Initiating Coverage | 21 June 2016
Sector: Tractors

Escorts

On fertile ground

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Escorts: On a fertile ground

Escorts

BSE Sensex	S&P CNX
26,813	8,220

CMP: INR182 TP: INR283 (+56%) Buy

Stock Info

Bloomberg	ESC IN
Equity Shares (m)	82.0
52-Week Range (INR)	189/113
1, 6, 12 Rel. Per (%)	0/6/60
M.Cap. (INR b)/(USD b)	14.9/0.2
AvgVal.(INR m)	206
Free float (%)	57.0

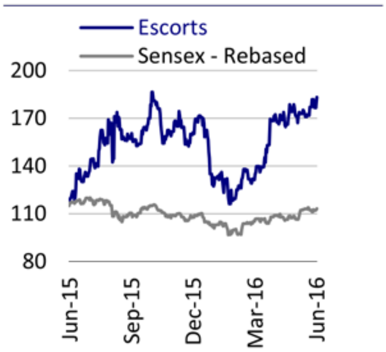
Financial Snapshot (INR b)

Y/E Mar	2016	2017E	2018E
Sales	35.4	41.6	47.2
EBITDA	1.5	2.6	3.6
NP	0.9	1.5	2.3
EPS (INR)	11.1	18.8	28.3
EPS Gr. (%)	-16.6	68.9	50.7
BV/Sh. (INR)	184.3	198.6	221.6
RoE (%)	6.1	9.8	13.5
RoCE (%)	7.6	12.6	17.7
P/E (x)	16.4	9.7	6.4
P/BV (x)	1.0	0.9	0.8

Shareholding Pattern (%)

As on	Mar-16	Dec-15	Mar-15
Promoter	43.0	43.0	43.0
Public	57.0	57.0	57.0

Stock Performance (one-year)



On a fertile ground

PAT to register CAGR of 60% on revamped sales strategy and cost-cutting measures

- **Tractor business (80% revenue share) is likely to see a rebound with sales CAGR of 14% over FY16-18E due to strategic decisions taken over the past two years.**
- **Apart from expectation of normal monsoon in FY17 (after 2 consecutive weak monsoons), Escorts will benefit from following initiatives: i) launch of 10 new models, including the innovative Anti-Lift tractor, to bridge gaps in its portfolio; ii) separate dealership for Powertrac and Farmtrac in northern markets to increase service area of dealers; iii) focused support to selected dealers in the south and west regions to increase market share.**
- **EBITDA margins to expand from 4.1% in FY16 to 7.6% in FY18 driven by a) initiatives to further lower RM costs by 80bp through vendor rationalization and value engineering, b) Employee cost reduction by 260bp through VRS over FY16-18E, and c) operating leverage benefit (~12% CAGR in volumes).**
- **Increase in tractor volumes and revival in the construction segment due to a rise in road sector tenders (up 41% in 2HFY16 YoY) should also aid margin expansion, while railways could be a major opportunity in the making.**
- **With initiatives to revamp sales growth, cost cutting and low level of utilization (at 52% in FY16) in tractor business (80% of revenue), we believe Escorts is on course to deliver 60% PAT CAGR. We initiate coverage with a 'Buy', value the stock at 10x FY18 EPS (40% discount to M&M) and arrive at a PT of INR283 (upside of 56%).**

New product launches and rejig in dealer strategy to boost tractor sales

Escorts market share declined from 14% in FY09 to 10.3% in FY16 (declined from 19% to 15.1% in its strong markets i.e North), primarily due to gaps in its product portfolio, limited awareness among dealers about modern sales techniques and its lack of focus in south and west region. To counter this, Escorts has launched 10 new models in the past two years (4 new models in 41-50hp, 4 models in 50+hp and 2 models of Anti-Lift tractor for haulage activity). It has also increased focus on opportunity markets of south and west regions by working closely with selected dealers and providing them all-round support, including higher dealer margins, financing and sales training. In northern markets, Escorts is separating Powertrac (economy brand) and Farmtrac (Premium brand) dealership to increase service area of dealers. It is also training dealers and sales personnel to familiarize them with modern sales techniques. These initiatives are expected to revive sales growth and bolster the tractor business (14% CAGR) over FY16–18.

Normal monsoon in FY17 to aid tractor industry

Due to weak rainfall, as a percent of LPA, in FY16 (86%) and FY15 (88%), the tractor industry decelerated 13% and 10%, respectively. Some key regions of Escorts faced acute rainfall shortage (average -26% deviation) in last two years. Expectations of normal monsoon (IMD's prediction at 106% of LPA) and La Nina pattern in 2016 should bode well for the overall tractor industry.

Reduction in raw material and employee costs to aid margin expansion from 4.1% in FY16 to 7.6% in FY18

Escorts began reducing raw material costs in June 2014 (71% of sales in FY15) and targets to bring it down to ~67–68% of sales. This is likely to be achieved through a 50% improvement on the procurement side (vendor rationalization and consolidation), while the remaining 50% would be through value analysis/value engineering on the design front. At the company level, manpower cost accounts for ~10–12% of sales (differs due to volume variation). Since Escorts has been operating for the past 70 years, permanent blue-collar employee cost is around 5–6x of a more productive casual/contractual workforce. Currently, there are ~2,500 permanent blue-collar employees (excluding VRS for 350 employees in FY15 and some natural retirements) which Escorts plans to decrease to 1,500 by offering VRS to 650-700 employees over the next 3 years as well as due to natural retirements. Also, Escorts is rationalizing the white-collar workforce, which stands at ~1700 vis-à-vis more than 2,200 three years ago. As a result, employee cost would fall to 7–8% of sales, on a volume base of 62–65K, which is likely to sustain in the long run.

Construction segment on revival path; Railways a major opportunity

Road construction tenders saw a sharp increase of 41% in 2HFY16, which translated into strong growth in the construction equipment segment in 4QFY16. We expect Escorts' construction segment to recover growth at a 25% CAGR (FY16-18) along with an improvement in the margin profile due to increased utilizations and product mix. In the railway segment, the company is set to capitalize on huge investment planned by Indian government (INR1,167b in the 5-year period from 2015-19) through launch of new products which have a combined addressable market size of INR18.8b.

Valuation and view

We expect Escorts' revenue and PAT to register a CAGR of 15% and 60%, respectively, over FY16–18E, along with strong FCF generation and significant expansion in return ratios (RoCE -post tax to improve from 7.4% to 13.1% during the same period). The stock currently trades at a PE of 10x/6x on FY17E/18E EPS (adjusted for treasury shares), and we value the stock at 10x (40% discount to M&M) FY18 EPS to arrive at a target price of INR283 (56% upside).

What went wrong for Escorts?	Corrective measures
▪ Decline in market share from 14% in FY09 to 10% in FY16 ▪ Product Gaps in 41-50hp category and haulage tractor; failed to move in-line with industry trends ▪ De-focus on opportunity markets (mainly in South and West). Opportunity markets grew 2.5% (3yr CAGR) against de-growth of 5.2% in Escorts strong market. ▪ Higher raw material costs (FY15-71%) vs efficient players in industry (66-67%) ▪ Legacy employees with cost 5-6x contractual employees ▪ Lack of training to dealers to keep up with changing times	▪ Launched 4 new models in 41-50hp category and Anti-Lift tractor (2 models) for haulage to fix gaps in portfolio ▪ Initiatives to lower raw material costs in-line with industry through value engineering and vendor rationalization ▪ Offered VRS to 350blue collar employees in FY15, plans to reduce the count to 1,500nos by offering VRS and through natural retirement. ▪ Separating Farmtrac and Powertrac dealership to expand service area in north region ▪ Dealer training and following 'go to' approach and reach out to villages ▪ Focus on selected dealers in opportunity markets (mainly South and West region) where it is weak

Good monsoon to drive tractor sales

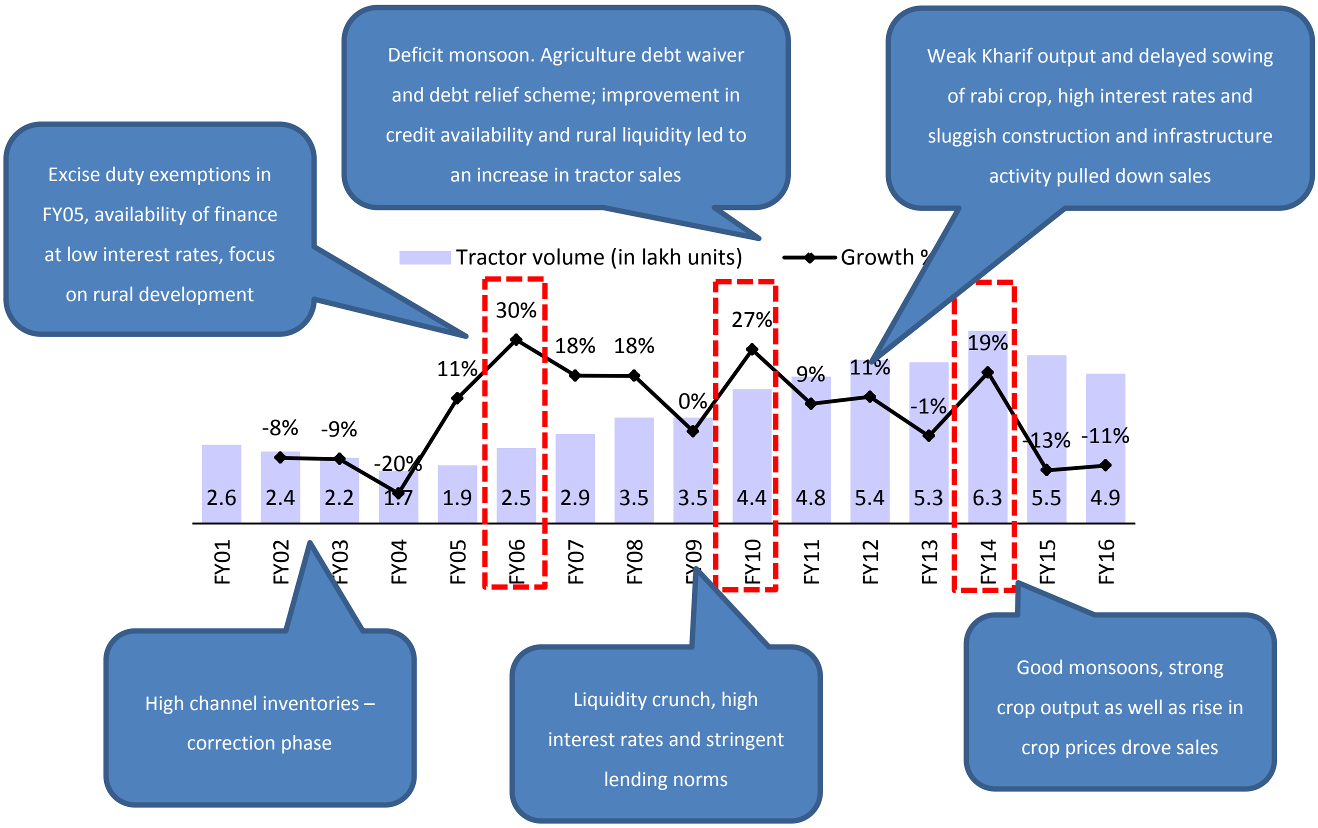
Low level of farm mechanization to aid robust long-term growth

- **FY15 & FY16 were characterized by weak monsoon due to strong EL nino in the country which led to decline of 13% and 11% respectively in the tractor industry.**
- **Latest data from various agencies like IMD and Skymet indicates that El Nino would weaken by June 2016 and expect rainfall of ~106% above Long Period Average (LPA) which shall aid tractor industry to rebound in FY17 and FY18.**
- **Farm mechanization in India stands at about 40-45 percent which is still low when compared to countries such as the US (95 percent), Brazil (75 percent) and China (57percent). Additionally, declining trend of agriculture workforce from 238m in year 2000 to 228m in 2012 adds to the need for higher level of farm mechanization.**

Tractor industry growth highly correlated to monsoon and MSP of crop

From FY01-16, the tractor industry has grown at a CAGR of 4.4% from 2.6lakh tractors in FY01 to 4.9lakh tractor in FY16. FY15 and FY16 registered a degrowth of 13% and 11% respectively on account poor monsoon (drought like situation across India). Additionally, it has been observed in the past that rise in crop MSP's which is an important indicator of farmers income bodes well for tractor industry.

