Company Report

ICICI direct.com
On-line Share Trading

Auto Ancillary

March 03, 2007
ICICIdirect Code: AUTAXL

Automotive Axles

OUTPERFORMER

Price	Target Price
Rs 590	Rs 716
Potential upside	**Time Frame**
21%	12 mths

Automotive Axles Ltd (AAL) is a major producer of drive axle assemblies for commercial vehicles. It caters to automobile majors such as Tata Motors and Ashok Leyland. With favourable trends in automobile offtake and new capacity, the momentum in earnings growth is likely to be sustained. We initiate coverage on the company with an Outperformer rating and 12-month target price of Rs 716.

KEY TRIGGERS

- **Buoyant demand to drive revenue growth**

  AAL is a major supplier to OEMs like Ashok Leyland and Tata Motors in India, and Arvin Meritor (its joint venture partner). Both Ashok Leyland and Tata Motors plan to increase production capacities. The company also supplies to other domestic CV majors. Increasing volumes from customers will boost demand for axles, supporting AAL's revenue growth. We project net sales to grow at a CAGR of 26.1% and net profit at 25.7% over FY06-09E.

- **Exports – the next growth driver**

  Though exports account for only 8% of the total turnover, their contribution is likely to increase to about 20% going forward. AAL's exports are mainly to Arvin Meritor through Meritor HVS (India). Arvin Meritor is the largest component supplier in the US. Increasing cost pressures for Arvin Meritor is likely to open up more outsourcing opportunities for AAL. Higher margins of around 32-35% on exports against 18-19% on domestic sales would further help it protect its margins at around 18% going forward.

- **Expansion to support intensifying demand**

  The company is scaling-up capacity and also setting up a gear sets facility. It is increasing its axle capacity by about 35% during FY06-08E, while its gear sets capacity would be 170,000 units. The company has been successful in passing on rising input costs to its customers and to a great extent is insulated from realization pressures. Volume growth along with better realizations would continue to expand the top line going forward.

VALUATIONS

At the current price of Rs 590, the stock is trading at 15.7x FY07E EPS of Rs 37.5 and 13.2x FY08E EPS of Rs 44.7. We believe the stock deserves a higher P/E due to the company's higher return ratios, assured volume growth and strong demand outlook. We rate the stock an OUTPERFORMER and value it at Rs 716, 16x the FY08E EPS.

Exhibit 1: Key Financials (Rs Crore)

Year to Sept 30	FY04	FY05	FY06	FY07E	FY08E
Net Profit (Rs crore)	22.6	36.9	42.8	56.7	67.6
Shares in issue (in crore)	1.5	1.5	1.5	1.5	1.5
EPS (Rs)	14.9	24.3	28.2	37.5	44.7
% Growth	12.9	62.6	16.3	32.9	19.1
P/E (x)	39.5	24.3	20.9	15.7	13.2
Price / Book (x)	15.1	12.0	9.4	7.1	5.3
EBITDA Margins (%)	18.0	18.9	18.5	18.2	18.2
EV/EBITDA (x)	20.1	14.1	11.1	8.7	7.2
RoCE (%)	39.5	49.5	50.1	50.8	46.3
RoE (%)	40.3	55.4	50.5	51.2	45.9

Company Profile

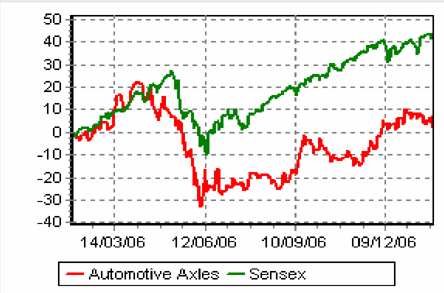
Registered Office
Hootagalli Industrial Area
Off Hunsur Road,
Mysore 570018
Tel: 91-821 2403235
www.autoaxle.com

Chairman: **Mr. B.N. Kalyani**
Business Group: **Kalyani**

Shareholding Pattern as on 31/12/2006	
Major Holders	%
Promoters	71.0
Institutional Investors	14.9
Other Investors	8.0
General Public	6.1

Stock Data	
Market Cap (Rs crore)	891.0
Shares Outstanding (in crore)	1.5
52-week High (Rs)	820.0
52-week Low (Rs)	331.0
Avg. Volume	4,612
Absolute Return 3 mth (%)	7.4%
Absolute Return 12 mth (%)	-4.7%
Sensex Return 3 mth (%)	-5.5%
Sensex Return 12 mth (%)	22.5%

Performance Chart



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COMPANY BACKGROUND

Automotive Axles Ltd (ALL) was incorporated in 1981 as a joint venture between Bharat Forge (the flagship company of the Kalyani Group, which today is the second largest forging company in the world), and Arvin Meritor Inc of the US, a Fortune 500 company that was formerly part of Rockwell International Inc.

