

# Tata Tea Ltd

Relative to sector: **Neutral**

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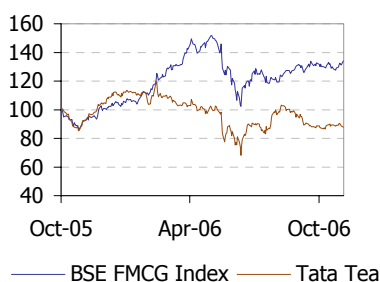
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## Relative Performance



Source: Bloomberg, ENAM Research

## Stock data

No. of shares	: 56.2mn
Market cap	: Rs.41.4bn
52 week high/low	: Rs.1,047/ Rs.560
Avg. daily vol. (6mth)	: 302,000shares
Bloomberg code	: TT IN
Reuters code	: TTTE.BO

## Shareholding (%) Sep-06 QoQ chg

Promoters	: 29.0	0.0
FII's	: 12.1	(5.0)
MFs / UTI	: 13.9	2.3
Banks / FIs	: 17.7	0.4
Others	: 27.3	2.3

## MERGER IMPLICATIONS

We recently met the management at Tata Tea to understand the financial implications of their recent acquisitions/investments and gain insight into the strategic direction of the company.

### Key highlights:

- Portfolio diversification - Diversifying its product portfolio from the traditional branded black tea segment to specialty tea, coffee and new age beverages has been the central theme of Tata Tea's recent strategic acquisitions. The revenue contribution from coffee would increase from 4% in FY06 to 21% in FY08E. Considering the EOC acquisition we expect revenue to grow at 15% CAGR in the next 2 years.
- The scope – Both acquisitions (EOC & Glaceau) are home to the one of the largest beverage markets in the world. Glaceau is part of the rapidly growing (~35 CAGR till FY10) 'enhanced water segment' and EOC is part of the largest coffee consuming nation with a CAGR of 8-9% till FY10.
- Strategic implications – EOC as an umbrella brand to introduce other coffee variants and extend the brand to Russia, Eastern Europe and other countries, whereas Glaceau marks its entry into the bottled water industry, which also provides a wider distribution reach for its Tetley brand of cold beverages in the US.
- Financial implication – ~USD1bn has been spent on 5 acquisitions in the last 12 months. Approx 60% of funding has come via debt raised through SPVs, resulting in gearing shooting up to over 2x in FY07E. A mix of internal accruals (operating cash flow ~Rs.5bn p.a.), capital infusion through preferential placement to Tata Group and sale of investment/assets is expected to lower the consolidated debt to ~Rs.35bn with gearing at 1.7x in FY08.
- Earnings implication – EOC and Glaceau are expected to be earnings accretive in FY07 and FY08 respectively, after considering the acquisition funding cost.

At CMP (Rs.736), the stock trades at 13x FY08E EPS of Rs.56.8. While the valuation upside is dependent on the growth of the Glaceau franchise, the earnings momentum is dampened in the intermediate term due to high gearing. Considering the extended payoff horizon, we have downgraded the stock to sector **Neutral** rating.

## Financial summary – Consolidated<sup>#</sup>

Y/E Mar	Sales (Rs.mn)	PAT (Rs. mn)	Consensus EPS* (Rs.)	EPS (Rs.)	Change YoY (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBIDTA (x)	DPS (Rs.)
2005	30,395	2,545	-	45.3	28	11.6	17.3	15.3	8.8	10.0
2006	31,065	2,797	-	49.7	10	17.4	17.6	15.7	12.5	12.0
2007E	37,100	2,856	56.2	48.4	(3)	15.2	15.5	12.4	15.1	13.0
2008E	41,023	3,350	60.0	56.8	17	13.0	15.5	11.0	12.9	14.5

Source: \*Consensus broker estimates, Company, ENAM estimate Note:# The consolidated financials incorporate Glaceau & EOC acquisitions.

