PROFITMART advisory

RESEARCH REPORT

21st Dec 2018

VARROC ENGINEERING LIMITED

BSE : VARROC | **Sector: AUTO LIGHTING & COMPONENTS** | **BSE: 541578**

Position: Close

CMP : Rs. 673

Target Price: Rs 1050 (In next 12 to 18 mths)

BUSINESS BACKGROUND

Varroc Engineering Ltd. is a global tier-1 auto components supplier engaged in the design, manufacture and supply of auto exterior lighting systems, plastic and polymer components, electricals-electronics components, and precision metallic components used in passenger cars, commercial vehicles, 2-wheelers (2W), 3-wheelers (3W), and off-highway vehicles (OHV) OEMs. Varroc Lighting Systems division is the sixth-largest supplier globally and one of the top three independent exterior lighting suppliers. Varroc's business consists 1) Global Lighting Business involved in design, manufacture and supply of exterior lighting for passenger cars,with the products sold to OEMs globally; 2) India Business involved in design, manufacture and supply of a variety of auto components to Indian 2W and 3W OEMs; and 3) Other Businesses, which include a manufacturer of hot-steel forged parts for the construction and oil & gas industries in Italy, and a manufacturer of high-end lighting systems for global motorcycle OEMs, with operations in Italy, Romania and Vietnam.

INVESTMENT HIGHLIGHTS

Strong Financial Performance in H1 FY19 –

Varroc reported a steady set of FY18 numbers with net sales at Rs 10378.50 crs as compared to a revenue of Rs 9608.54 crs last year, with EBIDTA placed at Rs 877.56 crs from Rs 581.75 crs last year with the PAT placed at Rs 450.25 crs from Rs 313.10 crs. VEL has declared a dividend of 50% for FY18.

For VEL H1FY19 was also steady with Sales up by 26% at Rs 5985.60 crs with PAT at Rs 243.80 crs from Rs 191 crs up by 27% YoY.

Varroc enjoys a strong competitive position leading to robust growth –

Varroc is the sixth-largest tier-1 automotive exterior lighting manufacturer globally and one of the top three independent exterior lighting players. Going ahead VLS plans to capitalize on future growth in the passenger vehicle exterior lighting market & thus it is in the process of setting up a new plant in Brazil, to serve the South American market, and Morocco, to serve the southern European and North African markets.

For domestic market, it is the second largest Indian auto component group & and a leading tier-1 manufacturer and supplier to Indian two-wheeler and three-wheeler OEMs. Varroc believes that higher domestic as well global growth is the result of growing share of business with existing customers, winning new customer contracts, geographical expansion and the development of more technologically sophisticated products

KEY DATA

FACE VALUE Rs	1.00
DIVD YIELD %	0.07
52 WK HI/LOW	1177/631
NSE CODE	VARROC
BSE CODE	VARROC
MARKET CAP	RS 9137 CRS

SHAREHOLDING PATTERN

PROMOTERS	-	85%
BANKS, MFs & DIIs	-	3%
FIIs	-	3%
PUBLIC	-	9%

KEY FUNDAMENTALS

YE	FY19	FY20	FY21
Rev Gr%	18	18	15
EBIDTA Gr%	26	25	16
PAT Gr%	10	24	34
EPS Gr%	10	24	34
EPS (Rs)	36.72	45.62	61.20
ROE %	16	17	19
ROCE %	14	14	15
P/E(x)		15	11

Long term Drivers for DHFL look good in view of the follow18

Business Overview of Varroc is as follows –

- **Founded in 1988** in Aurangabad, India by the Jain family
- Investment by Omega TC Holdings Pte. Ltd. and Tata Capital Financial Services Limited in FY14

Two primary business lines:

1. **Varroc Lighting Systems ("VLS")**: global supplier of exterior lighting systems to passenger car OEMs
2. **Varroc India Business**: manufacturer and supplier of diverse range of auto components primarily to 2W and 3W OEMs

- **Strong, long-lasting, growing customer relationships** with marquee auto OEMs globally and in India
- **Well-diversified global auto component business** across geographies, products and customers

- **Low cost, strategically located global** manufacturing footprint
- **36 manufacturing facilities** across Asia, Europe and North America

