

Sterlite Technologies (SOTL IN)

Available at trough valuations

BUY

Share Price INR 125
 12m Price Target INR 190 (+52%)
 Previous Price Target INR 210

3QFY20 EPS below estimates, valuation attractive

3QFY20 recurring EPS was 18%/9% below our/street forecasts due to the products business weakness. The systems integration business is holding up. The products business should turn around soon as US-China trade talks are making progress and 5G launches are picking up globally. SOTL is trading at an attractive 8.3x FY21E EPS. We cut FY20-22E EPS by 4-14% to factor in products weakness and slow tendering in systems integration business. Maintain BUY with a lower TP of INR190, pegged at 7x FY21E EBITDA, a 30% discount to peers to reflect near term underperformance.

Guidance for performance to pick-up from 4Q

Optical fibre (OF) capacity utilisation declined to 76% in 3Q from 100% in 2Q due to end-of-year (Dec qtr) demand weakness. OF price declined to USD6/fkm from USD6-6.5/fkm in 2Q. Management expects volumes to pick up from 4Q, driven by: a) order intake in 3Q; b) new markets; c) finalisation of capex plans for CY20; and d) 5G deployment. China officially rolled out 5G services in 50 cities in Nov'19, while the US and Europe are adding the number of cities with 5G. Management has guided for capacity utilisation of 75-80% for FY21E based on its expanded capacity of 50m fkm for OF and 33m fkm for OF cables.

Systems integration business holding up

The execution of the two large contracts continues to drive the systems integration business. New orders were strong at INR14.3b (book-to-bill of 2x) in 3Q, taking the total order book to INR48b (1.7x FY20E revenue). This includes an INR11b contract (additional INR7b in Phase II) from the Telangana state government. SOTL is bidding for similar contracts in 4-5 other Indian states. The central government's focus on digitalization and broadband penetration should drive a pick-up in orders in FY21E.

Valuation attractive, FCF yield of 11.5% for FY21E

At 8.3x FY21E EPS, we believe valuation is attractive. SOTL is trading at a 40-50% discount to peers in terms of P/E and 48-50% discount based on FY20-21E EBITDA. We believe SOTL is well placed to benefit from the anticipated pick-up in 5G rollout from 2HCY20 onwards. In addition, with the capex cycle ending in 1HFY21, we forecast FCF yield to improve to 11.5-19.1% for FY21-22E from 2.2% in FY20E.

FYE Mar (INR m)	FY18A	FY19	FY20E	FY21E	FY22E
Revenue	32,055	50,87	53,354	61,063	68,966
EBITDA	7,494	11,27	11,328	13,119	15,180
Core net profit	3,343	5,62	5,251	6,058	7,790
Core EPS (INR)	8	14	13	15	19
Core EPS growth (%)	64.9	67.	(7.0)	15.4	28.6
Net DPS (INR)	2	4	3	4	5
Core P/E (x)	37.5	15.	9.6	8.3	6.5
P/BV (x)	10.7	5.1	2.4	2.0	1.6
Net dividend yield (%)	0.6	1.6	2.6	3.0	3.9
ROAE (%)	32.5	38.	27.6	26.3	27.9
ROAA (%)	10.1	10.	7.1	7.5	9.0
EV/EBITDA (x)	18.0	9.4	6.3	5.2	4.1
Net gearing (%) (incl perps)	70.3	90.	89.1	65.0	34.4
Consensus net profit	-	-	5,772	6,545	7,544
MKE vs. Consensus (%)	-	-	(9.0)	(7.4)	3.3

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Company Description

SOTL provides transmission solutions for the telecom industry. It offers a range of end-to-end optical fibers for a variety of applications.

