stock idea

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Sundaram Clayton

Apple Green

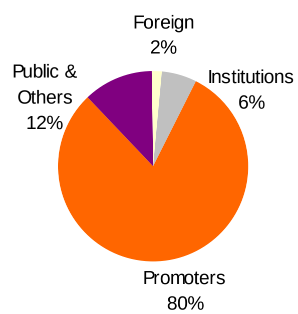
Br(e)aking new ground

Buy; CMP: Rs1,178

Company details

Price target:	Rs1,550
Market cap:	Rs 2,232 cr
52 week high/low:	Rs1,199/590
NSE volume: (No of shares)	2,826
BSE code:	520056
NSE code:	SUNDRMCLAY
Sharekhan code:	SUNCLA
Free float: (No of shares)	38 lakh

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	10.6	37.9	49.9	63.4
Relative to Sensex	2.2	13.3	3.1	-15.4

Key points

- Sundaram Clayton Ltd (SCL) would benefit from the buoyancy in the country's commercial vehicle (CV) industry. The shift from hydraulic brakes to air brakes expected in the CV industry augurs well for SCL.
- WABCO, holding a 39.17% stake in SCL, is scouting for a low-cost producer of brakes in India and SCL would be the ideal choice. We expect SCL to become a major sourcing hub for WABCO and meet its global requirements of brakes and machined castings. Such an arrangement would increase SCL's business opportunities significantly.
- We believe that the much-awaited demerger of SCL is about to take place. A demerger would enhance the business focus of both the divisions and lead to the unlocking of the value of the company's investments in group companies.
- SCL has introduced anti-lock braking systems (ABSs) in India. It would get a boost from the government's move to make the use of ABS in CVs mandatory from January 2007. Also, the margins in ABSs are higher than that in the conventional braking systems which should further boost the company's margins.
- The value of SCL's total investment in group companies works out to Rs1,930 per share. While computing SCL's value, we have assumed a 75% discount to the company's total investment. After adjusting for this, the SCL stock is currently trading at around 8.8x its stand-alone FY2008E earnings and around 7.1x its stand-alone FY2008E earnings before interest, depreciation, tax and amortisation (EBIDTA). We believe the valuations are attractive and hence recommend a Buy on SCL with a one-year price target of Rs1,550.

Company background

Promoted by the $2.6-billion TVS group, SCL started its operations in 1962. It has two divisions: an air-brake division and a castings division. The air-brake division was set up in collaboration with Clayton Dewandre Holdings Plc, UK (now WABCO Vehicle Control Systems, UK) and contributes 70% of the company's revenues. The castings division was set up in 1968 and accounts for about 30% of the total revenues. SCL has a majority holding in group companies like TVS Motors, TVS Electronics, and TVS Finance and Services among others.

Key financials Rs (cr)

Particulars	FY2005	FY2006E	FY2007E	FY2008E	FY2009E
Net profit	46.3	52.5	80.9	110.5	150.1
Shares in issue (cr)	1.9	1.9	1.9	1.9	1.9
EPS	24.4	27.7	42.6	58.2	79.1
% y-o-y growth		*13.4*	*54.1*	*36.6*	*35.8*
PER	28.7	25.3	16.4	12.0	8.8
P/B	10.8	9.3	7.2	5.8	4.5
EV/EBIDTA	41.3	19.9	14.6	10.2	7.1
ROCE (%)	30.6	26.7	28.0	31.7	36.7
RONW (%)	22.5	21.9	26.2	28.5	30.1

The company has two manufacturing facilities, one near Chennai for air brakes and the other near Bangalore for aluminium castings. SCL is the leading manufacturer of complete air-brake systems in India and caters primarily to the CV industry. Its castings business has also entered the export market.

