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Amber Enterprise India Ltd.

(Contract Manufacturing)

Can it add cool moments to your portfolio?

-Read and Decide

Shareholding Pattern	
Promoter Holding	44.02%
Mutual Funds	7.22%
FPI	12.36%
Public	36.4%

CMP:	Rs. 1520
Market Cap (Rs. in crores):	Rs. 4779.87
Industry:	Manufacturing

A few days back, I came across an article written by Boston Consultancy Group examining on how certain companies emerged stronger from the 2008 financial crisis. The highlight for me was how the company developed an outsourcing business model to focus on other activities like R&D in this case.

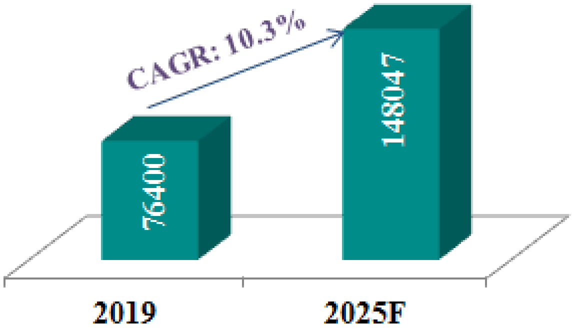
ASML Holding: It's a Dutch technology company that makes lithography machines, the equipment that semiconductor manufacturers use to produce microchips. The company has performed extremely well since the financial crisis. In 2007, ASML had an extremely strong market position among both large and small chip manufacturers. However, ASLM like the most companies in tech industry was impacted by financial crisis. When demand for electronics slowed, ASML felt the upstream effects as semiconductor manufacturers eased production and reduced their equipment spending. The industry was in a wait and see mode. ASML decided to outsource the manufacturing of most components and subassemblies. That allowed them to reduce cost and increase R&D expenditure. As a result, the company developed new lithography technologies and systems that allowed customers to reduce their chip-manufacturing costs and increase yields. As a result of these investments—made during a period of broad economic uncertainty—ASML saw some of its competitors exit the market, leaving it with an even stronger market position for leading-edge lithography equipment.

Index

Consumer Durables:

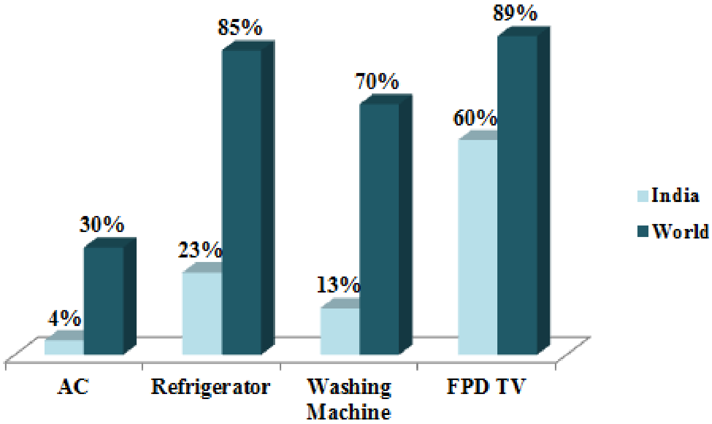
GROWTH IN WHITE GOODS SPACE

Indian Appliance and Consumer Electronics Industry (Rs. in crores)



Source: CEAMA, Frost and Sullivan Report

Penetration in white goods space

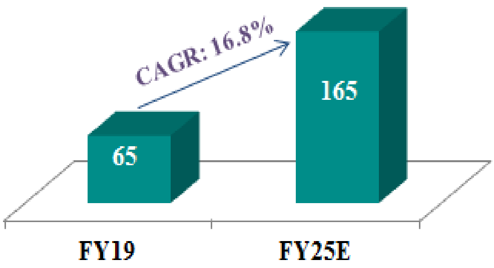


Source: IBEF Presentation

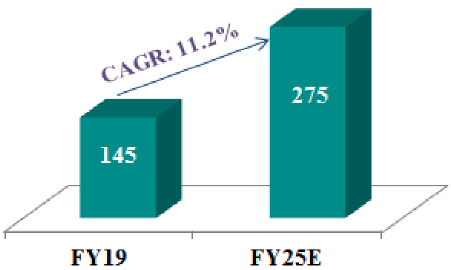
The industry had a total market size of Rs. 76,000 crores in 2018-19, in which Rs. 32,200 crores was contributed from domestic manufacturing.

Production of Major White Goods (volume in lakhs)

