

Timken India | BUY



ABC amalgamation to be EPS accretive from Year 1

We resume coverage on Timken India (Timken) and publish our revised numbers to factor in the consolidation of ABC Bearings (ABC). In our view, the amalgamation of ABC Bearings would be EPS accretive from FY19 as net profit of the consolidated entity should increase 17% (factoring in 11-month consolidation in FY19) vs. 11% stake dilution through a share swap. Over FY18-21, we forecast sales and earnings CAGR of 16% and 25%, respectively, for the consolidated entity, led by a) strong growth in the domestic CV market (entry in wheel bearings segment), b) bounce-back in exports on easing of capacity constraints and favourable USD/INR movement and c) a production ramp-up at ABC as it is operating at sub-optimal capacity utilisation levels. We maintain BUY with a Mar'20 TP of INR 675, as we lower our target multiple to 25x (30x) FY21E EPS due to increased competition in the railways segment, a sharp reduction in net exports in the past 3 years and amalgamation of a single-digit RoE business (ABC has low RoEs due to muted capacity utilisation).

- ABC amalgamation to be EPS accretive in FY19:** Despite ABC's poor track record (10-year sales CAGR of 1.3%), Timken acquired the company at a PE of 41x FY17 and 37x FY18 as it provided several benefits such as **a)** consolidation of its leadership position in tapered roller bearings, **b)** lower future capex requirements as current capacities are operating at sub-optimal levels of 45-50%, **c)** entry opportunity in wheel bearing and desired product portfolio manufacturing footprint and **d)** synergistic benefits from rationalisation of its distribution network. We expect the amalgamation to be EPS accretive from FY19 as we expect consolidated net profit to increase 17% (factoring 11-month consolidation in FY19) vs. 11% stake dilution.
- CVs, exports and capacity ramp-up at ABC to drive growth:** Timken is slated for strong profitability growth over FY18-21E due to bounce-back in key segments (CVs and exports), easing of capacity constraints on commissioning of new facilities and synergistic benefits arising from the amalgamation of ABC. ABC also offers an alternate product line to Timken's export customers, thus improving the addressable market size globally.
- Strong growth in 1QFY19:** Timken and ABC both reported strong sets of results as sales grew 28% and 34% YoY, respectively, led by strong growth in the domestic CV segment and a revival in exports. Operating margins expanded on improving capacity utilisations and resulted in a sharp jump in net profit of 44% and 594%, respectively.
- Lower target PE, but maintain BUY rating:** We forecast 16%/25% CAGR in consolidated sales/earnings over FY18-21E led by continued growth in CVs, exports and operating leverage benefits due to a capacity ramp-up. We maintain BUY with a Mar'20 TP of INR 675, as we lower our target multiple to 25x FY21E EPS (in line with peers) due to increased competition in the railways segment, where it had a dominant market share of 60%, sharp reduction in net exports in the past 3 years (down to 1% vs. 13% in FY15) and amalgamation of a single digit RoE business. **Key risks** to our call are a slump in the domestic CV cycle and sharp increase in commodity prices.

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Recommendation and Price Target

Current Reco.	BUY
Previous Reco.	NR
Current Price Target (18M)	675
Upside/(Downside)	21.7%
Previous Price Target	650
Change	3.8%

Key Data – TMKN IN

Current Market Price	INR554
Market cap (bn)	INR41.7/US\$0.6
Free Float	32%
Shares in issue (mn)	75.2
Diluted share (mn)	75.2
3-mon avg daily val (mn)	INR18.0/US\$0.2
52-week range	1,008/549
Sensex/Nifty	34,299/10,301
INR/US\$	74.4

Price Performance

%	1M	6M	12M
Absolute	-16.5	-25.7	-28.1
Relative*	-6.5	-26.8	-33.3

* To the BSE Sensex

Financial Summary		(INR mn)				
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
Net Sales	10,562	12,340	17,061	19,620	22,327	
Sales Growth (%)	-0.5	16.8	38.3	15.0	13.8	
EBITDA	1,580	1,633	2,586	3,089	3,589	
EBITDA Margin (%)	15.0	13.2	15.2	15.7	16.1	
Adjusted Net Profit	972	920	1,383	1,704	2,036	
Diluted EPS (INR)	14.3	13.5	18.4	22.7	27.1	
Diluted EPS Growth (%)	3.5	-5.3	35.9	23.2	19.5	
ROIC (%)	18.7	13.7	15.1	13.5	14.2	
ROE (%)	17.1	13.9	13.8	12.4	13.3	
P/E (x)	38.8	41.0	30.1	24.5	20.5	
P/B (x)	6.1	5.4	3.2	2.9	2.6	
EV/EBITDA (x)	26.2	25.4	15.5	13.2	11.2	
Dividend Yield (%)	0.3	0.2	0.3	0.4	0.5	

Source: Company data, JM Financial. Note: Valuations as of 09/Oct/2018. Post FY18 numbers are consolidated

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Synergies arising from the ABC amalgamation: Timken India (Timken) acquired ABC Bearings (ABC) in an all-stock deal. ABC is a manufacturer of tapered, cylindrical and spherical roller bearings and slewing rings and operates primarily out of manufacturing facilities in Gujarat and Uttarakhand. ABC's shareholders will receive 5 shares of Timken for every 8 shares they hold in the company.

