Business Standard -The Smart Investor

Can Bharat Forge beat Infosys?

N Mahalakshmi in Mumbai | June 13, 2005

With powerful growth potential in auto ancillaries and a management that is all geared to exploit the opportunity, Bharat Forge could soon enjoy richer valuations than that of Infosys. This means its stock, too could outperform.

It is well known that when Infosys came up with its maiden public issue in the early nineties there were hardly any takers for the stock. Cut to 2005. The market capitalisation Infosys (Rs 59,500 crore -- Rs 595 billion) is the fifth largest in the country. Led by an exceptionally competent management and powerful outsourcing opportunity in software services, Infosys has seen its revenues and earnings climb a minimum 30 per cent every year even during its worst times. Backed by this untiring growth, the stock recorded an annual return of 63 per cent after adjusting for all pay-outs and stock-splits as compared to a Sensex of 5.3 per cent since March 31, 2005. In value terms, if you had invested Rs 100 in Infosys ten years ago, the value of your holding would now be Rs 16,460 while the value of Sensex would have grown to a miserly Rs 172. Still, Infy is going strong with an expected earnings growth of 25-30 per cent over the next few years. In short, the Infy stock provided the shortest route to the millionaire club to stock holders.

That may sound like a fairy tale never to be repeated. But hold on. Another company, in an altogether different sector, is scripting a similar story. If stock markets were to be believed, Pune-based Bharat Forge, which manufactures and sells auto forgings, is now poised at the same level at which Infosys was a few years ago. Combine the huge global outsourcing opportunity in the auto ancillary sector and the strength of the company's management team and Bharat Forge displays the same magic mix that made Infy what it is today. "This is the golden period for Bharat Forge," says Jamshed Desai, head (retail advisory and strategy), IL&FS Investmart. It is not as though the stock markets are not in the know. Buoyed by the spectacular growth in earnings and internal restructuring efforts, which made its balance-sheet look a lot cleaner, Bharat Forge has seen a re-rating at the bourses. Its stock has delivered a return of 765 per cent (in absolute terms since march 31, 2005) while its valuations have surged - the stock now enjoys a price-earning multiple of 29 times based on trailing 12-month earnings compared to 13 times in fiscal 2003. Based on valuations, Bharat Forge is marching closer to Infy which now trades at 33 times trailing 12-month earnings (See table).

How they compare		
(Rs crore)	Bharat Forge	Infosys
Net sales	2001	6860
EBITDA	431.9	2325
EBITDA margin (%)	21.6	33.9
Profit before tax	313	1534
Net profit	201	1859
Net margin (%)	10	27.1
RoCE (%)	26.4	51.4
EPS (Rs)	49.8	67.5
FY06 EPS forecast	70	85
FY07 EPS forecast	92	105
Price (Rs)	1433.9	2212.78
Market-cap)	5671.07	57873.26
P/E		
FY05	28.8	32.8
FY06 (E)	20.48	26.03
FY07 (E)	15.59	21.07
Note: Figures for Bharat Forge are consolidated while those for Infosys are standalone.		

In terms of market-cap, however, Bharat Forge commands less than one-tenth the value of Infy. How far can Bharat Forge go?

Over the past three years, Bharat Forge has seen spectacular growth. Consolidated revenues have seen a compounded annual growth of 66 per cent to Rs 2,001 crore (Rs 20.01 billion). Revenues from outside India have been much stronger at 126 per cent, growing from exports of Rs 110 crore (Rs 1.10 billion) in FY02 to Rs 1,285 crore (Rs 12.85 billion) coming from direct exports plus contribution from its overseas acquisition. Profit before tax grew 106 per cent (CAGR) during the same period from Rs 35 crore (Rs 350 million) to Rs 313 crore (Rs 3.13 billion). On a standalone basis, the company has increased its exports contribution from less than one-forth in FY02 to about 42 per cent currently. Over the next three years, exports is expected to contribute about 60 per cent of sales.

From a low profile company relying on the domestic auto sector for a long time, Bharat Forge has re-invented itself to make the best of the global opportunity. While vibrant domestic demand has more than helped, Bharat Forge cannot be denied it's due for bold overseas initiatives - it acquired CDP Gmbh in January 2004 for euro 29 million and CDP-AT in November 2004 for euro 6.3 million. "These acquisitions have given the company an edge of dual shore model and tremendous opportunity to leverage existing customer relations of the two companies, especially the European passenger car manufacturers," says Baba Kalyani, chairman and managing director. Infy, on the other hand, has largely relied on organic growth. It made its first and only acquisition till date only about 18 months ago.

Till FY02, Bharat Forge derived 90 per cent of its export revenues from a single customer and had a single product line (CV forgings). Now, it also caters to the passenger-car segment and diesel engines - the size of the passenger-car segment is touted to be four times the size of the CV forgings business. While car and CV forgings will continue to be top on the agenda till 2008, the management is aiming to transcend to the next level in the value chain - from a forgings company into an engineering solutions company, extending into tool designing and product development apart from product testing and validations.

While the search for potential acquisitions in North America is on, the company is also planning to set up a manufacturing base in China. "Since most of the global OEMs (original equipment manufacturers) have manufacturing centres in China it makes imminent sense to set up a plant in the country," says Kalyani. Currently, India accounts for 35 per cent of total revenues, Europe 39 per cent, US 17 per cent and Asia Pacific 9 per cent. The company's Rs 500-crore (Rs 5 billion) capacity expansion for this fiscal (to be completed by December 2005) is already pre-sold.

