SURGE CAPITAL

29th May 2024

GARWARE HITECH FILMS

GARWARE HI-TECH FILMS

Rating	Conviction Rating
BUY	★★

Price: 1650

Surge Capital Focuses on Six Key Attributes of Long-Term Earnings Growth

- Strong Business Model
- Innovation & Pivot ✓
- Change & External Trend ✓
- Optionalities
- Leadership & Edge
- Stellar Management Execution

Industry:	Polyester Films
Market Cap:	Rs3840 Crores
Revenues:	Rs1677 Crores
Net Profits:	Rs203 Crores
Net Debt:	-

✓ Indicates attributes present in the stock

Investment Bucket: Non-Linear

Brief Thesis

Garware Hi-Tech is an export focused polyester films manufacturing company.

Company divides its business lines into two segments- Consumer Product Division (CPD) and Industrial Product Division (IPD).

CPD consists of value added & branded businesses of Solar Control Films (SCF) and Paint Protection Films (PPF).

Over last six years, the company has undergone major transformation wherein it has moved from largely a commodity business to a value-added business. This transformation has had all round improvement in terms of growth, profitability and capital efficiencies & profile.

And continued improvement in share of value-added business should lead to sustained benefits for the company going ahead.

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GARWARE HI-TECH

Garware Hi-tech Films (earlier Garware Polyester) is into manufacturing of various types of polyester films. It is an exported oriented business with ~78% of revenue coming from international markets.

The company divides its business into two broad categories;

Consumer Products Division (CPD)		Industrial Products Division (IPD)	
Solar Control Films (SCF)	Paint Protection Film (PPF)	Value Added Products	Commodity Products
38%	27%	24%	11%

VALUE ADDED BUSINESSES

FY24 Revenue Mix

A. Solar Control Films (SCF)

Solar control films are primarily used within the automotive space to provide heat & UV resistance for car windows. The use case also extents to protection & safety films that increases the durability of window glass.

These films are also seeing increasing acceptance within the architectural segment wherein they are used for multiple use cases of heat control, safety, privacy and decoration.

Garware is a global player within the SCF space with ~8-10% global market share and is among the top-3 brands in the US & European markets.

Sun Control Films

1. Applied to the inside surface of Glass Windows
2. Reduces solar heat, UV light & glare, keeps inside room cooler
3. Multiple SKUs with different properties to suit your needs

Safety & Security Films

1. Holds broken glass shards intact & minimizes chances of injuries
2. Maintains visual identity of the glass
3. Protects glass surface from scratches

Privacy Films

1. Provides privacy to rooms, conference rooms, bath areas and improves confidentiality
2. Improves ambience and aesthetics

Designer & Decorative Films

1. Transforms normal clear glass to a designer glass – varied colors & designs
2. Freedom to change glass designs on renovation by changing only the film, not the more expensive glass

It has 2nd largest SCF manufacturing capacity globally and is also highly backward integrated. It currently exports ~92% of its SCF.

B. Paint Protection Films (PPF)

Paint protection films protect car paint from damages like scratches, dust, dirt etc. These films also have self-healing and hydrophobic properties.

Garware is the only manufacturer of professional grade PPF in India and exports ~90% of its PPF.

C. Value Added IPD

Within its IPD division, Garware manufactures certain value-added products. Shrink films is the key product within this segment wherein Garware has >70% domestic market share and exports 2/3rd of its production.

Shrink Film

Wrapping & labelling plastic bottles, containers, cans, cups, etc. of various sizes

Electrical & Electronics

Used in electronics industry because of properties like electrical insulation, thermal stability, moisture resistance, & excellent dimensional stability.

Release Liners

Coated with silicon on one side to enhance release properties & used in applications like release labels

D. Commodity IPD

Within this segment, Garware produces various low value & high-volume products primarily on the packaging side.

Thermal Lamination

Provide heat insulation, energy efficiency, increased comfort & protection in various applications like Book covers, Posters, etc.

Plain Film

Offers excellent mechanical & optical properties used in as label stocks, photographs, tags, lamination, OPH, etc.

Packaging & Lidding Film

Protects & preserves various products like food, beverages & consumer goods

Metalized Film

Provides design versatility, shiny appearance & barrier properties to meet customer specific needs

SCF & PPF- Key Advantages

A. Branded Business

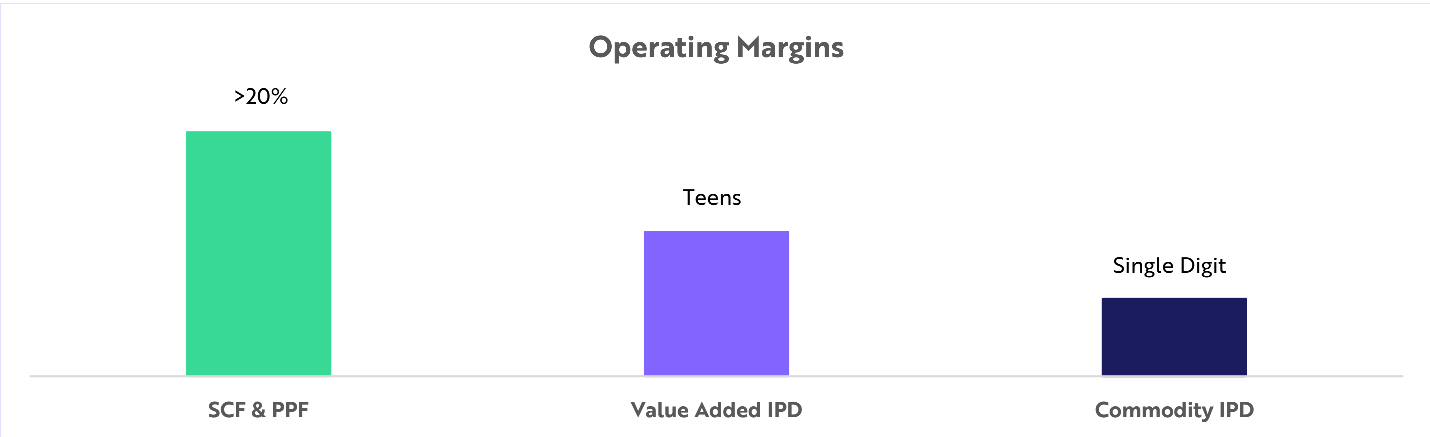
Both SCF & PPF business are branded in nature wherein the products are sold in company's brand name through a distribution channel.

Garware sells its products under multiple brands across different tiers of the market; primarily the premium & above end of the market.

Global beings its flagship & super premium brand and the 2nd brand being Garware.

