Buy

Automotive Axles

Industry: Auto and Auto Components

'Axle'rating on CV cycle...

Established in 1981, Automotive Axles Limited (AAL) is a joint venture of Kalyani Group and Meritor Inc., USA (formerly the automotive division of Rockwell International Corporation), 35.52% stake each. With manufacturing facilities located at Mysore (Karnataka), Pantnagar (Uttarakhand) and Jamshedpur (Jharkhand), the company manufactures drive axles, non-drive axles, front steer axles, specialty & defense axles and drum & disc brakes. It provides these products to the major domestic and global manufacturers of trucks & buses pertaining to segments such as light, medium & heavy commercial vehicles, military & off highway vehicles, aftermarket and exports. Although the CV industry is facing short term headwinds like liquidity crunch, rising interest rates and fuel costs the long term demand is intact as BS VI implementation and scrappage policy will trigger a strong and continuous demand for the sector. The company being market leader in axles business is well placed in gaining incremental business from its clients in an event of any regulations mentioned above getting materialized. Strong topline growth, hefty margins & return ratios, clean balance sheet, healthy growth potential, capacity expansion plans draw our attention towards this stock. We initiate the stock with a BUY recommendation with a target price of ₹ 1,898.

Investment Rationale

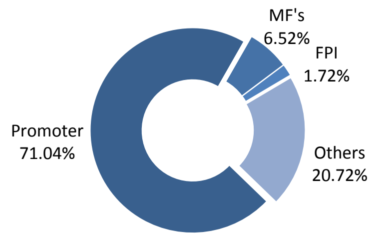
Proxy to the domestic CV cycle up move….

Post a lull observed after the DeMon, BS IV and GST implementations, CV industry took a U turn and bounced back with healthy growth rates close to 25-30%. The year FY18 ended at a growth rate of 19.4% for the trucks segment. In the first seven months of FY19 too, the sector reported 42% growth rate and is expected to end the year with at least 15-20% growth given the headwinds mentioned above which the sector may face in the remaining months of FY19. However, the long term macro drivers for the CV space to grow are in place. With infrastructure activities gathering steam across India, especially in the states/cities like UP, Delhi and Mumbai the demand for trucks is expected to remain buoyant. Post the easing up of mining ban in Karnataka, tipper demand is on an up move. The recent floods in Kerala may require the government bodies to rebuild infrastructure in major part of the state. This may lead to truck demand going up in the state in the coming months. With elections scheduled in 2019, there will be a rush to complete many infrastructure projects that is expected to improve CV sales. Public sector investments and public consumption, good monsoons driving rural demand, and burgeoning e-commerce segment are instrumental in economic recovery and hence commercial demand.

The company has a strong customer base in the domestic market catering to all major OEMs in Indian CV industry and continues to retain its position as the largest independent manufacturer of rear drive axles for medium and heavy commercial vehicles (M&HCV) in India.

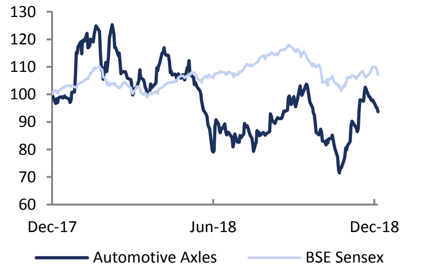
Stock Data	
Current Market Price (₹)	1,285
12M Price Target (₹)	1,898
Potential upside (%)	48
BSE / NSE Symbol	505010 / AUTOAXLES
Reuters / Bloomberg	ATOA BO / ATXL IN
FV (₹)	10
Market Cap Full (₹ bn)	20.10
52-Week Range (₹)	1,849 / 987

Shareholding Pattern



YE Mar	FY17	FY18	FY19E	FY20E
Revenues(₹ mn)	11,723	15,194	18,929	22,419
EBITDA (%)	9.7%	11.0%	12.0%	12.7%
PAT (%)	3.8%	5.4%	6.2%	6.7%
EPS ((₹)	32.7	55.6	78.1	99.9
P/E (x)	40.6	23.9	17.0	13.3
P/B (x)	5.3	4.5	3.7	3.0
EV/EBITDA (x)	176.6	120.0	88.0	70.3
ROE (%)	13.1%	18.9%	21.7%	22.6%
ROCE (%)	19.4%	27.9%	27.9%	29.0%

