Tata Steel Ltd.: 2QFY10 earnings review

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ANTIQUE

CMP:	INR543
Target price:	INR581
Recommendation:	HOLD

Sumeet Singhania
+91 22 4031 3431
sumeet@antiquelimited.com

Key highlights

- 2QFY10 consolidated earnings for Tata Steel was lower than our estimates, primarily due to softer realisation, surging raw material cost and one off charges on account of Tata Steel Europe (TSE).
- While consolidated revenues declined 43% on a YoY basis, it was up 9% sequentially largely bouyed by a18% QoQ volume growth in TSE. Accordingly, consolidated EBITDA stood at INR3.7bn, against negative EBITDA of INR299m in 1QFY10. However, restructuring charges of INR9.1bn led to consolidated net loss of INR27bn for the quarter under review.
- Going forward, we expect reversal of trend in EBIDTA in 2HFY10 at TSE, as the benefits of higher utilisation (80%), lower raw material cost and stable pricing enviornment make their impact, aided positively by lower one off charges. The trend would be acclerated by the uptrend in operations at Teesside Cast Products (TCP), which has starterd yielding positive gross contribution in the current quarter.
- The positive rub-off from the above factors can be ascertained from the fact that TSE has already turned EBITDA positive in October 2009. Despite this, Tata Steel's consolidated earnings will be in the red for FY10.

Valuation

- At the CMP of INR545, the stock trades at 8.7x FY10 EPS and 5.8x FY10 EV/ EBITDA.
- Tata Steel is in the process to enhance its India steel capacity by 43% to 9.7mt by mid-2011, and increase Cold rolled capacity by 50%.
- We believe that operational scale up in India and positive contribution from TSE would impart earning stability in 2HFY10 and a scale up in FY11. Considering that the worst is behind, the fair valuation for the company would be at 6x EV/EBITDA, which enables us to arrive at a fair value price of INR581 per share.

Tata Steel Ltd.: 2QFY10 earnings review - earnings disappoint

HOLD CMP: INR543 Target price: INR581

Operating performance snapshot - 2QFY10

Particulars	TSI	TSE	S.E Asia Sub
Deliveries (mt)	1.5	3.9	1.0
Revenues (USDm)	1,183	3,486	541
ASP (USD/t)	810	894	541
EBITDA (USDm)	415	(375)	37
EBITDA (USD/t)	284	(96)	37

Source:

Sales volume up 18% QoQ, driven by demand improvement in European region.

Average realisation in TSE dropped 8% sequentially due to drop in long products prices.

Negative EBITDA on account of higher raw material cost which was primarily sourced from previous year's contracts.

Consolidated Earnings snapshot

INRm	2QFY10	2QFY09	1QFY10	YoY (%)	QoQ (%)
Sales	253,950	441,990	232,923	(43)	9
EBITDA	3,718	82,497	(299)	(95)	(1,345)
EBITDA margin (%)	1.5	18.7	(0.1)	(92)	
Depreciation	11,535	11,470	10,890	1	6
Interest	7,172	8,208	8,819	(13)	(19)
Exceptionals	(9,113)	-	(2,188)	NA	317
PAT	(27,073)	47,717	(22,087)	(157)	23

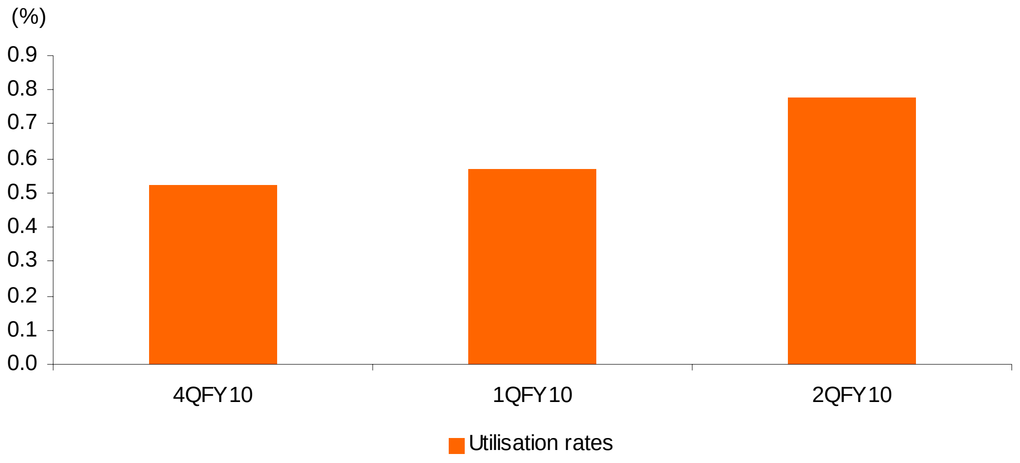
Source:

EBITDA turned positive in the reported quarter due to higher contribution from standalone operations.

