Mahindra

Rise.

Swaraj Engines Ltd (NSE Code: SWARAJENG) – Alpha/Alpha + stock recommendation for Oct'13

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Company Snapshot (As on 6th Oct'13)

Current Market Price – Rs 469

Dividend yield – 2.77%

BSE Code – 500407

NSE Code – SWARAJENG

Market capitalization – Rs 582 cr.

Total Equity shares – 1.242 cr.

Face Value – Rs 10.00

52 Weeks High/Low – Rs 535.00/ Rs 382.00

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13
Engines sold (in no.)	16,408	28,539	39,143	47,413	55,239	57,377
Income from operations	125.54	208.17	282.44	360.63	448.58	470.03
Operating Profit	23.90	31.87	49.57	60.71	69.37	71.49
Operating Profit margin (%)	19.04%	15.31%	17.55%	16.83%	15.46%	15.21%
Other Income	2.75	5.04	9.98	8.10	12.24	15.32
Depreciation	4.59	4.69	4.84	4.46	4.26	7.16
Profit Before tax	22.04	32.33	54.71	64.35	77.27	79.50
Tax expense	7.68	10.95	17.36	20.44	24.45	24.10
Net Profit	14.36	21.27	37.35	43.91	52.82	55.40
Cash flows from operations	39.85	31.53	37.1	30.56	49.87	47.46
Return on Avg. equity	18.08%	23.64%	34.00%	31.94%	31.21%	29.16%

Dear Members,

In all the gloom and doom surrounding the Indian economy, there's been one major positive this year and that is above average rainfall in almost all the parts of India. The cumulative rainfall for the country as a whole till 1st Oct'13 was 6% above the average. The rainfall has been in excess of 9% in all the regions, except east and northeast India where it's 28% below average.

In area-wise distribution, 48% area of the country received excess & 38% area received normal rainfall. Remaining 14% area received deficient rainfall.

Seasonal Rainfall Scenario (1st June to 30th September 2013)			
Regions	Actual Rainfall (mm)	Normal Rainfall (mm)	% Departure from LPA
Country as a whole	936.7	886.9	6%
Northwest India	671.8	615.0	9%
Central India	1195.3	974.2	23%
South Peninsula	825.6	715.7	15%
East & northeast India	1037.9	1437.8	-28%

We believe good monsoon augurs well for companies related directly/indirectly to the agriculture segment. While we already have VST Tillers Tractors under our coverage another company in the same segment that looks good is Swaraj Engines (NSE Code – SWARAJENG).

Swaraj Engines – Basic Details

Swaraj Engines (SEL) was set up by the Punjab government's industrial development arm in 1986, in technical and financial collaboration with Kirloskar Oil Engines Ltd (KOEL). It was set up to manufacture diesel engines for sole supply for "Swaraj" brand of tractors manufactured by Punjab Tractors (PTL). After several rounds of ownership changes, both PTL and Swaraj Engines are now controlled by India's largest tractors company, Mahindra and Mahindra (M&M).

Swaraj Engines (SEL) manufactures 20-50 horsepower (HP) engines for **"Swaraj" tractors division of Mahindra and Mahindra Ltd (M&M)**. Besides, it also supplies hi-tech engine components to SML Isuzu Ltd for assembly of commercial vehicle engines; however this division's contribution to the turnover is very low at about 4-5%.

Since the start of commercial operations in 1989-90, SEL has supplied around 517,000 engines for fitment into "Swaraj" tractors.

As mentioned above, Swaraj brand of tractors were originally promoted by Punjab Tractors Ltd (PTL). PTL also had 33.16% stake in Swaraj Engines along with Kirloskar Oil Engines 17.39% stake. In June 2007 PTL was acquired by Mahindra and Mahindra and thereby Mahindra ended up owning "Swaraj" brand of tractors and 33.22% stake in Swaraj Engines while Kirloskar continues to be the co-promoter with 17.39% stake.

Since the takeover of PTL by M&M, there's been complete turnaround in the fate of "Swaraj" brand of tractors and the same has also rubbed off on Swaraj Engines. While Swaraj tractors had slipped to 5th place with 9% market share before the acquisition by M&M in 2007, it now commands a market share of 13.1% and ranks 3rd behind M&M tractors and TAFE.

Turnaround of Swaraj Tractors after the takeover by M&M

Swaraj Engines major business is manufacturing diesel engines for Swaraj Tractors division of M&M. Thus, its growth is eventually dependent on the growth of Swaraj tractors division of M&M.

