

Mahindra CIE Automotive (MACA)

Automobiles

BUY

JANUARY 14, 2015

INITIATING COVERAGE

Coverage view: **Attractive**

Price (₹): **243**

Target price (₹): **280**

BSE-30: **27,426**

The making of a global auto-component player. We initiate coverage on Mahindra CIE with a BUY rating and target price of ₹280. Mahindra CIE will become a global auto-component powerhouse with the scale of business in India and merger of CIE Automotive's global forgings business. We expect the company to deliver strong earnings growth over the next few years, led by an operational turnaround in Mahindra's European forgings business and strong growth in the Indian business.

Company data and valuation summary

Mahindra CIE Automotive

Stock data

52-week range (Rs) (high,low) 252-46

Market Cap. (Rs bn) 22.7

Shareholding pattern (%)

Promoters 78.6

FIs 2.9

MFs 5.4

Price performance (%)

Absolute 9.6 25.1 356.0

Rel. to BSE-30 8.7 19.7 249.4

Forecasts/Valuations

EPS (Rs) 1.2 5.0 9.6

EPS growth (%) (63.1) 305.0 90.5

P/E (X) 195.7 48.3 25.4

Sales (Rs bn) 55.4 60.9 67.4

Net profits (Rs bn) 0.4 1.6 3.1

EBITDA (Rs bn) 4.8 6.4 8.4

EV/EBITDA (X) 8.4 5.8 4.0

ROE (%) 2.9 10.9 17.9

Div. Yield (%) 0.0 0.0 0.0

Mahindra CIE to become a global auto component player

CIE Automotive bought controlling stake (53%) in Mahindra CIE, formed after the merger of Mahindra's forgings, stampings, gears, castings and CIE Automotive's European forgings business. CIE Automotive is a global supplier with a significant presence in forgings, stampings and plastics in Europe and NAFTA. CIE grew briskly through organic and inorganic routes but maintained double-digit EBITDA margins and post-tax RoCE of 17% in the automotive business. CIE Automotive has a strong track record of operational excellence. We believe with the change in management, Mahindra CIE will become a global auto-components player with strong capabilities in forging, stamping, gears and casting.

Turnaround of Mahindra Europe and new product development would be key catalysts

The company is likely to implement its strategy in two phases. In the first phase (FY2014-17), it will focus on improving Mahindra CIE's Europe business profitability through (1) price negotiation for some old contracts, (2) productivity enhancement, (3) EUR4 mn annual power subsidy from the German government, (4) reduction of some temporary staff and (5) outsourcing low-end jobs. We expect EBITDA margin in the Europe business to improve to 12.9% in FY2017 from 6.2% in FY2014.

In the second phase (FY2017-20), the company will focus on enhancing the product portfolio of its businesses in India and adding new clients. In phase two, we expect new products to account for about half the incremental revenue over FY2017-20. We expect Mahindra CIE's revenues and EBITDA to grow by 2X and 4X respectively over FY2014-20.

We initiate coverage with a BUY rating

We initiate coverage on the stock with a BUY rating and target price of ₹280. We value the stock at 12X FY2017E EBITDA. We believe 12X EV/EBITDA multiple is justified, driven by strong growth in EBITDA over the next six years. We believe the company can grow its EBITDA by 4X over FY2014-20. We expect the company to deliver strong cash flow (FCF/EBITDA conversion of 40-50%) and fund its capex plans through internal accruals. We see weak execution as a key risk to our investment thesis.

MAHINDRA CIE—FINANCIAL SNAPSHOT

Exhibit 1: Mahindra CIE: forecast and valuation

March fiscal year-ends, 2014-17E (₹ mn)

	Net sales (Rs mn)	EBITDA (Rs mn)	PAT (Rs mn)	EPS (Rs)	EV/EBITDA (X)	P/E (X)	RoCE (%)	RoE (%)
2014	55,911	3,935	1,084	3.3	23.0	65.9	4.5	7.9
2015E	55,409	4,845	400	1.2	18.4	178.7	7.1	2.8
2016E	60,939	6,419	1,620	5.0	13.3	44.1	12.3	10.3
2017E	67,416	8,371	3,086	9.6	9.8	23.0	18.5	16.4

