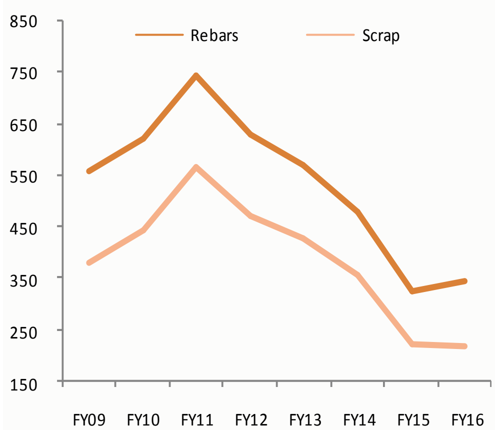
STEEL INDUSTRY OF PAKISTAN

Dec 28th, 2016

Fig: 1 **Master Plan Of Steel Mill Township, Karachi**

Source: Herald/Dawn, Nael Research

Historical Prices (USD/ton)



Source: Company Accounts, Nael Research

VIBRANT GROWTH PROSPECTS AMIDST CHALLANEGES

Initiation and establishment of the industry

Pakistan is amongst the various underdeveloped countries and still in it's developing phase. The political instability of the country and uncertain law and order situation has always dented the industrialization and development significantly. The steel sector plays a vital role in the infrastructure development of the country but unfortunately our nation has been deprived of a large scale and outpacing steel sector ever since. As reported by **Pakistan Steel Melters Association,** the initial idea for the domestic iron and steel industry was put forward in the first five year plan (1955—1960) of Pakistan but the first feasibility for having a domestic iron and steel industry was approved eleven years later in 1971 in the form of "Pakistan Steel Mill" when the GOP of the time took seriously that continuous imports of iron and steel will drastically hurt the fiscal deficit of the country.

Later, in December 1973 with due techno-assistance of USSR the foundation stone was laid for the Pakistan Steel Mills Corporation (Pvt.) Ltd. in South East of Karachi in close proximity to Port Qasim. The production capacity of Pakistan Steel Mills was expandable upto 3 Million Metric Tons per annum. This kick started the industrialization phase and sooner more private companies came into existence standing as competitors to the largest capacity of Pakistan.

The smoothly operating PSM (which was solely producing around more than 1 MT tons of the country's total steel output) could not survive long due to negligence & mismanagement of the executives. On June 10th 2015, the tandems of the huge capacity of PSM abruptly ceased operations owing to gas supply cut by SSGC on account of its un cleared dues of approximately PKR 35bn.

The unanimous production halts and difficulties PSM faced let the competitors i.e. MUGHAL, ASTL, ISL and etc. reap its market share although the capacities of these listed companies are far less than the PSM.

Industry Overview

The steel sector is counted amongst the various sectors that contribute to the GDP of Pakistan significantly. As reported by SBP, the Pakistan steel industry produces ~ 6 million metric tons of steel annually which depicts the growth prospects of construction material sector. Likewise cements this industry is also dependent upon the infrastructure development and "PSDB (Public Sector Development Budgets)".

The steel sector of Pakistan has always been subject to various challenges and therefore could not reap margins like other businesses. Our industry materially relies on steel scrap (imported) which is why the imports lead to squeeze out the margins as exchange rate parity applies. The alternative source for steel scrap is the ship-breaking yard of Gadani which is facing many challenges already and due to its downfall our steel industry substantially relies on imports only.

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WORLD STEEL RANKING 2016

Rank	Nation	Output (MnT)
1	China	70.65
2	Japan	8.648
3	India	8.059
4	United States	6.748
5	Russia	6.012
6	South Korea	5.43
7	Germany	3.811
8	Turkey	2.729
9	Brazil	2.506
10	Ukraine	2.173

Source: seasi.com/SEASI, Nael Research

The dumping of steel in Pakistan by China & the Free — Trade Agreements have also materially injured the sector, as cheaply priced steel is dumped in Pakistan snatching the market share of the local producers. Alongside this drastic issue that we face in our domestic market our exports are deteriorating too as China i.e. the largest producer and consumer of steel & other metallurgies of the world has captured the foreign markets as well. The rankings for the production output clearly indicates the huge gap between China and several other nations ranked as top 10. Even the 2nd top producer of Steel in the world i.e. Japan is way below (-717%↓) in comparison to China.

This outlier put forward the extreme competitive advantage strategy and barrier for new entrants in the global market China has shaped.

Product Portfolio of the Industry

The Pakistan Steel Industry supplies steel in a diversified product mix inclusive of Billets, Re-bars, Galvanized Steel, HoT & Cold Rolled Coils and etc.

PRODUCT PORTFOLIO OF THE STEEL INDUSTRY

Sr. No.	Finished Products	Unsorted Products	By - Products
1	Billets	HR	Pig Iron
2	Re-bars	CR	Hard Coke
3	Hot Rolled	GP	-
4	Cold Rolled	-	-
5	Galvanized	-	-

Source: Pak Steel, Nael Research

NAEL CAPITAL

MUGHAL IRON & STEEL (MUGHAL)

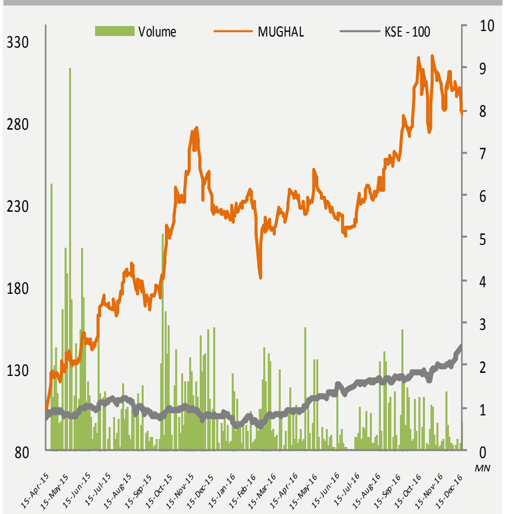
BUY

Price Target : PKR 113/sh

COMPANY DATA	
52-week Price Range (PKR)	99.59—57.88
No. of Shares Outstanding (mn)	125.80
P/B (x)	1.95
EV/Ebitda (x)	7.18
Market Cap (PKRmn)	10,787
Market Cap (USDmn)	102.91
Free Float (%)	24 %
Year End	Jun
KATS Code	MUGHAL

Source: KSE

RELATIVE TO KSE—100



Source: PSX, Nael Research

- **We initiate our coverage on MUGHAL with 'BUY' rating:** Our Jun-17 DCF based price target of PKR 113/sh implies 32% upside potential from current price levels of PKR 85/sh.

- **Demand room due to materialization of CPEC:** MUGHAL currently operates at capacity utilization of 75% for its rolling mill and 64% for the melt-shop respectively (FY16). This implies a room for uptick in capacity utilization owing to

  I) Increase in demand of billets and re-bars.

  II) Pending CPEC projects to be materialized in the near future.

- **Price uptick & Variations :**

  I) Regulatory Duty replaced from 15% to 30% on re-bars..