So let's look at how M&M has fared in turning around PTL since its takeover in 2007 and where does the company stand now. (*Source: Business today*)

When **Mahindra & Mahindra** (M&M) acquired **Punjab Tractors Ltd** (PTL) for Rs 1,489 crore in March 2007, the latter was a pale shadow of its former robust self. Once the country's most profitable tractor company, with its 'Swaraj' brand renowned throughout north India, PTL had suffered due to poor management, which had reduced it from being the second biggest player in the industry at the turn of the century to fifth place. Started in 1970, with the Punjab government as the majority shareholder, PTL began floundering after 2003 as the state government tried to divest its shareholding.

The acquisition of PTL made sense for M&M as well. In 2005, its number one position in the industry had been threatened for the first time. That was the year when, in May, Chennai-based Tractor and Farm Equipment (**TAFE**) bought Eicher Motors's tractor division, increasing its market share to 22 per cent. This brought TAFE, whose earlier market share was just 14 per cent, within striking distance of M&M, whose share was 31 per cent. The acquisition also gave TAFE an entry into northern markets such as Punjab, Uttar Pradesh and Himachal Pradesh, which account for a third of all tractor sales.

M&M needed to increase its lead and it did so by buying out PTL, raising its market share to 40 per cent. Besides, PTL, like Eicher, was strong in the North and would thus complement M&M's strong presence in the West and South. But, only provided M&M restored it to its former health and integrated it successfully into its fold.

Inputs from employees – First step towards restoration of PTL's health – The man assigned the challenging task of turning around PTL was Bishwambhar Mishra, who at the time was heading M&M's operations in China, but was brought back as PTL's managing director in July 2007. The first crucial step he took was to commission an external agency to find out what was wrong with the company by interviewing its 300-odd employees, who spoke out freely. They said PTL had neither a vision nor a long-term plan; decision making was slow and invariably top down; production was not market linked; and no major investments in product development had been made in recent years. The outcome was revealing as the employees didn't hold back their thoughts.

Further, they sought a clear vision of the company's future, a major thrust towards product development, large scale training, skill development and better welfare measures for themselves and better control on overbearing labor union.

Long term and short term goals – The new management set forth on creating the vision document and named it **Nayi Manzil** (new destination), which was to make Swaraj one of the top two tractor brands in the country.

An important shorter goal was also set, called '**3-2-3**' - in three years, the revenue should double and the profits, treble. Just how this would be achieved was also laid down in a document called **Nayi Disha** (new direction). Its overall thrust was to make PTL an innovation-led, customer driven, performance-centric organization with a participative management culture.

But more immediate details also had to be taken care of. PTL was in a financial mess. Though it was still profitable when M&M took it over, it had a huge inventory of unsold stock while out of its total sales of Rs 969 crore that year, Rs 600 crore had yet to be collected.

As per Mr. Mishra, the first six months were spent liquidating stock, improving collections and securitization of debt. He set up a Swaraj Leadership Team consisting of himself and all the other functional heads to take major decisions quickly. Similar leadership teams were set up for other divisions as well which ensured participatory management.

Growth drivers – The initial problems tackled, '**growth drivers**' were launched in early 2008. The sales division was remodeled and dealerships extended. A brand building exercise began with a flurry of TV advertisements, backed by retail finance, tied up with Mahindra Finance. Productivity and quality improvement targets were set. PTL was finally merged into M&M and became its '**Swaraj Division**' in 2008/09. Product development too followed.

New products, R&D spend, etc – Even before the acquisition by M&M, Swaraj products were rugged and known for their durability. Competitors used to benchmark themselves against PTL when it came to frugal engineering. The new management built on these strengths; they identified product gaps and invested Rs 800 crore in R&D. Global expertise was sought if required. The management worked with engineering group AVL Austria to upgrade the Swaraj engines to improve fuel efficiency and meet new emission norms.

The fit and finish of the tractors - a chink in Swaraj's armour earlier - was refined and finally two new products were launched in 2009 and 2010 after a gap of many years.

Labor Union – How did the management deal with them? It was not all smooth sailing for the new management. The PTL union, used to having its way with the earlier management, resisted the push for greater discipline and higher productivity by resorting to a 'go-slow'. But the new men in charge had provided plenty of carrots along with the stick and soon the union had no choice but to relent.

Soon after the acquisition the management rolled out many benefits which were beyond the expectations of the employees. Salaries were raised to align them with those in the market, medical benefits were improved, the canteen was refurbished, greater safety measures were introduced and higher involvement of employees' families with the workplace was encouraged.

Thus, on the one hand they ruthlessly demanded performance, but on the other they showed their human side too.

Has M&M been able to turn around PTL? Production has risen to 70,000 units from 28,045 in FY 08 when the acquisition took place. During the same period standalone revenue trebled to around Rs 3,000 crore from Rs 969 crore, while profit has risen more than six times to over Rs 500 crore from Rs 65 crore. Swaraj, with a market share of 13.1 per cent now ranks No. 3, behind only M&M badged tractors itself and TAFE. The combined market share of M&M and Swaraj is a formidable 42 per cent.

