# Bharat Forge (BHFC IN, CMP: Rs297, Not Rated)

## Passing through the transition phase

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September 8, 2011

# Bharat Forge – passing through the transition phase

## BHFC IN, CMP: Rs297

Not Rated

- **Targeting consolidated revenue CAGR of 20% over FY11-13; aim at 60% of revenue from non-auto segment at the standalone level:** Bharat Forge (BHFC IN) targets a 20% consolidated revenue CAGR over FY11-13, led by demand recovery in the domestic market, higher revenue contribution from machined components and rising demand for forged components related to shale gas exploration/production in the US. Automotive forging demand from the EU and US is robust YTD, with exports and foreign subs revenue both up by more than 60% y-y, although management believes this robust growth is primarily owing to low base. It has guided for capacity utilization at foreign subs at around 50-55% along with a 15-20% sales CAGR at FAW China (a 52% stake) over FY11-13. Management expects revenue contribution at 60% from the non-auto business by FY14, with current utilization at Baramati non-auto forging facility at around 45%. Sales from Alstom JV is expected to kick-start from FY14 onwards. EPC business sales is expected at Rs8 bn in FY12-13.
- **Increase machining capacity by 55% by the end of FY12:** With machining capacity set to increase by 55% from FY13 to 1.25 mn units, management expects the machined component revenue contribution to improve from the existing 40% levels to at least 50% from FY13 at the standalone level. Steel forging capacity is set to increase by 10% to 400,000 MT at the standalone level, with incremental capacity coming in primarily led by debottlenecking at the existing plant at Mundhwa. Management expects standalone capacity utilization to remain around 65% levels in FY12-13.
- **Standalone EBITDA margin target at ~22-24% and foreign subs margin at a minimum of 10%:** Management targets a standalone EBITDA margin of ~22-24% over FY11-13, with a gradual improvement in capacity utilization at the Baramati facility and higher mix of machined component revenue. We expect gross profit/tonne to improve by at least 5% from the current levels of Rs80,000/tonne led by a rise in higher-margin machined component revenue contribution. Management targets for at least 10% EBITDA margin from foreign subs. We believe a lack of infrastructure for machined components at foreign subs facilities is one reason for their lower margin. We expect consolidated EBITDA margin to be in the range of 15-16% over FY12-13E.
- **Capex and investment of Rs5 bn in FY12-13; FCCB redemption of US$130 mn in FY13-14:** Capex for FY12-13 is at Rs3 bn, primarily for expanding forging and machining capacity by 10% and 55%, respectively. Investment at Rs2 bn is to cater to the remaining equity stakes in various JVs. Redemption of US$130 mn, including premium, is due in FY13-14.

**Financials and valuation**

| | Revenue | | EBITDA | | Adjusted net income | | EPS | P/E | EV/EBITDA | ROCE | ROE |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | (Rs mn) | Growth(%) | (Rs mn) | Margin (%) | (Rs mn) | Growth(%) | (Rs/share) | (x) | (x) | (%) | (%) |
| FY10 | 33,428 | (30.2) | 2,458 | 7.4 | (633) | NA | (2.8) | NA | 30.5 | 0.0 | (4.1) |
| FY11 | 51,080 | 52.8 | 7,894 | 15.5 | 2,898 | NA | 12.4 | 23.9 | 9.6 | 13.8 | 17.2 |
| FY12E | 61,963 | 21.3 | 9,904 | 16.0 | 4,102 | 41.5 | 17.6 | 16.9 | 7.4 | 18.2 | 19.8 |
| FY13E | 69,049 | 11.4 | 10,356 | 15.0 | 4,386 | 6.9 | 18.8 | 15.8 | 6.7 | 18.9 | 18.3 |

Note: Pricing as on 07 September 2011; Source: Company data, Quant Global Research estimates

| | |
|---|---|
| **Market cap:** | **Rs63.6 bn (US$1.4 bn)** |
| 52-week high/low: | Rs413/Rs259 |
| Share o/s: | 233 mn |
| Share o/s (fully diluted): | 233 mn |
| Avg daily trading vol (3m): | 473 ('000) |
| Avg daily trading val (3m): | Rs142 mn (US$3.1 mn) |

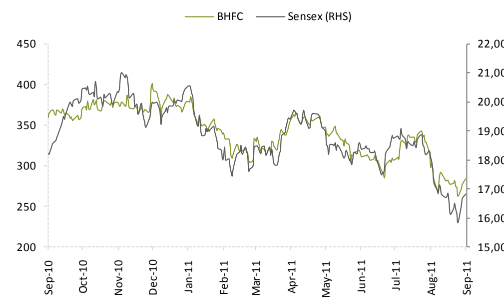
Source: Bloomberg

**Shareholding pattern (%)**

| | Jun-11 | Mar-11 | Dec-10 |
|---|---|---|---|
| Promoters | 42.1 | 42.1 | 42.1 |
| FIIs | 12.2 | 12.4 | 14.1 |
| DIIs | 19.6 | 19.7 | .18.8 |
| Others | 26.2 | 25.9 | 25.0 |

