Safal Niveshak StockTalk #3: Voltas

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Welcome to the third issue of the Safal Niveshak StockTalk.

After covering L&T and Tata Steel in the first two reports, this time I delve deeper into another Tata Group company, Voltas, which is one of India's two largest players in the business of electro-mechanical projects (includes air-conditioning, mechanical, electrical, and plumbing works), and also a leading name in the home home air-conditioner business.

Before we dive deeper into Voltas, here is a brief overview of the sections of this report:

1. About Voltas
2. Voltas's Shareholder Value Creation Model
3. Safal Niveshak's 25-Point Checklist
4. Intrinsic Value Assumptions
5. Financial & Market Snapshot
6. "Should I Buy Voltas?" Checklist

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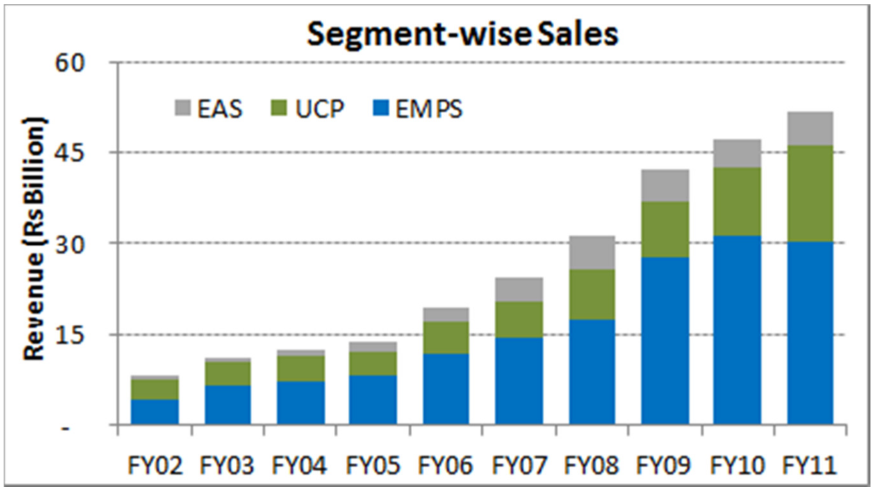
1. About Voltas

Voltas is a Tata Group Company and is a major player in the electro-mechanical projects and services (EMPS) business. In simple terms, EMPS involves the air-conditioning, mechanical, electrical, and plumbing parts of a construction project. The EMPS division account for around 60% of the company's total sales, with the rest coming from its sales of air-conditioners (UCP-Unitary Cooling Products), mining & construction equipments, and textile machinery (EAS-Engineering Agency & Services).



Data Source: Ace Equity, Safal Niveshak Research

During the past few years, Voltas has emerged from being a consumer appliance company operating in a highly competitive arena (air-conditioners) to one that has expertise in the niche engineering area of EMPS where it is currently a leader in India.

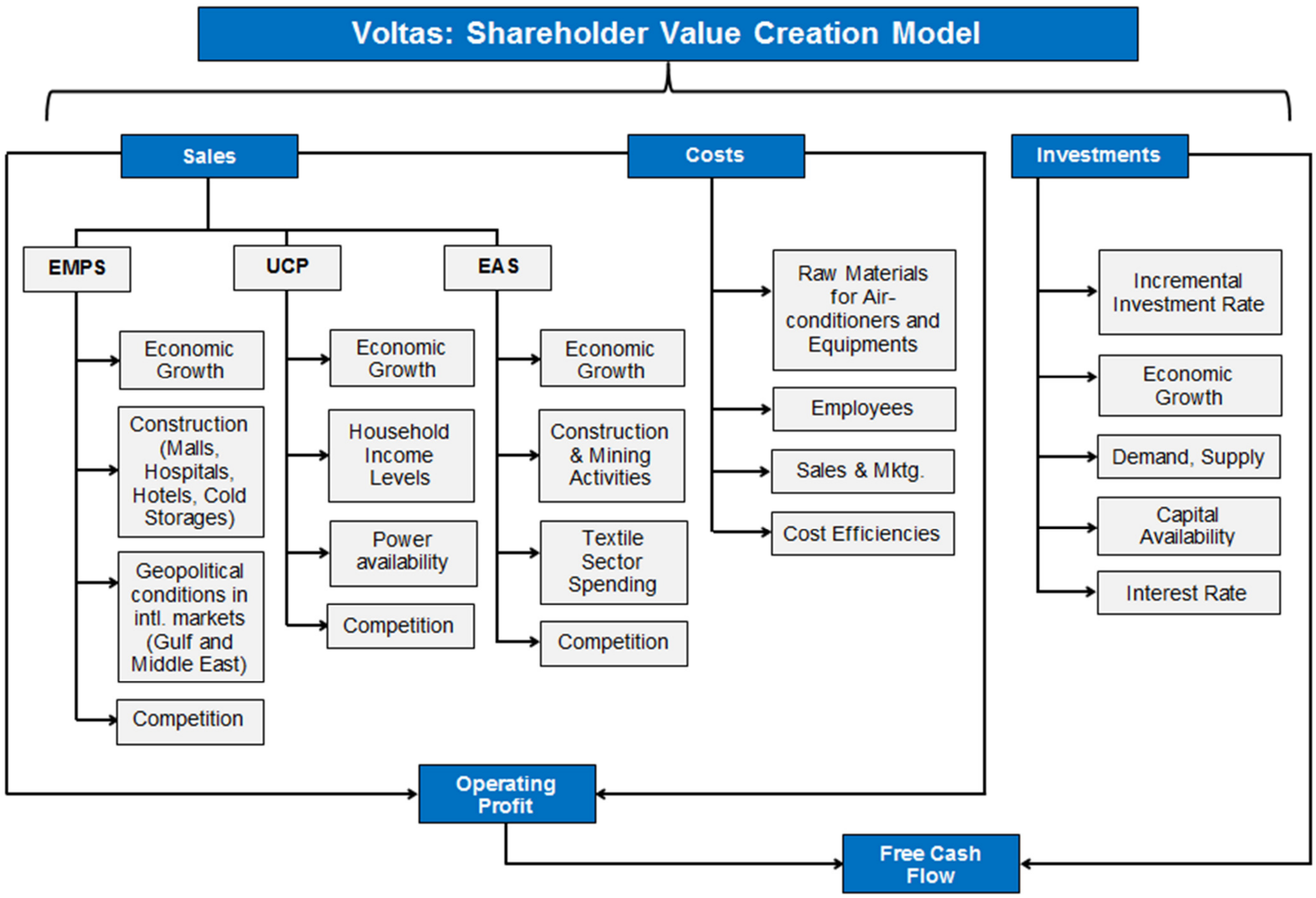
The company has also built up an enviable track record of executing large, prestigious EMPS projects in the Indian and international markets (largely across regions like Abu Dhabi, Qatar and Saudi Arabia). Over the past 10 years, Voltas has grown its net sales and profits at an average annual rate of 22% and 34% respectively. The company has also maintained a relatively safe balance sheet and has generated good (and rising) free cash flows.

