Mughal Steel: Value Investment, Low Risk

FY25 D/Y: 6.3%	Current Price: PKR 64/sh	BUY
FY25 PE: 4.16x	Target Price: PKR 106/sh	

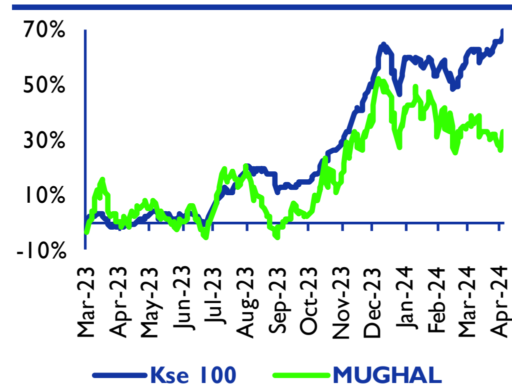
- **We initiate our coverage on Mughal Steel (MUGHAL), wherein we see improvement in earnings after FY24. MUGHAL continues to shine on copper ingot exports to China. We have anticipated some 5000 tons of exports during 9MFY24.**
- **Mughal Steel has raised its finances by issuing a secured Sukuk-II certificate in order to finance the company's working capital requirements. It has also issued a Sukuk III certificate. This also makes a Sharia-compliant case for investors.**
- **Mughal Steel had acquired Mughal Energy Limited (MEL) in November 2023.We see MUGHAL to be better than steel manufacturers like Karachi based AGHA, and ASTL since they are depicting negative EPS. MUGHAL depicts FY25 PE of 4.16x - POSITIVE - as per our methodology.**
- **We initiate a BUY stance for Mughal Steel based on the DCF target value of PKR 106/sh, which provides an upside potential of 65% from the current market price.**
- **Going forward, the IMF, the principal lender, projected a 'positive outlook' on inflation and GDP.**

WAJAHAT ULLAH SIDDIQUI
Research Analyst
info@scstrade.com
021-111-111-721

Friday, 3 May 2024

MUGHAL Snapshot	
Market Capitalization (PKR)	21.8 bn
Market Capitalization ($)	78.4 mn
Market Price	64/sh
Target Price (DCF Based)	106/sh
Beta	1.61x
Average Volume	748,428

Relative Index



Source: SCS Research, PSX

Future Outlook: We initiate our coverage on MUGHAL:

1) Wherein we see an improvement in earnings in the future.
2) During FY24, we saw a decline in EPS associated with decreased gross margins. Almost all companies are facing higher power costs amid low sales volume in the country. The low sales is commiserate with sluggish economy. But Mugal is also into exports of copper ingots, which is salvaging pride. Mugal is better off due to exports directed to China.
3) Going forward, after FY24, we may see jump in EPS, along with free cash flows.

We forecast revenue based on an increase in price (the average price hovers at ~PKR 261K/tons) with a slight increase in volumetric growth until FY25. After FY25, we see some growth picking up in sales volume, which would coincide with a decrease in official inflation in the country. Our premise is that MUGHAL will improve EPS.

DCF price PKR 106/sh: We have forecasted our model until FY28 and calculated DCF based on that, which gives a valuation of PKR 106/sh. The future price of ferrous and non-ferrous materials (copper ingots) is expected to rise, propelling revenues to grow, which is reflected in our model. Moreover, in the future, we see a decrease in the policy rate from 22% by SBP, which will improve net margins in FY25 and onwards. Even though lower capacity utilization in FY24 would result in a decrease in EPS by 33% in FY24, albeit with lower volume sales and a high power cost, Nevertheless, in FY25, the EPS will improve by 123%, which could be a huge jump along with some improvement in the dividend yield. Hence, MUGHAL is a value investment play, as per our perspective and our top steel sector pick.

In 9MFY24, we see 23% of sales arising from export, which can be mostly from copper ingot sales. In FY23, we see copper ingot contributing 30% to sales, and the best part about copper ingot is that it is created from scrap metal, which requires very little cost. So, if copper ingot sales contribute more to total sales in the future, then we see better gross margins in MUGHAL.

Sukuk-II & Sukuk-III: The finance cost is expected to increase because of the high policy rate and the introduction of a secured Sukuk-II certificate at a rate of 3M KIBOR + 1.45%. Also in 19th April the company have issues Sukuk-III certificate at a rate 6M KIBOR rate + 1.1%. We see a reversal in the allowance of expected credit loss because of the recovery of overdue trade debts.

Asset growth: We see an increase in inventory in 2QFY24 attributed to increased costs and an increase in inventory in transit. We see a decline in loans and advances due to a decline in advances to suppliers. Property, plant, and equipment have also slightly decreased because of the decrease in capital work in process. We see overall assets increasing by 14% in 3QFY24 as compared to 4QFY23. This is mainly attributed to an increase in investments to fully acquire Mughal Energy Ltd. (MEL).