Exhibit 1: Hike in crops MSP and monsoon are critical for tractor industry growth



Source: Company, MOSL

Key regions where Escorts has strong presence faced acute rainfall shortage in last two years except for Rajasthan which received normal rainfall

Exhibit 2: Strong regions

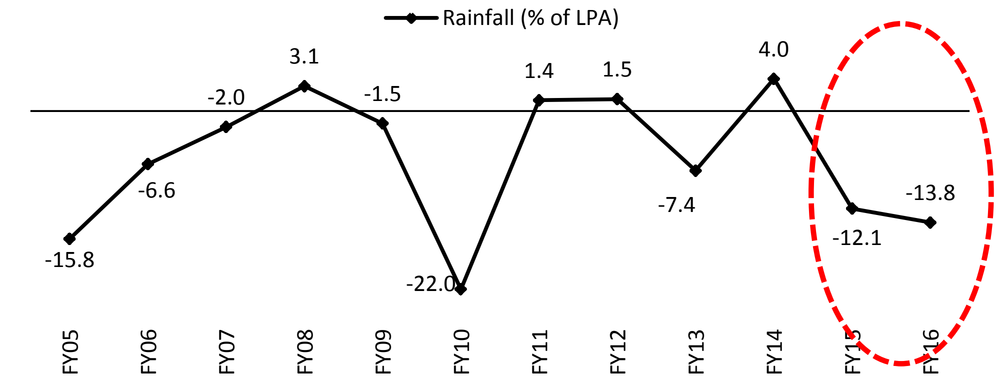
Strong regions (Escorts)	2 Yr Avg Rainfall Deviation (%)
Punjab	-32.1
Uttar Pradesh	-40.6
Bihar	-21.7
Rajasthan	7.4
Madhya Pradesh	-12.6
Haryana	N.A

Source: IMD

IMD's forecast of above normal monsoon for 2016 reiterates global forecast of La Nina in 2016

India Meteorological Department (IMD) has forecasted 'above normal' monsoon of 106% of the Long Period Average (LPA) which stance is also reiterated by the by the fact that global forecasters from Japan to Europe expect La Nina in 2016. In the last two years, India has seen El-nino occurrence which led to India receiving sub-normal (86% and 88% rainfall in FY16 and FY15 as a % of LPA).

Exhibit 3: Drought situation in FY15 & FY16

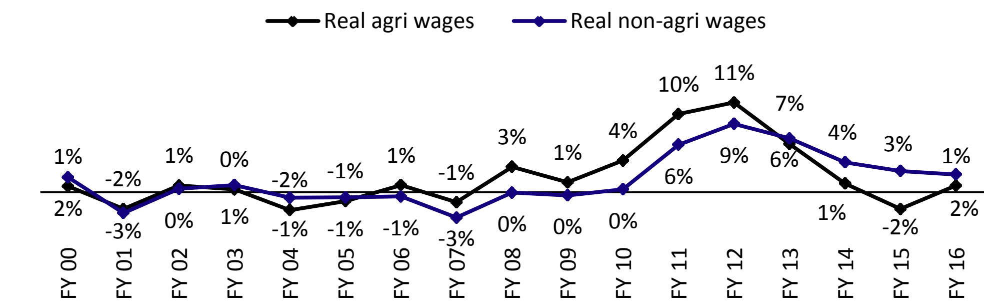


Source: Company, MOSL

Low level of farm mechanization makes a strong case for long-term growth

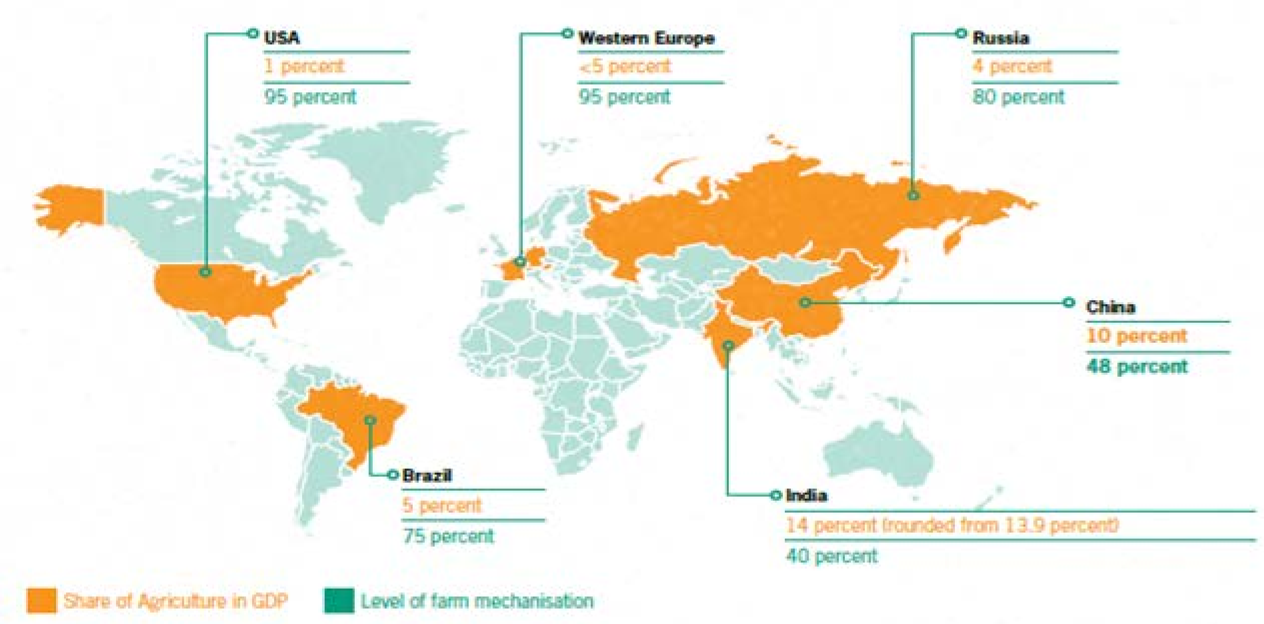
Farm mechanization in India stands at about 40-45 percent. This is still low when compared to countries such as the US (95 percent), Brazil (75 percent) and China (57percent). While the level mechanization lags behind other developed countries, the level of mechanization has seen strong growth through the last decade. Also, increase in non-agri wages at a higher pace makes case for farm mechanization

Exhibit 4: Non agri wages growing at a higher pace in last 3 years



Source: Company, MOSL

Exhibit 5: India amongst the lowest level of farm mechanization

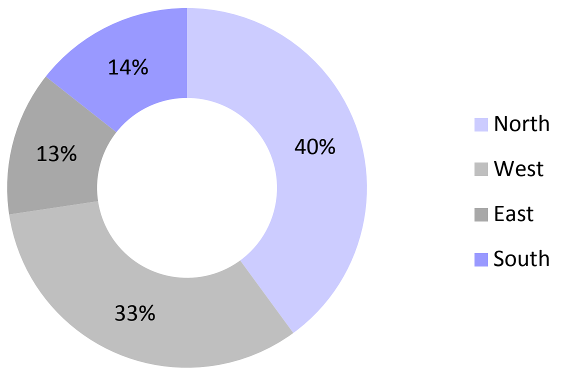


Source: FICCI, MOSL

In India, the level of mechanization varies significantly by region. Northern states such as Punjab, Haryana and Uttar Pradesh have a high level of mechanization due to productive land and a diminishing labor force. The state governments have also provided adequate support to promote farm mechanization. Western and Southern states have a lower level of mechanization due to smaller land holdings, which are more scattered. Moreover, in several instances, mechanization has been uneconomical, thereby leading to lower development.

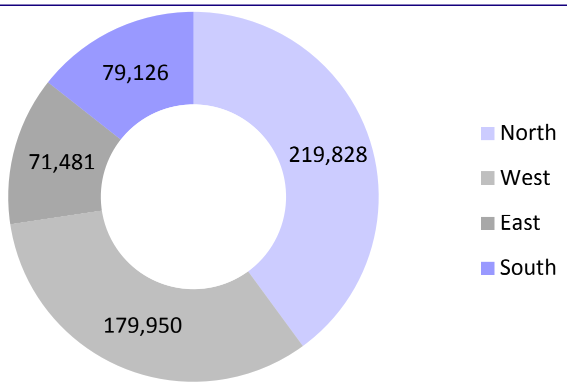
In Northeastern states, the level of mechanization is extremely low primarily due to factors such as hilly topography, high transportation cost, lack of state financing, and other financial constraints owing to socio-economic conditions and dearth of industries manufacturing agricultural machinery. Operation-wise, the level of mechanization varies from 42% for soil working and seed bed preparation, and 29% for seeding and planting to 34% for plant protection and 37% for irrigation.

Exhibit 6: Contribution of various regions in tractors market (%)



Source: Company, MOSL

Exhibit 7: Contribution of various regions in tractors market (nos.)



