AIA Engineering

Sustainable growth led by deeper mining penetration

OUTPERFORMER

29 September 2014
BSE Sensex: 26597
Sector: Engineering

Stock data

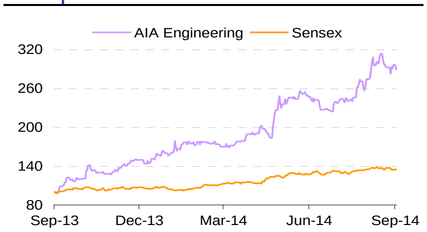
CMP (Rs)	926
Mkt Cap (Rsbn/USDbn)	87.3 / 1.4
Target Price (Rs)	**1060**
Change in TP (%)	**+18**
Potential from CMP (%)	**+15**
Earnings change (%)	
FY15E	⇔
FY16E	⇔
Bloomberg code	AIAE IN
1-yr high/low (Rs)	1032/305
6-mth avg. daily volumes (m)	0.19
6-mth avg. daily traded value (Rsm/US$m)	135.4 / 2.2
Shares outstanding (m)	94.3
Free float (%)	38.4
Promoter holding (%)	61.7

We met the management of AIA engineering (AIA). Key takeaways:

- ***Volume growth led by mining:*** We expect a 21% volume CAGR for AIA over FY14-17E led by 33% volume CAGR for its mining segment. Growth in mining is being led by clients shifting from forged to high chrome grinding media given cost advantages, better corrosive strength and higher efficiency. The addressable market of chrome grinding media for mining is estimated at ~1.5m tonnes (AIA's FY14 mining volume – 96,000 tonnes), which will ensure sustainable growth for AIA in the medium term.
- ***Aggressive capex plans to support volume growth:*** AIA has planned a 120% increase in capacity to 440,000 tonnes in FY16 from 200,000 tonnes in FY14. The capex of ~Rs6bn for this would be funded by internal accruals. The expansion would make AIA the largest manufacturer of high chrome mill internals.
- ***Sustainable margins of 20-23%:*** AIA expects sustainable margins of 20-23% in the long term given its strong positioning (cost advantage, efficiencies, etc). It does not perceive any pricing threat from smaller players as they are already operating at very thin margins. AIA's margins may increase or decrease based on product mix (larger grinding media, liners, etc) and cost dynamics (free trials, discounts, currency movements, etc).

We expect AIA to continue making inroads into grinding media for mining, aided by its 'total solutions' approach and cost-effective products. Margins are likely to be in the range of 22-23% due to improvement in product mix and fewer free trials and discounts. However, we estimate a 150bp margin decline to 22.5% over FY14-16E due to ramp-up in capacity utilisation. Valuations of 19.7x FY16E earnings appear attractive given the oligopolistic nature of the industry and AIA's long-term growth potential (16% earnings CAGR over FY14-17E). We reiterate our Outperformer rating on AIA.

Price performance – relative and absolute



(%)	3-mth	6-mth	1-yr
AIA Engineering	17.0	70.0	189.2
BSE Sensex	6.0	19.1	34.8

Key financials (Consolidated)

As on 31 March	FY13	FY14	FY15E	FY16E	FY17E
Net sales (Rs m)	17,513	20,801	23,342	29,019	35,489
Adj. net profit (Rs m)	2,108	3,467	3,836	4,423	5,401
Shares in issue (m)	94	94	94	94	94
Adj. EPS (Rs)	22.3	36.8	40.7	46.9	57.3
% change	*16.8*	*64.5*	*10.6*	*15.3*	*22.1*
PE (x)	41.4	25.2	22.8	19.7	16.2
Price/ Book (x)	6.1	5.0	4.3	3.6	3.1
EV/ EBITDA (x)	27.8	17.2	15.8	13.0	10.4
RoE (%)	15.8	21.9	20.2	19.8	20.6
RoCE (%)	19.0	26.6	24.3	24.7	26.2

