

Publication : The Analyst

Nature: Monthly Financial Magazine

Date : April 8, 2007

Readership : 40,000

Hindalco-Novelis

### INTERVIEW

**The combination of Hindalco and Novelis will establish a global integrated aluminum producer with low-cost alumina and aluminum production facilities combined with high-end aluminum-rolled product capabilities.**

What type of synergies do you think Hindalco can derive from the Novelis acquisition?

**Hitesh Agrawal:** The most important synergy that is possible for the two companies combined is the fact that Novelis is a downstream value-added product player and Hindalco is one of the lowest cost base metal producer in the world i.e., in terms of aluminum. Currently, the problem with Novelis is that it is not able to explore its metal, which it converts into value-added stuff at reasonable prices. As you know aluminum prices are ruling very strong. So, what will happen is that, Hindalco has announced various capacity expansion plans in the next 3 to 5 years. And, when it will have these additional capacities in upend running, it will supply base material to Novelis since it does not make alumina or aluminum base material itself. And whatever it has currently is very small; very insignificant to the entire scheme of thing. So, in the future, when Hindalco will have additional capacity, which it can share with Novelis, then it will help Novelis to bring down the cost. It will lead to improvement of margins for Novelis and it will, at the same time, be beneficial for both the companies. Apart from that, it is basically for the presence of Novelis that Hindalco will get a ready-made customer base, as Novelis has some of the best customers in the world. So, from that point of view, Hindalco has an advantage. Because if Hindalco, tries to build up such a big franchisee or such a big customer base, and market network, it will probably take them a much longer time. But, with the help of this acquisition they can manage to do this in one single go.

Though the capacity right now is not very big, Hindalco's capacity expansion plans for the next 3 to 5 years, as per my calculations reveal that it will be able to supply around 0.15 million tons, roughly an average of 0.2 million tons by FY09. So, from that point of view, if you look at it, it is not that big. Because, for Novelis with a 3 million tons capacity, it would not be that significant. But at least it will start from thereon. The other thing is that this is not the only thing for Novelis. Novelis is paying the price for getting into a contract, which was not very wise. It had entered into a contract with some of its customers, according to which it will provide cans at a price which is tapped, beyond which Novelis will pay the cost. And with aluminum prices going through the roof, Novelis had to bear it all. But the good part of it is that by the beginning of 2007, half of these contracts have expired and half are pending for FY09-10.



**Hitesh Agrawal**  
Senior Research Analyst, Angel Broking

So, at least, the burden of Novelis will now be reduced. From that point of view, Novelis will incur now lesser losses in 2007 and after that. If the aluminum prices come down then it would be able to improve its profitability among other things. Definitely, 2007 or 2008 portends better times for Novelis.

**Rishi Sahai:** The combination of Hindalco and Novelis will establish a global integrated aluminum producer with low-cost alumina and aluminum production facilities combined with high-end aluminum-rolled product capabilities. The complementary expertise of both these companies will create and provide a strong platform for sustainable growth and ongoing success.

There are many analysts predicting huge risks associated with the Novelis acquisition. What is your view?

**Hitesh Agrawal:** Definitely, in any kind of acquisition, whether it is small or big, there is a high risk factor associated with it. But here the risk is a little extra, because of the kind of size that the company is about to acquire. For Hindalco, Novelis is really big. But the factor is that if you want such kind of a player with a huge market and the best customers in the world to be on your team, I think you have to pay a strategic price for that. Because I think this is a strategic acquisition and it fits well into the entire scheme of Hindalco. If Hindalco would have paid a lower price, then probably, it would not be able to catch up the Novelis deal. So it is always subjective in hindsight to say that it is a very expensive deal. But the question is that probably below that, Novelis wouldn't have sold out. Therefore, it is very difficult to come to a conclusion, whether they overpaid or not. Definitely, from valuation point of view, it may seem to be a little expensive. But you have to understand that Hindalco is getting a ready-made market, ready-made customers, ready product profile; the size is tripling. From all this, it is fine as the stock is paying the price for that. But Hindalco is no more a one-year story because in the next one or two years down the line nothing is going to happen. It's a 3- or 5-year story now. It's very difficult to say, as things may go wrong. It is never safe to assume that 100% will go right as per plans. Now we have to see how they recover and what will be the benefits to Hindalco.

**Rishi Sahai:** The biggest risk in M&A is not the deal itself, it is the post-merger integration and there is still a lot of inexperience in Indian companies. Ambitious as they are, they are not quite global as yet.

## Business Environment

There is risk of the price being paid, as the valuations of the acquired companies could be far in excess of those of the acquiring companies. If Indian companies want to go global and want to hit the kind of scale you see, not just from the top companies in India, but globally *Fortune* 100 companies, they have to buy that growth.

