India I Equities

Automobiles

Initiating Coverage

4 March 2010

Escorts

Core focus, market share gains; initiate at Buy

Rating: **Buy**
Target Price: Rs202
Share Price: Rs138

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- **Multiple positives.** We initiate coverage on Escorts with a Buy rating and a target price of Rs202. We estimate the turnaround in operations, focus on core business, agri-equipment's strong performance and potential from construction equipment and railway components segments would lead to a 68% net profit CAGR over FY09-12.

- **Renewed focus on core business.** Escorts has re-invented itself by focussing on its core competencies and divesting peripheral businesses. We expect this to lead to faster new-product introduction.

- **Tractor market-share gain.** Escorts' tractor market share has slid more than 200bps over FY06-09. Now, with a better product portfolio, improved channels and good tractor demand, we estimate it would gain market share of 400bps over FY09-12.

- **Bright prospects for construction equipment, railways.** Given the ongoing recovery in construction goods, we estimate the new launches to lead to a 20% revenue CAGR in the segment over FY09-12. This is also the case in the railway components segment.

- **Initiate with a Buy.** At our target price of Rs202, the stock would trade at 10x 12-month forward earnings, a 25% discount to the target multiple for M&M's core business. At that price, it would trade at 6.5x FY10e EV/EBITDA.

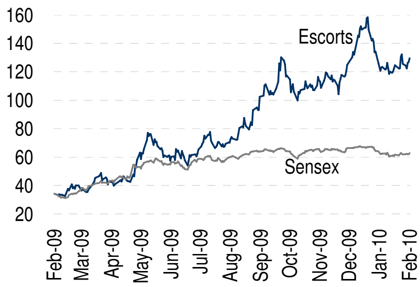
Key data	ESC IN/ESCO.BO
52-week high/low	Rs160/Rs32
Sensex/Nifty	16998/5089
3-m average volume	US$5.2m
Market cap	Rs12.23bn/US$265.8m
Shares outstanding	94.32m
Free float	69.90%
Promoters	30.10%
Foreign Institutions	16.33%
Domestic Institutions	15.85%
Public	37.72%

Key financials (Consolidated)

Year end 30 Sep	FY08	FY09	FY10e	FY11e	FY12e
Sales (Rsm)	27,661	26,617	33,113	40,187	47,101
Net profit (Rsm)	-131	645	1,254	2,136	3,071
EPS (Rs)	-1.6	7.7	14.9	25.4	36.5
Growth (%)	NM	NM	94.5	70.3	43.8
PE (x)	NM	18.0	9.3	5.4	3.8
PBV (x)	2.4	3.9	2.9	1.9	1.3
RoE (%)	-2.8	22.6	31.2	35.5	34.4
RoCE (%)	8.5	25.7	31.1	33.7	35.3
Dividend yield (%)	0.0	8.2	9.3	10.6	12.2
Net gearing (%)	70.3	64.5	70.6	60.4	47.9

Source: Company, Anand Rathi Research

Relative price performance



Source: Anand Rathi Research

Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 30 Sep	FY08	FY09	FY10e	FY11e	FY12e
Net sales	27,661	26,617	33,113	40,187	47,101
Sales growth (%)	-1.9	-3.8	24.4	21.4	17.2
- Op. expenses	26,312	24,508	30,208	36,397	42,107
EBIDTA	1,348	2,109	2,904	3,790	4,994
EBITDA margins (%)	4.9	7.9	8.8	9.4	10.6
- Interest	970	860	696	696	696
- Depreciation	508	480	579	579	601
+ Other income	256	166	205	205	205
- Tax	260	290	550	544	780
Reported PAT	-372	286	1,254	2,136	3,071
Adjusted PAT	-131	645	1,254	2,136	3,071
Adj. PAT growth (%)	NM	NM	94.5	70.3	43.8
FDEPS (Rs/share)	-1.6	7.7	14.9	25.4	36.5
CEPS (Rs/share)	4.7	14.0	21.8	32.3	43.7
DPS (Rs/share)	0.0	11.3	12.9	14.6	16.8

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

Year end 30 Sep	FY08	FY09	FY10e	FY11e	FY12e
Share capital	805	805	841	841	841
Reserves & surplus	3,883	2,054	3,181	5,174	8,080
Shareholders' fund	4,688	2,859	4,023	6,015	8,921
Debt	8,351	4,020	4,020	4,020	4,020
Deferred tax / others	-211	42	42	42	42
Capital employed	12,828	6,921	8,084	10,077	12,983
Fixed assets	5,009	4,328	4,226	4,248	4,246
Investments	2,382	1,067	1,067	1,067	1,067
Working capital	4,013	-437	1,667	2,236	2,792
Cash	1,423	1,964	1,124	2,527	4,878
Capital deployed	12,827	6,921	8,084	10,077	12,983
No. of shares (m)	81	81	84	84	84
Net Debt/Equity (%)	147.8	71.9	72.0	24.8	-9.6
W C turn (days)	47	8	30	30	30

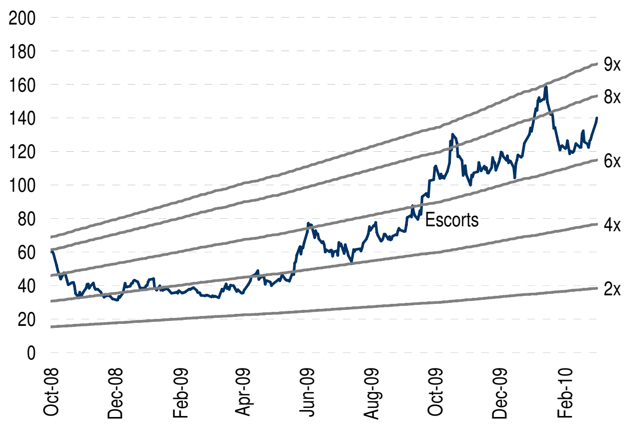
Source: Company, Anand Rathi Research

Fig 3 – Cash flow statement (Rsm)

Year end 30 Sep	FY08	FY09	FY10e	FY11e	FY12e
Reported profit	864	1,461	1,980	2,872	3,818
+ Depreciation	508	480	579	579	601
Cash profit	1,372	1,941	2,559	3,451	4,419
+ (Incr)/Decr in WC	-1,772	4,508	-2,104	-568	-556
Operating cash flow	-400	-2,567	4,663	4,020	4,975
+ Capex	3,859	201	-477	-600	-600
Free cash flow	3,458	-2,768	5,141	4,620	5,575
+ Dividend	0	-91	-108	-123	-141
+ Equity raised	70	0	36	0	0
+ Debt raised	855	-4,331	0	0	0
+ Investments	71	1,315	0	0	0
+ Misc. items	-5,098	-8,865	6,125	3,339	3,366
Net cash flow	-643	540	-840	1,403	2,351
+ Opening cash	2,066	1,423	1,964	1,124	2,527
Closing cash	1,423	1,964	1,124	2,527	4,878

