

Company Focus

1 November 2007 | 8 pages

Tata Chems (TTCH.BO)

 Change in opinion
 Rating change
 Target price change
 Estimate change

Downgrade to Hold on Excessive Valuations

- Downgrade to Hold (2M)** — After a sharp 32% run-up in the stock over the past three months, we believe the stock now trades at levels where the risk-reward ratio is not favourable, even on our higher Rs360 target price. We are, consequently, downgrading the stock to Hold/Medium risk.
- 2Q results in line** — Reported net income (standalone) of Rs1.43bn was in line with estimates, though operating profits were slightly lower than expected due to a shutdown at Mithapur owing to the Gujarat rains. However, higher other income boosted by forex gains helped shore up the bottom line.
- Adjusting FY08-10E earnings** — With the FY07 annual report providing consolidated financials for the first time, we introduce our detailed FY08-10E earnings forecasts for Tata Chem consolidated for Brunner Mond. Standalone FY08-09E earnings have also been revised by 9-14% to factor in details from the FY07 annual report and the continued positive global soda ash outlook.
- Soda ash outlook positive; fertilizer business remains uncertain** — Strong soda ash prices (now c.US\$250/MT) are likely to continue amid supply disruptions in China. Though the government has approved the new pricing policy for domestic fertilizers, which is supportive of de-bottlenecking, we are not hopeful of any medium-term progressive measures and maintain our cautious stance.
- New initiatives still a while away** — Bio-fuels, bio-nano R&D, and fresh produce supply chain plans, though impressive, are not close to value creation.

Hold/Medium Risk	2M
<i>from Buy/Medium Risk</i>	
Price (01 Nov 07)	Rs317.00
Target price	Rs360.00
<i>from Rs273.00</i>	
Expected share price return	13.6%
Expected dividend yield	2.7%
Expected total return	16.2%
Market Cap	Rs68,188M US\$1,740M

Price Performance (RIC: TTCH.BO, BB: TTCH IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	4,283	17.59	25.8	18.0	3.1	20.3	2.2
2007A	5,080	20.87	18.6	15.2	2.7	21.2	2.5
2008E	6,255	25.69	23.1	12.3	2.3	22.5	2.7
2009E	7,047	28.94	12.7	11.0	2.0	21.9	2.8
2010E	7,572	31.10	7.5	10.2	1.7	20.3	2.8