European Operations!!

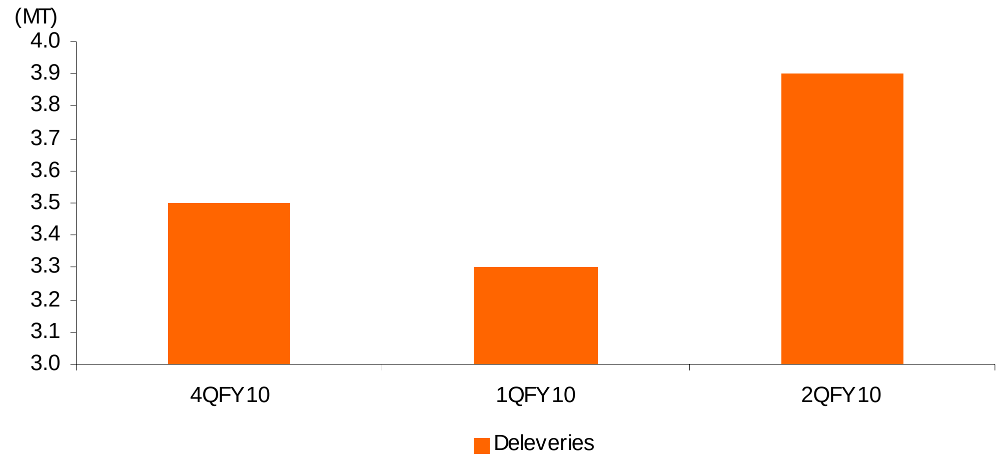
Emerging trends signal improving operations

