# ANALYSIS BEYOND CONSENSUS

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**Bharat Forge** **Annual Report Analysis** January 18, 2010

## Exchange losses play havoc

- Bharat Forge availed the option of capitalising/deferring foreign exchange difference on long-term monetary items provided by Accounting Standard 11. Consequently:
  - Exchange loss aggregating INR 1.4 bn was capitalised and will be depreciated over the balance life of related assets. Additional depreciation pursuant to capitalisation of exchange loss aggregates INR 47.5 mn.
  - Exchange loss aggregating INR 340.2 mn (net of amortisation aggregating INR 185.4 mn) was accumulated in "foreign currency monetary translation difference account" and will be recognised over the next two financial years.
  - Exchange gain aggregating INR 403.7 mn, recognised last year, was deducted from general reserves.
    - Gains aggregating INR 105.9 mn were transferred to the "foreign currency monetary translation difference account" and would be re-recognised over the next two fiscals.
    - Gains aggregating INR 297.8 mn were deducted from fixed assets.

  As a result, net profit for the year was higher by INR 1.7 bn, ~2.9x the reported PAT.
- Exchange losses recognised during the year aggregate INR 1.0 bn (FY08: gain, INR 211.2 mn), 1.7x the reported PAT.
- Foreign currency denominated loans (at the standalone level) aggregate INR 13.5 bn, ~74.6% of standalone loan book. There are no derivative instruments outstanding as on March 31, 2009. With the INR appreciating by ~10% since March 2009, a significant part of these losses can be recouped.

## Accounting policy highlights

- No provision is made for redemption premium on FCCBs. Consequently, net profit for the year is higher by INR 1.2 bn, ~ 2.1x the reported PAT; net worth is higher by INR 2.7 bn, ~ 16.6% of net worth, comprising:
  - Redemption premium pertaining to FY09: INR 814.9 mn.
  - Exchange loss on redemption premium pertaining to earlier years aggregating INR 412.8 mn.
  - Redemption premium pertaining to earlier years aggregating INR 1.5 bn.
- Diminution in the value of investments aggregating INR 24.2 mn is adjusted in reserves and surplus, instead of being charged in the income statement.
- A Germany-based subsidiary migrated to IFRS from German GAAP in CY08. However, the impact of such migration is not material and resulted in lower PAT (by INR 15.0 mn).
- Bharat Forge adopted AS 30 during the year. However, as at march 31, 2009, there are no derivative contracts outstanding and the balance of hedging reserve is nil.

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### Market Data

| | |
|---|---|
| 52-week range (INR): | 307 / 69 |
| Share in issue (mn): | 222.7 |
| M cap (INR bn/USD mn): | 65.5 / 1,434.5 |
| Avg. Daily vol. BSE ('000): | 230.9 |

### Share Holding Pattern (%)

| | | |
|---|---|---|
| Promoters | : | 44.0 |
| MFs, FIs & Banks | : | 17.5 |
| FIIs | : | 11.7 |
| Others | : | 26.8 |

** Promoters pledged shares (% of share in issue) : Nil*

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## Old outstanding debtors increase 58.4%; provisions multifold

- Debtors, outstanding for more than six months and considered good, increased 58.4% to INR 1.3 bn (FY08: INR 815.4 mn) despite aggregate debtors decreasing 20.9% to INR 5.3 bn (FY08: INR 6.7 bn) and average receivable days declining by 11.7% to 46 days sales (FY08: 52.1 days sales).
- Provisions for doubtful debts and advances increased to INR 97.8 mn (FY08: INR 5.6 mn), ~ 8.8% of profit before tax and 1.3% of total receivables and advances.

## Other financial highlights

- Un-hedged foreign currency exposure stands at INR 13.3 bn (liabilities, net), ~ 81.1% of net worth.
- Disputed claims against the parent company (statutory and others) stand at INR 773.2 mn, ~ 4.7% of net worth.

