Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

Equity Research

Industry: Electrical Goods
Date: June 17, 2011

V-GUARD INDUSTRIES LTD.

Analyst Recommendation: Buy

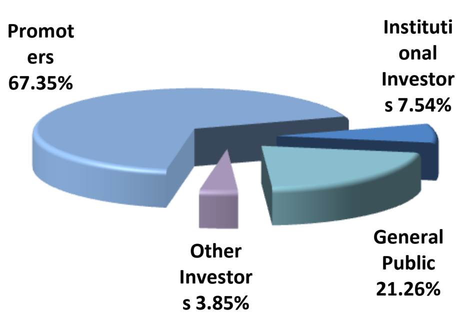
Buy | Accrue | Hold | Ease | Sell

BSE Code:	532953	NSE Code:	VGUARD	Reuters:	VGUA.BO	Bloomberg Code:	VGRD:IN

CMP:	**₹224**
1 Year Target:	**₹300**
SL:	**₹193**

EPS (₹)	14.3
P/E (X)	15.7
Revenue (₹ mn)	7,266.2
EBITDA (₹ mn)	747.4
EBITDA Margin (%)	10.3
EV/EBITDA (X)	10.7
Market Cap (₹ mn)	6,673.9
Free Float Mar Cap (₹ mn)	2,179.0
52 week high/low	234/97
Total Debt (₹ mn)	1,397.9
Enterprise Value (₹ mn)	8,000.8
Book Value per Share	57.6
P/BV	3.9

Shareholding pattern as on March 31, 2011



Investment Rationale

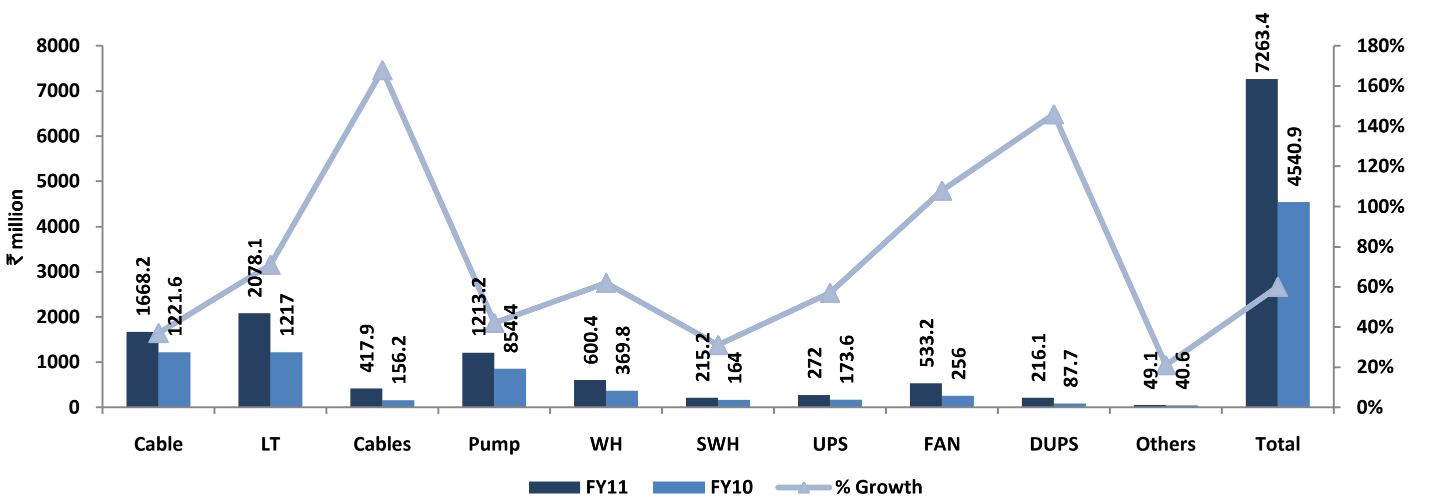
- ✓ V-Guard Industries Ltd. (VGIL) reported its highest ever quarterly revenues during 4Q FY'11 with a top line growth of 56% yoy and 26% qoq to ₹2,227 mn and a strong net profit growth of 134% yoy and 66% qoq to ₹142 mn.
- ✓ Management strategy to move away from being a south centric player to a Pan India player is beginning to yield results which is evident from the rising sales from products like cables & fans (in absolute terms), rose by 71% and 42% respectively.
- ✓ Increasing share of revenues from non south markets from 15% in FY'10, to 21% in FY'11 and expected to form 27% in FY'12 and 33% of revenues in FY'13 would enable VGIL to become a Pan India player from being a south centric company.
- ✓ VGIL's outsourcing model enables it to focus on product development and distribution and with its network of 230 distributors covering 11,000 dealers, it is believed VGIL is well placed to leverage its well entrenched brand equity in South India and traction witnessed in middle class consumption.
- ✓ VGIL is working on a number of initiatives to reduce the working capital strain inherent in the business which is believed would get reflected in the coming two years.
- ✓ As per the ability of the management and its business model it is expected that VGIL will grow the net profits at a CAGR of 31% over the next two years on the back of an expected 27% growth in revenues.

