IDFC SSKI

INDIA RESEARCH

30 September 2008

BSE Sensex: 12860

Company update

Bharat Forge

Rs183

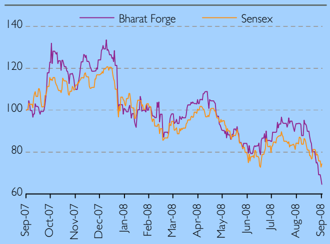
OUTPERFORMER

Diversity saves from adversity

Mkt Cap: Rs41bn; US$961m

Stock data	
Reuters	BFRG.BO
Bloomberg	BHFC.IN
1-yr high/low (Rs)	390/180
1-yr avg daily volumes (m)	0.26
Free float (%)	59.4

Relative price performance



Performance (%)

	3-mth	6-mth	1-yr	3-yr
Bharat Forge	(21.5)	(30.9)	(35.5)	(47.4)
Sensex	(4.5)	(17.8)	(25.6)	48.9

Bharat Forge (BFL) has attained the creditable feat of growing its topline as also margins in FY08 despite the slowdown pangs faced by customers and a steep rise in input costs. While Indian ancillary suppliers are under immense pressure, a diversified (and hence derisked) business model, global scale, pricing power and technology lead have helped BFL beat the tough market conditions. Going forward, the downturn in domestic CV and export markets (USA and Europe) would be offset by growth impetus from non-auto components business and favourable currency movement (in FY09). Non-auto business would form 40% of total sales by FY12E. While we expect 16% revenue CAGR over FY08-10, rising share of the higher-margin non-auto business in the mix would lead to a 230bp margin expansion, and thus a higher 27% PAT CAGR. Maintain Outperformer with a price target of Rs262.

Diversification – BFL's antidote to slowdown: BFL's derisked business model focuses on diversifying its portfolio across segments/ customers as also geographies. While diversification has aided BFL in weathering the slowdown in global auto markets (USA and Europe), market share gains among Indian key customers, ramp-up of European operations and favorable currency movement would be the key future growth drivers.

Non-auto businesses – the next growth propeller: BFL supplies components used in oil & gas, energy and engineering applications (18% of FY08 sales). With five segments, viz. aerospace, energy, oil & gas, transportation (railways & marine applications) and mining identified as key focus areas, we expect the non-auto portfolio to contribute 40% of BFL's revenues by FY12. Importantly, the businesses entail high margins, and thus we expect a 230bp margin expansion for BFL over FY08-10. We expect 16% CAGR in topline and a much higher 27% CAGR in PAT over FY08-10.

Strong topline and stronger PAT growth; Outperformer: Factoring in a higher interest burden stemming from the proposed Rs8bn NCD rights issue (coupon rate assumed @8%), we cut our FY10E earnings by 7.3%. The stock trades at 9.1x FY10E fully diluted earnings and 4.6x EV/ EBIDTA. Given BFL's status as a Tier I auto ancillary supplier which wields pricing clout, the stock's premium valuations appear justified. Maintain Outperformer with a price target of Rs262 (13x FY10E earnings).

Key valuation metrics

Year to 31 March	FY06	FY07	FY08	FY09E	FY10E
Net sales (Rs m)	30,189	41,783	46,523	52,520	62,904
Adj. net profit (Rs m)	2,505	3,027	3,015	3,470	4,854
Shares in issue (m)	*222*	*222.7*	*223*	*223*	*223*
Fully Diluted EPS (Rs)	10.7	12.6	12.5	14.4	20.2
PE (x)	17.2	14.6	14.6	12.7	9.1
Price/ Book (x)	3.0	2.5	2.2	2.0	1.7
EV/ EBITDA (x)	8.9	7.6	7.7	6.2	4.6
RoE (%)	26.1	20.4	17.4	17.7	21.5
RoCE (%)	21.4	15.4	13.8	15.2	19.2

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INVESTMENT ARGUMENT

The efficacy of BFL's diversification strategy has been established in FY08 – an extremely tough year for auto ancillary suppliers – wherein it managed to stave off a growth slowdown. The impact of lower sales in the US and Indian CV industry was offset through market share gains in new product segments in USA and EU and with Tata Motors in the domestic market. While BFL would continue to gain incremental market share, we expect favourable currency movement to compensate for any decline in exports in FY09. In the longer term, a marked shift in business mix towards the high-margin non-auto business (offering better asset turnover of 2.5-3x as against the capital guzzler auto ancillary business) would drive topline as also PAT growth; we expect 16% revenue CAGR and 27% PAT CAGR with ~230bp margin expansion over FY08-10. Being a preferred Tier I component supplier to global auto majors, BFL has the ability to pass on the higher input costs to customers. We believe BFL deserves its premium valuations; maintain Outperformer.

BUSINESS OVERVIEW

Bharat Forge is the second largest and technologically most advanced manufacturer of forged & machined components player in the world with a total capacity of ~700,000 tonnes (including ongoing expansions). Over the years, BFL has evolved from being a supplier of components to becoming a development partner of choice for nearly all global OEMs. The company has manufacturing operations across six countries at 12 locations – four in India, three in Germany, one each in Sweden, Scotland, USA, and two in China.