Punjab Tractors's fortunes changed after the M&M acquisition					
	Production (units)	Market Share	Revenue	Profit	Industry Ranking
FY 08	28045	9%	969 crore	65 crore	5
FY 12	69292	13.10%	3000 crore	500 crore	3

By 2009/10, M&M had recovered its investment in Swaraj. Indeed, in many tractor markets, Swaraj is now M&M'S closest competitor.

Deming Prize and very high rating on customer satisfaction – Swaraj Tractors is now the second tractor company in the world to have won the coveted Deming Award (Mahindra Tractors got the award in 2003). Deming Prize is the highest prize in best manufacturing practices and was awarded to the company on 14th Nov'12 in Tokyo.

Besides, Swaraj Division of M&M now leads overall Farm Equipment Sector (FES) of M&M in terms of customer satisfaction index.

Growth drivers for the tractors industry

Coming back to Swaraj Engines, while good/bad monsoon is a key determinant of tractor sales in any particular year, we believe the long term prospects of the industry are bright on account of the following factors.

1. Shrinking human resource and land for agriculture.
2. Government's focus on food security and high minimum support prices for farm produce.
3. Under-penetration of farm mechanization. The power productivity relationship shows that those states having higher farm power availability/ha have higher productivity and therefore the additional requirement of food grains in future is likely to be met through improving productivity by using more farm equipment.

4. Increasing financing from Private Sector banks and NBFCs as the NPAs are low. Today 50-55% financing is done by NBFCs and Private Banks against almost 0% a few years back.
5. Schemes such as NREGA which are diverting people away from farm labor to government projects
6. Shorter replacement cycle – The conventional markets such as Punjab, Haryana and western Uttar Pradesh have been saturated for years, however the shrinking replacement cycle of tractors (from 10-12 years to 8-9 years) has resulted in strong replacement demand in these markets.

We must grow more food from less land and human resources – One doesn't need a crystal ball to predict the two most crucial challenges that Indian agriculture will face in the coming years. If the shrinking resources of land and water are one, the other more serious concern is the availability of human resources.

Some time ago, the Minister of State for Agriculture announced in the Lok Sabha that the agriculture sector is on the verge of losing four million workers in the Twelfth Plan period.

The 2011 Census points to another important trend. The movement of labor away from agriculture has gathered momentum in recent decades. The result that has attracted the most attention is that the farmer population has shrunk by nine million between 2001 and 2011.

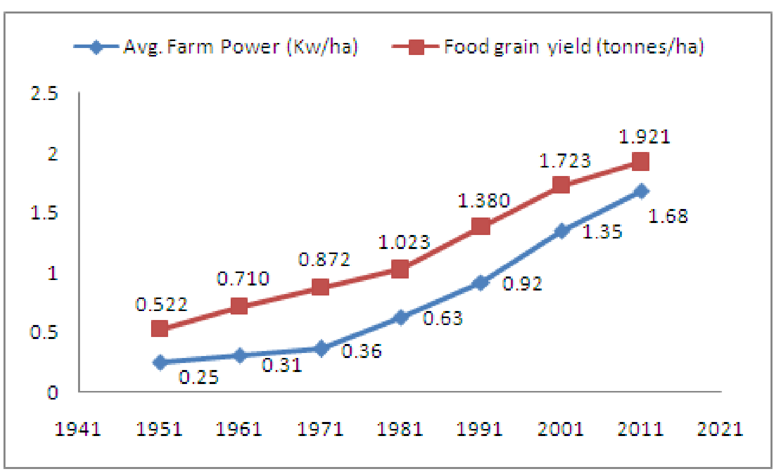
Owing to the pressure of population, the average size of land holding is also getting even more fragmented over time.

Infusion of technologies – One doesn't need to be an expert to understand that Indian agriculture needs infusion of technologies, including mechanization, as there is scarcity of labor to undertake activities such as weeding in corn cultivation or manual transplantation in rice cultivation.

