Opinion: TATA Steel

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KEY INFORMATION

Name of the Company: **Tata Steel**
Sector: **Steel**
Ticker Symbol: **TATASTEEL**
Current Price: **398.45**
EPS: **51**
P/E: **7.8**
P/B: **0.91**
Dividend Yield: **2.92%**
Face Value: **10**
Market Cap: **39000 Cr**
Avg. ROE (2004-2007): **38%**
Avg. ROE(2008-2012): **11%**

Peer Comparison

Name of the Company: **SAIL**
Ticker Symbol: **SAIL**
Current Price: **88**
EPS: **8.7**
P/E: **10.11**
P/B: **0.9**
Dividend Yield: **2.28%**
Face Value: **10**
Market Cap: **36260 Cr**
Avg. ROE (2004-2007): **50%**
Avg. ROE(2008-2012):**17.25%**

Name of the Company: **JSW Steel**
Ticker Symbol: **JSWSTEEL**
Current Price: **810**
EPS: **33.83**
P/E: **23.94**
P/B: **1.09**
Dividend Yield: **0.93%**
Face Value: **10**
Market Cap: **18044 Cr**
Avg. ROE(2004-2007): **NA**
Avg. ROE(2008-2012):**9.75%**

Please refer to the last page for important disclosures.

Overview

Tata Steel is among the top ten Steel companies in the world with an annual crude steel capacity of over 28 million tons per annum (MTPA) .With operations in 26 countries and a commercial presence in over 50 countries, it is one of the world's most geographically diversified steel producers. The company employs close to 81000 people and is ranked 401st in the 2012 Fortune global 500 rankings of the world's biggest corporations.

Tata Steel primarily serves customers in the automotive, construction, consumer goods, engineering, packaging, lifting and excavation, energy and power, aerospace, and shipbuilding sectors. The company has manufacturing operations in India, China, UK, Thailand, Singapore, Australia and Netherlands.

In its bid to maintain its leadership position, Tata Steel is aggressively expanding its production capacity. The company has set a target of achieving an annual production capacity of 100 million tons by 2016, which would make it the 3rd largest producer by capacity.

Sr. No	Plant	Expansion Details
1	Jamshedpur	3 mtpa capacity addition
2	Odisha	6 mtpa greenfield steel plant
3	Chattisgarh	5 mtpa greenfield steel plant
4	Karnataka	3 mtpa greenfield steel plant

In this report, we discuss Tata Steel across 2 time frames. One is an analysis of the company before the Corus acquisition and then we focus on the post-acquisition phase. This is because we believe that the Corus acquisition has dramatically altered the nature of the company in terms of revenues, profitability, capital structure and other important metrics!!

Tata Steel- Pre Corus (2004/2007)

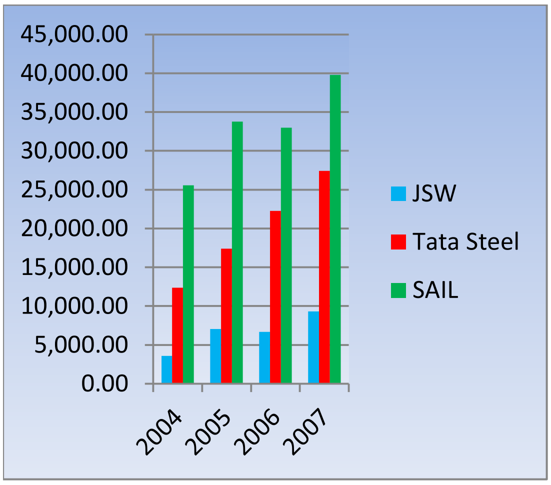


Fig 1: Revenues in Cr.

In this section, we do a comparative analysis of Tata Steel and its peers. The analysis is based over a time period of 2004 to 2007, before Tata completed the acquisition of Corus. This was a golden period for steel producers, a period in which the economy was booming and demand was at its peak! The two main competitors of Tata Steel are SAIL and JSW Steel.

As seen from figure 1, From 2004 to 2007, Tata Steel recorded a CAGR in revenues of 27% whereas JSW and SAIL managed a CAGR OF 44 % and17 % respectively.

