

Company Flash

21 January 2008 | 7 pages

Bharat Forge (BFRG.BO)

Hold: Sedate Performance

- Recurring PAT -5% Y/Y** — Results 6% below expectations. Sharp escalation in capital costs (interest, depreciation) affected net profits, negating the c10% growth in EBITDA. BHFC's margin trend remains steady (QoQ) at 24.5%, but declined c150bps Y/Y. Contribution margins rose by 120bps Y/Y and 80bps Q/Q – we await details from management.
- Exports affect revenue growth** — Overall revenue growth of c17% was driven in equal parts by domestic and export sales. In the backdrop of declining CV sales, the domestic growth implies that BHFC continues to gain share with key clients, also increasing its focus in cars (a structural positive – though margins will be lower in this business as it is more competitive). Exports growth disappointed (impact of currency on export revenues yet to be quantified). We expect exports will continue to be affected by slowdown in the US (c20-25% of overall revenues).
- Consolidated performance disappoints** — Performance of subsidiaries reflects a slowdown in key end markets, and (we assume) translation losses that resulted in revenues declining 3% and margins declining 60bps Y/Y, 70 bps Q/Q to ~7.4%. Subsidiary PAT declined 20% Y/Y. Overall consolidated PAT declined ~8% Y/Y.
- Outlook** – Currency remains an area of concern – we expect an appreciating rupee will continue to affect performance for the next 12 months. Reiterate Hold (2L). Upside risks a) turnaround in subsidiaries' operations, b) reduction in input costs, Downside risks a) rising cost pressures, b) declining demand from key clients.

Hold/Low Risk	2L
Price (21 Jan 08)	Rs309.85
Target price	Rs325.00
Expected share price return	4.9%
Expected dividend yield	1.3%
Expected total return	6.2%
Market Cap	Rs68,989M US\$1,759M

Price Performance (RIC: BFRG.BO, BB: BHFC IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	2,505	10.57	4.0	29.3	5.5	28.7	1.0
2007A	2,988	12.43	17.5	24.9	4.7	22.0	1.1
2008E	3,578	14.88	19.7	20.8	4.0	22.6	1.3
2009E	4,318	17.96	20.7	17.3	3.4	23.0	1.5
2010E	5,388	22.40	24.8	13.8	2.8	24.1	1.8

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Figure 1. Bharat Forge Standalone- 3QFY08 Sales Break Up

	3QFY07	3QFY08	% chg YoY	Comments
Domestic sales	3,197	3,721	16.4	Commendable, despite decline in CV sales – focus continues to increase on light trucks, passenger cars
Exports	1,958	2,298	17.4	
Total	5,155	6,019	16.8	Disappointing – impact of slowdown in US remains uncertain
Domestic sales (%)	62.0	61.8		
Exports (%)	38.0	38.2		

Source: Citi Investment Research

Figure 2. Bharat Forge Standalone- 3QFY08 Financial Results

	3QFY07	3QFY08	% chg YoY	Comments
Net sales	4,771.2	5,567.3	16.7	6% below expectations
Decrease/(Increase) in Stocks	(80.4)	(12.2)		
Raw Materials	2,255.4	2,484.3	10.1	Contribution margins continue to improve
Mfg expenses	837.8	983.8	17.4	
Staff costs	277.9	381.0	37.1	Employee costs continue to ramp up as machining facilities increase
Other expenses	241.5	366.7	51.8	Reflects capacity expansion underway in machining facilities
Total Expenditure	3,532.2	4,203.5	19.0	
EBITDA	1,239.0	1,363.8	10.1	5% below expectations
Interest	215.3	294.2	36.6	
Other income	162.0	178.9	10.4	
EBDT	1,185.6	1,248.5	5.3	
Depreciation & Amortization	252.6	353.4	39.9	
PBT	933.0	895.2	(4.1)	
Exceptional expenditure		-23		
Tax	303.3	290.1	(4.3)	
PAT	629.7	581.8	(7.6)	
PAT (pre exceptionals)	629.7	597.3	(5.1)	6% below expectations
Profit Margins (%)				
EBITDA (%) net sales	26.0	24.5		In line with expectations
EBIT (%)	19.1	16.8		
Pre tax margins (%)	18.1	14.9		
Tax / PBT (%)	32.5	33.3		
Net profit margins (%) Net Sales	13.2	11.0		
Cost ratios (%)				
Raw materials / sales	45.6	44.4		
Staff costs / sales	5.8	6.8		
Mfg and Other expenses / sales	22.6	24.3		

Source: Company, Citi Investment Research

Figure 3. Bharat Forge Consolidated- 3QFY08 Financial Results

	3QFY07	3QFY08	% chg YoY
Net sales	10,174	10,800	6%
Expenditure	8,504	9,050	6%
EBITDA	1,670.32	1,750.04	5%
Other Income	197	194	-1%
Interest	254	325	28%
Depreciation	461	545	18%
PBT	1,151	1,075	-7%
Tax	381	365	-4%
PAT	769.57	709.57	-8%
EBITDA (%)	16.4	16.2	
PAT (%)	7.6	6.6	

Source: Citi Investment Research

Figure 4. Bharat Forge - 3QFY08 Imputed Performance of Subsidiaries

	3QFY07	3QFY08	% chg YoY
Sales	5,403.3	5,232.7	-3%
EBITDA	431.36	386.24	-10%
PAT	139.84	97.17	-31%
EBITDA (%)	8.0	7.4	

Source: Citi Investment Research

Note: Doesn't include FAW Bharat Forge results

Bharat Forge

Company description

Bharat Forge is a global-scale forging major and the largest exporter of auto components in India. As global automakers increase component outsourcing to offset declining profitability, Bharat Forge sees a larger export market, as well as steady sales domestically. Cross-border acquisitions over the past two years were initially value-accretive, but inability to rapidly turn them around has hit BHFC's consolidated financial profile.