* * *

2. Voltas: Shareholder Value Creation Model

Here is a simple model I've created to showcase what all goes into the creation of free cash flow for Voltas. Free cash flow, as you know from our past discussions, is what ultimately creates shareholder value.

This chart will help you understand the working of Voltas and also serve as a helpful tool in analyzing other similar companies.



Note: EMPS – Electro-Mechanical Projects and Services,
UCP – Unitary Cooling Products, EAS – Engineering Agency & Services,

3. Safal Niveshak's 25-Point Checklist

I've analyzed Voltas by answering 25 important questions that span its:

- Business performance,
- Financial performance,
- Management quality, and
- Competition.

Here is the complete 25-point checklist with my explanations.

Before we move ahead, here are the symbols that I've placed against each checklist point and that will tell you at a glance whether I have a positive or negative view on that particular point.

Indicates my positive view

Indicates my negative view

Let's get started.

A. Business Performance

1. Can I, in one sentence, say exactly what the company does?

Yes. Voltas is involved in the business of manufacturing air-conditioners and also works on air-conditioning project for malls, hotels, hospitals and other similar properties.

2. Is it in my circle of competence?

Yes. Voltas's business, which largely caters to the air-conditioning market in India and the Gulf region, is easy to understand (as I've explained in the shareholder value creation model above). It is thus in my circle of competence.

3. Is it a low risk business?

No. Voltas's business across all the three segments is dependent largely on economic growth and spending by others sectors like construction, hotels, and hospitals. Plus the company is also dependent on the level of consumer spending in India, which in itself is dependent on the levels of household income, aspiration levels (air-conditioner is still an aspirational product in India), and spending patterns. Plus, the company also faces good competition from companies like Blue Star (in the EMPS segment) and several MNC players (in the home air-conditioner space).

4. Does the business have high uncertainty?

Not really. Yes, Voltas's business is dependent on economic growth but I won't go to the extent of saying it as one with high uncertainty. The company is a known name in the air-conditioning business in India and Gulf and has worked on several landmark projects including the Burj Khalifa in Dubai, which is the tallest building in the world. It also maintains an order backlog (projects that have been booked but yet to add to revenue), which provides some visibility for the future.

5. Is it a good business?

Yes, but only if you have the capabilities to execute large projects, whether it relates to air-conditioning or other aspects like mechanical, electrical, and plumbing tasks. Voltas has made a good name for itself in this space over the past few years, and it is reaping the benefits of the same.

6. Has the business got an enormous moat?

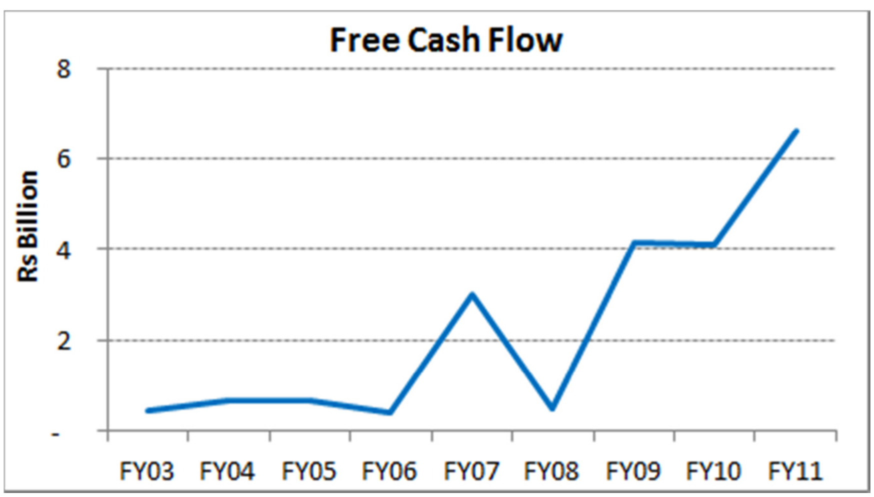
Not enormous, but as I mentioned above, if you are an established player with landmark projects to show in your resume, you have a competitive advantage against other smaller companies. So Voltas has a moat in terms of its solid brand image, not only in the Indian market but also internationally.

