investor's eye

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Bajaj Auto	15-Nov-05	1,873	**2,600**	3,500
BHEL	11-Nov-05	1,203	**1,837**	2,650
Infosys	30-Dec-03	1,378	**2,728**	3,324
Ranbaxy	23-Dec-03	534	**362**	600
TV18	23-May-05	280	**402**	704

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Bharat Bijlee

Apple Green

Stock Update

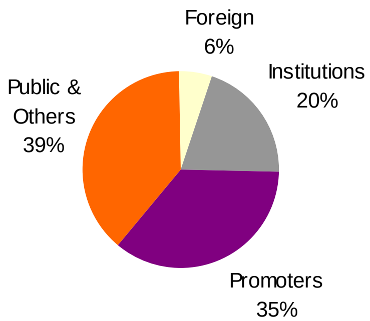
Inside the annual report

Buy; CMP: Rs826

Company details

Price target:	Rs1,900
Market cap:	Rs467 cr
52 week high/low:	Rs1,709/425
BSE volume: (No of shares)	25,723
BSE code:	503960
Sharekhan code:	BHARATBIJ
Free float: (No of shares)	37 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-50.8	-31.5	12.7	54.3
Relative to Sensex	-32.5	-17.5	16.0	16.6

We recently spoke to the management of Bharat Bijlee (BBL) and have also gone through their recently released annual report. The highlights of the same are presented below. BBL is basically a manufacturer of industrial motors and transformers.

Transformer business growing by leaps and bounds

During FY2006 the net revenues of BBL grew by a very impressive 24% to Rs300 crore. This was on the back of a strong pick-up in the sales of transformers, which grew at a staggering 73% to Rs162.3 crore. The sales of industrial motors grew by 16% to Rs100 crore.

Rs (crore)	2001	2002	2003	2004	2005	2006	% CAGR
Transformer	46	35	46	76	94	162	36
% y-o-y chg		*-22*	*29*	*65*	*24*	*73*	
Motors	49	39	39	52	87	101	21
% y-o-y chg		*-21*	*2*	*33*	*65*	*16*	

Operating profit grows by a staggering 121%

Driven by an impressive 24% growth in the revenues, which brought operating leverage into play, BBL's operating profit for FY2006 has registered a growth of 121% and the same stood at Rs51.3 crore. The operating profit margins (OPMs) for the year registered a strong 750-basis-point improvement and stood at 17.1%. The improvement in the OPMs came on the back of a 480-basis-point improvement in the raw material cost, which as a percentage of sales stood at 60%. The commendable thing is that BBL has exercised strict control on its overheads. For example even after a 12% increase in its employee cost, its total fixed cost has remained absolutely stagnant at Rs44 crore. However going forward the margin expansion is likely to be muted on account of two factors. Firstly as the company has commissioned its new plant, the overheads on the same will be built-in and the new plant will achieve higher capacity utilisation gradually. Secondly the long-term wage agreement with the union expired on December 31, 2005 and the negotiations for the new long-term wage agreement are on. We expect that there will be 10-12% increase in the employee cost and hence expect the margin expansion to be muted going forward.

BBL net earnings up by 74%

During the last year BBL had sold the services part of its lift division and consequently realised Rs36 crore. Out of the total sum, Rs15.5 crore has been invested in NHB capital gains bonds to save on the tax on the profit realised from the sale of the lift division. The balance was utilised to pay off Rs16.2 crore worth of long-term loans and to fund its own working capital requirement. Even then BBL's interest charge has gone up by 23% year on year (yoy) to Rs4.68 crore. This signifies the company's increased need for working capital. Basically BBL's debtor days (debtors expressed as days of sales) have gone up substantially whereas the creditor days have fallen as the company paid cash to its vendors to avail of cash discounts. The stable depreciation has buoyed BBL's pre-exceptional net profit by 74%. We have treated the gains from the sale of the lift division as one-time profit and hence the reported profit has grown by 29% to Rs35.7 crore.

