15 April 2019

AIA Engineering

Improving prospects, retaining a Buy

Rating: **Buy**
Target Price: ₹2,218
Share Price: ₹1,798

Customers added in the gold, copper and platinum sectors should lead to healthy volume growth for AIA Engineering. A call with an expert affirms stirring prospects for the company in the long term in mining-grinding media. The higher entry barrier (technological advances) and deeper penetration are likely to keep good volume growth at least for the next five years. We expect earnings to clock a 21% CAGR over FY18-21. Thus, we retain our Buy rating, with our target price of ₹2,218, at 27x FY21e earnings.

Key takeaways. AIA Engineering has deepened its penetration and brand recall over the last five years due to technological advancement and better servicing than peers. At present, there is a clear demarcation of market exposure with AIAE's greater concentration on mining juniors (miners with two or three mining operations in remote locations). Forthcoming prospects are likely to provide healthy demand growth for AIAE. Mining liners are also likely to offer strong prospects in coming years.

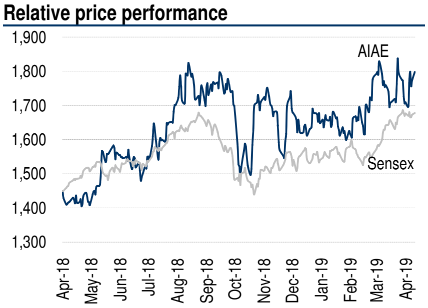
Profitability likely to improve. Higher entry barriers and technological superiority make the grinding media market less vulnerable to competitive pressure. Per our expert call, price pass-throughs are easy, but only once or twice in a year to avoid volatility. This strengthens our expectation of profitability improving from ₹28 a kg to ~₹32 due to commodity cost pass-through in the next two years.

Valuations. Volume growth and margin expansion would lead to a healthy, 15%, revenue CAGR over FY18-21. With traction from developing countries and expansion by major miners, growth prospects seem appealing. Increasing low-grade, higher-volume ores can further increase growth prospects by ~100,000-150,000 tonnes. We expect a 21% earnings CAGR over FY18-21. **Risks:** Volatile currency movements, raw-material prices.

Key data	AIAE IN / AIAE.BO
52-week high / low	₹2026 / 1389
Sensex / Nifty	38767 / 11643
3-m average volume	$0.7m
Market cap	₹170bn / $2451m
Shares outstanding	94m

Shareholding pattern (%)	Dec'18	Sept'18	Jun'18
Promoters	58.5	58.5	58.5
- of which, Pledged	-	-	-
Free float	41.5	41.5	41.5
- Foreign institutions	21.6	22.5	23.0
- Domestic institutions	14.5	13.9	13.5
- Public	5.4	5.1	5.0

Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY17	FY18	FY19e	FY20e	FY21e
Sales (₹ m)	22,460	24,451	30,614	34,886	37,194
Net profit (₹ m)	4,572	4,436	5,063	7,011	7,747
EPS (₹)	48.5	47.0	53.7	74.3	82.1
PE (x)	32.0	30.4	33.5	24.2	21.9
EV / EBITDA (x)	21.3	22.9	23.2	16.8	14.9
PBV (x)	5.4	4.5	5.0	4.3	3.7
RoE (%)	18.1	15.5	15.8	19.0	18.1
RoCE (%)	24.4	19.3	21.4	24.8	23.7
Dividend yield (%)	0.5	0.6	0.5	0.8	0.9
Net debt / equity (x)	-0.4	-0.4	-0.4	-0.4	-0.4

Source: Company, Anand Rathi Research

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Research Analyst

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Quick Glance – Consolidated Financials and Valuations

Fig 1 – Income statement (₹ m)

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
Volumes (tonnes)	**214,477**	**228,020**	**258,020**	**293,020**	**313,020**
Net revenues	22,460	24,451	30,614	34,886	37,194
Growth (%)	**7.0**	**8.9**	**25.2**	**14.0**	**6.6**
Material cost	9,564	11,970	15,705	16,396	17,481
Employee, other expenses	6,550	7,124	8,114	9,244	9,544
EBITDA	**6,346**	**5,357**	**6,796**	**9,246**	**10,169**
EBITDA margins (%)	28.3	21.9	22.2	26.5	27.3
- Depreciation	725	656	752	915	1,145
Other income	1,044	1,218	1,277	1,364	1,643
Interest expenses	45	69	69	69	69
PBT	6,620	5,850	7,252	9,626	10,598
Effective tax rate (%)	30.9	24.2	30.2	27.2	26.9
+ Associates / (Minorities)	-	-	-	-	-
Net income	4,572	4,436	5,063	7,011	7,747
Adjusted income	4,572	4,436	5,063	7,011	7,747
WANS	94	94	94	94	94
FDEPS (₹ / sh)	48.5	47.0	53.7	74.3	82.1
EPS growth (%)	0.1	-3.0	14.1	38.5	10.5