## Subsidiaries dampen results

- Subsidiaries have incurred substantial losses of ~INR 450.2 mn, which is a cause for concern.
- Auditors of two subsidiary companies, Bharat Forge America (USA) and Bharat Forge Scottish Stampings (Scotland), have drawn attention to the appropriateness of going concern assumption used for preparing their respective financial statements.
  - **Bharat Forge America, USA**
    - In CY08, it reported net loss of INR 264.3 mn on turnover of INR 1.7 bn.
    - Net worth stands at INR 35.9 mn versus total liabilities of INR 1.1 bn.
    - Despite continuous losses, the subsidiary's management is confident about the company's future. Also, an impairment review carried out by the management did not indicate any impairment loss.
    - In the parent company's standalone books, investment in Bharat Forge America stands at INR 730.4 mn. Details regarding loans granted or guarantees provided are not available.
  - **Bharat Forge Scottish Stampings, Scotland**
    - In CY08, it reported net loss of INR 423.1 mn on turnover of INR 2.6 bn mn, including exceptional expenditure aggregating INR 298.9 mn, comprising a settlement claim of INR 247.3 mn and redundancies cost of INR 51.6 mn.
    - Net worth has eroded and stands at INR (192.5) mn versus total liabilities of INR 1.5 bn.
    - Subsidiary's future largely depends on support from the parent company, which even its management considers uncertain.
    - Details regarding investment in Bharat Forge Scottish Stampings, loans granted or guarantees provided are not available.

**Summary group financials** **(INR mn)**

| Particulars | Standalone | | Subsidiaries | | Consolidated | |
|---|---|---|---|---|---|---|
| | FY08 | FY09 | FY08 | FY09 | FY08 | FY09 |
| Sales | 21,965 | 20,576 | 24,558 | 27,165 | 46,523 | 47,740 |
| Total income | 22,849 | 21,064 | 24,667 | 27,364 | 47,516 | 48,427 |
| EBITDA | 5,228 | 4,454 | 1,705 | 1,092 | 6,934 | 5,545 |
| EBITDA margin (%) | 23.8 | 21.6 | 6.9 | 4.0 | 14.9 | 11.6 |
| Depreciation | 1,391 | 1,497 | 881 | 1,023 | 2,273 | 2,519 |
| Interest | 1,050 | 1,004 | 219 | 288 | 1,269 | 1,291 |
| PAT | 2,736 | 1,033 | 279 | (450) | 3,015 | 583 |
| ROACE | 16.4 | 11.0 | 9.4 | 0.7 | 14.5 | 8.3 |

*Source: Company annual report, Edelweiss research*

*Note: *Total investments in subsidiaries in the books of parent's standalone accounts stand at INR 3.7 bn.*

## Profitability analysis (ROE analyser)

ROE analyser analyses profitability on the scale of operating efficiency and capital allocation efficiency (detailed concept explained in Annexure A). We have analysed the profitability of Bharat Forge for FY08 and FY09; results and key findings are given below:

***Lower RNOA triggers significant decline in ROAE***

**ROE analyser**

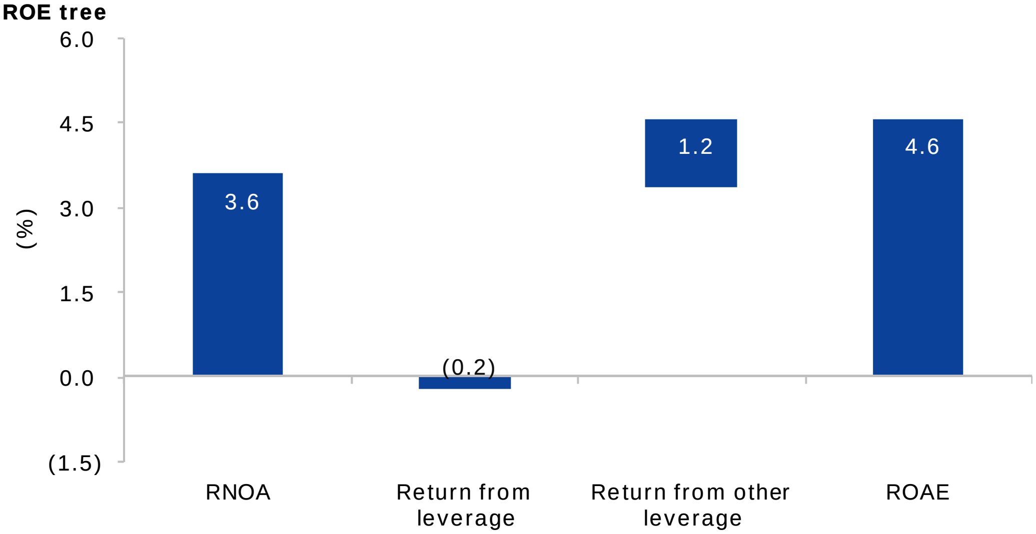
| Particulars | | FY08 | | FY09 |
|---|---|---|---|---|
| **A. Return on net operating assets (RNOA) (OPATO x NOPAT margin) (%)** | | **12.3** | | **3.6** |
| OPATO (operating asset turnover) (x) | 1.7 | | 1.4 | |
| NOPAT margin (%) | 7.2 | | 2.5 | |
| **B. Return from leverage (FLEV x spread) (%)** | | **4.8** | | **(0.2)** |
| FLEV (financial leverage) (x) | 0.6 | | 0.9 | |
| NBC (net borrowing cost) (%) | 4.5 | | 3.8 | |
| Net financial spread (RNOA -NBC) (%) | 7.9 | | (0.2) | |
| **C. Return from other funding (%)** | | **1.0** | | **1.2** |
| **ROE Derived (A+B+C) (%)** | | **18.2** | | **4.6** |

