Varroc Engineering

Buy

DART DOLAT ANALYSIS & RESEARCH THEMES IN-DEPTH• PRECISE• ACTIONABLE

Result Update

Cruising into growth trajectory, deleveraging in focus

- In the past two years, high capex, leveraged BS and demand slowdown, both in India and global markets, impacted earnings and cash flows of Varroc Engineering (VAR). However, we expect that the worst is behind and project strong earnings growth over the next 2-3 years supported by 1) revival in demand across key global markets, 2) cut in capex will help generate strong FCF and de-leverage balance sheet, 3) incremental revenue from past capacity addition (capex of ~Rs 28bn in FY19-20) and 4) cost cutting measures to help in expansion of operating margin.
- In 2QFY21, EBITDA grew by 13% YoY at Rs. 2.4bn with margin of 8.3% on account of better operating efficiency and benefit of operating leverage in India business. China JV revenue also showing strong revival grew by 11% to Rs. 1.2bn with margin of 16.8% vs 0.3% in Q2 FY20.
- The company generated ~Rs.4bn FCF in 1HFY21 due to better working capital management and cost saving, resulted into net debt reduction of Rs 3.5bn in 1HFY21; Net Debt equity stands at 1.1x.
- The near-term key objective of the company is to de-leverage the balance sheet by optimizing cash flows through control on capex and opex both.
- We expect strong revenue/EBITDA CAGR of 16/54% in FY21-23E for VAR led by revival in VLS business, recovery domestic 2W market, sharp margin expansion and reduction in interest cost. We value the stock Rs 484 (based on 20x for FY23E EPS.)

VLS on the recovery path

VLS business grew by 21% to Rs. 19.78bn and margin remain flat YoY at 7.6%. Varroc's international lighting business (~62% of its sales) is expected to see sharp growth from 2HFY21 on the back of revival in global PV volume and new orders wins. Moreover, the company has invested ~160mn euros towards setting up a greenfield facility in Brazil, Morocco and Poland which has a potential to generate incremental sales of ~ 500mn euros (50% additional sales) over the next 2-3 years. As 64% revenue comes from PV segment. Revival in volume of its key clients like Volkswagen, Tesla, FCA, Ford, Renault to stimulate earnings.

Q2FY21 Result (Rs Mn)

Particulars	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Revenue	29,161	27,032	7.9	12,747	128.8
Total Expense	26,729	24,875	7.5	14,651	82.4
EBITDA	2,433	2,158	12.8	(1,904)	(227.8)
Depreciation	2,270	1,664	36.4	2,069	9.7
EBIT	163	494	(67.1)	(3,973)	(104.1)
Other Income	232	114	103.1	500	(53.7)
Interest	443	351	26.0	432	2.6
EBT	(49)	256	(119.0)	(3,905)	(98.8)
Tax	429	27	1495.5	(709)	(160.5)
RPAT	(401)	224	(279.3)	(3,077)	(87.0)
APAT	(401)	224	(279.3)	(3,077)	(87.0)
			(bps)		(bps)
Gross Margin (%)	35.6	38.6	(296)	32.3	328
EBITDA Margin (%)	8.3	8.0	36	(14.9)	2328
NPM (%)	(1.4)	0.8	(220)	(24.1)	2277
Tax Rate (%)	(881.8)	10.5	(89233)	18.2	(90000)
EBIT Margin (%)	0.6	1.8	(127)	(31.2)	3173

CMP	Rs 299
Target / Upside	Rs 484 / 62%
NIFTY	12,749

Scrip Details

Equity / FV	Rs 135mn / Rs 1
Market Cap	Rs 40bn
	USD 543mn
52-week High/Low	Rs 524/ 120
Avg. Volume (no)	3,26,340
Bloom Code	VARROC IN

Price Performance	1M	3M	12M
Absolute (%)	(5)	38	(38)
Rel to NIFTY (%)	(5)	39	(32)