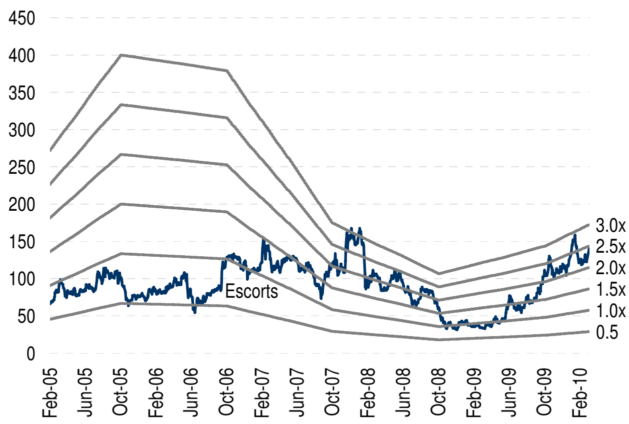
Source: Company, Anand Rathi Research

Fig 4 – PE Band



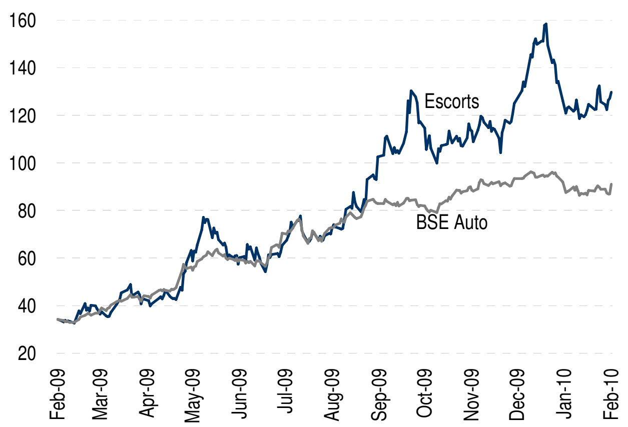
Source: Anand Rathi Research

Fig 5 – Price-to-Book Band



Source: Anand Rathi Research

Fig 6 – Escorts vs BSE Auto



Source: Anand Rathi Research

Investment Argument and Valuation

We initiate coverage on Escorts with a Buy rating and a target price of Rs202. We estimate that the turnaround in operations, focus on core business, agri-equipment's strong performance and potential from construction equipment and railway parts segments would lead to a 68% net profit CAGR over FY09-12.

Renewed focus on core business

Escorts has re-invented itself by focusing on its core competencies and divesting peripheral businesses. Its key business segments now are agri-machinery, railway parts, auto components and construction equipment.

The three pillars of Escorts' re-defined strategy are agri-machinery, construction equipment, and railway / transportation components

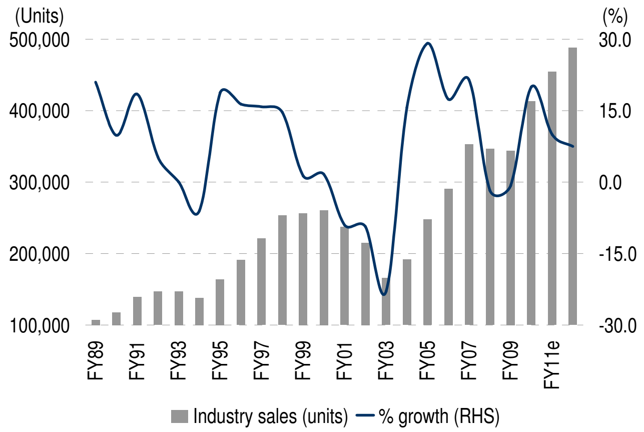
After reaching financial nadir in FY04, it has repositioned itself as an engineering company, its core competency. The outcome was evident in FY09. The three pillars of this re-defined strategy are agri-machinery, construction equipment, and railway/transportation components. Along with the divestment of cash-burning non-core activities, Escorts has also sought to lower its debt burden, and thus turn leaner.

Tractor market-share gain

Escorts has renewed emphasis on its tractor business, thereby stabilizing its market share. A more comprehensive product range, improved channels and good tractor demand is likely to lead to 400bps market-share gain over the FY09-12.

Escorts' strategy to increase market share involves its successful positioning as a farm-solutions provider and a re-invigorated focus on the tractor market. Its Nov '09 market share in India was 13.1% (up from the low of 10.7% in Jul '09). We estimate its market share to reach 16% by FY12.

Fig 7 – Tractor volume growth



Source: CMIE, Anand Rathi Research

Bright prospects for construction equipment, railway components

Escorts' construction-equipment division is recovering; we expect it to report good growth following new product launches. Similarly, new orders are likely to drive the railway-components segment.

There is great potential in the railways segment given the buildup of dedicated freight corridors, EMUs, high-speed trains, as well as the fact that Escorts plans on entering the metro- and mono-rail segments.

Valuation

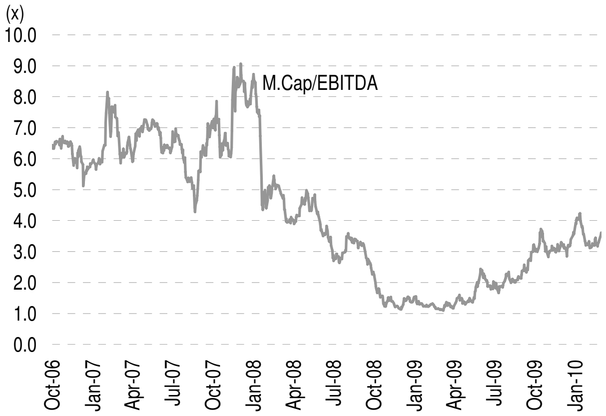
At our target price of Rs202, the stock would trade at 10x 12-month forward earnings, a 25% discount to the target multiple for M&M's core business. At that target price, it would trade at 6.5x FY10e EV/EBITDA.

Fig 8 – Comparative valuation of Escorts and M&M (standalone, core EPS)

	Escorts*	M&M	Escorts discount (%)
EPS (Rs)	20.1	63.0	
Target PE (x)	10.0	13.5	25.0
Target price (Rs)	202	820	
Valuation discount of Escorts to M&M			
Consolidated EPS (Rs)	20.1	90.7	
Current Cons. PE (x)	6.8	11.9	42.3

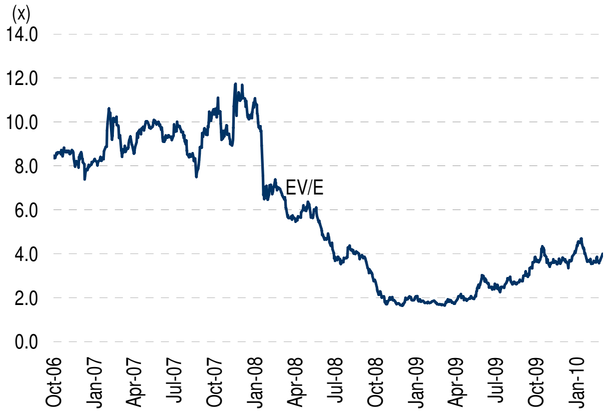
*Source: Anand Rathi Research; * Note: Escorts' EPS as per rolling EPS for y/e Mar '11, i.e. 12-month forward*

Fig 9 – Market cap/EBITDA



Source: Company, Anand Rathi Research

Fig 10 – EV/EBITDA



Source: Company, Anand Rathi Research

Risks to valuation

- Tractor demand can be impacted by external factors such as the monsoons and financing availability. Any shortfall in the rains could affect volume growth. Similarly, if financing availability decreases, demand could suffer.
- If the recovery in economic growth is sluggish, recovery in the construction equipment segment would be further delayed.
- While the process of financial reconstruction is nearly complete, any further write-offs on the remaining subsidiaries cannot be ruled out.