Source: Company, MOSL

Revised strategy to revamp growth in tractors

Eyeing Southern and Western markets

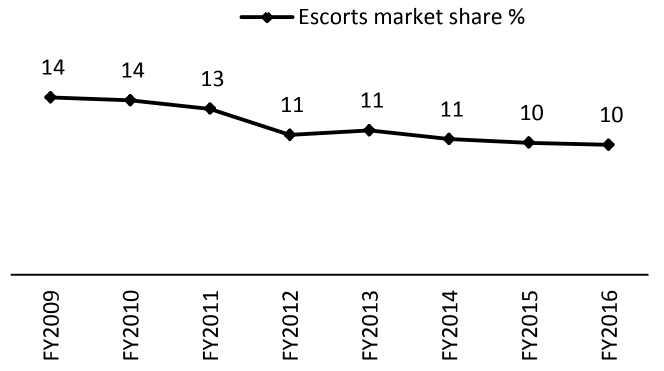
- **Escorts has seen a market share decline from 14% in FY09 to 10.3% in FY16 primarily due to gaps in product portfolio, lack of dealers accustomed to modern sales techniques, lack of focus in South and West region.**
- **To arrest the decline in market share the company has initiated certain corrective measures in the last 2 years. The company has worked on three pronged strategy which includes new model launch, focus in South and West through selected dealers and separating Powertrac and Farmtrac dealers in North.**
- **Escorts launched 10 new models in last 2 years. It launched 4 new models in 41-50hp, 4 models in 50+hp category and 2 models of Anti-Lift tractor for haulage activity.**
- **Focus on it weak markets in Southern and Western regions by working closely with select dealers and providing all-round support including higher dealer margins, financing, and salesman training.**
- **In Northern markets, Escorts is separating Powertrac and Farmtrac dealership in order to increase the service area of dealers. These initiatives are expected to revive sales growth and bolster the Tractor business (14% CAGR) over FY16–18.**

Turnaround on cards

Escorts market share declined from 14% in FY09 to 10.3% in FY16. The primary reasons for the decline were:

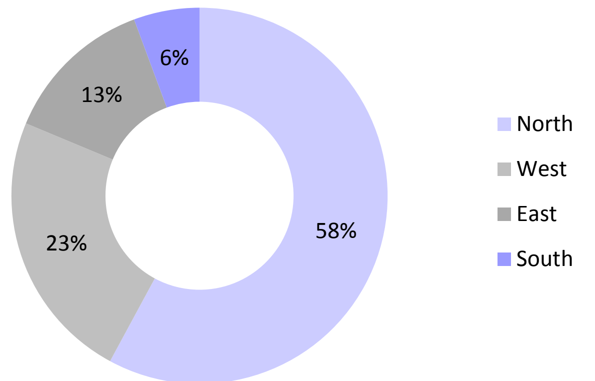
1. Gaps in product portfolio: Industry wide shift towards haulage application where the company did not had a suitable product whereas the trend was moving towards 41-50hp category where again it lacked products.
2. Being an old company, it had a lot of legacy dealers who lacked skills in modern sales technique and were accustomed to old ways of working where customer used to walk in to the store for purchasing a tractor.
3. Lack of focus in South and West market which together contributes 47% of the total market.

Exhibit 8: Escorts Slide in market share



Source: Company, MOSL

Exhibit 9: Largely focused on North, FY16 revenue contribution (%)



Source: Company, MOSL

In order to arrest the loss of market share, the company initiated various corrective measures in last 2 years. It includes launch of new products to fill gaps, working closely with dealers, focus on markets of South and West where it is weak.

New product launches to plug gaps

Launch of Anti-Lift Tractor: There has been a gradual shift towards tractors used for haulage applications as they are also used in mining, construction and non farm uses like carrying bricks, cement and pipes. As per industry estimates, non-farm usage accounts for 30% of the demand of tractors. Due to government focus on rural infrastructure, tractor usage for non-farm has been on the rise. Tractors have being looked upon as a better alternative to commercial vehicles, as tractors are more economical, can carry weight, and also can maneuver easily on rough, rural roads.

Escorts lacked a suitable product and was thus loosing on market share. To offset this issue, the company launched indigenously designed, India's first Anti-Lift Tractor (ALT) in FY15. Tractors in general are usually vulnerable because of their front Lift nature, resulting in reduced or no steering of front wheels. This endangers the safety of the driver and results in considerable damage which increases the maintenance cost for the owner.

Escorts R&D has developed an innovative technology through series of path breaking measures such as shifting the center of gravity and hitch point forward, unique hub-reduction transmission, increased wheel base, heavy front axle, stiffener bars and plates, custom-designed 85kg front bumpers and high-intensity extra front lamps. These features considerably improve the front Lift resistance capability of the tractor.

Launched higher HP tractors: As per industry data, there is a shift towards higher hp category tractors mainly towards 41-50hp category and the trend is likely to intensify. Farmers are likely to upgrade to higher hp segments, realizing the benefits of higher productivity from increased usage of implements along with tractors. Additionally, growing trend of collaborative farming and higher irrigation intensity are factors that will boost usage of higher hp tractors.

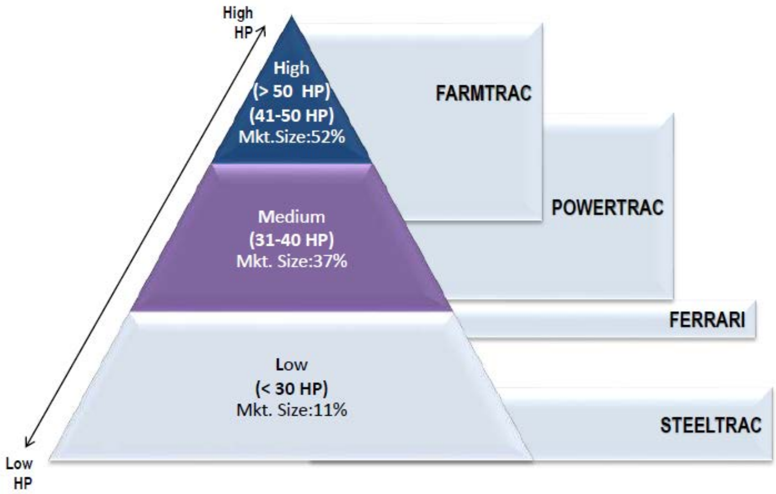
To move in-line with the trend, Escorts introduced Euro 45 and Euro 50 series under the Powertrac brand and Classic series under the Farmtrac brand in the 41–50HP category in FY16. Escorts had lost market share in 41-50hp category from 13.1% in FY13 to 9.7% in FY15 which has been arrested and infact the company gained market share to 10.9% in FY16 because of these launches.

Exhibit 10: Launch of new models to plug gaps

Source: Company, MOSL

In terms of HP at industry level, 41–50HP category has the highest share at 46%, followed by 31–40HP (36.6%), less than 30HP (10.8%) and >50HP (6.6%). Escorts is present in the higher HP categories, i.e., 41–50HP and greater than 50HP categories mainly through the Farmtrac brand, while Powertrac brand is primarily for the medium HP category, i.e., 31–40HP. The company has a presence in lower categories through Steeltrac and Ferrari brands.

Exhibit 11: Focus on higher HP categories of tractors



Source: Company, MOSL

Farmtrac brand is more prestigious and ford legacy brand. The equipment's features include modern engineering and machines with extreme power and traction that can pull bigger traction with greater efficiency. This premium set of tractors is available in the range of 37–75HP. Farmtrac is a high performance, versatile rugged machine with maximum comfort for the driver. This series of tractors combines style and substance, and is available in the following three series:

1. XP series (entry level tractor) – 37–41HP
2. Classic series/Jai Kisan series – 45–50HP and includes midrange iconic Framtrac 45 and Farmtrac 60
3. Executive series – 45–75HP and the most modern tractors; also available as 4x4 option

Powertrac brand have been designed mainly from economy perspective. It offers maximum power and fuel efficiency at an attractive value for money proposition. The brand is considered as the most efficient for industries, with power ranging from 25HP to 55HP under the Diesel saver and Euro series. **Anti-Lift (ALT)** is available in two HP categories in 31-40hp and the company will be launching in 41-50hp category.

Reorganization of dealer strategy

Escorts, with a total of 780 dealers across India, does not plan to appoint additional dealers. In fact, the company intends to focus on select dealers. In the Southern market, Escorts is working closely with a few dealers to increase their market share. The company also offers adequate support in the form of higher dealer margins, finance, and sales promotion, among others. For example, in Andhra

Pradesh, the company has a total of 70 dealers, but is currently focusing on 16–17; as a result, there has been significant improvement in market share if selected dealers. The company intends to replicate this success model with other dealers, going forward.

In the Northern market, there was an issue related to legacy dealers who have been associated with the company for more than 50 years. These dealers were accustomed to clients visiting the showroom for pre-decided purchase ideas; however, dealers needed to be more aggressive due to changing trends. Escorts has been providing training to such dealers and sales representatives with 'Go To' strategy. To fine tune the process they use technology for quick feedback and follow up with customers.

Strong finance tie up key aspect for driving tractor sales

There are basically two types of financing:

1. Channel financing: A dealer can avail finance facility at an attractive interest rate of 9.9% through banks compared to 16–17% offered by Escorts two-three years earlier. However, this is nothing unique as other players also offer similar facilities.
2. Retail financing: Escorts has tied up with more than 30 banks and the NBFC for offering finance for tractor purchase. To differentiate itself from peers, the company entered into an exclusive tie-up with DLL (Rabobank's subsidiary) to offer Escorts Credit, an easy finance solution to Indian farmers (currently in the pilot stage).

Southern and Western markets prime focus areas

From region prespective, Escorts is strong in Northern states like Punjab, Haryana, Uttar Pradesh & Uttaranchal, Bihar, Rajasthan & Madhya Pradesh while the opportunity market includes Andhra Pradesh, Gujarat, Karnataka, Tamil Nadu & West Bengal where it is weak in terms of market share.

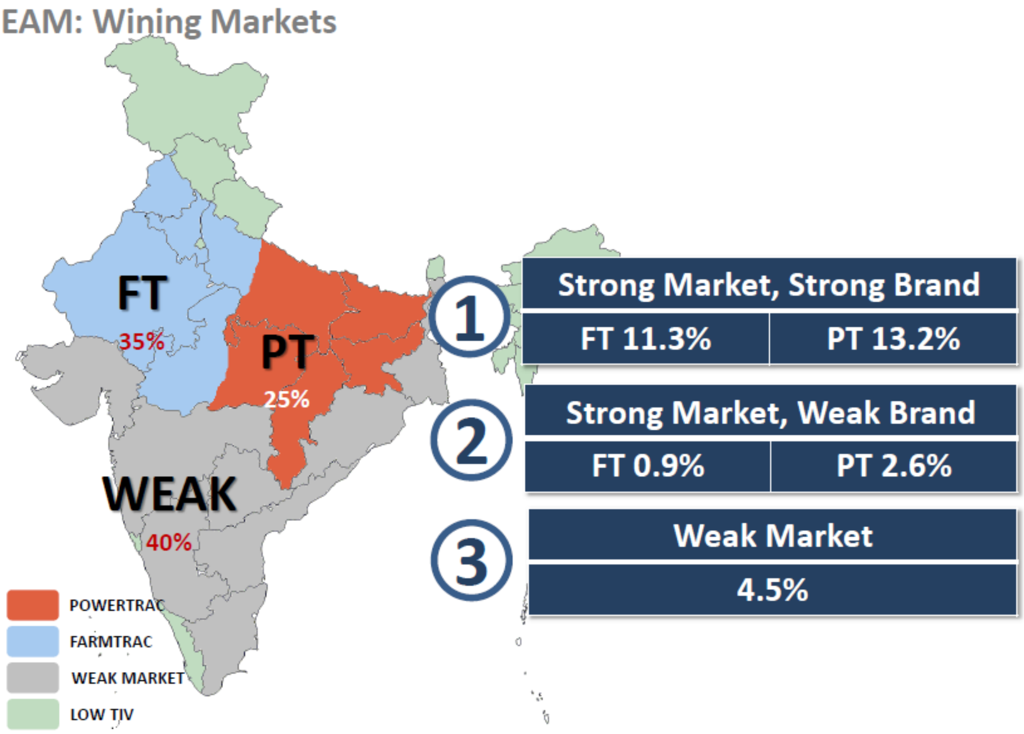
In the last 3 years, the opportunity market has grown at a CAGR of 2.5% while the markets where Escorts is strong has de-grown at CAGR of 5.2%. As the presence and focus of Escorts was weak in opportunity market, it could not grow in tandem with the industry.