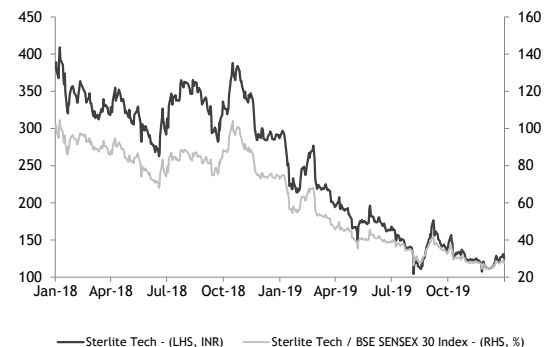
Statistics

52w high/low (INR)	297/104
3m avg turnover (USDm)	3.4
Free float (%)	45.5
Issued shares (m)	404
Market capitalisation	INR50.5B USD712M

Major shareholders:

Volcan Investments Ltd. (Bahamas)	51.8%
DSP Investment Managers Pvt Ltd.	2.2%
Aditya Birla Sun Life AMC Ltd.	1.2%

Price Performance



	-1M	-3M	-12M
Absolute (%)	9	(9)	(56)
Relative to index (%)	7	(16)	(62)

Source: FactSet

Cut EPS by 4-14% for FY20-22E

Factoring in the 3Q performance, we revised down our FY20-22E revenue forecasts by 12-17%. Specifically, we cut our products business revenue by 9-16% to factor in lower volumes and price. We also lowered our systems integration business revenue by 16-17% to factor in the slower orders in 9MFY20. We raise our EBITDA margin by 80-190bps to factor in the 9M performance, strong cost management and improvement in systems integration EBITDA margin to 15-16% from 14% earlier. Overall, we cut our EPS forecasts by 4-14%. The company has made an INR507m as full and final settlement under for a disputed excise duty demand of INR1.9b under the Sabka Vishwas (Legacy Dispute Resolution) Scheme, 2019.

Fig 1: Earnings and TP changes

FYE March	FY20E		Chg (%)	FY21E		Chg (%)	FY22E		Chg (%)
	New	Old		New	Old		New	Old	
Revenue (INRm)	53,354	63,914	-17	61,063	71,944	-15	68,966	78,430	-12
Product business	25,770	30,580	-16	31,782	37,113	-14	38,877	42,945	-9
System integration business	27,181	32,931	-17	28,168	33,717	-16	28,809	34,205	-16
EBITDA (INRm)	11,328	12,337	-8	13,119	14,577	-10	15,180	16,603	-9
EBITDAM	21.2%	19.3%	+190bp	21.5%	20.3%	+120bp	22.0%	21.2%	+80bp
Recurring net profit (INRm)	5,251	5,483	-4	6,058	7,037	-14	7,790	8,657	-10
Recurring EPS (INR)	13.0	13.6	-4	15.0	17.4	-14	19.3	21.4	-10
Net debt (INRm)	19,578	20,165	-3	17,149	17,142	0	11,026	10,001	10
TP (INR)	190	210	-10						

Source: Maybank Kim Eng

Fig 2: Revenue & EBITDA by segments

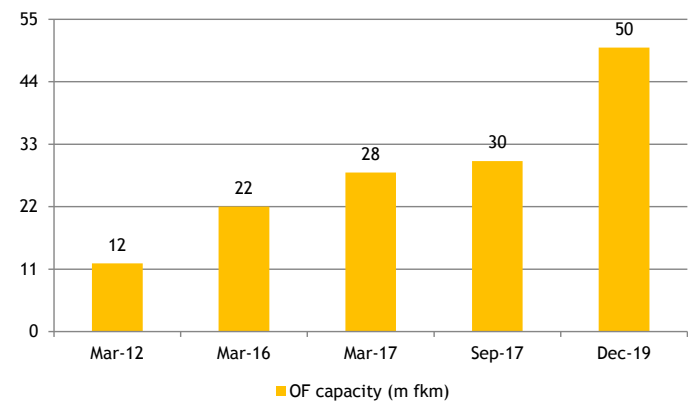
Particulars	FY18	FY19	FY20E	FY21E	FY22E
Revenue by segments					
Products	23,720	32,050	25,770	31,782	38,877
System integration & software	8,334	18,823	27,584	29,281	30,089
Total	32,055	50,873	53,354	61,063	68,966
% of revenue					
Products	74%	63%	48%	52%	56%
System integration & software	26%	37%	52%	48%	44%
Total	100%	100%	100%	100%	100%
EBITDA by segments					
Products	6,661	9,202	7,190	8,422	10,361
System integration & software	832	2,070	4,138	4,697	4,819
Total	7,493	11,271	11,328	13,119	15,180
EBITDA margin by segments					
Products	28.1%	28.7%	27.9%	26.5%	26.7%
System integration & software	10.0%	11.0%	15.0%	16.0%	16.0%
Total	23.4%	22.2%	21.2%	21.5%	22.0%

