Solar Industries India Ltd (SIIL) : Play on Industrial Explosive & Defence

Wtg% in portfolio = 6% [Initial 3% b/w 1070-1120 & final 3% b/w 950-1000]

Price target = Around INR 3500 by 2024 (Assuming 25% CAGR for next 5 years)

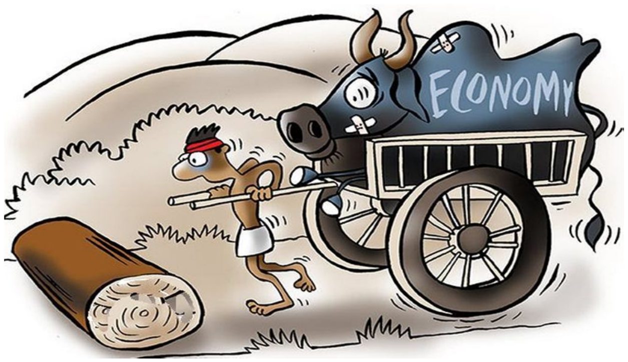
Market Cap: 10120 Cr	**Current Price : 1118**	52 weeks H/L: 1311 / 923
Book Value: 145	Stock P/E: 34	Dividend Yield: 0.63 %
ROCE: 26.50 %	ROE: 22.80 %	Sales Growth (3Yrs): 19.3 %
Face Value: 2	Promoter Holding: 73.15 %	Dividend Pay-out: 24.22 %
Sales Growth (5Y): 18 %	Profit Growth (5Y): 16 %	ROE (5Y): 21.66 %

Note: *This business idea may not be classified under "multibagger" but it is certainly a safe "compounder" stock which is a must have in any stable portfolio. They are the largest manufacturer of industrial explosives and explosive initiating systems in India and have the world's largest manufacturing facility for packaged explosives. With a licensed explosives capacity of over 290,000 MT/annum, the company has ~28% market share in India. Solar Industries, with a 70% market share in exports from India, exports to 51 countries around the world. Economic Explosives, a 100% subsidiary, manufactures detonators. Solar has manufacturing facilities spread across 25 locations and eight states in India. In recent years expanded its manufacturing base to Nigeria, Zambia, South Africa, Turkey, Ghana and Australia. SIIL has also interests in the coal mines (in Chattisgarh) through two JVs.*

Dear Friends,

Indian Economy - Down but Not Out…

The crisis brewing within the Indian economy has gained unanimous acceptance by now. This is an indication of tougher times ahead. Be it the recent collapse of the automobile sector or the rising number of non-performing assets (NPAs), sluggish consumer demand or failing manufacturing sector; all have a hand in this deceleration of growth rate. In fact, India has not experienced a recession in recent history, but there were times when the country witnessed slowdown in about two to four quarters. In 1991, on account of the spike in global oil prices; in 1997, due to the Asian financial crisis; in 2000, because of the dot-com bubble (or the tech-bubble), in 2008-09, in the wake of the US' financial crisis and, briefly in 2011, which could be attributed to business cyclicality. Any investment done during above slowdown period must have generated exceptional returns, so do not miss the current opportunity.



India's GDP growth has been recorded at 4.5 per cent for Q2 of FY20. The last time India witnessed a GDP growth of less than 5 per cent was in the fourth quarter of FY13, when it grew at 4.3 per cent. While the Indian economy is not in the pink of health, it is still slowly pacing ahead. India is currently facing slowdown if not recession. Under such circumstances government capital expenditures might help revive the economy. Since we do not prefer to invest in PSU hence we started looking for a leading private sector company run by first generation entrepreneur (promoter run business) with unquestionable integrity, a proven track record of more than a decade and a leadership status in terms of market share which will be the biggest beneficiary of government expenditure in Infra, Defence, and Mining etc.

