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

Equity Research

Industry: Industrial Gear
Date: June 24, 2011

SHANTHI GEARS LTD.

Analyst Recommendation: Buy

Buy | Accrue | Hold | Ease | Sell

BSE Code: 522034 **NSE Code:** SHANTIGEAR **Reuters Code:** SHNT.BO **Bloomberg Code:** SG:IN

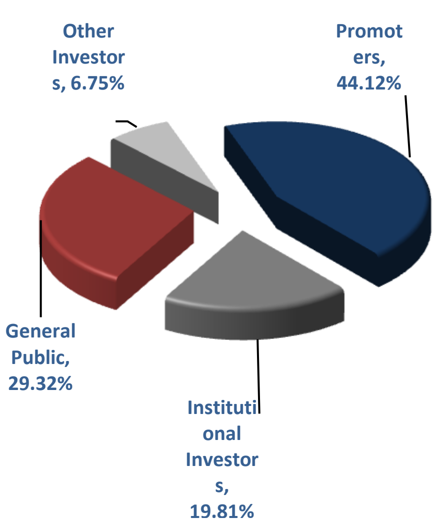
CMP:	**₹41.35**
1 year target:	**₹70**
SL:	**₹35**

EPS (₹)	3.4
P/E (X)	12.1
Revenue (₹mn)	1,603.6
Operating Profit (₹mn)	714.8
Operating Margin (%)	43.3
EV/Interest Income (X)	4.2
Market Cap (₹mn)	3,379
Free Float Mar Cap (₹mn)	1,888.3
52 week high/low	55/32.65
Total Debt (₹mn) (FY10)	97.5
Enterprise Value (₹mn)	3,001.1
Book Value per Share	28.0
P/BV	1.5

Investors Rationale

- The net profits of Shanthi Gears Ltd (SGL) during Q4FY11 registered an impressive growth of 84.7% and 57.9% on y-o-y and q-o-q basis, respectively at ₹95.1 million, owing to robust growth in its top-line.
- Post the completion of its restructuring programme at the operational as well as the managerial level in 2010, SGL has stepped into a path of renaissance.
- SGL's increasing focus on high-end gear boxes and big gears by attaining self-reliance in gear technology will fuel the growth, giving it an edge over its peers.
- The company has proposed the launch of a new range of standard industrial gear boxes within the coming 6 months that will add another batch of strong clientele across various sectors, powering its ability to earn higher revenues.
- Given its superior margin profile and engineering capabilities in industrial gears, we believe that the decision to expand into new product lines like mining and material handling equipments including compressors is a logical extension for SGL as gears form an important component in these products.
- Virtually a debt free company with cash per share of ₹6 and close to 70 acres of vacant land at Krishnapuram and Singanallur in Coimbatore puts SGL in a sweet spot in a business which is working capital intensive.
- EPS of SGL stands stable among its peer group at ₹3.4 and we expect it to grow more than two-fold to ₹7.7 in next two years.

