

TATA STEEL LIMITED: CONVERTIBLE ALTERNATIVE REFERENCE SECURITIES (B)

Professor Vasant Sivaraman, Professor Mayank Joshipura and Adithya Anand wrote this case solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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In July 2008, Sandip Biswas, group head of corporate finance at the Tata Steel Group, rose to address a class of business students after following a case analysis of the successful capital-raising effort in 2007 by Tata Steel Ltd (the company). There were some insights Biswas and Raghav Sud, senior manager of the treasury at Tata Steel Ltd, had to offer on the issuance of convertible alternative reference securities (CARS) by the company.

The acquisition of Corus by Tata Steel Ltd had led to large bridge loans and a key priority of the treasury function in the company was to replace these with term financing. The size of the acquisition had led to the anticipated downgrade of the outstanding debt by rating agencies. The structure of the financing mix would be critical in the review of the rating and, to that extent, it was important to consider issuances of convertibles that might mitigate the impact on the rating. In the summer of 2007, when Tata Steel had embarked on global fund raising, the nervousness in the markets in response to unfolding events that would go on to build up to the financial crisis was already beginning to be apparent. In a conscious move, the Tata Steel team had chosen to sweeten the terms of the CARS to reduce uncertainties in the closure of all tranches of financing. The attractiveness of the CARS was achieved by resorting to a relatively low level of implied volatility — this was argued on the basis that there was no market from which to derive long-term volatility for Tata Steel.

With the increased volatility of the weeks leading up to the CARS offering, spreads on credit derivatives on Tata Steel Ltd had exploded from about 90 basis points (bp) to about 490 bp; in this backdrop, approaching the capital markets with a bond structure was ruled out. The appetite for bank lending was also limited in view of existing exposures of the lenders to the company, which meant that new capital providers had to be tapped. These factors, when combined with the desire to limit the dilution on voting rights, made the CARS an appropriate vehicle for term financing. A final argument in favour of the CARS was that they would provide a mechanism for foreign institutional investors (FIIs) to freely acquire a stake in the company. As of September 30, 2007, FIIs held a shade more than 21 per cent of the equity and local regulations capped FII holdings at 24 per cent with a proviso that any trade that might take FII holdings beyond 22 per cent would need the prefact approval of the Reserve Bank of India. As a result, FIIs usually

traded amongst themselves in order to stay within the limits. This constraint could hamper a “true” price for an FII buying the stock — something that the CARS provided a solution to. These were some of the reasons for the issuance of CARS in 2007 but changed circumstances caused the company to extend an exchange offer in late 2009. Some developments during these two years are described below. For the holders of CARS, the exchange offer posed a possible opportunity based on whether they decided to accept the offer or to pass on the offer.

In the year ended March 31, 2009, the company recorded a net turnover of Rs1,473,293 million and its profit after tax, minority interest and share of profits from associates was Rs49,509 million. In the quarter ending June 2009, the consolidated bottom line was a loss due to lower prices and production losses at Corus. During the quarter, Corus operated at 60 per cent capacity after slowdown in demand from the auto industry and from the building industry. For the quarter ending June 30, 2009, Tata Steel recorded net sales of Rs232,923.10 million and loss after tax, minority interest and share of profits from associates of Rs22,086.80 million. The share price of the company on November 11, 2009, was Rs526.35 on the Bombay Stock Exchange Limited (BSE) and Rs526.55 on the National Stock Exchange of India Limited (NSE). For more information on the financial statements and for stock prices on the stock exchanges, refer to Exhibit 1 and Exhibit 2. For exchange rates between the US\$ and Indian Rupee and for dividend payouts, see Exhibit 3 and Exhibit 4. A summary of some of the major events that took place between November 2007 and November 2009 that could affect the existing or future outlook of the company is presented in Exhibit 5. The shareholding pattern of the company as on September 30, 2009 is available in Exhibit 6.

