Nelcast Ltd

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Independent Equity Research

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Important disclosure on the last page

Nelcast is India's largest producer of SG Iron castings, which is used in Tractors, MHCVs, Railways, etc. It's also a key player in Grey Iron Castings. Sales volume grew 30% annually over last two years and is expected to grow 20% annually over next three years. Margins will expand substantially due to operating leverage. Nelcast will also benefit from a couple of structural shifts towards greater use of castings.

DCF Value (1-year out) Rs.45 | Current Price Rs.20 | Potential 2.3x

At current price, stock trades at 5 times FY12 expected EPS of Rs.4 with expected earnings growth of 28-29% in FY13 & FY14. Maximum debt/equity over the last five years was 1.7 and is not likely to exceed 0.5 over next three years. At our fair value of Rs.45, the stock will trade at 7.6x FY13 EPS and 5.9x FY14 EPS. RoE is expected to expand to ~20% by FY14.

Key Data

Market Cap	Rs.174cr US$36mn
Shares Outstanding	8.7 crore
52 wk Hi-Lo	30 – 11
Avg Trading Vol	No. of shares
1 month	83,000
3 months	81,000
1 year	701,000
BSE Scrip Code	532864
BSE Group	B
NSE	NELCAST
Shareholding %	**30Jun11**
Promoters	72.07
Institutions	0.56
Others	27.37
Valuation	**FY12E**
EV/ EBITDA	3.7x
Market Cap/Sales	0.26x
P/E	5.0x

Products

SG Iron Castings & Grey Iron Castings, made from steel scrap, used primarily in Tractors, MHCVs, Railways, machinery components, engine parts, etc.

Key Investment Points

- Nelcast is India's largest producer of SG Iron Castings and one of the largest producers of Grey Iron castings. Very few producers of SG castings due to technological and experience-related entry barriers.
- Agriculture growth and rural infrastructure spending are key growth drivers at present and over long term
- MHCV segment, though facing slowdown currently, is a long-term growth driver
- Trend towards multi-axle vehicles doubles castings requirements
- Shift in demand from forging to casting in some applications
- Metro rail to contribute to growth and margins
- Operating leverage to play out and expand margins significantly
- Significant & consistent reduction in inventory helping operating cashflows
- Expanding capacity by 40% to enter into niche areas of large high-value castings
- Substantial cash inflow, which came from sale of stake in Nelcast Energy, is being used to repay debt and will be used for funding capex.

Watch out for

- Sustained de-growth in MHCVs can impact Nelcast's growth, as MHCVs contribute 40% to Nelcast's revenues.
- Monsoon failure and absence of rural infrastructure spending can impact Nelcast's sales to Tractors segment, which contributes another 40% to its sales.

Introduction

Nelcast Ltd, a company with FY11 revenues of Rs.557 crore, is India's largest manufacturer of SG Iron Castings. It's also one of the leading manufacturers of Grey Iron Castings. Its products find applications primarily in Tractors & Trailers, Medium & Heavy commercial vehicles (MHCVs), and Railways. Steel scrap is a key raw material for it. Its major clients include TAFE, ITL, Eicher, Tata Motors and Ashok Leyland. Nelcast has been catering to many of these customers for 20-25 years. It has two plants (foundries) near Chennai.

Approximately 40% of Revenues come from Tractors & Trailers, 40% from MHCVs, and balance from Railways, machinery components, engine parts, pipe fittings, etc.

Other producers of SG Iron casting in India are Hinduja Foundries, Brakes India, Kirloskar Ferrous, and Amtek India. There are many producers of Grey Iron castings. Some of the large producers of GI castings are Amtek India, Hinduja Foundries, Kirloskar Ferrous, and Kores (India).

China is the global leader in castings with ~43% market share and annual production of 35mn tons. India is a distant number two with ~9% market share and annual production of 7-8mn tons. About 70% of castings produced in India are GI Castings with 4500 units, of which, ~90% are SMEs. Some of the customers tried China castings but came back to Nelcast due to quality issues. China, therefore, is unlikely to be a competition for quality SG Castings.

SG Casting segment has very few players, as technology and experience act as entry barriers. SG (Spheroidal Graphite Iron) Castings are stronger than GI castings.

The casting process consists of pouring of injecting molten metal into a mold containing a cavity with the desired shape of the casting.

Investment Arguments

India's largest producer of SG Iron Castings & a key producer of GI Castings

SG Iron Castings are technologically superior and are stronger than GI Castings. Nelcast is India's largest producer of SG Iron Castings. There are only a handful of players in SG castings, as technology & experience act as entry barriers. Nelcast is also one of the largest producers of GI castings in India. GI castings market is competitive due to presence of large number of producers including SMEs.

Nelcast sales volume grew 31-32% in FY10 and FY11. We expect sales volume to grow at 20% annually for next three years driven by demand from all customer segments. Nelcast continues to add to its clients list. It has lately sent samples to Caterpillar and BEML. In Europe, it added Danfoss as its client.