Source: Company, IDFC Securities Research

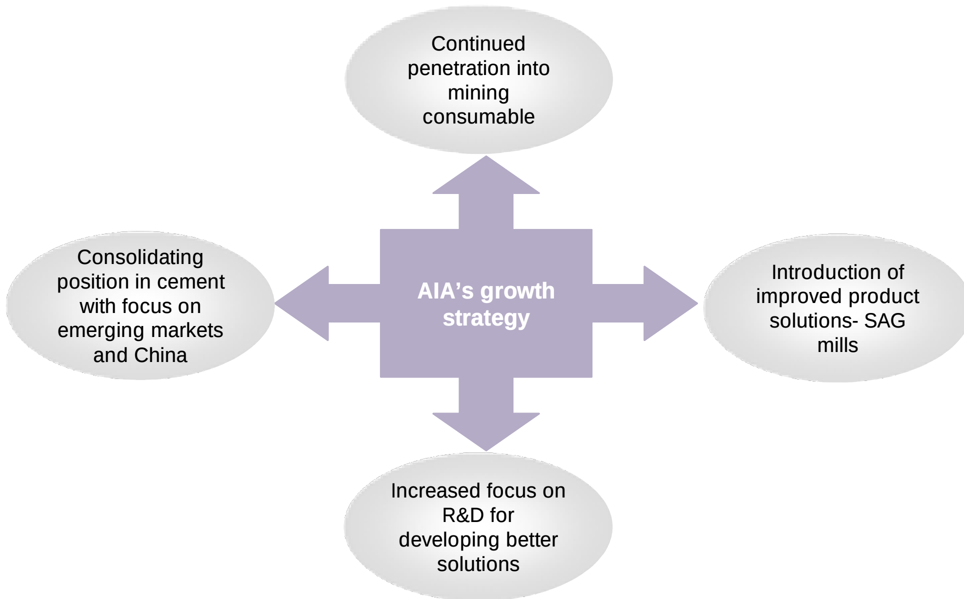
Bhoomika Nair
bhoomika.nair@idfc.com
91-22-6622 22561

Abhishek Ghosh
abhishek.ghosh@idfc.com
91-22-6622 2658

❑ Large addressable market for mining consumables

The estimated addressable market opportunity pertaining to wear parts in the mining industry is 1.5m-2m tonnes. The opportunity for AIA to gain market share in high chrome grinding media is huge as only ~15% of the market for replacement of mill consumable has converted into high chrome grinding media. The rate of conversion from traditional forged media is high as chrome grinding media offers: 1) longer life (lower wear rate), 2) better recovery rate in ore extraction and, hence, better yield, 3) lower power/ fuel cost and 4) higher productivity.

Exhibit 1: AIA's long-term growth strategy

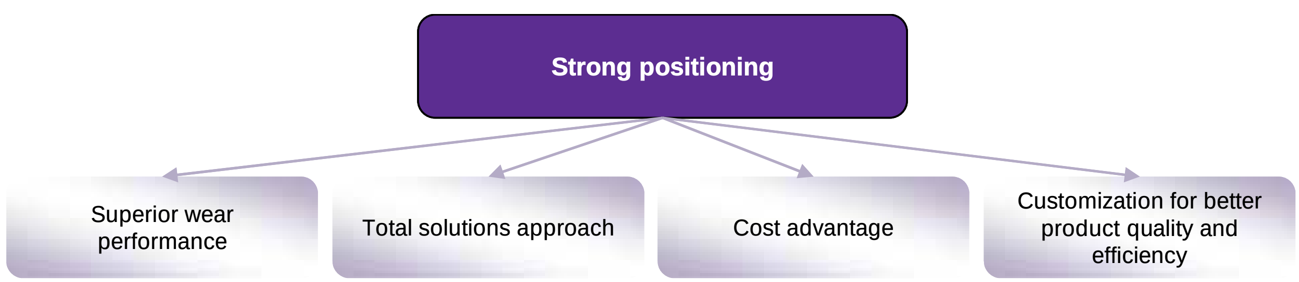


Source: Company, IDFC Securities Research

❑ Strong positioning to drive volume growth

AIA supplies to all major global mining companies. It has a presence in 30-40 mining sites across Australia, Africa and North America. Most of AIA's clients are outside India (70% of revenues from international markets).

