Tata Sponge Iron Limited

December 24, 2018

Summary of rating action

Instrument**	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund Based – Proposed Term Loan	304.35	0.00	Revised from [ICRA]AA& to [ICRA]AA-/Stable; long-term rating is 'withdrawn'
Fund Based – Cash Credit	110.00	110.00	Downgraded to [ICRA]AA- from [ICRA]AA; removed from 'watch with developing implications', and 'Stable' outlook assigned
Non-Fund Based Limits	148.15	148.15	[ICRA]A1+ reaffirmed, and removed from 'watch with developing implications'
Commercial paper programme	-	4,000.00	[ICRA]A1+ assigned
Total	**562.50**	**4,258.15**	

**Instrument details are provided in Annexure-1; &: Under rating watch with developing implications

Rationale

The rating action factors in the Rs. 4,850 crore[1] proposed acquisition, on a slump sale basis, of the steel business of Usha Martin Limited (UML) by Tata Sponge Iron Limited (TSIL), which is quite large relative to TSIL's current scale of operations and its existing balance sheet size of Rs. 1,214.2 crore as on March 31, 2018. The proposed acquisition of the 1 million metric tonne per annum (MMTPA) steel plant at Jamshedpur would be part-funded by a mix of debt and equity and is likely to lead to a weakening of TSIL's capital structure and debt coverage indicators. Nevertheless, ICRA expects TSIL's overall gearing to remain at a comfortable level of ~0.9 times as on March 31, 2019, and total debt/OPBITDA to remain in the range of 2.5 - 3.1 times in the medium term. ICRA also notes that TSIL has hitherto remained a sponge iron and power producer, without any track record in steel-making. However, the support extended by the company's parent Tata Steel Limited (TSL, rated [ICRA]A1+ and Ba3 with a Positive outlook by Moody's), with a long track record in running a large steel business in India, provides comfort and is a strong mitigating factor.

The proposed acquisition will be part-funded by a mix of Rs. 1800-crore rights issue, fully underwritten by TSL, TSIL's existing cash balance of Rs. 673.8 crore outstanding as on September 30, 2018 and proposed long-term debt of up to Rs. 2500 crore, with an elongated maturity profile. ICRA expects TSIL's management to be able to secure such long-term funding before the maturity of the commercial paper (CP) programme, which is proposed to be used as a bridge finance for the acquisition. ICRA also takes comfort from the parent's committed financial support, and the Tata Steel Group's demonstrated ability to arrange for long-term funds at favourable terms.

ICRA understands that TSL has also earmarked an additional Rs. 1,000-crore capital for subscribing to the non-convertible redeemable preference shares (NCRPS) of TSIL, on a private placement basis, to fund the latter's future growth plans. The acquired asset seems has a strategic fit to the Tata Steel Group's product basket, broadening its offering in the fast-growing alloy steel long product segment[2] by catering to the specialised needs of end-user industries like automobile (especially M&HCV[3]), auto ancillary, tractor, railways, general engineering, defence, forging, construction and wire ropes,

[1] Includes registration charges
[2] In FY2018, consumption of alloy steel longs grew by 11.7% YoY, and in 7M FY2019, the same grew by a much sharper 45.5% YoY (Source: JPC)
[3] Medium and heavy commercial vehicles

among others. This apart, the proximity of the acquired plant to TSL's existing Jamshedpur steelmaking hub and the nearby captive iron ore mines stands to benefit TSIL, giving it access to TSL's global procurement channels, and lending it the added flexibility to supplement the plant's iron ore requirement with ore sourced from TSL's captive mines. This, in turn, is likely to reduce its external ore dependency.

UML's steel-manufacturing assets have a strong backward integration, which includes captive power plants with a capacity of up to 130-MW, an operational iron ore mine[4] (which can meet around 40% of the plant's ore requirement[5]), and a thermal coal mine[6] (under-development, which can feed the sponge iron and captive power plants[7]) along with a sinter plant, a pellet plant, a sponge iron kiln, a blast furnace, an electric arc furnace, wire rod and bar and bloom mills. ICRA notes that while UML reported net losses in the last five years, the steel business of UML has been profitable in the recent years at OPBITDA levels. The EBITDA from UML's steel business witnessed a sharp improvement from Rs. 5,569/MT in FY2018 to around Rs. 9,750/MT in H1 FY2019, largely supported by improving realisations. Given the vertical linkage, locational advantage and TSL's experience in the steel sector, ICRA expects the acquired business to remain profitable and contribute meaningfully to the overall turnover and profits of TSIL, going forward. Post takeover by the new management, in ICRA's view, potential savings from synergy benefits and higher asset sweating are expected to partly mitigate the downward pressure on margins, as steel prices moderate from the current year highs.

