

Stock Note

Vardhman Special Steels Ltd.

December 30, 2022





Vardhman Special Steels Ltd.

Industry	LTP	Recommendation	Base Case Fair Value	Bull Case Fair Value	Time Horizon
Iron & Steel Products	Rs 297.6	Buy in Rs 295-300 band and add on dips to Rs 255-260 band	Rs 328	Rs 359.5	2-3 quarters

HDFC Scrip Code	VARSTEEQNR
BSE Code	534392
NSE Code	VSSL
Bloomberg	VSSL IN
CMP Dec 29, 2022	297.6
Equity Capital (Rs cr)	40.6
Face Value (Rs)	10
Equity Share O/S (cr)	4.1
Market Cap (Rs cr)	1206.9
Book Value (Rs)	148
Avg. 52 Wk Volumes	74824
52 Week High (Rs)	332
52 Week Low (Rs)	200

Share holding Pattern % (Sep, 2022)	
Promoters	60.8
Institutions	1.6
Non Institutions	37.6
Total	100.0



HDFCsec Retail research
stock rating meter

for details about the ratings, refer at the end of the report

* Refer at the end for explanation on Risk Ratings

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Our Take:

Vardhman Special Steels Ltd (VSSL) is among India's leading steel bar producers for automotive applications. It caters to various sectors such as Engineering, Automotive, Tractor, Bearing and Allied Industries. The company is a part of Vardhman Group, whose flagship company, Vardhman Textiles (VTXL) is the largest shareholder in VSSL (~60.8%). The company is expanding its capacity to 2.3 Lakh MT by FY25 from current level of 2 Lakh MT, which will mainly be funded through equity infusion and internal accruals. Increased capacity coupled with higher operating margin of ~10-11% will improve the net cash accruals in the near term, which will be sufficient to cover the future annual net debt obligations. The management focus on value added steel business, high capacity utilization (~95%) and considerable backward integration (~90%) should drive growth in operating income and improve profitability over the medium term. Susceptibility to fluctuations in raw material prices, exposure to cyclical demand in the automotive industry and rising competition are some of the key risks to watch out for.

Valuation & Recommendation:

Sustained improved operating performance of VSSL in FY23 with further small improvement expected in FY24, driven by the recovery in demand from the automobile industry, healthy offtake from its customers and expected traction in exports could boost performance of VSSL in the near term. We expect to grow by ~15% YoY in FY23. The operating margin is expected to remain in the range of ~10-11% in FY23 & FY24, on the back of healthy capacity utilization and operational efficiencies. The higher margin is in line with expectation of EBITDA/MT to likely sustain Rs 7,000-10,000 per ton over FY22-FY25. Beyond FY25E, this number is likely to increase upto ~Rs 10,000-12,000 EBITDA/MT. FY22 was an unusually good year for VSSL due to high levels of EBITDA/Ton in Q1, Q2 and Q4 on account of inventory gains. Growth over FY22 operating profits could happen in FY24, although lower tax rate could result in PAT growth in FY23 as well as in FY24 over FY22 PAT.

We believe investors can buy the stock in in Rs 295-300 band (9.5x FY24E EPS, 7.7x FY24E EV/EBITDA) and add on dips to Rs 255-260 band (8.3x FY24E EPS, 6.8x FY24E EV/EBITDA) for base case target of Rs 328 (10.5x FY24E EPS, 8.4x FY24E EV/EBITDA) and bull case target of Rs 359.5 (11.5x FY24E EPS, 9.1x FY24E EV/EBITDA) for a period of 2-3 quarters.



