FAG Bearings India Ltd (NSE Code: FAGBEARING) – Alpha/Alpha + stock recommendation for Oct'12

Content Index

Dear Members,

As you are aware a few weeks back we closed a special situation opportunity in NRB Bearings; however while looking at the details of NRB Bearings, we started checking out details of other bearing manufacturers and were positively surprised by the quality of the companies in the bearings segment.

In particular, we liked **FAG Bearings India** on both absolute basis and on comparing it with its peers and believe it has the potential to deliver ~20% annualized returns over the next few years on the back of automobile and industrial growth in India. It is the second largest player in the Indian Bearings industry with ~15% market share and ~29% market share in the organized segment.

Yes, as can be observed from the market share details, organized and un-organized players account for almost equal share of the Indian bearings industry.

If FAG is the second largest, then which is the largest player?

Well the largest player is SFK India and is again a listed company like FAG; however as mentioned above, we found FAG better and would therefore like to share the details on the company. Besides FAG and SKF, Timken India and NRB are two other prominent players in the organized segment.

Before we discuss the finer details, here's a brief snapshot:

- Market capitalization – Rs 2,850 cr.
- Net debt – Rs 0 cr.
- Cash and cash equivalents – Rs 200 crores
- Average cash flows from operations (post tax) for the last 3 years – Rs 125.38
- Average Net profit for the last 3 years – Rs 121.03

Investment Snapshot (As on 14th Oct'12)

Recommendation – Buy

Portfolio Allocation Strategy –

1. Start with ~4% portfolio allocation in the range of 1750-1800.
2. We may consider increasing allocation to around 6-7% in case of a correction to 1400-1450

Profit Booking – Refer Alpha/Alpha + weekly

BSE Code – 505790; **NSE Code** – FAGBEARING

Bloomberg Code – FAG: IN

Market capitalization – Rs 2,850 cr.

Total Equity shares – 1.66 cr.

Face Value – Rs 10.00

52 Weeks High/Low – Rs 1826.85/ Rs 978.00

Promoter's holding – 51.33%

Bearings Industry – Overview

Everything moves on a bearing, that's the axiom that holds true for the automobile industry. Yes, Auto industry cannot exist without bearings. For instance, 60-70 bearings are needed to make a car and 10-15 goes in a bike.

Basically, bearings are required wherever there is motion. Bearings thus play critical role in industrial progress.

So every vehicle requires bearing and other industrial areas, material handlings, and many other areas also need bearings. In short where ever there is machine movement there is a bearing, big or small. Further, depending on the working of the machine the bearings start wearing out and need to be replaced. Therefore, there's continuous demand from both the OEMs and in the aftermarket.

Bearings of various types and sizes are used for different sectors. The major sectors are as follows:

- Automobiles
- Railways
- Electrical Motors
- Electric Fans
- Diesel Engines
- Pumps
- Machine Tools
- Textile Machinery and
- Other heavy industries (Steel plants, Sugar plants, Heavy earth moving equipments, Cement plants, Power generation plants, etc)

Some important features of the Indian Bearings industry

Market size – The total size of the bearings industry in India is estimated at Rs 8,500 crores at the end of Mar'12, of which organized players accounted for Rs 4,500 crores, while the small scale companies and imports accounted for the rest.

Concentrated – The top four players (SKF, FAG, Timken, NRB) in the organized sector account for 80 per cent of the organized industry, the small scale industry and unorganized sector comprises the remainder.

Global Collaboration – All the manufacturers in the organized sector have entered into collaboration agreements for supply of complete process know how as well as supply of major manufacturing machinery.

Automobile industry: Major customer – The demand for bearings is primarily from the automobile sector at ~55 per cent of the total demand. Industries such as textile machinery, general engineering, electrical and material handling, and railways account for the remaining demand.

Entry Barriers – The industry has high entry barriers in the form of capital intensity and restricted access to technology. This insulates existing players in the organized segment from competition in the OEM segment, however the margins are lower. In replacement market the margins are much better; however the organized players face stiff competition from cheaper imports, counterfeit products from small unorganized players in the replacement market.