Merger rationale:

- Strengthen Timken's leadership position in tapered roller bearings (84% of ABC's turnover in FY16) and increase market share from 15% to 20%.
- Low capex requirement as ABC has 2 manufacturing plants, where current capacity utilisation levels are at 45-50%.
- Timken's superior technological capabilities coupled with ABC's labour cost advantage are likely to bring in operational efficiencies for the merged entity.
- Facilitate entry in the domestic wheel bearing segment (market size: INR 6bn) and provide a manufacturing base to leverage Timken's global reach.
- ABC also has a capacity for 0-4 inch (0-100cm) cylindrical roller bearings, which can help Timken reduce imports and manufacture locally at ABC's plant.

Transaction value pegged at INR 4.8bn: The acquisition value of ABC is pegged at INR 4.8bn (INR 419 per share), implying 37x FY18 PE (25% discount to Timken) and 16.3x FY18 EVE (48% discount to Timken). In our view, the premium valuations are justified given better PAT CAGR of 20% during FY13-18 compared with Timken's 16% and access to ABC's 60% under-utilised capacity to which Timken can leverage its technology and internal processes, generating operational efficiencies as utilisations pick up. The transaction consideration will be paid through the issue of 7.2 million additional shares of Timken, resulting in a decrease in the parent's shareholding to 67.8% (vs. 75%).

Exhibit 1. Transaction snapshot

ABC Bearings: Timken India	
Swap ratio	5:8
ABC shares outstanding (mn)	11.55
No of shares issued (mn)	7.219
Value at INR 670/share (INR mn)	4,837
Valuation (on FY17 basis)	
EV/EBITDA (x)	16.2
P/E (x)	40.8
P/B (x)	3.5
Valuation (on FY18* basis)	
EV/EBITDA (x)	16.3
P/E (x)	36.6
P/B (x)	3.3

Source: Company, JM Financial. *calculated on reported FY18 numbers as the deal was announced prior to FY18-end

Background

Timken India (Timken) is a leading manufacturer of taper roller bearings and bearing components. It manufactures taper rolling bearing in India, while it imports spherical, cylindrical and specialty ball bearings. It was incorporated in 1987 as a JV with Tata Steel, where each held a 40% stake, but it subsequently acquired Tata Steel's stake in 1999. Currently, the Timken Group (USA), through its Singapore arm, holds a 75% stake in the company, reduced from 80% through an OFS in Apr'14. Timken has 2 facilities in India, 1 in Jamshedpur to manufacture tapered roller bearings, and a gear servicing plant in Raipur. Besides these, the parent company also has a manufacturing plant located in Chennai for the manufacture of large-sized bearings (feeder factory for other locations) and a global research centre in Bangalore. It recently acquired ABC Bearings (ABC) in an all-stock deal.

Exhibit 2. Key assumptions

YoY Growth	FY17A	FY18A	FY19E	FY20E	FY21E
Timken Standalone					
Domestic	4%	22%	19%	12%	12%
- Indian Railways	0%	15%	10%	10%	10%
- Commercial Vehicles	15%	129%	25%	10%	10%
- Process ind/aftermarket	2%	-16%	20%	15%	15%
Exports	-9%	5%	25%	15%	15%
ABC Bearings	6%	0%	25%	20%	20%
Timken Consolidated	-1%	17%	20%	15%	14%

Source: Company, JM Financial

Investment rationale

Bulk of sales portfolio shielded from competition: Timken has a 7% market share (will reach double digits after consolidation) in the Indian bearings industry and is among the top suppliers to railways and commercial vehicle segments. Timken faces little competition for nearly 60% of its sales constituting **a)** exports (28% of sales) where 100% of sales are to the parent company, **b)** railways (18% of sales) which is a duopoly market and **c)** industrials aftermarket (18% of sales), where sales are B2B in nature.

Capacity augmentation to address opportunity: Timken has expanded its railway bearing capacity at its Jamshedpur plant with an investment of INR 1.25bn and spent INR 600mn for tapered roller bearings 0-8 capacity to cater to both emerging domestic and global demand. Given the brownfield expansion, we expect incremental revenue generation from new capacities along with operating leverage benefits.

