Voltamp Energy

Stable margins, all eyes on power transformer plant

05 July 2011
CMP: RO 0.530
HOLD

Sector
Power

Target Price
RO 0.597

Face Value
100 baiza

Equity Capital
RO 5.5MN

Market cap
RO 29.15MN

52 Week H/L
0.724 / 0.413

Bloomberg
VOES OM

MSM Index
5934

Price change	VOES	MSM30
1 month return	-1.85%	-2.42%
3 month return	-4.16%	-5.34%
1 Year return	23.26%	-2.35%

Number of shares (in MN)	% holding
Al Anwar Holdings SAOG	28.71%
SABCO LLC	7.82%

Oman - Strong power generation and distribution opportunities

Oman's power demand is expected to grow at 9% over next six years on the back of sustained demand and aggressive government spending on infrastructure buildup. As per OPWP, power generation capacity is expected to grow from 4,347 MW in 2011 to 5,711 MW in 2014, implying strong pipeline for power equipment requirement. Oman Electricity Transmission Company (OETC), the nodal agency in Oman, is expected to install an additional 2446 MVA and 8127 MVA of power transformers in 2011 and 2012 respectively, thus providing a strong visibility for Transformer business in the country.

Capex to drive growth

Voltamp is expanding capacity of all three business segments, namely Switchgears, Power and Distribution Transformers. The company is expanding its Switchgear capacity by 60% by the end of August 2011. It is also expanding its existing Distribution Transformer capacity by 15% by end of FY11. The company is opening a new revenue stream by setting up a 6500 MVA capacity Power Transformer manufacturing facility in Sohar, at an estimated cost of RO 9mn. The new facility, currently under trial runs and various testing phases, is expected to become operational by end of FY11, subject to successful laboratory testing. The company has already won an order for RO 1.65mn to provide four 125MVA Power Transformers to OETC, and is expected to deliver these transformers by Q4 FY11.

Internal efficiencies to maintain distribution transformer margins

The company constantly invests in R&D activities to improve its product design and reduce costs through internal efficiencies. The company is currently testing a few advancements to its Distribution Transformers and is expecting a 15% reduction in Distribution Transformer cost from these advancements. We opine that these changes in its product design will help it maintain its high profit margins in the future.

One of its kind manufacturer in GCC, to benefit from sustainable competitive advantage over foreign players in Power Transformer business

The company's upcoming Power Transformer manufacturing plant will have a capacity to produce Power Transformers of rating ranging from 20MVA to 315MVA. It is the only manufacturer of its kind to produce Power Transformers of this rating in the entire GCC, putting it in direct competition with global players such as ABB, Siemens, Crompton Greaves, etc. Being a GCC player, the company will have a sustainable competitive advantage over its global peers in pricing and tendering of transformer contracts. It will benefit from a GCC weightage (usually 5%) in tender point calculation. Also, being a GCC entity, it will not have to pay the 5% custom duty which global players are subject to, giving it a pricing advantage over its peers. It will, however, pay a 3% royalty on Power Transformer turnover to its technology partner Tatung.

Valuation and Target Price

We estimate FY11e and FY12e EPS at 39bz and 46bz. At the current price of RO 0.530, the stock trades at PE of 13.6x FY11e and 11.6x FY12e earnings. On EV/EBITDA level, the stock trades at 9.4x FY11e and 7.4x FY12e multiples. We initiate coverage with a HOLD rating and a 12 month price target of RO 0.597. Our blended target price is based on weighted combination of DCF and target EV/EBITDA multiple. Key upside surprises can come from higher Power Transformer utilization and lower than expected depreciation and interest rate. Key downside risks include delay in Power Transformer business rollout, higher than expected depreciation and interest cost, any unexpected delay in the delivery of order to OETC and lower than expected utilization from Power Transformer business. We continue to watch progress on the Sohar plant and its certification results in Q3 FY11.