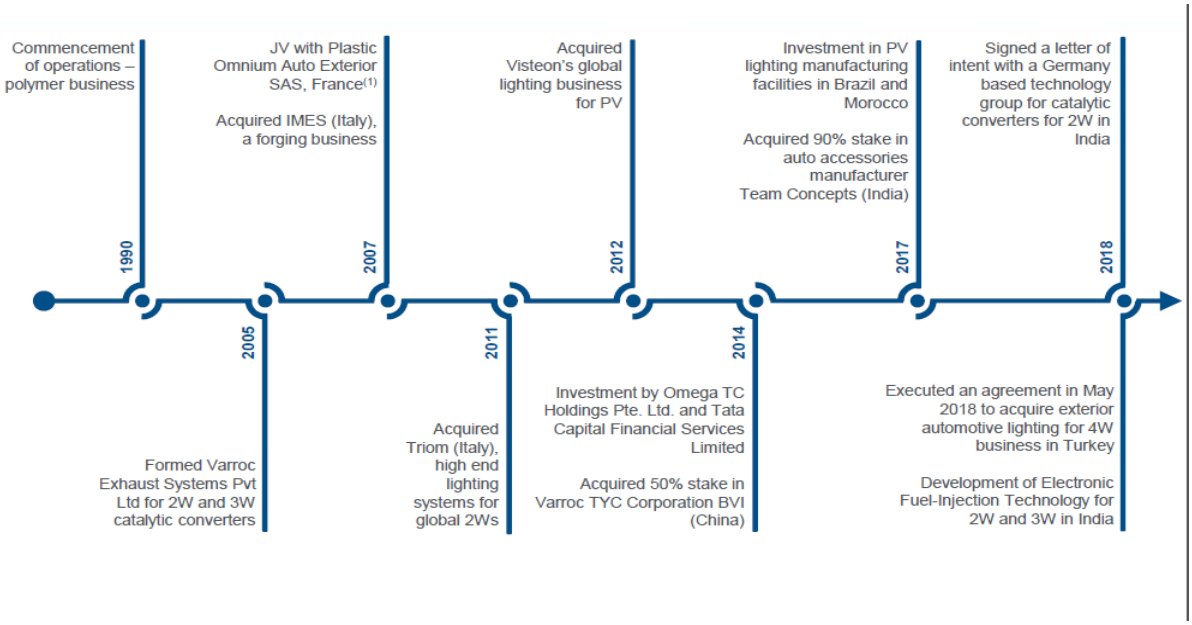
- **In-house R&D capabilities** in India, Czech Republic, China[5], USA, Mexico, Germany, Italy, Romania and Poland
- **1,414 R&D engineers[6]; 185 patents granted globally[6]**

- **Experienced management team supported by reputed Board**
- **14,200+** employees across the globe[6]

Leading
tier-1 manufacturer and supplier to the Indian 2W and 3W OEMs[4]

6th
Largest[2], fastest growing among top six global exterior auto lighting suppliers[3]

INR 104bn FY18 revenue
Track record of consistent growth with 14.3% CAGR for FY15-18



Key Product Segments serviced by VEL –

VEL functions in two main segments viz. Global Lighting Business and India Business contributing to 95% of the business. The Global Lighting Business consists of manufacturing and supply of exterior lighting systems to automobile OEM's. VEL aims to build new manufacturing facilities in Brazil and Morocco, enabling them to cater to the South American and North African markets.

Varroc's manufacturing facilities in the Global Lighting Business, are located in Mexico, the Czech Republic, China (through China JV) and India, allowing it to serve the North American, European, Chinese and Indian markets, respectively. VLS is in the process of setting up a new plant in Brazil, to serve the South American market & Morocco, to serve the southern European and north African markets. Company VEL anticipates that its plants in Brazil & Morocco will commence production in FY19

It has long-term relationships with marquee auto manufacturers across the premium, mid-range and mass market pricing spectrum, including Ford, Jaguar Land Rover, the Volkswagen Group (VW group), Renault-Nissan-Mitsubishi, Groupe PSA, FCA, a European multinational car manufacturer and an American electric car manufacturer. VLS has a broad portfolio of lighting products, including Halogen, Xenon/high-intensity discharge, light-emitting diode (LED), Matrix LED, high definition Micro- Electro-Mechanical Systems (MEMS) and digital micro-mirror device (DMD), surface LED, organic light emitting diode (OLED) module, Flex LED, LED pixel and LED pixel headlamp, catering to the five product segments within external automotive lighting

Varroc's India Business –

Within its Indian Business, VEL has 25 manufacturing facilities and five R&D centres spread across India. Its Indian manufacturing and distribution footprint is strategically located across key Indian automotive hubs, allowing the company to be closer to its customers and helping to ensure cost efficiency. The company has a long-standing relationship with Bajaj Auto, which has been its customer for the past 28 years and to whom the company has been providing components across its product lines. The other key 2-W customers in India include Honda, Royal Enfield, Yamaha, Suzuki and Hero Group.

