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Vardhman Special Steel (VSSL), a Vardhman group company, is a mid-sized steel company engaged in production of special steel and alloy steel catering to a wide range of sectors like automotive, engineering, tractor, bearing and allied industries. In terms of capacity, VSSL has a steel melting shop capacity of 200000 tonnes, rolling mill capacity of 180000 tonnes and bright bar capacity of 36000 tonnes. As the company is currently operating at healthy utilisations level of ~90% currently, it has chalked out plans to augment its capacity to cater to incremental demand. Consequently going forward, we expect VSSL to report sales, EBITDA and PAT CAGR growth of 17%, 24% and 23%, respectively, in FY18-21E.

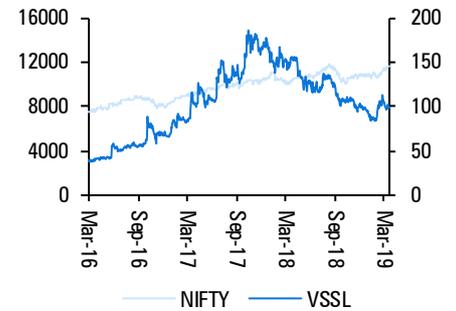


**VARDHMAN SPECIAL STEELS LTD.**  
A COMMITMENT TO QUALITY

## Highlights

- Established track record with strong clientele** – VSSL specialises in manufacturing high strength steel bars/rods for varied user industry like automotive, bearings, engineering, etc. The products of the company mandate high quality and low failure rate as they form a part of critical component in an auto OEM model. VSSL, with four decades of presence in the special steel space, has, over the years, garnered approval from all major auto OEMs. Hence, it has emerged as a supplier of choice to these quality conscious automotive OEMs in India. The company serves the exact needs of renowned corporations such as Hero, Maruti, Hyundai, TVS, Bajaj, Ashok Leyland, etc, and has a presence across segments such as two-wheelers, passenger vehicle, commercial vehicle, etc
- Presence in niche segments limits competition:** VSSL has a presence in northern India where competition in alloy steel and special steel is comparatively less compared to other parts of India. Additionally, it is also closer to Maruti and Hero's plant, providing it an edge. Within the broader spectrum, VSSL chooses to be in niche spaces where it enjoys the status of an important supplier or a sole supplier
- Capacity expansion to provide visibility-** VSSL is undertaking capacity expansion wherein by H1FY21 it plans to increase the steel melting shop capacity to 240000 tonnes, rolling mill capacity to 220000 tonnes and bright bar capacity to 50000 tonnes. The capex incurred for the same is ~₹ 200 crore. VSSL reported healthy volume growth of ~15% during FY13-18. Likewise, going forward, we believe the company will swiftly reap the benefits of expansion and report a volume CAGR of ~9.2% in FY18-21E. We value the stock at 6x FY21E EV/EBITDA and arrive at a target price of ₹ 130. We have a **BUY** recommendation on the stock

## Price Performance



## Research Analyst

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## Key risk

### Business specific

**Stagnancy or de-growth in automobile sector:** The automobile sector accounts for ~95% of the volume offtake for VSSL. In terms of revenues for 9MFY19, the passenger vehicle segment accounted for ~43% of revenues followed by the 2-W segment accounting for ~32%. Any stagnancy or de-growth in growth rate of overall automobile demand will adversely impact the overall performance of the company.

### Company specific

**Delay in capex completion/subsequent ramp up:** The company's capex programme is slated to be completed by H1FY21E and contribute positively with subsequent ramp up. Thus, project completion remains a key monitorable, as any delay would result in cost and time overrun.

**Description**

Established in 1972, the steel business of the Vardhman Group has grown both organically and inorganically from 0.5 lakh tonne initially to 1.8 lakh tonne currently. The steel division was demerged from Vardhman Textiles effective January 1, 2011. VSSL's business draws strength from its backward integrated operations consisting of 30 tonnes ultra-high power electric arc furnace (EAF) with electromagnetic stirrer, 30 tonne ladle refining furnace, a vacuum degassing system and a bloom caster. Furthermore, the company caters to the growing demand of the auto and auto components sector that accounts for ~90-95% of Vardhman's sales volume. In the auto sector, the company has a long standing relationship with key auto OEMs like Hero, Maruti, TVS, Bajaj, Ashok Leyland, Daimler, John Deere, GNA Axles, etc.

