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Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Offshore	03-Mar-05	330	**1,213**	1,760
HLL	24-Nov-05	172	**251**	300
ICICI Bank	23-Dec-03	284	**645**	770
Orient Paper	30-Aug-05	214	**643**	800
UltraTech	10-Aug-05	384	**853**	1,000

Sharekhan Ltd
A-206, Phoenix House, 2nd Floor, Senapati Bapat Marg, Lower Parel, Mumbai - 400013, India.

BASF India

Ugly Duckling

Stock Idea

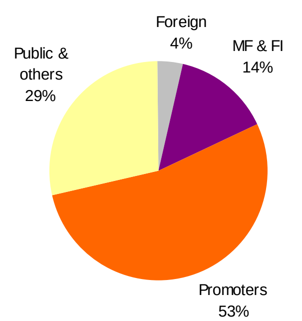
Piggybacking on consumption boom

Buy; CMP: Rs220

Company details

Price target:	Rs300
Market cap:	Rs616 cr
52 week high/low:	Rs279/148
NSE volume: (No of shares)	41,770
BSE code:	500042
NSE code:	BASF
Sharekhan code:	BASF
Free float: (No of shares)	1.3 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-2.7	32.3	-2.5	0.9
Relative to Sensex	-8.5	4.4	-13.3	-31.4

Key points

- We expect BASF India (BASF) to benefit from the changing demographics and the resulting consumption boom in India.
- BASF's products are used in industries like white goods, textiles, home furnishing, paper, construction and automobiles all of which have been growing at a fast pace in contemporary times.
- To capitalise on the resulting opportunity, BASF is expanding the capacity of its two key products, expandable polystyrene and polymer dispersion, which are used in the white goods industry and paper industry respectively.
- We expect BASF's revenues to grow at a compounded annual growth rate (CAGR) of 31% and its earnings to grow at CAGR of 32.8% over FY2006-08E.
- It has seen consistent return ratios in the past five years. It has RoCE of 24.8% and RoNW of 17.1% for FY2006; the same are expected to improve to 33.8% and 23.8% respectively by FY2008E.
- BASF has a dividend yield of 3.3% and a high dividend pay-out of 40% which provide a margin of safety to the investment.
- At the current market price of Rs220, the stock is quoting at 7.6x its FY2008E earnings per share (EPS) and 4.3x its FY2008E EV/EBIDTA.
- We believe that the stock is trading at attractive valuations given that:
  - the outlook for the company's business is very bright over next two years;
  - the return ratios, RoCE and RoNW, are likely to show sharp improvement; and
  - the dependence on agrinutrients business is likely to reduce substantially.
- We recommend a Buy on BASF with a price target of Rs300.

Company background

BASF is a 52.7% subsidiary of BASF AG, Germany. BASF manufactures and markets expandable polystyrene, tanning agents, leather chemicals, textile chemicals, dispersions and specialty chemicals and crop protection chemicals. The company is expanding its presence in the specialty chemical business by moving into production of polyurethane, which has applications in packaging, furniture and automobiles.

Key financials Rs (cr)

Year ended March 31	FY2004	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs crore)	34.1	38.0	45.4	56.2	80.1
Shares in issue (crore)	2.8	2.8	2.8	2.8	2.8
EPS (Rs)	12.1	13.5	16.1	20.0	28.4
% y-o-y change	2.2	*11.4*	*19.6*	*23.9*	*42.4*
PER (x)	17.8	16.0	13.3	10.8	7.6
Book value (Rs)	83.3	89.9	98.0	110.0	129.2
P/BV (x)	2.6	2.4	2.2	2.0	1.7
EV/EBIDTA (x)	8.5	6.8	6.8	5.9	4.3
EV/Sales (x)	1.2	0.9	0.9	0.7	0.5
Dividend yield (%)	2.8	2.8	3.3	3.3	3.7
RoCE (%)	17.3	22.9	24.8	27.5	33.8
RoNW (%)	15.0	15.6	17.1	19.2	23.8

Investment arguments

Robust growth in major user industries

BASF manufactures and markets various specialty chemicals that are used in the industries that are growing at a robust pace.

Product	Usage
Expandable polystyrene	White goods, consumer goods, cold storage and air-conditioning industries
Performance products	Textile, paper, construction, leather auxiliary industries
Chemicals	Petrochemicals and petrochemical intermediates
Agrinutrients	Pesticides, insecticides
Polyurethane	Automobiles, furniture

