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Sector – Consumer Durable

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Important disclosure on the last page

Symphony Ltd *(www.symphonycomfort.com)*

Simply Cool

The world's largest portable aircooler company has been growing rapidly in a lowly-penetrated category on the back of domestic consumptions surge & expansion overseas. This is expected to continue as there is vast untapped potential. This 'free cash flow positive' company can go places with sagacious use/distribution of free cash.

DCF Value Rs.1500 | **Current Price Rs.403** | **Potential 3.72x**

The stock currently trades at 5.3 times and 3.5 times the estimated EPS for FY11 (Rs.76) and FY12 (Rs.114) respectively. We expect EPS to grow 50% plus in each of the next two years. Our DCF value estimate comes to around Rs.1500 (CoE & WACC at 16.1%). We estimate its RoCE and RoE to be maintained at 40% plus.

Key Data

Market Cap	Rs.2.8bn US$62mn
Shares Outstanding	7mn
52 week High-Low	439 - 54
Avg Trading Vol	No. of shares
3 months	3600
12 months	2800
BSE Scrip Code	517385
BSE Group	B
Shareholding %	**31Mar10**
Promoters	75.00
Institutions	00.14
Others	24.86
Multiple Valuation	**YE Jun10E**
EV/EBITDA	4.7x
EV/ EBIT	4.8x
Market Cap/Sales	1.5x
P/E	7.9x

Products & Services

Air Coolers (Evaporative)
Water Heaters (Geysers)

Key Investment Points

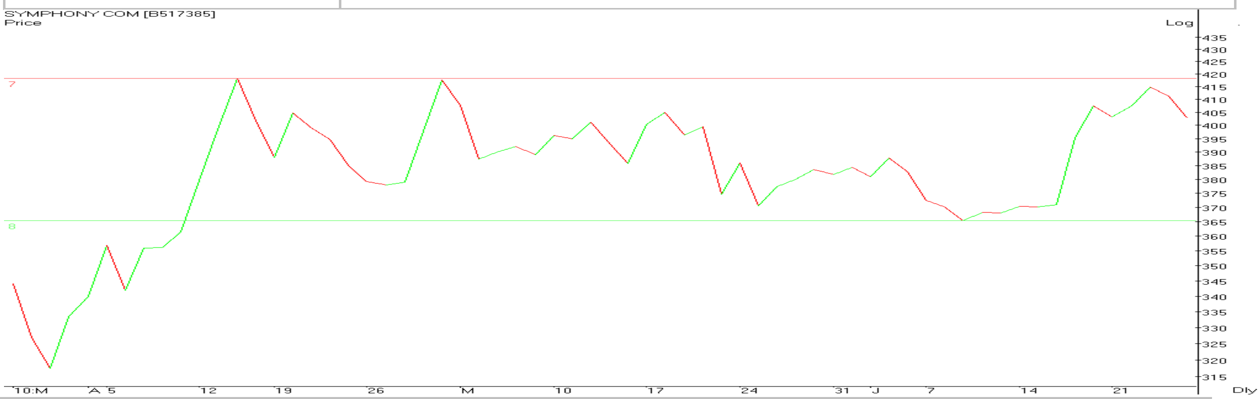
- Shift in business strategy from multiple products for one market to focused strategy of one product (coolers) for multiple markets (the world)
- Very low penetration, rising disposable income, low ticket item, improving quality & range, rising heat to drive growth
- Barely scratched surface in international markets. Acquisition of 49% indirect stake in a Mexican cooler company, first major move to tap international potential.
- Market share gain from large unorganised sector to continue on the back of innovation, quality, reliability & relevance.
- Edge over organised competitors like Kenstar & Bajaj
- Significant cost & other benefits over ACs as a cooling solution
- Introduction of new models, strengthening of distribution & service network to enable growth
- Huge growth potential, low capital intensity & competitive edge – a potent combination

Value Kickers

- Launch of industrial & commercial coolers next year
- Gainful deployment or distribution of substantial free cash

Points of Concern

- Rising input costs may impact margins in short term
- Deployment of free cash in capital intensive opportunities
- Retention of substantial free cash



Introduction

Symphony Ltd (Symphony Comfort Systems Ltd till Jun 10) is the world's largest in portable air coolers (room coolers) with annual revenues of around Rs.1.8bn. Air Coolers' is a fragmented industry with a large unorganized sector. Symphony was the first company in the organized sector and introduced aesthetics & sophistication in air coolers. Exports contribute around 20% to its revenues. It also holds 49% indirect stake in Impco, an air cooler company in Mexico.

