

Salzer Electronics Limited

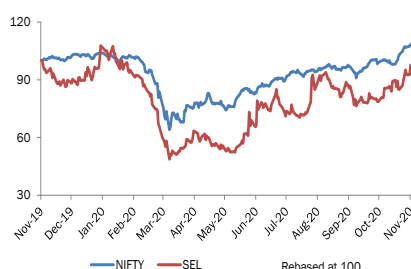
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New products, collaborations and exports will drive growth and profitability

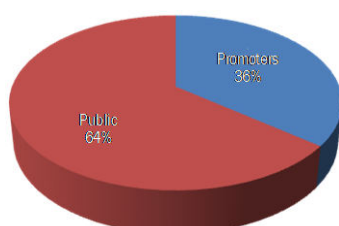
BUY

Sector	: Electrical Equipment
Target Price	: Rs 162
Current Market Price	: Rs 113
Market Cap	: Rs 181 crore
52-week High/Low	: Rs 130/54
Daily Avg Vol (12M)	: 51,267
Face Value	: Rs 10
Beta	: 0.99
Pledged Shares	: 0%
Year End	: March
BSE Scrip Code	: 517059
NSE Scrip Code	: SALZERELEC
Bloomberg Code	: SZE IN
Reuters Code	: SALZ.BO
Nifty	: 12,874
BSE Sensex	: 43,953
Analyst	: Research Team

Price Performance



Shareholding Pattern



Initiating Coverage

Investment Summary

- Salzer Electronics Limited (SEL) has evolved from a single-product company into a manufacturer offering a wide portfolio of electrical equipments of international standards.
- SEL is a market leader in industrial switchgear products (~45% of revenues), commanding a 25% market share in the Indian CORS market.
- New offerings in SEL's other major division of Wires & Cables (~45% of revenues) such as Salzer-branded products and LAN cables will drive revenues and margins.
- Contribution from the Building Electricals division, SEL's only a B-to-C business, is seen to increase in 2-3 years, driven by opportunities in real estate
- SEL's strong clientele and robust technical collaborations give it a competitive edge. Marquee customers include ABB, Honeywell, Schenider Electric, GE, L&T, Philips, C3 Controls, LMW, Premier, Valeo, Europa and others.
- SEL strong R&D focus and state-of-the-art manufacturing facilities are key elements in establishing manufacturing excellence.
- The company expects to reap benefits from businesses moving out of China, resulting in expanding exports (20% in FY20).
- SEL registered a strong bounce-back in 2Q FY21 from the COVID-led slowdown in 1Q FY21. Going forward, management expects steady performance through the remainder of FY21. We have modelled resumption of growth in FY22 with margin improvement driven by expanding export revenues, better product mix and cost reduction. The company continues to focus on improving its working capital management, which will positively affect short-term borrowing requirement and consequently interest expense and cash flow. The SEL stock currently trades at an attractive forward P/E level of 5.6x FY22E EPS. Expecting improvements in return ratios and solid earnings growth in FY22, we value SEL at 8.0x FY22E EPS with a price target of Rs 162, informing a BUY rating with an upside potential of 43%.

Key Financial Metrics (Standalone)

Rs crore	FY18A	FY19A	FY20A	FY21E	FY22E
Operating revenue	442.8	559.8	566.9	555.4	648.1
Growth		26.4%	1.3%	-2.0%	16.7%
EBITDA	53.3	63.6	65.2	65.5	82.3
EBITDA margin	12.0%	11.4%	11.5%	11.8%	12.7%
PAT	20.0	24.0	26.4	20.2	32.4
PAT margin	4.5%	4.3%	4.7%	3.6%	5.0%
Diluted EPS (Rs)	13.45	15.10	16.51	12.64	20.29

Source: Company data; Khambatta Research

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SEL generates over 90% of its revenues from the B2B market

Company Profile

Headquartered in Coimbatore, Tamil Nadu, Salzer Electronics Limited (SEL) was established in 1985. The company is a manufacturer of electrical components such as cam-operated rotary switches, selector switches, cable/wire ducts, voltmeter switches, circuit breakers, copper wires and cables, electrical transformers, street light controllers and other products.

