

Vardhman Special Steel (VAR SPE)

CMP: ₹ 200

Target: ₹ 260 (30%)

Target Period: 12 months

BUY

October 19, 2023

Wider opportunity at play with Aichi Steel Corporation as strategic partner, PLI beneficiary, portfolio play...

About the stock: Vardhman Special Steel (VSSL) established since 2010 and headquartered in Ludhiana (Punjab), is a leading value-added player domestically supplying special and alloy steel to automobile industry. It has an installed capacity of 2.4 lakh tonnes of billets per annum, 2 lakh tonnes of rolled bars and 0.5 lakh tonnes of bright bars.

- VSSL in the recent past i.e., 2019 has entered into a strategic alliance with Aichi Steel Corporation (ASC) Japan, part of Toyota group, wherein ASC had purchased 11.4% stake in the company through preferential allotment and as same time entered into a Technical Assistance Agreement thereby helping VSSL upgrade its systems and processes in order to be a globally competitive quality supplier of special steel.
- VSSL possesses one of the unique features of producing special steel through EAF route of steel making thereby having controlled carbon emissions; green steel at play.

Investment Thesis

- Aichi Steel association- a structurally long term positive:** Aichi Steel is a global conglomerate belonging to Toyota group wherein steel produced by ASC is the source of high-quality products that support the automotive industry. VSSL has long been trying to rope in Aichi Steel for a strategic alliance with deal finally cracked in 2019. ASC with its engineering & technology prowess as well as high quality standards in manufacturing special steel is expected to transform VSSL into a truly world class organisation supplying quality/value added components for the automobile industry. It will open a broader export play with VSSL planning to up the game in this domain supplying special steel to ASC approved plants/vendors in South East Asian markets with intent to grow export sales to 20-25% of sales volume by FY25E vs. 5% in FY23.
- Brownfield expansion under execution, much larger vision for 2030:** With sales volume of ~2 lakh tonne in FY23, the company is witnessing capacity constraints amidst steady state growth in the domestic automobile space. It is however expanding brownfield from 2 lakh tonne to ~2.5 lakh tonne of rolled products capacity in phases and is expected to be completed by FY26E at a total capex spend of ~₹300 crore which also includes land acquisition for new plant. Organically we have built in 4.8% sales volume CAGR over FY23-26E, consequent Sales/PAT growth is seen at 6.2%/8.6% CAGR over FY23-26E. The company however envisaged a much larger role with ultimate aim to emerge as the #1 special steel manufacturer in India by 2030.

Rating and Target Price

- We assign **BUY** rating to the stock gaining confidence from VSSL's aim to make it big in the special steel domain amidst backing of Aichi Steel Corporation. We value VSSL at **₹260** i.e., 18x PE on FY25E-26E average EPS of ₹14.3/share
- We drive comfort from controlled leveraged B/S at VSSL (Debt: Equity 0.2x as of FY23), Capital efficient business model (RoE at ~12-15%) and positive CFO generation

Key Financial Summary

Key Financials	FY19	FY20	FY21	FY22	FY23	4 year CAGR (FY19-23)	FY24E	FY25E	FY26E	3 year CAGR (FY23-26E)
Net Sales	1,120.8	846.2	937.1	1,368.5	1,735.0	11.5%	1,796.1	1,914.2	2,079.0	6.2%
EBITDA	67.8	39.7	103.4	173.7	141.3	20.1%	139.2	167.5	193.3	11.0%
EBITDA Margins (%)	6.1	4.7	11.0	12.7	8.1		7.8	8.8	9.3	
Net Profit	22.2	3.3	44.2	100.8	100.4	45.8%	91.3	103.8	128.5	8.6%
EPS (₹)	6.2	0.8	5.5	12.4	12.4		11.2	12.8	15.8	
P/E	32.2	241.9	36.7	16.1	16.2		17.8	15.7	12.6	
RoNW (%)	6.1	0.8	9.6	18.2	15.6		12.6	12.6	13.7	
RoCE (%)	6.4	2.1	11.2	19.9	14.0		12.4	12.3	13.4	

