Result Update

GREAVES COTTON LTD

PRICE RS.120 **TARGET RS.146** **BUY**

Greaves Cotton (GCL) reported good numbers, which were a tad ahead of our estimates. A notable highlight is that this was the highest profit growth in last seven quarters.

Key Highlights

- After three quarters of double digit growth, revenue slackened in Q2FY19. The management indicated that OEMs slowed down procurement of engines from the company due to excess inventory.
- EBITDA margins largely stable despite commodity cost pressures

Valuation and Outlook

The company's largest revenue segment (ie three-wheeler engines business) has been going through a prolonged phase of slowdown due to 1) Shift from diesel to CNG engines and 2) Emergence of electric vehicles. GCL is responding to this challenge by positioning itself as a fuel-agnostic engine maker including electric mobility.

GCL is currently trading at 13.5x and 12.4x FY19 and FY20 earnings respectively, which is attractive compared to peers in the capital goods and manufacturing sector. However, considering the moderate growth profile of the business, we are according it a lower target PE. We now value the stock at 15x FY20E (earlier 16x FY20E), thus arriving at a price target of Rs 146 (Rs 165 earlier). However, due to good upside, we upgrade the stock to BUY.

Quarterly performance

Rs mn	Q2FY19	Q2FY18	YoY (%)	Q1FY19	QoQ (%)
Net Revenues	**4951**	**4524**	**9.4**	**4582**	**8.1**
Expenditure	4218	3846	9.7	3972	6.2
Raw Material costs	3113	2870	8.4	2873	8.3
Purchase of traded goods	233	170	36.9	219	6.2
Staff costs	434	452	-4.1	466	-6.9
Other costs	439	353	24.4	414	6.1
Operating profit	**733**	**679**	**8.0**	**609**	**20.3**
Depreciation	125	141	-11.2	125	-0.1
Other income	127	110	15.5	103	22.7
EBIT	**734**	**647**	**13.4**	**587**	**25.0**
Interest	13	-2	-794.7	5	169.4
PBT	**721**	**649**	**11.1**	**582**	**23.8**
Tax	227	220	3.5	184	23.7
PAT before exc items	**493.6**	**429.4**	**15.0**	**398.4**	**23.9**
Exceptional items	0	63	-100.0	0	
Reported PAT	**494**	**492**	**0.3**	**398**	**23.9**
EBITDA (%)	14.8	15.0		13.3	
Raw Material costs to sales (%)	67.6	67.2		67.5	
Other exp to sales (%)	8.9	7.8		9.0	
Tax rate (%)	31.5	33.8		31.6	
EPS Rs	2.0	1.8		1.6	

Source: Company

Stock Details

Market cap (Rs mn)	:	29061
52-wk Hi/Lo (Rs)	:	165 / 111
Face Value (Rs)	:	2
3M Avg. daily vol (Nos)	:	837,787
Shares o/s (mn)	:	244

Source: Bloomberg

Financial Summary

Y/E Mar (Rs mn)	FY18	FY19E	FY20E
Revenue	17,921	19,707	21,388
Growth (%)	9.6	10.0	8.5
EBITDA	2,553	2,974	3,255
EBITDA margin (%)	14.2	15.1	15.2
PAT	1,536	2,164	2,370
EPS	6.3	8.9	9.7
EPS Growth (%)	(13.9)	40.9	9.6
BV (Rs/share)	37.3	39.8	43.0
Dividend/share (Rs)	5.5	5.5	5.5
ROE (%)	16.3	21.9	22.4
ROCE (%)	17.1	20.0	20.5
P/E (x)	19.1	13.5	12.4
EV/EBITDA (x)	9.4	7.9	6.9
P/BV (x)	3.2	3.0	2.8

Source: Company, Kotak Securities - PCG

Shareholding Pattern (%)

(%)	Sep-18	Jun-18	Mar-18
Promoters	51.0	51.0	51.0
FII	12.2	7.3	7.3
DII	17.5	13.8	16.9
Others	19.3	27.9	24.8

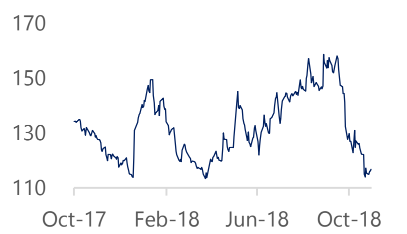
Source: Company

Price Performance (%)

(%)	1M	3M	6M
Greaves Cotton	(6.8)	(19.1)	(4.6)
Nifty	(4.1)	(6.2)	(1.5)

Source: Bloomberg

Price chart (Rs)



Source: Bloomberg

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Reported Vs Estimated performance

