Subros

Well poised to ride passenger vehicle recovery

Passenger vehicle industry to grow in double-digits over the next two years: After two consecutive years of no growth, the passenger vehicle industry has shown signs of recovery in the last few months. In the YTD FY2015 period (April to November 2014), the industry witnessed a growth of 3%. Green shoots of revival in the industry are clearly visible and we expect the growth to accelerate over the next two years. Consumer sentiments have improved considerably and we expect the passenger vehicle industry to report a double-digit growth (11% CAGR) over FY2015-2017 on account of (a) Improved economic outlook resulting in higher disposable incomes among consumers, (b) Downwerd trend in fuel prices resulting in lower cost of ownership, and (c) Expected reduction in interest rates.

In-house manufacturing, higher capacity utilization, and JPY weakening to aid in margin improvement: Subros is targeting to reduce its raw material costs by increasing in-house manufacturing of components. It has started manufacturing certain components like evaporators, compressors and heat exchange parts and invested in a tooling room which would enable it to further localize other components. It aims to increase the localization of components and further bring down material costs to 65% of sales (from current 68%) over the next two to three years. Also, a strong double-digit growth in the passenger vehicle industry would improve its capacity utilisation levels (current capacity utilization stands at ~55%), thus resulting in operating leverage. Further, the recent weakening of the Japanese Yen (JPY) would also boost margins, given that 50% of the raw materials consumed by the company are JPY denominated imports.

Outlook and Valuation: We expect Subros to clock a revenue CAGR of 13% over FY2014-FY2017 aided by a recovery in the passenger vehicle industry and market share regain by its key clients. Initiation of supplies to Denso Corporation would also boost Subros' top-line. Also, Subros' margins are expected to improve owing to increased localisation, operating leverage and weakness in JPY. We also expect the company's interest costs to recede, given the reduction in the debt levels. We expect Subros to report a PAT CAGR of 29% over FY2014-FY2017. At the current market price of ₹67, the stock trades at 15.3x and 9.2x its FY2016 and FY2017 earnings, respectively. **We initiate coverage on the stock with a Buy recommendation and target price of ₹80 based on 11x FY2017E EPS, indicating an upside of 19% from the current levels.**

Key financials

Y/E March (₹ cr)	FY2014	FY2015E	FY2016E	FY2017E
Net sales	1,171	1,255	1,416	1,706
% chg	*(7.9)*	*7.2*	*12.8*	*20.6*
Net profit (Adj.)	20	19	26	44
% chg	*(0.9)*	*(5.2)*	*36.8*	*66.1*
EBITDA margin (%)	11.2	11.2	11.3	11.3
EPS (₹)	3.4	3.2	4.4	7.3
P/E (x)	19.8	20.9	15.3	9.2
P/BV (x)	1.3	1.3	1.2	1.1
RoE (%)	6.9	6.2	8.1	12.4
RoCE (%)	7.7	7.4	9.0	12.3
EV/Sales (x)	0.6	0.6	0.5	0.4
EV/EBITDA (x)	6.1	5.8	5.0	4.0

Source: Company, Angel Research, Note: CMP as of January 8, 2015

BUY

CMP	₹67
Target Price	₹80
Investment Period	12 Months

Stock Info	
Sector	Auto Ancillary
Market Cap (₹ cr)	404
Net Debt (₹ cr)	401
Beta	1.5
52 Week High / Low	81 / 23
Avg. Daily Volume	15,183
Face Value (₹)	2
BSE Sensex	27,275
Nifty	8,235
Reuters Code	SUBR.BO
Bloomberg Code	SUBR@IN

Shareholding Pattern (%)	
Promoters	40.0
MF / Banks / Indian FIs	10.1
FII / NRIs / OCBs	26.6
Indian Public / Others	23.3