Stable operational and financial matrices

BBL's key operational matrices have remained stable with the company's strict control on its inventory. For example its inventory has remained stable at 52 days of sales. However the debtors have gone up on account of the higher proportion of state electricity board (SEB) orders. BBL's return ratios have improved substantially with values of 44.4% for the return on capital employed (RoCE) in FY2006 as against 36.6% in FY2005. Similarly its ROE has improved from 35.4% to 41.7% in the same period.

Key ratios

	FY01	FY02	FY03	FY04	FY05	FY06
RoCE (%)	12.0	-0.6	16.6	20.5	36.6	44.4
Roe(%)	2.1	-18.9	8.9	4.8	35.4	41.7
Debt-equity (x)	1.08	1.09	0.88	0.79	0.67	0.55
Interest coverage	0.31	-0.12	1.12	1.52	4.11	11.15
Inventory days	83.13	92.27	95.35	77.24	52.93	52.21
Debtor days	150.7	144.8	125.6	121.5	102.4	118.6
Creditor days	163.5	181.0	196.4	168.6	105.5	81.1

Entry into high-end 100MVA+ transformers gaining ground

During FY2006 the management made an entry into the 100MVA+ transformer market and has already procured orders for 9 units. This is commendable as this segment is basically a strong forte of players like Crompton Greaves and BHEL. Going forward the management expects to secure further such orders, which will help the company to optimally utilise the enhanced capacity. As the 100MVA transformers are a high margin segment, the management expects its margins to improve on the back of higher contribution from this segment.

BBL on capital expenditure (capex) binge

Looking at the strong performance of its transformer business and the expectation of the same to continue (the government is planning to add 64,000MVA power generation capacities), the company has increased the capacity of its transformer division from 3,800MVA as at March 31, 2005 to 8,000MVA as at March 31, 2006. During FY2006 some capex was also incurred on the motors plant and with some re-engineering like plant layout, the rated capacity has jumped from 380,000 horsepower (HP) to 702,000HP. However there is no significant jump in the production of motors. The management expects a slowdown in the growth of the motors business, which we have already factored in our estimates.

Order backlog grows by 48% yoy

Driven by a ramp-up in the generation capacity and the improved financial health of SEBs, BBL's order book has grown by a very impressive 48% yoy. The management has informed us that there are some orders in the pipeline, which are expected to be awarded in next 6-8 weeks and hence the management expects that the order backlog will jump substantially.

Particulars	FY02	FY03	FY04	FY05	FY06
O/B at the beginning of year	86	84	114	99	110
% y-o-y change	*-2*	*36*	*-13*	*11*	
Order inflow during the year	139	193	205	286	395
% y-o-y change	*39*	*6*	*39*	*38*	
Revenue booked during the year	141	163	220	275	342
% y-o-y change	*16*	*35*	*25*	*24*	
Order backlog at the end of the year	84	114	99	110	163
% y-o-y change	36	-13	11	48	

Outlook

Overall FY2006 was a phenomenal year for BBL with an overall improvement in its financial and operational performances. But the moot question remains—what does the future hold in store for BBL? On a broader basis the scenario seems perfectly fine. Here is the reason.

During the 11th Five Year Plan 64,000MW of power capacity addition is likely to take place. This in turn will require a mammoth 448,000MVA incremental transformer capacity, which entails an average of approximately 90,000MVA per year. Currently with 80% capacity utilisation levels, the total production stands at 62,000MVA. Hence we see that looking at the current transformer capacity shortfall, there will be an increase in the pace of order flows for the transformer industry. We believe such a huge potential will essentially maintain the growth momentum in the order books of all transformer manufacturers and Bharat Bijlee (BBL) being a leading transformer manufacture, will be a direct beneficiary.

Recent correction in stock price has brought valuations to extremely attractively levels

During the recent market mayhem the entire basket of power equipment stocks was hammered. Bharat Bijlee had more than its fair share of pain and consequently the stock price has corrected significantly. However we believe that such a sharp deterioration in valuation multiples is just a temporary phase and we expect that the multiples for the sector itself will jump up again as the growth prospects for the sector are still the same. Hence at the current levels the stock presents an attractive opportunity to capitalise on the gains that are likely to accrue.

