AISHA STEEL MILLS LIMITED (ASL)

June 6th, 2017

BUY

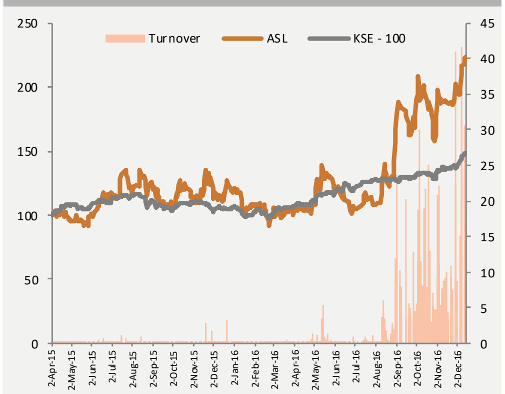
Price Target : PKR 33/share

COMPANY DATA

52-week Price Range (PKR)	28.22—7.5
No. of Shares Outstanding (mn)	685.56
Market Cap (PKRmn)	17,749.2
Market Cap (USDmn)	169.31
Free Float (mn shares)	255.72
Year End	Jun
Shariah Status	Non—Shariah
KATS Code	ASL

Source: KSE

RELATIVE TO KSE—100



Source: KSE

- **We initiate our coverage on ASL with 'BUY' rating:** Our Dec-17 DCF based price target of PKR 33/sh implies 31% upside potential from current price levels of PKR 25/sh.
- **Reaching potential capacity - Owing to buoyant CRC demand**: ASL currently operates at maximum capacity utilization of ~107% (FY17E) on the back of:
  - i. Increased local demand
  - ii. Recent developments and growth in automobile and electrical goods industries
  - iii. Timely expansions of CRC and GI to add value
- **Progressing margins on Δ b/w HRC & CRC: …** The GP margins of ASL significantly propelled from 10% (FY16A) to 21% (9MFY17) increasing by 11ppts owing to lower priced inventory of HRC stocked by the company. However, we believe that these margins are substantially high and are not sustainable due to severe volatility in international steel prices.
- **Expanding market share:** During FY16—17, owing to certain demand triggers i.e. 1) Higher Infrastructural development, 2) Materialization of CPEC, 3) Booming automobile industry and 4) Better economic conditions ...
- **Timely expansions of CRC and Galvanized Lines (GI) to add value:** … ASL has also declared a rights issue of 20% to raise finances to cater the capex of PKR 5.3bn for the expansion of the current capacity of CRC from 220k tons per annum to 650k tons per annum and installation of a new line of 250k tons of galvanized steel. The new plant & machinery shall be a mix of German and Chinese plants...
- **Investment Risk:** Key risks to our investments thesis are 1) Price volatility 2) Surge in HRC prices 3) Decline in local demand 4) Privatization of PSM.

ASL FINANCIAL HIGHLIGHTS

	FY17E	FY18E	FY19E	FY20E	FY21E
* EPS @ 817mn shs	1.20	0.91	1.97	2.81	3.73
DPS	-	-	1.00	1.50	2.00
Sales/sh	17.28	19.86	24.81	30.61	37.24
PE (x)	21.57	28.25	13.11	9.18	6.91
P/s (x)	1.45	1.26	1.01	0.82	0.67
EBITDA Margin (%)	19%	15%	18%	19%	19%
ROA (%)	9%	8%	16%	18%	20%
ROE (%)	15%	11%	20%	26%	30%
Gross Margin (%)	20%	14%	18%	20%	20%
Net Profit Margin (%)	7%	5%	8%	9%	10%

Source: Company Accounts, NAEL Research
** EPS is subject to share capital taken by management in company's projection*

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Valuation

We initiate our coverage on ASL with '**BUY'** recommendation using discounted free cash flow method. We have used Free Cash Flow to Firm methodology to derive the intrinsic value of ASL at PKR 33/sh. The following assumptions have been incorporated to arrive at our target price

- Terminal growth rate of 4%
- Risk free rate of 8% (10yr PIB)
- Market Risk Premium of 6% & Adjusted Beta of 1.0 (using 5yrs)

Based on above assumptions, ASL's Dec-17 PT is reckoned at PKR 33/share, offering 31% upside potential from its closing price.

