IDFC SSKI
INDIA RESEARCH

Automobiles

Escorts

Rs147

Reshaping the future

Mkt Cap: Rs11.8bn; US$260mn

Reason for report: Initiating coverage

OUTPERFORMER

Escorts has emerged leaner and stronger post its restructuring exercise, wherein it has exited unprofitable businesses and used the sale proceeds to reduce its debt burden from Rs8.8bn in FY05 to Rs4bn (gearing at 0.3x as of FY09). Core business segments (agri machinery, construction equipment and engineering equipment) are witnessing strong growth traction, and we see Escorts well-positioned to capitalize on the opportunity with adequate capacity and a new management in place. We expect 48% earnings CAGR for Escorts over FY09-12. Escorts' priority from here would clearly be to optimize shareholder value by focusing on improving return ratios, targeting better working capital management and working on zero debt. Initiating coverage with Outperformer and a 12-month price target of Rs195 – 33% upside from CMP.

Corporate restructuring has helped reduce leverage: Having exited loss-making businesses and reduced its debt to Rs4bn from Rs8.8bn in FY05, Escorts is all set to focus on the core businesses. Escorts Agri USA (a subsidiary) has also been merged with the parent and balance sheet issues (bad debtors, obsolete inventory, etc) stand resolved. Post the restructuring, the focus is on agri machinery (72% of FY09 sales; 87% of EBIT), construction equipment (16%; 10%), railway equipment (7%; 25%) and auto components (3%; loss making).

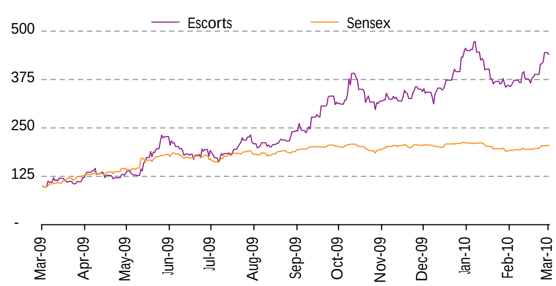
Focus on core segments; we expect 48% earnings CAGR over FY09-12: Performance of tractor business has improved considerably (margins at all-time high of 11% in Q4FY09; market share up 400bp from 9% in FY06), and momentum should sustain in the construction equipment and its most profitable railway equipment division (39%yoy growth in FY09). With renewed management focus, adequate capacity, immense growth potential across businesses, cost-cutting efforts and reduced interest burden, Escorts is expected to witness a sharp delta swing in earnings (estimated EPS at Rs24.1 for FY12 against Rs7.4 for FY09).

Valuations attractive; Outperformer: The restructuring could not have come at a more opportune time as all businesses are set to exhibit good growth traction. With professionals having extensive and relevant industry experience at the helm, the right product mix and latest technology, each business segment would witness robust earnings growth and higher return ratios. In recognition of the strong growth potential, we expect the stock to be re-rated. Initiating coverage with Outperformer and a 12-month price target of Rs195.

Key valuation metrics

Year to 30 September	FY08	FY09	FY10E	FY11E	FY12E
Net sales (Rs m)	27,661	26,617	31,676	36,080	41,302
Adj. net profit (Rs m)	(131)	645	1,544	1,704	2,102
Shares in issue (m)	81	81	84	84	84
Fully Diluted EPS	(1.5)	7.4	17.7	19.5	24.1
% change	(326.6)	(594.6)	139.2	10.4	23.4
PE (x)	n/a	19.9	8.3	7.5	6.1
Price/ Book (x)	1.2	0.8	0.8	0.7	0.6
EV/ EBITDA (x)	14.4	6.4	4.5	3.7	2.8
RoE (%)	(1.3)	5.3	10.1	10.1	11.4
RoCE (%)	3.6	7.7	10.1	11.6	13.0

Price performance



Bloomberg: ESC IN	**6m avg daily vol. (m): 2.82**
1-yr High/ Low (Rs): 160 / 31.8	**Free Float (%): 69.9**

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Consolidated debt down to ~Rs4bn as of Sep-2009 from Rs8.8bn in FY05

Focus returns to core business; initial signs of a marked turnaround post management level re-jig

INVESTMENT ARGUMENT

- **As a part of restructuring, Escorts has exited all its loss making businesses and utilized the sale proceeds to reduce leverage and strengthen balance sheet**
- **Focus back on core businesses, viz. agri machinery, construction equipment and engineering equipment – all of them witnessing strong growth traction**
- **Adequate capacity in place; to enable Escorts to grow without substantial fund infusion into any of the businesses**
- **Expect sharp delta swing in forward earnings – and thereby higher return ratios**
- **We assign a target multiple of 10x FY11E earnings (5x EV/ EBITDA) for Escorts – a 30% discount to Mahindra & Mahindra, the market leader in tractors. Initiating coverage with Outperformer and a price target of Rs195**

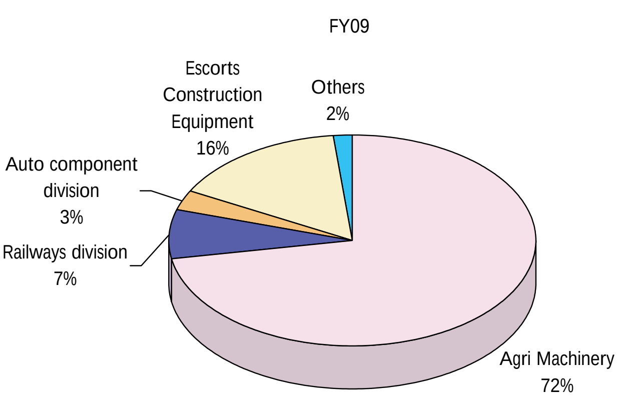
Escorts – a cleaner and stronger balance sheet post restructuring

Since early 2004, Escorts has been undergoing a business restructuring exercise by exiting all its loss making units with focus back on the core businesses, viz. tractors, construction equipment and engineering equipment (comprising railway equipment and auto components). Proceeds from the sale of loss-making units have been utilized to cut debt (Rs4bn as of FY09 from Rs8.8bn in FY05). The reduced leverage would lower its interest burden substantially, which in turn would aid earnings expansion going forward. Further, Escorts Agri Machinery, USA (EAMI) – a subsidiary – has been merged with the parent after filing for insolvency. Balance sheet concerns now stand addressed as certain investments, fixed assets, doubtful debts, etc have been written off against a Business Reconstruction Reserve.

Focus on core businesses; strong growth traction ahead

Post the restructuring, focus has been on the core business of tractors, and construction and engineering equipment. The restructuring, we believe, could not have been effected at a more opportune time as all the businesses are exhibiting good growth traction. Further, Escorts has – as a part of the restructuring – brought about considerable changes in key senior personnel positions across segments to improve the management bandwidth. The new team has proved its execution capabilities – evident in the sharp swing in earnings over the last few quarters (PAT of 234m in Q1FY10 against a marginal loss of Rs3m in Q1FY09). This infuses confidence in the company's ability to achieve growth targets set across various divisions.

Exhibit 1: Escorts – revenue-wise break-up (FY09)



Expect strong earnings growth across segments (FY09-12E)

(%)	Rev. CAGR	Margins	EBIT CAGR
Agri Machinery	16	8-10	18
Engg: Railway equipment	15	22-24	17
Engg: Auto component equipment	11	NA*	NA
Construction equipment	18	5-7	42

**Currently loss making*

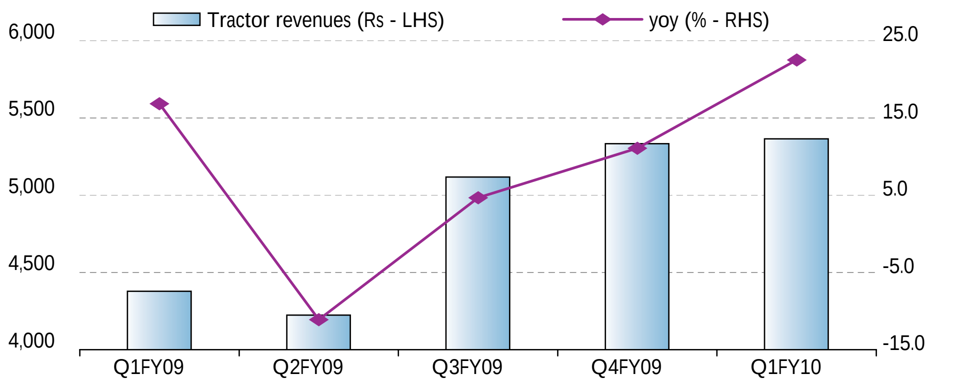
Source: Company, IDFC SSKI Research

Market share gains and margin expansion over the last few quarters

Agri Machinery division – back on growth path

Escorts' tractor segment performance has significantly improved with market share rising to 13% from 9% in FY06. Margins too have touched an all-time high of 11% in Q4FY09 (4% at the beginning of the fiscal), led by stronger topline growth and cost cutting initiatives as well as better working capital management. The company is set to launch 7-8 new tractor variants in FY10. With annual capacity of 98,940 units and sales of only about 45,627 units in FY09, Escorts is well placed to capitalize on the growth opportunities in the sector.

