Sector Note

Construction and Materials | India | June 14, 2021

INITIATION

India

Neutral *(Initiating coverage)*

Highlighted Companies

Astral Ltd.

REDUCE, TP Rs1720, Rs1935 close

Improving sales mix and scale benefits would lead to superior EBITDA/EPS CAGR of 17%/15% over FY21-23F. Cyclical uptrends have led to premium valuation. We initiate coverage with a Reduce rating.

Supreme Industries

HOLD, TP Rs2345, Rs2249 close

Diversified presence across plastic products segment with market leadership position. Incremental share gains, higher value-added product sales and capacity reinvestments are catalysts for future growth. Steep PVC prices have led to stock price doubling over the past 12 months. We initiate coverage with a Hold rating.

Kajaria Ceramics

ADD, TP Rs1176, Rs1022 close

Clear beneficiary of global vendor diversification programme led by COVID-19. Healthy volume growth, cost controls and bathware turnaround are key positives. Joint ventures/outsourcing partnerships ensure low capex. Dividends stepped up. We initiate coverage with an Add rating.

Summary Valuation Metrics

P/E (x)	Mar21-F	Mar22-F	Mar23-F
Astral Ltd.	96.94	88.57	73.12
Supreme Industries	29.24	35.29	34.52
Kajaria Ceramics	47.05	38.21	32.02

P/BV (x)	Mar21-F	Mar22-F	Mar23-F
Astral Ltd.	20.5	17.4	14.81
Supreme Industries	9.01	7.72	6.77
Kajaria Ceramics	8.55	7.64	6.78

Dividend Yield	Mar21-F	Mar22-F	Mar23-F
Astral Ltd.	0.1%	0.26%	0.36%
Supreme Industries	0.98%	0.98%	1.07%
Kajaria Ceramics	0.98%	1.22%	1.47%

Analyst(s)

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Building Materials

Structural demand shift to national brands

- Demand revival in urban housing/industrial capex is well supported by strong growth in rural consumption; investing to widen reach and new capacities.
- Higher market cap plastic pipe stocks are pricey today. Relative valuations are attractive for tiles/ply/bathware/metal pipe stocks, in our view.
- Initiate coverage with Neutral sector rating (marketcap based). Add ratings on APL/Cera/Kajaria/Century Ply, Hold on Supreme/Finolex, Reduce on Astral.

Well-balanced demand recovery from all customer segments

Discretionary retail consumption, industrial capex and government project expenditure are key demand drivers for building material products. We glimpsed some demand recovery during the COVID-19 unlocking (2Q-4QFY21). Customer sub-segments include urban residential/commercial real estate, rural housing, private/public sector factory capex and government capex on improving basic living standards and better urban infrastructure. Building material companies have announced capex plans to create supply to meet rising demand. We estimate sales CAGR of over ~15% across all five product categories covered in this report over FY21-23F.

Adequate supply being created to meet robust demand

Companies plan to invest to widen/deepen their national distribution reach and create supply commensurate with expected rise in demand. The COVID-19 pandemic accelerated the market share shift towards national brands that started with demonetisation (Nov 2016) and Goods and Service Tax laws (Jul 2017). Manufacturing plants at all four corners of India (lower transport costs/lead time), enhancing wholesaler/distributor network in top cities in every Indian state and being available in all ~19k PIN codes should improve reach in the Indian hinterland to cater to customers earlier served by the unorganised sector. Faster growth in tier-2/-3 cities would lead to improving share of rural revenues, in our view.

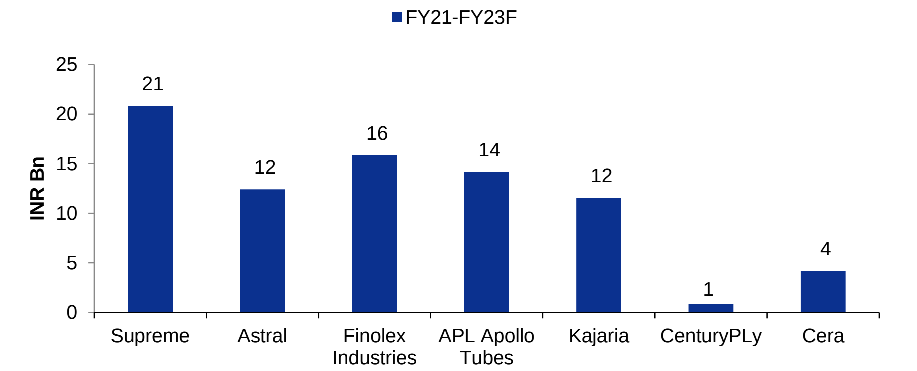
Expect average profit CAGR of 18% at an average RoCE of +25%

We expect improved ability to pass on input cost inflation, better sales mix due to higher value-added product sales, optimum manufacturing capacity utilisation and COVID-19-led cost discipline to result in EBITDA margin expansion for sector companies. Strict working capital management and unfinished capex led to lifetime-high free cash flow in FY21. We estimate average EPS CAGR of 18% over FY21-23F and FY23F RoCE of +25% for our coverage companies. Cumulative capex/FCF will be Rs38bn/Rs80bn over FY21-23F.

Valuation and risks, initiate with Neutral sector rating

We are enthused by market share gains, superior business execution capability and capital allocation discipline for all companies covered in this report. However, we initiate coverage on the sector with a Neutral (market-cap weighted) rating. We see no/limited upside potential for plastic pipe stocks and, hence, have Reduce ratings on Astral and Hold on Supreme and Finolex, and Add ratings on APL, Kajaria, Century Ply and Cera. Upside risks: High PVC prices, faster drop in competition. Downside risks: adverse FX rates and capex execution delays or cost overruns.

Figure 1: Cumulative free cash flow for our coverage companies (Rs bn)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

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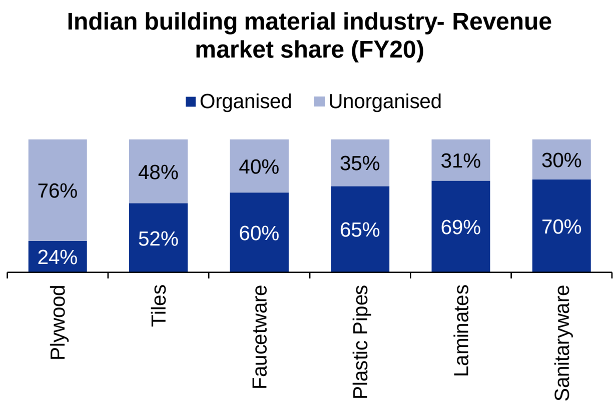
KEY CHARTS

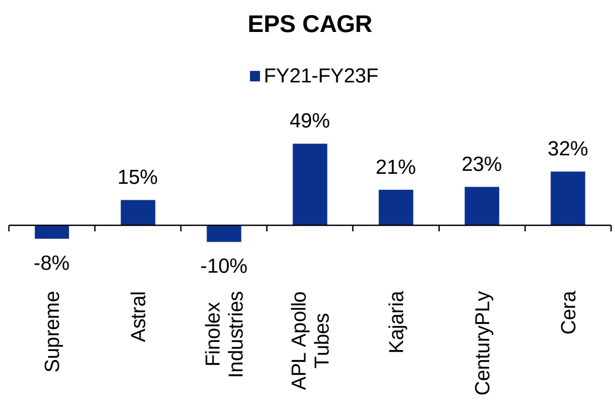
Scope for market share expansion

There is sufficient scope to capture revenue market share from the unorganised sector in India across product categories for building material products. Plywood presents the maximum scope to expand presence with laminates/sanitaryware being reasonably organised categories.



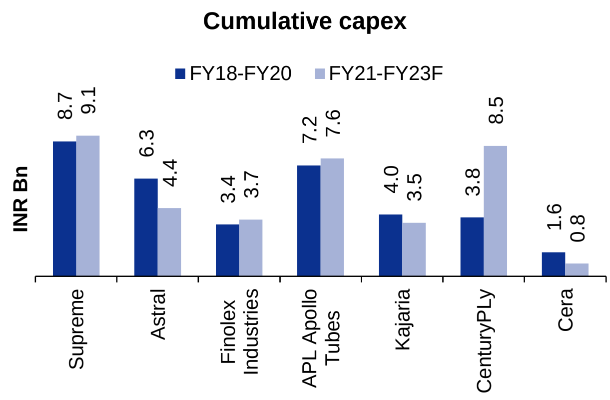
Strong profit growth, except for plastic product companies

We expect strong performance of sub-sectors like metal tubes, tiles, plywood and sanitaryware over FY22-23F. Plastics pipe manufacturers would report lower profit growth than the above listed sectors, in our view.



Planned capex trends

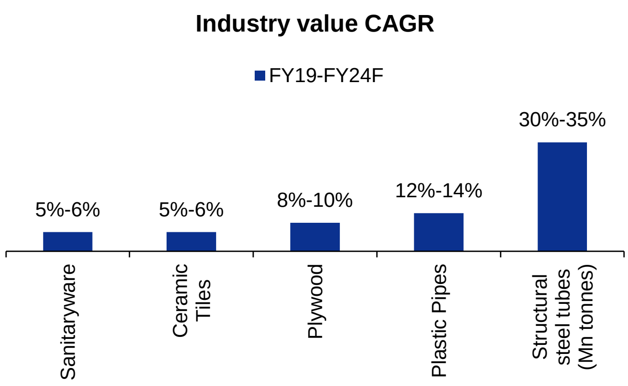
We expect cumulative capex over FY21-23F to be largely flat compared to the past three fiscals. Astral, Kajaria and Cera have planned for lower capex than in the past, while Century Plyboards will invest in greenfield projects.



Tubes and pipes industry growth higher versus others

The metal structural tube and plastic pipe industry growth would be much faster than sanitaryware, tiles and plywood industry over the next three years (Prince Pipes Red Herring Prospectus).

We think this reflects in premium valuations of the stocks as well. At current stock prices, plastic pipe stocks offer no/limited upside potential, in our view.



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, PRINCE PIPES RED HERRING PROSPECTUS

Figure 2: Peer comparison table

Company Name	Bloomberg ticker	Rating	Market cap US$m	Closing price (Rs)	Price Target (Rs)	Upside (%)	P/E (x)		EV/E (x)		CAGR % (FY21-23F)		FY23F	
							FY22F	FY23F	FY22F	FY23F	Revenue	EPS	RoE (%)	RoCE (%)
Astral Ltd.	ASTRA IN	REDUCE	5,320	1,935	1,720	-11.1	88.6	73.1	54.5	45.9	17.1	15.1	21.9	28.6
Supreme Industries	SI IN	HOLD	3,909	2,249	2,345	4.3	35.3	34.5	23.3	21.5	8.4	-8.0	20.9	25.7
APL Apollo Tubes	APAT IN	ADD	2,461	1,440	1,592	10.5	35.7	22.6	20.4	14.9	20.1	48.6	31.1	36.2
Kajaria Ceramics	KJC IN	ADD	2,225	1,022	1,176	15.1	38.2	32.0	23.8	20.2	17.1	21.2	22.4	28.0
Finolex Industries	FNXP IN	HOLD	1,459	172	180	4.7	22.7	19.6	16.1	13.7	6.2	-9.8	19.0	22.0
Century Plyboards	CPBI IN	ADD	1,274	419	469	11.9	38.9	30.2	24.2	18.5	17.7	26.7	18.8	22.2
Cera Sanitaryware	CRS IN	ADD	776	4,360	5,140	17.9	40.7	32.2	25.6	20.4	17.0	32.1	16.5	20.3
Simple Average							**42.9**	**34.9**	**26.8**	**22.1**	**14.8**	**18.0**	**21.5**	**26.1**
Havells India	HAVL IN	ADD	8,713	1,017	1,174	15.4	55.9	47.7	36.6	31.3	12.0	13.1	21.2	26.5
Polycab India	POLYCAB IN	HOLD	3,720	1,823	1,706	-6.4	31.1	25.6	19.3	16.0	15.7	9.8	18.3	23.5
KEI Industries	KEII IN	ADD	826	672	677	0.7	17.6	13.9	10.6	8.3	18.6	26.1	18.9	24.7
Crompton Greaves Consumer Electricals	CROMPTON IN	ADD	3,698	430	443	2.8	46.7	38.9	34.1	28.4	12.4	6.5	29.6	39.1
Finolex Cables	FNXC IN	ADD	1,049	501	504	0.6	15.7	14.1	11.7	9.8	13.2	16.0	13.6	14.4
V-Guard Industries	VGRD IN	ADD	1,568	266	291	9.1	46.6	39.4	31.4	27.3	13.5	20.4	19.4	25.6
Orient Electric	ORIENTEL IN	ADD	887	306	347	13.5	43.6	39.6	24.3	21.6	14.4	16.9	26.9	38.8
Simple Average							**36.7**	**31.3**	**24.0**	**20.4**	**14.3**	**15.5**	**21.1**	**27.5**

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG. DATA AS AT 11 JUN 2021

Structural demand shift to national brands

Growth drivers

Given the uptick in the infrastructure and industrial capex anticipated, based on India's public and private sector capex plans, we think various customer segments would collectively contribute to the building material industry growth going forward:

- **Urban infrastructure:** The government of India plans to have 100 additional airports by 2024 and invest Rs190bn in upgrading airport infrastructure especially in smaller cities over the next three years in India.
- **Urban real estate:** India's vertical growth increased the number of high-rise buildings with Ground floor+20 floors or more to record highs in 2019 (Source: APL Apollo Corp investor presentation). The government has formed a panel to look into the upward revisions of floor space index (FSI) norms in all major cities. This implies similar high-rise construction spreading over a lot of urban areas and tier-1 cities.
- **Affordable housing:** Trends for affordable housing at low cost and faster completion is picking in India. Modular buildings will be the future construction methodology. Modular steel structures are constructed in-house with final assembly occurring on-site, where the steel modules are stacked and connected together.
- **Irrigation:** About 72.2m hectares are still under rainfed conditions (according to Land Use Statistics at a Glance 2006-07 to 2015-16). During FY20, 1.2m hectares was brought under micro-irrigation, the highest coverage in any calendar year so far. Since Apr 2016, Central government assistance of Rs133bn has been released to the States for the implementation of Pradhan Mantri Krishi Sinchayee Yojana (PMKSY-PDMC), which includes Rs13.5bn released during 9MFY21. The Rainfed Farming System (RFS) division is implementing the Per Drop More Crop Component of the PMKSY-PDMC and Rainfed Area Development (RAD) component of the National Mission for Sustainable Agriculture (NMSA).

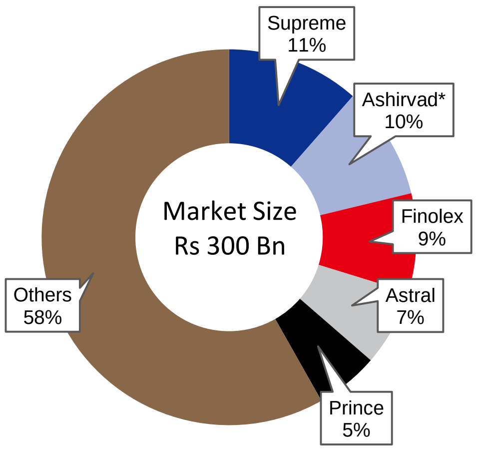
Figure 3: Private capex announcements over Nov 2020 - Mar 2021

Company	Industry	Intimation date	Capex value (Rs m)	Completion time	Area of capex
Lux Industries	Textile	23-03-2021	1,100	Mar-Sep 2022	Manufacturing + Warehousing
Indo Count	Textile	18-03-2021	2,000	Sep 2021	Manufacturing (expansion of bed lined capacity) + modernising spinning capacity
Bajaj Electricals + Mahindra Logistics	Logistics	03-03-2021	10,000	To be spent over the next 5 years	Warehousing + supply chain--> two large ultramodern mega-warehouses in Delhi and Mumbai, with latest technology, automation
MAX Ventures and Industries	Commercial RE	10-02-2021	6,000	The company recently leased ~62,500 sq. ft. to Yes Bank and ~7,300 sq. ft. to DBS It leased ~25,000 sq. ft. at Max Towers to Indian Energy Exchange (IEX) Limited	Leased 80,000 sq. ft. office space at Max Towers, Noida, to Cyril Amarchand Mangaldas
Metropolis	Healthcare	05-02-2021		Complete	New 5,200 sq. ft. laboratory in Kochi
Hindustan Foods	FMCG	22-12-2020	1,250	Mar 2022	Food and beverage manufacturing facility for a leading FMCG brand in North India
Hindustan Foods	FMCG	01-11-2020	1,500	Dec 2021	Home and personal care product manufacturing plant at Hyderabad
Navin Fluorine International	Specialty Chemicals	16-12-2020	1,950	Sep 2022	Life science and crop science multi-purpose plant at Dahej
Meghmani Organics	Agro Chemicals	26-11-2020	1,520	Completed	Expansion of Herbicide 2, 4 D Acid
Meghmani Organics	Agro Chemicals	26-11-2020	3,100	Mar 2022	Expansion of caustic soda and captive power plant capacity
MAX Ventures and Industries	Commercial RE	23-11-2020	4,000	Mar 2023	Construction of 0.7m sq. ft. of retail and office space on Noida Expressway.
Lumax Industries	Automobile	27-03-2021	800	Dec 2021	New unit at Sanand, Gujarat, for MG Motors and others
Minda Industries	Automobile	27-03-2021	900	Mar 2022	New unit at Bhagapura, Gujarat, for 4W automotive lighting
Minda Industries	Automobile	27-03-2021	1,670	Jun 2022	Expansion of the Bawal, Haryana, 4W alloy wheel plant

SOURCES: INCRED RESEARCH, COMPANY REPORTS

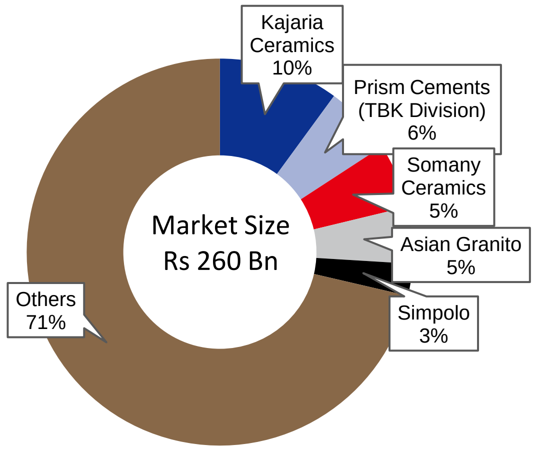
Industry landscape

Figure 4: India's plastic pipes market size and share (FY20)



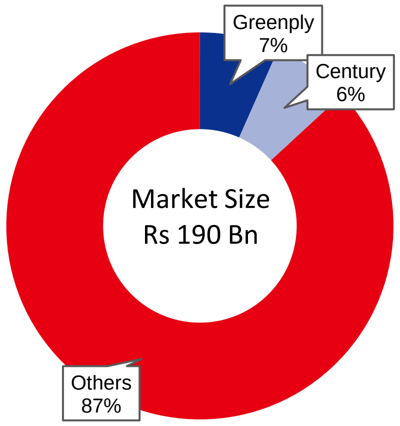
*COMPANY LEVEL REVENUE CONSIDERED FOR ASHIRVAD PIPES
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 5: India's tiles market size and share (FY20)



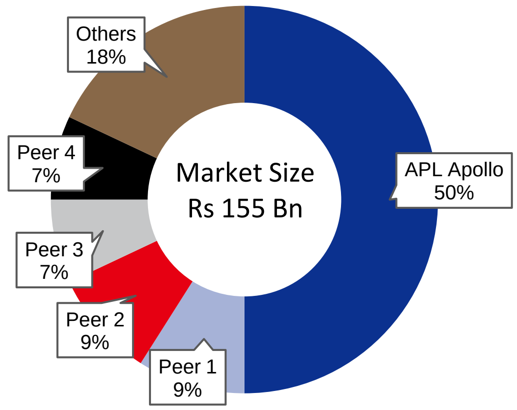
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 6: India's plywood market size and share (FY20)



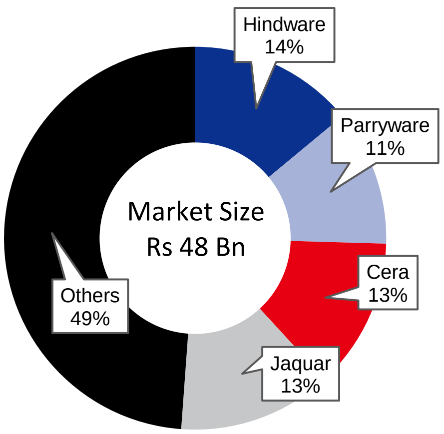
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 7: Structural steel tubes market size and share (FY20)



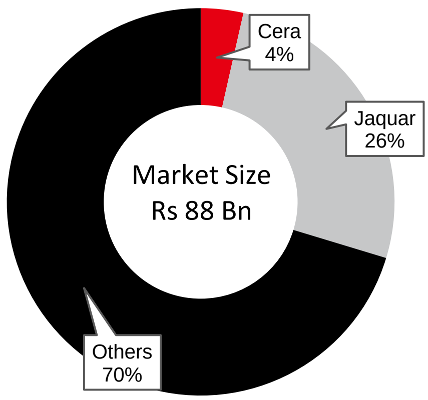
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 8: Sanitaryware market size and share (FY20)



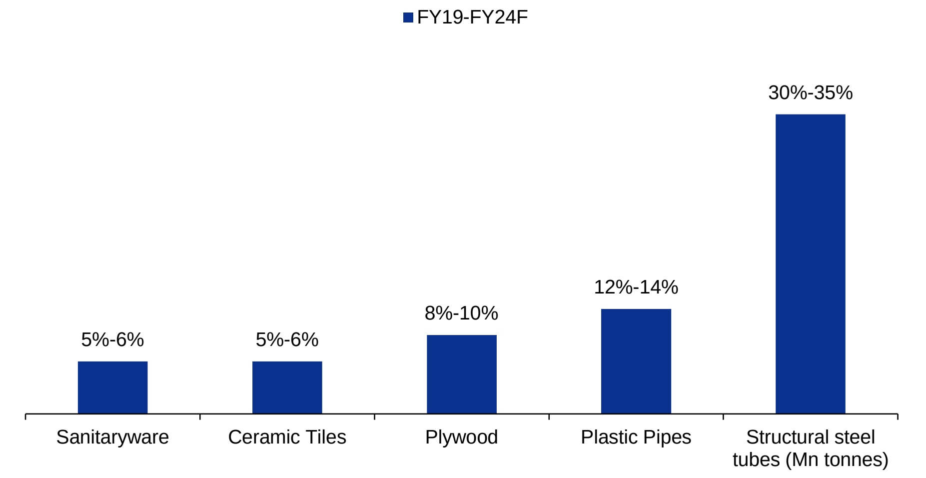
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 9: Faucetware market size and share (FY20)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

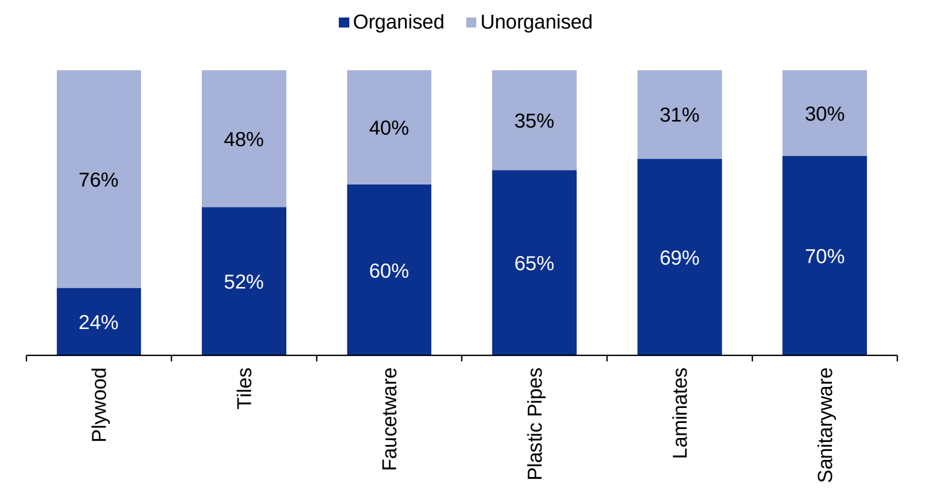
Figure 10: Industry value growth CAGR over FY19 to FY24F



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, PRINCE PIPES RED HERRING PROSPECTUS

Numerous customers are still served by regional unorganised players in India. Given relatively stronger balance sheets, our coverage companies can invest sensibly and continue to gain from market share structural shifts.

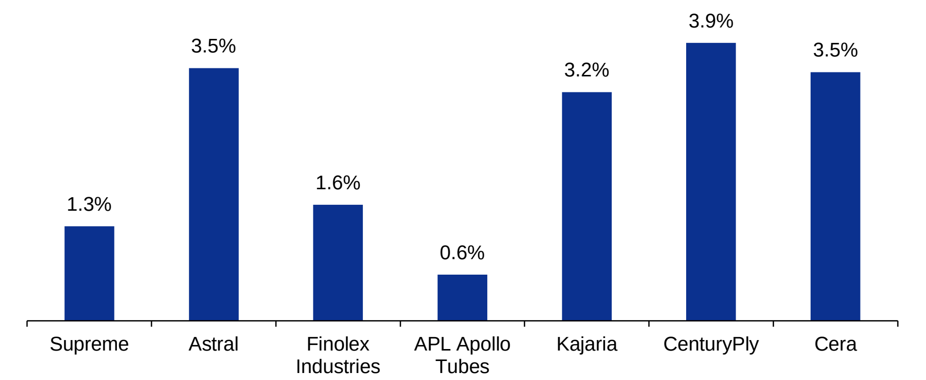
Figure 11: Organised sector share for building material categories (FY20)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Advertising spends are higher for customer-facing product companies. Pipe companies too are trying to build brand equity and influence customer decisions by increasing ad spends.

Figure 12: Advertisement and sales promotion spends as % of sales (FY20)



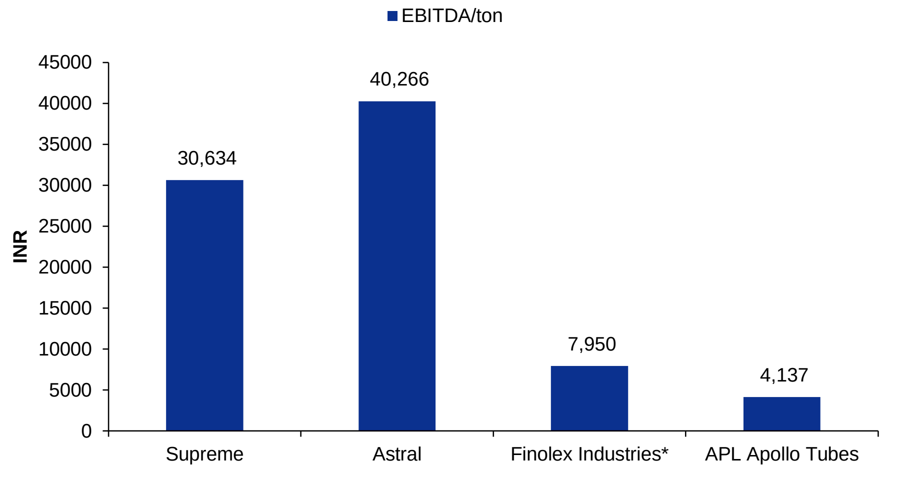
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 13: Advertisements by coverage companies

SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Higher CPVC pipe revenue mix leads to better blended margins driving the EBITDA/tonne matrix for plastic pipe companies. Agri-pipes earn relatively lower margins while metal pipes (not directly comparable) are working to improve unitary profit margins.

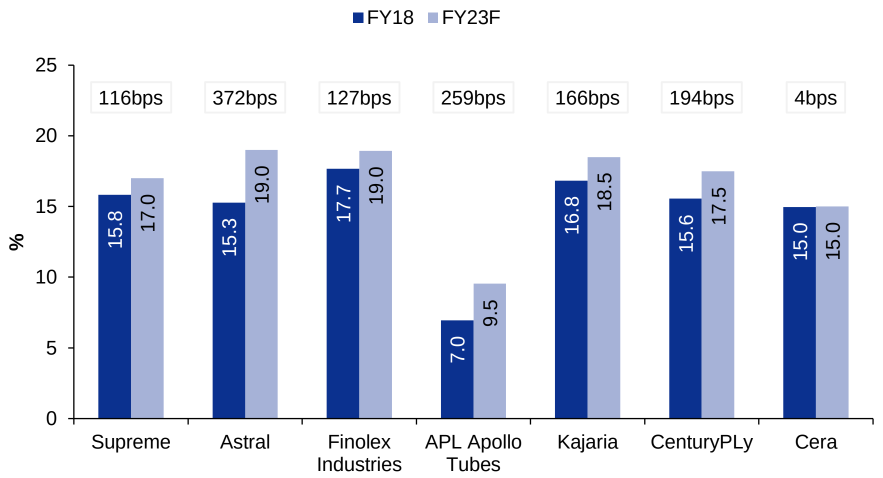
Figure 14: EBITDA/ton of plastic/metal pipe companies (FY21)



EBITDA/TON INCLUDES INVENTORY GAINS ;*FY20 EBIT/TONNE FOR FINOLEX INDUSTRIES
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Higher value-added product mix, efficient raw material sourcing methods, disciplined expense management and operating leverage have led to higher EBITDA margins.

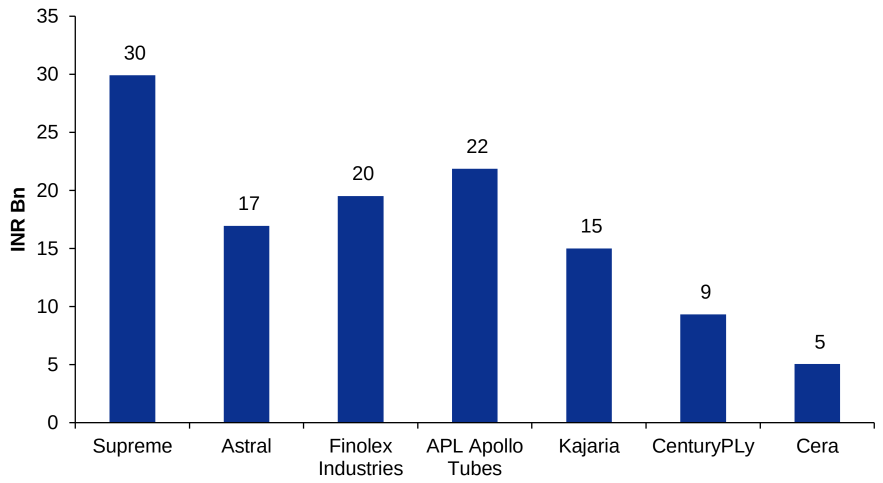
Figure 15: EBITDA margin trend across coverage companies



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Good working management and healthy operating cash flows for our coverage companies reflect superior business execution skills and brand power. Unorganised players do not possess this and lose out on competitiveness.

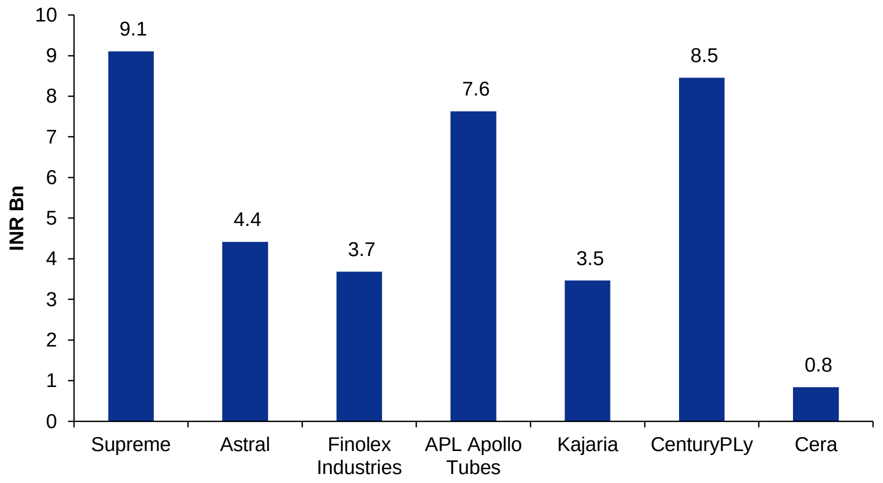
Figure 16: FY21-FY23F cumulative operating cash flow



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

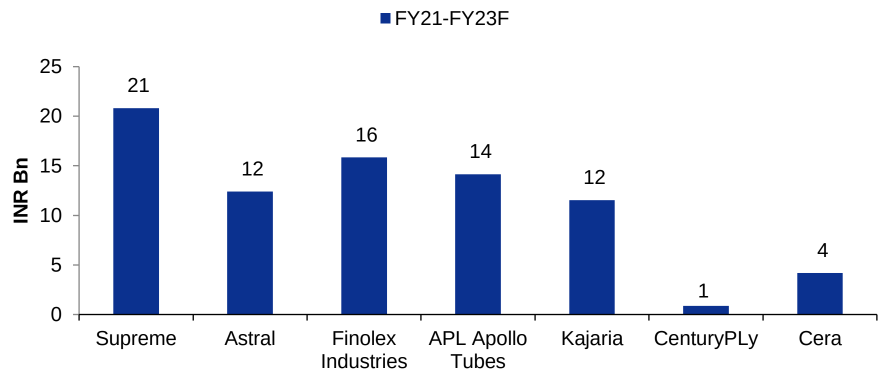
Capex intensity for the sector will remain largely similar to historical levels (cumulative capex of Rs38bn over F21-23F vs. Rs35bn over FY18-20). Supreme, APL Apollo and Century are investing in greenfield capacities.

Figure 17: FY21-FY23F cumulative capex



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

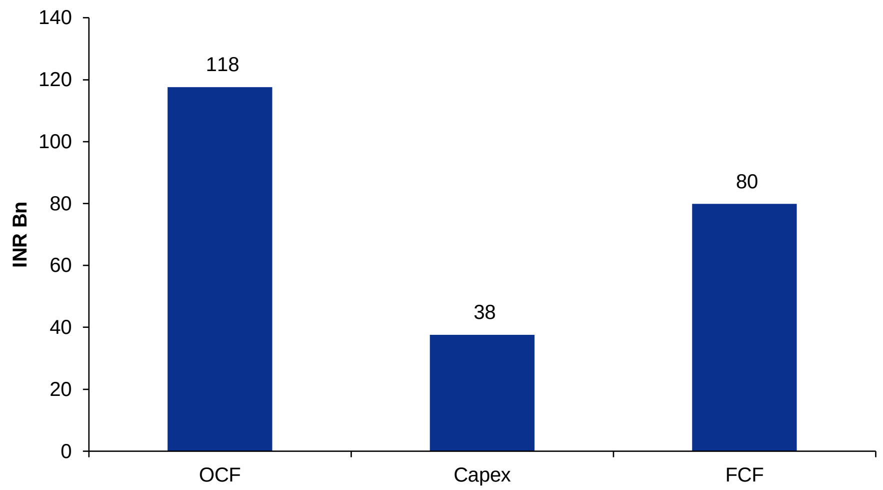
Figure 18: FY21-FY23F free cash flow to firm (Rs bn)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

These businesses have displayed superior capability in converting profits into cash flows and it will not be any different going forward. Cumulative FCF of Rs80bn further adds to reinvestment ability without adding financial leverage. Incremental market share gains are imminent, in our view.

Figure 19: FY21-FY23F cumulative OCF, capex and FCFF for coverage companies



OCF = OPERATING CASH FLOW; FCFF = FREE CASH FLOW TO FIRM
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Investment summary

Astral Ltd - Reduce

We expect Astral to gain revenue market share across product categories and estimate consolidated revenue CAGR of 17% over FY21-23F backed by a) strong plastic products revenue CAGR of 15.9% and; b) adhesive revenue CAGR of 20.6%. We expect gradual improvement in sales mix in favour of chlorinated polyvinyl chloride (CPVC) products, pipe fittings, water tanks/valves and adhesives. We think improving sales mix and scale benefits (optimum capacity utilisation) will help sustain elevated EBITDA margins and estimate EBITDA CAGR of 21% over FY21F-23F. Tapering capex and the shorter working capital cycle imply cumulative FCF of Rs12.4bn over FY21F-23F (FY18-20: Rs4bn). We estimate RoE/ RoCE/ RoIC of 22% /29% /39% in FY23F that could translate to higher dividend payouts (20-25% vs. 4-6% over FY16-20). We initiate coverage with a Reduce rating and TP of Rs1,720, based on P/E of 65x FY23F EPS, a 30% premium to five-year mean P/E. Upside risks: COVID-19 resurgence and adverse raw material price/forex fluctuations.

Supreme Industries - Hold

Supreme Industries has a broad-based plastic product portfolio spanning pipes, packaging, industrial and furniture segments. We estimate a volume/revenue CAGR of 15.5%/8.4% over FY21-23F. Across four product segments, the company created new capacities for better quality and cheaper products that earn higher EBITDA margins (over 17%) vs. company level average margins of 15-16% (FY17-20). Steep rise in PVC resin prices over past 12 months led to exceptional gross/EBITDA margins of 36.5/20.2% in FY21 that we expect to normalise (16.5-17%) over FY22-23F. We expect planned capex of Rs6.8bn and steady net working capital cycle at ~30 days of sales over FY22F-23F with net cash of Rs13.2bn by Mar 2023F. Estimate cumulative FCF of Rs10.6bn over FY22F-23F. Strong profit growth led to the stock rising by 60% (Nifty Midcap 150: 48%) since Feb 2020 to May 2021 due to historical high PVC resin prices. We like Supreme's revenue market leadership and well-diversified product portfolio but find risk-reward balanced at current prices. We initiate coverage with a Hold rating and TP of Rs2,345 based on P/E of 36x FY23F EPS, a 20% premium to its five-year mean P/E. Upside risks: Elevated PVC prices, and receding competition. Downside risks: Adverse forex rates, and prolonged COVID-19.

APL Apollo Tubes - Add

APL is a clear market leader with ~50% volume market share (FY21) in structural steel tubes. It is the lowest cost producer in a highly commoditised industry. We estimate revenue CAGR of 20% over FY21-23F backed by more market share gains. Value-added products (VAP) form 57% of total sales (FY21) and management intends to scale upto 75% over the next three years. VAPs earn 2x EBITDA per tonne of over Rs4k/tonne vs. a standard product's EBITDA of ~Rs2k/tonne as per APL. We estimate EBITDA CAGR of 31.4% with margins at 8-9.5% over FY21-23F. Meaningful working capital release and unfinished capex led to meaningful improvement in FCF of over Rs6.8bn in FY21 that would normalise over FY22F-23F averaging at Rs3.5bn-4bn/year. We estimate return ratios to improve and RoE/RoIC of 31.1%/43.3% by FY23F. Initiate coverage with Add rating with TP of Rs1,592 based on P/E of 25x FY23F EPS, a ~30% premium to its past five-year P/E. Downside risks: Capex execution delays, prolonged COVID-19 and sharp revival in unorganised competition.

Kajaria Ceramics - Add

Kajaria had revenue market share of ~10% in FY20 and is well ahead of its closest competitors in the Indian tile market. We estimate tile volume/revenue CAGR of 14%/16% over FY21-23F. Factors like higher capacity utilisation, bathware scale/profitability, price hikes and lower discretionary spends are key levers for gross/EBITDA margins improvement over FY21-23F. We estimate gross/EBITDA margins of 59.5%/18.5% in FY23F, respectively. We estimate cumulative capex of Rs3.5bn over FY21-23F and steady net working capital cycle at 55-60 days of sales implies cumulative FCF of Rs11.5bn over FY21-23F, up 3x from Rs3.8bn over FY18-20. We expect RoE/RoCE/RoIC to improve to 22.4%/28%/36% in FY23F. We estimate EPS CAGR of 21% over FY21-23F. We initiate coverage with an Add rating and TP of Rs1,176 based on P/E of 37x FY23F EPS, a ~10% premium to its five-year mean P/E. Downside risks: Rising natural gas prices, global reversal of anti-dumping duties on Chinese imports, and poor urban real estate demand.

Finolex Industries - Hold

Finolex Industries commanded 9% of the revenue market share at Mar 2020 and is a leading player in the agri-pipe segment. We estimate revenue/EBITDA CAGR of 6.2%/-9.8% over FY21-23F. Higher structural EBITDA margin improvements driven by improving sales mix, higher captive resin consumption and internally-funded capex would lead to cumulative FCF of Rs15.8bn over FY21-23F. We estimate RoE/RoCE/RoIC of 19%/22%/40% in FY23F. We are positive on Finolex due its leadership position in agri-pipes, increasing market share, structural improvements in business mix, healthy cash flows and strong return ratios. However, the stock rose 55% since 1 Feb 2020 and currently trades at FY23F P/E of 19.6x (+1SD its past 1 year forward five-year mean P/E). We see limited upside potential from current levels and initiate coverage with a Hold rating and TP of Rs180 (P/E of ~20x FY23F EPS), a 20% premium to its five-year mean P/E of 17x. Downside risks: slow ramp-up of non-agri products, forex volatility. Upside risks: Prolonged high RM prices.

Century Plyboard - Add

Wood panel companies saw volume growth recovery across plywood, laminates, medium density fibre (MDF) and particle board (PB) segments during FY21. Optimum utilisation of existing capacities and large new capex announcements would lead to revenue CAGR of 17.7% led by MDF revenue CAGR of 34.5% over FY21-23F. We estimate plywood/laminates revenue CAGR at 14.3%/15.6% respectively. Improving sales mix, focus on cost leadership and recovering volumes throughput would likely result in operating leverage benefits. We estimate EBITDA CAGR of 23.7% and margins to rise by 163bp (218bp over FY20-23F) to 17.5% over FY21-23F. We estimate cumulative operating cash flow of Rs9.3bn to be entirely utilised to create new MDF capacities and replacement/balancing capex over FY21-23F. We estimate RoE/RoCE at 18.8%/22.2% in FY23F. We expect EPS CAGR of 22.9% over FY21-23F. We initiate coverage with an Add rating and TP of Rs469 based on P/E of 34x FY23F EPS, a 30% premium to its past five-year mean P/E. Downside risks: Steep rise in raw material prices, delayed capex execution, capex cost overruns and prolonged COVID-19 pandemic.

Cera Sanitaryware - Add

We estimate revenue CAGR of 17%, with faucets growing fastest at 17.5% CAGR over FY21-23F. It has well balanced revenue mix with tier-3/-4 markets at 58% of revenues (Mar 2021), while premium products have 50% overall share (Dec 2020). It has an asset-light manufacturing strategy with optimum mix of in-house and outsourcing partnerships. We estimate EBITDA margin to increase by 210bp (FY23F: 15%) and EBITDA CAGR of 26% over FY21-23F. Planned capex remains low at ~Rs350m/year, while the net working capital cycle will be stable at 50-55 days of sales. We expect cumulative FCF of Rs4.2bn over FY21-23F and net cash balance of Rs5.7bn by FY23F. We estimate EPS CAGR of 32% over FY21-23F. Return on invested capital (RoIC) is estimated to rise from 16.5% to 32.3% over FY21-23F. We initiate coverage with an Add rating on Cera and value the stock at Rs5,140 based on 38x FY23F EPS, a ~20% premium to its five-year mean P/E of 32x. Downside risks: High competition in tile segment, prolonged COVID-19 pandemic and treasury management.

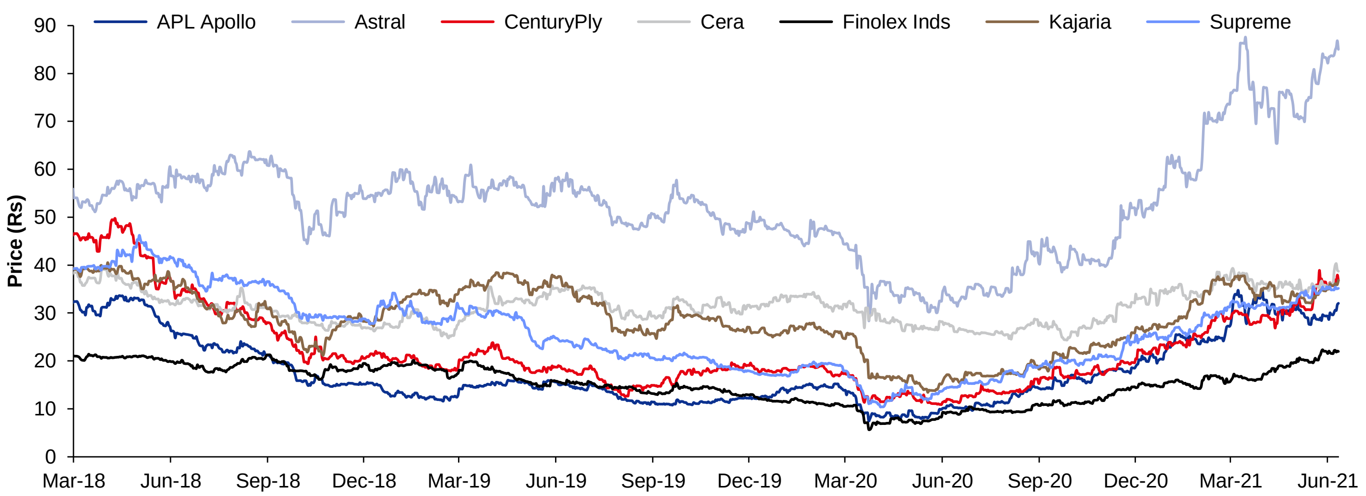
Valuation and risks

We use price to earnings ratio (P/E) to value stocks. The companies covered in this report are market leaders in the sub-segments they operate in and have a lot of scope to gain incremental market share and grow profitably over the next decade, in our view. All of these companies generate free cash flows that are enough to reinvest in the business and fund their capex needs from internal accruals. We think these businesses will compound profits at 18% CAGR (average for the companies covered in this report) over FY21-23F and, hence, are the best to be valued based on P/E (growth businesses) vs the discounted cash flow (DCF) method generally used for low-growth steady-state cash flow businesses.

We apply premiums (10-30% range) to historical multiples based on each company's revenue/net profit growth outlook. Also, the industry has a robust demand outlook as indicated by various corporate senior management for key customer segments of residential/commercial urban real estate, rural housing, industrial capex by large private/public sector businesses and overall discretionary consumption over the next five years. We expect strong franchises to emerge even stronger given significant market share gains and report solid cash flow growth over the next three to five years.

We initiate with a Neutral sector rating since over 60% of the sector market cap for stocks (Astral, Supreme and Finolex) covered in this report have Reduce or Hold rating. We see higher upside potential for the balance ~40% market cap stocks (APL, Kajaria, Century Ply and Cera) having Add rating.

Figure 20: Historical P/E trend for coverage companies



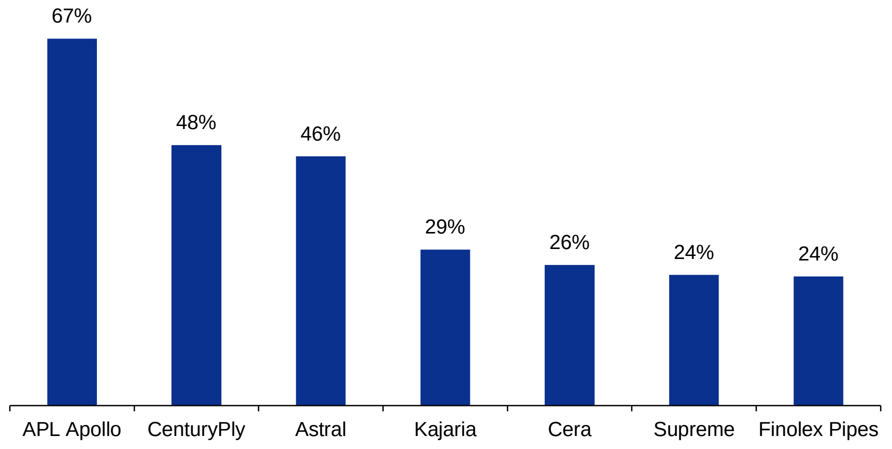
SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Figure 21: Valuation Summary

Company	CMP (Rs)	TP (Rs)	P/E -2SD (x)	P/E -1SD (x)	P/E Mean (5 Yrs)	P/E +1SD (x)	P/E +2SD (x)	FY23F P/E (x)
Astral	1,935	1,720	24	36	50	60	72	73
Supreme	2,249	2,345	12	20	28	36	44	35
APL Apollo	1,440	1,592	4	11	19	26	33	23
Kajaria	1,022	1,176	15	24	34	43	52	32
Finolex Inds	172	180	8	12	17	21	26	20
CenturyPly	419	469	6	16	26	36	46	30
Cera	4,360	5,140	23	27	32	37	41	32

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. DATA AS AT 11 JUN 2021

Figure 22: Historical 7-year stock price CAGR (Apr 2014- Jun 2021)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Upside risks

- **Elevated PVC prices:** Unprecedented rise in PVC prices has led to exceptional profits for pipe-making companies. Prolonged high prices might result in short-term inventory gains leading to better-than-expected profits.

- **Faster decline in unorganised competition:** Organised players have been gaining market share from weaker unorganised regional brands. Incremental COVID-19 led lockdowns make small players even weaker and might result in weakening competition.

- **Sustaining working capital improvements:** Strict control over receivables and inventory management in light of COVID-19 disruption led to shortening of working capital cycles. Some larger brands could dictate their own terms and were able to operate on the cash-and-carry model with very low credit period to customers. If these exceptional benefits sustain, it could lead to better-than-expected performance.

Downside risks

- **Adverse forex rates:** Adverse forex rate fluctuations and the inability to pass through the same to customers would impact profits for companies that have significant imports on a net basis (net of exports).
- **Capex execution delays:** External factors like labour/equipment shortages due to COVID-19-led movement restrictions could lead to cost overruns or delays in capex timelines and impact performance negatively.
- **Short-term impact on consumer demand:** Intermittent COVID-19-related stoppage in business activity impacts product demand in the short term. A prolonged second wave of COVID infections might impact performance of consumer product-focused businesses.

CGSCIMB

InCred Equities

INITIATION

Company Note

India

REDUCE *(Initiating coverage)*

Consensus ratings*:	Buy 8	Hold 6	Sell 9

Current price:	Rs1,935
Target price:	Rs1,720
Previous target:	NA
Up/downside:	-11.1%
InCred Research / Consensus:	3.1%
Reuters:	ASPT.BO
Bloomberg:	ASTRA IN
Market cap:	US$5,320m
	Rs388,726m
Average daily turnover:	US$8.4m
	Rs616.0m
Current shares o/s:	200.9m
Free float:	44.3%

*Source: Bloomberg

SOURCE: BLOOMBERG

Price performance	1M	3M	12M
Absolute (%)	17.3	3.1	193.8
Relative (%)	9.0	(0.2)	89.1

Major shareholders	% held
Promoters	55.7
Steadview Capital Mauritius	7.2
Axis Long Term Equity Fund	3.3

Astral Ltd.

Solid execution, need to wait for lower price

- Macro tailwinds, market share gain and high-capacity utilisation going ahead.
- Improving sales mix and scale benefits will help sustain existing margins.
- Expensive valuations lead to a Reduce rating. Initiate coverage with TP of Rs1,720.

Organised players left to compete for upcoming cyclical uptrend

Over the past year, visible cyclical uptrends have led to healthy plastic pipe and adhesive demand. Urban/rural housing pipeline, normal monsoons, industrial and infrastructure capex and specific government efforts to ensure water availability to every household are required for a sustainable demand uptick for Astral's products going forward. COVID-19 accelerated the shift to the organised sector, initiated by demonetisation/GST. We expect Astral to gain market share across product categories and estimate consolidated revenue CAGR of 17% over FY21F-23F backed by a) strong plastic products revenue CAGR of 15.9% and; b) adhesive revenue CAGR of 20.6%. We believe revenue share of value-added products (tanks and valves) will gradually increase over time.

Improving sales mix and scale benefits will help sustain margins

We expect gradual improvement in sales mix in favor of CPVC products, pipe fittings, water tanks/valves and adhesives. These earn relatively higher EBITDA margins or are still to reach their true margin potential, in our view. Current EBITDA margin (FY21: 20.3%) is inflated owing to steep rise in resin prices (over 100% yoy) that has led to inventory gains and price hikes inflating gross margins. We think improving sales mix and scale benefits (optimum capacity utilisation) will help sustain elevated EBITDA margins. We estimate EBITDA CAGR of 13.3% and 18.5%-19% margins over FY22F-23F.

High cumulative FCF led by slower capex and shorter WC cycle

Astral's priority is to exploit peak potential of existing capacities before firming up its next capex phase. We estimate lower cumulative capex of Rs4.4bn over FY21F-23F (FY18-20: Rs6.2bn). The FY21 net working capital (WC) cycle at 18 days halved yoy despite severe input cost inflation. Higher channel financing can further optimise receivables. Better margins, tapering capex and the shorter WC cycle imply cumulative FCF of Rs12.4bn over FY21F-23F (FY18-20: Rs4bn). We estimate FY23F RoE / RoIC of 22%/39% that could lead to higher dividend payouts (20-25% vs. 4-10% in FY16-21).

Risk-reward unfavorable at current price; initiate with Reduce

Astral's stock price rose at a CAGR of 55% over FY14-21. We believe this is a function of consistent market share gains, capital allocation discipline and compounding cash flows. We expect a similar situation going ahead. However, we find risk-reward unfavorable at the current stock price. Given the low margin of safety, we initiate coverage with a Reduce rating and TP of Rs1,720, based on P/E of 65x FY23F EPS, a 30% premium to five-year mean P/E. Upside risks: Better PVC pipe segment performance, faster market share gains for adhesives, incremental capital release from receivables.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	25,073	25,779	31,763	38,022	43,521
Operating EBITDA (Rsm)	3,849	4,429	6,445	7,034	8,269
Net Profit (Rsm)	1,971	2,479	4,010	4,389	5,316
Core EPS (Rs)	13.1	16.5	20.0	21.8	26.5
Core EPS Growth	(10.6%)	25.5%	21.3%	9.5%	21.1%
FD Core P/E (x)	132.64	117.51	84.82	88.57	73.12
DPS (Rs)	0.6	1.0	2.0	5.0	7.0
Dividend Yield	0.03%	0.08%	0.10%	0.26%	0.36%
EV/EBITDA (x)	101.28	87.80	59.71	54.48	45.89
P/FCFE (x)	240.26	(7,666.08)	431.08	263.76	86.33
Net Gearing	7.4%	(0.2%)	(21.4%)	(25.4%)	(35.9%)
P/BV (x)	22.78	19.40	20.50	17.40	14.81
ROE	17.2%	17.8%	23.6%	21.3%	21.9%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)				0.93	0.90

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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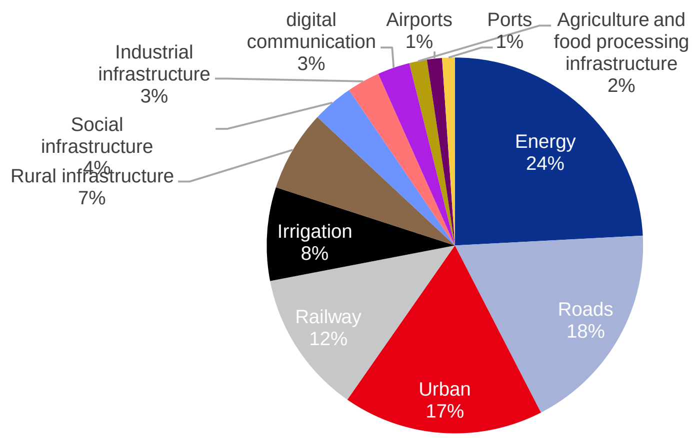
Solid execution, need to wait for lower price

Government and private capex to drive plastic pipe demand over the next decade »

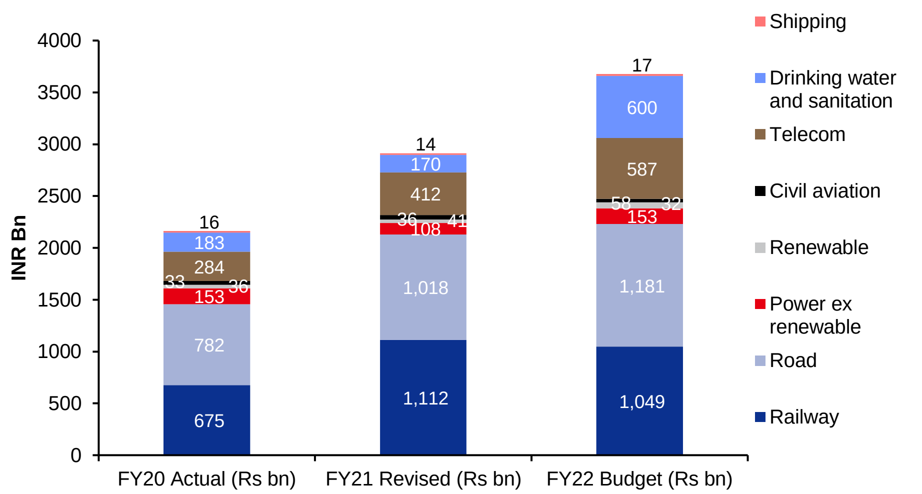
Strong outlook for new capacity and replacement capex

Figure 23: Indian government to incur capex of Rs111 lakh crore for infrastructure development under NIP over FY20-FY25F. More than 60% of this will go towards roads, urban infrastructure, railways, irrigation, and rural infrastructure



NIP = NATIONAL INFRASTRUCTURE PIPELINE
SOURCES: DEPARTMENT OF ECONOMIC AFFAIRS (GOVERNMENT OF INDIA), INCRED RESEARCH

Figure 24: Government spends on infrastructure



SOURCES: BUDGET DOCUMENTS, INCRED RESEARCH

Figure 25: Excerpts from the Finance Minister's speech on Union Budget 2021-2022

Railway Infrastructure
"I am providing a record sum of `1,10,055 crores, for Railways of which `1,07,100 crores is for capital expenditure."

Urban Infrastructure
"A total of 702 km of conventional metro is operational and another 1,016 km of metro and RRTS is under construction in 27 cities. Two new technologies i.e., 'MetroLite' and 'MetroNeo' will be deployed to provide metro rail systems at much lesser cost with same experience, convenience and safety in Tier-2 cities and peripheral areas of Tier-1 cities."

Rural Infrastructure
"We are enhancing the allocation to the Rural Infrastructure Development Fund from `30,000 crores to `40,000 crores."

National Infrastructure Pipeline
"The NIP was launched with 6835 projects; the project pipeline has now expanded to 7,400 projects. Around 217 projects worth `1.10 lakh crores under some key infrastructure Ministries have been completed."

Road Infrastructure
"I am also providing an enhanced outlay of `1,18,101 lakh crores for Ministry of Road Transport and Highways, of which `1,08,230 crores is for capital, the highest ever"

RRTS = REGIONAL RAPID TRANSIT SYSTEM
SOURCES: INCRED RESEARCH, BUDGET SPEECH 2021-2022

"The setting up of the Jal Shakti Ministry and the Nal Se Jal scheme, which offers basically the single line mission of Nal Se Jal, is to bring piped water access to every rural household in the country. I am glad to state that we have already started seeing demand from Nal Se Jal programmes at a state level in certain markets."

– Prince Pipes, 3QFY20 investor call

Plastic pipes demand spectrum is well balanced across various industries and hence the segment does not suffer from specific cyclical slowdowns in consumption or industrial spending. Some applications are listed below:

- Plumbing: Urban and rural housing – hot- and cold-water applications
- Insulation: Chilling thermal insulation, building construction, cable insulation
- Industrial: Metals, treating pulp & paper, food & beverages, industrial waste water disposal, chemical processing, etc.
- Sewerage drainage: Residences, commercial complexes, resorts, hospitals, academic institutes, etc.
- Fire sprinklers: High-rise buildings, schools and institutions
- Agriculture: Sandy and chemically-aggressive water, submersibles, irrigation
- Urban infrastructure: Flyovers and bridges, expressways, tunnels, airports, metro railways, etc.

Planned capex by the Indian Government and large private sector companies over the next three to five years entails meaningful spending on the above-mentioned applications. Plastic pipes accounts for ~5-10% of the total project capex and implies sustainable demand for PVC pipes going forward, in our view.

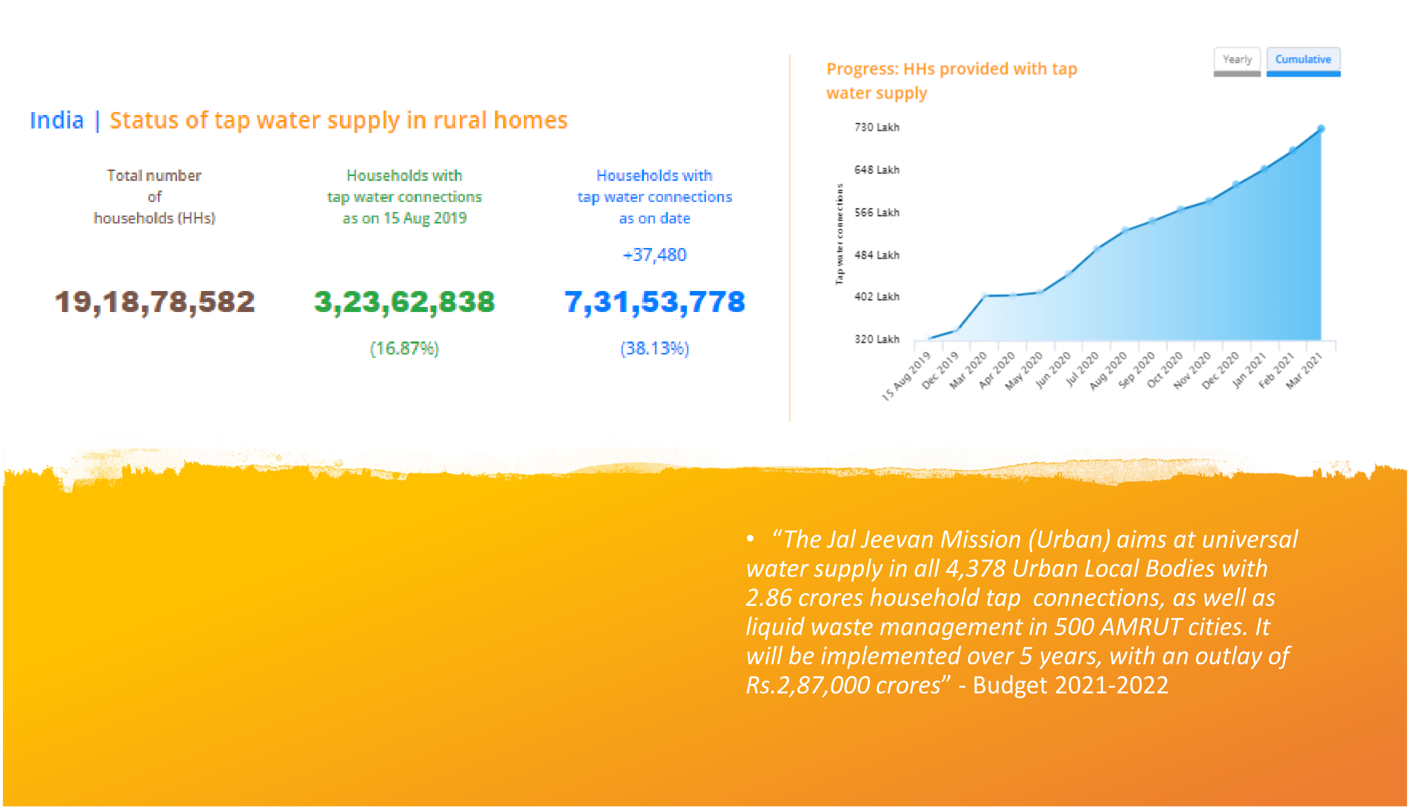
Given the country's ambition to modernise infrastructure, advance its cities with smart development, and boost employment, India is expected to become the third largest construction market in the world by 2025. (Source: Aliaxis SA 2020 annual report).

Figure 26: Private capex announcements over Nov 2020 - Mar 2021

Company	Industry	Intimation date	Capex value (Rs m)	Completion time	Area of capex
Lux Industries	Textile	23-03-2021	1,100	Mar-Sep 2022	Manufacturing + Warehousing
Indo Count	Textile	18-03-2021	2,000	Sep 2021	Manufacturing (expansion of bed lined capacity) + modernising spinning capacity
Bajaj Electricals + Mahindra Logistics	Logistics	03-03-2021	10,000	To be spent over the next 5 years	Warehousing + supply chain--> two large ultramodern mega-warehouses in Delhi and Mumbai, with latest technology, automation
MAX Ventures and Industries	Commercial RE	10-02-2021	6,000	The company recently leased ~62,500 sq. ft. to Yes Bank and ~7,300 sq. ft. to DBS It leased ~25,000 sq. ft. at Max Towers to Indian Energy Exchange (IEX) Limited	Leased 80,000 sq. ft. office space at Max Towers, Noida, to Cyril Amarchand Mangaldas
Metropolis	Healthcare	05-02-2021		Complete	New 5,200 sq. ft. laboratory in Kochi
Hindustan Foods	FMCG	22-12-2020	1,250	Mar 2022	Food and beverage manufacturing facility for a leading FMCG brand in North India
Hindustan Foods	FMCG	01-11-2020	1,500	Dec 2021	Home and personal care product manufacturing plant at Hyderabad
Navin Fluorine International	Specialty Chemicals	16-12-2020	1,950	Sep 2022	Life science and crop science multi-purpose plant at Dahej
Meghmani Organics	Agro Chemicals	26-11-2020	1,520	Completed	Expansion of Herbicide 2, 4 D Acid
Meghmani Organics	Agro Chemicals	26-11-2020	3,100	Mar 2022	Expansion of caustic soda and captive power plant capacity
MAX Ventures and Industries	Commercial RE	23-11-2020	4,000	Mar 2023	Construction of 0.7m sq. ft. of retail and office space on Noida Expressway.
Lumax Industries	Automobile	27-03-2021	800	Dec 2021	New unit at Sanand, Gujarat, for MG Motors and others
Minda Industries	Automobile	27-03-2021	900	Mar 2022	New unit at Bhagapura, Gujarat, for 4W automotive lighting
Minda Industries	Automobile	27-03-2021	1,670	Jun 2022	Expansion of the Bawal, Haryana, 4W alloy wheel plant

SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 27: Indian government committed to provide tap water to each household



HH = HOUSEHOLDS
SOURCES: INCRED RESEARCH, JALJEEVANMISSION.GOV.IN

Figure 28: Water supply and sewerage connectivity projects under the AMRUT scheme

SOURCES: INCRED RESEARCH, AMRUT.GOV.IN

Replacement or conversions to support overall demand

"Substitution demand from the metal pipe, as you are all aware, there is a significant technological advantage of PVC as opposed to metal… so that substitution market still goes on."

– Prince Pipes, 3QFY20 investor call

Plastic pipes have several advantages over metal pipes. For instance, the price of plastic pipes is declining structurally excluding for the COVID-19 led inflation. Plastic pipe raw materials are derivatives of crude oil. Hence, prices of plastic pipes are correlated to crude oil prices. The fall in crude oil prices has lowered raw material prices, and, thus, plastic pipe prices. Superior real estate properties and low prices have accelerated the substitution of metal pipes by plastic pipes. Going forward, the increase in availability of raw materials (polyvinyl chloride [PVC], polyethylene [PE] and polypropylene random copolymer [PPR]) following the commissioning of new petrochemical facilities in India will further support the plastic pipes industry. Another factor driving long-term demand is the replacement of older pipes with plastic pipes. Within the plastic pipes industry, demand is expected to be driven by increasing applications of high-density poly ethylene (HDPE) and chlorinated polyvinyl chloride (CPVC) pipes (Source: Prince Pipes IPO prospectus).

Traditional pipe materials like iron, steel and concrete used earlier in buildings are getting older and corroded, reducing their stability. PVC/CPVC pipes are highly recommended as replacements by plumbers due to their lower cost and ease of installation. (Source: Astral Limited FY20 Annual Report).

Figure 29: Salient features of various pipes used for water supply

	Galvanised iron (GI)	UPVC	CPVC	HDPE	PPR
Life (years)	15-20	20-25	30-35	50	50
Max operating temperature (degrees Celsius)	200-250	60-70	90-100	90-100	90-100
Strength (hoop)	Higher than plastic pipes	500-600	450-550	350-400	250-300
Cost	Costlier than plastic	Cheaper than GI	Cheaper than GI, costlier than UPVC	Cheaper than GI, costlier than UPVC	Cheaper than GI, costlier than UPVC
Corrosion	Corrodes faster	No effect due to chemical resistance	Has anti-corrosive properties	Excellent anti-corrosion and chemical resistance	Good chemical resistance and corrosion resistance
Leakage	Vulnerable to leakage	Leakage-free	Leakage-free for lifetime	Leakage-free	Relatively leak-free but requires installation by skilled manpower
Bacterial growth	More prone to bacterial growth compared to plastic	Relatively low compared to GI	Extremely low compared with GI	Extremely low compared with GI	Relatively low compared with GI
Installation	Time- and energy-consuming	Through cold welding	Through cold welding	Cold welding. Known for more tolerance to poor installation	Fusion-welded system which requires specialised training and equipment
Thermal conductivity and insulation	Needs insulation as heat loss occurs faster due to high thermal conductivity	Requires less insulation as low thermal conductivity reduces heat loss	Requires less insulation as low thermal conductivity reduces heat loss	Require less insulation as low thermal conductivity reduces heat loss	Higher thermal conductivity than CPVC, requires insulation

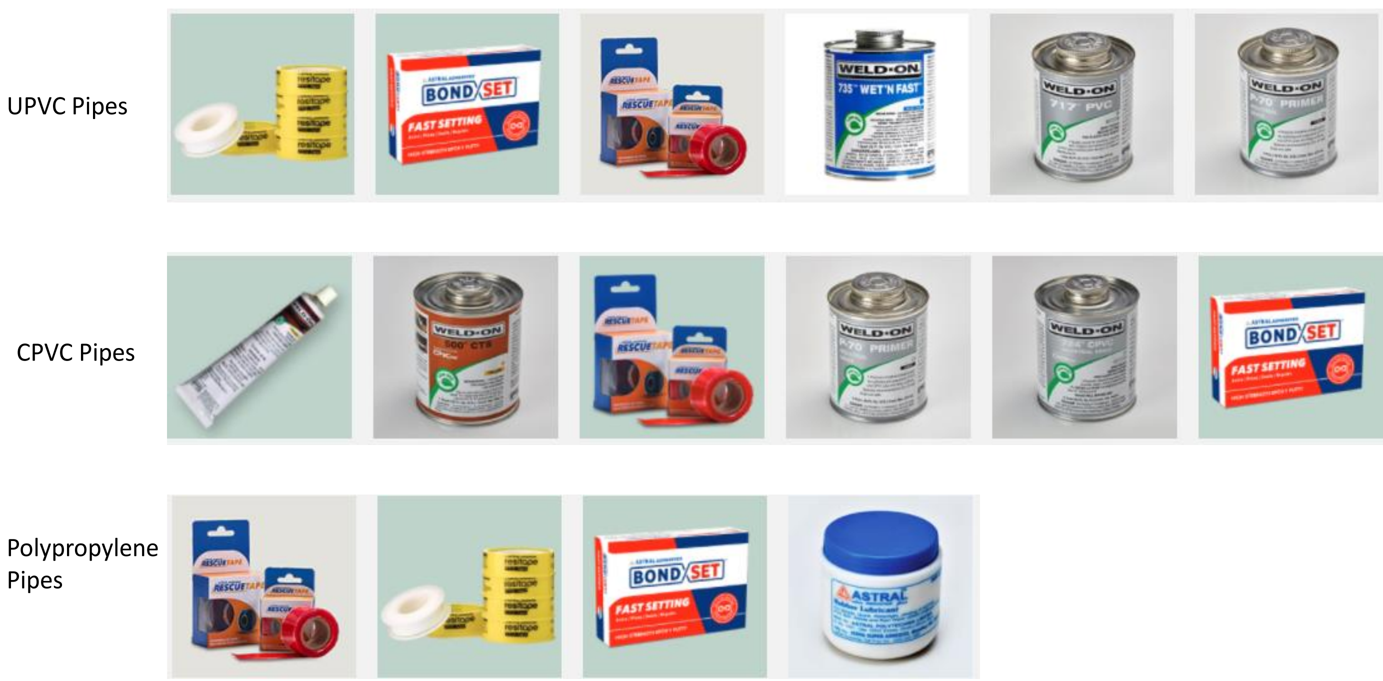
SOURCES: INCRED RESEARCH, PRINCE PIPES RED HERRING PROSPECTUS

Adhesives category being built in sync with plastic pipe

"If you see the products, almost 90% plus of our Resinova business comes from retail. So, I don't think we are an industrial products company."
– Astral, Feb 2021 investor call

Astral has developed a wide range of adhesives catering to complimentary plastic pipe-related demand and in other varied applications like tiling and levelling, gap filling, automotive, construction, wood care, adhesives tapes, etc. Astral has over 60 brands and over 700 SKUs across the industrial and consumer adhesives and sealant market in India. It caters to over 400k retailers. Astral's adhesives business segment's revenue was Rs5.8bn in FY20 and has a long way to grow in a large ~Rs100bn opportunity size market as India, in our view.

Figure 30: Astral offers wide range of adhesives to cater to variety of plumbing needs



SOURCES: INCRED RESEARCH, WWW.ASTRALPIPES.COM

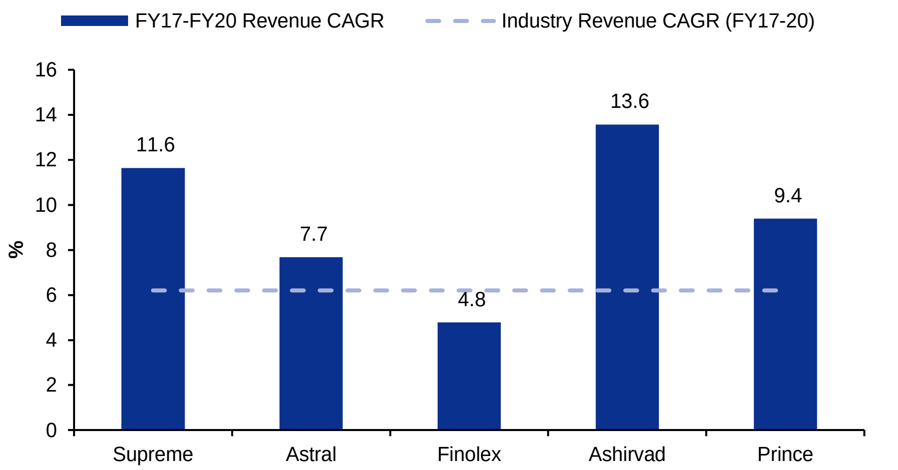
Competition now only between large brands; unorganised fringe players losing market share

"I would also point out that there were market share shifts, which is now happening. What we saw in the second quarter has continued into the third quarter from the unorganised to organised sectors." – Anil Rai Gupta, MD, Havells (3QFY21 Investor Call)

Indian plastic pipe consumption grew at 6-8% CAGR over FY17-20, in our view. As can be noticed across sectors in India, unorganised fringe players found it very difficult to compete with larger brands over the last five years since the Indian Government implemented measures to curb non-tax compliant cash dealings and began enforcing Goods and Services Tax (GST) compliance.

