ISGEC Heavy Engineering

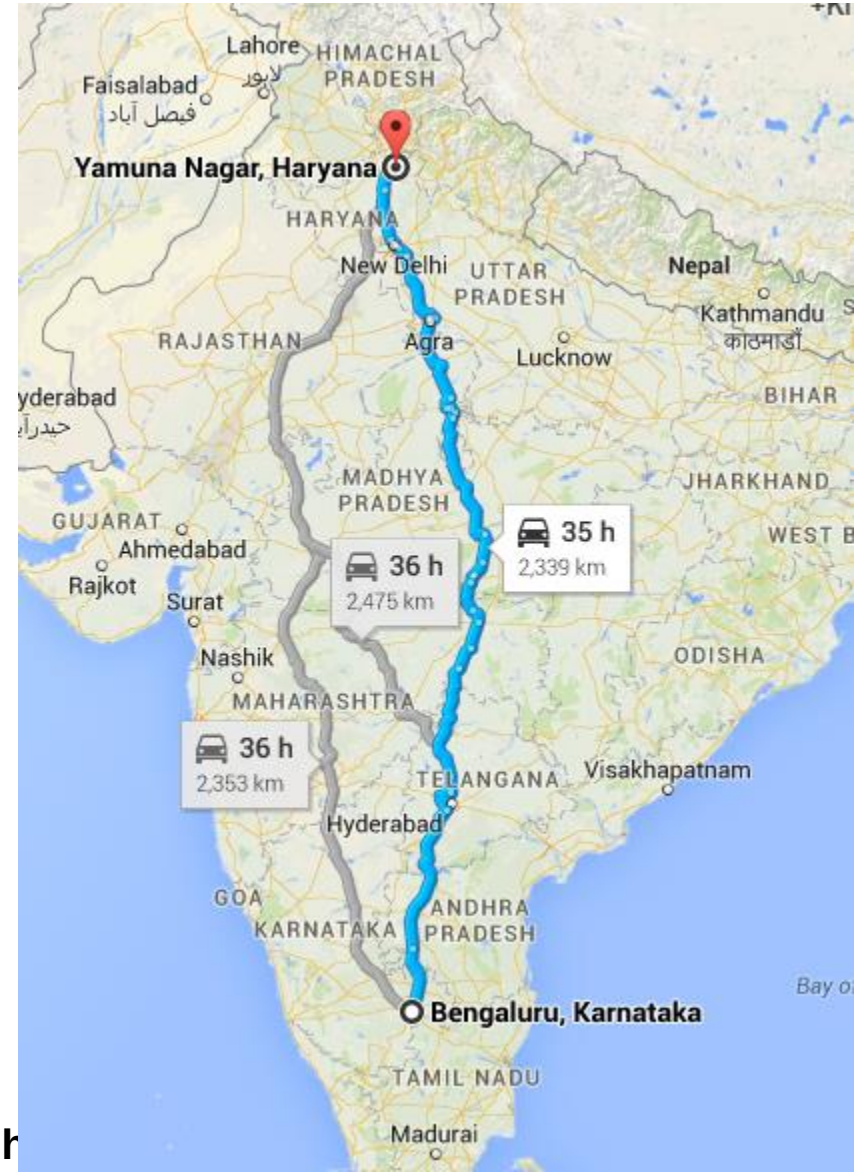
Basic Details

- *Industry:* Capital Goods
- *Market Cap:* 4100 cr
- *Current Market Price:* Rs. 5638
- *Price to Earnings:* 37x (TTM Standalone EPS: Rs.154)
- *Price to Book:* ~ 6x
- Promoter holds ~ 63%; Buyback failed
- *Disclosure:* Own > 10% of portfolio currently

ISGEC History

- ISGEC Heavy Engineering Limited was previously known as Saraswati Industrial Syndicate Limited
- Established in 1946, the initial business was of sugar production (sugar mill) and the company later diversified into heavy engineering.
- In 1964, they established a JV with John Thompson that was known as ISGEC John Thompson (IJT).
- In 1981, ISGEC acquired stake from John Thompson in the JV and also acquired majority stake in UP Steels.
- Both these companies were subsequently amalgamated into ISGEC Heavy Engineering Limited.
- ISGEC obviously is an abbreviation for Indian Sugar and Engineering Corporation. Much more Engineering than Sugar now

Where is ISGEC located exactly?