₹Million	FY10A	FY11A	FY12E	FY13E
Operating Income	4,543.7	7,266.2	9,170.0	11,783.4
EBITDA	517.9	747.4	981.4	1,316.3
Net Profit	254.7	426.4	550.3	749.7
Share Capital	298.5	298.5	298.5	298.5
EPS (₹)	8.5	14.3	18.5	25.1
PE (x)	26.2	15.7	12.1	8.9
P/BV (x)	4.7	3.9	2.9	2.2
EV/EBITDA (x)	14.3	10.7	8.2	6.2
ROE (%)	18.0	24.8	24.3	24.9
ROA %	11.2	13.4	14.4	15.9

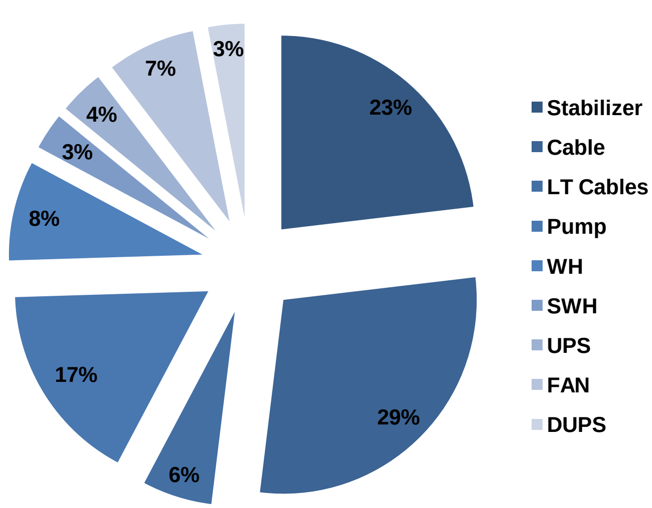
Robust growth in Q4 FY11 net profit on strong top line growth

During the fourth quarter ended 2011, VGIL reported strong top line growth of 56% yoy and 26% qoq to ₹2,227 million. Volume played a vital role for this robust performance in revenues which were mainly driven by growth from non-south region and rise in sales from products like cables & fans (in absolute terms), which rose by 71% and 42% respectively. Growth-wise, LT cables and Digital UPS were the best performing products with 168% and 146% yoy growth respectively. Further, the company recorded its highest ever quarterly revenues, driven by higher sales in the non-south region that accounted 21% of the turnover compared to 15% in FY10. Net Profits grew 134% yoy and 66% qoq to ₹142.3 million, on the back of the top line advance. EBITDA margins however were 9% owing to 58% yoy rise in operating expenses. Net profit margins jumped by 211 basis points to 6.37% due to an exceptional item of ₹36.4 million and a lower tax rate from its new Kachipuram plant, which enjoys tax benefits.

