Bajaj Electricals – BUY

07 April 2011

Top Mid-cap Pick

IIFL Institutional Equities

Resilient consumer play

Bajaj Electricals (BJE) is one of our top picks in the mid-cap space, as highlighted in our recent report on mid-caps. A leading player in consumer appliances, BJE enjoys a market share of 20-30% in most of the consumer-durable categories it operates in. We expect earnings growth of 25%+ driven by volume growth in consumer durables, owing to under-penetrated semi-urban markets. While margin pressures in the engineering segment could weigh on near-term earnings, management plans to remain cautious in winning new orders, which should support longer-term earnings. At 13.3x FY12ii PE, valuations are attractive for a branded consumer play.

Strong brand name and distribution to drive growth: BJE is primarily a marketing company and outsources most of its manufacturing, which mitigates competitive risks from lower-cost regional producers and imports. The company plans to launch new products (eg pressure cookers), which are under-penetrated in rural areas. Competition from incumbents is unlikely, as they would have to incur distribution costs as against BJE's established network in rural markets.

Selective growth pursuit in the industrial segment: Management has indicated that while they remain committed to growing the engineering segment, the focus would be on pursuing orders with reasonable margins. While near-term margins in the segment may come under pressure from contracts won earlier, investor concerns on longer-term margins should be assuaged by their commitment to pursue profitable contracts.

Pricing power to partly offset cost pressure: BJE's pricing power is supported both by its strong brand and a rational competitive environment. For instance, EBITDA margin losses were contained at just 30bps during the commodity inflation cycle of FY08–09. Management believes that price hikes in the face of cost increases should not impair volume growth meaningfully.

Company update

CMP	Rs265
12-mth TP (Rs)	*325 (23%)*
Market cap (US$ m)	570
Bloomberg	BJE IN
Sector	MIDCAPS

Price performance (%)

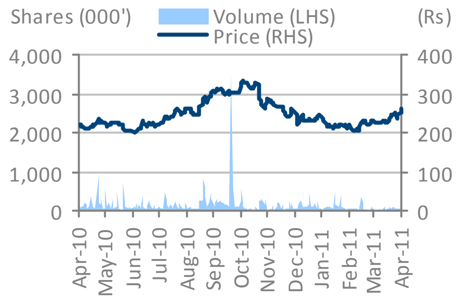
	1M	3M	1Y
Bajaj Electricals	12.9	8.2	16.4
Rel. to Sensex	**6.4**	**11.2**	**6.6**
Havells India	11.4	0.3	24.5
Kalpat. Power	15.7	-18.5	-33.8

Shareholding pattern (%)

Promoters	64.9
FIIs	8.3
DIIs	11.7
Others	15.1

52Wk High/Low (Rs)	347/188
Shares o/s (m)	99
Daily volume (US$ m)	0
Dividend yield FY11ii (%)	0.9
Free float (%)	35.1

Stock performance



Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	17,657	22,286	27,241	32,657	38,810
EBITDA Margins (%)	10.2	10.9	9.5	10.4	10.5
Pre-Exceptional PAT (Rs m)	893	1,304	1,468	1,937	2,358
Reported PAT (Rs m)	893	1,254	1,468	1,937	2,358
EPS (Rs)	**10.3**	**13.4**	**15.1**	**19.9**	**24.2**
Growth (%)	22.2	29.3	12.6	31.9	21.7
IIFL vs consensus (%)			0.5	1.6	-0.1
PER (x)	**25.7**	**19.8**	**17.6**	**13.3**	**10.9**
ROE (%)	42.6	35.3	26.4	27.6	26.7
Debt/Equity (x)	0.9	0.3	0.2	0.2	0.2
EV/EBITDA (x)	**11.5**	**9.2**	**8.4**	**6.3**	**5.0**
Price/Book (x)	9.2	5.1	4.1	3.2	2.6

Source: Company, IIFL Research. Priced as on 06 April 2011

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Brand and distribution key to growth

