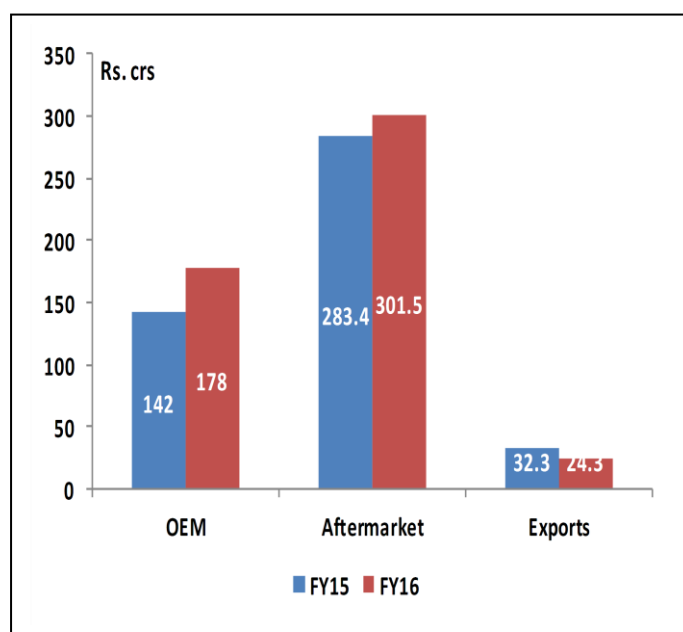
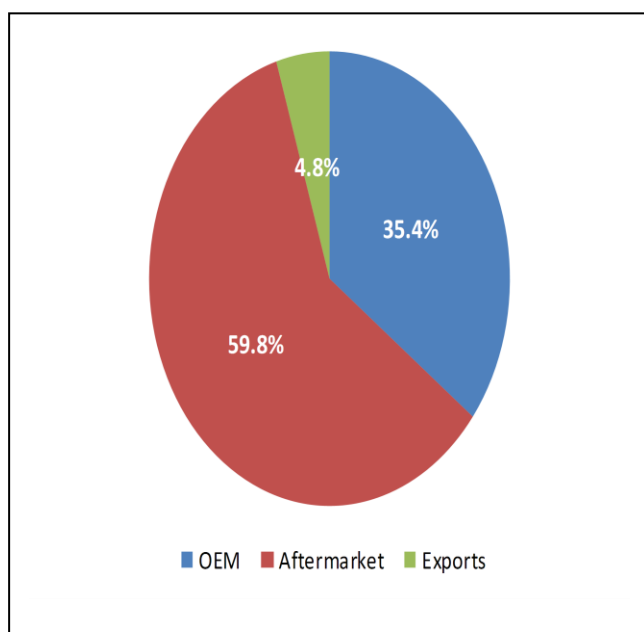




## Stock Idea- Setco Automotives Ltd.

Setco Automotive Ltd (SAL) is the largest manufacturer of clutches for commercial vehicles. The company has a market share of 85% in the MHCV OEM segment, supplying to majors like Tata Motors, Ashok Leyland, Volvo-Eicher, Bharat Benz, Asia Motor Works and Mahindra & Mahindra. In the MHCV replacement segment, SAL has a market share of about 65%. SAL's products are sold under the "Lipe" brand. It has four manufacturing facilities; two in India (Gujarat and Uttarakhand) and one each in the US and the UK with Gujarat plant being the biggest one. Setco had entered into technological collaboration with Lipe, a unit of US based Dana Corporation, which it later acquired in 2005-06. Setco was a 'sick' unit in 1997-98 with network of -30 crore before the management team lead by Harish Sheth turned it around to profit making unit.



### OEM business to continue to sustain momentum

Company continues to protect its market share in MHCV at ~85-90% and it works with almost all OEMs. MHCV cycle is expected to continue for another 2-3 years on the back of reforms in the infrastructure, industrial and mining sectors. Applicability of scrappage policy, which the Govt. is keen on implementation, will give further impetus to MHCV vehicles. Thus a secular growth can be seen in MHCV OEM business over next 4-5 years.