Renewed focus on core business

Escorts has re-invented itself by focusing on its core competencies and divesting peripheral businesses. We expect this to lead to faster new-product introduction.

Core competencies

Over the years, Escorts had diversified into multiple businesses, in various sectors, a move away from engineered products. This had resulted in stretched resources, a higher debt burden, and mounting losses.

After reaching financial nadir in FY04, Escorts has worked towards repositioning itself as an engineering company, its core competency. The outcome of this was evident in FY09. The three pillars of this re-defined strategy were – agri-machinery, construction equipment, and railway / transportation components. Escorts is now poised to become a significant participant in the earthmoving-equipment sub-segment as well.

Fig 11 – Increased diversification and subsequent divestment

1950s	1960s	1970s	1980s	1990s	Up to 2009	Post-2009
Tractors and agri-implements	Tractors and agri-implements	Tractors and agri-implements	Tractors and agri-implements	Tractors and agri-implements	Tractors and agri-implements	Tractors and agri-implements
	Rajdoot motorcycles	Rajdoot motorcycles	Yamaha motorcycles	Yamaha motorcycles		Railway components
		US JV	US JV	US JV	US JV	Construction equipment
		Excavators	Excavators	Excavators	Construction equipment	
				Rail parts	Escorts Hospital	
		Railway components	Escorts Hospital	Escorts Hospital	IT subsidiary	
			Railway components	IT subsidiary	Railway components	
				Telecoms		

Source: Company, Anand Rathi Research

Financial re-structuring complete

Along with the hiving off of cash-burning non-core activities, Escorts has also sought to lower its debt burden – and turn leaner. Attempts at debt reduction have largely been successful, with debt being reduced from FY05 levels: overall, term debt is down from Rs8.9bn to Rs4bn in FY09.

In addition, accumulated reserves (including revaluation reserves, share premium account, etc.) have been transferred to a Business Reconstruction Reserve, specially created for the purpose, after obtaining High Court approval. The result has been a much cleaner balance sheet, with better gearing and no impact on return ratios. With the balance-sheet correction complete, Escorts is now in a much better position to start focusing on improving return-ratios.

Fig 12 – Impact of revaluation reserve on Fixed Assets (standalone)

(Rsm)	FY06	FY07	FY08	FY09
Gross Block	14,010	14,370	14,159	20,598
of which: Revaluation Reserve	4,786	4,719	4,665	11,371
Gross Block after RR	9,225	9,651	9,495	9,227

Source: Company

Fig 13 – Debt reduction (standalone)

(Rsm)	FY06	FY07	FY08	FY09
Secured Loans	**4,225**	**4,140**	**4,226**	**2,538**
Convertible debentures	0	608	608	608
Cash credit/export credit/WC loans	2,069	1,130	1,633	990
Term loans from banks	2,147	2,395	1,980	936
Term loans from others	10	7	6	4
Unsecured Loans	**1,678**	**311**	**144**	**104**
FD	444	116	0	0
Short-term loans from banks	89	0	0	0
Short-term lease finance	0	0	15	18
Short-term loans from others	572	110	75	0
Lease finance	0	0	36	42
Other loans	61	56	50	44
Bank overdraft	513	29	20	0
Total Loan Funds	**5,904**	**4,451**	**4,371**	**2,642**

Source: Company

Fig 14 – Impact of BRR and revaluation reserve on Reserves and Surpluses (s/a)

(Rsm)	FY06	FY07	FY08	FY09
Securities Premium Account	847	1,862	2,560	2,560
Capital Redemption Reserve	8	8	8	0
Capital Reserve	0	0	0	3
Share Forfeiture Reserve	32	32	32	0
Amalgamation Reserve	485	485	485	0
General Reserve	4,696	4,696	4,696	4,719
P&L Account	-1,390	-1,455	-1,336	508
Revaluation Reserve	4,786	4,719	4,665	750
ESOPs outstanding	0	10	10	9
Deferred Employee Compensation Expense	0	-5	0	0
Debenture Redemption Reserve	0	0	0	261
Business Reconstruction Reserve	0	0	0	4,726
Total	**9,463**	**10,352**	**11,120**	**13,535**

Source: Company

Poised to capture growth

For Escorts, infrastructure is in place, with the product mix, R&D and brand equity all available. Hence, it would benefit from road transport and real estate infrastructure growth in India. Similarly, on the agri-machinery side, it is evolving from a tractor manufacturer into a farm-solutions provider.

The company has focused on quality through its 'Quality Push Mission'. This aims at manufacturing products highly regarded by customers through more efficient manufacturing processes that hold defects to a minimum.

Apart from product quality, another area being targeted for growth is deeper penetration. Escorts is increasing its all-India reach by widening its market span and share. It has concentrated on better marketing, strong financial systems and controls, innovative engineered products, increased dealer penetration, and the greater importance of export markets to achieve its objectives.

Tractor market-share gain

Escorts' tractor market share has slid by more than 200bps over FY06-09. Now, with a better product portfolio, improved channels and good tractor demand, we estimate it would gain market share of 400bps over FY09-12.

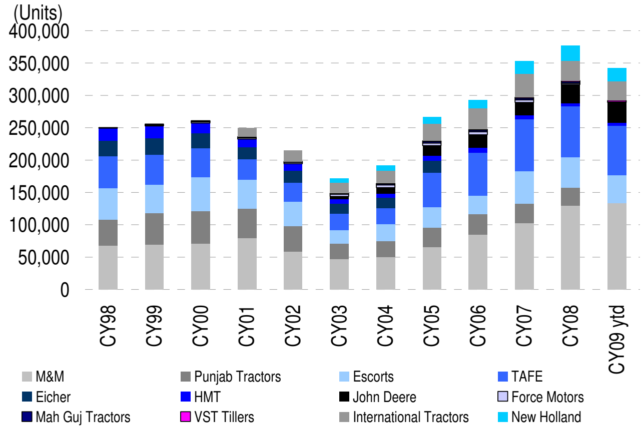
Competitive market

The Indian tractor sector is competitive, with an ongoing multi-pronged battle for dominance, and occasional bouts of industry consolidation (such as the Punjab Tractors acquisition by M&M and Eicher Motors' tractor business by TAFE).

In the Indian tractor market, M&M is the largest player and has the largest sales and distribution network. John Deere has an edge over competitors in product development and technological expertise.