Exhibit 1: Key milestones achieved

Year	Milestone Achieved	Remarks
Nov-03	Acquired Carl Dan Peddinghaus Germany	Second largest forgings company in Germany engaged in the manufacture of passenger car components, BFL became the second largest forgings player in the world post the acquisition
Dec-04	Acquired CDP Aluminiumtechnik	Provided BFL with an entry into the hi-end & fast growing aluminium component business in Europe
Sep-05	Acquired Imatra Kilsta AB, Sweden along with its subsidiary Scottish Stampings, Scotland (together called the Imatra Forging Group - IFG)	IFG is the second largest manufacturer of front axle beams and the second largest crankshaft producer in Europe
Jun-05	Acquired Federal Forge Inc, USA	Provided BFL with a manufacturing presence in one of its largest export markets, US
Dec-05	52:48 JV with FAW Corporation, China	Forging unit of FAW is the largest in China, provides BFL an entry into the large & fastest growing Chinese auto industry
Feb-08	51:49 JV with NTPC	Marks the companies foray into power equipment mfg
Aug-08	Commissioning of the 4,000T open die press at Mundhwa for the non-auto business	BFL expects the non-auto business to contribute to about 40% to total revenues by 2012

Source: Company, IDFC-SSKI Research

A WELL-DIVERSIFIED BUSINESS MODEL: BFL'S SUCCESS *MANTRA* …

Diversification has been at the core of BFL's growth strategy. Over the years, BFL has focused on diversifying its product mix, moving into different geographies and widening its customer base. Thus, BFL has successfully built a stable business model by reducing its product, industry, geography and customer concentration.

❑ Product diversification

Dependence on CVs gradually cut to 35% of sales; 65% sales from PV industry, diesel engine parts, non-auto business

From being a supplier of chassis components to the CV industry in FY01, BFL has now evolved as a forging components supplier across segments of the auto sector. CV chassis components now form only one-third of its sales while the remaining accrues from sale of components to the passenger vehicle industry, diesel engine parts and the non-auto business.

❑ Geographic diversification

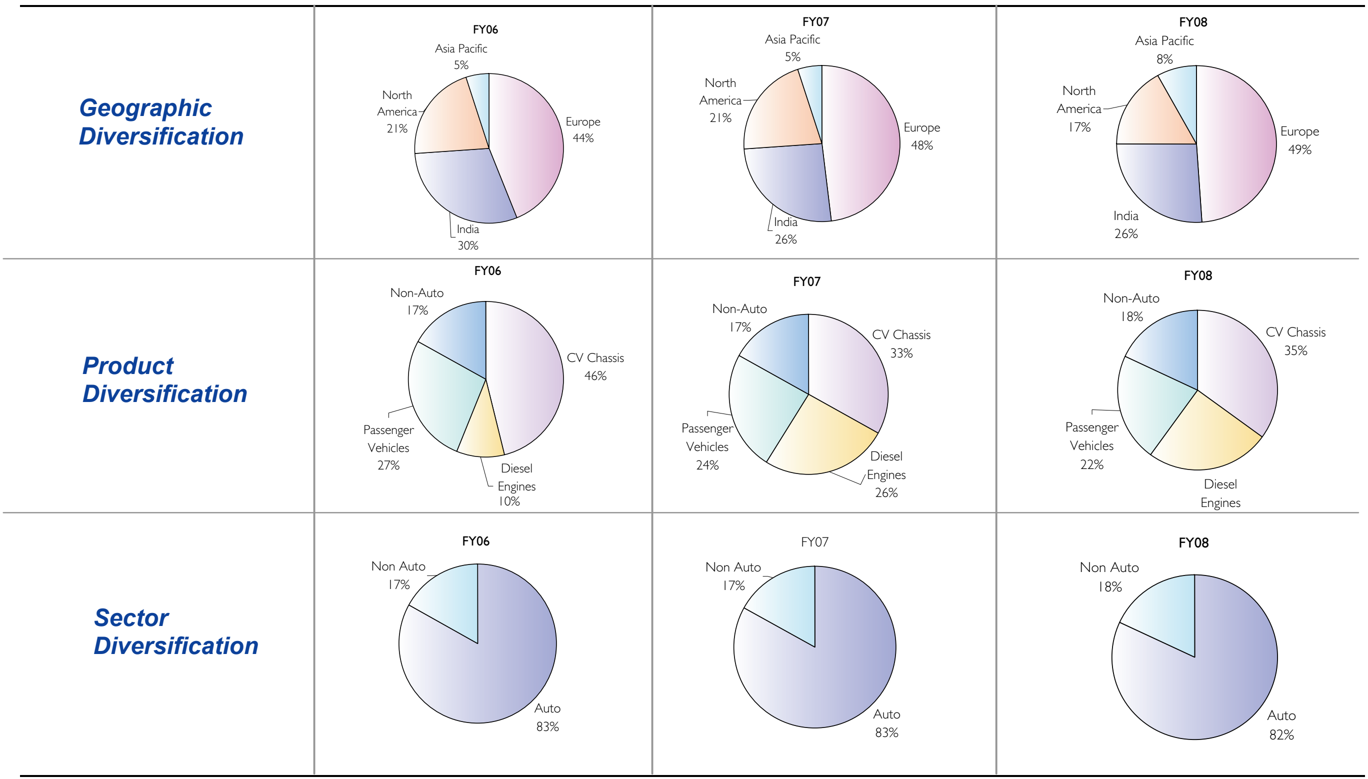
BFL sells in six key geographies with 49% of revenues coming from EU and 26% from India

BFL's customer base spans six countries – China, India, Germany, Scotland, Sweden and the US – serviced from a local manufacturing base in each of these geographies. Revenues from Europe constitute the bulk of BFL's consolidated revenues (49%) while India operations contribute only ~26% to overall sales. The company supplies engine and chassis components to almost all global OEMs and Tier I companies, including the top five passenger car and CV manufacturers.