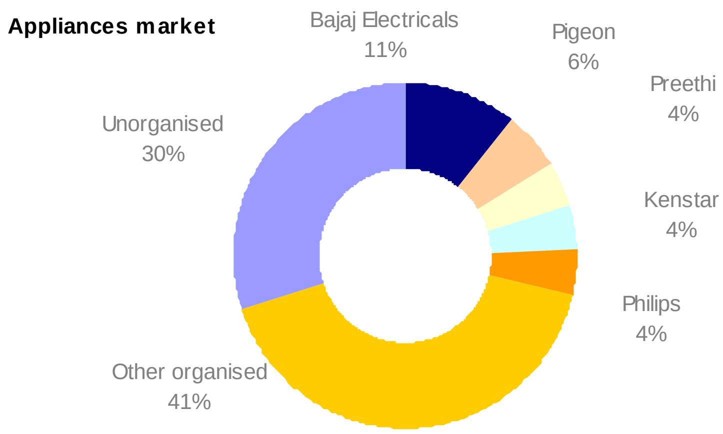
BJE has a strong brand franchise in small home appliances. It sells a range of appliances, including irons, mixers, water heaters, room coolers, grinders, food processors and home UPSes. Until FY03, the company sold primarily to the mass segment. To extend its presence to higher-priced segments, it signed a technical collaboration and brand licensing agreement with Morphy Richards, UK, in FY03 for the sales and marketing of electrical appliances under the brand name 'Morphy Richards' in India. In FY09, the company tied up with Nardi of Italy, to enter the growing premium kitchen appliance market in India. With this tie-up, the company targets 25% market share of the premium gas hobs/chimney market in India.

Consumer appliance market: Well-entrenched *Bajaj* brand keeps growth momentum high

BJE's management pegs the domestic appliance market at ~Rs60bn, of which ~70% is in the hands of organised players. The company estimates that it is the largest player in the domestic appliance market, with a ~15% share amongst organised players (or ~10% of the market). In the premium segment, foreign brands dominate the Indian market. Key competitors for the Morphy Richards brand in India are Philips, Black & Decker and Braun.

Thanks to its distribution network for appliances that reaches out to over 25,000 retail outlets in India, and frequent introduction of new models, BJE's revenues from appliances have grown at ~31% annually during FY06-10. We estimate this segment's revenues will grow at ~25% annually over the next 2-3 years, driven by: 1) increase in distribution reach to penetrate semi-urban/rural markets; 2) increase in market share of premium segments of its brands Bajaj Platini, Nardi and Morphy Richards; and 3) entry into promising new segments (mainly water purifiers).

Figure 1: BJE, the largest player in the appliance market, has a well-entrenched brand franchise both in urban and rural markets in India



Source: Company, IIFL Research

Fans: Innovation and imports key to driving growth

BJE estimates the fans market in India—comprising ceiling fans, pedestal fans, wall-mounted and exhaust fans (industrial & domestic) and air circulators—at ~Rs20bn. Through a combination of its tie-up with China's Midea, and its own in-house development and manufacturing facilities, Bajaj Electricals sells both lower-priced and premium products. In the premium segment, BJE has driven growth mainly through introduction of novel products such as decorative fans, remote-controlled fans, and models for children (with Disney characters).

The fans segment has maintained a robust revenue CAGR of 28% during FY06-10, and we estimate its revenues will grow at 22% annually over the next three years, driven by:

- increase in rural penetration of existing products especially in the low-to-mid-tier segments;
- increased presence in the industrial fans, and motors segment; and
- continued innovation in the premium segment both through in-house R&D and alliances with international brands.

Lighting: CFL is the way to grow

For many decades, BJE has had a presence in lighting through GLS lamps, fluorescent tube-lights, domestic luminaires and ballasts & starters. To tap the growing market for energy-efficient lighting, the company entered the CFL segment, through the acquisition of a 32% stake in Starlite Lighting Ltd (which has a CFL manufacturing unit). The company estimates the CFL market at ~Rs20bn and the rest of the lighting market at Rs36bn. BJE has maintained a leading presence in this market with its entry into the CFL market, and is well-poised to benefit from strong growth in this market.

BJE's revenues from this segment grew at 25% annually during FY06-10, and we estimate a 20% CAGR over the next three years, driven by: a) strong growth in CFLs; b) expansion of distribution both to *kirana* stores and modern retail formats; and c) rural electrification and increase in power availability in remote areas.

Marketing and distribution strength are critical support factors

BJE's key strength is its ability to build strong brands through marketing efforts and the fact that it has among the widest distribution reaches amongst consumer-durable companies in India. Ad spends account for ~3% of the company's sales and the proportion is likely to remain at these levels, as the 'Bajaj' brand is well-entrenched in the minds of both urban and rural consumers.

