INDIA

HOLD

Swaraj Engines

Automobiles

Result Update **1 November 2017**

Many positives already priced in, Maintain Hold

On the back of impressive growth in the India tractor industry, Swaraj Engines (SWE) reported its best ever quarter in terms of engine sales volume and net profits. But considering strong growth reported by M&M's tractor division, this performance was below estimates. 2QFY18 EBITDA/PAT improved 20.3%/22.1% YoY, on the back of 11.6% growth in volumes and 51 bps YoY improvement in EBITDA margin. SWE's EBITDA margin was slightly ahead of our expectations, however sales and net profits missed estimates. While we acknowledge that SWE is poised to leverage the continued good growth in tractor volumes, current reach valuations limit the upside in the near term-term, in our view. Consequently, we maintain our Hold rating on the stock, with a target price of Rs2,183.

- **Tractor story playing out well:** SWE's volumes rose 11.6% YoY to 24,984 units, and net realizations increased 4.5% YoY/0.3% QoQ to Rs83,517, which pushed up the company's top-line by 16.6% YoY to Rs2,087bn, below our estimates. The company's EBITDA margin expanded by 51bps YoY. The company's 2QFY18 EBITDA margin stood at 16.8% against our estimate of 16.6%. Interestingly, during this quarter the company reported its highest ever margin in the past 27 quarters. Consequently, 2QFY18 EBITDA/PAT grew by 20.3%/22.1% YoY. 2QFY18 PAT stood at Rs235mn against our estimate of Rs65mn, primarily due to lower than expected volume growth.
- **Dealer's confidence in Swaraj Tractors remains intact:** Based on our recent interactions with Swaraj tractor dealers, we understand that the overall demand was mixed during Q2FY18. In some geographies, sales were hurt due to ongoing government crackdown on illegal mining which has hit sand supply for construction work. However, overall demand was okay on the back of good monsoon and early start of festival season. Dealers have pointed out that there were no incidences of discounting during the quarter. Swaraj Tractors launched its new tractor model 742FE, during Q1FY18 catering to the 40-45hp category. The model has been well received by the market, considering the number of enquiries the dealers have received for the same.
- **Valuation and recommendations:** At the CMP of Rs2,091, the stock is currently trading at 28.8x FY18E EPS and 24.3x FY19E EPS. While we believe that Swaraj Tractors would be one of the key beneficiaries of the continued growth in tractor volumes, the current valuations already factor in a large part of the estimated growth and consequently we see limited upside in the near to medium term. While our investment thesis remains intact, we would wait for a better risk reward before getting more constructive on the company. We value SWE on our differentiated AOCF/EV methodology and arrive at a TP of Rs2,183 (25x FY19E EPS) which indicates a small upside from current levels. Hence we maintain our Hold rating on the stock. Key risks are a) dependence on a single client (i.e. Swaraj tractors) and b) lower-than-estimated growth in tractor volumes.

Y/E Mar (Rs mn)	1QFY18	1QFY17	YoY (%)	4QFY17	QoQ (%)	1QFY18E	Var. (%)
Total Income	**2,087**	**1,789**	**16.6**	**1,940**	**7.6**	**2,325**	**(10.3)**
Operating costs	1,736	1,497	15.9	1,617	7.3	1,939	(10.5)
EBITDA	**351**	**292**	**20.3**	**323**	**8.7**	**386**	**(9.1)**
EBITDA margin (%)	16.8	16.3	51bps	16.6	17bps	16.6	21bps
Depreciation	42	42	1.2	42	0.2	40	6.7
Interest	-	0		-		-	NA
Other Income	51	45	13.3	48	5.8	58	(12.6)
PBT	**360**	**295**	**22.0**	**329**	**9.3**	**405**	**(11.2)**
Taxes paid	125	102	21.9	114	9.4	140	(11.1)
Reported PAT	**235**	**193**	**22.1**	**215**	**9.3**	**265**	**(11.2)**
PAT margin (%)	11.3	10.8	50bps	11.1	18bps	11.4	(12)bps
EPS	18.9	15.5	22.1	17.3	9.3	21.3	(11.2)

