

**BUY**

**Rs 470.9**

**Sensex: 10,477 Nifty: 3,083**

**Stock data**

Bloomberg	TATA.IN
Reuters	TISC.BO
Shares outstanding (mn)	553
Market cap (Rs bn)	261
Market cap (USD mn)	5805
Three-month daily avg vols	4,224,251

**Share price performance**

52-week high/low (Rs)	679/329		
	-1m	-3m	-12m
Abs (%)	-27.9	11.2	33.9
Rel* (%)	-14.8	10.6	-18.9

\*to Nifty

**Financial snapshot**

Rs mn

Ye March	FY05	FY06	FY07E
Net revenues	144,990	151,394	175,303
		4.4	15.8
(%) change			
EDBITA	60,454	59,311	71,456
(%) change		(1.9)	20.5
Net Income	34,742	35,060	43,726
(%) change		0.9	24.7
EPS (Rs.)	62.8	63.3	79.0
(%) change		0.9	24.7
P/E (x)	7.5	7.5	6.0
ROE (%)*	48.6	36.1	34.1
ROCE (%)*	53.2	41.6	41.5

**Vishal Mishra**

+91 22 67069943

vishal.mishra@investsmartindia.com

**Sameer Dalal**

+91 22 67069921

sameer.dalal@investsmartindia.com

**Tata Steel**

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**Lower steel prices and higher raw material costs take toll on profitability**

Tata Steel has reported lower than expected Q4FY06 results. While net revenues have increased 6.8% YoY and 12.2% QoQ the net profit has declined 13.8% YoY. The average steel realisations were lower by 16.6% YoY while steel volumes grew 6.8% YoY. The firming steel prices coupled with the company's strategy of inorganic growth would translate into robust growth. We rate the company as a 'Buy' with a price target of Rs665.

- ◆ Tata Steel is one of the lowest cost producers of steel in world. This is in view of its captive iron ore mines and efficient operations.
- ◆ Focus towards value-add products, branded products and automobile grade steel products have resulted in more stability to the company's realizations and have thus partially insulated itself from the vagaries of steel price volatility.
- ◆ Tata Steel has been looking for acquisitions in the global market. While the company has already acquired NatSteel Asia, it is in the process of completing the acquisition of Millennium Steel. The company has also shown interest in further acquisitions in South Africa. Once the operations of these companies are integrated with Tata Steel, there will be tremendous cost savings leading to margin expansion for these companies, which will flow into Tata Steel's bottomline making its valuations more attractive.
- ◆ Tata Steel is trading a P/E of 6.9X FY07E earnings and an EV/EBIDTA of 3.8X FY07E. Given its low cost production facilities, high share of value-add and branded products, we recommend a 'Buy' on the company with a price target of Rs665.

The key investment highlights are:

- ◆ Higher volumes growth helped Tata Steel pare off the decline in steel prices leading to a 6.8% YoY growth in net revenues in Q4FY06. While steel sales volumes increased 25.7%, the average steel realisations were lower by 16.6%. The drop in steel realisations was in view of lower steel prices prevailing in Q4FY06 vis-à-vis Q4FY05.
- ◆ The operating profit margins too suffered in the quarter declining by 580 basis points YoY. While a dip in average realisations was the key reason for the dip in margins, higher raw material costs (especially coking coal and coke) further dented the operating profit margins. While fresh coking coal contracts have been entered into at significantly lower levels, the benefits from the same would occur only in H2FY06 once the old inventory of raw materials bought at higher prices is exhausted
- ◆ Tata Steel reported net profit of Rs7.5bn (20.9% YoY decline) during Q4FY06. The decline was due to lower operating profits and higher deferred tax provision.

**Valuations**

On a standalone basis, Tata Steel is trading at a P/E of 6.9X FY07E and 3.8X EV/EBIDTA. Given the company’s expansion plans at its existing facilities and strategy of growing inorganically coupled with the now recovering steel prices, we believe that the company is poised for steady growth, going forward. In view of Tata Steel’s fully integrated steel facilities, we have valued the company on the basis of 4.75X EV/EBIDTA multiple and arrived at a target price of Rs665. We thus recommend a ‘Buy’ rating on the company. However, it is to be noted that our numbers do not factor in the incremental revenues of NatSteel Asia and Millennium Steel, which would make the valuations attractive

**Business and financial profile**

With steel prices now bottoming out and showing signs of recovery, we believe that higher volumes and control over costs will drive Tata Steel’s growth going forward. The company is not only increasing its capacities at existing locations and setting up new green field projects but is aggressively looking at overseas markets for growing inorganically.

**Capacity expansions to drive volumes growth**

Tata Steel is a fully integrated steel producer with its own captive iron ore and coal mines. While the company’s entire iron ore requirements are met through captive sources, almost 68% of coal requirements are met internally. At Jamshedpur, the company plans to increase its capacity by 1.8mn tonnes (predominantly billets) and increase crude steel capacity to 6.8mn tonnes. This apart, the company has also entered into MOUs with the Jharkhand, Orissa and Chattisgarh governments for setting up steel plants. Thus, the company would be able to register steady volumes growth, going forward.

