January 20, 2017

Tata Sponge Iron Limited

Instrument*	Rated Amount (in crore)	Rating Action
Fund Based- Term Loan	304.35^	[ICRA]AA (Stable) reaffirmed
Fund Based- Cash Credit	110.00	[ICRA]AA (Stable) reaffirmed
Non-Fund Based Limits	313.15	[ICRA]A1+ reaffirmed

*Instrument details are provided in Annexure-1
^proposed

Rating Action

ICRA has reaffirmed the [ICRA]AA (pronounced ICRA double A) rating assigned to the Rs. 304.35 crore[1] proposed term loans and Rs. 110 crore fund based bank limits of Tata Sponge Iron Limited (TSIL)[2]. The outlook on the long term rating is stable. ICRA has also reaffirmed the [ICRA]A1+ (pronounced ICRA A one plus) rating assigned to the Rs. 313.15 crore non-fund based bank limits of TSIL.

Rationale

The reaffirmation of the ratings takes into account TSIL's highly conservative capital structure, its strong debt protection metrics and a comfortable liquidity position, given a large cash balance and liquid investment portfolio, which imparts a high degree of financial flexibility to the company. ICRA, however, notes the weak demand scenario for sponge iron in the country, which has resulted in a decline in sponge iron realization in FY2016 as well as in H1FY2017, thereby impacting the operating profits of the company. This impact has been checked to some extent by the benign raw material price scenario. However, sponge iron realisations have witnessed some improvement in recent months with the hardening of international scrap prices. ICRA notes that the industry outlook for the long product is unfavourable in the medium term, given the weak demand condition. The ratings continue to factor in the uncertainty pertaining to the amount and timeliness of compensation to be received by TSIL, following the de-allocation of the Radhikapur East coal block, which is adversely impacting its overall business returns. ICRA notes that TSIL is exposed to significant project-related risks, though the same is at a nascent stage at present, given that it has large capital expenditure plans relative to its current balance sheet size. Going forward, ICRA would continue to monitor the performance of the company from its core sponge iron operations, which remains exposed to the cyclicality inherent in the steel industry as well as any significant changes in prices of imported non-coking coal and fluctuation in exchange rate, which make its cash flows and margins volatile.

The ratings, however, continue to reflect TSIL's established position in the sponge-iron industry, its status as a 54.5% subsidiary of Tata Steel Limited (TSL) and its strong operating profile characterised by superior quality of produce that allows the company to command a premium over prevailing market rates. The ratings are also supported by the presence of captive power generation facilities that reduce TSIL's operational costs. Income from sale of power and returns on investments provide additional sources of revenue, which are relatively more stable than the cash flow from the commodity sponge iron operations.

[1] 100 lakh = 1 crore = 10 million
[2] For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications.

Key rating drivers

Credit Strengths

- Strong financial risk profile
- Efficient cost of production of sponge iron
- Sale of power and investment income provides some stability to cash flows
- Status as a subsidiary of TSL

Credit Weakness

- Adverse market conditions have kept turnover and profitability under pressure in FY2016 and H1FY2017; unfavourable industry outlook in the near term, given the weakness in demand conditions in the long product segment
- Exposure to cyclicality inherent in the steel industry
- Partial exposure to forex-related risk due to import of coal
- Large capital expenditure plans, though at a nascent stage at present

Description of key rating drivers highlighted above:

High capacity utilisation despite a weak market scenario; revenue from sale of power plant supported profits

TSIL has a long track record in the sponge-iron business, with an annual capacity of 390,000 tonnes per annum (tpa). The company has two power plants based on waste heat generated from the kilns with a combined generation capacity of 26 MW, which ensure availability of power at a low cost. The company usually maintained a high level of capacity utilisation in the past. However, capacity utilisation declined in FY2016 on account of a temporary shutdown of one of its kilns having an annual capacity of 1,20,000 tpa for repair and maintenance. However, capacity utilisation has improved thereafter in the current year to 101% in H1FY2017 on an annualised basis.

Consequent to the increase in the production of sponge iron, and therefore, higher availability of waste gas from the kilns, the company was able to generate more units of power in H1FY2017 compared to the previous year. The average PLF increased to 83% in H1FY2017 from 72% in FY2016. After meeting its internal requirements, the company exports surplus power, which accounted for around 10% of the operating income in H1FY2017 and provided an additional source of revenue. Nevertheless, a major part of the company's revenues come from the sponge iron sales, which accounted for around 90% of the OI during H1FY2017. Although the average realisations for sponge iron had declined for the company during the current year, in line with that of the industry, the company still commanded a premium over market averages, given the superior quality of the product produced by the company.