### Product portfolio diversification through acquisitions

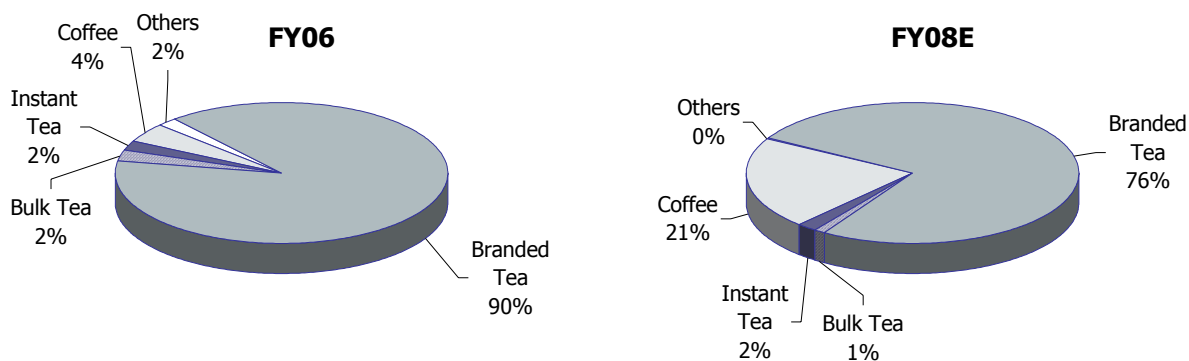
Diversifying the product portfolio from the traditional branded black tea segment to specialty tea, coffee and new age beverages has been the central theme of the company's recent strategic acquisitions. A total of 5 acquisitions/investments in the 12 months is expected to change the revenue growth trajectory and product portfolio of the consolidated entity. Simultaneously, the company has extended its presence and reach in one of the largest beverage markets in the world, USA.

### Recent Acquisitions / Investments at a glance

Date	Company	Region	Deal size	Revenues	Local Mkt size	Category
Oct, 2005	Good Earth, 2006	USA	USD32mn	USD18mn	USD1.7bn	■ Black & Specialty teas
Nov, 2005	JEMCA, 2006	Czech Republic	Not disclosed	USD14mn	USD70mn	■ Fruit & Herbal specialty tea
June, 2006	Eight o'clock coffee	USA	USD227mn	USD 109mn	USD34bn	■ Branded whole bean & value gourmet segment.
Aug, 2006	Energy Brands Inc., Glaceau (Investment)	USA	USD677mn	~USD355mn	USD4.4bn	■ Enhanced water products
Oct, 2006	Joekels Tea Packers	S. Africa	Not disclosed	USD5mn	USD100mn	■ Black tea manufacturing