Strong yoy growth throughout its product portfolio



Product-wise revenue contribution for FY11



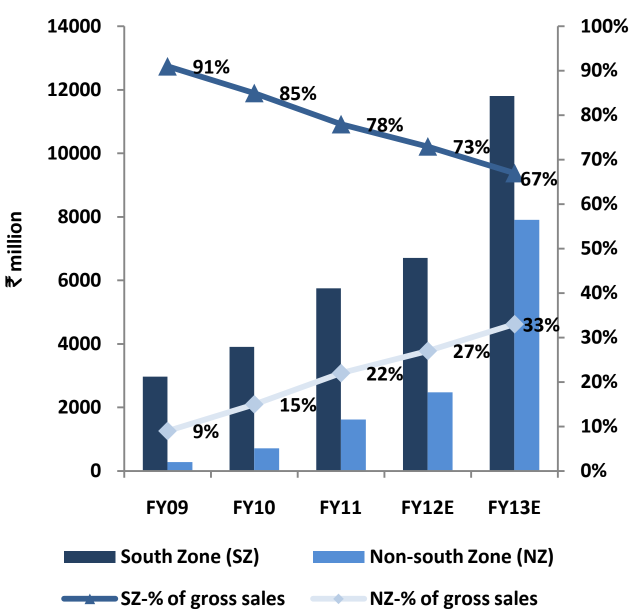
Product wise growth performance

The success of VGIL lies in its diverse product portfolio which is directly related to the rise in disposable income of the middle class consumer in India. VGIL's major chunk of revenue is generated through cables and stabilizer contributing 29% and 23% respectively. Both the products grew substantially by 37% and 71% yoy. Further, LT Cables, Digital UPS and Fans individually registered triple digit growth at 168%, 146% and 108% respectively. Other products such as Pumps, Water Heaters and Solar Water Heater reported expansion in its sales by 42%, 62% and 31% respectively.

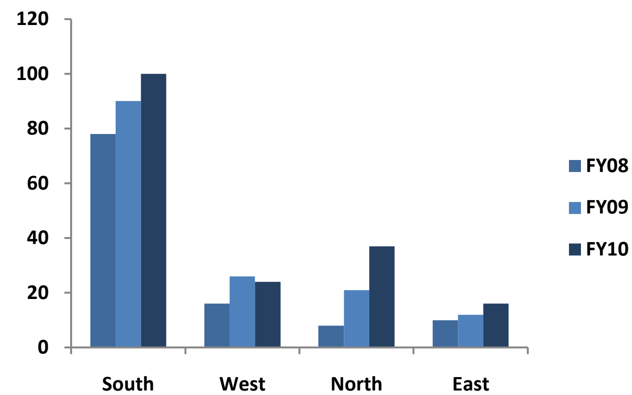
VGIL planning to expand its Pan India presence in FY12

VGIL's performance has been dominated from the southern region led by its strong brand name as well as its distribution network. It had been primarily focusing on these markets and has built a comprehensive product portfolio. Moreover, over the past few years it has widened its distribution network to pan-India. The company ventured into Maharashtra, Haryana, Madhya Pradesh, Orissa, Himachal Pradesh, Chhattisgarh, Uttar Pradesh and Gujarat in FY10, with an objective to focus on pan-India presence. Going ahead the company wants to expand its presence particularly in Bihar and the north-eastern states. FY10 witnessed 15% of revenues coming from non-south market which has now increased to 21% during FY11 and going forward we expect this to increase to 27% this fiscal and 33% of revenues in FY'13 in sync with its strategy of moving towards becoming a Pan India player from being a predominantly south centric player so far. This strategy, although margin dilutive in the initial years would in our opinion enable VGIL to become a formidable player in all its product categories in a few years from now.

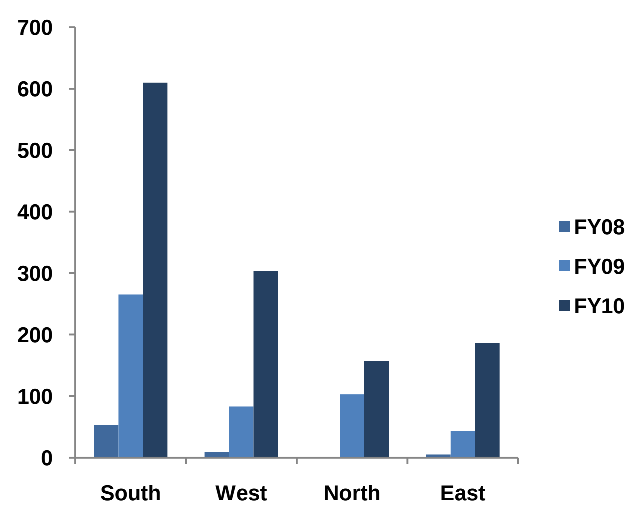
33% sales from non-south markets in FY13 to drive revenues