Source: Company, Centrum Research Estimates

Target Price	Rs2,183
CMP*	Rs2,091
Upside	4.4%
Previous Target	Rs2,169
Previous Rating	Hold

Price Performance (%)*

	1M	6M	1Yr
SWE IN	2.9	16.3	53.2
NIFTY	5.6	11.1	19.8

Key Data	
Bloomberg Code	SWE IN
Curr Shares O/S (mn)	12.4
Diluted Shares O/S(mn)	12.4
Mkt Cap (Rsbn/USDmn)	26/401.2
52 Wk H / L (Rs)	2517.7/1201.8
5 Year H / L (Rs)	2545/380.1
Daily Vol. (3M NSE Avg.)	3416

**as on 31 October 2017; Source: Bloomberg, Centrum Research*

Shareholding pattern (%)*

	Sep-17	Jun-17	Mar-17	Dec-16
Promoter	50.6	50.6	50.6	50.6
FIIs	5.5	5.2	5.0	6.7
Dom. Inst.	12.2	12.4	12.2	12.1
Public & Others	31.7	31.8	32.2	30.6

*Source: BSE, *as on 31 October 2017*

Earning Revisions summary

Particulars (Rs in mn)	FY18E			FY19E		
	New	Old	Chg (%)	New	Old	Chg (%)
Sales	7,891	7,813	1.0	9,005	9,041	(0.4)
EBITDA	1,307	1,260	3.8	1,497	1,497	(0.0)
EBITDA margin (%)	16.6	16.1	47 bps	16.6	16.6	2 bps
PAT	901	873	3.2	1,070	1,072	(0.2)

Source: Centrum Research Estimates

Centrum vs. Bloomberg Consensus*

Particulars (Rs mn)	FY18E			FY19E		
	Centrum	BBG	Var (%)	Centrum	BBG	Var (%)
Sales	7,891	7,890	0.0	9,005	9,108	(1.1)
EBITDA	1,307	1,293	1.1	1,497	1,521	(1.6)
PAT	901	857.6	5.1	1,070	1016	5.3

Bloomberg Consensus*				Centrum Target Price (Rs)	Variance (%)
BUY	SELL	HOLD	Target Price (Rs)		
3	0	3	2,354	2,183	(7.3)

**as on 31 October 2017; Source: Bloomberg, Centrum Research Estimates*

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Y/E Mar (Rsmn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	EPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY15	5,397	(11.3)	747	13.8	518	(24.0)	41.7	22.0	21.4	21.2	12.2
FY16	5,259	(2.6)	738	14.0	513	(1.0)	41.3	19.6	19.1	21.3	12.2
FY17	6,661	26.7	1,047	15.7	688	34.1	55.4	25.2	24.6	22.5	12.6
FY18E	7,891	18.5	1,307	16.6	901	30.9	72.6	31.4	30.7	28.8	17.9
FY19E	9,005	14.1	1,497	16.6	1,070	18.7	86.1	36.1	35.4	24.3	15.4

Source: Company, Centrum Research Estimates

Valuation and recommendations

SWE's stock has risen nearly 16% in the last six months on account of strong quarterly performances, along with strong volume growth. Structurally the company still retains its fundamental strengths and is all set to grow its business with expected strong demand for tractors. We value SWE on our differentiated AOCF/EV methodology and arrive at a TP of Rs2,183. We ascribe a premium to historical multiples and specify the key reasons for the same below.

AOCF/EV valuation – 55% premium ascribed to historical AOCF/EV yield

As per our AOCF/EV based valuation, we note that SWE's four year average AOCF/EV yield stands at 6.7%. We have ascribed a 55% premium to this average to arrive at a target AOCF/EV yield of 4.3%, and hence, the implied EV/AOCF multiple of 23.2x. We use average AOCF over FY16-19E and a 23.2x EV/AOCF multiple to arrive at our target EV and our TP of Rs 2,183/share.