Biggest beneficiary of Govt. expenditures

Generally we avoid investing in company where competition is very high, it is always better to invest in proxy play than core. E.g. instead of tyre companies invest in rubber chemical producers like NOCIL or OCCL or Rajratan Global Wire (Bead wire producer). Instead of investing in branded consumer durable players we preferred investing in Dixon Tech or Amber Enterprises, an outsourcing agent for branded players where competition is very high. This time we have picked - Solar Industries India, primarily involved in manufacturing of complete range of industrial explosives and explosive initiated devices. It manufactures various types of packaged emulsion explosives, bulk explosives and explosive initiating systems for major clients which include Coal India, Singareni Collieries & Defence.

- ✓ India's largest maker of Industrial Explosives (by revenue) and the first private supplier of explosives for warheads.
- ✓ World's largest cartridge manufacturing facility at a single location at Chakdoh, Nagpur.
- ✓ India's first domestic supplier in private sector of HMX (High Melting Explosive) & HMX Compounded products to the defence sector.
- ✓ Huge entry barriers, Oligopoly biz, only listed competitor is Premier Explosives.
- ✓ First generation down to earth promoter Shri Satyanarayan Nandlal Nuwal with unquestionable integrity. In the late 1970s he moved to Maharashtra state to work with a relative, sleeping in a railway station because he couldn't afford an apartment. Nuwal's son Manish recalls his mother mortgaging her jewellery to raise funds to survive.

Undisputed leader with 28% Market share

Established in 1995, Solar Industries is the largest manufacturer of industrial explosives and explosive initiating systems in India and has the world's largest manufacturing facility for packaged explosives. With a licensed explosives capacity of over 290,000 MT/annum, the company has ~28% market share in India. Solar, with a 70% market share in exports from India, exports to 51 countries around the world. Economic Explosives, a 100% subsidiary, manufactures detonators. Solar has manufacturing facilities spread across 25 locations and eight states in India. In recent years expanded its manufacturing base to Nigeria, Zambia, South Africa, Turkey, Ghana and Australia. SIIL has also interests in the coal mines (in Chattisgarh) through two JVs. In fiscal 2011, the group entered the defence sector to manufacture high energy explosives, delivery system, ammunition filling and pyros fuses.

Key Growth Drivers

#1) Robust market position - With a market share of 28% in the domestic explosives segment, the group is one of the largest manufacturer and exporter of explosives and initiating systems in India. The group's manufacturing unit in Nagpur is world's largest cartridge plant at a single location. Solar group is one of the few players with a complete product range and capability to develop and supply customized products on demand. Along with healthy growth in domestic market, Solar group has also expanded significantly in the overseas market over the last few years. Furthermore, the group is also the largest supplier of explosives to Coal India Limited. With diversified revenue profile the group has been able to reduce its dependence on CIL which contributed 17% of total sales in fiscal 19 as against 58% in fiscal 07. Further, the group forayed into defence business in 2011 and has gained advantage by setting up high energy explosives, delivery system, ammunition, rocket/missile integration, pyros, and igniters/fuses manufacturing facilities.

Limited shelf life of the explosives, regular consumption requirement of the Armed Forces, Make in India focus and typical long term tenure of defence supply contracts provide steady medium-term revenue visibility. For the first half of fiscal 20, performance remained flat with sale of 1.56 lakh MT of explosives as against 1.58 lakh MT during the corresponding period of last fiscal. This was mainly on account of prolonged rainfalls and subdued economic activity in both domestic & international markets.

#2) Strong operating efficiencies with significant backward integration - Majority of raw materials (apart from ammonium nitrate) such as detonator components, emulsifiers, sodium nitrate, and calcium nitrate are manufactured internally, leading to cost savings, quality control and a stable operating margin of 20% over the five fiscals through fiscal 2019. Also, all of the group's 25 bulk explosive manufacturing units are located in a 50-60 kilometre radius from major mining regions. Solar group is able to pass on the variations in raw material prices to its customers through the price escalation clause in the contracts thus maintaining margin even in volatile raw material price movements.