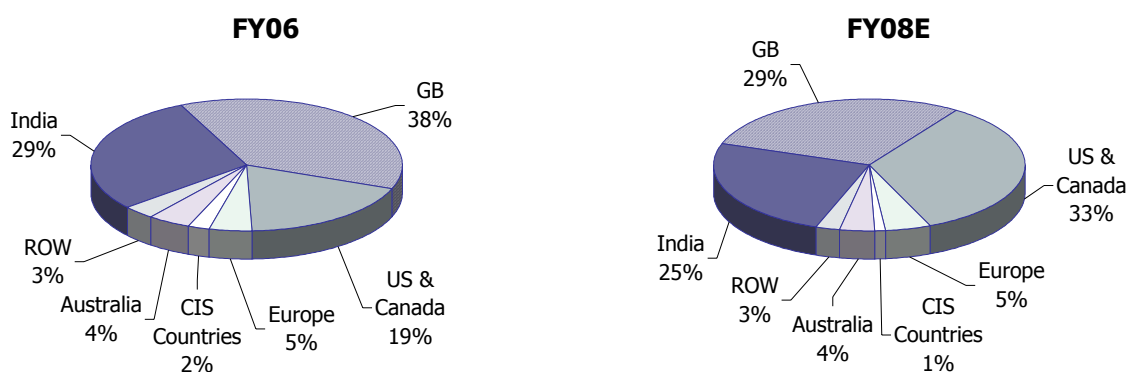
Source: Company, ENAM Research

### Category-wise revenue break-up



Source: Company, ENAM Research

### Region-wise revenue break-up



Source: Company, ENAM Research

**At a Glance: Eight O' Clock coffee acquired by subsidiary, Tata Coffee Ltd.**

	Remarks
<b>Date of acquisition</b>	<b>25-Jun-06</b>
Quarter of Incorporation	Sep-06
Product Offering	EOC has over 100 years of brand history and retail coffee experience in the U.S. It is a leading player in the <u>branded whole bean</u> and a category leader in the <u>value gourmet segment</u> in the U.S. retail market.
Deal Size	USD 227.9mn (INR ~10bn)
<b>Mode of acquisition</b>	Through Special Purpose Vehicle in Delaware, USA by the name of 'Consolidated Coffee Inc.(CCI), where 51% shares held by Tata Coffee, 33% by Tata Tea and 16% by a Tata Sons Subsidiary (Tata Enterprise)
Funding	Debt raised by CCI - USD 168mn. Capital stock contribution of USD 59.9mn by Tata Tea (19.9mn), Tata Coffee (30 mn) and Tata Enterprise (10mn) through CCI.
<b>Company info</b>	
Financials	CY05 (10 months) – Revenue Rs.4914 mn, EBIT margins –19%, Reported PAT 308mn. Existing debt of Rs.4,792 mn as of CY05 ended.
Market data	After oil, coffee is the second largest import in the United States, with U.S. consumers drinking one-fifth of the world's coffee, making them the largest consumers of coffee in the world. The U.S. Coffee and RTD Coffee market is estimated at \$34 billion in 2005 with specialty coffee at 45-50% of the market. The market is expected to touch \$48bn by 2010 which represents a CAGR of 8-9% -
Growth rates	EOC is currently penetrates ~67% of the market which is concentrated in the East coast. Tata Tea plans to expand the network and distribute the products in the west coast as well. Currently the company is growing at 8-10%.
Strategic benefits	Strong brand with over a 85-year-old history. Sells 100% Arabica Whole bean and ground in premium packaged products with over 20 SKUs selling through grocery, mass retailers and food service and club outlets. Tata Coffee plans to use EOC as an umbrella brand to introduce other coffee variants and extend the brand to Russia, Eastern Europe and other countries
Competitive Landscape	Third largest coffee brand after Folgers & Maxwell with an attractive positioning: "Premium coffee at an affordable price". Strategy to introduce products in Russia as western brands perceived to be superior to Asian brands in Russia

Source: Company, ENAM Research

**EOC product portfolio**

## EOC ACQUISITION OUTLOOK

**Revenue growth potential:** With the US coffee market expected to grow at an 8-9% CAGR till 2010 and US consumers being the largest consumers of coffee, EOC is present in a very favorable growth environment. With its premium coffee products and an opportunity to expand in the US West Coast, we expect EOC to deliver a sustainable growth rate of ~7% in the next 3 years. The proposed extension of distribution reach to the US West Coast and introduction into CIS countries, especially Russia, could give EOC a higher growth trajectory. However, the management is still evaluating the prospects and is likely to adapt a wait-and-watch strategy for the next few months.

**Margins:** EOC with its premium brand perception and a strong legacy of over 100 years in the US market has garnered substantial pricing power, which would help mitigate the rising input costs of raw materials. We have assumed 19% EBIT margins for the next 2 years. Margins could further improve if Tata Tea successfully expands EOC as an umbrella brand to the CIS, Russian and other countries.

**Earnings impact on consolidated entity:** EOC had reported a net profit of Rs.308mn (PAT margins – 6%) in 10 months CY05. The management indicated that sales of USD28mn and PAT of USD1.75mn for 2 months has been consolidated in Q2FY07.

### EOC estimated financials (Rs.mn)

Eight O Clock (EOC)	(12m) Feb-04	(10m) Dec-05	CY06E	CY07E	CY08E
<b>Sales</b>	<b>4,205</b>	<b>4,914</b>	<b>6,633</b>	<b>7,098</b>	<b>7,595</b>
<i>YoY</i>	-	-	35%	7%	7%
Cost of Goods Sold	2,506	3,026	4,113	4,401	4,709
<i>% of Sales</i>	60%	62%	62%	62%	62%
Gross Profit	1,699	1,888	2,521	2,697	2,886
<i>% of Sales</i>	40%	38%	38%	38%	38%
SG&A	1,109	934	1,260	1,349	1,443
<i>% of Sales</i>	26%	19%	19%	19%	19%
EBIT	591	954	1,260	1,349	1,443
<i>% of Sales</i>	14%	19%	19%	19%	19%
Interest cost - on EOC books	296	482	431	409	409
Interest cost - On CCI books	-	-	547	529	512
<b>Adj. PAT</b>	<b>188</b>	<b>298</b>	<b>179</b>	<b>260</b>	<b>331</b>
<i>% of Sales</i>	4%	6%	3%	4%	4%
Minority Interest	-	-	50	108	137
<b>Tata Tea consolidation</b>					
Share of PAT	-	-	105	152	193
EPS impact	-	-	2	3	3

