Initiating Coverage

Sharda Motor Industries Ltd.

December 13, 2021

RETAILRESEARCH

Sharda Motor Industries Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Auto Ancillaries	Rs 836	Buy in Rs 830-845 band & add more on dips to Rs 735-750 band	Rs 915	Rs 990	2 quarters

HDFC Scrip Code	SHAMOT
BSE Code	535602
NSE Code	SHARDAMOTR
Bloomberg	SHMO IN
CMP Dec 10 , 2021	835.8
Equity Capital (Rs cr)	6.0
Face Value (Rs)	2
Equity Share O/S (cr)	3.0
Market Cap (Rs cr)	2492
Book Value (Rs)	749.1
Avg. 52 Wk Volumes	45,100
52 Week High (Rs)	860.0
52 Week Low (Rs)	311.1

Share holding Pattern % (Sep, 2021)	
Promoters	73.2
Institutions	0.4
Non Institutions	26.4
Total	100.0

* Refer at the end for explanation on Risk Ratings

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Our Take:

Sharda Motor Industries Ltd. (SMIL) is a leading auto-ancillary company supplying exhaust and suspension systems to major OEMs. The company is benefitting from the BS-VI implementation and prepared with products to meet the next significant update in emission norms for CEV and tractors. It has entered in JV with Eberspaecher to manufacture commercial vehicle exhaust systems in India which would double its addressable CV/CEV market (>2.5L) and increase content per equipment by more than 100%. Even in the PV segment its content per vehicle is expected to increase by 15% with the implementation of Real Driving Emissions (RDE) norms.

It has also forayed into EV space through a JV with Kinetic Green for developing Battery Packs with Battery Management Systems (BMS) for electric vehicles and stationary applications. SMIL aims to become powertrain agnostic in the next 5-10 years. While SMIL could benefit out of industry growth of PV and CV, implementation of TREM-IV from Oct'21 and turnaround in its JV with Eberspaecher till FY24, post that the growth due to TREM V implementation will be even faster.

Valuation & Recommendation:

We expect SMIL's revenue/EBITDA/PAT to grow at 21/35/53% CAGR over FY21-FY24, led by increased content per vehicle in both the PV and CV segment, improvement in JV profitability and operating leverage. The company is debt-free, holds substantial cash and cash equivalents with healthy return ratios and available at inexpensive valuation considering the strong growth prospects. We believe investors can buy the stock in Rs 830-845 band and add on dips to Rs 735-750 band (10.5x Sep-23E EPS) for a base case fair value of Rs 915 (13x Sep-23E EPS) and bull case fair value of Rs 990 (14x Sep-23E EPS) over the next 2 quarters.

Financial Summary

Particulars (Rs cr)	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)	FY21	FY22E	FY23E	FY24E
Operating Income	587	444	32.1	472	24.5	1,737	2,153	2,606	3,074
EBITDA	61	34	79.2	40	52.7	129	205	261	317
APAT	42	21	102.2	24	71.2	67	124	181	239
Diluted EPS (Rs)	14.0	6.9	102.2	8.2	71.2	22.4	41.8	60.7	80.2
RoE (%)						16.8	25.7	29.4	30.2
P/E (x)						37.3	20.0	13.8	10.4
EV/EBITDA (x)						17.1	10.4	7.4	5.4

(Source: Company, HDFC sec)

Recent Developments

Q2FY22 Result Update

SMIL reported strong numbers for Q2FY22 with PAT doubling to Rs 42cr yoy and growing 71% sequentially. Consolidated revenue came in at Rs 587cr, growing by 32% yoy. Gross Margins expanded 263bps to 20.4% driven by stable production. EBITDA increased by 79% yoy to Rs 61cr and EBITDA margin expanded 274bps led by gross margin improvement and higher capacity utilisation. Other income was higher at Rs 10cr against Rs 6cr in Q2FY21 on account of higher investments made by the company. The company has undertaken cost optimising initiatives in its JV with Eberspacher and expects to breakeven in the next 3-4 quarters with a pickup in CV volumes.