Revenue break-up

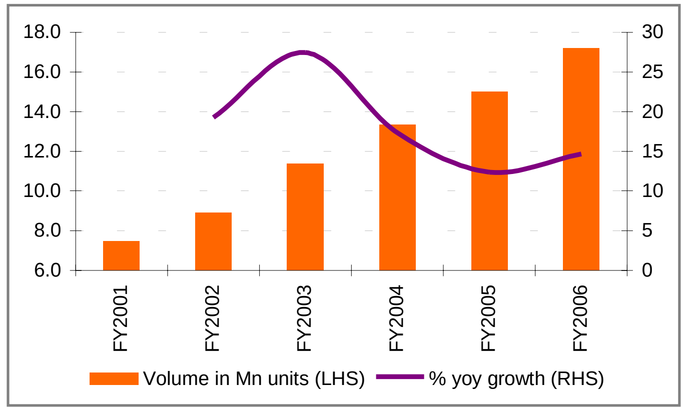
Particulars	FY2004	FY2005	FY2006
Gross revenue (Rs cr)			
Expandable polystyrene	90.6	154.6	163.2
Performance products	320.3	360.0	383.6
Chemicals	11.3	12.s9	27.3
Agrinutrients	229.7	210.2	192.7
Total	**653.3**	**740.2**	**771.6**
PBIT (Rs cr)			
Expandable polystyrene	7.6	13.1	15.8
Performance products	41.5	39.9	39.0
Chemicals	0.0	9.8	10.5
Agrinutrients	28.7	29.7	33.7
Total	**87.1**	**93.5**	**100.2**
PBIT (%)			
Expandable polystyrene	8.4	8.4	9.7
Performance products	12.9	11.1	10.2
Chemicals	0.0	75.8	38.2
Agrinutrients	12.5	14.1	17.5
Total	**13.3**	**12.6**	**13.0**

Expandable polystyrene—riding demographic trends

Expandable polystyrene is used in packaging and insulation. The major end-users in the packaging segment are consumer electronics and white goods industries. In the insulation segment, the major consumers include cold storage and air-conditioning industries.

The story of India's changing demographics is not unknown. The increasing population of younger people, the rising per capita income and the ongoing retail boom are some of its striking features. These coupled with the easier availability of finance, increased distribution/penetration of consumer goods have resulted in a strong secular growth in the consumer electronics industry, which has grown at a CAGR of 18% over FY2001-06.

% yoy growth in consumer electronics (volumes)

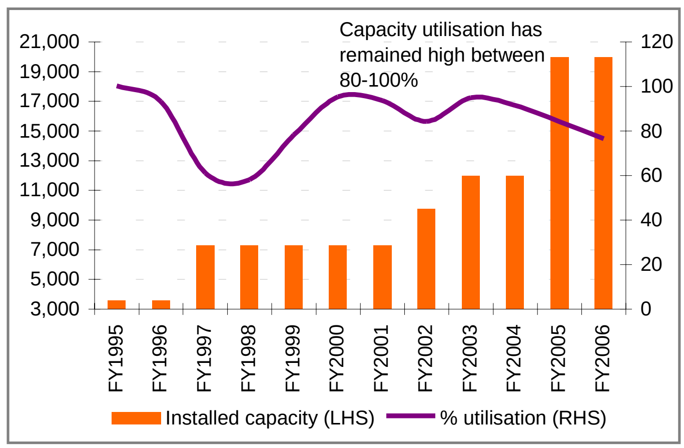


Source: Industry associations

Note: Includes volumes of CTV, refrigerators, washing machines

Commensurate with the same, BASF's expandable polystyrene division has been witnessing higher capacity utilisation in the range of 80-100% despite increasing capacities.

Expandable polystyrene enjoys high utilisation (%)



Source: Company, Sharekhan research

Performance products—riding export boom

The performance product business includes tanning agents, and leather, textile, specialty and dispersion chemicals with the last one being used in the paper industry.

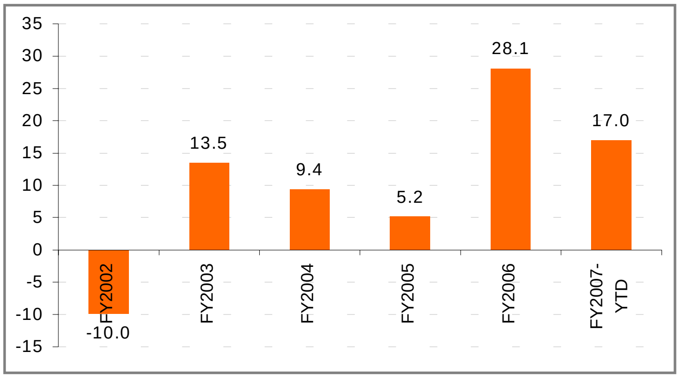
The leather chemical business has seen a declining demand due to a couple of reasons:

- China has become a major exporting country in the footwear segment, causing a decline in India's importance in international trade in the industry;
- the availability of raw hides has been a significant problem for the footwear industry.

The textile chemical industry has seen a robust growth after the abolition of the quota system from January 2005. The growth in textile exports has entered a new trajectory.

The textile industry in India, after the phase-out of the quota regime, has attracted new investments and seen better utilisation of capacities, leading to in a strong demand for textile chemicals.