Abs. (%)	3m	1yr	3yr
Sensex	3.9	31.6	72.1
Subros	2.7	149.7	199.1

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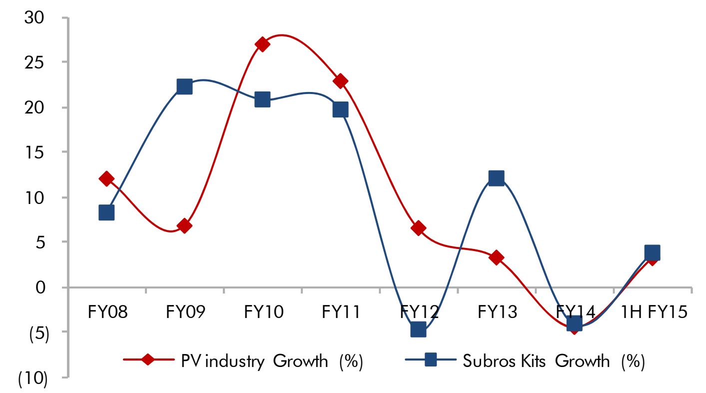
Investment Arguments

PV industry recovery to accelerate; set to grow in double-digits in FY2016-17

For two consecutive years (FY2013 and FY2014), the demand for passenger vehicles remained flat (declining by about 1%). The industry staged a recovery in FY2015 on back of improved consumer sentiments post the election of the new government. Passenger vehicle volumes have grown by 3% in YTD FY2015 (April-November 2014). Early signs of recovery are clearly visible and we expect the pent up demand to drive passenger vehicle volumes. We expect the recovery to accelerate further over FY2016-17 on account of (a) Improved economic growth outlook with the government's focus on policy reforms, (b) Stable/downward trend in fuel prices, (c) Inflation being in a downward trajectory which is likely to lead to lowering in interest rates. We expect the passenger vehicle industry to grow at a CAGR of 11% over the next two years thereby retracting to its long term double digit CAGR growth.

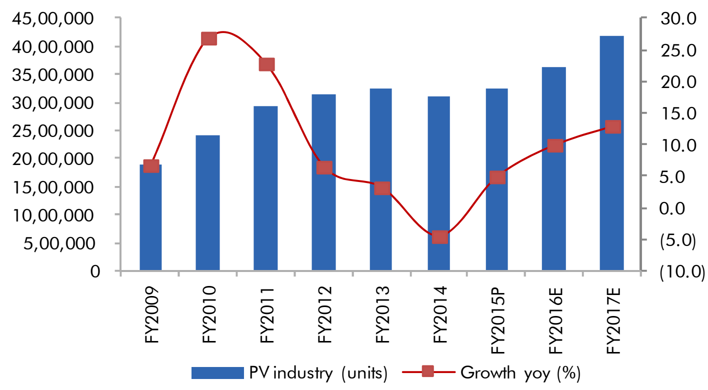
The passenger vehicle segment contributes by about 88% to Subros' revenues. An expected upcycle in the segment would thus boost Subros' revenues.

Exhibit 1: Correlation with PV volumes



Source: Company, Angel Research

Exhibit 2: PV industry growth trend

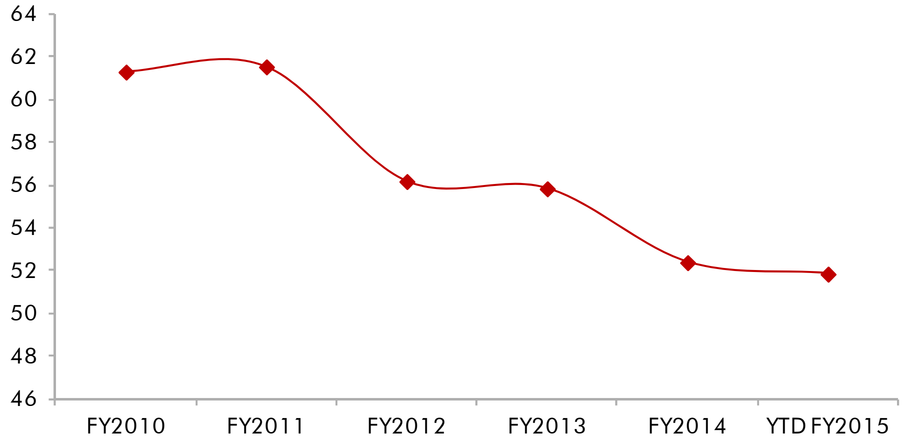


Source: SIAM, Angel Research

Market share regain by key clients to help Subros outpace PV industry growth

Maruti Suzuki is the largest client for Subros constituting about 80% of the overall revenues. M&M and Tata Motors contribute about 15% of the overall revenues. Maruti Suzuki has outperformed the passenger vehicle industry in YTD FY2015 and is likely to retain market share on back of new launches. Subros' other customers Mahindra & Mahindra (M&M) and Tata Motors however, have underperformed in the last two years due to lack of new models and limited presence in the fast growing petrol segment. The two lost market share by 250bp and 510bp, respectively, over the aforementioned period. Overall, the market share of Subros' customers viz Maruti Suzuki, M&M and Tata Motors, declined by ~400bp, over the past two years.

