![ASK Securities]

26 June 2007

AIA Engineering

Rs1,598; Buy

Initiating Coverage

Sector: Capital Goods

Target Price	**Rs1,940**
Market cap	Rs30.0 bn/US$735.1 mn
52-week range	Rs1,690/501
Shares in issue (mn)	18.8
6-mon avg daily vol (no of shares)	50,345
6-mon avg daily vol (mn)	Rs80.5/US$2.0
Bloomberg	AIAE IN
Reuters	AIAE.BO
BSE Sensex	14,488
Website	www.aiaengineering.com

Shareholding Pattern (%)

Promoters	69.6
FIIs	5.9
MFs/FIs/Banks	18.1
Publc	3.9
Others	2.5

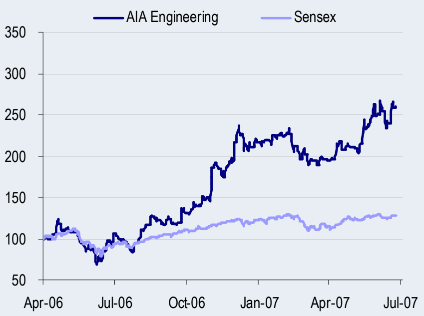
(As of 31 March 2007)

Price Performance (%)

	1M	3M	12M
Absolute	4.4	32.8	166.6
Relative*	3.4	23.8	127.4

** To the BSE Sensex*

Relative Performance



(As of 25 June 2007)

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Get the ball rolling

Investment highlights

- **Conversion to high chrome mill internals to drive demand:** The market for high chrome mill internals is set to multiply over the next few years, given its benefits over conventional forged products. Growth will be led by the mining sector, which accounts for nearly 80% of the global mill internals market. Technical expertise and skills in metallurgy provides AIA Engineering (AIA) a huge opportunity to tap this market.
- **Capacity expansion at an optimum time:** AIA has embarked on an aggressive capacity expansion to meet the growing requirements of cast mill internals. The expansion is coming at an optimum time given that the domestic cement and mining segments too are in a capex mode. AIA's capacity will increase from 115,000 tpa at present to 265,000 tpa in FY09E to meet the incremental requirements.
- **Technical barriers to limit competition:** AIA has inherited the technical expertise in high chrome media from Magotteaux, its erstwhile partner. AIA and Magotteaux together control nearly 90% of the high chrome market globally. Competition is limited due to lack of technical knowledge among competitors. With limited competition globally and manufacturing operations in India, we believe AIA is in a sweet spot.

Investment concerns

- **Rupee appreciation will impact earnings:** Exports account for 50% of AIA's revenues at present and will increase to nearly 70% of revenues by FY09E. In a scenario of sharp appreciation in rupee, revenues as well as profitability will be impacted to an extent.

Valuations

- **DCF gives a fair value of Rs1,940, initiate coverage with Buy:** In our view, aggressive capacity addition will drive the 53% volume CAGR over FY07-09E, which will lead to 43% revenue CAGR and 40% net profit CAGR for AIA over FY07-09E. Our DCF analysis gives us a fair value of Rs1,940, at which the stock will trade at a PE of 19.7x FY09E earnings and an EV/EBITDA of 14.4x. We believe AIA will continue to trade at such premium due to its scalable business model, strong growth visibility, high operating margin and limited competition. We initiate coverage on AIA Engineering with a Buy rating.

Exhibit 1: Financial summary (Consolidated) **(Rs mn)**

Y/E March	FY06	FY07	FY08E	FY09E
Net sales	4,070	5,230	8,033	10,659
EBITDA	815	1,244	1,844	2,430
EBITDA (%)	20.0	23.8	23.0	22.8
Net Profit (Adj)	543	956	1,434	1,860
EPS (Rs)	29.4	50.2	75.6	98.3
EPS Growth (%)	-	70.4	50.7	30.0
ROCE (%)	27.2	14.8	20.2	22.4
ROE (%)	19.8	19.7	23.2	23.7
PE (x)	54.3	31.9	21.1	16.3
Price/Book Value (x)	11.0	6.2	4.9	3.8
EV/EBITDA (x)	37.0	23.8	15.6	11.6

Source: Company data, ASK Securities. Note: Valuations as of 25 June 2007.

Please see important disclaimer at the end of the report.

