

Equities

2 May 2012 | 44 pages

European Steel Equities

Prefer Voestalpine for 1H12, ArcelorMittal for 2H12

- **Conclusion(s)** — We currently prefer Voestalpine but believe that ArcelorMittal may perform better in 2H12. VOE remains differentiated and looks cheap and we see the company's Railways restructuring resulting in higher divisional margins. MT should perform better in 2H12 as it achieves better pricing for its Liberian iron ore and as restructuring measures in Europe bear fruit.
- **#1 Buy Voestalpine** — VOE remains our top pick in European steel as it looks the cheapest in our steel coverage. We think exiting the loss-making standard rails business is a prudent move and although there is a provision linked to this exit, we see EBIT margins rising to 12% from the current ~9% post this restructuring move. VOE will report FY results on 30 May and we expect EBIT at €651m (€856m ex charges). We raise our target price to €36 (from €35) and 2013-14 estimates to reflect higher expected earnings in Railways.
- **#2 Position for ArcelorMittal in 2H12** — We upgraded ArcelorMittal to Buy in September 2011 on valuation grounds. This coincided with a trough in steel prices, but in Q1 a couple of issues have held back earnings momentum. We examine the possibility of a dividend cut and present our preview for Q1 results on 10 May. We trim 2012-2014 EPS to reflect weaker shipments in Flat Carbon Europe consistent with weak European auto production.
- **#3 Salzgitter – value but slow-burn** — Salzgitter should benefit from two tailwinds in 2012 – close to €100m in EBT tailwinds as restructuring measures taken in 2011 start to impact P&L in 2012 and tax loss carry forwards that can be used after a change to the company's holding structure. We expect a weak Q1 as the Tubes division lost a large order in Iran due to EU sanctions but better prospects for the rest of the year. We expect a small pre-tax loss due to these one off issues in Q1 and results are due on 15 May. We raise estimates after factoring in the use of tax loss carry-forwards in the P&L and remove the NPV of these tax losses from our valuation.
- **#4 Kloeckner and Co. – losing steam** — We expect Klöckner to continue to face challenges in 2012 with limited upside to steel prices and weak pricing power pressuring margins. In the absence of a European recovery the stock is likely to remain range bound with valuation support from net working capital around £10. We expect €45m of EBITDA when KCO report results on 9 May. We raise estimates slightly to reflect future year gains from restructuring measures taking place now.

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Ticker	Rating		Target Price		Current Year Earnings Estimates		Next Year Earnings Estimates	
	Old	New	Old	New	Old	New	Old	New
ISPA.AS	1	1	€19.00	€19.00	US\$1.59	US\$1.54	US\$3.17	US\$3.06
KCOGn.DE	2	2	€12.00	€12.00	€0.38	€0.38	€1.07	€1.14
SZGG.DE	1	1	€54.00	€54.00	€2.61	€2.78	€3.55	€5.20
VOES.VI	1	1	€35.00	€36.00	€2.83	€2.05	€3.25	€3.27

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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VOE for the First Half, MT for the Second Half

Our universe of European carbon steel equities has had a mixed start to 2012. In US\$ terms, Voestalpine has been the best performer, up 10% YTD, followed by Salzgitter (-2%), Klöckner (-3%) and ArcelorMittal (-9%). The SXPP Index is up 11.8% as a comparison.

Voestalpine: The stock remains our top pick in European steel as it looks the cheapest stock in our steel coverage. We think exiting the loss-making standard rails business is a prudent move and although there is a non-cash impairment charge linked to this exit, we see EBIT margins rising to 12% from the current ~9% post this restructuring move.

ArcelorMittal: We upgraded ArcelorMittal to Buy in September 2011 on valuation grounds. This coincided with a trough in steel prices, but in Q1 a couple of issues have held back earnings momentum. Most of the headwind has come from logistics and Fe % grade discounts for Liberia iron ore, lower iron ore spot prices overall for the mining division and some volume issues in the CIS.

Salzgitter: Salzgitter should benefit from two tailwinds in 2012 – close to €100m in EBT tailwinds as restructuring measures taken in 2011 (staff cuts and site closures) start to impact P&L in 2012 and tax loss carry forwards that will be used after a change to the company's holding structure. We expect a weak Q1 as the Tubes division lost a large order in Iran due to EU sanctions but better prospects for the rest of the year.

Klöckner & Co.: We expect Klöckner to continue to face challenges in 2012 with limited upside to steel prices and weak pricing power pressuring margins. In the absence of a European recovery the stock is likely to remain range bound with valuation support from NWC around £10.

Figure 1. Steel and raw material prices

Prices US\$/t	Current	1m ago	3m ago	6m ago	US\$ monthly change
Europe HRC	719	724	673	751	-5
Europe CRC	786	793	722	856	-7
Europe heavy plate	794	823	783	829	-29
US HRC	747	748	823	732	-1
US CRC	853	868	920	832	-15
US heavy plate	922	917	957	924	5
US rebar	805	805	813	793	0
Shanghai HRC (2mm)	716	702	694	693	14
Shanghai CRC (1mm)	800	812	811	819	-12
Shanghai rebar	654	653	652	660	1
62% Iron ore fines - China CFR	144	147	140	120	-3
US HMS scrap	440	439	469	443	1
Australia low vol. coking coal \$/t	208	206	216	237	2
EU HRC conversion margin \$/t (spot raw mats.)	298	299	247	347	-2

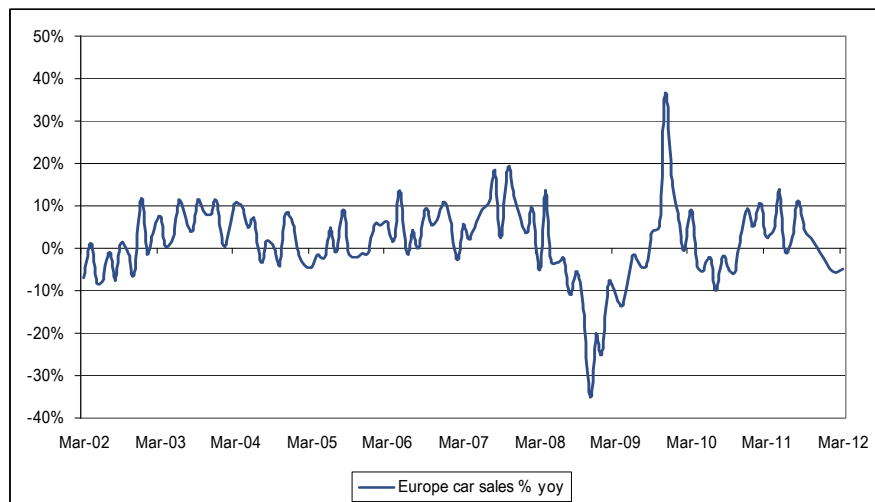
Source: DataStream

In summary, we would say that the European steel sector is currently characterised by negative demand conditions, but offsetting this are some positive supply side developments. We examine these issues in detail.

1. The key negative – demand

Auto sales in Europe have been weak with yoy drops in new car registrations in France, Italy, Belgium, Netherlands, Spain. Of the major markets, UK and Germany registered positive yoy comps in March 12.

Figure 2. Car sales and new car registrations look weak (ex UK and Germany)



Source: Bloomberg

In addition to this, the explosion at the Evonik CDT plant could create disruptions to the auto supply chain in late Q2-early Q3 2012. CDT is used in making a resin called PA12, which is used just in time components like hydraulic tubes, pumps etc. As of now, we have not heard of explicit plant shutdowns (like specific outages during the tsunami in Japan), but our autos and chemicals analysts are fairly certain that some measure of disruption to auto production is likely due to this event.

European construction activity remains weak, with no real change in the EU construction confidence indicator and a recent resurgence of macro worries (French elections, Spanish bond yields) will do little to improve this picture in Q2.

Figure 3. European construction – bouncing along the bottom

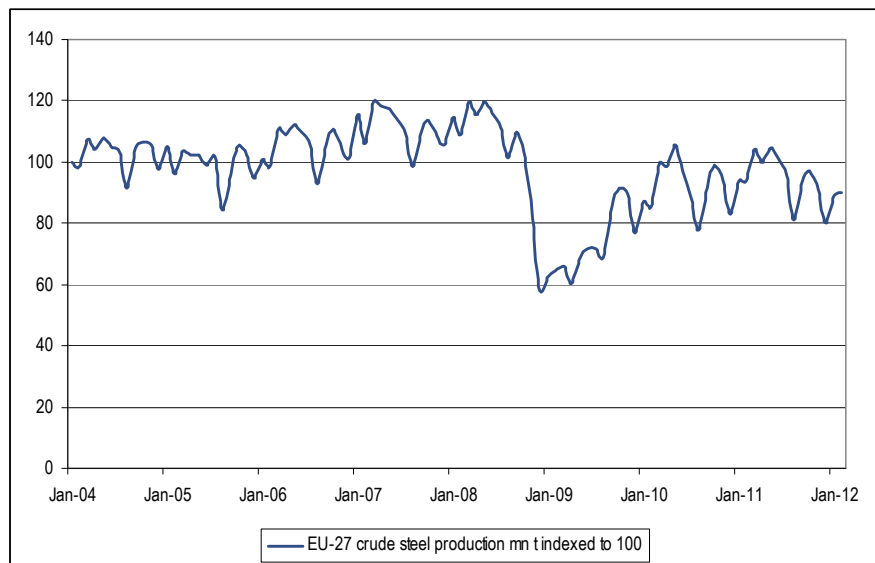


Source: Bloomberg

2. European steel sheet prices remain quite stable

Although European demand remains fairly hand to mouth (according to the mills we cover), plant closures by ArcelorMittal and some maintenance shut downs have kept supply in check. As expected, demand in S.Europe is weak – but this is hardly new news anymore.

Figure 4. Production suggests > 80% utilization in Europe



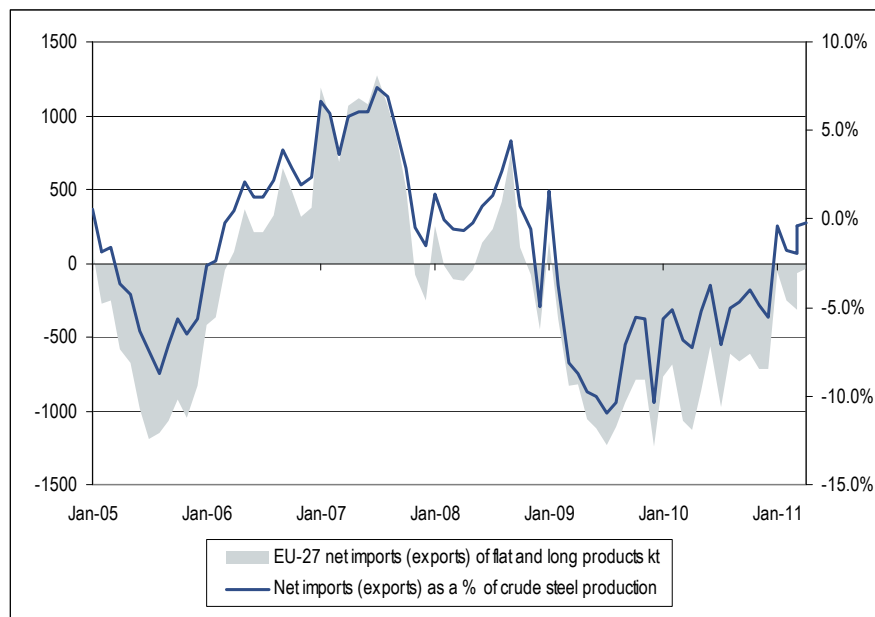
Source: IISI

With coking coal and iron ore prices rising from their lows and utilisation rates high (~90% in N.Europe for flat products), EU flat product prices could rise a bit more. Most of the recovery from the lows of November seems done, but we are looking for a further €5-10/t over summer. This was a tough ask a few weeks back as US HRC prices fell from \$750/s.ton to \$670-680/s.ton, but even US prices look set to rise with mills pushing for a \$20-\$25/s.ton hike over current levels.

3. European net exports are recovering - a weak € is a tailwind

Also underpinning the positive supply story for European steel is lack of imports from Asia and a strong bounce in European steel exports. A weaker €/ \$ exchange rate (down ~ 8.5% yoy) is helping this trade balance recover as European exports become more competitive.

Figure 5. Trade balance shifts in favour of European mills

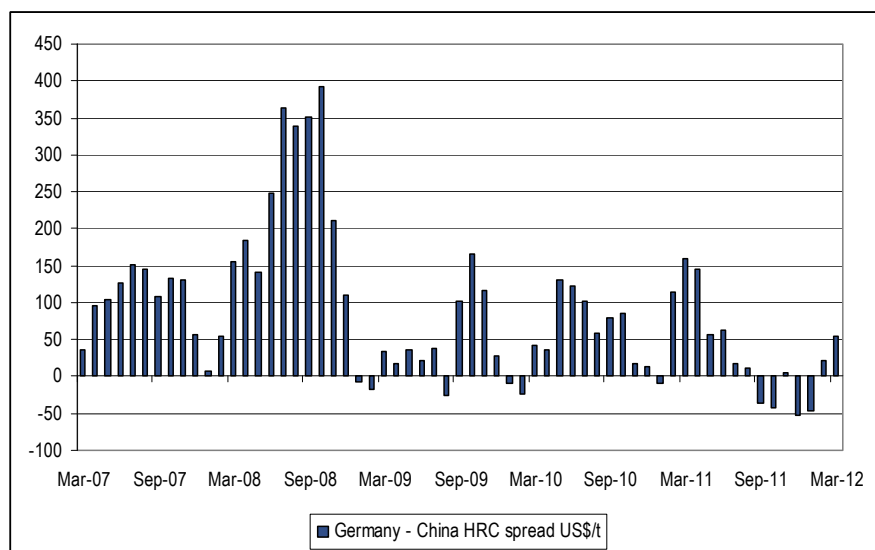


Source: Eurofer

Salzgitter's management confirmed this trend at a recent analyst meeting, when it said that its PTG electric arc furnace has reached 80% utilisation in Q1 due to strong export business.

In addition, the price-arbitrage for Europe-Asia HRC prices remains at rather low levels and with Asian prices firming up this week, the case for higher European steel prices has also improved.

Figure 6. Price arbitrage with Asia is also supportive of stable to higher EU prices

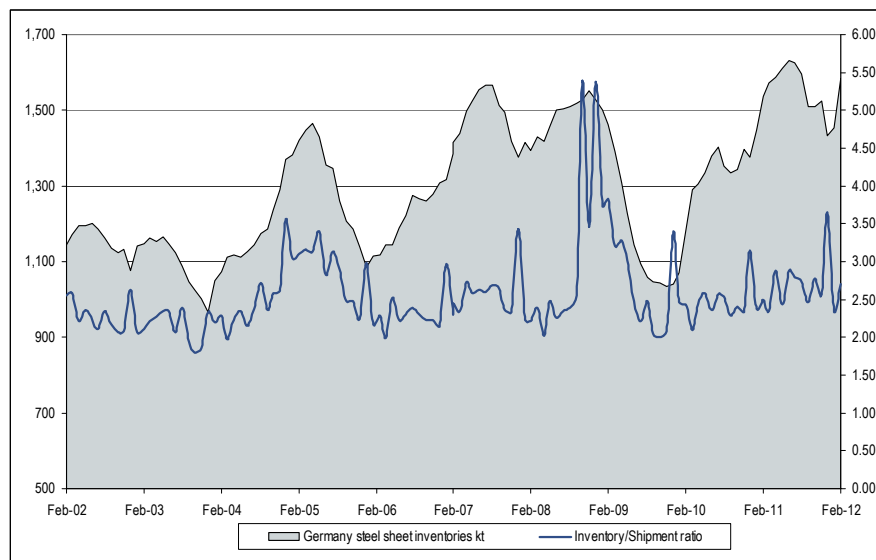


Source: CRU

4. 2H de-stocking risk less than 2011 due to price and fx

Q3 is usually a seasonally weak quarter for steel, but after the steep decline in steel prices in Q4, investors are understandably nervous about what 2H12 holds for steel prices and volumes.