Over 90% of SEL's revenues are generated from the B2B market. The company operates through the four divisions, viz. Industrial Switchgears, Wires & Cables, Building Electricals, and Energy Management. Some of SEL's major customers in the Industrial division, which offers switchgear components, include Larsen & Toubro, GE, ABB, Schneider, Siemens and other industrial equipment companies. The Copper division is engaged in contract manufacture of wires and cables. The Building Electricals division offers consumer electrical systems for buildings where the company's primary target market includes real estate builders and developers. The Energy Management division provides control devices and energy saving solutions for street lighting systems, primarily executing projects in the EPC mode. Between 2017 and 2019, SEL acquired Salzer Magnet Wires and Kaycee Industries with an eye to complement the company's existing portfolio in wires & cables and switchgears, respectively.

SEL earned about 20% of its FY20 revenues from exports

In FY20, SEL earned about 20% of its revenues from exports. The company exports industrial switchgear components to several countries across the globe in Europe, the North and the South Americas, Asia-Pac, and Middle East & Africa.

SEL operates 5 manufacturing units and a state-of-the-art R&D centre for product innovation and development in Coimbatore. This contributes to the company's strong engineering capabilities, ensuring strong product development and better customisation, thus giving it a competitive advantage. SEL's facilities are equipped with a full-fledged laboratory, R&D set-up and captive tool room for the development of new products and ensuring. The company's in-house R&D capability is recognised by the Department of Scientific & Industrial Research, Government of India. SEL's modern manufacturing infrastructure complies with techniques like TQM, TPM, Six Sigma, Lean Manufacturing and 5-S. The company has an employee strength of approximately 2,000.

SEL is led by a team of technocrats, engineers and professionals. The company's Managing Director, Mr. R Doraiswamy is an electrical engineer, technocrat and entrepreneur with over two decades' experience. He has vast experience in foreign collaboration with strong global contacts. The Joint Managing Director, Mr. D Rajeshkumar is an electrical engineer with a post-graduate degree in business management from the US and is responsible for driving the vision of the company.

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SEL has competitors and peers in India as well as international markets

Peer Group

SEL has competitors and peers in India as well as international markets. Some of its competitors across different product categories are C&S Electric, HPL Electric & Power, Connectwell, Technic Electronic, Honeywell, Anchor, Legrand and Havells. Below we compare SEL with some of its peers that are listed in Indian stock exchanges.

Honeywell Automation India: Honeywell Automation India is a leading provider of integrated automation and software solutions including process solutions and building solutions. It has a wide product portfolio in environmental and combustion controls, and sensing and control while also providing engineering services in the field of automation and control.

Havells India: Havells India is an electrical equipment company offering a wide array of products such as industrial & domestic circuit protection devices, cables & wires, Motors, fans, modular switches, home appliances, air conditioners, electric water heaters, power capacitors, and lights for domestic, commercial and industrial applications.

HPL Electric & Power: HPL Electric & Power is an electric equipment manufacturer with a wide array of products across metering solutions, switchgears, modular switches, LED lighting, and wires & cables. It is the fifth largest manufacturer of LED lamps and the oldest manufacturer of LV switchgears in India.

Modison Metals: Modison Metals manufactures custom-made electrical contacts and contact materials for the switchgear industry. The company is the only global manufacturer of electrical contact materials and finished contacts for low, medium, high and extra-high voltage switchgears. Modison also supplies products to the automotive, engineering, aerospace, marine, defence and railway sectors.

Peer Comparison: Key Financials Metrics, FY20

Rs crore	Salzer Electronics	Honeywell Automation	Havells India	HPL Electric & Power	Modison Metals
Revenue	566.9	3,271.4	9,407.1	976.5	219.3
EBITDA	65.2	636.4	1,012.7	124.9	26.9
EBITDA margin	11.5%	19.5%	10.8%	12.8%	12.3%
PAT	26.4	491.5	735.4	21.8	15.1
PAT margin	4.7%	15.0%	7.8%	2.2%	6.9%
Diluted EPS (Rs)	16.51	555.88	11.76	3.39	4.66
ROCE	14.9%	28.4%	24.5%	8.5%	12.1%
ROE	8.5%	25.0%	17.3%	2.9%	10.6%