Undoubtedly, Bharat Forge has emerged as the a role model for the auto ancillary industry in the country. Analysts vouch that the company has a robust business model -- well-diversified across products, markets, clients and geographies. Analysts are equally confident about the ability of the management to forge a global footprint. Already, Bharat Forge supplies to 35 of 40 global OEM manufacturers.

All this may not have been easy but for an outsourcing opportunity as strong as in software services. Shrinking margins and shorter product life-cycle have necessitated faster product development, resulting in increased engineering and developing costs. "Global OEMs unable to achieve significant cost reduction from conventional supply sources have started outsourcing and offloading component/assembly manufacturing work to specialists in low-cost destinations," says an analyst. The addressable market for Bharat Forge currently stands at around $10 billion per annum.

The company is targeting a share of $1 billion by FY08, nearly double its existing turnover. In terms of size, Bharat Forge is pretty much in the same position as Infosys was four years ago. Infosys closed FY01 with revenues of Rs 1,900 crore (Rs 19 billion). Last fiscal, the company crossed the $1 billion mark with revenues totaling to Rs 6,859 crore (Rs 68.59 billion). Net profit stood at Rs 1,859 crore (Rs 18.59 billion), up from Rs 623 crore (Rs 6.23 billion) in FY01. To put it in perspective, over the past four years, Infy has seen its revenues and earnings climb by 37.84 per cent and 31.43 per cent respectively.

As for Bharat Forge, analysts are hopeful of 40 per cent plus growth per annum over the next four years. So four years hence, can Bharat Forge command as much investors' wealth as Infy does today? May be not. That's is primarily because its business is not as profitable as Infy's. Bharat Forge currently enjoys a net profit margin of 10 per cent while Infy - even after tremendous pressure on billion rates and rising wage costs (employee costs have gone up from 37.77 per cent to 46.39 per cent over the last four years) - maintained a net margin of 27.10 per cent. So even if Bharat Forge compounds its revenues at the same rates over the next four years, its earnings may not match that of Infosys in absolute terms.

Not just that, it produced a 51.43 per cent return on capital employed last fiscal (62.62 per cent in FY01), driven by high profitability margins and a good asset turnover ratio. Every one rupee deployed in Infy's business is capable of generating sales of Rs 4-4.5. Bharat Forge, on the hand, has an asset-turnover ratio of around 1.5. If one strips off the cash in the two companies, the difference in return ratios would be even more stark (Infy will look even better). "The sheer difference in return ratios will ensure that Bharat Forge will not be getting the same earnings multiple as Infy," says an analyst.

Then again, the success of an auto ancillary company depends on its operating performance and capital efficiency. Unless the company works hard on improving capital efficiency, higher sales and earnings will not be possible without commensurate addition in assets which will involve diluting equity or additional debt burden.

But there are some contrarian views. According to Bharat Shah, managing partner, ASK Raymond James Investment Managers, Bharat Forge may well get a small premium over Infy in the future. He rests his case on four pillars. Firstly, auto ancillary business has far more entry barriers than software services. What makes the auto ancillary tougher is that unlike in IT services, cost competitiveness alone is not the key driver - it is an extremely skill- and design-intensive industry. It takes a long time to develop competencies in this business. Having developed the skill sets, put up capacities and established credentials with clients, it is only a matter of leveraging that strength for Bharat Forge. In software services, business tends to be episodic where clients engagements tend to be on a project-by-project basis, depending on the requirements. Secondly, Bharat Forge's business is more scaleable in the sense that the company can address a large size of business without much additional efforts. As scale builds up, the company could realise better economies of scale which may improve profitability significantly. Thirdly, being a manufacturing set-up the durability of assets is far higher in the case of Bharat Forge. For Infy, the real asset is its 32,000-odd employees. Infy's greatest strength has been its human resources, which it has managed to keep healthy with the lowest attrition rates (9.7 per cent last fiscal). Fourthly, Bharat Forge is a full tax paying company while Infy is not. Last year, Infy's effective tax rate was 4.74 per cent while that of Bharat Forge was 40 per cent.

Shah points out that though Infosys also has scaleable business model, it is not the character of the business but the aptitude of the management which makes the company scaleable. Infy's business, like many other technology or services businesses, is a lot more dependent on the management. "I would any day prefer a business which is less dependent on the management and can run on its own strength," says Shah.

Agrees Desai, "There is a lot more durability to Bharat Forge's business unlike software services where in the long run, labour costs could come down and the competitiveness could diminish." Bharat Forge does not face too much competitive threat as it will cost much higher for foreign companies to come and set up shops here. It is not just about producing where it is most competitive and selling where it is most profitable. "Bharat Forge is competitive not just because of its pricing but because of the way it does business," emphasises Desai.

Yet, it needs to be remembered that Bharat Forge is dependent on the fortunes of the global auto sector and it will be vulnerable to the ups and downs in the sector. Technology being an enabler, Infy should not be as cyclical.

With an impeccable management and a global delivery model, and a far bigger addressable market for IT and IT-enabled services, Infy should still see an earnings growth of 25 per cent over the next few years. According to Nasscom's estimates, the total value of outsourcing is estimated to grow from the current (2004) $39.6 billion to $94 billion in 2008. India's share is likely to grow from $17.2 billion to $48 billion. Infosys has reengineering itself, focusing on new service lines and tweaked its cost and organisation structure to the changing market dynamics. With its subsidiaries driving growth - Infosys Consulting is expected to clock $250 million revenue run rate by March 2007 and BPO Progeon about $150 million run rate by March 2007 -- Infosys should continue to be a front-runner, although its golden period may be over. "Infy is now at the top of the hump. Bharat Forge is yet to get there," says Desai.