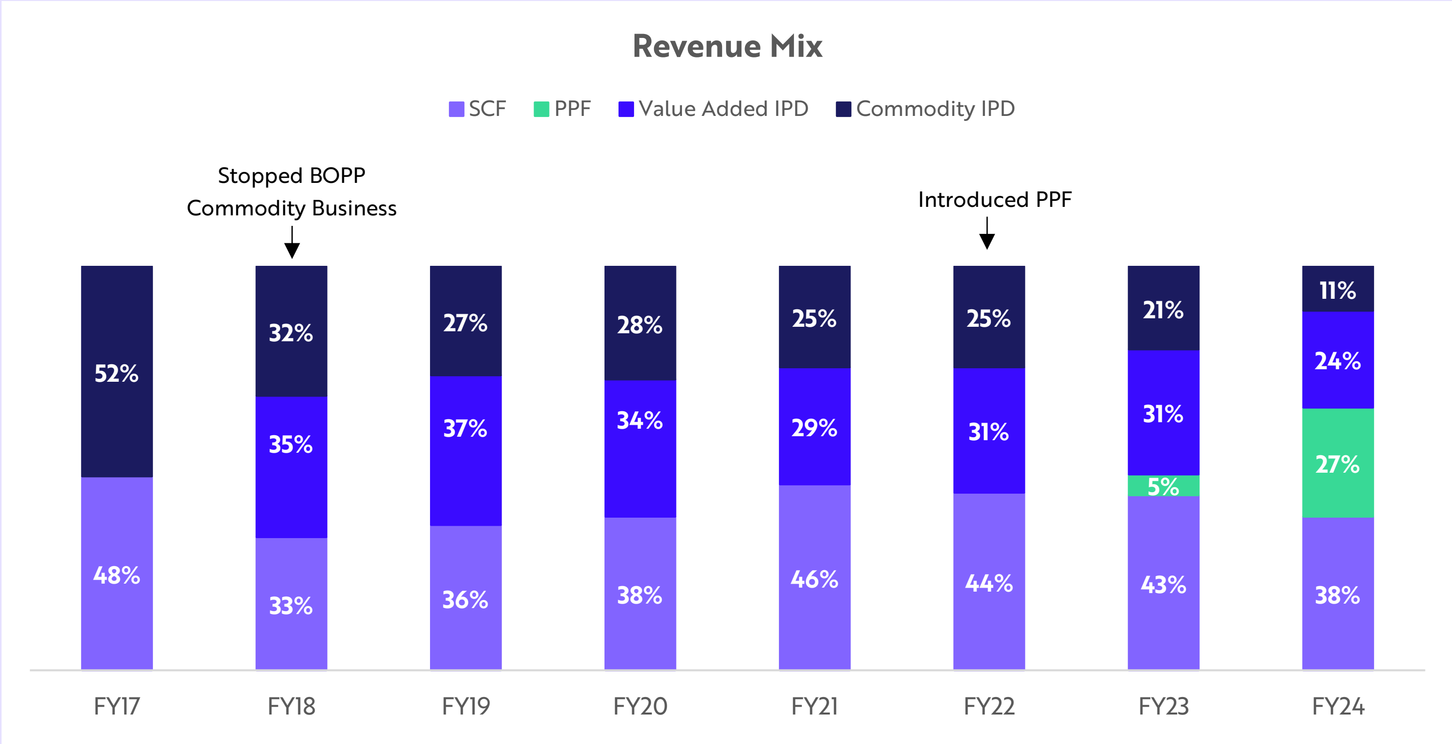
B. These businesses operate under cash & carry model and has little to no receivables.

C. The margins in these businesses are much higher than other polyester film products.



TRANSFORMATION OF BUSINESS

Over last six years, Garware has taken some major steps to transform from a commodity business to a value-added business.

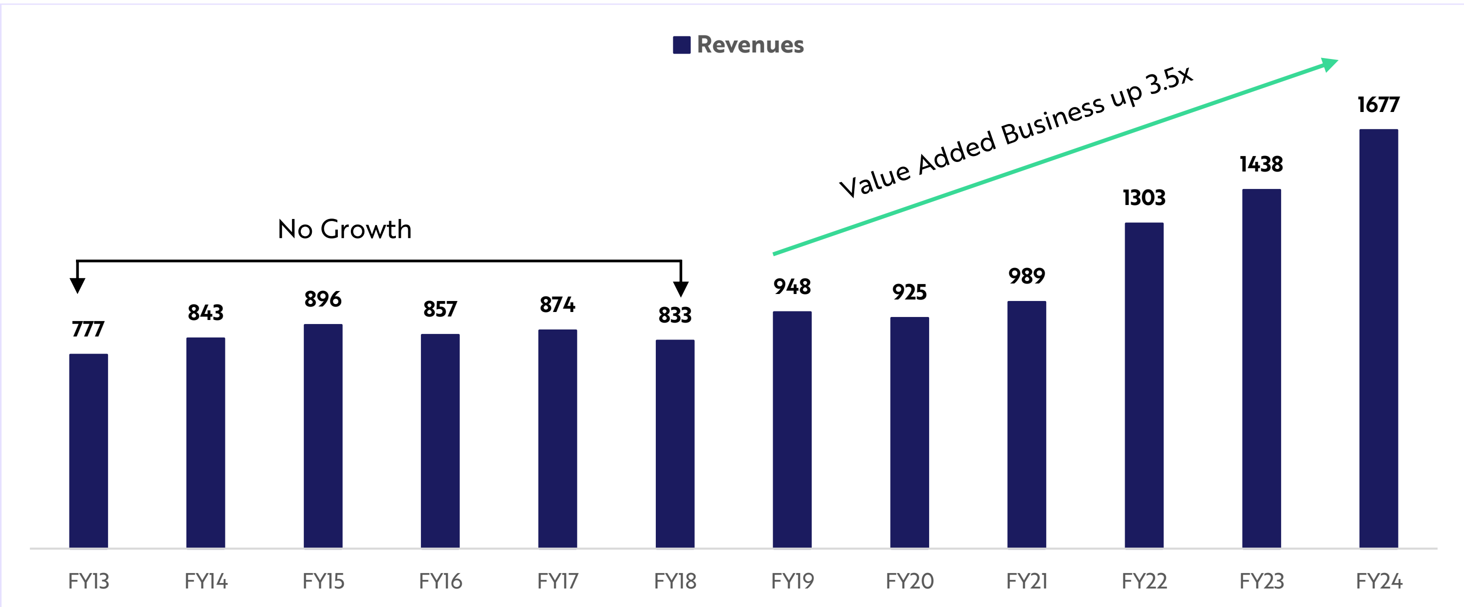


(Note: FY17 SCF share includes SCF + Value Added IPD)

This transformation has led to all round improvement in company's business;

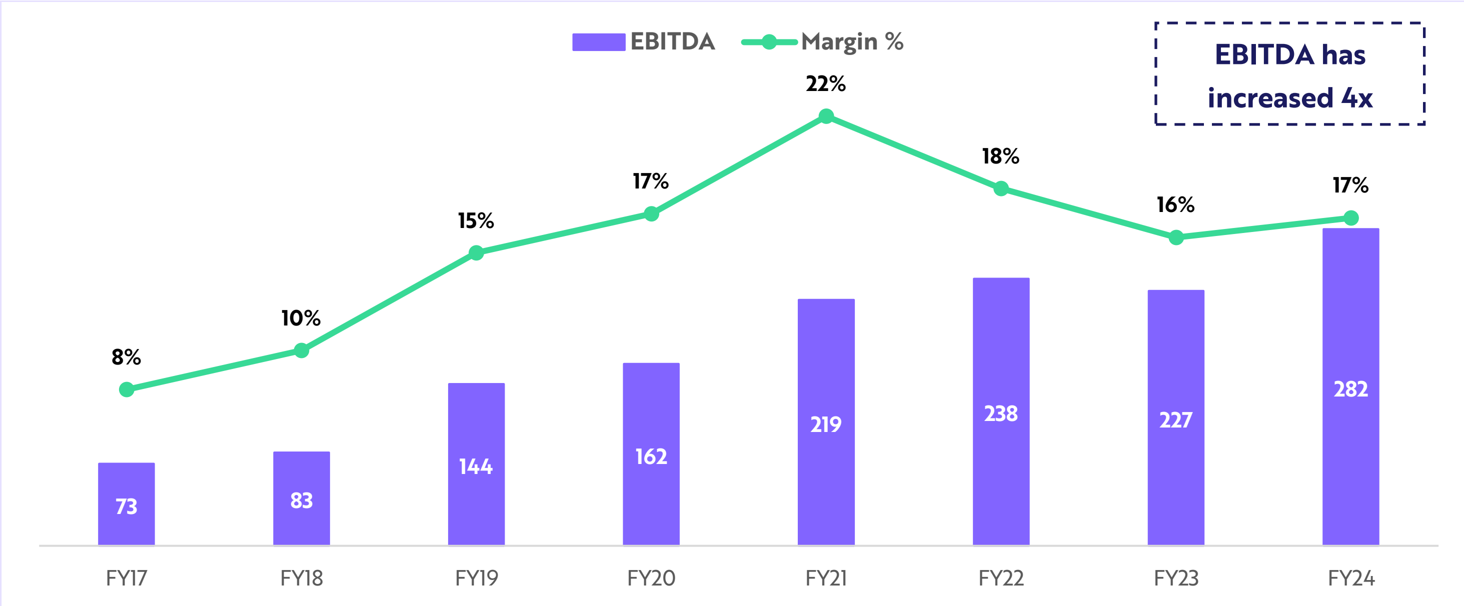
1. Improved Growth

Before FY18, there was hardly any growth in company's business, but with increased focus on CPD and value-added business, the overall company has started growing despite reduction in commodity business.