Investment highlights

We are initiating coverage on AIA Engineering with a Buy rating and target price of Rs1,940, an upside of 21% from the current level. Globally, growth prospects are immense for high chrome mill internals and AIA Engineering is in a sweet spot being an end-to-end solutions provider with little competition and relative cost advantage over peers. Limited competition in the high chrome segment, with only AIA and Magotteaux being the key players, has led to significantly high operating margin for AIA, which in our view will continue going forward. We believe the new capacities will drive a 43% revenue CAGR and 40% profit CAGR over FY07-09E.

A leading player in mill internal industry

Largest supplier of high chrome mill internals in India.

- **Leading supplier of mill internals:** AIA is the largest high chrome mill internal supplier in India. With over two decades of experience and having gained the technical expertise, it has established itself as a complete solutions provider of high chrome cast mill internals to the domestic players. AIA dominates supply of mill internals to domestic cement industry, over 90% share in the grinding media space. It also enjoys strong position in terms of supply to utilities and mining industry. Competition is inadequate due to high entry barriers in the form of technical know-how, strong relations established over the years and limited manufacturing capacity of peers.

High operating margin on account of duopoly and lobour cost advantage.

- **Niche player with high operating margin:** Globally there are just two notable high chrome mill internal players with sizeable capacities viz. Magotteaux and AIA. The industry is predominantly in a duopoly situation, with these two companies controlling majority of supplies. Magotteaux's plants are located at 12 locations viz. USA, Europe, Latin America and Asia, while all of AIA's plants are located in India. Given the labour intensive nature of the business, India centric operations have a direct advantage in terms of labour cost differential of 10-12% compared to developed counterparts. This has led to higher operating margin for AIA's business, leading to higher profitability and greater ability to absorb cost pressures.

Customised solutions provider.

- **One stop solutions provider for mill internals:** AIA is an end-to-end solutions provider for high chrome mill internal requirements (see Exhibit 11 on page 11). Its offering includes a wide set of products required in tube and vertical mills along with process improvement services. The company, being a complete solutions provider, is able to understand and build customised solutions for its clients so as to provide optimal grinding. We believe that its complete range of offering and experience in metallurgy gathered over the years will enable it to develop better solutions for the mining industry, where the size, shape and metallurgy of the grinding media varies significantly depending on the ore contents.

- **Leverage on domestic leadership:** AIA has demonstrated its superiority in the domestic high chrome market, having gained almost 95% share of the cement segment and 20% share in the mining segment. The company is a preferred supplier to many end users. We believe AIA can leverage on its learning in the domestic market in its international foray.

Huge opportunity waiting to be tapped

Meets 95% of domestic cement mill internals demand and 15% of global cement demand.

- **Cement sector - AIA's forte:** AIA derives 80% of its sales from the cement sector. It has a strong relationship with both domestic and global cement manufacturers such as ACC, Grasim, Gujarat Ambuja. Ultratech, Holcim, Lafarge and Cemex. In the domestic market, it enjoys a lion's share of over 90% in the grinding media space, beyond India it has a respectable 15% market share. The annual global consumption of mill internals in the cement industry is 0.28 mn and is expected to grow at 3.3% CAGR over 2006-10E.

- **AIA to grow faster than the industry:** We expect domestic demand for cement sector mill internals to grow by 11% CAGR over 2006-10E on back of capacity expansion plans laid down by the cement manufacturers in India. Globally (outside India), the growth is muted at 2.5% CAGR over 2006-10E. However, AIA's ability to leverage existing relationships (with cement manufacturers and consultants such as FL Smidth) will enable it to grow faster than the industry. We estimate mill internal demand from cement industry to span out as follows:

Exhibit 2: Projected demand from the cement sector (MT)

	FY06	FY07	FY08E	FY09E
Domestic	21,973	24,055	31,781	38,425
% YoY	7.6	9.5	32.1	20.9
Global (excl India)	252,263	259,910	265,159	270,845
% YoY	3.3	3.0	2.0	2.1

Source: Company, ASK Securities.

Mining segment offers demand potential of 7x current capacity of AIA and Magotteaux.