Shareholding pattern as on March 31, 2011

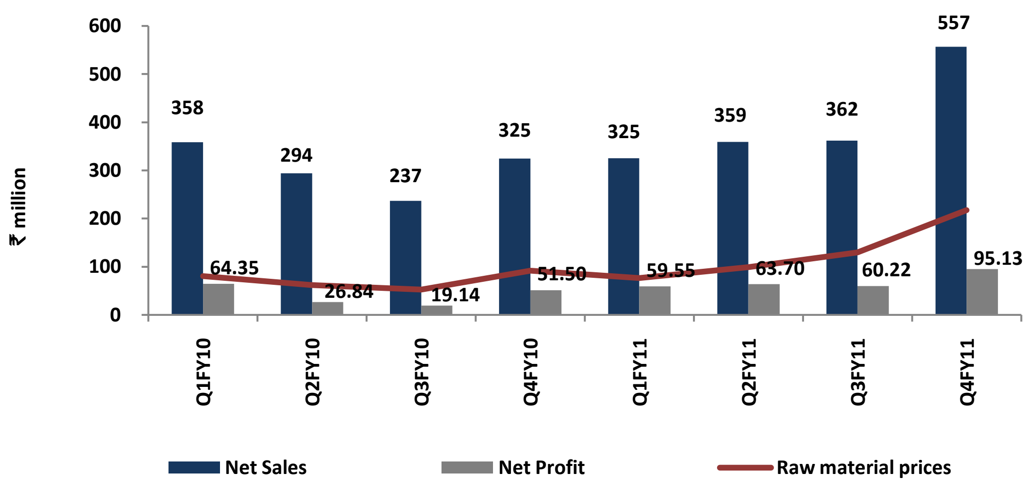


₹Million	FY10A	FY11A	FY12E	FY12E
Operating Income	1,213.9	1,603.6	2,148.8	3,029.8
Operating Profit	550.7	714.8	901.7	1,177.5
Net Profit	161.9	278.6	425.7	628.1
Share Capital	81.7	81.7	81.7	81.7
EPS (₹)	2.0	3.4	5.2	7.7
PE (x)	20.9	12.1	7.9	5.4
P/BV (x)	1.6	1.5	1.3	1.1
EV/Operating Profit (x)	2.7	1.8	1.3	0.9
ROE (%)	7.7	12.2	16.1	20.4
ROA %	7.9	11.3	15.1	19.2

Strong Q4FY11 net earnings powered by higher net sales

During the fourth quarter ended March 2011, the net profits of SGL stood at ₹95.1 million, registering an impressive growth of 84.7% and 57.9% on y-o-y and q-o-q basis, respectively. The robust bottom-line of the company is mainly fuelled by the significant growth of 71.5% (y-o-y) and 53.7% (q-o-q) in the net sales of SGL at ₹556.6 million. Total income from operations during the quarter increased 65% to ₹577.1 million, which included other operating income of ₹20.5 million. However, a sharp rise in operating expenses, which recorded a huge 68.1% (y-o-y) and 66.1% (q-o-q) growth at ₹347.94 million, restricted the growth in operating profit by 60%(y-o-y) and 50% (q-o-q) at ₹229.1 million, resulting in 120 basis points decline in operating margins at 39.7%. Of the total operating expenses, raw material cost alone grew by 137.6% (y-o-y) and 67.3% (q-o-q) to ₹217.65 million during the period. Other income decreased significantly by 64% (y-o-y) to ₹0.88 million from ₹2.45 million in the corresponding quarter a year ago. Further with the decline in interest expenses by 69% to ₹1.7 million and depreciation by 3% to ₹68.1 million, the PBT of SGL increased by 118% to ₹160.2 million.

Higher raw material prices has pressurized net earnings over the year



Source: Company

Growth strategy in FY11

- When most of the players in the industry are into the manufacturing of standard products, SGL choose to manufacture niche products compared to standardised products, due to its enhanced productive efficiency and engineering skills to manufacture customised products and services in short span of time.
- The Company has enhanced its focus on high margin orders and has also reduced the share of low margin orders from its order book, which presently stands at a range of around ₹600-700 million with a execution period of 4 months for gear & gear box.
- After the completion of operational and organizational restructuring programme in 2010, the major production and related activities of SGL were shifted to the unit located at Muthugoundanpudur. As a result, SGL benefited from the synergies of additional flexibility in production planning, supply of goods in shorter duration and also from the manufacturing of better quality niche and value added products.

Growth Drivers for SGL in FY12 and onwards

- SGL's increasing focus on high-end gear boxes and big gears by attaining self-reliance in gear technology and introducing a new line of products in mining and material handling segment.

- SGL's plan to launch a new range of standard industrial gear boxes and air compressors of various capacities within the coming 6 months will furnish a strong clientele base across various sectors, powering its ability to earn high revenues further.