#3) Strong financial risk profiles - Capital structure is healthy with strong net worth of Rs.1237 crore and moderate gearing at 0.46 times as on March 31, 2019. Furthermore, cash accrual is expected to remain healthy, backed by strong growth in revenue and profitability, which will be sufficient to repay upcoming debt obligations and partly meet annual capital expenditure (capex) of about Rs 250-300 crore over the medium term. Hence, incremental borrowing would be modest. Interest coverage and net cash accrual to total debt ratios remained healthy at 9 times and 0.46 time, respectively, in fiscal 2019. The estimated tax savings to the company for the year would be approximately Rs.30 Crores due to Taxation Law Amendment Ordinance, 2019.

#4) Diversified customer profile (Domestic + Exports + Defense) - CIL (Coal India) accounts for around 17% of its consolidated sales in fiscal 2018, however, this dependence has come down from 58% of overall sales in fiscal 2007. Over the past six years, the group has diversified sales mix by increasing exports and share of infrastructure and non-CIL related orders. Entry into the defence sector is expected to enhance revenue diversity further. The government's drive to indigenise defence manufacturing will benefit the group, especially as it is one of the two manufacturers for propellants and exclusive manufacturer for high energy explosives. Share of exports and defence in the overall revenue will increase in future.

#5) Business of Propulsion systems for space application (ISRO) - The Company has entered into the Business of Propulsion system for space application, which is synergistic with current business of ammunition. This will enable it to develop and offer products which will cater to the demand of ISRO and other companies in India and across the globe. The company has received supply order from ISRO as well. In line with our strategic decision, the company has decided to make an investment of Rs.17.5 Crores in Skyroot, a start-up company which is entering into the business of launching small satellites, over a period of two years. Solar will also be the exclusive supplier of rocket propulsion system to this company. For more details refer - https://yourstory.com/2019/10/tech-30-spacetech-startup-isro-scientist-launch-vehicle

#6) Superior liquidity position (30% profit as dividend) - Cash accrual is expected to be more than Rs 250 crore per annum against yearly debt obligation of Rs 100-150 crore in fiscals 2020 and 2021. Cash and cash equivalents stood at Rs 107 crore as on March 31, 2019. On a standalone basis, SIIL has access to fund-based limit of Rs 355 crore which is marginally utilised. Capex of Rs 250-300 crore per annum will be partly met through internal accrual, leading to low incremental borrowing. Bank limit is expected to be sufficient to meet incremental working capital requirement, which are assessed to be minimal. SIIL has a policy of paying 30% of its profit as dividend.

#7) Healthy Order book position - The order book at the end of 2QFY20 is Rs.1645 crore (Coal India's - 1067 crores ; SCCL's (Singareni Collieries Company) - Bulk + Accessories 214 crores; Defence - As-on-date stands at 364 crores). Company revised its revenue growth guidance to 5-10% YoY (earlier 20%) in FY20.The Management is confident of volume growth in domestic market but indicated that there will be less room for further margin improvement. They expect better profitability from overseas subsidiaries in Turkey & South Africa on account of improvement in economic environment of local spheres. Guidance of 1,000 Cr of overseas & exports shifted to FY21 due to other stressed overseas markets across the globe.

#8) Earnings Update – 2QFY20

a) Domestic explosives demand likely to revive: 2QFY20 witnessed subdued demand for domestic explosives from the mining sector (owing to lower mining activity impacted by prolonged rainfall) and infrastructure sector (liquidity tightness and low pace of construction). However, the same are likely to increase in the upcoming quarters as these are priority sectors for the government.

