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Tata Metaliks Ltd

Tata Metaliks Ltd, a company owned 46.66% by Tata Steel, is the largest producer of foundry grade Pig Iron in India. The company is doubling its capacity from the current 165,000 TPA to 330,000 TPA. Full benefit of the expanded capacity should be available from QE Mar-05. The expansion will also bring with it scale economies thereby reducing production cost. The company seems to be in a position to pass on the steep rise in the cost of coking coal, its key raw material.

Fair Value Rs.324

Price Rs.105

+208%

The stock currently trades at 2.8 times estimated EPS for FY05 and 1.7x estimated EPS for FY06. We expect its net profit to grow at 280% and 66% in FY05 & FY06 respectively. We estimate DCF fair value at around Rs.324. Present value of Free Cash Flows till FY2009 reduced by all debt is Rs.154 per share (47% greater than current market price) – implying substantial margin of safety.

Key Data

| | |
|--------------------------|---------------|
| Market Cap | Rs.2.7 bn |
| Market Cap at fair value | Rs.8.2 bn |
| Shares Outstanding | 25.3 mn |
| 52 week High-Low | Rs.120/Rs.22 |
| Average Daily Volume | No. of shares |
| BSE+NSE 365 days | 108,920 |
| BSE+NSE 30 days | 236,157 |
| BSE Scrip Code | 513434 |
| NSE Scrip Code | Tatametal |

Shareholding %

| | |
|-----------------------|-------|
| Promoters – Mar-04 | 46.66 |
| Jun-04 | 46.66 |
| Institutions – Jun-04 | 9.85 |
| Others - Jun-04 | 43.49 |

Stock Performance

| | |
|-----------|-----|
| 3 months | 60% |
| 6 months | 14% |
| 12 months | 66% |

Multiple Valuation

YE Mar-05E

| | |
|------------------|-------|
| EV/EBITDA | 1.9x |
| EV/EBIT | 2.0x |
| Market Cap/Sales | 0.65x |
| P/E | 2.8x |
| P/BV | 2.1x |

Key Investment Points

- Capacity and production of Pig Iron, the only product company makes, is going to double from Jan-05. Engineering, automobiles, and infrastructure sectors to drive significant growth in pig iron consumption
- Worldwide metallic market is very tight. This will enable the company to maintain margins despite exorbitant rise in cost of coking coal.
- It has a fixed price contract for half the requirement of coking coal till Mar-05 and for another half till Jun-05. Renewals likely at significantly higher cost but company is in a position to pass it on.
- Exports growing at rapid pace, as it spreads its footprint to newer markets
- Debt-free company. Current expansion without any debt. Even in future, debt is unlikely to be used except for short term financing needs.

Value Kickers

- Acquisitions and forward integration into castings, special steels, etc under deliberation. We expect something to materialise by early 2005.

Party Poopers

- Small capacity expansions being currently resorted to by number of domestic pig iron producers may exert pressure on realisations in the short term. Most of these capacities are likely to come up during Mar/Apr-05.

Near Term Likely Trigger

- Doubling of company's production capacity effective Jan-05
- Acquisition & forward integration opportunities can materialise in early 2005





Key Investment Arguments

Doubling of Pig Iron capacity effective Jan-05

Tata Metaliks currently has one mini blast furnace of 215 cubic meters. The company is expected to produce 165,000 MT from this furnace this year. It is adding another similar furnace at the cost of Rs.700mn. We expect this to commence full fledged production from January 2005. Hence, capacity and production will double from Jan-05 onwards. Scale economies will lead to reduction in unit production cost. Tata Metaliks is already the lowest delivered cost producer of foundry grade pig iron. After the expansion, the company will become the largest producer of foundry grade pig iron in the secondary sector in India.

Pig Iron: Growth in capacity and production

| YE Mar 31, | 2003 | 2004 | 2005E | 2006E |
|------------|---------|---------|---------|---------|
| Capacity | 130,000 | 130,000 | 330,000 | 330,000 |
| Growth % | - | - | 154% | - |
| Production | 133,920 | 123,120 | 200,000 | 330,000 |
| Growth % | 1.8% | -8.1% | 62.4% | 65.0% |

At the beginning of FY05, the company expanded capacity from 130,000 TPA to 165,000 TPA by commissioning Hot Blast Stove, high efficiency blower by modifying duct and by repairing top charging furnace equipment. Implementation of Hot Blast Stove resulted in 5.5% reduction in coke consumption rate. With the coke prices shooting through the roof, this is a significant achievement. Along with the new MBF, the company is also setting up a 4MW power plant.

