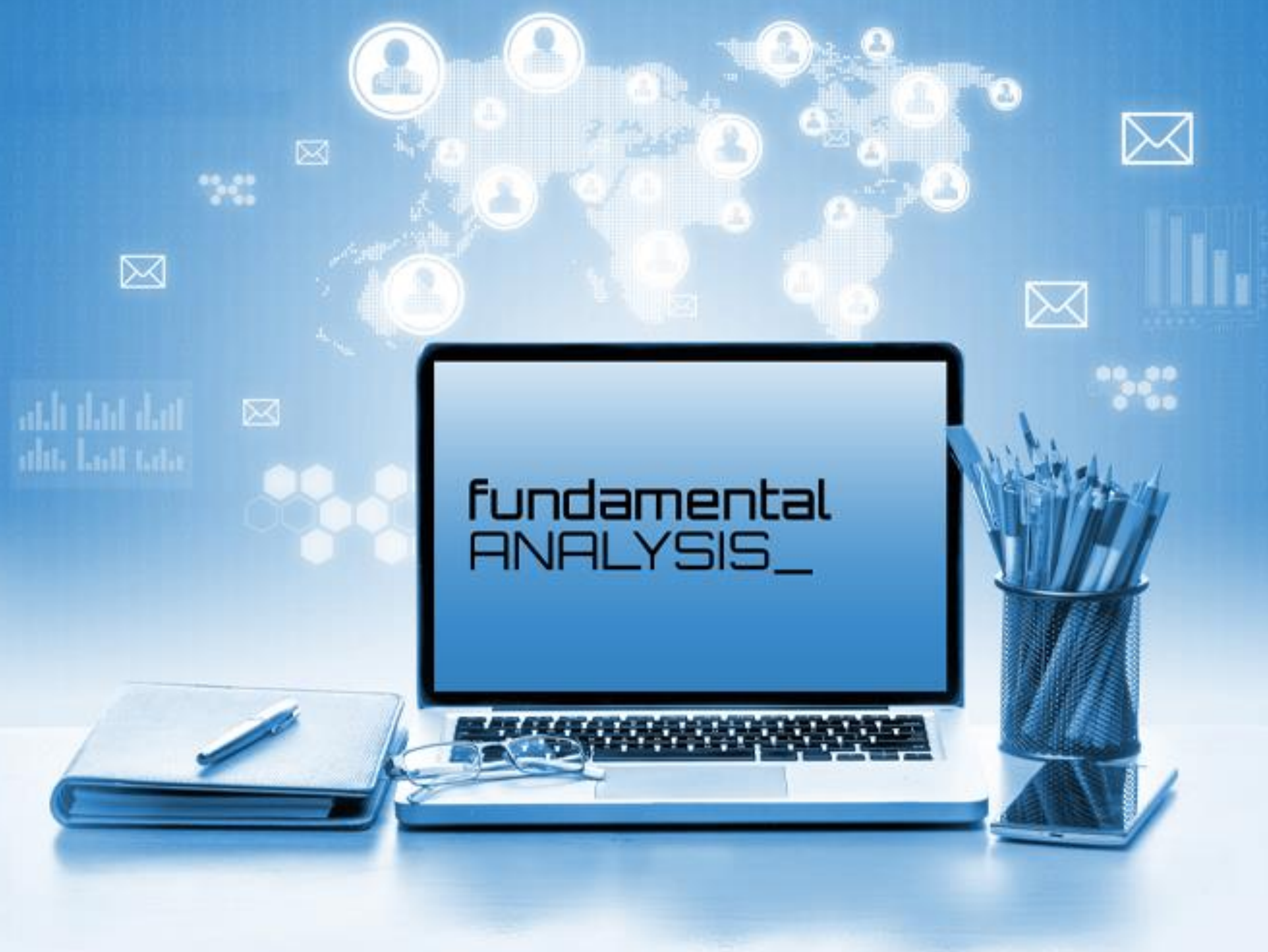
Stock Update

Sterling Tools Ltd.

September 11, 2023



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Sterling Tools Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Auto Ancillaries	Rs 369	Buy in Rs 365-375 band & add on dips in Rs 330-336 band	Rs 409	Rs 434	2-3 quarters

HDFC Scrip Code	STETOOEQNR
BSE Code	530759
NSE Code	STERTOOLS
Bloomberg	STRT IN
CMP Sep 8, 2023	368.8
Equity Capital (Rs cr)	7.2
Face Value (Rs)	2
Equity Share O/S (cr)	3.6
Market Cap (Rs cr)	1332
Book Value (Rs)	111.2
Avg. 52 Wk Volumes	191,000
52 Week High (Rs)	449.8
52 Week Low (Rs)	199.1

Share holding Pattern % (Jun 2023)	
Promoters	65.8
Institutions	5.6
Non Institutions	28.6
Total	100.0

* 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) suppliers 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 company has orders from 16 clients for MCU of which 8 have started production and the remaining are expected in H2FY24. STL has also invested in 3W cargo EV manufacturer 'Altigreen', which is showing rapid growth and could lead to a valuation uptick.