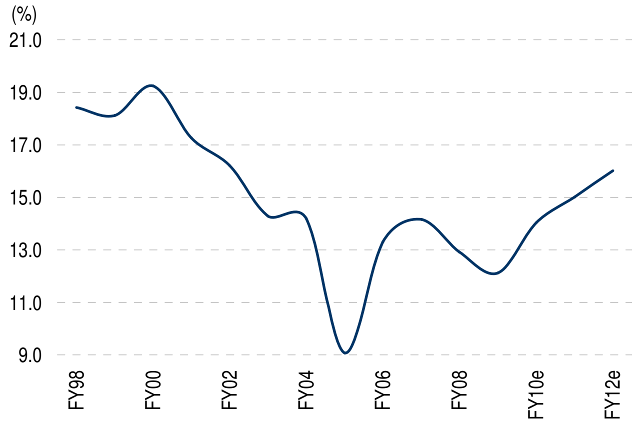
Geographically, TAFE is strong in the South, M&M in the West (and going all-India), and Eicher in UP and Haryana. M&M benefited from the lacklustre presence of Escorts in UP previously, but now Escorts has started outperforming its peers there.

Fig 15 – Relative market volumes of tractor companies



Source: CMIE

Fig 16 – Escorts' market-share trend; annual

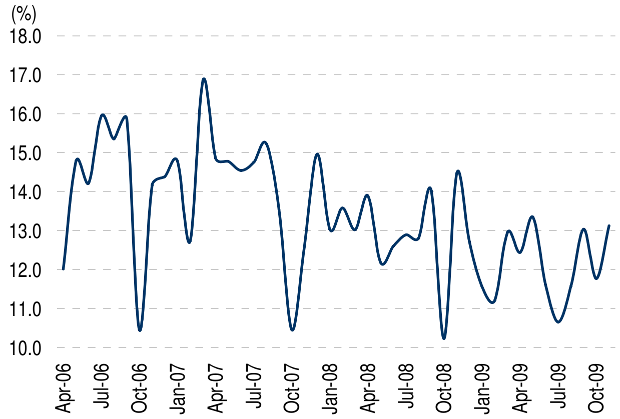


Source: CMIE, Company, Anand Rathi Research

After peaking in CY07, Escorts' market share has dipped. However, the decline in CY09 is mainly due to inventory correction measures undertaken by it. With this completed and with more focused strategies, market share gain is expected ahead

In CY09, Escorts has been able to stabilize its market share at ~13%

Fig 17 – Escorts' market-share trend; monthly



Source: CMIE, Company, Anand Rathi Research

Over the past 12 months, Escorts has been able to claw back lost market share. It aims to become a farm-solutions provider and to reinvigorate its focus on the tractor market.

It has renewed its emphasis on its tractor business, thereby stabilizing its market share. A more comprehensive range, renewed focus on operations and good tractor demand could lead to a 400-bp market-share gain over FY09-12.

Escorts' strategy is to increase market share by positioning itself as a farm-solutions provider. Its Nov '09 tractor market share in India was 13.1% (up from the low of 10.7% in Jul '09). Steady market share gains are expected hereon as well, culminating in 16% in FY12.

Comprehensive product range

Escorts has three tractor brands: the aspirational "Farmtrac", the entry-level "Escorts", and the workhorse "Powertrac" (for both farm and non-farm use). These three cover the full tractor range of 20 to 60 HP.

Farm tractors have many uses, with a shift in application orientation as there is no generic tractor. Escorts' wide range (25HP to 75HP) caters to various segments.

With the market expected to move towards higher-HP tractors, Escorts could benefit, as it has a lower (10%) market share in the 25-35HP range, comprising mainly the Escorts brand. It has a higher share in the 35HP-and-above range, comprising Powertrac and Farmtrac.

In the agri-machinery segment, Escorts added about seven new products in FY09, and plans five more. It also manufacturers the engines used in its tractors. In FY09, the new products added ~Rs1bn to revenue.

Fig 18 – Details of tractor product portfolio

Farmtrac	Premium range, with tractors in the 34-75HP range, also exported to developed nations
Powertrac	Value for money range, with fuel efficient tractors in the 34-55HP range
Escorts	Economy range, with 2-cyliner tractors in the 25-35HP range

Source: Company

Channels improved

Escorts has strengthened its operations in areas where it is not much represented, such as the South. It churned ~150 dealers (of 850; ie, dropped and reduced, but added 120). The strategy was to increase the number of penetration points, but reduce the number of dealers. Due to the wider penetration, Escorts' growth could be faster than industry growth.

Ninety percent of tractor sales are through channel financing. With such heavy reliance on financing, this function is crucial to growth in the tractor sector. Escorts has 55 financing relationships across India – a mixture of private banks, PSUs and NBFCs. It also took steps to ensure better cash availability to its customers. Further, bad debts for Escorts tractors are lower than 3% due to stringent monitoring. The company tracks sales even after retail closure.

Exports, a potential growth segment

Escorts is exporting tractors globally and reaching new markets and new customers. In exports, Africa, a very promising market, is important for Escorts. In Europe, Escorts has a small plant in Poland. It plans to manufacture 1,000 units there next year. It is also looking at higher HP tractors.

Exports will see a two-pronged thrust: in the African market and to upper-value European markets such as Turkey. Export supplies are mainly from Faridabad. For Turkey, supplies are from lines of a partner. In Ghana, Escorts has an 85% market share. Escorts is aiming at 8-10% of revenue from exports over the next two to three years.

Tractor financials have improved, industry outlook good

The tractor segment EBIT has recovered from the low of 3.1% in FY08 – to 7.3% in FY09. We expect a further improvement in FY10 – to 9.5%. With 75% of the total gross block and 85% of working capital being utilized in the tractors segment, this improvement augurs well for better return ratios for Escorts. A 2.5-3% increase in prices of tractors from Jan '10 would help EBIT margin improvement as well. As part of the restructuring, Escorts was able to unlock Rs1.5-1.6bn of cash. Overdues were also reduced significantly.

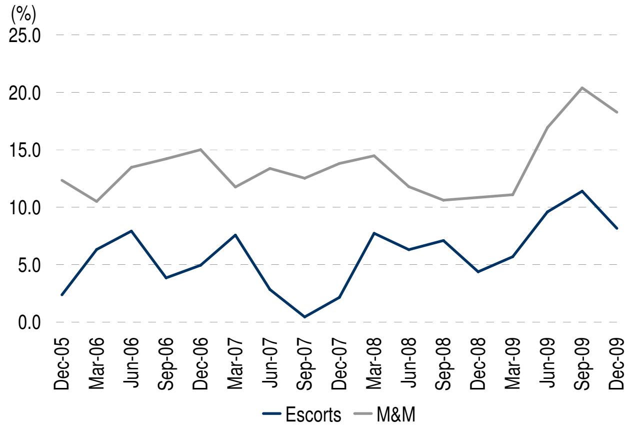
Fig 19 – Standalone tractor performance

Year-end Sep (Rsm)	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10
Revenues	4,378	4,224	5,117	5,333	5,364
Yoy growth (%)	16.8	-11.1	4.7	11.1	22.5
% of Total	87.3	85.9	87.7	87.2	88.5
EBIT	192	240	491	607	438
Yoy growth (%)	138.1	-34.6	59.6	78.3	128.4
% of Total	80.4	81.4	85.2	84.6	88.6
EBIT Margin	4.4	5.7	9.6	11.4	8.2
Capital Employed	7,007	6,801	5,681	9,273	8,983
RoCE	2.7	3.5	8.6	6.6	4.9
% of Total CE	41.4	40.7	36.8	54.3	51.8

Source: Company

In the past, Escorts' agri-machinery division has operated at a lower EBIT margin that that of M&M's. While we expect the performance of Escorts to improve further in this division, we do not expect it to match M&M's.

