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In Focus

Bharat Forge

Outperformer	Rs 349	May 25, 2006

FY06 Result Update – Margin Pressure to the Fore

Bharat Forge's resolve to turn into a global leader in forged and machined components is yielding results, judging by the way the topline leaped by a 90% CAGR between FY04 and 06. However, consolidated margins are now settling down to 17-18%. PAT for Q4 and FY06 crossed our expectations, whereas EBITDA margins were weak and lower than the 25% we anticipated. The standalone Q4 FY06 PAT rose 9.6%, to Rs 530m, on a 21.4% jump in net sales, to Rs 4.38bn. Global revenue, comprising exports from India—Rs 1.92bn (up 19.3%)—and from subsidiaries abroad sales—Rs 3.14bn (up 74.8%)—grew 51.4%, to Rs 5.05bn. But a sharp increase in raw material and manufacturing expenses, attributable to accelerating capacities that came on stream in Q4 FY06, led to the lowest EBITDA margins (24%) in the last 12 quarters.

For FY06, standalone net sales increased 29.4%, to Rs 15.78bn, with almost equal growth coming from the home market and from exports. The capacity expansions in PV have been timely and have provided the growth impetus so as to now account for 18% of standalone revenue, up from 16% a year ago. High raw material costs (up 330bp, to 46.3%) led to a 200bp fall in EBITDA margins, to 24.8%. The PAT margin slid slightly, to 13.1%, as PAT growth, at 29%, was slower than sales growth.

Consolidated net sales for Q4 FY06 grew 39.1%, to 7.52bn, while PAT grew 10.4% to Rs 636m. For the year, net sales, at Rs 30.2bn, jumped 51.4% while PAT, at Rs 2.5bn, was 24.6% higher yoy.

In the analyst meet, Management indicated that the company is now consolidating and ramping up. Consolidated forging capacity, on completing the on-going capacity expansion programme, would total 0.6m tpa. The company is also looking at opportunities in non-automotive forgings, especially those for the energy sector, and hopes that 25% of its global revenue would come from this segment alone (up from 17% in FY06). We maintain an OUTPERFORMER **rating on the consolidated valuation of 16.6x FY08E EPS of Rs 21.10, post-GDR and FCCB-led equity dilution.**

(Stock price as on May 24, 2006)