AAL's products include rear drive/non-drive axle assemblies, carrier assemblies and air actuated brake components for application on commercial vehicles (CVs). With manufacturing facilities located in Mysore, Karnataka, the company is currently the largest independent manufacturer of rear drive axle assemblies in the country.

The company currently has a 25% market share in the domestic market. Its customers include Ashok Leyland, Tata Motors, Vehicle Factory (Jabalpur), Mahindra & Mahindra, Asia Motor Works and Force Motors. It also exports to Arvin Meritor's plants in the US, Europe and China. Product design and sales & marketing support is provided by Meritor HVS (India), a JV in which Arvin Meritor is the majority shareholder with the Kalyani Group as partner.

Arvin Meritor is a leader in advanced solutions with sales of $8.8 billion in 2005. It is ranked as the 12th largest automotive supplier in the US and 16th worldwide. Its product portfolio includes revolutionary emissions technologies, industry-leading drive train systems and components, and comprehensive products for light vehicle, truck, trailer, specialty equipment OEMs and replacement market.

INVESTMENT RATIONAL

(I) Buoyant demand to drive revenue growth

Demand for axles would continue to remain strong on the back of surging volumes from its key customers – Ashok Leyland and Tata Motors. Ashok Leyland currently contributes around 56% of the revenues, while Tata Motors contribute around 15-18%. Ashok Leyland will be increasing its production capacity from 77,000 vehicles in FY06 to 200,000 vehicles by FY10. Tata Motors' capacity will be around 300,000 vehicles by FY10. The ramp-up in volumes by these two major customers would drive demand for axles, supporting AAL's revenue growth. The company also supplies axles to Eicher Motors, Force Motors, Swaraj Mazda, etc. Though the contribution from these companies is to AAL's revenue is small, volume growth from these counters is strong.

Exhibit 2: M & HCV capacity additions (Nos.)

	FY06	FY10E	% change
Ashok Leyland	77,000	200,000	29.9%
Tata Motors	190,500	300,000	57.5%
Eicher Motors	25,000	25,000	-
Volvo	1,200	1,200	-
Mahindra International	-	50,000	-
Man Force	-	2,400	-
Tatra	2,000	2,000	-
Daimler Chrysler	-	1,000	-

Source: Industry

AAL also exports axles and gears to Arvin Meritor through its Indian subsidiary company Meritor HVS (India), which contributes around 7–8% to revenues. Export demand is likely to grow at rapid pace on the back of increasing outsourcing opportunities. **We expect total sales volume to grow at a CAGR of 28.8% over FY06-FY08E.**

(I) Exports – the next growth driver

AAL's exports are mainly to Meritor HVS (India), a joint venture in which Arvin Meritor is the majority shareholder with the Kalyani Group. Arvin Meritor is the leading manufacturer and supplier of auto components in the US with an established network the world over. It is ranked as the 12th largest automotive supplier in the US and 16th largest worldwide. Its leading position in various product segments as shown in the exhibit below demonstrates its business size. Increasing cost pressure on Arvin Meritor is likely to open up more outsourcing opportunities in low-cost countries like India and China.

Exhibit 3: Arvin Meritor's share in North America and Europe

		North America		Europe
	Rank	Market share (%)	Rank	Market share (%)
Trailer axles	1	70	2	30
Truck axles	1	53	1	26
Brakes & ABS	1	77	1	40
Drivelines	2	27		
Transmission and Clutch	2	16		
Ride control	1	62		

Source:http://www.arvinmeritor.com

Arvin Meritor already has presence in India through Meritor HVS (India) and has identified AAL as a sourcing base for its global requirements. Currently, exports contribute only 8% to revenue. **Going forward, we believe exports will account for 20% of revenue. EBIDTA margins on exports are higher at 32-35% against 18-19% on domestic sales. The increasing contribution from exports would also expand bottom line in the coming years.**

(I) Expansion to support intensifying demand

The company increased its installed capacity for manufacturing axles by 30% to 108,000 units in FY06 from 83,000 units in FY05. Gear set capacity was increased to 170,000 units and axle- housing capacity was increased to 150,000 units from 109,200 units at capex of Rs 77.2 crore. The total expanded capacity is operational at 85% capacity utilization levels. The company is planning to spend around Rs 140 crore in the next two years to increase capacity further.

Exhibit 4: Capacity expansion and production (Nos.)

