

Tata Coffee (51% sub of Tata Tea)Rs760
OUTPERFORMER**Event Update – Acquisition of Eight O’Clock Coffee**

Mkt Cap: Rs42.6bn; US\$925.2m

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Key Valuation metrics

(Rs m)	Net Sales	yoy chg (%)	Net profit	EPS (Rs)	yoy chg (%)	EV / E	PER (x)
FY04	30,495	6.2	2,067	36.9	-	12.6	21.1
FY05	30,591	0.3	2,154	38.5	4.2	10.6	20.3
FY06E	31,239	2.1	2,992	53.4	38.9	9.3	14.6
FY07E	33,114	6.0	3,325	59.3	11.1	8.2	13.1
FY08E	34,769	5.0	3,729	66.6	12.2	7.2	11.7

Continuing to move along its inorganic growth route, Tata Coffee (51% subsidiary of Tata Tea) has acquired USD109m Eight O’Clock Coffee (EOC) in the US. The acquisition brings significant strategic and operational gains for Tata Coffee, as it gets an entry into the world’s largest coffee market (USD21bn), gets access to the deep distribution reach of EOC (toughest task in the US markets) and ability to also leverage the retail presence for Tata Tea portfolio. We also like the fact that Tata Coffee has not gone overboard, as the price paid for acquisition is fairly comparable to price at what Gryphon Investors had acquired EOC (2x revenues) from Atlantic and Pacific Tea Company in 2004.

Besides the operational gains and fair valuations, what enthruses us the most is the size of the transaction (2.5x existing size of TCL). It reinforces confidence in management’s willingness to take big leaps. We like the intent of the management of Tata Tea to become world’s largest beverages player and given the past track record of the parent company (Tetley acquisition), we are also confident of Tata Coffee’s ability to digest large size acquisition. The acquisition can potentially add ~Rs4 (post minority) to the EPS of Tata Tea. At Rs760, the stock trades at attractive valuations of 12x FY08E earnings (pre acquisition). Tata Tea remains one of our top pick in the sector with price target of Rs1000.

TATA COFFEE ACQUIRES EIGHT O’CLOCK COFFEE IN US

Tata Coffee has acquired USD109m (2.5x Tata Coffee’s existing size) Eight O’Clock Coffee (EOC) in the US at USD220m. EOC is the largest selling whole bean coffee brand in the US (54% market share), category leader in the value gourmet segment of the US retail market and also the third largest coffee brand by volume in the US. EOC sells under the brands Eight O’Clock Coffee and Royale Coffee. EOC makes attractive operating margins of ~25% (significantly better than Tata Coffee’s existing margins).

TATA COFFEE – A LEAP AHEAD

❑ Expand the opportunity space

With the acquisition of EOC, Tata Coffee will operate at a completely different pedestal, as it enters an opportunity space to USD21bn (US is the world's largest coffee market). With EOC present in most of the modern retail outlets and reaching out to 65% of the grocers in the US, Tata Coffee gets ready access to the retail distribution and entry into modern retail outlets (one of the most difficult task in the US markets). Tata Coffee can also leverage this distribution reach for the Tata Tea and Tetley portfolio (Tata Tea has been investing heavily in the US and Canada markets to enter the modern retail). We believe that the deal brings a lot of strategic and operational gains beyond more than tripling the portfolio of Tata Coffee.

❑ Price paid for acquisition – Fair Price

Tata Coffee has acquired the brand at USD220m (2x revenues) which can be best compared to the transaction value when Atlantic & Pacific Tea Company (A&P) had sold the brand to Gryphon Investors, a private equity player. A&P had sold the Eight O'Clock coffee business at USD107.5m cash and USD20m of performance linked instruments, while sales stood at USD65m. We believe that the acquisition is made at fair value, even when compared to Tata Coffee's existing valuations of 2.3x revenues. The deal will increase the gearing of Tata Coffee significantly, as the deal will be largely funded through debt.

Excerpts from the Annual report of The Great Atlantic & Pacific Tea Company, Inc.

The Great Atlantic & Pacific Tea Company, Inc. Notes to Consolidated Financial Statements – Continued

	Fiscal 2003			
	Northern New England	Kohl's	Eight O'Clock Coffee	Total
(Loss) income from operations of discontinued businesses				
Sales	\$ 32,726	\$ 123,229	\$ 65,265	\$ 221,220
Operating expenses	(42,536)	(174,890)	(60,179)	(277,605)
(Loss) income from operations of discontinued businesses, before tax	(9,810)	(51,661)	5,086	(56,385)
Tax benefit (provision)	4,120	21,698	(2,136)	23,682
(Loss) income from operations of discontinued businesses, net of tax	\$ (5,690)	\$ (29,963)	\$ 2,950	\$ (32,703)

Eight O'Clock Coffee

During fiscal 2003, we completed the sale of our Eight O'Clock Coffee business, generating gross proceeds of \$107.5 million and a net gain after transaction related costs of \$85.0 million (\$49.3 million after tax). The sale of the coffee business also included a contingent note for up to \$20.0 million, the value and payment of which is based upon certain elements of the future performance of the Eight O'Clock Coffee business and therefore is not included in the gain.

❑ What attracts is the intent

While we are very positive on the operational gains, new market entry as also the valuations at what the company is bought, what excites us the most is the ticket size of the acquisition. We like the ambition of the management to take big leap and play in larger opportunity space. The management has clearly indicated its intent to become world's largest beverage player, and moving in the direction, Tata Tea will have to take leveraged route, which is not a concern area. Knowing the track record of the parent company (Tata Tea) to go overboard and acquire a company (Tetley), three times its own size, we are confident of Tata Coffee's ability to digest the acquisition.

“By the end of the decade, we expect the Tata Tea group, including Tata Tea, Tetley, Tata Coffee and Eight O’Clock combine to become one of the largest and most admired beverage players in the world.”

- R K Krishna Kumar, Chairman, Tata Coffee.

❑ Tata Tea - Attractive valuations

Even taking into account highly leveraged transaction, we expect EOC to potentially generate PAT of USD10m. Post minority interest, it can convert into incremental EPS of ~Rs4 to Tata Tea. Given the transition to the branded portfolio and willingness and appetite of taking inorganic growth route, Tata Tea trades at highly attractive valuations of 12x FY08E earnings (pre acquisition of EOC). Tata Tea remains the top pick in the sector with price target of Rs1,000.

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2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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