**VASCON ENGINEERS: A turnaround story?**

* **About the company:**

Vascon Engineers Ltd, established in 1986, is a Construction Engineering Company in India with presence in Real Estate business having an asset light model and Clean Room Partition manufacturing business.

The company operates in 3 segments:

**1) EPC** – 65.4% of total sales vs (54% in FY 19). (17% 8-year avg ebitda margins) (High Roce ) ( **Cash cow segment)**

**2) Real Estate Development** – 9.4% vs (15% in FY 19) (Very volatile in terms of sales and margins) (Low Roce)

**3) Manufacturing & BMS** - 25% vs (31% in FY 19). ((Stable though low margin (6-8%) business))

**Clean Room Partition Business:**

As a part of backward integration, the Co had acquired GMP technical solutions, an integrated provider of engineering services, in August 2010. GMP is one of the largest manufacturers of Clean Room Partitioning Systems and Turnkey Solution Provider.

* **External order book of Rs. 1739 crore as on March 31, 2023.** Almost 78% of the orders are derived from government projects, which lends visibility to the uninterrupted cash flow, thereby providing assurance of stable operating performance over the medium term and supporting the business risk profile.

**INVESTMENT THESIS:**

* **VASTLY IMPROVED FINANCIAL HEALTH:**

**Debt reduction –**

Debt reduced from 278cr to 142cr.

Net debt at 11crs vs 186crs in FY20.

Interest payments down to 13cr vs 27cr in FY21 vs 40cr in FY16.

High cost of capital of 15% reduced to 11%

**Vast improvement in working capital position –**

FY23 working capital days at 84 vs 300+ in previous 6-7 years

Receivables reduced to 69 days vs 142 days in fy19. (Receivables have been on an improving trend since the government bodies became the main counterparty for the EPC business. The company will continue to focus on government-related projects, which will help keep the receivables low.)

**Improvement in credit ratings:** CRISIL BBB+/Stable (Upgraded from 'CRISIL BBB/Stable)

* There has been continued improvement in VEL’s operational and financial profile supported by steady execution, healthy profitability and healthy accretion of reserves. The healthy profit margins and accruals are driven by the prudent project bidding, stable manufacturing segment and higher deliveries in the real estate segment in fiscal 2023.
* Reduction of high-cost debt has allowed company to get decent credit ratings from credible rating agencies like CRISIL and Acuité, and it opens up avenues for the company to carry forward the growth cycle that has started in the year gone by.
* **REASON FOR IMPROVEMENT: GROWTH IN EPC BUSINESS AND INFRASTRUCTURE SECTOR REVIVAL:**
* The company’s EPC segment is its cash cow. It has very good average margins and great returns on capital. (17% 8-year avg ebitda margins) (High Roce )
* The EPC segment has witnessed tremendous growth since FY17. Sales have grown from 196cr to 654cr in 6 years growing at 22% CAGR (even considering COVID years). With the company focusing on Government projects, it has lead to improved working capital position and steady cash generation which has allowed it to reduce debt and improve its financial position.
* The growth in EPC segment was due to revival in infrastructure sector due to Government thrust on infrastructure spending.
* Infrastructure revival has also led to improving performance of its Manufacturing business which has consistently growth over the last 5 years. FY23 EBITDA at 19cr vs -5cr in FY19.
* **EPC BUSINESS TO CONTINUE ITS GROWTH JOURNEY:**
* The EPC segment will continue to grow given the infrastructure upcycle and Government thrust on infrastructure spending.
* **Improved funding position to lead to higher orderbook:** Company’s EPC orderbook was stagnant for last 3 years due to constraints on their Bank guarantee levels because of weak financial position. But now with company’s credit ratings improving, **the company has applied for enhancement of bank guarantees and this will allow them to significantly increase their order book position and continue the EPC execution run rate.** Company has just got CRISIL rating upgrade for proposed enhanced bank guarantee of 80crs (Existing facilities of 243cr). Thus EPC segment will keep on growing quite well.

(“The EPC will continue to look for order booking year-on-year, augmentation of their banking facilities as we grow. And so it's a cyclical thing. We grow our banking limits then we take more orders. We grow further. We keep going back to the banks. So that process will continue. And hopefully, from here, the EPC story is to keep delivering similar or slightly better PBTs while they continue to grow at booking 20%-25% year-on-year in terms of their top lines.” - Management)

* Increased Bank Guarantees -> Higher EPC order book -> higher growth and improving financials -> better credit ratings -> Increase bank guarantees (It’s a virtuous cycle)
* **REAL ESTATE – Multiple on-going projects and learning from past mistakes:**
* Multiple Real Estate projects of the company will be complete in FY25. (So in FY '23, we had completions from about 3 or 4 real estate projects. And that is why those revenues have reflected on the balance sheet. And the bottom lines are also reflecting. Going forward, in FY '24, we do not foresee us completing any bigger projects because most of them have just started, including Coimbatore and Kharadi. And so these projects will not be completed in the coming year. They will get completed in the year after that, so again, **a good chunk of revenue recognition, we foresee to be happening in FY '25 and not in FY '24 for real estate**. So FY '24 will be slightly softer or maybe some decline in terms of sales)
* 985cr expected sales value from near-term launches in real estate project pipeline. 880cr expected sales from other projects.
* Change of business model to asset light in Real estate to avoid past troubles.

