investor's eye

Visit us at www.sharekhan.com August 31, 2006

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Loyd	03-Mar-05	330	**1,226**	1,760
HLL	24-Nov-05	172	**235**	300
ICICI Bank	23-Dec-03	284	**596**	750
Orient Paper	30-Aug-05	214	**423**	675
UltraTech	10-Aug-05	384	**769**	1,000

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

Subros

Ugly Duckling

Stock Update

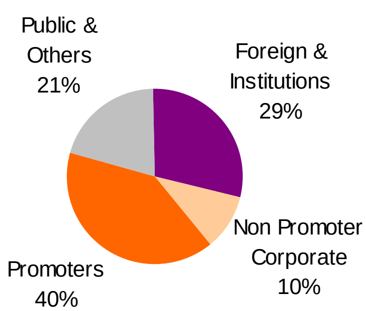
Annual report review

Buy; CMP: Rs214

Company details

Price target:	Rs370
Market cap:	Rs257 cr
52 week high/low:	Rs270/131
NSE volume: (No of shares)	22,114
BSE code:	517168
NSE code:	SUBROS
Sharekhan code:	SUBROS
Free float: (No of shares)	72 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	9.8	-0.8	25.6	29.1
Relative to Sensex	-0.1	-9.5	9.8	-15.9

We recently analysed the annual report of Subros and present the highlights of the same below.

The key themes of the annual report are:

- Sound operational and financial performance for the year
- Strengthening client portfolio with the addition of new clients like Mahindra and Mahindra (M&M) and Eichers
- Proactive capacity expansion to drive volumes, and focus on quality, cost and delivery levels to protect margins.

Sound operational and financial performance for the year

Volume growth of 8.2%—realisation dropped by 11.5%

During FY2006, Subros registered a decent volume growth of 8.2% in the automotive air-conditioning system (AAS) and Ventilator-Fan Motor Assembly businesses. The same was in line with the growth in the passenger car segment and came on the back of a higher offtake by its key customers, Maruti Udyog Ltd (MUL) and Tata Motors (TAMO). The gross sales however decline by 9% to Rs657 crore as the excise duty on AAS came down and the benefit of the same was passed on to the original equipment manufacturers (OEMs). Adjusted for the drop in the excise duty, the overall realisation fell 11.5%. With an 8.2% growth in the volume and an 11.5% drop in the realisation volume, the net sales for the year declined by 4% to Rs565 crore.

Revenue table

Rs crore	FY2006	FY2005	% yoy chg
Gross sales	657.2	724.6	-9.0
Excise duty	92.1	134.2	-31.0
Excise duty as % of sales	*14.0*	*19.0*	
Net sales	565.1	590.4	-4.0

The growth in the volume and drop in the realisation as show in the following exhibit are in line with our expectations. Usually the OEMs like MUL and TAMO bargain on prices in terms of higher volumes. Subros in turn negotiates the rates with its material vendors; hence the drop in the realisation does not materially affect the margins.

Volume and realisation

Particulars	2006	2005	2004	2003	2002
Air-conditioning system—auto					
Capacity utilised (%)	78.6	72.8	62.9	60.5	62.5
Sales quantity (nos)	393,071	364,043	283,167	181,320	187,248
% change y-o-y	*8.0*	*28.6*	*56.2*	*-3.2*	*1.1*
Sales realisation/unit (Rs)	14,206	17,066	18,474	21,319	22,548
% change y-o-y	*-16.8*	*-7.6*	*-13.3*	*-5.5*	*-6.6*
Ventilator-fan motor assembly					
Capacity utilised (%)	61.5	56.8	48.9	104.3	91.7
Sales quantity (nos)	307,901	283,900	220,898	156,612	137,589
% change y-o-y	*8.5*	*28.5*	*41.0*	*13.8*	*-1.5*
Sales realisation/unit (Rs)	2,293	2,822	2,834	2,932	2,942
% change y-o-y	*-18.8*	*-0.4*	*-3.3*	*-0.3*	*0.9*

Operating margins improve driven by rigorous cost-cutting measures

Even after a 4% drop in the revenues, Subros has been able to improve its operating profit margin (OPM) by 190 basis points to 10.9%. The improvement in the OPM came entirely from the improvement in the material cost, which as a percentage of sales, declined from 76.5% in FY2005 to 72.2% in FY2006. This improvement took place primarily because of Subros' continuous thrust on indigenisation of components. The fixed costs for the company grew by 9%, largely because of a higher employee cost.