Figure 7. German sheet inventory levels similar to 1H11



Source: CRU

We think inventories are looking similar to 1H11 to start with in 2012, with German sheet inventories up 3% yoy at ~1.58m tonnes in Feb-12. Distributors are also likely to have been more cautious in Feb and March in building stocks, given the experience of 2011, when inventories rose sharply from Jan-11 to July-11 (2.4m of shipments to 2.8m of shipments).

While we need the March data to get a better picture of a better inventory situation vs. 2011, we would highlight that steel prices in Europe are down 12.6% yoy and the €/US\$ exchange rate is 11.6% lower yoy. Both these factors should suggest that de-stocking in 2H11 should be a normal seasonal progression, and not the sharp in volumes and prices that we saw in 2H11.

Figure 8. Global Steel Comps

Company	Rating	Market Cap	Currency	Share Price	Upside	P/E (x)			EV/EBITDA (x)			EBITDA Margin		
						2011A	2012E	2013E	2011A	2012E	2013E	2011A	2012E	2013E
ArcelorMittal	1	27,002	EUR	13.1	45.4%	11.8	10.9	5.5	4.0	4.8	3.7	11%	10%	12%
voestalpine	1	5,474	EUR	24.5	43.1%	8.1	7.8	6.8	5.1	5.1	4.6	13%	13%	14%
Klöckner & Co.	2	1,354	EUR	10.3	17.1%	94.3	27.0	9.6	6.6	6.4	4.6	3%	3%	5%
Salzgitter	1	3,138	EUR	39.4	36.9%	20.7	15.1	11.1	6.3	5.6	4.6	5%	7%	7%
Commercial Metal	1	1,712	USD	14.8	15.2%	30.8	10.1	7.6	8.5	5.2	3.9	4%	6%	7%
Steel Dynamics	1	2,811	USD	12.8	40.3%	10.3	8.8	6.7	6.0	5.1	3.8	10%	11%	15%
AK Steel Holding	2H	826	USD	7.5	7.1%	67.6	47.2	7.9	11.9	10.1	6.9	4%	5%	7%
Allegheny Tech	1	4,605	USD	43.0	27.9%	19.3	16.5	10.5	10.0	8.5	6.0	12%	13%	16%
Carpenter Tech	2	2,473	USD	55.9	2.0%	24.7	17.4	14.6	12.3	8.2	6.6	13%	18%	21%
Nucor	1	12,428	USD	39.2	30.1%	16.4	15.3	10.1	6.8	6.5	4.9	10%	10%	13%
US Steel Corp	1H	4,113	USD	28.6	22.5%	163.0	11.4	6.3	8.4	5.0	3.5	4%	7%	9%
Severstal	1	13,576	USD	13.5	18.8%	6.3	8.0	12.0	4.2	5.1	6.0	23%	19%	15%
Evrast	3	8,150	GBP	3.7	-26.4%	17.5	23.6	-168.2	4.6	6.2	7.8	18%	14%	11%
Mechel	3	3,580	USD	8.6	-7.0%	3.0	2.9	5.9	4.0	4.0	6.1	28%	28%	22%
NLMK	3	13,125	USD	2.2	744.7%	13.9	23.2	33.4	6.8	9.3	10.5	19%	15%	13%
POSCO	1	28,968	KRW	375500	17.2%	7.8	8.7	7.3	5.3	7.1	5.7	11%	9%	12%
Maanshan Iron	2H	489	HKD	2.2	14.2%	201.9	124.8	13.4	4.6	5.4	3.8	7%	7%	9%
Angang Steel	3H	743	HKD	5.3	-20.2%	14.8	88.6	29.2	13.1	6.8	5.4	5%	9%	10%
Baoshan Steel	2H	13,877	CNY	5.0	3.4%	12.2	7.6	18.9	6.3	6.2	5.5	10%	13%	13%
Steel Authority	2	7,439	INR	94.9	13.9%	8.0	8.2	7.6	5.2	5.7	5.5	19%	19%	21%
Tata Steel	2	8,550	INR	463.7	-4.7%	11.6	11.2	6.6	5.9	5.8	4.9	11%	12%	14%
JSW Steel	1	2,931	INR	692.0	33.0%	13.0	9.1	6.2	5.8	4.9	4.0	15%	17%	19%
Ternium	2	4,801	USD	24.0	8.6%	9.2	7.3	5.7	3.2	3.3	2.9	18%	18%	19%
Usiminas	3	2,909	BRL	10.9	0.7%	41.5	23.5	19.3	10.3	13.7	12.8	12%	10%	11%
Gerdau	2	10,759	BRL	17.9	0.4%	16.9	13.0	10.7	8.2	7.0	6.1	12%	14%	15%
Siderurgica Nacional	3	12,488	BRL	16.4	4.0%	5.8	11.5	11.3	4.6	5.5	5.6	39%	36%	37%

Source: dataCentral

Company Focus

- Company Update
- Target Price Change
- Estimate Change

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Buy	1
Price (30 Apr 12)	€24.75
Target price	€36.00
	from €35.00
Expected share price return	45.5%
Expected dividend yield	3.6%
Expected total return	49.1%
Market Cap	€4,183M
	US\$5,545M

Price Performance

(RIC: VOES.VI, BB: VOE AV)



voestalpine AG (VOES.VI)

Differentiated and Cheap – Reiterate Buy

- **Goodbye commodity rails** — Voestalpine is exiting its commodity rail production business in Germany. The TSTG unit was a key supplier to Deutsche Bahn, but was suffering from severe competition from other under-utilised steel producers and is also the subject of a German anti-trust investigation. VOE said that a €205m provision has been made to cover both customer compensation and plant closure costs. No fine is expected as VOE was the whistle-blower in the case. We include the provision in FY11/12 results, which causes a reduction to our 2012 earnings forecast.
- **Hello specialty rails** — Production at Donawitz, Austria will remain focused on more specialty rails, high quality billets and blooms. This is complemented by strong market positions in turnout systems and track based monitoring systems. Post-restructuring, we expect EBIT margins in Railways to improve to ~12% from the 9-10% range we have seen since 2009.
- **Raising 2013-14 estimates and target price** — We raise our 2013-2014 estimates and target price for Voestalpine (from €35 to €36). These changes are driven by higher earnings in Railways in coming years. Post these changes, VOE trades on 8.9X 2012E EPS and 7.7x 2013E EPS.
- **Results on 30 May** — VOE will report 4Q11/12 (calendar Q1) on 30 May. The €205m provision in Railways will be taken in this quarter; hence we expect a sharp q/q drop in profits. This should be widely expected in the market now. We expect full year revenues at €11.6bn and EBIT at €651m.

voestalpine AG (EUR)

Year to 31 Mar	2010A	2011A	2012E	2013E	2014E
Sales (€M)	8,550.1	10,953.7	11,648.4	11,256.5	11,534.8
Net Income (€M)	106.3	512.7	345.8	553.3	651.8
Diluted EPS (€)	0.63	3.05	2.05	3.27	3.86
Diluted EPS (Old) (€)	0.63	3.05	2.83	3.25	3.74
PE (x)	39.0	8.1	12.1	7.6	6.4
EV/EBITDA (x)	8.7	5.2	5.5	5.0	4.4
DPS (€)	0.50	0.80	0.76	0.86	0.98
Net Div Yield (%)	2.0	3.2	3.1	3.5	4.0

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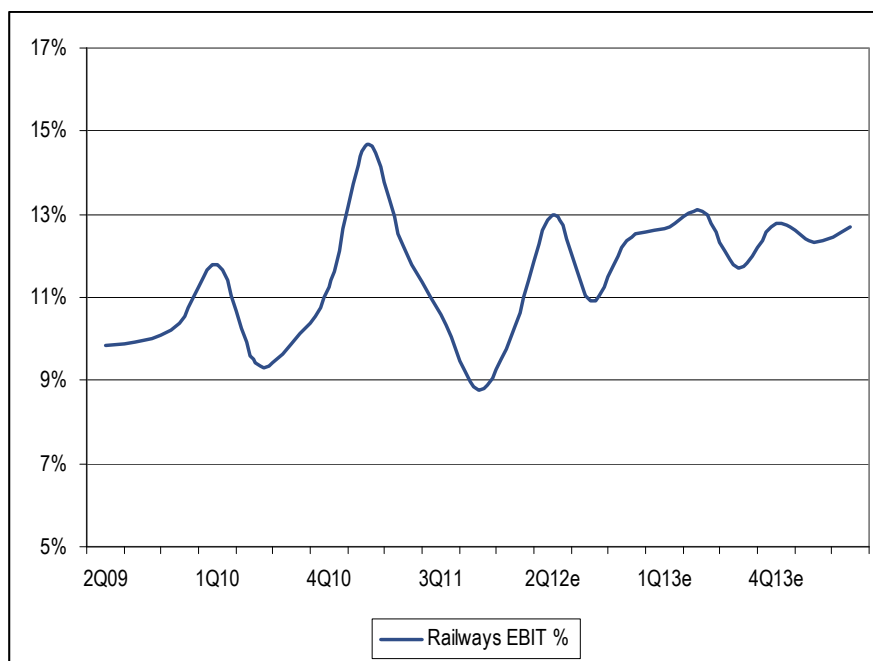
VOES.VI: Fiscal year end 31-Mar						Price: €24.75; TP: €36.00; Market Cap: €4,184m; Recomm: Buy					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	8,550	10,954	11,648	11,257	11,535	PE (x)	39.0	8.1	12.1	7.6	6.4
Cost of sales	-8,084	-9,902	-10,952	-10,285	-10,464	PB (x)	1.0	0.9	0.9	0.8	0.7
Gross profit	466	1,052	696	972	1,070	EV/EBITDA (x)	8.7	5.2	5.5	5.0	4.4
Gross Margin (%)	5.4	9.6	6.0	8.6	9.3	FCF yield (%)	23.9	11.5	9.3	15.5	14.9
EBITDA	1,004	1,606	1,459	1,550	1,653	Dividend yield (%)	2.0	3.2	3.1	3.5	4.0
EBITDA Margin (%)	11.7	14.7	12.5	13.8	14.3	Payout ratio (%)	79	26	37	26	25
Depreciation	-538	-554	-763	-578	-582	ROE (%)	2.5	11.6	7.3	11.0	11.8
Amortisation	-116	-67	-45	-24	-2	Cashflow (€m)	2010	2011	2012E	2013E	2014E
EBIT	350	985	651	948	1,068	EBITDA	1,004	1,606	1,459	1,550	1,653
EBIT Margin (%)	4.1	9.0	5.6	8.4	9.3	Working capital	872	-237	-148	84	-59
Net interest	-189	-234	-171	-159	-135	Other	-271	-411	-329	-364	-349
Associates	20	30	32	31	32	Operating cashflow	1,606	958	982	1,270	1,244
Non-op/Except	0	0	0	0	0	Capex	-615	-479	-595	-620	-620
Pre-tax profit	181	781	512	819	965	Net acq/disposals	32	12	0	0	0
Tax	3	-186	-113	-180	-212	Other	-331	100	0	0	0
Extraord./Min.Int./Pref.div.	-78	-82	-54	-86	-101	Investing cashflow	-914	-367	-595	-620	-620
Reported net profit	106	513	346	553	652	Dividends paid	-254	-162	-135	-128	-145
Net Margin (%)	1.2	4.7	3.0	4.9	5.7	Financing cashflow	-540	-390	-385	-378	-395
Core NPAT	106	513	346	553	652	Net change in cash	152	200	2	271	229
Per share data	2010	2011	2012E	2013E	2014E	FCF ex acquisitions & explorn	1,023	491	387	650	624
Reported EPS (€)	0.63	3.05	2.05	3.27	3.86						
Core EPS (€)	0.63	3.05	2.05	3.27	3.86						
DPS (€)	0.50	0.80	0.76	0.86	0.98						
CFPS (€)	9.59	5.70	5.81	7.51	7.36						
FCFPS (€)	5.92	2.85	2.29	3.84	3.69						
BVPS (€)	25.01	27.48	28.56	31.08	34.08						
Wtd avg ord shares (m)	167	168	169	169	169						
Wtd avg diluted shares (m)	167	168	169	169	169						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	-27.1	28.1	6.3	-3.4	2.5						
EBIT (%)	-64.6	181.5	-33.9	45.5	12.7						
Core NPAT (%)	-79.9	382.1	-32.5	60.0	17.8						
Core EPS (%)	-80.4	380.5	-32.9	60.0	17.8						
Balance Sheet (€m)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	1,029	1,233	1,235	1,507	1,736						
Accounts receivables	1,458	1,710	1,818	1,757	1,800						
Inventory	2,198	2,824	3,003	2,902	2,974						
Net fixed & other tangibles	4,484	4,371	4,203	4,246	4,283						
Goodwill & intangibles	2,295	2,183	2,183	2,183	2,183						
Financial & other assets	831	755	787	818	850						
Total assets	12,294	13,076	13,230	13,412	13,826						
Accounts payable	1,726	2,197	2,336	2,257	2,313						
Short-term debt	1,448	1,428	1,428	1,428	1,428						
Long-term debt	3,268	3,071	2,821	2,571	2,321						
Provisions & other liab	1,589	1,690	1,690	1,690	1,690						
Total liabilities	8,032	8,385	8,275	7,946	7,752						
Shareholders' equity	4,190	4,618	4,828	5,253	5,760						
Minority interests	73	73	127	213	314						
Total equity	4,262	4,691	4,955	5,466	6,074						
Net debt	3,688	3,265	3,013	2,492	2,012						
Net debt to equity (%)	86.5	69.6	60.8	45.6	33.1						

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For definitions of the items in this table, please click [here](#).

Differentiated and Cheap

We increase our 2013-2014 estimates and price target for VOE to account for the restructuring in the Railways division. The standard rails plant in Duisburg is being closed and VOE is exiting the business, which has been plagued by recent pricing pressure and a legacy anti-trust investigation. VOE is setting aside €205m to compensate large customers like Deutsche Bahn and included in this figure are some tens of millions of euros to cover plant closure costs.