Growing Distributor's network



Growing Dealer network



Growth in market presence to be supported by strong distribution system

Currently, VGIL's products are sold through 230 exclusive distributors and 11,000 dealers with 85% of sales concentrated in four southern Indian states of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. Its network is also spread across all states in India except North East and Jammu & Kashmir. The company has a diversified client base which differs from product to product and includes direct marketing agents, distributors and retailers. V Guard has now increased product prices by 3% and is offering a cash discount to dealers who collect cash immediately and is also talking to banks for channel financing for distributors. This in our view should ease its working capital position going forward.

Growing middle class consumption in India to fuel growth of VGIL

VGIL has a comprehensive product profile catering to the mass consumption market and it meets the basic requirements of household electrical instrument usage. As a result, demand for these products is expected to remain strong. Additionally, the rising disposable income of the consumer and increased availability of power will result in higher demand for its products. The number of high income households (income>₹0.18 million/ year) rose from 13.8 million households in 2001-02 to 46.7 million households in 2009-10, as per NCAER. Going ahead, the numbers of middle income households are expected to increase by 70% to 238 million by 2015. Moreover, VGIL will gain on increasing urbanization and change in consumer preference. The robust rise of middle income households and growing disposable income coupled with strong demand will help in a 27% growth in revenues for VGIL in the next two years.

Higher ad spend to improve brand perception and visibility across India

During FY11, the company incurred ₹646 million as selling and distribution expenses, out of which the advertisement expenses stood at ₹240 million and for FY12 it is likely to be around ₹350 million. Higher spending on marketing, promotion and branding will enable the company to compete against its formidable peers in the organised segment and help improve brand perception on a national scale. VGIL has earmarked ₹200 million in FY'12 towards capital expenditure. This includes setting up of a manufacturing facility for solar water heater at Perundurai with improved technology.

Utilisation of the IPO funds in VGIL's manufacturing

During FY08, VGIL raised ₹656 million through an Initial Public Offer (IPO), issue price being ₹82 per share and face value of ₹10. The funds raised were to be utilized in setting up new manufacturing facilities in Himanchal Pradesh and Tamil Nadu as well as two distribution centers. VGIL has two windmills at Coimbatore with a generation capacity of 230KW operating at a PLF of approximately 33%. Till FY11, the company has invested ₹666 million in the development of these facilities out of the envisaged ₹739 million outlined in VGIL's prospectus.

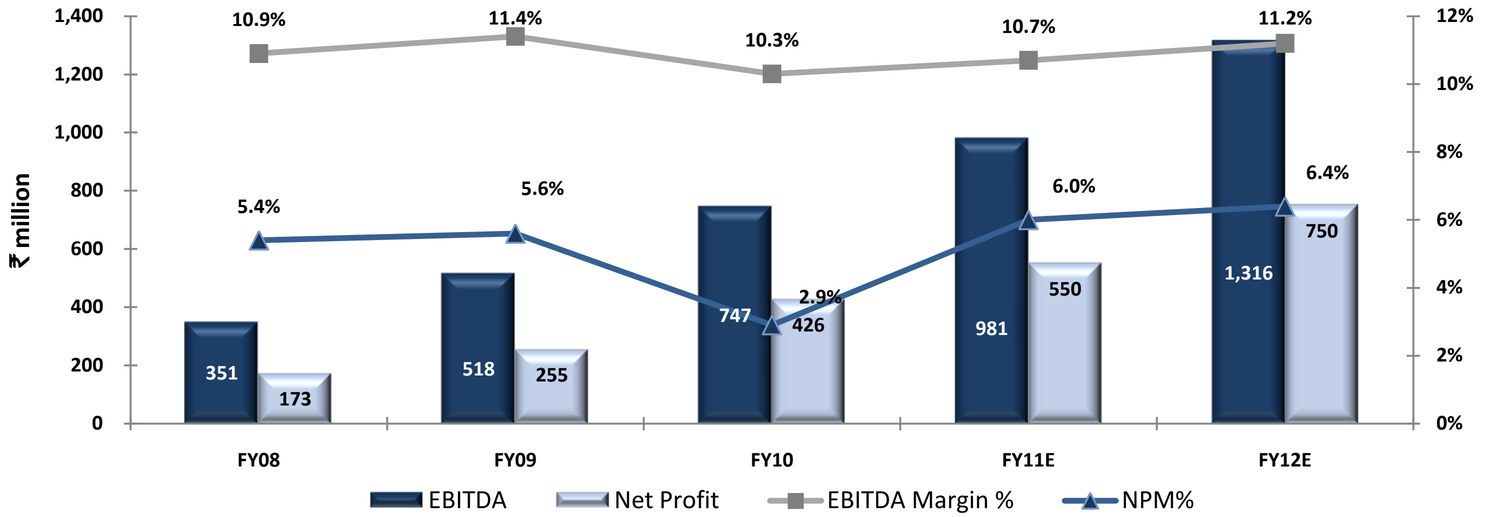
Unique outsourcing business model to boost revenues