Source: BSE

**Price movement (Rs) vs the Sensex**




Source: Bloomberg

# Business update

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September 8, 2011

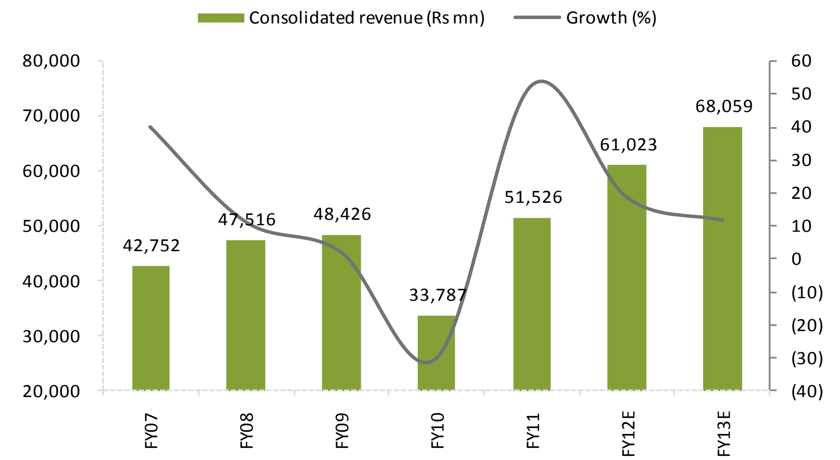
# BHFC – management targets non-auto revenue of ~60% by FY14

## Key issue: domestic demand recovery against rising uncertainty from foreign markets

**Management expects to sustain domestic demand, although rising economic uncertainty in the EU and the US remains a key concern**

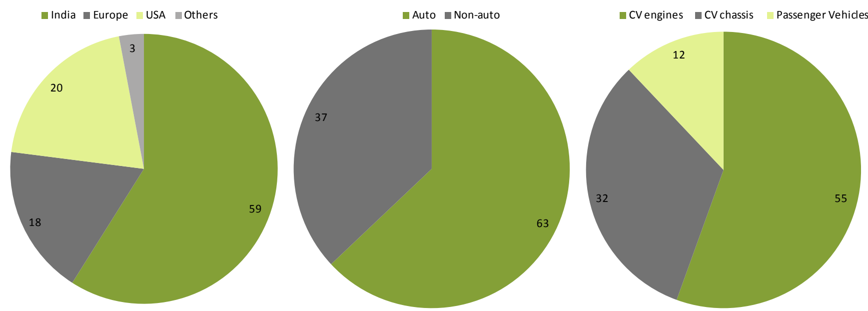
- **Present revenue scenario and outlook**
  - Standalone revenue is getting bolstered by rising non-auto revenue, contributing 37% currently vs. 25% a year ago, despite relatively sluggish automotive demand. Management says there is sizeable scope for demand growth in the non-auto segment portfolio led by sectors like oil & gas, wind power and aviation. This is helping BHFC remain partially insulated from the relative slowdown in domestic CV demand. Exports contribute ~50% of the non-auto revenue in the standalone entity.
  - Management plans to expand standalone forging capacity to 0.4 mn tonnes from 0.365 mn tonnes by FY12-end along with increasing machining capacity from 0.80 mn units to 1.25 mn units. The Baramati non-auto facility is running at ~45% utilization currently vs 70% utilization at the Mundhwa facility.
  - FAW China (a 52% stake) is currently running at around 55% capacity utilization along with other foreign subs, which are running at around ~50% utilization levels. Management says the breakeven capacity utilization level at the foreign subs has reduced to 35-40% from 45-50%, after the restructuring of fixed overhead expenses in FY11.
  - We do not expect any revenue from JVs with Alstom and NTPC at least until end of FY13, although fresh foray in the EPC segment is set to derive revenue of Rs8 bn in FY12-13E.
  - We are modeling in 12% y-y growth in consolidated sales in FY13E to Rs69 bn, after factoring in a 5% revenue contraction at subs. level. We expect standalone revenue to contribute 67% of consolidated revenue and India to contribute 62% of standalone revenue, signifying India contributing ~41% of consolidated revenue in FY13E.

**We are expecting a revenue CAGR of 16% over FY11-13E**




Source: Company data, Quant Global Research estimates

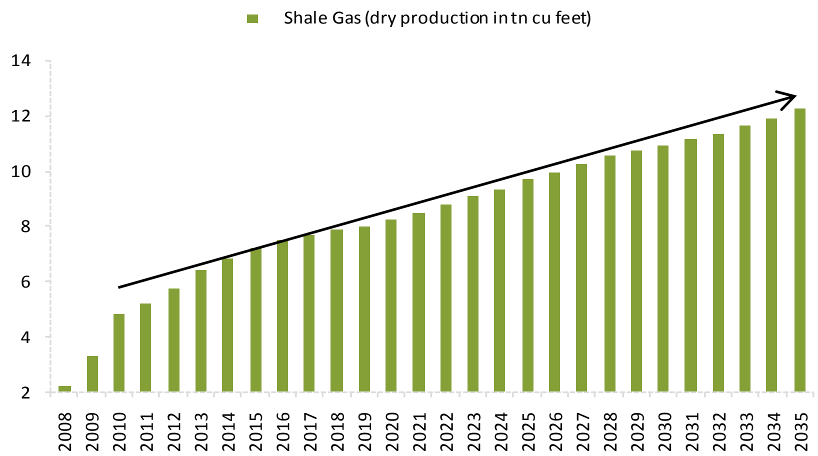
**Revenue contribution from India, the non-auto segment and CV set to move up**