  III) Upsurge in steel prices post Gadani incident

- **Re—Commencement of 9.3MW Gas Power plant:** Mughal steel has a slightly diversified energy mix as the company uses power from internal generation from its 9.3MW Gas power plant.

  I) We have incorporated the impact of the 9.3MW Gas fired power plant in our model at a lower utilization level.

  II) This can add up to PKR 2.25/sh in the earnings of the company in FY17E annualized.

- **Conversion of Bar Mill into Tandem & Installation of induction furnaces**: Successfully this year MUGHAL was able to modify its bar mill converting it into a tandem mill which would charge in further efficiencies as tandem allows rolling in one pass...

- **Investment Risk:** Key risks to our investment thesis are 1) Price volatility 2) Surge in steel scrap prices 3) Decline in local demand 4) FTA with China & 5) Privatization of PSM .

FINANCIAL HIGHLIGHTS

	FY17	FY18	FY19	FY20	FY21
EPS	11.86	12.39	15.26	15.67	15.45
BV/sh	43.95	51.38	61.14	70.24	79.63
P/Ex	7.23	6.92	5.62	5.47	5.55
DPS	5.00	5.00	5.50	6.50	6.00
EBITDA/sh	20.5	20.2	24.3	24.9	24.5
EBITDA Margin (%)	12%	11%	12%	12%	11%
ROA	18%	18%	19%	18%	16%
ROE	29%	26%	26%	23%	20%
Gross Margin (%)	14%	13%	14%	13%	12%
Net Profit Margin (%)	7%	7%	8%	7%	7%

Source: Company Accounts, NAEL Research

Figure: A **PT Sensitivity**

		Risk free rate				
		6.8	7.3	7.8	8.3	8.8
Growth rate %	2%	99	94	89	84	80
	3%	112	106	100	94	89
	4%	129	121	**113**	106	100
	5%	152	141	131	122	114
	6%	185	169	155	143	133

Source: Nael Research

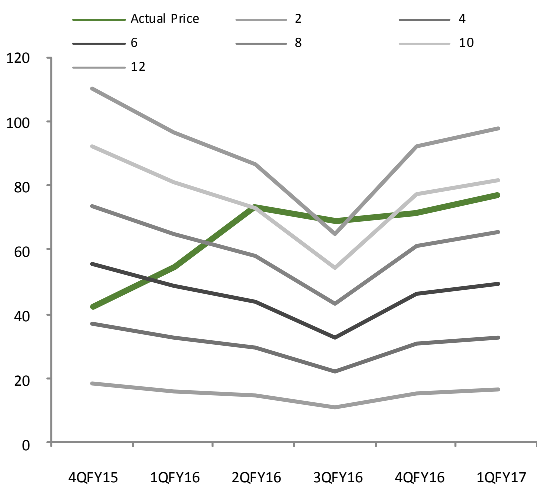
Valuation

We initiate our coverage on MUGHAL with '**BUY'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of MUGHAL at PKR 113/sh. The following assumptions have been incorporated to arrive at our target price.

- Terminal growth rate of 4%
- Risk free rate of 7.8% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 1.17 (using 1yr)

Based on above assumptions, MUGHAL's Jun-17 PT is reckoned at PKR 113/share, offering material upside potential of 32% from the LDCP & Dividend Yield (%) of 5.8%.

Figure: B **MUGHAL: P/Ex Band Analysis**



Source: Nael Research

Valuation	FY17E	FY18E	FY19E	FY20E	FY21E
WACC	12%	11%	11%	11%	11%
FCFF	928	904	1,430	1,404	1,511
PV of FCFF	928	813	1,162	1,020	978
Debt	4,232	4,196	4,196	4,188	4,180
PV of FCFF	4,901				
Terminal Value	20,982				
PV of Terminal Value	13,580				
Enterprise Value	18,481				
PV of Debt	4,232				
Equity Value	14,249				
Target Price 06/30/2017	113				
Current Price	85				
Upside	32%				
# of shares	126				

Company Overview

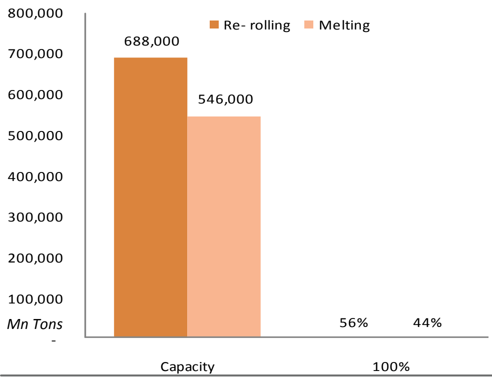
MUGHAL steel is a Lahore based company having its plant and factory in Shiekhupura District of Punjab. The entity got it self listed at PSX recently in 2015 after a successful IPO.

The company is specialized in producing billets, re-bars, hot -rolled steel and unsorted end cuts. In FY16A the company showed a growth of 13.4%YoY in comparison to FY15A reporting net profit of PKR 893mn. The net turnover of the firm grew by noteworthy 55% YoY in FY16A clocking in at PKR 12.24bn owing to outpacing local demand.

Alongside a significant growth in turnover MUGHAL also managed to retain its gross margins at stagnant 11% although price fluctuations in Steel Scrap were also witnessed in the international market. We observe MUGHAL as a strong participant of the industry owing to its significant capacity to produce 688k tons from its rolling mill and 546k tons from the melt-shop.

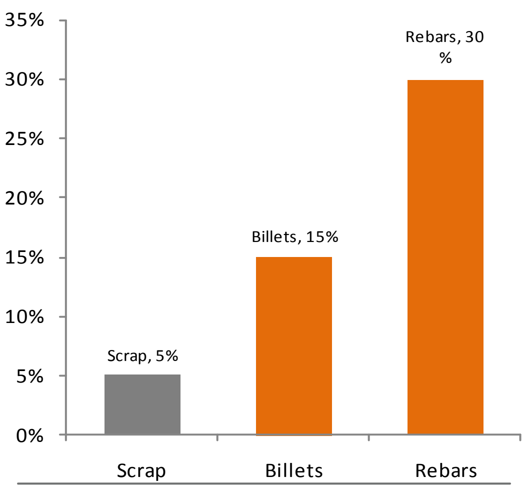
If the outlook for demand remains steady MUGHAL can efficiently utilize its capacity to cater the surging appetite of consumption of the steel in the country.

Fig: 1.1 **Total Plant Capacity**



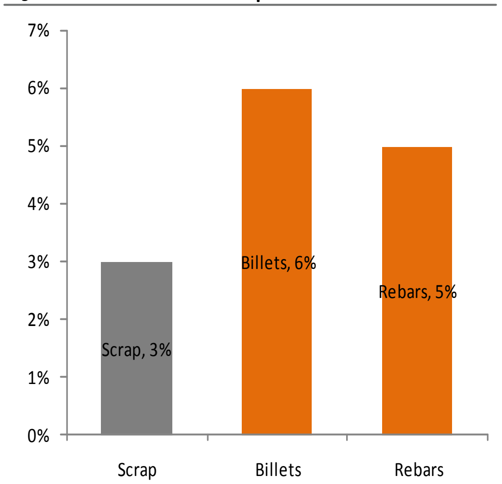
Source: Company Accounts, Nael Research

Fig: 2 **RD Composition**



Source: Industry Sources, Nael Research

Fig: 3 **CD Composition**



Source: Industry Sources, Nael Research

Investment Argument

Our investment view on MUGHAL is based on improving cost efficiencies and growth in earnings for FY17E-FY19E based on following fundamentals alongside a few risk factors and challenges the industry may face:

Demand room due to materialization of CPEC

MUGHAL currently operates at capacity utilization of 75% for its rolling mill and 64% for the melt-shop respectively (FY16A). This implies a room for uptick in capacity utilization owing to

- increase in demand of billets and re-bars
- the pending CPEC projects to be materialized

Based on current financials, we don't expect the company to plan any expansionary project soon.