Utilisation rates are picking up



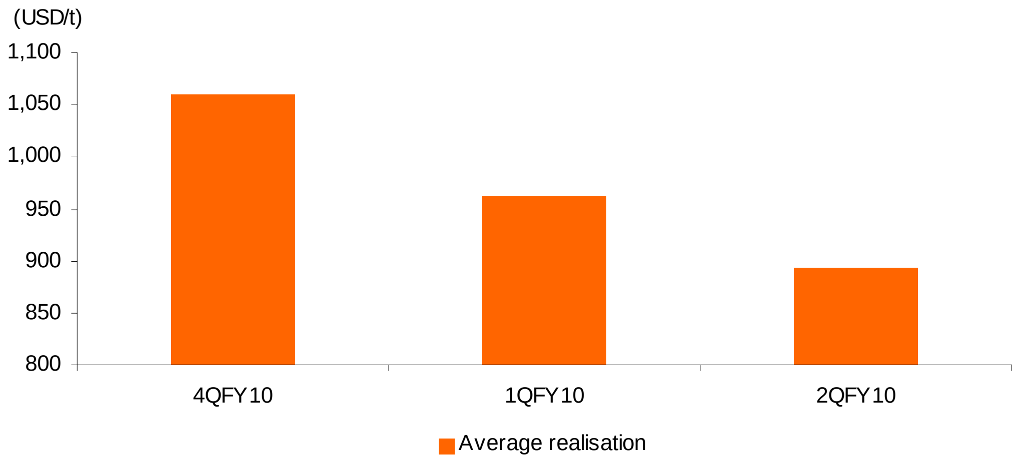
Source: Company, Antique

Accordingly deliveries moved up too…



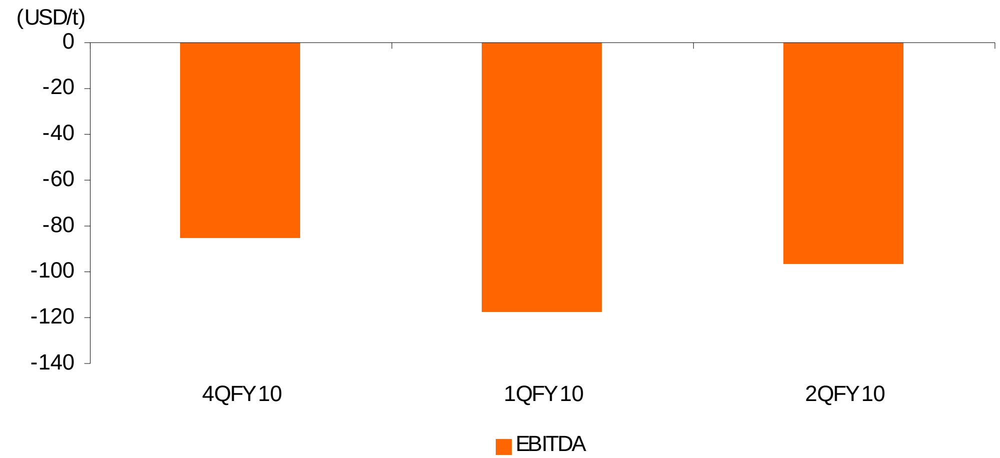
Source: Company, Antique

Weak realisation remains a concern



Source: Company, Antique

EBITDA improving due to cost reduction

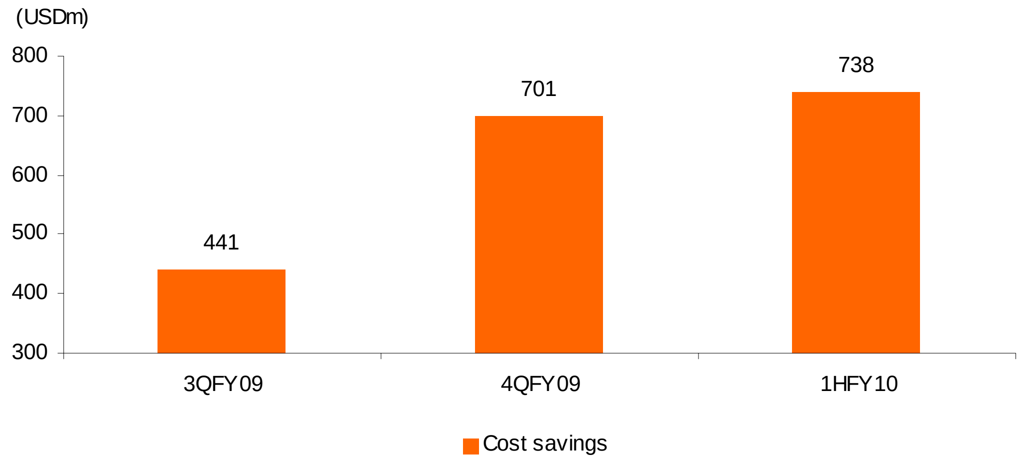


Source: Company, Antique

Savings initiative at Tata Steel Europe (TSE)

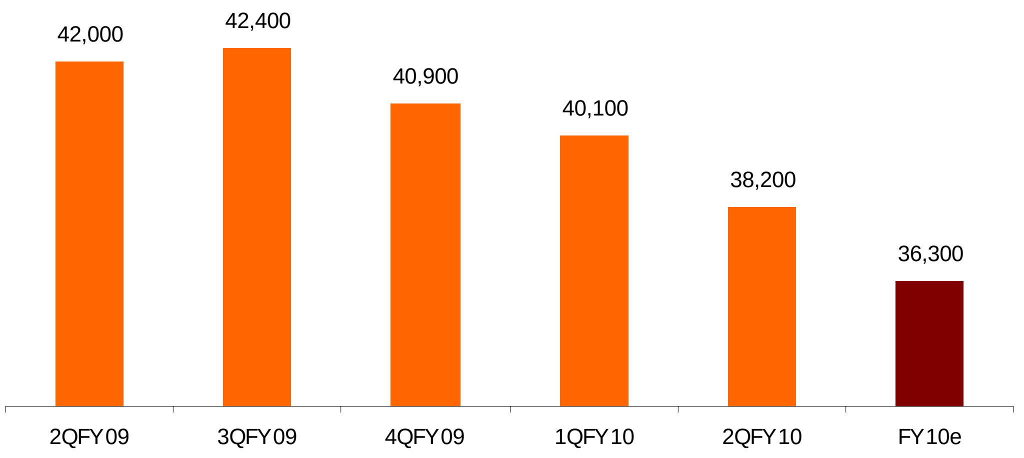
Ongoing cost reduction programme yielding operating efficiency