VGIL operates a unique business model which is a mix of manufacturing and outsourcing for its product portfolio. It manufactures products such as cables and solar water heater, whereas it outsources the manufacturing of stabilizers, pumps, electric water heater, fans, UPS and Digital UPS from around 69 charitable organisations, with whom the company has a tie-up. FY10 onwards, the company has undergone a change of outsourced products that formed 70% of the revenue and in-house products contributed 30%, against FY09, which saw in-house products contribute 63%, whereas outsourced products accounted for 37%. Given the short lifecycle of a consumer electronic product, its design capabilities along with outsourcing operations has helped to rationalize its capex requirement and simultaneously branch out into new product lines. VGIL is looking at launching 3 new product categories in consumer appliances in the next 3 years. All new products are developed at its R&D centre and then given to vendors for manufacturing. Expense-wise, it provides cost control as it can have the vendors near the market, saving on transportation cost. Moreover, since the product portfolio of the company demands intense market penetration through proper branding, promoting and strong network channel, VGIL can focus on new product development, branding and distribution rather than manufacturing all products in house.

Manufacturing and Outsourcing facilities of the VGIL

Products	Outsourced	Manufactured
PVC Wiring Cables		2
LT Cables		1
Pumps & Motors	11	1
Fans	6	1
Solar Water Heaters		1
Stabilizers	60	
UPS	12	
Electric Water Heaters	6	

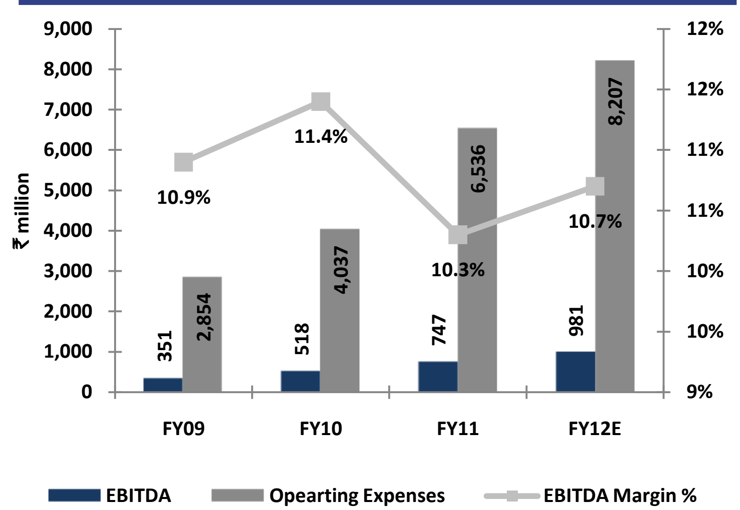
VGIL is focused on the volume growth rather than rising margins



Risk Factors

- ✓ Volatility in raw material prices, mainly in copper and PVC.
- ✓ Intense competition in most of its product lines where major players are present.
- ✓ During FY11, creditor days have reduced to 40 days from 62 days in FY10 due to change in credit policy of copper suppliers like Hindalco Industries and Sterlite Industries.
- ✓ VGIL is south focused and built its business in South India, and it may be difficult to replicate its success in south across India.
- ✓ There is a huge presence of unorganized markets in most of the segments where VGIL operates.
- ✓ For consumer goods, it is very important to have a strong distribution channel. Inability to maintain a strong network will affect its growth.
- ✓ Slow down in economy could impact the demand for its products.