❑ Sector diversification

To further de-risk its business model, BFL is increasingly focusing on its non-auto business with a varied product mix including forged and machined products for oil & gas, construction equipment and engineering sectors. The non-auto business constitutes ~18% of its overall business from just about 5% in FY01.

Exhibit 2: Well diversified across product segments and geographies



Source: Company, IDFC-SSKI Research

…EFFICACY OF STRATEGY PROVED IN FY08

BFL's derisked business model has helped it overcome the adverse macroeconomic situations (slowdown in USA and Indian automobile markets, rising crude oil and steel prices, and the appreciation of INR against USD) in FY08. Despite the slowdown in two of its key markets, viz. USA and India (43% of total revenues), BFL achieved a reasonable 10.7% increase in its consolidated revenues in FY08 on account of the following measures:

❑ USA – 40% decline in CV sales offset by growth in other segments

Diversification into heavy engine parts, passenger cars and non-auto segments helped BFL soften hit of slower CV sales in US in FY08

BFL has had to contend with a slowdown in the US CV industry, which declined 40% in CY07. However, diversification into the heavy duty engine parts, passenger cars and non-automotive applications helped BFL cushion the impact of the slower CV sales in US in FY08. Despite the slowdown, BFL reported 11.9%yoy growth in exports (in USD terms; flat in rupee terms as the INR appreciated 8% against the USD in the year) to the US in FY08.

❑ Slowdown in domestic CV segment offset by market share gains

Market share gains for BFL as Tata Motors sold more trucks fitted with Cummins engines

BFL's domestic revenues registered a 9.7% increase in FY08 despite sales in CV segment (~55% of domestic revenues, mainly from Tata Motors) growing only by ~4% and MHCV volumes declining by 1.6% over this period. The commendable feat is attributable to the fact that Tata Motors sold more trucks fitted with Cummins Engines (100% crankshafts supplied by Bharat Forge) vis-à-vis the past trend of higher proportion of trucks with Tata's own engines (crankshafts supplied by Tata Motors' own unit). This led to increased business for Bharat Forge even as vehicle sales remained muted.

BFL has now started engaging itself with domestic OEMs as a development partner for their global platforms with long-term relationship and commitment, which would further strengthen its position in the domestic market.

❑ Ramp-up of European operations drives topline growth

Exports to Europe saw a quantum jump and posted an 82% yoy increase in FY08

In the European markets, BFL successfully ramped up several programmes for CV chassis, heavy duty engine parts and passenger car applications in FY08. In the same year, exports to Europe saw a quantum jump and posted an 82% yoy increase. European exports now form 45% of BFL's total exports from 32% in FY07. Also, BFL's strong presence and relationships with major OEMs through its operations in Europe are helping it secure more business in BFL (India), thereby hedging it against the slowdown in exports to US and Indian markets.

NON-AUTO BUSINESSES: THE NEXT GROWTH DRIVER

BFL has, over the years, been supplying components to non-auto segments for several applications including oil & gas, energy production and a range of heavy engineering applications. While the auto segment would continue to be the focus area, BFL has started building on the non-auto component business by gradually adding new product application in varied sectors in order to further derisk its model. BFL has identified five major segments, viz. aerospace, energy, oil & gas, transportation (including railways and marine applications) and the mining sector. Significant business opportunities from these segments that are expected to drive demand for the non-auto forging components business globally have been enumerated below:

Supply constraints in the rapidly growing wind energy industry augur well for BFL

Wind Energy: Wind energy industry is slated to register a CAGR of 17% up to 2011 to 33,000 MW. With severe constraints already existing in the supply chain, the segment offers tremendous business opportunities for BFL going forward.

Transportation (Marine/ Railways): The marine sector is expected to sustain its strong growth momentum over the next 3-4 years with an order backlog of >6,500 new vessels. Railways industry is also witnessing rapid growth fuelled by rising cost of road transportation. Both these sectors offer significant business opportunities for BFL going forward.

Aerospace: Boeing estimates the demand for global aircraft fleet to expand from 18,200 currently to 36,400 by 2026. The offset clause, on the back of large aircraft acquisitions by Indian companies, would generate huge opportunities for Indian forging players.

BFL has the requisite capabilities in power equipment sector; time ripe for BFL to consolidate its position

Power: The power equipment sector is already facing several bottlenecks with lead times for critical components ranging from 3-5 years. This offers huge business opportunities for forging players like BFL.

In most of these sectors, BFL has already acquired the requisite product and design capabilities and have built strong customer relationships over the years. With a global scale and technical capabilities matching the best in the world, BFL is all set to tap the significant growth opportunities offered by each of these segments.

