September 24, 2014

SKF India (SKFBEA)

₹ 1040

Leader in bearings space…

SKF India (SKF) is the largest bearing manufacturer in India with an overall market share of ~28%. Being the largest player in the industry, SKF commands scalability bandwidth coupled with a lean balance sheet and is poised to capture the opportunity arising from the revival of demand in the automotive and industrial segments. The company has an equal presence across the industrial (46% of sales) and automotive segment (54% of sales), spread across OEMs (55% of sales) and aftermarket. Hence, SKF is well diversified to weather the cyclical downturns in any segment. Going ahead, with an anticipated recovery in end user industry, we expect revenues to bounce back at 13.4% CAGR over CY13-16E and margins to recover to 13.6% in CY16E vs. 11.5% in CY13, driving earnings growth at a CAGR of 24% in CY13-16E. A healthy balance sheet, robust cash flow generation, strong parentage & product profile and strong distribution reach are other key positives. Hence, we initiate coverage with a BUY recommendation on the stock.

Leading bearing manufacturer with equal presence in industrial & auto

SKF is the leader in the Indian bearing market with ~28% share. Known for deep groove ball bearings (forming ~35% of revenues and ~45% market share), SKF is equally present across the industrial (46% of sales) and automotive segments (54% of sales). With the auto segment showing signs of a recovery and an expected industrial revival, going ahead, SKF, is well poised to capture the opportunity given its strong balance sheet with cash flow generation and scalability bandwidth. We expect revenues to grow at 13.2% CAGR over CY13-15E to ₹ 2809 crore.

Localisation of industrial bearing to boost margins & market share…

Industrial bearings (46% of revenues) are sourced from the parent (~90%) and SKF Technologies. We expect import substitution of industrial bearings, through ramp up in SKF Technologies, to be a key revenue driver for SKF's revenues and margin expansion as SKF would improve its turnaround time while the resultant cost saving would lead to market share gains. Consequently, we expect industrial (traded goods) sales to grow at 11.3% CAGR over CY13-16E with overall EBITDA margins recovering to 13.6% in CY16E vs. 11.5% in CY13.

Premium valuations driven by growth prospects ahead…

SKF is trading at 17.2x CY16E EPS. Given SKF's leadership position in the bearing space, strong earnings growth (CAGR of 24% in CY13-16E), healthy balance sheet with robust cash flow generation (₹ 675 crore over CY14E-16E) and core RoEs in excess of 30%, we ascribe a P/E multiple of 24x (implying a PEG of 1x) on the average of CY15E and CY16E EPS. Hence, we assign a target price of ₹ 1324/share with a **BUY** rating.

Exhibit 1: Valuation Metrics

(Year-end December)	CY12	CY13	CY14E	CY15E	CY16E
Net Sales (₹ crore)	2,204.1	2,246.4	2,466.5	2,804.9	3,257.9
EBITDA (₹ crore)	258.4	261.4	309.9	375.9	450.9
Net Profit (₹ crore)	190.1	166.7	217.5	263.6	318.0
EPS (₹)	36.0	31.6	41.2	50.0	60.3
P/E (x)	28.9	32.9	25.2	20.8	17.2
Price / Book (x)	4.7	4.3	3.8	3.3	2.9
EV/EBITDA (x)	20.0	19.5	16.0	12.8	10.2
RoCE (%)	18.6	16.6	17.8	19.2	20.3
RoE (%)	16.5	13.1	15.1	15.9	16.6

Source: Company, ICICIdirect.com Research

Rating Matrix

Rating	:	Buy
Target	:	₹ 1324
Target Period	:	12-15 months
Potential Upside	:	27%

YoY growth (%)

(YoY Growth)	CY13	CY14E	CY15E	CY16E
Net Sales	1.9	9.8	13.7	16.2
EBITDA	1.2	18.6	21.3	20.0
Net Profit	(12.3)	30.4	21.2	20.6
EPS	(12.3)	30.4	21.2	20.6

Current & target multiple

(x)	CY13	CY14E	CY15E	CY16E
P/E	32.9	25.2	20.8	17.2
Target P/E	41.9	32.1	26.5	21.9
EV / EBITDA	19.5	16.0	12.8	10.2
P/BV	4.3	3.8	3.3	2.9
RoNW (%)	13.1	15.1	15.9	16.6
RoCE (%)	16.6	17.8	19.2	20.3

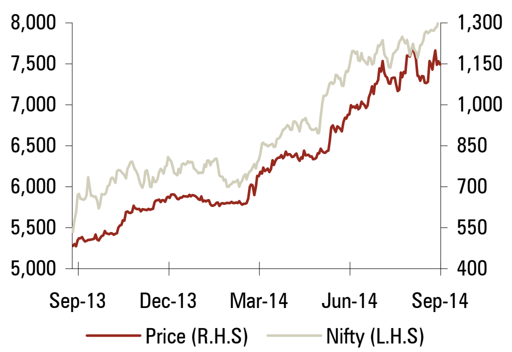
Stock Data

Bloomberg/Reuters Code	SKF IN / SKFB.NS
Sensex	26,736
Average volumes	72,613
Market Cap (₹ crore)	5,483.9
52 week H/L	1209 / 482
Equity Capital (₹ crore)	52.7
Promoter's Stake (%)	53.6
FII Holding (%)	15.5
DII Holding (%)	17.1

Comparative return matrix (%)

Return %	1M	3M	6M	12M
SKF India	(1.5)	23.8	73.0	142.4
FAG Bearings	6.0	21.4	64.1	137.0
NRB Bearings	20.9	28.7	170.1	233.2
Timken India	31.6	92.2	151.5	177.4

Price movement



Analyst's name

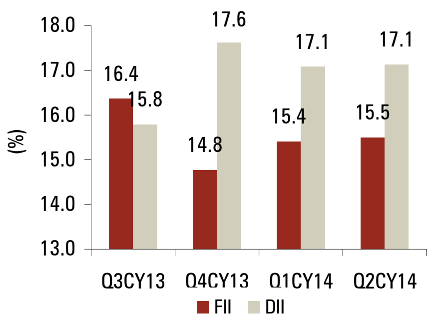
Chirag J Shah
shah.chirag@icicisecurities.com

Bhupendra Tiwary
bhupendra.tiwary@icicisecurities.com

Shareholding pattern (Q2CY14)

Shareholder	Holding (%)
Promoters	53.6
Institutional investors	32.6
General public	13.8

FII & DII holding trend (%)



Company background

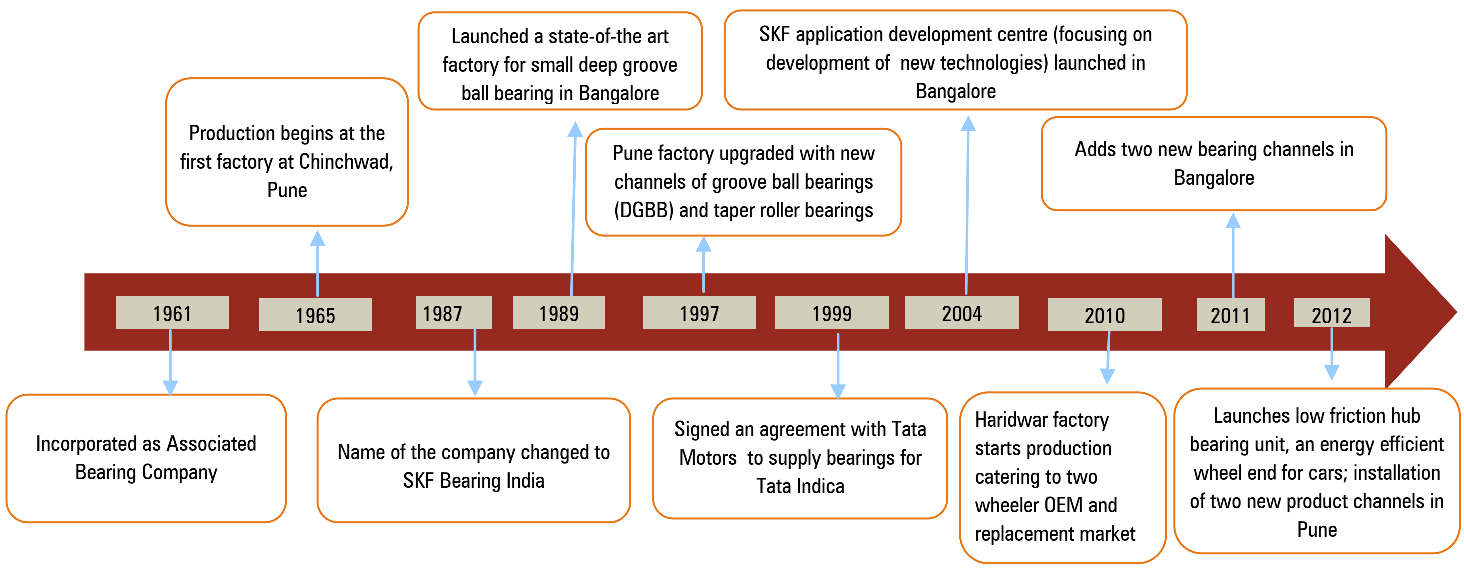
Incorporated in 1961, SKF India is the Indian subsidiary of the Sweden based SKF Group, which is a global leader in bearings, seals and mechatronics & lubrication systems. The company is a leader in the Indian bearing market with ~28% market share. SKF is well diversified across the automotive (54% of revenues including exports, which are manufactured in India) and industrial segment (46% of revenues, which are mainly imported from SKF Group companies) as well as SKF Technologies (the subsidiary of the parent).

In the automotive segment, SKF India caters to both two-wheelers as well as four-wheelers (PV, CV, tractors, etc.) of which two-thirds come from OEMs and remaining from the replacement markets. SKF India caters to almost all automotive OEMs in India such as Tata Motors, Hero MotoCorp, HMSI, Maruti, Bajaj Auto, Mahindra & Mahindra, TVS, Bosch, etc. In the industrial segment, SKF India supplies to all major industries like heavy industries such as steel, mining etc, agriculture, power, capital goods, oil & gas and food & beverage (F&B). Within industrial, ~65% pertains to aftermarket and 35% to OEMs. Its clientele includes: **heavy industries**: SAIL, Coal India, JSW, Essar, Tata Steel; **energy**: NTPC, Tata Power, Suzlon; **industrial machinery:** Bhel, GE, L&T; **oil & gas:** Reliance, ONGC, Cairn India; **F&B:** Nestlé, ITC, Pepsi.

SKF India has three manufacturing facilities:

- **Pune**: Established in 1965, it produces deep groove ball bearing, tapered roller bearing, truck hub units, hub bearing units, etc. for the automotive & industrial (small portion) segments
- **Bangalore:** Established in 1989, it produces deep groove ball bearing and value-added solutions like rocker arm bearing, rocker arm assembly, clutch lifter, cam follower, cylindrical rollers, solid oil ball cage, steering column bearings and one way clutch for the automotive & industrial (small portion) segments
- **Haridwar:** Established in 2010, it produces deep groove ball bearings for the two-wheelers segment

Exhibit 2: SKF India – a timeline of company milestone



Source: Company, ICICIdirect.com Research

Exhibit 3: SKF – Segmental look at company

	Automotive segment	Industrial Segment
Products	Hub bearing units, tapered roller bearings, small deep groove ball bearings, steering column bearing, suspension bearing units, magnetic bearings	Spherical and cylindrical roller bearings, angular contact ball bearings, medium deep groove ball bearings, super-precision bearings, bearing housings and units – as well as lubrication systems, linear motion products, magnetic bearings, by-wire systems and couplings
Revenue share (CY13 revenue)	~54% (including 9% exports) ₹ 1189 crore	~46% ₹ 1057 crore
OEM share	67%	35%
Aftermarket share	33%	65%
Gross margins (Average over CY10-13)	48% (Manufactured in India)	18% (Sourced from SKF AB and SKF Technologies)
Growth drivers	Auto sales volumes influenced by inflation, per capita income and GDP growth	Pick-up in industrial activity, IIP growth, localisation of sourcing from SKF Technologies
Major Clients	Auto majors such as Tata Motors, Hero MotoCorp, HMSI, Maruti, Bajaj Auto, Mahindra & Mahindra, TVS, Bosch, etc	**Heavy industries:** SAIL, Coal India, JSW, Essar, Tata Steel **Energy:** NTPC, Tata Power, Suzlon **Industrial Machinery:** BHEL, GE, L&T **Oil & Gas**: Reliance, ONGC, CAIRN **F&B:** Nestle, ITC, Pepsi

Source: Company, ICICIdirect.com Research

Investment Rationale

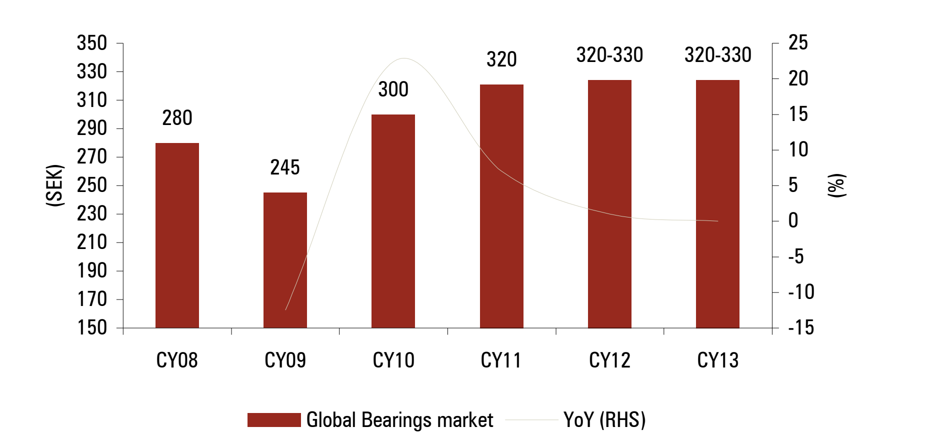
Strong parentage – leadership in global bearings markets

Global bearings industry

The global bearing industry has been pegged at SEK 320-330 billion (~US$47-48 billion). The global bearing industry has remained muted over the last two years given the overall slowdown in the end user industry. We highlight that the global bearings industry grew 1% and nil in CY12 and CY13, respectively.

The global bearing industry has remained muted over the last two years given the overall slowdown in the end user industry.

Exhibit 4: Global bearing market trend



Source: Company, ICICIdirect.com Research

In terms of geographical spread, Asia commands 50% of the global market sahre led by China and Japan that command 25% and 15% share, respectively. Europe is also a major market with 25% share wherein Germany commands a handsome 10% of global production.