Key Triggers

PV/CV regulation changes to drive strong topline growth

The new emission norms for construction equipment vehicles (CEV-IV) have been implemented from Apr 1, 2021 (for high powered), CEV-V norms from April 2024 (for low powered) and for agricultural tractors and other equipment (TREM-IV- for higher HP) from October 1, 2021. With the implementation of new emission norms, the addressable market segment for the company is expected to grow sharply in the next 5 years and content per equipment is likely to increase by more than 100%. TREM - IV norms were earlier intended to be implemented from Oct 1, 2020. Further, the next stage of emission norms for construction equipment vehicles and tractors i.e. CEV-V and TREM-V (for lower HP) is scheduled to be implemented from Apr 1, 2024 which would further increase the addressable market/content per vehicle for the company and lead to strong topline growth over the medium term.

BS-VI (homologation) for PV got implemented from April 01, 2020 and this helped SMIL to show a sharp jump in sales in FY20 and FY21. In the PV segment the government would be enforcing BS-VI norms on RDE norm Apr 1, 2023. RDE is the most preferred emission regulation method since it is aimed at reducing the gap between type-approval emission that occur during the certification (homologation) testing phase and those in the real world. Under these norms, car manufacturers will be made to randomly pick three customer vehicles every year and test them for emissions. The exercise will be conducted in cooperation with government-backed vehicle test agencies that also issue certification for a vehicle’s street-worthiness. RDE norms will result in addressable market CAGR of ~7% over the next 5 years and content per vehicle is expected to increase by 10-15%.

Every higher emission norms results in higher costs and higher bought out component initially for SMIL. This leads to faster growth in topline but slower growth in absolute operating profit. SMIL may manufacture some of this bought out components (like Catalyst) in house to earn higher margins.

JV performance set to improve

In FY19, SMIL had formed a 50:50 JV with Germany based Eberspaecher Exhaust Technology International to manufacture commercial vehicle exhaust systems in India (SMIL investment Rs 37.5cr as of March 2021). The JV develops, produces and sells exhaust after treatment systems for Indian CV manufacturers meeting the latest BS-VI norms. The second plant of the JV in Pune has started commercial production. The JV reported loss of Rs 23.1cr in FY21 on a turnover of ~Rs 140cr as CV sales were hit due to economic slowdown, Covid pandemic and chip shortage. In H1FY22, it reported sales of Rs 67cr. However, the management is confident of faster than industry growth, as the economy revives and CV sales pick up in H2FY22.

The Eberspächer Group of Companies is an international automotive supplier with 80 locations in 28 countries, having revenues of Euro 4.9bn in 2020. It brings in global know-how for the local market. The company is a segment leader in the developed economies with a 75% market share in Europe and 50% market share in the US.

Foray into EV space

SMIL has also forayed into EV space by forming a 74:26 JV with Kinetic Green Energy for developing Battery Packs with Battery Management Systems (BMS) for electric vehicles and stationery applications. The JV has inked a technical collaboration with Indian Institute of Technology, Madras, for the same. Under the technical collaboration agreement, Centre for Battery Engineering and Electric Vehicle (CBEEV), the research and development centre of IIT Madras, will provide technology for Li-ion battery energy storage for electric 2 wheelers, 3 wheelers and other small electric vehicles to the JV.

Kinetic Green Energy manufactures electric 3W and has sold around 30,000 units so far. Recently it emerged as one of the six lowest bidders for an estimated Rs 3,000cr state-run Convergence Energy Services Ltd’s (CESL) tender to procure 100,000 electric 3W vehicles. The JV would start production by Q3FY23 and KGEL would be the only customer. In the 2nd phase, it would look at supplying sub-components to other companies as well.