	Dec 17E	FY18E	FY19E	FY20E	FY21E
PV of FCFF	686	(263)	1,481	1,738	2,144
WACC	10%	10%	11%	10%	11%
PV of FCFF	5,785				
Terminal Value	49,977				
PV of Terminal Value	33,282				
Ent Value	39,067				
PV of Debt	12,222				
Equity Value	26,845				
Target Price 12/31/2017	33				
Current Price	25				
Upside	31%				

Domestic Steel Industry

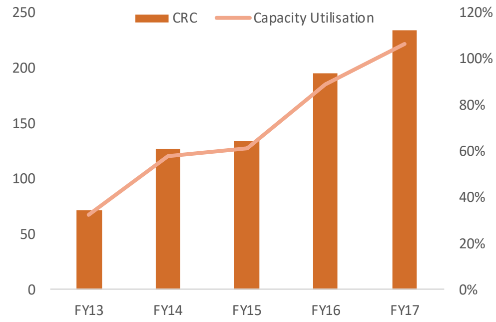
Our domestic iron and steel industry has been majorly relying on imports. According to national economic survey our average local demand stands around 4—5mn tons out of which about 3mn tons is produced locally and the rest is imported. This proposes that our local industry is supply deficient by 40%.

The domestic steel is categorized into several product types: 1) Long rolled, 2) Flat steel, 3) Semi—finished and 4) Steel Tubes. The long rolled products are then further classified into HRC (Hot rolled coils), CRC (Cold Rolled Coils, HGDS (Hot dipped galvanized steel) and etc.

Substantially relying on higher infrastructural development and growth the demand of construction materials are at boom. During the year end of 2015 the steel demand grew by 36%, however the capacities that exist locally are not sufficient to meet the generated demand in the country. Alongside the construction sector the auto and appliances industries are also pulling steel demand collectively, as they consume HR/CR coils as their direct raw materials.

Fig: 1 **ASL— Turnover**

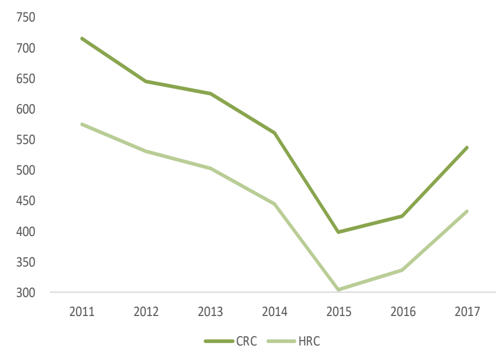
'k' tons



Source: Company Accounts, Nael Research

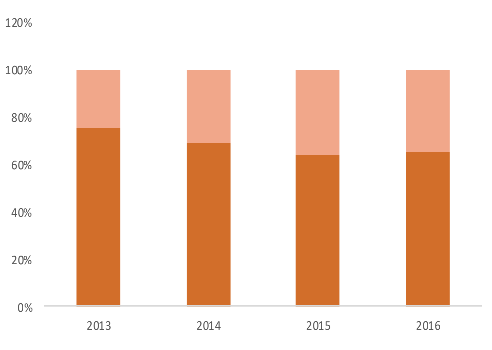
Fig: 2 **International Prices (HRC & CRC)**

US$/ton



Source: Bloomberg, Nael Research

Fig: 3 **CRC Market Share (ASL vs. ISL)**



Source: Company Accounts, Nael Research

Investment Argument

Our investment view on ASL is based on improving cost efficiencies and growth in earnings at CAGR of 33% for FY17E-FY20E based on following fundamentals:

Reaching potential capacity - Owing to buoyant CRC demand

ASL currently operates at maximum capacity utilization of ~107% (FY17E) on the back of:

- Increased local demand;
- Recent developments and growth in automobile and electrical goods industries;
- Timely expansions of CRC and GI to add value;

Improving efficiencies & market share

- **Progressing margins on Δ between HRC & CRC:**

The core business of ASL is to manufacture CRC i.e. Cold Rolled Coils using HRC i.e. Hot Rolled Coils as raw material. HRC is usually imported from Japan, China & Singapore and is further processed into CRC .