The following exhibit discusses the non-auto business segments in markets where BFL seeks to have a presence:

Exhibit 3: Characteristics of the non-auto business segments across key markets

Segments	US	Europe	India	Asia - Pacific	Outlook for BFL
Wind Energy	One of the largest & fastest growing markets in the world	Largest market in the world	4th largest market in the world	China - fast growing demand but low opportunity due to localisation	Already supplier to small WTG
	Legislation to generate 10-20% of electricity through alternate sources including wind energy	Well developed industry	Good growth rate forecasted	Brazil expected to be a large market in the near future	Opportunity to supply to global OEMs and Tier I
		Low growth rate	Shift from 1MW to 2 & 2.5MW turbines		Products include Main shafts, rings & gear box
					Will supply from the 4,000 ton press line in Mundhwa & ring rolling facility at Baramati
Railways	Mature markets	Western Europe expected to be flat	Strong growth forecast for Asia		Huge opportunity in India, China and Western Europe
	Growth expected to be flat	Strong double digit growth forecast for East Europe	Boom driven by infrastructure spending in India and China		Resourcing opportunities in US and Western Europe
					Products include crankshafts, connecting rods, pistons, axles and camshafts, will supply from the 80 MT hammer at Baramati
Marine	Strong growth in engine volumes expected to sustain over the next 3-4 years				Dealing with all major engine manufacturers
	Japanese, Korean and Chinese shipbuilders are currently having a order backlog of 3-4 years				Products like crankshafts, connecting rods & propellor shafts
	Global OEMs are investing heavily in expanding capacities				Will supply from the 80 MT hammer at Baramati
Oil & Gas	Globally, oil & gas exploration initiatives are intensifying				In a strong position to leverage its current relationships and capabilities and grow its business in this space
	Key growth area is the sub surf (undersea) explorations				Will supply from the 80MT hammer at Baramati & 4,000T press at Mundhwa
Aerospace	Favorable trends such as replacement and refurbishment of legacy fleets				Final stages of accreditation
	Boeing estimates the current aircraft fleet would expand to about 36,400 from 18,200 currently				Products like structural, airframe and engine parts
	Under the off-set clause, 30-40% of the value of the aircraft bought by India will have to be offset by procurements of manufactured goods / services from India				Will supply from the 80MT hammer at Baramati
Power	Legacy infrastructure in developed markets is getting replaced to conform to new emission norms				Huge opportunity in India and China
	Domestic power equipment sector is facing severe bottlenecks in its supply chain with lead times for critical components ranging from 3-5 years				Will supply from the 80MT hammer at Baramati & 4000T press at Mundhwa

Source: Company

Having identified the immense potential in the non-auto forgings space globally, BFL has embarked upon a Rs5bn investment plan to set up manufacturing capacities for its non-auto component foray in Maharashtra at Baramati (commercial production expected to commence in Q1FY10) and Mundhwa (commercial production expected to commence in Q4FY09).

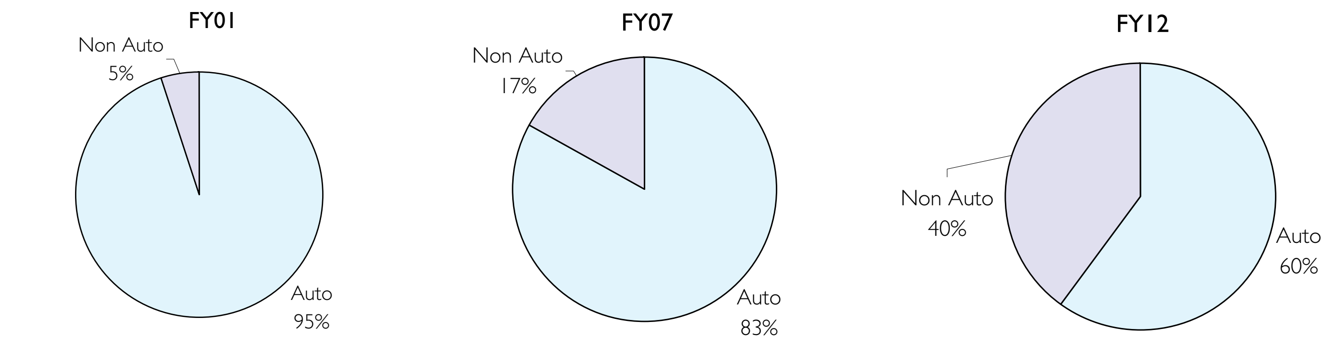
Exhibit 4: Non-auto expansion plan

Location	Types of products and industry addressed	Capacity (per annum)	Estimated start of production
Baramati			
Centre for Advanced manufacturing - 80MT hammer	Large components for Energy sector, Hydrocarbon exploration sector, transportation including aerospace, railways and marine	40,000 tpa	Q1FY10
Machining for the above	Supply of machined components	12,000 units	Q1FY10
Ring Rolling facility	Large rings and gear blanks for various sectors	25,000 tpa	Q1FY10
Mundhwa - Pune			
Heavy forging division - 4,000T Press	Wind turbine components, hydro, gas and steam turbine components for mining, metal industry and general engineering applications	60,000 tpa	Q4FY09
Satara			
Machining for the above	Supply of machined windmill shafts	1,400 units	Q4FY09

Source: Company

Together, these plants would have an annual forging capacity of 125,000 tpa and a total revenue potential of Rs9bn-10bn at full capacity utilization. Revenue contribution from the new non-automotive plants in FY10 is likely to be ~Rs5bn (at ~50% capacity utilization). BFL has already secured three long-term contracts of ~USD50m each from global OEMs.