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Key Financials

RO '000

Balance Sheet	FY09	FY10	FY11e	FY12e
PPE	2,207	4,686	9,377	9,269
Investments	202	734	734	734
Total Non-Cur Assets	2,581	5,648	10,339	10,231
Inventories	3,169	2,546	3,142	3,803
Trade Receivables	5,269	4,498	4,817	5,909
Cash & Equivalent	6,111	8,126	6,018	7,644
Total Current Assets	16,568	15,170	13,978	17,356
Total Assets	**19,149**	**20,818**	**24,317**	**27,586**
Shr Cap & Reserves	12,366	12,607	12,822	13,120
Retained Earnings	2,473	2,965	2,973	3,259
Total Equity	15,175	15,572	15,794	16,378
Long Term Loans	790	2,110	5,110	7,110
Total Non-Curr Liab	906	2,249	5,274	7,299
Trade Payables	2,169	2,891	3,142	3,803
Total Curr Liab	3,069	2,997	3,248	3,909
Total Liabilities	3,975	5,246	8,522	11,208
Total Liab & Equity	**19,149**	**20,818**	**24,317**	**27,586**

RO '000

Cash Flow Statement	FY09	FY10	FY11e	FY12e
Cash From Operations	2,433	3,948	2,003	2,386
Cash From Investing	(3,160)	2,353	(5,186)	(836)
Cash From Financing	(1,278)	360	1,075	75
Change in Cash	(2,005)	6,661	(2,108)	1,625
Closing Cash	837	7,498	5,391	7,016

RO '000

Income Statement	FY09	FY10	FY11e	FY12e
Revenues	12,433	13,559	15,415	18,910
COGS	(8,591)	(9,388)	(10,683)	(12,930)
Gross Profit	3,842	4,172	4,732	5,980
SGA	(1,292)	(1,667)	(1,847)	(2,235)
EBITDA	2,613	2,566	2,935	3,795
Depreciation	(142)	(138)	(309)	(608)
Profit from Ops	2,470	2,459	2,626	3,187
Net Finance Income	299	266	(186)	(336)
Profit before Taxation	2,769	2,726	2,440	2,851
Taxation	(319)	(267)	(293)	(342)
PAT to Equityholders	2,196	2,444	2,147	2,509

Key Ratios	FY09	FY10	FY11e	FY12e
EBIT (%)	19.9%	18.1%	17.0%	16.9%
EBITDA (%)	21.0%	18.9%	19.0%	20.1%
PAT (%)	17.7%	18.0%	13.9%	13.3%
ROE (%)	14.7%	15.9%	13.7%	15.6%
ROIC (%)	21.8%	25.2%	25.6%	19.5%
EPS (RO)	0.044	0.044	0.039	0.046
BVPS (RO)	0.303	0.283	0.287	0.298
PE (x)	12.1	11.9	13.6	11.6
P/B	1.7	1.9	1.8	1.8
EV/EBITDA	8.4	8.8	9.4	7.4
WC/Sales (%)	50.4%	30.6%	31.3%	31.3%

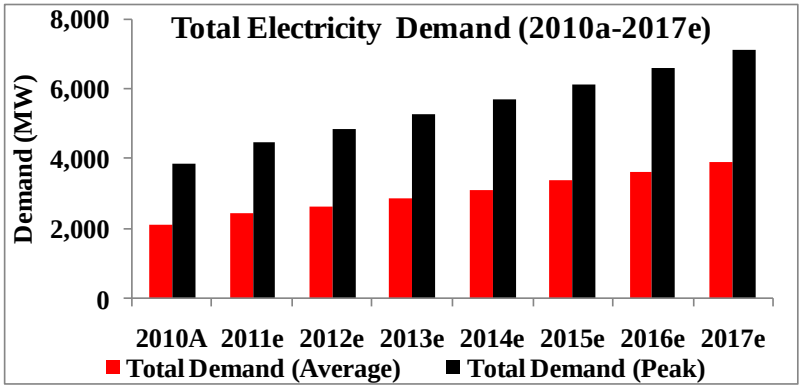
Source: Company Financials, BankMuscat Equity Research

Investment Argument

Oman Power Sector Review

OPWP's Oman Electricity Demand Projection

As per Oman Power and Water Procurement's (OPWP) central 7-year demand projection for Oman, average demand is expected to increase from 2140 MW (18.8 TWh) in 2010 to 3907 MW (34.2 TWh) by 2017, an average growth rate of about 9% per year. Peak demand is expected to increase at around the same rate, rising from 3856 MW in 2010 to 7090 MW by 2017. OPWP has also proposed two other scenarios of electricity demand (low growth and high growth). Under OPWP's low growth scenario, demand growth is expected around 6% per year, reaching a peak demand of 6000 MW by 2017, about 1090 MW lower than the base case scenario. Under the high growth scenario, demand growth is expected around 12-13%, translating in a peak demand of 8817 MW by 2017, about 1500 MW higher than the base case scenario.