7. Is there room for future growth?

Yes. Voltas has grown its sales at an average annual rate of 22% over the past 10 years. With a strong presence in the air-conditioning industry that is growing a fast pace (though with its share of ups and downs), I see no major problems for Voltas maintaining a good growth rate in the future. And not just the international markets where Voltas has created a good name for itself, rising demand in the hospitality and retail sectors in India is also going to provide a good fillip to Voltas's overall business going forward. Also, as more and more Indian families move into the aspirational category, there would be a higher demand for air-conditioners. Voltas has a good growth opportunity on this front as well.

8. Does the business generate strong free cash flow?

Yes. Voltas has generated positive free cash consistently for the past 10 years. What is more, the free cash flow has been rising year after year, which is a good indicator of the company's profitability and cash utilization strategy.



Data Source: Ace Equity, Safal Niveshak Research

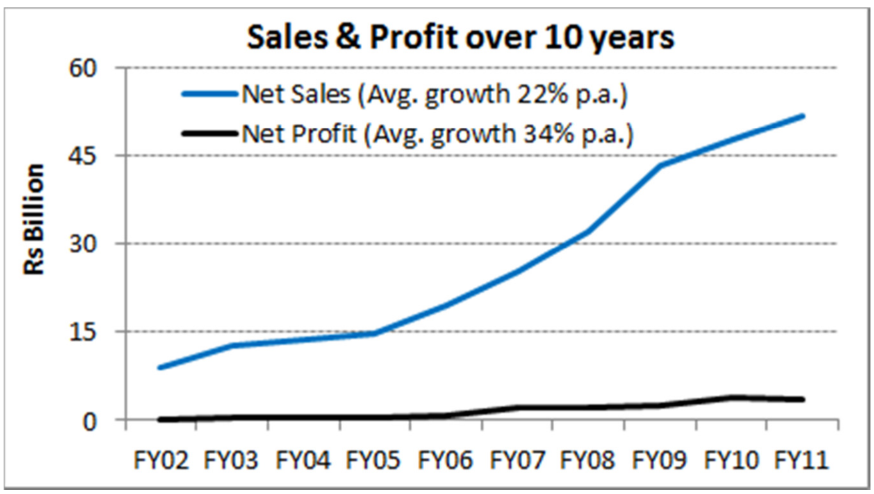
9. What is the bargaining power of suppliers and buyers?

High. Given the rising competition in the industry, both the suppliers (of raw materials) and buyers (of Voltas's products and services) have seen their bargaining power rise over the years. The company's bargaining power is especially weak in the international markets as it faces considerable competition from the local players out there.

B. Financial Performance

10. Does the business have a consistent sales and profit growth history?

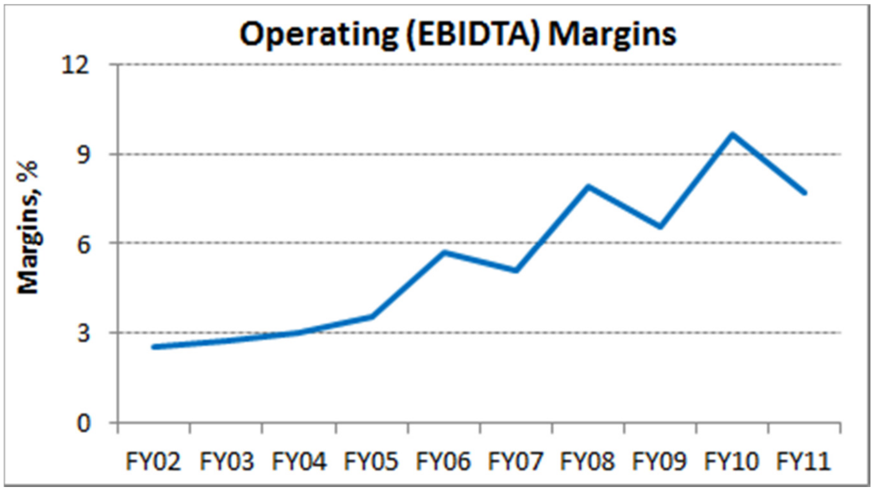
Yes. Voltas has grown its consolidated sales and net profits at an average annual rate of 22% and 34% over the past 10 years, which is a good pace of growth. Also, during these 10 years, the company has not seen a single year of decline in sales, while its profit has declined just once on a year-on-year basis (in FY11). So it's been a good performance from Voltas on the sales and profit growth front. Overall, I'm comfortable with its past track record on the sales and profits front, and see no reason why the company won't be able to maintain this over the next 5-10 years as well, of course along with its share of ups and downs.



