Date: 26th July, 2020

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Stock Idea

Polycab India Ltd

Switching gears from B2B to B2C

Contents

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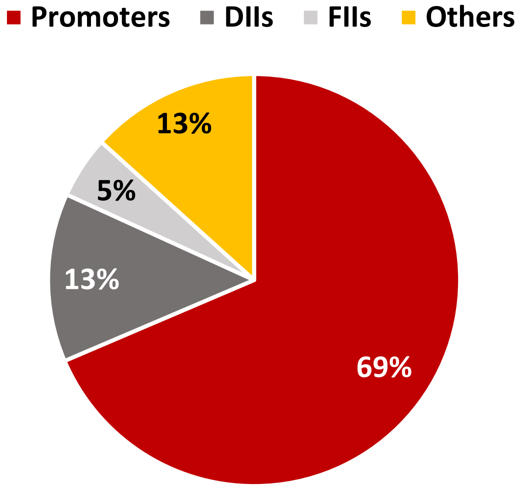
Snapshot

- **Total Weightage % in portfolio = 6%**
- **Best buying range = Buy 3% b/w 800-830 & avg down 3% b/w 600-700 range**
- **Price target = Rs 4000 by 2026 (Expect 30% CAGR in next 6 years)**

Company is the largest player in the Indian Wires and Cables industry and is currently undergoing a massive transition from being a B2B powerhouse to a B2C player. With a pan-India distribution network, strong brand recall and strong balance sheet, the company is well positioned to become a major player in the Fast Moving Electrical Goods (FMEG) segment.

Shareholding % as on March 31, 2020



Market Cap: INR 12,205 Cr.	**Current Price: INR 819**	52 weeks H/L: 1,182.00 / 525.05
Book Value: 257.37	Stock P/E: 16.66	Dividend Yield: 0.83 %
ROCE: 29.34%	ROE: 22.35%	Sales Growth (3Yrs): 17.09%
Face Value: 10	Promoter Holding: 68.58%	Dividend Payout: 13.73%
Sales Growth (5Y): 14%	Profit Growth (5Y): 42%	Pledged percentage: 0.00%

Source: Screener.in, As on July 26, 2020

Capacity to suffer/Capacity to reinvest

Dear Friends,

Consistency is wonderful unless it masks an intolerance for "pain" or complacency.

A straight line that is "up and to the right" is a beautiful sight when it comes to a graph of a company's revenue, earnings, free cash flow or any other financial metric that matters. We get excited when we see that a company has performed so well that everything looks so perfect. More often than not, that excitement is quickly tempered by a dose of skepticism.

As an investor - yes - we generally like consistency and predictability in the businesses that we buy a stake in, but we don't like when that consistency and predictability is artificially manufactured. We don't like when management teams dial back marketing investment or any other important investment because they want to hit an arbitrary 10% earnings growth target that they committed to a year prior. In other words, we don't want earnings consistency at the expense of activities that widen the moat. We're ok if earnings take a hit because the company wants to make an investment that has the potential to bear fruit later. This is more or less the core idea behind the "capacity to suffer" or the "capacity to reinvest" - It's an idea that's been popularized by value investor Tom Russo over the years.

Capacity to suffer is closely connected with the idea of delayed gratification. Delayed gratification happens when someone resists the temptation of an immediate reward in preference for a later reward. Delayed gratification is associated with resisting a smaller but more immediate gain in order to receive a larger or more enduring reward later. An ability to think long term, set long term goals/expectations and a capacity and a willingness to suffer (or reinvest) to meet those long term goals are an important assessment of management quality.

One such company that we believe displaying this capacity to suffer is Polycab India Ltd. **Even though the company is the largest player in Wires and Cables (W&C) industry, about 6 years back the management made a decision to enter into the Fast Moving Electrical Goods (FMEG) segment. The vision behind this this move was to make the company a B2C player and move away from being a B2B powerhouse.**

We believe the sufferings the company is experiencing today will lead to enduring rewards later.