Margins were impacted in recent quarters due to material inflation which is being passed on to the customers. Management has guided for EBITDA margin of 15-16% for FY24. With minimum capex requirement, strong cash flows, comfortable debt levels and expanding product portfolio, we believe that STL has strong growth opportunities.

On February 8, 2023, we had initiated coverage on the company (Link) with a recommendation to 'Buy in Rs 355-360 band & add on dips in Rs 317-322 band' for base case fair value of Rs 401 and bull case fair value of Rs 425. Both targets were achieved within the given timeframe.

Valuation & Recommendation:

We expect STL's Revenue/EBITDA/PAT to grow at 24/28/37% CAGR over FY23-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 365-375 band and add on dips in Rs 330-336 band (13.5x FY25E EPS) for a base case fair value of Rs 409 (16.5x FY25E EPS) and bull case fair value of Rs 434 (17.5x FY25E EPS) over the next 2-3 quarters.

Financial Summary

(Rs cr)	Q1FY24	Q1FY23	YoY (%)	Q4FY23	QoQ (%)	FY22	FY23	FY24E	FY25E
Operating Income	221	174	26.9	212	4.2	510	772	976	1,184
EBITDA	25	22	15.7	22	13.5	67	98	129	160
APAT	13	10	36.3	8	68.0	26	48	68	89
Diluted EPS (Rs)	3.6	2.7	36.2	2.2	68.0	7.3	13.3	19.0	24.8
RoE-%						7.6	12.7	15.9	18.0
P/E (x)						50.8	27.7	19.4	14.9
EV/EBITDA (x)						21.1	14.4	11.0	8.8

(Source: Company, HDFC sec)

Q1FY24 Result Review

STL continued to report strong numbers for Q1FY24 driven by pick up in MCU segment. Consolidated revenue increased by 27% to Rs 221cr. MCU revenue doubled to Rs 74cr YoY despite a slowdown in June due to reduction of FAME-II subsidies for 2W EV manufacturers. EBITDA increased by 16% YoY to Rs 25cr and EBITDA margin contracted 150bps to 11.5% on account of higher revenue from MCU segment. However, sequentially EBITDA margin expanded 90bps. PAT for the quarter came in at Rs 13cr, up 36% YoY while PAT margin expanded 40bps to 5.9%. The management has guided for EBITDA margins of 15-16% for FY24 while maintaining the revenue run rate.

Key updates

Improving 2W EV sales

Electric two-wheeler sales which had witnessed a significant fall in June this year, are slowly reviving and are experiencing an increase in July despite the FAME II subsidy reduction. The total two-wheeler sales in India increased by more than 18% MoM despite the subsidy reduction. In the first seven months of CY2023, 489,622 units were sold, up 59.51% YoY growth. STL's JV with GTake (100% stake by STL - STL has infused a total equity of Rs 28.5cr over FY2021-FY2023) has ~40% market share in high-speed scooter segment and ~30% overall in 2W segment. It has an installed capacity of 300,000 MCUs and expanding it to 600,000 MCUs by the end of FY24. It has a healthy order book with improving margins. STL has 16 confirmed contracts for its MCUs which would drive topline growth going forward.

Going by the standard definition, the MCU is a critical part which is more like an electronics package that operates between the batteries and the motor to control the electric vehicle's speed and acceleration much like a carburetor does in a gasoline-powered vehicle.

