

Sterlite Technologies (SOTL IN)

Concerns over weak optical fibre priced in

EPS/TP cut, long term data story remains intact; BUY
 4QFY19 EPS was in line with our and street estimates. However, slight weakness in ASP of optical fibre (OF) and OF cable, and accelerated growth in low-margin system integration business has led us to cut our FY20-21E EPS by 13-19%. We also cut TP 24% to INR340 after lowering our target EV/EBITDA multiple to 11x FY20E vs 12.5x earlier, below its 3-year avg. 13.7x and 11.5x for global peers to factor the changed business mix.

We forecast 20% EPS CAGR over FY19-22E with 25%+ ROCE and unchanged long-term revenue growth driven by high data usage. The shares have taken a hit along with other domestic small/midcap stocks, as well as on concerns over weak OF prices and the promoter pledging 100% of shares (52% stake) as loan collateral. Upside catalysts: faster than expected order bookings, rising FCF in FY20-21 on lower capex, and falling net D/E. The timing of the removal of share pledge is uncertain.

System integration to help offset commodity cycles

We forecast the system integration business to make up 43-48% of FY20-21 revenue vs 25-28% earlier, driven by: a) faster-than-expected execution of orders; and b) a strong order intake at 2x of FY19 revenue. This will help SOTL offset the commodity related cyclicality in the business. This will also lead to a decline in company level EBITDA margin and an increase in working capital. We believe the working capital needs will be offset by the low capex business requirements.

Forecast EBITDA margin of 19.3 - 20.3% for FY20-21

Factoring in the recent tender prices in China, we cut our OF ASP to USD 7/fibre km, 10% lower YoY. We are, however, not overly worried on the pricing front for SOTL because: a) its China exposure is 4% of total revenue; b) pricing action in China has not spilled over to other geographies; c) it has term contracts with clients; and d) high priced value-added fibre forms 22% of total supplies, which is expected to increase. The OF capacity starting by end June 2019 should drive the product revenue. SOTL has maintained its net profit guidance of USD100m for FY20, +25% YoY, which is above our estimate of USD89m.

Data story intact, rising FCF and falling net D/E

SOTL's expansion is well timed to benefit from the next phase of demand from fibre deployment for 4G in its key markets, as well as the onset of 5G deployment expected in FY20/21. We believe the fall in its stock price is a strong buying opportunity. Reiterate BUY.

FYE Mar (INR m)	FY18A	FY19A	FY20E	FY21E	FY22E
Revenue	32,055	50,873	70,982	80,253	88,839
EBITDA	7,494	11,272	13,683	16,285	18,816
Core net profit	3,343	5,628	6,238	7,922	9,610
Core EPS (INR)	8	14	15	20	24
Core EPS growth (%)	64.9	67.7	10.8	27.0	21.3
Net DPS (INR)	2	4	4	5	6
Core P/E (x)	37.5	15.6	12.5	9.8	8.1
P/BV (x)	10.7	5.1	3.6	2.9	2.3
Net dividend yield (%)	0.6	1.6	2.0	2.5	3.1
ROAE (%)	32.5	38.9	32.2	32.5	31.4
ROAA (%)	10.1	10.5	7.9	8.7	9.7
EV/EBITDA (x)	18.0	9.4	7.1	5.8	4.7
Net gearing (%) (incl perps)	70.3	90.9	76.9	51.6	23.1
Consensus net profit	-	-	6,675	7,779	9,320
MKE vs. Consensus (%)	-	-	(6.6)	1.8	3.1

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BUY

Share Price **INR 193**
 12m Price Target **INR 340 (+76%)**
 Previous Price Target **INR 450**

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.

