INITIATING COVERAGE

CMP: ₹597/-

15th October 2018

BUY

SECTOR: AUTOMOBILES

Escorts Ltd.

FIRING ON ALL CYLINDERS

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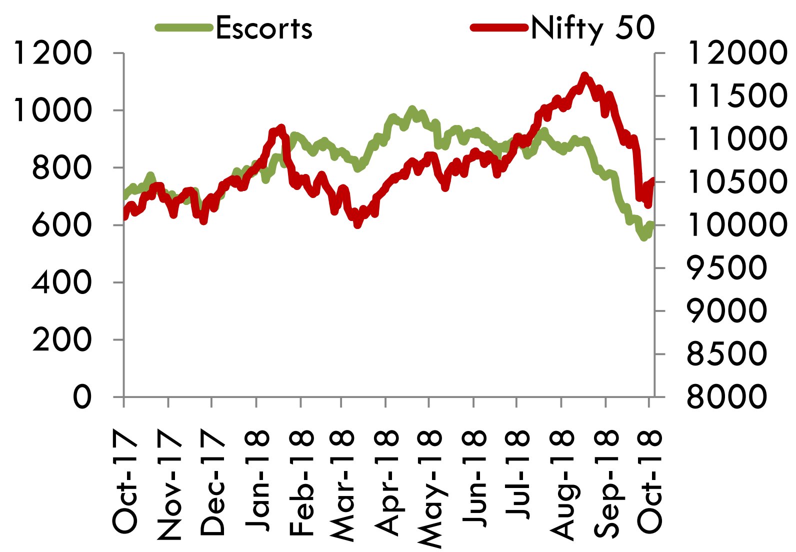
Company Details

Key Stock Data	
CMP	₹597
Market Cap (₹ Mn)	73,221
52W High/Low	1,019/543
Shares o/s (Mn)	122.5
Bloomberg	ESC:IN
NSE Code	ESCORTS
BSE Code	500495

Comparison Chart



Shareholding Pattern (Jun-18)	
Promoters	40.07
Institutions	29.80
Public & Others	30.13

Investment Theme and Valuation

- Escorts has successfully turned around in the past 2-3 years by focusing on (i) new products to stabilize market share, (ii) cost reduction to improve tractor gross margins and (iii) shedding unprofitable ventures. It is now focusing on the next phase of the turnaround where through a dual brand strategy (premium Farmtrac and mass Powertrac) and aggressive distribution focus in opportunity markets, it seeks to improve market share.
- In the second phase of the turnaround, the company's focus is on improving market share in tractors as it seeks to get back to 13-14% market share from 11% currently. Escorts has not only filled white spaces in its portfolio but also extended both its brands- premium Farmtrac (towards lower horsepower) and mass Powertrac (towards higher horsepower). With new products for exports, the company aspires to do volumes of 8,000-10,000 in exports by 2022 as against ~2000 units in FY18. It is also aggressively expanding its distribution network by focusing on taking Powertrac deeper in its opportunity markets (South and West). It also targets a 200-300bps improvement in other expenses by improving shopfloor productivity, combining back-end function across divisions etc.
- Investment in new products has paid off in the railway equipment division too, with orderbook steadily rising from ₹1bn in Q1FY17 to >₹3bn as at Q1FY19. With more products to be launched in the next few years, we believe the contribution of this division would only increase going forward. Material cost reduction efforts are now focused on construction equipment side, where the focus is to take it from 2% EBIT margin to double digit EBIT margins. The construction equipment industry is also cyclically supportive, with ~25% CAGR over FY15-18.
- Escorts earnings growth of 23% over FY18-20E is among the best among auto OEM's, which would be largely driven by 11% volume CAGR in tractors business over FY18-20E and steady EBITDA margin expansion of ~100bps over the next 2 years. With surplus capacities across segments, Escorts has limited capex needs leading to strong FCF generation and healthy return ratios over the next 2-3 years. **At CMP of ₹597, Escorts is currently trading at a FY20E PE and EV/EBITDA of 10.1x (adjusted for treasury stock) and 8.5 respectively. We value Escorts at ₹807 per share by applying 13.7x P/E (10% discount to average P/E of 15.2 of all other auto OEM's) to its consolidated FY20E EPS of ₹59.**

Company Overview

- The Escorts group is an Indian engineering company that operates in the sectors of agri-machinery, construction and material handling equipment and railway equipments. The company manufactures tractors under the brand name of Powertrac, Farmtrac and Steeltrac. The construction equipment division manufactures and markets construction and material handling equipment like pick and carry cranes, backhoe loader, vibratory rollers and forklifts. Railway Equipment Division manufactures and supplies critical railway components such as air brake system, EP brake system, draft gears and couplers, composition brake blocks, dampers and rubber components to Indian Railways.

Tractor Segment

FY18 sales: ₹40.1bn
Contribution: 79%

FY18 EBIT: ₹5,404mn
Margin: 13%

Construction Equipment Segment

FY18 sales: ₹7.8bn
Contribution: 15%

FY18 EBIT: ₹150mn
Margin: 2%

Railway Equipment Segment

FY18 sales: ₹2.8bn
Contribution: 6%

FY18 EBIT: ₹398mn
Margin: 14%

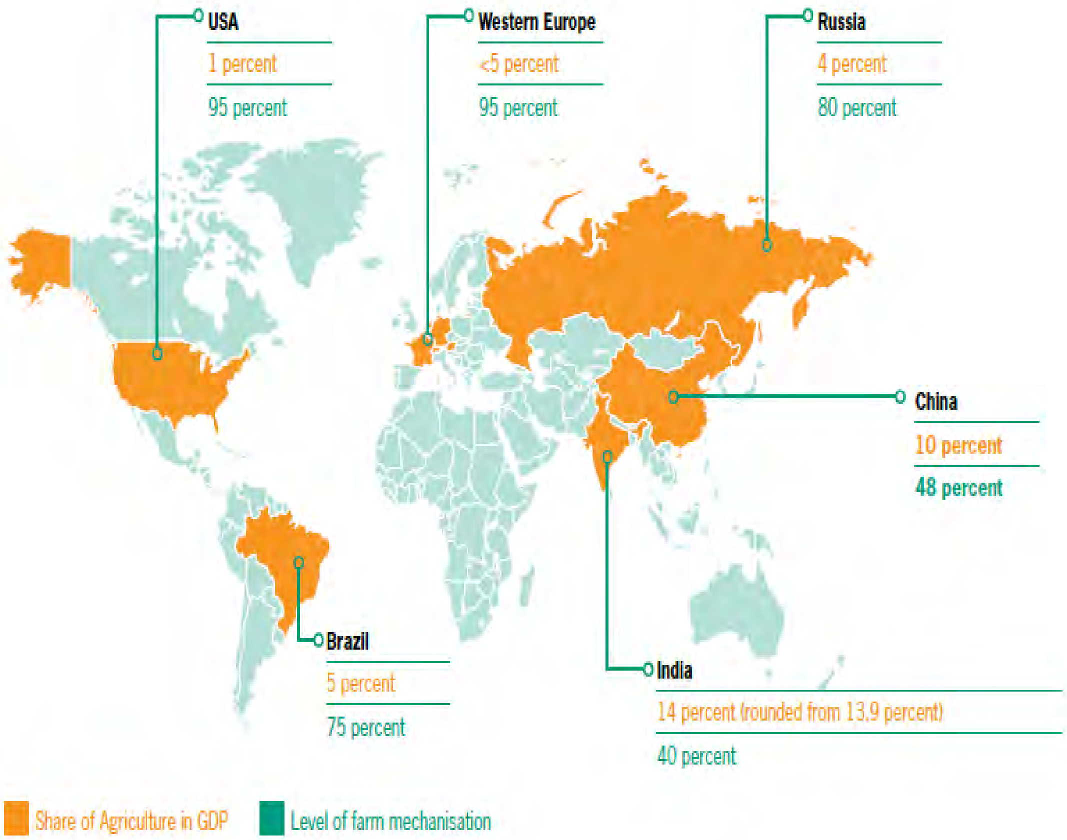
Source : Annual Report, Way2Wealth Institutional Equity

Long Term Industry Positives

Long Term Industry Positives

- **Low-level of farm mechanization to aid robust long term growth**
  - Farm mechanization in India stands at 40% which is still low when compared to countries such as the US (95 percent), Western Europe (95%), Russia (80 percent), Brazil (75 percent) and China (48 percent). While India lags behind developed countries, the level of mechanization has seen strong growth over the last decade. Also, faster increase in real non-agriculture wages than real agriculture wages makes case for farm mechanisation.
  - Farm mechanization has been known to provide a number of social and economic benefits to farmers ,primary one being improved yield that comes as a result of greater level of mechanization. Looming water scarcity crisis along with the need to ensure food security in the country, the benefits of farm mechanization makes it a crucial component of Indian agriculture.
  - Owing to large geographical area under cultivation, the Indian agriculture and allied sector supports 18% of the world's population and 15% of the global livestock. With land and water being limited, there is stress on their availability. Rising population, boost in infrastructure development and limited availability of resources restrict the availability of cultivable land. In comparison to other countries, India's productivity in terms of wheat and rice growth is much lower.
  - In India, the level of mechanization varies greatly in different regions. Northern States such as Punjab, Haryana and Uttar Pradesh have high level of mechanization due to highly productive land in the region as well as declining labor force. The State Governments have also provided timely support in promoting mechanization of farms. The Western and Southern States have lower levels of mechanization due to smaller land holdings prevalent in the region as well as land holding being more scattered. As a result, mechanization has been uneconomical leading to lower development. The level of mechanization has been extremely low in north-eastern states due to factors such as hilly topography, high transportation cost, lack of state financing and other financial constraints.