Source: Company, ICICI Direct Research



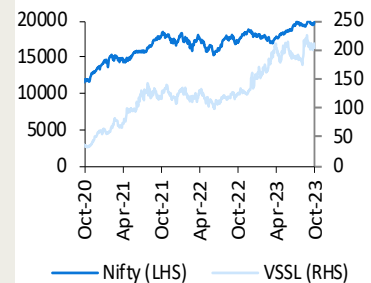
Particulars

Particulars	₹ crore
Market capitalisation	1,625.1
Total Debt (FY23)	142.9
Cash & Investment (FY23)	29.6
EV (₹ crore)	1,738.5
52 week H/L (₹)	234 / 120
Equity capital (₹ crore)	81.3
Face value (₹)	10.0

Shareholding pattern

	Dec-22	Mar-23	Jun-23	Sep-23
Promoter	60.8	60.7	60.7	60.7
FII	0.5	1.1	1.2	1.0
DII	0.8	1.0	1.1	2.4
Other	37.9	37.1	37.0	35.9

Price Chart



Key Risks

- Lower than build in improvement in EBITDA/tonne levels for FY24-26E
- Delay in execution & commissioning of new brownfield capacity

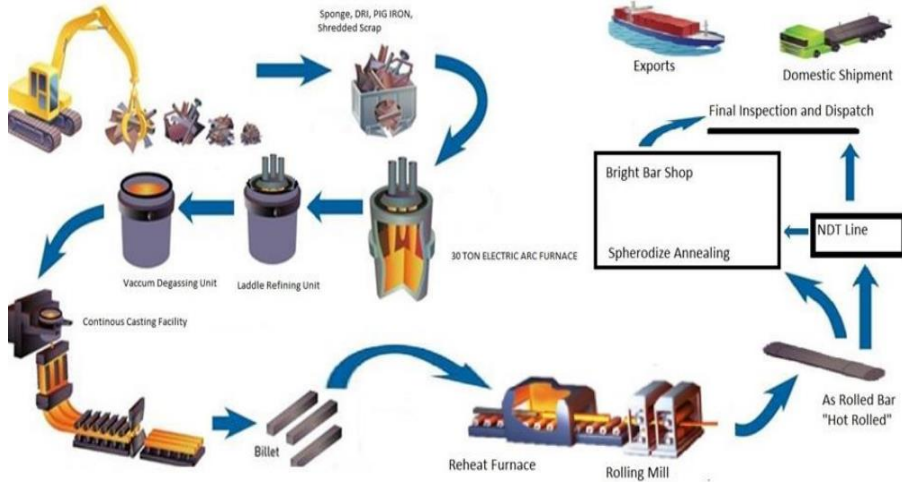
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Company Background

Vardhman Special Steel (VSSL) headquartered in Ludhiana (Punjab), is the leading special steel manufacturer for automotive application (90-95% of sales; largest exposure is towards PV segment, followed by 2W, CV and others). Its key customers include Maruti Suzuki, Hyundai, Toyota, Hero MotoCorp, Caterpillar, among others. Alongside automotive it also caters to other industries like Engineering, Bearing and other Allied Industries. It has an installed capacity of 2.4 lakh tonnes of billets per annum, 2 lakh tonnes of rolled products and 48,000 tonnes of bright bars.

Exhibit 1: Manufacturing process – VSSL manufacturers steel using EAF route of steel making



Company manufactures hot rolled bars ranging from 16-120 MM in diameter through self-consumption of billets produced

Company also produces bright bars ranging from 14.66 to 78 MM (peeled) & 18 to 55.25 MM in (drawn) diameter

Source: Company, ICICI Direct Research

Exhibit 2: Application of products – largely all critical components for automotive space

Axle Gears		Transmission Gear
Stabilizer Bar		Drive-Shaft
Knuckle Spindle		Tie-Rod
Piston		Bearings
Connecting Rod		Companion-flange
Camshaft		Axle Shaft
Center Velocity Joint		Piston-Pin
Crankshaft		Steering-Yoke
Differential Gears		Steering Shaft