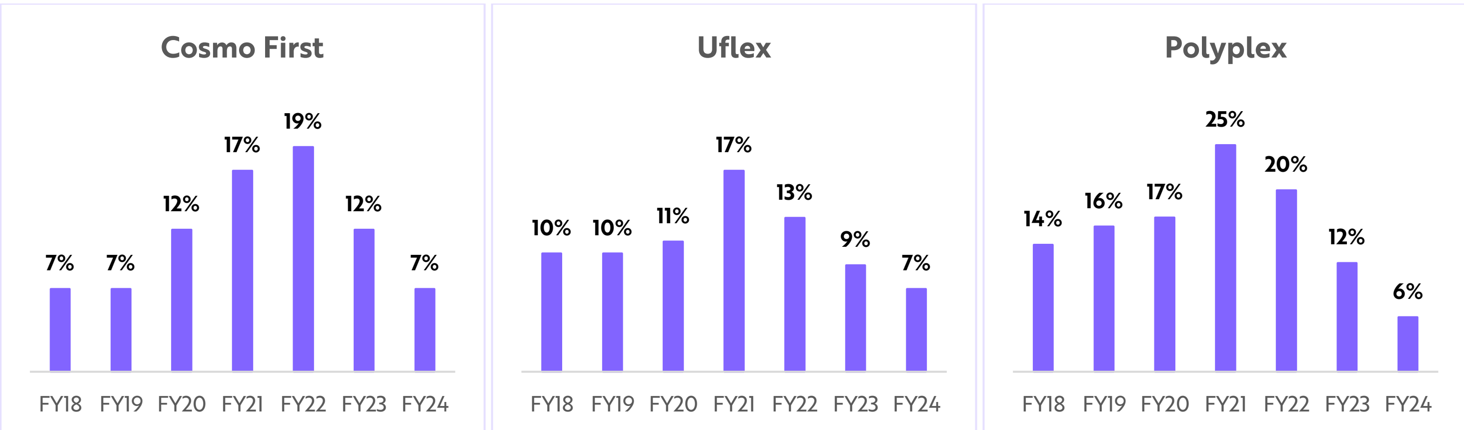
2. Improved Profitability

Valued added business (especially the CPD businesses) have much higher margins than the commodity business and thus with the change in business mix, the overall profitability of the company has improved significantly.



(Note: Post covid, there was major boom in commodity films space due to sharp increase in raw material prices and supply shortages resulting in super normal margins in the commodity business and that led to very high margins in FY21 & FY22 and opposite of that is playing out in last two years)

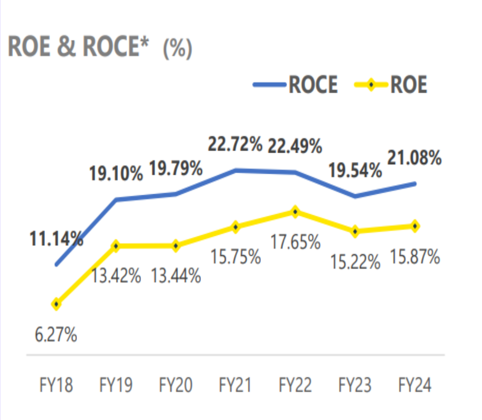
Margin movement of other commodity film companies;

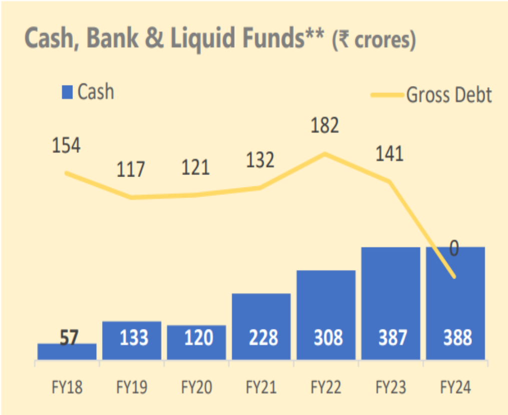


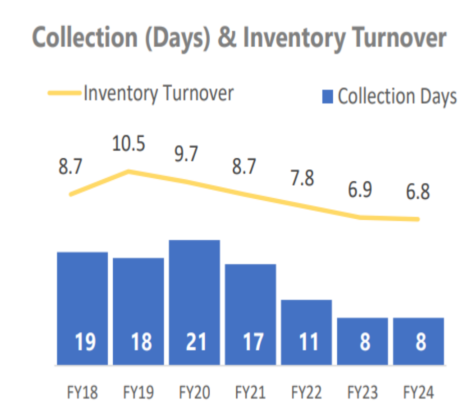
3. Improved Capital Efficiencies & Profile

Along with higher margins, CPD businesses are also efficient in terms of working capital and are primarily cash & carry businesses. As a result, overall debtor days have reduced to low single digits now, which coupled with higher profits has put Garware in a net cash surplus position.

And higher profitability and better capital efficiencies has also resulted in improved ROCEs.







(Note: ROCE and ROE are calculated adjusting for revaluation reserve on land created during transition to Ind-AS)

SHARP FOCUS ON CPD

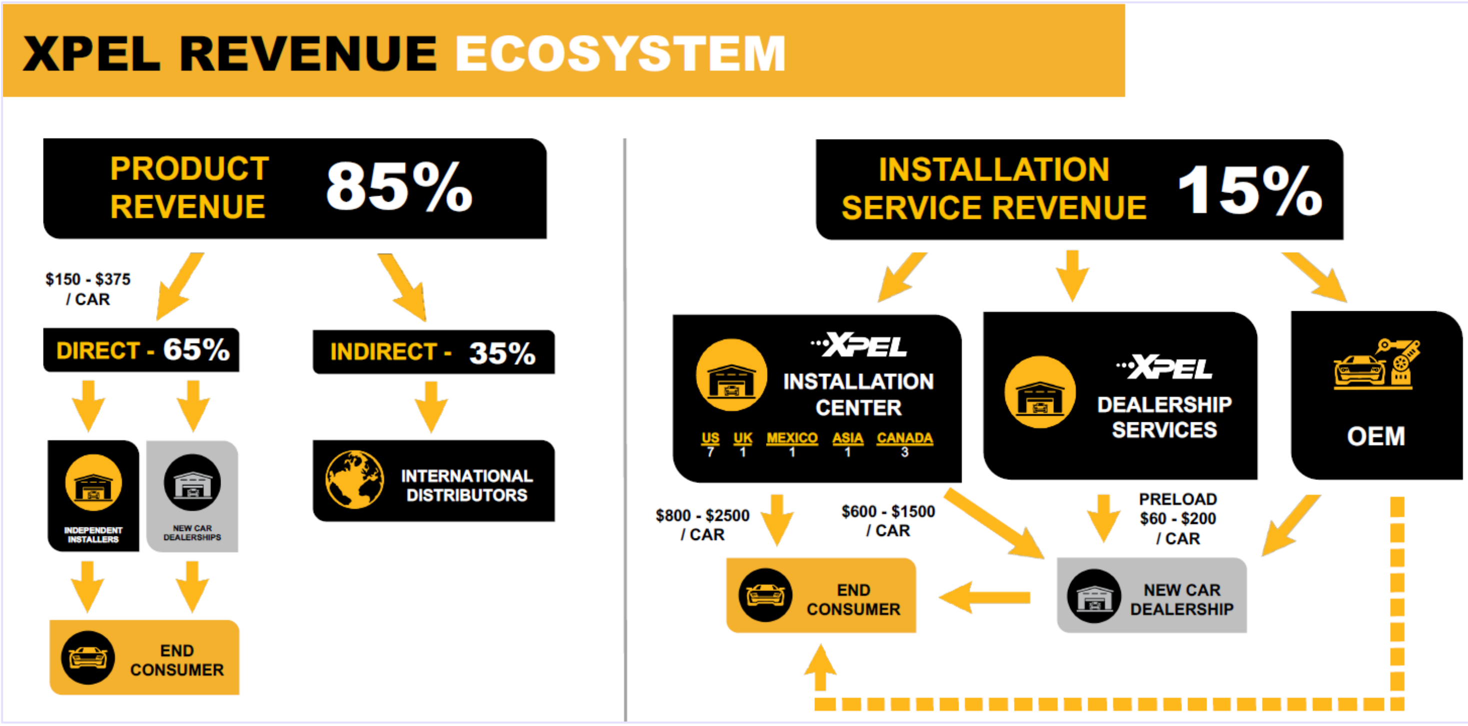
Garware has been manufacturing SCF for over two decades, however it lacked front end activation which is key in this business given its branded nature.

