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METALS & MINING

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Valuations attractive but tough quarter ahead

Quick Note

August 14, 2012

Rating Remains	**Buy**
Target price Remains	INR 550
Closing price August 13, 2012	INR 395

TATA Steel reported Q1FY13 results largely in line with our estimates. Some key highlights from the conference call are as follows:

Net debt increased on account of higher capex, inventory accruals and revaluation impact

TATA Steel's net debt increased to USD9.7bn from USD8.6bn at the end of March 2012 (Gross debt increased from USD10.7bn to USD11.7bn). The company attributed the increase to: 1) capex of USD641mn in Q1FY13 (for the full year, the target capex is USD2-2.3bn), and 2) revaluation impact of USD482mn. Inventory has gone up by USD480mn – as per stock increase in the P&L account.

The company generated consolidated cash flow of close to USD500mn and a net debt increase of USD1.1bn – so a combination of the above three factors explain the total cash outflow.

Indian expansion on track for production from Q3FY13

TATA Steel has started the blast furnace (BF) operations – the new blast furnace produced close to 0.6mn tonnes during Q1FY13. However, this was masked by maintenance shutdown at older BF and hence there is no perceptible increase in hot metal production.

The company has said that this was deliberate given coke oven batteries have not yet been commissioned and this should be completed by Q3FY13. The company maintained its guidance of a 1mn tonne increase in volumes in FY13 – in line with our estimates.

Indian volumes were impacted by power issues

TATA Steel's volumes were impacted by power outages during Q1FY13 as bar mills and cold rolled mills were affected by power shortages. Therefore, despite producing higher hot metal volumes, this didn't translate into sales volume. The company hopes to make up for it from the next quarter.

European operations: looking at a tough 2 quarters ahead, outlook should improve in Q4FY12

TATA Steel guided for a better H2FY13 – however, management also said that the next two quarters are looking tough. The company has seen prices falling in June and July, however, raw material prices have also come off.

The focus would be on maintaining contribution margin (steel realization-raw material prices) and the company hopes to see an improvement in contribution margin from Q3FY13. With volumes expected to rebound in Q4 on account of seasonal factors and cost benefits of the Port Talbot BF rebuilding, EBITDA should rebound, according to management.

- Orissa expansion: started spending on the projects but it's at the early stages. No debt taken yet. Total project cost of INR400bn for 6mn tonne expansion – 2 phases of 3mtpa each.
- Benga coal mines have started deliveries – the profit from this venture to be recorded as share of associates

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Key highlights from standalone results

- Blended steel realizations increased by INR2400/t vs our estimates of flat QoQ.
- TATA Steel reported inventory accretion of INR5bn in Q1FY13; this is in line with other companies also seeing inventory increase. While the company has attributed lower sales to power outages, this also highlights slightly weaker demand conditions in India, but we would get back with more details on this.
- Power and fuel costs increased sharply by18% QoQ as well as YoY; the company attributed it to the power shortage scenario and external purchases.
- Other expenditure at INR22.3bn – please note that TATA Steel accounts for forex losses in other expenses and not extraordinary losses; we had estimates of INR20bn of other expenses and INR2bn of forex losses separately: adjusted, costs are in line with our estimates.
- EBITDA at INR27.8bn vs our estimate of INR26.8bn (adjusted for forex loss of INR2bn) – EBITDA/t at INR17,500/t – the company has been able to maintain profitability on account of sharply higher realizations.
- Net profit at INR13.6bn was marginally below our estimates, though PBT at INR21.2bn (vs our estimate of INR21.3bn) was in line. Tax rate at 36% was much higher than the company's usual rate of 31%. The higher tax rate was primarily on account of deferred tax.

European operations

- EBITDA at USD35/t vs our estimate of 30/t – driven primarily by realization increase of USD40/t QoQ.
- Total EBITDA at USD111mn – vs our estimate of USD96mn, however key to watch would be the next two quarters, where we expect to see: 1) a drop in realizations and 2) seasonally weak quarters.
- For ex-India operations, employee costs are down to USD705mn from USD745mn in Q4FY12; most other costs are also in line with our estimates. Other expenses were up sharply to USD939mn from USD839mn in Q4FY12.

SE Asian operations

- No major change: EBITDA/t at USD24/t, total EBITDA of USD17mn; flat realizations and EBITDA/t QoQ.
- The company is looking at a demand revival in Thailand as the government is expected to pump in money for the reconstruction post the flood-related destruction last year.