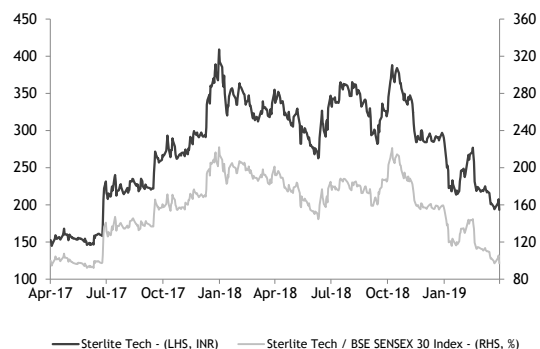
Statistics

52w high/low (INR)	388/193
3m avg turnover (USDm)	7.1
Free float (%)	43.9
Issued shares (m)	403
Market capitalisation	INR77.8B
	USD1.1B

Major shareholders:

Twinstar Overseas Ltd.	52.0%
L&T Investment Management Ltd.	3.0%
DSP Investment Managers Pvt Ltd.	2.3%

Price Performance



	-1M	-3M	-12M
Absolute (%)	(13)	(33)	(46)
Relative to index (%)	(14)	(37)	(51)

Source: FactSet

Despite higher revenue forecast, cut EPS 13-19% on lower PM

We raise our revenue forecast for FY20-21 by 7-9%. This is driven by a) 79-82% increase in our revenue forecasts for system integration business driven by pick up in execution and new ordering; and b) 16-22% cut in our product business to factor cut in ASPs. We expect the product business EBITDA margin to be 26-26.5% for FY20-21 vs 28.7% in FY19. Scale benefit will lead to improvement in EBITDA margin of the system integration business to 12% for FY20-21 vs 11% for FY19. Further we forecast the system integration business to make up 43-48% of total FY20-21 revenue vs 25-28% earlier. This has led to 430-460bps cut in our EBITDA margin forecast. Accordingly, we cut our EPS forecasts by 13-19% for FY20-21.

Fig 1: Earnings and TP changes

FYE March	FY20E		Chg	FY21E		Chg
	New	Old	(%)	New	Old	(%)
Revenue (INRm)	70,982	66,063	7	80,253	73,688	9
Product business	36,918	47,037	-22	45,815	54,810	-16
System integration business	34,064	19,026	79	34,438	18,878	82
EBITDA (INRm)	13,683	15,784	-13	16,285	18,135	-10
EBITDAM	19.3%	23.9%	-460bp	20.3%	24.6%	-430bp
Net profit (INRm)	6,238	7,689	-19	7,922	9,068	-13
EPS (INR)	15.5	19.2	-19	19.7	22.6	-13
TP (INR)	340	450	-24			

Source: Maybank Kim Eng

4QFY19 - strong revenue growth and order book, EBITDA margin decline due to change in revenue profile

4QFY19 revenue increased 34.6% QoQ and 111.6% YoY driven by doubling of system integration revenue. Products business revenue declined QoQ due to decline in ASP of OF and OF cable. The share of system integration business increased to 52% of revenue vs 33% in 3Q. Order booking momentum was maintained with order book at close of FY19 at INR105.2b. The order intake in FY19 was 2x of revenue. The system integration order intake was even stronger at 3.1x of FY19 revenue. Of the EBITDA margin decline of 440bps QoQ, about 300bps was due to higher share of revenue from system integration business and 140bps due to lower ASPs. Going forward, management has guided for EBITDA margin of 18-20%.

Entering new markets: North America cloud providers for products and telcos for system integration

The company added 35 new customers in FY19 across geographies. SOTL increased OF deployments across Europe (13% YoY), India (16% YoY) and other parts of the world such as LATAM and Middle East (7% YoY). The company gained entry into the world's top two cloud providers. This augurs well for the North America market where it had no presence till now. It also made inroads into a new tier-1 telcos. We believe all of the above will help it raise demand for the new OF capacity of 20m fkm, to be commissioned in end June 2019. Revenue from China halved to 4% of FY19 revenue from 8% in FY18, lowering its dependence of the geography. Europe contributes about 70% of its product order book. In the system integration business, SOTL secured network design and rollout contracts from India's two largest telcos. This opens up a new opportunity apart from its work for the state and central government funded smart cities and broadband network projects.