It is only in last 6-7 years when it has really been proactive in growing this business line by improving its front-end presence.

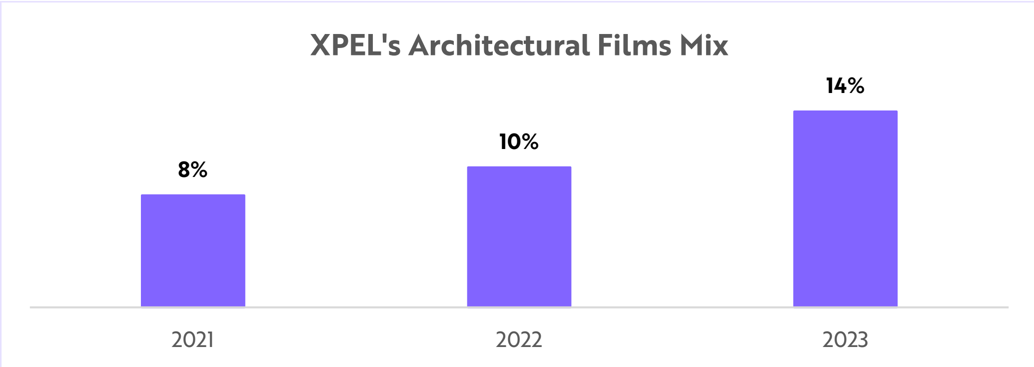
PPF is an adjacent product to SCF and is sold through the same distribution channel. But despite having an existing end-to-end setup (manufacturing to distribution), Garware never really focused on PPF in the past. But in last few years it has filled that gap by introducing PPF in 2021.

Proactiveness of Garware is also visible if we look at what the industry leader- XPEL is doing.

- XPEL is the industry leader in PPF in the US markets. The company initially started as a software business providing software used to pre-cut PPF films for different car specifications.
- In 2010, it then entered selling the PPF itself wherein it adopted a different approach than the existing players like 3M by focused primarily on the branding & front-end vs manufacturing.
- It adopted a direct approach wherein instead of selling to distributors, it tied-up with end applicators and in turn made them XPEL branded franchisees. It also tied up with auto dealers wherein it provided its own applicators to offer PPF application services. In short it created a direct distribution channel, while outsourcing manufacturing.



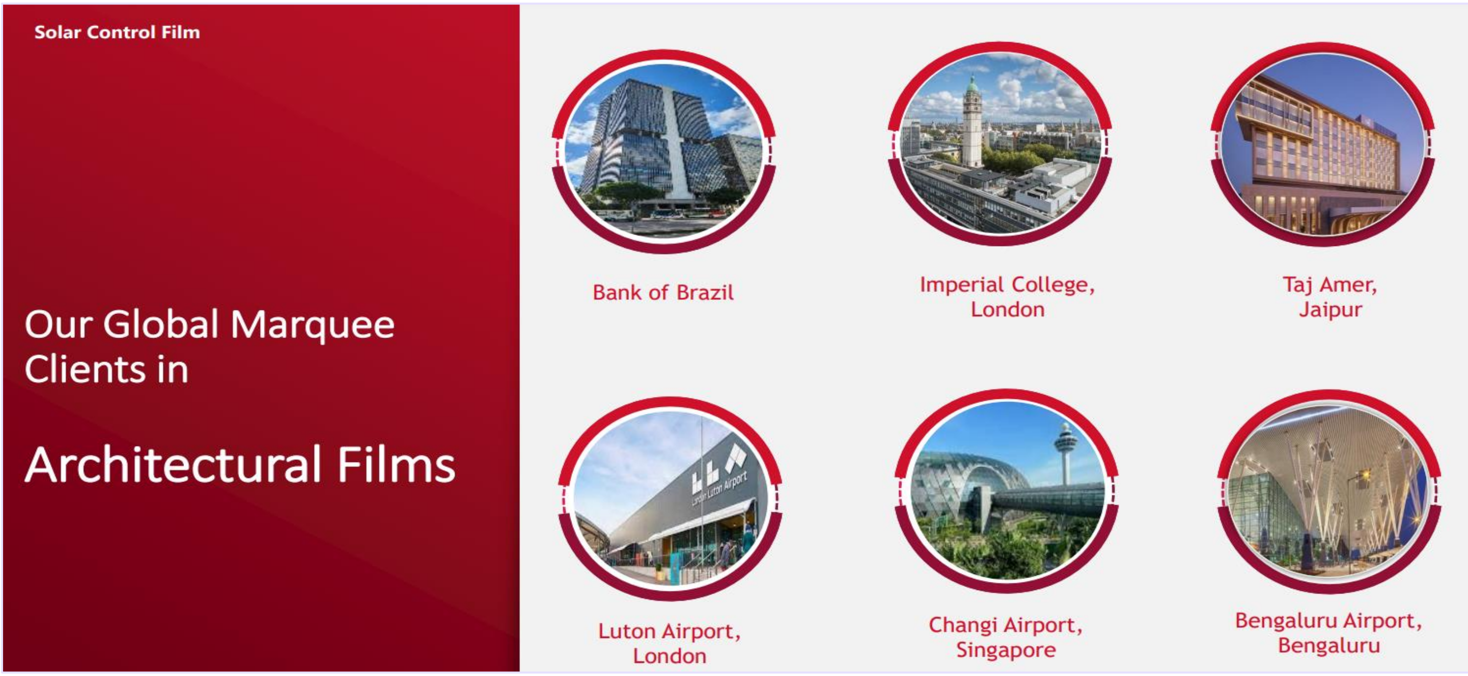
In recent years, XPEL has introduced architectural films within its SCF segment;



Architectural film is a growth segment within XPEL's solar film business.

(note: distribution channel for architectural films is different than automative films)

This time rather than sitting idle for years, Garware has been quick to enter architectural segment in 2022;



Snippet from Garware's Q4FY24 concall-

Deepak Joshi:	Domestic, actually, if I bifurcate the growth story, so there are three segments. So, I will speak first, like overall growth, which the maximum growth we are expecting from architectural segment, as we mentioned that we have made a separate dedicated teams and made separate products for architectural segment, because we have been in the past always been viewed as a Company which is fully dedicated to automotive segment. With our efforts since last two, three years working, now we have full team, which is dedicated to architectural segment and we have launched many new products in that, which is DecoVista series and Spectra Pro series and some of the Rooftop is also being applied in that segment. So, with this, we expect a very good growth, almost double the growth on architectural segment. That's one we are committed to deliver in that way.