	Price		Change
	10-05-2006	15-06-2006	%
BSE SENSEX	12612	9545	-24
A B B	3236	2069	-36
Siemens	1180	840	-29
B H E L	2392	1837	-23
Crompton Greaves	1181	790	-33
Thermax	345	228	-34
EMCO	715	406	-43
Bharat Bijlee	1516	826	-46

At the current market price of Rs826 the stock is trading at 10.3x its FY2007 earnings and 8.4x its FY2008 earnings. Even on a comparative basis BBL's valuations are reasonable. Further BBL has cash and cash equivalents of Rs260 per share, which provides a decent margin of safety. (However with the constant change in the stock prices this margin of safety keeps fluctuating). We believe with the positive outlook for the power sector, a strong earnings growth of 31% compounded annual growth rate (CAGR) and an improvement in return ratios, the stock is trading at attractive valuations. We maintain our Buy recommendation on the stock with a price target of Rs1,900.

Peer comparision

Company	FY2007		FY2008	
	PER	EV/EBIDTA	PER	EV/EBIDTA
Bharat Bijlee	10.3	5.0	8.4	3.8
EMCO	9.3	5.7	6.5	4.5
Crompton Greaves	14.5	12.0	12.5	10.0
BHEL	18.5	11.7	14.6	8.7

(Source: Sharekhan Research)

Earnings table

Year ended Mar 31	FY04	FY05	FY06E	FY07E	FY08E
Net profit (Rs cr)	1.4	18.5	32.2	45.2	55.3
% y-o-y growth	*-36.0*	*1184.0*	*74.0*	*40.0*	*22.0*
Reported net profit	1.5	27.7	35.7	45.2	55.3
Shares in issue (Cr)	0.57	0.57	0.57	0.57	0.57
EPS (Rs)	2.6	32.8	57.0	80.1	97.8
% y-o-y growth	*-36.0*	*1184.0*	*74.0*	*40.0*	*22.0*
Reported EPS	2.6	49.0	63.2	80.1	97.8
PER (x)	323.3	25.2	14.5	10.3	8.4
Book value (Rs)	53.7	92.6	136.8	206.9	294.7
P/BV (Rs)	15.4	8.9	6.0	4.0	2.8
EV/EBIDTA (x)	38.6	15.3	7.0	5.1	3.8
Dividend yield (%)	0.5	1.1	1.6	1.2	1.2
RoCE (%)	20.5	36.6	44.4	42.5	37.8
RoNW (%)	4.8	35.4	41.7	38.7	33.2

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

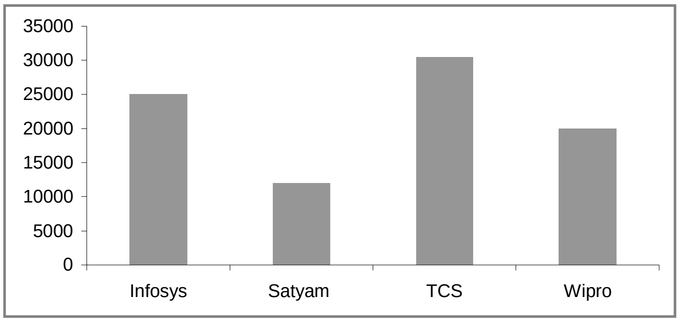
Information technology

Sector Update

Growing appetite for acquisitions

Given the robust demand scenario, there has been a considerable improvement in the growth outlook for the Indian information technology (IT) service companies. This is clearly reflected in the impressive growth guidance given by leading offshore vendors like Infosys Technologies (30%) and Cognizant (47%), and the aggressive recruitment targets set by the front-line domestic IT service companies during the current fiscal.

