Setco Automotive

MHCV upcycle to stoke growth

BUY	
CMP	₹ 242
Target Price	₹ 286
Investment Period	12 Months

Setco Automotive Ltd (SAL) which is the market leader in manufacture of MHCV clutches (about 65% market share) is likely to reap rich benefits of upcycle in both the OEM (30% of sales) as well as replacement markets (70% of sales).

Direct beneficiary of MHCV upcycle

After two consecutive years (FY2013 and FY2014) of a steep double-digit decline, the MHCV segment is on course for a cyclical upturn. The uptrend is clearly visible with the segment reporting a growth of 13% in YTD FY2015 (April 2014 to January 2015). We believe the MHCV segment is well poised to maintain the double-digit growth over the FY2015-FY2017 period due to a) Better economic outlook which is likely to generate freight revenues, b) Firming of freight rates and improvement in fleet operators' profitability, c) Expected reduction in interest rates which would revive the investment cycle, and d) Budgetary focus to increase road network which would enhance usage of commercial vehicle (CV)s. SAL would be the direct beneficiary of uptick in MHCV OEM demand as it commands 85% market share, drawing about 30% of its total revenues from the space.

Aftermarket and export focus to be growth drivers

Improved fleet utilization due to higher freight availability is likely to propel the replacement demand for clutches. SAL previously used to cater to replacement market only through the OEM authorized distribution channels. However, SAL is now teaming up with multi branded distributors (network partners other than the OEM authorised outlets) to independently tap the replacement market. These distribution channels provide huge opportunity as SAL can effectively tap the third and fourth replacement cycle for clutches which are typically done outside the OEM authorized dealerships. We expect SAL aftermarket segment to post a CAGR of ~18% over the next two years. Also, SAL is negotiating with American and European OEM's to commence supplies to their authorized aftermarket channels. SAL is already supplying to these OEMs in India and is now aiming to initiate supplies to their overseas arms. We expect exports (contributing about 9% of the revenues) to register a healthy 25% CAGR over the FY2015-FY2017.

Outlook and valuation: SAL is likely to clock a 24% CAGR in revenues over the next two years given the improvement in the MHCV OEM space and market share gains in the replacement segment. Also, SAL's operating margin is also expected to improve by 200bp over the next two years, given the operating leverage, enhanced capacity utilization and procurement of captive castings. Given the healthy top-line growth and margin improvement, SAL is expected to post a robust 49% CAGR in earnings. SAL's return ratios are also likely to expand due to improved profitability and moderate capex. **We initiate coverage on the stock with a Buy recommendation and target price of ₹286 (based on 15x FY2017E earnings).**

Key financials

Y/E March (₹ cr)	FY2014	FY2015E	FY2016E	FY2017E
Net sales	**390**	**565**	**718**	**862**
% chg	*(2.4)*	*45.0*	*27.0*	*20.0*
Net profit (Adj.)	**11**	**23**	**36**	**51**
% chg	*(59.6)*	*115.9*	*56.4*	*42.5*
EBITDA margin (%)	9.7	12.3	13.3	14.3
EPS (₹)	**4.0**	**8.5**	**13.4**	**19.0**
P/E (x)	61.2	28.3	18.1	12.7
P/BV (x)	3.4	3.2	2.8	2.4
RoE (%)	5.6	11.2	15.4	18.6
RoCE (%)	9.0	12.3	15.1	17.4
EV/Sales (x)	1.5	1.1	1.0	0.8
EV/EBITDA (x)	15.9	9.3	7.2	5.9

Source: Company, Angel Research, Note: CMP as of March 13, 2015

Stock Info	
Sector	Auto Ancillary
Market Cap (₹ cr)	646
Net Debt (₹ cr)	173
Beta	0.9
52 Week High / Low	294 / 68
Avg. Daily Volume	12,735
Face Value (₹)	10
BSE Sensex	28,503
Nifty	8,648
Reuters Code	SETC.BO
Bloomberg Code	SETC@IN

Shareholding Pattern (%)	
Promoters	63.0
MF / Banks / Indian FIs	3.8
FII / NRIs / OCBs	18.4
Indian Public / Others	14.8