Source: Powered by dataCentral

Saurabh Handa¹

 +91-22-6631-9858
 saurabh.handa@citi.com

Rahul Singh¹

 +91-22-6631-9863
 rahul.r.singh@citi.com

Garima Mishra¹

garima.mishra@citi.com

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	18.0	15.2	12.3	11.0	10.2
EV/EBITDA adjusted (x)	10.0	8.2	7.1	6.0	5.5
P/BV (x)	3.1	2.7	2.3	2.0	1.7
Dividend yield (%)	2.2	2.5	2.7	2.8	2.8
Per Share Data (Rs)					
EPS adjusted	17.59	20.87	25.69	28.94	31.10
EPS reported	17.59	20.87	25.69	28.94	31.10
BVPS	103.15	119.53	138.65	161.12	186.03
DPS	7.00	8.00	8.50	9.00	9.00
Profit & Loss (RsM)					
Net sales	40,344	58,096	63,091	67,465	70,560
Operating expenses	-34,620	-50,729	-54,742	-57,563	-60,040
EBIT	5,725	7,367	8,348	9,902	10,520
Net interest expense	-505	-824	-591	-956	-926
Non-operating/exceptionals	787	939	1,100	906	957
Pre-tax profit	6,007	7,481	8,857	9,852	10,552
Tax	-1,723	-2,401	-2,603	-2,805	-2,980
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	4,283	5,080	6,255	7,047	7,572
Adjusted earnings	4,283	5,080	6,255	7,047	7,572
Adjusted EBITDA	7,565	10,105	11,553	13,322	13,993
Growth Rates (%)					
Sales	34.1	44.0	8.6	6.9	4.6
EBIT adjusted	51.5	28.7	13.3	18.6	6.2
EBITDA adjusted	46.7	33.6	14.3	15.3	5.0
EPS adjusted	25.8	18.6	23.1	12.7	7.5
Cash Flow (RsM)					
Operating cash flow	4,170	9,744	6,351	9,811	10,653
Depreciation/amortization	1,840	2,739	3,205	3,420	3,473
Net working capital	-1,745	2,043	-2,747	-845	-603
Investing cash flow	-1,275	-6,067	-6,069	-5,791	-2,541
Capital expenditure	-1,275	-6,067	-6,069	-5,791	-2,541
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-295	-1,477	-1,169	-2,012	-4,412
Borrowings	1,303	536	971	200	-2,200
Dividends paid	-1,598	-2,013	-2,140	-2,212	-2,212
Change in cash	2,600	2,200	-887	2,007	3,700
Balance Sheet (RsM)					
Total assets	58,944	66,126	68,894	75,540	80,271
Cash & cash equivalent	1,165	1,545	1,573	3,580	7,280
Accounts receivable	7,655	9,665	9,114	10,662	12,002
Net fixed assets	27,794	30,561	33,425	35,796	34,865
Total liabilities	36,751	40,407	39,061	40,873	40,244
Accounts payable	8,160	9,031	10,937	12,195	13,442
Total Debt	18,277	18,642	19,091	19,291	17,091
Shareholders' funds	22,194	25,718	29,833	34,668	40,027
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.8	17.4	18.3	19.7	19.8
ROE adjusted	20.3	21.2	22.5	21.9	20.3
ROIC adjusted	12.7	12.2	13.2	15.0	15.4
Net debt to equity	77.1	66.5	58.7	45.3	24.5
Total debt to capital	45.2	42.0	39.0	35.8	29.9

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Adjusting FY08-09E earnings

We are introducing our detailed FY08-10E consolidated P&L forecasts for Tata Chem following details from the FY07 annual report. On a standalone basis, our FY08-09E earnings for Tata Chem have been revised up by 9-14%. This is primarily to factor in:

1. Higher urea sales – driven by an increase in production from 1.0MMT in FY07 to 1.2MMT in FY10E following de-bottlenecking at Babrala, likely to be completed by Oct-08E
2. Better urea realizations – driven by the implementation of the new pricing policy which is supportive of de-bottlenecking of urea plants
3. Higher soda ash sales – driven by the Mithapur expansion (capacity to increase from 0.9MMT currently to 1.2MMT in FY10E)
4. Better soda ash realizations – driven by the current strong soda ash pricing environment which is likely to sustain in the medium term amidst supply disruptions in China

Figure 1. Tata Chem (standalone) – Earnings Revisions

Year to	Sales (Rs Mils.)			EBITDA (Rs Mils.)			Net Profit (Rs Mils.)		
	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2008E	39,057	42,397	8.6%	7,708	7,476	-3.0%	4,473	4,877	9.0%
2009E	39,882	45,421	13.9%	7,739	8,772	13.3%	4,582	5,237	14.3%
2010E	na	47,414	na	na	9,058	na	na	5,454	na

Source: Citi Investment Research estimates

Our estimates for Brunner Mond have also been adjusted, with FY08-09E EBITDA going up by 10-23% to factor in FY07 actual operating performance. The growth in profitability from FY07 to FY10E is a combination of: (1) increasing sales following expansion of the Magadi capacity from 0.365MMT to 0.715MMT, which is albeit delayed by a few months and (2) gradual increase in operating margins given the natural soda ash advantage. Our earnings changes for Tata Chem on a consolidated basis are depicted in the table below.