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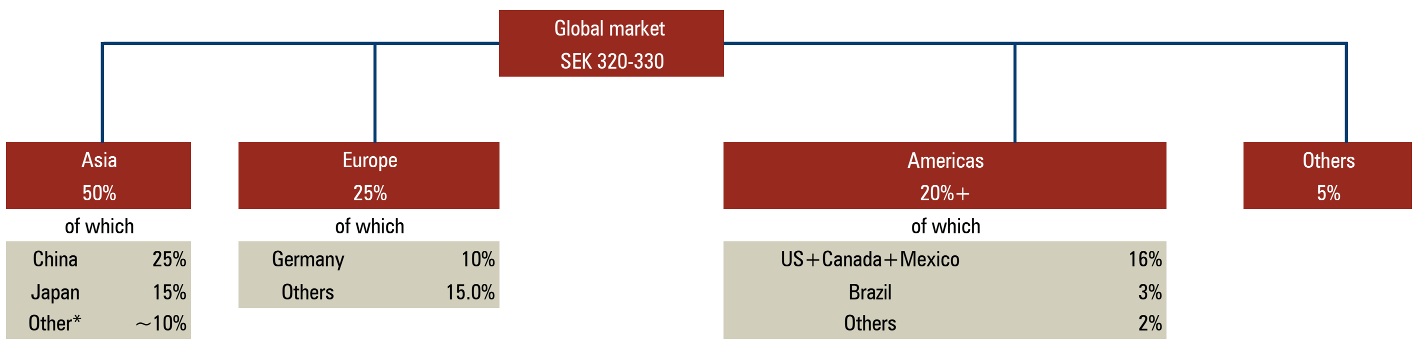
The top six world bearing manufacturers (SKF AB, Schaeffler Group, Timken, NSK, NTN, and JTEKT) represent about 60% of the global rolling bearing market while the group of Chinese bearing companies, including small and larger ones, represents less than 20% in the world.

Exhibit 5: Global bearing market

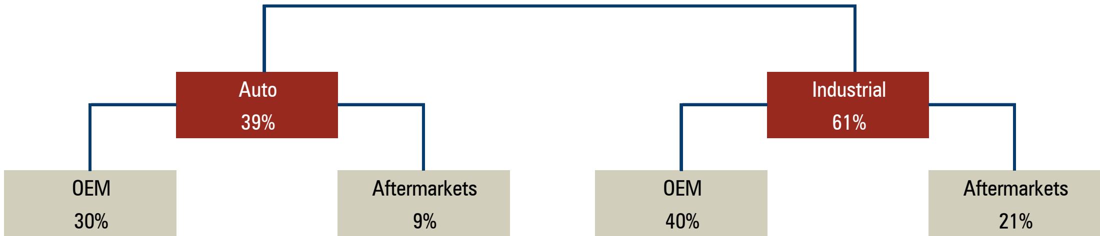


**(India, Indonesia Thailand, Malaysia, Korea)*

Source: Company, ICICIdirect.com Research

The automotive segment accounts for ~39% (~30% OEM and 9% after sales) of the bearing market while the remaining 61% (~40% OEMs and ~21% after sales) pertains to the industrial segment.

Exhibit 6: Segmentation of global bearing market



Source: Company, ICICIdirect.com Research

SKF Group – leader in global bearings industry

The SKF Group (SKF AB) is a leading global supplier of products, solutions and services within rolling bearings, seals, mechatronics, services and lubrication systems. Services include technical support, maintenance services, condition monitoring, asset efficiency optimisation, engineering consultancy and training.

SKF AB is the world leader in the bearings market with other major international companies including the Schaeffler Group, Timken, NSK, NTN and JTEKT. SKF, with a turnover of SEK 63.6 billion (US$9.3 billion) in CY13, holds ~19.2% share in the global bearings market. In terms of segmental bifurcation, the industrial segment contributes 68% of overall revenues while the rest comes from the automobile segment. Geographically, Western Europe, North America, Asia Pacific constitutes a lion's share of revenues at 35%, 24%, 24% in CY13, respectively.

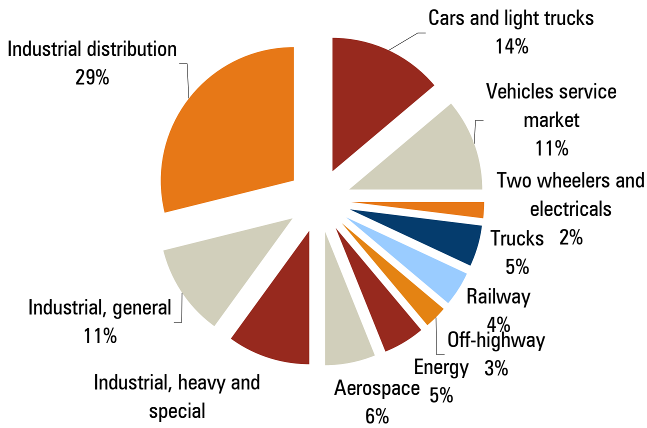
Founded in 1907, SKF has rapidly grown to become a global company and is well established in all five continents. SKF AB is present in nearly all industries, including cars & light trucks, marine, aerospace, renewable energy, railway, metal, machine tool, medical and food & beverage.

SKF, with a turnover of SEK 63.6 billion in CY13, holds ~19.2% share in the global bearings market

SKF has segmented its business into four areas namely:

- **Automotive:** This segment consists of five business units that offer and deliver a full range of products, solutions and services to both OEMs and aftermarket customers. The business units are: power train/electrical/two-wheelers, car chassis, trucks, sealing solutions and vehicle service market
- **Industrial market, strategic industries:** It consists of seven business units that develop, offer and sell a full range of products, solutions and services to both OEMs and end users for their different customer industries. The business units are: aerospace, renewable energy, traditional energy, Railway and off-highway, industrial drives, precision and lubrication
- **Industrial market, regional sales and service:** Regional sales and service develops the full range of solutions for both OEMs and end users within its "focused industries" metals, pulp & paper, mining & cement, food & beverage and marine as well as all other industrial customers not covered by strategic industries
- **Specialty business:** It is a new business area, which will cover the range of products, solutions, services and expertise that are complimentary to the other three business areas

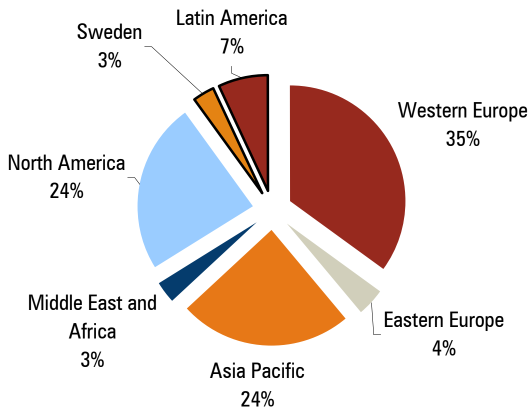
Exhibit 7: Net sales 2013 by customer industries



Source: Company, ICICIdirect.com Research

Asia Pacific (forming 24% of the sales) is the second largest market for SKF AB

Exhibit 8: Net sales in 2013 by geographic area



Source: Company, ICICIdirect.com Research

Financial targets of the group

SKF AB's financial targets are to achieve an operating margin of 15%, annual sales growth in local currencies of 8% and a return on capital employed (RoCE) of 20%.

While the Indian business unit does not spell out explicit financial targets, we believe that given the fact that the Asia Pacific region would be driving the growth, India business growth would be higher than group level growth

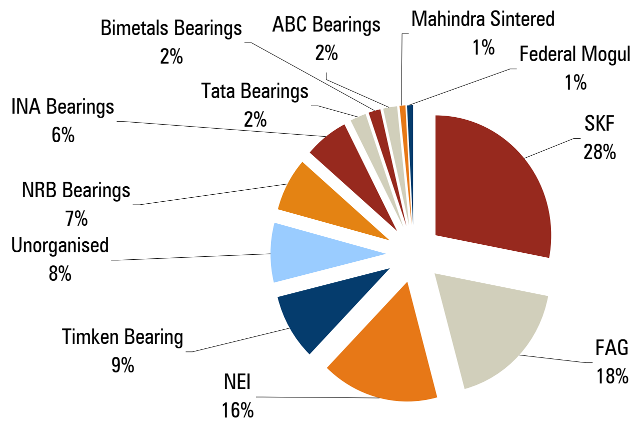
While the Indian business unit does not spell out explicit financial targets, we believe that given the fact that the Asia Pacific region would be driving the growth, India business growth would be higher than group level growth. Furthermore, being the leader in the Indian bearing industry backed by large capacity and strong parent linkage, SKF is well poised to capture the revival in the Indian bearing sector on the back of a recovery in the overall economy.

Indian bearing industry – Economic recovery to propel growth

The Indian bearing industry, pegged at ₹ 8000-8500 crore, accounts for less than 4% of the world's bearing market

The domestic bearing industry, pegged at ₹ 8000-8500 crore, accounts for less than 4% of the global bearing market. It comprises both the organised and unorganised segment. Organised players include global bearing majors like SKF, FAG and Timken who cater to the Indian market through a mix of import from their parents (mainly for industrial bearings) and domestic manufacturing facilities. Other players in the organised space include domestic players such as NEI, NRB, ABC and Tata. In terms of market dominance, MNCs like SKF (28% share), FAG (18%) and Timken (9%) cumulatively command 55% of the overall market.

Exhibit 9: Break-up of market share (by sales)

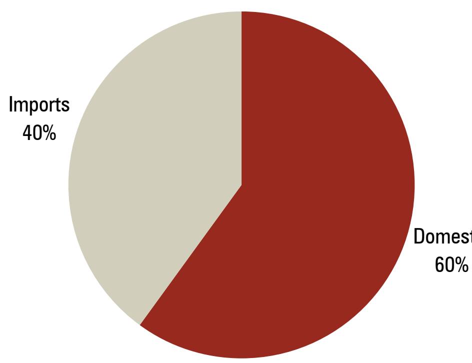


Source: Capitaline, ICICIdirect.com Research

Total 60% of the industry demand is met through domestic production while imports of industrial bearings, especially by leading players, meet the remaining 40% of demand

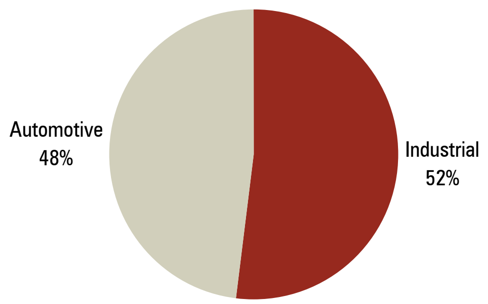
In terms of consumption, 60% of the industry demand is met through domestic production while imports of industrial bearings, especially by leading players, meet the remaining 40% of demand. The bearing sector is equally distributed between the industrial and automotive segments. In terms of customer profiling, OEMs are the chief demand driver, with ~65% share while the after market segment forms the remaining 35%.

Exhibit 10: Total 60% of industry demand met through domestic production



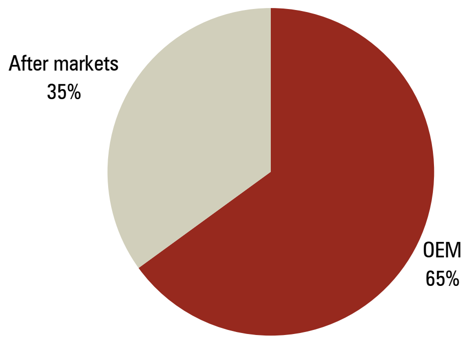
Source: Company, ICICIdirect.com Research

Exhibit 11: Equally distributed between industrial & automotive segment



Source: Company, ICICIdirect.com Research

Exhibit 12: OEMs chief demand driver, with ~65% share

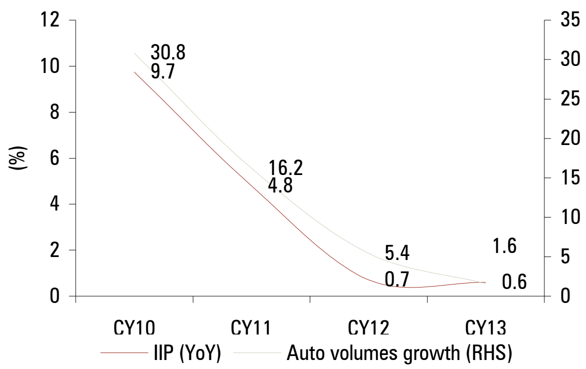


Source: Company, ICICIdirect.com Research

Over the last two or three years, the industry has remained muted given the overall slowdown in the economy (IIP fell to 0.6% in CY13 vs. 9.7% in CY10) as well as stagnant auto sales (1.6% in CY13 vs. 30.8% in CY10)

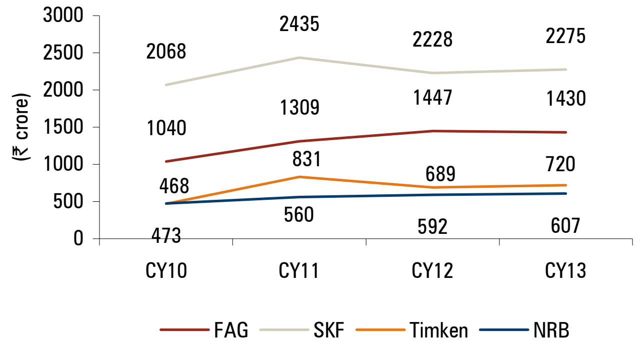
Over the last two or three years, the industry has remained muted given the overall slowdown in economy (IIP fell to 0.6% in CY13 vs. 9.7% in CY10) as well as stagnant auto sales (1.6% in CY13 vs. 30.8% in CY10). With industry linked usage and demand of the bearing sector, the long term prospects of the Indian bearing market would be led by the recovery in the overall economy. The economic recovery is expected to revive industrial as well automotive segment demand.

Exhibit 13: Slowdown in IIP, auto volume growth…



Source: Company, ICICIdirect.com Research

Exhibit 14: …leads to slowdown in revenues of all key players



Source: Company, ICICIdirect.com Research

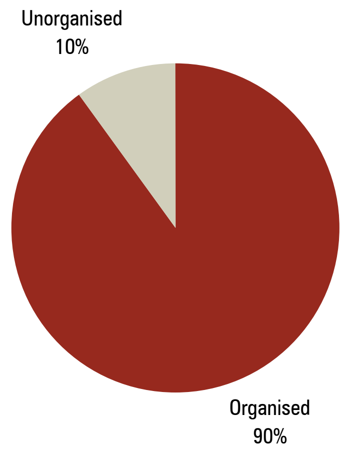
Industry structure – Low to moderate competitive intensity

Organised space forms 90% of market

The domestic bearing industry comprises both the organised as well as the unorganised segment. Players from the organised space contribute ~90% of the total industry size while the remaining 8-10% is from the unorganised segment, which comprises mainly the Chinese bearings serving the auto aftermarket. It should be noted that given the increasing preference for quality, focus on role of precision and technology, the overall pie has been shifting towards the organised space.