Exhibit 3: Cumulative Market share of key clients



Source: SIAM, Angel Research

However, both M&M and Tata Motors have lined up new products which would enable them to regain market share. M&M has planned three new product launches in the compact UV space. It also aims to launch petrol variants commencing from 4QFY2015. Further, Tata Motors has recently introduced "Zest" and also plans to launch compact car "Bolt" in 4QFY2015. New product launches by Subros' key customers would enable it to outpace growth in passenger vehicles.

Exhibit 4: New product launches by key clientle

Clients	New launches
Maruti Suzuki	Crossover, Utility vehicle and LCV
M&M	Two compact utility vehicles and new LCV
Tata Motors	Bolt (hatchback) Nexon (Compact UV)

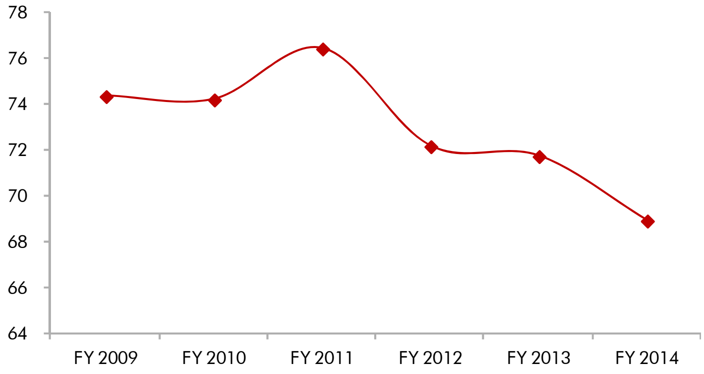
Source: Angel Research

Improving passenger vehicle outlook coupled with new launches by key customers will enable to outpace industry growth

Increased in-house manufacturing, operating leverage and JPY depreciation to keep margins at elevated levels

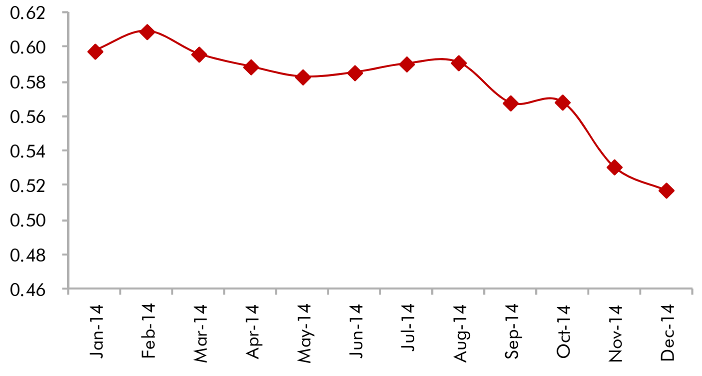
Subros is focusing on increasing in-house manufacturing of components in order to reduce material costs. It earlier procured raw materials in the CKD format and has recently shifted focus on in-house manufacturing. Increased localization has enabled the company to bring down raw material costs from 72% of sales in FY2012 to 69% in FY2014, thus resulting in margin improvement. Subros is working on localization of critical parts such as evaporators, compressors and heat exchangers. Further, it has also invested in the tooling center at Noida to prepare dies and moulds, leading to in-house manufacturing of critical components. It aims to accelerate the localization process further and is targeting to bring down the raw material cost by about 300bp to 65% of sales over the next three years.

Exhibit 5: Raw material costs (% of sales)



Source: Company, Angel Research

Exhibit 6: INR-JPY trend



Source: Angel Research

Subros' capacity utilisation levels are expected to improve on back of increased offtake from its key customers. We expect the utilization levels to inch up from 55% currently to 75% in FY2017, thus resulting in benefits of operating leverage. Also, JPY has recently depreciated against the INR on back of monetary easing policy by the Japanese government. The outlook for JPY remains weak in the medium term. Subros would be the prime beneficiary of the weak JPY as raw material imports from Japan constitute about 30% of overall sales.