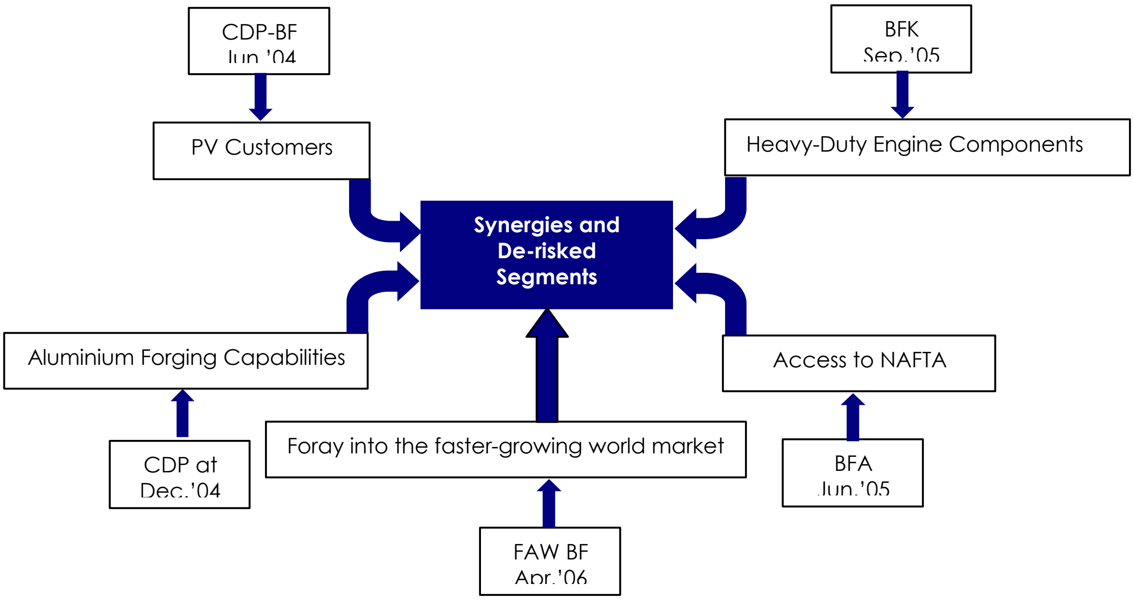
Key Figures for the standalone entity

Y/e March	FY05	FY06	FY07E	FY08E
Net Sales *(Rs m)*	12,191	15,800	21,459	29,271
PAT *(Rs m)*	1,616	2,090	2,975	4,118
EPS *(Rs)*	6.8	8.8	12.5	17.3
EPS Growth (%)	*2.3*	*29.3*	*42.3*	*38.4*
PER *(x)*	51.4	39.8	28.0	20.2
Cash EPS *(Rs)*	10.8	12.8	17.9	25.0
CPER *(x)*	32.2	27.3	19.5	14.0
EV / EBIDTA *(x)*	22.2	19.2	13.1	9.2
EV / Sales *(x)*	6.0	4.8	3.5	2.5
RoE (%)	*50.2*	*27.3*	*22.7*	*23.9*
RoCE (%)	*55.7*	*36.9*	*33.4*	*38.9*

Acquisitions have brought synergies and de-risking to the table

BF's aggressive acquisitions, starting with CDP in June '04 to the latest Chinese JV (with FAW), have brought both synergies and de-risked segments to the table as illustrated below. While India would remain the most profitable and the largest arm, the low-cost competitive destination in China could increasingly play an important role in the years ahead.

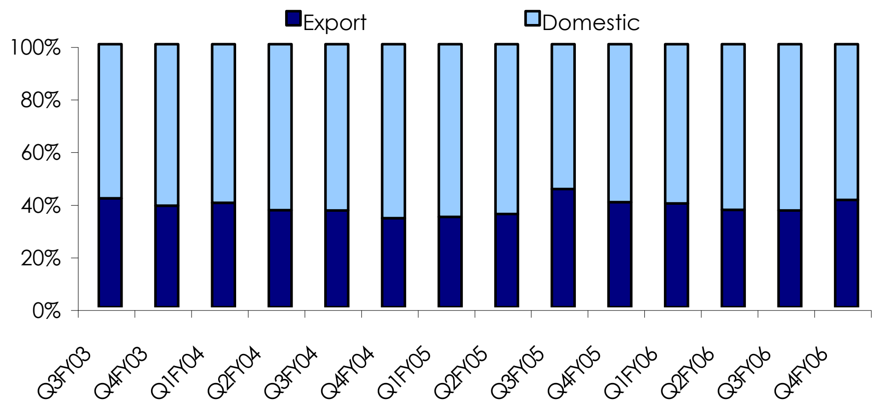
Synergy on the table



Source: Company Data, PL Research

Currently, the company's capacities are geographically well spread. India (forging capacity of 0.24m tpa and 0.65m pieces pa of crankshaft machining), accounting for 30% of its global forging capacities and 80% of its global machining capacity, would still remain central to its business. And the company is now progressing towards graduating up the value chain from being a mere supplier to a development partner.