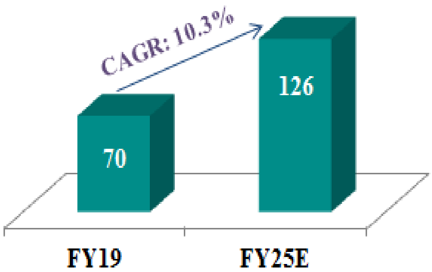
Air Conditioners



Refrigerators



Washing Machines

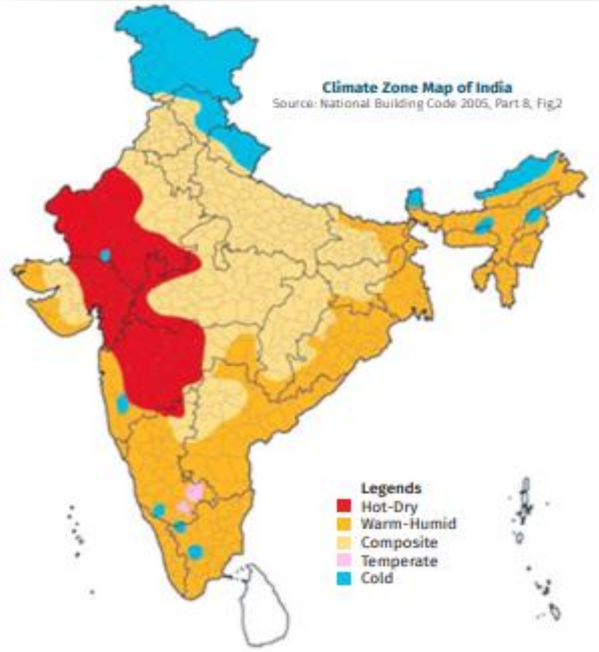


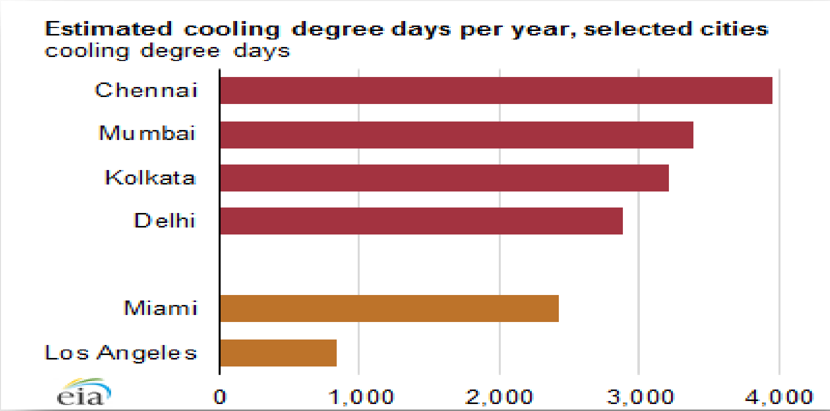
Source: IBEF Presentation

SECTION I: Why Room Air Conditioners (RAC)?

It is the **most under-penetrated product** in the country in the white goods space. The requirement of other white goods like Washing Machines or refrigerators is limited to one per house whereas ACs can reach with **multiple installations per house**. This way, the potential for expansion is significant. Once considered a luxury, the air conditioners are now gradually turning into **a necessity** in the Indian households, given the tropical climate and soaring temperature in our country. The **replacement cycle has reduced** from 13 years to 7-8 years. **Rising disposable income** with **increased electrification** is expected to drive the demand of AC.

– **Favorable Indian weather, higher cooling requirements, increases scope for RAC demand**





RAC sales have strong correlation to changes in temperature. Cooling degree days is a metric that provides overall need of cooling. India's higher cooling requirement is expected to increase demand for cooling products including air conditioners.

Cooling degree days (CDD) measure temperatures compared with a specific temperature or comfort level and are often used to measure potential weather-related energy consumption. All else being equal, locations with high levels of cooling degree days and large populations tend to have significant demand for air conditioning. For instance, four large cities in India are much larger than Los Angeles, California, and they also have more cooling degree days than Miami, Florida, one of the hottest metropolitan areas in the United States.

Why betting on Contract Manufacturing is better in air conditioner industry?

The AC industry is highly fragmented with some high credible brands co-existing with the low priced brands. In India, most AC manufacturers follow the outsource and assembly model. There are low entry barriers in this segment. Moreover they deal into many products and not just one.

– **The contract manufacturing model allows the company to:**

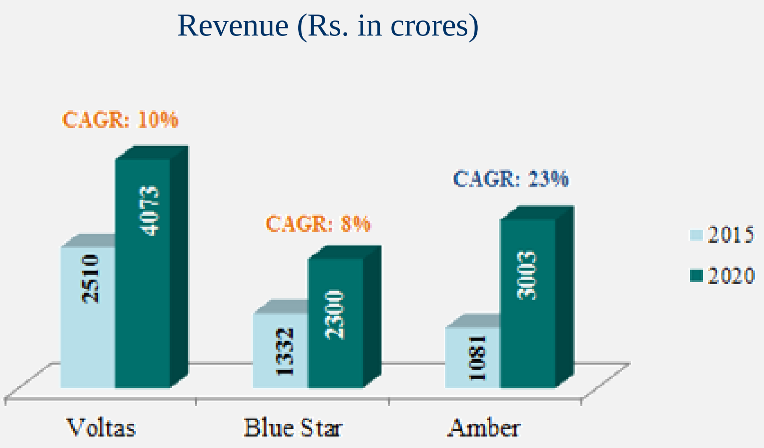
i. Optimise asset turns and low capex requirement (light balance sheet)
ii. Frees up resources for brand building, marketing and expanding distribution networks

– **Strong entry barriers on the contract manufacturing business:**

i. **Product Approval Cycle**
There are entry barriers on the component side of the business in terms of reliability cycle. It takes 2-3 years to add new customers because of the longer reliability cycle.