Cost movements & margins

Particulars	2006	2005	2004	2003	2002
As % of sales					
Material cost	72.2	76.5	77.4	76.1	79.4
Employee cost	5.2	4.3	4.5	5.5	4.8
Total variable costs	77.0	80.3	81.1	80.5	83.3
Total fixed costs	12.2	10.7	10.3	11.3	10.4
Margins as % of net sales					
OPM	10.9	9.0	8.7	8.2	6.3
EBIDTA	11.2	9.2	9.0	8.9	6.8
EBT	6.2	4.9	4.6	3.4	2.1
EAT	4.3	3.5	2.9	2.0	1.4
Tax rate	30.8	29.9	37.1	40.6	35.3

Stable balance sheet and return ratios

As far as Subros' balance sheet and return ratios are concerned, there hasn't been any drastic improvement or deterioration in either. The debt/equity ratio, though marginally higher at 0.6x as compared with 0.5x for FY2005, is still at a comfortable level. Further the return ratios at 20.6% for the return on capital employed and 18.9% for the return on net worth are more or less stable as compared with last year.

Key ratios

Particulars	2006	2005	2004	2003	2002
Asset turnover	5.9	6.8	6.4	4.3	4.3
Interest coverage (x)	10.4	11.3	8.8	4.7	3.1
Debt/Equity (x)	0.6	0.5	0.4	0.4	0.5
Quick ratios	2.3	2.0	1.8	1.4	1.3
RoCE (%)	20.6	21.2	20.6	13.4	10.1
RoNW (%)	18.9	18.7	15.2	8.7	6.7

Working capital ratios (expressed as days of net sales)

Particulars	2006	2005	2004	2003	2002
Inventory	55.3	57.5	58.1	69.2	34.0
Debtors	17.5	16.8	21.2	44.8	33.0
Creditors	35.3	40.4	50.0	89.2	67.9
Working capital cycle	37.4	33.8	29.4	24.8	-0.9

Management's outlook and efforts

Management sees competition intensifying

According to the management discussion and analysis, the automobile industry is expected to see large capacity additions. However the increasing interest of global automobile majors would intensify competition in the market. Even though large capacity creation by domestic players and increasing interest of the global majors would create good opportunities for the auto component industry, the increasing free trade agreements of India with various countries and the reducing duty barriers will further intensify competition in the industry.

Aim to achieve global QCD level

In the wake of the increasing opportunities and rising competition, the management is focused to achieve global quality, cost and delivery levels (QCD). To back these efforts the management has clearly charted three areas of focus:

- New product introduction
- Capacity augmentation
- Higher indegenisation

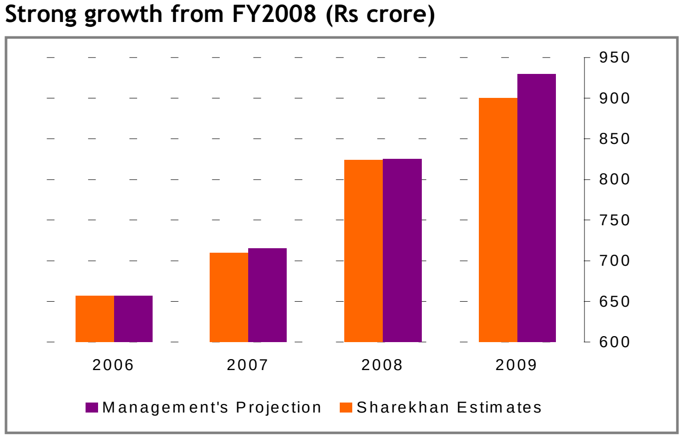
New product introduction with client addition

MUL and TAMO contribute almost 95% to Subros' volume. In order to widen its client portfolio the company has been focusing and developing products for the other automobile companies as well. In its first successful attempt of widening the client base, in FY2006 Subros got a letter of intent (LOI) from M&M for its new car that is yet to be launched. It has also got an LOI from Eicher Motors. The company has got another LOI from MUL for supplying AAS for the latter's recently launched Swift. With Swift already being acclaimed as the car of the year, Subros' volume as well as integration with MUL is all set to rise.