The COVID-19 pandemic has accelerated this demand as well as shifted supply to organised players and market share gains were largely visible in the past 12 months.

Figure 31: Organised players growing ahead of the market

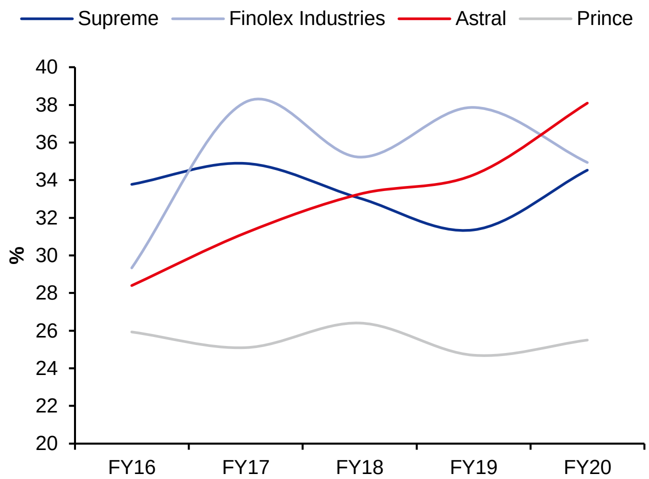


SOURCES: INCRED RESEARCH, COMPANY REPORTS, PRINCE RHP

Competition within organised players ensuring stronger industry foothold

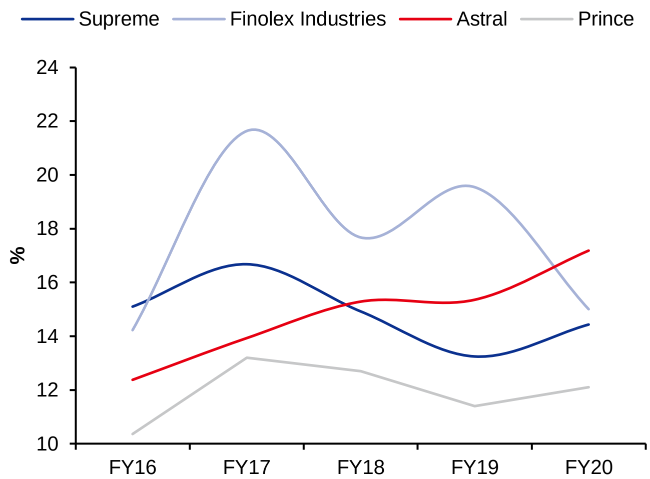
During this period, we believe healthy competition among larger organised brands have led to these companies becoming more efficient in day-to-day operations as well as management teams focusing on better profitability and higher returns on capital employed than ever before. Over FY16-20, gross and EBITDA margins for large pipe manufacturers expanded, indicating operating leverage benefits and efficiency gains.

Figure 32: Peer comparison of gross margin



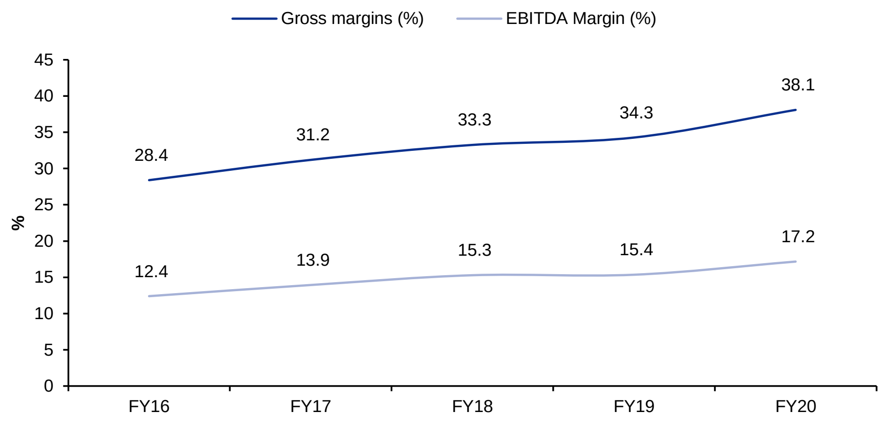
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 33: Peer comparison of EBITDA margin



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 34: Gross and operating margin trend of Astral

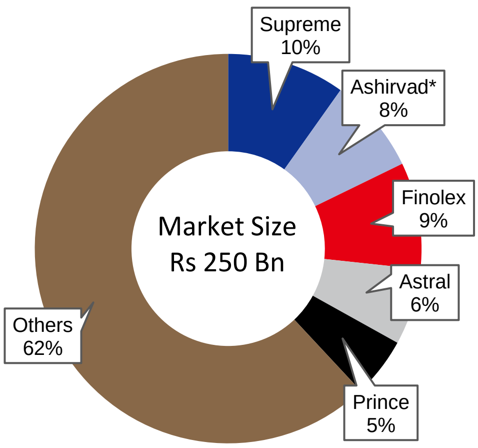


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Market share cornered by a few large pipe manufacturers

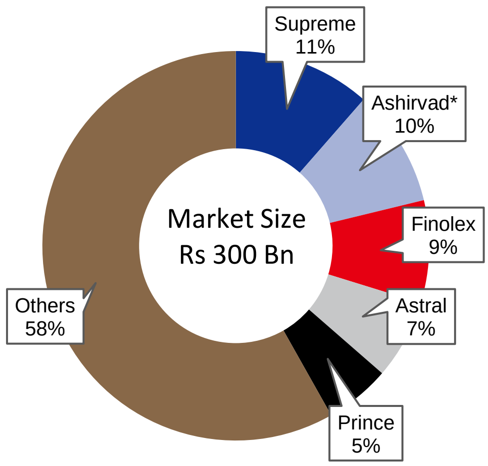
We believe a pan-India distribution presence through dealers and retailers, strong balance sheets to invest in branding and trade channel expansion, and the launch of timely customer-centric innovative products has been a clear advantage for larger companies that gained market share in the past. We think these trends are likely to continue going forward and a few large brands would command the majority of the pipe manufacturing market in India.

Figure 35: Market share (FY17)



*COMPANY-LEVEL REVENUE HAS BEEN USED FOR ASHIRVAD
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 36: Market share (FY20)



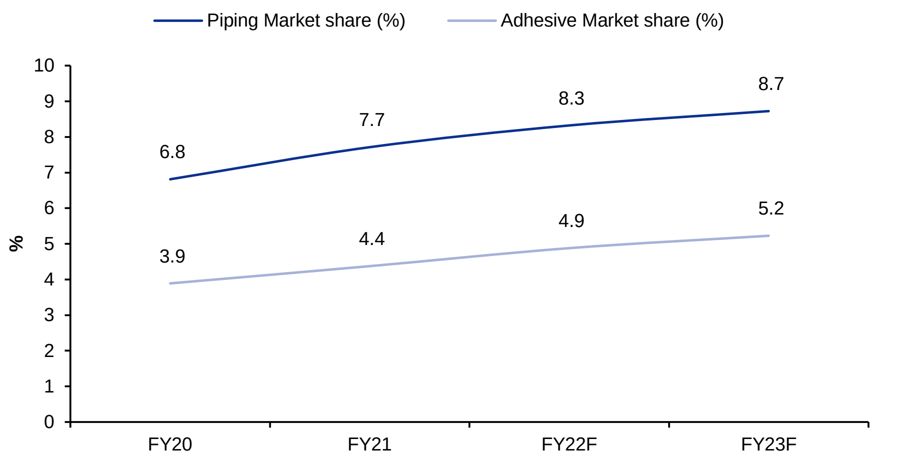
*COMPANY-LEVEL REVENUE HAS BEEN USED FOR ASHIRVAD
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Astral's market share in the piping sector is just 6%. So, we have to do a lot of hard work in the coming years to gain market share. There is a huge opportunity available for us to grow in this segment. CPVC, definitely, it will be much more, where our market share will be very high."
– Astral's Feb 2021 investor call

"Even this year, you see that because of this situation of polymer price, now tougher implementation of GST, even agri business has started moving to the organised player. Small unorganised players are being wiped out of the system. So that will always be there. The consolidation will be there and that is going to help all bigger players."
– Astral's Feb 2021 investor call

"Regarding our Seal IT UK, the UK, despite the pandemic, has done well because the country never imposed lockdowns on business. Not only has demand grown in the UK, but margins have grown to a new level. We are exporting a few products in the construction industry for the housing roofing products which are made in the UK and sold in a good quantity in the US."
– Astral's Feb 2021 investor call

Figure 37: Astral set to gain market shares in piping and adhesives, in our view



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Acquired adhesive entities grew profits at double-digit CAGR ›

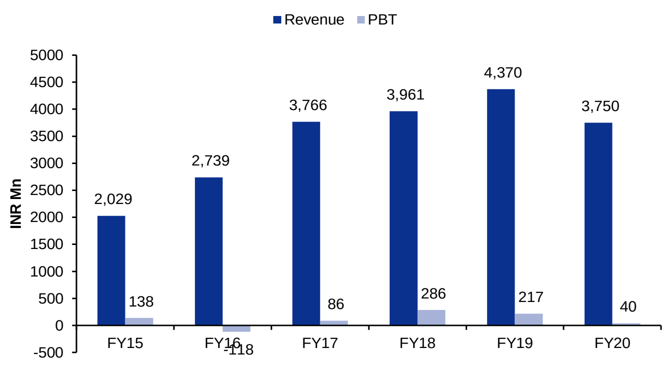
Astral entered the adhesive business through its acquisitions of Seal IT, UK, and Resinova Chemie Ltd., India, in Aug and Nov 2014, respectively. Both were profitable entities bought for an investment of ~Rs2.75bn, with annual revenues/EBITDA of Rs3bn/Rs200m, respectively. The Resinova business in India has grown much faster than the overseas business in the UK and the US. Indian business revenue/EBITDA CAGR stood at 13.8%/26.9%, while the overseas business grew sales/EBITDA at CAGR of 7.5%/11.2%, respectively, over FY14-20.

Figure 38: Historical financial performance (Rs m)

	FY14	FY20	CAGR (%)
Seal IT (UK + USA)			
Revenue	1,330	2,057	7.5
EBITDA	80	151	11
Resinova Chemie			
Revenue	1,725	3,750	13.8
EBITDA	127	531	26.9

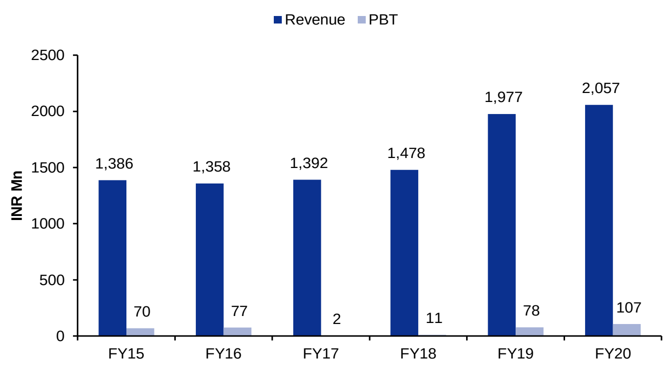
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 39: Resinova's financial performance



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 40: Seal IT's financial performance



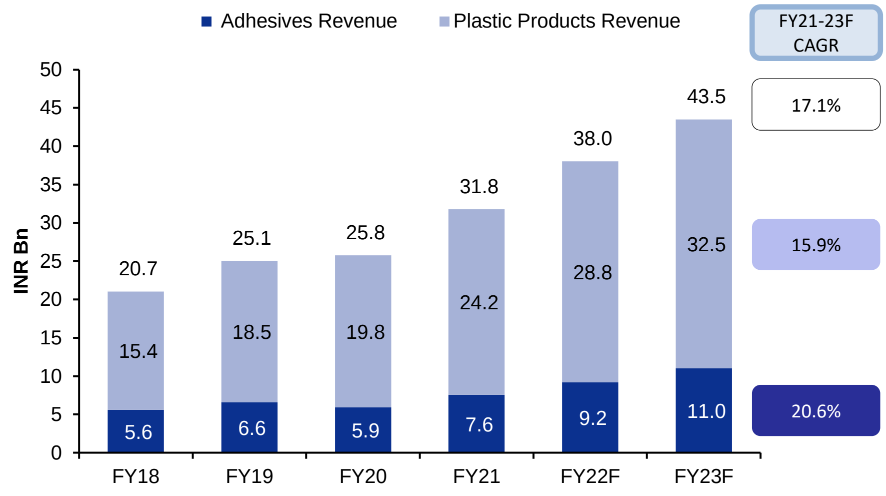
SOURCES: INCRED RESEARCH, COMPANY REPORTS

"We will be obviously looking at a much better number than 20% on the growth part for adhesives, but now if you see the longer base, 20%-25% should be a number which we should keep achieving."
– Astral's Feb 2021 investor call

Strong revenue growth over the upcoming five years ›

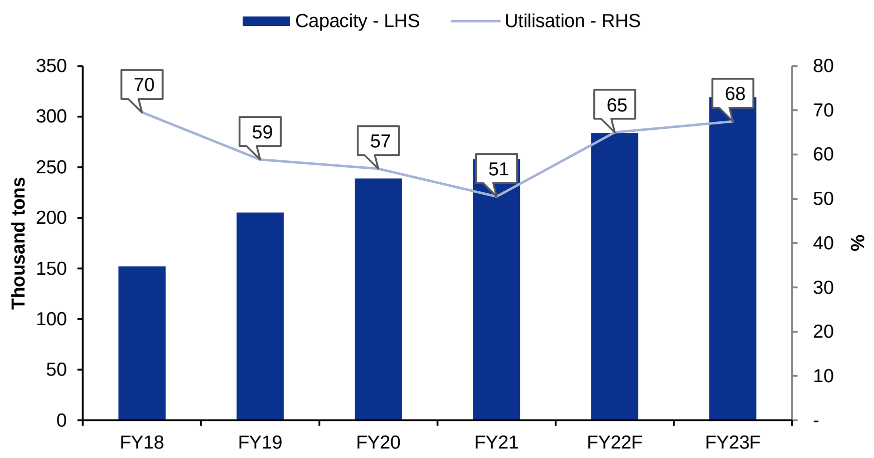
We expect consolidated revenue CAGR of 17% over FY21-23F. Owing to its low base we expect the adhesive segment to have a revenue CAGR of 20.6% (over FY21-23F), while plastic products (predominantly pipes, apart from tanks and valves) will grow at a revenue CAGR of 15.9% in the same period. This compares to relatively slow growth rates of plastic products and adhesives of 13.3% and 2.9% over FY18-20.

Figure 41: Segmental revenue growth trend



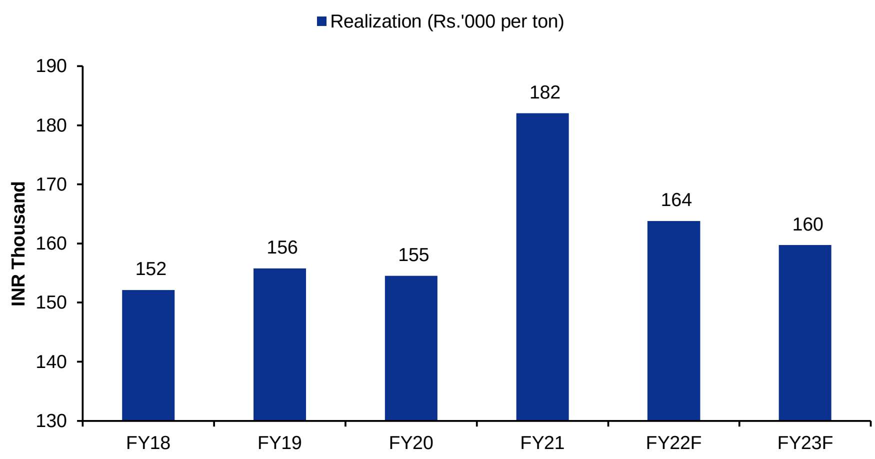
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 42: Piping capacity and utilisation charts



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 43: Plastic products/ piping realisation per ton



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Gradual ramp-up of water tank and valves business; government to drive infrastructure segment growth

Moving ahead on its plan to increase its share of value-added products, Astral, in Nov 2020, bought assets of Shree Prabhu Petrochemicals Pvt. Ltd. for a total consideration of Rs510m. This enables entry into the plastic water tank industry in India estimated at Rs50bn in annual revenue (Source: Acquisition press release), 70% dominated by unorganised players.

Shree Prabhu sells water tanks in the brand name of Sarita through its 550-dealer network in India. The company has a ready capacity of 4.5k tons of HDPE/drip irrigation pipe manufacturing (Astral did not have a presence in this segment yet).

"The valve manufacturing unit, which had to be setup in Ahmedabad at Dholka, the work started again last month. The project was delayed by almost three months to four months, but we should be completing this project by the end of this fiscal."
– Astral's 1QFY21 investor call

Astral expects the water tank business to pick up pace once the manufacturing set-up at a few of its Indian plants is completed. Annual revenue of Rs2bn-3bn (4-6% revenue market share) achieved in the next five years would be a meaningful achievement, in our view.

With regards to the valves segment, the company expects to reach an annual revenue of Rs1.5bn-2bn in the next five years.

Astral would also build its infrastructure business segment largely providing plastic products to the Indian government, the revenue share of which was marginal in FY20. This includes sales of double corrugated pipe, cable ducting, telecom pipes, perforated pipes, etc. This could also be a Rs1.5bn-2bn annual revenue opportunity, in our view.

Adhesive segment margins:
"The leader has a legacy and we are creating certain things. We had to go through a phase of correction. Give us a few more quarters for growth, for improving the margin, but we don't want to give the wrong guidance, but I am sure that in the next 2, 3 quarters, you will see all these changes coming."
– Astral's Feb 2021 investor call

Favorable revenue mix and optimum capacity utilisation to drive gross and EBITDA margins›

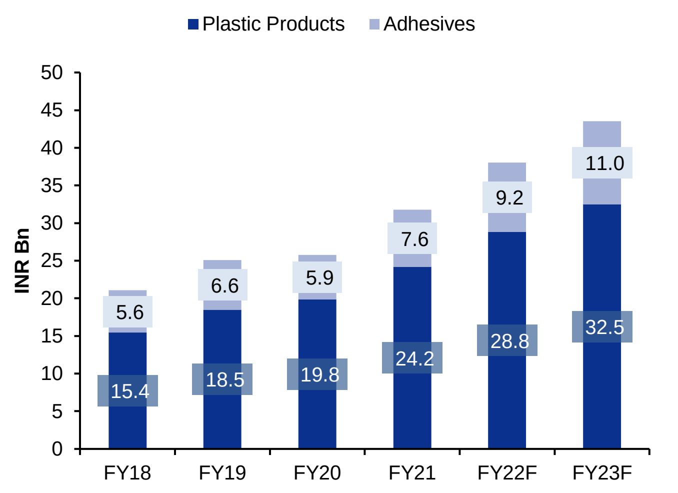
Increasing adhesive revenue share to aid overall margins

With most of the correction phase now done with after the acquisition of the adhesive entities Resinova and Seal IT, and also due to the small base, we expect adhesive revenues to grow relatively faster and their revenue share to increase gradually going forward (FY23F: 25.3%).

EBITDA margins have been range bound between 13-13.5% over FY17-20. However, based on our assumptions of meaningful pick-up in adhesive segment revenue growth rates, we expect the EBITDA margins to expand to 17.3% by FY23F, 180bp increase over FY21, driving the consolidated margins higher.

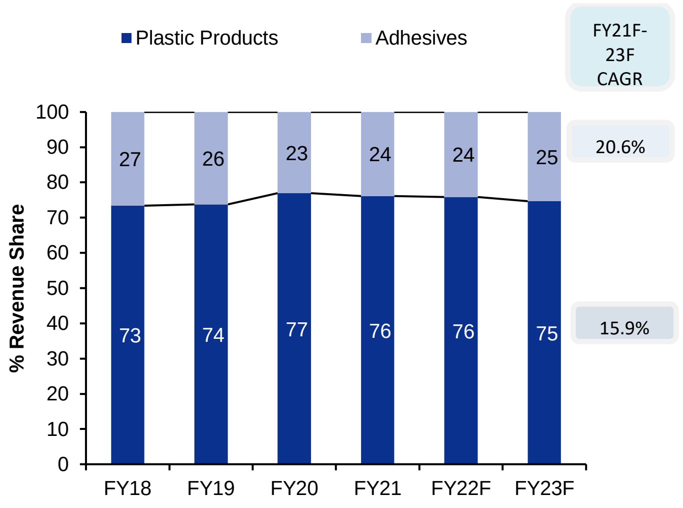
Compared to the market leader Pidilite Industries (CMP: Rs2,117, TP: Rs1,690, Rating: Hold), there are enough product gaps to be filled by Astral that in turn would help it post industry-leading growth, improve margins and gain scale and size in the adhesive segment.

Figure 44: Segment revenue



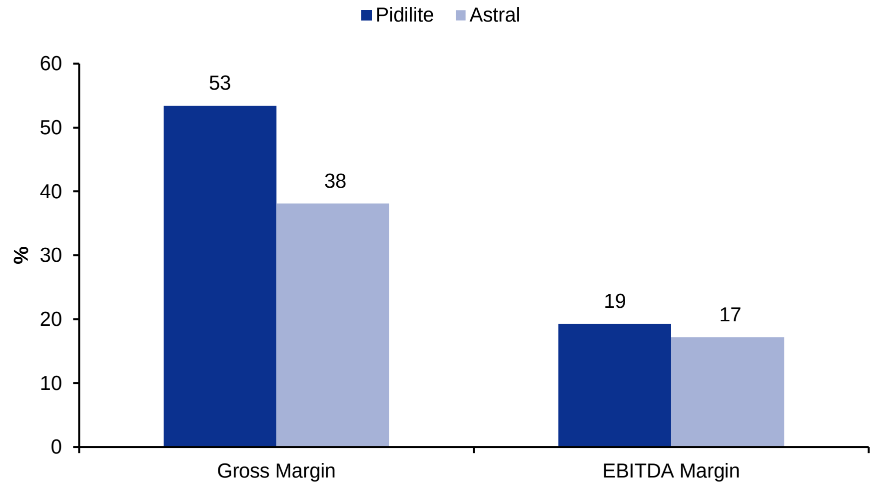
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 45: Segmental revenue mix (%)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

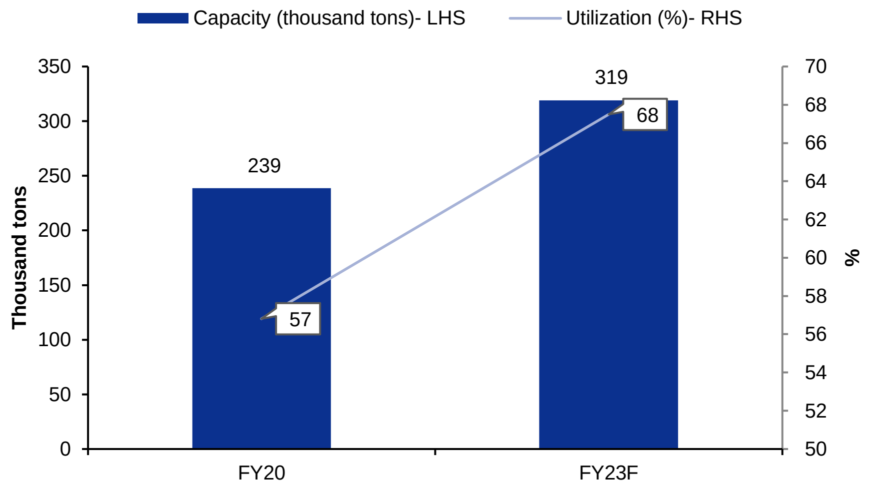
Figure 46: Scope for adhesives segment to improve margin – Pidilite vs Astral margin profile (FY20)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

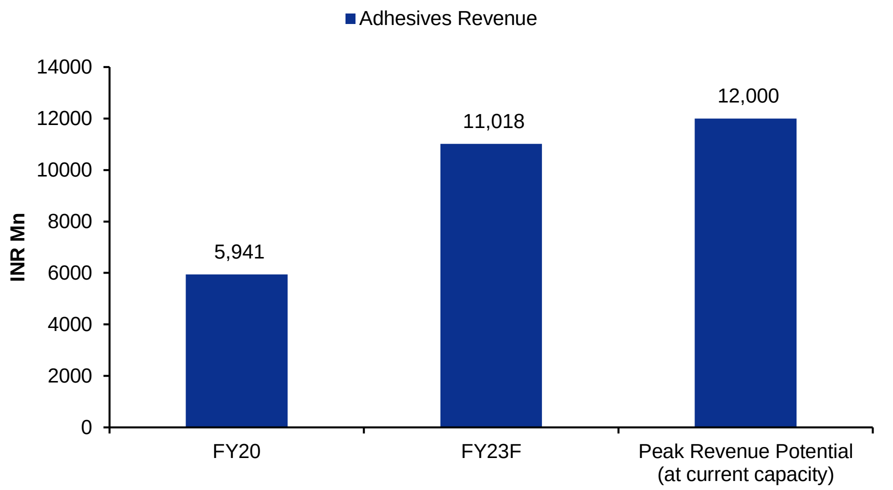
Astral to focus on realising peak revenue potential, optimum utilisation of existing capacities ensures operating leverage benefits

Figure 47: Astral's plastic/piping products capacity utilisation to reach peak potential



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 48: Astral's adhesive segment revenue



PEAK REVENUE ESTIMATES ARE BASED ON COMPANY ESTIMATES
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

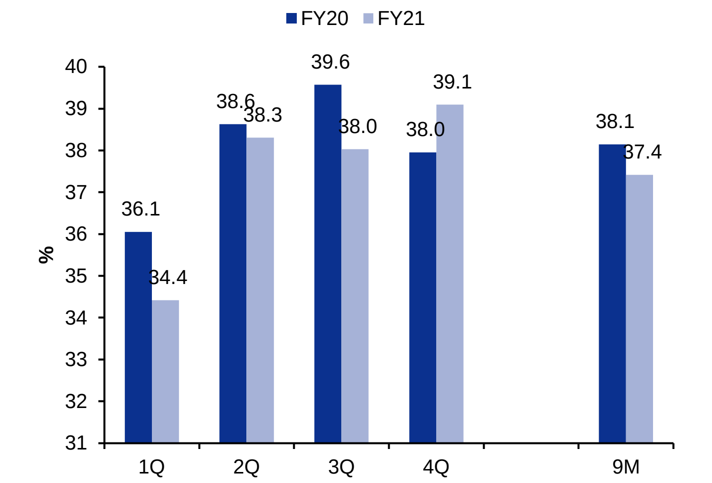
EBITDA margin peaked at FY21F level, expect to be lower in FY21-23F; remains aggressive on advertising/branding ›

UPVC resin prices doubled over the past year owing to global supply chain disruptions caused by the COVID-19 pandemic. CPVC resin prices have seen relatively lower inflation and we expect consequent price hikes for related plastic products to be taken going forward.

Given sharp spikes in raw material prices in a short period, plastic pipe manufacturers raised prices to pass on raw material cost inflation and booked inventory gains on the raw material inventory (Astral is mostly a CPVC product company and gains are much lower than PVC peers). This has resulted in very high gross and EBITDA margins in the plastic product segment for FY21.

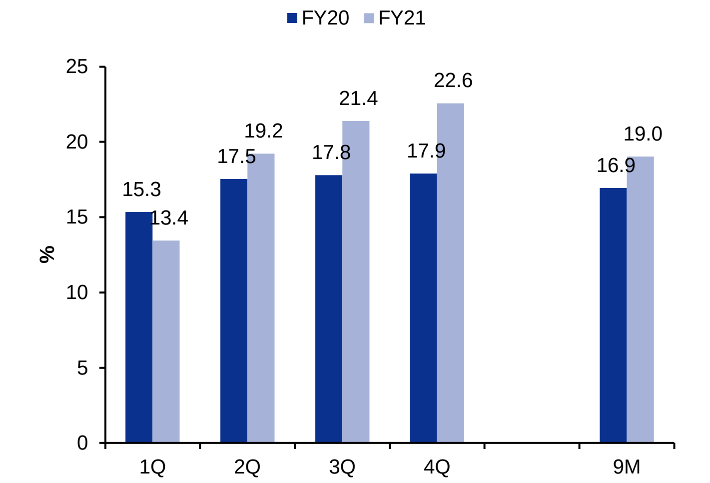
We expect flat gross margins while EBITDA margins to stabilise at 18.5-19% over FY22-23F.

Figure 49: Quarterly gross margin trend



*4QFY21F IS AN ESTIMATE
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 50: Quarterly EBITDA margin trend

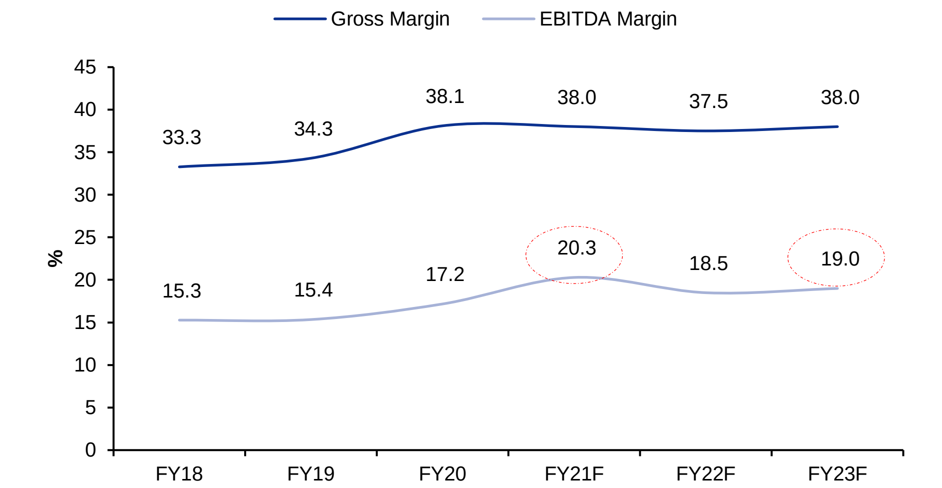


*4QFY21F IS AN ESTIMATE
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

"In the press release our EBITDA margin has grown much faster than the topline. The reasons are better product mix, value-added products and inventory gains because of the PVC price hike."

– Astral's Feb 2021 investor call

Figure 51: Astral's margins to normalise over FY22-23F



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Raw material supply agreement

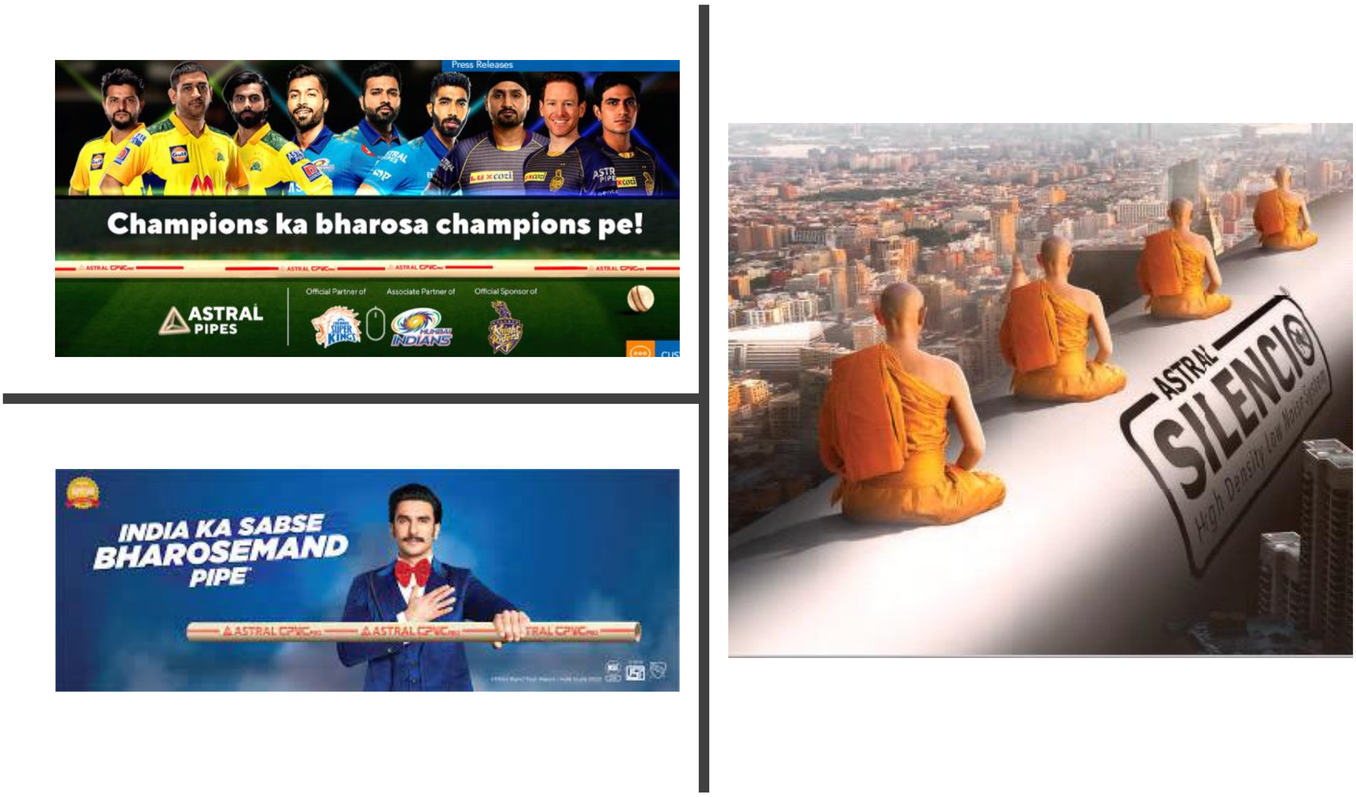
PVC AND CPVC resins are key raw materials for Astral to manufacture plastic products like pipes, water tanks, valves, etc. The company sources CPVC resins from Sekisui, Japan, from its plants in Thailand and Japan. Though Astral has signed a long-term contract with Sekisui, pricing is fixed on a quarterly basis as resins are crude oil derivatives. PVC resins are bought locally or imported based on pricing and availability.

Large producers of PVC resin in India are Reliance Industries (~50% of Indian production) (RIL:IN, CMP: Rs2,213, TP: Rs1,400; Reduce), Chemplast Sanmar (filed prospectus for an IPO in Apr 2021), Finolex Industries (FNXP IN, CMP: Rs172, TP: Rs180, Add) , DCW Limited (DCW IN, CMP: Rs37, Not rated) and DCM Shriram (DCMS IN, CMP: Rs728, Not rated).

Astral's advertising spends the highest among its peers

Branding activities involve national television advertisement, in-film branding, train/bus/auto banners, advertisement hoardings, sports sponsorship, shop hoarding boards; plumber/architects/distributors meet, etc. Astral is also conducting meets for plumbers and consultants to create awareness about its products. In FY18, in-film branding was carried out in the film Toilet Ek Prem Katha with Bollywood star Akshay Kumar. For sports branding, the company was an associate sponsor of the Sunrisers Hyderabad and Rajasthan Royals teams of the Indian Premier League (IPL) 2018.

Figure 52: Branding efforts – pipes



SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

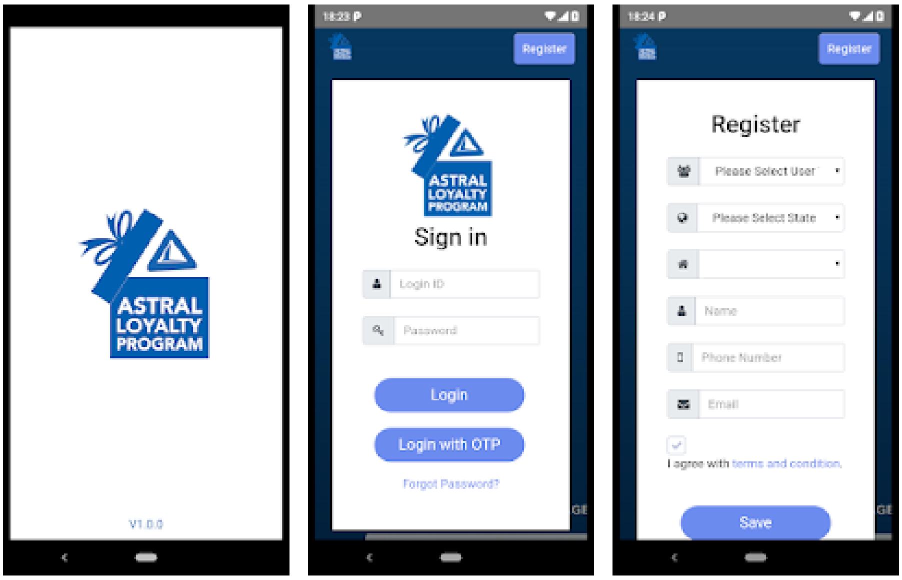
Figure 53: Branding efforts – Adhesives

SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Strengthening influencer relationships critical for long-term success

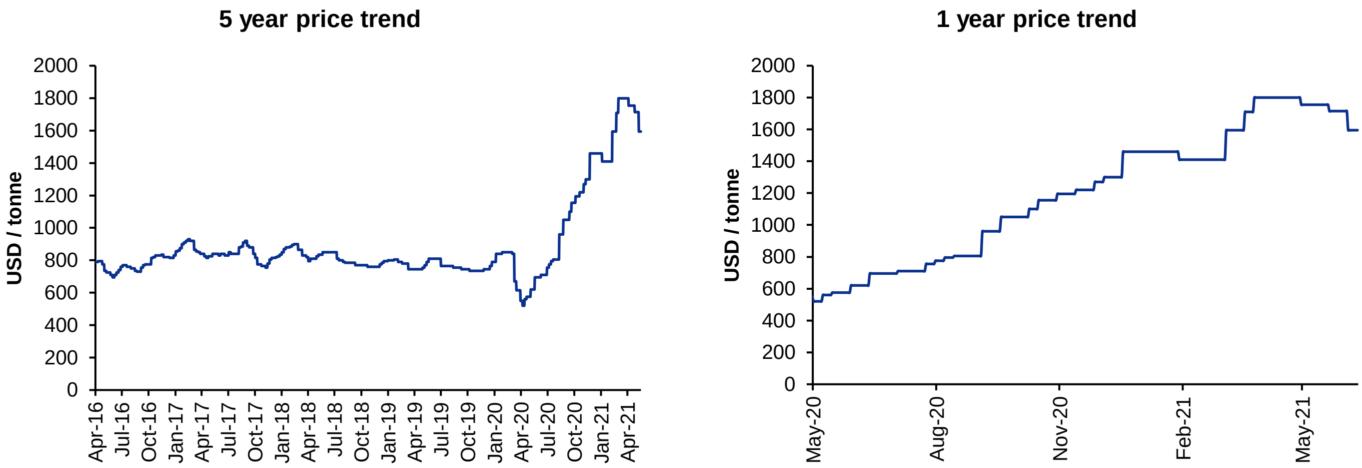
Residential/commercial pipes and adhesives are product categories for which demand is largely dependent on influencers like plumbers, masons and carpenters vs direct customers influencing buying decisions in a few cases. Astral trains more than 85k plumbers every year in India and has launched a unique loyalty programme to strengthen its plumber connect.

Figure 54: Astral Loyalty Program



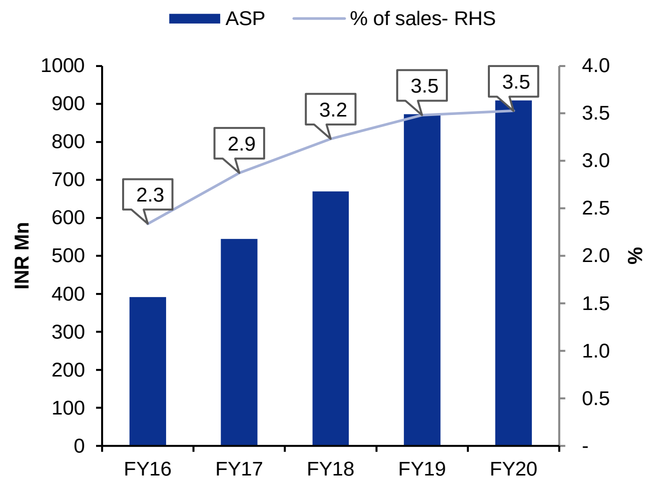
SOURCES: INCRED RESEARCH ESTIMATES, GOOGLE PLAY STORE

Figure 55: PVC resin price trend



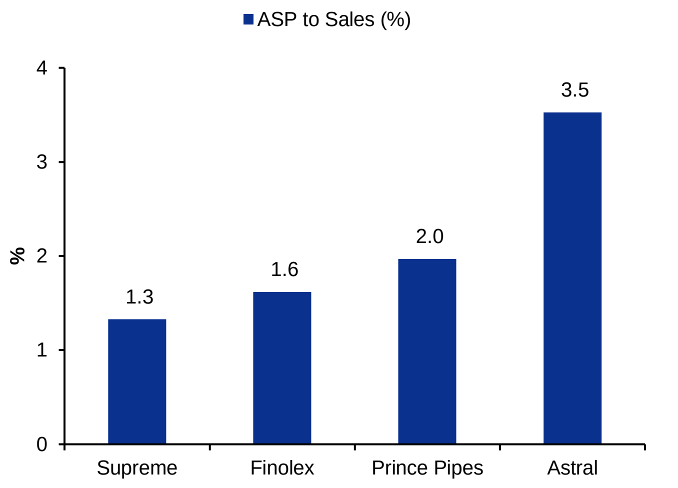
SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 56: Astral spends the most on advertising and sales promotion (ASP)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 57: ASP spend of peers (FY20)



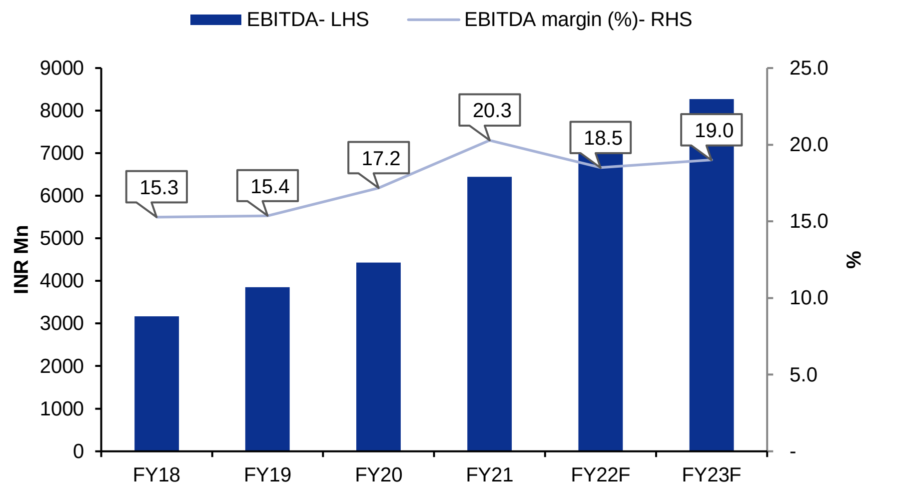
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 58: Astral's product range

SOURCES: INCRED RESEARCH, ASTRAL ANNUAL REPORT 2020

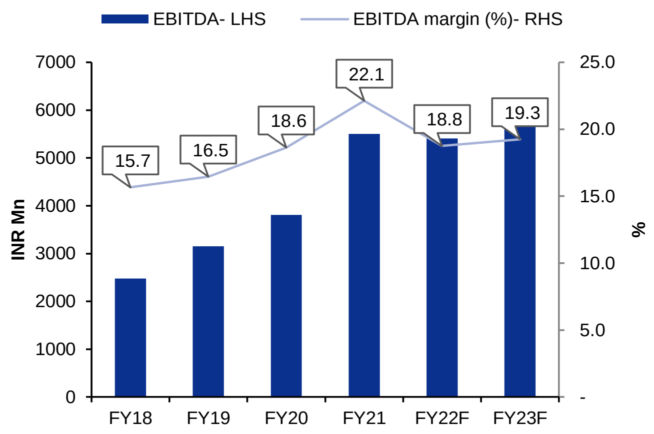
EBITDA CAGR of 13% over FY21-23F

Figure 59: Consolidated EBITDA and margin estimates



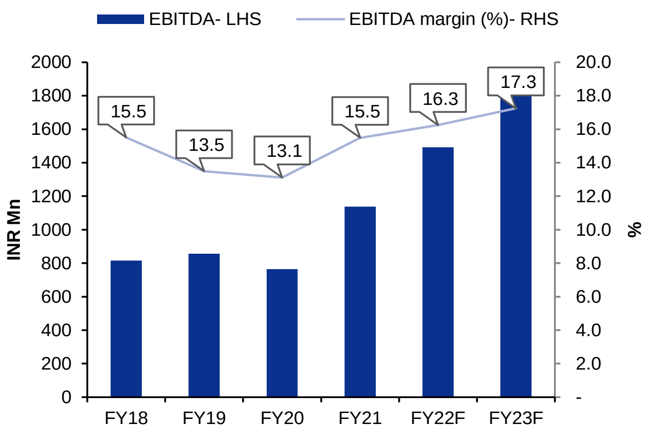
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 60: Plastic products/piping EBITDA trend



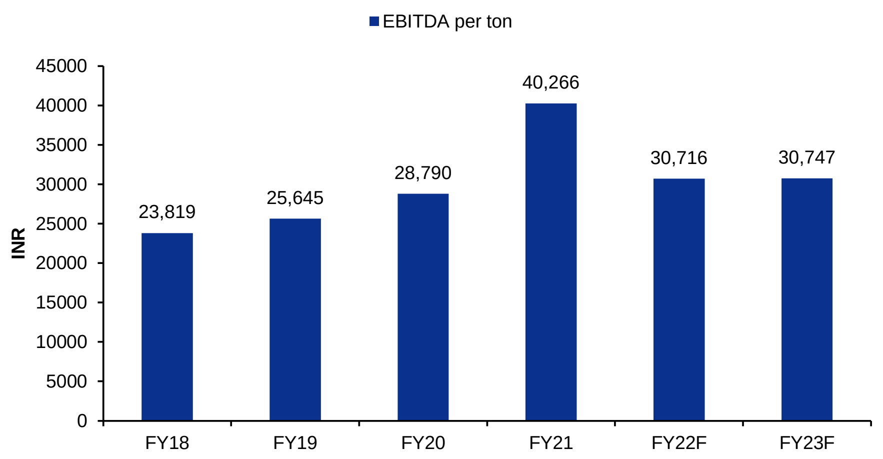
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 61: Adhesives EBITDA trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 62: Plastic products/ piping EBITDA per ton



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Low capacity capex + shorter WC cycle = high FCF

Pace of capacity addition to slow down over FY21-23F ›

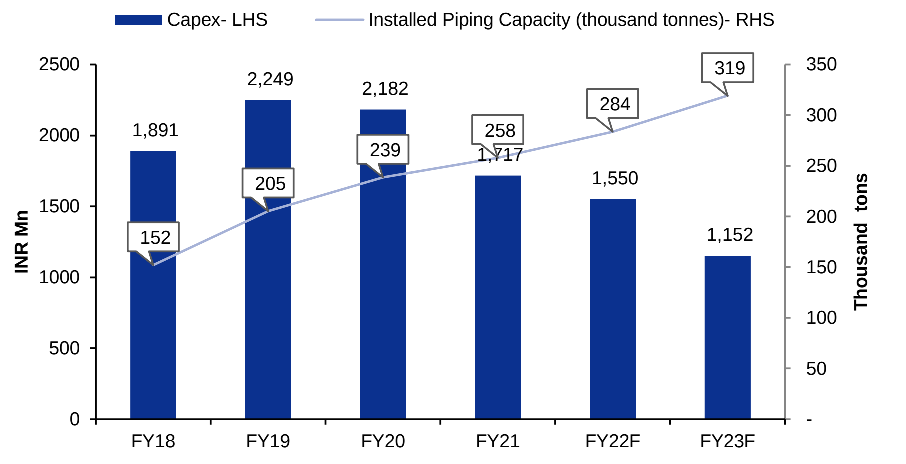
"We have to rework the capex plan. So hopefully, in the next quarter, I will be in a better position to guide you on what kind of capex will be there, but of course, it will not be a sizeable capex because tanks and all businesses are very light capex businesses."
– Feb 2021 investor call

Astral has guided for capex of Rs1bn-1.5bn per year over the next three years. The company spent ~Rs9bn in cumulative capex over FY16-20 (averaging Rs1.8bn/year). We estimate cumulative capex of Rs4.4bn over FY21-23F (average of Rs1.5bn/year) to be spent on piping capacity additions, incremental backward integration and marginal fresh capacity addition in the adhesives segment.

We estimate plastic products and adhesives segment capacity to reach ~310k tons and ~100k tons respectively by FY23F.

The company is focussed on increasing utilisation of existing capacities and realising its full revenue potential before deciding on the next phase of large capacity creation. We expect ~70% utilisation to be achieved by FY23F for both product segments.

Figure 63: Focus on capacity utilisation; new capacity additions to slow down



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 64: Capex plans at different plant locations in FY22

Product segment	Location
Phase 1: PVC pipe facility; Phase 2: CPVC pipes facility	Sangli
Fittings facility (~Rs200m)	Hosur
Water tank facility	Ahmedabad, Ghiloth, Aurangabad and Orissa

SOURCES: INCRED RESEARCH, COMPANY REPORTS

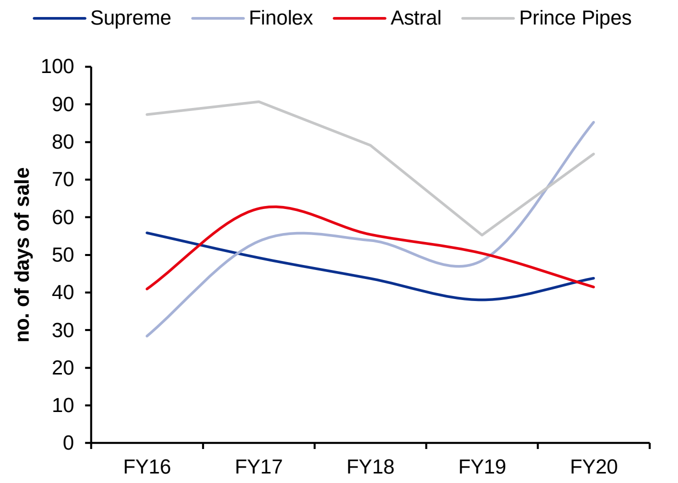
Despite sharp spike in raw material prices, inventory cycle down while receivables cycle flat yoy in FY21 ›

"During the current quarter also, we have tried to reduce our receivables days and squeeze the working capital cycle. Despite so much rise in the raw material price, inventory is under control. Despite topline growth, we have reduced the absolute level debtors yoy."
– Astral's 3QFY21 investor call

Despite strict controls on incremental credit sales and inventory management due to COVID-19 pandemic-related risks, we believe Astral has decent scope to improve its receivables cycle. Management believes there is incremental scope to increase the share of channel financing for dealers, and that meaningful improvements in the form of further reduction in receivable days is possible. Peers like Supreme Industries and Finolex Industries operate on a cash-and-carry model, with receivable days at 5-15 days for the plastic pipes business segment.

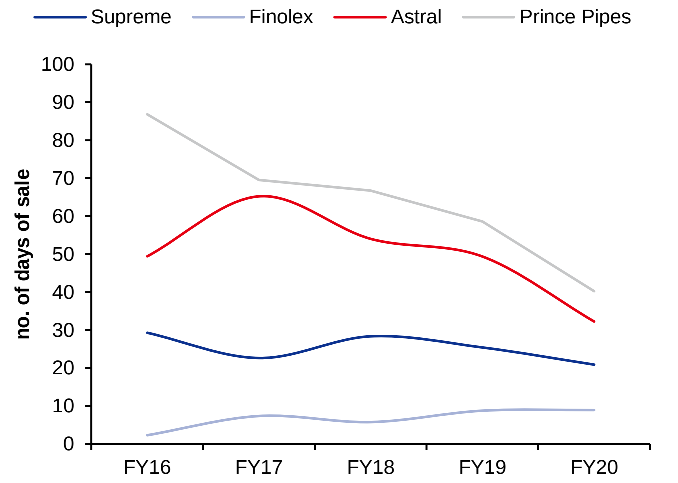
We expect Astral's net working capital cycle at 30-35 days of sales over FY22-23F and wait for execution on receivable improvement plan to build shorter debtor cycles.

Figure 65: Core working capital peer comparison



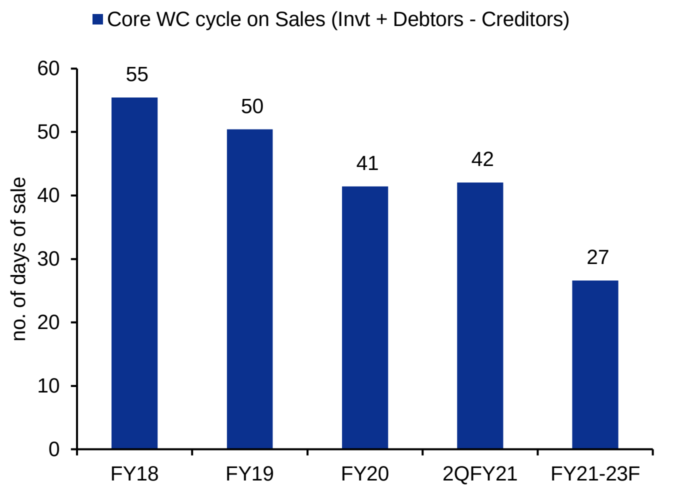
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 66: Receivable days peer comparison



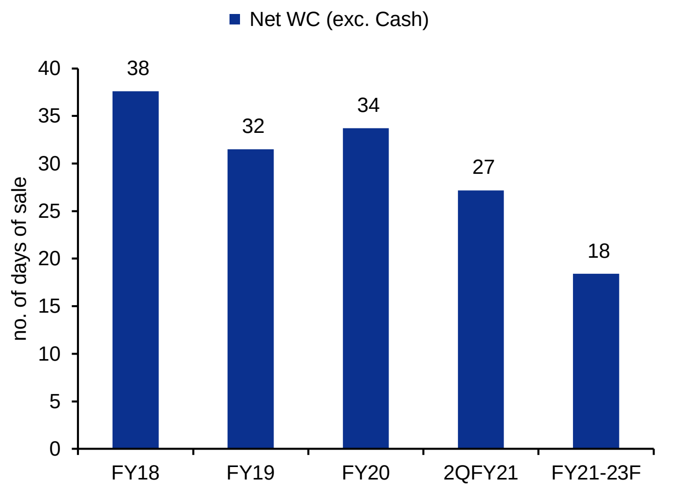
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 67: Core working capital (WC) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

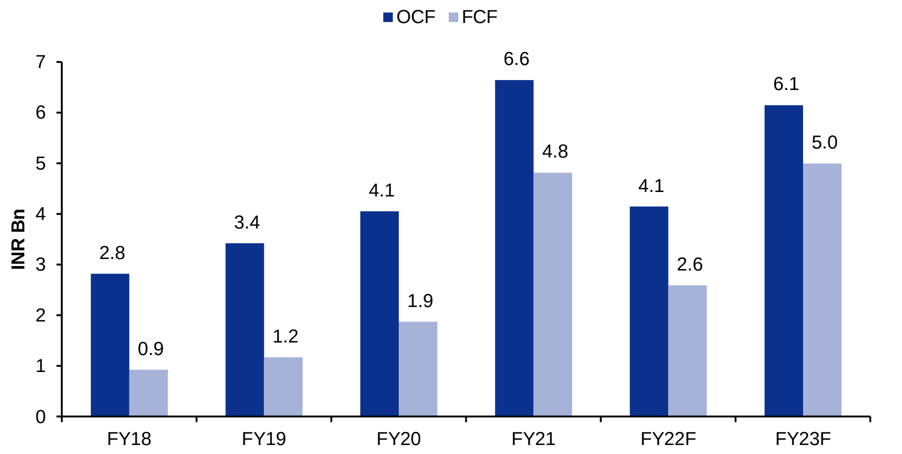
Figure 68: Net working capital (excluding cash) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Superior free cash flow generation over FY21-23F; scope for higher dividend payouts ›

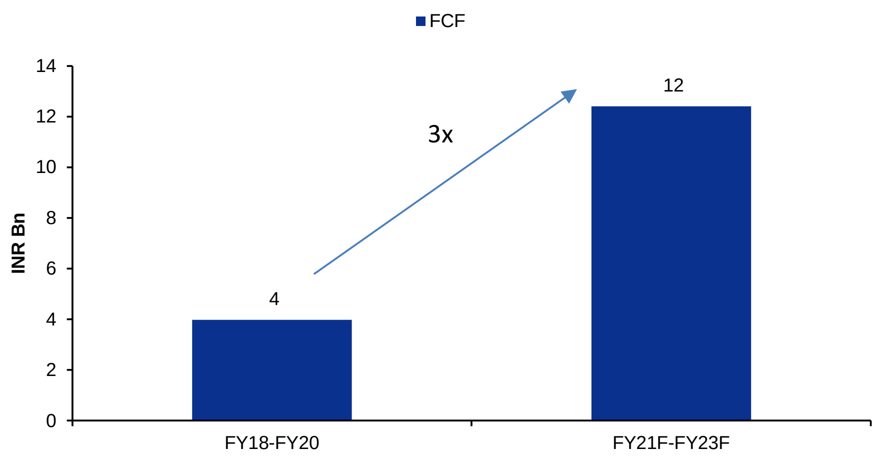
Figure 69: OCF and FCF trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

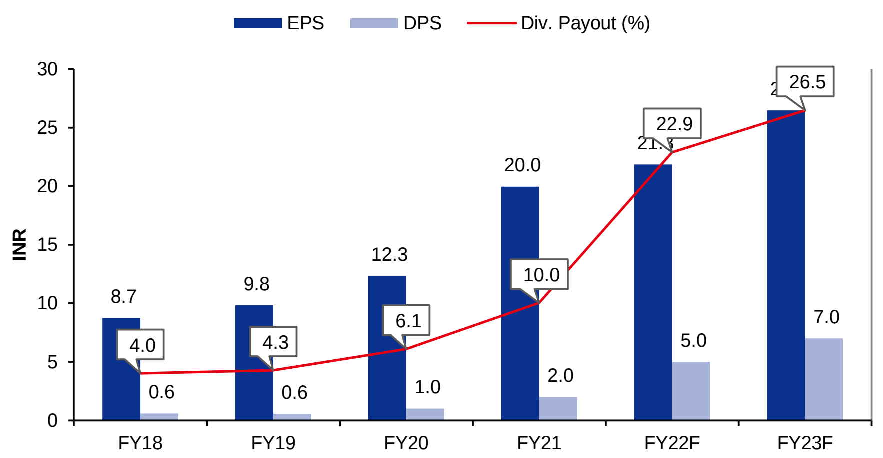
"We are improving the dividend payout and hopefully, by year end, we will be working on the dividend payout policies because now there will be a robust free cash flow available with management. So, definitely we have to improve the payout ratio, but exactly [by how much] our board will decide by the year end and then we will communicate to you."
– Astral's 2QFY21 investor call

Figure 70: Significantly higher cumulative FCF vs past



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 71: EPS, DPS and payout (%) trend

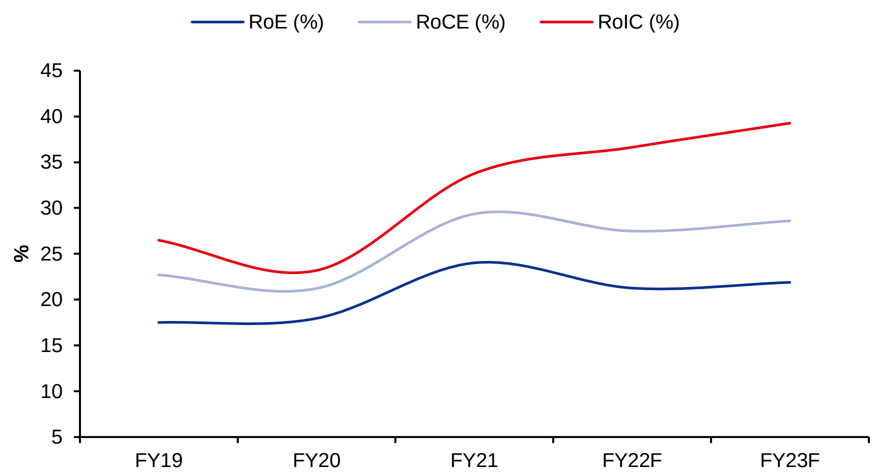


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

COVID-19 accelerates debt-free balance sheet target ›

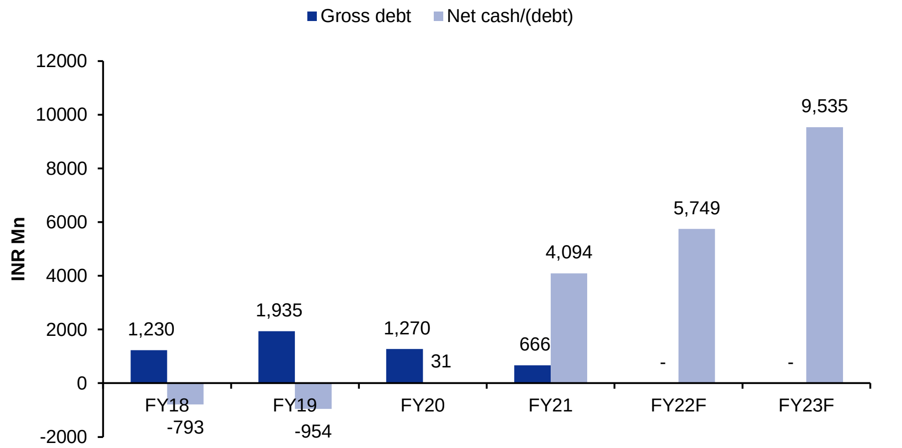
Astral reported meaningful improvement in working capital management led by the reduction in inventory levels in FY21. Overall, over Rs1bn of working capital was released leading to higher return ratios (decline in capital employed) and a net cash balance sheet at the end of Mar 2021.

Figure 72: Return ratios



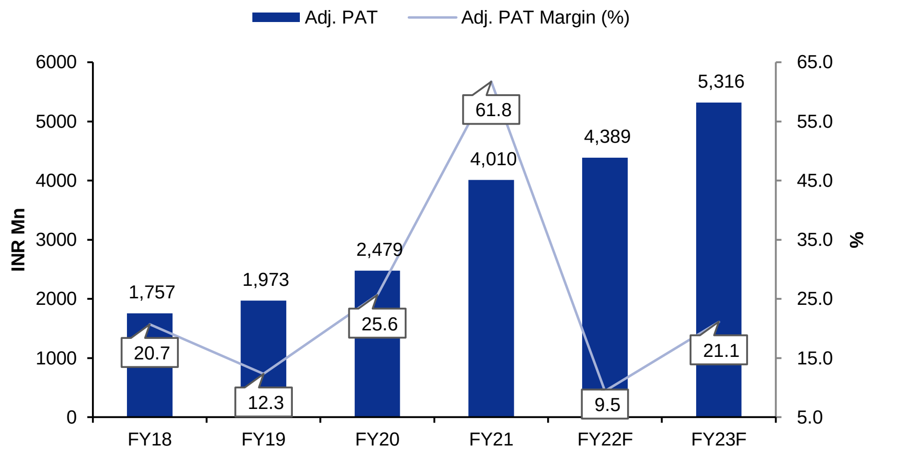
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 73: Astral ended FY21 with net cash of over Rs4bn



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 74: Adjusted PAT and margin trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Valuation and risk ›

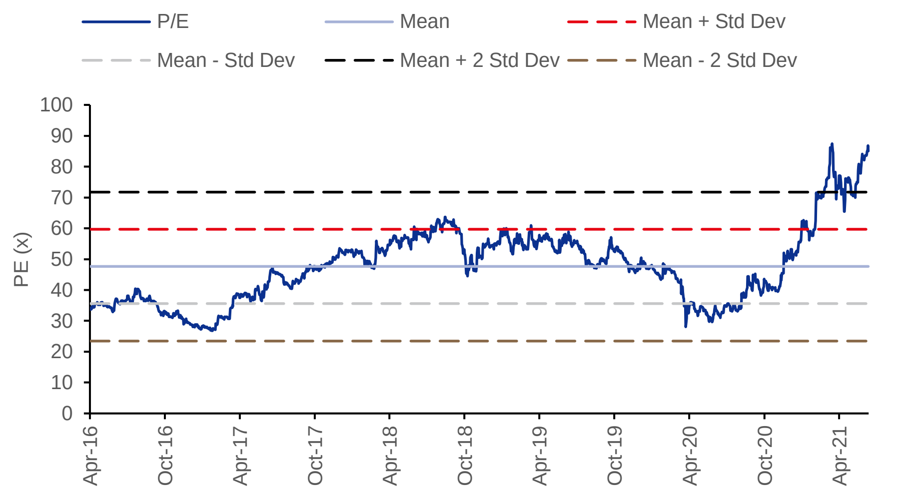
Stock price captures all the expected positives; initiate with Reduce rating ›

Stock price CAGR was a robust ~41% over the past seven years.

- Factors such as consistent market share gains, higher asset turns, topline CAGR of over 17%, improving revenue mix, scope for operating leverage benefits, EPS CAGR of over 15%, strong FCF and healthy return ratios over FY21-23F are key positives for Astral.
- The stock's price has rallied 124% since 1 Feb 2020 and trades at P/E of +2SD to its past five-year mean P/E of ~50x. This rally was driven by strong pent up pipe demand and temporary inventory gains due to rise in PVC prices.
- Sharp stock rally, risk of inventory losses and expensive valuations leaves no further stock price upside from current levels, in our view. The stock trades at P/E of 73x and EV/EBITDA of 46x its FY23F estimates.
- The stock is trading at higher than fair value. We have a TP of Rs1,720, based on P/E of 65x FY23F EPS, a 30% premium to its five-year mean P/E.
- Despite applying sector upcycle premium to historical P/E multiples, the stock offers no potential upside and hence we initiate with a Reduce rating.
- Astral's stock is valued at the upper end (30%) of the P/E multiple premium range owing to a) superior EPS growth (15% vs. Supreme and Finolex degrowing EPS over FY21-23F) prospects within the plastic pipe stocks covered in this report, b) substantial market share gain in the adhesive segment, c) tapering capex and FCF growth of 3x over FY21-23F vs. FY18-

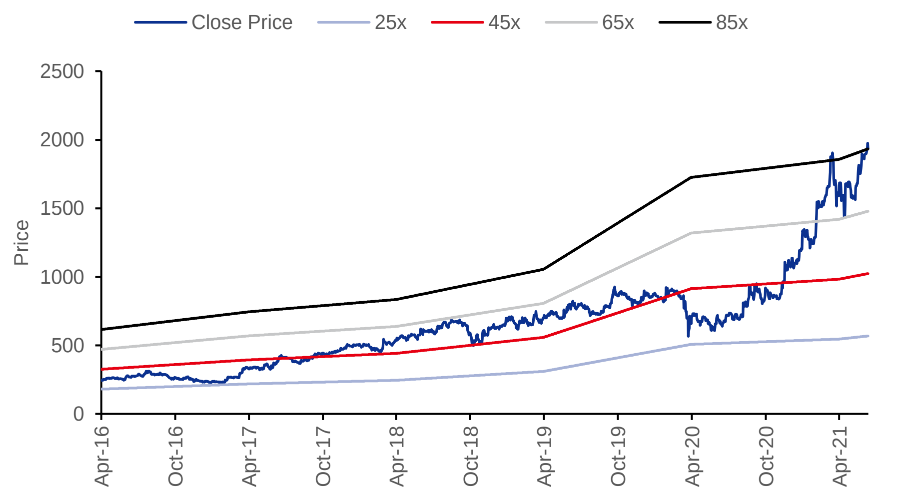
20 and d) further scope to improve FCF through working capital improvements.

Figure 75: Astral trading above +2SD its 5-year mean P/E (1 year forward)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG

Figure 76: P/E Band Chart



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Upside risks ›

- **New product revenue growth:** Astral is a predominantly CPVC pipe manufacturer and has launched multiple new PVC products. Faster-than-expected pick-up in new product demand could lead to higher-than-expected revenue estimates.
- **Incremental loss of unorganised market share:** Small fringe regional brands for plastic pipes and adhesives face immense challenges to compete with large brands in the ever-increasing tax-compliant business environment. Incremental brands forced out of the business or opting out intentionally could lead to faster-than-anticipated revenue growth and higher margins.
- **Shorter cash conversion cycle:** Astral is working hard to improve its receivables and inventory management terms. In case of faster implementation of effective controls, meaningful capital can be freed from working capital leading to better capital return ratios.
- **Strong adhesive segment performance:** Astral's adhesive segment has a low revenue base and is a fast-growing segment driving consolidated revenue growth for the company. Faster market share gains would lead to higher-than-expected revenue growth.

SWOT analysis

Figure 77: SWOT Analysis

Strengths

- First mover advantage for CPVC pipes in India
- Senior management execution skills
- Product innovation and R&D

Weakness

- Evolving national pipe brand presence
- High import dependence for raw material needs
- Exposed to adverse forex fluctuations

SWOT

Opportunities

- Urban and rural housing demand
- Capture large unorganised market share
- Diversify PVC product portfolio

Threats

- Stiff organised competition
- Slow pick-up of new product demand
- No. 1 adhesive players controls majority of the market

SOURCES: INCRED RESEARCH

About Astral Ltd.

Incorporated in 1996, Astral has established itself as one of India's dominant brands in the plastic piping segment especially into CPVC pipes with diverse end-user applications. The company is steadily progressing in the adhesive and infrastructure products segments.

Astral has been a pioneer in introducing CPVC pipes and fittings in India. It is present in four countries, has manufacturing plants at 12 locations and had over 1,600 permanent employees as of Mar 2020. The company currently has a pan-India distribution reach of ~30k dealers in the piping segment, and ~130k in the adhesives segment.

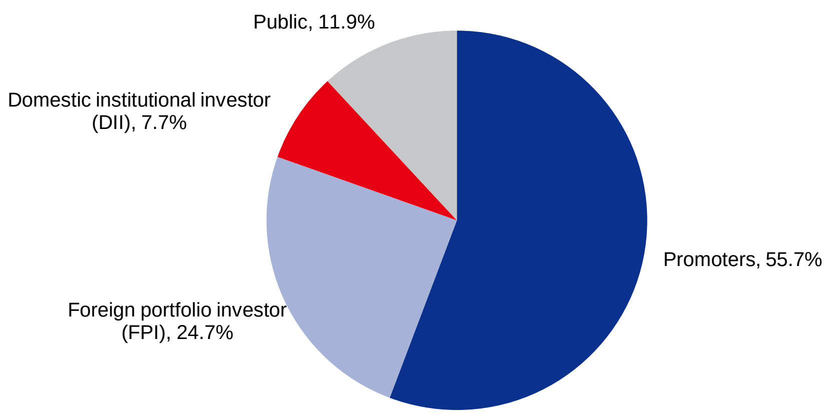
The board of directors consists of six independent and four non-independent directors.

Figure 78: Key management profile (FY20)

Mr. Sandeep P. Engineer, Managing Director	Mr. Engineer is a chemical engineer and started his career as a project engineer at Cadila Laboratories Limited. After about a year, he decided to promote Shree Chemicals, a proprietorship concern, in 1986. In 1992, he promoted the pharmaceutical venture Kairav Chemicals Private Limited to manufacture bulk drugs. Inspired by its success, he diversified into plastic pipes by collaborating with Specialty Process LLC for further growth and development, and later introducing CPVC in the Indian markets.
Mrs. Jagruti S. Engineer, Wholetime Director	Mrs. Engineer has a Bachelors in English. She began her career as a partner in Jagruti Pharmaceuticals till 1992. She has been actively involved in the day-to-day affairs of the company since its inception. She is experienced in Human Resource Management.
Mr. Hiranand Savlani, Chief Financial Officer	Mr. Savlani is a finance professional with over 25 years of experience in financial planning, insurance, global taxation, investor relations, merger acquisitions, legal and statutory compliances. Under his leadership Astral has had five successful acquisitions, diversifying its business into piping, adhesives and sealants, infrastructure, and plastic tanks.