Relative Price Performance



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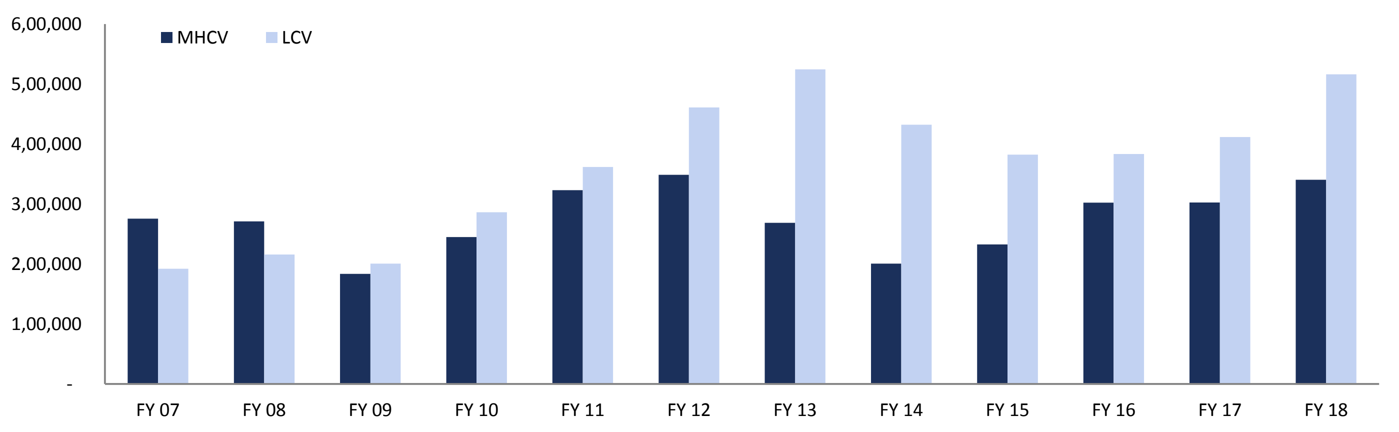
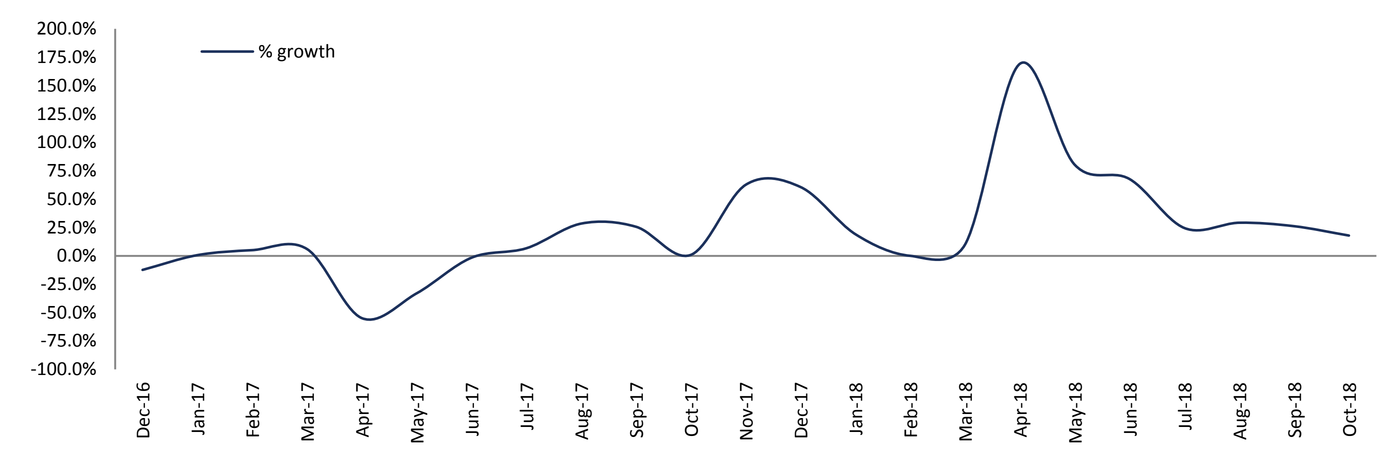
Annual domestic M&HCV & LCV volumes (No. of units)



Source: SIAM, LKP Research

M&HCV monthly volume growth trend (% growth)



Source: SIAM, LKP Research

Strong clientele and management provides comfort level and steady performance during tough macro environment

AAL being a JV between Arvin Meritor Inc., USA (formerly the automotive division of Rockwell International Corporation), a Fortune 500 company, and the Kalyani Group ensures sound management support. Products manufactured at AAL are based on technology provided by Meritor through its subsidiary Meritor HVS India Ltd, and more than 90% of the sales are routed through it. AAL's domestic OEM customers include Ashok Leyland, Daimler India, Man Trucks, Mahindra & Mahindra, Tata Motors, Volvo Eicher, Asia Motor Works and Indian Army, among others. AAL also exports its products indirectly through Meritor HVS India Ltd. to various countries including the US, France, Italy, China and Brazil. Ashok Leyland's 75-80% of requirement is sourced from AAL, while 15% of Tata Motors' requirement is sourced from AAL. Tata Motors has its captive, in-house facility to manufacture axles, however due to cost efficiencies the OEM is now starting to buy from AAL. AAL has won order to supply to the Ultra series of trucks of Tata Motors. Being in strong collaboration with such big names, AAL has been able to easily weather the macroeconomic and sectoral ups and downs over the past several years, which can be justified by the fact that the topline has grown three fold in the period between FY14-18, while the bottomline has grown at a CAGR of 45% in the same period.