Figure 9. Railways EBIT % to increase by 3%

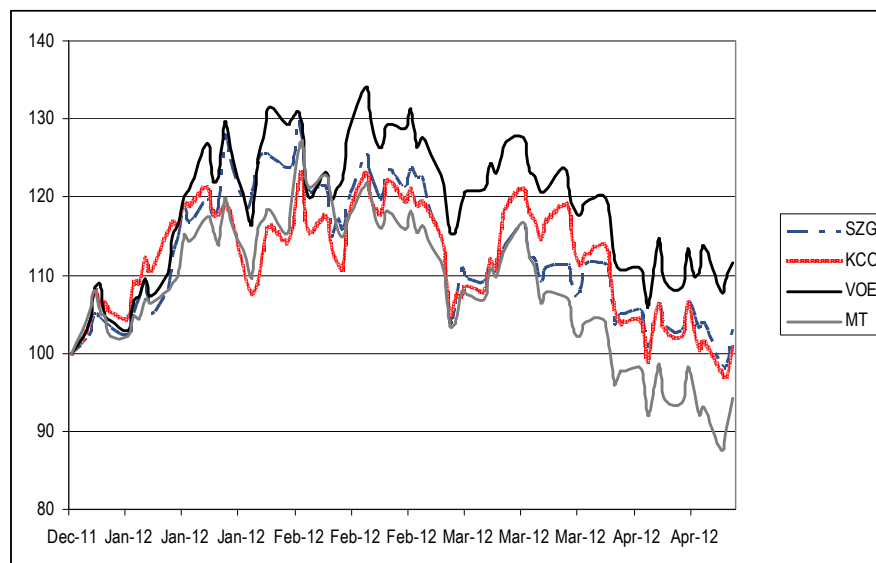


Source: Company Reports and CIRA Estimates

Post this move, VOE will focus on specialty products like head hardened rails, seamless, turnouts and switching gear and we expect EBIT margins in the division to increase to 12% from the recent 9-10% range. We have built in a €150m decline in annual revenues, a 150kt decline in volumes and higher margins. Using 2011/12 as a base case scenario, we estimate that the restructuring will result in a structural 8% lift to the profitability of the division.

Voestalpine has outperformed its European peers since the start of the year. We think this is partly to do with asset quality and margins vs. the peer group, but also the group's exposure to the German auto industry – one of the two major markets in Europe that is still witnessing volume growth.

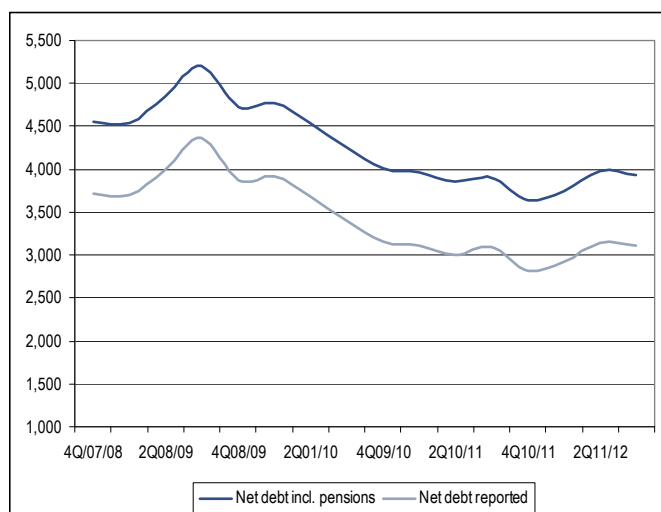
Figure 10. VOE vs. European steel peers



Source: DataStream

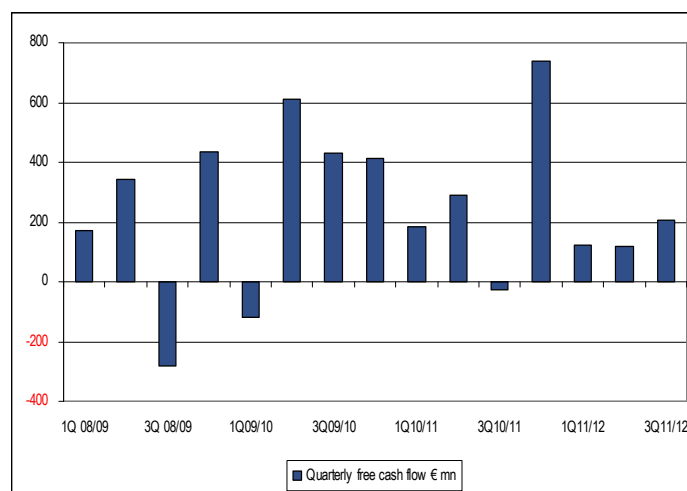
The group has also consistently generated free cash flow and slowly reduced net debt. VOE still has a restrictive net debt position in our view – including pensions, net debt is pretty similar to market cap and we believe this somewhat reduces the company's ability to embark on major expansions or acquisitions. As such, we expect the near term strategy of the company to focus on small acquisitions and channel the lion's share of cash generated to further bring down gearing.

Figure 11. Some progress on net debt reduction



Source: Company Reports

Figure 12. Consistently positive FCF generation



Source: Company Reports

Results on 30 May

VOE will report 4Q11/12 (calendar Q1) on 30 May. The €205m provision in Railways will be taken in this quarter; hence we expect a sharp q/q drop in profits. This should be widely expected in the market now. We expect full year revenues at €11.6bn and EBIT at €651m.

Figure 13. VOE full year results for 2011/12 (year ending Mar-12) on 30 May

€mn	1Q09/10	2Q01/10	3Q09/10	4Q09/10	1Q10/11	2Q10/11	3Q10/11	4Q10/11	1Q11/12	2Q11/12	3Q11/12F	4Q11/12F
Group Revenue	2,093	2,089	2,107	2,261.7	2,556.11	2,636	2,745	3,017	3,051	2,926	2,900	2,771
Operating costs	-1,959	-1,856	-1,810	-1,921	-2,205	-2,276	-2,348	-2,519	-2,589	-2,565	-2,606	-2,430
EBIT (Pre PPA)	6	100	132	227	203	211	244	327	326	223	159	-11
Adj. EBIT	-26	69	132	175	203	211	244	327	318	214	145	-25
EBIT%	-1.26%	3.31%	6.29%	7.72%	7.95%	8.00%	8.89%	10.83%	10.41%	7.31%	5.00%	-0.90%
PBT	-70.1	27.8	89.9	133.7	156.5	160.9	197.50	266.1	271.8	171.5	90.5	-21.6
Net Income	-48.2	28.4	71.5	133.0	121.1	128.5	150.6	194.3	209.6	136.5	65.3	-11.9
EPS (€)	-0.40	0.05	0.30	0.68	0.60	0.64	0.78	1.03	1.12	0.69	0.27	-0.04

Source: Company Reports and CIRA Estimates

Valuation

We value VOE using a blend of DCF, multiples, residual income and FCF methods. Our price target of €36 is set as a blend of these four methods.

Figure 14. DCF

€mn	FY09/10	FY10/11	FY11/12e	FY12/13e	FY13/14e	FY14/15e	FY15/16e	Terminal
EBITDA	1,004	1,606	1,459	1,550	1,653	1,650	1,518	1,500
Tax	3	-186	-113	-180	-212	-214	-195	-210
Maintenance Capex	-538	-467	-575	-600	-600	-600	-600	-625
Assoc+Others	20	30	32	31	32	32	31	25
WC	872	-237	-148	84	-59	-8	79	-10
FCF	1,362	745	655	884	813	859	833	680
PV of cash flows			609	760	645	627	557	6,314
							EV	9,511
							NPV	5,991
							NPV/sh	€36

Source: Company Reports and CIRA Estimates

Figure 15. Sum of parts valuation

€ mn	2010/11	2011/12	2012/13	2013/14	2014/15
Steel	595	442	566	641	640
Special Steel	388	417	440	475	471
Railways	422	417	408	413	403
Profilform	159	147	110	98	94
Automotive	121	109	103	108	125
Corporate	-80	-73	-77	-83	-82
Multiples used	2010/11	2011/12	2012/13	2013/14	2014/15
Steel	5.5	5.5	5.5	5.5	5.5
Special Steel	6.0	6.0	6.0	6.0	6.0
Railways	6.0	6.0	6.0	6.0	6.0
Profilform	5.0	5.0	5.0	5.0	5.0
Automotive	4.5	4.5	4.5	4.5	4.5
Corporate	6.0	6.0	6.0	6.0	6.0
EV	8,995	8,225	8,750	9,336	9,298
Equity Value/share			€34	€39	€42

Source: Company Reports and CIRA Estimates

Figure 16. FCF analysis

€ mn	FY09/10	FY10/11	FY11/12e	FY12/13e	FY13/14e	FY14/15e	FY15/16e
EBITDA Mgn %	11.7%	14.7%	12.5%	13.8%	14.3%	14.3%	13.5%
EBITDA	1,004	1,606	1,459	1,550	1,653	1,650	1,518
- Net Financial	-189	-234	-171	-159	-135	-112	-87
-Taxes Paid	3	-186	-113	-180	-212	-214	-195
-Working Capital & Other	872	-237	-148	84	-59	-8	79
-Capex	-615	-479	-595	-620	-620	-620	-620
-Minority Interest	73	73	127	213	314	416	509
FCF from Operations	1,003	396	305	461	312	280	187
Stock Price (\$)	24.42	23.91	23.91	23.91	23.91	23.91	23.91
shares O/S	167	168	169	169	169	169	169
Equity Value	4,089	4,018	4,042	4,042	4,042	4,042	4,042
Value/sh		€ 35	€ 27	€ 40	€ 27	€ 24	€ 16

Source: Company Reports and CIRA Estimates

Figure 17. Residual income

(€mn):	FY09/10	FY10/11	FY11/12e	FY12/13e	FY13/14e	FY14/15e	FY15/16e	Terminal
Reported EPS (€)	0.63	3.05	2.05	3.27	3.86	3.88	3.53	
EBIT %	5.4%	9.6%	6.0%	8.6%	9.3%	9.1%	8.4%	
ROE %	2.8%	7.5%	4.9%	7.1%	7.7%	7.4%	6.5%	
Net Income	106	513	346	553	652	657	598	600
+ Depreciation & Amortization	538	554	763	578	582	597	577	577
- Sustaining Capex	-538	-467	-575	-600	-600	-600	-600	-625
Economic Earnings to Shareholders	106	599	534	531	634	654	574	552
Economic Earnings/Equity - %	2.5%	13.0%	11.1%	10.1%	11.0%	10.4%	8.6%	10.3%
Beginning Equity	4,190	4,618	4,828	5,256	5,767	6,262	6,698	5,374
Required Rate of Return - %	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%	9.5%
Required Return	398	439	459	499	548	595	636	511
Residual Income	-292	161	75	32	86	59	-62	41
Excess Rate of Return	-7.0%	3.5%	1.6%	0.6%	1.5%	0.9%	-0.9%	0.8%
Present Value of Residual Income	-271	139	60	23	59	37	-35	746
Residual Income Valuation Results:								
	€ mn	Per Share						
Shareholders' Equity	4,618	€ 27						
+ PV of Residual Income Years 1-6	282	€ 2						
+ Terminal Value	746	€ 4						
Total Equity Value	5,646	€ 34						

Source: Company Reports and CIRA Estimates

Company Focus

- Company Update
- Estimate Change

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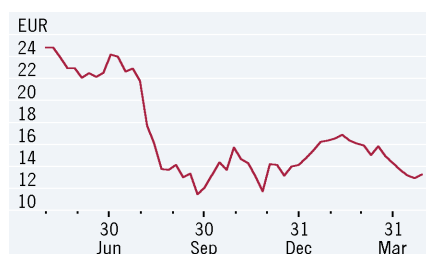
Heath R Jansen

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Buy	1
Price (30 Apr 12)	€13.33
Target price	€19.00
Expected share price return	42.6%
Expected dividend yield	4.2%
Expected total return	46.8%
Market Cap	€20,799M US\$27,568M

Price Performance

(RIC: ISPA.AS, BB: MT NA)



ArcelorMittal (ISPA.AS)

Dividends: Time to Use the 'Nuclear Option'?

- **Defending the rating** — The market is paying a fair bit of attention to the probability of MT's credit rating being potentially downgraded. S&P has MT on negative outlook and equity investors appear focused on this as the company has said that maintaining investment grade is a priority. The combination of these two factors has once again led to some questions on the need for a capital increase. We think a combination of divestments, improvements in working capital and potentially dividend measures are sufficient to defend the rating.
- **Divestments moving a little slowly** — Equity market conditions remain challenging and a resurgence of macro fears in China and Europe this year have probably slowed down the divestment process for MT's non core assets. MT raised \$267m from the sale of 134.3m shares. If the warrants attached to the share sale are exercised in 3, 6 and 8.5 months, MT would raise a similar amount. There has not been any further news on divestments of European or Chinese steel minority stakes.
- **Use the nuclear option (like Lafarge)** — We argued in a previous note that cutting the dividend would be viewed as the "nuclear option" at MT, as the dividend is seen as a symbol of strength and stability. However, with equity investors still nervous about a rating downgrade and tough market conditions for divestments, we think it would be prudent for MT cut the dividend in half. We examine the situation at Lafarge which was cut to junk recently, did the same in mid Feb 2012 and got a positive reaction from the market.
- **1Q12 results on 10 May** — MT will report Q1 results on 10 May. The company's guidance of 1H EBITDA higher than 2H11 and lower than 1H11 set a range of \$4.12-5.99bn EBITDA. We forecast \$4.4bn – close to the bottom end of this range. For Q1, we also expect a non-cash impairment charge related to the Erdemir stake sale. Our Q1 EBITDA forecast is \$1.77bn.
- **Changes to EPS** — We have trimmed 2012-2014 EPS to reflect weaker shipments in Flat Carbon Europe – we feel this is consistent with the weak auto production statistics that we are seeing so far in 2012, especially ex-Germany.

ArcelorMittal (USD)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (\$M)	78,025.0	93,973.0	94,032.4	96,393.6	98,278.9
Net Income (\$M)	2,913.8	2,263.0	2,389.8	4,735.6	5,126.2
Diluted EPS (\$)	1.85	1.46	1.54	3.06	3.31
Diluted EPS (Old) (\$)	1.85	1.46	1.59	3.17	3.34
PE (x)	9.5	12.1	11.5	5.8	5.3
EV/EBITDA (x)	5.1	4.1	4.9	3.8	3.4
DPS (\$)	0.75	0.75	0.75	0.75	0.75
Net Div Yield (%)	4.2	4.2	4.2	4.2	4.2

