Q1FY10 Result Update

August 12, 2009

We had initiated coverage on AIA Engineering Ltd. (AEL) on 11 July 2006 (CMP Rs 601.6) and recommended to buy the stock in the range at Rs.506-562 (FV Rs10). Following the spurt in the stock price to Rs.1,500-1,600 price band, we had suggested that the high price discounts the earlier estimated earnings of Rs.70 for FY08(E) as the stock was trading at P/E of 20x. In our report dated August '06 2007 we had advised investor to reduce exposure to the stock in the Rs.1500-1550 band. Subsequently the stock price touched Rs.1,524 on November 1, 2007. Investors were advised to wait for the effect of Phase II expansion in Q4FY08 before looking to reenter the scrip.

On May 04, 2009 we had advised investors to re-enter the scrip (CMP Rs 169.25) with sequential targets of Rs 208 & Rs 235 in 2-3 quarters time, which it subsequently achieved. We present an update on the stock after declaration of Q1FY10 results.

Q1FY10 (Consolidated) Result Review

- AEL achieved a production of about 22,619 MTs in Q1FY10 as compared to 23,987 MT achieved in Q1FY09. Sales volumes for the quarter stood at 22,300 MTs – 5.1% increase over corresponding quarter primarily led by uptick in mining volumes with more focus on copper, platinum and gold besides iron ore. Volumes from mining sector have risen to 4000 MTs from almost negligible volumes last year. This helped to offset the lower volumes in the cement sector (8000 MTs) due to slowdown in construction activity in international markets. Of the total volumes, exports volumes accounted for 12,000 MT while the rest came in from domestic segment.

- Sales have risen 13.4% to Rs 226.7 crs from Rs 199.9 crs y-o-y with better realizations and volumes. Realizations improved 7.8% y-o-y to Rs 101.6/- kg but fell 10.4% q-o-q. Mining sector realizations were muted owing to the product mix which did not include liners, diaphgrams etc. Overall realization from mining sector is lower compared to the cement sector. Any major fall in realization from the current levels is unlikely according to the management. This sector contributed 14% to overall sales compared to 3.4% in Q1FY09. Sales outside India were Rs 119.1 crs in Q1FY10 vs Rs 101.9 crs in Q1FY09.

- Order backlog stood at ~ Rs 350 crs, a 5% improvement q-o-q but has fallen 14% y-o-y. Fall over corresponding quarter was because of pass through of lower raw materials prices and lower cement orders in international markets. Cement sector volumes on the domestic front could see a revival led by production growth. To counter lower volumes outside India, AEL is focusing on market share gains in other markets like China.

- Operating margins have come down y-o-y to 24.8% from 26.8% owing higher other operating expenses as percentage cost to sales (increase from 23.1% to 30.8 %). Other operating expenses include forex loss of Rs 13 crs this quarter arising out of hedging transaction. The company has a notional MTM loss of ~Rs 81 crs on un-expired forex derivative contracts. Lower operating margins resulted in a marginal increase in net profits of 2.2% to Rs 40.7 crs. Other income of Rs 8.7 crs include Rs 4 crs of dividend income.

- Debtor days have come down to 75 days this quarter from 82 days in March '09 quarter. Net Cash balances stood at ~ Rs 363 crs. Management indicated use of surplus cash flows for future acquisitions, increased dividends etc.

(Rs in crs)

	Q1FY10	Q1FY09	VAR [%]	Q4FY09	VAR [%]
Net Sales	226.7	199.9	13.4	264.4	-14.3
Other Income	8.7	7.4	18.6	9.1	-4.4
Total Income	235.4	207.3	13.6	273.5	-13.9
Total Expenditure	170.4	146.4	16.4	207.8	-18.0
PBIDT	65.1	60.9	6.9	65.8	-1.1
Interest	1.0	0.5	106.5	0.8	25.0
Depreciation	5.8	4.4	31.3	5.7	1.6
PBT	58.3	56.0	4.1	59.3	-1.7
Tax (incl. DT & FBT)	17.6	16.1	9.0	20.4	-13.7
PAT	40.7	39.9	2.2	38.9	4.6
EPS	4.3	4.2		4.1	
Equity	18.9	18.8		18.9	
Face Value	2	10		2	
OPM (%)	24.8	26.8		21.4	
PBIDT(%)	28.7	30.5		24.9	
PATM (%)	17.3	19.2		14.2	
Costs % to Sales					
Input cost	39.9	45.0		48.2	
Staff cost	4.4	5.2		3.8	
Other expenses	30.8	23.1		22.5	

(Source : Company)

Concerns

- Delay in orders from cement, mining and other sectors.
- Given its large exports, the Company is exposed to foreign exchange rate fluctuation risk.
- Fluctuation in the raw material prices.

Conclusion

AEL operates in a high-tech, niche engineering segment, making parts for coal grinding in equipment that is used in power plants, cement units and the mining industry. The demand for AIA's products stems primarily from the switch in the user industries' preference to high-chrome mill internals against the conventional forged ones. This leaves plenty of room for growth as the current share of high-chrome mill internals stands at only about 15 per cent of the total demand. High-chrome mill internals, which are used to grind clinker in cement mills; coal in thermal power plants and mineral ore in mines are likely to attract higher demand in the coming years as they offer higher productivity, greater control over grinding process, lower power consumption and lower wear rates. Demand for AIA's products may also derive strength from the fact that there has not been any major scaling down in capex plans by the cement majors. Cement has seen resurgence in demand in the last couple of months on back of strong demand arising from infrastructure projects, personal housing construction in rural and semi-urban areas and supply shortage in some areas. Also, nearly 70% demand is from the replacement market which protects it from delays in new cement projects.

On the mining front, company has started focusing on other mining areas such as gold, copper, platinum etc besides iron ore which used to be its main focus area. This could lead to higher volumes from Q3FY10. Trends in order inflows from the mining sector, therefore, may require a close watch in the coming quarters as mining industry constitutes a major portion of mill internals demand followed by cement. Company is also exploring opportunities in limestone crushing in the cement sector.

	FY09	FY10*(QE)
Sales	1024	1125
EBIDTA Margin(%)	26	25.5
PAT	171	182
EPS	18.2	19.3
PE	12.3	11.6

* Quick estimates

The management expects to maintain EBIDTA margins of 25% but has refrained from giving outlook on future volumes.

At current price of Rs 223.4, AEL is trading at 11.6x FY10 earnings. We have revised our estimates for FY10 to factor in slightly lower volumes and PBIDT margins. FY11 outlook is robust with likely recovery in the global commodity cycle, strong capacity addition in the Indian cement sector and healthy balance-sheet. We, however have a neutral rating on the stock. Investors who had entered the stock on our recommendation got a chance to exit at profit. Depending on the share price movement and developments in the company we may review our view on the stock.

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