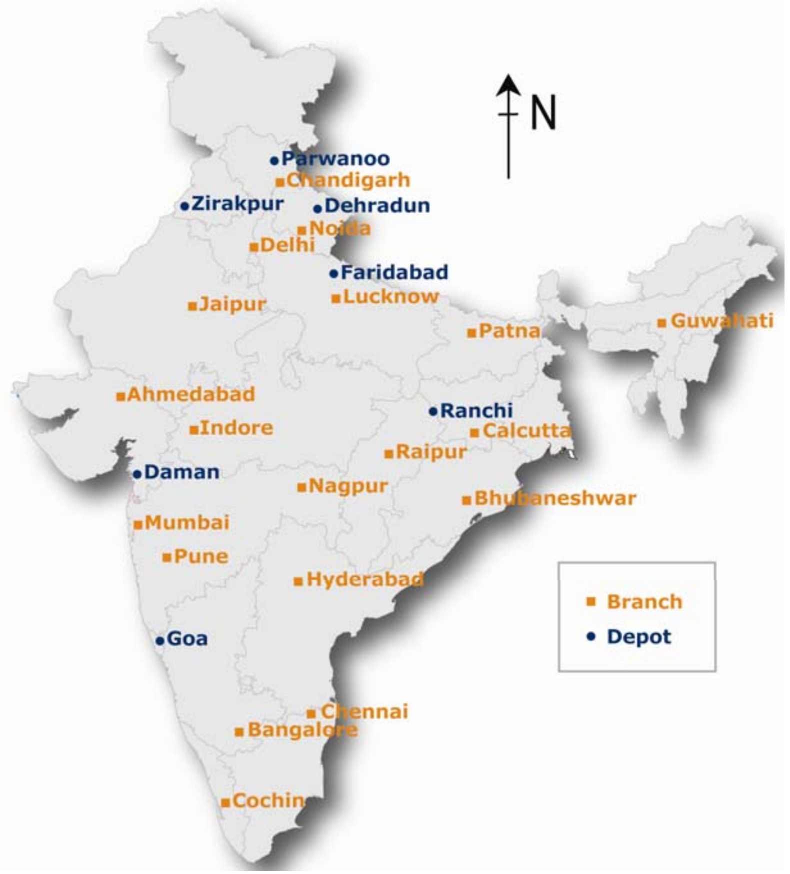
Figure 2: Most of the products are outsourced from dedicated vendors in the consumer category

Appliances	Vendors in Himachal, Noida and imports from China
Fans	Own factory at Chakan
	Vendors in Hyderabad, Himachal, imports from China
CFL lamps	Own factory of associate company Starlite, Nasik
Electrical lamps, tubes	Own factory of associate company Hind Lamps, UP
Luminaires	Vendors in Daman, Himachal, imports from China
High masts, poles, towers	Own factory at Ranjangaon and Chakan

Source: Company, IIFL Research

Currently, BJE reaches over 300,000 retail outlets in India through 5,000+ dealers and 600+ distributors. Since after-sales service is key to consumer appliance products (especially for the premium brands), the company will also focus on widening its reach beyond the 240 service centres that it already has. Distribution costs, which account for ~2.5% of sales, could see some increase, as the company seeks to increase its presence in semi-urban and rural markets as well.

Figure 3: BJE reaches out to more than 300,000 outlets in India – one of the largest distribution presence amongst consumer durable companies



Source: Company, IIFL Research

Consumer segment: Inorganic growth will not increase leverage significantly

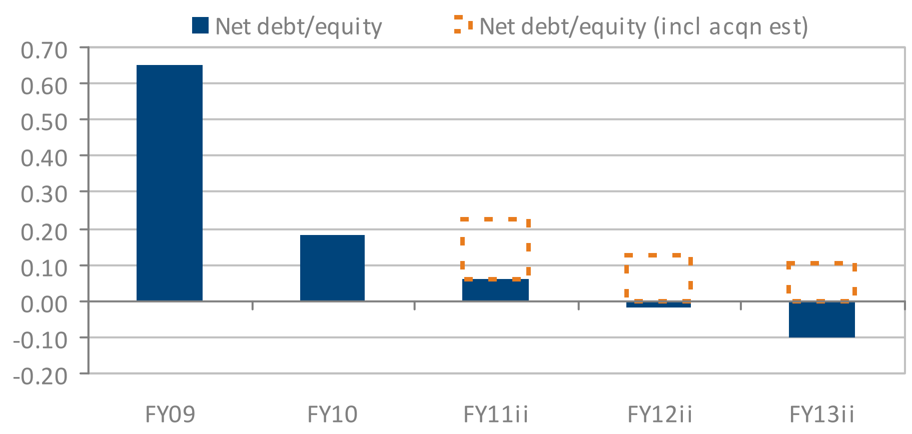
Management indicated that it would likely pursue inorganic growth by:

(a) buying brands (rather than manufacturing facilities) in the consumer appliance space. The company will consider buying brands that have strong penetration in geographies where BJE's brands are weak, or brands that could allow BJE to enter new product categories, complementary to its existing product suite; and

(b) acquiring companies with technological know-how/contracting experience in the engineering & projects segment.

The company has no plans to make large acquisitions (that is, with annual revenue of over Rs1bn). Given its comfortable gearing position (net debt/equity of 0.2x), the company will not need to raise any equity for these acquisitions. If the acquisitions were to be funded entirely by debt (assuming acquisition consideration of 12-15x PE), net debt/equity will rise to only about ~0.4x.

Figure 4: Even if inorganic growth (estimated at Rs1bn) is funded entirely by debt, leverage will increase to only ~0.4x



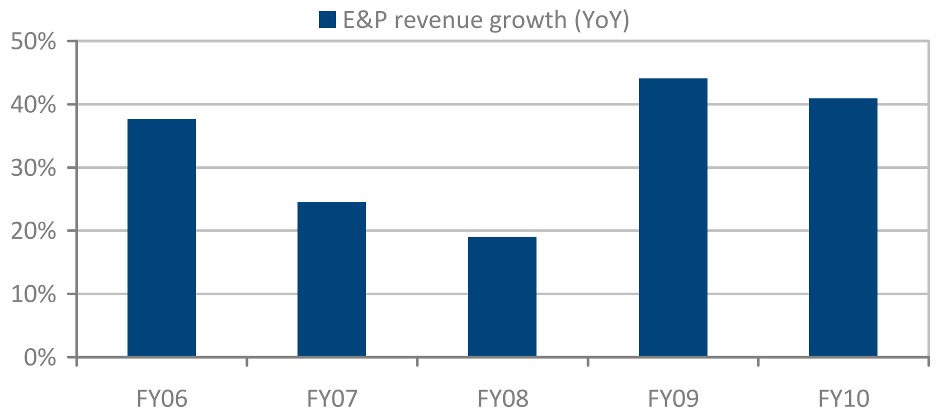
Source: Company, IIFL Research

Sustained growth in infra spending to drive engineering segment

The Engineering & Projects division has three main sub-divisions:

- **High masts and poles:** involves setting up streetlights (customers include municipal corporations, infrastructure players, government spending under Jawaharlal Nehru National Urban Renewal Mission), high masts/poles for factories/facilities of corporates, and signages (customers include HPCL, BPCL and Reliance).
- **Towers:** covers manufacture and setting up of transmission towers. The key driver for this segment is capacity expansion by companies such as Power Grid Corporation.
- **Special projects:** mainly involves project execution under the government's rural electrification programme (Rajiv Gandhi Grameen Vidyutikaran Yojana), and lighting projects (for power plants, factories, sports stadiums, etc).

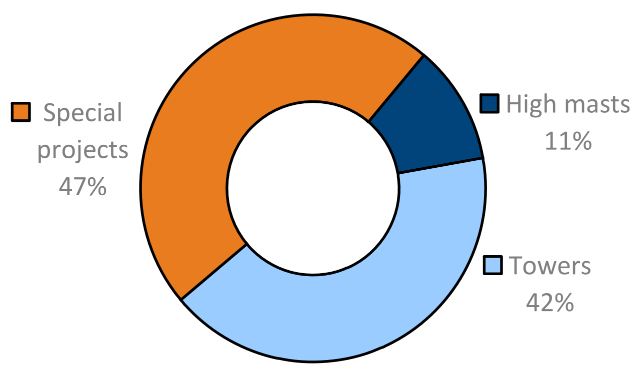
Figure 5: Transmission towers revenues, which registered 73% revenue CAGR during FY06-10, was the key growth driver for the E&P segment



Source: Company, IIFL Research

The E&P segment's revenues grew at 32% annually during FY06-10. Growth was driven mainly by the transmission tower segment, owing to rapid expansion by telecom companies, and power capacities. The company currently has a Rs1.8bn order book, and is well-placed for orders worth Rs1.25bn. Coupled with the 14-18 month average gestation period for projects gives us visibility for ~20% YoY revenue growth in this segment during the next year.