Farm Power Availability and Average Productivity of Food grains in India in 2001		
	Farm Power availability (kw/ha)	Food Grain Productivity (Kg/ha)
Punjab	3.5	4032
Haryana	2.3	3088
Uttar Pradesh	1.8	2105
Andhra Pradesh	1.6	1995
Uttaranchal	1.6	1712
West Bengal	1.3	2217
Tamil Nadu	0.9	2262
Karnataka	0.9	1406
Kerala	0.8	2162
Bihar	0.8	1622
Assam	0.8	1443
Gujarat	0.8	1169
Madhya Pradesh	0.8	907
Himachal Pradesh	0.7	1500
Maharashtra	0.7	757
Rajasthan	0.7	884
Jharkhand	0.6	1095
Jammu & Kashmir	0.6	1050
Orissa	0.6	799
Chhattisgarh	0.6	799
All India Average	**1.35**	**1723**

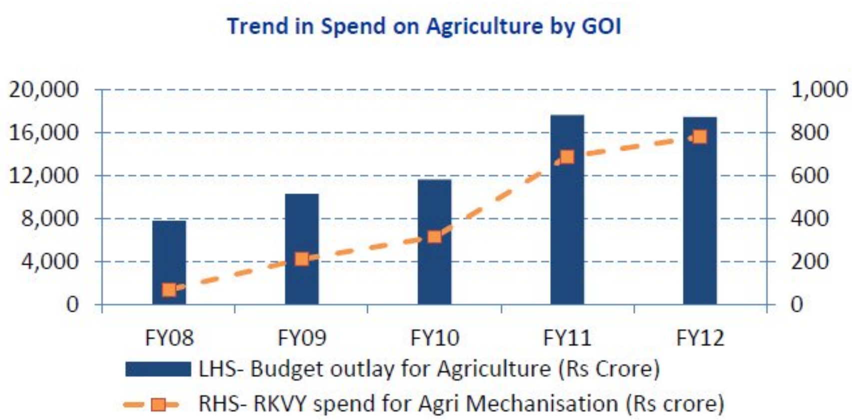
Further, a positive relationship has been observed between farm power availability and average yields of food grain. As can be observed above, states with higher availability of farm power have, in general, higher productivity as compared to the others.

Although India is the largest manufacturer of tractors in the world, accounting for one-third of the global production, farm mechanization in India is still at a nascent stage, with the average farm power availability in the country lower than in countries such as Korea, Japan and the US.



Union Minister of Agriculture Sharad Pawar recently informed MPs that in order to attain the projected demand of 280 MT of food grains by 2020-21, farm power availability in the country has to be scaled up to at least 2.0 kw/ha by the end of the Twelfth Plan (2012-2017) from 1.68 kw/ha at the end of 2011.

Govt. support for agriculture & rural development – Agriculture employs over 50% of the domestic workforce and remains a key focus area for the GoI. In order to ensure self-sufficiency in food grain production in the backdrop of a rising population, state agencies have assumed a greater role as facilitators of technology adoption. GoI has consistently increased its budget outlay for agriculture and allied activities and also increased its allocations for schemes like Rashtriya Krishi Vikas Yojana (RYVY) to boost farm output and improve labor productivity.

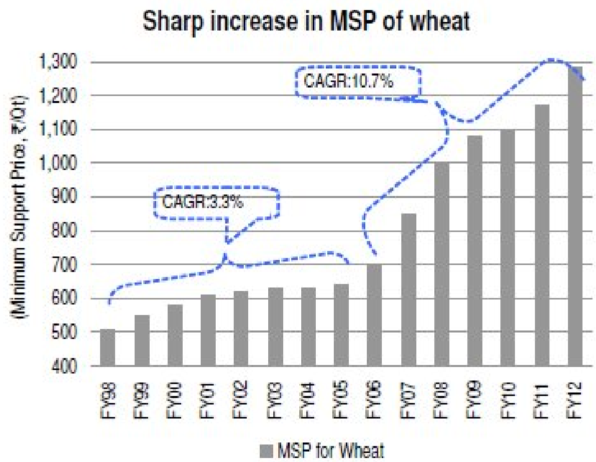


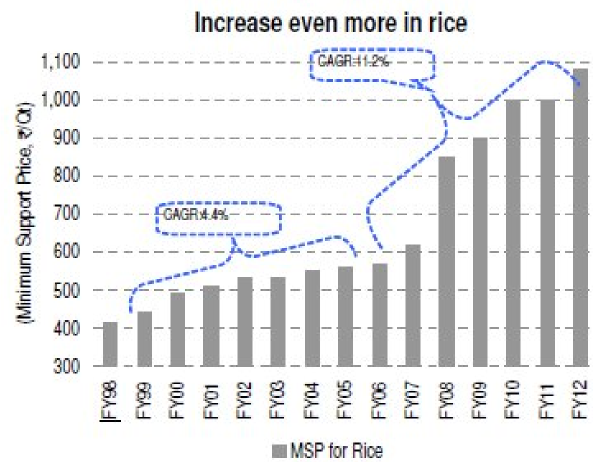
Further, subsidies on fertilizers, electricity and diesel have also supported rural prosperity, and favorably influenced the demand-side drivers of farm mechanization.