Reasonable pricing power – The fluctuation in steel prices does not have a major impact on the operating margins of players as the manufacturing of bearing requires precision-engineering, which is controlled by just a few players in the organized segment. Hence, companies have been able to pass on significant portion of the increase in the prices of raw materials, though with a certain time lag.

What controls the growth of bearings industry in India? – In a developing economy like India, with greater focus on mechanization of the manufacturing process; demand for bearings has outperformed industrial growth.

The Capital Goods and Manufacturing Sectors present a strong opportunity for the Bearings industry. Further, the Bearings Segment has a direct co-relation with the Auto

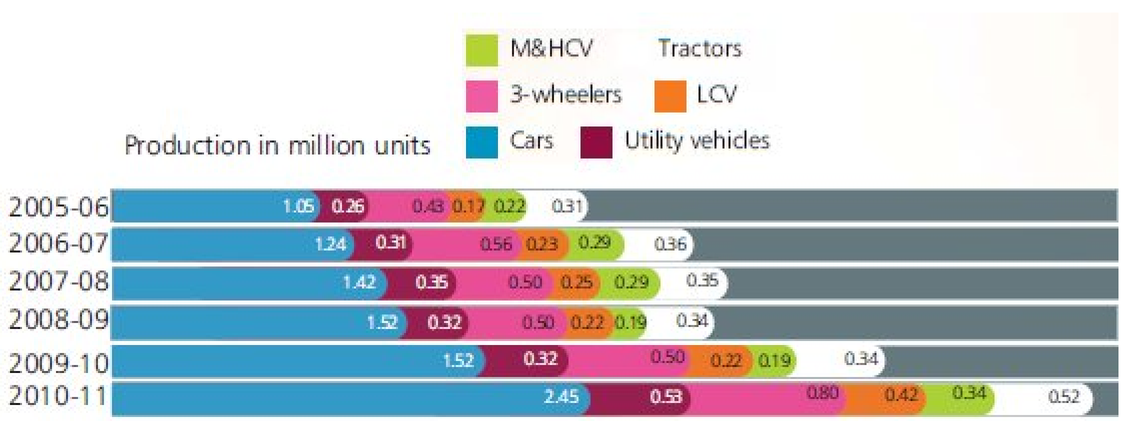
Sector growth, which is expected to post double-digit growth per annum over the next 4-5 years.

The bearings industry prospects are therefore derived from demand arising in the Capital Goods and Automobile industries and on the population of the existing machines and automobiles.

Automobile sector growth: As mentioned above, automobile sector is the single largest customer of bearings and therefore automotive bearing sales growth is directly proportional to the growth in new vehicle roll-out each year. Roll-out of new vehicles in any year contributes directly to the OEM sales in the first year, while it also adds to the replacement demand over a recurring cycle depending on the movement of the vehicle.

The OEM business is driven by fresh vehicle (2-3-4-wheelers, commercial vehicles, etc) demand in any particular year. Aftermarket sales are influenced by the number of vehicles in use, average distance travelled and population growth.

The automobile (2W + 4W) sector saw a 9% volume CAGR over five years (2005-06 to 2009-10), while 4-wheeler OEM sales grew about 13% CAGR between 2005-06 and 2009-10.



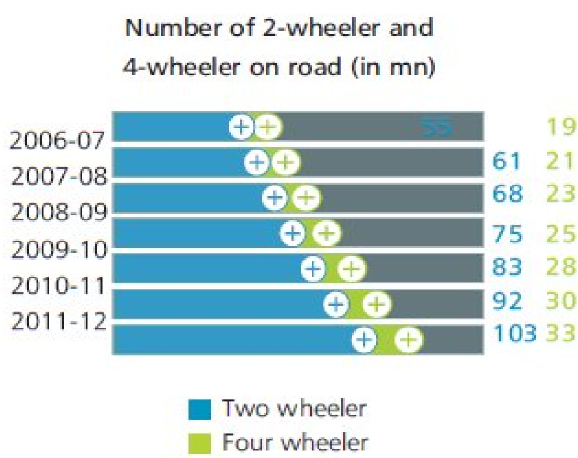
CAGR for the last five years (2005-06 to 2010-11): Car – 18.6%, UV 15.2%, 3W – 13%, LCV – 18.9%, M&HCV – 9.4% and Tractor – 10.8%