Cost savings trend



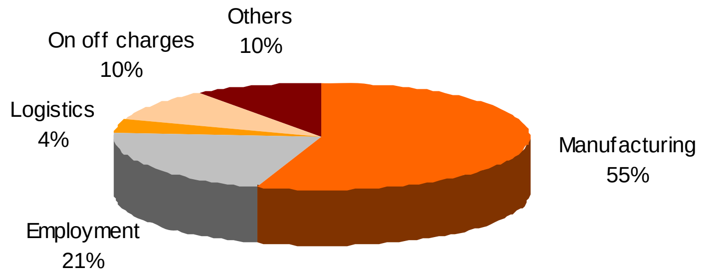
Source: Company, Antique

Employee size at TSE



Source: Company, Antique

Components of cost savings



Source: Company, Antique

- Rightsizing of employee forms an important area in cost savings programme.

Teesside cast products (TCP)

Order visibility keeps it going

- Post cancellation of the off-take agreement in 1QFY10 by the leading customers, TSE was exposed to sell more than 3mt slabs in the depressed market.
- Accordingly, TCP recorded an EBIT loss of USD220m in 1HFY10 on account of low utilisation rates, high material carry over cost and high fixed cost. However, improving order visibility and cost reduction measures have turned TCP to breakeven in the current 3QFY10.
- TSE has secured slab orders for TCP, and hence, the facility will be operating in 3QFY10. Tata Steel is in the process of finalising the long-term plan for TCP; it will either be mothballed or redeveloped.

Tale of two halves - 2HFY10 looks much better than 1HFY10 for TSE

- We expect average raw material prices to reduce in 2H as raw material contracts at new benchmark rates start flowing in. Previous benchmark rates for iron ore and coking coal stood at USD96/t and USD300/t, respectively.
- Severe impact of loss making TCP operations will be minimised in 2H; it will either make profits or will be mothballed.
- Improving demand environment to help boost utilisation rates and shipments - average utilisation rate in 2H is expected at 80–85% against 67% in 1H; current operating rate in 3QFY10 is at 80%.
- Expected savings of USD144m from “Fit for Future” programme in 2H should further boost operating profits.
- **TSE has already turned EBITDA positive in October 2009 and expects to scale up into 3Q and 4QFY10. Three driving factors in 2HFY10 will be volumes, cost savings and reducing exceptional charges.**

2HFY10 performance will be more cost driven than price driven

Projects update

Focus on International raw material assets

Mozambique coal project

- The company has received a mining contract from the Mozambique government; the feasibility study for Benga project with the JV partner is completed.
- Logistics and alternate low cost transportation is being evaluated; capital cost to develop Benga project stage I is estimated at USD270m.
- Tata Steel holds off-take rights of 40%; production is expected to commence from Jan 2001 and coal will be supplied to both TSI and TSE operations.

Canada Iron ore project

- The company has signed a joint venture agreement for Direct shipping Ore (DSO) project for an estimates reserve of 100mt quality ore.
- Tata Steel has 100% off-take right; production is expected to commence from May 2011 with an annual run rate of 4mt.
- Total estimated capital cost is at USD300m; Tata Steel holds 80% equity stake in the joint venture.