The rise in production in FY05 has also been due to the fact that there was an eighteen days shutdown in the last quarter of FY04 for the above mentioned installations and repair. Moreover, productivity improved significantly to 2.1 MT/cu meter/day (165,000/365/215) from 1.73 in earlier years.

Engineering, automobiles, and infrastructure driving the growth

Foundry grade pig iron is used mainly in castings, which in turn are used in sectors like automobiles, engineering and infrastructure. All these sectors are exhibiting strong growth and we expect overall demand from these sectors to remain buoyant going forward. This will ensure growing demand for casings and therefore pig iron.

Value proposition and differentiated service driving higher growth

Tata Metaliks' value proposition to customers is to supply more and more customized grades based on their specific end-use requirements. Sale of customized grades is showing a rising trend over the years. In FY04, revenue from sale of customized grade accounted for 32%.

Technical support and related services to foundries also adds to the value proposition offered to the foundry industry to optimize their operational performance. This is helping the company to increase its share of, pig iron in foundry's charge mix and to sustain the premium over competition. Sales linked to technical support and related services have increased substantially.

IMRB, an independent agency, had conducted a customer perception survey to assess customers' perception about product and service offered by it. The Customers Satisfaction Survey rated the company as an "Industry Leader" in most of the attributes.



Debt-free capital structure – sagacious for highly cyclical business

Tata Metaliks is in a highly cyclical business with high operating leverage. We are happy to see the company operating at zero financial leverage. Even the doubling of capacity is being done without any debt. Even going forward, the company does not want to use debt except for short term funding requirements.

Fixed price contracts for inputs till Mar/Jun 2005

Metallurgical coke (met coke) and iron ore are the two key raw materials for producing pig iron. Other raw materials are dolomite, lime stone, quartzite, and manganese ore. The company does not buy met coke but buys coking coal and gets it converted into met coke from third party cokeries (coke ovens or coke batteries). In FY04, met coke accounted for 81% of its raw material cost and iron ore 18%.

It buys half the requirement of coking coal from BHP Billiton of Australia and another half from Tata Steel. It buys its entire requirement of Iron Ore from Tata Steel. It enters into annual fixed price contract with these suppliers. With Tata Steel, the period is April to March and with BHP, it is July to Jun. Thus, cost of 100% of iron ore and 50% of coking coal requirement are locked in till Mar-05 and the cost of balance 50% of coking coal requirement is locked in till Jun-05.

Cost of both the key raw materials have risen substantially since Apr/Jul-04 and so has price of pig iron. The contract renewals are likely to take place at significantly higher prices as compared to last year's prices. However, we expect pig iron prices to also rise commensurately given the tight situation for metallic globally. Pig Iron demand is currently growing at 6.5% annually.

Agreement with two new cokeries

The company has ensured the enhanced coking coal conversion requirements post expansion by entering into agreement with two new cokeries closer to its plant. One of these will start conversion for Tata Metaliks in Jan-05 and another will do so by Aug/Sep-05. Earlier, the company had planned to set up a 60,000 TPA cokery within its plant but this plan has now been shelved. These two cokeries together will meet 50% of the company's increased conversion requirement.

Tata Steel together with WBIDC is planning to set up a large met coke plant. Tata Metaliks had evinced interest in participating in this venture but nothing seems to have fructified yet. We understand the venture is progressing but it will take at least 18 months before it can start production. This is to ensure long term availability of met coke for Tata group companies.

Rapidly expanding geographic market coverage

Predominantly a domestic player till FY02, the company started exploring global market place in FY03 with 7% of sales coming from exports in FY03. Exports went up to 17.4% of sales in FY04 and are much higher this year. The company is spreading its footprint to newer export markets and this has been driving its export and therefore overall demand. With rising exports, the company has significantly reduced the risk of slowdown in domestic market.

The Department of Statistics and Economics of Tata Services Ltd had carried out a survey of the Company's preparedness in the post-WTO regime and found the company reasonably well prepared.