*Entry into LCV and Farm Equipment sector to de-risk business model*

To de-risk its business (MHCV segment is ~90% of sales), company has also started working with LCVs and Tractor manufacturers. Given that the MHCV players it works with also manufactures LCVs, it would be easier for the company to increase its wallet share in LCV segment. It is already present in Tata's ACE.

**Aftermarket business to grow through both the channels**

Aftermarket sales form ~60% of Setco's revenues. Setco is also a market leader in MHCV aftermarket segment with share of ~65%. Company operates in aftermarket through two channels:

- Original Equipment Supplier (OES): Herein company uses dealer network of its OEM clients to sell its products. This segment generally caters to the replacement demand in initial 5 years of the commercial vehicle's life or the first ownership cycle. Since after buying a vehicle the buyer generally prefers service of the OEM, through this channel Setco can reach out to them.
- Independent: In last couple of years, Setco also started selling its product in aftermarket under its own brand name. By entering into this segment, company is able to service clutches in the entire vehicle lifecycle after the first ownership cycle;

Through its presence in both the channels, Setco is able to serve clutches throughout the lifecycle of the CV vehicle. With its foray into LCV and tractor segment, the addressable market size of company also increases.

*Margin differential:*

Say, if the company earns Rs.100 margin in OEM then it earns 107-108 in OES network and 115-118 when it sells independently.

**Export markets important for next phase of growth**

Setco will now also start focusing extensively on export markets and aims to turnaround its loss making units in the UK and the US. Because of backward integration that Setco has done, the quality of its product will improve and it'll help them get those orders which earlier didn't went to them because of quality issues. SAL has also introduced newer products in its portfolio and globally also it aims to diversify beyond MHCV.

Further, India has emerged as an attractive hub for global sourcing of auto components in view of cost advantages, premium quality and availability of skilled manpower. This has attracted global commercial



vehicle manufacturers to start operations in India, both, for tapping domestic opportunities and also use it to meet their global demand. SAL's overseas subsidiary incurred losses of ~10 crs (~33% of Standalone profits) which it aims to break even in near term and report marginal profits in couple of years.

### **Backward integration to aid Margin expansion and reduction of working capital cycle**

*Diaphragm Plant:* Company has set up its own manufacturing unit for diaphragm clutches (an input for its final product), at capital cost of 28 crore, which will be completely utilized for their captive consumption. Earlier it used to import these from Europe and because the supply was erratic it had to stock large amount of diaphragms.

*Foundry:* Setco has set up a foundry with capacity of 30,000 tpa in JV with a Spanish company Lingetos (80% stake with Setco) named Lava Cast Pvt. Ltd. Lingotes Especiales, Spain, who have an equity stake of 20% will provide Technical & Operational know-how to SAL. Setco has spent ~Rs. 185 crore to set up this facility. One-third of the capacity would be used for captive consumption while rest will be sold outside. Through this foundry, Lingetos will also supply to its existing clients like Ford, Volkswagen, Renault, Fiat, and others, which will also give SAL an entry into new markets. Company is targeting utilization level of 60% in FY17 of which 12,000 tonnes would be used captively.

With both these initiatives, Setco plans to reduce its raw material cost by 15-16%. Further, it will also reduce its inventory levels as earlier it had to stock huge inventories due to erratic supply. If demand for the product is there it can increase the capacity with minimum incremental costs.

### **Growth Prospects**

With all the above initiatives Setco plans to double its turnover from Rs.556 crore to Rs.1,000 crore in 2-3 and at the same time take its EBITDA margin to 17% (from current 12.5-13%). It had earlier clocked highest margin of 18% which company wants to replicate again. On a longer term basis Setco has kept a target of reaching revenues of Rs.5000 crore by FY21.

### **Risk & Concerns**

*Global market weak:* Company is banking a lot on export market for its growth but with global environment weak, company can face some headwinds. In FY16, company's export revenue declined by 25% (from 32 crs to 24 crs)



*Inability to diversify:* 90% of company's revenues come from MHCV segment and it is exposed to cyclical nature of industry. Though it plans to diversify to LCV and Tractor, these segments are already dominated by other MNC players.