Investment arguments

Benefits of buoyancy in the CV industry, dominating status in industry

SCL is expected to benefit significantly from the ongoing boom in the country's CV industry, as it manufactures the entire range of air-brake actuation components, including a large variety of compressors, reservoirs, air dryers, controlling and regulating valves. It also makes a wide range of vacuum brake equipment for light commercial vehicles. It is the leading provider of a complete set of air-brake solutions to the original equipment manufacturers (OEMs) for CVs. It has a dominant share of both the OEM (85%) and the replacement (75%) market. It currently meets most of the air-brake needs of the Indian CV majors including Ashok Leyland (99%) and Tata Motors (93%). Knorr Bremse, another global air-brake giant, has entered the Indian market in a joint venture with Tata Auto Components. As a result Tata Motors' contribution to SCL's revenues is expected to fall to 80% in FY2007. Meanwhile SCL is aiming to acquire new clients such as International Truck, Force Motors and Volvo among others. The big growth could come from the export business since there appears a strong possibility of SCL becoming the outsourcing base for WABCO, which is actively scouting for a low-cost producer of brakes in India.

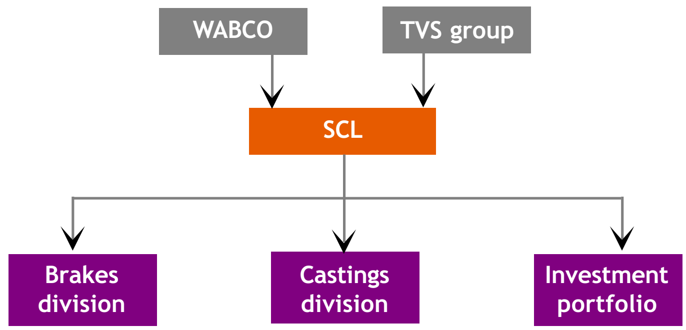
The CV industry is also expected to shift from the hydraulic braking system to the air-brake system, as the former does not conform to the international norms for brake response time, stopping distance etc. The shift would compel the CV manufacturers to switch to the air-brake system. Since SCL is the leading manufacturer of air brakes in the country, we expect it to be the biggest beneficiary of this change.

Demerger to unlock value

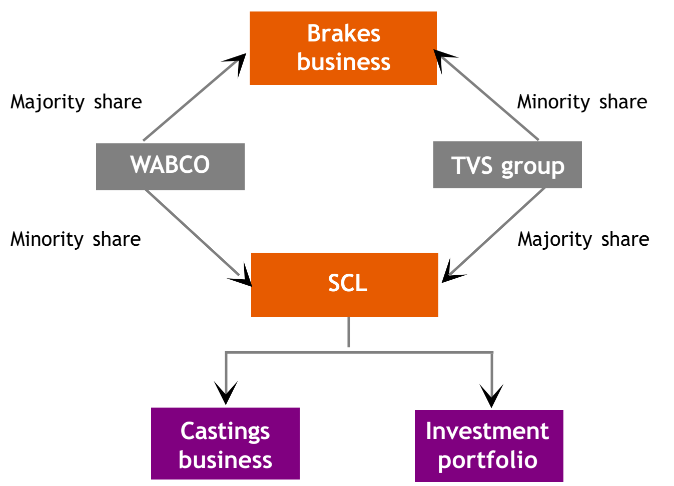
SCL has been toying with the idea of demerging its two divisions, ie the air-brake division and the castings division, for quite some time now. We believe that it is now close to finalising the demerger, which might take place shortly. As part of the demerger plan, the air-brake division will be hived off into a new company with WABCO as its major stakeholder. However the castings division as well as the company's investments in group companies would remain in SCL's fold. The demerger is expected to benefit the air-brake business, given the possibility of the new company becoming an outsourcing hub for WABCO.

SCL holds a considerable stake in group companies like TVS Motors and TVS Electronics. It holds a 56.83% stake in TVS Motors (8.84% directly and the balance through a subsidiary, Anusha Investments), 59.69% in TVS Electronics and 58.17% in TVS Finance. At present, the value of its total investment works out to Rs1,930 per share. We believe that the demerger would enhance the focus of the company's two businesses, unlock the value of its investment portfolio and lead to the re-rating of its stock.