Average Demand Summary	2010A	2011e	2012e	2013e	2014e	2015e	2016e	2017e	Gr %
MIS	1924	2176	2367	2542	2753	2991	3225	3464	9%
Salalah System	216	253	289	331	369	394	419	443	11%
Total Demand (Average)	2140	2429	2656	2873	3122	3385	3644	3907	9%

Peak Demand Summary	2010A	2011e	2012e	2013e	2014e	2015e	2016e	2017e	Gr %
MIS	3500	4048	4383	4714	5079	5488	5923	6371	9%
Salalah System	356	415	471	537	597	638	678	719	11%
Total Demand (Peak)	3856	4463	4854	5251	5676	6126	6601	7090	9%

Source: OPWP

OPWP Electricity Supply Projection

As per the OPWP projections, total supply is expected to rise at c3%, rising from the current 4347 MW in 2011 to 5332 MW in 2017. Existing supply projections expect a supply deficit starting from 2015 under the normal demand scenario. The demand will outstrip supply by 2013 and 2016 in a "high case" and "low case" demand scenario. This presents an urgent need to beef up existing power supply infrastructure to meet the growing demand in the future.

Supply Summary	2011e	2012e	2013e	2014e	2015e	2016e	2017e	Gr %
MIS Supply	3807	4717	5006	4910	4817	4815	4531	3%
Salalah System Supply	540	801	801	801	801	801	801	7%
Total Supply	4347	5518	5807	5711	5618	5616	5332	3%

Source: OPWP

New Integrated Power Plants to meet the supply deficit

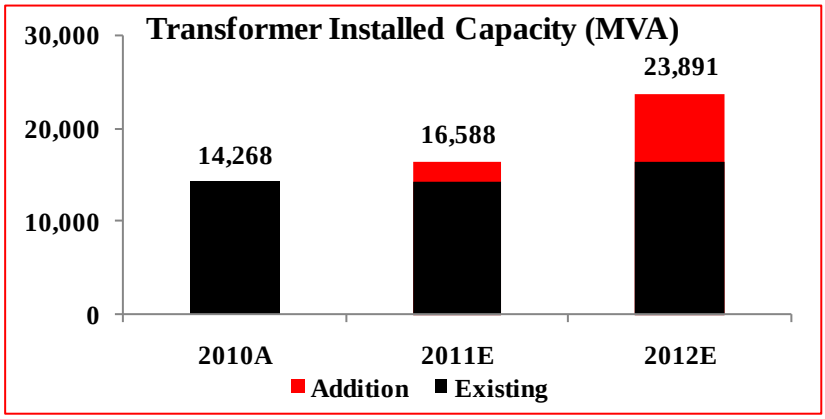
OPWP is considering various options to bridge the expected supply deficit mentioned above. Foremost among the plans is to build new Integrated Power Plants to bridge the deficit. OPWP is planning to build a new Integrated Power Plant (IPP) at Sur, on Oman's Sharqiyah coast, with an installed generation capacity between 1500 to 2000 MW. OPWP is currently in the process of short listing bidders for the plant, and expects the IPP to start generating at full capacity starting summer of 2014. It is also exploring options to build another IPP at Duqm with an installed generation capacity of 1000 MW to meet the expected surge in demand from the Duqm Port, once it becomes operational. Together, these two IPPs are expected to add between 2500 and 3000 MW of generation capacity in next 5 years, providing a strong pipeline for power ancillary companies.