*Source: Company annual report, Edelweiss research*

*Note: *Excluding exceptional items*

***Leverage, despite non-provisioning of redemption premium on FCCBs, depleted ROE***

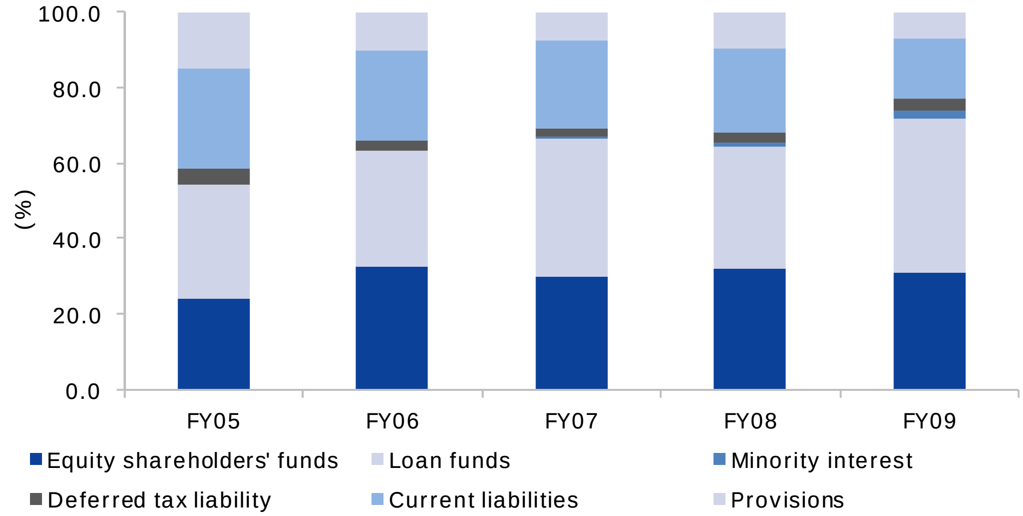
**ROE tree**




*Source: Company annual report, Edelweiss research*

***Loan funds increase to recoup lower current liabilities and provisions, keeping non-equity liabilities constant***

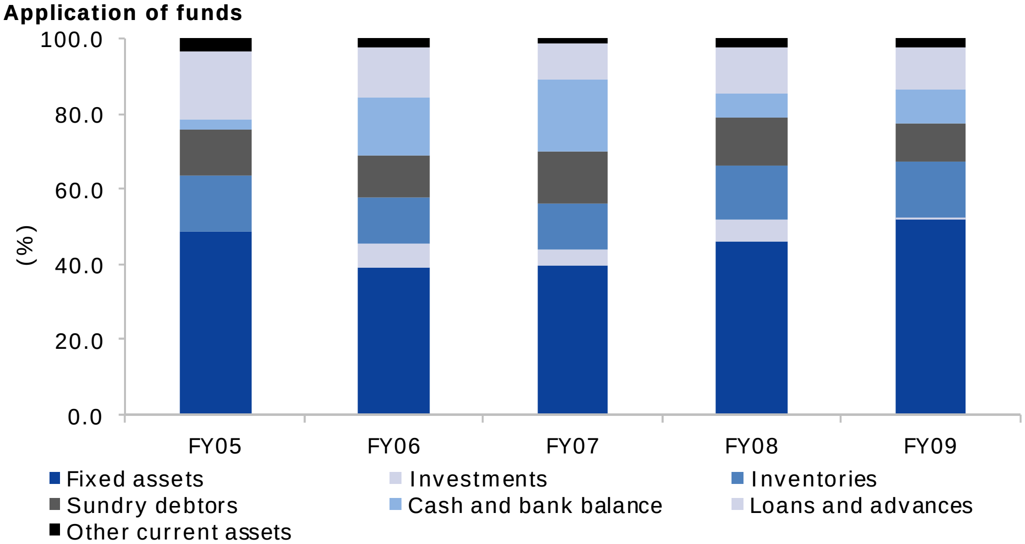
**Sources of funds**




*Source: Company annual report, Edelweiss research*

***Fixed assets continue to increase***

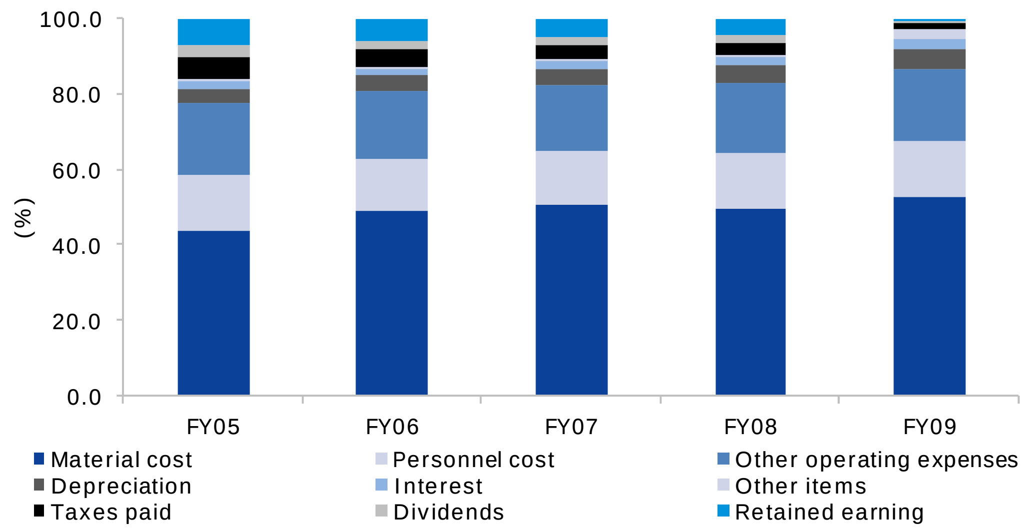
**Application of funds**




*Source: Company annual report, Edelweiss research*

***Material cost continues to increase; other items (exchange loss) increase substantially***

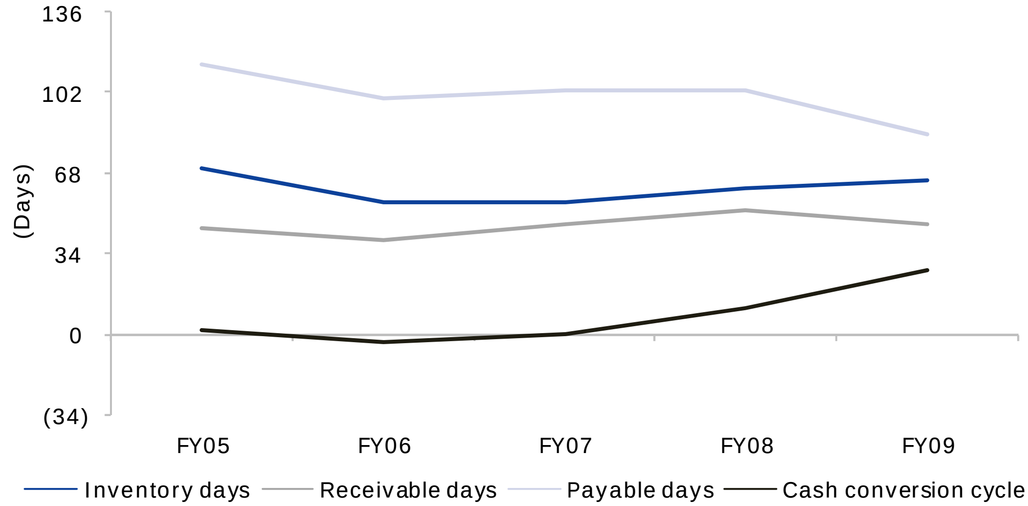
**Utilisation of income**




*Source: Company annual report, Edelweiss research*

***Lesser payable days increase cash conversion cycle***

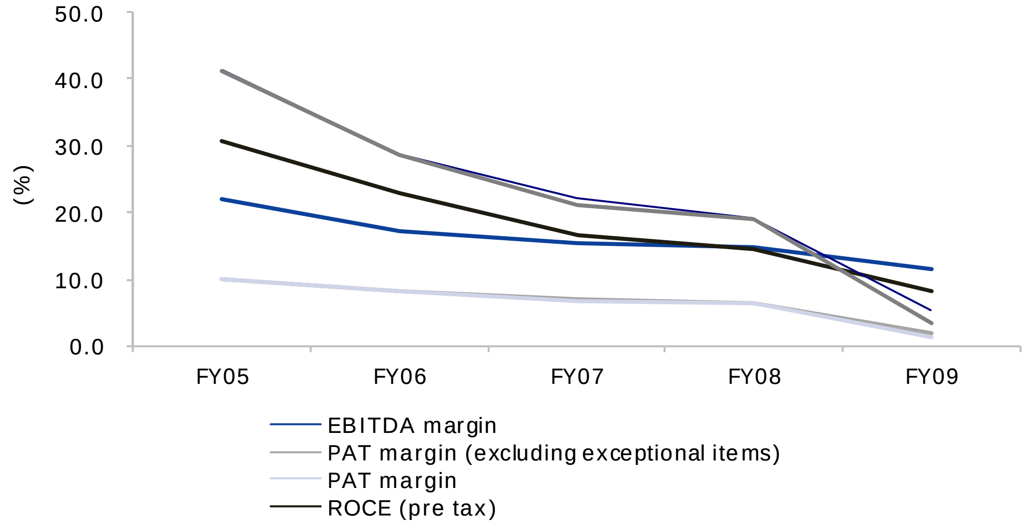