**Focus on branded and automotive sales brings stability to realisations**

Tata Steel has been aggressively promoting the sale of branded and value-add products. During FY06, branded sales accounted for 27% of the total domestic revenues. This apart, the company has identified automotive steel as a key focus area and has been consistently increasing its market share in the same. This has not only resulted in higher average realizations for the company but has also reduced the susceptibility of average realizations to volatility in steel prices – thereby reducing the overall business risk for the company.

(US\$/tonne)	Price decline during FY06 for...	
	Tata Steel	Comparable global peer
HR	140	154
CR	117	170
Galvanised	154	190
<b>Total Flat products</b>	<b>132</b>	<b>165</b>

Source: Company

**Control over costs to help offset steel pricing pressure**

Tata Steel is one the world's lowest cost steel producers. The company has been gradually reducing its dependence on imported coal. During FY06, Tata Steel reduced the ash content in West Bokaro coal from 15% to 13.8%. This resulted in a reduction in the imported coal requirement from 46% in FY05 to 32% in FY06. This apart various other initiatives like reduction in the coke consumption rate and a 26% improvement in labour productivity to 326 tonnes per man p.a. have enabled the company reduce its overall cost of production.

**Revenues from recent acquisitions make valuations further attractive**

Tata Steel had recently acquired NatSteel Asia and in the process of completing the acquisition of Millennium Steel. NatSteel Asia reported net profits of Rs1.29bn in FY06. Once the acquisition of Millennium Steel is completed, it too would add to Tata Steel's EPS. This apart, given that Tata Steel is looking for further acquisitions, any development on this front would make the valuations attractive. NatSteel and Millennium Steel operate at low operating profit margins. While the operating profit margin of NatSteel for FY06 was 5.9%, it was 9.2% for Millennium Steel. Once the 1.8mn tonne capacity expansion at Jamshedpur is completed by FY08, the billets requirements of its subsidiaries will be sourced through the same. This would lead to a tremendous reduction in the cost of production leading to an expansion in operating profit margins. This would further add to Tata Steel's EPS making its valuations further attractive.

<b>NatSteel Asia</b>			<b>Millennium Steel</b>		
<b>(Rs mn)</b>	<b>16th Feb-Mar-05</b>	<b>FY06</b>	<b>(US\$ mn)</b>	<b>FY05</b>	<b>FY06</b>
Net sales	5,440	40,520	Net sales	419	464
EBIDTA	195	2,390	EBIDTA	65	43
EBIDTA Margin	3.6%	5.9%	EBIDTA Margin	15.5%	9.3%
Net income	75	1,285	Net income	30	9
Net income margin	1.4%	3.2%	Net income margin	7.2%	1.9%

Quarterly result table					Rs mn
Y/E March	Q4 FY06	Q4 FY05	YoY %	Q3 FY06	QoQ %
Net Sales	41,289.7	38,646.5	6.8	36,808.0	12.2
Total Expenses	28,281.7	24,217.2	16.8	22,899.0	23.5
(Increase)/Decrease in stock	1,607.1	1,189.3		(991.1)	
Purchase of finished / Semi Finished	1,251.0	3,429.8	(63.5)	1,758.7	(28.9)
Raw material Consumed	7,542.7	3,918.2	92.5	6,127.7	23.1
Employee cost	3,725.2	3,162.9	17.8	3,360.4	10.9
Purchase of power	2,289.5	1,802.8	27.0	2,024.2	13.1
Freight and handling	2,810.8	2,600.1	8.1	2,616.4	7.4
Other expenditure	9,055.4	8,114.1	11.6	8,002.7	13.2
EBIDTA	13,008.0	14,429.3	(9.9)	13,909.0	(6.5)
Other Income	643.6	297.4	116.4	412.8	55.9
PBIDT	13,651.6	14,726.7	(7.3)	14,321.8	(4.7)
Interest	171.5	94.4	81.7	364.3	(52.9)
Depreciation	1,932.7	1,522.3	27.0	2,356.8	(18.0)
PBT	11,547.4	13,110.0	(11.9)	11,600.7	(0.5)
Tax	2,967.5	3,936.6	(24.6)	3,692.9	(19.6)
deferred	1,092.7	(294.9)	(470.5)	84.4	1,194.7
PAT	7,487.2	9,468.3	(20.9)	7,823.4	(4.3)
Extra-ordinary item	343.9	(382.5)		(286.0)	
Adj PAT	7,831.1	9,085.8	(13.8)	7,537.4	3.9
Equity	5,536.7	5,536.7	0.0	5,536.7	0.0
EPS	14.1	16.4	(13.8)	13.6	3.9
<b>Key Ratios (%)</b>					
EBIDTA Margin	31.5	37.3		37.8	
Interest / Sales	0.4	0.2		1.0	
Tax / PBT	35.2	27.8		32.6	
NPM	19.0	23.5		20.5	

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