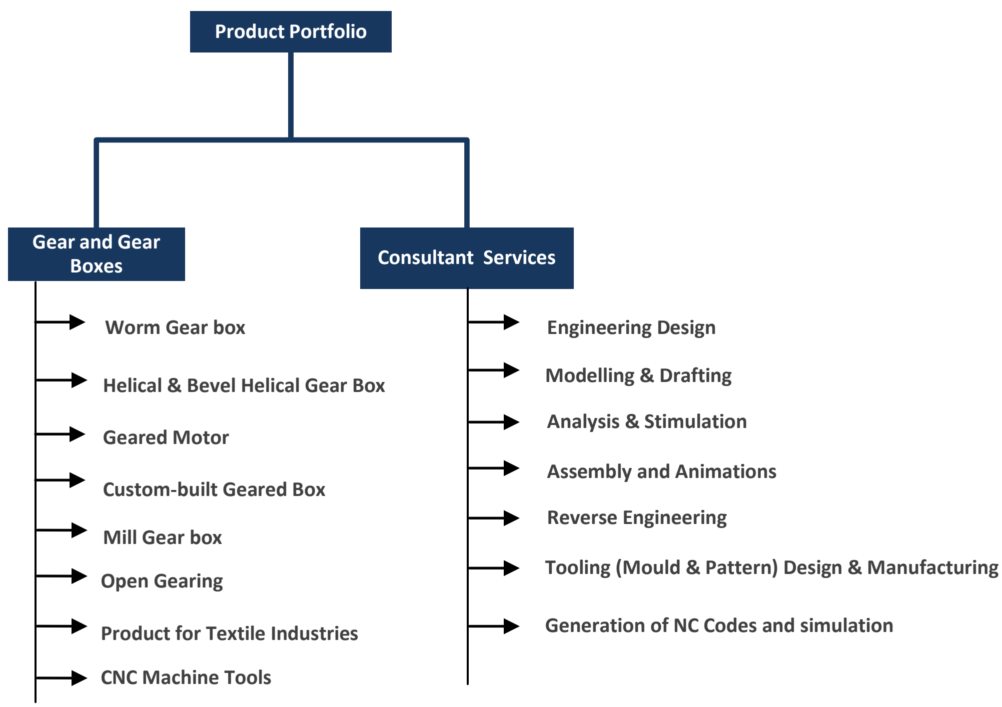
FY11-Financial highlights

- During year ended March 2011, the net profit of SGL recorded 72% growth at ₹278.6 million from ₹161.9 million in the prior year.

- The net sales of the company during the year rose to ₹1,603.6 million, reflecting a growth of 32% from ₹1,213.6 million in FY10.

- SGL has recommended 100% or ₹1 as dividends for every equity share of ₹1.

An overview of SGL's wide range products and services



Source: Company

Restructuring synergies to power product mix further

When most of the Indian Gear Manufacturers are into the manufacturing of standard gear and allied products, SGL opted to specialise in the manufacturing of niche products, due to its enhanced productive efficiency and engineering skills to manufacture customised products and services in a short span of time. Currently around 50% of SGL's revenue comes from the manufacturing of non-standard gear boxes, accounting for around 45% of the operating margins while the remaining is achieved from standard gear boxes, geared motors and loose gears. With the completion of the operational and organizational restructuring programme in 2010, SGL's strong state of art manufacturing facility has garnered new strength to execute urgent and emergency orders as per need of its customer base, which in turn brightens SGL's scope of enhancing its market share in the non-standard as well as standard gear segment.

Technological self reliance to support exponential growth

SGL is planning to enhance its focus on high-end gear boxes and big gears and thereby register exponential growth by attaining self reliance in gear technology. With the growing infrastructure development, the need for high-tech gears has also increased across various sectors. SGL aims to make high-margin, larger gears and allied products to supply to firms across various sectors like steel, compressors, conveyor/material handling, windmill, sugar and cement.

