

Demand recovery key for rerating!

Sterlite Tech's (STL) Q2FY21 performance was weak, albeit much better sequentially, on the operating front as expected, which is reflective of the weak demand in the product segment and residual Covid-19 led execution challenges in solutions /services business. Revenues came in at ₹ 1160 crore, down 14.7% YoY with product forming ~65% (implying ~11% decline YoY) and services 35% of the topline, which would have declined ~20% YoY as per our calculations. EBITDA was at ₹ 202 crore, down ~30% YoY, with margins at 17.5%, down 376 bps YoY, impacted by negative operating leverage on account of revenues decline. PAT came in lower at ₹ 58.5 crore, down 63.4% YoY, on account of weaker than expected operating performance and higher depreciation.

H2FY21 to be better than H2FY20, albeit on benign base...

STL perceives the global 5G investment cycle is on the cusp of starting and demand is likely to pick up from H2CY20 (albeit Indian cycle likely from FY23 onwards), with decade long expected growth cycle. **Factors such as adoption of open source standard and software defined networking, isolation of Chinese vendors are some drivers of growth for the company ahead, in the medium term. It has also guided for a better H2FY21 than H2FY20, which is also due to benign base as declining revenue trend started from Q3FY20 onwards.** We bake in decline of 1% YoY FY21 revenues, notwithstanding expanded OF capacity, given the washout H1FY21. We expect FY22 revenues to witness a spurt (up ~27% YoY) driven by improved capacity utilisation as well as continued traction in solutions based business. We build in margins of 18%, 19% for FY21E, FY22E, respectively, based on management guidance of margin band of 18-20%.

Order book provides decent visibility...

The order book was at ₹ 10705 crore (vs. ₹ 10312 crore in Q1), of which O&M portion was 25% (~₹ 2676 crore). STL expects outstanding order execution worth ₹ 2564 crore in H2FY21 with remaining in FY22 and thereafter. The open participation funnel has grown ~20% QoQ to ₹ 12000 crore. The order inflows traction has been encouraging with key order wins from a European telco, Japanese telco and Airtel in Q2.

Valuation & Outlook

While long term target is attractive, the fibre pricing weakness persists. We would await meaningful traction in demand before turning constructive. Better capital allocation is need of the hour as decision of buyback/dividend amid leverage & demand challenge is a dampener. **We highlight that net debt was up by ₹ 188 crore in H1 to ₹ 2158 crore, mainly due to dividend and buyback outflows of ₹ 260 crore, which is not a prudent capital allocation decision, in our view amid leverage and demand challenges.** We maintain REDUCE rating, valuing it at revised target price of ₹ 150/share.

Key Financial Summary

(Year-end March)	FY18	FY19	FY20	FY21E	FY22E	CAGR (FY20-22E)
Net Sales (₹ crore)	3,205.5	5,087.3	5,154.4	5,103.7	6,500.9	12.3
EBITDA (₹ crore)	749.3	1,127.2	1,069.3	917.7	1,236.8	7.5
Net Profit (₹ crore)	334.3	562.8	433.9	320.3	467.2	3.8
EPS (₹)	8.3	14.0	10.8	8.1	11.8	
P/E (x)	19.0	11.3	14.7	19.6	13.4	
Price / Book (x)	5.4	3.7	3.3	3.2	2.9	
EV/EBITDA (x)	9.5	7.1	7.7	9.2	7.1	
RoE (%)	28.7	33.0	25.0	16.5	21.4	
RoCE (%)	29.7	27.8	20.9	15.4	19.7	

