, this will have a negative EPS impact of PKR0.2/PKR0.4 in FY18/FY19. At the same time, a dumping duty of ~40% is being touted on rebars, however, we view such a quantum of price increase as highly unlikely, though partial pass-through cannot be ruled out.

Risks: Increase in scrap prices portends a key risk to manufacturers' margins, including Mughal. In this regard, historically, cost pass-through has been on a lagged basis with the current scrap price run-up no exception. Our estimates already incorporate 15% increase in scrap price for FY17 with 3% thereafter. Additionally, any change in duty structure (whether positive or negative) and potential disruption in power supplies can lead to variance from our estimates.

BUY

TARGET PRICE (PkR)	SHARE PRICE (PkR)
86	**69** (As of 03 May 2017)
UPSIDE / DOWNSIDE	DIVIDEND YIELD
25%	**3.0%**

MARKET DATA

Market cap (PkRbn)	17.3	Free float	24%
Market cap (USDmn)	165.3	Bloomberg	MUGHAL PA
12m ADTV (USDmn)	0.5	Reuters	MUGH.KA

FINANCIALS & RATIOS

	FY16	FY17E	FY18E	FY19E
EPS	3.2	4.0	5.6	9.5
EPS Growth	13%	23%	41%	68%
D/Y	2%	3%	3%	5%
P/E (x)	21.3	17.3	12.2	7.3
EBITDA Margin	9%	10%	12%	15%
ROE	21%	18%	20%	28%

Source: PSX & FCEL Research

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Steel demand to remain robust

CPEC to lead the demand growth complemented by increasing PSDP and increasing housing demand.

CPEC in the driving seat

With infrastructure development the new mantra for Pakistan, demand for construction materials including steel is set to continue. In this regard, under the incumbent government, the development expenditure has increased to PKR1.3tn by FY16 compared to PKR777bn in FY12. At the same time, we expect spending to continue in the same fashion for at least the next two years given focus on development by all political parties alike.

China Pakistan Economic Corridor (CPEC), a trade corridor moving across Pakistan from China to the Arabian Sea, is a more than USD56bn investment by China which mainly constitutes spending on power projects and infrastructure development. The investment is an addition to the ongoing government spending on infrastructure, and is expected to further prop up the demand for steel. Mughal, located in Lahore, enjoys close proximity to the Northern region of Pakistan where most of the development is expected to take place.

Already having government contracts in its order book will play in Mughal's favor, going forward, as management expects a reasonable share in projects like Suki-Kunari and Dasu Hydropower project. Moreover, Grade-60 rebar which Mughal produces and which is also a requirement for these big ticket projects provides Mughal a competitive advantage in a fragmented industry. In this regard, given its usage in the Construction sector, steel (read: rebar) is closely linked to Cement demand where we conservatively foresee rebar demand depicting a 5 year CAGR of 9% - where capacity constraints would already result in increased imports of the commodity.

Snapshot of some projects under CPEC	USD mn
Sahiwal 2x660MW Coal-fired Power Plant, Punjab	1,600
Rahimyar Khan Coal Power Project, Punjab	1,600
Zonergy 900MW Solar Park, Bahawalpur, Punjab	1,215
Karot Hydropower Station, AJK & Punjab	1,420
Matiari to Lahore Transmission line	1,500
Matiari to Faisalabad Transmission line	1,500
Peshawar-Karachi Motorway (Multan-Sukkur Section)	2,846

Source: FCEL Research & GoP

Low per capita steel consumption warrants upside

Pakistan's per capita steel consumption currently stands at approximately 37.5kg, significantly below the world average of 208kg. We expect per capita consumption to increase amid a rising middle class, resulting in higher and better housing demand underpinned by increasing income levels, rate of urbanization (3.3%) and welfare.

