

Sterlite Technologies (SOTL IN)

Technology Hardware

16 Jan 2020

NEUTRAL

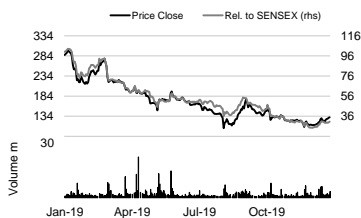
TP: Rs135.0/CP: Rs131.4

Broadly In-line Q3 With Weaker Revenues Compensated by Margin Beat

Basic Share Information

Market cap	Rs53.05bn / US\$0.75bn
Daily traded value (3mth)	US\$3.25mn
Shares outstanding	408.0mn
Shares in issue	406.9mn
Net debt-to-equity	82.6%
1 yr high - low	Rs297.2 - Rs104.2

Price/Volume



Source: Bloomberg

	1mth	3mth	12mth
Absolute	8.4%	-2.9%	-54.9%
Absolute USD	8.4%	-1.9%	-54.8%
Relative to SENSEX	6.3%	-11.6%	-70.2%

Realization Continued to Trend Downwards

Sterlite Tech reported in line Q3 FY20 earnings, with revenue (Rs12bn, -10% YoY) missing HTIe of 1.3% YoY decline, largely due to lower than expected volume in its Fiber business. Realization in the Optical Fiber (OF) business declined to US\$6.0/fKm during the quarter, which management believes is near its bottom. EBITDA margin of 20.1% (down 110bps QoQ) was above HTIe by 150bps, mainly due to better raw material cost management (down 13% YoY). Q3 order book was Rs85.3bn (+5% QoQ, 1.5x trailing 12m book to bill), with another QoQ decline in Product order book. It reported adj. PAT (excl. one time Excise Duty settlement) of Rs1.0bn, down 29% YoY.

Continue to Expect Environment to Stay Challenging in FY21

SOTL's cost control measures (Project Junoon, including raw material, manufacturing and fixed cost reduction) have been impressive, as we expected the margin compression to be more severe given the reduction in OF prices (down 30% in little over a year). While we still expect EBITDA margin to decline from Q4 onward, we now believe the company would deliver at the mid-point of its guided band of 18-20%. On the other hand, we continue to have a cautious view of the industry demand-supply environment, which we expect to stay unfavorable in FY21 as well, as any scaled investment in Fiber for 5G is still some time away. Also, we continue to expect a decline in the Services & Software business (HTIe FY20 revenue share of 50%), as the company has won only one large project (T-Fiber) to replace two mega projects (Indian Navy and Mahanet) which drove FY19-20 services growth but will go into maintenance in early FY21. This would lead to an 11% YoY revenue decline for the segment, wiping away any growth support from increased capacity in the product segment. We expect earnings CAGR over FY20-22 to remain low at 3%, with a decline in FY21 followed by a recovery in FY22. We have marginally tweaked our EPS forecasts.

Financials & valuation

The shares currently trade at 12x our FY21 EPS forecast, which we see as fair. We maintain our target price at Rs.135 as our margin estimate tweak for FY21 is minor. Our target multiple remains at 12.5x (in line with its global peer group), applied on FY21 EPS. We retain our Neutral rating on the stock.

Risks

The main upside risks to our rating and attainment of target price are recovery in global OF demand and faster supply compression than expected, while the downside risks are further reduction in OF prices, delay in 5G rollout and delay in receivable payment from government projects.

