# Initiating Coverage

# Sterling Tools Ltd.

February 8, 2023


RETAILRESEARCH

# Sterling Tools Ltd.

HDFC securities Click. Invest. Grow. 20 YEARS

| Industry | LTP | Recommendation | Base Case Fair Value | Bull Case Fair Value | Time Horizon |
|---|---|---|---|---|---|
| Auto Ancillaries | Rs 357 | Buy in Rs 355-360 band & add more on dips in Rs 317-322 band | Rs 401 | Rs 425 | 2-3 quarters |

| | |
|---|---|
| HDFC Scrip Code | STETOOEQNR |
| BSE Code | 530759 |
| NSE Code | STERTOOLS |
| Bloomberg | STRT IN |
| CMP Feb 7, 2023 | 357.3 |
| Equity Capital (Rs cr) | 7.2 |
| Face Value (Rs) | 2 |
| Equity Share O/S (cr) | 3.6 |
| Market Cap (Rs cr) | 1287 |
| Book Value (Rs) | 107.2 |
| Avg. 52 Wk Volumes | 145,500 |
| 52 Week High (Rs) | 390.6 |
| 52 Week Low (Rs) | 116.1 |

| Share holding Pattern % (Dec 2022) | |
|---|---|
| Promoters | 65.8 |
| Institutions | 5.3 |
| Non Institutions | 28.9 |
| 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:

Sterling Tools Ltd. (STL) is the 2nd largest automotive fastener manufacturer in India, in existence since last 4 decades with a well-diversified presence across all automotive segments and customers. It entered the EV space in 2020 and has become one of the largest e-2W MCU (Motor Control Unit) supplier in India. It has also started supplying MCUs for LCVs. EV penetration in 2W and 3W is expected to increase at a fast rate over the next few years which augurs well for the company's growth. The collaboration with Meidoh for high tension fasteners could lead to higher orders from Japanese manufacturers. STL has also invested in 3W cargo EV manufacturer which is showing rapid growth and could lead to a valuation uptick.

With minimum capex requirement and strong cash flows, the management has guided for a growth of 15-18% in FY24. Margins were impacted in FY22 due to company's limited ability to pass on inflationary pressures. However, softening of raw material costs should lead to higher margins in the coming quarters.

## Valuation & Recommendation:

STL maintains a conservative capital structure with low gearing levels and comfortable coverage indicators. We expect STL's Revenue/EBITDA/PAT to grow at 26/31/51% CAGR over FY22-FY25E, led by strong growth in EV business, higher share of specialised fasteners, improved realisations, and strict control on cost overheads. We believe investors can buy the stock in Rs 355-360 band and add on dips in Rs 317-322 band (13.5x Dec'24E EPS) for a base case fair value of Rs 401 (17x Dec'24E EPS) and bull case fair value of Rs 425 (18x Dec'24E EPS) over the next 2-3 quarters.

## Financial Summary

| (Rs cr) | Q3FY23 | Q3FY22 | YoY (%) | Q2FY23 | QoQ (%) | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|---|---|---|---|---|
| Operating Income | 208 | 122 | 70.4 | 179 | 16.4 | 510 | 755 | 892 | 1,017 |
| EBITDA | 28 | 16 | 76.5 | 25 | 12.2 | 67 | 102 | 126 | 151 |
| APAT | 14 | 5 | 155.4 | 17 | -16.2 | 26 | 54 | 71 | 90 |
| Diluted EPS (Rs) | 3.9 | 1.5 | 155.2 | 4.6 | -16.3 | 7.3 | 15.0 | 19.7 | 24.9 |
| RoE-% | | | | | | 7.6 | 14.3 | 16.4 | 17.9 |
| P/E (x) | | | | | | 49.2 | 23.8 | 18.2 | 14.3 |
| EV/EBITDA (x) | | | | | | 20.5 | 13.4 | 10.7 | 8.6 |

