Stock Note

Swaraj Engines Ltd.

December 18, 2023

RETAILRESEARCH

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Swaraj Engines Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Auto Ancillaries	Rs 2280	Buy in Rs 2260-2300 band & add on dips in Rs 2020-2060 band	Rs 2493	Rs 2688	2-3 quarters

HDFC Scrip Code	SWAENGEQNR
BSE Code	500407
NSE Code	SWARAJENG
Bloomberg	SWE IN
CMP Dec 15, 2023	2280.2
Equity Capital (Rs cr)	12.2
Face Value (Rs)	10
Equity Share O/S (cr)	1.2
Market Cap (Rs cr)	2772
Book Value (Rs)	254
Avg. 52 Wk Volumes	13,700
52 Week High (Rs)	2299.0
52 Week Low (Rs)	1513.2

Share holding Pattern % (Sep 2023)	
Promoters	52.1
Institutions	12.0
Non Institutions	35.9
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:

Swaraj Engines (SEL) has a strong brand value and has a key role to play in the increase of farm mechanisation in India. The largely in line monsoon, current lower penetration, the government's thrust on agri-mechanization, and the scarcity of inexpensive farm labour are some of the key drivers for the tractor industry and, in turn, for Swaraj Engines in the long run. India remains a highly lucrative tractor market because of the decreasing availability of farm labor. Capacity expansion as per needs enables the company to remain debt-free. M&M has launched a new range of compact lightweight tractors under the Swaraj brand which is likely to benefit SEL.

SEL is debt-free company with healthy cash flows resulting in superior return ratios. Being a subsidiary of M&M – the largest tractor manufacturer in the country – provides the company with ready business. Due to its limited capex needs, SEL pays out most of its earnings in the form of dividends and has an attractive dividend yield of 4%.

Valuation & Recommendation:

The tractor industry experienced a 6% surge in domestic sales on a year-on-year basis in November, reaching a total of 72,266 units, but 38% fall when compared to the preceding month of October. For the April-November 2023 period, total domestic tractor sales reached 6.6 lakh units, showing a 3% decline. The decline in tractor sales seem to have come to an end. The impact of El Nino on monsoons, resulting in below-average rainfall in key agricultural regions, along with cyclicality and a high base have so far led to this fall.

We expect revenue/EBITDA/PAT of the company to grow at CAGR of 8/8/9% over FY23-FY25E on the back of higher volumes driven by increasing farm mechanization in India. We think the stock can be rerated more by valuations than earnings for the near term. We believe investors can buy the stock in the band of Rs 2260-2300 and add on dips in Rs 2020-2060 band (15.75x FY25E EPS) for a base case fair value of Rs 2493 (19.25x FY25E EPS) and bull case fair value of Rs 2688 (20.75x FY25E EPS) over the next 2-3 quarters.

Financial Summary

Particulars (Rs cr)	Q2FY24	Q2FY23	YoY (%)	Q1FY24	QoQ (%)	FY22	FY23	FY24E	FY25E
Operating Income	389	385	1.1	400	-2.7	1,138	1,422	1,508	1,645
EBITDA	52	51	3.2	55	-5.5	155	186	199	217
APAT	38	36	5.0	41	-7.9	109	134	145	157
Diluted EPS (Rs)	31.0	29.6	4.9	33.7	-7.9	90.2	110.0	119.2	129.5
RoE (%)						37.3	41.2	40.8	41.2
P/E (x)						25.3	20.7	19.1	17.6
EV/EBITDA (x)						17.0	14.1	13.2	12.0

(Source: Company, HDFC sec)

Q2FY24 Result Review

SEL reported subdued results for Q2FY24 with flattish revenue at Rs 389cr, on account of falling realization. Sales volume increased 3% YoY to 37876 units while average realization fell 2% to Rs 1.03 lakh. The impact of material inflation moderated resulting in gross margin expansion of 105bps YoY to 21.1%. On a sequential basis gross margin expanded 40bps. EBITDA grew by 3% YoY to Rs 52cr as SEL benefitted from operating leverage. EBITDA margin expanded 30bps YoY to 13.4%. PAT increased by 5% yoy to Rs 38cr while PAT margins improved by 36 bps to 9.7%.

