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VARROC ENGINEERING LIMITED

June 22, 2018

SMC Ranking

★★☆☆☆ (2/5)

Issue Highlights

Industry	**Auto Ancillary**
Offer for sale (Shares)	20,221,730
Employee reservation	100,000
Net Offer to the Public	**20,121,730**
Issue Size (Rs. Cr.)	1951-1955
Price Band (Rs.)	965-967
Offer Date	26-Jun-18
Close Date	28-Jun-18
Face Value	1
Lot Size	15 Equity Share

Issue Composition

	In shares
Total Issue for Sale	20,121,730
QIB	10,060,865
NIB	3,018,260
Retail	7,042,606

Shareholding Pattern (%)

Particulars	Pre-issue	Post-issue
Promoters & promoters group	86.30%	85.00%
QIB	0.00%	7.46%
NIB	13.70%	2.24%
Employee reservation	0.00%	0.07%
Retail	0.00%	5.22%
Total	**100.00%**	**100.00%**

*calculated on the upper price band

Objects of the Issue

The objects of the Offer are to achieve the benefits of listing the Equity Shares on the Stock Exchanges and to carry out the Offer for Sale by Selling Shareholders

Book Running Lead Manager

- Kotak Mahindra Capital Company Limited
- Citigroup Global Markets India Private Limited
- Credit Suisse Securities (India) Private Limited
- IIFL Holdings Limited

Name of the registrar Link Intime India Private Limited

About the Company

Varroc Engineering Limited is a global tier-1 automotive component group. The company designs, manufactures and supplies exterior lighting systems, plastic and polymer components, electricals-electronics components, and precision metallic components to various automobile companies worldwide. 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. The company has expanded in India through acquisitions, mergers, joint-ventures and has expanded its manufacturing and R&D footprint by investing in nine manufacturing plants and an additional R&D center in India since 2012. The company has two primary business lines: (1) the "Global Lighting Business" under which it design, manufacture and supply of exterior lighting systems to passenger cars OEMs worldwide and (2) the "India Business" under which serves India, primarily two-wheelers and three-wheelers. At present, the company has a global footprint of 36 manufacturing facilities spread across seven countries, with six facilities for Global Lighting Business, 25 for India Business and five for Other Businesses. Companies like Bajaj, Honda, Yamaha, KTM, etc. constitute the client base of the company. The company's goal is to bring leading technologies to the mainstream markets with high quality, cost competitive solutions.

Strength

Strong competitive position in attractive growing markets: The company enjoys the advantage of growing exterior lighting market, which results in the increase of its global lightning business in nearly all the major passenger vehicle markets globally, including high growth markets such as China (through China JV) and India. The company's strong and long-lasting relationships with its customers helps in addition to generating further business in the Indian two-wheeler and three-wheeler markets more generally, particularly from within the Indian scooter and motorcycle markets, from both existing and new customers. In the Indian Business, the company's longest-standing relationship is with Bajaj, who has been its customer since 1990. While the company has many key customers who have been doing business with them for a long time, Varroc nevertheless has a diversified customer base and 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.

Comprehensive product portfolio: The Company has a comprehensive portfolio of products, which allows it to be a one stop- shop for its customers and to cross-sell its products. This portfolio consists 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. Apart from the products offered under the two business lines, the company's comprehensive product portfolio is engine agnostic as it is capable of being used across all fuel types. The fact that the company has a significant presence and significant customer relationships in each of its product segments helps it derive strength from the product portfolio. The company's revenue is also diversified with 66.9% and 63.8% of the consolidated total invoiced amounts for FY2017 and FY2018 attributable to four-wheelers, 31.1% and 33.1% to two-wheelers and three-wheelers and 2.1% and 3.1% to others, respectively. Moreover, the company is a supplier of external lighting systems to a leading electric vehicle manufacturer.