Acquisitions and forward integration opportunities to unfold soon

Tata Metaliks is exploring acquisition and forward integration opportunities like castings, special steel, etc. We understand the company is actively working on it and at least one deal should fructify by early 2005.

Stringent scrap import requirements to help pig iron demand

After the recent explosion in Bhushan Steel plant, scrap import requirements have been made stringent. This will shift part of the scrap demand towards pig iron and sponge iron.

Company to operate on negative net working capital from FY06

We estimate that the company will operate on net working capital from FY06. This is despite our assumption of reducing suppliers' credit from 111 days in Mar-04 to 80 days in Mar-06. The major reduction in working capital will come from reduction in coking coal inventory. With the doubling of capacity, one shipload of imported coking coal (which forms 40% of raw material cost) and most of raw material inventory will be half the present number of days' consumption. Thus there can be significant reduction in total raw material inventory due to halving of imported coking coal inventory. We estimate total raw material inventory to fall from 156 days in Mar-04 to 120 days in Mar-05 and 90 days in Mar-06.

Risks / Concerns

Half a million ton of addition to domestic capacity by Mar/Apr-05

A few small capacity additions totaling 500,000 TPA are expected to come up by Mar/Apr-05. As half a million ton additional capacity comes at a time, it may exert short term pressure on pig iron price realizations and therefore margins. There will be additional pig iron capacity in the short run from steel makers till they complete the steel plant. These have the potential to disrupt the market in the short run. However, with robust pig iron demand worldwide and given the fact that metalics are in short supply globally, things should be evened out in a short span.

Ownership and Management

Tata Metaliks is 46.66% owned by Tata Steel. Institutional investors hold 9.85% and the balance is the public. The company is professionally managed with Mr. Harsh Kumar Jha as its Managing Director.

Valuation and key underlying assumptions

We estimate discounted cash flow value per stock at around Rs.324 at 18% cost of equity (Rs.390 at 15% CoE). At the current price of Rs.105, the stock offers significant appreciation potential. Present value of the company's likely free cashflows over the next four and a half years reduced by all debt is 47% greater than its current market capitalization. This implies that you are not paying for some uncertain cashflows in distant future but relatively certain cashflows over the next four and a half years -- tremendous margin of safety.

Key assumptions are optimum capacity utilization, 20% growth in pig iron realization in FY06 and stable price thereafter, met coke unit cost to rise 47.5% in FY06, iron ore unit cost to rise 20% in FY06 and remain stable thereafter.

The stock currently trades at 2.8 times estimated EPS for FY05 and 1.7x estimated EPS for FY06. We expect its net profit to grow at 280% and 66% in FY05 & FY06 respectively.



Income Statement

| <i>Rs. Mn.</i> | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|-----------------------|---------------|----------------|----------------|
| <i>No. of months:</i> | <i>12</i> | <i>12</i> | <i>12</i> |
| Revenues | 1576 | 3988 | 7895 |
| EBIT | 375 | 1388 | 2341 |
| PBT | 380 | 1392 | 2399 |
| Adj. PAT | 248 | 942 | 1568 |
| EPS (Rs.) (cum-right) | 9.80 | 37.24 | 62.00 |

Ratios

| <i>No. of months:</i> | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|-----------------------|---------------|----------------|----------------|
| <i>12</i> | <i>12</i> | <i>12</i> | <i>12</i> |
| Revenue Growth % | 25.2 | 151.0 | 98.9 |
| EPS Growth % | 89.2 | 280.1 | 66.5 |
| RoE % | 46.7 | 91.8 | 76.7 |
| D/E x | 0 | 0 | 0 |
| Receivables days | 8 | 8 | 8 |
| Inventory days - FG | 15 | 15 | 15 |
| -- RM | 156 | 120 | 90 |
| Creditors days | 111 | 90 | 80 |

Balance Sheets

| <i>Rs. Mn.</i> | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|--------------------|---------------|----------------|----------------|
| Assets | | | |
| Net Block | 515 | 1215 | 1215 |
| Investments | 40 | 136 | 1392 |
| Net Current Assets | 86 | 59 | (53) |
| Liabilities | | | |
| Equity Capital | 253 | 253 | 253 |
| Reserves | 300 | 1009 | 2106 |
| Preference Capital | 0 | 0 | 0 |
| Debt | 0 | 0 | 0 |
| Non-Current Liab. | 88 | 148 | 195 |