Financial Summary (Consolidated):

Particulars (Rs cr)	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	FY21	FY22	FY23E	FY24E
Operating Income	443	336	32.0	469	-5.5	937	1,368	1,714	1,734
EBITDA	35	46	-23.9	46	-23.7	103	174	158	180
APAT	28	24	15.4	30	-7.5	44	101	111	127
Diluted EPS (Rs)	6.8	5.9	15.4	7.4	-7.5	10.9	24.8	27.5	31.2
RoE-%						10.1	19.9	18.5	17.9
P/E (x)						27.3	12.0	10.8	9.5
EV/EBITDA (x)						13.0	7.7	8.5	7.7

(Source: Company, HDFC sec)

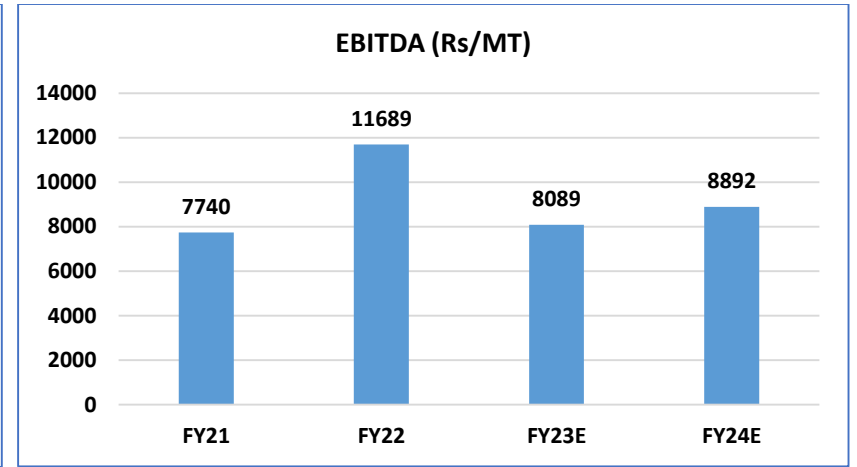
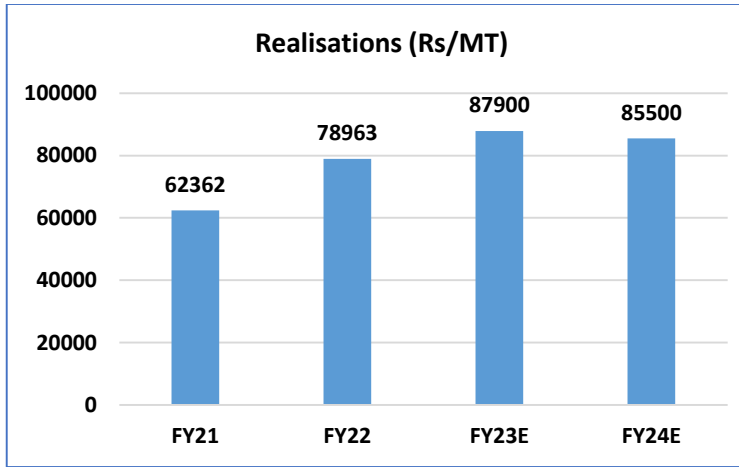
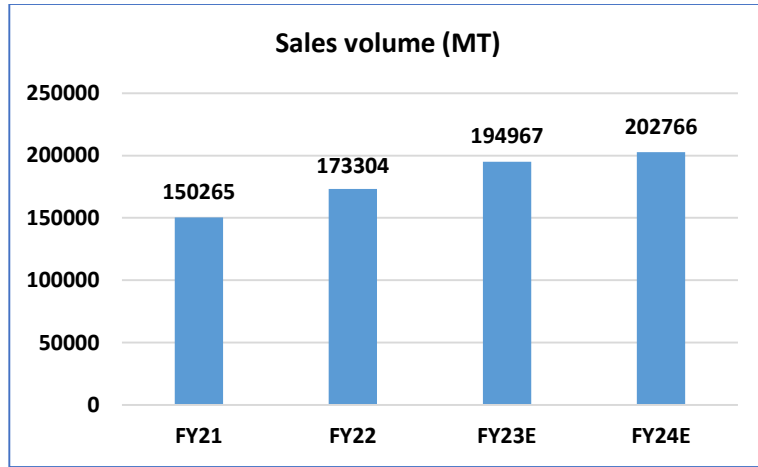
Q2FY23 Result Review:

Financial Performance: Consolidated revenue from operations during the quarter stood at Rs 443 crores, up by ~32% YoY, mainly due to higher sales volumes coupled with better realizations. EBITDA during the quarter stood at Rs 35 crores, ~-23.9%, YoY. Gross margins decreased mainly due increase in prices of raw materials. EBITDA margin during the quarter was at ~7.9%, -570bps YoY. Profit after tax during the quarter stood at Rs 28 crores, +15.4% YoY due to lower tax rate. Delay in pass through of rising costs, volatility in cost of raw materials has resulted in moderation in operating margin in H1FY23 by ~570 bps to ~9%. However, realisations were higher due to changes in raw material procurement strategy and benefits accruing from the technical know-how of Aichi Steel Corporation, Japan (ASC, a Toyota group associate).

Operational Performance:

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)	H1FY23	H1FY22	YoY (%)
Sales Volume (MT)	50961	43283	17.7	52265	-2.5	103226	86985	18.7

(Source: Company, HDFC Sec)



(Source: Company, HDFC Sec)

Key Developments & Triggers:

Strategic Alliance with Aichi Steel Corporation

VSSL has a strategic alliance with Aichi Steel Corporation (ASC) Japan. (main material maker for Toyota). ASC holds ~11.41% stake in VSSL. In Phase-I of this arrangement, ASC shared technical know-how with VSSL to make steel for Toyota and other OEMs. This alliance will improve the quality of steel of VSSL to be supplied to future ready cars like Hybrid, Hydrogen Fuel and Electric. In Phase-II, the aim is to increase VSSL’s production capacity with high quality combined with minimum cost and eventually enable VSSL to build an optimal global production system for customer requirements in India and ASEAN regions. The management also highlighted that first 3 years of agreement which Aichi Steel Corporation has been completed and it has now signed an agreement for another 3 years. Approvals have started coming from Toyota and production have started for some parts. For FY23, Management has given guidance of ~3000-4000 MT of sales to Toyota, which will go up to ~30000 MT in next 3 years. This will be done by tapping markets in Thailand, Philippines and Indonesia, where it could replace supplies by existing Aichi facilities. It also expects some orders from other Japanese customers, apart from Toyota, as its product quality is expected to keep improving due to its association with Aichi.

Following are the expected synergic benefits to VSSL from this alliance:

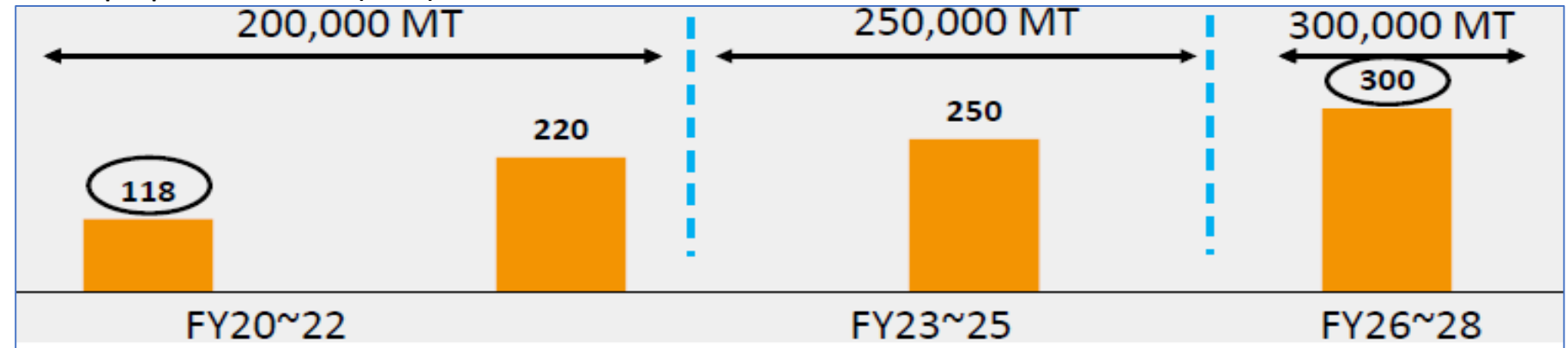
- Future Ready products - Patent steel grades developed for special application in EVs, hybrid and conventional cars.
- Own In House R&D – Toyota Car Company takes input from Aichi on special steel to be developed car parts. It means target more approvals for VSSL in Maruti Suzuki and Toyota.
- More customers for Vardhman in India and ASEAN region.
- Export expected to increase from current ~1% in FY21 to ~20-25% by FY25.
- Forward Integration of VSSL into specialized Forging plant in India (This plan is still under consideration)