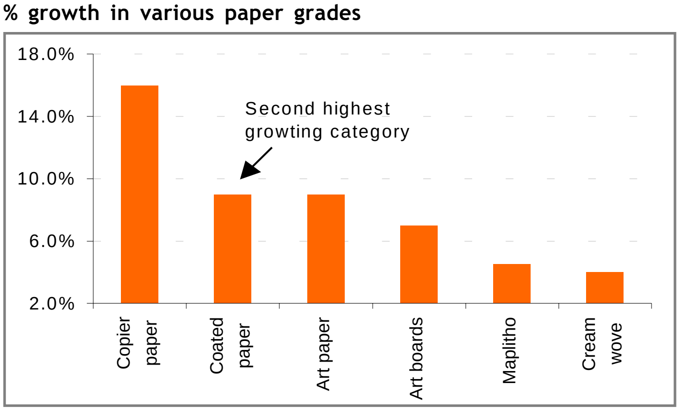
% y-o-y growth in India's textiles exports



Source: DGCI&S, Ministry of Commerce and Industry

Dispersion chemicals, used primarily in paper coating, have been riding on the favourable change in the product mix of the paper manufacturers in India. The efforts by the paper manufacturers to move up the value chain, and consequently improve their realisations and profitability have made coated paper segment the second highest growing segment in the paper industry.

% growth in various paper grades



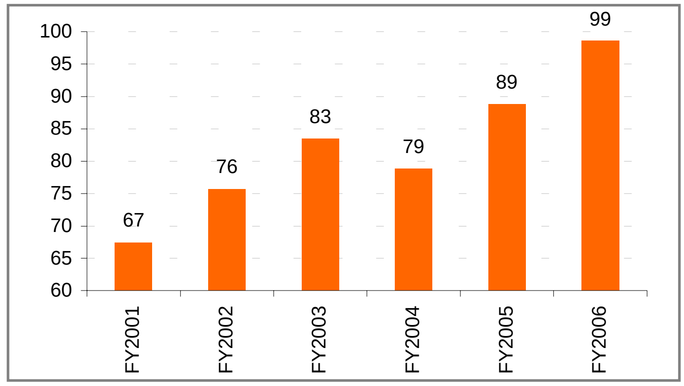
Source: Industry, Sharekhan research

Many of the paper manufacturers in India have embarked on major expansion plans that are likely to get completed over the next two years of which nearly 50% (300,000 tpa) will be in coated paper segment.

Company	Present capacity	Addition	Expanded capacity
AP Paper	155	22	177
Ballarpur Inds	460	300	760
Century Textiles	122	68	190
JK Paper	160	60	220
Seshasayee Paper	115	0	115
Sirpur Paper	83	55	138
Star Paper Mills	71	29	100
T N Newsprint	230	15	245
West Coast Paper	180	90	270
	1,576	**639**	**2,215**

Source: Companies, Sharekhan Research
Capacity in '000 tonne per annum

Capacity utilisation in dispersion chemicals (%)



Source: Company, Sharekhan research

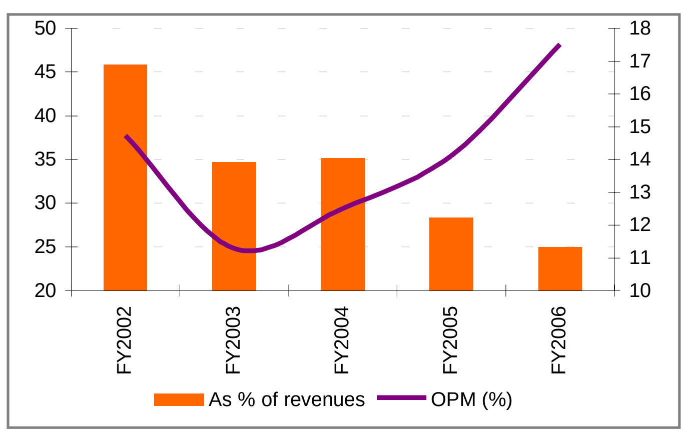
Agrinutrients—rationalised portfolio, reduced dependence

BASF's agrinutrient business went throught a bad patch in FY2003. The worst drought in the monsoon season of 2002-03 coupled with severe competition from the unorganised players resulted in a severe drop in its revenues and a 350-basis-point fall in its margins. Consequently, its profit before interest and tax (PBIT) almost halved in that year.

We see the agrinutrient business improving BASF's financials in two ways:

- The agrinutrient business saw a major turn-around over FY2004-06. BASF rationalised its agrinutrient product portfolio by eliminating the low-margin generic products and focusing on larger numbers of crops, especially fruits and vegetables. Hence the sales in this business declined by 1% over FY2003-06, albeit the PBIT from this business grew at a CAGR of 13% and the PBIT margin improved by a whopping 620 basis points over the same period.
- With the rapid expansion expected in the plastic and performance product businesses, the share of the agrinutrient business is likely to decline from the current level of 24% to 15.5% in FY2008E. The declining contribution of the agrinutrient business to the revenues as well as earnings will bring down the volatility in the company's earnings and improve the stock's valuations.

Share of agrinutrients declining with improving margins



Source: Company, Sharekhan research

Polyurethane—chemical of numerous capabilities

Polyurethane (PU) is one of the most versatile materials today. In its flexible foam form, it is used in upholstered furniture whereas in its rigid foam form, it is used as insulation in walls and roofs. It is also used in paints, coatings and adhesives as well as in the automotive interiors.

PU has four key applications:

- *Home furnishings*

  It is used as cushioning for a wide variety of home furnishings like carpets, sofas and cushion. With its softness and ability to take any shape, PU finds best application in comfort-furnishings.

- *Automobiles*

  In automobiles, PU is used both in seats and upholstery like panels and the inner side of doorframes.