Exhibit 1: AOCF/EV based valuation

Average 4-yr adj. cash flow yield (FY14-17, %)	6.7
Premium	55%
Average 4-yr adj. cash flow yield (FY16-19, %) after discount	4.3
Implied EV/4 yr AOCF Multiple (x)	23.2
Average Operating cash flow after interest (FY16-19E, Rs mn)	1,043
Target Enterprise Value (Rs mn)	24,157
Net Debt (FY19, Rs mn)	(2,959)
Target Market Cap (Rs mn)	27,116
No of shares	12
Target Price (Rs/shr)	**2,183**

Source: Company, Centrum Research Estimates

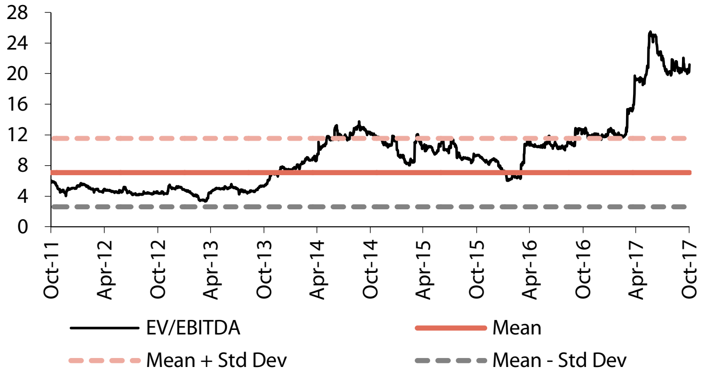
We believe that the premium assigned to the multiple is justified on account of the following reasons:

- **Gaining market share:** SWE has been a direct beneficiary of consistent industry outperformance by Swaraj tractors post acquisition of PTL by M&M. Swaraj tractors has been beating the industry growth rate by an average margin of ~500 bps in the last 8 years. This implies that there is a strong demand for Swaraj tractors which was reaffirmed by our interaction with the dealers. All this has led to continued market share gain by Swaraj tractors, which translated into SWE's strong performance. We expect the outperformance by Swaraj to be maintained going forward.

- **Asset light model and low payback period for new capex:** Our detailed financial analysis shows that SWE enjoys a high net asset turnover of ~7x (expected to improve to ~10x by FY19) and also has an impressive payback period of just ~1 year, if the new capacity gets fully utilized. Average capacity utilization was 86.5% during FY11-FY17. We expect this to further improve in the coming years.

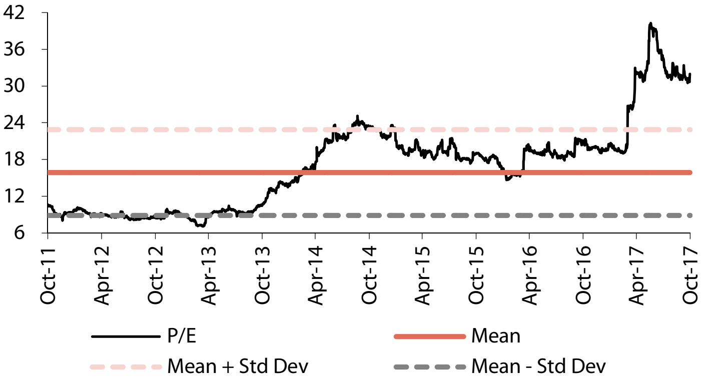
- **High return ratios and consistent dividend pay-outs:** SWE has maintained its profitability ratios (ROE & ROCE) above 20%, except in FY16 when the domestic tractor volumes declined for two year consecutively. However, it returned back to ~25%, when the volume growth picked up in FY17. Additionally, due to its capability of generating strong FCF, SWE has been rewarding its shareholders handsomely with an average 75% pay-out ratio. We expect these return ratios to improve in the years ahead.