**Cash conversion cycle**




*Source: Company annual report, Edelweiss research*

***Downward spiral of margins and returns continues unabated***

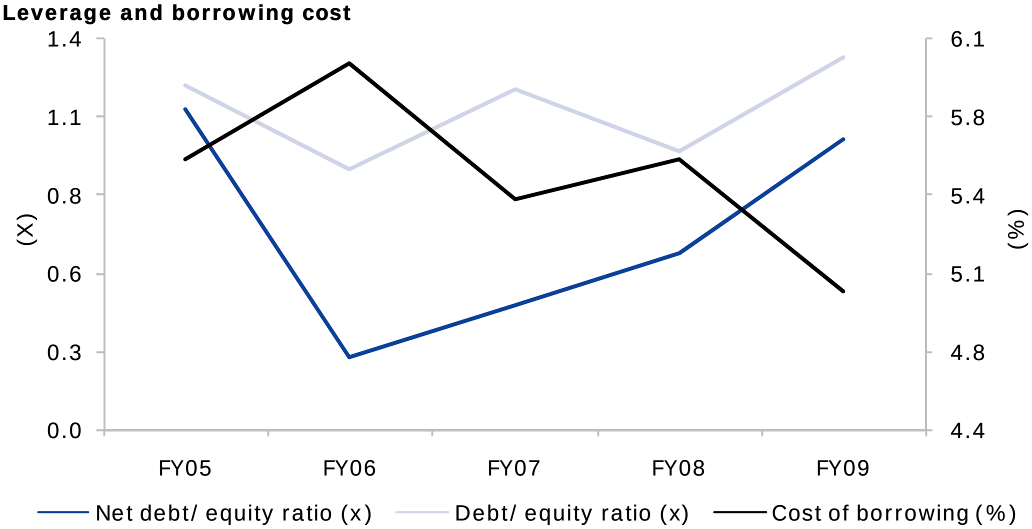
**Profitability and return ratios**




*Source: Company annual report, Edelweiss research*

***FCCBs (~42.5% of borrowings): Non provisioning of redemption premium keeps borrowing cost low; restatement at depreciated INR increased leverage and further reduced borrowing cost***

**Leverage and borrowing cost**




*Source: Company annual report, Edelweiss research*

**Summary financials** **(INR mn)**

| Particulars | FY05 | FY06 | FY07 | FY08 | FY09 |
|---|---|---|---|---|---|
| Sales | 19,934 | 30,189 | 41,783 | 46,523 | 47,740 |
| Total income | 20,014 | 30,850 | 42,752 | 47,516 | 48,427 |
| EBITDA | 4,375 | 5,240 | 6,478 | 6,934 | 5,545 |
| EBITDA margin (%) | 21.9 | 17.4 | 15.5 | 14.9 | 11.6 |
| Depreciation | 774 | 1,283 | 1,883 | 2,273 | 2,519 |
| Financial costs | 411 | 683 | 1,067 | 1,269 | 1,291 |
| Net profit | 2,011 | 2,505 | 2,906 | 3,015 | 583 |