Price uptick & variations

- **Anti—dumping Duty expected to be imposed on dumped steel/ Re– bars from China :**

Price variance is a key factor in the steel sector as margins are squeezed and even little fluctuations in the prices cause material impact on the earnings/margins. Recently NTC has took the plea for imposition of the anti—dumping duty on steel reinforcing bars (Rebars) and the decision is predicted to materialize in the near future. We assume that increasing the duty on imported steel will provide room for evolution of the domestic steel industry and might discourage the imports, creating positive grounds for major players inclusive of MUGHAL & ASTL.

Current structure of duties i.e. Regulatory Duty & Custom Duty levied on the steel products is displayed in Fig 2 & 3. (RD on rebars was 15% previously and now it has been increased to 30%)

- **Upsurge in re-bars prices post Gadani incident**

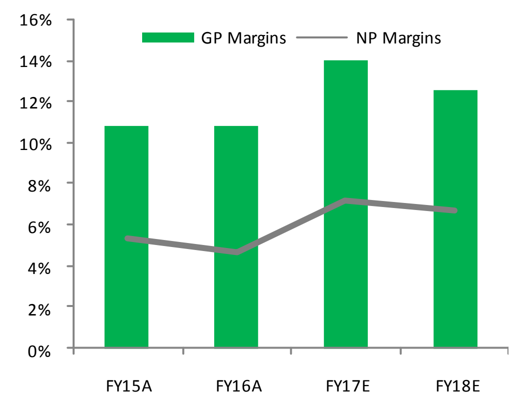
The ship-breaking yard at Gadani is considerably an alternative source of raw material for the Pakistan's steel industry in the form of scrap/billets. Recently, due to an incident at Gadani the commercial activities were ceased at the ship-breaking yard as fire blew post explosion in a ship which was being dismantled. The incident's impact was immediately witnessed by the industry as the steel prices surged upto ~ 15,000/ton post suspension of commercial activities at the ship breaking yard.

We expect this to stimulate the earnings and help the steel players to retain margins .

Price/ ton	Billets	Re-bars
Grade 60	-	73,000
Grade 6 & 7	74,000	-
Grade 9	75,000	-

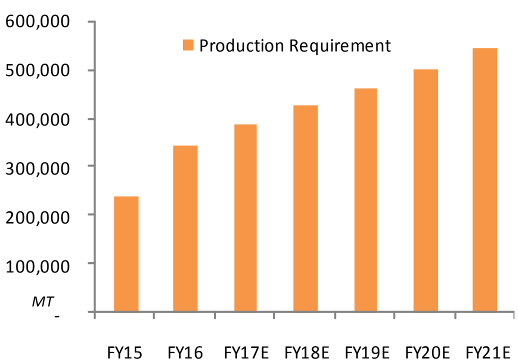
Source: Company Accounts/Pak Steel, Nael Research

Fig: 4 **Margins**



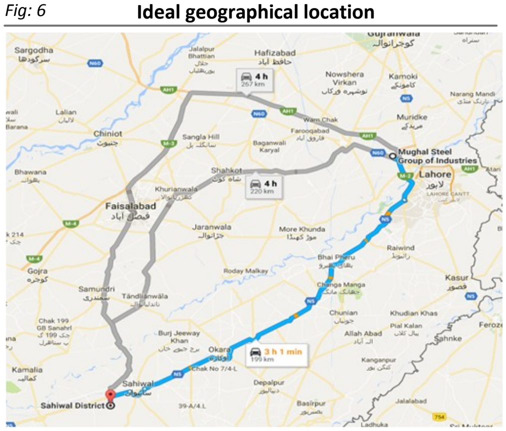
Source: Company's Account, Nael Research

Fig: 5 **Production Outlook**



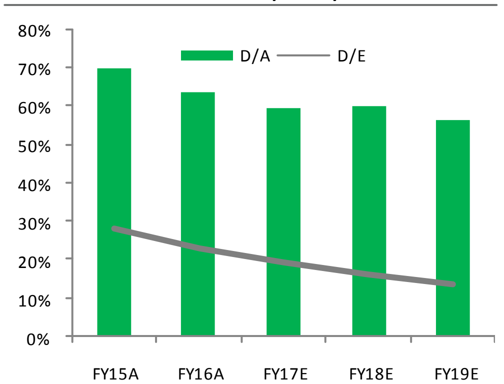
Source: Company Accounts, Nael Research

Fig: 6 **Ideal geographical location**



Source: Maps, Nael Research

Fig: 7 **MUGHAL's D/A & D/E**



Source: Company Accounts, Nael Research

- **<u>Re-commencement of 9.3MW Gas fired power plant</u>**

Mughal steel has a slightly diversified energy mix as the company uses power from internal generation from its 9.3MW Gas power plant along side the grid to lit the electric furnace. Recently, through a notice the firm announced that their gas fired power plant has started commencing operations again. This gas fired power plant was un-operational previously due to non-availability of gas in the vicinity of the plant and factory.

However, being skeptical and conservative we have incorporated the impact of the 9.3MW Gas fired power plant in our model at a lower utilization level. We believe that re-commencement and continuous operations can add up to PKR 2.25/sh in the earnings of the company in FY17E (annualized) pulling the gross margins up to 14% in FY17E from 11% of FY16A .

New coal gasification plant to act as an energy alternative:

The company has invested in procurement of the first ever coal gasification power plant in the country. Once the Coal gasification plant comes online MUGHAL will be able to produce clean syngas from the plant which could be used as an alternative of natural gas (the availability of which is an issue in the region where the plant lies) in the heating process.

The company has already incurred the CAPEX in this regard but not declared the time frame yet as to when the plant shall be procured and start commencing operations, therefore we have not incorporated its impact in our model.

- **<u>The Sahiwal Coal Power Project</u>**

The Mughal Iron & Steel's plant lies at a distance of 17Km from the Shiekhupura road in Lahore. The ideal geo-graphical position has given MUGHAL an advantage to supply steel bars to the New Sahiwal Coal Power Project which is under construction at Sahiwal just 3 hours away by road from Shiekhupura's plant location (Refer Figure.6).

This project is supposed to add up to the company's turnover somehow as its 2nd phase is to start up soon this year.

- **<u>Conversion of Bar Mill into Tandem & Installation of induction furnaces</u>**

Successfully this year MUGHAL was able to modify its bar mill converting it into a tandem which would charge in further efficiencies as tandem allows rolling in one pass unlike an old rolling mill in which rolling is done in several passes.