Fig 20 – Comparison of agri-machinery segment EBIT margin - Escorts & M&M



Source: Company, Anand Rathi Research

Fig 21 – Consolidated segment-wise tractor performance

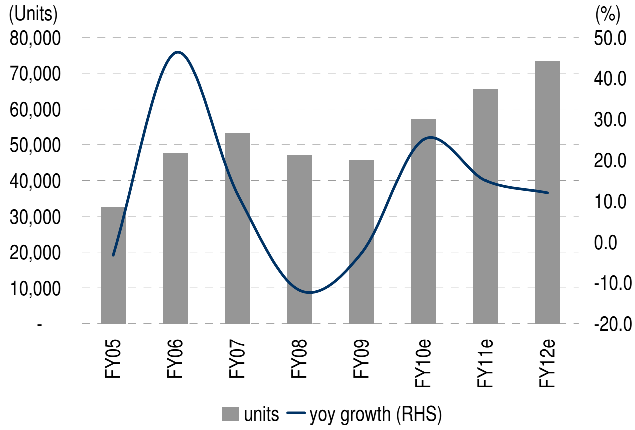
Year-end Sep (Rsm)	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Revenues	19,742	22,937	19,689	19,538	24,911	29,894	34,677
Yoy growth (%)	47.3	16.2	-14.2	-0.8	27.5	20.0	16.0
% of Total	75.2	76.5	71.2	73.4	75.2	74.4	73.6
EBIT	833	807	604	1,419	2,367	3,019	3,884
Yoy growth (%)	-152.5	-3.1	-25.2	135.0	66.8	27.6	28.6
% of Total	194.7	66.7	57.2	74.7	73.4	71.6	70.4
EBIT Margin	4.2	3.5	3.1	7.3	9.5	10.1	11.2
Capital Employed	6,217	8,171	8,174	8,873			
RoCE	13.4	9.9	7.4	16.0			
% of Total CE	41.8	47.5	45.2	47.5			

Source: Company, Anand Rathi Research

There would be no additional creation of capacity, since current capacity utilization is ~50%. FY09 had no revenue growth due to inventory correction. Current channel inventory is ~9,000 units, down from 16,000 earlier.

From the nadir in FY08, Escorts is now well positioned to outperform the tractor industry and thereby increase its market share

Fig 22 – Tractor volumes for Escorts



Source: Company, Anand Rathi Research

As for demand, while the poor monsoons were a worry, the higher MSPs took care of the problem. Infrastructure speed-ups have traditionally been huge triggers. Tractor industry growth is expected at 3-5%, while for Escorts, it should be higher, thereby resulting in market-share gain.

Bright prospects in construction/ railway equipment

Given the ongoing recovery in construction goods, we estimate Escorts' new launches to lead to a 20% revenue CAGR in the segment over FY09-12. This is also the case in the railway components segment.

Construction-equipment and material handling

Potential for high growth

The construction-equipment and material-handling business is carried out through a 100% subsidiary. Escorts aims to become a one-stop shop to provide end-to-end solutions for the construction sector.

It is the current global leader in pick-and-carry cranes (+50% market share in India). This constituted 60% of the construction-equipment business. It also has ~25% market share in compactors. Other products manufactured are forklifts and screw clips.

With backhoe loaders, the company is making a trial entry into the earth-moving products sub-segment. It was prohibited from doing so earlier owing to a non-compete agreement with JCB (they had a tie-up since '83-84). Much effort has been put into developing this product. Brand recall for Escorts in backhoe loaders is the second-highest after JCB. At present, JCB manufactures 1,200 machines per month, and has a 75-78% market share. Competitors are Tata Hitachi, Kobalco and Ace.

In FY09, the company tied up with Hunan Zoomlion International Trade Co., China, to bring world-class truck cranes and all-terrain cranes to India. This is in line with its focus on technological advancement, tying up with international manufacturers and introducing new and improved products.

Over Jan-Mar, it would be introducing five products. So far Escorts is the only one in the materials-handling segment, which gives it 35% of value in the construction-equipment segment. It is now entering the earth-moving products sub-segment, which constitute 70% of the construction-equipment segment (by value). Hence, the product mix could change for the better.

Fig 23 – Escorts' construction equipment product portfolio

Escorts construction equipment	Forklift trucks
	Front-end Loaders
	Backhoes
	Cranes
	Compactors

Source: Company

Fig 24 – Financials for the construction-equipment business

Year-end Sep (Rsm)	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Revenues	3,455	4,529	5,873	4,177	4,803	6,004	7,205
Yoy growth (%)	38.1	31.1	29.7	-28.9	15.0	25.0	20.0
% of total	13.2	15.1	21.2	15.7	14.5	14.9	15.3
EBIT	297	375	297	155	336	480	684
Yoy growth (%)	89.0	26.4	-20.8	-47.8	116.6	42.9	42.5
% of total	69.3	31.0	28.2	8.2	10.4	11.4	12.4
EBIT Margin	8.6	8.3	5.1	3.7	7.0	8.0	9.5
Capital Employed	770	1,570	2,051	2,280			
RoCE	38.5	23.9	14.5	6.8			
% of total CE	5.2	9.1	11.3	12.2			

Source: Company, Anand Rathi Research

FY09 was a slow year for ECE. In the next three years, we expect a 20% revenue CAGR for the construction equipment segment. It plans to raise the EBITDA margin from 4.5-6% to 8% by FY12. Margin expansion could come from new products, and some from older products. Exports, which was not targeted until recently, is now on the radar, and Escorts has started exploring opportunities here.

Railway components

Railway growth augurs well

Railway capex at Rs2.5trn for the next five years, providing growth opportunities

Escorts has been operating in the railway segment for the past 30 years. All its products sold are for rolling stock. It dominates in braking systems. A new "vertical" in the Indian Railways is in fabrications /infrastructure. Orders for monorails and railway expansion would provide a further fillip for growth in this segment. Hence, ahead, the rail-components vertical would add much value to revenue.

In FY09, revenue in the railway components business was Rs2bn; in the past two years, there has been a 31% CAGR. We expect a 23% revenue CAGR over FY09-12. The new plant at Rudrapur operates at 98% capacity. For additional demand, the company also has a plant at Faridabad. Escorts is introducing 10-12 new products to augment its already wide range. The EBITDA margin in this segment is in the range of 18-20%.