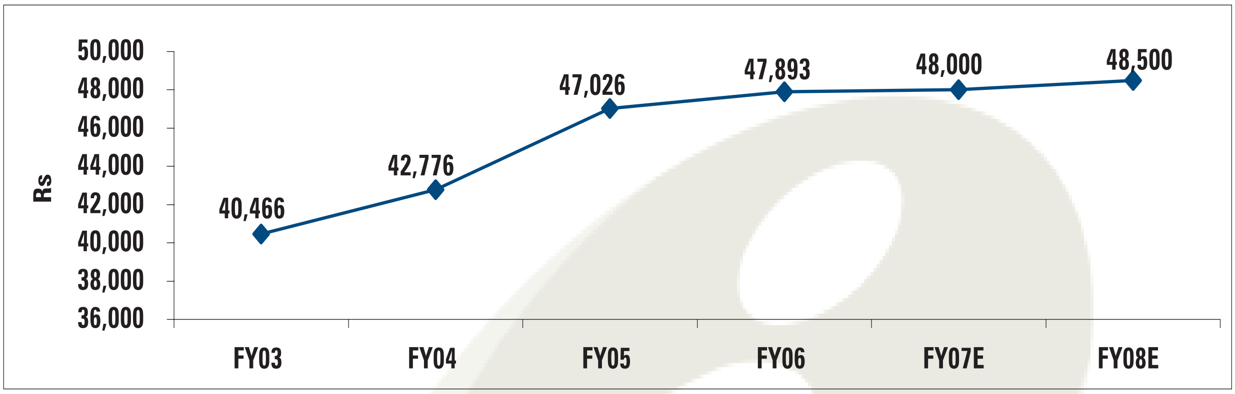
	FY03	FY04	FY05	FY06	FY07E	FY08E	% chg(FY06-08))
Axle-housing							
Installed capacity	70,224	86,000	109,200	150,000	175,000	200,000	33.30%
Production	55,709	77,740	90,464	114,041	143,750	173,750	52.40%
Axles							
Installed capacity	62,400	65,000	83,000	108,000	150,000	200,000	85.20%
Production	46,059	58,251	70,012	92,034	123,300	152,500	65.70%

Source:Company, ICICIdirect Research

The company is expected to operate at higher capacity utilizations of 75-85% on the expanded capacity. Continuous improvement in the production is the driving force. Further, captive consumption of gears from the newly-commenced production would also bring savings in operational costs. Increasing contribution from exports will result in better realizations along with higher EBITDA margins.

While the auto ancillary industry is facing a problem of passing on rising input costs to customers (mostly domestic auto companies), AAL has managed to do so and successfully protected its margins. **Volume growth along with higher realizations would continue to expand top line in coming years. We expect net sales to grow at a CAGR of 26.1% to Rs 734.3 crore over FY06-08E.**

Exhibit 5: Axle av. realizations



Source: Company, ICICIdirect Research

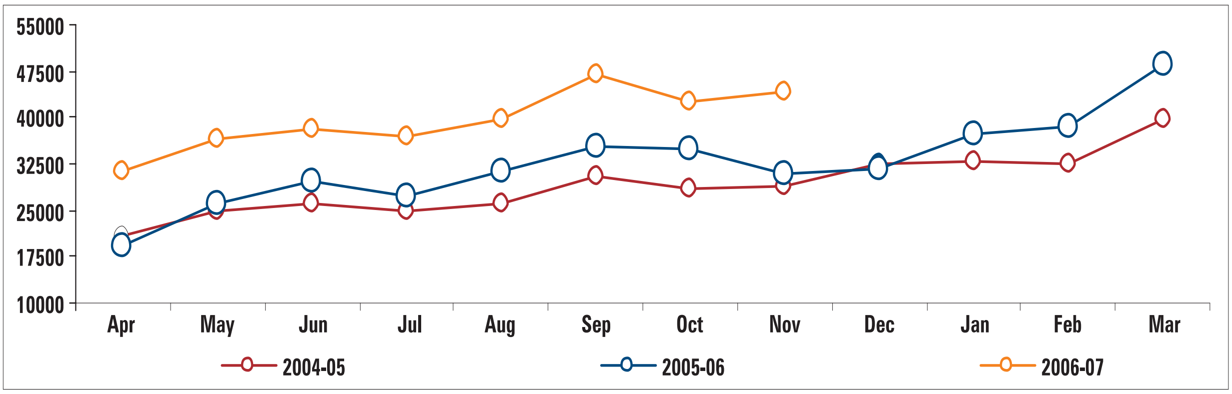
INDUSTRY OVERVIEW

(I) Buoyant demand to drive revenue growth

Most OEMs have their own axle-production facilities. However, they are now focusing more on value-added features and new designs. Many are also increasing capacities and have started outsourcing part of their requirements to AAL.