The management has enhanced the capacity expansion target to 1.95 lakh units from 1.8 lakh earlier and compared to 1.5 lakh current capacity. Funds for the expansion would be met through internal accruals.

Recent Developments

New launches and capacity expansion augurs well

Swaraj Tractors launched a new range of compact lightweight tractors with price starting from Rs 5.35 lakh (ex-showroom). The company said it will roll out two models -- Target 630 and Target 625 -- in 20-30 HP category under the new Target range. The introduction of Swaraj Target opens a new segment for growth of Swaraj Tractors and facilitates horticulture mechanisation, a fast-growing segment in Indian agriculture. It has also announced plans to launch a new tractor platform.

SEL has been expanding capacities every few years to cater to the increased demand for its engines. Currently it has plans to increase its manufacturing capacity from 1.5 lakh units to 1.95 lakh units, through internal accruals. We have built in volume growth of 6% CAGR from FY23-FY25 for the company.

Tractor growth momentum to continue albeit at slower pace

In FY23, tractor sales volumes grew by ~10% to hit a record high of Rs 9.44 lakh units as farm sentiment remained healthy after another good monsoon and increase in Minimum Support Price (MSP) for the 2022-23 market season. According to Crisil, domestic tractor sales volume growth is seen halving to 4-6% in FY24 from a high base created by a CAGR of 10% over FY20-FY22 on the back of successive normal monsoons. Tractor volume growth will be driven by both, the farm and commercial segments. The 5% increase in MSP for wheat for the ongoing rabi crop will improve farm incomes, while the government's infrastructure push and higher construction activity is expected to drive commercial demand.

Government support for rural economy

Government initiatives toward rural development, farm mechanization, and various factors, such as high rural wages and scarcity of farm labor, are likely to increase the tractor volume over the long term. In terms of units, India is one of the largest tractor markets globally, selling over 900,000 tractors per annum.

After increasing the minimum support prices (MSP) for rabi crops last year, the Government announced a 5.3% to 10.35% hike in MSP of all mandated Kharif crops for marketing season 2023-24, with moong seeing the highest increase and urad the lowest. In the 2022-23 marketing season, the increase in kharif crop MSP was recorded in the range of 4.44% to 8.86%. Regular increases in MSP would drive higher farm income which is essential for increased tractor sales.

Decreasing labor availability to drive higher mechanization

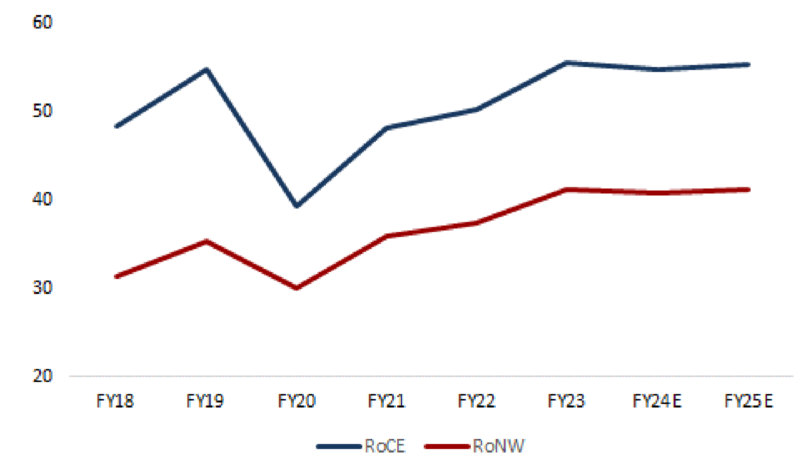
With economic growth there are many other opportunities available for employment for the working population and the availability of cheap labor for agricultural needs is gradually decreasing. This has given rise to innovative business models, such as custom hiring solutions for tractors. Many State Governments have launched schemes to provide subsidy for the purchase of tractors and other equipments to increase the mechanization of agriculture. Thus, with the rising government support for enhancing farm mechanizations and expansion in crop production, the sale of agriculture tractors is anticipated to rise in the upcoming years.