....and strengthening leadership

SOTL has strengthened its leadership team with the addition of four leaders: three with technology prowess and a human resources head. The leadership addition clearly indicates the company’s focus to remain ahead on technology and benefit from the interplay of products, network design and technology. We are particularly encouraged by the addition of Dr Jitendra Balakrishnan as CTO - Optical products. Dr Jitendra established Corning’s R&D presence in India. He was with Corning for almost 18 years. His last responsibility at Corning was Research Director, Innovation & Technology for Emerging Markets. If SOTL were to tap the US market, its prospects will improve. Dr. Ambica Rajagopal, Head of Data Science - Ambica has a Doctorate in Mathematics from Purdue University and a Master’s in Mathematics from the Birla Institute of Technology and Science. She has led global data science practices at Cummins, KPMG, RMS and Fidelity Investments. Manuj Desai, Head of Technology Transformation has over 20+ years of experience in corporate development, product development, business operations and strategy. He has held senior positions in AIG, PayPal and Sprint Nextel, among others.

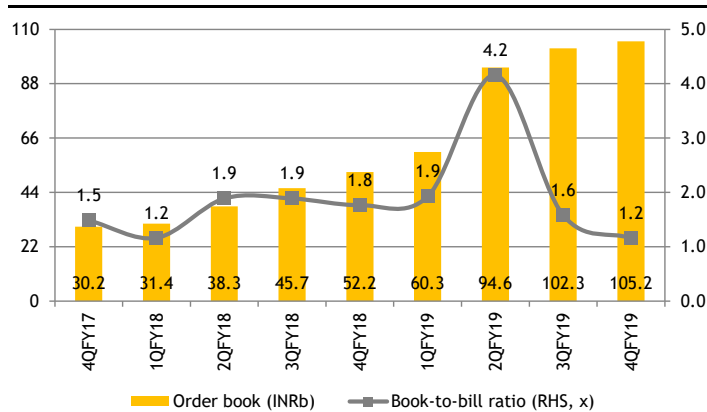
FCF generation to improve from FY20 onwards

FY19 was the year of peak capex of INR10.4b for greenfield OF and OFC capacity. The company also concluded the purchase of Metallurgica Bresciana for EUR46.5m. Capex during FY20-21 will be INR3.2b for the new OF capacity and INR2.2b for additional OF cable capacity. We forecast FY20-21 capex of INR3.6 - 5.3b. We believe FCF generation will improve and be utilized for: a) reducing debt; and b) funding any additional working capital needs of the business. We forecast an overall net working capital of 48.4-56.2 days for FY20-21 vs 43.7 days in FY19.

Promoter have pledged 100% of its stake for bridge funding

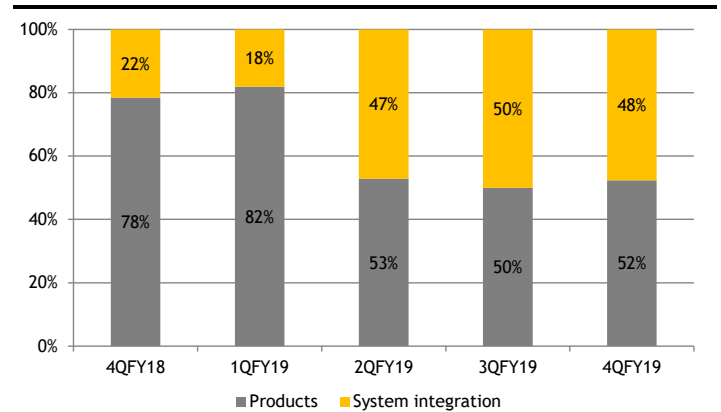
Promoter, the Vedanta Group holds a 52.05% stake in SOTL through Twin Star Overseas Limited. 100% of this stake was pledged in Sep’18 to fund its buyback of Vedanta Resources plc, listed on the London Stock Exchange. Of the total debt of USD1.1b raised, USD900m is currently outstanding. Collateral of 3x the value of the outstanding debt has been provided, and the SOTL stake pledge is part of this collateral. The collateral has been tested every 3 months starting Feb’19. Management is confident of resolving the pledge and sees no impact of this on the business. However, no formal timeline has been disclosed for an unwinding of the stake pledge.