The growth of the axle industry is closely linked to the growth in commercial vehicles (CVs). In the first 9 months of the current financial year, CV sales grew by a healthy 36.3% in volume terms (266,227 vehicles). The volume growth was supported by impressive sales growth of 32.4% in light commercial vehicles (LCVs) and 39.3% sales growth in medium and heavy commercial vehicles (M & HCVs).

Exhibit 6: CV monthly sales trend (Nos.)

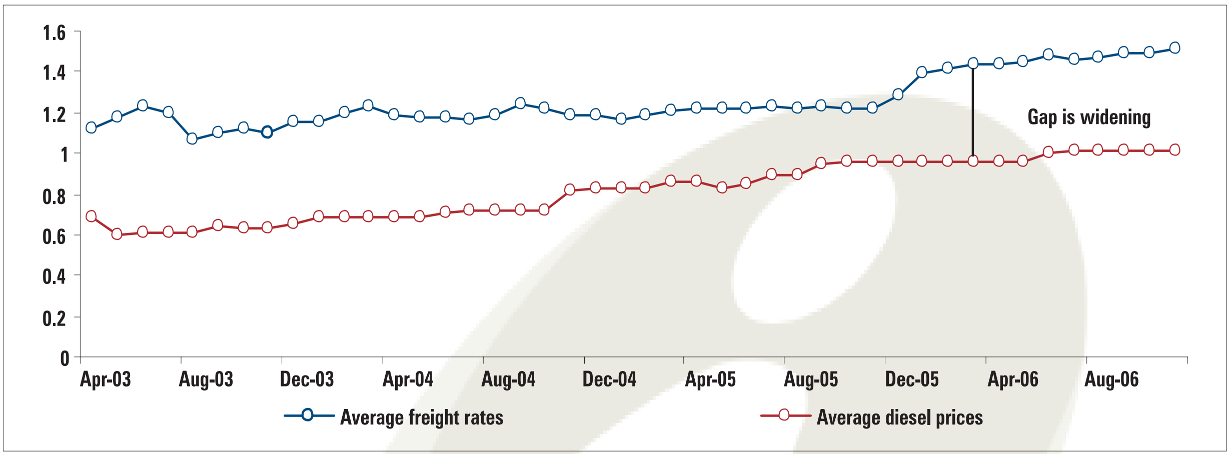


Source: SIAM

Going forward, we expect CV sales to rise by around 28% in FY07 in volume terms, driven by healthy growth rates in both LCV and MHCV sales. We expect LCV sales to increase by around 28-30% in FY07 and around 10% in FY08. MHCV sales are expected to rise by around 30% in FY07 and remain flat in FY08. The growth in the LCV segment has been driven by a significant substitution from three-wheelers to Tata's ACE, while that in MHCVs is a result of healthy freight rates, sustained industrial growth, increased emphasis on infrastructure developments and Supreme Court's ruling on overload restrictions (issued in November 2005).

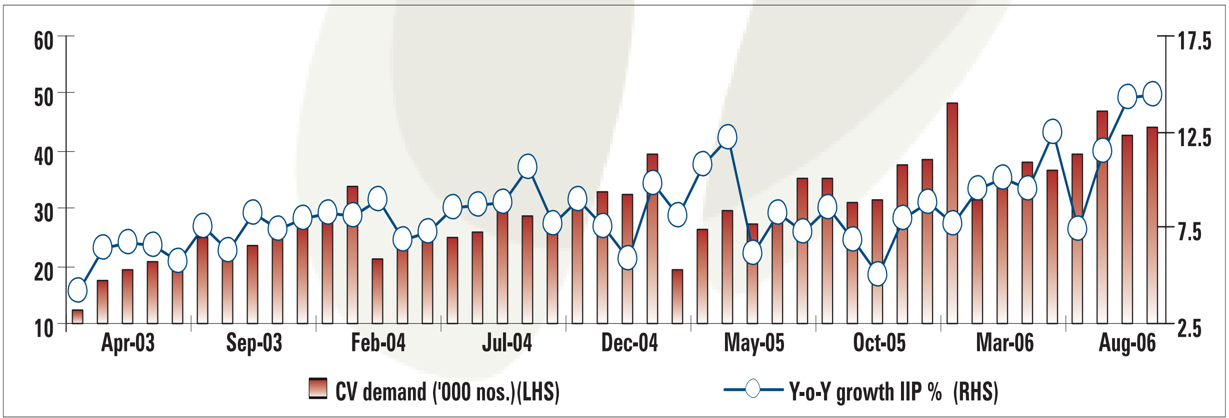
Freight rates rose by around 5% from March 2006 to Nov 2006. Though diesel prices were hiked during that period, truck operators were able to maintain their profitability, as the rise in freight rates was higher than that in diesel prices.

