10 January 2022

Mughal Iron & Steel Industries Ltd (MUGHAL PA)

Diversifying further in the Non-ferrous segment

Mughal Iron & Steel Industries Ltd (MUGHAL PA) recently announced plans on further diversifying operations in the Non-ferrous segment, including enhancement of Copper capacity, while also venturing into the Aluminum segment (hinted at by the management in a recent Analyst Briefing). The salient features of the announcement are given below.

Salient features of the expansion

Procurement and installation of melting plant for non-ferrous segment	The capex expected to be incurred for this project is PKR2.9bn, which will allow for the exporting of aluminum ingots and improving efficiency of the copper segment.
Procurement of parts for re-rolling mill	Estimated capex to be incurred is an additional PKR400mn
Financing	80:20 Debt-to-Equity
Sukuk	Issue of an additional PKR5bn Sukuk with a 5yr tenure and rate similar to current Sukuk issues (Kibor + 1.3%)
Disposal of old re-bar mill	PKR568mn book-value
COD	Maximum 20 months (potentially by 1QFY24)

Source: Company Announcements

Project can be value accretive, but will need high utilization levels

MUGHAL's venture into the Non-ferrous segment (Copper ingots) has proved very profitable since inception (FY20). The segment is presently contributing c.25% of overall revenues with healthy gross margins of c.35% in 1QFY22 (14% on Steel revenues), because of not only hefty inventory gains but also high efficiency and processing standards. MUGHAL mainly exports copper to China and benefits from sales prices that are at a lower discount compared with that from other regional countries (LME price -2.5%, vs -7.5% initially). Streamlining of the copper segment through an expansion is likely to further improve margins, in our view, while the company will process nearly double the present volumes (c.1,000MT/month from 500-600MT/month at present).

As per channel checks, MUGHAL will be able to process and export 35,000-40,000 MT of aluminum ingots annually through the plant, at expected gross margins of at least 12%. Given that the company is able to achieve 100% capacity utilization in the aluminum segment and successfully double copper segment exports, we estimate c.30% incremental revenues over our present estimates for FY24-26f (assumed commissioning of plant by end-1QFY24). We also estimate c.20% higher net profits from our base estimates. However, it is worth noting that since MUGHAL began the Non-ferrous segment, it has been unable to reach full utilization (we estimate c.6,200 MT exported in FY21, at c.62% capacity utilization), because of constraints on supplies of quality compressor scrap.

Although the project appears promising for MUGHAL, the rise in debt through additional planned Sukuk issue of PKR5bn (in addition to PKR3bn recently issued), given already elevated leverage is a key concern (D/A will be c.50% with the project), in our view, especially in light of the prevailing macroeconomic situation. Based on preliminary calculations, we estimate the new plant to be value accretive at a capacity utilization above 50% (for aluminum). Assuming c.70% utilization level, the project adds c.20% to our base-case TP (of PKR135/sh). Below 50% utilization levels, however, it decreases our TP by c.5%.

MUGHAL remains our top pick in the Steel space

MUGHAL is our top-pick in the IMS Steel coverage (June 2022 TP of PKR135/sh) on account of strong performance in both Ferrous and Non-ferrous segments, and resilient revenues/earnings during times of economic downturns. We expect that robust farmer income will keep demand for girders healthy, while rebar demand will depend on sustained construction activities (which may be slow until June 2022 due to ongoing monetary/fiscal tightening). But bigger steps towards diversification into Non-ferrous segment increases our liking for the scrip. MUGHAL is trading at an undemanding FY22f P/E of 5.5x.

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Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
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*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks: (i) PKR depreciation against USD, (ii) volatility in international commodity prices, (iii) low pricing power due to surplus capacity in the sector, and (iv) enhanced restrictions due to new variants

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