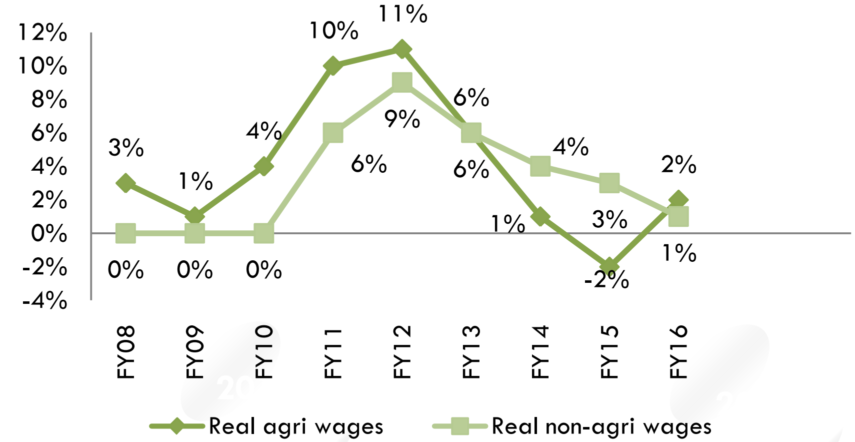
Global spotlight: Share of agriculture in GDP vs. level of mechanisation



Source: World Bank Indicators, CIA Fact book, Mechanisation and Farm Technology Division of Department of Agriculture and Cooperation, Trading Economics, FAO Yearbook 2013

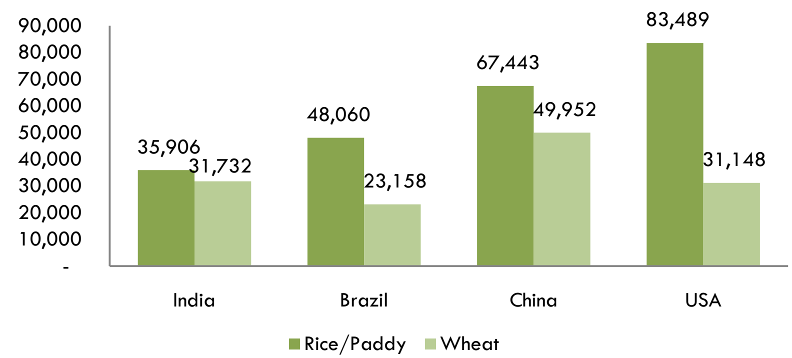
Source : FICCI Report

Real Agriculture Wages vis-a-vis Real Non-agriculture wages



Source : Way2Wealth Institutional Equity

India's relative rice and wheat productivity (yield per hectare)



Source : Way2Wealth Institutional Equity

Long Term Industry Positives

➢ **Forecast of normal monsoon along with steep increase in MSP and other farmer friendly measures to boost tractor demand**

- The tractor industry has grown at a CAGR of 6% from 2.6L tractors in FY01 to 7.1L tractors in FY18. FY15 and FY16 saw a de-growth of 13% and 11% respectively on account of drought like situation across the country. The last 2 years have witnessed strong monsoons and consequently strong year on year tractor growth of 18% and 22% respectively.
- Good increase in MSP's along with continued thrust of the Government in agri and rural development has also augured well for the tractor industry. The Union Government, in July 2018 approved the hike in MSP of all Kharif crops to 1.5x of the cost of production-based on A2+FL. Consequently, MSP growth ranged from 3.7% (for Urad) to 52.5% (for Ragi), implying production-weighted average growth of 15.8% in FY19 v/s 7.1% in FY18. This is the fourth highest growth in MSP during the past two decades, with higher growth in FY08, FY09, and FY13. However, whether the MSP actually boosts farmer's income or not actually depends on better reach and higher procurement of various procurement agencies of the centre and states.

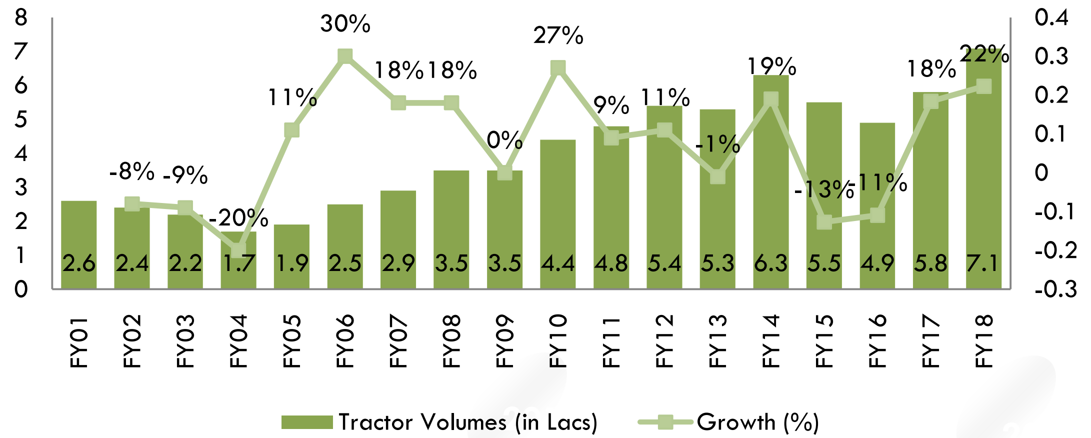
The Government is committed to doubling of farmer income by 2022. Apart from increase in MSP, various other measures being taken by the Government are:-

- The crop insurance premium rates to be paid by farmers are very low – 2% of sum insured for all kharif crops, 1.5% for all rabi crops and 5% for commercial and horticulture crops under smart technology through phones & remote sensing for quick estimation and early settlement of claims.
- Govt. is focusing on improving production and productivity of crops such as rice, wheat, coarse grains and pulses under National Food Security Mission.
- A dedicated online interface e-KrishiSamvad provides direct and effective solutions to problems of farmers.
- Budget 2018-19 has extended favorable tax treatment to Farmer Producers Organisations for helping farmers aggregate their needs of inputs, farm services, processing and sale operations.
- Under Paramparagat Krishi Sinchai Yojana (PKVY), the Govt. is promoting organic farming and development of potential market for organic products.

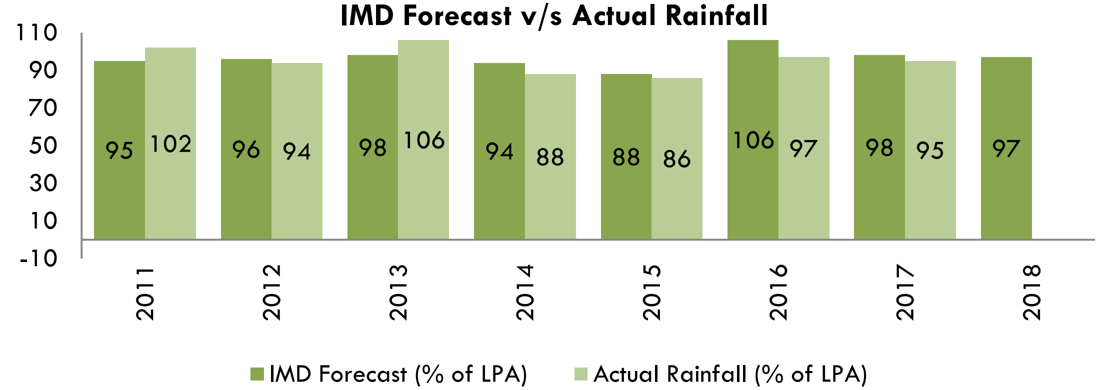
Long Term Industry Positives

Commodity	% increase in MSP approved for 2018-19 season
Paddy-Common	12.90%
Paddy-Grade A	11.32%
Jowar- Hybrid	42.94%
Jowar- Maldandi	42.03%
Bajra	36.84%
Ragi	52.47%
Maize	19.30%
Arhar (Tur)	4.13%
Moong	25.11%
Urad	3.70%
Groundnut	9.89%
Sunflower Seed	31.42%
Soyabean	11.44%
Sesamum	17.91%
Nigerseed	45.11%
Cotton- Medium Staple	28.11%
Cotton- Long Staple	26.16%

Source : Govt. Press Release

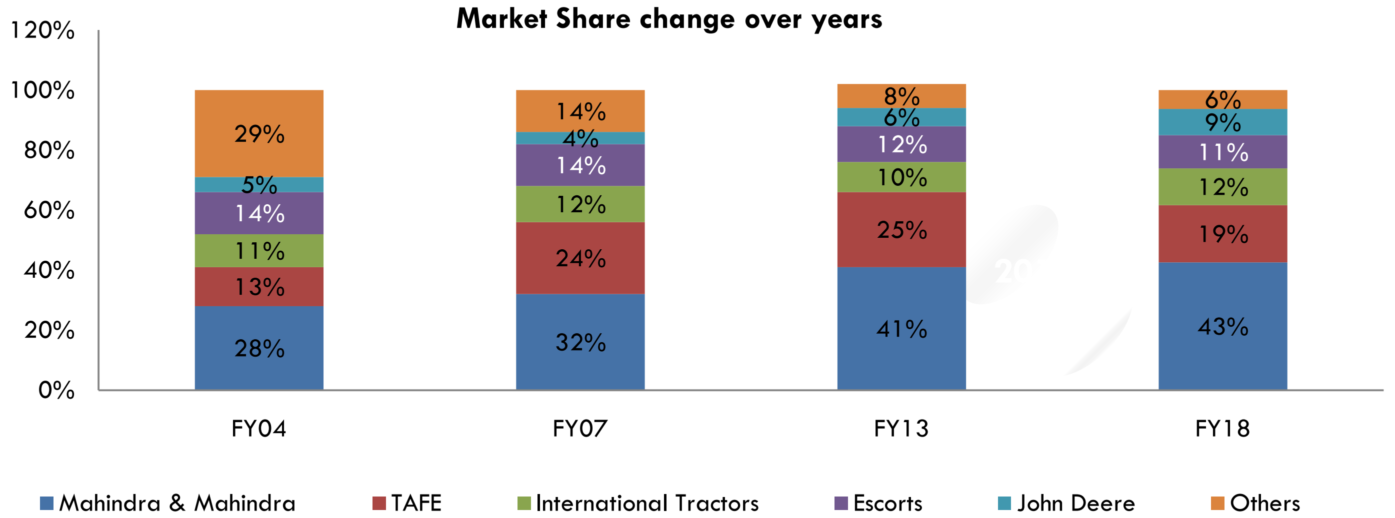


Source : Industry Reports, Way2Wealth Institutional Equity



Source : Company, Way2Wealth Institutional Equity

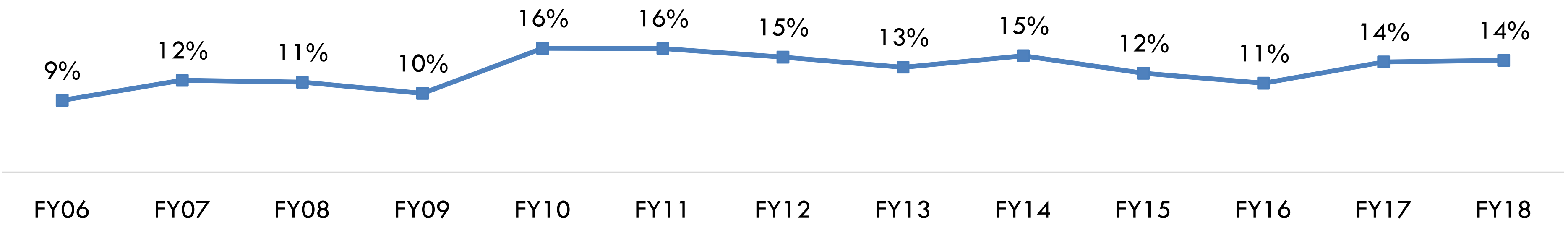
➢ The Indian tractor industry is fairly consolidated with the top 5 tractor manufacturers accounting for ~94% of the industry volumes. The Indian tractor industry was fairly competitive till FY04 when manufacturers would frequently compete on pricing and industry realizations would go down. However, acquisition of Eicher by TAFE in 2005 and Punjab Tractors by Mahindra & Mahindra in 2009 consolidated the industry. TAFE has seen market share loss to Mahindra & Mahindra and John Deere over the last few years.



Source : Company Reports, Way2Wealth Institutional Equity

➢ Post consolidation in the industry, there has been an improvement in the profitability of tractor companies especially during down cycles. In the previous downcycle of FY08 and FY09, industry EBIT margins declined to 10%, whereas in FY15/FY16, the EBIT margins declined only marginally to 15%. This points to better pricing power prevailing in the tractor industry primarily due to consolidation in the industry.