Source: Company, Maybank Kim Eng

EBITDA margin performance better than expected despite declining revenue

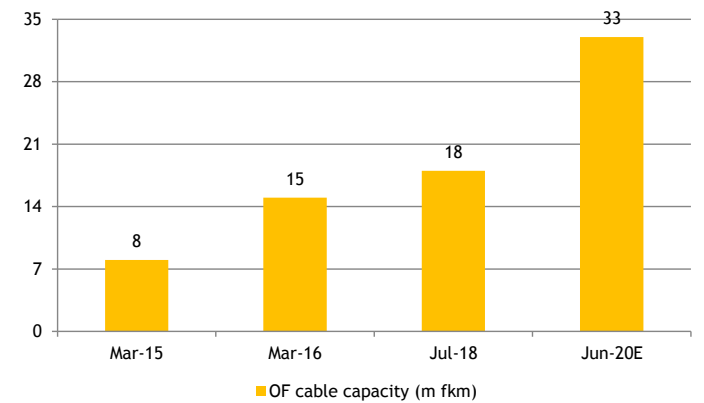
We believe management has done well in controlling costs and improving EBITDA margin. This is attributed to managing the yields from raw materials, renegotiations with vendors, improving in-house processes, reduction in consumable costs, optimising power load factors, and lowering fixed costs by improving efficiency in sales and administration expenses. The margins in the systems integration business have improved from 11-12% to 15-16% over the past couple of quarters. Increase in scale of operations has led to the margin improvement. The products business EBITDA margin has stabilised at around 26-27% despite the decline in volumes and prices. The company has also increased its optical fibre capacity to 50m fkm in 3Q from 30m in 2Q.

Fig 3: Optical fibre capacity ramped up to 50m fkm in Dec 2019, currently in test production phase



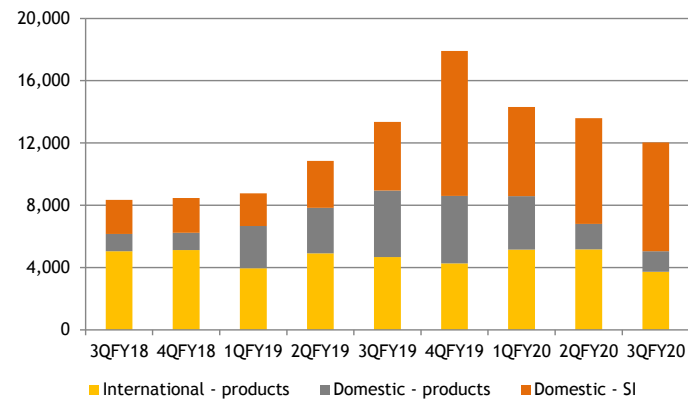
Source: Company

Fig 4: To increase optical fibre cable capacity to 33m fkm by Jun 2020 maintaining the OF/optical fibre cable split



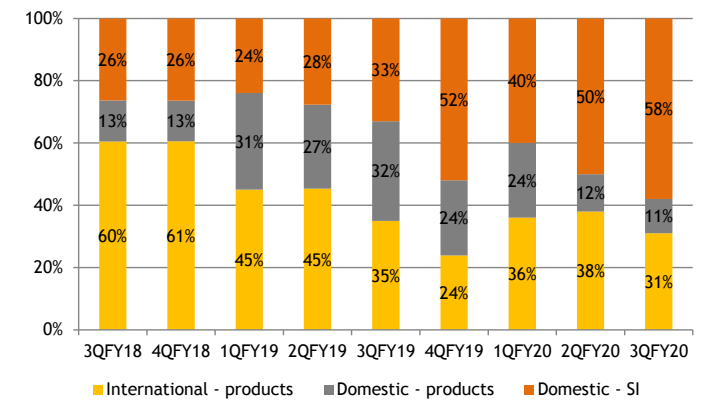
Source: Company

Fig 5: Products business weak in 3QFY20, while systems integration was steady (INRm)

