Stock Update – Open Offer Opportunity

Escorts Ltd.

November 26, 2021

RETAILRESEARCH

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Escorts Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Time Horizon
Automobile - Tractors	Rs 1814	Buy in Rs 1800-1830 band & add more on dips to Rs 1650-1680 band	Rs 2000	2 quarters

HDFC Scrip Code	ESCORTEQNR
BSE Code	500495
NSE Code	ESCORTS
Bloomberg	ESC IN
CMP Nov 25, 2021	1813.9
Equity Capital (Rs cr)	134.8
Face Value (Rs)	10.0
Equity Share O/S (cr)	13.5
Market Cap (Rs cr)	24456
Book Value (Rs)	399.9
Avg. 52 Wk Volumes	17,30,000
52 Week High	1831.3
52 Week Low	1100.0

Share holding Pattern % (Sep, 2021)	
Promoters	36.6
Institutions	29.2
Non Institutions	32.2
Total	100.0

HDFCsec Retail research stock rating meter

for details about the ratings, refer at the end of the report

* Refer at the end for explanation on Risk Ratings

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Our Take:

The macroeconomic factors for the tractor industry remain positive with monsoon recovering in September, increased Kharif crop sowing and all time high Rabi crop procurement by the government. The increase in MSP for both the Kharif as well as Rabi crops and rise in retail finance penetration would drive higher demand for tractors. In line with its strategy Escorts has been adding new dealers mostly in the southern and western regions. Its penetration in >40HP tractors (60% of sales) has been increasing. Sales to global Kubota network are also gradually increasing.

The recent preferential allotment to Kubota and the following open offer would make Kubota a majority shareholder in Escorts. The company has become cash rich and working on its mid-term plan (6-7 years) which will be ready by Jul-2022. Kubota could leverage India's lower cost base for its global products and distribution network which would drive increased volume for Escorts.

With the government thrust on asset monetization, build India thrust to revive the economy and improve the liquidity availability, construction equipment demand is expected to recover to its full potential in H2FY22, post the monsoon season. Opening of the railways as the pandemic situation improves would bring in new orders for the Railway Equipment division. Order book for the division stood at ~Rs 310cr at the end of Q2FY22.

On December 22, 2020, we had initiated coverage on the stock with a recommendation to 'Buy on dips to Rs 1200-1208 band and add more in Rs 1082-1090 band' for base case fair value of Rs 1323 and bull case fair value of Rs 1422 (Link). The stock had achieved our base case target on January 6 and bull case target on February 3, 2021.

Valuation & Recommendation:

The company continues to be net debt free with sufficient available liquidity for growth. Also the Kubota induction as a majority promoter and outlook of recovery in railway/construction space is encouraging. We expect Escorts Revenue/EBITDA/PAT to grow at 9/6/6% CAGR over FY21-FY24, led by improvement in domestic volumes and increased exports. At the current price the stock trades at 18.6x Sep-23 EPS estimate which is not expensive given its strong medium term prospects post Kubota becoming the majority stakeholder. We believe investors can buy the stock in the band of Rs 1800-1830 and add on dips to Rs 1650-1680 band (17x Sep-23E EPS) for a base case fair value of Rs 2000 (20.5x Sep-23E EPS) over the next 2 quarters. Investors can offer their shares in the open offer expected over the next few months at Rs 2000. Post the completion of the offer we expect the stock price to react downwards, but over the medium term the open offer price may be exceeded.

Financial Summary

Particulars (Rs cr)	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)	FY21	FY22E	FY23E	FY24E
Operating Income	1662	1640	*1.4*	1671	*-0.6*	6929	7566	8233	8879
EBITDA	210	301	*-30.2*	233	*-9.9*	1129	1112	1215	1332
APAT	177	230	*-23.1*	185	*-4.6*	874	862	949	1031
Diluted EPS (Rs)	1.7	2.3	*-23.1*	1.8	*-4.6*	86.4	85.4	93.9	102.1
RoE (%)						19.7	14.9	14.2	13.5
P/E (x)						21.0	21.2	19.3	17.8
EV/EBITDA (x)						13.6	13.2	11.5	9.8

(Source: Company, HDFC sec)

Recent Developments

Q2FY22 Result Update

Escorts reported a subdued set of numbers in Q2FY22 as irregular and uneven rainfall impacted demand for tractors. Operating income stood at Rs 1662cr, growing marginally. Agri Machinery revenues decreased 6% YoY to Rs 1241 due to 14% YoY decline in tractor volumes offset partially by improved realisation of 9% to Rs 5.9 lakh/unit. Construction Equipment(ECE) division revenue surged 58% YoY to Rs 249cr, as sales volume increased 31% to 1074 units. Railway Equipment Division (RED) recorded a topline of Rs 170cr vs. Rs 160cr in Q2FY21.