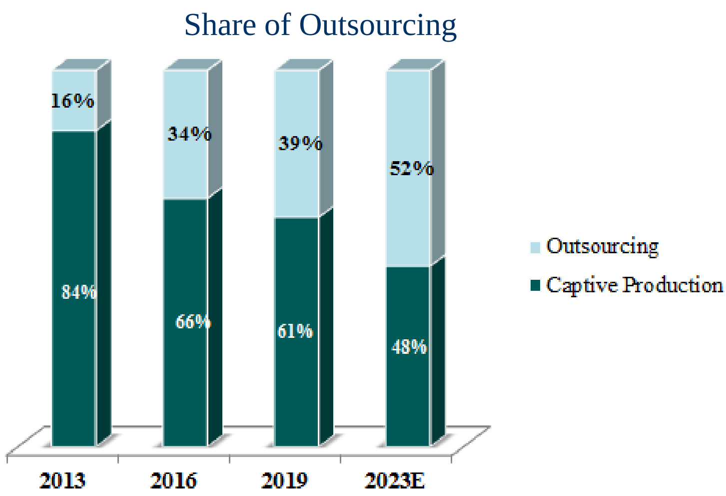
ii. **Adding new customers**
Acquisitions of new customers require continued investments, time and capital.

– **Amber's (contract manufacturer) topline grew more than 2 times the industry leader, Voltas (brand) during FY 2015-20.** This is because the company supplies multiple products and components to various RAC brands.



– **Contract Manufacturing to gain market in the coming years. Why?**

Contract Manufacturing of RAC constitutes around 39% in 2019 of the total RAC market in India. By FY 2023, it is expected to reach 52% of the total RAC market volume. The trend shows the fact that the industry is moving towards the contract manufacturing route. **The company is the leading player with 55% market share in volume terms in the overall OEM/ODM market in India.**

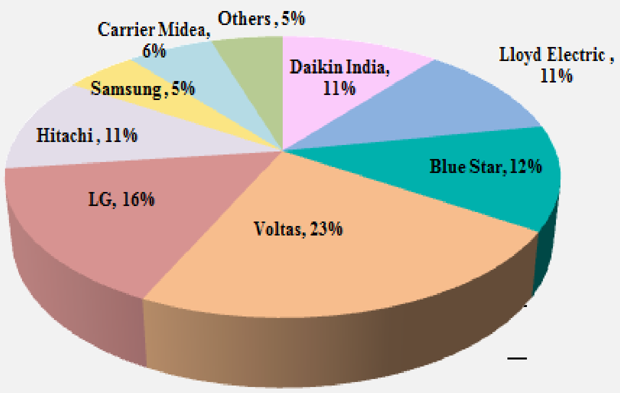


For many component businesses, it is difficult for RAC brands to justify economies of scale. Hence, they outsource from the OEMs either locally or through imports.

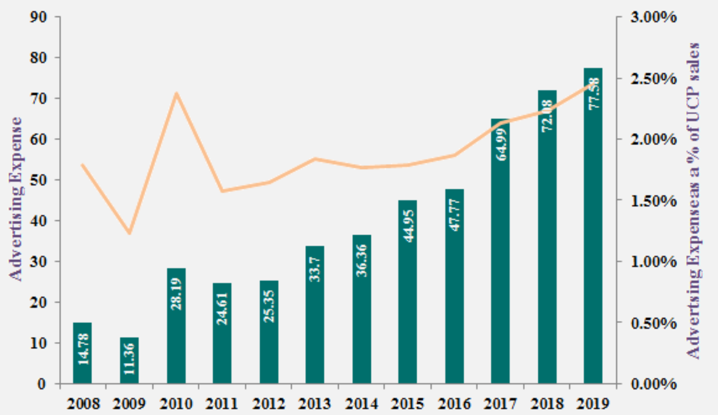
– **RAC brands prefer asset light strategy. Why?**

Intense Competition in the RAC market has forced these companies to focus on marketing and promotion to expand their sales. Distribution reach becomes the key differentiator in the business so as to expand its sale to Tier 2-3 cities.

Market Share of RAC brands



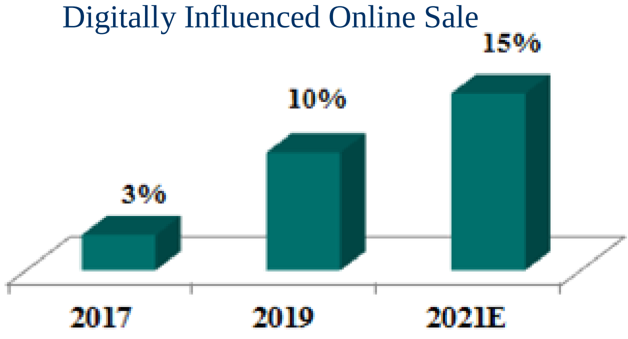
Advertisement Expenditure of Voltas



Source: Company

– Also the **entry of new e-commerce players** like Amazon and Flipkart lack backward integration and make them reliant on OEM companies.