Indian market is another growth opportunity that XPEL has been talking about recently;

Snippets from XPEL's recent concalls-

> Other points in Asia, Latin America, India also, these are priority markets for us for deeper investment and engagement using everything we learned in the other markets where we've gone direct and then in China, as a particularly interesting comparison, especially when looking at the strategy for a market like India. So, this is an area of tremendous work for us,

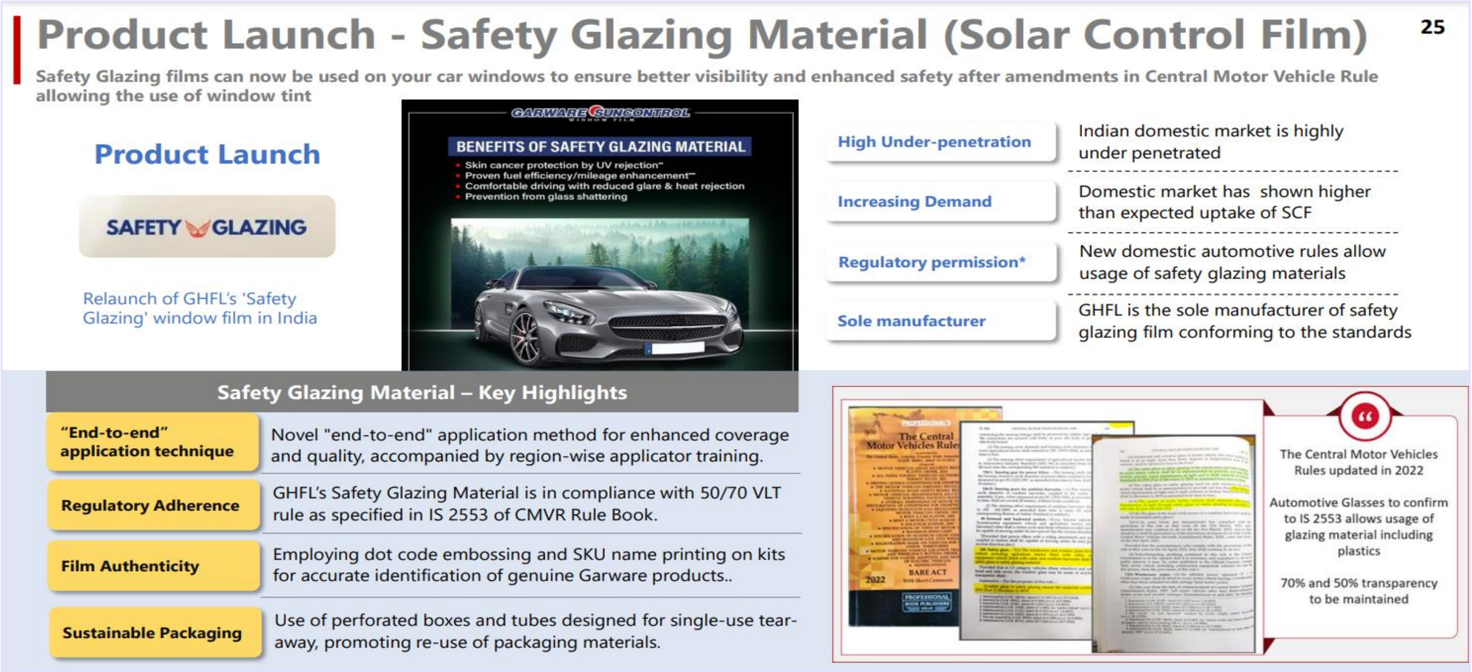
> So I think we're very active on that. I would expect to see what we're doing there evolve next year for the better based on all the feedback we get and whatever modifications to the go-to market. And I guess similarly to India, India is a market that we have very little revenue from today, but we see the great prospects for development as the country development - country continues to develop, and per capita incomes grow and the number of people at higher incomes continues to grow.
>
> And I think one of our lessons candidly from China applied into India is that we need to be on the ground and we need to be present not to say we have to - there's no room for local distribution, and there's no room for a bifurcated go-to-market strategy. All those things are on the table. But we need to be there and be present at the very beginning. And so that's what you're seeing us do with India. We're relocating a leader from Texas to India to lead that.

> eliminate the lumpiness of our China business in terms of sell-in versus sell-through. And as we're doing with China, we're also establishing our first facility in India which will be opened at the beginning of the year and looking at a more direct approach for that market as it develops and as it's in its infancy.

> And the rest of the world outside the U.S. and China had a good quarter, growing a little over 30% record quarters in Europe and A-Pac and Middle East, Latin America. Again, Q1 is typically the lowest quarter for these regions as well. So continued good performance there. And our operation in India is well on way as well on the way to being fully established and it's going to provide a lot better support for our customers in the Middle East and our expansion there. So very pleased with how that's going in addition to what we plan to do in the domestic market in India. So good progress.

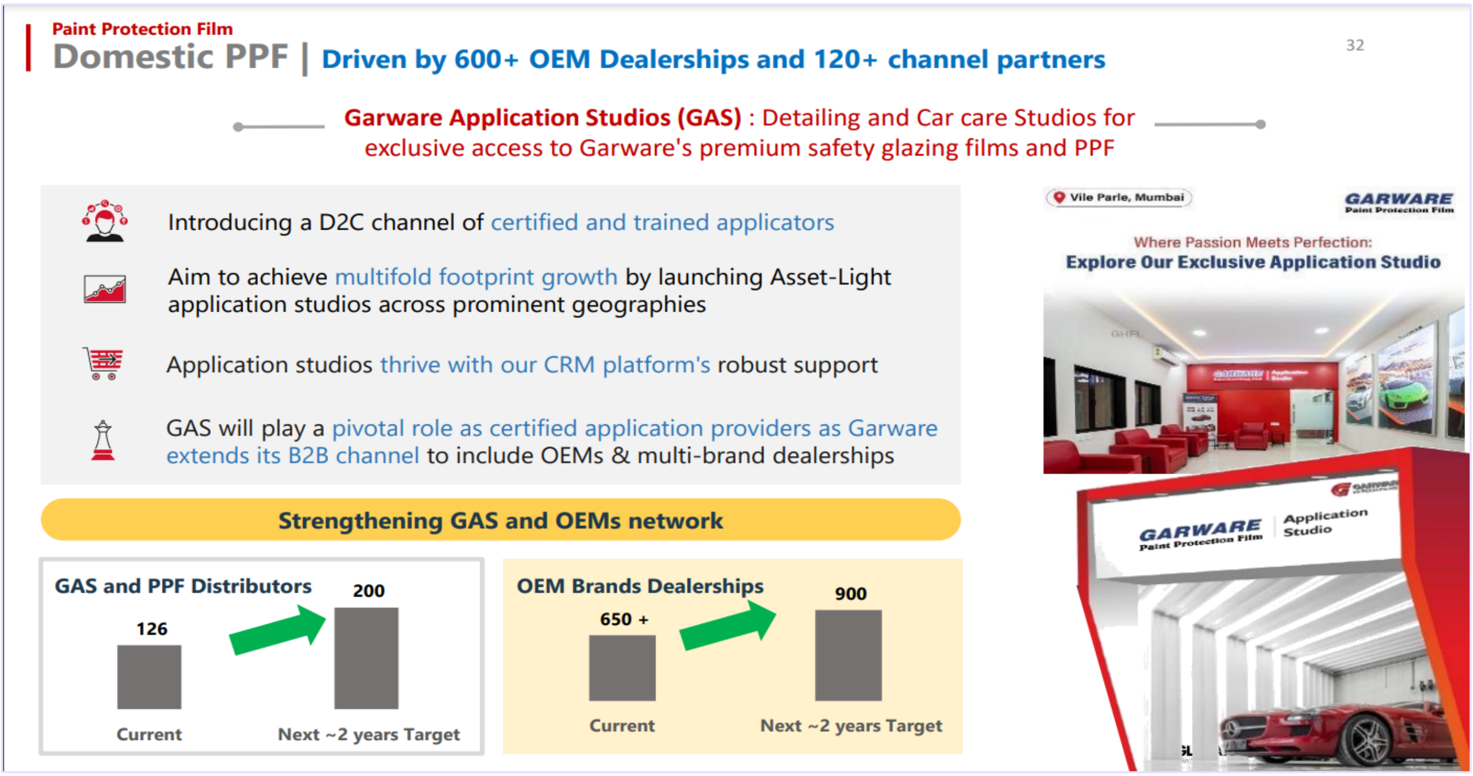
Garware has been proactive in seeding the opportunity in India. Earlier tinting of car windows was prohibited under Indian law; however, some recent changes has allowed certain types of films.