Tata Steel is the lowest cost steel producer in the world. This fact is quite evident from figure 3 as the raw material/ revenue ratio of Tata has consistently been less than or equal to 35%. The two most important raw materials utilized in producing steel are:-iron ore and coal. Company owned and operated mines have met most of the raw material needs of Tata Steel, a reason which accounts for the low cost of raw materials. A September 2006 analysis from Enam Research reveals a steep advantage for Tata Steel: Its iron ore and coal costs add up to only $81 a ton, while they are $231 for JSW Steel and $196 for the Steel Authority of India Ltd., two other large Indian steel producers.

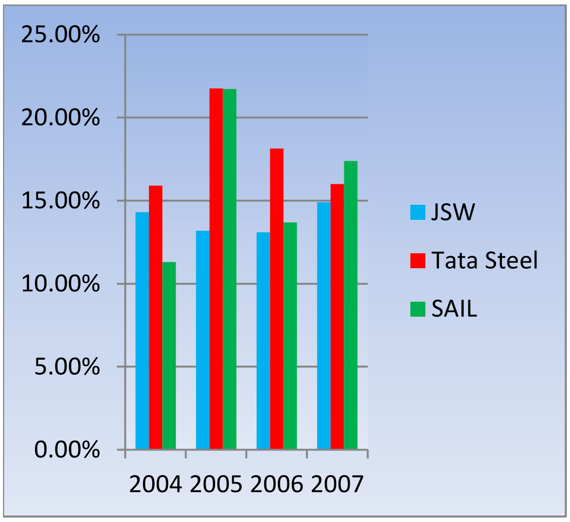


Fig 2: Net Profit Margin

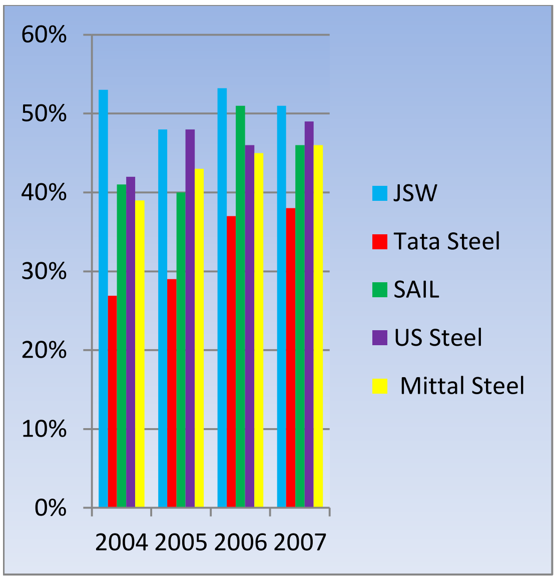


Fig 3: Raw materials/Revenues

Fig 4: Tata factory in Jamshedpur

Tata – Corus Acquisition

Tata Acquired Corus for $12.4 billion!! The highest price paid by an Indian firm for an acquisition.

We believe that the Corus acquisition, (now known as Tata Steel Europe) has completely altered the financial performance of Tata Steel and as a result depressed its equity price. Therefore, we believe that it is imperative to discuss what exactly happened.

On 20 October 2006 the board of directors of Anglo-Dutch steelmaker Corus accepted a $7.6 billion takeover bid from Tata Steel at 455 pence per share of Corus. The following months saw a lot of negotiations from both sides of the deal. Tata Steel's bid to acquire Corus Group was challenged by CSN, the Brazilian steel maker. Finally, on January 30, 2007, Tata Steel purchased a 100% stake in the Corus Group at 608 pence per share valued at USD 12.04 Billion. The deal is the largest Indian takeover of a foreign company and made Tata Steel the world's fifth-largest steel company.

It was estimated that synergies worth $476 million would be realized by 2010. By end of 2010 only $83 million worth of synergies were realized.

The Perceived Synergies

There were a lot of apparent synergies between Tata Steel which was a low cost steel producer in a fast developing region of the world and Corus which was a high value product manufacturer in the region of the world demanding value products.

1- Tata was one of the lowest cost steel producers in the world and had self-sufficiency in raw material. Corus was struggling to keep its productions costs under control and was on the lookout for sources of iron ore. Therefore the combination of the low cost production in India with the high-end downstream processing facilities at Corus was a primary reason which led Tata to bid for Corus.