Source: Company data, Quant Global Research

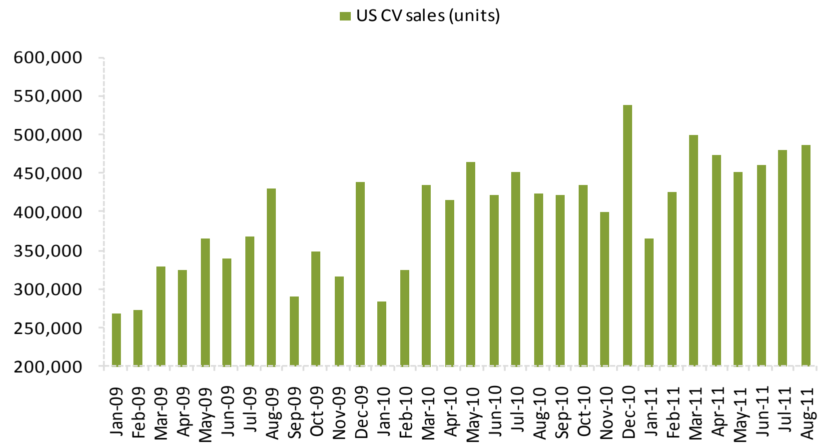
# BHFC – domestic demand set to improve; tapping shale gas growth potential can reduce cyclicality for foreign subsidiaries

**Sizeable potential in the US for BHFC with regards to rising production of shale gas**



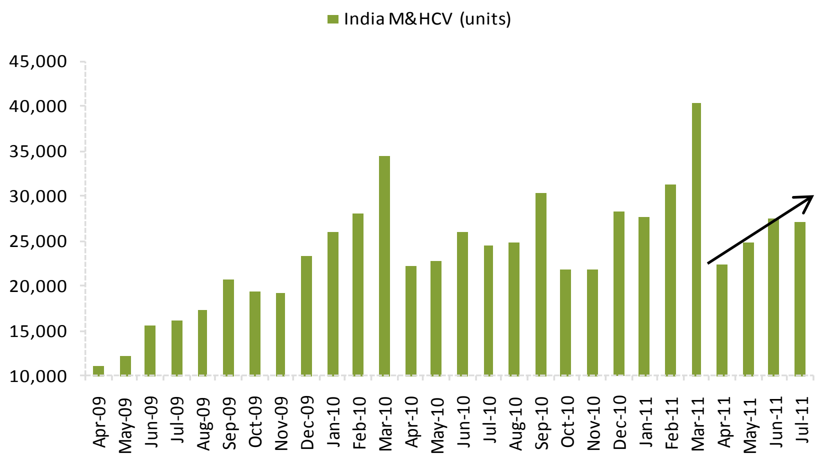

Source: EIA

**Monthly CV sales trend in the US (excluding imported units)**



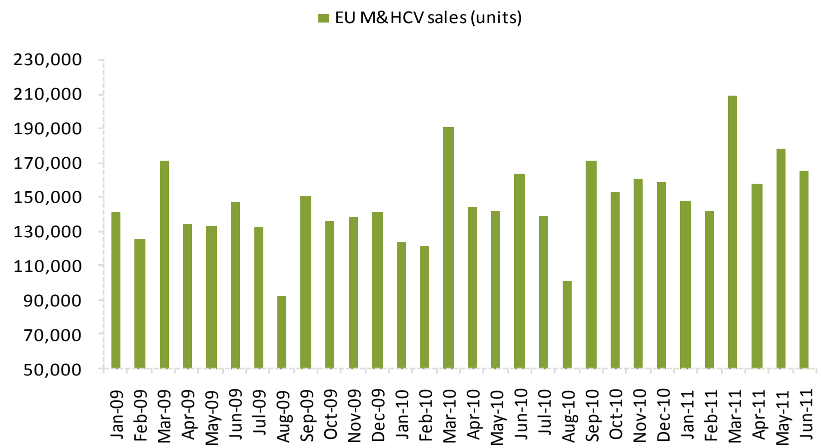

Source: Bloomberg

**India M&HCV sales on a strong footing despite adverse macro situation**




Source: SIAM

**Monthly CV sales trend in the EU: growing on a lower base**

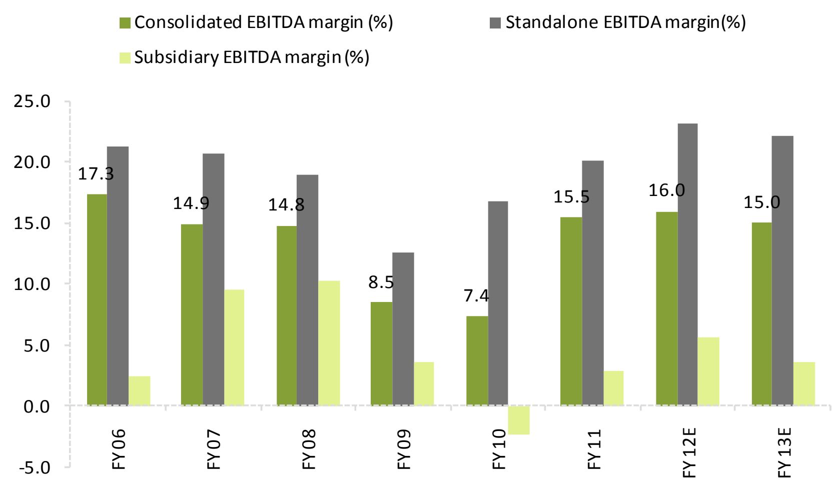



Source: : Bloomberg

**Management targets an EBITDA margin in the range of 22-24% over FY12-13 at the standalone level and 10% at the subs level**