Players from the organised space contribute ~90% of the total industry size while the remaining 8-10% is from the unorganised segment, which mainly comprises the Chinese bearings serving the auto aftermarket

Exhibit 15: Organised segment contributes ~90% of total industry size



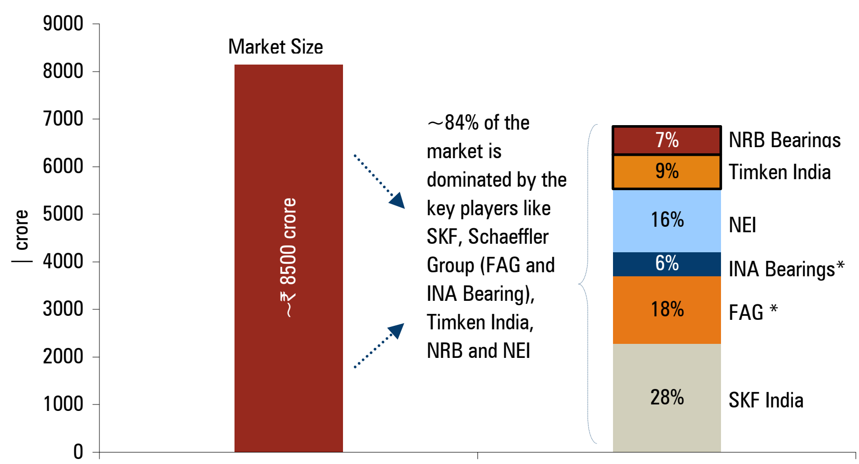
Source: Company, ICICIdirect.com Research

Top 6 players dominate over~80% of market

The Indian bearing industry is dominated by MNC players like SKF, Schaeffler Group (Fag and INA Bearing) and Timken India apart from India based manufacturers like NRB Bearings and NEI. These top players command over 80% of the market share, implying a concentrated industry structure.

Top players command over 80% of the market share, implying a concentrated industry structure

Exhibit 16: More than 80% of market dominated by top five players



Source: Company, ICICIdirect.com Research
** part of Schaeffler Group*

The competitive intensity in the bearing industry is relatively moderate as each of them specialise in a particular area, which forms the major portion of their revenues

Each players specialises in a particular area

While leading players such as SKF, Fag and Timken are present in production of all types of bearings, the competitive intensity in the bearing industry is relatively moderate. This is because each of them specialise in a particular area, which forms the major portion of the revenues. While SKF is a strong player in the ball bearing segment (forms 35% of revenues), Fag is a leader in the roller bearing segment (cylindrical and spherical with 45% share), NRB is a key player in the needle roller bearings (70% market share) and Timken is a leader in the tapered roller bearings segment (40-45% market share).

Exhibit 17: Competitive landscape

Players	Key competence	Market share	Closest Competitor	Application
SKF India	Deep Grove Ball Bearings	45%	FAG	Used in wheel axles, transmission, pumps, gear boxes, fans etc
FAG Bearings	Roller Bearings	45% (Spherical & Cylindrical)	SKF	Car suspension, drive shaft, heavy machinery, machine tools etc
NRB Bearings	Needle Roller Bearing	70%	INA Bearings	niche application in engine, gearbox.with less load & thrust.
Timken India	Tapered Roller Bearings	40-45%	SKF, FAG	Wide usage in commercial vehicles

Source: Company, ICICIdirect.com Research

Given the technology intensive nature of the industry, especially in terms of precision and advanced bearings, the current structure of the industry ensures the existing top players would continue to lead the sector

Technology tie-up key USP for all key players whether with parent/foreign partner

Given the strong role of technological expertise, especially for OEMs' bearings demand, most dominant names in the organised segment have a product/R&D back-up either with their parent (SKF,FAG and Timken) or a collaboration with a foreign partner(NEI, NRB and ABC), which ensures technological support. We highlight that given the technology intensive nature of the industry especially in terms of precision and advanced bearings, the current structure of the industry ensures the existing top players would continue to lead the sector.

Exhibit 18: Indian bearing sector and foreign technological partners

Indian player	Technological partner/parent
SKF India	SKF AB, Sweden
Fag Bearings	Schaeffler Group, US
Timken India	The Timken Company, US
NEI	NTN Japan
NRB Bearing	Nadella (erstwhile partner)
INA Bearings	Schaeffler Group, US

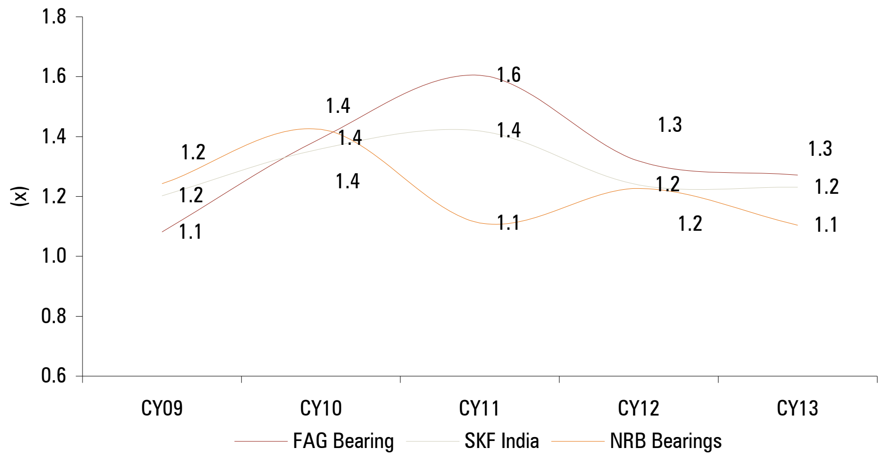
Source: Company, ICICIdirect.com Research

The bearing industry is a highly capital intensive business with a low asset turnover

High capex intensive – with low asset turnover

The bearing industry is a highly capital intensive business with a low asset turnover. While optically MNCs with a considerable proportion of traded goods have a higher asset turnover, adjusted for manufactured goods, the asset turnover ranges between 1.1x and 1.6x. Currently, in FY14/CY13, owing to underutilisation of capacity, asset turnovers of key players had touched CY09 lows. With the current IIP (April-July) growth of 3.3% and a strong recovery in auto segment volumes, demand should recover boosting asset utilisation. Hence, we believe the asset turnover is likely to recover from here on.

Exhibit 19: Industry characterised by high capex requirement with low asset turnover



Source: Company, ICICIdirect.com Research; #calculated on manufactured goods sales
**The data for NRB Bearings is for FY10, FY11, FY12, FY13 and FY14 respectively*

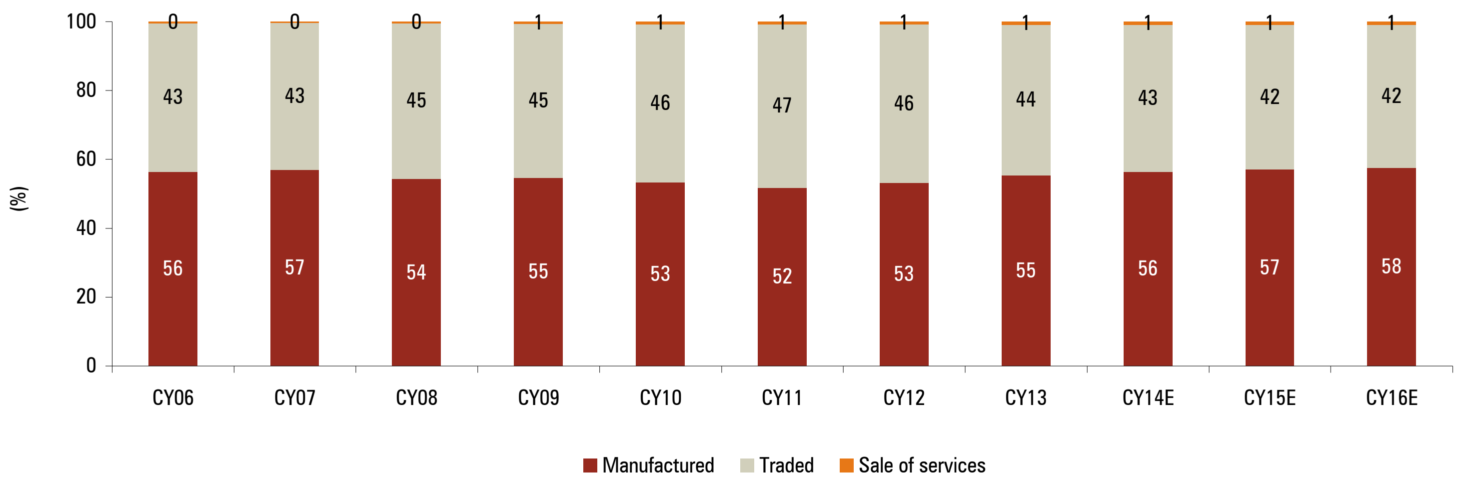
SKF India – Leader with diversification across segments…

Equal presence across automotive and industrial segment

SKF India is the largest player in the domestic bearings industry, pegged at ₹ 8000 crore, with ~28% market share. The company has consistently maintained its market share in CY07-13 between 26% and 28%. The ratio of manufactured goods to trading sales was 55:45 in CY13. While automotive bearings are manufactured locally, industrial bearings are imported from the parent (majority) as well as sourced from SKF Technologies (Indian subsidiary of the parent).

SKF is equally present across the industrial and automotive segments. While industrials form 46% of revenues, domestic automotive sales form 45% of revenues while the remaining 9% (all of which is automotive) is exported (refer exhibit 23).

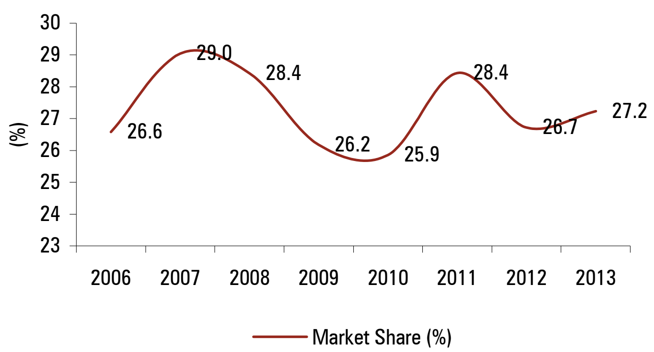
Exhibit 20: Break-up of net sales



Source: Company, ICICIdirect.com Research

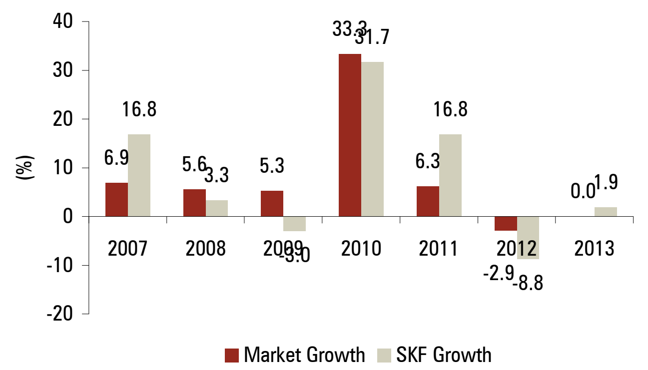
SKF, being the market leader, has mirrored industry growth. Over CY07-13, the bearing industry witnessed revenue CAGR of 7.3% vs. 6.2% CAGR for revenues of SKF. However, on a per annum revenue growth basis, SKF has outperformed the industry growth on four occasion in last seven years.

Exhibit 21: Trend in market share of SKF India over CY07-13



Source: Company, ICICIdirect.com Research

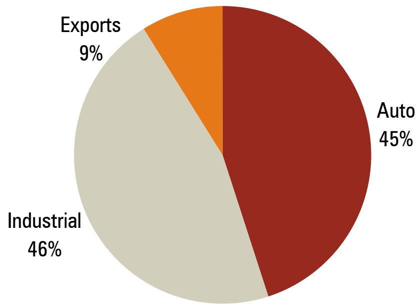
Exhibit 22: SKF's growth vis-à-vis industry revenue growth



Source: Company, ICICIdirect.com Research

SKF is equally present across the industrial and automotive segments. While industrial forms 46% of revenues, domestic automotive sales forms 45% of revenues and the remaining 9% (all of which is automotive) is exported

Exhibit 23: Revenue break-up (H1CY15)



Source: Company, ICICIdirect.com Research

Well diversified among OEMs and Aftermarket…

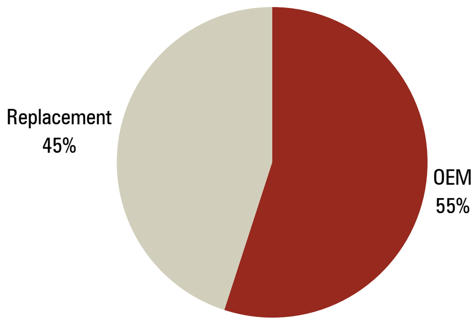
In terms of OEM and aftermarket segment, revenues are in the ratio of 55:45. In the auto segment, OEMs command 67% share of revenues while the aftermarket forms the remaining 33%. On the industrial business, aftermarket with 65% of the segment forms the major portion with industrial OEMs garnering the remaining 35%.

In the automotive segment, SKF has positioned itself in a well diversified manner across two wheelers (forming 50% of the automotive OEM segment) and four wheelers (PV, CV and off highways). Similarly, in the industrial segment, it is present across all sectors such as construction, aerospace, home appliances, food & beverage, industrial machinery, marine, material handling, pulp, paper, renewable, etc.

SKF's diversification across the auto and industrial segments and across customer profiling (OEMs vs. aftermarket) insulates it from a slowdown in a particular sector. Furthermore, no single customer forms more than 5% of revenues ensuring limited adverse impact in case of a demand slowdown from a particular client.