Exposure to changes in prices of imported non- coking coal as well as fluctuations in the exchange rate

TSIL had coal linkage from various subsidiaries of Coal India Limited, which was discontinued during 2011-12. This led to TSIL meeting its coal requirements from e-auctions and imports of non-coking coal. Use of high quality international coal resulted in a decline in specific consumption of coal and hence helped lower costs. This has been negated to an extent with the increase in international non-coking coal prices. ICRA, however, notes that 100% reliance on imported coal exposes TSIL's profitability to fluctuations in international non-coking coal prices as well as fluctuations in USD-INR exchange rate, although a defined hedging policy mitigates forex risks to an extent.

In order to improve its raw material security, TSIL had taken steps towards integrating backwardly into captive coal mining. The company was earlier allocated the Radhikapur (East) coal block with reserves of around 115 million tonnes. ICRA notes that there is uncertainty pertaining to the amount and timeliness of compensation to be received by TSIL, following the de- allocation of the Radhikapur East coal block, which is adversely impacting its overall business returns.

Decline in turnover and profitability in recent years due to the sluggish demand leading to weak sponge iron realisations; notwithstanding the improvement in performance in the current year.

The capacity utilisation of TSIL's kilns declined to 92% during FY2016 on account of a temporary shutdown of one of its kilns, which resulted in a decline in production and sales volumes. This coupled with a declining trend in sponge iron realisations resulted in decline in revenue from sponge iron sales during FY2016. Consequent to decline in production of sponge iron, the company was able to generate and sell lower units of power, thereby resulting in lower revenue from the power business. However, in the current year, with the repaired kiln, capacity utilisation has increased to 101% in H1FY2017.

Operating margins registered a significant decline in FY2016 to 4% on account of decline in sponge iron realisations as well as a one-time inventory write-off taken by the company on account of declining raw material prices. The margins have subsequently improved to 10% in the current year. The net profits of the company were supported by non-operating income from its investments. The net profit margin for TSIL has followed the trend in operating margins. Going forward, the profitability of the company remains susceptible to fluctuation in sponge iron realisations as well as international non-coking coal prices.

Healthy accretion to reserves and debt free status impart significant financial flexibility
TSIL has remained a debt-free company in the past couple of years. This acts as a credit positive for the company that operates in an industry exhibiting cyclical trends. TSIL's conservative capital structure has translated into strong debt protection metrics for the company as also reflected by OPBDITA/Interest & Financial charges of 22.4 times during H1FY2017. ICRA notes that the current debt free status imparts a high degree of financial flexibility to the company. ICRA also notes that TSIL is exposed to significant project related risks, at a nascent stage at present because it has large debt-funded capital expenditure plans relative to its current balance sheet size.

Analytical approach: While reaffirming the rating, ICRA has looked at the consolidated performance of Tata Sponge Iron Ltd.

Links to applicable Criteria
Corporate Credit Rating –A Note on Methodology, Steel Methodology

About the Company:

TSIL was originally set up as a joint venture between Tata Steel Ltd. (TSL) and Industrial Promotion & Investment Corporation of Orissa Ltd. (IPICOL) in 1982. At present, TSIL is a 54.5% subsidiary of TSL. The company is one of the early entrants in the domestic sponge iron industry, with its plant located in Keonjhar district of Odisha. TSIL's sponge iron capacity is 390,000 metric tonnes per annum. The company is self sufficient in its power requirement, with a 26-MW captive power plant running on the waste heat gases produced in the sponge iron kiln.

Status of non-cooperation with previous CRA: Not Applicable

Any other information: Not Applicable

Rating History for last three years:

Table: Rating History

S.No	Name of Instrument	Current Rating			Chronology of Rating History for the past 3 years		
		Type	Rated amount (Rs. Crores)	Month-year & Rating	Month- year & Rating in FY2016	Month- year & Rating in FY2015	Month- year & Rating in FY2014
				January 2017	December 2015	December 2014	February 2014
1	Cash Credit	Long Term	110.00	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
2	Proposed Term Loan	Long Term	304.35	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
3	Non fund based Limits	Short Term	313.15	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

Complexity level of the rated instrument:
ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1

Details of Instrument

Name of the instrument	Date of issuance	Coupon rate	Maturity Date	Size of the issue (Rs. Cr)	Current Rating and Outlook
Proposed Term Loans	-	-	-	304.35	[ICRA]AA (Stable)
Cash Credit	-	-	-	110.00	[ICRA]AA (Stable)
Non fund based limits	-	-	-	313.15	[ICRA]A1+

Source: Tata Sponge Iron Limited

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About ICRA Limited:
ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.
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