European Steel Equities
2 May 2012

ISPA.AS: Fiscal year end 31-Dec						Price: €13.33; TP: €19.00; Market Cap: €20,807m; Recomm: Buy					
Profit & Loss (US\$m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	78,025	93,973	94,032	96,394	98,279	PE (x)	9.5	12.1	11.4	5.8	5.3
Cost of sales	-73,894	-88,525	-89,536	-89,666	-91,118	PB (x)	0.4	0.5	0.5	0.4	0.4
Gross profit	4,131	5,448	4,497	6,727	7,161	EV/EBITDA (x)	5.1	4.1	4.9	3.8	3.4
Gross Margin (%)	5.3	5.8	4.8	7.0	7.3	FCF yield (%)	2.4	-8.7	-3.4	11.6	20.2
EBITDA	8,525	10,117	9,058	11,647	12,180	Dividend yield (%)	4.2	4.2	4.2	4.2	4.2
EBITDA Margin (%)	10.9	10.8	9.6	12.1	12.4	Payout ratio (%)	41	51	49	25	23
Depreciation	-4,394	-4,669	-4,561	-4,919	-5,019	ROE (%)	4.7	3.8	4.2	7.9	8.1
Amortisation	0	0	0	0	0	Cashflow (US\$m)	2010	2011	2012E	2013E	2014E
EBIT	4,131	5,448	4,497	6,727	7,161	EBITDA	8,525	10,117	9,058	11,647	12,180
EBIT Margin (%)	5.3	5.8	4.8	7.0	7.3	Working capital	-2,531	-3,825	-677	-293	-272
Net interest	-1,483	-1,822	-1,750	-1,600	-1,600	Other	-1,979	-3,835	-4,508	-3,185	-2,106
Associates	451	620	322	505	537	Operating cashflow	4,015	2,457	3,874	8,169	9,803
Non-op/Except	-1,245	-1,566	-200	0	0	Capex	-3,346	-4,838	-4,800	-5,000	-4,280
Pre-tax profit	1,854	2,680	2,869	5,632	6,098	Net acq/disposals	0	0	0	0	0
Tax	1,479	-882	-459	-901	-976	Other	-92	1,160	265	0	0
Extraord./Min.Int./Pref.div.	-420	465	-20	5	4	Investing cashflow	-3,438	-3,678	-4,535	-5,000	-4,280
Reported net profit	2,914	2,263	2,390	4,736	5,126	Dividends paid	-1,260	-1,194	-1,162	-1,162	-1,162
Net Margin (%)	3.7	2.4	2.5	4.9	5.2	Financing cashflow	-8	-540	-2,662	-2,662	-2,662
Core NPAT	2,914	2,263	2,390	4,736	5,126	Net change in cash	287	-1,829	-3,323	507	2,861
Per share data	2010	2011	2012E	2013E	2014E	FCF ex acquisns & explorn	669	-2,381	-926	3,169	5,523
Reported EPS (\$)	1.85	1.46	1.54	3.06	3.31						
Core EPS (\$)	1.85	1.46	1.54	3.06	3.31						
DPS (\$)	0.75	0.75	0.75	0.75	0.75						
CFPS (\$)	2.55	1.59	2.50	5.27	6.33						
FCFPS (\$)	0.43	-1.54	-0.60	2.05	3.57						
BVPS (\$)	41.29	36.60	37.39	39.70	42.26						
Wtd avg ord shares (m)	1,512	1,549	1,549	1,549	1,549						
Wtd avg diluted shares (m)	1,574	1,549	1,549	1,549	1,549						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	22.1	20.4	0.1	2.5	2.0						
EBIT (%)	612.2	31.9	-17.5	49.6	6.4						
Core NPAT (%)	nm	-22.3	5.6	98.2	8.2						
Core EPS (%)	nm	-21.1	5.6	98.2	8.2						
Balance Sheet (US\$m)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	6,298	3,905	582	1,089	3,950						
Accounts receivables	5,725	6,452	6,818	7,098	7,183						
Inventory	19,583	21,689	22,450	22,482	22,939						
Net fixed & other tangibles	54,344	54,251	54,225	54,305	53,566						
Goodwill & intangibles	14,373	14,053	14,053	14,053	14,053						
Financial & other assets	30,581	21,530	21,530	21,530	21,530						
Total assets	130,904	121,880	119,658	120,558	123,221						
Accounts payable	13,256	12,836	13,286	13,306	13,576						
Short-term debt	6,716	2,784	2,784	2,784	2,784						
Long-term debt	19,292	23,634	22,134	20,634	19,134						
Provisions & other liab	25,540	22,149	19,729	18,541	18,473						
Total liabilities	64,804	61,403	57,933	55,264	53,967						
Shareholders' equity	62,430	56,690	57,918	61,492	65,456						
Minority interests	3,670	3,787	3,807	3,802	3,798						
Total equity	66,100	60,477	61,725	65,294	69,254						
Net debt	19,710	22,513	24,336	22,329	17,968						
Net debt to equity (%)	29.8	37.2	39.4	34.2	25.9						

For further data queries on Citi's full coverage universe please contact CIRA Data Services Europe at CIRADatServicesEMEA@citi.com or +44-207-986-4050
For definitions of the items in this table, please click [here](#).

Dividends: Time to Use the Nuclear Option?

MT recently sold down its stake in Turkish steel producer – Erdemir. The transaction comprised of an accelerated book build to sell 134.3m shares with warrants attached to the shares. The transaction proceeds were ~\$267m and a similar number of shares will be sold will be raised if the warrants are exercised.

Investor feedback has been mildly positive – positive as it's a step in the right direction and consistent with what MT has been communicating to the market. Mild, as the amount raised is not sufficient to make a dent in the still cumbersome net debt position.

Meanwhile, a resurgence of macro fears (China and Europe) have probably dented investors' risk appetite and the speed of the divestment process. In this note we examine other options available to the company – notably a reduction in the full year dividend.

Our logic for this is:

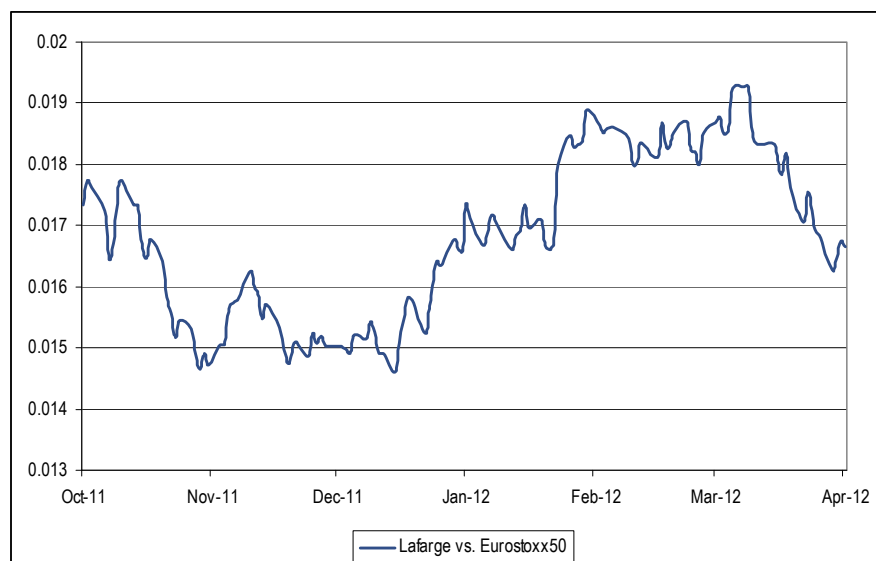
1. Investors in our view own MT for earnings recovery and beta - not for income
2. The company's current dividend yield of 4.2% is actually quite high for the materials sector (BHP is 3.5%, VOE is 3.5%), with an annual dividend cash call of ~\$1.1bn; we estimate a 50% cut in the dividend would save a meaningful \$550m of cash annually.

Lessons from Lafarge

We use the example of Lafarge as a highly leveraged basic materials company (net debt of €12bn vs. market cap of €8.5bn at the time of FY11 results). Lafarge reported its full year 2011 results on 17 Feb – net profit of €593m was down 28% yoy. The company guided to “significant debt reduction in 2012”.

The company guided to €1bn of divestments in 2012 and cut its annual dividend in half to €0.50/sh (saving €143.6m of annual cash flow).

Figure 18. Markets reacted positively to Lafarge's dividend cut



Source: DataStream

The stock outperformed the SX5E Index by 11% over the next one.

Despite these measures, S&P revised Lafarge to negative outlook on 13 March. This combined with the broader market sell off has left Lafarge's outperformance vs the market at just 1%.

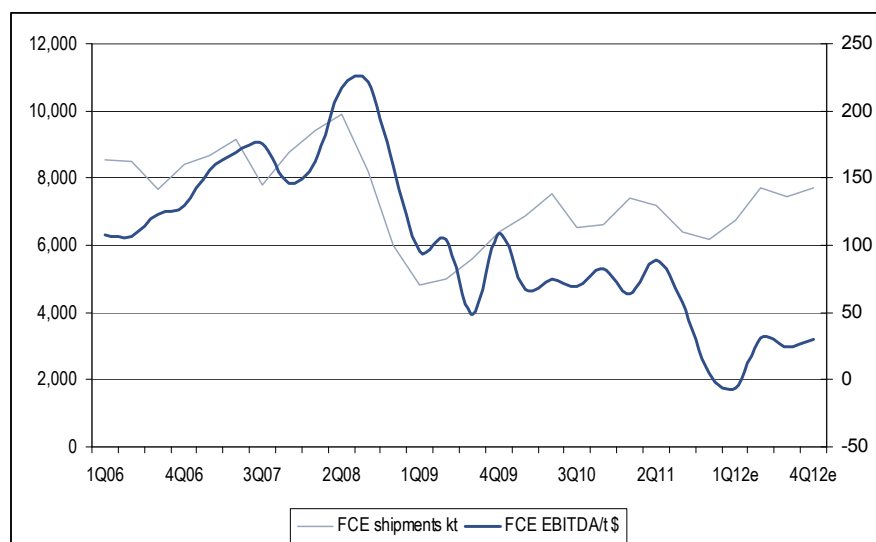
If MT cuts its annual 75c dividend in half, we see savings of \$581m annually against net debt of ~\$22.5bn at the end of 2011. This compares with Lafarge's €143.6m annual saving on year end net debt of ~€12bn.

If MT cut its dividend in half, it would therefore be nearly twice as effective (annual saving/last reported net debt) than the example we used (Lafarge).

FCE needs to perform this year and in 2013

We think that a big chunk of the MT equity story for 2012 and 2013 rests on how successful the company is turning around its ailing Flat Carbon Europe business. Figure 19 below shows how the fortunes of this division (largely the legacy Arcelor business) have turned.

Figure 19. FCE holds a lot of operational leverage



Source: Company Reports and CIRA Estimates

We see three sources of significant operational leverage

1. We forecast EBITDA/t recovering to \$30/t in 2012 from \$4/t in Q4, and if shipments stay at Q4 levels (6.1m tonnes), this would represent a \$219m quarterly EBITDA swing.
2. Given the state of European auto production, we think volumes will not improve much in 2012 (rather, downside risk). However, if consumer confidence returns and sovereign debt fears ease, there is probably 1.5 to 2m tonnes of annual volumes to play for in this division – a further \$45-60m of EBITDA.
3. The company has guided to the start of cost benefits from site closures in Europe – \$1bn of cost savings with a two year payback and realisation of these savings should start in 2H11.

1Q12 results on 10 May

MT will report 1Q12 results on 10 May. The company has guided to 1H12 EBITDA above 2H11 and below 1H11. This would imply a range of \$4.1bn to \$5.99bn.

We forecast 1Q12 EBITDA at \$1.61bn vs. 4Q12 at \$1.71bn and 1Q11 at \$2.58bn. We also include an impairment charge as a stake sale in Erdermir will trigger a revaluation for the entire holding. Including this charge we expect EPS of \$(0.02).

Figure 20. ArcelorMittal divisional forecasts

	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12e	2Q12e	3Q12e	4Q12e
Flat Carbon Americas Shipments (mm tonnes)	5,271	5,346	4,979	5,432	5,563	5,520	5,708	5,458	5,633	5,925	5,725	6,009
Flat Carbon Europe Shipments (mm tonnes)	6,856	7,540	6,521	6,593	7,384	7,166	6,385	6,188	6,739	7,432	6,937	7,432
Long Carbon Steel Shipments (mm tonnes)	5,694	5,984	5,772	5,698	5,872	6,167	5,984	5,846	6,216	6,625	6,472	6,914
AA&CIS Shipments (mm tonnes)	3,204	3,409	3,261	3,392	3,142	3,304	3,005	3,065	3,358	3,461	3,141	3,415
AM3S Shipments (mm tonnes)	4,353	4,602	4,467	4,751	4,202	4,594	4,607	4,957	4,957	5,056	4,904	5,003
Total Shipments	25,378	26,881	25,000	25,866	26,163	26,751	25,689	25,514	26,903	28,500	27,180	28,773
Average sales price achieved	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12e	2Q12e	3Q12e	4Q12e
Avg. sales price - Americas flats	722	810	826	769	830	961	910	868	855	850	820	816
Avg. sales price - Europe flats	757	776	855	907	928	1,026	1,021	954	932	882	880	878
Avg. sales price - Longs	728	808	832	837	902	973	967	906	931	925	886	902
Avg. sales price - AA&CIS	557	624	630	621	691	768	771	713	709	714	675	688
Avg. sales price - AM3S	802	869	890	900	1,014	1,093	1,063	984	965	913	911	910
EBITDA/ton	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12e	2Q12e	3Q12e	4Q12e
EBITDA/ton - FCA	68	123	76	29	95	167	74	43	66	132	115	119
EBITDA/ton - FCE	67	74	69	82	64	89	57	4	9	46	36	41
EBITDA/ton - Longs	84	113	104	55	82	99	73	58	50	65	41	51
EBITDA/ton - AA&CIS	71	122	84	63	81	140	95	78	92	110	118	117
EBITDA/ton - AM3S	13	41	28	18	30	25	10	-4	10	18	14	18
EBITDA US\$mn	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12e	2Q12e	3Q12e	4Q12e
Flat Carbon Americas	361	657	379	158	528	924	420	237	371	782	656	715
Flat Carbon Europe	460	560	452	543	471	636	367	26	58	342	249	305
Long Carbon	480	677	603	315	480	610	438	338	313	430	264	354
AA&CIS	229	417	274	215	254	462	284	238	310	380	371	401
AM3S	57	187	126	87	127	115	48	-19	48	92	67	91
Mining					607	835	842	779	551	716	702	656

Source: Company Reports and CIRA Estimates

Valuation

We value MT using a blend of DCF, multiples, residual income and free cash flow. Our target price of €19 is set as an average of these three methods.

Figure 21. DCF valuation

US\$ mn	2004	2005	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E	Terminal
EBITDA	16,000	14,900	14,784	19,290	20,035	5,749	8,525	10,117	9,058	11,647	12,180	12,910
Tax	-1,466	-1,018	-1,654	-3,038	-1,098	4,469	1,479	-882	-459	-901	-976	-1,200
Maintenance Capex	-2,298	-2,625	-4,775	-5,448	-5,531	-2,792	-3,346	-4,838	-4,800	-5,000	-4,280	-4,500
Assoc+Others	66	68	569	854	1,653	57	451	620	322	505	537	600
WC	-2,824	-1,520	-1,472	-2	-8,055	6,560	-2,531	-3,825	-677	-293	-272	0
FCF	9,478	9,806	7,452	11,656	7,004	14,043	4,579	1,192	3,444	5,957	7,190	7,810
PV of cash flows									3,127	4,911	5,373	70,589
EV												78,626
Less net debt												-35,726
Equity Value												39,230
NPV/sh												\$25
In €												€ 18

Source: Company Reports and CIRA Estimates

Figure 22. FCF analysis

US\$ mn	2009	2010	2011E	2012E	2013E	2014E
EBITDA Mgn %	9.0%	10.9%	10.8%	9.6%	12.1%	12.4%
EBITDA + JV	5,806	8,976	10,737	9,380	12,151	12,717
- Net Financial	-1,493	-1,483	-1,822	-1,750	-1,600	-1,600
-Taxes Paid	4,469	1,479	-882	-459	-901	-976
-Working Capital & Other	6,560	-2,531	-3,825	-677	-293	-272
-Capex	-2,792	-3,346	-3,838	-3,800	-4,000	-3,280
-Minority Interest	43	-90	4	-20	5	4
FCF from Operations	12,593	3,006	374	2,674	5,362	6,594
Equity Value	51,339	53,579	27,623	27,623	27,623	27,623
Value/sh		NA	NA	€ 18	€ 37	€ 45

Source: Company Reports and CIRA Estimates

Figure 23. Sum of parts valuation (US\$ mn)

