

Tata Power

Rs509

OUTPERFORMER

Event Update – Tata Power buys 30% stake in Indonesian coal mines

Mkt Cap: Rs100bn; US\$2.3bn

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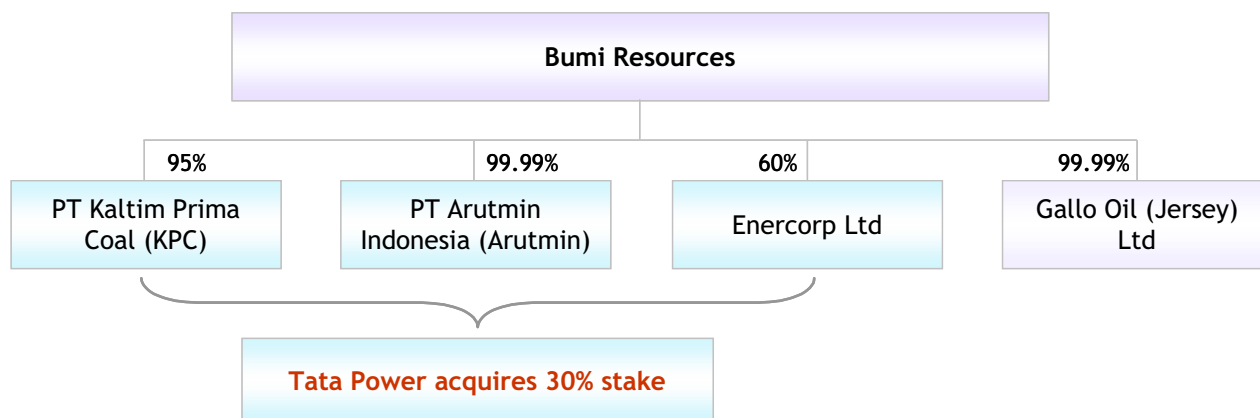
Tata Power acquired 30% stake in two Indonesian coal mines namely PT Kaltim Prima Coal (KPC) and PT Arutmin Indonesia (Arutmin) and an associated trading company Enercorp Ltd. for US\$1.1bn. The two mines produced sold 50mn tons of coal in CY06. TPC has contracted to buy 10mn tons of coal from the mines thereby meeting 50% of its total imported coal requirements over the next five years. TPC acquired these mines at 11x CY08 earnings or 7.9x CY08 EV/EBITDA, which is in line with other regional peers. The acquisition is being done through and offshore SPV, which is likely to have a gearing of 2-2.5x resulting in net equity requirement of Rs15-18bn for TPC. TPC has cash of Rs18bn and investment in group companies of Rs16bn, which has a total market value of Rs75bn. As a result, TPC can easily fund the equity of Rs15-18bn of the SPV created for acquisition on its own strength. Overall, we believe the acquisition is likely to be earnings neutral as the prorata share of earnings of the coal mines would be broadly offset by the interest cost on the debt taken for funding the acquisition. However, the acquisition is a long term positive for TPC as it ties up the coal requirements for its 7000MW generating capacity addition over the next five years. We maintain our Outperformer rating on the stock with a target price of Rs608/share.

KEY HIGHLIGHTS

□ Tata Power takes 30% stake in Indonesian coal mines

Tata Power (TPC) has signed agreements to purchase 30% equity stakes in two major Indonesian thermal coal producers, PT Kaltim Prima Coal (KPC) and PT Arutmin Indonesia (Arutmin) and a related trading company Enercorp Ltd owned by PT Bumi Resources Tbk (Bumi). Moreover, as part of the purchase, TPC has signed an offtake agreement with KPC, which entitles it to purchase about 10 mn tonnes of coal per annum.

Exhibit 1: Holding structure of Bumi Resources



Source: Bumi Resources, SSKI Research

□ Total reserves of 2.7bn tonnes, target to produce 90mn tonnes by 2010

As at 30th June 2005, the coal mines are estimated to have coal resources of 2.7bn tonnes, with marketable coal reserve of 1.14bn tonnes (778 mn tonnes proved resources and 181mn tonnes of probable reserves). The coal mines have a well connected coal infrastructure and are strategically well located to meet the growing supply at cost effective prices.

Exhibit 2: Reserves of coal mines at 2.7bn tonnes

Coal reserves	Marketable reserves			Total coal reserves	Calorific value
	Proven	Probable	Total		
KPC's reserves	525	79	604	1,830	5,500-6800
Arutmin's reserves	253	105	358	896	5500-6800
Total coal reserves	778	184	962	2,726	-

Source: Bumi website, SSKI Research

The total production in CY2006 has been 54mn tonnes, of which 50.1mn tonnes were sold. The target set by the management for sales by both the mines in 2010 is estimated at 90mn tonnes.