Tata Steel is the lowest cost steel producer in the world. Its iron ore and coal costs add up to only $81 a ton, while they are $231 for JSW Steel and $196 for the Steel Authority of India Ltd., two other large Indian steel producers.

2- Tata had a strong retail and distribution network in India and SE Asia. This would give the European manufacturer an in-road into the emerging Asian markets. Tata was a major supplier to the Indian auto industry and the demand for value added steel products was growing in this market. Hence there would be a powerful combination of high quality developed and low cost high growth markets.

Debt to Equity ratio of Tata rose to 2.74 from 1.1 as a result of the acquisition.

Pitfalls

The major pitfall of the deal was the high price paid by Tata for the acquisition. Tata Steel ended up paying approximately 7.7 times the Enterprise Value. Corus's EBITDA at 8% was also much lower as compared to Tata Steel's 30%. Debt of US $ 6.14 was raised against the cash flows of Corus. It was a risky proposition. Tata's debt to equity ratio increased to 2.74 from 1.1 which it was maintaining earlier. Cost of production per unit increased. There was also high dependence on the growth of the market, a factor which has contributed the most to the below average performance of Tata Steel post the acquisition.

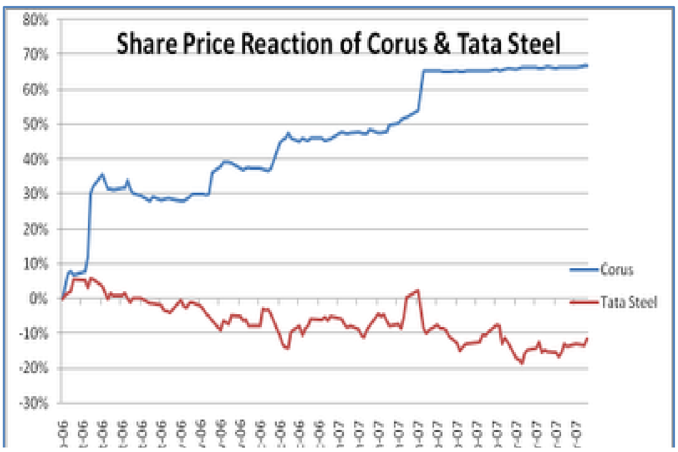
A leverage Buyout model has used to finance the acquisition, which meant that Tata ended up paying only a third of the acquisition price!!

Funding for the deal

Tata Steel used the Leverage Buyout Model (LBO) to provide funding for the Corus deal. 100% of Corus's equity was bought by Tata Steel for close to $12 billion. Out of this Tata raised $4.1 billion.The remaining $8 billion was raised as debt with the help of a Special purpose entity, (Tata Steel UK) which was to be repaid on the strength of Corus's Balance sheet. What that meant was that Tata Steel paid only a third of the acquisition price. This kind of a structure was possible because of the low amount of debt on the balance sheet of Corus, a factor which allowed Corus to borrow more.

After the deal was announced, Tata Steel's stock was down nearly 12% whereas Corus's stock was up by close to 70%.

A clear indication that the market expected lower synergies from the deal!!



Tata Steel- Post Corus (2008/2012)