Exhibit 2: AIA key competitive strengths in the mining segment



Source: Company, IDFC Securities Research

Some of the key drivers that would enable AIA to gain market share in the mining space are:

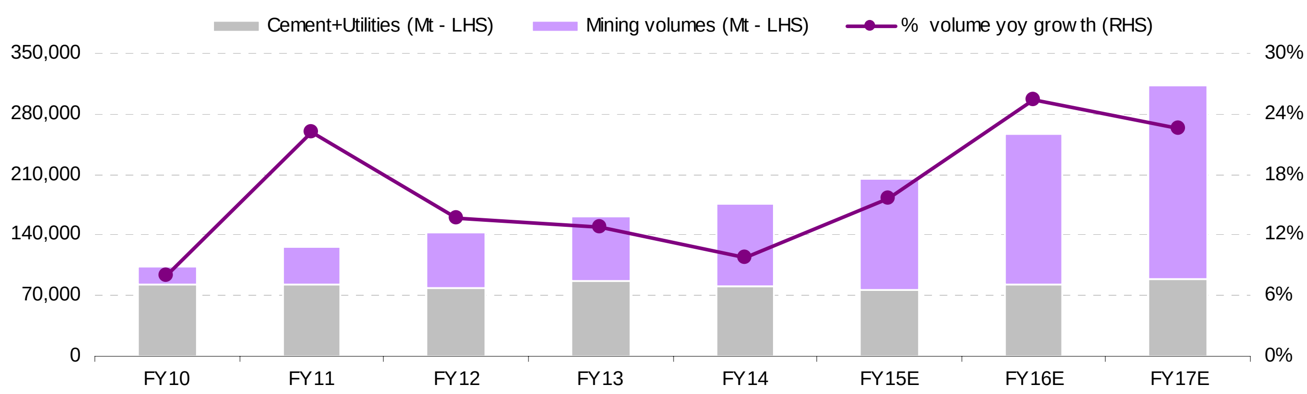
Presence across ores: AIA entered the mining consumable business in FY09 by supplying mill internals for iron ore and platinum mining. In FY12, AIA forayed into gold and copper mining, where the replacement market is typically large and high chrome media penetration is low. The management indicated that sea water used for copper extraction causes higher wear. Conversion to chrome would provide a higher conversion rate. With a large proportion of an expected 33% CAGR in mining volumes expected to be driven by the copper and gold segments, we see AIA clocking a volume CAGR of 21% over FY14-17E.

Customization of solutions leads to client stickiness: The replacement market of forged media to high chrome grinding media entails a higher degree of customization and is marked by low penetration. The grinding needs of every client significantly vary depending on ore quality. Accordingly, the process of customization could be fairly long, ranging from 9-15 months depending on the degree of customization. However, the demands of this process ensure customer stickiness and repeat orders. Also, the fact that any snag in plants due to quality issues on mill internals could disrupt production contributes to customer stickiness.

Expansion of product portfolio: AIA foray into mining was initially marked by high chrome grinding media and subsequently development of specialized solutions in the space. AIA is extending its range of products in the mining consumable segment by developing mining liners, which would ensure volume growth in the segment over the medium term. The foray into liners (capacity of 40,000 tonnes) could improve AIA's addressable market and margins. AIA is also strengthening its product basket by developing expertise for SAG mills.

Given its strong positioning, we expect AIA to witness a 21% CAGR in volumes led by a 33% CAGR in mining volumes.