Liabilities: MUGHAL has raised its finances by issuing a secured Sukuk-II & Sukuk-III certificate in order to finance the company's working capital requirements. In 3QFY24, we see a 194% jump in trade and other payables as compared to 4QFY23. A huge increase is due to the increase in foreign suppliers on account of the deferred letter of credit. **(See valuations & VAR on the next page)**

MUGHAL P&L Statement

PKR in bn	FY22	FY23	FY24E	FY25F
Sales - net	66.15	67.39	80.45	110.14
COGS	-56.02	-57.72	-71.55	-95.37
Gross Profit	10.13	9.67	8.90	14.77
Market Exp	-0.25	-0.16	-0.18	-0.24
Admin Exp	-0.70	-0.68	-0.80	-1.10
Other Exp	-0.53	-0.35	-0.42	-0.58
Allowance-ECL	-0.03	-0.03	-0.04	-0.06
Other Income	0.21	0.32	0.26	0.36
Finance cost	-2.62	-4.42	-4.83	-6.61
PBT	6.20	4.35	2.89	6.54
Tax	-0.79	-0.87	-0.58	-1.37
PAT	5.41	3.48	2.31	5.16
EPS	16.12	10.37	6.88	15.38

Source: SCS Research, Company Book

DCF Sensitivity Analysis

Terminal Growth Rate (%)	WACC (%)						
	19.7	20.2	20.7	21.2	22.7	24.2	25.7
1.0	95	90	85	80	67	55	45
2.0	102	96	90	85	71	59	48
3.0	110	103	97	91	76	63	52
4.0	118	111	104	98	81	67	56
5.0	128	120	112	106	87	72	60
6.0	139	130	122	114	94	78	64
7.0	151	141	132	124	102	84	69
8.0	166	155	145	135	111	91	75
9.0	184	171	159	148	121	99	81

Source: SCS Research

Acquisitions: Mughal Steel acquired Mughal Energy Limited (MEL) in November 2023. This will enhance the competitive position of the company. Land and hybrid power plants have already been imported by MEL. However, the acquisition of Mughal International DMCC is still in process.

Dividend Yield: We see dividend payments and D/Y improving in FY25 as the increase in dividend payments is correlated with an increase in EPS. The dividend yield in FY24 is expected to be 2.3%, and in FY25 it could be 6.3%. Nevertheless, MUGHAL, like any construction sector company, is a value play.

Valuation and Peer Comparison: We see MUGHAL as being better than steel manufacturers like AGHA and ASTL because of its negative EPS. However, CSAP is undervalued as compared to MUGHAL. In FY24, we see a higher PE for MUGHAL standing at 9.85x, but after that, the PE will decline, which is **POSITIVE.**

By comparing the PE of MUGHAL with that of neighboring countries like India, we see positive development as the steel manufacturers of the peer country have higher PE as compared to the PE of MUGHAL. Here we see that MUGHAL has the potential to grow as it is undervalued compared to other neighboring peers.

Moreover, we see that the PE of KSE 100 is undervalued, giving a PE of 5x when compared with the markets of India, Bangladesh, and Sri Lanka, giving PEs of 25.2x, 14.4x, and 9.9x, respectively.

Value-at-Risk (VAR) – Low Risk: We see that currently MUGHAL has a VaR of **4.34%** at a confidence level of 95% and **6.15%** at a confidence level of 99%. It means we have 95% confidence that the loss will not surpass **4.34%** on a daily basis. The same goes for 99%, where the loss will not surpass **6.15%**. This is calculated based on average returns and the standard deviation taken from the start of 2021 to the present. Both of these values can be seen between very low and low level band. MUGHAL depicts low risk in the VAR bands.

Investment Decision: We initiate a **BUY** stance for Mughal Steel based on the DCF target value of PKR 106/sh, which is up by 65%. The calculation of target value based on the DCF model considers: 1) 5-Year Beta of 1.61x; 2) Cost of Debt of 22%; 3) Total Equity Risk Premium (GDP weighted) of Asia is 6.28%; 4) Terminal growth rate of 5%, which is Pakistan's long-term sustainable GDP growth rate, taken from the IMF website; and 5) Risk-free rate of 14.6%, i.e., PIBs.

These inputs are based on our best estimates, but the valuation may vary slightly because of future uncertainty. So we have given a sensitivity analysis of the DCF target price by considering different scenarios of WACC and terminal growth rate.

Economy and Sector Outlook: We see that the growth of the steel sector is directly correlated with the GDP of Pakistan. According to IMF projections, we see a positive outlook for inflation and GDP. Inflation is estimated to drop to 6.5% in FY27 and onward from 24.8% in FY24, and the GDP growth rate is forecast to increase to 5% in FY27 and onward from 2% in FY24.

This economic foresight may have a positive bearing on MUGHAL, which is still one of the biggest long steel players in the northern zone, given improvements in steel offtake, albeit an increase in blast furnace capacity utilization. For FY24, we may see a subdued performance, but after that, MUGHAL has the potential to perform well if the economy indeed takes off.

Pakistan's steel sector is highly dependent on the import of raw materials. The positive development in the economy will also cause the PKR currency to gain value in the future, which in turn will make imports of raw materials cheaper and improve gross margins.

