

SCHAEFFLER INDIA

One Schaeffler India: Strong merger

India Equity Research | Bearing

Schaeffler India, a leader in cylindrical and spherical roller bearings, has announced merger of its group companies INA Bearings (leader in needle roller bearings) and LuK India (a clutch and transmission component systems player for automotive systems) with itself. The merger will create a combined entity of INR35.7bn in revenue, having EBITDA of INR5.68bn and PAT of INR3.24bn. We believe the Schaeffler group, a leading Indian automotive and industrial bearings supplier, is well placed to gain from the structural and cyclical uptick expected in both segments and further gain from capex of ~INR7.5-10bn planned over 5 years as a group. Structural benefits of localisation, innovative products, and capex incurred as one entity will help it outperform industry sales as well as earnings along with recording strong cost synergies. Maintain 'BUY'.

Merger rationale

We believe merging 3 entities to create "One Schaeffler India" is a positive as: 1) Will realise revenue and cost synergies due to bundling of product offerings, leverage distribution networks and reduce overhead costs; and 2) Create value for stakeholders – higher growth and margin expansion. Combined entity (on pro-forma basis) recorded revenue CAGR of 10.1% during CY13-16 (versus 8.2% CAGR for Schaeffler India). EBITDA margin of combined entity improved from 9.3% in CY13 to 15.9% in CY16.

Our view

The merger paves the way for other MNCs to create a transparent, unified and simplified structure to outgrow market. In this case, while stock valuation implies 12% earnings dilution on CY16 basis, over long term the combined entity will outperform drawing on its portfolio offerings with leadership in cylindrical and spherical alongside needle bearings. Further, cost synergies could impel Schaeffler's EBITDA margins. In our view, on strong synergies, the combined entity will get re-rated ahead and start fetching better valuations than what we are currently looking at as all the group companies will be in the listed entity.

Outlook and valuations: Positive; maintain 'BUY'

We believe Schaeffler India, a leading Indian automotive and Industrial supplier, is well poised to gain from the structural and cyclical uptick in both segments. It stands to further gain from capex of ~INR7.5-10bn planned over next 5 years as a group. We maintain 'BUY' based on target multiple of 28x CY18E EPS.

Financials (CY16)	(INR mn)			
	Schaeffler India	INA Bearings	LuK India	Combined
Revenue	18,139	10,418	7,298	35,694
EBITDA	2,961	1,461	1,262	5,684
PAT	1,945	685	611	3,241
EPS (INR)	117.0	12.8	27.2	103.7
EBITDA Margin (%)	16.3	14.0	17.3	15.9
PAT Margin (%)	10.7	6.6	8.4	9.1

EDELWEISS RATINGS			
Absolute Rating		BUY	
Investment Characteristics		Growth	
MARKET DATA (R: , B: SCHFL IN)			
CMP	: INR 4,258		
Target Price	: INR 5,102		
52-week range (INR)	: 5,167 / 3,774		
Share in issue (mn)	: 16.6		
M cap (INR bn/USD mn)	: 71 / 1,105		
Avg. Daily Vol. BSE/NSE ('000)	: 4.8		
SHARE HOLDING PATTERN (%)			
	Current	Q4FY17	Q3FY17
Promoters *	51.3	51.3	51.3
MF's, FI's & BKs	26.8	26.9	26.9
FII's	5.5	5.4	5.6
Others	16.4	16.4	16.2
* Promoters pledged shares (% of share in issue)	:		NIL
PRICE PERFORMANCE (%)			
	BSE Midcap Index	Stock	Stock over Index
1 month	1.1	(8.7)	(9.8)
3 months	7.0	(6.8)	(13.8)
12 months	17.8	4.3	(13.5)
Shradha Sheth +91 22 6623 3308 shradha.sheth@edelweissfin.com			
Sanyam Jain +91 22 4040 7412 sanyam.jain@edelweissfin.com			
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Key Highlights

Schaeffler India, leader in cylindrical and spherical roller bearings, has announced merger of its group companies, INA Bearings (leader in needle roller bearings) and Luk India (a clutch and transmission component systems for automotive systems) with itself. Consequently, this will create a combined entity of INR35.7bn, with EBITDA of INR5.78bn and PAT of INR3.24bn (as of CY16).