Data Source: Ace Equity, Safal Niveshak Research

11. Are EBIDTA margins higher than 15%?

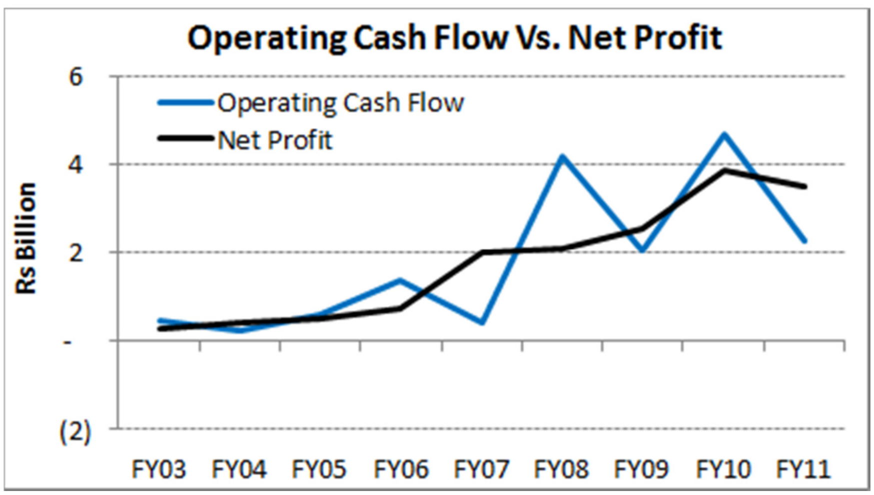
No, but I am not concerned much on this account. Voltas's business is such that generates sub-10% margins, so the company has done well to gradually move towards this level. Also, given that the company's capital turnover is high, it can still earn a high return on capital even with lower margins – as it has done in the past.



Data Source: Ace Equity, Safal Niveshak Research

12. Is its operating cash flow higher than net profits?

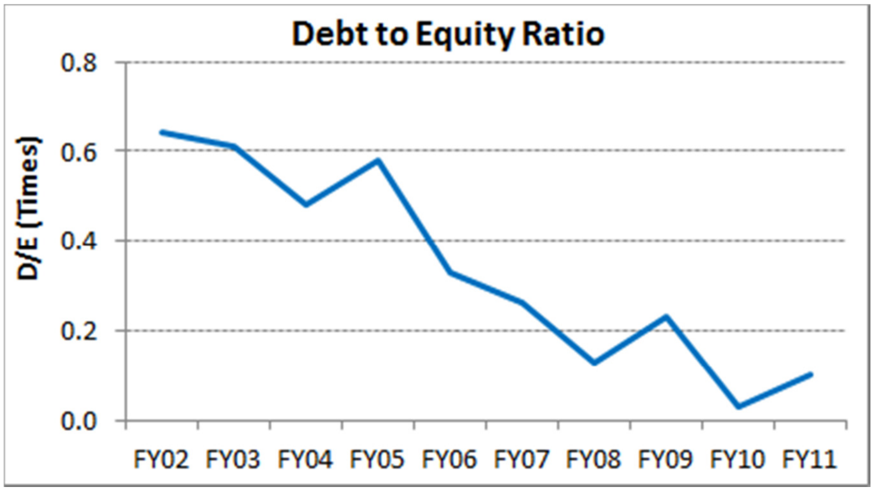
Largely yes. On an average, for the past 10 years, Voltas's consolidated OCF has been slightly higher than its net profits though there have been occasional bouts of volatility owing to the nature of the business.



Data Source: Ace Equity, Safal Niveshak Research

13. Is the debt to equity below 0.5 times?

Yes. Voltas has maintained very low levels of debt over the past 10 years. Its debt to equity ratio has averaged just around 0.3 times during this period, which is very much within my comfort level of 0.5 times.

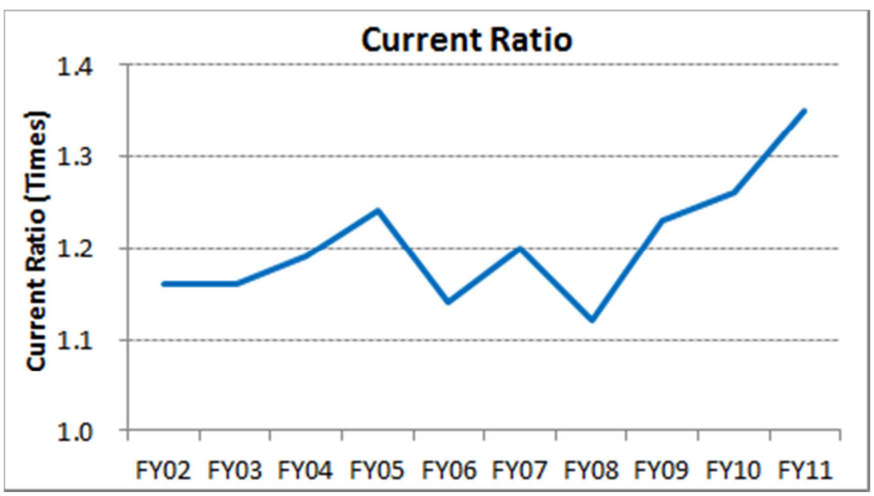


Data Source: Ace Equity, Safal Niveshak Research

14. Is the current ratio greater than 1.5?

No. Voltas's average current ratio over the past 10 years has been 1.2 times, which is below my comfort zone.

As a general rule, a current ratio of 1.5 or greater suggests that a company can meet its short-term operating needs sufficiently. However, a higher current ratio can suggest that a company is hoarding assets instead of using them to grow the business. While this is not the worst thing in the world to do, it is something that could affect long-term returns.