SOURCES: INCRED RESEARCH, COMPANY REPORTS

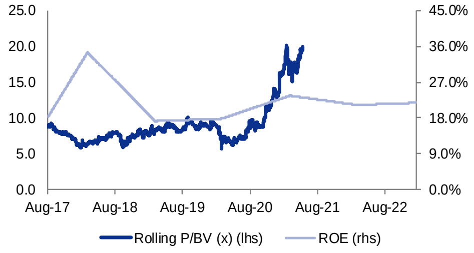
Figure 79: Shareholding pattern (Mar 2021)



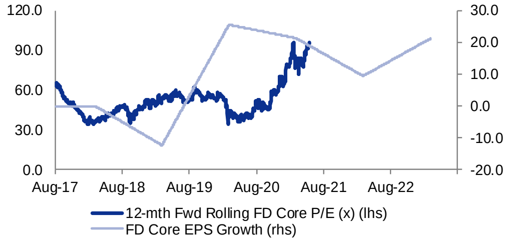
SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS

P/BV vs ROE



12-mth Fwd FD Core P/E vs FD Core EPS Growth



Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**25,073**	**25,779**	**31,763**	**38,022**	**43,521**
Gross Profit	**8,596**	**9,822**	**12,074**	**14,258**	**16,538**
Operating EBITDA	**3,849**	**4,429**	**6,445**	**7,034**	**8,269**
Depreciation And Amortisation	(814)	(1,079)	(1,165)	(1,306)	(1,435)
Operating EBIT	**3,035**	**3,350**	**5,280**	**5,728**	**6,834**
Financial Income/(Expense)	(258)	(318)	36	65	195
Pretax Income/(Loss) from Assoc.	(36)	(16)	(70)		
Non-Operating Income/(Expense)	93	45	50	100	105
Profit Before Tax (pre-EI)	**2,834**	**3,061**	**5,296**	**5,893**	**7,135**
Exceptional Items					
Pre-tax Profit	**2,834**	**3,061**	**5,296**	**5,893**	**7,135**
Taxation	(861)	(565)	(1,248)	(1,462)	(1,773)
Exceptional Income - post-tax	(2)				
Profit After Tax	**1,971**	**2,496**	**4,048**	**4,431**	**5,362**
Minority Interests		(17)	(38)	(42)	(46)
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**1,971**	**2,479**	**4,010**	**4,389**	**5,316**
Recurring Net Profit	1,973	2,479	4,010	4,389	5,316
Fully Diluted Recurring Net Profit	**1,973**	**2,479**	**4,010**	**4,389**	**5,316**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	3,849	4,429	6,445	7,034	8,269
Cash Flow from Invt. & Assoc.					
Change In Working Capital	308	188	1,142	(1,527)	(452)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow					
Net Interest (Paid)/Received	258	318	93	(65)	(195)
Tax Paid	(768)	(815)	(1,162)	(1,462)	(1,773)
Cashflow From Operations	**3,647**	**4,120**	**6,518**	**3,980**	**5,849**
Capex	(2,249)	(2,182)	(1,717)	(1,550)	(1,152)
Disposals Of FAs/subsidiaries	53	49			
Acq. Of Subsidiaries/investments	(771)	(1,055)	(2,856)	(500)	(500)
Other Investing Cashflow	54	11	32	210	306
Cash Flow From Investing	**(2,913)**	**(3,177)**	**(4,541)**	**(1,840)**	**(1,346)**
Debt Raised/(repaid)	354	(981)	(1,188)	(666)	
Proceeds From Issue Of Shares	2		1		
Shares Repurchased					
Dividends Paid	(94)	(240)	(151)	(1,005)	(1,407)
Preferred Dividends					
Other Financing Cashflow	(312)	(409)	(140)	(145)	(110)
Cash Flow From Financing	**(50)**	**(1,630)**	**(1,478)**	**(1,816)**	**(1,517)**
Total Cash Generated	684	(687)	499	324	2,985
Free Cashflow To Equity	**1,088**	**(38)**	**789**	**1,474**	**4,503**
Free Cashflow To Firm	**415**	**549**	**1,846**	**1,995**	**4,392**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	981	1,301	4,760	5,749	9,535
Total Debtors	3,391	2,278	2,767	3,646	4,173
Inventories	3,970	5,404	4,721	6,250	7,154
Total Other Current Assets	369	647	442	524	599
Total Current Assets	**8,711**	**9,630**	**12,690**	**16,169**	**21,461**
Fixed Assets	8,517	9,591	9,977	10,537	10,254
Total Investments	2	2			
Intangible Assets	2,538	2,553	2,570	2,570	2,570
Total Other Non-Current Assets	1,224	1,116	1,490	1,174	1,174
Total Non-current Assets	**12,281**	**13,262**	**14,037**	**14,281**	**13,998**
Short-term Debt	304	201	229		
Current Portion of Long-Term Debt					
Total Creditors	3,897	4,754	5,172	5,729	6,558
Other Current Liabilities	1,669	1,193	1,157	1,563	1,789
Total Current Liabilities	**5,870**	**6,148**	**6,558**	**7,292**	**8,346**
Total Long-term Debt	1,631	1,069	437		
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	31	48	162	162	162
Total Non-current Liabilities	**1,662**	**1,117**	**599**	**162**	**162**
Total Provisions	533	430	400	400	400
Total Liabilities	**8,065**	**7,695**	**7,557**	**7,854**	**8,908**
Shareholders Equity	12,777	15,029	18,958	22,342	26,251
Minority Interests	150	168	212	254	300
Total Equity	**12,927**	**15,197**	**19,170**	**22,596**	**26,551**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	21.0%	2.8%	23.2%	19.7%	14.5%
Operating EBITDA Growth	21.5%	15.1%	45.5%	9.1%	17.6%
Operating EBITDA Margin	15.4%	17.2%	20.3%	18.5%	19.0%
Net Cash Per Share (Rs)	(6.34)	0.21	20.38	28.62	47.46
BVPS (Rs)	84.93	99.75	94.36	111.21	130.66
Gross Interest Cover	9.51	8.50	40.31	39.51	61.99
Effective Tax Rate	30.4%	18.5%	23.6%	24.8%	24.8%
Net Dividend Payout Ratio	3.3%	7.9%	7.6%	17.2%	19.8%
Accounts Receivables Days	47.01	40.13	28.99	30.78	32.79
Inventory Days	83.54	107.21	93.85	84.26	90.66
Accounts Payables Days	81.83	98.94	92.01	83.72	83.11
ROIC (%)	26.5%	23.2%	33.8%	36.6%	39.3%
ROCE (%)	22.7%	21.2%	29.3%	27.5%	28.6%
Return On Average Assets	16.4%	15.4%	21.2%	20.4%	21.1%

SOURCES: INCRED RESEARCH, COMPANY REPORTS

CGSCIMB

INITIATION

InCred Equities

Company Note

Building Materials | India | June 14, 2021

India

HOLD *(Initiating coverage)*

Consensus ratings*:	Buy 17 Hold 6 Sell 5
Current price:	Rs2,249
Target price:	Rs2,345
Previous target:	NA
Up/downside:	4.3%
InCred Research / Consensus:	2.9%
Reuters:	SUPI.NS
Bloomberg:	SI IN
Market cap:	US$3,909m
	Rs285,683m
Average daily turnover:	US$3.2m
	Rs235.6m
Current shares o/s:	127.0m
Free float:	51.2%

**Source: Bloomberg*

Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	1.8	10.9	108.6
Relative (%)	(5.5)	7.3	34.3

Major shareholders	% held
Promoters	48.9
Nalanda India Fund	4.8
Axis Focused 25 Fund	3.0

Supreme Industries

Most positives priced in

- Demand revival and lower unorganised competition augurs well, in our view.
- Improving sales mix in favour of higher value-added products would lead to sustainably better EBITDA margin profile versus the past, in our view
- Stock run-up since Feb 2020 and EPS CAGR of -8% over FY21-23F leaves limited upside potential. Initiate coverage with Hold rating and TP of Rs2,345.

Rising demand trends and market share gains are key positives

Supreme Industries (Supreme) has a broad-based plastic products portfolio spanning the pipes, packaging, industrial and furniture segments. India saw declining economic growth over 2017-21 and early signs of demand for B2B/B2C segments over Jun 2020-Mar 2021. Broader trends of revival in discretionary consumer spends, rising capex of large private/public sector entities, customer preference shifting to national brands and weakening unorganised competition are key catalysts to drive topline growth over the next three years. We estimate a volume/revenue CAGR of 15.5%/8.4% over FY21-23F.

Improving nation-wide presence and value-added product sales

Supreme is focused on setting-up manufacturing facilities and widening distribution reach (Dec 2020: 4k channel partners) pan India to better serve customers. The share of value-added products was ~40% (Rs25bn) of FY21 revenues from 30% in 2017. Across four product segments, Supreme has increased product sales of products that earn higher EBITDA margins (over 17%) vs. on average company-level margins of 15-16% (FY17-20). The steep rise in PVC resin prices over the past 12 months led to exceptional FY21 EBITDA margins of 20.2%. We think improving global/local resin supplies would cool off resin prices. We expect lower EBITDA margins of 16.5%-17% over FY22-23F.

Consistent balance sheet improvement and FCF generation

Conscious of financial leverage, Supreme added ~200k tons of manufacturing capacity across segments over FY17-21 entirely funded through internal accruals. Net working capital averaged 35 days of sales over FY17-20 while ending at 19 days of sales in Mar 2021. Cumulative free cash flow was ~Rs20bn over FY17-21. We expect planned capex of Rs6.8bn and net WC cycle of ~30 days of sales over FY22F-23F with net cash of Rs13.2bn by Mar 2023. We estimate cumulative FCF of Rs10.6bn over FY22F-23F.

Stock up 60%+ since Feb 2020, limited upside potential in our view

High profits led to the stock rising by 60%+ (Nifty Midcap 150: +56%) since Feb 2020 due to pent up demand and inventory gains. Supreme's focus on retaining market leadership, profitable capital reinvestment and consistent FCF are key positives. However, recent stock rally, peaking margins and EPS CAGR of -8% over FY21-23F leaves limited upside potential, in our view. We initiate coverage with a Hold rating and TP of Rs2,345 (P/E of 36x FY23F EPS, a 20% premium to its five-year mean P/E). Upside risks: high PVC prices, receding competition. Downside risks: Adverse forex rates, prolonged COVID-19.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	56,120	55,115	63,571	71,087	74,650
Operating EBITDA (Rsm)	7,846	8,346	12,843	11,872	12,690
Net Profit (Rsm)	4,486	4,674	9,771	8,096	8,276
Core EPS (Rs)	30.0	36.8	76.9	63.7	65.2
Core EPS Growth	(11.3%)	22.5%	109.0%	(17.1%)	2.2%
FD Core P/E (x)	63.68	61.12	29.24	35.29	34.52
DPS (Rs)	13.0	14.0	22.0	22.0	24.0
Dividend Yield	0.70%	0.75%	0.98%	0.98%	1.07%
EV/EBITDA (x)	36.57	34.45	21.65	23.29	21.47
P/FCFE (x)	176.69	51.28	44.87	84.75	43.73
Net Gearing	5.8%	7.9%	(24.2%)	(25.0%)	(31.3%)
P/BV (x)	13.26	12.63	9.01	7.72	6.77
ROE	18.8%	21.2%	36.0%	23.6%	20.9%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)				1.03	0.94

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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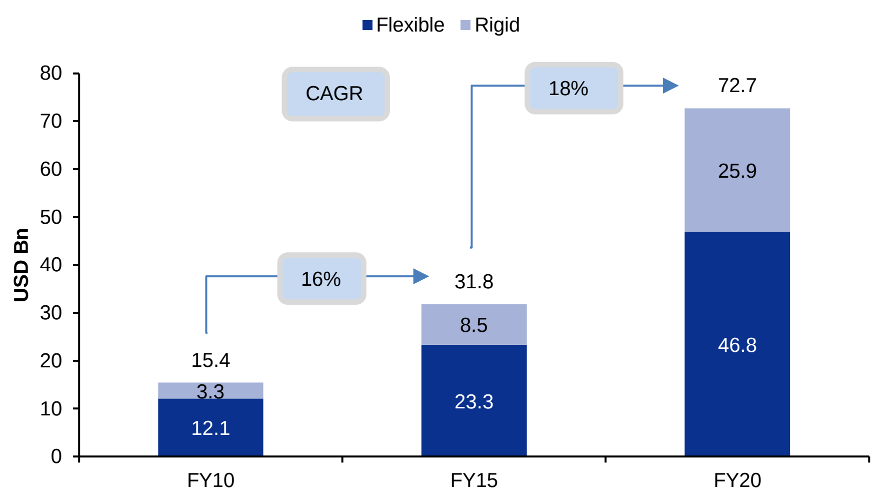
Powered by EQUITEC

Most positives priced in

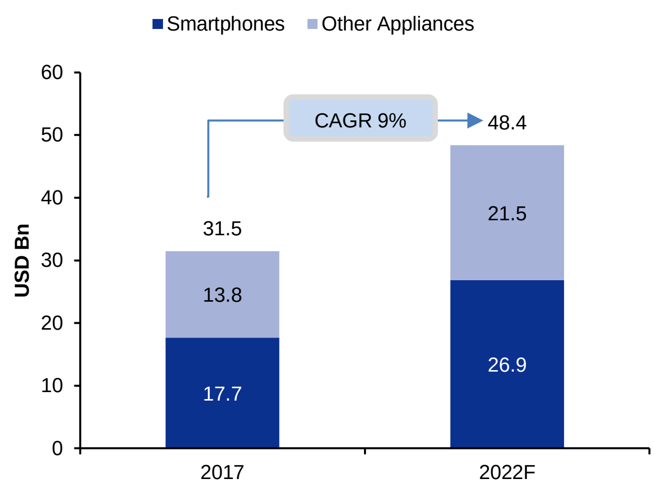
Demand revival across customer segments, receding competition to aid growth ›

Figure 80: Plastic packaging industry outlook (US$ bn)



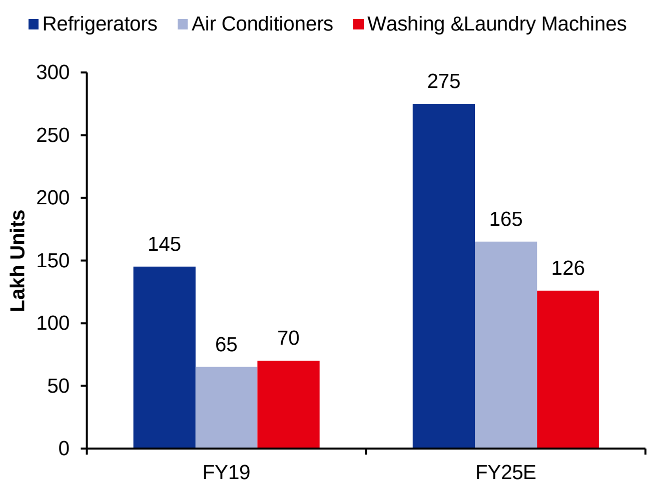
SOURCES: INCRED RESEARCH, A REPORT ON PLASTIC INDUSTRY KNOWLEDGE, FICCI

Figure 81: Indian appliance and consumer electronics industry (US$ bn)



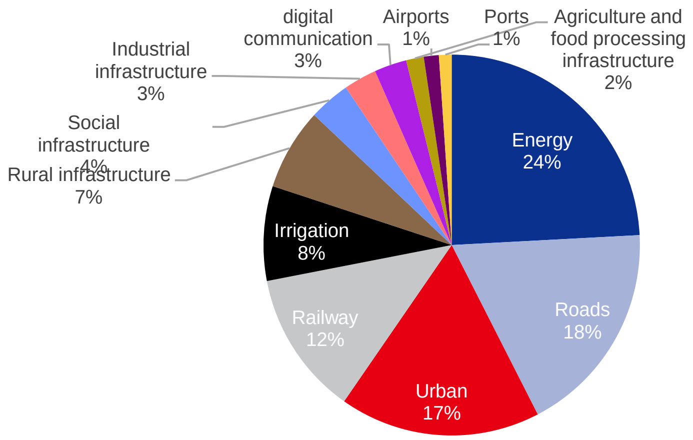
SOURCES: INCRED RESEARCH, INDIA BRAND EQUITY FOUNDATION (IBEF)

Figure 82: Production of major white goods in India(lakh units)



SOURCES: INCRED RESEARCH, IBEF

Figure 83: Government has planned capex of Rs111 lakh crore under NIP over FY20-FY25F. Over 60% allocated for roads, urban/rural infrastructure, railway and irrigation



SOURCES: INCRED RESEARCH, WWW.DEA.GOV.IN

Figure 84: Excerpts from the Finance Minister's speech on Union Budget 2021-2022

Railway Infrastructure
"I am providing a record sum of `1,10,055 crores, for Railways of which `1,07,100 crores is for capital expenditure."

Urban Infrastructure
"A total of 702 km of conventional metro is operational and another 1,016 km of metro and RRTS is under construction in 27 cities. Two new technologies i.e., 'MetroLite' and 'MetroNeo' will be deployed to provide metro rail systems at much lesser cost with same experience, convenience and safety in Tier-2 cities and peripheral areas of Tier-1 cities."

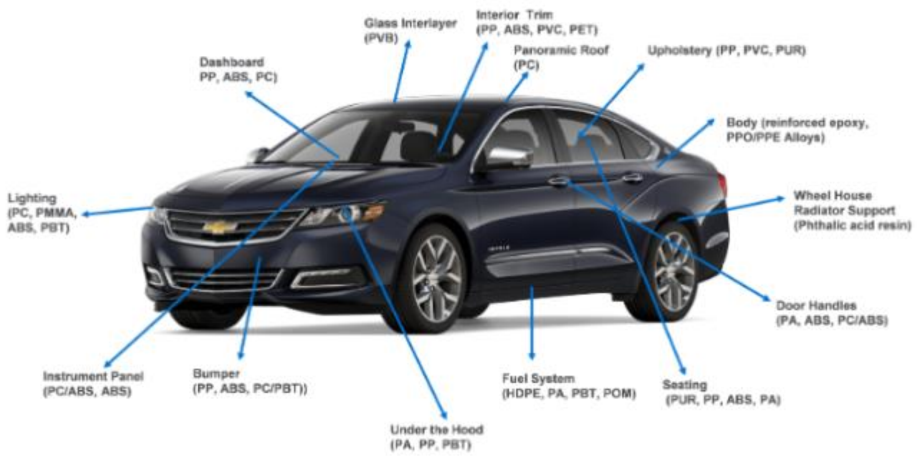
Rural Infrastructure
"We are enhancing the allocation to the Rural Infrastructure Development Fund from `30,000 crores to `40,000 crores."

National Infrastructure Pipeline
"The NIP was launched with 6835 projects; the project pipeline has now expanded to 7,400 projects. Around 217 projects worth `1.10 lakh crores under some key infrastructure Ministries have been completed."

Road Infrastructure
"I am also providing an enhanced outlay of `1,18,101 lakh crores for Ministry of Road Transport and Highways, of which `1,08,230 crores is for capital, the highest ever"

RRTS = REGIONAL RAPID TRANSIT SYSTEM
SOURCES: INCRED RESEARCH, BUDGET SPEECH 2021-2022

Figure 85: Plastic applications in auto parts



SOURCES: INCRED RESEARCH, WWW.NEXANT.COM

Accelerated reduction in unorganised competition led by COVID-19 pandemic ›

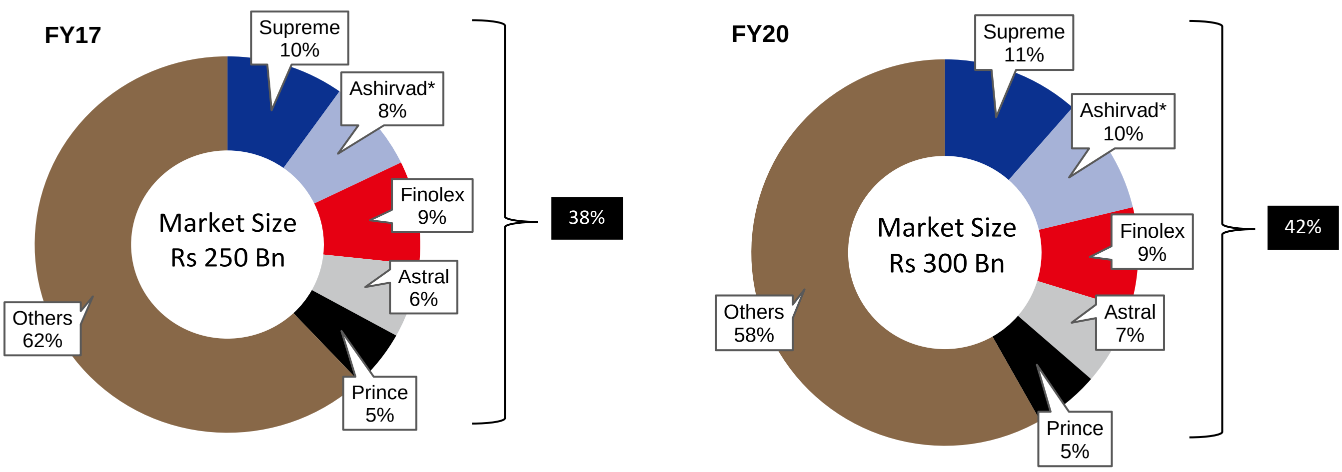
"Last year the PVC market countrywide had degrowth of ~15%. Our company had degrowth of PVC consumption by 3.5%. So, we were able to increase our market share in the PVC piping sector last year."

– Supreme Industries, 4QFY21 earnings call

The shift in consumer preferences to organised brands, that started during 2016-17 due to demonetisation and GST enactment, accelerated further in 2020. The COVID-19 pandemic impacted micro, small, and medium enterprises (MSMEs) much more than larger players across industries. Balance sheets stretched largely due to elongated working capital cycles led to a delayed re-start of MSMEs, which are now finding it difficult to regain lost share of business.

With regards to plastic pipes, listed company managements have been highlighting incremental market share gains through the period post the COVID lockdown (Jun-Mar 2021) in their quarterly earnings call.

Figure 86: Aggregate market share of top 5 piping players increased from 38% in FY17 to 42% in FY20



*COMPANY-LEVEL REVENUE TAKEN FOR ASHIRVAD PIPES
SOURCES: INCRED RESEARCH, COMPANY REPORTS, WWW.MCA.GOV.IN

Figure 87: Listed company management commentary of market share shift to organised players

SOURCES: INCRED RESEARCH, INVESTOR CONCALL TRANSCRIPTS

"The overall turnover of value-added products increased to Rs24.8bn compared to Rs20bn in the previous year, achieving growth of 20%."

– Supreme Industries, 4QFY21 earnings call

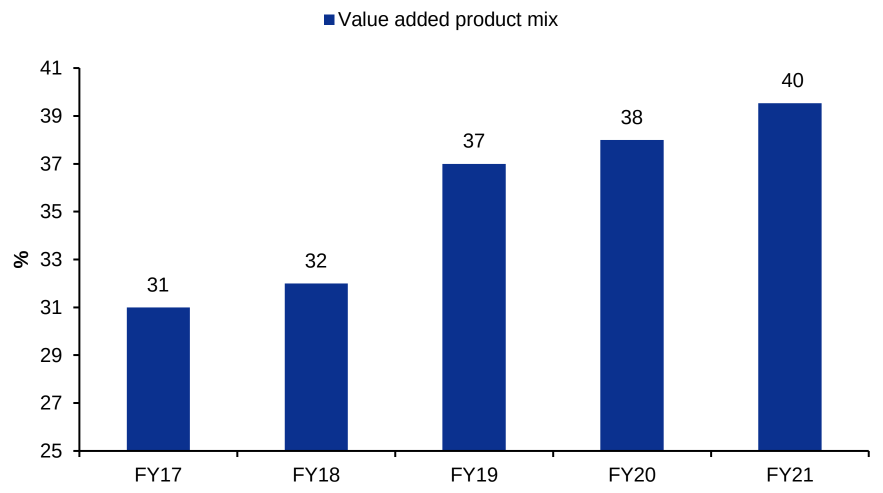
Investing in right areas at the right time ›

New capacity creation with higher share of value-added products

Supreme has been investing in and continuously creating capacity. The company focusses on new product innovations that are relatively better in quality than existing products made available to customers at cheaper prices.

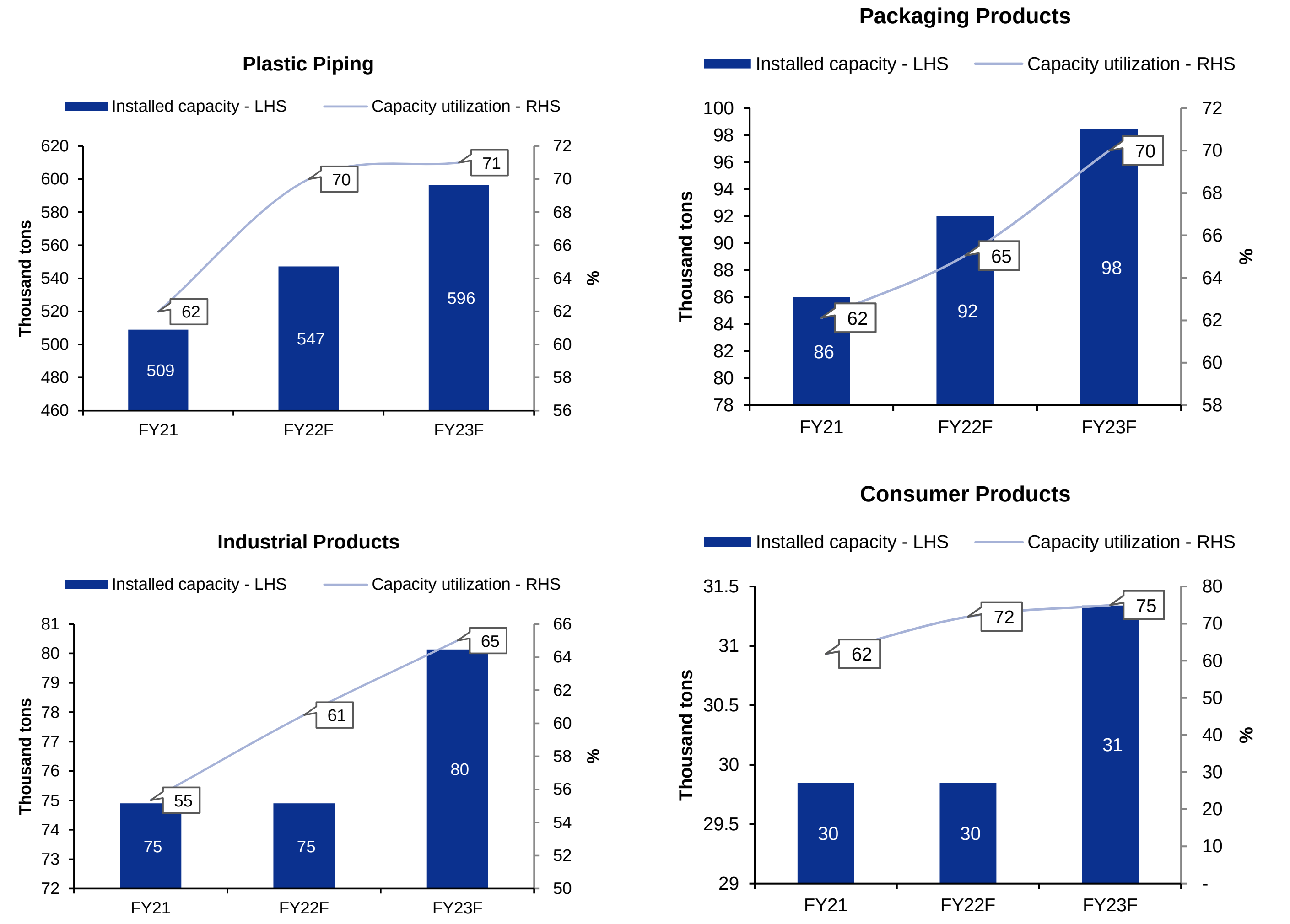
Capacities have increased across all product segments of plastic pipes (CPVC + PVC), industrial products, packaging and consumer products (largely furniture). While doing this, the company focused on increasing share of value-added product revenue, which rose to ~40% at the end of FY21 from 31% in FY17.

Figure 88: Supreme Industries' share of value-added products in total sales inching up



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 89: Segmental capacity utilisation trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 90: Supreme Industries' product launches over past years

Segment	Products
Plastic piping	Light Hazard Fire Sprinkler System
	Bathroom Fittings
	DWC HDPE Pipe System
	HDPE Pipes above 315mm diameter & up to 800mm diameter
	CPVC Pipe System - 6" & above for industrial use
	Water tanks & septic tanks
	Sewerage & Drainage System
	Industrial Valves
Packaging	XL Bonded Film - 35 GSM to 250 GSM
	30 & 35 GSM Cross Laminated Film & Cross Laminated Film - 400 GSM
	Varieties of Insulation Products in Protective Packaging Division
	Various Floor Protection & Sound Proofing Products in Protective Packaging Division
	Retail Product Range in Protective Packaging Division
Consumer	Blow Moulded Furniture
	Several varieties of new furniture products
	Roto Moulded Furniture
Industrials	Several varieties of crates, pallets & dust bin
	Composite LPG cylinder

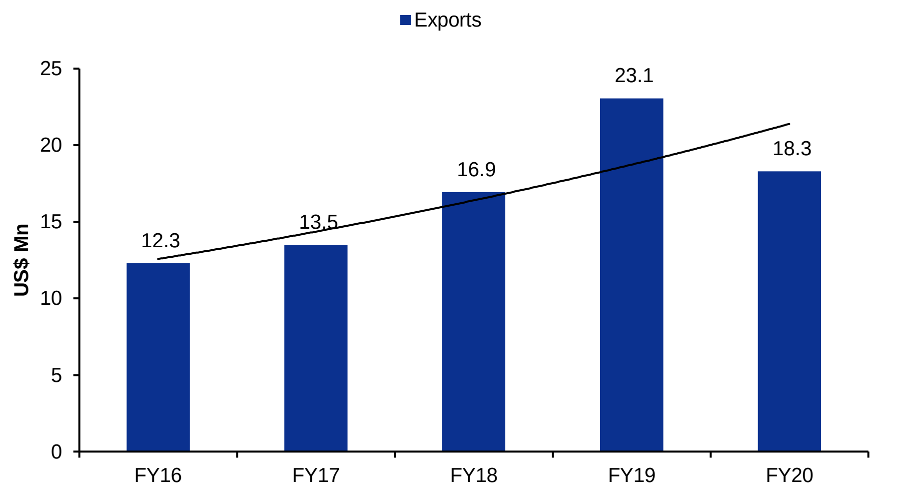
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Export focus

"The thrust in the coming year in exports will be mainly on developing newer applications, entering new markets and targeting chain stores and super markets for sale through their online portals."
– Supreme Industries, 4QFY21 investor call

With a renewed push to reach more international markets, Supreme participated in over 16-20 international exhibitions in 2019-20. The company is in talks with a large number of leading retailers in the US, Europe, the UK, Japan, and hopes to begin business with many of them once COVID-19-led travel restrictions reduce. The company has already completed the initial vendor assessment process and its Lalru manufacturing unit has cleared the Sedex Members Ethical Trade Audit (SMETA) required for social compliance by most global large retailers. Exports stood at ~US$18m (2% of total sales) in FY20 and we expect them to increase meaningfully over the next three to five years.

Figure 91: Supreme Industries' exports trend



SOURCES: INCRED RESEARCH, COMPANY REPORTS

We estimate revenue CAGR of 8% over FY21-23F

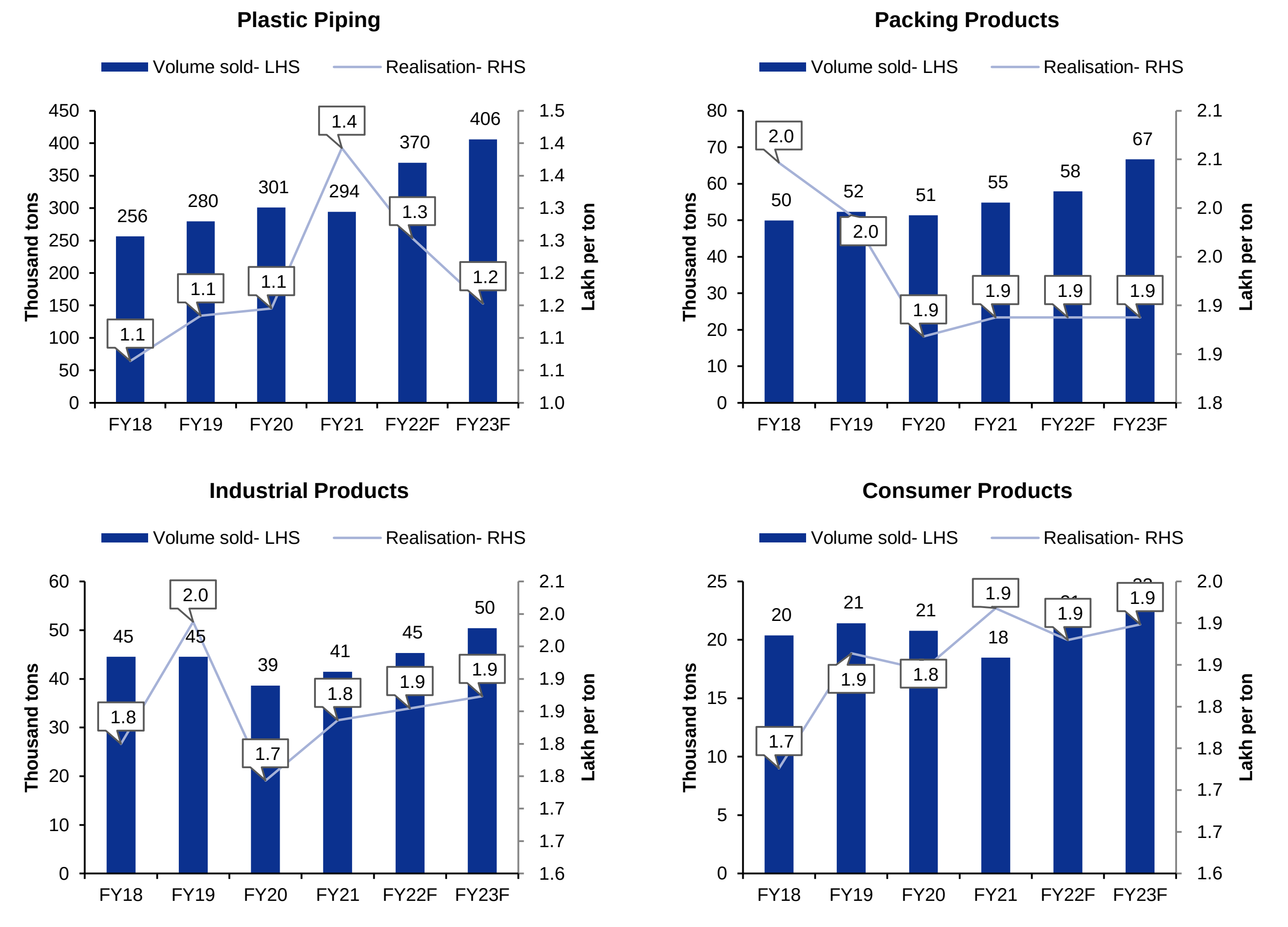
"The situation has become volatile due to steep increase in polymer prices. The increase in PVC prices was steepest. In the last 40 years, international prices of PVC have never reached levels seen in Apr 2021 especially in India."
– Supreme Industries, 4QFY21 earnings call

Product realisations have increased sharply owing to steep rise in raw material (PVC resin) prices led by supply shortages globally (COVID-19 disruption) since Jun 2020. As supplies restore both in India and internationally, we expect PVC prices to cool-off and settle at normalised levels over CY21-22. On a per ton basis, realisations across segments for Supreme Industries have risen and we expect prices to cool over the next two years assuming COVID-19 infections go down as vaccination coverage improves.

PVC price outlook

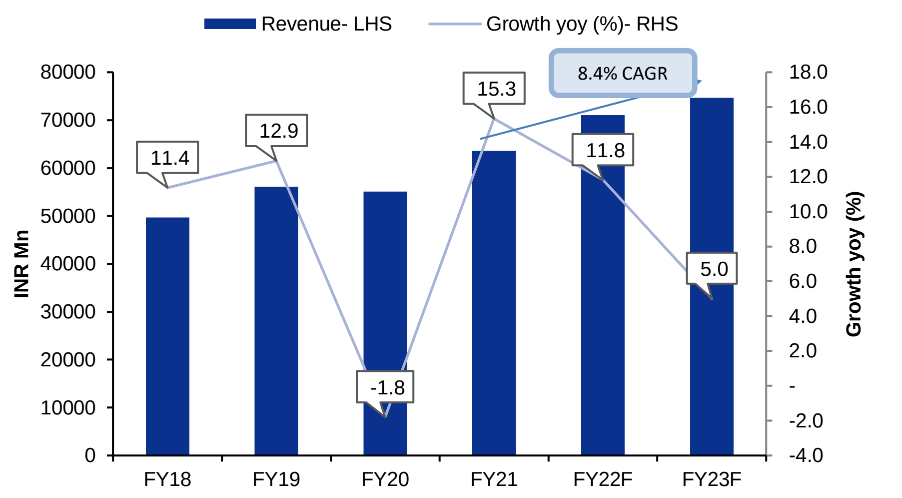
According to Mr Nihar Chheda, AVP, Corporate Strategy, Prince Pipes, 4QFY21 investor call, "We have seen a slight reversal in PVC as of yesterday. This one has been India-specific PVC pricing reduction, however across the globe prices continue to remain firm. In terms of do we foresee it to be as steep, maybe not. Of course, it is hard to predict these things, but what we understand is that the fall is not going to be as sharp as with an increase. And PVC normal levels may not ever come back to what the initial normal levels were. So, that is our best estimate at this time."

Figure 92: Segmental volume and realisation trend



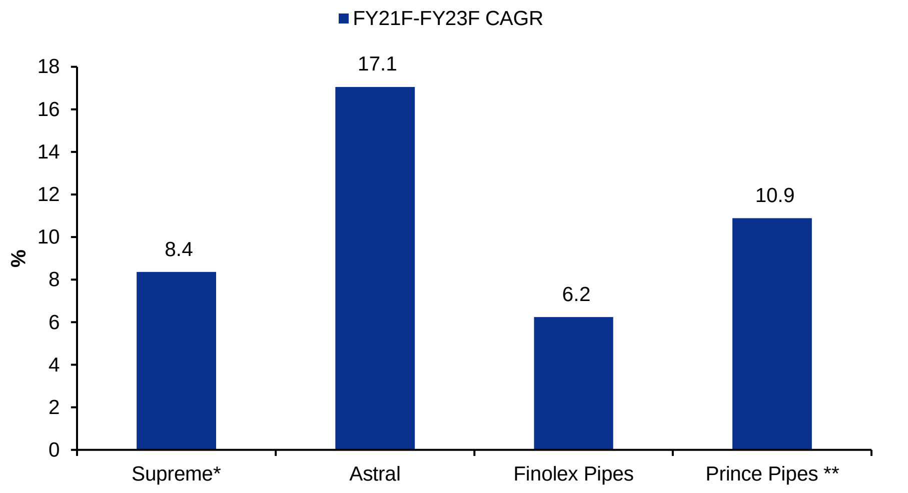
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 93: Supreme Industries' revenue trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 94: Revenue CAGR for listed plastic pipe makers



*FY21 ACTUAL NUMBERS FOR SUPREME INDUSTRIES, **BLOOMBERG CONSENSUS ESTIMATES FOR PRINCE PIPES
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG

Exceptional margins to normalise over FY21-23F

Unprecedented PVC price inflation globally

"The company, however, has come out of extremely adverse situations with unparalleled performance where the profit of the company was highest in its 79 years of operations. This was partly supported by more than Rs2bn of inventory gain on account of raw material price increase which accrued in its operations for the year."

– Supreme Industries, 4QFY21 earnings call

India's PVC resin production capacity is short of annual needs and India imported over 50% of its annual resin requirement in FY18 as per Chemicals and Petrochemicals Manufacturers Association (CPMA) of India. Large producers of PVC resin in India are Reliance Industries (~50% of Indian production) (RIL:IN, CMP: Rs2,213, TP: Rs1,400; Reduce), Chemplast Sanmar (filed for an IPO in Apr 2021), Finolex Industries (FNXP IN, CMP: Rs172, TP: Rs180, Add) , DCW Limited (DCW IN, CMP: Rs37, Not rated) and DCM Shriram (DCMS IN, CMP: Rs728, Not rated).

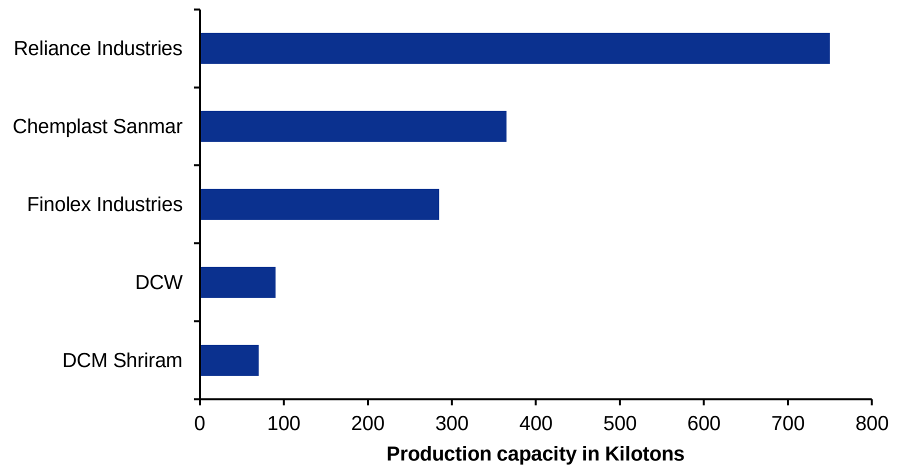
PVC resin prices have risen sharply as the COVID-19 pandemic has hit global production. Resin prices are up 150% over Jun 2020-May 2021 (Source: Bloomberg) leading to significant inventory gains and exceptional profit margins for plastic pipe companies during 9MFY21.

Figure 95: India PVC resin capacity and demand supply (m tons)

	2017-18 A	2018-19 F	2019-20 F	2020-21 F
Capacity	1.6	1.6	1.6	1.6
Production	1.4	1.4	1.5	1.5
Imports	1.7	1.8	2.1	2.4
Apparent Demand	3.0	3.2	3.6	3.9
Demand Growth (%)	2.0%	4.6%	13.4%	6.9%

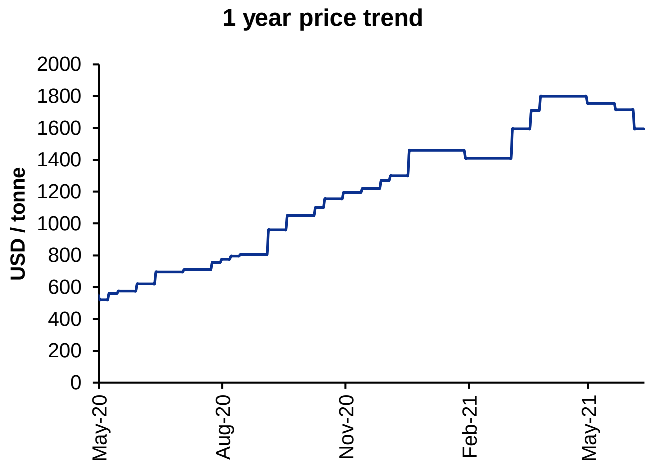
SOURCES: INCRED RESEARCH, CHEMICALS AND PETROCHEMICALS MANUFACTURERS' ASSOCIATION (CPMA) INDIA ESTIMATES

Figure 96: Estimated PVC resin production capacity across India in financial year 2019, by company



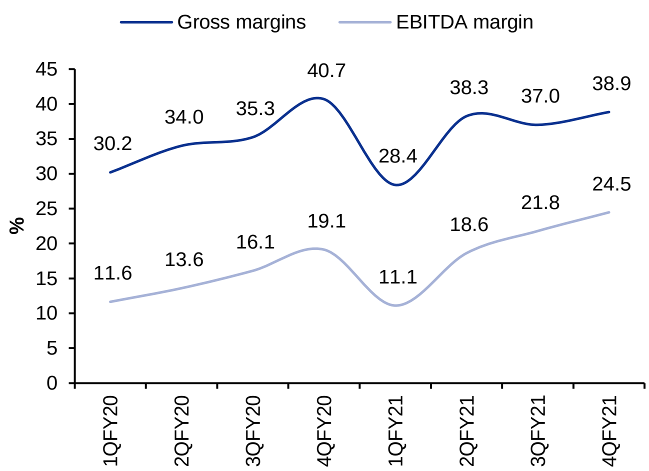
SOURCES: INCRED RESEARCH, STATISTA

Figure 97: PVC (Polyvinyl chloride) resin price trend



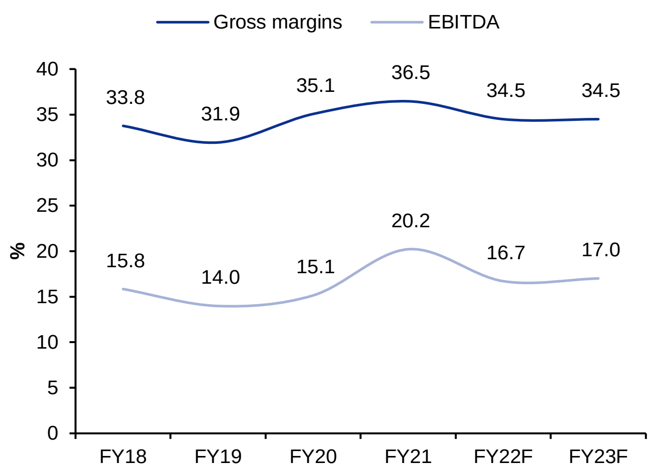
SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 98: Quarterly gross and EBITDA margin trend



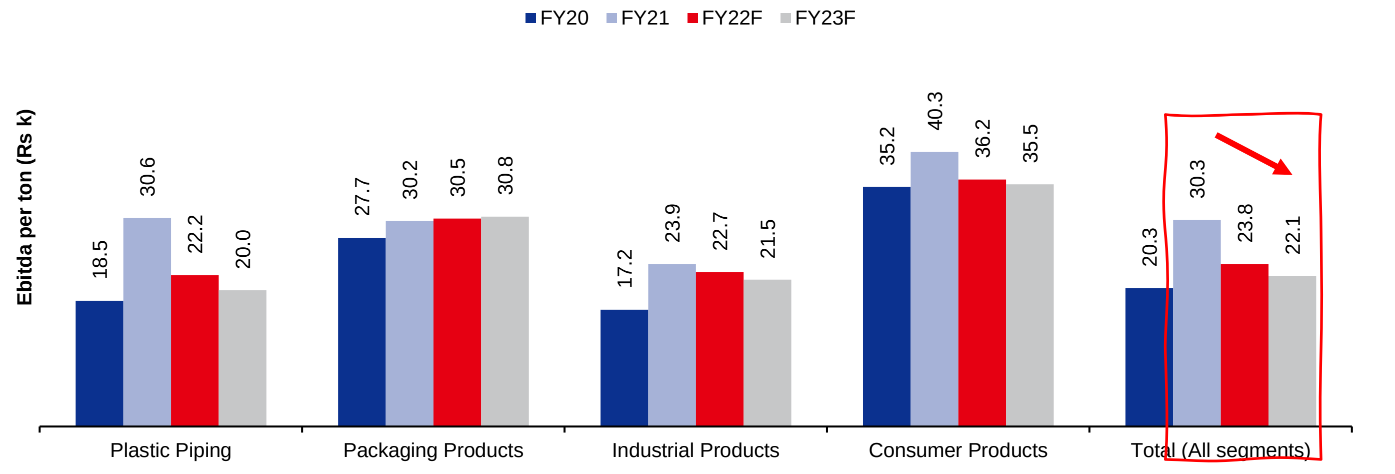
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 99: Yearly gross and EBITDA margin trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 100: We estimate EBITDA per ton to drop once PVC resin prices normalise (FY20-23F)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Expansion of manufacturing capacity and distribution reach across India is a key focus area ›

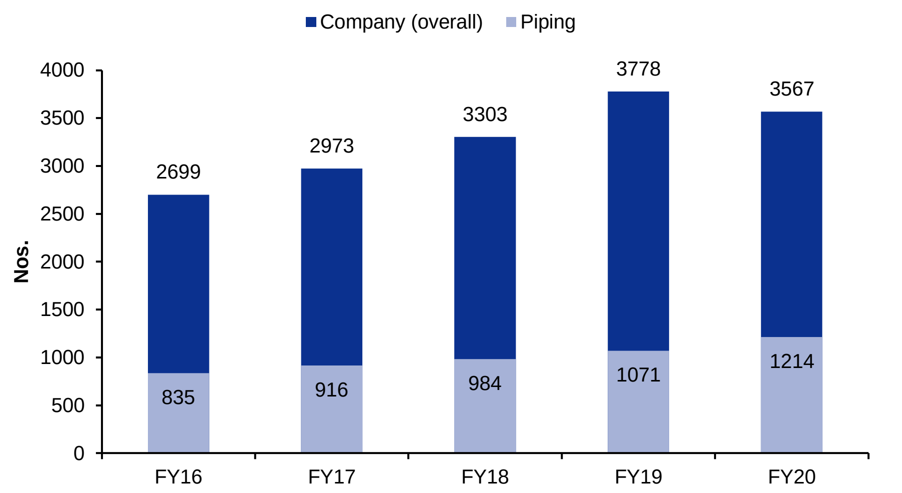
Supreme Industries' piping products were available at 32k retail outlets across India and furniture products at 13k as at Mar 2020.

Supreme Industries is the market leader in the plastic pipe industry in India with 11% revenue market share and annual production capacity of ~700k tons (Mar 2021). The company has consistently expanded its channel partnerships with dealer/distributors across India. It had over 8k SKUs across its various product segments as of Mar 2020.

The number of channel partners (distribution reach) has improved every year. Pipe channel partnerships stood at 1214 at the end of Mar 2020, and furniture at 1,113. Overall, the company had 3,567 channel partners in Mar 2020.

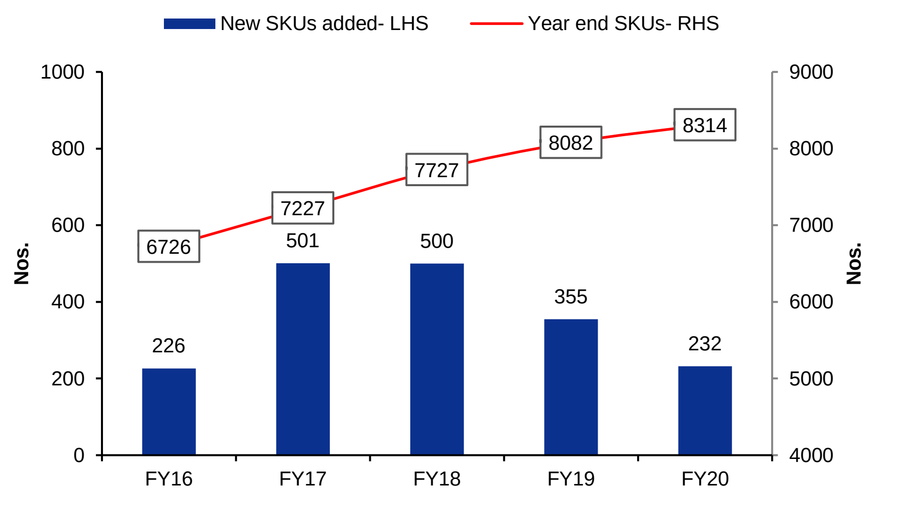
Supreme Industries spends ~1.5% of its sales on advertising and publicity activities annually.

Figure 101: Channel partner network development over years



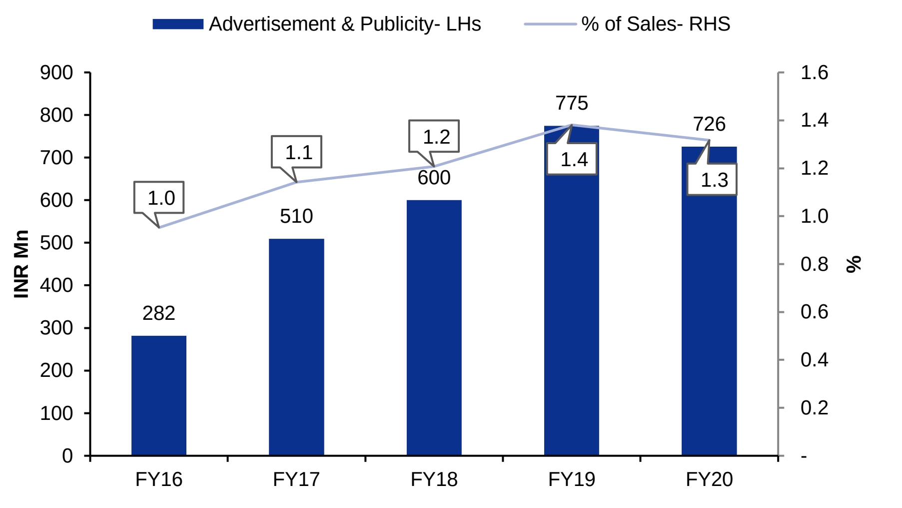
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 102: Total SKUs and yearly addition trend



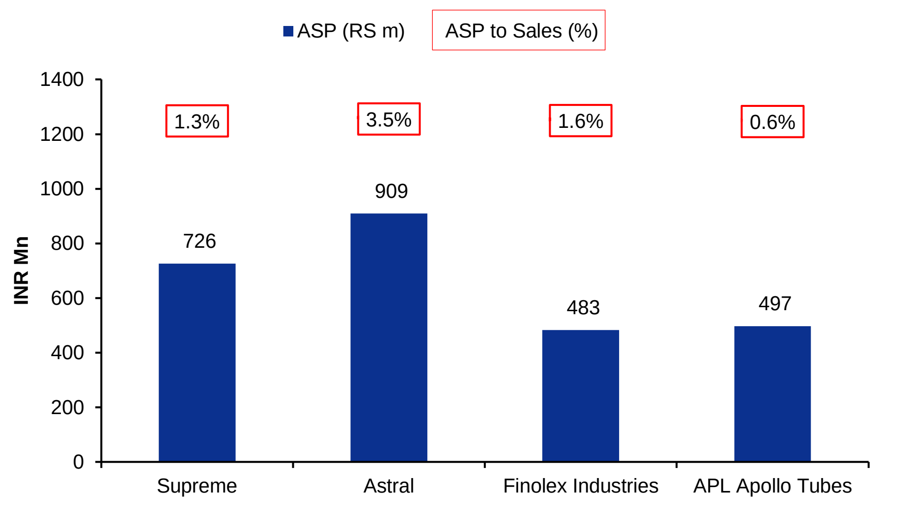
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 103: Supreme Industries' annual ASP spends



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 104: Advertising spends across plastic/metal pipe companies (FY20)



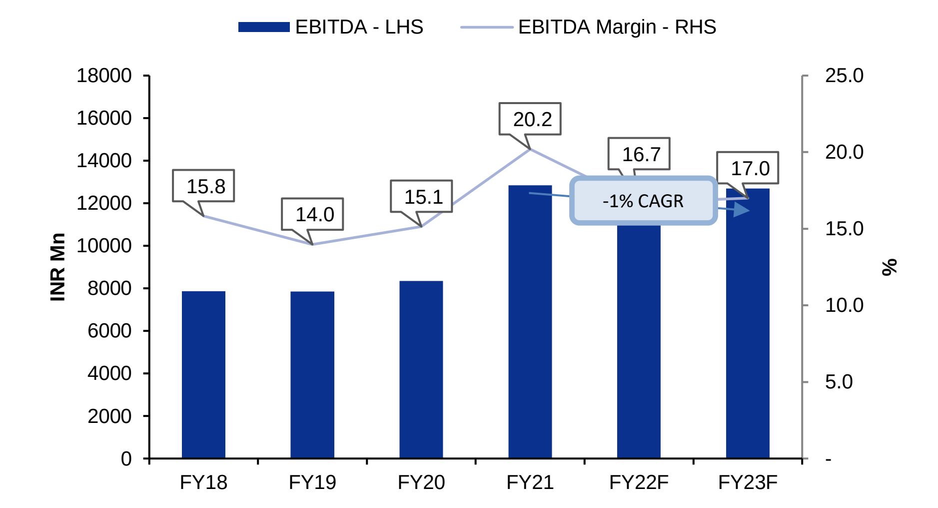
SOURCES: INCRED RESEARCH, COMPANY REPORTS

"In the third quarter, our operating margin has gone up to 21.53%. When I say Rs80 crores was inventory gain and if you divide this Rs80 crore by the Rs1,765 crore turnover, it will come down by more than 4%. If I exclude inventory gain the operating margin will be something close to 17%- 17.2%."
– Supreme Industries, 3QFY21 earnings call

Expect reported EBITDA to be flat over FY21-23F ›

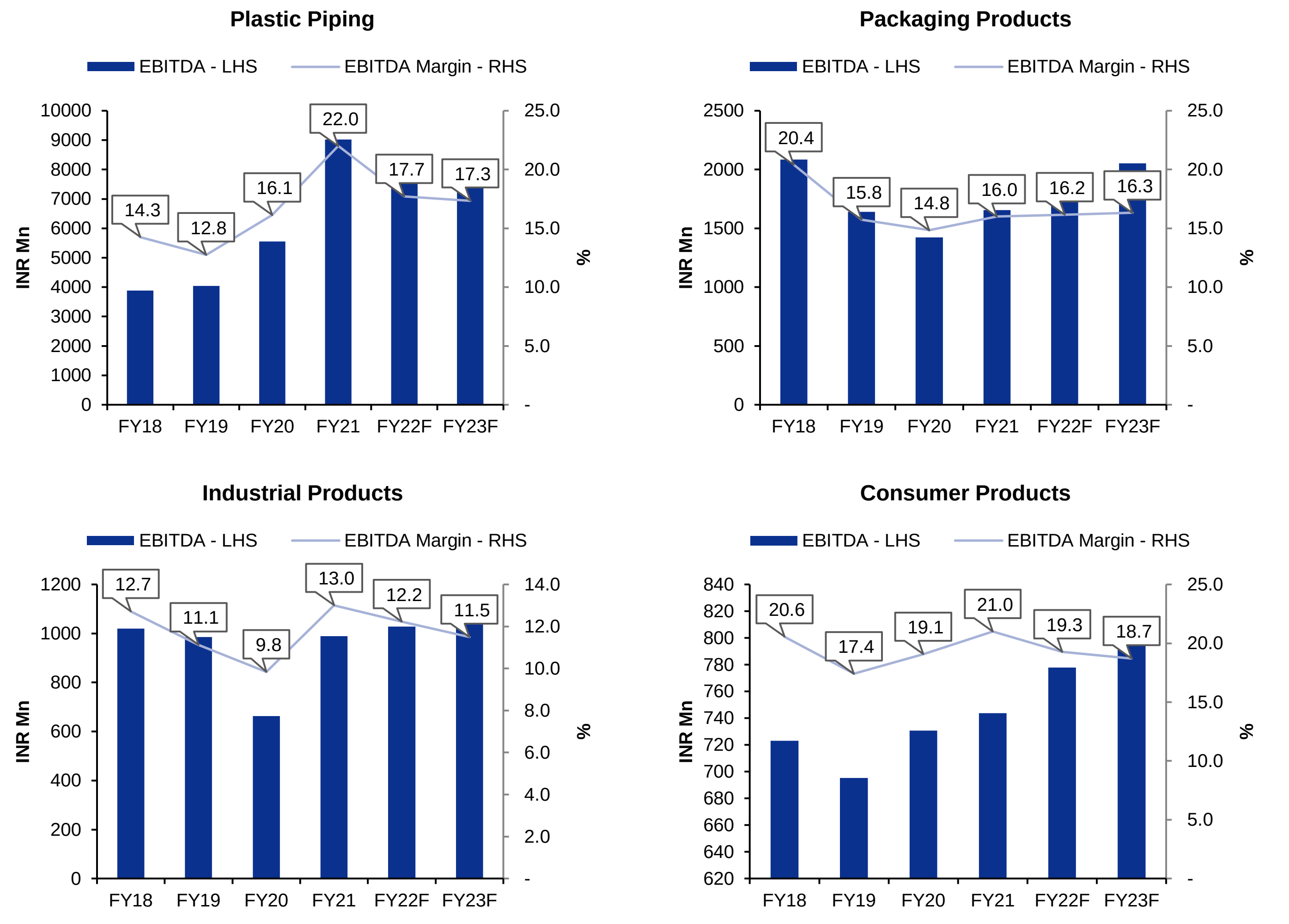
Owing to extraordinary inventory gains of over Rs2bn, the reported EBITDA for FY21 is inflated, in our view. Adjusted for these temporary gains, we expect EBITDA CAGR of 8.2% over FY21-23F. However, EBITDA margins would decline 280bp to 17% (15-17% is sustainable in our view) in FY23F from 20.2% in FY21.

Figure 105: Supreme Industries' annual EBITDA and margin trend



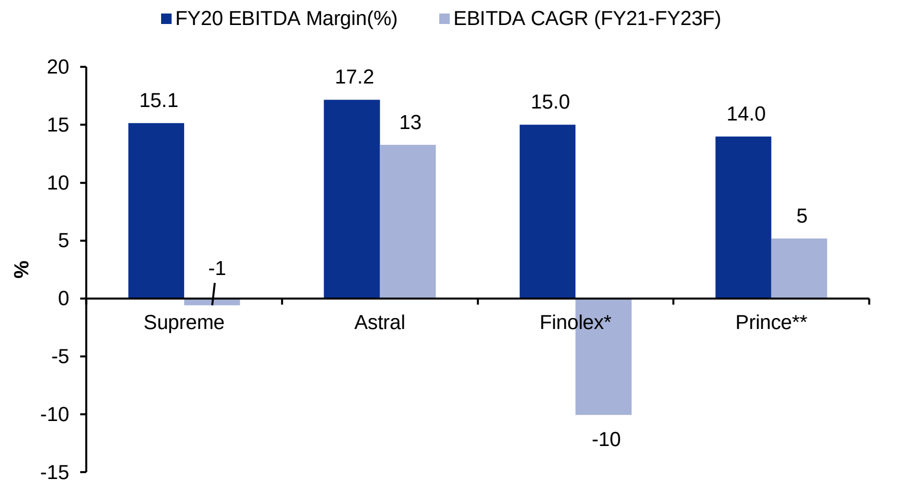
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 106: Segmental EBITDA and margin trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 107: EBITDA margin and growth peer comparison



*FY21F FOR FINOLEX INDUSTRIES; ** DENOTES BLOOMBERG CONSENSUS
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG

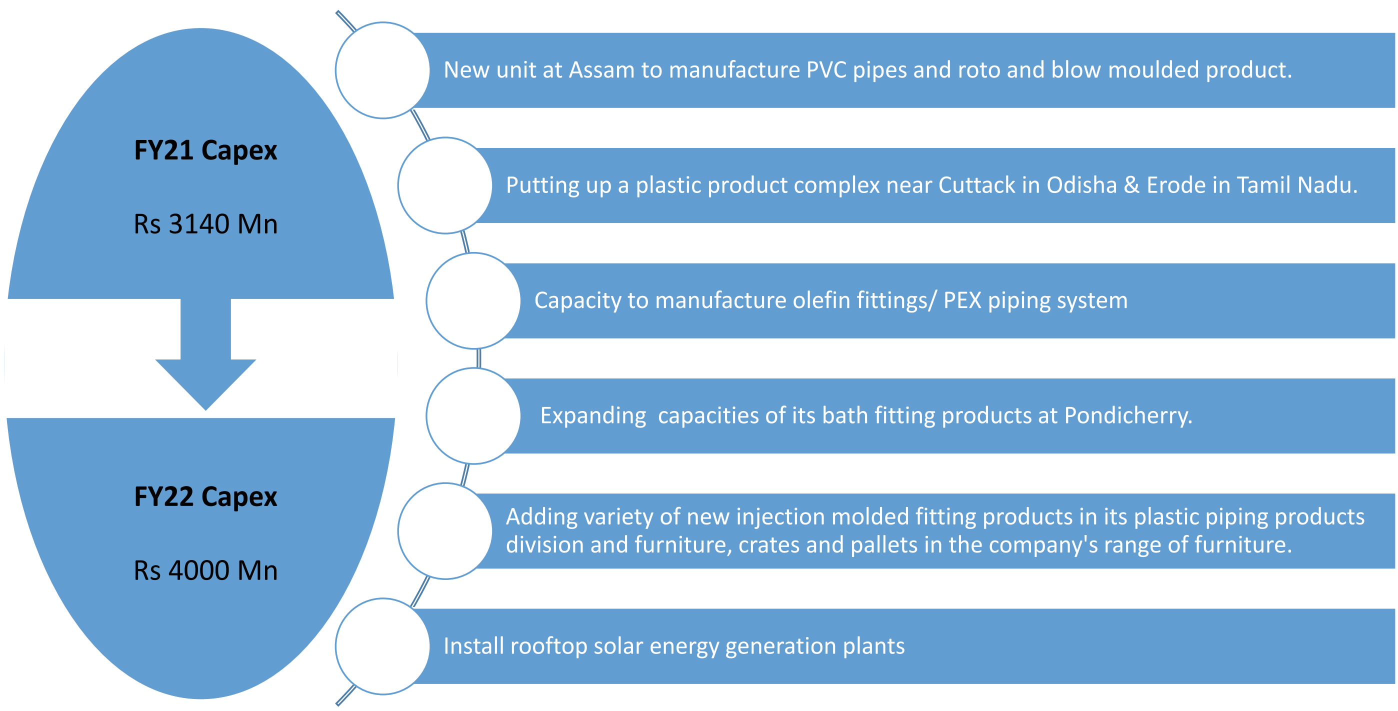
Creating supply for future demand; structural margin improvements to result in higher cash flow generation

Company to invest nearly Rs4bn over the next 12 months

"During the current year, that is, 2021-22, the company envisages new capex of about Rs400 crore, that include carry-forward commitments of Rs198 crore at the beginning of the year."
– Supreme Industries, 4QFY21 earnings call

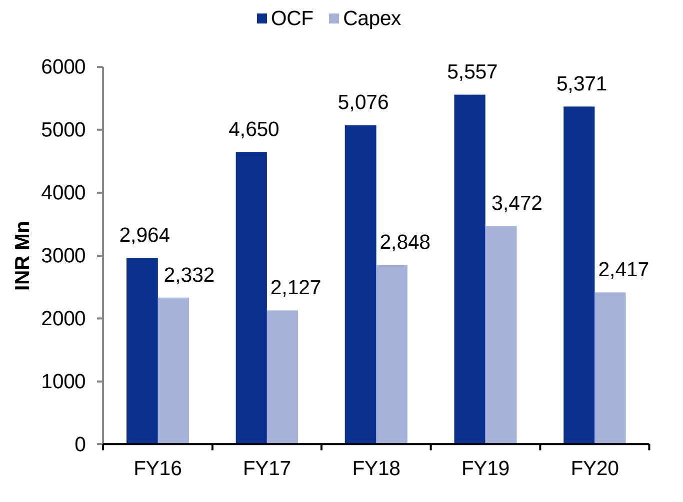
As highlighted earlier, Supreme Industries has consistently increased capacities across segments. Given the robust demand outlook for PVC pipes and other plastic products, Supreme is creating supply commensurate with likely demand and we estimate a cumulative capacity increase of over 100k tons over FY22F-23F to the existing base of ~700k tons. This would entail a capex of Rs6.8bn. The details of the FY22 capex spends are given below.

Figure 108: Supreme Industries' capex plan in FY22F (as per 4QFY21 investor call transcript)



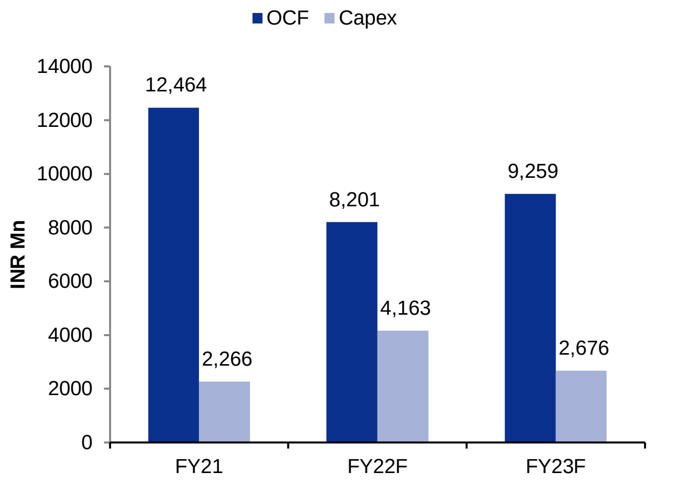
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 109: Supreme's OCF and capex trends (FY16-FY20)



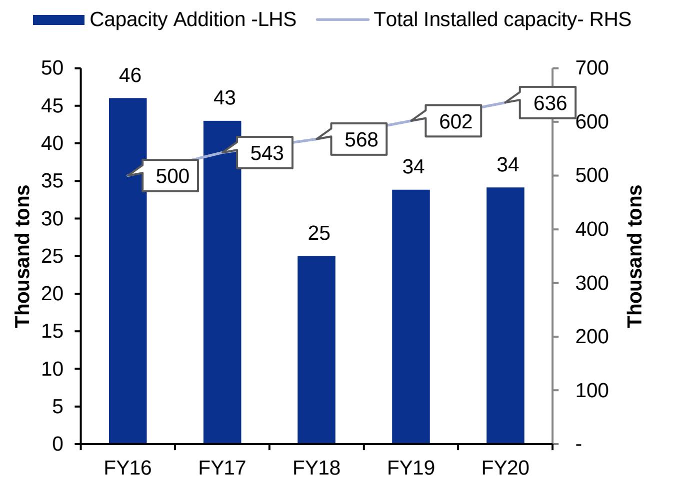
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 110: Supreme's OCF and capex (FY21-FY23F)



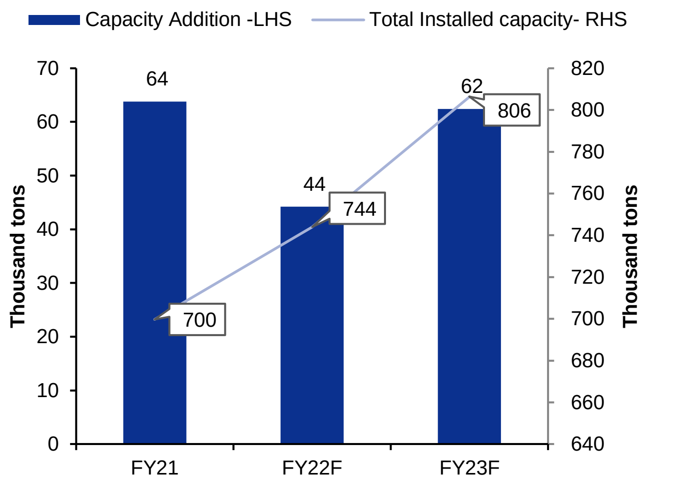
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 111: Supreme's annual capacity and yearly addition (FY16-FY20)



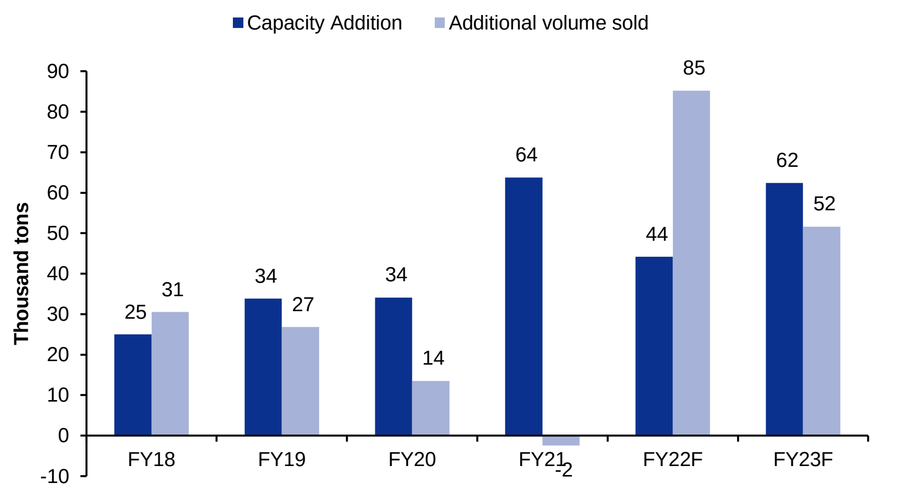
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 112: Supreme's annual capacity and yearly addition (FY21-FY23F)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 113: Supreme's new capacity addition and incremental sales volume each year

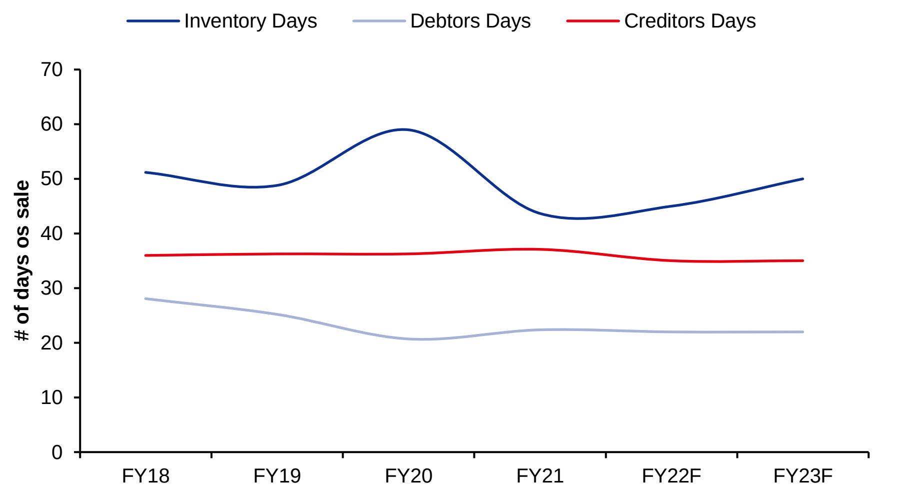


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Disciplined management of working capital

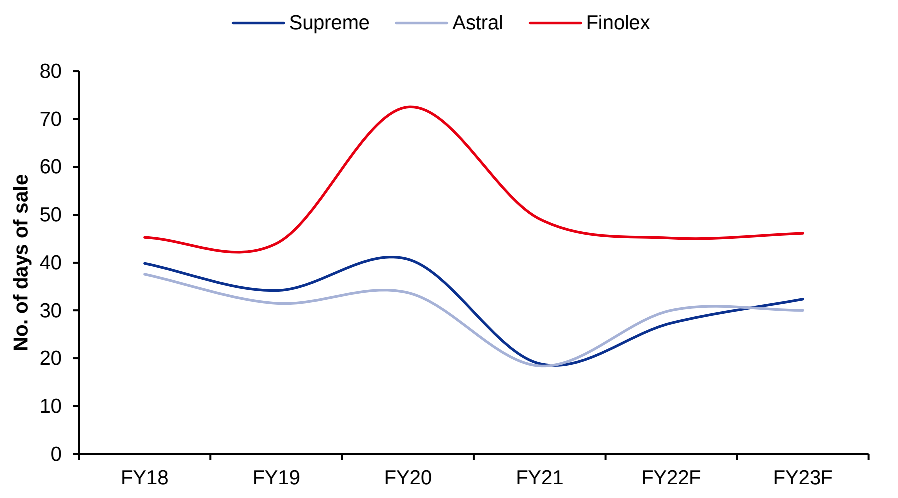
Supreme operates with a very lean net working capital cycle, with inventory at 45-50 days of sales and debtors at 20-25. Assuming FY21 as an exceptional year (steep PVC price rise, extra caution with respect to cash collections and inventory controls), we estimate the net working capital cycle to be 25-30 days of sales vs 35-40 over the past three years.

Figure 114: Debtors, creditors and inventory days



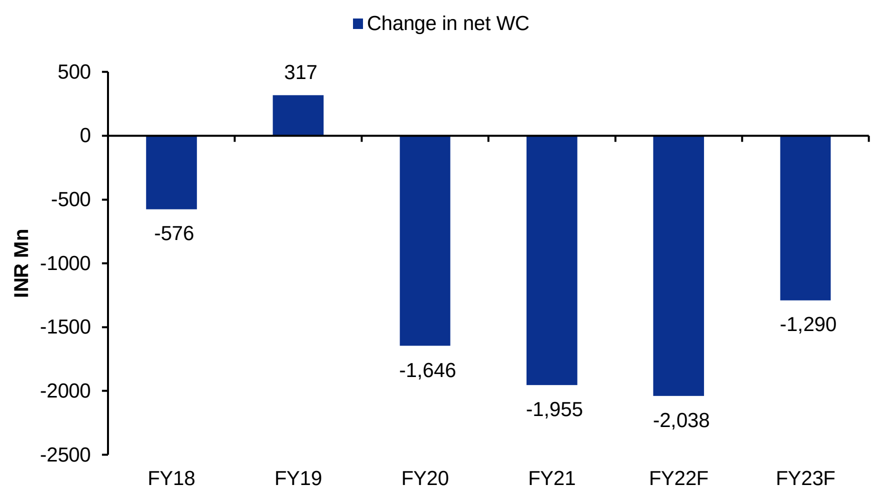
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 115: Peer comparison for net working capital (excluding cash)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 116: Change in absolute WC investment yoy

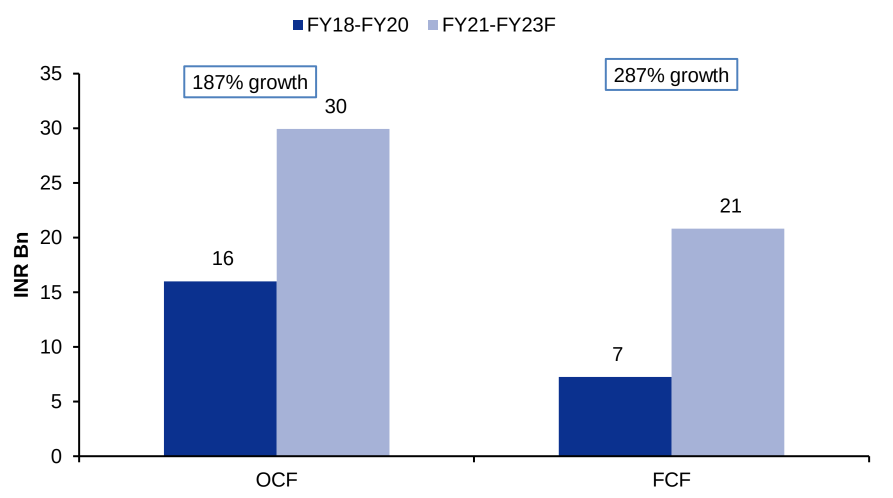


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Strong free cash flows on the back of improving margins ›

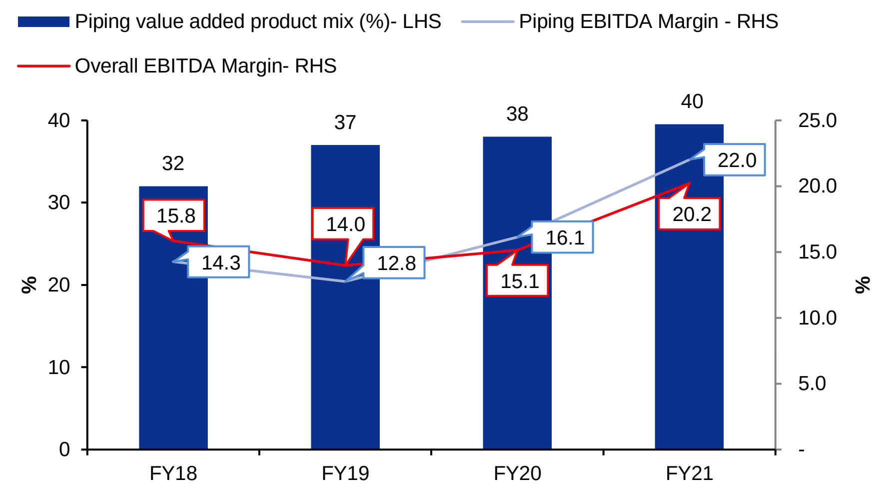
Higher EBITDA margins driven by improving sales mix (higher value-added product revenue share) would lead to better cash flow generation going forward, in our view. We estimate cumulative FCF of Rs21bn over FY21-23F.