Exhibit 7: Trend in freight rates and diesel prices (Rs/km)



Source: CRISIL

Exhibit 8: CV demand and Y-o-Y growth in industrial production



Source: SIAM

The rise in the interest rates did not impact the demand for CV finance by truck operators. The hike was substituted by increase in the tenure for repaying the loan, keeping the EMIs constant. Hence, there was negligible impact on the annual cash outflow of transport operators.

For FY08, demand is expected to remain flat. This is because the base in FY07 was high due to the huge one-time demand on account of purchases following the Supreme Court's ban on overloading.

Most of the capacity expansions of various companies would be operational by FY08 and support volume growth post-FY08. Increased volumes are expected to trigger demand growth for ancillary companies.

RISKS & CONCERNS

Client concentration

Around 56% of AAL's revenue comes from Ashok Leyland and about 18% from Tata Motors. Both these auto majors have their own in-house facilities for drive axles. Any demand slowdown from these companies could adversely impact AAL's volume growth and revenue going forward.

Rising input costs

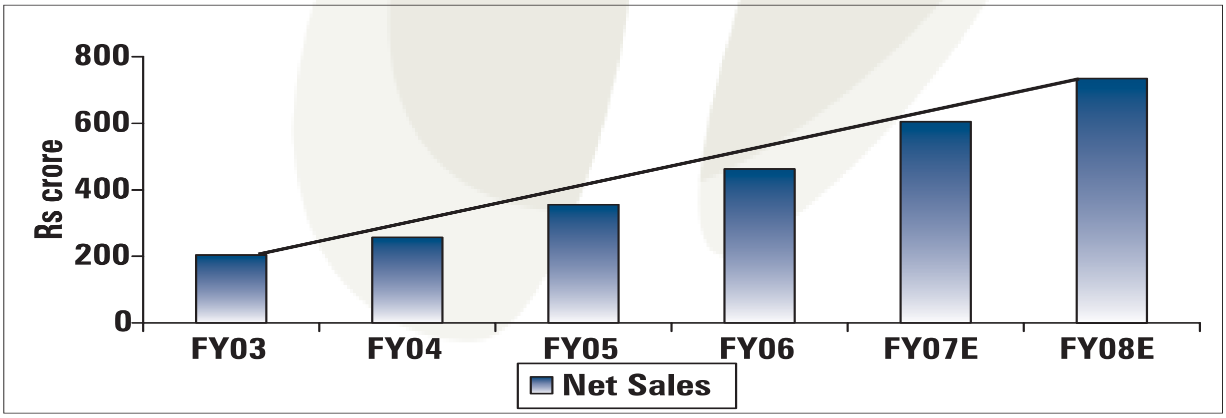
Raw material costs account around 66% of revenue. Rising input costs is a major concern for margin expansion. We have assumed a price increase of 5-12% in our revenue model. If raw material prices rise beyond our expectation, EBITDA margins would come under pressure.

FINANCIALS

For the year ending September 30, 2006 (FY06), revenue increased 30.2% to Rs 461.8 crore against Rs 354.7 crore the previous year. EBITDA margins were marginally down to 18.5% from 18.9%. Higher interest and depreciation provisions, which were higher by 144% and 26% respectively due to the capex incurred, restricting growth in net profit to 16% at Rs 42.8 crore from Rs 36.9 crore.

We expect revenues to rise at CAGR of 26.7% to Rs 734.3 crore in FY08 from Rs 461.8 crore in FY06. EBITDA margins are expected to remain flat at 18%. The company's expansion plan will lead to an increase in borrowings, which in turn would result into higher interest costs and depreciation provisions. Net profit would grow at a CAGR of 25.7% to Rs 67.6 crore in FY08 from Rs 42.8 crore in fY06, translating into an EPS growth of 25.8% over FY06-08E. We expect the company to report an EPS of Rs 44.7 in FY08E against Rs 28.2 in FY06.