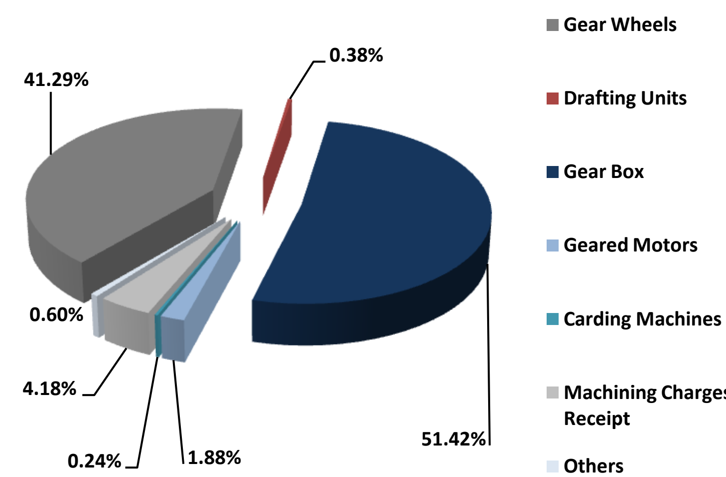
New Product range to add high profile clientele

The company is planning to come up with a new range of standard industrial gear boxes in the coming 6 months. Besides, the company intends to enhance its focus on its core strength of supplying non-standard gear boxes and big size gears, thereby increasing its dominance among its peers. With the introduction of a new product range, SGL is likely to reap the benefits of an additional high profile clientele across various sectors, powering its ability to earn high revenues future. SGL has also been consistently trying to supply gearboxes for the aerospace industry and has been accordingly bidding for orders, which in an optimistic case of materialisation will add another batch of high profile clientele to SGL's existing customer base. Even historically, empowered by its wide product range and product quality, SGL has managed to continuously enhance its customer base while retaining its existing clientele.

Changing Product mix to reduce earnings volatility

SGL intends to forward integrate into manufacturing of material handling equipment including compressors of various capacities and mining equipment, in which gears and gear-boxes constitute a vital component. SGL's revenue till FY11 has been highly dependent on the manufacturing of customized gear and gear boxes. Introduction of two new product lines will not only reduce SGL's dependency on single segment revenue but will also go a long way in improving the margins of the company. The two new product lines will enjoy the advantage of SGL's established engineering background, giving ample opportunity for the integrated & customized gear major to expand its market share in other allied fields.

Product-wise revenue generation in FY10



Source: Company

Rising raw material cost to burden margins

During FY11, SGL margins were pressurised by the marked increase in raw material cost, which grew at a rate of 138% during the twelve month period. This was mainly due to rising steel prices in the international market. Steel rods and steel forging are the two main raw materials used by SGL in the manufacturing of Gear and gear boxes. With the continuous hike in contract prices of iron ore and coking coal in the international market, steel prices are likely to stay elevated.

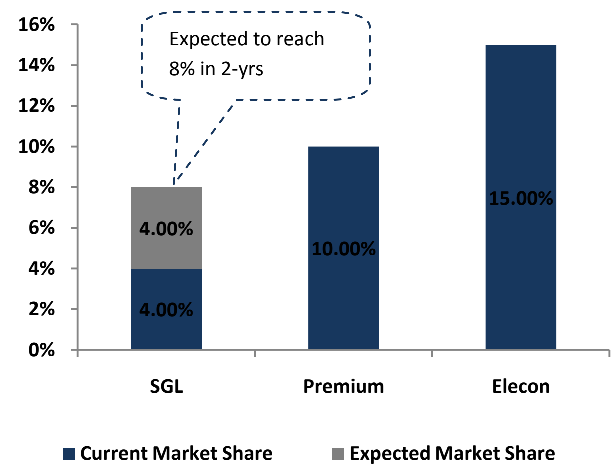
SGL emerges with renewed strength to cater growing demand for Gear and Gear boxes

SGL caters to Original Equipment Manufacturers (OEM) as well as replacement markets, thereby protecting itself from the inherent cyclicality in the engineering industry to an extent. With the recovery in the economy after the 2008 economic crisis, all OEM witnessed significant demand across the sectors due to a huge demand and supply gap. And to bridge the same, SGL with the completion of operational and organizational restructuring programme in 2010 has emerged as a promising supplier. The post restructuring synergies are likely to help SGL in providing value added product and services to its clients.