Abs. (%)	3m	1yr	3yr
Sensex	4.2	30.9	60.0
Setco	(3.2)	240.8	103.9

3-Year Daily price chart

Source: Company, Angel Research

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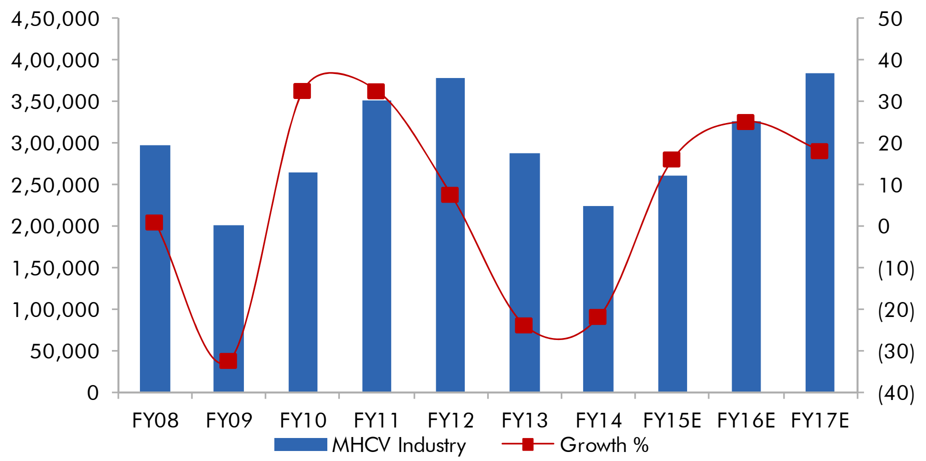
Investment Arguments

SAL to be direct beneficiary of MHCV upcycle

After two consecutive years of double-digit decline (FY2013 and FY2014), the MHCV segment has resurged in FY2015. During the April 2014-December 2014 period, the segment registered a healthy growth of 13%. Improvement in the MHCV segment can be attributed to a) Better economic growth, given the reform driven policies of the government, b) Firming of freight rates and improved freight availability, c) Reduction in diesel prices and lower inflation leading to improvement in operating metrics of fleet operators, and d) Reduction in interest rates.

Macro-economic indicators have turned favourable and we expect economic growth to accelerate, going ahead. Further, the government's thrust on infrastructure (development of road network) would indirectly boost demand for MHCVs. We believe the MHCV segment has resumed its uptrend and is well poised to maintain double digit growth momentum over the next two years (FY2015-FY2017). SAL would stand to be a direct beneficiary of the revival in the MHCV OEM space as it derives about 30% of its revenues from this segment.

Exhibit 1: MHCV industry growth trends



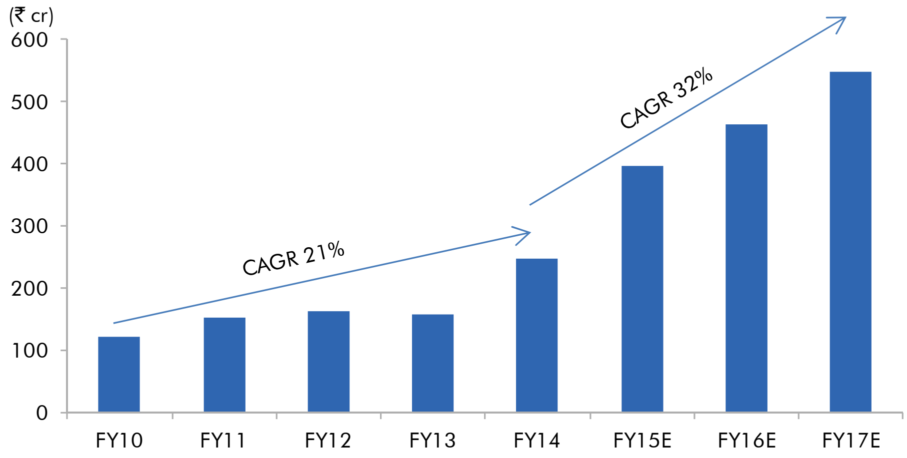
Source: SIAM, Angel Research

Improvement in replacement demand and independent aftermarket channel to fuel growth

Improved economic outlook and better freight availability are likely to spur capacity utilization of the freight operators. Increased usage of vehicles would boost replacement demand over the next two years. As per industry estimates, the market size of the replacement segment is about 3x the size of the OEM segment.