EBITDA	2008	2009	2010	2011	2012E	2013E	2014E
Flat Carbon Americas	5,834	1,119	1,555	2,109	2,523	2,951	2,874
Flat Carbon Europe	6,448	1,918	2,015	1,500	954	1,682	2,140
Long Carbon	6,678	1,666	2,075	1,866	1,361	1,704	1,780
AA&CIS	3,764	1,002	1,135	1,238	1,462	1,941	1,931
AM3S	1,124	-97	457	271	298	368	371
Mining				3,063	2,625	3,127	3,214
Corporate	-4,747	-53	-640	70	-165	-126	-129
Multiples used	2008	2009	2010	2011	2012E	2013E	2014E
Flat Carbon Americas	4.5	7.0	6.5	5.0	5.5	5.5	5.5
Flat Carbon Europe	5.0	7.0	5.0	5.0	5.0	5.0	5.0
Long Carbon	4.5	8.0	6.0	6.0	6.0	6.0	6.0
AA&CIS	5.0	8.0	5.0	5.0	5.0	5.0	5.0
AM3S	5.5	8.0	5.5	5.5	5.0	4.5	4.5
Mining				4.5	4.5	4.5	4.5
Corporate	4.5	4.5	4.5	4.5	4.5	4.5	4.5
EV+ Associates	92,183	41,589	37,941	59,020	54,684	67,728	70,390
Equity Value €					12	22	26

Source: Company Reports and CIRA Estimates

Figure 24. Residual income valuation

US\$ mn	2009	2010	2011E	2012E	2013E	2013E	Terminal
Reported EPS (\$)	0.10	1.85	1.46	1.54	3.06	3.31	
EBIT %	-2.6%	4.6%	5.2%	4.8%	7.0%	7.3%	
ROE %	0.3%	4.7%	4.0%	4.1%	7.7%	7.8%	
Net Income	157	2,912	2,263	2,390	4,736	5,126	5,000
+ Depreciation & Amortization	-5,169	-4,394	-4,669	-4,561	-4,919	-5,019	-5,000
- Net Capex	-2,792	-3,346	-3,838	-3,800	-4,000	-3,280	-4,280
Economic Earnings to Shareholders	2,534	3,960	3,094	3,151	5,655	6,866	5,720
Economic Earnings/Equity - %	4.2%	6.3%	5.5%	5.4%	9.2%	10.5%	9.9%
Beginning Equity	61,045	62,430	56,690	57,918	61,492	65,456	57,918
Required Rate of Return - %	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Required Return	6,105	6,243	5,669	5,792	6,149	6,546	5,792
Residual Income	-3,571	-2,283	-2,575	-2,641	-494	320	-72
Excess Rate of Return	-5.8%	-3.7%	-4.5%	-4.6%	-0.8%	0.5%	-0.1%
Present Value of Residual Income				-2,401	-409	264	-742
	\$ mn	Per Share					
Shareholders' Equity	57,918	\$37					
+ PV of Residual Income Years 1-2	-2,545	-\$2					
+ Terminal Value	-742	-\$0					
Total Equity Value		€ 26					
Current Price		€ 13					

Source: Company Reports and CIRA Estimates

Company Focus

- Company Update
- Estimate Change

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Buy	1
Price (25 Apr 12)	€38.29
Target price	€54.00
Expected share price return	41.0%
Expected dividend yield	0.7%
Expected total return	41.8%
Market Cap	€2,301M
	US\$3,036M

Price Performance

(RIC: SZGG.DE, BB: SZG GR)



Salzgitter AG (SZGG.DE) Slow Burn Story – Updating Numbers

- **Changes to EPS** — We upgrade our EPS estimates for Salzgitter to reflect two factors. Operationally, we have factored in a weak Q1 as a large Iranian pipe order was lost and Europipe was underutilised. Secondly, we have lowered our tax assumptions as the company is now in a position to use its tax loss carry forwards, having merged the relevant holding companies.
- **No change to target though** — Our target price for Salzgitter remains unchanged at €54. Previously, we added the NPV of the tax losses to our valuation. Since this is now captured in the P&L, we remove the NPV. We are forecasting EBT of €170m in 2012, down from €202m in 2011. Most of the weakness will come in Q1 2012 due to a weak result in tubes (loss of a key order due Iran sanctions) and steel due to price-cost squeeze.
- **Lack of near term catalysts, but long term value** — We view SZG as a slow-burn story now, given the tax loss catalyst has crystallised. The company is cutting costs at its PTG electric arc furnace plant, its precision tubes business and the KHS packaging business. In addition, a healthy export market is helping volumes recover at the PTG plant and Europipe should see margins recover from Q2 2012. Combined with a strong balance sheet, we continue to see longer term value in the shares.
- **Q1 2012 results on 15 May** — Salzgitter will report Q1 2012 results on 15 May. We are forecasting a pre-tax loss of €8.4m due to the reasons discussed above. A weak Q1 has been well flagged by management in recent analyst and investor meetings. Salzgitter trades on 5.7x 2012E EBITDA and 4.0X 2013E EBITDA.

Salzgitter AG (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (€M)	8,304.6	9,839.6	9,929.5	10,684.7	10,834.5
Net Income (€M)	29.9	233.0	168.4	322.5	338.2
Diluted EPS (€)	0.50	3.79	2.78	5.20	5.44
Diluted EPS (Old) (€)	0.50	1.81	2.61	3.55	3.80
PE (x)	77.1	10.1	13.8	7.4	7.0
EV/EBITDA (x)	6.0	5.6	5.7	4.0	3.6
DPS (€)	0.32	0.38	0.28	0.52	0.54
Net Div Yield (%)	0.8	1.0	0.7	1.4	1.4

European Steel Equities
2 May 2012

SZGG.DE: Fiscal year end 31-Dec						Price: €38.29; TP: €54.00; Market Cap: €2,301m; Recomm: Buy					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	8,305	9,840	9,930	10,685	10,835	PE (x)	77.1	10.1	13.8	7.4	7.0
Cost of sales	-8,221	-9,616	-9,727	-10,305	-10,438	PB (x)	0.5	0.5	0.5	0.5	0.4
Gross profit	84	224	202	380	397	EV/EBITDA (x)	6.0	5.6	5.7	4.0	3.6
Gross Margin (%)	1.0	2.3	2.0	3.6	3.7	FCF yield (%)	-10.3	-6.5	5.5	5.5	12.2
EBITDA	461	583	601	811	831	Dividend yield (%)	0.8	1.0	0.7	1.4	1.4
EBITDA Margin (%)	5.6	5.9	6.1	7.6	7.7	Payout ratio (%)	64	10	10	10	10
Depreciation	-377	-359	-399	-431	-434	ROE (%)	0.8	6.0	4.1	7.5	7.4
Amortisation	0	0	0	0	0	Cashflow (€m)	2010	2011	2012E	2013E	2014E
EBIT	84	224	202	380	397	EBITDA	461	583	601	811	831
EBIT Margin (%)	1.0	2.3	2.0	3.6	3.7	Working capital	-440	-963	-23	-188	-40
Net interest	-111	-101	-108	-105	-104	Other	188	576	-107	-129	-130
Associates	68	78	70	70	70	Operating cashflow	209	197	471	494	662
Non-op/Except	9	2	6	6	6	Capex	-446	-363	-345	-370	-373
Pre-tax profit	49	202	170	351	369	Net acq/disposals	-12	-93	0	0	0
Tax	-19	34	1	-23	-26	Other	-214	105	0	0	0
Extraord./Min.Int./Pref.div.	0	-3	-3	-5	-5	Investing cashflow	-672	-352	-345	-370	-373
Reported net profit	30	233	168	323	338	Dividends paid	-14	-17	-21	-15	-28
Net Margin (%)	0.4	2.4	1.7	3.0	3.1	Financing cashflow	242	-85	-68	-15	-28
Core NPAT	30	233	168	323	338	Net change in cash	-219	-868	58	109	261
Per share data	2010	2011	2012E	2013E	2014E	FCF ex acquisitions & explorn	-249	-260	126	124	289
Reported EPS (€)	0.50	3.79	2.78	5.20	5.44						
Core EPS (€)	0.50	3.79	2.78	5.20	5.44						
DPS (€)	0.32	0.38	0.28	0.52	0.54						
CFPS (€)	3.46	3.22	7.52	7.89	10.51						
FCFPS (€)	-3.93	-2.47	2.12	2.09	4.67						
BVPS (€)	70.77	73.63	76.36	82.03	87.76						
Wtd avg ord shares (m)	54.2	54.2	54.2	54.2	54.2						
Wtd avg diluted shares (m)	60.2	63.8	63.8	63.8	63.8						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	6.2	18.5	0.9	7.6	1.4						
EBIT (%)	118.9	166.7	-9.7	88.0	4.5						
Core NPAT (%)	107.8	679.3	-27.7	91.5	4.9						
Core EPS (%)	107.8	663.7	-26.7	86.9	4.7						
Balance Sheet (€m)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	1,574	946	1,004	1,113	1,374						
Accounts receivables	1,176	1,447	1,461	1,572	1,594						
Inventory	1,730	2,106	2,122	2,246	2,276						
Net fixed & other tangibles	2,731	2,790	2,735	2,674	2,612						
Goodwill & intangibles	122	121	121	121	121						
Financial & other assets	1,356	1,390	1,467	1,543	1,619						
Total assets	8,689	8,800	8,909	9,269	9,595						
Accounts payable	713	801	807	854	865						
Short-term debt	128	147	147	147	147						
Long-term debt	591	601	601	601	601						
Provisions & other liab	3,410	3,252	3,204	3,204	3,204						
Total liabilities	4,843	4,800	4,759	4,806	4,817						
Shareholders' equity	3,835	3,991	4,139	4,446	4,756						
Minority interests	11	9	12	17	22						
Total equity	3,846	4,000	4,150	4,463	4,778						
Net debt	-855	-198	-256	-365	-626						
Net debt to equity (%)	-22.2	-5.0	-6.2	-8.2	-13.1						

For further data queries on Citi's full coverage universe please contact CIRA Data Services Europe at CIRADatServicesEMEA@citi.com or +44-207-986-4050
For definitions of the items in this table, please click [here](#).

Updating Estimates on Taxes and Tubes

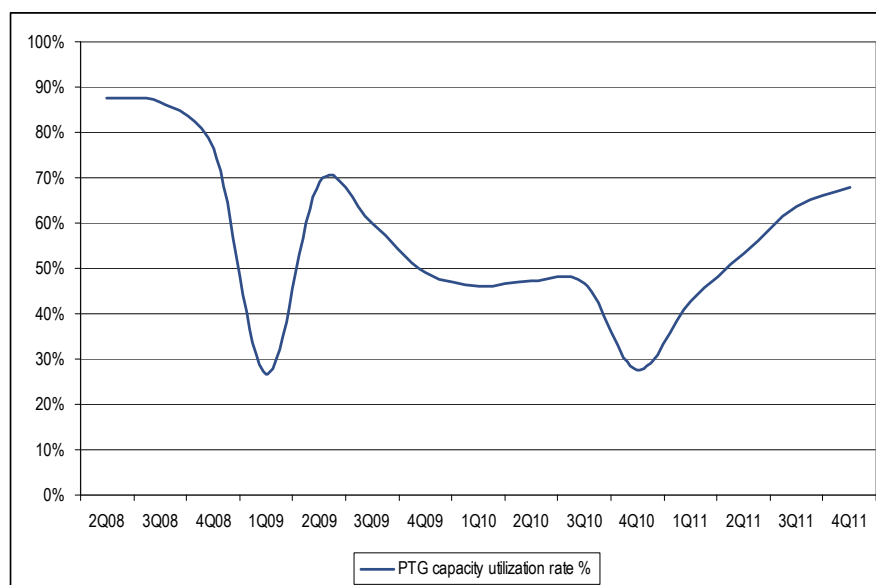
Previously we accounted for SZG's tax loss carry forwards by adding an NPV of these tax losses to our overall group valuation. SZG is in a position now to utilise these tax losses and the required holding company merger has been completed. We remove the NPV method and incorporate the tax losses into our P&L. We also allow for a severe volume disruption at Europipe in Q1 as the company had to drop a large order in Iran. While this has been replaced by an Australian order, there will be a real volume and financial impact, which we expect in Q1.

We expect group EBT of €170m in 2012 vs. €202m in 2011, mainly due to a weak Q1.

PTG volumes improving – both in long products and slabs

The problem child in SZG's steel portfolio has been the Peiner (PTG) electric arc furnace facility which specialises in producing beams and sections. A second EAF was commissioned and from 2011 is being run in parallel with the older furnace. A new slab caster is also being ramped up to diversify PTG away from long products to semi-finished slabs.

Figure 25. Exports and slab ramp up have helped PTG volumes recover



Source: Company Reports and CIRA Estimates

With section exports picking up, we would expect a pretty strong performance from PTG in 1H12, with utilisation rates reaching 80% by Q2 2012. In addition, coking coal and iron ore prices are recovering.

Restructuring measures

Salzgitter has three restructuring programmes in place which could help earnings in coming quarters. These are:

1. Steel division: 25% staff reduction at PTG completed and redirection of focus to export markets. SZG expects €64m of P&L impact in 2012
2. Technology division: reduction of 300 staff in KHS (technology division), partial re-location of plant sites with view of focusing on larger plants and standardisation measures.

3. Precision tubes: two plants in France are being closed to reduce capacity and some product lines are being dropped

Results on 15 May

Salzgitter will report its Q1 results on 15 May. Due to one-off volume issues in Tubes (Europipe had to drop an order in Iran) and lagged raw material prices in Steel, we expect a sharp q/q drop in operating profit and EBT. Management has already guided to this negative trend in results in the quarter.

Figure 26. Q1 results in mid-May

Quarterly Results, €mn	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12e
Sales	1,925	2,109	2,158	2,112	2,308	2,466	2,558	2,508	2,169
Reported EBIT	5	34	32.0	88.7	81	96	62	65	19
EBT	-17.30	12.00	10.80	43.50	56.40	73.60	39.10	33.50	-8.41

Source: Company Reports and CIRA Estimates

Valuation

We value Salzgitter using a blend of DCF, free cash flow, multiples and residual income. Our €54 price target is set as an average of these four methods.