Figure: Percentage of Rural/Urban population

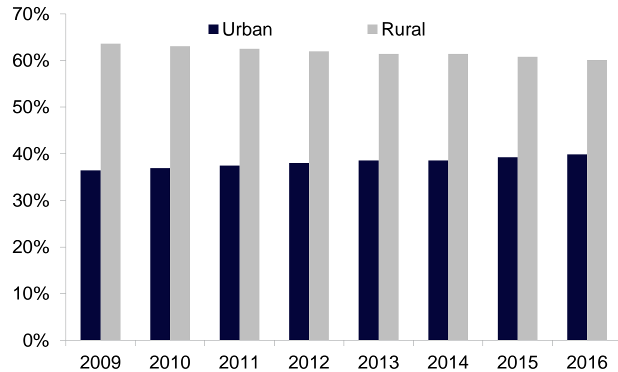
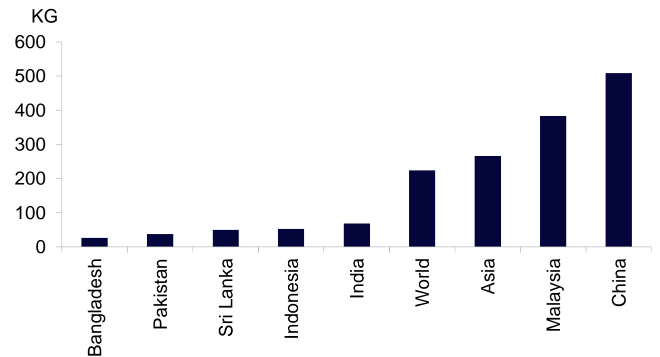


Figure: Per capita steel consumption



Source: FCEL Research, Pakistan Economic Survey & World Steel Association

At the same time, the low interest rate regime has resulted in a cumulative increase of 38% in house-building loans in last two years and is expected to improve further amid continued low interest rate regime despite interest rate hikes potentially towards the tail-end of this year / beginning of next year. Finally, emergence of mega projects like DHAs (Karachi, Multan, Peshawar etc.) and Bahria Towns (Karachi, Lahore, Islamabad etc.) will provide a much needed push to demand from the retail sector.

Figure: Increasing per capita income & infrastructure spending

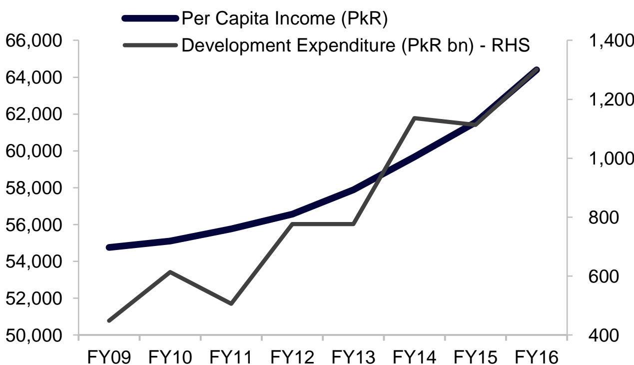
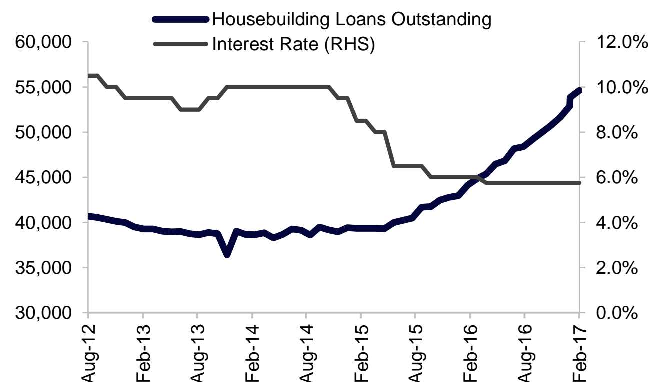


Figure: Housebuilding loans increase as interest rates declined



Source: FCEL Research, Pakistan Economic Survey & State Bank of Pakistan

Mughal, historically, has been mainly focused towards commercial projects but lately, the focus on the retail has been increasing with introduction of Mughal Supreme, which is mainly focused towards retail customers. Hence, a mixture of commercial and retail demand looks set to pick up further with Mughal in a perfect position to reap the benefits.