Agriculture & rural income growth are strong growth drivers at present

Currently, there are concerns on overall slowdown in economy. However, agriculture growth continues to be strong leading to higher rural incomes and spending. Increased investment in rural infrastructure also helps rural incomes. In Q1FY12, agriculture growth was 3.9% as against 2.4% in Q1FY11. These are expected to reflect in strong growth in Tractors & Trailers. Tractors & Trailers segment contribute 40% to Nelcast's sales. International Tractors Ltd (Sonalika group), TAFE, and Eicher are its key clients in this segment. M&M expects 12-15% volume growth in Tractors in FY12. In QE Jun-11, Tractors, Tippers and Trailers showed good growth.

MHCV segment, though facing slowdown currently, is also a long term growth driver

Medium & Heavy commercial vehicles (MHCVs) contribute another 40% to Nelcast's sales. Currently MHCV segment is witnessing slowdown with volume growth expected to be in the range of 5-10% in

FY12. The consensus estimate is at around 8.5% volume growth in FY12 and 12% volume growth in FY13. While economic growth is slowing down, it's still growing and due to multiplier effect on freight movement, there should be good addition to MHCV fleets in FY13. This is likely to lead to a double digit growth in MHCVs in FY13. Slowdown in infrastructure build-up due to political events is a major contributor to current economic slowdown. Once infra spending picks up pace, we should see overall improvement in economic growth.

The long-term outlook on MHCVs is very positive and hence MHCVs continue to be a long-term growth driver for castings. Highways constitute only 2% of all roads in India. As proportion of highways increases, demand for MHCVs increases too. Freight corridor is expected to be operational from Dec-12 in phases. Higher infra spending is expected to propel MHCV demand. The optimism over MHCV demand is reflected in entry into India of global CV majors like Navistar, Mann, Daimler, Foton (China), etc.

Trend towards multi-axle vehicles doubles castings requirement

Within the MHCVs, there is a trend towards multi-axle vehicles, as these offer improved operating economics. Requirement of castings doubles in multi-axle vehicles. This structural shift towards multi-axle vehicles is another growth driver within the MHCV segment.

Casting is replacing steel (forging process) in some applications

In quite a few applications, casting is replacing steel parts made by forging process. Forging is a manufacturing process where metal is shaped by plastic deformation under great pressure into high strength parts. Forging normally requires multiple steps while casting is a one-step process. Casting parts cost 30% less than forged parts. Therefore, wherever feasible, casting is replacing forging. This is another growth driver for castings.

Metro Rails to contribute to growth and margins

Metro rail orders, though sporadic, offer high margins. As metro rail infrastructure is being created and more & more cities are likely to go for Metro Rail to tackle traffic woes, Metro rail orders will continue to contribute to castings sales over long term. Indian Railways orders, which are taken to fill spare capacity, carry low margins.

Operating Leverage to play out

Nelcast operated at 64% of its achievable capacity in FY11. At our estimate of 20% annual volume growth, Nelcast will reach 98% of its achievable capacity in FY13. As company utilizes slack in the capacity, we expect significant operating margin expansion due to operating leverage in its cost structure. Operating margin, which was at 6.7% in FY11, is estimated to be at 9.6% in FY12 and 10.4% in FY13.

Entry into large high-value castings

Nelcast plans to get into large high-value castings that offer high margins and provides another avenue for growth. It's getting into niche markets like earth moving equipments. In such niche market, it is will compete with companies like Steelcast and AIA Engineering.

Significant capacity expansion planned to support growth

We estimate that Nelcast will hit full capacity in FY13. To support growth beyond FY13, Nelcast has planned a capex of Rs.100cr to expand casting capacity from present 150,000 TPA to 250,000 TPA. About 80% of the installed capacity is achievable capacity. Bulk of this capex will take place in FY13. The additional capacity will be mainly for large-sized castings.

Sale of stake in Nelcast Energy provides funds for growth

In FY11, Nelcast sold its stake in Nelcast Energy Corporation Ltd at an after-tax profit of Rs.75cr. Due to cash inflow from this sale; it had surplus cash of Rs.52cr at the end of FY11. Its net debt was Rs.40cr and net-worth was Rs.215cr. The surplus cash, internal accrual till FY13, and leveraging capacity due to low debt/equity ratio imply it can comfortably fund its capex plan to support future growth.

Significant reduction in inventory in the last four quarters

Nelcast achieved significant and consistent reduction in finished goods and WIP inventory over the last four quarters. The reduction is to the extent of Rs.51cr and is significant in relation to size of the company. This has greatly helped reduce working capital and increase operating cashflows. Net working capital to revenues came down from 45% in FY09 to 24% in FY11. While we expect inventory levels to rise somewhat from the current levels, overall net working capital to revenues is estimated to be at around 23% going forward.