Source: Company, Kotak Institutional Equities estimates

Exhibit 2: We expect EBITDA CAGR of 28% over FY2014-17E

Mahindra CIE, pro-forma financial summary, March fiscal year-ends, 2014-17E (₹ mn)

	2014P	2015E	2016E	2017E
Profit model (Rs mn)				
Net sales	55,911	55,409	60,939	67,416
EBITDA	3,935	4,845	6,419	8,371
Other income	389	467	577	677
Interest expenses	(1,499)	(1,254)	(1,120)	(907)
Depreciation	(2,940)	(3,114)	(3,286)	(3,457)
Profit before tax	(115)	944	2,590	4,684
Exceptional gains	2,188	—	—	—
Tax expenses	(988)	(544)	(970)	(1,597)
Profit after tax	1,084	400	1,620	3,086
EPS	3.3	1.2	5.0	9.6
Balance sheet (Rs mn)				
Shareholder equity	13,724	14,124	15,745	18,831
Deferred tax liability	151	151	151	151
Borrowings	22,419	21,169	19,197	16,765
Provisions	4,140	4,140	4,140	4,140
Current liabilities	7,206	7,905	9,343	10,382
Total liabilities	47,641	47,490	48,576	50,269
Net fixed assets	30,402	30,138	29,702	29,095
Investments	712	712	712	712
Cash	2,198	2,553	3,991	5,112
Other current assets	14,329	14,087	14,172	15,351
Total assets	47,641	47,489	48,576	50,269
Cash flow (Rs mn)				
Operational cash flow	2,151	4,768	6,026	7,450
Change in working capital	1,324	941	1,353	(140)
Capex	(1,791)	(2,850)	(2,850)	(2,850)
Free cash flow	1,684	2,859	4,529	4,460
Ratios (%)				
EBITDA margin (%)	7.0	8.7	10.5	12.4
PAT margin (%)	1.9	0.7	2.7	4.6
Net debt/equity (X)	1.5	1.3	1.0	0.6
RoCE (%)	4.5	7.1	12.3	18.5
RoE (%)	7.9	2.8	10.3	16.4

Source: Company, Kotak Institutional Equities estimates

Exhibit 3: We expect EBITDA to increase by 4X over FY2014-20

Mahindra CIE revenue and EBITDA estimates, 2014-20E (₹ mn, %)

	2014P	2015E	2016E	2017E	2018E	2019E	2020E
Net sales							
Forgings	3,865	3,930	4,624	5,416	7,041	9,505	12,832
Stampings	7,230	7,091	8,237	9,573	11,966	14,958	18,697
Gears	1,455	1,605	1,859	2,102	2,354	2,637	2,953
Castings and composites	5,256	5,584	6,509	7,259	8,711	10,453	12,544
India revenues	17,806	18,210	21,229	24,350	30,072	37,553	47,026
Forgings Europe	34,042	32,940	35,246	38,386	40,305	42,321	44,437
Gear Europe	4,062	4,259	4,464	4,680	4,914	5,160	5,418
Europe revenues	38,104	37,199	39,710	43,066	45,219	47,480	49,854
Rest of the world (forgings)					8,000	8,400	8,820
Total net revenues	55,910	55,409	60,939	67,416	83,291	93,433	105,700
EBITDA							
Forgings	523	673	843	1,058	1,479	2,186	3,208
Stampings	510	402	612	825	1,197	1,795	2,244
Gears	201	229	287	332	377	422	473
Castings and composites	357	336	484	609	871	1,045	1,254
India EBITDA	1,591	1,640	2,226	2,824	3,923	5,448	7,178
Forgings Europe	2,243	2,972	3,810	5,095	5,643	6,348	6,665
Gear Europe	101	234	383	452	491	516	542
Europe EBITDA	2,344	3,206	4,193	5,547	6,134	6,864	7,207
Rest of the world					1,200	1,260	1,323
EBITDA	3,935	4,846	6,419	8,371	11,257	13,572	15,709
EBITDA margin (%)							
Forgings	13.5	17.1	18.2	19.5	21.0	23.0	25.0
Stampings	7.1	5.7	7.4	8.6	10.0	12.0	12.0
Gears	13.8	14.3	15.4	15.8	16.0	16.0	16.0
Castings and composites	6.8	6.0	7.4	8.4	10.0	10.0	10.0
India EBITDA	8.9	9.0	10.5	11.6	13.0	14.5	15.3
Forgings Europe	6.6	9.0	10.8	13.3	14.0	15.0	15.0
Gear Europe	2.5	5.5	8.6	9.7	10.0	10.0	10.0
Europe EBITDA	6.2	8.6	10.6	12.9	13.6	14.5	14.5
Rest of the world					15.0	15.0	15.0
EBITDA	7.0	8.7	10.5	12.4	13.5	14.5	14.9