Exhibit 3: Strong volume growth led by the mining segment

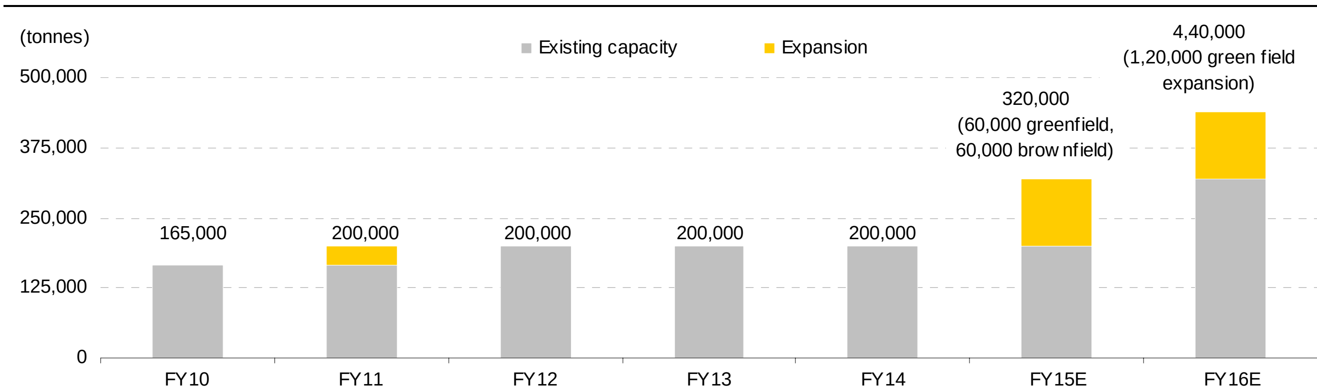


Source:Company, IDFC Securities Research

❑ Capacity expansion to tap long-term volume growth

AIA plans to aggressively increase capacity to 440,000 tonnes by FY16 from 200,000 tonnes as of FY14. Brownfield expansion of 60,000 tonnes has been completed (Q1FY15). The first phase of greenfield expansion of ~60,000 tonnes is expected to be completed by Mar 2015. The remaining 120,000 tonnes would be established in two phases of 60,000 tonnes each by the end of FY16. The total outlay for the expansion is Rs6bn, which would be funded by internal accrual. So, we expect mining volumes to almost double to ~170,000 tonnes by FY16 from ~96,000 tonnes as of FY14.

Exhibit 4: Aggressive capacity expansion



Source:Company, IDFC Securities Research

❑ Margins to moderate over FY15-16E

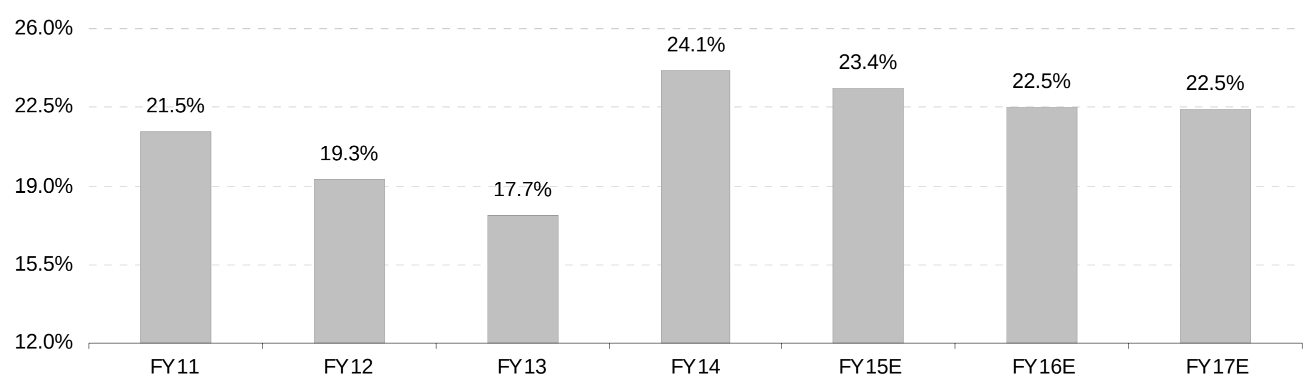
AIA's operating profit margins expanded by 640bp yoy to 24.1% in FY14. This was led by price hikes, better product mix and rupee depreciation. The management believes long-term sustainable margins would be in the range of 20-23% given AIA's strong positioning (cost advantage, efficiencies, etc). It does not perceive any pricing threat from smaller forging players as they operate at very thin margins. AIA's margins may increase or decrease based on product mix (larger grinding media, liners, etc) and cost dynamics (free trials, discounts, currency, etc).