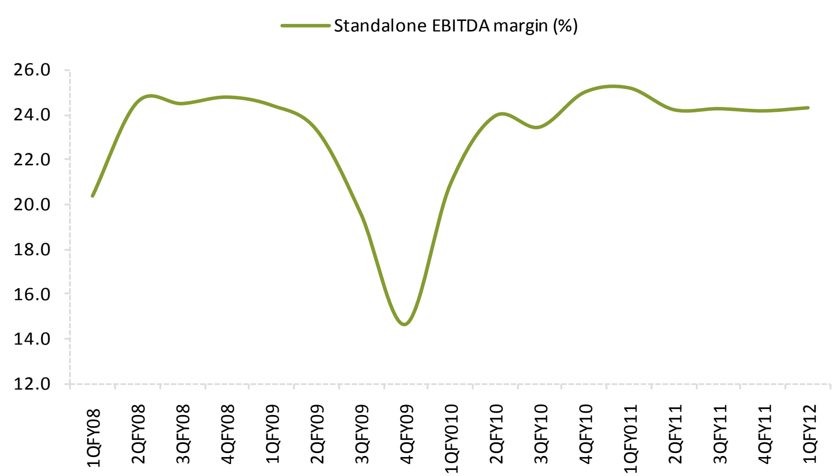
- **Margin outlook**
  - Management expects a standalone EBITDA margin of 22-24% over FY12-13, led by expectations of higher gross margin on the back of higher machining capacity. It expects machining capacity to increase by 50% in FY12 to 0.125 mn units, which as per our analysis should lead to a ~1000-bp increase in sales contribution by higher margin machined components, thereby cushioning margin. We also believe rising capacity utilization at the overall standalone level will add to margin with huge scope of higher utilisation both at Mundhwa and Baramati plants.
  - Withdrawal or the reduction in rate of benefit from duty entitlement pass book (DEPB) can impact margin of the standalone business as exports contribute ~38-42% of standalone revenue along with an average rate of exports benefit of around 7% of export value. Thus, at a consolidated level, EBITDA margin impact can be at the most around 180-200bp in case of a full withdrawal of DEPB benefits.
  - The restructuring exercise by way of transferring assets and operations of its Scottish subsidiary to Sweden in FY10, spending Rs720 mn, has helped BHFC reduce the breakeven capacity utilization level for foreign subsidiaries on a combined basis to around 40% from 50%.
  - Management expects a ~10% EBITDA margin from foreign subs on a combined basis, subject to stable demand scenario in the corresponding markets.
  - EPC business EBIT margin, as per management, is expected to be around 7-8%, operations starting from FY12, although on a small scale.

**Expect consolidated margin to stabilise around 15% levels**




Source: Company data, Quant Global Research estimates

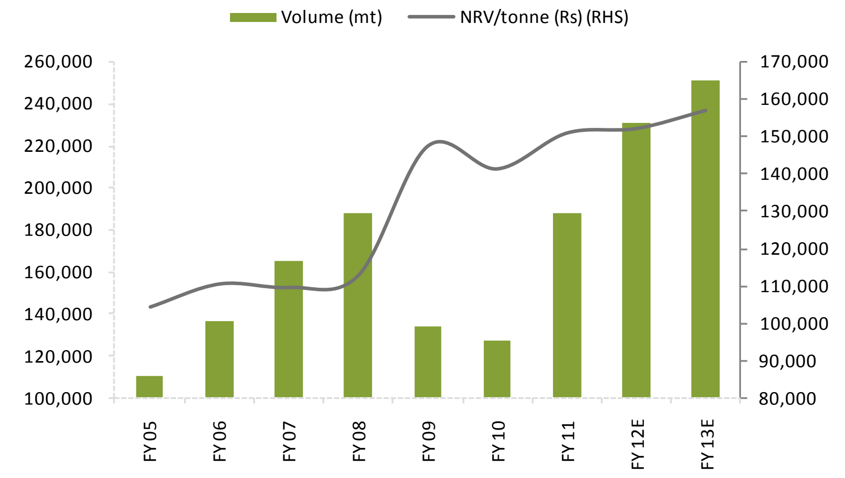
**Standalone margin stable at current levels of ~24%**




Source: Company data, Quant Global Research

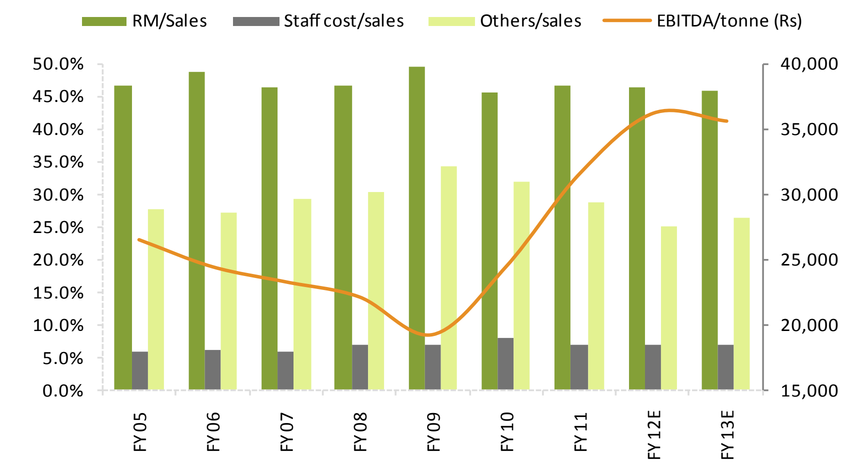
- **Around 50% increase in machining capacity against a mere 10% increase in forging capacity suggests the potential for product mix improvement from FY13**
  - BHFC is planning to enhance machining capacity by more than 50% from 0.80 mn units pa to 1.25 mn units pa against a hike in forging capacity by 10% to 0.4 mn tonnes by the end of FY12. Management says this would improve the product mix as BHFC would be able to cater to rising demand for higher margin finished/machined components.
  - The worst case scenario for standalone margin can arise in case of a fall in demand after the addition of capacity in FY13 along with the impact of DEPB withdrawal, if at all. On a conservative note, we do not expect EBITDA/kg to fall below Rs35-36 against current levels of Rs39-40.

