

# Escorts

Margin plays hide-and-seek; new fiscal, fresh outlook



analysis adds up

India Equity Research | Auto & Auto Ancillaries

November 30, 2010

Result Update

Escorts (ESC) reported 10% y-y growth in standalone revenue in 4Q FY10 to Rs6.7 bn, led by 8.2% growth in tractor volume. FY10 standalone revenue grew by 26.4% to Rs27.6 bn, primarily led by a 32% jump in tractor volume to 60,086. The construction equipment segment (ECE) revenue grew by 30% y-y to Rs6.1 bn, leading to FY10 consolidated revenue growth of 27% to Rs33.8 bn. On the standalone operating margin front, the company disappointed by reporting a drop of 480bp q-q to 4.9%, led by a sharp jump in other expenditure due to scattered accounting strategy followed by management. Other expenditure/sales jumped to 18.1% this quarter against the first three-quarter average of 12.5%, resulting in a full-year figure of 13.8% at par with the FY09 figure. We revise our consolidated revenue figure for FY11E and FY12E to Rs37.8 bn and Rs44.8 bn and cut our operating margin by 90bp and 120bp to 8.4% and 9.1%, respectively. We reiterate our BUY rating on ESC with a revised 12-month PT of Rs267 (from Rs300) based on 6x FY12E EV/EBITDA (at a 25% discount to a five-year average traded forward multiple).

**In-line revenue; we are factoring in a 15% revenue CAGR during FY10-12E:** Standalone revenue for 4Q FY10 grew by 10% y-y to Rs6.7 bn, led by an 8.2% rise in tractor volume. For FY10, standalone revenue was up 26.4% to Rs27.6 bn, with tractor volume growing by 32% y-y to 60,086. ECE revenue grew by 30% y-y to Rs6.1 bn, leading to consolidated revenue growth of 27% to Rs33.8 bn. We expect consolidated revenue to grow at a CAGR of 15% to Rs44.9 bn in FY12E, led by a 14% volume CAGR in tractors.

**Margin plays spoilsport; scattered accounting treatment of other expenditure leading to lack of relevance of first three-quarter margin:** ESC reported a standalone operating margin of 4.9% this quarter, down 480bp q-q, led by a 630-bp rise in other expenditure/sales. As per management, scattered accounting of fixed cost elements led to skewness in other expenditure elements getting accounted in 4Q, although on a y-y basis other expenditure for FY10 was at par with FY09 at 13.8%. Against a first three-quarter average other expenditure of 12.5%, the balancing act in 4Q would give us the lack of clarity on actual operational performance based on the upcoming quarter numbers, signifying incremental stress to be given to gross margin rather than operating margin. For FY10, standalone operating margin contracted by 100bp to 8.4%, primarily led by higher RM costs. At the consolidated level, margin contracted by 110bp to 7.3% in FY10. We are modelling operating margin levels of 8.4% and 9.1% in FY11E and FY12E, respectively.

**Consolidated ROCE improves to 10%; expect it to improve to 16-18% in FY12E:** ESC reported a ROCE of 10% in FY10, primarily led by improved capital intensity through higher tractor volume. We believe, on the back of requirement of nominal capex in FY11-12E and scope of improvement in margin, ESC can generate free cash flow to the extent of Rs6 bn on a cumulative basis between FY11-12E along with driving the ROCE up to 16-18% levels.

**Re-iterate BUY with revised 12-month PT of Rs267 (Rs300 earlier):** We re-iterate our BUY on ESC with a revised 12-month PT of Rs267 based on 6x FY12E EV/EBITDA (based on target multiple at 25% discount to 5-year average traded forward multiple). At our target price we expect ESC to trade at 10.6x FY12E earnings on the back of expected 42% earnings CAGR between FY10-12E. Inability to improve tractor market share, improve margin in core agri machinery business along with ECEL are the major risks to our estimates and in turn our price target.

## Exhibit 1. Financials and valuation summary

	Revenue		EBITDA		Adjusted net income		EPS (Rs/share)	ROaCE (%)	ROaE (%)	PE (x)	EV/EBITDA (x)
	(Rs mn)	Growth(%)	(Rs mn)	Growth(%)	(Rs mn)	Growth(%)					
2009	26,617	(3.8)	2,224	55.2	645	NA	7.1	8.8	5.4	27.3	9
2010	33,781	26.9	2,450	10.2	1,266	96.4	12.0	9.6	8.1	16.2	9.2
2011E	37,811	11.9	3,176	29.6	1,876	48.2	17.8	12.5	10.5	10.9	6.4
2012E	44,864	18.7	4,083	28.5	2,667	42.2	25.2	16.6	13.4	7.7	4.1