Strong advantages for customers: High-chrome mill internals reduce breakdown time, improve productivity, lower the cost of power and production and are subject to lower wear and tear of parts used for grinding (implying longer life). The overall cost saving is estimated to be 15-25% over the life cycle of the product, which allows AIA to retain its margins as cost benefits of clients outstrip price increase.

Customized solutions driving customer stickiness: The need for reliable and efficient grinding media is extremely crucial for smooth crushing/ grinding operations. Mill internals form an integral part for the entire manufacturing process and inferior products could severely affect output, leading to a hit to profitability. Also, the fact that AIA customizes products for clients implies lower threat from competition.

Margins of 22.5% in FY16E: We expect margins to fall by 150bp over FY14-16E to 22.5% as AIA is still in the process of increasing utilization levels of the expanded capacity by acquiring new clients in the mining segment. However, there could be upside to our margin estimates, aided by an improvement in product mix (liners, SAG mills, etc).

Exhibit 5: Operating margins to remain at 22-23% levels



Source:Company, IDFC Securities Research

Income statement (Consolidated)

Year to 31 Mar (Rs m)	FY13	FY14	FY15E	FY16E	FY17E
Net sales	**17,513**	**20,801**	**23,342**	**29,019**	**35,489**
% growth	*23.6*	*18.8*	*12.2*	*24.3*	*22.3*
Operating expenses	14,411	15,779	17,890	22,479	27,497
EBITDA	**3,103**	**5,021**	**5,451**	**6,541**	**7,992**
% change	*13.5*	*61.8*	*8.6*	*20.0*	*22.2*
Other income	213	334	571	493	565
Net interest	(64)	(64)	(38)	(36)	(24)
Depreciation	345	382	492	665	802
Pre-tax profit	2,907	4,910	5,492	6,333	7,732
Deferred tax	12	17	55	63	77
Current tax	780	1,419	1,593	1,836	2,242
Profit after tax	**2,116**	**3,475**	**3,844**	**4,433**	**5,412**
Minorities	(8)	(7)	(8)	(10)	(11)
Net profit after non-recurring items	2,108	3,467	3,836	4,423	5,401
% change	*16.8*	*64.5*	*10.6*	*15.3*	*22.1*

Balance sheet (Consolidated)

As on 31 Mar (Rs m)	FY13	FY14	FY15E	FY16E	FY17E
Paid-up capital	189	189	189	189	189
Reserves & surplus	13,989	17,200	20,264	23,748	27,991
Total shareholders' equity	14,259	17,466	20,538	24,033	28,287
Total current liabilities	2,446	3,457	3,576	4,544	5,565
Total debt	1,609	1,206	1,206	1,206	706
Deferred tax liabilities	132	200	255	318	395
Total liabilities	4,188	4,862	5,036	6,068	6,666
Total equity & liabilities	**18,446**	**22,329**	**25,575**	**30,101**	**34,953**
Net fixed assets	4,190	5,035	6,835	8,638	8,803
Investments	1,941	5,291	5,291	5,291	5,291
Total current assets	12,316	12,003	13,449	16,172	20,858
Working capital	9,869	8,546	9,873	11,628	15,294
Total assets	**18,447**	**22,329**	**25,575**	**30,101**	**34,953**

Cash flow statement (Consolidated)

Year to 31 Mar (Rs m)	FY13	FY14	FY15E	FY16E	FY17E
Pre-tax profit	2,907	4,910	5,492	6,333	7,732
Depreciation	345	382	492	665	802
Chg in Working capital	(800)	509	(797)	(1,236)	(1,982)
Total tax paid	(780)	(1,419)	(1,593)	(1,836)	(2,242)
Operating cash Inflow	1,672	4,382	3,594	3,925	4,310
Capital expenditure	(794)	(1,227)	(2,292)	(2,467)	(967)
Free cash flow (a+b)	878	3,156	1,302	1,458	3,342
Chg in investments	(538)	(3,350)	-	-	-
Debt raised/(repaid)	1,130	(403)	-	-	(500)
Dividend (incl. tax)	(332)	(445)	(778)	(797)	(970)
Misc	152	449	(0)	0	-
Net chg in cash	1,290	(594)	524	661	1,872

