

Lower margin visibility drives PO downgrade



Results lag expectations, lower PO

Q4 results were impacted by 190bps decline in margins. As a result, FY06 consolidated profit registered slower than expected growth of 19.7% to Rs688mn (MLE Rs958mn). We are lowering forecast EPS by 12.5% in FY07 and 10.5% in FY08, to account for lower margin visibility. We however retain bullish stance, as we expect Bharat Forge to re-enter high growth phase soon, following supplies from expanded facilities, and integration with recent global acquisitions. Revised PO of Rs 426 reflects downward revision in forecasts and lower exit multiple.

Higher costs, subsidiary operations impact margins

Standalone EBITDA grew 17.2% YoY, slightly lower than expectation as margins contracted 85bps due to start up expenses on product development, and higher fixed costs pending utilization of new capacity. Consolidated margins declined 190bps, reflecting growing contribution from subsidiaries. As a result, standalone net profit grew at a slower than expected 9.6% to Rs 530mn (MLE Rs640mn), and consolidated profit rose just 19.7% to Rs 688mn (MLE Rs 958mn).

Estimates revised down

We have revised down forecast EPS by 12.5% in FY07 and 10.5% in FY08, reflecting lowered margin expectations. We retain revenue assumptions, given our expectations of growth led by supplies from expanded capacities and recent acquisitions. We expect 39.3% EPS CAGR over FY06-08.

Retain Buy, Lower PO to Rs 426

Bharat Forge trades at 22x FY07 and 16.4x FY08 consolidated EPS, which is reasonable considering the company's proven financial track record. At our PO of Rs 426, the stock would trade at 20x FY08 EPS. This is towards the lower end of P/E range to other domestic industrials and outsourcing themes rated by ML, exhibiting comparable growth rates and efficiencies.

Estimates (Mar)

(Rs)	2004A	2005A	2006E	2007E	2008E
Net Income (Adjusted - mn)	1,216	1,986	2,492	3,698	4,982
EPS	6.46	10.04	10.98	15.84	21.29
EPS Change (YoY)	---	55.6%	9.3%	44.3%	34.4%
Dividend / Share	2.00	2.50	3.00	6.00	8.00
Free Cash Flow / Share	5.43	(20.69)	(37.06)	3.54	16.15

Valuation (Mar)

	2004A	2005A	2006E	2007E	2008E
P/E	54.00x	34.71x	31.75x	22.00x	16.37x
Dividend Yield	0.574%	0.717%	0.861%	1.72%	2.30%
EV / EBITDA*	35.50x	20.15x	16.31x	10.81x	8.49x
Free Cash Flow Yield*	1.33%	-5.32%	-10.63%	1.01%	4.63%

* For full definitions of *iQmethod*SM measures, see page 8.

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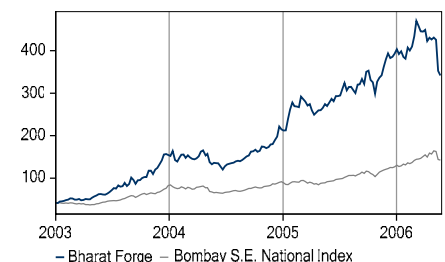
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Stock Data

Price	Rs348.55
Price Objective	Rs426.00
Date Established	30-May-2006
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs266.40-Rs485.00
Mkt Val / Shares Out (mn)	US\$1,676 / 220.6
Average Daily Volume	218,007
ML Symbol / Exchange	XRRGF / BSE
Bloomberg / Reuters	BHFC IN / BFRG.BO
ROE (2006E)	29.0%
Net Dbt to Eqty (Mar-2005A)	105.7%
Est. 5-Yr EPS / DPS Growth	25.0% / 25.0%
Free Float	64.2%



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Refer to important disclosures on page 9 to 10. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

30 May 2006

iQprofileSM Bharat Forge

Key Income Statement Data (Mar)