- *Insulations*

  PU-based insulations help in reducing the leakage of energy. For example, the PU insulation over the pipes that carry steam helps prevent the loss of heat. It's also used as a sealant in preventing leakages of liquids and in cold storage systems to insulate the same from outside temperature.

- *Construction*

  In the construction segment, PU finds two applications, in paints and coatings, and in roofing and wall insulation.

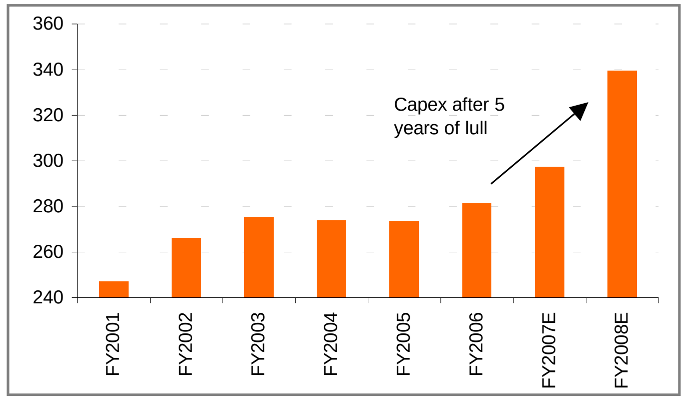
Capital expansion at right time...

BASF has not undertaken any major expansion plans over FY2001-06 despite generating operating cash flows of nearly Rs130 crore over the same period. The cash flows were primarily used to pay off its debts and become a debt-free company.

BASF has drawn up an expansion plan of Rs58 crore to be implemented over the next two years. As per the plan, it shall expand its expandable polystyrene and polymer dispersion capacities. While the expandable polystyrene capacity will be raised from the current 20,000 tonne per annum (tpa) to 25,000tpa by FY2008, the polymer dispersion capacity will be tripled to 65,000tpa by FY2008.

BASF has entered the PU business through its 100% subsidiary, BASF Polyurethane India, which is setting up a PU capacity of 10,000tpa.

Gross block (Rs crore)



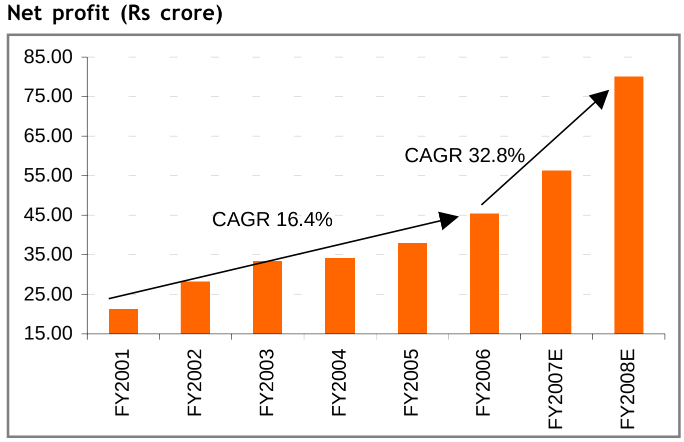
Source: Company, Sharekhan research

...to drive revenues and profitability

BASF's revenues grew at a CAGR of 13% over FY2001-06 and its earnings grew by 16.0% over the same period. With the proposed capacity expansion, we expect BASF's revenues and earnings to grow at a CAGR of 30% and 32% respectively over FY2006-08E driven by the volume growth.

However, we expect its PBIT margins to contract by 120 basis points over FY2006-08E primarily because of the PU business, where technical know-how is of utmost importance. We expect BASF to buy the required raw materials from outside and restrict itself to providing the required technological expertise to the prospective clients. As a result, we expect the margins in the PU business to be low.

Net profit (Rs crore)



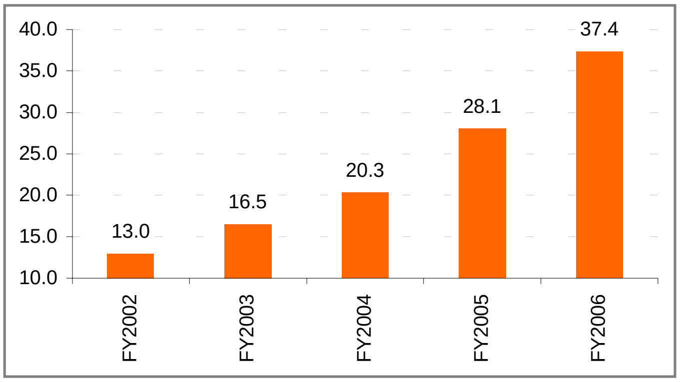
Source: Company, Sharekhan research

Access to vast product portfolio of BASF AG

BASF's parent company has a portfolio of hundreds of products in various segments like plastics, performance products, fine chemicals (used in coatings, paints, adhesives, fragrances), functional polymers, agrinutrients etc. BASF AG has not introduced many of these products in India because of weak intellectual rights protection laws here. BASF imports these chemicals to India on behalf of BASF and earns indenting commission on the same.