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	Mar-18A	Mar-19A	Mar-20E	Mar-21E	Mar-22E	Trend
Total turnover (Rsm)	31,771	50,873	56,260	57,403	67,308	— ■■■■ ■■
Operating profit (Rsm)	5,671	9,322	8,676	7,922	10,433	— ■■■■ ■■
Pre-tax profit (Rsm)	5,026	8,635	6,793	6,027	8,279	— ■■■■ ■■
Net income to ord equity (Rsm)	3,352	5,628	5,352	4,470	6,159	— ■■■■ ■■
Net profit growth	66.4%	67.9%	(4.9%)	(16.5%)	37.8%	■ ■ ■ — —
P/E (x)	15.92	9.50	9.99	11.96	8.68	■ — — — —
Adj EV/EBITDA (x)	8.18	6.07	5.66	5.52	4.08	■ ■ ■ — —
P/B (x)	4.24	2.95	2.37	2.04	1.71	■ ■ ■ — —
ROE	31.4%	36.6%	26.3%	18.3%	21.4%	■ ■ ■ — —
Dividend yield	1.5%	2.7%	1.5%	1.3%	1.7%	— ■ ■ — —
EPS HTI old (Rs)	8.25	14.74	12.71	10.90	14.65	— ■ ■ ■ ■
EPS HTI New (Rs)	8.25	13.83	13.15	10.99	15.14	— ■ ■ ■ ■
Consensus EPS (Rs)	8.33	13.37	15.20	17.87	23.19	— ■ ■ ■ ■
HTI EPS vs Consensus	(1.0%)	3.5%	(13.4%)	(38.5%)	(34.7%)	— — — ■ ■

Source: Company data, Bloomberg, HTI estimates

Click [here](#) to download the working model

Key Conference Call Highlights

Macro View

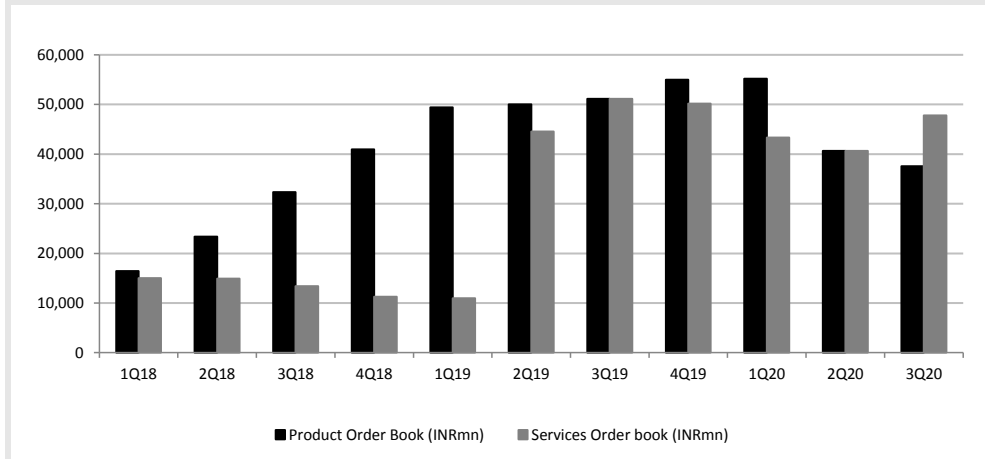
- Global fiber demand declined by 7% in 2019, led by China decline of 13% while US/Europe grew 4% YoY
- India also saw restructuring which resulted in 29% de-growth
- New growth drivers are commercial 5G services launch in 2020 and large Edge networks
- India – are seeing good degree of action on both Bharatnet and from Telco. India will recover in 2020
- 5G: rollouts happening in US and China and are expected in Europe
- This should lead to capex expansion in 2020
- Increased fiberization requirement in 5G will benefit growth
- Cloud data center will also be a driver for fiber demand
- Also see Defense, Indian railways and Power Grid as key opportunities
- Industry realization – industry is in range of \$5-6/fKm, STL is \$6/fKm due to value added products
- Also seen telecom companies are spending towards network creation
- Expect 5G demand to pick up from H2 FY21