In the short term, increase in spending towards agriculture could be affected by lack of fiscal flexibility available with the government; however, over the long term, the rural sector should continue to see large investments towards overall infrastructure development and improved accessibility of various farm mechanization tools such as tractors and power tillers.

Buoyancy in rural income with higher minimum support prices (MSPs) – Ever since the UPA government came to power in 2004, MSPs for many crops has more than doubled.

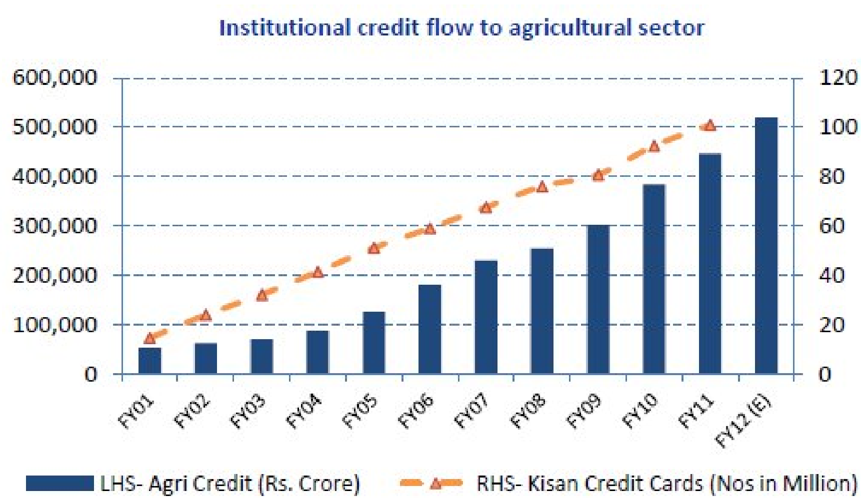
The MSP of rabi crops like wheat registered 10.7% CAGR between FY06 and FY12, 11.2% CAGR for rice and ~15% for pulses.





Higher MSPs lead to higher disposable income at the farmers' end. Higher income levels coupled with appreciating land value has enabled a larger farm audience to adopt tilling and planting machinery.

Credit flow to agriculture fuels industry volumes – There exists a strong correlation between farm mechanization and availability of agri-credit. While scheduled commercial banks are mandated by the Reserve Bank of India (RBI) to meet a target of 18% of their net banking credit for the agricultural sector, growth is driven by increased lending by non-banking finance companies, especially in the southern states.



Institutional credit to the farm sector increased at a CAGR of 19.9% from FY06 to Rs. 446,779 crore in FY11. Apart from increase in the magnitude of credit availability, the sector has also benefited from introduction of innovative credit delivery schemes such as the Kisan Credit Cards (KCC)

However, despite government's push for credit coverage for the entire farming community, only 50% of total farmer households in India are under agricultural credit net which includes both formal and informal sources of credit.

According to a National Sample Survey Organization report on indebtedness of farmer households, of the 89.35 million farmer households, 43.42 million households are under debt. The report says that the most important source of loan in terms of percentage of outstanding loan amount is banks (36%) followed by moneylenders (26%) and co-operative societies (20%)

Thus, there's still immense potential for expansion of agri-credit to farmer households which will drive the sales of tractors and other farm machinery.

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Swaraj Engines – Performance Snapshot

As discussed above, since the takeover of PTL by M&M, the "Swaraj" brand of tractors have reported strong growth and so has Swaraj Engines as it manufactures engines for ~80% of the "Swaraj" tractors manufactured in a year.

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM
Engines Sold (in No.)	16408	28539	39143	47413	55239	57377	61146
Income from Operations	**125.54**	**208.17**	**282.44**	**360.63**	**448.58**	**470.03**	**499.03**
Operating Profit	**23.9**	**31.87**	**49.57**	**60.71**	**69.37**	**71.49**	**75.57**
Operating Profit Margin (%)	**19.04%**	**15.31%**	**17.55%**	**16.83%**	**15.46%**	**15.21%**	**15.14%**
Other Income	2.75	5.04	9.98	8.1	12.24	15.32	16.94
Interest Cost	0.02	0.05	0.03	0.04	0.08	0.15	0.16
Depreciation	4.59	4.69	4.84	4.46	4.26	7.16	7.88
Profit Before Tax	**22.04**	**32.22**	**54.71**	**64.35**	**77.27**	**79.5**	**84.47**
Tax expense	7.68	10.95	17.36	20.44	24.45	24.1	25.95
Profit After Tax	**14.36**	**21.27**	**37.35**	**43.91**	**52.82**	**55.4**	**58.52**
Cash flows from Operations	**39.85**	**31.53**	**37.1**	**30.56**	**49.87**	**47.46**	
ROAE (return on avg. equity)	**18.08%**	**23.64%**	**34.00%**	**31.94%**	**31.21%**	**29.16%**	

Besides good growth, what is noteworthy is the quality of growth; the company has done well on all the metrics such as cash flow generation, return on equity, margins etc. Excluding the impact of other income, the cash flows from operations have been higher than the reported profits as there's virtually immediate payment terms with M&M.