Overall, the results are better than we had expected. The company has managed to maintain the profitability of its Indian operations while even its European operations have reported credible performance.

While the European operations would likely remain under pressure in the near term, we expect things to improve gradually with: 1) cost benefits of the Port Talbot BF rebuild and 2) a fall in raw material costs to help maintain contribution margins.

Fig. 1: TATA Steel standalone: key details from Q1FY13 results

(INR mn)	**Q1FY13**	**Q4FY12**	**Q1FY12**	**YoY**	**QoQ**	**Q2FY12E**
Steel sales (tonnes)	1,590,000	1,768,000	1,593,000	-0.2	-10.1	1,600,000
(INR mn)						
Net Sales	**89,080**	**94,794**	**78,603**	**13.3**	**-6.0**	**86,219**
Expenditure						
Change in stock	-4,966	1,872				
Total RM costs	24,997	22,116	15,729	58.9	13.0	20,800
Staff Cost	8,591	9,363	6,870	25.1	-8.2	8,000
Purchase Power	5,478	4,603	4,593	19.3	19.0	4,320
Freight & handling	4,819	4,636	4,064	18.6	3.9	4,320
Other Expenditure	22,363	22,288	16,315	37.1	0.3	20,000
Total Expenditure	**61,282**	**64,878**	**47,571**	**28.8**	**-5.5**	**57,440**
Operating profit	**27,798**	**29,916**	**31,032**	**-10.4**	**-7.1**	**28,779**
Margins	*31.2*	*31.6*	*39.5*			*33.4*
Other income	1,519	1,829	5,526			1,000
Interest (net)	4,544	5,140	2,273	100.0	-11.6	3,500
Depreciation	3,544	2,900	2,853	24.2	22.2	2,950
Profit before tax & Exceptional I	**21,229**	**23,706**	**31,432**	**-32.5**	**-10.5**	**23,329**
Exceptional Items	**0**	**0**	**0**			**-2,000**
PBT	**21,229**	**23,706**	**31,432**	-32.5	-10.5	**21,329**
Provision for taxation	7,663	8,101	9,238			6,612
Provision for Deferred Taxation	0	0	0			0
Total taxes	**7,663**	**8,101**	**9,238**			**6,612**
Tax rate	***36.1***	***34.2***	***29.4***			***31.0***
PAT	**13,566**	**15,605**	**22,194**	**-38.9**	**-13.1**	**14,717**
EPS (INR)	13.5	16.3	22.7	-40.6	-17.1	15.3

Source: Company data, Nomura estimates

Fig. 2: TATA Steel consolidated: key details from Q1FY13 results

(INR mn)	**Q1FY13**	**Q1FY12**	**Q4FY12**	**YoY**	**QoQ**	**Q1FY13E**
Net sales	**338,212**	**330,002**	**339,986**	2.5%	-0.5%	**342,599**
Expenditure:						
Material cost	150,498	148,944	165,645	1.0%	-9.1%	165,594
Staff cost	47,825	42,316	47,221	13.0%	1.3%	45,447
Other expenditure	74,593	66,484	64,977	12.2%	14.8%	65,934
Power & fuel	13,906	12,093	12,743	15.0%	9.1%	12,558
Freight & handling	17,358	15,937	17,611	8.9%	-1.4%	17,551
Total expenditure	**304,179**	**285,773**	**308,197**	6.4%	-1.3%	**307,084**
EBITDA	**34,033**	**44,229**	**31,788**			**35,515**
EBITDA margin	*10.1*	*13.4*	*9.3*			*10.4*
Other income	2,894	38,823	2,220			1,500
Interest	9,690	7,377	11,280	31.4%	-14.1%	9,000
Depreciation	13,080	11,508	10,931	13.7%	19.7%	11,450
PBT & extraordinary	**14,157**	**64,167**	**11,798**			**16,565**
Exceptional items	**0**	**0**	**0**			**-2,000**
PBT	**14,157**	**64,167**	**11,798**			**14,565**
Provision for taxes	8,986	11,230	9,766			7,612
Tax rate	*63.5%*	*17.5%*	*82.8%*			*52.3%*
PAT	**5,170**	**52,937**	**2,032**			**6,953**
Minority interest	**-399**	**248**	**-301**			**-400**
Share of associates	**410**	**281**	**2,002**			**200**
Net profit	**5,979**	**52,969**	**4,335**			**7,553**
EPS (INR)	5.7	55.2	4.0			7.9

