SURGE CAPITAL

25 February 2022

RACL GEARTECH

Rating: Conviction Rating:

BUY ★★★

Price: Rs537

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

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

Industry:	Auto Ancillary
Market Cap:	Rs 584 Crores
Revenues:	Rs 268 Crores
Net Profits:	Rs 27 Crores
Net Debt:	Rs 149 Crores

✔ *Indicates attributes present in the stock*

Brief Thesis

RACL Geartech is an auto-ancillary manufacturing precision gears and related parts for 2-Wheelers, 3-Wheelers, Agriculture Equipment and Recreational vehicles. Company has a strong value-added manufacturing business on the back of low-volume & high-value products for high-end vehicles of customers like BMW, KTM, Kawasaki, Kubota etc and derives 70% of business from exports.

Company's value proposition is further evident by its ability to provide high customization, high precision, large SKUs and all manufacturing processes to its customers. Such value addition has allowed RACL to generate Strong margins, High ROCE and maintain High Client Stickiness.

Company would invest nearly Rs100 crores in capex over FY21-FY22 combined. This capex is backed by firm customer orders and provides good visibility on growth going ahead.

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Value Added Manufacturing Business-

B2B Manufacturing businesses are typically not a great business to be in. Manufacturing is highly capital-intensive business with high fixed overheads and thus running plants at maximum utilization as much as possible is important. And this is relatively easy to achieve by doing manufacturing of a single or couple of large volume mass market products that are required round the year on a continuous basis.

But in such a model, it is very difficult to establish a differentiation compared to other players whom you are competing with; resulting in a situation wherein the power rests with your customers, resulting in lower margins and lower stickiness of business.

However, there are few ways in which one can differentiate-

1. Being the lowest cost producer (This allows stickiness but rarely high margins)
2. Ability to produce something that no one else can on the back of some patented process or technology (Rare situations)
3. Provide Value Addition

Value Addition can be provided by addressing customer's requirements around areas of-

LOW VOLUME PRODUCTION	**SERVICING LARGE SKUs**	**HIGH CUSTOMIZATION**

1. Low Volume Production:

Some customers' requirements are very small, wherein they don't require a product every week or every month round the year., rather they require small batches of products maybe couple of times a year. Not everyone can do this given that it would result in only part utilization of capacity and thus requires one to acquire large number of projects in order to utilize capacity well. Further, small volumes are typically required by premium customers with high-end products and it is difficult to acquire such premium customers.

2. **Servicing Large SKUs:**
   Manufacturing large variety of products is difficult for most manufacturers as either it would require separate production line for each product or it would need switchover in the plant & machinery every time a different product is required to be produced, resulting in downtime and thus lower utilization. However, in some industries the requirements are such that large variety of products are required to meet diverse requirements of various customers. This further adds a level of complexity as one needs to maintain high level of inventory given that it is not possible to produce say 500 kinds of products each month, one has to manufacture say 100 SKUs in one month & 100 SKUs in another month and keep the inventory ready to meet a customer's demand.

3. **High Customization:**
   This adds to another level of complexity for the manufacturer as providing a customized product as per customer requirement would mean that the manufacture would have to invest time & resources to develop the product and implement the custom process in its manufacturing process.