Shareholding Pattern

	Mar'20	Jun'20	Sep'20
Promoters	85.0	85.0	85.0
MF/Banks/FIs	10.1	9.0	8.9
FIIs	2.8	0.6	1.0
Public / Others	2.1	5.4	5.1

Valuation (x)

	FY21E	FY22E	FY23E
P/E	(11.8)	26.8	12.3
EV/EBITDA	12.1	6.2	4.8
ROE (%)	(12.0)	5.6	11.4
RoACE (%)	(3.2)	3.5	6.3

Estimates (Rs mn)

	FY21E	FY22E	FY23E
Revenue	1,04,429	1,22,785	1,39,880
EBITDA	5,744	10,559	12,869
PAT	(3,408)	1,506	3,269
EPS (Rs.)	(25.2)	11.2	24.2

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India business to ride on 2W recovery

India business revenue de-grew by 7% to Rs.9.32bn in 2Q, however EBIDTA margin expanded by (+280bps YoY) to 13.5%, led by cost saving measures. Domestic business accounts (~38% of sales). We see sharp revival in revenue led by strong recovery in 2W business. The company has started new BS-VI related products like catalytic converter and electronic fuel injection systems which will provide additional support to revenue. In terms of client additions for India business, new client additions were in the form of Hero MotoCorp and TVS Motors (BS-VI Magneto).

Capex cycle near to end

Bulk of the capex spent on VAR capacity enhancement already done (Rs 28bn over FY18-20) and the management has reduced capex guidance for FY21. Management is looking to incur a capex of Rs 1.4-1.5bn for India business (vs last two years' average 3bn) and Euro 45mn for VLS (vs last two years' average Euro 85-90mn). FY22 capex is also likely to be ~Rs.6bn. Varroc is coming to the end of its investment cycle we expect profitability to improve and VAR to generate FCF of ~Rs17bn over FY21-23E.

Exhibit 1: Actual vs DART Estimates

Particulars (Rs mn)	Actual	Dart Estimates	Variance (%)	Comments
Revenue	29,161	23,666	23	Better than expected recovery in VLS division
EBIDTA	2,433	1,657	47	Better cost control measures
EBIDTA Margin (%)	8.34	7.00	134.26 (bps)	
APAT	(401)	(244)	64	

Exhibit 2: Assumption Table

Segment revenue (Rs.mn)	FY19	FY20	FY21E	FY22E	FY23E
Global Lighting Business (VLS)	73,423	68,011	68,258	81,910	94,197
YoY%	10	(7)	0	20	15
India Business	40,910	36,940	31,399	37,678	42,200
YoY%	14	(10)	(15)	20	12
Others	6,032	6,268	4,772	3,196	3,484
Total	**1,20,365**	**1,11,219**	**1,04,429**	**1,22,785**	**1,39,880**
YoY%	**16**	**(8)**	**(6)**	**18**	**14**

Source: DART, Company

Conference call highlights:

Outlook

- Revenue growth expected to continue in Q3; end customer demand will be key for sustainability of growth.
- New plants at Poland, Morocco and Brazil are likely to face issue initially in the near term but expect the situation to improve going forward.
- Recent lockdown in Europe is not impacting the operation as borders are still open. However, expect December volume to be down by~20% due to holidays and maintenance shut down but expect rebound in volume from January onwards.
- Management is cautious about the growth of Indian auto industry post festive season.

VLS business:

- 8.9% VLS revenue growth in Euro term led to 9% growth in North America, 11% growth in Europe and double digit growth of India business.
- Margin was flat due to low capacity utilization in Europe business. Company expect to improve VLS margin to double digit going forward led by ramp up in production. Poland breakeven is around Euro 8mn /monthly and Morocco is around Euro 6mn/month. Expect to cross 100mn Euro revenue in FY22 from each of the plant.
- Growth in revenue led by ramp up in Morocco and Poland facilities, however these two facilities are still not contributing at EBIDTA level.
- North America: Europe revenue mix stood at 1:2 in 1HFY21.
- North America – key clients are Tesla, FCA and Ford.
- Inventory is at low level and expect to increased FG and Raw material inventory going forward.
- In new business LED contribution for front end lighting is 70-75% and for back lighting is 80-90%.