Acquisition of ABC to provide growth with synergies: Timken recently acquired ABC in an all-stock deal. The acquisition brings significant operational synergies and would help strengthen Timken's leadership position in the tapered roller bearings segment (84% of ABC's turnover in FY16) and increase market share from 15% to 20%. ABC's 60% free capacity will provide bandwidth to execute an opportunity-driven growth trajectory (in railways and CVs), increase exports and allow a re-entry into the wheel end market globally.

Return ratios to crawl upwards on higher asset turns and operating efficiencies: Return ratios have dipped from 19.5% in FY16 to an average 15.5% in FY17/18 led by higher capex. We believe higher asset turns – led by improving utilisations at the Jamshedpur plant – coupled with better exports would drive RoEs back to 19-20% levels. ABC has weak RoEs in single digits as its plants operate at sub-optimal levels of 45-50%; this is likely to ramp up in the next three years, thus improving RoEs to the 17-20% range.

Key risks

Shift in manufacturing allocation from Timken: Nearly 28% of sales are to the parent company in the form of exports. However, any change in manufacturing allocation from Timken India to other Timken entities may result in a decline in exports and would have an adverse impact on profitability. Currently, the Timken Group has 14 manufacturing units for mobile industry products and only 2 of these are located in Asia, the other one being in Yantai, China.

Commodity price inflation: Among MNC bearing majors, Timken India has one of the highest shares of manufactured goods at 65-70% of sales. Thus, any sharp appreciation in steel prices is likely to result in compression of gross margins and thus impact profitability.

Financial Tables (Standalone)

Income Statement		(INR mn)				
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
Net Sales	10,562	12,340	17,061	19,620	22,327	
Sales Growth	-0.5%	16.8%	38.3%	15.0%	13.8%	
Other Operating Income	0	0	0	0	0	
Total Revenue	10,562	12,340	17,061	19,620	22,327	
Cost of Goods Sold/Op. Exp	6,240	7,283	9,892	11,237	12,766	
Personnel Cost	737	905	1,255	1,454	1,594	
Other Expenses	2,005	2,520	3,328	3,841	4,378	
EBITDA	1,580	1,633	2,586	3,089	3,589	
EBITDA Margin	15.0%	13.2%	15.2%	15.7%	16.1%	
EBITDA Growth	-2.8%	3.3%	58.4%	19.5%	16.2%	
Depn. & Amort.	289	431	597	634	650	
EBIT	1,291	1,201	1,989	2,455	2,939	
Other Income	99	208	136	159	183	
Finance Cost	8	12	33	40	45	
PBT before Excep. & Forex	1,382	1,397	2,092	2,575	3,077	
Excep. & Forex Inc./Loss(-)	0	0	0	0	0	
PBT	1,382	1,397	2,092	2,575	3,077	
Taxes	410	478	708	871	1,041	
Extraordinary Inc./Loss(-)	0	0	0	0	0	
Assoc. Profit/Min. Int.(-)	0	0	0	0	0	
Reported Net Profit	972	920	1,383	1,704	2,036	
Adjusted Net Profit	972	920	1,383	1,704	2,036	
Net Margin	9.2%	7.5%	8.1%	8.7%	9.1%	
Diluted Share Cap. (mn)	68.0	68.0	75.2	75.2	75.2	
Diluted EPS (INR)	14.3	13.5	18.4	22.7	27.1	
Diluted EPS Growth	3.5%	-5.3%	35.9%	23.2%	19.5%	
Total Dividend + Tax	113	107	166	204	244	
Dividend Per Share (INR)	1.4	1.4	1.8	2.3	2.7	

Source: Company, JM Financial

Cash Flow Statement		(INR mn)				
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
Profit before Tax	1,382	1,397	2,092	2,575	3,077	
Depn. & Amort.	-1,689	404	973	634	650	
Net Interest Exp. / Inc. (-)	0	0	0	0	0	
Inc (-) / Dec in WCap.	696	-1,082	-184	-1,416	-741	
Others	0	0	0	0	0	
Taxes Paid	-409	-424	-905	-871	-1,041	
Operating Cash Flow	-20	296	1,975	921	1,945	
Capex	366	-566	-479	-1,200	-1,200	
Free Cash Flow	346	-270	1,496	-279	745	
Inc (-) / Dec in Investments	-522	354	0	0	0	
Others	0	0	0	0	0	
Investing Cash Flow	-156	-212	-479	-1,200	-1,200	
Inc / Dec (-) in Capital	0	0	0	0	0	
Dividend + Tax thereon	-113	-107	-166	-204	-244	
Inc / Dec (-) in Loans	41	75	-212	-37	-26	
Others	98	32	111	0	0	
Financing Cash Flow	26	0	-267	-241	-270	
Inc / Dec (-) in Cash	-150	84	1,229	-520	475	
Opening Cash Balance	334	184	268	1,497	977	
Closing Cash Balance	183	268	1,497	977	1,451	