Stiff recruitment targets



But despite the expectations of a robust organic growth over the next couple of years, there has been a heightened focus on inorganic initiatives by the Indian IT service companies. Among the front-line companies Wipro and Tata Consultancy Services (TCS) have been more active than their peers. But the strategy to aggressively scout for acquisition is not limited to the front-line IT companies. Some of the mid-sized companies like KPIT Cummins, 3i Infotech and Subex Systems have also identified inorganic initiatives as an important part of their overall growth strategy and announced a slew of acquisitions in the past few quarters.

Need for acquisitions

The inorganic route has gained significance as it is increasingly viewed as an effective and quicker way to enhance the range of service offerings, deepen domain skills and penetrate newer geographies. Apart from this, it is seen as way to productively utilise the cash that is getting piled up on the books of most IT service companies (especially the front-line companies that have cumulative cash and cash equivalents of around Rs17,500 crore on the books as on end of March 2006).

Benefits of acquisitions

In addition to some of the obvious benefits of acquisitions mentioned above, we believe that the acquisitions have become strategically important for the Indian IT service companies for the following reasons.

Gearing up for the large deals: Acquisitions are important in terms of gearing up for the huge opportunity emerging from the estimated renewal of over $100 billion worth of large outsourcing contracts over the next couple of years. The tech companies are scrambling to enhance their range of offerings and acquire offsite (near shore) development centres as it would enable them to bid for a greater share of business in the large outsourcing deals.

Reducing geographical risk: The ramping-up of the employee base in offsite centres (in Latin America, east Europe and parts of the Asia-Pacific region) reduces the geographical risk associated with the company's ability to generate business and also mitigates the concern related to the delivery of services. For instance, the outbreak of

On an acquisition spree (done over past four quarters)

Company	Acquisition (nos)	Employees acquired	Acquisition cost ($ mn)	Annual revenue ($ mn)	Acquisition cost/revenue
Wipro	6	1540	197	114	1.7
TCS*	3	5047	303	272	1.1
Satyam	1	75	5	4	1.5
3i Infotech	4	480	17	15	1.1
Subex Systems	2	217	143	31	4.6
KPIT Cummins	3	230	13	14	0.9

* Includes amalgamation of Tata Infotech but does not include the Pearl deal

SARS had resulted in the cancellation of client visits a couple of years back and the domestic companies had lost out on potential business.

In addition to this, the offsite or near shore development centres will play a critical role in terms of achieving sustained growth over the long term. Especially so given the growing shortage of quality manpower in India. The demand for manpower is expected to considerably outstrip the supply by 2009-10. According to our estimates, the five front-line companies and the leading global companies that have aggressive employee ramp-up plans in India would need a net addition of 1.2-1.5 lakh employees (in software service alone) annually by 2010, around 20% higher than the estimated supply of quality manpower. Thus, the ability to ramp up the employee base in offsite centres would significantly influence the growth sustainability over the longer term.

Mega moves

Barring a few exceptions (like Polaris-Orbitech deal or to an extent Wipro's acquisition of Spectramind), the companies have not faced any serious integration issues due to the relatively small size of the acquired companies (usually less than 20% of the company making the acquisition). However, the media is abuzz with stories of possible mega acquisitions by front-line companies like Infosys (reports of a $200-million acquisition) and TCS (a $800-$1,000-million deal reported today).

Though the markets are likely to react positively (in the short term) to any announcement related to a big-ticket acquisition, the ability of the acquiring company to quickly and effectively integrate the acquired company with itself would be critical over a longer term. Apart from the integration pangs, most acquired companies tend to have relatively lower margins due to the onsite-centric model followed by them. What's more, it would be difficult to quickly shift work offshore (local opposition and regulations, eg in the UK it is not allowed to retrench employees of an acquired company).

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Telecom

Sector Update

Bharti stays ahead

According to recent media reports, the Hong Kong-based Hutchison Whampoa group is close to acquiring the 5.1% stake held by Hindujas in its Indian mobile telephony arm Hutchison Essar, for a consideration of $580-590 million (around Rs2,650-2,700 crore). The acquisition would take Hutchison Whampoa's total holding to around 40% with the other partner the Essar group holding a 33.6% stake in Hutchison Essar.