The old girder mill was also modified into direct rolling through proper installation of induction furnaces. The new "Direct Rolling" will enable the company to produce the girder directly from scrap and thus save the energy and production cost as re-heating furnaces for re-heating billets would not be needed.

Projected Profit & Loss

PKR 'mn'	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Net Sales	12,241	18,983	20,711	22,978	24,658	26,969	29,266
Cost Of Sales	10,915	16,925	17,797	20,083	21,256	23,493	25,861
GP	1,326	2,059	2,914	2,896	3,402	3,476	3,405
Distribution Expense	62	95	104	115	124	135	147
Admin. Expenses	160	208	247	277	291	323	350
Other Income	15	47	30	37	79	111	155
Other Expenses	45	87	155	149	185	189	190
EBIT	1,074	1,717	2,439	2,391	2,882	2,940	2,873
Finance Cost	440	425	277	196	178	164	136
PBT	634	1,292	2,162	2,195	2,703	2,776	2,737
Taxation	(25)	399	670	637	784	805	794
Tax Rate %	-4%	31%	31%	29%	29%	29%	29%
PAT	659	893	1,492	1,559	1,919	1,971	1,943
EPS	6.26	7.10	11.86	12.39	15.26	15.67	15.45

Source: Company Accounts, Nael Research

Projected Balance Sheet

PKR 'mn'	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Assets							
Current Assets	8,113	7,852	8,110	8,818	9,917	11,031	12,361
Total Non Current Assets	3,354	3,928	4,179	4,547	4,727	5,016	5,137
Total Assets	**11,467**	**11,780**	**12,290**	**13,365**	**14,644**	**16,047**	**17,499**
Liabilities							
Current Liabilities	6,812	5,862	5,503	5,643	5,695	5,953	6,224
Total Non-Current Liabilities	1,250	1,683	1,689	1,694	1,694	1,686	1,678
Total Liabilities	8,062	7,545	7,192	7,337	7,389	7,639	7,902
Equity							
Authorized Share Capital	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Reserves & Paid-up Capital	3,405	4,235	5,098	6,028	7,255	8,408	9,597
Total Equity & Liabilties	**11,467**	**11,780**	**12,290**	**13,365**	**14,644**	**16,047**	**17,499**

Source: Company Accounts, Nael Research

NAEL CAPITAL

AMRELI STEELS LIMITED (ASTL)

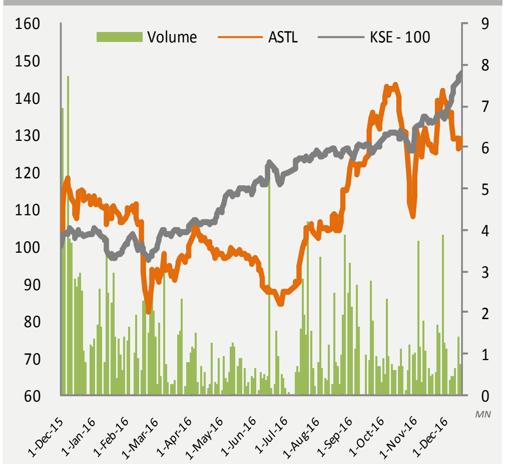
BUY

Price Target : PKR 84.40/sh

COMPANY DATA	
52-week Price Range (PKR)	76.92—44.21
No. of Shares Outstanding (mn)	297.01
P/B (x)	2.12
EV/Ebitda (x)	12.9
Market Cap (PKRmn)	19,977
Market Cap (USDmn)	190.5
Free Float (%)	25 %
Year End	Jun
KATS Code	ASTL

Source: KSE

RELATIVE TO KSE—100



Source: PSX, Nael Research

- **We initiate our coverage on ASTL with 'BUY' rating:** Our Jun-17 DCF based price target of PKR 84.4/sh implies 25% upside potential from current price levels of PKR 67/sh.
- **Robust turnover growth on account of demand boom:** We envisage ASTL amongst the major beneficiaries to reap benefits from the demand boom in the industry post expansion, owing to;
  1. Urbanization leading to increased infrastructure development
  2. Higher utilization of PSDB (Public Sector Development Budget)
  3. Manifestation of CPEC.
- **New 100% Equity Financed Rolling Capacity at Dhabeji:** The current position of the industry proposes vibrant growth prospects as infrastructural development is at its peak. To create further room to produce and cater the demand ASTL is currently in the process of expanding its rolling mill capacity of Dhabeji by 300k tons & Melt Shop by 150k tons per annum …
- **Dhabeji's Plant proximity to Port—Qasim:** The Dhabeji Plant of the rolling capacity of ASTL which currently stands at 180k tons per annum enjoys the advantage of its closer proximity to the Port Muhammad Bin Qasim. The plant lies only 25.4km (38mins drive) away from Port Muhammad Bin Qasim...
- **Change in duties structure to add value:** … The change in the duty structure/anti-dumping imposition on re-bars will discourage imports of re-bars and will provide good selling grounds to our domestic producers including ASTL ...
- **Investment Risk:** Key risks to our investment thesis are 1) Further delays in expansion 2) Surge in steel scrap prices 3) Decline in local demand 4) FTA with China & 5) Privatization of PSM .

FINANCIAL HIGHLIGHTS

	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	4.29	8.55	9.98	11.18	11.19
DPS	2.00	4.50	4.50	5.00	5.00
P/Ex	15.73	7.90	6.76	6.04	6.03
BV/sh	32.74	41.69	48.17	55.58	61.68
EBITDA/sh	8.00	14.12	16.32	18.10	18.20
EBIDTA Margin (%)	18%	26%	25%	25%	23%
ROA	16%	21%	20%	18%	16%
ROE	13%	24%	24%	23%	21%
Gross Margin (%)	19%	29%	28%	28%	25%
Net Profit Margin (%)	10%	16%	16%	16%	14%

Source: Company Accounts, Nael Research

Figure: A **PT Sensitivity**

		Risk free rate				
		6.8	7.3	7.8	8.3	8.8
Growth rate %	2%	81	77	74	71	68
	3%	86	82	79	75	72
	4%	94	89	**84**	80	77
	5%	103	96	91	87	82
	6%	114	107	100	94	89

Source: Nael Research

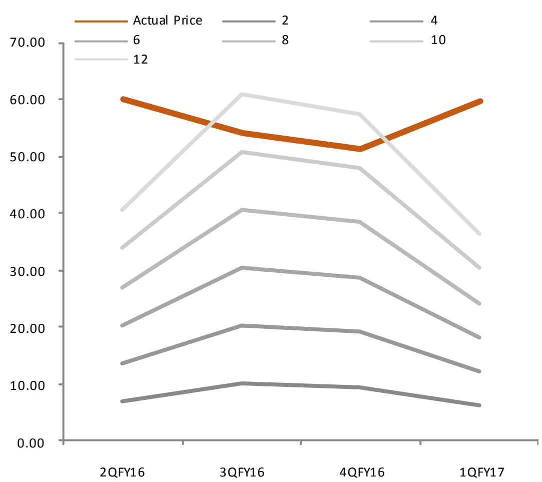
Valuation

We initiate our coverage on ASTL with '**BUY'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Equity methodology to derive the intrinsic value of ASTL at PKR 84.4/sh. The following assumptions have been incorporated to arrive at our target price.