EBITDA fell 30% YoY to Rs 210cr while EBITDA margin contracted 570bps to 12.6% on account of adverse impact of rising commodity prices, negative operating leverage, and low volumes. The company reported PAT of Rs 177cr, a decline of 23% YoY.

For the month of Oct, its exports business recorded a robust sales growth of 58% YoY to 765 units v/s 484 in Oct'21. However, in the domestic market there was a decline of 3%. The sales volume for the domestic business for the month of October stood at 12749 v/s 13180 in Oct'21. Escorts Construction Equipment sales grew by 15.8% in Oct'21. It sold 462 machines, as against 399 machines sold in Oct/20.

Key Triggers

Opportunity in open offer

The Board of Escorts approved a preferential allotment of 93.6 lakh shares to Japan's Kubota Corporation at Rs 2000/share for a total consideration of Rs 1873cr. This would trigger an open offer by Kubota for a 26% stake in Escorts. Assuming that the open offer is successful and the entire treasury shares (held in Escorts Benefit & Welfare trust) are cancelled Kubota would have a 53.5% stake in company, which could further increase as it evaluates to merge its two JVs in India with Escorts. The name of the company is proposed to be changed to Escorts Kubota Ltd.

Shareholding Pattern

Current Shareholding		
Shareholder	No of shares	% Stake
Nanda Family	1,56,33,649	11.6%
Treasury Book	3,37,00,031	25.0%
Total Promoter Group	**4,93,33,680**	**36.6%**
Kubota	1,22,57,688	9.1%
Total Shares	**13,48,34,566**	**100.0%**

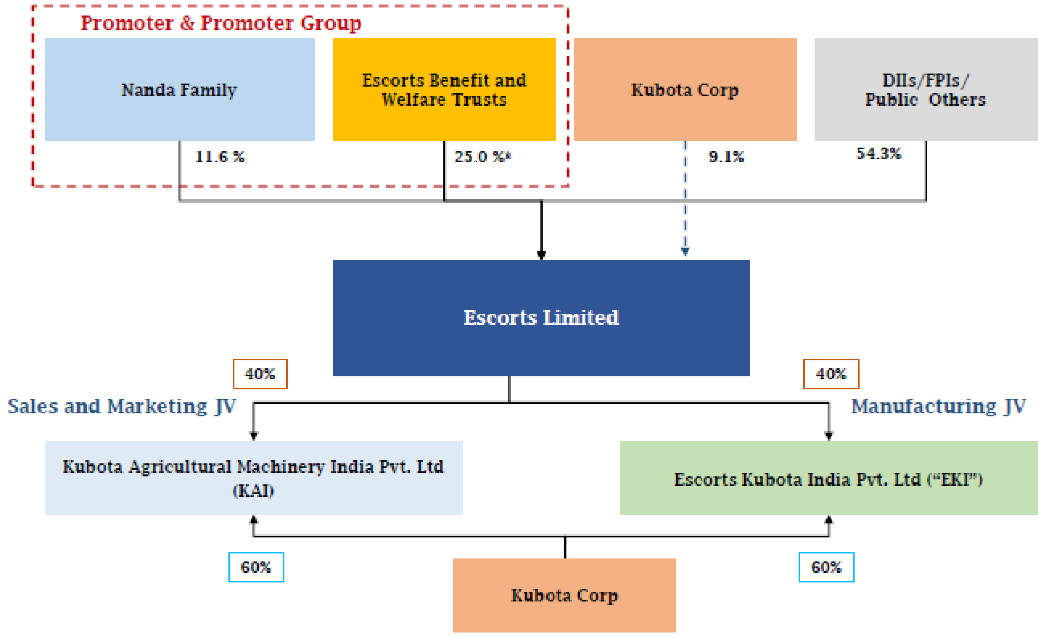
Post preferential allotment		
Shareholder	No of shares	% Stake
Nanda Family	1,56,33,649	10.8%
Treasury Book	3,37,00,031	23.4%
Total Promoter Group	**4,93,33,680**	**34.2%**
Kubota	2,16,21,414	15.0%
Total Shares	**14,41,98,292**	**100.0%**

