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THINKING FUTURE

Q3FY19 Result Update

Skipper Limited

Independent Equity Research

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SKIPPER LTD (SKIPPER)

➢ *Recommendation*

Recommendation	HOLD; Do not Average
CMP (BSE)	Rs. 60
Upside (15-18mths)	85% - 114% (Rs.110 -Rs.127)
Outlook	We would like to monitor the company for 1 more quarter

Q3FY19 Performance Highlights

Particulars (INR Mn.)	Q3FY18	Q2FY19	Q3FY19	YoY (%)	QoQ (%)	9MFY 18	9MFY 19	YoY (%)	FY18
Net Sales	**5,664**	**5,240**	**4,348**	**-23.2%**	**-17.0%**	**14,809**	**14,375**	**-2.9%**	**20,737**
Total Operating expenses	5,085	4,705	4,078	-19.8%	-13.3%	13,165	13,061	-0.8%	17,988
Core EBITDA	**579**	**535**	**271**	**-53.3%**	**-49.4%**	**1,644**	**1,314**	**-20.1%**	**2,749**
Core EBITDA Margin	**10.2%**	**10.2%**	**6.2%**			**11.1%**	**9.1%**	**-17.7%**	**13.3%**
EBIT	462	438	185	-59.8%	-57.7%	1,298	1,017	-21.7%	2,290
EBIT Margin	8.1%	8.4%	4.3%			8.8%	7.1%		11.0%
Interest & Finance Charges	176	257	235	33.3%	-8.4%	545	766	40.4%	784
PAT (adjusted)	130	172	-87	-166.6%	-150.6%	388	188	-51.5%	902
Forex Gain/Loss	162	-147	151			296	-54		276
PAT (Reported)	**292**	**25**	**65**	**-77.9%**	**158.8%**	**684**	**134**	**-80.3%**	**1,178**
PAT Margin	**5.2%**	**0.5%**	**1.5%**			**4.6%**	**0.9%**		**5.7%**
EPS - after E.O.	2.85	0.24	0.63	-77.9%	158.8%	6.68	1.31	-	11.48
Order book and order inflow									
Order Book	25,000	24,500	26,380	5.5%	7.7%	25,000	26,380	5.5%	26,270
Order inflow	5,250	4,100	5,060	-3.6%	23.4%	13,140	11,410	-13.2%	19,340

- **Revenues** – Revenues in the quarter declined by 23.2% YoY to Rs. 4.3 bn. Decline in the revenue was mainly due to the challenges faced in execution of domestic T&D segment. Also, management made a conscious decision to slowdown supplies to customers where the management foresaw credit risk.
- **EBITDA Margins –** Core EBITDA excluding the impact of forex gain/loss declined by 53.3% YoY to Rs. 271 mn. EBITDA margins declined to 6.2% from ~13% levels seen earlier. Decline in margins was on account of higher incidence of fixed cost projects on a lower revenue base, higher commodity prices impacting telecom projects and lower capacity utilization of around 70% as against the norm of 85-90%. Management is however confident to revert back to double digit margins in Q4FY19 and FY20 and considers the current margins as more of an aberration.
- **Forex Gain/Loss –** Company registered forex gain of Rs. 151 mn in the quarter (Rs. 250 mn notional M2M gains on forward contracts and realized loss of Rs. 99 mn on derivatives premium). Forex loss in 9MFY19 stood at Rs. 54 (Rs. 75 mn of notional M2M gain and realized loss of Rs. 127 mn on derivatives premium).
- **PAT after forex gain/loss –** PAT declined 78% YoY to Rs. 65 mn. Decline in revenue and margins mainly led to the decline in PAT. Led in increase in working capital borrowing, interest cost as % of sales also remained high at 5.4% leading to pressure on net profitability.
- **Orders –** Order inflows in the quarter stood at Rs. 5 bn taking the total order book to the company's highest ever level of Rs. 26.3 bn. 83% of the order book is from engineering T&D sector, while telecom and railways form 12% and 5% of the OB respectively. Within T&D, 36% of OB comes from PGCIL orders, 34% from SEB and other domestic players, while the remaining 13% comes from export orders. While Skipper is still heavily dependent on domestic T&D orders, management is steadily reducing dependence on the same by increasing proportion of telecom and railways (13% of OB now vs. 5% at the end of Q3FY18).