Exhibit 2: Tractor sales have significantly improved in the recent past



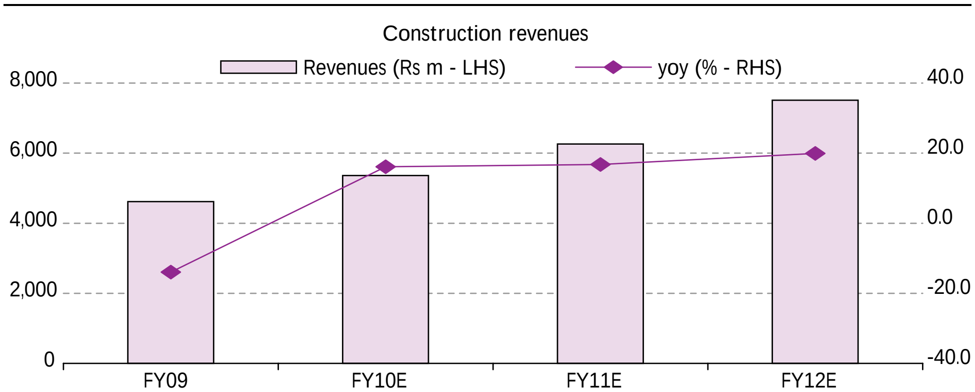
Source: Company, IDFC SSKI Research

Strong growth momentum in construction activity to drive earnings growth for Escorts

Construction Equipment division – full of promise

Escorts is the world's largest manufacturer of Pick 'n' Carry Hydraulic Mobile Crane (54% market share in India) and commands a 25% market share in the vibratory compactor segment. Escorts is consolidating its leadership position in this business by focusing on technological advancements, introducing new and improved products and tying up with international manufacturers to market their products in India. Going forward, Escorts aims to be a one-stop shop for providing end-to-end solutions to the construction industry. Further, with the expiry of non-compete agreement with JCB, its erstwhile JV partner, Escorts can now manufacture and sell competing products in India. Given the robust future outlook, we expect 18% 3-year revenue CAGR, to Rs7.5bn by FY12E, and 42% EBIT CAGR in the business.

Exhibit 3: Expect 18% revenue CAGR over FY09-12E in the Construction equipment business



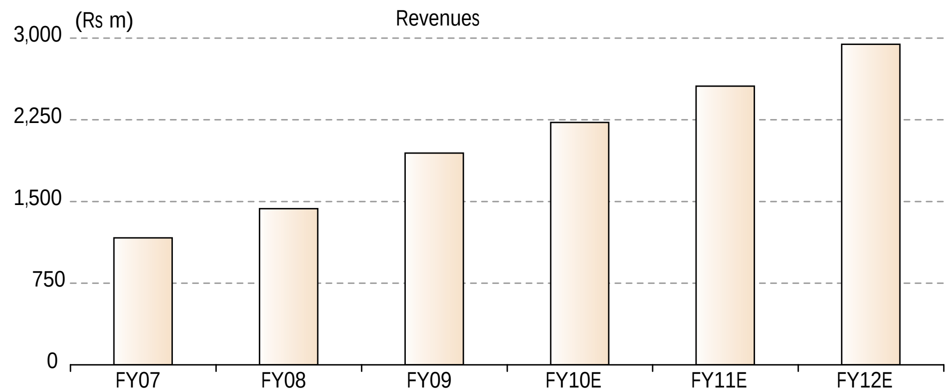
Source: Company, IDFC SSKI Research

Strong relationship with IR – Escorts expected to be the key beneficiary of hefty capex spend by IR

Railway Equipment division – on a roll

The railway equipment business has witnessed a robust 31% revenue increase over FY07-09. Notably, the IR has embarked on a massive modernization programme, with focus on safety and technology upgradation, involving a capex of Rs2.5trn. Given its extremely strong relationship with the entity, Escorts is well poised to capitalize on this tremendous growth opportunity. Further, with IR now according preference to domestic vendors vis-à-vis international suppliers, domestic players (including Escorts) are likely to witness higher order inflows from the IR. Led by the robust demand potential from IR, we have factored in 15% revenue CAGR for Escorts in this business over FY09-12. Notably, the business fetches high operating margins of ~25%, and hence would boost consolidated earnings going forward.

Exhibit 4: Strong revenue growth over the last few years



Source: Company, IDFC-SSKI Research

Auto Suspension division – breaking even

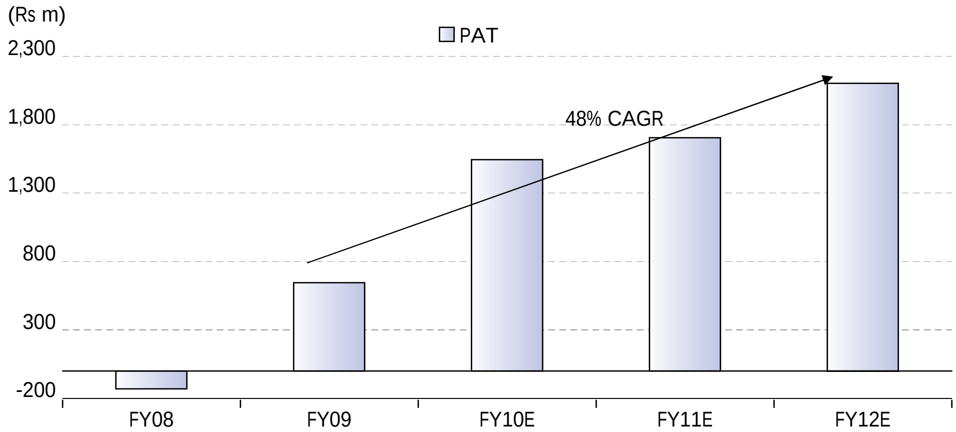
Escorts is the leader in auto suspension products including shock absorbers, struts and telescopic front forks. Driven by robust offtake from the domestic/ global OEM segments as well as the replacement market, the auto component industry is likely to touch USD40bn in size by 2015-16 (USD18bn currently). With much higher offtake, coupled with aggressive cost cutting measures (currently underway), we expect this division to break even at the operating level by FY11.

❑ Expect 48% earnings CAGR over FY09-12

Higher volumes and enhanced efficiency expected to drive 48% earnings CAGR for Escorts over FY09-12

With core business segments witnessing strong growth traction, Escorts is well poised to capitalize on the opportunity. The company has adequate capacity in place across divisions. With repayment of term loan of ~Rs1bn in FY09 and prudent working capital management, Escorts has been able to reduce its interest burden significantly to Rs68m in Q1FY10 from Rs164m in Q1FY09. On the back of adequate capacity, immense growth potential across businesses, cost-cutting efforts and reduced interest burden, Escorts is likely to witness a sharp delta swing in earnings (estimated EPS at Rs24.1 for FY12 against Rs7.4 for FY09).

Exhibit 5: Earnings on a higher growth trajectory



Source: Company, IDFC SSKI Research

❑ Valuations appear attractive; initiating coverage with Outperformer

Buy the stock with a 12-month price target of Rs195 –33% upside from current price

With professional business leaders at the helm of each core business, the right product mix and leveraging technology, Escorts' transformation is now clearly evident. Management's priority from here would be to optimize shareholder value by focusing on its core business segments, improving return ratios, better working capital management and targeting zero debt.

At CMP, the stock trades at 6.1x FY12E earnings and 2.8x EV/EBIDTA and appears very attractive. Given that each segment is witnessing robust earnings growth, which would translate into stronger return ratios, the business is a prime candidate for re-rating. We assign a target multiple of 10x FY11E earnings (5x EV/ EBITDA) for Escorts – a 30% discount to Mahindra & Mahindra, the market leader in tractors to account for the considerable difference in market share and size of the two players. Initiating coverage with Outperformer rating and a 12-month price target of Rs195.

Exhibit 6: Comparative valuations

	CMP (Rs)	Mkt Cap (Rs bn)	Earnings CAGR FY09-11E (%)	PE (x) @FY11E
Escorts	147	11.8	62	7.5
M&M	1,122	306	26	13.6

Source: IDFC SSKI Research

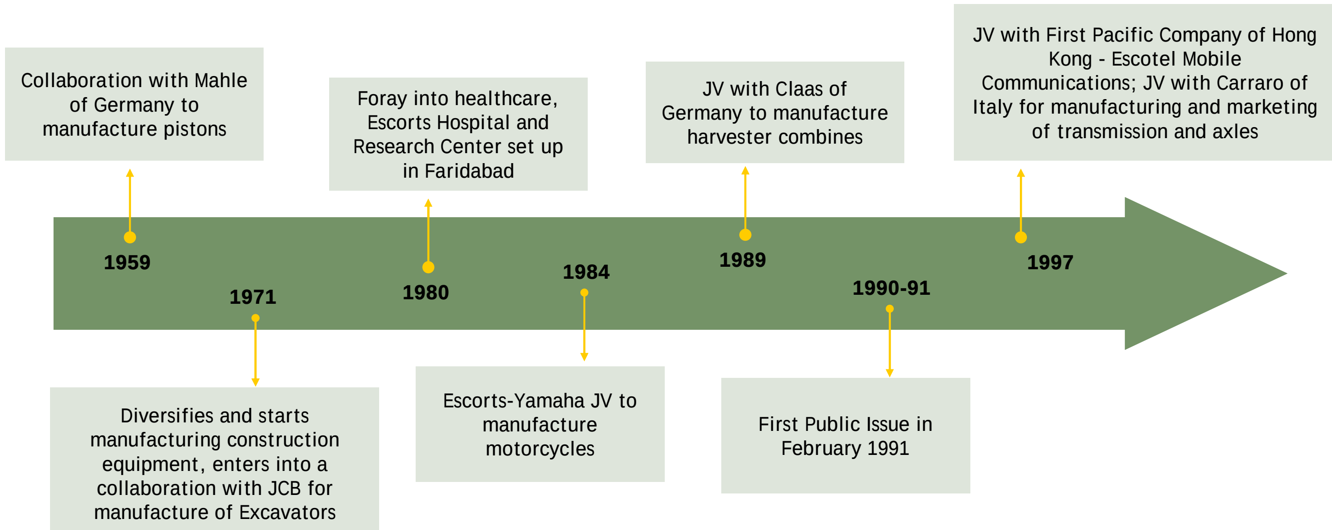
Escorts: Back in business

- **Escorts among India's top three manufacturers and exporters of agri machineries with leadership in 41-50hp tractors**
- **While diversification into too many businesses in 1990s diluted management focus, ambitious ventures like telecom and hospitals were a drain on balance sheet**
- **The cyclical downturn (over FY01-03) in tractor business, Escorts' cash cow, led to precarious balance sheet health with huge debt on books**
- **Business restructuring over the last four years has enabled Escorts to cut debt by using proceeds from sale of loss-making businesses; also, focus is back on core business of agri machinery, and construction and engineering equipment**

❑ Escorts – a chequered history…

Escorts started out in 1944 as an agency to sell tractors in Lahore, Pakistan, and became a franchisee of Massey Ferguson tractors in India in 1949 under the leadership of Mr H.L. Nanda. In the year 1961, the company set up a facility at Faridabad (Haryana) for manufacturing tractors in collaboration with URSUS of Poland and launched the Escort brand of tractors. Highlighted below are the key milestones for the company.