Data Source: Ace Equity, Safal Niveshak Research

15. Does the company have a good dividend history?

Yes. In terms of dividend payout (amount of dividend paid as percentage of net profit), Voltas has averaged around 25% over the past 10 years. This is a comfortable level from a shareholder's point of view.

16. Is the Altman Z score > 3?

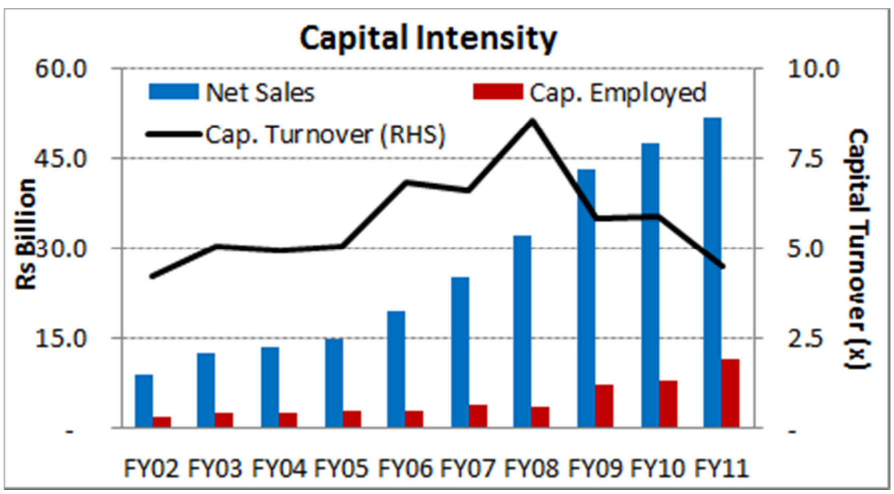
Yes. It's at 6.5, which makes Voltas far-far away from any possible bankruptcy.

17. How capital intensive is the business?

Low. As you can see the chart below, Voltas's capital turnover ratio (Capital Employed divided by Net Sales) has been reasonably high at an average of around 6 times (6x) over the past 10 years. On an average, the company has employed Rs 5 billion of capital every year and has generated average annual sales of Rs 27 billion.

The legendary investor, Warren Buffett wrote in his 1992 letter to shareholders – "The best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or will, do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return. Unfortunately, the first type of business is very hard to find."

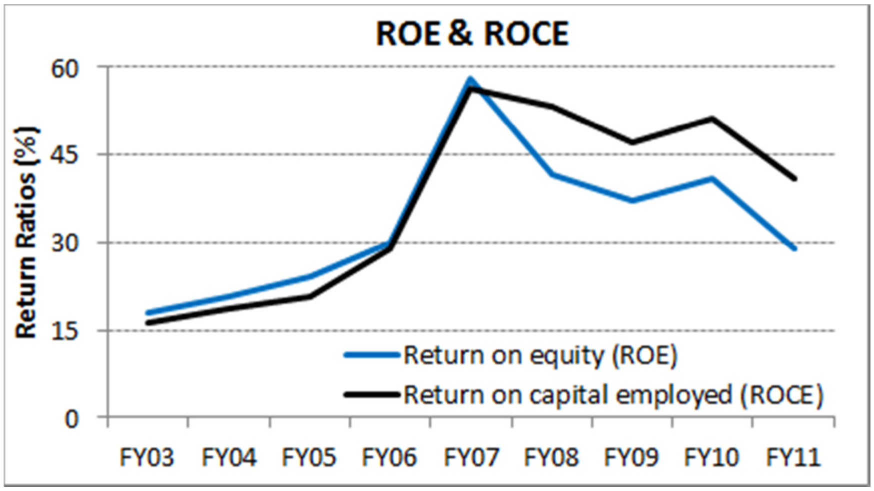
As such, while Voltas has employed less amounts of capital in the past (as compared to its sales), it has also been able to earn a reasonable rate of return on this capital (above 35%), which suggests a good capital allocation and utilization on behalf of the company and its management.



Data Source: Ace Equity, Safal Niveshak Research

18. Has it got a high and consistent return on capital and return on equity?

Yes. One of the key strengths of Voltas's business model is that of low capital engagement (as we discussed in the above point) and high return on capital. The company has not leveraged its Balance Sheet for borrowing and has been conservative in managing its cash flows, which has helped it earn good return ratios in the past.



Data Source: Ace Equity, Safal Niveshak Research

C. Management Quality

19. Is the management known for its capital allocation skill and integrity?

Yes to both integrity and capital allocation skill. As far as its operating business is concerned, Voltas has a history of earning high return on capital (average in excess of 35%), which is a strong indicator of the management's capital allocation skill.

As far as the integrity part is concerned, there's no doubt that the company (along with most of its other group companies) are among the best in India when it comes to business integrity.

20. Is management shareholding > 10%?

Yes. Voltas's chief promoter Tata Sons and its group companies together own around 30% stake in the company.

21. Has there been any substantial equity dilution in the past?

No. Voltas has never diluted its equity capital by issuing new shares.

22. Are management's salaries too high?

No. The combined salary of Voltas's top management personnel is low by the standards of measurement of management compensation in India.

23. What has management done with the free cash in the past?

Voltas has employed part of its free cash flow towards dividend to equity shareholders. Its average dividend payout (dividend paid out as percentage of net profits) has been over 25% over the past 10 years, which is a good number from a shareholders' point of view. A part of the free cash has also been employed to meet its working capital requirements.