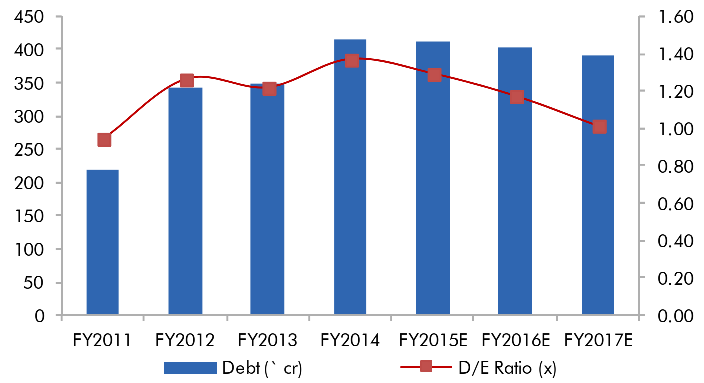
Supply to Denso Corporation for Cooling modules and Radiators to boost top-line and turnover ratios

Subros entered into a MoU with Denso Corporation for supply of cooling modules and radiators. Subros would manufacture these products at its Manesar plant and supply to Denso Corporation. The production would commence by early FY2017 and the company is aiming at revenues of ₹80cr in FY2017. At full utilization, the project has a revenue potential of ₹200cr. The agreement entails a capex of ₹50cr to be invested over FY2015-2017. The new order will require minimal capex as the radiators would be manufactured at the existing Manesar plant and would also utilize current machinery. Thus, the new order is expected to boost Subros' top-line and turnover ratios, going forward.

Capex cycle over, return ratios to improve on back of increased capacity utilisation and debt reduction

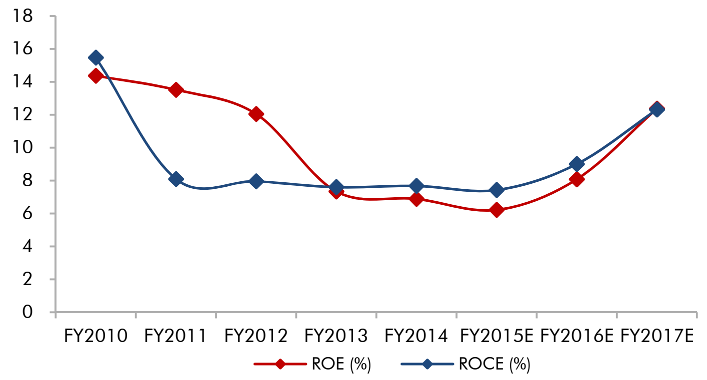
Post the recent commissioning of the Chennai plant and increase in the kits capacity, there is no major capex lined up for Subros over the next two years. The capacity utilization is expected to improve due to recovery in the passenger vehicle segment. Also, Subros plans to reduce the debt levels going ahead which will boost its return ratios. We expect the company's ROCE to improve from 7.7% in FY2014 to 12.3% in FY2017. Similarly, ROE is estimated to reach 12% in FY2017 from 7% levels currently.