Source: Kotak Institutional Equities estimates

VALUATIONS: STRONG GROWTH PROSPECTS DESERVE PREMIUM VALUATIONS

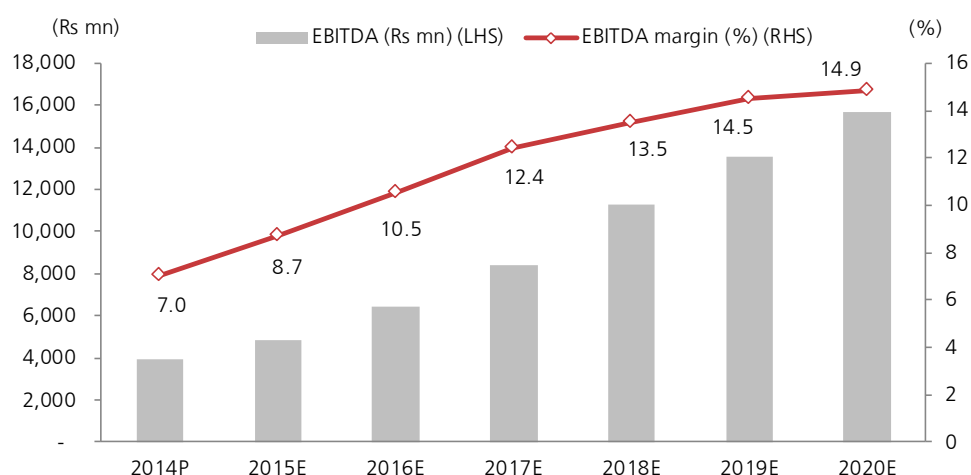
We initiate coverage on Mahindra CIE with a BUY rating and target price of ₹280. Our target price is based on 12X FY2017E EBITDA. We expect Mahindra CIE to deliver strong earnings growth over the next six years, led by improved profitability in overseas businesses and strong revenue growth in the Indian business due to the addition of new products and clients. We expect revenue and EBITDA to grow by ~2X and ~4X respectively over FY2014-20. The stock trades at 10.5X FY2017E EBITDA, which we believe is inexpensive, given the company's strong growth prospects.

Mahindra CIE was formed by merging Mahindra's forgings, castings, gears, stampings, composites and CIE's European forgings businesses. CIE Automotive holds 53% and M&M 20% stake in Mahindra CIE.

We initiate coverage on Mahindra CIE with a BUY rating and target price of ₹280, based on 12X FY2017E EBITDA. The 12X EV/EBITDA multiple is justified for the stock as we believe the company can grow its EBITDA by 4X over FY2014-20. We expect the company to deliver strong cash flows (FCF/EBITDA conversion of 40-50%) and fund its capex plans through internal accruals. We expect the company to reduce its net debt by half during this period, which is likely to strengthen the balance sheet. Net-debt-to-EBITDA ratio is likely to fall to 0.5X by FY2020 from 5X in FY2014.

