11 May 2009

BSE Sensex: 11683

INDIA RESEARCH

AIA Engineering

Rs172

OUTPERFORMER

COMPANY UPDATE

Mkt. Cap: Rs16.2bn; US$320mn

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We recently did a conference call with the AIA Engineering (AIA) management to get an update and outlook on the business. The management expects the volume growth to continue across sectors as has been witnessed in FY09. Moreover, volumes from the mining sector are likely to pick up as over the past 3-4 months, AIA has diversified its focus from only iron ore mining to various other mining areas such as gold, copper, zinc, platinum, etc in various countries (Brazil, Australia, South Africa, etc). We have estimated volume growth of 20% in FY10, with the mining sector contributing 15,000 tons, in view of the subdued mining activity globally considering the weak commodity prices. Overall, we expect AIA, the world's 2nd largest high chrome mill internals player, to be the key beneficiary of both replacement and capex led demand in cement, mining and power utilities across the domestic and international markets. We expect the capacity expansion and inroads into the mining sector to drive strong volume and earnings growth over the longer term (FY11-12). We believe valuations of 9.1x FY10E earnings, are quite attractive considering the oligopolistic nature of the industry and the non-cyclical nature of revenues (75% of revenues are replacement driven). We re-iterate our Outperformer rating on the stock.

The salient points discussed with the management are highlighted below:

❑ Volume outlook remains strong driven by the diversification into the mining sector

The management has indicated that FY09 volumes have grown at a strong pace and likely to achieve ~Rs10bn in revenues. The cement sector contributes to almost 70% of the volumes, while the balance is from utilities and mining sector.

- In FY10, volumes from the cement sector are estimated to be at ~85,000 tons (20% growth), which will be primarily driven from the replacement demand and market share gains in international cement market.
- Volumes from the utility segment are likely to grow by 20% yoy, stemming entirely from Indian markets driven by capacity additions and replacement demand.
- Volumes in the mining sector are likely to be the key growth driver for volumes in FY10. The management expects volumes to stem primarily from international markets. AIA has been focussing on the mining sector, particularly for iron ore mining, over the past 6-9 months by getting qualified by various international mining companies such as CVRD, Rio Tinto, Minnesota Mines, etc. However, the recent melt down in iron ore prices and lower demand have led to lower mining activity in the iron ore sector. Over the past 3-4 months, AIA has diversified its focus within the mining sector from only iron ore mining to other mining areas such as gold, copper, zinc, platinum, etc. Accordingly, AIA expects demand for the mining sector to pick up in 2HFY10.

We have factored in 114,000 tons of volumes in FY10, a 20% growth. We believe the lower mining activity is likely to continue driven by lower demand and commodity prices. Accordingly, till mining volumes do not show signs of pick up, we have factored in only 15,000 tons from the mining sector in FY10.

❑ De-bottlenecking existing facilities to expand capacity

Currently, AIA has a production capacity of 165,000 tons annually. Considering the strong growth envisaged over the next 2-3 years, AIA is looking to expand its capacity. Accordingly, AIA has begun a de-bottlenecking activity at its plants, which will expand capacity by 25,000-30,000 tons taking the total capacity to 200,000 tons by FY10 end. In the meanwhile, AIA continues to eye SEZ land for its new facility as international revenues are likely to increase to 75-80% of total by FY11. AIA has already identified 2 proposed SEZ facilities, which are yet to be notified.

❑ Realizations to not fall in line with raw material price correction

The raw material prices for ferro chrome and steel have fallen sharply from their peaks by 50-80%, which is likely to impact realizations as AIA passes on the benefit of lower raw material prices to its clients. However, raw material prices have stabilized since January 2009 onwards and are likely to remain steady with limited volatility going forward in FY10. Accordingly, realizations are likely to fall by 20% yoy in FY10, which is lower than the raw material price correction as AIA expects a better revenue mix towards higher value add products. Accordingly, AIA expects margins to remain stable at 22-24% levels based on the product and revenue mix. AIA has been incurring forex losses as it had entered into forward covers for its receivables. The losses are likely to continue into FY10 and FY11 as it has outstanding forward cover position of Rs2.5bn for FY10 and at Rs1.5bn for FY11.

❑ Maintain Outperformer

Overall, we expect AIA, the world's 2nd largest high chrome mill internals player, to be the key beneficiary of both replacement and capex led demand in cement, mining and power utilities across the domestic and international markets. Moreover, AIA has added capacity (doubling capacity over FY07-10) to meet the strong demand and garner higher market share in both mining and cement from international markets. Consequently, we believe valuations, at 9.1x FY10 earnings, are quite attractive considering the oligopolistic nature of the industry and the non-cyclical nature of revenues (75% of revenues are replacement driven). We re-iterate our Outperformer rating on the stock with a price target of Rs210/share.

Key financials

As on 31 March	FY2006	FY2007	FY2008	FY2009E	FY2010E	FY2011E
Net sales (Rs m)	4,070	5,230	6,912	10,156	10,621	12,921
Adj. net profit (Rs m)	524	944	1,333	1,676	1,786	2,145
Shares in issue (m)	88.9	94.0	94.0	94.3	94.3	94.3
Adj. EPS (Rs)	5.9	10.0	14.2	17.8	18.9	22.7
% growth	45.6	70.3	41.2	25.3	6.5	20.1
PER (x)	29.1	17.1	12.1	9.7	9.1	7.6
Price/Book (x)	5.4	3.2	2.6	2.1	1.7	1.4
EV/EBITDA (x)	18.0	11.6	9.2	6.2	5.5	4.8
RoE (%)	28.2	24.2	23.8	24.0	20.8	20.5
RoCE (%)	31.0	27.3	26.0	31.9	27.1	26.7

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Disclaimer

Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

Disclosure of interest:

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