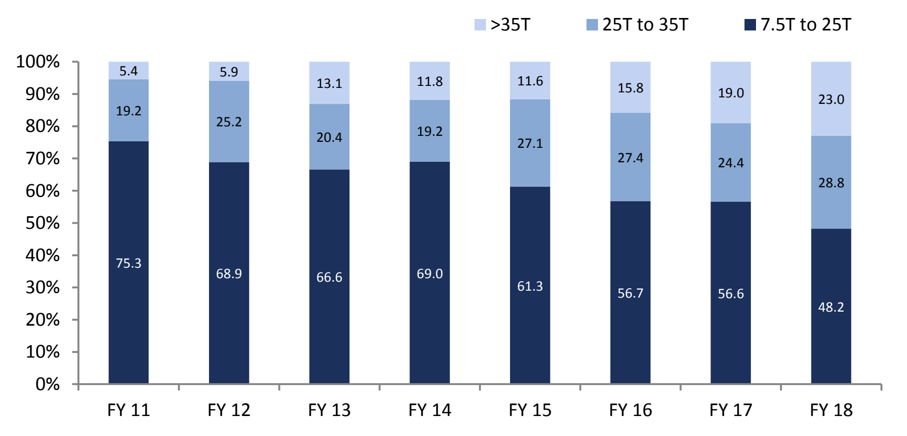
Key clientele

Source: Company, LKP Research

AAL, a big beneficiary of shift towards Multi Axle Vehicles (MAVs)

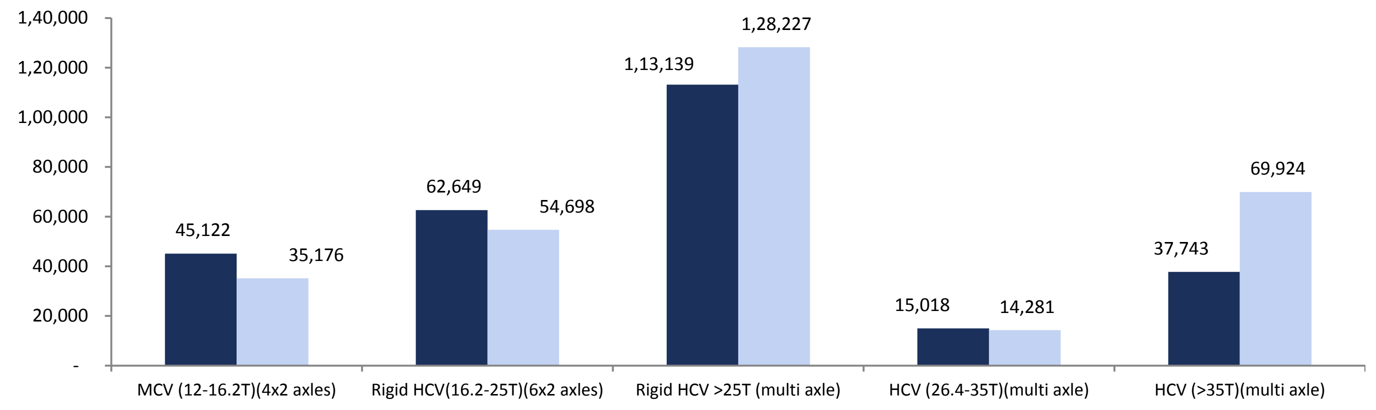
Implementation of GST has led to a single market by scrapping check posts. Also improvement in road conditions, smoother and speedier trucking has reduced the delivery time by 20-25% post GST implementation. Economics, overloading norms are driving transporter attention towards bigger, multi axle trucks that can haul more. There is a structural shift towards the 'Hub and Spoke' model of logistics leading to rise in demand for higher tonnage, multi axle CVs to economize logistics between the hubs. Consolidation of warehouses, post GST implementation is expected to drive demand for LCVs. Share of higher tonnage vehicles have increased to 23% by FY18 end from 5.4% in FY11. Stricter implementation of overload norms has led to higher CV demand; enforcement of overloading restrictions along with the implementation of new axle norms have forced fleet operators to stick to rated loads forcing the fleet operators to switch to multi axle trucks owing to their low cost per tonnage, better fuel efficiency. Compliance with the new emission norms under BS VI will also force a gradual buying of new trucks by fleet operators.