Quarterly

| <i>Rs. Mn.</i> | <i>Jun-04</i> | <i>Jun-03</i> | <i>Var</i> |
|-----------------------|---------------|---------------|------------|
| <i>No. of months:</i> | <i>3</i> | <i>3</i> | <i>%</i> |
| Net Revenues | 470 | 314 | 49.7 |
| EBITDA | 290 | 84 | 245.2 |
| Depreciation | 9 | 7 | 23.3 |
| EBIT | 281 | 77 | 266.4 |
| Interest | 3 | (1) | |
| Other Income | 7 | 5 | |
| PBT | 285 | 82 | 247.7 |
| Tax | 106 | 29 | |
| PAT – Adj | 179 | 53 | 239.2 |
| Equity Capital | 253 | 253 | |
| EPS –annualised (Rs.) | 28.33 | 8.35 | 239.2 |

Quarterly Ratios

| <i>%</i> | <i>Jun-04</i> | <i>Jun-03</i> | <i>% point</i> |
|-----------------------|---------------|---------------|----------------|
| <i>No. of months:</i> | <i>3</i> | <i>3</i> | <i>Chg.</i> |
| EBITDA / Sales | 43.8 | 26.1 | +17.8 |
| EBIT / Sales | 42.5 | 23.8 | +18.7 |
| Tax/PBT | 36.6 | 35.9 | |
| Material cost/sales | 47.8 | 59.2 | -11.4 |
| Staff cost/sales | 2.1 | 3.8 | -1.7 |
| Other cost/sales | 6.2 | 10.9 | -4.6 |

Multiple Valuation

| | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|------------------|---------------|----------------|----------------|
| EV/EBITDA x | 7.0 | 1.9 | 1.2 |
| EV/EBIT x | 7.5 | 2.0 | 1.2 |
| Mkt. Cap/Sales x | 1.64 | 0.65 | 0.33 |
| P/E x | 10.7 | 2.8 | 1.7 |
| Price/Book x | 4.8 | 2.2 | 1.1 |

Free Cash Flow

| <i>Rs. Mn.</i> | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|-------------------------------|---------------|----------------|----------------|
| <i>No. of months</i> | <i>12</i> | <i>12</i> | <i>12</i> |
| NOPLAT | 245 | 939 | 1530 |
| Change in Net Working Capital | 61 | 120 | 122 |
| Operating Cash Flows | 183 | 819 | 1408 |
| Net Capex & others | 186 | 638 | (47) |
| Free Cash Flow | (3) | 181 | 1454 |
| Non-opr. Cash flow | 7 | 3 | 38 |
| Cash Flow to Investors | 4 | 184 | 1492 |

Financing Cash Flow

| <i>Rs. Mn</i> | <i>Mar-04</i> | <i>Mar-05P</i> | <i>Mar-06P</i> |
|----------------------------------------|---------------|----------------|----------------|
| <i>No. of months:</i> | <i>12</i> | <i>12</i> | <i>12</i> |
| Post-tax Interest | 4 | 0 | 0 |
| Repayment/ (issue) of Debt | 16 | 0 | 0 |
| Equity Share | 75 | 89 | 235 |
| Dividend | | | |
| Buyback/Redn/ (issue) of equity shares | 0 | 0 | 0 |
| Increase in excess cash | (90) | 96 | 1257 |
| Financing Cash Flow | 4 | 184 | 1492 |

DCF Valuation

| | <i>Rs. Mn.</i> | <i>%</i> |
|-------------------------------|----------------|----------|
| <i>Key Assumptions</i> | | |
| Terminal Growth Rate | | 2.0 |
| WACC | | 18.0 |
| Cost of Equity | | 18.0 |
| <i>DCF Valuation</i> | | |
| NPV FY05 to FY09 | 4137 | |
| NPV Terminal Cash Flows | 4225 | |
| PV of non-operating assets | 61 | |
| Contingent Liabilities @ 100% | 1 | |
| Enterprise Value | 8422 | |
| Debt, Pref. Cap, PV of NCL | 234 | |
| Equity Value | 8188 | |
| <i>Fair Value Range (Rs.)</i> | 287-360 | |
| Per share Value (Rs.) | 324 | |
| Stress Value per share (Rs.) | 180 | |



Important Disclosure

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