

In the news recently for the wrong reasons and free falling stock price, this company, one of the top steel makers in India, came up our research radar a couple of years ago (Sep 2012 to be precise) when one of our institutional clients had requested us to analyse it (based on specific issues concerning its balance sheet).

The stock price was around the INR 470 level then and its technical chart looked stronger compared to its domestic peers who were facing negative headwinds and their stock prices were dipping southward. Therefore, while the market focused on top-line growth, aggressive capacity expansion and better-than-peer margins of this company, our analytical conclusions were based around the following points:

- 1) Leverage-driven growth.
- 2) Significant amount of un-hedged foreign currency loans.
- 3) Aggressive expense capitalization (boosting margins!)
- 4) Other parameters emphasizing balance sheet strain.

Let us examine these points in detail:

1) Leverage-driven growth:

Almost all of the aggressive capacity expansion plans of the company were funded by debt (including preference share capital, which is non-convertible) due to insufficient internal accruals. This led to alarmingly (well, not alarming to their lenders!!) high leverage on the balance sheet.

	2005	2006	2007	2008	2009	2010	2011	2012
Long Term D/E	1.37	1.89	2.26	3.24	3.86	4.02	3.60	3.94
Total D/E	1.86	2.26	2.69	3.59	4.18	4.33	5.03	5.13

Interest Coverage :	2005	2006	2007	2008	2009	2010	2011	2012
Based on incurred Interest exp.	2.30	1.42	1.59	1.38	0.81	1.35	1.12	0.88
Based on P&L reported Interest exp.	3.09	2.92	5.93	4.94	3.23	6.40	4.07	2.29

As can be seen in this table, in some years, EBIT was not enough to even pay the interest expenses (based on amount of incurred interest).

Strangely enough, there was a visible decline in how well the company was utilizing its core assets i.e. its fixed assets turnover (*even after adjusting for CWIP*), leading to a question as to whether the 'capex' was well spent?

	2005	2006	2007	2008	2009	2010	2011	2012
Sales/Total assets	1.05	0.77	0.71	0.47	0.41	0.32	0.28	0.30
Sales/Total assets (Excluding WIP)	1.24	1.21	1.09	0.98	1.04	0.90	0.39	0.44

	2010	2011	2012
Preference shares as %ge of Debt	9%	15%	15%
Preference shares as %ge of Total Assets	6%	8%	8%

With the help of this preference share allotment, the company was financing its capex without any resultant impact on profitability. The dividend and the premium on redemption (which is actually the interest exp.) were not being routed through the P&L and were directly charged to the net worth.

2) Un-hedged forex loans:

Significant leverage by the company to fund its expansion was in the form of foreign currency borrowings. Forex borrowings made up for more than 1/3rd of the total debt outstanding as on March 2012. Also, the company was not hedging any of the exposure related to that, thereby exposing itself to currency fluctuations in a significant way.

Foreign Exchange gain or loss :

	2008	2009	2010	2011	2012
Foreign Exchange gain / (Loss)	334	-	834	428	(1,132)
Interest expense due to exchange fluctuation	292	1,349	-	920	4,819
(Before capitalization)					
Net Impact of Foreign exchange fluctuation	43	(1,349)	834	(493)	(5,951)
Impact PBT	1%	-24%	7%	-4%	-44%

Forex Impact

	2008	2009	2010	2011	2012
Loans in foreign currency	22,116	29,006	30,954	53,442	90,527
as a % of total loans	38.6%	34.1%	24.7%	28.8%	37.2%

Derivative exposure	-	-	-	-	-
as a % of NW	0.0%	0.0%	0.0%	0.0%	0.0%
Unhedged currency exposure – Foreign currency Receivable / (Payable)	(27,826)	(32,434)	(34,799)	(60,838)	(1,01,099)
as a % of NW	-171.2%	-159.2%	-120.2%	-154.7%	-196.4%

3) Expense Capitalization:

Another eye-catching point here is the aggressive capitalisation of expenses. Earlier “pre-operative expenses capitalised” were just 1-2% of the total revenue of the company. However, from 2010, they jumped to the tune of 7% of total sales. Interest expense capitalization also has had significant impact on the company’s financials (as shown below). Therefore, with such accounting manoeuvring, the company might have been able to report higher margins as well as OCF (Operating Cash Flows). In addition, our analysis suggested that once the planned capacities became operational (and the company is not able to capitalize pre-operative expenses and interest expense any further), future profitability could be adversely affected.