Figure 27. DCF valuation

€mn	2007	2008	2009	2010	2011	2012e	2013e	2014e	2015e	Terminal
EBITDA	1,531	1,295	99	461	583	601	811	831	889	775
Tax	-409	-327	110	-19	34	1	-23	-26	-16	-32
Capex	-373	-638	-653	-446	-363	-345	-370	-373	-374	-400
Associates/Other	10	8	57	68	78	70	70	70	70	70
Δ Working Capital	-685	-967	846	-440	-963	-23	-188	-40	-35	-40
FOCF	74.0	-628.3	458.5	-376.2	-630.8	304.3	299.7	462.8	533.9	373.2
PV						284	260	373	398	5015
EV										6329
Less net debt and pensions										1637
Equity Value										4683
NPV/sh										€ 73

Source: Company Reports and CIRA Estimates

Figure 28. FCF valuation

(€ mn)	2010	2011	2012e	2013e	2014e	2015e
EBITDA Mgn %	5.6%	5.9%	6.1%	7.6%	7.7%	8.1%
EBITDA	461	583	601	811	831	889
Associates/Other	68	78	70	70	70	70
less Net Financial	-111	-101	-108	-105	-104	-96
less Taxes Paid	-19	34	1	-23	-26	-16
Working Capital & Other	-440	-963	-23	-188	-40	-35
less Maintenance Capex	-446	-363	-345	-370	-373	-374
less Minority Interest	-0	-3	-3	-5	-5	-6
FCF from Operations	-487	-735	194	189	353	431
Stock Price (€)	37.29	52.00	52.00	52.00	52.00	52.00
shares O/S	60	64	64	64	64	64
Equity Value	2,245	3,315	3,315	3,315	3,315	3,315
Value/sh	NA	NA	€ 50	€ 49	€ 91	€ 111

Source: Company Reports and CIRA Estimates

Figure 29. Sum of parts valuation (€mn)

EBITDA	2007	2008	2009	2010	2011	2012e	2013e	2014e	2015e
Steel	915	733	-12	262	362	387	457	451	504
Tubes	345	367	211	115	135	104	191	191	191
Trading	250	192	-87	91	82	101	141	150	154
Services	73	48	36	50	46	54	55	56	56
Technology	17	39	-105	8	-35	-2	11	27	27
EV/EBITDA	2007	2008	2009	2010	2011	2012e	2013e	2014e	2015e
Steel	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Tubes	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Trading	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Services	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Technology	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
EV	2007	2008	2009	2010	2011	2012e	2013e	2014e	2015e
Steel	5,033	4,034	-65	1,443	1,989	2,128	2,514	2,481	2,774
Tubes	2,071	2,202	1,268	692	812	622	1,148	1,148	1,148
Trading	1,252	961	-435	456	411	503	703	750	771
Services	291	194	143	200	184	215	221	224	225
Technology	52	116	-314	23	-106	-7	32	81	81
Consolidation	100	100	100	101	102	103	104	105	106
EV	8,598	7,405	498	2,713	3,189	3,358	4,515	4,579	4,894
Less net debt and pensions	-161	1,373	452	1,071	1,695	1,637	1,528	1,267	928
less minorities	49	27	13	11	9	12	17	22	29
Equity value	8,710	6,005	33	1,631	1,485	1,709	2,971	3,290	3,937
Per share						€ 27	€ 47	€ 52	€ 62

Source: Company Reports and CIRA Estimates

Figure 30. Residual income valuation

Residual Income (€mn):	2010	2011	2012e	2013e	2014e	2015e	Terminal
Reported EPS (€)	0.50	3.79	2.78	5.20	5.44	6.58	
EBIT %	1.0%	2.3%	2.0%	3.6%	3.7%	4.1%	
ROE %	0.8%	5.8%	4.1%	7.3%	7.1%		
Net Income	30	233	168	323	338	411	325
+ Depreciation & Amortization	377	359	399	431	434	436	436
- Net Capex	-446	-363	-345	-370	-373	-374	-374
Economic Earnings to Shareholders	-39	229	223	384	400	473	387
Economic Earnings/Equity - %	-1.0%	5.7%	5.4%	8.6%	8.4%	9.2%	9.4%
Beginning Equity	3,835	3,991	4,139	4,446	4,756	5,138	4,139
Required Rate of Return - %	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Required Return	345	359	372	400	428	462	372
Residual Income	-384	-130	-149	-16	-28	11	15
Excess Rate of Return	-10.0%	-3.3%	-3.6%	-0.4%	-0.6%	0.2%	0.4%
Present Value of Residual Income			-137	-14	-22	8	200
Residual Income Valuation Results:							
	€ mn	Per Share					
Shareholders' Equity	3,991	66					
+ PV of Residual Income Years 1-2	-165	-3					
+ Terminal Value	200	3					
Total Equity Value	4,027	€ 67					

Source: Company Reports and CIRA Estimates

Company Focus

- Company Update
- Estimate Change

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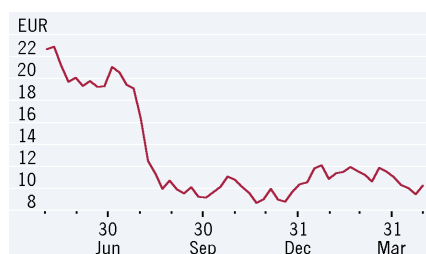
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Neutral	2
Price (30 Apr 12)	€10.25
Target price	€12.00
Expected share price return	17.1%
Expected dividend yield	0.0%
Expected total return	17.1%
Market Cap	€1,022M
	US\$1,354M

Price Performance

(RIC: KCOGn.DE, BB: KCO GR)

Klöckner & Co. (KCOGn.DE)
Steel Challenged

- **Range bound** – With upside capped by limited pricing power and downside supported by net working capital, we continue to expect the shares to remain range bound. 2012 forecasts are unchanged, however we make modest upgrades to 2013/2014 on the back of higher volume assumptions. We maintain our Neutral rating and €12 price target.
- **Structurally challenged** — More volatile pricing cycles and increasing macroeconomic instability have combined to reduce KCO's pricing power, limiting its leverage to the up-cycle in steel. At the same time its commoditised product mix makes it vulnerable to a down-shift in sentiment. Stuck between a rock and a hard place its margins have suffered, down from 5.7% pre 2008 to 3.8% post 2009. The business model looks ill-suited to the uncertainty that has followed the global financial crisis, unlike US service centres which have widened their margin outperformance over KCO from 3pps to 6pps over the course of 2011.
- **Acquisition risk returns** — With limited ability to grow organically into the service centre segment, the only way to materially gain exposure is via large scale acquisition. The company imposed a moratorium on its M&A until 2H12 and as such overpayment risk remains a feature of the stock.
- **Valuation support** – Despite the structural challenges KCO remains fundamentally well supported. The stock is just 10% above the value of NWC adjusted for net debt and pensions. With prices having done little (on a blended basis) in the two months since the inventory was likely purchased, this is a readily realisable value.
- **Q1 results 9 May** — We forecast reported EBITDA of €45m (post €5m restructuring), up €30m on Q411, in the middle of the company's guided range of €40-50m, but 20% below consensus. KCO trades on 6.4x 2012E EBITDA.

Klöckner & Co. (EUR)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (€M)	5,198.2	7,095.5	7,909.5	8,292.7	8,497.7
Net Income (€M)	77.5	11.7	43.4	128.4	180.3
Diluted EPS (€)	1.00	0.10	0.38	1.14	1.59
Diluted EPS (Old) (€)	1.00	0.10	0.38	1.07	1.48
PE (x)	10.2	99.2	26.7	9.0	6.4
EV/EBITDA (x)	5.0	7.0	6.4	4.5	3.5
DPS (€)	0.30	0.30	0.00	0.07	0.36
Net Div Yield (%)	2.9	2.9	0.0	0.6	3.5

European Steel Equities
2 May 2012

KCOGn.DE: Fiscal year end 31-Dec						Price: €10.25; TP: €12.00; Market Cap: €1,022m; Recomm: Neutral					
Profit & Loss (€m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	5,198	7,095	7,910	8,293	8,498	PE (x)	10.2	99.2	26.7	9.0	6.4
Cost of sales	-5,046	-6,984	-7,773	-8,047	-8,179	PB (x)	0.6	0.6	0.6	0.5	0.5
Gross profit	152	111	137	246	319	EV/EBITDA (x)	5.0	7.0	6.4	4.5	3.5
Gross Margin (%)	2.9	1.6	1.7	3.0	3.8	FCF yield (%)	1.0	-5.7	-8.7	12.0	16.6
EBITDA	238	217	270	383	454	Dividend yield (%)	2.9	2.9	0	0.6	3.5
EBITDA Margin (%)	4.6	3.1	3.4	4.6	5.3	Payout ratio (%)	30	288	0	6	23
Depreciation	-86	-105	-134	-137	-135	ROE (%)	6.5	0.8	2.4	6.7	8.8
Amortisation	0	0	0	0	0	Cashflow (€m)	2010	2011	2012E	2013E	2014E
EBIT	152	111	137	246	319	EBITDA	238	217	270	383	454
EBIT Margin (%)	2.9	1.6	1.7	3.0	3.8	Working capital	-185	-127	-199	-43	-38
Net interest	-68	-84	-75	-65	-65	Other	-18	-100	-93	-117	-139
Associates	0	0	0	0	0	Operating cashflow	35	-10	-22	223	277
Non-op/Except	0	0	0	0	0	Capex	-27	-56	-79	-83	-85
Pre-tax profit	84	27	61	181	254	Net acq/disposals	-161	-427	0	0	0
Tax	-4	-17	-18	-52	-74	Other	0	0	0	0	0
Extraord./Min.Int./Pref.div.	-3	1	0	0	0	Investing cashflow	-188	-483	-79	-83	-85
Reported net profit	78	12	43	128	180	Dividends paid	0	-22	0	-7	-36
Net Margin (%)	1.5	0.2	0.5	1.5	2.1	Financing cashflow	252	542	0	-7	-36
Core NPAT	78	12	43	128	180	Net change in cash	108	36	-101	133	156
Per share data	2010	2011	2012E	2013E	2014E	Free cashflow to s/holders	8	-66	-101	140	192
Reported EPS (€)	1.00	0.10	0.38	1.14	1.59						
Core EPS (€)	1.00	0.10	0.38	1.14	1.59						
DPS (€)	0.30	0.30	0	0.07	0.36						
CFPS (€)	0.45	-0.09	-0.19	1.97	2.45						
FCFPS (€)	0.11	-0.59	-0.89	1.23	1.70						
BVPS (€)	17.47	18.19	18.63	19.85	21.30						
Wtd avg ord shares (m)	73	100	100	100	100						
Wtd avg diluted shares (m)	78	113	113	113	113						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	34.7	36.5	11.5	4.8	2.5						
EBIT (%)	213.6	-26.8	22.7	80.1	29.7						
Core NPAT (%)	152.1	-84.9	271.3	195.7	40.4						
Core EPS (%)	152.1	-89.7	271.3	195.7	40.4						
Balance Sheet (€m)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	936	990	889	1,022	1,179						
Accounts receivables	703	922	1,057	1,086	1,111						
Inventory	899	1,362	1,504	1,535	1,563						
Net fixed & other tangibles	626	732	677	623	574						
Goodwill & intangibles	227	560	560	560	560						
Financial & other assets	100	140	140	140	140						
Total assets	3,491	4,706	4,827	4,967	5,126						
Accounts payable	585	750	828	845	860						
Short-term debt	40	377	377	377	377						
Long-term debt	1,021	1,068	1,068	1,068	1,068						
Provisions & other liab	556	668	668	668	668						
Total liabilities	2,201	2,863	2,941	2,958	2,973						
Shareholders' equity	1,275	1,815	1,858	1,980	2,124						
Minority interests	15	29	29	29	29						
Total equity	1,290	1,843	1,887	2,009	2,153						
Net debt	124	455	556	423	267						
Net debt to equity (%)	9.6	24.7	29.5	21.0	12.4						

For further data queries on Citi's full coverage universe please contact CIRA Data Services Europe at CIRADatServicesEMEA@citigroup.com or +44-207-986-4050
For definitions of the items in this table, please click [here](#).

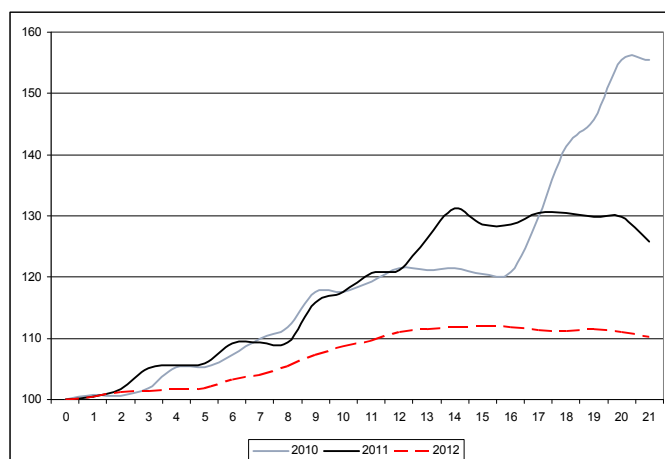
Steel Challenged

With upside capped by limited pricing power and downside supported by NWC, we continue to expect the shares to remain range bound and maintain our Neutral rating and €12 price target.

Near term: weak pricing cycle

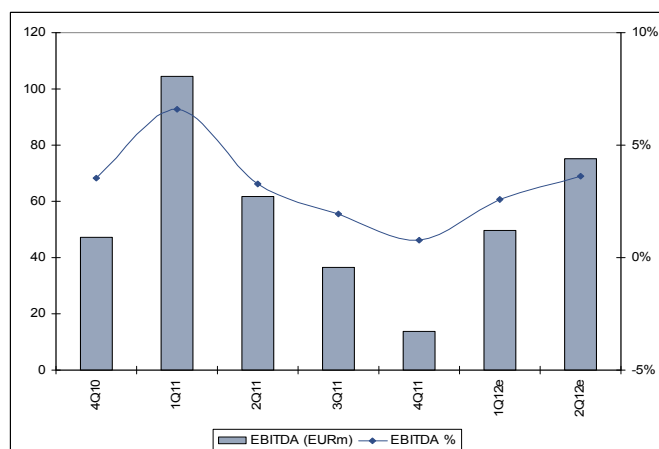
The rally in European HRC prices from the cyclical lows at the end of last year has lagged prior years (Figure 31). 21 weeks into this upturn prices are up just 10% compared to c.30% in 2011 and c.50% in 2010. As an intermediate business, Klöckner's earnings are directly leveraged to changes in the steel price, suggesting earnings in 1H 12 should be somewhat down on 1H 11. We forecast €125m (pre restructuring) vs. €166m last year (Figure 32).

Figure 31. Tepid Rally In 2012 Compared To Prior Years (EU HRC)



Source: Bloomberg, CIRA

Figure 32. EBITDA Progression



Source: Company Reports, Citi Estimates

While this tepid price action has suppressed earnings it has also limited pre-buying from stockists, lessening the likelihood of aggressive destocking and a subsequent price shock, as occurred in 2011.

Key themes

Structural challenges hard to shake

As we recently highlighted ([Klöckner & Co: The Decline of Pricing Power](#), 13 March 2012) increasing steel price volatility and macroeconomic uncertainty are inhibiting KCO's pricing power, limiting its ability to achieve its traditional 20% gross margin mark up. As such the company's leverage to the upside in the steel cycle has declined, while its commoditised product mix makes it vulnerable when sentiment turns. As a result we have seen a steady compression of margins from an average of 5.7% pre 2008 to 3.8% post 2009, with margin volatility up 19%.

We see limited potential for this situation to change in 2012. While continued strength in the US should support the Americas division, KCO's core European market is likely to remain a significant earnings drag as sovereign debt fears return and the impact of austerity measures begin to bite. As shown in Figure 3, confidence in the European construction industry remains low while machinery orders, previously a bright spot, saw a 5% decline YoY in February. At a group level these end markets represented >60% of sales in 2011.

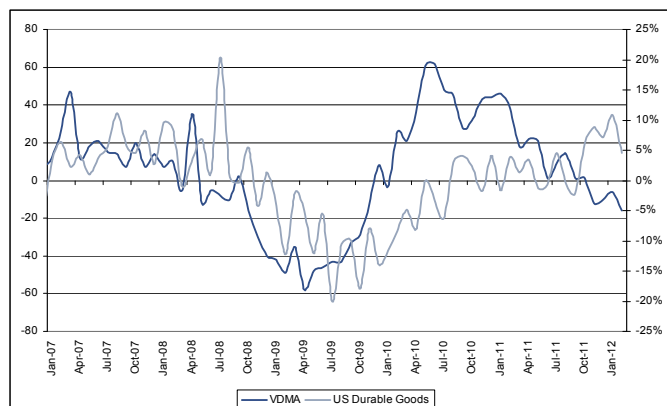
As a result we expect Americas to continue to contribute >50% of earnings.