Details of the Merger

- The swap ratio will be 10 shares of Schaeffler India for every 65 shares of INA Bearings and 10 shares of Schaeffler India for every 35 shares of Luk India.
- As per the swap ratio, 8.21mn of Schaeffler India shares will be issued to the shareholders of INA Bearings and 6.43mn shares of Schaeffler India will be issued to Luk India shareholders.
- The 14.64mn new shares will increase Schaeffler India's outstanding shares from 16.62mn to 31.26mn shares.
- PAT in CY16 will stand higher from INR1.95bn (10.7% net profit margin) of Schaeffler India standalone to INR3.24bn (9.1% net profit margin) for combined entity
- Appointed date for the proposed merger is January 1, 2018 and the merger process is expected to be completed in about 12 months.
- Promoter shareholding (Schaeffler AG, Germany) in the listed entity will increase from 51% currently to 74%.

Merger Rationale

As per management, resultant merger synergies include:

- One unified and simplified structure will enable Schaeffler entity to outgrow market. Merger will create a leading automotive and industrial supplier with ~INR35.7bn revenue and nearly 3,000 employees.
- Revenue and cost synergies will arise due to bundling of product offerings, leveraging of distribution networks and reduction of overhead costs in sales, marketing, distribution and admin functions.
- Merger will result in higher growth and margin expansion. Schaeffler India posted 8.2% CAGR during CY13-16, while INA Bearings and LuK India registered 15.8% and 8.3% CAGR over the mentioned period, respectively.

Table 1: Revenue and EBITDA CAGR (CY13-16)

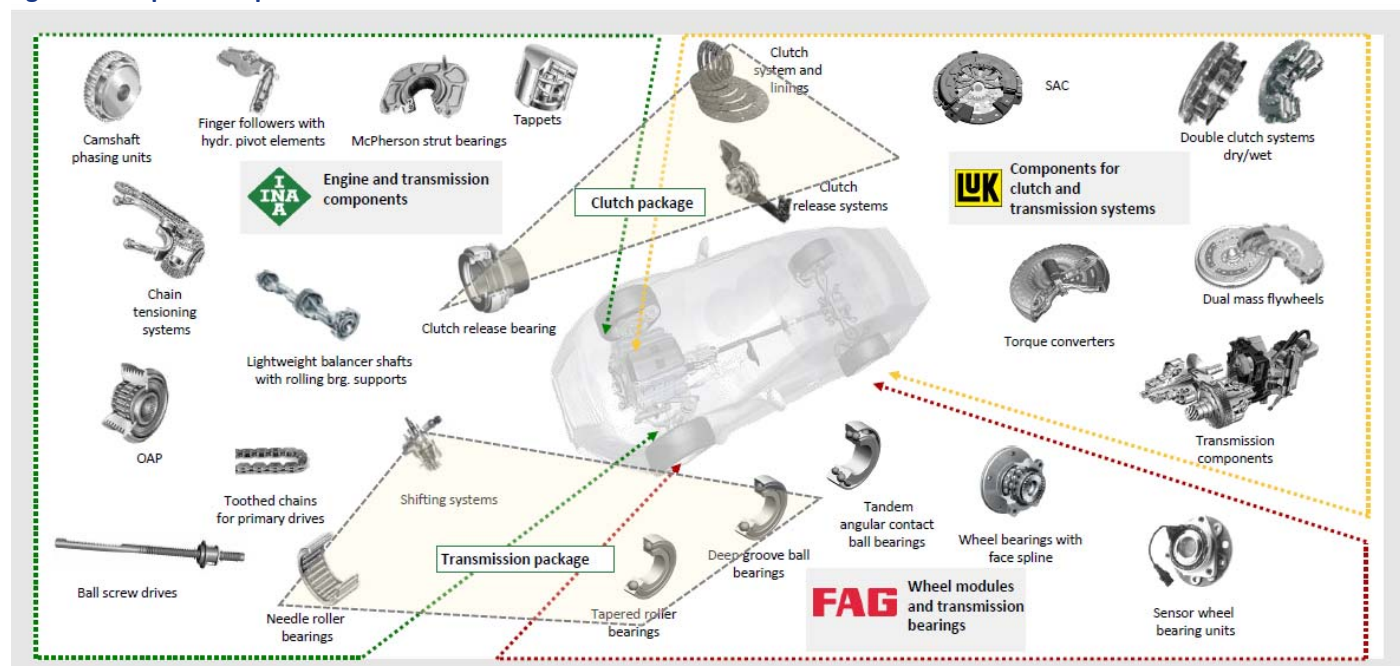
	Revenue CAGR (CY13-16) (%)	EBITDA CAGR (CY13-16) (%)
Schaeffler India	8.2	17.3
INA Bearings India	15.8	79.0
LuK India	8.3	50.1
Combined	10.1	32.1

Source: Company, Edelweiss research

- In the bearings space, Schaeffler India's range will expand to include needle rollers, linear rollers and precision spindle bearings.