Exhibit 12: Opportunity markets grew at faster pace

	FY11	FY12	FY13	FY14	FY15	FY16	3 Year CAGR
Strong market	261	292	338	405	348	288	-5.2%
Opportunity market	219	243	190	229	203	205	2.6%
Total Domestic industry	480	535	528	634	551	493	-2.3%

Note: Strong markets include Punjab, Haryana, UP+UA, Bihar, Rajasthan & MP while opportunity market includes Andhra Pradesh, Gujarat, Karnataka, Tamil Nadu & West Bengal.

Exhibit 13: Escorts is strong in Northern market and weak in South and West



Source: Company, MOSL

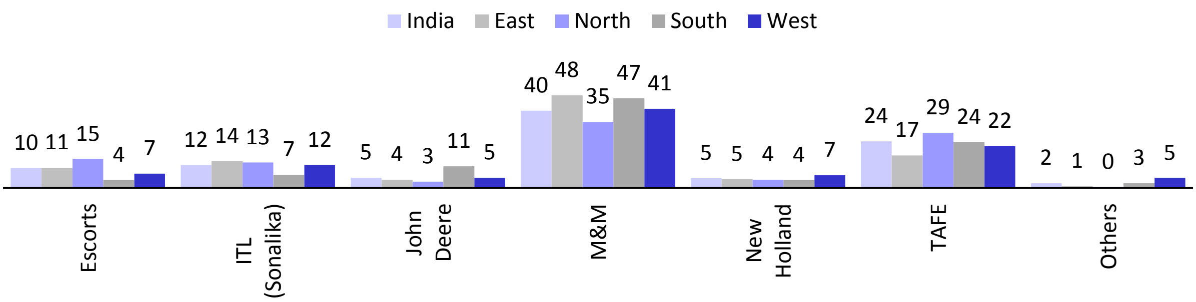
Exhibit 14: Impact of strategy showing improvement signs in some regions

Market Share Gain/Loss in 9M FY16 v/s 9M FY15

Key States	SOM Gain/Loss
Punjab	-1.1%
Haryana	+1.6%
UP	+0.1%
Rajasthan	-1.0%
MP	+0.2%
Bihar	+0.9%
AP	+0.5%
Maharashtra	-0.2%
Karnataka	+0.2%

Source: Company, MOSL

Exhibit 15: Player-wise region-wise market share (FY15 %)



Source: Company, MOSL

Multiple levers to aid margin expansion

Focus on reducing raw material and employee costs

- **Escorts's EBITDA margins are the lowest in the industry (4.1% in FY16) due to high employee and raw material costs. The company is focusing on reducing the raw material cost in tractor business to 67–68% of sales from 71% earlier through vendor rationalization and value engineering.**
- **Escorts commenced the raw material cost reduction project in June 2014 which mainly entails 50% improvement on the procurement side (vendor rationalization and consolidation) and 50% on value analysis/value engineering on the design front. The results are expected to be reflected in financials by the end of FY17.**
- **The cost of permanent blue-collar employee is around 5–6x of a more productive casual/contractual workforce. Through rationalization, the employee cost will be brought down to 7–8% over next 3 years which is likely to be sustained in the long run.**

Margins lowest among peers

We benchmarked Escorts to International Tractor Ltd (Sonalika brand) which is considered to be having best margins in the industry and found that Escorts mainly lacked in EBITDA margins due to high Raw material cost and Employee cost. Escorts Raw material costs stood at 71.2% (FY15 % of sales) compared to benchmark cost of 66-67% as raw material contracts being priced at premium to competition. Employee cost stood at 10.9% (% of sales) compared to benchmark cost of 6-7% on account of cost associated with legacy blue collar employees in the overall business.

Exhibit 16: Peer company EBITDA margins %

	FY14	FY15
TAFE	11.3	12.9
ITL (Sonalika)	20.8	20.0
Escorts	6.0	4.0

Source: Company, MOSL

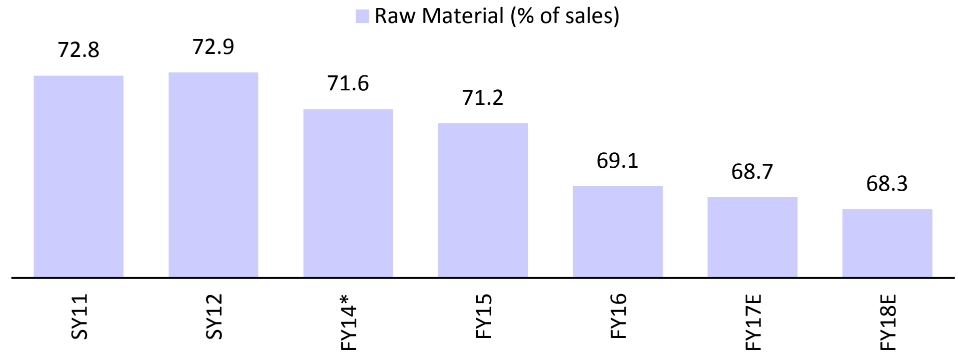
Initiated Project Shikhar to bring down Raw material cost

In order to bring down the raw material costs, Escorts introduced Project Shikhar to achieve industry benchmarks on the following parameters:

1. To reduce raw material costs in Tractor business from 72% to 67-68%.
2. To build lean supplier base with best in class suppliers (reduction by 25%)

The target is to bring down raw material costs to around 67-68% of sales which mainly involves 50% improvement from the procurement side (vendor rationalization and consolidation) and other 50% is from Value Analysis/Value engineering on design side. The results are expected to be fully visible in financials by FY17 end.

Exhibit 17: Raw material cost to improve by 290bp over FY15-18

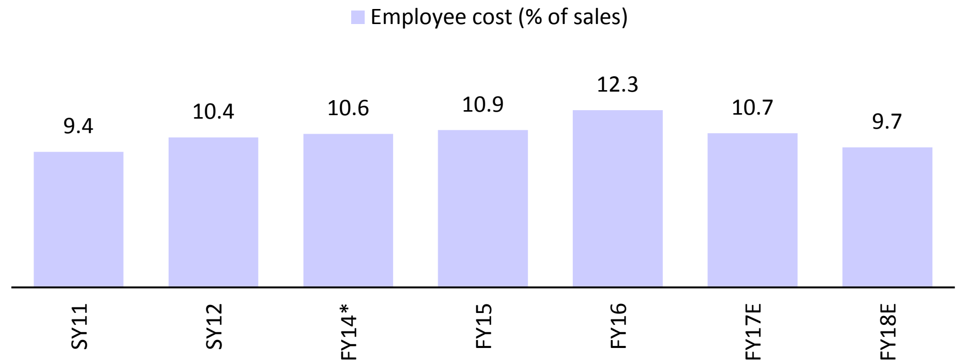


Source: Company, MOSL

Legacy employee cost a drag on margins

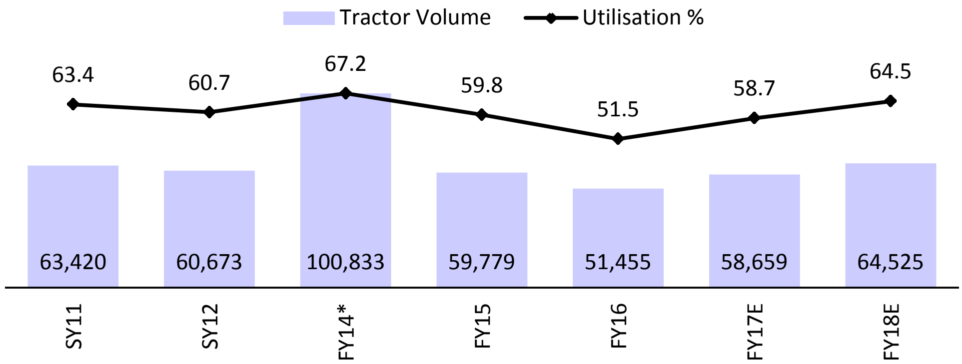
Being a 70 year old company permanent blue collar employee cost is around 5-6 times as that of more productive casual/contractual workforce. Currently, Escorts have around 2,500 permanent blue collar employees (after VRS of 350 given last year and some natural retirements), this number is targeted to bring down to 1500 (650-700 more VRS in next 3 years and rest from natural retirement). Also the company is rationalizing its white collar work force which stands at around 1700 as that of 2,200+ 3 years back. On account of this, employee is expected to come down to 7-8% at current set up on a volume base of 62-65K and will maintain same in long run.

Exhibit 18: Employee cost to gradually decline over the long term



Source: Company, MOSL

Exhibit 19: Increase in capacity utilization to provide operating leverage benefits

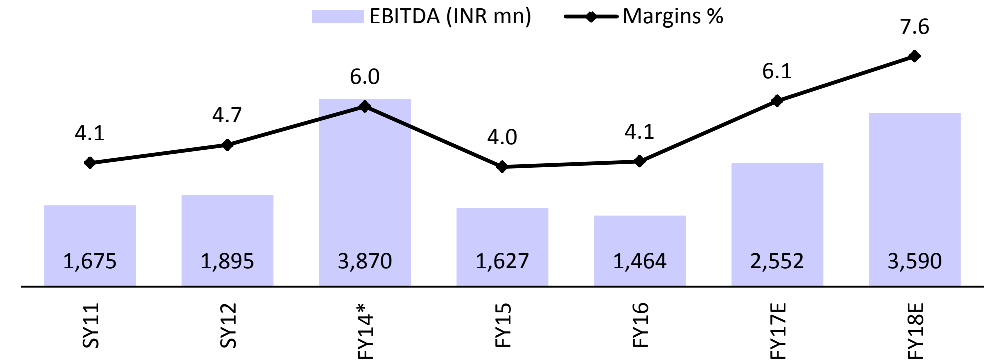


*18m period,

Source: Company, MOSL

Escorts has a total capacity of 100,000 tractors per year where utilization levels were 51% in FY16. This is expected to improve to 65% in FY18 which shall also aid in operating leverage benefits.