Rising share of higher tonnage vehicles (%)



Source: SIAM, LKP Research

Tonnage wise M&HCV classification in FY 17 and 18 (No. of units)



Source: SIAM, LKP Research

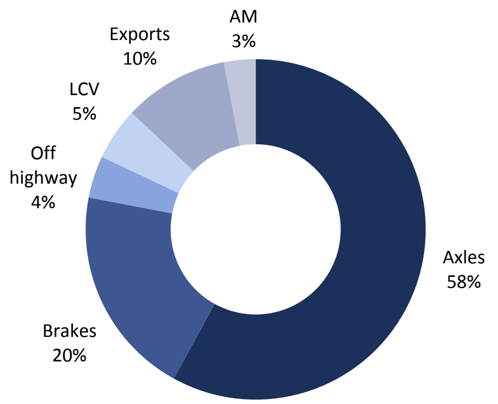
Vehicle scrappage policy a major driver for CV demand

The much awaited VVMP (Voluntary Vehicle Fleet Modernization Programme) or the scrappage policy as commonly said, to exchange vehicles with age of 15 years and above (65% of pollution is caused by vehicles aged more than 15 years and above) would be a massive driver for CV demand. This policy is on the verge of finalization and will be creating huge replacement demand. The tentative date of announcement and implementation is April 2020. It is likely to boost the industry turnover by 3-4x over 5 years post implementation thus benefitting the entire supply chain from vendors to OEMs.

Capacity expansion to cater to the mid-long term CV demand

AAL's plants operate at optimal capacity currently. However, with anticipation of flourishing CV demand, the company is in process of expanding its manufacturing capacities by >25-30% till FY 20. The existing axle capacity which is at 14,500 units per month is slated to move up to 20,000 per month and brake capacity which currently stands at 85,000 units per month will expand up to 120,000 per month. The financing requirement will be to the tune of ₹ 250-300 cr for this and will be done in 50:50 arrangement as in internal accrual: LT debt raised. This expansion will accommodate the rising CV demand in the coming years.

Revenue breakup



Source: Company, LKP Research

Rising exports opportunity

AAL's parent Meritor Inc. is a largest player in designing and manufacturing rear axles for commercial vehicles on global platform. Meritor has supply agreements with OEM from North & South America, Europe and Asia across variety of loading parameters. Improving economy in US and Europe to boost the demand for commercial vehicles in long term; AAL being a prime vendor for Meritor has natural advantage of gaining from the rising demand from developed nations. Currently AAL sources 10% of its topline from exporting loose parts that go into making of axles and brakes at Meritor Inc (in addition to the complete axle sets), has ample scope to grow given the reach and relations of Meritor with global OEMs.

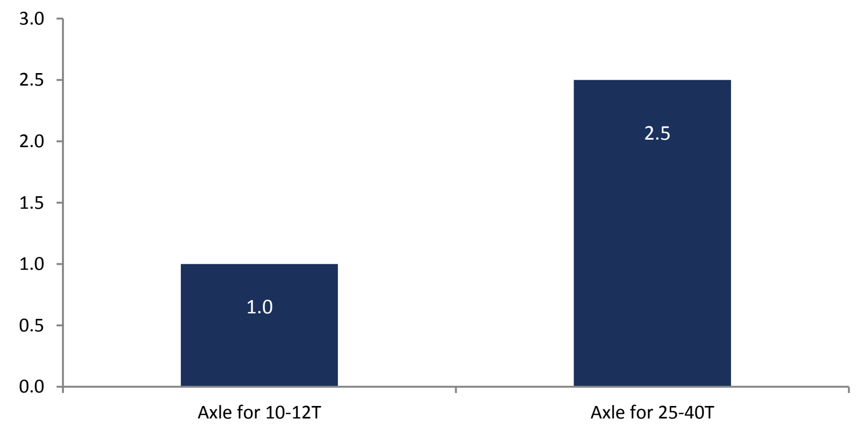
Improved product mix to trigger margin growth

Meritor India, the JV partner of AAL has entered the suspension market by manufacturing the slipper type suspension. It is a type of leaf spring suspension which has some clear benefits over the conventional Bellcrank suspension currently used in India. A study done by fitting the suspension in customer vehicles revealed maintenance cost reduction from 15 to 20 paise per km to 3-5 paise per km. Weighing 80-100kg less, it enables the operator to carry extra load. Tyre wear was found to be 30% after 60,000km whereas in Bellcrank suspension tyre has to be replaced after 40,000km. With just 10% increase in cost over the conventional suspension, operators would derive significant savings in the long run. As the demand for light weight, technologically advanced axles rise post BS VI implementation and the export opportunities for axles along with the new products like suspension system which will help the company expand its product bouquet and increase its content per vehicle. As more and more OEMs adopt this technology in India, revenues of AAL could see a sharp jump. Further AAL has introduced new products that combine suspension system with axle assembly and is looking forward to introduce integrated system combining suspension, axles and brakes in the near future. All these will create a differentiated product and push sales and margins upwards over the next few years. Also the margins will be supported by increasing demand for higher tonnage trucks as the realizations for axles of such trucks is in the multiples of 2-2.5x of the axles of normal trucks.