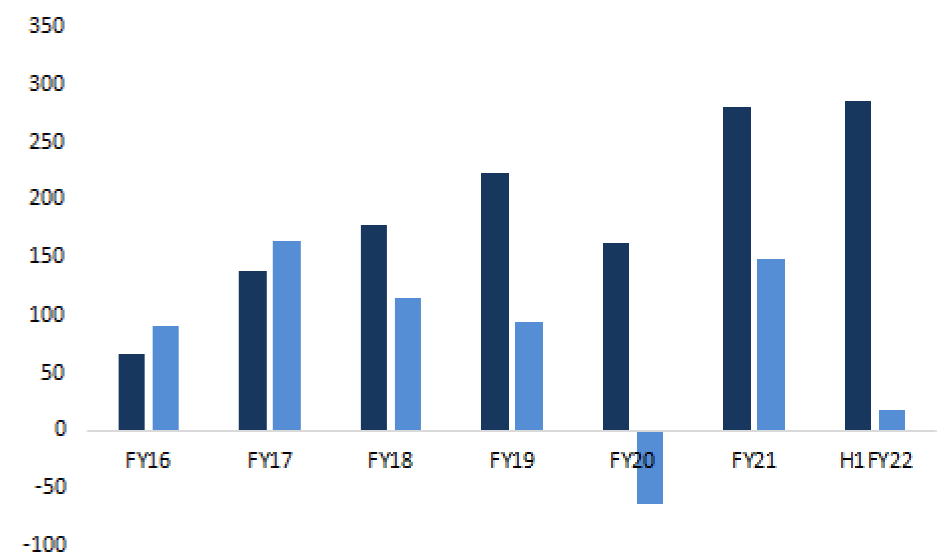
KGEL has recently introduced a one tonne vehicle which can carry 500 kgs of cargo and tied up with all leading e-commerce companies like Amazon, Flipkart, Delhivery, Big Basket and their third-party logistics companies.

SMIL is taking small steps in this JV and is committing small sums at this point. Depending on the progress it is ready to commit higher sums going forward.

Strong cash generation

SMIL is well capitalised and does not have any significant capex plans in the near future. The company is debt-free and any capex requirement would be funded through internal accruals. Consequently cash generation is expected to remain strong in the coming years which the company intends to utilise for inorganic opportunities or return it to shareholders. SMIL had cash and current investments of Rs 286cr at the end of H1FY22.

Operating cash generation has been strong

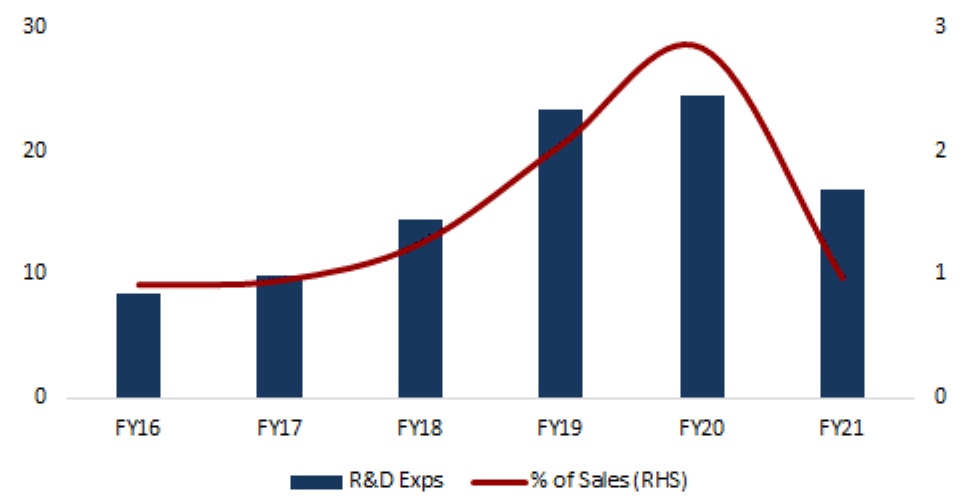


(Source: Company, HDFCsec)

Focus on R&D

SMIL has a strong focus on R&D and develops a lot of products in-house which enable it to control development costs. Its R&D department is headed by Dr S. Rajadurai, who is a world-renowned scientist in the field of catalysis, physical chemistry, and emission control, focused on protection of the global environment. His research on solid oxide solutions, free radicals, catalyst structure sensitivity, catalytic converter designs and exhaust system for emission control & noise control has revolutionized the field of chemistry.