Polymer business – VEL is one of the largest polymer solution providers to the 2-W OEMs with a Pan-India presence. Some of the major products include Air Filter Assemblies, Mirror assemblies, Seat Assemblies, Trims (Interior & Exterior) and others. The division has around 15 manufacturing facilities across India and caters to 2-W, 3-W, PV & CV segment

Electrical business – Within the Electrical division, the company offers comprehensive solutions in electrical-electronics components, assemblies for automotive applications and lighting products. Some of the major products include Digital Instrument clusters, CDI, Motor (Starter & Wiper), Magneto and others. The division has 7 existing manufacturing facilities & 2 upcoming facilities in India, and caters to 2-W, 3-W, PV & CV segment

Metallic business – Within the Metallic division, the company supplies precision forged & machined parts for engines and transmissions. It also supplies engines valves in domestic and international markets. Some of the major products include Transmission assembly, Crankshaft, Connecting Road, Engine Valve, Gears and others. The division has around 5 manufacturing facilities across India and caters to 2-W, 3-W, PV, CV & OHV segments

Others Business segments include IMES & Triom – In 2007, Varroc acquired I.M.E.S. (a manufacturer of hot steel forged parts for the construction and oil and gas industries) in Italy and in 2011 it acquired Triom (a manufacturer of high end lighting systems for global motorcycle brands) with operations in Italy, Romania and Vietnam and in 2012, VEL acquired Visteon's global lighting business, now known as Varroc Lighting Systems

IMES – This business is into manufacturing of hot steel forged parts for the construction and Oil & Gas Industries. Some of the major products include Undercarriage Links, Drill bit cones & heads and others. The division has 2 manufacturing facilities in Italy, and caters to Earth moving & Oil-drilling segment.

TRIOM – This unit is into high end lighting system for the global 2-W industry. Some of the major products includes Tail and Blinker, Head and Tail light and others. The division has around 3 manufacturing facilities in Italy, Romania & Vietnam and caters to the 2-W segments. As on FY18 Varroc gets around 61% of its consolidated revenues from Lighting, 16% from Polymers, 10% from Electricals, Mettalics 6% and Others 7%. Geographically Europe accounts for 42% of consolidated revenues, India 35%, N America 22%

Varroc enjoys well established & long-standing customer relationships –

Varroc has strong & long-standing relationships with many of their customers. Its Global Lighting Business' customers include marquee auto manufacturers across the premium, mid-range and mass market pricing spectrum, including **Ford, Jaguar Land Rover, FCA, Groupe PSA, the VW Group,** a European multinational car manufacturer and an American electric car manufacturer. While Varroc has many key customers with them for a long time, however they continue to add new customers, such as **Renault-Nissan-Mitsubishi, Volvo,** a Spanish automobile manufacturer and a German automobile manufacturer. Newly added customers for FY2018 and FY2019 include Dell'Orto S.p.A and Tata Cummins.

For India business, their customers include nearly all the major two-wheeler and three wheeler OEMs, including **Bajaj, Royal Enfield, Yamaha, Suzuki, Honda, Hero, Piaggio and Harley Davidson**. Moreover, going ahead Varroc has further room to grow their revenue with new customers, such as Hero Motocorp, who currently purchases only plastic and painted parts from Varroc,

Varroc enjoys a comprehensive and diversified product portfolio –

Varroc has a comprehensive portfolio of products which allows them to be a one stop-shop for their customers and to crosssell products. Varroc's global lighting business has a broad portfolio of lighting technologies, including Halogen, Xenon/high-intensity discharge, LED, Matrix LED, high definition MEMS and DMD, surface LED and OLED module, Flex LED and LED Pixel headlamp, covering the five automotive external lighting product lines.