Source: Company, ICICI Direct Research

Exhibit 3: Esteemed Customer profile at VSSL

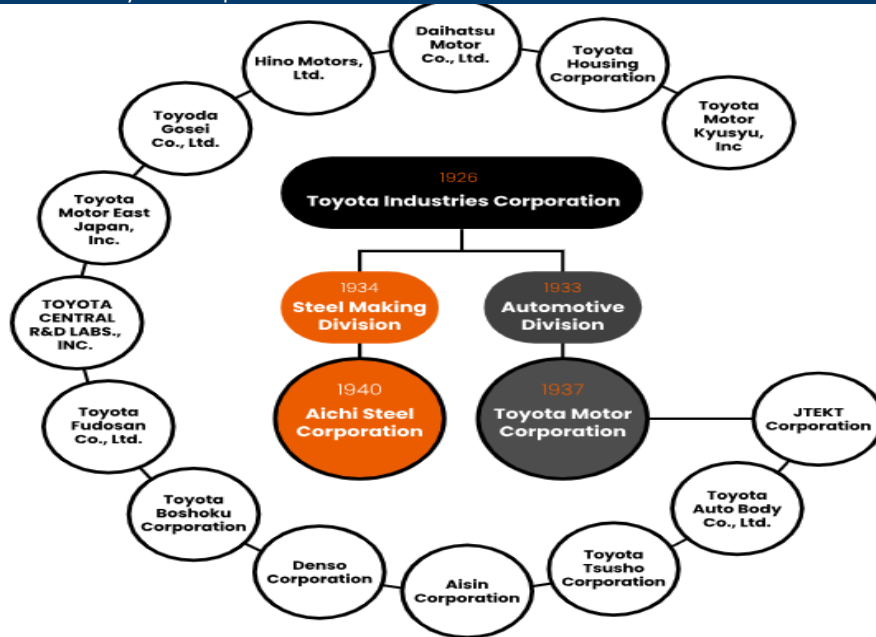
Cars 	Two Wheelers 	HCL/LCVs
Auto Components 	Tractors 	Off Highway Vehicles

Source: Company, ICICI Direct Research

Aichi Steel Corporation

Aichi Steel Corporation (ASC) is Toyota group company (only materials manufacturer in the group) est. since 1940-45 and is the leading manufacturer of speciality steel & other materials (electronic components, magnets, dental material, sensors etc.).