*(Source: Company, HDFC sec)*

## Q3FY23 Result Review

STL reported strong numbers for Q3FY23 with highest ever quarterly consolidated revenue of Rs 208cr, up by 70% YoY led by increased offtake for MCU. The turnover in EV business has increased to Rs 119cr in 9MFY23 as compared to just Rs 7cr in the corresponding period previous year. Ola which is the major customer for MCU reported monthly wholesale sales of 20000+ units in October-December period. EBITDA increased by 76% YoY to Rs 28cr and EBITDA margin expanded 40bps to 13.5% on account of higher capacity utilisation. However, sequentially EBITDA margin declined 13.5%. PAT for the quarter came in at Rs 14cr, up 155% YoY while PAT margin expanded 220bps to 6.7%. New capacity utilisation was to the tune of 70%.

## Key updates

**Auto sales to improve going forward**

According to Crisil Research, growth across the automobile sector segments could level off next fiscal as the base effect of last fiscal wanes. Commercial vehicle sales are expected to drive past pre-pandemic levels next fiscal along with passenger vehicles, which did so this fiscal, and tractors, which recorded an all-time high in pandemic-impacted fiscal 2021. Two-wheelers will continue to lag as the hike in their total cost of ownership (TCO) has been much sharper than for passenger vehicles.

The passenger vehicle sector was the hardest hit in fiscal 2022 due to semiconductor shortages on account of rising semiconductor intensity per vehicle. CRISIL Research expects domestic volumes in FY24 to rise 27-29% on-year to ~3.9 million vehicles, surpassing the pre-pandemic high of 3.4 million vehicles. The volumes would be supported by strong pent-up demand, a healthy order book across original equipment manufacturers (OEMs), improving model availability, new model launches and the loan-to-value (LTV) inching towards near 100% of on-road financing.