- Terminal growth rate of 4%
- Risk free rate of 7.8% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 1.08 (using 1yr)

Based on above assumptions, ASTL's Jun-17 PT is reckoned at PKR 84.4/share, offering 25% upside potential from the LDCP and DY(%) of 2.98%.

Figure: B **MUGHAL: P/Ex Band Analysis**



Source: Nael Research

Valuation	FY17E	FY18E	FY19E	FY20E	FY21E
PV of FCFE	277	1,974	1,911	1,821	1,742
Cost Of Equity	14%	14%	14%	14%	14%
PV of FCFE	7,448				
Terminal Value	30,054				
PV of Terminal Value	17,621				
Equity Value	25,068				
Target Price 6/30/2017	**84.40**				
Current Price	67.00				
Upside	25%				
# of shares	297.01				

Source: Company Accounts, Nael Research

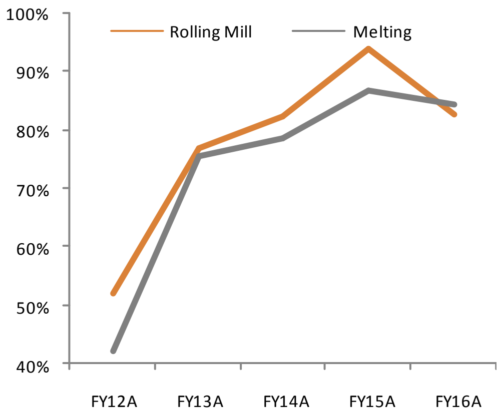
Company Overview

ASTL is a Karachi based steel company having its plant & factory located in the vicinity of Dhabeji, Thatta & Site Industrial area of Karachi. The company is one of the largest manufacturers of steel re-enforcement bars aka (Rebars) in the steel sector of Pakistan.

Previously being a private limited company, ASTL recently got itself listed on the Stock Exchange of Pakistan via successful IPO. The company reported a profit of PKR 1.2bn in FY16A depicting a growth of 26%YoY in comparison to the previous financial year despite a sharp decline in the revenues of the company by -14%YoY.

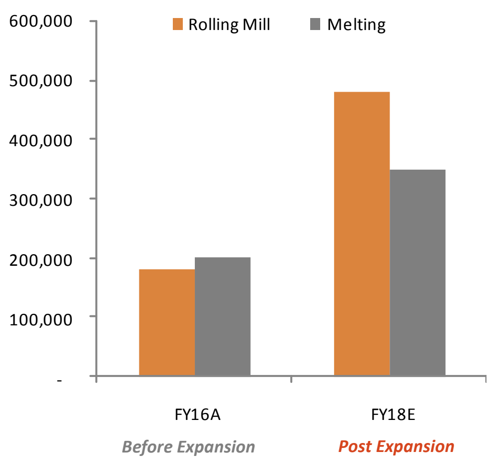
The decline in the sales of the company was mainly attributable to a decline in the volumetric sales as well as the price of re-bars. The cheap imported re-bars hurt the market share of ASTL as buyers turned down being a little price concerned and ASTL had to slash its prices to regain its market share, which the company efficiently and effectively did.

Fig: 1.1 **Capacity Utilization Levels**



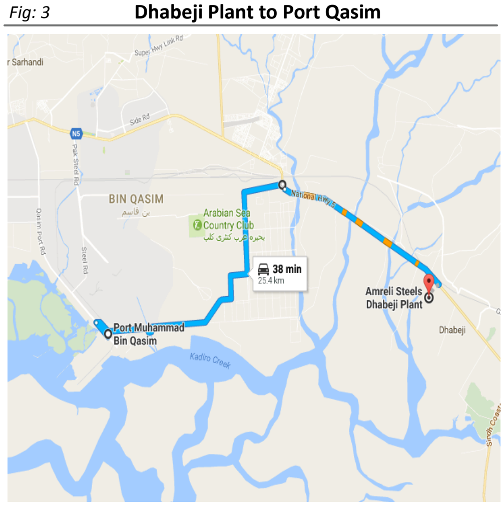
Source: Company Accounts, Nael Research

Fig: 2 **Plant Capacity**



Source: Company Accounts, Nael Research

Fig: 3 **Dhabeji Plant to Port Qasim**



Source: GoogleMaps, Nael Research

Investment Argument

Our investment view on ASTL is based on improving margins and growth in earnings for FY18E-FY21E owing to mentioned fundamentals and factors:

Robust turnover growth on account of demand boom

ASTL currently operates at a capacity utilization of 83% for its rolling mill and 84% for its melting capacity respectively (FY16A) which prompts an alert for further growth expectations with the current capacity. We envisage ASTL amongst the major beneficiaries to reap benefits from the demand boom in the industry post expansion, owing to:

1. Urbanization leading to increased infrastructure development
2. Higher utilization of PSDB (Public Sector Development Budget)
3. Manifestation of CPEC

ASTL is currently in the process of expanding its Dhabeji rolling capacity and billet manufacturing capacity to maintain market share and stay as an active participant of the industry, the new rolling capacity is expected to come online by the 2nd quarter of FY18E.

New 100% Equity Financed Rolling Capacity at Dhabeji

The current position of the industry proposes vibrant growth prospects as infrastructural development is at its peak. To create further room to produce and cater the demand ASTL is currently in the process of expanding its rolling mill capacity of Dhabeji by 300,000 tons & Melt Shop by 150,000 tons per annum. The said project of the rolling capacity is 100 percent equity financed and costs around PKR 3.4bn i.e. 11.4/ sh. The new expansion will take the current rolling capacity to 480,000 tons per annum.

As reported by the company, the plant is expected to come online from 2nd quarter of FY18E, therefore we have incorporated its impact in our model from the said quarter of FY18E. Once the plant is operational we expect the revenues to grow 48% CAGR (FY17E-FY19E).

- **Dhabeji's Plant proximity to Port—Qasim**

The Dhabeji Plant of the rolling capacity of ASTL which currently stands at 180k tons per annum enjoys the advantage of its closer proximity to the Port Muhammad Bin Qasim. The plant lies only 25.4km (38mins drive) away from Port Muhammad Bin Qasim.

As the whole industry inclusive of ASTL is solely relying on the imports of RM i.e. scrap the distance of ASTL to Port Qasim adds value to the company in regards of freight—in cost efficiencies. Although it is known that this may not add a material impact on the transportation expenses of the company but will some how benefit in terms of efficiencies the company achieve via timely and quick supply of RM form the port to the plant.

- **Imposition of Anti-dumping: Investigation in process by NTC**

As mentioned earlier, NTC has taken the plea of levying Anti—dumping on imported re-bars. The change in the duty structure will discourage imports of steel products from China and will provide good selling grounds to our domestic producers specially ASTL i.e. one of the largest re-bars manufacturer.

