

Company In-Depth

21 March 2007 | 9 pages

Tata Chems (TTCH.BO)

Upgrade to Buy: Positive Outlook Highlighted at India Conference

 Rating change
 Target price change
 Estimate change

- Correction appears overdone** — Tata Chem has underperformed the Sensex by 35% over the past year on uncertainty over domestic fertilizer policies and poor clarity on Brunner Mond's integration. Our interactions with management suggest a positive outlook for the inorganic business and fair progress in the Brunner Mond integration. Upgrade to Buy (1M) with a target price of Rs273.
- Brunner Mond integration on track, raising earnings** — Teething issues at the Kenya soda-ash expansion seem to have been fixed, and the project should contribute significantly to FY08E earnings. Upgrading estimates for FY08-09 on continued strength in the soda-ash cycle and the urea plant's de-bottlenecking.
- Positive soda ash pricing outlook** — Strong soda ash prices (currently US\$185/MT) are likely to sustain in the medium term amid supply disruptions in China. Tata Chem should benefit significantly from the uptrend, as its low-cost natural soda ash expansion at Magadi will begin operations from Apr 2007.
- Policy initiative on fertilizers imminent** — Government is expected to provide clarity on fertilizer policies soon. Tata Chem believes that the policy will be supportive of de-bottlenecking of urea plants and that its Barbala plant will be a beneficiary. We are building in higher urea capacity from FY09E.
- New initiatives, acquisitions could be future drivers** — Investment of Rs500m over 2-3 years is planned in bio/nano R&D, including bio-fuels. It is also investing in building a supply chain (farm advisory, cold chain, packaging and wholesaling) for fresh farm products using Tata Kisan Sansar Network.

Buy/Medium Risk	1M
<i>from Hold/Medium Risk</i>	
Price (21 Mar 07)	Rs197.00
Target price	Rs273.00
<i>from Rs250.00</i>	
Expected share price return	38.6%
Expected dividend yield	4.1%
Expected total return	42.6%
Market Cap	Rs42,375M
	US\$970M

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



See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	3,406	13.99	54.4	14.1	2.1	16.9	3.3
2006A	3,530	14.50	3.7	13.6	2.0	17.0	3.6
2007E	4,244	17.43	20.2	11.3	1.8	18.6	4.1
2008E	4,473	18.37	5.4	10.7	1.6	17.7	4.1
2009E	4,582	18.82	2.4	10.5	1.5	16.5	4.1

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	14.1	13.6	11.3	10.7	10.5
EV/EBITDA adjusted (x)	8.3	7.2	5.7	5.3	5.0
P/BV (x)	2.1	2.0	1.8	1.6	1.5
Dividend yield (%)	3.3	3.6	4.1	4.1	4.1
Per Share Data (Rs)					
EPS adjusted	13.99	14.50	17.43	18.37	18.82
EPS reported	13.99	14.50	17.43	18.37	18.82
BVPS	92.85	100.75	111.33	122.98	135.14
DPS	6.50	7.00	8.00	8.00	8.00
Profit & Loss (RsM)					
Net sales	30,081	35,175	38,051	39,057	39,882
Operating expenses	-26,303	-30,744	-32,286	-33,006	-33,889
EBIT	3,778	4,431	5,765	6,051	5,992
Net interest expense	-246	-93	-582	-518	-389
Non-operating/exceptionals	997	771	880	950	1,037
Pre-tax profit	4,529	5,109	6,063	6,483	6,640
Tax	-1,124	-1,578	-1,819	-2,010	-2,058
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	3,406	3,530	4,244	4,473	4,582
Adjusted earnings	3,406	3,530	4,244	4,473	4,582
Adjusted EBITDA	5,155	5,820	7,319	7,708	7,739
Growth Rates (%)					
Sales	18.2	16.9	8.2	2.6	2.1
EBIT adjusted	19.7	17.3	30.1	5.0	-1.0
EBITDA adjusted	12.1	12.9	25.8	5.3	0.4
EPS adjusted	54.4	3.7	20.2	5.4	2.4
Cash Flow (RsM)					
Operating cash flow	8,062	3,004	5,224	5,832	6,349
Depreciation/amortization	1,377	1,389	1,554	1,657	1,747
Net working capital	3,777	-1,745	-692	-363	-46
Investing cash flow	-2,371	-3,708	-1,480	-2,118	-1,868
Capital expenditure	-645	-1,275	-1,575	-2,075	-1,825
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	4,252	-295	-2,117	-3,966	-4,966
Borrowings	5,587	1,303	-396	-2,000	-3,000
Dividends paid	-1,335	-1,598	-1,721	-1,966	-1,966
Change in cash	9,943	-999	1,627	-253	-486
Balance Sheet (RsM)					
Total assets	44,667	47,379	49,601	50,184	49,966
Cash & cash equivalent	14,104	2,652	2,893	2,684	2,241
Accounts receivable	4,404	6,014	6,416	6,590	6,712
Net fixed assets	15,624	15,510	16,589	17,007	17,085
Total liabilities	24,688	25,702	25,611	23,722	20,888
Accounts payable	4,538	4,275	4,282	4,311	4,373
Total Debt	13,242	14,545	14,149	12,149	9,149
Shareholders' funds	19,978	21,677	23,955	26,462	29,077
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.1	16.5	19.2	19.7	19.4
ROE adjusted	16.9	17.0	18.6	17.7	16.5
ROIC adjusted	10.7	12.0	15.4	15.0	14.3
Net debt to equity	-4.3	54.9	47.0	35.8	23.8
Total debt to capital	39.9	40.2	37.1	31.5	23.9

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Core soda-ash business looking good

After the acquisition of Brunner Mond, inorganic chemicals contribute nearly 60% of Tata Chemical's revenues. Soda ash is the dominant inorganic product for the group; Tata Chemicals controls 7.5% of total world capacity for this chemical.