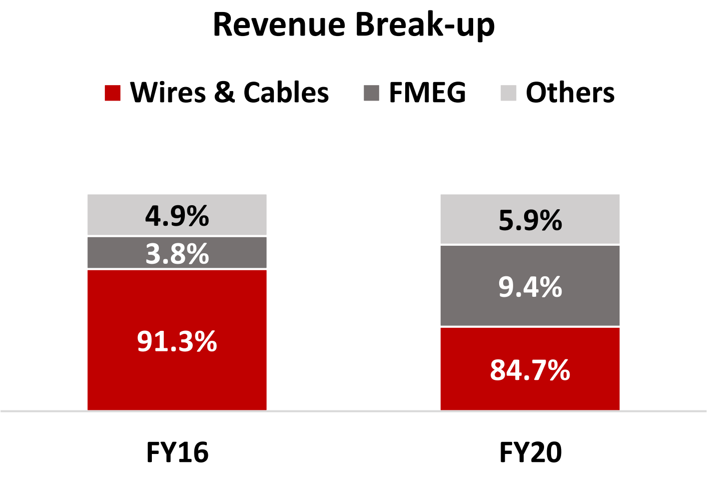
About

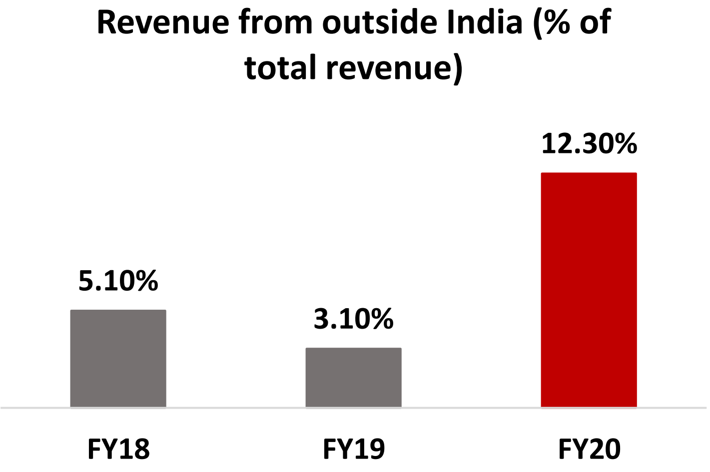
Polycab India Limited (PIL) (NSE: POLYCAB, BSE: 542652) is the largest player in India's wires and cables (W&C) industry. The investment thesis on PIL is based on its continuing leadership position in W&C industry and rapid growth and transformation into a multiproduct player in the high margin Fast Moving Electrical Goods (FMEG) industry.

The company has presence in all the major segments in the W&C industry and also across high growth potential categories in the FMEG sector.

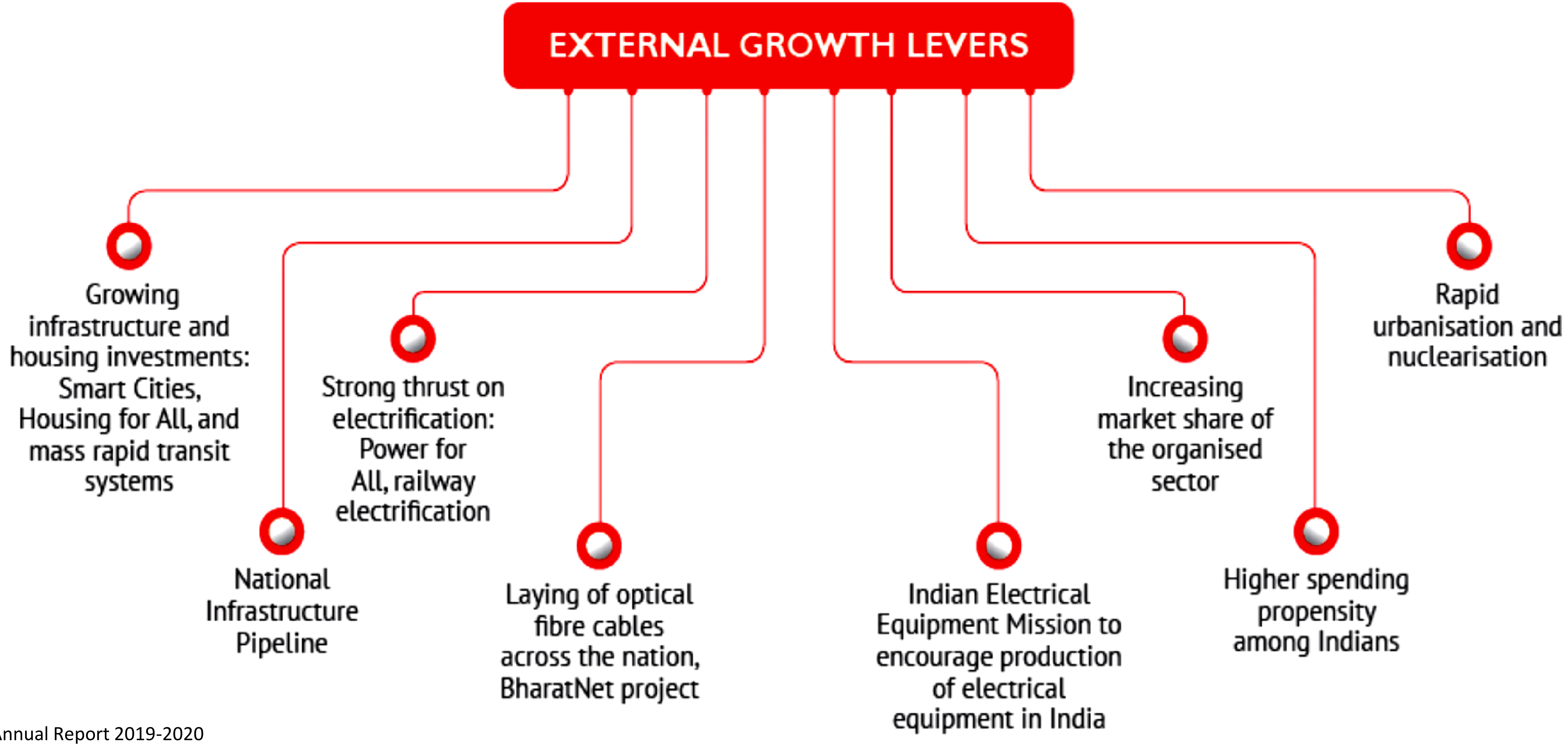
The company wants to transition itself as a B2C player from the current B2B powerhouse and want to increase the B2C revenue share to 50% from the current 35%.

