SECTOR: AUTO ANCILLARY

# Enkei Castalloy

| BSE SENSEX | BLOOMBERG |
|---|---|
| 10,666 | EKC IN |
| **S&P CNX** | **REUTERS CODE** |
| 3,178 | ENKI.BO |

25 May 2006

**Buy**

Rs 385

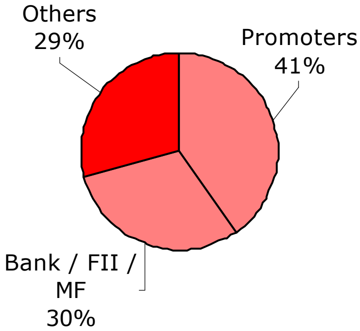
| | |
|---|---|
| Equity Shares (m) | 5.0 |
| 52-Week H/L (Rs) | 410/223 |
| 1,6,12 Rel. Perf. (%) | 36/21/-8 |
| M.Cap. (Rs b) | 1.9 |
| Avg. Daily Vol. ('000) | 4.4 |

| YEAR END | NET SALES (Rs M) | PAT (Rs M) | EPS (RS) | EPS GROWTH (%) | P/E (X) | P/BV (X) | ROE (%) | ROCE (%) | EV/ SALES (X) | EV/ EBITDA (X) |
|---|---|---|---|---|---|---|---|---|---|---|
| 3/05A | 668 | 59 | 11.8 | 167.0 | - | - | 35.9 | 20.9 | - | - |
| 3/06A | 1,227 | 82 | 16.4 | 38.7 | 23.5 | 7.8 | 33.2 | 17.1 | 2.2 | 12.0 |
| 3/07E | 2,250 | 132 | 23.9 | 46.4 | 16.1 | 3.7 | 23.2 | 19.7 | 1.3 | 8.1 |
| 3/08E | 3,500 | 238 | 43.2 | 80.6 | 8.9 | 2.6 | 29.5 | 26.1 | 0.9 | 5.3 |

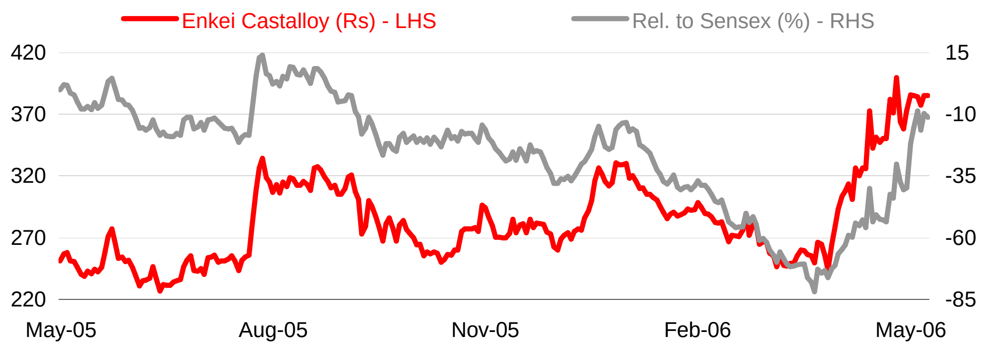

Enkei Castalloy Ltd. (ECL), a 38% subsidiary of Enkei Corporation Japan, is a leading manufacturer of aluminum alloy castings for the auto sector. Recently, it has launched alloy wheels, which have huge domestic and export potential. We expect sales CAGR of 69% through FY08 and EPS CAGR of 63%, even after considering the recent 10% equity dilution. We recommend **Buy.**

- **High market share with auto majors:** ECL has a 50% market share with Bajaj Auto and Hero Honda for cylinder heads. It also meets 100% of Maruti's manifold requirements for certain models. We expect ECL to be a major beneficiary of the estimated 13-15% growth in the auto sector through FY08.
- **Alloy wheels and exports - fresh growth drivers:** ECL commenced alloy wheels sales in FY06 (Rs80m). The product has huge domestic and export potential. Backed by its parent Enkei Corporation Japan, we expect ECL to achieve total exports of Rs500m by FY08E (Rs160m in FY06).
- **Volume growth and value-add to help sustain margins:** Going forward, margins could be under pressure due to volatile prices of raw material (mainly aluminum) and high pricing power of auto OEMs. We expect volume growth and higher value-add (machining and painting of finished components) to cushion margins.
- **EPS CAGR of 63%. Valuation attractive. Buy:** We expect ECL to report a 69% CAGR in sales and 70% CAGR in PAT through FY08. Adjusting for 10% equity dilution, the EPS CAGR works out to a healthy 63%. At CMP of Rs385, the stock trades at 8.9x FY08E earnings. We recommend **Buy** with a 1-year price target of Rs520 (12x FY08E EPS of Rs43.2).