Capacity expansion plan

The company is expanding its capacity to 2.3 Lakh MT by FY25 from current level of 2 Lakh MT at cost of Rs 300 crores, which will mainly be funded through equity infusion and internal accruals. The equity infusion of Rs 50 crores in FY20 (from Aichi -46.3 lakh shares at Rs.108 per share) have been utilized for funding the capex. The Ministry of Environment has already granted Environmental Clearance for expansion from 2,00,000 MT per annum to 2,80,000 MT annum of rolled capacity. The company has a long term vision of expanding its capacity upto 7 Lakh MT by FY30 and this next phase of expansion will cost around Rs 1700 crores.

Road map of production volume (billets)



(Source: Company, HDFC Sec)

Major initiative implemented for raw material sourcing

In FY22, the company has implemented major initiatives in relation to its raw material sourcing. Till the previous year, it used imported scrap as the key input in steel manufacturing process. The company switched to domestic steel scrap in FY22. Due to this, a big change was required tweaking its steel-making process to ensure its steel quality was sustained despite this change. This step has made the company's operations cost-competitive and sustainable. Currently, the company is largely relying more on domestic scrap for its raw material requirement. Prices of imported scrap are lower as compared to domestic scrap prices. VSSL keeps shifting to imported scrap purchase as and when the international prices have fallen. There is a gap of Rs 2000-4000/t between domestic and international prices which is an unusual situation as per the management.



Timeline for various activities

Phase-I (FY19-22)

- Continuous improvement in quality and productivity by strengthening existing procedures
- Focus on Improving safety levels
- Start marketing to customers in India, Thailand, Philippines and Indonesia
- FY 2021-22 – Year of Sampling for Aichi

Phase-II (FY22-25)

- Initiate CAPEX to increase production capacity to 250,000 MT in first phase
- FY 23: Year of manufacturing of Trial orders for Aichi
- Anticipate to receive orders from Aichi for Southeast Asia as well as import substitutions
- FY 24: Start supply of products against firm orders for Aichi

Take Japanese approvals like Yamaha, Mushashi, JTEKT, Toyota, Aichi Forge, Suzuki, Hino Motors

Phase-III (FY25-28)

- Vardhman may look forward to Forging business in India
- Time for Aichi to Invest more in Vardhman
- VSSL AICHI may lay foundation for future steel company in India

(Source: Company, HDFC Sec)

Strong relationship with Auto OEM and other established players in engineering segment

The company's market position is supported by a strong customer base, including automotive original equipment manufacturers and other established players in the engineering segment. The contribution from top 5 clients stood at ~30%. Passenger and 2-wheeler segment contributes ~70-75% of total revenue. In-house manufacturing of billets, along with ability to pass on price increases to clients resulted in improved operating efficiency.



(Source: Company, HDFC Sec)



Moderate debt levels

Despite increase in capex plans from Rs 250 crores to Rs 300 crores, the management said its debt/equity ratio is expected to remain healthy as it is to be funded through equity infusion and internal accruals as the management expects the long term debt levels expected to reduce from Rs 110 crores in FY22 to Rs 50-55 crores in FY24, in line with the company's goal to become debt free by FY25-26 with current plans.