Figure 6: Order book dominated by transmission towers and govt infra schemes



Source: Company, IIFL Research

Given the government's continued thrust on infrastructure schemes (both rural and urban) and the recent fillip in industrial capacity expansion, we expect BJE's E&P revenues to grow at ~20% annually during the next three years.

Figure 7: Rs450bn demand potential for E&P should comfortably support ~20% CAGR estimate for revenue growth over 2-3 years

Segment	Growth driver
Towers	Rs200bn demand from power transfer capacity increase (from 9000MW to 30,000 MW)
High Masts and Poles	Rs125bn spending under JNNURM over five years
Special projects	Rs120bn spending under rural electrification projects; 25 non-metro airport development

Source: Company, IIFL Research

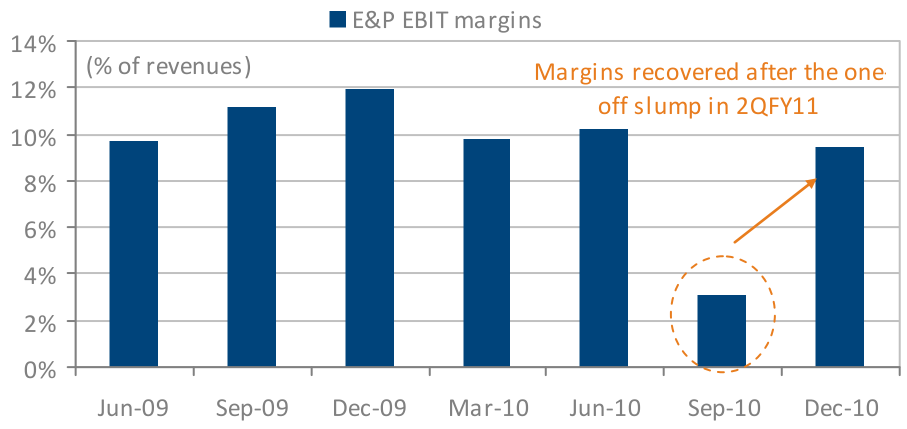
FY11 margins in the E&P segment affected by one-off factors in 2QFY11

The share of 'product execution' vs 'products' in the E&P business was skewed significantly during 2QFY11 in favour of 'product execution', which intrinsically has very low margins, since this part of the business involves mainly costs incurred in erection and commissioning of projects.

This was mainly driven by the rush in project execution ahead of the Commonwealth Games in Delhi, which accounted for the largest share of projects executed during the quarter, thus putting most other projects in abeyance for 2HFY11. Additionally, the higher-margin transmission-tower business was affected by a slowdown during 2QFY11, owing to the heavier-than-normal monsoon this year.

In-line with management's guidance, EBITDA margin in the E&P business rebounded in 3QFY11 to 9.4% after the disappointing performance in 2QFY11 (when margins were down to 3%).

Figure 8: E&P margins rebounded after the 2QFY11 disappointment



Source: Company, IIFL Research

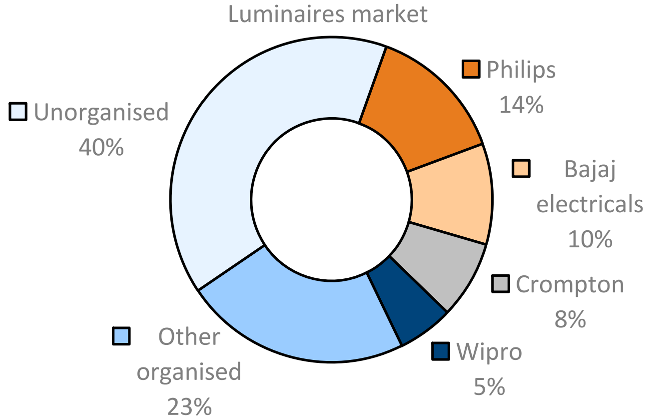
Luminaires: order flow has regained strength

The luminaires segment caters mainly to industrial applications, flood lighting and street lights. This market is pegged at Rs25bn (according to company estimates), of which ~40% is in the hands of unorganised players. BJE is a leading player (2nd largest after Philips) amongst organised players, thanks to both its strong product portfolio and technical tie-ups with global leaders in the space.