Moreover, varroc is also a supplier of external lighting systems to a leading electric vehicle manufacturer namely Tesla. The company's domestic business offers a diverse range of products catering to two wheelers, three-wheelers, passenger vehicles, commercial vehicles and off-highway vehicles across their business segments of polymers/plastics, electrical electronics and precision metallic components. Further Varroc's product portfolio is engine agnostic as it is capable of being used across all fuel types

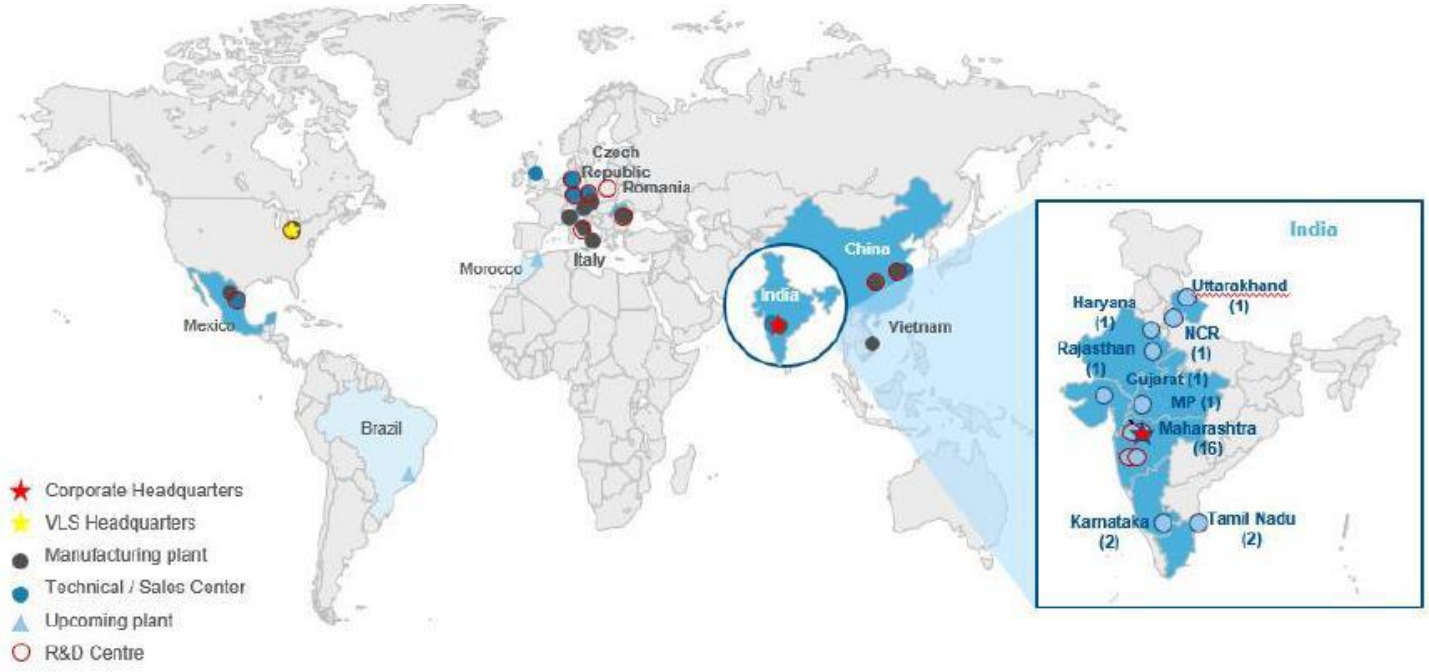
	VLS	Varroc's India Business			Other	
	PV Lighting	Polymer	Electrical	Metallic	IMES	Triom
Description	• Leading global supplier of exterior automotive lighting systems for PV	• One of the largest polymer solution providers to the 2W OEMs with a Pan-India presence	• Offers comprehensive solutions in electrical-electronics components, assemblies for automotive applications and lighting products	• Supplies precision forged & machined parts for engines and transmissions • Supplies engines valves in domestic and international markets	• Manufactures hot steel forged parts for the construction and oil & gas industries	• High end lighting systems for the global 2W industry
Select Product Portfolio	Head Lamps: Xenon, LED, Matrix; Rear Lamps: LED; Other Lights	Air Filter Assemblies, Mirror Assemblies, Seat Assemblies, Trims (Interior & Door)	Digital Instrument Cluster, CDI, Motor (Starter & Wiper), Magneto	Transmission Assembly, Crankshaft, Connecting Rod, Engine Valves, Gears	Undercarriage Links, Drill bit cones & heads, Undercarriage Segments	Tail + Blinker, Headlight, Tail Light
Manufacturing Facilities	6 Facilities – Czech Republic (2), China (2), Mexico & India 2 upcoming Facilities – Brazil & Morocco	15 Facilities – India[1]	7 Facilities – India[1] 2 upcoming Facilities – India	5 Facilities – India[1]	2 Facilities – Italy	3 Facilities - Italy, Romania and Vietnam
Revenue Mix[2]	60.8%	16.0%	10.2%	6.3%	4.1%[3]	
Customer Segment	PV	2W, 3W, PV & CV	2W, 3W, PV & CV	2W, 3W, PV, CV & OHV	Earth-moving & Oil-drilling	2W