India division:

- Margin improvement of 280bps YoY was led by impact of temporary cost saving place during the quarter (salary reduction) and improved capacity utilization. Expect margin to settle between 12.5% to 13% going forward.
- Gross margin is improved due to increase in electronic parts.
- Company is in discussion with major customers for Electrical products, Traction Motor and Controller, Telematics, lighting, Catalytic Convertor and Polymer products.

China JV:

- Expect china revenue to grow in November and December month as this month are pick season for auto industry.

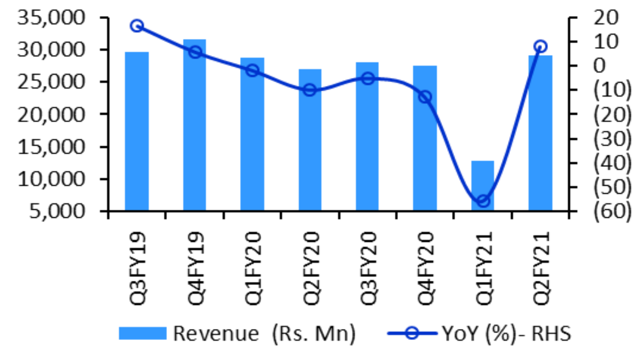
Debt and Capex:

- VAR has reduced its net debt by Rs.4bn to Rs. 30.64bn vs Rs. 34.bn in Q1FY21. Goal to reduce net debt to Rs 26bn by FY21 end is achievable.
- Large part of capex is completed and further capex to be limited. VLS capex 45mn euro for FY21 and 50mn euros in FY22. 20% would be maintenance capex. Overall capex to be incurred is Rs 6.50bn for FY22.

Others

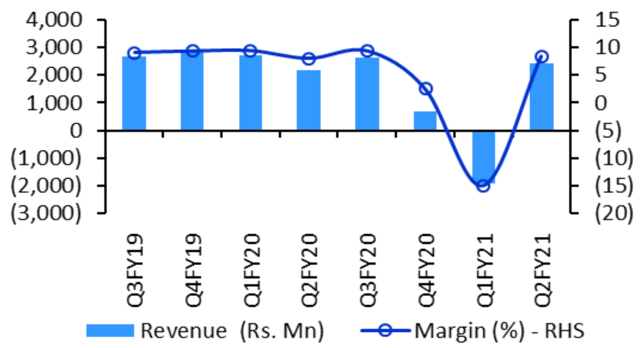
- Depreciation higher due to capitalization of new facilities, most of the capex has been done except for Morocco and Poland and expect depreciation to be in similar range going forward.
- Interest cost higher due to higher average borrowings during the period, caused by the disruption to the working capital cycle.
- Tax expenses higher due to adjustment of deferred tax and expect it is to be in the similar range for H2FY21.
- EV related product market share is ~20% for global business.
- Electronics unit in Romania started production in Q3.