SGL's market Share in Industrial gears to grow two-fold

The ₹10 billion gear and gear box market of India is highly dependent on the automotive, engineering and machine tools industry for its production. Automotive sector is the largest consumer of gear and gear boxes, followed by the industrial sector. SGL with a well established engineering background is a leading player in industrial gear segment with 4% stake in market. Elecon engineering Ltd tops the race with 15% dominance followed by Premium Transmission Ltd, which occupies a significant 10% stake in the industrial gear market. With the operational and managerial restructuring of SGL beginning to yield better results, the company is expected to grow into a high margin niche player. SGL's market share in the coming two years is expected to register a two-fold growth at 8%.

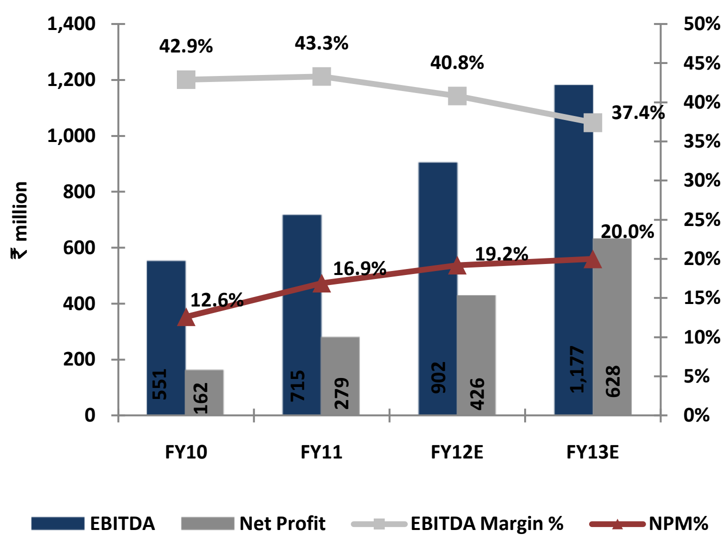
SGL's market share in industrial gears to rise significantly



Risk Factors

- SGL's foray into manufacturing of material handling equipment including compressors and mining equipment, involves huge capital expenditure. Failure of any one these will adversely affect the margins of SGL.
- Volatility in prices of raw materials like steel and aluminium alloy, which make up 60 per cent of their input costs, are likely to pressurise margins
- The Company's policy of manufacturing value added products puts it in a position to supply its products to selected customers, which may limit the growth.
- Delay in investments in the sectors served by SGL could adversely affect its revenues and net earnings in the future.