Risks / Concerns

Sustained de-growth in cyclical MHCV segment can impact growth

A sustained de-growth in cyclical MHCV segment of the kind witnessed in FY08 (-1%) & FY09 (-33%) can severely impact Nelcast's growth, as 40% of its sales come from this segment. We, however, do not see a de-growth scenario playing out. A slowdown in MHCV sales growth has taken place and may continue this year. Tata Motors expects 7-10% growth in MHCV this year.

Monsoon failures to impact growth to tractor segment

Monsoon has been good this year and hence tractors demand is expected to remain robust this year. Tractors grew 32% in FY10 and 20% in FY11. M&M expects tractors sales growth to be 12-15% this year. A bad monsoon in the absence of absence of strong rural infrastructure spending can severely impact Nelcast's sales from this segment. This segment contributes ~40% to Nelcast's sales.

Simultaneous occurrence of the above two risk factors in any year can be a deadly blow to Nelcast. That's a rare occurrence but one has to watch out for.

Ownership & Management

Promoters, led by P Radhakrishna Reddy, owned 72.07% of the company as on 30-Jun-11. Some of the public shareholders, holding 4.73% stake, appear to be part of promoters. Thus promoters holding can be taken as ~77%. Institutional holding is negligible. Kanuri family (Kanuri Family Trust and Healthy Investments Ltd) hold 3.35% stake in public category. Top Management comprises of members of promoter group.

Valuation and key underlying assumptions

We estimate one-year out fair value per share to be around Rs.44 by discounting free cash flows. Key assumptions are 20% volume growth for next three years (31-32% over the last two years), 15% NOPLAT growth and 20% ROIC in the first phase.

We calculated Nelcast's beta over multiple time frames and against multiple indices. SPL has the highest beta (1.21) against BSE-smallcap index over three-year timeframe. We chose to use this to build conservatism in our valuation.

At the current price of Rs.20, the stock trades at 5x FY12 estimated EPS of Rs.3.97 and 3.9x FY13 estimated EPS of Rs.5.07.

Financials

Income Statement

Rs. Cr.	FY11	FY12E	FY13E
Net Revenues	507	667	841
EBIT	22	57	75
PBT-Adj.	17	51	66
PAT-Adj.	9	35	45
EPS Rupees	0.99	4.00	5.16

Ratios

%	FY11	FY12E	FY13E
Revenue Gr%	43.2	46.9	24.3
EPS Growth %	25.9	304.0	29.0
RoE %	4.3	15.0	17.4
D/E x	0.4	0.2	0.5
Debtors Days	63	63	63
Creditors Days	70	70	70
WIP Days	13	13	13
FG Days	14	18	18

Balance Sheets

Rs. Cr.	31Mar11	31Mar12	31Mar13
Assets			
Net Block	171	163	250
CWIP	1	20	-
Net Curr. Assets	105	134	165
Surplus Funds	52	-	-
Liabilities			
Equity Capital	17	17	17
Reserves	197	218	244
Debt	92	57	124
Non-Current Liab	22	25	30

Interim Performance

Rs.Cr.	Sep10	Dec10	Mar11	Jun11
Months	**3**	**3**	**3**	**3**
Revenues	127	131	154	156
Decr. in stock	10	19	11	11
EBITDA	7.5	8.7	8.4	15.9
EBIT	5.4	6.2	5.8	13.2
PBT	3.5	5.0	6.2	11.6
PAT-Adjusted	2.5	3.1	4.0	7.8
Eq Capital	17.4	17.4	17.4	17.4
EPS Rs.	0.29	0.36	0.46	0.90
EBIT Margin %	4.2	4.7	3.8	8.5
Other income/PBT %	0.0	8.0	12.9	0.9
Tax/PBT %	28.6	38.0	35.5	32.8

Multiple Valuation

	FY11	FY12E	FY13E
EV/EBITDA x	7.9	3.7	2.8
EV/EBIT x	11.2	4.4	3.3
Mkt. Cap/Sales x	0.34	0.26	0.21
P/E x	20.2	5.0	3.9
Price/Book x	0.81	0.74	0.67

Free Cash Flow

Rs. Cr.	FY11	FY12E	FY13E
NOPLAT	13	38	51
Change in Net Working Capital	(12)	37	35
Operating Cash Flows	**25**	**1**	**16**
Net Capex & others	-60	8	62
Free Cash Flow	**86**	**-7**	**-46**
Non-opr. Cash flow	81	2	-
Cash Flow to Investors	**167**	**-5**	**-46**

Financing Cash Flow

Rs. Cr.	FY11	FY12E	FY13E
Post-tax Interest	7	6	6
Repayment/ (issue) of Debt	81	35	-66
Equity Share Dividend	27	6	14
Equity Buyback/(issue)	-	-	-
Inc / (Dec) in surplus cash/Investments	52	-52	-
Financing Cash Flow	**167**	**-5**	**-46**

DCF Valuation

Key Assumptions	%
Terminal Growth Rate	2.5
WACC	15.6
Cost of Equity	17.8
Terminal ROIC	17.1
Outcome	**Rs.**
Fair Value Per Share (Rs.)-1 year out	**45**

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