Varroc Engineering Limited

05 May 2022

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

BUY

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 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)

<table>
<thead>
<tr>
<th>` crore</th>
<th>2Q-3Q FY22A</th>
<th>FY23E</th>
<th>FY24E</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenue</td>
<td>2,997</td>
<td>6,417</td>
<td>7,072</td>
</tr>
<tr>
<td>Growth (annualised)</td>
<td>7.1%</td>
<td>10.2%</td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>208</td>
<td>468</td>
<td>573</td>
</tr>
<tr>
<td>EBITDA margin</td>
<td>7.0%</td>
<td>7.3%</td>
<td>8.1%</td>
</tr>
</tbody>
</table>

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.
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).

Analyst Certification

I/We, Research Analysts and authors, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

Terms & Conditions and Other Disclosures:

Khambatta Securities Limited (Khambatta Securities) is a full-service, integrated merchant banking and is, inter alia, engaged in the business of stock broking and distribution of financial products.

Khambatta Securities is one of the merchant bankers. We and our associates might have investment banking and other business relationship with companies covered by our Investment Research Department. Khambatta Securities generally prohibits its analysts, persons reporting to analysts and their relatives from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

The information and opinions in this report have been prepared by Khambatta Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of Khambatta Securities. While we would endeavor to update the information herein on a reasonable basis, Khambatta Securities is under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent Khambatta Securities from doing so.

This report is based on information obtained from public domain and is believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and shall not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. Khambatta Securities will not treat recipients as customers by virtue of the receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgment by any recipient. The recipient should independently evaluate the investment risks. The value and return on investment may vary because of changes in interest rates, foreign exchange rates or any other reason. Khambatta Securities accepts no liabilities whatsoever for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Investors are advised to understand the risks associated before investing in the securities markets. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

Khambatta Securities or its associates might have received any compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of investment banking or merchant banking, brokerage services or other advisory services. Khambatta Securities encourages independence in research report preparation and strives to minimize conflict in preparation of research report. Khambatta Securities or its analysts do not receive any compensation or other benefits from the companies mentioned in the report or third party in connection with preparation of the research report. Accordingly, neither Khambatta Securities nor Research Analysts have any material conflict of interest at the time of publication of this report.
Varroc Engineering Limited  
05 May 2022

It is confirmed that Research Analysts of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months. Compensation of our Research Analysts is not based on any specific merchant banking, investment banking or brokerage service transactions.

The Research Analysts engaged in preparation of this Report (a) may or may not have any financial interests in the subject company or companies mentioned in this report; (b) do not own 1% or more of the equity securities of the subject company mentioned in the report as of the last day of the month preceding the publication of the research report; (c) do not have any other material conflict of interest at the time of publication of the research report.

It is confirmed that Research Analysts do not serve as an officer, director or employee of the companies mentioned in the report.

Neither the Research Analysts nor Khambatta Securities have been engaged in market making activity for the companies mentioned in the report.

We submit that no material disciplinary action has been taken on Khambatta Securities by any Regulatory Authority impacting Equity Research Analysis activities.

This report has been prepared by Khambatta Securities. Khambatta Securities has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.