We have seen that a manufacturer whose business model is such that

-It Can Accommodate Low Volume Products

-Service Large SKUs & Maintain Large Inventory

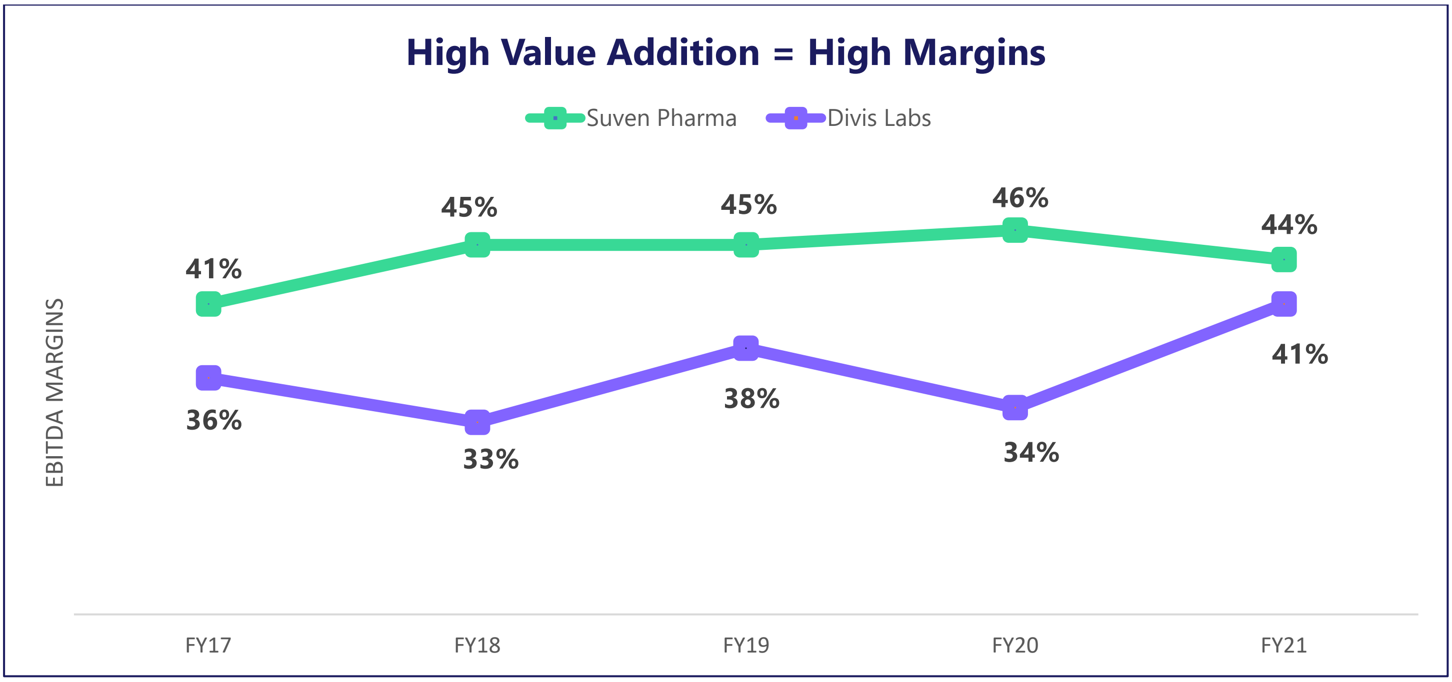
-Offer Customization To Its Customers

Command Premium Pricing, Higher Margins, Better Client Stickiness and High Growth Opportunities, resulting in a Strong Business Model.

We have seen this play out across industries and businesses, few of which includes-

1. **Contract Manufacturing for Innovators in Pharma Space (CRAMS/CDMO)**
   CRAMS/CDMO business models are working on the same principles that we discussed above,
   a. They are manufacturing drugs for Large Pharma companies that are under development and thus are needed in only small quantities.
   b. Their customers do not require these drugs round the year, instead they require the same maybe once-twice a year.
   c. CRAMS/CDMO players undertake larger number of such low volume projects in order to utilize their capacities well.
   d. Not everyone is able to do CRAMS/CDMO with innovators given that it is difficult to establish relation with such Large Pharma Companies. But once the relationship is established, it continues for decades.
   e. Each product that they have to manufacture are different and are highly customized as per requirements of their customers.

Companies like Suven Pharma and Divis Labs who are able to do so have created a strong business model wherein they command very high margins, have high client stickiness and good growth opportunities.



2. **Off-Highway Tires Industry**

Off-Highway Tiers are tires for Agriculture, Construction, Mining vehicles etc. The industry dynamics are such that a manufacturer needs to work with low volumes & high varieties of products. Reason for the same being that these vehicles are not mass-market products and their tires are huge and thus are not mass produced, but are produced in batches and that too in a variety of configurations. And since not everyone can handle low volumes & high varieties, the industry is said to be highly concentrated with top 4 players commanding ~70% global market share.

Balkrishna Industries is an Indian tire company that has focused on this low-volume & high variety manufacturing and using the low-cost base of India created a very strong business model; and have created huge wealth for investors.