In addition to sales through the OEM aftermarket network, SAL has tied up with multibranded distributors (touch points other than OEM authorized channels). SAL previously used to cater to replacement market only through the OEM authorized distribution channels. SAL is, thus independently tapping the replacement space. We believe this strategy provides a huge opportunity to SAL as it would enable the company to effectively tap the third and the fourth replacement cycle of the clutch (beyond five years of the vehicle age). This would be considering that replacements for such aged vehicles are typically carried outside the OEM's authorised aftermarket channels. SAL commenced its independent network in September 2013 and has already realized 10% of the revenues through this network. We believe this strategy provides SAL with a huge untapped opportunity and would likely fuel growth. We estimate SAL's aftermarket revenues to grow at robust 18% CAGR over FY2015-2017 period.

Exhibit 2: SAL after market growth trend

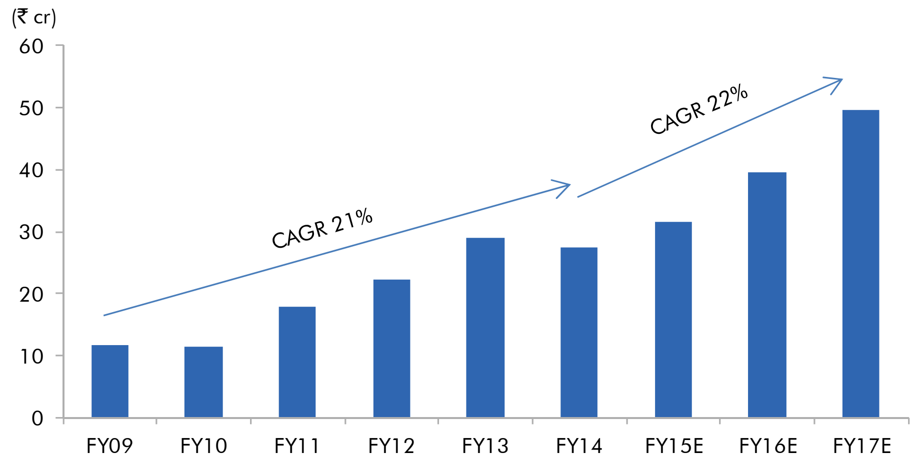


Source: Company, Angel Research

Focus on exports provides another growth lever

SAL is focusing on enhancing exports by tapping the replacement markets overseas. To boost exports, it is focusing on three key markets viz America, Europe and Africa. The company has developed a new product (Angular spring) for the US markets, for which the supplies would commence from the beginning of FY2016. SAL is targeting revenues of ₹150cr from the US over the next three years. Also, SAL is in talks with the European OEMs – MAN and Bharat Benz, for the supply of clutches through their aftermarket channels. SAL is already supplying clutches through their aftermarket network in India and is hopeful of tapping the European replacement segment. Apart from US and Europe, SAL is also aggressively tapping the African market given that most of the trucks are of European make, for which, SAL already has a product. We expect SAL export revenues to grow at healthy CAGR of 25% over the next two years