R&D Expenses trend



(Source: Company, HDFCsec)

Established market position and strong customer base

SMIL is a prominent player in the Indian automotive components industry with strong presence in both the spaces – exhaust systems and suspension systems. Experience of around three decades in manufacturing exhaust systems has enabled the promoters to develop healthy relationships with OEMs such as M&M, for which SMIL is the preferred supplier of independent front suspension systems. It also caters to various models of Hyundai Motor India Ltd and Tata Motors. Apart from exhaust systems, SMIL manufactures and supplies various suspension systems and also trades in catalytic convertors for its customers.

The JV with Eberspächer has enabled the company to manufacture exhaust systems for CV which could result in incremental opportunity with companies where it is supplying exhaust system for PV.

Risk & Concern

Slowdown in automobile sales

The products of the company primarily cater to the automobile industry (PV and CV) and any slowdown in the industry could have a significant impact on the company's profitability.

Losses in JV company

The JV with Eberspächer has been making losses due to lower CV sales in the last couple of years. The company has commenced production at the 2nd plant and delays in revival of CV sales would further impact consolidated profits.

Susceptibility to increase in raw material prices and pricing pressure from OEMs

The company has limited bargaining power with OEMs, which periodically revise prices based on their financial standing and willingness. As such, any benefit in operating margin comes with a lag.

Faster adoption of EV could render products obsolete

Large scale adoption of EV for passenger and commercial vehicles would take time in India. However, faster adoption could render many products of the company obsolete in few years.

Covid related disruptions

The 3rd/4th wave of Covid is causing disruptions in western countries. Any such wave in domestic markets could derail the economic revival and may negatively impact the auto volumes. Further, if the general economic slowdown extends further, it will impact the economy which may have negative implications for the company. Chip shortage is impacting vehicle sales and hence the sales of SMIL could also get affected going ahead if the situation does not improve soon.

Customer concentration

The top 3 customers accounted for ~80% of the FY21 revenue. Loss of any of these customers could have a substantial impact on the company's financials.

Any further postponement of the implementation schedule for the emission norms could postpone the revenue upside for SMIL.

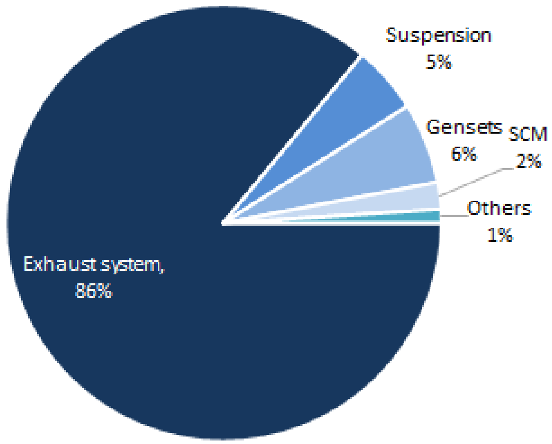
Company Background:

SMIL is the market leader in manufacturing of Exhaust System. It also manufactures Catalytic Converter, Independent Suspension, Seat Frames, Seat Covers (Two Wheelers & Four Wheelers), Soft Top Canopies, and Pressed part- White goods products. Established in 1986, SMIL is fully backward integrated and has nine manufacturing units including the JV plants, three sales offices and one world class R&D center. Its plants are strategically located across the country – Nashik, Pune (Maharashtra), Kancheepuram (Tamil Nadu), Haridwar (Uttranchal), Gautam Budh Nagar, Greater Noida (Uttar Pradesh), & Sanand (Gujarat) – near the auto clusters. Capacity utilisation across the plants is close to 85% and higher output requires incrementally smaller capex.