Oman-UAE Grid to become operational by end of 2011

Oman's Main Interconnected System (MIS) is being connected to the power system of the Emirate of Abu Dhabi by a 220kV link currently under construction. The link is expected to enter operation by end of 2011. The double circuit link is expected to support transfers of up to 200 MW. The scheme is part of the larger GCC Grid between the six member nations.

OETC Transformer Requirement Projections

Oman Electricity Transmission Company (OETC) is the nodal agency in Oman to manage Electricity Transmission. As per its latest annual Transmission Capability Statement, the country is expected to upgrade many of its existing power transmissions in the next two years. OETC is planning to install 10,500MV of power transformers (with a rating of 63MW and higher) by 2012, about 70% of its existing setup. This presents a large demand and a very good opportunity for Voltamp to serve from its upcoming Sohar facility, which is expected to become operational by end of FY11.



Source: OETC, All figures in MVA Transformer Capacity

About Voltamp

Voltamp Energy SAOG (MSM:VOES) manufactures a wide range of transformers, LV Switchgears and packaged switchyards through its three manufacturing units in Muscat, Oman. The company also has a service capability for these products. Voltamp is setting up a new facility at Sohar for manufacturing transformers of higher ratings and capacities of above 20 MVA. The new plant is the first of its kind in the entire GCC region, with a capacity to produce transformers of higher ratings. This puts the company in direct competition with global peers such as ABB, Siemens and Crompton Greaves.

Distribution Transformers

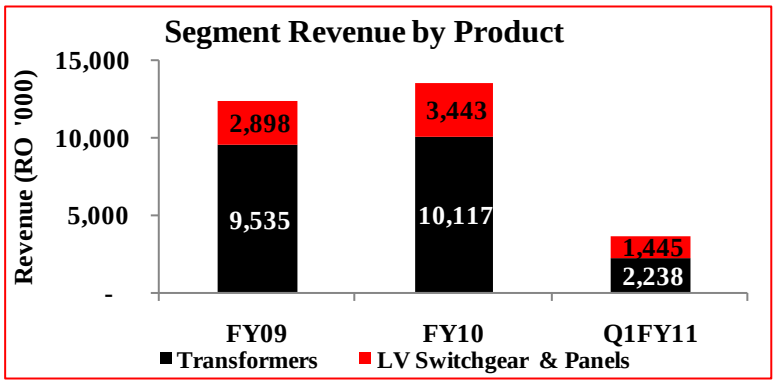
The company, through its subsidiary Voltamp Transformers Oman LLC (VTO), specializes in a range of distribution and specialty transformers. It designs and manufactures special multi-tap transformers for the Oil & Gas sector. VTO has a manufacturing facility in Muscat, Oman, where it manufacturers transformers with capacities ranging from 50KVA to 30MVA, 33KV Class. VTO has an annual installed capacity of 2100 MVA. It is expanding its capacity by another 15%, which is expected to become operational by Q4 FY11. The Distribution Transformers business had a revenue of RO 10.1mn in FY10 (FY09: 9.5mn, Q1 FY11: 2.2mn), translating in 75% of the group's revenue in FY10 (FY09: 77%, Q1 FY11: 61%).

LV Switchgears

The subsidiary company VTO also specializes in the production of Low Voltage (LV) Switchgears. The company's switchgear business had a revenue of RO 3.44mn in FY10 (FY09: 2.9mn, Q1 FY11: 1.4mn), translating into a revenue share of 25% of group's revenue for FY10 (FY09: 23%, Q1 FY11: 39%). The company is expanding its LV Switchgear capacity by 60%, which is expected to become operational by Q3 FY11.

Power Transformers

As part of its growth strategy, the company, through its subsidiary Voltamp Power Oman LLC is setting up a Greenfield factory at Sohar, Oman to manufacture Power Transformers. The total capital expenditure is expected to be around RO 9mn. The new factory will have a total of 6500 MVA Power Transformer production capacity. The civil work on the plant is complete and the plant is undergoing trial runs and product testing phase. If all the tests are completed on time and with expected results, the company plans a begin production from Q4 FY11. It has already secured an order for four 125MVA Power Transformers from OETC for RO 1.65mn. The company expects to deliver these transformers by end of 2011.