Likely shareholding after open offer and 1st round of capital reduction		
Shareholder	No of shares	% Stake
Nanda Family	1,56,33,649	11.8%
Treasury Book	2,14,42,343	16.3%
Total Promoter Group	**3,70,75,992**	**28.1%**
Kubota	5,91,12,970	44.8%
Total Shares	**13,19,40,604**	**100.0%**

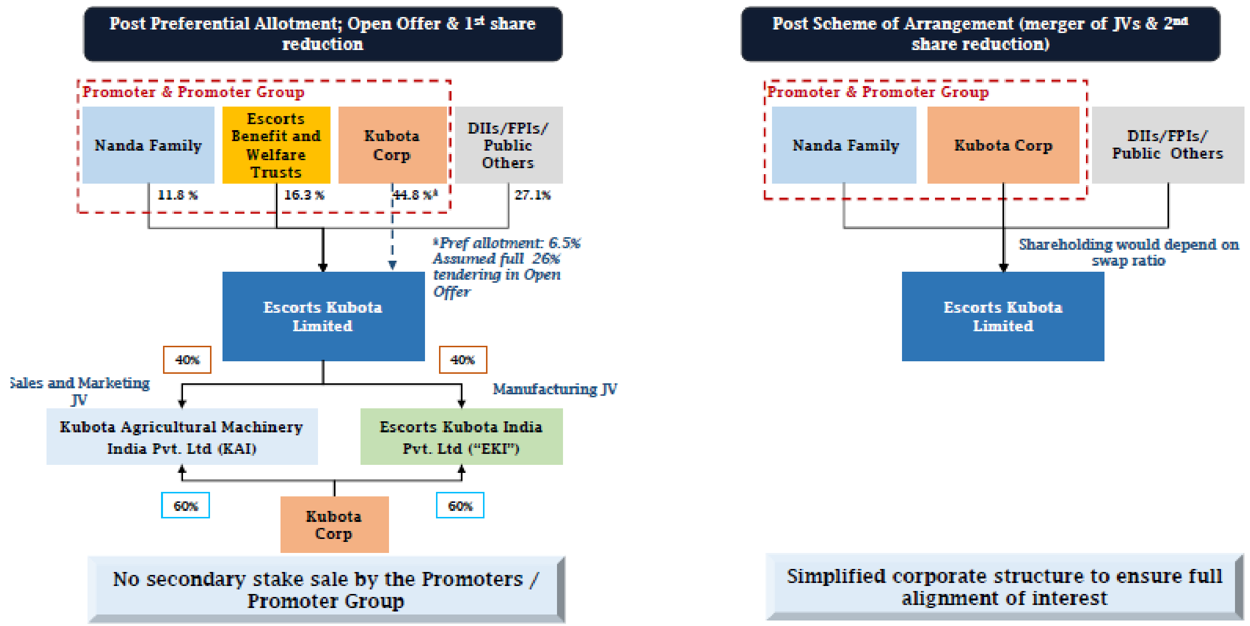
Likely shareholding after open offer and 2nd round of capital reduction		
Shareholder	No of shares	% Stake
Nanda Family	1,56,33,649	14.1%
Treasury Book	0	0.0%
Total Promoter Group	**1,56,33,649**	**14.1%**
Kubota	5,91,12,970	53.5%
Total Shares	**11,04,98,261**	**100.0%**

(Source: Company, HDFC sec)

Current Structure



Resulting Structure



(Source: Company, HDFC sec)

The Board also proposed to increase the limit on maximum number of directors of the Company from 15 to 18 as it plans to have four directors nominated by Kubota (from two currently), four nominated by the promoters, and eight independent directors.

As per the shareholders' agreement between Kubota and the promoters, there would be a five-year lock-in equity holding. Mr. Nanda reiterated that they are fully committed to Escorts and have no intention of selling any shares. The company expects to complete the preferential allotment and open offer by the end of FY22.