Note: Pricing as on 29 November 2010. Source: Company data, Quant Global Research estimates

## BUY

Rs194

Reuters: ESCO.BO;

Bloomberg: ESC IN

12-month price target

Rs267

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Market cap	Rs20.5 bn (US\$0.4 bn)
52 week high/low:	Rs246/Rs104
Share o/s:	106 mn
Share o/s (fully diluted):	106 mn
Avg daily trading vol (3m):	894 ('000)
Avg daily trading val (3m):	Rs193 mn (US\$4 mn)

	Buy(s)	Hold(s)	Sell(s)
Nos	11	0	0

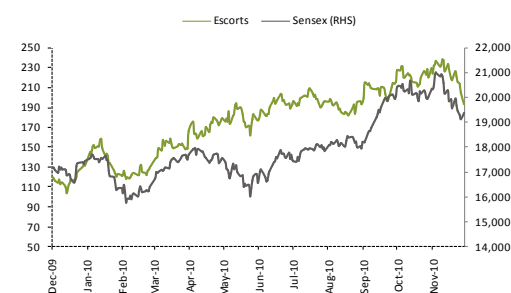
Source: Bloomberg

### Shareholding pattern

	Sep 10	Jun 10	Mar 10
Promoters	26.8	27.9	30.1
FIs	29.7	22.9	21.8
MF/s/FIs/Banks	17.9	19.9	19.0
Others	25.6	29.3	29.1

Source: NSE

### Price movement



Source: Bloomberg

## 480bp q-q rise in other expenditure/sales (%) surprise negatively

Exhibit 2. 4Q FY10 – quarterly results

YE Sep Standalone (Rs mn)	4Q FY10	4Q FY09	3Q FY10	Y-y (%)	Q-q (%)	Comments
Net sales	6,721	6,113	8,109	9.9	(17.1)	In line with tractor volume trend
Raw materials	4,550	3,827	5,510			
(% of sales)	67.7	62.6	67.9			Stable metal prices led to stable RM cost
Employee cost	629	693	861			
(% of sales)	9.4	11.3	10.6			On a falling trend
Other expenditure	1,216	824	955			
(% of sales)	18.1	13.5	11.8			Going ahead it would be tough to infer quarterly operational performance
Operating profit	326	770	783	(57.6)	(58.3)	
OPM%	4.9	12.6	9.7			Lack of visibility for full year numbers based on first three quarter trend
Other income	1.0	15.4	0.0			
PBIDT	327	786	783			
Depreciation	96.4	128	95.6			Expected to stay flat on the back of lower incremental capex
Interest	61.1	129	(2.8)			To come down further on debt repayment
PBT	170	529	690			
Tax	56	(68)	226			
ETR%	33.2	(12.9)	32.7			
Adjusted PAT	114	597	465	(81.0)	(75.6)	
PAT margin	1.7	9.8	5.7			
Extraordinary income/ (exp.)	154.9	3	(6.4)			
Reported PAT	268	600	458	(55.3)	(41.5)	
No. of shares (mn)	105.6	105.6	105.6			
Adj EPS (Rs)	1.1	5.7	4.4			
Tractors sold (units)	13,985	12,931	17,917	8.2	(21.9)	4.4% farm growth in 2QFY10 to augur well for tractor demand in coming months
Net average realisation/vehicle	424,769	409,234	417,229	3.8	1.8	

Source: Company data, Quant Global Research

Exhibit 3: Other expenditure/sales (%) for FY10 remain unchanged

YE Sep Standalone (Rs mn)	FY10	FY09	Y-y (%)
Net sales	27,647	21,881	26.4
Raw materials	18,627	14,418	
(% of sales)	67.4	65.9	
Employee cost	2,892	2,384	
(% of sales)	10.5	10.9	
Other expenditure	3,815	3,019	
(% of sales)	13.8	13.8	
Operating profit	2,312	2,059	12.3
OPM%	8.4	9.4	
Other income	1.0	15.4	
PBIDT	2,313	2,075	11.5
Depreciation	434.8	492	
Interest	117.4	515	
PBT	1,761	1,068	64.9
Tax	505	213	
ETR%	28.7	20.0	
Adjusted PAT	1,256	854	47.0
PAT margin	4.5	3.9	
Extraordinary income/ (exp.)	119.3	43	
Reported PAT	1,375	897	53.3
No. of shares (mn)	105.6	105.6	
Adj EPS (Rs)	13.0	8.5	
Tractors sold (units)	60,086	45,627	31.7
Net average realisation/vehicle	411,707	416,615	(1.2)

