A brief about the opportunity

Pennar Industries (Pennar) is a manufacturer of engineered steel products having applications across railway coaches & wagons, metro coaches, solar, auto, white goods, hydraulics etc. In 2010, through its subsidiary - Pennar Engineered Building Systems Ltd (PEBS) - the Company forayed into pre-engineered steel structures with applications across warehouses, factory buildings, commercial centers, high-rise buildings etc. Over the last few years, Pennar has also scaled up its water infra subsidiary (Enviro) wherein it provides turnkey solutions for building water treatment plants and water treatment chemicals. We like the company because of visible growth in the end user industries that it caters to. The same is also reflected in the reported numbers over the last few quarters. Driven by strong growth in underlying sectors, we believe there is a potential opportunity to participate in earning growth journey of Pennar Industries

We believe participating in Pennar Industries through PEBS (its other listed subsidiary) can be more rewarding as we see a potential arbitrage there. There is an impeding merger between the two companies which if goes through can generate the excess returns. We explain more on this later in the note.

On the back of conservative assumptions, we believe the stock can deliver 2.2-2.8x returns in 3 year from current price of INR 46/share with sufficient good margin of safety.

Key Business Segments

The Company operates through various segments making steel products for number of industries. Below is a brief on each of the segments it operates in:

Standalone Segments

1. **Railways** - The Company makes components and parts for coaches and wagons. It is a certified supplier of RDSO and RITES. It manufactures components and parts of body frames, side walls, roofs, door frames etc and counts ICF, MCF, BEML, Texmaco among many of its clients.
2. **Solar** - Pennar makes Module Mounting Structures (MMS) to support solar PV panels. Customers are, mainly, Solar EPC players. Current capacity stands at 60,000 MT, which translates into INR 4Bn in sales (1,000 MW of solar installations). Pennar has been able to reduce tonnage of material required in solar structures for its clients because of its engineering capabilities.
3. **Tubes** - The Company is a supplier of precision engineered CDW and ERW pipes used in myriad applications across industries. Majority of revenues come from automotive and industrial clients. Repeat orders form 70% of revenue mix.
4. **Industrial Components** - The Company manufactures a range of pressed components and hydraulic systems for auto, white goods and general engineering sector. Portfolio for the automobile industry includes tubes for bus body builders, floor panels, side panels, bumpers for LCVs and MCVs etc. It counts Ashok Leyland, BEML, Ford, Hero,

Honda, Hyundai, TATA Motors, Maruti, Eicher, IFB etc as few of its many customers. Hydraulics products cater to industries such as agriculture, construction, mining, marine, ship building and bulk cargo handling, off highway and earth movers etc

5. **Steel Products** - It's a legacy business where it manufactures cold rolled steel strips, ESP electrodes and other steel related commodity products. It caters to auto, white goods, and various other industrial applications

Subsidiaries

PEBS – It's a listed subsidiary of Pennar. PEBS is a provider of pre-engineered steel buildings solutions, custom designed steel structures and engineering services. The Company caters to customized requirements of its clients and has the ability to build complex steel structures. It has to its name Asia's largest building (1km long) which it built for ONGC. Current capacity stands at 90,000 MTPA, on-going expansion will take the capacity to 120,000 MTPA. Pre-engineered buildings are a modern and fast way of installing buildings such as - warehouses, factory works building, commercial complex, aircraft hangers, hospitals, malls, multi-story buildings etc. PEBS has technical know-how licensing agreement with NCI Group Inc. USA, which has 20% market share in global pre-engineered steel building space.

- PEBS recently started providing engineering services to pre-engineered steel building players and fabricator contractors in USA. It's a very high margin business generating ~50% EBITDA margins albeit on a very small annual revenue run rate of INR 250 Mn. It contributes 5-6% of group EBITDA with just 1-1.5% of revenue mix.
- PEBS has a market share of ~10-12% in India's pre-engineered steel building market (valued at ~45,000 Mn)
- South and West regions contribute 75% of sales
- Top 10 clients contribute 30-40% of revenues
- The Company claims of being the only company in India to have the capability to build clear span buildings (without the support of any columns)

Enviro – A subsidiary of Pennar which operates in water infra space. It provides turnkey solutions for Water Treatment Plants, Sewage Treatment Plants, Effluent Treatment/recycling Plants, Zero Liquid Discharge Plants etc. Enviro also makes water treatment chemicals.