| Equity shareholders' funds | 4,862 | 12,542 | 14,796 | 16,541 | 16,435 |
| Loan funds | 6,000 | 11,693 | 17,996 | 16,544 | 21,908 |
| Net fixed assets | 9,632 | 14,814 | 19,449 | 23,611 | 27,902 |
| Investments | - | 2,535 | 2,073 | 2,988 | 2 |
| Current assets loans and advances | 10,293 | 20,849 | 27,686 | 24,781 | 25,316 |
| Current liabilities and provisions | 8,252 | 12,999 | 14,994 | 16,226 | 12,081 |
| Net current assets | 2,042 | 7,850 | 12,692 | 8,556 | 13,236 |
| Cash flow from operating activities | NA | 2,646 | 3,771 | 4,284 | 2,835 |
| Cash flow from investing activities | NA | (6,388) | (4,473) | (7,383) | (1,978) |
| Cash flow from financing activities | NA | 9,223 | 4,159 | (3,106) | 843 |
| Net cash flows | NA | 5,481 | 3,457 | (6,206) | 1,700 |
| CAPEX | NA | (4,180) | (5,592) | (7,045) | (5,393) |
| Working capital investments | NA | (4,125) | (4,126) | (2,361) | 574 |

*Source: Company annual report, Edelweiss research*

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