Rising raw material cost to pressurize operational margins



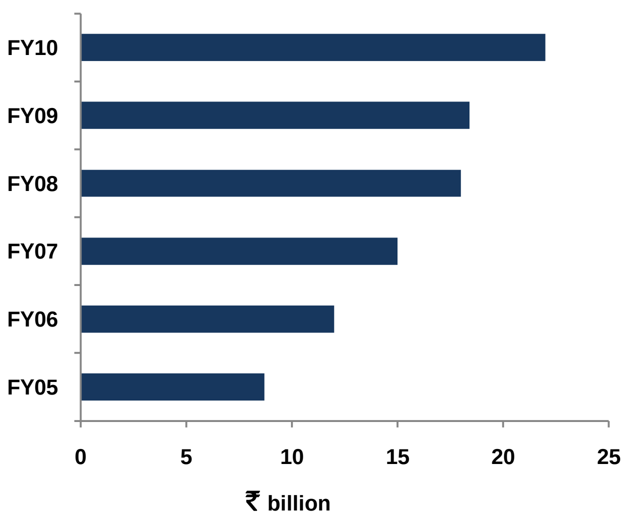
Business Summary

Shanthi Gears Ltd (SGL), established in 1969, is one of the largest integrated manufacturers of gears and gear products in India. It offers a wide range of customised gears that caters to various segments, across a wide range of industries, including steel, compressors, earthmoving, conveyor/material handling, windmill, sugar and cement. SGL is currently operating with 6 manufacturing plants in Tamil Nadu. SGL has dominance in the production of non-standard gear boxes, with 50% of its revenue coming from this segment and the remaining from standard gear boxes, geared motors and loose gears. In 2010, on the back of tough business environment, SGL decided to revamp and restructure its entire organisational and operational structure, which resulted in the scaling down of plant operations and the reduction of its personnel and administration cost, etc. And post the completion of its restructuring programme, SGL has come up with renewed strength, exhibiting a significant improvement of 85% growth in its Q4FY11 net earnings.

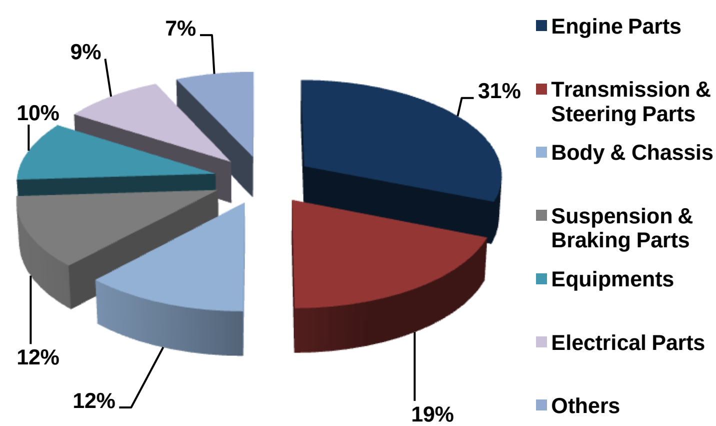
The Indian Auto Component Industry-Gears & Gear Boxes

The ₹10 billion Gear and gear box market of India is highly dependent on the automotive Industry, engineering Industry and machine tools Industry for its production. Automotive sector is the largest consumer of gear and gear boxes, followed by the industrial sector. Traditionally it was the European countries, North America, and some regions of Asia that lead the world gear market. But recently the focus has shifted to previously unknown regions like China, India, and East Europe. Though gear manufacturing is a low margin in nature, it happens to be a steady revenue generating business. Moreover, Indian gear manufacturers enjoy the 25-30% cost advantage over developed nations due to availability of low cost skilled labour in these regions, which opens huge opportunities for the domestic manufacturers to ramp up its export portfolio. The demand for reliable power, smaller sizes and more energy-efficient power transmission systems create several opportunities for gear industry. Industrial gears are used in sectors ranging from sugar to steel to textiles, and the major demand driver for these gears is huge capital expenditure in the industrialization of economy.

Turnover of the Auto Component Industry in past 5 years



Auto Component Industry- Product Range (FY10)



Importance of Gears in Automotive Sector

Gear Manufacturing is a significant part of the auto component industry and hence is directly proportionate to the movement in the Auto Industry. The Auto component sector comprises of varied segments like engine and engine parts, transmission and steering parts, suspension and braking parts, equipments and others. Gears, wheels, steering systems, axles and clutches are important sub-segments of the Transmission and Steering segment of the industry, which accounts for a 19% of the production in the auto component industry. Bharat Gears, Gajra Bevel Gears and Eicher are some of the major players in the gears sub-segment. Two international companies, Graziano Trasmissioni and SIAP Gears India, have set up their base in India, intensifying the competition in the region. Gears play an important role in gear boxes to control the speed of automobile and taking into consideration the criticality of its role, the automobile industry of India prefers to import gear box technology in India, thereby opening ample technology sharing and up gradation opportunity for the domestic gear manufacturers.