Capacity augmentation-completion of phase I by October 2006

In view of the buoyancy in the economy and the huge capital expenditure (capex) plans of the automobile majors, the management is expecting a significant volume growth from April 2007. The growth will be driven by higher volumes targeting the existing models as well as the models that are to be launched by MUL, TAMO and M&M in future. Subros has already submitted the prototype of AAS for the above-mentioned models and expects the LOI shortly.

Strong growth from FY2008 (Rs crore)



To cater to the growth plans of two of its major clients, Subros had lined up an ambitious plan to increase its total capacity to 10,00,000 AC units from 5,00,000 units currently. As per the two-phase expansion plan, it would set up two new plants, one each in Manesar and Pune. The first phase is expected to be completed by October 2006 wherein the capacity would be increased to 7,50,000 units. In the second phase the company plans to increase its capacity to 10,00,000 units by the end of FY2008. The total outlay for the new capacity creation is Rs150 crore to be funded by a debt of Rs30 crore and the balance through internal accruals. The outlay for the first phase of the capex programme is Rs120 crore and that for the second phase is Rs30 crore. Though the company would be operating at a lower capacity utilisation in the initial years, the capacity expansion would work out well for the company in the long run, looking at the rising demand in the automobile industry.

Capex plan

	Capacity (No of units)		Cost (Rs crore)
	From	To	
Phase I	500,000	750,000	120.030.0
Phase II	750,000	1,000,000	

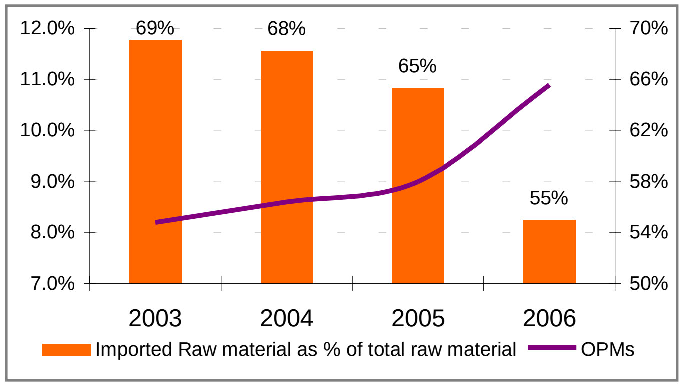
Saving in logistic cost as the new plants are located near key customers

As mentioned earlier, Subros' is setting up two new plants at Manesar (near Gurgaon) and Pune. Both these plants would save significantly on the logistic cost as they are being set up in the proximity of the manufacturing units of its key customers, MUL and TAMO. The Manesar plant is located near MUL's plant, whereas the Pune facility is located near TAMO's plant. However we believe that the savings in the logistic cost would be partly passed on to the customer.

Focus on indigenisation continues

Subros has been continuously focusing on increasing the indigenisation of components. This is clearly visible, as the imported raw material as a percentage of total raw material has fallen from as high as 69% in FY2003 to 55% in FY2006. During the same period its OPM has improved from a meagre 8.2% in FY2003 to 10.9% in FY2006. In order to further focus on product indigenisation, increase its product quality and gain competitive cost advantage, the company has set up its own design, and research and development (R&D) centre in Noida at an estimated cost of Rs10 crore. The R&D centre offers virtual prototyping and simulation of various air-conditioning components. The centre also comprises an environment test chamber (wind tunnel) with the capability of testing components in temperatures ranging between -30 degrees to 60 degrees centigrade. This, in effect, would reduce the product development cost of Subros by one-sixth. The R&D activity will also help Subros to increase component indeginisation, which in turn will improve the margins. Further, the investment in the R&D facility would also lead to some tax benefits for the company.