**Standalone volume moving up the ladder after bottoming in FY10**



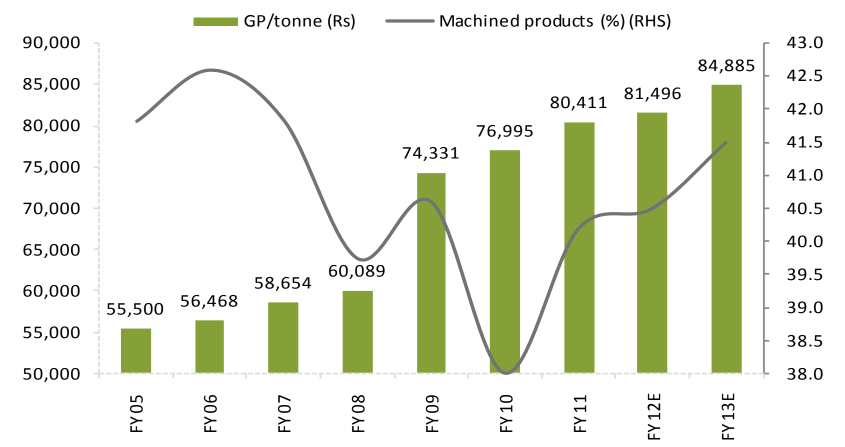

Source: Company data, Quant Global Research estimates

**EBITDA /tonne improving with rising capacity utilization; higher machining to add to it**




Source: Company data, Quant Global Research estimates

**GP/tonne up steadily after FY09; rise in machined components (%) to add to GP /tonne**



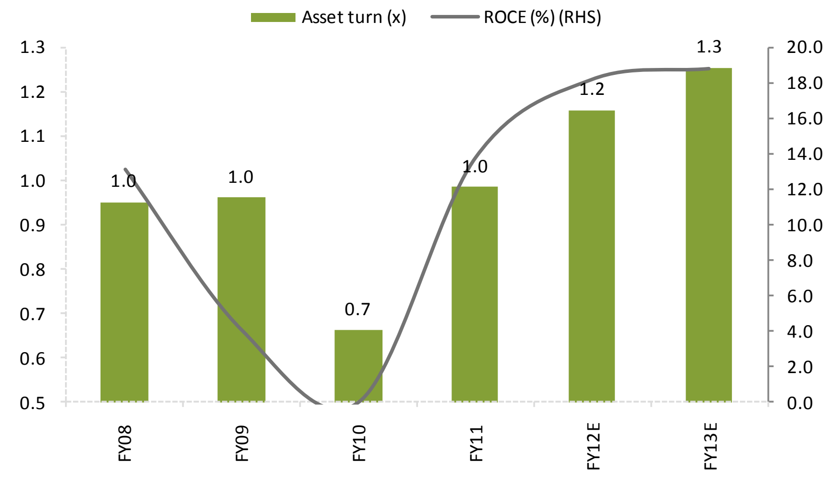

Source: Company data, Quant Global Research estimates

# BHFC – lower capex needs and debt repayment to push capital efficiency

## Expect consolidated ROE in the range of 18-20%

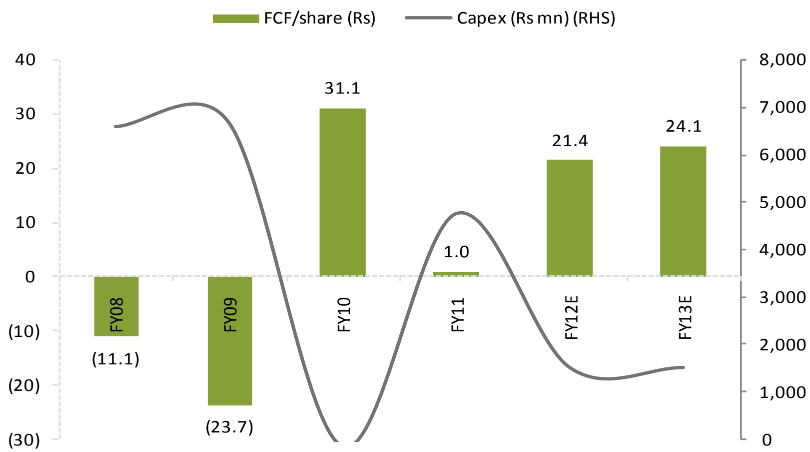
- **ROCE set to improve; FY13E FCF yield at ~8-9% at the CMP**
  - A gradually improving asset turn combined with stable consolidated margin and debt reduction, we believe are the key drivers of improving capital efficiency for BHFC. We expect ROCE to improve to 19% by FY13E
  - Given BHFC is operating at around 70% capacity utilization at standalone level and 50-55% for foreign subs, we do not see need for any major capex barring addition of machining capacity and basic maintenance capex needs. Management is guiding for Rs3 bn capex in FY12-13E.
  - BHFC turned FCF-positive from FY10 post demand slowdown in FY08-09 and with visibility of improving revenue, stable margin and lower capex needs, we believe BHFC is currently trading at a ~8% FY13E FCF yield.
  - We expect the net debt/equity at 0.6x in FY11 to fall to 0.2x by FY13E. As per management, FFCB redemption to the tune of US$130 mn is due in April 2012 and April 2013 combinedly.