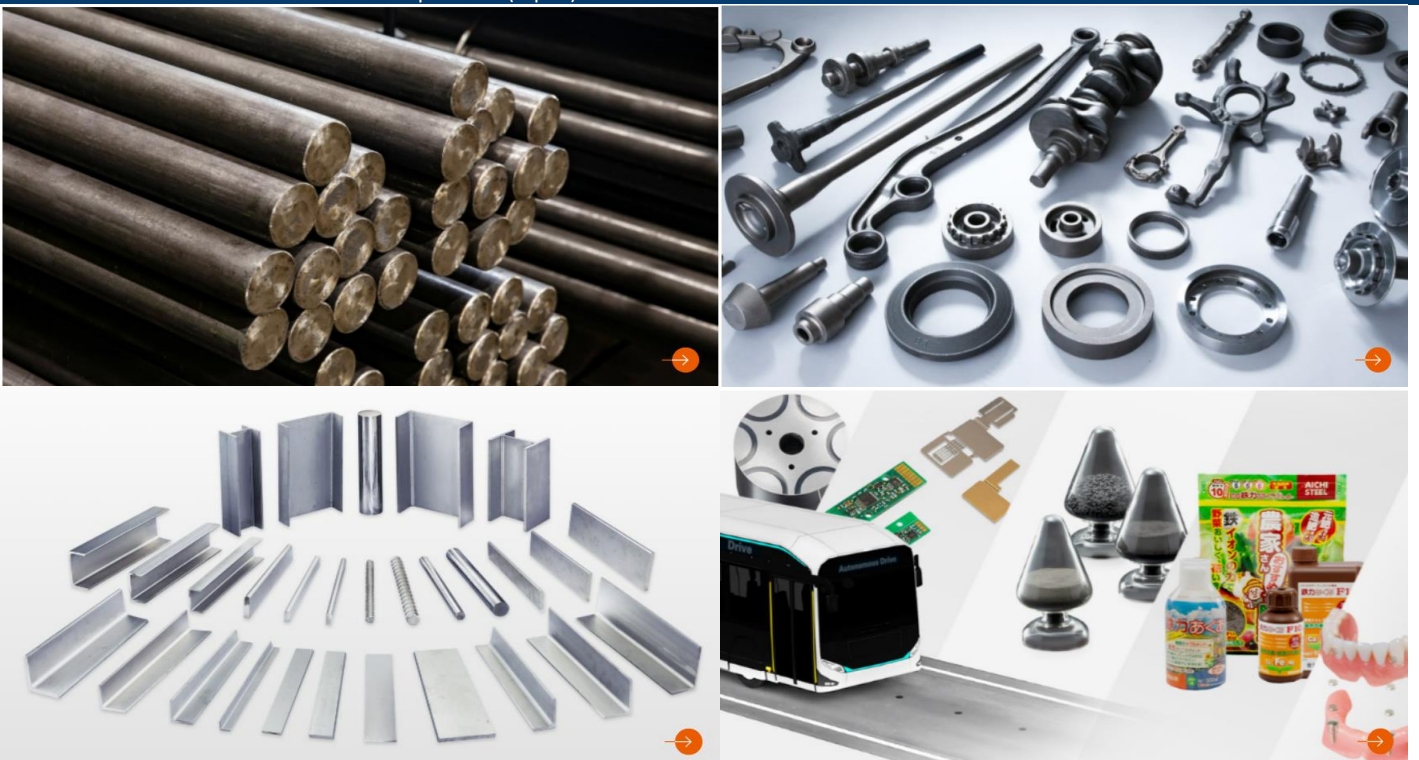
Exhibit 4: Toyota Group



Source: Company, ICICI Direct Research

It primarily operated into four main segments namely; (i) **speciality steel** (ranging from 10-230 mm in diameter for round bars), (ii) **forged products** (like e-axle products, engine related components, transmission products, chassis components, etc), (iii) **stainless steel/titanium** (also includes building structure engineering function) and (iv) **Electronic function materials and components/magnetic application products**

Exhibit 5: Product Profile at Aichi Steel Corporation (Japan)



Source: Company, ICICI Direct Research

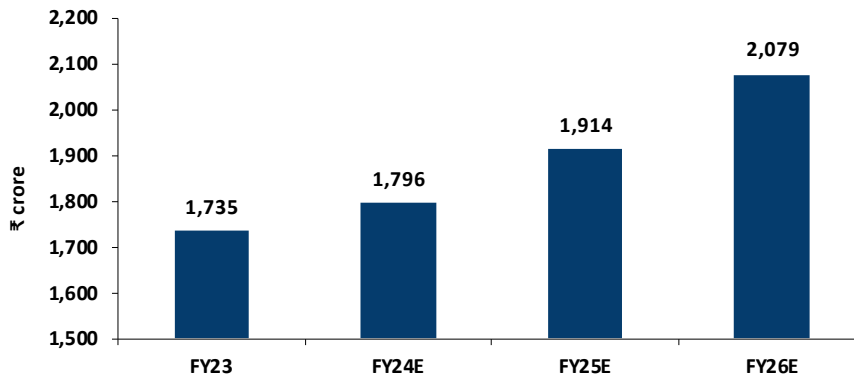
VSSL in 2019 has entered into a strategic alliance with Aichi Steel Corporation (ASC), wherein ASC had purchased 11.4% stake in the company and as same time entered into a Technical Assistance Agreement thereby helping VSSL upgrade its systems and processes in order to be a globally competitive quality supplier of special steel.