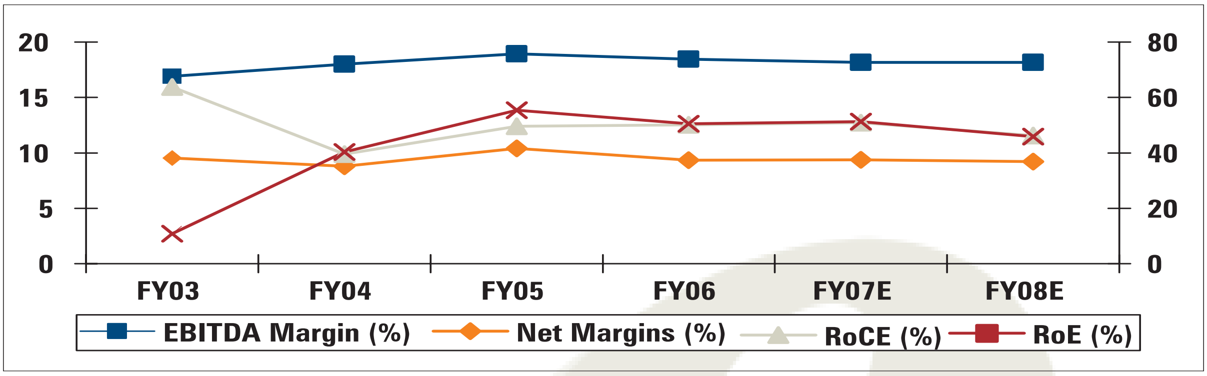
Exhibit 9: Net sales rising steadily



Source: Company, ICICI direct Research

RoCE is currently 50.1% and RoE 50.5%. The company is favorably leveraged with debt-equity ratio of 0.6. For its planned capex of Rs 140 crore, it is planning to fund 50% of its requirements through debt and the balance from internal accruals. Cash generated from operating activities has always remained positive in the past and with the drastic decline in debtor's collection period from 67 days to 29 days in FY06, it is expected to remain positive going forward.

Exhibit 10: Higher profitability ratios



Source: ICICIdirect Research

RoCE and RoE have shown a declining trend in FY08E. But it should be noted that it is mainly due to increased capital employed as well as increasing net worth. These are still high and expected to remain above 45%.

Quarterly performance

For the Oct-Dec 2006 quarter (Q1FY07), AAL reported a 44% jump in net sales to Rs 145.3 crore on the back of improving sales and realization. However, raw material costs to sales ratio increased from 64% to 68%, resulting in lower EBITDA margins of 17.2% against 18.1% in the corresponding quarter the previous year. Net profit grew at an impressive rate of 38.6% to Rs 13.6 crore from Rs 9.8 crore, translating into quarterly EPS of Rs 9.

Exhibit 11: Quaterly performance (Rs.crore)

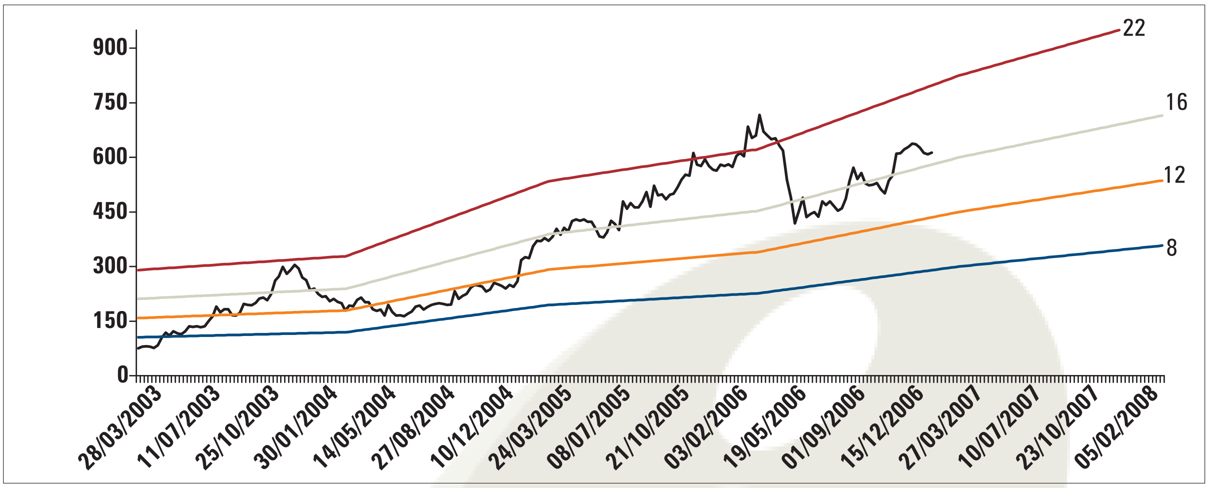
Year to Sept 30	Q1FY07	Q1FY06	% change
Net Sales	145.3	100.9	44.0
Raw Material Costs	98.8	64.7	52.8
Other Expenses	15.0	12.5	19.8
Staff Expenses	6.5	5.5	18.9
Total Expenditure	120.3	82.7	45.5
EBITDA	25.0	18.3	37.1
EBITDA Margin (%)	17.2%	18.1%	-
Other Income	1.3	0.1	-
Interest	1.8	0.8	132.6
Depreciation	4.0	2.8	46.4
Prov. for Tax- Cur	6.9	5.1	37.5
Profit after Tax.	13.6	9.8	38.6
Equity share capital	15.1	15.1	-
EPS (Rs)	9.0	6.5	38.6
CEPS (Rs)	12.0	8.3	45.0