Exhibit 20: EBITDA margins to expand from 4.1% in FY16 to 7.6% in FY18E



*18m period, Source: Company, MOSL

Railways – a significant opportunity

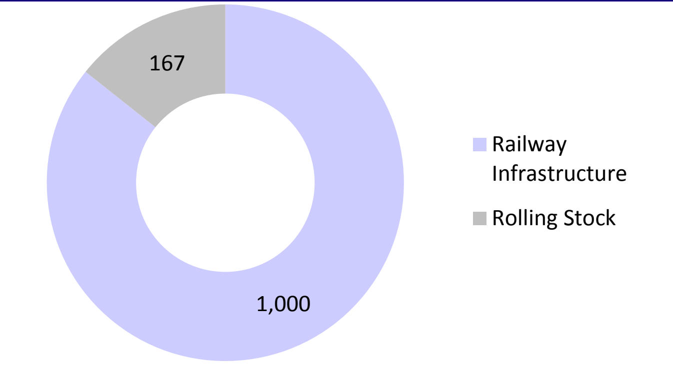
Construction business to be revived; ongoing plans to hive off Auto business

- **The government has allocated INR1,167b for railways over 2015–19. The investment planned in rolling stock is INR167b (coaches, wagons, locomotive, EMU/CMU, metros etc.). Within rolling stock, a considerable amount has been earmarked for modernizing the railway sector.**
- **This provides a huge opportunity for Escorts which is into manufacturing of products like Brakes, Couplers and Shockers. These products have an addressable market size of ~INR5bn with competition from 4 to 5 players. Escorts is also introducing new products like Bogey mounted brake system and Axle mounted brake system which has an addressable market size of INR3b and also evaluating 4-5 new products which has a potential market size of INR15.8b.**
- **The tendering activity for Road sector is also quite strong (41% increase in 2HFY16 YoY) which shall aid revival in construction segment. We expect the segment to recover with a revenue CAGR of 25% over FY16-18E.**

Government focus on railways

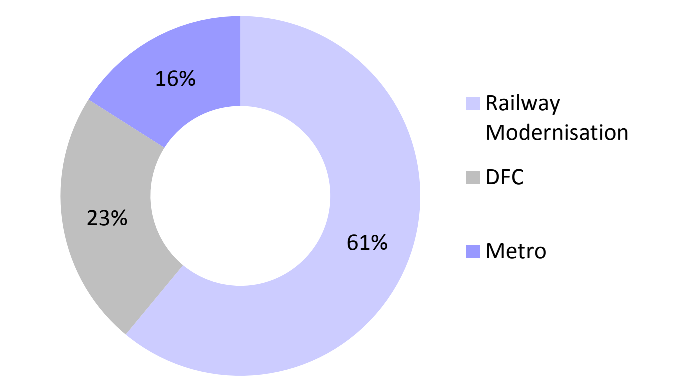
The government has planned a total investment of INR1,167b over 2015–19. Initially, the investment is expected to be skewed toward railway infrastructure sub-segments (for example, tracks, bridges, network expansion, electrification, signaling and safety). Investment planned in rolling stock is INR167b (coaches, wagons, locomotive, EMU/CMU, metros etc.). Within Rolling stock, a large portion of the investment is expected to be used for modernization initiatives.

Exhibit 21: Investments over 2015–19 (INR b)



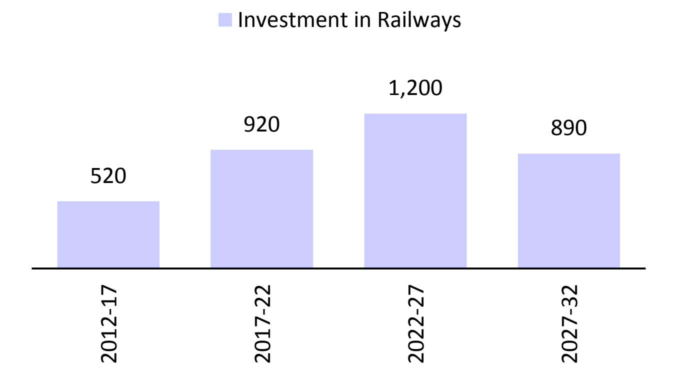
Source: Company, MOSL

Exhibit 22: Split of investments within rolling stock



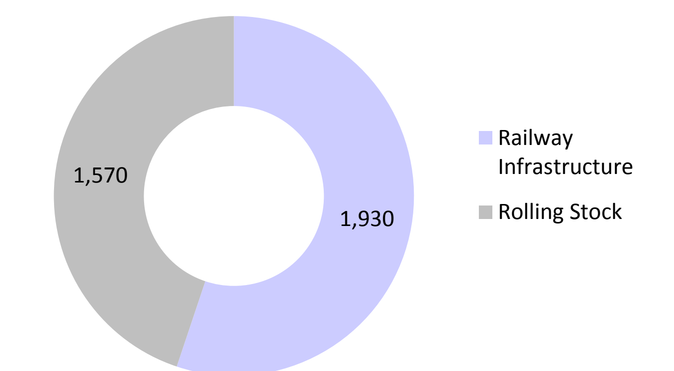
Source: Company, MOSL

Exhibit 23: Investments over 2015–32 (INR b)



Source: Company, MOSL

Exhibit 24: Split of investments



Source: Company, MOSL

Braking system largest contributor to Escorts' Railway revenue

Escorts current product portfolio in railways includes Brakes (Air brakes, EP brakes, brake pads), Couplers (AARH coupler, SHAKU coupler) and Shockers (Suspension). Cumulatively, these products contributed 4.5% to the topline to INR1.84b and have an addressable market size of INR5b.

Exhibit 25: Geography-wise revenue breakup (FY15)

	LHB Coach	BMBS Wagon	EMU/ DMU	Diesel Loco	Electric Loco	Metro
Brakes	YES	YES	YES	UD	UD	PLAN
Couplers	YES	N/A	YES	YES	YES	PLAN
Shockers	UD	N/A	YES	YES	YES	N/A

UD: Under Development

Source: Company

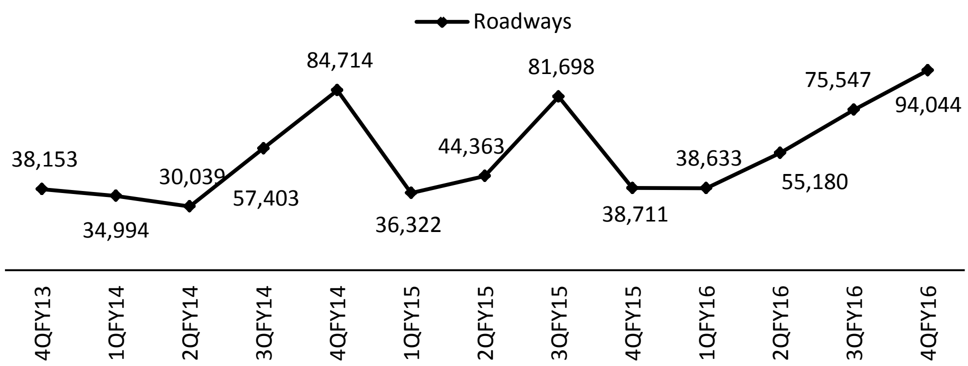
Escorts to expand product basket and addressable market

Escorts has lined up two new product launches which includes Bogey mounted brake system (testing completed) and Axle mounted brake system (on going testing). These products combined have an addressable market size of INR3b with 1-2 competitors. Additionally, it is also evaluating 4 to 5 new products (including an automatic door system) which as per company's estimated is expected to have an addressable market size of INR15.8b with 4-5 competitors in the space.

Revival in construction segment on cards

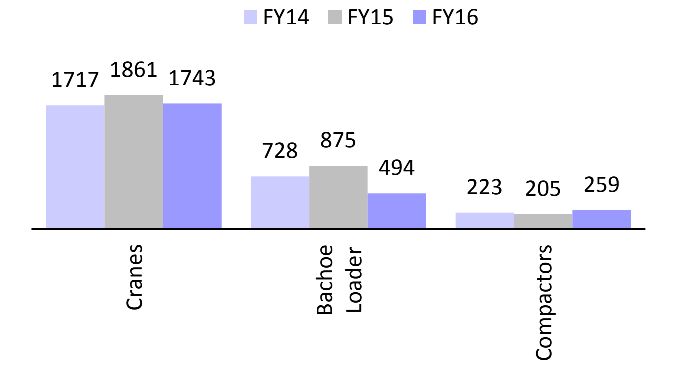
Escorts construction business contributed 13% to the revenue of Escorts in FY16 de-growing by 11% to INR4,556m reporting PBIT loss of INR300m due to lower utilization of 26% and loss in market share. The construction business of Escorts has been struggling for last 4 years reporting a loss at PBIT level. Within the overall construction equipment industry, Escorts is present in Earthmoving category (Backhoe Loaders), Material Handling (Pick and carry cranes) and Road Building (Compactors). The tenders in Road sector has increased by 41% in 2HFY16 on YoY basis. This sharp increase in tenders has initiated recovery in construction segment.

Exhibit 26: 41% growth in Road tender in 2HFY16



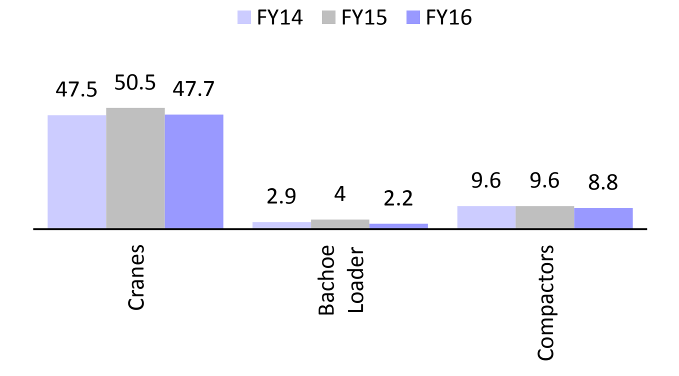
Source: MOSL

Exhibit 27: Volume trend in construction business



Source: Company, MOSL

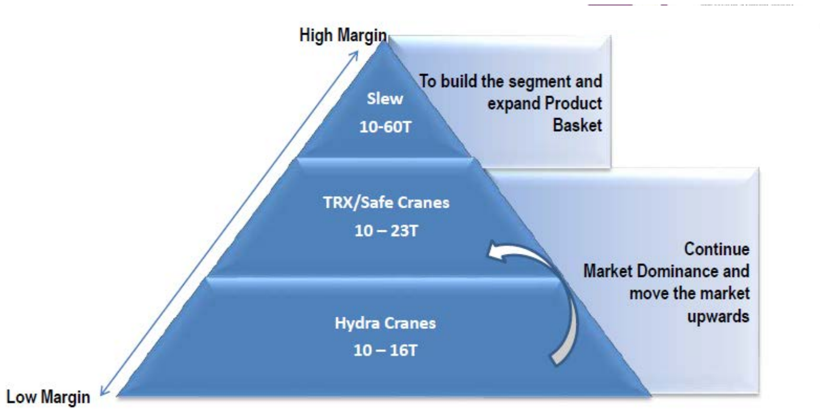
Exhibit 28: Market share trend in construction business



Source: Company, MOSL

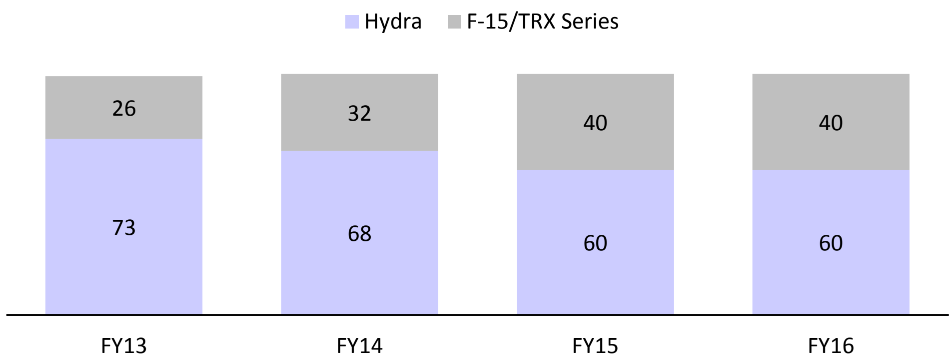
The company also intends to move up ladder by increasing its share from higher value and higher margin TRX/Safe cranes from Hydra cranes.