Source: Company data; Bloomberg; Khambatta Research

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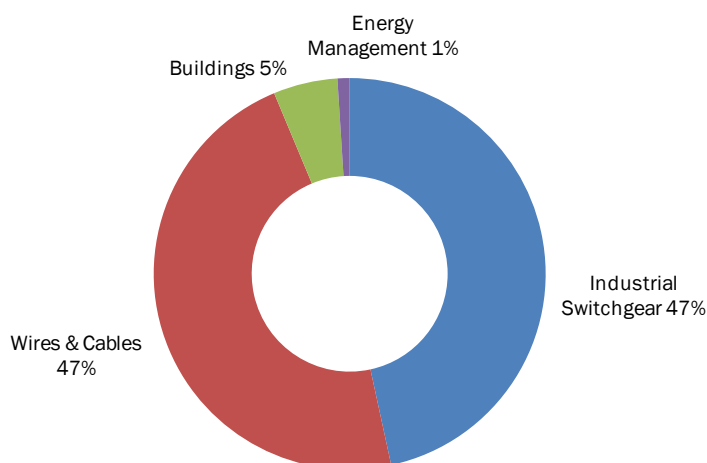
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SEL has collaborated with major global electrical equipment manufacturers such as L&T, Plitron (Canada), and Trafomodern (Austria)

Investment Thesis

SEL has evolved from a single-product company into a manufacturer offering a wide portfolio of electrical equipments of international standards. SEL commenced operations in 1985 with the single product of cam-operated rotary switches (CORS) in India in collaboration with German Salzer Electric GmbH. The use of CORS expanded with improvements in technology and product innovation. With an absolute focus on this product, SEL became the leading manufacturer of CORS in India. Having expanded its product range over time, SEL now manufactures more than 15 products under four broad categories. SEL has introduced a number of products of international standard in the Indian market with the help of its collaborations with major global electrical equipment manufacturers. Through its associations with L&T (since 1993), Plitron, Canada (since 1995) and Trafomodern, Austria (since 2016), the company has focused on implementing niche technologies which are key value drivers for the business. The addition of three-phase dry type transformers and wire harness business will generate incremental revenues and aid margin expansion. The wire harness business is already bringing in new customers. All of SEL's products are internationally certified with the company having secured the "preferred vendor" status from global giants such as GE and Schneider.

Revenue split by division (2Q FY21)



Source: Company data

The Industrial Switchgear division generates the highest EBIDTA margin of 15%-16%

SEL is a market leader in industrial switchgear products. The largest contributor of revenues at ~45%, the Industrial Switchgear division also generates the highest EBIDTA margin (15%-16%). SEL is a market leader in India as well as Asia in certain categories in this division which offers products such as CORS, transformers, contactors, relays and isolators. The company has identified and developed new products with high demand which are primarily imported in India such as three-phase transformers and wire harnesses. Management is focusing on increasing the contribution of

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The Wires & Cables division
earns EBITDA margins of 7%-
8% on average

these products to 8%-10% of revenues in the next 3 years. SEL commands a 25% market share in the Indian CORS market and after its recent acquisition of Kaycee Industries, the second-largest manufacturer of CORS in India, the company's overall CORS market share (Salzer and Kaycee brands combined) has gone up to ~40%. SEL has a 30%-35% market share in wire ducts and a 15%-20% market share in toroidal transformers in India.

New products in wires & cables will drive revenues and margins. The Wires & Cables division is the joint largest revenue contributor at ~45%. The division earns EBITDA margins of 7%-8% on average. A majority of products in this category are white-labelled. Earlier the company handled contract manufacturing for L&T and subsequently started manufacturing for other brands. SEL has a strong presence in the agriculture cables market, which contributes a majority of the Wires & Cables division's revenues. SEL is also one of the leading suppliers of elevator cables and works closely with a majority of elevator companies in India. Recently, the company launched Salzer-branded wires and cables, and it has been slowly gaining market share and recognition among customers. Further, the company setup a data cable plant to produce LAN wires, which being a value-added product will help expand division margins.

Management looks to increase contribution from the Building Electricals division. The Building Electricals division is the SEL's only a B-to-C business. The company plans to increase the contribution from this category in the coming 2-3 years to around 10% as further opportunities open up in real estate and management looks to secure annual rate contracts with major builders. SEL's fourth division Energy Management is an order book-driven business where the company executes turnkey projects. The company has executed city street lighting projects in the past. At present, the company does not have any new orders while it services a few AMCs for previously-executed orders.

SEL's strong clientele and robust technical collaborations impart it a competitive edge. Backed by high standards and continuous innovation, SEL has created a strong client base. Some of the company's marquee customers are ABB, Honeywell, Schenider Electric, GE, L&T, Philips, C3 Controls, LMW, Premier, Valeo, Europa, V-Guard, BHEL, Elgi, Eaton, Yokogawa, SEARS, CED and Alstom. SEL has strong customer relations across the globe as (a) a preferred supplier to GE and Schneider; (b) the only approved supplier to the Nuclear Power Corporation; and (c) the largest supplier of rotary and load-breaking switches to the Indian Railways. Besides, it has strong relations with L&T and uses the latter's distribution channels to market its products. It has joined hands with C3 Controls to manufacture contactors and relays for the US market and consequently its products are internationally certified and universally accepted.