- Combined entity will gain from better positioning with a broader range of automotive components, and bundling of offerings for package deals for OEM customers (eg. Clutch Package, Transmission Package).

Fig. 1: Broad product spectrum – Automotive Division



Source: Company, Edelweiss research

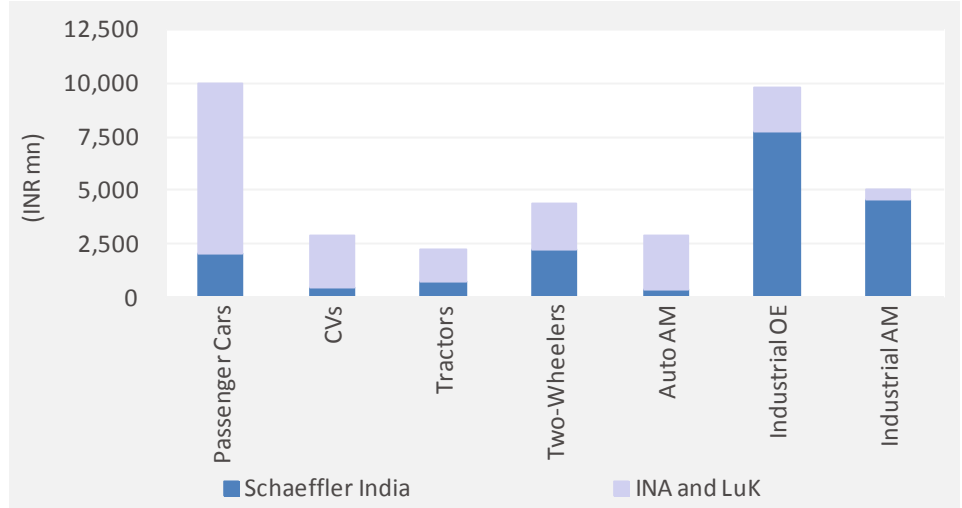
- The combined group outperformed industry in each of the respective segments during 2011-16.
- Schaeffler India will add to the high-growth attractive automotive business as currently it accounts for 70% industrial and 30% auto sales versus 40% auto and 60% industrial sales for the group.

Table 2: Schaeffler Group in India has outgrown the industry

Segment	Revenue CAGR (CY11-16) (%)		Revenue in CY16 (INR mn) (%)	
	Industry	Schaeffler Group in India	Schaeffler India	Combined Entity
Passenger Cars	4.3	18.8	1,989	9,904
CVs	-1.7	9.9	396	2,891
Tractors	0.6	8.0	740	2,211
Two-Wheelers	5.9	10.7	2,201	4,354
Auto AM	NA	14.5	305	2,866
Industrial OE	2.2	9.4	7,742	9,790
Industrial AM	4.7	2.6	4,568	5,006

Source: Company, Edelweiss research

Chart 1: Will gain greater exposure to the faster growing auto segment



Source: Company, Edelweiss research

- Currently, all entities have dedicated and independent distribution channels. Merger will provide potential to leverage these distribution channels to expand reach.

Table 3: Combined Financials

(INR mn)

CY16

Entity	Revenue	EBITDA	PAT	Shares (mn)	EPS (INR)	Promoter Stake (%)	EBITDA margin (%)	PAT Margin (%)
Schaeffler India	18,139	2,961	1,945	17	117	51.0	16.3	10.7
INA Bearings India	10,418	1,461	685	53	13	100.0	14.0	6.6
LuK India	7,298	1,262	611	23	27	100.0	17.3	8.4
Combined	35,694	5,684	3,241	31	104	74.1	15.9	9.1

H1CY17

Entity	Revenue	EBITDA	PAT	Shares (mn)	EPS (INR)	EBITDA margin (%)	PAT Margin (%)
Schaeffler India	9,205	1,746	1,115	17	67	19.0	12.1
INA Bearings India	5,855	892	414	53	8	15.2	7.1
LuK India	4,078	684	353	23	16	16.8	8.7
Combined	19,077	3,323	1,881	31	60	17.4	9.9

Source: Company, Edelweiss research

Company Description

FAG is part of the Schaeffler Group of Germany, a leading global supplier in bearings with revenues of EUR13bn (as of CY16). FAG, Germany, holds 51% stake in the company. In India, FAG is the second largest player with market share of ~17% and ~45% in overall bearings industry and roller bearings segment, respectively.