Exhibit 3: Revenue improved 8% YoY



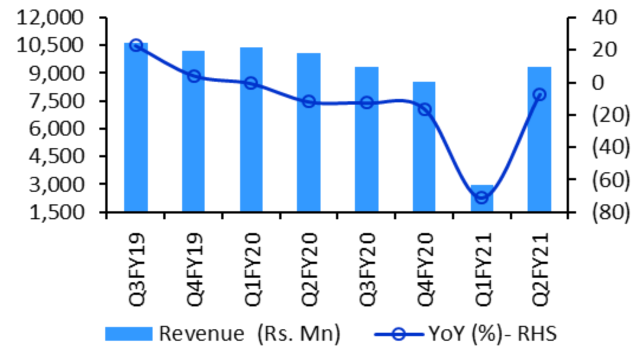
Source: Company, DART

Exhibit 4: EBITDA Margin recovered sharply



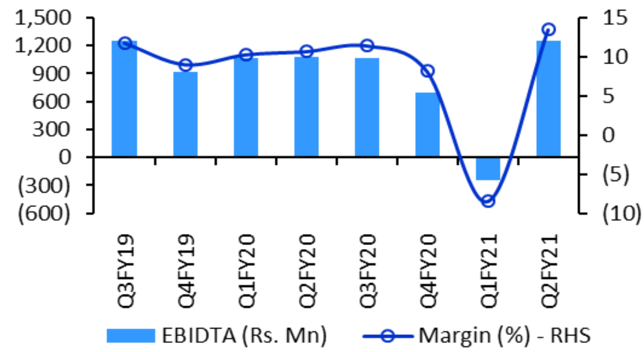
Source: Company, DART

Exhibit 5: IND-revenue recovered



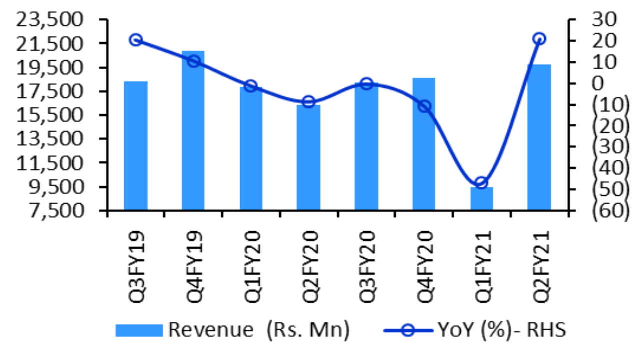
Source: Company, DART

Exhibit 6: IND-Margin rebound sharply



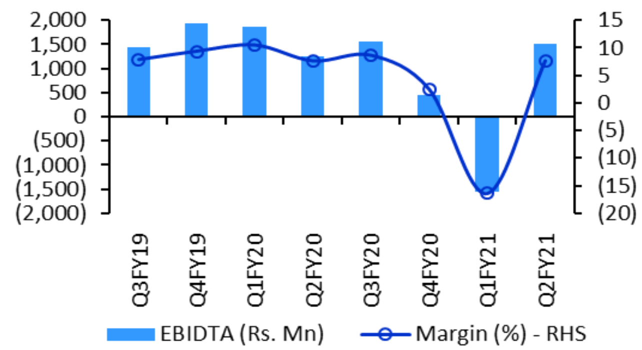
Source: Company, DART

Exhibit 7: VLS revenue grew 21% YoY



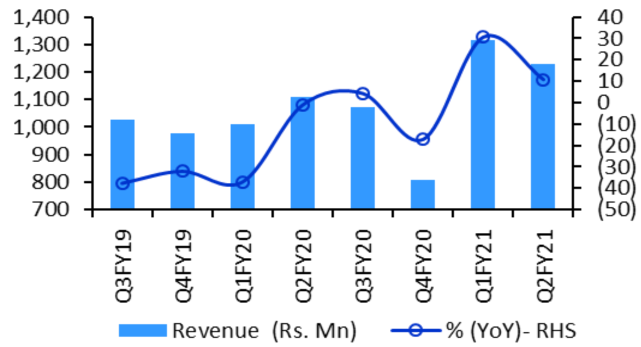
Source: Company, DART

Exhibit 8: VLS EBIDTA margin back to normal level



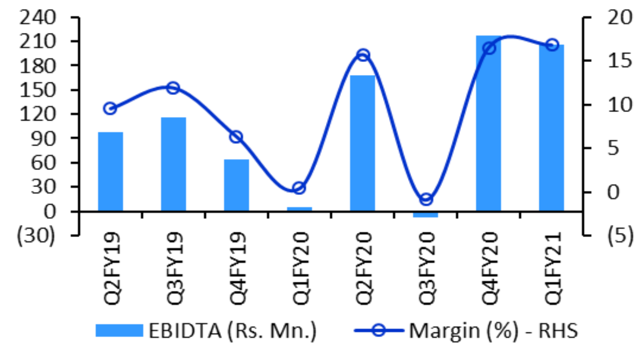
Source: Company, DART

Exhibit 9: China JV revenue continue to grow



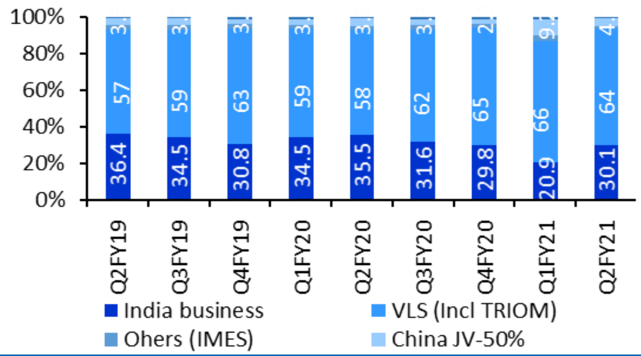
Source: Company, DART

Exhibit 10: China JV margin remain at higher level



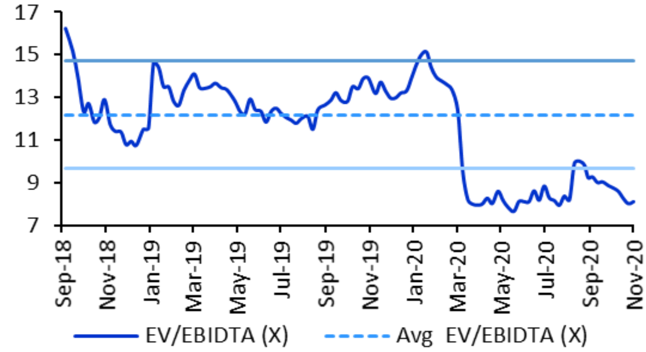
Source: Company, DART

Exhibit 11: Geography mix (%)



Source: Company, DART

Exhibit 12: 1 Yrs FWD EV/EBIDTA



Source: Company, DART

DART

Profit and Loss Account

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
Revenue	**1,11,219**	**1,04,429**	**1,22,785**	**1,39,880**
Total Expense	**1,03,010**	**98,685**	**1,12,225**	**1,27,011**
COGS	69,861	66,312	77,354	88,404
Employees Cost	15,929	15,664	16,453	18,464
Other expenses	17,220	16,709	18,418	20,143
EBIDTA	**8,208**	**5,744**	**10,559**	**12,869**
Depreciation	7,319	8,662	8,909	9,215
EBIT	**890**	**(2,918)**	**1,650**	**3,654**