EV penetration across vehicle segments over the medium term

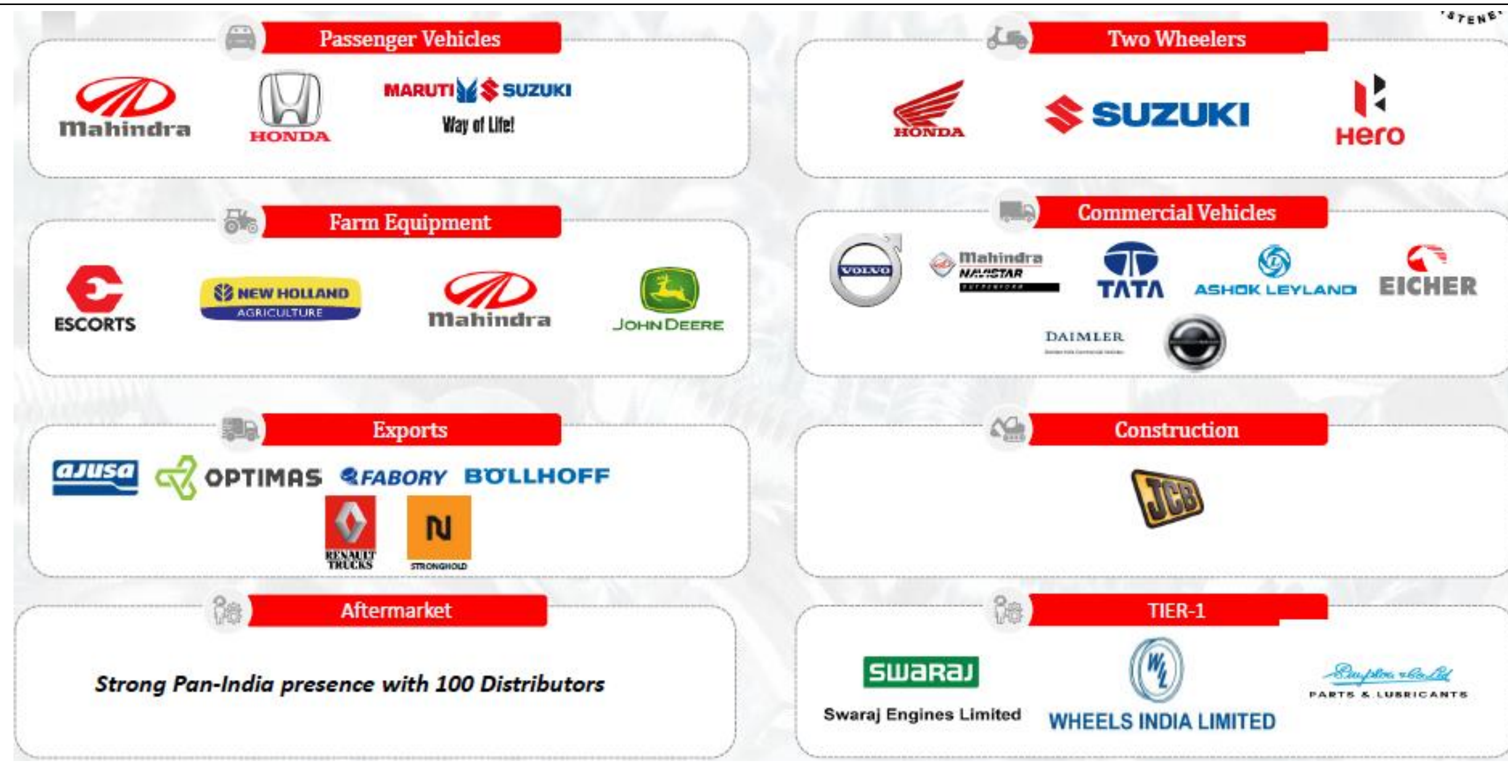
EV penetration	FY22	FY23	FY24	FY27
Passenger vehicles	1%	1-3%	2-4%	6-8%
Two-wheelers	3%	4-6%	8-10%	22-24%
Three-wheelers	5%	9-11%	14-16%	31-33%
Light commercial vehicles	0.0%	0-1%	0-2%	3-4%

(Source: CRISIL, MI&A Research)

Expanding clientele with entry into MCU for LCV
STL has expanded its product offering by developing MCU for Light Commercial vehicles (LCV). LCVs witnessed ~27% increase in sales in FY23. Revenue from LCV segment is expected to start from Q3FY24.

Diversified revenue profile across automotive segments
STL's revenue profile in fasteners 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 25% of its OEM revenues (FY23), followed by passenger vehicles (PVs) (~24%), two-wheelers (~20%), and tractors (~16%). 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)

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. It is further looking to raise Rs 700cr for its next round of production at a valuation of $350 million. With the funding, the company aims to speed up the production of its three-wheelers and invest in new models. 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 70% of revenues. Even in EV MCU business, the JV supplies largely to one customer and relies on one product.