Strong financial matrix

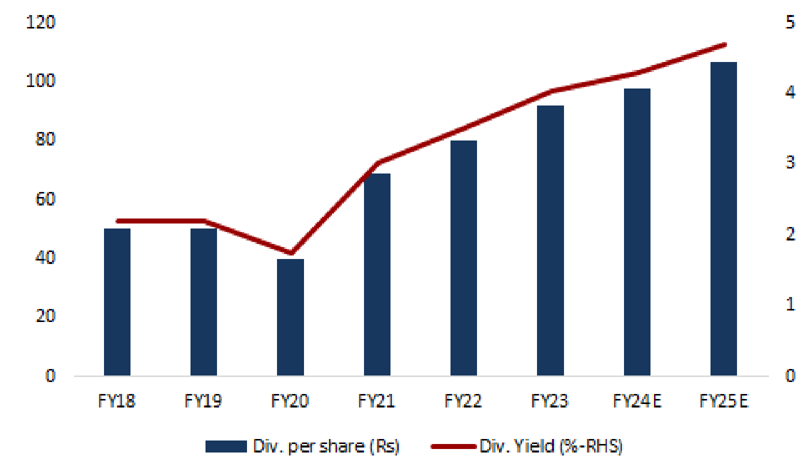
Swaraj Engines operates with a low working capital cycle and has a debt-free balance sheet with good free cash flow generation. With its debt-free status and strong cash pile of Rs 135cr, the company is able to withstand adverse business cycles like the one witnessed during Covid. Also, dividend payout of the company has been strong in excess of 80% for the past three years, resulting in a good dividend yield of 4% (based on FY23 dividend).

Over the last 5 years its topline has grown at CAGR of 13% driven by increased sales volume. However, the company has absorbed increase in raw material expenses to some extent in the last few years resulting in EBITDA/PAT margin declining 170/100 bps to 13.1%/9.4% respectively. We have built in 12% CAGR topline growth for the company over FY23-FY25. With material inflation cooling down, we expect EBITDA/PAT margins to expand 90/70 bps to 14%/10.1%. Capacity expansion would be met through internal accruals and the company does not require to take on any debt.

Return ratios set to increase (%)



Dividend payout to remain strong



(Source: Company, HDFC sec)

Risks & Concerns

High correlation with monsoons

The tractor industry volume growth has a high correlation with the deviation of monsoons from their long-term average. 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.

Slowdown in rural economy

Tractors are largely used in rural areas for agriculture, haulage and transportation purposes. Any slowdown in the rural economy could impact the demand for tractors.

Lower operating leverage

SEL has expanded capacity on expectations of higher volume growth. Delays in volume growth would result in deferral in fixed costs recovery impacting the net margins.

High competitive intensity

Although M&M has the highest market share in the tractor industry and Swaraj is a well-known brand, there are a large number of international players vying for a pie in the Indian tractor market. Higher competitive intensity could result in slower growth for M&M and in turn for SEL.