So, What does ISGEC do?

- Manufactures heavy engineering equipment for Power Industry, Sugar Industry, Fertilizer Industry and Defence sector.

- The company's product portfolio comprises of Boilers, Power Plants, Sugar Machinery, Fertilizer Machinery, Pressure Vessels, Heat Exchangers, Mechanical & Hydraulic presses and Castings.

What interested us in ISGEC? – Financials (Consolidated)

(in Rs. Cr)	FY 07	FY08	FY09	FY10	FY11	FY12	FY13
SALES	1501.3	1755.5	1938.76	2714	2714.09	3049.07	2934.04
OI	23.7	22.5	20.24	45.93	24.91	33.93	42.96
TOTAL INCOME	1525	1778	1959	2230	2739	3083	2977
PBDIT	129.89	183.16	313.32	176.9	201.51	281.87	247.33
INTEREST	17.97	50.49	46.78	36.23	24.88	31.45	26.93
EXTRA	-	52.47	69	-	-	53.83	33.13
PBT	88.35	48.28	156.43	99	127.46	141.24	122.86
TAXES	32.08	23.39	55	32.85	39.11	45.81	47.2
PAT	56.27	24.89	101.43	66.15	88.35	95.43	75.65
FIXED ASSETS	296.59	406.47	398.85	443.85	482.83	529.08	561
EQUITY	301.39	324.57	416.2	478.19	550.62	634.61	716
DEBT	182.7	423.7	191.18	220.62	182.98	217.3	300
CASH & EQI	78.32	103.36	190.33	305.54	339	339.82	641
WORKING CAP	**224.4**	**343.8**	**116**	**96**	**50.85**	**199**	**-15**
ADVANCES	**244**	**309**	**275**	**465**	**609.3**	**477**	**616**
DIVIDEND	100	20	100	100	100	100	100

What interested us in ISGEC? – Relative Undervaluation

ISGEC at a huge discount to Thermax when we bought it		
	Thermax	**ISGEC**
Sales	5500	3000
PAT	350-375	80-90
MCAP at 1st Buy	10000	1200
MCAP to PAT	26.67	13.3
Order Book	1x Sales	1.3x Sales
Margins	Higher	Room For Improvement
Promoter Pedigree	Excellent	Excellent
Investor Awareness	HIGH	VERY LOW
Revenues	Power Related	Multiple Industry

What interested us in ISGEC? - Investment Arguments (1/3)

A Diversified Engineering Player with a focus on Quality

- Unlike many engineering players that are heavily dependent on a single industry, ISGEC has an extremely diversified revenue stream like Sugar Machineries, Power Machineries and others.

- *It is this diversified revenue streams coming from sales to more than 70 countries that has helped the company to consistently grow from Rs 300 crores revenue in 2001 to Rs 3000 crores revenues in 2013 without facing any significant headwinds during the recessionary period post 2008.*

- On the manufacturing side, Isgec has its facilities spread across 250 Acres of land at various locations across Yamunanagar, Dahej, Bawal & Muzaffarnagar and offices in Noida, Pune, Chennai, Mumbai & Kolkata in India.

What interested us in ISGEC? - Investment Arguments (2/3)

Quality Leadership Status in its field

- ISGEC has been known for its quality, timely delivery and post installation service.
- ISGEC enjoy number 1 position for a turnkey project provider to Sugar plants.
- On the power boilers side, ISGEC has a very strong experience of producing more the 500 boilers around the globe.
- In the past, ISGEC could only produce boilers in the range of 10 TPH to 250 TPH, however, it now has to capability to produce anything up to 1000 TPH.

What interested us in ISGEC? - Investment Arguments (3/3)

Order Book

- As of December 2013, ISEC had an order book of Rs 4000 cr on a standalone basis executable roughly in 14-18 months. Add to that the orders in the new *JV –ISGEC Hitachi Zosen* that will focus on the process equipment to fertilizer industry. The traction in its entire business is reasonably good with strong demand from exports and potential revival of domestic economy.

Operating Leverage

- Due to economic slowdown, some segments of ISGEC had large under-utilized capacities and improving business climate can thereby lead reasonable operational leverage.

Solid Balance Sheet

- ISGEC had maintained a very strong financial position across last decade with *near zero debt*. The liabilities *majorly comprised of advances from customers* for project execution. ISGEC as a policy does not believe in client financing and never takes order without advance. *Advances can vary from 10% to 20% of the order size* and are usually shown under the long term and short term borrowings.