**Shares of Hindalco Industries fell soon after the announcement of Novelis acquisition. What factors do you attribute to the market's thumbs down to the acquisition news? What are your views on the nature of the deal?**

**Hitesh Agrawal:** The key reason why the shares of Hindalco fell is that it was overpaid. Secondly, it is a huge deal, which will have an adverse effect on Hindalco's profit and loss or balance sheet. When we immediately work for the numbers, how Novelis will impact the consolidated numbers of Hindalco, we can only assume. Though Hindalco may make profits in the long run, now it will be raising almost \$2.3 bn because, recently, Hindalco has made a preferential offer to its promoters. Its promoters' means will fund the balance for internal growth and other means. So, the \$2.3 bn it will raise from the market will have to be recovered from Novelis' books. If you take the interest component into consideration, i.e., the interest servicing part or the debt servicing part, it will probably report a loss of \$100 mn, which is still considerably lower than the \$275 mn it paid this year in terms of losses. But \$100 mn in terms of Hindalco is a straight 18 to 20% hit on Hindalco's EPS. From that point of view, FY08 or FY09 will be a hit for Hindalco's consolidated numbers. So, the stock will not be good in the next 18 to 20 months.

**Rishi Sahai:** This kind of reaction is, however, hasty overlooking of the long-term benefits of achieving global scale, new markets and new customers; high-end intellectual property of either process technology, or product technology patterns of some kind and skill-sets. Such acquisitions also add incremental value to the acquirer's brand, the ability to serve the customer close to a point of need and of course, getting economies of scale. This, in the present day can be achieved through inorganic means and that attracts a premium.

**With Novelis having a debt of \$2.33 bn i.e., a debt-equity ratio of 7.23:1, what strategies will Hindalco take-up to revive the business of Novelis? Does it put any threat to Hindalco's balance sheet?**

**Hitesh Agrawal:** Strategy-wise it is very clear that Hindalco will try its best to supply and procure raw materials to Novelis at the best possible price. But as the debt is very high plus the additional burden that Hindalco will be raising on Novelis' books only, there is no way that they can reduce the impact of this on the consolidated balance sheet of Hindalco. As of now, we do not know of the interest rate they will have to pay to release the debt. So, from a financial point of view, there is no way that this effect can be saved. Hindalco's current debt-equity will be 0.4. What will happen is when it takes additional debt on its books,

as Novelis will now be a part of the consolidated Hindalco, the debt will be in Hindalco's books. And that may amount up to over 1 times. So, there is no way that the balance sheet picture can be saved. It will look vague in the next 2 to 3 years.

**Rishi Sahai:** The one group I would bet on being able to get the integration cost down would be the Aditya Birla Group. It is a company that has been brilliant in execution pretty much so far.

If you ask the Indian investor today, they will probably take the view that they paid too high a price; hence, you have seen the share price decline in most of the companies that were involved in M&A deals. It is, in some way, a bet on the execution capabilities of the company to get those cost synergies. At the high-end of any price, and that goes pretty much across the board whether it is Birla Group or Tatas, or for that matter Vodafone coming into India or expanding its presence here or even the Essar deal. All those deals are critically dependent on what I said about the post-merger integration.

**In the backdrop of rising aluminum prices, how do you feel the consolidated entity will be affected?**

**Hitesh Agrawal:** It is a very strange situation. Because, if aluminum prices are strong then Hindalco will gain, while Novelis will lose. As for every increase in dollar for aluminum prices, Novelis is incurring a loss. It is because it has capped its pricing for the cans it supplies to the various companies. So, for the next 2 to 3 years, it will be very strange situation; because Hindalco will be making money while Novelis will be losing it. So, until and unless these contracts expire by FY09-10, the profitability of these two companies will behave contrary to each other. It's not that Novelis will not make profits due to sales, but rising aluminum price scenario will eat into the profits of Novelis.

**Rishi Sahai:** That's the benefit that comes with such M&A deals. Here, the economies of scale will play its part. Technology and process leadership, cost-effective manpower and ready market will help rationalize the cost structures and balance the pressure on bottom lines.

**Any other comments.**

**Hitesh Agrawal:** Counter bidding—if it should have come—would have probably come by now. I don't expect any counter bidding to come because, the way Hindalco has structured the entire deal, if Novelis enters into a deal with any other, it has to pay \$100 mn. Plus, any bidder to win Novelis has to bid higher than what Hindalco has by \$2 to 3. That would raise the cost of acquisition, based on the enterprise value from \$6 bn to \$61/2 bn. So, when all are saying that \$6 bn is expensive, then why would anybody bid for 61/2. Plus, we have to understand the kind of synergy that Hindalco can derive, because it is totally backward integrated. I don't know how many other players will like to take that thing. But I don't foresee any counter bid and we are quite positive about the deal.



**Rishi Sahai**  
Board Director, IndusView