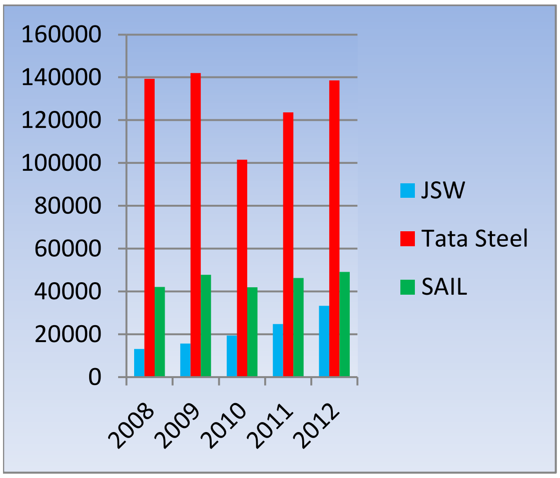


Fig 6: Revenues

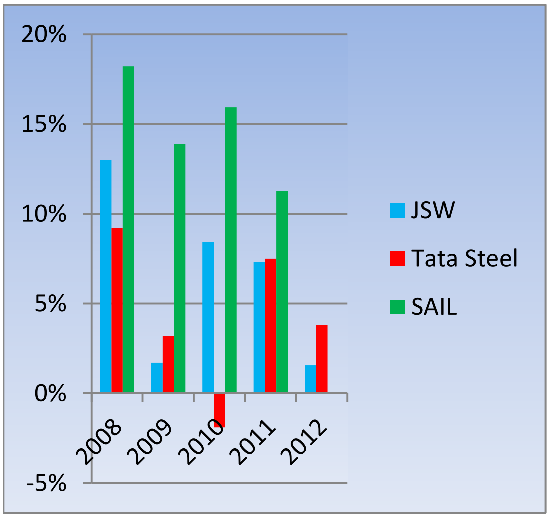


Fig 7: Net Profit Margin

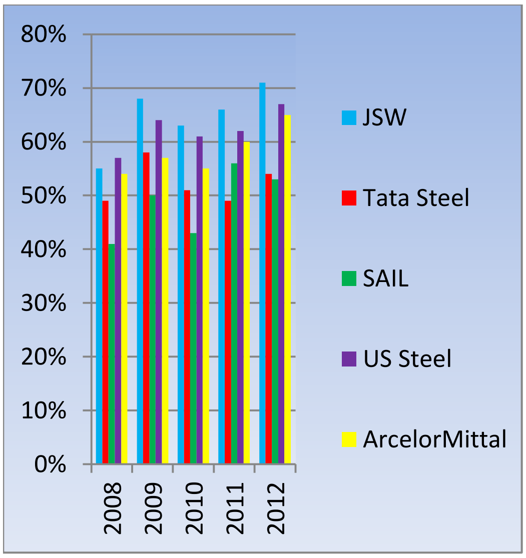


Fig 8: Raw materials/Revenues

In this section we analyse Tata Steel on a consolidated basis after Tata acquired Corus comparing Tata Steel with its peers JSW Steel and SAIL. The comparison is done over a time period of 2008 to 2012.

As seen from figure 1, it is evident that after the acquisition of Corus, Tata's revenues jumped from about 28000 cr in 2007 to about 140000 cr in 2008. A jump of 400 %. But the more interesting thing to note here is the steep fall in profits that Tata has witnessed after the acquisition. The average Net Profit Margin of Tata Steel over 2008-2012 fell to about 4% from a level of >15% that Tata witnessed over 2004-2007. The main reason for such a drastic change could be the bad timing of the acquisition. Corus was acquired right before the 2008 crisis. 2008-2012 were the years when the world witnessed sluggish demand for steel as can be clearly seen from the figure below. Another reason which explains this is the drastic increase in the raw material costs. Raw materials as a percentage of revenues increased from an average of 32.5% in 2004/07 to about 52% in 2008-12.

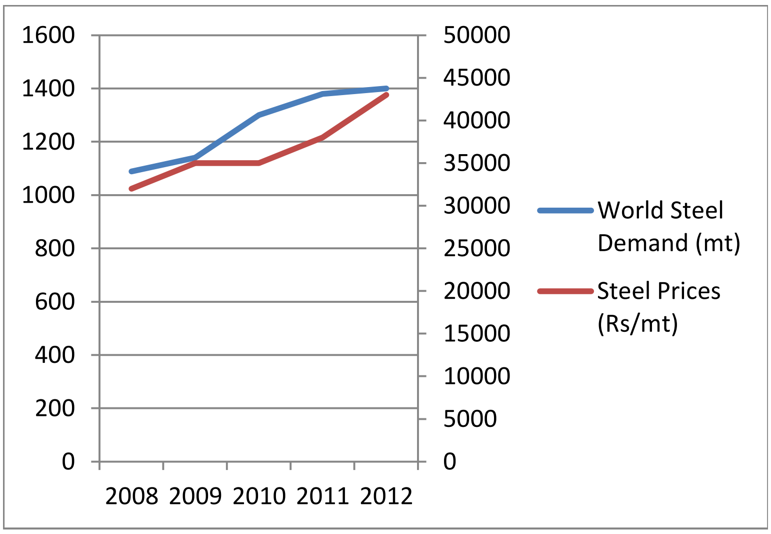


Fig 9: Steel Price (right y axis)
Steel Demand (left y axis)

What went wrong?