Exhibit 2: 1 year forward EV/EBITDA chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 3: 1 year forward P/E chart



Source: Bloomberg, Company, Centrum Research Estimates

Quarterly financials, Operating Metrics and Key Performance Indicators

Exhibit 4: Quarterly Financials

Y/E March (Rs mn)	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18
Net Sales	**1,056**	**1,140**	**1,717**	**1,789**	**1,548**	**1,608**	**1,940**	**2,087**
Raw Materials	801	846	1,280	1,328	1,144	1,204	1,429	1,558
Employee Costs	65	63	73	76	81	81	81	89
Other Expenditure	63	71	81	94	93	82	107	89
EBITDA	**128**	**160**	**284**	**292**	**230**	**241**	**323**	**351**
Depreciation	33	35	40	42	40	42	42	42
Interest	0	-	0	0	1	0	-	-
Other Income	37	40	47	45	44	36	48	51
PBT	132	165	291	295	234	235	329	360
Tax	49	48	101	102	81	82	114	125
Tax rate (%)	*36.8*	*28.8*	*34.7*	*34.7*	*34.7*	*34.9*	*34.6*	*34.6*
Reported PAT	**83**	**118**	**190**	**193**	**153**	**153**	**215**	**235**
Other Comprehensive Income	-	(1)	-	-	-	2	-	-
Total PAT	**83**	**117**	**190**	**193**	**153**	**155**	**215**	**235**
YoY Growth (%)								
Revenue	*3.5*	*9.3*	*12.1*	*16.8*	*46.6*	*41.0*	*13.0*	*16.6*
EBITDA	*7.4*	*19.8*	*27.5*	*28.3*	*80.2*	*50.6*	*13.7*	*20.3*
PAT	*0.8*	*42.7*	*21.4*	*23.9*	*83.2*	*29.8*	*13.2*	*22.1*
QoQ Growth (%)								
Revenue	*(31.1)*	*8.0*	*50.6*	*4.2*	*(13.5)*	*3.9*	*20.7*	*7.6*
EBITDA	*(43.9)*	*25.5*	*77.2*	*2.7*	*(21.2)*	*5.0*	*33.8*	*8.7*
PAT	*(46.3)*	*41.0*	*61.4*	*1.3*	*(20.5)*	*(0.1)*	*40.7*	*9.3*
Margin (%)								
EBITDA	*12.1*	*14.1*	*16.5*	*16.3*	*14.9*	*15.0*	*16.6*	*16.8*
PAT	*7.9*	*10.3*	*11.1*	*10.8*	*9.9*	*9.5*	*11.1*	*11.3*
Key Drivers								
Engine sales (in Units)	12,845	13,970	20,910	22,395	19,150	19,842	23,287	24,984
Per Vehicles basis (Rs.)								
Realizations (Rs/Engine)	82,203	81,596	82,109	79,888	80,820	81,025	83,300	83,517
Raw material costs (Rs/Engine)	62,320	60,558	61,196	59,299	59,728	60,679	61,356	62,356
Employee costs (Rs/Engine)	5,076	4,495	3,486	3,376	4,209	4,067	3,470	3,550
Other Expenditure (Rs/Engine)	4,873	5,075	3,850	4,188	4,877	4,118	4,612	3,570
EBITDA (Rs/Engine)	9,934	11,467	13,577	13,025	12,005	12,161	13,862	14,041

Source: Company, Centrum Research

Exhibit 5: Key Performance Indicators

	FY14	FY15	FY16	FY17	FY18E	FY19E
Capacity (in units)	**75,000**	**75,000**	**1,05,000**	**1,05,000**	**1,20,000**	**1,20,000**
Engine Sales (in units)	74,062	64,595	64,088	82,297	95,629	1,07,055
Capacity Utilization (%)	*98.7*	*86.1*	*61.0*	*78.4*	*79.7*	*89.2*
Engine Realization (Rs)	79,637	81,344	79,455	78,621	80,194	81,798
Engine Revenues (Rs mn)	5,898	5,254	5,092	6,470	7,669	8,757
Component Revenues (Rs mn)	50	20	22	28	35	42
Total (Rs mn)	**5,948**	**5,274**	**5,114**	**6,498**	**7,704**	**8,799**
Other operating Income (Rs mn)	135	123	145	163	188	206
Total Operating income (Rs mn)	**6,083**	**5,397**	**5,259**	**6,661**	**7,891**	**9,005**