Air coolers use evaporative cooling process. In this process, a fan/blower pulls air through wet pads. The air thus pulled is cooled air due to evaporation and is thrown in the space to be cooled. Air cooler works best in dry climate and hence is normally not seen in areas with humid climate like coastal areas. The company considers its business to be that of climate control equipments. Though, it has a small presence in Geysers (water heaters) accounting for 2-3% of its sales.

Symphony commenced air coolers business in 1988. It then diversified into other white goods like washing machines and domestic flour mills. Symphony could not get desired success in these white goods. It also got into bad debts with its regional distributors and had disputed sales tax liabilities. These issues had weighed down the company despite success of its air coolers. The company put an end to all these issues last year. With the past behind it (debts recovered, liabilities cleaned up), the company appears all set to leap ahead with renewed focus on air coolers.

Shift in business strategy

Multiple products for One Market → One Product for Multiple Markets

Investment Arguments

Single digit penetration in air coolers

Aircooler penetration in India is estimated at less than 10% of households/ establishments in dry climate areas. It takes time for any product concept to catch on. The concept of aircoolers, especially branded aircoolers, is catching on and we think the tipping point is yet to come. With such low penetration, the category is at an early stage of product/category growth cycle. There are a number of years of growth ahead for the category.

"Considering the vast latent potential of the air cooler category, we believe our work has barely begun." Mr Achal Bakeri, Chairman, Symphony Ltd.

Domestic consumption surge in consumer durables augurs well

Consumer durable sector is one of the best performing sectors in India today. This is being driven by rising disposable incomes, nuclearisation of families, new home sales, and better products at same/lower prices. Aircooler category has also been growing in line with consumer durable space. Rising heat has been an additional driver for the growth of this category. Due to expected high economic growth in India, most of these drivers are expected to be in place for a long time to come and keep driving sales of durables including coolers. Durables did well even in FY09, a year of gloom for many. Symphony's domestic sales grew 55% in YE Jun09.

Market share gain from unorganized sector

Aircooler category has a large number of local unorganized players. When Symphony came in this business in 1988, coolers were made only by these unorganized players. Symphony pioneered many innovations in coolers over time – aesthetically superior non-rusting ABS plastic body instead of wooden/metal body; electronic controls, silent instead of noisy, powerful air throw, compact instead of large-sized/bulky, different models with different shapes, sizes, capacities, and features for various segments. While some of these have been copied by competition over time, the Symphony brand recall (even unaided) is very high among consumers.

While the category is growing, Symphony has been growing faster due to gain in market share from unorganized sector due to its innovative, quality products that come with assurance, consistency & reliability of a branded product. We expect organized sector including Symphony to continue to gain market share from the unorganized local fringe.

Symphony has been lately introducing many smaller, lower priced models to further take on this fringe.

Symphony is one-up over organized competitors

Kenstar (Videocon group) and Bajaj (Bajaj Electricals) are number two and three respectively in organized aircoolers market. Symphony continues to be number one in terms of sales as well as number of models that it offers. There are other branded players like Usha, Birla Lifestyle but these are too small. None of these players are focused players in aircoolers; they all straddle various product categories. Symphony is the only pure play focused player in Aircoolers. Over the years, many branded players entered the category and exited; some of them are Onida, Crompton, and Polar. In the mid 1990s, there were ~20 branded cooler players.

