Industry Flash

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Indian Shipbuilding

2QFY08 – Key Takeaways

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- **Stable quarter** — Indian shipbuilders (ABG and Bharati) reported stable 2Q numbers, in-line with our estimates, driven by a combination of (1) seasonality on account of rains and (2) robust operating margins.
- **2Q a seasonally weak quarter** — 2Q (alongwith 1Q) is typically seasonally weak as rains result in fewer deliveries and hence lower income recognition during this period. 1HFY08 shipbuilding revenues are, however, currently trending at 42-43% of our FY08 revenue estimates for both companies, in-line with historical trends and lending comfort to our earnings estimates for the full year.
- **Operating margins remain robust** — Clean operating margins (ex-subsidy) during the quarter remained strong, particularly for ABG at 23% (Bharati's shipbuilding margins were also strong at 19%, albeit lower than ABG). As the companies start executing more recently won, higher-priced contracts, EBITDA margins are likely to remain robust over the next few quarters, higher raw material costs notwithstanding. Our 17-18% margin forecast over FY08-10E for both companies is therefore quite conservative.
- **Maintain positive sector outlook** — We continue to believe the Indian shipbuilding sector offers attractive value with fundamentals remaining strong, driven by (1) continued tightness in the global shipbuilding sector, (2) the robust E&P cycle and (3) strong global economy fundamentals. Clarity on extension of the subsidy scheme and announcement of more new orders would be key catalysts for the stocks. We maintain Buy (1M) on ABG and Bharati.

Indian Shipyards – Statistical Abstract

Indian Shipyards	RIC	Price		Mkt cap	Target	P/E (x)			EPS CAGR
Company Name	Code	30-Oct-07	Rating	(US$m)	price	FY08E	FY09E	FY10E	FY08-10E
ABG Shipyard	ABGS.BO	741	1M	958	775	24.3	15.3	10.6	51.7%
Bharati Shipyard	BHAR.BO	641	1M	366	790	16.9	12.2	7.6	49.5%

Source: Powered by dataCentral

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

[1]Citigroup Global Markets India Private Limited

Figure 1. ABG Shipyard – 2QFY08 Results (Rupees in Millions)

Year to 31-Mar	1Q FY07	2Q FY07	3Q FY07	4Q FY07	1QFY08	2QFY08	% yoy	Comments
Net sales	**1,657**	**1,680**	**1,776**	**1,931**	**2,033**	**2,118**	**26.1%**	1Q and 2Q are seasonally weaker quarters
- ow subsidy	*na*	*na*	*290*	*185*	*100*	*190*		
(Increase)/decrease in stock in trade	(54)	(4)	(40)	(144)	(132)	(162)	4449.5%	
Raw material consumed	1,127	991	1,059	1,265	1,402	1,386	39.8%	
Staff cost	36	39	37	36	42	47	20.1%	
Other expenses	100	169	194	276	171	203	20.0%	
Total expenditure	1,210	1,196	1,250	1,434	1,483	1,474	23.2%	
EBITDA	**447**	**484**	**526**	**497**	**550**	**644**	**33.2%**	
EBITDA margin	*27.0%*	*28.8%*	*29.6%*	*25.7%*	*27.1%*	*30.4%*		
EBITDA margin (ex-subsidy)	*na*	*na*	*15.9%*	*17.9%*	*23.3%*	*23.5%*		Extremely strong operating margins maintained but may not be sustained
Interest	42	63	69	93	61	109	73.7%	Increase on account of higher WC loans
Depreciation	13	15	15	17	17	17	18.0%	
Other income	15	1	9	29	33	1	-14.1%	
PBT	407	408	450	416	506	520	27.3%	
Tax	137	137	157	86	172	178	30.0%	
Tax rate	*33.8%*	*33.6%*	*34.9%*	*20.8%*	*34.0%*	*34.3%*		
PAT	**269**	**271**	**293**	**330**	**334**	**341**	**26.0%**	

Source: Company Reports and Citi Investment Research

Figure 2. Bharati Shipyard – 2QFY08 Results (Rupees in Millions)