**History and track record**

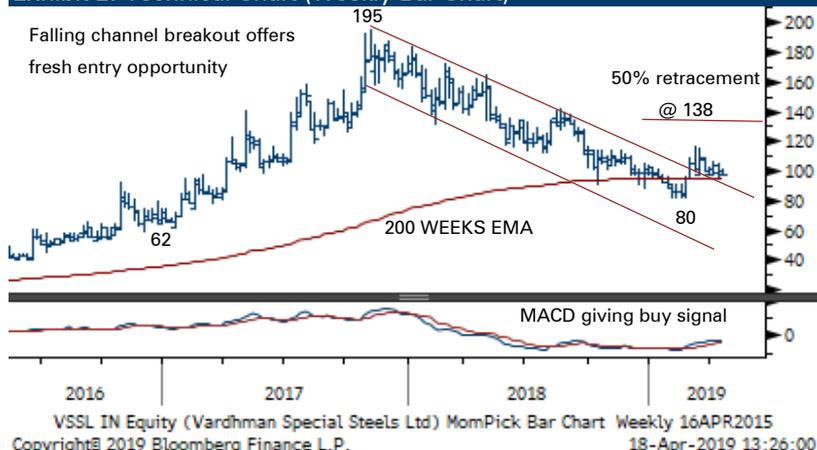
- Set up Oswal Steels at Faridabad in 1973, with an initial capacity of 50000 metric tonnes of special and alloy steels. In 1986, the company acquired the plant of Mohta Alloys in Ludhiana with installed capacity of ~100000 metric tonne. In 2001, VSSL added bright bars to its product profile. In the same year, the company closed its operations in Faridabad
- In 2010, Vardhman Special Steel was incorporated as an independent company given its demerger from Vardhman Textiles. In 2013, the company installed a fully automatic rolling mill with capacity of 1500000 metric tonne
- In 2015, VSSL expanded its bright bar and hot rolled capacity to 36000 tonnes and 180000 metric tonnes, respectively. In 2016, melting capacity was increased to 200000 tonnes
- In October 2017, the company purchased ~8 acres of land at Ludhiana for ₹ 36 crore plus government duties

**Exhibit 1: Earnings Estimates**

| ₹ crore                | FY17  | FY18  | FY19E  | FY20E  | FY21E  |
|------------------------|-------|-------|--------|--------|--------|
| Total Operating Income | 673.8 | 859.0 | 1150.3 | 1198.4 | 1377.1 |
| EBITDA                 | 59.8  | 61.9  | 70.4   | 92.3   | 118.8  |
| EBITDA margin (%)      | 8.9   | 7.2   | 6.1    | 7.7    | 8.6    |
| PAT                    | 19.1  | 25.0  | 27.0   | 28.9   | 46.5   |
| EPS (₹)                | 5.4   | 7.0   | 7.6    | 8.1    | 13.0   |

Source: Company, ICICI Direct Research

**Exhibit 2: Technical Chart (Weekly Bar Chart)**



Source: Bloomberg, ICICI Direct Research

**Stock data**

|   |          |
|---|----------|
| Market Capitalization (₹ crore)           | 347.9    |
| 52 Week High / Low (₹)                    | 165 \ 81 |
| Promoter Holding (%)                      | 66.6     |
| FII Holding (%)                           | 0.0      |
| DII Holding (%)                           | 10.1     |
| Dividend Yield (%)                        | 0.0      |
| 12M / 6M stock return (%)                 | -36/ -10 |
| Debt (₹ crore) (FY18)                     | 220.0    |
| Cash and Cash Equivalent (₹ crore) (FY18) | 15.7     |
| Enterprise Value (₹ crore)                | 561.3    |
| 5 Year Revenue CAGR (%) (FY13-18)         | 14.0     |
| 5 Year EBITDA CAGR (%) (FY13-18)          | 28.5     |
| 5 Year PAT CAGR (%) (FY13-18)             | 38.9     |