According to data compiled by Bloomberg, between 2011 and 2013 Tata Steel had debt obligations of about US\$7.5 billion coming up for redemption. The company had incurred a substantial amount of indebtedness in connection with the acquisition of Corus and as of September 30, 2009, the total outstanding indebtedness was Rs303,462 million. On February 5, 2009, Standard & Poor’s lowered the company’s rating to BB with negative outlook due to weak market conditions; on April 3, 2009, Fitch lowered the company’s rating to BB+ with negative outlook; and on June 8, 2009, Moody’s lowered the company’s rating to Ba3 with stable outlook.

The downturn in the global economy that accelerated during the second half of 2008 had caused a sharp reduction in worldwide demand for steel. At the same time, driven in part by strong growth in steel consumption in China, the global steel industry experienced an expansion of production leading to some overcapacity. Steel prices had been volatile and the global steel industry had historically been cyclical. After rising during 2007 and through the summer of 2008, steel prices in global markets fell sharply beginning in the late summer of 2008 as a result of collapsing demand and the resulting excess supply in the market. The fall in prices during this period adversely affected the results of steel producers generally, including the company, resulting in lower sales revenues and write-downs of finished steel products and raw material inventories.¹

According to the 103rd Annual Report of Tata Steel Ltd, “The company’s financial strategy is focused on optimizing the cost of capital in its marginal financing, improving its credit rating and efficient allocation of resources. This is designed to enable the company to focus on rebalancing its capital structure for the long term benefit of shareholders.” On the state of the business environment, the report said, “In the second half of 2008-09, a sharp decline in steel demand and prices and reduced capacity utilization had severely eroded the profitability of Tata Steel Europe.”² A very gradual economic recovery has started to take shape in 2009-10.”

¹ Offering circular dated November 19, 2009.

² Company registered in England and parent of certain entities, including Corus.

THE EXCHANGE OFFER

On November 11, 2009, Tata Steel Limited extended an invitation to the holders of the one per cent convertible alternative reference securities (CARS) due in 2012 to exchange any or all of such CARS for U.S.-dollar-denominated 4.5 per cent convertible bonds (FCCBs) due 2014. These FCCBs issued by Tata Steel Limited were convertible in to ordinary shares of the company.

The exchange offer consisted of an Early Offer open from November 11, 2009, to November 12, 2009, and a Late Offer open from the close of the Early Offer through to November 16, 2009. The Early Offer allowed the CARS holders to convert a US\$100,000 principal amount of CARS into US\$111,000 of the FCCBs and the Late Offer allowed conversion into US\$109,500 of the FCCBs. The offer was subject to a minimum issue size of US\$350 million. The settlement for the CARS holders accepting the offer would take place on November 20, 2009, subject to the approval of the Reserve Bank of India for the conversion to the new FCCBs. Standard Chartered Bank, ABN AMRO Bank, Citigroup and Calyon were the managers of the exchange offering. The key terms of the FCCBs versus the CARS are described in Exhibit 7.

In a filing with the Singapore Stock Exchange on November 11, 2009, the company stated that it was making the exchange offer with the objectives of i) lengthening its debt maturity profile; ii) reducing the cost; and iii) potentially reducing future repayment obligations.

The BS Reporter of November 13, 2009, highlighted that this move would extend the redemption date by two years. Terming the offer attractive for CARS holders, a senior vice-president of Edelweiss Securities was quoted as saying “There is uncertainty over the share price reaching the conversion price by 2011-12. If conversion fails, the company has to fund redemption liabilities through internal accruals or raising fresh debt. With the swap, there would be an \$875 million reduction in the company’s outstanding debt, assuming full acceptance of the offer. The company feels it is the right time to raise money, though they have two-three years still left to reach the conversion.”³ Soon after the exchange offer announcement, the shares of the company fell 2.75 per cent in a weak Mumbai market.

