THE SCANNER

Wealth Creation or Risk Exposure? A Deep Dive into an Indian EV Manufacturer's IPO

The current investment landscape in India is highly fertile, offering myriad opportunities for wealth creation. More importantly, the prevailing economic and business environment in the country is giving rise to multiple businesses with varying models. These businesses often cannot be assessed through purely traditional methods and require a more comprehensive evaluation. If not assessed robustly, investors might overlook the red flags and expose themselves to companies with dubious accounting practices and riskier business models with relatively high valuations. A case in point is a leading EV 2-wheeler manufacturer in India that is gearing up for an Initial Public Offering (IPO). The subject of our analysis is one of the largest electric 2-wheeler (E-2W) players, commanding a share of 52% in India's E-2W market . The company averages sales of 20,000 units per month, and in December 2023, it became the first EV company in India to sell over 2.5 lakh units in a year . Despite these noteworthy milestones and the potential presented by the player, investment in the company requires further due diligence.

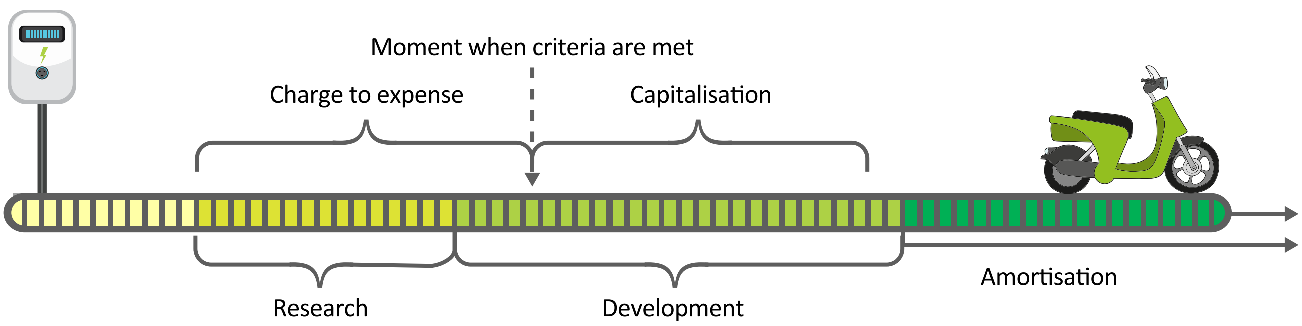
Apart from other analyses, there are four key points that investors should underscore and consider before making an investment decision:

Capitalisation of Research & Development (R&D) expenses:

From an accounting perspective, R&D expenses can be treated in two ways - if the R&D expense is incurred during the research phase, it should be expensed in the P&L, and if it is incurred during the development phase, it needs to be capitalised. In 2024, the EV manufacturer spent a cumulative INR 3.8 billion on R&D and capitalised around 80% of this expenditure. Over the years, the company has **capitalised ~80% - 90%** of its overall R&D spend. On the other hand, peers in the industry who have incurred similar R&D spends, **expensed ~93%** of the R&D spend and capitalised the rest. Another competitor of the company has a lower comparative intangible asset base, both in absolute and relative terms, indicating that the competitor also may not be capitalising a major share of its R&D spend.

The divergence between the two accounting policies is significant. Apart from deferring the expenditure, the company also has the leeway to amortise this expenditure over a time period that suits it well, considering that it uses a management estimate for the useful life of the asset. Further, early investors generally look at a path to profitability, and the capitalisation of R&D costs can aid in that direction by artificially propping up profits. The accounting policies adopted by the EV manufacturer are far more aggressive than those of industry peers.

Exhibit: Treatment of R&D expenses



1. Link 1
2. Link 2

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Extended Working Capital (WC) Cycle and Path to Profitability:

The EV manufacturer follows a business model where the bikes are directly sold to customers. This is significantly different from established peers who sell their bikes via dealers and thus maintain a relatively stable WC cycle. In FY 24, the company improved its WC cycle and brought it in line with peers. However, the company continues to bear inventory risk, with payable days significantly higher than industry peers. Extending the WC cycle by keeping the payable days more than the industry may not be sustainable, as vendors might demand similar payment terms. Thus, the WC cycle needs to be tracked to understand the capital needs of the company, because similar payable days as peers will require the company to invest in WC. If payable days move towards peers' payable days, then funding growth for the company may require additional investment in WC. Even a close competitor has a similar WC cycle to the well-established players, as it follows a similar business model. Also, because of the company's business model of owning its distribution network, it will require additional capital compared to peers for growth. It is unlikely that the working capital will be able to optimally fund this growth.

Further, a closer look at raw material costs indicates that ~85% - 90% of the sales of the EV manufacturer are raw material costs, which is significantly higher than the 70% maintained by peers. Considering a poor cost structure and potentially greater requirement of capital to fund growth compared to the well-established players, the company's path to profitability might be long drawn. Additionally, currently, the segment is a high-growth segment, which is likely to attract competition and thus capital. Increased competitive intensity will potentially diminish returns in the segment.