**Valuation**

|             | FY18 | FY19E | FY20E | FY21E |
|-------------|------|-------|-------|-------|
| P/E         | 14.0 | 12.9  | 12.1  | 7.5   |
| Target P/E  | 18.6 | 17.2  | 16.1  | 10.0  |
| EV / EBITDA | 9.5  | 9.4   | 6.9   | 5.2   |
| P/BV        | 1.0  | 1.0   | 0.9   | 0.8   |
| RoNW        | 7.4  | 7.4   | 7.3   | 10.5  |
| RoCE        | 8.3  | 7.8   | 10.4  | 13.5  |
| ROIC        | 7.4  | 7.1   | 9.7   | 12.8  |

**Quarterly performance**

| (₹ crore)         | Q4FY18 | Q1FY19 | Q2FY19 | Q3FY19 |
|-------------------|--------|--------|--------|--------|
| Sales             | 231.4  | 269.5  | 295.5  | 312.5  |
| EBITDA            | 17.2   | 17.8   | 15.3   | 22.0   |
| EBITDA Margin (%) | 7.4    | 6.6    | 5.2    | 7.0    |
| Depreciation      | 6.3    | 5.7    | 6.0    | 6.2    |
| Interest          | 5.9    | 4.9    | 5.6    | 6.5    |
| Other Income      | 2.3    | 1.8    | 1.2    | 0.4    |
| PAT               | 7.2    | 9.1    | 7.1    | 6.2    |
| EPS (₹)           | 2.0    | 2.5    | 2.0    | 1.7    |

**Shareholding trend (%)**

| Key Shareholders  | Q4FY18 | Q1FY19 | Q2FY19 | Q3FY19 |
|-------------------|--------|--------|--------|--------|
| Promoter group    | 65.8   | 66.1   | 66.4   | 66.6   |
| FII               | 0.0    | 0.0    | 0.0    | 0.0    |
| DII               | 10.1   | 10.1   | 10.1   | 10.1   |
| Non-institutional | 24.1   | 23.8   | 23.5   | 23.3   |

**Technical View**

The share price has recently registered a breakout from the falling channel containing the entire decline since November 2017 high (₹ 195) signalling reversal of the corrective trend.

The stock has rebounded from the major support area of ₹ 80-90 as it is the confluence of the 200 weeks EMA and 80% retracement of the previous major up move (₹ 62 to 195).

It has already taken 17 months to retrace just 80% of the previous 10 months up move (₹ 62-195) highlighting a positive price structure.

We expect the stock to test levels of ₹ 138 in the medium term as it is 50% retracement of the previous decline (₹ 195 to 80).

## What's the story?

Operates in quality conscious auto grade steel domain, boasts healthy track record and strong clientele

VSSL specialises in manufacturing high strength steel bars/rods for varied user industry like automotive, bearings, engineering, etc. During 9MFY19, passenger vehicles accounted for 43% of volume, two wheelers 32% of volume, commercial vehicles 20% of volume while others accounted for the balance 5% of volume. The products of the company mandate high quality and low failure rate as they form a part of the critical component in an auto OEM model. VSSL, with four decades of presence in the special steel space, has over the years garnered approval from all major auto OEMs. Hence, it has emerged as a supplier of choice to these quality conscious automotive OEMs in India. As with major component suppliers to OEMs, once a product is approved for a particular model/models, supply volumes become sticky as changing a supplier is time consuming and can prove to be a costly affair. Thus, approval from OEMs is a key entry barrier in the automotive steel segment. While VSSL supplies to tier-1 vendors that supply the components to the auto OEMs, quality approval and pricing is as per the terms with the auto OEMs directly. With respect to pricing the company follows a bi-annual negotiation mechanism, wherein the auto-grade steel prices are negotiated every six months (in April and October, respectively) to reflect changes in raw material cost. Hence, the company is largely covered for changes in prices of raw material. In terms of clientele, the company serves the exact needs of renowned corporations like Hero, Maruti, Hyundai, TVS, Bajaj, Ashok Leyland, etc, and has a presence across segments like two-wheelers, passenger vehicle, commercial vehicle, etc.

Capacity expansion provides healthy visibility...