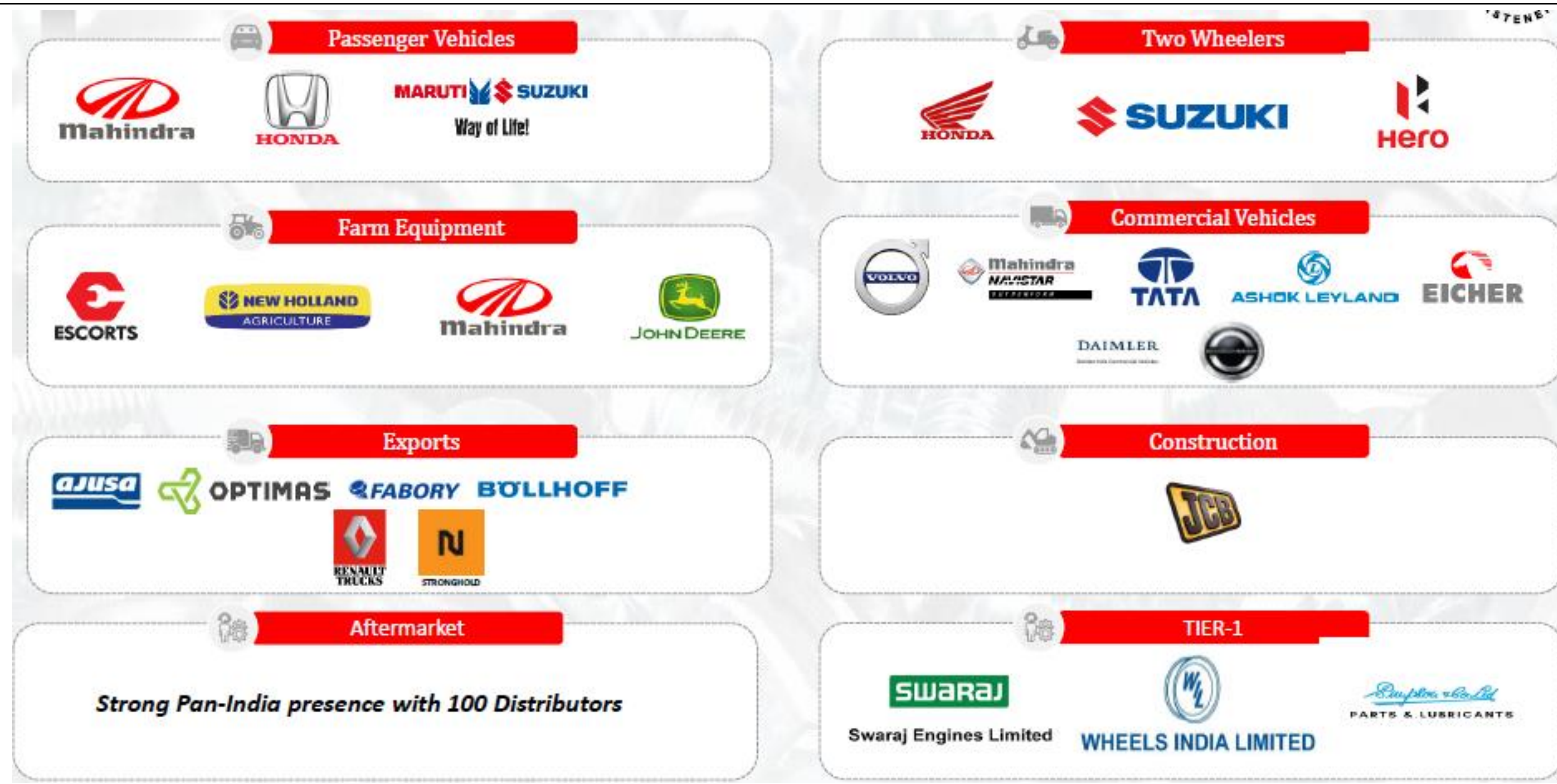
CV domestic sales volumes are expected to rise 31-33% on a low base of fiscal 2022 and grow 9-11% on a strong base of fiscal 2023 driven by improving fleet utilisation and transporter profitability levels, higher replacement demand and expectations of robust economic growth. Implementation of scrappage policy could also help. In 2W space, reopening of educational institutions and offices and positive rural sentiments backed by a regular monsoon and increased minimum support prices (MSPs) across crops, coupled with improved model availability and demand for electric vehicles (EVs), are expected to drive two-wheeler sales by 21-23% in fiscal 2023. Sales in fiscal 2024 are likely to be driven by expectations of a normal monsoon, coupled with improved model availability and demand for EVs.

Growing demand and the resultant rise in operating leverage is likely to boost profitability of auto ancillary companies like STL.

**Diversified revenue profile across automotive segments**

STL's revenue profile is well-diversified, catering to all major automotive segments, as well as some non-automotive segments. Furthermore, its dependence on each segment is limited, with commercial vehicles accounting for only 28% of its OEM revenues (FY2022), followed by passenger vehicles (PVs) (~27%), two-wheelers (~21%), and tractors (~15%). STL's diversified presence protects its revenues and earnings to some extent from demand downturns that impact specific automotive segments. The company caters to multiple OEMs across the automotive spectrum, with healthy share of business (SOB) with most leading OEMs and limited dependence on a single customer.

*Key Clientele - Fasteners*




*(Source: Company)*

**Increasing e-2W penetration**

Two wheelers and three wheelers account for over 80% of vehicle sales in India and domestic EV penetration is expected to be led by two-wheeler and three-wheeler segments. The favourable total cost of ownership (TCO), vehicle uptake from the delivery segment, and continued national and state-level subsidies are likely to boost sales.

STL forayed into the electric vehicle (EV) segment in Jan'20 through its partnership with Jiangsu Gtake of Shenzhen (China) called Sterling Gtake E-mobility Ltd (SGEM), through which it is manufacturing motor control units (MCUs) in India. It has become one of the largest e-2W MCU suppliers in India with a market share of 50% in high speed scooter segment, about 33% in overall 2W segment. It has an installed capacity of 300,000 MCUs and planning further expansion. SGEM received its first order worth Rs 60cr in July 2021 from an electric two-wheeler (e-2W) OEM, which was followed up by an additional order of Rs 100cr from the same OEM.