With a base of 16 million GSM-based mobile subscribers, Hutch Essar is valued at $11.5 billion, which works out to an enterprise value (EV) of $718 per subscriber.

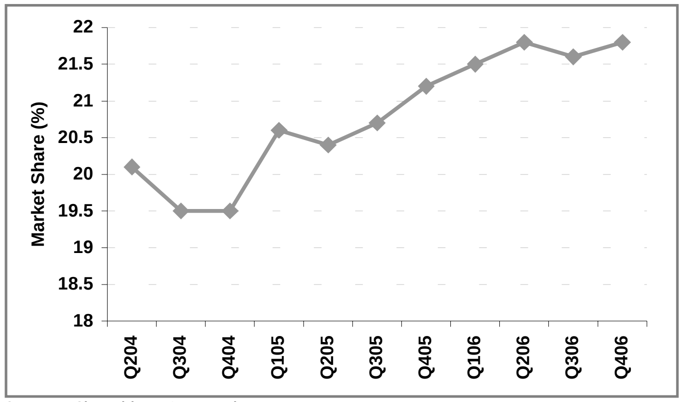
Bharti commands a premium over its peers

Though the suggested acquisition cost of $718 per subscriber is at a premium to the prevailing valuations of both Bharti Airtel and Reliance Communication Venture (RCVL), it is at a discount of 21% to EV/subscriber of around $910 paid by Vodafone for the acquisition of around a 10.05% stake in Bharti in November 2005. The premium commanded by Bharti seems to be justified given its leadership position driven by the company's ability to continuously improve its market share, pan India presence and investments in long distance (national and international) telephony network and operations.

Relative valuation

Particulars	Hutch	Bharti	RCVL
Enterprise value (EV in $ bln)	11.5	15.5	11.8
Subscriber base (wireless + wireline) (in mln)	16.0	23.2	21.8
EV/Sub ($)	718.0	669.0	542.0

Bharti's market share



Source: Sharekhan Research

In terms of its comparison with RCVL, Bharti trades at almost a 24% premium to its closest rival due to the better operational parameters (in terms of margins, average revenue per unit, revenue per minute of usage etc). Moreover, the media reports related to a possible launch of GSM-based mobile services (if not a complete shift from CDMA-based technology used by RCVL to provide wireless telephony services currently) is acting as a drag on its valuations as it would require huge capital expenditure.

Comparative matrix

Particulars	Bharti	RCVL
Gross ARPU (Rs/sub/month)	442	375
Minutes of usage per month	431	532
Revenue per minute	1.0	0.7
Value-added services		
SMS revenue (% mobile revenues)	6.8	1.7
Non voice revenue (% mobile revenues)	10.7	6.1

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Asahi India Glass

Analyst Meet

Improving product mix

CMP: Rs77

Promoted by Asahi Glass Co, Japan and the Labroo family, Asahi India Glass (AIS) is India's largest integrated glass company. It manufactures a wide range of international quality safety glass, float glass, architectural processed glass and other glass products.

The company has three operating business units as mentioned below.

a) AIS (Automotive) is India's largest manufacturer of world-class automotive safety glass and is, in fact, one of the largest glassmaker in Asia. It meets over 85% of automotive glass requirement of the Indian passenger car industry.

b) AIS (Float glass) is a leading manufacturer of international quality float glass and is the third largest float glass manufacturer in the country. AIS has a capacity to make glass for 2.5 million car sets, with a market share of about 85% in the passenger car industry and of 50% in the after-market segment. Its original equipment manufacturer customers include most of the automobile majors in the country including Maruti Udyog, Hyundai Motor India, Tata Motors, Mahindra and Mahindra, Honda Motor Company, General Motors, Eicher Motors, Piaggio and Swaraj Mazda.

c) AIS Glass Solutions has been trying to move up the value chain by transforming itself from just a glass supplier to a glass solution provider. Set up as a subsidiary of AIS in 2004-05, this company has emerged as the largest processor of glass in the country with brands in the high-quality architectural processed glass segment, such as *AIS Stronglas*, *AIS Securityglas* and *AIS Acousticglas*, and insulated glass units.