Exhibit 7: Debt levels



Source: Company, Angel Research

Exhibit 8: Return ratios



Source: Company, Angel Research

Commercial vehicle A/C and refrigerated units to provide the next leg of growth

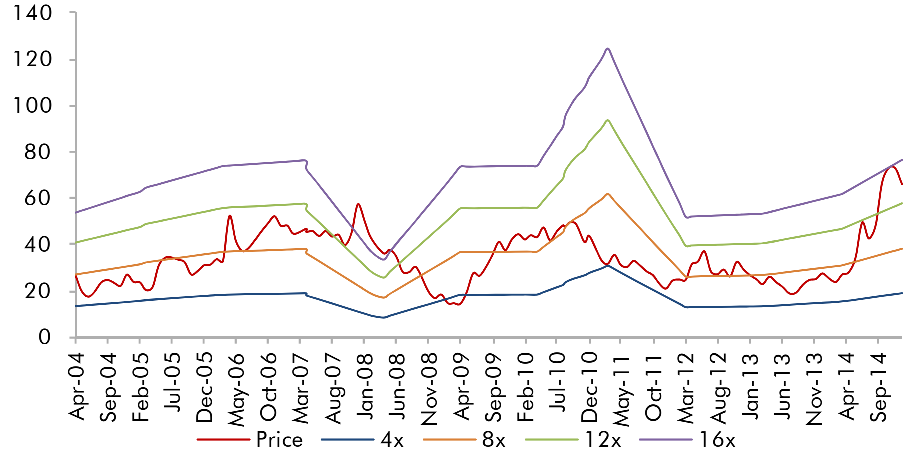
The trend for air-conditioning (A/C) in commercial vehicles is expected to pick up going forward. State Transport Undertakings are increasingly placing orders for air-conditioned buses to improve passenger comfort. Also, light commercial vehicle (LCV) manufacturers such as Tata Motors, M&M and Ashok Leyland have introduced air conditioned cabins in their top-end vehicles. We expect commercial vehicle manufacturers to increasingly opt for A/C systems in line with the trend in the developed markets. However, we expect the trend to take some time and a meaningful opportunity to emerge only after two to three years. Subros, being the only integrated manufacturer with established supplies to the passenger vehicle segment, would benefit immensely from this trend.

Also, in order to tap new business segments, Subros provides complete refrigerated solutions to automotive OEMs. It offers fully integrated solutions comprising of refrigeration kit and a specially insulated container which is fitted on vehicle chassis. It currently supplies to Ashok Leyland "Dost" vehicles and has also tied up with Tata Motors and M&M. Subros aims to ramp supplies to CV manufacturers from its Chennai plant, enabling it to diversify its business model and reduce concentration on a particular segment.

Outlook and Valuation

We expect Subros to clock a revenue CAGR of 13% over FY2014-FY2017 aided by a recovery in the passenger vehicle industry and market share regain by its key clients. Initiation of supplies to Denso Corporation would also boost Subros' top-line. Also, Subros' margins are expected to improve owing to increased localisation, operating leverage and weakness in JPY. We also expect the company's interest costs to recede, given the reduction in the debt levels. We expect Subros to report a PAT CAGR of 29% over FY2014-FY2017. At the current market price of ₹67, the stock trades at 15.3x and 9.2x its FY2016 and FY2017 earnings, respectively. **We initiate coverage on the stock with a Buy recommendation and target price of ₹80 based on 11x FY2017E EPS, indicating an upside of 19% from the current levels.**

Exhibit 9: One-year forward P/E band



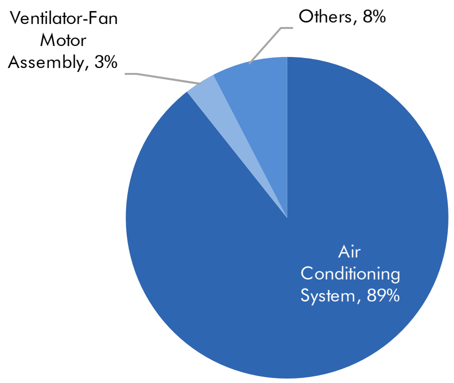
Source: Company, Angel Research

Company Background

Subros was incorporated in 1985 as a joint venture company with 40% ownership by Suri family and 13% each by Denso Corporation and Suzuki Motor Corporation. Subros, in technical collaboration with Denso, is the leading manufacturer of thermal products for automotive applications. It is the only integrated manufacturer for Auto air-conditioning units. It manufactures compressors, condensers, heat exchanges and all connecting elements required to complete AC loop. Subros caters to all the automotive segments viz passenger vehicles, commercial vehicles, off-roaders and railways. It has a well diversified presence and is located at almost all automobile manufacturing hubs. It has plants in Noida and Manesar (Northern region), Pune and Sanand (Western region) and has recently set up a plant in Chennai to cater to South based OEMs.

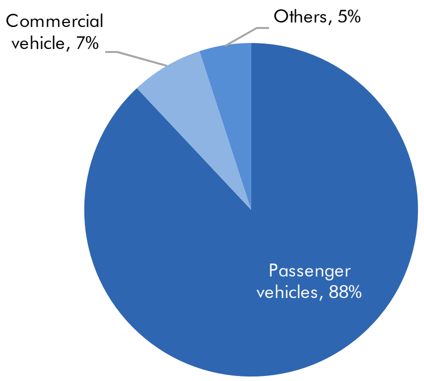
The passenger vehicle segment, contributing about 88% of the overall revenues, is its prime segment. Subros has 30% market share in the segment, supplying to key customers like Maruti Suzuki, M&M and Tata Motors. The commercial vehicle segment forms about 7% of the overall revenues with the company supplying to Force Motors, Ashok Leyland and Daimler (Bharat Benz). It also supplies refrigerated vans to customers besides supplying to the Railways.