*EV penetration across vehicle segments over the medium term*

| EV penetration | FY22 | FY23 | FY24 | FY27 |
|---|---|---|---|---|
| Passenger vehicles | 1% | 1-3% | 2-4% | 6-8% |
| Two-wheelers | 3% | 4-6% | 8-10% | 22-24% |
| Three-wheelers | 5% | 9-11% | 14-16% | 31-33% |
| Light commercial vehicles | 0.0% | 0-1% | 0-2% | 3-4% |

*(Source: CRISIL, MI&A Research)*

A Motor Control Unit (MCU) is an electronic module that interfaces with the Motor as well as the Battery Pack to control the electric vehicle's speed, acceleration and range based on the throttle input. MCUs make upto 10% of electric 2W cost. SGEM has production orders from 11 EV OEMs and is in advanced stages of discussions with more than 30 automobile EV OEMs for their MCU requirements for different vehicle segments, including two wheelers, three wheelers, passenger vehicles and commercial vehicles.

Recently it acquired business from 2 of the top 4 LCV players for MCU. Realization from MCU for a LCV is ~6x as compared to a 2W and it increases further as the power rating increases. With increasing penetration of EVs, STL expects revenue of ~Rs 150cr from MCU in FY23.

**Collaboration with Meidoh opens market to Japanese manufacturers in India**
In 2017, STL entered into a technical collaboration with Japan based Meidoh Co. Ltd., a technology leader and leading player in high tension fasteners. Meidoh invested Rs 44cr for 5% stake in STL in 2018 (@Rs.246.6 per share). It is among the largest suppliers to Toyota and the collaboration has helped the company to improve its product development capabilities for specialised fasteners. Partnering with a Japanese company has also led to increased orders from Japanese manufacturers like Toyota and Maruti Suzuki.

**Invested in 3W Cargo manufacturer**
STL invested Rs 4cr in 3W EV cargo manufacturer Altigreen in FY19. The company is making vehicles as per Indian roads and Indian weather conditions to give riders the best possible experience. In Feb'22, Altigreen raised Rs 300 crore (USD 40 million) in a funding round for capacity expansion, new products launch and to develop a pan-India network. The Series A investment is led by Sixth Sense Ventures, along with Reliance New Energy, Xponentia Capital, Accurant International, USA and Momentum Venture Capital, Singapore. The freshly raised capital will be utilized to ramp up production capabilities, accelerate R&D, fast-paced EV adoption and develop a robust pan-India network to offer the best and cleanest last-mile transportation solutions in the country. Post this fund raising, STL's investment reflects large upside potential.

## Risks & Concerns

**Slowdown in automobile industry**
STL supplies mainly to automobile manufacturers across segments. Any slowdown in the automobile industry could impact its growth.

**Raw material price volatility**
Sharp increase in raw material prices could hurt its performance as there is a lag effect in passing on the increase to its clients.

**Susceptibility to pricing pressure from OEMs and peers**
STL may not able to pass on the increase in costs easily to OEMs and remains susceptible to increasing competition in the auto component segment, and pricing pressures from auto OEMs.