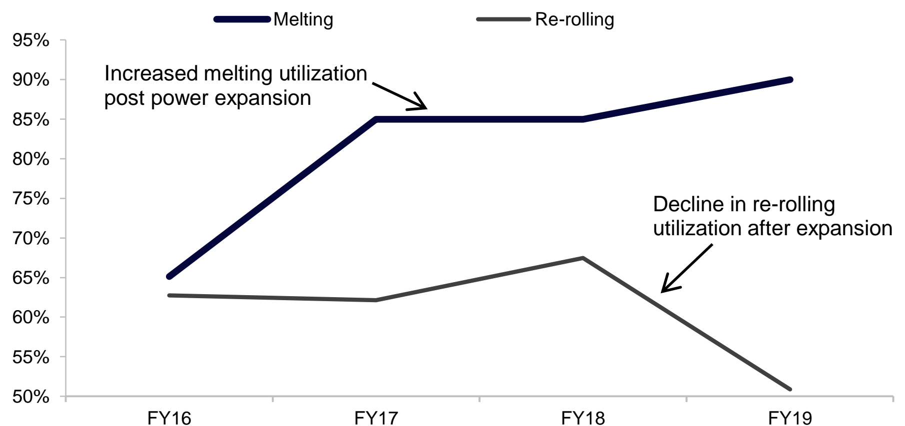
Improving power supply to be margin accretive

Margin accretion with improving power supply and billet substitution.

Billet substitution is of paramount importance…

Power has been constantly weighing on Mughal's capacity utilization. To recall, increasing the load capacity of grid was a part of Mughal's plan when it went for the IPO as the available grid capacity was not able to fulfill the power requirement, but even after several rounds of negotiations with the authorities, the issue still stands unresolved, resulting in capacity utilization of 63% in FY16. Lately, after getting the approval from authorities for increment in the allocated gas supply from 1.8mmcfd to 2.8mmcfd, Mughal has taken a step towards addressing power constraints by announcing capacity enhancement of gas power plant; taking the plant's capacity from 9.3MW to 27.9MW. The move will result in substitution of imported billets as the idle furnaces come online providing a cost benefit of approximately PkR6500/ton.

Figure: Mughal's capacity utilization against available capacity

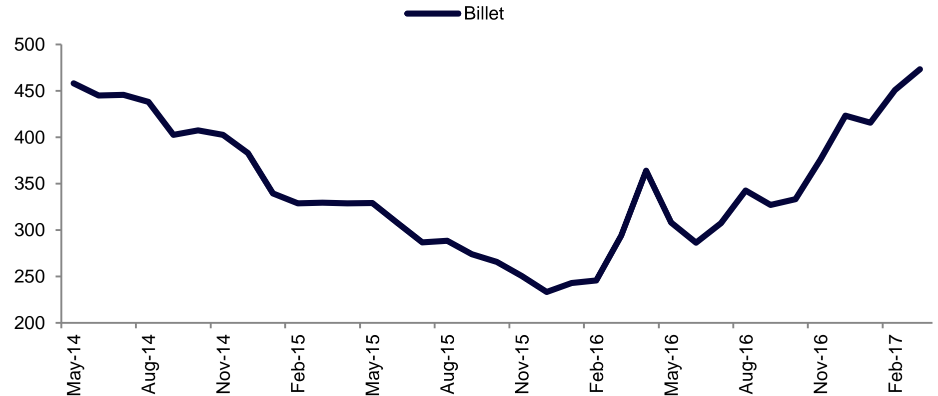


Source: FCEL Research & Company Accounts

…as international billet prices increase

With the commodity prices rebounding after having seen their lows in CY16, billet prices have jumped 43.5% since Mar-16, mainly on the back of increasing scrap prices, iron ore and coal. Mughal, currently having a gap of 132ktons between its available re-rolling and melting capacity (including the leased furnaces), relies on imported billets to cover the shortfall. With the current pricing dynamics, the margins get extremely squeezed with the use of imported billets thus making them unfeasible (current landed price of billet stands around PkR72k/ton while average market prices of rebar stand at PkR79k/ton).