Strategic Rationale of the transaction

- Creating one of the largest Indo-Japan agriculture collaboration to attain global leadership in Farm Equipment Sector
- Escorts to be the exclusive vehicle for manufacture and sale of certain products in India and for sourcing from India (existing and products to be jointly developed in future)
- Escorts will also house a major R&D and Innovation Centre to offer cutting edge products and new alternative technologies
- Seamlessly integrating Kubota's global reach and world class business processes and Escorts' proven capabilities in frugal engineering and manufacturing
- To enhance customer prosperity and accelerating mechanization with the most cost-competitive technologies in India and across the globe

Investors looking for short term gain can buy the stock at current price of ~Rs 1820. The acceptance ratio of shares in the open offer can be between 60-100% vs the theoretical ratio of 51%. As per the Sep-2021 shareholding pattern, FIIs hold 21.5% stake in the company, DII hold 7.6%, HNIs (upto Rs 2 lakh nominal value) hold 7.2% and other retail shareholders hold 12.7% stake. We expect institutions could tender 40-50% of their holdings and overall acceptance ratio to be between 75-85%. Existing Promoter i.e. the Nanda Family are not selling any shares and continues to remain fully invested in the Company. Assuming that the open offer is completed in 3 months and there is full acceptance of shares, an investor can earn an annualized return of ~40%.

Sensitivity Analysis of acceptance ratio in open offer and likely returns

Absolute returns

Post Buyback Price	Acceptance (%)			
	65	75	85	100
1800	6.0%	7.1%	8.2%	9.9%
1750	5.1%	6.5%	7.8%	9.9%
1700	4.1%	5.8%	7.4%	9.9%
1650	3.2%	5.1%	7.0%	9.9%
1600	2.2%	4.4%	6.6%	9.9%

Annualised return based on 3 months investment period

Post Buyback Price	Acceptance (%)			
	65	75	85	100
1800	24.5%	29.0%	33.4%	40.1%
1750	20.6%	26.2%	31.8%	40.1%
1700	16.7%	23.4%	30.1%	40.1%
1650	12.8%	20.6%	28.4%	40.1%
1600	8.9%	17.8%	26.7%	40.1%

We continue to remain bullish on the prospects of the company over the medium term and even if the price falls post the open offer investors need not panic and can continue to hold on to the stock given the MNC pedigree. Kubota's plan to acquire majority stake in Escorts lends credence to its commitment to this partnership. Kubota is likely to leverage India's low cost base in sourcing products like farm implements, construction equipment and components which could drive strong growth for Escorts in the medium to long term.

Entered into MoU with Indusind Bank

In a bid to help the farming community financially, Escorts Agri Machinery and IndusInd Bank have signed a Memorandum of Understanding to provide loans at affordable interest rates to the farming community. Both the entities will work to understand the financial needs of customers and design financial programs accordingly. These programs will be aimed at encouraging investments in modern equipment for raising farm productivity and income.

Under this MoU, IndusInd Bank will utilise its understanding of rural customers and penetration throughout India to help Escorts Agri Machinery in achieving its larger goals vis-à-vis India's farming community. The partnership between IndusInd Bank and Escorts Agri Machinery is aimed to usher in transparency, seamlessness and convenience to support farmers

Management expects volumes to decline in H2

The management of Escorts expects tractor volume to decline in second half of the current fiscal due to the high base effect of last year. Overall it expects volume to grow 2-3% for FY22. However it remains optimistic on exports with much headroom for growth. Tractor exports have registered good volume in H1FY22. Growing 104% to 3558 units as against 1745 units in the corresponding period last fiscal. On the export side, synergy benefits of Kubota is expected to gain traction and reflect in numbers this year onwards.

Price hikes to cushion impact of raw material inflation

Cumulatively, the commodity cost increase has been ~10-12%, against which the company has taken multiple price hikes (Nov-20, Apr-21 and Jun-21). A further ~2% impact is expected on the margin, which shall be passed on in the upcoming months. Given the steep rise in input prices, we expect margins to remain under pressure in the near term.