The company is undertaking capacity expansion wherein by H1FY21 the capacity of the steel melting shop will be increased to 240000 tonnes from (200000 tonnes currently), the rolling mill capacity to 220000 tonne (from 180000 tonnes) and bright bar capacity to 50000 tonnes (from 36000 tonnes currently). The capex incurred for the same is estimated to be ~₹ 200 crore. During FY13-18, VSSL reported healthy volume growth of ~15% in FY13-18 (from ~76000 tonne in FY13 to ~152000 tonne in FY18). Likewise, even going forward, we believe the company will swiftly reap the benefits of capacity expansion. Going forward, we believe VSSL will swiftly reap the benefits of capacity expansion clocking volume CAGR of ~9.2% in FY18-21E. Going forward, to de-risk its business, the company is exploring avenues to increase higher margin products, enter new geographies, change its customer-mix and expand into new industry applications. As Hyundai is an existing customer of VSSL, the upcoming Kia facility in India (sister concern of Hyundai Motor group) will also be a potential opportunity for the company. Over the medium term, the company is planning to focus on development of the market in non-automotive segment.

Presence in niche segments limits competition, innovation to provide edge...

VSSL has a presence in north India where competition in alloy steel and special steel is comparatively less than other parts of the country. Additionally, it is also closer to Maruti and Hero's plant, which provides it an edge. Furthermore, the company is present in niche small diameter steel bar space catering to passenger vehicles and two-wheelers. Within the broader spectrum, VSSL chooses to be in niche spaces where it enjoys the status of an important supplier or a sole supplier. Of total volumes, ~60% of volume goes to critical quality and special steel applications, which is generally an uncluttered space. In terms of customer profile, over the years, VSSL services the needs of 180+ customers pan-India, including 30+ OEMs in the automotive sector. The company's products also found acceptance across more than seven international markets viz. Thailand, Taiwan, Turkey, Russia, Spain, etc. VSSL has also taken various innovative steps to enhance its product offerings like development of quench and tempered steel for automotive application. The company has also developed quench & tempered steel to cater to overseas requirement for oil & gas industries in Russia and other applications in Turkey. VSSL has also developed special steel grade developed for die punches application for export supply of Vietnam. Going forward, the company is looking for a joint venture in downstream value added segments namely bright bars. VSSL is also planning to build a strong technical alliance with a global player.

EBITDA/tonne to inch upwards, return ratios to tread higher; recommend BUY!

On the back of steady pricing coupled with operating leverage, we expect VSSL's topline, EBITDA and PAT to increase at a CAGR of 17%, 24% and 23%, respectively, in FY18-21E. We expect EBITDA/tonne of VSSL to inch upwards to ₹ 4250/tonne in FY19E, to ₹ 5250/tonne in FY20E and further to ₹ 6000/tonne in FY21E. Similarly, with an increase in profitability, we expect its RoCE to increase to ~13.5% in FY21E from ~8.3% in FY18. We value the stock at 6x FY21E EV/EBITDA and arrive at a target price of ₹ 130. We have a **BUY** recommendation on the stock.

**Exhibit 3: Profit & Loss statement**

| Income Statement         | FY18  | FY19E   | FY20E   | FY21E   |
|--------------------------|-------|---------|---------|---------|
| Operating Income         | 859.0 | 1,150.3 | 1,198.4 | 1,377.1 |
| Growth (%)               | 27.5  | 33.9    | 4.2     | 14.9    |
| Raw Material Expenses    | 469.7 | 690.2   | 719.1   | 826.3   |
| Power & Fuel             | 127.8 | 138.0   | 140.8   | 158.4   |
| Employee Expenses        | 46.7  | 51.8    | 53.9    | 59.9    |
| Other Expenses           | 152.8 | 199.9   | 192.4   | 213.8   |
| Total Operating Expenses | 797.0 | 1,079.9 | 1,106.2 | 1,258.3 |
| EBITDA                   | 61.9  | 70.4    | 92.3    | 118.8   |
| Growth (%)               | 3.5   | 13.7    | 31.1    | 28.8    |
| Depreciation             | 21.5  | 24.1    | 28.4    | 30.8    |
| Interest & Finance Cost  | 21.4  | 24.0    | 26.8    | 24.9    |
| Other Income             | 6.1   | 5.9     | 6.0     | 6.2     |
| Exceptional Items        | -     | -       | -       | -       |
| PBT                      | 25.1  | 28.2    | 43.1    | 69.4    |
| Total Tax                | 0.1   | 1.1     | 14.2    | 22.9    |
| PAT                      | 25.0  | 27.0    | 28.9    | 46.5    |
| Growth (%)               | 30.8  | 8.0     | 6.8     | 61.0    |
| EPS                      | 7.0   | 7.6     | 8.1     | 13.0    |