The ratings also continue to factor in TSIL's established position in the domestic sponge-iron industry and its strong operating profile, characterised by the superior quality of the produce, which commands a premium over the prevailing market rates. In addition, the presence of captive power generation facilities that help reduce operational costs of its existing business, is also a significant factor. Income from the 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. ICRA also notes the pick-up in domestic demand for sponge iron, which in turn has supported the buoyancy in sponge iron realisations during the ongoing cyclical upturn in the steel industry. This, along with higher sales volumes, led to an improvement in the company's operating profits in FY2018 and during H1 FY2019. However, higher input costs led to some contraction in the operating profit margin in H1 FY2019 to 18.9% from 22.8% in FY2018. The long-term rating is, however, constrained by the cyclicality associated with the steel industry, which leads to variability in the profits and cash accruals of all steel players.

The outstanding long-term rating on TSIL's proposed term loan facilities have been withdrawn at the request of the company, and confirmation that TSIL has not availed any amount against the rated facility.

Outlook: Stable

The Stable outlook reflects ICRA's expectation that TSIL would continue to benefit from its status as a Tata Steel Group company and potential synergies from the large acquisition. The outlook may be revised to Positive if there is a substantial improvement in TSIL's capital structure and debt coverage indicators. However, it may be revised to a Negative if there is a significant weakening in margins, leading to lower profits and cash accruals than expectations, or if there is any further major debt-funded capital expenditure undertaken by the company, which adversely impacts its capital structure and debt coverage indicators.

[4] The Vijay II captive iron ore mine is located within 150 km from UML's steel plant, and has a raw ore production capacity of 2.5 MMTPA (< 55% Fe) and a beneficiated ore production capacity of 1 MMTPA (62-64% Fe)

[5] Necessary clearances for the transfer of iron ore mining lease from UML to TSIL is a condition precedent to the deal

[6] The Brinda-Sasai coal mine has approx. 25.4 MT of reserves (largely G10 grade), and a peak rated production capacity of 0.68 MMTPA. The mine has been won through auctions at a premium of Rs. 1804/MT

[7] Necessary clearances for the transfer of coal mining lease from UML to TSIL is a condition precedent to the deal

Key rating drivers

Credit strengths

Status as a subsidiary of TSL with strategic importance – TSIL's status as a 54.5% subsidiary of TSL imparts considerable financial flexibility to the company. TSL would be supporting TSIL's inorganic expansion as it has identified TSIL as the strategic vehicle to focus on the long-products segment. TSL has communicated its intent in supporting TSIL for the upcoming rights issue, and has, in addition, earmarked an additional capital of Rs. 1,000-crore for subscription to TSIL's non-convertible redeemable preference shares (NCRPS), on a private placement basis, to fund the latter's future growth plans. TSL would also be providing management and operational support to TSIL, going forward. While TSIL has hitherto remained a sponge iron and power producer, without any track record of steel-making, ICRA derives comfort from TSL's long track record in running a large steel business in India.

Integrated and cost-efficient operations of the combined business – The acquired business comprises integrated upstream and downstream facilities such as sinter, pellet, DRI kiln, blast furnace, electric arc furnace, wire rod and bar and bloom mills, captive power plants, a captive iron ore mine and an underdeveloped coal mine. The integrated nature of its operations, the power cost savings and the access to Tata Steel's global procurement channels, is likely to favourably impact the cost structure of the combined entity. TSIL would be able to unlock synergies in the form of considerable savings in costs, tie-ups with reputed OEMs[8] in the automobile sector, higher asset sweating and increase in productivity, going forward.

Healthy operations and profitability of the existing business – TSIL has a long track record in the sponge-iron business, with an annual capacity of 425,000 tonne per annum (tpa). The company has received environmental clearance to enhance its capacity to 465,000 TPA in December 2018. The company has two power plants, based on waste heat generated from the kilns with a combined generation capacity of 26 MW, which ensure the availability of low cost power. Operating margins increased to 22.8% in FY2018 from 11.1% in FY2017 on account of an uptrend in sponge iron realisations. However, the operating margin contracted to 18.9% in H1 FY2019 due to a rise in input costs, notwithstanding an increase in sponge iron realisations. The net profitability of the company in H1 FY2019 was supported by the sale of power and non-operating income from its investments.

Credit challenges

Large growth plans relative to current balance sheet size exposes company to business and financing risks – TSIL's Rs. 4,850-crore inorganic growth plan in the form of the proposed acquisition of UML's steel business would be part-funded by equity through a Rs 1,800-crore rights issue, the issuance of non-convertible redeemable preference shares to TSL, up to Rs. 1,000-crore, an external borrowing of up to Rs. 2,500-crore in addition to its existing cash balance. The acquisition would expose the company to significant business risks going forward, given the large investment plans, relative to its current balance sheet size of Rs. 1,214.24 crore as on March 31, 2018. The proposed acquisition would also exert some pressure on the free cash flows, capital structure and coverage indicators in the medium term. However, the potential synergies arising from the deal would mitigate the same to an extent. The acquisition exposes TSIL to financing risks as well, however, the committed financial support from the parent, which had successfully carried out large acquisitions in the past, and the Tata Steel Group's demonstrated ability to arrange long-term funds at favourable terms, mitigates the funding risk to a large extent. TSL plans to increase its involvement in the management as well as board representation of TSIL, which, given TSL's experience in operating integrated steel plants, is a credit positive.