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
Share capital	189	189	189	189	189
Net worth	27,173	30,093	34,093	39,631	45,751
Debt	1,158	1,231	1,231	1,231	1,231
Minority interest	80	89	89	89	89
DTL / (Assets)	712	735	761	909	991
Capital employed	**29,123**	**32,149**	**36,174**	**41,861**	**48,063**
Net tangible assets	6,482	6,492	7,923	9,491	10,829
Net intangible assets	218	219	213	207	200
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	426	968	1,000	1,000	1,000
Investments (strategic)	10	9	9	9	9
Investments (financial)	9,586	10,910	11,652	12,249	16,263
Current assets (ex cash)	12,701	14,338	17,852	20,381	21,738
Cash	2,478	2,650	1,675	3,131	2,938
Current liabilities	2,778	3,437	4,149	4,607	4,914
Working capital	9,923	10,902	13,702	15,774	16,824
Capital deployed	**29,123**	**32,149**	**36,174**	**41,861**	**48,063**
Contingent liabilities	3,273	3,678	-	-	-

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
PBT	6,620	5,850	7,252	9,626	10,598
+ Non-cash items	-269	-246	116	232	307
Oper. prof. before WC	6,352	5,604	7,368	9,857	10,905
- Incr. / (decr.) in WC	1,957	725	3,623	2,057	1,042
Others incl. taxes	1,665	2,316	2,162	2,467	2,769
Operating cash-flow	2,730	2,562	1,582	5,333	7,094
- Capex (tang. + intang.)	-751	-1,205	-2,207	-2,473	-2,473
Free cash-flow	1,979	1,358	-625	2,860	4,621
Acquisitions	-	-	-	-	-
- Div. (incl. buyback & taxes)	755	886	1,063	1,472	1,627
+ Equity raised	-1	21	-	-	-
+ Debt raised	-348	73	-	-	-
- Fin investments	-580	718	109	-79	3,199
- Misc. (CFI + CFF)	220	-324	-822	11	-11
Net cash-flow	1,236	172	-974	1,456	-194

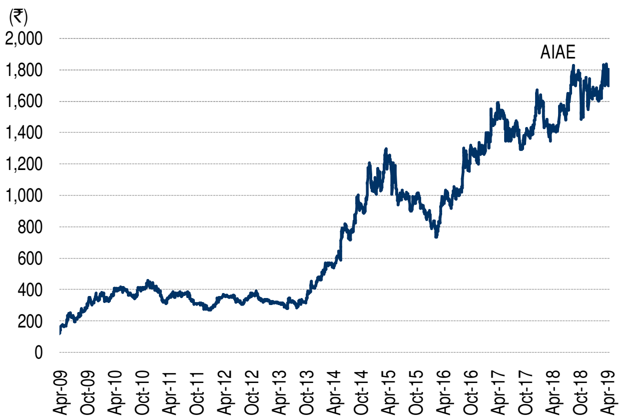
Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
P/E (x)	32.0	30.4	33.5	24.2	21.9
EV / EBITDA (x)	21.3	22.9	23.2	16.8	14.9
EV / Sales (x)	6.0	5.0	5.1	4.5	4.1
P/B (x)	5.4	4.5	5.0	4.3	3.7
RoE (%)	18.1	15.5	15.8	19.0	18.1
RoCE (%) - after tax	24.4	19.3	21.4	24.8	23.7
RoIC (%) - after tax	28.9	25.1	24.6	28.6	28.1
DPS (₹ / sh)	8.0	8.0	9.9	14.2	15.9
Dividend yield (%)	0.5	0.6	0.5	0.8	0.9
Dividend payout (%) - incl. DDT	16.5	20.0	21.0	21.0	21.0
Net debt / equity (x)	-0.4	-0.4	-0.4	-0.4	-0.4
Receivables (days)	80	90	88	88	88
Inventory (days)	87	83	83	83	83
Payables (days)	17	22	24	23	25
CFO : PAT %	59.7	57.8	31.3	76.1	91.6

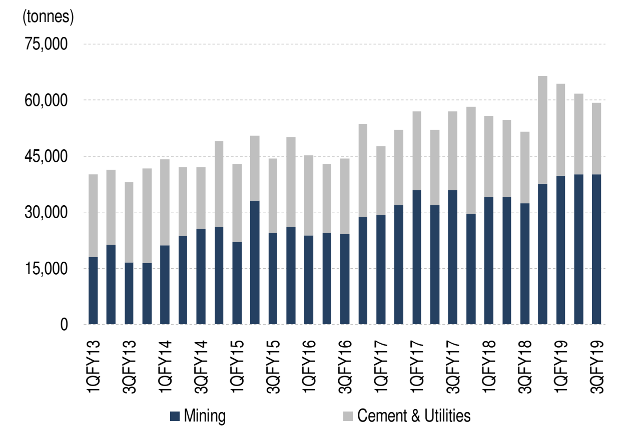
Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 6 – Mining vs. cement & aggregate volume trends