- **Mining to become key growth driver:** The demand for mill internals from the global mining space is very large at 2.4 mn tpa (80% of the total mill internal market). While most of the demand is currently met by forged mill internals, AIA is betting big on shifting it to more efficient high chrome mill internals. The global mining industry has demand potential to the tune of 7x of the current capacity of Magotteaux and AIA, the only notable player in the high chrome cast media industry. Currently, Magotteaux is double the size of AIA at 235,000 tpa. However, AIA has lined up a series of expansion plans to take its capacity to 265,000 tpa by end FY09E.

  The case for AIA in the mining sector stems from the fact that ores are of varied quality depending on the condition and locations of mines. Thus the consumption of grinding media varies from 15 gms/tonne for Alumina mine to as high as 750 gms/tonne for Zinc mines. The cost of grinding media as proportion of total mining cost is as high as 10% versus a meagre 1.5% for cement. AIA with its strong expertise in metallurgy and total solutions offering is in a strong position, compared to downstream steel players supplying forged media, to supply optimum grinding media to generate superior savings for the mines. In the domestic mining space, AIA has around 25% market share. It supplies its products to plants such as Kudremukh Iron ore, Hindustan Zinc and Balco's aluminium mines.

- **Utilities - small yet important in the domestic market:** The opportunity in the utility (power) sector is small compared to that in mining and cement. However, investments chalked down by the Indian government in this sector viz. addition of 100,000 mw by 2012, with over 80% in coal based thermal power plants, would enable the company to generate incremental demand.

Four fold expansion of capacities

Capacity expansion to make in-roads in global mining sector.

- **265,000 MT capacity by FY09E:** While demand for cast mill internals is a given, the sector, and more particularly AIA, is restricted due to low capacities to meet the strong demand. To counter this and make in-roads into the global mining sector as well as increase its share in the cement sector, AIA had chalked out expansion plans to increase its capacity from 65,000 MT in FY06 to 265,000 MT in FY09E (Exhibit 3). Funding for the expansion has been through fresh issue of equity in FY06 and institutional placement in FY07, while additional requirements will be met out of internal accruals.

Exhibit 3: Commissioning of new facilities (MT)

	1Q FY08	3Q FY08E	4Q FY09E
Capacity Addition	50,000	50,000	100,000
Cumulative	115,000	165,000	265,000

Source: Company, ASK Securities.

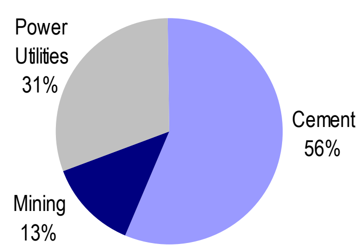
De-risked business model

- **To penetrate global mining industry:** AIA has been effective in de-risking its revenues in terms of user industries and geographies (see Exhibit 4). Cement, mining and utilities companies are its major customers in the domestic market. In the overseas market, it currently supplies only to large cement manufacturers. However, going forward AIA expects to penetrate the global mining industry, encouraging them to convert from the conventional forged mill internals to high chrome.

Exhibit 4: Sales break-up (FY07)

Overall	
Domestic	**50%**
Sectors supplied to:	
	Cement
	Utilities
	Mining
Export	**50%**
Sectors supplied to:	
	Cement

Domestic



Source: Company, ASK Securities.

Further, in terms of manufacturing and distribution network, AIA has its plants located in Ahmedabad and Bangalore in India, which enables it to keep its operating costs low compared to global competitors with plants located in USA and Europe. In order to boost its exports, AIA has set up marketing and distribution subsidiaries in USA, UK and Middle East under the name of Vega Industries (see Exhibit 15 on page 13).

Investment concerns

Higher exposure to forex with increase in exports.

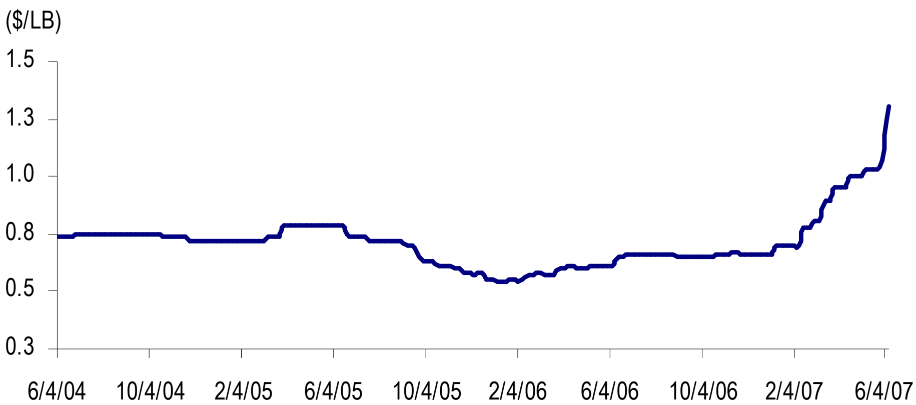
- **Rupee appreciation will impact earnings:** Exports account for 50% of AIA's revenues at present and will increase to nearly 70% of revenues by FY09E. In a scenario of sharp appreciation in rupee, revenues, as well as profitability, will be impacted to an extent.