Reducing import dependence and increasing OPMs



Valuation and view

We believe Subros is a strong play on India's growing passenger car segment. Going forward, a strong growth in the volumes of its major clients, MUL and TAMO, and its efforts to expand its portfolio by supplying to M&M will maintain the momentum in its earnings growth. Further a sharp revival in the sales of small cars, particularly those of MUL and TAMO (Subros is virtually the only supplier to these OEMs), would beef up the volume growth. We remain positive on the company's prospects and expect its earnings to grow at a healthy compounded annual growth rate of 32% over FY2006-08. At the current market price of Rs214, the stock is trading at compelling valuations of 9x FY2007 earnings per share and 5.9x FY2008 earnings. It is available at a huge discount to its peers. We maintain our Buy recommendation on the stock with a price target of Rs370.

Earnings and valuation table

Year ended Mar 31	2005	2006	2007E	2008E	2009E
Net profit (Rs cr)	21.2	24.3	28.6	43.4	49.1
% yoy growth	*44.0*	*19.0*	*17.6*	*51.9*	*13.0*
Shares in issue (cr)	1.2	1.2	1.2	1.2	1.2
EPS (Rs)	17.7	20.3	23.8	36.2	40.9
% yoy growth	*44.0*	*19.0*	*17.6*	*51.9*	*13.0*
PER (x)	12.6	10.6	9.0	5.9	5.2
Book value (Rs)	91.1	107.4	128.4	161.8	199.8
P/BV (Rs)	2.3	2.0	1.7	1.3	1.1
EV/EBIDTA (x)	5.8	5.4	3.8	2.8	1.8
Dividend yield (%)	1.4	1.2	1.2	1.2	1.2
RoCE (%)	21.2	20.6	21.4	28.1	27.6
RoNW (%)	18.7	18.9	18.6	22.4	20.5

Essel Propack

Viewpoint

Acquisition of Packaging India

CMP: Rs76

Essel Propack Ltd (EPL) has acquired a 100% stake in the Chennai-based Packaging India Private Ltd (PIPL) from the CavinKare group. PIPL was set up in 1990 to meet the captive demand for flexible packing needs of the CavinKare group. It has a state-of-the-art manufacturing facility at Pondicherry with the average life of machines below three years. PIPL has a client base of reputed names in the food product, personal care and detergent segments.

Reasonable valuation

The 100% stake has been acquired in an all-cash deal worth Rs63.5 crore. Including the Rs24 crore debt on the books of PIPL, the acquisition has been done at a reasonably attractive valuation of 0.9x FY2006 PIPL's revenues of Rs98.9 crore. PIPL is a profitable company with an operating profit margin (OPM) of 14.4% and a net margin of 3.9% in FY2006. PIPL has a healthy asset turnover of 196% (more than double of EPL's 85%) and return on equity of 21.7% (much higher than 12.8% of EPL).

The management has indicated that the margins have been dragged down by the capital expenditure (capex) undertaken for the extensive modernisation of the manufacturing plant in the past couple of years. Moreover, the utilisation levels were also reasonably low at around 65% in FY2006.

EPL expects to utilise the strong internal accruals (around Rs165-170 crore annually) to repay the debt taken to fund the acquisition of PIPL. In spite of the recent slew of acquisitions (it acquired Tacpro Inc, USA and Avalon Medical Services Pte Ltd, Singapore for consideration of Rs48 crore in April 2006) and expansion of manufacturing facilities (in India, the USA and Poland), the management expects the debt-equity ratio to come down to a comfortable level of 0.7x at the end of CY2007. Thus, there are no plans for any equity dilution.

Benefits to EPL

EPL is an established player in laminated, plastic and mini tube packaging segments globally. The acquisition of PIPL would facilitate EPL's entry into the flexible and speciality material packaging segments. The flexible and speciality material packaging market is estimated to be worth Rs2,500 crore and is growing at a healthy rate of 15% annually. The demand for the same is largely driven by food product, retailing and pharmaceutical industries.