<u>Raw material (RM) and ability to pass through price hikes</u>

Steel is a major raw material. While pricing its products, the Company builds in RM price hikes of 5-10%. RM price hikes pressures on margins. It further mitigates RM price volatility risk by stocking up steel for 2-3 months. In Pennar's standalone business, delivery cycle is short and contracts come for renewal within a couple of months thereby providing an opportunity to adjust any fluctuations in RM prices. In PEBS, delivery cycle for ~50% of the contracts go beyond 6 months thereby exposing to RM price fluctuations. That's a weak point for the Company; steel price hikes affects PEBS division the most.

Investment thesis

- *A cyclical company, perhaps, past its trough* - Pennar is a cyclical company as most of its revenue is driven by clients from infrastructure space. Starting FY 2012, capex cycle in India slowed down which affected the standalone business of Pennar very badly. Standalone PAT declined by more than 80% to INR 130 Mn in FY 2014 from a peak of INR 690 Mn in FY 2011. Since then the Company has recovered sharply, and last few quarters have shown promising improvement in standalone business as shown below:

Sharp revival in revenues and earnings in FY18 - Standalone Business

	2011	2012	2013	2014	2015	2016	2017	2018
Net sales	1,109	1,011	881	812	859	903	988	1,228
Growth		*-9%*	*-13%*	*-8%*	*6%*	*5%*	*9%*	*24%*
EBITDA	140	118	81	52	69	79	87	114
EBITDA growth		*-16%*	*-32%*	*-35%*	*32%*	*14%*	*11%*	*31%*
EBITDA margins	12.6%	11.7%	9.2%	6.4%	8.1%	8.7%	8.8%	9.3%
PAT	69	54	31	13	21	27	29	40
PAT Growth		*-22%*	*-43%*	*-60%*	*70%*	*27%*	*7%*	*39%*
PAT margins	6.3%	5.4%	3.5%	1.5%	2.5%	3.0%	2.9%	3.3%

- *Growth in end user industries* -
  - *Railways* - Increased budgetary allocation for railways augurs well for Pennar. Companies across railways' value chain are very bullish. Recently released order for 9,000 wagons and another upcoming order for 22,000 wagons will benefit already fast growing railways vertical. Current coaches capacity is at 100% utilization and company is adding more capacity. Management has high visibility on next 2 years of sales.
  - *Warehouses* - Post GST implementation, companies would rationalize their warehousing infra. Corporate are now expected to build larger warehouses at a few key locations in the country as opposed to smaller warehouses in every state of operations. GST has given rise to a new demand for warehouses which should aid in top-line growth of PEBS
  - *Solar* - Government driven solar energy capacity addition is happening at a very fast pace. FY 2017 saw highest ever capacity addition of 5.5 GW; FY 2018 capacity addition was even higher at 9.1GW. Tenders are coming out at an unprecedented rate, 30GWs of tendering is expected for next 2 years - FY 2019 and FY 2020.
  - *Auto and white goods* - back to back two good monsoons and increase in MSPs (minimum support prices for farm crops) are expected to boost sales of auto and white goods sector. Going by managements' commentary (in these industries), demand pick up is expected in coming quarters
  - *Enviro* - This unit has order book of INR 2,000 Mn. Water infra is one of the fast growing segments in India. Government is also focused on improving state of water infra in the country.