**Limited product diversification with fasteners constituting bulk of revenues**

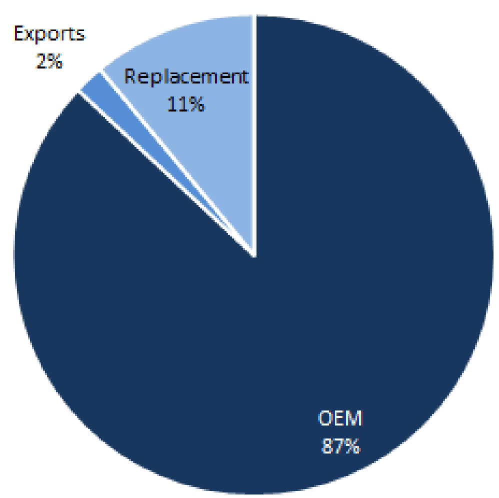
STL has historically operated in a single product category of fasteners, thereby limiting its product diversification and offerings. Although it has diversified into MCU, fasteners continue to account for more than 80% of revenues.

## Company Background:

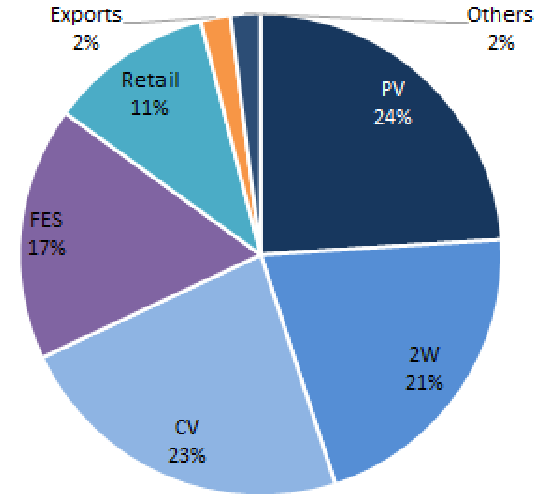
Established in 1979, STL manufactures and markets high tensile cold forged fasteners, primarily for the automobile industry. It currently offers a comprehensive product portfolio consisting of Standard, Chassis, Special and Engine Fasteners. At present, it is positioned as the second largest fastener manufacturer in India, after Sundaram Fasteners. The company caters to leading automotive companies in India and tier-I auto component manufacturers in USA, Europe, South America and the Middle East. STL's product portfolio includes fasteners, which find application in both automotive and non-automotive segments.

STL has three manufacturing plants at Faridabad, Ballabhgarh and Palwal (all in Haryana), with a fourth manufacturing plant near Bengaluru. The company has a total manufacturing capacity of approximately 38,000 MT per annum at its existing plants, with an additional ~10,000 MTPA capacity at its new facility in Karnataka.