In India, FAG's exposure to the auto segment is 30% and industrial bearings contribute to 40% of sales. While the company manufactures automotive bearings and part of industrial bearings (~35%), balance 65% of industrial bearings are imported.

Investment Theme

FAG is expected to deliver strong revenue and profit CAGR of 15% and 20% CAGR, respectively over CY16-18E along-with core ROCE of ~25%+ by CY18E. High exposure to four wheelers (~70%+ of auto OEM sales) will drive FAG's revenues led by cyclical uptick. Historically company has averaged fixed asset turn of 5x. EBITDA margin of the company is likely to expand owing to gross margin expansion led by substitution of traded sales (imported) with manufactured sales (localization) and higher operating leverage.

Key Risks

Delay in recovery in key segments can impact our sales growth projections since four wheelers and commercial vehicles together contribute ~75% to FAG's auto OEM revenues.

Forex fluctuation

FAG buys traded goods from group company (Schaeffler Tech AG, Germany). As a result, INR depreciation against EUR may negatively impact margin on these EUR-denominated imports. Imports constitute 33% of net sales. This also includes currency headwinds on ~34% of raw material costs (~11% of net sales) which are imported.

Royalty rate increase

Currently, royalty, trademark and service fees as a percentage of overall sales stand at 2%. Any increase in the same could pose a risk.

Financial Statements

Key Assumptions

Year to December	CY15	CY16	CY17E	CY18E
Macro				
GDP(Y-o-Y %)	7.2	6.5	7.1	7.7
Inflation (Avg)	4.9	4.5	4.0	4.5
Repo rate (exit rate)	6.8	6.3	5.8	5.8
USD/INR (Avg)	65.0	67.5	66.0	66.0
Sector				
Auto OEM(2W) vol. growth	3.0	13.0	9.0	9.0
Auto OEM PV vol. growth	8.0	14.0	9.0	10.0
Auto CV ind. vol. growth	30.0	14.0	9.0	10.0
Company				
Auto 2W OEM vol. growth	12.0	12.0	9.0	14.0
Auto PV OEM vol. growth	10.0	9.0	15.0	17.0
Auto CV OEM vol. growth	2.0	-	12.0	15.0
Auto aftrmkt sale growth	(6.9)	(9.8)	7.0	15.4
Industrial sales growth	-	6.0	9.0	15.0
Export revenue growth	1.7	(0.9)	10.0	15.0
Industrial sales growth	2.6	2.1	9.5	13.0
Manufactured	72.6	73.2	74.3	74.8
Traded	27.4	26.8	25.7	25.2
Mfg. gross margin (%)	47.3	46.3	46.8	47.1
Traded gross margin (%)	27.4	18.5	22.5	22.8

Income statement

(INR mn)

Year to December	CY15	CY16	CY17E	CY18E
Net revenue	17,244	18,139	20,765	23,928
Materials costs	9,907	10,826	12,282	14,054
Gross profit	7,338	7,313	8,483	9,874
Employee costs	1,321	1,513	1,608	1,839
Other Expenses	2,964	2,840	3,265	3,752
Operating expenses	4,285	4,353	4,873	5,591
Total operating expenses	14,192	15,179	17,155	19,645
EBITDA	3,053	2,961	3,610	4,284
Depreciation	655	641	719	779
EBIT	2,398	2,320	2,891	3,505
Add: Other income	561.6	682.6	855.77	1,032.77
Less: Interest Expense	21	18	18	18
Profit Before Tax	2,938	2,985	3,729	4,520
Less: Provision for Tax	963	1,040	1,231	1,492
Reported Profit	1,975	1,945	2,499	3,028
Adjusted Profit	1,975	1,945	2,499	3,028
Shares o /s (mn)	17	17	17	17
Adjusted Basic EPS	118.8	117.0	150.3	182.2
Diluted shares o/s (mn)	17	17	17	17
Adjusted Diluted EPS	118.8	117.0	150.3	182.2
Adjusted Cash EPS	156.1	151.4	193.6	229.1
Dividend per share (DPS)	10.0	12.0	13.0	13.0
Dividend Payout Ratio(%)	9.8	12.0	10.1	8.3