Current scenario



Post-demerger scenario



Outsourcing opportunities to drive future growth

The demerger would create a new brake company with WABCO as its major stakeholder. To meet some of its global needs, WABCO is actively looking for a low-cost producer and we believe SCL would be the obvious choice. Thus SCL can be a major sourcing base for WABCO and cater to the latter's global requirements for brakes as well as castings. We feel that such an arrangement would be a major growth driver for SCL.

The castings division, caters to TVS Motors, Cummins, Hyundai in the domestic market. SCL has also won a long-term contract from the Volvo group for the supply of engine and transmission castings for trucks. We believe that there will be a significant ramp-up in the export revenues once the supplies for the Volvo order commences.

ABS—a hidden opportunity

SCL is the first Indian company to manufacture the next-generation braking systems—ABS and anti-spin regulation (ASR)—developed in-house. An ABS is used to prevent a vehicle from skidding in moments of panic and to bring it to a controlled stop. The company has already given samples to Ashok Leyland and Tata Motors. The cost differential between an ABS and an air brake is in the range of Rs30,000-35,000 per vehicle and the margins in ABS are higher than those in the conventional braking systems. The regulations regarding the usage of ABS in CVs are expected to be implemented by the end of 2006. Depending on the nature of the regulations, we feel that the replacement demand can be huge as there is a tremendous potential in this business if the government makes the usage of ABS mandatory.

New orders to boost export revenues of castings division

The castings division actually began as a captive unit to manufacture high-precision aluminium castings but it has since evolved to become a high-quality producer of aluminium castings. The company has increased the capacity of the castings division from 15,000 tonne to 24,000 tonne currently which will be further increased to 50,000 tonne by FY2008. The capital expenditure is expected to be about Rs35-40 crore for the castings division in FY2006-07.

SCL has widened its domestic customer base by adding new customers like Honda Siel Cars, Sona Koyo Steering, Tata Holset, Ford India and Visteon. It has also won an export contract from the Volvo group for the long-term supply of engine and transmission castings for trucks. The exports to the Volvo group are expected to touch Rs60 crore (Rs35 crore currently) over the next two years. Besides, additional business from its existing customers is expected to fetch another Rs40 crore worth of export revenues during the same period.

Concerns

Entry of Knorr Bremse

Knorr Bremse, a leading manufacturer of air-brake systems globally, has entered into a joint venture with Tata Auto Components to manufacture air-brake systems and ABSs in India, and will cater to the local market. As Tata Motors is one of the major customers of SCL, there has been a cut in the share of the company's supplies to Tata Motors. The share of the Tata business is expected to come down to 75% going ahead.

Rising input prices

The prices of key inputs such as steel and aluminum have increased sharply. SCL sources its aluminum requirements from Tata Steel, Hindalco Industries and Indal. It also imports raw materials from Sri Lanka. The raw material cost (RMC) to sales ratio is 55% in the air-brake division whereas the same is 45% in the castings division. The impact of a higher RMC is mitigated with value engineering, process improvements and better sourcing. Also, the company has a price variation clause to provide for raw material price increases.

Valuations

We believe that SCL would continue to do well on the back of the booming CV industry and its dominating status in the air-brake industry. The demerger of the company should act as a strong trigger for the stock and may lead to its re-rating. The proposed demerger, we believe, would create new outsourcing opportunities for the brake business as the new brake company is expected to cater to the needs of the parent company, WABCO. The castings division of SCL continues to do well and is exploring the opportunities in the export market in a big way. Further, the demerger should also lead to the unlocking of the value of the company's investment portfolio.