Over FY2002-06, BASF's income from the indenting business has grown at a CAGR of 23.5%. The immense growth potential of the indenting business can be gauged from the fact that BASF AG has a product catalogue that lists hundreds of products having diverse uses. The growth of the indenting business will have two advantages for BASF: It will not only boost its operating margins because of a very low cost attached but also improve its return on capital employed (RoCE; as suggested by even historical numbers) because of almost negligible capital employed.

Income from indenting business (Rs crore)



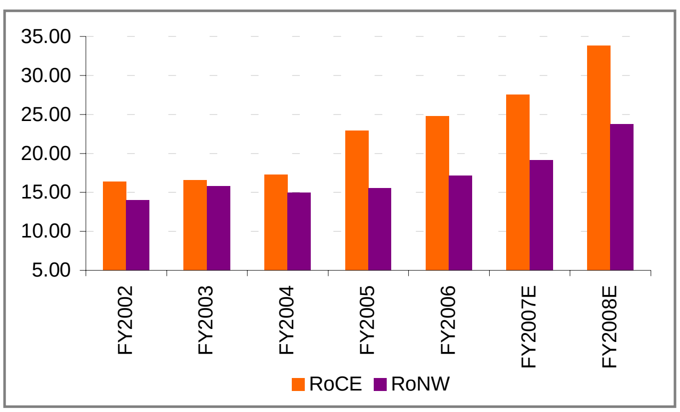
Source: Company

Strong improvement in the return ratios

BASF has shown consistent improvement in the return ratios over the last five years primarily because of the absence of any capital expenditure (capex). The RoCE has improved from 16.4% to 24.8% over FY2002-06 and the return on net worth (RoNW) has improved from 14% to 17.1% over the same period.

We expect the RoCE to further improve to 33.8% and the RoNW to 23.8% over FY2006-08E, despite the proposed capex plan.

Improving RoCE and RoNW (%)



Source: Company, Sharekhan research

Dividend yield provides cushion

BASF has maintained a consistent pay-out of 45-50% over the last six years. We expect the policy to continue in future too. With a dividend of Rs8 per share expected in FY2008E, the stock has a high dividend yield of 3.7% which provides cushion to the downside.

We expect a decline in the pay-out ratio over the next two years (dividend assumed to remain at 80%) due to the capex and increase in the working capital requirement. We expect the pay-out ratio to come back to the 40% level by FY2009, which can result in a dividend yield of 6%+.

Risk and concerns

- All raw materials of BASF are based on crude oil. The crude oil prices have seen a steep rise over the last two years, crossing the $70 per barrel mark. Commensurate with the same, BASF has also seen its raw material cost going up. The raw material cost/sales ratio has moved up from 58.7% in FY2002 to 61.3% in FY2006. Any further rise in the crude oil prices can dent BASF' PBIT margin. We have already factored a 70-basis-point contraction in its PBIT margin from its existing business over FY2006-08E to take into account any further rise in oil prices.
- Currently about 24% of BASF's revenues come from the agrinutrient business, which is dependent on the monsoon. A bad monsoon can hurt the performance of this business. However, with the expansion of the plastic and performance product businesses, we expect the contribution of the agrinutrient business to BASF's revenues to come down to 15.5% by FY2008.

  Incidentally, we believe that the reduced contribution from the agrinutrient business may only help BASF in improving its valuations.

Valuation and view

At the current market price of Rs220, the stock is quoting at 7.6x its FY2008E EPS and 4.3x its FY2008E EV/EBIDTA.

We believe that the stock is trading at attractive valuations given that:

- the outlook for the company's business is very bright over next two years;
- the return ratios, RoCE and RoNW, are likely to show sharp improvement; and
- the dependence on agrinutrients business is likely to reduce substantially.

We recommend a Buy on BASF with a price target of Rs300.

Financials

Profit and loss account

Rs (cr)

Particulars	FY04	FY05	FY06	FY07E	FY08E
Net sales	581.9	657.3	683.0	836.7	1165.5
Other income	8.4	3.5	5.5	2.5	2.5
Total income	590.3	660.8	688.5	839.2	1168.0
Total expenditure	503.0	567.4	593.7	730.5	1020.6
Operating profit	78.9	90.0	89.3	106.2	145.0
Depreciation	21.2	24.4	22.1	23.2	25.5
Profit before interest and tax	57.8	65.6	67.2	83.0	119.5
Interest	10.5	6.1	2.4	1.2	2.0
VRS expenses	4.5	3.1	-	-	-
Profit before tax	51.1	59.9	70.4	84.3	120.1
Tax	17.1	21.9	25.0	28.1	40.0
Reported net profit	34.1	38.0	45.4	56.2	80.1

Balance sheet

Rs (cr)

Particulars	FY04	FY05	FY06	FY07E	FY08E
Sources of funds					
Share capital	28.2	28.2	28.2	28.2	28.2
Reserves total	206.7	225.3	248.1	281.8	336.1
Total shareholders funds	234.8	253.5	276.3	310.0	364.3
Total debt	67.0	10.0	5.0	19.0	20.0
Net deferred tax	6.1	0.8	-3.5	-3.5	-3.5
Total liabilities	**308.0**	**264.2**	**277.8**	**325.5**	**380.8**
Application of funds					
Net block	95.5	77.0	63.9	56.8	73.3
Capital work in progress	0.2	1.4	16.1	42.0	0.0
Investments	5.0	0.0	2.9	2.9	2.9
Net current assets	204.2	185.9	194.9	223.8	304.6
Miscellaneous expenses not written off	3.1	0.0	0.0	0.0	0.0
Total assets	**308.0**	**264.2**	**277.8**	**325.5**	**380.8**