In FY05, the company entered into a distribution agreement with Trilux Lenze of Germany for high-end technical lighting. BJE has since supplied luminaires for a number of large projects, among them the Indira Gandhi Stadium, Jawaharlal Nehru Stadium, and TCS's green-building projects in Chennai.

BJE has also entered into a tie-up with Securiton of Switzerland for fire-alarm and security systems, and with Delta Controls for HVAC controls, access and building management systems (BMS). This enables the company to offer integrated BMSes, which is targeted mainly at new IT, BPO and retailing projects.

Figure 9: Technical excellence through tie-ups with global leaders support BJE's leadership in luminaires



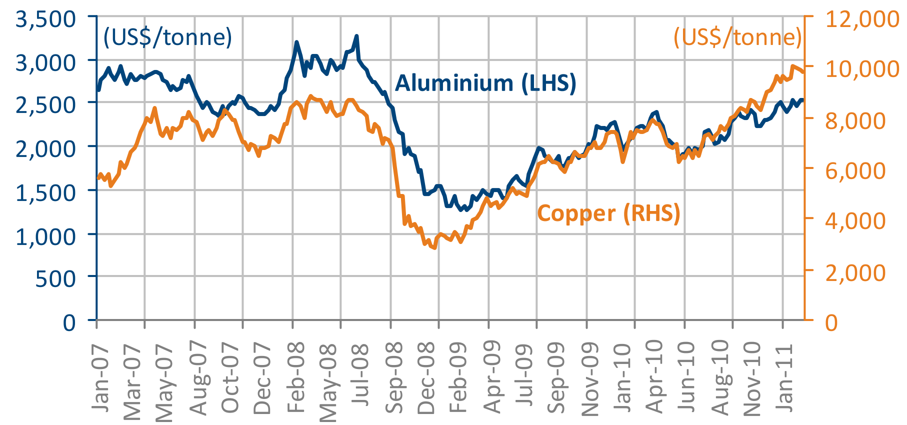
Source: Company, IIFL Research

A slump in industrial activity caused this segment's revenues to fall by 2.5% YoY during FY10. According to the management, order flow has since revived (1QFY11 revenues from luminaires were up 78% YoY). We estimate this segment's revenue growth at ~15% annually over the next three years as it trends towards historical growth rates (revenues registered 21% CAGR during FY06-09).

Pricing power to partly offset cost pressure

Copper, aluminium and steel are key raw materials in both consumer and engineering segments. Commodity price inflation continues to be a cause for concern—raw-material prices for BJE were up 25-50% YoY in 3QFY11 and show no signs of declining.

Figure 10: Raw-material inflation already running high for BJE



Source: Company, IIFL Research

BJE has demonstrated strong pricing power during previous commodity inflation cycles, especially in its consumer product segments. During FY08-09, for instance, when commodity prices were 10-30% above current levels, BJE was able to pass on a substantial part of the cost increases, though in a staggered fashion, thus protecting its margins (consumer segment EBITDA margins declined just 30bps YoY during FY09 and subsequently expanded 250bps YoY in FY10 once commodity prices corrected).

We expect BJE to continue to be able to pass on cost increases in the current environment too. However, there may be some time lag, as consumer acceptance for a price rise is better secured through steady increases rather than sudden jolts. As a result, we currently expect margins to decline 40bps YoY during FY10-12, assuming modest inflation in commodity prices from current levels. However, any unforeseen shocks to commodity prices will pose downside risk to our current margin estimates for the consumer segment.

E&P segment faces both margin and receivables risk

As BJE's bids in the E&P segment are in relatively low-tech areas, there are no entry barriers to speak of. This is attracting an increasing number of smaller players to the business. As such, BJE's EBITDA margins in this business, which are currently at 10-12%, will come under further pressure in the years ahead. We estimate 200-300bps margin erosion over the next two years in this segment.