Low cost, strategically located manufacturing and design footprint: The company has its facilities primarily in low-cost countries near major automotive markets and it has made further investments to expand into new countries such as Brazil and Morocco, which allow Varroc to keep costs low while meeting its customers' supply needs across

Robust in-house technology, innovation and R&D capabilities: The 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. Technology capability is essential for automotive component manufacturers to remain competitive in the future, especially with global trends regarding restrictions on emission volumes, as well as other trends such as, autonomous driving, electrification, shared mobility and connectivity. The Company's R&D teams are focused on quick adoption of technology, enabling it to grow its product portfolio in line with customer expectations and industry developments.

Strategies

Focus on high growth markets for Global Lighting Business: In order to capture global growth in the exterior lighting segment, the company intends to expand its international footprint through the development of new plants in Brazil and Morocco, in order to open up the South American, southern European and north African markets. These markets, in addition to the Indian and Chinese markets, together accounted for more than 80% of passenger car and LCV sales by volume in 2016. This increased global footprint will not only give access to additional markets, but also deepen customer engagement (mainly with Renault-Nissan-Mitsubishi and a large European car manufacturer) and improve its ability to service existing customers, many of whom look for single source suppliers across the globe for their product lines. Through China JV, the company currently has two plants and two R&D centres in China. With the current footprint in China, it covers two major automotive clusters in the east and west of China. The company targets global platforms with global OEMs, as well as the local SUV and the growing electric car segments.

Focus on increasing customer revenue for India Business: India is the second largest two-wheeler manufacturer in the world (after China). 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. The company intends to increase its revenue with its existing customers by expanding the array of its existing products that it supplies and by continuing to develop technology solutions aligned with the customers' need. The strategic positioning of the manufacturing hubs of the company gives it a competitive advantage.

Continue to invest in R&D: The Company aims at expanding its R&D, engineering and software development capabilities in order to capture future growth trends. It seeks to expand its capabilities in a cost efficient manner, by focusing on low-cost geographies nearby major automotive markets, in order to expand its capabilities in a cost-efficient manner. For example, in India the company established a R&D facility specifically catering to VLS, which provides support to the core R&D facility in the Czech Republic. Moreover, it has established a new R&D facility in Poland which started operations in 2018.

Pursue strategic joint ventures and inorganic growth opportunities: The Company is mainly focused on growing existing product lines, such as automotive lighting and electronics for the global exterior automotive lighting market, in key markets including North America. In particular, the company will seek to make acquisitions that provides access to new technologies, or new customers, or new geographies. Historically, the company entered into joint ventures and agreements with a number of partners in order to gain access to new technologies, advanced manufacturing know-how, and access to new customers and geographies.

Focus on operational efficiency: The Company applies a lean manufacturing standard in the Global Lighting Business, called the Varroc Excellence System ("VES"). VES is structured to boost industrial efficiencies and increase profits and operating cash flows by reducing costs and eliminating waste in excessive stocks, workforce and processes. For the company's India Business, it has implemented total preventive maintenance ("TPM") in order to help ensure high quality, low costs and on-time delivery for its customers. The TPM initiatives focus on improving the efficiency of production and support functions by identifying and eliminating losses.

Risk Factors

Pricing pressure from Original Equipment Manufacturers (OEMs): Pricing pressure from customers may adversely affect the company's gross margin, profitability and ability to increase its prices, which in turn may materially adversely affect the business, results of operations and financial condition.

Dependence on certain major customers: The Company's business is dependent on certain major customers, with whom it does not have firm commitment agreements. The loss of such customers, a significant reduction in purchases by such customers, or a lack of commercial success of a particular vehicle model of which the company is a significant supplier could adversely affect the business, results of operations and financial condition.

Changes in consumer preferences, regulatory or industry requirements or in competitive technologies: Failure to identify and understand evolving industry trends and preferences and to develop new products to meet the customers' demands may materially adversely affect the company's business.

No assurance to integration of strategic partnerships and alliances: The Company has undertaken and may continue to undertake strategic investments and alliances, acquisitions and mergers in the future, which may be difficult to integrate and manage. These may expose the company to uncertainties and risks, any of which could materially, adversely affect business, financial conditions and results of operations.