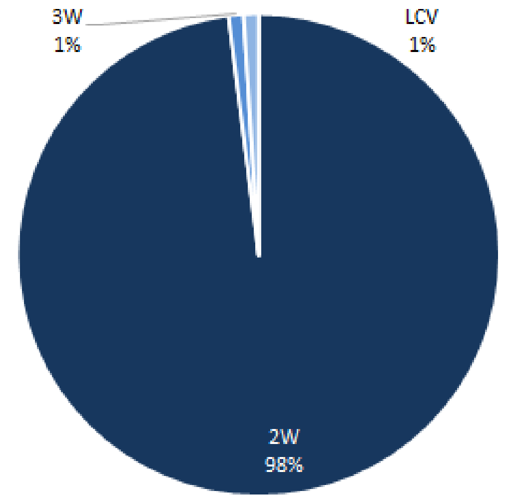
*Revenue breakup (Q3FY23)*




*Fastener business*




*EV business*




*(Source: Company, HDFC Sec)*

## Financials

### Income Statement

| (Rs cr) | FY21 | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|---|
| **Net Revenues** | **355** | **510** | **755** | **892** | **1017** |
| ***Growth (%)*** | ***-2.4*** | ***43.3*** | ***48.1*** | ***18.1*** | ***14.1*** |
| Operating Expenses | 294 | 443 | 652 | 765 | 866 |
| **EBITDA** | **62** | **67** | **102** | **126** | **151** |
| ***Growth (%)*** | ***1.6*** | ***7.7*** | ***53.7*** | ***23.4*** | ***19.7*** |
| ***EBITDA Margin (%)*** | ***17.4*** | ***13.1*** | ***13.6*** | ***14.2*** | ***14.9*** |
| Depreciation | 26 | 27 | 32 | 34 | 37 |
| Other Income | 3 | 3 | 11 | 12 | 14 |
| **EBIT** | **38** | **42** | **81** | **104** | **129** |
| Interest expenses | 8 | 7 | 9 | 9 | 9 |
| **PBT** | **31** | **35** | **72** | **95** | **120** |
| Tax | 7 | 9 | 18 | 24 | 30 |
| **Adj. PAT** | **24** | **26** | **54** | **71** | **90** |
| ***Growth (%)*** | ***-22.8*** | ***8.9*** | ***107.0*** | ***31.0*** | ***26.7*** |
| EPS | 6.7 | 7.3 | 15.0 | 19.7 | 24.9 |

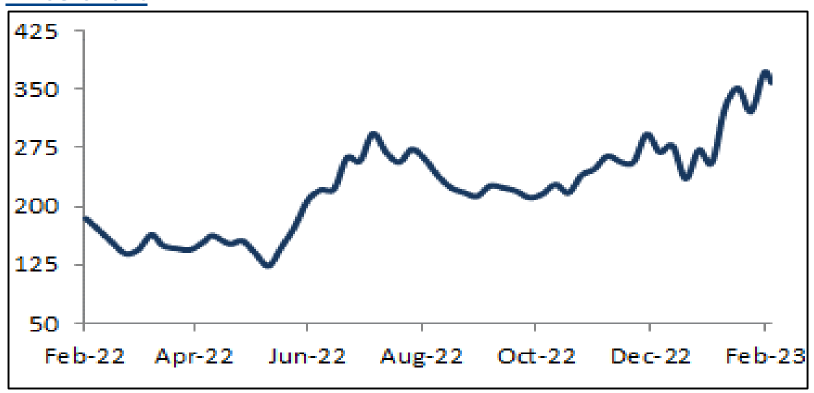
### Balance Sheet

| (Rs cr) | FY21 | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|---|
| **SOURCE OF FUNDS** | | | | | |
| Share Capital | 7 | 7 | 7 | 7 | 7 |
| Reserves | 324 | 349 | 395 | 455 | 532 |
| **Shareholders' Funds** | **331** | **356** | **402** | **462** | **539** |
| Total Debt | 105 | 109 | 109 | 89 | 64 |
| Net Deferred Taxes | 17 | 16 | 16 | 16 | 16 |
| Other Non-curr. Liab. | 17 | 16 | 24 | 29 | 33 |
| **Total Sources of Funds** | **470** | **498** | **552** | **597** | **652** |
| **APPLICATION OF FUNDS** | | | | | |
| Net Block & Goodwill | 257 | 280 | 273 | 274 | 268 |
| CWIP | 0 | 1 | 1 | 0 | 0 |
| Investments | 26 | 23 | 23 | 23 | 38 |
| Other Non-Curr. Assets | 13 | 13 | 19 | 22 | 25 |
| **Total Non Current Assets** | **296** | **318** | **316** | **320** | **332** |
| Inventories | 110 | 116 | 182 | 208 | 228 |
| Debtors | 42 | 47 | 72 | 91 | 98 |
| Cash & Equivalents | 32 | 23 | 16 | 14 | 36 |
| Other Current Assets | 37 | 46 | 56 | 61 | 65 |
| **Total Current Assets** | **220** | **232** | **326** | **373** | **428** |
| Creditors | 31 | 32 | 52 | 56 | 61 |
| Other Current Liab & Provisions | 16 | 20 | 39 | 40 | 46 |
| **Total Current Liabilities** | **47** | **52** | **90** | **96** | **107** |
| Net Current Assets | 174 | 180 | 236 | 277 | 321 |
| **Total Application of Funds** | **470** | **498** | **552** | **597** | **652** |