Strong support from parent

Prior to its demerger from Vardhman Textiles Ltd (VTXL), business conducted by VSSL was its steel division. Around 61% of VSSL's equity shares are owned by the flagship company, its promoters, and other promoter-holding/investment companies and ~11.41 % owned by Aichi Steel Corporation (ASC); while the rest is owned by the public. VSSL continues to benefit due to strong parentage, such as using the Vardhman group logo, and common banking and treasury operations with VTXL.

PLI Scheme for specialty steel industry

The Indian government has announced a PLI scheme for the specialty steel industry for 5 years starting from 2023-24. The scheme is supposed to benefit both steel making giants as well as the MSMEs. This scheme is expected to draw investments of Rs 400 billion (\$5.37 billion) and expand the capacity of specialty steel from 18 MT in 2020-21 to 42 MT in 2026-27. VSSL's expansion plan has been approved by the government under this scheme. VSSL will hence be eligible for benefits under the scheme.

Automotive industry outlook

The automotive sector displayed remarkable resilience despite the second wave of Covid-19 and a global shortage of semiconductors. Retail sales of vehicles increased by 7% in 2021-22 when compared with the previous year. The 2-wheeler segment, which was already a non-performer due to rural distress, saw further dampening due to rise in vehicle ownership cost coupled with rising fuel cost.

The passenger vehicle segment continues to see high demand and long waiting period as semi-conductor availability still remains a challenge even though supplies slightly improved from the previous month. The Russia-Ukraine war and China lockdown will further dent supplies and hence press brakes on vehicle availability thus making waiting period more frustrating for customers.

In the passenger vehicle segment, demand isn't going to be a problem - there is a massive backlog of orders with every company. With demand still buoyant in the passenger vehicle segment despite challenges of commodity price increases, many automobile manufacturers are upbeat to embrace new technologies, especially in the electric mobility space which is expected to witness a slew of launches in both four- and two-wheeler categories in the coming year.



Key Risks & Concerns:

Volatility in prices of raw materials: The company manufactures special alloy steel using iron ore and metallurgical coke as its main input. The prices of these input have remained in volatile in recent times and have a direct impact on profitability of VSSL. The company also imports some portion of its raw material requirement and is, thus, also exposed to forex fluctuations.

Slowdown in user segments: The company is a small player in the alloy steel industry, with only about ~4% of the total capacity in India (although it has a sizeable share in special alloy steels for Auto industry). Products are used in the automotive, tractor, bearings, engineering and allied industries, with higher dependence on the automotive sector (accounts for over 85% of the company's total revenue). This exposes VSSL to cyclical in the automotive industry, as witnessed during the recent economic slowdown.

Relations with Aichi: VSSL has a strategic alliance with Aichi Steel Corporation and its holds ~11.41% stake in VSSL. Any dispute between the two can have a significant negative impact on the operations of the company as VSSL is dependent on Aichi for technical know-how support and introducing new customers in Toyota group and others.

Volatility in EBITDA margins: However, this number depends on the steel price which impacts the denominator. The right metric to track is EBITDA/ton.

Company Background:

Vardhman Special Steels Ltd (VSSL) is among India's leading steel bar producers for automotive applications. It caters to various sectors such as Engineering, Automotive, Tractor, Bearing and Allied Industries. The company offers specialized products which include steel bars and rods, bright bars of various categories of special & alloy steels. It has strong domestic and international customer base for forging applications in countries like Thailand, Taiwan, Turkey, Russia, Germany and Spain. The Vardhman group had set up Oswal Steels in 1972 to manufacture special and alloy steels with initial capacity of 0.5 lakh tonne per annum (tpa). In 1986, the firm acquired a plant in Ludhiana which increased capacity to 1 lakh tpa. Oswal Steels became a division of VTXL in 1992. VTXL demerged its steel division as VSSL effective January 1, 2011. VSSL has capacity to manufacture 2 lakh tpa of steel billets and also 2 lakh tpa of steel rolled products. Manufacturing unit is equipped with a 30-tonne ultra-high-power electric arc furnace with an electro-magnetic stirrer, a vacuum degassing system and a bloom caster. Sunflag Iron and Mukand Sumi Special Steels are peers of VSSL in the organized sector.



