ICRA

May 21, 2019

Tata Steel Limited - Update on Material Event

Summary of Rated Instrument:

Instrument	Rated Amount (Rs. crore)	Rating Outstanding
Commercial Paper	15,000.00	[ICRA]A1+ outstanding
Total Limits	**15,000.00**	

Material Event

The comprehensive package of remedies offered by Tata Steel Limited (TSL) and thyssenkrupp AG was not sufficient to allay the concerns of the European Commission (EC) to clear the proposed European joint venture (JV). As the EC was seeking further commitments and improvements on the remedy package in the form of asset divestments, which would have adversely impacted the intended synergies of the JV, the partners decided to call-off the JV on May 10, 2019.

Impact of the Material Event

ICRA believes that the European JV setback is marginally credit negative on TSL's credit profile in the context of a steadily increasing share of the Indian steel business in the Tata Steel Group's overall portfolio[1]. TSL's FY2020 consolidated gross debt/EBITDA of around 3.4 times in the prevailing scenario (without the JV) is largely in line with ICRA's previous estimate of 3.6 times[2], which considered the JV starting from FY2020. However, in the current scenario, the annual steady-state synergy benefits of Euro 400-600 million[3], which would have accrued to the JV, and which in turn would have led to high dividend payouts to the partners, will not be available.

Tata Steel Europe has two large steelmaking hubs, one in the Netherlands (7.3 mtpa steel plant at Ijmuiden), and another in the United Kingdom (5.1 mtpa steel plant at Port Talbot). The Ijmuiden plant remains one of the lowest-cost steel producers in Europe and has been generating positive free cash flows. However, ICRA notes that though the operations at Port Talbot is generating positive OPBITDA[4], it is yet to achieve cash-breakeven[5]. Going forward, turning around the residual UK operations into a self-sustaining business would remain important from the credit perspective.

The Tata Steel Group has deleveraged by ~Rs. 18,550 crore in H2 FY2019, and has guided for a further reduction of US$ 1 billion (~Rs. 7,000 crore) in FY2020. ICRA believes that notwithstanding the JV failing to take-off, the ongoing large brownfield capex at Kalinganagar Phase II, and the last leg of the STAR[6] capex programme in the Netherlands, the Tata Steel Group is favourably placed to meet its guided deleveraging target for the current fiscal, supported by strong underlying earnings from the India business. However, this assumes no further large-scale asset acquisition inorganically.

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[1] Around 80% of the consol EBITDA in FY2020 is expected to come from the Indian steel business (including subsidiaries)

[2] Previous estimates drawn in June 2018

[3] The synergies would have led to a structural EBITDA uplift of around US$ 25-30/MT to Tata Steel's European operations

[4] Operating profits before interest, tax, depreciation and amortisation

[5] After meeting operating costs, debt service and sustenance capex

[6] Strategic Asset Roadmap (STAR)

The rating remains unchanged at [ICRA]A1+.

The rating takes into account TSL's large scale of operations globally, and its status as a leading producer of high-quality steel with significant vertical integration and captive raw material linkages for its Indian operations, which not only imparts cost-efficiency, but also partially hedges the company's profits against volatility in raw material prices. TSL's captive mines meet 100% and 30% of the company's domestic iron ore and coking coal requirements respectively, giving the company a distinct competitive advantage over its peers. The rating also takes into consideration TSL's diversified product portfolio in the flat and long product categories, characterised by a high share of value-added and branded products, which support higher margins and strengthen TSL's operating profile. TSL has been able to ramp-up and stabilise operations at its Kalinganagar plant, helping the company lower its operating leverage. Apart from the higher volumes at its Kalinganagar plant, buoyancy in domestic and global steel prices, and an uptick in domestic steel demand growth led to a healthy growth in the company's earnings in FY2018 and FY2019.

The Tata Steel Group had completed an aggressive domestic expansion plan in FY2019, which has seen its domestic steelmaking capacity increasing from 13 million tonne per annum (mtpa) to 19.6 mtpa, supported by the acquisitions of Bhushan Steel Limited (BSL) and steelmaking assets of Usha Martin Limited (UML). BSL has an attractive product portfolio in the high-margin flat product segment, with a substantial presence among institutional customers spread across automotive, white-goods and engineering sectors. In its first year of operation under the Tata Group management, the 5.6 mtpa integrated steel plant of Bhushan Steel at Meramandali (in Odisha) has seen its capacity utilisation rate increase to around 70% in FY2019 from less than 55% during the pre-acquisition period, helping contribute around 10% to the consolidated Group EBITDA in FY2019. Going forward, its ability to ensure optimal asset sweating of the acquired assets would remain critical from the credit perspective.

In addition to the inorganic acquisitions, TSL's 5-mtpa Kalinganagar – Phase II brownfield expansion is expected to exert pressure on the free cash flows, leverage, and coverage indicators in the medium term. However, these growth plans provide an opportunity to have a greater footprint in the growing domestic market. The short-term rating also considers TSL's low and volatile profitability from the UK operations, TSL's exposure to regulatory risks, given its presence in the highly regulated iron ore and coal mining operations, and its exposure to forex risks, given that around 50-55% of its consolidated debt (as on March 31, 2019) is denominated in foreign currency, whereas around 80% of the consolidated FY2019 EBITDA is generated from the Indian operations of TSL and its subsidiaries. ICRA however notes that the close linkages between dollar movements and steel prices provide a natural hedge to TSL, partly mitigating forex risks.

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

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