D. Competition

24. Does the business face high competition?

Yes. Competition for Voltas largely comes from its closest peer Blue Star and other smaller unorganized market players.

25. Has the management focused on mrkt share or profitability in the past?

As per my last few discussions with Voltas's management, while the company has been very conscious on the profit margins front when it comes to its India business, it has sacrificed margins to get new business in the international markets. The reason for the latter is because Voltas faces high competition from local players in the international markets, and thus the only way it could penetrate deeper was to be willing to work at a lower price. But overall, given that the company has seen higher EBITDA margins, my view on this factor is largely positive.

* * *

4. Intrinsic Value Assumptions

Before I move into calculating the intrinsic or fair value range for Voltas, let me make one thing very clear. Intrinsic value isn't a definite figure but just a 'calculated' value. In fact, the calculation of intrinsic value of a business mostly throws up a highly subjective figure. And this figure changes as estimates of variable like future cash flows are revised (given that the future is unknown).

Anyways, what I have done here is rather than arrive at a single intrinsic value figure for Voltas, I have calculated the value using 5 different methods and then arrived at a 'fair value range' for the stock.

1. Net present value based on a 2-stage 10-year DCF

The discussion about the calculation of net present value using a discounted cash flow model (DCF) can be found in the 7th lesson of my free course on investing – Value Investing for Smart People.
I have done a 2-stage DCF analysis for arriving at the intrinsic value for Voltas.

But as a reference, here is the formula for calculating the NPV:

$$\mathbf{NPV = CFi / (1+k) + CF2 / (1+k)2 + \ldots [TCF / (k - g)] / (1+k)n\text{-}1}$$

Where:
PV = present value
CFi = cash flow in year i
k = discount rate
g = growth rate assumption in perpetuity beyond terminal year
TCF = the terminal year cash flow
n = the number of periods in the valuation model including the terminal year

I have calculated Voltas's future cash flow for the next 10 years, assuming 2 different rates of growth in cash flows of 10% (years 1-5), and 8% (years 6-10). As for the discount rate, I've assumed it at 15% assuming the average cost of capital for the company. My expected terminal growth rate for the company's cash flows – expected growth in cash flow after 10 years and till eternity – is 2%.

Rs 256

Based on these numbers and after reducing the net debt (debt minus cash), the present or discounted value of future cash flows for Voltas is coming at Rs 256 per share, which is also the stock's intrinsic value using this method.

2. Earnings Power Value (EPV)

After DCF, the second most reliable measure of a firm's intrinsic value is the value of its current earnings. This method is known as 'Earning Power Value' or EPV. This value can be estimated with more certainty than future earnings or cash flows, and it is more relevant to today's values than are earnings in the past.

The formula for EPV of a company is:

EPV = Adjusted Earnings x 1/R

Here, 'R' is the cost of capital.

Voltas posted an adjusted EPS (earnings per share) of Rs 10.8 in the latest completed fiscal FY11. Now, if Voltas's profits were to stagnate and remain at Rs 10.8 per share going forward, and applying the EPV formula here, I multiply Rs 10.8 with 1/15% (15% is the approx. cost of capital for the company).

Rs 72

This gives me a value of Rs 72 per share, which is Voltas's intrinsic value as per the EPV calculation.

3. Pricing relative to 10 year average P/E ratio

True value investors, as Graham has prescribed, won't pay a price based on the stock's latest P/E or the company's latest earnings. They will take a much longer term view…as long as 10 years. Here, I have attempted to estimate the intrinsic value of Voltas using the company's last 3 years average earnings, and last 10 years average P/E ratio. So the formula is:

Last 3 Years Average EPS x Last 10 Years Average P/E Ratio

Rs 121

Voltas's average P/E ratio for the past 10 years has been around 12 times, while its last 3 years' average EPS has been Rs 10 per share. Base d on the formula, Voltas's intrinsic value is coming to around Rs 121 per share.

4. Graham number

Graham number is the formula Ben Graham used to calculate the maximum price one should pay for a stock. As per this rule, the product of a stock's price to earnings (P/E) and price to book value (P/BV) should not be more than 22.5 i.e., P/E of 15 multiplied by P/BV of 1.5.

But why did Graham specifically used a P/E of 15 and P/BV of 1.5? Why didn't he use some other numbers?

Well, he thought that nobody should be willing to pay more than the AAA bond yield at that time. AAA bond yield at that time was 7.5%. Therefore, AAA P/E was arrived at 1/7.5 or 13.3, which was rounded up to 15. Similarly he thought that nobody should pay more than 1.5 P/BV for a stock.

Graham insisted that the product of the two shouldn't be more than 22.5.
In other words,

(P/E of 15) x (P/BV of 1.5) = 22.5

Rs 100

Put another way:

(P/E) x (P/BV) = 22.5
Price(sqr)/(EPS x BVPS) = 22.5
Price(sqr) = 22.5 x EPS x BVPS

Take the square root of both sides, and you get the equation for the Graham Number.

Fair Value Price = Square Root of (22.5 x EPS x BVPS)

Applying this formula, Voltas's intrinsic value comes to around Rs 100 per share.

5. Dividend discount model

As we have discussed in the DCF method above, the value of a stock is worth all of the future cash flows expected to be generated by the firm, discounted by an appropriate risk-adjusted rate or discount rate. Now, as per the Dividend Discount Model or DDM, dividends are the cash flows that are returned to the shareholders.

