

ESCORTS

Margins disappoint but expect improvement ahead

■ Strong Y-o-Y growth, but sequential disappointment

Escorts reported a profit of INR 234 mn in Q1FY10 (versus a loss of INR 0.4 mn in Q1FY09). Revenues, driven by strong tractor volumes at INR 6bn were up 21% Y-o-Y but flat Q-o-Q. Although EBITDA margins improved 260bps Y-o-Y, the sequential decline in excess of 350bps disappointed. The tax rate was also well ahead of expectations.

■ High material costs compress margins

EBITDA margin, at 8.9%, posted a sequential decline of 370bps during the quarter, which was disappointing. While cost-cutting measures led to a sequential decline in other operating expenses (down 110bps Q-o-Q), raw material expenses-to-sales ratio jumped 460bps Q-o-Q. This may be partially attributable to higher commodity costs.

■ Lower interest costs reflect improved balance sheet strength

The 48% sequential decline in interest costs to INR 67.8 mn reflects the substantial decline in debt with the D/E ratio close to 0.12:1. Also, the absence of any one off / extraordinary items seems to indicate that most balance sheet related issues have been adequately addressed in the past quarters.

■ Outlook and valuations: Positive; maintain 'BUY'

We believe Escorts is now more focused with the teething balance sheet issues subsiding. While Q1FY10 results do disappoint, we believe the coming quarters are likely to post better results on account of: (a) the average increase of 3-4% in tractor prices that the company has effected in January; and (b) lower tax rate on account of write offs in the previous years. Further, we expect strong cost cutting measures to flow through in the next few quarters.

On our estimates, the stock trades at a P/E of 11x FY10E and 9x FY11E, respectively, considerably lower than its peers. We maintain our **'BUY'** recommendation on the stock.

January 18, 2010

Reuters : ESCO.BO Bloomberg : ESC IN

EDELWEISS RATING

Absolute Rating **BUY**

MARKET DATA

CMP	:	INR 149
52-week range (INR)	:	159 / 31
Share in issue (mn)	:	94.3
M cap (INR bn/USD mn)	:	14.1 / 308.7
Avg. Daily Vol. BSE ('000)	:	2,283.1

SHARE HOLDING PATTERN (%)

Promoters*	:	30.1
MFs, FIs & Banks	:	15.9
FIIIs	:	15.5
Others	:	38.6
* Promoters pledged shares (% of share in issue)	:	11.9

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	3.8	32.7	28.9
3 months	1.3	23.5	22.2
12 months	88.3	293.3	205.0

Financials

Year to September	Q1FY10	Q1FY09	% change	Q4FY09	% change	FY09	FY10E
Net revenues (INR mn)	6,002	4,953	21.2	5,989	0.2	21,578	24,259
EBITDA (INR mn)	541	297	82.4	770	(29.7)	2,059	2,583
Adj. net profit (INR mn)	234	(3)	8,463.2	597	(60.8)	854	1,271
Diluted EPS (INR)	2.6	(0.0)	93.3	6.6	(0.7)	9.4	14.0
Diluted PE (x)						10.6	9.2
EV/EBITDA (x)						7.2	5.2
ROACE						11.4	14.8

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Financial snapshot

Year to September	Q1FY10	Q1FY09	% change	Q4FY09	% change	FY09	FY10E
Revenues (net)	6,002	4,953	21.2	5,989	0.2	21,578	24,259
Other operating income	59	64	(7.0)	125	(52.6)	303	303
Total revenues	6,061	5,016	20.8	6,113	(0.9)	21,881	24,561
Dec/(inc) in stock	1	(79)	101.1	(138)	100.6	(182)	-
Raw material	4,070	3,562	14.3	3,965	2.7	14,600	16,375
Staff costs	696	556	25.2	693	0.6	2,384	2,426
Other expenses	752	680	10.6	824	(8.7)	3,019	3,178
Total expenditure	5,520	4,719	17.0	5,343	3.3	19,821	21,978
EBITDA	541	297	82.4	770	(29.7)	2,059	2,583
Interest	68	164	(58.7)	129	(47.3)	515	400
Depreciation & amortisation	119	125	(4.8)	128	(7.0)	492	514
PBT	355	8	4,551.6	529	(33.0)	1,068	1,694
Tax	121	10	1,056.5	(68)	276.4	213	424
Adj. net profit	234	(3)	8,463.2	597	(60.8)	854	1,271
Extraordinary exp/Mis exp	-	1	(100.0)	(3)	100.0	(43)	-
Net profit	234	(3)	6,958.2	600	(61.0)	897	1,271

