

SAZEW... Endogenous Growth!

We initiate our coverage on Sazgar Engineering Works (SAZEW). We expect SAZEW to post an earnings of PKR 153.76mn (8.56/sh) in FY17. Our stance in the company is at the pretext of:

- continuous increase in the demand of three-wheeler autos;
- benefit from tractor rim sales to Millat Tractor (MTL) in light of surge in tractor demand;
- Supreme Court judgement for allowing three-wheeler on roads only by registered manufacturers as per todays newspapers.

SAZEW is a leader in sale of 3-wheelers. The company is also engaged in manufacturing tractor rims with Millat Tractor (MTL) being one of the principal customer as mentioned in books. The company has shown progress in previous years with 5-year sales CAGR of 11%.

Capacity...we are encouraged by overutilization

SAZEW has utilized capacity of 90.05% in FY16 whereas significant rise in demand has pushed company to utilize production capacity at 107% and 117% in 1Q and 2Q of FY17 respectively.

According to data at PAMA, the unit sales numbers are impressive for the month of Jan and Feb. We expect sales may increase with similar proportion during 2HFY17 as against 1HFY17. The average monthly unit sales have increased to 1,565 autos as depicted in chart on RHS.

Achieving operational efficiency...hard work pays

SAZEW has shown growth in margins in FY16 as compared to FY15. We expect the company to make gross margins around 10% in FY17. The contribution of other income to the bottom line is not very significant; we expect decrease in other income during FY17 as compared to FY16 that included a one-time gain on disposal. The decreased interest rates has resulted in finance cost saving wherein we expect the company to continue benefitting from this. Currently, the company has not entered into any fresh loan arrangements. The long-term debt to equity is 17.09% as per 1HFY17 books.

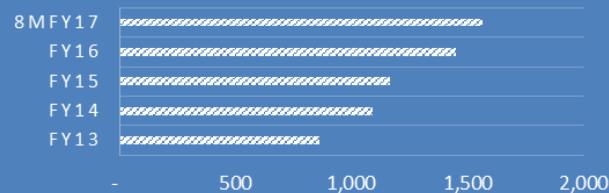
The rate of tax decreased to 32% in FY16, wherein we further anticipate its impact of 31% in FY17. This may enable the company to attain net margin of 3.85% as per our expectations against 3.75% in FY16 (being on conservative side).

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Ticker	SAZEW
Bloomberg	SAZEW PA
Price	90.72
52 weeks high (18/11/16)	111
52 weeks low (15/04/16)	30.25
P/E (FY16)	15.1
P/E (FY17E)	10.6
Market Cap	1.69bn

Source: SCS Research

MEAN MONTHLY UNIT SALES



Source: PAMA & SCS Research

DuPont Analysis...noticeable

With increased efficiency, the company has been able to increase the profit margins. Because of the increase in the margins of company's operations, the company was able to maintain healthy operating margins in 1HFY17. A jump of 200% witnessed in other income in FY16 as compared to FY15, which is a result of one-time gain due to profit on sale of non-current asset.

Although tax burden has remained range bound in the previous years, the recent increase in 1HFY17 shows a decrease in the effective tax rates. As per company's books, the tax rate has declined to 31% from 32% in 1HFY17. The declining tax is a positive sign for the company's bottom-line. From the FY13 onwards, the interest burden trend is showing an increase that recently, according to the 1HFY17 books, is more than 99% exhibiting the impact of interest charges has decreased. The company was able to achieve this because of declined non-current liabilities. The non-current liabilities to asset ratio is currently 7% as per 1HFY17 company books.

With continuous upswing in demand of auto rickshaws and trending sales of tractor rims, the company has enlarged its sales. The company's financial leverage has remained stable, as it hasn't broaden its asset base. The company might need to increase non-current assets if they plan for expansion as the company is currently operating at more than 90% capacity, although no such announcements have been made so far.

All the factors above have contributed positively to the return on equity of the company. The ROE is more than 15.62% in FY16 showing a major increase as compared to previous 3 years. We are expecting company to maintain this ROE in FY17. Further discussion about the company-estimated profits is in the valuation section.

Liquidity management...some impressive things

The company has shown major progress in working capital and liquidity management in FY16. The days inventory outstanding has decreased significantly to 69 days from 90 days, which depicts company is efficiently managing the clearance of inventory. The surge in demand of the auto rickshaws has enabled company to convert their production into sales quickly than before.

The company's efficient cash conversion cycle is a result of effective decline in days sales outstanding, the company has been able to receive the outstanding from debtors within 13 days in FY16 as compared to 24 and 20 days in FY15 and FY14 respectively.

	DuPont Model			
	2016	2015	2014	2013
Tax Burden Ratio	69.93%	73.94%	68.97%	69.21%
Interest Burden Ratio	98.23%	95.22%	97.27%	95.94%
Operating Profit Margin	5.45%	4.23%	4.28%	5.32%
Profit Margin Ratio	3.75%	2.98%	2.87%	3.53%
Sales/Total Assets	244.03%	227.22%	216.57%	187.54%
Financial Leverage Ratio	170.82%	176.47%	167.00%	177.53%
ROE	15.62%	11.94%	10.38%	11.77%

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Day's payables outstanding have also reduced over the years. The major cause of concern in the 1HFY17 company books is significant increase of payables. The payables currently stand at PKR 901mn which surpasses company's cash (PKR 267mn) and receivables (PKR 108mn) combined. Although we do not see any problem for company in cash generation considering heightened sales.

Valuation...FY17 PE is 10.5x

We expect SAZEW to post an earning of PKR 154mn (8.56/sh) in the ongoing FY17. We also expect the company to issue a final dividend of PKR 2.25/sh in addition to an already paid interim dividend of PKR 1.25/sh taking the full year dividend to PKR 3.5/sh. The dividend yield as per FY17 expectations is 3.9% and SAZEW is yielding FY17 P/E of 10.5x.

SAZEW is a Lahore based auto assembler and catering to the demand of general public needs on affordable transport. There have been government initiatives to improve quality of autos (rickshaws) wherein SAZEW is a listed entity and thus in limelight.

SAZEW P'n'L Snapshot

mn'	FY17	FY16
Net Sales	3,996.89	2,873.87
CoS	(3,596.09)	(2,585.18)
GP	400.81	288.69
Operating Expense	(192.53)	(139.23)
	208.27	149.45
Other income	4.22	7.28
Operating profit	212.49	156.74
Finance cost	(1.72)	(2.78)
PBT	210.78	153.96
Tax	(57.02)	(46.29)
PAT	153.76	107.67
EPS	8.56	5.99
DPS	3.50	2.50
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