Peer comparison

Co_Name	Operating Income	PAT	EPS	P/E	P/BV	BV	FV	PRICE	MCAP
Motherson Sumi	56293.32	2437.65	11.58	26.48	6.53	46.95	1.00	306.65	64558.70
Bharat Forge	8357.69	814.16	17.49	34.80	6.09	99.91	2.00	608.60	28335.72
Endurance Technologies	6538.14	408.89	29.07	43.47	8.18	154.47	10.00	1263.55	17773.45
Varroc Engineering	10,378.46	450.78	33.44	28.86	4.58	211.32	1.00	967.00	13036.27

* Financials are annualised
**Peer companies financials are based on TTM

Valuation

Considering the P/E valuation on the upper price band of Rs.967 EPS and P/E of annualised FY2018 are Rs.28.92 and 33.44 multiple respectively and at a lower price band of Rs. 965, P/E multiple is 28.86. Looking at the P/B ratio on the upper price band of Rs.967 , book value and P/B of annualised FY18 are Rs.211.32 and 4.58 multiple respectively and at a lower price band of Rs. 965 P/B multiple is 4.57. No change in pre and post issue EPS and Book Value as the company is not making fresh issue of capital.

Industry Overview

The global Personal Cars and Light Commercial Vehicle sales are expected to reach 99 million units in 2021 at a CAGR 2016-2021 of 2%. This growth will be majorly driven by emerging markets where GDP growth per capita will enable more households to purchase their first car. Whereas, the overall domestic two-wheeler production is estimated to grow at a robust pace of 8-10% CAGR in the next three years to reach around 26.3 million units by FY2020. Between FY2017 and FY2020, three-wheeler sales are expected to increase at a 13-15% CAGR because of moderate domestic growth of 8-10% CAGR and a healthy exports growth of 20-22% CAGR.

The automotive lighting market has following growth drivers: Increased LED penetration rate; technology innovation; design differentiation and increased lighting content per vehicle. The demand for engine valves in two and three-wheeler segment is expected to be in line with demand for two and three-wheeler vehicles, with higher growth estimated in the two-wheeler segment. The overall two- and three-wheeler polymer industry is expected to increase at a compound annual growth rate (CAGR) of 19-21%.

Outlook

Varroc Engineering has a global footprint of 36 manufacturing facilities spread across seven countries, with six facilities for Global Lighting Business, 25 for India Business and five for Other Businesses. The company is heavily dependent on the performance of the global passenger vehicle market and the two wheeler and three wheeler market in India. It generates revenue of 65% from global plants and 35% from domestic plants. Any adverse changes in the conditions affecting these markets can adversely impact its business. Also the company has experienced negative cash flows in prior periods and any negative cash flows in the future could adversely affect its financial condition. Also the issue looks expensive. High risk investors may invest in this IPO for medium to long term.

An Indicative timetable in respect of the Issue is set out below:

EVENT	INDICATIVE DATE (On or about)
Bid/Offer Opens Date	June 26, 2018
Bid/Offer Closing Date	June 28, 2018
Finalisation of Basis of Allotment with the Designated Stock Exchange	July 03, 2018
Initiation of refunds (if any, for Anchor Investors)/unblocking of funds from ASBA Account	July 04, 2018
Credit of Equity Shares to depository accounts of Allottees	July 05, 2018
Commencement of trading of the Equity Shares on the Stock Exchanges	July 06, 2018

Annexure

Consolidated Financials

Profit & Loss

Rs. in Cr.