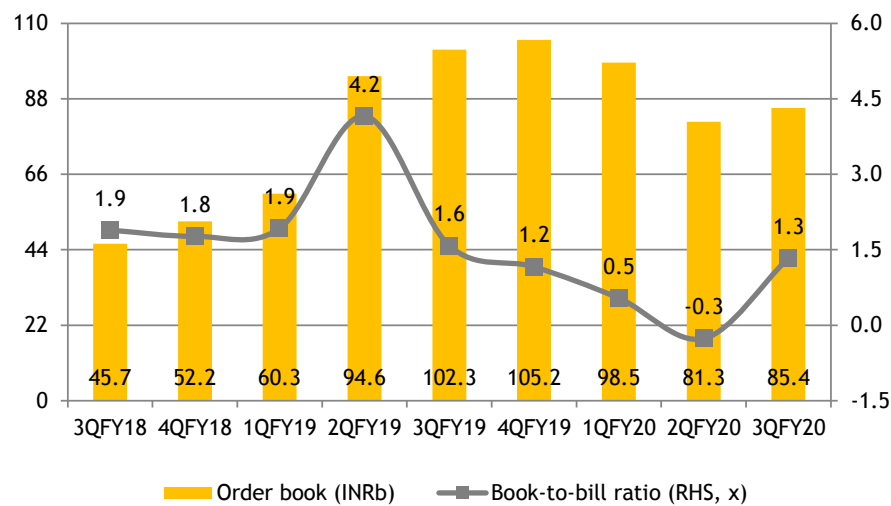


Source: Company

Fig 6: Revenue share of systems integration increased to 58% in 3QFY20 (%)



Source: Company

Fig 7: Order book improves in 3Q, driven by pick-up in new orders


Source: Company

Fig 8: Peer comparison

Company name	Bbg		CMP	Rating	TP (INR)	Upside/Downside	Mkt cap (USDm)	ROE	EV/EBITDA (x)			P/E (x)		
	Code	Curr						FY19	Y	Y+1	Y+2	Y	Y+1	Y+2
Sterlite Technologies	SOTL IN	INR	125	BUY	190	52%	709	38.9%	5.9	6.2	5.2	8.9	9.6	8.3
Fujikura	5803 JT	JPY	434	NR	NR	NA	1,213	6.3%	5.9	6.9	6.4	85.3	33.0	13.9
Prysmian	PRY IM	EUR	21	NR	NR	NA	5,074	7.1%	14.2	9.2	8.7	16.2	13.7	12.1
Corning	GLW US	USD	30	NR	NR	NA	22,819	7.8%	10.4	9.3	9.0	16.7	17.0	16.2
Yangtze Optical Fibre	6869 HK	HKD	16	NR	NR	NA	2,765	22.2%	7.5	21.7	16.4	7.6	16.3	13.6
Finolex Cables	FNXC IN	INR	421	NR	NR	NA	907	15.2%	13.7	12.3	11.1	16.0	13.5	12.2
Vindhya Telelinks	VT IN	INR	981	NR	NR	NA	164	NA	7.1	NA	NA	4.2	NA	NA
Average of peers								11.7%	9.8	11.9	10.3	24.3	18.7	13.6