Internationally the steel prices are relatively volatile unlike any other commodity. The prices for HRC were substantially higher hovering nearer to USD 576/ton during FY 11—12 after which a downward trend was witnessed by the global markets specially in China. Recently during FY17 the prices of HRC remained in between the range of USD 313/ton—USD 474/ton. The price drop was an affect of over supply of steel globally that is significantly maneuvered by China being the largest producer of steel.

The GP margins of ASL significantly propelled from 10% (FY16A) to 21% (9MFY17) increasing by 11ppts owing to lower priced inventory of HRC stocked by the company. **However, we believe that these margins are substantially high and are not sustainable due to severe volatility in international steel prices.**

- **Expanding market share**

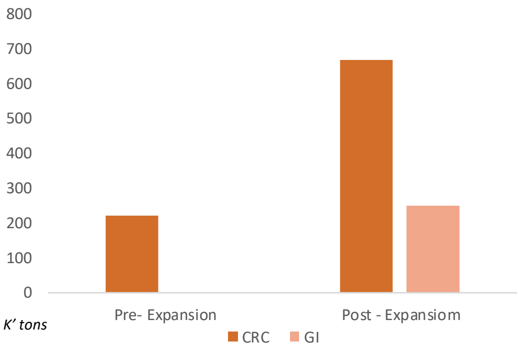
Pakistan stands around ~ 4.4mn (mt) of total steel demand out of which only about 3mn tons is met by the domestic players while the rest is imported. This directs to a short fall of ~ 1.4mn (mt). As internationally the steel prices are volatile and our domestic players are dependent upon the imports for the raw materials hence any price surge/decline directly impacts the cost and earnings of the domestic companies significantly.

During the era of FY 11—12 when the input prices were high, global steel scenario was shaky and the domestic steel players were not protected, the domestic steel demand was majorly met by imports. Hence, less turnover of sales and higher cost of doing business kept the margins subdued.

During FY16—17, owing to certain demand triggers i.e. 1) Higher Infrastructural development, 2) Materialization of CPEC, 3) Booming automobile industry and 4) Better economic conditions, the subdued flat rolled steel players specially ASL & ISL came into limelight.

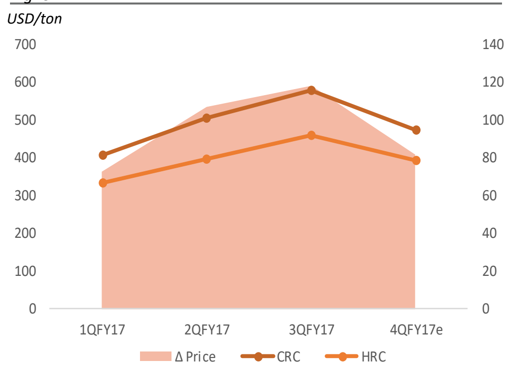
ASL's net revenues climbed to PKR 10.7bn (9MFY17) from PKR 9.6bn (FY16A) showing a robust growth of 11%YoY. We expect ASL to record revenues of PKR 14.12bn for FY17E which shall translate into a growth of 46%YoY in comparison to FY16A and further grow at CAGR of 21% (FY17E—FY20E).