Source: Company, ICICI Direct Research



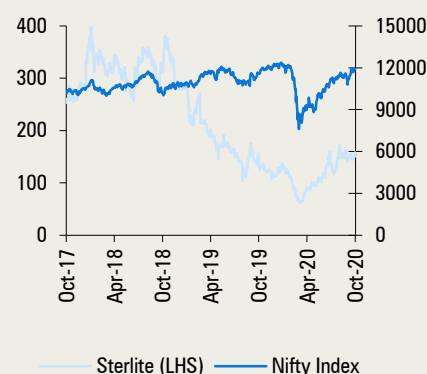
Particulars

Particular	Amount
Market Capitalization (₹ crore)	6,273.8
Total Debt (FY20) (₹ crore)	2,448.0
Cash & Inv (FY20) (₹ crore)	477.6
EV (₹ crore)	8,244.2
52 week H/L (₹)	198/ 60
Equity capital (₹ crore)	80.2
Face value (₹)	2.0

Key Highlights

- STL has guided for a better H2FY21 than H2FY20, which is also due to benign base as declining revenue trend started from Q3FY20 onwards
- Maintain REDUCE on stock. We value it at ₹ 150/share (implying 7x FY22E EV/EBITDA and 13x FY22E P/E)

Price Chart



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Exhibit 1: Variance Analysis

	Q2FY21	Q2FY21E	Q2FY20	Q1FY21	YoY (%)	QoQ (%)	Comments
Revenue	1,159.5	1,100.4	1,359.7	876.2	-14.7	32.3	
Other Income	9.3	9.5	9.1	9.5	2.2	-2.0	
Cost of raw material	584.8	498.5	622.7	396.5	-6.1	47.5	
Purchase of traded goods	0.8	8.8	2.1	0.3	NA	NA	
Employee Expenses	157.0	143.0	166.7	147.1	-5.8	6.7	
(Increase) / decrease in inventories	-8.2	16.5	27.7	21.5	-129.7	-138.3	
Other Expenses	222.8	235.5	252.0	189.1	-11.6	17.8	
EBITDA	202.4	198.3	288.5	121.7	-29.8	66.4	EBITDA was impacted by negative operating leverage on account of revenue decline
EBITDA Margin (%)	17.5	18.0	21.2	13.9	-376 bps	357 bps	
Depreciation	81.6	74.2	75.0	74.2	8.8	10.0	
Interest	49.8	53.9	59.7	50.1	-16.7	-0.6	
Total Tax	23.6	19.9	3.3	4.1	607.2	471.6	
PAT	58.5	63.5	159.6	6.0	-63.4	881.0	

Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

(₹ Crore)	FY21E			FY22E			Comments
	Old	New	% Change	Old	New	% Change	
Revenue	5,044.5	5,103.7	1.2	6,327.5	6,500.9	2.7	Realign after management commentary and Q2 results
EBITDA	907.1	917.7	1.2	1,203.8	1,236.8	2.7	
EBITDA Margin (%)	18.0	18.0	0 bps	19.0	19.0	0 bps	
PAT	327.5	320.3	-2.2	460.0	467.2	1.6	
EPS (₹)	8.1	8.1	-0.5	11.4	11.8	3.3	