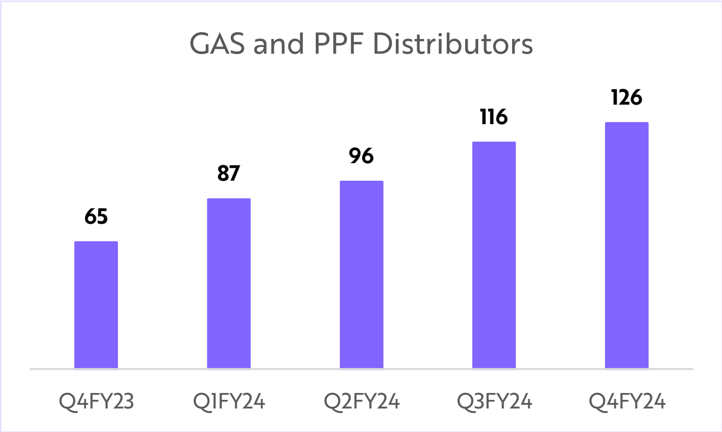
Garware has been quick to re-introduce its SCF that conforms to the new guidelines;

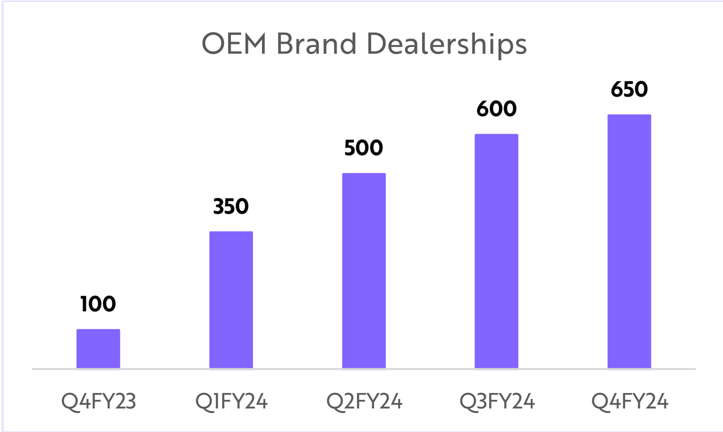


Another interesting aspect is that within India, Garware is looking to do something similar to what XPEL has done in the US in terms of distribution & branding.

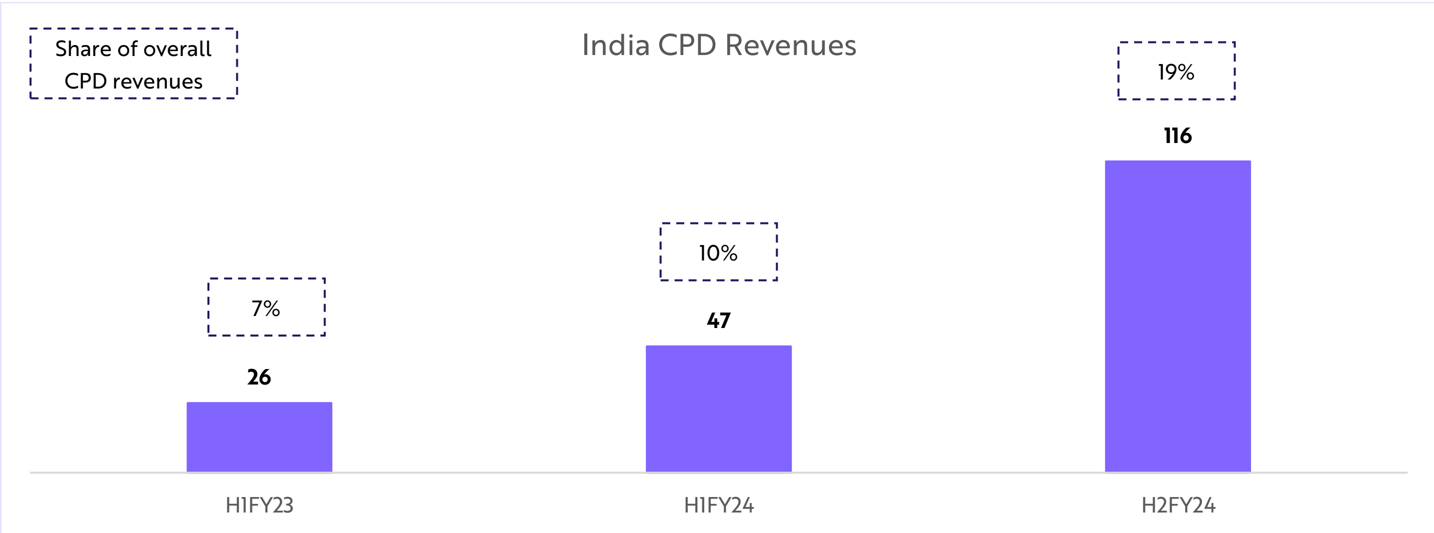
It has been partnering with its distributors to open Garware Application Studios which will provide SCF & PPF application services to end customers and is also signing up with OEM dealerships to provide SCF & PPF services to new car buyers directly from dealerships.







Garware is already seeing strong traction in the domestic markets; India contributed to ~15% of total CPD business in FY24-



So CPD is where the opportunity lies for Garware both in terms of growth & better profitability, it is where its focus has been since last few years and is also where it has been investing heavily;

