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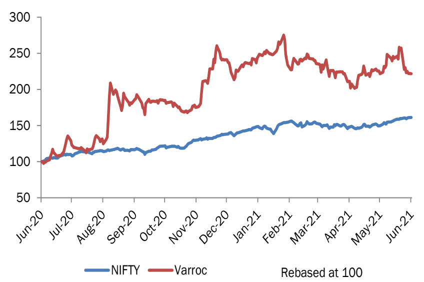
Varroc Engineering Limited

16 June 2021

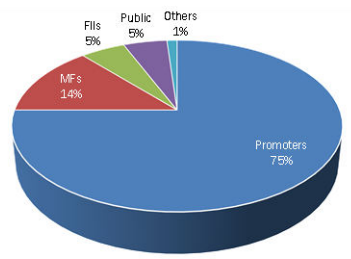
Project RACE launched to get VLS margins up to industry benchmark — BUY

Sector	: Auto Ancillary
Target Price	: Rs 490
Current Market Price	: Rs 378
Market Cap	: Rs 5,775 crore
52-week High/Low	: Rs 478/154
Daily Avg Vol (12M)	: 3,06,515
Face Value	: Re 1
Beta	: 1.34
Pledged Shares	: 0%
Year End	: March
BSE Scrip Code	: 541578
NSE Scrip Code	: VARROC
Bloomberg Code	: VARROC IN
Reuters Code	: VARE.NS
Nifty	: 15,768
BSE Sensex	: 52,502
Analyst	: Ritwik Bhattacharjee

Price Performance



Shareholding Pattern



4Q FY21 Update

Result Analysis

Robust 4Q FY21 revenue growth was primarily driven by an industry-beating 44.6% y-o-y growth at the India business (aided by 29%/27% y-o-y increase in 2W/PV production volume). While the ongoing global semiconductor shortage continued to plague VLS's business with the company's established plants in Mexico and the Czech Republic witnessing declines, overall VLS revenues grew by 13.7% y-o-y in euro terms (+25.1% y-o-y in INR terms), thanks to higher production at the new plants in Poland and Morocco. That said, volume ramp-up at the new plants was slower than expected as they continue to operate below breakeven levels. Management continued to deliver on its promise of debt reduction with net debt declining from ~Rs 2,730 crore in Dec-20 to ~Rs 2,250 crore in Mar-21.

Outlook & Valuation

VLS continues to be negatively affected by semiconductor shortages leading to production cuts at OEMs. With foundries adding capacities, the supply situation expected to normalise by September. As a result, we expect VLS EBITDA margins to remain weak during 1H FY22 and subsequently improve through the second half of the financial year. EBITDA margins at the India business are expected to remain robust. With overall EBITDA margins anticipated to improve on a y-o-y basis, we have modelled Varroc's bottom-line to turn green for the full year in FY22. FY23 is seen to realise significant positive impact from Project RACE, the programme undertaken with support from a global consulting firm to get VLS margins up to industry benchmark levels. We continue to believe Varroc's medium-to-long term prospects remain intact. The company is a leading future-ready player with 15% to 20% of VLS revenues coming from EVs, a strong position in LED lighting systems and presence in emerging technologies such as matrix lights and adaptive driving beam. Revising our forecast based on emerging data-points and expected benefits from Project RACE, we assign a target P/E multiple of 18.0x (5Y historical average vs 23.0x earlier) as we factor in our improved outlook explicitly in terms of upgraded FY23 estimates and to discount the dilution effect of 1.8 crore shares' issue through a QIP in March. Based on this, we value Varroc at Rs 490, informing a BUY rating with an upside of 30%.

Key Financial Metrics (Consolidated)

Rs crore	FY19A	FY20A	FY21A	FY22E	FY23E
Operating revenue	12,036	11,122	11,303	13,009	14,675
Growth		*-7.6%*	*1.6%*	*15.1%*	*12.8%*
EBITDA	1,059	821	397	973	1,476
EBITDA margin	*8.8%*	*7.4%*	*3.5%*	*7.9%*	*9.1%*
PAT	429	3	(629)	16	419
PAT margin	*3.6%*	*0.0%*	*-5.6%*	*0.1%*	*2.9%*
Diluted EPS (Rs)	31.54	0.01	(46.75)	0.83	27.19

Source: Company data; Khambatta Research

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Financial Performance (Consolidated)

Rs crore	4Q FY20	4Q FY21	Y-o-y	FY20	FY21	Y-o-y
Operating revenue	2,744.7	3,619.3	31.9%	11,121.9	11,302.8	1.6%
EBITDA	66.6	117.2	75.8%	820.8	396.8	-51.7%
EBITDA margin	*2.4%*	*3.2%*	*81 bps*	*7.4%*	*3.5%*	*-387 bps*
PAT (adjusted for exceptional items)	(137.1)	(144.3)	-5.3%	2.5	(520.9)	-20884.7%
Adjusted PAT margin	*-5.0%*	*-4.0%*	*101 bps*	*0.0%*	*-4.6%*	*-463 bps*
Diluted EPS, reported (Rs)	(10.20)	(10.67)	-4.6%	0.01	(46.75)	-467600.0%

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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