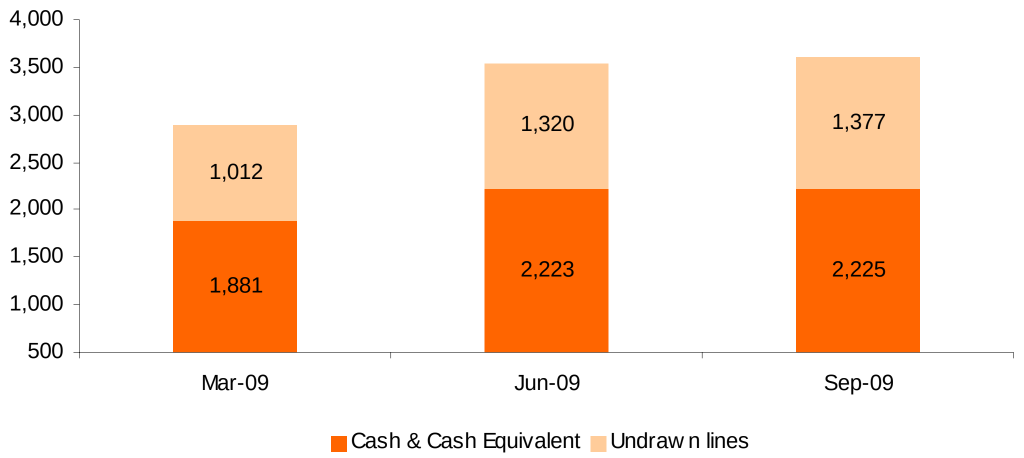
Orissa projects - 6mt steel plant

- The company has already acquired 3,400acres of land and the balance is in the process of acquisition. Rehabilitation and Resettlement (R&R) programme for 70% families is already done.
- Construction work at project site expected to commence in another 2–3 months.

Liquidity position: comfortable

No material repayment liability in the next 1 year

Available liquidity of USD3.6bn



Source: Company, Antique

Capital raised

- USD447m through NCD.
- USD591m through new loans.
- USD104m through CPs.
- USD500m through GDRs.

Repayment

- Repaid USD410m term loans.
- Prepaid USD160m senior debt in TSE.
- USD180m to be prepaid in 2HFY10.

Debt structure

Particulars	USDm
Gross debt as on Mar 09	12,453
New loans	1,342
Repayments	1,062
revaluation impact	159
Gross debt as on Sep 09	12,892
Cash & cash equivalents	2,343
Hedge on Forex loans	676
Net debt as on Sep 09	9,873

Source: Company, Antique

- Tata Steel is targeting to reduce USD2bn from its gross debt in the medium term. However, capital commitment in growth projects might pose as a challenge in achieving the same.
- Potential equity dilution on the cards, to finance growth projects and balance sheet management.

Valuation & recommendation

Change in estimates

- We have changed our earnings estimate for FY10 on account of significant variation in reported profits in 1HFY10. Our EBITDA/t estimate for TSE is reduced by 25% as we slightly reduce our price assumption in 2HFY10.
- Accordingly we now estimate a net loss of INR26bn for FY10 from our earlier estimate of INR21bn net profit.
- We maintain our FY11 earnings estimates

Valuation and rationale

- At the CMP of INR545, the stock trades 8.7x FY10 EPS and 5.8x FY10 EV/EBITDA. We value this stock at 6x to arrive at a fair value price of INR581 per share.
- Tata Steel is in the process to expand its low-cost integrated India facility by 43% to 9.7mt by mid-2011. Besides, its Cold rolled capacity will increase by 50%, which will help to gain market share in the high growth automobile sector.
- Positive contribution from TSE to help earning stability. We believe, although TSE witnessed the worst in 2QFY10, it will record positive earnings from 2HFY10 onwards.
- Global steel prices have witnessed the worst and may experience volatility in small cycles over the medium term. Cost rationalisation at European facility will help improve margins despite price volatility.

Earnings estimate

INRbn	2008a	2009a	2010e	2011e	2012e
Revenues	1,315	1,471	886	1,050	1,273
EBITDA	172	173	63	161	197
EBITDA margin (%)	13.1	11.8	7.2	15.3	15.5
PAT	60	81	(28)	53	77
EPS (INR)	79	61	(31)	63	90
P/E	6.3	8.2	(17.6)	8.7	6.0
P/BV	2.6	4.0	5.5	3.6	2.4
EV/EBITDA	6.9	5.4	14.6	5.8	4.7
RoE (%)	18	29	(12)	19	22

Source: Company, Antique

Valuation

Particulars	Amount
EBITDA - FY11 (INRm)	160,688
EV/EBITDA multiple (x)	6.0
Enterprise value (INRm)	964,128
Net debt (INRm)	487,600
Market value (INRm)	476,528
Value per share (INR)	581

Source: Company, Antique

Important Disclaimer:

Antique Stock Broking Limited

Nirmal, 2nd Floor, Nariman Point, Mumbai 400 021.

Tel. : +91 22 4031 3444 • Fax : +91 22 4031 3445

www.antiquelimited.com