Product portfolio

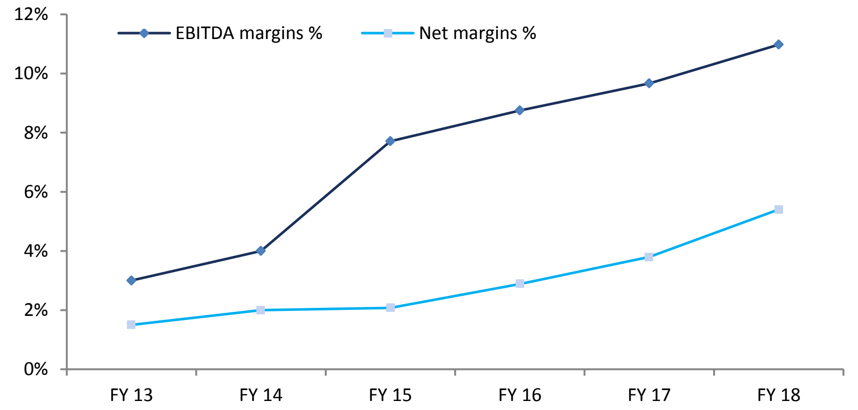
Source: Company, LKP Research

Higher realizations and better margins for high tonnage axles(x)



Source: Market estimates, LKP Research

Margin performance



Source: Company, LKP Research

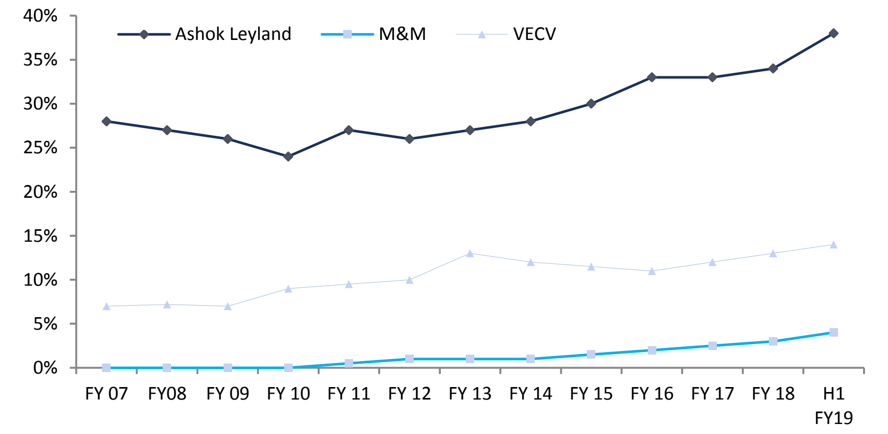
Clientele performance key to AAL's growth

Excluding Tata Motors the #1 CV maker in India, which has its own captive axle arm, the other leading CV makers in the country are largely dependent on AAL. Ashok Leyland, M&M, Volvo Eicher CV (VECV) are its largest clients. AAL accounts for 75-80% of Ashok Leyland's axle requirement. The OEM has gained market share in M&HCV domain for last 4 years – from 27% in FY 14 to 34% in FY 18 and has moved forward to 38% in HY FY19. In the same period when the M&HCV industry has grown by 14.4%, Ashok Leyland has grown at a CAGR 0f 21.5%.thus grabbing the market share especially in the 31T to 37T MAV segment. As the segment matures, the industry is moving towards launching of higher tonnage trucks. Tata Motors has already unveiled a product in 40T segment, followed by Ashok Leyland and VECV who have recently launched their products in this nascent space which is expected to see a great traction and at a good pace.

AAL being the prime vendor, has lion's share in the axles supplied to M&M CV across latter's portfolio; M&M CV has outgrown the industry by quite a margin i.e. 35.5% CAGR in last 4 years (FY14-18) vs industry growth of 14.4%, though on a smaller base. With the success of the existing portfolio (Mahindra Trucks and Buses has broken even in FY18), M&M CV is becoming aggressive in building momentum and targets to be a leading player in the M&HCV segment. AAL, being a prime vendor would be a big beneficiary of M&M's M&HCV growth story.