Rising raw material costs to keep growth in operational margins more or less flat



Business Summary

V-Guard Industries Ltd. (VGIL), founded in 1977 was promoted by Mr Kochouseph Chittilappilly. The company mainly operates in three divisions, which are electronics (manufacturing voltage stabilisers, UPS and digital home UPS), electrical/ electro-mechanical products (for PVC insulated cables, pumps, water heaters, fans and LT power and control cables) and others (solar water heaters, gas water heaters, water level controller, windmill energy etc). VGIL directly employs 700 people and indirectly over 5,500 people. The company also conducts research and development initiatives for electronic products, electric geysers, electro-mechanical products, electrical wires and solar water heaters. It has manufacturing facilities at Coimbatore (Tamil Nadu), Kashipur (Uttaranchal) and Kala Amb (Himachal Pradesh). VGIL started as a south India focused company by manufacturing stabilisers is now moving towards becoming a Pan India entity aiming for 33% of revenues in FY13 from non south markets.

Indian Electrical Goods Industry

Industry scenario

The electrical equipment industry comprises several products such as transformers, switchgears, motors and control equipment. In 2009-10, the size of the electrical equipment industry stood at ₹525 billion. So far, the electrical equipment industry expanded at 11.3% during 2009-10. The main buyers of electrical equipment are power utilities. A typical electric equipment component has a life of 20-25 years; hence, replacement demand would incrementally add to the growth opportunities. The raw material cost of electrical equipment manufacturers is estimated at 50-60% of sales. Primary raw materials include copper, aluminium and steel. A few large players dominate the electrical equipment industry. However, several other small and medium-sized players too specialise in specific product lines. In addition, there has been substantial competition from Chinese equipments manufacturers especially in the high voltage category. The electrical equipment industry is highly working capital intensive as it takes 4-5 months to recover payments from SEBs, which are their major clients.

Categories

PVC Insulated Cables domestic market is approximately ₹40 billion p a., with improving at a rate of 13%. These cables are used in residential complexes, buildings, households etc. The demand for cables/wires domestically has been increasing due to booming household and infrastructure. With the spending on infrastructure projects expected to continue, the demand for cables is expected to remain strong going ahead too.

Low Tension (LT) Power & Control Cables are used for low voltage transmission of electricity and are typically used for last mile connectivity from the step-down transformer onwards, with a market size of at ₹80 billion.

The solar water heater market in India is pegging at ₹3 billion p.a. with small unorganized players catering to the household market and the industrial demand being met by the larger organized players.

The cable industry is currently estimated at ₹120 billion and is expected to grow at 13-15%.

Stabilizers are primarily used along with home appliances such as CTV's, refrigerators and air conditioners. The demand for these products is expected to be high due to the increasing disposable income.
The pump industry in India is estimated to be around USD 40bn and is growing at 8%.

In electric water heater (mainly geysers) has been growing moderately at a pace of around 20% over the previous 4-5 years on account of increasing electrification and increase in disposable income.

The fan industry is estimated to be around ₹20bn and is growing at 10%. The demand for this industry is expected to be robust due to the climatic conditions in the country, increased housing activity and higher power availability.

Products	Market Size (in billion ₹)	Dominant players
PVC Insulated Cables	40	Unorganised
LT Power & Control Cables	80	Organised
Solar Water Heaters	3	Organised
Pumps	40	Unorganised
Stabilisers	21	Organised
Water Heaters	8	Unorganised
Fans	35	Organised
UPS	20	Unorganised

Outlook:

In FY10, electrical equipment industry’s size stood at ₹525 billion. The electrical equipment industry grew at 11.3% during 2009-10. The main buyers of electrical equipment are power utilities. A typical electric equipment component carries a life cycle of 20-25 years, hence, replacement demand would incrementally add to the growth opportunities. Primary raw materials include copper, aluminium and steel. In addition, there has been substantial competition from Chinese equipment manufacturers especially in the high voltage category. Moreover, consumer behaviour also plays a crucial role in building demand for such products. Therefore it becomes important to focus on product superiority in terms of power savings etc in addition to the overall cost of ownership of these products to the end user.

