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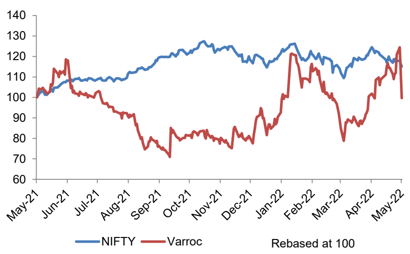
Varroc Engineering Limited

05 May 2022

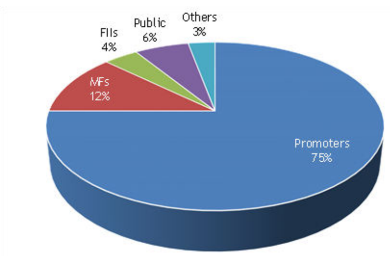
Value-unlocking of profitable India ops, reinforced by a debt-free balance sheet — BUY

Sector	: Auto Ancillary
Target Price	: Rs 450
Last Closing Price	: Rs 367
Market Cap	: Rs 5,601 crore
52-week High/Low	: Rs 494/260
Daily Avg Vol (12M)	: 5,85,367
Face Value	: Re 1
Beta	: 1.30
Pledged Shares	: 0%
Year End	: March
BSE Scrip Code	: 541578
NSE Scrip Code	: VARROC
Bloomberg Code	: VARROC IN
Reuters Code	: VARE.NS
Nifty	: 16,678
BSE Sensex	: 55,669
Analyst	: Research Team

Price Performance



Shareholding Pattern



Update on the Divestment of Global 4W Lighting Business

Commentary

The total value of the recently announced sale of Varroc Engineering's 4W lighting system operations in the Americas and Europe to the French automotive parts company Compagnie Plastic Omnium SE is pegged at Euro 600 mn (approximately Rs 4,800 crore). With the divestment, the company looks to strategically align its resources with the high value and high growth primary markets of China, India, and the global 2W segment. The India operations will now become Varroc's core business (approximately 85% of the overall post-divestment operations). The company will also continue to operate its China JV, the international 2W lighting operations in Romania, Italy and Vietnam, and the global electronics businesses in Poland and Romania.

Outlook & Valuation

Based on a pro forma annual revenue run-rate of approximately Rs 6,000 crore, we model a 7.1% and 10.2% growth rate in FY23E and FY24E, respectively. We expect EBITDA margins to improve from 7.0% in 2Q-3Q FY22 to 7.3% FY23 and further to 8.1% in FY24, driven by low double-digit EBITDA at the India business, and operating leverage from improved capacity utilisation at the global 2W lighting operations and the Romania electronics plant. The Varroc stock has fallen by 3% since our 3Q FY22 update report dated 17 February 2022 with a HOLD rating. Based on a target EV/EBITDA multiple of 12.0x FY24E EBITDA, we value Varroc at Rs 450, upgrading it to a BUY with an upside of 23% from current levels.

Pro-forma Key Financial Metrics (Consolidated)

₹ crore	2Q-3Q FY22A	FY23E	FY24E
Operating revenue	2,997	6,417	7,072
Growth (annualised)		*7.1%*	*10.2%*
EBITDA	208	468	573
EBITDA margin	*7.0%*	*7.3%*	*8.1%*

Note: Pro-forma financial metrics for operations Varroc is retaining
Source: Company data, Khambatta Research

Key Takeaways from Call

With guidance of the deal's conclusion by 2Q FY23, the key takeaways from the call organised by Varroc's management on 02 May 2022 are:

- The net proceeds from the transaction after debt, tax and escrow is expected to be Euro 150-175 mn.
- Varroc will continue to enjoy technology transfer and non-compete benefits in India. However, there will be no non-compete arrangement in China.

- The company looks to unlock growth in India through EV products, having already won one major customer in EV. It is making inroads with other EV players including emerging EV players and traditional OEMs that are existing customers. Further, Varroc is exploring one or two OEMs in the international markets.
- The company is focusing on electronic fuel injection systems (capable of delivering > 1 million units a year) and camera systems (for both fleets and OEMs) in electronics. China and India are higher growth markets for high-end electronics.
- Focus on global 2W LED lighting in Europe (primarily concentrating on the premium segment).
- The India operations possess capacity to generate up to Rs 6,000 crore in annual revenues without the need for any fresh capex. Capacity utilisation and sales are expected to progressively increase as the chip shortage mitigates.
- Capex will be well within EBITDA levels with the company not needing any debt to finance future growth in either India or global businesses.
- May look at inorganic opportunities in high-end electronics if there are good opportunities but the current focus is on stabilizing the existing businesses, at least for the next one year.
- Focus on and target of strong FCF and high ROCE in the range of 20-25% going forward.
- Debt at the India business was Rs 850 crore as of FY22-end. Factoring in some interim financing requirements between March-end and deal closure, the net cash proceeds from the deal will be around Rs 200 crore.

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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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