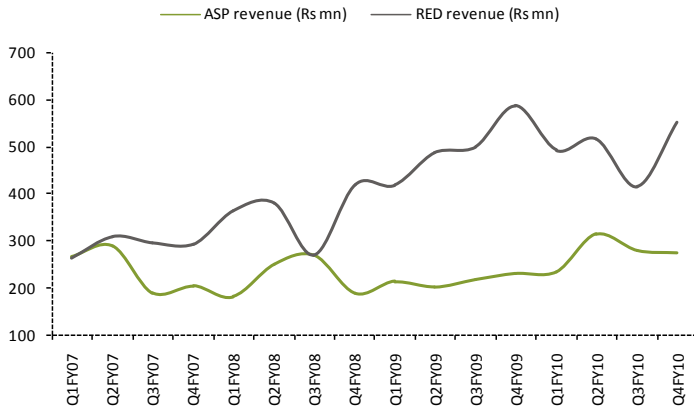
Source: Company data, Quant Global Research

Exhibit 4: Consolidated margin hit primarily due to higher RM costs

YE Sep Consolidated (Rs mn)	FY10	FY09	Y-y (%)
Net sales	33,783	26,617	26.9
Raw materials	23,225	17,741	
(% of sales)	68.7	66.7	
Employee cost	3,296	2,815	
(% of sales)	9.8	10.6	
Other expenditure	4,812	3,836	
(% of sales)	14.2	14.4	
Operating profit	2,450	2,224	10.1
OPM%	7.3	8.4	
Other income	19.0	22.5	
PBIDT	2,469	2,247	9.9
Depreciation	532.2	595	
Interest	181.0	717	
PBT	1,756	935	87.8
Tax	490	290	
ETR%	27.9	31.0	
Adjusted PAT	1,266	645	96.1
PAT margin	3.7	2.4	
Extraordinary income/ (exp.)	57.2	(359)	
Reported PAT	1,323	286	362.6
No. of shares (mn)	105.6	105.6	
Adj EPS (Rs)	12.0	6.1	

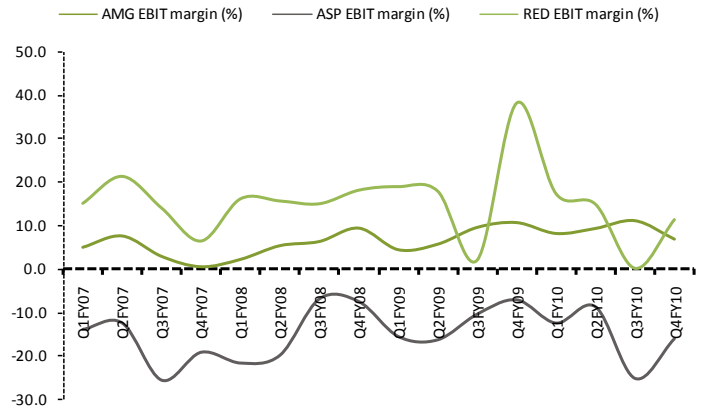
Source: Company data, Quant Global Research

**Exhibit 5: RED revenue saw revival after sudden fall in 3Q; ASP flat**



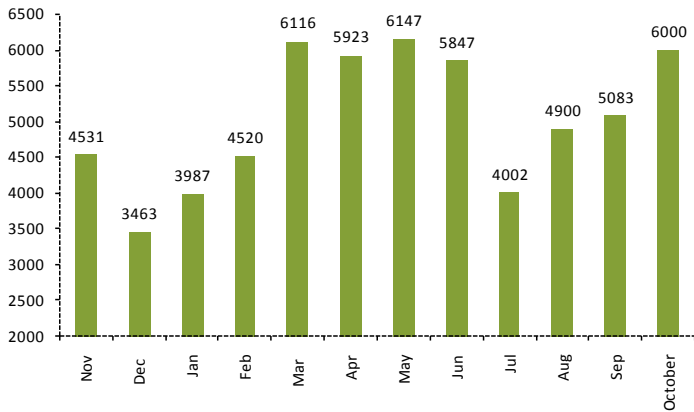
Source: Company data, Quant Global Research