Hence, to value a company using the DDM, you calculate th e value of dividend payments that you think a stock will throw-off in the years ahead. Here is what the formula is:

Intrinsic value = Dividend per share/Discount rate

The modified formula for valuing a company with a constantly growing dividend is…

Intrinsic value = Dividend per share/(Discount rate – Dividend Growth Rate)

Given that Voltas has paid higher dividends over the years, we use this 'dividend growth' formula for calculating the stock's intrinsic value. Assuming a discount rate of 15%, dividend growth rate of 12%, and the latest dividend of Rs 2 per share, and inputting these numbers in the above DDM formula, I get to an intrinsic value of Rs 67.

Rs 67

Fair Value Range

Based on the above calculated intrinsic values for Voltas, I have arrived at a 'fair value range' for the stock. Here is how I calculate it:

High End of the Fair Value Range = [Average of above four intrinsic values]
Low End = [(Average of above four intrinsic values) – (0.5) x (Std Dev)]

Based on this, the fair value range for Voltas's stock is Rs 85 to Rs 125.

Rs 85 to Rs 125

Assuming a margin of safety of around 25%, I would be comfortable buying Voltas's stock at any price less than Rs 95.

Given that the stock's current price is just around this level, if I have surplus cash to invest, I will be happy to buy Voltas's stock at the current levels.

Given the overall weak scenario in the stock markets, the stock might fall further down from the current levels. But that is not what value investors are worried about when they've already taken into account an appropriate margin of safety.

As far as Voltas's business is concerned, the key risks to watch out for are a further worsening of economic growth in India that can impact construction activities and thus the company's business from the air-conditioning segment. Also, any worsening in consumer demand can impact its sales of air-conditioners. I also see Voltas's concentration in the Gulf region as a slight negative considering the geopolitical tensions seen there.

However, if you were to keep these risks into mind, and then provide for an appropriate margin of safety, Voltas's is a good business to be had in one's long term portfolio.

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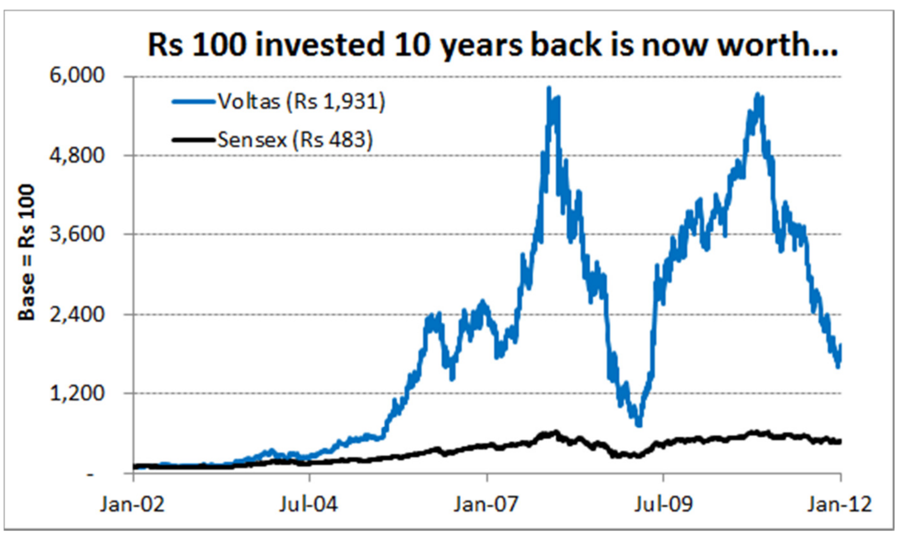
5. Financial & Market Snapshot

10-Year Financial Performance (Consolidated)											
Description	**Unit**	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY08**	**FY09**	**FY10**	**FY11**
Net Sales	Rs m	8,812	12,555	13,600	14,771	19,544	25,267	32,029	43,259	47,575	51,768
Operating profit/EBIDTA	Rs m	222	349	410	528	1,116	1,281	2,530	2,831	4,596	4,001
EBIDTA margin	%	2.5%	2.8%	3.0%	3.6%	5.7%	5.1%	7.9%	6.5%	9.7%	7.7%
Net profit (after tax)	Rs m	258	297	404	523	737	2,016	2,077	2,514	3,810	3,572
Net profit margin	%	2.9%	2.4%	3.0%	3.5%	3.8%	8.0%	6.5%	5.8%	8.0%	6.9%
Adjusted EPS	Rs	0.8	0.9	1.2	1.6	2.2	6.1	6.3	7.6	11.5	10.8
Equity	Rs m	2,079	1,864	2,148	2,195	2,714	4,237	5,772	7,898	10,852	13,617
Debt	Rs m	985	1,089	1,029	1,265	901	1,116	737	1,814	352	1,381
Debt/Equity	Times	0.5	0.6	0.5	0.6	0.3	0.3	0.1	0.2	0.0	0.1
Return on equity	%	-	17.9%	20.6%	24.1%	30.0%	58.0%	41.5%	37.2%	41.0%	28.7%
Return on capital employed	%	-	16.1%	18.8%	20.8%	29.0%	56.2%	53.3%	46.9%	51.1%	40.7%
Average P/E	Times	-	6.7	11.4	13.9	40.5	40.7	28.0	17.9	14.0	17.1