**ROCE set to improve on the back of redemption of FCCBs and lower capex**



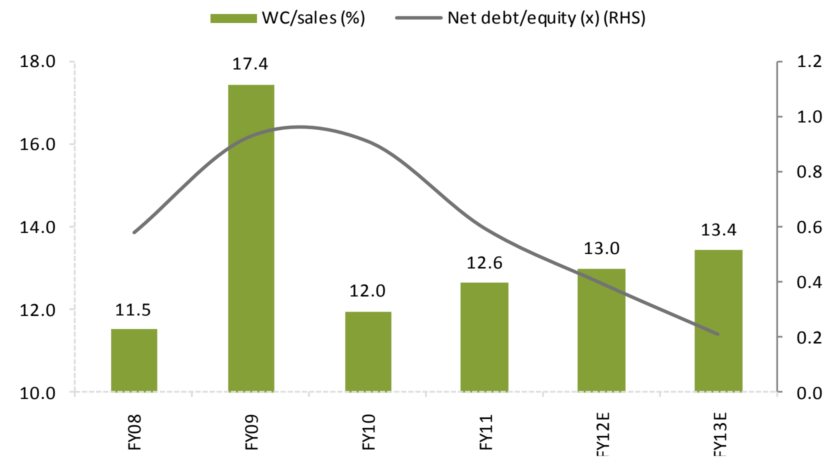

Source: Company data, Quant Global Research estimates

**Capex+ investment of Rs5 bn in FY12-13; FCF set to move up against stable margin**




Source: Company data, Quant Global Research estimates

**Debt on books to decline by US$130 mn in FY12-13; stable WC/sales at 12-13%**




Source: Company data, Quant Global Research estimates

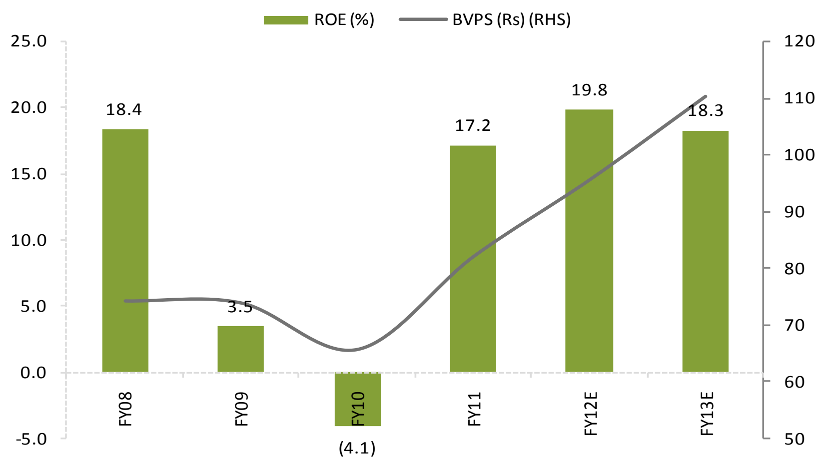
# BHFC – trading at ~7x fwd rolling EV/EBITDA and ~2.6x FY13E P/B

- **BHFC is currently trading at around 16x one-year forward rolling earnings estimate against the mean level of 21x in the past 12 months**
  - BHFC traded at a mean forward P/E of about ~21x in the past 12 months. Currently, it is trading around 16x forward earnings against an estimated earnings CAGR of 23% during FY11-13E.
  - Currently, BHFC is trading at ~7x one-year forward rolling EV/EBITDA against a three-year mean of 12.7x .
  - Against visibility of BHFC ROE hovering ~18-19% over FY12-13E, the stock is currently trading at ~2.6x FY13E P/B.