Commentary on Q3FY20 Outcome

- Increased new product revenue in total to 19% YTD from 10% in FY16
- Q4 revenue growth – seeing volume growth vs Q3 and have more visibility and OB of services which will drive that
- Net debt – Rs 20.7bn.
- EBITDA decline due to both volume and realization decline.
- Expect to improve absolute EBITDA due to new markets, cost reduction, new products and improvement in capacity utilization and pricing
- Fiber - 46% utilization, cable - 76% of 18mn expanded capacity
- Volume in Q3 in fiber came down while cable is stable
- Volume contracts are there while price renegotiation is happening
- OFC volume will be flat to growing vs last year but expected to increase volumes in FY21
- Trade receivable – 100 days. Have some overdue from BSNL for more than 6-8 months. Have Rs 1.6bn pending and collected Rs 1.4bn
- Capex for fiber optics are completed while cable will continue
- FY20 capex should be less than Rs 5.5bn
- Tax rate – 25% for full year
- Realization - \$6 on Fiber& \$15 on cables
- Services margins – Witnessing margin of 17% and projects are coming in at 20-21%.
- Margin level of stable level will be 15-17% and fiber will be 20-22%. Overall will be between 18-20%
- Made provision of Excise settlement of Rs 0.5bn, awaiting approval
 - Provision – under new scheme and will not be expecting more
- New markets – SEA, ME, NA. Have started good degree of traction, incl. in LA.
- Navy project completed 65%, Mahanet completed 55%

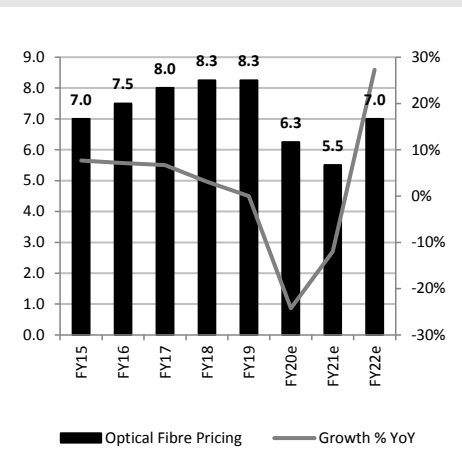
- Project Junoon - Implementation of this project will lead to cost reduction across Raw material (Yield, vendor, Process improvement), manufacturing cost (consumable, power load), and fixed cost (lean and agile)
- Expect order book to grow on the back of expected new order in Q4
- State fiber rollout –Scopes are different by state.
- Capacity utilization increase – by June 2020 full capacity will come onboard
- 75-80% capacity utilization targeted in FY21 for both OF and OFC

Figure 1: Sterlite Tech Order Book (INRmn)