Exhibit 3: SAL export growth trend



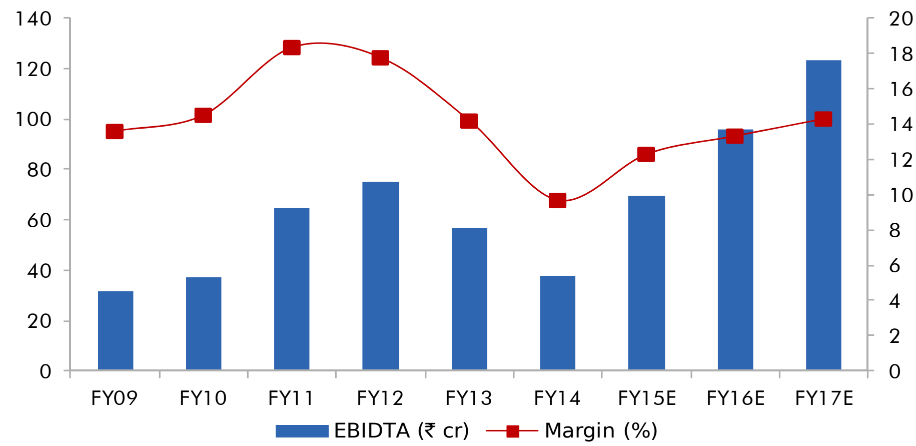
Source: Company, Angel Research

Operating leverage coupled with backward integration to enhance margins

SAL's revenues are likely to grow at a CAGR of 24% over FY2015-FY2017 given the upcycle in the MHCV OEM segment and healthy growth in the replacement market due to economic revival and with the company setting up an independent network. Further, SAL is currently operating at capacity utilization of about 65%. SAL is likely to realize benefits of operating leverage given the uptick in volumes and higher capacity utilization.

Also, SAL has entered into a JV with Lingotes Especiales S.A., a Spanish firm, for the manufacture of machined castings which are critical in the manufacture of clutches. The JV has planned to incur a capex of ₹150cr and production is slated to commence in March 2015. About 35% of the production would be used for SAL's captive consumption and the remaining would be sold outside. Apart from margin improvement due to captive production, SAL would also benefit from timely procurement. We expect SAL's margins to improve by about 200bp over the next two years.

Exhibit 4: EBIDTA margin trend



Source: Company, Angel Research

Increased supplies to LCV and farm equipment segment provides diversification

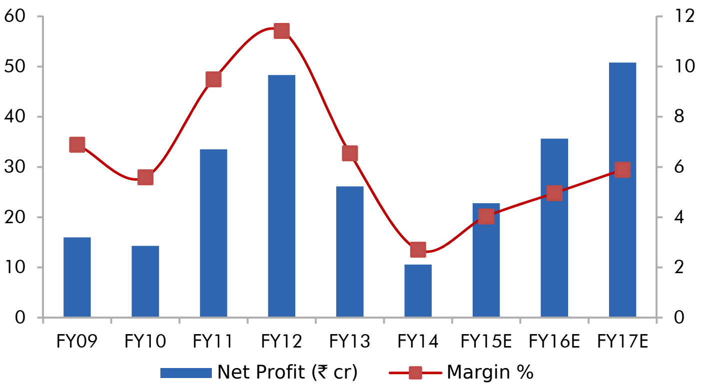
SAL derives more than 90% of its revenues from the MHCV segment. The MHCV segment is cyclical in nature having direct relation with economic growth. Any slowdown in the economy impacts freight availability, thereby leading to negative sentiments and steep decline in MHCV sales (sales have declined in double-digits in the previous down cycles). In order to diversify and reduce volatility in revenues, SAL is increasing supplies to the less cyclical LCV and farm equipment segments.

SAL can easily scale up presence in the LCV space given that most of its existing customers viz Tata Motors, Ashok Leyland, Eicher are already present in the LCV segment and SAL has well established relations with these OEMs. To further diversify, SAL would also commence supplies to the tractor segment.

Improving margins and capacity utilization to boost return ratios

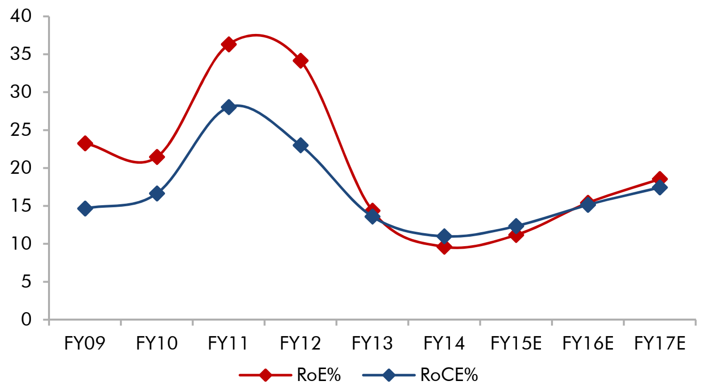
SAL's margins are likely to improve by 200bp over FY2015-17 on back of operating leverage and backward integration. Further, capacity utilization levels would also increase from about 65% currently to about 90% levels by FY2017. Also, SAL has no major capex lined up over the next two years, which would augment the asset turnover ratios. These factors are expected to boost the return ratios. RoE is expected to improve from 11% in FY2015 to 19% levels in FY2017. Similarly the RoCE is expected to improve from 12% in FY2015 to 17% in FY2017.