With the growth in the laminated and plastic tube segments stagnant at 5-6% in India, the company had been actively looking at setting up a manufacturing plant for its foray in the relatively faster growing flexible and speciality material packaging segment (growing by over 15% annually). The acquisition of PIPL has eliminated the gestation period involved in setting up of a greenfield plant. Moreover, PIPL has a strong client base in the food product and personal care segments. Consequently, the management expects the acquisition to boost the revenue growth in EPL's Indian operation. The revenues from the Indian operations have grown at a tepid rate of 2.6% annually over the past two-year period CY2003-05.

Moving up the value chain

EPL plans to introduce high-end packaging products specifically aimed at the pharmaceutical industry through PIPL. The details of the investment have not been disclosed yet. The management has indicated that the packaging product for the pharma industry has been developed by the in-house research team at EPL and the business would be build on the existing customer relationship of its medical device business (the medical device business involves manufacturing polymer-based cardiovascular and balloon catheters).

The management believes that the introduction of high-end products and the improved capacity utilisation are expected to result in a marked improvement in the margins of PIPL.

Valuations

At the current market price the stock trades at 13.2x CY2005 and 11x CY2006 consensus earning estimates of Rs6.9 per share.

P&L account Rs (cr)

Particulars	CY2002	CY2003	CY2004	CY2005
Net sales	470.3	575.8	668.5	816.6
Total expenditure	325.0	416.4	490.3	622.9
Operating profit	145.3	159.4	178.1	193.7
Other income	23.6	25.1	23.2	17.1
Interest	26.2	21.7	19.1	13.2
Depreciation	56.1	62.8	64.1	76.6
Profit before tax	86.6	99.9	118.3	121.0
Tax	28.8	32.0	32.7	30.8
Minority interest	-0.9	-0.6	0.8	0.0
Extraordinary items	-1.8	-1.4	-0.5	-
Net profit	64.7	72.0	81.3	90.2
EPS (Rs)	4.1	4.6	5.2	5.8
Margins				
OPM (%)	30.9	27.7	26.6	23.7
NPM (%)	13.8	12.5	12.2	11.0

Key financials

Particulars	CY2002	CY2003	CY2004	CY2005
Net profit (Rs cr)	64.7	72.0	81.3	90.2
Shares in issue (cr)	15.7	15.7	15.7	15.7
EPS (Rs)	4.1	4.6	5.2	5.8
% y-o-y growth	*5.6*	*11.2*	*13.0*	*10.9*
PER	18.4	16.5	14.6	13.2
Book value	38.0	40.9	44.3	44.9
P/BV	2.0	1.9	1.7	1.7
EV/EBIDTA	10.1	8.8	8.1	7.8
Dividend yield (%)	1.7	2.1	2.4	2.6
ROCE (%)	12.3	13.0	13.3	12.1
RONW (%)	10.9	11.2	11.7	12.8

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

Sharekhan Stock Ideas

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
Associated Cement Companies
Bajaj Auto
Balrampur Chini Mills
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Heavy Electricals
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Godrej Consumer Products
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico Industries
Maruti Udyog
MRO-TEK
Lupin
Nicholas Piramal India
Omax Auto
Ranbaxy Laboratories
Satyam Computer Services
SKF India
State Bank of India
Sundaram Clayton
Tata Motors
Tata Tea
Unichem Laboratories
Wipro

Cannonball

Allahabad Bank
Andhra Bank
Cipla
Gateway Distriparks
International Combustion (India)
JK Cement
Madras Cement
Shree Cement
Transport Corporation of India

Emerging Star

3i Infotech
Aban Loyd Chiles Offshore
Cadila Healthcare
KSB Pumps
Marksans Pharma
Navneet Publications (India)
New Delhi Television
Orchid Chemicals & Pharmaceuticals
ORG Informatics
Solectron Centum Electronics
Television Eighteen India
Thermax
TVS Motor Company
UTI Bank
Welspun Gujarat Stahl Rohren

Ugly Duckling

Ashok Leyland
Deepak Fertilisers & Petrochemicals Corporation
Genus Overseas Electronics
HCL Technologies
ICI India
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
Subros
Sun Pharmaceutical Industries
Surya Pharmaceuticals
UltraTech Cement
Union Bank of India
Universal Cables
Wockhardt

Vulture's Pick

Esab India
Orient Paper and Industries
WS Industries India

Home