Common size metrics

Year to December	CY15	CY16	CY17E	CY18E
Operating expenses	24.8	24.0	23.5	23.4
Gross margin	42.6	40.3	40.9	41.3
Interest Expense	0.1	0.1	0.1	0.1
EBITDA margins	17.7	16.3	17.4	17.9
EBIT margins	13.9	12.8	13.9	14.6
Net Profit margins	11.5	10.7	12.0	12.7

Growth ratios (%)

Year to December	CY15	CY16	CY17E	CY18E
Revenues	5.7	5.2	14.5	15.2
EBITDA	26.3	(3.0)	21.9	18.7
Adjusted Profit	29.2	(1.5)	28.5	21.2
EPS	29.2	(1.5)	28.5	21.2

Balance sheet (INR mn)				
As on 31st December	CY15	CY16	CY17E	CY18E
Share capital	166	166	166	166
Reserves & Surplus	12,726	14,359	16,581	19,356
Shareholders' funds	12,892	14,525	16,747	19,523
Long Term Liabilities	235	272	272	272
Def. Tax Liability (net)	87	17	-	-
Sources of funds	13,215	14,815	17,019	19,795
Gross Block	7,780	8,786	9,586	10,386
Net Block	3,456	3,861	3,942	3,963
Capital work in progress	519	241	400	400
Intangible Assets	1	-	-	-
Total Fixed Assets	3,976	4,103	4,343	4,364
Cash and Equivalents	4,704	6,406	8,597	10,921
Inventories	2,203	2,740	2,374	2,706
Sundry Debtors	3,364	3,318	3,440	3,928
Loans & Advances	2,136	1,808	1,808	1,808
Other Current Assets	171	195	195	195
Current Assets (ex cash)	7,874	8,060	7,816	8,636
Trade payable	2,405	2,803	2,786	3,175
Other Current Liab	935	951	951	951
Total Current Liab	3,339	3,754	3,737	4,126
Net Curr Assets-ex cash	4,534	4,306	4,079	4,510
Uses of funds	13,215	14,815	17,019	19,795
BVPS (INR)	775.7	874.0	1,007.7	1,174.6

Free cash flow (INR mn)				
Year to December	CY15	CY16	CY17E	CY18E
Reported Profit	1,975	1,945	2,499	3,028
Add: Depreciation	655	641	719	779
Interest (Net of Tax)	14	12	12	12
Others	(735)	(561)	(850)	(1,027)
Less: Changes in WC	90	109	(227)	430
Operating cash flow	1,819	1,928	2,606	2,362
Less: Capex	578	931	959	800
Free Cash Flow	1,241	997	1,647	1,562

Cash flow metrics				
Year to December	CY15	CY16	CY17E	CY18E
Operating cash flow	1,819	1,928	2,606	2,362
Investing cash flow	(2,221)	(1,387)	(959)	(800)
Financing cash flow	(172)	(218)	568	762
Net cash Flow	(574)	323	2,216	2,324
Capex	(578)	(931)	(959)	(800)
Dividend paid	(150)	(200)	(253)	(253)

Profitability and efficiency ratios				
Year to December	CY15	CY16	CY17E	CY18E
ROAE (%)	16.5	14.2	16.0	16.7
ROACE (%)	24.7	21.9	24.0	25.0
ROA	15.9	13.9	15.7	16.5
Inventory Days	76	83	76	66
Debtors Days	66	67	59	56
Payable Days	84	88	83	77
Cash Conversion Cycle	58	63	52	45
Current Ratio	3.8	3.9	4.4	4.7
Net Debt/Equity	(0.4)	(0.4)	(0.5)	(0.6)
Interest Coverage Ratio	113.1	131.8	164.3	199.1
Debt / Cap employed (%)	25.9	25.5	22.0	20.8