Fig 2: 4QFY19 order book surged 101% YoY



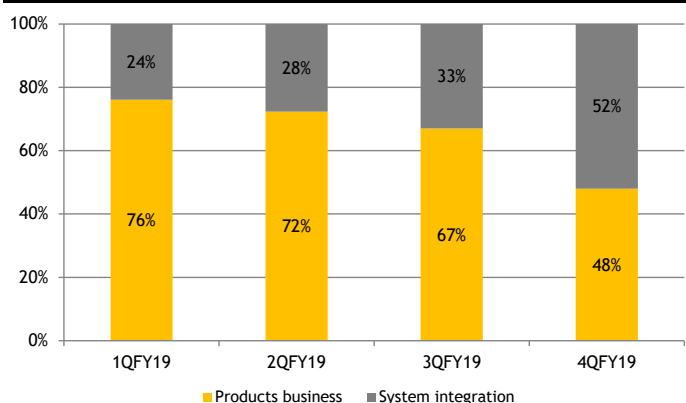
Source: Company

Fig 3: System integration witnesses faster order intake



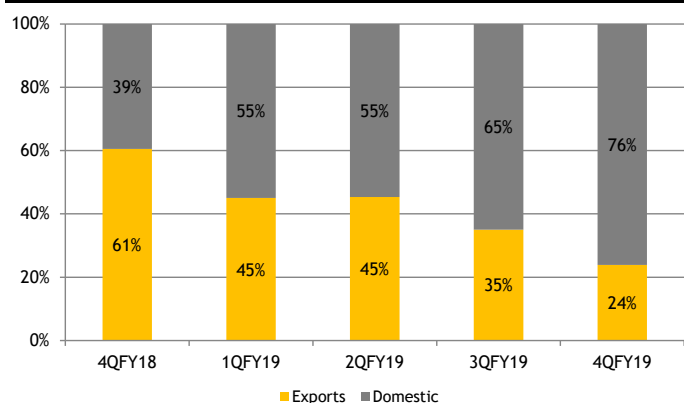
Source: Company

Fig 4: Share of system integration increasing



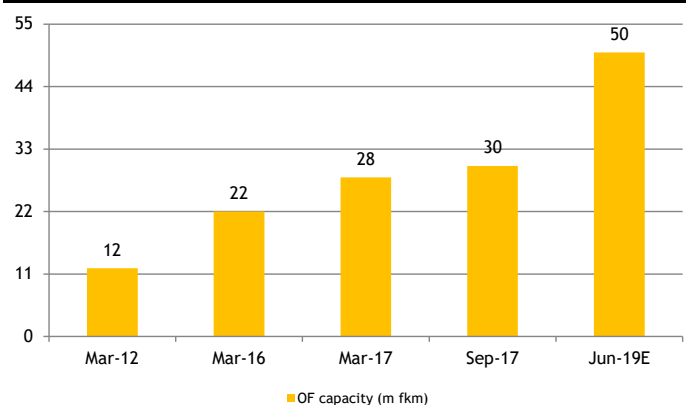
Source: Company

Fig 5: System integration business driving domestic business



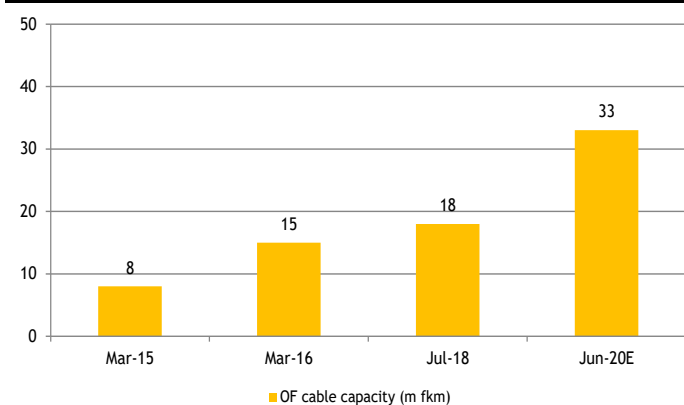
Source: Company

Fig 6: OF expansion to be completed by Jun 2019E



Source: Company

Fig 7: OF cable capacity to close to double by Jun 2020E



Source: Company

Fig 8: Peer comparison

Company name	Bbg		CMP	Rating	TP (INR)	Upside/Downside	Mkt cap (USDm)	ROE FY19E	EV/EBITDA (x)			P/E (x)		
	Code	Curr							FY19	FY20E	FY21E	FY19E	FY20E	FY21E
Sterlite Tech	SOTL IN	INR	208	BUY	340	64%	1,205	38.9%	8.9	7.4	6.1	14.9	13.4	10.6
Fujikura	5803 JT	JPY	469	NR	NR	NA	1,242	1.7%	6.5	6.4	6.0	34.0	9.3	8.3
Prysmian	PRY IM	EUR	16	NR	NR	NA	3,890	7.0%	14.2	6.9	6.3	12.4	9.7	8.4
Corning	GLW US	USD	34	NR	NR	NA	26,972	7.8%	10.4	8.8	8.3	19.3	17.0	15.3
Yangtze Optical Fibre	6869 HK	HKD	22	NR	NR	NA	3,732	22.2%	7.5	22.5	16.7	10.3	14.9	14.9
Finolex Cables	FNXC IN	INR	458	NR	NR	NA	1,007	15.3%	14.8	12.9	11.2	19.4	17.1	14.6
Vindhya Teletinks	VT IN	INR	1,344	NR	NR	NA	229	NA	NA	NA	NA	NA	NA	NA
Average of peers								10.8%	10.7	11.5	9.7	19.1	13.6	12.3

