Company Analysis – Cochin Shipyard Limited (COCHINSHIP)

About

Cochin shipyard ltd (CSL) is a PSU and in operation since 1972. The company provides ship building and repair services in the Defense, LNG, large commercial and small vessel space. The company has mainly been a supplier for other PSUs and govt entities such as the Navy, coast guard and IWAI etc. It has a much smaller order book for domestic or international commercial shipping companies due to lack of scale, funding (finance) and other structural dis-advantages.

It has two main lines of business

- **Ship building**: This is the larger segment for the company. The company has been involved in building navy vessels and some commercial vessels too. This operation is conducted at the shipyard in Kochi

- **Ship repair**: This is the second segment of the company. This is the more profitable segment and accounts for 28% of the topline

Industry review

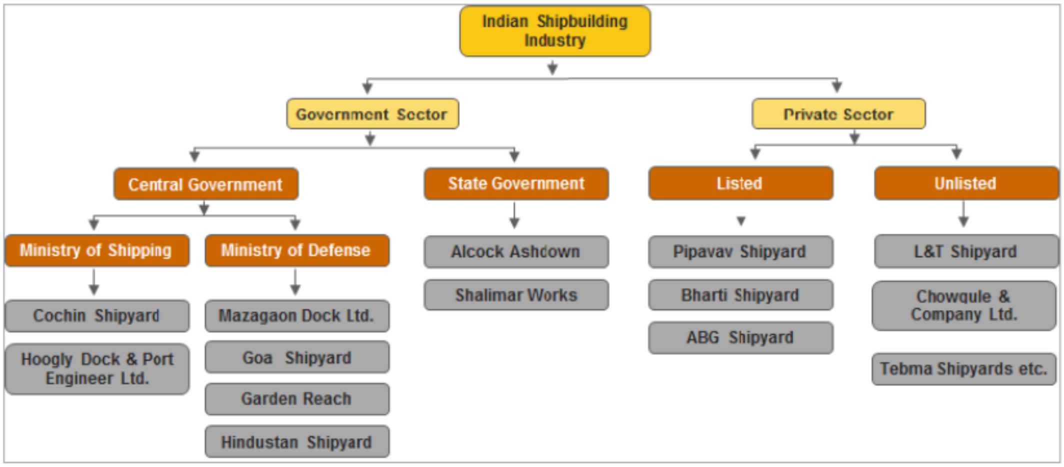
Commercial Shipbuilding is a cyclical industry which went through a major trough from 2009 to 2014. The industry is dominated globally by the Chinese, South Korean and Japanese shipyards. These shipyards are supported by the govt via cheap financing options and other subsidies. As a result, these companies can offer generous financing options to shippers.

The shipping industry is a highly cyclical one with periodic over capacity. The industry went through a building boom prior to 2008. The demand for shipping dropped sharply during 2008-09 recession. This caused a collapse in new build activity leading to sharp drop in profitability for the ship building industry. The effect of this downturn was felt in India where several of the domestic ship builders have gone bankrupt

In the shipbuilding industry, there is a sub-segment of defense which is not exposed to the same competitive dynamics. This involves the build of Aircraft carriers, Submarines, Warships, patrol boats and so on. Due to the sensitive nature of these vessels, most countries contract it out to domestic companies.

The Indian navy has laid out an expansion plan to acquire 56 warships, 6 submarines and additional vessels in response to the threat from china. The contract for these ships has been given to Indian companies (mostly the PSU companies) via the bidding process. In effect, there is enough demand for the Indian shipbuilders with low threat of foreign competition.

The Indian shipbuilding industry is split into the private and public sector as shown below