Brands	No of Models	Estimated Organized Market Share %	Key Strategic Differentiation
Symphony	13 (to add 2 more shortly)	40-45	Premium pricing over competition, Price-maker, Innovation
Kenstar	11	30-35	Mass market, trade driven, price-taker
Bajaj	10	10	Trade driven, price-taker

Significant cost advantage over Air-conditioners

Coolers have significantly lower upfront and running cost as compared to ACs. Branded coolers are priced in the range of Rs.3,000-9,000. Branded Window ACs are priced in the range of Rs.10,000-33,000. In general, upfront cost of a cooler is one-third the cost of an AC. Similarly, running cost (electricity & maintenance) of a cooler is mere 10-20% of the cost of running an AC. Despite growing sales of ACs, an AC is still a luxury for most people in India. To get respite from scorching heat, cooler is their main savior.

Air cooler: Not just a poor man's AC

Coolers are not just poor men's AC. They are much more than that. Besides significant cost advantage, coolers offer many other benefits over ACs. Coolers are portable; offer much needed humidity & fresh air; offer flexibility to move around, as doors can be kept open; are the only cooling solution for open air areas like open-air restaurants, lawns.

Introducing new models to straddle across segments

Symphony keeps introducing new models to cater to varying needs of different segments of consumers. It currently has 13 models in market and is going to introduce two more models soon. Symphony has the largest range of models in the industry.

Strengthening distribution & Service infrastructure

In light of the past bad experience with regional distributors; the company has set up its own distribution network and has appointed its own sales, marketing & sales personnel throughout the country. Symphony currently has 22 decentralized warehousing facilities, over 400 distributors and over 6400 retail dealers. Its products are available in over 2000 cities and towns across India. It has been increasing its trade partners. It is appointing a new set of dealers for focused marketing of new range of DIET coolers.

After sales service is a key success factor for a consumer durable brand. The company continues to strengthen its service infrastructure by appointing more franchisees.

There has been 40-50% rise in trade channel this year and a similar rise is expected next year as well.

International markets – huge untapped potential

Symphony has barely scratched surface in international markets. There is a huge untapped potential out there. In YE Jun09, exports contributed 20% to sales and 22% to PAT. Yet, Rs.256mn sales in a handful of countries is nothing more than scratching the surface, as the company is yet to have a meaningful penetration in these countries and targets to expand its presence from a handful of countries (Philippines, Iraq, etc) to most of the 183 countries in the world. It entered South Africa, Brazil & Mali this year. In tropical areas of the developed countries like the US, aircoolers still sell. Contrary to popular belief, aircoolers are not just for third world.

Symphony's coolers have got CE mark (European standard for safety), SASO (Saudi Arabian Standard Organization), and UL mark (the highest standard of quality for USA).

Till last year, it was only exporting to some of the countries. In YE Jun09, its then wholly owned subsidiary Sylvan Holdings Pte Ltd Singapore (Sylvan) acquired 99.99% in Impco, a Mexican aircooler company. By Sep-09, Symphony's stake in Sylvan was reduced to 49%. Two other investors in aggregate now hold 51% in Sylvan. We understand that these two investors' fund contribution in Sylvan is similar to that of Symphony. Thus, Symphony now holds an indirect 49% stake in Impco through Sylvan.

This indirect stake in Impco has given Symphony access to the US and Mexican markets. Impco has a manufacturing facility in North Mexico. Symphony has started selling its own products as well in these markets. It sells to stores like Wal-Mart and Home Depot.

As it expands its international presence, seasonality will become less & less pronounced. Summer period differs from country to country. Countries in northern hemisphere and those in southern hemisphere have summers at totally different periods of the year. The company will be able to utilize its facilities better with lessened seasonality.

Symphony's exports grew 178% to Rs.256mn in YE Jun09, a year of global recession.

Industrial & Commercial Coolers – new product range to be launched

Acquisition of Impco has given access to industrial & commercial coolers to Symphony. Symphony plans to start marketing these in India shortly. The initial feedback from HVAC consultants and a few potential customers has been encouraging. These coolers are much bigger in capacity, made of metal body, and more sophisticated than metal body coolers from unorganized players. These will be aimed at Malls, Factories, and large commercial establishments.

Huge Cash Surplus & Low capex requirements

Symphony had Rs.316mn (Rs.45/share) of surplus cash at the end of Jun09. We estimate the surplus to rise to Rs.429mn (Rs.61/share) at the end of Jun10. We estimate the surplus to go up to Rs.2.4bn by Jun-13 assuming token dividends and no acquisition.