Interest	1,392	1,590	1,160	1,020
Other Income	989	1,100	1,000	1,100
Exc. / E.O. items	0	0	0	0
EBT	**487**	**(3,408)**	**1,490**	**3,734**
Tax	370	400	425	949
RPAT	2	(3,408)	1,506	3,269
Minority Interest	23	0	0	0
Profit/Loss share of associates	**(92)**	**400**	**440**	**484**
APAT	**2**	**(3,408)**	**1,506**	**3,269**

Balance Sheet

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
Sources of Funds				
Equity Capital	135	135	135	135
Minority Interest	249	249	249	249
Reserves & Surplus	29,910	26,502	27,376	29,856
Net Worth	**30,045**	**26,637**	**27,511**	**29,991**
Total Debt	42,506	36,006	32,006	27,006
Net Deferred Tax Liability	1,195	1,200	1,800	1,800
Total Capital Employed	**73,996**	**64,093**	**61,567**	**59,046**
Applications of Funds				
Net Block	**54,745**	**52,727**	**51,518**	**49,503**
CWIP	3,976	3,000	2,000	2,000
Investments	7,710	8,336	9,136	9,636
Current Assets, Loans & Advances	**43,408**	**32,793**	**36,810**	**39,373**
Inventories	10,758	8,583	10,092	11,497
Receivables	10,893	9,155	11,437	13,030
Cash and Bank Balances	10,688	6,606	7,021	5,935
Loans and Advances	0	0	0	0
Other Current Assets	11,069	8,448	8,259	8,911
Less: Current Liabilities & Provisions	**35,844**	**32,763**	**37,897**	**41,466**
Payables	25,366	22,888	25,230	28,743
Other Current Liabilities	10,478	9,875	12,668	12,724
sub total				
Net Current Assets	7,565	29	(1,087)	(2,093)
Total Assets	**73,995**	**64,093**	**61,567**	**59,046**

