Emkay Research

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Hindalco Ltd.

Event Update

Hindalco acquires Novelis in all cash deal for $3.33bn and debt of $2.4bn

Not Rated

Price	Target Price
Rs149	**NA**
Sensex	**14,191**

Price Performance

(%)	1M	3M	6M	12M
Absolute	-13	-19	-10	-9
Rel. to Sensex	-13	-24	-28	-35

Source: Capitaline

Stock Details

Sector	Metals
Reuters	HALL.BO
Bloomberg	HNDL@IN
Equity Capital	1159
Face Value	1
52 Week H/L	251/139
Market Cap (Rs bn)	173
Daily Avg Volume (No of shares)	45,31,610
Daily Avg Turnover (US$ mn)	18

Shareholding Pattern (%)

(31st Dec.'06)	
Promoters	26.8
FII/NRI	33.5
Institutions	16.2
Private Corp.	8.2
Public	15.3

Hindalco announced acquisition of Novelis for a cash consideration of $3.33bn ($44.93 per share) and will also take over debt of $2.4bn. Novelis is a world leader in aluminium rolled products. The company operates in 4 continents, 11 countries and has 34 plant locations, with over 12,500 employees. Novelis has a 19% market share in rolled products globally. The takeover is friendly in nature and the board of Novelis has recommended the deal to the shareholders. The deal needs approval from at least two-third of the shareholder. The deal is expected to be completed by 2QFY07. Novelis will continue to function as 100% subsidiary of Hindalco, as it will not be merged in the near term. Hindalco has stated that it will not dilute its equity to finance the deal, nor will it add any debt on its balance sheet. However, it will raise debt on the balance sheet of Novelis, part of which will be guaranteed by Hindalco

The deal

No. of shares of Novelis	74,014,691
Cash per share offered	$44.93
Total equity value of the deal	$3.33bn
Total Debt to be taken over	$2.4bn
Total Enterprise Value	**$5.73bn**

Source: Company

Hindalco will pay $44.93 (premium of 16.6% over last closing price of $38.54 on Friday Feb 9, 2007) and will also take over debt to the tune of $2.4bn. This implies a total equity value of $3.33bn (for 74mn shares outstanding) and EV of $5.73bn.

How will the deal be financed?

Cash from the treasury of Hindalco	$450mn
Borrowing from group company	$300 mn
Debt to be raised to finance the balance (financing mode is yet to be decided)	$2.58bn
Debt on the balance sheet of Novelis to be taken over by Hindalco	$2.4bn
Total Enterprise Value	**$5.73bn**

Source: Company

What is worth noting here is that as per the management, debt will not be raised on the balance sheet of Hindalco; however, some portion of the debt will be taken up with recourse to Hindalco's balance sheet, which implies there will be certain portion of debt for which Hindalco will provide guarantee. Hindalco will also refinance some of the debt of Novelis to bring down its interest cost.

The deal - Advantage for Hindalco

Hindalco will get access to global markets in a single stroke and adds nearly 3mt of downstream aluminium facility. It also gets access to strong research and development facility of Novelis. Key customers of Novelis include- GM, Ford, Coca Cola, Thyssenkrupp.

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The deal - Advantage for Novelis

Novelis will be able to source aluminium from Hindalco at low very low cost as Hindalco is one of the lowest cost producers of aluminium globally. Currently Novalis buys around 40% of its requirement of aluminium sheet ingots from Alcan (36% in 3QFY07). However, this advantage will flow in CY2010 once major Greenfield projects of Hindalco are completed and it is in a position to supply aluminium ingots to Novelis. Till then, we feel, it will continue to post very low margins. However, we need to see how much aluminium Hindalco can ship to Novelis even after completion of all its Greenfield projects.

Slim chance of a competitive bidding situation

Novelis is already a spin off of Alcan, which had demerged its rolled products business on May 18, 2004 to adhere to antitrust rulings after it acquired Pechiney SA of France for $4bn. We believe, Alcoa will also not be interested in buying out Novelis, as it operates in all the regions where Novelis operates and might not be willing to weaken its margins by taking over Novelis. The Russian aluminium giant Rusal is currently in the process of merging itself with two other aluminium giants – Sual and Glencore which will result in creation of world's largest aluminium producer with a capacity of 4mt of aluminium and 12mt of alumina accounting for around 12.5% of global aluminium production and 16% of global alumina production.

We believe, the deal will not see a competitive bidding as seen in the Corus takeover. However, we cannot rule out any other aluminium producer citing interest in the deal as Novelis will immediately provide global footprint to the acquirer.

As per the agreement between Hindalco and Novelis, the board of Novelis can only recommend an alternate offer which should be substantially better than that of Hindalco. Secondly, the second bidder will not be allowed any due diligence before submitting any bid. Finally, Hindalco will be entitled to a breakaway fee of $100mn in case the Board of Novelis recommends an alternate offer.

Novelis – Weak but improving fundamentals

Novelis reported net sales of $8.4bn in CY2005 and a net profit of meager $90mn. For the nine month ended Sep 2006, the company has reported a turnover of 7.4bn (yoy up 16%) and a net loss of $ 170mn. Novelis reported EPS of -$2.30 for nine months ended Sep 2006 ($1.38 for 3QCY2006) It shipped 2,231kt of metal, primarily rolled products in the nine months ending Sep 2006 (3,087kt in CY2005). The company is not an integrated producer of aluminium and as such as has low margins. Metal price ceiling contracts have resulted in losses for the current year.

Metal Price ceiling contracts

The key reason attributable for the dismal performance during 2005 and 2006 is metal price ceiling contract which the company has entered into for sale of sheets in North America. These contracts have cap on metal price which can be transferred to the buyer. Novelis has not been able to fully pass on the increasing cost of aluminium resulting in a loss of around $350mn for the nine months ended Sep '06 ($115mn in 3QCY06). The company has approximately 20% of its total shipments for CY2006 metal price ceiling contracts, which is expected to reduce to 10% of its estimated shipments for CY2007. For CY2007, the metal price ceiling contract is expected to account for nearly 10% of the total shipments for CY2007.

Our view on the deal

We believe, Hindalco will not have significant surplus to ship to Novelis. As such, the deal will be margin eroding in the short run. Further, Novelis still has around 10% of its contracts under the metal price ceiling which will continue to erode its margins if the aluminium price at LME strengthens. However, in the long run, the merger will give the company strong hold on global rolled products market and with its ability to produce primary aluminium at significantly lower cost as compared to competitors globally, we feel, the deal will create shareholder value. The management has also mentioned that the deal will be profitable after 2010.

Hindalco has reported net sales of $3bn for the nine months ending Dec 2006 with a net profit of $414mn as compared to Novelis' net sales of $7.4bn for nine months ending Sep 2006 and net loss of $170mn

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