Exhibit 7: Escorts: Diversification into too many businesses – a key concern in the recent past



Source: Company

The capital-guzzling telecom and hospitals business a major strain on balance sheet…

During its long journey, Escorts ended up diversifying into too many businesses, which eventually resulted in diffused focus. While presence in too many business segments diluted management attention, funds generated from the core business of agri-machinery too had to be ploughed into new ventures – especially the capital-intensive telecom and hospitals businesses. While the agri-business was a cash cow for Escorts all this while, three successive monsoon failures till FY01 pushed the tractor industry into a cyclical downturn. With the only source of cash flow drying, the company subsequently got trapped into a debt quagmire (taken up to fund new businesses) while the telecom business as also some other ventures still required considerable fund infusion.

...eventually sold off to reduce debt burden

Eventually, in order to repay the huge debt accumulated over the years as also to focus on core business segments (agri-machinery, construction equipment, railway and auto component), the management sold off all its loss-making business units including the telecom and the hospitals businesses. The company also hived off its loss making JVs in auto-components (Escorts Mahle), agri machinery (Escorts Class & Escorts Agri Machinery USA) and the telecom business (Cellnext Solutions) during the period.

❑ ...but restructuring has undone excesses of the past

Post the restructuring, focus is being laid on the core business of tractors, construction equipment and engineering. The restructuring, we believe, could not have been effected at a more opportune time as all the business segments of Escorts are now exhibiting good growth traction.

Exhibit 8: A new-look Escorts

Escorts restructuring

- Divested stake in 3 JVs to their respective partners for a total consideration of Rs2.35bn
  - i) 40% stake in Escorts JCB – Construction Business
  - ii) 60% stake in Escorts Class – Harvester Business
  - iii) 50% stake in Escorts Mahle – Auto component business
- Sold its telecom business Escotel to Idea for a net cash of Rs2.1bn
- Sold its hospitality business Escorts Heart and Research Institute to Fortis for about Rs5.85bn
- Sold Cellnext (part of the telecom business) to Value First for Rs70mn

→ Proceeds used to repay debt (down to Rs4bn from Rs15bn in FY03)

- Merged Escorts Agri Machinery (USA) with itself
- Created a Business Reconstruction Reserve and wrote off certain investments, fixed assets, doubtful debts and loans and advances, inventories, carry forward losses and other miscellaneous items aggregating to Rs5.9bn against this reserve.

→ Addressed passed balance sheet issues – thereby cleaning up the balance sheet

Current focus on...

Agri machinery	• 3rd largest tractor manufacturer • Expect 16% revenue CAGR over FY09-12E
Construction equipment	• Well placed to capture the robust growth opportunity in this space
Railway equipment	• Supplier to Indian Railways (IR) for 30 years • Robust outlook given Rs2.5trn capex plan of IR over next 5 years
Auto component	• Small business expected to breakeven by FY11

Source: Company, IDFC SSKI Research

❑ Business restructuring centred on debt reduction…

Consolidated debt down to ~Rs4bn as of Sep-2009 from Rs8.8bn in FY05

A business restructuring exercise has been underway at Escorts since early-2004, aimed at reducing debt and exit from loss-making businesses. Proceeds from the sale of these businesses have been utilized to reduce the debt burden (consolidated debt down to ~Rs4bn as of Sep-2009 from Rs8.8bn in FY05). Further, Escorts Agri Machinery, USA (EAMI) – a subsidiary – has been merged with the parent after filing for insolvency. In a bid to clean up its balance sheet by writing off doubtful debtors, obsolete inventory, etc, Escorts has created a Business Reconstruction Reserve (BRR) by transferring amounts lying in Amalgamation Reserve, Capital Redemption Reserve, Revaluation Reserve and Share Forfeiture Reserve as of April 2009. Escorts has also revalued some fixed assets and the resultant difference has been transferred to the BRR. Against this reserve, the company has written off certain investments, fixed assets, doubtful debts and loans and advances, inventories, carry forward losses and other miscellaneous items (total aggregating to Rs5.9bn), thereby cleaning up its balance sheet.

Exhibit 9: A BRR created to address balance sheet concerns

		(Rs m)
Business Reconstruction Reserve		11,896
Balance as on 30 Sep 2008		
Write-Offs / Impairments etc		
Accumulated losses of Escorts Agri Machinery written off	1,567	
Provisions made, written off	1,982	
Dimunition/impairment of investments / assets	1,483	
Depreciation on revalued assets trasferred to P&L account	69.8	
Transfer to revaluation reserve	750	
Total		**5,852**
BRR balance as on 30 Sep 2009		**6,044**

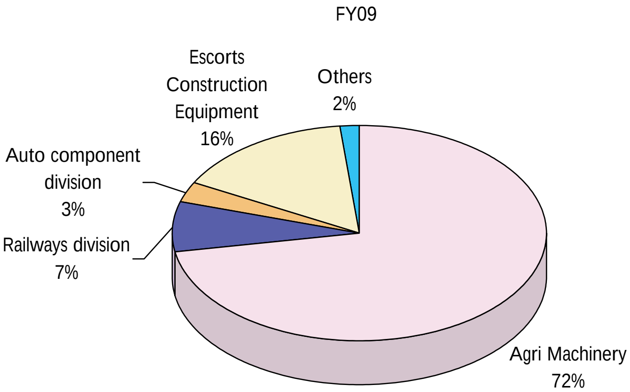
Source: Company

❑ …and emphasis on fast-growing core businesses

Operations streamlined to focus on agri-machinery, construction and engineering equipment

Post the restructuring, Escorts is focused on its core business portfolio comprising agri-machinery (72% of revenues in FY09), construction & material handling equipment (16%; in a 100% subsidiary Escorts Construction & Equipment), railway equipment (7%) and auto components (3%). Escorts is among India’s top three tractor manufacturers. In the railway equipment space, the company has been a supplier of safety components to Indian Railways for the last 40 years. Further, Escorts is the world's largest manufacturer of Pick 'n' Carry Hydraulic Mobile Crane (54% market share in India) and also commands a 25% market share in the vibratory compactor segment. Escorts’ engineering equipment division is the leader in auto suspension products including shock absorbers, struts and telescopic front forks.

Exhibit 10: Escorts – revenue-wise break-up (FY09)



Expect strong earnings growth across segments

FY09-12E (%)	Rev. CAGR	Margins	EBIT CAGR
Agri Machinery	16	8-10	18
Engg: Railway equipment	15	22-24	17
Engg: Auto component equipment	11	NA*	NA
Construction equipment	18	5-7	42

**Currently loss making*

Source: Company, IDFC SSKI Research

Led by an improved economic outlook, robust growth traction expected for Escorts…

❑ The restructured entity poised for a take-off…

Escorts is in a sweet spot. With a steadily improving economy (FY11 GDP expected at 7.4%), all of Escorts' core businesses are poised for robust growth ahead. The restructuring, we believe, could not have been effected at a more opportune time as all the business segments of Escorts are now exhibiting good growth traction. Also, a major part of the debt has been repaid using the proceeds of sale of non-remunerative businesses. With a cleaner balance sheet and loss-making businesses no more a drain, we see Escorts well-positioned to capitalize on the growth potential offered by the core businesses.

…business restructuring and a new management team to fuel growth

❑ …steered by a strong management team

In order to beef up the management bandwidth, Escorts has inducted new talent for critical roles. As a part of this endeavor, a host of senior personnel have been recruited with vast experience in their respective fields. The re-jig at the senior management level has worked well for the company – as is evident in market share gains as also margin expansion in the tractor business as also accelerated growth in railway and construction equipment businesses over the last few quarters. We highlight below a list of new recruits hired at the senior level over the last two years:

Exhibit 11: New management team at Escorts

	Experience	Designation
At corporate level		
Shailendra Agarwal	27	Chief of Operations
O K Balraj	28	Executive VP & Group CFO
Partha Pratim Dasgupta	31	Group Head - HR & ER
Ciby Cyriac James	26	VP, Business Excellence and Quality
Praveen Kumar Sinha	27	Chief General Manager Corporate HR
AC Sharma	33	AVP - Marketing
Vipin Kumar	15	Chief General Manager IT
Manish Singhal	21	VP - International Business
Agri machinery business		
Anil Kumar	21	GM - HR and IR
Rahtosh Mal	29	Executive Director and CEO
Engineering equipment division		
Arun Babbar	31	Head - Manufacturing

Source: Company

AGRI MACHINERY: GROWTH IS BACK!