Exhibit 5: Non auto business – the future growth driver



Source: Company, IDFC-SSKI Research

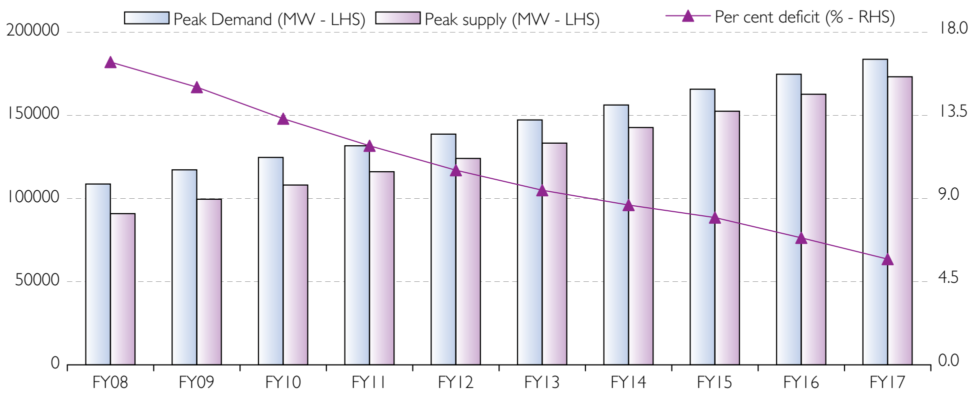
Non-auto business likely to constitute 40% of revenues by 2012

The non-auto business is likely to be the key revenue driver going forward and is expected to contribute ~40% to BFL's revenues (18% currently) by 2012.

❑ Foray into power equipment manufacturing – a big opportunity

India faces a chronic power crunch that is viewed as a major threat to its fast-growing economy. The Planning Commission of India has set a target to add nearly 78,577 MW of generation capacity in order to bring down the demand supply deficit to ~10.5% by the end of the 11th 5-Year Plan (2007-2012).

Exhibit 6: Power deficit to continue over the 12th Plan



Source: Crisinfac, IDFC-SSKI Research

A JV set up to capitalize upon the boom in the power equipment market…

CRISIL estimates investments of ~Rs3.5trn to flow to the power sector in the 11th 5-Year Plan, which translates into tremendous business opportunities for power equipment manufacturers. To capitalize on this huge opportunity, BFL has formed a 51:49 JV with NTPC, viz Bharat Forge NTPC Energy Systems (BNES), at an estimated initial investment of Rs1bn-2bn. BNES would initially manufacture forgings, castings, fittings and high pressure pipings that find application in power and other industries, Balance of Plant (BOP) equipment for the power sector, etc. In due course (possibly by 2011 or 2012), the JV would also manufacture complete power plant equipment (including turbines, rotors, etc) with a total capacity of ~4500MW.

…another JV in the offing

BFL is also likely to set up a US$ 500m JV with Alstom Power to produce high-value, super-critical turbine/ generator (TG) sets for thermal and nuclear power plants. Alstom's expertise in nuclear equipment could also open up significant business opportunities for the JV as and when this segment is further liberalized.

The foray into power sector offers significant revenue generation potential in the long term

Once operational (likely by 2011-12), these ventures would generate significant revenues for BFL. Increasing contribution from these initiatives also imply an improving product mix for BFL as the businesses yield higher margins than the auto business.

OUTLOOK FOR AUTO BUSINESS

The domestic CV industry (55% of BFL's domestic revenues come from this segment) has posted a meager 5% growth in the Apr-Aug '08 period. With rising interest rates and freight rates not keeping pace with the rise in fuel cost, the domestic CV industry is expected to post muted growth in FY08-10 (we expect only a 10% CAGR for the industry over FY08-10).

In addition, the automobile sector in the US is not expected to recover even in CY09. On the positive side, outlook for the Western Europe CV market remains stable with bulk of the growth coming from East Europe. Also, the Chinese, South East Asia and South American passenger vehicle segments have reported steady growth in the current fiscal; going forward, we expect the momentum to be sustained.

An outlook on BFL's key markets in the automotive segment has been presented in the following exhibit.

Exhibit 7: Outlook of PV/ CV industry in BFL's major markets

Segments	US	Europe	India	Asia - Pacific	Outlook for BFL
Passenger Vehicles	Market is flat	Flat outlook for 2008	Positive outlook for small & medium vehicles	China, South East Asia and South America are performing well	BFL has a small exposure and is gaining market share in this segment
	Big 3 are down while transplants are performing well		Less forging content per car		Growing demand for aluminium products
					Positive growth expected
CV	Witnessed a 40% fall in CY07	Outlook for Western Europe is stable with growth coming from Eastern Europe	Flat - subdued growth forecast	Chinese CV market is highly volatile	**Chassis** • Improved penetration • Increased value addition • New customer addition • **Stable business expected**
	Volatile environment and uncertain forecast for the year	Manufacturing and economic activity in Western Europe is buoyant		South America is witnessing strong growth	**Engines** • Relatively new segment for HDEP exports • Ramp up of new programs in progress • Several current and next generation platforms • **Overall positive outlook**

Source: Company

INR has depreciated against the USD and Euro, which would help BFL mitigate the impact of lower export volumes

However, further market share gains with key customers like Tata Motors would help BFL mitigate the impact of a slowdown in the domestic business. Also, favorable currency movement coupled with its diverse product profile would help BFL offset the prevailing slowdown in the US and Western European markets.