Figure 2. Tata Chem (consolidated) – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Div. Per Share (Rs)	
	Old	New	Old	New	% Chg	Old	New
2008E	6,193	6,255	25.44	25.69	1.0%	8.0	8.5
2009E	6,302	7,047	25.88	28.94	11.8%	8.0	9.0
2010E	na	7,572	na	31.10	na	na	9.0

Source: Citi Investment Research estimates

Figure 3. Tata Chem – 2QFY08 Standalone Results (Rupees in Millions)

Year to 31-Mar	2QFY07	1QFY08	2QFY08	% yoy
Net sales	11,260	6,689	12,551	11.5%
Inc/dec in stock	702	(1,304)	1,933	175.2%
Raw material cons	3,774	3,245	4,162	10.3%
Purchases	1,635	323	1,189	-27.3%
Staff cost	349	388	432	23.9%
Stores, Spares	410	413	401	-2.1%
Power & Fuel	1,040	739	898	-13.7%
Freight & Forwarding	664	621	680	2.4%
Other expenditure	714	633	765	7.2%
Total Expenditure	(9,288)	(5,057)	(10,460)	12.6%
EBITDA	1,972	1,632	2,092	6.1%
<i>EBITDA margin (%)</i>	<i>17.5%</i>	<i>24.4%</i>	<i>16.7%</i>	
Interest	(78)	376	(99)	28.3%
Depreciation	(365)	(367)	(367)	0.7%
Other income	682	121	443	-35.0%
Profit before tax	2,212	1,761	2,069	-6.5%
Tax	(636)	(550)	(643)	1.2%
<i>Tax rate (%)</i>	<i>28.7%</i>	<i>31.2%</i>	<i>31.1%</i>	
Net profit	1,577	1,212	1,426	-9.6%

Source: Company Reports

Tata Chems

Company description

Tata Chemical's key business segments are fertilizers and inorganic chemicals. In the fertilizer segment, the company produces nitrogenous and phosphatics. For the standalone company, fertilizers account for 62% of revenues and 40% of PBIT. The company's inorganic chemicals business accounts for 38% of revenues and 60% of PBIT. Soda ash is its key inorganic chemical, accounting for 19% of standalone revenues. Post the acquisition of Brunner Mond, Tata Chemicals now controls 2.8m MTs of soda ash capacity and inorganic chemicals contribute ~60% of consolidated revenues. The company also has a strong food additives business (edible salt and cooking soda). Tata Salt has a c.50% share in the branded edible-salt market. It also has a small cement-manufacturing unit in Mithapur (0.44m MTPA), which uses by-products from its inorganic chemical works in Gujarat.

Investment strategy

We rate Tata Chem as Hold/Medium Risk. The acquisition of a controlling stake in Brunner Mond has given Tata Chem control of 7.5% of global soda ash capacity. It has also reduced Tata Chem's dependence on earnings from the government-controlled fertilizer business. The stock has, however, outperformed over the few months, making the risk-reward ratio unfavorable at current levels. Despite progress on the Brunner Mond integration as well as the kicker to earnings from Brunner Mond's Kenya expansion, the fertilizer business, though stable, will result in muted overall earnings growth for Tata Chem (14% CAGR over FY07-10E on our estimates), which we believe is adequately priced into the stock. The significant value of holdings in the group companies will, in our view, provide downside support for the stock. New initiatives such as bio-fuels, bio-nano R&D, and fresh produce supply chain will be future growth drivers, though value monetization is still a while away.

Figure 4. Share price performance

	3M	6M	12M
Absolute	31.9	53.0	40.6
Relative	0.6	6.5	-9.2

Source: DataStream

Valuation

Our target price of Rs360 is based on our sum-of-the-parts value. Given Tata Chem's varied nature of businesses and its significant holdings in Tata Group companies, we believe SOTP best captures the value of Tata Chem. We have rolled forward our target multiples for the inorganic and fertilizer businesses to FY09E and factored in the increase in market value of holdings in our new target price. We now use 5.25x FY09E EV/EBITDA for the standalone entity's inorganic chemicals business, while for the government-controlled fertilizers business, we use 4.5x FY09E EV/EBITDA (4x FY08E), both in line with peers based on consensus. To value Tata Chem's stakes in listed Tata Group entities, we take an average 40% discount to the market value. For Brunner Mond, we attribute Rs95/share (Rs67 earlier) based on a 6.0x FY09E EV/EBITDA (higher than 5.25x for the domestic business due to its presence in the higher value-added business of sodium bicarbonate, a strong anticipated improvement in margins, and reduced integration risks). Our target price equates to a fully diluted consolidated P/E of 12.4x FY09E, a justifiable discount to the P/E of the market due to the regulated nature of part of Tata Chem's business.