Figure 117: Supreme Industries' cumulative OCF and FCF



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 118: Piping value-added revenue share and EBITDA margins



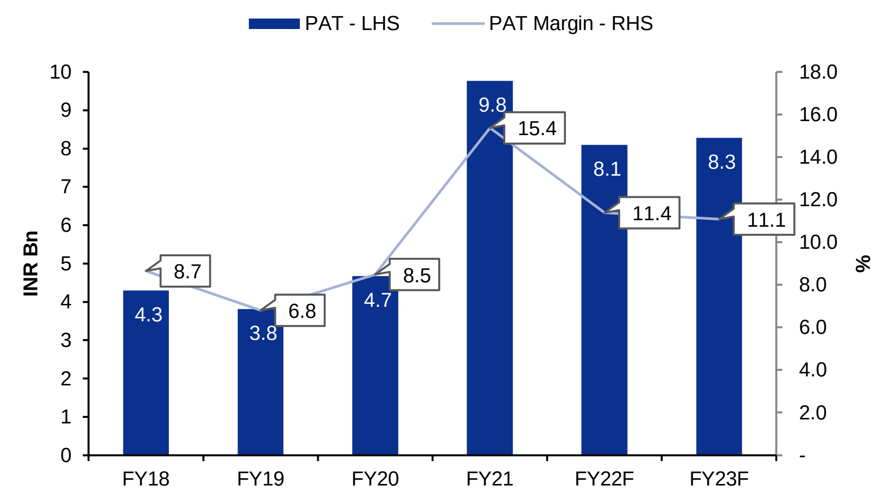
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Adjusted for inventory gains, we expect flat net profits over FY21-23F ›

We estimate reported net profits to degrow by 8% CAGR over FY21-23F. Adjusting for inventory gains of over Rs2bn in FY21, adjusted net profits (FY21: Rs8.2bn as per our internal estimates) will be flat over FY21-23F at Rs8.3bn.

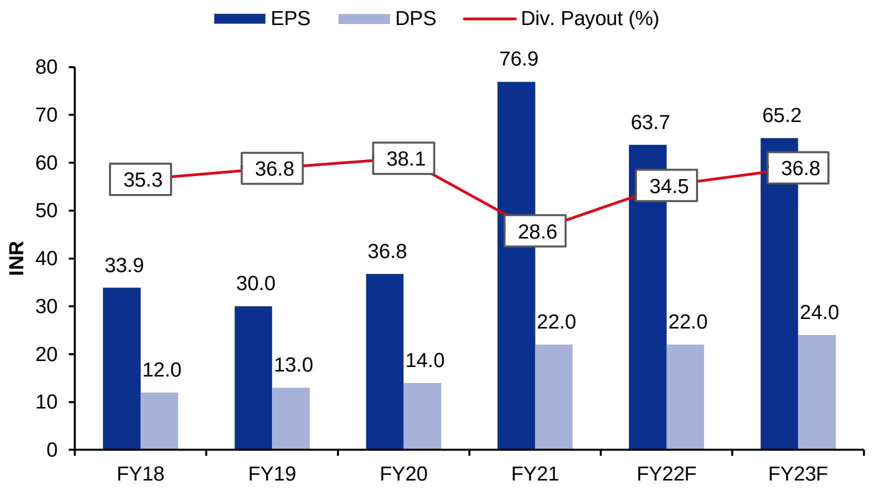
We expect dividend payouts to be maintained at historical levels of 35-40% of annual profits.

Figure 119: Supreme Industries' PAT and PAT margin trends



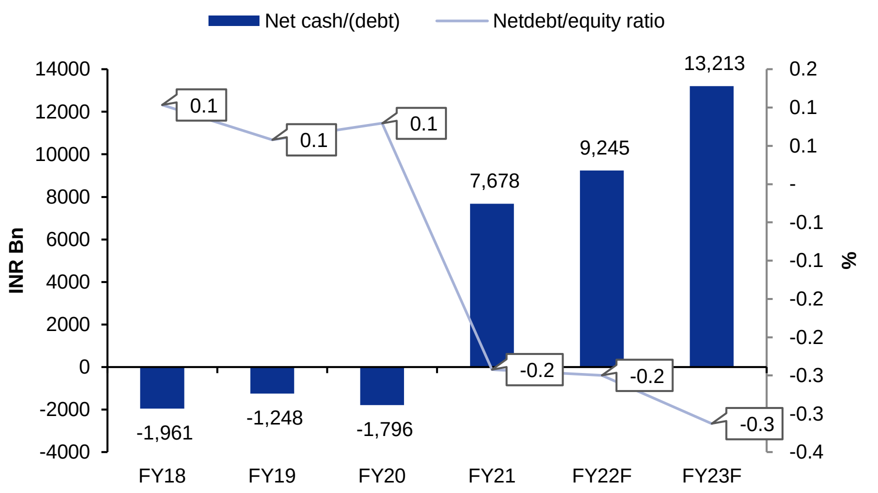
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 120: EPS, DPS and payout (%) trends



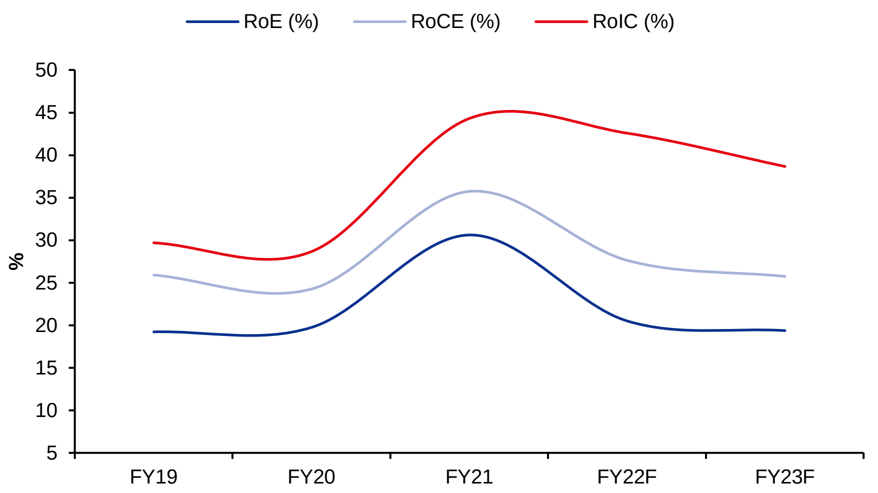
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 121: Absolute net debt/cash and net debt to equity ratio



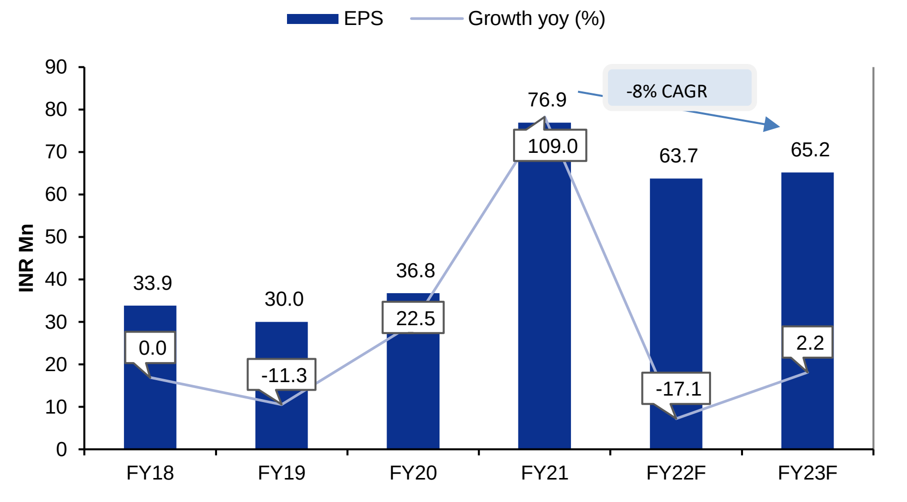
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 122: Return ratios



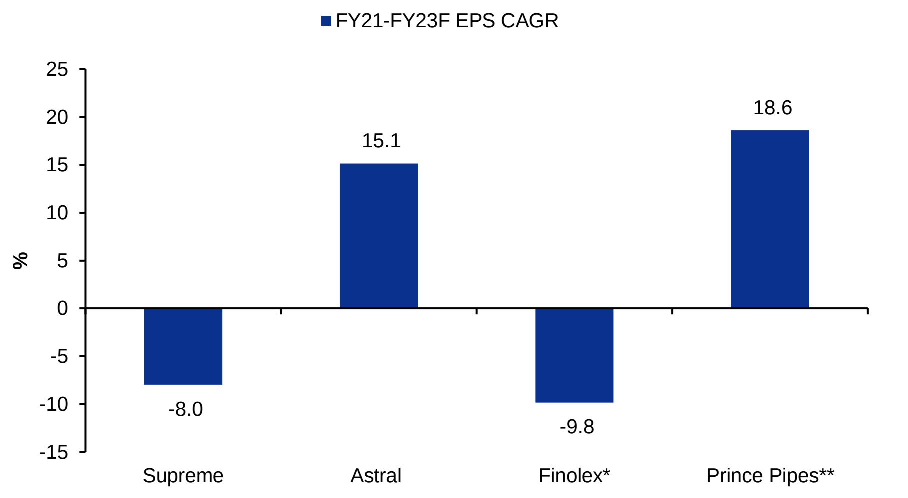
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 123: EPS trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 124: EPS CAGR peer comparison



*FY21F FOR FINOLEX INDUSTRIES; ** DENOTES BLOOMBERG CONSENSUS
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Valuation and risks

Current valuations leave limited upside, stock up ~65% since Feb 2020, initiate coverage with Hold rating ›

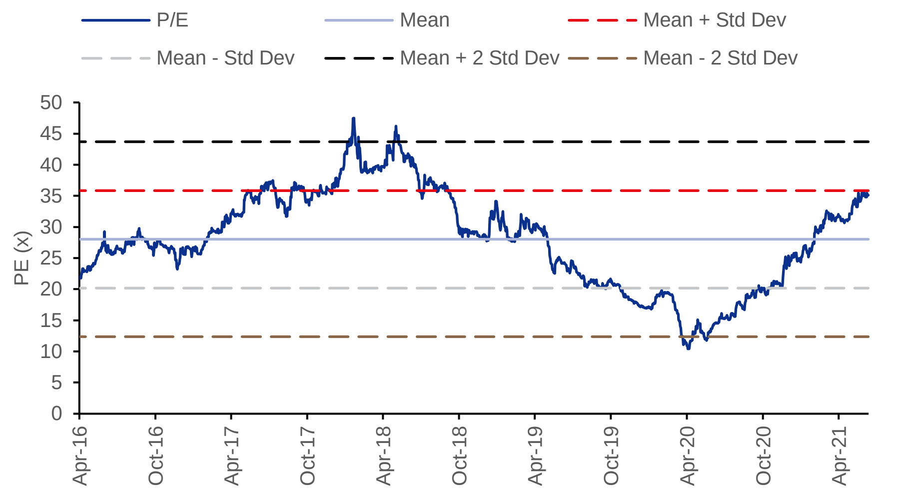
The stock price for Supreme Industries has compounded at ~25% over Apr 2014-May 2021.

We think the parameters below have been the guiding factors determining Supreme's premium equity valuations:

- Sustaining its market leadership at No. 1 position in terms of industry capacity/revenue share in the plastic pipe industry in India.
- Consistent reinvestment in capacity creation with the focus on higher margin products leading to better incremental profitability and return on capital.
- Capex funded through internal accruals and maintaining debt-free status.
- Disciplined working capital management despite high B2B revenue share.
- Converting profits into cash flows with average OCF to EBITDA of ~70% over the past five fiscals.
- The stock currently trades at FY23F P/E of 34.5x and EV/EBITDA of 21.5x
- Given the stock run-up of ~60%+ since Feb 2020, risk of inventory losses and the stock trading at +1SD to its five-year mean P/E, we see limited upside potential from current stock price levels.

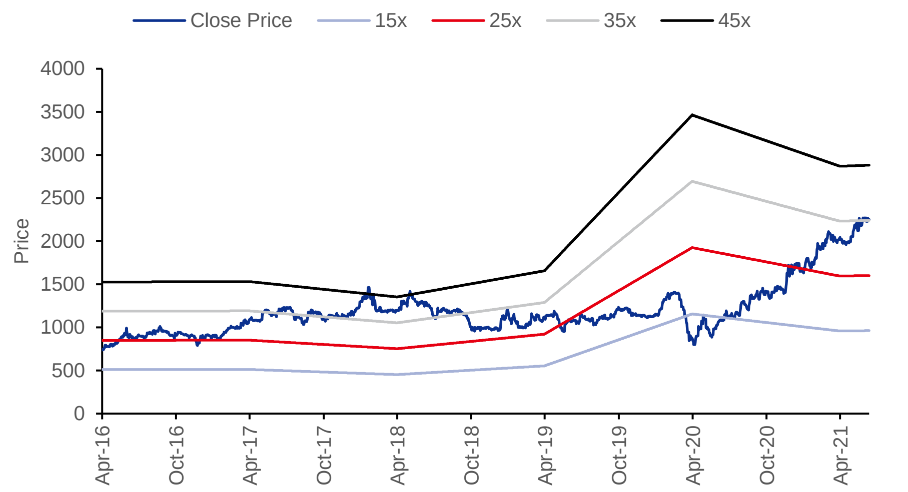
- Hence, we initiate coverage with a Hold rating and a TP of Rs2,345 based on P/E of 36x FY23F EPS, a 20% premium to its past five-year mean P/E levels of ~30x.
- We apply a mid range (20%) P/E premium to Supreme owing to a) it being the market leader in the plastic pipe segment in India, b) has a diversified product portfolio basket, c) possibility of inventory losses led by correction in PVC resin prices and d) EPS CAGR of -8% over FY21-23F.

Figure 125: Supreme Industries trading around +1SD its 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Figure 126: P/E Band Chart



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Risks

Upside risks

- **Elevated PVC prices:** Unprecedented rise in raw material prices has led to very high profits. Existing prices for a prolonged period might result in better business performance than our expectations.
- **Faster decline in unorganised competition:** Organised players like Supreme have been gaining market share from weaker unorganised regional brands. Incremental COVID-19-led lockdowns make small players weaker and might result in incremental share gains for Supreme leading to higher-than-estimated revenue growth.

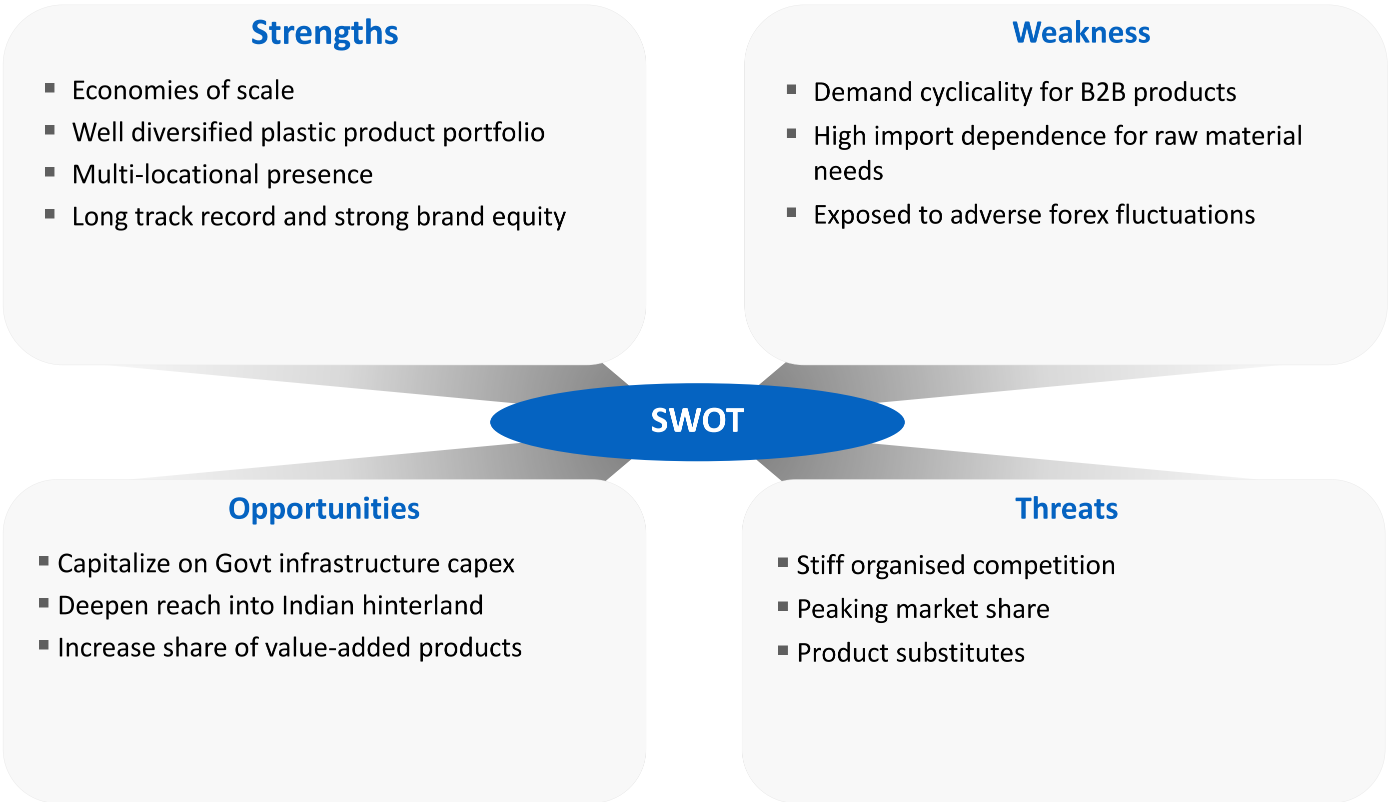
Downside risks

Supreme's import bill averages over Rs15bn/year and adverse FX fluctuations could impact profitability.

- **Adverse forex rates:** Supreme is a net importer with an average import bill of over ~Rs15bn/year over the past three years. Adverse forex rate fluctuations and inability to pass through the same to customers would impact profits.
- **Capex execution delays:** External factors like labour/equipment shortages due to COVID-19-led movement restrictions could delay capex timelines and impact performance negatively.
- **Short-term impact on consumer demand:** Intermittent COVID-19-related stoppage in business activity impacts B2C product demand in the short term. A severe second wave of COVID infections since Apr 2021 might impact performance of consumer products.

SWOT analysis

Figure 127: SWOT analysis

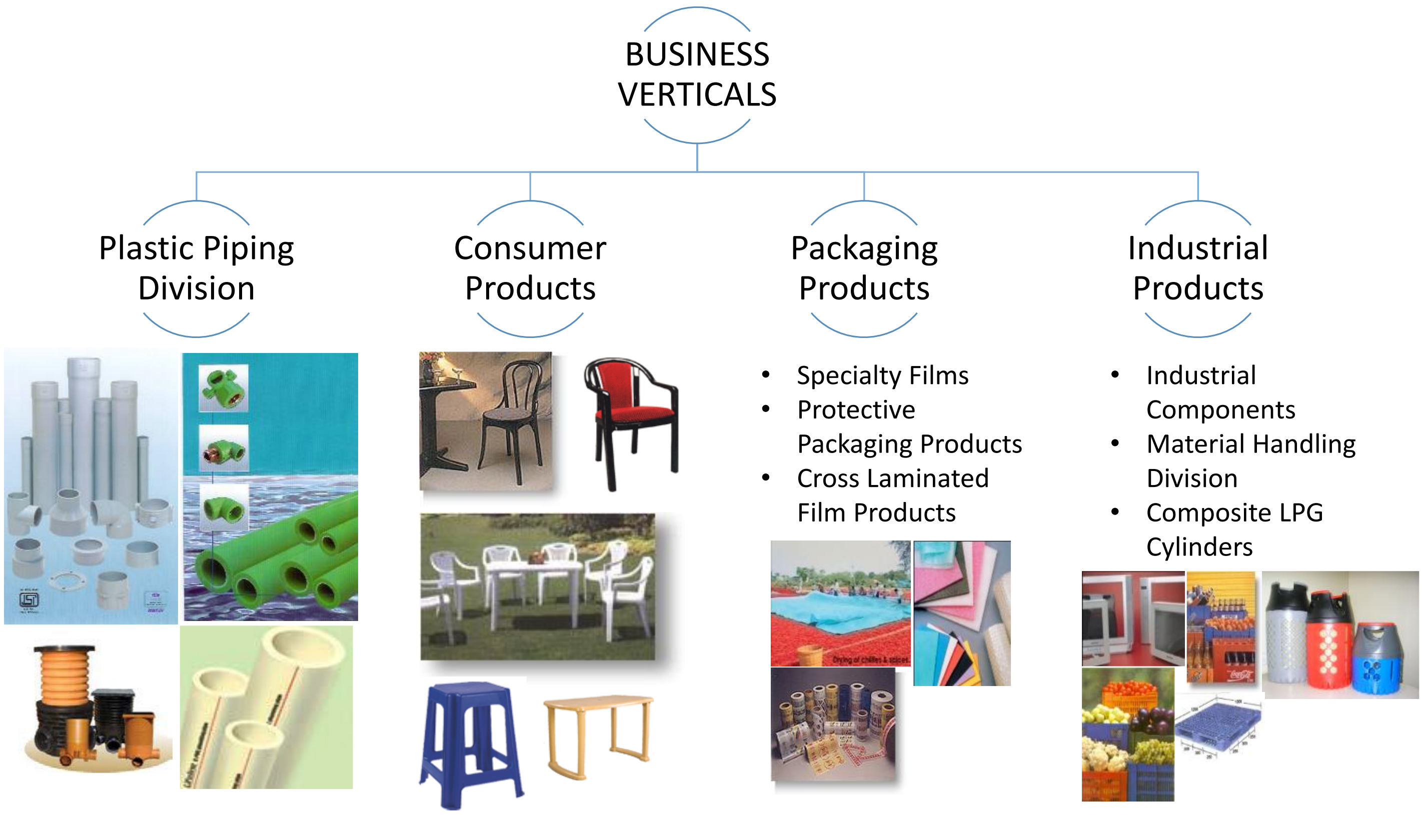


SOURCE: INCRED RESEARCH

Business description and management profile

Supreme Industries is India's leading plastic processing company with four key business divisions. The company has forayed into different types of plastic processing, such as injection moulding, rotational moulding (ROTO), extrusion, compression moulding and blow moulding. It offers a wide range of products with multiple applications in moulded furniture, cross laminated films (XF) & products, performance films, storage & material handling, industrial, protective packaging & composite plastic products, plastics piping systems & petrochemicals. The company offers the most comprehensive range of plastic products in India. Its 25 plants are powered by technology from world leaders, and complement extensive facilities for R&D and new product development. Supreme is credited with pioneering several products in India, such as cross-laminated, multilayer films and soil, waste and rain (SWR) piping systems.

Figure 128: Supreme's business verticals



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 129: Supreme's product portfolio (Mar 2020)

Business Verticals	Product Portfolio	Targeted Customer Segment
Plastic Piping System	uPVC Pipes, Injection Moulded fittings, Handmade fittings, Polypropylene Random, Co-polymer Pipes & Fittings, HDPE Pipe Systems, CPVC Pipes Systems, Inspection Chambers, Water Tanks, Septic Tanks, Toilets, DWC HDPE PIPE System, Bath Fittings, Olefin Fittings, PEX Pipe system for hot water,Low noise pipe system,Solvents	Potable Water Supply Irrigation Sewage & Drainage Plumbing & Sanitation Industrial Pipe System Fire Sprinkler System Nal se Jal
Consumer Products	Furniture	Household Office Establishments Institutions
Industrial Products	Industrial Components Material Handling Products (Crates, Pallets, Bins & Dustbins) Composite LPG Cylinders	Auto Sector Electronic Household Appliances Water Purification – filters Soft Drink Companies Agriculture & Fisheries
Packaging Products	Specialty Films Protective Packaging products Cross Laminated film products Cross Line Bonded Film Products	Consumer Appliances Industry Sports Goods Insulation Construction Automobiles Agriculture Floriculture Horticulture Grain Storage Tarpaulin Pond lining

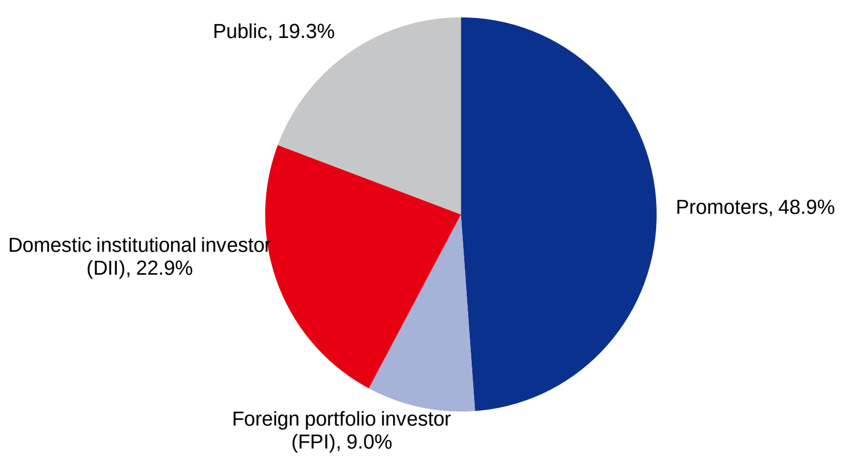
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 130: Key management profile (as at Mar 2020)

Mr. M.P. Taparia, Managing Director	Mr Taparia is the Non-Executive Chairman of Supreme Petrochem Ltd. and Managing Director and Director at Supreme Industries Ltd. Mr. Taparia is also on the board of 10 other companies. Previously he was President of the Organisation of Plastics Processors of India.
Mr. P. C. Somani, Chief Financial Officer	Mr Somani is the Chief Financial Officer at Supreme Industries. He is also a member of the risk management and Business Responsibility Committee.
Mr. R.J. Saboo, VP (Corporate Affairs) & Company Secretary	Mr Saboo holds the position of Vice President (Corporate Strategy) at Supreme Industries. He is also a member of the Business Responsibility Committee.

SOURCES: INCRED RESEARCH, COMPANY REPORTS

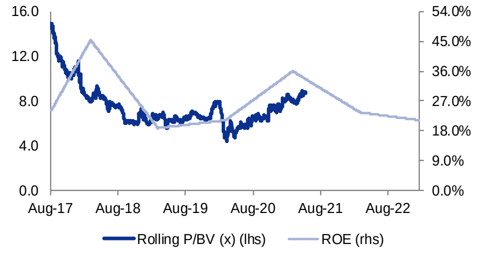
Figure 131: Shareholding pattern (Mar 2021)



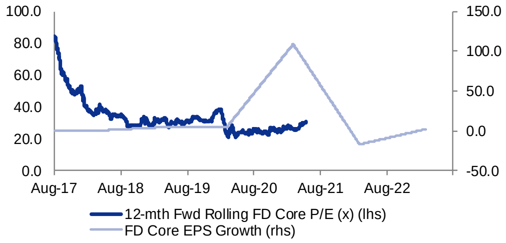
SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS

P/BV vs ROE



12-mth Fwd FD Core P/E vs FD Core EPS Growth



Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**56,120**	**55,115**	**63,571**	**71,087**	**74,650**
Gross Profit	**17,921**	**19,333**	**23,186**	**24,525**	**25,754**
Operating EBITDA	**7,846**	**8,346**	**12,843**	**11,872**	**12,690**
Depreciation And Amortisation	(1,835)	(2,057)	(2,128)	(2,467)	(2,707)
Operating EBIT	**6,010**	**6,289**	**10,715**	**9,405**	**9,984**
Financial Income/(Expense)	(287)	(228)	(95)	324	433
Pretax Income/(Loss) from Assoc.	144	312	1,460	1,050	600
Non-Operating Income/(Expense)	105	40	32	40	42
Profit Before Tax (pre-EI)	**5,972**	**6,413**	**12,112**	**10,819**	**11,060**
Exceptional Items					
Pre-tax Profit	**5,972**	**6,413**	**12,112**	**10,819**	**11,060**
Taxation	(2,158)	(1,739)	(2,341)	(2,723)	(2,783)
Exceptional Income - post-tax	672				
Profit After Tax	**4,486**	**4,674**	**9,771**	**8,096**	**8,276**
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**4,486**	**4,674**	**9,771**	**8,096**	**8,276**
Recurring Net Profit	3,815	4,674	9,771	8,096	8,276
Fully Diluted Recurring Net Profit	**3,815**	**4,674**	**9,771**	**8,096**	**8,276**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	7,846	8,346	12,843	11,872	12,690
Cash Flow from Invt. & Assoc.					
Change In Working Capital	317	(1,646)	(1,955)	(2,038)	(1,290)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	(335)	66	3,686	1,414	1,076
Net Interest (Paid)/Received	286	227	212	(324)	(433)
Tax Paid	(2,557)	(1,621)	(2,322)	(2,723)	(2,783)
Cashflow From Operations	**5,557**	**5,371**	**12,464**	**8,201**	**9,259**
Capex	(3,472)	(2,417)	(2,266)	(4,163)	(2,676)
Disposals Of FAs/subsidiaries	212	20	56		
Acq. Of Subsidiaries/investments	22	19	94	(1,000)	(500)
Other Investing Cashflow	181	198	124	339	449
Cash Flow From Investing	**(3,058)**	**(2,180)**	**(1,992)**	**(4,824)**	**(2,726)**
Debt Raised/(repaid)	(882)	2,380	(4,104)	(6)	
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid	(1,991)	(3,522)	(635)	(2,795)	(3,049)
Preferred Dividends					
Other Financing Cashflow	(287)	(271)	(166)	(15)	(16)
Cash Flow From Financing	**(3,160)**	**(1,414)**	**(4,905)**	**(2,816)**	**(3,065)**
Total Cash Generated	(661)	1,777	5,566	561	3,468
Free Cashflow To Equity	**1,617**	**5,571**	**6,367**	**3,371**	**6,533**
Free Cashflow To Firm	**2,165**	**2,895**	**10,251**	**3,362**	**6,517**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	373	2,314	7,684	9,245	13,213
Total Debtors	3,874	3,128	3,898	4,285	4,499
Inventories	7,504	8,906	7,608	8,764	10,226
Total Other Current Assets	1,626	1,729	1,469	2,021	2,122
Total Current Assets	**13,378**	**16,077**	**20,659**	**24,315**	**30,060**
Fixed Assets	15,210	15,492	16,471	18,175	18,144
Total Investments	2,223	2,073	3,366	3,366	3,366
Intangible Assets					
Total Other Non-Current Assets	1,482	2,544	2,327	2,319	2,319
Total Non-current Assets	**18,915**	**20,108**	**22,164**	**23,859**	**23,828**
Short-term Debt	1,609	4,101			
Current Portion of Long-Term Debt					
Total Creditors	5,574	5,475	6,462	6,817	7,158
Other Current Liabilities	2,175	2,140	3,220	2,921	3,068
Total Current Liabilities	**9,358**	**11,716**	**9,682**	**9,738**	**10,226**
Total Long-term Debt	11	9	6		
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	180	523	524	524	524
Total Non-current Liabilities	**192**	**532**	**530**	**524**	**524**
Total Provisions	1,204	1,326	919	919	919
Total Liabilities	**10,753**	**13,574**	**11,131**	**11,181**	**11,669**
Shareholders Equity	21,540	22,612	31,692	36,993	42,220
Minority Interests					
Total Equity	**21,540**	**22,612**	**31,692**	**36,993**	**42,220**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	12.9%	(1.8%)	15.3%	11.8%	5.0%
Operating EBITDA Growth	(0.3%)	6.4%	53.9%	(7.6%)	6.9%
Operating EBITDA Margin	14.0%	15.1%	20.2%	16.7%	17.0%
Net Cash Per Share (Rs)	(9.82)	(14.13)	60.44	72.78	104.01
BVPS (Rs)	169.57	178.01	249.49	291.22	332.37
Gross Interest Cover	17.91	21.20	48.42	626.98	633.90
Effective Tax Rate	36.1%	27.1%	19.3%	25.2%	25.2%
Net Dividend Payout Ratio	33.3%	33.4%	23.1%	25.8%	27.6%
Accounts Receivables Days	25.02	23.19	20.17	21.01	21.48
Inventory Days	69.15	83.70	74.62	64.17	70.88
Accounts Payables Days	50.03	56.35	53.94	52.04	52.16
ROIC (%)	29.7%	28.7%	44.3%	42.6%	38.7%
ROCE (%)	25.9%	24.3%	35.7%	27.6%	25.7%
Return On Average Assets	20.3%	19.4%	30.9%	23.1%	20.8%

SOURCES: INCRED RESEARCH, COMPANY REPORTS

India

ADD *(Initiating Coverage)*

Consensus ratings*:	Buy 8	Hold 3	Sell 1

Current price:	Rs1,440
Target price:	Rs1,592
Previous target:	NA
Up/downside:	10.6%
InCred Research / Consensus:	8.5%
Reuters:	APLA.BO
Bloomberg:	APAT IN
Market cap:	US$2,461m
	Rs179,869m
Average daily turnover:	US$6.3m
	Rs457.4m
Current shares o/s:	124.9m
Free float:	63.0%

Source: Bloomberg

Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	15.3	7.8	344.8
Relative (%)	7.0	4.4	186.4

Major shareholders	% held
Promoters	37.0
Kitara PIIN 1101	11.3
Smallcap World Fund Inc.	4.4

APL Apollo Tubes

Solid display of business execution

- Best play on metal pipe industry with clear revenue and cost leadership.
- New capacities and improving sales mix ensure industry leading growth.
- Significant balance sheet improvement. Initiate with Add and TP of Rs1,592.

Structural metal tube is a highly under-penetrated product category

The structural steel tube market size in India was ~4m tons (70% of APL's FY21 sales) and has the potential to surpass 20m tons by 2030 (APL Jan 2021 presentation). Investments in affordable housing, urban real estate, warehousing and urban infrastructure are long-term demand catalysts. APL is a market leader with ~50% volume market share in structural steel tubes (FY21). It is the lowest cost producer with focus on branding (14 brands - five product categories) in a highly commoditised industry. We estimate revenue CAGR of 20% over FY21-23F led by more market share gains.

Improving sales mix in favour of value-added products

Strategic focus to transform into a consumer brand entails scaling up the value-added premium product (VAP) portfolio. VAP forms 57% of APL's total sales (FY21) and management intends to scale it up to 75% over the next three years. VAP earns 2x EBITDA/ton of over Rs4k/t vs. a standard product's EBITDA of ~Rs2k/t as per APL. Management expects VAP revenue CAGR to be 40-50% vs. 5-10% for standard products. We estimate EBITDA CAGR of 31.4% with margins of 8-9.5% over FY21-23F.

Balance sheet management has been exceptional

Nearly Rs11.5bn of capex over the past five fiscals was funded largely by internal accruals while managing strict cash conversion cycles (net working capital [WC] days reduced from 41 days to 5 over FY17-21. COVID-19 gave way to the cash-and-carry model, reducing the receivables cycle to 6 days of sales vs. the average of ~25 days since FY17. Management indicated debtors would be maintained at this level in the foreseeable future. Exceptional working capital release and unfinished capex led to record FCF of Rs6.8bn in FY21, that we think should normalise over FY22F-23F averaging Rs3.5-4bn/year. We expect RoE/RoIC to improve to 31.1%/43.3% by FY23F.

Valuation and risks

APL's stock price rose at a CAGR of 60% over Apr 2014 to May 2021 on the back of 32% EPS CAGR. We believe APL is one of the best stocks to own in the Indian midcap universe given its consistent market gains, cost leadership, effective strategy execution, good capex and WC management. The stock trades at FY23F P/E of 22.6x and EV/EBITDA of 14.9x. Given the structural recovery in retail / industrial demand, we think the stock can rerate further. We initiate coverage with an Add rating and TP of Rs1,592 based on P/E of ~25x FY23F EPS, a ~30% premium to its past five-year P/E. Risks: Elevated steel prices, diminishing competition and faster capex execution.

Analyst(s)

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Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	71,523	77,232	84,997	102,000	122,613
Operating EBITDA (Rsm)	3,929	4,773	6,787	8,823	11,710
Net Profit (Rsm)	1,457	2,379	3,601	5,044	7,951
Core EPS (Rs)	12.1	19.3	28.8	40.4	63.7
Core EPS Growth	(7.0%)	58.7%	49.7%	40.1%	57.6%
FD Core P/E (x)	118.87	73.70	49.67	35.66	22.62
DPS (Rs)	14.0	0.0	0.0	2.0	3.0
Dividend Yield	0.23%	0.00%	0.00%	0.14%	0.21%
EV/EBITDA (x)	47.47	39.31	26.83	20.41	14.87
P/FCFE (x)	97.99	(879.42)	517.70	126.74	89.82
Net Gearing	68.7%	47.0%	4.6%	(7.9%)	(19.5%)
P/BV (x)	17.93	13.11	10.61	8.27	6.14
ROE	16.2%	20.5%	23.6%	26.1%	31.1%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)				1.05	1.28

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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Powered by EQUITEC

Solid display of business execution

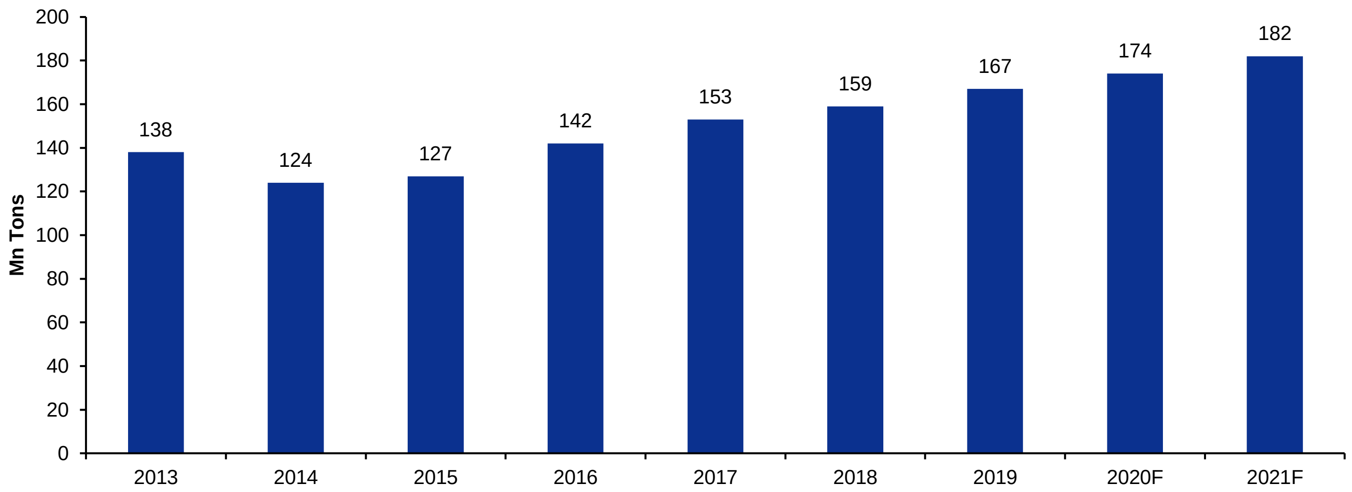
Long-term scope to grow in an underpenetrated structural pipe industry in India

Considerable scope for shift to organised market share ›

Structural steel tubes are essential for new age construction and would revolutionise the Indian construction industry, in our view.

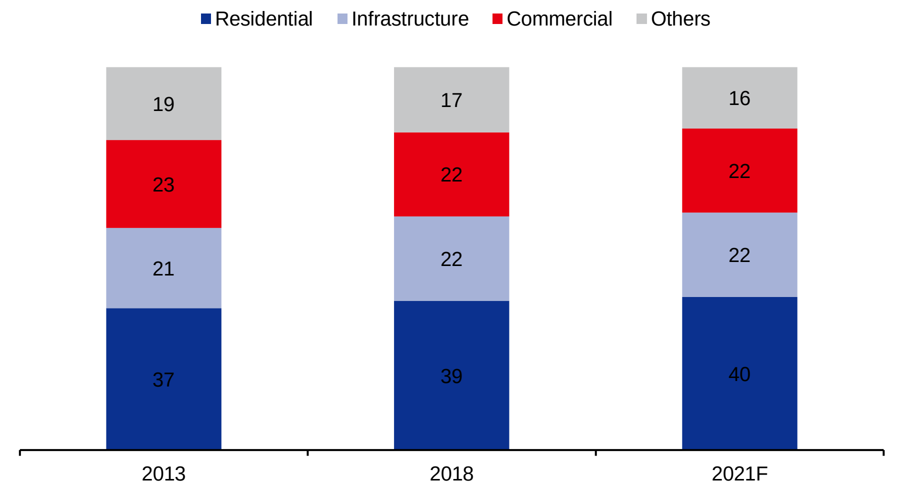
- **Warehousing:** Jones Lang LaSalle (JLL) projects that there will be 344m sq. ft of warehousing space in India by 2022. Logistics, engineering, auto and ancillaries, e-commerce, FMCG, retail and telecom, and white goods have remained the biggest demand drivers for warehousing industry growth.
- **Affordable Housing:** Trends for affordable housing with low cost and faster completion are picking up in India. Modular buildings will be the future construction methodology. Modular steel structures are constructed in-house and assembled on-site, where the steel modules are stacked and connected together.
- **Urban Infrastructure:** The government of India plans to have 100 additional airports by 2024 and intends to invest Rs190bn in upgrading airport infrastructure, especially in smaller cities, over the next three years in India (Source: APL Apollo corporate presentation).
- **Urban Real Estate:** India's vertical growth pushed high-rise buildings with G+20 floors or more to record highs in 2019. The government has formed a panel to look into increasing FSI norms in all major cities. This implies similar high-rise construction spreading over lot of urban and tier-1 cities.

Figure 132: Global structural steel volume growth forecasts



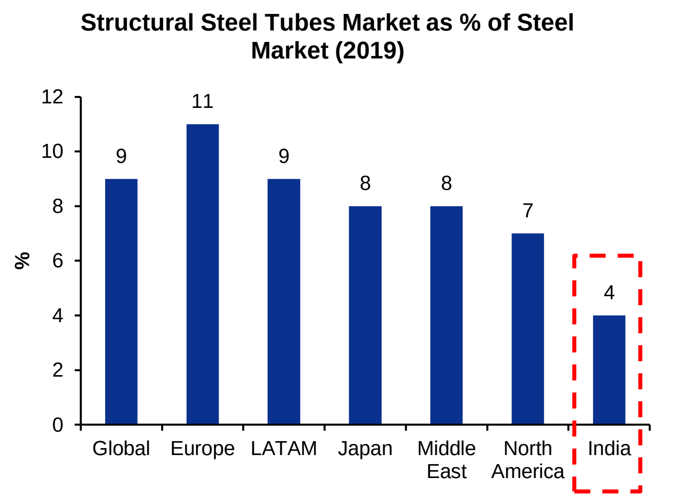
SOURCES: INCRED RESEARCH, COMPANY ESTIMATES

Figure 133: Global structural steel tubes application – segment-wise breakdown (%)



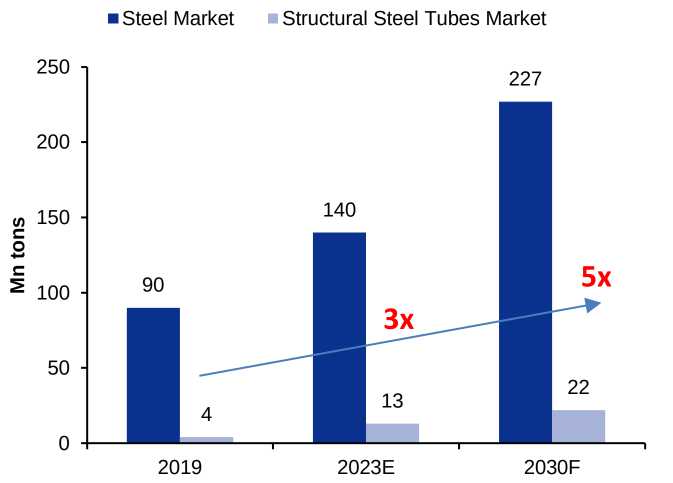
SOURCES: INCRED RESEARCH, COMPANY ESTIMATES

Figure 134: Nascent structural steel tube market in India



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 135: Potential structural steel tubes market in India



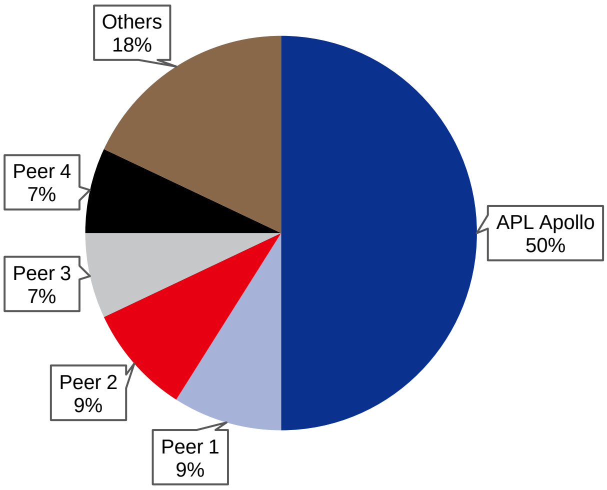
SOURCES: INCRED RESEARCH, COMPANY ESTIMATES

Figure 136: APL's product presence across applications (FY20)

Product category	Product category	Sectoral applications	Revenue share (%)
Apollo Structural	Structural steel; construction material: Residential, Commercial, Infrastructure	Structural, Piling, Sheds, Handrails, Gates, Fencing, Balcony Grills, Staircase, Light Structures, Structural for Metros, Airports, Stadiums, Stations, Heavy Equipment	53%
Apollo Z	Galvanised structural steel construction material: Residential, Commercial, Infrastructure	Galvanised structural steel tubes for coastal markets	21%
Apollo Galv	Hot-dip galvanised structural steel construction material: Residential, Commercial, Infrastructure	Galvanised Structural, Greenhouse Structures, Plumbing, Firefighting	6%
Apollo Standard	Construction material, Industrial	Industrial and Agriculture	13%
Apollo Tricoat	Home improvement applications	Door Frame, Staircase Steps, Furniture, Plank, Designer Tubes, Fencing, Electrical Conduits	2%

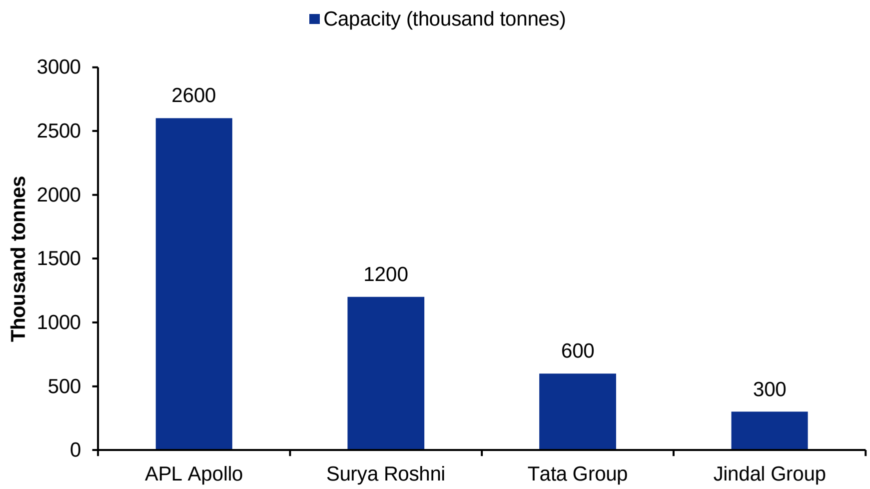
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 137: Market share of top 5 players (FY21)



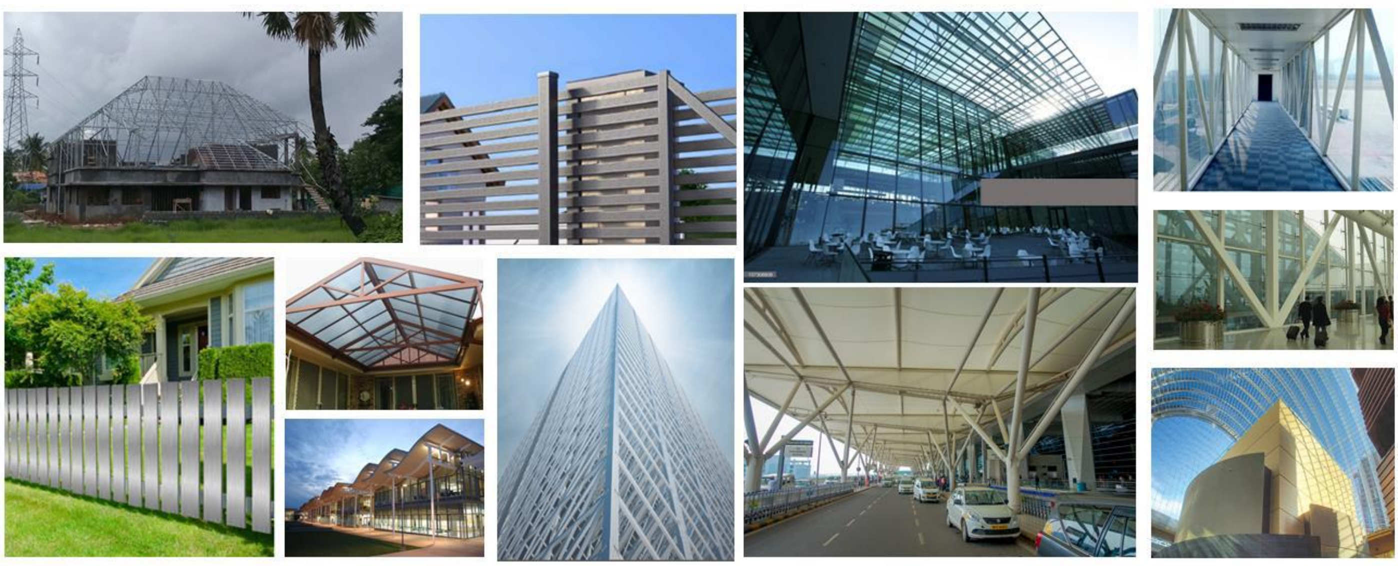
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 138: Estimated structural tube capacity of top industry peers (FY21)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

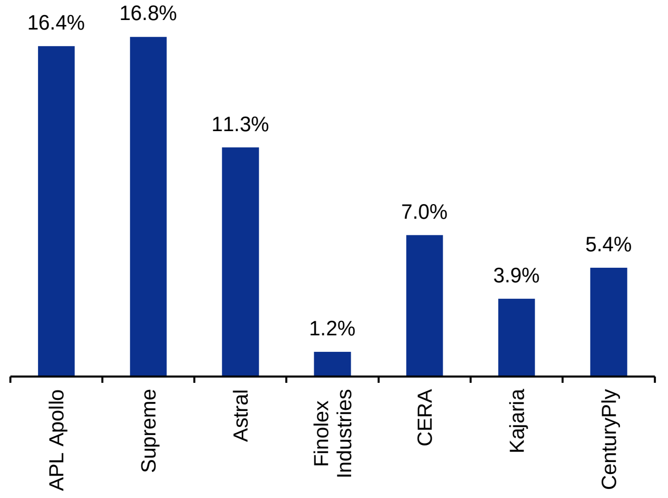
Figure 139: APL's structural steel tubes applications (in pictures)



SOURCES: INCRED RESEARCH, APL'S CORPORATE INVESTMENT PRESENTATION

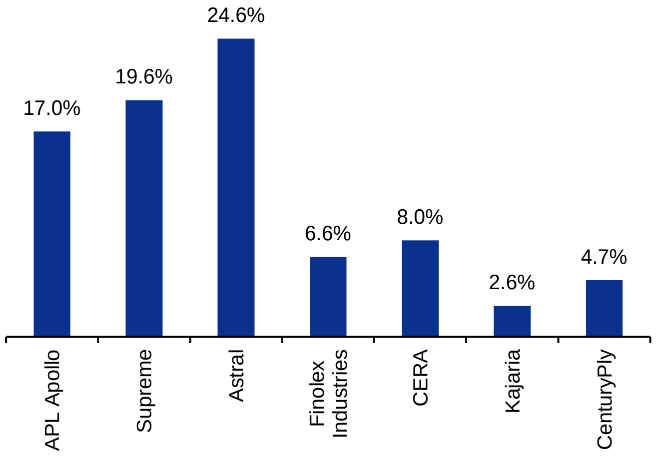
APL has been on top of its game; among the top performers within its building materials industry peer group ›

Figure 140: Building materials (FY16-FY20 revenue CAGR across coverage)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 141: Building materials (FY16-FY20 EPS CAGR across coverage)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

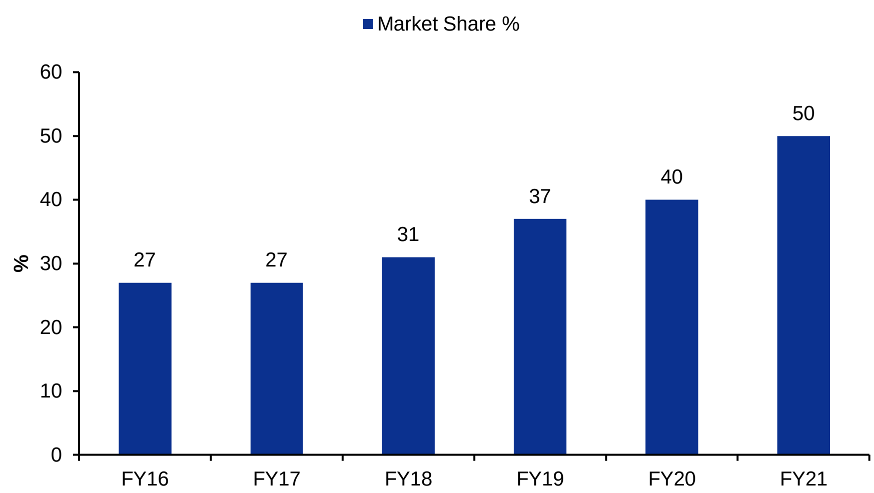
Revenue and net profit grew at CAGR of 16.4% and 17.0%, respectively, over FY16-20.

Significant scale advantage leads to lowest raw material procurement costs and optimum fixed-cost absorption for structural pipe manufacturing

APL Apollo consumed 2% of India's entire steel output and 10% of India's entire hot rolled coil consumption in FY20. It is one of the largest customers for steel producers and, hence, enjoys preferential terms of trade compared to its peers. Cost leadership has been a function of the lowest raw material procurement costs coupled with large scale manufacturing for APL Apollo.

Consistent delivery over the past five years has led to market share gains. APL has gained share each year over the last five years.

Figure 142: APL's market share in Indian structural tubes market (%)



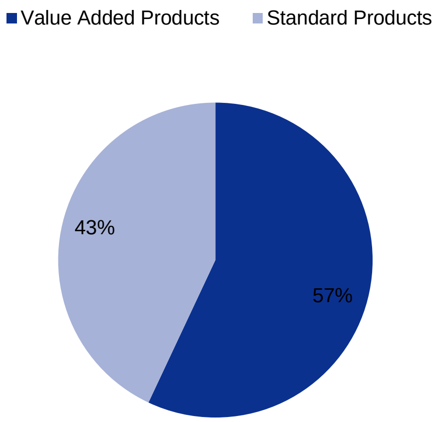
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Focus on value addition, customer centricity and national presence

"We keep challenging our R&D team to come up with innovative designs and applications ahead of our peers. Converting the financial year 2016-17 as our blockbuster year, we delivered as many as seven design patents. We currently own eight patents for our innovative products."
– R&D section on APL's website

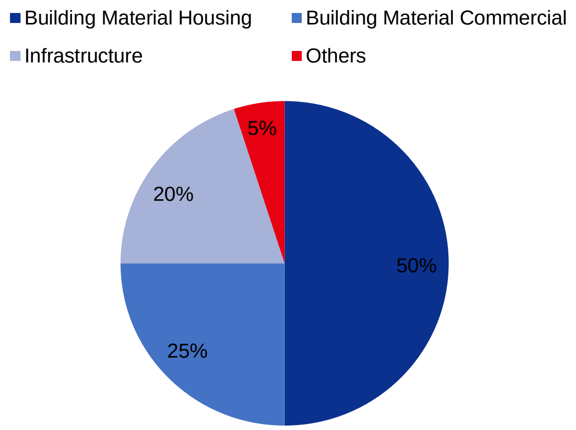
- **Value-added products (VAP):** Share of value-added product sale volumes was 57% for FY21 and the company aims to increase this to 75% of overall sales in the next three years. Standard products earn EBITDA/t of ~Rs2k while value-added premium products earn over Rs4k/t as per APL. Higher VAP revenue share leads to better blended margins.
- **Research and development (R&D):** APL has been proactively investing in R&D for innovative product solutions. The company holds eight new product patents that aid increase in revenue share of VAPs. Most of these products are used in residential housing/commercial building construction (75% of total sales) that have recurring demand profile and are less cyclical in nature.
- **Pan-India availability:** With a wide network of over 800 distributors and 50k retailers and fabricators, APL is India's only structural tube manufacturer that has a national presence. It is present in over 2k towns and has ten production facilities. Extensive reach keeps the company ahead of its competitors by significantly reducing lead time and ensuring on-time delivery.

Figure 143: Value-added products (Apollo Z and Tricoat) are 57% of company's volume share (FY21)



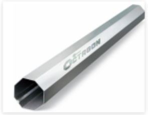
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 144: APL's product – Application mix (as per FY21 sales volume)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 145: Innovative products by APL (APL has 8 patents in its name; as at Mar 2021)

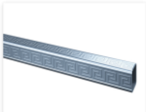


Apollo Octagon
A range of exclusively designed tubes that are widely used in furniture, railings, solar panels, and lighting poles

Apollo D section
Light-weight and sturdy, Apollo D Section tubes are used in making railings for balconies, roofs, etc.

Handrail
Enduring and lightweight, Apollo Handrails are widely employed in place of the wooden hand rails and steel flat combination.

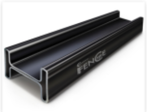
Plank
A new-age steel product in India that is conceived to completely replace wood with steel across the country.



Signature
A range of designer galvanized tubes; an upgrade to the conventional galvanized steel tubes by virtue of engraved designs.

Apollo Oval
Strong and durable, Apollo Oval is a range of highly versatile tubes that have an array of applications.

Apollo Elliptical
High quality tubes that are used in transformers, gates, railings, and steel furnitures.



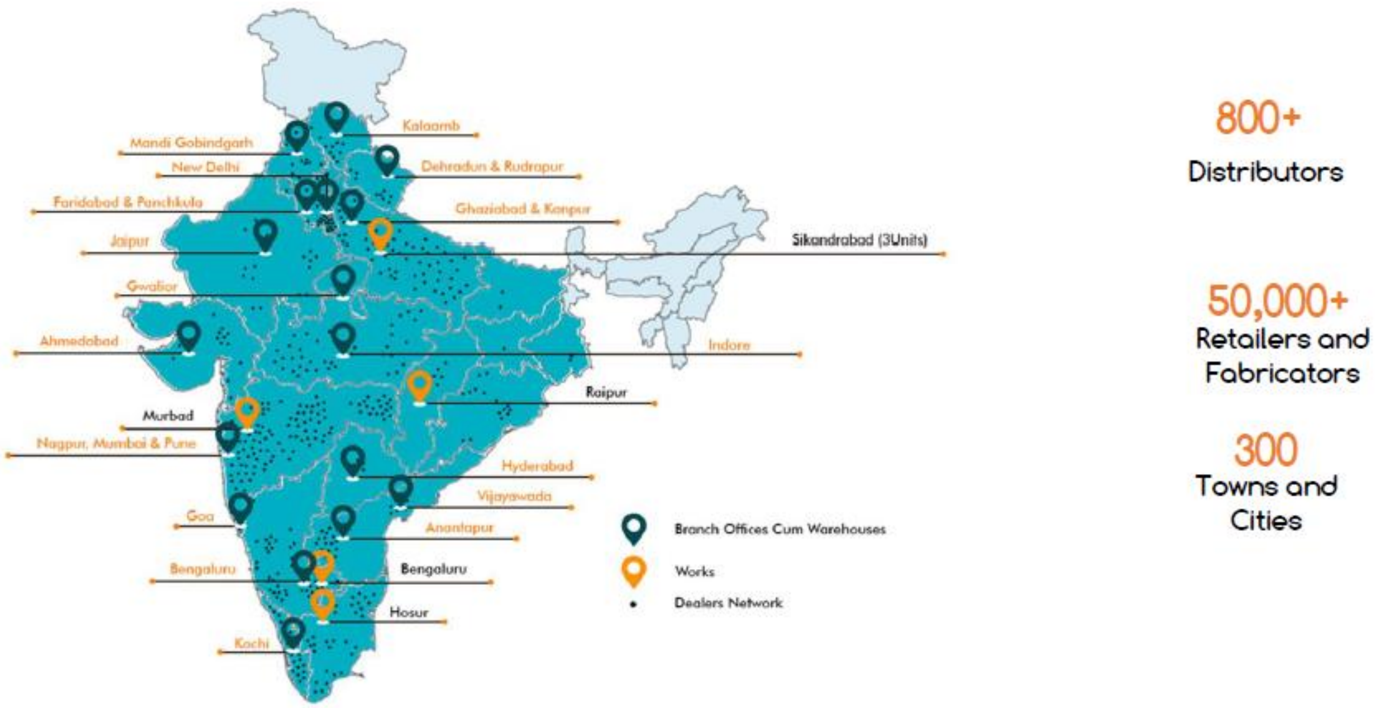
Apollo Fence
A unique design H shaped tube which is used for fencing posts and replacing concrete boundary walls.

Chaukhat
India's first closed steel door frames that are made of quality steel, and assure strength, durability, and quality.

Wondoor
A complete door solution with smooth finish and great strength to add on to the aesthetics of your house and grant resilience to it.

SOURCES: INCRED RESEARCH, COMPANY WEBSITE

Figure 146: Focus on pan-India availability (Mar 2020)

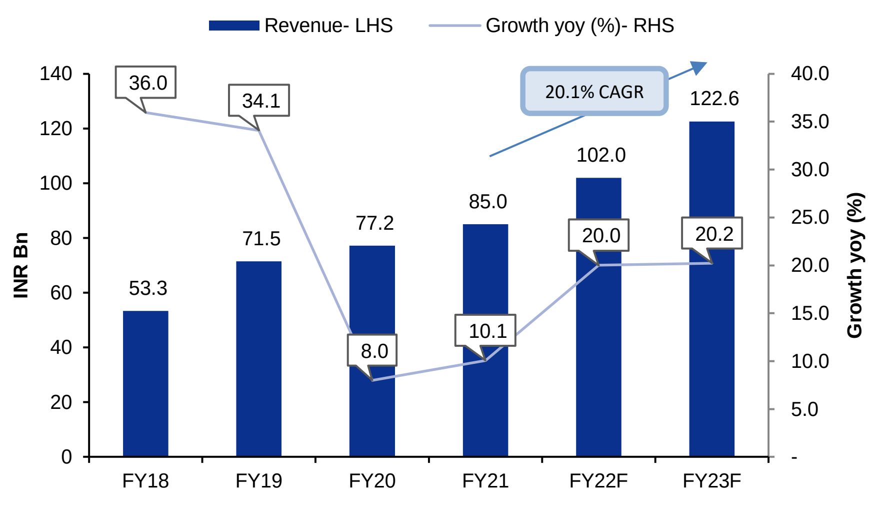


SOURCES: INCRED RESEARCH, CORPORATE INVESTOR PRESENTATION

Investments paying off by way of increased market share and enhanced revenue conversions ❯

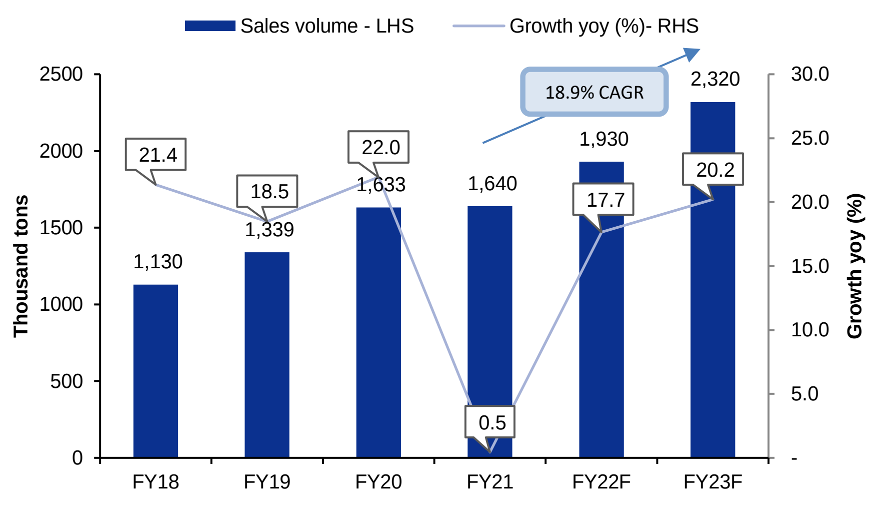
We estimate revenue CAGR of 20% for FY21-23F largely driven by volume growth.

Figure 147: APL's revenue trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 148: APL's volume trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

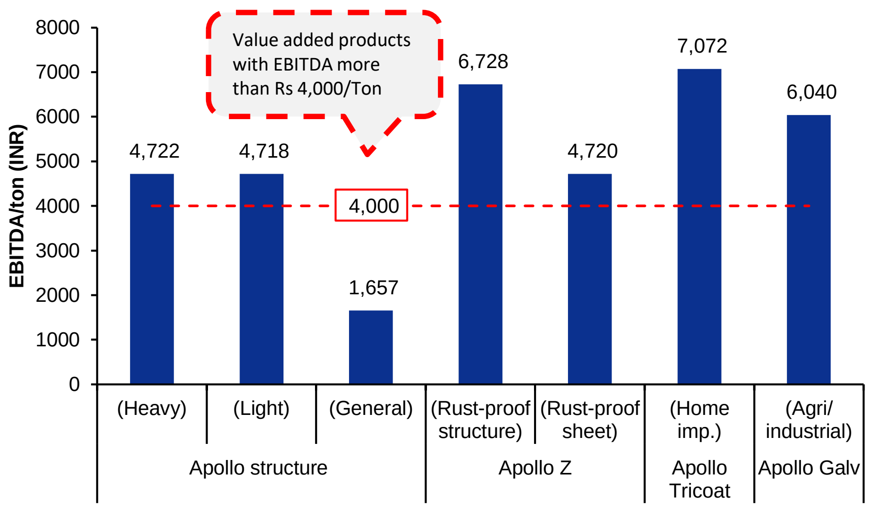
Better sales mix leading to higher margins

"In conventional products, the chances of growth are very low, maybe single-digit growth, and in value-added we are targeting growth of 40-50%, so that in the coming 2-3 years the value-added products which are 45% will cross 75%."

– APL Apollo, 2QFY21 earnings call

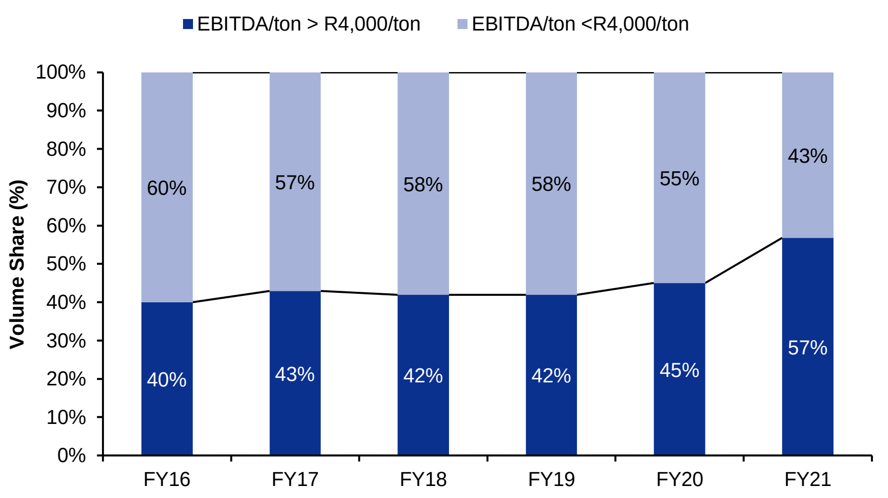
Sales-mix improvement was led by value-added products contribution of 57% to overall volumes in FY21F. APL has been consistently introducing new products across segments enhancing unitary profitability (maximising EBITDA/t). Over FY16-21, VAP volume share rose from 40% to 57% and the company intends to increase this to 75% over the next three years by producing more branded and specialty products like door frames, designer pipes, fencing tubes, high diameter and thickness tubes, among others, and these would all be replacements for wood and RCC (reinforced cement concrete).

Figure 149: Segmental EBITDA/t (FY21)



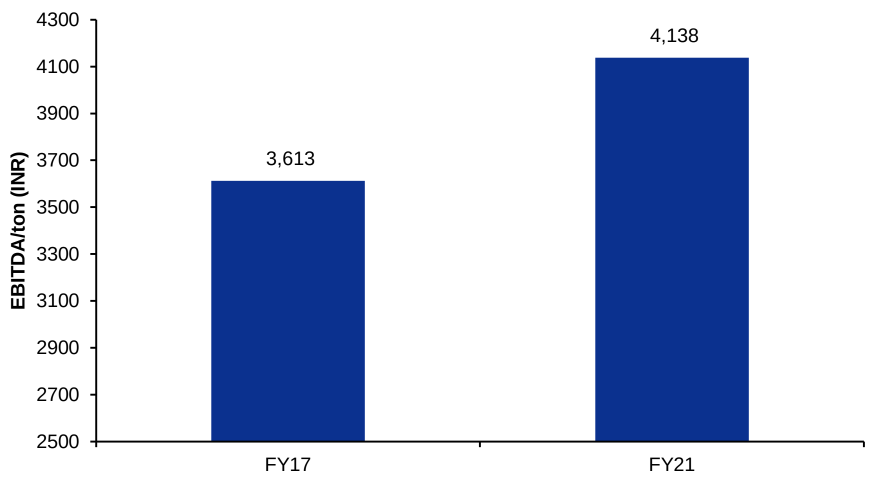
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 150: Increasing volume mix of value-added premium segment



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 151: APL's blended EBITDA/t improvement over past five years



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

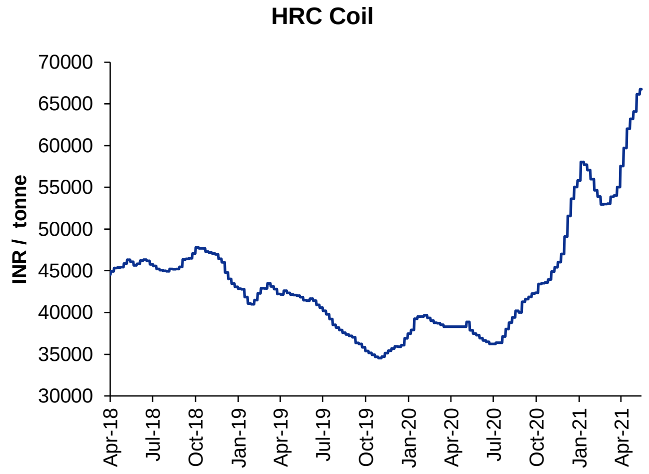
Volatile raw material prices result in volatile margins

Hot rolled steel coil (HRC) is the key raw material for structural steel pipe manufacturing. APL sources most of its HRC from the JSW and Tata groups. As steel is a global commodity, prices are governed by the international demand-supply balance and Indian production dynamics. APL works on a cost plus model and all steel price rises are passed through to end customers.

Steel prices have been on a tear since the COVID-19 pandemic globally resulted in the shut-down of steel production capacities. Gross and EBITDA margins as a percentage of sales have since been very volatile while the company focusses on maintaining unitary profitability (EBITDA/t) as a measure to judge business performance. For FY21, gross/EBITDA margins expanded 80bp/180bp yoy to 15.7%/8%.

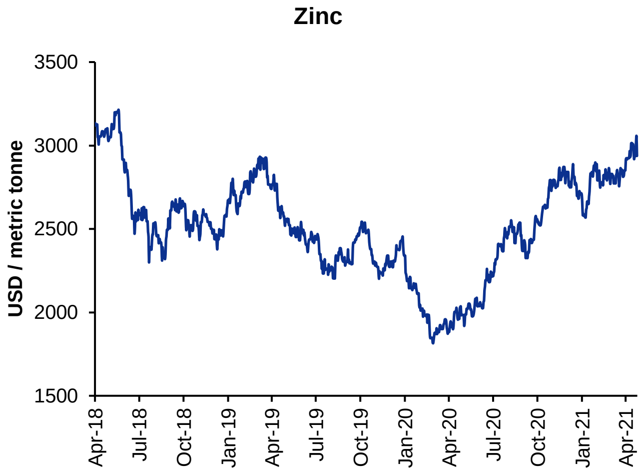
Apollo maintained ~10-20 days of raw material inventory and ~15 days of finished goods inventory during FY17-20. This results in inventory gains/losses, as the case maybe, and distorts gross margins in percentage terms. Fixed costs remain the same while revenues rise due to higher steel pricing, leading to optically high EBITDA margins in percentage terms.