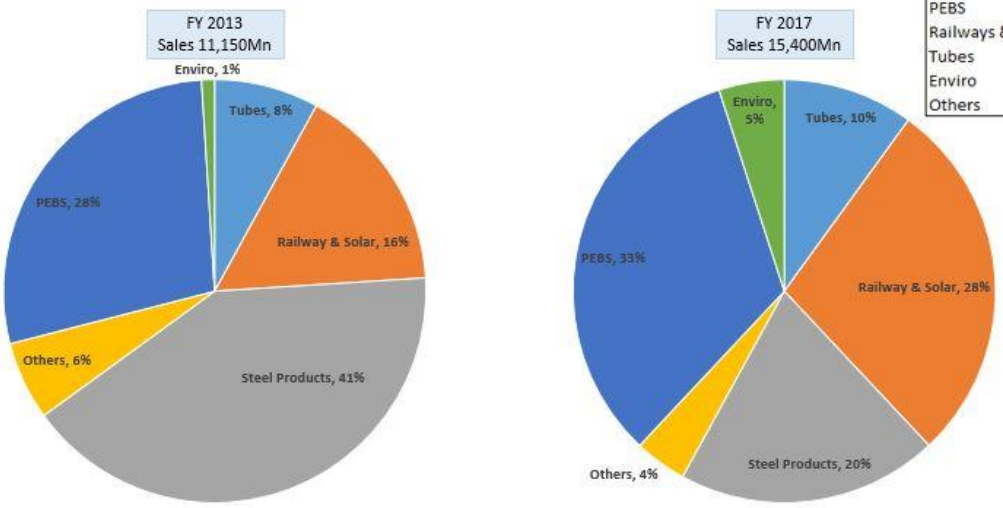
- *Strong incremental economics* - The Company is expected to clock incremental ROCE of 30-35% on the back of operating & financial leverage and sale of non-core assets. Every new product/project is vetted for a payback period of less than 2 years. Pennar launched 10 such new projects in FY 2017 and more than double the number in FY 2018. It has an even bigger pipeline ready for FY 2019, which would entail a capex of INR 670 Mn with a revenue potential of INR 4,000 Mn and margins higher than company average.

INR Mn

Metrics	FY17	FY21 P	Incremental	CAGR
Sales	15420	27,376	11,956	15%
EBIT	1490	2,711	1,221	16%
PAT	470	1,321	851	29%
CE	9080	12,600	3,520	9%
ROCE	**16%**	**22%**	**35%**	

- *Management's execution capabilities* - Management has continuously focused on getting into new but related product lines. The strategy of entering into new products has enabled Pennar to maintain its top-line even in worst of the years as new products were replacing lost revenues of other product lines. We also credit the management team for never over-leveraging its balance sheet even during worst of the times in the last 5 years. Below mentioned points highlight the execution capabilities of management team -
    - PEBS' revenues grew to INR 5,000 Mn in FY 2017 from scratch in 2010
    - Few quarters back, the company forayed into engineering services vertical, which at the moment is small (INR 200 Mn run rate) but highly profitable (50%+ EBITDA margins)
    - In its water business, company is on a INR 1,300 Mn run rate vs revenues of ~INR 60 Mn in FY 2013
    - Few years back, wagons business contributed ~INR 4,000 Mn in sales which became almost negligible by FY 2016 because of paucity of wagons tenders by Indian Railways. However, management shifted its focus on to coach business, which contributed 14% to revenues from almost nothing few years back
    - In FY 2012, the Company also ventured into solar mounting structures, which contributed more than 20% to company's revenues in FY 2018.

Better margin verticals (railways, PEBS & enviro) grew at a faster pace than lower margin vertical (steel products) which degrew



Segment	CAGR
Steel Products	-9%
PEBS	13%
Railways & Solar	25%
Tubes	15%
Enviro	62%
Others	-2%

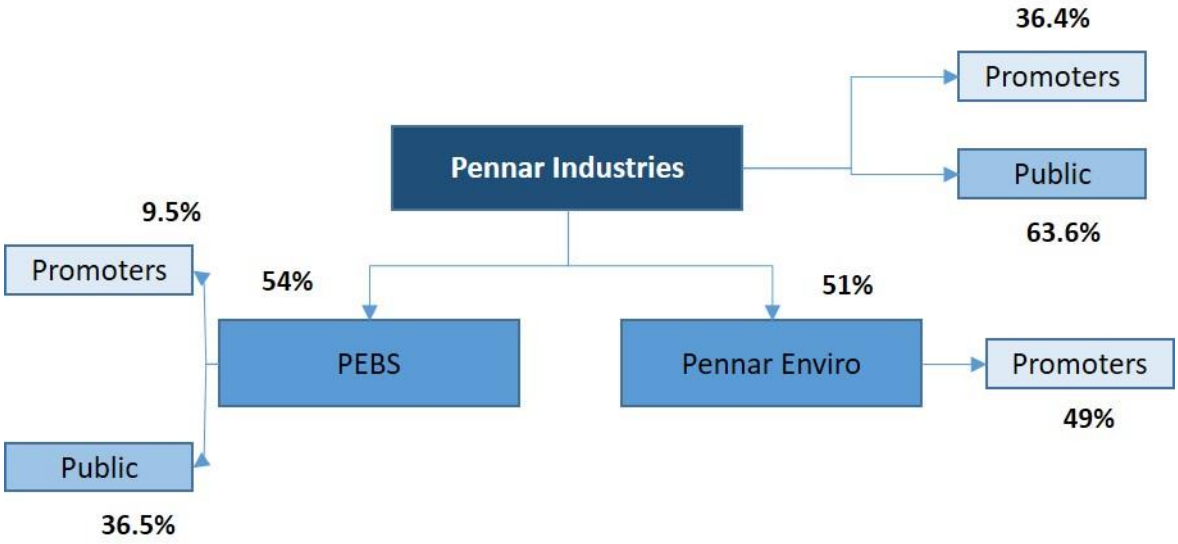
- *Good track record and strong balance sheet*- During the previous up-cycle (FY 2007 - FY 2011), company had reported an average ROCE of 24% and revenue CAGR of 26%. ROCE of the consolidated entity during the last 5 down-years has been 16% (PEBS 23%, Standalone 12%). Currently, net debt on books is ~INR 920 Mn which translates into net debt/equity of less than 0.2x and Net Debt/EBITDA of just 0.5x. Pennar is in a strong position to fund its future capex and working capital needs. ***Over the last 10 years, book value per share has compounded by 16% p.a.***