Figure 33. Group EBITDA Margin Volatility

Group	To 4q 07	From 1q 10	Change
Margin St Dev	1.8%	2.2%	19.4%
Average Margin	5.7%	3.8%	-33.2%
+1 st dev	7.5%	6.0%	-20.4%
-1 st dev	3.9%	1.6%	-57.8%

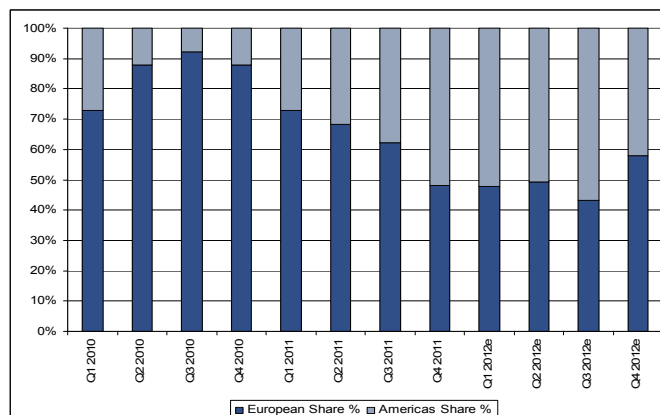
Source: Company Reports and CIRA

Figure 34. Durable Goods Orders YoY in Europe and US



Source: Datastream

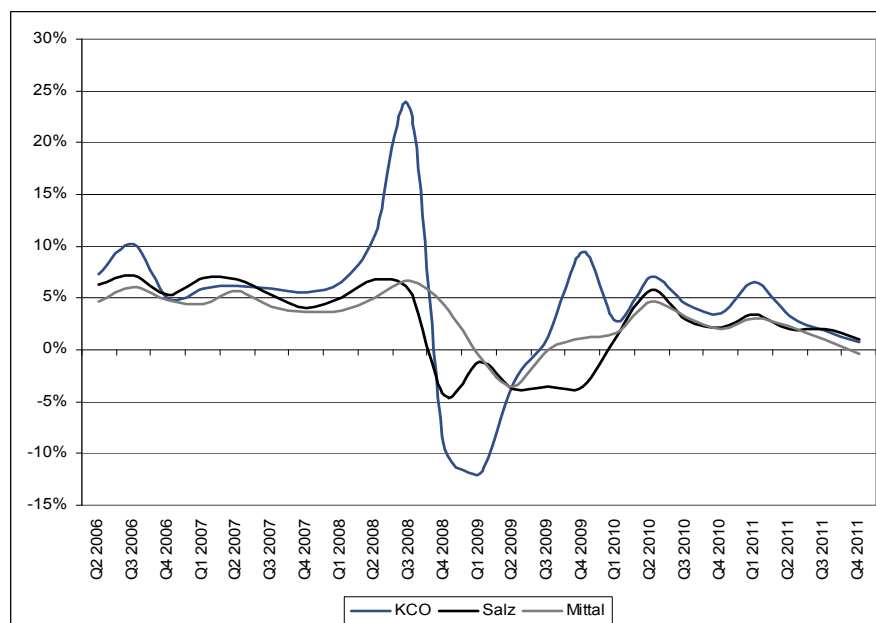
Figure 35. EBITDA Share By Division



Source: Company Reports, Citi Investment Research and Analysis

With the market still in oversupply and demand weak, the intensity of competition for sales is unlikely to abate, in our view. Pricing cycles are likely to remain volatile and the willingness of consumers to accept mark-ups limited. Indeed while prices are currently stable, this is not stability borne out of increased confidence but decreased visibility. Many consumers are sitting on the fence awaiting a more discernable pricing trend. Thus we expect continued pressure on margins, with KCO unlikely to regain its premium over mill-linked peers.

Figure 36. EBITDA Premium Eroded Over Mill-linked Peers



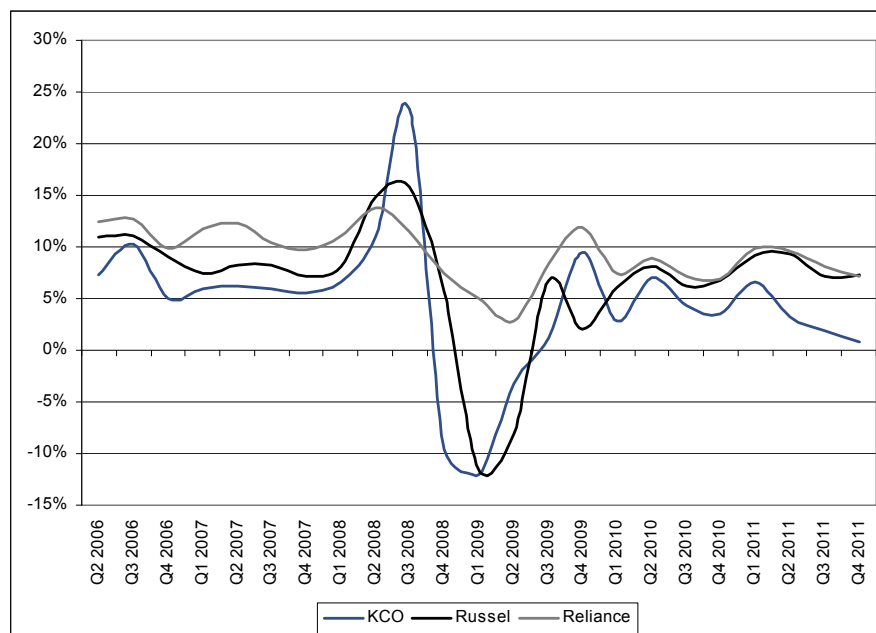
Source: Company Reports, CIRA

Acquisition risk returns in 2H 12

In the absence of a European recovery, it is unlikely in our view that KCO will be able to regain lost pricing power and achieve its 6% EBITDA margin target in the mid-term. This limitation to organic growth is likely to force the company back on the acquisition trail once its self-imposed moratorium on M&A ends in 2H 12. With

limited scope to upgrade existing distribution centres, we believe the only way materially increase exposure to the service centre segment, and arrest margin decline, is through large-scale acquisition. Given the company's chequered deal history, this poses a risk for shareholders. Offsetting this risk is the prospect of the appointment of a new CFO in 2012, which could act as a catalyst for the shares.

Figure 37. Less Stable, Lower Margins Than Service Centres

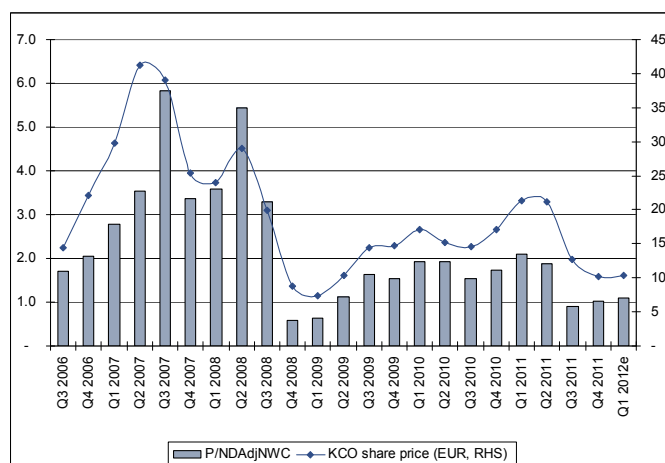


Source: Company Reports, CIRA

But underpinned by valuation support

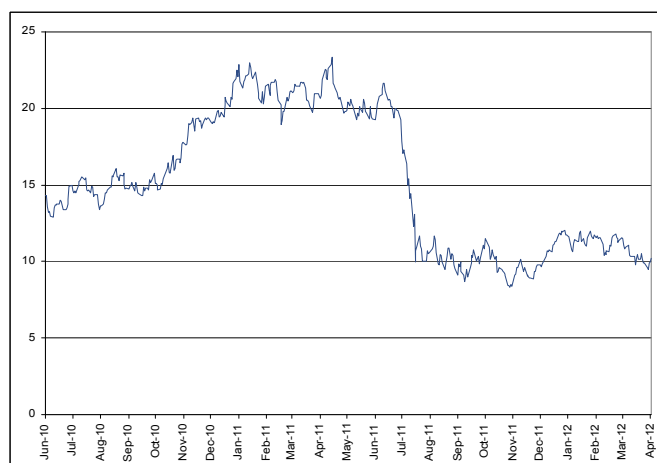
Despite the strategic challenges the company faces the stock remains well supported on a deep value basis, trading at just a 10% premium to the liquidation value of its NWC after adjusting for net debt and pensions. As KCO's inventory is readily realisable in value, this has provided an effective floor at around €10.

Figure 38. Price to Trailing Net Debt-Adjusted NWC



Source: Company Reports, Bloomberg, CIRA Estimates

Figure 39. KCO Share Price (€)



Source: Datastream

Q1 results on 9 May

We forecast reported EBITDA of €45m post €5m restructuring costs, up c.€30m on Q411. While this is in the middle of the company's €40-50m guidance range it is some 20% below consensus on €58m (Bloomberg).

In Q2 we expect this number to rise to €75m on the back of strengthening volumes and the benefit from a higher pricing exit rate from Q1. For the full year we have €265 (post restructuring), 8% below consensus.

Figure 40. KCO Group Earnings

€mn	1Q10A	2Q10A	3Q10A	4Q10A	1Q11A	2Q11A	3Q11A	4Q11A	1Q12E	2Q12E
Net Sales	1,049	1,416	1,401	1,332	1,587	1,885	1,885	1,739	1,922	2,070
Reported EBITDA	29	100	61	47	104	62	37	14	45	75
%	2.8%	7.1%	4.4%	3.6%	6.6%	3.3%	1.9%	0.8%	2.3%	3.6%
Shipments kt	1,180	1,448	1,368	1,318	1,498	1,763	1,765	1,636	1,757	1,824
EBITDA €/t	25	69	45	36	70	35	21	8	25	41

Source: Company Reports, CIRA Estimates

Valuation

We value Klöckner using an equal-weighted blend of DCF, free cash flow, multiples and residual income resulting in a target price of €12.

Figure 41. DCF Valuation

€mn	2008	2009	2010e	2011e	2012e	2013e	2014e	2015e	Terminal
EBITDA	601	-66	238	217	270	383	454	481	481
Taxes	-79	86	-4	-17	-18	-52	-74	-83	-83
Capex	64	-22	-191	-500	-79	-83	-85	-87	-87
Change in working capital	-105	764	-185	-127	-199	-43	-38	-35	0
FOCF	480	761	-142	-428	-26	205	257	277	312
PV					-24	175	203	202	3,787
EV									4,343
Less net debt, pensions and minorities									734
Equity value									3,609
NPV/sh									32

Source: Company Reports and CIRA Estimates

Figure 42. Sum of the Parts Valuation

€mn	2011	2012e	2013e	2014e	2015e
Europe	167	147	237	302	308
N.America	81	147	179	191	216
Corporate	-31	-24	-33	-39	-42
EV/EBITDA multiples used					
Europe	4.5	4.5	4.5	4.5	4.5
N.America	5.0	5.0	5.0	5.0	5.0
Corporate	4.5	4.5	4.5	4.5	4.5
EV €mn	1,017	1,290	1,813	2,137	2,274
Equity value / share	-1	5	11	15	18

Source: Company Reports and CIRA Estimates

Figure 43. FCF Valuation

€mn	2011	2012e	2013e	2014e	2015e
EBITDA	217	270	383	454	481
Net financial expense	-84	-75	-65	-65	-65
Taxes	-17	-18	-52	-74	-83
Capex	-483	-79	-83	-85	-87
Change in working capital	-127	-199	-43	-38	-35
FCF€mn	-494	-101	140	192	212
Value/sh	NA	-12	17	23	26

Source: Company Reports and CIRA Estimates

Figure 44. Residual Income Valuation

€mn	2011	2012e	2013e	2014e	2015e	Terminal
Net Income	12	43	128	180	202	202
+ Depreciation & Amortization	105	134	137	135	132	132
- Net Capex	-500	-79	-83	-85	-87	-87
Economic Earnings to Shareholders	-383	98	182	230	247	247
Economic Earnings/Equity - %	-21%	5%	9%	11%	11%	11%
Beginning Equity	1,815	1,858	1,980	2,124	2,276	2,276
Required Rate of Return - %	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
Required Return	154	158	168	181	193	193
Residual Income	-538	-60	14	49	54	54
Excess Rate of Return	-29.62%	-3.22%	0.72%	2.33%	2.36%	2.36%
Present Value of Residual Income		-51	11	35	35	668
Residual Income Valuation Results:						
Shareholders' Equity	1,815					
+ PV of Residual Income Years 1-5	30					
+ Terminal Value	668					
Total Equity Value/sh	22					

Source: Company Reports and CIRA Estimates

voestalpine AG

Company description

voestalpine AG is a leading European steel producer and a manufacturer and distributor of a wide range of steel products, primarily serving customers in the European automotive, machinery, and white goods industries. voestalpine is also a leading global player in the production of rails and railway related equipment.

Investment strategy

We rate voestalpine AG Buy. We think the key investment drivers are:

The steel price and demand cycle: The metal spread for contracted producers is above average and a demand recovery should improve the earnings outlook.

Strong technology and process know-how: The group targets expansion in businesses where the cyclicity of demand is lower than in the steel cycle.

Strong downstream presence: The group should improve its product mix, margins and stability of earnings, as processing capability increases.

The group's product mix and raw material negotiating power provide a buffer in a downturn.

Valuation

We have a €35 target price for voestalpine. We use an equal-weighted combination of DCF, multiples, residual income and free cash flow to equity.

Our DCF-based model calculates a value of €36 (WACC of 7.9%, beta 1.18x, risk-free rate 3.5%, equity risk premium 4.5%, terminal growth 2%).

The steel sector has historically traded at 5x EV/EBITDA. We use a 10% premium to this to reflect the average excess margin generated by VOE vs. its European peer group. Our SOTP valuation suggests a €34 valuation. We also use a residual income model and a free cash flow model which value VOE at a fair value of €34 and €40, respectively.

We arrive at our €36 price target as a rounded average of the four methods.

Risks

voestalpine is exposed to industry- and company-specific risks:

Inland Location: voestalpine's major production sites have land-locked locations, which increases the comparative transportation cost of raw materials. This risk is partly offset by the group's closer proximity to finished product customers.

Steel Price Risk: voestalpine focuses on high-strength steels and processing activities to minimise the impact of volatile steel prices and volumes.

Raw Material Costs: Higher iron ore, coking coal, scrap steel, ferro-alloy and energy costs are major cost risks.

Industry Exposure: voestalpine strategically targets increased processing activities directed at the automotive sector in several of its divisions.

If the impact of these risk factors is more or less negative than we currently anticipate, then the share price could fail to reach or rise above our target price.

ArcelorMittal

Company description

ArcelorMittal is the largest steel company in the world, with c.9% of global steel capacity. The company has operations in North and South America, Africa, Europe and Asia. The group is split into six divisions - Mining, Flat Carbon Americas, Flat Carbon Europe, Long Carbon, Asia, Africa and CIS and Distribution.

Investment strategy

ArcelorMittal is directly exposed to steel price and volume cycles. The group's raw material assets increase its operational gearing to the cycle.

The group also has high exposure to developing markets. These markets are mostly net exporters of steel, which increases cyclical exposure, despite generally higher-demand-growth and lower-production costs.

The group's acquisitive growth resulted in higher financial gearing (than the average), which increases the group's financial gearing to the steel cycle. The convertible bond and share issues have reduced the debt, but gearing remains high and valuation remains at a premium to peers.

We have a Buy recommendation.

Valuation

We have a €19 target price for ArcelorMittal. We use an equal-weighted combination of DCF value, Residual income, EV/EBITDA and FCF analysis.