Projected Profit & Loss

PKR 'mn'	FY15A	FY16A	FY17E	FY18E	FY19E	FY20E	FY21E
Net Sales	14,414	12,400	12,908	15,890	19,043	21,384	23,671
Cost Of Sales	11,899	9,608	10,395	11,262	13,651	15,302	17,686
GP	2,514	2,792	2,514	4,628	5,392	6,082	5,984
Distribution Expense	229	216	131	185	208	247	215
Admin. Expenses	281	341	209	299	333	402	345
Other Income	35	15	16	20	24	27	29
Other Expenses	100	165	164	323	384	443	409
EBIT	1,940	2,085	2,026	3,840	4,491	5,016	5,044
Finance Cost	668	336	205	214	257	274	309
PBT	1,272	1,749	1,820	3,626	4,234	4,742	4,735
Taxation	261	470	546	1,088	1,270	1,422	1,411
Tax Rate %	20%	27%	30%	30%	30%	30%	30%
PAT	1,011	1,279	1,274	2,539	2,964	3,319	3,324
EPS	4.54	4.31	4.29	8.55	9.98	11.18	11.19

Source: Company Accounts, Nael Research

Projected Balance Sheet

PKR 'mn'	FY15A	FY16A	FY17E	FY18E	FY19E	FY20E	FY21E
Total Current Assets	4,589	8,150	8,094	11,846	15,083	18,020	20,835
Total Non Current Assets	7,674	8,615	7,954	7,662	7,372	7,061	6,735
Total Assets	**12,262**	**16,765**	**16,048**	**19,508**	**22,455**	**25,081**	**27,570**
Current Liabilities	4,236	4,339	3,355	4,157	5,180	5,602	6,280
Total Non-Current Liabilities	4,074	3,566	3,152	4,608	4,906	5,275	5,247
Total Liabilities	8,310	7,905	6,507	8,765	10,085	10,877	11,527
Equity							
Authorized Share Capital	500	500	500	500	500	500	500
Reserves & Paid-up Capital	3,952	8,861	9,541	10,743	12,370	14,204	16,043
Total Equity & Liabilities	**12,262**	**16,765**	**16,048**	**19,508**	**22,455**	**25,081**	**27,570**

Source: Company Accounts, Nael Research

NAEL CAPITAL

INTERNATIONAL STEELS LIMITED (ISL)

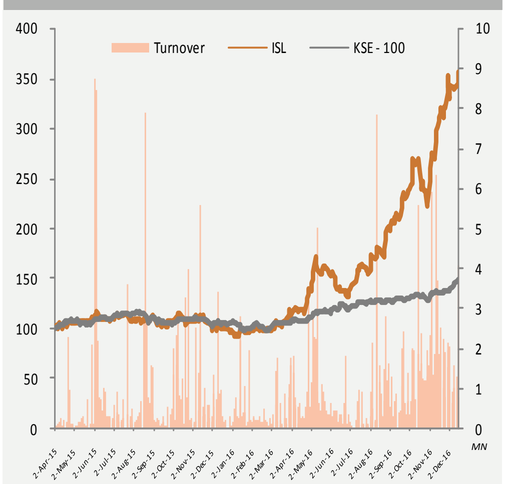
BUY

Price Target : PKR 123/sh

COMPANY DATA	
52-week Price Range (PKR)	96.66—23.34
No. of Shares Outstanding (mn)	435
P/B (x)	4.38
EV/Ebitda (x)	11.3
Market Cap (PKRmn)	42,738.7
Market Cap (USDmn)	407.7
Free Float (%)	40 %
Year End	Jun
KATS Code	ISL

Source: KSE

RELATIVE TO KSE—100



Source: PSX, Nael Research

- **We initiate our coverage on ISL with 'BUY' rating:** Our Jun-17 DCF based price target of PKR 123/sh implies 27% upside potential from current price levels of PKR 97/sh.

- **Under-utilized Capacity after expansion to break the streak:** Recently, after the successful expansion of the company's galvanizing capacity from 150k tons per annum to 462k tons per annum (+208% Addition) and Cold Rolled Steel capacity to 550k tons per annum from 250k tons (+120% Addition) in FY16A..

  1. **Going concern auto industry pulling CRC demand :** … surge in auto production units can pull up the demand for CRC (Cold Rolled Steel) as it is consumed as a major RM by the auto industry. (Refer Fig. 1.2 on Pg. 14)

- **Penetrating into a new export region i.e Indonesia:** … ISL recently penetrated into another export region as reported in the recent interim report of the company. Besides South Africa and Middle East, ISL now export to 'Indonesia' as well.

- **Revision of duties on Cold Rolled & Galvanizing Steel** The free—trade agreement (FTA) with china is crucially damaging the local industry and its producers. The company has already pledged to NTC for the revision of duty structure on Cold Rolled Steel and Galvanizing Steel …

- **Debt Structure:** The firm has an ideal debt/equity structure as weightage for debt is 36% and the rest is equity. Although, this also pops an alert for the investors if in near future the Discount rate % hikes.

- **Investment Risk:** Key risks to our investment thesis are 1) Price volatility of HRC & CRC 2) Surge in steel scrap prices 3) Decline in local demand/ Demise of the Automobile Industry 4) FTA with China & 5) Surge in discount rate.

FINANCIAL HIGHLIGHTS

	FY17E	FY18E	FY19E	FY20E	FY21E
EPS	6.67	7.43	9.91	11.71	13.46
BV/sh	22.5	23.4	25.7	29.6	35.8
P/Ex	14.77	13.26	9.94	8.41	7.32
DPS	3.00	3.25	4.50	5.25	6.25
EBITDA/sh	12.9	13.9	17.3	19.7	21.9
EBITDA Margin (%)	21%	19%	21%	21%	21%
ROA	23%	23%	28%	29%	28%
ROE	37%	34%	36%	35%	33%
Gross Margin (%)	20%	18%	21%	21%	21%
Net Profit Margin (%)	11%	10%	12%	12%	13%

Source: Company Accounts, NAEL Research

Figure: A **PT Sensitivity**

		Risk free rate				
		6.8	7.3	7.8	8.3	8.8
Growth rate %	2%	112	105	100	94	89
	3%	125	117	110	104	98
	4%	142	132	123	116	108
	5%	165	152	140	130	122
	6%	196	178	163	150	139

Source: Nael Research

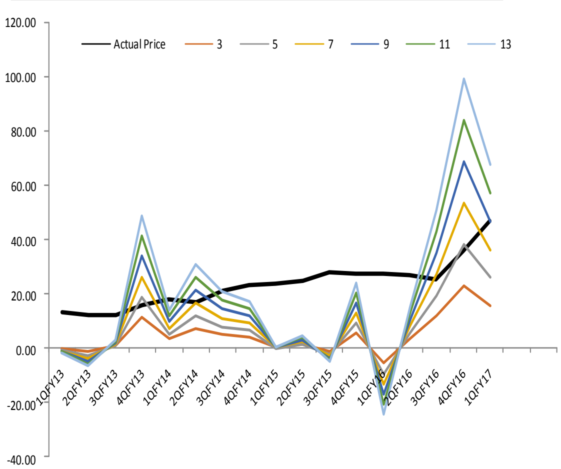
Valuation

We initiate our coverage on ISL with '**BUY**' recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of ISL at PKR 123/sh. The following assumptions have been incorporated to arrive at our target price.