Exhibit 10: Product-wise break up



Source: Company, Angel Research

Exhibit 11: 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	**1,116**	**1,272**	**1,171**	**1,255**	**1,416**	**1,706**
% chg	*2.4*	*14.0*	*(7.9)*	*7.2*	*12.8*	*20.6*
Total Expenditure	**1,019**	**1,150**	**1,040**	**1,114**	**1,256**	**1,513**
Net Raw Materials	805	912	807	867	980	1,181
Other Mfg costs	60	63	58	64	72	87
Personnel	84	100	105	110	120	145
Other	69	74	69	73	84	101
EBITDA	**97**	**122**	**131**	**141**	**160**	**193**
% chg	*30.3*	*26.1*	*7.5*	*6.9*	*13.8*	*20.9*
(% of Net Sales)	*8.7*	*9.6*	*11.2*	*11.2*	*11.3*	*11.3*
Depreciation & Amortisation	53	73	77	85	91	97
EBIT	**44**	**50**	**54**	**56**	**69**	**96**
% chg	*29.7*	*13.1*	*9.1*	*3.3*	*23.5*	*39.3*
(% of Net Sales)	*3.9*	*3.9*	*4.6*	*4.5*	*4.9*	*5.6*
Interest & other Charges	26	36	37	41	41	40
Other Income	22	11	2	4	5	6
PBT (reported)	**40**	**25**	**19**	**18**	**33**	**62**
% chg	*22.3*	*(39.1)*	*(21.6)*	*(4.1)*	*77.8*	*89.8*
Extraordinary Expense/(Inc.)	18	0	0	0	0	0
PBT (adjusted)	**59**	**25**	**19**	**18**	**33**	**62**
Tax	10	4	(1)	(1)	7	19
(% of PBT)	*17.4*	*16.4*	*(5.3)*	*(4.0)*	*20.0*	*30.0*
PAT (reported)	**48**	**21**	**20**	**19**	**26**	**44**
ADJ. PAT	**30**	**20**	**20**	**19**	**26**	**44**
% chg	*2.1*	*(32.2)*	*(0.9)*	*(5.2)*	*36.8*	*66.1*
(% of Net Sales)	*2.7*	*1.6*	*1.7*	*1.5*	*1.9*	*2.6*
Basic EPS (₹)	**8.1**	**3.4**	**3.4**	**3.2**	**4.4**	**7.3**
Fully Diluted EPS (₹)	**5.0**	**3.4**	**3.4**	**3.2**	**4.4**	**7.3**
% chg	*2.1*	*(32.2)*	*(0.9)*	*(5.2)*	*36.8*	*66.1*

Balance sheet statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
SOURCES OF FUNDS						
Equity Share Capital	12	12	12	12	12	12
Reserves& Surplus	259	275	290	304	323	359
Shareholders Funds	**271**	**287**	**302**	**316**	**335**	**371**
Total Loans	342	349	414	416	409	389
Deferred Tax Liability	25	28	27	27	27	27
Other long term liab.	0	0	0	0	0	0
Long term provisions	2	3	2	2	2	2
Total Liabilities	**640**	**667**	**745**	**761**	**774**	**790**
APPLICATION OF FUNDS						
Gross Block	720	848	963	1,054	1,132	1,210
Less: Acc. Depreciation	334	403	480	564	655	752
Net Block	**386**	**445**	**483**	**490**	**477**	**458**
Capital WIP	90	107	103	116	125	133
Investments	**3**	**3**	**3**	**4**	**4**	**4**
Loans and adv.	41	42	51	51	51	51
Other non curren assets	0	0	0	0	0	0
Current Assets	324	285	273	285	325	393
Cash	12	11	11	6	11	15
Loans & Advances	58	38	25	31	35	43
Other	255	236	238	247	279	336
Current liabilities	204	214	168	185	209	250
Net Current Assets	**120**	**71**	**105**	**100**	**116**	**143**
Total Assets	**640**	**667**	**745**	**761**	**774**	**790**