As % of net revenues

Raw material	67.2	69.4		62.6		65.9	66.7
Staff costs	11.5	11.1		11.3		10.9	9.9
Other expenses	12.4	13.6		13.5		13.8	12.9
Expenses capitalised	0.0	0.0		0.0		0.0	0.0
EBITDA	8.9	5.9		12.6		9.4	10.5
Adj. net profit	3.9	(0.1)		9.8		3.9	5.2
Tax rate	34.0	136.7		(12.9)		20.0	25.0

■ Company Description

The Escorts Group consists of three major divisions—tractors/farm equipment, engineering, and construction. While the construction space is listed through a separate subsidiary, the other two divisions are a part of the standalone business. Tractors comprise 72% of the total business, railways 7%, and construction 15%.

■ Investment Theme

We believe Escorts is now more focused with the teething balance sheet issues subsiding. While in the near term the tractor business is on track, we are also enthused by the company's focus on segments in the infrastructure space. On our estimates, the stock trades at a P/E of 10x FY10E and 9x FY11E, respectively, considerably lower than its peers.

■ Key Risks

● Execution will be key

Management intends to scale up businesses such as railways and construction over the next few years. While the opportunities are strong and Escorts seems to have a certain edge in these businesses, execution will be particularly important.

● Balance sheet details still awaited

Whilst our discussion with the management indicates that the potential bad debts/write offs have been completed, a confirmation could come through only when the annual report is released.

● Higher-than-expected input cost

A substantial rise in commodity costs, largely steel and aluminium, could lead to significant margin pressure for the company. Further, we note that the company has one of the weakest EBITDA margins in the industry. Hence, the impact on profitability in the event of a marginal change in input costs could be substantially higher.

● Impact of poor monsoon

Rainfall in India has been nearly 23% below normal in last year's monsoons and is slated to impact crop production. While there has been no visible impact on tractor volumes till now, there is the possibility of lower rains affecting volumes in the future. We do note though that the negative impact may be offset by late rains.

Financial Statements

Income statement				(INR mn)
Year to March	FY08	FY09	FY10E	FY11E
Income from operations	20,515	21,881	24,561	27,206
Materials costs	14,488	14,418	16,375	18,160
Manufacturing expenses	663	770	849	942
Staff costs	2,026	2,384	2,426	2,690
S G & A expenses	1,814	2,249	2,329	2,583
Total operating expenses	18,991	19,821	21,978	24,375
EBITDA	1,525	2,059	2,583	2,832
Depreciation and amortisation	510	492	514	516
EBIT	1,014	1,568	2,069	2,316
Interest	559	515	400	400
Non-Operational income	0	15	25	35
Profit before tax	456	1,068	1,694	1,951
Provision for tax	143	213	424	488
Current taxes	143	213	424	488
Core profit	313	854	1,271	1,463
Extraordinary income/ (loss)	(194)	43	0	0
Profit after tax	119	897	1,271	1,463
Profit after minority interest	119	896	1,269	1,460
Consolidated PAT	119	897	1,271	1,463
Shares outstanding	91	91	91	91
Earnings per share (EPS)	3.4	9.4	14.0	16.1
Diluted shares outstanding	91	91	91	91
Diluted EPS	3.4	9.4	14.0	16.1
Cash EPS	9.1	14.8	19.7	21.8

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10E	FY11E
Operating expenses	92.6	90.6	89.5	89.6
Materials costs	70.6	65.9	66.7	66.7
Staff costs	9.9	10.9	9.9	9.9
S G & A expenses	8.8	10.3	9.5	9.5
Depreciation	2.5	2.2	2.1	1.9
Interest expenditure	2.7	2.4	1.6	1.5
EBITDA margins	7.4	9.4	10.5	10.4
Net profit margins	1.5	3.9	5.2	5.4

Growth metrics (%)

Year to March	FY08	FY09	FY10E	FY11E
Revenues		6.7	12.3	10.8
EBITDA		35.1	25.4	9.6
PBT		134.3	58.7	15.1
Net profit		173.1	48.7	15.1
EPS		173.1	48.7	15.1