Source: Company, ICICI Direct Research

**Exhibit 5: Balance Sheet**

| Balance Sheet                    | FY18  | FY19E | FY20E | FY21E |
|----------------------------------|-------|-------|-------|-------|
| <b>Liabilities</b>               |       |       |       |       |
| Share Capital                    | 35.7  | 35.7  | 35.7  | 35.7  |
| Reserves & Surplus               | 303.6 | 330.6 | 359.5 | 406.0 |
| Total Shareholders Fund          | 339.3 | 366.3 | 395.2 | 441.7 |
| Total Debt                       | 220.0 | 300.0 | 275.0 | 255.0 |
| Others                           | 0.9   | 0.9   | 0.9   | 0.9   |
| Total Liabilities                | 560.2 | 667.2 | 671.1 | 697.5 |
| <b>Assets</b>                    |       |       |       |       |
| Net Block                        | 249.5 | 316.1 | 368.8 | 384.0 |
| CWIP                             | 7.0   | 15.0  | 10.0  | -     |
| Net Fixed Assets                 | 256.5 | 331.1 | 378.8 | 384.0 |
| Investments                      | 8.2   | 5.2   | 0.1   | 0.1   |
| Inventory                        | 158.6 | 214.3 | 203.6 | 226.4 |
| Debtors                          | 194.6 | 226.9 | 210.1 | 241.5 |
| Other Current Assets             | 29.0  | 29.3  | 22.3  | 17.0  |
| Cash & Bank Balance              | 7.5   | 6.6   | 9.9   | 7.4   |
| Total Current Assets             | 389.7 | 477.1 | 445.9 | 492.2 |
| Trade Payables                   | 60.6  | 110.3 | 111.6 | 128.3 |
| Other Current Liabilities & Prov | 55.9  | 58.7  | 61.6  | 64.6  |
| Total Current Liabilities        | 116.5 | 169.0 | 173.2 | 192.9 |
| Total Net Current Assets         | 273.2 | 308.2 | 272.7 | 299.3 |
| Other Non Current Assets         | 22.3  | 22.7  | 19.6  | 14.2  |
| Total Assets                     | 560.2 | 667.2 | 671.1 | 697.5 |

Source: Company, ICICI Direct Research

**Exhibit 4: Cash Flow Statement**

| Cashflow Statement                  | FY18   | FY19E  | FY20E  | FY21E  |
|-------------------------------------|--------|--------|--------|--------|
| Profit/(Loss) After Taxation        | 25.0   | 27.0   | 28.9   | 46.5   |
| Add: Depreciation & Amortisation    | 21.5   | 24.1   | 28.4   | 30.8   |
| Net Increase in Current Assets      | (53.3) | (88.3) | 34.5   | (48.8) |
| Net Increase in Current Liabilities | (42.9) | 52.5   | 4.2    | 19.7   |
| Cashflow from Operating Activities  | (49.7) | 15.3   | 96.0   | 48.1   |
| Increase/(Decrease) in Investments  | (7.2)  | 3.0    | 5.1    | -      |
| Increase/(Decrease) in Fixed Assets | (12.4) | (98.7) | (76.0) | (36.0) |
| Others                              | (11.0) | (0.4)  | 3.2    | 5.4    |
| Cashflow from Investment Activities | (30.6) | (96.2) | (67.7) | (30.6) |
| Inc/(Dec) in Equity Capital         | 17.1   | -      | -      | -      |
| Inc/(Dec) in Loan                   | (34.2) | 80.0   | (25.0) | (20.0) |
| Dividend & Div Dist Tax             | -      | -      | -      | -      |
| Others                              | 98.9   | 0.0    | 0.0    | 0.0    |
| Cashflow from Financing Activities  | 81.9   | 80.0   | (25.0) | (20.0) |
| Net Cashflow                        | 1.6    | (0.9)  | 3.3    | (2.5)  |
| Opening Cash                        | 5.9    | 7.5    | 6.6    | 9.9    |
| Closing Cash                        | 7.5    | 6.6    | 9.9    | 7.4    |