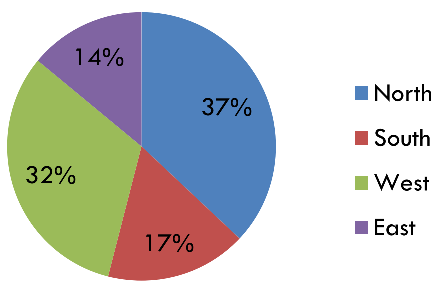
Mahindra & Mahindra EBIT Margins



Source : M&M Annual Reports, Way2Wealth Institutional Equity

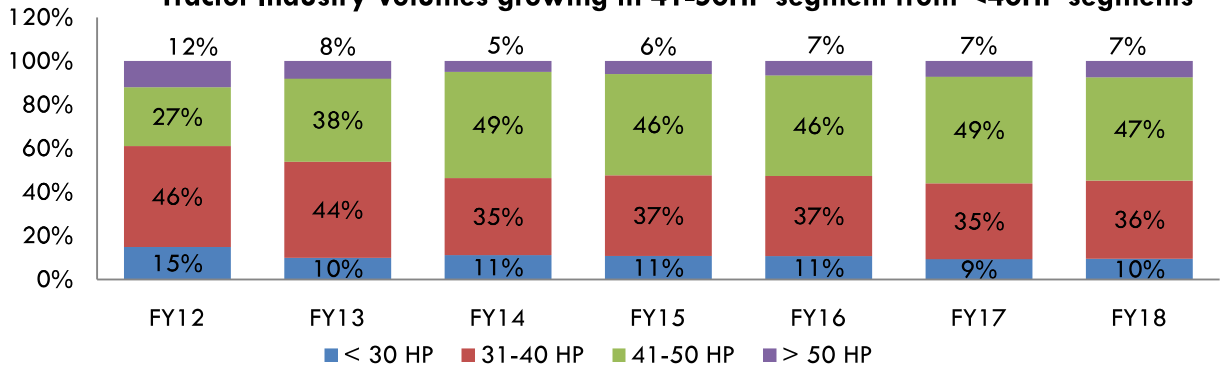
- Region wise, the North and East markets (strong market for Escorts) account for ~51% of total tractor volumes and South and West (opportunity market for Escorts) account for the balance ~49%. Penetration of tractors in some of the Northern markets has peaked and demand is mostly coming from the replacement segment. In terms of HP, we have been seeing a structural trend in the industry where 41-50HP tractors are increasingly being preferred over sub 40HP tractors. We expect the shift towards higher HP tractors to continue in the future as well.

Region wise volume mix



Source : Company Reports, Way2Wealth Institutional Equity

Tractor Industry Volumes growing in 41-50HP segment from <40HP segments



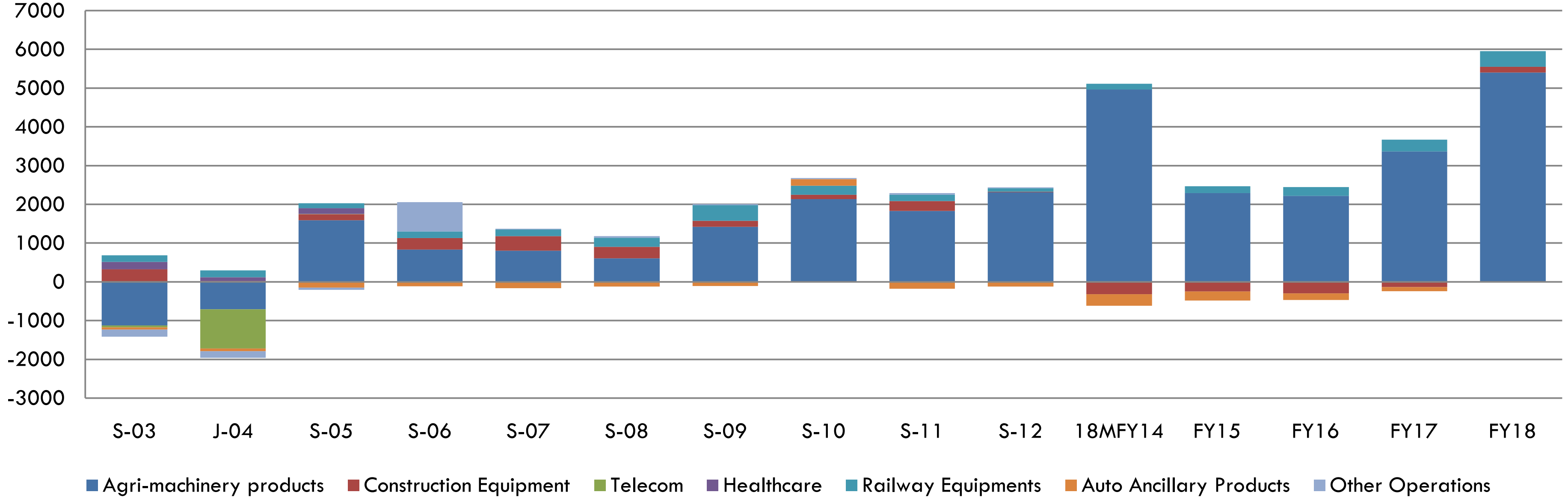
Source : Company Reports, Way2Wealth Institutional Equity

Investment Rationale

Phase –I Margin focus driven turnaround

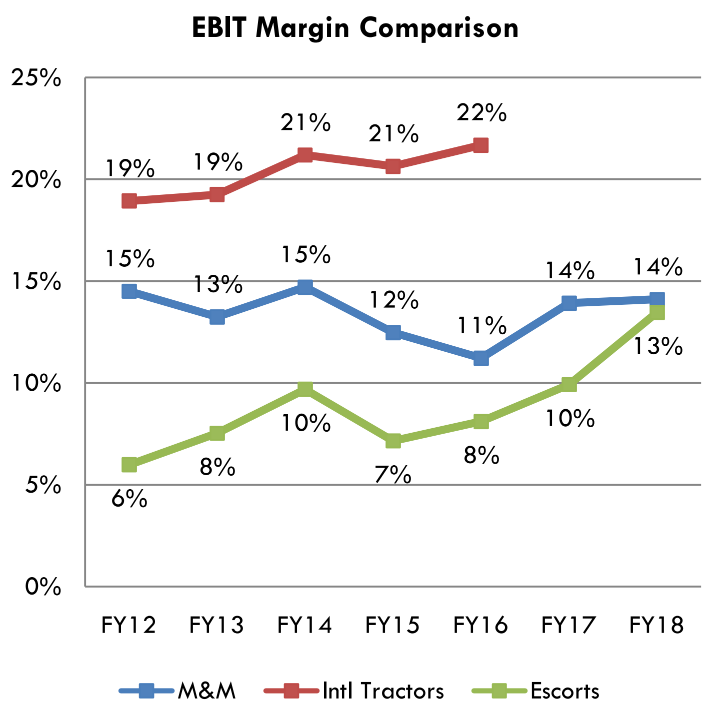
- Escorts had a very difficult phase in the early 2000's, which forced it to exit a number of non-core businesses such as hospital and telecom in 2005-06. Problems were compounded by a sharp slowdown in its cash cow agri-business due to 3 consecutive monsoon failures and rise in competitive intensity (as MNC players entered India post the sector opening up). Escorts struggled to repay its debt during this phase resulting in the company being forced to sell off its hospital, telecom and IT business.
- The focused turnaround started in FY12 when the company started investing in new products and engaged Mckinsey as a consultant to focus on improving gross margins which improved ~600bps over the last 7 years, albeit also partially aided by lower commodity costs and favourable tractor cycle.

Contribution to EBIT from various businesses

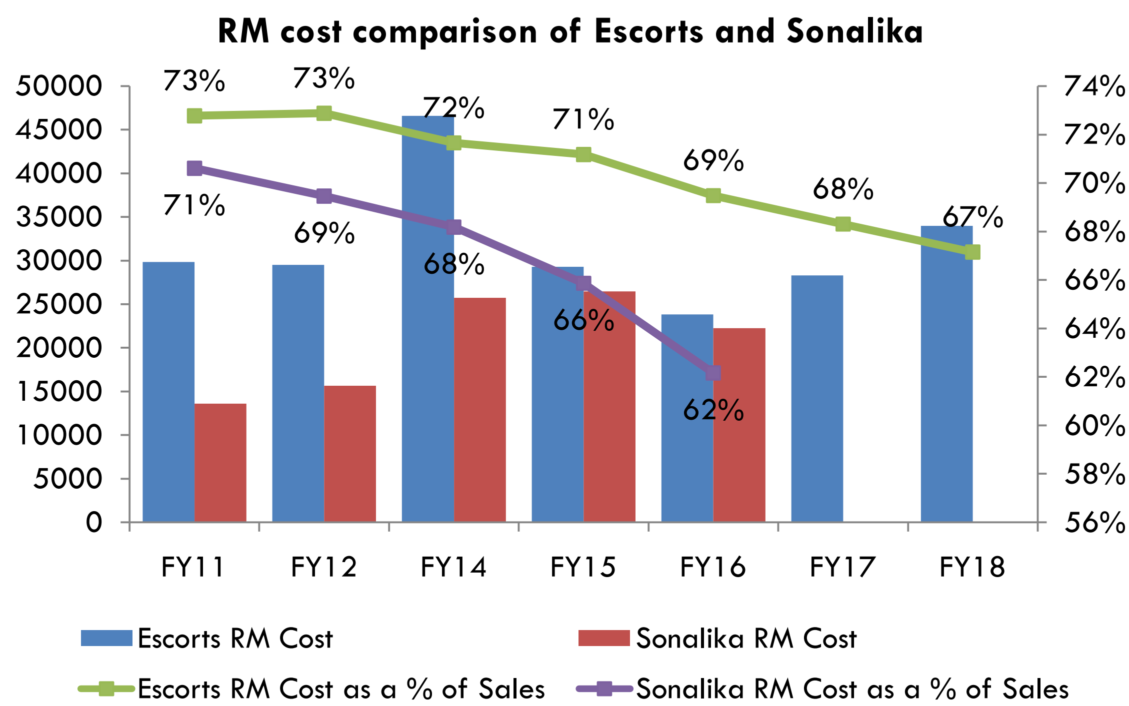


Source : Company Annual Reports

- Escorts divested its auto parts business in August 2016 which had been making losses for many years to Badve Engineering in an all cash deal for ₹180mn, the cash being largely used to settle liabilities. The auto component business was making double digit EBIT margin loss for many years.
- Escorts tractor segment EBIT margins were the lowest in the industry. Despite a steady improvement over the past 3 years, there is still a considerable difference between margins of Escorts and Sonalika. The main gaps are on the raw material and employee cost side.