Cash flow statement

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
Profit before tax	59	25	19	18	33	62
Depreciation	53	70	76	85	91	97
Change in Working Capital	(59)	48	(34)	1	(12)	(23)
Others	22	3	(11)	(0)	-	-
Other income	(22)	(11)	(2)	(4)	(5)	(6)
Direct taxes paid	(10)	(4)	1	1	(7)	(19)
Cash Flow from Operations	42	131	49	100	100	112
(Inc.)/ Dec. in Fixed Assets	(189)	(145)	(111)	(105)	(86)	(86)
(Inc.)/ Dec. in Investments	(0)	0	0	(1)	(0)	(0)
Other income	22	11	2	4	5	6
Cash Flow from Investing	(167)	(134)	(109)	(102)	(82)	(81)
Issue of Equity	0	0	(0)	0	0	0
Inc./(Dec.) in loans	124	7	64	3	(7)	(20)
Dividend Paid (Incl. Tax)	8	5	5	6	7	8
Cash Flow from Financing	117	2	59	(3)	(14)	(28)
Inc./(Dec.) in Cash	(9)	(1)	(0)	(4)	5	4
Opening Cash balances	20	12	11	11	6	11
Closing Cash balances	12	11	11	6	11	15

Key ratios

Y/E March	FY2012	FY2013	FY2014	FY2015E	FY2016E	FY2017E
Valuation Ratio (x)						
P/E (on FDEPS)	12.9	19.0	19.3	20.9	15.3	9.2
P/CEPS	4.7	4.2	4.0	3.9	3.4	2.9
P/BV	1.4	1.4	1.3	1.3	1.2	1.1
Dividend yield (%)	1.7	1.1	1.1	1.2	1.5	1.6
EV/Sales	0.6	0.5	0.6	0.6	0.5	0.4
EV/EBITDA	7.4	6.0	6.0	5.8	5.0	4.0
EV / Total Assets	1.1	1.1	1.1	1.1	1.0	1.0
Per Share Data (₹)						
EPS (Basic)	5.0	3.4	3.4	3.2	4.4	7.3
EPS (fully diluted)	5.0	3.4	3.4	3.2	4.4	7.3
Cash EPS	13.9	15.5	16.2	17.3	19.5	23.5
DPS	1.1	0.7	0.7	0.8	1.0	1.1
Book Value	45.1	47.8	50.3	52.6	55.8	61.8
Dupont Analysis						
EBIT margin	3.9	3.9	4.6	4.5	4.9	5.6
Tax retention ratio	0.8	0.8	1.1	1.0	0.8	0.7
Asset turnover (x)	2.1	2.0	1.7	1.7	1.9	2.2
ROIC (Post-tax)	6.8	6.5	8.2	7.8	7.3	8.8
Cost of Debt (Post Tax)	7.6	8.7	10.3	10.4	8.0	7.0
Leverage (x)	1.0	1.2	1.3	1.3	1.2	1.1
Operating ROE	5.8	3.8	5.6	4.4	6.4	10.7
Returns (%)						
ROCE (Pre-tax)	8.0	7.6	7.7	7.4	9.0	12.3
Angel ROIC (Pre-tax)	7.0	7.6	7.4	7.4	9.1	12.4
ROE	12.0	7.3	6.9	6.2	8.1	12.4
Turnover ratios (x)						
Asset Turnover (Gross Block)	1.7	1.6	1.3	1.2	1.3	1.5
Inventory / Sales (days)	58	55	55	55	55	55
Receivables (days)	21	17	16	17	17	17
Payables (days)	62	60	51	52	52	52
WC cycle (ex-cash) (days)	26	24	24	27	26	25
Solvency ratios (x)						
Net debt to equity	1.2	1.2	1.3	1.3	1.2	1.0
Net debt to EBITDA	3.4	2.8	3.0	2.9	2.5	1.9
Interest Coverage (EBIT / Int.)	1.7	1.4	1.5	1.3	1.7	2.4

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DISCLAIMER

Disclosure of Interest Statement	**Subros**
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%)* *Reduce (-5% to -15%)*	*Accumulate (5% to 15%)* *Sell (< -15%)*	*Neutral (-5 to 5%)*

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