Rs mn	Reported	Estimated
Revenue	4951	5000
EBITDA %	14.8	14.5
PAT	494	475

Source: Kotak Securities – Private Client Research

Result Highlights

Revenue growth showing signs of upturn

- The company reported 9.4% y-o-y growth in revenue, aided by modest growth in engine volumes and accompanied by 3-4% price hikes.
- This was the highest quarterly revenue since FY2014. This indicates that although the company is not growing at a robust pace but there is a definite recovery after years of stagnation.
- The company's revenue mix comprises of automotive engines for 3W and 4W Light commercial vehicles (~70%), DG sets (15%) and Agriculture products (15%).
- In terms of product mix, engines/spares/others accounted for 50%/25%/25% of revenues in Q2FY19.
- The company had been posting tepid/contraction in revenue in the past several quarters mainly due to stagnation in domestic three-wheeler market.
- However, in recent quarters, there has been definite signs of upturn in demand for 3W. This product segment is bouncing back from the twin effects of demonetization and GST implementation. In the second quarter, the company indicated that there was surplus inventory with the OEMs, consequently, there was some reduction in engine procurement from Greaves' clients.
- The demand for 3W has a correlation with the Commercial Vehicles (CV) segment due to the need for last mile connectivity. In recent months, the monthly volumes of CVs has shown a strong upturn, which has started to reflect on the demand for 3W.

Engine volumes

(Nos)	Q2FY19	Q2FY18	YoY (%)
3W Engine	77988	78450	-0.6%
4W Engines	8932	6294	41.9%
DG sets	1338	1084	23.4%
Pumpsets	16691	16000	4.3%
Tillers	1000	800	25.0%

Source: Company

Client OEMs of GCL in 3W

Corporate	Brand	Fuel	Engine
Piaggio	Ape Xtra and City	CNG, Diesel, LPG	4 stroke single cylinder
M&M	Alfa and Champion	Diesel and CNG	4 stroke single cylinder
TVS	King	Diesel	4 stroke single cylinder
Atul Auto	Shakti, Gem and Gemini	Diesel	4 stroke single cylinder

Source: Company

EBITDA margins largely stable despite commodity cost pressures

- EBITDA margins contracted by 50 bps on a y-o-y basis to 14.8%, mainly due to 4% y-o-y increase in commodity cost inflation.
- Although the company had taken price hikes of 3-4% in Q2FY19 to accommodate the commodity price inflation, it has not been able to completely offset the cost increase.
- Efficient currency hedging and value engineering also helped the company contain the decline in margins.

PAT before exceptional items rose 15% y-o-y

- PAT before exceptional items rose 15% on a y-o-y basis led by moderate growth in revenues but partly offset by minor contraction in margins.
- The notable thing is that this is the highest profit growth achieved by the company in the past eight quarters.

Fuel mix shifting towards CNG engines from diesel/petrol engines:

In the Automotive Engine segment, the Company provides fuel agnostic powertrain solutions to three-wheeled passenger and cargo vehicles and four-wheeled mini-trucks.

The company has a 75% market share in the 3-wheeler Diesel engines market. While earlier, diesel engines were the preferred mode for last mile connectivity, stricter environmental norms is driving sales of CNG engines even as the share of diesel engines have been reducing in recent years. In urban markets, replacement demand has been an important growth driver wherein improving network of CNG fuel stations is driving replacement of older petrol or diesel powered 3Ws with ones based on CNG. In FY18, around 50% of the three wheeler sales were of CNG engines.

As the Government has set April 2020 deadline for the implementation of BS-VI norms, demand for conventional 3W diesel engines is likely to be affected in the future, the management opines.

GCL's weak product positioning in CNG 3W engines has led to underperformance in the 3W sales growth

GCL's focus as well as its forte has been on light diesel engines (75% market share in light diesel engines), which is also aligned with the positioning of its prime client Piaggio Vehicles (PVPL), who is a leader in the 3W cargo segment. In Cargo, diesel engines are better suited than their CNG counterparts on account of higher load carrying capacity and lack of CNG pump infrastructure in rural/semi rural areas. Given the focus of GCL on diesel engine segment, it appears that the company has been late in having a strong product in the CNG engine space.

GCL currently has a larger engine (400 cc) in CNG 3W market which is mainly being used in the 5+1 passenger 3W segment. However, the major market for passenger 3W is in the 2+1 category where a smaller engine (200-230 cc) is fitted. GCL has been largely missing in this segment and even its existing diesel engine customers like Atul/Piaggio are not fully sourcing CNG engines from the company.

With a view to address the weakness on CNG engine, GCL is offering the Pinnacle engine

GCL has entered into technical collaboration with Pinnacle Engines for CNG and Petrol segments. The Pinnacle engine are BS-VI compliant and come with revolutionary piston technology that offers 25-30% fuel efficiency over the conventional ones.