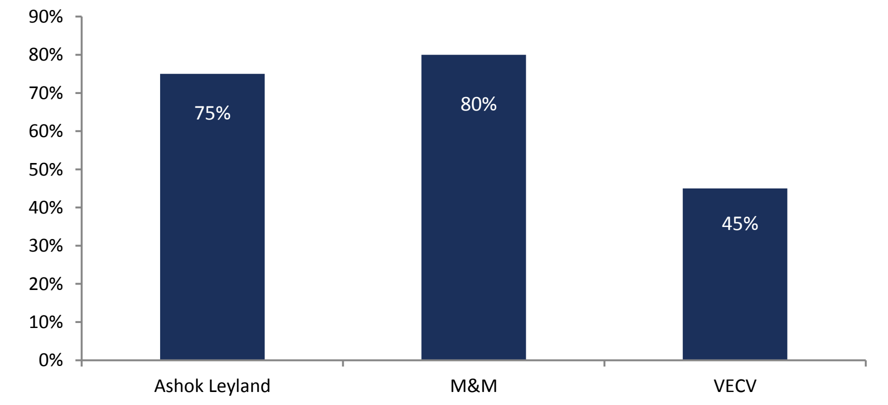
Though VECV has slightly underperformed the industry by growing at 13.9% v/s 14.4% industry growth in the last four years the company has been participating and will participate in the growth story of the company.

Market shares growth of AAL's key clients



Source: SIAM, LKP Research

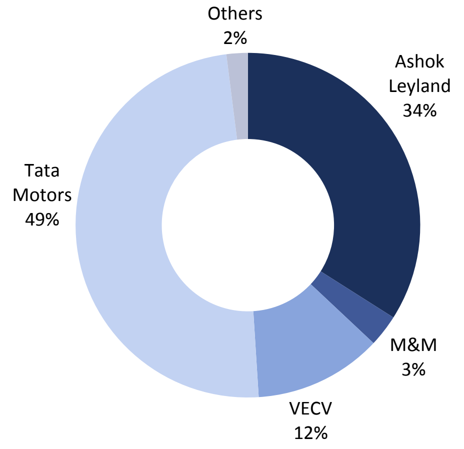
AAL's market share* in key M&HCVs clients



Source: Company, LKP Research

** Approximate numbers*

M&HCV market shares – FY18



Source: SIAM, LKP Research

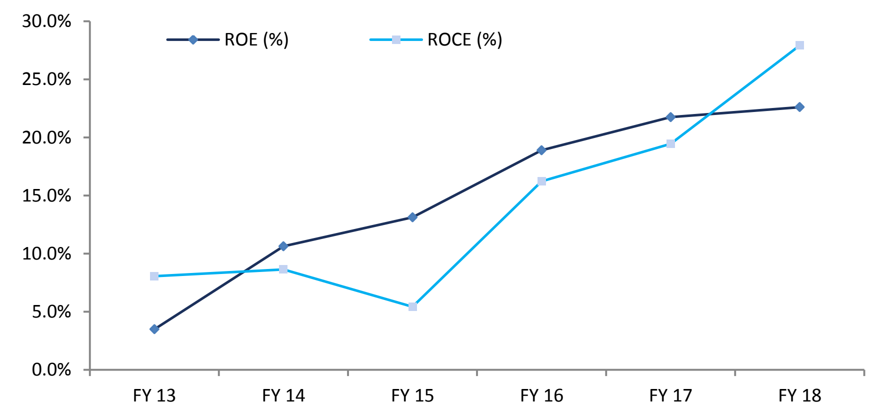
New axle overloading norms – a golden chance

The GOI has increased the permissible Gross Vehicle Weight (GVW) of heavy trucks (GVW higher than 16T) by about 12-25% across combination of body types, axles and tyres besides scrapping the mandatory annual renewal of fitness certificates for freight carriers. All trucks approved on or after July 16, 2018 shall be tested for the higher axle loads by testing agencies. The new axle norms would impact around 50% of the M&HCV industry; while the remaining 50% would be relatively unaffected as it caters to the voluminous load e.g. trailers, water tankers, fragile goods carriers, oil tankers etc. where space is a constraint. Stringent implementation of new axle norms is likely to push the new demand given the extent of over loading prevalent in the segments like tippers, transporters fleets etc. where they do not limit the overloading to 20-25% of the licensed capacity which would now become the new licensed capacity. The implementation of revised axle norms is likely to cause some postponement of sales in short term, however, more stricter implementation would drive demand for the higher tonnage trucks owing to the lower operating costs for the transporters.