Source: Investor Presentations





Growth Levers



Source: Annual Report 2019-2020

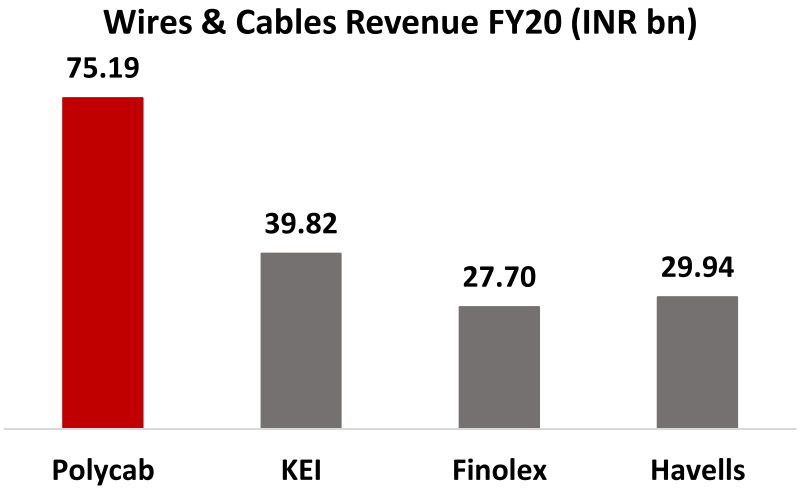
Investment Thesis (1/2)

1. Leadership in Wires and Cable Industry: PIL is the undisputed market leader of India's W&C industry, with an ~18% market share in the organized sector and a ~12% overall share. **Its W&C business is more than twice the size of its nearby competitors.**

The W&C segment continues to be the dominant contributor to the total revenue and we expect this trend to continue in the medium term.

The company has continuously led the W&C market owing to robust distribution network, wide product offerings, efficient supply chain management, strong manufacturing capabilities and strong brand image.

The organized-unorganized price gap is also likely to narrow down owing to structural reforms such as GST along with gains in efficiency and cost structures.



Source: Company Annual Reports

While there is limited scope for product differentiation in the W&C industry, PIL has set itself apart from its branded competitors by:

- Working with major clients in power utilities, IT parks, oil & gas , cement , agriculture, construction metro rail and EPC companies for supplying W&C - Increased offerings and customized products i.e made to order specifications.
- Differentiated and innovative offerings (in-house R&D) like lead-free cables, green cables, flame retardant low smoke PVC insulated cable.
- Backward integration through JV's ensuring steady RM supplies while in-house manufacturing assuring quality products with longer useful life of products.
- Ensuring availability of wide product range at its dealers and working with distributors for quick delivery of products.