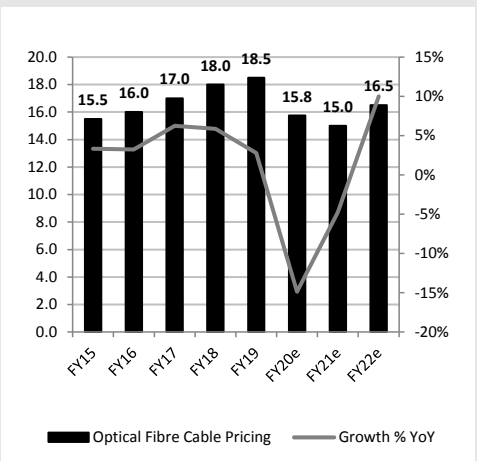
Source: Company data

Figure 2: Optical Fibre Pricing – SOTL



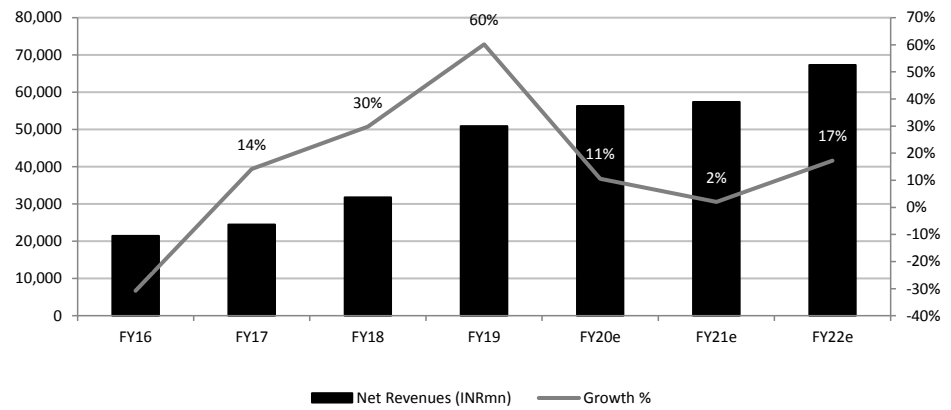
Source: Company data, HTI estimates

Figure 3: Optical Fibre Cable Pricing – SOTL



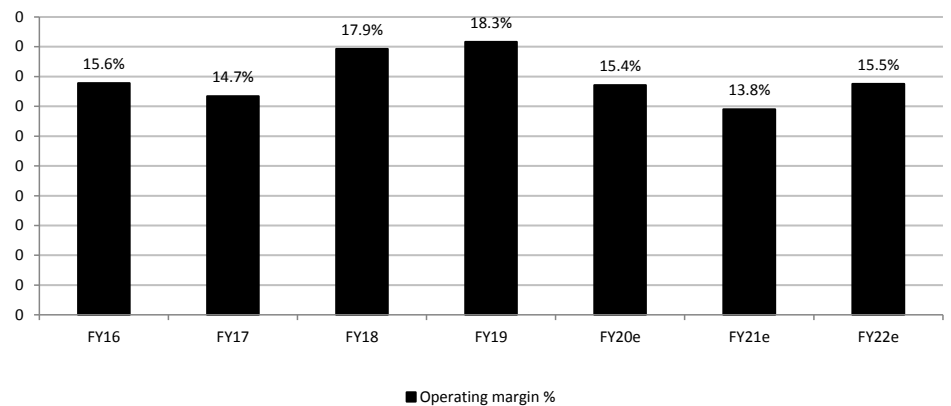
Source: Company data, HTI estimates

Figure 4: Revenue and Revenue Growth (%)