Investment strategy

We rate Bharat Forge Hold/Low Risk. India's advantages in auto parts are well documented: highly skilled engineers and relatively lower wages. Bharat Forge remains well-positioned to benefit from the trend of increased outsourcing of auto parts to low-cost countries. For Bharat Forge, we forecast exports will account for around 37% of FY08E standalone sales (a CAGR of 22% over FY05-08E). Despite these advantages, we believe BHFC's consolidated profits growth will slow over the near term due to: 1) high base effect; 2) slower than forecast turnaround of subsidiaries leading to a further de-rating of the stock. Despite its underperformance, we reckon the stock could trade lower, to factor expectations of relatively slower EPS growth.

Valuation

Our Rs325 target price is based on a P/E multiple of 18x - far lower than the 26x implied by the DCF - based methodology that we previously employed. We switch from DCF to a P/E based methodology because: 1) Bharat Forge's secular growth prospects remain strong (measured over a 3-5 year horizon). But on a YoY basis, volatility in revenue growth will intensify due to a) changing emission norms in various markets, which will dislocate and accelerate demand from OEM customers; and b) BHFC's subsidiaries abroad (which account for >50% of revenues) are being restructured by BHFC management, which will lead to further volatility in overall consolidated earnings. 2) DCF doesn't adequately capture the volatility in earnings, and the subsequent impact on the earnings multiple of the shares. Given these issues, we reckon that P/E is a more appropriate multiple. In the past, BHFC traded at P/E multiples of 34x 1 year forward, on expectations of 40%+ earnings growth, which implied a PEG of around 0.85x. Applying the same PEG multiple, we arrive at a one-year forward target multiple of 17x, based on 20% earnings CAGR over FY07-09E. Over the past fiscal year, the stock has traded at an average P/E of around 23.5x, with a maximum of 27x and a low of 19.5x. Our target multiple which is at the lower end of the current trading range reflects our view that the multiple has yet to decline to reflect lowered expectations of earnings growth.

Risks

We rate Bharat Forge Low Risk, in line with our quantitative risk-rating system. Key upside risks to our recommendation are as follows: 1) faster than forecast turnaround in subsidiaries' operations, which might meaningfully impact our forecasts, 2) reduction in input costs and the attendant positive impact on earnings, 3) further acquisitions, which are earnings accretive in nature. Downside risks are 1) rising cost pressures, 2) decline in demand from key OEM clients, 3) product liability claims, which might impact profitability 4) inability to rapidly turnaround the Chinese venture.

Appendix A-1

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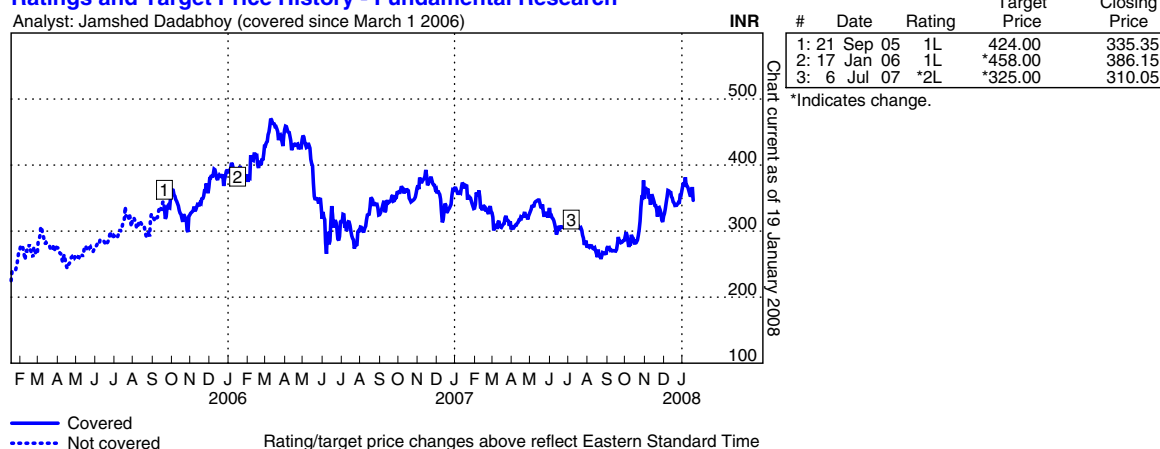
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Ratings and Target Price History - Fundamental Research

Analyst: Jamshed Dadabhoy (covered since March 1 2006)



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