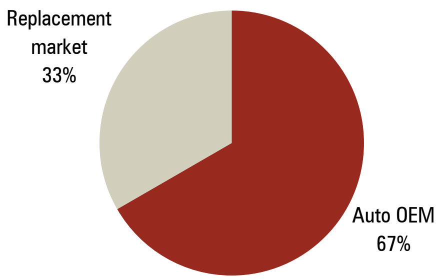
In the auto segment, OEMs with two-third of automotive revenues form the major part while aftermarket forms the remaining third of auto revenues. On the industrial business, aftermarket with 65% of the segment forms the major portion with industrial OEMs making up the remaining 35%

Exhibit 24: Overall break-up between aftermarket and OEM



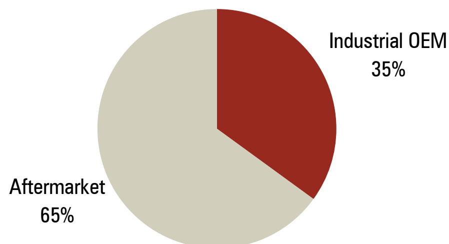
Source: Company, ICICIdirect.com Research

Exhibit 25: Break-up of auto OEMs and aftermarket



Source: Company, ICICIdirect.com Research

Exhibit 26: Break-up between industrial OEMs and aftermarket



Source: Company, ICICIdirect.com Research

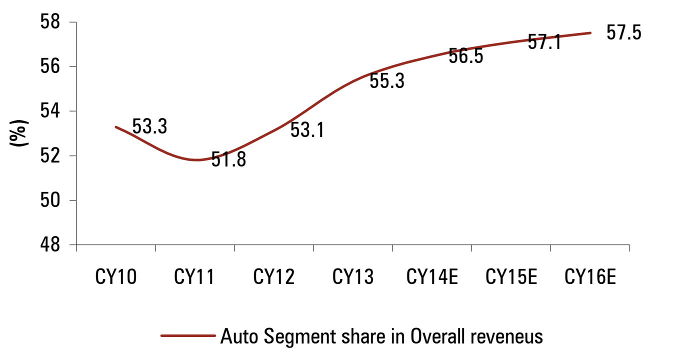
Automotive segment – improved sentiments to boost volumes ahead….

OEM dominates auto segment…

Category	Key Clients
2 wheelers	Hero Motocorp, Bajaj, HMSI
4 wheelers	Maruti, Hyundai
CV	Tata Motors, M&M, Ashok Leyland

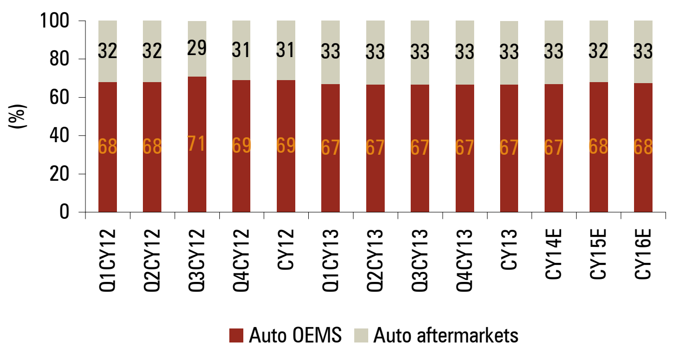
SKF manufactures automotive bearings in India and calls it manufactured goods while industrial bearings are imported from the parent and SKF Technologies and are termed as traded goods. The automotive segment (including exports) forms ~54% of revenues of SKF India. The auto segment of SKF is highly correlated to auto sector sales volumes as OEMs form two-third (~67%) of the segment for SKF. Over CY10-13, revenues of the auto segment have grown at a CAGR of 3% i.e. from ₹ 1087 crore in CY10 to ₹ 1189 crore in CY13. Within the auto segment, OEM segment revenues have grown at a CAGR of 3.1% while the after sales market recorded growth at 2.9% CAGR. Going ahead, the auto segment share is expected to grow to ~57.5% in CY16E driven mainly by strong auto volumes growth over the next three years. Furthermore, the OEMs share is also expected to increase to ~68% by CY16E, given the incremental pick in auto volumes.

Exhibit 27: Auto segment has formed ~53-55% of topline



Source: Company, ICICIdirect.com Research

Exhibit 28: OEMs with ~67% share dominate auto segment



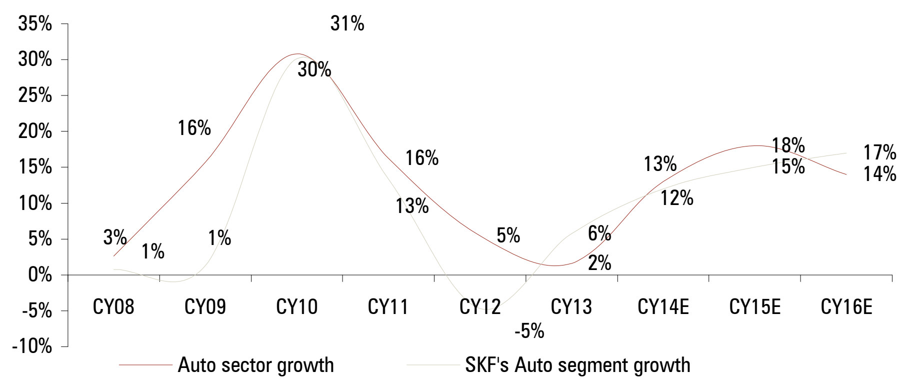
Source: Company, ICICIdirect.com Research

SKF's auto segment growth mimics auto industry sales volumes…

The auto segment sales growth has mimicked auto sales volumes. It is noteworthy, for the year, wherein auto volumes have jumped sharply SKF has shown a similar sharp uptick. For example, in CY10, when overall auto volumes grew ~30%, SKF's auto segment grew ~31% YoY. Similarly, during CY12 and CY13, which was challenging for the automotive segment (5% and 2% YoY growth in CY12 and CY13, respectively),SKF's auto segment declined at 0.2% CAGR in CY11-13 (-5% & 6% YoY in CY12 & CY13, respectively) exhibiting a strong correlation.

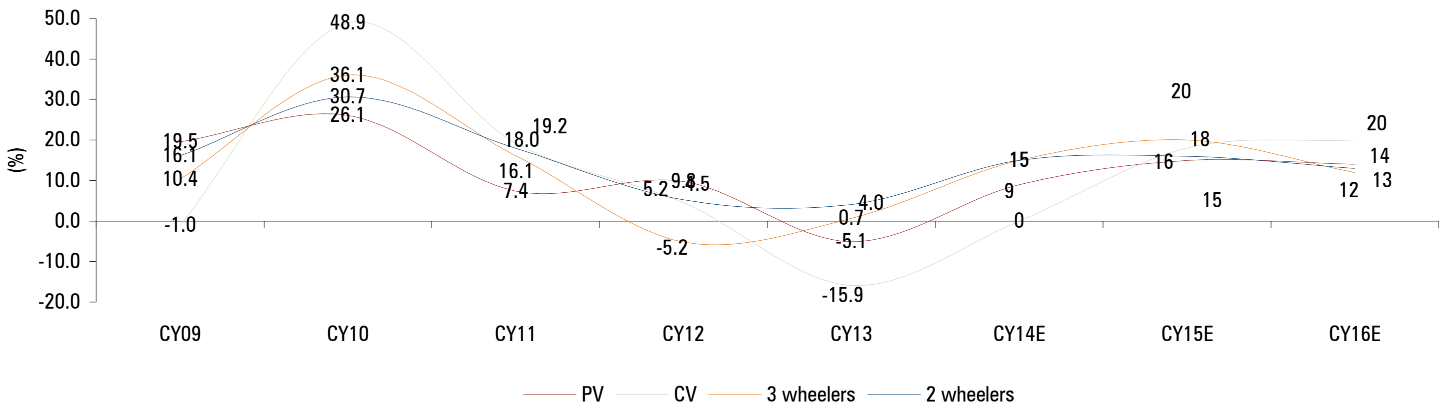
SKF's automotive segment sales growth (-0.2% CAGR over CY11-13) has mimicked auto sales volumes, which have remained muted in the last two years (~5% and ~2% YoY growth in CY12 and 13 respectively)

Exhibit 29: Auto sales growth and SKF auto segment growth trend



Source: Company, Bloomberg, ICICIdirect.com Research

Exhibit 30: YoY growth of auto volumes - segment wise



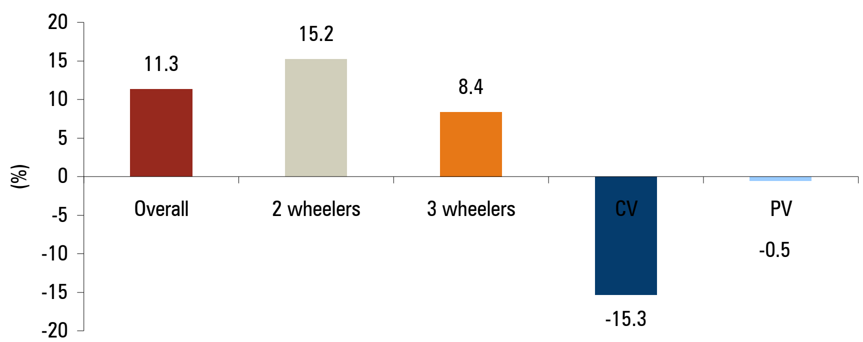
Source: ICICIdirect.com Research

For YTDCY14, the auto sector has shown signs of a recovery with ~11.3% growth (mainly driven by two wheelers segment growth, which was up 15.2% YoY)

Early signs of revival seen…strong launch pipeline bodes well for bearing demand…

For YTDCY14, the auto sector has shown signs of recovery with ~11.3% growth (mainly driven by two wheeler segment growth, which was up 15.2% YoY). With the auto industry finally showing signs of recovery after nearly two years of a demand slump, new launches and product refreshes are the key, going ahead (refer exhibits 32 and 33). Going ahead, with an improvement in overall economic activity, we believe macro headwinds like currency, interest rate and inflation will turn positive and help the industry.

Exhibit 31: Recovery seen in CY14YTD led by two wheelers segment



Source: Company, ICICIdirect.com Research

Exhibit 32: Launches by various automakers

Company	Launch Plans
Two wheelers	
Hero MotoCorp	10 launches/refreshes over next two years including Dare, Dash, Leap in the scooter segment and HX250R in motorcycles
Bajaj Auto	Two new Pulsar and one Discover variant in next year
TVS Motors	Two commuter bikes, one scooter and refreshes
HMSI	Honda CBR300 and one commuter bike over the next year
Mahindra two wheelers	Two new scooters and two bikes launched
Four wheelers	
Maruti Suzuki	Launches in the form of Dzire and Swift facelift and new products like XA Alpha, Ciaz and S-Cross SX4
Tata Motor	Bolt and Nano Diesel
M&M	Two UVs in the compact SUV segment, one LCV, Scorpio refresh and other facelifts
Hyundai	Refreshes of existing products
Honda	Vezel in the SUV segment and the new Jazz
Nissan	Datsun Go Plus & Datsun Go Sedan

Source: Company, ICICIdirect.com Research

Exhibit 33: Upcoming launches for car and bikes

Upcoming car Launches		Upcoming bike launches		
Mahindra Scorpio Facelift	Renault Lodgy	Kawasaki Z250	Hero Dare	Hero Leap Hybrid SES
Fiat Avventura	Ford Ka	Mahindra Gusto	Bajaj Pulsar SS200	Bajaj Pulsar CS400
Maruti Suzuki Ciaz	Volkswagen Taigun	Vespa 946	Vespa Fly125	Hero ZIR
Renault Duster AWD	Datsun Redi GO	Hero Splendor Pro Classic	Yamaha YZF R25	Honda CBR 650F
Maruti Suzuki Swift Facelift	Maruti Suzuki S-Cross SX4	Kawasaki Versys 1000	Mahindra Mojo 300	Honda CBR300R
Maruti Suzuki Swift Dzire Facelift	Toyota Vios	Bajaj Pulsar 180NS	Hero Dash	Suzuki Gladius 650
Volkswagen Vento Facelift	Honda Jazz	Hero Xtreme Sports	Hero Impulse 250	Hero RNT
Ford Figo Concept Sedan	Ford B-MAX MPV	Piaggio Liberty 125	Harley Davidson Street 500	Yamaha Ray 125
Tata Bolt	Datsun Go Plus	Bajaj Pulsar 200NS FI	Honda CB500X	Honda PCX125
Skoda Octavia vRS	Renault Duster Facelift	Bajaj Pulsar 150NS	Hero HX250R	KTM 390 Adventure
Mahindra Quanto AT	Mahindra XUV500 Hybrid	Kawasaki ER-6n	Honda CB500F	Hero Hastur
Mahindra S101	Fiat Punto Abarth	Bajaj Pulsar SS400	Honda CBR500R	

Source: www.carwale.com, www.bikewale.com, ICICIdirect.com Research

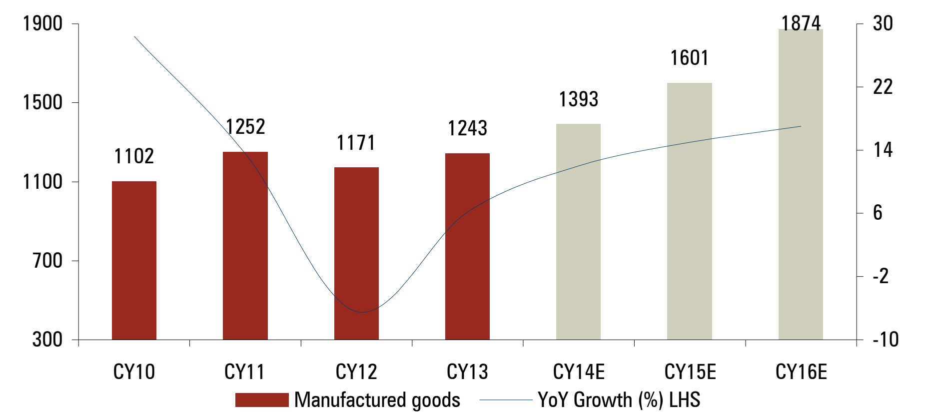
Automotive segment to witness ~14.6% CAGR over CY13-16E

We expect SKF's manufactured product (auto) sales to exhibit ~14.6% CAGR over CY13-16E, in line with overall auto growth assumptions. Consequently, net revenues from manufactured goods is expected to grow from ₹ 1243 crore in CY13 to ₹ 1874 crore in CY16.

Our revenue assumption is largely based on the overall auto growth assumptions, which are 13%, 18% and 14% for CY14E, CY15E and CY16E, respectively. Furthermore, we also derive comfort from the huge launch pipeline in the four wheelers (24 launches/refreshes in the next two years) and two-wheelers space (35 launches/refreshes in the next two years). We believe that SKF, with leadership in the bearing space, commands scalability bandwidth coupled with a lean balance sheet and is poised to capture the opportunity arising from the revival of demand in the automotive segment.