- **Delay in setting up of new capacities:** AIA has laid aggressive capacity expansion plans over next two years (see Exhibit 3). It plans to take its consolidated capacity to 265,000 tpa by end FY09E. The recent capacity expansion was delayed by 3-4 months. Any delay in commissioning of the fresh capacities could adversely impact our growth estimates and valuations to that extent.

Chrome prices increased by 45% in last one year.

- **Chrome prices riding high:** The company uses chrome to the extent of 5-30% of raw material in its mill internals. Chromium prices have increased by 40-45% during the last one year (see Exhibit 5). This steep increase in input prices may put AIA's operating margin under pressure. Further, if the company passes on the hike in material costs, it will reduce the savings generated by high chrome as compared to conventional forged media.

Exhibit 5: Chrome price up 45% YoY



Source: Bloomberg.

- **Price cut could put pressure on margins:** In order to grab the larger share of demand at a faster rate, AIA and Magotteaux could enter into a pricing war initially, which may put pressure on margins.

Valuations

Premium valuations justified due to strong growth visibility, scalable business model and high operating margin.

- **DCF method gives us a price target of Rs1,940:** Our DCF analysis gives us a fair value of Rs1,940, based on terminal value exit multiple of 11.7x. At our DCF value, the stock will trade at a PE of 19.7x FY09E earnings and an EV/EBITDA of 14.x. We believe that the company will trade at such a premium due to its scalable business model, strong growth visibility, high operating margin and superiority amongst competitors. We have been relatively conservative in our assumption of 4% terminal growth. We initiate coverage on AIA Engineering with a Buy rating. The stock is currently trading at a PE of 16.7x and an EV/EBITDA of 11x FY09E numbers.

Exhibit 6: DCF value (Rs mn)

NPV of cash flows	11,560	31.4%
Terminal value	25,207	68.6%
Enterprise value	36,767	100.0%
Net debt/ (cash)	301	
Equity value	36,467	
Number of shares (mn)	19	
Equity value/share (Rs)	**1,940**	

Source: Company, ASK Securities.

Exhibit 7: DCF valuation key paramenters (Rs mn)

Beta	0.8
Risk Free rate	7.5
Risk Premium	7.5
WACC (%)	12.9
Terminal growth rate (%)	4.0

Source: Bloomberg, ASK Securities.

Exhibit 8: DCF sensitivity analysis

		Terminal growth rate (%)				
		2.0	**3.0**	**4.0**	**5.0**	**6.0**
WACC (%)	10.9	2,171	2,388	2,667	3,041	3,569
	11.9	1,891	2,050	2,250	2,508	2,853
	12.9	1,672	1,793	**1,940**	2,124	2,362
	13.9	1,499	1,591	1,702	1,838	2,009
	14.9	1,360	1,432	1,517	1,620	1,745

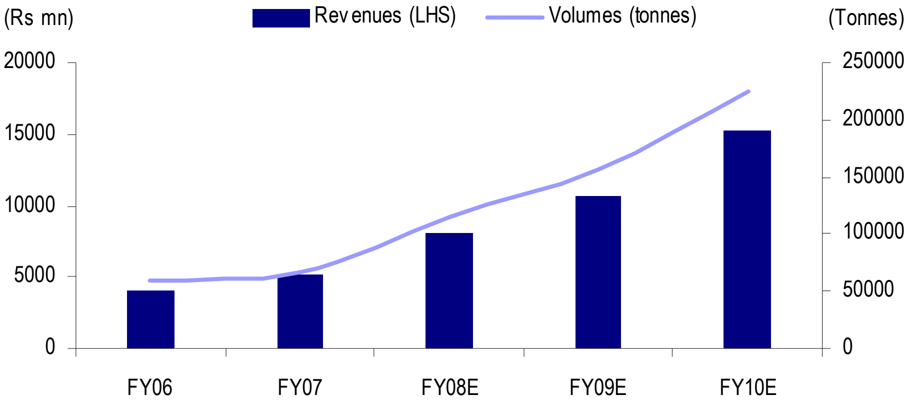
Source: Company, ASK Securities.