SHAREHOLDING PATTERN




STOCK PERFORMANCE (1 YEAR)





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# Investment Argument

## High market share with auto majors

Enkei Castings Ltd (ECL) offers a comprehensive range of castings, mainly for the auto sector. Its major products are engine parts for two- and four-wheelers, namely, cylinder heads, manifolds and crank cases. It has a high market share with auto majors like Bajaj Auto, Hero Honda and Maruti.

| ECL's Products | Clientele |
|---|---|
| Cylinder Heads | Bajaj Auto and Hero Honda (50% market share), Yamaha and TVS |
| Manifold / Brackets | Maruti (100% for specific models) |
| Crank Case | Tata Motors, Greaves |
| Alloy wheels | Honda (100% for Accord segment) |

We are confident of ECL sustaining its market shares given fairly strong entry barriers to this business -

- skilled labor and hands-on experience in designing of castings;
- alignment with OEMs' JIT (just-in-time) delivery schedules; and
- up-to-date inventory control systems.

## Demand growth to drive castings business

Backed by high GDP growth, we expect 2-wheelers to grow at 15% p.a. and cars at 13% per annum through FY08.

| Customer | Volumes | | CAGR |
|---|---|---|---|
| | FY06 | FY08E | (%) |
| Bajaj Auto | 19,00,000 | 28,00,000 | 21.40 |
| Hero Honda | 30,00,000 | 39,30,000 | 14.46 |
| TVS | 806,000 | 10,20,000 | 12.49 |
| Maruti | 561,000 | 7,20,000 | 13.29 |

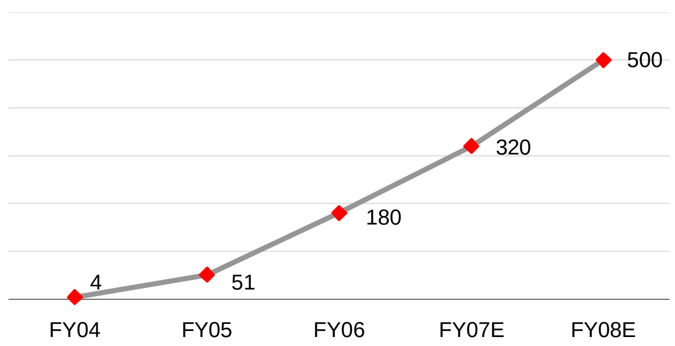
ECL is continuously adding capacity to match demand growth. In FY04, it set up a dedicated plant for intake manifolds to Maruti at its existing facility in Shikrapur, Pune. In FY06, it expanded the same and also added capacity for 2-wheeler cylinder heads. In 4QFY06, it commissioned Phase 1 of its new plant in Gurgaon, Haryana dedicated for North India based two-wheelers. The full benefit of these expansions will start flowing in FY07 onwards.

## Alloy wheels and exports - fresh growth drivers

Enkei Corporation of Japan has a 38% stake in ECL, and is a world leader in alloy wheels. ECL commenced alloy wheel production in March 2005. It supplies 100% of the requirement for Honda Accord. In FY06, the first full year, it clocked impressive sales of Rs80mn.

Further, ECL embarked on exports just three years ago. High precision products coupled with support from Enkei saw exports leap from nil in FY03 to Rs180m in FY06. Given high potential for alloy wheels and repeat orders from customers, we expect ECL to achieve exports of Rs500m by FY08E.

EXPORTS (RSM)




*Source: Company / Motilal Oswal Securities*

## Background

Enkei Castalloys Ltd (ECL) was incorporated in 1990 as Pegasus Castalloys Ltd. It manufactures aluminum alloy castings mainly for the auto sector. In FY03, Enkei Corporation, Japan picked up a 38% stake in the company (1.9m shares @ Rs17.60). Enkei is a world leader in alloy wheels, ECL's latest addition to its product portfolio.