Investment Thesis (2/2)

2. Improving FMEG segment: PIL forayed into the high margin FMEG business in FY14 by launching the switch business. It further diversified into fans, LED lightings and switchgear in FY15. With a strong distribution network already in place for wires and cables, it was able to rapidly scale up the FMEG business as the products were a part of the same 'electrical' ecosystem. The retail touchpoints for wires & cables, switches, lightings, switchgear, fans and conduits are largely overlapping as electrical stores often stock most of these product categories.

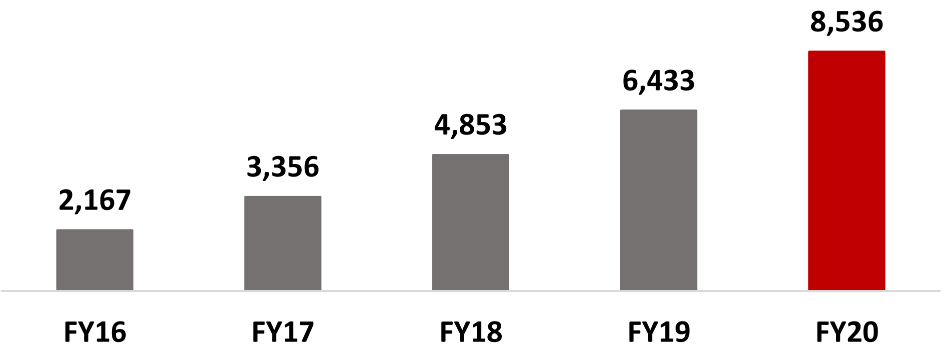
The FMEG segment achieved an operating break even in the third year since its inception in FY14 and its revenue share is on a steady rise year-on-year. The company's FMEG revenue registered a CAGR of about 40% during the past five years.

PIL's FMEG revenues have grown at fast pace as compared to peers. FMEG revenues crossed INR 500 Cr. in a period of 4 years while peers like V-Guard & Havells have achieved the same milestone in 11 & 8 years respectively.

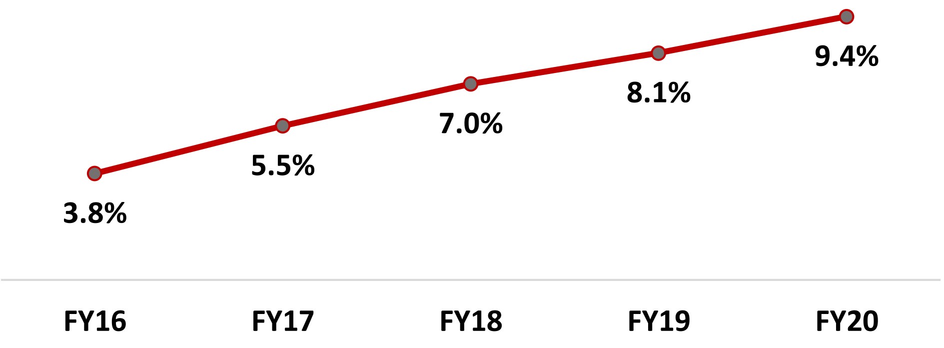
The company shifted from outsourcing model to in-house manufacturing to have a tight control over manufacturing planning, costs and quality.

PIL has significantly scaled up its marketing spend since FY2014 post its entry into FMEG segments. Advertising and promotional (A&P) spend for the company has increased from 0.4% of sales in FY14 to 1.2% of revenues in FY20. Advertisement and publicity spend were party curtailed given the virus outbreak in FY20.

FMEG Total Income (INR mn)



FMEG % of Total Revenue



Source: Annual Report 2019-2020

Distribution Network

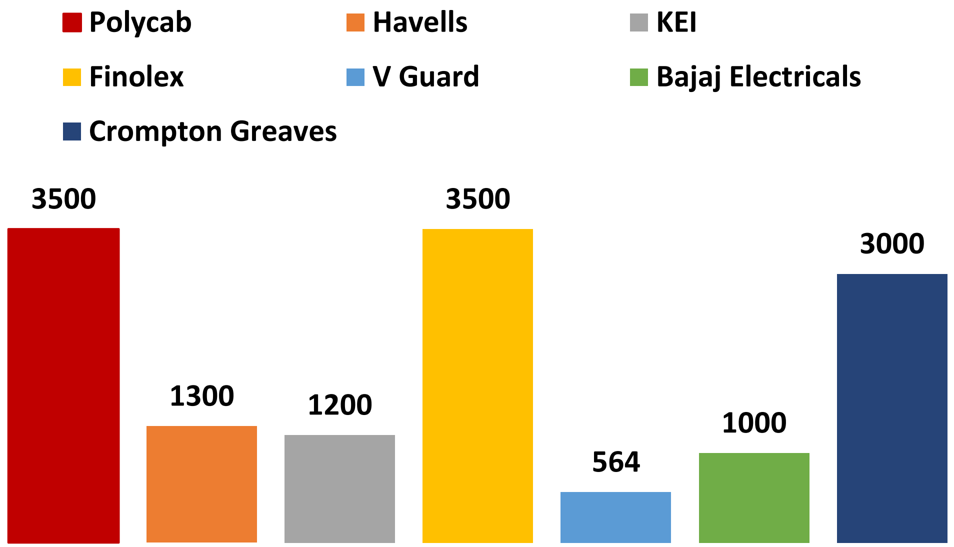
The company has a pan-India distribution network to support diverse customer base and product categories.