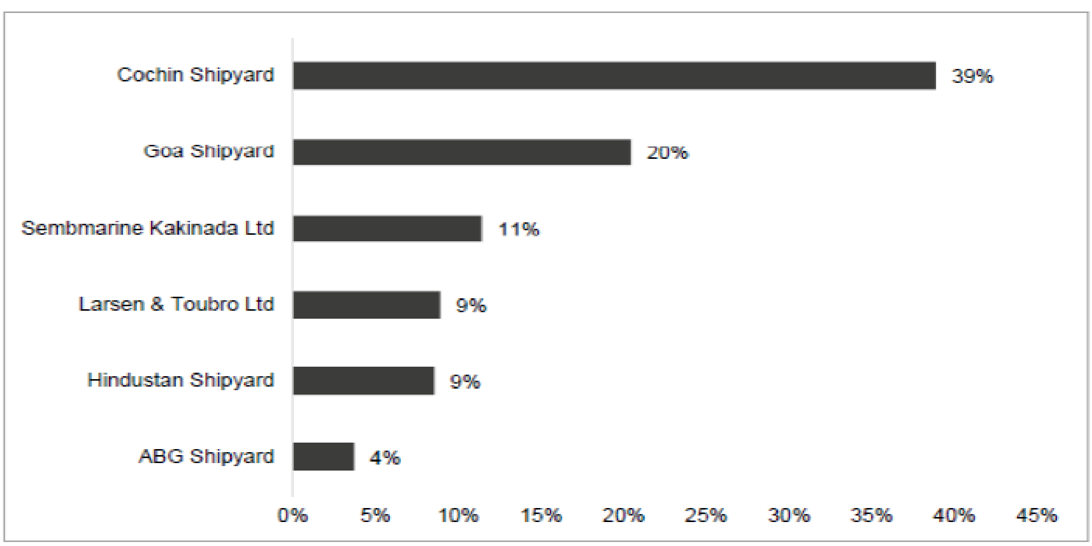


The private sector was impacted by the slowdown in the past and as a result several companies such as Bharti shipyard, ABG shipyard etc. have gone into liquidation. There are only a handful players such as L&T shipyard which are still active.

The public sector space has companies such as Goa shipyard, Garden reach and Mazagaon docks which operate in the same space as CSL.

In the ship repair segment, Cochin shipyard has the highest share in the industry and has a natural advantage over the global competition due to lower labor costs and the location of our country (along the major shipping lanes)

Market share of major players in the Indian ship repairing industry (as of 2014-15)



Source: Statistics of India's shipbuilding and ship repairing industry (2014-15), published by the Ministry of Shipping; CRISIL Research

The company is currently capacity constrained in the repair segment and has been working actively on increasing this capacity (more on it later in the note).

Financials

The company has grown at 10% CAGR in the last 10 years from a topline and profitability perspective. This can be broken into the 2010-2014 phase where the industry was going through a downturn and the company grew topline by 8% and profit was almost flat.

In the last 4 years as the industry has normalized, topline has grown at 12% and profit has grown at 18% CAGR. Profit and topline has grown mainly from the improvement in ship repair and due to the IAC contract (driven by the naval spend detailed earlier)

The company operates on negligible working capital and as a result has a very high ROC of around 50%+. It has maintained an operating margin of 20%+ in the last 10 years.

The company has around 1500 Crs of excess cash on its books which is being used for the following capex

- ISRF – new repair facility for 970 crs which will be ready by FY 22 and will improve through put by 70%. This will enable the company to bid for more repair contracts and offer faster turnaround times (compared to 3+ month of lead times at present due to capacity constraints)

- New dry dock – This will improve the capability to build large tech intensive vessels such as LNG carriers, offshore drills, aircraft carrier etc. This will happen around 2 years from now and will add to the topline from FY22/23.

- In addition to this the company has a JV with HCSL for building inland and coastal vessels, Ongoing agreement for ship repair at Mumbai port, similar agreement with Kolkata port trust and an MOU with the A&N administration.

All these initiatives should help the company grow the repair business and add to the ship building segment too.

Competitive analysis

The main competitors for the company are the domestic ship builders (PSU and private). In the private sector space companies like Reliance naval, ABG shipyard etc have gone bankrupt and do not pose much of a competition. L&T shipyard is the only private sector player of significance, though it continues to make losses in this division. The Adani group is also entering this segment, though it does not have a shipyard of its own.

The main competitors in the PSU space for the company are Garden reach shipbuilders, Goa shipyard, and Mazagaon docks. The closest competitor for the company in terms of capabilities seems to be Garden reach, though CSL does not have the capability to build frigates. In terms of product width and competency, Mazagaon docks has the widest skillset with the capability to build submarines, destroyers, frigates, corvettes etc.

All the domestic PSUs are capacity constrained which can be seen from two key variables – Book to bill ratio and Liquidated damages. The first variable is around 11-13.5 for the domestic PSUs, indicates a demand pipeline of 7-9 years at current build rate. The second variable – Liquidated damages is the amount a company must pay if the delivery of the ship is delayed beyond the committed date (with certain pre-conditions). The publicly listed shipbuilders (except for CSL) have ongoing provision for this expense indicating that they are unable to meet the committed dates due to various internal reasons.