Exhibit 4: EBITDA to increase by 4X over 2014-20E

Mahindra CIE EBITDA and EBITDA margin, March fiscal year-ends, 2014-20E (₹ mn, %)



Source: Bloomberg, Kotak Institutional Equities

The company is in the nascent stage of scaling up its business and hence comparing its valuations to any Indian component player may not give the correct picture of the stock's steady-state trading multiple. We believe the stock will trade at premium valuations in the near term due to depressed earnings versus other large global auto component players.

We believe Mahindra CIE may be compared to Bharat Forge to judge the steady-state multiple at which the company should trade once it scales up its business.

Discount to Bharat Forge likely to contract given strong earnings momentum

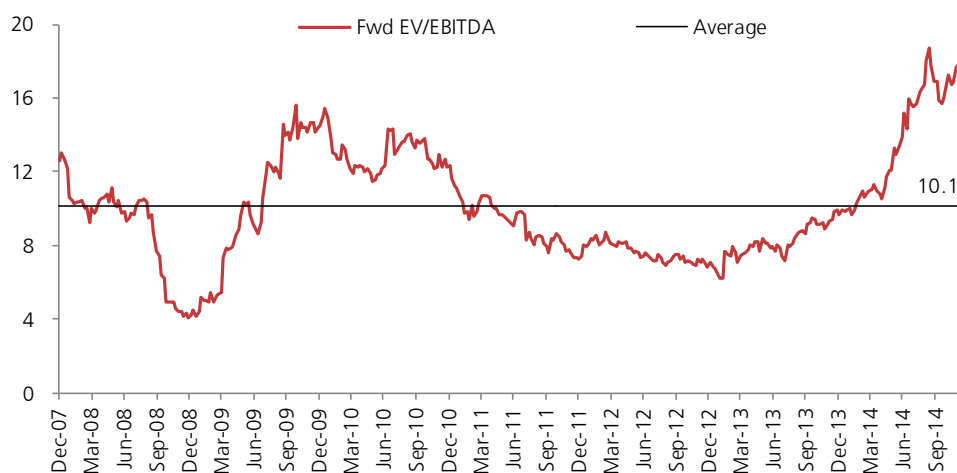
Mahindra CIE trades at a 25% discount to Bharat Forge. We believe Mahindra CIE will trade at 5-10% discount to Bharat Forge on a steady-state basis. Mahindra CIE is in a transformation phase with improvement in profitability and in balance sheet strength. Mahindra CIE has ample opportunity to grow, given the sub-scale nature of the domestic business, which can be scaled up through new products and customer diversification that will lead to narrowing of the discount of Mahindra CIE with Bharat Forge over the medium term.

On a steady-state basis, we believe Bharat Forge will trade at a premium to Mahindra CIE for the following reasons.

- ▶ Bharat Forge's business model is well-diversified; Mahindra CIE is focused on a few customers. Bharat Forge operates in the automotive and non-automotive businesses. The non-auto business, which accounts for 40% of Bharat Forge's standalone revenue, offers good growth prospects as the opportunity size is large. Mahindra CIE is dependent on Daimler Europe and Mahindra & Mahindra for business.
- ▶ Bharat Forge and Mahindra CIE have similar shares in the heavy truck market in Europe. Bharat Forge has a sizeable presence in the US CV market but Mahindra CIE is not present in the US. Bharat Forge has a much wider presence across the globe than Mahindra CIE. However, Mahindra CIE will become a global player when CIE merges its forgings businesses, in China, Brazil and Mexico, in Mahindra CIE.
- ▶ Mahindra CIE is present in forgings, castings, stampings and gears while Bharat forge has a presence only in the forgings industry. However, Mahindra CIE has to scale up the castings, gears and stampings businesses to capture strong growth opportunities in these segments.
- ▶ Mahindra CIE and Bharat Forge can deliver post-tax RoCE of 17-18% over the medium term but the growth prospects of Bharat Forge are far superior due to the strong growth potential of the non-auto business. Scale-up of the Mahindra CIE business will depend on new products and the addition of new customers in the automotive segment.

Exhibit 5: Bharat Forge trades at ~16X one-year forward EV/EBITDA

Bharat Forge forward EV/EBITDA, March fiscal year-ends (X)



Source: Bloomberg, Kotak Institutional Equities