With ~16% of distributors being common for W&C and FMEG products, it gives the company an opportunity to cross sell products and enables faster introduction of new products giving it an edge over its competitors.

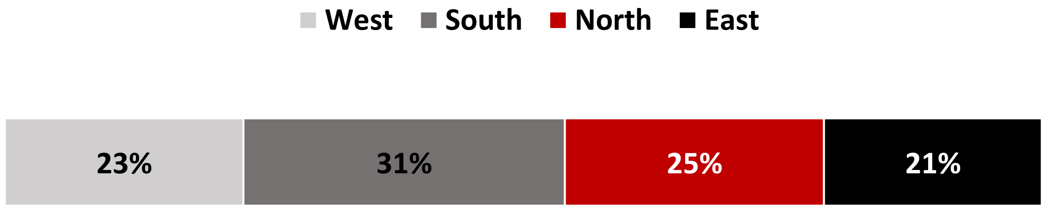
PIL's distribution network includes:

- 3500+ authorized dealers and distributors
- 1,750+ dealers and distributors pan-India exclusively for FMEG
- 125,000+ retail outlets
- 30 warehouses across 20 States and Union Territories
- 3 regional offices and 20 local offices across India

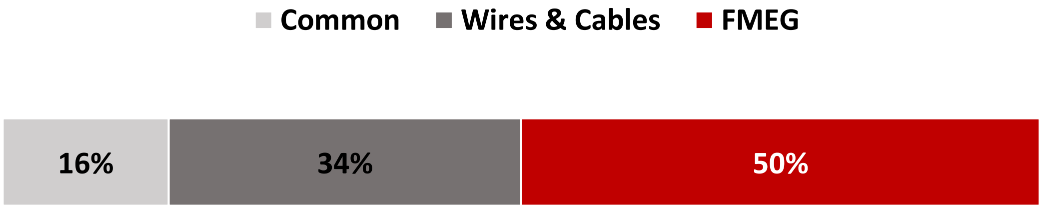
Peer Comparison of Distribution Network



Distribution by Geography



Distribution by Product



Source: Investor Presentations, 3C Research

Manufacturing Facilities

PIL has 25 manufacturing facilities across 7 locations in India.

Further, the company has a high degree of backward integration, ensuring a reliable and consistent supply of quality raw materials while reducing the risk and reliance on external procurement and being cost efficient.

Of the 25 manufacturing facilities 4 are dedicated for FMEG products. For a few FMEG products that contribute smaller percentages to the revenue, the manufacturing is outsourced.

The company recently acquired the remaining 50% stake in Ryker from Trafigura making Ryker a wholly owned subsidiary of PIL. Ryker was started as a 50:50 JV with the Singapore-headquartered commodity trading company Trafigura in FY16, to set up a copper rod manufacturing facility in Waghodia, Gujarat.

However, post Trafigura's global strategic decision to exit from value-add manufacturing businesses in India, PIL decided to buyout their stake. The plant started commercial operation in 1QFY20 with an annual capacity of 2,25,000 tones.

The company has also entered into JV with Techno Electromech for manufacturing LED lighting products.

PIL incurred INR 280 Cr. in capex for FY20. The company has further plans to invest between INR 200 Cr. to INR 250 Cr. annually in next 2 years.

Production Capacity (per year)

Product	Location	Annual Capacity
Wires & Cables	Halol/Daman	3.7 million kms
Lighting & Luminaires	Chhani	18.2 million units
Switchgears	Nashik	7.2 million units
Fans	Roorkee	3.1 million units
Copper Rods	Waghodia	2,25,000 tonnes

Source: Annual Report 2019-2020

Clientele

PIL run a small Engineering, Procurement and Construction (EPC) business (which is a part of its Others segment). It primarily undertakes EPC projects which have high contribution of wires & cables.

