Stock Update

Shanthi Gears Ltd.

May 22, 2023

RETAILRESEARCH

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Shanthi Gears Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Industrial Equipments	Rs 419	Buy in Rs 415-425 band & add more on dips in Rs 375-380 band	Rs 460	Rs 488	2-3 quarters

HDFC Scrip Code	SHAGEAEQNR
BSE Code	522034
NSE Code	SHANTIGEAR
Bloomberg	SG IN
CMP May 19, 2023	418.8
Equity Capital (Rs cr)	7.7
Face Value (Rs)	1
Equity Share O/S (cr)	7.7
Market Cap (Rs cr)	3245
Book Value (Rs)	39.4
Avg. 52 Wk Volumes	184,600
52 Week High (Rs)	436.0
52 Week Low (Rs)	182.7

Share holding Pattern % (Mar, 2023)	
Promoters	70.5
Institutions	4.5
Non Institutions	25.0
Total	100.0

HDFCsec Retail research stock rating meter

for details about the ratings, refer at the end of the report

* Refer at the end for explanation on Risk Ratings

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Our Take:

Shanthi Gears Ltd. (SGL) is an Industrial Gearing Solutions company supplying gears and gearboxes to different industries. It has in-house R&D and designing capabilities developing better products which has helped its clients to improve productivity and save on costs. It is now focussing on developing products for export market and looking to increase its exports. Strong growth in end user industries like Steel, Cement, Power, Paper, etc. is likely to increase demand for gears. The company is part of the Murugappa group and exploring the possibilities of jointly marketing products with Tube Investments (TI) and CG Power (CG). This could lead to strong topline growth and lower costs resulting in margin expansion going forward.

On April 28, 2022, we had initiated coverage on the stock (Link) with a recommendation to 'Buy in Rs 203-207 band & add more on dips to Rs 180-184 band' for base case fair value of Rs 224 and bull case fair value of Rs 238. The bull case target was achieved on April 29, 2022.

Valuation & Recommendation:

The management has targeted sales to double between FY21-FY24E and profit to triple in the same period. Close linkage to capex cycles exposes SGL's revenues to cyclicality in end-user industries, considerable share of revenues from the replacement segment and presence across multiple segments with no segment contributing to more than 30% of the revenues in FY2022, mitigate the risk to an extent. It has a diversified client base with its top 10 customers accounting for only one-fifth of its revenues in FY2022, thereby insulating its revenues from the customer concentration risk. We expect SGL's Revenue/PAT to grow at 22/25% CAGR over FY23-FY25E, led by increased demand from end user industries. We believe investors can buy the stock in Rs 415-425 band and add on dips in Rs 375-380 band (27.5x FY25E EPS) for a base case fair value of Rs 460 (33.5x FY25E EPS) and bull case fair value of Rs 488 (35.5x FY25E EPS) over the next 2-3 quarters.

Financial Summary

Particulars (Rs cr)	Q4FY23	Q4FY22	YoY (%)	Q3FY23	QoQ (%)	FY22	FY23	FY24E	FY25E
Operating Income	123	104	19.1	115	7.6	337	446	546	661
EBITDA	27	19	41.0	23	15.4	60	90	112	138
APAT	19	12	59.3	18	11.0	42	67	85	105
Diluted EPS (Rs)	2.5	1.6	59.3	2.3	11.0	5.5	8.7	11.1	13.7
RoE (%)						17.1	23.8	25.8	26.9
P/E (x)						75.6	47.9	37.8	30.5
EV/EBITDA (x)						51.9	34.3	27.5	22.1

(Source: Company, HDFC sec)

Q4FY23 Result Review

SGL reported strong growth for Q4FY23 with highest ever revenue of Rs 123cr, growth of 19% YoY. Gross margins improved to 52% from 47% in Q4FY22, driving 41% growth in EBITDA to Rs 27cr and 340bps expansion in EBITDA margin to 21.6%. PAT increased 59% YoY to Rs 19cr on account of lower tax rate. PAT margin stood at 15.8% as compared to 11.8% in Q4FY22 and 15.3% in Q3FY23. SGL generated Free Cash Flow of Rs 39.2cr during FY23. The Board declared a special dividend of Rs 2 per share taking the total dividend to Rs 5 per share for FY23.

Key Triggers

Govt. maintains focus on infrastructure sector

Infrastructure sector is a key driver for the Indian economy. The sector is highly responsible for propelling India's overall development and enjoys intense focus from Government for initiating policies that would ensure time-bound creation of world class infrastructure in the country. A new World Bank report estimates that India will need to invest $840 billion over the next 15 years—or an average of $55 billion per annum—into urban infrastructure if it is to effectively meet the needs of its fast-growing urban population. SGL supplies gears to companies in the steel, cement and power to name a few. Expansion in these industries would drive higher demand for SGL products.