Source : Capitaline, Company Reports, Way2Wealth Institutional Equity

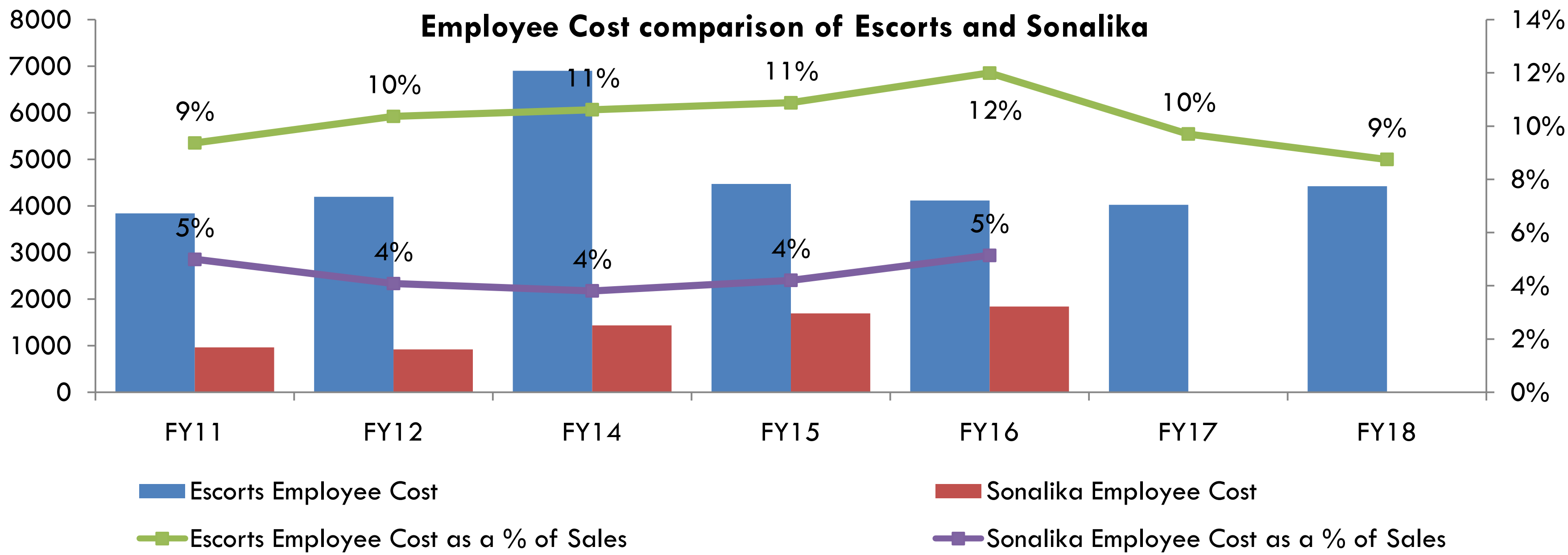


Note: Escorts Data for FY11 and FY12 indicates September ended financial year. FY14 is 18 months for Escorts.

Source : Capitaline, Way2Wealth Institutional Equity

- **High cost of permanent workers elevated overall cost structure**

With multiple cost increases given to blue collar workers over the last many years, their salaries are now 5-6x more than that of contract workers deployed for the same task. The share of contract workers in Escorts is only 60% as compared to 80% for other auto OEM's. Escorts plans to use natural retirement and VRS to reduce the number of permanent blue collar workers from 2,200 to 1,500 over the next few years with a reduction of ~450-500 from natural retirement and balance from VRS. Whilst the earlier target was to bring down the employee cost as a percentage of sales from 10.5% to 8%, it later targeted for a reduction only to 9%. There is still a considerable gap between employee cost of Escorts and Sonalika, which should reduce in the coming years.

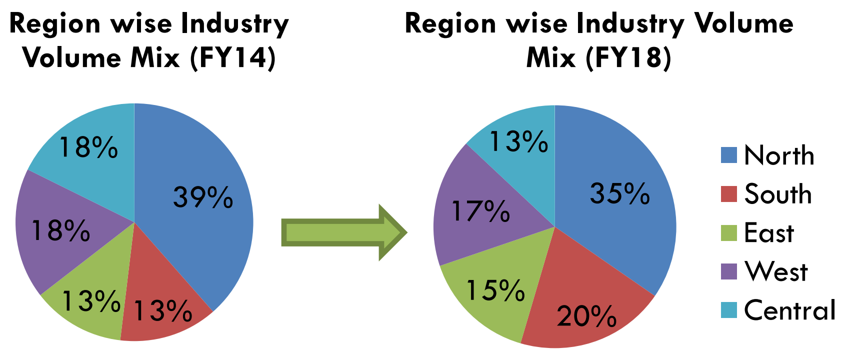


Note: Escorts Data for FY11 and FY12 indicates September ended financial year. FY14 is 18 months for Escorts.

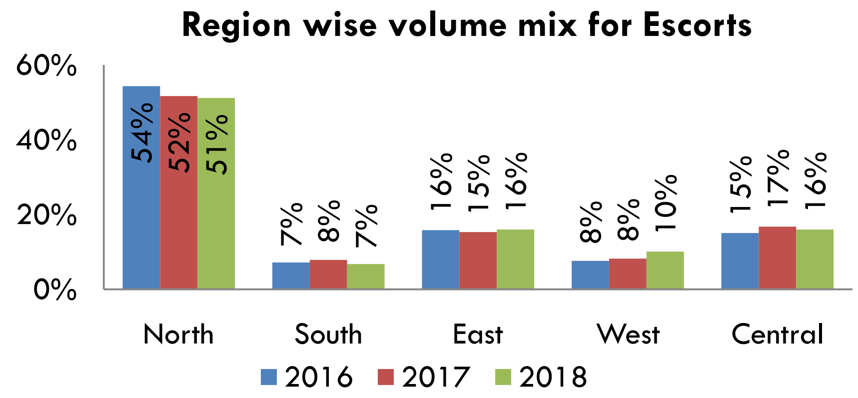
Source : Capitaline, Way2Wealth Institutional Equity

Phase-II Focusing on weak markets as some markets in strong geographies have reached saturation point

- Escorts has traditionally had a stronghold in the Northern and Eastern markets with double digit market share in large markets of Haryana, Punjab, Rajasthan, Uttar Pradesh, Bihar, Madhya Pradesh and smaller markets of Himachal Pradesh, West Bengal and Assam. Its weakness lies in the Southern and Western markets of Gujarat, Andhra Pradesh, Maharashtra, Karnataka and Tamil Nadu. Tractor penetration in some of the large northern markets has reached saturation point and demand is coming only from the replacement market in these states.
- The company has plans to expand its network in both the strong markets (North and East) and opportunity markets (South and West). Currently, Escorts has 850+ dealers (1500+ touchpoints) with 68% in strong markets and 32% in opportunity markets. In the strong markets, the company plans to set up Farmtrac dealerships where Powertrac is strong and vice versa. In the opportunity markets- predominantly south- the idea is to use the Powertrac brand as it is a mass market brand and also suitable for wet land applications more suited for the southern market.
- Along with a few addition to dealers, the company plans to focus on improving the quality of dealers by working in a focused manner with identified dealers and offering them support to improve their share in their respective regions. The company has also tied up with the Indian subsidiary of Rabo Bank DLL India to launch Escorts credit to provide faster loans to its customers from its dealerships. This arrangement has facilitated the company to bring down the average approval for a loan from one week to less than two days.



Source : Industry Data, ICRA

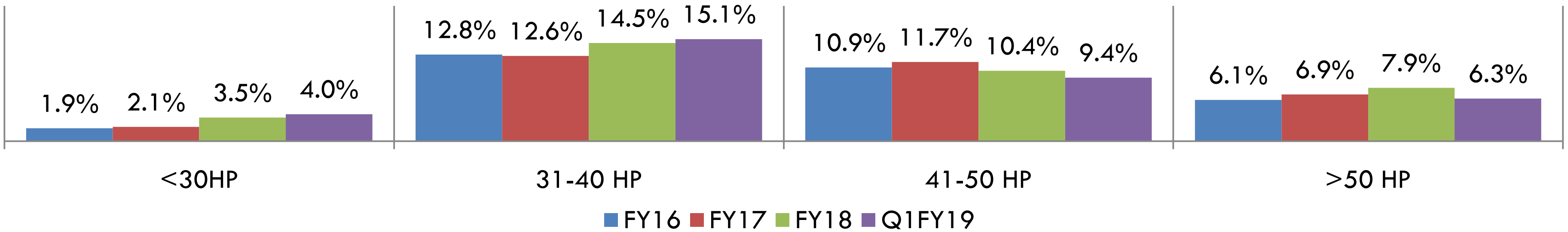


Source : Industry Data, ICRA, Way2Wealth Institutional Equities

New launches to plug whitespaces in product portfolio

- Escorts has a three brand strategy (Powertrac, Farmtrac and Steeltrac) just like Mahindra & Mahindra (Mahindra, Swaraj and Trakstar). Escorts positions the Farmtrac brand as the premium brand and Powertrac as the mass segment brand. Steeltrac is the sub20 HP brand. Farmtrac is more suitable for dry applications and Powertrac is more suitable for wet applications.
- Traditionally, Farmtrac has been a >45HP brand and Powertrac has been a <40HP brand. Escorts has been focusing on launching Farmtrac products in 31-40 HP segment and Powertrac products in >40HP segment. Farmtrac product launches in <40HP segment include Farmtrac XP (31-40HP) and Atom Series (<30HP). Powertrac product launches in the >40HP segment include Powertrac Euro and Powertrac ALT 4000. Farmtrac Atom is designed for every type of orchard farming. It is ideal for all applications including high end sprayers, rotavators and haulage. Farmtrac F20 is India's first double HP tractor that offers 100% power on full load and bigger savings on ideal load. It not only enables farmers to save up to 20% on fuel, but also improves life of machinery by optimizing load handling. Escorts has also launched India's first electric and hydrostatic concept tractor, Farmtrac 26E.
- With the launch of Farmtrac XP (31-40HP) and Farmtrac Atom (<30 HP), the company's market share in the 31-40HP category has improved from 12.8% in FY16 to 15.1% in Q1FY19 and in the <30HP category, the market share has improved from 1.9% in FY16 to 4.0% in Q1FY19. However, the launches in Powertrac in >40HP segment haven't really clicked for the company and the company has lost market share, from 10.9% in FY16 to 9.4% in Q1FY19. As a result of the launch of Farmtrac in <40HP segment, the company's average realization per tractor has been falling and the management has indicated that the trend is likely to continue.