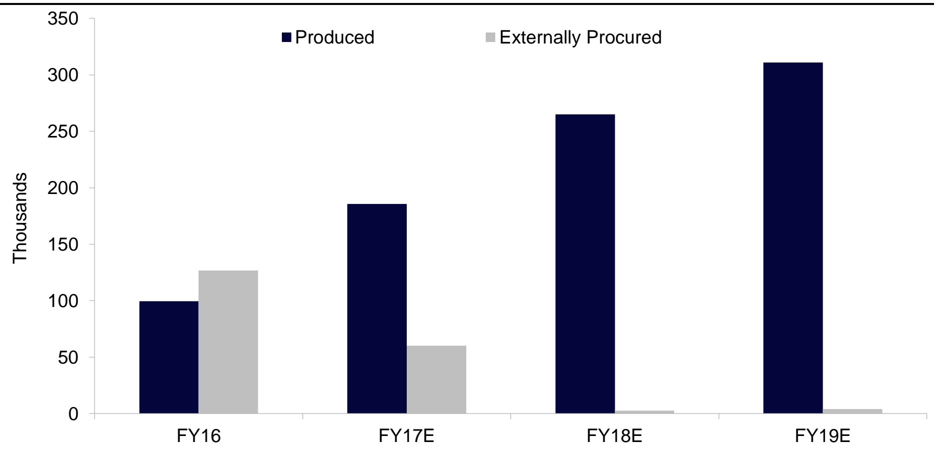
Figure: Recovering prices of Chinese billets (USD/ton)



Source: FCEL Research & Bloomberg

To counter the negative effect on margins, Mughal is increasingly working towards minimizing the use of external billets and the move to lease two furnaces with a combined capacity of 96ktons is expected to provide respite, moving forward. The operational lease agreement is for two years where Mughal has to pay a minimal cost of PkR12mn/year while all the operating expenses are to be borne by Mughal. We expect billet prices to sustain the current levels in near future as China's conviction for capacity cuts increases, going forward, thus making it essential for Mughal to continue working on elimination of reliance on external billets. Every 1k billets produced in-house result in an incremental EPS of PKR0.1/share.

Figure: In house billet use vs. imported use



Source: FCEL Research & Company Accounts

Custom Duty	5%
Regulatory Duty	15%

Duty structure of billets

Anti-dumping duty on billets: An investigation by NTC on imports of Chinese billets is currently underway and we believe that the decision will be out soon. NTC had already calculated a dumping margin of 32.73% on import of Chinese billets in the preliminary determination. A duty on billet can be marginally negative for Mughal. Assuming the entire billet shortfall being met by imports, we expect a PkR450/ton decrease in margin for every 1% increase in duty over billets while an imposition of ~32.73% duty will result in EPS impact: PKR0.2/PKR0.4 in FY18F/FY19F.

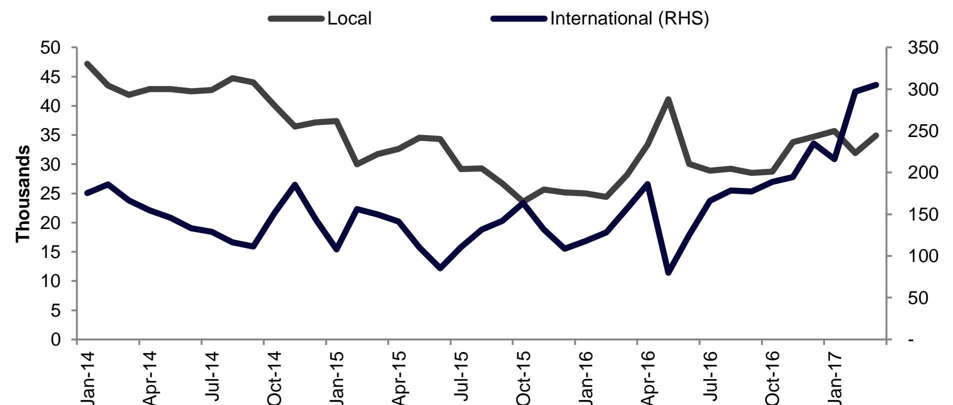
Downward stickiness of prices is a cause for concern

Lack of pricing power with the manufacturers remains a key concern.

Rebar prices in the local industry have historically tracked the landed cost of imported Chinese rebar, but after the recovery in prices of Chinese Rebar (up 43.4% since Mar-16), local prices have failed to register the same increase as the construct of the industry does not allow players the power to increase prices at their will. This has affected the margins of Mughal as the gross margins went down to 8.5% in 2QFY17 from previous 12% in 1QFY17.