Though OEM sales have slowed down since the last 1 year on account of various micro and macro economic factors, in the longer run the twin factors of increasing affordability and low penetration are expected to help sustain double digit growth for the next 5 years in India's automobile demand.

Replacement market – Replacement demand is the after demand where as a part of the maintenance of the machines or rotating machine, the bearings are replaced by new bearings after it is failed as natural life deterioration/wear and tear or due to premature failures and need replacement. The replacement market represents the demand arising on account of replacing the used and worn-out bearings.

The size of replacement market is dependent on equipment population and frequency of maintenance. As per the industry stats, the replacement market accounts for 40% of the total demand, while OEMs account for the rest.

Talking specifically of the automobile segment, at the end of FY 03 there were 6.7 crore registered vehicles in India while the number of registered vehicles are expected to have crossed a mark of 13.5 crore at the end of FY 12.



As the bearings start wearing out, the performance of machines and automobiles starts deteriorating and therefore bearings need to be replaced. In view of the same, companies like FAG Bearings are expected to benefit from the ever increasing number of registered vehicles on the Indian roads, though it is important to note here that in replacement market FAG faces tough competition from cheaper imports and counterfeit products from small unorganized players.

FAG Bearings India Ltd – An Introduction

FAG was incorporated as Precision Bearings India Ltd in the year 1962. In 1986, the company changed its name to FAG Precision Bearings Ltd and in 1999 they got their present name FAG Bearings India Ltd. It is engaged in the manufacture of ball/roller bearings and related components. In 1997, FAG set up India's first 100% Export Oriented Unit (EOU) for bearings.

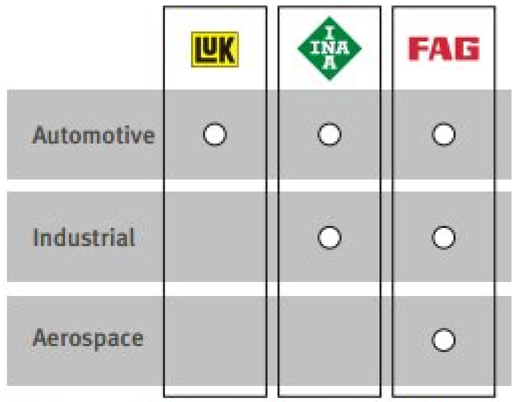
FAG Bearings India is the second largest player in the Indian bearings industry with **Schaeffler Group, Germany** as the promoters of the company with 51.33% stake. FAG has consistently outperformed Bearings industry growth and it now commands around 15% market share in the bearings industry in India and ~29% market share in the organized segment.

Since the inception of FAG Bearings India Limited, the Indian Railways has been its important customer. Apart from being a leading OEM supplier to the automotive, mechanical and electrical engineering industry, it also sells bearings for replacement market through dealers throughout the country. The company also exports its bearings to various countries with the help of its parent company.

Schaeffler Group has been extremely critical in the success of FAG India. Know why?

'**Schaeffler Group**' of Germany is a global leader in the bearing industry. It has operations in 75 countries and has been in existence for the past 120 years. It is among the innovation leaders in the industry with around 1,600 patent registrations annually and a total of nearly 16,000 patents in force.

With its brands LuK, INA and FAG, Schaeffler is a leading global manufacturer of rolling bearings and linear products, as well as a renowned supplier to the automotive, industrial and aerospace industry. With sales of around €10.7 billion in 2011, Schaeffler is one of the largest German and European industrial companies in family ownership.