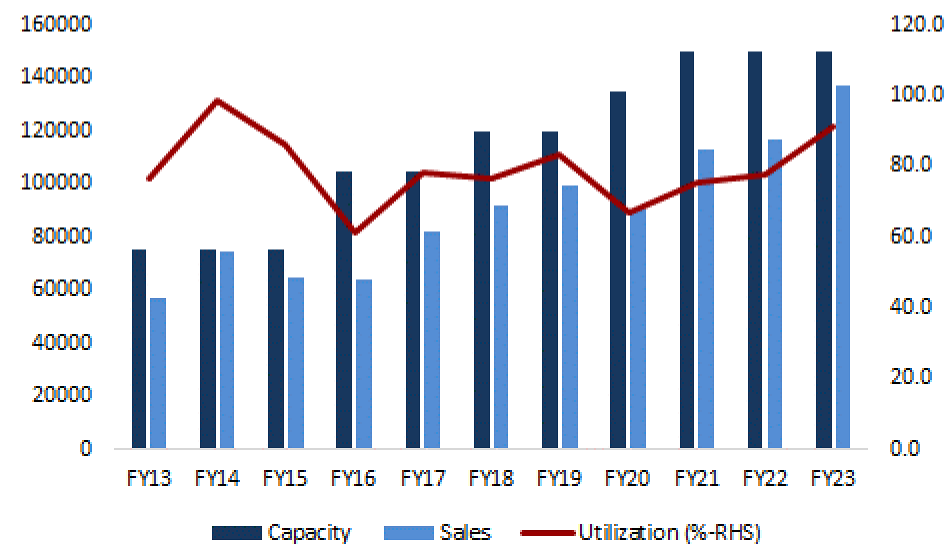
Client concentration

Over 90% of the revenues of SEL come from manufacturing and supplying engines to Swaraj brand of tractors, part of the Mahindra group. Further more than 90% of M&M's engine requirements for Swaraj tractors is met by SEL. In case sales of 'Mahindra' brand grows faster than that of 'Swaraj' brand, then SEL may not participate fully in the upside of tractor sales growth.

Company Background:

Swaraj Engines Limited (SEL) is a Punjab based company originally established to manufacture engines for the erstwhile Punjab Tractors Ltd (PTL). The Company was a joint venture between PTL and Kirloskar Oil Engines Ltd (KOEL). Shareholding of KOEL was shifted to Kirloskar Inds Ltd in FY11. Post the acquisition of PTL by Mahindra & Mahindra (M&M) in FY07, SEL now manufactures diesel engines for M&M tractors. Besides diesel engines the company is also into manufacturing high tech engine components for Swaraj Mazda and spare parts. Engine business constitutes over 96% of SEL's revenues with the remaining coming from components and spare parts business. The company is equipped with highly productive & precise quality analyzing machines. Till date SEL has supplied over 1.45 mn engines for fitment into Swaraj tractors. M&M acquired Kirloskar's stake in Sep'22 and currently owns 52.1% stake in the company, making it a subsidiary of M&M. SEL has an installed capacity of 1.5 lacs engines (p.a.), which it plans to enhance to 1.95 lacs.

Manufacturing capacity and utilization



(Source: Company, HDFC sec)

Financials

Income Statement

(Rs cr)	FY21	FY22E	FY23	FY24E	FY25E
Net Revenues	**987**	**1138**	**1422**	**1508**	**1645**
Growth (%)	***27.6***	***15.4***	***24.9***	***6.0***	***9.1***
Operating Expenses	851	983	1235	1309	1428
EBITDA	**136**	**155**	**186**	**199**	**217**
Growth (%)	***35.1***	***14.6***	***20.0***	***6.7***	***9.1***
EBITDA Margin (%)	***13.7***	***13.7***	***13.1***	***13.2***	***13.2***
Depreciation	20	18	19	20	21
Other Income	9	10	12	15	15
EBIT	**124**	**147**	**180**	**195**	**211**
Interest expenses	0	0	0	0	0
PBT	**124**	**147**	**180**	**194**	**211**
Tax	32	37	46	50	54
PAT	**93**	**109**	**134**	**145**	**157**
Growth (%)	***30.2***	***18.3***	***22.0***	***8.4***	***8.6***
EPS	76.2	90.2	110.0	119.2	129.5

Balance Sheet

As at March (Rs cr)	FY21	FY22E	FY23	FY24E	FY25E
SOURCE OF FUNDS					
Share Capital	12	12	12	12	12
Reserves & Surplus	268	294	330	356	383
Shareholders' Funds	**281**	**306**	**342**	**368**	**395**
Minority Interest	0	0	0	0	0
Total Debt	0	0	0	0	0
Net Deferred Taxes	1	0	-1	-1	-1
Other Non-curr. Liab.	0	0	1	1	1
Total Sources of Funds	**281**	**306**	**342**	**368**	**395**
APPLICATION OF FUNDS					
Net Block & Goodwill	92	95	88	120	127
CWIP	1	2	2	5	3
Investments	34	36	26	59	92
Other Non-Curr. Assets	6	37	57	35	22
Total Non Current Assets	**133**	**170**	**172**	**220**	**244**
Inventories	62	62	70	83	87
Debtors	113	104	128	149	153
Cash & Equivalents	117	91	109	78	79
Other Current Assets	33	35	56	42	54
Total Current Assets	**325**	**292**	**363**	**353**	**373**
Creditors	164	130	166	178	189
Other Current Liab & Provisions	13	26	27	27	33
Total Current Liabilities	**177**	**156**	**193**	**205**	**222**
Net Current Assets	148	136	170	148	151
Total Application of Funds	**281**	**306**	**342**	**368**	**395**