It has been close to 6 years since Tata Steel acquired Corus, (now known as Tata Steel Europe) for over $12billion. The deal increased the company’s steel producing capacity by five-fold, but did the deal really live upto the expectation?

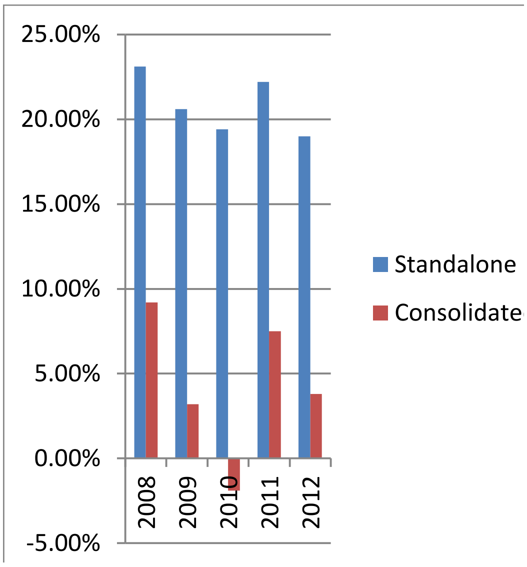


Fig 10: Net Profit Margin

Economy

Tata Steel's European operations have had a torrid time since the acquisition. The UK has seen steel production fall every year since 2007. So can this be attributed to bad timing? Probably yes! Volatile demand from consumer intensive industries such as automobiles, consumer durables and capital goods in the European region resulting from the setbacks of the credit crisis, has affected the company's financial performance.

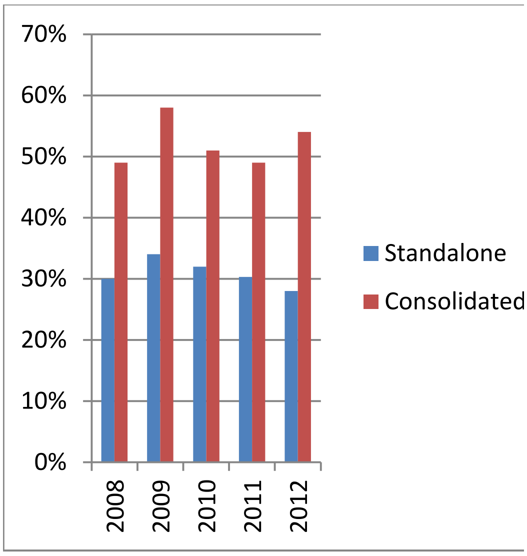
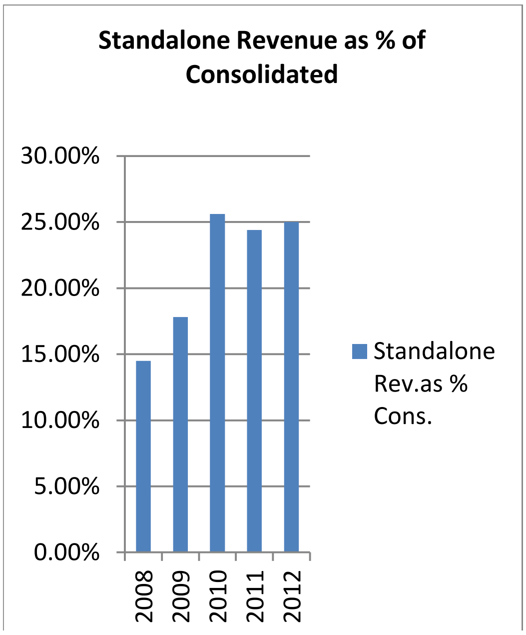


Fig 11 : Raw materials/Revenues

Despite producing less than50% of the steel volumes that European operations produce, Tata Steel's Indian operations have accounted for a major share (upto 96 per cent in some years) of the firms total profits between 2008 and 2011. If we compare Tata Steel on a standalone basis with Tata Steel on a consolidated basis, we realize that the NPM of Tata on a standalone basis (16-18% range from 2008-2012) far exceeds the NPM on a consolidated basis (-2% to 9%) thereby indicating that Corus is actually incurring losses!

Outside of structural inefficiencies at the UK operations, the root problem for the European operations lies in its inability to pass on high-raw material costs to the end-consumer given the weak demand scenario.