We expect SKF's manufactured product (auto) sales to exhibit ~14.6% CAGR growth over CY13-16E

Exhibit 34: Manufactured goods sales trend



Source: Company, ICICIdirect.com Research

Industrial segment – economy linked recovery to aid growth….

Industrial segment sales highly correlated with IIP growth…

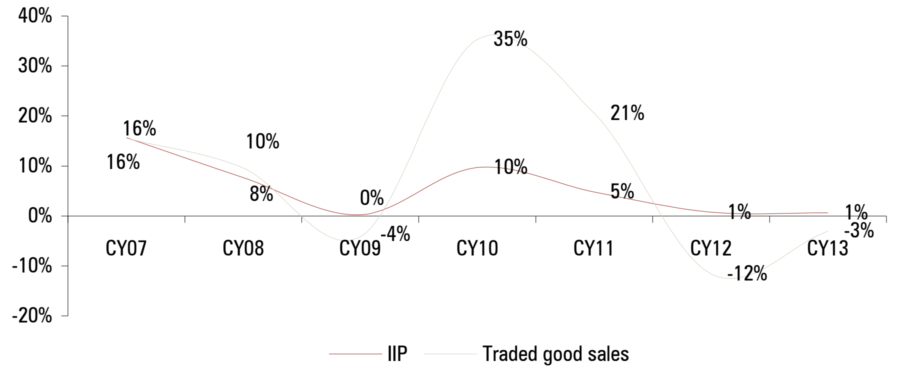
Bearings have industry wide applications across material handling equipment, machine tools, power, railways, mining, defence, renewables, etc. In India, most major players who serve the industrial segment do it through imports as the given the demand requirements do not justify the sizeable capex requirement. For SKF Bearings, industrial bearings (forming ~46% of revenues) are mainly sourced from the parents through imports (~90% of the requirement) and SKF Technologies, which has a plant in Ahmedabad. The share of industrial segment revenues in total revenues has been 44-46% and exhinbited 2.5% CAGR during CY10-13.

IIP and industrial bearings sales growth has a strong correlation given the industry linked demand structure. From exhibit 35, we can clearly see that SKF's traded goods sales (mostly industry segment goods) have de-grown (-12% YoY and -3% YoY in CY12 and CY13, respectively) over the last two years given the economic and industrial growth slowdown (IIP grew 0.6% and 0.7% in CY12 & CY13, respectively). We also highlight that during CY10 & CY11, the industrial segment revenues grew at 35% & 21% YoY vs. IIP growth of ~10% & 5%, respectively, clearly depicting the sharp multiplier effect during the recovery years.

The IIP and industrial bearings sales growth has a strong correlation given the industry linked demand structure

YoY	CY10	CY11	CY12	CY13
Industrial Sales	35%	21%	-12%	-3%
IIP	10%	5%	1%	1%
Multiplier	3.6x	4.3x	NM	NM

Exhibit 35: IIP growth and traded goods sales growth trend



Source: Company, Bloomberg, ICICIdirect.com Research

Key industrial segment growth drivers

Power

Bearings are used in boiler feed pumps, fans, motors, steam turbines, pillow blocks, gearboxes and material handling equipment used in the power generation industry.

Huge power generation capacity addition target of ~88 GW in the Twelfth Five Year Plan bodes well for the bearing sector boosting demand for the industry linked product

Power, with over 30% share in infrastructure investment, is one of the key areas of investment. The Twelfth Five Year Plan envisages capacity addition of ~88 GW vs. ~67.5 GW (including ~17 GW renewable) achieved in Eleventh Five Year Plan. In the renewable segment, the Ministry of New & Renewable Energy (MNRE) has set a target of capacity addition of 29.8 GW from various renewable energy sources during the Twelfth Five Year Plan period. The target comprises 15 GW from wind, 10 GW from solar, 2.1 GW from small hydro and 2.7 GW from bio-power.

Mining

Usage of bearings in mines include shovels, draglines, haul trucks, loaders, crushing, screening and material handling.

Over the last two years, the mining sector has received a setback in the form of a ban in Odisha, Karnataka, and Goa with a subsequent capping

The subsequent re-allocation of mines coupled with removal of mining ban in states would pave the way for a pick-up in mining activity, which would drive the demand for mining equipment and allied products like bearings

of their output. Furthermore, the recent Supreme Court ruling terming all coal block allocation post 1993 as illegal is likely to have a near term overhang on the sector. However, we believe that in case of cancellation of the above-mentioned coal block, the subsequent re-allocation would pave the way for a pick-up in mining activity, which would drive the demand for mining equipment and allied products like bearings.

Railways

In the railway sector, bearings are used in wheel axles, drive units, traction motors, etc.

Railways would be a key area of investment in the Twelfth Plan period. The areas proposed for private investment during the Twelfth Plan period are Elevated Rail Corridor in Mumbai, parts of the DFC, redevelopment of stations, power generation/energy saving projects and freight terminals.

The rolling stock addition is expected to grow ~70% in the Twelfth Five Year Plan over the Eleventh Five Year Plan and would be a key driver for bearing demand from the railway segment

The rolling stock addition is expected to grow ~70% in the Twelfth Five Year Plan over the Eleventh Five Year Plan. We highlight that such an incremental demand would be a key driver for bearing requirement from the railway segment.

Exhibit 36: Rolling stock requirement anticipated in Twelfth Plan

Items	10th Plan Actual	11th Plan Target	11th Plan Actual	12th Plan Target
Wagons	36222	62000	63481	105659
Coaches (including EMU/DEMU/MEMU)	12202	19863	17085	33066
Diesel Locomotives	622	1019	1288	2000
Electric Locomotives	524	1205	1218	2010

Source: Indian Railways Demand for Grants 20th Report , ICICIdirect.com Research

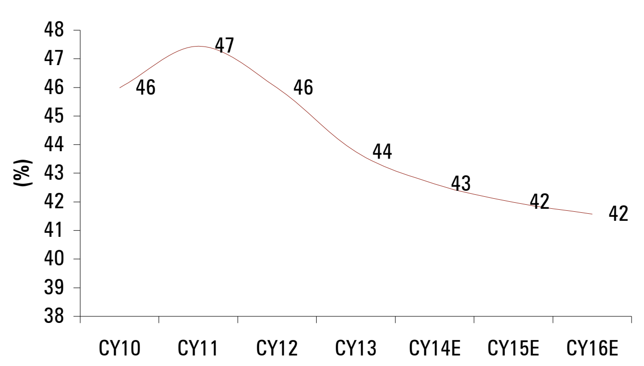
Industrial segment to grow at 11.3% CAGR during CY13-16E

Going ahead, the company has clearly indicated that the growth of the industrial division is linked to the economic recovery. With the formation of a government with a complete majority, expectations of policy reforms and a revival of the investment cycle, going ahead, the economy is expected to get back on the growth trajectory over the next two or three years. We highlight that SKF is well poised to capture the opportunity from the same given the availability of cash and scalability bandwidth.

We expect SKF's industrial (traded) sales to grow at 11.3% CAGR over CY13-16E to ₹ 1354 crore

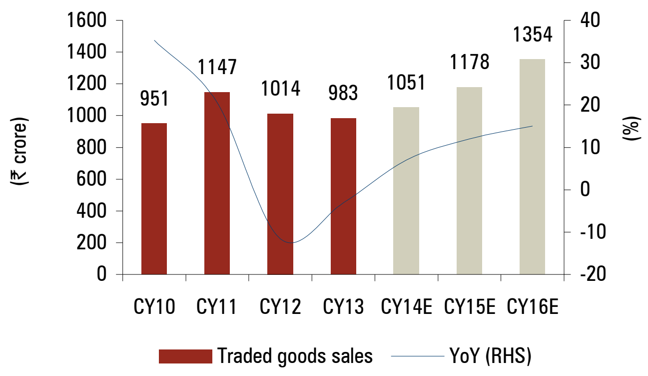
We expect SKF's industrial (traded) sales to grow at 11.3% CAGR over CY13-16E to ₹ 1354 crore. Given the superior auto segment growth, the overall share of industrials is, however, expected to come down to ~42% in CY16E vs. ~44% in CY13. We highlight that our growth assumptions still remain conservative considering the sharp multiplier effect that could be seen in the industrial segment during the period of recovery.

Exhibit 37: Industrial share to come down to 42% in CY16E



Source: Company, ICICIdirect.com Research

Exhibit 38: Industrial sales to grow at 11.3% CAGR over CY13-16E



Source: Company, ICICIdirect.com Research

SKF Technology – localisation to boost market share & margins…

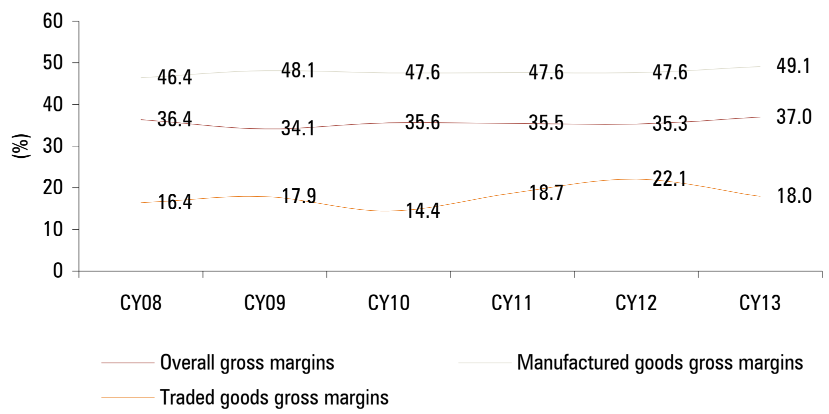
SKF Technologies Pvt Ltd is a wholly-owned subsidiary of SKF AB in India. It owns two manufacturing plants for sealing solutions in Mysore and large sized industrial bearings in Ahmedabad.

The company had an exclusive five-year agreement to supply Suzlon with special bearings for its wind turbines from the Ahmedabad plant. However, the agreement fell through as Suzlon cut its growth plans given the overall slowdown in 2008. Consequently, the Ahmedabad plants were re-calibrated and currently produce industrial bearings catering to the renewable energy segment, railways, defence and materials handing industry.

It is noteworthy that only ~10% of the traded goods purchase is from SKF Technologies. Currently, while manufactured goods (auto segment) command an average gross margin of ~49%, gross margins of traded goods (industry segment) stand at 18%. A pick-up in demand in industrial bearings would be the key to ramp up SKF Technologies leading to localisation of industrial bearings with the resultant cost benefits (lower transportation cost) improving margins. We believe that localisation of industrial bearings and increasing supply from SKF Technologies would also be instrumental for SKF to gain market share by passing on some of the cost benefits.

A pick-up in demand in industrial bearings would be the key to ramp up SKF Technologies leading to localisation of industrial bearings with the resultant cost benefits (lower transportation cost) improving margins

Exhibit 39: Manufacturing gross margins way ahead of trading margins



Source: Company, ICICIdirect.com Research

Focus on new product innovation to boost market share and margins…

SKF AB has continuously striven for new product innovation by focusing on its research and development. The group's R&D expenditure at SEK 1.84 billion formed ~2.9% (2.5% in CY12) of revenues in CY13. The R&D spending, in local currencies, rose by 16% YoY in CY13. In CY13, SKF AB recorded 650 invention disclosures and successfully registered 468 first filing of patent applications.

At SKF, the SKF Application Development Centre in Bangalore focuses on the development of new technologies.

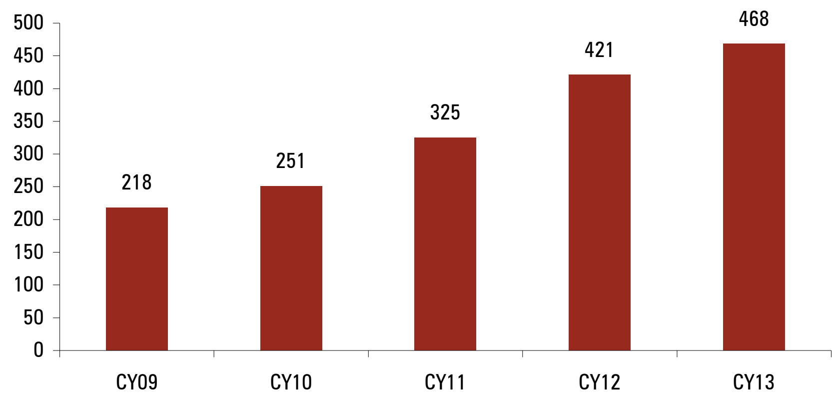
SKF has developed a **BeyondZero** concept wherein the focus is on using innovation for enhanced environmental performance characteristics. While currently, the company imports most of the same, it intends to indigenise the same in India. Following are some examples of BeyondZero portfolio with its benefits across industrials and automotives globally.

- **SKF Energy Monitoring Service for pump systems:** helped reduce CO_2 emissions by 1,700 tonnes per year
- **SKF StopGo for two-wheelers:** reduces CO_2 emissions by 5 g per km
- **SKF rotor positioning bearing:** reduces fuel consumption and CO_2 emissions by up to 15%

SKF India plans to increase the contribution of new products to 20% of total revenues vs. 12-13% currently

SKF India plans to increase the contribution of new products to 20% of total revenues vs. 12-13% currently. We believe that with the company's focus on profitable growth, the incremental contribution of the new product from innovation at the group as well as country level could be a major driver for market share gains and margin expansion.

Exhibit 40: SKF Group's first filings of patent applications



Source: Company, ICICIdirect.com Research

We believe the increased focus on distribution would boost the industrial aftermarket segment insulating it from the cyclicity of industrial growth

Strong distribution network: Focus on increasing reach of industrial bearings

SKF boasts of a strong distribution network comprising 400 distributors across India with ~25000 retail touch points. It should be noted that most of the distribution network pertains to the automotive segment while the industrial aftermarket distribution started only two years back.

SKF is focusing on increasing the distribution network for the industrial aftermarket segment over the last two years. It has added over 1500 retailers in the industrial segment and has a target of 2500 retailers for the same. We believe the increased focus on distribution would boost the industrial aftermarket segment insulating it from the cyclicity of industrial growth. Another key feature of the industrial segment is that distribution of this business is of an exclusive nature implying a direct driver of industrial sales growth.