Key ratios (%)

Particulars	FY04	FY05	FY06	FY07E	FY08E
OPM	13.6	13.7	13.1	12.7	12.4
PATM	5.8	5.7	6.6	6.7	6.9
RoCE	17.3	22.9	24.8	27.5	33.8
RoNW	15.0	15.6	17.1	19.2	23.8

Valuations

Particulars	FY04	FY05	FY06	FY07E	FY08E
EPS (Rs)	12.1	13.5	16.1	20.0	28.4
PER (x)	17.8	16.0	13.3	10.8	7.6
P/BV (x)	2.6	2.4	2.2	2.0	1.7
EV/EBIDTA (x)	8.5	6.8	6.8	5.9	4.3
EV/Sales (x)	1.2	0.9	0.9	0.7	0.5

The author doesn't hold any investment in any of the companies mentioned in the article.

MRO-TEK

Apple Green

Stock Update

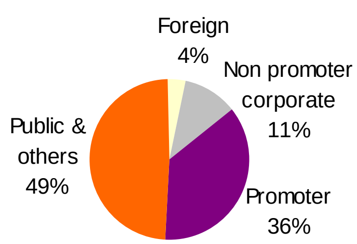
Book out

Book out; CMP: Rs67

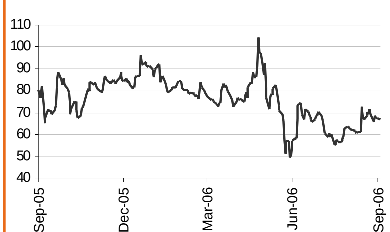
Company details

Market cap:	Rs137 cr
52 week high/low:	Rs109/49
BSE volume: (No of shares)	2.4 lakh
BSE code:	532376
Sharekhan code:	MRO-TEK
Free float: (No of shares)	1.3 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	5.7	23.0	-13.3	-9.4
Relative to Sensex	-0.6	-3.0	-23.0	-38.4

MRO TEK's performance lacked lustre in the previous two quarters. Recognising the signs of a slowdown, we had downgraded the stock to Hold recommendation before the announcement of the company's first quarter results in July 2006. We believe that the situation has further deteriorated in the past couple months. Consequently, we advise investors to book out of the stock and the reasons for the same are given below.

Higher-than-expected pricing pressure

The aggressive pricing strategy adopted by some of the Chinese vendors (like ZTE and Huawei) has resulted in a higher-than-expected decline in the average realisations during the current fiscal. Especially in the network equipment segment some of the product categories have witnessed a 15-20% drop in the realisation as compared with an average decline of 10% witnessed in the previous years.

Volume growth not sufficient to achieve guided revenue growth

On the other hand, the company has been unable to effectively tap the robust demand from the key user industries, such as telecommunication service providers, that have chalked out aggressive capital expenditure plans to expand their networks. MRO TEK appears to have been losing its market share in the existing product lines and has been unable to introduce any significant revenue-generating or high-margin products in the past few quarters. Consequently, the growth in volumes would not be sufficient to achieve the guided 15-20% growth in its revenues during the current year.

WiMax revenues to contribute from the second half of FY2008

The broadband network product based on wireless technologies (like WiMax and Wi-Fi) is also not expected to make any material contribution in the current year. Given the fact that the regulator is yet to decide on the spectrum allocations, the roll-out of WiMax-based networks is likely to pick up only in the latter part of 2008.

Book out

MRO TEK is a cash rich company and does not have any significant requirement for capital expenditure in the coming years. Consequently, the dividend policy is likely to remain liberal that would result in a decent dividend yield at the current level. However, the inability of the company to grow in the robust demand environment would continue to act as a drag on the stock's valuation. We advise booking out of the stock.

Key financials

Particulars	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	12.3	17.6	20.4	24.4
No of shares (cr)	2.0	2.0	2.0	2.0
EPS (Rs)	6.0	8.6	10.0	12.0
% y-o-y change	*134.4*	*43.4*	*15.9*	*20.1*
PER (x)	11.2	7.8	6.7	5.6
Price/BV (x)	1.9	1.6	1.4	1.2
EV/EBIDTA(x)	8.9	4.7	3.6	2.7
Dividend yield (%)	1.9	3.4	3.4	3.4
RoCE (%)	18.5	29.2	31.7	32.2
RoNW (%)	17.1	20.9	20.5	20.9

Sundaram Clayton

Apple Green

Stock Update

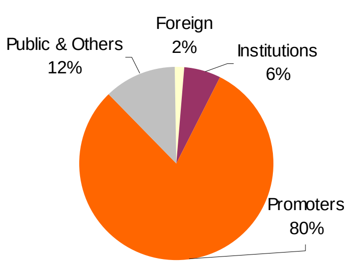
Annual report review

Buy; CMP: Rs1,040

Company details

Price target:	Rs1,550
Market cap:	Rs1,973 cr
52 week high/low:	Rs1,373/701
NSE volume: (No of shares)	2,148
BSE code:	520056
NSE code:	SUNDRMCLAY
Sharekhan code:	SUNCLA
Free float: (No of shares)	38 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	0.3	21.7	11.8	27.8
Relative to Sensex	-5.6	-4.0	-0.7	-13.1

The key takeaways from the latest Sundaram Clayton Ltd's (SCL) annual report are mentioned below.