Source: Company, ICICI Direct Research

**Exhibit 6: Key Ratios**

| Key Ratios                   | FY18 | FY19E | FY20E | FY21E |
|------------------------------|------|-------|-------|-------|
| <b>Per share data (₹)</b>    |      |       |       |       |
| EPS                          | 7.0  | 7.6   | 8.1   | 13.0  |
| Cash EPS                     | 13.0 | 14.3  | 16.0  | 21.6  |
| BV                           | 95.0 | 102.6 | 110.7 | 123.7 |
| DPS                          | -    | -     | -     | -     |
| Cash Per Share               | 2.1  | 1.9   | 2.8   | 2.1   |
| <b>Operating Ratios (%)</b>  |      |       |       |       |
| EBITDA Margin                | 7.2  | 6.1   | 7.7   | 8.6   |
| PBT / Total Operating income | 2.9  | 2.4   | 3.6   | 5.0   |
| PAT Margin                   | 2.9  | 2.3   | 2.4   | 3.4   |
| Inventory days               | 67   | 68    | 62    | 60    |
| Debtor days                  | 83   | 72    | 64    | 64    |
| Creditor days                | 26   | 35    | 34    | 34    |
| <b>Return Ratios (%)</b>     |      |       |       |       |
| RoE                          | 7.4  | 7.4   | 7.3   | 10.5  |
| RoCE                         | 8.3  | 7.8   | 10.4  | 13.5  |
| RoIC                         | 7.4  | 7.1   | 9.7   | 12.8  |
| <b>Valuation Ratios (x)</b>  |      |       |       |       |
| P/E                          | 14.0 | 12.9  | 12.1  | 7.5   |
| EV / EBITDA                  | 9.5  | 9.4   | 6.9   | 5.2   |
| EV / Net Sales               | 0.7  | 0.6   | 0.5   | 0.4   |
| Market Cap / Sales           | 0.4  | 0.3   | 0.3   | 0.3   |
| Price to Book Value          | 1.0  | 1.0   | 0.9   | 0.8   |
| <b>Solvency Ratios</b>       |      |       |       |       |
| Debt / Equity                | 0.6  | 0.8   | 0.7   | 0.6   |
| Debt / EBITDA                | 3.6  | 4.3   | 3.0   | 2.1   |
| Current Ratio                | 3.3  | 2.8   | 2.6   | 2.6   |
| Quick Ratio                  | 2.0  | 1.6   | 1.4   | 1.4   |

Source: Company, ICICI Direct Research

## Key risks to investing in Nano stocks

- Nano stocks may not be in the limelight and inherently being micro cap in nature will have a high risk return profile
- We advise clients to be disciplined in investing at all times. Allocate only a small proportion of your investible income to these stocks and diversify well
- Try to diversify your exposure within the Nano stocks as well by investing equal proportions in several picks
- These stocks may have low volumes and trade infrequently
- Micro cap stocks the world over are, to a large extent, affected by the “Pump and Dump” phenomenon of inflated price buying and depressed price selling
- As explained above, the clients should be patient and trade only through limit orders on any side of the trade.
- The risk of volatility remains in such micro cap stocks as they can move up or down with large buy/sell orders
- The fair value of Nano stocks are subject to expected growth potential in the future. Though due diligence has been done to a fair extent, the actualisation of growth still has a degree of uncertainty attached to it

Nano stocks report tries to highlight companies with good and scaleable business models, dependable management and sound financials. However, these stocks may not be in the limelight and have a high risk high return potential. Please watch out for the following factors before investing in these stocks:

Allocate a small proportion of your investible income to these stocks and diversify well. If you choose to invest in these stocks, most of your assets allocated towards equity should remain in more stable investments like stocks of large companies. Moreover, try to diversify your exposure within the Nano stocks as well by investing equal proportions in several picks. This will help you avoid losing too much of your total wealth if the investments do not turn out well. When you invest in micro-cap stocks there is a higher risk of impairment.

These stocks may have low volumes and trade infrequently. This can create a situation in which you may not be able to find any willing buyers for your stocks when you wish to sell. We advise our clients to be patient and trade only through limit orders to avoid volatile fluctuations, both while putting a buy and sell order in these stocks.

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Buy: >10%/15% for large caps/midcaps, respectively;

Hold: Up to +/-10%;

Sell: -10% or more;



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## ANALYST CERTIFICATION

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