Soda ash prices remain at the high levels of 2006 (the average soda ash price in 2006 was US\$185) and the trend is likely to continue in the medium term with supply disruptions in China due to re-location of 3 soda ash facilities there. Importantly, demand-supply is likely to stay in balance in the medium term, with incremental supplies matching demand growth at 3-4% pa. Tata Chem looks well positioned to benefit from the sustained strength in soda ash prices with the expansion of the natural soda ash facility at Lake Magadi, Kenya from 350ktpa to 715ktpa likely to be operational from April 2007. Cash costs of natural soda ash are c.50% lower than those for synthetic soda ash. We expect the Kenyan operations to contribute significantly to consolidated revenues and operating profits from FY08E.

Fertilizer business: Policy uncertainty continues

The government is expected to provide clarity on the fertilizer policy soon and announce a new pricing policy for domestic fertilizers. Tata Chem believes that the new policy will be supportive of de-bottlenecking of Urea plants. The Barbala plant de-bottlenecking (a 33% increase in capacity for Rs1.5bn) will be a positive. We are building in higher urea capacity from FY09E.

However, we are not hopeful of any progressive measures in the fertilizer industry in the medium term. Fertilizer subsidies provided in the budget are clearly inadequate, and this will impact cashflows of domestic companies; currently Tata Chem has outstanding dues of Rs3.5bn from the government on account of subsidies. Regressive government measures can be a risk for Tata Chem, even though greater exposure to the inorganic chain has reduced dependence on fertilizer earnings.

New initiatives, acquisitions are future drivers

Tata Chem is looking to invest Rs500m over the next 2-3 years in R&D on new technologies in the biofuels (Jatropha, sweet sorghum), nano tech space. Also, Tata Chem has formed a joint venture with Total Plc of Ireland for development of a supply chain for fresh produce using the Tata Kisan Sansar Network. The supply chain linkages will include farm advisory, procurement, sorting, packaging, transportation/cold chain and wholesaling of the fresh produce. The initial investment in the supply chain will be marginal (c.Rs260m) and will involve setting up of supply chains in two cities (Ludhiana and Kolkata). We believe that these are seed investments and will take time to fructify.

With cash and investments of Rs6bn on its books, Tata Chem will likely look at inorganic opportunities to drive growth.

Raising earnings estimates

With continued strength in the soda ash segment and building in the urea plant de-bottlenecking, our standalone earnings estimates for Tata Chem rise by 11-14% over FY07-08E. Our estimates for consolidated earnings are also higher by 1-20%.

Figure 1. Tata Chemical's Consolidated Earnings, FY06-09E (Rs Millions)

Year to 31 st March	FY06	FY07E	FY08E	FY09E
Revenues	40290.1	54,603	58,116	58,941
Ebitda	7360.3	10,017	11,409	11,440
Ebitda Margin	18.3%	18.3%	19.6%	19.4%
Interest	284	929	865	736
Other Income/Share in JV profits	817.5	1,130	1,200	1,287
Depreciation	1840.4	2,660	3,010	3,100
PBT	6,053	7,558	8,734	8,891
Tax	1770	2,123	2,541	2,589
PAT	4,283	5,435	6,193	6,302
% change over previous estimate		1.4%	6.8%	18.6%
Basic EPS	19.9	25.3	28.8	29.3
fd Diluted EPS	17.6	22.3	25.4	25.9
Earnings growth		27%	14%	2%
Consolidated Valuations at Rs196				
fd P/E	11.6	8.8	7.7	7.6
EV/Ebitda	7.9	6.1	5.4	5.4
P/B	1.9	1.7	1.5	1.3
P/S	0.8	0.8	0.7	0.7

Source: Citigroup Investment Research estimates

Figure 2. Tata Chem — Standalone Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
	Old	New	Old	New	% Chg	Old	New
31-Mar							
2007E	3,818	4,244	15.68	17.43	11.1%	7.00	8.00
2008E	3,912	4,473	16.07	18.37	14.3%	7.00	8.00
2009E	na	4,582	na	18.82	na	na	8.00

Source: Citigroup Investment Research estimates

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 65% of revenues and 42% of PBIT. The company's inorganic chemicals business accounts for 35% of revenues and 58% of PBIT. Soda ash is its key inorganic chemical, accounting for 20% 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 40% share in the branded edible-salt market. It also has a small cement-manufacturing unit in Mithapur (0.44m MTPA, 3.7% of revenues), which uses by-products from its inorganic chemical works in Gujarat.