Expanding capacity to be future ready

Escorts is expanding its production capacity of tractors from 120,000 units per annum to 150,000 units. It clocked total domestic volumes of more than 1 lakh units for the first time in FY21, while exports stood at about 5,000 units. The company expects volumes to increase due to new product introduction and penetration into more markets. Also, the JV with Japan's Kubota is expected to open up new markets for the company. The JV has commenced production during last fiscal and produced close to 5,400 units. The capacity of this JV unit will also be ramped up to 30,000 units this year. Thus, overall, the company is likely to have a capacity of about 180,000 units. The company expects capex of Rs 300-325cr in FY22 of which Rs 270-280cr would be for tractors.

Gaining market share
Escorts is gradually gaining back its market share which it had lost earlier due to peak capacity operations. Its domestic market share in H1FY22 was 9.9% vs 10.2% in H1FY21. The management aims to achieve a 14-15% share in the next three years with expansion into western and southern India, where tractor penetration is low.

Risk & Concern

High correlation with monsoons
The tractor industry volume growth has a high correlation with the deviation of monsoons from their long-term average. Although the monsoons started on a strong note, the month of August witnessed lower monsoons. Any significant deviation (especially back to back in two years) resulting in weak monsoons could lead to a sharp decline in the industry's growth.

Increasing commodity prices
Rising commodity prices is forcing tractor manufacturers to hike prices, which can have an impact on demand.

Covid related disruptions
The pandemic is again a hanging sword. We don't know what will happen, looking at developed countries where fourth-fifth waves are happening.

Slower ramp up in new product launches
Weak reception to new product launches like compact tractors and paddy specialists and a slower-than-expected channel ramp-up in opportunity markets of South and West could lead to lower-than-expected volume growth.

Dependence on infra spending for construction equipment
The construction equipment industry is highly dependent on government spending, which accounts for two-thirds of the demand. A slowdown in order execution or additional ordering could impact demand and, thereby, profitability for the segment.

Lower spending by railways
Lower-than-expected spending by the government in railways and delays in getting approvals for its new products like Bogie-mounted brake systems, axle-mounted disc brakes, etc., could impact growth of the railway business in the long term.

Competition in the industry
A sharp decline in tractor margins due to a significant slowdown in tractor demand resulting in higher industry discounting and adverse operating leverage.

JVs might take time to become significant
JVs with Tadano and Kubota may not yield the desired result and cultural differences between the teams may delay execution.

Cost increase may be difficult to pass on resulting in margin squeeze.
Over the past few months prices of commodities have risen sharply. Any inability or delay in passing over the increased costs to customers may result in lower margins.

Longer time in completing the open offer
The company expects to complete the preferential allotment and open offer by the end of FY22m. If the timeline gets stretched then the expected annualized returns could shrink.

Company Background:

Escorts Ltd. began its journey in 1948 as an agri-machinery company and has grown to be one of India's leading engineering conglomerates with over seven decades of experience. In 1969 it partnered with Ford motors in a JV to manufacture 40-50 HP range tractors which it later acquired and merged with itself. Over the years, the company diversified into other products to emerge as a multi-business entity, with interests in agri-machinery, railway equipment, industrial and construction equipment. Other non-core businesses like automotive components, telecommunication equipment and services, healthcare and software, and its JV stake in Carraro were divested during the mid-2000s. Escorts is the fourth largest tractor manufacturer in India with ~11.6% market share in FY21 and has a strong brand name offering more than 45 models ranging from 25HP to 80HP.

The Group has earned the trust of over 5 million customers by way of product and process innovations over seven decades of its existence and helped accelerate India's socio-economic development through its presence across the high growth sectors. Escorts endeavours to transform lives in rural and urban India by leading the revolution in agricultural mechanization, modernization of railway technology and transformation of Indian construction.

Escorts operates three core business verticals in which its pursuing innovation, fostering collaborations, driving modernisation and implementing advanced manufacturing practices, to bring the best that the world has to offer to India; and take India's best capabilities to the world.

Escorts Agri Machinery (EAM)

The pioneer of farm mechanization in India, Escorts Agri Machinery has in the last seven decades, committed itself to enhancing India's agricultural productivity and add value to the farmer's life. Escorts currently provides technologically superior range of 22HP to 80HP tractors under two star brands - Farmtrac and Powertrac. With a growing network of over 800 customer touch-points, Escorts Agri Machinery ensures the satisfaction of its customer base of over 14,00,000 and also promises maximum uptime of their tractors and equipment.