Almost the entire operational cash flows are free cash-flows, as capex requirement is minimal. Dies and moulds are its major capital expenditures. Most of the components are bought out and it is largely an assembly operation. Advertisement, brand building, promotion are its major expenses but these are operational expenses. Sagacious deployment or distribution of free cash-flows can make or mar its valuation.

Very low beta stock

We calculated Symphony's beta against Sensex using 1-year, 3-year and 5-year data with both simple and log returns. The maximum beta amongst the six betas is 0.49. The low beta makes it an extremely defensive stock for portfolios. Yet, we chose to use beta of 1.0 for valuation to build in conservatism and build in free-cash flow usage risk.

Risks / Concerns

Sharp rise in input costs

Key inputs to a cooler are polymers (for body), fan/blower, motor, and pump. Polymer prices are a function of crude oil prices among others. Other components prices are a function of prices of steel, copper among others. There has been a sharp rise in input prices this year due to both cost push and demand pull. This led to margin contraction of two percentage points in the first three quarters of the year. We expect 2-3% margin contraction in the high season quarter of Jun-10 as well, as the company did not pass on the cost increases. We would expect the cost increases to be passed on in the next year beginning Jul-10.

We understand that it is difficult to pass on cost increases in the middle of the season (production period is Oct-Jul). Therefore, cost increases, that take place mid-season, are likely to impact margins in the interim.

Deployment of surplus cash in relatively capital-intensive opportunities

In YE Jun-09, Symphony acquired 99.99% of Impco Mexico through an SPV Sylvan Holdings Pte Ltd Singapore. By Sep-09, it reduced its holding in Sylvan to 49% by bringing two investors in Sylvan. We understand that these investors also brought in similar funds as contributed by Symphony into Sylvan/Impco. At the end of Jun09, Symphony had invested a total Rs.227mn in Sylvan. Bulk of this was by way of interest bearing loan. Sylvan in turn invested this amount in Impco -- again bulk of this was by way of loan. Assuming similar funds inflow from other strategic investors, an amount of about Rs.500mn would have been infused in Impco. We understand that bulk of the amount is for working capital during season. The net working capital of Symphony Ltd was only Rs.159mn at the end of Jun-09. In light of this, the acquisition appears highly working-capital intensive as compared to Symphony's operations. Though, part of this is due to the fact that Jun is end of season in India while it's season in Mexico.

Symphony has plans to grow overseas through JVs & acquisitions. We hope & wish that the company does not deploy cash in any kind of capital-intensive opportunity. Though financial details of Impco are not known, it appears to be a highly working-capital intensive business based on limited data. However, we are yet to see impact of cross selling Impco's industrial & commercial coolers in India and Symphony's product range in the US.

Retention of surplus cash

It is always best to find gainful deployment opportunities for surplus funds in business. However, retention of surplus in the absence of such opportunities depresses overall return on capital leading to compression in valuation. We think it's best to return surplus cash back to shareholders and let them deploy it gainfully elsewhere. Retention of large surpluses is a concern. One can always leverage and raise funds back from shareholders, who will be too happy to invest if surpluses are returned to them when not required in near term.

Ownership & Management

The company is owned 75% by promoters – Bakeris from Ahmedabad. Mr Achal Bakeri, who holds masters in business management from the University of Southern California, is chairman & managing director of the company. He is supported by professional managers in key positions. There is negligible holding by institutional investors at present.

Valuation and key underlying assumptions

We estimate fair value per share to be around Rs.1500 using the discounted free cash flows. Key assumptions for the valuation are 5% terminal growth rate in NOPLAT, 3% terminal ROIC spread over WACC, Cost of equity at 16.1% based on beta of one (though the calculated beta is 0.49), risk free rate of 8.1% and market risk premium of 8%.

At the current price of Rs.403, the stock trades at 8 times YE Jun10 expected EPS of Rs.50.42. It trades at 5.3x and 3.5x expected EPS for YEJun11 and YEJun12 respectively. The company has no net debt and is cash positive.