E – Estimates

Important Ratios

Particulars	FY20A	FY21E	FY22E	FY23E
(A) Margins (%)				
Gross Profit Margin	37.2	36.5	37.0	36.8
EBIDTA Margin	7.4	5.5	8.6	9.2
EBIT Margin	0.8	(2.8)	1.3	2.6
Tax rate	76.0	(11.7)	28.5	25.4
Net Profit Margin	0.0	(3.3)	1.2	2.3
(B) As Percentage of Net Sales (%)				
COGS	62.8	63.5	63.0	63.2
Employee	14.3	15.0	13.4	13.2
Other	15.5	16.0	15.0	14.4
(C) Measure of Financial Status				
Gross Debt / Equity	1.4	1.4	1.2	0.9
Interest Coverage	0.6	(1.8)	1.4	3.6
Inventory days	35	30	30	30
Debtors days	36	32	34	34
Average Cost of Debt	4.2	4.0	3.4	3.5
Payable days	83	80	75	75
Working Capital days	25	0	(3)	(5)
FA T/O	2.0	2.0	2.4	2.8
(D) Measures of Investment				
AEPS (Rs)	0.0	(25.2)	11.2	24.2
CEPS (Rs)	54.2	38.9	77.1	92.5
DPS (Rs)	8.5	0.0	4.7	5.9
Dividend Payout (%)	63260.4	0.0	42.0	24.2
BVPS (Rs)	222.6	197.3	203.8	222.2
RoANW (%)	0.0	(12.0)	5.6	11.4
RoACE (%)	2.3	(3.2)	3.5	6.3
RoAIC (%)	1.5	(4.8)	2.9	6.8
(E) Valuation Ratios				
CMP (Rs)	299	299	299	299
P/E	22160.8	(11.8)	26.8	12.3
Mcap (Rs Mn)	40,331	40,331	40,331	40,331
MCap/ Sales	0.4	0.4	0.3	0.3
EV	72,150	69,731	65,316	61,402
EV/Sales	0.6	0.7	0.5	0.4
EV/EBITDA	8.8	12.1	6.2	4.8
P/BV	1.3	1.5	1.5	1.3
Dividend Yield (%)	2.9	0.0	1.6	2.0
(F) Growth Rate (%)				
Revenue	(7.6)	(6.1)	17.6	13.9
EBITDA	(22.5)	(30.0)	83.8	21.9
EBIT	(82.0)	(428.0)	(156.6)	121.4
PBT	(90.0)	(800.0)	(143.7)	150.5
APAT	(100.0)	(187357.2)	(144.2)	117.1
EPS	(100.0)	(187363.9)	(144.2)	117.1

Cash Flow

(Rs Mn)	FY20A	FY21E	FY22E	FY23E
CFO	14,137	10,070	11,807	13,224
CFI	(12,592)	(6,061)	(5,600)	(7,500)
CFF	7,331	(8,090)	(5,792)	(6,810)
FCFF	266	4,546	5,807	6,724
Opening Cash	1,637	10,688	6,606	7,021
Closing Cash	10,688	6,606	7,021	5,935

E – Estimates

DART RATING MATRIX

Total Return Expectation (12 Months)

Buy	**> 20%**
Accumulate	**10 to 20%**
Reduce	**0 to 10%**
Sell	**< 0%**

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SEBI Registration No: BSE - INB010710052 & INF010710052, NSE - INB230710031& INF230710031, Research: INH000000685
Registered office: Unit no PO6-02A - PO6-02D, Tower A, WTC, Block 51, Zone-5, Road 5E, Gift City, Gandhinagar, Gujarat – 382355
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