~27% 5-Year Avg. EBITDA MARGINS	**~21%** 5-Year Avg. ROCE	**~34%** 5-Year Stock Price CAGR
~12% 5-Year Revenue CAGR	**~16%** 5-Year Avg. EBITDA CAGR	**~21%** 5-Year PAT CAGR

Balkrishna Industries FY21 Annual Report Highlighting the same…

The key product range of your Company is Specialty Tires commonly known as "Off Highway Tires" which caters to Agriculture, Industrial, Construction, Earthmoving, Mining, Port, Lawn and Garden and All-Terrain Vehicle (ATVs) Tires. The Company's Carbon Black Product which is mainly used for captive and partly sold in Market has been well accepted in terms of quality.

The Tire segment is highly technical & capital intensive and known as "large varieties low volume segment" where any credible player needs to maintain large number of Stock Keeping Units (SKUs) to meet the diverse requirement of its customers worldwide. Apart from this, it needs to service its clients pre & post sales. While the sub segment (agriculture) is largely known as non-cyclical in nature, the other sub segment (industrial, construction and mining) is generally considered as cyclical and the performance of it is largely linked to overall economic outlook of the world. The market for Company's range of tires is mainly Europe, America, Australasia and India.

3. Personal Experience

One of our family relatives runs a Woven Sacks business. Even though the standard business practice is to manufacture some standard SKUs which it required by larger customers, they have instead focused on catering to smaller volume customers wherein the requirements are quite diverse and requires customization. This model of doing smaller volume and higher varieties has allowed them to generate higher conversion per Kg than what others in the industry generates and has allowed them to scale business quite well.

Value Addition in RACL's Business-

RACL's business model is based on the same principles of value addition.

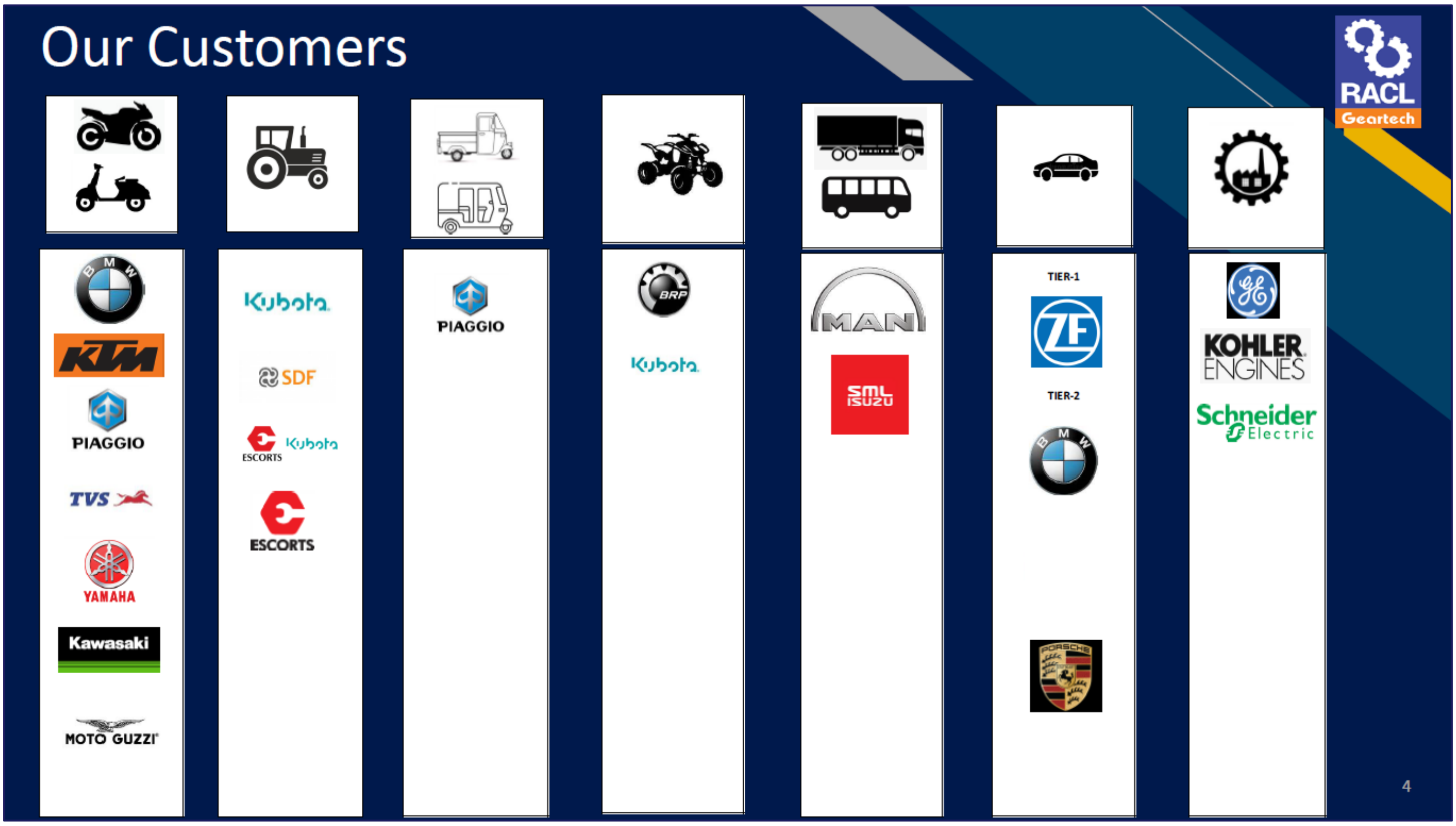
1. RACL caters primarily to high end vehicles of premium customers. Its customers include the likes of BMW, KTM and Kawasaki in 2W which produces very high-end bikes that are high value products but are sold in less quantities and thus require high value parts but in less quantities.