Metrics	2008	2009	2010	2011	2012
Revenue growth		17%	22%	39%	-9%
EBITDA margins	12%	12%	14%	13%	12%
ROCE	21%	23%	29%	35%	25%
ROE	16%	19%	23%	26%	18%
Net D/E	0.6	0.6	0.6	0.4	0.4

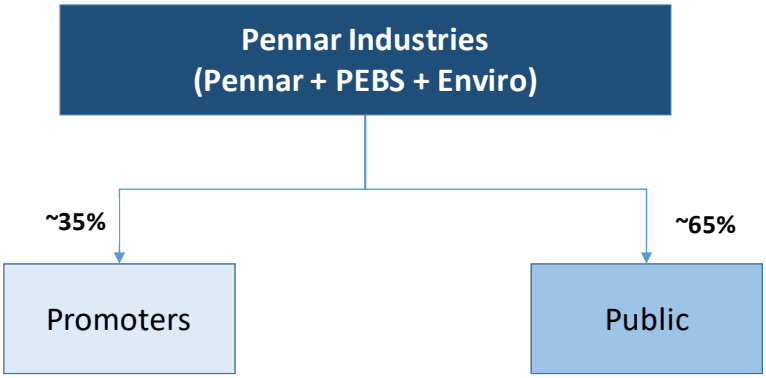
beginning of down-cycle

- *Simplifying corporate structure* - Post merger of PEBS and Enviro into Pennar, all businesses will fall under one company: Pennar Industries. This move will not only result in costs savings for the group but will also simplify shareholding structure. Promoter's shareholding would come down by 150-200 bps as a result of this merger.

Current Structure



Proposed Structure



- *Other value unlocking triggers* - Sale of idle land would further strengthen the balance sheet. Market value of this land is ~INR 3,000 Mn.

Risks & challenges

- *Dependence on govt policy* - Significant part of revenues come from railways, which is highly dependent on govt budgetary allocation. Although, Railways is one of the high priorities for the govt because of poor state of infra (tracks, safety, coaches, wagons, stations etc), any slowdown in railways spending by govt will be harmful for the company. Similarly, Solar sector in India is growing on the back of govt's push to take India's solar capacity to 100 GW by 2022. Continued govt support is needed in both the sectors for sustained growth momentum.

- *Raw material price volatility* - steel is the major raw material. Over the last few quarters, steel prices have been trending upwards constantly causing a dent on gross margins.

- *Increase in competition* - Barring railways, it is very easy for a competitor to get into the product verticals where Pennar operates. Any increase in competition will certainly put pressure on margins. Only (natural) mitigation is continued growth in end user industries.

- *Increase in interest rates* - The Company incurs a lot of costs to finance its working capital needs. Finance costs as % of sales stood at 3.8% for FY18. Given the current macro scenario, rates are expected to increase from here on. Any inability of the company to control its interest costs would harm PAT growth of the company.