Particulars	Period ended 31-Mar-18 (9 Months)	Period ended 31-Mar-17 (12 Months)	Period ended 31-Mar-16 (12 Months)
Total Operating Income	10,378.46	9,608.54	8,218.90
Total expenditure	9,500.89	9,026.79	7,646.05
Operating Profit	**877.57**	**581.75**	**572.85**
OPM%	8.46	6.05	6.97
Other Income	38.61	93.73	20.62
PBDIT	**916.18**	**675.48**	**593.47**
Depreciation	386.47	337.08	292.25
PBIT	**529.71**	**338.40**	**301.22**
Interest	86.17	90.40	-40.75
Profit before exceptional item and tax	**443.54**	**248.00**	**341.97**
Exceptional items	69.03	79.19	49.83
PBT	**512.57**	**327.19**	**391.80**
Tax	61.79	23.80	21.97
Profit after tax	**450.78**	**303.39**	**369.82**

Balance sheet is on next page

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Balance Sheet

Rs. in Cr.

Particulars	As on 31-Mar-18	As on 31-Mar-17	As on 31-Mar-16
Non-current Assets	**0.00**	**0.00**	**0.00**
Property, Plant And Equipment	2586.32	2251.21	1974.85
Capital Work-in-progress	244.05	246.46	263.60
Investment Properties	14.06	14.63	15.21
Goodwill	33.47	15.08	15.08
Other Intangible Assets	170.11	114.60	120.96
Intangible Assets Under Development	100.03	46.08	51.71
Investments Accounted For Using The Equity Method	356.50	292.71	264.31
Financial Assets			
Investments	0.02	0.02	0.02
Loans	10.68	8.56	6.38
Other Financial Assets	31.63	75.92	82.77
Income Tax Aeets(net)	12.44	15.30	16.15
Deferred Tax Assets (net)	103.00	13.02	13.24
Other Non Current Assets	129.67	48.61	62.89
Total	**3791.95**	**3142.20**	**2887.18**
Current Assets	**0.00**	**0.00**	**0.00**
Inventories	864.10	753.47	682.89
Financial Assets	**0.00**	**0.00**	**0.00**
Investments	3.03	-	11.94
Trade Receivables	1402.73	1138.29	1185.20
Cash And Cash Equivalents	326.58	350.03	163.61
Other Bank Balances	2.36	4.03	13.47
Loans	4.01	4.23	3.98
Other Financial Assets	261.28	301.25	137.57
Other Current Assets	196.35	167.19	160.02
Total Current Assets	**3060.44**	**2718.48**	**2358.68**
Total Assets	**6852.39**	**5860.68**	**5245.86**
Non-current Liabilities			
Financial Liabilities			
Borrowings	0.00	0.00	0.00
(i) Borrowings Other Than Covered	636.15	755.27	557.35
Under (ii) Below	0.00	0.00	0.00
(ii) Liability Portion Of Ccps	-	-	206.04
Other Financial Liabilities	12.28	9.12	7.47
Provisions	100.24	74.00	76.54
Deferred Tax Liabilities (net)	50.89	13.00	47.27
Other Non-current Liabilities	31.03	8.32	7.95
Total Non-current Liabilities	**830.59**	**859.71**	**902.61**
Current Liabilities			
Borrowings	**343.93**	**599.19**	**641**.87
Trade Payables	2000.41	1549.69	1269.07
Other Financial Liabilities	565.31	469.15	499.64
Provisions	44.85	59.73	25.83
Current Tax Liabilities (net)	8.13	17.89	13.82
Other Current Liabilities	210.40	99.48	109.85
Total Current Liabilities	**3173.03**	**2795.13**	**2560.08**
Total	**4003.62**	**3654.85**	**3462.70**
	2848.77	2205.83	1783.16
Net Worth Represented By:	**0.00**	**0.00**	**0**
Equity Share Capital	13.48	13.48	26.24
Other Equity	2814.52	2171.89	1736.64
Non-controlling Interests	20.77	20.16	20.28
Net Worth	**2848.77**	**2205.53**	**1783.16**

RANKING METHODOLOGY

WEAK	★
NEUTRAL	★ ★
FAIR	★ ★ ★
GOOD	★ ★ ★ ★
EXCELLENT	★ ★ ★ ★ ★

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