Main brands and divisions of the Schaeffler Group

As mentioned above, the industry has high entry barriers in the form of capital intensity and restricted access to technology and we therefore believe that the association of Schaeffler Group is extremely critical in the success of FAG Bearings India, as all (yes, all) the large and successful players of the Indian Bearings industry are dependent on the technology provided by their parent companies or foreign collaborators.

With Schaeffler's strong research and development and continuous improvement in product portfolio, FAG can march ahead of its competitors as has been the case for the last few years.

Restricted technology also acts as an entry barrier to the growth of number of bearing manufacturers in India in the organized segment. Though, there are numerous players in the unorganized segment, however, they primarily cater to the replacement market and continue to serve the very low-end market as well as form the core of the counterfeit products in the market.

Diversified client base across automotive, electrical and heavy engineering industries – FAG has clients like, Indian Railway, Maruti Udyog, Mahindra & Mahindra, Tata Motors, Ashok Leyland, Bajaj Tempo, Bajaj Auto, LML, TAFE, Siemens, ABB, HMT, Kelvinator, Lucas TVS and LMW, Eicher tractors, FIAT India, Ford India, General Motors, Hero

Honda, HMT, Hyundai India, John Deere, Kinetic Motor, New Holland, Telco, Yamaha Motor, Kirloskar Group, Usha, NTPC, BHEL, Crompton.

Having clients across several industries helps FAG mitigate the risk of downturn in a particular industry.

Why FAG and not SKF?

In the very beginning we mentioned that even though SKF is the largest player we find FAG Bearings a better company. Well, the various reasons behind the same are as below (also refer Peers comparison section):

Consider this: FAG is virtually half the size of SKF India (1,308 crores sales in CY 11 against SKF's 2,424 crores sales) and yet its operating profit in CY 2011 was almost equal (231.45 crores against SKF's 248.55 crores) to that of SKF India.

- Over the last 5 years, FAG's rate of growth has been much higher in comparison to SKF or for that matter any other major player from the organized segment.
- We found a striking difference in the operating margins of the two companies. While FAG has been able to maintain its operating margins in the range of 18-21% (very good), SKF's operating margins have hovered in the range of 12-13%.
- Besides operating margins, FAG has done much better in terms of utilization of its assets.

Why does FAG commands higher margins in comparison to SKF – FAGs manufacturing process is batch driven where a greater degree of product customization is possible whereas SKF India has an assembly-driven manufacturing process. This explains why within the ball bearing segment, FAG margins are better than SKF India in spite of the scale available with the latter.

Further, SKF India is the market leader in the ball bearing space. The bulk of spurious bearings as well as cheaper imports attack ball bearings segment the most. This significantly affects SKF India's profitability in the replacement market. FAG also gets affected but to a lesser extent as its batch-driven manufacturing is able to choose a more profitable mix within ball bearings.

Lastly, SKF Technologies will remain an overhang on SKF India. SKF Sweden has commissioned a large bearing plant in Ahmedabad which has no ownership of SKF India. However, SKF India has given a loan to SKF Technologies, Ahmedabad at a market rate of interest (which is significantly lower than its return on capital employed) to fund its capital expenditure. In the medium term, SKF Technologies will export most of its production in which SKF India would not receive any trading margin. FAG does not have any such confusing arrangement with its parent.

Performance Snapshot

Particulars (In cr.)	CY 11	CY 10	CY 09	CY 08	CY 07	CY 06
Net Sales	1312.34	1048.59	818.69	760.07	651.47	549.5
Operating Profit	257.75	188.68	124.15	166.82	141.1	125.66
Operating Profit Margin (%)	19.64%	17.99%	15.16%	21.95%	21.66%	22.87%
Other Income	27.06	16.76	7.73	5.98	2.82	3.42
Finance cost	1.26	0.89	0.70	0.48	0.40	0.00
Depreciation	22.59	20.11	20.08	20.59	19.36	18.3
Profit Before Tax	260.96	181.88	111.1	151.73	124.16	110.78
Exceptional Items						
Tax	84.99	60.38	34.04	51.63	44.95	37.08
Profit After Tax	175.97	121.5	65.54	95.72	79.53	73.7
Profit After Tax Margin (%)	13.41%	11.59%	8.01%	12.59%	12.21%	13.41%
Cash from Opt.	80.79	132.01	163.36	42.91	82.18	70.00
Return on Average Equity	27.00%	23.47%	15.12%	26.47%	28.12%	32.81%