Year to 31-Mar	1Q FY07	2Q FY07	3Q FY07	4Q FY07	1Q FY08	2Q FY08	% yoy	Comments
Net sales	**673**	**755**	**897**	**1,274**	**1,472**	**1,480**	**96.1%**	1Q and 2Q are seasonally weaker quarters. Wind power accounts for <3% of sales
Raw material consumed	385	434	514	711	818	833	91.7%	
Staff cost	65	83	97	174	167	149	80.1%	
Other expenses	89	93	118	174	191	183	95.9%	
Total expenditure	539	611	728	1,059	1,176	1,165	90.8%	
EBITDA	**134**	**144**	**169**	**215**	**295**	**315**	**118.7%**	
EBITDA margin (shipbuilding)	*19.9%*	*19.1%*	*18.8%*	*16.8%*	*17.6%*	*19.1%*		Operating margins remain stable
Interest	27	36	39	49	52	47	29.3%	
Depreciation	10	11	16	14	19	19	83.4%	
Other income	86	95	153	314	99	142	49.2%	
- ow subsidy	71	89	147	310	88	131	47.2%	
PBT	184	193	268	466	324	391	103.0%	
Tax	62	66	91	158	101	134	102.0%	
Tax rate	*34.0%*	*34.3%*	*34.1%*	*34.0%*	*31.3%*	*34.2%*		
PAT	**121**	**127**	**176**	**308**	**222**	**258**	**103.4%**	

Source: Company Reports and Citi Investment Research

ABG Shipyard

Company description

ABG Shipyard, the largest private sector yard in India, has built more than 90 ships since 1990. It has a shipbuilding facility in Magdala, near Surat in Gujarat, which is focused on the offshore support vessel market. It is now setting up a new shipyard at Dahej besides expanding its capacity at Surat. The first phase of the Dahej shipyard, being constructed at a cost of Rs4bn, can build ships with capacity of up to 120,000 DWT, targeted at the dry-bulk segment. The company also plans to set up a facility at Dahej to manufacture rigs, a big-ticket profitable segment.

Investment strategy

ABG Shipyard is India's leading private shipbuilder and has one of the world's largest AHTS (Anchor Handling Tug) order books. The company has a robust order book of Rs71bn, providing strong earnings visibility for the next 3 to 4 years. Fundamentals for Indian shipbuilders remain robust, driven by (1) continued tightness in the global shipbuilding sector and (2) the robust E&P cycle ensuring demand in the OSV segment. ABG has expanded its existing yard at Surat and is building a new greenfield yard at Dahej, which will likely be commissioned in April 2008. The Dahej yard will have capability to produce ships up to 120,000 DWT and is targetted at the fast growing dry-bulk segment. In its second phase of expansion, the yard would also have a rig-building facility. This should increase the order book execution rate and provide an entry into new shipbuilding segments. Further, we view the recent acquisition of Western India Shipyard as a key positive, giving the company a strong presence in the high margin ship and rig repair business.

Valuation

We rate ABG Shipyard Buy/Medium Risk (1M). We value ABG at Rs775, which is 15x FY09E earnings, at a slight premium to other similar profiled Singapore shipyards that have significantly lower earnings growth, but in line with our target multiples for the Korean shipyards. Given ABG's superior earnings CAGR of 46% over FY07-10E and an order book that provides a cover of 6.7x FY08E sales, we believe the stock deserves to trade at a slight premium to its Singapore peers, subsidy concerns notwithstanding. Our target price also includes Rs47/share as the value accretion to ABG following the recent acquisition of Western India Shipyard.

Risks

We rate ABG Shipyard Medium Risk, which differs from our 260-day quantitative rating of High Risk. We believe the lower rating is justified given the strong order book cover of 6.7x FY08E sales driven by the continued tightness in global shipbuilding and strong demand from the offshore segment. Being a small shipyard in the global context, ABG is subject to industry-wide risk factors that include a rise in raw material costs and a steep rise in global ship building capacity. Key risks include: 1) removal of subsidies; 2) declining oil prices; and 3) execution risk.

Bharati Shipyard

Company description

Set up in 1973, Bharati Shipyard is one of the largest private shipyards in India. From its shipyards, spread across three regions – Ratnagiri, Ghodbunder, and Goa - the company has built ships including OSVs, cargo ships, and a wide range of tugs/deepwater trawlers. It is setting up a new shipyard in Mangalore and has expanded its capacity in Ratnagiri. It has bagged an order to build a jack-up rig, a first for any Indian shipyard. Its order book currently stands at Rs44bn. The company had an initial public offering in May 2004 and subsequently raised $100m through an FCCB in Dec 2005.

Investment strategy

Bharati Shipyard has strong earnings momentum and an order book cover of 5.5x FY08E sales. We rate the stock Buy/Medium risk (1M) with a target price of Rs790. Fundamentals for Indian shipbuilders remain strong, driven by: (1) the robust E&P cycle ensuring demand in the OSV segment and (2) the continued tightness in the global shipbuilding sector. Our positive stance is backed by solid 50% earnings CAGR for FY08-FY10E. The company's current order book of Rs44bn is geared towards the oil & gas segment, which has strong demand drivers. The company has also bagged an order for a jack-up rig, the first of its kind for an Indian company. Its aggressive expansion plans are backed by its strong order book. The company has expanded its capacity at Ratnagiri, while its greenfield yard at Mangalore should start generating revenues in 2HFY08E. The Mangalore yard will be able to produce ships of up to 60,000 DWT and will also house the rig building unit.