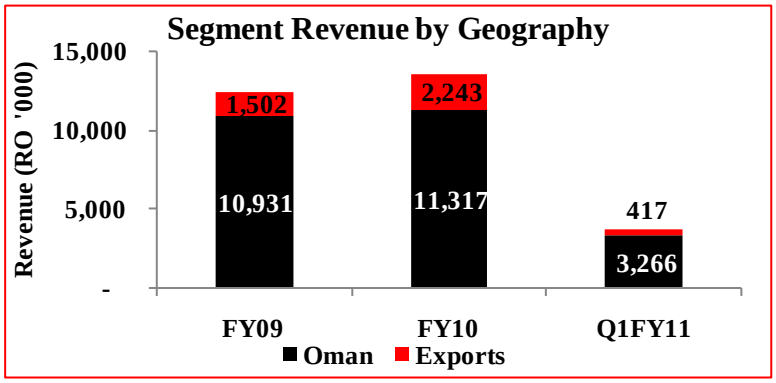
Source: Company Financials

Geographical Segmentation

Oman
Since the time company started disclosing its geographical revenue mix in Q4 FY09, Oman as geography has maintained its dominant position as the largest market for the company. Oman accounted for 83% of total revenue in FY10 (FY09: 88%, Q1 FY11: 89%). Considering the company's philosophy to remain a niche player to maintain its higher margins, Oman is expected to remain the dominant market going forward.

Exports
Outside of Oman, the company has a good customer base in the GCC region. Within GCC, the company has a strong presence in Qatar, Kuwait and UAE. The company has discontinued providing country-wide segmentation from FY10. However, from our channel sources, we opine that the company continues to focus on these export markets. Due to the severe competition and lower margins, the company has so far withheld entry into Saudi Arabia.

Going forward, once the Power Transformer segment begins operation, we expect the company's export revenue share to grow from the current levels.



Source: Company Financials

Aggressive expansion plans to drive future growth
As part of its growth strategy, company is expanding its switchgear capacity by 60% by Q3 FY11. It is also expanding its distribution transformer capacity by another 15% by end of FY11. The company is setting up a new power transformer facility in Sohar at a capital expenditure of RO 9mn. The new facility will have an installed capacity of 6500MVA, and is expected to open a new revenue stream.

Stiff competition from reputed global players
Apart from Voltamp, various foreign players are active in power and distribution transformer business in Oman and GCC. Some of the key competitors in this segment include ABB, Siemens, Crompton Greaves and GE, among others. The advantage for Voltamp comes from its unique geographic dividend. Voltamp is the only player of its kind with an expertise to manufacture transformers having higher than 20MVA capacity in the entire GCC region. This gives the company a sustainable competitive advantage in GCC tendering process and benefits from custom duty.

Sustainable Competitive Advantage of being the only GCC player of its kind

Voltamp's new power transformer plant is being setup to manufacture transformers with capacity between 20MVA up to 315MVA. It is the first plant of its kind to manufacture high capacity transformers in the entire GCC region. The company is expected to benefit in two ways by being the only GCC player of its kind:

- Tender boards of GCC countries follow a point based system in allotting tenders, where a certain weight, usually around 5% is allocated to GCC based companies. Voltamp is expected to benefit from this preference, as it gives the company a direct 5% advantage over its global competitors in tendering activity.
- The global peers need to pay a 5% custom duty at the time of importing their machinery to GCC region. Voltamp is exempted from this cost, as it a GCC based company. The company, however, has to pay 3% royalty on turnover from Power Transformer business to its technology partner Tatung.