- Terminal growth rate of 4%
- Risk free rate of 7.8% (10yr PIB)
- Market Risk Premium of 6% & Beta of 0.83 (using 5yr)

Based on above assumptions, ISL's Jun-17 PT is anticipated at PKR 123/share, offering 27% upside potential from the LDCP and DY(%) of 3%.

ISL: P/Ex Band Analysis

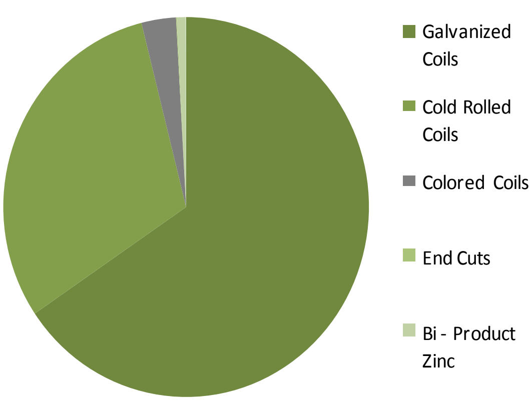


Source: Company Accounts, Nael Research

Valuation	FY17E	FY18E	FY19E	FY20E	FY21E
WACC	10%	10%	11%	12%	12%
FCFF	2,193	3,198	4,406	4,899	5,843
PV of FCFF	2,193	2,899	3,578	3,530	3,710
Debt	10,312	8,655	6,719	4,872	3,230
PV of FCFF	15,910				
Terminal Value	75,704				
PV of Terminal Value	48,065				
Ent. Value	63,975				
PV of Debt	10,312				
Equity Value	53,663				
Target Price 6/30/2017	**123**				
Current Price	97				
Upside	27%				
# of shares	435				

Source: Company Accounts, Nael Research

Fig: 3 **Product Portfolio**



Source: Company Accounts, Nael Research

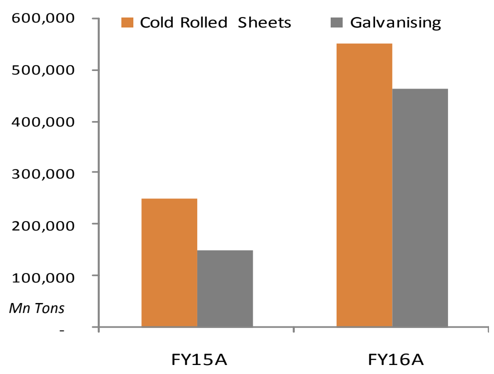
Company Overview

International Steels Limited is a Karachi based company having its plant and factory in Landhi Industrial Area, Karachi. The firm is specialized in the production of Hot & Cold Rolled Coils and Galvanized Steel. ISL is a subsidiary of International Industries Limited (INIL) and the first and only company in Pakistan that manufacture Color Coated Steel in the country.

The Financial Year of 2016 turned out to be extremely fruitful for the company as the firm extensively outperformed in terms of margins and profitability. Although globally the steel prices tightened but yet ISL managed to maintain its turnover growth alongside showing a robust growth in the earnings by 483%YoY that clocked at PKR 1.17bn in FY16A.

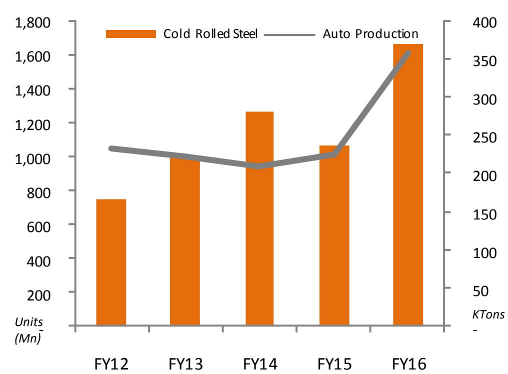
The GP margins of ISL almost doubled surging to 14% from 8% of FY15A, whereas the net profit margins propelled to 6% in FY16A against 1% of the previous year (FY15A). We eye International Steels Limited as the top participant in the industry which is expected to increase its market share with its diversified product portfolio and best quality.

Fig: 1.1 **Total Plant Capacity**



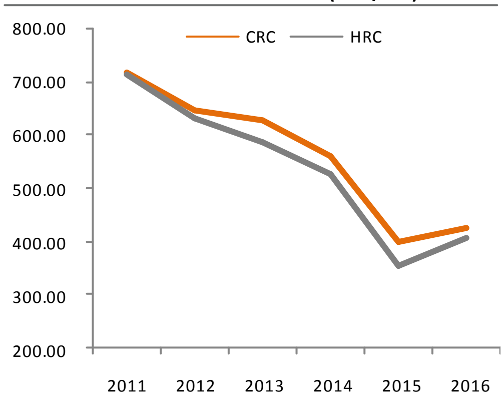
Source: Company Accounts, Nael Research

Fig: 1.2 **Cold Rolled Steel Vs. Auto Production Units**



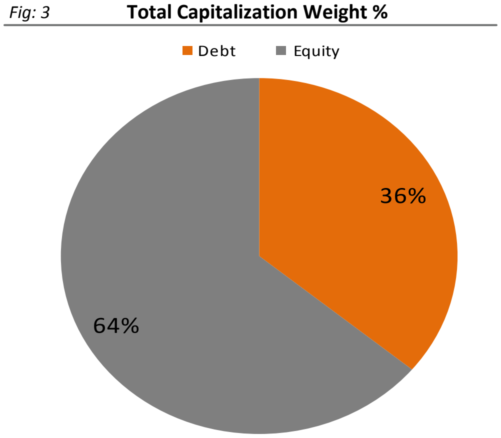
Source: Company Accounts, Nael Research

Fig: 2 **HRC & CRC Price Trend (USD/ton)**



Source: Bloomberg, Nael Research

Fig: 3 **Total Capitalization Weight %**



Source: Company Accounts, Nael Research

Investment Argument

Our investment view on ISL is based on the company's significant growth in margins and earnings & the capacity expansions that will add value:

Under-utilized Capacity after expansion to break the streak

Recently, after the successful expansion of the company's galvanizing capacity from 150k tons per annum to 462k tons per annum (+208% Addition) and Cold Rolled Steel capacity to 550k tons per annum from 250k tons per annum (+120% Addition) in FY16A, we expect that the company has sufficient unutilized capacity which can add up immense value in terms of turnover through the surging demand.

1. ISL is currently operating at a plant utilization of 67% and 55% for its Rolling and Galvanizing Capacity Respectively. The Hot dip galvanized steel (HDGS) holds almost 61% of the company's total product portfolio concentration being the most sold product of the company, whereas CRC (Cold Rolled Coils) holds ~ 33% as it is the second most sold product of the company.

2. The capacity additions in the similar lines can bode well, catering the demand boom created by growing economy on account of urbanization and CPEC (China Pakistan Economic Corridor) whereas surge in auto production units can pull up the demand for CRC (Cold Rolled Steel) as it is consumed as a major RM by the auto sector. (Refer Fig. 1.2)

- **Penetrating into a new export region i.e Indonesia**

ISL is amongst those manufacturers in Pakistan which has a good export footprint globally. Despite the challenges every local producer faces in exports having China as the leader of the market on account of its surplus capacity, ISL recently penetrated into another export region as reported in the recent interim report of the company. Besides South Africa and Middle East, ISL now exports to 'Indonesia' as well.