❑ Favorable currency movement to mitigate impact of global slowdown

In FY08, the INR appreciated sharply against the USD (8% over FY07), thereby rendering a hit of Rs879m to BFL's export realizations. Despite strong 44% growth in overall exports in USD terms, BFL could realize only 28% revenue growth in rupee terms. However, the INR has depreciated against the USD and Euro, which has helped BFL boost its Q1FY09 sales to the extent of ~Rs165m.

Exhibit 8: INR depreciates against USD / Euro in Q1FY09

Currency	Q1FY09	Q1FY08	Q4FY08	yoy(%)	qoq(%)
USD	41.8	41.2	39.8	1.52	5.16
Euro	65.1	55.6	59.7	17.03	9.03

Source: IDFC-SSKI Research

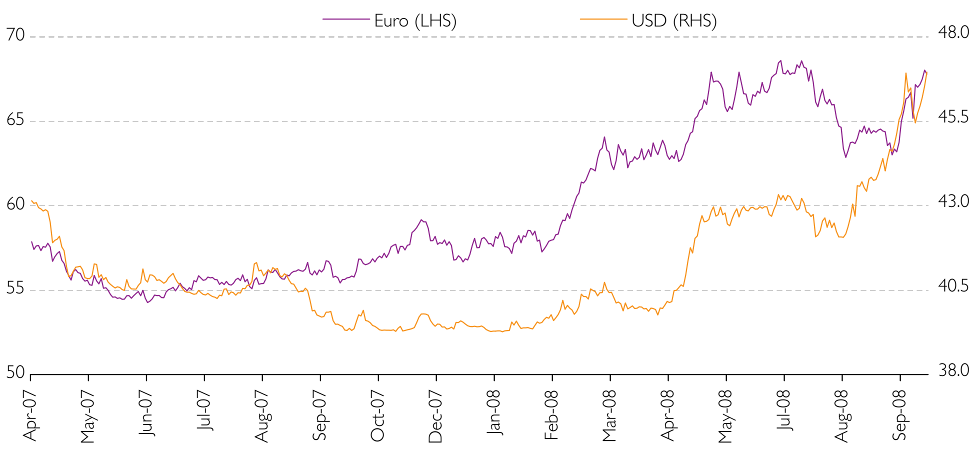
In the second quarter of the current fiscal, the rupee has further depreciated by ~4.6% against the USD while it has remained almost steady against the Euro.

Exhibit 9: INR further depreciates against USD, stable against Euro in Q2FY09

Currency	Q2FY09	Q2FY08	Q1FY09	yoy(%)	qoq(%)
USD	43.8	40.5	41.84	8.05	4.65
Euro	65.8	55.7	65.08	18.09	1.1

Source: IDFC-SSKI Research

Exhibit 10: Favorable currency movement



Source: IDFC-SSKI Research

We expect the favorable currency movement in FY09 to help BFL tide over the slowdown in the US and European markets.

CONCERNS

❑ Subsidiary performance disappoints

No material traction in profitability at the subsidiaries since their acquisition

BFL has posted a marginal 6% yoy increase in CY07 revenues from its subsidiaries, including its China operations. Performance has been subdued on account of the slowdown in North American and European automobile markets. Among BFL's overseas subsidiaries, BFL America has seen a hefty drop in business volumes in CY07 due to a decline in truck and car sales as also given its high dependence on a single customer – General Motors.

BFL's subsidiaries reported a combined EBIDTA margin of 7.8% in CY07 vis-à-vis 8.4% in CY06. BFL has set an internal target of achieving 12% EBITDA margin from its subsidiaries by FY10 (consolidated EBIDTA margin of 20% by FY10). We believe this could be a daunting task as there has been no material growth traction or profitability improvement at the subsidiaries since their acquisition. The slowdown in vehicle sales in North American and European markets as well as surging cost pressures could exert further pressure on margins.

❑ Out-of-money FCCBs may stretch BFL's capex plans

BFL had raised FCCBs of about USD 200m in four tranches, the details of which are enumerated below:

Exhibit 11: Out-of-money FCCBs

Amount (USD m)	Conversion price (Rs)	No. of shares converted (m)	No. of shares outstanding(m)	Due
60	336*	2.1	5.6	**2010**
60	384*	0	6.8	**2010**
40	604	0	2.9	**2012**
40	690	0	2.6	**2013**

*Note: *Adjusted for 1:5 split*
Source: Company, IDFC-SSKI Research

Given the recent steep price correction, the entire FCCB amount is unlikely to be converted into equity…

Notably, the entire FCCB amount of ~USD 200m appears to be out-of-money, and the likelihood of these getting converted into equity appears highly unlikely given the huge differential between the strike price and the current market price. In such a scenario, BFL could be forced to pay out the entire debt with a coupon. This, we believe, may prove an extremely expensive proposition for the company and thus throw its gearing totally out of proportion. Subsequently, BFL could be forced to go in for another huge equity dilution or the next round of FCCBs.