Segmental Performance:

Revenue (INR Mn.)	Q3FY18	Q2FY19	Q3FY19	YoY (%)	QoQ (%)	9MFY 18	9MFY 19	YoY (%)	FY18
Engineering Products	4,863	4,776	3,839	-21.1%	-19.6%	12,858	12,656	-1.6%	17,782
Infrastructure Projects	261	105	178	-31.9%	70.1%	599	468	-21.9%	855
PVC Products	540	359	331	-38.7%	-7.8%	1,352	1,251	-7.5%	2,100

Revenue (INR Mn.)	Q3FY18	Q2FY19	Q3FY19	YoY (%)	QoQ (%)	9MFY 18	9MFY 19	YoY (%)	FY18
Net Sales	**5,664**	**5,240**	**4,348**	**-23.2%**	**-17.0%**	**14,809**	**14,375**	**-2.9%**	**20,737**
Revenue Mix %									
Engineering Products	86%	91%	88%			87%	88%		86%
Infrastructure Projects	5%	2%	4%			4%	3%		4%
PVC Products	10%	7%	8%			9%	9%		10%
Total	**100%**	**100%**	**100%**			**100%**	**100%**		**100%**
EBIT (INR Mn.)	**Q3FY18**	**Q2FY19**	**Q3FY19**	**YoY (%)**	**QoQ (%)**	**9MFY 18**	**9MFY 19**	**YoY (%)**	**FY18**
Engineering Products	477	526	268	-43.8%	-49.1%	1,388	1,255	-9.6%	2,372
Infrastructure Projects	32	0	-1	-101.6%	-216.3%	73	24	-67.4%	108
PVC Products	36	-11	-11	-130.9%	2.8%	95	-29	-130.9%	151
Un-Allocable expense	83	78	70			254	231		332
EBIT Total	**462**	**438**	**186**	**-59.7%**	**-57.5%**	**1,302**	**1,018**	**-21.8%**	**2,299**
EBIT Margin%									
Engineering Products	9.8%	11.0%	7.0%			10.8%	9.9%		13.3%
Infrastructure Projects	12.3%	0.4%	-0.3%			12.1%	5.1%		12.6%
PVC Products	6.7%	-3.0%	-3.4%			7.0%	-2.3%		7.2%
Total EBIT Margin %	**9.6%**	**9.8%**	**5.9%**			**10.5%**	**8.7%**		**12.7%**

- **Engineering segment–**
  - **Revenue:** Engineering segment**,** which contributes 88% to the total revenue, faced execution slowdown in the quarter. Thus, revenues from the segment declined by 21.1% to Rs. 3.8 bn.
  - **Margins:** Impacted by higher commodity prices and greater proportion of fixed price contracts executed in the quarter, EBIT margins for the segment declined by 280 bps YoY to 7%. Also due to lower capacity utilization, fixed cost as % of sales increased impacting margins further. However, management is confident of posting margins in line with the past trend of 10%+ EBIT margin.
- **PVC Products segment –**
  - **Revenue:** Due to the restructuring of the business under Vector consultancy, company is conducting multiple pilot projects to increase branding and presence of the company products. Even though the pilot projects are showing strong growth, the management sees pain in the segment in the medium term due to highly competitive nature of the business.
  - **Margins: Due to the company's engagement with Vector consultancy,** the management is currently focusing more increasing the company's market share and transforming supply chain, than on making higher margins. EBIT margins thus stood at a negative 3.4% in the quarter. Management has guided for an EBIT positive performance of the segment in next 4-5 quarters.