Source: Company data, Nomura estimates

Fig. 3: TATA Steel standalone – Per tonne analysis

(INR)	**Q1FY13**	**Q4FY12**	**Q1FY12**	**YoY**	**QoQ**	**Q2FY12E**
Net realization (INR/t)	51,530	49,103	45,832	12.4	4.9	49,000
RM costs (INR/t)	12,598	13,568	9,874	27.6	-7.1	13,000
Power cost (INR/t)	3,445	2,603	2,883	19.5	32.3	2,700
Other costs (INR/t)	17,096	15,229	12,793	33.6	12.3	15,200
Total Expenditure (INR/t)	**38,542**	**36,696**	**29,862**	**29.1**	**5.0**	**35,900**
Blended EBITDA (INR/t)	**17,483**	**16,921**	**19,480**	**-10.3**	**3.3**	**17,987**

Source: Company data, Nomura estimates

Appendix A-1

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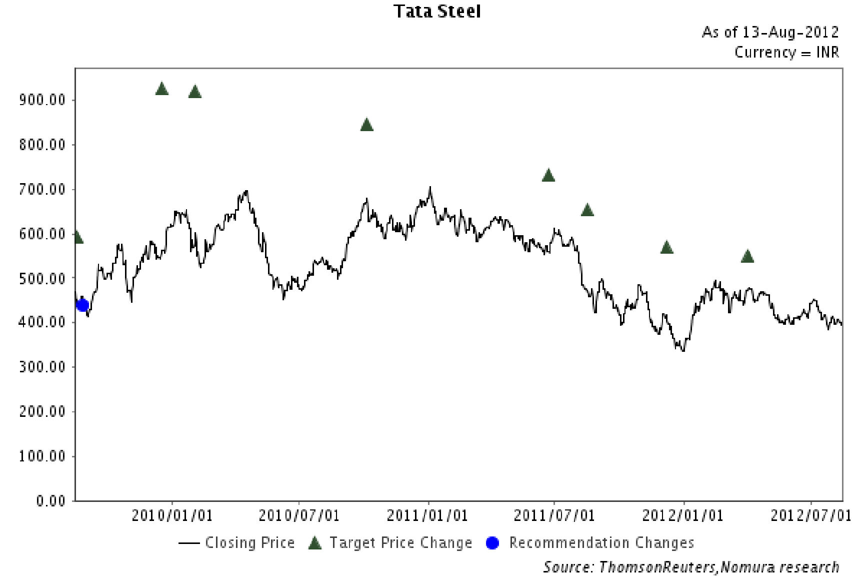
Tata Steel	TATA IN	INR 395	13-8-2012	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Tata Steel	Reduce	18-8-2009

Tata Steel (TATA IN) **INR 395 (13-8-2012)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
02-Apr-12		550.00	471.75
07-Dec-11		568.00	417.55
16-Aug-11		653.00	469.00
22-Jun-11		733.00	558.10
05-Oct-10		846.00	668.35
01-Feb-10		920.00	579.85
16-Dec-09		926.00	557.65
18-Aug-09	Buy		451.70
18-Aug-09		591.00	451.70

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We value TATA Steel at INR 550/share with Indian operations contributing INR 678/share (6x FY13F EV/EBITDA), -145/share from European operations (5x FY13F EV/EBITDA) and INR 17/share from stakes in Benga coal project and SE Asian operations. The stake in the Benga project is based on a valuation of USD2.5bn.

Risks that may impede the achievement of the target price 1) Steel prices fall more than expected: We are expecting steel prices of USD600/t going forward and a correction on INR2,000/t in domestic steel prices. If average prices fall below these levels, there would be downside risk to our estimates. 2) Worse-than-expected demand at European operations: We have built in 13.2mn tonnes of deliveries for European operations in FY13F, down from 14.87mn tonnes in FY11 and 13.9mn tonnes expected in FY12F. If the demand situation is worse than expected, there could be downside risk to our estimates. 3) Delay in expansion plans: We have built in 35% production from 2.9mtpa in FY13F. Any delay in expansion would negatively impact our estimates.

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