A diversified product portfolio catering to 2W, 3W, PV, CV & OHV Segments
Low-cost strategically located global manufacturing facilities; pan-India presence near major auto hubs

Varroc has low cost & strategically located manufacturing facilities –

Varroc has a strong global footprint of 36 manufacturing facilities spread across seven countries, with six facilities for global lighting business, 25 for domestic business and five for other businesses. Further, company has a strong position from a costs perspective as they developed footprints in countries with low labour costs (such as in Mexico or the Czech Republic), thus benefiting from low cost engineering compared to the average engineering cost in European countries.

Further Varroc has made additional investments to expand into new countries such as Brazil and Morocco, which allow them to keep costs low while meeting their customers' supply needs across geographies. It has also started a facility in Turkey in FY2019. Similarly, for domestic business, the company has also located their domestic facilities in close proximity to major OEMs in India, which leads to greater cost effectiveness, quicker product launches, and faster turn-around times & thus allowing them to serve customers' needs in a timely manner



Varroc has built robust in-house technology, innovation and R&D capabilities –

Varroc's key focus is on the development of in-house R&D capabilities in order to manufacture technologically advanced automotive components in cost-effective ways so that sophisticated technological solutions are made accessible to the larger mass markets.

Varroc's R&D teams are focused on quick adoption of technology, enabling them to grow their product portfolio in line with customer expectations and industry developments. For global business, its R&D efforts are on designing and developing products and technology solutions that is capable of being adopted by their customers across large product platforms. Further this R&D focus has allowed varroc to establish a presence in key emerging technologies (such as LED) as well as a broad portfolio of headlamp technologies (such as matrix LED and laser), and to supply products for electric vehicles. In terms of R & D costs Varroc incurred Rs 461.50 crs in FY18 from Rs 244.50 crs in FY16 indicating its strong commitment towards this approach for getting a stronger competitive and innovative lead with customers.

For domestic business, company's R&D efforts seek to capitalize on emerging trends such as the increased use of electronics, stricter environmental regulations, emission reduction and light-weighting of vehicles, as well as the emergence of new technologies such as multi-point fuel injection.

Varroc plans to focus on high growth markets of Global Lighting Business –

The global exterior automotive lighting market is expected to grow at a CAGR of 4.3% between 2016 and 2021. Such growth is driven by the trend towards autonomous driving and connectivity between cars, with lighting becoming an increasingly prominent design and aesthetic feature, as well as playing a critical role in safety requirements and lighting technologies playing a greater role in energy efficiency and design flexibility. As such, Varroc is looking to expand its market share in the global exterior automotive lighting market, including projection systems, signaling functions and electronics.

Historically, while still part of Visteon, the Global Lighting Business had relationships with customers such as Jaguar Land Rover and a central European car manufacturer. Since acquisition of Visteon's lighting business in 2012, the company has grown its relationships with existing customers and expanded its customer base to include new OEMs such as the VW Group, Renault-Nissan-Mitsubishi and Volvo Truck. With cost efficient and global manufacturing footprint, Varroc is well-positioned to continue to serve its customers' needs across different car models and geographies

Also Varroc plans to focus on increasing customer revenue for its India business –

India is the second largest two-wheeler manufacturer in the world (after China), and the production of two wheelers in India grew at a 5% CAGR between FY2012 and FY2018. Demand from India grew at a 7% CAGR during calendar years 2013 to 2016, with domestic sales of 17.7 million units in 2016, whilst China's sales fell at a 10% CAGR during the same period.

Overall domestic two-wheeler production is expected to grow at a robust pace of 8-10% CAGR in the next three years to reach around 26.3 million units by FY2020.