Interest Expenses	2005	2006	2007	2008	2009	2010	2011	2012
Actual Incurred	1,064	1,708	2,886	4,899	10,090	10,087	16,338	27,215
Capitalised	270	878	2,114	3,529	7,553	7,958	11,861	16,751
P&L Interest Exp.	794	830	773	1,370	2,536	2,128	4,477	10,464
%ge wise Analysis:	2005	2006	2007	2008	2009	2010	2011	2012
Actual Incurred	100%	100%	100%	100%	100%	100%	100%	100%
Capitalised	25%	51%	73%	72%	75%	79%	73%	62%
P&L Interest Exp.	75%	49%	27%	28%	25%	21%	27%	38%
Gross Block and Capital WIP	20,435	30,911	45,858	74,953	1,06,840	1,48,843	1,98,240	2,73,775
Increase / (Decrease)	5,144	10,476	14,947	29,095	31,887	42,003	49,398	75,534
Impact due to Interest Capitalisation	5%	8%	14%	12%	24%	19%	24%	22%

Amounts in INR Millions

Nearly 1/4th of the increase in the “Gross Block” was coming from interest capitalized. While one could see it in the reference of debt taken to fund that and the higher debt-to-equity ratio deployed by the company, the ill effects of ‘easy money’ flowing into mal-investments usually show up in pronounced ways when the tide turns down along with a higher risk of shareholders’ net-worth getting wiped out due to high leverage.

Impact on Profits: As can be seen below, significant portion of profits would have been wiped out if the total interest expense was being expensed.

	2005	2006	2007	2008	2009	2010	2011	2012
PBT	1,657	1,597	3,724	5,403	5,649	11,498	13,765	13,454
Interest Exp. as per P&L	794	830	773	1,370	2,536	2,128	4,477	10,464
Actual Incurred Interest Exp.	1,064	1,708	2,886	4,889	10,090	10,087	16,338	27,215
Adjusted PBT	1,386	719	1,610	1,874	(1,904)	3,540	1,904	(3,298)
Reduction in PBT	-16%	-55%	-57%	-65%	-134%	-69%	-86%	-125%

Even on peer comparison (though there might be differences pertaining to Debt/Equity deployed for funding new projects, specific purpose loans with different interest rates etc.) the extent of interest capitalization was distinctly higher in the case of this company. Interest capitalised as % of total Interest Expenses:

	2005	2006	2007	2008	2009	2010	2011	2012
Company in Question	25%	51%	73%	72%	75%	79%	73%	62%
TATA Steel	0%	2%	0%	1%	2%	5%	6%	7%
JSW Steel	2%	15%	17%	14%	18%	19%	21%	19%
SAIL	0%	1%	0%	1%	22%	41%	51%	33%

Increase in Gross Block and CWIP due to Interest Capitalisation:

	2005	2006	2007	2008	2009	2010	2011	2012
Company in Question	5%	8%	14%	12%	24%	19%	24%	22%
TATA Steel	0%	0%	0%	0%	2%	nmf	3%	2%
JSW Steel	1%	3%	4%	1%	3%	15%	6%	6%
SAIL	0%	1%	0%	0%	1%	3%	6%	9%

4) Other indicators:

Apart from the above mentioned issues, there were some other clear signals emanating from our analysis which raised enough red flags for a risk-oriented investor.

a) M-Score: One of the indicators which shed some light on the likelihood of earnings manipulation is the M-Score (by Messod D Beneish, Professor, Indiana University). In this company's case, this score gave enough warnings to a risk-oriented investor in the form of frequency distribution where 7 out of 15 years were in the risky zone.

Please refer Appendix #1

b) AZS: The Altman Z Score, which is an indicator of possible stress on the balance sheet,

also reflects continuing weakness.

2008 2009 2010 2011 2012

Altman's Z score 1.24 1.02 1.07 0.97 0.99

Please refer Appendix #2

c) Cash Conversion Cycle: Apart from heavy borrowings to fund the capex, which causes a strain on the balance sheet, even the working capital cycle deterioration warranted caution.

