

L&T Demerger: Do L&T shareholders stand to benefit?

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CDC Capital Partners has laid down certain conditions for picking up a stake in L&T Cement (formed by hiving off L&T's cement division). On perusing the terms and conditions, it is unclear as to how L&T's shareholders stand to benefit from the deal.

According to the deal, L&T's cement division will be hived off into a separate company in which CDC will acquire a 6.8% stake by subscribing to fully convertible debentures (FCDs). Hence, it will be a preferential allotment by L&T Cement. Reportedly, L&T will hold a 70% stake in L&T Cement and the balance will be offered to existing shareholders of L&T.

Terms of the Offer

According to the Offer, which is valid till 31 December '02, FCDs of the demerged cement company will be convertible into not less than 6.8% of equity of L&T Cement at the option of CDC by December '04. The coupon rate for the FCD is 6% in US Dollar terms.

If CDC decides not to convert, the debentures will be redeemable in three equal installments between 2005-07 (since the conversion option is available till December '04; redemption option cannot be earlier than 2005).

CDC has an option of clubbing its entire stake with the stake sale, if any by L&T in L&T Cement during the period 2005-2007. However, at a cut off price of Rs158/share, the conversion itself is highly improbable and even if the conversion option is exercised, it is logical to get a premium valuation by offering controlling stake in L&T Cement and that cannot happen before 2008. Hence, we have not considered the option of sale of entire stake by CDC during 2005-2007.

If the conversion route is taken, CDC will not only have the option of selling its entire stake post 2007, but L&T will also be required to sell 51% stake in L&T Cement. In other words, sell 44.2% stake in L&T Cement. Basically, the buyer will get a majority stake and management control in L&T Cement. Effectively, the deal ensures a 3-year lock-in for CDC if the conversion option is exercised.

It is interesting to note that CDC is exempted from making an Open Offer (Reg 3 specifically includes CDC) though in this case by subscribing to 6.8% equity of L&T Cement, it effectively controls 51% stake. Minority shareholders will have to wait till 2008 for an open offer to materialise and there is very little that SEBI can do about it.

Why the deal does not set any benchmarks?

The deal does not set any benchmarks in any manner whatsoever. The price at which the stake is acquired by financial investors does not set any benchmarks.

Consider the following:

(1) Ambuja paid Rs370/share to acquire 14.4% equity stake in ACC; never once since the deal (3 years ago) has the ACC stock reached those levels.

(2) Warburg, without seeking any Board representation, paid Rs225/share of GACL. A year later, it did not exercise the option of converting Warrants and the GACL share is still way below Rs225.

(3) If the price paid by CDC is a benchmark for cement valuation, logically GACL, with an EBIDTA margin of 22.12% for the period ended July-September '02 compared to 12.97% of L&T for the same period or 19.8% for FY02 (including profit on assignment of ST liability) compared to 32.09% of Ambuja, should quote at a significantly higher price of Rs242.8. The valuation has been arrived at after adjusting for ACR's debt and capacity and treating FCCB as debt.

If the 6.8% stake in L&T Cement is worth Rs2.91bn, the division (estimated debt: Rs28bn) is worth Rs70.79bn and at US \$ = Rs48.27, per tonne valuation works out to be US \$88.9.

Why the deal does nothing for shareholders of L&T?

If the deal goes through, CDC will pay Rs2.91bn for the stake and because it is preferential allotment (L&T itself cannot issue FCDs of another company, in this case L&T Cement), no cash inflow will accrue to L&T.

L&T Cement will be listed but has two distinct disadvantages viz., the company (L&T Cement) has the lowest EBITDA margin among cement majors and the second highest capital employed after GACL (based on segment-wise figures in H1FY03 results of L&T). We have excluded India Cements because of its poor financial health. These factors plus the capacity valuation based on the capital cost of GACL's Maratha unit, the last greenfield capacity to be commissioned, will be reflected in the valuation of L&T Cement. L&T's average cost of debt in FY02 was 9.63%. Hence, even if the funds are used to retire debt of the cement division, net of interest on FCDs, the impact will be marginal.