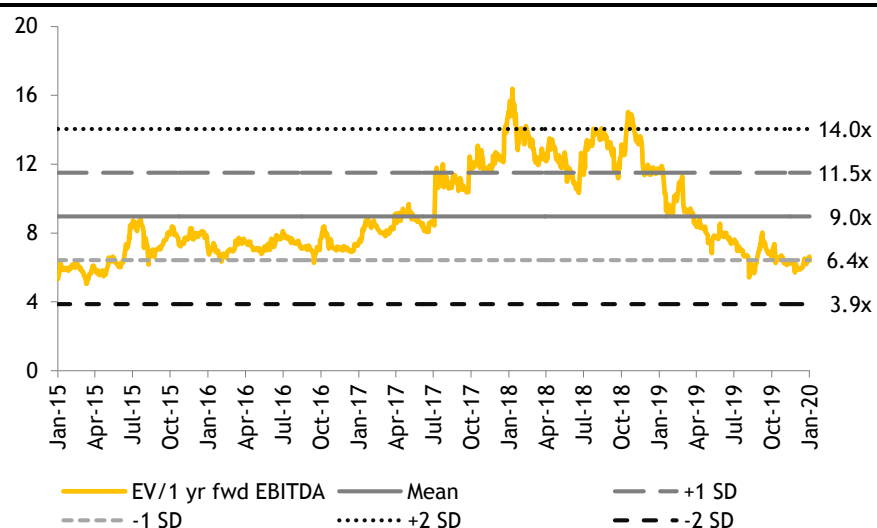
Source: Bloomberg, Maybank Kim Eng

Fig 9: Results summary

FY Mar (INRm)	Quarterly					Cumulative		
	3QFY20	3QFY19	% YoY	2QFY20	% QoQ	9MFY20	9MFY19	% YoY
Revenue	12,027	13,349	-9.9	13,597	-11.5	39,943	32,961	21
Cost of sales, ex depr	(7,338)	(7,793)	-5.8	(8,192)	-10.4	(24,062)	(17,737)	36
Selling & admn. exp.	(2,275)	(2,617)	-13.1	(2,520)	-9.7	(7,348)	(7,103)	3
EBITDA	2,414	2,939	-17.9	2,885	-16.3	8,533	8,121	5
Depreciation	(701)	(512)	36.8	(750)	-6.6	(2,135)	(1,452)	47
Operating profit	1,713	2,427	-29.4	2,135	-19.7	6,399	6,669	-4
Other income	60	104	-42.3	91	-34.1	239	237	1
Interest expense	(557)	(274)	103.4	(597)	-6.7	(1,617)	(748)	116
Pretax Profit	1,216	2,257	-46.1	1,629	-25.3	5,020	6,158	-18
Tax	(191)	(760)	-74.9	(33)	473.9	(958)	(1,960)	-51
Minority interests	8	(41)	n.a.	0	n.a.	(20)	(222)	-91
Recurring net profit	1,033	1,456	-29.0	1,596	-35.2	4,043	3,976	2
Exceptional items	(507)	0	n.a.	0	n.a.	(507)	0	n.a.
Net profit	526	1,456	-63.9	1,596	-67.0	3,536	3,976	-11
Recurring EPS (INR)	2.6	3.6	-29.3	4.0	-35.3	10.0	9.9	1
Gross Margin (%)	33.2	37.8	-460bp	34.2	-100bp	34.4	41.8	-740bp
EBITDA Margin (%)	20.1	22.0	-190bp	21.2	-110bp	21.4	24.6	-320bp
EBIT Margin (%)	14.2	18.2	-400bp	15.7	-150bp	16.0	20.2	-420bp
Tax rate (%)	15.7	33.7	n.a.	2.0	n.a.	19.1	31.8	n.a.

Source: Company

Fig 10: One-year forward EV/EBITDA

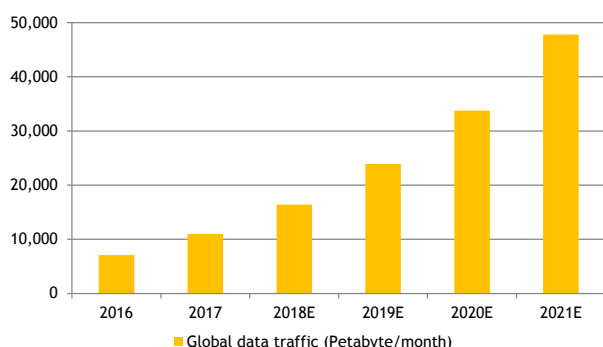


Source: Bloomberg, Maybank Kim Eng

Value Proposition

- SOTL is one of only eight fully integrated optical fibre (OF) manufacturers globally.
- SOTL dominates India's OF market with 40% market share and 6% share of the global market.
- High investments and low initial returns are entry barriers.
- OF cable demand took a pause in 2018 after increasing at a 17% CAGR (2013-17). The data story is intact, fuelled by upgrade of telco networks and building of fibre-to-the-home networks.
- Increase in capacity will change the outlook for returns. OF capacity increased to 50m fkm in Dec '19 from 30m fkm and OF cable capacity to 33m fkm by Jun'20 from 18m fkm currently.