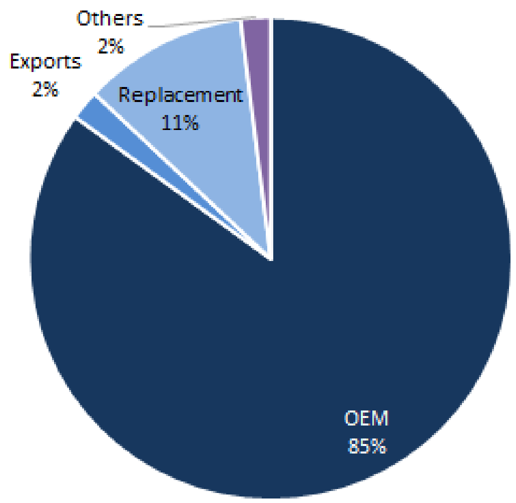
Company Background:

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.

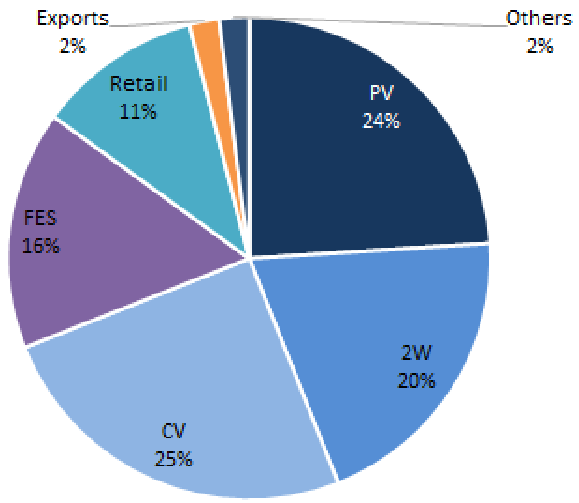
For Sterling Tools, direct supply to the OEMs is the major component of the business (as much as 85%), followed by replacement (11%), exports (2%) and others (2%).

STL has four manufacturing plants at Faridabad, Ballabhgarh, Palwal (all in Haryana) and near Bengaluru. The company has a total manufacturing capacity of approximately 48,000 MT per annum at its existing plants. It has initiated capacity expansion of MCU from 3,00,000 to 6,00,000 units per annum.

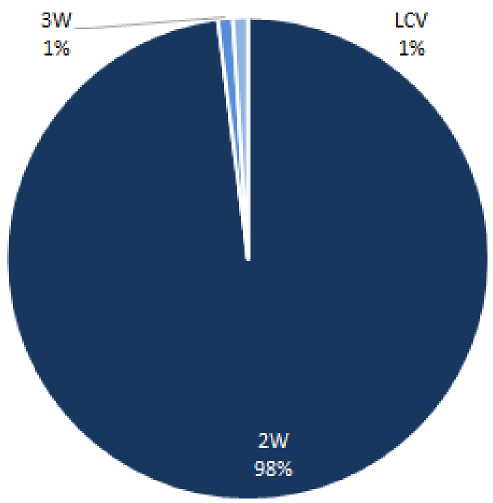
Revenue breakup (FY23)



Fastener business



EV business



(Source: Company, HDFC Sec)

Financials

Income Statement

(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
Net Revenues	**355**	**510**	**772**	**976**	**1184**
Growth (%)	***-2.4***	***43.3***	***51.5***	***26.4***	***21.3***
Operating Expenses	294	443	674	847	1024
EBITDA	**62**	**67**	**98**	**129**	**160**
Growth (%)	***1.6***	***7.7***	***46.6***	***32.1***	***24.0***
EBITDA Margin (%)	***17.4***	***13.1***	***12.6***	***13.2***	***13.5***
Depreciation	26	27	32	33	34
Other Income	3	3	3	7	8
EBIT	**38**	**42**	**69**	**103**	**134**
Interest expenses	8	7	9	12	15
PBT	**31**	**35**	**63**	**91**	**119**
Tax	7	9	15	23	30
Adj. PAT	**24**	**26**	**48**	**68**	**89**
Growth (%)	***-22.8***	***8.9***	***83.2***	***42.7***	***30.7***
EPS	6.7	7.3	13.3	19.0	24.8