Source: Company, JM Financial

Note: Post FY18 numbers are consolidated

Balance Sheet		(INR mn)				
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
Shareholders' Fund	6,179	7,023	12,968	14,468	16,260	
Share Capital	680	680	752	752	752	
Reserves & Surplus	5,499	6,343	12,216	13,716	15,508	
Preference Share Capital	0	0	0	0	0	
Minority Interest	0	0	0	0	0	
Total Loans	84	159	123	86	60	
Def. Tax Liab. / Assets (-)	-32	22	0	0	0	
Total - Equity & Liab.	6,231	7,205	13,091	14,554	16,320	
Net Fixed Assets	2,887	3,049	7,083	7,650	8,200	
Gross Fixed Assets	2,811	3,420	7,374	8,574	9,774	
Intangible Assets	0	0	3,174	3,174	3,174	
Less: Depn. & Amort.	505	909	3,496	4,129	4,779	
Capital WIP	581	538	31	31	31	
Investments	906	552	552	552	552	
Current Assets	4,947	6,188	9,007	10,921	12,767	
Inventories	1,880	2,455	3,061	4,032	4,588	
Sundry Debtors	1,935	2,254	2,979	4,032	4,588	
Cash & Bank Balances	184	268	1,497	977	1,451	
Loans & Advances	948	1,212	1,469	1,881	2,141	
Other Current Assets	0	0	0	0	0	
Current Liab. & Prov.	2,510	2,584	3,551	4,569	5,199	
Current Liabilities	1,568	1,966	2,082	2,688	3,058	
Provisions & Others	942	618	1,469	1,881	2,141	
Net Current Assets	2,437	3,603	5,456	6,352	7,568	
Total - Assets	6,230	7,205	13,091	14,554	16,320	

Source: Company, JM Financial

Dupont Analysis						
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
Net Margin	9.2%	7.5%	8.1%	8.7%	9.1%	
Asset Turnover (x)	1.8	1.8	1.7	1.4	1.4	
Leverage Factor (x)	1.0	1.0	1.0	1.0	1.0	
RoE	17.1%	13.9%	13.8%	12.4%	13.3%	

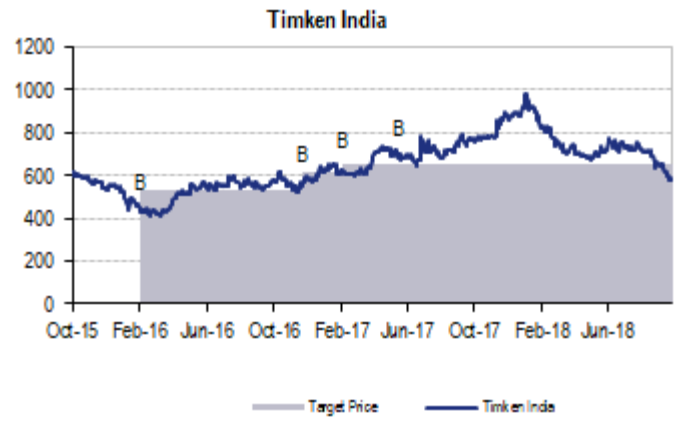
Key Ratios						
Y/E March	FY17A	FY18A	FY19E	FY20E	FY21E	
BV/Share (INR)	90.9	103.3	172.4	192.3	216.2	
ROIC	18.7%	13.7%	15.1%	13.5%	14.2%	
ROE	17.1%	13.9%	13.8%	12.4%	13.3%	
Net Debt/Equity (x)	0.0	0.0	-0.1	-0.1	-0.1	
P/E (x)	38.8	41.0	30.1	24.5	20.5	
P/B (x)	6.1	5.4	3.2	2.9	2.6	
EV/EBITDA (x)	26.2	25.4	15.5	13.2	11.2	
EV/Sales (x)	3.9	3.4	2.4	2.1	1.8	
Debtor days	67	67	64	75	75	
Inventory days	65	73	65	75	75	
Creditor days	64	67	52	59	60	

Source: Company, JM Financial

History of Earnings Estimate and Target Price

Date	Recommendation	Target Price	% Chg.
12-Feb-16	Buy	535	
1-Dec-16	Buy	615	15.0
13-Feb-17	Buy	650	5.7
25-May-17	Buy	650	0.0
9-Oct-18	Buy	675	3.8

Recommendation History



APPENDIX I

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