Exhibit 5: Net Profit and margin trend



Source: Company, Angel Research

Exhibit 6: Return ratios

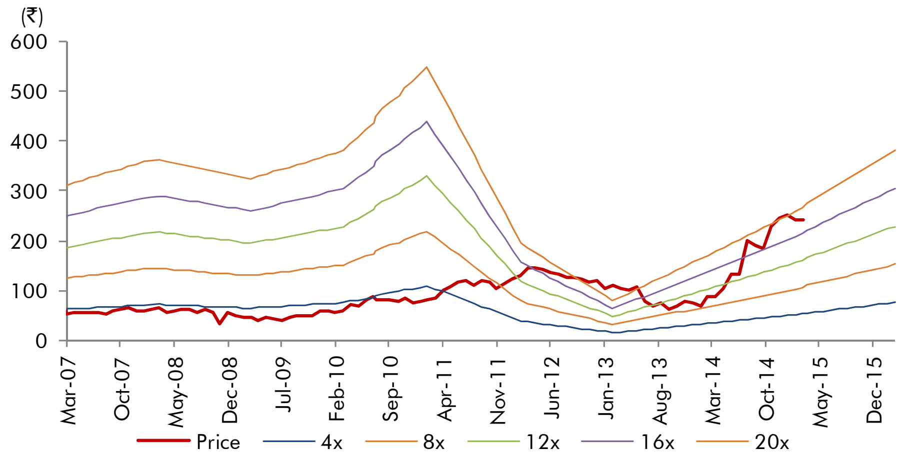


Source: Company, Angel Research

Outlook and Valuation

SAL is likely to clock a 24% CAGR in revenues over the next two years. Revenues are expected to be driven by an upcycle in the MHCV OEM segment, coupled with the company setting up independent aftermarket outlets, and with the company's increased focus on exports. Further, the joint venture with Lava Cast for casting supplies provides additional growth prospects to the company. SAL's operating margin is also expected to improve by 200bp over the next two years, given the operating leverage, enhanced capacity utilization and procurement of captive castings. Given the healthy top-line growth and margin improvement, SAL is expected to post a robust 49% CAGR in earnings. SAL's return ratios are also likely to expand due to improved profitability and moderate capex. **We initiate coverage on the stock with a Buy recommendation and target price of ₹286 (based on 15x FY2017E earnings).**

Exhibit 7: One-year forward P/E band



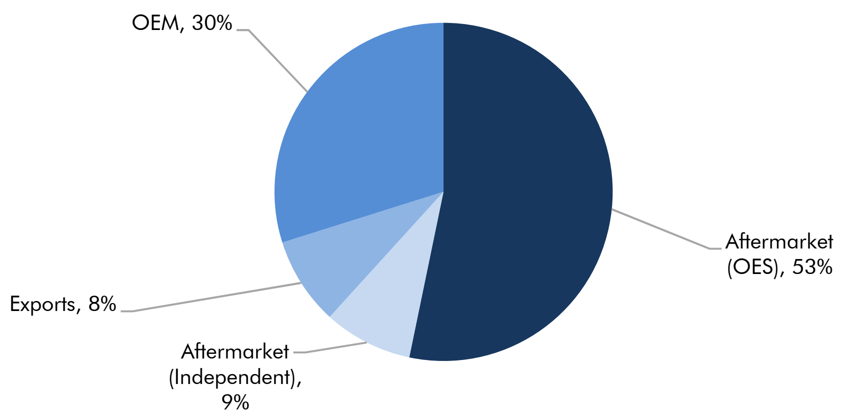
Source: Company, Angel Research

Company Background

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. Apart from commercial vehicles, SAL also manufactures clutches for hydraulic products used in the construction equipment industry and precision engineering components.

The replacement segment is the largest contributing segment accounting for about 62% of the overall revenues. Aftermarket sales through the OEM channel contribute 53% of the revenue while sales through the independent route contribute 9%. OEM sales form 30% of the overall revenues while exports account for 9%.