SEL has a strong R&D focus and advanced engineering capabilities. SEL places a lot of importance on product innovation and consequently innovation is regarded as a strategic area of operation. Over the years, R&D

SEL is a preferred supplier to
GE and Schneider

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SEL has patented rotary switches and owns 5 other process patents

expenses have risen and so has the company's product range. This has enabled it to achieve greater customisation and gain market share. SEL' R&D centre, which is managed by more than 35 qualified engineers, is recognised by the Department of Science, Government of India. The company has a full-fledged type-testing laboratory which includes an environmental test chamber for humidity test and can handle loads up to 500 amps, a salt-spray test, and all basic tests according to UL standards. It also has an in-house tool-room to manufacture and service moulds and press tools, CNC wire-cutting machines and spark-erosion machines, a CNC machining centre, EDM drilling (conventional machines), and the latest digital-measuring equipment inspected and certified by GE Tools Division. SEL has patented rotary switches and has 5 other process patents. These are in the areas of manual single-phase starters with no voltage tripping; energy-saver systems for street-lighting; integrated ammeter/voltmeter selector cam-operated rotary switches; track-feed battery changeover systems; and fuse automatic changeover systems. Enabled by its robust R&D, SEL manufactures more than 80% of components in-house.

R&D expense



Source: Company data

SEL is currently operating at 75% capacity utilisation

SEL's state-of-the-art manufacturing facilities are a key element in establishing manufacturing excellence. SEL operates 5 state-of-the-art manufacturing units in Coimbatore, Tail Nadu. Each of these units is engaged in the manufacture of different product categories. SEL's manufacturing processes other than wires and cables are labour intensive as the products are manufactured and assembled by hand. As a result, the capacity cannot be precisely quantified. Currently the company (all divisions combined) is running at 75% capacity with a maximum available capacity of 85%-90%. If the company sees demand rising, it can add an assembly line with a minimum capex of Rs 5 crore to Rs 10 crore.

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SEL's largest export market is Europe, followed by the Americas, Asia-Pacific and Middle East & Africa

Focus on expansion of exports will reap benefits in the medium term as the company expects to gain from businesses moving out of China. SEL's ambition to become a world-class manufacturer of electrical products has helped it evolve as a company with an enviable list of clients. The company has successfully ramped up exports, which comprising products from the Industrial Switchgear division, over the past few years. With a view to increasing exports further, SEL has been continuously expanding its global operations. It has added new territories with direct networks in 50 countries through 40 international distributors. About 17% of the company's revenues is sourced through global distributors. In FY20, exports accounted for approximately 20% of revenues with management expecting international sales to grow by 25%-30% going forward. Exports generate about 2 percentage point higher margin than domestic sales in the same product categories. SEL's largest export market is Europe, accounting for 6% of the company's topline, followed by the Americas (4%), Asia-Pacific (3.5%) and Middle East & Africa (2.5%). The COVID-19 pandemic has thrown up new opportunities for SEL with companies looking for alternatives to Chinese manufacturers. SEL is already gaining from this with many enquiries coming from companies intending to quit China. It has already started working with Eton Power and is in preliminary talks with a few others. The company has also been receiving various enquiries from Australia. The management is optimistic about converting at least some of these opportunities.

Valuation

At 8.0x FY22E EPS, we rate SEL a BUY with a target price of Rs 162 and an upside potential of 43%. SEL registered a strong bounce-back in 2Q FY21 from the COVID-led slowdown in 1Q FY21, reporting 8.7% y-o-y growth in revenue to Rs 149.8 crore. EBITDA increased by 7.2% y-o-y to Rs 18.8 crore. Demand in the export market was particularly robust with the company achieving the highest-ever quarterly export revenue in history. 1H FY21 revenue and EBITDA declined by 18.2% y-o-y and 17.1% y-o-y on account of the sharp fall in sales and profits in 1Q FY21. Going forward, management expects steady performance through the remainder of FY21. We have modelled resumption of growth in FY22 with improvement in margins driven by expanding export revenues, better product mix and cost reduction. The company continues to focus on improving its working capital management, which will positively affect short-term borrowing requirement and consequently interest expense and cash flow. The SEL stock currently trades at an attractive forward P/E level of 5.6x FY22E EPS. Expecting improvements in return ratios and solid earnings growth in FY22, we value SEL at 8.0x FY22E EPS with a price target of Rs 162, informing a BUY rating with an upside potential of 43%.