Source: Company

Expert Call Highlights

Quality over pricing

- The operational performance of grinding media depends on its hardness, level of customisation, corrosiveness, lower contamination, the right chemical composition and the amount of impurities.
- Price hikes are easily accepted once quality parameters have been ensured. Optimising the recovery and minimizing impurities are priorities for customers than low-cost procurement.
- At the entry point, usually 8% (mining majors) and 15% (mining juniors) discounts are given to compensate for structural shifts to high-chrome grinding media
- Anti-dumping duties are in place in Brazil and are expected in South-East Asia and Australia. However, no significant impact would be seen on demand for unique and critical products with high quality standards.
- Due to the main focus on effectiveness and efficiency, pricing and payment terms do not lead to changes in decision-making of customers.

Penetration of high-chrome grinding media

- In developed countries ~30% of the market has already seen a structural shift toward high-chrome grinding media; in developing markets this is still a new concept. The market is faced with challenges in developing countries due to supply-chain management issues. The expert we spoke to expects this space to show visible growth potential in the near future.
- In mining (for gold, platinum and copper), due to the abundance of higher-volume and lower-grade ores, the trend in developed countries such as North America and Australia is shifting toward high-chrome grinding media (as the focus is more on improvements in recovery).
- A higher percentage of recovery, an improved consumption rate (of ~30-40%), savings in energy cost and overall process optimisation are a few of the major benefits.
- In cement, there is a lower penetration of high-chrome grinding media.
- The shift from forged grinding media to high-chrome grinding media takes 12-18 months depending upon percentage of integration. If individual operations are shifted, 3-6 months are required. For a larger impact in switching over 1–1.5 years is the ideal time.
- AIA provides extensive trial runs, consultations and tests at various levels in order to induce customers to convert to high-chrome grinding media.
- Due to the focus on higher recovery levels (ie, from 92% to 97%), a deeper penetration of high-chrome grinding media is likely in Africa and the US.

Competitive context

- Magotteaux with its ~ 650,000-tonne capacity leads the market in higher grades and bulk orders. It caters to mining majors who can afford its high-cost, premium products.

- Molycop deals in its niche variety of premium segment products. It has developed new products recently and is incurring capex in many regions to increase capacity. However, it operates in the higher premium segments, which are costlier than AIA.
- Both the companies have business models of catering to mining majors who work in cluster (like Anglo-American, Rio Tinto). AIA focuses more on mining juniors, who are in remote regions.
- For mining majors, it is quite rare to see changes in past suppliers.
- The quality of Chinese manufacturers, even with lower realisations, does not meet industry requirements.

Competitive Advantage of AIA

- With its ~340,000-tonne capacity, AIA has good customer relations, a design and development team, high standards and better servicing. It also caters to high quality quench and heat-resistant treatments.
- It is ranked as the best grinding media for stronger resistance to wear and abrasion by various Universities (Australia, Canada, South Africa). It is weaker than other competitors in corrosion optimisation.
- Its quality has significantly improved over time (the last 5-6 years) ie, improved efficiency and reduced contamination. It caters to customer requirements and achieves flexibility in hardness, chemical composition, reduction in levels of impurities, etc. For example, earlier, it manufactured products with less than 10% chrome; now in the Philippines, it has reached ~30-40% and in South Africa, up to 70-80%.
- It deals in lower grade bulk orders and has realisations lower than Magotteaux and Molycop.
- It has established itself in the Middle East, the UAE, South-East Asia, and the Philippines. However, it is underpenetrated in Africa (Central and the Ghana regions), Australia and USA, where other local manufacturers have gained market share.
- As per expert, AIA can easily increase volumes, by ~100,000-150,000 tonnes without much competitive pressure.
- Single-plant sourcing gives it a competitive advantage in the Middle East, Africa and Asia, while local bases are still advantageous in Australia and North America due to mining activities in cluster.
- Generally, the hardness required is 50-60%, sometimes 70-75%. AIA Engineering focuses on ~60% hardness.
- As per expert, vulnerability to volumes in AIA is high due to greater exposure to mining juniors. However, slower commodity cycle is expected to lead to better volumes at lower realizations.