Recently, local rebar prices have finally passed on the impact of increase in scrap prices as prices have gone up from 2QFY17's average of PkR73000/ton to PkR79000/ton currently, providing some respite to local manufacturers. Moving forward, we believe, that the landed price of imported rebar at approximately PkR94000/ton leaves ample room for a further price increase in case of another spike in scrap prices. However, the low pricing power of the manufacturers will continue to be an obstacle.

Figure: Rebar-scrap spreads



Source: FCEL Research & Bloomberg

Scrap prices to remain strong

Scrap is the primary input for the production of billets. The scrap used by big players like Mughal is imported as the locally produced scrap does not yield high quality which leaves the current players open to volatility risk in international scrap prices. Scrap prices witnessed their 12-yr low of USD169/ton in Oct-15 but since then have started recovering (up 43% since Feb-16).

Although the recent spike from Oct-16 to Mar-17 proved to be short-lived, which was a result of rising coal and iron ore prices, we expect the scrap prices to maintain their high ground in medium term on the back of increasing conviction coming out of China for capacity cuts while international demand is also expected to remain upbeat. We term this situation uncomfortable considering the pricing dynamics of the local industry.

Figure: Scrap prices returning after the recent spike

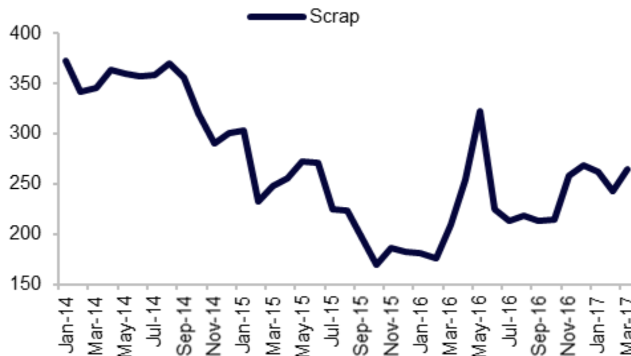


Figure: EPS Sensitivity to Scrap prices and local rebar prices for FY18F

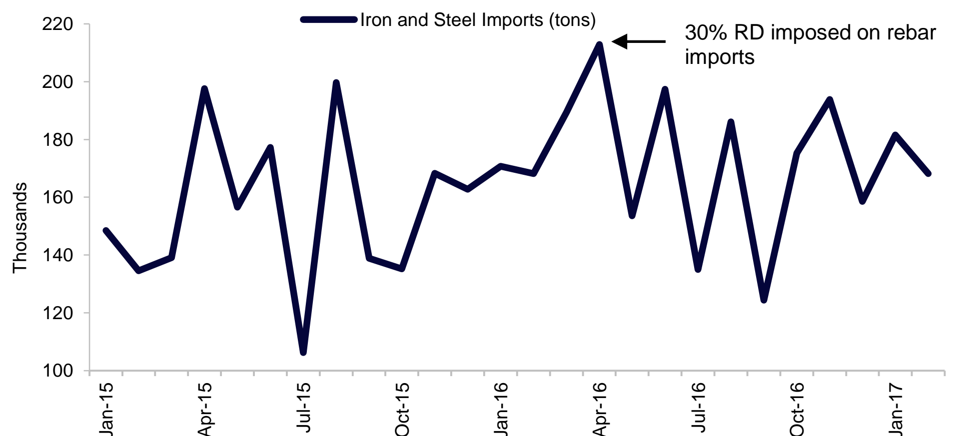
Local Rebar Prices (PkR/ton)	Scrap Prices (USD/ton)		
	247	252	257
77,040	5.3	4.8	4.4
79,040	6.1	5.6	5.2
81,040	6.9	6.4	6.0

Source: FCEL Research & Bloomberg

Anti-dumping duty on rebar will further increase our conviction

Chinese imports have always been a big threat to local manufacturers. Local manufacturers find it hard to compete with low-cost Chinese manufacturers hence the local volumes and prices have suffered immensely in the past. After repeated appeals, government imposed a regulatory duty of 15% on import of rebars and later increased it to 30% in Mar-16. Although the current prices of Chinese rebar have abated the risk of imports as the landed price comes out at approximately PkR94k/ton, higher than local prices of PkR79k/ton, the risk of Chinese dumping has led National Tariff Commission (NTC) to initiate an investigation over Chinese dumping of rebars after local manufacturers filed for the same. Our industry sources are expecting the duty of around 40% to be imposed on Chinese Rebar. If imposed, the duty, in our view, will be significantly positive for local manufacturers as (1) prices can be increased resulting in improved margins, and (2) elimination of Chinese imports resulting in further augmented demand for the locally produced.