ECL has one plant in Shikrapur, Pune and has recently commissioned a new plant in Gurgaon for auto OEMs based in North India.

## Volume growth and value-add to help sustain margins

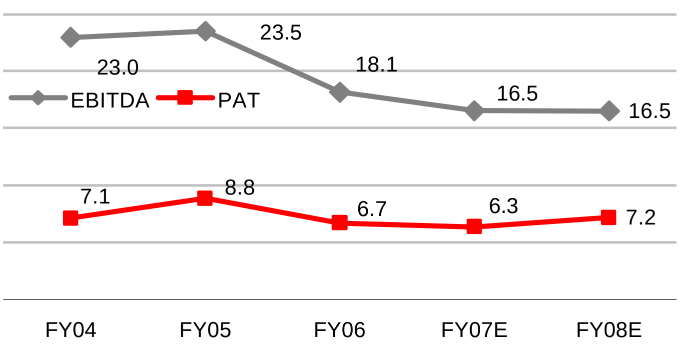
ECL's EBITDA margin is seen impacted from 23.5% in FY05 to 17.8% in FY06. In fact, in 4QFY06, it was as low as 16.1%. However, this is more an arithmetical issue rather than an operational one.

The company has clearly stated that beginning 2QFY06, the company's sales includes raw material whereas earlier it was on a conversion basis i.e. the raw material was provided by the customer. This is also evident in the raw material to sales ratio which has shot up from 31.8% in FY05 to 43.2% in FY06.

Going forward, margins could be under pressure due to volatile prices of raw material (mainly aluminum) and high pricing power of auto OEMs. ECL's hedge strategy includes–

- passing on the impact of raw material prices to customers (but this happens with a time lag);
- higher value-add - from machining to painting of finished components; and
- higher volume growth, especially in alloy wheels.

MARGINS (%)




*Source: Company / Motilal Oswal Securities*

## Financials & Projections

ECL is in a leveraged, hyper growth mode. Thus, FY02 through FY06 –

- Sales is up 8.4x;
- PAT is up almost 10x;
- Dividend payout is low;
- Debt-equity has shot up from 1.5:1 to 3:1 and
- Average ROCE is 20% and ROE a healthy 26%.

For FY06, ECL reported revenues of Rs1.23b (against Rs668m for FY05), EBITDA Rs221m (Rs157m) and PAT Rs80m (Rs59m).

We expect ECL to record sales CAGR of 69% through FY08, backed by higher offtake from domestic auto OEMs and exports. With stable margins, PAT CAGR works out to 70%.

## Valuation and recommendation

Recently, ECL raised Rs200m by private placement of 500,000 shares at Rs400 per share. The proceeds will be used to part-finance the Rs800m expansion at Gurgaon and Pune plants.

Even after this dilution, the EPS CAGR through FY08 works out to a healthy 63%.

At CMP of Rs385, the stock trades at a PE of 16x FY07E and 8.9x FY08E. **We recommend Buy with a 1-year price target of Rs520** (12x FY08E EPS of Rs43.2). This is a 35% upside from the current levels.

## Investment Concerns

**Aluminum prices –** ECL's major raw material is aluminum, which is a volatile commodity. Higher aluminum prices coupled with pressure for price reduction from auto OEMs could affect margins.

***Mitigant* –** We expect ECL to eventually pass on raw material price hikes, but with some time lag. High volume growth and focus on value addition should also cushion margins.

**High leverage –** We expect debt to be Rs890m as on March 2007 (debt-equity of 1.6:1). This makes the company vulnerable to rising interest rates.

***Mitigant* –** We don't expect interest rates to rise so much as to make a significant change to our future PAT estimates.