- **Good performance in FY2006:** SCL delivered a strong performance as its top line rose by 17.3% to Rs629.3 crore in FY2006 as both the die-casting and brakes divisions rendered good performances. The net profits for the year marked an increase of 39.8% to Rs74.5 crore in FY2006.
- **Improving operating metrics:** The company continued to generate strong cash flows, while the return ratios also marked an improvement during the year as the return on capital employed (ROCE) improved to 27.8% as compared with 26.7% last year while the return on net worth (RONW) grew to 23.7% as against 21.9% last year.
- **Both divisions perform well:** The brakes division performed well in FY2006 and the outlook remains bullish with the implementation of the norms such as IS 1852-2001 and the implementation of the anti-lock braking systems (ABS). The revenues from sourcing to WABCO are also expected to rise in the coming years. The die-casting division also showed a remarkable volume growth and the exports prospects for the division are quite bright.
- **Capex:** For FY2007, SCL has lined up a capital expenditure (capex) of Rs49 crore for the brakes division and that of Rs75 crore for the die-casting division.
- **Reiterate Buy:** At the current market price (adjusted for value of investments) the stock trades at 11.1x FY2008E earnings and 9.2x FY2008 earnings before interest, depreciation, tax and amortisation (EBIDTA). We maintain our Buy recommendation on the stock with a price target of Rs1,550.

Good performance

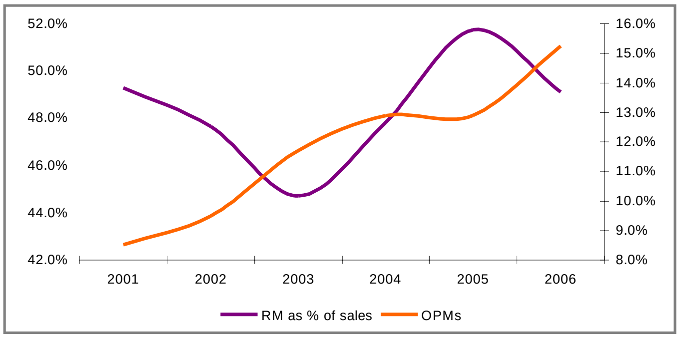
With buoyancy in the Indian automobile sector and particularly in the commercial vehicles industry, SCL delivered a strong performance as its top line rose by 17.3% to Rs629.3 crore in FY2006 as both the die-casting and brakes divisions rendered good performances. The company was able to improve its operating margins by a brilliant

Key financials (valuations—adjusted)

Particulars	FY2004	FY2005	FY2006E	FY2007E	FY2008E
Net profit (Rs cr)	46.3	52.5	68.6	102.3	140.9
EPS (RS)	24.4	27.7	36.2	53.9	74.3
% y-o-y growth		*13.4*	*30.7*	*49.1*	*37.7*
PER	33.8	29.8	22.8	15.3	11.1
P/B	9.6	8.2	6.8	5.5	4.3
EV/EBIDTA	36.4	23.3	16.9	13.1	9.2
RoCE (%)	30.6	26.7	27.8	30.9	36.7
RoNW (%)	22.5	21.9	23.7	28.5	30.5

230 basis points to 15.3% during the year due to the rising efficiencies as its raw material cost as a percentage of sales reduced to 49.1% from 51.7% a year earlier. The net profits for the year marked an increase of 39.8% to Rs74.5 crore in FY2006. Going forward, the company expects the automobile industry in India to continue to perform well with the growing domestic demand and India becoming a global outsourcing hub. This will have a positive impact on the company's performance. Measures like the ban on overloading of vehicles are also likely to improve the performance of the company.

Improving margins

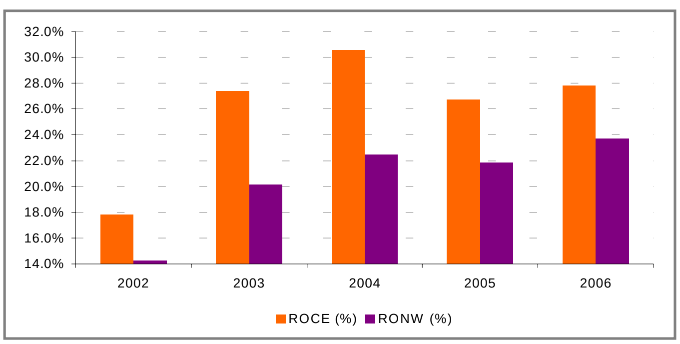


Improving operating metrics

The company continued to generate strong cash flows as the net cash flows from operations for the year stood at Rs62.7 crore as against Rs68.8 crore a year ago. The decline was due to the increasing impact of the change in the working capital due to the higher contribution of exports. Overall, the cash and cash equivalents increased from Rs2 crore in the last fiscal to Rs14.8 crore in FY2006.