MUGHAL Valuation Table

	FY22	FY23	FY24E	FY25F
EPS	16.12	10.37	6.88	15.38
DPS	3.00	3.20	1.50	4.00
P/E (x)	3.97	6.17	9.30	4.16
BV/sh	62.11	75.60	78.98	90.36
PBV (x)	1.03	0.85	0.81	0.71
Gross Margin	15.3%	14.4%	11.1%	13.4%
Net Margin	8.2%	5.2%	2.9%	4.7%
D/Y	4.7%	5.0%	2.3%	6.3%

Source: SCS Research, Company Book
** PKR/ton in "000"*

IMF Forecast (Pakistan)

	FY24E	FY25F	FY26F	FY27F	FY28F	FY29F
Inflation Rate	24.8%	12.7%	7.6%	6.5%	6.5%	6.5%
GDP Growth	2.0%	3.5%	4.5%	5.0%	5.0%	5.0%

Source, SCS Research, IMF

95% Confidence	
Very Low	4.25%
Low	4.40%
Medium	4.49%
High	4.59%
Very High	4.65%

Source: SCS Research

99% Confidence	
Very Low	6.13%
Low	6.25%
Medium	6.39%
High	6.53%
Very High	6.61%

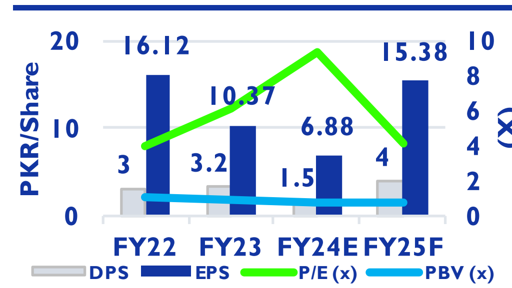
Source: SCS Research

Peer Comparison

	Exp P/E (x)
MUGHAL	9.30 x
ASTL	N/A x
AGHA	N/A x
CSAP	2.5 x
Steel Authority of India*	39.4 x
TATA Steel*	-32.40 x
JSW Steel Ltd*	22.00 x
Jindal Steel & Power*	31.5 x

Source: SCS Research, companiesmarketcap.com
**Indian Peers as of April 2024 (TTM)*
**N/A x mean negative EPS*

EPS vs DPS



Source: SCS Research, Company Book

References:

https://www.scstrade.com
https://www.psx.com.pk
https://www.imf.org/external/datamapper/profile/PAK
https://companiesmarketcap.com/
https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

Disclaimer

'Research Analyst' Certification

'Research Analyst' involves in this 'Research Report' certifies that:

- 'Research Analyst' or any of his close relatives do not have a financial interest in the securities of the 'Subject Company' aggregating more than 1% of the value of the 'Subject Company'
- 'Research Analyst' or his close relative has neither served as a director/officer in the past 3 years nor received any compensation from the Subject Company in the previous 12 months
- His compensation will not be related to the recommendations or views given in 'Research Report'

Distribution of 'Research Report'

Standard Capital Securities (Pvt.) Ltd. will distribute Research Report to clients in a timely manner through electronic distribution vide email or through physical distribution such as courier express. Standard Capital will make all efforts; even so it is possible that not all clients may receive Research Report at the same time given technical glitches or breakdown/slowdown of internet during the process of sending emails.

'Research Entity' Disclosures

Standard Capital Securities (Pvt.) Ltd. or any of its officers and directors does not have a significant financial interest (above 1% of the value of the securities) of the subject company.

Standard Capital Securities (Pvt.) Ltd. employee including directors, officers or associates has not served the subject company in preceding 36 months.

Subject Company is not been a client for Standard Capital Securities (Pvt.) Ltd. during the publication of Research Report

Standard Capital Securities (Pvt.) Ltd. has not managed public offering, take over or buyback of securities for the Subject Company in the past 12 months neither receives any compensation from the subject company for corporate advisory or underwriting services in the past 12 months.

Standard Capital Securities (Pvt.) Ltd. hasn't recently underwritten/or not in the process of underwriting the securities of an issuer mentioned herein. Standard Capital Securities (Pvt.) Ltd. hasn't have provided/providing advisory services to the issuer mentioned herein.

Risk disclosures impeding target price

The Subject Company is exposed to market risks, such as changes in interest rates, exchange rates, changes in raw material prices. Subject company can also exposed to risk such as derivative transaction or certain regulatory changes from government authorities.

Rating System

Standard Capital Securities (Pvt.) Ltd. standardized recommendation structure i.e. Positive, Hold and Negative, based on rating system i.e.

- (Target Price, if any/Current Price - 1) > 10% Positive
- (Target Price, if any/Current Price - 1) < 10% Hold
- (Target Price, if any/Current Price - 1) < -10% Negative

The time duration is the financial reporting period of Subject Company

Valuation method

Following research techniques adopted to calculate target price/recommendation

- Price to earnings & Price to Book, EV-EBITDA multiple
- Discounted Cash Flows or Dividend Discount Model or Enterprise Value