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[8] Original Equipment Manufacturers

Exposure to volatility in steel prices and exchange rate fluctuations – TSIL's profitability and cash flows are exposed to the cyclicality associated with the steel industry, which keeps margins of all players volatile. TSIL imports 95% of total non-coking coal requirements from South Africa. ICRA notes that high reliance on imported coal exposes TSIL's profitability to fluctuations in international non-coking coal prices as well as fluctuations in the USD-INR exchange rate.

Liquidity Position

TSIL enjoys considerable financial flexibility for being a part of the Tata Steel Group, which has the demonstrated ability to refinance debt at attractive terms, given its established relationship with banks. With the acquisition, TSIL's net working capital requirement is estimated to be ~Rs. 300 crore. ICRA notes that while TSIL has a liquidity buffer of Rs. 110 crore undrawn working capital limits at present, the company would be able to arrange for further working capital limits, given its established relationships with bankers. In addition, TSL has also earmarked an additional Rs. 1,000-crore capital for subscribing TSIL's NCRPS, on a private placement basis.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Ferrous Metals Industry
Parent/Group Support	Parent/Group Company: Tata Steel Limited (TSL) TSIL is a 54.5% subsidiary of TSL. TSL has communicated that it would provide management and operational support to TSIL for the acquisition of UML's steel business. TSL would be participating in the Rs. 1,800 crore rights issue and has also earmarked additional capital of Rs. 1,000 crore for subscription to the non-cumulative redeemable preference shares of TSIL.
Consolidation / Standalone	For arriving at the ratings, ICRA has ICRA has analysed TSIL on a standalone basis and has not factored in the performance of its subsidiary as it is yet to commence operations

About the company

Tata Sponge Iron Limited (TSIL) was originally set up as a joint venture between Tata Steel Limited (TSL) and Industrial Promotion & Investment Corporation of Orissa Limited (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 a plant in Keonjhar district of Odisha. TSIL's sponge iron capacity is 425,000 metric tonne per annum, which received environmental clearance for an enhanced capacity to 465,000 TPA in December 2018. The company is power-sufficient with a 26-MW captive power plant, which runs on the waste heat gases produced in the sponge iron kiln.

In FY2018, the company reported a net profit of Rs. 140.86 crore on an operating income of Rs. 800.52 crore compared to a net profit of Rs. 58.74 crore on an operating income of Rs. 557.60 crore in FY2017. In H1 FY2019, the company reported a net profit of Rs. 73.17 crore on an operating income of Rs. 477.15 crore.

Key financial indicators (audited)

	FY2017	FY2018	H1 FY2018	H1 FY2019
Operating Income (Rs. crore)	557.60	800.52	342.56	477.15
PAT (Rs. crore)	58.74	140.86	58.16	73.17
OPBDIT/ OI (%)	11.07%	22.83%	21.31%	18.88%
RoCE (%)	12.45%	27.71%		
Total Debt/ TNW (times)	-	-	-	-
Total Debt/ OPBDIT (times)	-	-	-	-
Interest coverage (times)	25.26	56.29	124.02	147.66

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years

		Current Rating (FY2019)					Chronology of Rating History for the past 3 years		
					Date & Rating	Date & Rating	Date & Rating in FY2018	Date & Rating in FY2017	Date & Rating in FY2016
	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs Crore)	Dec 2018	Nov 2018	Jan 2018	Jan 2017	Jan 2016
1	Fund Based – Proposed Term Loan	Long Term	0.00	0.00	[ICRA]AA- (Stable)* *(Withdrawn)*	[ICRA]AA&	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
2	Fund Based – Cash Credit	Long Term	110.00	0.00	[ICRA]AA- (Stable)	[ICRA]AA&	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
3	Non-Fund Based Limits	Short Term	148.15	0.00	[ICRA]A1+	[ICRA]A1+&	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+
4	Commercial paper programme^	Short Term	4,000.00	0.00	[ICRA]A1+	-	-	-	-

**: Rating withdrawn; ^ Proposed; &: Under rating watch with developing implications*

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: Instrument Details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Fund-based – Proposed Term Loan	NA	NA	NA	0.00	[ICRA]AA-(Stable)* (Withdrawn)
NA	Fund-based – Cash Credit	NA	NA	NA	110.00	[ICRA]AA-(Stable)
NA	Non-Fund Based Limits	NA	NA	NA	148.15	[ICRA]A1+
NA	Proposed Commercial Paper programme	NA	NA	NA	4,000.00	[ICRA]A1+

Source: Tata Sponge Iron Limited

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