FY21

Rs135 crores

1st PPF Line

FY22

Rs135 crores

New SCF line, 75% increase in capacity

FY25

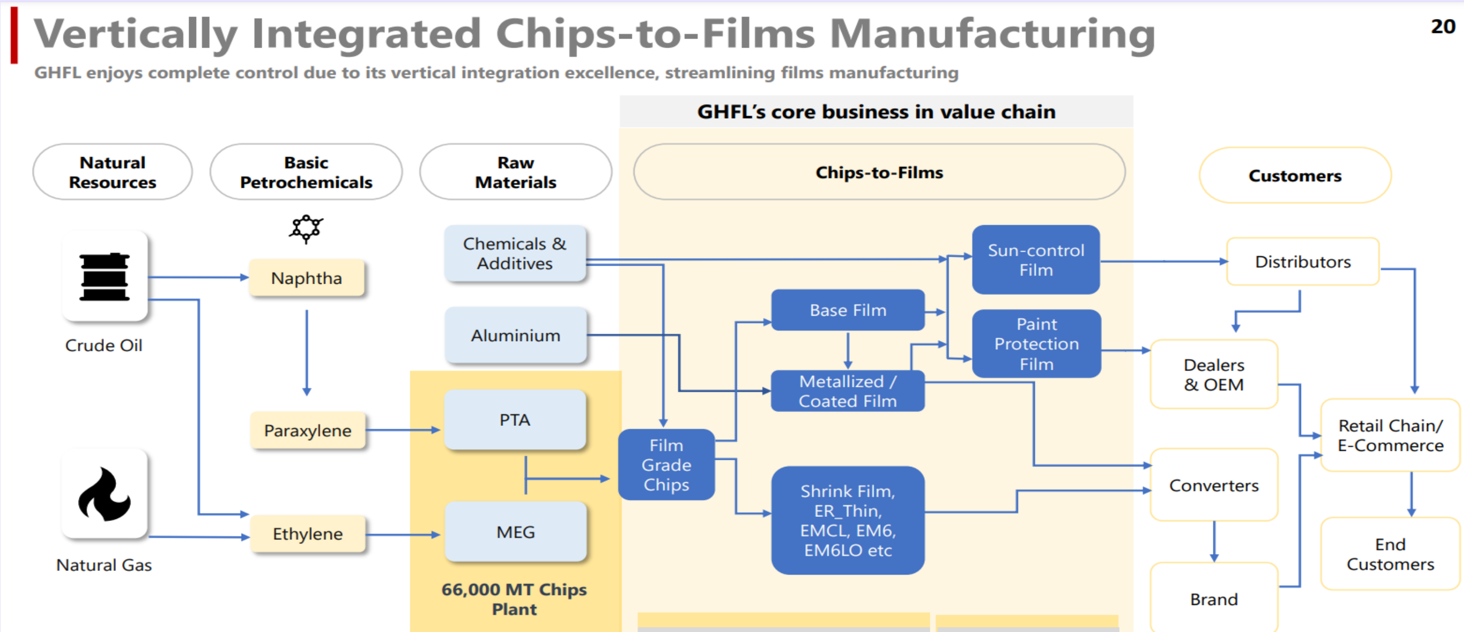
Rs125 crores

2nd PPF line; doubling of capacity

CAPEX

Another important point that we want to highlight is the possible margin upside in the PPF segment.

Garware is highly backward integrated within its SCF segment wherein it manufactures all the components including adhesives in-house.



Within PPF it initially started with buying some components from outside and once the product got established, it is now looking to backward integrate within PPF as well.

Snippet from Q1FY24 concall-

Yogansh Jeswani: A couple of questions on your PPF business. So, if my understanding is correct, your Sun control films is quite strong because of the backward integration that we have, while in the PPF we still aren't very backward integrated. We are still importing couple of films and adhesives and then working on it in our facility. So, if you could share what is the technical expertise that we have in PPF, how much is the value addition that we are doing, and how confident are we in terms of being able to make margin similar to how we have in SCF given the limitation that we have in terms of backward integration?

Deepak Joshi: So, on PPF, this is relatively a fairly new business for us. So, to stabilize the quality, we have used some top of the class products to start with, but we have actually almost all the components developed except one major film, which is a different segment which is not a polyester film. So, apart from that, all the components and adhesives and everything have been developed by our in-house team, and it will take some time. Your understanding it, I would say, outstanding. So, in going I can say six months to one year's time, we will be, I mean, we have developed everything, but once the product is stabilized, we have taken three years of hard work to penetrate into the market. So, before going to market with changes into the product, we always be doubly sure or triply sure, and we do our own aging test, accelerated weathering tests and lot of other tests before we put any minor change also takes a big, I mean, a long time period of validation process whichever R&D and NPD team does that. So, Mr. Adsul, if you would like to add anything on that?

Deepak Joshi:	So, our backward integration from petrochemical to resins to polyester films to thermal lamination to dying of the same and then going to metalizing and finally lamination and also some of the part of PPF. So, it really gives us a very good, I mean, I would say realization as compared to the competitors. Even if the top of the line in USA, they buy their adhesives or they buy their codes or they buy their material, base material from outside, whereas in Sun control, we do most or almost everything by ourselves. So, that gives us a very good competitive advantage both in terms of pricing and at the same time on quality and consistency of the product, whereas on paint protection films, we have not been able to use our components 100%. So, most of them are ready with us, but it will be a process of six months to one year where we will be able to penetrate all whatever we manufacture the component to put into the PPF and their margins will also significantly improve EBITDA margin on PPF side also.

EXPECTATIONS GOING AHEAD

We believe that Garware will see continued all round improvement on the back of sustained increase in share of CPD business.

The company has guided for Rs2500 crore revenues by FY26 (~20% CAGR) which we believe is doable given company's focus, traction and the recent investments in the CPD business.

The growth will be supported by further improvement in profitability led by increased CPD mix, upside from PPF backward integration and some upside from mean reversion in commodity product's margins.

We are buying the stock at ~20x its FY24 profits which we believe is very reasonable for the growth & branded profile of the business. The reason for this lower valuation is because most market participants have ignored the major transformation that has happened in the business & its future potential, on account of some smaller issues of corporate governance (discussed below).

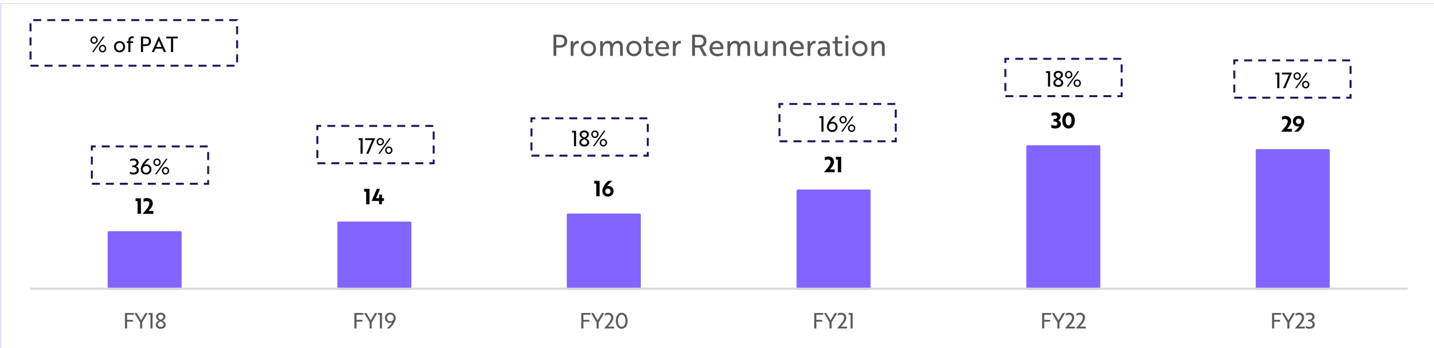
We expect significant re-rating in company's valuations overtime.

RISKS

1. Issues of Corporate Governance?

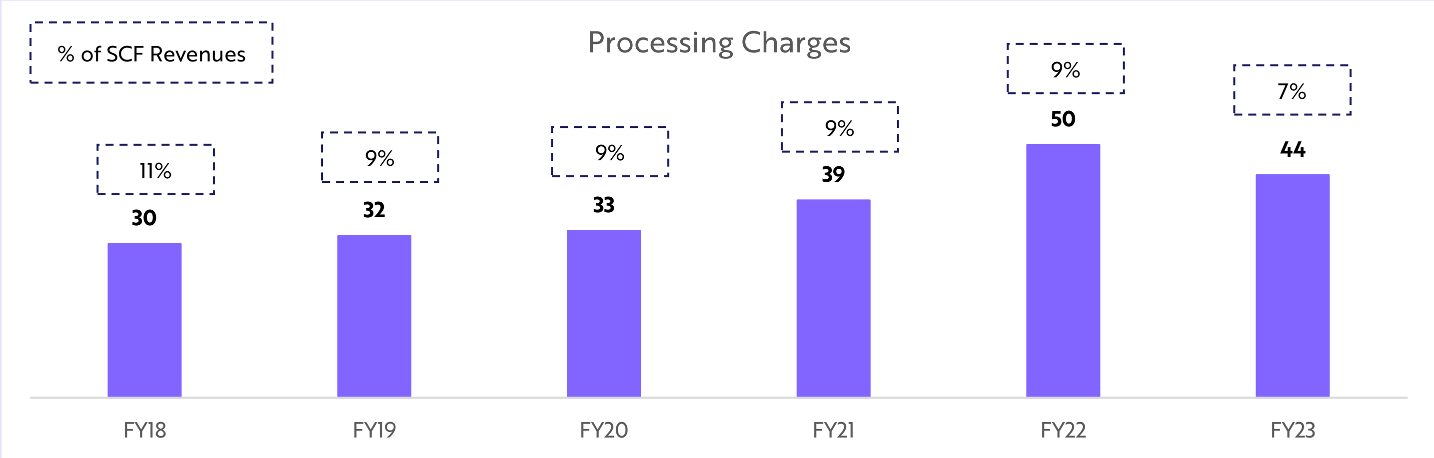
Most investors highlight three areas of possible poor corporate governance;

a. High Promoter Salaries



b. Processing Charges

Promoters has a company called- Garware Industriees. Garware Hi-tech pays a processing charge to this company for carrying out a certain dyeing process for its SCF product.