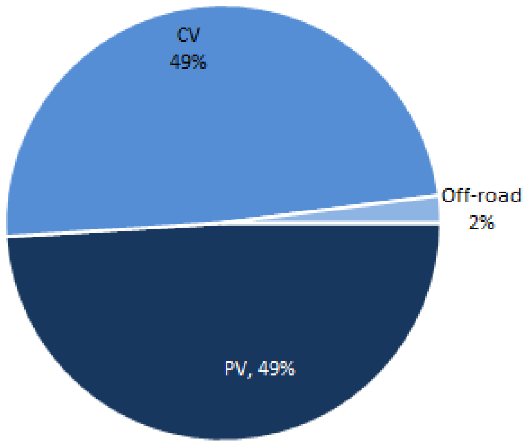
SMIL has a market share of ~30% in exhaust systems in the domestic PV industry catering to almost all major OEMs except Maruti. Ex-Maruti its share is 60%. It also caters to major tractor manufacturers like Escorts, TAFE, Kubota, etc. and CV players like Tata Motors, Ashok Leyland, Force Motors, etc. In addition, the company also supplies to non-auto players (for genset applications) like Cummins, Carriers, and, others. Apart from SMIL, the other key players in the Indian market are Tenneco, Faurecia, JBM and Mark Exhaust in the exhaust systems. In the CV segment SMIL has lower market share of 10-20% due to requirement of high technology, which post the recent JV, MIL has and this could lead to higher market share going forward.

As a backward integration step, it also has 3 stamping plants managing all critical stamping in-house and two tube mills producing stainless steel and aluminium steel tubes for exhaust systems. In the suspension segment it has market share of 7-8% with two manufacturing units at Nashik and Pune.

Revenue breakup (FY21)



Exhaust system revenue breakup



(Source: Company, HDFCsec)

Financials

Income Statement

(Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
Net Revenues	**863**	**1,737**	**2,153**	**2,606**	**3,074**
Growth (%)	***-24.3***	***101.2***	***24.0***	***21.0***	***18.0***
Operating Expenses	767	1,607	1,949	2,345	2,758
EBITDA	**96**	**129**	**205**	**261**	**317**
Growth (%)	***-34.0***	***34.8***	***58.3***	***27.4***	***21.5***
EBITDA Margin (%)	***11.1***	***7.4***	***9.5***	***10.0***	***10.3***
Depreciation	40	44	39	41	43
Other Income	24	21	27	34	42
EBIT	**79**	**107**	**193**	**254**	**316**
Interest expenses	1	1	2	2	3
PBT	**78**	**105**	**191**	**251**	**313**
Tax	21	27	48	64	79
PAT	**58**	**79**	**142**	**188**	**234**
Share of Asso./Minority Int.	-5	-12	-18	-7	5
Adj. PAT	**52**	**67**	**124**	**181**	**239**
Growth (%)	***-39.7***	***27.3***	***86.5***	***45.3***	***32.1***
EPS	17.6	22.4	41.8	60.7	80.2