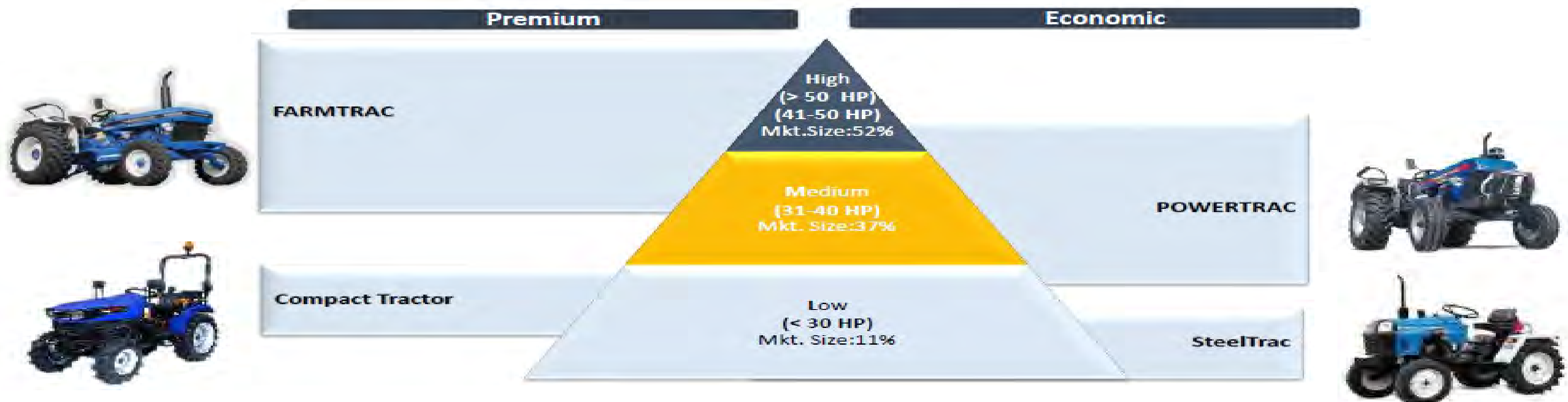
Segment wise Market Share in Q1FY19



Source : Company Reports, Way2Wealth Institutional Equity

Investment Rationale

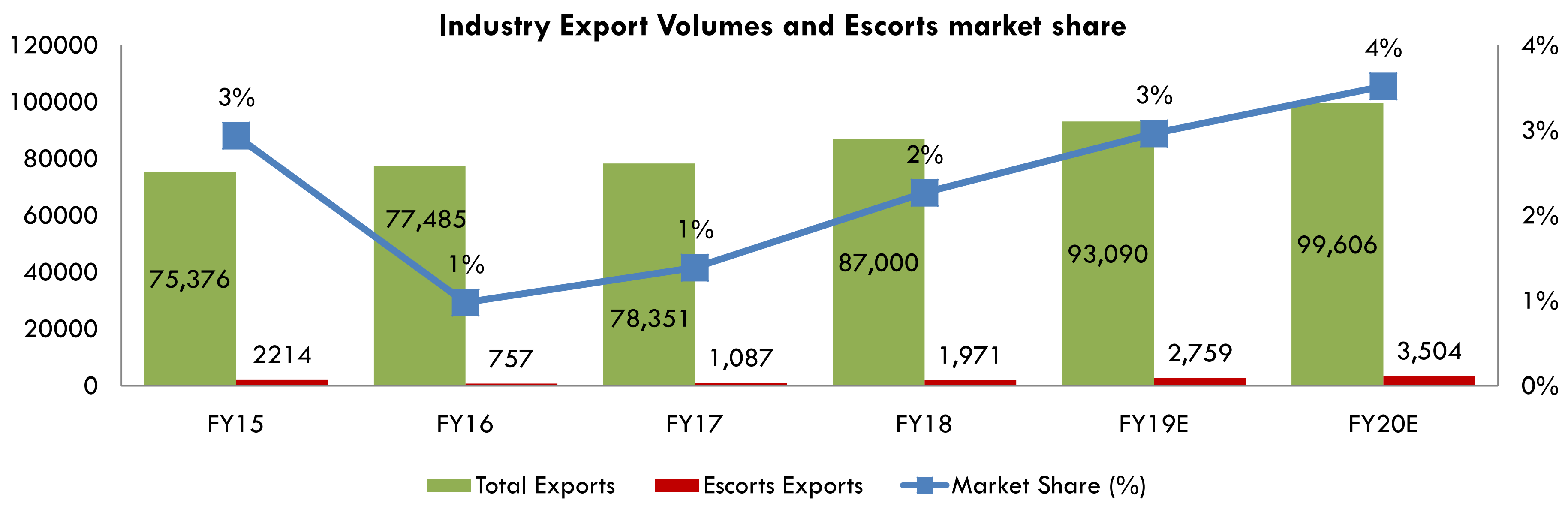
Source : Company Reports, Way2Wealth Institutional Equity



Source : Company Reports, Way2Wealth Institutional Equity

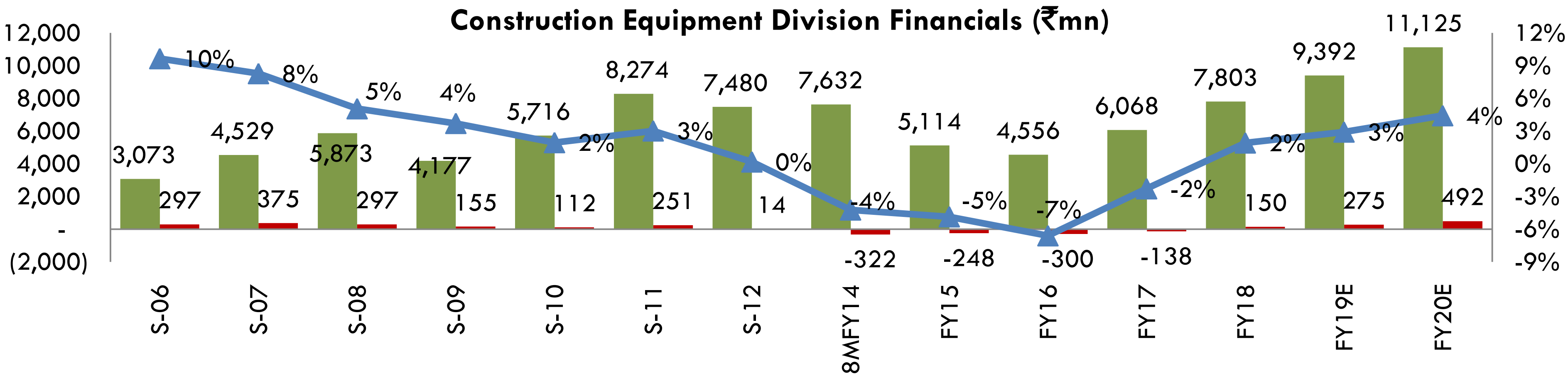
- **Huge opportunity in tractor exports**

Escorts is also working towards improving its export franchise. It used to have 15-20% market share in exports till FY07, however with currency appreciating and lack of product launches subsequently, the company lost out on its exports market share. In recent times, the company has been focusing on investing in new product launches and growing export volumes. Given the large opportunity and small market share of Escorts currently, there is ample room for strong growth over the next many years. The company aspires to achieve volumes of 8,000-10,000 export volumes by FY22. We have conservatively estimated volume growth of 33% over FY18-20E. On the basis of our estimate, we believe Escorts will clock volumes of ~3500 in FY20.

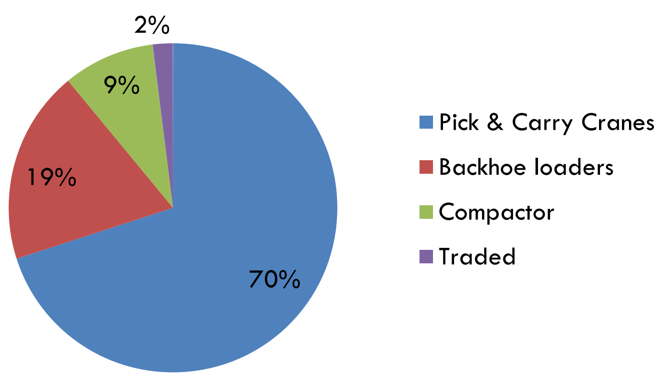


Source : Tractor and Mechanization Association, Escorts Annual Reports

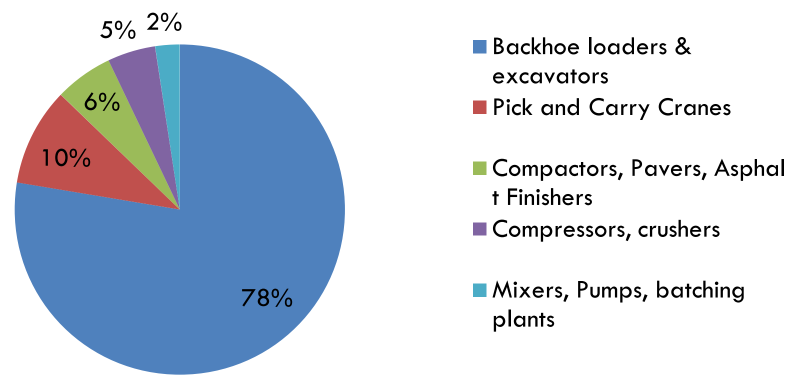
- **Construction Equipment Business**
  - Escorts has presence in the construction equipment business through 3 sub-segments namely backhoe loaders, pick and carry cranes and compactors. The industry is highly competitive with several MNC players and domestic manufacturers competing for volumes. Given the industry's dependence on real estate construction and infrastructure, the industry tends to be highly cyclical and depends on capex spends by the Govt.
  - The Govt's focus on infrastructure spending over the past years towards roads, railway and metro project has augured well for the construction equipment industry. Future outlook also looks bright as the Indian Govt. has large investments planned towards roads, railways and metro.
  - The sub-segments within the construction equipment industry along with their revenue contribution include Earthmoving (78%), Material Handling(10%), Road Construction(6%), Concrete Equipment(2%) and Material Processing(5%). Escorts is present in Earthmoving through Backhoe loader, Material Handling through pick and carry cranes and road building through compactors. Within the Construction Equipment Segment, Material Handling, Earth Moving and Road Construction contribute 60%, 20% and 10% to revenues of Escorts respectively.
  - The served segments of backhoe loaders, Pick and Carry cranes and compactors of the industry grew by 31% in FY18. Material handling emerged as the biggest gainer with 82% growth, followed by backhoe loaders at 26% and compactors at 16%. Escorts total Construction Equipment volumes grew by 35% from 3,315 units in FY17 to 4,486 units in FY18. Escorts outperformed the industry owing to increasing focus on strategic tie-ups, material cost management, export reach, channel financing, dealership and outlet reach.
  - Going forward, Escorts plans to strengthen earth-moving portfolio after having entered into an exclusive distribution agreement with South Korea's Doosan Infracore Co. Ltd., developing differentiated products for foreign geographies such as cranes and backhoes for focused markets, enhanced after-sales focus for optimizing product life cycle, launching niche products with application focus and improving product mix to improve contribution. Following an exclusive distribution agreement with Doosan Infracore Co. Ltd. in February 2018, Escorts now caters to more than 80% of the industry in value terms from 40% of the revenue potential previously.
  - Escorts has projected the construction equipment sector to grow at a CAGR of 16-18% over the long term and aspires to achieve triple-fold revenue by 2022 from 2017 revenue base.