- **A comprehensive product range with >45 variants of tractors within the 25-80HP category; market leader in 41-50HP category with a 29% share**
- **Market share in the tractor segment up to 13% from 9% in FY06 on the back of new product launches**
- **Margins have touched an all time high of 11% in Q4FY09 driven by cost cutting measures (sourcing efficiencies, value engineering, etc) and higher volumes**
- **Tractor sales to remain buoyant led by favorable policy initiatives and expectations of a bumper rabi crop**
- **With adequate capacities in place, we see Escorts well placed to capitalize on the growth opportunities**

Tractor business (72% of FY09 revenues; 87% of EBIT)…

A comprehensive product range with more than 45 variants of tractors within the 25-80HP category

Among India's top three tractor manufacturers, Escorts offers a comprehensive product range with more than 45 variants of tractors within the 25-80HP category. Escorts is the market leader in the 41-50HP category with a 29% share as of end-FY09. Importantly, ~51% of its total domestic tractor sales accrue from this segment. Escort, Farmtrac and Powertrac are Escorts' key brands:

- Farmtrac: World-class premium tractors between 34-75 HP
- Powertrac: Utility and value-for-money tractors between 34-55 HP
- Escort: Economy tractors between 27-35 HP

Escorts 3rd largest tractor player

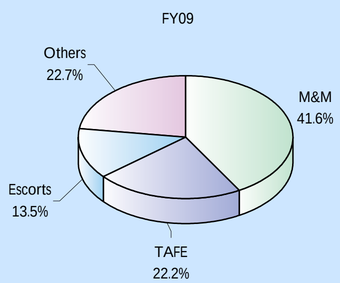


Exhibit 12: Category-wise market share – Escorts leader in the 41-50HP tractor category

(%)	Up to 30 hp	31-40 hp	41-50HP	>50HP
M&M	43	44	29	58
TAFE	29	31	7	1
Escorts	15	8	29	0
International Tractors	7	9	9	10
John Deree	0	2	8	30
Others	7	5	17	2

Source: Crisinfac, IDFC SSKI Research

Exhibit 13: Escorts – strong presence in North India; weak in South

(%)	North	South	East	West
M&M	33.7	51.6	48.9	42.2
TAFE	25.8	20.3	17.2	20.7
Escorts	19.1	5.8	14.0	11.4
International Tractors	11.5	0.0	9.9	8.6
John Derre	0.0	11.3	0.0	6.5
Others	9.9	11.1	10.0	10.7

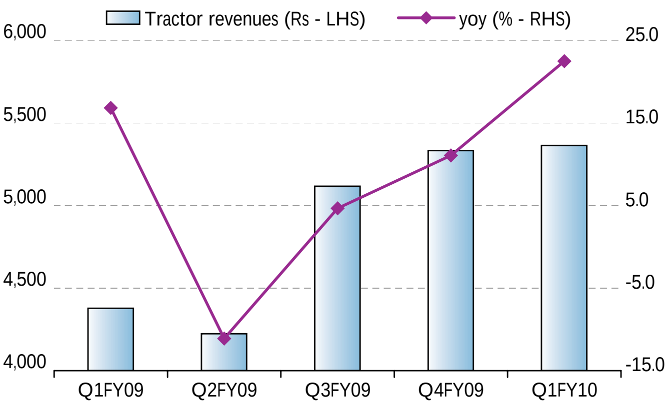
Source: Crisinfac, IDFC SSKI Research

…in the harvest season

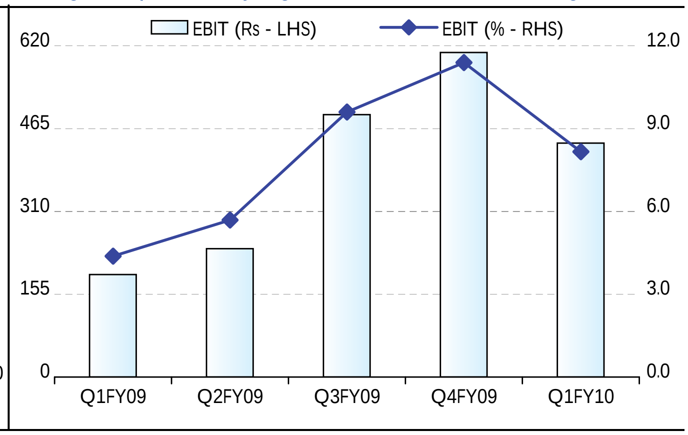
Good prospects ahead for tractor industry; higher capacity utilization at Escorts to drive earnings

Escorts' tractor segment performance has significantly improved with market share rising to 13% from 9% in FY06. Margins too have touched an all-time high of 11% in Q4FY09 (4% at in Q1) led by stronger topline growth and cost cutting initiatives. The company is set to launch 7-8 new tractor variants in FY10. With annual capacity of 98,940 units and sales of only about 45,627 units in FY09, Escorts is well placed to capitalize on the growth opportunities in the sector. We expect 16% revenue CAGR in the division over FY09-12E. Increased capacity utilization levels would, in turn, accelerate earnings growth (18% EBIT CAGR over FY09-12E) for Escorts.

Exhibit 14:Tractor sales have significantly improved...



...margins expand led by higher volumes and cost cutting



Source: Company, IDFC SSKI Research

The tractor industry – 'plough'ing time

With over 300,000 tractors sold annually, India is the second largest tractor market after the US. The tractor industry has progressed at an estimated 25% CAGR over FY04-09 to reach Rs153bn in size. Around 93% of the demand comes from 12 major states, of which Uttar Pradesh is the largest market. After a slowdown in the industry over FY08-09, tractor sales have significantly picked up from H1FY10, led by increase in disposable incomes on the back of four consecutive good monsoons as well as rising MSPs over the past few years. Spending power with rural masses has shot up owing to various policy measures including a substantial increase in allocation for the National Rural Employment Guarantee Scheme (up 33% in the recent Union Budget), Pradhan Mantri Gram Sadak Yojana (up 51%), increase in credit disbursement for agriculture, selective extension of debt waiver and relief schemes, etc. With a large rural population dependent on farming and allied industries, agriculture will remain a priority area for policymakers – which would continue to feed tractor demand. Further, increasing use of tractors for the purpose of construction, transportation, etc would boost demand going forward.

The damage to kharif crops from a deficit monsoon is likely to be more than compensated for by an expected bumper rabi output in this fiscal. Further, improving irrigation facilities in the country have reduced dependence of agricultural output on monsoons. Also, the government has maintained its thrust on infrastructure, agriculture and rural development in the recent budget. Given that structural demand drivers are in place, we expect tractor sales to remain buoyant and expect the domestic tractor industry to clock 15% volume CAGR over FY09-12.

Exhibit 15: Tractor industry – snapsot of key players

	M&M Group	TAFE	Escorts	International Tractors
Installed capacity (no.)	233,000	94,800	98,940	30,000
Market share (%)	42	22	13	9
Change in mkt share over the last 5 years (bp)	200bp	0	100bp	(200)bp
Segment-wise mkt share (%)				
<30HP	43	29	15	7
31-40HP	44	31	8	9
41-50HP	29	7	29	9
>50HP	58	1	0	10
Region-wise mkt share (%)				
North	34	26	19	12
South	52	20	6	4
East	49	17	14	10
West	42	21	11	9

Source: Crisinfac, IDFC SSKI Research

CONSTRUCTION EQUIPMENT: HIGH-RISE

- **World's largest manufacturer of Pick 'n' Carry Hydraulic Mobile Crane (54% market share in India); a 25% share in the vibratory compactors market**
- **Led by policy thrust on infrastructure creation, construction equipment industry to touch ~USD15bn by 2015E (USD2.4bn currently); Escorts likely to be a key beneficiary among construction equipment suppliers**
- **Expiry of non-compete agreement with its erstwhile JV partner JCB allows Escorts to manufacture and sell competing products in India**
- **We expect the division to post 18% 3-year revenue CAGR, to Rs7.5bn by FY12**

❑ Construction equipment (16% of FY09 sales; 10% of EBIT)

Escorts is world's largest manufacturer of pick-n-carry cranes and a strong player in compactors

Escorts manufactures and markets a diverse range of construction and material handling equipment like cranes, loaders, vibratory rollers and forklifts in its 100% subsidiary – Escorts Construction Equipment (ECEL). Escorts is the pioneer and innovator in the crane industry in India and remains the only company with the most comprehensive crane product range in the country.

With >30 years of existence in the industry, Escorts is the world's largest manufacturer of both mobile and Pick 'n' Carry Hydraulic Mobile Cranes. Escorts commands ~54% market share in the Pick 'n' Carry/ Hydraulic Cranes/ Lorry Loaders and 25% share in vibratory compactors (rollers) segment. Escorts' range of compaction equipment is among the most preferred in the market, and is viewed as the most efficient and effective compaction solutions available in the country. A nationwide network of 16 sales offices, 50 dealership locations and >300 company-trained service engineers gives it the best market reach in India for after-sales service.

Exhibit 16: Escorts' positioning in key segments

Segment	Annual industry size	Mkt share (%)	% of FY09 sales	Other key players
Pick n Carry cranes	5,000-6,000 units	54	~60	Action Construction, Omega
Compactors	1,000-1,200 units	25	~20	L&T, Volvo, Greaves

Source: Company, Media reports, IDFC SSKI Research

❑ Taking big strides

Escorts aims to evolve as a one-stop shop for providing end-to-end solutions for its clients

Escorts is working towards becoming a one-stop shop for providing end-to-end equipment solutions for the construction industry. Escorts is consolidating its leadership position by focusing on technological advancements, introducing new and improved products and tying up with international manufacturers. Some of the tie-ups that Escorts has entered into recently are as follows:

JVs signed with global majors to market their products in India

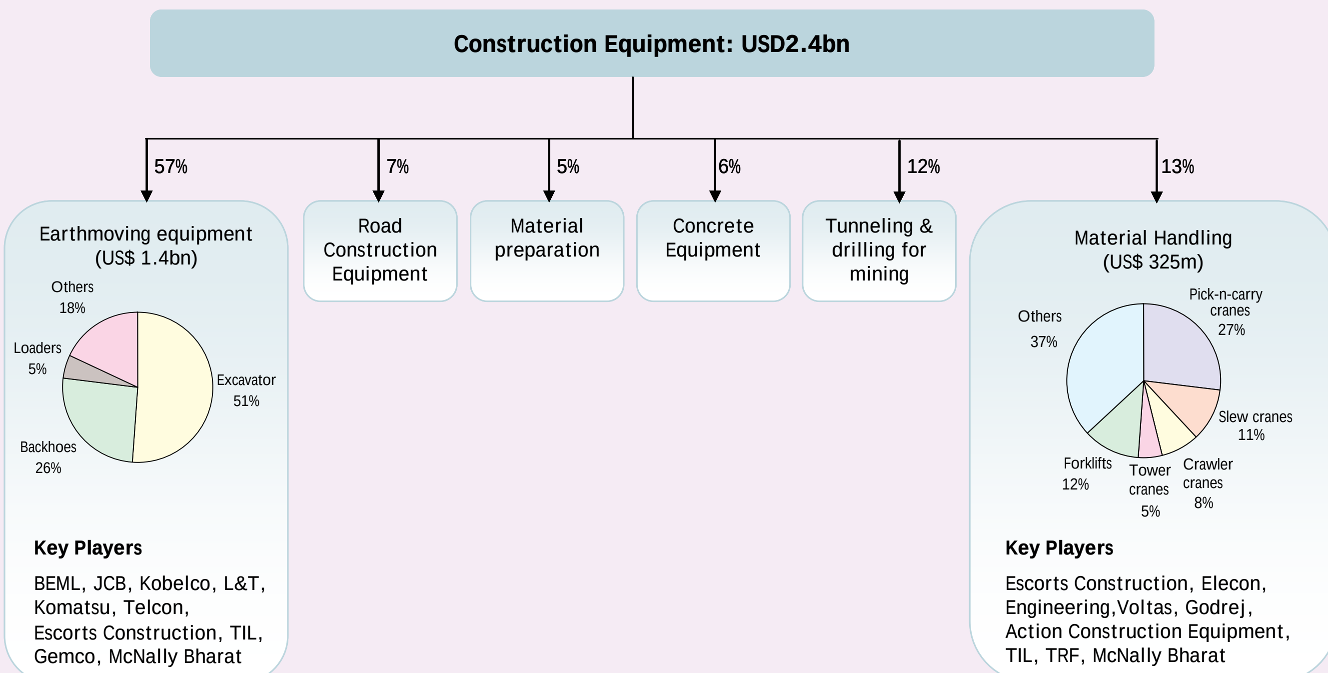
- In FY09, Escorts signed an agreement with Hunan Zoomilion International Trade Co. Ltd, China (among the world's top 10 mobile crane manufacturer) to market its world-class truck cranes (12T-150T) and all-terrain cranes (180T-350T) in India. The launch of these products is expected to complement ECEL's existing range of material handling products. With these products, Escorts looks to cater to large construction companies engaged in infrastructure development – a highly lucrative space given the keen policy focus on infrastructure creation in India.
- Escorts has signed a distribution agreement with M/s Manitou BF, SA Corporation of France (the world leader with ~35% share in global telescopic

handler market) for its Maniscopic range of telescopic handlers and range of access platforms. Escorts Manitou has already bagged sizeable orders from two leading construction companies in India.

- ECEL also entered into an agreement with Xiamen Machinery of China for marketing the latter's products in India. Wheel loaders and motor graders for earthmoving segment have also been introduced in the Indian market.

Construction equipment business – full of promise

Demand for construction and material handling equipment shows high correlation to growth in infrastructure sectors like construction, ports, pipelines, roads, steel, power projects, mining, building construction, etc. The construction equipment sector in India has been growing at a scorching pace of over 30% annually, driven by the huge investments being made by the government and the private sector in infrastructure development. Infrastructure development has been high on the agenda for the Indian government as it is a key driver of overall economic development. According to the 11th 5-year plan (2007-12), the core infrastructure sector comprising power, roads, highways, railways, ports, airports, mining and irrigation will require massive investments to the tune of USD490bn over the next 5 years to sustain current 9-10% GDP growth pa. Given that the construction industry accounts for 40-50% of the plan outlays, the future prospects of the construction equipment industry appears promising. A 6% GDP growth needs to be supported by infrastructure sector growth of ~12%, which implies 20% growth for the construction equipment industry. Given the thrust on infrastructure creation, the construction equipment industry is expected to touch ~USD15bn by 2015 (USD2.4bn currently).



Source: Media reports, IDFC SSKI Research

Exhibit 17: Construction equipment industry – full of promise (an excerpt from our earlier report on the sector – dated May07)

Exhibit 1: Infrastructure potential – Rs12,660bn over the next five years

Rs bn	Budgetary grant	Debt: Multi lateral borrowings	Debt: Market borrowings	Internal accruals	Sub-total	Privatisation / BOT	Funding not tied up	Total	Construction component %	Construction component Rs bn
Power	264	270	2,353	384	3,271	2,245	-	5,516	43	2,349
Roads	228	186	123	-	537	1,857	80	2,474	100	2,474
Ports	38	75	50	50	213	345	-	558	60	335
Railways	75	50	120	350	595	300	600	1,495	42	628
Airports	10	25	25	25	85	300	15	400	42	168
Pipelines	-	-	250	150	400	-	-	400	40	160
Irrigation & Water supply	226	206	321	8	761	25	-	786	45	354
Urban infra	97	295	58	60	510	521	-	1,031	60	619
Total	**938**	**1,107**	**3,301**	**1,027**	**6,373**	**5,593**	**695**	**12,660**	**56**	**7,086**

Source: SSKI Research, Plan documents

Expiry of non-compete agreement with JCB allows Escorts to sell competing products in India

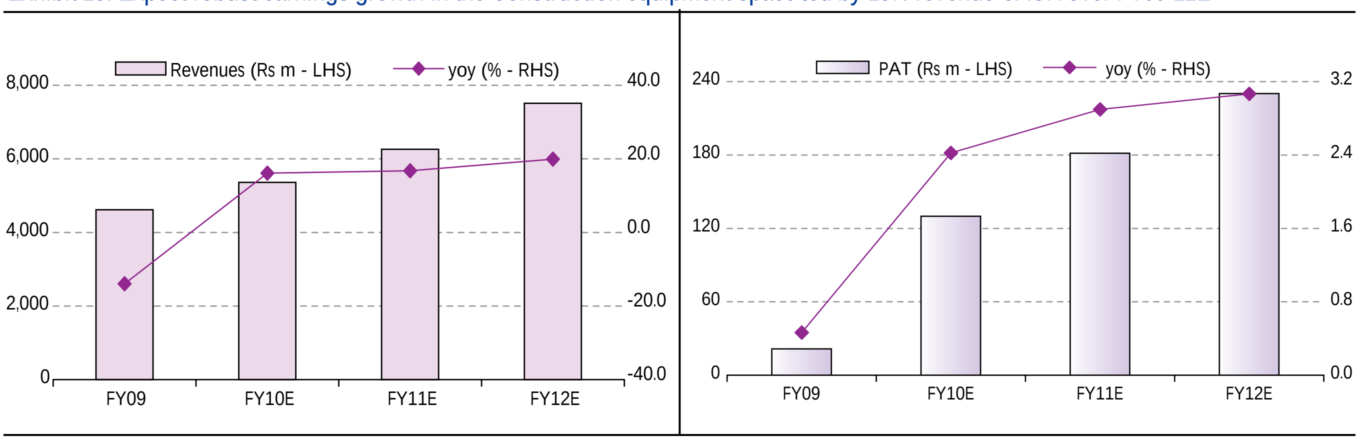
❑ Expiry of non-compete agreement with JCB – a key positive

Escorts had a 40:60 JV with JC Bamford Excavators Ltd (JCB) that sold *JCB Escorts* backhoe loaders. The British company bought out Escorts' holding in 2003 and is now selling products under its own brand. Notably, the non-compete agreement that Escorts had signed with JCB has expired in January 2008, which means that Escorts can now supply competing products in India. More importantly, the Escorts brand still has a strong recall value – as indicated by a survey done by Escorts.

❑ Accelerated revenue and earnings growth ahead

Escorts plans to expand its product line to include backhoe loaders, diesel engine forklifts and high capacity cranes for the domestic market. The prototype of a 76 hp backhoe loader is likely to be ready by July 2010 and the commercial launch is expected by end-2010. Given the robust business outlook going forward, we expect the construction equipment division to post an 18% 3-year revenue CAGR, to Rs7.5bn by FY12E, and 121% earnings CAGR (albeit on a low base) over the period.

Exhibit 18: Expect robust earnings growth in the Construction equipment space led by 18% revenue CAGR over FY09-12E



Source: Company, IDFC SSKI Research

ENGINEERING EQUIPMENT: ON A ROLL

- **Escorts a supplier to Indian Railways (IR) for four decades; expected to be a key beneficiary of the IR's ambitious capex plan (~Rs2.5trn over the next five years)**
- **Railway equipment the most profitable business for Escorts with EBITDA margins at ~25%; strong growth traction in the business augurs well for Escorts**
- **Escorts the leader in auto suspension products including shock absorbers, struts and telescopic front forks**
- **Driven by higher offtake from domestic auto OEMs and aggressive cost cutting initiatives underway, we expect break even at operating level by FY11**

Railway equipment (7% of FY09 revenues; 25% of EBIT)

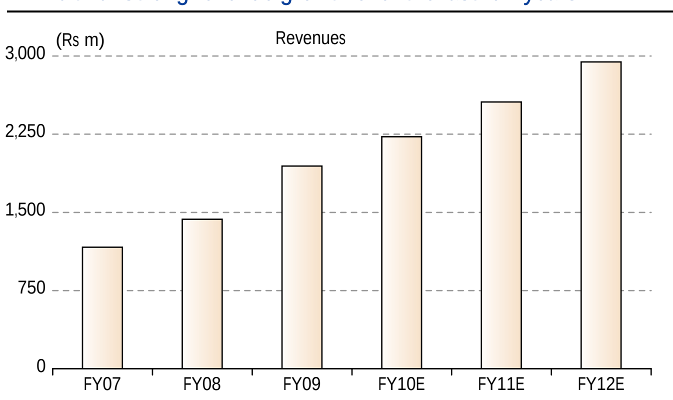
Railway equipment the most profitable business in Escorts' kitty

Escorts has been one of the oldest suppliers of critical railway components, primarily safety components, to the Indian Railways (IR) over the last 40 years. Safety components supplied by Escorts include brake systems, couplers systems, damper systems, coach products and track products. These components are also exported to more than 15 countries worldwide including Australia, New Zealand, Malaysia, Thailand, Sri Lanka, Egypt, Iran, Iraq, Senegal, etc. Escorts is Asia's largest manufacturer of air brake systems. The initial source of technology for manufacturing these components has come from some of the leaders in their respective fields like: Schaku of Germany for couplers, Knorr Bremse of Germany for air brakes, REXLOK for Resilient Rail Fastening System, ICER of Spain for composite brake blocks and Vulcanite of Australia for vulcanized rubber parts.