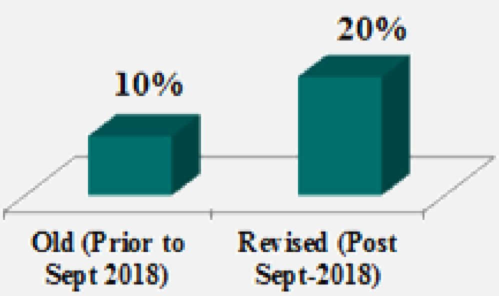
Digitally Influenced Online Sale



Source: Company

– **Hike in import duty of CBU AC**

The hike in custom duty on complete built units may push leading RAC brands to go for domestically produced products. AEL is better placed than the competitors due to:



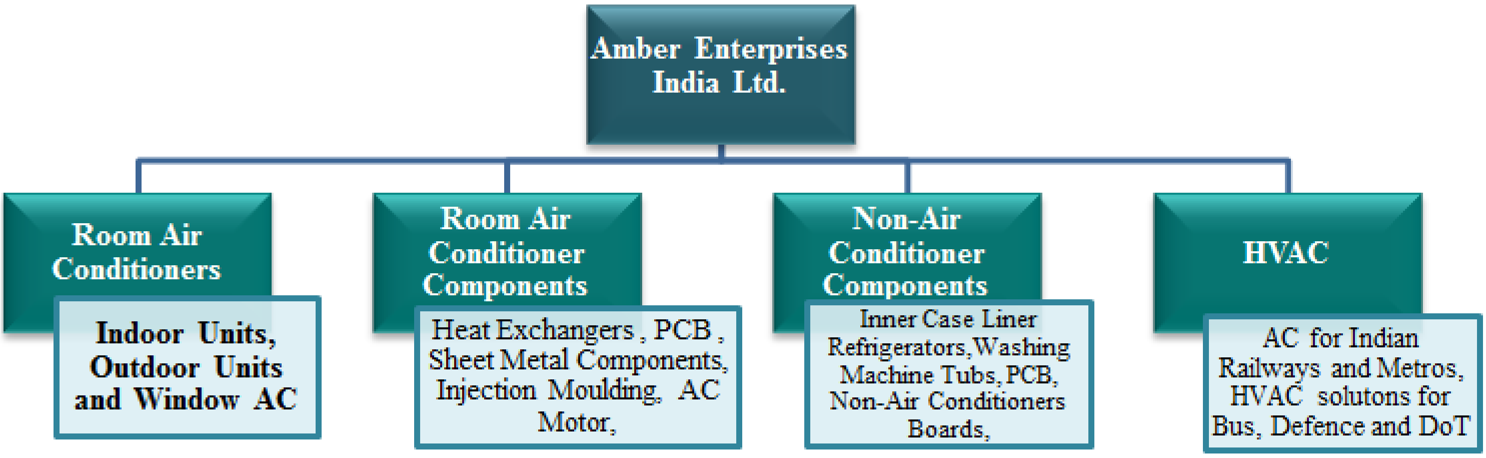
i. Backward integration

It also gives flexibility to control manufacturing process and reduce dependence on external suppliers.

ii. One stop solution provider for most needs vis-a-vis peers

This has allowed the company to increase wallet share in the existing customer companies.

SECTION II: Understanding the Business Model



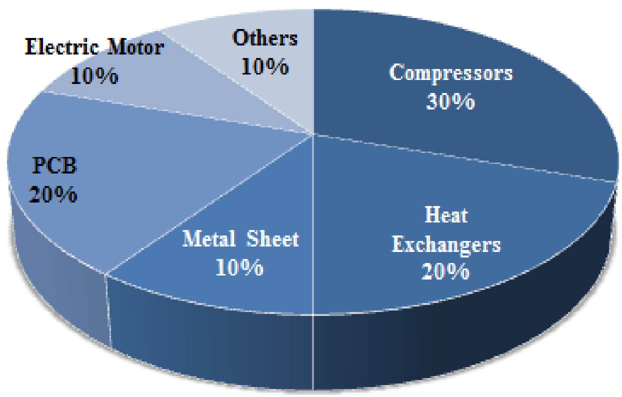
1. Room Air Conditioners: Understanding the basic working of the industry

i. How are the contracts made to contract manufacturers?

Generally, the visibility by various brands is given for one year broken into quarterly and monthly orders. The contracts are made quarterly wherein any change in price is passed on with a lag of a quarter. The company receives a one month fixed plan with a rolling plan of next two months. The rolling plan is subject to any additions or subtractions.

ii. RAC Manufacturing Cost Break up

RAC manufacturing Cost Break Up



- **Compressors**

Mostly all companies import compressors, as it requires economies of scale to become viable. There is only one company in India named Highly which produces compressors. Amber imports from China, Korea and also source domestically from India. They are largely supplied by the brands. Hence, there isn't much impact if there is any increase or decrease in price.

- **Heat Exchangers**

Amber manufactures heat exchangers at its own plant. There is captive consumption as well as procurement from other AC players.

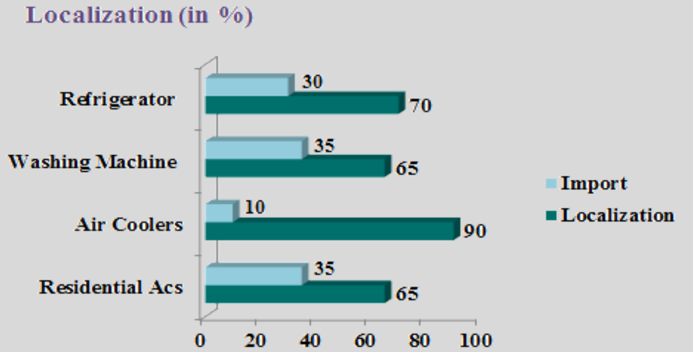
- **Printed Circuit Board**

It is generally not produced by any AC Players. Amber acquired IL JIN & EVER in 2018 becoming one of the leading producers of PCB for inverter ACs and also helping it to increase wallet share among existing customers.