**Exhibit 6: Revival in RED margin; AMG margin disappoints**



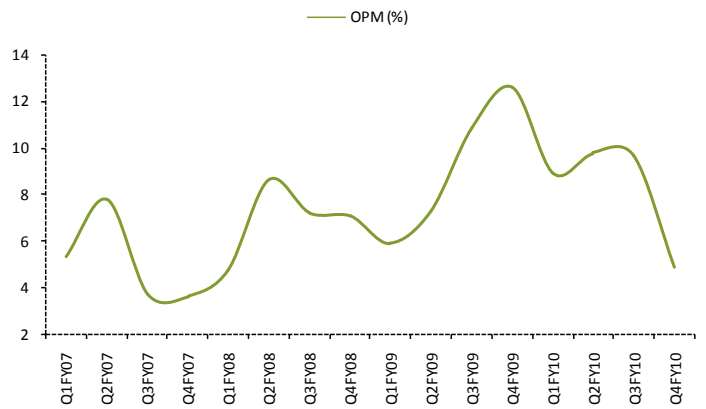
Source: Company data, Quant Global Research

**Exhibit 7: Monthly volume on a revival path post monsoon impact**



Source: Company data, Quant Global Research

**Exhibit 8: Margin surprises negatively led by scattered accounting approach**



Source: Company data, Quant Global Research

**Exhibit 9: Revision in estimates**

Particulars (Rs mn)	Earlier		Revised	
	FY11E	FY12E	FY11E	FY12E
Revenue	39,181	46,466	37,811	44,864
Operating profit	3,648	4,766	3,176	4,083
PAT	2,281	3,260	1,876	2,667
EPS (Rs)	22.5	32.1	17.8	25.2
Rating	BUY		BUY	
Price target (Rs)	300		267	

Source: Company data, Quant Global Research estimates

**Exhibit 10: Forward rolling EV/EBITDA chart; trading at discount to 5-year mean levels**



Source: Company data, Quant Global Research estimates, Bloomberg

## Financial summary

**Exhibit 11. Financial summary (YE September, Rs mn)**

Income Statement (Rs mn)					Balance Sheet (Rs mn)				
	2009	2010	2011E	2012E		2009	2010	2011E	2012E
<b>Net revenue</b>	<b>26,617</b>	<b>33,781</b>	<b>37,811</b>	<b>44,864</b>	Equity capital	907	1056	1056	1056
<b>Expenditure</b>	<b>24,393</b>	<b>31,331</b>	<b>34,635</b>	<b>40,781</b>	Reserves and surplus	13446	15889	17575	20030
Raw materials	17,741	23,225	25,787	30,732	Deferred tax liability (net)	(302)	(39)	(39)	(39)
Employee expenses	2,815	3,296	3,554	4,127	<b>Total equity</b>	<b>14051</b>	<b>16906</b>	<b>18592</b>	<b>21047</b>
Other expenditure	3,837	4,810	5,294	5,922	Secured loans	3815	3850	1850	50
<b>EBITDA</b>	<b>2,224</b>	<b>2,450</b>	<b>3,176</b>	<b>4,083</b>	Unsecured loans	204	204	204	204
Non-operating income	23	19	200	350	Minority interest	401	84	84	84
Depreciation	595	532	559	571	<b>Total borrowings</b>	<b>4420</b>	<b>4138</b>	<b>2138</b>	<b>338</b>
EBIT	1,629	1,918	2,617	3,511	Current liabilities	10188	10446	11832	14219
Net interest expense	717	181	137	52	<b>Total liabilities</b>	<b>28659</b>	<b>31490</b>	<b>32562</b>	<b>35605</b>
Adjusted pre-tax profit	912	1,737	2,480	3,460	Cash	2066	2117	2437	3973
Unusual or infrequent items	—	—	—	—	Inventory	3292	4365	4792	5459
<b>Reported pre-tax profit</b>	<b>934</b>	<b>1,756</b>	<b>2,680</b>	<b>3,810</b>	Debtors	4261	4502	4885	5797
Less: taxes	<b>290</b>	<b>490</b>	804	1,143	Other current assets	2198	3038	3038	3038
<b>Reported net profit</b>	<b>645</b>	<b>1,266</b>	<b>1,876</b>	<b>2,667</b>	<b>Total current assets</b>	<b>11816</b>	<b>14022</b>	<b>15153</b>	<b>18266</b>
Add: extraordinary items (post-tax basis)	—	—	—	—	Gross block	21949	23049	23549	24049
Less: minority/associate earnings	—	—	—	—	Less: depreciation and amortisation	(6352)	(6884)	(7443)	(8014)
<b>Reported net profit for shareholders</b>	<b>645</b>	<b>1,266</b>	<b>1,876</b>	<b>2,667</b>	Add: capital work-in-process	123	123	123	123
<b>Adjusted net profit for shareholders</b>	<b>645</b>	<b>1,266</b>	<b>1,876</b>	<b>2,667</b>	<b>Total fixed assets</b>	<b>15720</b>	<b>16288</b>	<b>16228</b>	<b>16157</b>
					Investments	1067	1067	1067	1067
<b>EPS (Rs), based on wtd avg shares</b>	<b>7.1</b>	<b>12</b>	<b>17.8</b>	<b>25.2</b>	of which, liquid investment	—	—	—	—
<b>EPS (Rs), based on fully diluted shares</b>	<b>7.1</b>	<b>12</b>	<b>17.8</b>	<b>25.2</b>	Other assets	57	114	114	114
Year-end shares outstanding (mn)	90.7	105.6	105.6	105.6	<b>Total assets</b>	<b>28659</b>	<b>31490</b>	<b>32562</b>	<b>35604</b>
Weighted average shares outstanding (mn)	90.7	105.6	105.6	105.6	<b>Net working capital</b>	<b>4368</b>	<b>6252</b>	<b>5997</b>	<b>6723</b>
Fully diluted shares outstanding (mn)	90.7	105.6	105.6	105.6					
<b>Growth ratio (%)</b>					<b>Cash flow statement (Rs mn)</b>				
Net revenue	(3.8)	26.9	11.9	18.7	<b>Operating cashflow</b>				
EBITDA	55.2	10.2	29.6	28.5	Pre-tax income	934	1756	2680	3810
Adjusted net profit	(595.2)	96.4	48.2	42.2	Add: depreciation and amortisation	595	532	559	571
					Less: interest expense (net)	(694)	(162)	63	298
					Less: other adjustments	—	—	—	—
					Less: taxes paid	(290)	(490)	(804)	(1143)
					Add: working capital changes	4502	(1896)	575	809
					<b>Total operating cashflow</b>	<b>5742</b>	<b>(98)</b>	<b>3011</b>	<b>4047</b>
					<b>Investing cashflow</b>				
					Capital expenditure	(5724)	(1100)	(500)	(500)
					Investments	1315	—	—	—
					Others	—	—	—	—
					<b>Total investing cashflow</b>	<b>(4409)</b>	<b>(1100)</b>	<b>(500)</b>	<b>(500)</b>
					<b>Financing cashflow</b>				
					Share issuances	102	1857	—	—
					Loans	27	(287)	(2063)	(2099)
					Less: Dividends paid (incl. divi. tax)	(124)	(158)	(190)	(211)
					<b>Total financing cashflow</b>	<b>4</b>	<b>1411</b>	<b>(2253)</b>	<b>(2310)</b>
					<b>Net change in cash</b>	<b>643</b>	<b>52</b>	<b>320</b>	<b>1535</b>
					Opening cash	1423	2066	2117	2437
					Add: other adjustments	—	—	—	—
					<b>Closing cash</b>	<b>2066</b>	<b>2117</b>	<b>2437</b>	<b>3973</b>