DIFFERENTIAL VOTE SHARES IN INDIA

Indian companies had been allowed to issue shares carrying differential rights as to voting and/or dividends under the Companies Act, 1956, if the conditions specified under the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001, were met. However in spite of the rules being framed as early as 2001, Indian markets witnessed limited issuances of shares carrying differential rights. The following were the only two companies having differential vote shares listed on the stock exchanges:

- a. Tata Motors Limited — Shares carrying differential vote and dividend rights termed as “A” Ordinary Shares were issued as part of its rights issue offering in 2008. The “A” Ordinary Shares carried inferior rights as to voting (one vote for every 10 “A” Ordinary Shares held) and superior dividend rights (five percentage points of additional dividends over the ordinary shares during any financial year in which dividends would be declared). Tata Motors Limited was the first company in India to issue CARS as a zero coupon bond.
- b. Pantaloon Limited — Shares carrying differential vote and dividend rights termed as Class B Shares were issued as bonus shares in 2008. The Class B Shares carried inferior rights as to voting (one vote

³ “Tata Steel offers to swap \$875 mn of securities,” www.business-standard.com, accessed on November 13, 2009.

for every 10 Class B Shares held) and superior dividend rights (five percentage points of additional dividends over the ordinary shares during any financial year in which dividends would be declared).

Exhibits 8 and 9 have the trading patterns of Tata Motors Limited “A” Ordinary Shares and Pantaloon Limited Class B Shares.

The Companies Bill, 2008, which was yet to be passed by the Parliament of India as of November 2009, had no provisions for the issue of shares carrying differential rights as to dividends or voting, as opposed to the Companies Act, 1956.

The Securities and Exchange Board of India (SEBI) had, through its circular dated July 21, 2009, amended the Listing Agreement and inserted clause 28A, which prevented companies from issuing shares that conferred on any person superior rights as to voting or dividends vis-à-vis existing listed equity shares. Tata Motors Limited had sought clarification from the SEBI on the impact of the amendment to the Listing Agreement on its existing outstanding “A” Ordinary Shares and its ability to issue further “A” Ordinary Shares in the future. The clarification from SEBI was awaited as of November 2009.

INVESTMENT PROPOSAL

An investment analyst with Lombard Odier Darier received the offer invitation from Tata Steel Ltd for the conversion of its existing CARS into the new FCCBs. Lombard Odier Darier was one of the larger holders of the CARS, having them in a number of its portfolios. The analyst was required to present a recommendation to her investment committee to either hold on to the existing CARS (trading history in Exhibit 10) or to convert them into FCCBs at either the Early Offer period or the Late Offer period.

Professor Vasant Sivaraman and Professor Mayank Joshipura are with S P Jain Institute of Management and Research, Mumbai, India, and Adithya Anand is with JM Financial Consultants P Ltd, Mumbai, India.

Exhibit 1

SUMMARY FINANCIALS OF TATA STEEL LIMITED

Consolidated Profit and Loss Data

Particulars	FY 2007 in Rs million	FY 2008 in Rs million	FY 2009 in Rs million	FY 2009 in US\$ million
Net sales	252,172	1,315,336	1,473,293	28,962
Material expenses	91,799	602,287	729,377	14,338
Employee expenses	20,380	168,996	179,751	3,533
Other manufacturing expenses	67,021	366,229	382,888	7,527
EBIDTA	72,971	177,824	181,277	3,564
Depreciation	10,110	41,370	42,654	838
Other income	2,142	4,759	2,657	52
Net finance charges	1,873	40,854	32,902	647
Extraordinary items loss/(gain)	0	(63,351)	40,945	805
PBT	63,130	163,711	67,432	1,326
PAT	41,656	123,218	48,492	953
PAT after minority interest	41,773	123,500	49,509	973
Basic EPS	64.70	176.80	66.1	1.30
Diluted EPS	64.70	162.60	59.0	1.16

Consolidated Balance Sheet

Particulars	FY 2007 in Rs million	FY 2008 in Rs million	FY 2009 in Rs million	FY 2009 in US\$ million
Total shareholders' funds	146,222	341,740	277,143	5,448
Loans	249,255	536,247	599,005	11,775
Provision for employee separation	11,183	10,801	10,424	205
Total assets	420,748	921,936	913,551	17,959

Consolidated Cash Flows

Particulars	FY 2007 in Rs million	FY 2008 in Rs million	FY 2009 in Rs million	FY 2009 in US\$ million
Cash flow from operating activities	55,030	133,937	156,299	3,072
Cash flow from investing activities	(162,882)	(461,985)	(107,567)	(2,115)
Cash flow from financing activities	204,803	205,426	(27,540)	(541)

Source: Offering circular dated November 19, 2009.