The navy has a large capex plan for multiple submarines, Destroyers and other naval vessels. Due to the sensitive nature of this equipment and the Make in India initiative, this demand will be awarded to the domestic players. Due to the capacity constraints, it is quite likely that some incremental demand will go to the newer domestic players (who don't have too much of a history and demonstrated capability) and existing PSUs (including CSL).

In effect, it appears that the industry has a shortage of capacity rather than demand.

The other PSU like garden reach and mazagaon docks have a much lower EBDITA in the range of 5-7% (CSL is around 22%). This differential is mainly due to much higher Employee costs. Goa shipyard seems to have comparable numbers to CSL – similar operating margins of 22-23%, ROE of 19% and a much higher topline growth of 25%+ for the last five years.

Positives

CSL has been in the business of ship building and repair since 1975 and has accumulated considerable knowledge and expertise in this field. It is among the top shipbuilders in terms of capacity (measured as DWT) which will increase further with the completion of the new dry dock. Building a dock is a time consuming and expensive process and such capacity cannot be added in a short period of time. In addition to the long lead time, the industry has seen the exit of major competitors in the private sector space due to bankruptcies and hence PSUs are the main source of capacity in the industry.

The company is the no.1 ship repair company and is adding to its capacity via ISRF (new ship repair facility) and JV with various ports such Mumbai, Hooghly and A&N (Andaman and nicobar). The company is short of capacity in the ship repair segment as its current docks are being utilized for the pending ship building orders. This additional capacity should allow the company to take up more order in the repair segment and provide faster turnaround to the commercial segment.

The company continues to be bid for additional orders from the navy and coast guard for various types of defense vessels. In addition to that the company is developing capabilities to diversify into LNG carriers, Ro-Pax ferries, Mini bulk carriers and so on. This should reduce the extreme dependence on the defense sector and reduce the topline risk for the company.

As of current date the company has an order book of 15253 Crs (book to build of 4 year) which gives it revenue visibility for 3+ years.

The company operates on a very high Return on capital due to very low working capital. It has close to 1500 Crs+ of free cash which is being invested in the new dry dock and repair facility. Once this capex cycle is completed, it should allow the company to improve its topline and profits considerably.

Finally, although being a PSU is considered as a liability by the market, it is also a positive in a certain sense. The likelihood of the accounts being fudged or the management committing a large-scale fraud is much lower as they have no benefit from misreporting the numbers.

Risks

If the company operates in a protected (domestic defense ship build) and a high margin segment (repair), then why is the market still discounting the company so heavily?

The primary reason I think is that the company is a PSU. That label alone is enough to scare away most investors. However, I think we should consider it in a more nuanced fashion. If you look across PSUs, the tendency of the govt to meddle in the affairs is more when the company can be used to win votes. If the PSU is bank, OMC or any such customer facing firm, the govt tends to change the pricing of its product to benefit the end user (read voters). In all such cases, the economics of the business is always impacted.

On the other hand, PSUs where the business is in the B2B segment or not customer facing, there is less tendency to meddle in its affairs (such as Concor, BEL, RITES etc). In all such cases, the economics of the business tends to drive the profitability of the business.

CSL is not immune from govt meddling but has not faced any such interference in the past. The company bids competitively for the various defense ship building contracts and in all these cases the govt has never directed the company to price its products

The second risk for the company is the sustainability of its order book. The company has been building the IAC (Indian aircraft carrier) since 2013 and this single order has accounted for 50%+ of the order book over this period of time. The market is concerned about revenue visibility once this order is complete by 2021/22. Management has been working actively to build the order book by expanding into other areas such as submersible pontoons and other defense carriers. Management shared that they are bidding for 16000+ crs of orders involving fast patrol vessels, multi-purpose vessels and new generation missile vessels.

The company is expanding its ship repair facilities and has tied up with various docks such as Mumbai port, Hooghly etc to expand the ship repair capacity. This segment of the business should provide additional revenue and help in the growth of the topline over the long term.

The third key risk is the high level of dependence on the Navy/Coast guard. Although the company is expanding its business into ship repair and commercial segment, it is highly exposed to the change in demand from the Navy/coast guard. The navy, coast guard and MOS (ministry of shipping) has plans to expand the fleet from a defense standpoint. The other PSUs in ship building are currently capacity constrained with a book to build ratio of 10-13 (7-8-year backlog) and hence CSL has a good opportunity to win the new contracts. There is an added competition from the private sector (domestic), though the intensity of this would be less as most pvt players have gone bankrupt.