Exhibit 8: Segment wise revenue break up



Source: Company, Angel Research

Profit & Loss Statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
Total operating income	**423**	**399**	**390**	**565**	**718**	**862**
% chg	*19.9*	*(5.6)*	*(2.4)*	*45.0*	*27.0*	*20.0*
Total Expenditure	**348**	**343**	**352**	**496**	**623**	**739**
Net Raw Materials	241	222	219	312	393	467
Personnel	40	46	52	70	83	98
Other	66	74	81	114	146	174
EBITDA	**75**	**57**	**38**	**70**	**96**	**123**
% chg	*16.0*	*(24.7)*	*(33.4)*	*84.2*	*37.7*	*28.8*
(% of Net Sales)	*17.8*	*14.2*	*9.7*	*12.3*	*13.3*	*14.3*
Depreciation & Amortisation	11	12	14	16	19	21
EBIT	**68**	**49**	**34**	**53**	**77**	**102**
% chg	*20.0*	*(27.3)*	*(31.8)*	*58.8*	*44.7*	*32.7*
(% of Net Sales)	*16.0*	*12.3*	*8.6*	*9.4*	*10.7*	*11.9*
Interest & other Charges	19	20	23	27	32	38
Other Income	3	5	9	12	14	16
PBT (recurring)	**49**	**29**	**10**	**27**	**45**	**64**
% chg	*11.0*	*(39.8)*	*(65.4)*	*162.8*	*68.3*	*42.5*
Extraordinary Expense/(Inc.)	(3)	0	8	0	0	0
PBT (reported)	**46**	**29**	**18**	**27**	**45**	**64**
Tax	1	3	0	4	9	14
(% of PBT)	*1.3*	*11.2*	*(3.5)*	*15.0*	*21.0*	*21.0*
PAT (reported)	**45**	**26**	**18**	**23**	**36**	**51**
ADJ. PAT	**48**	**26**	**11**	**23**	**36**	**51**
% chg	*44.0*	*(45.9)*	*(59.6)*	*115.9*	*56.4*	*42.5*
(% of Net Sales)	*11.4*	*6.5*	*2.7*	*4.0*	*5.0*	*5.9*
Basic EPS (₹)	**25.8**	**9.8**	**6.8**	**8.5**	**13.4**	**19.0**
Fully Diluted EPS (₹)	**27.4**	**9.8**	**4.0**	**8.5**	**13.4**	**19.0**
% chg	*44.0*	*(64.2)*	*(59.6)*	*115.9*	*56.4*	*42.5*

Balance sheet statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
SOURCES OF FUNDS						
Equity Share Capital	18	27	27	27	27	27
Reserves& Surplus	115	155	163	177	205	247
Shareholders Funds	**133**	**182**	**189**	**204**	**231**	**274**
Total Loans	142	173	178	220	270	305
Deferred Tax Liability	6	7	7	7	7	7
Other long term liab.	-	-	-	-	-	-
Long term provisions	1	1	1	1	1	1
Total Liabilities	**282**	**362**	**375**	**432**	**509**	**587**
APPLICATION OF FUNDS						
Gross Block	154	202	230	270	310	350
Less: Acc. Dep.	52	65	80	97	115	136
Net Block	**103**	**137**	**150**	**174**	**195**	**214**
Capital WIP	12	14	8	8	8	8
Investments	**22**	**37**	**51**	**61**	**68**	**74**
Loans and adv.	33	40	46	56	72	86
Current Assets	207	214	216	270	344	416
Cash	9	3	5	5	7	6
Other	177	191	189	233	298	363
Current liabilities	74	59	75	106	138	164
Net Current Assets	**133**	**155**	**141**	**164**	**206**	**252**
Total Assets	**282**	**362**	**375**	**432**	**509**	**587**