Cash Flow Statement

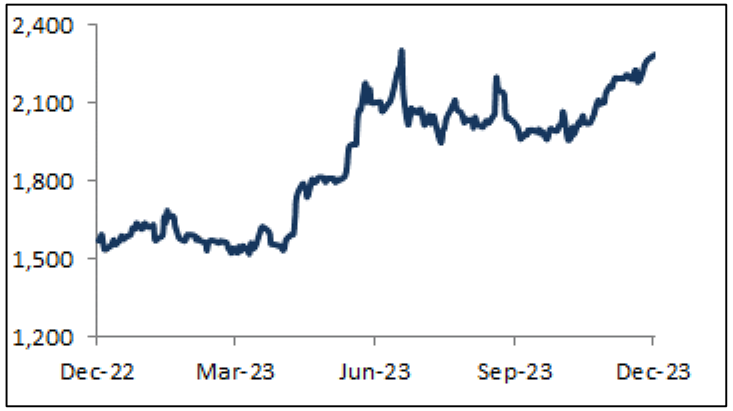
(Rs cr)	FY21	FY22E	FY23	FY24E	FY25E
Reported PBT	124	147	180	194	211
Non-operating & EO items	0	-1	0	21	13
Interest Expenses	-8	-8	-11	0	0
Depreciation	20	18	19	20	21
Working Capital Change	-72	-14	-6	-9	-3
Tax Paid	-36	-38	-48	-50	-54
OPERATING CASH FLOW (a)	**28**	**103**	**133**	**176**	**189**
Capex	-5	-21	-11	-55	-25
Free Cash Flow	23	82	122	121	164
Investments	77	-2	12	-33	-33
Non-operating income	-55	-28	-38	0	0
INVESTING CASH FLOW (b)	**16**	**-51**	**-38**	**-88**	**-58**
Debt Issuance / (Repaid)	0	0	0	0	0
Interest Expenses	0	0	0	0	0
FCFE	44	52	95	88	131
Share Capital Issuance	0	0	0	0	0
Dividend	-49	-84	-97	-119	-130
Others	0	0	0	0	0
FINANCING CASH FLOW (c)	**-49**	**-84**	**-97**	**-119**	**-130**
NET CASH FLOW (a+b+c)	**-4**	**-32**	**-2**	**-31**	**1**

Key Ratios

	FY21	FY22E	FY23	FY24E	FY25E
Profitability Ratios (%)					
EBITDA Margin	13.7	13.7	13.1	13.2	13.2
EBIT Margin	12.6	12.9	12.6	12.9	12.8
APAT Margin	9.4	9.6	9.4	9.6	9.6
RoE	35.8	37.3	41.2	40.8	41.2
RoCE	48.2	50.1	55.5	54.8	55.4
Solvency Ratio (x)					
Net Debt/EBITDA	-0.9	-0.6	-0.6	-0.4	-0.4
Net D/E	-0.4	-0.3	-0.3	-0.2	-0.2
PER SHARE DATA (Rs)					
EPS	76.2	90.2	110.0	119.2	129.5
CEPS	92.5	105.1	125.2	135.3	146.5
BV	231.1	251.8	281.7	302.9	325.4
Dividend	69.0	80.0	92.0	98.0	107.0
Turnover Ratios (days)					
Debtor days	22	35	30	34	34
Inventory days	18	20	17	19	19
Creditors days	49	47	38	42	41
VALUATION (x)					
P/E	29.9	25.3	20.7	19.1	17.6
P/BV	9.9	9.1	8.1	7.5	7.0
EV/EBITDA	19.3	17.0	14.1	13.2	12.0
EV / Revenues	2.7	2.3	1.9	1.7	1.6
Dividend Yield (%)	3.0	3.5	4.0	4.3	4.7
Dividend Payout (%)	90.5	88.7	83.7	82.2	82.6

(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.

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