	2004A	2005A	2006E	2007E	2008E
(Rs Millions)					
Sales	8,321	19,934	30,189	48,384	56,722
Gross Profit	3,227	5,763	7,211	10,895	13,532
Sell General & Admin Expense	(825)	(1,531)	(1,984)	(3,004)	(3,489)
Operating Profit	1,944	3,461	3,946	6,191	8,253
Net Interest & Other Income	(133)	(331)	(21)	(134)	18
Associates	---	---	---	---	---
Pretax Income	1,812	3,130	3,925	6,057	8,272
Tax (expense) / Benefit	(563)	(1,119)	(1,419)	(2,189)	(2,979)
Net Income (Adjusted)	1,216	1,986	2,492	3,698	4,982
Average Fully Diluted Shares Outstanding	188	198	229	236	236

Key Cash Flow Statement Data

Net Income (Reported)	1,249	2,011	2,505	3,707	4,990
Depreciation & Amortization	458	772	1,281	1,700	1,789
Change in Working Capital	544	(1,317)	(3,602)	(2,437)	(715)
Deferred Taxation Charge	---	---	---	---	---
Other Adjustments, Net	68	77	40	46	0
Cash Flow from Operations	2,284	1,504	204	2,994	6,064
Capital Expenditure	(1,261)	(5,597)	(8,381)	(2,214)	(2,500)
(Acquisition) / Disposal of Investments	(344)	344	(1,471)	(2,050)	0
Other Cash Inflow / (Outflow)	---	---	---	---	---
Cash Flow from Investing	(1,605)	(5,253)	(9,853)	(4,264)	(2,500)
Shares Issue / (Repurchase)	0	(81)	5,663	(100)	0
Cost of Dividends Paid	(458)	(640)	(764)	(1,512)	(2,011)
Cash Flow from Financing	(827)	4,114	12,061	3,176	(2,368)
Free Cash Flow	1,023	(4,093)	(8,178)	780	3,564
Net Debt	2,770	5,349	9,840	12,646	11,093
Change in Net Debt	(233)	2,580	4,491	2,806	(1,553)

Key Balance Sheet Data

Property, Plant & Equipment	5,389	9,632	16,096	16,559	17,270
Other Non-Current Assets	---	---	---	---	---
Trade Receivables	1,001	2,451	4,428	7,166	8,296
Cash & Equivalents	86	451	2,863	4,769	5,965
Other Current Assets	2,809	4,385	5,837	6,587	7,487
Total Assets	10,961	19,925	35,771	46,769	51,903
Long-Term Debt	2,856	5,800	12,703	17,415	17,058
Other Non-Current Liabilities	---	---	---	---	---
Short-Term Debt	---	---	---	---	---
Other Current Liabilities	1,488	3,000	4,602	6,032	7,161
Total Liabilities	8,530	14,864	23,663	32,516	34,672
Total Equity	2,431	5,062	12,108	14,252	17,231
Total Equity & Liabilities	10,961	19,925	35,771	46,769	51,903

iQmethodSM - Bus Performance*

Return On Capital Employed	25.1%	25.6%	15.8%	14.9%	17.1%
Return On Equity	60.3%	53.0%	29.0%	28.1%	31.6%
Operating Margin	23.4%	17.4%	13.1%	12.8%	14.6%
EBITDA Margin	28.9%	21.2%	17.3%	16.3%	17.7%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.9x	0.8x	0.1x	0.8x	1.2x
Asset Replacement Ratio	2.8x	7.3x	6.5x	1.3x	1.4x
Tax Rate (Reported)	31.1%	35.8%	36.2%	36.1%	36.0%
Net Debt-to-Equity Ratio	113.9%	105.7%	81.3%	88.7%	64.4%
Interest Cover	6.0x	8.4x	5.8x	8.4x	11.0x

Key Metrics

* For full definitions of iQmethodSM measures, see page 8.

Company Description

Bharat Forge is the largest manufacturer and exporter of forgings and machined components in India. Key products are engine and chassis components both for passenger cars and CVs. The company's operations are spread over India and Germany with major thrust on export markets. Key export destinations are US, Europe and Asia-Pacific. The company has an impressive list of 36 large clients such as Tata Motors, Maruti, Daimler Chrysler, Ford and VW.

