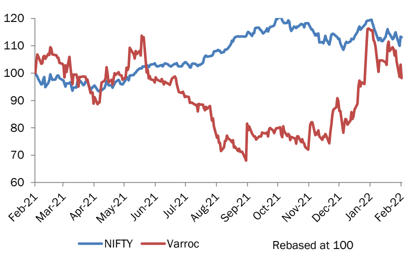
Varroc Engineering Limited

17 February 2022

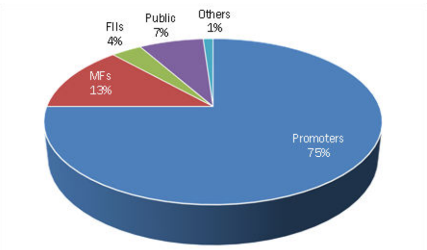
Visibility around the timing of turnaround awaited — HOLD

Sector	: Auto Ancillary
Target Price	: Rs 425
Current Market Price	: Rs 377
Market Cap	: Rs 5,756 crore
52-week High/Low	: Rs 458/260
Daily Avg Vol (12M)	: 4,05,719
Face Value	: Re 1
Beta	: 1.31
Pledged Shares	: 0%
Year End	: March
BSE Scrip Code	: 541578
NSE Scrip Code	: VARROC
Bloomberg Code	: VARROC IN
Reuters Code	: VARE.NS
Nifty	: 17,322
BSE Sensex	: 57,997
Analyst	: Research Team

Price Performance



Shareholding Pattern



3Q FY22 Update

Result Analysis

- Varroc's business performance remained under stress in 3Q FY22 as the semiconductor shortage continued to affect production at OEMs, impacting VLS sales negatively (-15% y-o-y in euro terms). Although 2W production volumes in India was weak during the quarter, revenues at the India business grew marginally (+2% y-o-y). Consolidated revenues saw a modest sequential improvement, driven by a 10.7% increase in VLS's euro sales.
- EBITDA (excluding FX loss/gain on intercompany loans) was down on a y-o-y basis, although it was up sequentially as the company reported material EBITDA in 3Q FY22, compared to a negligible amount in the quarter before. The margin pressure is attributable to sub-optimal capacity utilisation at older VLS plants, input cost pressures, and supply chain disruptions.
- The net loss was up on a y-o-y basis while, sequentially, the loss was lower.

Outlook & Valuation

VLS's operations continue to be negatively affected by semiconductor shortages, leading to production cuts at OEMs. While capacity additions have been announced by major global foundries, it will be some time before they come online. Consequently, we do not expect the situation to normalise before CY23. We expect VLS's margins to remain weak, albeit with progressive improvements, in FY23, gaining further through FY24. EBITDA margins at the India business are expected to remain healthy. Over the next couple of quarters, margins should also benefit from the lagged effect of pass-through of higher raw material prices. Management reaffirmed progress in Project RACE, which is expected to contribute incremental margins going forward. While we believe Varroc is a turnaround story, we will be following key data-points and looking for more visibility over the next few quarters. The Varroc stock has fallen by 7% since we initiated coverage on the company on 14 December 2020. Its underperformance could be attributed to the continued short supply of semiconductors, leading to under-utilisation at VLS's plants and consequent losses recorded by the company. Based on a target P/E multiple of 18.0x FY 24E EPS, we value Varroc at Rs 425, downgrading it to HOLD with an upside of 13% from current levels.

Key Financial Metrics (Consolidated)

₹ Crore	FY19A	FY20A	FY21A	FY22E	FY23E	FY24E
Operating revenue	12,036	11,122	11,303	12,338	13,671	15,352
Growth		*-7.6%*	*1.6%*	*9.2%*	*10.8%*	*12.3%*
EBITDA	1,059	821	397	98	900	1,550
EBITDA margin	*8.8%*	*7.4%*	*3.5%*	*0.8%*	*6.6%*	*10.1%*
PAT	429	3	(629)	(1,036)	(263)	365
PAT margin	*3.6%*	*0.0%*	*-5.6%*	*-8.4%*	*-1.9%*	*2.4%*
Diluted EPS (₹)	31.54	0.01	(46.75)	(68.05)	(17.48)	23.63

Note: EBITDA for past periods includes FX loss/gain on intercompany loans
Source: Company data, Khambatta Research

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Financial Performance (Consolidated)

₹ crore	3Q FY21	2Q FY22	3Q FY22	Y-o-Y	Q-o-Q	9M FY21	9M FY22	Y-o-Y
Operating revenue	3,492.7	3,032.6	3,135.0	-10.2%	3.4%	7,683.5	9,109.1	18.6%
EBITDA	245.7	3.8	72.2	-70.6%	1790.1%	332.3	93.7	-71.8%
EBITDA margin	*7.0%*	*0.1%*	*2.3%*	*-473 bps*	*218 bps*	*4.3%*	*1.0%*	*-330 bps*
PAT	(137.0)	(297.2)	(264.4)	-93.1%	11.0%	(484.3)	(790.9)	-63.3%
PAT margin	*-3.9%*	*-9.8%*	*-8.4%*	*-451 bps*	*137 bps*	*-6.3%*	*-8.7%*	*-238 bps*
Diluted EPS (₹)	(10.29)	(19.52)	(17.35)	-68.6%	11.1%	(36.09)	(51.95)	-43.9%

Note: EBITDA in the historical comparison excludes FX loss/gain on intercompany loans

Source: Company data, Khambatta Research

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Guide to Khambatta's research approach

Valuation methodologies

We apply the following absolute/relative valuation methodologies to derive the 'fair value' of the stock as a part of our fundamental research:

DCF: The Discounted Cash Flow (DCF) method values an estimated stream of future free cash flows discounted to the present day, using a company's WACC or cost of equity. This method is used to estimate the attractiveness of an investment opportunity and as such provides a good measure of the company's value in absolute terms. There are several approaches to discounted cash flow analysis, including Free Cash Flow to Firm (FCFF), Free Cash Flow to Equity (FCFE) and the Dividend Discount Model (DDM). The selection of a particular approach depends on the particular company being researched and valued.

ERE: The Excess Return to Equity (ERE) method takes into consideration the absolute value of a company's return to equity in excess of its cost of equity discounted to the present day using the cost of equity. This methodology is more appropriate for valuing banking stocks than FCFF or FCFE methodologies.

Relative valuation: In relative valuation, various comparative multiples or ratios including Price/Earnings, Price/Sales, EV/Sales, EV/EBITDA, Price/Book Value are used to assess the relative worth of companies which operate in the same industry/industries and are thereby in the same peer group. Generally our approach involves the use of two multiples to estimate the relative valuation of a stock.

Other methodologies such as DuPont Analysis, CFROI, NAV and Sum-of-the-Parts (SOTP) are applied where appropriate.

Stock ratings

Buy recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) by at least 15%.

Hold recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) between 5% and 15%.

Sell recommendations are expected to improve up to 5% or deteriorate, based on consideration of the fundamental view and the currency impact (where applicable).

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