- **AC Motors**

70% of the motor demand is being imported. Amber acquired PICL in 2012 to increase its wallet share among the customers. The company added resin-core motors to its portfolio in 2018 used in making indoor units AC. Earlier, it just used to manufacture motors for outdoor and window ACs. PICL is the first company to make motors for indoor units. Earlier, the entire indoor AC industry used to import the motor. As per the management, the industry size is around 5 million units. Amber Enterprise is the market leader in contract manufacturing of Room Air Conditioner in India and also manufactures components for white goods. The company has expanded its reach by entering into mobility and commercial AC segment with acquisition of Sidwal in 2019.

iii. Localization levels



AEL is a one stop solution provider in an otherwise fragmented industry offering wide range of components to RAC brands. The presence in multi-geographical region also gives the company an edge over its peers.

Daikin: Daikin's management (India), in one of the interviews stated that the strategy of higher localisation has curbed costs by nearly 35% as compared to the 2010 production expense. It has also helped the company to reduce price-gap with the market leader from 50% in 2009 to 15% in 2016.

Blue Star:

The company manufactures close to 60% of the total revenue and remaining 40% comprises of procurement from contract manufacturers within India or imports. Blue Star aims to further reduce import content and rely on domestic manufacturing and sourcing to drive higher value addition, ensure supply chain efficiency and improve margins.

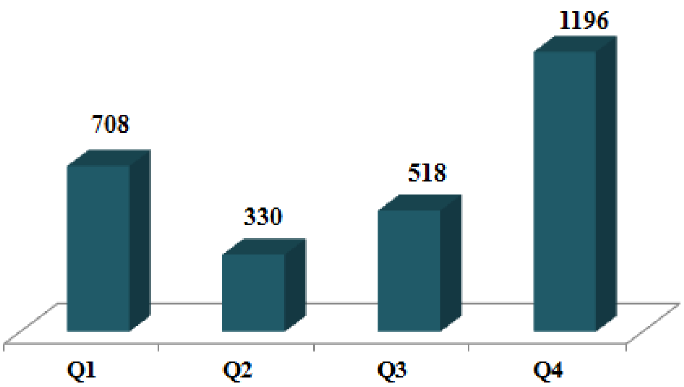
LG:

LG just buy components from Amber and doesn't outsource the complete unit but still are one of the largest customers of the company.

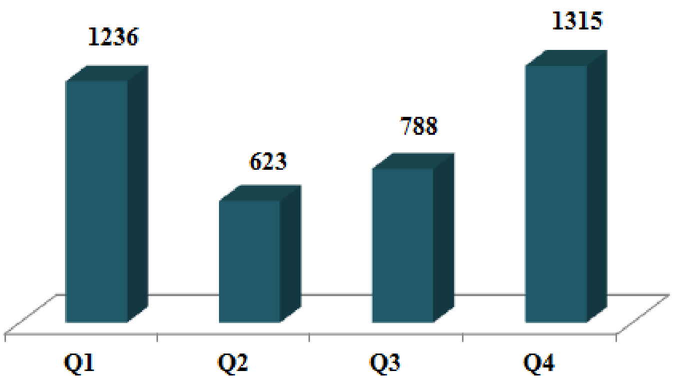
iii. Seasonal Factor

Q4 and Q1 are seasonally strong quarters for RAC sales. As per the management, delta seasonality curve has been reducing over the years. The sales might get affected due to rain in one quarter but then eventually sales would be done in next quarter. The wide geographic presence also allows having diverse sales in all seasons.

Sales FY 2019 (Rs. in crores)



Sales FY 2020 (Rs. in crores)



iv. Mult-Geographic presence and near its customers

The company's focus has been to set up plants where there is customer cluster. For instance, they haven't been able to tap Samsung because its plant is in Chennai. The company doesn't have a plant in Southern India yet because there aren't a lot of companies there. The company plans to set up a plant in the south once there is customer activity there.

v. Purchase made through Consumer Financing

For instance, 40% of the AC sales happen through consumer financing route at Blue Star. The conservative approach by consumer financing companies during COVID times could act as a hurdle for RAC brands.

vi. Capex requirement

Setting up an additional line for assembly of air conditioners doesn't require much capex. It just needs around Rs. 6-7 crores to add an additional line. But, in case of component business like heat exchangers, motors or boards, that requires heavy capital expenditure to achieve economies of scale.

SECTION III: About the Company

Amber Enterprise is mainly engaged in designing and manufacturing of room air conditioners (RAC) in India. The company is the market leader in the RAC OEM/ODM industry with a market share of 55% in terms of volume. Further, its overall share in RAC market in India, in terms of volume has grown from ~15% in FY15 to ~20% in FY 19. Today, the company caters to 8 out of the top 10 RAC brands in India.

Over the years, the company has developed 12 manufacturing facilities located near customer clusters.