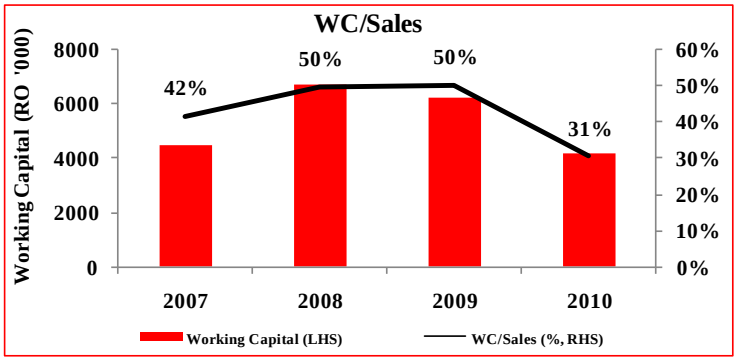
Yet to establish its technological prowess, technical certification expected by year end FY11

Voltamp plans to test its higher capacity power transformers at KEMA, The Netherlands, in August 2011. Post the tests and result, subject to successful completion of testing, the company is expecting to commission the plant by end of FY11. Power Transformers is a highly specialized business, and manufacturer reputation is a key variable in contract award decision making. We opine that the upcoming testing at KEMA and its order performance with OETC for 4x125MVA power transformers will be a key performance indicator. We expect the plant to stabilize and operate at 65% capacity starting FY14e, if it can prove its product performance.

Financials

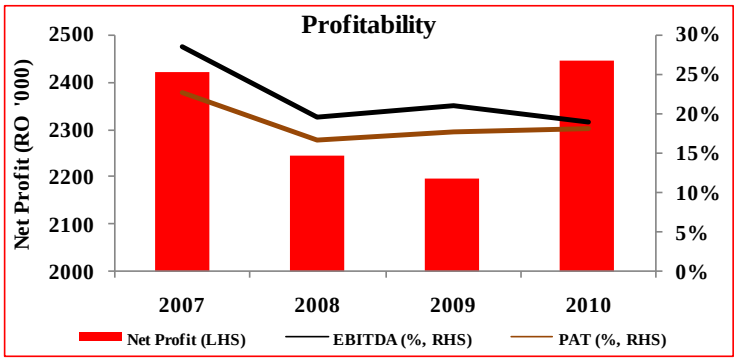
Cost structure prone to commodity price fluctuations, insulation from back-to-back ordering
Voltamp's cost structure is heavily dependent on commodity price fluctuations, which in recent years have become very volatile. Of the total raw material cost, Copper accounts for ~50%, CRGO Steel for ~25%, Transformer Oil for ~10% and Steel and other commodities account for the remaining material cost. Voltamp follows back-to-back ordering process, which insulates it from unforeseen fluctuations in commodity prices. Over the last three years, the company has maintained stable EBITDA margin, indicating that the company's sourcing strategy has played out positively to keep costs under control. We expect the company to continue to deliver stable EBITDA margin in the future.

Improving working capital to sales ratio to reduce debt burden
The company's working capital to sales ratio, which hovered around 50% in 2008 and 2009, has come down to a more sustainable level of 31% in 2010. We opine that improving economic conditions after the global financial crisis of 2008-09 helped the company to improve its working capital, which as a percentage of sales declined to 31% in 2010. We expect working capital to sales level between 30-35% going forward. However, with the commissioning of the new power transformer plant, the company may face short term spikes in working capital in 2012.



Source: Company Financials, BankMuscat Equity Research

Excellent Operating and Profit Margins, highest among peers
The company has managed to maintain its profitability ratios even during the tough years of 2008-09. Its profit margin plunged to 16.7% in 2008, and has since been gradually improving. The company achieved 18% PAT margin on the back of 11% profit growth in 2010. The management seemed hopeful to maintain current level of profitability even after the new expansion at existing facilities is completed.



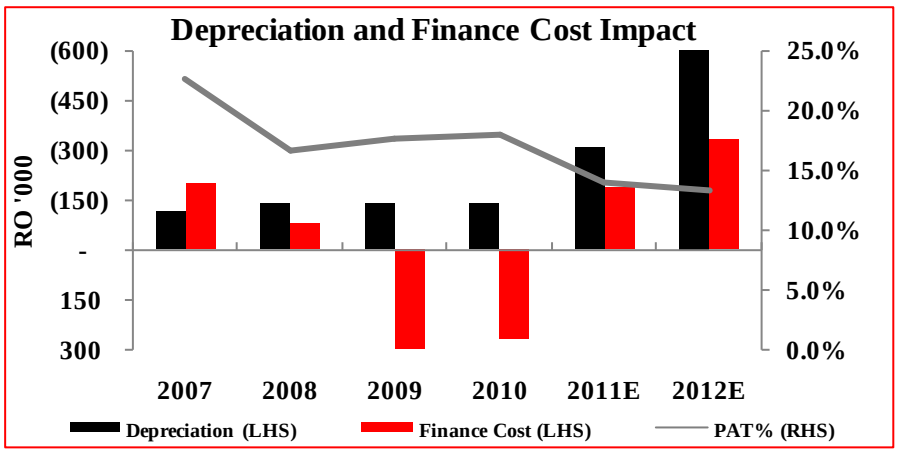
Source: Company Financials, BankMuscat Equity Research