   To put this in management's words,

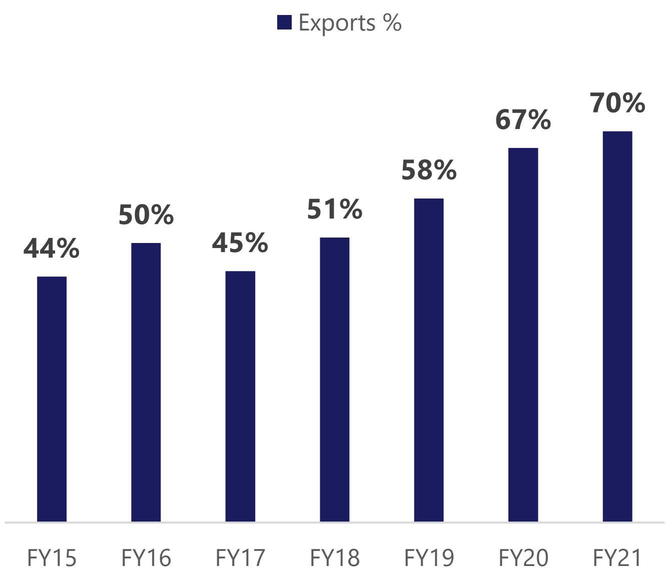
   > **"A 2-wheeler vehicle manufacturer in India, let's say produce 6,00,000 vehicles a month, whereas our customer produces 100,000 vehicles in a year"**
   >
   > -Gursharan Singh, MD RACL Geartech

RACL derives 70% of its business from exports to such high value & low volume premium product customers. Company has recently entered into the 4-Wheelers space through ZF (big auto-component manufacturer globally) and its initial two projects are with premium vehicle manufacturers- Porsche and BMW, which further indicates its strong focus on low volume-high value products.

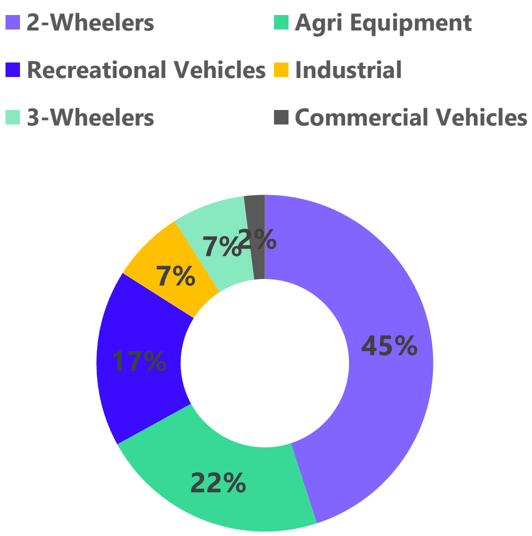
RACL's Customer Base...