Market leader in the RAC OEM/ODM industry

55%

market share (volume)

Overall share in **total RAC** market

20%

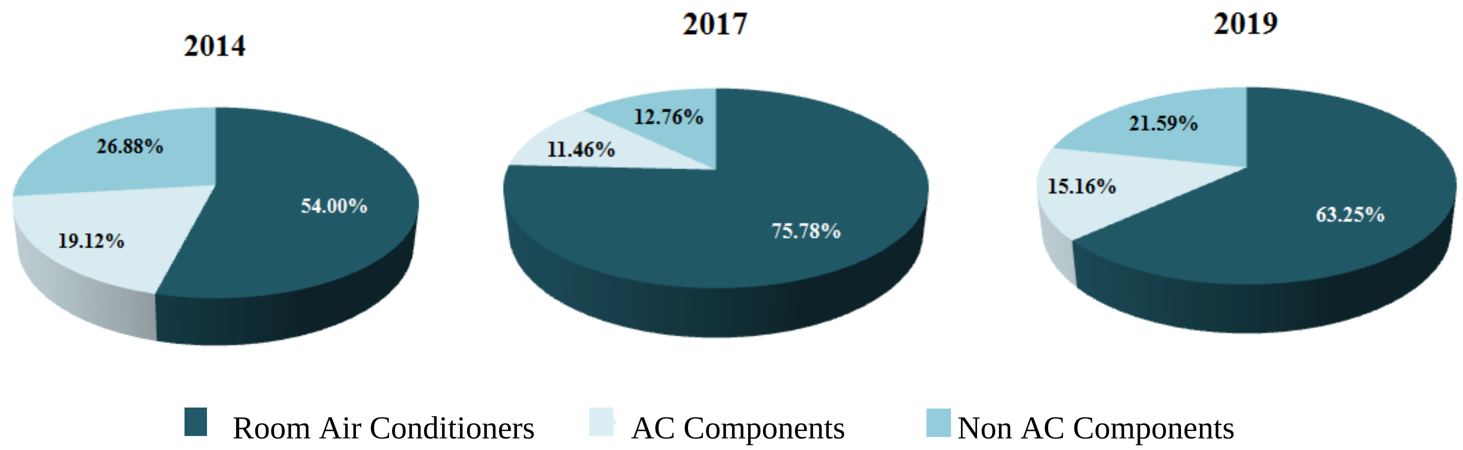
(volume terms)

Journey of Amber Enterprise India Ltd.

Initially, the company just manufactured only one component of AC (i.e. sheet metal which is 10% of the total cost) and then started manufacturing heat exchangers in 2008 (which contributes 20% to the total cost). Over the last few years, the company increased its focus on backward integration of RAC manufacturing and acquired PICL (India) Pvt Ltd to enter the manufacturing of electric motors (10% of the total cost). It also acquired IL JIN in 2017 and EVER in 2018 to foray into PCB manufacturing for inverter ACs (20% of the total cost). Further, the company also entered the heat, ventilation and air conditioning (HVAC) segment by acquiring Sidwal Refrigeration Industries Pvt Ltd in May 2019.

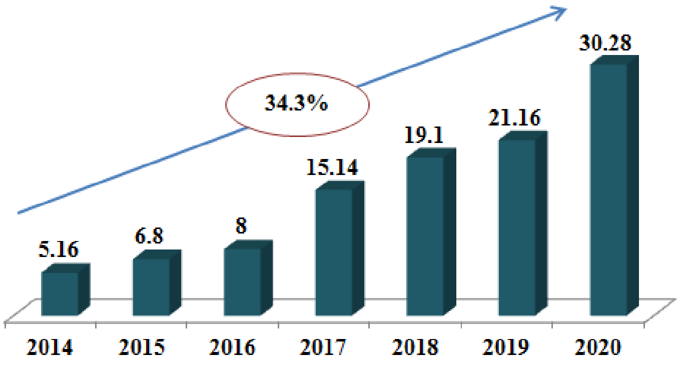
Amber has a total installed capacity of 4.8 million units.

Division Wise Distribution



Source: Company

Amber Growth Volumes (in lakhs)



Source: Company

SECTION IV: Amber's Competitive Edge

The company has performed reasonably well in the past and the earnings visibility on the basis of industry dynamics show that the **business growth is sustainable** in the coming years.

The gain in market share and the focus on backward integration shows that the company has been **able to fend competition over time**.

The company serves 8 out of top 10 RAC brands. The **large customer base** is an asset to them. The top line growth indicates that the company has been able to grow faster than the industry and gradually adding market share in the segment.

In some of the component business like PCB, the approval from customers takes almost 2-3 years. Hence, there is **a large entry barrier due to reliability cycle** on the supplier side and high switching costs for customers too.

The **one stop solution provider (backward-integrated)** and **market leadership with 55% market share** in OEM industry in an otherwise fragmented market also acts as an advantage to them. AEL is in a sweet spot to cater to the increasing demand from RAC brands.

The company focuses on just one product i.e. air conditioners and they don't intend to enter into other segments.

The margin expansion can happen through buying leverage and operating leverage. The company is now in a better position to negotiate better terms with suppliers and being a backward integrated manufacturer allows them to have reasonable negotiations with customers.

Going forward, what can play out for Amber?

COVID-19 unlocks lucrative opportunities for Contract Manufactures.

Rising fixed costs due to lockdown and uncertain outlook in some sector discourage companies from making capital investments. They would rather choose to be asset light and focus on their core competencies better if they can outsource their products from other companies. This will enable to them to not only save costs buts also take advantage of skills and economies of scale.

Amber Enterprise is expected to benefit from the current scenario on the back of solid fundamentals and some operational advantages could turn out to be in in favour of the company.