Figure 5. Tata Chemicals – Sum-of-the-Parts Valuation

Particulars	Rs m	Rationale
(a) Chemicals business (standalone)	30,775	5.25x FY09E EV/EBITDA (5x FY08E earlier)
(b) Fertilizer business (standalone)	13,096	4.5x FY09E EV/EBITDA (4x FY08E earlier – Indian fertilizer companies operate in a regulated environment)
Core business EV	43,871	(a)+(b)
Holdings in group companies	22,954	At 40% discount to market value
Total EV	66,825	
Net debt	9,473	
Equity value	57,352	
No. of shares	215	
Fair value	267	
Value of Brunner Mond	95	Based on 6.0x FY09E EV/EBITDA (5.5x FY08E earlier – higher value attributed due to presence in higher value-added pharmaceutical sodium bicarbonate business)
Fair Value	361	

Source: Citi Investment Research estimates

Risks

We rate Tata Chem Medium Risk even though our quantitative risk-rating system, which tracks 260-day share price volatility, gives it a Low Risk rating. We believe a higher risk rating is justified as Tata Chem's key product, soda ash, is a cyclical commodity, while the fertilizer business is subject to government policy uncertainty. The downside risks to our target price include: 1) Tata Chem's key inorganic chemical product is soda ash (a commodity), which is exposed to the global soda ash cycle; 2) the company's fertilizer business is controlled by the government; 3) Tata Chem's salt business faces strong competition from consumer non-durables companies; and 4) any value-destructive acquisition. The upside risks to our target price include a stronger, sustained rise in soda ash prices, progressive government policies on fertilizers, and earlier value realization from the new initiatives.

Appendix A-1

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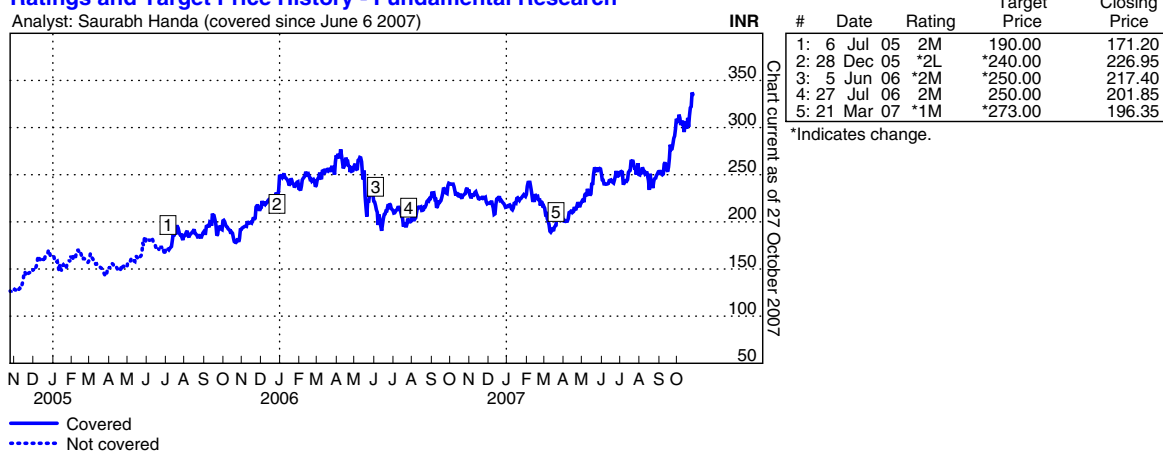
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Analyst: Saurabh Handa (covered since June 6 2007)



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