Domestic mix loses strength in Q4

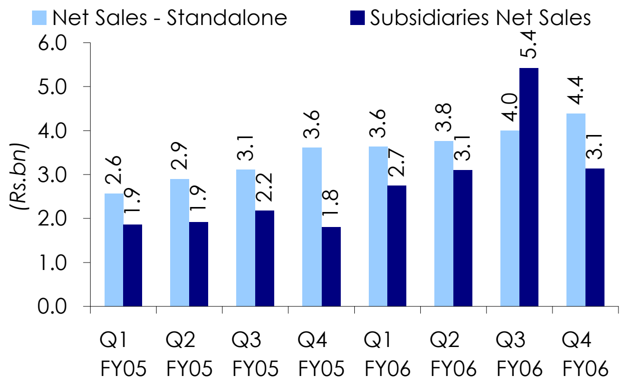


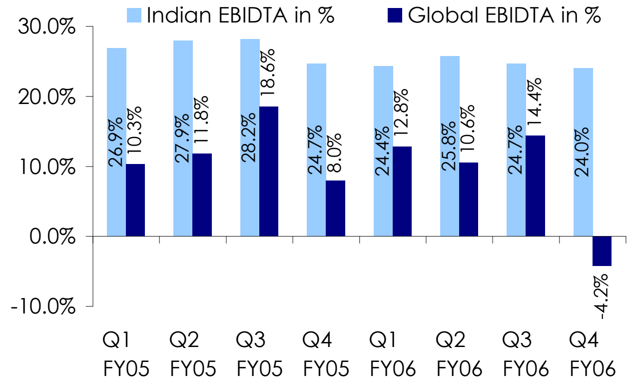
Source: Company Data, PL Research

Sales of Subsidiaries falter in Q4 FY06 and EBIDTA margins turn negative

After continuously rising in the first three quarter of this fiscal, sales of BF's subsidiaries faltered in Q4. Net sales dropped 42% qoq, to Rs 3.14bn, but still managed to rise 75% yoy. For Q4 FY06, EBITDA margins of the subsidiaries sharply eroded, as they turned a negative 4.2%, indicative of the challenges in turning around bankrupt companies. As explained by the management, the company is working towards a global integration program where cultural integration is as important as business strategy integration. We believe that the company would be able to smoothly integrate as is evident from its experience with its first acquisition, CDP.

Margins of Subsidiaries turn Negative





Source: Company Data, PL Research

Fund raising would enable additional value capturing

BF has effectively raised $328m by way of:

- GDRs -- $100m in May '05
- FCCBs -- $120m in two tranches in May '05
- Warrants converted -- $28m
- FCCB issue -- $80m in two tranches in April '06

These funds have not only enabled the expansion in India but also the acquisitions of Federal Forge and Immatra Kilsta. BF is still small in North America—just 50,000 tpa from its Federal Forge acquisition. The management admitted that this is insufficient and is looking at suitable capacities to substantially raise its presence and thus capture more value in this all-important market.

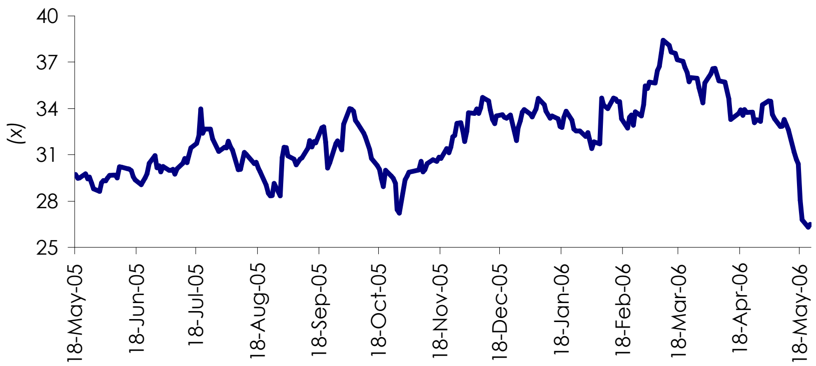
Non-automotive business is showing promise

Non-automotive business in India as well as abroad has immense growth potential, especially in energy. From just 17% of its global revenue, BF hopes to increase this business to 25% of its revenues in the next three years. It has the requisite API approvals to commence supplies to the oil and gas sector. It is now actively scouting for business from oilrig builders. The potential in India's energy sector is very promising, considering power projects of 19,142 MW being implemented. Even other sectors (heavy engineering, steel manufacturing, railways, etc.) require large forgings that BF is in a position to supply.