Product Quality:

The EV manufacturer provides warranties for its bikes as well as for the battery and battery life, and if anything happens, they have to reimburse or repair the bike during that time. The company has spent 6% of its total revenues on warranty costs in FY 24, and this expense has been on the rise since FY 22, when it was at 3.5% of sales. We can compare this to two other EV players in the market. In FY 22, competitor 1 had a warranty cost of 0.6% of revenues, compared to 3.5% for the company. In FY 23, competitor 2 had a warranty cost of 3.5% of revenues, compared to 4.4% for the company. Further, competitor 2 has seen a relative decline in warranty costs from the previous year. Well-established players have a minimal amount as warranty costs. This may indicate that the product might not match the quality of peers and thus requires higher warranty costs. This also puts pressure on the margins of the company and adds to the uncertainty around the path to its profitability.

Valuation:

Based on the most recent funding round, the company was valued at ~USD 6 billion. However, the IPO of the company is at an ~25% discount to the previous funding round. This is higher than its closest competitor, which is valued at USD 680 million (based on a funding round completed in June 2024[3]) , which is approximately a third of its size in terms of revenue generated. Additionally, the company's current valuation is ~35% of the valuation of the largest 2W manufacturer in India. The current multiples of the company indicate an implied growth of 10-12% for the next 10 years with a P/Sales of ~2-3. Although the EV market can grow at that rate, profitability for the high multiple can be a concern, especially when established players are trading at cheaper multiples.

Considering the red flags highlighted above, and uncertainties regarding the road to profitability, we believe that the current valuations may not be justified. The relevant multiples for the company are as follows:

Exhibit: Valuation Metrics (INR)

3. Link 3

Exhibit: Comparative valuation

	EV Manufacturer	Industry player 1	Industry player 2
P/Sales	7	5.8	2.9
P/BV	19	9.0	6.1

Exhibit: Comparison of working capital cycles

Particulars	EV Manufacturer (FY 24)	Industry Player 1 (10-yr Average)	Industry Player 2 (10-yr Average)
Receivable Days	12	20	20
Inventory Days	51	18	18
Payable Days	99	58	56
Cash Conversion Cycle (No. of days)	(36)	(20)	(19)

Keeping in mind the above fundamental and valuation metrics, it would be prudent for investors to be judicious in their approach to this IPO.

Q&A

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What are your views on the growth potential of the EV industry in India?

The EV industry in India and around the world is currently in its nascent stages. The level of penetration of 2Ws in India, on an overall basis, is lower than in other countries. In terms of E-2Ws, the level of penetration remains very low. According to an industry report, in the first half of FY 24, E-2Ws accounted for approximately 5% of all 2W registrations. The report further suggests that there is a significant scope for growth in the EV space, especially for 2Ws. The share of EVs in the overall market is expected to increase to 20-25%, growing at ~70% during the period.

Do you see competition for EVs from other fuel sources?

Over the years, there could be competition from other fuel sources as well. Although not direct competition, one of India's leading two-wheeler manufacturers launched its CNG bike recently, which is significantly more cost-efficient than petrol bikes. Better availability of CNG compared to charging stations can act as a deterrent for customers to buy an EV. There have been developments in hydrogen as a fuel for mobility, and prototypes have been developed for an ICE engine based on hydrogen as a fuel. The proliferation of this technology can also be a source of competition for the EV space. However, EVs continue to remain the most cost-efficient currently among all the variants and have significant growth potential.

What do you think are the key ingredients for the success of EVs?

It is a business of selling scooters and will attract competition from incumbent players and new players, as seen in the Indian market currently. A large market with significant growth potential usually attracts a lot of competition. However, in the end, companies that keep an eye on costs while delivering a good product to consumers are likely to succeed. A case in point has been one of India's leading bike manufacturer's foray in African markets where it has been able to establish itself as one of the largest 2W sellers despite stiff competition from Chinese players who sell at low costs. The Chinese players were present for a while in these markets; however, good product quality, although at a higher price than Chinese players, has helped the company gain a leading market share in the African markets. The distribution network, the proliferation of EV charger networks, and improvement in the range of the vehicle are other key factors that will play a role in the success of the product.

Is the government incentivising the growth of EVs in India?

The government has rolled out various schemes that are focused on incentivising the growth of the EV ecosystem. The National Electric Mobility Mission Plan 2020 of the Government of India covers multiple incentives, including FAME subsidies, lower GST, and favourable registration fees for EVs. In 2020, the Indian government launched the PLI scheme to boost domestic manufacturing, reduce import dependence, encourage exports, and generate employment. The FAME schemes had provided subsidies for purchasing 2-wheelers, but these have been slashed by approximately half since June 23.

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