As indicated by management, PIL undertakes EPC projects wherein there is ~60% wires & cables work. We expect this business to remain at current levels.

During the year, PIL, along with its consortium undertook projects under BharatNet phase two projects in the state of Gujarat and Bihar and connected almost 4700 gram panchayats or villages in a period of about 10 months.

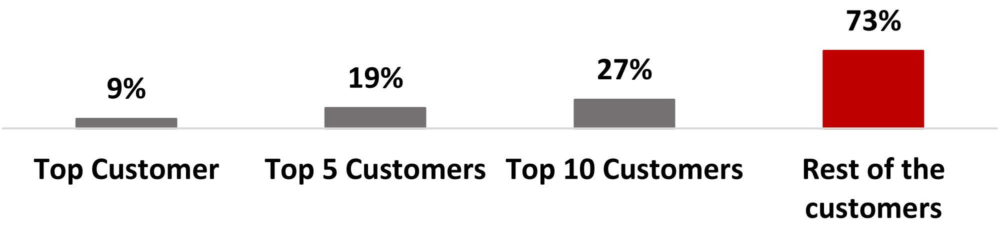
Being an established leader in electrical manufacturing domain, the company aims to replicate project management skills and actively pursue large digital infrastructure projects, including Smart Cities, surveillance, BharatNet and digital village.

In 2019, the company had won ~INR 950 Cr. export order from Dangote Group of Africa to supply cables, to be executed over 2 years.

The company has already executed order up to INR 750 Cr., while balance INR 200 Cr. will be executed over next few months.

Moreover, the company plans to further expand its presence overseas and has recently set up unit in US to procure orders on its behalf. The company expects exports to contribute ~10% to the revenues in the medium term.

Total Revenue Contribution in FY20



Source: Annual Report 2019-2020, Investor Presentations

Financial & Business Analysis (1/2)

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	FY16	FY17	FY18	FY19	FY20
Net Sales (INR mn)	52,075.00	55,365.00	67,831.00	79,856.00	88,300.00
W&C Revenue (INR mn)	52,320.00	56,163.00	62,423.00	69,295.00	75,192.00
FMEG Revenue (INR mn)	2,167.00	3,356.00	4,853.00	6,433.00	8,356.00
EBIT (INR mn)	3,749.00	3,899.00	6,089.00	8,090.00	9,667.00
PAT (INR mn)	1,880.00	2,406.00	3,586.00	5,003.00	7,656.00
EPS (INR)	13.20	17.00	25.40	35.40	51.20
Cash From Operating Activities (INR mn)	1,897.10	2,964.00	3,624.40	12,299.60	2,446.40

- W&C continues to be the largest contributor to the total revenue. The total revenue of the company has grown at a CAGR of 14% from FY16-20. Earnings before interest and tax (EBIT) and Profit after tax (PAT) have grown at a CAGR of 27 % and 42% respectively over the same period.
- While W&C revenue has grown at a CAGR of 9%, FMEG revenue of the company has grown at a CAGR of 40% during FY16-20.
- W&C segment revenue increased 7% YoY in FY20. FMEG segment grew 30% YoY in FY20 driven by portfolio augmentation, better product mix, overall distribution expansion. Fans continued to see great traction across portfolio improved sales mix and pricing actions led to better profitability.
- Domestic distribution channel sales posted a slight decline in FY20 while institution business was stable helped by execution of Optic Fibre Cable (OFC). OFC sales for the year was over INR 180 Cr.
- Barring 2019, cash flow from operation is quite similar to profit after tax. That is a positive sign implying whatever profit the company is making is able to convert into cash. Cash and cash equivalents stood at INR 281.31 Cr. against long term debt of 10.66 Cr. for FY20.
- **EPS of the company has grown at a CAGR of 40% during FY16-20.**

Financial & Business Analysis (2/2)

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	FY16	FY17	FY18	FY19	FY20
EBIT Margin	7.20%	7.00%	9.00%	10.10%	10.90%
W&C EBIT Margin	7.60%	8.40%	10.50%	11.80%	12.20%
FMEG EBIT Margin	-	0.80%	1.80%	1.20%	2.10%
PAT Margin	3.60%	4.30%	5.30%	6.30%	8.70%
RoCE	15.00%	15.20%	21.00%	27.90%	26.40%
RoE	10.50%	12.00%	15.20%	17.50%	19.90%
Inventory Days	89	131	96	122	110
Receivable Days	95	79	69	61	59
Payables Days	110	136	82	148	105
Cash Conversion Cycle	74	74	83	35	64