# Financials and Projections

**INCOME STATEMENT** (Rs million)

| Y/E DECEMBER | 2004 | 2005 | 2006 | 2007E | 2008E | |
|---|---|---|---|---|---|---|
| **Net sales** | **311** | **668** | **1,227** | **2,250** | **3,500** | |
| *Change (%)* | *-87.1* | *114.9* | *83.6* | *83.4* | *55.6* | *Impact of alloy wheel exports & revenue recognition* |
| | | | | | | |
| Raw Materials | 87 | 212 | 528 | 972 | 1,540 | |
| *% to Sales* | *28* | *32* | *43* | *43* | *44* | *Change from conversion charges to Sales with RM* |
| Power & Fuel Cost | 38 | 56 | 85 | 191 | 298 | |
| *% to Sales* | *12* | *8* | *7* | *9* | *9* | |
| Employee Cost | 39 | 59 | 88 | 159 | 222 | |
| *% to Sales* | *13* | *9* | *7* | *7* | *6* | |
| Other Manufacturing Expenses | 56 | 139 | 235 | 405 | 630 | |
| *% to Sales* | *18* | *21* | *19* | *18* | *18* | |
| Selling and Admin. Expenses | 19 | 42 | 65 | 146 | 228 | |
| *% to Sales* | *6* | *6* | *5* | *7* | *7* | |
| | | | | | | |
| **EBITDA** | **71** | **157** | **223** | **372** | **578** | |
| *Change (%)* | *-72.7* | *120.0* | *41.7* | *66.9* | *55.4* | |
| Depreciation | 24 | 37 | 55 | 84 | 115 | |
| **EBIT** | **48** | **120** | **168** | **288** | **462** | |
| Interest | 17 | 40 | 50 | 90 | 101 | *Capex funded largely through Debt* |
| Other income | 2 | 7 | 9 | 5 | 5 | |
| **PBT & EO items** | **34** | **88** | **127** | **203** | **366** | |
| | | | | | | |
| **PBT** | **34** | **88** | **127** | **203** | **366** | |
| Tax | 12 | 29 | 45 | 71 | 128 | |
| *Rate (%)* | *34.4* | *32.6* | *35.3* | *35.0* | *35.0* | |
| | | | | | | |
| **REPORTED PAT** | **22** | **59** | **82** | **132** | **238** | *A CAGR of 70%* |
| **Adjusted PAT** | **22** | **59** | **82** | **132** | **238** | |
| *Change (%)* | *-87.9* | *167.0* | *38.7* | *61.0* | *80.6* | |
| | | | | | | |
| *EBITDA margin (%)* | *23.0* | *23.5* | *18.1* | *16.5* | *16.5* | |
| *PAT margin (%)* | *7.1* | *8.8* | *6.7* | *5.9* | *6.8* | |

*E: MOSt Estimates*

## Financials and Projections (contd...)

**BALANCE SHEET** (Rs million)

| Y/E DECEMBER | 2004 | 2005 | 2006 | 2007E | 2008E | |
|---|---|---|---|---|---|---|
| **Networth** | **112** | **164** | **246** | **568** | **806** | |
| Equity share capital | 50 | 50 | 50 | 55 | 55 | *10% dilution @ Rs400* |
| Reserves | 62 | 114 | 196 | 513 | 751 | |
| Minority Interest | 0 | 0 | 0 | 0 | 0 | |
| Loans | 183 | 420 | 753 | 890 | 950 | |
| Net deferred tax liability | 18 | 26 | 33 | 33 | 33 | |
| **Capital employed** | **313** | **610** | **1,031** | **1,491** | **1,789** | |
| Gross fixed assets | 294 | 553 | 760 | 1,209 | 1,509 | |
| Less: Depreciation | 96 | 128 | 180 | 264 | 379 | |
| **Net fixed assets** | **198** | **425** | **580** | **945** | **1,129** | |
| Capital WIP | 31 | 98 | 149 | 150 | 10 | |
| Investments | 0 | 0 | 0 | 0 | 0 | |
| **Curr. assets** | **167** | **281** | **506** | **864** | **1,334** | |
| Inventory | 34 | 62 | 101 | 192 | 303 | |
| Debtors | 89 | 169 | 308 | 513 | 817 | |
| Cash & bank balance | 8 | 7 | 6 | 10 | 15 | |
| Loans & advances | 37 | 43 | 91 | 150 | 200 | |
| **Current liab. & prov.** | **84** | **194** | **204** | **469** | **685** | |
| Creditors | 38 | 119 | 95 | 309 | 480 | |
| Other Liabilities | 32 | 42 | 44 | 75 | 95 | |
| Provisions | 14 | 34 | 65 | 85 | 110 | |
| **Net current assets** | **84** | **87** | **302** | **396** | **649** | |
| **Application of funds** | **313** | **610** | **1,031** | **1,491** | **1,789** | |