Exhibit 41: Automotive distribution network

Source: Company, ICICIdirect.com Research

Exhibit 42: Industrial distribution network

Source: Company, ICICIdirect.com Research

Financials

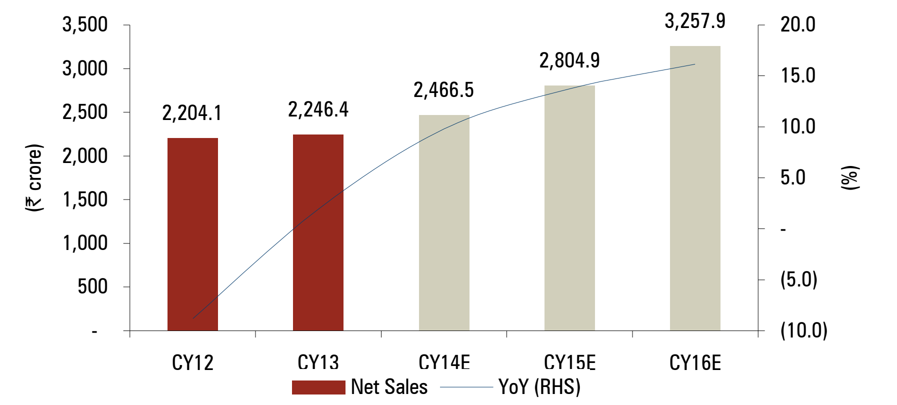
Revenues to grow at 13.2% CAGR during CY13-16E

SKF's revenues grew at 14.3% CAGR during CY08-11. However, given the overall slowdown in the economy affecting the industrial as well as automotive segments, revenues have declined at 3.3% CAGR over the last two years (CY11-13).

Revenue growth, going ahead, would hinge on the economic recovery, which, in turn, would boost the industrial and automotive segment demand. We build in an overall revenue growth of 13.2% over CY13-16E. While for CY14 revenues growth is expected at 9.8%, revenue growth in CY15E & CY16E is expected at 13.7% & 16.2%, respectively, given the expected economic revival.

Revenue growth, going ahead, would hinge on the economic recovery, which, in turn, would boost the industrial and automotive segment demand. We build in an overall revenues growth of 13.2% over CY13-16E

Exhibit 43: Consolidated revenue growth trend



Source: Company, ICICIdirect.com Research

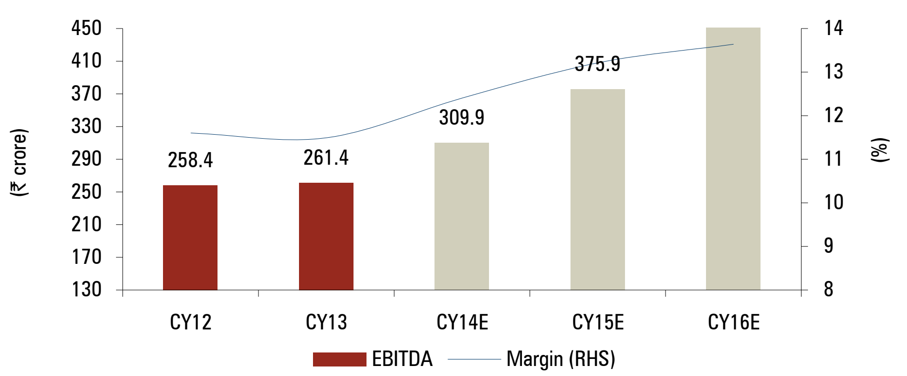
EBITDA to grow at 19.8% CAGR during CY13-16E

The EBITDA margins of SKF have come down to 11.5% in CY13 vs. 13.3% in CY10 given the lower utilisation levels on account of muted revenues.

Going ahead, we expect the EBITDA to grow at 19.8% CAGR during CY13-16E led by the handsome revenue growth boosting the operating leverage through higher utilisation and increasing share of domestically produced bearings sale as the company moves towards localisation of imports. We expect EBITDA margins to recover to 13.6% in CY16E vs. 11.5% in CY13.

Going ahead, we expect EBITDA to grow at 19.8% CAGR during CY13-16E

Exhibit 44: EBITDA growth trend



Source: Company, ICICIdirect.com Research

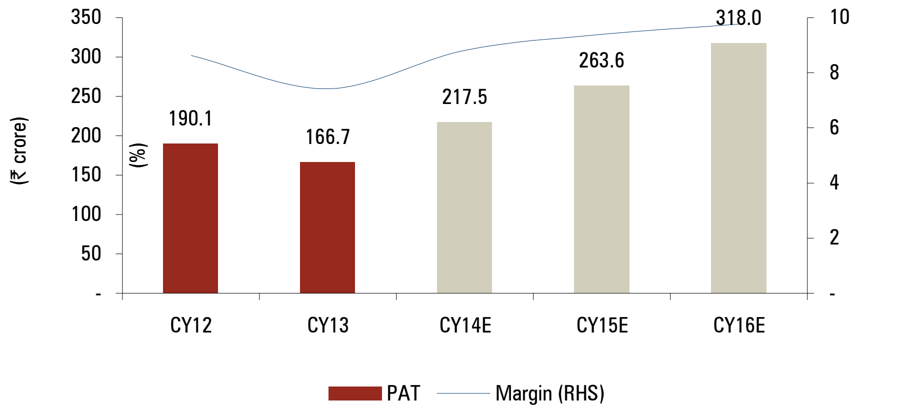
PAT is expected to grow at a CAGR of 24% in CY13-16E driven by healthy revenue growth and superior margins

PAT growth of 24% CAGR in CY13-15E

SKF's PAT has remained muted given the sluggish revenues and declining margins over the last couple of years. However, during business up cycles like that of CY08-11, the bottomline had grown at 17.8% CAGR signifying that SKF, being a leader, is a major beneficiary of a demand cycle pick-up.

Going ahead, PAT is expected to grow at a CAGR of 24% in CY13-16E driven by healthy revenue growth and superior margins.

Exhibit 45: PAT & PAT margin trend



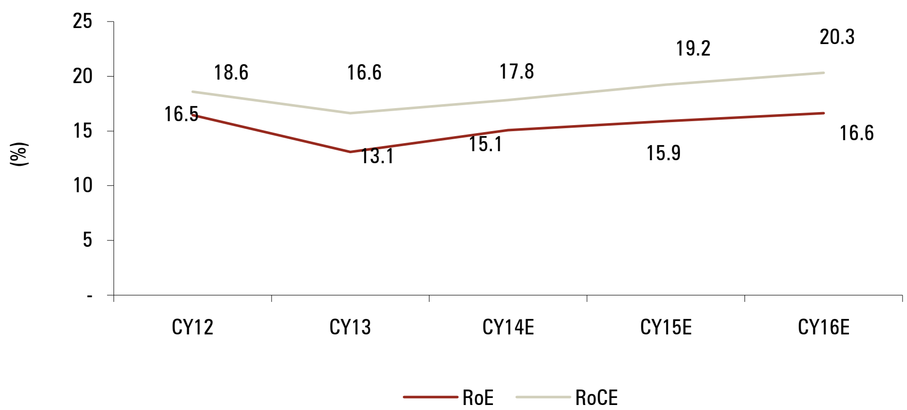
Source: Company, ICICIdirect.com Research

RoEs and RoCEs are expected to improve to 16.6% and 20.3% in CY16 vs. 13.1% and 16.6%, respectively, in CY13

Return ratios to improve led by earnings growth

Historically, SKF has enjoyed an average RoE and RoCE of 20%+ and 25%+, respectively. However, given the lower capacity utilisation and decline in earnings during the challenging economic scenario, return ratios have slipped below 20%. We expect return ratios of to improve, going ahead, as revenue CAGR of 13.2%, margin expansion of 200 bps coupled with 24% PAT CAGR over CY13-CY16E will lead to ROE expansion. Hence we estimate, RoEs and RoCEs to improve to 16.6% and 20.3% in CY16 vs. 13.1% and 16.6%, respectively, in CY13.

Exhibit 46: Return ratios to improve



Source: Company, ICICIdirect.com Research

Given the strong cash balance of SKF, core RoCE would be the right ratio to gauge the return generation ability

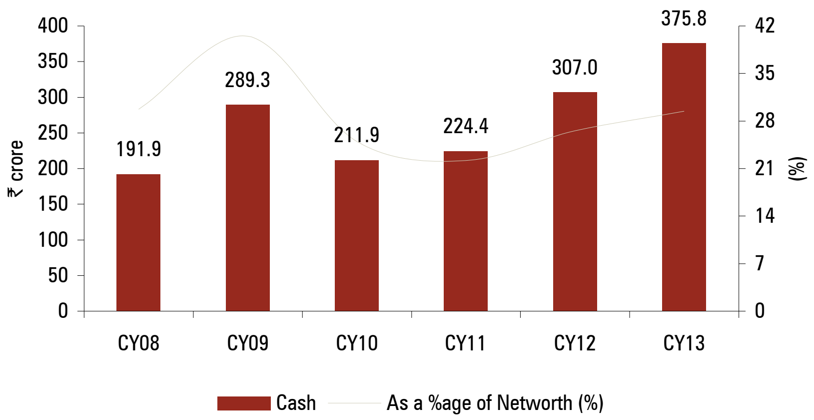
Strong core RoCE across business cycle…

SKF enjoys a strong cash balance on its books (₹ 376 crore or ~30% of its networth as on CY13). Consequently, core RoCE would be the right parameter to gauge its return generation.

We highlight that the company enjoys a handsome core RoCE across the business cycle. During CY08-10, when earnings grew at 17.8% CAGR, the company averaged core RoCE of ~40.6%. Even during the challenging period of CY10-13 when earnings were muted at -2% CAGR, the company enjoyed a healthy core RoCE of ~29.1%. This clearly depicts the inherent strength in the business model and is also an indicator as to why the business commands premium valuations.

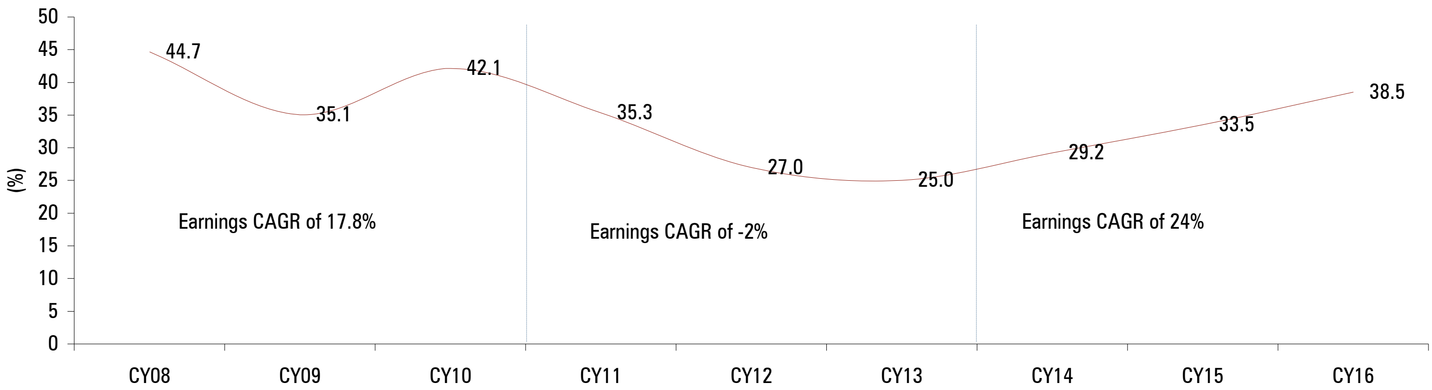
Core RoCE has been robust across business cycles, clearly signifying the strength in the business model and the subsequent premium valuations that it has commanded over time

Exhibit 47: SKF enjoys huge cash on balance sheet



Source: Company, ICICIdirect.com Research

Exhibit 48: Core RoCE has been robust across business cycle, clearly signifying strength in business model



Source: Company, ICICIdirect.com Research

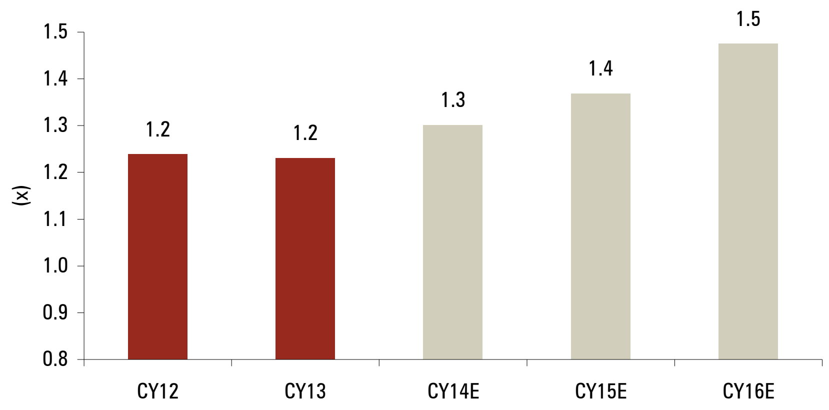
A healthy earnings growth coupled with a minimum maintenance capex would be the driver for strong FCF generation, going ahead

Asset turnover to improve as growth picks up

Given the overall slowdown in the economy impacting demand, SKF has been operating at ~15-20% below the standard optimum capacity utilisation of ~80%.

Going ahead, with the expected improvement in the economy and industrial growth percolating to bearing demand, we expect the asset turnover (taking into account manufactured products), to improve to 1.5x by CY16E vs. 1.2x in CY13.

Exhibit 49: Asset turnover to improve as revenue growth picks up



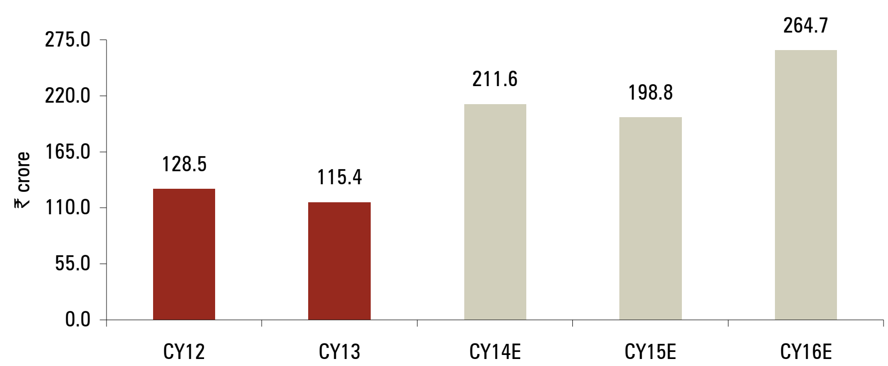
Source: Company, ICICIdirect.com Research

Strong FCF generation over next three years

A healthy earnings growth coupled with a minimum maintenance capex would be the driver for strong FCF generation, going ahead. We expect SKF to generate FCF of ~₹ 675 crore over the next three years.

Furthermore, repayment of loan to SKF Technologies (through bullet payments over the next six years) would also be a boost to the working capital, thereby boosting cash flows.