Balance Sheet

(₹million)	FY10A	FY11A	FY12E	FY13E
Share Capital	298.5	298.5	298.5	298.5
Reserve and surplus	1,116.3	1,421.3	1,969.2	2,703.5
Net Worth	**1,414.8**	**1,719.8**	**2,267.3**	**3,001.6**
Loan Funds	805.1	1,397.9	1,492.9	1,635.0
Net Deferred Tax Liability	57.3	61.2	65.7	72.4
Capital Employed	**2,277.2**	**3,178.9**	**3,826.0**	**4,722.0**
Gross fixed assets	1,378.9	1,463.1	1,760.9	2,173.3
Less: accumulated depreciation	256.0	335.3	420.5	549.2
Capital Work in Progress	28.9	30.0	36.1	44.6
Net Fixed assets	**1,151.9**	**1,157.8**	**1,376.5**	**1,668.7**
Investment	45.8	0.0	0.0	0.0
Net Current Assets	1,079.6	2,021.1	2,449.5	3,053.3
Capital Deployed	**2,277.2**	**3,178.9**	**3,826.0**	**4,722.0**

Profit & Loss Account

(₹million)	FY10A	FY11A	FY12E	FY13E
Net Sales	**4,543.7**	**7,266.2**	**9,170.0**	**11,783.4**
Other income	11.5	17.1	18.5	20.1
Total Income	4,555.1	7,283.3	9,188.5	11,803.5
Expenses	4,037.2	6,535.9	8,207.1	10,487.2
EBITDA	**517.9**	**747.4**	**981.4**	**1,316.3**
EBITDA Margin %	*11.4*	*10.3*	*10.7*	*11.2*
Depreciation	71.5	79.4	85.2	128.7
EBIT	446.4	668.1	896.2	1,187.6
Interest	51.3	113.3	138.0	170.8
Profit Before Tax	**395.1**	**591.1**	**758.2**	**1,016.8**
Tax	140.4	164.7	207.9	267.1
Profit after Tax	**254.7**	**426.4**	**550.3**	**749.7**
NPM %	*5.6*	*5.9*	*6.0*	*6.4*

Key Ratios & Valuations

	FY10A	FY11A	FY12E	FY13E
EBITDA Margin (%)	11.4	10.3	10.7	11.2
EBIT Margin (%)	9.8	9.2	9.8	10.1
NPM (%)	5.6%	5.9%	6.0%	6.4%
ROCE (%)	19.6	21.0	23.4	25.2
ROE (%)	18.0	24.8	24.3	24.9
ROA (%)	11.2	13.4	14.4	15.9
Interest Coverage (x)	8.7	5.9	6.5	7.0
EPS (₹)	8.5	14.3	18.5	25.1
Cash EPS (₹)	2.5	2.4	2.7	3.0
P/E (x)	26.2	15.7	12.1	8.9
BVPS	47.4	57.6	76.1	101.1
P/BVPS (x)	4.7	3.9	2.9	2.2
EV/Operating Income (x)	1.6	1.1	0.9	0.7
EV/EBITDA (x)	14.3	10.7	8.2	6.2
EV/EBIT (x)	16.6	12.0	9.0	6.9

Valuations

VGIL has reported strong financial performance over past and it continue to grow at CAGR of 27% over the next two years (FY12 and FY13) along with a CAGR of 31% in the net profits. The higher growth trajectory of the company will be supported by its high demand diversified product portfolio, extending its reach in non-south regions and its unique business model. Further, the revenue growth will also be mobilised by the strengthening the distribution channel and rise of middle income households and growing disposable income. At the current market price of ₹223.6, we rate the stock as 'BUY', with a 1 year target price of ₹300. At the current market price the stock is trading at a PE of 15.7x on FY12E EPS of ₹14.3 and 12.1x on FY13E EPS of ₹18.5.

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