Brief on Pinnacle Engines - Pinnacle Engines Inc manufactures and sells combustion engines and controllers for automotive, motorcycle, marine, and power sports industries, as well as industrial and commercial markets in the United States and internationally. The engine is based around an opposed piston design. In most engines, a cylinder contains a single piston. In these engines, two pistons face each other from opposite ends of the same cylinder. The change effectively gives these engines a dynamic, more efficient compression chamber for burning fuel.

However, success depends on the outcome of the simulation tests

Greaves Cotton Limited had entered into an agreement with Pinnacle Engines, Inc. for the purpose of grant of licenses to the company for manufacture and sale of internal combustion engines. Size of agreement: USD 7.5 million linked payment plus 5% Royalty to Pinnacle. The advantage with tying up with Pinnacle is that it significantly reduces the "Go to Market" time for GCL, if it had decided to develop its own CNG engine.

The Pinnacle engine would be in the 200-250 cc range, which will be suitable for the 2+1 passenger 3W segment.

The company will start making prototypes in the coming days and simulation tests will be completed by Dec 2018. If the simulation results are successful, then the company can look forward to outsourcing deals from 3W makers.

What can possibly go wrong?

Although the Pinnacle engine comes with a strong technology platform, there are two factors that need to be watched out

1) While the engine offers 25-30% fuel efficiency, the ultimate cost of engine needs to be competitive for the customer as there are royalty payments to be made. Having said that, the GCL management is convinced about the value proposition.
2) The Pinnacle engine has not been commercially produced anywhere in the world hence does not have a performance track record.

Conference call highlights

- Greaves Cotton recently announced that they have entered into definitive agreements as per which it will acquire a majority stake in Electric Vehicle manufacturer - Ampere Vehicles Pvt. Ltd. Ampere is one of the leading brands in the last mile mobility electric vehicles segment. It has strong in-house capabilities in designing, developing, manufacturing & marketing electric vehicles with a wide range of applications. Through this acquisition, Ampere can benefit from Greaves' distribution, aftermarket and service strengths to grow more rapidly. The company completed acquisition of majority stake in Oct 2018. The financial numbers of Ampere will be shared in the future investor interactions.
- The company's after market (spares) business accounted for around ~ 25% of revenues (including spares for Auto, DG sets and Farm). Apart from the ongoing aftermarket sales (including Auto, DG and Farm) through the company's distribution outlets, GCL has also forayed into sale of multibrand spares through "Greaves care" outlets. It works on a franchise based model

as per which Greaves Cotton collects fee from the franchisee. In addition to this, Greaves benefits from manufacturing of spare parts sold through Greaves Care.

- The company share in the addressable market in DG sets has increased by 0.5% to 6%. It has recently launched 500 kva engine in the DG set market.
- The company continues to be debt free and had cash and equivalents of Rs 4.4 bn at the end of Q2FY19 (15% of market cap).
- In the current fiscal, the company has planned for capex of Rs 1.0 bn, which will be mainly for meeting R&D/product development expenses for BS VI compliant engine.
- The company expects employee costs to rise 6% in the current fiscal.

Valuation and Target price

GCL is currently trading at 13.5x and 12.4x FY19 and FY20 earnings respectively, which is attractive compared to peers in the capital goods and manufacturing sector stocks. However, considering the moderate growth profile of the business, we are according it a lower target PE. We now value the stock at 15x FY20E (earlier 16x FY20E), thus arriving at a price target of Rs 146 (Rs 165 earlier). We upgrade the stock to BUY.

Company background

Greaves Cotton Limited, established in 1859, is into manufacturing of Diesel / Petrol Engines, Gensets and Pumpsets. Greaves has a strong knowledge base in single cylinder diesel engines used for low cost transportation and its engines are extensively used in the three wheeler segment. Mr. Karan Thapar, who is Non-Executive Chairman of the company. The day-to-day management is vested with Mr. Mr. Nagesh Basavanhalli, Managing Director and CEO of the company, who is a professional and has joined the company in 2016.

The Business Divisions are:

Business Division	Product Lines
Agricultural Equipment	Petrol / Kerosene Engines: 1 to 5 HP, Pumpsets and Power Tillers
Automotive	Light Diesel Engines:
Auxiliary Power	Large Diesel Generating Sets Range: 2.5 KVA to 500 kVA single unit and upto 2500 kVA in parallel running
Industrial Engines	Diesel Engines: 1.4 to 1000 HP range