Fig 25 – Product portfolio for the Railways

Railway equipment product range	Shock absorbers (oil dampers) for coaches, locomotives, EMUs, MEMUs, DMUs, metro and rail cars
	Air brakes for coaches, freight cars, DMU and OHE cars
	Automatic/semi-permanent couplers for EMUs, DEMUs, MEMUs
	Electro-pneumatic brake systems for EMUs and MEMUs
	Composition brake blocks for coaches, locomotives, freight cars, EMUs
	Composition brake blocks for coaches, locomotives, freight cars, EMUs
	Rail-fastening systems for wooden, steel and concrete sleepers
	Direct admission valves for vacuum-braked coaches
	Testing equipment for brake systems and shock absorbers
	Air brake accessories for passenger coaches, freight cars, locomotives and self-propelled vehicles
	Metal to rubber bonded vulcanized components
	Automatic twist locks for container freight cars

Source: Company

Fig 26 – Financials of the railway components segment

Year end Sep (Rsm)	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Revenues	1,151	1,165	1,434	1,995	2,294	2,982	3,728
Yoy growth (%)	-12.1	1.3	23.0	39.1	15.0	30.0	25.0
% of total	4.4	3.9	5.2	7.5	6.9	7.4	7.9
EBIT	171	168	237	404	573	716	895
Yoy growth (%)	33.3	-1.6	41.3	70.4	42.0	24.8	25.0
% of total	39.8	13.9	22.5	21.3	17.8	17.0	16.2
EBIT margin	14.8	14.4	16.5	20.3	25.0	24.0	24.0
Capital employed	617	695	784	938			
RoCE	27.7	24.1	30.2	43.1			
% of total CE	4.1	4.0	4.3	5.0			

Source: Company, Anand Rathi Research

Escorts has tied up with a US company to ship concrete products to India. It has also tied up with a French company for monorails. Components are also exported to various countries, with product development for the German railways.

Business growth potential is high as fresh entrants face a high entry barrier (these being safety products). The approval process is lengthy, and only five or six companies supply such products. Hence, if the Indian Railways were to purchase new products or replace old ones, volumes would be high enough for everyone.

The potential in this area comes from the Railways' plans for dedicated freight corridors, EMUs, high-speed trains, as well as the fact that Escorts plans to enter the metro- and mono-rail segments.

Other engineered products

The rubber-processing unit is key to the division's future range of products. The auto-suspensions business was not hit in FY09. Escorts aims to double revenue by 2012. We expect a 25% revenue CAGR over FY09-12.

Defense is another option for growth. Escorts currently builds shock absorbers for tanks. It is also entering into bio-toilets for the Railways and Defense. These would be bio-degradable, but functional. In Defense, quantities supplied are large. Escorts also supplies Defense with cranes.

Financials

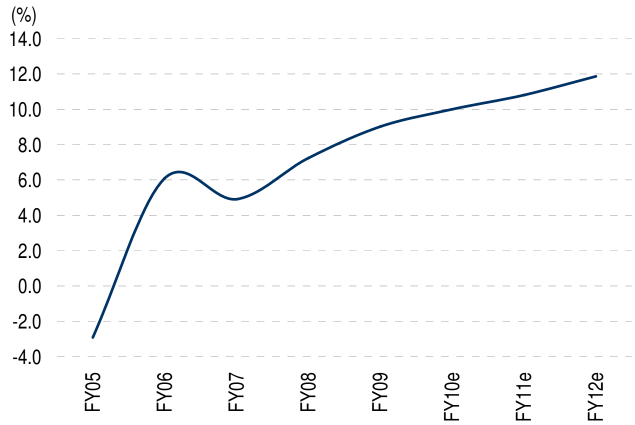
We estimate Escorts to report a consolidated 21% revenue CAGR over FY09-12, with an EBITDA CAGR of 33.3%. Financial restructuring, operating leverage and greater efficiencies could lead to EBITDA expansion of 280bps and a higher profit CAGR of 68.2% over the same period.

Standalone performance

We expect Escorts to report a standalone revenue CAGR of 20% over FY09-12, with an EBITDA CAGR of 31.6%. The EBITDA margin is likely to improve from 9% in FY09 to 11.9% three years later. We estimate net profit CAGR over the same period of 50.7%.

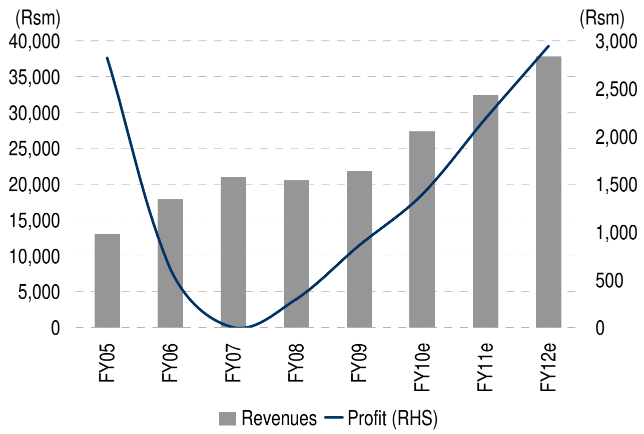
Revenue growth would be driven by better tractor volumes following deeper penetration and market-share gains. Control over costs and higher operating leverage could help EBITDA margin expansion. Financial restructuring and lower debt could significantly reduce interest expense, thereby driving a higher CAGR in profitability.

Fig 27 – Trend in standalone EBITDA margin



Source: Company, Anand Rathi Research

Fig 28 – Trend in standalone revenue and profit



Source: Company, Anand Rathi Research

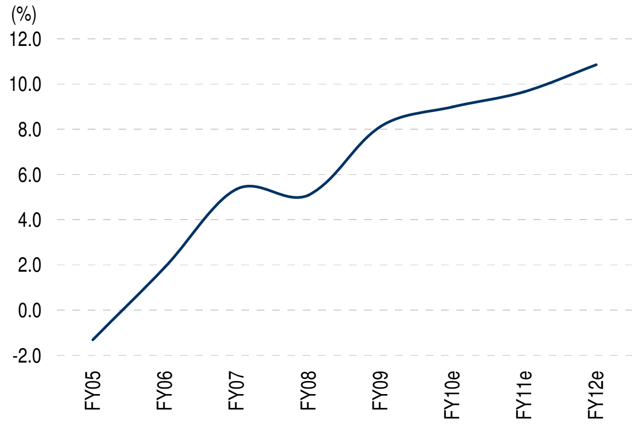
Consolidated performance

We expect Escorts to report a consolidated revenue CAGR of 21% over FY09-12, with an EBITDA CAGR of 33.3%. Financial restructuring, operating leverage and greater efficiencies could lead to an EBITDA expansion of 280bps and a higher profit CAGR of 68.2%.

Apart from good tractor growth, the consolidated performance would also be driven by a recovery in demand for construction equipment, and good growth in the railway equipment segment.

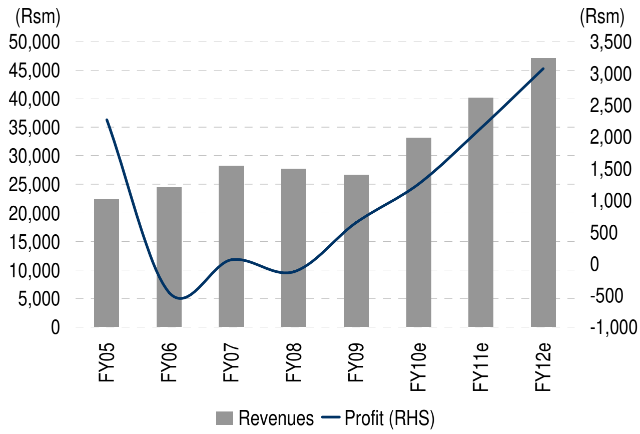
In FY09, Escorts targeted cost compression strategies on materials, operating costs and financing costs. This could help improve profitability. Cost control actualized, resulted in annualized savings of Rs2bn in 4QFY09. Overall improvement in cash flows also helps reduce debt.