**Trading at ~7x one-year forward rolling EV/EBITDA against historical mean at 12.7x**

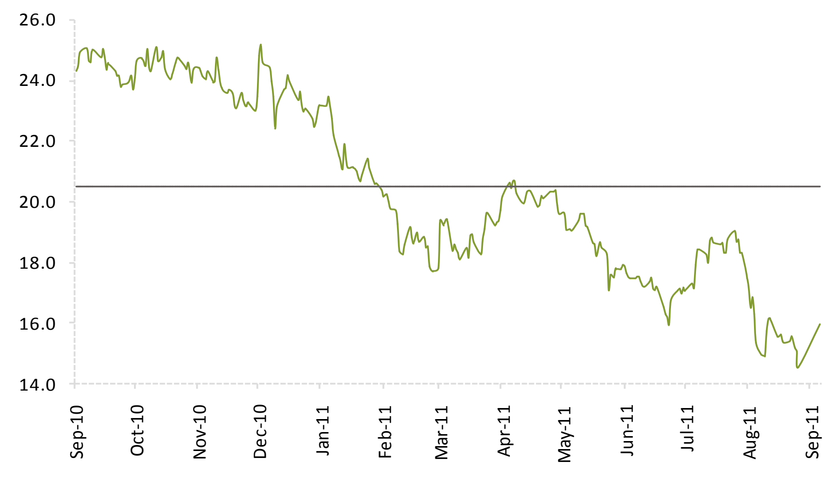

Source: Bloomberg, Quant Global Research estimates

**Expect to maintain ROE of around 18%; trading at ~2.6x FY13E P/B**




Source: Company data, Quant Global Research estimates

**Trading at a one-year forward earnings multiple of 16x**




Source: Bloomberg, Quant Global Research estimates,

# BHFC – risks to the business

- **Risks to the business**
  - Prolonged slowdown in the CV/PV cycle in the domestic market along with economic slowdown in US/EU would hamper overall demand from the automotive segment.
  - Rising inflation in the domestic market to affect a majority of sectors driving non-auto demand for BHFC like marine, industrials and infrastructure.
  - Incremental competition at the global level to tap non-cyclical opportunities in the form of shale gas exploration in the US.
  - Rise in forging capacity from FY13 coinciding with weaker demand at he standalone level can put a halt to improving economies of scale benefit for BHFC.

# Financials

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# BHFC – financial statements

## YE March (Rs mn)

| Income Statement (Rs mn) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Net revenue | 33,428 | 51,080 | 61,963 | 69,049 |
| Expenditure | 30,970 | 43,186 | 52,059 | 58,693 |
| Raw materials | 15,781 | 23,372 | 28,727 | 32,634 |
| Employee expenses | 5,239 | 6,365 | 7,563 | 8,035 |
| Other expenditure | 9,951 | 13,449 | 15,770 | 18,024 |
| EBITDA | 2,458 | 7,894 | 9,904 | 10,356 |
| Non-operating income | 187 | 338 | 160 | 100 |
| Depreciation | 2,451 | 2,548 | 2,685 | 2,832 |
| EBIT | 193 | 5,683 | 7,379 | 7,624 |
| Net interest expense | 1,135 | 1,417 | 1,199 | 997 |
| Adjusted pre-tax profit | (942) | 4,267 | 6,180 | 6,627 |
| Unusual or infrequent items | (10) | (28) | - | - |
| Reported pre-tax profit | (952) | 4,239 | 6,180 | 6,627 |
| Less: taxes | 117 | 1,399 | 1,978 | 2,121 |
| Reported net profit | (1,069) | 2,839 | 4,202 | 4,506 |
| Add: extraordinary items (post-tax basis) | 305 | 127 | - | - |
| Less: minority/associate earnings | 132 | (68) | (100) | (120) |
| Reported net profit for shareholders | (633) | 2,898 | 4,102 | 4,386 |
| Adjusted net profit for shareholders | (633) | 2,898 | 4,102 | 4,386 |
| | | | | |
| EPS (Rs), based on wtd avg shares | NA | 12.4 | 17.6 | 18.8 |
| EPS (Rs), based on fully diluted shares | NA | 12.4 | 17.6 | 18.8 |
| Year-end shares outstanding (mn) | 223 | 233 | 233 | 233 |
| Weighted average shares outstanding (mn) | 223 | 233 | 233 | 233 |
| Fully diluted shares outstanding (mn) | 223 | 233 | 233 | 233 |

| Balance Sheet (Rs mn) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Equity capital | 445 | 466 | 466 | 466 |
| Reserves and surplus | 14,185 | 18,652 | 21,808 | 25,247 |
| Deferred tax liability (net) | 839 | 1,321 | 1,321 | 1,321 |
| Total equity | 15,469 | 20,439 | 23,594 | 27,033 |
| Secured loans | 18,573 | 15,310 | 12,510 | 9,410 |
| Unsecured loans | 3,954 | 3,639 | 3,639 | 3,639 |
| Minority interest | 783 | 1,542 | 1,642 | 1,762 |
| Total borrowings | 22,527 | 18,950 | 16,150 | 13,050 |
| Current liabilities | 14,194 | 18,075 | 21,473 | 23,887 |
| Total liabilities | 52,973 | 59,005 | 62,859 | 65,732 |
| | | | | |
| Cash | 5,977 | 3,110 | 2,157 | 1,718 |
| Inventory | 6,575 | 8,115 | 10,075 | 11,568 |
| Debtors | 5,044 | 7,539 | 10,327 | 11,978 |
| Other current assets | 6,576 | 8,878 | 9,121 | 9,621 |
| Total current assets | 24,171 | 27,641 | 31,680 | 34,885 |
| Gross block | 41,347 | 45,010 | 47,579 | 50,079 |
| Less: depreciation and amortisation | (17,269) | (20,383) | (23,068) | (25,900) |
| Add: capital work-in-process | 1,987 | 3,069 | 2,000 | 1,000 |
| Total fixed assets | 26,065 | 27,696 | 26,511 | 25,179 |
| Investments | 2,737 | 3,668 | 4,668 | 5,668 |
| of which, liquid investment | 2,448 | 3,667 | 4,667 | 5,667 |
| Other assets | - | - | - | - |
| Total assets | 52,973 | 59,005 | 62,859 | 65,732 |
| Net working capital | 4,000 | 6,457 | 8,049 | 9,280 |