In an attempt to insulate the European arm from volatile input costs, Tata Steel has in the past five years invested in iron ore and coking coal mines in Canada, Africa and Australia. These moves are expected to begin boosting margins of the European operations over the next few years.

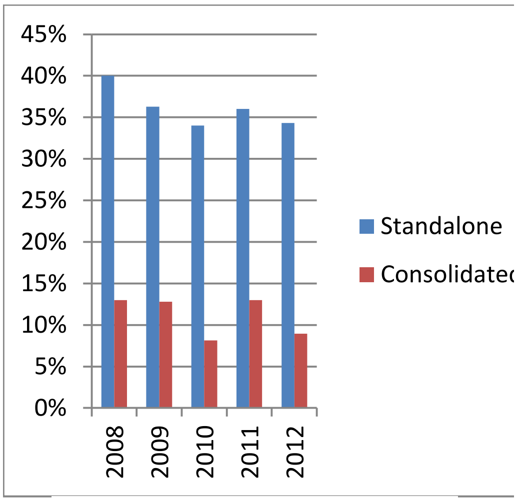


Fig 13: Operating Margin

Since the beginning of 2009, Tata Steel has cut more than 5000 jobs, mostly from its UK plants in order to cut costs.

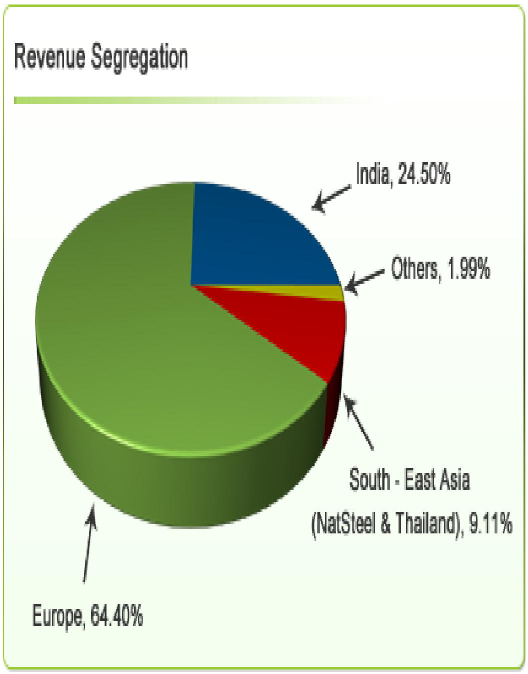


Fig 14: Revenue Segregation

A range of other assets have either been sold off (including Corus' aluminium and chemical businesses) or mothballed (South wales hot strip mill). Since the beginning of 2009, it has cut more than 5,000 jobs, mostly from its UK plants with the most recent layoff happening in November 2012 when close to 900 employees were laid off.

While the benefits accruing from captive sourcing for Corus will result in better margins, Europe is likely to remain a challenging market for Tata given the weak demand. It will therefore be up to the Indian operations once again to drive growth for the company over the next couple of years. Therefore the company needs to increase its presence back home while reducing costs in Europe. Tata Steel increased its brownfield steel capacity from 7 million tonnes to 10 million tonnes last November and with the addition of Odhisha, the capacity will move to 13 million tonnes.

The Road Ahead…

Therefore the critical question that arises now is whether the situation in Europe will improve and in the meantime will Tata be able to turnaround Corus?

In our opinion, the Economy moves in cycles- booms and busts. Europe has been witnessing a slowdown since 2008 (Credit crisis) but we at ThirdWave are of the opinion that the worst is behind us. The only uncertainty that we foresee is the standoff over the fiscal cliff in the United States. (the economic effects that could result from tax increases, spending cuts and a corresponding reduction in the US budget deficit beginning in 2013 if existing laws are not changed by the end of 2012).If that goes off smoothly, then the situation in Europe should begin to improve.

Corus is currently losing 2000 cr on a standalone basis. We are of the opinion that Tata would do whatever it takes to atleast get Corus to breakeven. (Tata is trying to cut costs by mothballing plants, reducing the workforce!).If it manages to do so, and if we assume a stable multiple of 7, then that is a straight 14000 cr jump in Market cap to 49000 from a current market cap of 35000 cr !!

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