Govt ownership and high dependence on the navy/coast guards means that the company will always have some latent risk and as result may not get a premium valuation in the future based on financials alone.

Management quality checklist

- Management compensation: As the company is a PSU, management is on the lower side compared to the private sector. Senior management received compensation to the tune of 0.5% of profits, with no stock options or commissions.
- Capital allocation record – Management seems to have a reasonable capital allocation record. It is currently distributing around 35-40% of profits as dividends. The excess capital on the balance sheet is being re-invested into the business via capacity expansion and small JV/Acquisitions. The long-term result of the capex remains to be seen
- Shareholder communication – appears adequate. Inspite of being a PSU, management communicates regularly with investors via annual report, quarterly updates and conference calls. On the conference calls, they are open about the order book and prospects of the company
- Accounting practice – appears reasonable
- Conflict of interest – None
- Performance track record – The current management have been with the company since joining the work force (as trainees with this company). The current MD also joined as a trainee and became the CEO in 2016. The same is the case with the CFO and all other senior managers of this company.

  The management appear to be competent operators, but as they are PSU employees, will not take extra risk in growing the business. In other words, they are not entrepreneurs.

  The history shows that the company and its management have executed quite well for their customers and delivered most projects /ships on time. In the past, there have been some delays in the beginning, but the company was able to accelerate at a later point and deliver on time.

  The management has also built the company's competency in new areas of ship building over the years. In addition, the management started the process of expanding its capacity via the new ship building and ship repair facility in 2013. These new capacities will finally come onstream in 2021/22 which shows the time it takes to complete the whole process of due diligence, approvals and final construction of these facilities in the case of PSUs.

Conclusion

In the current market scenario, PSU are a despised group. The market is not wrong in giving low valuation to all the PSU due to the horrible performance of most of these companies. A lot of PSUs are in sectors which have not created value for a long time such as Mining, Power generation and distribution, Capital goods and the poster child – Banking. The reason for this dislike is not surprising. The government constantly interferes with the working of customer facing PSUs and uses these companies as its piggybank.

Banks have been used to dole out loans to all kinds of companies and individuals for non-economic reasons. OMC and power companies under-charge for their products so that the govt can provide subsidies and get votes from the general population.

There is a small group of PSUs which have been shielded from this kind of interference as they do not face the consumer (read voters directly). As a result, the govt has no reason to interfere with the pricing of their products. Examples of such companies are Concor, RITES, Midhani, and Balmer Lawrie (an old position of ours).

The common risk this second group of companies is the lack of growth inspite of opportunities. The reason here is management incentives. PSU managers are extremely risk averse as they salaried employees who have nothing to gain from exceptional performance and everything to lose if they take a risk which does not work out.

Running a company means taking measured risks which sometimes don’t play out. This is something a PSU management will not take. As result we will never see a PSU grow inspite of its sector. The only case where a PSU will grow rapidly is if its industry has a big tailwind and its own position is protected due to regulations. In such cases, the company will ride the wave and make above average profits. In such cases, management is essentially ‘operating’ the company and taking advantage of the existing tailwind.

CSL like some of the others in the group appears to be in that position. The defense ship building industry is protected from foreign competition and has limited domestic competition for now. Also, entry barriers for the domestic industry is high due to the long lead time required to build a new shipyard. In the repair segment the same entry barrier of a new shipyard and capabilities exist. As a result of these factors the company can earn a decent return on capital.

Unlike the other companies in the sector, the company has kept its employee costs and overheads low and thus able to earn a higher margin. This is to credit of the management.

The main risk as perceived by the market is the lack of visibility once the construction of IAC ends (in 2021/22). It appears unlikely that IAC2 will be approved due to the lack of budget with the Navy. This has spoilt the mood of the market for the company.

The above sentiment assumes that the management is going to sit still and do nothing to build its order book. That is clearly not the case and the management has said it in as many words in the recent conference call. They are already building the order book by bidding for new vessels.

In addition, the new dry dock is being built in such a manner that it can accommodate a new aircraft carrier or other large vessels depending on the nature of the order book. In other words, the new capacity is not being purpose built for aircraft carriers alone. In addition to this segment, the company is also expanding in the ship repair segment which should add to profitability and margin in the future.

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