Growing Exports



FY21 Business Split



2. RACL manufactures large number of SKU's (>500) and carries relatively higher inventory for its customers. This value addition not only allows it the ability to service varied needs of its customers but it also allows it to command higher pricing for the same. This part of business was very well explained in the recent concall-

> "When we are to produce say, 800 different parts, it's not that all 800 kinds of parts I'm producing every month. Some month, we are producing 100 components of X variety, the next month again 100 pieces of X/Y/Z variety. So, I have to maintain certain minimum inventory levels of our raw material and WIP as in the Premium segment and the volumes are not very high. **We have 20 active customers, with totally different brands so eventually we have a large variety of products, so we have to keep inventories of the tooling and raw material, but our product costing is built in all this and we are charging the same from the customer**."
>
> -Q2FY22 Concall

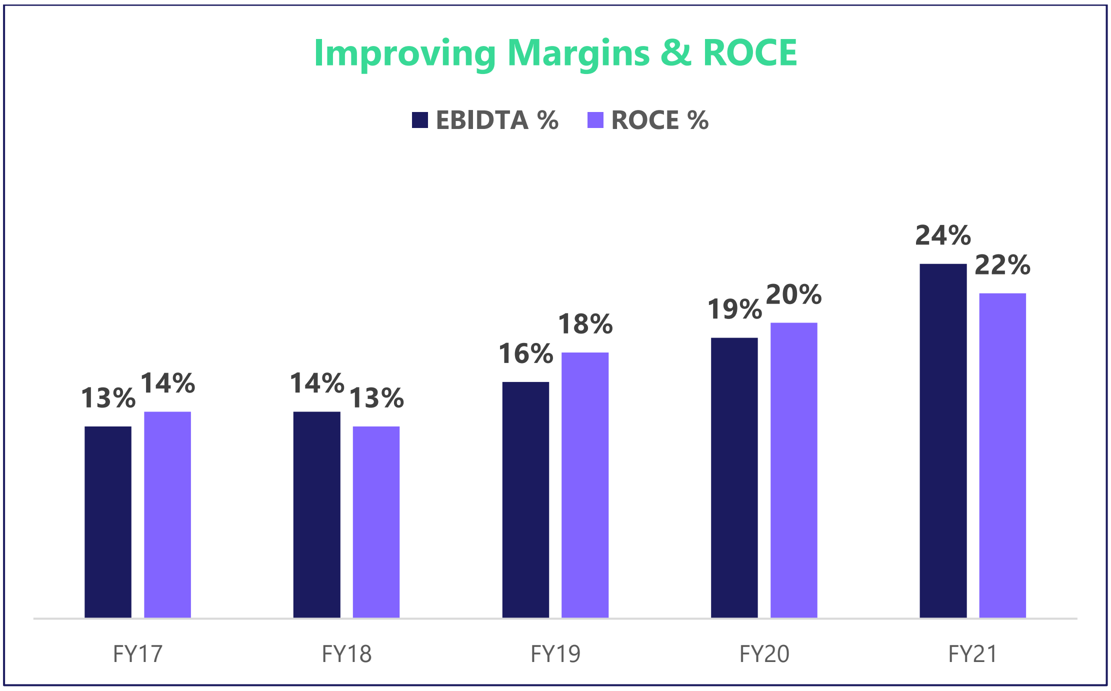
3. It offers highly customized products to its customers. In-fact, 10-15% of company's workforce actually works in tandem with the customer's R&D on process development and concurrent engineering. Further, company has always focused on upgrading itself to provide solutions that are needed by its customers.

Snippet from Q2FY22 Concall...