Escorts has 4 tractor manufacturing plants in Faridabad, Haryana and Poland with a combined capacity of over 1.2 lakh tractors. It also has 1 plant in JV with Kubota with annual installed capacity of 50,000 tractors. EAM accounted for 82% of the revenues in FY21.

Escorts Construction Equipment (ECE)

Escorts is a dominant player in material handling cranes, compactors and backhoe loaders of construction equipment. It is among the world's largest manufacturers of Pick and Carry (PnC) hydraulic mobile cranes. ECE provides equipment for material handling, road building, earth moving and other services, addressing the large national opportunity with a comprehensive basket of products. Thereby meeting the growing requirements of the country's infrastructure development, mining, realty, and other sectors.

The company has 1 manufacturing plant for construction equipment at Haryana with an annual capacity of 10,000 units and 1 plant in a JV with Tadano, Japan at Haryana. ECE contributed to 11% of total revenues in FY21.

Railway Equipment Division (RED)

RED is the supplier of advanced components for Indian Railways, anchored around safety, comfort and reliability. These include brake systems, couplers, suspension systems, shock absorbers and rail fastening systems, among others. Since 1962, the company has been a reliable partner of Indian Railways throughout its journey of modernization. Escorts has a presence in almost all the rolling stock segments of Passenger Coach, Locomotive, Wagons, EMUs and Metro. Escorts Railway Products are certified to ISO 9001:2008 and its products conform to Indian standards such as RDSO as well as international standards such as UIC and AAR, besides having won the IRIS certification.

The company has 1 plant at Haryana for manufacturing railway products with monthly capacity of 11,760 couplers (AARH and Shaku), 18,000 air brakes, 3,600 EP brakes and ~11 lakh brake blocks. The railway division accounted for 7% of revenues in FY21.

Sales breakup (FY21)

(Source: Company, HDFC sec)

Financials

Income Statement

(Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues	**5761**	**6929**	**7566**	**8233**	**8879**
Growth (%)	***-7.0***	***20.3***	***9.2***	***8.8***	***7.8***
Operating Expenses	5085	5800	6454	7018	7547
EBITDA	**676**	**1129**	**1112**	**1215**	**1332**
Growth (%)	***-7.8***	***67.1***	***-1.5***	***9.3***	***9.6***
EBITDA Margin (%)	***11.7***	***16.3***	***14.7***	***14.8***	***15.0***
Depreciation	105	116	127	140	155
Other Income	83	155	169	193	209
EBIT	**654**	**1168**	**1154**	**1268**	**1385**
Interest expenses	15	11	4	3	3
PBT	**639**	**1157**	**1150**	**1265**	**1382**
Tax	**153**	**283**	**287**	**316**	**351**
PAT	**486**	**874**	**862**	**949**	**1031**
Adj. PAT	**493**	**874**	**862**	**949**	**1031**
Growth (%)	***3.4***	***77.5***	***-1.4***	***10.0***	***8.6***
EPS	55.4	86.4	85.4	93.9	102.1

Balance Sheet

As at March (Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
SOURCES OF FUNDS					
Share Capital - Equity	123	135	135	135	135
Reserves	3358	5257	6085	6999	7996
Total Shareholders Funds	**3480**	**5392**	**6219**	**7134**	**8130**
Total Debt	7	0	20	20	20
Net Deferred Taxes	30	23	34	34	34
Other Non-current Liab. & Prov.	83	133	146	161	177
TOTAL SOURCES OF FUNDS	**3600**	**5547**	**6420**	**7349**	**8361**
APPLICATION OF FUNDS					
Net Block	1665	1713	1739	1800	1846
CWIP	124	64	63	63	63
Investments	551	723	709	743	779
Other Non-Curr. Assets	133	139	153	169	185
Total Non-current Assets	**2473**	**2640**	**2664**	**2775**	**2874**
Cash & Equivalents	957	2968	3612	4421	5329
Inventories	822	674	1057	1150	1241
Debtors	757	698	1016	1105	1192
Other Current Assets	303	222	244	269	296
Total Current Assets	**2839**	**4563**	**5929**	**6945**	**8058**
Creditors	1264	1187	1658	1805	1946
Other Current Liabilities & Provns	448	469	516	567	624
Total Current Liabilities	**1712**	**1656**	**2174**	**2372**	**2570**
Net Current Assets	1127	2907	3755	4574	5487
TOTAL APPLICATION OF FUNDS	**3600**	**5547**	**6420**	**7349**	**8361**

Escorts Ltd.