As can be observed from the above illustration, the performance of the company has been excellent on various parameters: growth, margins, profitability, cash flows from operation, return on shareholder's funds etc.

What's noteworthy is that during the last 5 years both Automotive and capital goods industries (bearings are used in almost all the industries) witnessed good and bad periods, however FAG consistently delivered higher sales (even during FY 09) at the rate of 19% annualized.

Similarly, the profits of the company have also grown at the same rate of 19% annualized on the back of consistently improving operating income and interest income on ~200 crore surplus funds with the company.

Yes, FAG Bearings is a debt free company, with surplus funds, as it has been able to consistently generate very good cash flows from operations.

While discussing the key features of bearings industry we mentioned that the organized players are able to pass on the increase in the prices of raw materials to their customers, though with a certain lag; similarly FAG has been able to maintain its operating margins in the range of 18-21% during most of the years.

During 2009, as we are all aware, the automobile demand witnessed a sharp contraction in comparison to previous years and therefore FAG's operating margins also dipped to a low of 15%, however with the revival of demand it could again reclaim 18-20% margins in subsequent years.

Peer Comparison

Particulars	5 Yr Sales CAGR	10 Yr Sales CAGR	5 Yr Net Profit CAGR	10 Yr Net Profit CAGR
FAG Bearings India	19.01%	20.33%	18.37%	27.17%
SKF India	12.56%	21.57%	16.64%	30.71%
Timken India	14.28%	17.41%	11.20%	20.20%
NRB Bearings	12.42%	15.76%	5.10%	15.96%

Operating Profit Margins (%)	Dec'11	Dec'10	Dec'09	Dec'08	Dec'07	Dec'06
FAG Bearings India	19.64%	17.99%	15.16%	21.95%	21.66%	22.87%
SKF India	12.19%	12.87%	10.84%	12.72%	16.64%	12.71%
Timken India	13.36%	15.24%	13.25%	17.23%	17.61%	19.13%
NRB Bearings	19.94%	23.39%	17.49%	16.05%	22.76%	25.84%

Return on Avg. Equity (%)	Dec'11	Dec'10	Dec'09	Dec'08	Dec'07	Dec'06
FAG Bearings India	27.00%	23.47%	15.12%	26.47%	28.12%	32.81%
SKF India	22.42%	22.64%	13.86%	21.44%	33.21%	26.48%
Timken India	NA	14.38%	10.38%	19.59%	16.60%	20.34%
	Mar'12	**Mar'11**	**Mar'10**	**Mar'09**	**Mar'08**	**Mar'07**
NRB Bearings	20.82%	26.52%	13.48%	2.40%	19.63%	26.70%

As can be observed from the above illustrations, FAG's been the most consistent performer across all the operating parameters. The company's growth in sales and profits has been consistent across both 5 and 10 years segments, it commands higher margins in comparison to its peers and has consistently delivered higher return on shareholder's funds.

Operating efficiency

	Net Sales (cr.)	*Avg. Capital Employed (cr.)	*Avg. Working Capital (cr.)	Capital Turnover	Sales to Working Capital	Debt Equity ratio
FY 06	549.5	177.37	80.2	3.10	6.85	0
FY 07	651.47	226.52	105.28	2.88	6.19	0
FY 08	760.07	305.98	166.18	2.48	4.57	0
FY 09	818.69	318.51	173.53	2.57	4.72	0
FY 10	1048.59	278.26	136.95	3.77	7.66	0
FY 11	1312.34	340.83	181.18	3.85	7.24	0

* - Excludes Capital work in progress, fixed deposits

As can be noticed from the above table, the good point about FAG's performance has been an overall improvement in operating and capital allocation efficiency.