…refinancing of these FCCBs to strain BFL's funding options

BFL has already planned a fund raising programme of about Rs8bn by way of non-convertible debentures with detachable warrants convertible into equity shares on a rights basis. The higher interest burden (assumed @8%) has compelled us to cut our FY10E earnings estimates by about 7.3%. The funds would be utilized to finance BFL's foray into the capital goods sector as well as for organic and inorganic growth opportunities. In such a backdrop, refinancing of FCCBs would further strain BFL's funding options.

FINANCIAL ANALYSIS

BFL's strategy to derisk its business model across geographies, customers and product segments is expected to help it protect its topline in tough years (as seen in FY08) and leverage growth opportunities in good years.

❑ Expect 16% CAGR in topline over FY08-10

We expect revenue CAGR of ~16% for BFL over FY08-10 driven by a ramp-up of non-auto business post the commencement of serial production at the two new facilities in Maharashtra at Mundhwa and Baramati.

❑ Richer product mix to lead to 230bp margin expansion over FY08-10

Rising share of non-auto sales to drive margin expansion…

BFL, given its global scale and technological prowess – and thus its ability to pass on any incremental costs to customers by way of pre-negotiated terms, has managed to maintain margins despite the recent surge in steel prices (30% over Jan-July '08). Further, BFL mostly grants price hike to steel suppliers only after securing a price revision from customers. Thus, the incremental steel cost is not expected to materially impact BFL's margins, except for some minor time lags.

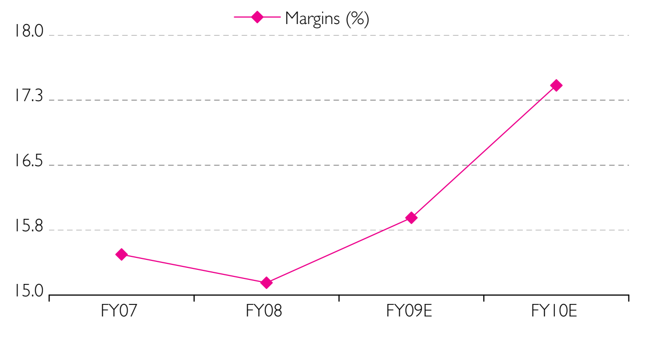
Further, the shift in product mix towards the high-margin non-auto business is expected to lead to margin expansion. Commendably, at a time when many ancillay players are witnesing margin erosion, BFL is expected to see a 230bp margin expansion over FY08-10 to ~17.4% in FY10, mainly due to higher proportion of the high-margin non-automotive components in the product mix.

❑ Return ratios set to improve

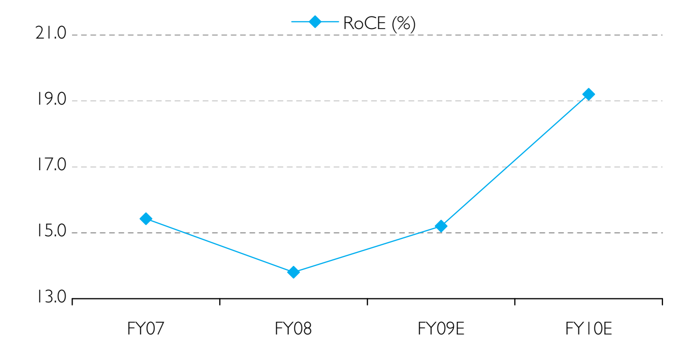
…and 27% PAT CAGR over FY08-10; return profile too set to improve

On account of the strong margin expansion, topline growth would likely lead to a much higher growth in PAT (27% CAGR over FY08-10E) for BFL. BFL had witnessed a steep fall in RoCE to 13.8% in FY08 (from ~39% in FY05), primarily on account of the huge capex (Rs15.4bn) over the last four years. However, with a marked shift in product mix to the more profitable non-auto business (offering better asset turnover of 2.5-3x as against the capital guzzler auto ancillary business) leading to strong PAT growth and a leaner capex plan over FY09-10 (Rs5.5bn), we expect RoCE to improve to 19% by FY10.

Exhibit 12: Improved product mix leads to margin expansion



Return ratios (RoCE) set to improve



Source: Company, IDFC-SSKI Research

VALUATIONS & VIEW

Strong topline growth with stronger PAT growth and superior return ratios make a case for re-rating; Buy with a price target of Rs262

While domestic market share gains from key customers like Tata Motors, favorable currency movement and growth in European/ Chinese markets is expected to drive topline growth in FY09, the ramp-up of non-auto business would be the key revenue driver in FY10. The new facilities at Mundhwa and Baramati are likely to operate at ~50% capacity utilization in FY10 and have a revenue potential of Rs9bn-10bn at 100% utilization. We believe BFL would need to plan a further expansion in its automotive components business as the company is expected to reach ~100% capacity utilization in this segment by FY10. Escalations in steel prices are a pass-through with most customers for BFL and hence would not impact margins materially. Going forward, we expect higher proportion of non-automotive components to lead to ~230bp margin expansion and a strong 27% PAT CAGR for BFL over FY08-10. We have currently not factored in any upside from the company's proposed foray into the capital goods sector with NTPC.

The stock trades at 9.1x FY10E earnings (fully diluted) and 4.6x EV/EBIDTA. Given BFL's superior return profile and its status as a Tier I auto ancillary supplier which wields pricing clout, the stock's premium valuations appear justified. Maintain Outperformer with a price target of Rs262 (13x FY10E earnings).