Operating ratios				
Year to December	CY15	CY16	CY17E	CY18E
Total Asset Turnover	1.4	1.3	1.3	1.3
Fixed Asset Turnover	4.8	5.0	5.3	6.1
Equity Turnover	1.4	1.3	1.3	1.3

Valuation parameters				
Year to December	CY15	CY16	CY17E	CY18E
Adj. Diluted EPS (INR)	118.8	117.0	150.3	182.2
Y-o-Y growth (%)	29.2	(1.5)	28.5	21.2
Adjusted Cash EPS (INR)	156.1	151.4	193.6	229.1
Diluted P/E (x)	35.8	36.4	28.3	23.4
P/B (x)	5.5	4.9	4.2	3.6
EV / Sales (x)	3.8	3.5	3.4	2.8
EV / EBITDA (x)	21.6	21.7	17.2	14.0
Dividend Yield (%)	0.2	0.3	0.3	0.3

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		CY17E	CY18E	CY17E	CY18E	CY17E	CY18E
Schaeffler India Limited	1,105	28.3	23.4	17.2	14.0	16.0	16.7
SKF India	1,245	27.3	22.6	17.4	14.1	15.7	17.9
Median	-	27.8	23.0	17.3	14.0	15.9	17.3
AVERAGE	-	27.8	23.0	17.3	14.0	15.9	17.3

Source: Edelweiss research

Additional Data

Directors Data

Avinash Gandhi	Chairman	Dharmesh Arora	Managing Director
Klaus Rosenfield	Director	Dietmar Heinrich	Director
R Sampath Kumar	Director	Frank Huber	Director
Sanak Mishra	Director	Renu Challu	Director
Rakesh Jinsi	Director		

Auditors - B.S.R & Co

Holding Top -10

	Perc. Holding		Perc. Holding
Templeton Asset Mgmt	4.01	UTI AMC	2.22
HDFC Asset Management Co Ltd	2.93	HDFC Life Insurance	2.15
Sundaram Asset Management	2.74	ICICI Prudential AMC	2.07
SBI Funds Management	2.58	Kotak Mahindra	1.95
IDFC Mutual Fund	2.3	Birla Sun Life Asset Management	1.79

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**as per last available data*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**as per last available data*

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.

Board: (91-22) 4009 4400, Email: research@edelweissfin.com

Aditya Narain

Head of Research

aditya.narain@edelweissfin.com

Coverage group(s) of stocks by primary analyst(s): Bearing

Schaeffler India Limited, SKF India

Recent Research

Date	Company	Title	Price (INR)	Recos
18-Aug-17	SKF India	Scaling the value chain; <i>Visit Note</i>		Buy
01-Aug-17	SKF India	Moving up the value chain; <i>Result Update</i>		Buy
30-May-17	SKF India	Sales trajectory intact; strong capex ahead; <i>Result Update</i>		Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240

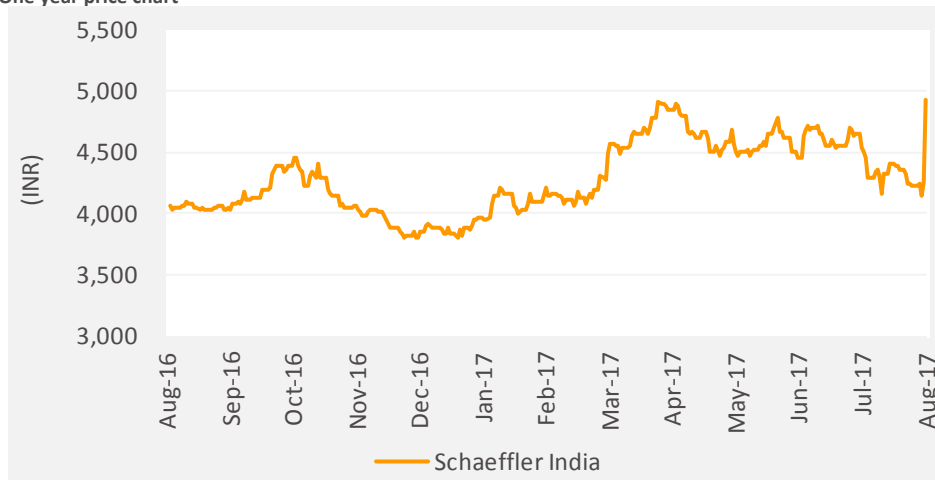
* 1stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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