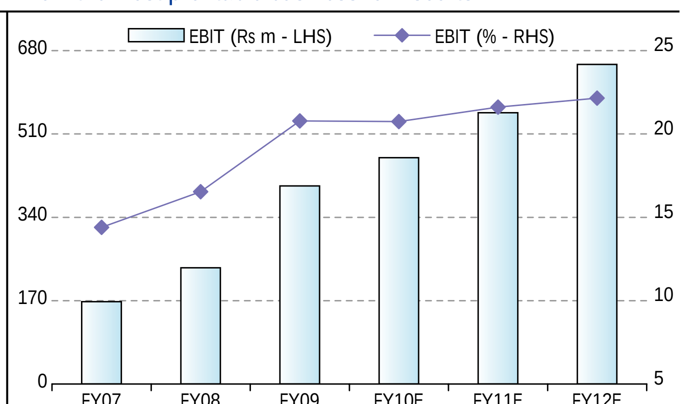
Escorts has already bagged four new orders from IR; nine others in advanced stages of negotiations

The business is witnessing strong demand growth (31% CAGR over FY07-09) with sustained margins – mainly on account of the robust offtake from IR. Notably, the IR has embarked on a massive modernization and expansion programme, with focus on safety and technology upgradation, involving a capex of Rs2.5trn. Given its extremely strong relationship with the entity, Escorts is well poised to capitalize on this tremendous growth opportunity in the segment. Further, with IR now according preference to domestic vendors vis-à-vis international suppliers, domestic players (including Escorts) are likely to witness higher order inflows from the IR. Escorts has recently bagged four new orders from the IR while nine others are in advanced stages of negotiation. Escorts recently won its biggest-ever export order to supply 30,000 sleeper sets along with resilient rail clips, liners, inserts and rubber pads to Rexlok, Australia. The order is valued at ~Rs160m.

Exhibit 19: Strong revenue growth over the last few years...



...from the most profitable business for Escorts



Source: Company, IDFC-SSKI Research

Indian Railways – on a capex spree

Indian Railways is the largest rail network in Asia and the world's second largest network under a single management encompassing 63,140 route kms. The Indian Railways is in the midst of a major modernization and expansion programme with focus on safety and technology upgradation. The IR has turned around from a cash deficit to a cash surplus situation and is posied for strong growth with focus on safety and technology upgradation of rolling stock, infrastructure and signaling sectors. The IR has finalized a Rs2.5trn capex plan over the next five years for creating the proposed dedicated freight corridors, doubling of lines, electrification, gauge conversion and addition of rolling stocks. Further, as per 'Vision 2020' of IR, it needs Rs14trn in the next 10 years for capacity augmentation and modernization to transform into a world-class network. The proposals in Vision 2020 include addition of 25,000 km of new lines, electrification of 14,000 km of routes, doubling and quadrupling of lines, construction of several dedicated freight corridors, development of world-class stations, setting up of rolling stock manufacturing units, logistics hubs, Kisan Vision projects, and expansion and management of optical fibre cables network.

Exhibit 20: IR – aggressive capex plans over the next decade

	2010-2012E		2013-2020E		Total	
(Rs trn)	Nos.	Investment	Nos.	Investment	Nos.	Investments
Freight wagon	33,909	101.7	255,227	765.7	289,136	867.4
Diesel wagon	690	72.5	4,644	487.6	5,334	560.1
Electric loco	555	67.2	3,726	581.5	4,281	648.7
Passenger coaches	6,912	110.6	43,966	714.6	50,878	825.2
Upgradation / expansion		103.6		912.3		1015.9

Source: Indian Railways, IDFC-SSKI Research

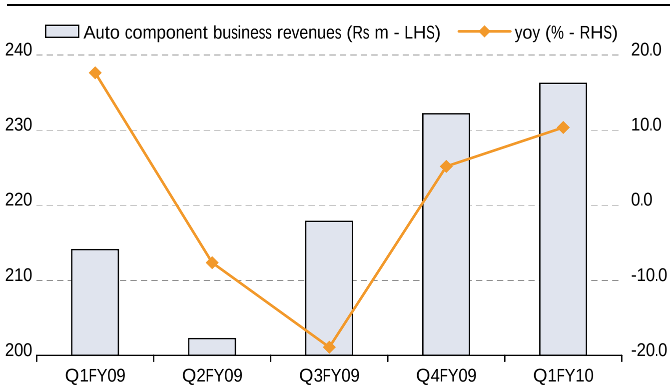
With higher offtake by auto OEM segment, we expect the division to break even at operating level by FY11E

Led by the robust demand potential from IR, we have factored in 15% revenue CAGR for Escorts in this business over FY09-12. Notably, the business fetches high operating margins of ~25%, and hence would boost consolidated earnings going forward.

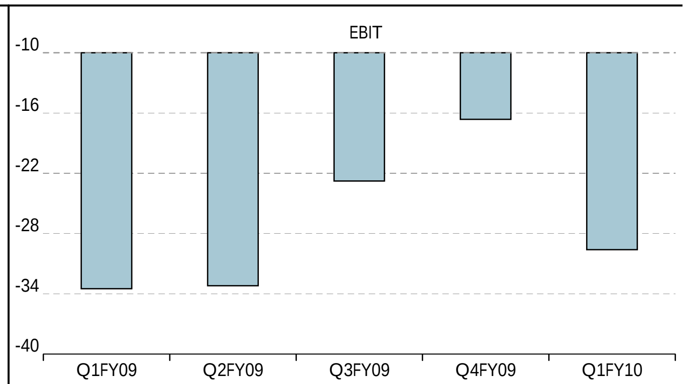
❑ Auto Suspension division (3% of FY09 revenues)

Escorts is the leader in auto suspension products including shock absorbers, struts and telescopic front forks. In technical collaboration with Fichtel & Sachs – Germany, Escorts was the pioneer in automotive shock absorber manufacturing in India in 1966. The company also has a technical collaboration with world leader – Kayaba of Japan – for motorcycle front forks and shock absorbers. A strong in-house design and development team of the division enables introduction of new applications as per specifications of customers. However, the auto components division has remained stagnant over the years and is currently reporting losses at the operating level.

Exhibit 21: Revenues have picked up...



...but business still loss-making at operating level



Source:Company, IDFC SSKI Research

Domestic auto component space – significant demand ahead

The domestic automobile industry has witnessed robust growth in FY10 (24%yoy YTDFY10), led by a combination of factors including payout of arrears pertaining to the Sixth Pay Commission recommendations, favorable policies for farmers (including rising MSPs, NREGS, etc) that translate into higher disposable incomes and higher rural offtake, robust exports led by one-time scrappage incentives in Europe and an 8% cut in excise duty over the last one year. With the economy poised to show robust growth and the consequent increase in disposable incomes, the Indian automobile sector is expected to be one of the fastest growing in the world over the next several years. Also, India is fast emerging as the manufacturing hub for many global auto OEMs, which would provide further impetus to demand. Given that domestic ancillary players are cost-competitive and possess adequate technical expertise compared to their western counterparts, as also the fact that most global OEMs are keen to increase their localization content in order to cut costs, most of these global auto majors are likely to source components from domestic ancillary suppliers. Driven by robust offtake from the domestic / global OEM segments as well as the replacement market, the auto component industry is likely to touch USD40bn in size by 2015-16 (USD18bn currently). With this, India's share in the global auto component market is expected to surge to 3% (1% currently).

The robust growth expected in the automobile sector would drive topline growth for domestic ancillary major including Escorts. Driven by a much-higher offtake and the aggressive cost cutting exercise undertaken by the company, we expect this division to break even at the operating level by FY11.

FINANCIAL ANALYSIS

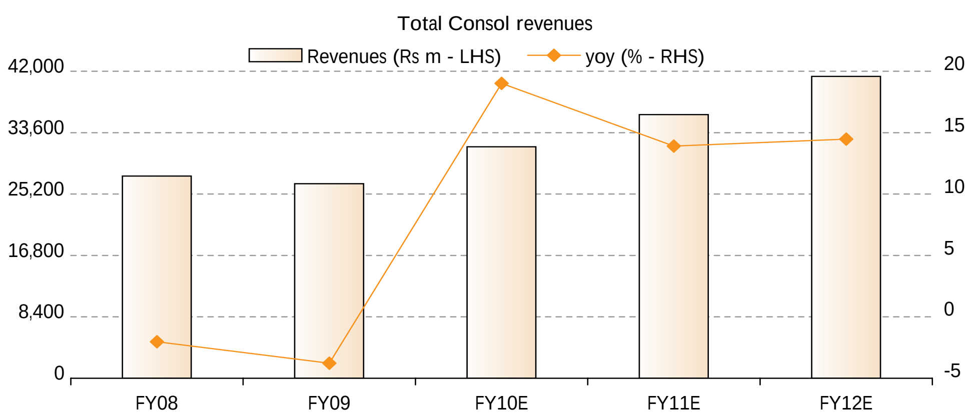
- **All businesses witnessing strong growth traction led by improving economic outlook; we expect Escorts to post 16% 3-year sales CAGR to Rs40.9bn in FY12**
- **Higher volume offtake and cost cutting initiatives expected to negate the impact of rising input costs; we expect margins to remain stable at 9%**
- **Substantial debt reduction (Rs4bn in FY09 from Rs8.8bn in FY05) would reduce interest burden, which would further boost earnings going forward**
- **We expect 48% CAGR in consolidated earnings over FY09-12**

❑ Double-digit revenue growth across business segments

Robust outlook for each of its core business units is expected to drive a 16% 3 year revenue CAGR over FY09-12E

In an improving economic environment, Escorts has been witnessing high growth across its business verticals over the last couple of quarters. Overall, revenues for the standalone entity have grown by ~23% to Rs6bn in Q1FY10 from the low witnessed in Q2FY09. The company has adequate capacity in place and a marquee client list across segments, which would help it capitalize on the growth opportunities going forward. While we expect 16% revenue CAGR in agri machinery division over FY09-12, we see railway equipment and construction segments witnessing CAGR of 15% and 18% respectively. Overall, we expect 16% 3-year revenue CAGR for Escorts, to Rs40.9bn in FY12.