Stock Data

Price to Book Value 6.4x

Results lag expectations, lower PO

Q4 results were impacted by 190bps decline in margins. As a result, FY06 consolidated profit registered slower than expected growth of 19.7% to Rs 688mn (MLe at Rs958mn). We are lowering forecast EPS by 12.5% in FY07 and 10.5% in FY08, to account for lower margin visibility. We however retain bullish stance, as we expect Bharat Forge to re-enter high growth phase soon, following supplies from expanded facilities, and integration with recent global acquisitions. Revised PO of Rs 426 reflects downward revision in forecasts and lower exit multiple.

- Standalone sales grew 21.4% YoY to Rs 4.4bn, slightly ahead of our estimates. On a consolidated basis, sales grew 78% to Rs9.67bn, driven by recent acquisitions in US and Europe. JV with FAW group of China (starts April 2006) would further boost sales in FY07;
- Standalone EBITDA at Rs1.05bn grew 17.2% YoY, slower than expected. The impact was primarily due surge in raw material expenses, which included start up expenditure on new product development. Also, fixed costs (included as part of other expenses), remained high on new capacity pending utilization.
- Consolidated EBITDA grew 60% at Rs1.67bn, with margins at 17.2% (down 190bps). The impact was also due to spate of acquisitions, all of which are operating at single digit margins. Going forward, management has guided for 12-14% consolidated margins, following integration of operations by way of cost restructuring and revenue enhancement. We however believe that margins will decline further before stabilizing.
- Other income was sharply up at Rs144mn. However, this was offset by higher interest outgo at Rs155mn (up 70%), driven by growing scale of operations, mainly rising exports, necessitating increased working capital requirements;
- Standalone net profit grew 9.6% to Rs530mn (MLe Rs 640mn), and consolidated profit at Rs688mn represented growth of 19.7% YoY (MLe Rs 958mn).

Table 1: Quarterly Earnings Summary

(Rs mn)	Q4FY06	Q4FY05	YoY	QoQ
Net Sales	4,384	3,613	21.4%	9.8%
Expenses	3,331	2,714	22.7%	10.8%
RM costs	2,875	2,160	33.1%	18.1%
Staff cost	209	177	18.3%	-16.7%
Other expenses	247	378	-34.5%	-23.3%
Operating profit	1,053	899	17.2%	6.7%
Other income	144	21	580.7%	-10.2%
Interest	155	91	69.7%	0.9%
Depreciation	214	135	58.7%	12.1%
Pre-tax profit	828	694	19.4%	3.2%
Current tax	256	275	-7.1%	-3.8%
Deferred tax	42	(66)	-164.5%	NM
After-tax profit	530	484	9.6%	-0.5%
Ratios				
OPM	24.0%	24.9%	-85bps	-68bps
RM/Sales	65.6%	59.8%	579bps	463bps
Staff Cost/Sales	4.8%	4.9%	-12bps	-151bps
Other Expenses/Sales	5.6%	10.4%	-481bps	-244bps
NP/Sales	12.1%	13.4%	-130bps	-125bps
Tax Rate	36.0%	30.3%	573bps	237bps
Consolidated Results				
Net Sales	9,666	5,436	77.8%	1.0%
EBITDA	1,666	1,041	59.9%	8.1%
PAT	688	575	19.7%	9.7%

Source: Company, ML Research

Table 2: Annual Earnings Summary

(Rs mn)	FY06	FY05	YoY
Net Sales	15,779	12,191	29.4%
Expenses	11,883	8,916	33.3%
RM costs	9,838	7,168	37.2%
Staff cost	917	693	32.4%
Other expenses	1,128	1,055	6.9%
Operating profit	3,896	3,275	19.0%
Other income	531	74	617.8%
Interest	548	342	60.1%
Depreciation	730	526	39.0%
Pre-tax profit	3,149	2,481	26.9%
Current tax	924	858	7.7%
Deferred tax	155	6	NM
After-tax profit	2,070	1,616	28.0%
Ratios			
OPM	24.7%	26.9%	-217bps
RM/Sales	62.3%	58.8%	355bps
Staff Cost/Sales	5.8%	5.7%	13bps
Other Expenses/Sales	7.1%	8.7%	-151bps
NP/Sales	13.1%	13.3%	-14bps
Tax Rate	34.3%	34.8%	-57bps
Consolidated Results			
Net Sales	30,189	20,014	50.8%
EBITDA	5,227	4,239	23.3%
PAT	2,505	2,011	24.6%

Source: Company, ML Research

Revision in forecasts

Estimates cut

We are revising down consolidated net profit estimates by 12.5% in FY07 and 10.5% in FY08, on the back of altered margin assumptions, both for standalone and operations of subsidiaries. We are retaining volume and thereby revenue assumptions.