*Shares Pledged:* The promoters have pledged ~50% of its shareholding. Promoters shareholding is 63.5%.

*Debt on books:* Due to the expansion activities it is undertaking, company's Debt has increased significantly. However the management claims that not further debt would be raised and they will bring the D/E ratio under 1 in couple of years.

*Loss making subsidiaries:* Company's UK subsidiary recorded a loss of ~12.3 crore in FY16 eroding fair portion of company's standalone profits. It is imperative for overseas business to fire if company has to perform well on consol basis.

### **Financial & Ratios**

Description	Setco Automotive Ltd.						
	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Net Sales	262.0	359.1	427.1	417.9	414.0	524.2	563.7
Operating Profit (Excl OI)	38.8	64.8	75.2	56.7	37.7	63.9	74.1
Exceptional Income / Expenses			-2.8		7.7		
Profit Before Tax	19.5	43.9	46.1	29.4	17.9	26.1	28.4
Profit After Tax	14.3	33.5	45.5	26.1	18.2	20.6	23.0
Earnings Per Share	3.2	3.8	5.2	2.0	1.4	1.5	1.8
Cash From Operating Activities	25.5	35.1	35.8	30.7	56.9	13.4	
PBIDTM (%)	15.1	17.8	17.3	13.9	10.9	12.2	13.2
ROE (%)	23.2	42.2	40.7	18.5	11.7	12.4	11.0
ROCE (%)	17.5	28.1	25.4	15.8	12.2	12.5	11.3
Total Debt/Equity(x)	1.8	1.4	1.2	1.2	1.2	1.8	1.7
Interest Cover(x)	2.7	4.5	3.5	2.5	1.8	2.0	1.9
Adjusted PE (x)	11.1	6.5	7.6	11.2	12.8	31.1	22.9
Price / Book Value(x)	2.4	2.4	2.6	1.9	1.5	3.7	2.7
Cash Flow Per share	28.9	19.9	20.3	11.5	21.3	5.0	



Ratio (%)	Last 3 Year	Last 5 Year	Last Year
Revenue (CAGR)	10.5%	9.4%	7.5%
EBITDA (CAGR)	9.4%	2.7%	16.1%
PBT (CAGR)	-1.2%	-8.4%	8.9%
PAT (CAGR)	-4.2%	-7.2%	11.6%
EPS (CAGR)	-3.7%	-14.4%	13.1%
RoE (AVERAGE)	11.71	15.45	11.72
RoCE (AVERAGE)	12.01	15.45	11.93
EBITDA (%) (AVERAGE)	12.07	13.48	12.68
P/E (AVERAGE)	22.27	17.13	26.98
P/B (AVERAGE)	2.61	2.48	3.19
Debt / Equity (AVERAGE)	1.58	1.43	1.79
Interest Coverage Ratio (AVERAGE)	1.87	2.31	1.92

### Valuation

At CMP of Rs. 42 the stock is quoting at 11X FY18E EPS (bases on our back of the envelope calculation) and on TTM basis the stock is trading at 23X FY16 P/E and 13X FY16 EV/EBITDA.

### Estimated Growth

Ballpark growth estimates based on management guidance.

	FY16	FY17E	FY18E
<b>Sales</b>			
OEM	201.07	247.32	301.73
Export	22.26	24.27	27.91
Aftermarket	339.66	370.23	418.36
Foundry	0.00	41.04	54.60
<b>Total Sales</b>	<b>563.00</b>	<b>682.86</b>	<b>802.60</b>
<b>EBITDA</b>	<b>74.10</b>	<b>98.33</b>	<b>122.00</b>
EBITDA Margin	13.2%	14.4%	15.2%
Other Income	6.40	7.00	7.50
Depreciation	18.70	21.50	23.00
Interest	33.40	31.50	30.00
PBT	28.40	52.33	76.50
Tax	5.47	13.08	19.12
Eff Tax rate (Company has MAT credit)	19.3%	25.0%	25.0%
PAT	22.93	39.25	57.37

Shareholding Pattern	%
Promoters	63.5
FII	3.9
DII	10.0
Others	22.6



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