Exhibit 22: Expect 16% revenue (consolidated) CAGR over FY09-12



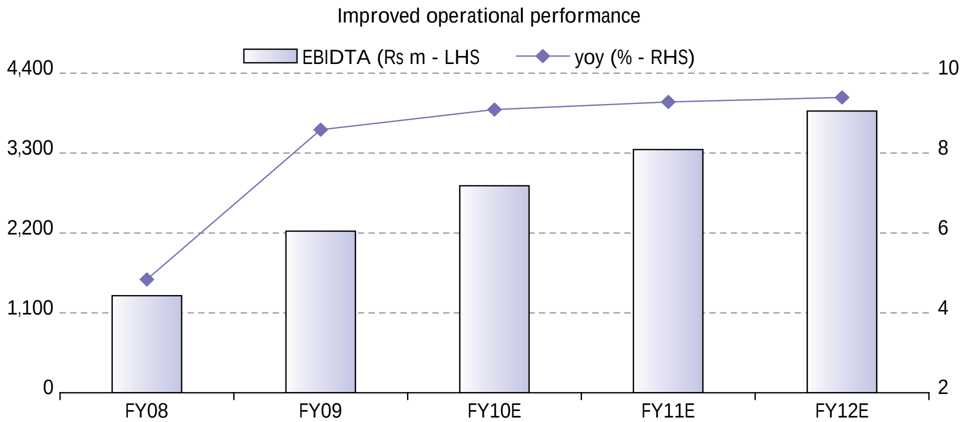
Source: Company, IDFC SSKI Research

❑ Margins likely to sustain despite rising input costs

Higher offtake, coupled with cost cutting initiatives, likely to offset rising input cost pressure

Escorts has effected a significant improvement in its operational performance over the past few quarters driven by an enhanced product mix as well as aggressive cost cutting initiatives. The cost cutting exercise is focused on reducing two major cost overheads, viz. material costs and conversion cost. To this end, a range of initiatives have been undertaken including value analysis/ value engineering, best practices in purchasing, alternate sourcing of raw materials and inventory control. Further, power and fuel cost reduction were achieved through reduction in shifts, reallocation of workforce and utilization of surplus manpower. The robust revenue growth is likely to lead to substantial improvement in utilization levels across businesses. Coupled with cost rationalization, this would support margins in a rising input cost scenario.

Exhibit 23: Higher volumes, cost rationalization efforts boost operational performance



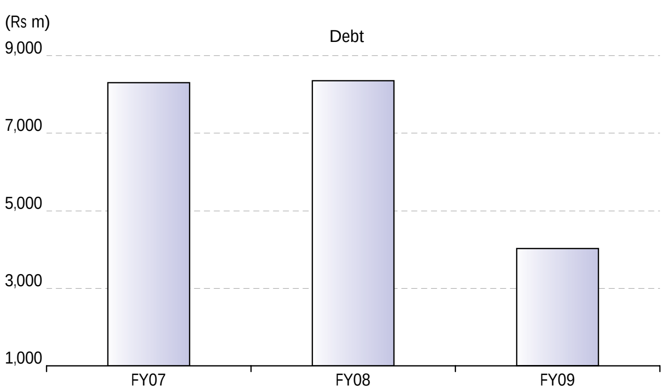
Source: Company, IDFC SSKI Research

❑ Substantially lower debt burden…

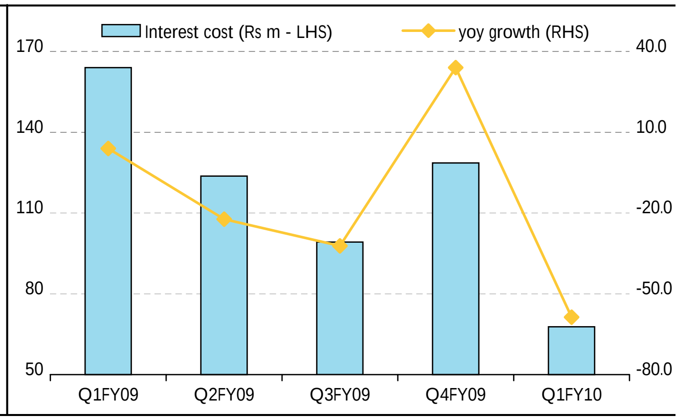
Reduced interest burden to further boost earnings

Escorts has repaid ~Rs1bn of term loans and Rs680m of working capital debt in FY09. While improved cash flows helped retire the term loan, efficient working capital management enhanced liquidity which lowered its short-term fund requirements. Debt (standalone) now stands at Rs2.6bn (including working capital debt) with ~Rs900m in term loans and Rs600m of convertible debentures (convertible at ~Rs190; leading to a dilution of about 4.66%) while gearing is at a comfortable 0.18x. Debt at the consolidated level is at Rs4bn – significantly down from the FY05 levels of Rs8.8bn. Resultant, Escorts' interest burden (standalone) has dropped to Rs68m as of Q1FY10 against Rs164m in Q1FY09. While comfortable gearing would help improve its credit rating, thereby facilitating loans at lower interest rates, reduced interest burden would also boost earnings going forward.

Exhibit 24: Debt has reduced substantially in FY09 ....



....leading to substantially reduced interest burden



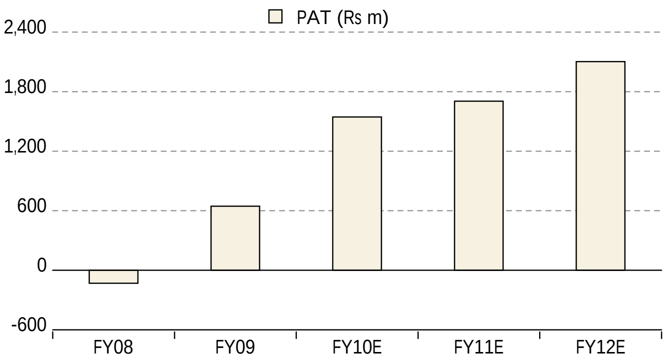
Source: Company,IDFC SSKI Research

Expect 48% earnings CAGR over FY09-12E led by robust operational performance, cost cutting initiatives and lower interest burden

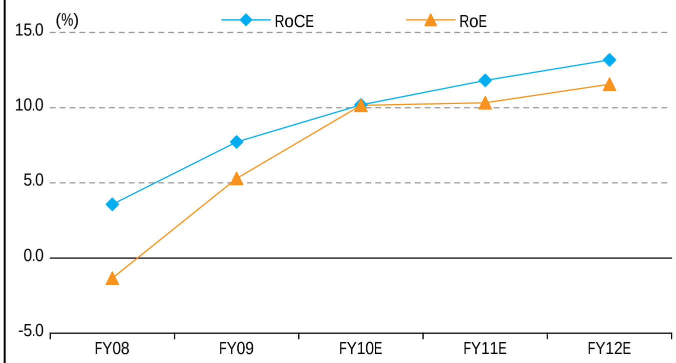
❑ …expect 48% earnings growth over FY09-12

With repayment of term loan of ~Rs1bn in FY09 and prudent working capital management, Escorts has cut its interest burden significantly to Rs68m in Q1FY10 from Rs164m in Q1FY09. Coupled with a marked improvement in operational performance, this should drive a 48% earnings CAGR for Escorts over FY09-12 (PAT of ~Rs2.1bn in FY12). With strong earnings growth without any incremental capex, return ratios too are expected to be on an uptrend going forward.

Exhibit 25: Expect 48% earnings CAGR over FY09-12…



…and improving return ratios



Source: Company, IDFC SSKI Research

KEY CONCERNS

Deficient monsoons, sharp raw material price swings and execution delays – key risks to our estimates

Deficient monsoons may play spoil-sport

Given the rainfall deficiency in the year and the resultant impact on kharif production in five of the major agri producing states in India, agri GDP is expected to marginally decline in FY10 against 1.6% growth in FY09. A lower agri output may impact tractor demand in FY11, thereby impacting our revenue assumptions.