Financial analysis

Sales volumes to increase from 66,600 tonnes in FY07E to 156,750 tonnes in FY09E.

- **Revenue CAGR of 43% over FY07-09E:** In our view, aggressive capacity addition will drive the 53% volume CAGR over FY07-09E, which will drive the 43% revenue CAGR for AIA over FY07-09E. We expect sales volumes to increase from 66,600 tonnes in FY07E to 156,750 tonnes in FY09E, driven primarily by exports. We have forecasted a CAGR of 80% for export sales over FY07-09E, while domestic sales during the same period is expected to record a modest 20% CAGR. Due to this, share of the exports business is expected to increase to 70% in FY09E from 50% currently.

Exhibit 9: Revenue and volume growth



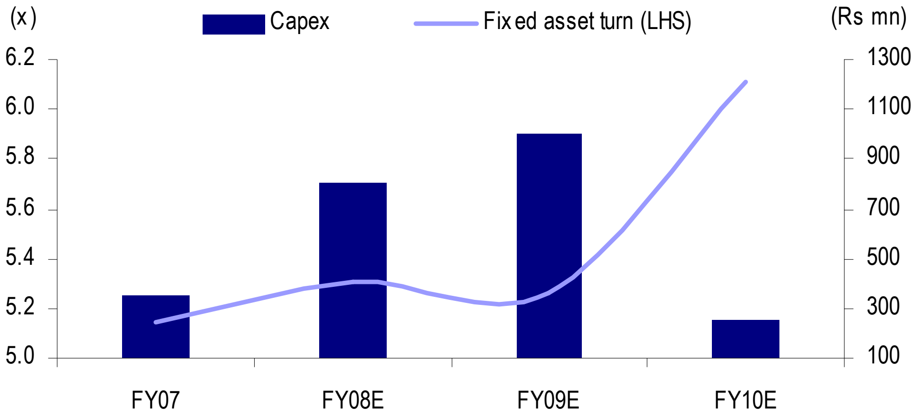
Source: Company, ASK Securities.

Niche business and low competition result in high operating margin.

- **EBITDA margin to remain stable:** In our view, AIA's margins do not have much scope for rising due to its entry into newer markets and segments. We expect the company's operating margin to contract to some extent, going forward, due to steep increase in chromium prices recently. Yet, given the niche area in which AIA operates and the relatively low competition (with just two key players globally), margins will not fall much. We have forecasted for a 100 bps decline over FY07-09E. However, with the new facility in an EOU, we have forecasted for 24% effective tax rate in subsequent years. We expect a 40% CAGR in net profit over FY07-09E to Rs1.86 bn.

- **High asset turn to keep return ratios healthy:** Post the current capacity expansion, AIA will continue to enjoy a high fixed asset turn of nearly 5x as on FY08E (see Exhibit 10). This, coupled with low gearing, will improve capital efficiency and keep the return ratios healthy. As per our estimates, return on capital will improve to 30% in FY09E from the current level of 25%.

Exhibit 10: High fixed asset turn



Source: Company, ASK Securities.

- **Strong free cash generation:** Despite the current aggressive capex program over FY08-10 and increased working capital requirements with the rise in exports, we believe AIA will generate strong free cash from its operations. The business would, however, require capital spending every 3-4 years to maintain the growth momentum.

Financials (Consolidated)

Sales CAGR of 53% over FY07-09E.

Tax rate declining in FY08E as new facility setup in EOU.

