



Nelco

Vulture's Pick

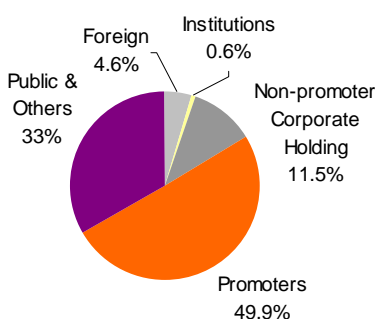
In the army now

Buy; CMP: Rs144

Company details

Price target:	Rs216
Market cap:	Rs329 cr
52 week high/low:	Rs196/33
NSE volume: (No of shares)	1.2 lakh
BSE code:	504112
NSE code:	NELCO
Sharekhan code:	NELCO
Free float: (No of shares)	1.2 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-10.7	189.5	175.1	224.1
Relative to Sensex	-14.8	125.6	112.1	107.9

Key points

- Defence orders:** Nelco is benefiting immensely from its past initiatives to focus on the niche market of security and surveillance systems for the defence forces. Given its alliances/tie-ups with leading global majors, the company has been able to establish itself as a reliable supplier of superior technology products. On the demand side, the government has considerably enhanced its spending on electronic communication warfare systems and is encouraging private participation. Consequently, the strategic electronic business of Nelco is poised to grow at a compounded annual growth rate (CAGR) of 40% over the next three years.
- Robust industrial demand:** In the light of the increased investments by the key user industries, such as steel, cement and utilities, the company is witnessing a robust growth in its other businesses of SCADA and power drive systems. It has built a robust order pipeline, which has improved the growth visibility of these businesses significantly. Another key business division of VSAT-based network systems is also growing at a steady rate.
- Margins to firm up:** The margins have improved significantly in the last fiscal to double-digit levels. The operating profit margin (OPM; excluding the real estate inflow) is likely to improve further and stabilise around 20-22% on the back of a higher contribution from the high-margin defence orders and service business.
- Realty gains:** It will further unlock the value in its real estate business by developing 50,000 square feet (sq. ft.) of saleable area in each of the next three years. We estimate the fair value of the cash flows from the real estate business at Rs10 per share.
- Attractive valuations:** At the current market price of Rs144, the stock trades at a discount of 9.9x its FY2007 estimated earnings. We initiate coverage on Nelco with a Buy recommendation and a 12-month price target of Rs216.

Company background

Nelco, part of the reputed Tata group, is largely involved in the business of providing automation and control systems (ACS), and VSAT (very small aperture terminal) equipment and related network solutions.

Key financials

Year ended 31st March	FY2004	FY2005	FY2006E	FY2007E
Net profit* (Rs cr)	-12.0	4.5	25.8	33.1
EPS (Rs)	-5.3	2.0	11.3	14.5
yoy change (%)	-	-	477.8	28.1
PER (x)	0.0	73.5	12.7	9.9
Price/BV (x)	14.4	14.4	7.1	4.3
EV/EBIDTA(x)	0.0	30.3	7.4	5.7
Dividend yield (%)	0.0	0.0	0.7	1.4
RoCE (%)	-1.2	8.4	36.8	40.4
RoNW (%)	-81.4	1.1	63.1	48.1

*Adjusted for the extraordinary expenses and inflows from the real estate business

Nelco also has a business division involved in real estate development, which is carried out in association with a group company, Tata Housing Development Corporation (THDC).

Revenue mix

(%)	FY2005
Automation & Control	67.8
- <i>Strategic electronics</i>	34.0
- <i>SCADA</i>	10.0
- <i>Drive systems and traction systems</i>	24.0
Network Systems	24.5
Property Development	7.7

The ACS business division generates the bulk of the company's revenues, with a contribution of 67.8% in FY2005. Traditionally, the company has been involved in selling supervisory control and data acquisition (SCADA) systems, power drives and traction electronic systems through this division. However, over the last few years, it has taken initiatives to penetrate the lucrative and niche market for security and surveillance systems for the defence forces through a dedicated business division, Strategic Electronic Group (SEG).

In most of the business segments, Nelco has built a strong portfolio of cutting-edge technology products through its alliances/tie-ups with leading global engineering and technology companies.

Technology tie-up

Defence	Eagle Telonics, US; Galdor Systems, Israel; Thales, France; ASL, Bangalore
SCADA	Serck control, UK; GE Harris, US
VSAT	VIASET, US; STM Inc., US; Navis Llc, US
Drives	ABB; GE, Hitachi, Adtranz, Swiss

Investment arguments

Establishing itself as a reliable supplier to the defence forces

In the past, the ACS business division was largely focused on the industrial segment, which was severely affected by a tepid user demand and increased competition from the multinational companies. This compelled the management to restructure the business model and diversify into newer area of providing security and surveillance systems for the defence forces. This space is less crowded due to the high entry barriers and is witnessing a strong demand growth in the light of the continued infiltration into the country's borders. On its part, the government has substantially increased the budgetary allocation for the modernisation of the armed forces and is encouraging participation from the private sector.