Valuation

Given below is our valuation of L&T's cement division along with some disadvantages of the division. Entry of a financial partner will do nothing to change that. We are not even estimating the per share value as only net worth (difference between assets and liabilities) of a division can be worked out but break up of net worth into equity and free reserves cannot be done. Debt is also an estimate.

Plant-wise Capacity (as on Oct '02)							Million Tonne
	ST Status	Capacity	Expansion by	Year	De-rated		Capacity
L&T-ACW (Alwarpur)	Deferral	2.50	0.5	May-00			3.00
L&T-HCW (Hirmi-MP)	Deferral	1.45	0.45	May-00			1.90
Gujarat	Exemption	4.00	0.2	May-00			4.20
			1.00	Sep-02			5.20
AP	Deferral	2.00	0.6	May-00			2.60
				Sep-02	0.7		1.90
Jafrabad		0.40					0.40
				Total Clinkering Capacity			12.40
				(%)			75.15
Grinding Units							
JCW		0.70	0.1	May-00			0.80
Magdalla		0.67	0.03	May-00			0.70
Ratnagiri		0.33	0.07	May-00			0.40
ARCW (TN)							1.20
WBCW (W. Bengal)							1.00
			79.992				
				Grinding Capacity			4.10
	Capacity (MT)	Cost (Rs Million)	Per Tonne	Value (Rs Million)	\$/Tonne	Realistic Value of Narmada (Rs/tonne)	
Maratha Unit of GACL	2	7082.60	3541.30			2500.00	
Less: CPP-40 MW		400.00	200				
L&T Clinkering Capacity	12.40		3541.30	43911.98			
Grinding Capacity	4.10		1300.00	5329.95		1100.00	
Total	16.50			49241.93			

Per Tonne				2984.37	61.92		
Exchange Rate (US \$-Rupee)				48.20			
Amount Paid for NCL acquisition				2430.00			
Not Considered for Valuation:							
(1) 39.5% of clinkering capacity is on ST deferral. In Gujarat, L&T is on ST exemption. Dispatches in Gujarat from the unit accounted for 47.35%. Among all markets of L&T, Gujarat has the lowest ST rate of 8.8% and hence the ST profit is also low. Units with deferral and exemption cannot command the same rate as exemption contributes 22-25% of PBT.							
(2) Narmada has been valued at higher than the acquisition cost of L&T. Post acquisition, nothing much has changed. It is a Sick Company and virtually non-operational since August '02.							
(3) L&T has the highest lead distance and therefore highest freight cost/tonne. Net Realisation is amongst the lowest in the industry-majors.							
(4) In FY02, L&T accounted for 79.21% of the country's clinker exports with the Gujarat unit accounting for 74.3% of the country's exports. For April-October '03, the Gujarat unit accounted for 36.24% of the country's clinker exports while the Jafrabad unit accounted for 11.7%.							
(5) No presence in the North, which will remain the most lucrative market because of least imbalance between supply and demand.							
(6) In the East, another region with supply-demand almost matching, not a market leader in a single state. No.3 in the region, after Lafarge and ACC. The East accounts for barely 17.35% of the domestic dispatches (Q2FY03) and 15.15% of the total dispatches with clinker.							

Impact of ST in Maharashtra (Rs/bag)

Basic Price	70.00
Add:	
Excise	17.50
Freight	20.00
Sales Tax	16.45
Dealers commission/discount	2.00
Sales Price	125.95
ST rate	15.30%

Note: Exemption does not result in ST not being charged. ST is charged but not paid and hence contributes straight to PBT. In deferral, ST charged and collected gets reflected under Unsecured Loans and not in P&L Account.



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Company Update

Stock Ratings Absolute Returns

Buy : > 25%
Out Performer : 16 - 25%
Market Performer : 0 - 15%
Under Performer : < 0%

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