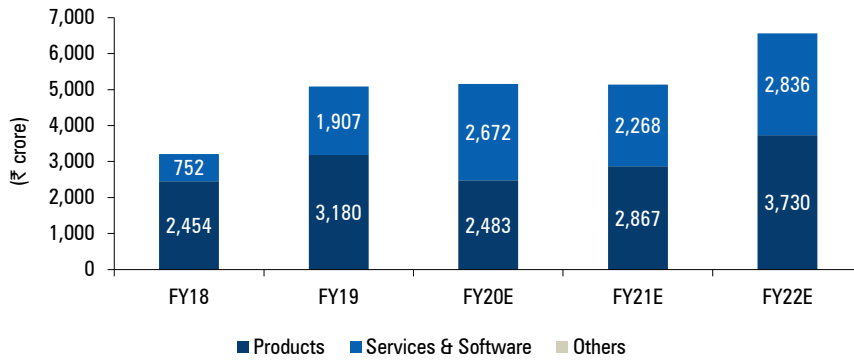
Source: Company, ICICI Direct Research

Business Highlights

- **Global fibre demand:** Global fibre demand contracted 9% in H1 2020, on account of China slowing down after a massive 4G build. On the overall fibre demand perspective, the company perceives that 5G investment cycle is on cusp of beginning and demand is likely to pick up from H2CY20 (~6% YoY growth expected in H2), with decade long expected growth cycle. For its own business growth, the company expects the factors such as adoption of open source standard and software defined networking, isolation of Chinese vendors as some of the drivers of growth as company aims transformation into solutions based player vs. a product company, earlier. STL indicated that demand/supply in the non-Chinese market is firming up with stable pricing.
- **Capacity utilisation and expansion:** Optic fibre capacity utilisation is ~60% including new capacity (total fibre capacity is ~50 mn fkm). Cabling capacity is operating at ~90% utilisation at a current capacity of 18 mn fkm. We highlight that the same was slated to expand to 33 mn fkm by June 2020. However, the company that had decided to push the capacity expansion of OFC by six to nine months given the Covid-19 led disruption and demand challenge, has now reinstated the plan and expects the capacity to come on ground by June, 2021
- **Project status & order inflow:** Order inflow traction has been encouraging with key order wins such as a) fibre roll out for 10 circles for Airtel, b) *Opticonn* solution for a leading telecom player in Europe, c) Digital transformation for a leading telco in Africa and d) Wi-fi- hardware & Wi-fi service management platform (access solutions) for leading telecom operator in Japan. Project Varun (Indian Navy project) is 83% complete. Mahanet package A is 88% complete while package B is 1% complete. Key new projects under execution are T-Fibre project (order size ₹ 1700-1800 crore), which is 14% completed while package B is 8% completed and fibre and FTTH rollout for two large telcos, and 5% and 2% complete, respectively
- **Other highlights**
 - Manufacturing is back to pre-Covid levels. The company expects H2FY21 to be better than H2FY20
 - The company indicated that it would focus on improving operating cash flows which were at ₹ 372 crore in H1. The capex for H1 was at ₹ 268 crore. The balance of ₹ 550 crore capex is to be paid over the next four to five quarters for fibre and cable capacity expansion
 - **The net debt was up by ₹ 188 crore in H1 to ₹ 2158 crore, mainly due to dividend and buyback outflows of ₹ 260 crore, which is not a prudent capital allocation decision by the company amid leverage and demand challenges. The company, however, expects the net debt equity ratios to improve from the current levels of 1.2x.**