Figure 152: Hot rolled coil (HRC - steel) price trend



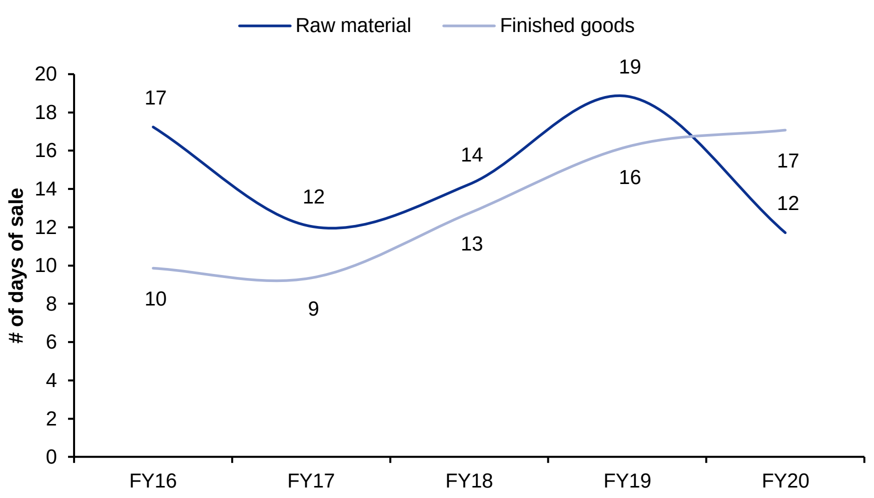
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 153: Zinc price trend



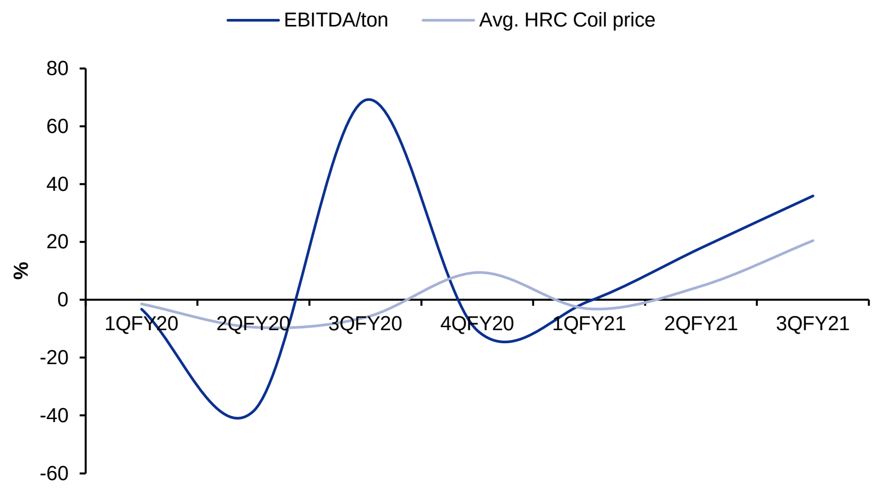
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 154: Inventory trend



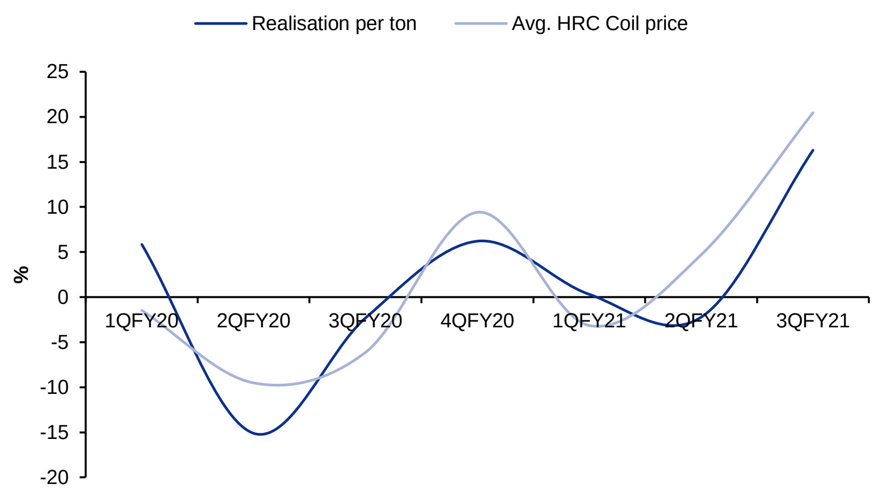
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 155: Quarterly EBITDA/t swings (% qoq change) not perfectly correlated to RM price changes



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG, STEELMINT

Figure 156: Realisation/t volatility due to steel price fluctuations (% qoq change)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG, STEELMINT

The journey to transform into a national consumer brand ›

APL started its journey to move closer to customers by investing in R&D and launching customised products in 2017. In line with the overall strategic focus to transform brand APL Apollo into a perceived pan-India consumer brand, the company has been working to develop sub-brands in each of its revenue segments and expand its distribution channel network. As at Mar 2021, APL had 14 brands across five product categories and 800+ distributors nationally.

Advertising and sales promotion (ASP) spends were stepped up significantly to ~Rs500m (0.6% of total sales) in FY20. Historically ASPs were 0.1-0.2% of sales till FY19. APL plans to maintain ASPs at ~Rs100m/quarter (~Rs400m/year) over the next three years.

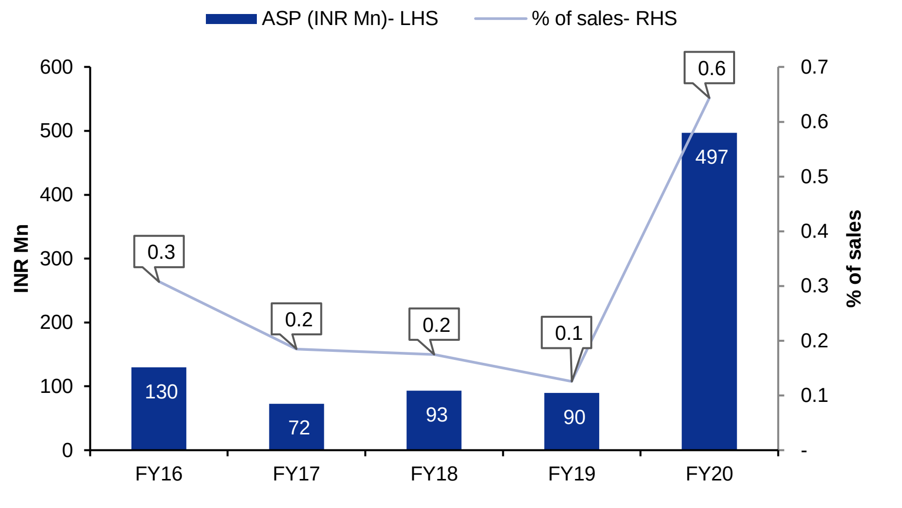
"We had promised you that you will see us more as a consumer brand. We have taken a strategic shift from a commodity to consumer product. In the current year itself we are planning to spend as much as Rs400m-500m on making APL Apollo a brand worth the name. We already have Mr. Amitabh Bachchan as our brand ambassador for the next two years. We have started a campaign through IPL, now we will be starting a big campaign through TVC, media and print."

APL Apollo Tubes, 1QFY20 earnings call

Figure 157: A glimpse of APL's advertising

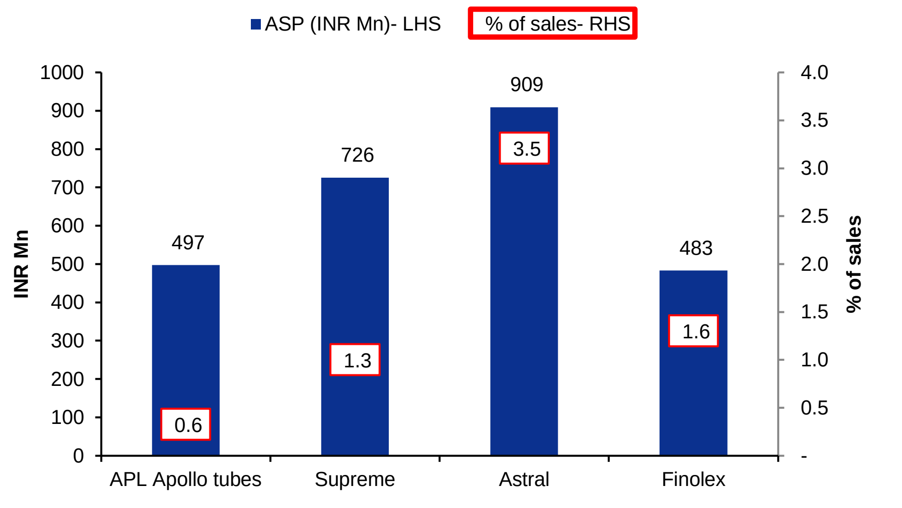
SOURCES: INCRED RESEARCH, COMPANY PRESENTATION - JANUARY 2021

Figure 158: ASP spends and % of sales



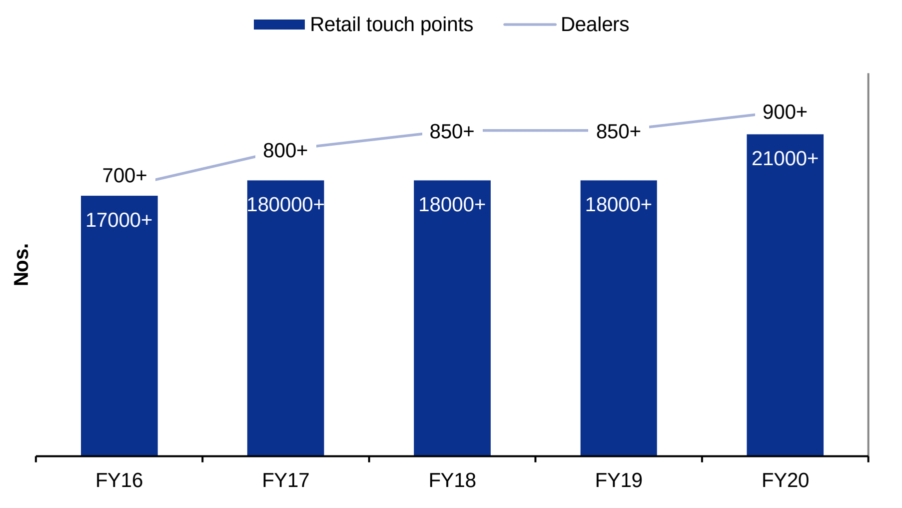
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 159: Marketing spend (ASP) comparison of plastic pipe companies (FY20)



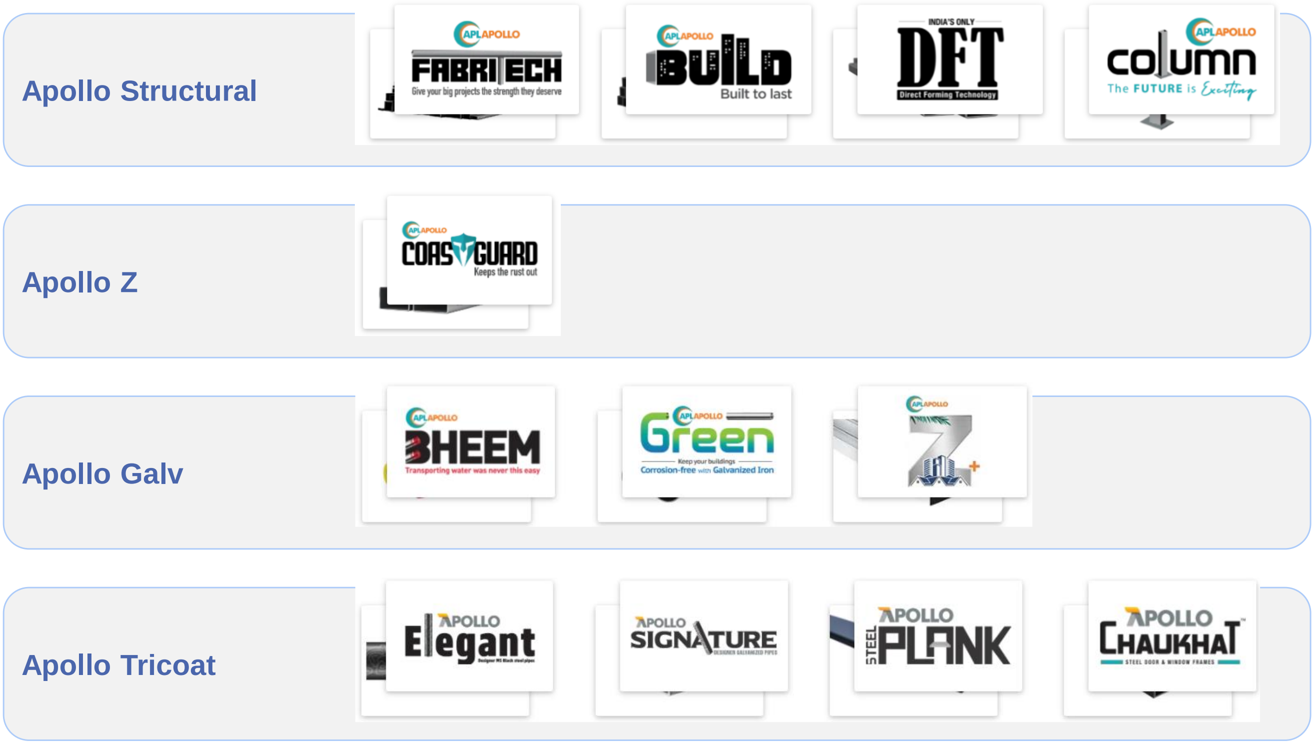
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 160: APL's distribution reach growth



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 161: APL's brands



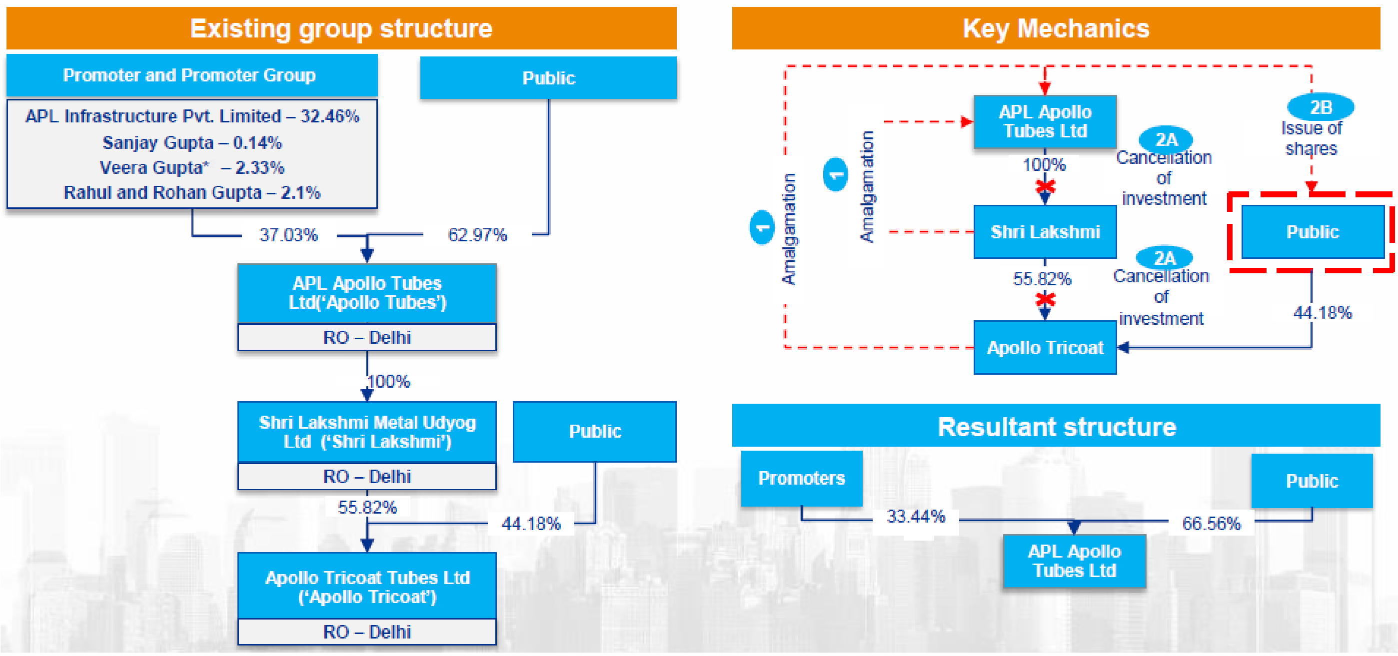
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Apollo Tricoat merger provides opportunities to introduce new products for the home innovation segment and leverage APL's distribution network leading to meaningful cost synergies going forward.

Merger with Apollo Tricoat further boosts value-added pie

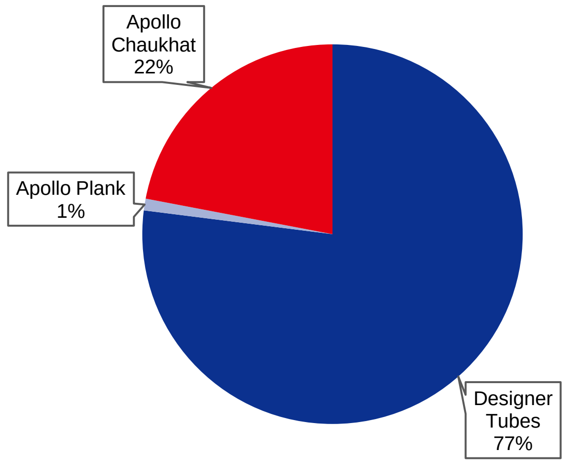
Apollo Tricoat is a 55%-owned subsidiary of APL Apollo listed on the Indian stock exchanges. The company manufactures steel pipes but focusses only on value-added products like designer tubes. APL Apollo's merger with Apollo Tricoat is effective from Apr 2021 and is expected to complete by Mar 2022. The merger is margin and RoE accretive and will enhance APL Apollo's branding given Tricoat's customer-centric product portfolio. The approved merger ratio is 1:1 and Apollo Tricoat minority shareholders will hold shares in APL Apollo Tubes after the merger.

Figure 162: Apollo Tricoat merger arrangement with APL Apollo



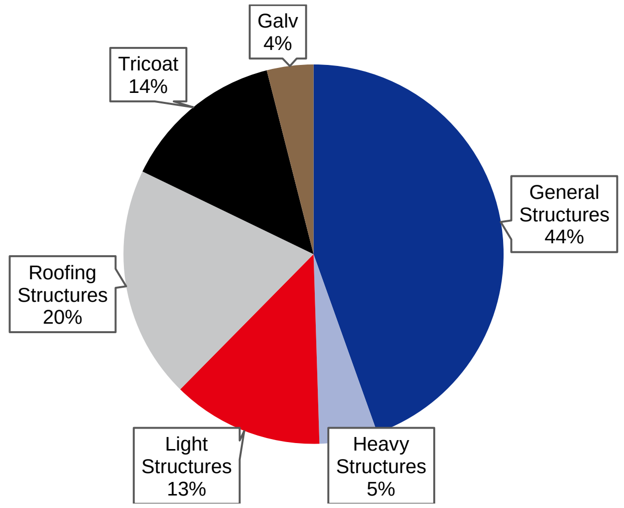
*VEERA GUPTA IS NOT PART OF PROMOTER FAMILY
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 163: Apollo Tricoat product portfolio (9MFY21)



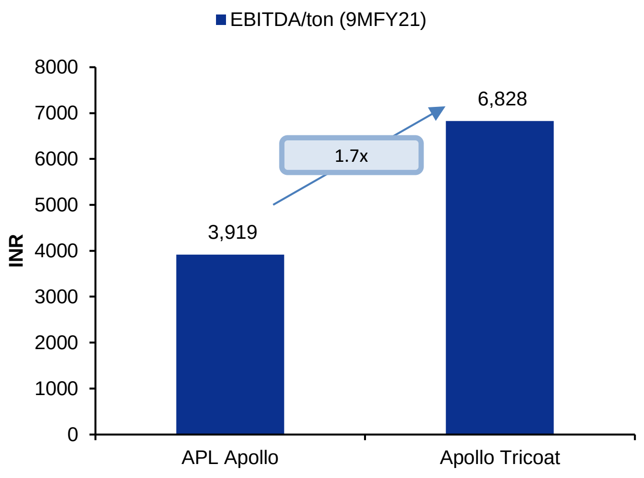
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 164: APL Apollo product portfolio including Apollo Tricoat (9MFY21)



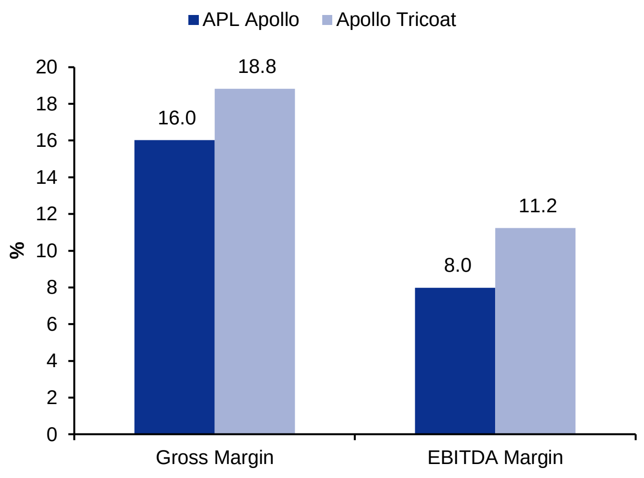
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 165: Apollo Tricoat has higher EBITDA/t



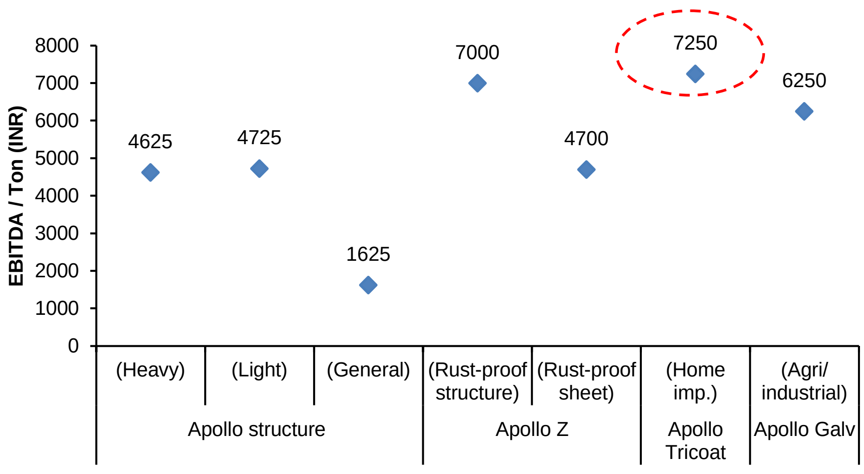
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 166: Apollo Tricoat has better margins (%, 9MFY21)



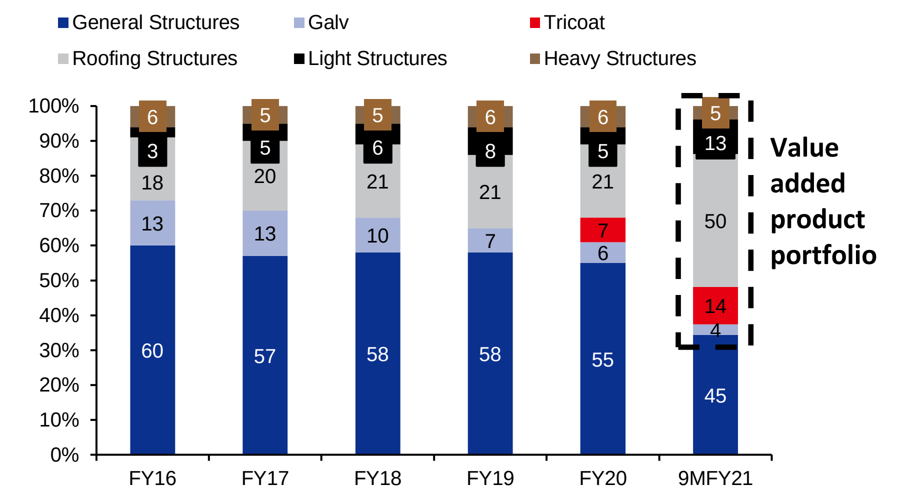
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 167: Apollo Tricoat has a higher EBITDA/t than any APL Apollo product (FY21)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

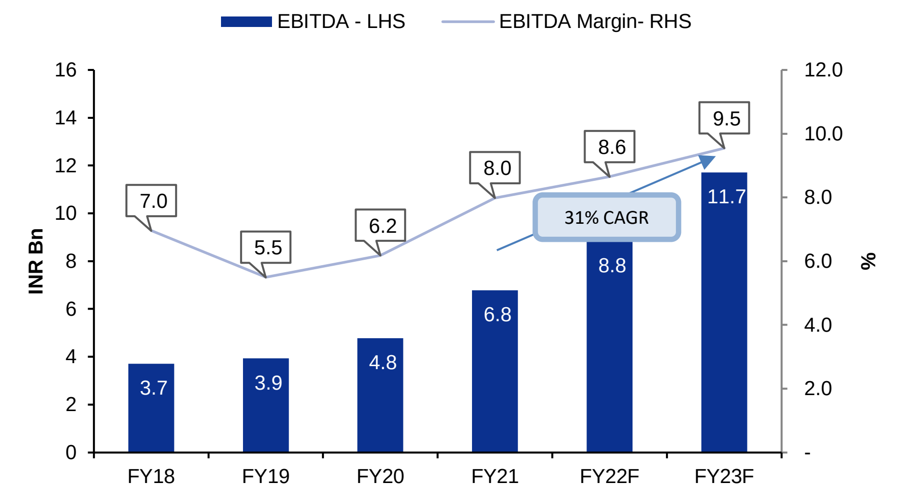
Figure 168: Higher revenue share from value-added products post merger



SOURCES: INCRED RESEARCH, COMPANY REPORTS

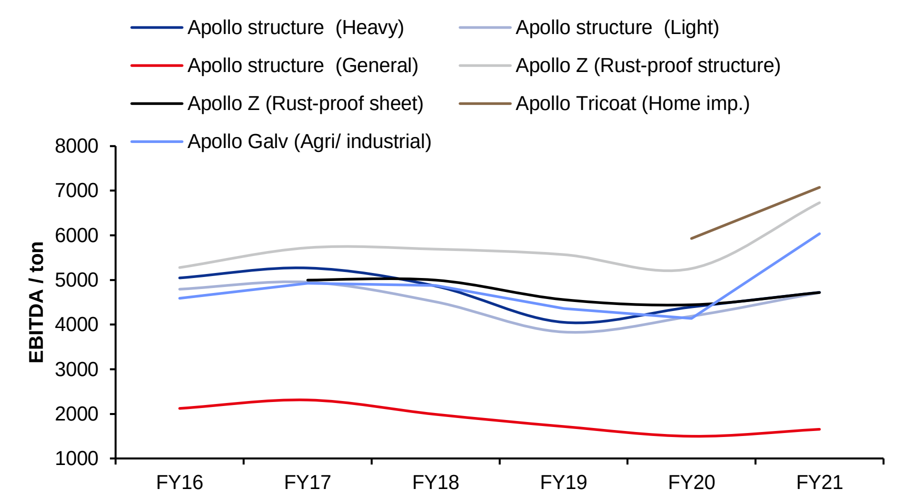
Expect FY21-23F EBITDA CAGR of over 31.4% with rising margins ❯

Figure 169: APL's EBITDA trend



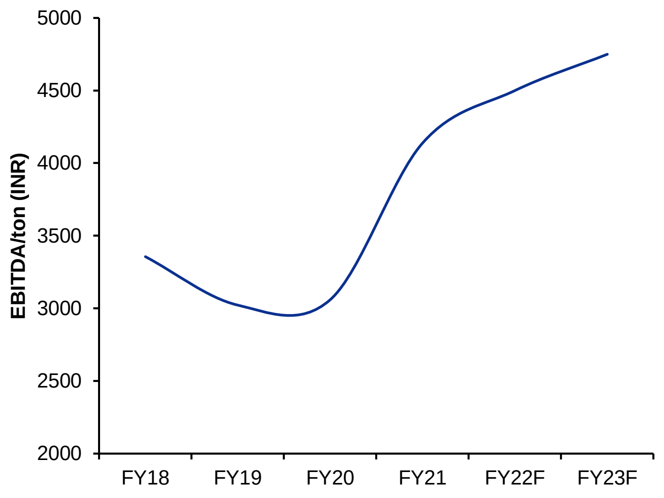
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 170: APL's segment and overall EBITDA per ton trend



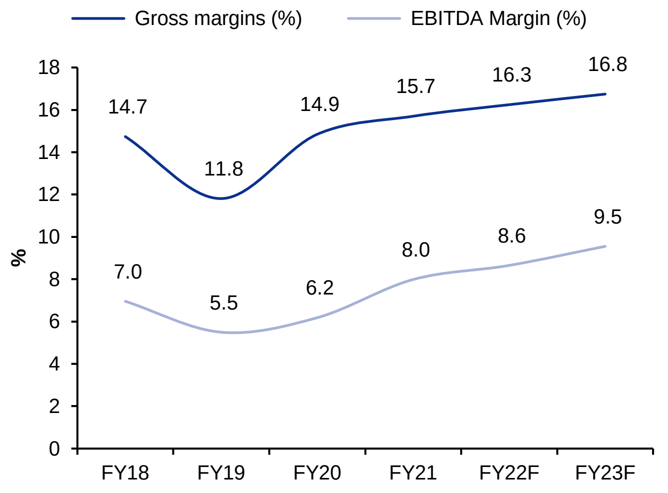
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 171: APL's EBITDA/t trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 172: APL's GM and EBITDA margin trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

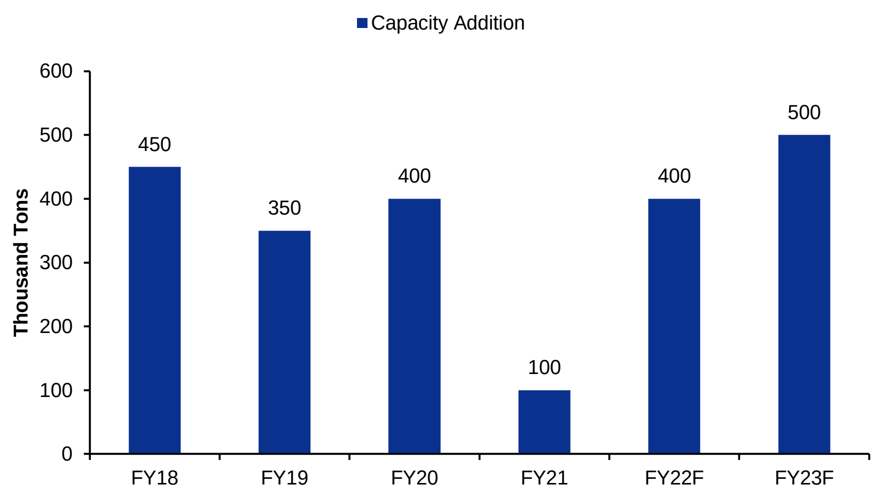
Efficient capex and working capital management

All future capacity addition funded through internal accruals

APL is setting up its 11th pipe manufacturing plant at Raipur, Chhattisgarh, with approximately 900k tons of total annual capacity. The plant would be built in two phases largely devoted to manufacturing of large diameter pipes and value-added products like colour-coated tubes/sheets. We expect the plant to become commercial over FY22F-23F.

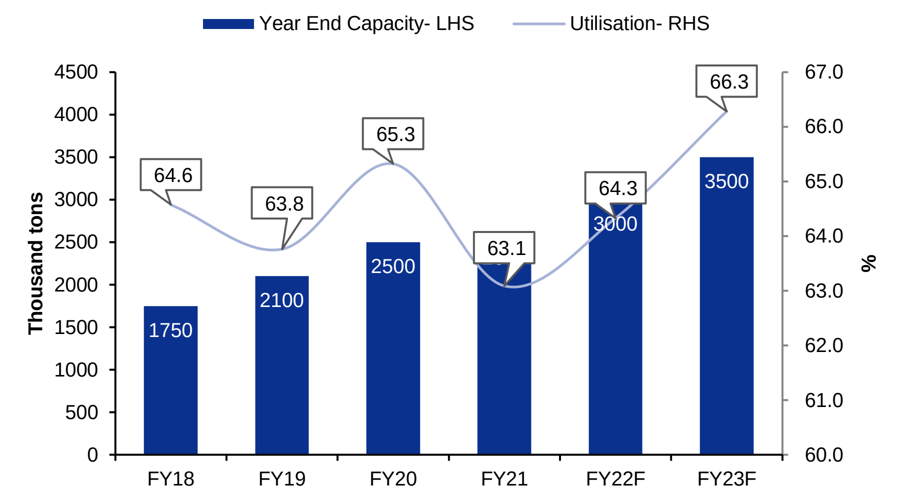
APL has set up a new wholly-owned subsidiary – Apollo Building Products – to avail of the income tax concessions that were announced in Sep 2019 to boost Indian manufacturing. The plant's profits would attract a lower concessional income tax rate of 15% plus surcharge/cess as applicable.

Figure 173: APL's capacity-addition trends



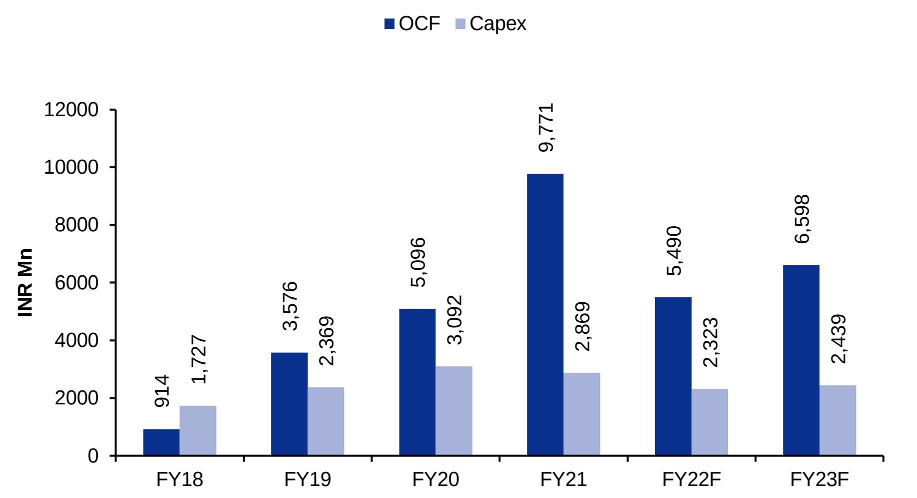
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 174: APL's capacity and utilisation chart



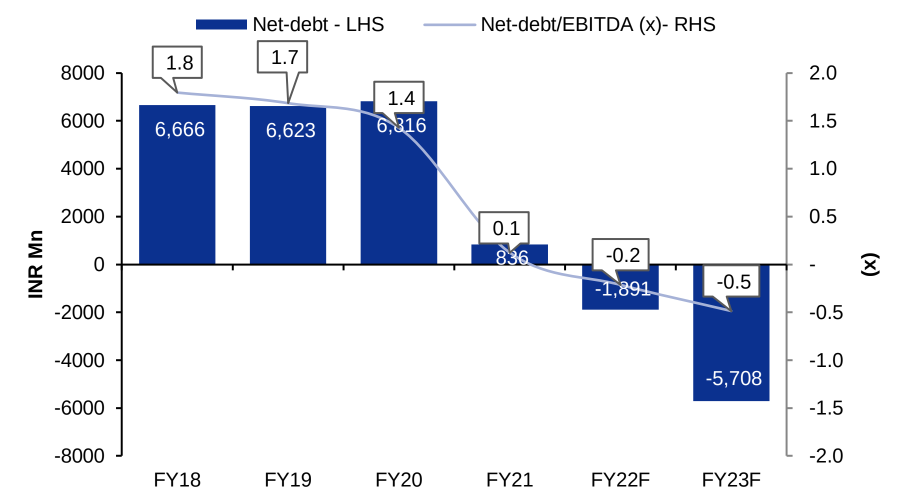
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 175: APL's OCF and capex (including acquisitions till date) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 176: APL's net debt and net debt/EBITDA trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

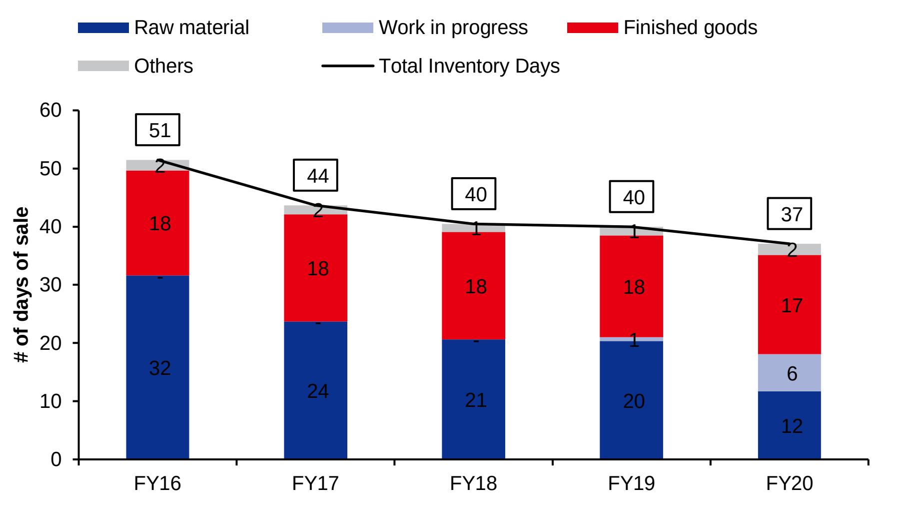
Brand power and macro factors enable cash and carry; low receivables cycle is a major positive ›

"We have switched to the cash-and-carry model, which means our debtor days reduced to six from 19, six months ago. This is the lowest debtor days in the building materials industry."
APL Apollo Tubes, 2QFY21 earnings call

During the COVID-19 pandemic, management was very cautious with respect to timely collection of receivables. Given APL Apollo's brand strength and collateral damage to unorganised players, the company switched to the cash-and-carry model reducing debtors to less than 10 days of sales vs 25-30 over the past three years. Management indicated this was a structural change to its business and its receivables cycle would stabilise at these levels going forward.

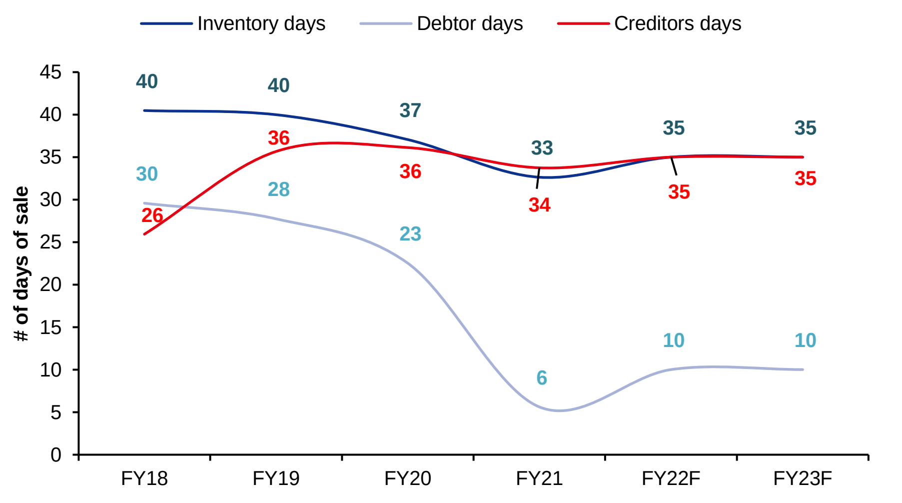
This has led to substantial working capital release of Rs4.1bn in FY21. The average annual FCF is expected to be Rs3.5bn-4bn over the next three years, in our view.

Figure 177: APL's inventory breakup (number of days of sale)



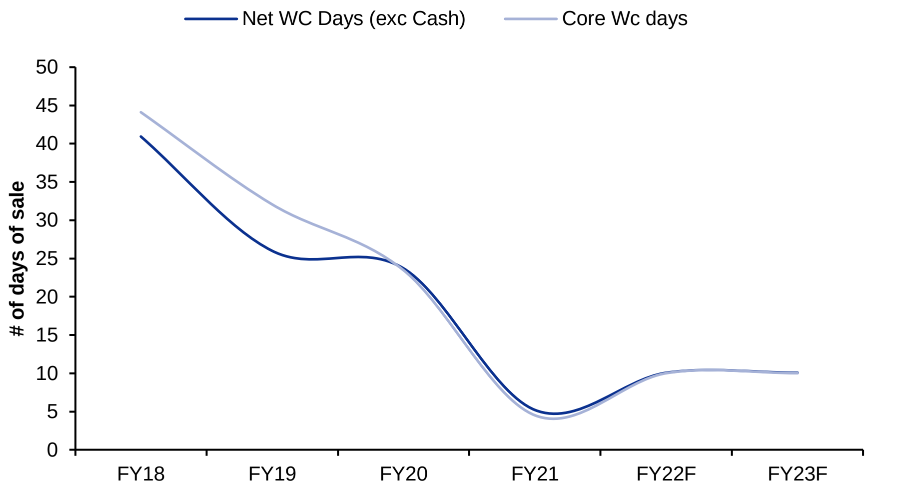
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 178: APL's debtors, creditors and inventory days



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 179: APL's net working capital and overall working capital chart



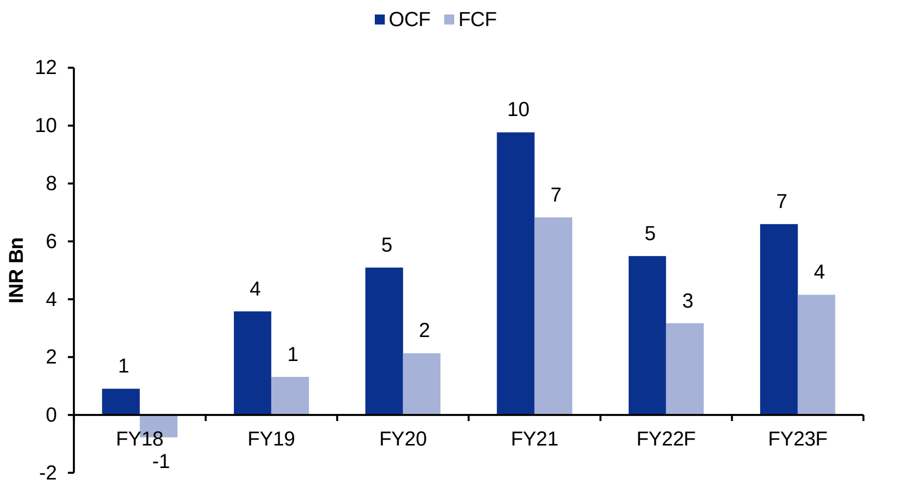
CORE WC: INVENTORY + DEBTORS – CREDITORS
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Improving return ratios with substantial cash flows

Owing to Apollo Tricoat's higher-margin product portfolio, its100% merger would result in enhanced returns on capital on a combined basis, in our view.

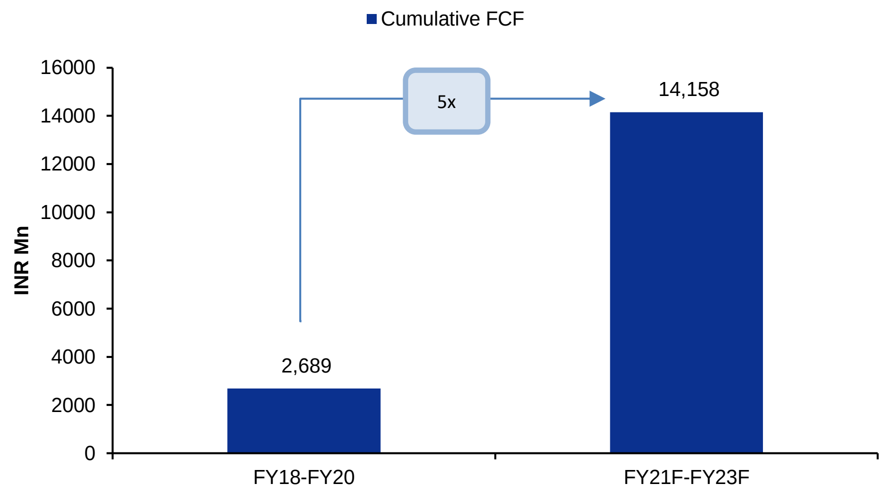
We expect meaningful improvement in return ratios with ROE/RoIC increasing by 750bp to 31.1% and 1850bp to 43.3% over FY21-23F. We estimate cumulative FCF at Rs14.2bn over FY21-23F vs. Rs2.7bn over FY18-20.

Figure 180: APL's OCF and FCF



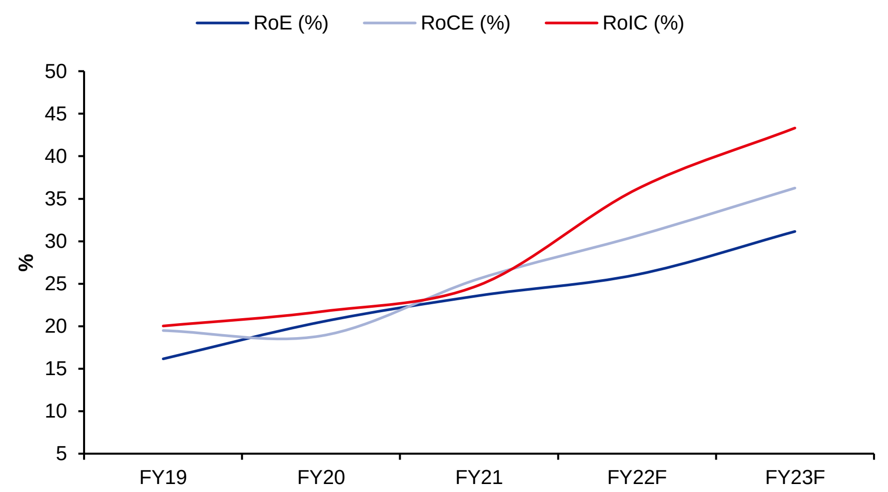
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 181: Cumulative FCF for FY21F-23F to be 5x cumulative FCF of FY18-20



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

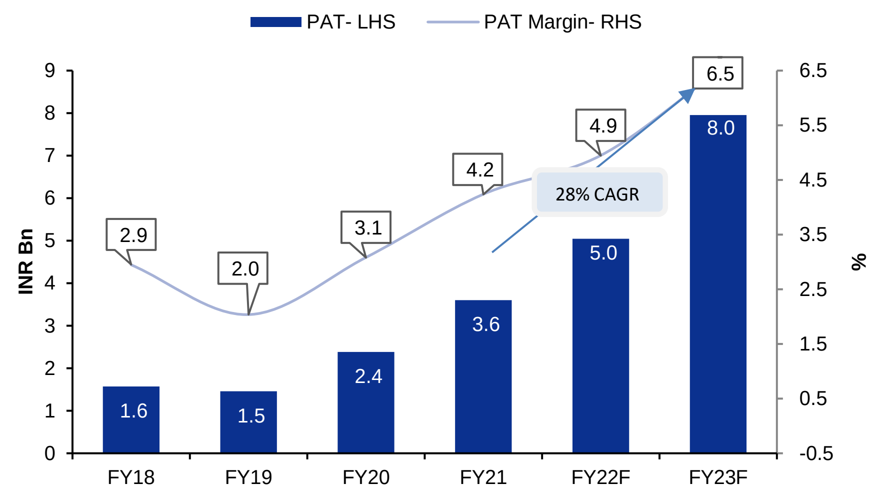
Figure 182: APL's return ratios (%)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

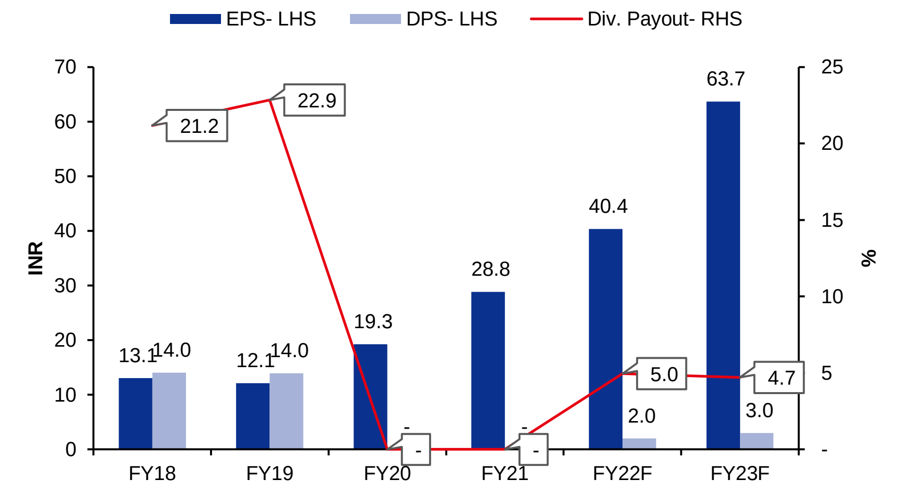
PAT CAGR of 45%+ over FY21-23F (post Tricoat merger)

Figure 183: APL's PAT and PAT margin trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 184: APL's EPS, DPS and payout (%) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

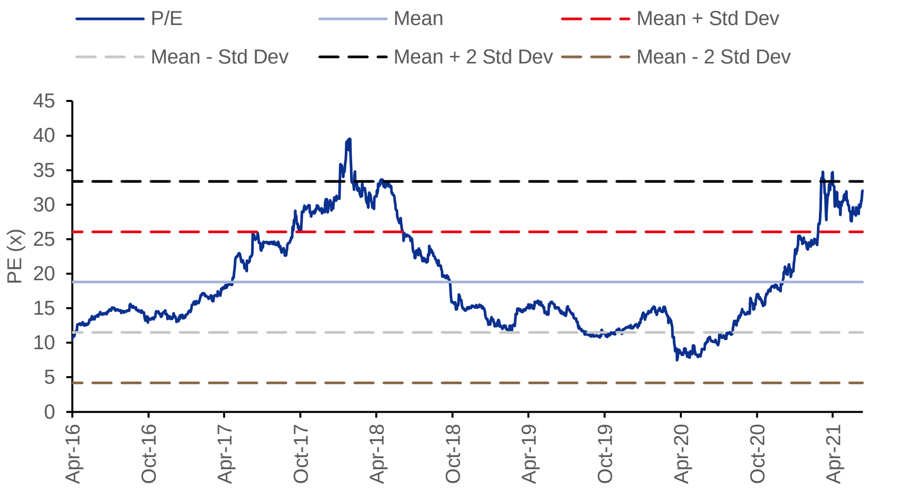
Valuation and risk

Valuation ›

With a stock price CAGR of 60% between Apr 2014 and Apr 2021, APL has been one of the best small cap investments among Indian-listed equities.

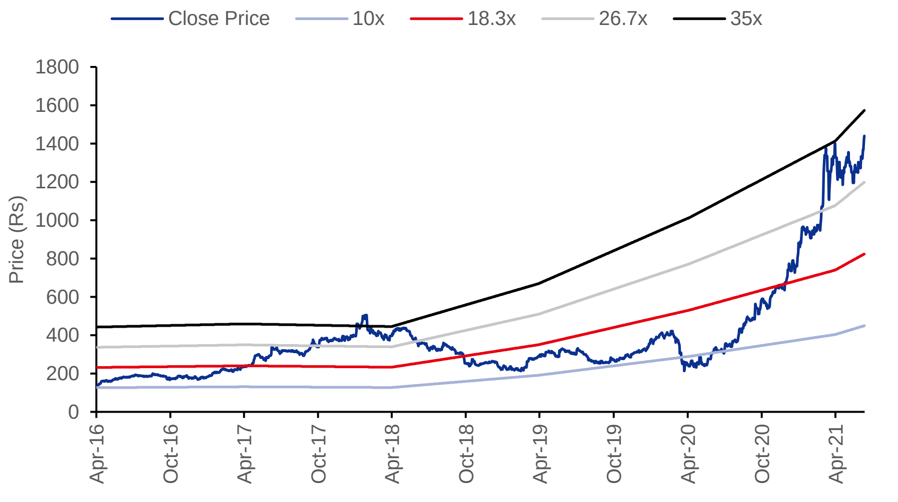
- The stock trades at an FY23F P/E of 22.6x and EV/EBITDA of 14.9x.
- Net profit CAGR was 18% over FY16-20. In our view, APL has been one of the most consistent Indian building materials stocks delivering net profit growth since 2014.
- Superior execution capability has transformed a commodity business into a consumer brand with clear market leadership.
- Urban/rural housing construction are on the path to recovery given the severe demand slump in the past five years in India. This should help sustain premium valuations, in our view.
- The stock is up 3x over Feb 2020-May 2021 on the back of exceptional business performance. At flat sales volume growth yoy, EBITDA/PAT rose 42%/51% yoy in FY21.
- We initiate coverage on APL Apollo with an Add rating and a TP of Rs1,592 based on P/E of 25x FY23F EPS, a ~30% premium to its five-year mean P/E of 19x.
- APL's stock is valued at the upper end (30%) of the P/E multiple premium range owing to a) clear revenue market leadership position in the structural steel pipe segment in India as at Mar 2021, b) structural steel pipes industry to grow fastest (Source: Prince Pipes prospectus) amongst all the building material product segments covered in this report, c) higher EPS growth of over 45% over FY21-23F versus 21% over FY18-20 and d) superior working capital management.

Figure 185: APL Apollo Tubes trading around +2SD its 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Figure 186: P/E Band Chart



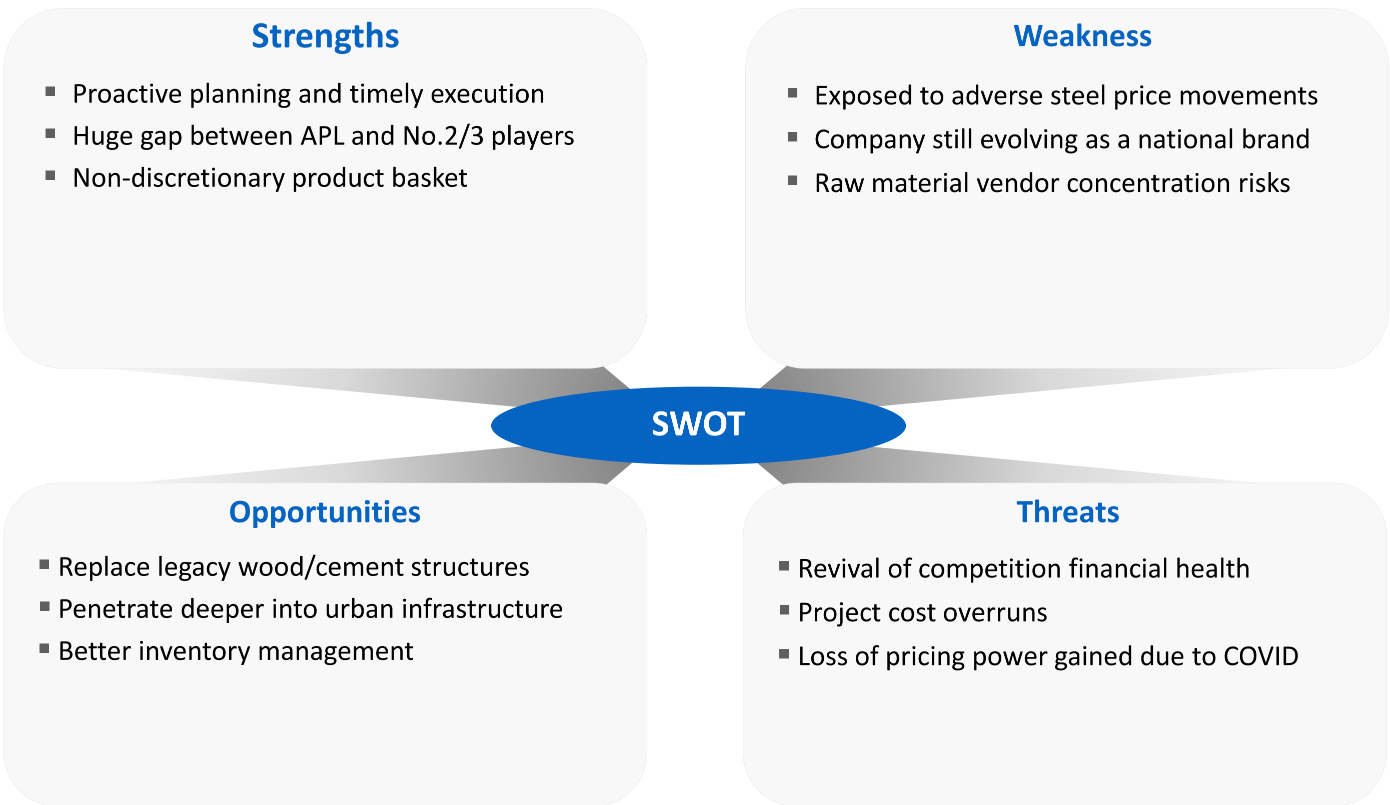
SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Downside risks ›

- **Capex execution delays:** APL has a large capex planned for FY22F-23F. Execution delays or cost overruns could impact our revenue/profit assumptions negatively.
- **Revival of unorganised competition:** The COVID-19 pandemic led to severe disruption in the business operations of unorganised players. Sharp reversal of market share gains by large brands could lead to lower-than-estimated revenues.
- **Resurgence in COVID-19 infections:** A prolonged second wave that started in the second half of Mar 2021 leading to intermittent lockdowns could impact our medium-term growth expectations negatively.
- **Reversal of significant working capital benefits:** APL reported meaningful improvement in receivable management in FY21. The receivable days dropped to less than 10 days of sales versus an average of ~25 days over FY17-20. Though management indicated that these are sustainable levels going forward, the reversal of such benefits would lead to lower-than-expected FCF.
- **Competitive product demand:** Steel pipes replace plastic/cement pipes across various applications. Cheaper alternative products owing to steep rise in steel prices could impact steel pipe demand negatively, in our view.

SWOT analysis ›

Figure 187: SWOT analysis



SOURCE: INCRED RESEARCH

Business description and management profile

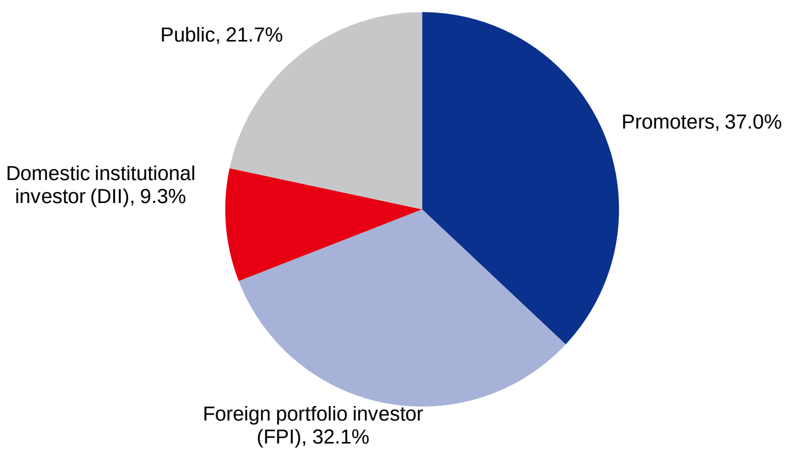
APL was incorporated as Bihar Tubes Pvt Ltd on 24 February 1986, and started its operations with a unit at Sikandrabad in Uttar Pradesh to manufacture electric resistance welding (ERW) pipes with a capacity of 6k tons. Currently, APL manufactures steel pipes and tubes with a capacity of 2.6m tons as at Mar 2021 on a consolidated basis. APL acquired majority equity stake in two companies during FY20, Taurus Value Steel & Pipes, located in Hyderabad in May 2020 with a production capacity of 0.2m tons and which became operational from 2QFY20, and Apollo Tricoat Tubes Ltd (through a wholly-owned subsidiary), with existing and new production capacity of 2 lakh tons p.a. Apollo Tricoat Tubes has a pan-India presence with manufacturing units in Sikandarabad, Bengaluru, Hyderabad, Hosur, Raipur and Murbad.

Figure 188: Key management profile (as at Mar 2020)

Sanjay Gupta, Chairman & Managing Director	Mr Gupta has more than 30 years of experience in diverse steel industry segments. Under his leadership, the company has evolved and developed from a steel tube manufacturer into a global leader in branded structural steel tubing products.
Arun Agrawal, Chief Operating Officer	Mr Agrawal is a chartered accountant and has 20 years of experience in the steel industry. He has been associated with the company since 2009. He is involved in all strategic decisions of the group and shouldered more responsibilities over the years at APL Apollo. He has been assigned responsibility of driving all the plants.
Vinay Gupta, Director	Mr Gupta possesses in-depth knowledge of manufacturing and marketing structural steel tubes and has over 20 years of experience in exports and international markets. He has been assigned the development of the company's Apollo Z (pre-galvanised steel tubes) product category. Mr Gupta has an MBA from the University of Pennsylvania.
Deepak Goyal, Chief Finance Officer	Mr Goyal has over 18 years of experience, 15 of which have been with the steel industry. He has been associated with APL Apollo Tubes for the last five years and is involved in its the day-to-day operations. He leads an efficient team and oversees budget planning, funds management, treasury, and taxation matters.
Romi Sehgal, Director	Mr Sehgal has been in the steel and tubes industry for more than 35 years, and has been involved in designing and manufacturing tube mills, setting up greenfield projects, commissioning projects and ensuring uninterrupted optimum production at factories. He has been associated with APL Apollo Tubes for 12 years. He is a Science graduate and has had managerial and leadership positions in such companies as Atlas Steel Tubes, Atma Steel Tubes, Bharat Steel Tubes, and Gallium Industries.
Anubhav Gupta, Chief Strategy Officer	Mr Gupta joined the company in 2019 with a focus on strengthening strategic capabilities, and identifying and evaluating innovative opportunities for APL Apollo in the longer run. He advises on corporate development, communications, and marketing of the APL Apollo brand, aimed at creating a strong position for the company within domestic and global markets. He has over 12 years of experience in fundamental research and analysis in the investment world, including leadership positions across investment advisory and investment banking firms.
Ashok Khushu, Head – New Projects	Mr Khushu is a mechanical engineer from the Thapar Institute of Engineering & Technology and has 30 years of experience in the steel industry. He has worked with companies like Bhushan Power and Steel Limited and Allied Strips in strategy and operations at senior management levels. Currently, he is the head of New Projects at APL Apollo Tubes and looking after on-going developments and innovation work.

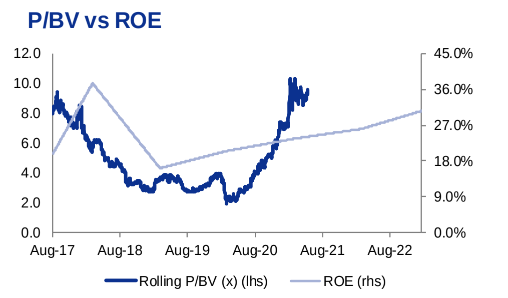
SOURCES: INCRED RESEARCH, COMPANY WEBSITE

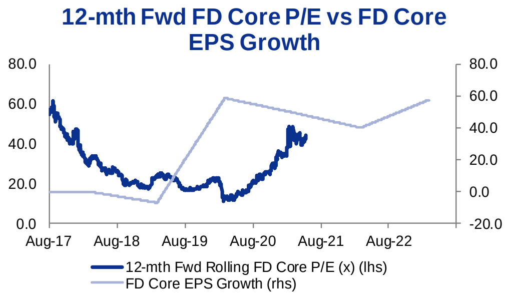
Figure 189: Shareholding pattern (as at Mar 2021)



SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS





Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**71,523**	**77,232**	**84,997**	**102,000**	**122,613**
Gross Profit	**8,446**	**11,469**	**13,349**	**16,575**	**20,538**
Operating EBITDA	**3,929**	**4,773**	**6,787**	**8,823**	**11,710**
Depreciation And Amortisation	(643)	(959)	(1,028)	(1,161)	(1,326)
Operating EBIT	**3,286**	**3,814**	**5,759**	**7,662**	**10,384**
Financial Income/(Expense)	(1,131)	(1,048)	(454)	(192)	32
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)	89	197	152	200	210
Profit Before Tax (pre-EI)	**2,244**	**2,963**	**5,457**	**7,670**	**10,626**
Exceptional Items					
Pre-tax Profit	**2,244**	**2,963**	**5,457**	**7,670**	**10,626**
Taxation	(787)	(403)	(1,381)	(1,930)	(2,674)
Exceptional Income - post-tax					
Profit After Tax	**1,457**	**2,560**	**4,077**	**5,740**	**7,951**
Minority Interests		(180)	(475)	(696)	
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**1,457**	**2,379**	**3,601**	**5,044**	**7,951**
Recurring Net Profit	1,457	2,379	3,601	5,044	7,951
Fully Diluted Recurring Net Profit	**1,457**	**2,379**	**3,601**	**5,044**	**7,951**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	3,929	4,773	6,787	8,823	11,710
Cash Flow from Invt. & Assoc.					
Change In Working Capital	287	1,017	4,120	(1,602)	(568)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	(1,072)	(927)	(395)	8	(1,837)
Net Interest (Paid)/Received	1,105	1,048	454	192	(32)
Tax Paid	(673)	(816)	(1,195)	(1,930)	(2,674)
Cashflow From Operations	**3,576**	**5,096**	**9,771**	**5,490**	**6,598**
Capex	(2,369)	(3,092)	(2,869)	(2,323)	(2,439)
Disposals Of FAs/subsidiaries	112	132	(72)		
Acq. Of Subsidiaries/investments	(390)	(1,430)	(3,711)	(500)	(500)
Other Investing Cashflow	13	41	183	252	343
Cash Flow From Investing	**(2,636)**	**(4,349)**	**(6,469)**	**(2,571)**	**(2,596)**
Debt Raised/(repaid)	826	(946)	(2,957)	(1,500)	(2,000)
Proceeds From Issue Of Shares	56	1,775			
Shares Repurchased					
Dividends Paid	(403)	(411)		(250)	(375)
Preferred Dividends					
Other Financing Cashflow	(1,014)	(1,193)	(623)	(443)	(311)
Cash Flow From Financing	**(534)**	**(776)**	**(3,579)**	**(2,193)**	**(2,685)**
Total Cash Generated	407	(29)	(277)	726	1,317
Free Cashflow To Equity	**1,767**	**(199)**	**346**	**1,419**	**2,002**
Free Cashflow To Firm	**(193)**	**(326)**	**2,641**	**2,476**	**3,692**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	478	456	3,579	4,805	6,623
Total Debtors	5,433	4,764	1,306	2,795	3,359
Inventories	7,835	7,842	7,599	9,781	11,757
Total Other Current Assets	1,039	1,422	1,507	1,694	2,036
Total Current Assets	**14,785**	**14,484**	**13,991**	**19,075**	**23,775**
Fixed Assets	10,106	14,738	15,032	17,171	18,283
Total Investments	494	15	15	15	15
Intangible Assets	230	1,375	1,375	1,375	1,375
Total Other Non-Current Assets	2,123	2,048	3,576	2,599	2,599
Total Non-current Assets	**12,953**	**18,176**	**19,998**	**21,160**	**22,272**
Short-term Debt	5,356	3,229	2,580	1,703	535
Current Portion of Long-Term Debt					
Total Creditors	6,989	7,644	7,859	9,781	11,757
Other Current Liabilities	2,224	1,369	1,344	1,677	2,016
Total Current Liabilities	**14,569**	**12,241**	**11,783**	**13,161**	**14,308**
Total Long-term Debt	1,745	4,043	1,835	1,211	380
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	584	848	930	930	930
Total Non-current Liabilities	**2,329**	**4,891**	**2,765**	**2,142**	**1,311**
Total Provisions	1,200	1,012	1,112	1,112	1,112
Total Liabilities	**18,098**	**18,144**	**15,659**	**16,414**	**16,730**
Shareholders Equity	9,641	13,562	16,947	21,741	29,318
Minority Interests		954	1,383	2,079	
Total Equity	**9,641**	**14,516**	**18,330**	**23,820**	**29,318**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	34.1%	8.0%	10.1%	20.0%	20.2%
Operating EBITDA Growth	5.9%	21.5%	42.2%	30.0%	32.7%
Operating EBITDA Margin	5.5%	6.2%	8.0%	8.6%	9.5%
Net Cash Per Share (Rs)	(55.18)	(55.19)	(6.69)	15.14	45.70
BVPS (Rs)	80.32	109.81	135.69	174.07	234.74
Gross Interest Cover	2.83	3.55	8.71	17.29	33.42
Effective Tax Rate	35.1%	13.6%	25.3%	25.2%	25.2%
Net Dividend Payout Ratio	17.9%			3.6%	3.5%
Accounts Receivables Days	24.89	24.09	13.03	7.34	9.16
Inventory Days	39.78	43.51	39.33	37.13	38.51
Accounts Payables Days	31.20	40.61	39.49	37.68	38.51
ROIC (%)	20.0%	21.7%	24.8%	36.2%	43.3%
ROCE (%)	19.5%	18.8%	25.6%	30.6%	36.2%
Return On Average Assets	13.6%	13.3%	17.7%	21.2%	24.6%

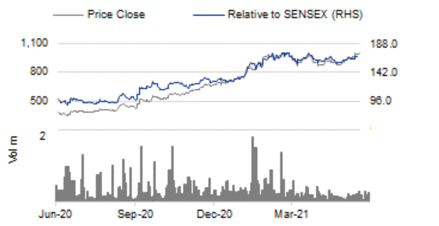
SOURCES: INCRED RESEARCH, COMPANY REPORTS

India

ADD *(Initiating coverage)*

Consensus ratings*:	Buy 28 Hold 2 Sell 2
Current price:	Rs1,022
Target price:	Rs1,176
Previous target:	NA
Up/downside:	15.1%
Incred research / Consensus:	26.4%
Reuters:	KAJR.BO
Bloomberg:	KJC IN
Market cap:	US$2,225m
	Rs162,557m
Average daily turnover:	US$4.6m
	Rs337.3m
Current shares o/s:	159.1m
Free float:	52.5%

**Source: Bloomberg*



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	16.2	2.5	186.2
Relative (%)	8.0	(0.8)	84.2

Major shareholders	% held
Promoters	47.5
Government Pension Fund Global	4.6
Smallcap World Fund Inc.	4.1

Kajaria Ceramics

Attractive story with structural tailwinds

- Clear beneficiary of the global anti-China drive. Structural tailwinds ahead.
- High volume growth, cost optimisation and bathware are key margin drivers.
- Higher payouts due to better FCF; initiate coverage with TP of Rs1,176. Add.

Global anti-China drive improves Indian tile demand-supply balance

An oversupplied market, slowing economic growth and low urban housing demand led to subdued tile pricing, sales volumes over FY17-20 in India. Since the COVID-19 outbreak, large global importers are diversifying vendor sourcing to reduce their dependence on China. An anti-China drive implies a higher export share for India as it follows China in terms of cost economics. In CY20, overall exports rose ~25% yoy resulting in market share gains for organised brands in the Indian market. Kajaria had ~10% revenue market share in FY20 and is well ahead of other players in the Indian tile market. Management expects organised brands to gain share and unorganised players to focus on higher exports over FY21-23F. Kajaria has guided for FY22F tile volume growth of 20-25% and 15% thereafter. We estimate tile volume/revenue CAGR of 14%/16% over FY21-23F.

Multiple factors driving gross and EBITDA margin expansion

Factors like a) higher tile throughput resulting in optimum in-house capacity utilisation; b) increasing bathware scale and profitability; c) price hikes and lower dealer schemes/ promotions to offset higher gas prices and; d) need based advertising spends, are key levers for gross and EBITDA margins improvement over FY21-23F. We estimate gross/EBITDA margins to improve from 55%/18.3% in FY21F to 59.5%/18.5% in FY23F, respectively. EBITDA margins are largely flat as sharp discretionary cost cuts of FY21F would be restored over this period, in our view.

Higher dividends due to new policy, FCF of Rs12bn over FY21-23F

We expect cumulative capex of Rs3.5bn over FY21-23F to be entirely funded by internal accruals. Management has guided for ~Rs2bn (implies tile capacity of 10m sq m) capex in FY22F. Strategic use of joint venture/ outsourcing capacity would ensure meeting sudden demand spikes. Steady net working capital cycle at 55-60 days of sales implies cumulative FCF of Rs12bn over FY21-23F, up 3x over FY18-20 (Rs3.8bn). We expect RoE/ RoCE/ RoIC to improve to 22%/28%/36% in FY23F. We estimate dividend payouts of ~45-50% of profits over FY21-23F led by the new dividend policy adopted in Jan 2021.

Strong EPS growth would hold valuations near mean levels

We estimate EPS CAGR of 21% over FY21-23F. The stock trades at FY23F P/E of 32x and EV/EBITDA of 20.2x. Given continuing market leadership with distant competitors, solid management track record and consistent high cash flows, we initiate coverage with Add rating and TP of Rs1,176 based on P/E of 37x FY23F EPS, a ~10% premium to its five-year mean P/E. Downside risks: Rising natural gas prices, global withdrawal of anti-dumping duties on Chinese imports and poor urban real estate demand.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	29,562	28,080	30,469	36,872	41,792
Operating EBITDA (Rsm)	4,495	4,159	5,561	6,637	7,732
Net Profit (Rsm)	2,266	2,553	3,454	4,255	5,077
Core EPS (Rs)	14.4	16.1	21.7	26.7	31.9
Core EPS Growth	(1.9%)	11.2%	35.2%	23.1%	19.3%
FD Core P/E (x)	71.79	63.64	47.05	38.20	32.02
DPS (Rs)	3.0	6.0	10.0	12.5	15.0
Dividend Yield	0.35%	0.71%	0.98%	1.22%	1.47%
EV/EBITDA (x)	35.97	38.96	28.65	23.82	20.18
P/FCFE (x)	(309.17)	114.11	38.26	72.56	45.52
Net Gearing	(9.6%)	(6.6%)	(20.0%)	(23.3%)	(29.2%)
P/BV (x)	10.32	9.48	8.55	7.64	6.78
ROE	15.7%	15.5%	19.1%	21.1%	22.4%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)			1.21	1.12	1.10

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

Analyst(s)

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Attractive story with structural tailwinds

Domestic consumption picking up after a long time ›

Indian tile demand has been lower than production over the past five years owing to slowing residential and commercial real estate consumption across the country and lower replacement market demand. The domestic volume production rose at 10.4% CAGR, while consumption CAGR was at a low single digit over CY15-CY19.

The ceramic tiles industry in India has followed similar trends internationally which have been characterised by excess capacities and falling margins. Countries like Malaysia, Thailand, Indonesia, Sri Lanka and Vietnam are setting up their own plants. China has emerged as a major competitor. Producers from Spain and Italy have the advantage of lower transportation costs while exporting to the USA and Germany (Source: The Indian Council Of Ceramic Tiles and Sanitaryware).

"Exports is big as far as Morbi is concerned. Till 31 Mar 2020 of last year, exports were about Rs90bn-95bn. As of Dec 2020, they have already done exports worth Rs73bn. Ending Mar, they will be doing exports worth Rs110bn-115bn, because two things happened. One, anti-dumping [duty] was put by America on Chinese goods, Chinese tiles, lot of countries have put anti-dumping duty on China. Also, with the sentiment of whatever is prevailing, anti-Chinese, a lot of export business has come to India, more to Morbi, because the manufacturers are closer to the port.
Secondly, India is the second most competitive player in the world after China as far as production is concerned."
– Kajaria Ceramics, 3QFY21 investor call

Indian tile export market

Tile exports from India have been growing at a rapid pace – 10x in the last ten years (Source: Prism Johnson 2020 annual report) – with the Gulf Cooperation Council (GCC), USA and ASEAN countries accounting for the majority of Indian exports. This upward trend has enabled India to become the world's fourth largest exporter country (11th in 2013) with exports amounting to ~25% of its total output in CY19.