Fig 29 – Trend in consolidated EBITDA margin



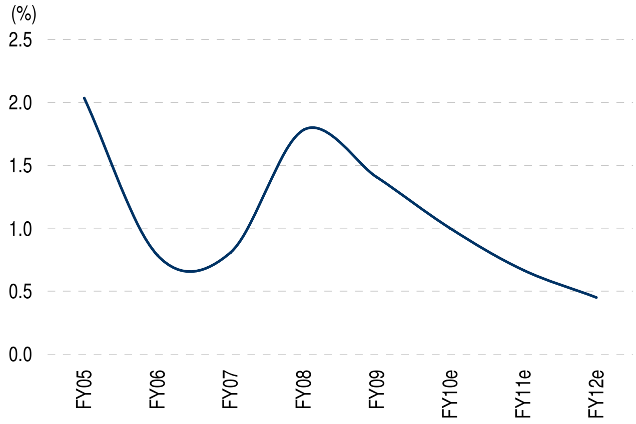
Source: Company, Anand Rathi Research

Fig 30 – Trend in consolidated revenue and profit



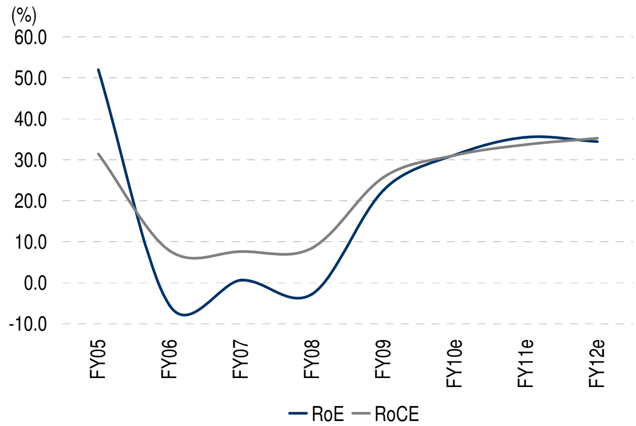
Source: Company, Anand Rathi Research

Fig 31 – Trend in debt-equity ratio



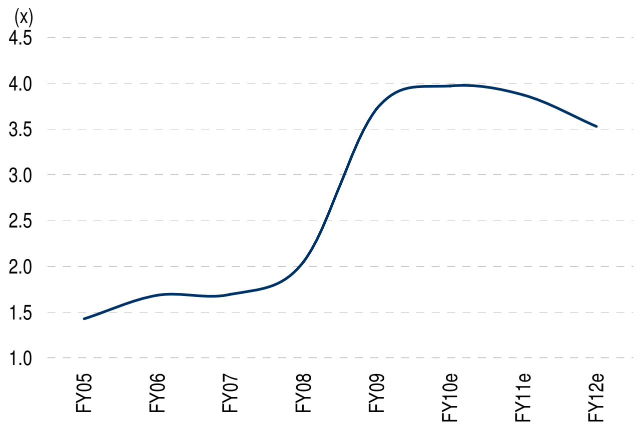
Source: Company, Anand Rathi Research

Fig 32 – Trend in return ratios



Source: Company, Anand Rathi Research

Fig 33 – Trend in asset-turnover ratio



Source: Company, Anand Rathi Research

Fig 34 – Income statement

Year-end 30 Sep (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
Net Sales	26,532	25,979	32,317	39,232	46,002
Change (%)	*-3.6*	*-2.1*	*24.4*	*21.4*	*17.3*
Business Income	1,129	637	796	956	1,099
Change (%)	*70.8*	*-43.5*	*25.0*	*20.0*	*15.0*
Total Income	27,661	26,617	33,113	40,187	47,101
Change (%)	*-1.9*	*-3.8*	*24.4*	*21.4*	*17.2*
Expenditure	26,312	24,508	30,208	36,397	42,107
EBITDA	1,348	2,109	2,904	3,790	4,994
Change (%)	*-8.4*	*56.4*	*37.7*	*30.5*	*31.8*
EBITDA Margin (%)	*5.1*	*8.1*	*9.0*	*9.7*	*10.9*
Depreciation	508	480	579	579	601
EBIT	841	1,629	2,326	3,211	4,393
Interest & Fin. Charges	970	860	696	696	696
Other Income	256	166	205	205	205
PBT before extraordinaries	126	935	1,835	2,720	3,902
Non-recurring Expense	242	359	0	0	0
PBT	-116	575	1,835	2,720	3,902
Tax	260	290	550	544	780
Effective Rate (%)	*-224.5*	*50.3*	*30.0*	*20.0*	*20.0*
Rep. Net profit (after EO)	-376	286	1,284	2,176	3,121
Change (%)	*622.7*	*-176.1*	*349.1*	*69.5*	*43.4*
% of Net Sales	*-1.4*	*1.1*	*3.9*	*5.4*	*6.6*
Minority Interest	-3	0	30	40	50
Profit after MI	-372	286	1,254	2,136	3,071
Change (%)	*575.9*	*-176.7*	*339.2*	*70.3*	*43.8*
Adj. Net profit	-131	645	1,254	2,136	3,071
Change (%)	*-326.6*	*-594.2*	*94.5*	*70.3*	*43.8*

Source : Company, Anand Rathi Research

Fig 35 – Balance Sheet

Year-end 30 Sep (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
Sources of Funds					
Issued Share Capital	907	907	943	943	943
Less: held by JVs	102	102	102	102	102
Share Capital	805	805	841	841	841
Reserves after RR	3,883	2,054	3,181	5,174	8,080
Net Worth	**4,688**	**2,859**	**4,023**	**6,015**	**8,921**
Minority Interest	**388**	**401**	**401**	**401**	**401**
Loans	**8,351**	**4,020**	**4,020**	**4,020**	**4,020**
Unsecured	286	204	204	204	204
Secured	8,065	3,815	3,815	3,815	3,815
Deferred Tax Liability	1,485	1,441	1,441	1,441	1,441
Less: Deferred tax assets	1,970	1,743	1,743	1,743	1,743
Capital Employed	**12,943**	**6,978**	**8,141**	**10,134**	**13,039**
Application of Funds					
Gross Fixed Assets after RR	11,490	10,557	11,157	11,757	12,357
Less: Depreciation	6,673	6,352	6,931	7,509	8,111
Net Fixed Assets	**4,817**	**4,205**	**4,226**	**4,248**	**4,246**
Capital WIP	192	123	-	-	-
Investments	2,382	1,067	1,067	1,067	1,067
Curr. Assets, L & Adv.	**15,898**	**11,714**	**15,717**	**19,773**	**24,720**
Inventory	3,908	3,292	4,427	5,374	6,302
Sundry Debtors	7,555	4,261	7,968	9,674	11,343
Cash & Bank Balances	1,423	1,964	1,124	2,527	4,878
Others	107	241	241	241	241
Loans & Advances	2,904	1,957	1,957	1,957	1,957
Current Liab. & Prov.	**10,461**	**10,187**	**12,926**	**15,010**	**17,050**
Sundry Creditors	8,019	7,001	9,739	11,823	13,864
Other Liabilities	1,240	1,817	1,817	1,817	1,817
Provisions	1,202	1,370	1,370	1,370	1,370
Net Current Assets	**5,436**	**1,527**	**2,791**	**4,763**	**7,670**
Miscellaneous Exp.	115	57	57	57	57
Application of Funds	**12,942**	**6,978**	**8,141**	**10,134**	**13,039**