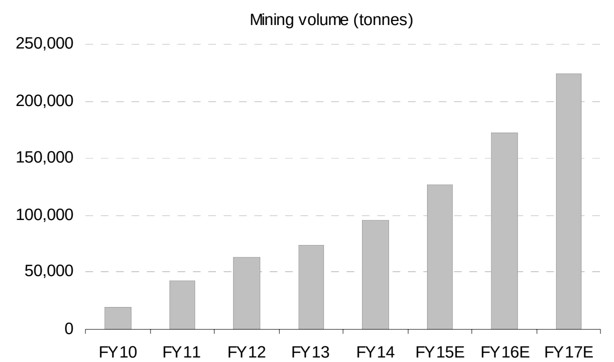
Key ratios (Consolidated)

Year to 31 Mar	FY13	FY14	FY15E	FY16E	FY17E
EBITDA margin (%)	17.7	24.1	23.4	22.5	22.5
EBIT margin (%)	15.7	22.3	21.2	20.2	20.3
PAT margin (%)	12.0	16.7	16.4	15.2	15.2
RoE (%)	15.8	21.9	20.2	19.8	20.6
RoCE (%)	19.0	26.6	24.3	24.7	26.2
Gearing (x)	(0.1)	(0.1)	(0.1)	(0.1)	(0.2)

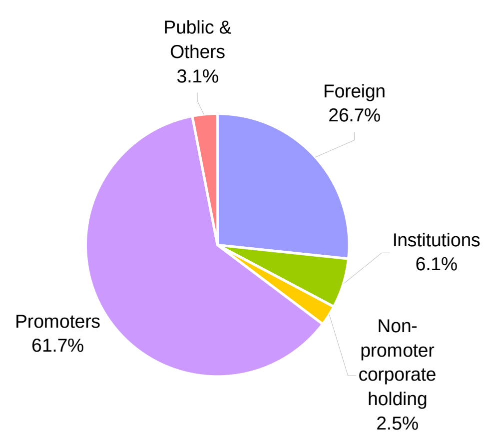
Valuations (Consolidated)

Year to 31 Mar	FY13	FY14	FY15E	FY16E	FY17E
Reported EPS (Rs)	22.3	36.8	40.7	46.9	57.3
Adj. EPS (Rs)	22.3	36.8	40.7	46.9	57.3
PE (x)	41.4	25.2	22.8	19.7	16.2
Price/ Book (x)	6.1	5.0	4.3	3.6	3.1
EV/ Net sales (x)	4.9	4.2	3.7	2.9	2.3
EV/ EBITDA (x)	27.8	17.2	15.8	13.0	10.4
EV/ CE (x)	5.4	4.6	3.9	3.3	2.8