Concall and Management Meet Notes:

Parameters	Management Commentary
Reasons for Revenue decline	▪ After almost 23 quarters, revenue has declined on YoY basis for the first time with margins being at their lowest level in the same period. ▪ There were Execution challenges in domestic T&D orders due to which the company was not able to convert orders into revenue. ▪ Management decided to slowdown the supply to customers who were facing credit risk.
Reasons for Margin decline	▪ Higher incidence of fixed cost on lower base of revenue. ▪ Impact of higher commodity prices in the fixed cost telecom projects and few fixed cost T&D projects. ▪ Plant utilisation in the quarter remained low at ~70% as against usual 85-90%. ▪ Increased Working capital borrowing on account of reduced payable days.
Short term Guidance	▪ Revenues in Q4FY19 would be similar to Q4FY18 (~Rs. 4.9 bn) ▪ Margins in Q4FY19 would revert back to double digits. ▪ FY20: Revenue to grow at ~15% ▪ FY20: EBITDA margins of 13-14% is achievable once the domestic T&D space rebounds.

Parameters	Management Commentary
Long term Guidance	▪ Aiming to achieve order book diversification as follows: 50% from domestic T&D (as against current 70%) with the remaining 50% coming from railways, telecom and export orders. ▪ Management aims to grow exports to 40% of the revenues in the next 2 years and 50% in the next 3 years from current 15%.
Opportunity in Railways & Telecom	▪ Company sees a large opportunities in Railways over the next 7-8 years. ▪ On PBT level, margin profile for Railways is superior compared to T&D because of lower interest cost owing to shorter working capital cycle of 3 months. ▪ Same manufacturing facilities are being used for railways and T&D, Hence the company does not need to make any additional capex to serve the segment.
Opportunity in Export markets	▪ There is a strong bid pipeline of Rs. 37 bn over the next 1 year of which, Rs. 24.5 is from export orders. This is against the company's current order book size of Rs. 26.3 bn. ▪ As per the management, Skipper is one of the most competitive player globally. Due to the depreciated currency, Skipper's bid price is 8-10% lower than Chinese players. ▪ Opportunities are expected to come majorly from countries in Latin America, Africa and south-east Asia. ▪ Company has obtained certifications to supply tower to North American and European market. However, obtaining orders from these countries is still some time away.
Forex Gain/Loss	▪ Company hedges 100% of its export orders in order to lock in the margins at the currency levels at the time of signing contract. ▪ The company sells dollars in the forward contract in order to hedge its exposure. It earns a premium of 4-5% on the contract. However, as per the Ind-AS requirement, the notional gain/loss due to change in currency has to be reported in the P&L. ▪ However, when the contract ends, the company does not incur any loss of revenue. ▪ In Q3FY19, the company booked a gain of Rs. 151 mn of forex gain of which, Rs. 250 mn is notional M2M gain on forward contracts and realized loss of Rs. 99 mn on derivatives premium.
Working Capital	▪ Debtor numbers are similar to Q2FY19 at ~95 days. ▪ NWC/Sales ratio in the quarter looks skewed due to lower revenue. ▪ Management has stated that on yearly basis, NWC days will remain at guided level of 90-100 days.

➢ Outlook:

The company has delivered one of the worst quarterly performance in Q3FY19. Pressure is visible on both Engineering segment, as well as its Polymer segment. Engineering segment was impacted by slowdown in the execution and impact of higher costs in fixed cost projects, whereas polymer segment continues to undergo pain due to business restructuring.

However**, management guidance with regards to operational turnaround from Q4FY19 itself, is very positive**. In the concall conducted by the company Mr. Sharan Bansal, Director, Skipper Ltd, said "**Q3FY19 was an exception and an outlier in the long-term growth story of the company**". ***Management has stated that it is confident of reverting back to 15% revenue growth in FY20 with EBITDA margin of 13-14%.***

Considering this guidance, at this stage we would like to monitor the company's performance for one more quarter. We would specifically like to monitor the below parameters in the next quarter.

