Tata Sponge Iron Limited

November 01, 2018

Summary of Rated Instruments

Instrument	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund Based – Term Loan^	304.35	304.35	[ICRA]AA&; Placed under Rating Watch with developing implications
Fund Based – Cash Credit	110.00	110.00	[ICRA]AA&; Placed under Rating Watch with developing implications
Non-Fund Based Limits	313.15	148.15	[ICRA]A1+&; Placed under Rating Watch with developing implications
Total	**727.50**	**562.50**	

^Proposed

Material Event

Tata Sponge Iron Limited (TSIL) announced on October 24, 2018 that its Board of Directors has approved the acquisition of the steel business of Usha Martin Limited (UML) through a slump sale on a going concern basis. The company has also adopted a financing plan for the acquisition, whereby it would raise funds through a rights issue of up to Rs. 1,800 crore, external borrowings of up to Rs. 2,500 crore and issuance of non-convertible redeemable preference shares to Tata Steel Limited (TSL) of up to Rs. 1,000 crore, and also utilise its existing cash and cash equivalents.

Impact of the Material Event

ICRA has placed the long-term rating of [ICRA]AA (pronounced ICRA double A)[1], outstanding on the Rs. 304.35-crore[2] proposed term loan and the Rs. 110-crore fund-based working capital facilities, and the short-term rating of [ICRA]A1+ (pronounced ICRA A one plus), outstanding on the Rs. 148.15-crore (reduced from Rs. 313.15 crore) non-fund based facilities of TSIL, on rating watch with developing implications. ICRA will continue to monitor the developments in this regard and would take suitable rating action when more clarity emerges.

Rationale

The ratings have been placed under watch with developing implications on account of the company's proposed acquisition of UML's steel business through a slump sale. The transaction is expected to be completed in the next six to nine months. The acquired business comprises a ~1 million metric tonne per annum (MMTPA) alloy-based manufacturing capacity in the long products segment, DRI kilns, pellet and sinter plants, an operating iron-ore mine, a coal mine under development and captive power plants. The cash consideration for the transaction would be in the range of Rs. 4,300-4,700 crore, which is quite large relative to TSIL's balance sheet size of Rs. 1,214.24 crore as on March 31, 2018. This acquisition would be part funded by equity through a rights issue of up to Rs. 1,800 crore, issuance of non-convertible redeemable preference shares to TSL of up to Rs. 1,000 crore and external borrowings up to Rs. 2,500 crore. While TSIL is a debt free company at present, with substantial cash and liquid investments of ~Rs. 681.94 crore as on March 31, 2018, the impact of the acquisition on the company's revenue and profitability, capital structure and debt coverage indicators, post conclusion of the above transaction, would have a bearing on the company's credit profile.

[1] *For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications*

[2] *100 lakh = 1 crore = 10 million*

The ratings, however, continue to reflect TSIL's established position in the domestic sponge-iron industry, its status as a 54.5% subsidiary of TSL and its strong operating profile characterised by superior quality of produce, which commands 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. 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 a contraction in operating profit margin in H1 FY2019 to 18.9% from 22.8% in FY2018. The ratings, however, also continue to factor in the uncertainty pertaining to the amount and timeliness of compensation to be received by TSIL, following de-allocation of the Radhikapur East coal block by the Hon'ble Supreme Court.

The previous detailed rating rationale is available on the following link: Click here

Outlook: Rating Watch with Developing Implications

The ratings have been placed under watch with developing implications, given TSIL's proposed acquisition of UML's steel business through a slump sale. TSIL has executed a novation agreement with TSL and UML to acquire the latter's steel business. The closing of the acquisition would remain subject to execution of definitive agreements with TSIL and fulfilment of various conditions under the said agreements including regulatory approvals required for the transfer of the steel business. ICRA will continue to monitor the developments in this regard and will review the situation when more clarity emerges on matters pertaining to the transaction, its funding pattern, business integration between TSIL's existing operations and the acquired business and the synergy benefits accruing to TSIL.

Key rating drivers

Credit strengths

Healthy operations and profitability – TSIL has a long track record in the sponge-iron business, with an annual capacity of 425,000 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. 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 profits of the company were supported by sale of power and non-operating income from its investments.

Status as a subsidiary of TSL – TSIL's status as a 54.5% subsidiary of TSL, along with its debt-free status at present, 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.

Strategic location of manufacturing facilities favourably impacts the company's cost structure - Given the raw material intensive nature of the business, proximity to sources of raw material provides with an advantage to sponge iron manufacturers. TSIL's manufacturing facility is favourably located at Joda in Keonjhar district, Odisha, an area with rich reserves of iron ore. Moreover, proximity to the iron ore mines ensures that the company is well placed in terms of its freight costs, thereby, positively impacting its cost structure. The company procures iron ore from TSL's mines operating in Odisha at a discount to prevailing market rates, which provides it with a competitive edge.

Credit challenges

Large growth plans relative to current balance sheet size – TSIL's inorganic growth plan in the form of the proposed acquisition of UML's steel business would be part-funded by equity through a rights issue of up to Rs. 1,800 crore, issuance of non-convertible redeemable preference shares to TSL up to Rs. 1,000 crore and external borrowing up to Rs. 2,500 crore. The acquisition would expose the company to significant business risks going forward, given the large investment plans relative to its current balance sheet size. ICRA would continue to closely monitor the developments and funding pattern for the same.

Exposure to changes in realisation of sponge iron, prices of imported non-coking coal as well as fluctuations in the exchange rate – Sponge iron is an intermediate commodity, the price of which shows high volatility. TSIL's margins depends on the raw material and sponge iron prices. 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 USD-INR exchange rate.

At present, the company has a coal linkage of 42,900 MT from Eastern Coalfields Limited. Moreover, 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 tonne. ICRA notes that there is uncertainty pertaining to the amount and timeliness of compensation to be received by TSIL, following de-allocation of the Radhikapur (East) coal block. TSIL paid an advance of Rs. 168.24 crore towards land acquisition for the coal mine, which remains outstanding as on date.

Analytical approach: For arriving at the ratings, ICRA has applied its rating methodologies as indicated below**.**

Links to applicable criteria:

Corporate Credit Rating Methodology

Rating Methodology for Entities in the Ferrous Metals Industry

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 its plant located in Keonjhar district of Odisha. TSIL's sponge iron capacity is 425,000 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.

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 H1FY2019, 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%	23.75%	26.03%
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 in FY2018	Date & Rating in FY2017	Date & Rating in FY2016
	Instrument	Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs Crore)	Nov 2018	Jan 2018	Jan 2017	Jan 2016
1	Fund Based – Term Loan^	Long Term	304.35	-	[ICRA]AA&	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
2	Fund Based – Cash Credit	Long Term	110.00	-	[ICRA]AA&	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)
3	Non Fund Based Limits	Short Term	148.15	-	[ICRA]A1+&	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

& - Rating watch with developing implications; ^Proposed

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 – Term Loan^	NA	NA	NA	304.35	[ICRA]AA&
NA	Fund Based – Cash Credit	NA	NA	NA	110.00	[ICRA]AA&
NA	Non-Fund Based Limits	NA	NA	NA	148.15	[ICRA]A1+&

& - Rating watch with developing implications; ^Proposed

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.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

For more information, visit www.icra.in

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