With every passing year the company has been generating more revenue for every single rupee employed in the business (barring 2008-09 when there was a significant drop in demand).

Further, since the company has been generating good cash flows from operations, they have been able to repay all the debts while still carry out requisite expansion every year and maintain surplus funds.

Capacity and Sales expansion

Particulars	Dec'11	Dec'10	Dec'09	Dec'08	Dec'07	Dec'06	Dec'05
Installed Capacity (in no.)	50957000	50038000	50038000	49728000	47103000	43338000	30174000
Production (in no.)	78324524	67749073	47711012	46436359	45146713	44140102	32289550
Capacity Utilization	153.71%	135.40%	95.35%	93.38%	95.85%	101.85%	107.01%
Sales (in no.)	77454390	66271133	49259019	45411889	44621155	42971186	32062545
Sales (in cr.)	853.84	668.76	502.02	525.23	474.7	417.79	332.76

As can be observed above, FAG's been very efficient with capacity utilization and has reported more than 95% capacity utilization on consistent basis.

It keeps on making gradual additions to its capacity, ensuring there's not much un-utilized capacity and therefore extremely efficient with asset utilization and overall operating performance.

Considering the fact that it achieved more than 150% capacity utilization during CY 11, FAG spent more than 150 crores during the calendar year 2011 (l00 crores capital work in progress) on expanding its capacities in the existing Vadodara plant and for setting up a new plant at Savli.

(Rs. in million)

	SCHEDULE	31.12.2011	31.12.2010
(I) SOURCES OF FUNDS			
(1) Shareholders' funds:			
(a) Capital	1	166.2	166.2
(b) Reserves and surplus	2	7,134.2	5,568.4
		7,300.4	5,734.6
(2) Deferred tax liabilities (Net) [Note 18]		31.7	29.3
Total		**7,332.1**	**5,763.9**
(II) APPLICATION OF FUNDS			
(1) Fixed assets:	3		
(a) Gross block		4,752.3	4,189.9
(b) Less: Depreciation		2,969.1	2,779.9
(c) Net block		1,783.2	1,410.0
(d) Capital work-in-progress		568.4	61.7
(e) Capital advances		501.6	24.3
		2,853.2	1,496.0

Trading Sales

Particulars	Dec'11	Dec'10	Dec'09	Dec'08	Dec'07	Dec'06	Dec'05
Purchases (in no.)	1336194	941708	852575	708081	761562	272521	150494
Sales (in no.)	1236333	924574	943331	583286	676224	239365	157698
Purchases (in cr.)	318.64	267.59	212.32	206.06	114.95	78.35	59.63
Sales (in cr.)	414.67	340.6	275.98	202.1	135.44	86.64	68.45

Besides manufacturing bearings at its own plants, FAG also imports certain large diameter and special bearings that are not manufactured in India, from its holding and numerous associate companies.

Being a part of Schaeffler Group plays a crucial role in the trading sales segment of FAG India, as the company gets access to technically advanced products sought by OEMs and that are not manufactured in India.

Further, as can be observed above, the company has been able to scale up its trading sales at a much higher growth rate on account of its well established association with OEMs and easy access to products from associate companies.

Shareholding Pattern

	Sep'12	Jun'12	Mar'12	Dec'11	Sep'11
Promoter and Promoter Group	**51.33%**	**51.33%**	**51.33%**	**51.33%**	**51.33%**
Foreign	51.33%	51.33%	51.33%	51.33%	51.33%
Public	**48.67%**	**48.67%**	**48.67%**	**48.67%**	**48.67%**
Institutions	31.82%	31.66%	32.13%	31.97%	31.64%
FII	14.53%	13.90%	13.84%	13.79%	13.86%
DII	17.29%	17.76%	18.29%	18.18%	17.78%
Non-Institutions	16.85%	17.01%	16.54%	16.70%	17.03%
Bodies Corporate	5.53%	5.53%	4.93%	5.03%	5.03%
Total	**16617270**	**16617270**	**16617270**	**16617270**	**16617270**

As mentioned above, Schaeffler Group from Germany is the promoter of FAG Bearings India and with 51.33% stake in the company its interests are well aligned with the public shareholders of the company.