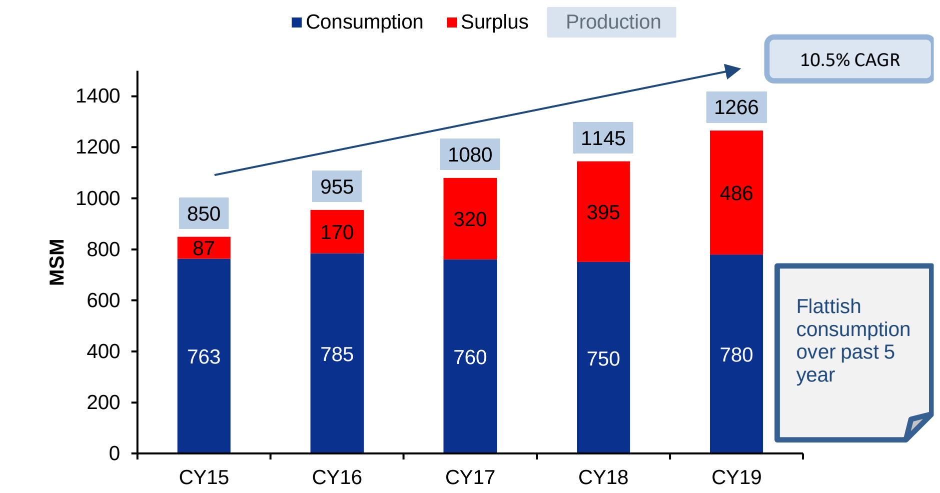
The top-end of the global exports market is presently dominated by China (36.8%) and Italy (15.1%), according to the Indian Council of Ceramic Tiles and Sanitaryware. Indian exports cater to the lower end of global consumption.

Leading tile players suffered from low volume and pricing growth trends

Owing to the oversupplied Indian tile market, tile realisations have de-grown each year of the past five fiscals. The slowing pace of new urban projects of residential/commercial real estate have not helped either, implying volume CAGR of 5%% over FY16-20.

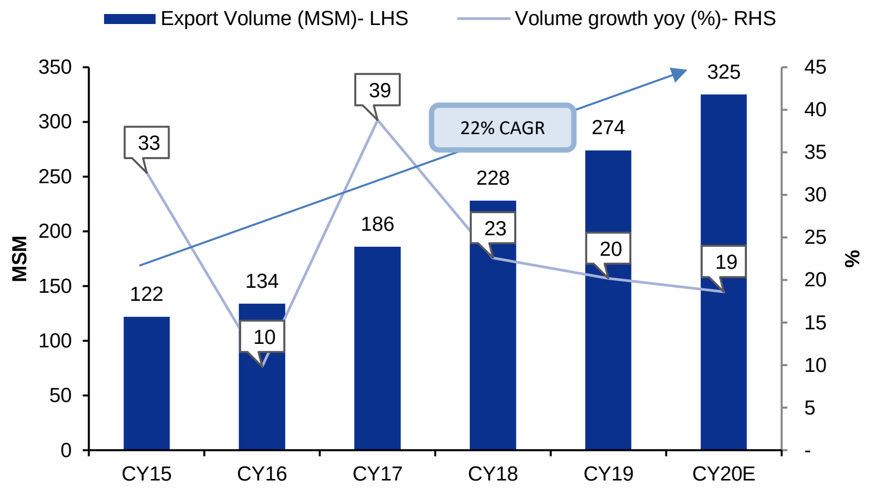
"Exports have played a major role in offsetting partially the impact of the persistent real estate slowdown in the domestic market. Domestic consumption grew at a CAGR of 4%, whereas exports grew at 35% in the last five years. In fact, exports grew ten times in the last ten years. Tiles exports to USA quadrupled in FY19 and has good scope to improve due to low base anti-dumping duty on Chinese tiles and rupee depreciation."
– Prism Johnson FY20 Annual Report

Figure 190: India's tile production and sales statistics



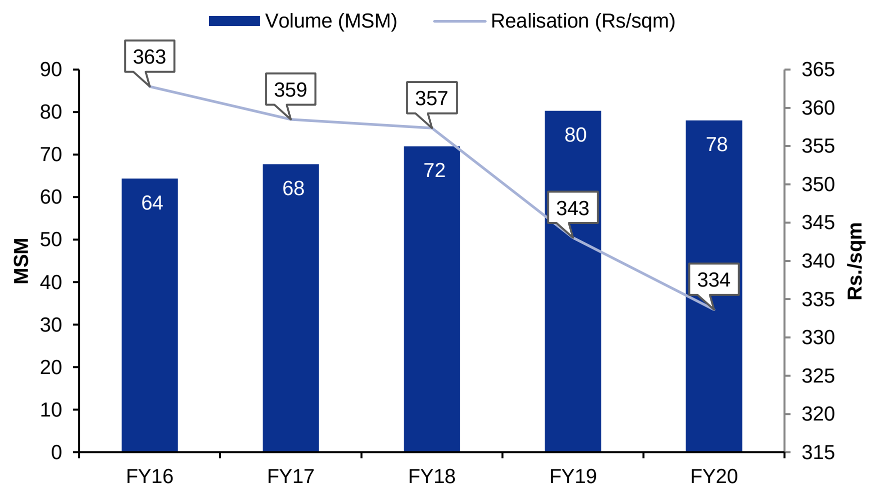
MSM IS MILLION SQUARE METER
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 191: Indian tile exports



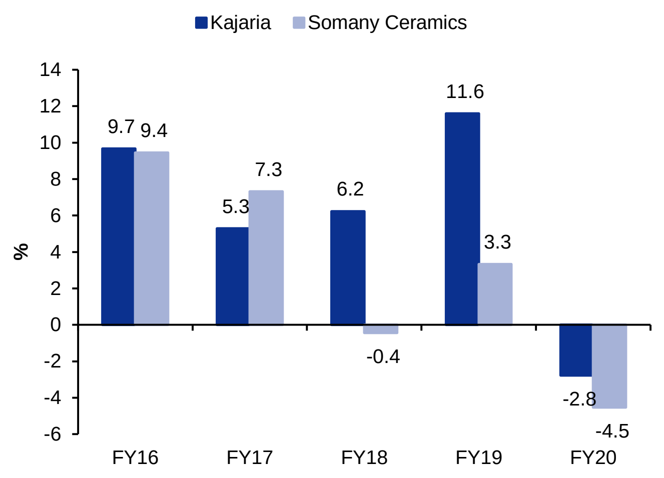
MSM IS MILLION SQUARE METER
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 192: Kajaria Ceramics' volume and realisation trend



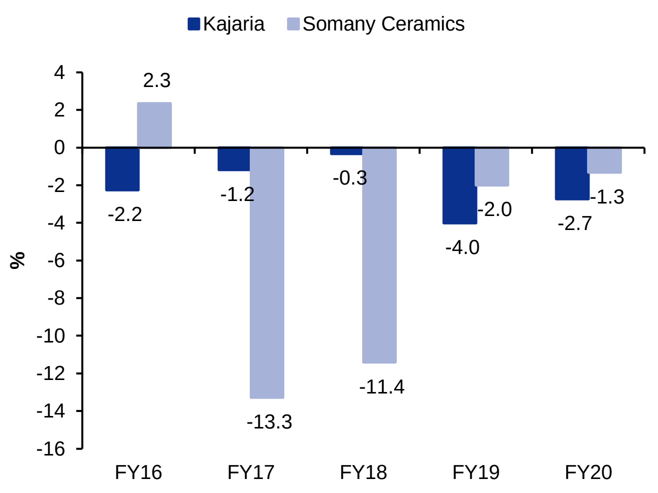
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 193: Volume growth of leading industry players (yoy)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 194: Realisation growth of leading industry players (yoy)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Initial signs of improving domestic demand-supply environment

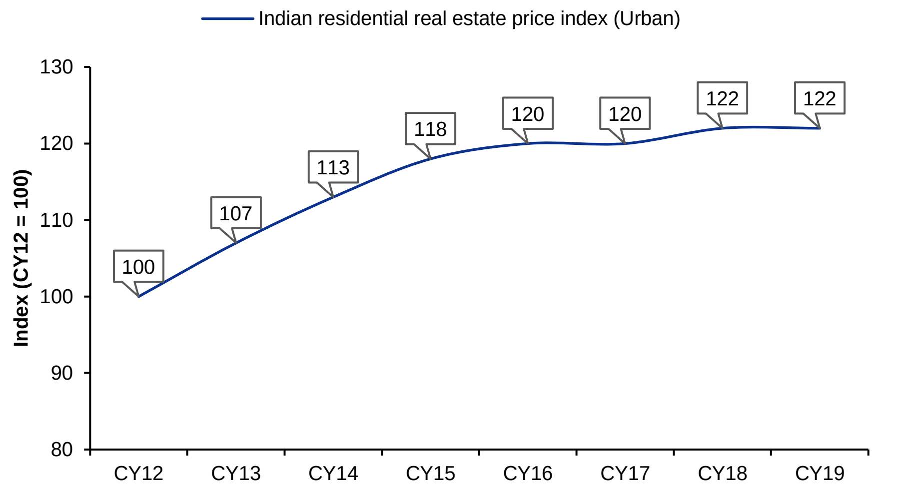
"We have not seen this kind of demand scenario after 2012. After eight years we are now witnessing a scenario where it is difficult to meet demand."
– Cera Sanitaryware, 3 Feb 2021 investor call

Excerpts from the 2Q/3QFY21 investor calls

Somany Ceramics 2QFY21: "Think the answer is to take a little more longer-term view. In five to six years, the industry will at least double."

Kajaria Ceramics 3QFY21: "As far as demand is concerned, it is positive, every month it is positive. That is how you could see the numbers of 3Q. 4Q, as we are talking about, is going to be positive. Next financial year, demand being positive in tier 1, 2, 3 and the metros, we are looking at 20% to 25% volume growth in sales next year."

Figure 195: Indian urban residential real estate price index has been broadly flat over the past 5 years, suggesting pain for the industry as its growth underperforms inflation growth



THIS CONSIDERS THE TOP 7 CITIES ONLY
SOURCES: INCRED RESEARCH, ANAROCK RESEARCH

Discretionary consumption disrupted due to multiple hiccups over the past five years ›

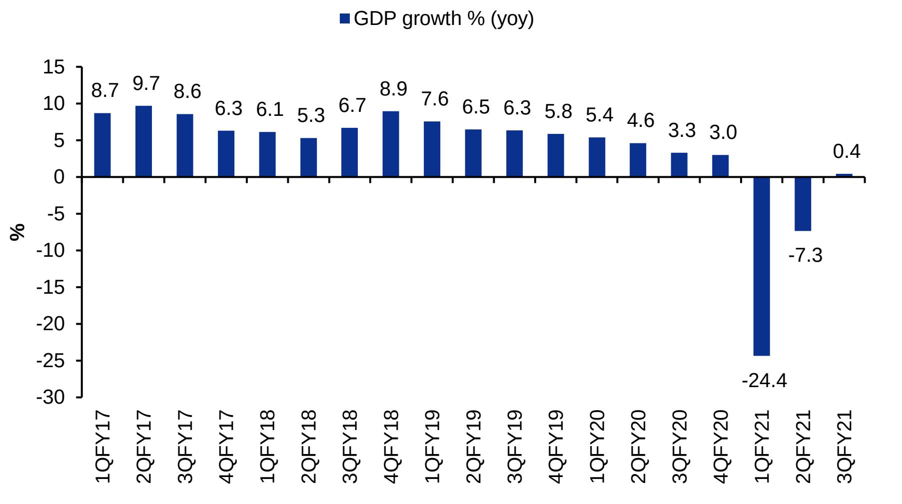
Economic growth slowdown since 2017

"The main reason for lower growth was the demonetisation impact, marked by cash shortages and reduced customer spending."
– Somany Ceramics, FY17 Annual Report

India's economic growth has been slowing since 2017. The slowdown also saw some major government actions/reforms such as demonetisation in Nov 2016, implementation of GST in Jul 2017 and COVID-19 pandemic in Mar 2020 that disrupted consumption demand periodically. The top three tile players also struggled to grow, and revenue CAGR was -3% over FY16-20.

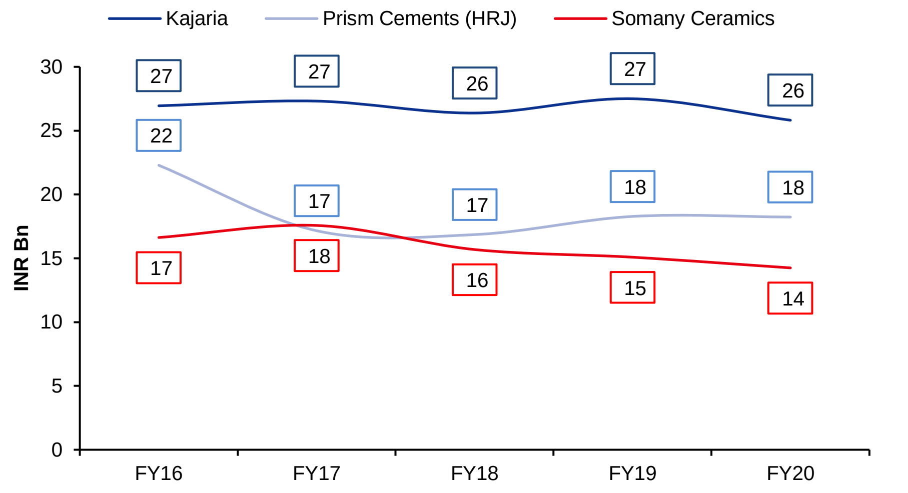
"The government's demonetisation initiative (Nov 2016) dealt a severe body-blow to the anyway stuttering tile demand. The company registered 3.5% net sales growth despite the subdued sentiment prevailing in the real estate industry and the temporary disruption in the cash economy due to demonetisation."
– Kajaria Ceramics, 2017 Annual Report

Figure 196: Quarterly estimates of GDP growth at constant prices, 2011-12 series



SOURCES: INCRED RESEARCH, MINISTRY OF STATISTICS & PROGRAMME IMPLEMENTATION

Figure 197: Revenue has been flat or even degrown over past five years



HRJ: H R JOHNSON (PRISM CEMENTS TILE AND BATHWARE DIVISION)
SOURCES: INCRED RESEARCH, COMPANY REPORTS

"We consider ourselves fortunate to have witnessed the roll out of the most decisive and path-breaking fiscal change in post-Independence India – the One Nation, One Tax regime with the launch of the Goods and Services Tax. But this transformation resulted in anxiety for a number of business establishments (largely the MSME sector) which were impacted by this policy change. As a result, this sector, which forms the crux of our retail sales, postponed its purchases of tiles impacting our sales volumes."

– Kajaria Ceramics, 2018 Annual Report

"The premium GVT (glazed vitrified tiles) segment faced intense competition due to significant capacity addition by Morbi-based players. This resulted in a drop in prices impacting business profitability."

– Somany Ceramics, 2017 Annual Report

GST implementation in 2017

Prism Cement – 2018 Annual Report

"However, the annual performance was impacted by GST and Real Estate Regulatory Authority (RERA) implementation in the first half of 2017 and resulted in increased commodity prices. GST is expected to result in a significant benefit for the organised sector in India, which would extend to your Company."

Somany Ceramics – 2018 Annual Report

"By the time we had our SAP implementation sorted (we had a good May 2017), we ran into the next big challenge: the GST. The implementation of this tax was a step in the right direction but the reality is that in Jun 2017 most of our primary customers elected to de-inventorise in anticipation of lower taxes that would otherwise have saddled them with higher-taxed stocks."

Oversupplied market due to large unorganised capacity creation (Morbi region in the state of Gujarat)

A majority of Indian tile manufacturers hail from Morbi (Gujarat) which accounts for ~60-70% of India's tile production, according to Kajaria's management. New capacity creation during 2010-2016 at Morbi, driven by export demand and the lack of respect for local laws, resulted in an oversupplied tile market in India. Based on channel checks, these players were non-compliant with the central/state tax regulations, environmental pollution norms, minimum wage norms, etc, in order to ensure low cost of operations. These players compete hard for revenue share majorly in the lower-end of the ceramic and polished vitrified tile (PVT) categories in India and internationally.

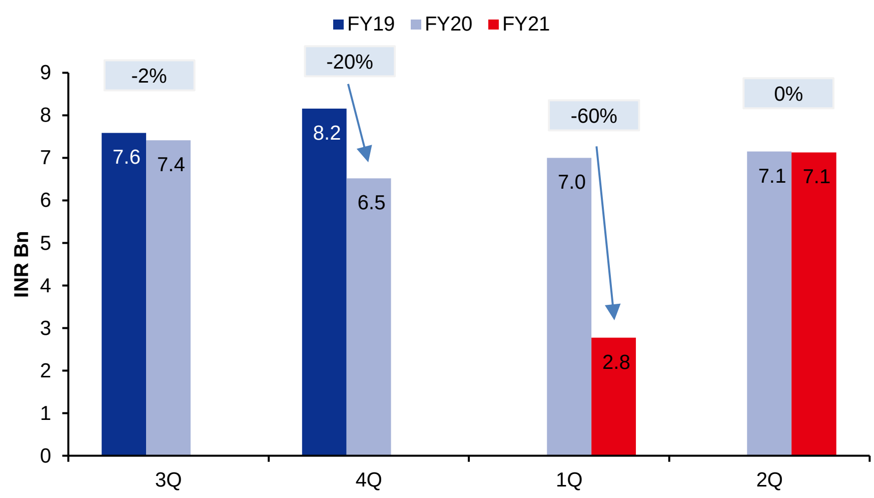
A lot of changes have taken place to ensure a level playing field over the past five years. GST was made effective nationwide in Jul 2017 to ensure uniformity in industry practices. With regards to severe air and water pollution issues due to inferior tile production processes at Morbi and nearby areas, on 6 Mar 2019, the National Green Tribunal (NGT), Delhi bench, ordered the shutdown of all ceramic units that operate on coal gasifiers. The NGT asked ~550 units (of the total ~1k units) to shift to LNG/PNG to continue operations. The Gujarat High Court upheld this decision after the Morbi Ceramic Association protested against the order.

As highlighted earlier, higher exports have resulted in much better demand-supply balance for the Indian tile industry. Large brands appear confident of a structural recovery in tile demand going forward and have guided for double-digit volume CAGR over the next three years.

COVID-19 pandemic disruption in 2020

The global outbreak of COVID-19 pandemic in 2020 hit Indian industry hard with national lockdown imposed in the second half of March 2020 leading to virtually nil production for Apr and May for the company.

Figure 198: COVID-19 pandemic disrupted 2020 performance – yoy revenue growth



SOURCES: INCRED RESEARCH, COMPANY REPORTS

"What I do know is that the export - which used to be 21% of total revenue has climbed to between 35-40% of total Morbi revenue. The export continues to be strong there because the markets, which had the anti-dumping levied on China is looking at India very aggressively. Also the other traders, which want to hedge their bets against China, are looking at India very aggressively. So, we are looking at exports becoming at least 40% to 45% of Morbi's revenue for across the globe and not only the concentrated markets of America, Brazil, Indonesia, etc."

– Somany Ceramics 3QFY21 investor call

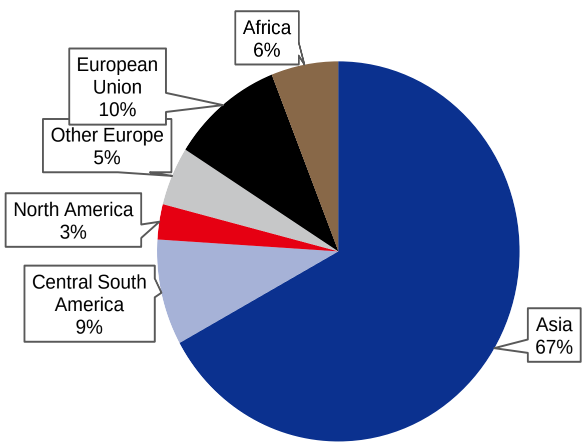
Global anti-China movement enabling India to grab higher revenue share of global tile exports ›

India has become the world's fourth largest exporter with exports amounting to 25-30% of its total domestic output (ICCTAS Magazine, Aug 2020). This growth has partly been driven by the ability to win market shares previously held by China in countries and regions that introduced anti-dumping duties on Chinese ceramic tiles (European Union [EU], Brazil, Taiwan, Chile, Vietnam and South Korea, among others).

As per current operating cost dynamics, India is believed to be the next best after China in terms of tile cost of production (based on company reports) and, hence, benefitting from the global vendor base shift from China to other countries.

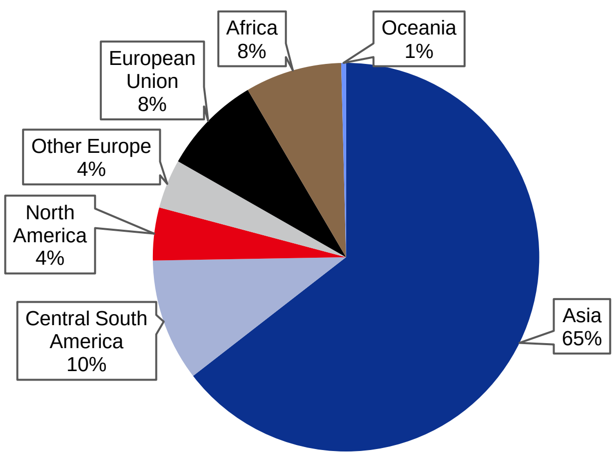
Large brands like Kajaria have a very low share of export revenue (FY20: less than 1% of total sales) and focus on large size value-added tiles for the domestic market. The Morbi region focus shift to exports has reduced the local production surplus and implies better volume growth and pricing environment over the next two to three years at least, in our view.

Figure 199: Global share of tile production (supply) – CY19



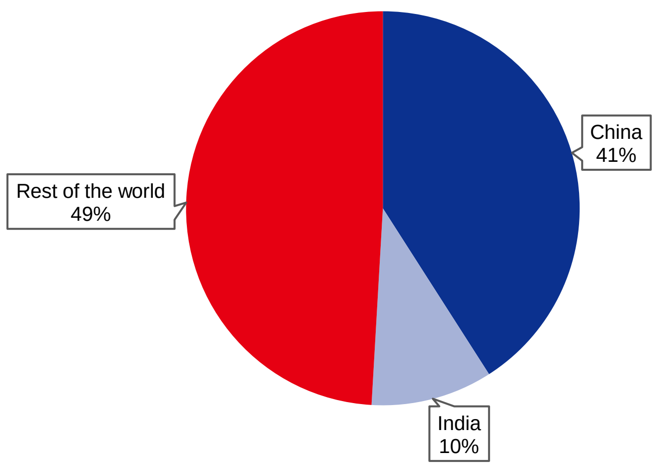
SOURCES: INCRED RESEARCH, COMPANY REPORTS (CERAMIC WORLD REVIEW)

Figure 200: Global share of tile consumption (demand) – CY19



SOURCES: INCRED RESEARCH, COMPANY REPORTS (CERAMIC WORLD REVIEW)

Figure 201: India and China together produce 50% of the world's tiles (CY19)



SOURCES: INCRED RESEARCH, COMPANY REPORTS (CERAMIC WORLD REVIEW)

"As far as Bathware is concerned, Sanitaryware and Faucets have started making money from the quarter and it will be very positive for the next three months and for the years ahead. There have been many developments in those plants in the last few months. As far as ply is concerned, we started that business in Jul 2019. This year we will be doing a turnover of ~Rs400m. Next year we are targeting Rs700m. That business is losing money. Next two years, it may still lose money, but after that it will be workable because that's a new baby which we started."

– Kajaria Ceramics, 3QFY21 investor call

Tile revenue CAGR at 16% over FY21-23F, bathware and plywood higher due to low revenue base ›

Kajaria entered the sanitaryware and faucets categories in 2014 through its brand Kerovit, and entered the plywood segment in 2018 with its brand Kajaria Ply. Bathware products are manufactured in-house with factories at Morbi and Gailpur, while plywood is sourced from third-party vendors.

We expect revenue CAGR over FY21-23F of 24% for bathware and 50% for plywood. The bathware business turned profitable in FY21 while the plywood division would take a couple more years to break even, according to management.

WestBridge Capital owns 15% of the bathware subsidiary

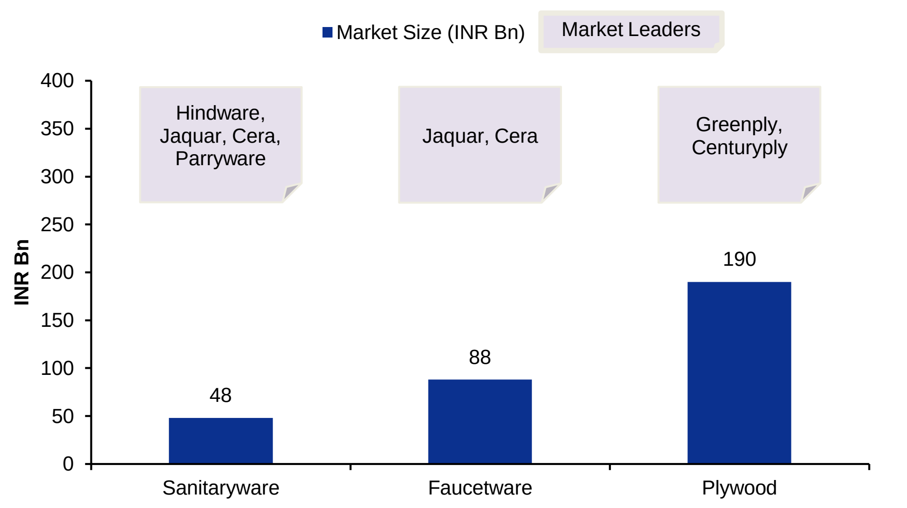
Kajaria Bathware is an 85%-owned subsidiary of Kajaria Ceramics. WestBridge Capital Partners owns the remaining 15% equity stake by subscribing to the compulsory convertible preference shares (CCPS) issue and infusing Rs645m into Kajaria Bathware in Apr 2018.

Existing competitive landscape in India

Sanitaryware and Faucets: The market leaders are Hindustan Sanitaryware, Cera Sanitaryware, ROCA Bath products (Parryware) and Jaquar.

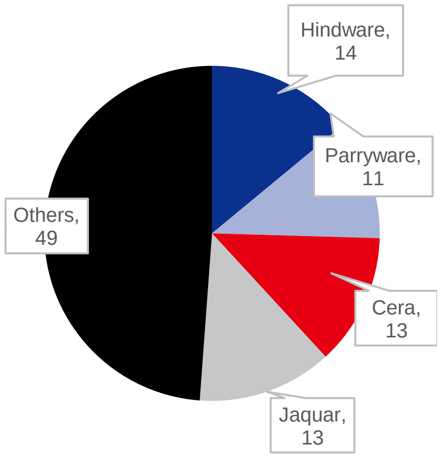
Plywood: Greenply and Century Plyboard lead the plywood and wood panel markets along with other regional players.

Figure 202: Market size of top players in Kajaria's new sectors



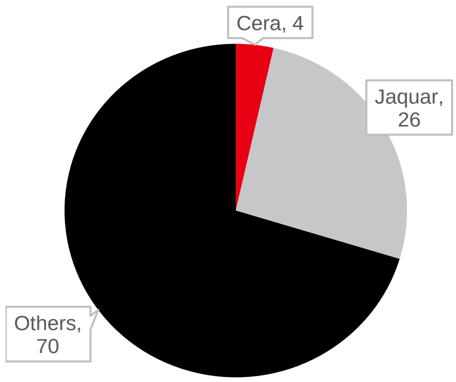
SOURCES: INCRED RESEARCH, SOMANY CERAMICS FY20 ANNUAL REPORT, COMPANY REPORTS

Figure 203: Indian sanitaryware industry's revenue market share (FY20)



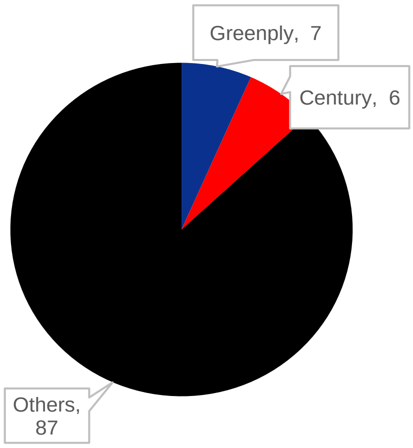
SOURCES: INCRED RESEARCH, COMPANY REPORTS, WWW.MCA.GOV.IN

Figure 204: Indian faucetware industry's revenue market share (FY20)



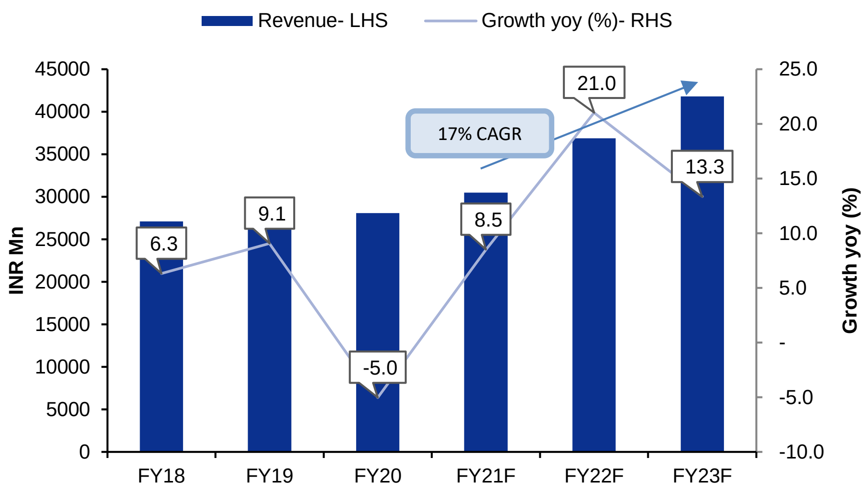
SOURCES: INCRED RESEARCH, COMPANY REPORTS, WWW.MCA.GOV.IN

Figure 205: Indian ply industry's revenue market share (FY20)



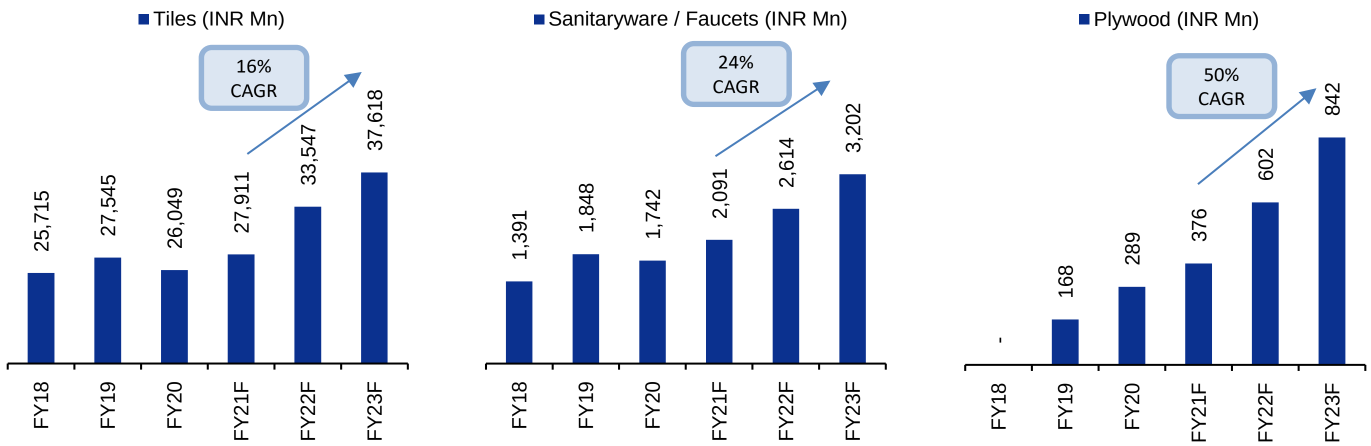
SOURCES: INCRED RESEARCH, COMPANY REPORTS, WWW.MCA.GOV.IN

Figure 206: Kajaria's revenue trend



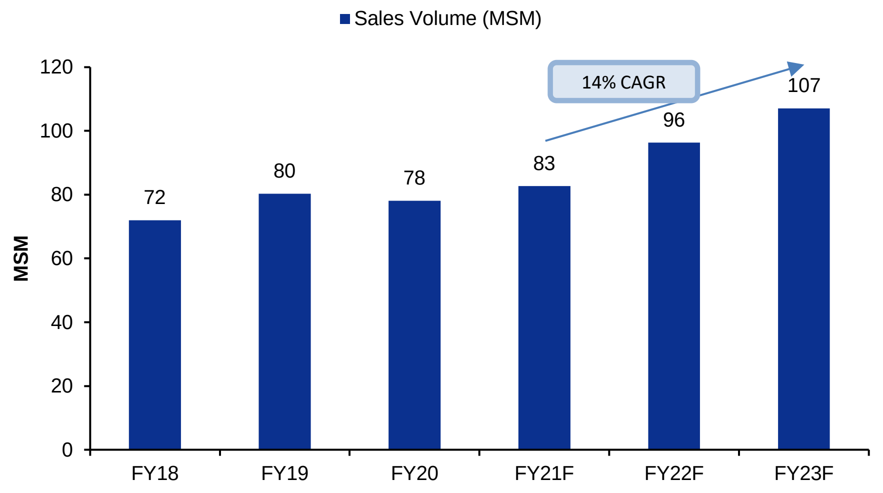
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 207: Kajaria's segmental revenue trends



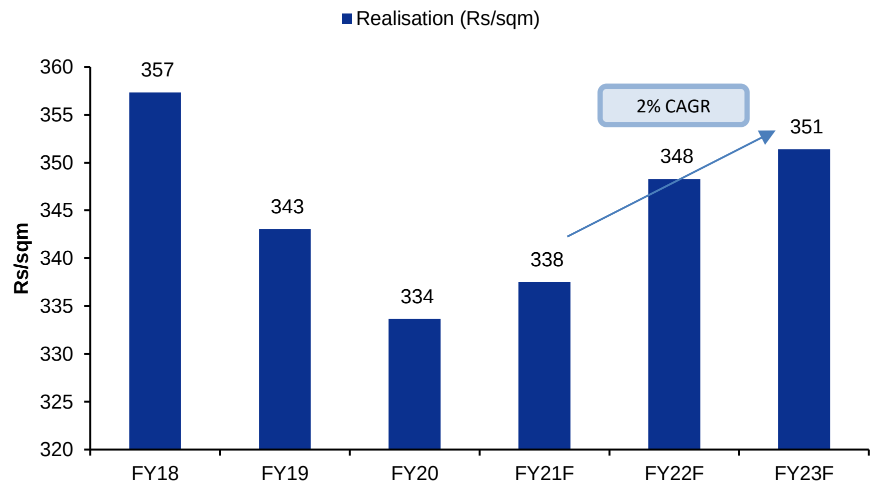
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 208: Kajaria's tile volume growth trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 209: Kajaria's tile realisation trend



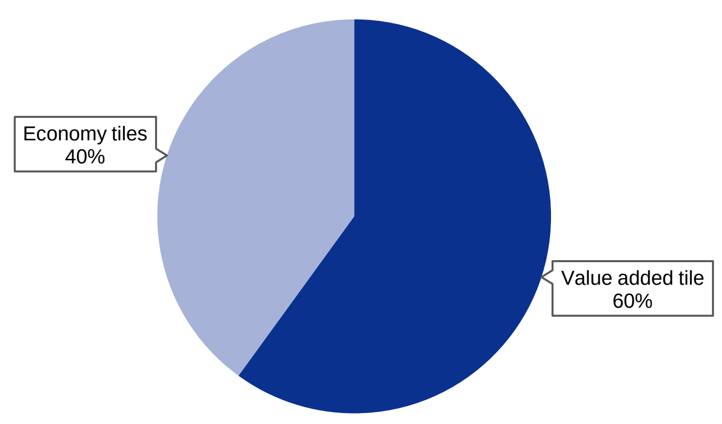
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Improving sales mix, bathware turnaround and cost controls to drive operating margin improvement ›

With regard to tiles, the share of value-added tiles (large size tiles) increased to ~60% across all three segments (Ceramic, PVT and GVT) as at Dec 2020. Capacity/ revenue share improved in favour of polished/glazed vitrified tiles over FY16-20, accounting for ~60% of total capacity and aiding operating margins. Higher share of value-added tiles coupled with the bathware segment breaking even drove EBITDA margins higher by 240bp yoy in 9MFY21 to 17.4%.

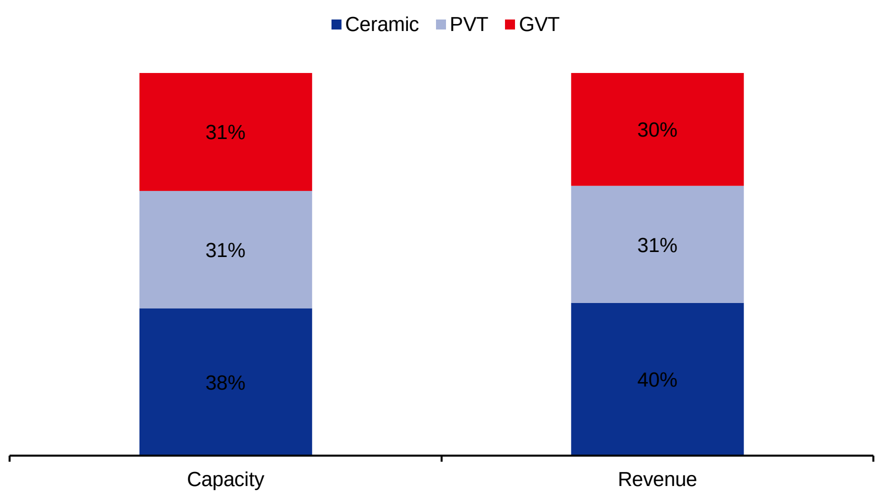
Owing to the COVID-19 pandemic in 2020, Kajaria initiated several cost control measures resulting in staff costs and operational expenses falling 15.5% and 35.5% yoy, respectively, in 9MFY21. Management has indicated lower advertising, publicity and sales promotion spends (FY21F: down 50% yoy to ~Rs450m) owing to strong demand trends in India.

Figure 210: Value-added tiles account for 60% of overall tile volume sales (as of 3QFY21)



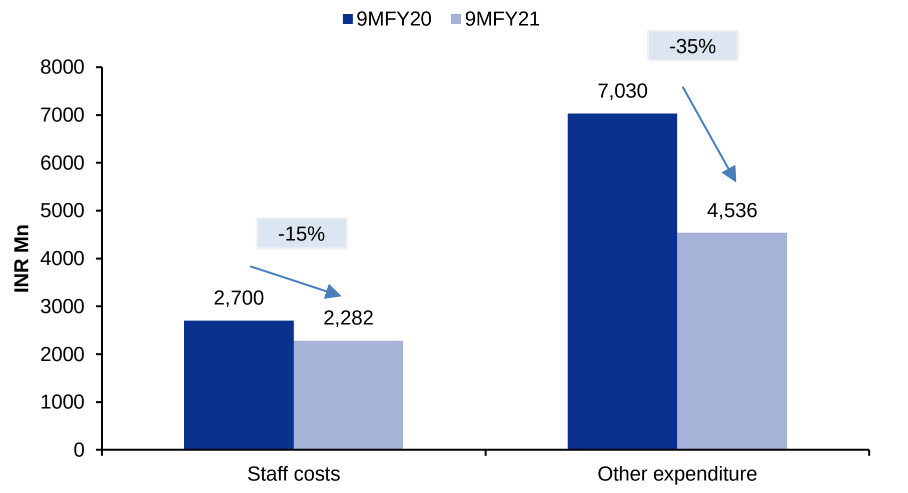
SOURCES: INCRED RESEARCH ESTIMATES,

Figure 211: Kajaria's FY20 revenue and capacity breakdown



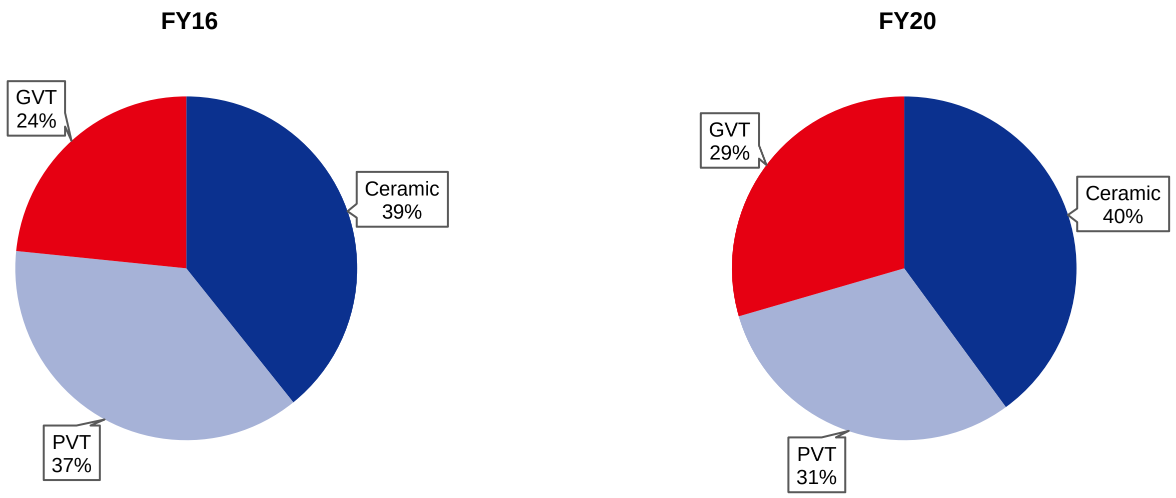
PVT = POLISHED VITRIFIED TILES, GVT = GLAZED VITRIFIED TILES
SOURCES: INCRED RESEARCH, COMPANY REPORT

Figure 212: Staff costs and other expenses for 9MFY20 and 9MFY21



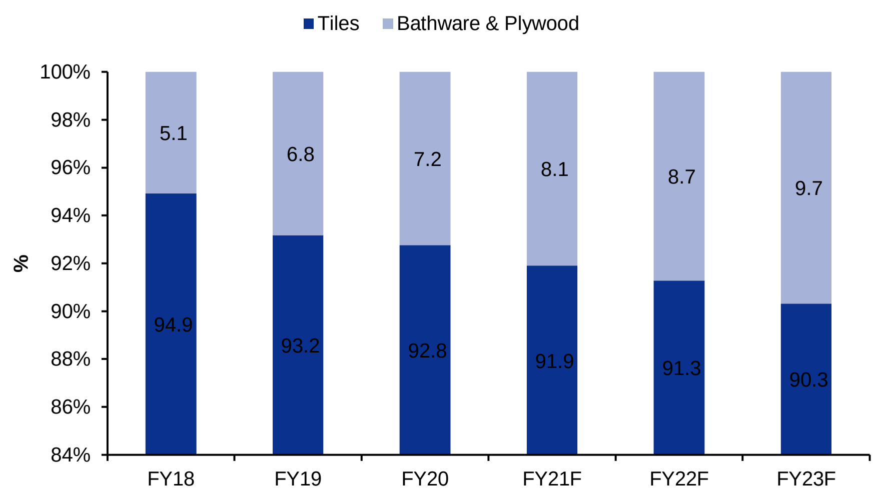
SOURCES: INCRED RESEARCH, COMPANY REPORT

Figure 213: Kajaria Ceramics revenue share by tile type



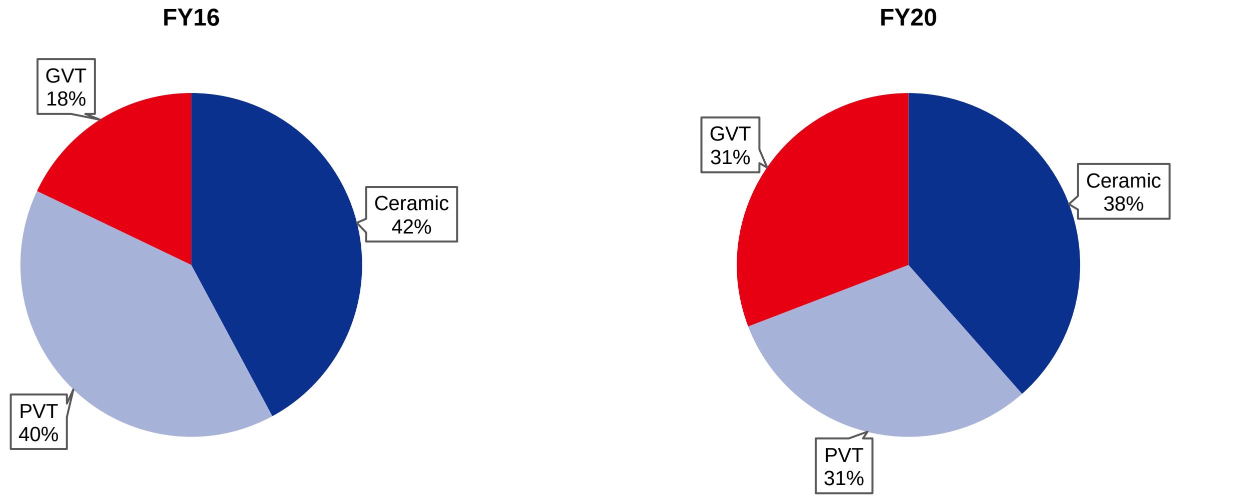
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 214: Kajaria Ceramics' bathware and plywood revenue ramp-up



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 215: Capacity share by tile type – Kajaria focussed on increasing glazed vitrified tile capacities over the past few years



SOURCES: INCRED RESEARCH, COMPANY REPORTS

"As far as the gas price is concerned, this year gas prices have been cheaper, as far as our Gailpur and Sikandrabad plants are concerned, by almost Rs4.5-5 per SCM. And for nine months, it's almost the same scenario."

– Kajaria Ceramics, 3QFY21 investor call

"As far as Morbi is concerned, whatever price GSPC charges, we have to pay. And as you are aware, it increased prices by Rs4 per SCM on 24 Dec 2020. There is no such thing as a kind of long term at Morbi."

– Kajaria Ceramics, 3QFY21 investor call

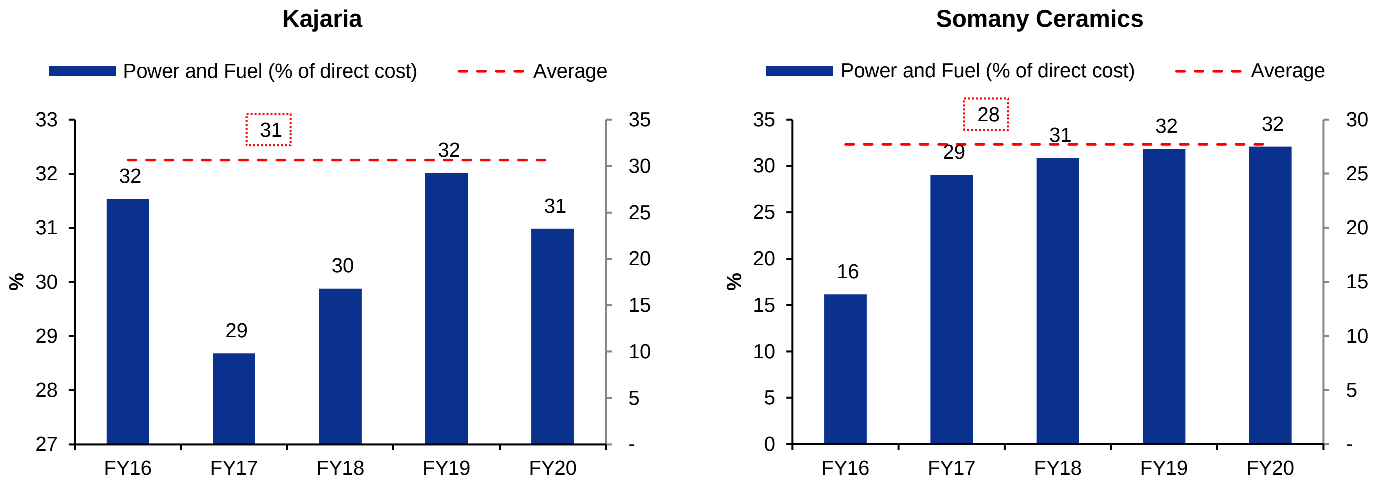
Gas prices play important part in tile segment profitability ›

Power and fuel (mainly natural gas) accounted for ~30% of the total production costs and ~20% of net sales in FY20. Given the oversupplied market situation in the tile industry, it has been difficult to pass on higher gas prices to customers and operating margins have been negatively impacted (eg, FY19).

The gas sourcing contract differs on a regional basis. The Gujarat plants at Morbi source their gas requirements from the Gujarat State Public Corporation (GSPC) on a spot basis, while the plants in Rajasthan and Uttar Pradesh have a mix of long-term and spot-gas sourcing contracts. Overall, at the company level, the long- and short-term sourcing mix was 50:50 as of Dec 2020.

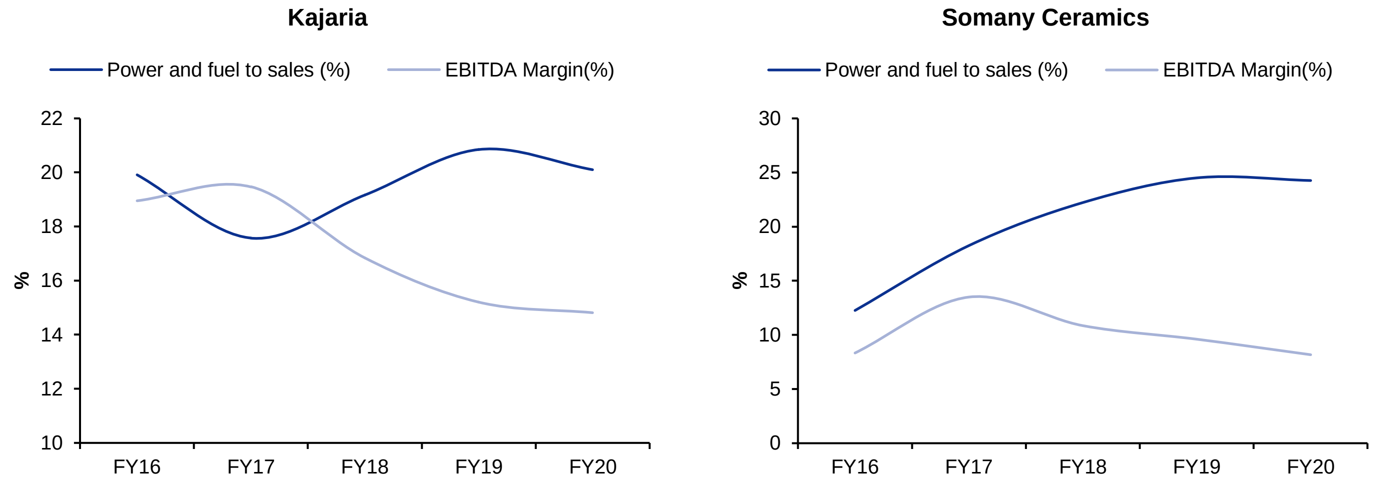
Gas pricing has been benign over 9MFY21 resulting in higher EBITDA margins yoy (9MY21: 17.4%; 9MFY20: 15%). However, gas prices were hiked by Rs4-5/scm in Gujarat in Dec 2020.

Figure 216: Power and fuel comprise 31-32% of direct cost for tile manufacturers in India



DIRECT COSTS MEAN ALL MANUFACTURING COSTS INCLUDING RAW MATERIAL, STORES AND SPARES PARTS, REPAIR AND POWER/FUEL COST
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 217: Margins are highly dependent on power and fuel costs for tile manufacturers



DIRECT COSTS MEAN ALL MANUFACTURING COSTS INCLUDING RAW MATERIAL, STORES AND SPARES PARTS, REPAIR AND POWER/FUEL COST
SOURCES: INCRED RESEARCH, COMPANY REPORTS

"As far as 4Q margins are concerned, there'll be some pressure because of the increase in some gas [price]. Some paper prices have gone up, that is for the boxes and some raw material prices have also gone up like feldspar, and quartz and silica. The impact will be close to 1.5%".
– Kajaria Ceramics, 3QFY21 investor call

COVID-19 has disrupted other raw material supplies too; prices have risen sharply

Key raw materials used to manufacture tiles and sanitaryware include clay, feldspar, silica and quartz. For Faucets, brass is the key raw material, forming 70% of total material costs. Timber, adhesives and other chemicals are primary raw materials for plywood manufacturing. Owing to supply chain disruption globally and in India, raw material prices have risen sharply. Marginal price hikes would offset some impact, however this remains a key risk to our EBITDA margin estimates over FY21-23F.

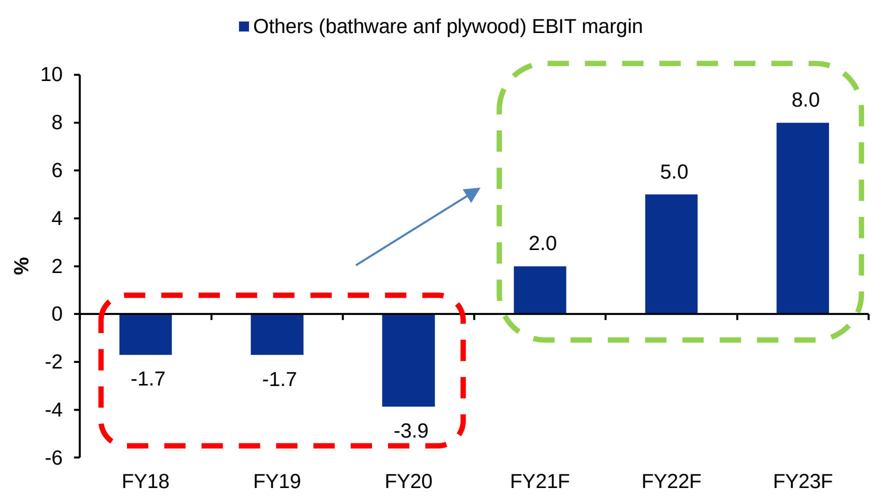
However, management has guided for price hikes of finished products and some cost controls (lower dealer scheme discounts) to offset raw material price inflation and maintain EBITDA margins near the 20% range in FY22F.

Strong demand trends allow lower ad spends and optimum capacity utilisation; bathware breaks even to aid margins ›

"Going forward, every quarter you would see improvement in subsidiary, especially Bathware, which was making losses and now started making profit, and every quarter would be a better quarter, which will add to the overall margins."
– Kajaria Ceramics, 3QFY21 investor call

Owing to the turnaround in the bathware subsidiary's profitability (Kerovit), the overall EBITDA margin improved by 240bp from 15% to 17.4% in 9MFY21. We expect this segment to contribute positively going forward and segment EBIT margins (bathware + plywood combined) to improve by 600bp from 2% to 8% over FY21-23F.

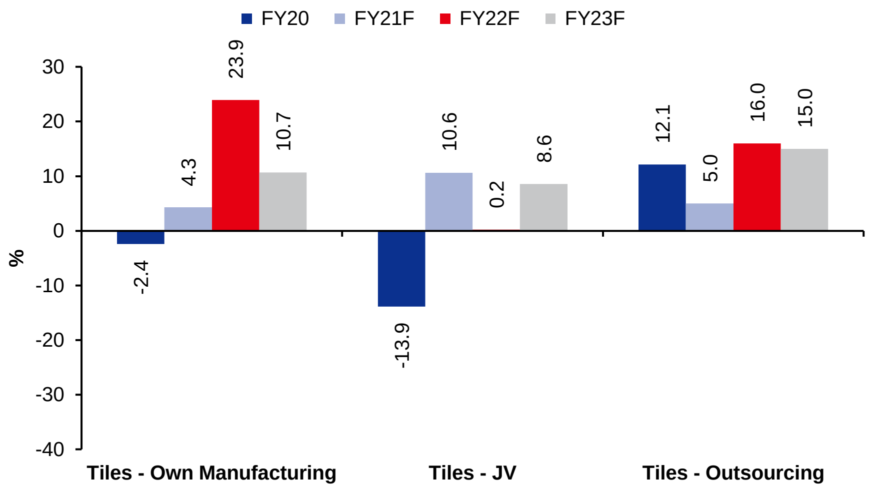
Figure 218: Bathware and Plywood (Others segment) EBIT margin trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Also, owing to optimum capacity utilisation of manufacturing facilities, both in-house and under joint ventures, should lead to operating leverage benefits in the form of higher EBITDA margins.

Figure 219: Volume growth of tiles based on sourcing (FY20-23F)

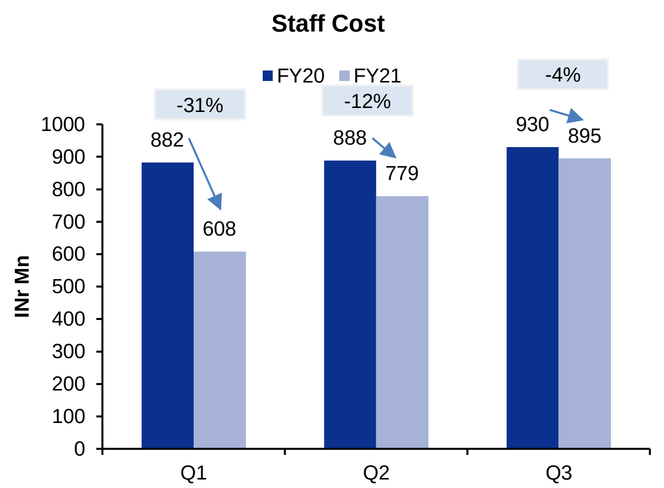


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Strict cost controls and advertising spend cuts to aid margins as well

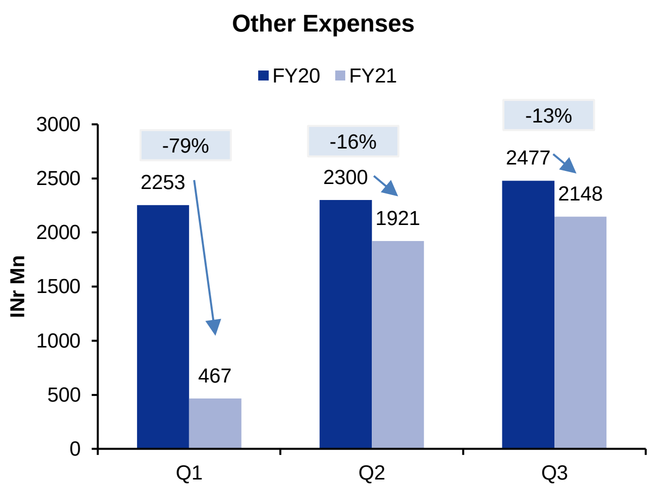
1HFY21 operating costs were strictly controlled and monitored given the business uncertainty led by the COVID-19 national lockdown. Apart from better working capital management, discretionary costs were curtailed aiding EBITDA margins.

Figure 220: COVID-19 led to controlled staff costs in 9MFY21…



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 221: … other expenses rationalised as well

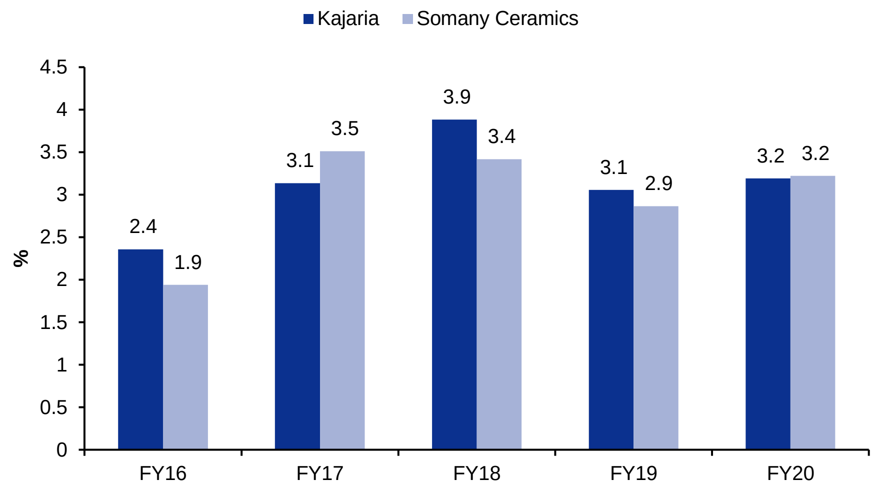


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Lower advertising and sales promotion spends expected over FY21-23F

Management believes the strong demand environment could provide leeway for lower advertising and sales promotion (ASP) spends going forward. Annual advertising budgets have been 3-3.5% (~Rs900m over FY19-20) of sales for Kajaria. The company has appointed Bollywood celebrities to promote its branding in the bathware and plywood segments. Going forward, management guides for ASP spending between 1.5% and 2% of sales over F21-23F.

Figure 222: Annual advertising budgets of 3-4% of sales for leading tile players

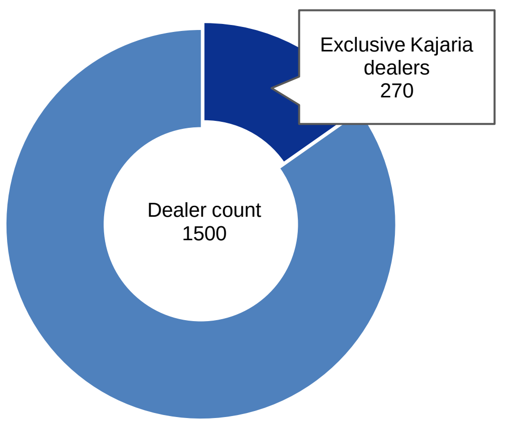


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Distribution presence

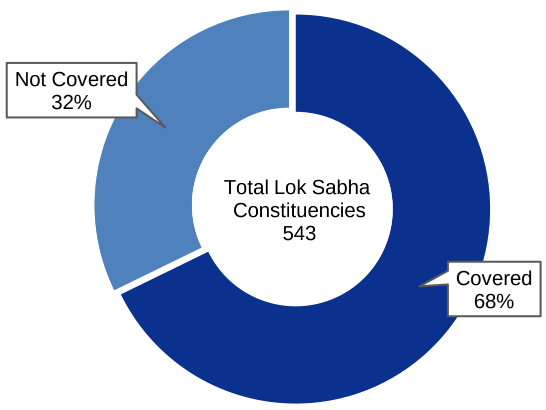
Kajaria had a network of ~1,500 dealers pan India, with ~270 being exclusive to the company as at Mar 2021. In terms of retail presence, the brand covers ~370 Lok Sabha constituencies and intends to cover the balance ~175 over the next two years.

Figure 223: Dealer reach in India (FY21)



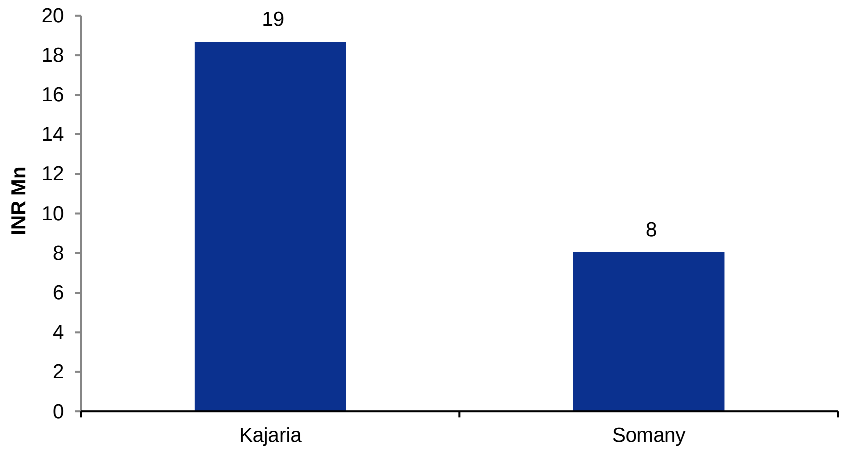
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 224: Kajaria reaches two-third of the Lok Sabha constituencies through its distribution network (Dec 2020)



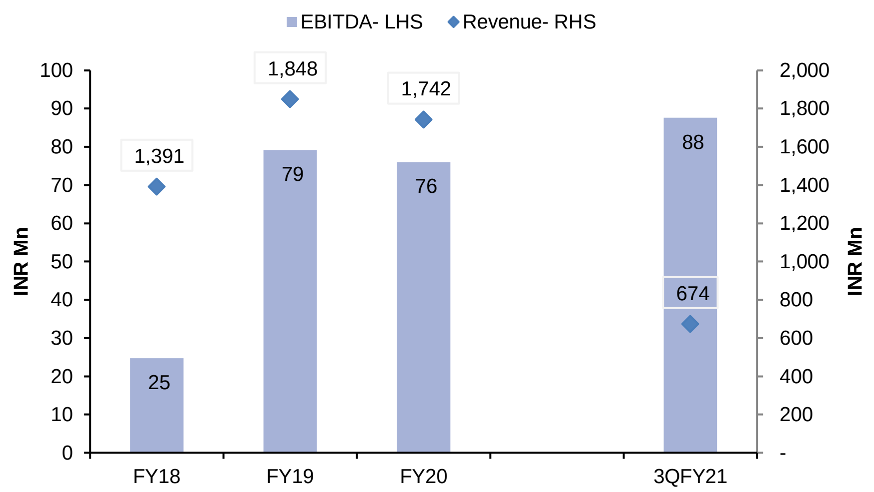
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 225: Revenue per dealer (FY20)



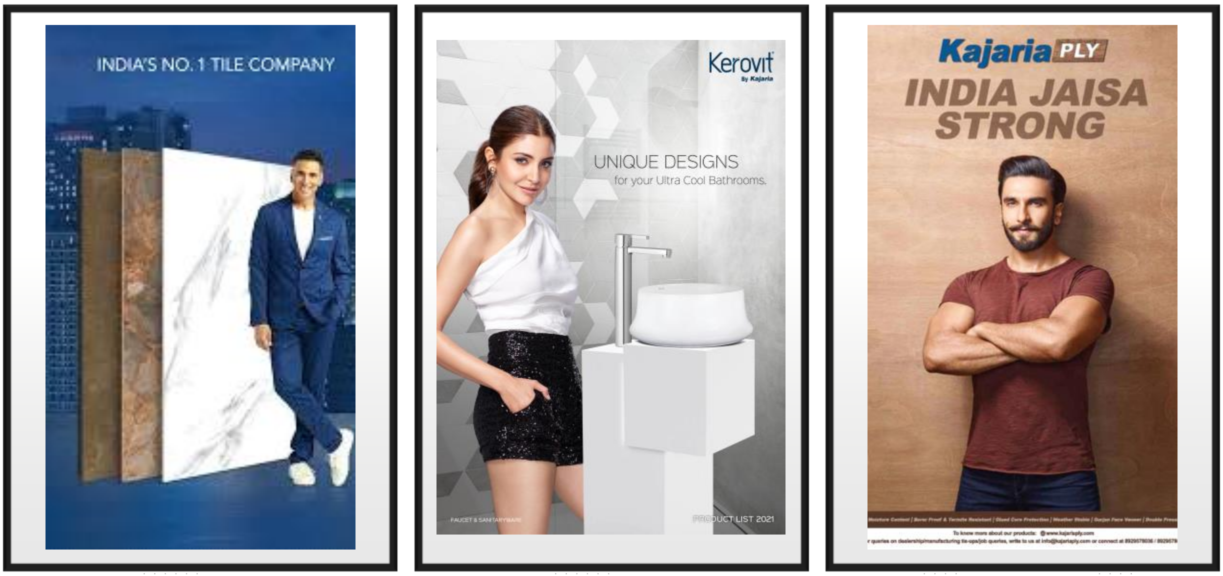
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 226: Bathware revenue and EBITDA trend



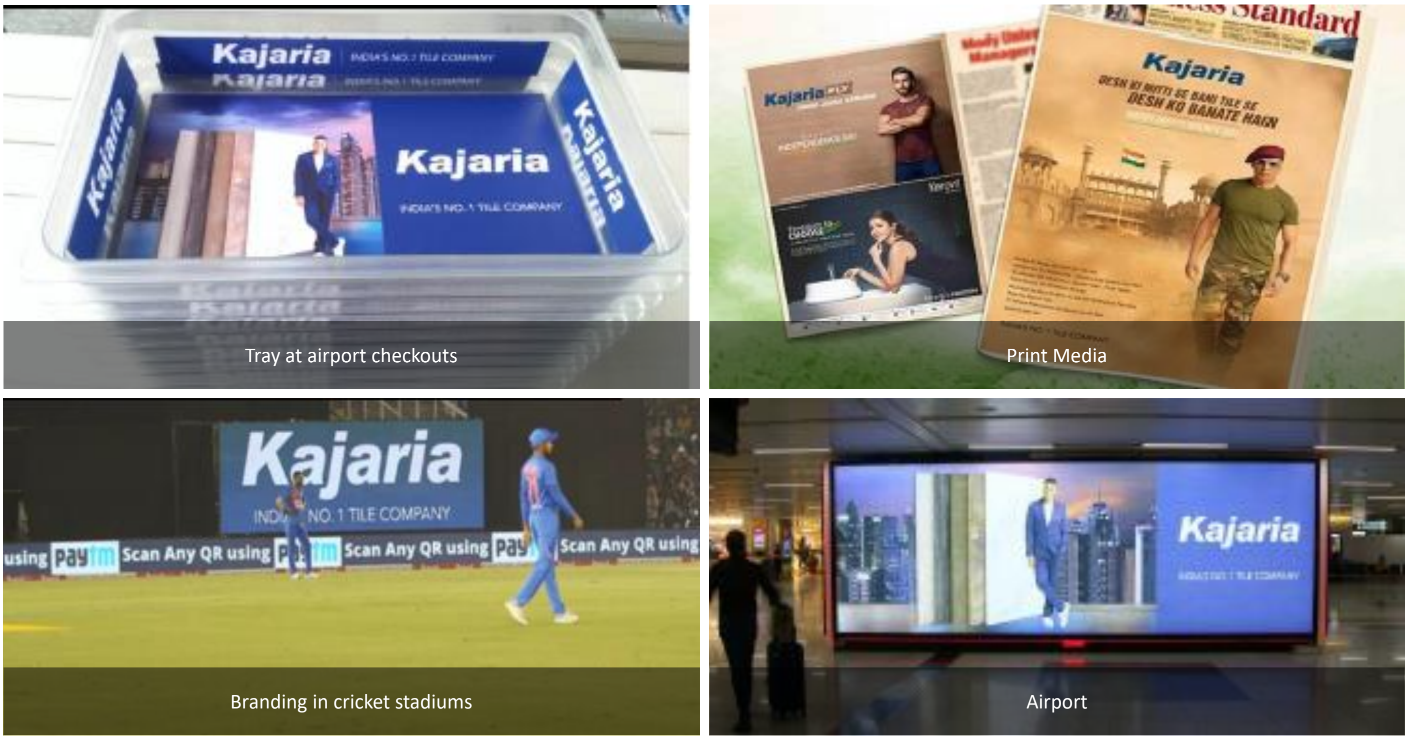
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 227: Kajaria has hired Bollywood actors as brand ambassadors for its complete range of products



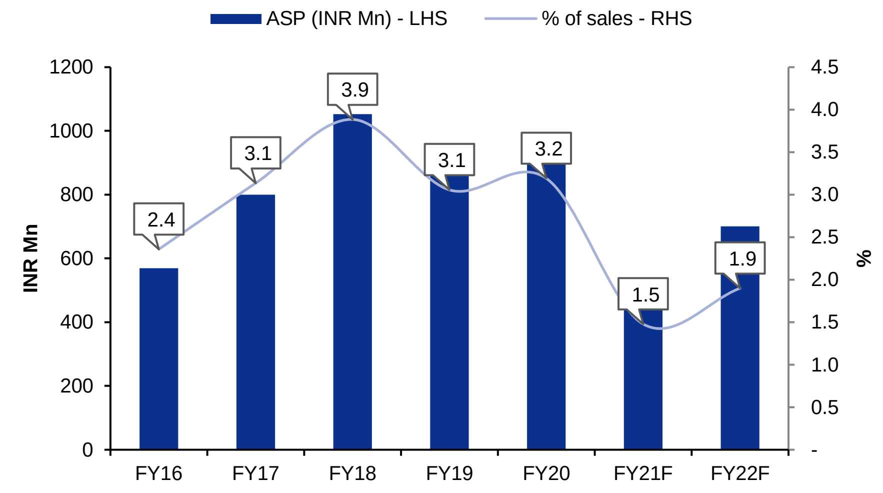
SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Figure 228: Kajaria's advertisements across diverse mediums



SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Figure 229: ASP trends over FY16-22F



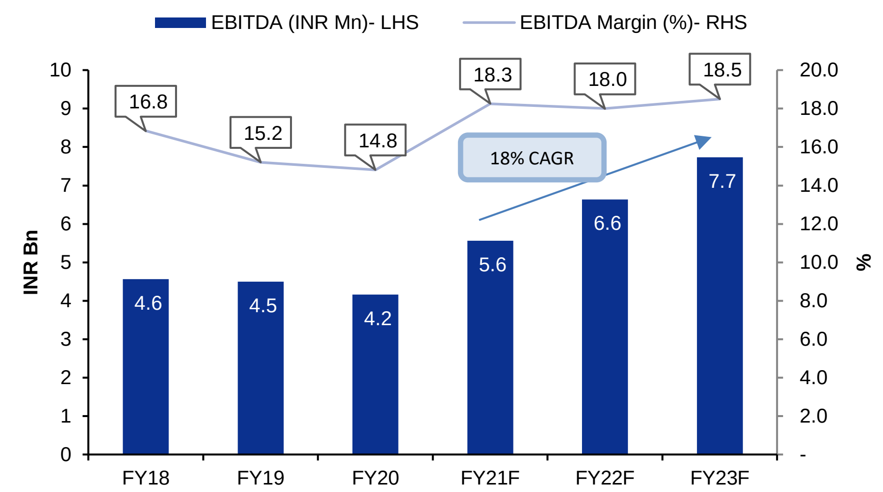
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Well-rounded EBITDA growth

We estimate an EBITDA CAGR of 18% over FY21-23F.