Cash flow statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
Profit before tax	46	29	18	27	45	64
Depreciation	16	13	15	16	19	21
Change in Working Capital	(39)	(28)	17	(23)	(41)	(47)
Others	2	1	0	(0)	0	0
Direct taxes paid	(1)	(3)	0	(4)	(9)	(14)
Cash Flow from Operations	24	13	51	16	14	25
(Inc.)/ Dec. in Fixed Assets	(32)	(49)	(22)	(40)	(40)	(40)
(Inc.)/ Dec. in Investments	(13)	(15)	(15)	(10)	(7)	(6)
(Inc.)/ Dec. in Loans & Adv	(7)	(7)	(6)	(0)	(7)	(6)
Cash Flow from Investing	(52)	(72)	(43)	(50)	(54)	(52)
Issue of Equity	0	9	0	0	0	0
Inc./(Dec.) in loans	38	31	5	42	50	35
Dividend Paid (Incl. Tax)	(8)	(8)	(8)	(8)	(8)	(8)
Others	4	22	(2)	0	0	0
Cash Flow from Financing	34	53	(5)	34	42	27
Inc./(Dec.) in Cash	5	(6)	2	0	2	(1)
Opening Cash balances	4	9	3	5	5	7
Closing Cash balances	9	3	5	5	7	6

Key ratios

Y/E March	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
Valuation Ratio (x)						
P/E (on FDEPS)	8.8	24.7	61.2	28.3	18.1	12.7
P/CEPS	7.2	16.8	26.7	16.5	11.9	9.0
P/BV	3.2	3.6	3.4	3.2	2.8	2.4
Dividend yield (%)	1.7	1.1	1.1	1.3	2.1	2.9
EV/Sales	1.3	1.5	1.5	1.1	1.0	0.8
EV/EBITDA	7.5	10.5	15.9	9.2	7.2	5.9
EV / Total Assets	2.0	1.6	1.6	1.5	1.4	1.2
Per Share Data (₹)						
EPS (Basic)	27.4	9.8	4.0	8.5	13.4	19.0
EPS (fully diluted)	27.4	9.8	4.0	8.5	13.4	19.0
Cash EPS	33.5	14.4	9.1	14.6	20.3	26.9
DPS	4.0	2.7	2.7	3.2	5.0	7.1
Book Value	75.5	68.2	71.0	76.5	86.7	102.7
Dupont Analysis						
EBIT margin	16.0	12.3	8.6	9.4	10.7	11.9
Tax retention ratio	1.0	0.9	1.0	0.9	0.8	0.8
Asset turnover (x)	1.5	1.1	1.1	1.3	1.4	1.5
ROIC (Post-tax)	24.5	12.2	9.4	10.6	12.1	13.9
Cost of Debt (Post Tax)	13.0	10.2	13.6	10.2	9.4	9.8
Leverage (x)	1.0	0.9	0.9	1.1	1.1	1.1
Operating ROE	35.9	14.0	5.6	11.0	15.3	18.4
Returns (%)						
ROCE (Pre-tax)	24.0	13.6	9.0	12.3	15.1	17.4
Angel ROIC (Pre-tax)	24.8	13.7	9.1	12.5	15.4	17.6
ROE	36.3	14.4	5.6	11.2	15.4	18.6
Turnover ratios (x)						
Asset Turnover (Gross Block)	2.7	2.0	1.7	2.1	2.3	2.5
Inventory / Sales (days)	76.7	101.5	111.7	88.7	89.4	91.6
Receivables (days)	76.4	72.6	65.4	62.0	62.0	62.0
Payables (days)	63.5	53.7	70.1	68.4	70.2	69.4
WC cycle (ex-cash) (days)	107.4	139.1	126.9	102.3	101.2	104.2
Solvency ratios (x)						
Net debt to equity	1.0	0.9	0.9	1.1	1.1	1.1
Net debt to EBITDA	1.8	3.0	4.6	3.1	2.7	2.4
Interest Coverage (EBIT / Int.)	3.6	2.5	1.4	2.0	2.4	2.7

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DISCLAIMER

Disclosure of Interest Statement	**Setco Automotive**
1. Analyst ownership of the stock	No
2. Angel and its Group companies ownership of the stock	No
3. Angel and its Group companies' Directors ownership of the stock	No
4. Broking relationship with company covered	No

Note: We have not considered any Exposure below ₹1 lakh for Angel, its Group companies and Directors

Ratings (Returns):	*Buy (> 15%)*	*Accumulate (5% to 15%)*	*Neutral (-5 to 5%)*
	Reduce (-5% to -15%)	*Sell (< -15%)*	