Exhibit 29: Moving up the ladder



Source: Company

Exhibit 30: Increasing share of F-15/TRX series in Construction segment



Source: Company

Plans to divest auto ancillary segment to focus on core businesses

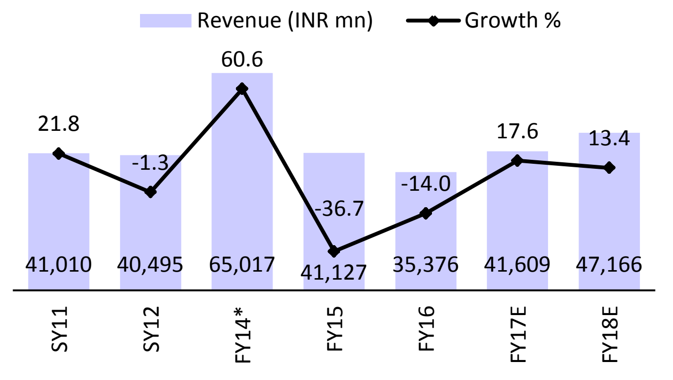
Escorts manufactures shock absorbers, McPherson struts and front forks as a part of its auto ancillary business. The segment has been a weak link with revenues of INR924m in FY16 as against INR1b in 2011, and loss of INR166m in FY16. The segment has been posting an EBIT loss in each of its years since 2011. Management in the past has expressed intent to find a strategic partner and has highlighted that it does not expect turnover in the business to post any meaningful growth.

Earnings to post 60% CAGR over FY16–18

Higher utilization, operating and financial leverage to drive PAT growth

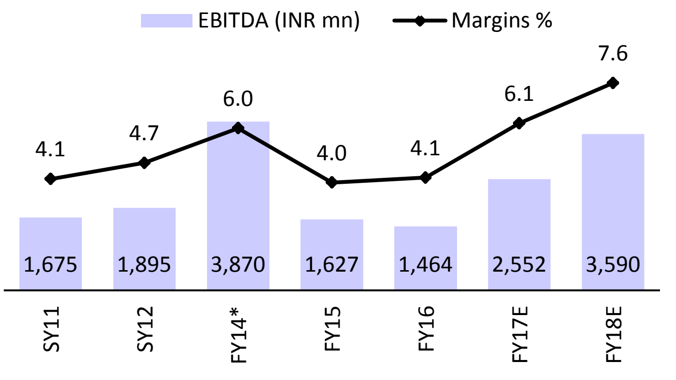
We expect tractor business to deliver a volume growth at a CAGR of 12% over FY16-18 and value growth of 14%. Additionally, construction business is set to grow at 25% CAGR on the back of revival in infrastructure sector. The EBITDA margins are expected to expand by 340bp to 7.6% in FY18. Cost cutting measures, operational leverage due to improvement in utilization and revival in construction business to aid margin expansion. Consequently, we expect EBITDA and PAT to register a CAGR of 57% and 60% over FY16–18 due to improving financial leverage.

Exhibit 31: Revenues to post 15% CAGR over FY16–18



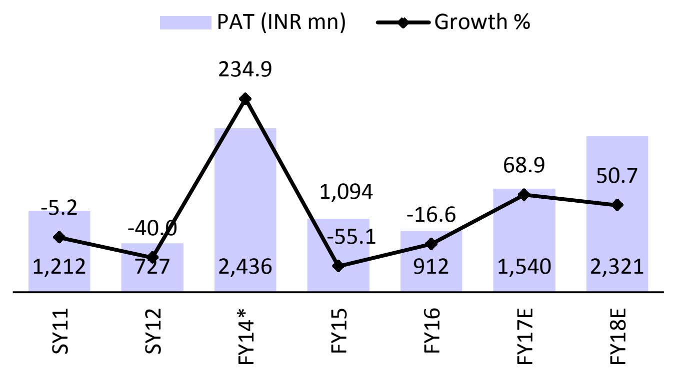
Source: Company, MOSL

Exhibit 32: EBITDA to record a CAGR of 57% over FY16–18



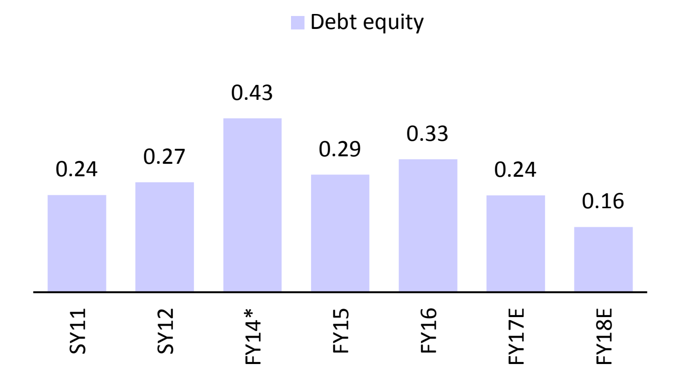
Source: Company, MOSL

Exhibit 33: PAT to register CAGR of 60% over FY16–18



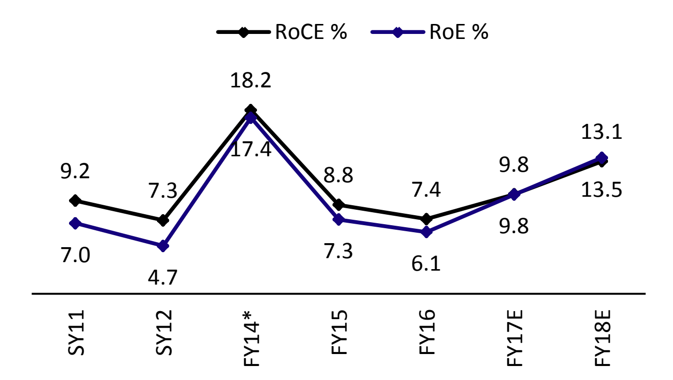
Source: Company, MOSL

Exhibit 34: Debt equity on a declining trend



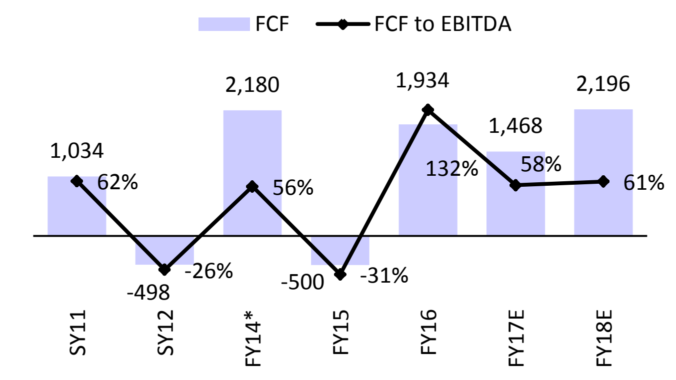
Source: Company, MOSL

Exhibit 35: RoCE to improve to 13.1% by FY18



Source: Company, MOSL

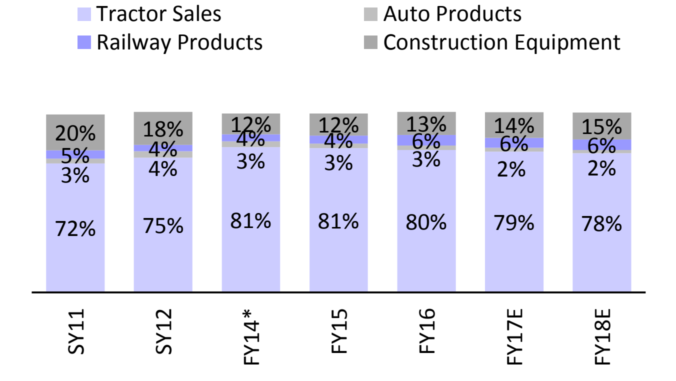
Exhibit 36: Free cash generation on cards



Source: Company, MOSL

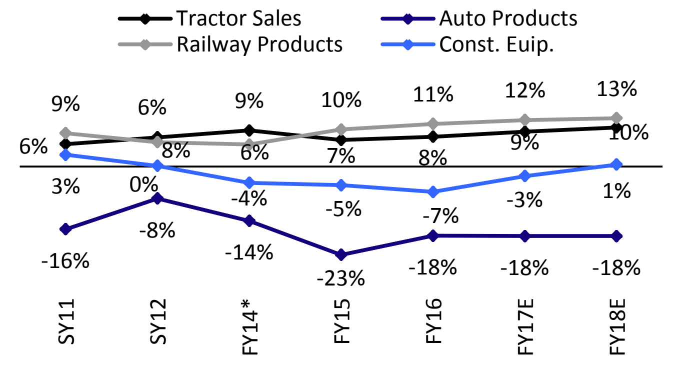
*FY14 was a 18 month period

Exhibit 37: Revenue mix trend



Source: Company, MOSL

Exhibit 38: EBIT margins segment wise



Source: Company, MOSL

The company has 30.43% of share capital held by Escorts benefit and Welfare Trust which we have adjusted in financials of the company.

SWOT Analysis

Strength

- ☑ Strong presence in North region
- ☑ Aggressive launches in the last two years
- ☑ Dealer initiatives like higher margins, financing, separation of economy and premium dealerships.
- ☑ Leader in innovation. Recent example being Anti-Lift tractor.

Weakness

- ☑ Higher than industry raw material and employee costs
- ☑ Automotive segment a drag on profitability
- ☑ High cost legacy employees
- ☑ Weak in South and West markets

Opportunity

- ☑ A normal monsoon shall lead to increase in farm incomes and greater demand for tractors.
- ☑ Planned investment of INR1,167b by Indian Railways presents a huge opportunity to Escorts which is present in manufacturing of products.
- ☑ Traction in Road sector tenders to bode well for its construction segment.

Threats

- ☑ High competitive intensity, players who have entered later have edged ahead in terms of market share.
- ☑ Seasonality in revenues with monsoon being a key indicator.