Ye Sab Theek Hai. Ye batao, maal kidhar hai?

Recent Results

ISGEC Results Summary: The sales for ISGEC grew by 20% y-o-y and EBITDA grew by 50% y-o-y.

ISGEC Rs Crore	Q2FY14	Q2FY15	Growth
Sales	729	875	20%
EBITDA	51	76	50%
PAT	34	41	20%

- Massive Operating Leverage still to come
- Growth in Exports and Domestic Markets De-bottlenecking
- These are just Standalone results. Consolidated results will have a kicker from:
  - ✓ Saraswati Sugar Mills
  - ✓ ISGEC - Hitachi Zosen JV (51:49)

Growth in Exports

- ISGEC has been able to increase its exports contribution from less than 20% a couple of years back to around 35-40% in FY13/FY14.

- ISGEC has a very strong name and near leader status, in Sugar Machineries segment across the world. The company has also been able to make inroads into a lot of geographies in the power boilers segments as well.

- To put things under perspective, Thermax in a recent management interaction mentioned that Africa could well turn out to be a large opportunity.

- In Africa, ISGEC has already secured large orders in the Sugar Machineries space as well as Power Boilers space.

Domestic Markets Revival

- The fruits of the debottlenecking task taken by the new government may start to show up anytime in the next 1-2 years.
- The uptick in the domestic capex cycle may help ISGEC to garner order from small and mid-sized power plants (captive and otherwise).
- In addition to this, ISGEC is also planning to rope in a technology partner (Foster Wheeler) for large boilers used by UMPP that will help ISGEC to bid for larger projects.
- All in all, the opportunities from domestic market revival are quite big. With increase in demand, comes an increase in margins
- On a massive sales base, even a 1% uptick in operating margins can give a huge kicker to net profits

ISGEC Hitachi Zosen JV (We think this aspect is severely under-estimated by the markets) – 1/2

- This Joint Venture between ISGEC and Hitachi Zosen was established in 2012 with a motive to cater to critical Process Equipment requirements of refineries, fertilizer & petrochemical industries, across the world.

- The technical & engineering skills of Hitachi Zosen and manufacturing expertise of ISGEC are intended to bring very healthy profits to this Joint Venture.

- This JV is operated out of the manufacturing facility of ISGEC in Dahej (Gujarat).

- The JV is now ready with an expanded capacity backed by strong order book of around Rs. 500 crores.

- This JV is looking to book orders for Gas-to-Liquid pressure vessels for all the emerging countries like India, China, Russia and South America.

ISGEC Hitachi Zosen JV (We think this aspect is severely under-estimated by the markets) – 2/2

- *From Hitachi Zosen AR - http://www.hitachizosen.co.jp/english/AR2014_E.pdf* (Page number 26)

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- *New plant construction in fiscal 2014 is continuing on a recovery track, and in conjunction with the global food shortages, demand is trending strongly from fertilizer plants and also from ammonia plants that operate in the upstream of fertilizer plants. In this context, orders for GTL-use pressure vessels increased and we are aiming to utilize ISGEC Hitachi Zosen Limited and enter into and expand our businesses in emerging markets (India, South America, Russia, and China)*
- *Compared to one year earlier, its production capacity is expected to increase by around 70%, while it also plans to increase its number of employees to around 750 people within the current fiscal year, which will be an increase of around 50% compared to the current number*
- *As a leading company in the field of process equipment, we are actively responding to the constantly rising demand from fertilizer plants and GTL plants*

ISGEC – Sugar Division

- One of India's largest sugar mills and crushes 13,000 Tonnes per day. Widely known as the most efficient Sugar mill manufacturer in India
- This is a subsidiary company based out of Yamunanagar
- Exposed to the vagaries of the Sugar market in India
- But positive news recently (well, some clarity atleast)…

UP keeps state advised price for sugar cane unchanged

http://www.financialexpress.com/article/economy/up-keeps-state-advised-price-for-sugar-cane-unchanged/

Forced to take note of the plight of the sugar industry, which has frozen capacities amid mounting losses, the Uttar Pradesh government on Wednesday decided to keep the state advised price (SAP) for sugarcane unchanged at R280/quintal for the marketing year that started in October. This is for the second year in a row that the SAP has been kept at the same level.