Source: Company, ENAM Research

## At a Glance: Investment into Energy Brand Inc

Glaceau	
<b>Date of acquisition</b>	<b>23-Aug-06</b>
Quarter of consolidation	From Q3FY07. To be considered as share of profits from associates.
Product Offering	Enhanced flavored water products (US only). Under this, it offer 3 products: <i>Vitamin water</i> in 17 variants, <i>Fruit water</i> (Flavor enhanced) in 4 variants and <i>Smart water</i> (Electrolyte enhanced)
Deal Size	USD 677mn (Rs.30 bn)
<b>Mode of acquisition</b>	TT has bought 30% stake in Energy Brands Inc., Glaceau through Tata Tea (GB), the special purpose vehicle (SPV) in which TT holds 84.5%, Tata Tea Inc 14.1% & Tata sons 1.4%.
Funding	Capital stock contribution of US\$250mn by Tata Tea (192mn) and Tata Sons (58 mn) to Tea Tea GB. Debt raised by Tata Te GB - US\$427mn.
<b>Company info</b>	
Glaceau Financials	Revenues estimated at USD 175mn (Rs. 7.4bn) for CY05. Glaceau enjoys a zero debt status in its growth phase.
Market data	The US bottled water industry is the 2nd largest commercial beverage category by volume, valued at ~USD10bn and growing at 10% p.a. in CY05. The flavored & enhanced water (part of bottled water industry) category is set to grow to from \$1.9bn in CY05 to \$8.6bn by '10 at a CAGR of 35%
Growth rates	Glaceau has been growing at a 200% CAGR since 1996 and is marketed in 45 US states. It is expected to double its revenues to ~USD355mn in CY06. The management expects to achieve a higher growth rate than the over all flavored & enhanced water industry (includes energy drinks). In the initial stages, the management is keen on strengthening the US market reach of Glaceau followed by geographical extension into other developed markets. Glaceau's debt free status can be leveraged to pursue an aggressive growth strategies
Strategic benefits	A platform to enter the global beverage industry and the accelerated learning experience to develop or acquire a similar product portfolio in India and other countries. Will also provide a wider distribution reach for its Tetley brand of cold beverages (Iced Tea etc) in the US market.
Competitive Landscape	Competition in this market includes - Fruit2O (Kraft), Aquafina (Pepsi), Dasani (Coke), Evian, Propel, Poland Spring, Perrier and FIJI brands. Avg. US bottled water is priced from 89c to \$1.99. Glaceau is avg. priced at \$1.29. Vitamin & Fruit water comes in 591ml and Smart water at 1L/bottle.

Source: Company, ENAM Research

### Glaceau product portfolio



## ENERGY BRANDS INVESTMENT OUTLOOK

**Appetite for enhanced water:** The US bottled water market generated total revenues of USD14.9bn in 2005, this representing a compound annual growth rate (CAGR) of 10.9% for the five-year period spanning 2001-2005. The enhanced & flavored water market, a subset of the bottled water market, is estimated at USD1.9bn in 2005 growing at 54% CAGR over the last 4 years. Despite the increasing base, industry estimates indicate a growth outlook of 35% CAGR till 2010.

**Revenue growth potential:** The nutrient enhanced water, now generically known as Glaceau Vitamin Water, has not only been a pioneer but also been in existence for over 10 years. Contrary to the conventional wisdom of calling the growth in vitamin waters as a recent fad, the brand has grown by 74% CAGR in the last 2 years to USD175bn in CY05. With a targeted revenue of USD350mn in CY06, the management expects a growth of over 50% in the next 2 years. Also, the initial focus will remain on increasing penetration in the US market by now tying up with large retail giants such as Wal-Mart, Tesco etc.