Source: Company

Financials: Consolidated

Profit and Loss Statement (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
Revenues	**16,344**	**17,921**	**19,707**	**21,388**
% change YoY	1.3	9.6	10.0	8.5
EBITDA	**2,436**	**2,553**	**2,974**	**3,255**
% change YoY	-8.8	4.8	16.5	9.5
Other Income	501.9	452.6	634.9	694.9
Depreciation	466.6	523.5	550.0	600.0
EBIT	**2,471**	**2,482**	**3,059**	**3,350**
% change YoY	-11.2	3.1	19.4	9.5
Net interest	8.1	8.1	11.0	11.0
Profit before tax	2,463	2,474	3,048	3,339
% change YoY	-8.2	0.5	23.2	9.6
Tax	680	939	884	968
as % of PBT	27.6	37.9	29.0	29.0
Profit after tax bef exep items	1,783	1,536	2,164	2,370
% change YoY	2.0	-13.9	40.9	9.6
Exceptional items	59.8	481.7	0	0
Reported PAT	**1,842**	**2,017**	**2,164**	**2,370**
Shares outstanding (m)	244.2	244.2	244.2	244.2
EPS (before exp items) (Rs)	**7.3**	**6.3**	**8.9**	**9.7**
CEPS (Rs)	9.2	8.4	11.1	12.2
DPS (Rs)	5.5	5.5	5.5	5.5

Source: Company, Kotak Securities – Private Client Research

Cash flow Statement (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
PBDIT	2,436	2,553	2,974	3,255
Direct tax paid	(736)	(919)	(884)	(968)
Adjustments	41	28	-	-
Cash flow from operations	1,740	1,663	2,090	2,287
Net Change in Working Capital	301	689	372	3
Net Cash from Operations	**2,040**	**2,352**	**2,462**	**2,290**
Capital Expenditure	(271)	(241)	(1,000)	(500)
Cash from investing	(43)	(505)	634	694
Net Cash from Investing	**(314)**	**(746)**	**(366)**	**194**
Interest paid	(8)	(8)	(11)	(11)
Issue of Shares/(buyback)	-	-	-	-
Dividends Paid	(1,617)	(1,472)	(1,571)	(1,571)
Debt Raised	(74)	72	1	1
Net cash from financing	**(1,699)**	**(1,408)**	**(1,581)**	**(1,581)**
Net change in cash	27	198	514	902
Free cash flow	1,769	2,111	1,462	1,790
cash at end	**100**	**298**	**812**	**1,715**

Source: Company, Kotak Securities – Private Client Research

Balance sheet (Rs mn)

(Year-end Mar)	FY17	FY18	FY19E	FY20E
Cash and cash equivalents	100	298	812	1,715
Accounts receivable	2,702	2,527	2,969	3,223
Inventories	1,294	1,094	1,346	1,461
Loans and Adv & Others	303	152	152	152
Current assets	4,399	4,071	5,280	6,551
Intangible assets	446	536	536	536
Other assets	394	419	420	421
LT investments	4,228	5,186	5,186	5,186
Net fixed assets	2,583	2,475	2,925	2,825
Def tax assets	0	0	0	0
Total assets	**6,187**	**7,396**	**8,502**	**9,651**
Payables	2,862	3,304	4,370	4,741
Others	0	0	0	0
Current liabilities	2,862	3,304	4,370	4,741
Provisions	189	233	233	233
LT debt	0	0	0	0
Other liabilities	175	275	276	277
Equity	488	488	488	488
Reserves	8,721	9,116	9,708	10,508
Total liabilities	**6,187**	**7,396**	**8,502**	**9,651**
BVPS (Rs)	36	37	40	43

Source: Company, Kotak Securities – Private Client Research

Ratio Analysis

(Year-end Mar)	FY17	FY18	FY19E	FY20E
EBITDA margin (%)	14.9	14.2	15.1	15.2
EBIT margin (%)	12.0	11.3	12.3	12.4
Net profit margin (%)	10.9	8.6	11.0	11.1
Receivables (days)	60.3	51.5	55.0	55.0
Inventory (days)	28.9	22.3	24.9	24.9
Sales/gross assets(x)	4.9	5.2	4.4	4.3
Interest coverage (x)	300.7	315.2	270.3	295.9
Debt/equity ratio(x)	-	-	-	-
ROE (%)	19.7	16.3	21.9	22.4
ROCE (%)	17.7	17.1	20.0	20.5
EV/ Sales	1.7	1.4	1.2	1.1
EV/EBITDA	10.3	9.4	7.9	6.9
Price to earnings (P/E)	16.4	19.1	13.5	12.4
Price to book value (P/B)	3.4	3.2	3.0	2.8

Source: Company, Kotak Securities – Private Client Research

RATING SCALE

Definitions of ratings

BUY	–	We expect the stock to deliver more than 12% returns over the next 12 months
ACCUMULATE	–	We expect the stock to deliver 5% - 12% returns over the next 12 months
REDUCE	–	We expect the stock to deliver 0% - 5% returns over the next 12 months
SELL	–	We expect the stock to deliver negative returns over the next 12 months
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NM	–	**Not Meaningful.** The information is not meaningful and is therefore excluded.
NOTE	–	Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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