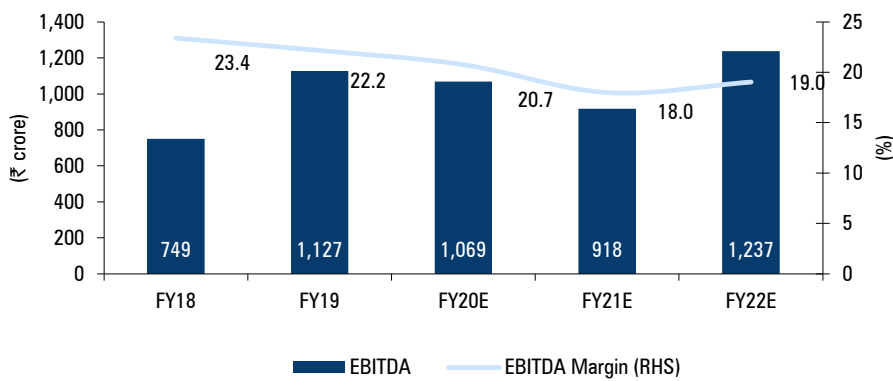
Financial story in charts

Exhibit 3: Topline growth trend



Source: Company, ICICI Direct Research

Exhibit 4: Margins to be in range of 18-20%



Source: Company, ICICI Direct Research

Financial summary

Exhibit 5: Profit and loss statement				
	₹ crore			
(Year-end March)	FY19	FY20	FY21E	FY22E
Total operating Income	5,087.3	5,154.4	5,103.7	6,500.9
Growth (%)	58.7	1.3	-1.0	27.4
Cost of raw materials	2,487.2	2,467.5	2,453.0	3,086.3
Employee Expenses	511.2	629.8	656.8	747.6
Administrative Expenses	961.7	987.8	1,076.2	1,430.2
Total Operating Expenditure	3,960.1	4,085.1	4,186.0	5,264.1
EBITDA	1,127.2	1,069.3	917.7	1,236.8
Growth (%)	50.4	-5.1	-14.2	34.8
Depreciation	195.0	290.3	321.5	344.5
Interest	105.5	221.0	212.9	301.4
Other Income	36.9	34.3	37.5	40.0
Exceptional Items	7.6	59.0	2.2	-
PBT	856.0	533.3	418.5	630.9
Minority Interest	15.0	(9.5)	(13.5)	5.0
Profit from Associates	-	-	-	-
Total Tax	278.2	108.9	111.7	158.7
PAT	562.8	433.9	320.3	467.2
Growth (%)	68.3	-22.9	-26.2	45.8
EPS (₹)	14.0	10.8	8.1	11.8

Source: Company, ICICI Direct Research

Exhibit 6: Cash flow statement				
	₹ crore			
(Year-end March)	FY19	FY20	FY21E	FY22E
Profit after Tax	562.8	433.9	320.3	467.2
Add: Depreciation	195.0	290.3	321.5	344.5
Add: Interest paid	105.5	221.0	212.9	301.4
(Inc)/dec in Current Assets	-1,986.9	319.3	-8.9	-1,049.1
Inc/(dec) in CL and Provisions	1,314.2	-577.1	-16.9	403.0
Others	0.0	0.0	0.0	0.0
CF from operating activities	190.6	687.4	829.0	466.9
(Inc)/dec in Investments	39.1	-197.9	150.0	50.0
(Inc)/dec in Fixed Assets	-1,457.8	-580.9	-500.0	-300.0
Others	490.1	203.1	-9.7	-10.7
CF from investing activities	-928.6	-575.7	-359.7	-260.7
Issue/(Buy back) of Equity	0.3	0.3	-1.7	0.0
Inc/Dec in Minority Interest	13.5	7.8	-13.5	5.0
Issue of Preference Shares	0.0	0.0	0.0	0.0
Inc/(Dec) in loan funds	944.0	345.8	150.0	0.0
Interest paid	-105.5	-221.0	-212.9	-301.4
Others	-19.1	-233.7	-286.9	-238.4
CF from financing activities	833.2	-100.9	-364.9	-534.8
Net Cash flow	95.2	10.9	104.3	-328.5
Opening Cash	138.4	233.7	244.5	348.8
Closing Cash	233.7	244.5	348.8	20.3

Source: Company, ICICI Direct Research

Exhibit 7: Balance sheet				
	₹ crore			
(Year-end March)	FY19	FY20	FY21E	FY22E
Liabilities				
Equity Capital	80.5	80.8	79.1	79.1
Preference Share Capital	0.0	0.0	0.0	0.0
Reserve and Surplus	1,638.8	1,839.0	1,872.5	2,101.2
Total Shareholders funds	1,719.3	1,919.8	1,951.6	2,180.3
Total Debt	2,102.1	2,448.0	2,598.0	2,598.0
Others	1,000.6	1,270.1	1,256.6	1,261.6
Total Liabilities	4,822.0	5,637.9	5,806.2	6,039.9
Assets				
Gross Block	3,754.7	4,653.5	5,153.5	5,453.5
Less: Acc Depreciation	1,394.1	1,715.7	2,037.2	2,381.7
Net Block	2,360.5	2,937.8	3,116.3	3,071.7
Capital WIP	419.4	132.8	132.8	132.8
Goodwill	107.4	121.8	121.8	121.8
Total Fixed Assets	2,887.3	3,192.4	3,370.8	3,326.3
Investments	242.8	455.1	305.1	255.1
Inventory	589.7	451.8	489.4	623.4
Debtors	1,356.6	1,563.1	1,547.8	1,971.4
Loans and Advances	42.7	36.6	36.2	46.1
Other Current Assets	1,699.7	1,317.9	1,304.9	1,786.4
Cash	233.7	244.5	348.8	20.3
Total Current Assets	3,922.4	3,614.0	3,727.2	4,447.7
Creditors	1,912.8	1,430.3	1,416.2	1,803.9
Provisions	67.2	10.9	10.8	13.8
Other current liabilities	317.7	279.4	276.6	288.9
Total Current Liabilities	2,297.6	1,720.6	1,703.7	2,106.6
Net Current Assets	1,624.7	1,893.4	2,023.5	2,341.1
Other non current assets	67.1	97.0	106.7	117.4
Application of Funds	4,822.0	5,637.9	5,806.2	6,039.9