- **Revision of duties on Cold Rolled Coils & Galvanizing Steel**

The free—trade agreement (FTA) with china is crucially damaging the local industry and its producers. The company has already pledged to NTC for the revision of duty structure on Cold Rolled Steel and Galvanizing Steel. The decision is still withheld by NTC and the award is not issued as yet.

The firm is expecting a preliminary relief on galvanized sheets and coils, once the decision is finalized for the duties on galvanized steel and CRC.

Refer Fig. 2 which depicts the price trend of HRC i.e. used as a raw material in producing CRC. The prices of both HRC & CRC touched a low of USD 355/ton and USD 399/ton respectively in 2015. The prices seem to be stabilize nearer to USD 450/ton in FY17E and if they remain within this range ISL will have a positive impact on its earnings.

- **Debt Structure**

The firm has an ideal debt/equity structure as weightage for debt is 36% and the rest is equity. Although, this also pops an alert for the investors if in near future the Discount rate % hikes.

Currently the discount rate % hovers around 5.75% on account of which the interest burden currently is mild.

Projected Profit & Loss

PKR 'mn'	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Net Sales	17,938	20,499	27,196	31,853	36,256	41,342	46,364
Cost Of Sales	16,453	17,586	21,856	26,002	28,787	32,837	36,775
GP	1,485	2,913	5,339	5,851	7,469	8,505	9,589
Distribution Expense	168	161	109	144	170	149	168
Admin. Expenses	168	207	192	219	244	219	243
Other Income	137	106	129	140	157	178	208
Other Expenses	22	265	372	455	632	753	891
EBIT	1,264	2,386	4,795	5,174	6,580	7,563	8,494
Finance Cost	1,028	732	710	622	506	388	245
PBT	236	1,654	4,085	4,552	6,074	7,174	8,249
Taxation	34	476	1,185	1,320	1,761	2,081	2,392
Tax Rate %	14%	29%	29%	29%	29%	29%	29%
PAT	202	1,179	2,900	3,232	4,313	5,094	5,856
EPS	0.46	2.71	6.67	7.43	9.91	11.71	13.46

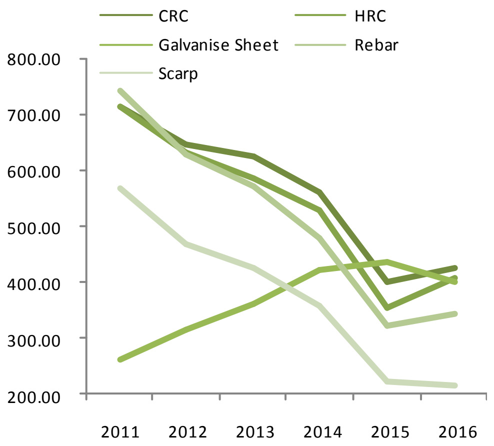
Source: Company Accounts, Nael Research

Projected Balance Sheet

PKR 'mn'	FY15	FY16	FY17E	FY18E	FY19E	FY20E	FY21E
Current Assets	6,742	8,364	12,789	14,048	15,558	17,733	20,649
Total Non Current Assets	12,333	12,620	13,174	13,031	12,842	12,678	12,298
Total Assets	**19,075**	**20,984**	**25,963**	**27,078**	**28,400**	**30,411**	**32,948**
Current Liabilities	7,412	8,961	11,838	12,544	12,882	13,167	13,030
Total Non-Current Liabilities	6,685	5,855	6,361	4,952	3,581	2,497	2,033
Total Liabilities	14,097	14,816	18,200	17,497	16,463	15,664	15,063
Equity							
Authorized Share Capital	5,000	5,000	5,000	5,000	5,000	5,000	5,000
Reserves & Paid-up Capital	4,978	6,168	7,764	9,582	11,937	14,747	17,885
Total Equity & Liabilties	**19,075**	**20,984**	**25,963**	**27,078**	**28,400**	**30,411**	**32,948**

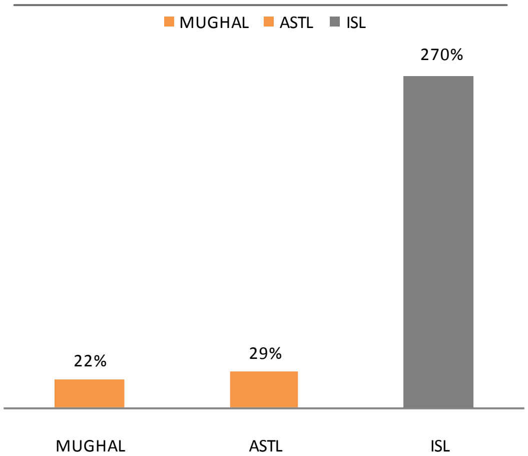
Source: Company Accounts, Nael Research

Steel Price Volatility (2011— 2016)



Source: Nael Research

Figure: B **Absolute Return % (Dec 15— Dec 16)**



Source: Nael Research

Key Risks

Price volatility of steel prices

Price volatility remains a downside risk to our target price owing to past trends seen. Subject to fluctuations of international steel FG prices positive/negative impacts on the scrip's price target can be witnessed of any particular company as it creates panic amongst investors'.

Surge in international scrap prices

The subject companies are significantly dependent upon steel scrap as it is the major RM consumed by our steel sector. Gross margins maintained and may erode with increase in scrap & iron ore prices. At macro level, current scenario support the companies where retail prices are kept constant and input prices are on bearish trend. The commodity super cycle poses a threat.

Decline in local demand & PSDB

The only driver of steel volumes under current scenario is supported by local demand. Likewise cement the exports of steel are also deteriorating as China and Ukraine has captured the export markets.

Our construction material industry relies on PSBD (Public Sector Development Budget), which notifies that decline in PSDB allocation can impact on the subject companies revenues.

Free—Trade Agreements with China

China has been dumping its steel in the form of scrap, re-bars and billets since ages. This has caused a material threat to the domestic producers. If this continues it proposes a direct threat to the local market and its players as margins are already squeezed.

Privatization of PSM & Re-commencement of Operations

The largest steel and iron capacity of Pakistan i.e. Pakistan Steel Mills which is at halt and not commencing operations since June 2015. The capacity is expandable up to 3 million metric tons and if by any means re—commence operations in the near future will hurt the turnover of MUGHAL, ASTL, ISL and etc. by reaping their market share.

Peer Comparison

Absolute Return %

On the basis of absolute return approach from Dec '15—Dec '16, we have witnessed that ISL has succeeded its two competitors i.e. MUGHAL & ASTL rigorously in terms of price gains from December 2015 to December 2016 showing a robust absolute return of 270%. (Refer Figure: B)

Our June'17E Price target of PKR 123/sh depicts ISL as our top pick in the sector currently.

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Disclosure Related to Author

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Stock Recommendation	Return
BUY	> 15%
HOLD	> -15% to < 15%
SELL	< -15%