Global data traffic growth (Petabytes/month)

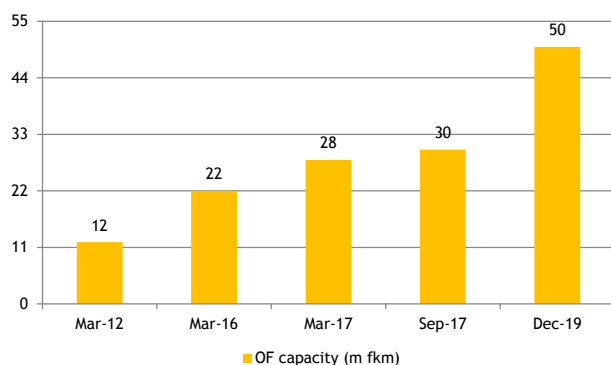


Source: Cisco Visual Networking Index Forecast

Financial Metrics

- As per Cisco Visual Networking Index Forecast, data traffic in India is expected to increase 365% over the next five years, boosting OF demand.
- Lower EBITDA margin of system integration business at 15-16% will overshadow the strong product margins of 25-28%. Hence company margin of 21.2-22% for FY20-22E.
- SOTL's earnings visibility is improving with entry into network design business, which will also reduce the dependence on the products business.
- Net D/E is comfortable at 1x for FY20E. This will start declining after completion of capex.

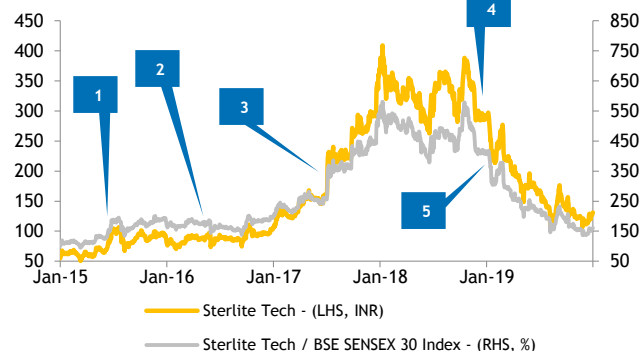
SOTL: planned optical fibre capacity additions



Source: Company

Price Drivers

Historical share price trend



Source: Company, Maybank Kim Eng

1. SOTL announced spin-off of the power business with guaranteed buyback by promoters at a fair value.
2. The share price is adjusted to give the effect of a de-merger of the power business.
3. Announces expansion on OF capacity of 50m fkm from 30m fkm.
4. Fears of fall in optical fibre prices due to delay in China Mobile tender
5. 100% pledging of promoters' stake driving down the stock price.

Swing Factors

Upside

- Pick-up in global demand and price of optical fibre.
- New order wins in systems integration business.

Downside

- Slowdown in global demand for OF and OF cables.
- Inability to secure large contracts in systems integration business.
- USD/INR appreciation to impact earnings owing to increasing exports dependence.