Investment Rationale

Fundamental levers for growth; VSSL – key PLI Beneficiary in special steel domain

With the aim to increase domestic manufacturing of speciality steel and rein in imports, the government has formulated PLI scheme for this space at a total outlay of ₹ 6,322 crore over FY24E-30E. VSSL which is currently undergoing brownfield expansion is an approved player under this scheme given its present capex spends. With steady growth prospects in automobile space, growth longevity particularly in the PV segment (highest exposure segment for VSSL), greater export play with ASC coming on board and phase wise commissioning of incremental capacities, we expect company to report 4.8% sales volume CAGR over FY23-26E. Consequent net sales CAGR over FY23-26E is pegged at 6.2%. Positive surprise along this journey could be sooner than expected announcement and execution of new greenfield capacity.

Exhibit 6: Sales trend (FY23-26E)

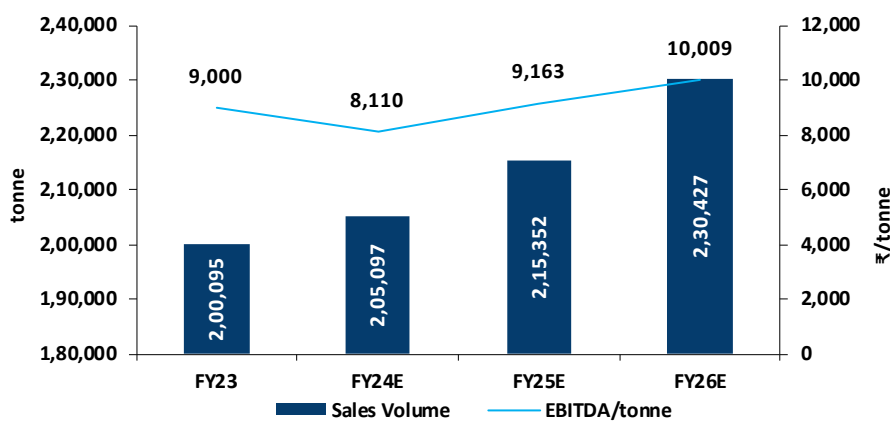


Source: Company, ICICI Direct Research

With operating efficiencies at bay, EBITDA/tonne to improve towards ₹10k level

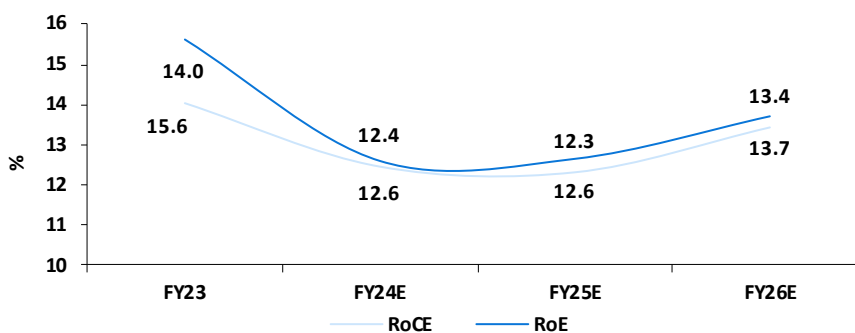
Going forward with operating efficiencies at play amidst rise in volumes as well as development of new grades under the guidance of ASC coupled with favourable price negotiation with customers, we expect EBITDA/tonne at VSSL to gradually improved to ~₹10,000 levels by FY26E vs. ~₹9,000 levels clocked in FY23 and ~₹7,700 in Q1FY24.

Exhibit 7: Sales Volume, EBITDA/tonne Trend (FY23-26E)



Source: Company, ICICI Direct Research

Exhibit 8: RoE, RoCE Trend (FY23-26E)



Source: Company, ICICI Direct Research

PLI Outlay over years

Financial Year	Outlay (in ₹ Cr)
2023-24	775
2024-25	1,088
2025-26	1,394
2026-27	1,377
2027-28	1,293
2028-29	222
2029-30	173
Total	6,322

Source: MOS, ICICI Direct Research

With the PLI scheme, government aims to more than double domestic production of special steel to **42 MT by FY27 vs ~17.6 MT in FY20** with exports expected to increase 3x (i.e., from 1.6 MT in FY20 to 5.5 MT by FY27) while imports expected to reduce ~4x (i.e., from 3.7 MT in FY20 to 0.9 MT by FY27). It also envisages a total investment of ~₹39,625 crore by FY30E in this domain

At VSSL, we expect EBITDA to grow at a CAGR of 11% over FY23-26E with margins slated to improve from 8.1% in FY23 to 9.3% in FY26E. Consequent PAT CAGR over FY23-26E is expected at 8.6% to ~₹130 crore by FY26E.