We still expect 39.3% consolidated EPS CAGR

We expect Bharat Forge's earnings to register 39.3% CAGR over the next 2 years, attributed to graded addition to capacity in its standalone operations, and healthier performance from subsidiaries.

Table 3: Subsidiaries wise financials

Rsmn	Revenues				PAT			
	FY05	FY06	FY07E	FY08E	FY05	FY06	FY07E	FY08E
Standalone	12,191	15,779	21,840	25,739	1,616	2,070	2,674	3,492
YoY	47%	29%	38%	18%	29%	28%	29%	31%
Subsidiaries	7,743	14,410	26,544	30,983	395	436	1,033	1,498
YoY		86%	84%	17%		10%	137%	45%
BF-CDP & AT	7,743	10,233	11,052	12,157	395	314	372	507
BF America		1,207	2,655	3,186		31	98	153
BF-Bettilingungs		2,970	9,800	10,780		91	388	510
BF-FAW			3,038	4,860			174	328
Consolidated	19,934	30,189	48,384	56,722	2,011	2,505	3,707	4,990
YoY	140%	51%	60%	17%	61%	25%	48%	35%

Source: Company, ML Research estimates

Retain Buy, albeit with lowered PO

Valuations reasonable

Bharat Forge trades at 22x FY07e and 16.4x FY08e consolidated EPS, a premium to the broader market (P/E of 16.5x and 14.9x respectively). We believe that valuations of Bharat Forge are reasonable on our expectations of 39.3% EPS CAGR, which is much faster than the estimated 17.2% CAGR for the broader market.

Retain Buy Rating

Bharat Forge remains our preferred pick in the fast growing auto parts space, given its proven financial track record and relative scale of operations. The company has consistently demonstrated ability to manage growth, by successfully expanding across various segments and in diverse geographies.

PO is Rs 426

We have lowered PO to Rs 426 (from Rs 523), following downward revision of forecasts. Our revised PO is based 20x FY08 EPS (down from 22x), which is at the lower end of the P/E range similar to other dominant industrials and outsourcing themes rated by ML, and exhibit comparable growth rates and efficiencies.

Table 4: Comparison with dominant industrials and IT companies

	ML Ticker	EPS CAGR	PER			RoE FY06	Target Multiple #
			FY06E	FY07E	FY08E		
BHEL	BHRVF	29.1%	29.4	19.9	17.6	24.3%	25x
L&T	LTOUF	32.6%	33.2	23.8	18.9	26.6%	20x
ACC	ADCLF	12.2%	16.0	14.1	12.5	35.9%	20x
Bharat Forge	XRRGF	39.3%	31.8	22.0	16.4	29.0%	20x
Infosys	INFYF	28.7%	32.8	25.0	19.8	40.4%	25x

Source: ML Research, # on 1-year forward multiple i.e. FY08E, except ACC on FY07E

Price Objective Basis & Risk

Our PO of 426 is based on 20x FY08 EPS, which is at the lower end of the P/E range similar to other dominant industrials and outsourcing themes rated by ML, and exhibit comparable growth rates and efficiencies. We believe that valuations of Bharat Forge are reasonable on our expectations of 39.3% EPS CAGR, which is much faster than the estimated 17.2% CAGR for the broader market.

Risks: 1) rise in input costs; 2) exchange fluctuations ; 3) managing growth

Analyst Certification

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30 May 2006

***iQmethod*SM Measures Definitions**

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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XRRGF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of April 30, 2006.

Investment Rating Distribution: Autos Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	31	40.26%	Buy	8	25.81%
Neutral	31	40.26%	Neutral	8	25.81%
Sell	15	19.48%	Sell	5	33.33%

Investment Rating Distribution: Global Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1145	40.29%	Buy	393	34.32%
Neutral	1474	51.86%	Neutral	430	29.17%
Sell	223	7.85%	Sell	44	19.73%

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