Source: Bloomberg, Maybank Kim Eng

Fig 9: Results summary

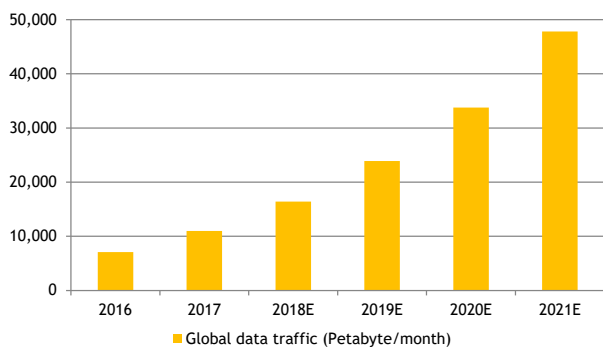
FY Mar (INRm)	Quarterly					Full Year		
	4QFY19	4QFY18	% YoY	3QFY19	% QoQ	FY19	FY18	% YoY
Revenue	17,912	8,466	111.6	13,349	34.2	50,873	32,055	59
Cost of sales, ex depr	(12,247)	(4,205)	191.3	(7,793)	57.2	(29,985)	(16,158)	86
Selling, admn. & R&D exp.	(2,514)	(2,058)	22.2	(2,617)	-3.9	(9,617)	(8,404)	14
EBITDA	3,151	2,203	43.0	2,939	7.2	11,272	7,494	50
Depreciation	(498)	(525)	-5.1	(512)	-2.8	(1,950)	(1,822)	7
Operating profit	2,653	1,679	58.0	2,427	9.3	9,322	5,671	64
Other income / expense	132	172	-23.1	104	26.6	369	393	-6
Interest expensed	(307)	(253)	21.3	(274)	11.9	(1,055)	(1,038)	2
Pretax Profit	2,478	1,597	55.1	2,257	9.8	8,635	5,026	72
Tax	(822)	(362)	126.9	(760)	8.1	(2,782)	(1,332)	109
Minority interests	(5)	(111)	-95.8	(41)	-88.6	(226)	(351)	-36
Recurring net profit	1,652	1,124	46.9	1,456	13.4	5,628	3,343	68
Exceptional items	0	0	n.a.	0	n.a.	-	-	n.a.
Net profit	1,652	1,124	46.9	1,456	13.4	5,628	3,343	68
Recurring EPS (INR)	4.1	2.8	46.4	3.6	13.4	14.0	8.3	68
Gross Margin (%)	28.8	44.1	-1530bp	37.8	-900bp	37.2	43.9	-670bp
EBITDA Margin (%)	17.6	26.0	-840bp	22.0	-440bp	22.2	23.4	-120bp
EBIT Margin (%)	14.8	19.8	-500bp	18.2	-340bp	18.3	17.7	+60bp
Tax rate (%)	33.2	22.7	+1050bp	33.7	-50bp	32.2	26.5	+570bp