Source : Company Reports, Way2Wealth Institutional Equity



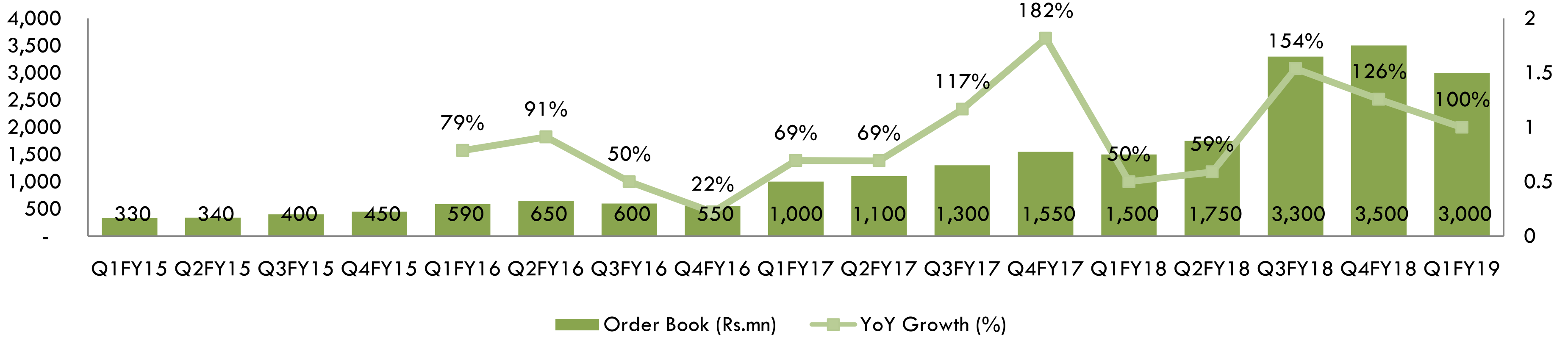
Source : Company, Way2Wealth Institutional Equity



Source : Company Reports, Way2Wealth Institutional Equity

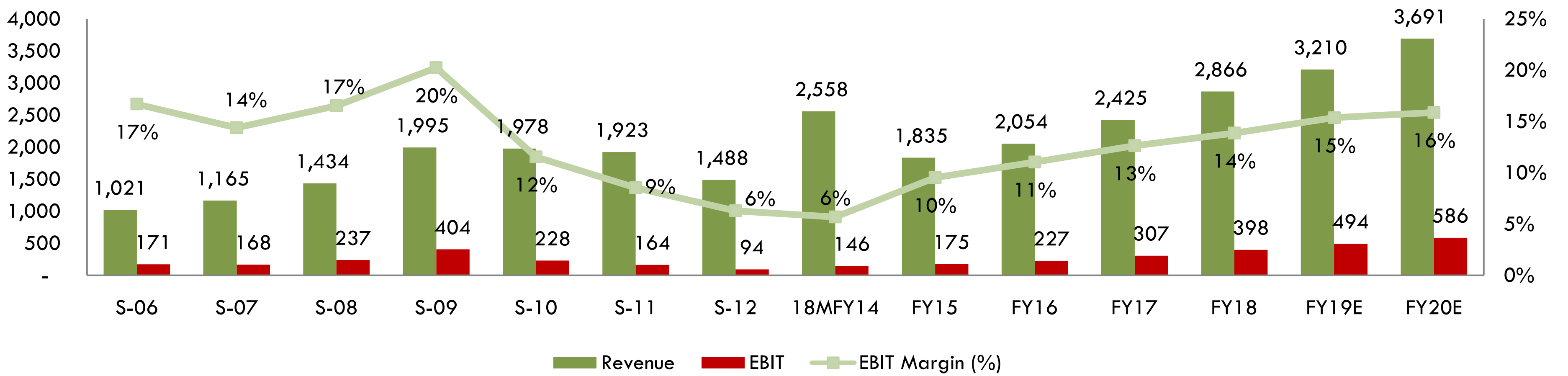
- **Railway Equipment Business**
  - Escorts Railway Equipment division is engaged in the design, manufacture, supply, installation and service of a wide range of products like brake systems, couplers, suspension systems and rubber and friction products. Apart from being a leading domestic player in the brake, coupler and suspension systems, it also exports to South Asian, South-East Asian, African, Australian and European countries. The revenue contribution from Railway Equipment business in FY18 stood at 5.7%. The annual production capacity of Escorts stood at 12,000 couplers, 20,000 air brakes, 2,000 EP brakes, one million brake blocks and 50,000 shock absorbers.
  - **Reasonable barriers to entry:** The railways business is a tender based business with tenders coming from Indian railways and other different wagon manufacturers. It takes time for a supplier to get approvals from Research Designs and Standards Organisation (RDSO) under the ministry of railways. The competitive intensity in this business is low, which is visible from healthy operating margins and return ratios.
  - Key projects undertaken in FY18 by Escorts include upgrading the bogie-mounted brake systems for wagons and commenced its pan-India commercialization, launching new type of EP brake systems for the Mumbai Rail Vikas Coaches and launched axle-mounted disc brake systems that are the mainstay of Indian Railways, Escorts is the only Indian company to receive approval for the same.
  - Till 2012, there was limited investment on railways by Escorts as it was not really focusing on this segment. However post 2012, the company started investing in new products which eventually helped scale up the business. Escorts has been investing in 7 new products, 3 of which have been commercialised (Axle mounted disc brake, Boggie mounted disc brake and Automatic door for metro and railways). It is in advanced testing phase in 3 other products which would be launched in the next few years.
  - The orderbook in the Railway Equipment Division remained largely steady from FY14-16. However, the company has been growing its order book since Q1FY17. Currently, the orderbook stands in excess of ₹3.0bn which the company plans to execute over the next 12-13 months.
  - The company aspires to achieve a 4x growth in revenue (from FY17) by 2022 and achieve EBIT margin in the range of 17-19%.

Railway Equipment Division Order Book (₹mn)



Source : Company Reports, Way2Wealth Institutional Equity

Railway Equipment Division Financials (₹mn)

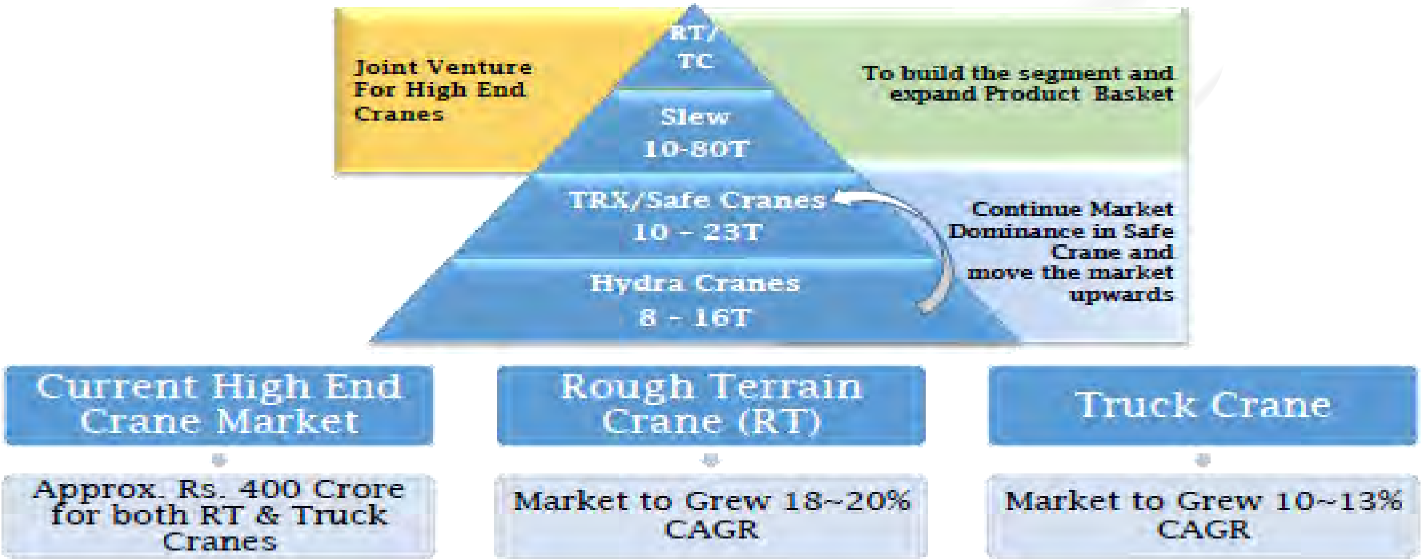


Source : Company Reports, Way2Wealth Institutional Equity

Joint Venture with Tadano Group

- Escorts and Tadano Group, Japan announced a 49:51 joint venture late in August 2018 to manufacture rough terrain cranes and truck mounted cranes. The joint venture will strengthen Escorts presence in the material handling equipment space.
- The JV will leverage Tadano's leading Japanese technology to cater to the heavier capacity and efficient Truck and RT Cranes and sophisticated truck mounted and rough terrain cranes in the 20 to 80 tonnage category. The joint venture will enable both partners to optimize their current and future capabilities in the segment globally. The JV will aim to take leading position in the high tonnage crane segment in medium to long term.
- Production by the joint venture is expected to commence at Faridabad in the 3rd quarter of FY2018-19 itself. The product offering will find a ready market with big construction companies servicing oil refineries, metro rail projects, smart city construction, solar power projects and alike. Export potential will be explored at a later stage. Key competitors include TIL Ltd. and SANY.

Indian Market Size and Opportunity



Source : Company, Way2Wealth Institutional Equity

Other Initiatives undertaken by Escorts

- **48-Hr parts (Smart Parts)**

  48-Hr parts is an initiative undertaken by Escorts wherein within 48 hours, the company undertakes to provide the latest spare parts to the user. Escorts has tied up with Reliance Jio for this initiative where Point of Sale contact will be installed. This will ensure genuine parts reach the user of the vehicle and also within 48 hours, unlike the present scenario wherein the farmer may have to wait up to 5-6 days for the spares.

- **Care Button**

  Care Button is a joint initiative by Escorts, Motherson Sumi and Vodafone wherein a Voice Box will be enabled in a tractor and the dealer will be notified of the defect in the tractor and it will service the tractor there itself. It is a sub ₹1000 chip enabled on the tractor compared to peers who are currently charging anywhere between ₹25,000-30,000.

- **TRAXI**

  TRAXI is an organized centre for renting of tractors. Typically a farmer uses a tractor for 5-6 months and rents out for the remaining 6-7 months. This practice is currently underway in an unorganized way. Escorts realized this opportunity and is converting this practice into an organized way.

- **ETC (Escorts Tractor Care)**

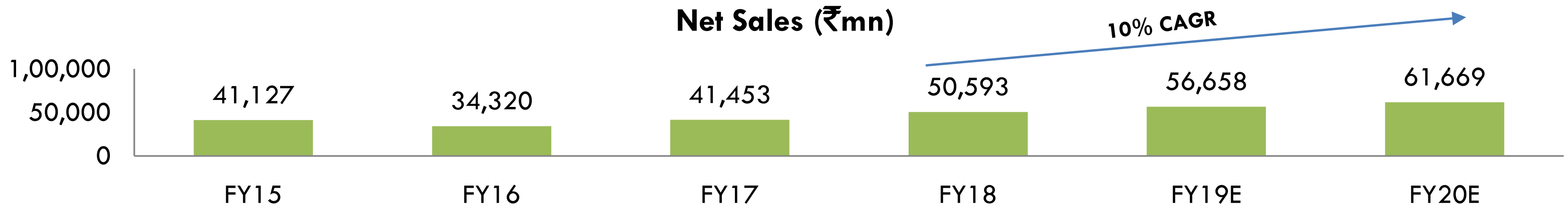
  ETC is a multi-brand tractor care wherein it seeks to convert local mechanics into multi brand service centre. This would result in increasing after sales revenue and increasing touchpoints.

- **Mol Anmol**

  Mol Anmol initiative by Escorts is similar to Mahindra First Choice and Maruti True Value. It purchases old tractor from farmers, refurbishes it and re-sells it. Currently, Escorts is undertaking this initiative for its own tractors only.