Exhibit 2

TRADING PATTERN IN THE COMPANY'S EQUITY SHARES

Particulars	BSE			NSE		
	High	Low	Trading volume	High	Low	Trading volume
Fiscal year						
2007	670.7	385.0	1,649,233	671.1	384.2	3,842,907
2008	990.6	424.1	996,884	988.9	423.9	2,650,777
2009	922.3	148.7	2,476,130	922.0	148.8	5,470,851
Monthly						
April 2009	293.4	209.9	5,418,961	293.0	209.8	15,140,257
May 2009	406.3	263.0	4,843,098	405.4	263.2	14,169,264
June 2009	487.9	387.9	4,577,895	488.1	388.3	12,624,289
July 2009	469.0	338.9	4,538,869	471.2	339.0	13,657,299
August 2009	483.6	424.3	3,540,762	485.2	424.3	11,233,688
September 2009	531.6	416.5	3,114,861	530.1	415.1	9,720,839
October 2009	575.3	468.1	2,132,257	575.2	467.7	7,675,573
Period ended November 16, 2009	535.1	445.6	2,487,154	536.6	445.3	8,206,460

Source: Offering circular dated November 19, 2009.

Exhibit 3

RUPEE PER U.S. DOLLAR EXCHANGE RATES

Particulars	Period end	Average	High	Low
Year ended March 31, 2003	47.5	48.4	49.1	47.5
Year ended March 31, 2004	43.4	45.9	47.5	43.4
Year ended March 31, 2005	43.8	45.0	46.5	43.4
Year ended March 31, 2006	44.6	44.3	46.3	43.3
Year ended March 31, 2007	43.6	45.3	47.0	43.1
Year ended March 31, 2008	40.0	40.2	43.2	39.3
Year ended March 31, 2009	51.0	45.9	52.1	39.9
Month ended				
April 2009	50.2	50.1	50.5	49.5
May 2009	47.3	48.5	49.8	47.2
June 2009	47.9	47.8	48.9	46.8
July 2009	48.16	48.48	49.40	47.79
August 2009	48.88	48.34	48.98	47.54
September 2009	48.04	48.44	49.06	47.96
October 2009	46.96	46.72	47.86	45.91
Period ended November 16, 2009	46.09	46.69	47.13	46.09

Source: Offering circular dated November 19, 2009.

Exhibit 4

DIVIDEND HISTORY

Fiscal year	Ordinary share capital in Rs million	Dividend per share	Dividend payout (%)
2004	3,691.80	10.00	24
2005	5,536.70	13.00	24
2006	5,536.70	13.00	23
2007	5,806.70	15.50 ⁽¹⁾	26
2008	7,307.80	16.00	30
2009	7,307.80	16.00	29

(1) Includes special dividends of Rs2.50 per share.

Source: Offering circular dated November 19, 2009; 103rd Annual Report, Tata Steel Ltd.

Exhibit 5**SOME MAJOR EVENTS BETWEEN NOVEMBER 2007 AND NOVEMBER 2009**

In November 2007, the company made a rights offering to its shareholders pursuant to which the company issued and allotted a total of 121,619,615 equity shares and 547,266,011 compulsorily convertible preference shares (CCPS). Every six CCPS issued would automatically be converted into one equity share on September 1, 2009, up to a maximum of 91,211,002 equity shares. The company raised a total of Rs91,209 million through the rights issue of which Rs90,000 million was used to repay short-term loans taken from State Bank of India and other banks.