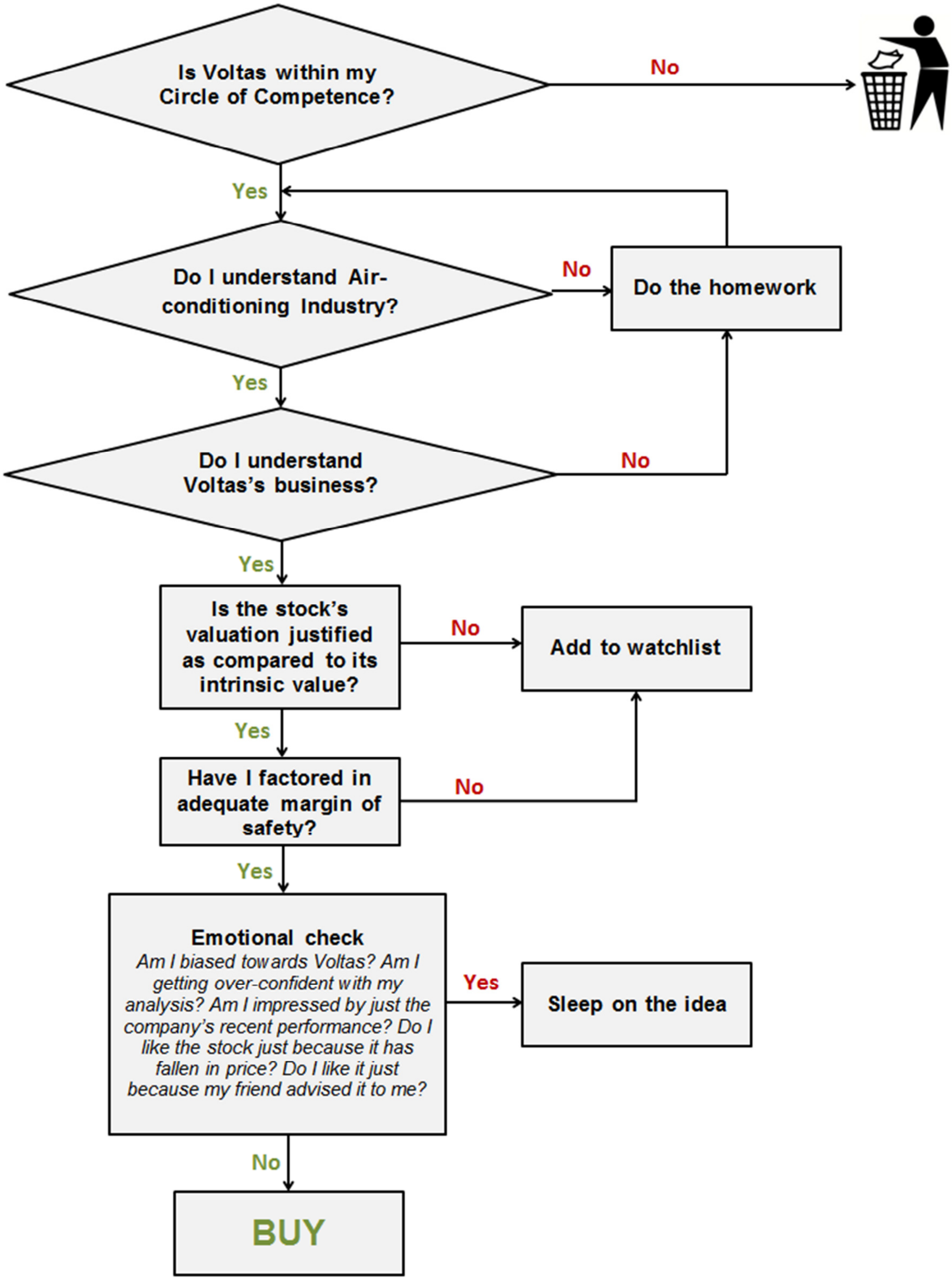
Data Source: Ace Equity, Safal Niveshak Research



Latest Stock Summary	
Latest Price (Rs)	92
52 Week High/Low (Rs)	219 / 72
Face Value (Re)	1.0
Market Cap. (Rs m)	30,441
Latest P/E (TTM, x)	9.0
Latest P/BV (x)	2.1

Shareholding Pattern (Dec-11)	
Category	**% Stake**
Promoter	30.3
Mutual Funds & Fin. Insti.	30.2
FIIs	17.5
Individuals	18.5
Others	3.6

6. "Should I Buy Voltas" Checklist



Your Feedback is Important!

So that was my take on Voltas as part of the Safal Niveshak StockTalk initiative.

I've tried to be as comprehensive in my analysis, while trying to keep the report very simple.

Let me know what you think of this report and the improvements therein.

Do you think I've missed mentioning something specific here?

Can the Safal Niveshak 25-Point Checklist be modified or expanded any further?

Do you find this report simple enough for your understanding?

Your answers would help me in making the Safal Niveshak StockTalk report, and the entire initiative, more beneficial for you.

So just let me know your feedback on this report.

Also, if you want to see your choice of stock covered here, just send me your request using the request form.

Use the following link to access the Safal Niveshak StockTalk Request Form:

http://www.safalniveshak.com/safal-niveshak-stocktalk-request-form/

With respect,
Vishal Khandelwal
Editor, Safal Niveshak StockTalk

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