The company recently enhanced its capacity of engines in two phases from 42,000 per annum at the end of Mar'11 to 75,000 engines per annum at the end of Mar'13. It incurred a sum of 95 crores on the above expansion and funded it entirely through internal accruals.

Despite the above expansion, Swaraj Engines still had ~110 crores surplus cash with it (after accounting for total dividend of Rs 33/- per share for FY 13 and other provisions) at the end of Mar'13 which is 19% of its current market cap of 580 crores.

BALANCE SHEET AS AT 31ST MARCH, 2013 (Rs. in lacs)

Particulars	Note		2013		2012
EQUITY & LIABILITIES					
Shareholders' Funds					
Share Capital	2.1	1241.98		1241.98	
Reserves and Surplus	2.2	18130.88	19372.86	17385.82	18627.80
Non-Current Liabilities					
Deferred Tax Liabilities (Net)	2.3	633.35		320.35	
Long-Term Provisions	2.4	126.45	759.80	125.99	446.34
Current Liabilities					
Trade Payables	2.5	4132.54		4349.06	
Other Current Liabilities	2.6	869.82		904.68	
Short-Term Provisions	2.7	4955.92	9958.28	2009.01	7262.75
Total			30090.94		26336.89
ASSETS					
Non-Current Assets					
Fixed Assets	2.8				
– Tangible Assets		8065.61		4176.91	
– Intangible Assets		6.63		2.79	
– Capital Work-in-Progress/Capital Spares		245.63		872.31	
Non Current Investments	2.9	–		1183.67	
Long Term Loans & Advances	2.10	403.37	8721.24	842.15	7077.83
Current Assets					
Current Investments	2.9	7415.08		6927.97	
Inventories	2.11	3934.68		3343.97	
Trade Receivables	2.12	925.01		1191.42	
Cash & Cash Equivalents	2.13	8071.50		6969.65	
Short-Term Loans & Advances	2.14	1023.43	21369.70	826.05	19259.06
Total			30090.94		26336.89

Cash and Cash equivalents (investments in various mutual fund schemes) and zero debt

We believe, in order for shareholders to realize gains from their investments, it is important for the company to grow, however what is even more important is the quality of growth. It's been observed in a lot many cases that the managements are hell bent upon conjuring higher sales and profitability at the cost of sacrificing the quality of their balance sheet and cash flows. Over a period of time, such companies end up in debt traps with abysmal returns for the shareholders.

However, Swaraj Engines's balance sheet is an investor's delight. The company has reported decent growth and their strong cash flows from operations have enabled them carry out requisite expansion as and when needed, while retaining debt free status.

Operating efficiency

Swaraj Engines could achieve the above depicted performance on account of gradual improvement in operating and asset utilization efficiency and reduction in working capital requirement in the last few years.

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Fixed assets	29.83	26.39	22.72	23.95	41.8	80.72	
Avg. fixed assets	30.74	28.11	24.56	23.34	32.88	61.26	
Sales	125.54	208.17	282.44	360.62	448.58	479.03	
Sales to fixed assets ratio	4.08	7.41	11.50	15.45	13.65	7.82	
Installed Capacity of Engines	36000	36000	36000	42000	60000	60000	75000
Engines Sold	16408	28539	39143	47413	55239	57377	
Capacity Utilization rate (%)	45.58%	79.28%	108.73%	112.89%	92.07%	95.63%	
Debt	0	0	0	0	0	0	
Operating Profit margin (%)	19.04%	15.31%	17.55%	16.83%	15.46%	15.21%	
Return on Avg. Equity (ROAE)	18.08%	23.64%	34.00%	31.94%	31.21%	29.16%	
Working capital to sales (%)	15.33%	3.41%	0.21%	2.57%	1.38%	1.83%	

For FY 13, Sales to fixed assets ratio has declined to 7.82 from 13.65 in FY 12, however it's important to understand here that fixed asset value of 80.72 crores for FY 13 is yearend value while the expanded capacity of 75,000 engines per annum was available starting FY 14 only.

What is good to note is that in the past Swaraj has achieved above 100% capacity utilization rate and assuming they are able to repeat the same the current installed capacity might be good enough for manufacturing 80,000-82,000 engines per annum.

Besides good asset utilization ratio, another factor that has contributed towards strong operating performance of the company is immediate payment terms with M&M.