**Margins:** The average net margins for beverage concentrate manufacturers (Coca-cola, PepsiCo) and alternate beverage manufacturers (Hansen Natural) range from 15% to 24%. While Glaceau is still in the growth phase, we estimate net margins at 18% when the critical mass of USD350mn revenue is crossed in CY06.

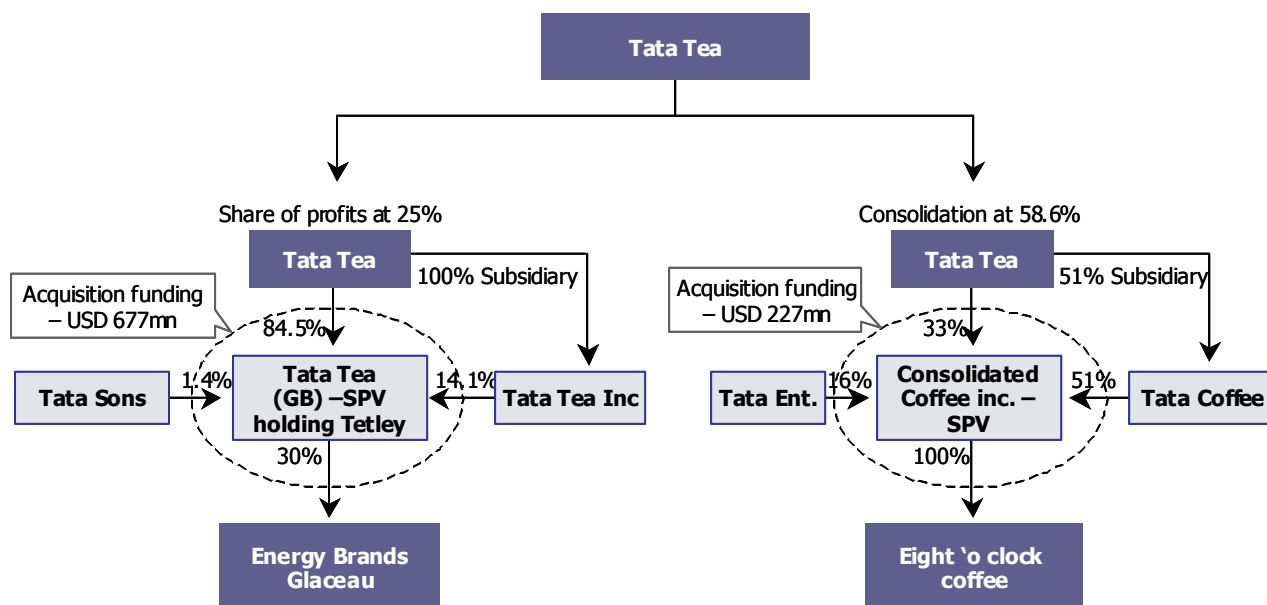
**Earnings impact on consolidated entity:** The Glaceau investment is expected to turn earnings accretive in CY07. The debt of USD427mn raised on Tata Tea (GB) is assumed at an estimated cost of 7% p.a (excluding tax shield). The ability of the Glaceau management to increase US market penetration and achieve higher volume sales are the determinants for a potential IPO listing in the next 2-3 years.

### Glaceau Estimated Financials

(USD mn)	CY05	CY06E	CY07E	CY08E
Enhanced Water Market	1,901	2,864	4,488	5,943
YoY Growth %	57%	51%	57%	32%
<b>Glaceau Sales</b>	<b>175</b>	<b>355</b>	<b>593</b>	<b>819</b>
YoY Growth %	103%	103%	67%	38%
Market Share %	9%	12%	13%	14%
EBITDA	-	99	178	262
EBITDA %	-	28%	30%	32%
<b>PAT</b>	-	<b>60</b>	<b>107</b>	<b>156</b>
NPM %	-	17%	18%	19%
<b>Tata Tea (GB) - SPV</b>				
PAT after cost of debt	-	(1)	13	27
<b>EPS impact (Rs. / share)</b>	-	<b>(1)</b>	<b>8</b>	<b>16</b>

Source: ENAM Research

## Acquisitions structure



Source: Company, ENAM Research

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