Figure: Iron & steel imports posting a declining trend after imposition of RD



Source: FCEL Research & PBS

Key risks

Scrap and billet prices: With high sensitivity towards scrap prices, variation in scrap prices poses a significant amount of risk to Mughal. Moreover, with the current pricing dynamics in play, any unforeseen spike in scrap prices will erode margins of Mughal

Duty structure: Local industry relies heavily on the protectionism provided by the government. Any adverse change in the duty structure will be negative for the local producers, leaving them exposed to low cost Chinese producers.

Power supply: Power supply still remains a big concern for Mughal, and our conviction for Mughal stem on the outlook of improving power supply. Any sustained disruption in power supply, going forward, will significantly impact our valuations.

Exchange Rate risk: Mughal imports bulk of its scrap which exposes the company to the foreign exchange movement. A significant depreciation of Pakistani rupee can hamper the margins of the company.

Economic Risk: The whole theme surrounding uptick in steel demand is based on healthy economic growth. Any unfortunate event, disturbing the positive sentiment surrounding the economy, will have a negative impact on Mughal as well.

Key Ratios (PkR/sh)	FY14	FY15	FY16	FY17F	FY18F	FY19F
EPS	1.56	2.87	3.24	3.99	5.64	9.48
DPS	0.00	0.00	1.50	2.00	2.00	3.25
BVS	5.27	14.47	16.83	27.00	30.64	36.87
PER(x)	44.26	24.07	21.28	17.29	12.24	7.28
Dividend Yield(%)	0%	0%	2%	3%	3%	5%
P/B(x)	13.09	4.77	4.10	2.56	2.25	1.87
Earnings Growth(%)	207%	84%	13%	23%	41%	68%
Operating Profit Margins	12%	9%	9%	9%	11%	14%
Net Profit Margin	7%	6%	4%	6%	7%	9%
EBITDA Margins	7%	7%	7%	7%	7%	7%
Income Statement						
Net Sales	5,857	12,241	18,983	18,197	20,720	25,661
Gross Profit	793	1,356	2,059	2,015	2,722	4,165
Operating profit	688	1,151	1,695	1,575	2,222	3,555
Other Income – Net	5.0	14.8	47.4	53.5	140.5	160.3
EBITDA	693	1,166	1,742	1,775	2,523	3,871
Profit Before Tax	399	725	1,215	1,224	2,027	3,407
Net Profit	392	721	816	1,004	1,419	2,385
Balance Sheet (PkR mn)						
Current Assets	4,189	8,164	7,852	8,745	9,464	11,062
Long Term Assets	2,884	3,306	3,928	4,648	5,362	5,326
Total Assets	7,074	11,470	11,780	13,393	14,826	16,387
Current Liabilities	3,618	6,812	5,862	5,891	6,409	6,403
Non-Current Liabilities	2,129	1,015	1,683	709	709	709
Total Liabilities	5,747	7,827	7,545	6,601	7,118	7,112
Total Equity	1,326	3,642	4,235	6,792	7,708	9,275
Cash Flow						
CF from Operations	(1,849.1)	1,170.1	(806.6)	(422.8)	1,106.4	1,614.9
CF from Investing	(516.8)	(512.4)	(622.5)	(866.2)	(875.0)	(119.5)
CF from Financing	2,379.3	(1,093.8)	864.3	1,043.1	(238.3)	(1,317.7)
Net Change in Cash	13.4	(436.0)	(564.8)	(245.9)	(6.9)	177.6
Cash & Cash Equivalents	117.3	450.3	576.1	330.2	323.3	500.9

Source: FCEL Research & Company Accounts

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Buy	Total stock return > 15%
Neutral	Total stock return between 0% - 15%
Sell	Total Stock return < 0%

* Total stock return = capital gains + dividend yield

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To arrive at our period end target prices, First Capital Equities Limited uses different valuation methodologies including but not limited to:

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)