*E: MOSt Estimates*

## Financials and Projections (contd...)

| RATIOS | | | | | (Rs million) | |
|---|---|---|---|---|---|---|
| **Y/E DECEMBER** | **2004** | **2005** | **2006** | **2007E** | **2008E** | |
| **Basic (Rs)** | | | | | | |
| **EPS** | **4.4** | **11.8** | **16.4** | **23.9** | **43.2** | *CAGR of 63% through FY08* |
| *Growth (%)* | *-57.8* | *167.0* | *38.7* | *46.4* | *80.6* | |
| Cash EPS | 9.1 | 19.1 | 27.3 | 39.2 | 64.2 | |
| Book value | 22.3 | 32.7 | 49.1 | 103.3 | 146.5 | |
| DPS | 1.0 | 1.3 | 1.3 | 1.5 | 2.0 | |
| Payout (incl. Div. Tax.) (%) | 25% | 12% | 9% | 7% | 5% | |
| **Valuation (x)** | | | | | | |
| P/E | | | 23.5 | 16.1 | 8.9 | |
| Cash P/E | | | 14.1 | 9.8 | 6.0 | |
| Price/Book value | | | 7.8 | 3.7 | 2.6 | |
| EV/Sales | | | 2.2 | 1.3 | 0.9 | |
| EV/EBITDA | | | 12.0 | 8.1 | 5.3 | |
| Dividend yield (%) | | | 0.3 | 0.4 | 0.5 | |
| **Profitability ratios (%)** | | | | | | |
| RoE | 19.7 | 35.9 | 33.2 | 23.2 | 29.5 | |
| RoCE | 12.3 | 20.9 | 17.1 | 19.7 | 26.1 | |
| **Turnover ratios** | | | | | | |
| Debtors (days) | 104 | 92 | 92 | 83 | 85 | |
| Asset turnover (x) | 1.0 | 1.1 | 1.2 | 1.5 | 2.0 | |
| **Leverage Ratio** | | | | | | |
| Debt/Equity (x) | 1.6 | 2.6 | 3.1 | 1.6 | 1.2 | *Decreasing Debt Equity Ratio* |

*E: MOSt Estimates*

## Financials and Projections (contd...)

**CASH FLOW STATEMENT** (Rs million)

| Y/E DECEMBER | 2004 | 2005 | 2006 | 2007E | 2008E |
|---|---|---|---|---|---|
| **PBT before EO items** | **34** | **88** | **127** | **203** | **366** |
| Add : Depreciation | 24 | 37 | 55 | 84 | 115 |
| Interest | 17 | 40 | 50 | 90 | 101 |
| Less : Direct taxes paid | 12 | 29 | 45 | 71 | 128 |
| (Inc)/Dec in WC | 405 | -4 | -216 | -90 | -248 |
| **CF from operations** | **467** | **132** | **-30** | **216** | **206** |
| | | | | | |
| EO, misc. & other items | 0 | 0 | 0 | 0 | 0 |
| **CF from oper. incl. EO items** | **467** | **132** | **-30** | **216** | **206** |
| | | | | | |
| (Inc)/Dec in FA | 238 | -330 | -261 | -450 | -160 |
| (Pur)/Sale of investments | 180 | 0 | 0 | 0 | 0 |
| **CF from investments** | **418** | **-330** | **-261** | **-450** | **-160** |
| | | | | | |
| Inc/(Dec) in networth | -1,005 | 7 | 14 | 200 | 12 |
| Inc/(Dec) in debt | 55 | 238 | 332 | 138 | 60 |
| Less : Interest paid | -17 | -40 | -50 | -90 | -101 |
| Dividend paid | -6 | -7 | -7 | -9 | -12 |
| **CF from fin. activity** | **-972** | **198** | **289** | **238** | **-41** |
| | | | | | |
| **Inc/Dec in cash** | **-87** | **0** | **-1** | **4** | **5** |
| Add: Beginning balance | 95 | 8 | 7 | 6 | 10 |
| **Closing balance** | **8** | **7** | **6** | **10** | **15** |

*Highly working capital intensive*

*E: MOSt Estimates*

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| **Disclosure of Interest Statement** | **Enkei Castalloy** |
|---|---|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |

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