Mining volume trend



Shareholding pattern



As of June 2014

Analyst	Sector/Industry/Coverage	E-mail	Tel.+91-22-6622 2600
Anish Damania	Co-CEO - IDFC Securities, Head - Institutional Equities; Strategy	anish.damania@idfc.com	91-22-6622 2522
Shirish Rane	Head of Research; Construction, Power	shirish.rane@idfc.com	91-22-662 22575
Prakash Joshi	Oil & Gas, Metals, Mining	prakash.joshi@idfc.com	91-22-662 22564
Nitin Agarwal	Pharmaceuticals, Real Estate, Agri-inputs	nitin.agarwal@idfc.com	91-22-662 22568
Hitesh Shah, CFA	IT Services & Telecom	hitesh.shah@idfc.com	91-22-662 22565
Manish Chowdhary	Financials	manish.chowdhary@idfc.com	91-22-662 22563
Bhoomika Nair	Engineering, Cement, Power Equipment, Logistics	bhoomika.nair@idfc.com	91-22-662 22561
Rohit Dokania	Media & Entertainment	rohit.dokania@idfc.com	91-22-662 22567
Deepak Jain	Automobiles, Auto ancillaries	deepak.jain1@idfc.com	91-22-662 22562
Ashish Shah	Construction, Power	ashish.shah@idfc.com	91-22-662 22560
Abhishek Gupta	Telecom, IT services	abhishek.gupta@idfc.com	91-22-662 22661
Mohit Kumar, CFA	Construction, Power	mohit.kumar@idfc.com	91-22-662 22573
Param Desai	Pharmaceuticals, Real Estate, Agri-inputs	param.desai@idfc.com	91-22-662 22579
Sameer Narang	Strategy, Economy	sameer.narang@idfc.com	91-22-662 22566
Vijayaraghavan G	Midcaps	vijayaraghavan.g@idfc.com	91-22-662 22690
Probal Sen	Oil & Gas	probal.sen@idfc.com	91-22-662 22569
Saumil Mehta	Metals, Mining	saumil.mehta@idfc.com	91-22-662 22578
Harit Kapoor	FMCG, Retail, Alcoholic Beverages	harit.kapoor@idfc.com	91-22-662 22649
Sameer Bhise	Financials	sameer.bhise@idfc.com	91-22-662 22635
Abhishek Ghosh	Engineering, Cement, Power Equipment, Logistics	abhishek.ghosh@idfc.com	91-22-662 22658
Dharmendra Sahu	Database Analyst	dharmendra.sahu@idfc.com	91-22-662 22580

Equity Sales/Dealing	Designation	E-mail	Tel.+91-22-6622 2500
Ashish Kalra	Managing Director, Sales	ashish.kalra@idfc.com	91-22-6622 2525
Rajesh Makharia	Director, Sales	rajesh.makharia@idfc.com	91-22-6622 2528
Palak Shah	SVP, Sales	palak.shah@idfc.com	91-22-6622 2696
Varun Saboo	VP, Sales	varun.saboo@idfc.com	91-22-6622 2558
Arati Mishra	VP, Sales	arati.mishra@idfc.com	91-22-6622 2597
Hemal Ghia	VP, Sales	hemal.ghia@idfc.com	91-22-6622 2533
Tanvi Dixit	AVP, Sales	tanvi.dixit@idfc.com	91-22-6622 2595
Nirav Bhatt	AVP, Sales	nirav.bhatt@idfc.com	91-22-6622 2681
Chandan Asrani	Manager, Sales	chandan.asrani@idfc.com	91-22-6622 2540
Sneha Baxi	Manager, Sales	sneha.baxi@idfc.com	91-22-6622 2537
Suryakant Bhatt	Director & Head - Sales trading	suryakant.bhatt@idfc.com	91-22-6622 2693
Mukesh Chaturvedi	Director, Sales trading	mukesh.chaturvedi@idfc.com	91-22-6622 2512
Viren Sompura	SVP, Sales trading	viren.sompura@idfc.com	91-22-6622 2527
Rajashekhar Hiremath	SVP, Sales trading	rajashekhar.hiremath@idfc.com	91-22-6622 2516
Alok Shyamsukha	VP, Sales trading	alok.shyamsukha@idfc.com	91-22-6622 2523

IDFC Securities US	Designation	E-mail	Telephone
Ravilochan Pola	CEO	ravilochan.pola@idfc.com	001 646 756 5865

www.idfc.com

IDFC Securities
Naman Chambers, C-32, 7th floor,
G- Block, Bandra-Kurla Complex,
Bandra (East), Mumbai 400 051
INDIA

Tel: +91 22 6622 2600
Fax: +91 22 6622 2503

IDFC Capital (USA) Inc,
Regus Business Centre
600 Third Avenue,
2nd Floor,
New York,10016

Tel: +1 646 571 2303
Fax: +1 646 571 2301

Our research is also available on Bloomberg and Thomson Reuters

For any assistance in access, please contact research@idfc.com