VSSL is a capital efficient player with double digit return ratios in the range of 12-15%.

Risk & Concerns

Dealy in commissioning of brownfield capacity

VSSL is currently witnessing capacity constraints with sales volume of ~2 lakh tonne in FY23 and rolled product capacity of similar magnitude i.e., ~2 lakh tonne. With ambition of greater export play with the help of ASC and steady demand prospects domestically, any delay in brownfield capacity commissioning will result in loss in volumes and is consequent adverse to our target price calculation.

Slowdown in domestic automobile sector, exposure to engine products – EV risk

VSSL realises substantially topline (~90%) from domestic automobile sector and even manufacturers steel for some of the engine products such as piston, crankshaft, camshaft among others. Hence any slowdown in domestic automobile space coupled with inadequate efforts on diversifying the product/customer base thereby mitigating the EV threat is a risk to our investment call on the company.

Inadequate and untimely price negotiation with customers

VSSL in ordinary course of business needs to negotiate its end product price with customers at periodic basis. However, since these customers are primarily large conglomerates (including Auto OEM's), VSSL possesses less bargaining power which in case of sharp movement in commodity prices (input costs) might hamper its profitability in the interim period. This is an inherent risk to our investment call.

Financial summary

Exhibit 9: Profit and loss statement		₹ crore			
(Year-end March)	FY23	FY24E	FY25E	FY26E	
Net Sales	1735.0	1796.1	1914.2	2079.0	
Other Operating Income	0.0	0.0	0.0	0.0	
Total Operating Income	1,735.0	1,796.1	1,914.2	2,079.0	
Growth (%)	26.8	3.5	6.6	8.6	
Raw Material Expenses	1,109.1	1,109.1	1,177.3	1,278.6	
Employee Expenses	89.9	89.8	95.7	103.9	
Other Operating Expense	394.6	458.0	473.8	503.1	
Total Operating Expenditure	1,593.7	1,656.9	1,746.7	1,885.6	
EBITDA	141.3	139.2	167.5	193.3	
Growth (%)	-18.6	-1.5	20.3	15.4	
Depreciation	28.1	29.1	35.8	42.0	
Interest	17.7	15.2	22.8	16.8	
Other Income	38.8	27.1	29.8	37.3	
PBT	134.3	122.1	138.7	171.8	
Exceptional Item	0.0	0.0	0.0	0.0	
Total Tax	33.9	30.8	35.0	43.3	
PAT	100.4	91.3	103.8	128.5	
Growth (%)	-0.3	-9.1	13.7	23.8	
EPS (₹)	12.4	11.2	12.8	15.8	

Source: Company, ICICI Direct Research

Exhibit 10: Cash flow statement		₹ crore			
(Year-end March)	FY23	FY24E	FY25E	FY26E	
Profit after Tax	100.4	91.3	103.8	128.5	
Add: Depreciation	28.1	29.1	35.8	42.0	
(Inc)/dec in Current Assets	-103.6	-41.8	-46.9	-65.4	
Inc/(dec) in CL and Provisions	41.2	12.7	15.6	21.7	
Others	17.7	15.2	22.8	16.8	
CF from operating activities	83.9	106.5	131.0	143.6	
(Inc)/dec in Investments	-4.6	-5.0	17.0	-2.0	
(Inc)/dec in Fixed Assets	-31.8	-70.0	-200.0	-50.0	
Others	-5.1	0.0	0.0	0.0	
CF from investing activities	-41.4	-75.0	-183.0	-52.0	
Issue/(Buy back) of Equity	0.1	40.6	0.0	0.0	
Inc/(dec) in loan funds	-18.0	-5.0	90.0	-60.0	
Dividend & interest outgo	-31.9	-23.3	-30.9	-29.0	
Inc/(dec) in Share Cap	0.0	0.0	0.0	0.0	
Others	0.9	-40.6	0.0	0.0	
CF from financing activities	-48.9	-28.3	59.1	-89.0	
Net Cash flow	-6.4	3.2	7.1	2.6	
Opening Cash	15.9	9.6	12.8	19.8	
Closing Cash	9.6	12.8	19.8	22.5	