Outlook

Over the past 6 years, the auto component industry has registered a healthy revenue growth of 22% (CAGR) in FY10 and is expected to grow by over four-fold to US$ 113 billion by 2020. And considering the gear industry's dependency on the automotive industry, the former too is expected to witness similar growth rate in the coming fiscals. Beside, with the Indian economy poised to grow at a rate of 9-10% in the coming fiscals, the manufacturing base of India is likely to strengthen, which is likely to fuel huge demand for engineering components like gear, gear box and allied products from diverse sectors various industries like textiles, steel, metal etc.

Balance Sheet (Standalone)

(₹million)	FY10A	FY11A	FY12E	FY13E
Share Capital	81.7	81.7	81.7	81.7
Reserve and surplus	2,026.8	2,210.4	2,561.2	3,000.9
Net Worth	2,108.5	2,292.1	2,642.9	3,082.6
Loan Funds	256.3	97.5	97.5	97.5
Net Deferred Tax Liability	174.9	142.6	142.6	142.6
Capital Employed	**2,539.7**	**2,532.3**	**2,883.0**	**3,322.7**
Gross fixed assets	3,441.3	3,595.0	4,038.6	4,670.8
Less: accumulated depreciation	1,692.0	1,960.5	2,255.8	2,554.0
Capital Work in Progress	51.7	20.0	20.0	20.0
Net Fixed assets	1,800.9	1,654.5	1,802.8	2,136.8
Net Current Assets	738.8	877.7	1,080.3	1,185.9
Capital Deployed	**2,539.7**	**2,532.3**	**2,883.0**	**3,322.7**

Profit & Loss Account (Standalone)

(₹million)	FY10A	FY11A	FY12A	FY13E
Net Sales	1,213.9	1,603.6	2,148.8	3,029.8
Other operating income	42.9	43.3	56.5	104.0
Total operating Income	1,256.7	1,646.9	2,205.3	3,133.8
Other Income	27.8	5.4	7.1	13.1
Total Income	1,284.5	1,652.4	2,212.4	3,146.9
Expenses	733.9	937.5	1,310.8	1,969.4
EBITDA	550.7	714.8	901.7	1,177.5
EBITDA Margin %	42.9	43.3	40.8	37.4
Depreciation	269.3	268.5	295.3	298.3
EBIT	281.4	446.4	606.4	879.2
Interest	38.1	8.8	8.8	8.8
Profit Before Tax	243.3	437.6	597.6	870.5
Tax	81.4	159.0	171.9	242.4
Profit after Tax	161.9	278.6	425.7	628.1
NPM %	12.6	16.9	19.2	20.0

Key Ratios & Valuations (Consolidated)

	FY10A	FY11A	FY12E	FY13E
EBITDA Margin (%)	42.9	43.3	40.8	37.4
NPM (%)	12.6	16.9	19.2	20.0
ROCE (%)	11.1	17.6	21.0	26.5
ROE (%)	7.7	12.2	16.1	20.4
ROA (%)	7.9	11.3	15.1	19.2
EPS	2.0	3.4	5.2	7.7
P/E (x)	20.9	12.1	7.9	5.4
BVPS	25.8	28.0	32.3	37.7
P/BVPS (x)	1.6	1.5	1.3	1.1
EV/Operating Income(x)	2.7	1.8	1.3	0.9
EV/EBITDA (x)	6.1	4.2	3.3	2.5
EV/EBIT (x)	11.9	6.7	4.9	3.3

Valuation

SGL has a long term strategy to capitalize on the prevailing strong and steady economic growth of India. With renewed strength in its state-of-art manufacturing facilities after the completion of the operational and managerial restructuring, SGL is looking forward to foray into the mining and material handling. At the current market price of ₹41.35, we rate the stock as 'BUY', with a 1 year target price of ₹70. At the current market price the stock is trading at a PE of 7.9x on FY12E EPS of ₹5.2 and 5.4x on FY13E EPS of ₹7.7.

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