> The biggest thing is that customer wants solution under one roof. And gear business or this precision components business is a very, very complex product. So, RACL has been actually very unique in defining our strategies for the last 10 years. We invested on the global technologies and build up a completely integrated set up under one roof. You can produce gears by 'n' number of processes, so, we have all the processes available within our company. The reason is that our company produces a very low end 3 wheeler component and we produce some parts for the Aircraft also. So, eventually, we have technologies which suits every product, which suits every customer and which suits every product requirement, or the customer demand so, we are kind of a conglomerate of all the technologies available and, as I said earlier also, this doesn't happen overnight. This is a long sustained effort strategy, which we grew about 15 years back. You know, RACL was the 1st Manufacturer to export gears to Japan in 2005 and in those days, company literally came back, it just came out of bankruptcy. But even then we followed this strategy. From there on, we're investing the way, customer is demanding but we have always invested judiciously. Whatever the customer demanded, we started investing in it, and, of course, every customer had different expectations, different demand. And by and by, we invest in general purpose kind of technology, which is not dedicated for a particular product or for a particular process. The customer comes to us and we provide him all solutions. He's happy. We are happy and we are able to grow continuously with this strategy.

This ability of RACL to manufacture low volume & high value products and ability to deliver large SKUs and highly customized products has resulted in a strong business model; with-

1. **Higher Margins and Strong Return on Capital**



ROCEs have more room improve given that recent large capex is yet to start contributing to Revenues.

RACL has one of the best Margins & ROCE matrix in the auto ancillary space; a clear indication of value addition nature of business.

2. **High Client Retention and Growth**

Many of RACL's contracts with its customers are very long term in nature running over 10 years with commitment towards volumes. It has been supplying parts to Kubota in Japan for nearly 15 years now.

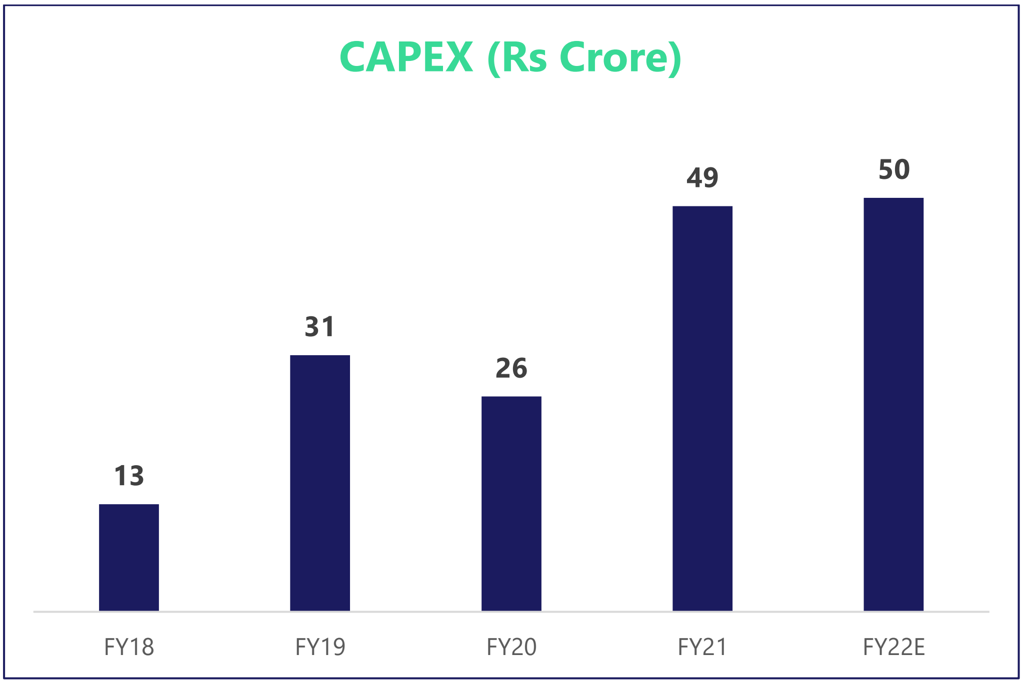
Company had recently worked with BMW on their 1st EV scooter- CE04