The SEL stock currently trades at an attractive forward P/E level of 5.6x FY22E EPS

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Relative Valuation: Price-to-Earnings

	High	Low	Average	Current
Salzer Electronics	28.1	3.5	13.0	6.7
Honeywell Automation	106.1	44.1	69.0	53.8
Havells India	74.1	14.5	47.7	71.8
HPL Electric & Power	30.3	3.7	15.9	10.7
Modison Metals	36.2	4.6	13.6	8.8

Note: Multiples from FY16 onwards except for HPL Electric, which are from FY18 onwards

Source: Bloomberg

Profit & Loss Account (Standalone)

Rs crore	FY18A	FY19A	FY20A	FY21E	FY22E
Revenue from operations	442.8	559.8	566.9	555.4	648.1
Growth		26.4%	1.3%	-2.0%	16.7%
Cost of sales and operations	389.5	496.1	501.8	489.8	565.8
EBITDA	53.3	63.6	65.2	65.5	82.3
EBITDA margin	12.0%	11.4%	11.5%	11.8%	12.7%
Depreciation & amortization	10.5	12.2	14.4	15.2	15.0
PBIT	45.9	52.2	51.6	51.1	68.1
Interest expense	14.9	19.9	21.2	22.5	22.3
PBT	30.9	32.3	30.5	28.6	45.9
Tax expense	10.9	8.4	4.1	8.4	13.4
PAT	20.0	24.0	26.4	20.2	32.4
PAT margin	4.5%	4.3%	4.7%	3.6%	5.0%
Diluted EPS (Rs)	13.45	15.10	16.51	12.64	20.29

Source: Company data; Khambatta Research

Abridged Balance Sheet (Standalone)

Rs crore	FY18A	FY19A	FY20A	FY21E	FY22E
Total shareholders' equity	273.4	287.0	309.4	329.6	362.0
Total debt	135.4	139.8	173.7	169.9	167.6
Trade payables	46.8	62.0	55.4	54.8	63.3
Total equity & liabilities	543.3	565.6	606.8	617.0	660.7
Property, plant & equipment	168.2	184.4	205.1	200.4	209.9
Inventory	138.5	142.7	157.2	148.5	167.5
Trade receivables	117.3	146.3	142.8	136.9	156.3
Cash and bank balance	10.0	14.1	8.9	29.9	20.3
Total assets	543.3	565.6	606.8	617.0	660.7

Source: Company data; Khambatta Research

Ratio Analysis

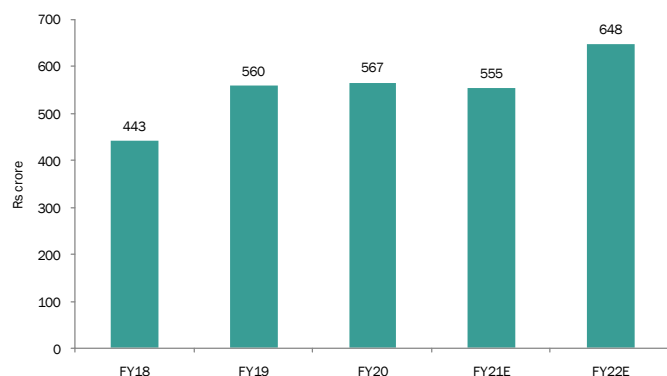
	FY18A	FY19A	FY20A	FY21E	FY22E
ROA	3.7%	4.2%	4.3%	3.3%	4.9%
ROCE	15.1%	16.8%	14.9%	14.1%	17.4%
ROE	7.3%	8.3%	8.5%	6.1%	9.0%
Debt-to-equity ratio	0.5x	0.5x	0.6x	0.5x	0.5x