- Copper & Aluminum together constitute ~75% of raw material (RM) costs. PIL has constantly improved its margins despite volatility in RM prices due to economies of scale in procuring raw materials, increasing number of products and customized offerings to cater to customer specific needs.
- Company is working on various cost optimization initiatives to improve operating leverage.
- Channel financing now covers ~65% of sales in the W&C and ~15% in FMEG segment. PIL has increased the use of channel financing whereby, it has reduced the debtor days and improved working capital management. However, in the current uncertain scenario due to COVID-19 we expect delayed payments from debtors resulting in higher debtor days in FY21E, followed by normalized levels by FY22E.
- **Trade receivables as on March 31, 2020 stood at INR 1,433.64 Cr. While the trade receivables has been increasing over the past 4 years, receivables as a % of revenue has come down. Receivables as a % of sales was 16.24% for FY20.**

Polycab Vs Havells

	FY16	FY17	FY18	FY19	FY20
Receivables as a % of sales					
Polycab	26.00	21.33	19.07	16.71	16.24
Havells	3.10	3.75	4.02	4.04	2.56
ROCE (%)					
Polycab	15.00	15.20	21.00	27.90	26.40
Havells	58.19	22.3	27.79	29.55	22.03
Cash Conversion Cycle					
Polycab	74	74	83	35	64
Havells	31.83	22.15	10.9	12.06	18.9
Net Cash Flow from operations (INR mn)					
Polycab	1,897.10	2,964.00	3,624.40	12,299.60	2,446.40
Havells	5,134.30	7,670.80	1,0999.30	5,012.80	8,267.10
EBITDA Margin (%)					
Polycab	9.30%	9.40%	10.90%	11.90%	12.80%
Havells	14.10%	13.40%	12.90%	11.80%	10.90%

Havell's brand name is very well know and this is also evident in its products' premium prices.

With branding comes great pricing power and better terms with retailers and wholesalers. Usually B2C companies get better valuation due to brand power, ability to increase price, lower working capital, higher return ratios etc.

For example both Havells India Ltd and Polycab India ltd have similar revenue and profitability but the valuation of Havells is more than 3 times that of Polycab.

But this is as of today, if we look 2-3 years down the line, things seems to get better for Polycab as they increase the FMEG(B2C) as well as higher proportion of B2C wires sales revenue by creating brand awareness via marketing and TV ads.

We believe Polycab is ticking all the right boxes to replicate the success of Havells in the future.

Polycab India Ltd Q1 FY21 Update (1/2)

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	Q1 FY20	Q4 FY20	Q1 FY21	% Change
Revenue (INR mn)	19,513.00	21,294.00	9,766.00	-54.00%
EBITDA (INR mn)	2,238.00	2,948.00	563.00	-81.00%
EBITDA margin (%)	11.50	13.80	5.80	-
PAT (INR mn)	1,353.00	2,151.00	1,176.00	-45.32%
PAT margin (%)	6.90	10.10	12.00	-

	Q1 FY20	Q4 FY20	Q1 FY21	% Change
W&C Revenue (INR mn)	16,104.00	18,434.00	7,935.00	-57.00%
W&C EBIT (INR mn)	1,862.00	2,810.00	243.00	-91.35%
W&C EBIT margin (%)	11.60	15.20	3.10	-
FMEG Revenue (INR mn)	2,401.00	1,833.00	1,378.00	-24.82%
FMEG EBIT (INR mn)	88.00	1.00	-56.00	-
FMEG EBIT margin (%)	3.70	0.10	-4.00	-

Polycab India Ltd Q1 FY21 Update (2/2)

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- As expected, the results of the company were severely impacted by the pandemic. **PAT margin at 12% was up largely driven by one-off items.**

- Domestic distribution channel sales were half of last year while institutional business was impacted severely due to delays in order finalisation. Within domestic distribution channel sales, housing wires business saw great traction posting a strong double-digit growth in month of June. However, it is likely to be **driven by pent up demand and pre-stocking due to price hikes.** Consumer footfalls in retail still remain low especially in large metros.