Source: Company, Centrum Research Estimates

Financials

Exhibit 6: Income Statement

Y/E March (Rs mn)	FY15	FY16	FY17	FY18E	FY19E
Net Sales	**5,397**	**5,259**	**6,661**	**7,891**	**9,005**
Raw Materials	4,091	3,957	4,955	5,840	6,673
% of sales	*75.8*	*75.2*	*74.4*	*74.0*	*74.1*
Personnel	308	268	310	339	380
% of sales	*5.7*	*5.1*	*4.7*	*4.3*	*4.2*
Manufact. & Other Exp.	251	297	349	405	456
% of sales	*4.6*	*5.6*	*5.2*	*5.1*	*5.1*
EBITDA	**747**	**738**	**1,047**	**1,307**	**1,497**
EBITDA Margin (%)	*13.8*	*14.0*	*15.7*	*16.6*	*16.6*
Depreciation & Amortisation	132	138	163	161	174
EBIT	**615**	**600**	**884**	**1,146**	**1,323**
Interest Expenses	0	0	1	-	-
EBT	**615**	**599**	**883**	**1,146**	**1,323**
Other Income	163	163	172	232	313
PBT	**778**	**762**	**1,055**	**1,378**	**1,636**
Tax-Total	260	249	366	477	566
Effective tax rate (%)	*33.4*	*32.7*	*34.7*	*34.6*	*34.6*
Extraord. items -Adj.	-	-	-	-	-
Reported PAT	**518**	**513**	**688**	**901**	**1,070**
Minority Interest	**-**	**-**	**-**	**-**	**-**
Adjusted PAT	**518**	**513**	**688**	**901**	**1,070**

Source: Company, Centrum Research Estimates

Exhibit 7: Key Ratios

Y/E March	FY15	FY16	FY17	FY18E	FY19E
Growth ratios (%)					
Net sales & operating other income	*(11.3)*	*(2.6)*	*26.7*	*18.5*	*14.1*
EBITDA	*(17.6)*	*(1.2)*	*41.9*	*24.9*	*14.5*
Adjusted Net Profit	*(24.0)*	*(1.0)*	*34.1*	*30.9*	*18.7*
Margin Ratio (%)					
EBITDA Margin	*13.8*	*14.0*	*15.7*	*16.6*	*16.6*
EBIT Margin	*11.4*	*11.4*	*13.3*	*14.5*	*14.7*
PBT Margin	*14.4*	*14.5*	*15.8*	*17.5*	*18.2*
PAT Margin	*9.6*	*9.8*	*10.3*	*11.4*	*11.9*
Return Ratio (%)					
ROE	*22.0*	*19.6*	*25.2*	*31.4*	*36.1*
ROCE	*21.4*	*19.1*	*24.6*	*30.7*	*35.4*
Turnover Ratio days (days)					
Gross Block Turnover (x)	3.41	2.95	3.42	3.82	4.04
Inventory Period	22	19	14	13	13
Debtors Period	5	5	7	5	5
Creditors	33	37	38	40	40
Cash Conversion Cycle	(5.5)	(13.0)	(17.0)	(22.0)	(22.0)
Solvency Ratio					
Debt-equity (x)	-	-	-	-	-
Net Debt-equity (x)	(0.6)	(0.7)	(0.7)	(0.7)	(0.8)
Liquidity ratio (x)	3.4	3.4	2.8	2.4	2.3
Interest coverage ratio (%)	*NM*	*NM*	*NM*	NA	NA
Per share (Rs)					
Adjusted EPS	41.7	41.3	55.4	72.6	86.1
CEPS	52.3	52.4	68.5	85.5	100.1
Book value	210.5	212.1	228.2	234.5	242.4
Dividend per share	33.0	33.0	33.0	55.0	65.0
Dividend Pay-out (%)	*79.1*	*79.9*	*59.5*	75.8	75.5
Dividend Yield (%)	*2.5*	*2.5*	*2.5*	4.1	4.9
Valuation					
P/E	21.2	21.3	22.5	28.8	24.3
P/BV	4.2	4.1	5.5	8.9	8.6
5 Year Average AOCF/EV Yield %	*5.6*	*6.3*	*4.8*	3.4	4.1
EV/EBITDA	12.2	12.2	12.6	17.9	15.4
EV/Sales	1.7	1.7	2.0	3.0	2.6