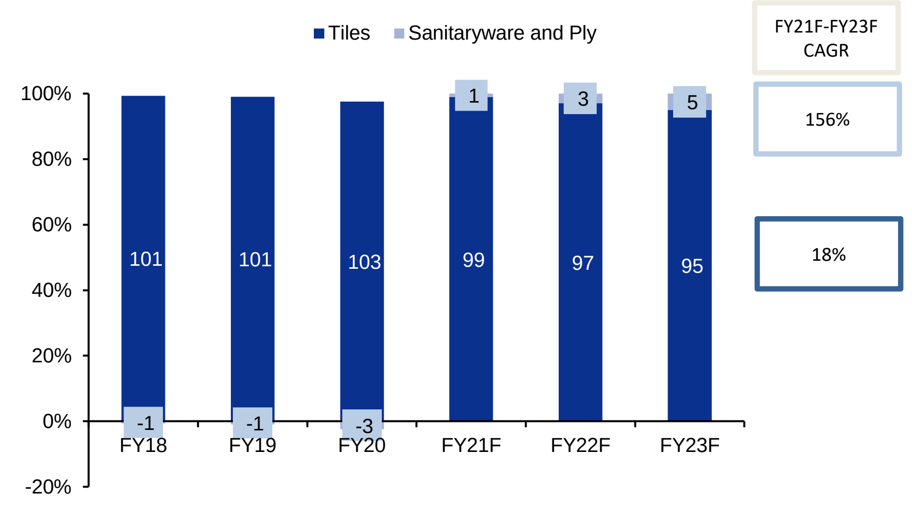
We believe a combination of factors such as higher volume growth, improving capacity utilisation, price hikes, lower spends on dealer promotions and advertising, and improving scale and profitability of the bathware division, should lead to EBITDA CAGR of 18% over FY21-23F. We expect EBITDA margins to be largely flat over FY21-23F at 18-18.5% (management guided for 20%) during the same period.

Figure 230: Kajaria Ceramics' EBITDA trend (Rs bn)



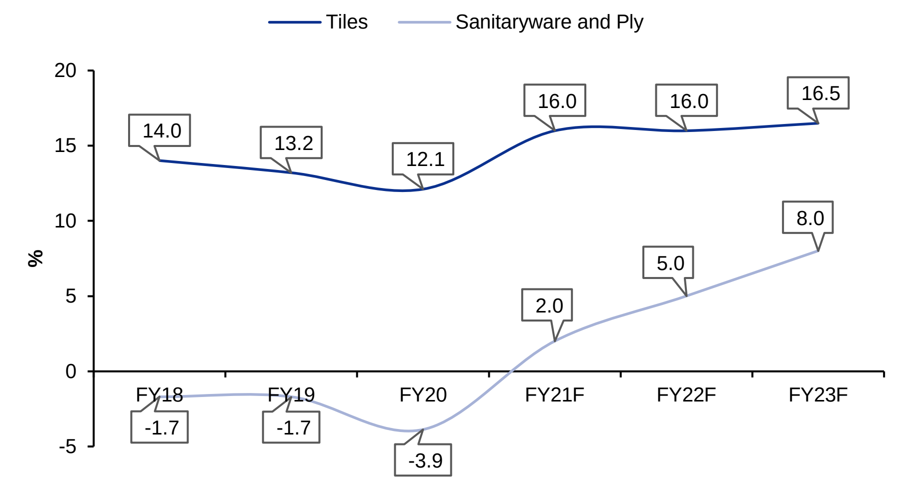
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 231: Kajaria Ceramics' segmental EBIT share and CAGR



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 232: Kajaria Ceramics' segment EBIT margin



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Capacity creation for higher domestic demand; new dividend distribution policy for ~40-50% payouts

Mix of own, joint venture and outsourced capacities ›

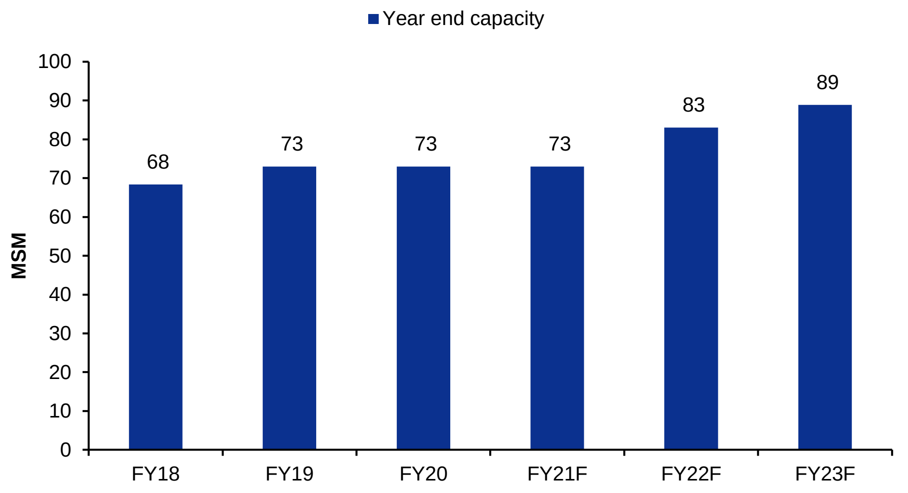
"In FY22, whatever capex we are talking about we are going to expand our existing plants. We are talking about expanding at Kajaria Tiles plant in Kalahasti. We are also going to modernise and increase the capacity at the Gailpur plant for ceramics. There will be no greenfield project in FY22 as of now."

– Kajaria Ceramics, 3QFY21 investor call

For 9MFY21, Kajaria had 57% of its tiles sales manufactured in-house at company-owned plants, while its joint venture (exclusive equity partnership) accounted for 22% of tile revenue. Kajaria has entered into outsourcing contracts with third-party vendors for spot purchases that accounted for the balance 21% of tile sales in 9MFY21.

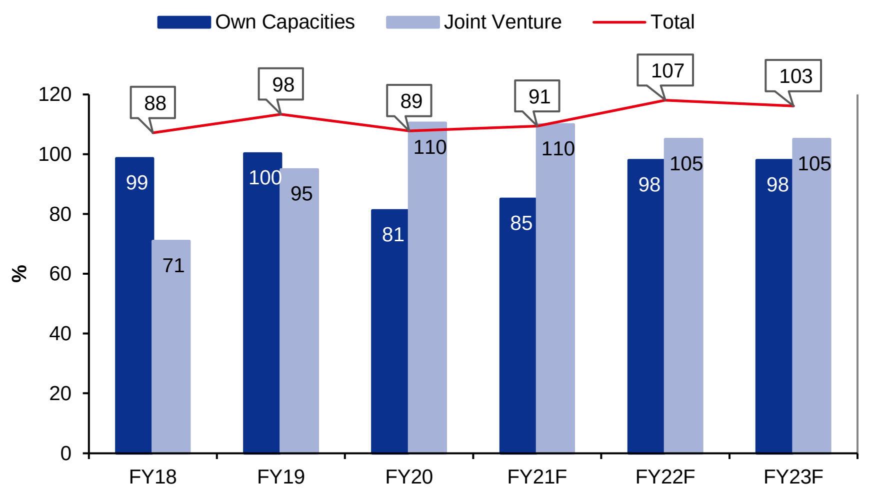
Going forward, management has guided for a ~10m sq m capacity addition in FY22. We estimate the year-end in-house capacity to rise from 73m sq m in Mar 2021F to 89m sq m by Mar 2023F. All of this capacity increase would be spread across existing plants and no greenfield facility is planned as of now.

Figure 233: Kajaria Ceramics' tile capacity over the years



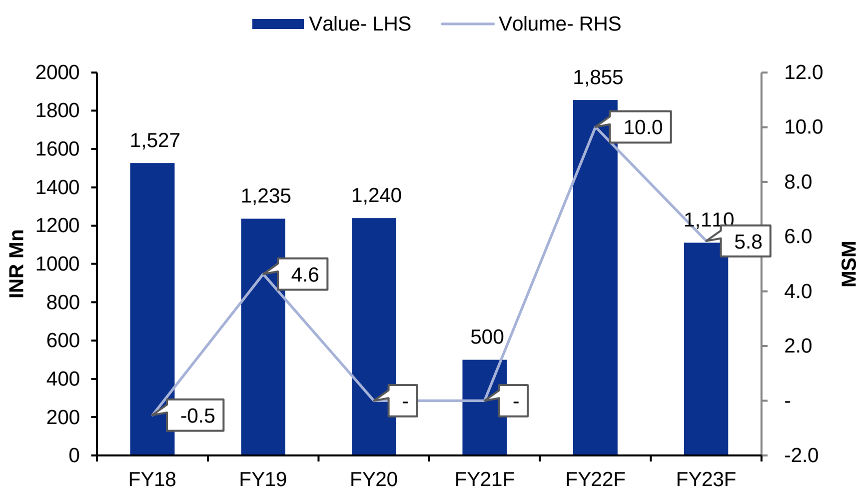
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 234: Capacity utilisation of Kajaria Ceramics' tile capacities (%)



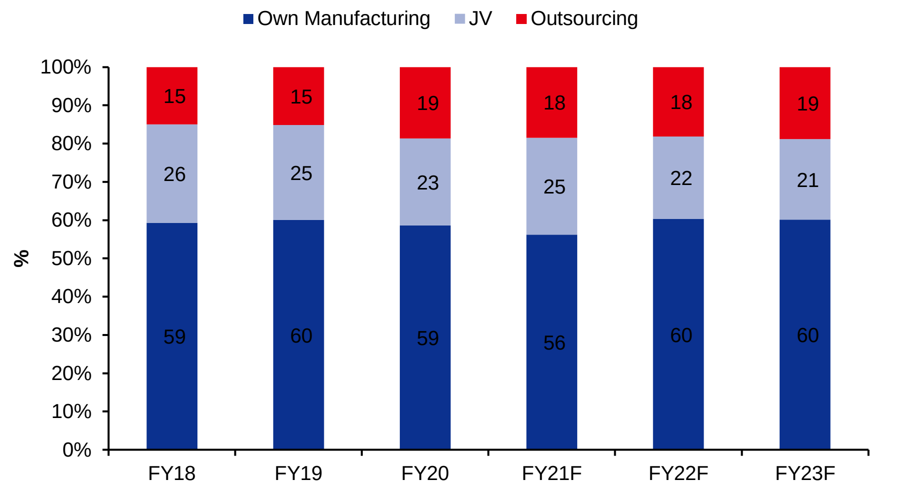
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 235: Kajaria Ceramics' volume and value capex



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 236: Revenue mix from own manufacturing vs JV vs outsourcing



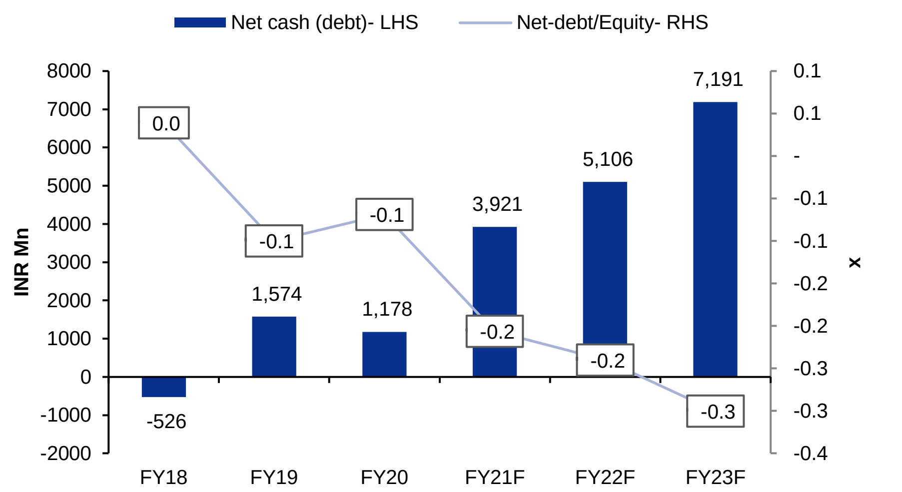
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

All capex funded through internal accruals over FY21-23F

Management has guided for ~Rs2bn capex for the addition of 10m sq m of tile manufacturing capacity in FY22F.

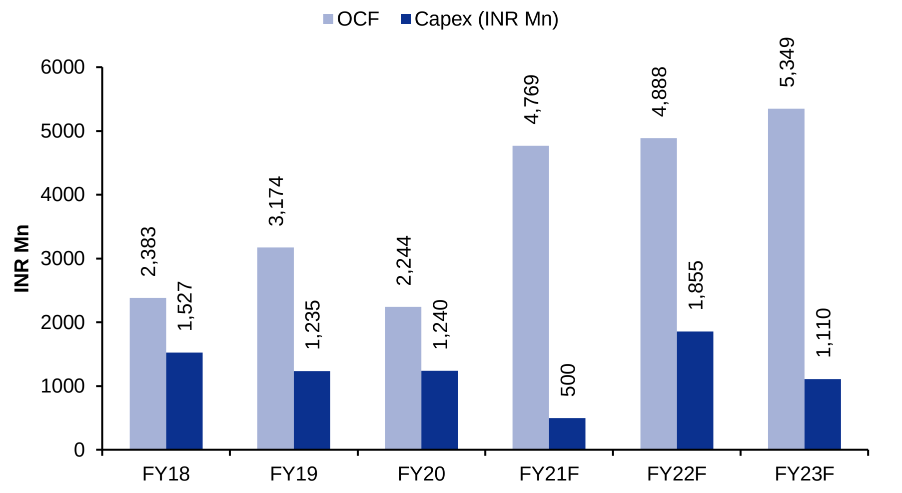
We model cumulative capex of Rs3.5bn over FY21-23F that would be entirely funded through internal accruals. We expect FY20 PAT to double to Rs5bn by FY23F, implying high cash conversion and net cash balance of Rs7.2bn by the end of FY23F.

Figure 237: Net debt to EBITDA ratio and net cash trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 238: OCF and capex trend

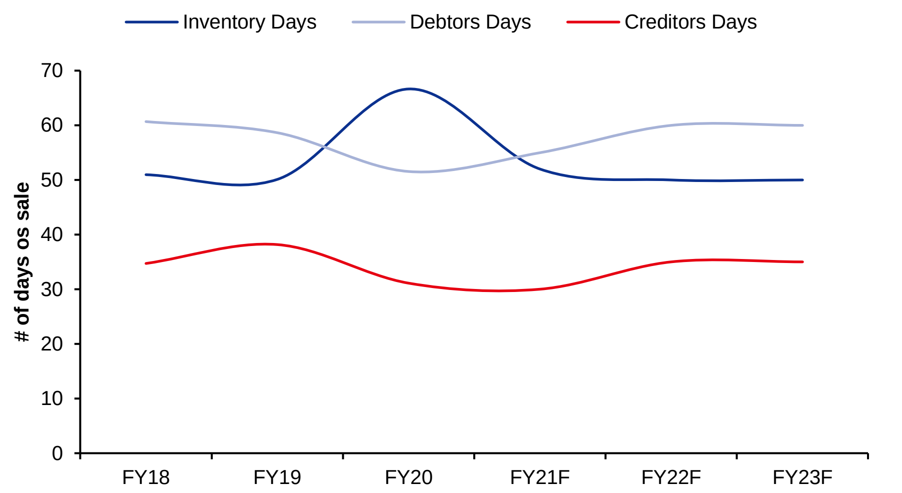


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Steady working capital of 55-60 days of sales

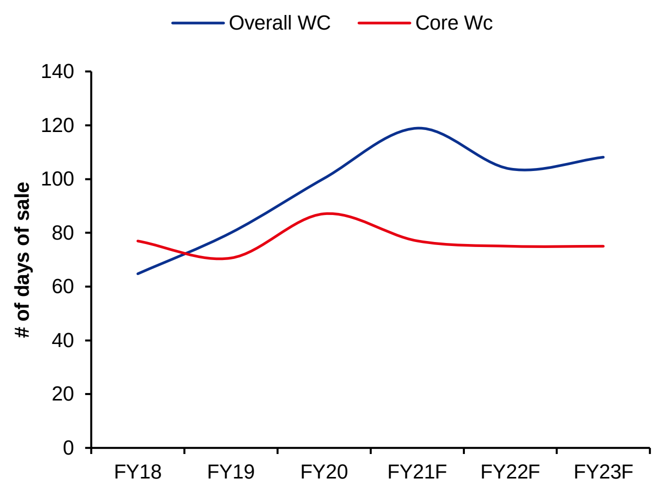
We do not expect material changes to the existing (adjusted for COVID-19 factors) net working capital cycle of 55-60 days of sales over FY21-23F.

Figure 239: Debtors, creditors and inventory days



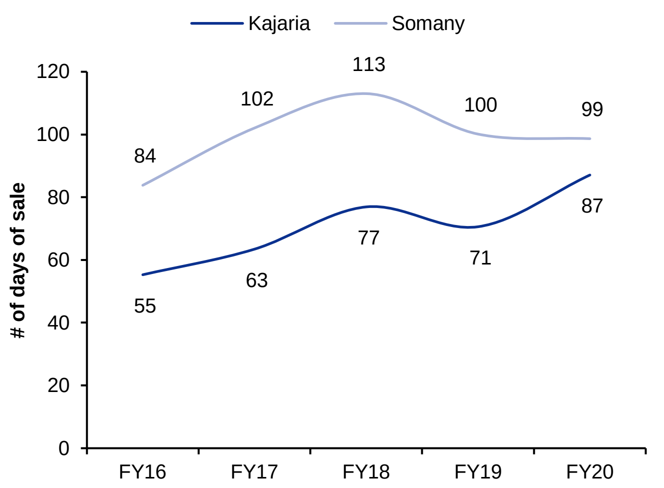
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 240: Core and overall WC trend of Kajaria



WC IS WORKING CAPITAL
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 241: Peer comparison of core WC



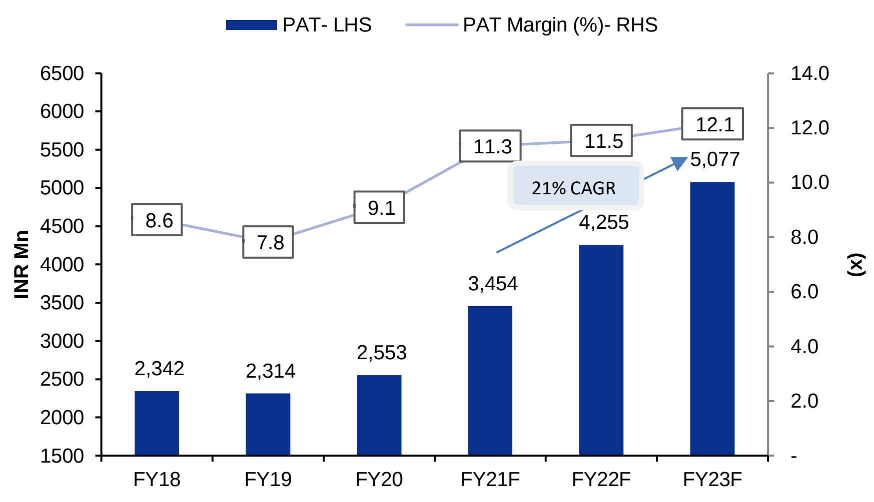
CORE WC= DEBTOR DAYS+INVENTORY DAYS-CREDITOR DAYS
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Expect higher return ratios and dividend payouts ›

We estimate net profit CAGR of 21% over FY21-23F. We expect cumulative free cash to jump 3x to Rs11.5bn over the same period, driven by limited capex needs and steady working capital cycle. RoE and RoCE are likely to improve to 22.4% and 28% in FY23F. On 21 Jan 2021, the company revised its dividend distribution policy and intends to distribute ~40-50% of annual net profits as dividends going forward.

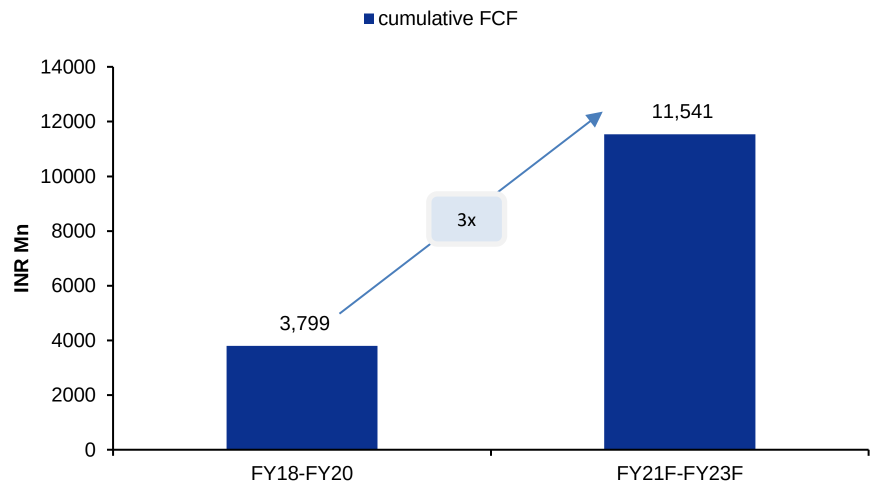
New Dividend Policy:
The Board shall endeavour to maintain a dividend payout ratio (dividend payable / profit after tax) at around 40% to 50% of consolidated profit after tax – 21 Jan 2021 board meeting press release.

Figure 242: Kajaria Ceramics' PAT and PAT margin trends



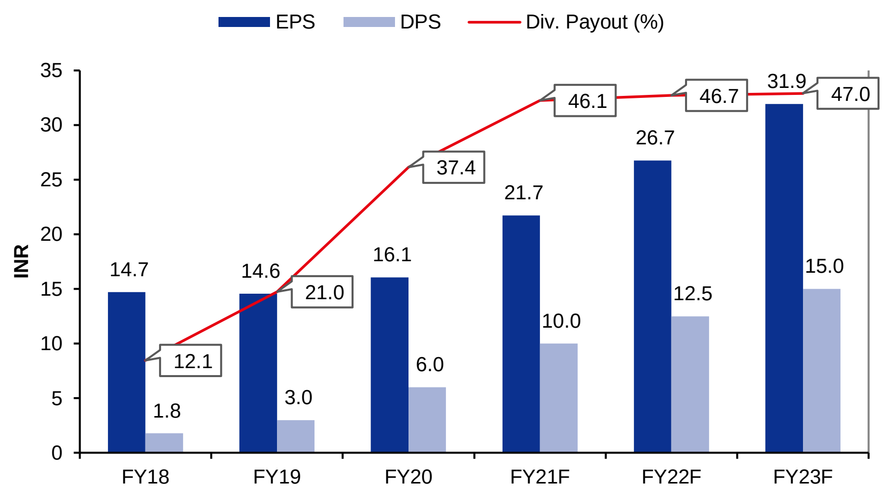
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 243: Kajaria Ceramics' cumulative FCF expected to be 3x over FY21-23F



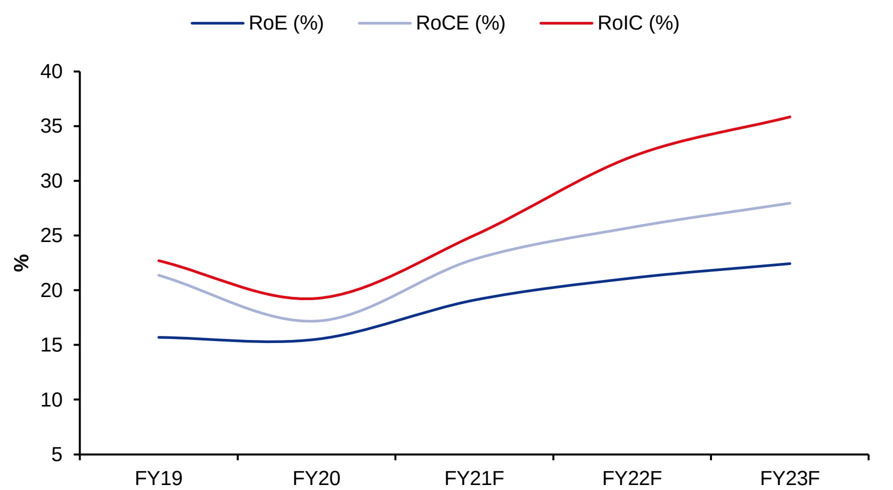
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 244: Kajaria Ceramics' EPS, DPS and payout (%) trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 245: Kajaria Ceramics' return ratios (%)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Valuation and risks

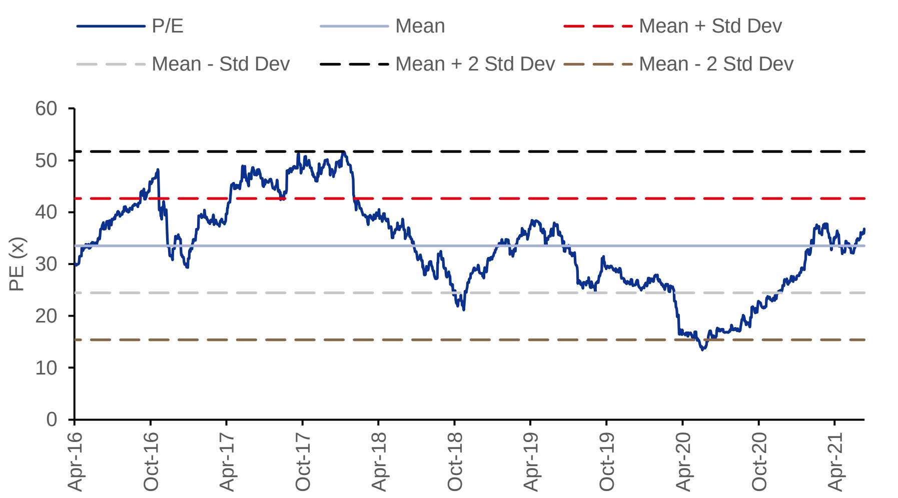
Valuation

Kajaria Ceramics' stock price CAGR has risen 27% since Apr 2014.

We think the following factors would determine the stock's valuations going forward:

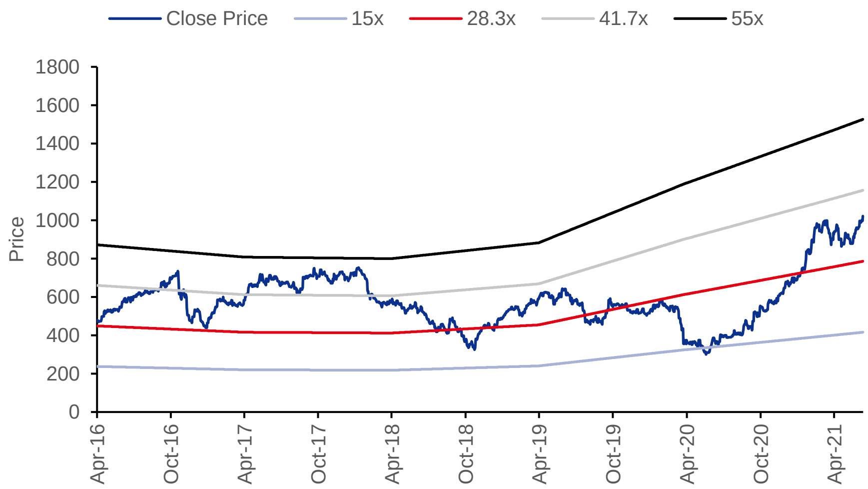
- Kajaria is much ahead of its peers in terms of market leadership for tiles with 10% revenue market share in FY20. The No. 2 and No. 3 players lag at a distance to Kajaria and would find it difficult to displace the company.
- Demonetisation, GST and the COVID-19 pandemic have accelerated market share gains for incumbents with high brand recall, deep distribution presence and healthy balance sheets. Unorganised fringe players have and will continue to lose market share, in our view.
- The anti-China drive globally is structural in nature and India would gain its fair share of incremental sourcing shift to other geographies. This will keep the local demand-supply situation in check.
- Growth will be driven by solid volume CAGR of 13.8% over FY21-23F and will be less dependent on stabilisation of pricing environment in India.
- We expect EBITDA margins to sustain FY21 levels despite the risk of rising gas prices and discretionary costs returning to normal levels.
- Low capex and steady working capital cycles imply strong FCF generation. We estimate cumulative FCF of Rs11.5bn over FY21-23F.
- The stock trades at a P/E of 32x FY23F EPS, a discount to its last five-year mean P/E of 33.5x.
- We initiate coverage with an Add rating and TP of Rs1,176, based on a P/E of 37x FY23F EPS, a ~10% premium to its past five-year mean P/E.
- We apply a lower P/E premium (10%) to value Kajaria's stock owing to a) cyclical uptrends in Indian tile demand, b) higher revenue growth of 17% over FY21-23F versus 2% over FY18-20, c) clear recovery in EPS growth of 21% over FY21-23F versus 4% over FY18-20, d) higher dividend payouts backed by strong FCF, e) tile is a highly competitive industry in India with large share of unorganised players.

Figure 246: Kajaria Ceramics trading around its 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Figure 247: P/E band chart



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Downside risks

- **Withdrawal of anti-dumping duties on Chinese imports:** The GCC region, USA and European Union countries have imposed heavy import duties on Chinese tile imports since Mar 2020. India's export revenues saw a quantum jump due to this. The withdrawal of these duties would lead to surplus tile inventory in India that could lead to unreasonable pricing pressure and lower-than-estimated volume sales over FY21-23F.
- **High price of natural gas:** Gas forms ~30% of production costs for tiles. Rising crude prices remain a risk to EBITDA margins wherein companies are not able to pass through rising gas prices to customers.
- **Housing capex:** Government capex under "Housing for All" schemes and recovery in urban residential real estate demand (driven by low home loan interest rates, state government concessions) are critical for consistent demand for building materials. Delays in government expenditure or tapering urban demand would impact our growth estimates negatively.
- **Treasury management:** Given the improving FCF generation and high cash balances, investment of surplus cash for any unrelated diversification needs to be monitored.

SWOT analysis ›

Figure 248: SWOT analysis

Strengths

- Solid lead over distant No.2/No.3 players
- Low capex needs due to JV/outsourcing partnerships
- Strong value-added product portfolio

Weakness

- No pricing power due to large unorganised market
- Dependent on natural gas price vagaries
- Recent entry into bathware/plywood

SWOT

Opportunities

- Efficient use of cash flows for new business growth
- Leverage existing distribution reach for bathware/plywood
- Capture large unorganised market share

Threats

- Reversal of anti-China drive globally
- Stiff competiton from market leaders in bathware/plywood
- Poor country economic growth

SOURCES: INCRED RESEARCH

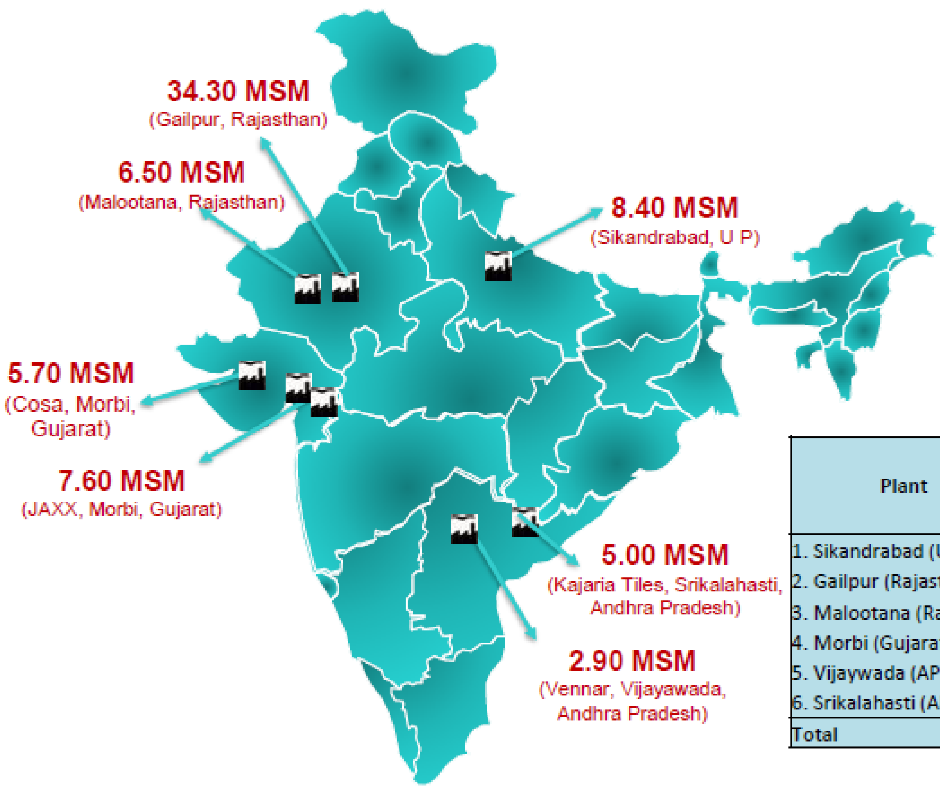
Business description and management profile

Kajaria Ceramics is the leader of the Indian tile industry with a presence across the entire tile value chain – ceramic wall tiles, and polished and glazed vitrified floor tiles.

Kajaria Ceramics, through its subsidiary Kajaria Bathware, has established a meaningful presence in bathroom solutions (sanitaryware and faucets) which are marketed under the Kerovit brand. With Kajaria Plywood Pvt. Ltd. (its subsidiary) the company entered the plywood sector, offering wood panel products under the brand name KajariaPLY.

A large section of the company's dealer network operates in tier-2, -3 and -4 towns – the new-age development hubs in India.

Figure 249: Kajaria's production capacities in India (total capacity 70.4m sq m) – Jan 2021



Plant	Production Capacity (MSM)			
	Ceramic Wall & Floor Tiles	Polished Vitrified Tiles	Glazed Vitrified Tiles	Total
1. Sikandrabad (UP)	-	-	8.40	8.40
2. Gailpur (Rajasthan)	25.20	-	9.10	34.30
3. Malootana (Rajasthan)	-	6.50	-	6.50
4. Morbi (Gujarat)	-	13.30	-	13.30
5. Vijayawada (AP)	2.90	-	-	2.90
6. Srikalahasti (AP)	-	-	5.00	5.00
Total	28.10	19.80	22.50	70.40

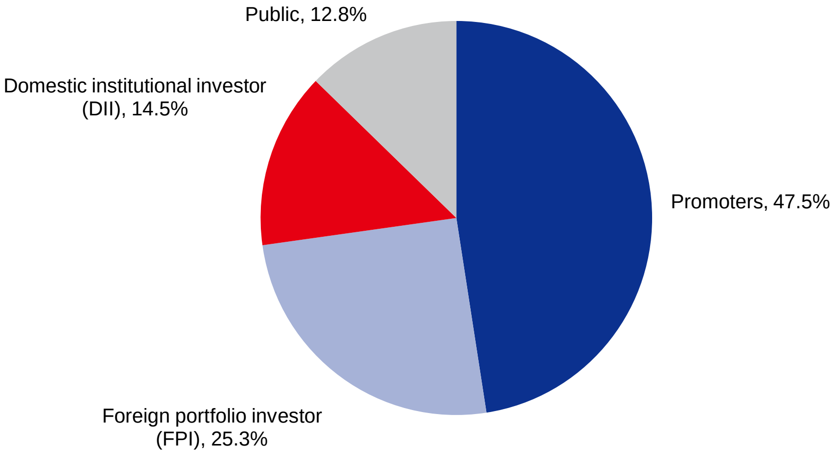
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 250: Key management profile (as at FY20)

Name and Designation	Profile
Mr. Ashok Kajaria, Chairman & Managing	Mr. Ashok Kajaria, the founding Chairman & Managing Director of the company, holds a Bachelor of Science (B.Sc.) degree and pursued Engineering (BSME) at UCLA (California), USA. In his career of over 44 years Kajaria has seen the rise of a 1m sq m tile fledging in 1988 into an industry leader in India. Mr. Kajaria has held several important industry positions, including President of the PHD Chamber of Commerce, Chairman of the Indian Council of Ceramic Tiles and Sanitaryware, and been a member of the executive committee of the Federation of Indian Chamber of Commerce and Industry.
Mr. Chetan Kajaria Joint Managing Director	Mr. Chetan Kajaria is a Bachelor of Petro Chemical Engineering (B.E.) from Pune University and holds an MBA from Boston College, U.S.A. Currently, he is the Chairman of the Indian Council of Ceramic Tiles and Sanitaryware (ICCTAS). He began working with Kajaria Ceramics in 2000 and has been instrumental in opening international-standard tile showrooms across the country, which has become an industry trend today. Mr. Kajaria is spearheading the ceramic tiles vertical and has played a key role in making Kajaria Ceramics a leading manufacturer of ceramic wall and floor tiles in India.
Mr. Rishi Kajaria Joint Managing Director	Mr. Rishi Kajaria holds a BS in Business Administration from Boston University, USA. He joined Kajaria Ceramics in 2003 and spearheads the vitrified tile vertical. Initially, he opted for trading vitrified tiles rather than set up capacities. After importing tiles for five years, he decided to manufacture them. Today the total production capacity of vitrified tiles is 44.90m sq m p.a. Mr. Kajaria identified the opportunity in the Bathware segment and started Kajaria Bathware. He is responsible for spearheading the lateral shift of the company into sanitaryware and faucets in keeping with the overall growth master plan.
Mr. Sanjeev Agarwal CFO	Sanjeev Agarwal is the Chief Financial Officer of Kajaria Ceramics Ltd. He was previously the Deputy Manager, Finance, at Orissa Synthetics Ltd.

SOURCES: INCRED RESEARCH, COMPANY REPORTS

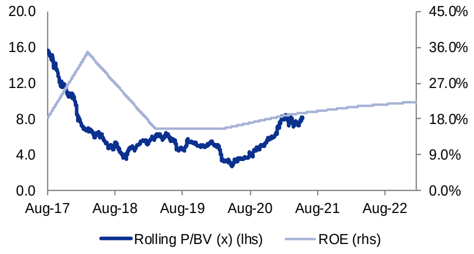
Figure 251: Shareholding pattern (as at Mar 2021)



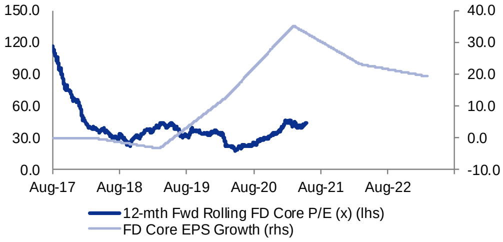
SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS

P/BV vs ROE



12-mth Fwd FD Core P/E vs FD Core EPS Growth



Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**29,562**	**28,080**	**30,469**	**36,872**	**41,792**
Gross Profit	**18,098**	**17,069**	**16,758**	**21,754**	**24,866**
Operating EBITDA	**4,495**	**4,159**	**5,561**	**6,637**	**7,732**
Depreciation And Amortisation	(891)	(1,081)	(1,064)	(1,135)	(1,220)
Operating EBIT	**3,604**	**3,078**	**4,497**	**5,502**	**6,511**
Financial Income/(Expense)	(16)	1	65	140	233
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)	41	46	48	51	53
Profit Before Tax (pre-EI)	**3,629**	**3,125**	**4,609**	**5,693**	**6,798**
Exceptional Items	(48)				
Pre-tax Profit	**3,580**	**3,125**	**4,609**	**5,693**	**6,798**
Taxation	(1,293)	(589)	(1,165)	(1,428)	(1,701)
Exceptional Income - post-tax					
Profit After Tax	**2,288**	**2,535**	**3,444**	**4,265**	**5,097**
Minority Interests	(22)	18	10	(10)	(20)
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**2,266**	**2,553**	**3,454**	**4,255**	**5,077**
Recurring Net Profit	2,297	2,553	3,454	4,255	5,077
Fully Diluted Recurring Net Profit	**2,297**	**2,553**	**3,454**	**4,255**	**5,077**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	4,495	4,159	5,561	6,637	7,732
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(117)	(993)	325	(372)	(735)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	99	77	113	191	286
Net Interest (Paid)/Received	24	6	(65)	(140)	(233)
Tax Paid	(1,327)	(1,005)	(1,165)	(1,428)	(1,701)
Cashflow From Operations	**3,174**	**2,244**	**4,769**	**4,888**	**5,349**
Capex	(1,235)	(1,240)	(500)	(1,855)	(1,110)
Disposals Of FAs/subsidiaries	96	27			
Acq. Of Subsidiaries/investments	(2,282)	134	48	(500)	(500)
Other Investing Cashflow	132	186	180	207	254
Cash Flow From Investing	**(3,289)**	**(893)**	**(272)**	**(2,148)**	**(1,356)**
Debt Raised/(repaid)	(411)	73	(250)	(500)	(421)
Proceeds From Issue Of Shares		3			
Shares Repurchased					
Dividends Paid	(575)	(1,150)	(1,591)	(1,989)	(2,387)
Preferred Dividends					
Other Financing Cashflow	(156)	(153)	(115)	(67)	(21)
Cash Flow From Financing	**(1,141)**	**(1,227)**	**(1,956)**	**(2,556)**	**(2,829)**
Total Cash Generated	(1,257)	124	2,541	184	1,164
Free Cashflow To Equity	**(526)**	**1,424**	**4,247**	**2,240**	**3,572**
Free Cashflow To Firm	**(271)**	**1,156**	**4,382**	**2,673**	**3,972**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	2,524	2,350	4,843	5,527	7,191
Total Debtors	4,751	3,967	4,591	6,061	6,870
Inventories	4,058	5,127	4,341	5,051	5,725
Total Other Current Assets	380	432	376	455	516
Total Current Assets	**11,712**	**11,876**	**14,150**	**17,094**	**20,302**
Fixed Assets	10,694	11,443	10,986	11,706	11,596
Total Investments	3	3	3	3	3
Intangible Assets	85	85	85	85	85
Total Other Non-Current Assets	1,238	979	872	872	872
Total Non-current Assets	**12,020**	**12,510**	**11,946**	**12,666**	**12,556**
Short-term Debt	635	956	616	282	
Current Portion of Long-Term Debt					
Total Creditors	3,091	2,393	2,504	3,536	4,007
Other Current Liabilities	2,140	1,674	1,670	2,525	2,862
Total Current Liabilities	**5,866**	**5,023**	**4,790**	**6,343**	**6,870**
Total Long-term Debt	315	215	305	140	
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	71	637	637	637	637
Total Non-current Liabilities	**386**	**853**	**943**	**777**	**637**
Total Provisions	1,073	731	731	731	731
Total Liabilities	**7,324**	**6,606**	**6,463**	**7,850**	**8,238**
Shareholders Equity	15,749	17,143	19,006	21,272	23,963
Minority Interests	659	637	627	637	657
Total Equity	**16,408**	**17,780**	**19,633**	**21,910**	**24,620**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	9.1%	(5.0%)	8.5%	21.0%	13.3%
Operating EBITDA Growth	(1.5%)	(7.5%)	33.7%	19.4%	16.5%
Operating EBITDA Margin	15.2%	14.8%	18.3%	18.0%	18.5%
Net Cash Per Share (Rs)	9.90	7.41	24.65	32.09	45.20
BVPS (Rs)	99.03	107.81	119.49	133.70	150.62
Gross Interest Cover	23.12	15.78	39.06	81.95	309.04
Effective Tax Rate	36.1%	18.9%	25.3%	25.1%	25.0%
Net Dividend Payout Ratio	15.9%	36.6%	34.4%	35.0%	35.2%
Accounts Receivables Days	57.15	56.66	51.26	52.72	56.47
Inventory Days	124.86	152.24	126.02	113.38	116.19
Accounts Payables Days	90.24	90.89	65.19	72.92	81.33
ROIC (%)	22.7%	19.3%	25.0%	32.2%	35.8%
ROCE (%)	21.4%	17.2%	22.8%	25.7%	28.0%
Return On Average Assets	16.2%	13.0%	18.0%	19.9%	21.0%

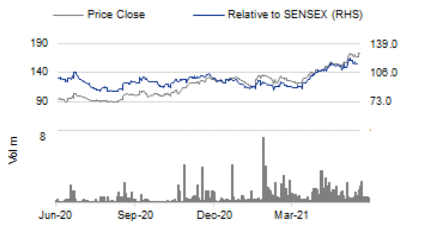
SOURCES: INCRED RESEARCH, COMPANY REPORTS

India

HOLD *(Initiating coverage)*

Consensus ratings*:	Buy 16 Hold 1 Sell 0
Current price:	Rs172
Target price:	Rs180
Previous target:	NA
Up/downside:	4.7%
InCred Research / Consensus:	20.9%
Reuters:	FINX.NS
Bloomberg:	FNXP IN
Market cap:	US$1,459m
	Rs106,629m
Average daily turnover:	US$1.9m
	Rs139.3m
Current shares o/s:	620.5m
Free float:	47.5%

**Source: Bloomberg*



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	10.5	32.1	84.9
Relative (%)	2.6	27.8	19.1

Major shareholders	% held
Promoters	52.5
DSP Mutual Fund	4.5
HDFC Mutual Fund	3.2

Finolex Industries

Fine and flexible to sustain over long term

- Formidable agri-pipe franchise in process to build non-agri product portfolio.
- Weak competition has aided market share, very high PVC prices have led to strong FY21F net profits; we estimate FCF of Rs15.8bn over FY21-23F.
- Stock trades at a premium to its five-year mean P/E, initiate coverage with Hold rating and TP of Rs180.

Formidable agri-pipe franchise building its non-agri portfolio

Finolex Industries, backed by over 70 years of the Finolex Group's business legacy, is a formidable player in the Indian plastic pipes industry. It had 9% of the revenue market share at Mar 2020 and is a leading player in the agri-pipe segment (~70% of company's revenue). Its focus is to raise its non-agri portfolio to 40% of revenues over the next five years. Higher sales of CPVC products, pipe fittings and plumbing/SWR (soil, waste and rain) products would help reach this goal. Additionally, some large agri-pipe players and smaller brands have lost market share in the past five years helping Finolex's growth.

Materially high margins due to backward-integrated operations

Finolex manufactures most of its PVC resin requirements in-house and is one of the few large backward integrated pipe manufacturers in India. Agri-related plastic products earn lower EBITDA margins (8-10%) vs. non-agri products (10-13%). However, owing to captive PVC capacities, Finolex pipe EBITDA margins (18-20%) are at par with its larger peers like Supreme Industries, though this entails a relatively longer inventory cycle of 70-80 days of sales vs 35-50 for its peers. Also, Finolex did not renew its contract (expired on 31 Aug 2020) with Lubrizol Corporation for Flowguard Plus pipes/fittings and would incrementally have CPVC products sold under its own brand-aiding margins.

Cumulative FCF of Rs15.8bn over FY21-23F, 2.5x of FY18-20

New capacity creation for piping (~60k tons) and replacement capex for PVC resin capacity would lead to cumulative capex of Rs3.7bn in FY21-23F. We expect the net working capital cycle to continue at past levels of 45-50 days of sales. Higher structural EBITDA margin improvements driven by improving sales mix, higher captive resin consumption and internally funded capex would lead to cumulative FCF of Rs15.8bn over FY21-23F. Dividend payouts are 35-40% of annual net profits and we expect similar payouts over FY21-23F. We estimate RoE/RoCE/RoIC of 19%/22%/40% in FY23F.

Initiate with Hold rating and TP of Rs180

We are positive on Finolex due to its leadership position in agri-pipes, market share gains, structural improvements in revenue mix, healthy cash flows and strong return ratios. However, the stock rose 56% since 1 Feb 2020 and currently trades at FY23F P/E of 19.6x (+1SD its past five-year mean P/E). We see limited upside potential from current levels and initiate coverage with a Hold rating and TP of Rs180 (P/E of ~20x FY23F EPS), a 20% premium to its five-year mean P/E of 17x. Downside risks: slow ramp-up of non-agri products, forex volatility. Upside risks: Prolonged high RM prices.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	30,913	29,860	33,805	35,125	38,161
Operating EBITDA (Rsm)	6,043	4,481	8,941	6,322	7,231
Net Profit (Rsm)	3,951	3,327	6,697	4,707	5,445
Core EPS (Rs)	6.4	5.4	10.8	7.6	8.8
Core EPS Growth	29.0%	(15.8%)	101.3%	(29.7%)	15.7%
FD Core P/E (x)	26.99	32.05	15.92	22.66	19.58
DPS (Rs)	2.0	2.0	4.0	3.0	3.2
Dividend Yield	1.40%	1.40%	2.33%	1.75%	1.86%
EV/EBITDA (x)	17.37	23.93	11.61	16.06	13.74
P/FCFE (x)	70.18	30.54	19.02	31.17	31.15
Net Gearing	(6.4%)	3.0%	(11.8%)	(18.9%)	(23.8%)
P/BV (x)	4.14	5.37	4.43	3.96	3.51
ROE	14.7%	14.6%	30.5%	18.5%	19.0%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)			1.11	1.01	1.09

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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Gradual structural improvements going forward ›

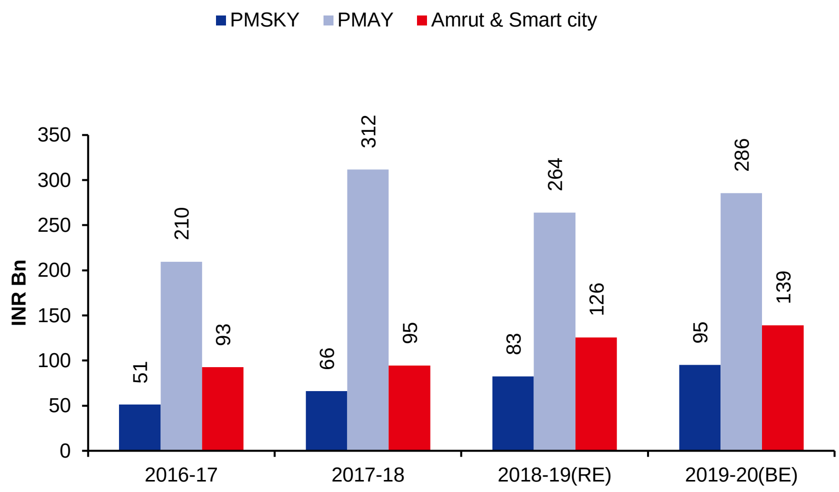
"I am providing a record sum of Rs1.1tr for Railways of which Rs1tr is for capital expenditure".
– Finance Minister of India, Budget speech 2020-2021

Two new technologies – MetroLite and MetroNeo – will be deployed to provide metro rail systems at much lesser cost with the same experience, convenience and safety in tier-2 cities and peripheral areas of tier-1 cities.
– Finance Minister of India, Budget speech 2020-2021

Finolex Industries is a plastic pipes manufacturer with leadership in the agriculture pipe segment in India based on revenue market share of 9% as at Mar 2020. Agriculture pipes contributed ~70% of the company's business while ~30% was derived from non-agriculture piping systems like plumbing, industrial and housing segments in FY20. Given the uptick in the infrastructure and industrial capex anticipated based on India's public and private sector capex plans, we think many sectors would collectively contribute to the plastic pipe industry growth going forward.

- **Irrigation:** About 72.2m hectares was still under rainfed conditions (according to Land Use Statistics at a Glance 2006-07 to 2015-16). During FY20, 1.2m hectares was brought under micro-irrigation, the highest coverage in any calendar year so far. Since Apr 2016, Central government assistance of Rs133bn has been released to the States for the implementation of Pradhan Mantri Krishi Sinchayee Yojana (PMKSY-PDMC) which includes Rs13.5bn released during 9MFY21. The Rainfed Farming System (RFS) division is implementing the Per Drop More Crop Component of the PMKSY-PDMC and Rainfed Area Development (RAD) component of the National Mission for Sustainable Agriculture (NMSA).
- **National Rail Plan:** The Indian government aims to develop adequate rail infrastructure by 2030. The objective is to increase rail freight share from 27% today to 45%. A total of 702km of conventional metro railway is operational and another 1,016km is under construction in 27 cities.
- **Urban infrastructure:** The Indian government will incur capex of Rs111 lakh crore for infrastructure development under the National Infrastructure Pipeline (NIP) over FY20-FY25F. More than 60% of this will go towards roads, urban infrastructure, railway, irrigation, and rural development.

Figure 252: Government allocation to various infrastructure development schemes



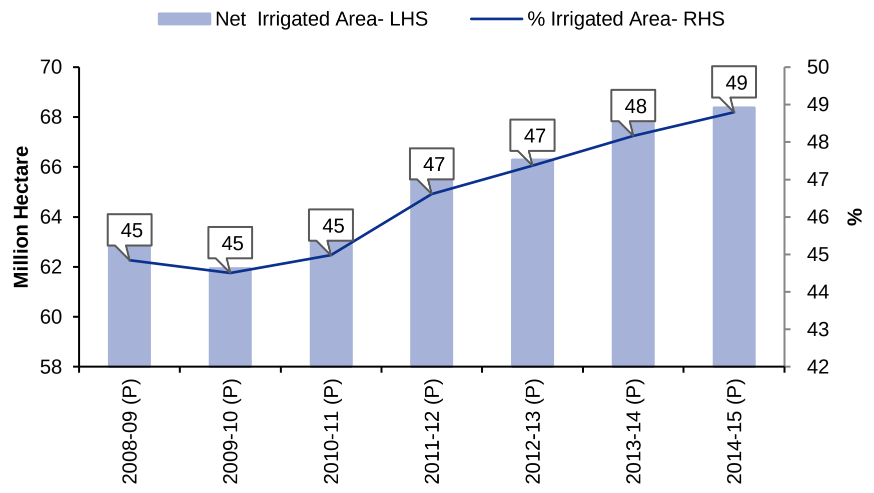
RE = REVISED ESTIMATES, BE = BUDGET ESTIMATES
SOURCES: INCRED RESEARCH, FINOLEX INDUSTRIES ANNUAL REPORT 2020

Figure 253: Huge scope to irrigate incremental ~50% of the balance cropped area

	2014-15 (P)
Area sown (million hectare)	140.13
Irrigated area (million hectare)	68.38
% Irrigated area	48.8

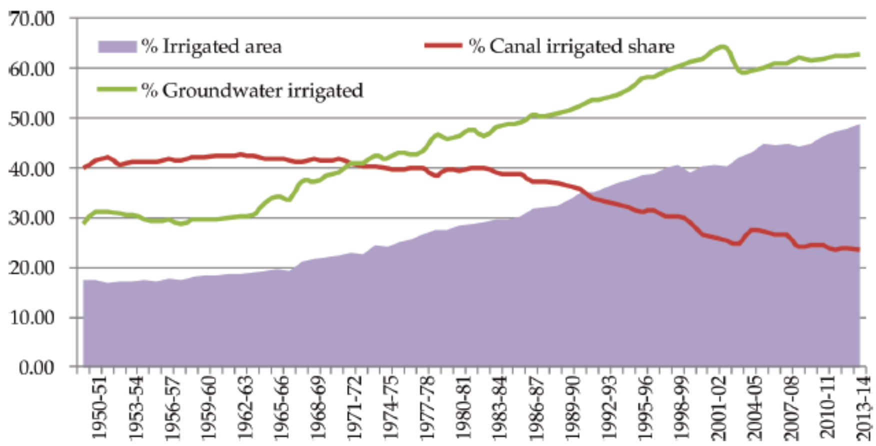
P STANDS FOR PROJECTED
SOURCES: INCRED RESEARCH, AGRICULTURAL STATISTICS AT A GLANCE 2018, DIRECTORATE OF ECONOMICS & STATISTICS

Figure 254: Government has been taking initiatives to increase irrigated land



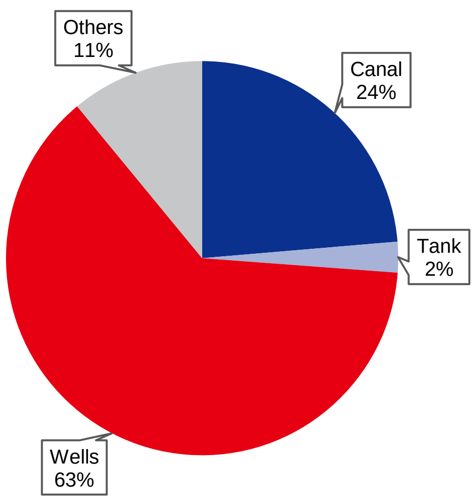
P STANDS FOR PROJECTED
SOURCES: INCRED RESEARCH, AGRICULTURAL STATISTICS AT A GANCE 2018, DIRECTORATE OF ECONOMICS & STATISTICS

Figure 255: Groundwater is the preferred source of water for irrigation in India



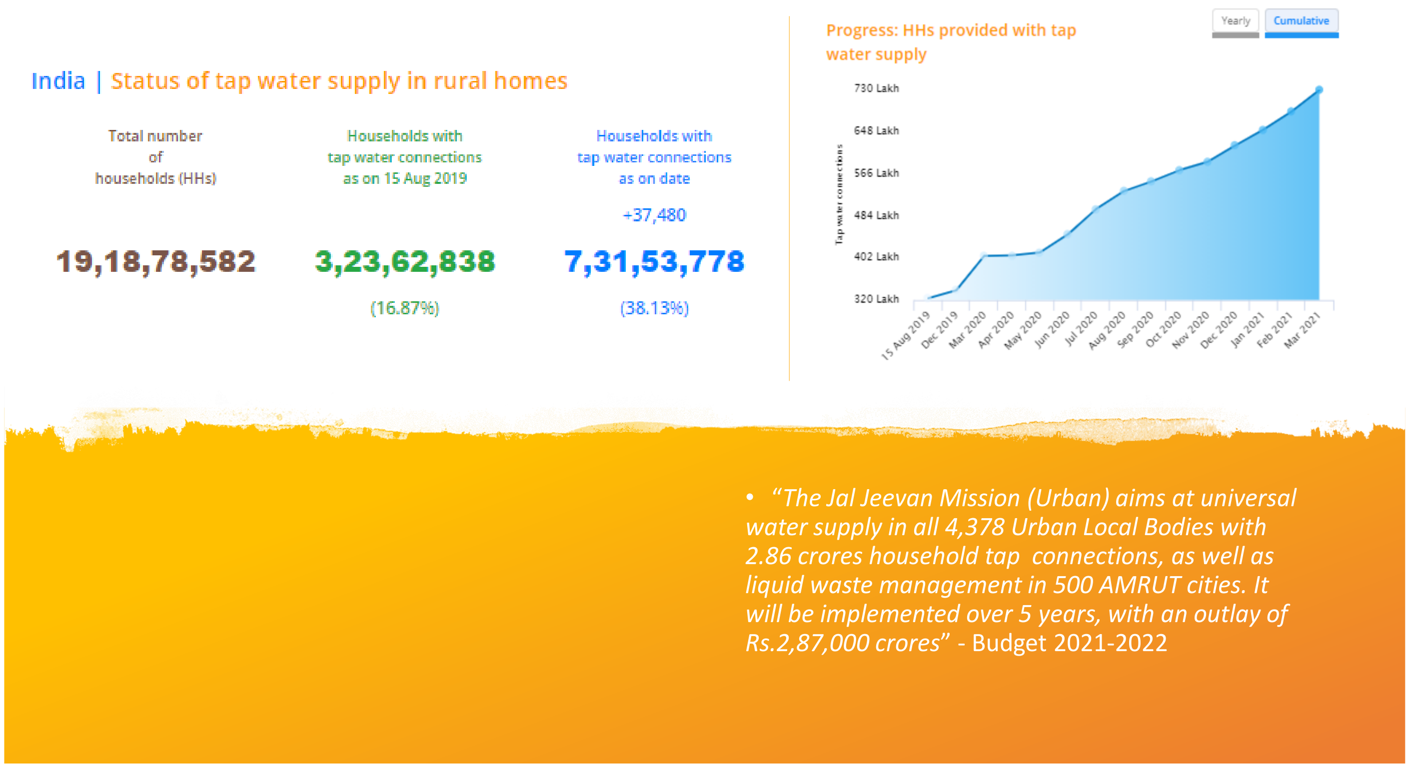
SOURCES: INCRED RESEARCH, JOURNAL OF SOIL AND WATER CONSERVATION, OCTOBER-DECEMBER 2019

Figure 256: Relative contribution of various sources to irrigated area (2019)



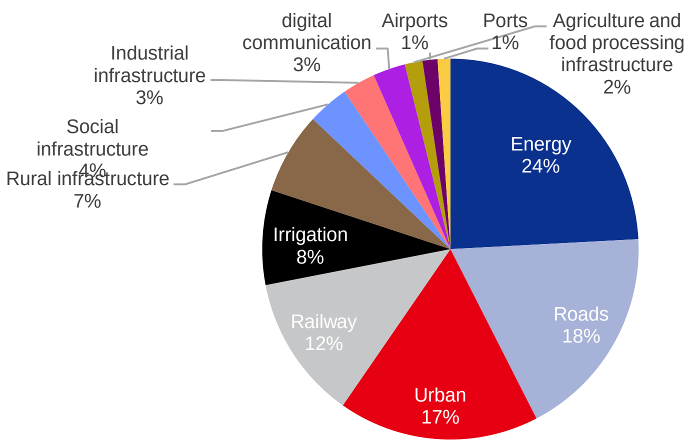
SOURCES: INCRED RESEARCH, JOURNAL OF SOIL AND WATER CONSERVATION, OCTOBER-DECEMBER 2019

Figure 257: Jal Jeevan Mission aims for universal water supply in all 4,378 urban bodies in India



SOURCES: INCRED RESEARCH, JALJEEVANMISSION.GOV.IN

Figure 258: Government has planned capex of Rs111 lakh crore under NIP over FY20-FY25F. Over 60% allocated for roads, urban/rural infrastructure, railway and irrigation (as at Aug 2019)



SOURCES: INCRED RESEARCH, WWW.DEA.GOV.IN,

"Last two years, we suffered because more than Rs15bn of the receivables were delayed, etc, which caused additional finance cost, which has caused disruption, which has caused default and, therefore, we got into debt restructuring."
– 3QFY21 Jain Irrigation result call

Supportive competitive dynamics with a few large agri players, and unorganised pipe brands losing market share ›

Agriculture piping accounts for 40-45% of the overall Indian plastic pipes demand (Source: Prince Pipes IPO prospectus). This implies agri pipe consumption of Rs120bn-150bn annually. A few large pipe manufacturers, accounting for over 20% of the market share, have reported declining plastic pipe sales and have lost market share consistently over the past five years – Jain Irrigation, Kisan Moulding, Skipper, etc. The competitive intensity has declined in the agri-pipe segment due to the deteriorating balance sheets of these companies. Either profit margins have fallen significantly (net losses in some cases) or working capital issues have severely impacted financial liquidity.

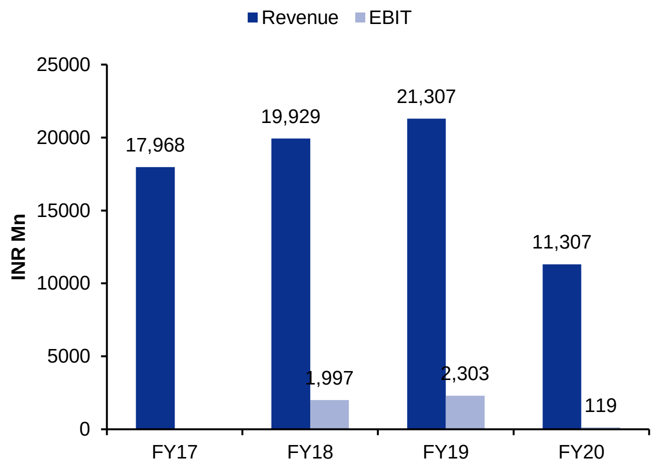
"But definitely this is expected that during the pandemic, many people in the smaller sector or unorganised sector would not get their operations started so well, because of either labour or shortage of credit facility, and that is why possibly there is a shifting that has happened."

– Finolex Industries, 2QFY21 result call

Also, the shift to more compliant larger organised brands, from smaller non-compliant unorganised pipe manufacturers, that started across India after the implementation of demonetisation and GST in 2016/17, accelerated during 2020 due to the COVID-19 pandemic.

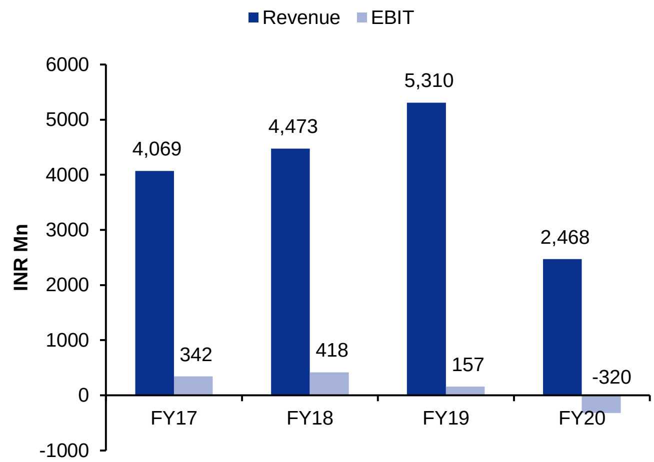
Cumulatively these factors have considerably benefitted stronger incumbents like Finolex Industries to gain a stronger foothold in the plastic pipes industry. Given the improving macro demand drivers and improved competitive environment, we expect Finolex Industries' revenue growth to be stronger over the next three to five years vs the past.

Figure 259: Jain Irrigation (Plastic division performance)



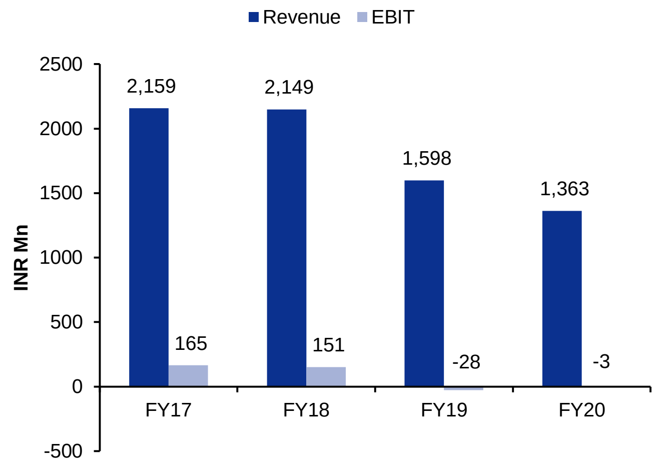
SOURCES: INCRED RESEARCH, ACE EQUITY, BLOOMBERG

Figure 260: Kisan Moulding (Pipes and Fittings division performance)



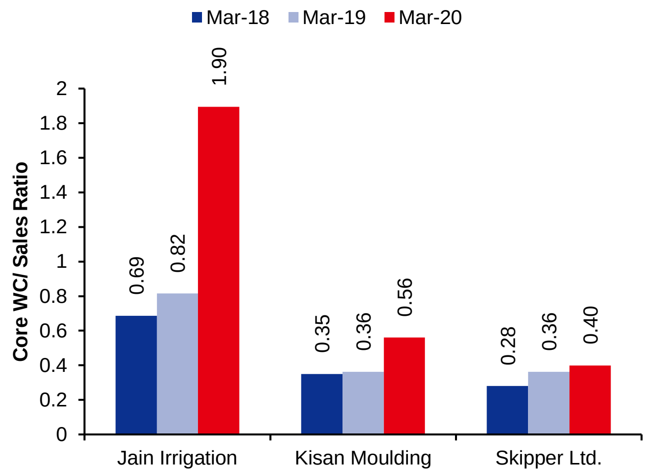
SOURCES: INCRED RESEARCH, ACE EQUITY, BLOOMBERG

Figure 261: Skipper Ltd (Polymer division performance)



SOURCES: INCRED RESEARCH, ACE EQUITY, BLOOMBERG

Figure 262: Deteriorating core working capital to sales ratio (x)



CORE WORKING CAPITAL: INVENTORY (+) DEBTORS (-) CREDITORS
SOURCES: INCRED RESEARCH, ACE EQUITY, BLOOMBERG

Improving sales mix in favour of non-agri products ›

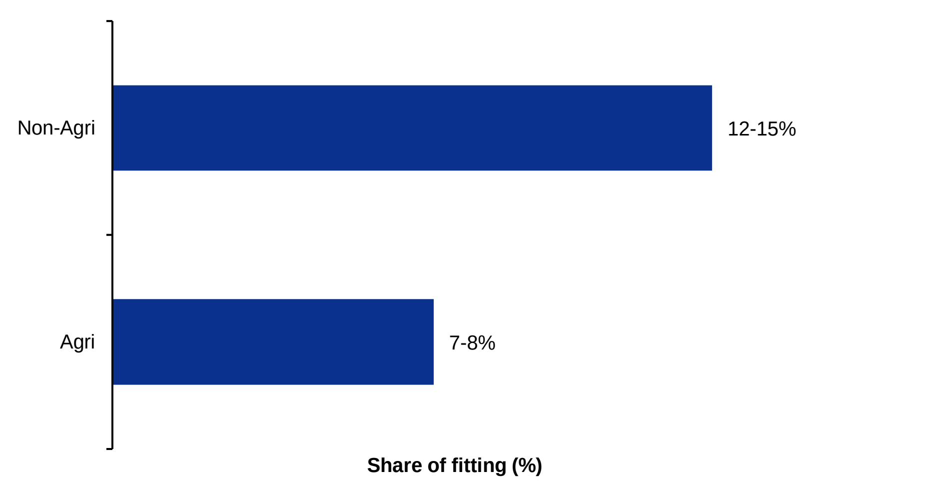
"We decided we would try to increase our focus on non-agri and increase our market size. We are definitely looking at increasing product profiles as well as our geographical reach, so both areas we are definitely going for aggressively."
– MD, Finolex Industries, 3QFY21 investor call

Finolex derives ~70% of its business through agriculture pipe sales, according to management. The company has been investing time and effort to increase revenue share of non-agri pipes like CPVC and SWR (soil, waste and rain) as well as its share of pipe fittings. This initiative will enable the company to increase its share of non-agri products to 40% in the next three to four years by way of new product launches in the non-agri segment and widening its distribution network into North and East of India.

Non-agri related pipes have nearly 2x higher volumes for fittings vs. agriculture piping as per Finolex. Fittings earn better margins and, hence, the overall shift to non-agri would imply higher revenue share from fittings going forward.

"Overall margins, if you see, we get 8-9% now in agri fittings though volumes are much lower and margins in fittings are better than the pipes, and non-agri pipes also have a better margin."
– Finolex Industries 2QFY21 investor call

Figure 263: Finolex's share of fittings in agri and non-agri pipes orders (as at Dec 2020)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

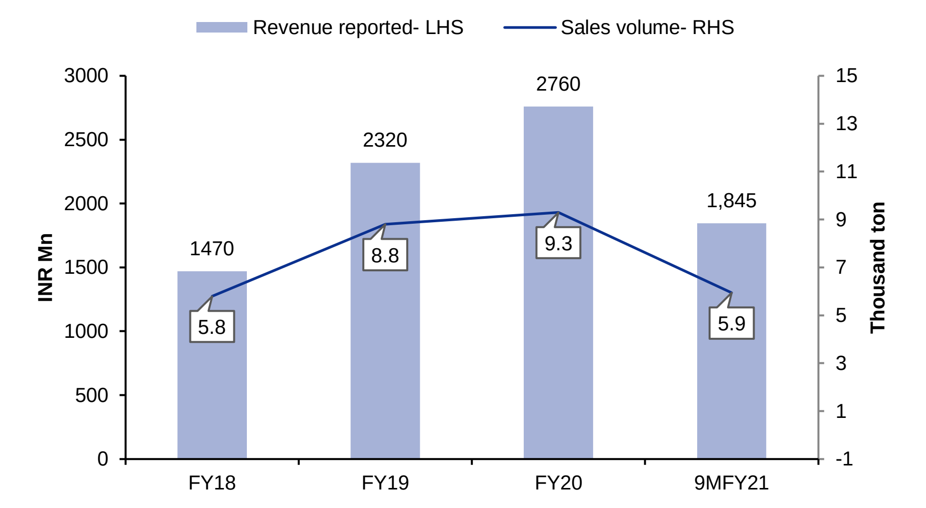
Agri vs. non-agri revenue share
"We were somewhere around 26%-74% earlier, today we are running about 30-70%. So, our growth rate in non-agri has been maintained continuously for the last [few] years. CPVC, particularly at this time, we have grown by 20% over last year this quarter."
– Finolex Industries, 3QFY21 investor call

CPVC piping segment performance

Finolex is a small player in the CPVC segment (~Rs50bn size in India) with manufacturing capacity of ~20k tons. The segment reported volumes of 9k tons while revenues of Rs2.8bn in FY20 (9MFY21 volume: 5.9k tons; sales: Rs1.9bn) utilising ~50% of its manufacturing capacity.

Finolex had signed an agreement with The Lubrizol Corporation in Feb 2017 to manufacture and sell Finolex FlowGuard Plus pipes and fittings to cater to building and construction industry pipe demand. This agreement was not renewed and expired with effect from 31 Aug 2020. Finolex plans to sell CPVC products under its own brand going forward.

Figure 264: PVC resin revenue and volume trend

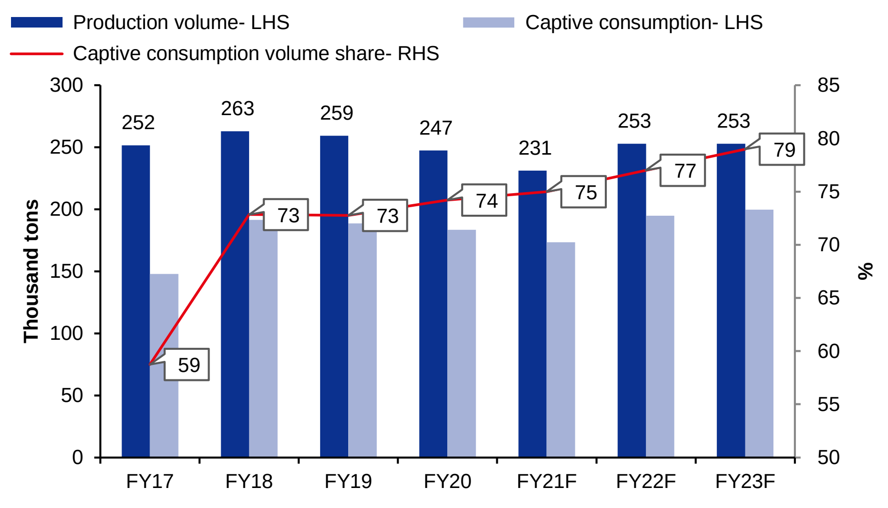


SOURCES: INCRED RESEARCH, COMPANY REPORTS

Higher captive consumption of PVC resins = better profitability

Finolex manufactures PVC resins in-house which it uses to manufacture its PVC pipes and some quantities are sold to outside customers. Over time pipe tonnage has risen and sales of resins to outside customers have dropped. We expect the trend to continue over FY21-23F that leads to better economics and higher overall margins in the case of higher captive resin consumption, in our view.