Expanding scope of Vande Bharat train

SGL is one of the suppliers of gearsets to Vande Bharat express trains. The Vande Bharat Express, previously known as Train 18, is a semi-high-speed, electric multiple unit train operated by Indian Railways. As of Apr'23, VB trains are running on 14 routes and there are plans to increase it to 75 by Aug 15, 2023. Indian Railways has placed orders for 48 second generation Vande Bharat trainsets in Jan'21, and an additional 58 rakes in Mar'22. In Mar'23, orders were placed for 200 Vande Bharat trains. In addition to ICF Chennai, Vande Bharat trains will be manufactured in Haryana's Sonipat and Maharashtra's Latur with a target ot have 475 Vande Bharat trains by 2025.

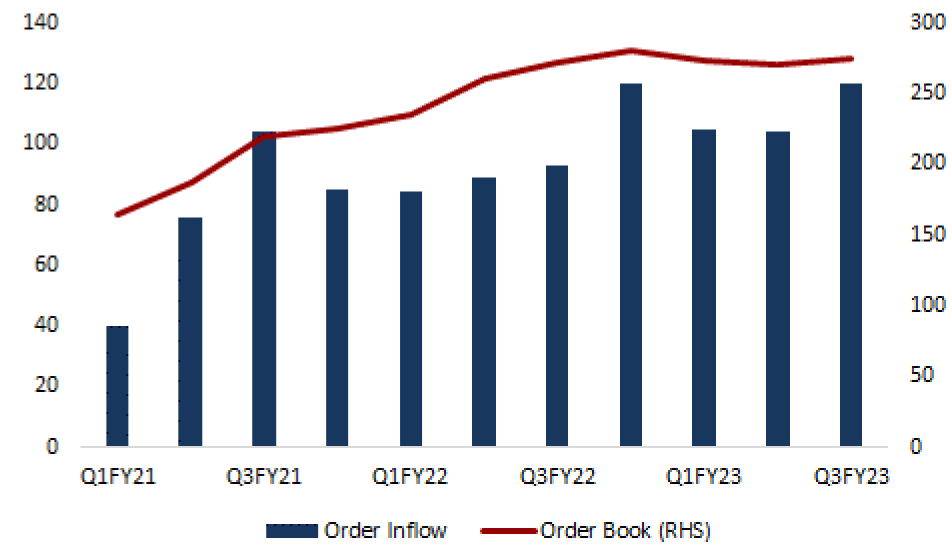
The Railways is also targetting to manufacture the first "standard gauge" (SG) version of this semi-high-speed train in the next one year, which will pave way for its export to markets in Europe, South America and east Asia by 2025-26. With the success of the Vande Bharat Express for passengers, the Railways is also planning to expand it to freight operations as well for super fast parcel services. Expansion of Vande Bharat programme would lead to increasing orders for SGL and is a strong positive for the company's growth.

Strong order inflows and execution

Order inflows for SGL have been growing and the company is now getting orders in excess of Rs 100cr every quarter. Execution by the company has also increased with SGL reporting highest ever quarterly revenue of Rs 123cr in Q4FY23. Higher capital and infrastructure expenditure undertaken in the end-user industries such as engineering, steel industries, among others and increase in replacement orders from its end customers are likely to drive higher order inflows in the coming quarters. Generally, 80% of the order book gets executed within

12 months. The healthy order book provides revenue visibility for the next few quarters. The company derives almost 70% revenues from custom made gears and gear boxes. It aims at raising the share of services from the current <2% of revenues.

Order Inflow and Order Backlog (Rs cr)



(Source: Company, HDFC sec)

Strong parentage by virtue of being a subsidiary of Tube Investments of India Limited (TIIL)

TIIL, the flagship company of the Murugappa Group, acquired 70.12% stake in SGL in 2012. Ever since, the company has benefitted from the strong management support and the operational synergies derived by being a subsidiary of TIIL. On April 9, 2019, SGL has undertaken a share buyback of fifty lakh equity shares at a cost of Rs 140 per share, post which TIIL's stake has increased to 70.47% from 70.12% as on March 31, 2019.

Healthy financials

SGL is a debt-free company with modest capex requirement in the near term. It has remained debt free since FY2013, primarily aided by healthy cash flows from operations (Rs 85cr in FY23) and sizeable cash and liquid investments (Rs 127cr as of FY23). We believe the company is in a strong position to grow its profitability driven by growth in end-user industries. Further, it enjoys strong financial flexibility and lender comfort, by virtue of being a subsidiary of Tube Investments of India Limited and being part of the well-established Murugappa Group.