- We are expecting a zero profit from this division in this year, although on average, ISGEC Sugar division contributes atleast 30 crores to the bottomline.

Snippets with the Management (1/2) – Our Edge

- In India, there is a demand for 3-4 plants every year (in case sugar cycle turns positive). Very little market here for ISGEC (and it's very competitive and ISGEC may not want to pursue some deals)

- ***Africa is very very under-saturated***. In Africa, for a 150,000 hectare farm, the total cost is $1B. Out of that, total machinery cost is only $300M.

- Demand is growing by 7% in Sugar globally

- Hitachi Zosen has the highest market share to manufacture critical process equipment across the world. There are only 3 players globally who can manufacture this critical process equipment.

- ***In the Dahej plant, IHZL uses only 20 acre of a 120 acre land.*** Capacity can be expanded till IHZL hits 120 acre (which would take a long time). Current capacity is 13000 MT. Out of this, 60% product is for critical equipment while 40% is general equipment. They plan to roughly maintain this ratio to be more conservative and move through economic cycles successfully (just in case demand for critical equipment reduces dramatically, they don't want to have the entire shop shut down).

Snippets with the Management (2/2) – Our Edge

- There is no defined demand on a year to year basis. ***India is running short of Urea and hence imports a lot. 7 Urea projects, who would be potential customers of IHZL, were in the process of launching the plant. However, there is a severe problem of gas availability***. Gas policy, if and when modified would be a big booster to set up these Urea plants and hence would result in increased demand for IHZL.

- Currently, we are executing projects for customers in Indonesia, Russia, Nigeria, Bolivia, USA. ***Because of the gas find in USA (shale), many projects are expected from USA and Canada.*** Engineers India (EIL) is managing some projects and they are one of IHZL's customers

- ***There were requests to expand the capacity by another 5000 tons, but IHZL decided to first stabilize the 13000 ton capacity and then go for further expansions.***

- Current advances are easily more than 100 cr. ***For this kind of critical equipment, usually there is a 30-60% advance payment. In fact, there are cases where there are 80% advance payments.*** Since the supply-side market has only few players with advanced technological capabilities, the demand side has to pay up. Contrast that to normal pressure vessels which can get only 20-25% as advances.

Risks to the Investment

- Overall depressed economic environment across India and major developing economies

- ISGEC is currently exposed to currency risk - exports constitute a large portion of its revenues. However, the margins are already at a cyclical low and can be easily improved if the domestic demand picks up.

Summary

- To summarize, ISGEC is well positioned to ride the domestic capex revival as well as international demand. Its capable management and the thrust to continuously improve its competencies in the heavy engineering area should enable it to bag large orders and thereby gives visibility for 3-5 years period.

- Investors investing at these levels might incur some opportunity cost. But management capability along with operating leverage makes this an attractive buy for any investor thinking 3-5 years

- ***Disclosure: > 10% of portfolio. I am no investment advisor. Please conduct your own due diligence before investing in this story***

Appendix

Partnerships and Collaboration with leading players across the world

Strategic Partnerships

- **ABB Lummus Heat Transfer, USA:** Technology License Agreement for Helix Heat Exchangers
- **Belleli, Italy:** Technology Agreement for manufacture of Breech Lock Heat Exchangers
- **Bosch Projects, South Africa:** Technology Transfer for Chainless Cane Diffusers
- **Envirotherm GmbH, Germany:** License & Cooperation Agreement for Design, Engineering, Manufacturing and Commissioning of ESPs upto 1000 MW
- **Foster Wheeler, Spain:** Licensing Agreement for HP & LP Feedwater Heaters & Condensers
- **Foster Wheeler, USA:** License Agreement for PC Fired Boilers upto 1000 MW
- **Foster Wheeler, USA:** Collaboration Agreement for CFBC Boilers upto 99.99 MWe and Oil & Gas Fired Package Boiler upto 260 TPH
- **Hitachi Zosen Corp., Japan:** Technology Transfer Agreement for Chrome-Moly Vanadium Reactors
- **Hitachi Zosen Corp., Japan:** Agreement for Critical Heat Exchangers for Fertilizer industry
- **Hitachi Zosen Corp., Japan:** Collaboration agreement for setting up Energy From Waste Power Plants, utilizing Municipal Solid Waste as fuel, on EPC basis
- **NEM Energy B. V., Netherlands:** License Agreement for Heat Recovery Steam Generators (HRSGs)