Exhibit 50: Free cash flow generation of ~₹ 675 crore over next three years



Source: Company, ICICIdirect.com Research

Risk & concerns

Japanese competition may thwart market share

Over the last few years, leading Japanese bearings players such as NSK, JTEKT (Koyo Bearings) and Nachi-Fujikoshi had plans to set up facilities in India. However, given the overall slowdown in the economy and demand they have slowed down their expansion plans.

We believe if the Japanese capacity fructifies that could intensify the competitive scenario in the Indian bearings market and, thus, pose a major risk in the long term

However, going ahead, Japanese players with global experience and deep pockets could be major competitors to existing players if the economy recovers and they revive their plans. The company has indicated that it has been competing against these players across the globe and as such should not be a major threat. We believe if the above-mentioned capacity fructifies it could intensify the competitive scenario in the Indian bearings market and, thus, pose a major risk in the long term.

Exhibit 51: Japanese player's plans in India

Company	Partner	Location	Proposed Capex (₹ crore)	Details
JTEKT (Koyo Bearings)	NA	Bawal, Haryana	420	Initially targeted sales of ₹ 650 crore by CY15
Nachi-Fujikoshi	KG International FZCO (Dubai)	Neemrana, Rajasthan	125	Initially targeted output of 1 mn units/month in FY15
NSK	ABC Bearings (India)	Kancheepuram, Tamil Nadu	130	Production of bearings (HUB unit bearings, bearings for transmission, bearings for magnetic clutch, etc.)

Source: Company, ICICIdirect.com Research

Sustained slowdown in key segment may derail earnings assumptions

The bearings industry is highly correlated with economic growth given the industry linked usage and demand for bearings.

We highlight that given the overall slowdown in the economy affecting the industrial as well as automotive segments, revenues have declined at 3.3% CAGR over the last two years (CY11-13). A sustained slowdown in any of the key segments (auto – two wheelers, CV, PV, etc) or industries could lead to an overall slowdown in sales growth, our earnings estimate.

A sustained slowdown in any of the key segment (auto – two wheelers, CV, PV, etc.) or industries could lead to an overall slowdown in sales growth and, consequently, our earnings estimate

Hence, we have run a sensitivity analysis to find out the impact of higher-than-expected or lower demand on our CY15E earnings assumptions.

Exhibit 52: Sensitivity of segmental growth and its impact on change from base case earnings

Automotive segment growth	Industrial Segment growth				
	5.0%	8.0%	12%	15%	18%
5%	39.6	40.2	41.0	41.6	42.2
10%	44.1	44.7	45.5	46.1	46.7
15%	48.6	49.2	50.0	50.6	51.2
18%	51.3	51.9	52.7	53.3	53.9
20%	53.1	53.7	54.5	55.1	55.7

Source: Company, ICICIdirect.com Research

Raw material cost rise could impact our earnings estimates

Sharp rise in key raw material like steel could also pose a risk to our earning estimates impacting the margins.

Hence, we have run a sensitivity analysis to find out the impact of change in RM to Sales on our CY15E earnings assumptions. We highlight that every 100 bps change in RM to Sales would impact our earnings by ~7%.

Exhibit 53: Sensitivity of RM to Sales on CY15E earnings

	RM to Sales				
	61.4%	62.4%	63.4%	64.4%	65.4%
CY15E EPS	57.1	53.5	50.0	46.5	42.9

Source: Company, ICICIdirect.com Research

Delay in SKF Technologies ramp up may delay localisation process

A pick-up in demand in industrial capex would be the key to a ramp up in SKF Technologies leading to localisation of industrial bearings and the resultant cost benefits (lower transportation cost). Therefore, any delay in a ramp up of production at SKF Technologies could impact our revenues/margins estimates.

Any delay in ramp up of production at SKF Technologies could impact our revenues/margins estimates

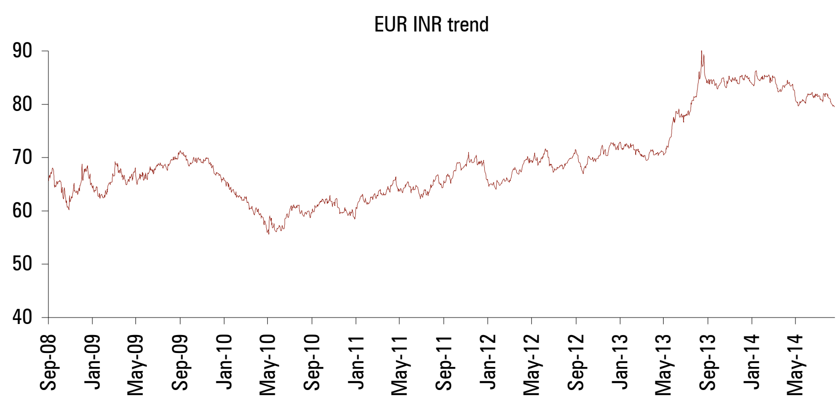
Furthermore, SKF India has also advanced a loan of ₹ 230 crore (₹ 245 crore including accrued interest) for the setting up of SKF Technologies Ahmedabad Plant. The management has indicated that the repayment of the same would be done over the next six years (by CY19). SKF has already received ₹ 10 crore as the first loan repayment instalment in CY14. Delay on that front could also be another risk.

Forex Risk can impact financial performance

SKF has forex exposure in the form of both imports and exports. Overall imports (in CY13) constitute ~32.7% of the revenues in the form of traded goods and raw materials while exports form 8% of the revenues. Netting off, SKF imports are ~25% of the revenues.

We highlight that SKF does not hedge its net currency exposure and has indicated that any increase in cost of materials and traded goods is passed on to the clients with a lag. However, any sharp headwind in the form of depreciation of INR vs. euro could pose a big threat.

Exhibit 54: Euro INR trend



Source: Company, ICICIdirect.com Research

Increase in royalty, trademark fees

Currently, royalty and trademark are 3% and 2%, respectively, as a percentage of manufactured sales. These rates are decided at the beginning of the year. We highlight that any increase in the same by the parent could pose a risk.

Hence, we have run a sensitivity analysis to find out the impact of higher royalty on our earnings assumptions wherein every 50 bps rise in royalty rates would impact our earnings by ~2%.

Every 50 bps rise in royalty rates would impact our earnings by ~2%.

Exhibit 55: Impact of royalty rates on EPS estimates

	Royalty Rates				
	3.0%	3.5%	4.0%	4.5%	5.0%
CY15E EPS	50.0	49.0	48.0	47.0	46.0
CY16E EPS	60.3	59.1	58.0	56.8	55.6

Source: Company, ICICIdirect.com Research

Valuation

We ascribe a multiple of 24x (implying a PEG of 1x) on the average of CY15 and CY16 earnings and arrive at target price of ₹ 1324 per share with a **BUY** rating on the stock.

The revenues of SKF have remained muted (declined at 3.3% CAGR during CY11-13) over the last two years, given the overall slowdown in economy affecting the industrial as well as automotive segments. However, the company has remained prudent enough not to have any major capex plan, thereby keeping the balance sheet lean with healthy cash flows. It should also be noted that during the good demand cycle, SKF's revenues grew at 14.3% CAGR during CY08-11, clearly signifying that SKF, being a leader, is a major beneficiary of demand cycle pickup.

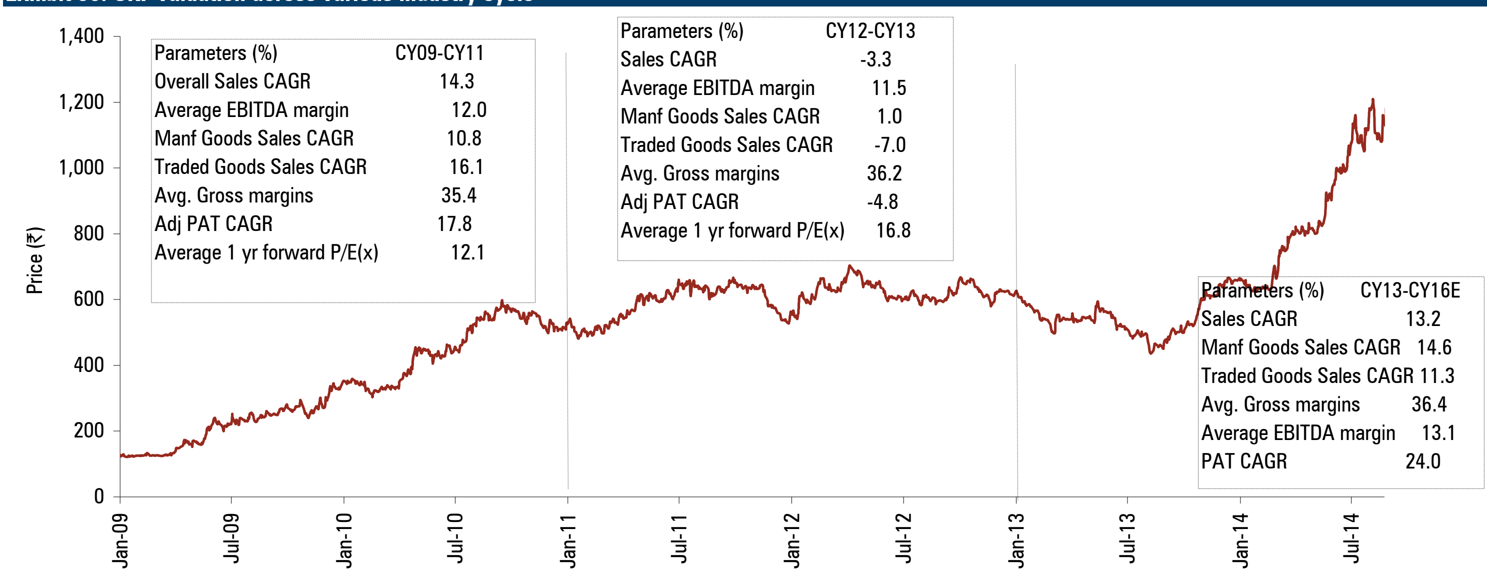
Going ahead, given the improvement in demand scenario with expected pick up in economy and industrial growth, SKF, being a leader in the bearing space, is expected to be a key beneficiary and post a revenues growth of 13.4% over CY13-16E. The pick-up in revenue growth would also translate into operating leverage through higher asset turnover. We highlight that given the lower utilisation currently, the company has headroom of 15-20% higher production on current capacity. We also expect import substitution of industrial bearings, through ramp up in SKF Technologies, to be a key revenue driver for SKF's revenues and margin expansion as the SKF would improve its turnaround time and resultant cost saving would be instrumental in capturing in the market share.

Historically, SKF has traded at a premium valuation given its leadership position, strong parentage, healthy balance sheet & cash flow generation and robust core RoCE signifying the strength in the business model. **Even during the stagnant demand cycle, SKF has commanded average P/E multiple of 16.8x over CY12-13 which has been increasing over time given the anticipated pick up in economy.** We also highlight that with anticipation of economic recovery post stable govt. formation as well as some respite on the inflation front, it has seen a huge multiple re-rating.

Given SKF's leadership position in the bearing space, strong earnings growth (CAGR of 24% in CY13-16E), healthy balance sheet with robust cash flow generation (₹ 675 crore over CY14-16E), we use P/E multiples for the fair valuation of the stock price.

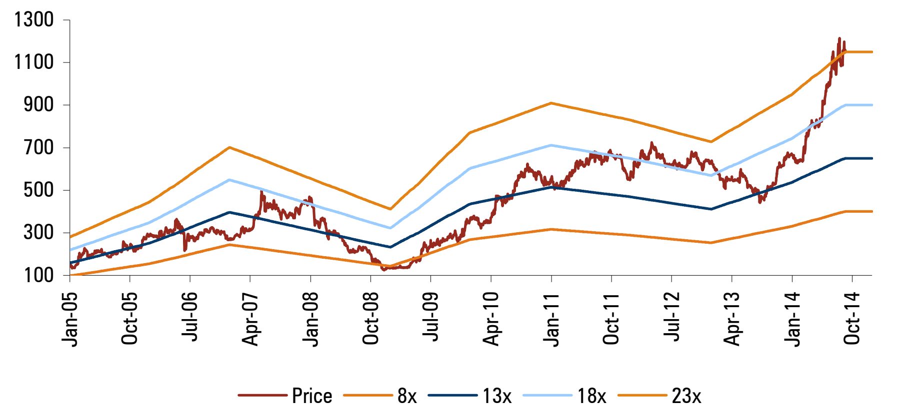
We ascribe a multiple of 24x (implying a PEG of 1x) on the average of CY15 and CY16 earnings and arrive at target price of ₹ 1324 per share with a **BUY** rating on the stock.

Exhibit 56: SKF valuation across various industry cycle



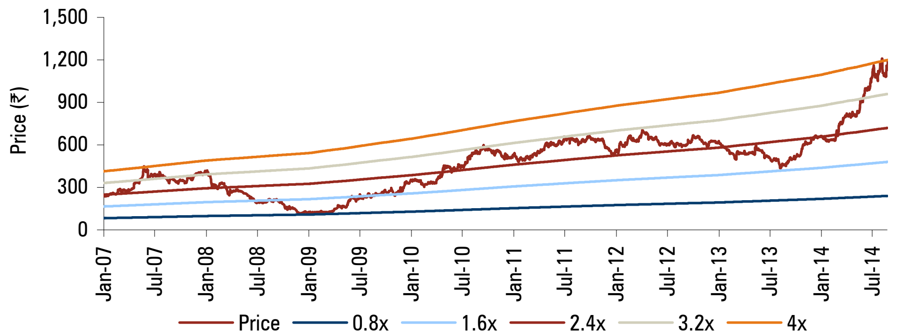
Source: Company, Bloomberg, ICICIdirect.com Research

Exhibit 57: Price/earnings



Source: Company, Bloomberg, ICICIdirect.com Research

Exhibit 58: Price/BV trend



Source: Company, Bloomberg, ICICIdirect.com Research

Exhibit 59: IDirect Estimate vs. consensus

₹ crore	Consensus	I-Direct	Deviation over consensus (%)
Revenues			
CY14E	2543.2	2466.5	-3.0
CY15E	2984.3	2804.9	-6.0
CY16E	3467.5	3257.9	-6.0
EBITDA			
CY14E	326.8	309.9	-5.2
CY15E	392.2	375.9	-4.1
CY16E	468.2	450.9	-3.7
PAT			
CY14E	226.1	217.5	-3.8
CY15E	271.9	263.6	-3.0
CY16E	327.7	318.0	-3.0

Source: Company, Bloomberg. ICICIdirect.com Research

Relative valuations

Relative to other MNC leaders in their respective sectors…

We highlight that given the global presence & leadership of the above-mentioned companies, they command premium valuations

In order to gauge the premium multiples that SKF commands, we have selected a set of MNC companies that are present in the industrial products space and are leaders in their respective set of categories. The set of companies include Cummins India (leading engine manufacturer), Bosch Ltd (largest auto ancillary player in the domestic automotive industry) and Wabco (leader in conventional braking products and advanced braking systems). All these companies also boast a strong margin and cash flow profile with minimum leverage on their balance sheets.