RACL is the Sole Supplier for next 10 Years

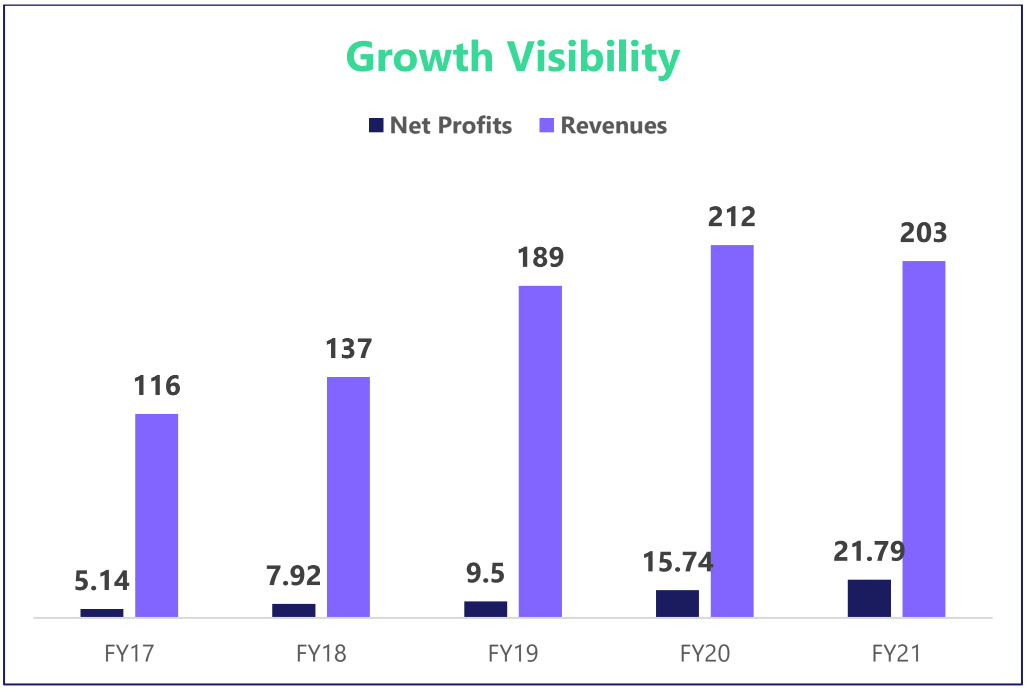
Growth visibility in the business is also good as company first looks for customers and then make investments. In FY21, company undertook a ~Rs50 crores Capex. This capex is towards new project from ZF wherein the entire plant is built around a specific product in-line with order specifications provided by the customer.

According, to the management, "This product has come into automotive industry only in 2015 and before 2015 this product was not there altogether in the vehicle itself. It is a new kind of feature coming into premium cars and at ZF we were shown this product and asked if we can produce the same. Today after the production starts, we will be one of the leading players in this product."

RACL is undertaking another ~Rs50 crores capex in FY22 which further adds to growth visibility.



LARGE CAPEX ON A SMALL REVENUE BASE OF RS200 Crores



GUIDANCE OF Rs500 CRORE REVENUES BY FY25

Expectations Going Ahead-

We expect RACL will continue to capture growth opportunities on the back of its strong value-added business model. Company has guided Rs500 crore revenues in FY25, which is a good 20% CAGR from here. As per management, the company has already tied up or is in advance stages of negotiations to attain this target and given the visibility on the back of capex, we believe that company should be able to achieve the same.

We also believe there is a case for some margins expansion as the scale of business increases and operating leverage plays out, something that has been playing out over last few years. Further, company's ROCE should increase from current level of ~20% as large capex done over last 2 years starts contributing to business.

The stock currently trades at 22x multiple of its trailing twelve months profits, which we believe for a strong business model like that of RACL with high margins, good growth visibility and improving ROCE profile are reasonable.

Risk-

Our core thesis is backed on RACL's strong business model of low volume premium products. If company moves into mass market products, then it would dilute its current business model. Even though management has said that they will do mass products only if it gives long term business sustenance, but our understanding is that it will be dilutive to margins and ROCEs. So, any such transition would be something that we would consider dilutive to our core thesis.

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

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Analyst Ownership of Stock: YES

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