## Cash Flow Statement

| (Rs cr) | FY21 | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|---|
| Reported PBT | 30 | 35 | 72 | 95 | 120 |
| Non-operating & EO items | -1 | -1 | 2 | 1 | 1 |
| Interest Expenses | 5 | 5 | 9 | 9 | 9 |
| Depreciation | 26 | 27 | 32 | 34 | 37 |
| Working Capital Change | -37 | -16 | -62 | -43 | -21 |
| Tax Paid | -8 | -11 | -18 | -24 | -30 |
| **OPERATING CASH FLOW ( a )** | **16** | **40** | **35** | **72** | **115** |
| Capex | -17 | -51 | -25 | -35 | -30 |
| Free Cash Flow | -1 | -11 | 10 | 37 | 85 |
| Investments | -7 | 6 | 0 | 0 | -15 |
| Non-operating income | -25 | 6 | 0 | 0 | 0 |
| **INVESTING CASH FLOW ( b )** | **-49** | **-39** | **-25** | **-35** | **-45** |
| Debt Issuance / (Repaid) | 31 | 5 | 0 | -20 | -25 |
| Interest Expenses | -7 | -6 | -9 | -9 | -9 |
| FCFE | -10 | 0 | 1 | 8 | 36 |
| Share Capital Issuance | 0 | 0 | 0 | 0 | 0 |
| Dividend | 0 | -4 | -8 | -10 | -13 |
| Others | 0 | 0 | 0 | 0 | 0 |
| **FINANCING CASH FLOW ( c )** | **24** | **-5** | **-17** | **-40** | **-47** |
| **NET CASH FLOW (a+b+c)** | **-10** | **-4** | **-7** | **-3** | **23** |

## Price chart




## Key Ratios

| Particulars | FY21 | FY22 | FY23E | FY24E | FY25E |
|---|---|---|---|---|---|
| **Profitability Ratios (%)** | | | | | |
| EBITDA Margin | 17.4 | 13.1 | 13.6 | 14.2 | 14.9 |
| EBIT Margin | 10.8 | 8.3 | 10.7 | 11.7 | 12.7 |
| APAT Margin | 6.8 | 5.1 | 7.2 | 7.9 | 8.8 |
| RoE | 7.5 | 7.6 | 14.3 | 16.4 | 17.9 |
| RoCE | 9.7 | 9.4 | 16.6 | 19.6 | 22.3 |
| **Solvency Ratio (x)** | | | | | |
| Net Debt/EBITDA | 1.2 | 1.3 | 0.9 | 0.6 | 0.2 |
| Net D/E | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 |
| **Per Share Data (Rs)** | | | | | |
| EPS | 6.7 | 7.3 | 15.0 | 19.7 | 24.9 |
| CEPS | 14.0 | 14.9 | 24.1 | 29.3 | 35.1 |
| BV | 92.1 | 98.8 | 111.7 | 128.4 | 149.7 |
| Dividend | 1.0 | 1.0 | 2.2 | 2.9 | 3.7 |
| **Turnover Ratios (days)** | | | | | |
| Debtor days | 36 | 32 | 29 | 33 | 34 |
| Inventory days | 87 | 81 | 72 | 80 | 78 |
| Creditors days | 27 | 22 | 20 | 22 | 21 |
| **VALUATION (x)** | | | | | |
| P/E | 53.6 | 49.2 | 23.8 | 18.2 | 14.3 |
| P/BV | 3.9 | 3.6 | 3.2 | 2.8 | 2.4 |
| EV/EBITDA | 21.8 | 20.5 | 13.4 | 10.7 | 8.6 |
| EV / Revenues | 3.8 | 2.7 | 1.8 | 1.5 | 1.3 |
| Dividend Yield (%) | 0.3 | 0.3 | 0.6 | 0.8 | 1.0 |
| Dividend Payout (%) | 15.0 | 13.8 | 14.6 | 14.7 | 14.8 |

(Source: Company, HDFC sec)

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## 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.



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