Fig: 4 **Production Capacity**



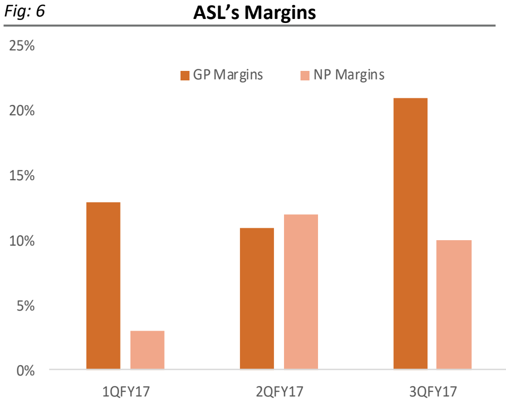
Source: Company's Account, Nael Research

Fig: 5 **HRC vs. CRC (Δ in US$)**



Source: Bloomberg, Nael Research

Fig: 6 **ASL's Margins**



Source: Company Accounts, Nael Research

- **Timely expansions of CRC and Galvanized steel to add value**

ASL currently operates at a utilization level of 107% (FY17E) for its sole production plant of CRC—Cold Rolled Coils. Whereas during FY16A the utilization levels were nearer to 89%. The major demand pull factor for the ASL has been the automobile sector and the electrical goods sector as these two sectors consume CRC as their direct raw material. According to a report of SBP the Electrical appliances (deep freezers, refrigerators, air conditioners and etc.) categorized under LSM showed robust growth of 15.28% in comparison to the previous year whereas automobile volumes grew 18% cumulatively.

ASL's current plant of 220k tons of CRC is not sufficient to cater the rising demand of CRC. The company's management is well aware that in this scenario where the demand is at its boom and the protectionist measures i.e. imposition of anti dumping on Chinese steel has already been levied to discourage imports, ASL is well positioned to capture the market share and reap the benefits of being amongst very few domestic CRC players in the country.

ASL has also declared a rights issue of 20% to raise finances to cater the capex of PKR 5.3bn for the expansion of the current capacity of CRC from 220k tons per annum to 650k tons per annum and installation of a new line of 250k tons of galvanized steel. The new plant & machinery shall be a mix of German and Chinese plants. The rolling mill and annealing equipment shall be procured from German suppliers whereas the pickling and galvanizing lines shall be procured from Chinese suppliers.

The equity issued through right will generate finances of PKR 2.36bn while the rest shall be brought in through borrowings. This collectively drives a debt to equity proportion of 54:43 for the capex.

We believe the expansion of CRC to commence operations from the mid of FY19 i.e. January'19. Although, any delays in commencement of operations would depress the market share of ASL as ISL is on the move to expand its capacity too.

Sensitivity of HRC prices over earnings and GP margins

The price sensitivity impact of HRC and CRC is material in this business model where HRC is consumed as RM and further processed into CRC—as the case is with Aisha Steel Mills Limited. The table below outlines the price differential between HRC & CRC and the Fig.6 on the left side of the table discloses the material impact over the margins of the company.

During 2QFY17, the gap between the prices widened to USD 107/ton from USD 73/ton. Immediately, the company recorded a direct impact on the GP margins the very next quarter as the lower priced HRC was stocked during 1QFY17/2QFY17. ASL recorded GP margins of 21% in 3Q from 13% and 11% of 1QFY17/2QFY17 respectively.

- **Δ between CRC & HRC**

USD/ton	CRC	HRC	Δ Price	Δ %
1QFY17	408	335	73	22%
2QFY17	504	397	107	27%
3QFY17	578	460	118	26%
4QFY17e	475	393	82	21%

Source: BLoomberg, Nael Research

PT Sensitivity

Figure: A

		Risk free rate				
		4.00%	6.00%	8.00%	10.00%	12.00%
Growth rate	3.0%	53	37	26	19	14
	3.5%	61	41	29	21	15
	4.0%	70	46	33	23	17
	4.5%	82	52	36	26	19
	5.0%	98	59	40	28	21

Source: Nael Research

Key Risks

Price volatility

ASL's price volatility remains a downside risk to our target price owing to past performance of management. Hence investors remain jittery and any unforeseen event will impact its share price negatively. (Initially, first two years after the IPO the Beta of the subject company was relatively high)

Surge in HRC prices

The subject company's margins are not stagnant and are expected to remain volatile owing to volatile international steel prices. Gross margins that have escalated are likely to erode with increase in HRC prices, being a direct raw material for of the company and if the impact of surge in prices is not passed on to the consumers. At macro level, current scenario supports the companies to boost its profitability where retail prices are kept constant and input prices are on bearish trend. The commodity super cycle poses a threat.