Profit & Loss Statement (Rs mn)

Y/E March	FY06	FY07	FY08E	FY09E
Net Sales	**4,070**	**5,230**	**8,033**	**10,659**
Cost of Goods Sold	1,770	2,230	3,354	4,551
Employees Remu.	226	222	359	430
Operating and Other Exps	1,258	1,535	2,476	3,248
Total Expenditure	**3,255**	**3,987**	**6,188**	**8,229**
Operating Profit	**815**	**1,244**	**1,844**	**2,430**
OPM (%)	***20.0***	***23.8***	***23.0***	***22.8***
Depreciation	71	82	110	161
EBIT	744	1,162	1,734	2,269
Interest	53	24	27	22
Other Income	104	164	180	200
PBT	**795**	**1,301**	**1,887**	**2,448**
Provision for Tax	252	346	453	587
Effective tax rate (%)	***32***	***27***	***24***	***24***
Adjusted PAT	**543**	**956**	**1,434**	**1,860**
Less: Minority interest	20	12	12	12
PAT after minority int.	**523**	**943**	**1,422**	**1,848**
EPS adjusted (FV Re 1)	***29.4***	***50.2***	***75.6***	***98.3***

Source: Company, ASK Securities.

Working capital intensive business.

Balance Sheet (Rs mn)

Y/E March	FY06	FY07	FY08E	FY09E
Equity Share Capital	178	188	188	188
Reserves and Surplus	2,562	4,670	5,982	7,655
Net Worth	**2,740**	**4,858**	**6,170**	**7,843**
Minority Interest	70	83	95	107
Secured Loans	404	304	254	204
Unsecured Loans	82	50	50	50
Total Loan Funds	**485**	**354**	**304**	**254**
Deferred Tax Liabilities (net)	20	20	20	20
Source of funds	**3,316**	**5,315**	**6,589**	**8,224**
Gross Fixed Assets	1,007	1,980	2194	3,275
Accumulated Depreciaion	436	518	628	789
Net Fixed Assets	**571**	**1,462**	**1,566**	**2,487**
Investments	**967**	**1,767**	**1,267**	**967**
Current Assets				
Inventories	598	599	873	1,147
Sundry Debtors	1,230	1,361	2,025	2,628
Cash and Bank balances	185	562	1,421	1,816
Loans and Advances	877	628	964	1,279
Current liabilities and provisions				
Current Liabilities	423	616	937	1,309
Provisions	689	448	589	790
Net Current Assets	**1,778**	**2,086**	**3,756**	**4,771**
Application of funds	**3,316**	**5,315**	**6,589**	**8,224**

Source: Company, ASK Securities.

Cash Flow Statement (Rs mn)

Strong free cash generation.

Y/E March	FY06	FY07	FY08E	FY09E
Reported PAT	**523**	**956**	**1,434**	**1,860**
Add: Depreciation	71	82	110	161
Add: Deferred tax Liab	20	0	0	0
Change in WC	(537)	45	(845)	(686)
Cash flow from operations	**77**	**1083**	**699**	**1334**
Change in FA	(343)	(972)	(214)	(1081)
Change in invt	(953)	(800)	500	300
Cash flow from investment	**(1,296)**	**(1,772)**	**286**	**(781)**
Change in bgs	(70)	(132)	(50)	(50)
Dividend paid	(3)	(52)	(75)	(110)
Pref dividend paid	(51)	0	0	0
Issue of equity (incl premium)	1,405	1,250	0	0
Cash flow from financing	**1,281**	**1,066**	**(125)**	**(160)**
Net increase in cash	62	377	860	394
Opening balance	**123**	**185**	**562**	**1,421**
Closing balance	**185**	**562**	**1,421**	**1,816**

Source: Company, ASK Securities.

Key Ratios

Y/E March	FY06	FY07	FY08E	FY09E
Growth (%)				
Revenues	38.6	28.5	53.6	32.7
PBT	95.1	63.6	45.0	29.7
PAT	101.9	75.9	50.1	29.7
Valuation (x)				
PE	53.9	31.7	21.0	16.2
EV/EBITDA	37.0	23.8	15.6	11.6
EV/Sales	7.4	5.7	3.6	2.7
Profitability (%)				
OPM	20.0	23.8	23.0	22.8
NPM	13.3	18.3	17.9	17.5
RONW	19.8	19.7	23.2	23.7
ROCE	25.6	24.9	29.1	30.0
Turnover (days)				
Inventory	104.9	98.0	95.0	92.0
Debtors	97.4	95.0	92.0	90.0
Creditors	54.3	65.0	68.0	70.0
Financial (x)				
Debt equity ratio	0.2	0.1	0.0	0.0
Current Ratio	2.6	3.0	3.5	3.3
Dividend (%)				
Dividend rate	25.7	35.0	50.0	80.0
Dividend Payout	10.0	8.0	7.7	9.5

Source: Company, ASK Securities.