Exhibit 3: Total sales of 50mn tonnes in 2006

Coal sales	2003	2004	2005	2006	...	2010
Sanggata	16.2	21.4	27.5	29.7		
Bengalon	0	0	0.7	5.5		
Total KPC	16.2	21.4	28.2	35.2		
% Growth		32.1%	31.8%	24.8%		
Senakin	6	6	4.5	4.6		
Satui	6.6	5.8	5.4	6.3		
Asam-asam/Mulia	0.2	1.8	4.2	1.9		
Batulicin	0.9	1.5	2.6	2.1		
Total Arutmin	13.7	15.1	16.7	14.9		
% Growth		10.2%	10.6%	(10.8%)		
Total	29.9	36.5	44.9	50.1		90
% Growth		22.1%	23.0%	11.6%		

Source: Bumi website, SSKI Research

Exhibit 4: Average selling price of US\$39/ton for Arutmin and US\$42/ton for KPC in 2006

Coal price trend	2001	2002	2003	2004	2005	2006	2007
Arutmin	25.9	26.1	23.4	28	33.2	38.6	38.6
KPC	32.4	29.1	25.9	33.1	44.8	42.2	42.2
Average International Coal price	34.5	31.9	26.8	40.5	46	48	50

Source: Bumi website, SSKI Research

□ Bumi resources – PAT of US\$222mn for both coal mines in CY2006

Bumi Resources, which owns the mines has reported revenues of US\$1.85bn and earnings of US\$222mn in CY2006. With the growth in coal production and higher coal prices, we estimate the coal mines to have revenues of US\$2.2bn in CY07 and US\$2.6bn in CY08, with a PAT of US\$278mn in CY07 and US\$333mn in CY08.

Exhibit 5: Key financials of Bumi Resources

US\$ mn	2003	2004	2005	2006	2007E	2008E	2009E	2010E
Revenues	451	1,054	1,639	1,852	2,222	2,592	2,962	3,333
EBITDA	35	245	241	400	480	560	640	720
PAT	13	121	126	222	278	333	383	441

Source: Bumi website, SSKI Research

❑ Background of Kaltim Prima coal (KPC)

Bumi Resources acquired PT Kaltim Prima Coal (KPC) in October 2003 from British Petroleum (U.K.) and Rio Tinto (U.K. and Australia). KPC produced 35.2 mn tonnes of coal in 2006, of which 97% was exported.

KPC reserves	Marketable reserves			Total coal reserves
	Proven	Probable	Total	
Sanggata	240	22	262	
Melawan	128	57	185	
Bengalon	157		157	
Total	525	79	604	1,830

In 1982, KPC, located at Sangatta, entered into a Coal Contract of Work, which is up for renewal in 2021, to explore, produce and market coals from its agreement area of 90,960 hectares. At Sangatta, KPC has developed a fully integrated and self-supporting mine with a series of open cut pits and coal preparation facilities. The Sangatta mine is supported by a 10 MW coal-fired power station and 5 generator sets of 9.4 MW of diesel capacity, 5 crushers each with 1,200tph capacity with additional crushing capacity in 2005 and a 13.2km overland belt conveyor link to the coast which had been upgraded to a maximum capacity of 4,000 tph in 1Q2005.

In 2005, KPC began to mine the Bengalon area, which is transported over 17km to the port. KPC's coal is primarily of high quality bituminous coal with high calorific value, low ash, moderate sulphur and moisture.

❑ Background of Arutmin Indonesia coal (Arutmin)

Bumi Resources owns 99.99% of share in PT Arutmin Indonesia (Arutmin). In 1981, Arutmin was licensed to explore and mine coal in an area of 1,260,000 hectares, based on a first generation Coal Contract of Work which expires in 2019. The CCOW has been reduced and now covers an area of 70,153 hectares. The total annual production at 4 coal mines reached 15 mn tonnes of washed and unwashed coal in 2006.

Arutmin's reserves	Marketable reserves			Total coal reserves
	Proven	Probable	Total	
Senakin	37	14	51	
Satui	50	30	80	
Asam-asam/Mulia	142	40	182	
Batulicin	24	21	45	
Total	253	105	358	896

Arutmin exports a substantial portion of its mined coal to international markets. It produces high quality bituminous Eco coal, with high calorific substance and low to medium ash content. In addition, it also produces the more economical but lower grade Eco coal product from its Asam-asam mines.

The coal mining operations of Arutmin are conducted by conventional open cut methods employing dozers, excavators, loaders and trucks. The coal products from the mines are transported by truck and are stockpiled at 1 of Arutmin's 4 barge ports. The final products are conveyed from the barge ports to the North Pulau Laut Coal Terminal at Tanjung Pemancingan by custom built, self-discharging barges or loaded directly onto ocean vessels at offshore barge transshipment anchorage.