State-of-art manufacturing facilities:

Steel metlting shop	Rolling Mill	Bright Bars
Annual Capacity : 2,00,000 TPA	Annual Capacity : 2,00,000 TPA	Annual Capacity : 48,000 TPA
30 MT Ultra High Power (UHP) Eccentric Bottom Tapping (EBT Type)	Rolling Mill installed in 2013-14 Mill with complete automation	Bar Peeling & Centreless Grinding
Fully automated continuous feeding system for DRI & other raw materials	33 TPH "Walking" Hearth Type Reheating Furnace	<ul style="list-style-type: none"> • Straightening • Peeling • Cold drawing • Polishing
Automatic lance manipulator for oxygen and coke injection	Reversible 2 high shift able stand with Bar Manipulator	<ul style="list-style-type: none"> • Centreless grinding • Full length bar Magnetic Particle Inspection • High Speed Band Saws • Circular Saw - Cut to Length Steel
Electrode regulation system - Melt Controller	10 Continuous Stands in Horizontal & Vertical configuration	
	Online Dimensional Measurements	
	Rack Type Cooling bed designed for better straightness & Hardness levels	
CELOX for active oxygen measurement (Electronite)	Abrasive Cutter	

(Source: Company, HDFC Sec)



Financials (Consolidated):

Income Statement

Particulars (Rs cr)	FY20	FY21	FY22	FY23E	FY24E
Net Revenues	846	937	1368	1714	1734
Growth (%)	-24.5	10.7	46.0	25.2	1.2
Operating Expenses	806	834	1195	1556	1553
EBITDA	40	103	174	158	180
Growth (%)	-41.5	160.2	68.0	-9.2	14.4
EBITDA Margin (%)	4.7	11.0	12.7	9.2	10.4
Depreciation	26	30	27	29	33
Other Income	9	13	29	38	43
EBIT	23	86	176	167	191
Interest expenses	26	20	17	18	21
PBT	-2	66	158	149	170
Tax	-6	22	58	38	43
PAT	3	44	101	111	127
Share of Asso./Minority Int.	0	0	0	0	0
Adj. PAT	3	44	101	111	127
Growth (%)	-85.0	-	127.9	10.6	13.7
EPS	0.8	10.9	24.8	27.5	31.2

Balance Sheet

Particulars (Rs cr)- As at March	FY20	FY21	FY22	FY23E	FY24E
SOURCE OF FUNDS					
Share Capital	40	41	41	41	41
Reserves	373	419	514	612	722
Shareholders' Funds	414	459	555	652	763
Minority Interest	0	0	0	0	0
Total Debt	258	191	162	172	247
Net Deferred Taxes	-20	-10	21	21	21
Other Non-curr. Liab.	0	1	1	1	1
Total Sources of Funds	652	641	738	846	1031
APPLICATION OF FUNDS					
Net Block & Goodwill	310	283	289	282	290
CWIP	12	13	13	39	169
Investments	5	0	15	15	15
Other Non-Curr. Assets	67	15	22	28	28
Total Non-Current Assets	394	311	340	365	502
Inventories	152	192	304	381	394
Debtors	180	224	222	278	294
Cash & Equivalents	2	52	16	24	49
Other Current Assets	22	13	39	49	50
Total Current Assets	356	482	581	732	788
Creditors	62	130	147	207	214
Other Current Liab & Provisions	36	22	35	44	45
Total Current Liabilities	98	152	183	251	258
Net Current Assets	258	330	399	481	529
Total Application of Funds	652	641	738	846	1031



Vardhman Special Steels Ltd.