Source: Company

Value Proposition

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

Global data traffic growth (Petabytes/month)

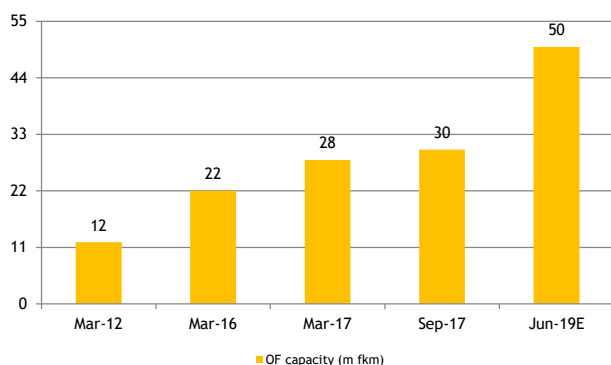


Source: Cisco Visual Networking Index Forecast

Financial Metrics

- As per Cisco Visual Networking Index Forecast data traffic in India is expected to increase 365% over the next five years, boosting optic fibre demand.
- Lower EBITDA margin of system integration business at 11-12% will overshadow the strong product margins of 26-28%. Hence company margin of 19.3-21.2% for FY20-22E.
- SOTL's earnings visibility is improving with entry into network design business, which will also reduce the dependence on product business.
- Net D/E is comfortable at 0.77x for FY20E. This will remain steady despite capex plan.

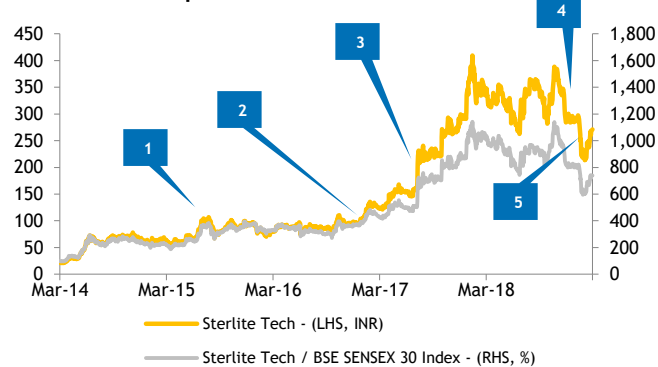
SOTL: Planned optical fibre capacity additions



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 demerger 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

- New order wins in network design segment.
- Faster than expected commissioning of new OF capacity.
- Demand pick-up in optic fibre cables volume in India.