Annexure – Company background

High chrome metallurgy products

- AIA Engineering is a major player in the value added, impact, abrasion and corrosion resistant high chrome metallurgy segment. These components include products like grinding media, liners, diaphragms, vertical mill parts, etc all manufactured in high chrome metallurgy. These products are collectively referred to as mill internals.
- Mill internals find application in the crushing and grinding operations in the mills in the cement, utility and mining industries. AIA's high chrome metallurgy products offer a lower wear rate, compared to conventionally used parts of manganese steel, nihard iron and forged steel. Further, AIA offers complete solutions in grinding to optimise the productivity of grinding mills.

Technical collaboration

- AIA had a technical-cum-financial collaboration with Belgium-based Magotteaux from 1991 to 2001, one of the leading manufacturers of hgh-chrome metallurgy based wear and impact resistant cast components. Presently, the company has a technical collaboration with Southwestern Corporation UK for process improvements relating to vertical mills.

Criticality of products

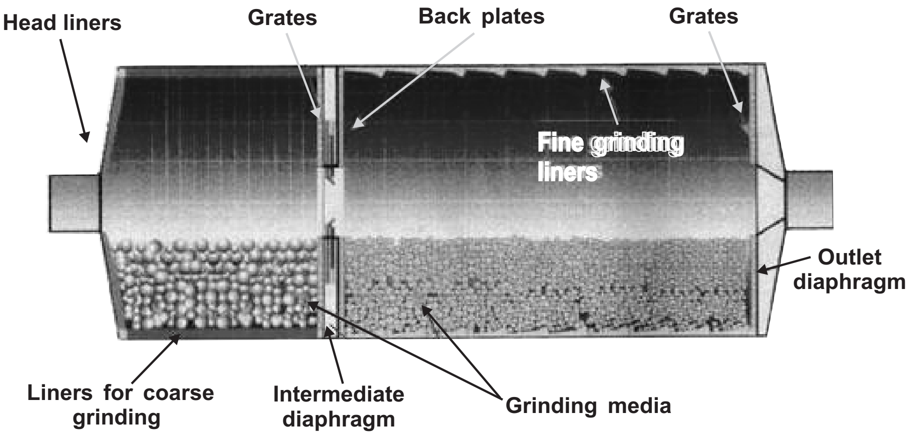
- Mill internals are used in grinding mills to ground clinker in cement manufacturing process (see Exhibit 12), coal in thermal power plants or mineral ore in mines. As the wear of mill internals increase, the grinding operation becomes less efficient and thus leads to greater consumption of time and power per unit of production. Further, in the event of breakage or cracking of mill internals, the grinding process comes to halt leading to stoppage of production. High chrome mill internals offer reduced wear rate, enabling savings in terms of lower time and power consumption per unit of production and reducing chances of any stoppage of production.

Exhibit 11: Products and services (mill audit to optimisation)

Mill audit	Understanding of the mill and mill internal requirements. Studying wear profiles and determination of proposed guarantees.
Designing	Determining the right design after reviews, verification and validations.
Alloy selection	Determining the alloy for mill internals based on wear mechanisms of impact, corrosion and abrasion.
Supervision during installation	Supervising the installation of wear parts supplied.
Optimising the grinding	Regularly conducting mill check-up to fine tune and optimise mill efficiency.

Source: Company, ASK Securities.

Exhibit 12: Tube/horizontal mill



Source: Company, ASK Securities.

Demand variables

- The demand for mill internals depends on the type of mill, user industry and the source (see Exhibit 13).

Exhibit 13: Mill internals demand variables

Type of mill	Tube (horizontal)
	Vertical
Type of user Industry	Cement
	Mining
	Power utilities
Origination of demand	OEM
	Replacement

Source: Company, ASK Securities.