- **Order inflow:** Although the domestic inflow is expected to remain muted over the next 2 quarter, the management is very optimistic about the export orders, especially from Latin American, African and South east Asian countries. Over the next 1 year, a large bid pipeline of Rs. 37 bn exists, of which exports form Rs. 24.5 bn, notably company's current order book itself is Rs. 26 bn.
- **Margin Traction:** over the past 3 years, company has registered average EBITDA margin of ~13%. This has declined to 6.2% in the current quarter. Management has guided for double digit margins in Q4 and reverting to 13-14% margin in FY20. Margin improvement would remain crucial in the near term.
- **Forex Gain/Loss:** Skipper has presence in export market as a tower supplier. For all export projects undertaken by the company, it hedges 100% of its foreign currency exposure. This ensures that the company does not lose any revenue due to currency fluctuation from the time the contract is signed to the time the it is executed. However, the company has to book gain or loss due to currency fluctuations as well as gain or loss on rollover of forward contracts. This makes the reported PAT volatile on QoQ basis. However, it has no impact on the overall profitability on project level upon its completion.

- **Progress on Demerger:** Management has tentatively guided for completion of demerger process by April/May of 2019. Obtaining all the relevant regulatory approvals on time remains key for the demerger to complete on time. This is especially important since the performance of polymer segment has been dragging down the performance of consolidated entity, demerger would therefore provide an opportunity to existing investors to choose between the two businesses.
- **Interest expense:** In 9MFY19, company has incurred interest expense of Rs. 766 mn, which is 5.3% of total sales. This is steep for a company of this size. Management has guided for Rs. 1 bn of interest cost expense in FY19. Company has to service fixed cost (Interest + depreciation) of ~Rs. 350 mn every quarter. Any contraction in the operating profits would put pressure on the company's ability to service these costs from its internal accruals. Thus, interest expense becomes a key monitorable.

In case we take management's guidance at face value, then there exists a possibility of re-rating of the stock. However, we would like to wait and watch the company's performance in the next quarter in order to ascertain the company's performance on all the above-mentioned parameters. We, therefore, **recommend investors to HOLD the stock and do not average at current levels. Basis the company's Q4 performance, we would review the performance and issue fresh recommendation**.

Valuation and recommendation:

BUY for 85-114% upside in 15 to 18 months

At CMP of Rs. 60, Skipper is currently trading at P/E of 9.8x on TTM EPS of Rs. 6.1. We have valued the company basis the projected EPS in FY20 and FY21. We have assigned PE multiple of 13-15, basis the 52-week high/Low range. Over the next 15-18 months, the stock has the potential to almost double provided profit trajectory improves in line with management guidance. Hence, **we are advising investors to HOLD their current investment and DO NOT AVERAGE at this stage as the conviction and visibility on the profit growth at this stage is low.**

Base Estimates:

Particulars (Cons)	15-18 Month Valuation		
	FY18	FY19E	FY20E
PAT (Rs. Mn.)	**698**	**222**	**615**
YoY (%)	-	*-68.2%*	*177.3%*
EPS (Rs.)	**6.79**	**2.16**	**5.99**
P/E (xs) @ CMP	8.8	27.6	9.9

	Particulars	52W -L	52W-H	CMP
	Stock Price (Rs./-)	48	292	60
	EPS- FY19	3.0	3.0	3.0
A)	PE- FY19	16.2	98.7	20.1
	EPS- FY120	7.5	7.5	7.5
B)	PE- FY120	6.4	38.7	7.9
	Avg. A and B	**11.3**	**68.7**	**14.0**

15 to 18-month outlook:

Attach PE Multiple (xs) to	FY20E EPS (Rs.)	Intrinsic Value (Rs.)	Upside (%)	FY20-21E Avg. EPS (Rs.)	Intrinsic Value (Rs.)	Upside (%)
7	7.5	53	*-11%*	9.4	66	*11%*
10	7.5	75	*27%*	9.4	94	*58%*
13	7.5	**98**	*65%*	9.4	**123**	*106%*
15	7.5	**113**	*90%*	9.4	**142**	*138%*
18	7.5	136	*128%*	9.4	170	*185%*
21	7.5	158	*166%*	9.4	198	*233%*
				Average Intrinsic range over 15 - 18M	**110**	**85%**
					127	**114%**

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