Downside

- Slowdown in global demand for OF and OF cable.
- Delay in commissioning of capacity.
- 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	12.5	9.8	8.1
Core P/E (x)	37.5	15.6	12.5	9.8	8.1
P/BV (x)	10.7	5.1	3.6	2.9	2.3
P/NTA (x)	10.7	5.1	3.6	2.9	2.3
Net dividend yield (%)	0.6	1.6	2.0	2.5	3.1
FCF yield (%)	2.2	nm	2.8	8.0	13.0
EV/EBITDA (x)	18.0	9.4	7.1	5.8	4.7
EV/EBIT (x)	23.8	11.3	9.1	7.3	5.9
INCOME STATEMENT (INR m)					
Revenue	32,054.9	50,872.6	70,981.5	80,253.4	88,839.1
Gross profit	14,074.9	18,938.2	21,652.1	25,370.7	28,805.4
EBITDA	7,493.5	11,271.5	13,683.4	16,285.1	18,816.1
Depreciation	(1,822.1)	(1,949.8)	(3,033.4)	(3,353.7)	(3,780.7)
Amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	5,671.4	9,321.7	10,650.0	12,931.4	15,035.3
Net interest income / (exp)	(1,038.3)	(1,054.9)	(1,785.8)	(1,605.8)	(1,245.8)
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	405.5	446.0	490.6
Pretax profit	5,025.8	8,635.4	9,269.7	11,771.6	14,280.1
Income tax	(1,331.5)	(2,781.6)	(2,780.9)	(3,531.5)	(4,284.0)
Minorities	(351.0)	(226.3)	(250.8)	(318.6)	(386.4)
Discontinued operations	0.0	0.0	0.0	0.0	0.0
Reported net profit	3,343.3	5,627.5	6,237.9	7,921.6	9,609.7
Core net profit	3,343.3	5,627.5	6,237.9	7,921.6	9,609.7
BALANCE SHEET (INR m)					
Cash & Short Term Investments	2,934.8	3,338.5	2,312.1	1,028.9	3,534.5
Accounts receivable	8,712.8	13,566.2	20,419.3	24,186.0	26,773.4
Inventory	3,378.5	5,896.5	8,227.3	9,301.9	10,297.1
Property, Plant & Equip (net)	15,171.7	27,799.6	30,111.2	30,332.5	29,051.8
Intangible assets	739.3	1,073.5	1,073.5	1,073.5	1,073.5
Investment in Associates & JVs	0.0	0.0	0.0	0.0	0.0
Other assets	6,180.3	18,448.5	25,673.4	28,980.8	32,043.5
Total assets	37,117.4	70,122.8	87,816.8	94,903.6	102,773.8
ST interest bearing debt	0.0	0.0	0.0	0.0	0.0
Accounts payable	6,561.8	19,127.5	26,686.8	29,793.5	32,613.5
LT interest bearing debt	11,775.4	19,842.3	19,842.3	15,842.3	11,842.3
Other liabilities	6,208.0	13,006.0	18,483.0	20,548.0	22,422.0
Total Liabilities	24,544.7	51,975.8	65,011.8	66,183.6	66,878.0
Shareholders Equity	11,753.2	17,193.0	21,600.1	27,196.7	33,985.9
Minority Interest	819.5	954.0	1,204.8	1,523.4	1,909.8
Total shareholder equity	12,572.7	18,147.0	22,804.9	28,720.1	35,895.7
Total liabilities and equity	37,117.4	70,122.8	87,816.8	94,903.6	102,773.8
CASH FLOW (INR m)					
Pretax profit	5,025.8	8,635.4	9,269.7	11,771.6	14,280.1
Depreciation & amortisation	1,822.1	1,949.8	3,033.4	3,353.7	3,780.7
Adj net interest (income)/exp	901.8	686.3	1,380.3	1,159.8	755.2
Change in working capital	203.8	(640.7)	(3,372.7)	(2,977.0)	(1,950.8)
Cash taxes paid	(1,106.8)	(2,259.3)	(2,780.9)	(3,531.5)	(4,284.0)
Other operating cash flow	469.4	0.0	0.0	0.0	0.0
Cash flow from operations	7,316.1	8,371.5	7,529.8	9,776.6	12,581.2
Capex	(4,577.0)	(10,400.8)	(5,345.0)	(3,575.0)	(2,500.0)
Free cash flow	2,739.1	(2,029.3)	2,184.8	6,201.6	10,081.2
Dividends paid	(380.8)	(1,654.1)	(1,830.8)	(2,325.0)	(2,820.4)
Equity raised / (purchased)	14.7	3.1	0.0	0.0	0.0
Change in Debt	(184.0)	8,066.9	0.0	(4,000.0)	(4,000.0)
Other invest/financing cash flow	(978.4)	(3,982.9)	(1,380.3)	(1,159.8)	(755.2)
Effect of exch rate changes	0.0	0.0	0.0	0.0	0.0
Net cash flow	1,210.6	403.7	(1,026.4)	(1,283.2)	2,505.6