Source: Company, Anand Rathi Research

Fig 36 – Cash flow statement

Year-end 30 Sep (Rsm)	FY08	FY09	FY10e	FY11e	FY12e
OP/(Loss) before Tax	841	1,629	2,326	3,211	4,393
Interest/Dividends Received	256	166	205	205	205
Depreciation & Amortisation	508	480	579	579	601
Direct Taxes Paid	-232	-334	-550	-544	-780
(Inc)/Dec in Working Capital	-1,772	4,508	-2,104	-568	-556
Other Items	-3,886	-1,784	-48	-61	-74
CF from Oper. Activity	**-4,286**	**4,665**	**407**	**2,822**	**3,788**
Extra-ordinary Items	-242	-359	0	0	0
Other Items					
CF after EO Items	**-4,528**	**4,305**	**407**	**2,822**	**3,788**
(Inc)/Dec in FA+CWIP	3,859	201	-477	-600	-600
(Pur)/Sale of Invest.	71	1,315	0	0	0
CF from Inv. Activity	**3,930**	**1,517**	**-477**	**-600**	**-600**
Issue of Shares	70	0	36	0	0
Inc/(Dec) in Debt	855	-4,331	0	0	0
Interest Rec./(Paid)	-970	-860	-696	-696	-696
Dividends Paid	0	-91	-108	-123	-141
CF from Fin. Activity	**-45**	**-5,282**	**-769**	**-819**	**-838**
Inc/(Dec) in Cash	**-643**	**540**	**-839**	**1,403**	**2,351**
Add: Beginning Balance	2,066	1,423	1,964	1,124	2,527
Closing Balance	**1,424**	**1,963**	**1,124**	**2,527**	**4,878**

Source: Company, Anand Rathi Research

Fig 37 – Ratio analysis @Rs138

Year-end 30 Sep	FY08	FY09	FY10e	FY11e	FY12e
Basic (Rs)					
EPS	-1.6	8.0	14.9	25.4	36.5
EPS Fully Diluted	**-1.6**	**7.7**	**14.9**	**25.4**	**36.5**
EPS Growth (%)	*-326.6*	*-594.2*	*94.5*	*70.3*	*43.8*
Cash EPS	4.7	14.0	21.8	32.3	43.7
Book Value per Share	58.2	35.5	47.8	71.5	106.0
DPS	0.0	11.3	12.9	14.6	16.8
Payout (Incl. Div. Tax) %	*0.0*	*146.9*	*86.5*	*57.4*	*46.1*
Valuation (x)					
P/E	-89.0	18.0	9.3	5.4	3.8
Cash P/E	29.5	9.9	6.3	4.3	3.2
EV/EBITDA	11.6	5.7	4.6	3.2	1.9
EV/Sales	4.2	4.2	3.6	2.9	2.4
Price to Book Value	2.4	3.9	2.9	1.9	1.3
Dividend Yield (%)	0.0	8.2	9.3	10.6	12.2
Profitability Ratios (%)					
RoE	-2.8	22.6	31.2	35.5	34.4
RoCE	8.5	25.7	31.1	33.7	35.3
Turnover Ratios					
Asset Turnover (x)	2.0	3.7	4.0	3.9	3.5
Leverage Ratio					
Debt/Equity (x)	1.8	1.4	1.0	0.7	0.5

Source: Company, Anand Rathi Research

Company Background & Management

One of India's leading agri-machinery manufacturers, Escorts also operates in the railway and auto-component segments. It is now expanding into the construction-equipment segment, envisaged as a huge growth driver ahead.

Background

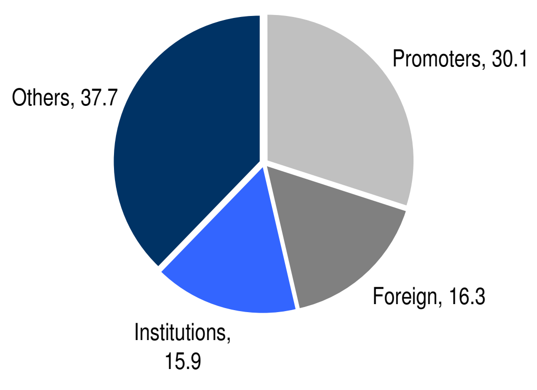
Started in 1944 by H P Nanda as an agency house, a franchise to distribute Massey Ferguson tractors soon followed (in 1949). Commencing manufacturing tractors in 1959, with technology from Poland, over the '60s-'90s, it diversified into other businesses – auto-suspension, railway equipment, health care, financial services, telecoms, software services and construction equipment and allied engineering products (as a separate company, ECE).

Subsequently, over FY04-09, Escorts has sharpening its focus – it has re-positioned itself as an agri-equipment and engineered products company, with the non-core businesses being disposed of. This has mitigated the ill-effects felt previously by over-diversification and consequent higher leveraging. The business reconstruction carried out in FY09 has resulted in a much leaner and cleaner balance sheet. Core competencies are back in focus, leading to a better fundamental business outlook.

Management

Rajan Nanda is chairman and managing director, with son Nikhil Nanda as joint managing director. O K Balraj is the CFO.

Fig 38 – Shareholding pattern (31 Dec '09)



Source: Capitaline

Products

Escorts' products can be classified into four broad segments – agri-machinery, auto-ancillaries, railway equipment, and construction equipment.

- Tractors – under the brands Farmtrac, Powertrac and Escorts.
- Implements – tillers, harrows, ploughs, baiters.
- Lubricants – gear and engine oil for Farmtrac and Powertrac tractors.

- Construction equipment – dozers, loaders, backhoes, forklifts, vibratory compactors, hydraulic mobile cranes and other types of cranes.
- Engines.
- Railway equipment – shock absorbers, couplers, brake systems, brake blocks.
- Automobile components – shock absorbers, front forks, McPherson struts.

Manufacturing

Escorts' manufacturing plants are in Faridabad near Delhi, while its railway components manufacturing plant is located at Rudrapur in Uttarakhand.

Appendix 1

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

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	Buy	Hold	Sell
Large Caps (>US$1bn)	>20%	5-20%	<5%
Mid/Small Caps (<US$1bn)	>30%	10-30%	<10%

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	Buy	Hold	Sell
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% who are investment banking clients	4%	0%	0%

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