Customer loyalty

- The customers loyalty depends on quality delivered.
- It is easy to change if the ore body is generic. But, if the ore body requires customisation it is difficult to switch because of specific metallurgy requirement.
- Mining majors tend to renew vendors (global supply agreements) every three years. However, it is very rare to see a change in past

suppliers. Mining juniors have annual contracts (to protect from volatility in prices).

- In critical parts of processing, premium products are used as long as they are reliable, achieve efficiency in power consumption and don't break down.

Mining Liners

- In 2017, AIA had ventured into mining liners. However, due to some constraints, it could not cater to high quality standards. Later, this was rectified and it offered discounts of up to ~50% to re-gain market share and prove its quality improvisation.

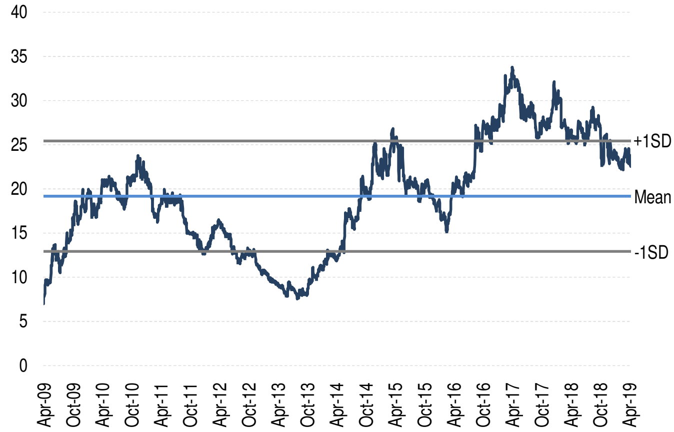
Other points

- Grinding media is ordered in a specific batch of ~1,000 tonnes, generally one tonne of steel is required for 20 tonnes of ore.
- Even in times of commodity pressures, the focus would be to maintain a higher level of recoveries to maintain profitability. This would encourage shifts toward high-chrome grinding media even in times of commodity pressures.
- Mining majors are likely to provide opportunities in new areas. It is not necessary to give contracts to the original vendor. This would increase AIA's chances.
- Catering to large mining companies is easier due to the involvement of consultants.

Valuation

A call with an expert affirms stirring prospects for the company in the long term in mining-grinding media. Volume growth and margin expansion would lead to a healthy, 15%, revenue CAGR over FY18-21. With traction from developing countries and expansion by major miners, growth prospects seem appealing. Increasing low-grade, higher-volume ores can further increase growth prospects by ~100,000-150,000 tonnes. We expect a 21% earnings CAGR over FY18-21. Hence, we maintain our Buy rating, with a target price of ₹2,218 (27x FY21e earnings).

Fig 7 – One-year-forward PER



Source: Company, Anand Rathi Research

Key risks

- **Volatility in currency movements and in raw-material prices:** Of the company's raw-material requirement, 25% (by sales value) is imported. 75% of its sales are exports. Hence, a net 50% of sales is exposed to currency volatility. To alleviate the currency risk, the company hedges short-term quarterly sales.
- **On higher returns, keener competition:** Higher return ratios in mining-grinding media would lead to keener competition and, hence, might cut into profitability.

Appendix

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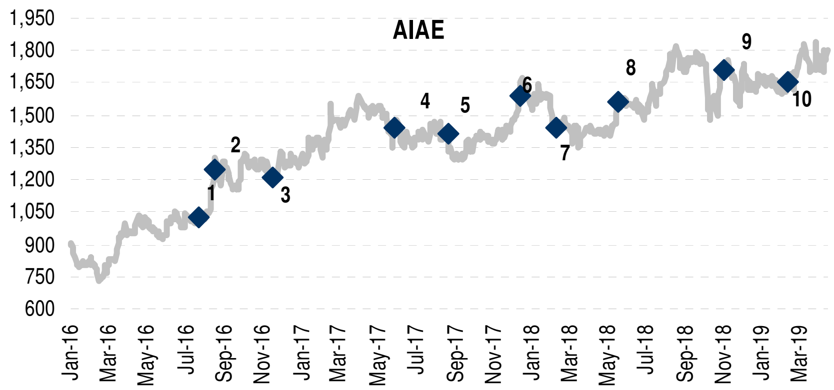

	Date	Rating	TP (₹)	Share Price (₹)
1	22-Jul-16	Buy	1,422	1,024
2	17-Aug-16	Buy	1,481	1,222
3	16-Nov-16	Buy	1,807	1,236
4	30-May-17	Hold	1,564	1,384
5	21-Aug-17	Hold	1,607	1,400
6	14-Dec-17	Buy	2,375	1,573
7	08-Feb-18	Buy	2,417	1,434
8	18-May-18	Buy	2,470	1,565
9	02-Nov-18	Buy	2,450	1,680
10	12-Feb-19	Buy	2,242	1,660

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