Domestic sales are also estimated to grow at a similar pace of 8-10% during this period, whilst exports are expected to increase at a faster pace of 9-11% from the 2017 base. By contrast, domestic sales across Indonesia, Vietnam and Thailand, all of whom saw consecutive years of negative sales growth prior to 2016, cumulatively totaled 10.7 million units.

The primary demand drivers for the Indian domestic two-wheeler industry are improving affordability and lower cost of ownership, whilst the key growth drivers for two-wheeler industry exports are rising crude oil prices and a focus on other markets. Given the high exposure of two-wheelers in rural areas, they depend, in turn, on trends in rural incomes and infrastructure

Varroc is also planning to pursue strategic joint ventures and inorganic growth opportunities –

Verroc intends to actively pursue acquisition opportunities and strategic alliances with targets that are complementary to its business. It is mainly focused on growing existing product lines, such as automotive lighting and electronics for the global exterior automotive lighting market. While it is likely to continue to focus on the polymer, electrical and metallic businesses within India, Verroc is also likely to continue to be disciplined in evaluating complementary businesses in India to increase its focus on other segments if necessary. Verroc has historically entered into joint ventures and agreements with a number of partners in order to ensure they gain access to new technologies, advanced manufacturing know-how, and access to new customers and geographies

Recent Developments post Q2FY19 conference call –

India business EBITDA margin expanded by 120 bps yoy in 2QFY19 due to manufacturing & purchasing efficiency and better absorption of fixed cost due to higher volumes in 2QFY19. Company is under discussions to supply 3 new products to Honda from FY2021 and with Hero to supply 5-6 products, which will get finalized in next 3-6 months.

VLS business EBITDA margin (excluding R&D impact) declined by 100 bps qoq in 2QFY19 due to operational issues in Czech Republic plant related to increase in logistic costs and increase in scrappage to meet launch deadlines of customer. Varroc management expects VLS EBITDA margin to improve in 2HFY19 led by improvement in operational efficiencies.

VLS revenues grew by 14.2% YoY in 2QFY19 mainly led by significant growth in JLR and VW business. Company expects VW and Renault customers to significantly scale up in FY2020 and expects Renault to become a top five customer by FY2020. Ford has also decided to shift Focus and Fiesta models to LEDs by next year, which should also help VLS improve profitability as Ford is largest customer of VLS.

Company also indicated that LED lighting revenues contributed 47% of VLS revenues in 2QFY19. In the electric car segment, VLS commands a 21% market share (second largest player globally) and 20% of VLS revenues come from VLS business.

Varroc has retained its target of achieving revenue of `200 bn by FY2021. Company has brought forward the commercial production of Morocco plant to February 2019 from April 2019 and Brazil to January 2019 end from March 2019 earlier.

Company has also won orders from new customers like Geely and Nissan in VLS business and TVS Motors in India. Bulgaria plant to start production later this year. Halol plant will start production by the end of this month and will supply to Hero Motocorp. Company is also scaling up its relationship with Hyundai, which it acquired post the acquisition in Turkey. VLS has also opened an office in Japan in order to get business from Japanese OEMs.

Turkey acquisition – The company has reported revenue of EUR8-9 mn this quarter with EBITDA margin of 18-20%.

VEL enjoys a strong balance sheet and both Topline and Bottomline growth is likely to remain strong going ahead –

VEL has maintained a strong balance sheet over the years and has also enjoyed healthy operating cashflows. Operating cashflows between FY15-FY18 has grown at a CAGR of 15% and where its growth in revenue and profitability has been consistent over the last few years.

Varroc has delivered a robust growth over the last five financial years both in terms of financial and operational metrics. Given organic and inorganic growth globally, their global lighting business has managed to outperform growth in the overall global exterior lighting market, and in the last five years i.e. FY14-FY18, the company's revenue & profitability has grown at a CAGR of 14% and 81% respectively. Moreover, during the same period, company's operating margin has improved from 6.5% in FY14 to 8.5% in FY18.

Since 2012, Varroc has invested in nine manufacturing plants in India, with two in each of Maharashtra, Tamil Nadu and Karnataka, and one in each of Gujarat, Madhya Pradesh and Rajasthan and one R&D center, which is located in Aurangabad. Varroc has been successful in managing growth and at the same time has maintained a healthy balance sheet. Company's leverage ratio has improved from 1.09x in FY15 to 0.30x in FY18.