Balance Sheet

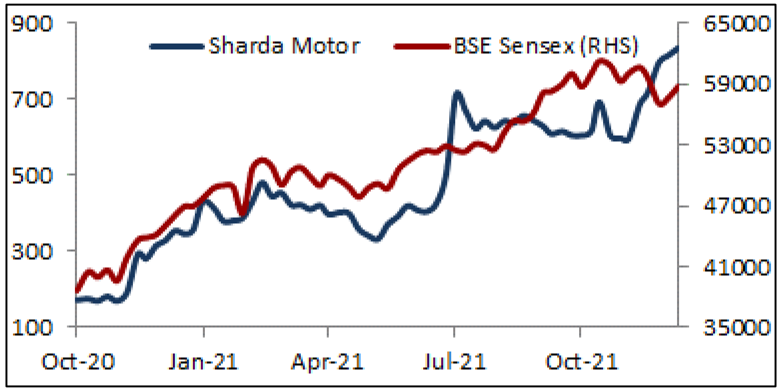
As at March (Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
SOURCE OF FUNDS					
Share Capital	6	6	6	6	6
Reserves	359	425	531	685	885
Shareholders' Funds	**365**	**431**	**537**	**691**	**891**
Borrowings	0	0	0	0	0
Net Deferred Taxes	0	-4	-4	-4	-4
Other Non-curr. Liab.	10	12	14	22	22
Total Source of Funds	**375**	**439**	**547**	**709**	**909**
APPLICATION OF FUNDS					
Net Block & Goodwill	186	179	170	165	162
CWIP	1	0	0	0	0
Investments	40	41	131	281	461
Other Non-Curr. Assets	15	12	17	28	26
Total Non-Current Assets	**242**	**232**	**318**	**473**	**649**
Inventories	107	139	211	262	285
Trade Receivables	117	324	315	407	501
Cash & Equivalents	146	263	261	290	330
Other Current Assets	10	12	18	23	24
Total Current Assets	**380**	**738**	**805**	**982**	**1141**
Trade Payables	207	471	487	640	762
Other Current Liab & Provisions	40	59	89	106	119
Total Current Liabilities	**247**	**530**	**576**	**746**	**880**
Net Current Assets	133	207	229	236	261
Total Application of Funds	**375**	**439**	**547**	**709**	**909**

Sharda Motor Industries Ltd.

Cash Flow Statement

(Rs cr)	FY20	FY21	FY22E	FY23E	FY24E
PBT	78	105	173	244	318
Non-operating & EO items	-174	-6	-4	-2	2
Interest Expenses	-5	-9	2	2	3
Depreciation	40	44	39	41	43
Working Capital Change	17	45	-23	22	16
Tax Paid	-21	-32	-48	-64	-79
OPERATING CASH FLOW (a)	**-64**	**148**	**138**	**243**	**302**
Capex	-13	-24	-30	-35	-40
Free Cash Flow	-77	124	108	208	262
Investments	79	-13	-90	-150	-180
Non-operating income	8	-116	0	0	0
INVESTING CASH FLOW (b)	**73**	**-152**	**-120**	**-185**	**-220**
Debt Issuance / (Repaid)	0	0	0	0	0
Interest Expenses	-1	-1	-2	-2	-3
FCFE	8	-6	16	56	79
Share Capital Issuance	0	0	0	0	0
Dividend	0	0	-18	-27	-39
FINANCING CASH FLOW (c)	**-1**	**-1**	**-20**	**-29**	**-41**
NET CASH FLOW (a+b+c)	**8**	**-6**	**-2**	**29**	**40**

Price chart



Key Ratios

	FY20	FY21	FY22E	FY23E	FY24E
Profitability Ratios (%)					
EBITDA Margin	11.1	7.4	9.5	10.0	10.3
EBIT Margin	9.2	6.1	8.9	9.7	10.3
APAT Margin	6.1	3.8	5.8	6.9	7.8
RoE	12.5	16.8	25.7	29.4	30.2
RoCE	18.9	26.8	39.8	41.3	39.9
Solvency Ratio (x)					
Net Debt/EBITDA	-1.5	-2.0	-1.3	-1.1	-1.0
Net D/E	-0.4	-0.6	-0.5	-0.4	-0.4
PER SHARE DATA (Rs)					
EPS	17.6	22.4	41.8	60.7	80.2
CEPS	31.1	37.2	54.9	74.4	94.5
BV	122.5	144.8	180.6	232.3	299.6
Dividend	0.0	2.6	6.0	9.0	13.0
Turnover Ratios (days)					
Inventory	53	46	54	51	54
Debtor	44	26	30	33	32
Creditors	84	71	81	79	83
VALUATION (x)					
P/E	47.5	37.3	20.0	13.8	10.4
P/BV	6.8	5.8	4.6	3.6	2.8
EV/EBITDA	24.2	17.1	10.4	7.4	5.4
EV/Revenues	2.7	1.3	1.0	0.7	0.6
Dividend Yield (%)	0.0	0.3	0.7	1.1	1.6
Dividend Payout (%)	0.0	11.7	14.4	14.8	16.2

(Source: Company, HDFC sec)

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.