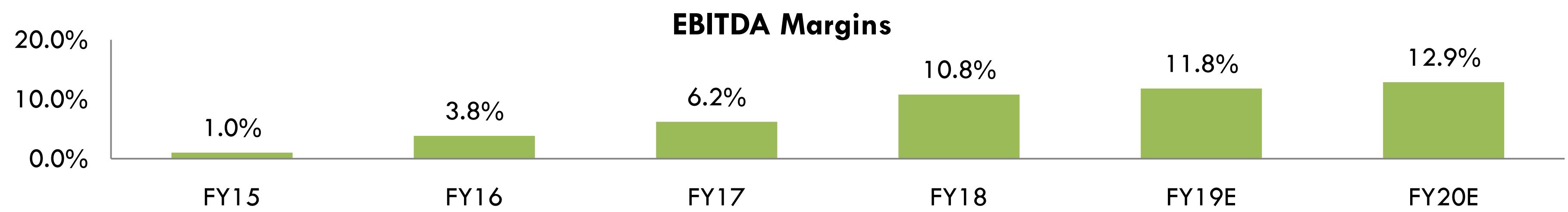
Financial Performance

- **Sales to post 10% CAGR over FY18-20E –** Given that Escorts derives ~80% of its revenues from tractors, topline growth will be driven to a large extent by this segment. We expect Escorts to record tractor revenue growth of 8%, driven by 11% volume growth. Given the strong upward cycle in construction equipment business and healthy order book on the railway equipment business side, we project revenue CAGR of 19% and 13% respectively, increasing overall topline growth to 10% CAGR over FY18-20E.



Source : Company, Way2Wealth Institutional Equity

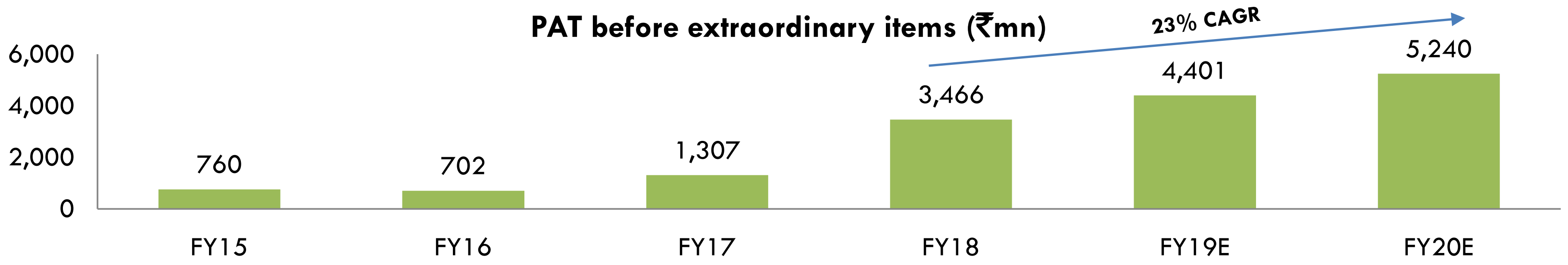
- **Operating Margins to expand by 210bps over FY18-20E –** Escorts has taken multiple initiatives over the past few years in the first phase of the turnaround to drive margin expansion, right from shedding unprofitable ventures to roping in Mckinsey to identify areas through which margins could improve. We expect Escorts to continue to focus on margin expansion in the second phase of the turnaround as well through more focus on exports (which yield better realizations), Farmtrac brand and various cost-cutting measures.



Source : Company, Way2Wealth Institutional Equity

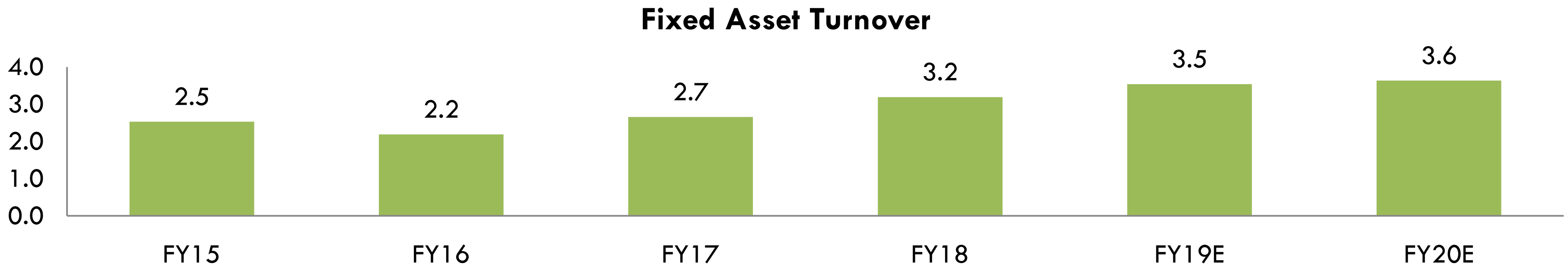
Financial Performance

- **PAT to post 23% CAGR over FY18-20E –** We expect PAT to post 23% CAGR over FY18-20E on the back of cost-cutting initiatives to be implemented by the company and improving contribution of tractor exports and railway equipment division. Further, surplus capacities across segments will result in lower capex going forward leading to higher growth in PAT.



Source : Company, Way2Wealth Institutional Equity

- **Fixed Asset Turnover Ratio to continue inching up –** We expect Fixed Asset Turnover Ratio to continue inching up in the future. As mentioned above, the company has surplus capacities across segments and hence the capex needs would be minimal over the next few years.



Source : Company, Way2Wealth Institutional Equity

- **Nikhil Nanda (Chairman and Managing Director)**
  Nikhil Nanda started his journey at Escorts as Director of Business Development division at Escorts Yamaha Motor Ltd. (EYML) in 1998. He has played a central role in leveraging Escorts inherent capabilities to strengthen its position as a company dedicated to frugal engineering. He is an alumnus of Wharton Business School with majors in Management and Marketing.

- **Shailendra Agarwal (Group Chief Operating Officer)**
  Mr. Agarwal is responsible for leading business operations, executing growth strategy and ensuring operational excellence. He is also spearheading initiatives with a focus on profitability and revenue as envisaged in Vision 2022. He is a mechanical engineer with 35 years of diverse experience in Tata Motors, Hero Motors and Escorts Ltd.

- **Bharat Madan (Group Chief Financial Officer)**
  Mr. Madan has 27 years of experience in financial management. He joined Escorts in 2005 and has played a key role in the integration and consolidation of the finance function across all business units of the group. In his last assignment, he was the Assistant Vice President- Finance with Electrolux Kelvinator. Mr. Madan is a 1988 batch Chartered Accountant.

- **Shenu Agarwal (Chief Executive- Escorts Agri Machinery) (Sales and Marketing and Emerging Businesses)**
  Mr. Agarwal is responsible for driving transformative sales and marketing initiatives for Escorts Agri Machinery. He joined the company as a Graduate Engineering Trainee and worked in numerous key positions across sales and marketing, product development, strategy and project management. He has done MBA from Duke University, USA and carries 26 years of industry experience.

- **Ajay Mandahr (Chief Executive- Escorts Construction Equipment)**
  Mr. Mandahr steers the ECE business division of the company. He is proficient in the areas of sales and marketing, product development and business formulation and strategy. He has previously worked with L&T, Indian Aluminium, Manitou South Asia Ltd. and Toyota Material Handling India. He is a management graduate with 26 years of diverse experience in leadership positions.

- **Dipankar Ghosh (Chief Executive- Railway Equipment Division)**
  Mr. Ghosh's competencies include full lifecycle product development, manufacturing operations, engineering management and business development. He is an ex-Indian Railway Service Officer and holds a six-sigma black belt. Prior to Escorts, he was heading the John Deere India Tech Center, managing the Caterpillar India Design and Bombardier Transportation Global Railway Design Centre (India).

Relative Valuation

Financials

Company	Sales (₹mn)		EBITDA (₹mn)		PAT (₹mn)		EPS CAGR (%) (FY18-20)
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	
Escorts	56,658	61,669	6,686	7,925	4,401	5,240	23
Mahindra & Mahindra	563,712	638,154	89,534	91,731	50,302	57,492	11
Maruti Suzuki	922,460	1,059,197	134,193	156,504	96,937	113,533	20
Ashok Leyland	304,310	354,270	33,431	40,410	19,628	24,340	18
Tata Motors	3,238,435	3,562,990	376,664	449,919	76,566	111,137	11
Bajaj Auto	288,056	319,994	51,857	57,990	44,598	49,683	9
Hero Motocorp	352,811	384,601	54,976	60,350	38,510	42,629	7
TVS Motor Co.	183,606	208,587	17,569	20,957	8,453	10,685	28

Valuations and Return on Equity

Company	P/E		EV/EBITDA		P/B		ROE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
Escorts	12.1	10.1	10.2	8.5	2.8	2.4	18.2	18.3
Mahindra & Mahindra	17.7	15.5	11.3	10.0	2.6	2.3	15.4	15.7
Maruti Suzuki	22.6	18.6	16.1	13.8	4.4	3.9	21.0	21.6
Ashok Leyland	19.7	16.0	10.8	8.9	4.7	3.9	25.3	26.7
Tata Motors	8.3	5.6	2.6	2.2	0.6	0.5	7.8	10.2
Bajaj Auto	17.0	15.3	13.4	11.9	3.4	3.0	20.5	20.6
Hero Motocorp	15.2	13.7	9.6	8.7	4.4	4.1	29.0	29.1
TVS Motor Co.	28.3	21.9	17.5	14.6	8.7	7.3	30.4	35.7
Average (ex. Escorts)	**18.4**	**15.2**	**11.6**	**10.0**	**4.1**	**3.6**	**21.3**	**22.8**

Source : Bloomberg Estimates as on 15.10.18, Way2Wealth Institutional Equity

Valuation & Recommendation

BUY with Target Price of ₹807 (upside potential of 35% over 12-18 months).

- Escorts has successfully turned around in the past 2-3 years by focusing on (i) new products to stabilize market share, (ii) cost reduction to improve tractor gross margins and (iii) shedding unprofitable ventures. It is now focusing on the next phase of the turnaround where through a dual brand strategy (premium Farmtrac and mass Powertrac) and aggressive distribution focus in opportunity markets, it seeks to improve market share.
- In the second phase of the turnaround, the company's focus is on improving market share in tractors as it seeks to get back to 13-14% market share from 11% currently. Escorts has not only filled white spaces in its portfolio but also extended both its brands- premium Farmtrac (towards lower horsepower) and mass Powertrac (towards higher horsepower). With new products for exports, the company aspires to do volumes of 8,000-10,000 in exports as against ~2000 units in FY18. It is also aggressively expanding its distribution network by focusing on taking Powertrac deeper in its opportunity markets (South and West). It also targets a 200-300bps improvement in other expenses by improving shopfloor productivity, combining back-end function across divisions etc.
- Investment in new products has paid off in the railway equipment division too, with orderbook steadily rising from ₹1bn in Q1FY17 to >₹3bn as at Q1FY19. With more products to be launched in the next few years, we believe the contribution of this division would only increase going forward. Material cost reduction efforts are now focused on construction equipment side, where the focus is to take it from 2% EBIT margin to double digit EBIT margins. The construction equipment industry is also cyclically supportive, with ~25% CAGR over FY15-18.
- Escorts earnings growth of 23% over FY18-20E is among the best among auto OEM's, which would be largely driven by 11% volume CAGR in tractors business over FY18-20E and steady EBITDA margin expansion of ~100bps over the next 2 years. With surplus capacities across segments, Escorts has limited capex needs leading to strong FCF generation and healthy return ratios over the next 2-3 years. **At CMP of ₹597, Escorts is currently trading at a FY20E PE and EV/EBITDA of 10.1x (adjusted for treasury stock) and 8.5 respectively. We value Escorts at ₹807 per share by applying 13.7xP/E (10% discount to average P/E of 15.2 of all other auto OEM's) to its consolidated FY20E EPS of ₹59.**

Risks & Concerns

- **Monsoon**

  Monsoon is a major risk associated with the tractor industry, since close to 52% of farm fields are dependent on the vagaries of the season.