The return ratios have also marked an improvement as the margins expanded due to the rising efficiencies and the benefit of scale. The RoCE rose to 27.8% as compared with 26.7% last year while the RONW grew to 23.7% as against 21.9% last year. The debt/equity ratio rose marginally to 0.5x as against 0.45x in FY2005 due to the company's capacity expansion plans and an increase in the working capital requirements.

Improving return ratios



Segmental performance

Both the brakes and die-casting divisions have performed well during FY2006.

Sales break-up division-wise

(in crores)	FY2006	FY2005	% Growth yoy
Airbrakes			
Domestic	398	352	13.1
Exports	11	10	10.0
Total	**409**	**362**	**13.0**
Die-casting			
Domestic	142	117	21.4
Exports	75	54	38.9
Total	**217**	**171**	**26.9**

Brakes division

The brakes division supplies the entire braking system to the original equipment manufacturer (OEM). Its main customers are commercial vehicle manufacturers. The brakes division witnessed a volume growth of 10.7% and the realisations improved by 2.8% during FY2006. The company has a very positive outlook for the division given that the government of India has introduced regulations that stipulate that the braking systems for the commercial vehicles should conform to the stringent IS 11852-2001 standards, wef April 2006 and the implementation of the anti-lock braking system, which is to become mandatory from October 2006 for commercial vehicles carrying hazardous substances.

Further, intermediate commercial vehicles and light commercial vehicles, which were using air over hydraulic braking systems, are being converted into full air brake systems, and this should further enhance the demand for the company's air brake actuation system products. Around 40% of medium and heavy commercial vehicles (M&HCVs) would probably have ABS over the next three years.

The company has also increased its efforts to cater to global requirements of its collaborator WABCO, which also presents a huge opportunity for the company. SCL continues to be on the lookout for newer clients. The company also added a new customer, Asia Motor Works, in the brakes division during Q1FY2007.

Die-casting division

The die-casting division supplies components to both the commercial vehicles and passenger vehicle segments. It reported a revenue growth of 27% mainly on the back of the volume growth of 33.3%. The exports sales increased by 41% year on year from Rs54 crore in FY2005 to Rs76 crore in FY2006 on the back of healthy exports to Cummins and its subsidiaries in the USA, Brazil, Japan and the UK. New businesses were developed with Volvo Trucks, Sweden. The exports revenues are further expected to improve with the change in the emission norms in the USA, whereby all manufacturers are required to develop engines compliant to the new emission norms. Volvo has identified SCL as the major source for developing the castings for its new range of engines. This recognition along with the ramping up of new businesses received from international customers will trigger the growth of the aluminium castings business.

WABCO buys its machined castings from Europe. This can shift to SCL due to its cost competitiveness.

Capacity increase in the casting division

For FY2007, SCL has lined up a capex of Rs49 crore for the brakes division and that of Rs75 crore for the die-casting division. This capex would be used for capacity expansion and new product development. SCL has already increased its casting capacity to 24,000 tonne from 15,000 tonne and plans to further increase it to 50,000 tonne by FY2008. The company has planned to meet this cost partly by internal accruals and partly by low-cost rupee loans and foreign currency loans.

Shift to ABS is a very lucrative opportunity

The usage of the ABS will become mandatory for vehicles carrying harzardous goods from October 2006 and is likely to be implemented for other commercial vehicles (CVs) soon. The company expects a huge revenue trigger due to this. ABS is a superior technology, which prevents a vehicle from skidding in moments of panic and helps to bring it to a controlled stop. SCL is the first Indian company to manufacture the ABS. It has already done extensive research on the same and has offered total solutions to its OEM clients. Being a high-margin product, this should also result in increasing the profitability of the company.

Concerns

- Knorr-Bremse Systems, a multinational air brake system manufacturing company, in joint venture with Tata Auto Components (TACO) has set up their new plant in Pune and has started supplies to Tata Motors. This development will lead to a reduction in the company's share of business.
- The company is also likely to encounter continued price pressures from its OEM customers. The increase in the cost of raw materials such as steel and aluminium not being fully compensated by the OEM customers might affect its profit performance.

Valuations

To summarise, SCL has two strong business divisions. Exports are also increasing, protecting SCL from the vagaries of the domestic market. SCL has delivered a strong growth over the past couple of years, and its prospects too appear bright. According to the annual report, the management expects huge growth prospects in both the domestic as well as the exports markets and the outlook for the company looks bright in 2006-07.

SCL holds 56.8% in TVS Motors (8.8% directly and 48% indirectly through its 100% subsidiary Anusha Investments Ltd. The investment value of the holdings in TVS Motors and TVS Electronics for SCL stands at Rs864 per share. Assuming a 75% discount to its investment value per share, the stock is currently trading at 11.1x FY2008E earnings and 9.2x FY2008 EBIDTA. We maintain our Buy recommendation on the stock with a price target of Rs1,550.

The author doesn't hold any investment in any of the companies mentioned in the article.

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