b) Overseas sales decline temporary: Exports and overseas sales declined by 8% affected by Rs 7.5 crores translation loss from the overseas business, lower sales in Turkey (due to political tensions) and Zambia (due to lower copper mining operations and Vedanta exit). Revenue booking from South Africa has commenced from 2QFY20, but profitability will remain subdued as new customer acquisition and overhead absorption are yet to happen. Trial productions at Ghana and Australia units will commence by 4QFY20, while Tanzania plant will start distribution from 3QFY20 onwards. The continued uncertainty over trade conflicts resulting in weakening economic activities in international markets has affected the company's international business.

c) Defence segment update: Defence sales were up 2% YoY at Rs 44.7 crores (9% of total sales). SIIL has participated in several defence products (including multimode hand grenades) tenders and expects healthy growth once the RFPs are finalized. SIIL expects defence sales of Rs 200-250 crores in FY20E.

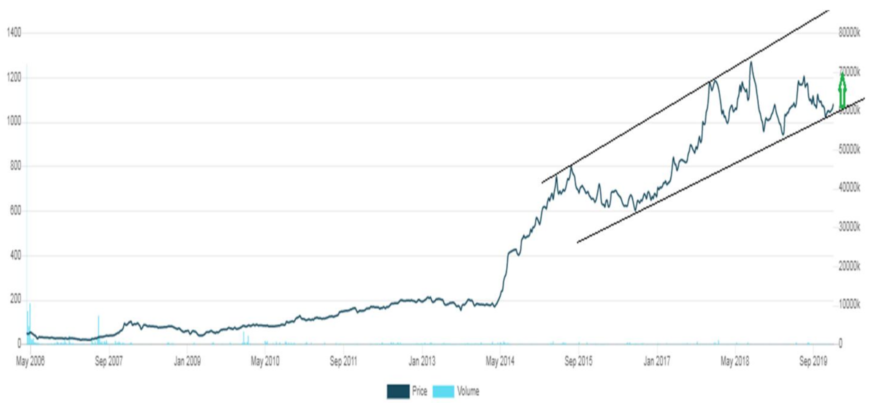
Risks &Concerns

#1) Exposure to regulatory risks - The explosives industry has high entry barriers as it requires industrial licensing, and various clearances from government, chief controller of explosives, and directorate general of mines safety. Furthermore, as per the Ammonium Nitrate Rules 2012, ammonium nitrate, key raw material (comprises 70% of the group's total raw material cost), has been classified as an explosive. Hence, its production, distribution, sale, and stocking require a licence. Sale of explosives is regulated by Petroleum and Explosives Safety Organization and Chief Controller of Explosives to prevent misuse of end products. <u>Though the Solar group takes precautions at all stages of</u>

the manufacturing process, and is also a member of SAFEX (an international apex body that promotes global best practices on safety standards in the explosives industry), it will remain susceptible to regulatory risks.

#2) Volatility in forex rates - Partial imports of raw material and operations in Nigeria, Zambia, South Africa, and Turkey exposes Solar group to adverse currency fluctuations. For instance, during first half of fiscal 20, the group incurred a translation loss of Rs.42.5 crore due to currency devaluation. In order to safeguard itself from volatility in forex rates, Solar group has begun borrowing debt in local currency in overseas markets. This reduces the forex rate risk considerably. Also, sale price in overseas markets is linked to dollar. The group has a policy of hedging all imports and keeping exports open. However, we believe, due to overseas presence, forex risk shall remain.

Future Outlook:



With technological excellence, strategic product profiles and financial strength, SIIL will be ahead of the growth curve of the explosives industry by capitalizing on opportunities in domestic and overseas markets. The extensive regulations, strict license controls, long gestation period and heavy capital investments mark the uniqueness of this industry and poses a challenging task for the new entrants.

Strong order book, overseas expansion, anticipated increase coal production, revival in mining activity and demand from infrastructure segment coupled with SIIL's expanding reach in overseas business from four countries to ten will be the key growth drivers going forward.

Happy Investing...

Regards

Binoy

Statutory Disclosure:

SEBI Research Analyst Registration No: INH200006451

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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.

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