- **Govt. policies**

  The sluggish pace of policy rollout and stringent regulatory measures directly and indirectly impact the construction equipment and railway equipment sector that are largely dependent on public spending.

- **Raw Material Cost**

  Rising cost of metal such as steel, influences the business, particularly construction equipment segment.

- **Fuel prices**

  Increasing international crude oil prices compound the upward pressure on automobile fuel in the domestic economy and raise the cost of equipment ownership.

Financials

Income Statement

(₹ mn)

Income Statement	FY16	FY17	FY18	FY19E	FY20E
Net sales	**34,320**	**41,453**	**50,593**	**56,658**	**61,669**
YoY (%)	(16.6)	20.8	22.0	12.0	8.8
Raw material cost	23,844	28,313	33,971	38,327	41,563
Employee Cost	4,130	4,134	4,492	4,464	4,550
Admin Expenses	5,025	6,441	6,665	7,181	7,631
Total expenses	32,999	38,888	45,129	49,972	53,744
EBIDTA	**1,321**	**2,565**	**5,465**	**6,686**	**7,925**
(%)	3.8%	6.2%	10.8%	11.8%	12.9%
Growth (%)	209%	94%	113%	22%	19%
Depreciation	581	634	732	754	805
EBIT	740	1,931	4,732	5,933	7,120
Interest	511	322	295	95	95
Other income	595	471	653	731	796
PBT	824	2,080	5,091	6,569	7,821
(-) Tax	123	773	1,625	2,168	2,581
Tax/ PBT	*14.9*	*37.1*	*31.9*	*33.0*	*33.0*
PAT	**702**	**1,307**	**3,466**	**4,401**	**5,240**
YoY (%)	(7.7)	86.4	165.1	27.0	19.1
PAT(%)	2.0%	3.2%	6.9%	7.8%	8.5%
Share of profit of associates	0	0	0	0	0
Minority Interest	-5	-5	-4	0	0
Extraordinary	-212	-45	24	0	0
Reported Profit	**918**	**1,358**	**3,446**	**4,401**	**5,240**

Balance Sheet

(₹ mn)

Balance Sheet	FY16	FY17	FY18	FY19E	FY20E
Equity capital	1,226	1,226	1,226	1,226	1,226
Reserves	17,277	18,691	24,298	28,403	33,272
Equity Appln. Money	3,838	3,707	3,372	3,372	3,372
Net worth	**14,665**	**16,209**	**22,151**	**26,256**	**31,126**
Minority Interest	19	17	-4	-4	-4
Total borrowings	3,681	2,654	511	511	511
Other Long Term Liabilities	571	509	401	401	401
Total Liabilities	**18,936**	**19,390**	**23,059**	**27,164**	**32,034**
Gross block	24,176	24,530	24,973	25,973	28,473
Less: Acc. Depreciation	8,785	8,719	9,095	9,849	10,654
Net block	**15,390**	**15,811**	**15,878**	**16,124**	**17,819**
Work in progress	584	347	657	657	657
Investments	637	2,123	5,490	6,990	8,990
Inventories	4,568	4,503	5,657	6,383	6,921
Debtors	3,750	4,565	5,920	6,647	8,079
Cash	2,530	2,441	3,173	5,672	6,348
Loans and advances	1,754	1,687	2,950	3,142	3,302
Current assets	**12,602**	**13,195**	**17,700**	**21,844**	**24,651**
Current liabilities	**9,164**	**11,238**	**14,972**	**16,766**	**18,249**
Deferred Tax Asset	469	515	-189	-189	-189
Provisions	1,582	1,365	1,506	1,686	1,835
Net current assets	**2,325**	**1,108**	**1,034**	**3,203**	**4,378**
Total Assets	**18,936**	**19,390**	**23,059**	**27,164**	**32,034**

Cash Flow Statement

(₹ mn)

Cash Flow	FY16	FY17	FY18	FY19E	FY20E
Net profit	918	1,358	3,446	4,401	5,240
Depreciation	581	634	732	754	805
Deferred tax	-95	-45	653	0	0
Change in W/C	2,168	1,174	102	330	-499
Operating cash flow	**3,573**	**3,121**	**4,932**	**5,485**	**5,546**
Capex	223	-117	-753	-1,000	-2,500
Investments	3,090	-1,487	-3,367	-1,500	-2,000
Investing cash flow	**3,312**	**-1,604**	**-4,120**	**-2,500**	**-4,500**
Free Cash Flow	**3,795**	**3,004**	**4,179**	**4,485**	**3,046**
Dividend and other	-1,323	-983	-729	-485	-370
Equity	-4,383	403	2,793	0	0
Debt	-1,163	-1,027	-2,143	0	0
Financing cash flow	**-6,868**	**-1,606**	**-80**	**-485**	**-370**
Net change in cash	17	-89	732	2,500	676
Opening cash	2,514	2,530	2,441	3,173	5,672
Closing cash	2,530	2,441	3,173	5,672	6,348

Ratio Analysis

Key Ratios	FY16	FY17	FY18	FY19E	FY20E
EPS (adjusted for Treasury Stock)	10	15	39	50	59
Book value	120	132	181	214	254
Cash /Share	-7	-2	22	42	48
P/E (x)			15.4	12.1	10.1
EV/EBDITA (x)			12.9	10.2	8.5
P/B (x)			3.3	2.8	2.4
ROCE	5.6%	10.4%	22.8%	24.0%	24.4%
ROE	4.3%	8.5%	18.1%	18.2%	18.3%
Free cash/Share	31.0	24.5	34.1	36.6	24.9
Dividend/Share	1	1	2	2	2
Dividend Yield	0.2%	0.2%	0.3%	0.3%	0.4%
Fixed Asset Turnover	2.2	2.7	3.2	3.5	3.6
Avg Net WC Days	7	-7	-13	-15	-13
Net W/C (% of sales)	-0.6%	-3.2%	-4.2%	-4.4%	-3.2%
Revenue/Day	94.0	113.6	138.6	155.2	169.0
Other Income (%PBT)	72%	23%	13%	11%	10%

Quarterly Performance

(₹mn)

Particulars	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19
Gross Sales	10,439	11,632	12,117	12,050	14,361	15,113
Excise Duty on Sales	216	209	-	-	-	-
Net Sales	**10,223**	**11,423**	**12,117**	**12,050**	**14,361**	**15,113**
Other operating income		-	-	-	-	-
Income from operation	**10,223**	**11,423**	**12,117**	**12,050**	**14,361**	**15,113**
Cost of material consumed	6,633	8,163	7,577	6,491	9,247	10,160
Purchases of stock-in-trade	628	754	489	568	516	889
Changes in inventories	(238)	(1,115)	15	959	(86)	(830)
Raw Material Cost	**7,022**	**7,802**	**8,081**	**8,019**	**9,676**	**10,219**
Staff Cost	1,070	1,012	1,157	1,049	1,093	1,211
Other expenditure	1,387	1,633	1,470	1,533	1,855	1,828
Total Expenditure	**9,480**	**10,448**	**10,708**	**10,600**	**12,624**	**13,257**
EBITDA	**744**	**975**	**1,409**	**1,450**	**1,738**	**1,855**
Depreciation	167	178	179	179	188	206
EBIT	**576**	**797**	**1,230**	**1,271**	**1,549**	**1,650**
Interest	112	80	84	59	63	29
Other Income	183	205	81	82	226	170
PBT	**647**	**923**	**1,227**	**1,294**	**1,712**	**1,791**
Current Tax	203	260	388	267	74	514
Deferred tax		36	(5)	107	512	81
Fringe benefits Tax						
Tax	203	297	383	375	587	595
PAT	**444**	**626**	**844**	**919**	**1,125**	**1,196**
Profit from discontinued operations after tax	4	-	-	-	-	11
Exceptional Items	(147)	-	69	(1)	-	-
Share of PAT in JV	-	-	-	-	-	-
Reported PAT	**595**	**626**	**776**	**919**	**1,125**	**1,207**
Other comprehensive income, net of tax	51	(4)	3	0	111	(0)
Total other comprehensive income, net of tax	646	623	778	919	1,236	1,207
Equity	1226	1226	1226	1226	1226	1226
EPS	3.6	5.1	6.9	7.5	9.2	9.8

Quarterly Performance

(₹mn)

Margins	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19
Gross margins	31.3%	31.7%	33.3%	33.5%	32.6%	32.4%
EBITDA	7.3%	8.5%	11.6%	12.0%	12.1%	12.3%
PAT	4.3%	5.5%	7.0%	7.6%	7.8%	7.9%
Tax Rate	31.4%	32.1%	31.2%	29.0%	34.3%	33.2%
Growth						
Sales		7%	22%	12%	40%	32.3%
EBITDA		11%	126%	59%	134%	90%
EBIT		9%	166%	70%	169%	107%
PAT		18%	140%	65%	153%	90.9%

Segmental	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19
Segmental Revenue						
Agri-Machinery products	8,018	9,421	9,733	9,484	10,941	11,772
Construction Equipments	1,840	1,646	1,651	1,846	2,660	2,460
Railway equipments	666	652	733	720	760	881
Auto-ancillary products (discontinued operation)	16	0			0	0
Unallocated	3	1	1	1	0	0
Total	**10,543**	**11,720**	**12,118**	**12,052**	**14,361**	**15,113**
Less : Intersegmental	88	88	2	1	0	
Income from operations	**10,455**	**11,632**	**12,117**	**12,050**	**14,361**	**15,113**
Segment Results						
Agri-Machinery products	808	1,018	1,338	1,386	1,657	1,666
Construction Equipments	39	-35	8	41	136	59
Railway equipments	72	64	119	94	121	223
Auto-ancillary products (discontinued operation)	4					17
Others	-3					
EBIT	**919**	**1,047**	**1,464**	**1,522**	**1,913**	**1,966**
Finance Cost	112	80	84	59	63	29
Exceptional items	-147		69	1		
Other un-allocable expenditure	156	45	153	169	139	129
Total Profit before Tax	**798**	**923**	**1,159**	**1,294**	**1,712**	**1,808**

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Name of the Security	**Escorts Ltd.**
Name of the analyst	**Chintan Gupta**
Analysts' ownership of any stock related to the information contained Financial Interest Analyst : Analyst's Relative : Yes / No Analyst's Associate/Firm : Yes/No	NIL No No No
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