Focus on preserving margins

The management has shown its inclination to remain a niche player in the industry, while maintaining its return ratios. There are global peers who have a much larger top line, but have to let go of their margins in order to grow in size. However, we opine that Voltamp wishes to maintain its margins at the cost of incremental business, which may come at reduced margins. The fact is reflected in its annual numbers over last four years since it became public. The company has consistently maintained its net margin even in the scenario of declining profits. We, however, opine that the net margin is set to decline due to higher depreciation and interest cost from FY11e onwards.

Depreciation and interest cost set to rise, to dent profitability

Many of company's existing plant and machinery are fully depreciated, which results in low depreciation on its income. With the new power transmission plant becoming operational from this year, we expect a depreciation impact to its income statement from FY11 onwards. Also, the company had large deposits till FY09, which it has invested in the new plant, resulting in net finance charge from FY10. We opine that these two expenses will erode its profitability from FY11e onwards. We estimate an additional depreciation charge from the Sohar plant of RO ~400k from FY12 and an interest burden of RO ~350k on its debt starting FY12. With these costs, we expect the net margins to fall and stabilize near 13-14% in the next couple of years.



Source: Company Financials, BankMuscat Equity Research; Depreciation and Finance Cost are on inverted scale.

Peer Valuation

The company enjoys one of the highest EBITDA and Profit margins among its peers in the transformer business. This is partly due to the company's philosophy to maintain its margins at the cost of new business.

Name	Revenue (FY10)	Profit (FY10)	Profit (%)	EBITDA (%)	PE	PB	ROE (%)	ROA (%)	ROIC (%)	EV/TTM EBITDA	D/E (%)
Voltamp Energy	**35**	**6**	**18%**	**18%**	**14.7**	**2.3**	**16%**	**12%**	**12%**	**12.08**	**14%**
El Nasr Company*	66	7	11%	12%	11.8	2.0	18%	10%	16%	7.94	0%
Crompton Greaves	2,197	195	9%	13%	22.4	6.1	31%	13%	24%	13.16	14%
ABB	1,375	14	1%	4%	266.7	7.0	3%	1%	5%	73.30	21%
Indo Tech Trans	24	(5)	-21%	-19%		1.8	-18%	-14%	0%		9%
BHEL	9,192	1,329	14%	22%	18.8	5.6	34%	11%	33%	10.16	1%

Source: Bloomberg. All values in Million USD. *El Nasr numbers pertain to FY09

Valuation Summary

We estimate FY11e and FY12e EPS at 39 and 46bz. At the current price of RO 0.530, the stock trades at PE of 13.6x FY11e and 11.6x FY12e earnings, above its peer average. On EV/EBITDA basis, the stock trades at 9.4x FY11e and 7.4x FY12e multiples, below its peer average. We recommend a HOLD on the stock with a 12 month price target of RO 0.597. Our blended target price is based on equal weighted combination of DCF and target EV/EBITDA multiple.

Our model assumes a utilization of 15% and 35% for Power Transformer business in FY12e and FY13e respectively. We have built-in RO 1.65mn revenue guidance from the Power Transformer business in FY11 from the OETC order. Key upside surprises can come from higher Power Transformer utilization and lower than expected depreciation and interest rate. Key downside risks include delays in Power Transformer business rollout, higher than expected depreciation and interest cost, any unexpected delay in the delivery of order to OETC and lower than expected utilization from Power Transformer business. We continue to watch progress on the Sohar plant and its certification results in Q3 FY11.

Disclosure

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