Source: Company data; Khambatta Research

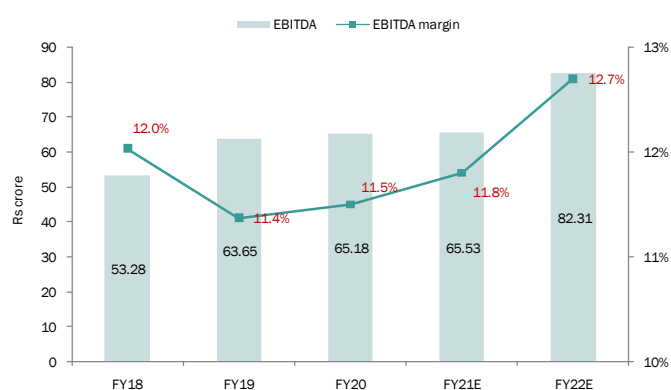
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Total revenue

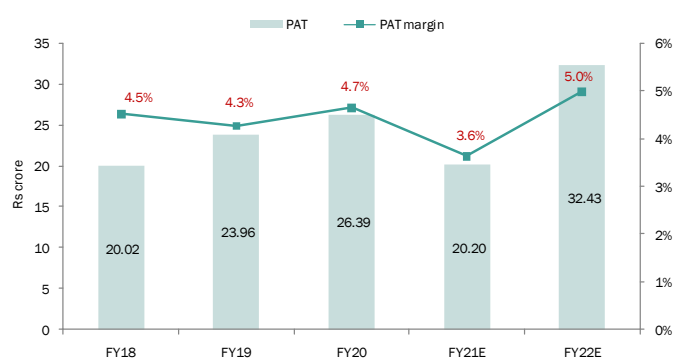


Operating profitability

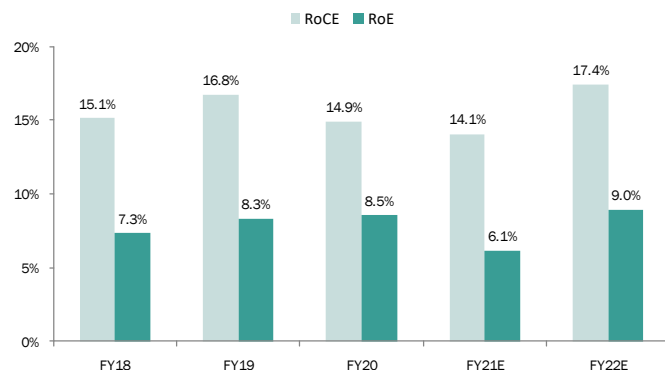


Source: Company data; Khambatta Research

PAT & PAT margin



Return ratios



Source: Company data; Khambatta Research

Key Risks

- Amongst other things, our assumption of higher exports is a key driver of our forecasts. The inability to expand export revenues in line with expectations can negatively impact growth and earnings forecasts.
- Material market share losses in key product categories will lead to underperformance of topline and earnings.
- An extended economic downturn owing to / as a fallout of the COVID-19 pandemic may lead to a delay in the revival of industrial spending and the resumption of the capex cycle, resulting in the underperformance of our forecasts.

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Guide to Khambatta's research approach

Valuation methodologies

We apply the following absolute/relative valuation methodologies to derive the 'fair value' of the stock as a part of our fundamental research:

DCF: The Discounted Cash Flow (DCF) method values an estimated stream of future free cash flows discounted to the present day, using a company's WACC or cost of equity. This method is used to estimate the attractiveness of an investment opportunity and as such provides a good measure of the company's value in absolute terms. There are several approaches to discounted cash flow analysis, including Free Cash Flow to Firm (FCFF), Free Cash Flow to Equity (FCFE) and the Dividend Discount Model (DDM). The selection of a particular approach depends on the particular company being researched and valued.

ERE: The Excess Return to Equity (ERE) method takes into consideration the absolute value of a company's return to equity in excess of its cost of equity discounted to the present day using the cost of equity. This methodology is more appropriate for valuing banking stocks than FCFF or FCFE methodologies.

Relative valuation: In relative valuation, various comparative multiples or ratios including Price/Earnings, Price/Sales, EV/Sales, EV/EBITDA, Price/Book Value are used to assess the relative worth of companies which operate in the same industry/industries and are thereby in the same peer group. Generally our approach involves the use of two multiples to estimate the relative valuation of a stock.

Other methodologies such as DuPont Analysis, CFROI, NAV and Sum-of-the-Parts (SOTP) are applied where appropriate.

Stock ratings

Buy recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) by at least 15%.

Hold recommendations are expected to improve, based on consideration of the fundamental view and the currency impact (where applicable) between 5% and 15%.

Sell recommendations are expected to improve up to 5% or deteriorate, based on consideration of the fundamental view and the currency impact (where applicable).

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