FYE 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Key Ratios					
Growth ratios (%)					
Revenue growth	23.6	58.7	39.5	13.1	10.7
EBITDA growth	44.4	50.4	21.4	19.0	15.5
EBIT growth	57.7	64.4	14.2	21.4	16.3
Pretax growth	93.2	71.8	7.3	27.0	21.3
Reported net profit growth	66.0	68.3	10.8	27.0	21.3
Core net profit growth	66.0	68.3	10.8	27.0	21.3
Profitability ratios (%)					
EBITDA margin	23.4	22.2	19.3	20.3	21.2
EBIT margin	17.7	18.3	15.0	16.1	16.9
Pretax profit margin	15.7	17.0	13.1	14.7	16.1
Payout ratio	24.0	25.0	25.0	25.0	25.0
DuPont analysis					
Net profit margin (%)	10.4	11.1	8.8	9.9	10.8
Revenue/Assets (x)	0.9	0.7	0.8	0.8	0.9
Assets/Equity (x)	3.2	4.1	4.1	3.5	3.0
ROAE (%)	32.5	38.9	32.2	32.5	31.4
ROAA (%)	10.1	10.5	7.9	8.7	9.7
Liquidity & Efficiency					
Cash conversion cycle	39.4	(19.7)	(37.0)	(36.0)	(33.7)
Days receivable outstanding	87.7	78.8	86.2	100.0	103.3
Days inventory outstanding	74.8	55.7	54.9	61.2	62.7
Days payables outstanding	123.1	154.2	178.1	197.3	199.7
Dividend cover (x)	4.2	4.0	4.0	4.0	4.0
Current ratio (x)	1.7	1.3	1.3	1.3	1.3
Leverage & Expense Analysis					
Asset/Liability (x)	1.5	1.3	1.4	1.4	1.5
Net gearing (%) (incl perps)	70.3	90.9	76.9	51.6	23.1
Net gearing (%) (excl. perps)	70.3	90.9	76.9	51.6	23.1
Net interest cover (x)	5.5	8.8	6.0	8.1	12.1
Debt/EBITDA (x)	1.6	1.8	1.5	1.0	0.6
Capex/revenue (%)	14.3	20.4	7.5	4.5	2.8
Net debt/ (net cash)	8,840.6	16,503.8	17,530.2	14,813.4	8,307.8

Source: Company; Maybank

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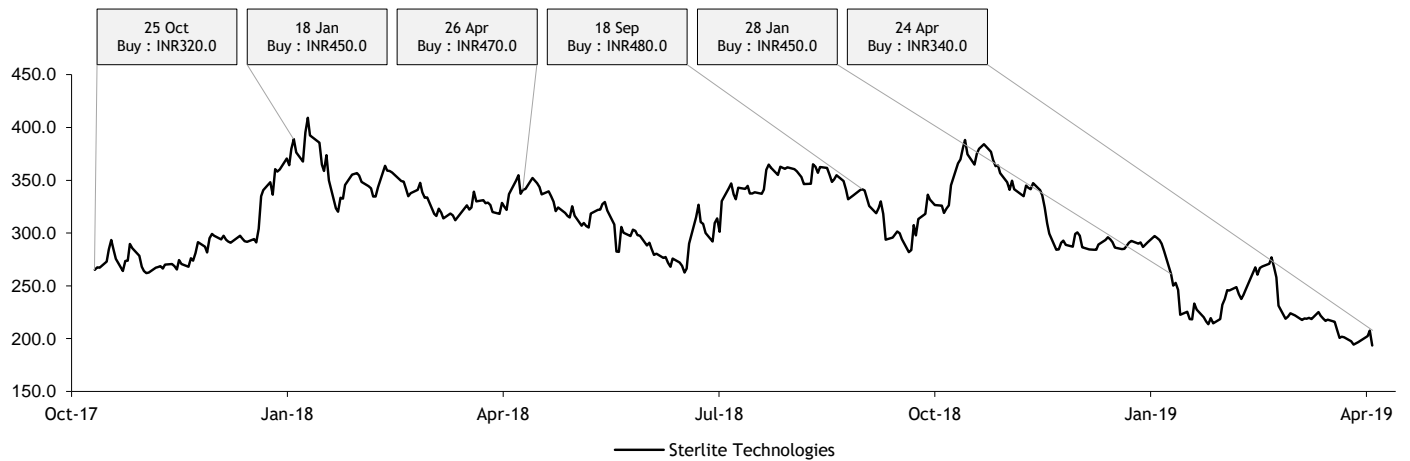
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