Source: Company, ICICIdirect Research

VALUATIONS

At the current price of Rs 590, the stock is trading at 15.7x FY07E EPS of Rs 37.5 and 13.2x FY08E EPS of Rs 44.7. We believe the stock deserves a higher P/E due to higher return ratios, assured volume growth and strong demand outlook. We rate the stock an OUTPERFORMER and value it at Rs 716, 16x the FY08E EPS.

Exhibit 12: P/E band



Source: ICICIdirect Research

Exhibit 13: Revenue model

		Units	FY03	FY04	FY05	FY06	FY07E	FY08E
Axle-housing	Installed capacity	Nos	70,224	86,000	109,200	150,000	175,000	200,000
	Production	Nos	55,709	77,740	90,464	114,041	143,750	173,750
	Sales (Quantity)	Nos	9,692	18,545	20,348	22,391	20,658	21,250
	Sales (Value)	Rs crore	8.2	15.5	19.1	20.8	19.1	19.6
	Sales value per unit	Rs/no	8,440	8,374	9,377	9,268	9,250	9,200
Axle	Installed capacity	Nos	62,400	65,000	83,000	108,000	150,000	200,000
	Production	Nos	46,059	58,251	70,012	92,034	123,300	152,500
	Sales (Quantity)	Nos	46,570	57,458	70,876	91,945	124,458	152,500
	Sales (Value)	Rs crore	188.5	245.8	333.3	440.4	597.4	739.6
	Sales value per unit	Rs/no	40,466	42,776	47,026	47,893	48,000	48,500
Others		Rs crore	41.5	30.5	50.0	63.1	75.0	80.0
Total		**Rs crore**	**238.2**	**291.8**	**402.4**	**524.2**	**691.5**	**839.2**

Source: ICICIdirect Research

FINANCIAL SUMMARY (Consolidated)

Profit and Loss Account

Net sales to rise at a CAGR of 26.1%

Net profit to grow at a CAGR of 25.7%

(Rs Crore)

Year to Sept. 30	FY08E	FY07E	FY06	FY05	FY04
Net Sales	734.3	605.1	461.8	354.7	257.5
% growth	21.4	31	30.2	37.8	22.4
Raw Material	491	403.6	306	234.2	160.6
Staff	33	28.7	22.5	16.9	14.4
Operating Expenses	69.8	56.9	43.1	33.3	31.7
Selling & Admin	7	6.1	4.9	3.2	4.4
Total Expenditure	-600.8	-495.2	-376.5	-287.6	-211.1
EBITDA	133.5	109.8	85.3	67.1	46.3
% growth	21.5	28.8	27	44.9	13.4
EBITDA margin (%)	18.2	18.2	18.5	18.9	18
Other income	0	0	-1.1	0.9	0.4
Interest	-9	-6.5	-5.8	-2.4	-1.1
Gross Profit	124.4	103.4	78.4	65.7	45.7
Depreciation	-22.7	-17.9	-13.7	-10.9	-10
Profit Before Tax	101.7	85.4	64.7	54.8	35.7
Tax	-34.2	-28.7	-22.1	-18.1	-13.1
Effective tax rate (%)	33.6	33.6	34.1	33.1	36.8
Net Profit	67.6	56.7	42.7	36.7	22.6
Extraordinaries	0	0	0.1	0.2	0.1
Reported Net Profit	67.6	56.7	42.8	36.9	22.6
% growth	19.1	32.7	16	62.9	13
EPS (Rs)	44.7	37.5	28.2	24.3	14.9
% growth	19.1	33	16.3	62.6	12.9

Balance Sheet

Capex funding

(Rs Crore)