Huge allocation for the capital expenditure

(Rs crore)	2004-05	2005-06
Total budgetary allocation	77000	83000
Allocation for capital expenditure	34500	33483

To establish itself as a reliable supplier, the company has formed a separate dedicated business division (SEG) and built a wide range of superior technology products acquired from its tie-ups with leading global companies. The efforts are yielding results now, with the company bagging regular orders for the supply of equipment like unattended ground sensors, global positioning system equipment, low power jammers and a host of communication electronic warfare systems to the defence forces.

Synergies with the group companies

The Tata group has emerged as one of the largest private sector suppliers to the Indian armed forces. It is likely to almost double its revenues from the defence sector to Rs1,100 crore in this fiscal, up from Rs550 crore in FY2004. Going forward, the group aims to further leverage on its capabilities in the information technology, communication, strategic electronic system and solution arena (given the multi-disciplinary resources of the group companies like Tata Motors, Tata Power, Nelco, Tata Consultancy, Tata Advanced Materials, Tata Infotech and CMC) to double the revenues from the defence business to Rs2,200 crore by 2008. Consequently, it is imperative for the Tata group to build synergies between the various group companies for the defence business.

Partner of choice

With its reputed parentage and an already established presence, Nelco has emerged as one of the preferred local partners for the global majors vying for the vast opportunity in the niche space of defence orders. It has already established strong relations with some of the best-known and reputed names in the global electronic warfare system segment. For instance, it supplies unattended sensors procured through its US-based alliance partner, Eagle Telonics, a leading player in the intrusion detection systems.

Another important tie-up is with a leading France-based firm, Thales Corporation, which has secured some significant orders in India. Through one of its subsidiaries, Thales Corporation would supply \$700 million worth of sub-systems like the underwater sensors, communication systems, optronics and electronics warfare equipment to the Indian Navy, as part of the \$3-billion order for six Scorpene submarines. Nelco is expected to be the local

partner to carry out the integration, installation and commissioning work. This alliance should generate a sustainable revenue stream in future.

Given the robust order pipeline, we estimate the SEG to grow at a CAGR of 40% over the three-year period FY2005-08.

Rising demand from the user industries

In addition to the expected growth in the defence business, the other businesses of SCADA systems, drive systems and VSAT-based networking solutions have shown a considerable improvement in their performance. What's more, the growth visibility is strong in most business lines on the back of a healthy order pipeline.

In the SCADA business, the company has bagged an order worth Rs30 crore from Jaipur Vidyut Vikas Nigam for electrical distribution automation. The company has bid for nine more tenders from the other state electricity boards (SEBs) for similar projects that are funded through the Accelerated Power Development & Reforms Programme (APDRP) fund. The SEBs have been plagued with a high level of transmission & distribution (T&D) losses due to a lack of investment in the T&D systems. To reduce these T&D losses (which are in the range of Rs21,000 crore), the government introduced the Rs40,000-crore APDRP fund in the 10th Five-Year Plan. Thus, the size of the opportunity is humongous.

In case of drive systems, the key user industries of steel and cement have witnessed a higher demand from the replacement as well as the expansion projects. The growth has also been aided by the company's ability to penetrate the overseas market. It has bagged orders for multi-voltage drive systems from the cement manufactures in the Middle East region.

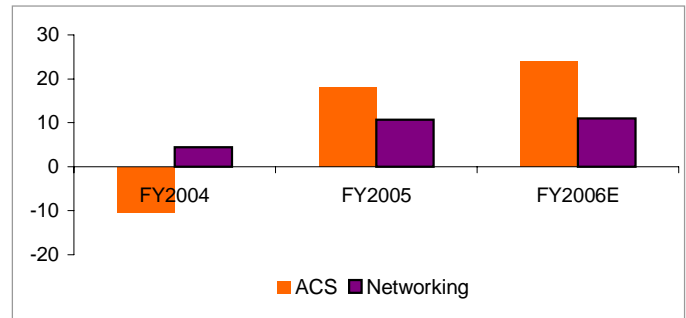
The network system business is expected to continue with its steady growth rate of 30-35% due to the demand for corporate wide area networks from the enterprise segment, especially the fast growing financial service sector.

Margins to catapult

In spite of the one-time charges of Rs7.3 crore for the bad/doubtful debts and an obsolete inventory, the OPM climbed to the double-digit level in the last fiscal. This was driven by the dramatic turn-around in the ACS business and the increasing share of the revenues from the service (both implementation and support) business. We expect the margins to further improve and stabilise around 20-22% levels in the coming years due to a higher proportion

of the incremental revenues from the high-margin defence orders and service business.