Cash Flow Statement

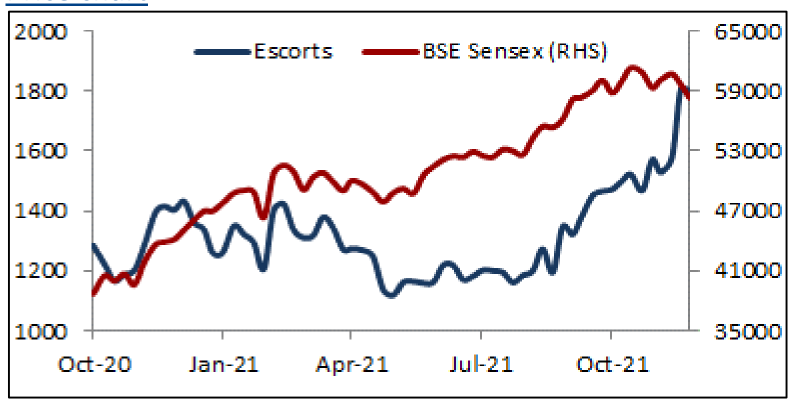
(Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
PBT	721	639	914	1049	1146
Non-operating & EO items	-83	-155	-169	-193	-209
Interest Expenses	15	11	4	3	3
Depreciation	105	116	127	140	155
Working Capital Change	317	232	-204	-9	-6
Tax Paid	-176	-290	-276	-316	-351
OPERATING CASH FLOW (a)	**817**	**1070**	**632**	**890**	**975**
Capex	-210	-104	-152	-201	-201
Free Cash Flow	607	967	480	689	774
Investments	-47	-130	14	-35	-37
Non-operating income	83	155	169	193	209
INVESTING CASH FLOW (b)	**-175**	**-79**	**31**	**-43**	**-29**
Debt Issuance / (Repaid)	-263	-7	20	0	0
Interest Expenses	-15	-11	-4	-3	-3
FCFE	328	949	496	685	771
Share Capital Issuance	-1	1129	0	0	0
Dividend	-27	-92	-34	-34	-34
FINANCING CASH FLOW (c)	**-307**	**1020**	**-19**	**-38**	**-38**
NET CASH FLOW (a+b+c)	**336**	**2011**	**644**	**809**	**908**

Key Ratios

	FY20	FY21	FY22E	FY23E	FY24E
Profitability Ratios (%)					
EBITDA Margin	11.7	16.3	14.7	14.8	15.0
EBIT Margin	9.9	14.6	13.0	13.1	13.3
APAT Margin	8.5	12.6	11.4	11.5	11.6
RoE	15.1	19.7	14.9	14.2	13.5
RoCE	14.4	19.3	14.5	13.8	13.2
Solvency Ratio (x)					
Net Debt/EBITDA	-1.4	-2.6	-3.2	-3.6	-4.0
Net D/E	-0.3	-0.6	-0.6	-0.6	-0.7
PER SHARE DATA (Rs)					
EPS	55.4	86.4	85.4	93.9	102.1
CEPS	66.4	97.9	98.0	107.8	117.4
BV	391.5	533.1	615.8	706.3	805.0
Dividend	2.5	7.5	2.8	2.8	2.8
Turnover Ratios (days)					
Inventory days	52	36	51	51	51
Debtor days	48	37	49	49	49
Creditors days	80	63	80	80	80
VALUATION (x)					
P/E	32.7	21.0	21.2	19.3	17.8
P/BV	4.6	3.4	2.9	2.6	2.3
EV/EBITDA	22.4	13.6	13.2	11.5	9.8
EV/Revenues	2.6	2.2	1.9	1.7	1.5
Dividend Yield (%)	0.1	0.4	0.2	0.2	0.2
Dividend Payout (%)	4.5	8.7	3.3	3.0	2.7

(Source: Company, HDFC sec)

Price chart



HDFC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. This stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.