Year to Sept. 30	FY08E	FY07E	FY06	FY05	FY04
Equity	15.1	15.1	15.1	15.1	15.1
Reserves	153.2	111.2	80	59.1	43.7
Net worth	168.3	126.3	95.2	74.2	58.9
Short-term Loans	7.6	12.6	7.6	29.5	29.0
Long-term Loans	82.1	62.1	47.1	31.7	16.1
Total Loans	89.6	74.6	54.6	61.2	45.0
Deferred tax liability	10.0	10.0	10.0	7.6	6.8
Liabilities	267.9	210.9	159.7	143	110.7
Gross Block	313.9	253.9	194.8	148.2	123.3
Depreciation	120.4	97.7	79.7	76.0	67.3
Net Block	193.5	156.3	115	72.2	56.1
Capital work-in-progress	-	-	9.2	11.9	10.8
Long-term Investments	0	0	0	0	0
Inventories	92.2	75.7	58.1	46.7	46.0
Debtors	52.3	44.8	36.8	63.9	38.3
Cash	20.4	8.8	2.5	5.2	4.7
Other Current assets	20.1	16.6	12.1	10.5	37.1
Total Current assets	185.0	145.8	109.5	126.3	126.0
Creditors	110.6	91.2	54.6	47.2	39.0
Other current liabilities	-	-	19.4	20.2	43.3
Total current liabilities	110.6	91.2	74.0	67.4	82.2
Net current assets	74.3	54.6	35.5	58.9	43.8
Total Assets	267.9	210.9	159.7	143.0	110.7

Cash Flow Statement

(Rs Crore)

Year to Sept. 30	FY08E	FY07E	FY06	FY05	FY04
EBIT	110.8	91.9	71.6	56.3	36.4
(Inc.)/Dec in working capital	-8.1	6.5	23.4	-18.1	-10.4
Cash flow from operations	102.7	98.4	95	38.2	26
Other income	0	0	-1.1	0.9	0.4
Depreciation	22.7	17.9	13.7	10.9	10
Interest paid (-)	-9	-6.5	-5.1	-2.2	-0.9
Tax paid (-)	-34.2	-28.7	-22.4	-15.8	-13.1
Dividends paid (-)	-25.6	-25.6	-22.3	-19.7	-14.0
Net cash from operations	56.6	55.7	57.8	12.4	8.4
Capital expenditure (-)	-60	-50	-53.7	-27.9	-20.0
Net cash after capex	-3.4	5.7	4.1	-15.5	-11.6
Inc./dec. in short-term borrowing	-5.0	5.0	-19.6	3.3	6.1
Inc./dec. in long-term borrowing	20.0	15.0	13.1	12.9	8.3
Inc./dec. in borrowings	15.0	20.0	-6.6	16.1	14.4
Inc./dec. in investments	0	0	0	0	0
Inc./dec. in preference capital	0	0	0	0	0
Equity issue/buyback	0	0	0		0
Cash from Financial Activities	15.0	20.0	-6.6	16.1	14.4
Others	0	-19.4	-0.2	-0.1	-0.1
Opening cash	8.8	2.5	5.2	4.7	2.0
Closing cash	20.4	8.8	2.5	5.2	4.7
Change in Cash	11.6	6.3	-2.6	0.5	2.7

Ratios

Year to Sept. 30	FY08E	FY07E	FY06	FY05	FY04
EBITDA Margins (%)	18.2	18.2	18.5	18.9	18.0
Net profit Margins (%)	9.2	9.4	9.3	10.4	8.8
RoCE (%)	46.3	50.8	50.1	49.5	39.5
RoE (%)	45.9	51.2	50.5	55.4	40.3
Debt/Equity (x)	0.5	0.6	0.6	0.8	0.8
Interest cover (x)	12.3	14.2	12.7	26.1	38.7
RM/Sales (%)	66.9	66.7	66.3	66.0	62.4
Staff/Sales (%)	4.5	4.8	4.9	4.8	5.6
Others/Sales (%)	10.5	10.4	10.4	10.3	14.1
EPS (Rs)	44.7	37.5	28.2	24.3	14.9
CEPS(Rs)	59.7	49.4	38.9	32.1	22.0
DPS (Rs)	15.0	15.0	13.0	12.5	10.0
Div. Yield (%)	2.5	2.5	2.2	2.1	1.7
P/E (x)	13.2	15.7	20.9	24.3	39.5
P/BV (x)	5.3	7.1	9.4	12.0	15.1
P/ Sales (x)	1.2	1.5	1.9	2.5	3.5
EV/EBITDA (x)	7.2`	8.7	11.1	14.1	20.1

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and ecommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;
Performer: Between 10% and 20%;
Hold: $\pm$10% return;
Underperformer: -10% or more.

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