We highlight that given the global presence & leadership of the above mentioned companies, they command a premium valuations. For instance, Bosch/Wabco/Cummins are trading at a 2 year forward valuations of 29.3x/26.6x/23.2x respectively.

Exhibit 60: Growth trend comparison

	Revenue Growth (%)			EBITDA Growth (%)			PAT Growth (%)		
	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E
Cummins India	-13.5	13.0	18.2	-16.5	12.7	21.1	-14.6	13.1	17.6
Bosch Ltd	1.9	10.5	22.5	-4.3	23.0	33.6	-7.7	30.0	34.3
Wabco	15.0	25.0	38.6	-14.4	33.7	58.3	-10.1	27.9	73.0
Average	1.1	16.2	26.4	-11.7	23.1	37.7	-10.8	23.7	41.6
SKF India	1.9	9.8	13.7	1.2	18.6	21.3	-12.3	30.4	21.2

Source: Company, Reuters, ICICIdirect.com Research
The estimates for Cummins India & Wabco s for FY14, FY15 and FY16 respectively

Exhibit 61: Profitability trend comparison

	EBITDA Margin(%)			ROE (%)			PAT Margin (%)		
	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E
Cummins India	17.9	17.8	18.3	24.2	25.0	26.2	15.4	15.4	15.3
Bosch Ltd	14.6	16.3	17.8	14.1	16.0	18.2	10.0	11.8	12.9
Wabco	15.0	16.0	18.3	15.6	16.9	23.0	10.6	10.8	13.5
Average	15.8	16.7	18.1	18.0	19.3	22.5	12.0	12.7	13.9
SKF India	11.5	12.4	13.2	13.1	15.1	15.9	7.4	8.8	9.4

Source: Company, Reuters, ICICIdirect.com Research
**The estimates for Cummins India & Wabco s for FY14, FY15 and FY16 respectively*

Exhibit 62: Valuations comparison

	P/E (1 yr forward)			P/B (1 yr forward)			EV/EBITDA (1 yr forward)		
	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E
Cummins India	30.8	27.5	23.2	7.2	6.5	5.8	26.2	23.2	19.0
Bosch Ltd	52.0	40.0	29.8	7.3	6.4	5.4	33.7	27.1	20.1
Wabco	58.9	46.1	26.6	9.2	7.8	6.1	40.5	30.0	18.7
Average	47.2	37.9	26.5	7.9	6.9	5.8	33.5	26.8	19.3
SKF India	32.9	25.2	20.8	4.3	3.8	3.3	19.5	16.0	12.8

Source: Company, Reuters, ICICIdirect.com Research
The estimates for Cummins India & Wabco s for FY14, FY15 and FY16 respectively

Peer Matrix

SKF along with other key MNC players in the bearing space in India like FAG and Timken have been trading at premium valuations with the strong parentage, healthy balance and market share that these groups command across the globe as well as Indian bearings market.

We highlight that with an expected recovery in economic growth, the overall bearings pack multiples have been re-rated over the last six months. Given the lower base and expected earnings growth over the next two or three years, the premium multiples seem justified.

Exhibit 63: Peer Matrix

	M Cap	EPS (₹)			P/E (x)			EV/EBITDA (x)			RoE (%)			RoCE (%)		
Company	(₹ Cr)	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E	CY13	CY14E	CY15E
SKF India	5484	31.6	41.2	50.0	32.9	25.2	20.8	19.5	16.0	12.8	13.1	15.1	15.9	16.6	17.8	19.2
FAG Bearings	4764	80.5	106.6	143.0	35.6	26.9	20.1	24.6	18.3	14.1	13.0	17.1	19.6	22.6	16.2	18.9
NRB Bearings	1280	3.4	5.7	7.2	38.8	23.2	18.3	13.4	10.6	9.0	15.8	22.6	24.6	12.6	13.3	15.5

Source: Company, Bloomberg, ICICIdirect.com Research
**The estimates for NRB Bearings is for FY14, FY15 and FY16 respectively*

Sensitivity Analysis

We highlight that revenue growth explanation remains the major driver of valuations. Every 200 bps change in our base revenue growth will have a ~15% impact on our target price assumptions, maintaining the same multiples.

Exhibit 64: Sensitivity of revenue growth to our target price

CY16 topline growth \ CY15 topline growth	9.7%	11.7%	13.7%	15.7%	17.7%
12.2%	837	996	1154	1312	1471
14.2%	919	1079	1239	1399	1559
16.2%	1001	1162	1324	1485	1647
18.2%	1083	1246	1409	1572	1734
20.2%	1165	1329	1494	1658	1822

Source: Company, ICICIdirect.com Research

Every 50 bps change in margins from our base assumptions would have a 2% impact on our target price assumptions

Exhibit 65: Sensitivity of margins to our target price

CY16 Margins \ CY15 Margins	12.2%	12.7%	13.2%	13.7%	14.2%
12.6%	1231	1252	1274	1295	1317
13.1%	1256	1277	1299	1320	1342
13.6%	1281	1302	1324	1345	1367
14.1%	1306	1327	1349	1370	1392
14.6%	1331	1352	1374	1395	1417

Source: Company, ICICIdirect.com Research

Tables and ratios

Exhibit 66: Profit & loss account

(₹ Crore)	CY12	CY13	CY14E	CY15E	CY16E
Net Sales	2,204.1	2,246.4	2,466.5	2,804.9	3,257.9
Other Operating Income	23.5	28.5	32.8	39.4	47.2
Total Operating Income	2,227.6	2,275.0	2,499.3	2,844.3	3,305.1
Other Income	68.3	63.2	69.5	77.8	89.5
Total Revenue	2,295.9	2,338.1	2,568.8	2,922.1	3,394.6
Cost of materials consumed	589.6	606.3	679.1	780.9	913.7
Purchase of stock-in-trade	830.3	833.0	891.3	998.3	1,148.0
Changes in inventories of finished goods, work-ir	21.6	(6.4)	-	-	-
Employee Expenses	169.4	185.3	203.8	224.2	257.8
Other Expenses	358.3	395.4	415.2	465.0	534.7
Total Operating Expenditure	1,969.2	2,013.6	2,189.3	2,468.3	2,854.2
EBITDA	258.4	261.4	309.9	375.9	450.9
Interest	-	-	-	-	-
PBDT	326.7	324.6	379.4	453.7	540.4
Depreciation	43.6	49.4	52.4	57.3	62.2
PBT	283.1	253.0	327.0	396.5	478.3
Tax	93.1	86.3	109.6	132.8	160.2
PAT	190.1	166.7	217.5	263.6	318.0
EPS	36.0	31.6	41.2	50.0	60.3

Source: Company, ICICIdirect.com Research

Exhibit 67: Balance sheet

(₹ Crore)	CY12	CY13	CY14E	CY15E	CY16E
Equity Capital	52.7	52.7	52.7	52.7	52.7
Reserve and Surplus	1,102.6	1,222.8	1,390.9	1,605.2	1,861.5
Total Shareholders funds	1,155.4	1,275.5	1,443.6	1,657.9	1,914.3
Total Debt	-	-	-	-	-
Deferred Tax Liability	8.4	4.0	4.0	4.0	4.0
Total Liabilities	1,163.7	1,279.5	1,447.7	1,662.0	1,918.3
Gross Block	945.4	1,010.4	1,070.4	1,170.4	1,270.4
Acc: Depreciation	597.4	634.0	686.4	743.7	805.8
Net Block	348.0	376.4	384.0	426.7	464.6
Capital WIP	59.1	24.7	24.7	24.7	24.7
Investments	-	-	-	-	-
Inventory	248.6	255.2	280.2	318.6	357.0
Debtors	319.6	329.8	334.3	380.2	441.6
Loans and Advances	312.4	322.5	331.0	326.2	316.6
Other Current Assets	4.3	8.6	9.4	10.7	12.5
Cash	307.0	375.8	538.1	687.6	890.5
Total Current Assets	1,191.9	1,291.8	1,493.0	1,723.3	2,018.2
Current Liabilities	342.6	327.1	359.2	408.4	474.4
Provisions	92.8	86.2	94.9	104.3	114.8
Net Current Assets	756.6	878.5	1,039.0	1,210.5	1,429.1
Total Assets	1,163.7	1,279.5	1,447.7	1,662.0	1,918.3

Source: Company, ICICIdirect.com Research

Exhibit 68: Cash flow statement

(₹ Crore)	CY12	CY13	CY14E	CY15E	CY16E
Profit after Tax	190.1	166.7	217.5	263.6	318.0
Depreciation	43.6	49.4	52.4	57.3	62.2
Interest	-	-	-	-	-
Other income	(68.3)	(63.2)	(69.5)	(77.8)	(89.5)
Prov for Taxation	93.1	86.3	109.6	132.8	160.2
Cash Flow before WC changes	258.4	239.3	309.9	375.9	450.9
Net Increase in Current Assets	36.8	(31.1)	(38.9)	(80.8)	(92.0)
Net Increase in Current Liabilities	(59.8)	(22.0)	40.7	58.8	76.4
Taxes Paid	(86.3)	(90.6)	(109.6)	(132.8)	(160.2)
Net CF from Operating activities	149.1	95.6	202.2	221.0	275.2
(Purchase)/Sale of Fixed Assets	(88.9)	(43.3)	(60.0)	(100.0)	(100.0)
(Purchase)/Sale of Investments	-	-	-	-	-
Other Income	68.3	63.2	69.5	77.8	89.5
Net CF from Investing activities	(20.5)	19.8	9.5	(22.2)	(10.5)
Inc / (Dec) in Equity Capital	-	-	-	-	-
Inc / (Dec) in Secured Loan	-	-	-	-	-
Inc / (Dec) in Unsecured Loan	-	-	-	-	-
Interest	-	-	-	-	-
Others	(46.0)	(46.6)	(49.4)	(49.4)	(61.7)
Net CF from Financing Activities	(46.0)	(46.6)	(49.4)	(49.4)	(61.7)
Net Cash flow	82.5	68.8	162.3	149.5	203.0
Opening Cash/Cash Equivalent	224.4	307.0	375.8	538.1	687.6
Closing Cash/ Cash Equivalent	307.0	375.8	538.1	687.6	890.5

Source: Company, ICICIdirect.com Research

Exhibit 69: Ratio analysis

(Year-end March)	CY12	CY13	CY14E	CY15E	CY16E
Per Share Data (₹)					
EPS	36.0	31.6	41.2	50.0	60.3
Cash EPS	44.3	41.0	51.2	60.9	72.1
BV	219.1	241.9	273.8	314.4	363.0
Operating profit per share	49.0	49.6	58.8	71.3	85.5
Operating Ratios (%)					
EBITDA / Total Operating Income	11.6	11.5	12.4	13.2	13.6
PAT / Total Operating Income	8.5	7.3	8.7	9.3	9.6
Return Ratios (%)					
RoE	16.5	13.1	15.1	15.9	16.6
RoCE	18.6	16.6	17.8	19.2	20.3
RoIC	25.1	23.5	28.3	32.7	37.8
Valuation Ratios (x)					
EV / EBITDA	20.0	19.5	16.0	12.8	10.2
P/E	28.9	32.9	25.2	20.8	17.2
EV / Net Sales	2.3	2.3	2.0	1.7	1.4
Market Cap / Sales	2.5	2.4	2.2	2.0	1.7
Price to Book Value	4.7	4.3	3.8	3.3	2.9
Turnover Ratios (x)					
Asset turnover	2.0	1.8	1.8	1.8	1.8
Debtors Turnover Ratio	6.9	6.8	7.4	7.4	7.4
Creditors Turnover Ratio	6.4	6.9	6.9	6.9	6.9
Solvency Ratios (x)					
Net Debt / Equity	-	-	-	-	-
Current Ratio	2.7	3.1	3.3	3.4	3.4
Quick Ratio	2.2	2.5	2.7	2.7	2.8

Source: Company, ICICIdirect.com Research

Appendix

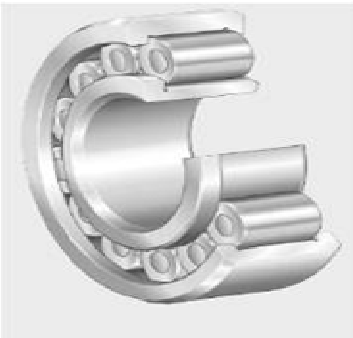
What is a bearing?

A bearing is a machine element that constrains relative motion and reduces friction between moving parts to only the desired motion. Bearings are highly engineered, precision-made components enabling the machinery to move at extremely high speeds and carry remarkable loads with ease and efficiency.

Types of bearings

Exhibit 70: Types of ball bearings

Ball Bearings



Cylindrical & Needle Roller Bearings

Tapered Roller Bearings

Spherical Roller Bearings

Source: ICICIdirect.com Research

Ball bearings

–Rolling function is provided by a ball
–Low friction, high speed, light to medium loading
–Light and general machine applications

Commonly found in fans, roller blades, wheel bearings, and under hood applications on cars etc.

Cylindrical & needle roller bearings

The rolling function is provided by a cylinder of some kind. May also be referred to as needle roller bearings (where length is much greater than diameter)

-Low friction, medium to heavy radial loading

Commonly found in general machine applications including gearboxes and transmissions, machine tool and construction equipment.

Tapered roller bearings:

A tapered version of a roller bearing is used for combined axial and radial loads, such as in wheel applications on trucks

Commonly found in heavy industrial, truck and wheel applications with combined radial and axial loads. Some examples are manual transmissions, gearboxes, power generation and other process equipment.

Spherical roller bearings

- A roller bearing that has a barrel shaped roller.
- Medium friction, medium to heavy loads and misalignment capabilities

Generally used for very high load applications with misaligned shafts to housings. Commonly found in gearboxes, conveyors, pulp and paper machines and other process equipment.

RATING RATIONALE

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Pankaj Pandey | Head – Research | pankaj.pandey@icicisecurities.com

ICICIdirect.com Research Desk,
ICICI Securities Limited,
1st Floor, Akruti Trade Centre,
Road No. 7, MIDC,
Andheri (East)
Mumbai – 400 093

research@icicidirect.com

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