Source: Company data, Hti Estimates

Figure 5: Operating margin %



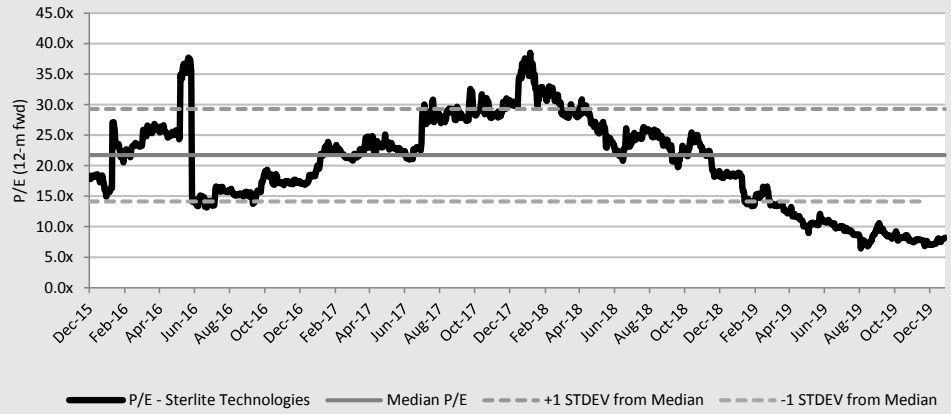
Source: Company data, Hti Estimates

Figure 6: Current Estimates versus Consensus and Previous Estimates

	Revenues			Operating margin (EBITDA)			EPS (GAAP)		
	FY 2020e	FY 2021e	FY 2022e	FY 2020e	FY 2021e	FY 2022e	FY 2020e	FY 2021e	FY 2022e
Haitong est. (INR, mn)	56,260	57,403	67,308	20.6%	19.0%	20.5%	13.15	10.99	15.14
YoY change	10.6%	2.0%	17.3%	-153bps	-162bps	150bps	-4.9%	-16.5%	37.8%
Consensus (INR, mn)	60,234	68,727	74,701	20.4%	20.0%	21.1%	14.35	16.42	20.06
YoY change	18.4%	14.1%	8.7%	-176bps	-38bps	5%	3.7%	14.4%	22.2%
Haitong vs. consensus	-6.6%	-16.5%	-9.9%	22bps	-102bps	-3%	-8.3%	-33.1%	-24.5%
Haitong (previous est.)	56,246	59,331	65,705	19.7%	18.5%	20.5%	12.71	10.90	14.65
YoY change	10.6%	5.5%	10.7%	-246bps	-120bps	200bps	-8.1%	-14.2%	34.4%
Current vs. previous	0.0%	-3.3%	2.4%	92bps	50bps	0bps	3.5%	0.8%	3.3%

Source: Company data, Hti Estimates

Figure 7: Sterlite Tech 12-month Forward PE chart



Source: Bloomberg

Key Ratios	Mar-18A	Mar-19A	Mar-20E	Mar-21E	Mar-22E
Valuation Measures					
Growth					
Revenue growth	29.7%	60.1%	10.6%	2.0%	17.3%
Operating profit growth	57.7%	64.4%	(6.9%)	(8.7%)	31.7%
Net profit growth	66.4%	67.9%	(4.9%)	(16.5%)	37.8%
Margins					
Gross margin	60.1%	51.1%	51.2%	50.0%	51.0%
Operating EBITDA margin	23.6%	22.2%	20.6%	19.0%	20.5%
Operating margin	17.9%	18.3%	15.4%	13.8%	15.5%
Pretax profit margin	15.8%	17.0%	12.1%	10.5%	12.3%
Tax rate	26.5%	32.2%	20.6%	25.0%	25.0%
Net profit margin	10.6%	11.1%	9.5%	7.8%	9.2%
Key Ratios					
ROE	31.4%	36.6%	26.3%	18.3%	21.4%
ROA	10.1%	10.5%	7.7%	6.2%	7.8%
Capex/revenue	14.2%	15.8%	8.9%	3.5%	3.0%
Credit analysis					
EBITDA/interest paid (x)	(7.22)	(10.68)	(6.16)	(5.76)	(6.41)
Debt/EBITDA (x)	1.55	1.71	1.71	1.86	1.51
Debt/equity	92.1%	106.5%	88.0%	77.6%	66.6%
Net debt to equity	63.2%	82.6%	54.0%	25.8%	9.2%

Profit & Loss (Rsm)	Mar-18A	Mar-19A	Mar-20E	Mar-21E	Mar-22E
Total turnover	31,771	50,873	56,260	57,403	67,308
Cost of sales	(12,670)	(24,872)	(27,443)	(28,701)	(32,981)
Gross profit	19,101	26,000	28,817	28,701	34,327
Total operating costs	(13,430)	(16,679)	(20,141)	(20,780)	(23,894)
Operating profit	5,671	9,322	8,676	7,922	10,433
Operating EBITDA	7,494	11,272	11,602	10,906	13,798
Depreciation and amortisation	(1,822)	(1,950)	(2,926)	(2,985)	(3,365)
Interest income	393	369	304	-	-
Interest expense	(1,038)	(1,055)	(2,187)	(1,894)	(2,154)
Pre-tax profit	5,026	8,635	6,793	6,027	8,279
Taxation	(1,332)	(2,782)	(1,401)	(1,507)	(2,070)
Minority interests	(342)	(226)	(40)	(50)	(50)
Net income to ord equity	3,352	5,628	5,352	4,470	6,159