Balance sheet				(INR mn)
As on 31st March	FY08	FY09E	FY10E	FY11E
Equity capital	907	907	907	907
Reserves & surplus	11,120	12,017	13,287	14,750
Shareholders funds	12,027	12,924	14,194	15,657
Secured loans	4,226	2,726	2,726	2,726
Unsecured loans	144	144	144	144
Borrowings	4,371	2,871	2,871	2,871
Deferred tax (Net)	(475)	(475)	(475)	(475)
Sources of funds	15,922	15,320	16,590	18,053
Gross block	14,159	20,304	21,495	22,495
Depreciation	5,934	6,426	6,940	7,456
Net block	8,225	13,878	14,556	15,039
Capital work in progress	144	192	0	0
Investments	4,258	577	1,818	2,665
Inventories	2,020	1,478	1,662	1,843
Sundry debtors	5,182	4,020	3,988	4,423
Cash and bank balance	1,145	1,079	1,213	1,345
Loans and advances	2,498	1,005	997	1,106
Other current assets	102	102	102	102
Total current assets	10,946	7,683	7,961	8,818
Sundry creditors	6,553	5,912	6,646	7,371
Provisions	1,208	1,208	1,208	1,208
Total current liab. & provisions	7,761	7,120	7,854	8,579
Net current assets	3,185	563	106	238
Miscellaneous expenditure not written off	110	110	110	110
Uses of funds	15,922	15,320	16,590	18,053
Book value per share (BV) (INR)	133	142	156	173

Free cash flow.

Year to March	FY08	FY09E	FY10E	FY11E
Net profit		6,544	12,860	14,053
Depreciation		1,298	1,406	1,513
Gross cash flow		7,842	14,266	15,567
Less: Changes in WC		1,791	685	937
Operating cash flow		6,051	13,581	14,630
Less: Capex		1,000	3,000	2,000
Free cash flow		5,051	10,581	12,630

Cash flow metrics

Year to March	FY08	FY09E	FY10E	FY11E
Operating cash flow		6,051	13,581	14,630
Financing cash flow		(3,394)	(4,324)	(4,424)
Investing cash flow		(2,586)	(9,146)	(10,140)
Net cash flow		72	111	66
Capex		(1,000)	(3,000)	(2,000)
Dividend paid		(2,894)	(3,724)	(3,724)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10E	FY11E
ROAE (%) - Adjusted	N.A	11.4	14.8	14.7
ROACE (%)	6.4	10.1	13.1	13.6
Inventory days	51	44	35	35
Debtors days	92	77	59	56
Payable days	165	158	140	141
Cash conversion cycle (days)	(22)	(37)	(45)	(49)
Current ratio	1.4	1.1	1.0	1.0
Debt/EBITDA	2.9	1.4	1.1	1.0
Fixed asset turnover (x)	1.4	1.3	1.2	1.2
Debt/Equity	0.4	0.2	0.2	0.2
Adjusted debt/equity	0.4	0.2	0.2	0.2

Operating ratios

Year to March	FY08	FY09E	FY10E	FY11E
Total asset turnover	1.3	1.4	1.5	1.6
Fixed asset turnover	2.5	2.0	1.7	1.8
Equity turnover	1.7	1.8	1.8	1.8

Du pont analysis

Year to March	FY08	FY09E	FY10E	FY11E
NP margin (%)	1.5	3.9	5.2	5.4
Total assets turnover	1.3	1.4	1.5	1.6
Leverage multiplier	1.3	1.3	1.2	1.2
ROAE (%)	2.6	6.8	9.4	9.8

Valuations parameters

Year to March	FY08	FY09	FY10E	FY11E
EPS (INR)	3.4	9.4	14.0	16.1
Y-o-Y growth (%)	0.0	173.1	48.7	15.1
Diluted consolidated EPS (INR)	3.4	9.4	14.0	16.1
CEPS (INR)	9.1	14.8	19.7	21.8
P/E (x)	43.2	15.8	10.6	9.2
Diluted consolidated P/E (x)	43.2	15.8	10.6	9.2
Price/BV (x)	1.1	1.0	1.0	0.9
EV/Sales (x)	0.6	0.7	0.5	0.5
EV/EBITDA (x)	8.2	7.2	5.2	4.4

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Coverage group(s) of stocks by primary analyst(s): Miscellaneous

Opto Circuits, Page Industries and Lakshmi Energy & Foods, Shree Renuka Sugar

Escorts



Recent Research

Date	Company	Title	Price (INR)	Recos
15-Jan-10	Sintex Industries	Healthy earnings visibility; <i>Result Update</i>	258	Buy
31-Dec-09	Escorts	On a turnaround; <i>Initiating Coverage</i>	130	Buy
30-Oct-09	Educomp Solutions	Need further clarity on change in smartclass revenue model; <i>Result Update</i>	801	Hold
30-Oct-09	Bharat Electronics	Strong show; <i>Result Update</i>	1,435	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	95	54	11	162

* 2 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	104	46	12

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	depreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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