PBIT margins (%)



Inflows from the real estate business

Nelco is developing an additional structure at the Technopolis Knowledge Park at Andheri in Mumbai in association with THDC. The management expects to develop 50,000 sq. ft. of saleable area in each of the next three years. The project is likely to generate a cash flow of Rs8.8 crore annually during the period FY2006-08. Even on a conservative basis, we estimate the fair value of the cash flows from the real estate development to be around Rs10 per share (after discounting the future cash flow to its present value). The proceeds are likely to be utilised to reduce and restructure the existing debt of Rs90 crore which will further boost the earnings.

Investment concerns

High working capital cycle

Nelco has fairly high debtor and inventory days. The working capital cycle deteriorated in the last fiscal. Though the management is taking steps to improve the same, the improvement would be limited due to the industry dynamics. Apart from this, the company had outstanding debtors of over Rs10 crore that were more than six months old, even after making provisions of Rs5.7 crore for doubtful receivables in FY2005.

Bureaucratic delays

The growth (to quite an extent) will be influenced by the company's ability to secure orders from the defence forces. In the past, it has been witnessed that the order flow can be severely affected due to bureaucratic delays, which can result in a weak performance during that particular year.

Pricing pressures

In certain segments, like those of drive systems and SCADA systems, the company competes with some of the leading multinational companies, who not only are capable of developing superior products but also compete aggressively

on pricing. Earlier also, the company had to reorient its focus away from the industrial electronic segment due to competition-led pricing pressures.

Valuation

Nelco has shown a marked improvement in its performance during the last fiscal. The past initiatives to establish itself in the niche space of security and surveillance systems are yielding results now. Moreover, the robust demand from the user industries in the other business lines is aiding the improvement in its overall performance.

We expect the company's revenues and earnings to grow at a CAGR of 32% and 172% respectively during the two-year period FY2005-07. At the current market price of Rs144, the stock trades at a discount of 9.9x its FY2007E earnings. We initiate coverage on Nelco with a Buy recommendation and a 12-month price target of Rs216. We have arrived at the price target price by taking Rs206 as the fair value of the company's core business (which is 12x the average of FY2007E and FY2008E normalised estimated earnings) and Rs10 per share as the value of the cash from its real estate business.

Financials

Profit and loss account

Rs (cr)

Particulars	FY2004	FY2005	FY2006E	FY2007E
Sales	131.8	135.7	183.1	235.4
Total expenditure	156.2	122.0	131.1	169.6
EBITDA	-24.5	13.7	52.0	65.7
Depreciation	6.1	3.8	4.1	4.3
Interest	19.2	9.4	6.1	5.5
Other income	35.5	4.2	1.5	1.5
Deferred revenue expense	6.5	4.2	4.0	3.6
PBT	-20.7	0.5	39.3	53.8
Tax	-2.2	0.3	10.2	17.2
PAT	-18.6	0.3	29.1	36.6
Adj net profit*	-12.0	4.5	25.8	33.1

* Adjusted for extraordinary expenses and inflows from real estate business

Balance sheet

Rs (cr)

Particulars	FY2004	FY2005	FY2006E	FY2007E
Share capital	22.8	22.8	22.8	22.8
Reserves and surplus	0.0	0.0	23.2	53.3
Networth	22.8	22.8	46.0	76.1
Total debt	99.2	90.7	86.8	84.3
Deferred tax liabilities	0.0	0.0	0.0	0.0
Capital employed	122.0	113.5	132.9	160.4
Net fixed assets	15.8	18.4	14.5	12.1
CWIP	0.1	0.2	2.0	2.0
Investments	5.1	5.1	5.1	5.1
Deferred tax assets	3.0	3.0	0.0	0.0
Net current assets	75.4	68.6	104.5	137.9
Msc expenditure not w/off	15.1	10.9	6.9	3.3
Debit balance transfer	7.6	7.3	0.0	0.0
Capital deployed	122.0	113.5	132.9	160.4

Valuation

Particulars	FY2004	FY2005	FY2006E	FY2007E
EPS (Rs)	-5.3	2.0	11.3	14.5
P/E	0.0	73.5	12.7	9.9
Book value	10.0	10.0	20.2	33.4
Price/BV	14.4	14.4	7.1	4.3
EV/Sales	3.2	3.1	2.1	1.6
Market Cap/Sales	2.5	2.4	1.8	1.4
EV/EBIDTA	0.0	30.3	7.4	5.7
Dividend yield (%)	0.0	0.0	0.7	1.4

Key ratios

Particulars	FY2004	FY2005	FY2006E	FY2007E
OPM (%)	-18.6	10.1	23.6	24.2
NPM (%)	-14.1	0.2	15.9	15.5
RoCE (%)	-1.2	8.4	36.8	40.4
RoNW (%)	-81.4	1.1	63.1	48.1

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

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