Valuation

We rate Bharati Shipyard Buy/Medium Risk (1M) with a target price of Rs790, based on 15x FY09E earnings. The valuation accounts for complete conversion of the FCCB, leading to a 42% dilution in earnings. This is based on our methodology of rating Indian shipbuilders, at a slight premium to other similar profiled Singapore shipyards that have significantly lower earnings growth, but in-line with our target multiples for the Korean shipyards. Given Bharati's superior earnings CAGR of 50% over FY08-10E and an unexecuted order book that is 5.3x FY08E sales, we believe that Bharati deserves to trade at a slight premium to its Singapore peers, subsidy concerns notwithstanding.

Risks

We rate Bharati Shipyard Medium Risk based on our global quantitative analysis. Being a small shipyard in the global context, Bharati is subject to industry-wide risk factors that include a rise in raw material costs and a steep rise in global shipbuilding capacity. Further, global macroeconomic variables such as a decline in GDP growth rates or a decline in sea trade could adversely affect Bharati Shipyards. Key risks include 1) removal of subsidies; 2) declining oil prices; and 3) execution risk.

Appendix A-1

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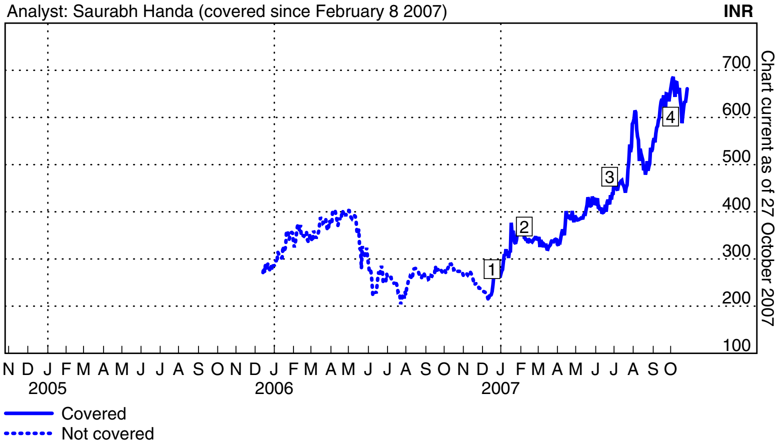
ABG Shipyard (ABGS.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Saurabh Handa (covered since February 8 2007)



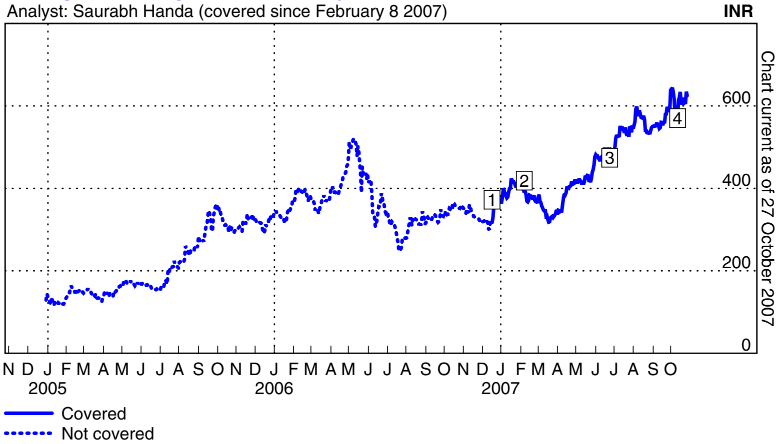
#	Date	Rating	Target Price	Closing Price
1:	18 Dec 06	1M	291.00	230.10
2:	7 Feb 07	1M	*430.00	345.15
3:	25 Jun 07	1M	*560.00	416.00
4:	30 Sep 07	1M	*775.00	659.80

*Indicates change.

Bharati Shipyard (BHAR.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Saurabh Handa (covered since February 8 2007)



#	Date	Rating	Target Price	Closing Price
1:	18 Dec 06	1M	421.00	317.10
2:	7 Feb 07	1M	*525.00	389.50
3:	25 Jun 07	1M	*670.00	497.20
4:	11 Oct 07	1M	*790.00	570.65

*Indicates change.

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