Valuation Methodology 1 - SOTP

There are 3 different businesses under consolidated entity - Standalone business, PEBS, and Pennar Enviro

- Standalone business -
    - FY18 PAT (adjusted for exceptional income) INR 400 Mn
    - Given the historical return profile, strong balance sheet and underlying growth drivers of standalone business, we feel it can be valued at 12x trailing PAT
    - Value of standalone business comes to INR 4,800 Mn
- PEBS -
    - It’s a listed subsidiary in which Pennar holds 53.98% stake
    - At current price of INR 58/share, market cap of PEBS comes to INR 2,000 Mn
    - Pennar's stake’s value INR 1,000 Mn

- Pennar Enviro -
    - Pennar owns 51.03% in this sub, which did revenues of 110Cr and adjusted (for one time income) PAT of 10Cr
    - Its a small growing company, we value this company at 10x trailing PAT

  - Pennar's stake's value comes to INR 510 Mn

- Clubbing valuation of these three businesses, Pennar's consolidated valuation comes to INR 6,310 Mn vs current market cap of INR 5,540 Mn.

Valuation Methodology 2 - Valuing the consolidated business as if it were one entity (on the lines of proposed merger)

- Post merger Pennar will have 150 Mn outstanding shares
- Consolidated PAT for FY18 was INR 750 Mn (adjusted for one time incomes, reported PAT was INR 900 Mn), Cash PAT was INR 1,040 Mn and EBITDA was INR 1,920 Mn
- At current price of INR 46/share, market cap of Pennar comes to INR 6,900 Mn (46*150); EV comes to INR 7,820 Mn (net debt of INR 920 Mn)
- Derived valuation multiples are: P/E of 9.2x, EV/EBITDA of 4.1x and P/Cash PAT of 6.6x
  - 10 year median P/E and EV/EVITDA are 11x and 6x
  - At current price, the company is trading below its long term median multiples despite having begun on cyclical recovery with a better product mix
- Given the historical performance and growth potential of the company we believe above valuation multiples indicate attractive entry point

Room for Error

- *Land value monetization* – Pennar has an idle land bank which is valued at INR 3,000 Mn at current market rates. Since we have not considered any economic benefits of this land sale, we believe this provides a good downside cushion to expected returns.

Participating in this opportunity through buying shares in PEBS

PEBS is a listed sub of Pennar. As per the swap ratio proposed in the merger, a shareholder of PEBS will get 23 shares of Pennar for every 13 shares of PEBS.

Just to explain further the working of swap ratio, assuming price of Pennar is INR/50 share then the merger equivalent price of PEBS should be INR 88/share. (100*23/13)

Currently PEBS is trading at INR 58/share and Pennar is trading at INR 46/share. However, going by swap ratio, price of PEBS should be INR 81.4/share (46*23/13). Assuming the merger happens, there is an arbitrage of 40%.

Participating in this opportunity through PEBS safeguards on downside as well as offers some returns on upside. But, there is a risk that merger will not go through, in which case one will end up holding shares in PEBS.

Our take on PEBS – It is going through tough times because of steep increase in prices of steel. Since inception PEBS has delivered average ROCE and ROE of 21% and 17% respectively. At current price of INR 58/share (merger equivalent price of Pennar Industries comes to INR 32.8/share, [58*13/23]) PEBS's market cap comes to INR 2,000 Mn. We believe that the long-term demand drivers for PEBS business are well in place, the business at the moment is facing margin pressures owing to higher RM (steel) prices. Once steel prices stabilize and demand picks up, PEBS can generate an EBITDA of INR 600-700 Mn. With zero debt on books, market cap of 2,000 Mn looks attractive as well.

Key Monitorables

- Interest cost as % of sales - management has guided for lower interest costs because of debt repayment and re-negotiating working capital financing rates with banks
- Proposed merger goes through
- Revival in PEBS business - new demand for warehouses and industrial recovery is the key here
- Land monetization and use of sale proceeds. Will the cash be put to good use (growth capex or dividend or buyback) or will it sit on books yielding fixed income returns?

Corporate Governance Checklist

Checklist Point	Comments
Capital Allocation	Very good barring one instance where Co put 150Cr in solar assets, however, the same has been sold at a decent profit now
Related party transactions	No red flag
Any advances given to related party being written off	No
Pledged shareholding of promoters	7% of promoters' holding is pledged
Cash tax rate	Cumulative rate of 29% over last 7 years
Promoters' salary as % of PAT	Below 10% of PAT over last 7 years
Any change in auditor	Old one replaced by Deloitte
Opinion of auditors	All ok in last 6 years
Promoters	no red flag

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