Figure 3. Tata Chem Share Price Performance

	3M	6M	12M
Absolute	-13.7	-14.1	-24.0
Relative	-8.7	-18.7	-34.7

Source: Datastream

Investment thesis

We rate Tata Chemicals as Buy/Medium Risk. The acquisition of a controlling stake in Brunner Mond has given Tata Chem control over 7.5% of global soda ash capacity. Soda ash is on a cyclical upswing. It has also reduced Tata Chemicals' dependence on earnings from the government-controlled fertilizer business. The stock has underperformed over the past year due to policy uncertainties on fertilizers and the lack of clarity on Brunner Mond's integration.

With progress on the Brunner Mond integration as well as the significant kicker to earnings from Brunner Mond's Kenya expansion, Tata Chem's consolidated earnings will grow at a 14% CAGR over FY06-09, on our estimates. We expect fertilizer earnings to remain stable, and the key risk is adverse government policies on fertilizers. Valuations appear undemanding at a consolidated P/E of 7.7x FY08E and consolidated EV/Ebitda of 5.4x. The significant value of holdings in the group companies and a dividend yield of c.4% will in our view provide downside support for the stock. While new initiatives on supply chain and bio fuels hold promise, they are likely to fructify over a longer time-frame. Tata Chem is also likely to look at inorganic opportunities to spur growth as a high level of cash on its balance sheet is hurting capital efficiency.

Valuation

Our target price of Rs273 is based on sum of the parts. 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 use 5x FY08E EV/EBITDA for the inorganic chemicals business, and for the government-controlled fertilizers business we use 4x FY08E EV/EBITDA, 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 Rs67/share based on a 5.5x FY08E EV/EBITDA (higher than 5x due to its presence in the higher value-added business of sodium bicarbonate) and a strong improvement in margins. Our target price equates to a fully diluted consolidated P/E of 10.7x FY08E, around a 30% discount to the P/E of the market due to the regulated nature of part of Tata Chem's business and integration risks from the Brunner Mond acquisition.

Figure 4. Tata Chemicals — Sum-of-the-Parts Valuation

Particulars	Rs Mills.	Rationale
a) Chemicals Business	23,725	5x FY08E EV/EBITDA
b) Fertilizer Business	11,850	4x FY08E EV/EBITDA (Indian fertilizer companies operate in a regulated environment)
Core Business EV	35,575	a+b
Holdings in Group Companies	20,633	At 40% discount to market value
Total EV	56,208	
Net Debt	11,893	
Equity Value	44,315	
No. of Shares	215	
Fair Value	206.0	
Value of Brunner Mond Acquisition	67.0	Based on 5.5x FY08E EV/EBITDA (higher value attributed due to presence in higher value-added pharmaceutical Sodium Bicarbonate business)
Fair Value	273.0	

Source: Citigroup Investment Research

Risks

We rate Tata Chem as Medium Risk even though our quantitative risk-rating system, which tracks 260-day share price volatility, gives it a Low Risk. We believe a higher risk rating is justified as Tata Chem's key product, soda ash, is a cyclical commodity, and Tata Chem is in the midst of integrating Brunner Mond and realizing synergies from the acquisition. 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 and progressive government policies on fertilizers.

Appendix A-1

Analyst Certification

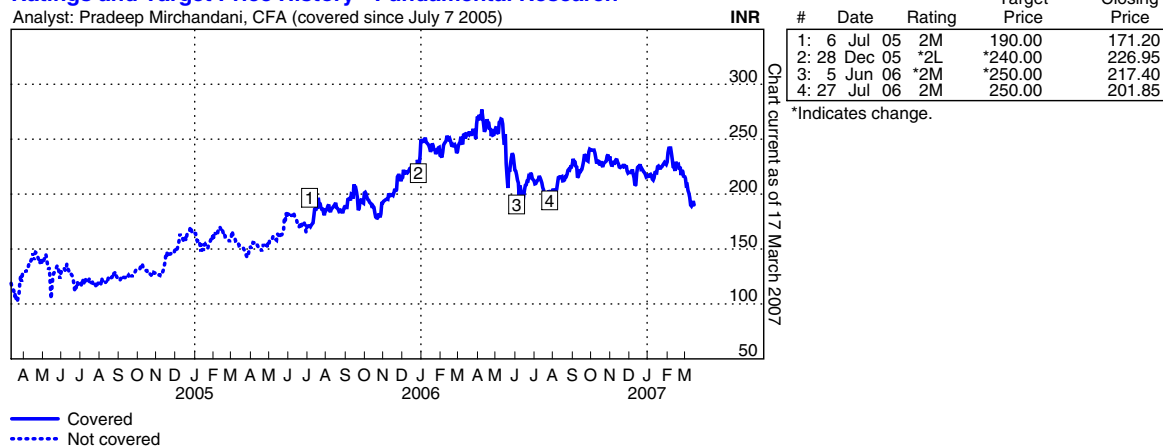
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Tata Chemicals (TTCH.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Pradeep Mirchandani, CFA (covered since July 7 2005)



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