For the near term, we are building in a ~100bps decline in margins in this segment to factor in cost inflation. While the segment is highly competitive, the wafer-thin margins already prevalent in the segment should temper price competition (at least a part of the cost increases will be passed on by most players).

On the other hand, we expect some strain on working-capital requirements of the segment, given that government orders constitute the largest share of the engineering segment's orders. With government finances remaining under strain, the receivables period could also come under risk.

Bear-case assessment implies 18% downside to our earnings estimate

In our estimate, if margins in both consumer and engineering segments approach the mid-cycle levels of the previous downturn, an incremental 100bps risk to our current margin estimate or ~10% downside to our current earnings estimate is possible. Also, assuming receivables days stretch by a further 15% from current levels (current receivable days are already comparable to the mid-cycle levels of the previous down-cycle), earnings would decline by a further 8%.

Overall, our bear-case assessment indicates ~18% downside to our current earnings estimate.

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Appliances revenue growth	28%	25%	25%	23%	20%
Fans revenue growth	22%	27%	25%	22%	20%
Lighting revenue growth	19%	25%	22%	20%	20%
Luminaires revenue growth	23%	-2%	25%	10%	10%
Engineering & projects revenue growth	44%	41%	18%	20%	20%

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	17,657	22,286	27,241	32,657	38,810
EBITDA	1,798	2,434	2,591	3,410	4,057
EBIT	1,713	2,343	2,490	3,301	3,938
Interest expense	-370	-314	-324	-449	-474
Others items	57	29	25	39	55
Profit before tax	1,400	2,057	2,191	2,891	3,519
Tax expense	-507	-754	-723	-954	-1,161
Extraordinary items	0	-50	0	0	0
Net Profit	**893**	**1,254**	**1,468**	**1,937**	**2,358**

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	1,713	2,343	2,490	3,301	3,938
Depreciation & Amortization	85	91	100	109	118
Tax paid	-542	-912	-729	-990	-1,291
Working capital change	55	-1,564	-674	-1,174	-1,248
Other operating items	99	55	0	0	0
Operating Cash-flow	1,410	14	1,187	1,246	1,517
Capital expenditure	-148	-147	-150	-180	-180
Free cash flow	**1,263**	**-133**	**1,037**	**1,066**	**1,337**
Equity raised	0	1,634	0	0	0
Investments	-92	-50	0	0	0
Debt financing/disposal	-228	-620	-395	-292	-719
Dividends paid	-161	-201	-222	-301	-393
Other items	-562	-504	-280	-303	-26
Net change in Cash & cash equivalents	**219**	**125**	**140**	**170**	**200**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	538	612	752	922	1,122
Sundry debtors	5,592	7,507	9,031	11,242	13,656
Trade Inventories	1,777	2,094	2,586	2,984	3,514
Other current assets	1,131	1,777	1,642	1,813	2,185
Fixed assets	971	1,017	1,066	1,137	1,199
Other assets	316	366	366	366	366
Total assets	**10,324**	**13,373**	**15,442**	**18,465**	**22,041**
Short-term debt	908	574	258	24	-551
Sundry creditors	5,704	6,911	8,117	9,723	11,791
Other current liabilities	0	5	5	5	5
Long-term debt/Convertibles	1,230	945	866	807	663
Other long-term liabilities	31	-5	-5	-5	-5
Networth	2,450	4,944	6,202	7,910	10,138
Total liabilities & equity	**10,324**	**13,373**	**15,442**	**18,465**	**22,041**

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	28.5	26.2	22.2	19.9	18.8
Core EBITDA growth (%)	25.6	35.3	6.4	31.6	19.0
Core EBIT growth (%)	26.1	36.8	6.3	32.6	19.3
Core EBITDA margin (%)	10.2	10.9	9.5	10.4	10.5
Core EBIT margin (%)	9.7	10.5	9.1	10.1	10.1
Net profit margin (%)	5.1	5.8	5.4	5.9	6.1
Dividend payout ratio (%)	18.1	16.0	15.0	15.0	15.0
Tax rate (%)	36.2	36.6	33.0	33.0	33.0
Net Debt/Equity (%)	65.3	18.3	6.2	-1.8	-10.1
Return on Equity (%)	42.6	35.3	26.4	27.6	26.7
Return on Assets (%)	9.6	11.0	10.2	11.3	11.3

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