Balance Sheet

(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
SOURCE OF FUNDS					
Share Capital	7	7	7	7	7
Reserves & Surplus	324	349	393	451	527
Shareholders' Funds	**331**	**356**	**400**	**459**	**535**
Total Debt	105	109	133	138	133
Net Deferred Taxes	17	16	16	16	16
Other Non-curr. Liab.	17	16	9	11	14
Total Sources of Funds	**470**	**498**	**558**	**624**	**697**
APPLICATION OF FUNDS					
Net Block & Goodwill	257	280	275	278	282
CWIP	0	1	11	6	3
Investments	26	23	20	20	20
Other Non-Curr. Assets	13	13	11	14	16
Total Non Current Assets	**296**	**318**	**317**	**318**	**322**
Inventories	110	116	163	214	266
Debtors	42	47	81	103	120
Cash & Equivalents	32	23	55	46	54
Other Current Assets	37	46	39	58	70
Total Current Assets	**220**	**232**	**338**	**420**	**510**
Creditors	31	32	58	70	81
Other Current Liab & Provisions	16	20	39	44	53
Total Current Liabilities	**47**	**52**	**97**	**113**	**134**
Net Current Assets	174	180	241	306	376
Total Application of Funds	**470**	**498**	**558**	**624**	**697**

Cash Flow Statement

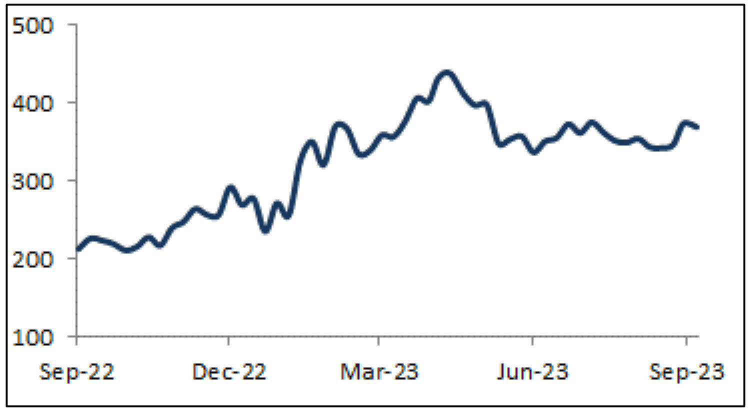
(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
Reported PBT	30	35	63	91	119
Non-operating & EO items	-1	-1	4	0	0
Interest Expenses	5	5	12	12	15
Depreciation	26	27	32	33	34
Working Capital Change	-37	-16	-32	-75	-61
Tax Paid	-8	-11	-16	-23	-30
OPERATING CASH FLOW (a)	**16**	**40**	**63**	**38**	**77**
Capex	-17	-51	-32	-30	-35
Free Cash Flow	-1	-11	30	8	42
Investments	-7	6	3	0	0
Non-operating income	-25	6	-24	0	0
INVESTING CASH FLOW (b)	**-49**	**-39**	**-54**	**-30**	**-35**
Debt Issuance / (Repaid)	31	5	7	5	-5
Interest Expenses	-7	-6	-8	-12	-15
FCFE	-10	0	8	1	22
Share Capital Issuance	0	0	0	0	0
Dividend	0	-4	-4	-10	-13
Others	0	0	0	0	0
FINANCING CASH FLOW (c)	**24**	**-5**	**-5**	**-17**	**-33**
NET CASH FLOW (a+b+c)	**-10**	**-4**	**4**	**-9**	**9**

Key Ratios

Particulars	FY21	FY22	FY23	FY24E	FY25E
Profitability Ratios (%)					
EBITDA Margin	17.4	13.1	12.6	13.2	13.5
EBIT Margin	10.8	8.3	8.9	10.6	11.3
APAT Margin	6.8	5.1	6.2	7.0	7.5
RoE	7.5	7.6	12.7	15.9	18.0
RoCE	9.7	9.4	13.8	18.2	21.3
Solvency Ratio (x)					
Net Debt/EBITDA	1.2	1.3	0.8	0.7	0.5
Net D/E	0.2	0.2	0.2	0.2	0.1
Per Share Data (Rs)					
EPS	6.7	7.3	13.3	19.0	24.8
CEPS	14.0	14.8	22.1	28.0	34.2
BV	92.1	98.8	111.2	127.3	148.4
Dividend	1.0	1.0	2.0	2.8	3.7
Turnover Ratios (days)					
Debtor days	36	32	30	34	34
Inventory days	87	81	66	71	74
Creditors days	27	22	21	24	23
VALUATION (x)					
P/E	55.3	50.8	27.7	19.4	14.9
P/BV	4.0	3.7	3.3	2.9	2.5
EV/EBITDA	22.5	21.1	14.4	11.0	8.8
EV / Revenues	3.9	2.8	1.8	1.5	1.2
Dividend Yield (%)	0.3	0.3	0.5	0.8	1.0
Dividend Payout (%)	15.0	13.8	15.0	14.8	14.9

(Source: Company, HDFC sec)

Price chart



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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.

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