Our DCF-based model calculates a value of €18 per share. The steel sector has historically traded at 5.5x mid-cycle EV/EBITDA. We use 5x 2012E EBITDA to calculate our mid-cycle value. We calculate a value of €12 per share based on this analysis. Our FCF and residual income models suggest a fair value of €18 and €26, respectively.

Risks

ArcelorMittal's net debt reduces investment flexibility.

ArcelorMittal shares are sensitive to spot steel prices, contract renegotiations and raw material input costs.

ArcelorMittal has high fixed costs, and high net debt overlays financial gearing to already high operational gearing to the cycle. The group is the key steel stock to own if you're positive the cycle, and key one to avoid if your negative the steel cycle.

If the impact of these risk factors is more negative than we currently anticipate, then the share price would be impeded from reaching our price target.

Salzgitter AG

Company description

Salzgitter AG is a Germany-based holding company that ranks within the top five steel producers in Europe. The group occupies a leading global position in the tubes sector. The group also constructs special machinery and participates in plant engineering.

Investment strategy

We rate Salzgitter Buy. We think the key investment drivers are:

Strong cash position: The group has a cash position of c€0.5bn (as of 3Q11), tempered by pension liabilities of €1.9bn.

Oil & gas exposure: Strong demand for distribution of oil & gas is fuelling demand for steel tubes. Salzgitter's margins should hold relatively well in the near term as low priced contracts roll off in 2H11.

Trading: Salzgitter's trading business ships more volume than its steel unit and we believe will generate windfall losses in a declining steel price environment.

The flat steel division is well utilised and geared to the German export/auto cycle, while the beams and sections business is under-utilised.

Valuation

We set our target price of €54 for SZG using an average of four valuation methodologies: DCF, multiples, free cash flow and residual income.

Additionally, we include Salzgitter's 6mn treasury shares in our diluted share count (in addition to 3.6mn shares from the convertible).

Our multiples/sum-of-the-parts valuation uses multiples that are consistent with our European steel and distribution coverage - 5.5x EBITDA for steel assets and 6.0x EBITDA for distribution.

Risks

Salzgitter and other participants in the steel industry are subject to significant external risks that could affect the results of the business. The major external risks are:

Steel Price Risk: We believe steel prices will remain volatile in the near term, despite the consolidation of the industry. Steel companies have high capital intensity and their cash flows are exposed to steel price fluctuations.

Contract Sales Structure: Salzgitter sells a high proportion of its flat carbon steel (60%) and large diameter tubes sales (70%) on longer-term contracts. A mismatch in the movement of raw materials and contract price adjustments can materially affect margins.

Acquisitive Growth: The group intends to invest the cash on its balance sheet in growth opportunities. Although the group allocates cash conservatively, the risk remains that the cash is spent at the top of the cycle.

If the volatility of these factors proves to be more or less negative than we currently anticipate, then the stock price might deviate significantly from our target price.

Klöckner & Co.

Company description

Kloeckner is a steel and metals distribution business and also owns service centre assets with more downstream capabilities. We forecast KCO to ship 6.5mn tonnes of steel and metal in 2011, with a 70:30 split between Europe and N.America.

Investment strategy

We rate KCO Neutral. The investment positives we see are: a) KCO is a self-funding growth vehicle as the distribution business model is very cash generative (forecast of 14% normalised FCF yield); b) KCO offers investors a good vehicle to express a bullish view on European and US steel prices without the fear of a raw materials squeeze; and c) the company is improving its service offering and margins through its recent acquisitions of service centres like Becker and MacSteel.

Valuation

Our €12 target price is set at the average of our DCF (€18), multiples (€3), free cash flow (€9) and residual income (€18) valuation methods. We use a 4.5x EBITDA multiple for Europe and a 5.0x multiple for the US based on peer multiples. Our DCF uses a 3.75% equity risk premium, a 3% terminal growth rate and a WACC of 9%.

Risks

We consider several risk factors, including an assessment of industry-specific risk, financial risk and management risk. In particular, we see the following key risks to the share price reaching our target price:

KCO's business model carries inherent inventory risk. Cash conversion days are over 100 at the moment and a sharp decline in the steel price could trigger inventory losses. KCO has, in the past, taken a proactive view on the steel price, such as reducing inventories when it has perceived prices to be at a peak or close to a peak. In 2010 for instance, this helped avoid severe inventory losses in Q3 and Q4.

KCO's growth partly relies on acquisitions. This creates the risk of overpaying for assets and buying assets at the wrong time in the cycle. Given some of the deals are fairly sizeable (€200-400m), this can stress the balance sheet and require a capital injection (as was the case in 2009). So far, most acquisitions have been small to mid-sized deals, but recent deals such as BSS and MacSteel indicate an increased appetite for larger deals. We think this implies a higher likelihood of paying close to fair value multiples and relying on cost cutting and synergies in order to crystallise value.

KCO has not had much competition so far from mills, as it executes its strategy of consolidating the distribution sector. The area has been relatively non-core for mills, but if this were to change, KCO would be forced to pay higher multiples for acquisitions. We think this risk is fairly unlikely as mills have indicated that M&A is likely to focus on either mining assets or on mill assets.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Salzgitter AG (SZGG.DE)

Ratings and Target Price History Fundamental Research

Analyst: Anindya Mohinta

Covered since May 24 2010



	Date	Rating	Target Price	Closing Price
1	9-Jul-09	*1M	*76.00	58.65
2	14-Sep-09	1M	*90.00	69.43
3	14-Jul-11	1M	*66.00	52.73

* Indicates change

	Date	Rating	Target Price	Closing Price
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	66.00	37.78
6	10-Oct-11	1	*64.00	38.71

	Date	Rating	Target Price	Closing Price
7	2-Nov-11	1	*63.00	39.24
8	9-Feb-12	1	*55.00	47.81
9	5-Mar-12	1	*54.00	42.88

Rating/target price changes above reflect Eastern Standard Time

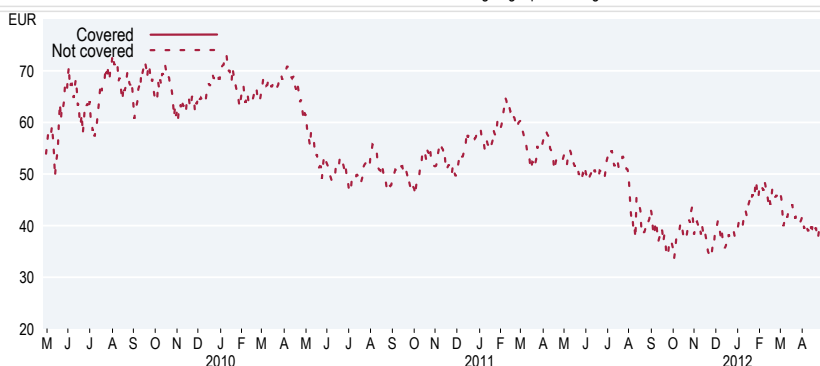
Salzgitter AG (SZGG.DE)

Ratings and Target Price History Best Ideas Research

Relative Call (3 Month)

Analyst: Anindya Mohinta

Covered since May 24 2010



* Indicates change

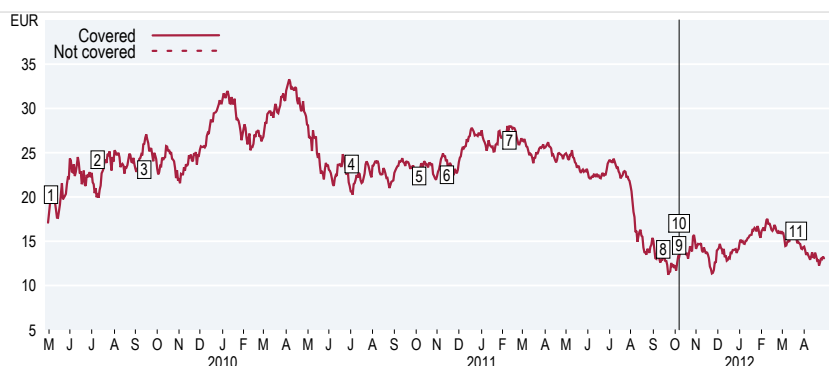
Rating/target price changes above reflect Eastern Standard Time

ArcelorMittal (ISPA.AS)

Ratings and Target Price History

Fundamental Research

Analyst: Anindya Mohinta
Covered since May 24 2010



	Date	Rating	Target Price	Closing Price
1	5-May-09	*3M	17.10	19.67
2	9-Jul-09	*2M	*20.90	20.43
3	14-Sep-09	*1M	*30.40	26.01
4	2-Jul-10	1M	*24.70	20.58

* Indicates change

	Date	Rating	Target Price	Closing Price
5	6-Oct-10	1M	*23.75	22.95
6	15-Nov-10	*2M	23.75	24.23
7	10-Feb-11	2M	*25.00	27.98
8	15-Sep-11	*1H	*20.00	13.44

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	Stock rating system changed		
10	7-Oct-11	*1	20.00	13.20
11	21-Mar-12	1	*19.00	15.44

Rating/target price changes above reflect Eastern Standard Time

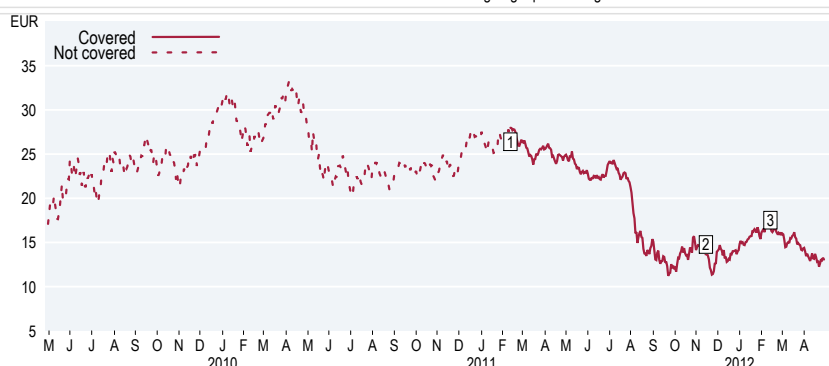
ArcelorMittal (ISPA.AS)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Anindya Mohinta
Covered since May 24 2010



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	27.98

* Indicates change

	Date	Rating	Target Price	Closing Price
2	15-Nov-11	*REM LP	-	13.59

	Date	Rating	Target Price	Closing Price
3	14-Feb-12	*ADD MP	-	16.72

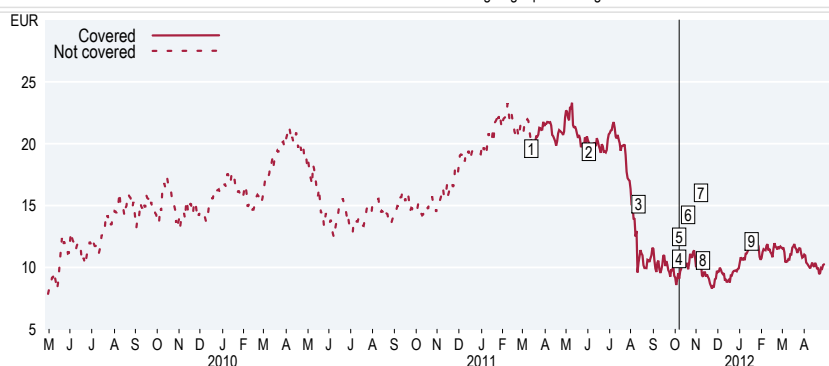
Rating/target price changes above reflect Eastern Standard Time

Klockner & Co. (KCOGn.DE)

Ratings and Target Price History

Fundamental Research

Analyst: Michael E Flitton
Covered since March 1 2012



	Date	Rating	Target Price	Closing Price
1	14-Mar-11	*1M	*28.25	20.29
2	2-Jun-11	1M	*25.00	20.08
3	11-Aug-11	*1H	*18.00	10.39

* Indicates change

	Date	Rating	Target Price	Closing Price
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	18.00	9.09
6	20-Oct-11	1	*16.00	9.85

	Date	Rating	Target Price	Closing Price
7	8-Nov-11	1	*14.00	10.22
8	10-Nov-11	1	*12.00	9.25
9	18-Jan-12	*2	12.00	11.76

Rating/target price changes above reflect Eastern Standard Time

Klockner & Co. (KCOGn.DE)

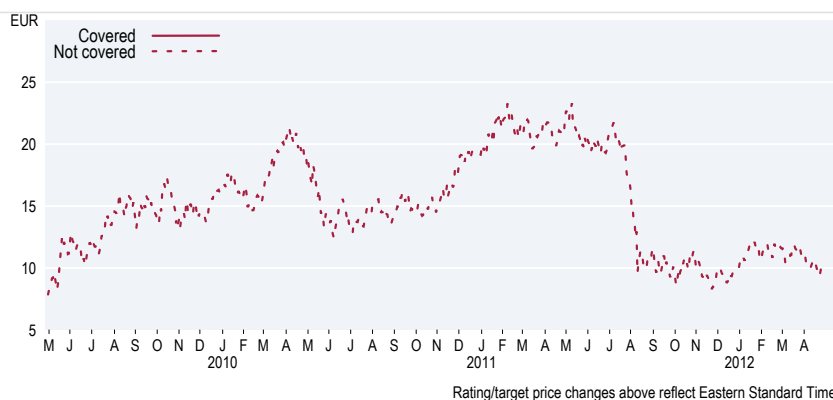
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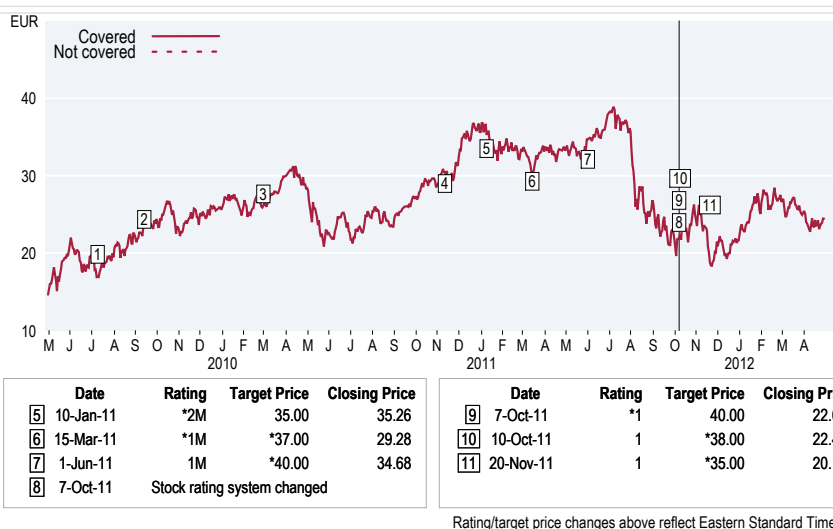
voestalpine AG (VOES.VI)

Ratings and Target Price History

Fundamental Research

Analyst: Anindya Mohinta

Covered since May 24 2010



	Date	Rating	Target Price	Closing Price
1	9-Jul-09	1M	*24.00	17.01
2	14-Sep-09	1M	*32.00	23.48
3	1-Mar-10	1M	*34.00	26.15
4	11-Nov-10	1M	*35.00	30.43

	Date	Rating	Target Price	Closing Price
5	10-Jan-11	*2M	35.00	35.26
6	15-Mar-11	*1M	*37.00	29.28
7	1-Jun-11	1M	*40.00	34.68
8	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	*1	40.00	22.04
10	10-Oct-11	1	*38.00	22.46
11	20-Nov-11	1	*35.00	20.10

voestalpine AG (VOES.VI)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Anindya Mohinta

Covered since May 24 2010



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