Expected flat performance in QE Jun10 – an opportunity to accumulate

We expect Symphony's performance in the high season Apr-jun10 to be muted. Sales growth of mere 23% YoY as compared to 77% in three quarters ended Mar-10. PAT is expected to be at the same level as last year's PAT (adjusted for bad debt recoveries) implying no PAT growth. We expect so for two reasons:

1. The company preponed a lot its sales by way of promotion to trade much before season to saturate trade channel with Symphony products. This not only pre-empted competition but also got the company favorable placement & display. As the company starts production much before season, it did not have to carry large inventory.
2. Cooler as a category grew strongly leading to capacity constraint for motors. The company has now put in place strategy to deal with such supply side constraints. It is also developing more supply sources including imports.

The slow revenue growth is not due to demand constraint, but due to manageable supply side constraint and planned preponing of sales. The flat profit growth is due to margin contraction as mentioned earlier. We expect the price increase next year to restore margins. A 5% rise in product realizations with stable input prices can restore its margins. Moreover, our broad call on commodities (including steel, copper, crude oil) is that of weakness going forward. This also should help margins.

Therefore, any weakness in stock price post QE Jun-10 result would be an opportunity to accumulate the stock.

Financials

Income Statement

Rs. Mn.	Jun10	Jun11	Jun12
Revenues	1,844	2,766	3,872
EBIT	490	767	1,142
PBT	534	797	1,198
PAT	353	533	800
EPS Rupees	50.42	76.12	114.34

Ratios

%	Jun10	Jun11	Jun12
Revenue Gr%	47.1	50.0	40.0
EPS Growth %	24.8	51.0	50.2
RoE %	50.8	47.5	45.4
D/E x	-	-	-
Debtor days	34	34	34
L&A/Rev	20.0	18.0	16.0
TaxProv/Tax	70%	70%	70%

Balance Sheets

Rs. Mn.	Jun10	Jun11	Jun12
Assets			
Net Block	70	80	95
Net Curr. Assets	326	462	564
Investments	29	29	29
Surplus Funds	429	791	1,441
Liabilities			
Equity Capital	70	70	70
Reserves	784	1,292	2,059
Debt	-	-	-

Interim Performance

Rs. Mn.	Sep09	Dec09	Mar10	Jun10E
Months	3	3	3	3
Revenues	72	257	696	819
EBITDA	-6	41	215	275
EBIT	-9	38	211	271
PBT	-6	39	217	278
PAT	-6	29	144	186
Eq Capital	70	70	70	70
EPS Rs.	-0.82	4.15	20.54	26.53
EBIT Margin	-13.0	14.7	30.3	33.1
Other income/PBT	-	15.1	3.0	2.4
Tax/PBT	-	26.4	33.7	33.2

Multiple Valuation

	Jun10	Jun11	Jun12
EV/EBITDA x	4.7	3.0	2.0
EV/EBIT x	4.8	3.1	2.1
Mkt. Cap/Sales x	1.5	1.0	0.7
P/E x	8.0	5.3	3.5
Price/Book x	3.3	2.1	1.3

Free Cash Flow

Rs. Mn.	Jun10	Jun11	Jun12
NOPLAT	914	1374	1895
Change in Net Working Capital	530	721	814
Operating Cash Flows	**530**	**721**	**814**
Net Capex & others	348	(24)	(19)
Free Cash Flow	**37**	**677**	**1100**
Non-opr. Cash flow	810	15	50
Cash Flow to Investors	**847**	**692**	**1149**

Financing Cash Flow

Rs. Mn	Jun10	Jun11	Jun12
Post-tax Interest	19	-	-
Repayment/ (issue) of Debt	734	-	-
Equity Share Dividend	226	329	520
Inc / (Dec) in surplus cash/Investments	(134)	364	630
Financing Cash Flow	**846**	**692**	**1149**

DCF Valuation

Key Assumptions	%
Terminal Growth Rate	5.0
WACC	16.1
Cost of Equity	16.1
Terminal ROIC	20.1
Outcome	**Rs.**
Fair Value Per Share (Rs.)	**1500**

Important Disclosure

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