**ASSET LIGHT MODEL: JV and JDA with landowners with low upfront deposit**

(“Again, we are not now looking for huge parcels like we used to 10, 12 years ago, 50- acre township projects. We are now looking for not more than 4-5 acres of land; not more than 1 million square feet in a project that we can deliver over a 3--4-year period and move on. So that is our strategy as of now to do with -- and as I said, we are not looking at land banking. We will be looking at joint ventures. So yes, that is the strategy for real estate.” - Management)

* **ROBUST GROWTH GUIDANCE:**
* “See, **we do expect 15%-20% growth is what I would give as a guideline over the next 3, 4 years.** That is definitely visible. We do not see any impediments to stop that kind of a trajectory, if not more; also, the bottom line on an average since we have the evolution of bottom line from real estate, which will be a bit volatile year-on-year due to Ind AS. So again -- but on an average over the next 4 years, we should be doing more than Rs 100 Crores as a bottom line; and growing Rs 1,000 Crores into 15%-20% Y-o-Y. That's a target we can take. They might not exactly double, but yes, hopefully, if we can, that will be even better – Management”
* Consolidated revenue is expected to increase ~7%, aided by EPC revenue which is expected to reach ~Rs. 700-730 crore in fiscal 2024 and stable manufacturing segment. Further, real estate collections are expected to increase gradually and will improve in the ongoing fiscal with healthy launch pipeline and committed receivables of Rs 111 crore as on March 31, 2023. (Credit Rating)
* **SALE OF NON-CORE ASSETS:**

Sale of non-core assets of Land and GMP technicals business could unlock further value.

* 9 acre land parcel in Aurangabad : NOC received from State Bank Of India and transaction is under process. (“About Rs 26 crores Rs 28 crores we expect from the sale of Aurangabad land, but see, that is Aurangabad land is pledged with SBI for our consortium banking limits. So we've got NOC from them to sell the land. And then the proceeds will be kept as an FD with the bank, at least in the short term till we find alternate collateral”)
* “For GMP Technical, have you got any bid or anything else, sir? Santosh Sundararajan: No. GMP, we have not yet started actively looking. I mean there are mandates. We're not desperate or looking very actively with a target in mind to sell it. We will look at valuations as and when we get offers, and if we feel something is good, then we will take it forward.”

**RISKS:**

* **EXPOSURE TO RISKS RELATED O REAL ESTATE PROJECTS:**

Saleability and implementation risks in the real estate sector persist, as reflected by sharp fluctuations in real estate income, sales and collections over the past few fiscals. In light of the weak demand scenario in the past, certain projects have demonstrated limited progress. Ability to liquidate real estate inventory of ~Rs 257 crore (excluding Rs 148 cr as land and development potential) as on March 31, 2023, delay in completion or launch of real estate projects and any additional debt taken on to support real estate cash flow mismatch will remain a key monitorable.

Inventory remained stretched over the last two years because of the strong backlog as a result of unsold real estate units, which stood at Rs 257 crore (excluding Rs 148 cr as land and development potential) as on March 31, 2023.

* **Vascon’s EPC operations are working capital intensive:**  Vascon’s EPC operations are working capital intensive, primarily on account of high receivable which include retention money it has to keep with clients (10-15 percent). Vascon has significant receivables in the EPC segment, with recoverable due for more than 3 years amounting to Rs. 55.03Cr as on December 31, 2022 and receivables due for more than two years but less than three years of about Rs. 13.65Cr out of total receivable of Rs. 107.70Cr as on December 31, 2022.

**VALUATION**

* Company currently trading at fair static intrinsic value.
* Upside of 35-40% on cmp, based on assumptions of 15% revenue growth cagr at 11% ebitda margins.

Discount rate - 12% (to accommodate for risks in execution of real estate and high current finance costs)

* Any external trigger like promoter increasing stake or sale of non-core assets can lead to more upside

(With improving EPC prospects and financial position, company is poised for growth and subsequent re-rating) BUY.

**MISCELLANEOUS**

* **GMP TECHNICALS IMPROVEMENT AND ITS GROWTH GUIDANCE**:

“If you see, in GMP, over the last 2-3 years, they have also -- just like our EPC division, the growth has stabilized. They have come out of whatever issues we had. And the bottom line this time has also -- the percentage EBITDA has stabilized. We look -- going forward now, it is a matter of growing. And I think that we -- they are also predicting -- that division is also predicting to grow at -- same like our EPC division, to grow at about 15%-20% year-on-year for the next 2-3 years. And the bottom line percentage would only slightly improve with scale.

GMP is currently having order book is more than Rs 200 Crores lying with them. So this is current condition, so -- as it's been said that the order keeps on coming every month every quarter. So GMP's growth is -- significant growth is expected next year also, is continued.

GMP is now clear of all its legacy troubles and issues. And it is now looking robust, ready to grow at the same pace, so we are expecting another 15%-20% growth in top line in the coming year. And the bottom line has now stabilized. The impact: With scale, we expect the bottom line would also, in fact, increase by a percentage point or 2 at the EBITDA level.” – Management

* The **presence of price escalation clauses in most of the outstanding contracts** in the order book reduces the exposure to raw material price volatility to an extent.
* What is your current rate of interest for that? Santosh Sundararajan: Current rate is 10% -11%. Cost to company as of now is 11%.
* Constant equity dilution – 219cr raised through equity dilution since 2016. 74cr in fy22. That could explain the debt reduction. (“It's a combination of all three. We did a preferential in this period, so that helped us reduce about Rs 40-odd Crores of debt. And then the balance has primarily been through cash from operations. We hardly had any one-off sales, nothing much Rs 7 - 8 Crores of one sale that we did. The balance has been cash inflow from operations.” - Management)
* There is -- so there's a lot of work in the building sector across the country, so as of now, no active plan to deliberately diversify into non-building.
* Going forward, for this year, we would want to focus that on our -- improving our rating also by a notch or two and then renegotiating our terms with the banking consortium so that our terms are much more efficient. As of now, we still feel we are not getting the best of terms. We haven't backed performance for a while. Now that we have performance on our side, we would want to negotiate our terms with the bank this year.