Valuations

We have kept our net sales estimates unchanged and slightly lowered our PAT estimates -- by 1%. A look at the one-year forward rolling PE (standalone) reveals that BF had repeatedly attempted to break the 34x band in the past year and succeeded when the overall market surged during Q4 FY06. However, the sharp correction in the last fortnight has seen valuations dip to the 26x band. Considering the clear prospects for ample revenue growth and the de-risked business model, we maintain an **OUTPERFORMER** rating on the standalone valuation of 20.2x FY08E EPS of Rs 17.30 and on the consolidated valuation of 16.6x FY08E EPS of Rs 21.10, post-GDR and FCCB-led equity dilution.

One-year forward rolling PE



Source:PL Research

Q4 FY06 Quarterly Overview *(Rs m)*

Y/e March	Q4 FY06	Q4 FY05	*yoy gr. (%)*	Q3 FY06	H2 FY06	H2 FY05	*yoy gr. (%)*	FY05	FY06	*yoy gr. (%)*
Exports	1,918	1,544	*24.2*	1,589	3,506	3,038	*15.4*	5,105	6,555	*28.4*
Domestic	2,782	2,322	*19.8*	2,724	5,505	4,155	*32.5*	8,000	10,431	*30.4*
Total Sales	**4,699**	**3,866**	***21.5***	**4,312**	**9,011**	**7,193**	***25.3***	**13,105**	**16,986**	***29.6***
Net Sales	**4,384**	**3,613**	***21.4***	**3,994**	**8,378**	**6,721**	***24.7***	**12,191**	**15,800**	***29.6***
Expenditure										
Net Raw Material	2,200	1,653	*33.1*	1,776	3,976	3,009	*32.2*	5,242	7,303	*39.3*
as % of Net Sales	*50.2*	*45.8*		*44.5*	*47.5*	*44.8*		*43.0*	*46.2*	
Personnel Cost	209	177	*18.3*	251	460	362	*27.0*	693	917	*32.4*
as % of Net Sales	*4.8*	*4.9*		*6.3*	*5.5*	*5.4*		*5.7*	*5.8*	
Mfgr. Expenses	675	538	*25.5*	658	1,333	1,021	*30.6*	1,927	2,535	*31.6*
as % of Net Sales	*15.4*	*14.9*		*16.5*	*15.9*	*15.2*		*15.8*	*16.0*	
Other Expenses	247	353	*(30.0)*	323	570	563	*1.3*	1,062	1,128	*6.2*
as % of Net Sales	*5.6*	*9.8*		*8.1*	*6.8*	*8.4*		*8.7*	*7.1*	
Total Expenditure	3,331	2,721	*22.4*	3,008	6,339	4,954	*28.0*	8,923	11,883	*33.2*
EBITDA	**1,053**	**892**	***18.1***	**986**	**2,039**	**1,767**	***15.4***	**3,268**	**3,917**	***19.9***
EBITDA Marg. (%)	*24.0*	*24.7*		*24.7*	*24.3*	*26.3*		*26.8*	*24.8*	
Depreciation	214	135	*58.7*	191	406	271	*49.9*	525.6	730	*39.0*
EBIT	**839**	**757**	***10.8***	**795**	**1,634**	**1,497**	***9.2***	**2,742**	**3,186**	***16.2***
Net Interest	155	84	*83.2*	153	308	174	*77.1*	336	548	*63.3*
Non-Operating Inc.	144	21	*579.4*	161	305	25	*1115.0*	74	531	*617.9*
PBT	**828**	**693**	***19.4***	**802**	**1,631**	**1,348**	***21.0***	**2,481**	**3,170**	***27.8***
Tax	298	210	*42.1*	270	568	450	*26.2*	865	1,079	
Tax Rate (%)	*36*	*30*		*34*	*35*	*33*		*34.8*	*34.1*	
Profit After Tax	**530**	**484**	***9.6***	**533**	**1,063**	**898**	***18.4***	**1,616**	**2,090**	***29.3***