1. In January 2008, the company entered into a loan agreement with State Bank of India and other banks for Rs25,000 million with maturity in June 2013. The proceeds were used for the refinancing of the borrowings with respect to the Corus acquisition.
2. In May 2008, the company issued Rs20,000 million non-convertible debentures (NCDs). The NCDs were divided into three series, two of which carried fixed rate interest, while one carried floating rate interest. The NCDs were to mature in seven, three and three years, respectively.
3. In May 2008, the company entered into a loan agreement with Axis Bank for Rs20,000 million with a maturity date of May 2010.
4. In November 2008, the company issued Rs12,500 million of NCDs carrying a fixed rate of interest and redeemable in three equal installments at the end of the sixth, seventh and eighth years.
5. In March 2009, the company entered into a loan agreement with State Bank of India for Rs20,000 million maturing in October 2014.
6. In May 2009, the company issued two series of NCDs of Rs15,000 million and Rs6,509 million that would be redeemed as a bullet repayment in May 2019.
7. In June 2009, the company entered into loan agreements with Housing Development Finance Corporation for Rs6,500 million maturing in June 2019.
8. In June 2009, the company entered into a loan agreement with Infrastructure Development Finance Company Limited for Rs1,990 million, which had a variable interest rate and a tenor of seven years.
9. In July 2009, the company issued global depository receipts (GDRs) for a gross amount of US\$500.00 million and allotted 65,410,589 GDRs. Each GDR represented one equity share.

The company acquired 3,400 acres of land for the proposed Orissa steel plant planned with a total capacity of six million tons per annum (mtpa). The company additionally entered into two memorandums of understanding with the Chhattisgarh and Jharkhand state governments to set up two steel plants with aggregate capacities of five mtpa and twelve mtpa.

Exhibit 6

SHAREHOLDING PATTERN AS OF SEPTEMBER 30, 2009

Category	Number of Shares	% held
Promoters	276,646,877	31.18
Mutual funds and UTI	32,207,198	3.63
FIs and banks	2,410,117	0.27
Central government and state government	121,659	0.01
Insurance companies	170,089,184	19.17
Foreign institutional investors	144,965,027	16.34
Foreign institutional investors — DR	20,284,920	2.29
Foreign bodies — DR	1,622,300	0.18
Bodies corporates	27,840,082	3.14
HNIs	167,005,855	18.82
Individuals retail	25,701,030	2.90
Trusts	5,336,720	0.60
Foreign corporate bodies	6,300	0.00
Custodians holding shares on behalf of DR holders	12,976,792	1.46
Total	887,214,061	100.00

Source: Bombay Stock Exchange website, www.bseindia.com, accessed June 16, 2010.

Exhibit 7

COMPARISON OF KEY TERMS OF THE CARS VERSUS THE FCCBs

Key Terms	CARS	FCCBs
Due date	September 4, 2012	November 21, 2014 (five years and one day)
Coupon rate	1% p.a. payable semi-annually	4.5% p.a. payable semi-annually
Status	Not rated but backed by letter of credit issued by Standard Chartered Plc	Direct, unconditional, unsubordinated and unsecured
Conversion right	Convertible into qualifying securities or shares at any time on or after September 4, 2011, and prior to August 6, 2012	Convertible into equity shares at any time on or after December 31, 2009, up to the close of business on November 11, 2014
Convertible into	If there has been a qualifying issue of qualifying securities then convertible into qualifying securities else into equity shares	Convertible into equity shares
Conversion price	Rs.733.1318 per equity share (reset price) at a fixed exchange rate of Rs.40.25 per US\$	Rs.605.5325 per equity share at a fixed exchange rate of Rs.46.36 per US\$
Mandatory conversion period	No mandatory conversion price	At any time on or after November 20, 2012, and prior to seven business days of the due date, provided that the closing price of the shares (translated into the then exchange rate for any 10 trading days out of the 30 consecutive trading days prior to the mandatory conversion notice) was at least 130 per cent of the conversion price at the then conversion price
Qualifying securities	Defined as either (i) A depository receipt (DR) issued in respect of one share on terms similar to GDR but where the holders had no right to convert into the underlying share (ii) An equity share issued by the company with differential rights as to dividends or voting (DVS) provided that the dividends received on such shares would be at least as favorable as dividends on existing shares (iii) A DR issued in respect of DVS	N/A
Accelerated principal amount	If the CARS were called for redemption prior to the due date, the redemption value would be calculated to provide a constant yield of 5.15% inclusive of accrued interest	N/A
Redemption value	US\$123,341.90 per US\$100,000 of the principal value of CARS	Redeemable at face value
Anti-dilution rights	Standard anti-dilution rights	Standard anti-dilution rights