In 2006, Arutmin exported around 93% of its production of 15 mn tonnes of high quality coals. Arutmin's main advantages are its competitive position in the global market, competitive cost structure due to the strategic Kalimantan location of its mines, which are near to the coast and its brand name establishment due to its high coal quality.

❑ Background of Enercorp Ltd.

Bumi Resources has 60% ownership in Enercorp Ltd. (Enercorp), an agency responsible for the marketing of Bumi's energy products (i.e., coal, oil and gas) in the domestic market. In addition to marketing the Bumi's coal, Enercorp may also markets coals from other non-related producers. Enercorp delivers robust profitability by focusing on the market effectively and efficiently, and optimizing resources professionally.

❑ Coal mines to meet TPC's requirement of coal for new projects...

TPC is in the process of developing ~7000MW of power on the western coast of India, including the recently won UMPP (Ultra Mega Power Plant) at Mundra. The power plants will be developed over the next 5 years, which will have an annual requirement of coal of ~21mn tonnes.

Exhibit 6: Tata power requires 21mn tonnes for its future power plants

Coal requirement	(MW)	mn tonnes
Mundra Ultra Mega Power plants	4000	13.5
Maharashtra Power plant	2000	6.5
Trombay Power plant	250	0.8
Total	6250	20.8

Source: Company, SSKI Research

❑ ... only 10mn tonnes tied in through the acquisition

However, TPC has signed an offtake agreement with the coal mines for 10 mn tones only. We believe TPC will look to source incremental coal from these mines, depending on the availability and pricing of the coal. On the other hand, TPC is also exploring coal supplies from Australian and African coal mines to meet coal requirements.

Moreover, as the production of the coal mines increases, TPC will be able to secure higher coal tonnage from the coal mines to meet its future coal requirements. Consequently, the acquisition of the coal mines secures TPC's fuel requirements over the next few years for its future growth initiatives. Moreover, the acquisition of the coal mines will help TPC to bid for more projects based on imported coal at competitive prices of power.

❑ Acquisition at 11x CY08 earnings

TPC will be paying a consideration of US\$1.1bn for its stake in the coal mines, prior to working capital and other adjustments. Assuming, a debt of US\$750mn, the total EV for the acquisition is US\$4.4bn, the acquisition which is at 11x CY08 earnings and 7.9x EV/EBITDA. Based on the profitability of the coal mines, we believe the coal mines have been acquired by TPC at a fair valuation.

Exhibit 7: Acquisition at 11xCY08 earnings

Price paid (US\$ mn)	1,100				
Stake (%)	30				
Implied Market Cap (US\$ mn)	3,667				
(US\$ mn)	2006	2007E	2008E	2009E	2010E
Debt	750	750	750	750	750
EV	4,417	4,417	4,417	4,417	4,417
EV/EBITDA (x)	11.0	9.2	7.9	6.9	6.1
PER (x)	16.5	13.2	11.0	9.6	8.3

Source: Company, SSKI Research

❑ Acquisition to be funded at a gearing of 2-2.5x at SPV level – to be earnings neutral

TPC will be acquiring stake in the coal mines, through an offshore Special Purpose Vehicle (SPV), which will be funded through a mix of debt (at SPV and parent level) as well as internal accruals of TPC. We estimate the gearing to be 2-2.5x for the SPV resulting in equity requirement of Rs15-18bn from TPC. With cash of Rs18bn and investments of Rs16bn (market value of Rs57bn), we believe TPC can easily fund the acquisition without any equity dilution. The acquisition is likely to be earnings neutral as the TPC share of earnings is likely to be offset by the interest cost of the debt taken to fund the acquisition.

❑ **Landed cost of coal at US\$55/ton for UMPP based on current prices**

Based on the average CY06 coal prices of US\$41 FOB of these coal mines, the landed cost (inclusive of customs duty) of coal at the western ports works out to US\$55/ton. We believe the landed price of coal is high for TPC's Mundra UMPP, especially considering its bid tariff of Rs2.26/unit. However, TPC has not disclosed its pricing arrangements for the 10mn tones of coal it has tied up.

❑ **Maintain Outperformer**

Tata Power is aggressively pursuing new growth opportunities across the entire value chain of power business in terms of new distribution circles, new generation capacities and the Powerlinks transmission project with PGCIL. Tata Power's healthy balance sheet puts it in a strong position to capitalize on these emerging opportunities. Tata Power is currently trading at 22.8x FY08E earnings and 9.8x FY08 EV/EBITDA, which we believe is attractive considering its stable cash flows and focus on core power business. We have arrived at the fair value of Tata Power using the DCF valuation methodology due to its steady cash flows and regulated nature of business. We maintain Outperformer rating on the stock with a fair value of Rs608/share.

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