Greenfield plans

Shanthi Gears, has entered into an agreement with M/s. Shreeji Metazine LLP on 18 January 2023 for purchasing Land and buildings at Sanand, Gujarat. SGL has been actively exploring the growth opportunities in order to meet business requirements from West & North region.

Risks & Concerns

Moderate scale of operations

The company has a moderate scale of operations with revenue of Rs 446cr in FY23. Higher scale enhances resilience to volatility in demand and enables better cost absorption.

Close linkage to capex cycle exposes revenues to cyclicality in end-user industries

SGL's revenues are exposed to the cyclicality in the domestic capex cycle and any economic slowdown could impact its revenues as witnessed in the past. However considerable share of revenues from the replacement market and presence across multiple segments with no segment contributing to more than 30% of the revenues, mitigates the risk to an extent.

Margins susceptible to fluctuations in raw material prices

The company's margins are susceptible to fluctuations in raw material prices due to a lag of two to three months in manufacturing lead time. Its major raw materials include steel and steel components, the prices of which had increased substantially over the past few quarters and have then corrected.

Bargaining power with OEMs

Due to its limited scale, the company may face delays in passing on the increase in costs to its customers. Consequently, its margins could get impacted.

Company Background:

SGL is an Industrial Gearing Solutions company that designs and manufactures Gears, Gearboxes, Geared Motors and Gear Assemblies. Commencing business as a gear manufacturer for the textile industry in 1969, the company has diversified over the years into manufacturing standard (off-the-shelf) and customised (non-standard) gears. It has manufacturing facilities (including a foundry) located in and around Coimbatore, Tamil Nadu.

SGL's product portfolio encompasses a range of customised gear boxes, loose gears, worm gear boxes and helical gear boxes used across various industries. It can manufacture gears from few mm dia to 3,200 mm dia with focus on industries such as Steel, Power, Cement, Mining, Sugar, Off-Highway, Defense and Railways. SGL is the only gear company in India having AS 9100C certification (Aero Standards) with fully integrated operations and strong in-house R&D and design capabilities. The Company has a strong marketing network with 15 Offices across India with a strength of 50 sales / service engineers and a strong distribution setup

In July 2012, Murugappa Group's Tube Investment of India announced the acquisition of the promoter's entire 44.12% stake in SGL for a sum of Rs 292cr. Subsequently, via tendering of an open offer, and a buyback in 2019, TIIL shareholding has increased to 70.47%.

Product portfolio

Standard

- Worm Gear Boxes
- Helical & Bevel Helical Gear Boxes
- Geared Motors
- Planetary Gear Boxes
- Shaft mounted Gear Boxes
- Cooling Tower / Extruder / Rolling Mill Gear Boxes

Custom Built

- Loose Gears Spur / Helical Gear
- Pinion Shaft
- Internal Gear
- Worm and Wheel
- Straight & Spiral Bevel Gear
- Spares for Gear boxes
- Special Gear Boxes for industries like:
  - Cement , Mining , Power , Paper , Steel , Rubber, Chemical

(Source: Company)

Financials

Income Statement

(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
Net Revenues	**216**	**337**	**446**	**546**	**661**
Growth (%)	***-11.0***	***56.4***	***32.2***	***22.5***	***21.0***
Operating Expenses	189	277	356	434	523
EBITDA	**27**	**60**	**90**	**112**	**138**
Growth (%)	***-22.9***	***125.3***	***49.6***	***24.6***	***23.4***
EBITDA Margin (%)	***12.4***	***17.8***	***20.2***	***20.5***	***20.9***
Depreciation	9	10	11	12	14
Other Income	8	9	11	14	17
EBIT	**26**	**59**	**90**	**114**	**141**
Interest expenses	0	0	0	0	0
PBT	**26**	**59**	**90**	**114**	**141**
Tax	6	16	23	29	35
PAT	**20**	**42**	**67**	**85**	**105**
Share of Asso./Minority Int.	0	0	0	0	0
Adj. PAT	**20**	**42**	**67**	**85**	**105**
Growth (%)	***-19.9***	***110.6***	***57.9***	***26.7***	***24.0***
EPS	2.6	5.5	8.7	11.1	13.7