1. Lower Penetration of RAC in India and also in the white goods space provides huge growth potential as discussed above.

2. Contract manufacturing to gain share in AC manufacturing as discussed above. Amber would be the key beneficiary here.

- RAC brands prefer more of localisation

-Increase in custom duty on import of complete built units from 10 to 20%

-RAC brands focusing towards de-risking its business risk profile by reducing dependency on imports from China

-Regulatory support through government initiatives like Aatmnarbhir Bharat and Make in India focusing on increased manufacturing in India

3. High degree of backward integration in an otherwise fragmented industry acts as an advantage to the company

4. **Make in India boost:** Local manufacturing to get a boost from government steps to promote India as the manufacturing hub. Any decrease in imports makes AEL a key beneficiary.

5. Strong Customer Base is an asset to them

The company has strong and established relationships with customers which include 8 out of 10 top RAC brands in India capturing 75% market share. Customer acquisition in this industry requires continued efforts and capital. The foray into different component business has allowed the company to increase wallet share in the existing customers over the years. During FY 20, company added new customers to its list including Amazon, Flipkart, Toshiba, Midea and Samsung. In India, adding new customer requires 2-3 years.

6. Favourable weather conditions in India for RAC

7. Increasing wallet share of the existing customers and continuous acquisition of the new ones

2. Components Business Segments: Recent acquisitions

i. ILJIN and Ever

Valuation: Amber acquired 70% stake in ILJIN in Oct 2017 for Rs. 54.4 crores. The company intend to acquire the balance in FY21-22.

Products: Both the companies manufactures PCB used in inverter AC, refrigerators, washing Machines and other white goods.

Synergies: This acquisition allowed the company to foray into component business of PCB which is an integral component of RACs and generally not manufactured by any AC players. It helped the company to increase its wallet share among the existing customers.

ILJN			
(Rs. in crores)	2020	2019	2018
Revenue	325	335	334
EBITDA	18.2	16.75	11.69
Margin	5.60%	5.00%	3.50%

vi.

EVER			
(Rs. in crores)	2020	2019	2018
Revenue	297	272	225
EBITDA	10.098	5.984	7.875
Margin	3.40%	2.20%	3.50%

ii. Sidwal

The company is a leading player in the mobile AC segment with a share of 50% in Indian Railways/Metros and 80% in defence.

Sidwal's business is a high margin business and help in enhancing Amber's ROE.

The company has an order book of Rs. 167 crores from BEML which during FY2020 which needs to be executed in 18-24 months.

Valuation: The company acquired 80% stake for ~ Rs. 202 crores out of which Rs.146 crores was paid in cash and the rest was debt taken on Sidwal's book.

Synergies: It enables the company to enter the product segment which has very long approval cycle. To get approval of Railways and Defence is very challenging. Entry Barrier to this business is nearly 6-7 years. This will increase customer base and product portfolio. It's a non-seasonal business resulting in reducing non-seasonality in the current structure.

Sidwal					
(Rs. in crores)	2020	2019	2018	2017	2016
Revenue	226	180	165	124	115
EBITDA	63	35	33.8		

PICL			
(Rs. in crores)	2020	2019	2018
Revenue	185	137	143
EBITDA	11	7.398	8.6
Margins	5.95%	5.40%	6.01%

SECTION V: Management Quality

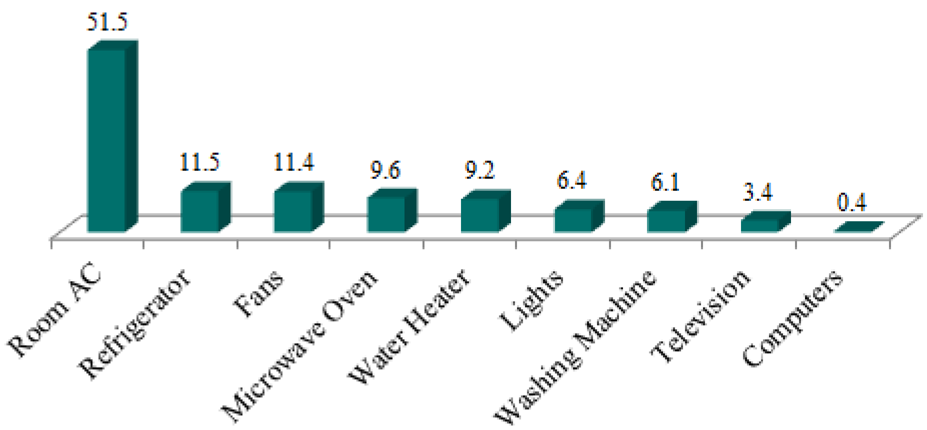
1. As discussed above in the journey of Amber section, it can be inferred that the management has focused on backward integration over the years and tried to become the one stop solution provider for the AC brands. I believe, the management's focus on just the AC segment and don't intend to enter the other consumer durable space is one of the good qualities.

2. Remuneration as a % of PAT is optimal.

SECTION V: Key Risks

1. Air Conditioners are the biggest electricity guzzlers. It increases the overhead expenses for households substantially.

Share of household appliances in electricity consumption (in %)



Source: ICICI Securities

> **Did you know?**
> Compressors consume the most electricity in air conditioners. Once the room, attains the temperature set by us, the compressor stops. Hence, ACs switched on for 8-10 hours a day continuously doesn't mean it would translate into huge electricity bills because compressor would stop once the set temperature in the room is attained.