Investment value

Present value of Investments:	
TVS Motors (Rs cr)	2293.2
TVS Electronics (Rs cr)	623.7
TVS Finance & Services (Rs cr)	757.4
Total value of investments (Rs cr)	**3674.2**
No of shares (SCL)	1.9
Investment value per share (Rs)	1936.9
SCL's CMP	1124.0
Less: Invesments@75% discount	484.2
Adjusted price (Rs)	**639.8**

As discussed earlier, the value of SCL's total investment works out to Rs1,930 per share. To value the company we have assumed a 75% discount to the total investment value per share. After adjusting for the investments, the stock is currently trading at around 8.8x its stand-alone FY2008E earnings and around 7.1x its stand-alone FY2008E EBIDTA. We believe that these valuations are quite reasonable considering the growth prospects of the company. Hence we are initiating coverage on the stock with a Buy recommendation and a one-year price target of Rs1,550.

Comparative valuation table

Company	EPS(08)	P/E	EV/EBITDA
Amtek Auto	32.0	11.0	5.3
Bharat Forge	22.0	19.7	15.0
Rico Auto	8.9	10.6	7.0
SCL	79.1	8.8	7.1

Financials

Profit and loss account

Rs (cr)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
Net sales	417.4	536.3	627.9	807.3	1,021.4
Operating expenses	363.6	467.1	532.6	673.7	843.0
Operating profit	53.8	69.2	95.4	133.6	178.4
Other income	28.3	32.4	43.7	45.1	54.0
EBIDTA	82.1	101.6	139.1	178.6	232.4
Depreciation	15.3	21.4	27.0	30.0	33.0
Interest	1.0	4.6	8.3	7.0	7.0
PBT	65.8	75.6	103.9	141.6	192.4
Tax	19.5	23.1	23.0	31.2	42.3
PAT	46.3	52.5	80.9	110.5	150.1

Balance sheet

Rs (cr)

Particulars	FY04	FY05	FY06E	FY07E	FY08E
Share capital	19.0	19.0	19.0	19.0	19.0
Reserves & Surplus	187.1	221.1	290.0	368.4	479.9
Shareholders fund	206.1	240.1	309.0	387.3	498.9
Total debt	44.8	109.2	142.0	100.0	100.0
Total liabilities	250.9	349.3	451.0	487.3	598.9
Gross block	239.5	331.7	428.0	548.0	588.0
Net fixed assets	160.3	233.9	303.1	393.1	400.1
C/work in progress	23.5	41.2	40.0	0.0	0.0
Investments	55.1	57.1	57.1	57.1	57.1
Current assets	130.3	175.1	215.0	248.4	394.6
Current liabilities	69.9	103.8	110.0	157.0	198.7
Net current assets	60.4	71.3	105.0	91.3	195.9
Misc exp not w/o	0.0	0.1	0.1	0.1	0.1
Deferred tax liability	-11.3	-13.4	-13.4	-13.4	-13.4
Total assets	250.9	349.3	451.0	487.3	598.9

Valuations--adjusted

Particulars	FY04	FY05	FY06E	FY07E	FY08E
EPS	24.4	27.7	42.6	58.2	79.1
PER	28.7	25.3	16.4	12.0	8.8
P/B	10.8	9.3	7.2	5.8	4.5
EV/EBIDTA	41.3	19.9	14.6	10.2	7.1
ROCE (%)	30.6	26.7	28.0	31.7	36.7
RONW (%)	22.5	21.9	26.2	28.5	30.1

Key ratios

Particulars	FY04	FY05	FY06E	FY07E	FY08E
OPMS (%)	12.9	12.9	15.2	16.5	17.5
EBIDTA (%)	19.7	18.9	22.2	22.1	22.8
PAT (%)	11.1	9.8	12.9	13.7	14.7
RoCE (%)	30.6	26.7	28.0	31.7	36.7
RoNW (%)	22.5	21.9	26.2	28.5	30.1
Debt/Equity (X)	0.2	0.5	0.5	0.3	0.2

The author doesn't hold any investment in any of the companies mentioned in the article.