Balance Sheet

(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
SOURCE OF FUNDS					
Share Capital	8	8	8	8	8
Reserves	229	252	295	349	420
Shareholders' Funds	**237**	**260**	**302**	**357**	**427**
Total Debt	0	0	0	0	0
Net Deferred Taxes	-2	-2	-4	-4	-4
Other Non-curr. Liab.	2	1	0	1	1
Total Sources of Funds	**237**	**259**	**298**	**353**	**424**
APPLICATION OF FUNDS					
Net Block & Goodwill	67	59	63	72	84
CWIP	0	3	2	1	1
Investments	54	57	64	84	114
Other Non-Curr. Assets	9	9	11	15	17
Total Non Current Assets	**130**	**128**	**140**	**173**	**216**
Inventories	78	64	67	90	109
Debtors	47	72	68	97	114
Cash & Equivalents	56	67	90	77	78
Other Current Assets	12	7	9	19	19
Total Current Assets	**193**	**211**	**233**	**283**	**320**
Creditors	55	44	44	57	63
Other Current Liab & Provisions	31	36	31	47	49
Total Current Liabilities	**86**	**80**	**75**	**104**	**113**
Net Current Assets	107	131	158	180	208
Total Application of Funds	**237**	**259**	**298**	**353**	**424**

Cash Flow Statement

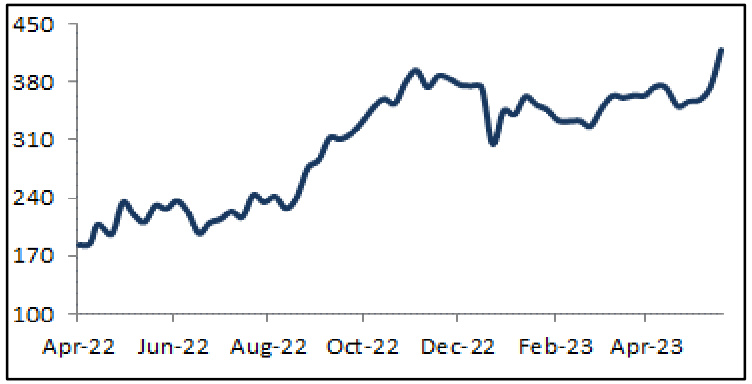
(Rs cr)	FY21	FY22	FY23	FY24E	FY25E
Reported PBT	20	42	67	114	141
Non-operating & EO items	4	13	23	-5	-2
Interest Expenses	-2	-3	-5	0	0
Depreciation	9	10	11	12	14
Working Capital Change	7	-13	-11	-35	-26
Tax Paid	-5	-15	-22	-29	-35
OPERATING CASH FLOW (a)	**33**	**35**	**63**	**58**	**91**
Capex	-15	-5	-15	-20	-25
Free Cash Flow	18	30	48	38	66
Investments	-9	-15	-16	-20	-30
Non-operating income	4	4	5	0	0
INVESTING CASH FLOW (b)	**-20**	**-16**	**-26**	**-40**	**-55**
Debt Issuance / (Repaid)	0	0	0	0	0
Interest Expenses	0	0	0	0	0
FCFE	12	19	37	18	36
Share Capital Issuance	0	0	0	0	0
Dividend	-12	-19	-23	-31	-35
Others	0	0	0	0	0
FINANCING CASH FLOW (c)	**-12**	**-19**	**-23**	**-31**	**-35**
NET CASH FLOW (a+b+c)	**1**	**-1**	**14**	**-13**	**1**

Key Ratios

Particulars	FY21	FY22	FY23	FY24E	FY25E
Profitability Ratios (%)					
EBITDA Margin	12.4	17.8	20.2	20.5	20.9
EBIT Margin	12.1	17.4	20.2	20.8	21.3
APAT Margin	9.4	12.6	15.0	15.6	15.9
RoE	8.7	17.1	23.8	25.8	26.9
RoCE	11.2	23.6	32.1	34.5	35.9
Solvency Ratio (x)					
Net Debt/EBITDA	-2.1	-1.1	-1.0	-0.7	-0.6
Net D/E	-0.2	-0.3	-0.3	-0.2	-0.2
PER SHARE DATA (Rs)					
EPS	2.6	5.5	8.7	11.1	13.7
CEPS	3.8	6.9	10.2	12.6	15.5
BV	30.9	33.9	39.4	46.5	55.7
Dividend	1.5	2.5	5.0	4.0	4.5
Turnover Ratios (days)					
Debtor days	72	65	57	55	58
Inventory days	118	77	54	52	55
Creditors days	72	53	36	34	33
VALUATION (x)					
P/E	159.3	75.6	47.9	37.8	30.5
P/BV	13.5	12.4	10.6	9.0	7.5
EV/EBITDA	117.7	51.9	34.3	27.5	22.1
EV / Revenues	14.6	9.2	6.9	5.6	4.6
Dividend Yield (%)	0.4	0.6	1.2	1.0	1.1
Dividend Payout (%)	57.0	45.1	57.2	36.1	32.8

(Source: Company, HDFC sec)

Price chart



HDFC Sec Retail Research Rating description

Green Rating stocks

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Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicality of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

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