Source: Company data, Bloomberg, HTI estimates

Balance Sheet (Rsm)	Mar-18A	Mar-19A	Mar-20E	Mar-21E	Mar-22E
Total cash and equivalents	3,629	4,332	7,652	13,560	17,945
Inventories	3,379	5,897	5,117	5,351	6,149
Accounts receivable	8,672	24,484	18,334	18,706	21,934
Total current assets	19,562	39,781	36,708	43,336	52,735
Tangible fixed assets	15,010	27,369	29,443	28,459	27,093
Intangible assets	901	1,504	1,504	1,504	1,504
Total other assets	1,644	1,469	1,799	1,581	1,644
Total non-current assets	17,555	30,342	32,747	31,544	30,242
Total assets	37,118	70,123	69,454	74,880	82,976
Short-term debt	4,627	9,827	9,827	9,827	9,827
Accounts payable	6,562	21,831	15,664	16,382	18,825
Total current liabilities	17,040	41,401	35,844	37,104	39,650
Long-term debt	6,954	9,497	9,997	10,497	10,997
Total non-current liabilities	7,505	10,575	11,075	11,575	12,075
Total liabilities	24,545	51,976	46,918	48,678	51,724
Common stocks	802	805	805	805	805
Shareholders' equity	12,573	18,147	22,536	26,201	31,252
Minority interests	-	0	0	0	0
Other equity	-	0	0	0	0
Total equity	12,573	18,147	22,536	26,202	31,252
Total liabilities & shareholders' equity	37,118	70,123	69,454	74,880	82,976

Cash Flow (Rsm)	Mar-18A	Mar-19A	Mar-20E	Mar-21E	Mar-22E
Operating profit	5,671	9,322	8,676	7,922	10,433
Operating cash flow	6,666	6,628	10,423	9,775	9,095
Cash flow from operations	6,461	5,286	10,905	10,162	9,179
Cash flow from investing activities	(5,848)	(11,721)	(5,000)	(2,000)	(2,000)
Cash flow from financing activities	(1,515)	5,702	(2,387)	(2,249)	(2,812)
Cash at beginning of period	2,030	2,079	3,330	6,650	12,558
Total cash generated	(895)	(701)	3,376	5,856	4,309
Implied cash at end of period	2,079	3,330	6,650	12,558	16,944
Free cash flow	1,960	(2,750)	5,905	8,162	7,179

Source: Company data, Bloomberg, HTI estimates

APPENDIX

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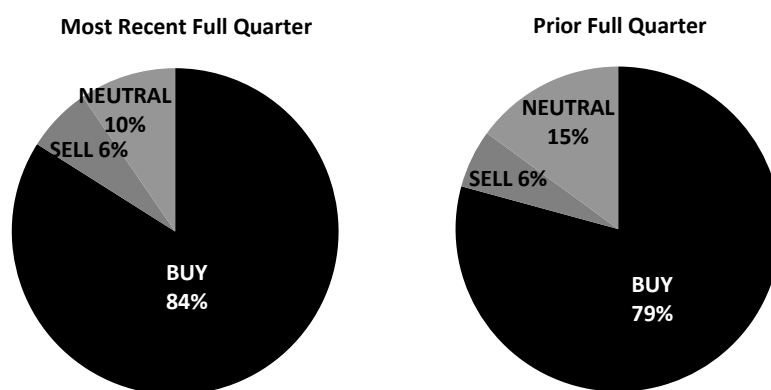
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Recommendation Chart



Date	Recommendation	Target (Rs)	Price (Rs)
2020-01-03	Neutral	135.0	128.8
2019-11-27	Neutral	130.0	122.6
2019-03-14	Neutral	235.0	258.2
2019-02-04	Buy	425.0	226.0
2018-11-30	Buy	465.0	347.7
2018-10-25	Buy	535.0	326.4
2018-07-20	Buy	525.0	330.9
2018-02-26	Buy	500.0	364.3
2018-01-18	Buy	440.0	389.5
2018-01-08	Buy	400.0	348.3

Source: Company data Bloomberg, HTI estimates