FYE 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Key Metrics					
P/E (reported) (x)	29.3	22.0	9.6	8.3	6.5
Core P/E (x)	37.5	15.6	9.6	8.3	6.5
P/BV (x)	10.7	5.1	2.4	2.0	1.6
P/NTA (x)	10.7	5.1	2.4	2.0	1.6
Net dividend yield (%)	0.6	1.6	2.6	3.0	3.9
FCF yield (%)	2.2	nm	2.2	11.5	19.1
EV/EBITDA (x)	18.0	9.4	6.3	5.2	4.1
EV/EBIT (x)	23.8	11.3	8.4	7.0	5.3
INCOME STATEMENT (INR m)					
Revenue	32,054.9	50,872.6	53,354.2	61,062.9	68,965.9
Gross profit	14,074.9	18,938.2	18,350.6	21,193.1	24,647.7
EBITDA	7,493.5	11,271.5	11,327.7	13,119.4	15,180.0
Depreciation	(1,822.1)	(1,949.8)	(2,847.6)	(3,222.9)	(3,290.9)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	5,671.4	9,321.7	8,480.1	9,896.5	11,889.0
Net interest income / (exp)	(1,038.3)	(1,054.9)	(2,126.5)	(2,012.8)	(1,680.3)
Associates & JV	0.0	0.0	0.0	0.0	0.0
Exceptionals	0.0	0.0	0.0	0.0	0.0
Other pretax income	392.7	368.6	350.2	385.2	423.7
Pretax profit	5,025.8	8,635.4	6,703.8	8,268.9	10,632.5
Income tax	(1,331.5)	(2,781.6)	(1,340.8)	(2,081.3)	(2,676.2)
Minorities	(351.0)	(226.3)	(112.0)	(129.2)	(166.2)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	3,343.3	5,627.5	5,251.0	6,058.4	7,790.1
Core net profit	3,343.3	5,627.5	5,251.0	6,058.4	7,790.1
BALANCE SHEET (INR m)					
Cash & Short Term Investments	2,934.8	3,338.5	3,109.1	2,537.7	4,660.9
Accounts receivable	8,712.8	13,566.2	16,079.4	18,402.5	20,784.2
Inventory	3,378.5	5,896.5	6,184.1	7,077.6	7,993.6
Property, Plant & Equip (net)	15,171.7	27,799.6	30,297.0	30,649.1	28,358.1
Intangible assets	739.3	1,073.5	2,129.5	2,129.5	2,129.5
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	6,180.3	18,448.5	19,823.9	22,637.1	25,521.2
Total assets	37,117.4	70,122.8	77,623.0	83,433.5	89,447.6
ST interest bearing debt	0.0	0.0	0.0	0.0	0.0
Accounts payable	6,561.8	19,127.5	18,998.3	21,673.1	24,314.2
LT interest bearing debt	11,775.4	19,842.3	22,687.1	19,687.1	15,687.1
Other liabilities	6,208.0	13,006.0	13,966.0	15,692.0	17,395.0
Total Liabilities	24,544.7	51,975.8	55,651.5	57,052.4	57,396.7
Shareholders Equity	11,753.2	17,193.0	20,905.6	25,185.8	30,689.5
Minority Interest	819.5	954.0	1,066.0	1,195.2	1,361.4
Total shareholder equity	12,572.7	18,147.0	21,971.6	26,381.0	32,050.9
Total liabilities and equity	37,117.4	70,122.8	77,623.0	83,433.5	89,447.6
CASH FLOW (INR m)					
Pretax profit	5,025.8	8,635.4	6,703.8	8,268.9	10,632.5
Depreciation & amortisation	1,822.1	1,949.8	2,847.6	3,222.9	3,290.9
Adj net interest (income)/exp	901.8	885.7	1,776.3	1,627.6	1,256.6
Change in working capital	203.8	(3,253.2)	(3,513.4)	(1,628.8)	(1,837.6)
Cash taxes paid	(1,106.8)	(2,227.6)	(1,340.8)	(2,081.3)	(2,676.2)
Other operating cash flow	469.4	320.4	0.0	0.0	0.0
Cash flow from operations	7,316.1	6,310.5	6,473.6	9,409.3	10,666.2
Capex	(4,577.0)	(8,090.1)	(5,345.0)	(3,575.0)	(1,000.0)
Free cash flow	2,739.1	(1,779.6)	1,128.6	5,834.3	9,666.2
Dividends paid	(380.8)	(968.0)	(1,541.2)	(1,778.1)	(2,286.4)
Equity raised / (purchased)	14.7	3.1	2.7	0.0	0.0
Change in Debt	(184.0)	7,747.4	2,844.8	(3,000.0)	(4,000.0)
Other invest/financing cash flow	(978.4)	(4,599.2)	(2,664.3)	(1,627.6)	(1,256.6)
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	1,210.6	403.7	(229.4)	(571.4)	2,123.2