FY2006 performance lacked gleam

AIS delivered a lacklustre performance in FY2006 with the consolidated top line remaining flat year on year at Rs587.7 crore. This was largely due to the three-month shutdown of its Taloja unit on account of flooding following heavy rains in Mumbai in July 2005. The shutdown led to a revenue loss of Rs26.7 crore for the year and the company had to incur additional operating expenses of Rs10 crore due to the floods. The operating profit for the year stood at Rs113.2 crore, marking a decline of 2%, with the margins declining considerably to 19.3% from 21.9% last year. The profit after tax (PAT) for the year grew by 10% to Rs103.8 crore due to the impact of a change in the depreciation policy of the company. Prior to the extraordinary items, on a like-to-like basis, the profit before tax (PBT) declined by 30%.

Looking at the performance of each unit separately, the automotive division, which accounts for 63% of the company's sales, marked a volume growth of 12% in FY2006. The growth was led by a 55% jump in the aftermarket sales and a pick-up in exports. During the year AIS commenced operations at its Chennai plant of tempered backlights and laminated windshields. The exports have commenced from the Chennai plant and the outlook for the export business is bright with the company having secured an order of Rs30 crore to supply automotive glass to Europe.

The sales of the float glass division, which contributes 37% of the company's sales, were down by 18%, impaired by the three-month closure of the unit due to floods last year. In volume terms, the sales of float glass declined to 304 metric tonne (MT) per day from 376MT per day in FY2006.

The glass solution subsidiary, in its first year of operation, delivered an impressive performance by recording sales of Rs14 crore. The division launched innovative value-added brands like *AIS Securityglas* and *AIS Acousticglas* during the year.

The way forward

AIS is in the process of setting up an integrated glass plant at Roorkee at a cost of Rs650 crore and the same is expected to become operational by December 2006. This plant would have a 700-tonne-per-day (tpd) float glass capacity (the existing float glass capacity of the Taloja unit is 500tpd); and facilities to manufacture automotive safety glass, architectural processed glass, glass products and valued-added glass like reflective and mirror. The expansion has been financed mainly through debt and internal accruals. The company's debt-equity ratio as on March 2006 stood at 3:1.

The total float glass manufacturing capacity more than doubled in the country with the recent commencement of Saint Gobain's new plant at Sriperumbudur near Chennai. Thus an overhang of 30% of the total float glass produced in the country is expected for the next two years till the demand catches up.

AIS plans to increase the share of value-added products in its portfolio. It is also looking to maximise its efforts to increase the internal consumption of float glass in order to increase the contribution of its value-added products to the total revenue. The company expects its glass solution business to contribute 20% of the total revenues by FY2010.

Outlook

For the current year AIS is targeting a consolidated sales growth of 25%. The operating profit margins are expected to be under pressure due to lower float glass prices and rising input costs. After the commencement of the Roorkee plant AIS expects its revenues to double in the coming two years.

With a capacity overhang, the company is exploring export opportunities. However these have to be congruent with the interests of its parent company, Asahi, Japan. With its high quality standards and strong operating efficiencies, AIS is of the belief that it can be a strong contender for exports in the years to come.

Valuations and view

Though the margins would be under pressure as a result of capacity overhang and rise in input prices, we expect that the improved product mix and higher exports growth shall mitigate the pricing pressures. Also, the company's strategy to move towards the more value added products seems to be right and should result in greater benefits over the long term. At the current market price of Rs77, the stock is quoting at 12.5x its FY2006 earnings.

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

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

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

Cipla
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Emerging Star

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Ugly Duckling

Ashok Leyland
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Genus Overseas Electronics
HCL Technologies
ICI India
Jaiprakash Associates
JM Financial
KEI Industries
Nelco
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
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