Management's rational here has been that this is a patented process that only two companies hold in the world. Promoters had setup this company & plant at a time when the listed entity was facing financial difficulties and over the years have invested in this company to meet the growing requirement of the listed entity.

c. Surplus Cash and Land Bank

As of FY24 end, Garware has a net cash surplus of ~Rs388 crores, plus it has some surplus land in Nashik and Mumbai.

Investor's contention is that company should look to distribute this surplus cash including proceeds from selling the land.

Our take on these issues is that, these are already discounted in the company's existing profitability and valuations and thus downside from these is very low, instead these are optionalities that can play out in the future.

Anyone who has invested in small caps for long enough would know that high management salary is one of the most common issues in smaller companies and that it gets resolved overtime as the business grows. The % of salary to net profits is not growing here.

In case of processing charges, the number has been stable to declining as a % of revenues.

In case of cash, the company has become debt free only in last few years and has stated multiple times that the Nashik land is already on the market and that they are looking for a right price to conclude the sale. And in terms of Mumbai land, there are some regulatory challenges which is making sale of that property difficult; the company is currently using that property for its corporate office and also has a Garware Application Studio on the property. And thus, it is too early to judge whether the company is willing or not willing to distribute surplus cash to its shareholders.

2. White Labelling

Within its SCF and PPF business, Garware also does white label manufacturing for other players given its large manufacturing capacities.

In FY24, PPF business has seen exponential growth of 6x. Though not directly confirmed by the management, but based on commentary from XPEL and Garware, it is evident that Garware has started supplying to XPEL post XPEL's recent tussle with its old manufacturing partner Entrotech and that has been a key contributor to this growth.

In future any slowdown in XPEL business or change in XPEL's sourcing can have a material impact on Garware's PPF business.

Management has stated in Q4FY24 concall that ~60% of PPF business in FY24 was from white labelling and remaining 40% was own brand.

3. Industry Disruption

In 2023, Entrotech (PPF film manufacturer & XPEL's main supplier) and PPG (major automative paints manufacturer) announced a JV for paints films business.

Paint films are essentially PPF films with an added layer of paint. This product is positioned as a replacement of factory paint and after market PPF with a single product that OEMs can use instead of traditional paint application method.

Entrotech has been manufacturing paint based PPF films since 2019. The goal of this JV is to bring the product into mainstream adoption by combining the strength of both the firms.

If the product finds mainstream acceptance, then it will do away with the need of PPF and disrupt the whole industry.

Based on what we have read about the same, the likeliness of this disruption is very low in near-medium term given the cost & application challenges with the product.

Ratings Explanation:

Buy: Expected total return (price appreciation plus dividend yield) of more than 10% over next 12 months.

Hold: Expected total return (price appreciation plus dividend yield) of +/- 10% over next 12 months.

Exit: No Further Coverage/Update on the stock.

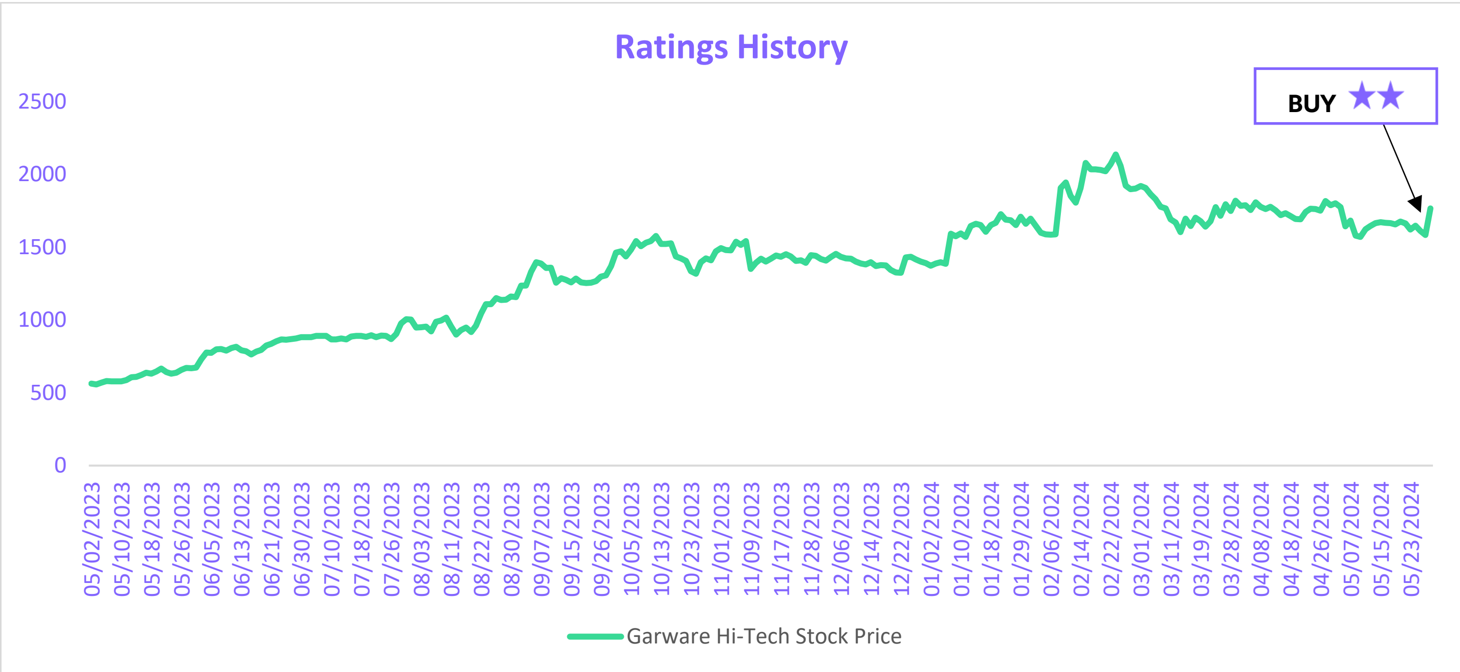
Conviction Rating:

Conviction rating reflects our understanding of return:risk ratio of the underlying stock for next 12 months. The rating is given within a range of 1-5 stars, wherein each higher star reflects a higher return:risk ratio; so, 1 star indicates a low return:risk ratio and 5 star indicates a high return:risk ratio.

The rating is based on our qualitative understanding of how the four factors of- Price Action, Earnings Growth, Valuations & Perception will play out over next 12 months for the stock.

Conviction ratings are to be read along with Buy & Hold ratings and no conviction rating is assigned for stocks with Exit rating.

Note: Ratings are valid till changed.



Note: Above chart indicates ratings assigned (including changes) over the period of coverage of stock.

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No associates

Analyst Certification

Analyst: Ankush Agrawal

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Analyst Ownership of Stock: NO

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Whether it or its associates have received any compensation for investment banking or merchant banking or brokerage services from the subject company in the past twelve months- **No**

Whether it or its associates have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past twelve months- **No**

Whether it or its associates have received any compensation or other benefits from the Subject Company or third party in connection with the research report. - **No**

Whether the research analyst has served as an officer, director or employee of the subject company - **No**

Whether the research analyst or research entity has been engaged in market making activity for the subject company - **No**