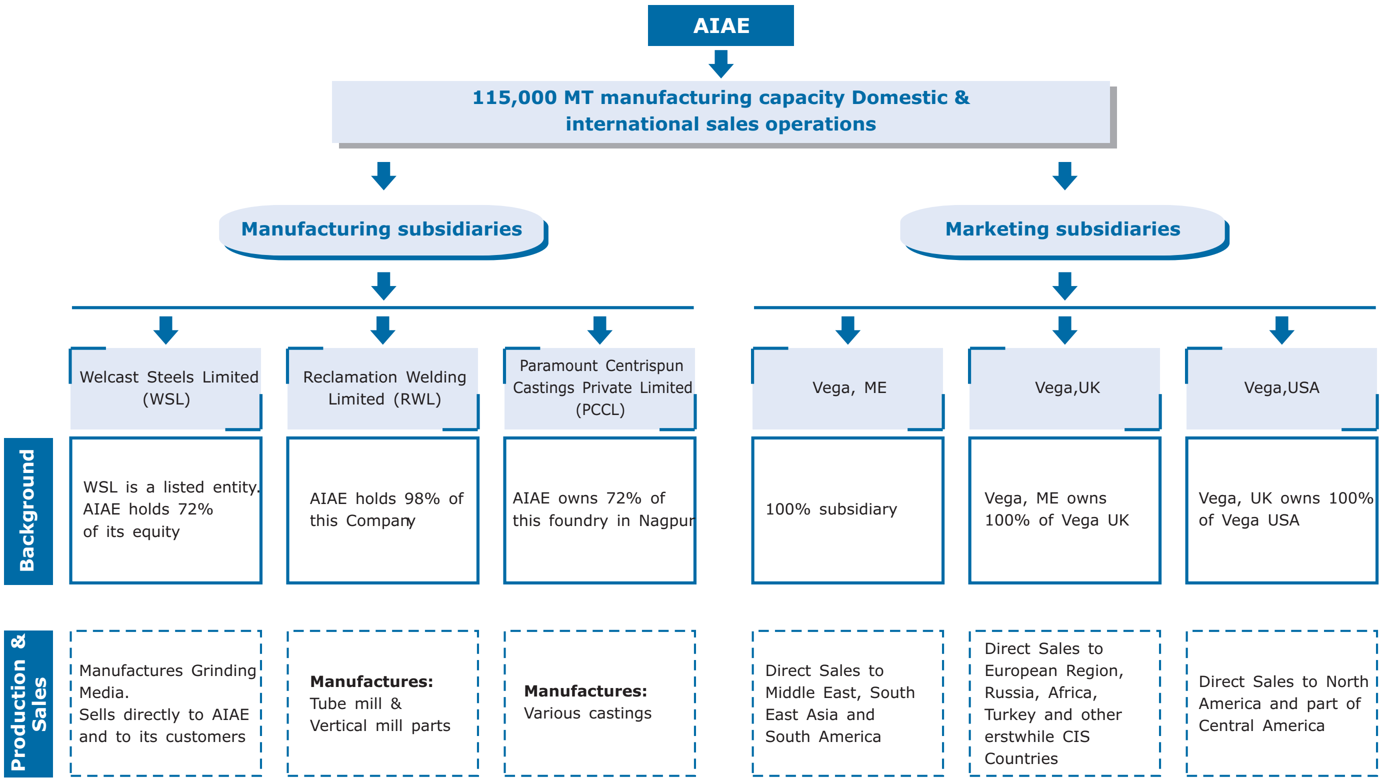
- The rate of usage of mill internals varies depending on the type of material to be crushed and life cycle of the mill internal (see Exhibit 14).

Exhibit 14: Usage of mill internals

Product	Source	Cement	Power Utilities	Mining
Grinding Media	OEM	300 tonne/ MTPA of Fresh capacity	147 tonne/ MW	Depends on the type of mine. For eg: 15 gms/ tonne for Alumina mine to 750 gms/ tonne for zinc mine
	Replacement	100 gms/tonne	15 gms/ MWh of generation	
Other mill internals	OEM	75 tonne/MTPA of Fresh capacity		
	Replacement	23 gms/ tonne		

Source: Company, ASK Securities.

Exhibit 15: Organisation structure



Source: Company, ASK Securities.

Notes

Notes

Rating Structure

Our Rating Structure is based on the following levels of expected Absolute Returns:

Rating	Target Price (if the value exceeds the Current Market Price)
Buy	by more than 15%
Hold	by 8% to 15%
Sell	is below 8%

The above rating structure has to be looked at in conjunction with the following:

- Our ratings structure is primarily meant to reflect our directional view on the stock.
- The target price is purely indicative and may not entirely capture certain non-quantifiable triggers and qualitative aspects of a company, which may influence our rating.
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