As evident from the above illustration, the working capital requirement of the company is just about 2% of its sales i.e. 9-10 crores which can be easily funded from internal accruals as against many other companies which have to depend on working capital loans and therefore bear the burden of interest cost.

As far as return on equity is concerned, it's been excellent in the past and the company is likely to generate strong returns, on full capacity utilization, even on the recent capital expenditure of 95 crores.

Particulars	Impact of 95 crore CAPEX	Assumptions from past record
Engine Sales (in no.)	33000	
Engine Sales (in value)	260 crore	450 crore sales for 57377 tractors in FY 13
OPM (%)	15.00%	15.21% operating margin in FY 13
Operating profit	39 crore	assuming 15% operating margin
Profit Before tax	34 crore	after accounting for depreciation
PAT	23 crore	
Return on Investment (ROI)	**24%**	

Growth opportunities for Swaraj Engines

Swaraj Engines' growth has been directly proportional to India's agriculture story. We expect tractors to do well in the long term, led by more scope for productivity, low penetration, need for mechanization, higher MSPs and policies (NREGA). The company's revenue is assured by supply for Swaraj tractors, where volume growth rates have been healthy so far.

M&M manufactured ~70,000 Swaraj Tractors in FY 13 while Swaraj Engines supplied 57,377 engines, thus meeting 82% of the engines requirement. As can be observed from the below illustration, Swaraj Engines has increased its share of engines requirement of Swaraj Tractors from around 58.5% in FY 08 to around 82% in FY 13.

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13
Swaraj Tractors sales	28045	NA	49422	60997	69292	NA
Swaraj Engines sales	16408	28539	39143	47413	55239	57377
Swaraj Engines's share (%)	58.51%		79.20%	77.73%	79.72%	

NA - Not available

With the expansion in capacity to 75,000 engines per annum, Swaraj Engines is now expected to cater to 90% requirement of Swaraj Tractors.

Considering Swaraj Engines's capability of above 100% utilization rate, the current capacity might be sufficient only till the end of FY 15, because even Swaraj Tractors is expanding its capacity to 90,000 tractors per annum and the same should be on-stream starting Apr'14. It's important to note here that the management of Swaraj Engines has indicated that it intends to increase production to 100,000 engines at its present location when the need arises.

Besides, if management of M&M so chooses, Swaraj can also supply engines to other Mahindra brand tractors in future since it is one of the lowest-cost and one of the most fuel-efficient engines.

Swaraj Tractors on massive production mood

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- Premji fund back in retail with Heritage Foods stake buy
- Mahindra Lifespace enters Andhra Pradesh
- Escorts aims to become top seller in big tractor segment

Mohali-based Swaraj Tractors (owned by the Mahindra Group) that was in doldrums few years back is in an expansion mode. Despite an inconsistent growth in the tractor industry in the past two years, the tractor player has doubled its production in last five years and has set the target to increase annual production by 20,000.

The company produced 30,000 tractors against the capacity of 60,000 tractors per annum in the year 2007-08, that was scaled up to 70,000 tractors per annum and has a target to manufacture 90,000 tractors in a year in the next year, said Bishwambhar Mishra, Chief Executive Tractor and Farm Mechanisation of Mahindra.

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This has been achieved without making any substantial investments. The optimum utilization of the available resources helped to achieve the higher targets, he aded.

The Swaraj tarctors has become the second tractor company in the world to win coveted Deming Award.

The Deming Prize (the highest prize in best manufactuing practices instituted after the name of renowned E W Demin) was awarded to the company on November 14 in Tokyo.

Swaraj Tractors was the second company in the world to get this award (Mahindra Tractors got the award in year 2003). He added that Mahindra took over Swaraj Tractors in year 2007 and transformed the outfit in various parameters. "The company has been awarded as it helped to improve the lives of all stakeholders and they are customers, employees, vendors, shareholders and society at large", said Mishra.

Shareholding pattern

	Sep'13	Jun'13	Mar'13	Dec'12	Sep'12
Promoter and Promoter Group	**50.62%**	**50.62%**	**50.62%**	**50.62%**	**50.62%**
India	50.62%	50.62%	50.62%	50.62%	50.62%
Foreign					
Public	**49.38%**	**49.38%**	**49.38%**	**49.38%**	**49.38%**
Institutions	12.34%	12.03%	12.43%	13.70%	14.79%
FII	1.90%	1.45%	1.53%	1.53%	1.75%
DII	10.44%	10.58%	10.90%	12.17%	13.04%
Non-Institutions	37.04%	37.35%	36.95%	35.68%	34.59%
Bodies Corporate	4.41%	4.76%	4.26%	3.48%	2.70%
Custodians					
Total	**1,24,19,820**	**1,24,19,820**	**1,24,19,820**	**1,24,19,820**	**1,24,19,820**

With the acquisition of Punjab Tractors, M&M indirectly acquired 33.22% stake in the company and is now the largest shareholder and the promoter of the company. Kirloskar Industries co-promoted Swaraj Engines with PTL in 1986 and is even now the co-promoter of the company with 17.39% stake.