Source: Company, ICICI Direct Research

Exhibit 8: Key ratios				
	₹ crore			
(Year-end March)	FY19	FY20	FY21E	FY22E
Per share data (₹)				
EPS	14.0	10.8	8.1	11.8
Cash EPS	18.8	18.0	16.2	20.5
BV	42.7	47.7	49.3	55.1
DPS	2.4	4.2	4.2	6.0
Cash Per Share	34.6	42.6	51.5	60.2
Operating Ratios (%)				
EBITDA Margin	22.2	20.7	18.0	19.0
EBIT Margin	18.3	15.1	11.7	13.7
PAT Margin	11.2	9.3	6.3	7.2
Inventory days	42.3	32.0	35.0	35.0
Debtor days	97.3	110.7	110.7	110.7
Creditor days	137.2	101.3	101.3	101.3
Return Ratios (%)				
RoE	33.0	25.0	16.5	21.4
RoCE	27.8	20.9	15.4	19.7
RoIC	22.7	15.7	11.5	15.4
Valuation Ratios (x)				
P/E	11.3	14.7	19.6	13.4
EV / EBITDA	7.1	7.7	9.2	7.1
EV / Net Sales	1.6	1.6	1.7	1.4
Market Cap / Sales	1.2	1.2	1.2	1.0
Price to Book Value	3.7	3.3	3.2	2.9
Solvency Ratios				
Debt/EBITDA	1.9	2.3	2.8	2.1
Net Debt / Equity	1.0	1.0	1.1	1.2
Current Ratio	1.9	2.3	2.4	2.4
Quick Ratio	1.6	2.0	2.0	2.1

Source: Company, ICICI Direct Research

Exhibit 9: ICICI Direct Coverage Universe (Telecom)

Sector / Company	CMP (₹)	TP (₹)	Rating	M Cap (₹ Cr)	EPS (₹)			P/E (x)			EV/EBITDA (x)			RoCE (%)			RoE (%)		
					FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Bharti Airtel	431	700	Buy	2,34,945	-59.0	-24.7	11.2	NM	NM	38.5	9.7	8.3	6.5	3.5	6.9	9.2	-4.7	4.2	11.3
Bharti Infratel	196	180	Reduce	36,234	17.8	16.7	17.4	11.0	11.8	11.3	5.7	5.6	5.3	18.1	19.8	21.7	24.4	23.7	25.5
Vodafone Idea	9	6	Sell	22,844	-25.7	-14.5	-6.8	NM	NM	NM	9.3	11.3	8.7	-5.7	-4.4	-3.4	NM	NM	NM
Sterlite Tech	159	150	Reduce	6,274	10.8	8.1	11.8	14.7	19.6	13.4	7.7	9.2	7.1	27.8	20.9	15.4	33.0	25.0	16.5
Tata Comm	925	1,055	Buy	26,358	-3.0	38.9	43.7	NM	23.8	21.2	10.8	8.0	7.1	7.8	14.9	16.4	-22.2	-426.5	142.5

Source: Company, ICICI Direct Research

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Sell: <-15%



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