Comfortable cash flow position key to sustain capex plans

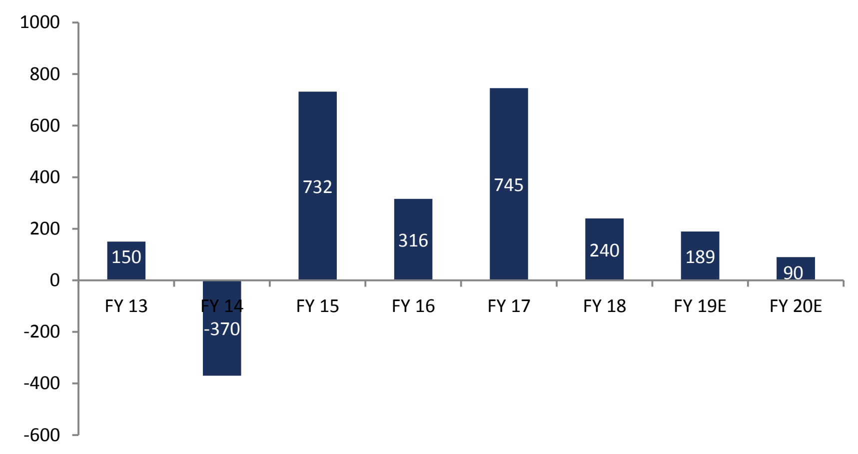
AAL has been a debt free company till FY 18. In anticipation of exponential demand for trucks post VVMP implementation, AAL is expanding its capacities both at the axles division and brakes division as the utilization rates are already to the north of 85%. The company has been raising about ₹ 2.5-3 bn in between FY17-20 to be funded through internal accruals and debt. In the last five years the company has been successfully throwing free cash flows except for FY14. In FY18, rising demand led to higher inventory and receivables, but was negated by equally higher payable days. Also the cash conversion cycle has significantly come down to 66 days in FY18 from 150 days in FY15 thus denoting meaningful improvement in working capital cycle in a short duration of time. Going forward, WC requirements are expected to grow at the pace of sales and would be comfortably taken care of by internal accruals, as a result of which AAL would not have to resort to short term debt to fulfill WC requirements. However, to fund the capex, the company has to raise long term debt to the tune of ₹ 1.25-1.5bn (as per our estimate), which would reduce down FCF in FY19E and 20E. However, we believe that FCF will still remain in positive territory. Return ratios have remained in healthy zone and are growing fast along with margins. Going forward too, with capacity expansions and higher operating leverage due to increasing CV demand, we believe return ratios will continue to grow in line with strong bottomline margins.

Improving return ratios



Source: Company, LKP Research

FCF (₹ mn)



Source: Company, LKP Research

Quarterly Performance

₹ mn	Q2 FY19	Q1 FY19	% qoq	Q2 FY18	% yoy
Total income	4,984	4,738	5.2%	3,496	42.5%
Raw material costs	3,405	3,291	3.5%	2,447	39.2%
Employee costs	312	316	-1.3%	229	36.5%
Other expenses	679	572	18.8%	429	58.4%
EBITDA	588	559	5.1%	393	49.8%
EBITDA margins %	11.8%	11.8%	0 bps%	11.2%	60 bps
Depreciation & Amortization	123	125	-1.8%	98	25.1%
Interest expenses	2	2	11.1%	1	66.7%
Other income	9	9	-4.4%	16	-46.0%
PBT	445	442	0.7%	310	43.7%
Tax	152	152	0.2%	105	44.6%
Adjusted PAT	293	290	1.0%	205	43.2%
Exceptional items	-	-	N/A	-	N/A
Reported PAT (₹)	293	290	1.0%	205	43.2%

Outlook and valuation

Being the one stop shop and market leader for all the axle and axle related equipment supplying to both domestic and international OEM players along with supplying to the aftermarkets, AAL is one of the biggest beneficiary of the M&HCV cycle excelling in the super positive territory. Regulations such as BS VI, new axle norms and VVMP would lead to very strong demand in coming years thus increasing content per vehicle and realization growth due to increase in demand for higher tonnage trucks. The company is blessed with a strong parent lineage of the Kalyani and Meritor Groups handing a comfort level to us. Sound financials and an exponential growth in both topline and bottomline despite macro headwinds historically make a clear case of investment. The company's initiative in diversifying its portfolio would lead to better margin performance. A debt free company with ROE and ROCE of 19% and 28% respectively in FY18, clean balance sheet and aggressive expansion plans (in line with the M&HCV growth) are the additional positives. On FY 20E earnings the stock is trading at 13x, which we believe can easily expand considering the positives of the CV industry. We recommend a BUY with a 12 month target of ₹ 1, 898.

