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5 MINUTE STOCK IDEA

BY SMART SYNC INVESTMENT ADVISORY SERVICES

SWARAJ ENGINES LTD

WHAT WE LIKE

STRONG MARKET POSITIONING:

The company is one of the leading producers of diesel engines ranging from 20 HP to 65 HP for fitment into Swaraj tractors manufactured by Mahindra & Mahindra Ltd. The company has maintained a strong ROCE of 30%+ **led by-**

- **Strong relationship:** Post-acquisition of a 17% stake in Kirloskar Industries, M&M now holds a 52% stake in the biz. This is material considering Swaraj Tractors (A M&M group co.) is the sole customer of the company & this ensures **High entry barriers** & a dominant 17% market share of Swaraj Tractors ensures the company's growth & margins are superior to the CV industry.
- **Stable margins:** The company has a terrific track record of maintaining margins irrespective of the industry downturn which also leads to high ROCE.

	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23
THREE STAGE MODEL						
Net Profit Margin (Net Income ÷ Sales)	10%	9%	9%	9%	10%	9%
Asset Turnover (Sales ÷ Total Assets)	2.2x	2.4x	2.2x	2.2x	2.5x	2.7x
Equity Multiplier (Total Assets ÷ Shareholders Equity)	1.5x	1.5x	1.5x	1.6x	1.5x	1.6x
Return on Equity	35.1%	34.6%	30.1%	33.0%	35.8%	39.0%

- **Strong working capital cycle:** The company's working capital days have been neglible in the past decade which has ensured capital is not stuck & ROCE is enhanced. .

HEALTHY PAST TRACK RECORD & PRUDENT CAPITAL ALLOCATION:

The company has stood the test of time by growing at a reasonable 5 yr CAGR of 13% by increasing its market share from 5-6% in FY16-17 to 17% in FY23-thus outgrowing the industry growth rate.

Compounded Sales Growth	
10 Years:	11%
5 Years:	13%
3 Years:	23%
TTM:	13%

Compounded Profit Growth	
10 Years:	10%
5 Years:	11%
3 Years:	24%
TTM:	16%

Stock Price CAGR	
10 Years:	14%
5 Years:	7%
3 Years:	15%
1 Year:	35%

Its long track record is also a testament to its capital allocation policy wherein-

- **High dividend payout>80%:** The management has returned excess cashflows to shareholders in the form of dividends (including special dividends) instead of misallocating into poor M&A ventures. It is interesting to note that it trades at a **lucrative dividend yield of 4.3%**
- **Capex:** The Company has increased its capex guidance y from 1,80,000 engines per annum to 1,95,000 engines annually (currently it stands at 1,50,000 engines)
- **Strong balance sheet:** Internal accruals are the primary source of capex with nil debt in the balance sheet.

CHANGE IN MANAGEMENT-A CATALYST?:

M&M group taking control of the business is a good development signalling its faith in the business & will also lead to more autonomy in decision making, better corporate governance standards (since Swaraj Tractors is the main client of the co.) & potentially better operational efficiency.

It is important to note that since the stake change took place in Sept 2022, it is no longer an undiscovered change in management-related- special situation opportunity, however, we still believe that the above positive effects might come in the long run due to M&M assuming control.

WHAT WE DON'T LIKE

RAW MATERIAL VOLATILITY RISK:

The major raw materials are ABS resins & isopropyl alcohol, which are very volatile in nature & can hurt OPM% considering raw material costs form 78-80% of overall sales. While it is able to pass on price increases to customers (which is visible from its stable OPM%), any significant movement in the price of raw material and a lag in passing on price fluctuations to the customer can impact profitability.

CLIENT & INDUSTRY CONCENTRATION RISK:

This is a major risk considering all the sales are made to Swaraj tractors which is itself susceptible to the agriculture sector's performance that has seen volatility in the recent past owing to dependence on monsoon, harvest, interest rates & credit availability, government policies among others.

Further, concentration on a single client, which is a related party, exposes the shareholders to **potential corporate governance lapses** like a sudden increase in credit period without any proportionate increase in margins to ensure that ROCE% remains unchanged.

	Mar 2019	Mar 2020	Mar 2021	Mar 2022	Mar 2023
Debtor Days	8	2	42	33	33
Inventory Days	26	23	29	25	22
Days Payable	58	61	78	53	53
Cash Conversion Cycle	-24	-36	-7	5	2

PRODUCT CONCENTRATION RISK:

The company derives its entire revenue from a single product. This is a major risk considering the business can be disrupted by changes in technology of diesel engines, EV among others.

SLOW GROWTH & TERMINAL VALUE RISKS:

As a result of high penetration of CVs & tractors in India, the company has seen limited reinvestment opportunities leading to high dividend payout & slow growth prospects. This coupled with its lack of efforts toward developing new product lines has also exposed the company to a **terminal value risk** wherein business model is highly susceptible to a single customer, product line & industry, therefore,any disruption would lead to the company's performance tapering down steadily after a certain period of time.

This might be one of the reasons why the company **optically looks cheap wherein P/E~19X, P/S~1.3X & Dividend yield~4.3%.**

Thus, improvements in the above factors will be the key drivers of shareholder returns going forward.

Earnings	132
Discount Rate (%)	14
Earning Growth Rate (%)	10
Terminal Growth Rate (%)	7
No Of Years	10

Year	Earnings	Growth Rate	Present Value
1	145	10.00%	127
2	160	10.00%	123
3	176	10.00%	119
4	193	10.00%	114
5	213	10.00%	110
6	234	10.00%	107
7	257	10.00%	103
8	283	10.00%	99
9	311	10.00%	96
10	342	10.00%	92

Terminal Year Cash Flow	366
Present value of 1-10 year	1,090
Terminal value	1,412
Intrinsic Value	2,085
Margin of saftey	-2%