Source: Company, ICICI Direct Research

Exhibit 11: Balance sheet		₹ crore			
(Year-end March)	FY23	FY24E	FY25E	FY26E	
Liabilities					
Equity Capital	40.6	81.3	81.3	81.3	
Reserve and Surplus	601.5	644.1	739.7	856.1	
Total Shareholders func	642.2	725.3	821.0	937.3	
Total Debt	142.9	137.9	227.9	167.9	
Deferred Tax Liability	20.1	20.1	20.1	20.1	
Minority Interest / Others	1.4	1.4	1.4	1.4	
Total Liabilities	806.6	884.7	1,070.4	1,126.7	
Assets					
Gross Block	481.4	488.3	613.3	788.3	
Less: Acc Depreciation	187.7	216.8	252.6	294.6	
Net Block	293.7	271.5	360.7	493.7	
Capital WIP	11.9	75.0	150.0	25.0	
Total Fixed Assets	305.6	346.5	510.7	518.7	
Investments	20.0	25.0	8.0	10.0	
Inventory	362.7	369.1	393.3	427.2	
Debtors	261.5	295.3	314.7	341.7	
Loans and Advances	4.3	4.5	4.8	5.2	
Other Current Assets	43.3	44.8	47.7	51.9	
Cash	9.6	12.8	19.8	22.5	
Total Current Assets	681.4	726.4	780.4	848.4	
Current Liabilities	185.6	196.8	209.8	227.8	
Provisions	3.0	3.2	3.4	3.7	
Current Liabilities & Prov	223.9	236.6	252.2	273.9	
Net Current Assets	457.5	489.8	528.2	574.6	
Others Assets	23.4	23.4	23.4	23.4	
Application of Funds	806.6	884.7	1,070.4	1,126.7	

Source: Company, ICICI Direct Research

Exhibit 12: Key ratios					
(Year-end March)	FY23	FY24E	FY25E	FY26E	
Per share data (₹)					
EPS	12.4	11.2	12.8	15.8	
Cash EPS	15.8	14.8	17.2	21.0	
BV	79.0	89.3	101.0	115.4	
DPS	1.0	1.0	1.0	1.5	
Cash Per Share	1.2	1.6	2.4	2.8	
Operating Ratios (%)					
EBITDA Margin	8.1	7.7	8.8	9.3	
PAT Margin	5.8	5.1	5.4	6.2	
Inventory days	76.3	75.0	75.0	75.0	
Debtor days	55.0	60.0	60.0	60.0	
Creditor days	39.0	40.0	40.0	40.0	
Return Ratios (%)					
RoE	15.6	12.6	12.6	13.7	
RoCE	14.0	12.4	12.3	13.4	
RoIC	14.8	14.3	14.8	14.1	
Valuation Ratios (x)					
P/E	16.2	17.8	15.7	12.6	
EV / EBITDA	12.3	12.4	10.9	9.1	
EV / Net Sales	1.0	1.0	1.0	0.8	
Market Cap / Sales	0.9	0.9	0.8	0.8	
Price to Book Value	2.5	2.2	2.0	1.7	
Solvency Ratios					
Debt/EBITDA	1.0	1.0	1.4	0.9	
Debt / Equity	0.2	0.2	0.3	0.2	
Current Ratio	3.6	3.6	3.6	3.6	
Quick Ratio	1.6	1.7	1.7	1.7	

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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