Financials

Income statement

YE Mar (₹ mn)	FY 17	FY 18	FY 19E	FY 20E
Total Revenues	**11,723**	**15,194**	**18,929**	**22,419**
Raw Material Cost	8,257	10,622	13,156	15,469
Employee Cost	814	993	1,155	1,368
Other Exp	1,518	1,911	2,347	2,735
EBITDA	**1,133**	**1,668**	**2,272**	**2,847**
EBITDA Margin (%)	9.7%	11.0%	12.0%	12.7%
Other income	20	45	60	80
Depreciation	391	429	568	673
Interest	12	5	4	3
PBT	**750**	**1,278**	**1,760**	**2,252**
PBT Margin (%)	6.4%	8.4%	9.3%	10.0%
Exceptional items	0	0	0	0
Tax	256	439	581	743
APAT	**494**	**839**	**1,179**	**1,509**
APAT Margins (%)	4.2%	5.5%	6.2%	6.7%
PAT	**494**	**839**	**1,179**	**1,509**
PAT Margin (%)	3.8%	5.4%	6.2%	6.7%

Key Ratios

YE Mar	FY 17	FY 18	FY 19E	FY 20E
Per Share Data (₹)				
Adj. EPS	32.7	55.6	78.1	99.9
CEPS	58.6	84.0	115.7	144.5
BVPS	249.4	294.3	359.1	442.0
DPS	5.5	8.0	13.3	17.0
Growth Ratios (%)				
Total revenues	8.0%	19.3%	21.8%	18.4%
EBITDA	19.2%	47.2%	36.2%	25.3%
PAT	45.6%	70.4%	37.7%	28.0%
EPS Growth	45.6%	70.4%	37.7%	28.0%
Valuation Ratios (x)				
PE	40.6	23.9	17.0	13.3
P/CEPS	22.7	15.8	11.5	9.2
P/BV	5.3	4.5	3.7	3.0
EV/Sales	17.1	13.2	10.6	8.9
EV/EBITDA	176.6	120.0	88.0	70.3
Operating Ratios (Days)				
Inventory days	43.7	47.1	50.0	54.0
Recievable Days	72.0	84.1	88.0	92.0
Payables day	52.6	61.5	62.0	64.0
Net Debt/Equity (x)	-0.09	-0.10	-0.10	-0.06
Profitability Ratios (%)				
ROE	13.1%	18.9%	21.7%	22.6%
ROCE	19.4%	27.9%	27.9%	29.0%

Source: Company, LKP Research

Balance sheet

YE Mar (₹ mn)	FY 17	FY 18	FY 19E	FY 20E
Equity and Liabilities				
Equity Share Capital	151	151	151	151
Reserves & Surplus	3,615	4,292	5,271	6,523
Total Networth	3,766	4,443	5,422	6,674
Total debt	0	0	550	700
Net Deferred Tax	11	-59	60	60
Other long term liabilities	6	7	7	7
Long term provisions	34	46	58	68
Current Liab & Prov	**52**	**-6**	**674**	**834**
Short term borrowings	0	0	0	0
Other current liabilities	75	205	255	305
Trade payables	1688	2562	3215	3931
Total provisions	56	79	99	119
Total Equity & Liabilities	**5,636**	**7,283**	**9,666**	**11,864**
Assets				
Net block	1,458	1,176	908	1,536
Capital WIP	73	167	517	367
Other non-current assets	152	209	229	249
Total fixed assets	**1,683**	**1,552**	**1,654**	**2,152**
Cash and Bank	351	445	1,116	1,113
Inventories	988	1,371	1,802	2,289
Trade receivables	2,314	3,500	4,564	5,651
Loan, Advances & others	288	401	516	646
Other current assets	14	14	14	14
Total current Assets	**3,954**	**5,731**	**8,012**	**9,712**
Total Assets	**5,636**	**7,283**	**9,666**	**11,864**

Cash Flow

YE Mar (₹ mn)	FY 17	FY 18	FY 19E	FY 20E
PBT	750	1,278	1,760	2,252
Depreciation	391	429	568	673
Interest	12	5	4	3
Chng in working capital	85	-720	-954	-970
Tax paid	313	508	581	743
Other operating activities	-581	-988	-1,155	-1,496
Cash flow from operations (a)	**971**	**512**	**803**	**1,204**
Capital expenditure	-244	-308	-650	-1,150
Chng in investments	0	0	0	0
Other investing activities	9	28	28	28
Cash flow from investing (b)	**-225**	**-272**	**-614**	**-1,114**
Inc/dec in borrowings	-288	0	681	160
Dividend paid (incl. tax)	-83	-121	-200	-256
Other financing activities	-26	-25	4	3
Cash flow from financing (c)	**-398**	**-146**	**484**	**-93**
Net chng in cash (a+b+c)	**348**	**94**	**674**	**-3**
Closing cash & cash equivalents	**348**	**442**	**1,116**	**1,113**

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