Decline in local demand

The only driver of cement volumes under current scenario is supported by local demand. The boom in automobile and electrical goods sector has well derived the volumes for Cold Rolled Coils.

Privatization of PSM

The largest steel capacity of Pakistan i.e. Pakistan Steel Mills is ceased for productions. If by any means PSM is privatized in the recent times it poses a direct threat to almost all steel players.

Projected Profit & Loss

PKR 'mn'	FY15	FY16	FY17e	FY18e	FY19e	FY20e	FY21e
Net Sales	9,492	9,634	14,123	16,233	20,276	25,013	30,436
Cost Of Sales	9,451	8,654	11,369	13,894	16,589	20,129	24,199
GP	40	980	2,755	2,339	3,686	4,884	6,237
Distribution Expense	38	20	39	43	48	65	77
Admin. Expenses	124	157	171	197	255	305	372
Other Income	6	25	31	35	44	54	66
Other Expenses	-	-	92	73	142	223	304
EBIT	(116)	829	2,483	2,062	3,285	4,346	5,549
Finance Cost	1,373	1,021	1,087	995	987	1,065	1,191
PBT	(1,488)	(192)	1,396	1,066	2,298	3,281	4,358
Taxation	(277)	(37)	419	320	689	984	1,307
Tax Rate %	19%	19%	30%	30%	30%	30%	30%
PAT	(1,211)	(155)	977	746	1,609	2,297	3,050
* EPS @ 817.19mn shs	(1.37)	(0.17)	1.20	0.91	1.97	2.81	3.73

Source: Company Accounts, Nael Research

*** Analyst's Adjusted Financial Statements*

** EPS is subject to share capital taken by management in company's projection*

Projected Balance Sheet

PKR 'mn'	FY15	FY16	FY17e	FY18e	FY19e	FY20e	FY21e
Assets							
Current Assets	4,167	4,468	10,737	9,076	9,977	12,444	15,484
Total Non Current Assets	11,170	10,884	11,812	13,499	13,679	13,960	14,161
Total Assets	**15,337**	**15,352**	**22,549**	**22,575**	**23,655**	**26,405**	**29,645**
Liabilities							
Current Liabilities	5,628	7,342	10,305	10,654	10,950	12,099	13,415
Total Non-Current Liabilities	6,898	5,355	5,576	3,785	2,758	2,119	1,285
Total Liabilities	12,526	12,697	15,880	14,439	13,708	14,218	14,701
Equity	5,157	5,157	8,172	8,172	8,172	8,172	8,172
Reserves / Un-app. P/L	(2,346)	(2,502)	(1,503)	(36)	1,775	4,015	6,772
Total Equity & Liabilties	**15,337**	**15,352**	**22,549**	**22,575**	**23,655**	**26,405**	**29,645**

Source: Company Accounts, Nael Research

*** Analyst's Adjusted Financial Statements*

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Disclosure Related to Author

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To arrive at our period end target price or intrinsic value of the subject security, Nael Capital (Pvt.) Ltd. uses different valuation methods which include 1) DCF, 2) DDM, 3) Relative Valuation (P/Ex, P/Bx, P/Sx and etc.)

Other Important Disclosures

The estimates of earnings and revenues does not incorporate the impact of new Galvanized Line (GI).

Security's 3-tier Rating System	Return
BUY	> 15%
HOLD	> -15% to < 15%
SELL	< -15%