Cash Conversion Cycle 2005 2006 2007 2008 2009 2010 2011 2012

Receivable Days	47	54	52	54	46	49	26	45
Inventory Days	90	70	84	119	114	172	239	172
Payable Days	56	70	77	111	80	86	77	52
Total Days	81	55	59	63	80	136	187	165

What is also noteworthy here is that apart from increasing inventory days (also reflected in worsening asset turnover), marked decline in payable days (credit period available to company) suggested that despite market share gains and increasing scale etc. suppliers were unwilling to extend a longer credit period to the company as opposed to lenders who were very comfortable, it seems, in extending a credit line to the company.

d) Grade: Our propriety score sheet on assigning Grade (business quality assessment) suggested a very poor score for the company, and therefore, we have classified it as Grade B- (Range is A, B+, B, B- and C; A is best, C being the worst). An interesting point here is that despite aggressive market share gains and robust sales growth, lack of free cash flow generation coupled with higher leverage and declining return on capital ratios had a telling effect on the quality parameters we use for assigning a grade.

Essentially speaking, we could draw the following observations within the "3 Bs" of investing:

- 1) BUSINESS – Cost of capital-type Business with no competitive advantage.
- 2) BALANCE SHEET – This is where TROUBLE is!
- 3) BARGAINS – Not so cheap. Given the B/S troubles, no margin of safety could be enough.

Appendix:

#1-M-Score: In his out-of-sample tests, Prof. Beneish found that he could correctly identify 76% of manipulators whilst only incorrectly identifying 17.5% of non-manipulators.

#2-AZScore:

Greater than 2.6 Safe zone

1.1 – 2.6 Grey zone

Below 1.1 Distress zone

Greater than 2.6 Safe Zone

1.1 – 2.6 Grey Zone

Below 1.1 Distress Zone

#3- Calculations: All calculations are as per the Multi-Act framework using publicly available information.

Statutory Details:- Multi-Act Equity Consultancy Private Limited
(SEBI Registered Portfolio Manager – Registration No. INP000002965)

Disclaimer

The views expressed in this article are for educational and reading purpose only. Multi-Act Equity Consultancy Private Limited (MAECL) does not solicit any course of action based on these views and the reader is advised to exercise independent judgment and act upon the same based on its/his/her sole discretion, their own investigations and risk-reward preferences.

The article is prepared on the basis of publicly available information, internally developed data and from sources believed to be reliable. Due care has been taken to ensure that the facts are accurate and the views are fair.

MAECL, its associates or any of their respective directors, employees, affiliates or representatives do not assume any responsibility for, or warrant the accuracy, completeness, adequacy and reliability of such views and consequently are not liable for any direct, indirect, special, incidental, consequential, punitive or exemplary damages, including lost profits arising in any way for decisions taken based on the said article.

It is stated that, as permitted by SEBI Regulations and the Company's Employee Dealing Policy, the associates, employees, affiliates of MAECL may have interests in securities referred to in the information.

The contents herein – information or views – do not amount to distribution, guidelines, an offer or solicitation of any offer to buy or sell any securities or financial instruments, directly or indirectly, in the United States of America (US), in Canada, in jurisdictions where such distribution or offer is not authorized and in FATF non-compliant jurisdiction and are particularly not for US persons (being persons resident in the US, corporations, partnerships

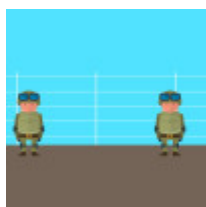
or other entities created or organized in or under the laws of the US or any person falling within the definition of the term “US person” under Regulation S promulgated under the US Securities Act of 1933, as amended) and persons of Canada.

Risk factors

General risk factors

- Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.
- Past performance of MAECL does not indicate its future performance.
- As with any investment in securities, the value of investments can go up or down depending on the factors and forces affecting the capital market. MAECL is not responsible / liable for any losses resulting from such factors.
- Securities investments are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.
- MAECL has renewed its SEBI PMS registration effective October 14, 2011 and has commenced its portfolio management activities with effect from January 2011. However MAECL has more than 10 years of experience in managing its own funds invested in the domestic market.

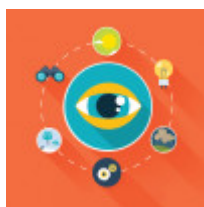
You may also like:



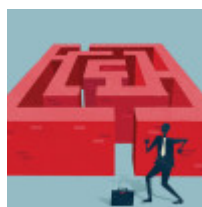
Aircraft
Manufacturer's
Risky Currency
Hedge



A Specialty
Canadian
Pharma
Company: High
on High Yield



Crystal ball for
Nifty – Using
Transition
Probability
Matrix



IBM: Big Blue
Shows Red