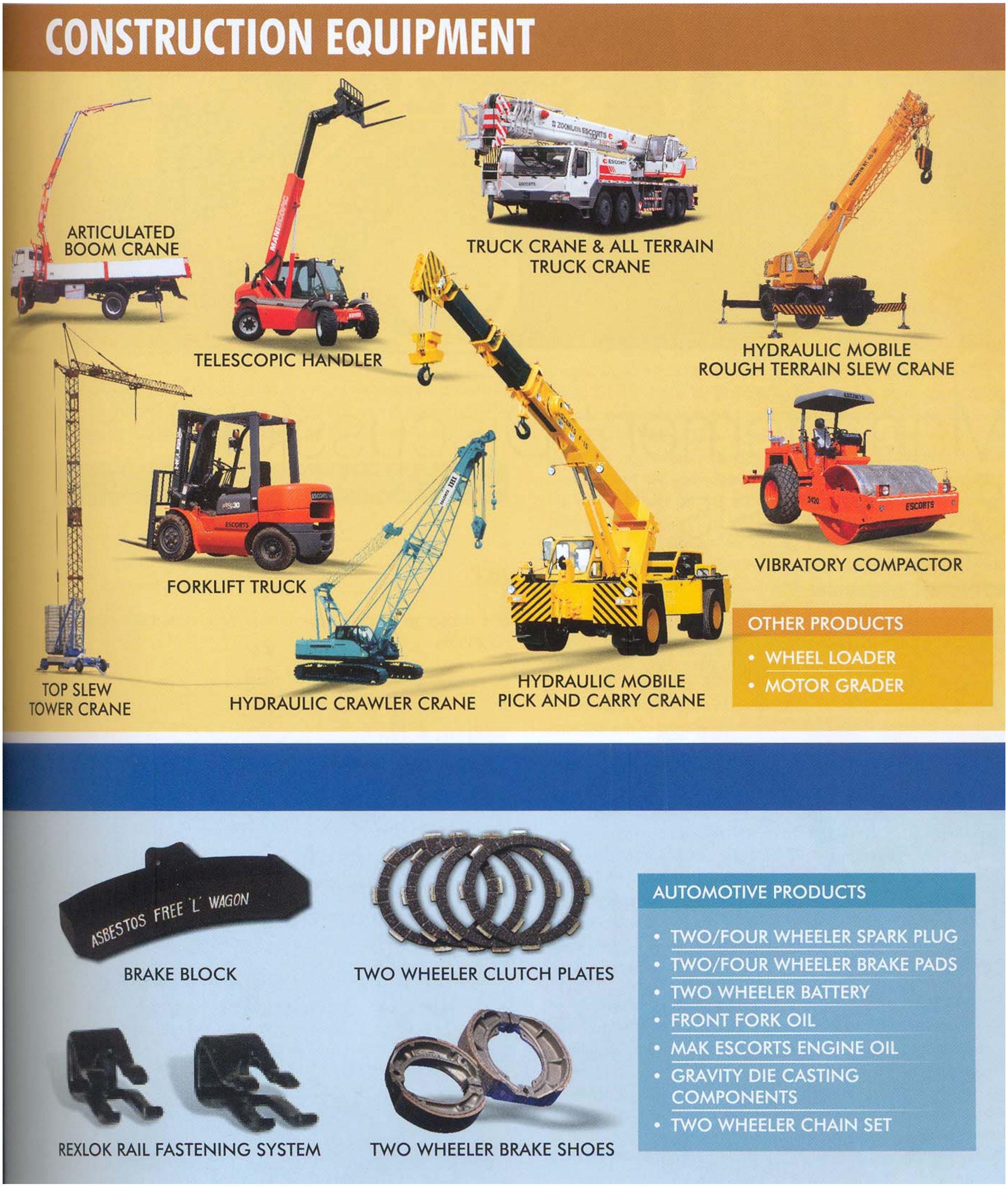
Execution delays may hinder future growth potential

While Escorts is set to capitalize on the robust growth opportunities across business segments, any execution delays (especially for the railway equipment business as well as for new products like back hoe loaders in the construction space) may restrict revenue growth going forward.

Higher-than-expected raw material prices may impact margins

We expect the marked improvement across business segments to mitigate the impact of rising raw material costs, and hence have factored in stable margins over FY10-12E. However, higher-than-expected rise in raw material prices remain a key risk to our estimates.

Annexure: Core Business units


CONSTRUCTION EQUIPMENT
ARTICULATED BOOM CRANE
TELESCOPIC HANDLER
TRUCK CRANE & ALL TERRAIN TRUCK CRANE
HYDRAULIC MOBILE ROUGH TERRAIN SLEW CRANE
VIBRATORY COMPACTOR
FORKLIFT TRUCK
OTHER PRODUCTS
• WHEEL LOADER
• MOTOR GRADER
TOP SLEW TOWER CRANE
HYDRAULIC CRAWLER CRANE
HYDRAULIC MOBILE PICK AND CARRY CRANE
ASBESTOS FREE 'L' WAGON
BRAKE BLOCK
TWO WHEELER CLUTCH PLATES
AUTOMOTIVE PRODUCTS
• TWO/FOUR WHEELER SPARK PLUG
• TWO/FOUR WHEELER BRAKE PADS
• TWO WHEELER BATTERY
• FRONT FORK OIL
• MAK ESCORTS ENGINE OIL
• GRAVITY DIE CASTING COMPONENTS
• TWO WHEELER CHAIN SET
REXLOK RAIL FASTENING SYSTEM
TWO WHEELER BRAKE SHOES

Income statement

Year to 30 Sep (Rs m)	FY08	FY09	FY10E	FY11E	FY12E
Net sales	**27,661**	**26,617**	**31,676**	**36,080**	**41,302**
% growth	*(2.0)*	*(3.8)*	*19.0*	*13.9*	*14.5*
Operating expenses	26,323	24,392	28,826	32,732	37,422
EBITDA	**1,338**	**2,224**	**2,850**	**3,348**	**3,880**
% change	*(4.4)*	*66.3*	*28.1*	*17.5*	*15.9*
Other income	6	23	100	111	123
Net interest	(626)	(717)	(349)	(221)	(112)
Depreciation	592	595	639	694	754
Pre-tax profit	126	935	1,962	2,544	3,138
Deferred tax	465	0	0	0	0
Current tax	(205)	290	418	839	1,035
Profit after tax	**(134)**	**645**	**1,544**	**1,704**	**2,102**
Minorities	3	0	0	0	0
Non-recurring items	(242)	(359)	0	0	0
Net profit after non-recurring items	(372)	286	1,544	1,704	2,102
% change	*575.9*	*(176.8)*	*439.8*	*10.4*	*23.4*

Key ratios

Year to 30 Sep	FY08	FY09	FY10E	FY11E	FY12E
EBITDA margin (%)	4.8	8.4	9.0	9.3	9.4
EBIT margin (%)	2.7	6.1	7.0	7.4	7.6
PAT margin (%)	(0.5)	2.4	4.9	4.7	5.1
RoE (%)	(1.3)	5.3	10.1	10.1	11.4
RoCE (%)	3.6	7.7	10.1	11.6	13.0
Gearing (x)	0.9	0.3	0.2	0.1	0.1

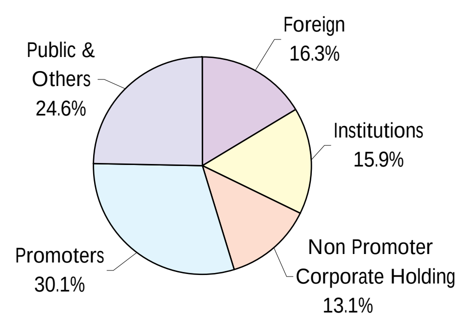
Valuations

Year to 30 Sep	FY08	FY09	FY10E	FY11E	FY12E
Reported EPS (Rs)	(4.6)	3.6	18.4	20.3	25.0
Diluted EPS (Rs)	(1.5)	7.4	17.7	19.5	24.1
PE (x)	n/a	19.9	8.3	7.5	6.1
Price/ Book (x)	1.2	0.8	0.8	0.7	0.6
EV/ Net sales (x)	0.7	0.5	0.4	0.3	0.3
EV/ EBITDA (x)	14.4	6.4	4.5	3.7	2.8
EV/ CE (x)	0.9	0.7	0.6	0.5	0.4

Balance sheet

Year to 30 Sep (Rs m)	FY08	FY09	FY10E	FY11E	FY12E
Paid-up capital	805	805	841	841	841
Reserves & surplus	8,548	13,446	14,826	16,311	18,195
Total shareholders' equity	9,742	14,652	16,068	17,553	19,437
Total current liabilities	9,207	8,818	10,709	12,206	13,983
Total debt	8,402	4,020	3,120	2,470	1,770
Deferred tax liabilities	1,485	1,441	1,441	1,441	1,441
Other non-current liabilities	1,202	1,370	1,623	1,849	2,119
Total liabilities	20,296	15,648	16,892	17,966	19,311
Total equity & liabilities	**30,038**	**30,299**	**32,960**	**35,519**	**38,748**
Net fixed assets	9,674	15,720	15,993	16,212	16,371
Investments	2,382	1,067	1,067	1,567	2,067
Total current assets	15,898	11,714	14,157	15,998	18,567
Deferred tax assets	1,970	1,743	1,743	1,743	1,743
Other non-current assets	115	57	0	0	0
Working capital	6,690	2,896	3,448	3,792	4,585
Total assets	**30,038**	**30,299**	**32,960**	**35,519**	**38,748**

Shareholding pattern



As of December 2009

Cash flow statement

Year to 30 Sep (Rs m)	FY08	FY09	FY10E	FY11E	FY12E
Pre-tax profit	126	935	1,962	2,544	3,138
Depreciation	592	595	639	694	754
Chg in working capital	(625)	4,393	516	(414)	(129)
Total tax paid	205	(290)	(418)	(839)	(1,035)
Operating cash inflow	(97)	5,800	2,953	2,212	2,996
Capital expenditure	(890)	(6,641)	(913)	(913)	(913)
Free cash flow (a+b)	(987)	(841)	2,040	1,298	2,083
Chg in investments	71	6,033	-	(500)	(500)
Debt raised/ (repaid)	102	(4,382)	(900)	(650)	(700)
Capital raised/ (repaid)	770	0	36	-	-
Dividend (incl. tax)	-	(106)	(164)	(219)	(219)
Misc	(600)	(164)	-	-	-
Net chg in cash	(643)	540	1,012	(70)	664

IDFC - SSKI INDIA

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Explanation of Ratings:

1. Outperformer: More than 5% to Index
2. Neutral: Within 0-5% to Index
3. Underperformer: Less than 5% to Index

Disclosure of interest:

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