M&M and Kirloskar Industries cumulatively hold 50.62% stake in the company.

In 2009, there were rumors of M&M negotiating with Kirloskar to buy out its 17.39% stake so as to consolidate its holding and further expand diesel engines business; however the same was not implemented.

We believe, if at all the above plan is executed in future, it would be beneficial for all the shareholders of the company.

As on 30th Sep'13, the details of the major shareholders of the company and their stakes are as below:

Name of the shareholder	Category	% stake in Swaraj Engines
Mahindra & Mahindra Ltd	Promoter	33.22%
Kirloskar Industries Ltd	Promoter	17.39%
Reliance Capital – Tax saver (ELSS) Fund	Public	4.97%
Reeta Keyur Parikh	Public	1.67%
Reliance Capital – Regular Saving Fund	Public	1.51%
SBI Magnum Multicap Fund	Public	1.42%
Vikram Chinubhai Shah	Public	1.42%
SBI Magnum Midcap Fund	Public	1.32%
Keyur H Parikh	Public	1.11%

Dividend Policy

Dividend Payout ratio						
	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13
Dividend Payout ratio	43.25%	29.18%	26.60%	28.28%	30.57%	73.98%

For the past 6 years Swaraj Engines has consistently been distributing more than 25% of its net profits in the form of dividends.

Recently, considering the surplus cash with the company and no major fund requirement (having already expanded engines capacity to 75,000/- per annum) in the foreseeable future, the company paid a dividend of Rs 33/- per share (including Special dividend of Rs 20/- per share) to its shareholders.

In our view the above is reflective of the fact that management does not wish to hoard excess cash and is willing to share the wealth with minority shareholders.

For FY 14, we expect the company to pay around Rs 16-17 per share as dividend i.e. a dividend yield of ~3.5%

Valuations

Before discussing valuations, let's recall all that we have learnt about Swaraj Engines and the tractors industry in the above sections:

- It's a part of Mahindra group which is one of the best corporate houses of India
- A focused company selling engines to M&M's Swaraj Tractors division which itself is performing extremely well
- Strong long term structural drivers for the tractors industry in the form of low tractor penetration, scarcity of farm labor, strong agricultural credit, govt. support in the form of higher MSPs and higher budgetary allocation and steady replacement demand
- Strong operating performance in terms of growth, margins, return on equity, cash flow generation
- Debt free with surplus cash to the tune of ~20% of the current market cap
- Good dividend policy with management not interested in hoarding very high amounts of cash

Despite all the above, at around current price of 460-470 the stock is available at 10 times trailing twelve months earnings and ~8.5 times 1 year forward earnings (assuming 20% growth in the light of expansion in capacity, good monsoon and strong tractor sales). In the past, the stock has largely traded in the range of 9-12 times 1 year forward earnings.

Considering the quality of operations, majority shareholding of M&M and the long term prospects of the industry, the valuations look reasonable to us. However, it's important to keep in mind that bad monsoon can play a spoilsport in any particular year and that should be used as an opportunity to increase allocation at lower prices.

Risks & Concerns

As discussed in the above sections, Swaraj Engines derives 95% of its business from single client i.e. Mahindra and therefore it can be a matter of concern for some, however M&M itself is the promoter of Swaraj Engines and sets very high standards of corporate governance. So, unless M&M divests its stake, we don't think there's any risk of loss of business from Mahindra.

Good monsoon holds key – Timing, distribution and magnitude of rainfall during the south-west monsoon are some variables that influence the *kharif* crop output, and bear on the domestic tractor market. Though dependence on the monsoon has lessened, ~50% of agriculture is still monsoon dependent. For instance, inadequate rainfall in FY 13 resulted in 2% decline in tractor sales in comparison to FY 12 and similarly surplus and well distributed rainfall in FY 14 has already boosted tractor sales in the Jun and Sep'13 quarters.

Adverse government policies such as farm loan waiver can dampen the spirits of lenders who are actively pursuing tractor loans and thus supporting growth of tractor sales in domestic market.

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Katalyst Wealth's **Alpha/Alpha +** services are focused on sharing our philosophy of value investing and making every individual an informed investor through un-biased and in-depth research, analysis and follow up on the stocks under our coverage.

For more information on **Swaraj Engines Ltd**, discuss with **Ekansh Mittal**

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