Source: Company data, Quant Global Research estimates

# BHFC – financial statements

## YE March (Rs mn)

| Growth ratio (%) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Net revenue | (30.2) | 52.8 | 21.3 | 11.4 |
| EBITDA | (39.1) | 221.2 | 25.5 | 4.6 |
| Adjusted net profit | NA | NA | 41.5 | 6.9 |

| Ratios (%) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Effective tax rate | NA | 33.0 | 32.0 | 32.0 |
| EBITDA margin | 7.4 | 15.5 | 16.0 | 15.0 |
| Adjusted net income margin | NA | 5.7 | 6.6 | 6.4 |
| Net debt/equity | 0.9 | 0.6 | 0.4 | 0.2 |
| ROaCE | 0.0 | 13.8 | 18.2 | 18.9 |
| ROaE | (4.1) | 17.2 | 19.8 | 18.3 |
| Total asset turnover ratio (x) | 0.7 | 1.0 | 1.2 | 1.3 |
| Inventory days | 71.8 | 58.0 | 59.4 | 61.1 |
| Debtor days | 55.1 | 53.9 | 60.8 | 63.3 |

| Per share numbers (Rs) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Diluted earnings | NA | 12.4 | 17.6 | 18.8 |
| Cash earnings | 8.2 | 23.4 | 29.1 | 31.0 |
| Free cash | 31.1 | 1.0 | 21.4 | 24.1 |
| Book value | 65.7 | 82.1 | 95.7 | 110.4 |

| Valuations (x) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Price to diluted earnings | NA | 23.9 | 16.9 | 15.8 |
| EV/EBITDA | 30.5 | 9.6 | 7.4 | 6.7 |
| Price to book | 4.3 | 3.4 | 2.9 | 2.6 |

Source: Company data, Bloomberg, Quant Global Research estimates

| Cash flow statement (Rs mn) | FY10 | FY11 | FY12E | FY13E |
|---|---|---|---|---|
| Operating cashflow | | | | |
| Pre-tax income | (648) | 4,365 | 6,180 | 6,627 |
| Add: depreciation and amortisation | 2,451 | 2,548 | 2,685 | 2,832 |
| Add: interest expense (net) | 1,135 | 1,417 | 1,199 | 997 |
| Less: other adjustments | | | | |
| Less: taxes paid | (520) | (903) | (1,978) | (2,121) |
| Add: working capital changes | 4,352 | (2,457) | (1,593) | (1,230) |
| Total operating cashflow | 6,771 | 4,971 | 6,493 | 7,105 |
| | | | | |
| Investing cashflow | | | | |
| Capital expenditure | 165 | (4,745) | (1,500) | (1,500) |
| Investments | (2,735) | (931) | (1,000) | (1,000) |
| Others | - | - | - | - |
| Total investing cashflow | (2,570) | (5,677) | (2,500) | (2,500) |
| | | | | |
| Financing cashflow | | | | |
| Share issuances | - | - | - | - |
| Loans | 618 | (3,577) | (2,800) | (3,100) |
| Less: Others | (3,726) | 1,416 | (2,146) | (1,944) |
| Total financing cashflow | (3,108) | (2,161) | (4,946) | (5,044) |
| | | | | |
| Net change in cash | 1,093 | (2,867) | (953) | (439) |
| Opening cash | 4,883 | 5,977 | 3,110 | 2,157 |
| Add: other adjustments | | | | |
| Closing cash | 5,977 | 3,110 | 2,157 | 1,718 |

# BHFC – company profile

- **Company profile**
  - Bharat Forge is one of the leading forgings manufacturers globally. While the company is well established in automobile forgings, it is also increasingly moving to non-automotive forgings to broaden its product mix. Bharat Forge has nine manufacturing plants in six countries including India, Sweden, the US, China and Germany. This gives it substantial geographic distribution of sales and production facilities.
  - Incorporated in 1961, Bharat Forge, the flagship company of the Kalyani Group, has been investing in state-of-the-art facilities, world-class capacities and capabilities. Its plants include fully automated forgings and machining lines, the largest of their kind and comparable with the best in the industry. In India, major plants are at Pune, Baramati and Satara.
  - Recently, BHFC has ventured into power equipment forging business through JVs with Alstom and Areva for thermal and nuclear power plant equipments, respectively.
  - Management is led by Baba Kalyani, managing director, and Amit Kalyani, executive director.

# Disclaimer

## Ratings and other definitions

### Stock rating system

**BUY.** We expect the stock to deliver >15% absolute returns.

**ACCUMULATE.** We expect the stock to deliver 6-15% absolute returns.

**REDUCE.** We expect the stock to deliver +5% to -5% absolute returns.

**SELL.** We expect the stock to deliver negative absolute returns of >5%.

**Not Rated (NR).** We have no investment opinion on the stock.

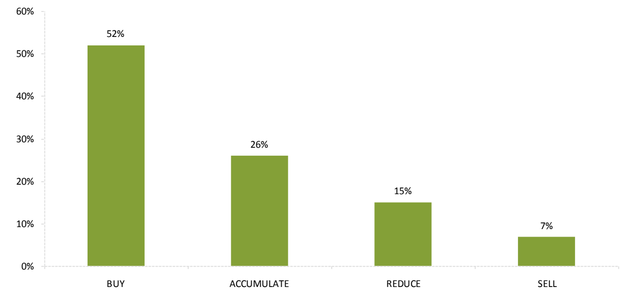
### Sector rating system

**OVERWEIGHT.** We expect the sector to relatively outperform the Sensex.

**UNDERWEIGHT.** We expect the sector to relatively underperform the Sensex.

**NEUTRAL.** We expect the sector to relatively perform in line with the Sensex.

## Institutional Equities Research coverage universe – distribution of ratings

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# Thank you

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analysis adds up