Valuation and view

Initiate with a Buy

Tractor business (80% revenue share) to see rebound in sales growth at CAGR of 14% over FY16-18E on the back of strategic decisions taken in past 2 years. It includes i. Launch of 10 new models including the innovative Anti-Lift tractor to plug gaps in its portfolio, ii. Separate dealership for Powertrac and Farmtrac in North markets to increase service area of dealers, iii. Focused support to selected dealers in south and west region to increase market share.

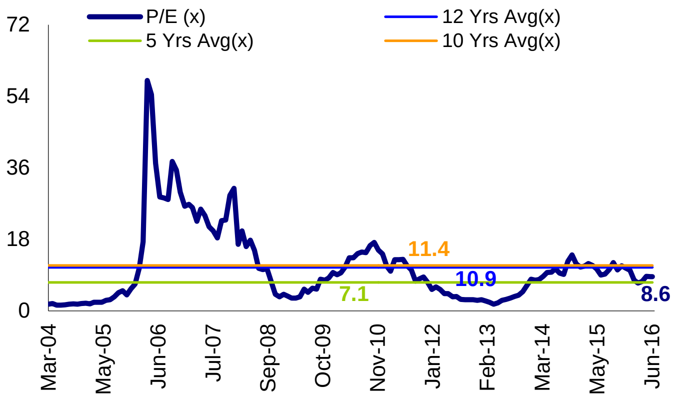
EBITDA margins to expand from 4.1% in FY16 to 7.6% in FY18 due to initiatives on lowering raw material costs to 67–68% of sales from 71% in FY15 through vendor rationalization and value engineering. Employee cost also to be reduced to 7-8% of sales through VRS in the next 3 years from the current 12% of sales.

Increase in tractor volumes, revival in construction segment due to pick in Road sector tenders (up 41% in 2HFY16 YoY) will also aid in margin expansion while railways could be a big opportunity in making.

We expect Escorts' revenue and PAT to register a CAGR of 15% and 60%, respectively, over FY16–18E, along with strong FCF generation and significant expansion in return ratios (RoCE -post tax to improve from 7.4% to 13.1% during the same period). The stock currently trades at a PE of 10x/6x on FY17E/18E EPS (adjusted for treasury shares), and we value the stock at 10x (40% discount to M&M) FY18 EPS to arrive at a target price of INR283 (56% upside).

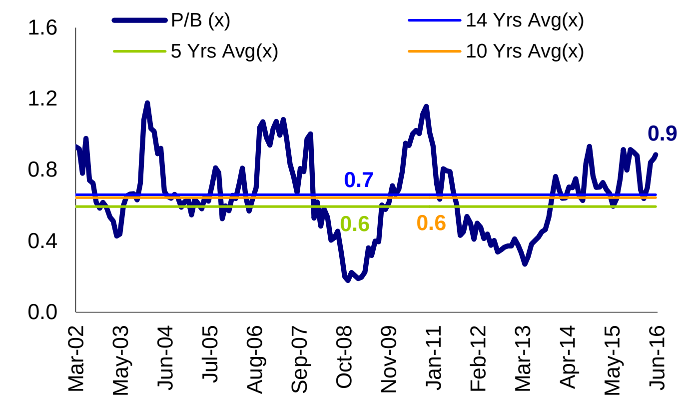
The company has 30.43% of share capital held by Escorts benefit and Welfare Trust which we have adjusted in financials of the company.

Exhibit 39: Price-to-earnings (one-year forward)



Source: Company, MOSL

Exhibit 40: Price-to-book (one-year forward)



Source: Company, MOSL

Exhibit 41: Key assumption

Assumptions	SY11	SY12	FY14	FY15	FY16	FY17E	FY18E
Tractor Sales	19%	3%	73%	-37%	-15%	16%	12%
Auto Products	14%	35%	47%	-51%	-11%	-5%	-2%
Railway Products	-3%	-22%	72%	-28%	12%	15%	15%
Construction Equipment	46%	-9%	2%	-33%	-11%	30%	20%
Total Revenue Growth (%)	**22%**	**-1%**	**60%**	**-37%**	**-14%**	**18%**	**13%**

Source: Company, MOSL

Risks and concerns

Uncertain monsoon

Unfavorable monsoon is the biggest risk for the agriculture based sectors. Delayed or deficient rainfall hurts sales return and, thus, negatively impacts growth. Similarly, unseasonal rainfall can damage standing crops, resulting in income loss for farmers.

Lower prices of agricultural produce

Decline in prices of agricultural commodities or lower MSP (minimum support price) can reduce farm incomes and, consequently, demand for agri-inputs. Unlike fertilizers, prices of agrochemicals are not subsidized and farmers may choose to decrease their purchase of agro-chemicals to lower their production cost.

Subdued tractor demand

Increasing demand for tractors remains key for Escorts. Any slowdown in demand or negative surprises can pose a threat to our estimates.

Slower than expected pruning of costs

One of the major drag remains its higher than industry costs for raw material and employee benefits. Our implicit assumption factors in a gradual reduction in costs through efficiency programmes and VRS for employees. Any executional delay in the same poses a risk.

Bull & Bear case

Bull case

Our bull case assumptions have positive impact on sales growth and operating margins. We assume higher volume growth in all segments over base case scenario leading to increased capacity utilization.

Instead of assuming 350bp of EBITDA margin improvement over FY16-18 in the base case, we are assuming 550bps YoY improvement over FY16-18 in bull case scenario assuming higher that company is able to achieve its VRS target in two years and operating leverage due to higher volume assumptions.

There is an increase of 126% in FY17E EPS and 61% in FY18E EPS in the bull case EPS to INR25.1 and INR40.4 respectively.

Assuming the same 10x target multiple that we have taken for the base case, we get a bull case target price of INR404 (upside of 122% to CMP) based on FY18 EPS instead of the base case target price of INR283, upside of 56%.

Exhibit 42: Valuation in bull case

	FY16	FY17E	FY18E
Sales (INR m)	35,376	43,382	51,363
Sales growth (%)	-14.0	22.6	18.4
EBITDA (INR m)	1,464	3,213	4,927
EBITDA Margin (%)	4.1	7.4	9.6
EBITDA growth (%)	-10.0	119.5	53.3
PAT (INR m)	912	2,056	3,311
PAT Margin (%)	2.6	4.7	6.4
PAT growth (%)	-16.6	125.5	61.0
EPS (INR)	11.1	25.1	40.4
Target multiple (x)			10
Target price (INR)			404
Upside/downside (%)			122

Source: MOSL

Bear case

Our bear case assumptions mainly have a negative impact on both sales growth and operating margins for FY17E and FY18E.

We are assuming EBITDA margins to remain flattish over FY16-18E in the bear case and subdued sales growth of 5% CAGR over FY16-18E against 15% CAGR in base case scenario.

In our bear case, we assume monsoons are poor, company is unable to withstand competition and unable to grow in its opportunity market. Additionally, we assume the company is unable to offer VRS to employees and unable to pass on increase in raw material costs to consumers.

This will lead to flattish growth in Adjusted PAT over FY176-18E against 60% increase in base case scenario.

Assuming the same 10x target multiple that we have taken for the base case, we get a bear case target price of INR110 (downside of 39% to CMP) based on FY18 EPS instead of the base case target price of INR283, upside of 56%.

Exhibit 43: Valuation in bear case

	FY16	FY17E	FY18E
Sales (INR m)	35,376	35,576	38,647
Sales growth (%)	-14.0	0.6	8.6
EBITDA (INR m)	1,464	1,358	1,676
EBITDA Margin (%)	4.1	3.8	4.3
EBITDA growth (%)	-10.0	-7.2	23.4
PAT (INR m)	912	609	905
PAT Margin (%)	2.6	1.7	2.3
PAT growth (%)	-16.6	-33.2	48.5
EPS (INR)	11.1	7.4	11.0
Target multiple (x)			10
Target price (INR)			110
Upside/downside (%)			-39

Source: MOSL

Management overview

Mr. Rajan Nanda, Chairman and Managing Director

Mr Rajan Nanda, a second-generation entrepreneur, has more than four decades experience in the engineering and manufacturing sectors. He took over as Chairman of Escorts Group in 1994 and has been involved in every aspect of the company's management. A visionary and astute leader, Mr Nanda has navigated the company in times of unprecedented economic challenges. His focus has been on strengthening the Escorts foundation by leveraging inherent design and development capabilities, instituting lean manufacturing practices, and improving the use of assets to move up in the value chain.

Mr. Nikhil Nanda, Managing Director

Mr Nikhil Nanda is a third-generation entrepreneur and the driving force for the Group's diversified business portfolio. He has played a vital role in monitoring the company's performance and steering operations to greater heights. His overall contribution, spanning more than 15 years, has been immeasurable, particularly in the areas of operations, finance and senior management functions such as strategic planning and investment decisions. Mr Nanda is an alumnus of Wharton Business School, Philadelphia, majoring in Management and Marketing.

Mr. Ravi Menon, CEO – Escorts Agri Machinery

Mr. Menon is an experienced professional who brings many years of leadership in corporate strategy, marketing, sales, branding, international markets and production. He has previously worked with John Deere, ACC Limited, Exide Industries Limited.

Mr. S Sridhar, CEO – Escorts Construction Equipment

Mr. Sridhar possesses over 27 years of expertise in automotive engineering & manufacturing. He specializes in brand and business strategies and was formerly CEO and President of Bajaj Auto Limited.

Mr. Dipankar Ghosh, CEO – Railway equipment and Auto products

Mr. Ghosh is and ex-Indian railway service officer with over 23 years of experience in product development, engineering and management. He has previously worked with John Deere, Bombardier Transportation and Caterpillar India in various leadership roles.

Mr. Bharat Madan, Group Financial Controller

Mr. Madan has 25 years of rich experience in all the domains of financial management. In his previous role, he was financial controller with Electrolux Kelvinator.

Company overview

Among pioneers in the tractor industry

Having pioneered farm mechanization in the country, Escorts has played a pivotal role in India's agricultural growth for over five decades. The company, one of the leading tractor manufacturers, offers a comprehensive range of tractors—more than 45 variants from 25–80HP. Escorts, Farmtrac and Powertrac are widely accepted and preferred tractor brands from the house of Escorts.

Escorts is the leading material handling and construction equipment manufacturer, having a diverse range of equipment such as cranes, loaders, vibratory rollers and forklifts. The company is currently the world's largest pick 'n' carry hydraulic mobile crane manufacturer.

Escorts has been a major player in the railway equipment business for nearly five decades. The company's product offering comprises brakes, couplers, shock absorbers, rail fastening systems, composite brake blocks and vulcanized rubber parts.

In the auto components segment, the company is a leading manufacturer of auto suspension products including shock absorbers and telescopic front forks. Over the years, Escorts has launched reliable products due to continued advancements in manufacturing technologies and design.