Source: Company, Centrum Research Estimates

Exhibit 8: Balance Sheet

Y/E March (Rs mn)	FY15	FY16	FY17	FY18E	FY19E
Sources of funds					
Capital	124	124	124	124	124
Reserves & Surplus	2,490	2,510	2,709	2,789	2,887
Shareholders' Funds	**2,615**	**2,634**	**2,834**	**2,913**	**3,011**
Minority Interest	-	-	-	-	-
Total Debt	-	-	-	-	-
Deferred Tax Liabilities	63	76	63	63	63
Total Liabilities	**2,678**	**2,710**	**2,896**	**2,976**	**3,074**
Application of funds					
Gross Block	1,634	1,936	1,961	2,170	2,290
Accumulated Dep.	(795)	(918)	(1,049)	(1,210)	(1,384)
Capital WIP	48	3	8	0	0
Net Fixed Assets	**886**	**1,021**	**921**	**960**	**906**
Investments	420	104	489	489	489
Goodwill	-	-	-	-	-
Inventories	331	277	261	281	321
Sundry Debtors	69	75	131	108	123
Other Current Assets	-	-	-	-	-
Cash & Bank Balances	1,457	1,817	1,862	2,142	2,470
Loans and Advances	89	72	58	79	90
Total Current Assets	**1,946**	**2,241**	**2,312**	**2,610**	**3,004**
Creditors	**482**	**540**	**701**	**865**	**987**
Other Current Liabilities	48	69	72	100	158
Provisions	45	47	51	118	180
Total Current Liabilities	**575**	**656**	**825**	**1,083**	**1,325**
Net Current Assets	**1,371**	**1,586**	**1,486**	**1,527**	**1,679**
Total assets	**2,678**	**2,710**	**2,896**	**2,976**	**3,074**

Source: Company, Centrum Research Estimates

Exhibit 9: Cash Flow

Y/E March (Rs mn)	FY15	FY16	FY17	FY18E	FY19E
Operating profit before WC changes	**475**	**500**	**674**	**1,062**	**1,244**
Net change in working capital	81	130	150	239	176
Cash flow from operating activities (a)	**556**	**630**	**824**	**1,302**	**1,419**
Adjusted Operating Cash flow	**556**	**630**	**823**	**1,302**	**1,419**
Capital expenditure	(167)	(273)	(65)	(200)	(120)
Adjusted FCF	389	357	758	1,102	1,299
Cash flow from investing activities (b)	**(107)**	**(138)**	**(319)**	**(200)**	**(120)**
Cash flow from financing activities (c)	**(505)**	**(492)**	**(492)**	**(822)**	**(972)**
Net change in cash (a+b+c)	(56)	1	13	280	328
Opening cash balance	62	6	7	20	300
Ending cash balance	**6**	**7**	**20**	**300**	**627**
Other bank balances	1,451	1,810	1,842	1,842	1,842
Cash on balance sheet	**1,457**	**1,817**	**1,862**	**2,142**	**2,470**

Source: Company, Centrum Research Estimates

Appendix A

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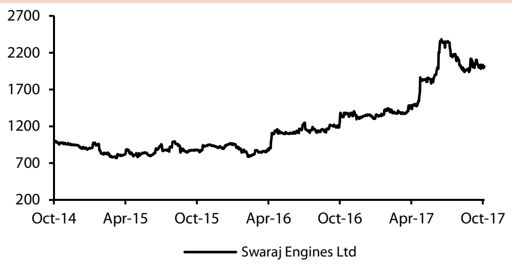
Swaraj Engines price chart



Source: Bloomberg, Centrum Research

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		Swaraj Engines
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