Also, company has delivered a stable return ratio with ROE & ROCE stands at 18% & 15% respectively as on FY18. Having successfully integrated and improved the operating performance of their international acquisitions, company is now looking to grow its international business organically, as evidenced by the ongoing development of two new plants in Brazil and Morocco, which they expect to commence operations in FY2019 apart from its Turkey unit which will also start contributing from FY19 onwards.

We expect that going ahead overall bottomline growth in the next 3 years starting FY19 onwards should easily increase at a CAGR of 18-20% and going ahead also we believe that net cash flows generated will remain healthy going ahead.

Business Outlook & Stock Valuation –

On a rough cut basis, in FY19, Topline will see a steady rise wherein Topline is expected to touch Rs 12246 crs in FY19E.

On the bottomline level we expect the company to record a PAT of Rs 495 crs in FY19E. Thus on a conservative basis, Varroc should record a EPS of Rs 36.72 for FY19E. For FY20E and FY21E our expectation is that earnings traction for Varroc would continue to be strong wherein we expect a EPS of Rs 45 and Rs 61 respectively.

Varroc is a Global Tier-1 automotive component group. Varroc designs, manufactures and supplies exterior lighting systems, plastic and polymer components, electricals-electronics components, and precision metallic components to passenger car, commercial vehicle, 2-wheeler, 3-wheeler and off highway vehicle (OHV) original equipment manufacturers (OEMs) directly worldwide.

Varroc on the one hand is working on growing organically by focusing on high growth markets for its global lighting business and increasing revenue share from its customer in India, on the other hand it is pursuing strategic joint ventures and inorganic growth opportunities in order to drive future revenue growth.

Going ahead VEL has a clear roadmap to sustain growth which is 1) to focus on high growth markets for Global lighting business; 2) Increase content per vehicle in India; 3) Invest in R&D & capitalize on future trends; 4) To look for Inorganic growth expansion and 5) Lastly, to focus on operational efficiency.

From a valuation perspective VEL trades at a PE of 15x and 11x on FY20E & FY21E which looks attractive considering its strong global and domestic customer footprint, a well diversified product portfolio, stronger financials with strong ROEs and ROCE of between 18% to 15% and a strong growth expected from both the domestic and global markets going ahead. Also the stock ever since its listing after its initial OFS in June 2018 at a IPO price of Rs 967 has seen a 43% correction from its earlier top of Rs 1177 which provides a good entry point for long term investors looking at a 2 year plus story which we believe looks attractive at present levels.

Varroc's global lighting business is No.6 globally in automotive exterior lighting, with a tilt toward LEDs. We believe that Lighting and LEDs is a segment that is structurally strong as the segment is powertrain agnostic, and LEDs help to save energy which is critical, especially from an EV perspective. Hence long term potential is huge for future scalability.

In conclusion we believe that VEL is supported by a competent management team and promoters, and is well positioned to for long term sustainable growth.

Hence we believe that the VEL stock should be purchased at the current price for a price target of around Rs 1050 over the next 18-24 months.

FINANCIALS

For the Year Ended March RsCrs	FY17A	FY18A	FY19E	FY20E	FY21E
Net Sales	9608.54	10378.45	12246.57	14450.95	16618.6
EBIDTA	581.75	877.56	1102.19	1372.84	1595.38
EBIDTA %	6.05	8.46	9.00	9.50	9.60
Interest	90.39	86.17	102.00	114.00	90.00
Depreciation	337.08	386.46	440.00	560.00	650.00
Non Operational Other Income	93.72	38.61	45.00	55.00	55.00
Profit Before Tax	327.19	512.56	605.19	753.84	910.39
Profit After Tax	313.1	450.25	495.00	615.00	825.00
Diluted EPS (Rs) FV Rs 1	23.23	33.40	36.72	45.62	61.20
Equity Capital	13.48	13.48	13.48	13.48	13.48
Reserves	2171.88	2814.51	3296.03	3897.03	4708.03
Borrowings	1354.46	980.06	1780.06	1800.00	1550.00
GrossBlock	2497.65	2830.36	3830.36	4830.36	5730.36
Investments	292.7	356.49	356.49	356.49	356.49

Source Company our Estimates

KEY CONCERNS.

Sensitivity to global economic and regulatory trends that could lead to weakening sales of its key customers

Lower pricing power during negotiations with OEMs, resulting in margin pressures for the company