Exhibit 44: Tractor business is largest segment

Escorts Ltd

Tractor Segment	Construction Equipment Segment	Railway equipment segment	Auto products segment
FY16 sales: INR28b Contribution: 79.7%	FY16 sales: INR4.5b Contribution: 12.9%	FY16 sales: INR2b Contribution: 5.8%	FY16 sales: INR0.9b Contribution: 2%
FY16 PBIT: INR2,169m Margin: 7.7%	FY16 PBIT: INR(300m) Margin: NA	FY16 PBIT: INR226m Margin: 11%	FY16 PBIT: INR(166m) Margin: NA

Source: Company, MOSL

Financials and valuations

Consolidated - Income Statement (INR Million)

Y/E March	SY10	SY11	SY12	FY14	FY15	FY16	FY17E	FY18E
Income from Operations	34,360	41,995	41,531	66,352	41,885	36,028	42,376	48,035
Less: Excise Duty	703	985	1,037	1,334	758	652	767	869
Total Income from Operations	**33,656**	**41,010**	**40,495**	**65,017**	**41,127**	**35,376**	**41,609**	**47,166**
Change (%)	27.4	21.8	-1.3	60.6	-36.7	-14.0	17.6	13.4
Total Expenditure	**31,383**	**39,334**	**38,599**	**61,148**	**39,500**	**33,912**	**39,057**	**43,576**
% of Sales	93.2	95.9	95.3	94.0	96.0	95.9	93.9	92.4
EBITDA	**2,273**	**1,675**	**1,895**	**3,870**	**1,627**	**1,464**	**2,552**	**3,590**
Margin (%)	6.8	4.1	4.7	6.0	4.0	4.1	6.1	7.6
Depreciation	482	477	502	860	686	612	721	738
EBIT	**1,791**	**1,199**	**1,393**	**3,010**	**941**	**852**	**1,831**	**2,852**
Int. and Finance Charges	702	711	970	1,122	583	524	406	211
Other Income	667	565	483	829	652	606	545	491
PBT bef. EO Exp.	**1,756**	**1,052**	**906**	**2,716**	**1,011**	**934**	**1,970**	**3,132**
PBT after EO Exp.	**1,813**	**1,097**	**919**	**2,751**	**704**	**789**	**1,870**	**3,132**
Current Tax	242	-62	62	411	136	22	411	814
Deferred Tax	248	-92	125	-129	-192	0	0	0
Tax Rate (%)	27.0	-14.0	20.4	10.3	-7.9	2.8	22.0	26.0
Less: Minority Interest	3	-13	-6	2	-3	-4	-4	-4
Reported PAT	**1,320**	**1,264**	**738**	**2,467**	**763**	**771**	**1,462**	**2,321**
Adjusted PAT	**1,278**	**1,212**	**727**	**2,436**	**1,094**	**912**	**1,540**	**2,321**
Change (%)	198.9	-5.2	-40.0	234.9	-55.1	-16.6	68.9	50.7
Margin (%)	3.8	3.0	1.8	3.7	2.7	2.6	3.7	4.9

Consolidated - Balance Sheet (INR Million)

Y/E March	SY10	SY11	SY12	FY14	FY15	FY16	FY17E	FY18E
Equity Share Capital	921	921	820	820	820	820	820	820
Total Reserves	15,939	16,917	12,046	14,247	13,898	14,288	15,463	17,353
Net Worth	**16,860**	**17,839**	**12,865**	**15,066**	**14,718**	**15,108**	**16,283**	**18,173**
Minority Interest	84	91	114	178	147	127	123	120
Deferred Liabilities	1,399	447	493	418	137	120	120	120
Total Loans	4,053	4,858	5,536	4,383	4,844	3,625	2,625	625
Capital Employed	**22,396**	**23,234**	**19,009**	**20,045**	**19,845**	**18,980**	**19,151**	**19,038**
Gross Block	22,377	22,917	23,212	24,504	24,425	25,441	26,041	26,641
Less: Accum. Deprn.	6,855	7,276	7,264	7,967	8,470	9,082	9,802	10,540
Net Fixed Assets	**15,522**	**15,641**	**15,948**	**16,537**	**15,955**	**16,360**	**16,239**	**16,101**
Goodwill on Consolidation	560	560	0	0	0	0	0	0
Capital WIP	203	479	668	387	557	0	397	356
Total Investments	**1,075**	**1,117**	**140**	**131**	**137**	**194**	**194**	**194**
Curr. Assets, Loans&Adv.	**14,021**	**17,119**	**14,808**	**15,225**	**14,108**	**13,151**	**14,808**	**15,973**
Inventory	4,365	4,959	5,244	5,871	4,528	4,265	5,169	5,825
Account Receivables	4,501	5,403	4,772	3,725	4,143	4,090	4,788	5,427
Cash and Bank Balance	2,117	2,453	1,452	2,707	2,514	2,455	2,229	1,783
Loans and Advances	3,038	4,304	3,341	2,922	2,923	2,342	2,623	2,938
Curr. Liability & Prov.	**10,446**	**12,262**	**13,056**	**12,788**	**11,592**	**11,307**	**13,069**	**14,168**
Account Payables	9,108	11,134	11,056	10,770	9,563	9,403	10,830	11,630
Provisions	1,338	1,128	2,000	2,019	2,030	1,904	2,239	2,538
Net Current Assets	**3,575**	**4,858**	**1,753**	**2,436**	**2,515**	**1,844**	**1,739**	**1,805**
Deferred Tax assets	1,439	579	500	553	680	581	581	581
Misc Expenditure	21	0	0	0	0	0	0	0
Appl. of Funds	**22,396**	**23,234**	**19,008**	**20,044**	**19,845**	**18,980**	**19,151**	**19,037**

E: MOSL Estimates; *FY14 was a 18 month period

Financials and valuations

Ratios

Y/E March	SY10	SY11	SY12	FY14	FY15	FY16	FY17E	FY18E
Basic (INR)								
EPS (adj. for treasury shares)	**13.9**	**13.2**	**8.9**	**29.7**	**13.3**	**11.1**	**18.8**	**28.3**
Cash EPS	19.1	18.3	15.0	40.2	21.7	18.6	27.6	37.3
BV/Share	183.0	193.6	157.0	183.8	179.5	184.3	198.6	221.6
DPS	2.0	1.9	1.8	2.7	1.8	1.8	2.9	4.4
Payout (%)	14.3	14.6	23.2	10.5	23.2	23.0	19.6	18.6
Valuation (x)								
P/E					13.6	16.4	9.7	6.4
Cash P/E					8.4	9.8	6.6	4.9
P/BV					1.0	1.0	0.9	0.8
EV/Sales					0.4	0.5	0.4	0.3
EV/EBITDA					10.6	11.0	6.0	3.8
Dividend Yield (%)					1.0	1.0	1.6	2.4
Return Ratios (%)								
RoE	8.2	7.0	4.7	17.4	7.3	6.1	9.8	13.5
RoCE	9.2	9.2	7.3	18.2	8.8	7.4	9.8	13.1
RoIC	7.3	7.2	6.2	16.1	6.1	5.0	8.7	12.8
Working Capital Ratios								
Asset Turnover (x)	1.5	1.8	2.1	3.2	2.1	1.9	2.2	2.5
Inventory (Days)	69	61	65	46	56	64	66	66
Debtor (Days)	48	47	42	20	36	41	41	41
Creditor (Days)	99	99	100	60	85	97	95	90
Working Cap. Turnover (Days)	16	21	3	-2	0	-6	-4	0
Leverage Ratio (x)								
Debt/Equity	0.2	0.3	0.4	0.3	0.3	0.2	0.2	0.0

Consolidated - Cash Flow Statement (INR Million)

Y/E March	SY10	SY11	SY12	FY14	FY15	FY16	FY17E	FY18E
OP/(Loss) before Tax	1,813	1,097	919	2,751	704	934	1,970	3,132
Depreciation	482	476	502	860	686	612	721	738
Interest & Finance Charges	59	257	472	262	11	524	406	211
Direct Taxes Paid	-608	-282	-370	-619	-209	-22	-411	-814
(Inc)/Dec in WC	-1,151	390	-957	214	-1,185	345	-221	-511
CF from Operations	**595**	**1,939**	**567**	**3,468**	**8**	**2,393**	**2,465**	**2,755**
Others	-116	139	18	-42	43	0	0	0
CF from Operating incl EO	**479**	**2,078**	**584**	**3,426**	**52**	**2,393**	**2,465**	**2,755**
(inc)/dec in FA	-531	-1,044	-1,082	-1,246	-552	-459	-997	-559
Free Cash Flow	**-53**	**1,034**	**-498**	**2,180**	**-500**	**1,934**	**1,468**	**2,196**
(Pur)/Sale of Investments	-562	-57	-39	10	-2	0	0	0
Others	346	-726	-183	1,365	296	-77	-4	-4
CF from Investments	**-747**	**-1,826**	**-1,304**	**128**	**-259**	**-536**	**-1,001**	**-562**
Issue of Shares	305	0	0	0	2	0	0	0
Inc/(Dec) in Debt	1,142	848	678	-1,153	592	-1,219	-1,000	-2,000
Interest Paid	-599	-598	-814	-944	-503	-524	-406	-211
Dividend Paid	-110	-185	-171	-254	-64	-177	-287	-431
Others	-317	20	25	51	-13	4	4	4
CF from Fin. Activity	**421**	**85**	**-282**	**-2,299**	**13**	**-1,916**	**-1,690**	**-2,639**
Inc/Dec of Cash	**153**	**337**	**-1,002**	**1,255**	**-194**	**-59**	**-226**	**-446**
Opening Balance	1,964	2,117	2,453	1,452	2,707	2,514	2,454	2,228
Closing Balance	**2,117**	**2,453**	**1,452**	**2,707**	**2,514**	**2,454**	**2,228**	**1,783**

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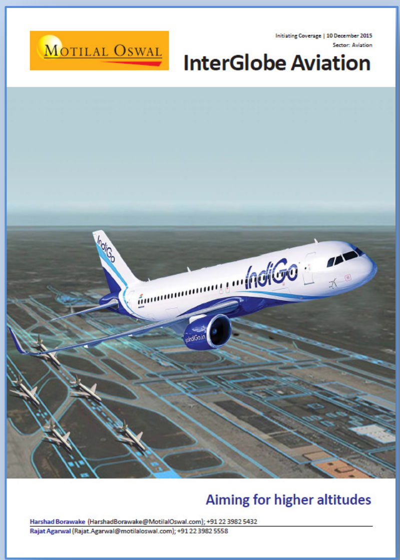
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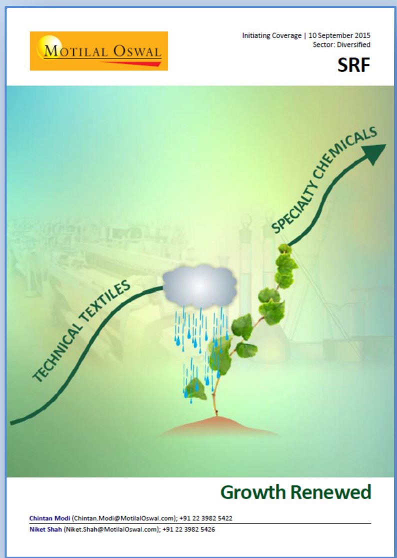
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