Income statement (consolidated)

Year to Mar 31 (Rs m)	FY06	FY07	FY08	FY09E	FY10E
Net sales	**30,189**	**41,783**	**46,523**	**52,520**	**62,904**
% growth	*51.4*	*38.4*	*11.3*	*12.9*	*19.8*
Operating expenses	24,962	35,319	39,478	44,180	51,984
EBITDA	**5,227**	**6,464**	**7,045**	**8,340**	**10,920**
% growth	*23.3*	*23.7*	*9.0*	*18.4*	*30.9*
Other income	662	969	993	727	814
Net interest	683	1,067	1,269	1,346	1,692
Depreciation	1,281	1,881	2,271	2,536	2,724
Pre-tax profit	3,925	4,485	4,498	5,184	7,319
Deferred Tax	162	142	152	207	293
Current Tax	1,258	1,386	1,437	1,555	2,196
Profit after tax	**2,505**	**2,956**	**2,908**	**3,422**	**4,830**
Preference dividend	0	0	0	0	0
Non-recurring items	1	(121)	148	0	0
Net profit after non-recurring items	2,506	2,906	3,163	3,470	4,854
% growth	*24.6*	*16.0*	*8.8*	*9.7*	*39.9*

Balance sheet

Year to Mar 31 (Rs m)	FY06	FY07	FY08	FY09E	FY10E
Paid-up capital	445	445	445	445	445
Reserves & surplus	13,075	15,459	17,272	19,796	23,210
Total shareholders' equity	13,507	16,218	18,419	20,895	24,286
Total current liabilities	12,999	14,994	16,418	17,700	21,166
Total Debt	11,693	17,996	16,544	20,544	19,744
Deferred tax liabilities	0	0	0	0	0
Other non-current liabilities	0	0	0	0	0
Total liabilities	24,692	32,990	32,962	38,244	40,910
Total equity & liabilities	**38,199**	**49,208**	**51,381**	**59,139**	**65,195**
Net fixed assets	14,806	19,443	23,603	23,567	23,843
Investments	2,535	2,073	2,988	2,988	2,988
Total current assets	20,849	27,686	24,781	32,575	38,356
Deferred tax assets	0	0	0	0	0
Other non-current assets	8	6	9	9	9
Working capital	7,850	12,692	8,364	14,875	17,190
Total assets	**38,199**	**49,208**	**51,381**	**59,139**	**65,195**

Cash flow statement

Year to Mar 31 (Rs m)	FY06	FY07	FY08	FY09E	FY10E
Pre-tax profit	3,925	4,485	4,498	5,184	7,319
Depreciation	1,281	1,881	2,271	2,536	2,724
chg in Working capital	(327)	(1,384)	(1,878)	(84)	(1,067)
Total tax paid	(1,258)	(1,386)	(1,437)	(1,555)	(2,196)
Ext ord. Items	-	-	-	-	-
Operating cash Inflow	3,621	3,595	3,453	6,081	6,780
Capital expenditure	(8,714)	(6,853)	(6,579)	(2,500)	(3,000)
Free cash flow (a+b)	(5,094)	(3,259)	(3,126)	3,581	3,780
Chg in investments	(2,535)	462	(915)	-	-
Debt raised/(repaid)	5,793	6,303	(1,352)	4,000	(800)
Capital raised/(repaid)	5,876	97	(100)	-	-
Dividend (incl. tax)	(775)	(921)	(920)	(1,105)	(1,708)
Misc	2,216	775	494	-	-
Net chg in cash	5,481	3,457	(5,920)	6,475	1,272

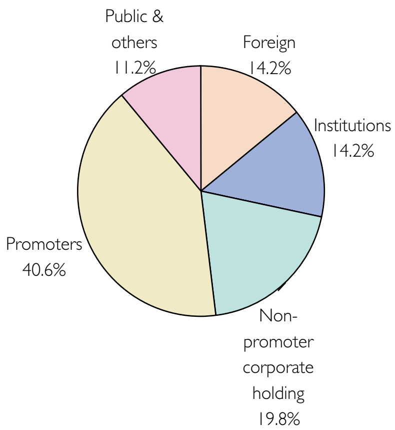
Key ratios

Year to March 31	FY06	FY07	FY08	FY09E	FY10E
EBITDA margin (%)	17.3	15.5	15.1	15.9	17.4
EBIT margin (%)	13.1	11.0	10.3	11.1	13.0
PAT margin (%)	8.3	7.2	6.5	6.6	7.7
RoE (%)	26.1	20.4	17.4	17.7	21.5
RoCE (%)	21.4	15.4	13.8	15.2	19.2
Gearing (x)	0.9	1.1	0.9	1.0	0.8

Valuations

Year to March 31	FY06	FY07	FY08	FY09E	FY10E
Reported EPS (Rs)	11.3	13.0	14.2	15.6	21.8
Adj. EPS (Rs)	10.7	12.6	12.5	14.4	20.2
PER (x)	17.2	14.6	14.6	12.7	9.1
Price/Book (x)	3.0	2.5	2.2	2.0	1.7
EV/Net sales (x)	1.5	1.2	1.2	1.0	0.8
EV/EBITDA (x)	8.9	7.6	7.7	6.2	4.6
EV/CE (x)	1.8	1.4	1.5	1.2	1.1

Shareholding pattern



As of June 2008

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