Cash Flow Statement

Particulars (Rs cr)	FY20	FY21	FY22	FY23E	FY24E
Reported PBT	-2	66	158	149	170
Non-operating & EO items	-3	9	0	-5	0
Interest Expenses	24	12	10	18	21
Depreciation	26	30	27	29	33
Working Capital Change	92	-40	-115	-74	-23
Tax Paid	-1	-10	-22	-38	-43
OPERATING CASH FLOW (a)	135	67	59	78	158
Capex	-35	-9	-35	-48	-170
Free Cash Flow	101	58	24	30	-12
Investments	-4	5	-15	0	0
Non-operating income	-49	11	41	0	0
INVESTING CASH FLOW (b)	-88	7	-9	-48	-170
Debt Issuance / (Repaid)	-69	-56	-29	10	75
Interest Expenses	-25	-19	-17	-18	-21
FCFE	-47	-1	4	22	42
Share Capital Issuance	49	1	0	0	0
Dividend	0	0	-6	-14	-16
Others	0	0	0	0	0
FINANCING CASH FLOW (c)	-45	-74	-52	-22	38
NET CASH FLOW (a+b+c)	2	0	-2	8	25

One Year Price Chart



Key Ratios

Particulars	FY20	FY21	FY22	FY23E	FY24E
Profitability Ratios (%)					
EBITDA Margin	4.7	11.0	12.7	9.2	10.4
EBIT Margin	2.8	9.2	12.8	9.7	11.0
APAT Margin	0.4	4.7	7.4	6.5	7.3
RoE	0.9	10.1	19.9	18.5	17.9
RoCE	3.5	13.0	25.7	21.7	20.8
Solvency Ratio (x)					
Net Debt/EBITDA	6.4	1.3	0.8	0.9	1.1
Net D/E	0.6	0.3	0.3	0.2	0.3
PER SHARE DATA (Rs)					
EPS	0.8	10.9	24.8	27.5	31.2
CEPS	7.2	18.4	31.5	34.5	39.3
BV	102.4	113.4	136.8	160.8	188.0
Dividend	0.0	1.5	3.5	3.5	4.0
Turnover Ratios (days)					
Debtor days	79	79	60	53	60
Inventory days	100	67.0	66	73.0	82
Creditors days	49	37	37.0	38	44
VALUATION (x)					
P/E	359.8	27.3	12.0	10.8	9.5
P/BV	2.9	2.6	2.2	1.9	1.6
EV/EBITDA	36.7	13.0	7.7	8.5	7.7
EV / Revenues	1.7	1.4	1.0	0.8	0.8
Dividend Yield (%)	0.0	0.5	1.2	1.2	1.3
Dividend Payout (%)	0.0	14.0	14.1	12.7	12.8

(Source: Company, HDFC Sec)



HDfC Sec Retail Research Rating description

Green Rating stocks

This rating is given to stocks that represent large and established business having track record of decades and good reputation in the industry. They are industry leaders or have significant market share. They have multiple streams of cash flows and/or strong balance sheet to withstand downturn in economic cycle. These stocks offer moderate returns and at the same time are unlikely to suffer severe drawdown in their stock prices. These stocks can be kept as a part of long term portfolio holding, if so desired. These stocks offer low risk and lower reward and are suitable for beginners. They offer stability to the portfolio.

Yellow Rating stocks

This rating is given to stocks that have strong balance sheet and are from relatively stable industries which are likely to remain relevant for long time and unlikely to be affected much by economic or technological disruptions. These stocks have emerged stronger over time but are yet to reach the level of green rating stocks. They offer medium risk, medium return opportunities. Some of these have the potential to attain green rating over time.

Red Rating stocks

This rating is given to emerging companies which are riskier than their established peers. Their share price tends to be volatile though they offer high growth potential. They are susceptible to severe downturn in their industry or in overall economy. Management of these companies need to prove their mettle in handling cyclicity of their business. If they are successful in navigating challenges, the market rewards their shareholders with handsome gains; otherwise their stock prices can take a severe beating. Overall these stocks offer high risk high return opportunities.

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