Exhibit 8

TATA MOTORS LIMITED — “A” ORDINARY SHARES REBASED

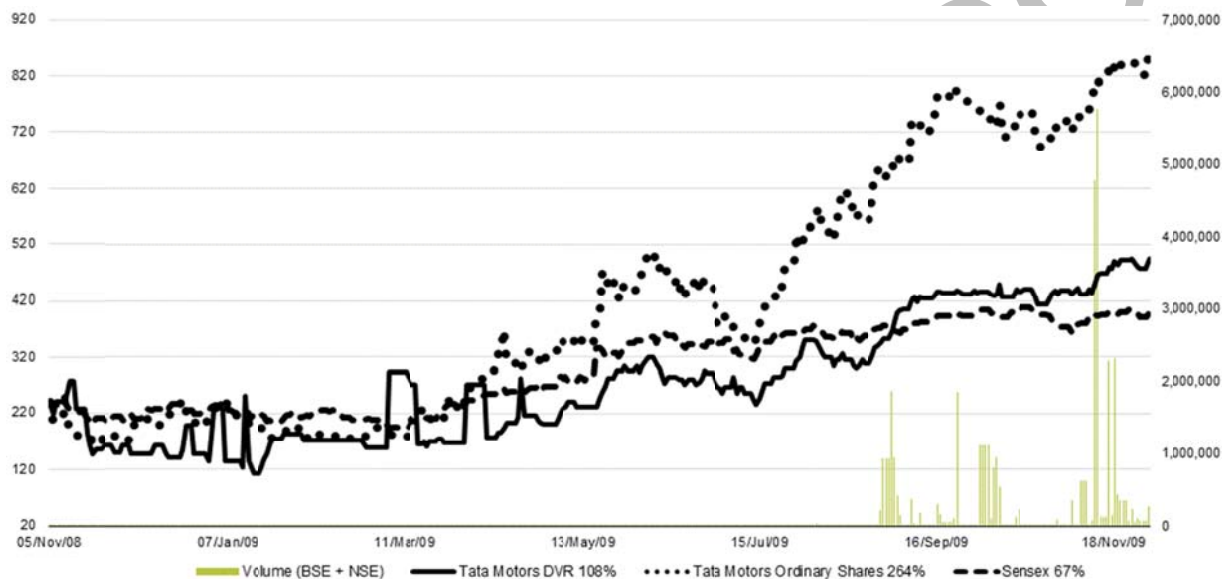


Exhibit 9

PANTALOON LIMITED — CLASS B SHARES REBASED