Being a Schaeffler group company has been one of the most important factors behind FAG's resounding success as it has helped the company launch technologically advanced products in the bearings market and thereby strengthen association with most of the OEMs.

Besides, the institutional shareholding is fairly high with some well known long only funds such as IDFC Premier, HDFC Midcap opportunities, etc invested in the company.

Dividend Policy

Dividend Payout ratio					
	Dec'07	**Dec'08**	**Dec'09**	**Dec'10**	**Dec'11**
Dividend Payout ratio	8.36%	7.81%	11.41%	6.84%	9.44%

Since many years FAG has been consistently deploying funds at higher rates of return and therefore retaining large portion of net profits has worked in favor of shareholders in terms of capital appreciation, however we believe that dividend payout can be higher at 15-20% of the net profit, especially since it's a debt free company with surplus funds in its kitty.

Valuations

As has been observed in the previous few sections, FAG has been very efficient with capital allocation, delivered consistently high return on shareholder's funds and has developed certain strengths/capabilities which should help the company extend advantage over its peers and grow at a much higher pace in comparison to the industry.

Further, rapid industrialization and economic growth will drive an ever increasing demand for personal transportation. This will push demand of passenger cars. Growing prosperity in rural areas will positively influence demand of motorcycles as well as agricultural tractors in India.

A large number of public and private investment programs in core sectors like steel, cement, power etc. manifest Indian government's priority to infrastructure development. Renewable energy too shows a lot of potential in the medium and long term.

Overall prospects for industrial development thus remain very positive in India and we expect strong demand of bearing products to continue in the coming future.

As far as valuations are concerned, FAG Bearings is currently available at a market cap of Rs 2,850 crores and holds fixed deposits of Rs 200 crores.

For CY 11, the company recorded profit before tax of Rs 261 crores. Considering the operating performance of the company, efficient capital allocation, debt free status with surplus funds to the tune of Rs 200 crores, overall growth prospects and collaboration with Schaeffler Group, we believe the valuations are in the fair zone at ~11 times CY 11 (Dec ending) profit before tax.

This is not to say that the stock cannot witness any short term corrections, however 10-15% correction to ~Rs 1350-1450 will make the stock even more attractive for long term investment.

In view of the same, we would suggest an initial portfolio allocation of 4% with further increase in allocation to 6-7% in case of a correction to Rs 1400-1450.

Risks & Concerns

We believe the risk of competition from unorganized players, cheap imports and counterfeit products has been prevalent for many years now and FAG's been able to counter the same through continuous focus on improving its product portfolio with strong support from global Schaeffler know how.

The major concern at the moment is the slowdown in automobile industry and all the other major industries which are the customers of bearing manufacturers. Though long term prospects are very bright for the automobile industry in India, in the short term however, demand growth may see some cyclic impact due to factors such as uncertain political scenario, global developments, increasing commodity prices etc.

Bearing steel constitutes a major portion of bearing costs. Though FAG enjoys pricing power with OEMs, there's a certain degree of delay before the company is able to pass on the hike to the customers and thus in a year with a sharp increase in prices of steel or a steep fall in demand, the margins of the company can come under pressure.

Katalyst Wealth – Alpha/Alpha + Portfolio

Katalyst Wealth **Alpha/Alpha + Portfolio** service is focused on helping individual investors/institutions beat market returns by a wide margin without taking large risks through in-depth research, analysis and follow up on the stock.

For more information on **FAG Bearings India Ltd**, discuss with **Ekansh Mittal**

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