FYE 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Key Ratios					
Growth ratios (%)					
Revenue growth	23.6	58.7	4.9	14.4	12.9
EBITDA growth	44.4	50.4	0.5	15.8	15.7
EBIT growth	57.7	64.4	(9.0)	16.7	20.1
Pretax growth	93.2	71.8	(22.4)	23.3	28.6
Reported net profit growth	66.0	68.3	(6.7)	15.4	28.6
Core net profit growth	66.0	68.3	(6.7)	15.4	28.6
Profitability ratios (%)					
EBITDA margin	23.4	22.2	21.2	21.5	22.0
EBIT margin	17.7	18.3	15.9	16.2	17.2
Pretax profit margin	15.7	17.0	12.6	13.5	15.4
Payout ratio	24.0	25.0	25.0	25.0	25.0
DuPont analysis					
Net profit margin (%)	10.4	11.1	9.8	9.9	11.3
Revenue/Assets (x)	0.9	0.7	0.7	0.7	0.8
Assets/Equity (x)	3.2	4.1	3.7	3.3	2.9
ROAE (%)	32.5	38.9	27.6	26.3	27.9
ROAA (%)	10.1	10.5	7.1	7.5	9.0
Liquidity & Efficiency					
Cash conversion cycle	39.4	(19.7)	(45.8)	(33.0)	(33.4)
Days receivable outstanding	87.7	78.8	100.0	101.6	102.3
Days inventory outstanding	74.8	55.7	67.6	65.1	66.1
Days payables outstanding	123.1	154.2	213.4	199.8	201.8
Dividend cover (x)	4.2	4.0	4.0	4.0	4.0
Current ratio (x)	1.7	1.3	1.4	1.4	1.4
Leverage & Expense Analysis					
Asset/Liability (x)	1.5	1.3	1.4	1.5	1.6
Net gearing (%) (incl perps)	70.3	90.9	89.1	65.0	34.4
Net gearing (%) (excl. perps)	70.3	90.9	89.1	65.0	34.4
Net interest cover (x)	5.5	8.8	4.0	4.9	7.1
Debt/EBITDA (x)	1.6	1.8	2.0	1.5	1.0
Capex/revenue (%)	14.3	15.9	10.0	5.9	1.4
Net debt/ (net cash)	8,840.6	16,503.8	19,578.0	17,149.4	11,026.2

Source: Company; Maybank

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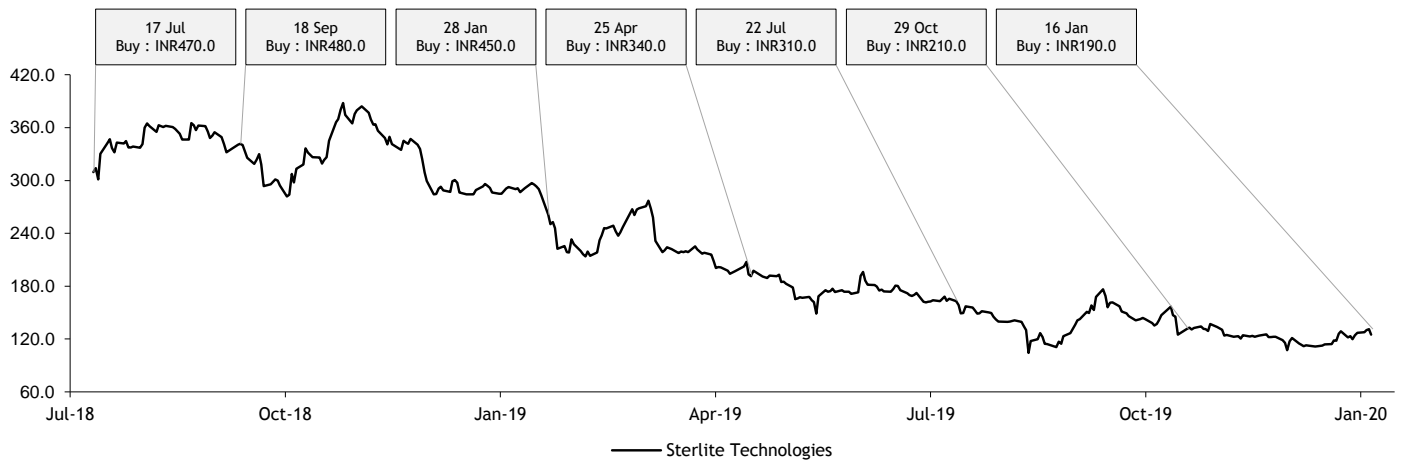
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