ACs consumes much more electricity than all other appliances combined. From the chart below, we can infer that room ACs constitutes 50% of the electricity consumption of a normal household. The stark difference in the electricity bill of our own homes in summer and winter shows the share of room ACs is substantial in the total electricity bill. At full load, a typical room AC consumes about 150 times the power of an LED light and 20 times that of a regular ceiling fan.

2. Growth in air coolers will be difficult to be replaced by ACs considering the demographics of India

Air Coolers are more affordable, consumes less electricity than ACs. They lie between fans and ACs on cost and expense metrics. It's a low ticket-value purchase with plug-and-play convenience and fulfils the cooling requirements to some extent.

3. Fluctuations in metal prices and currency can impact margins in short term

4. Presence of seasonality factor in the business

Sale of RACs is high in summers and low in winters and monsoon. Extended winters or untimely rains may adversely affect the sales. The seasonality delta curve for the company has reduced to some extent.

The Investing Tales

5. Changing industry trends, technological advancements and regulatory norms

Increased AC use also exacerbates harmful climate change caused by emissions of carbon dioxide from power generation and the release of refrigerants such as hydro chlorofluorocarbons (HCFCs) and hydrofluorocarbons (HFCs), potent heat trapping gases used in air conditioners. Hence, there can be evolving regulatory norms issued by government.

SECTION V: Financials

(Rs. in crores)	2014	2015	2016	2017	2018	2019	2020
Revenue	973.3	1230.2	1089	1644.3	2171.5	2751.99	3962.79
Growth		26%	-11%	51%	32%	27%	44%
EBITDA	74.89	102.50	113.70	128.55	226.98	212.87	309.27
PAT	22.20	28.78	24.11	27.89	62.33	94.79	164.14
EPS	10.84	13.26	11.11	12.80	23.16	30.14	52.20

Ratios							
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
NP Margin	0.02	0.02	0.02	0.02	0.03	0.03	0.04
Asset Turnover	1.13	1.22	0.98	1.28	1.26	1.16	1.37
Leverage	4.11	4.22	4.25	3.84	1.94	2.41	2.57
ROE	11%	12%	9%	8%	7%	10%	15%
Debtor Days		57.84	80.34	61.97	57.90	77.31	75.59
Payable Days		72.69	102.14	90.31	102.25	116.29	105.00
Inventory Days		59.65	80.70	61.10	66.64	73.51	62.38
Cash Conversion Cycle		44.81	58.90	32.76	22.29	34.53	32.97
Debt to Equity	1.23	1.40	1.41	1.03	0.14	0.26	0.35
EBITDA Margins	0.08	0.08	0.10	0.08	0.10	0.08	0.08

(Rs. in crores)	2014	2015	2016	2017	2018	2019	2020
CFO	113.6	80.8	152.1	98.5	127.02	-63.05	288.21

Valuation			
(Rs. in crores)	**2018**	**2019**	**2020**
PE	46.17	27.09	23.48
EV/EBITDA	14.79	13.20	13.44
FCFF	24.61	-183.46	143.27
Dividend Yield	-	-	0.22%

SECTION VI: Key Takeaways

About the Company

Engaged in designing and manufacturing of room air conditioners (RAC) in India for various RAC brands

Developed 12 manufacturing facilities located near customer clusters

55% market share in OEM/ODM market in India and 20% in total RAC market (volume terms).

Why Air Conditioners?

Air Conditioner is the most under-penetrated product and highest growth is expected in white goods space in India.

The industry is expected to grow at a CAGR of 16.8% from FY19-25

Increased electrification, higher cooling requirements, reduced replacement cycle increases the scope for RAC demand.

Ambers Competitive Edge

Industry dynamics show that business growth is expected to be sustainable

Has been able to fend competition over time

Large customer base

One stop solution provider in an otherwise fragmented market

Focus is only on one product

Margin expansion can happen through buying leverage and operating leverage

Why Contract Manufacturing ?

Intense Competition in RAC market

Optimises asset returns, low capex requirements and frees up resources for brand building and expanding distribution networks for RAC brands

Strong entry barriers on contract manufacturing business in some aspects: Product Approval Cycle and Acquisition of Customers

Outsourcing is expected to increase because:

i. Preference towards localisation and focus on asset light strategy by RAC brands
ii. Hike in import duty
iii. Entry of new e-commerce players
iv. Make in India boost
v. COVID-19 unlocks lucrative opportunities

Key Risks

Air Conditioners are the biggest electricity guzzlers. It increases the overhead expenses of households.

Growth in air coolers cannot be replaced by ACs.

Financials

(Rs. in crores)	2016	2017	2018	2019	2020
Sales Growth	-11%	51%	32%	27%	44%
EBITDA Margins	10.44%	7.82%	10.45%	7.74%	7.80%
EPS	11.11	12.80	23.16	30.14	52.20
Debt to Equity	1.41	1.03	0.14	0.26	0.35
ROE	9%	8%	7%	10%	15%
ROCE	16%	14%	18%	12%	15%
CFO	152.1	98.5	127.02	-63.05	288.21

Disclaimer

I am not a SEBI Registered Analyst. The views expressed therein are based on information available publicly/internal data/other reliable sources believed to be accurate. The information is provided merely for education purpose.