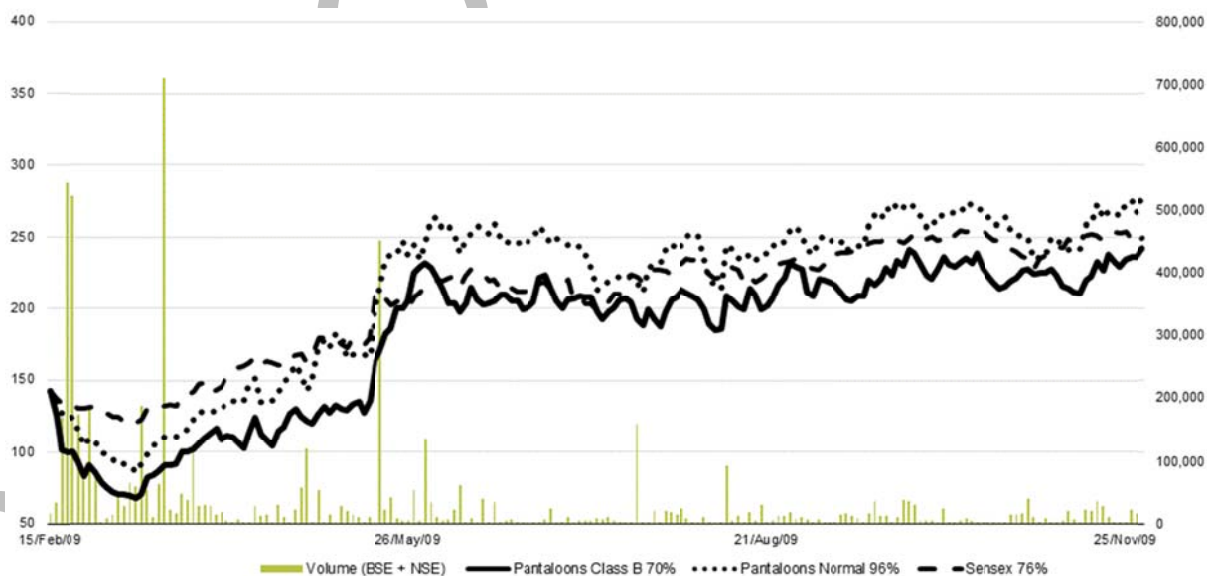
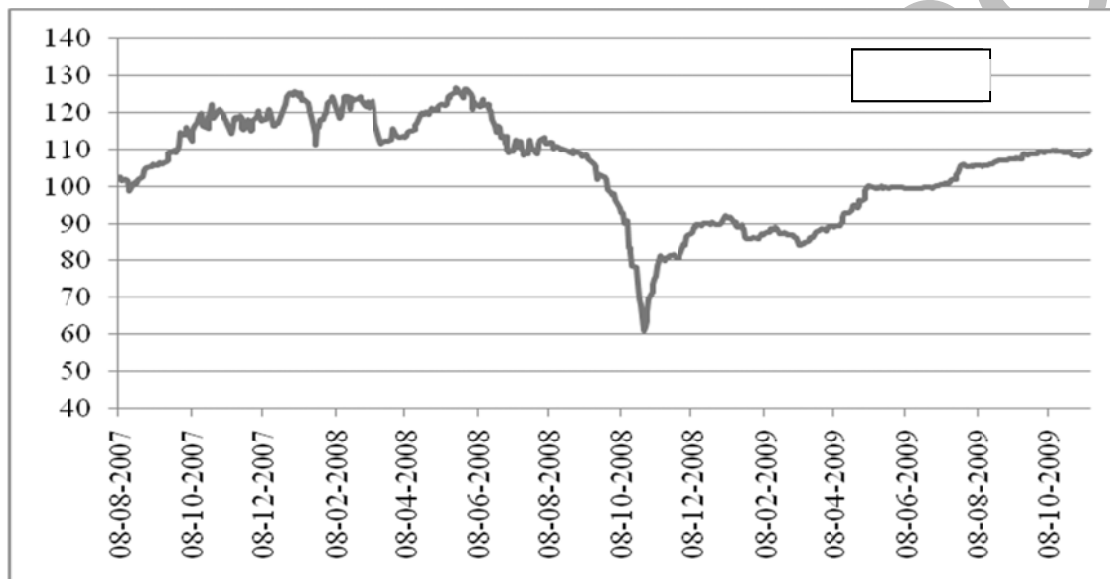


Exhibit 10
CARS TRADING HISTORY



Source: SGX.