- The business from metros continues to be impacted due to lock-down, which in normal circumstances would have contributed ~60% to the revenues, now stands at 45%. **The management stated that the company is working to further penetrate in tier-I, tier-II and rural areas where its presence is limited.**

- Dangote Project linked sales were nil in Q1 as the project in Nigeria is facing execution delays. Despite that exports posted robust growth led by good traction in select developed geographies. **It contributed over 10 % to overall top-line vs 2 % in Q 1FY20.**

- The company has got approvals from metro companies in Australia and has bagged similar projects. The management is also expecting to see improvements in export due to the ongoing anti-Chinese sentiment. The company is continuously exploring export opportunities in USA, Australia through its subsidiaries and Africa's large World Bank projects are being implemented.

- Balance sheet remains healthy with INR 2bn of net cash position as of June 2020 vs INR 1.6bn as of March 2020.

- The management is also looking at cost optimisation and synergies across its segments. **The management has taken a two-fold approach to focus on improving profitability and increasing working capital requirements for all the major business segments like wires, cables, fans and lighting luminaries.**

- **Capacity utilization as of now is hovering between 50% to 60%.** Capex is expected to be around INR 200 crore for the year and will be utilized towards debottlenecking for cable and wire business, additional capacities for FMEG business and modification in machinery and adding new machineries for exports business.

Risks & Concerns

1. Exposure to intense competition: The house wires and electrical cables segment is highly fragmented with a large number of unorganized players constraining the pricing power of organized sector players. Apart from unorganized sector, PIL also faces competition from organized sector players such as Havells India Ltd, Finolex Cables Ltd, and KEI Industries Ltd. While the domestic electrical market is becoming more quality conscious and there would be some pressure on the unorganized players for GST compliance, competition from organized and unorganized players in the market will continue to impact PIL's operating performance.

2. Susceptibility to economic downturns: PIL is susceptible to the economic environment in India. Electrical cables contribute more than 80% to PIL's revenue, and end-users of the product include construction (real estate), power, telecommunication and automobile industries. Growth in these industries is, in turn, linked to the economic environment, any slowdown in gross domestic product growth could lead to moderation in demand for electrical cables over the near term.

3. Vulnerability to fluctuations in raw material prices: PIL is susceptible to volatility in raw material prices (mainly copper). Copper and aluminum are the primary raw material used in the manufacture of cables and accounts for 60-70% of PIL's product value. The profitability would be impacted if the company is unable to pass on the price increase to its customers.

Future Outlook

The reason why the company has been pushing to improve its B2C business is clear. Raw materials continues to be the biggest cost and major determinant of its margins. Here the importance of target customer comes into play. If the customer is B2B, it is very difficult to change prices if there is raw material prices increase while for B2C, it can be done quite easily, given the positioning of your brand & non-negotiating power of retail customers.

Being the leader in W&C segment Polycab is well positioned to benefit from increasing share of organized players which is expected to touch ~74% by FY22E. Given the early stages of FMEG business, there are a lot of costs going into the operations and smaller scale leads to thinner spread over sales compared to W&C segment, hence the margins remains low.

We expect healthy revenue driven by a) recovery in demand in W&C segment b) beneficiary of demand shift from unorganized to organized sector, being a leading player in W&C segment c) Focus on higher margin products like EHV cables & Optic Fiber, d) further penetration in FMEG segment by increasing offerings and improving product margins.

The current crisis provides an opportunity from an investor's perspective to enter into a superior company for the long-term. PIL's product categories, dominant position in W&C segment, fast growing FMEG segment and superior brand recall offer investment comfort especially in a competitive economic environment. The company has been showcasing decent growth when the end user industries i.e. real estate, power and infrastructure is in a bad shape.

The company has clearly taken to steps to make its business model resilient to external forces. This is clearly evident from the stable margins and profitability the company has been putting over the past years.

PIL has partially resumed operations at its plants, while business at large metros continue to be under pressure. The management expects normalcy over next 1-2 quarters.

With improved cash flows and margins, we believe PIL will command valuations more than W&C peers like KEI and Finolex, but less than FMEG peers like Havells and V-guard in the medium term. However, with its continued leadership position in W&C segment, efforts to increase export business and transformation into a multiproduct FMEG player, we expect the valuations to improve in the long term and catch up to its FMEG peers.

Statutory Disclosure

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SEBI Research Analyst Registration No. : INH200006451

1. At the time of writing this article, **the analyst have no position in the stock** covered by this report.
2. The analyst has not traded in the recommended stock in the last 30 days.
3. The research analyst does not have any material conflict of interest at the time of publication of the research report.
4. The research analyst has not received any compensation from the subject company in the past twelve months.
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9. The analyst does not own more than 1% equity in the said company.