Ratios (%)				
	2009.0	2010.0	2011E	2012E
Effective tax rate	31.0	27.9	30.0	30.0
EBITDA margin	8.4	7.3	8.4	9.1
Adjusted net income margin	2.4	3.7	5.0	5.9
Net debt/equity	0.1	0.1	(0.1)	(0.2)
ROaCE	8.8	9.6	12.5	16.6
ROaE	5.4	8.1	10.5	13.4
Total asset turnover ratio (x)	0.9	1.1	1.2	1.4
Inventory turnover ratio (x)	45.1	47.2	46.3	44.4
Debtors turnover ratio (x)	58.4	48.6	47.2	47.2

Per share numbers (Rs)				
	2009.0	2010.0	2011E	2012E
Diluted earnings	7.1	12.0	17.8	25.2
Cash earnings	13.7	17.0	23.1	30.7
Free cash	0.2	(11.3)	23.8	33.6
Book value	154.9	160.1	176.0	199.3

Valuations (x)				
	2009.0	2010.0	2011E	2012E
Price to diluted earnings	27.3	16.2	10.9	7.7
EV/EBITDA	9.0	9.2	6.4	4.1
Price to book	1.3	1.2	1.1	1.0

Source: Company data, Quant Global Research estimates

## Ratings and other definitions

### Stock rating system

**BUY.** We expect the stock to deliver >15% absolute returns.

**ACCUMULATE.** We expect the stock to deliver 6-15% absolute returns.

**REDUCE.** We expect the stock to deliver +5% to -5% absolute returns.

**SELL.** We expect the stock to deliver negative absolute returns of >5%.

**Not Rated (NR).** We have no investment opinion on the stock.

### Sector rating system

**Overweight.** We expect the sector to relatively outperform the Sensex.

**Underweight.** We expect the sector to relatively underperform the Sensex.

**Neutral.** We expect the sector to relatively perform in line with the Sensex.

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