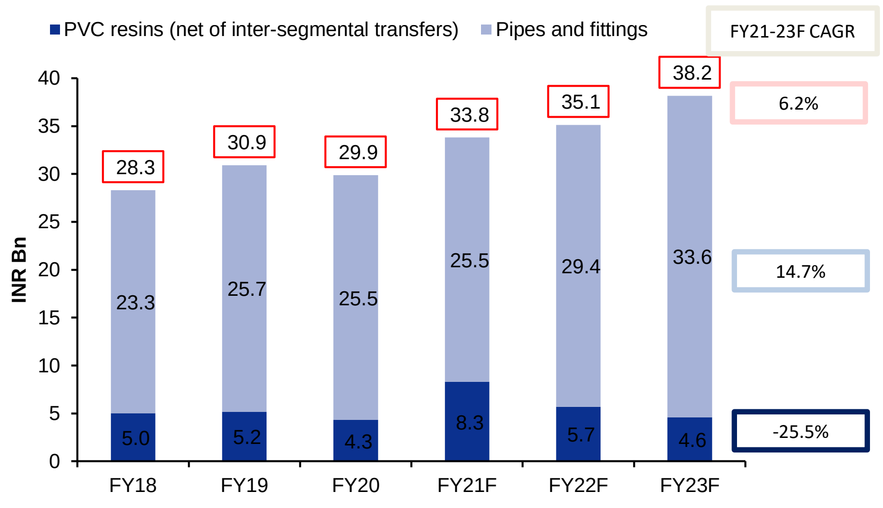
Figure 265: Rising in-house pipe manufacturing leads to higher captive resin use



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

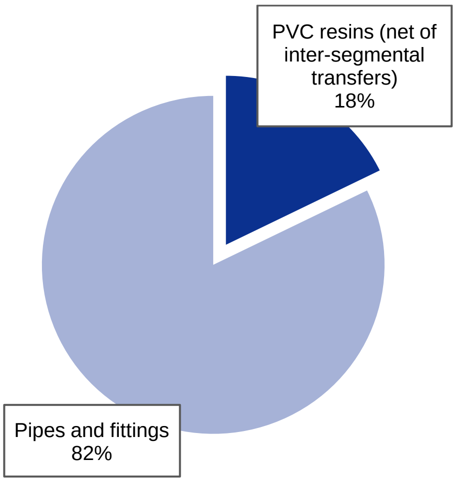
Deflating PVC price = Revenue CAGR < Volume CAGR ›

Figure 266: Finolex Industries' revenue trend



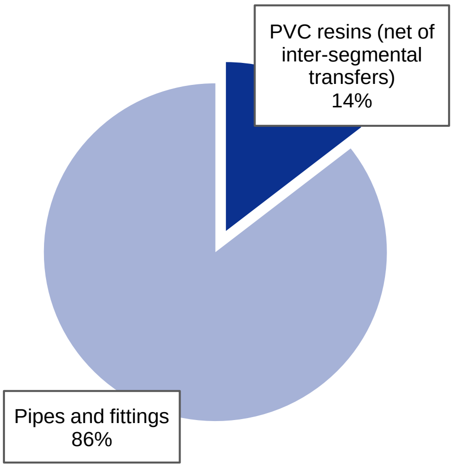
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 267: Revenue mix (FY18)



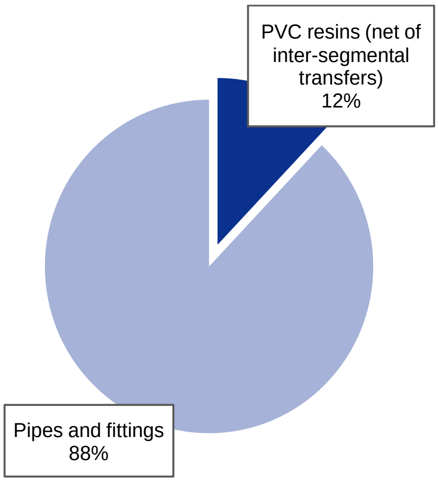
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 268: Revenue mix (FY20)



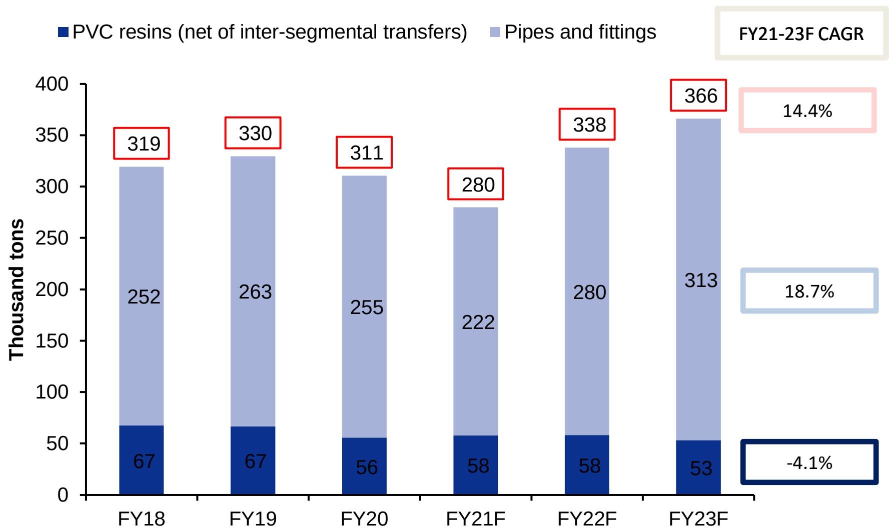
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 269: Revenue mix (FY23F)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 270: Finolex Industries' segmental volume trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

"The prices of PVC have gone up. At one point, during the pandemic it went down to Rs62/kg. Today it is Rs95/kg. So, there is a total rise of Rs32/kg in PVC. During the quarter, it was around Rs24/kg up to September end. Now even September or beyond, in October itself it went up another Rs10-12/kg."

–Finolex Industries 2QFY21 investor call

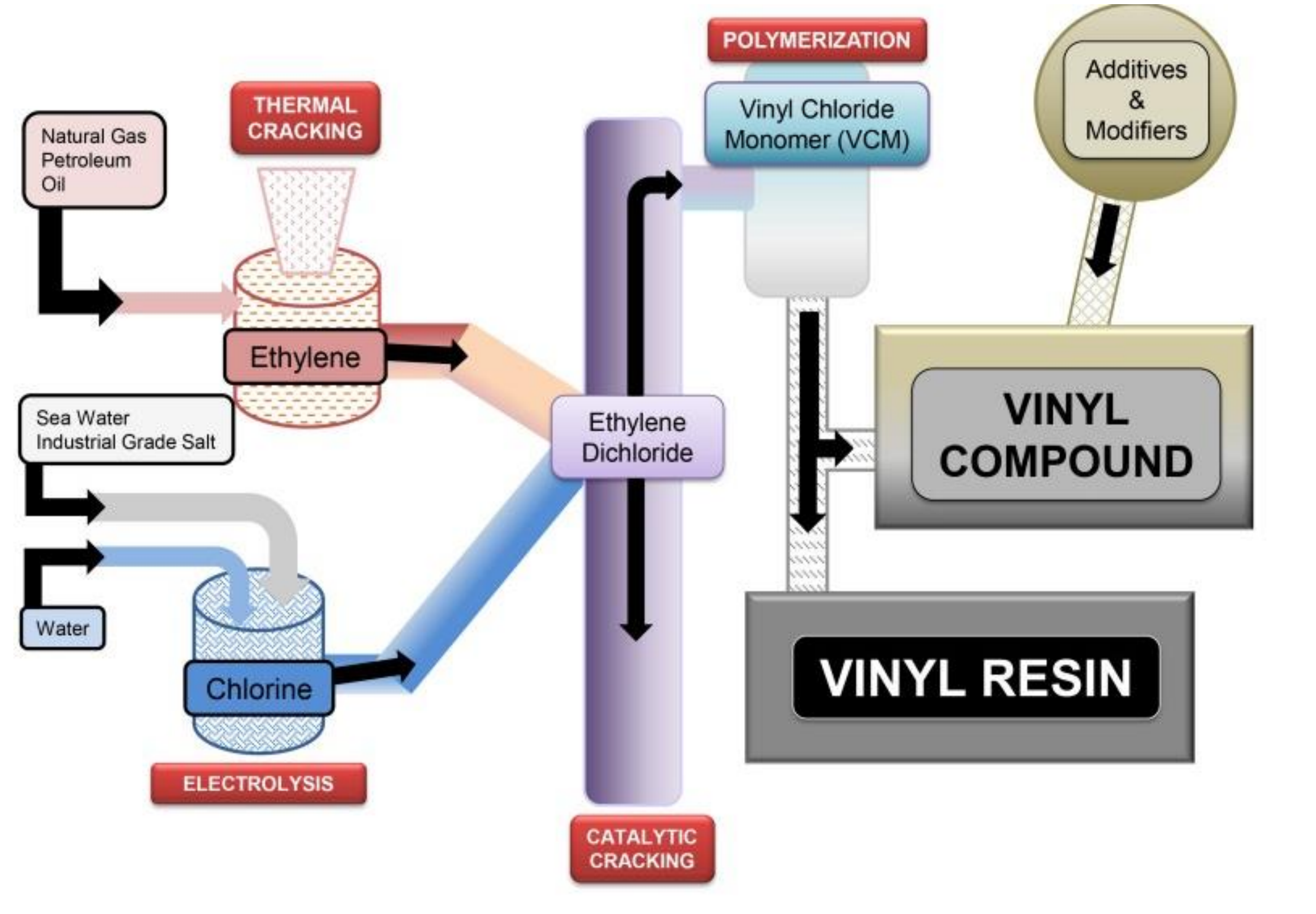
PVC prices drove EBITDA margins higher in FY21

Global supply disruption led to steep rise in PVC prices ›

PVC resin prices

PVC resins are key raw materials for the manufacture of plastic pipes. Polyvinyl chloride (PVC) resins are manufactured by the polymerisation of vinyl chloride monomer (VCM), produced by the thermal cracking of ethylene dichloride (EDC). Ethylene used in the manufacture of ethylene dichloride is produced by steam cracking of naphtha, gasoil and condensates while chlorine is derived from common salt by electrolysis.

Figure 271: PVC resin manufacturing process



SOURCES: INCRED RESEARCH, TECHNOR APEX

The COVID-19 pandemic disrupted production and supply chains for most of these commodities and impacted demand-supply equations driving unprecedented rise in prices of these products. Pipe manufacturing companies in India have passed on the steep input cost inflation in the form of higher PVC pipe pricing. However, during Jan-Mar 2021, there was some push back by farmers with regards to very high prices for agri-pipes resulting in slower demand in 4QFY21.

"PVC resin prices have gone up by Rs23/kg in the quarter, an increase of 25% in its pricing. PVC prices remain even now at an elevated level. At the increased price, there is demand resistance from the agriculture segment. It is expected that resin price may start softening by March."

– Supreme Industries, 3QFY21 investor call

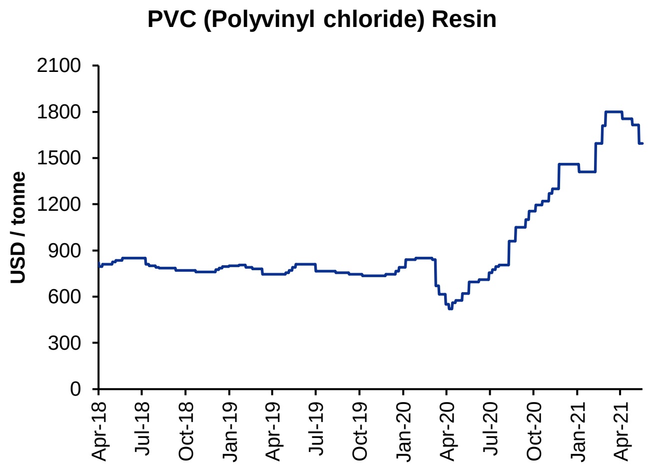
CPVC resin prices

There has not been similar inflation on the CPVC side of the business and the pricing has been relatively stable. However, based on our channel checks, CPVC piping segment prices were hiked partially in 4QFY21 and balance hikes would be taken in 1HFY22F.

Excerpts from the 2QFY21 investor call on CPVC pricing:

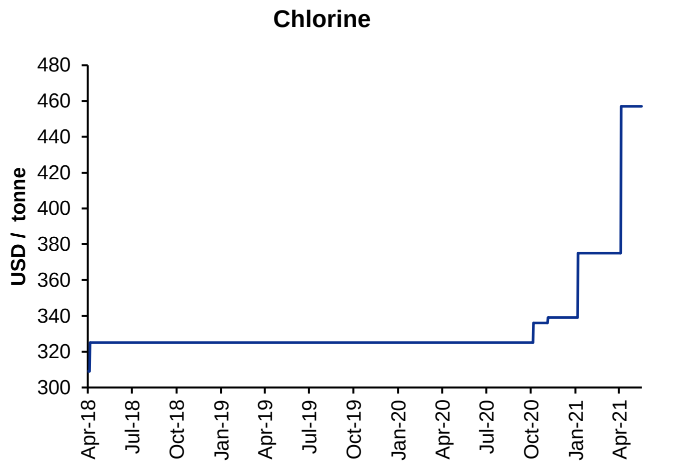
"Normally both on the input and finished goods side CPVC prices do not move as much as UPVC prices. Mainly for CPVC resin sourcing there are annual contracts. So, as the dollar prices are fixed, CPVC prices for finished goods will only change because of significant rupee-dollar movements, otherwise relatively their prices are stable. During this period there has been no increase in CPVC prices."

Figure 272: PVC resin price trend



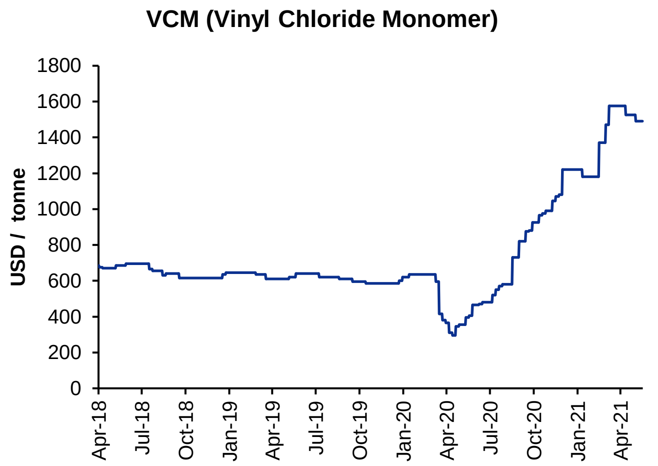
SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 273: Chlorine price trend



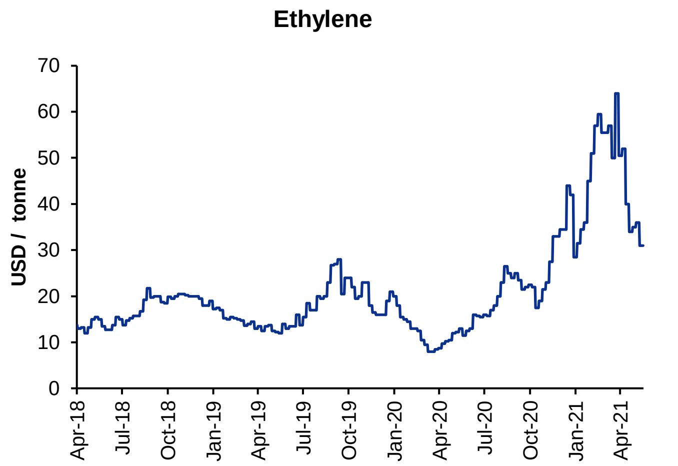
SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 274: VCM price trend



SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 275: Ethylene price trend

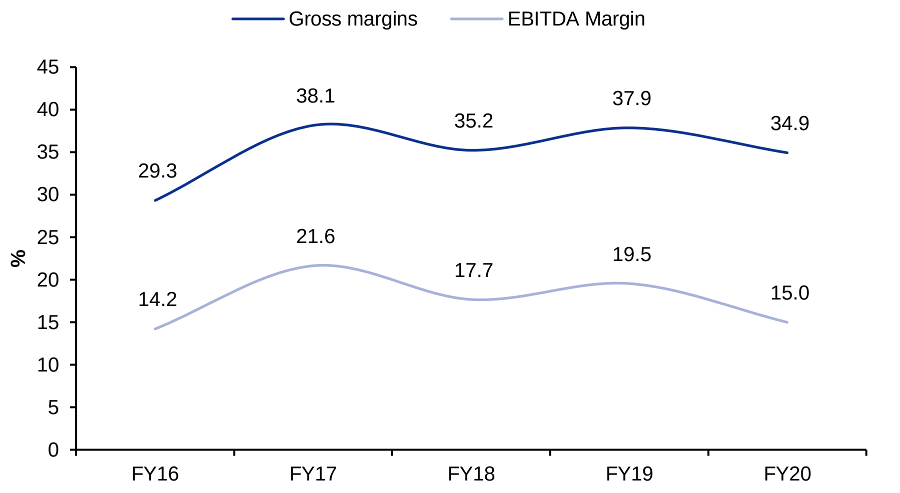


SOURCES: INCRED RESEARCH, BLOOMBERG

Higher PVC prices result in exceptional margins, restoring supply chains will normalise global prices, in our view ›

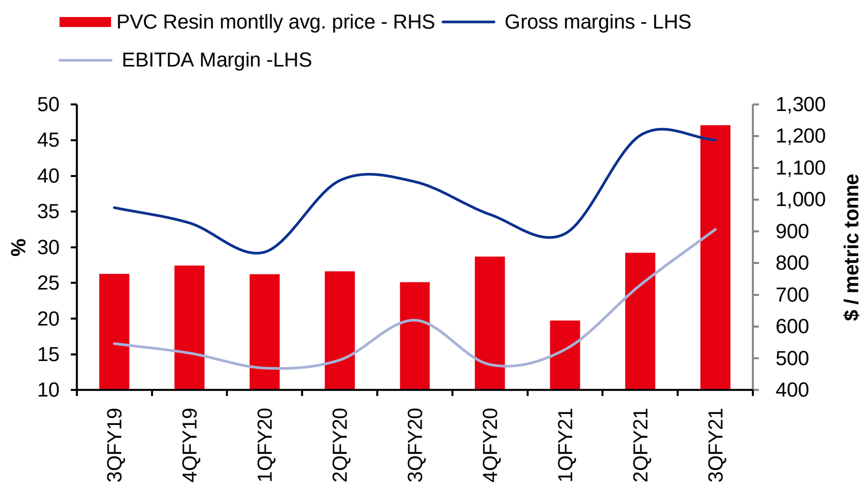
Finolex's backward integration into PVC resin manufacturing results in better operating economics for pipe manufacturing and results in higher operating margins, in our view. Going forward, as highlighted earlier, we expect pipe sale volumes to pick up implying declining resin sales to outside customers.

Figure 276: Finolex Industries' gross margin and EBITDA margin trend



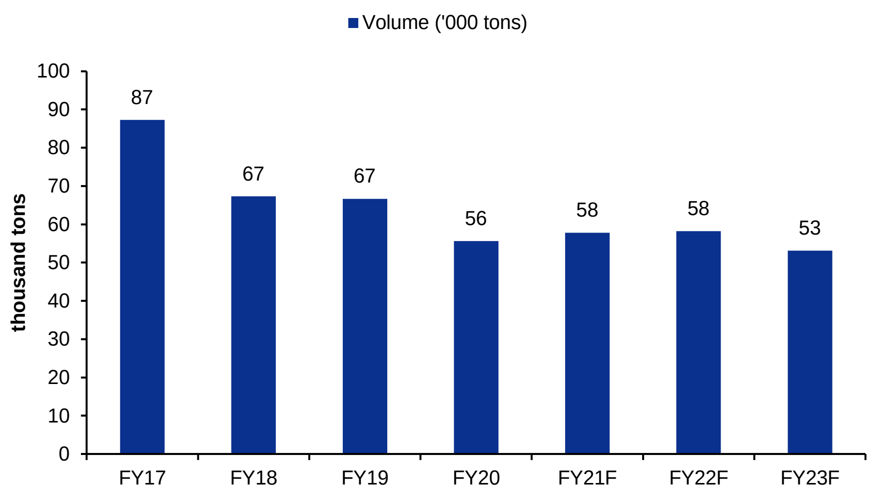
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 277: Gross and EBITDA margins react to steep raw material price changes



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 278: Declining PVC resin sales to outside customers



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

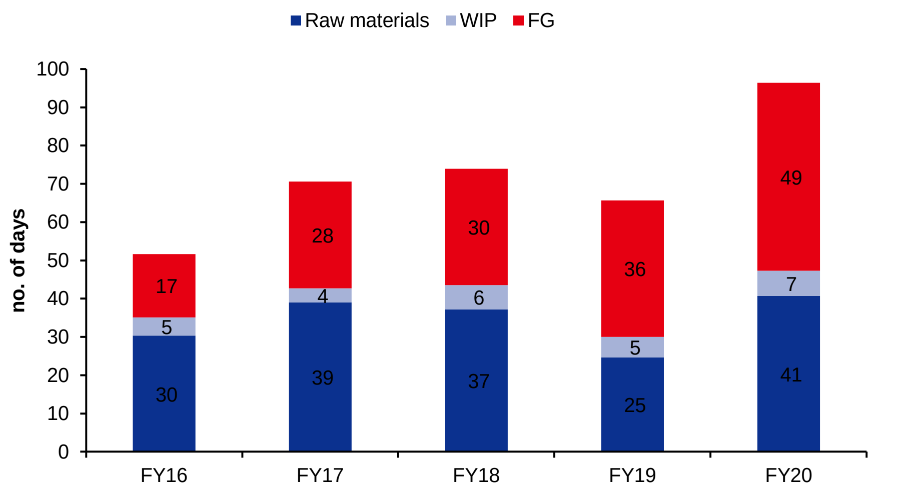
"If we talk of 3Q, it is a combination of inventory gain as well as better realisations compared to last year. Inventory gain is difficult to quantify, but yes, there would be a large part of it because PVC prices and pipes prices in turn moved up very sharply in a very short period."
– Finolex Industries, 3QFY21 investor call

"The operating profit margin improved significantly due to inventory gain on account of rapid price increase of PVC resin."
– Supreme Industries, 3QFY21 investor call

Inventory gains distort business profitability

On average Finolex maintains 35-40 days of raw material (RM) inventory. Sharp fluctuations in the prices of ethylene, chlorine and vinyl monomer lead to change in resin inventory valuations and result in inventory gains/losses. Given the steep rise in RM pricing during 2020, mark-to-market accounting of inventory led to significant inventory gains for companies like Finolex and to high gross margins. We would like to highlight that as PVC prices stabilise over CY21F/22F, price drops could also result in inventory losses going forward. Our estimates do not include in any of these losses and would be a key downside risk to our EBITDA estimates over FY21-23F.

Figure 279: Inventory breakdown over the past years



WIP=WORK IN PROGRESS, FG=FINISHED GOODS
SOURCES: INCRED RESEARCH, COMPANY REPORTS

"We are now trying to look at geographies of North and East India, so these are some of the areas where we were weaker earlier and we are concentrating on those areas. We are very strong on South as well as on West, may be because we are closer to the western region for our manufacturing setups."
– Finolex Industries, 3QFY21 investor call

Higher non-agri brand presence will need more aggressive advertising and sales promotion schemes

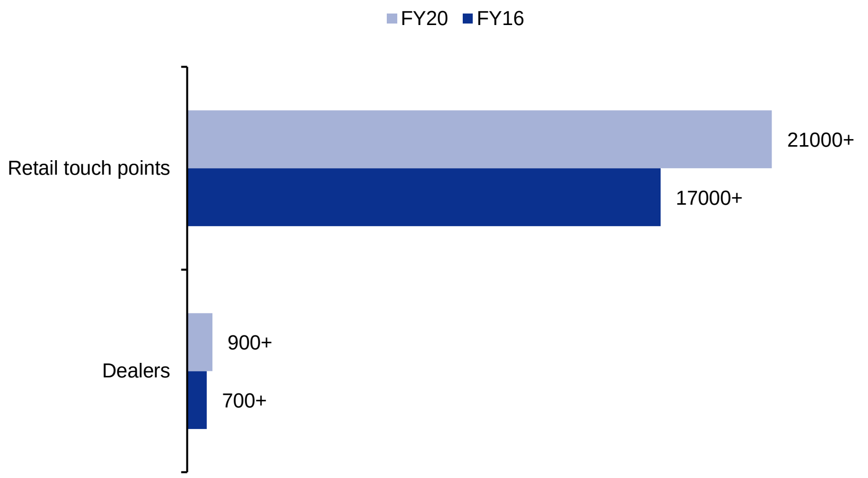
Finolex intends to widen its reach by increasing its trade channel reach in the North and East of India. West and South accounted for over 70% of Finolex's revenue in FY20. The company intends to add dealers and retail touchpoints over FY21-23F and gain market share in the non-agri pipe segment.

Advertising and promotion expenses averaged ~Rs450m/year over FY16-20 and accounted for 1.6% of net sales in FY20. We expect Finolex to step up ASP spends to build its brand presence in the housing and plumbing piping sectors going forward.

Figure 280: Finolex Industries' advertisements and promotion activities

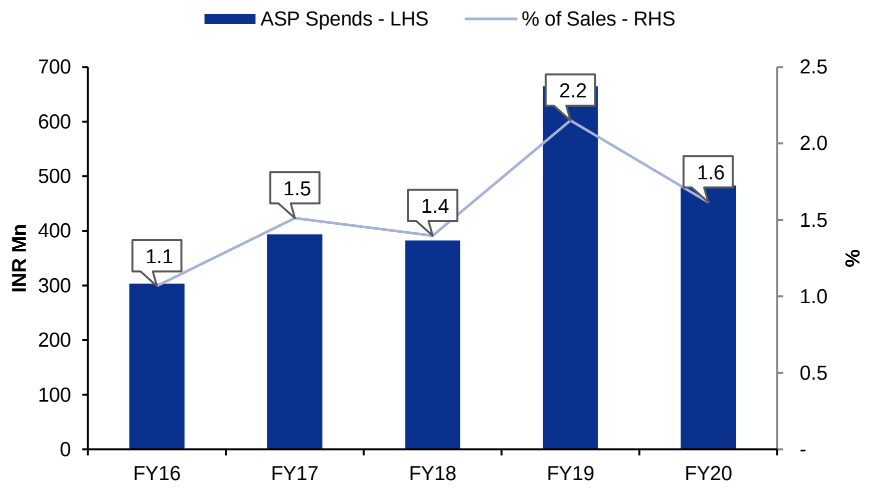
SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Figure 281: Dealer and distributor reach increasing gradually



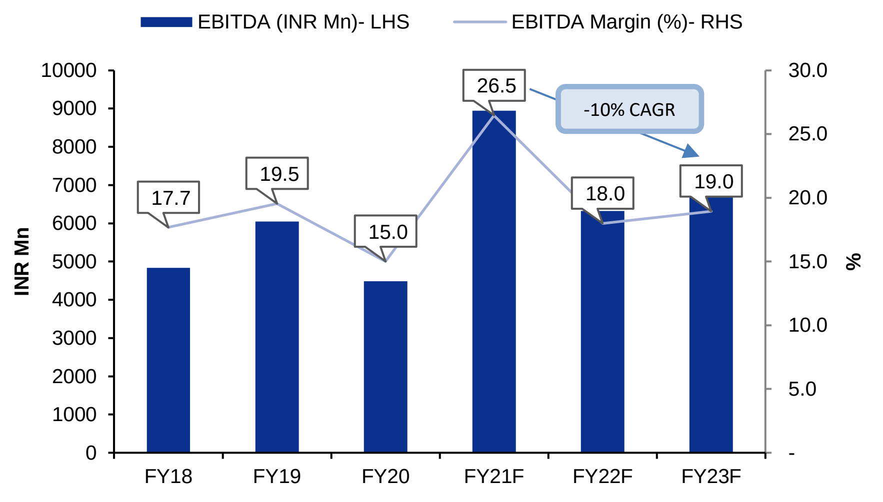
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 282: Finolex Industries' ASP trend



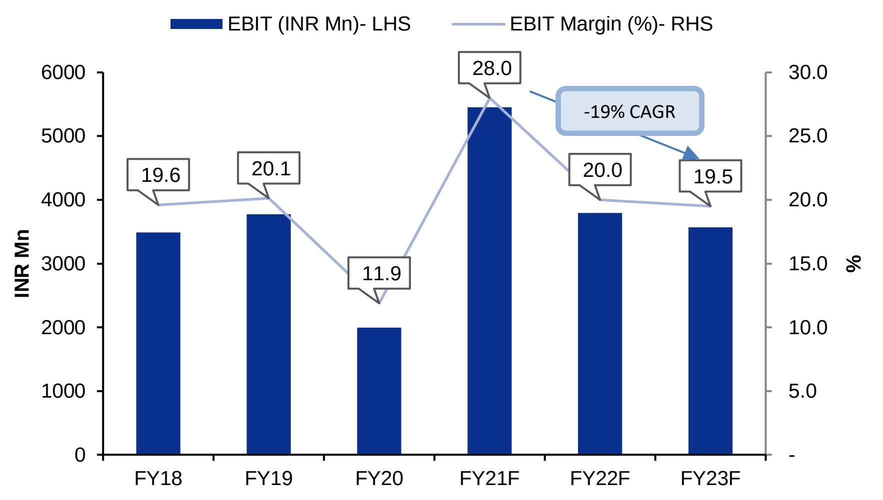
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 283: Finolex Industries' EBITDA and margin trend



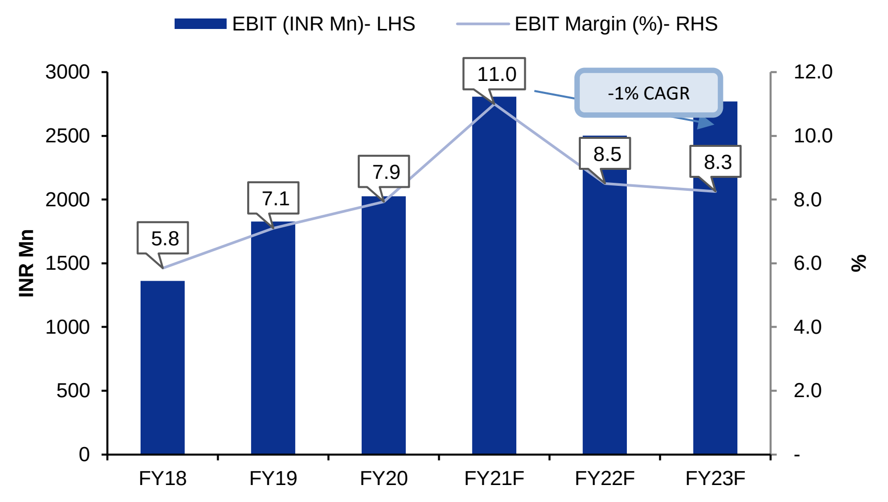
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 284: PVC resin (gross) EBITDA & margin trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 285: Pipes and fittings EBITDA and margin trend



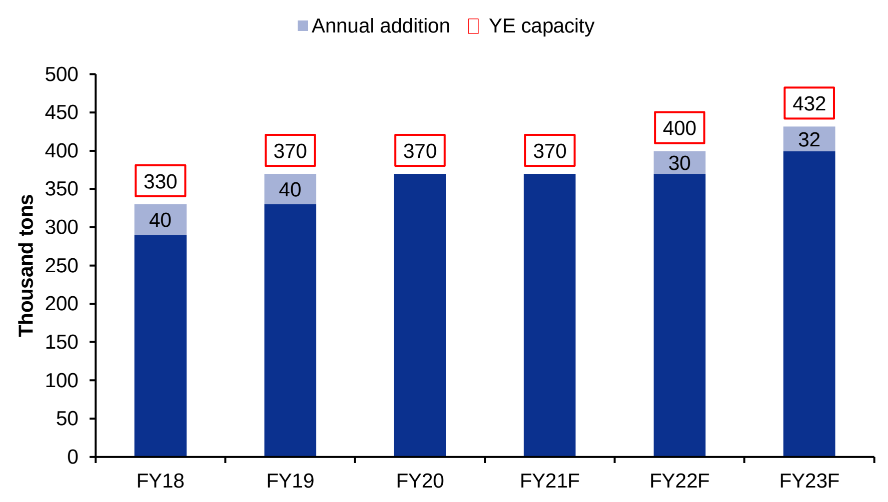
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Strong balance sheet, dividend payouts of 35-40% ›

All capex funded from internal accruals

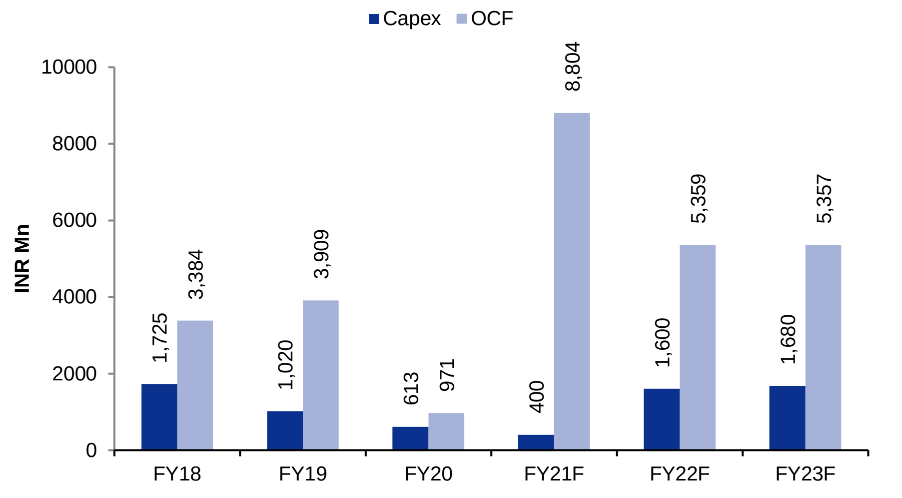
Finolex would add pipe manufacturing capacity in phases while only replacement capex would be incurred for resins. We expect ~60k tons of pipe capacity addition over FY21-23F and Finolex to reach a capacity of ~430k tons by Mar 2023F. Most of this capex will be internally funded and we expect net cash to reach ~Rs7.2bn by Mar 2023F.

Figure 286: Annual piping capacity



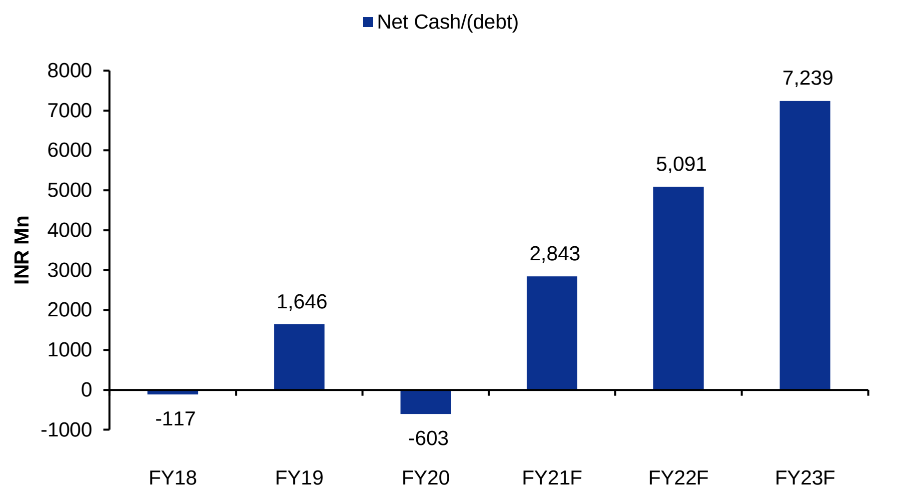
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 287: All capex to date; future capex will continue to be internally funded



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 288: Finolex Industries' net cash/(debt) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Net working capital cycle in line with peers ❯

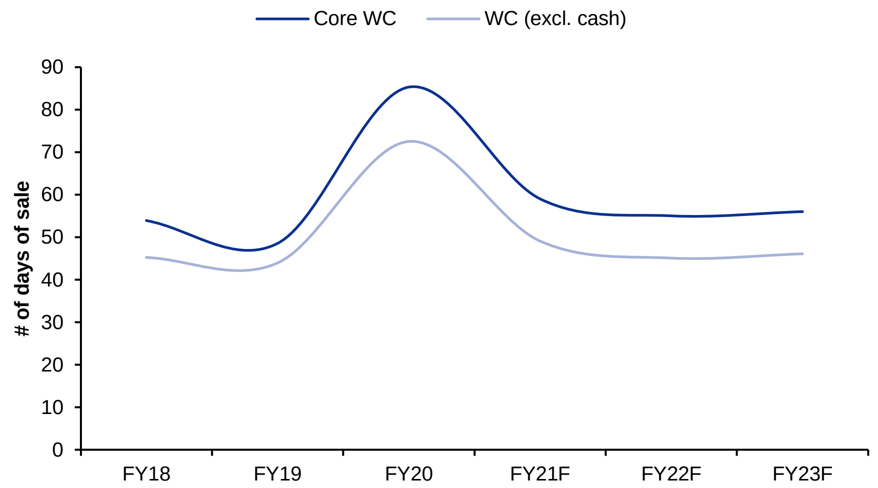
"Since last year we have been offering credit of 30 days on all non-agri products. Initially, we started with CPVC only, but then we extended credit to all non-agri products."

– Finolex Industries, 1QFY21 investor call

Net core working capital (inventory + debtors – creditors) was between 50 and 55 days of sales over FY18-20. We expect 45-50 days of cash-conversion cycle over FY21-23F. Finolex carries relatively higher inventory vs peers in the pipe manufacturing segment owing to in-house PVC resin manufacturing. The inventory days range between 70 and 80 days of sales vs 35-50 for peers. However, owing to its strong presence in the agri-pipe segment, the company functions on a zero-day credit policy and operates on cash-and-carry resulting in a best receivables cycle of ~6-10 days of sales vs peers' 25-40 days. We expect receivables to marginally rise to 9-11 days of sales over FY21-23F as the share of non-agri business grows going forward.

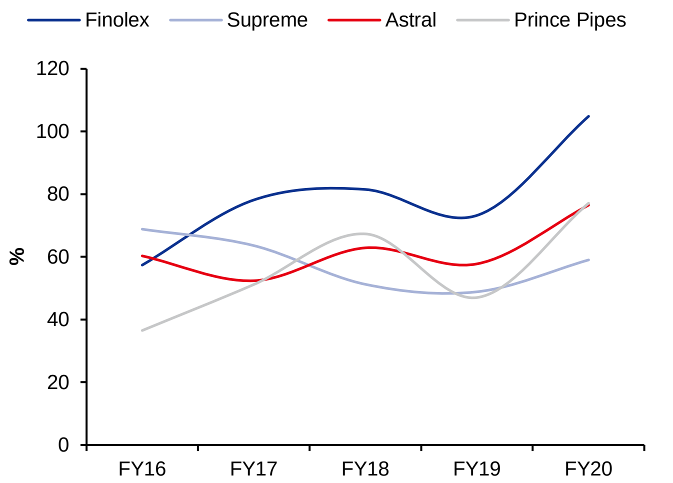
Given the focus on growing non-agri pipe revenue share, Finolex marginally relaxed its credit period to 30 days to create a meaningful presence in this highly competitive segment.

Figure 289: Core and net working capital cycle



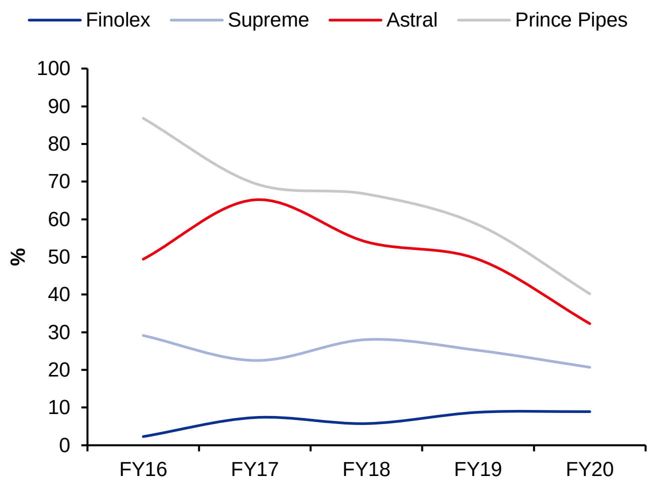
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 290: Finolex's inventory cycle among the longest…



SOURCES: INCRED RESEARCH, COMPANY REPORTS

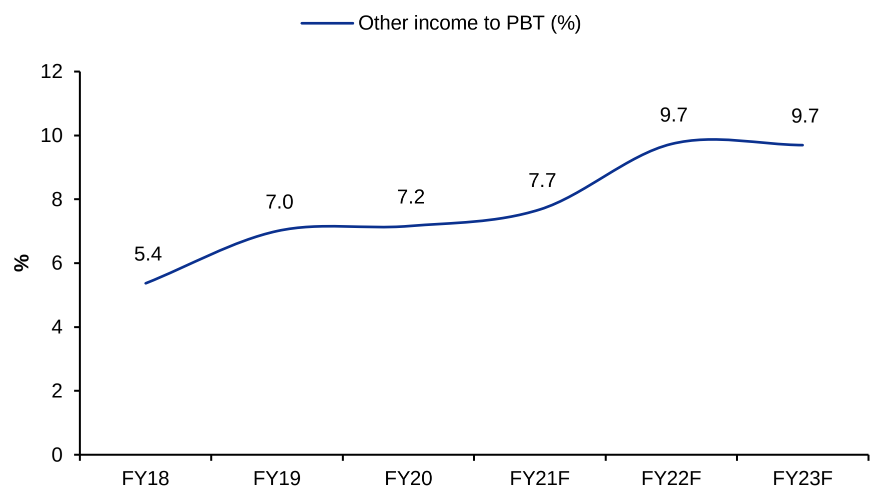
Figure 291: … and has shortest receivables cycle vs its peers



SOURCES: INCRED RESEARCH, COMPANY REPORTS

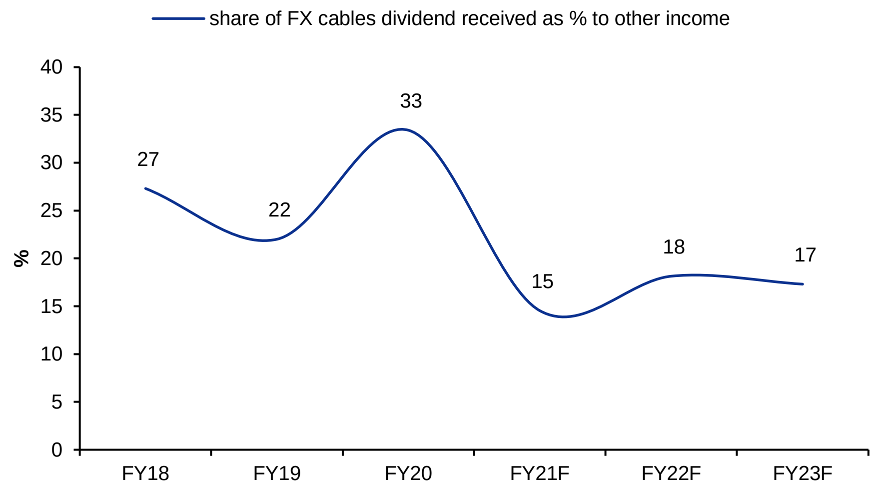
Significant jump in FCF over FY21-23F, marginal share of Finolex Cables dividends in overall treasury income ›

Figure 292: Other income as % to PBT



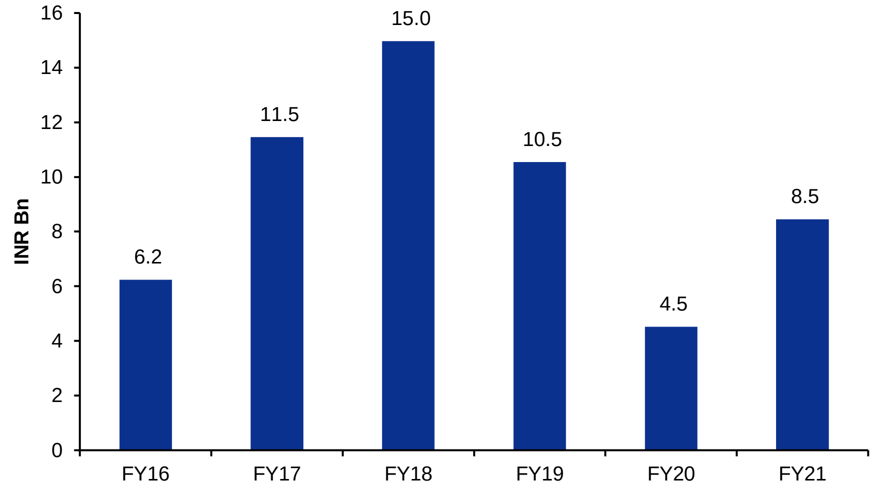
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 293: Dividend share in other income (14.5% equity stake in Finolex Cables)



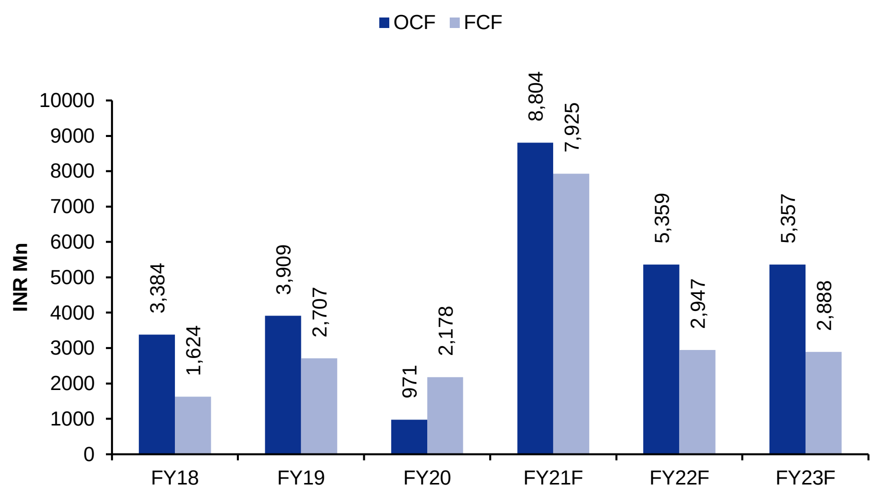
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 294: Market value of 14.5% stake in Finolex Cables (based on YE mcap)



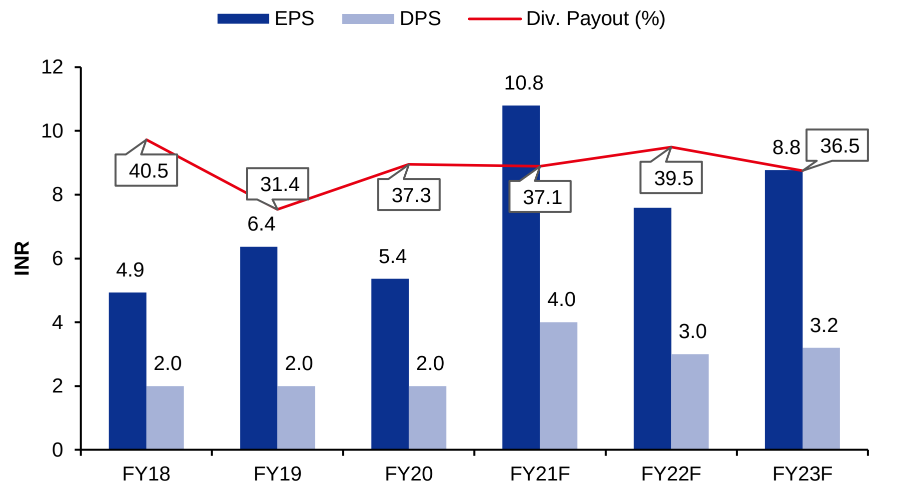
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 295: Finolex Industries OCF and FCF estimates



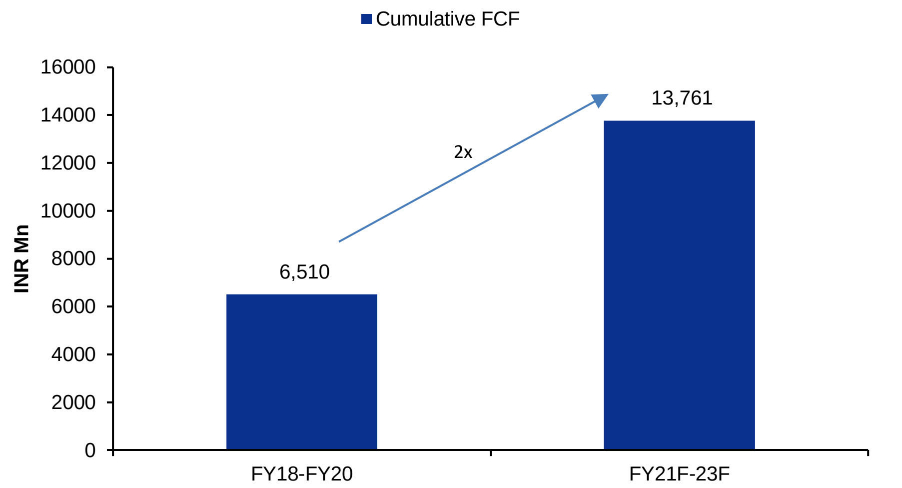
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 296: 30-40% of annual profits distributed as dividends every year



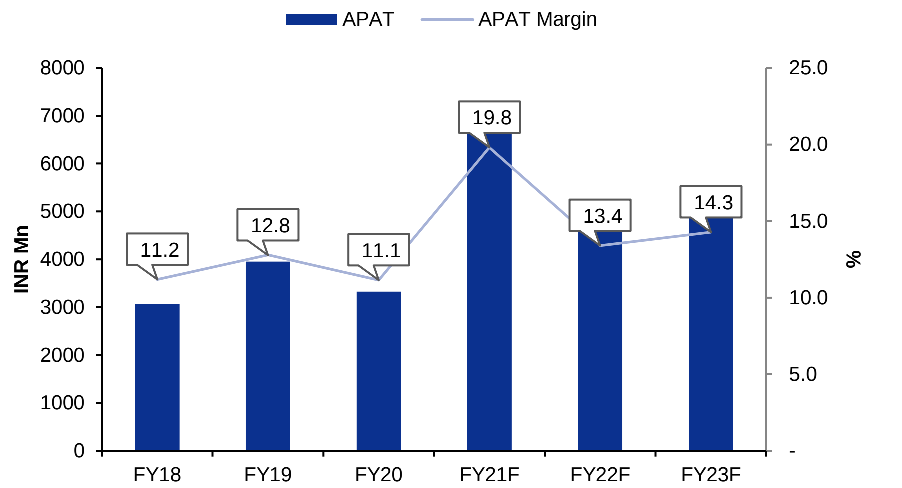
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 297: Significant jump in cumulative FCF over F21-23F



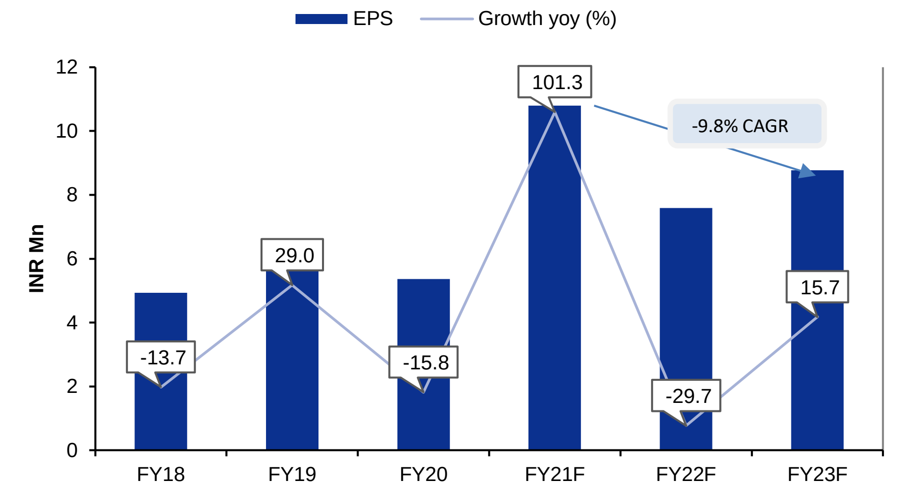
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 298: Healthy net profit margins



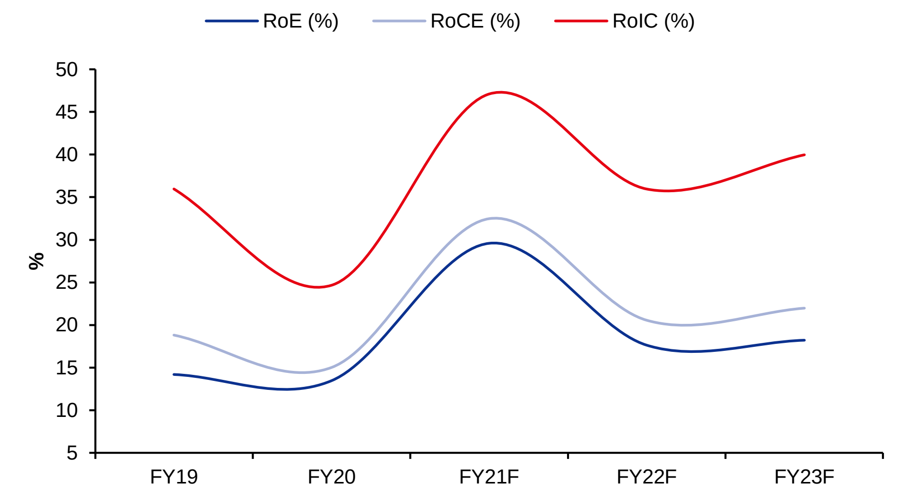
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 299: Volatile growth trends due to commodity price fluctuations



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 300: Return ratios (%)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Valuation and risks ›

Reasonably valued among sector peers ›

Finolex Industries' stock price CAGR rose 24.7% over the past ten years (Apr 2011 – Apr 2021)

Finolex Industries has a 40-year history and management has displayed reasonable discipline in maintaining industry leadership, business execution and capital allocation. If we look at the past ten years, the stock's price has compounded at 24.7%, while the EPS CAGR is ~17.4% over FY11-21F. The difference is the expansion in the P/E multiple (CAGR of 7.3%) that is a function of consistent performance delivery and evolving conviction in the long-term sustainability of the business, in our view.

Figure 301: P/E re-rating over the past ten years

	CAGR (%)
Stock price CAGR (Apr 2011- Apr 2021)	24.7
EPS CAGR (FY11-21)	17.4
P/E expansion	7.3

SOURCES: INCRED RESEARCH, COMPANY REPORTS

The Chhabria brothers filed legal suits (National Company Law Tribunal order dated 5 Dec 2018) against each other to claim ownership and management control of Finolex Cables. Finolex Industries owns a 14.5% equity stake in the family-controlled Finolex Cables as at Mar 2021.

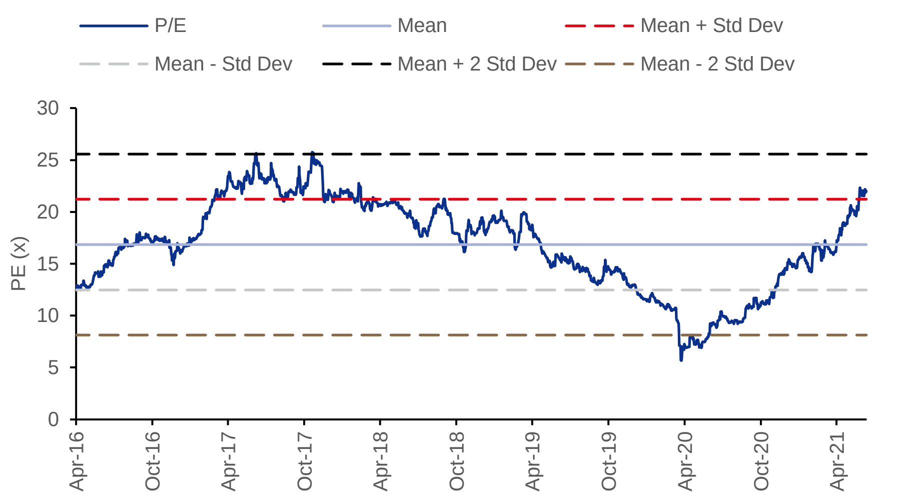
However, we note that there has not been any allegation by either party of any sort of misconduct in day-to-day business operations of Finolex Industries. We think the intrinsic business value should remain unaffected in case a decision on ownership favours either of the parties involved.

We focus on strong franchise value and profit growth

We think the Finolex brand has strong franchise value and high brand recall given the group's 70-year history in India. Even though we estimate decline in net profits over FY21-23F (mainly due to possibility of PVC prices cooling off during this period), we expect 2.5x jump in cumulative FCF during this period (Rs15.8bn) vs FY18-20 (Rs4.9bn). We believe the stock price would be primarily driven by cash flow growth and clarity on legal ownership of Finolex Group companies would incrementally help remove the overhang on the stock.

- The stock has rallied 56% since 1 Feb 2020. The rally has been driven by strong pent-up demand for plastic pipes and inventory gains boosting profits led by steep rise in PVC resin prices.
- We believe, the PVC resin demand-supply imbalance would normalise once COVID-19 infections subside globally and in India and might lead to correction in resin prices. This carries a risk of inventory losses in our view.
- Sharp short term stock rally, risk of inventory losses and the stock trading at +1SD to its past five-year mean P/E of ~17x imply limited upside potential from current levels.
- We initiate coverage with Hold rating and a TP of Rs180 based on P/E of ~20x FY23F EPS, a 20% premium to the historical five-year mean P/E of 17x.
- We apply a mid-range (20%) P/E premium to Finolex owing to a) decent management history of capital allocation, b) evolving non-agri pipe portfolio over the next three years, c) higher dependence on cyclical agriculture sector and, d) potential to deliver higher revenue/net profit growth than our estimates.

Figure 302: Finolex is trading near +1SD 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG

Figure 303: P/E band chart

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, BLOOMBERG

Downside risks ›

- **Commodity nature of the business:** Both PVC resins and pipes are commodity products and adverse PVC price fluctuations severely affect their business performances. Commodity businesses are cyclical and experience sharp volatility in net profits periodically. Business predictability remains low and, hence, these stocks command relatively lower valuation multiples than stable consumer discretionary stocks.
- **Continuous capex needs:** Pipe manufacturers need to continuously expand capacities and incur regular capex. Asset turns are well defined and incremental growth can be captured only by increasing production capacities**.** Delays in capacity expansion execution may lead to lower-than-estimated revenues and profits.
- **Adverse forex rates:** With no foreign exchange earnings, the company had an average foreign exchange outgo of ~Rs12bn per year over FY18-20. In the absence of natural hedges due to exports, adverse forex fluctuations could impact profitability.
- **Prolonged COVID-19:** Resurgence of COVID-19 infections in India could lead to intermittent lockdowns disrupting the normal course of business.

Finolex Industries had an average forex outgo of ~Rs12bn per year over FY18-20 with no cushion of forex earnings.

Upside risks ›

- **Prolonged high PVC prices:** Inventory gains leads to higher profits due to sharp rise in PVC prices for plastic pipe companies. Prolonged high PVC prices would lead to better-than-expected performance.
- **Faster pick-up in non-agri portfolio:** We expect gradual shift towards higher non-agri revenue share for Finolex. Better-than-expected execution on non-agri portfolio development would lead to higher-than-estimated margins.

SWOT analysis ›

Figure 304: SWOT analysis

Strengths
- Leadership in agriculture pipe applications
- Backward integration with inhouse resin manufacturing
- Strong brand equity

Weakness
- Evolving non-agri pipe portfolio
- Agri products earn relatively lower margins
- Regional revenue concentration

SWOT

Opportunities
- Gain market share in non-agri products
- Expand pan India distribution reach
- Further consolidate agri market share

Threats
- Exposed to agriculture sector vagaries
- Evenly spread steady rainy seasons
- Global export-import restrictions

SOURCES: INCRED RESEARCH

About Finolex Industries

Finolex Industries Ltd (formerly Finolex Pipes Ltd) was incorporated on 28 Mar 1981. The company offers a wide range of PVC pipes and fittings suitable for diverse applications in agriculture, plumbing, industrial and drainage systems. It is India's largest and only backward-integrated PVC pipes and fittings manufacturer with an annual production capacity of 370k tons p.a. of plastic pipes, and 270k tons of annual capacity for PVC resins. It was the first Indian PVC pipes manufacturer to be awarded the ISO 9001:2015 certification. The company has a network of over 21k retail outlets across India and is supported by more than 900 dealers as at Mar 2020.

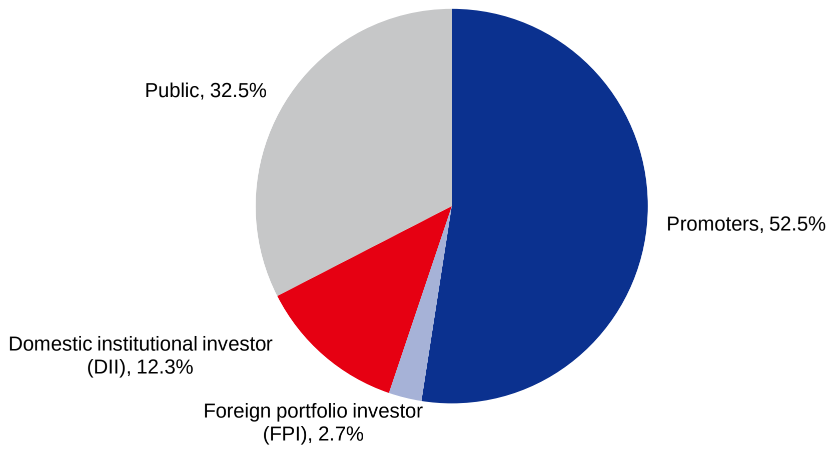
Its board of directors consists of six independent and four non-independent directors.

Figure 305: Key management profile

Name & Designation	Profile
Mr. Prakash P. Chhabria Executive Chairman	Mr. Chhabria is a well-known industrialist and is the Executive Chairman of the company. He has been a whole-time director since Mar 1992. He has a B.Sc. in International Business from the University of Evansville, USA, and has completed the Advanced Management Program from Wharton Business School, USA.
Mr. Sanjay S. Math Managing Director	Mr. Math has been the Managing Director of the company since 1 Dec 2016. Mr. Math is a B.E. (Chemicals), UDCT, and has a Post Graduate Diploma in Management, Mumbai. He is a member of the American Institute of Chemical Engineering. He has rich working experience in various projects and petrochemical plant operations. He has worked in well-known organisations like NOCIL, Bombay Dyeing, Rama Petrochemicals, Saudi Yanbu Petrochemicals, and Essar Refinery.
Mr. Anil Whabi Director - Finance & CFO	Mr. Whabi is Director (Finance) and CFO of the company. He has been a whole-time director of the company since 26 Aug 2016. Mr. Whabi is a chartered accountant, from the Institute of Chartered Accountants of India, and has worked with various companies in finance and accounts.

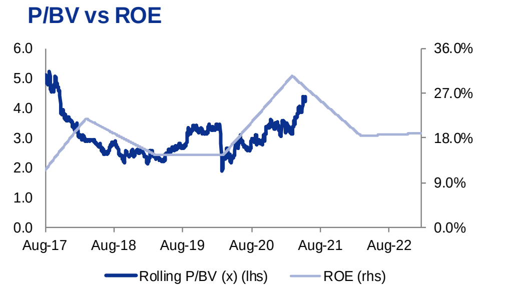
SOURCES: INCRED RESEARCH, COMPANY REPORTS

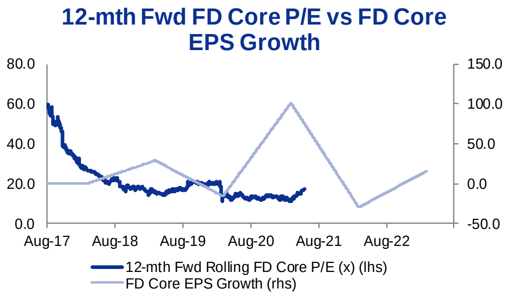
Figure 306: Shareholding pattern (as at Mar 2021)



SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS





Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**30,913**	**29,860**	**33,805**	**35,125**	**38,161**
Gross Profit	**11,704**	**10,433**	**14,266**	**12,821**	**14,253**
Operating EBITDA	**6,043**	**4,481**	**8,941**	**6,322**	**7,231**
Depreciation And Amortisation	(701)	(738)	(798)	(795)	(848)
Operating EBIT	**5,342**	**3,743**	**8,143**	**5,527**	**6,383**
Financial Income/(Expense)	50	63	208	350	456
Pretax Income/(Loss) from Assoc.	140	256	198	212	227
Non-Operating Income/(Expense)	231	118	400	200	210
Profit Before Tax (pre-EI)	**5,763**	**4,178**	**8,949**	**6,289**	**7,276**
Exceptional Items					
Pre-tax Profit	**5,763**	**4,178**	**8,949**	**6,289**	**7,276**
Taxation	(1,812)	(852)	(2,252)	(1,583)	(1,831)
Exceptional Income - post-tax					
Profit After Tax	**3,951**	**3,327**	**6,697**	**4,707**	**5,445**
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**3,951**	**3,327**	**6,697**	**4,707**	**5,445**
Recurring Net Profit	3,951	3,327	6,697	4,707	5,445
Fully Diluted Recurring Net Profit	**3,951**	**3,327**	**6,697**	**4,707**	**5,445**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	6,043	4,481	8,941	6,322	7,231
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(81)	(2,681)	1,517	207	(480)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	(192)	348	806	762	893
Net Interest (Paid)/Received	(92)	(48)	(208)	(350)	(456)
Tax Paid	(1,770)	(1,128)	(2,252)	(1,583)	(1,831)
Cashflow From Operations	**3,909**	**971**	**8,804**	**5,359**	**5,357**
Capex	(1,020)	(613)	(400)	(1,600)	(1,680)
Disposals Of FAs/subsidiaries	1	10			
Acq. Of Subsidiaries/investments	(1,437)	1,034	(2,684)		
Other Investing Cashflow	178	158	287	412	495
Cash Flow From Investing	**(2,278)**	**590**	**(2,797)**	**(1,188)**	**(1,185)**
Debt Raised/(repaid)	(112)	1,932	(400)	(750)	(750)
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid	(1,452)	(2,873)	(2,482)	(1,861)	(1,986)
Preferred Dividends					
Other Financing Cashflow	(71)	(111)	(79)	(62)	(39)
Cash Flow From Financing	**(1,634)**	**(1,052)**	**(2,961)**	**(2,673)**	**(2,775)**
Total Cash Generated	(3)	508	3,046	1,498	1,398
Free Cashflow To Equity	**1,519**	**3,492**	**5,607**	**3,421**	**3,423**
Free Cashflow To Firm	**1,556**	**1,460**	**5,928**	**4,109**	**4,134**

SOURCES: EIP RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet					
(Rs mn)	**Mar-19A**	**Mar-20A**	**Mar-21F**	**Mar-22F**	**Mar-23F**
Total Cash And Equivalents	2,541	2,223	5,270	6,767	8,166
Total Debtors	743	732	834	962	1,150
Inventories	6,205	8,578	6,946	7,217	7,841
Total Other Current Assets	1,025	710	936	973	1,057
Total Current Assets	**10,514**	**12,243**	**13,986**	**15,920**	**18,214**
Fixed Assets	9,509	10,169	9,743	10,548	11,380
Total Investments	11,359	5,316	8,000	8,000	8,000
Intangible Assets					
Total Other Non-Current Assets	1,935	1,186	1,080	1,080	1,080
Total Non-current Assets	**22,803**	**16,670**	**18,823**	**19,628**	**20,460**
Short-term Debt	895	2,827	2,427	1,677	927
Current Portion of Long-Term Debt					
Total Creditors	2,838	2,334	2,315	2,887	3,137
Other Current Liabilities	1,411	1,753	1,852	1,925	2,091
Total Current Liabilities	**5,144**	**6,914**	**6,594**	**6,488**	**6,154**
Total Long-term Debt					
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	786	783	783	783	783
Total Non-current Liabilities	**786**	**783**	**783**	**783**	**783**
Total Provisions	1,625	1,357	1,357	1,357	1,357
Total Liabilities	**7,555**	**9,053**	**8,734**	**8,628**	**8,294**
Shareholders Equity	25,762	19,860	24,075	26,920	30,379
Minority Interests					
Total Equity	**25,762**	**19,860**	**24,075**	**26,920**	**30,379**

Key Ratios					
	Mar-19A	**Mar-20A**	**Mar-21F**	**Mar-22F**	**Mar-23F**
Revenue Growth	12.9%	(3.4%)	13.2%	3.9%	8.6%
Operating EBITDA Growth	24.9%	(25.9%)	99.6%	(29.3%)	14.4%
Operating EBITDA Margin	19.5%	15.0%	26.4%	18.0%	19.0%
Net Cash Per Share (Rs)	2.65	(0.97)	4.58	8.20	11.67
BVPS (Rs)	41.52	32.01	38.80	43.39	48.96
Gross Interest Cover	43.54	31.42	103.34	89.80	163.45
Effective Tax Rate	31.4%	20.4%	25.2%	25.2%	25.2%
Net Dividend Payout Ratio	26.0%	35.8%	27.7%	29.6%	27.3%
Accounts Receivables Days	6.93	9.01	8.45	9.33	10.10
Inventory Days	117.05	138.87	145.00	115.89	114.95
Accounts Payables Days	50.76	48.59	43.43	42.57	45.98
ROIC (%)	36.0%	24.7%	47.1%	36.0%	40.0%
ROCE (%)	18.8%	15.0%	32.5%	20.5%	22.0%
Return On Average Assets	16.7%	13.2%	28.3%	17.4%	18.4%

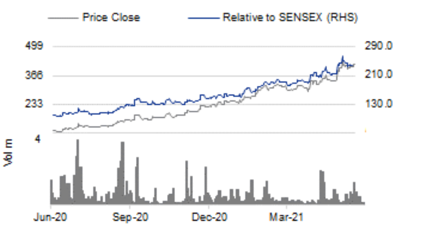
SOURCES: EIP RESEARCH, COMPANY REPORTS

India

ADD *(Initiating coverage)*

Consensus ratings*:	Buy 18 Hold 1 Sell 0
Current price:	Rs419
Target price:	Rs469
Previous target:	NA
Up/downside:	11.9%
Incred Research / Consensus:	28.2%
Reuters:	CNTP.NS
Bloomberg:	CPBI IN
Market cap:	US$1,274m
	Rs93,090m
Average daily turnover:	US$1.7m
	Rs121.1m
Current shares o/s:	222.2m
Free float:	27.0%

*Source: Bloomberg



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	22.9	30.9	290.1
Relative (%)	14.2	26.7	151.1

Major shareholders	% held
Promoters	73.1
DSP Equity & Bond Fund	3.1
Kotak Debt Hybrid Fund	2.8

Century Plyboards

Out of the woods

- Early signs of demand recovery visible for traditional, new-age wood panels.
- Improving sales mix, cost efficiency and operating leverage to drive margins.
- Re-investing cash flows for growth. We initiate coverage on Century Plyboards with Add rating and TP of Rs469.

Bright outlook led by market share gains and broad-based recovery

Market share shift in favor of large-organised players was visible across companies in our building materials coverage accelerated by the COVID-19 pandemic. Smaller fringe players are not able to compete in a COVID-19-led disruptive and GST-led compliant business world. Wood panel companies saw volume growth recovery across plywood, laminates, medium density fiber (MDF) and particle board (PB) segments during 2HFY21. Macro-economic recovery coupled with internal company initiatives promise a bright growth outlook over the next two to three years. Optimum utilisation of existing capacities and large new capex announcements drive confidence. We estimate revenue CAGR of 17.7% led by MDF revenue CAGR of 34.5% over FY21-23F. Plywood/laminates revenue CAGR is estimated at 14.3%/15.6% respectively.

Higher margins led by better sales mix, cost savings and leverage

MDF/PB demand-supply balance improved over 2019/20. MDF/PB earn relatively higher EBITDA margins (20-25%) than plywood/laminates (12-18%) and the rising utilisation of existing/new capacities would lead to higher blended margins, in our view. Century has appointed Boston Consulting Group (BCG) to execute a cost savings programme. Improving sales mix, focus on cost leadership and recovering volumes throughput would result in operating leverage benefits. We estimate EBITDA CAGR of 23.7% and margins to rise by 163bp (218bp over FY20-23F) to 17.5% over FY21-23F.

Operating cash flows to be re-invested to create new capacity

We estimate cumulative operating cash flow (OCF) of Rs9.3bn to be entirely utilised to create new MDF capacities and replacement/balancing capex over FY21-23F. Century has announced a Rs2bn brownfield expansion and is actively pursuing a greenfield facility (~Rs4bn-4.5bn) for MDF. These capacities would be ready in 12-24 months. We expect ~Rs2bn rise in debt and lower dividend payouts of ~5%. RoE/RoCE is estimated at 18.8%/22.2% in FY23F. We expect EPS CAGR of 22.9% over FY21-23F.

Track record and longevity make us bullish, initiate with Add rating

Superior execution track record and investing in future technologies drive our confidence in the business. The stock trades at P/E of 30.2x and EV/EBITDA of 18.5x FY23F estimates. We initiate coverage with an Add rating and TP of Rs469 based on P/E of ~34x FY23F EPS, a ~30% premium to its past five-year mean P/E. Downside risks: Steep rise in raw material prices, delayed capex execution, capex cost overruns and prolonged COVID-19 pandemic.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	22,638	22,827	21,135	24,623	29,301
Operating EBITDA (Rsm)	3,004	3,497	3,354	3,891	5,128
Net Profit (Rsm)	1,588	1,582	1,921	2,394	3,081
Core EPS (Rs)	7.1	8.7	9.0	10.8	13.9
Core EPS Growth	11.4%	21.2%	4.3%	19.3%	28.7%
FD Core P/E (x)	58.64	58.86	48.47	38.88	30.22
DPS (Rs)	1.0	1.0	0.0	0.5	0.5
Dividend Yield	0.29%	0.29%	0.00%	0.12%	0.12%
EV/EBITDA (x)	32.48	27.19	27.49	24.16	18.47
P/FCFE (x)	129.77	118.58	1,181.10	180.43	166.31
Net Gearing	46.0%	18.6%	(7.1%)	6.1%	9.1%
P/BV (x)	9.61	8.67	7.36	6.23	5.20
ROE	17.6%	18.8%	17.2%	17.4%	18.8%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)			1.04	0.87	0.94

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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Out of the woods

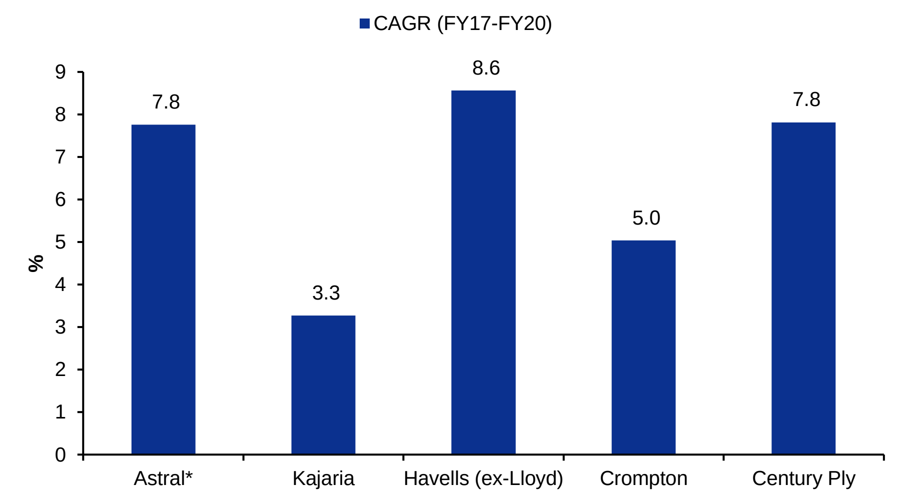
Visible recovery in wood panel product demand

Traditional and new trends coupled with COVID-19 led boost

"We have not seen this kind of demand scenario after 2012. After 8 years we are now witnessing a scenario where it is difficult to meet demand."
– Cera Sanitaryware, 3 Feb 2021 investor call

Consumer discretionary product demand has been very weak since 2016-17. Demand recovery green shoots were visible during the unlocking of consumer markets over Jun 2020-Feb 2021, post the COVID-19 national lockdown in Mar-May 2020. Higher home improvement spends during this period implied savings on vacation/lifestyle had been redirected.

Figure 307: Single-digit revenue CAGR for consumer discretionary businesses



*PLASTIC PRODUCT SEGMENT REVENUE CONSIDERED FOR ASTRAL
SOURCES: INCRED RESEARCH, COMPANY REPORTS

We highlight a few demand drivers that drive demand for discretionary products in India in general and especially for wood panel products.

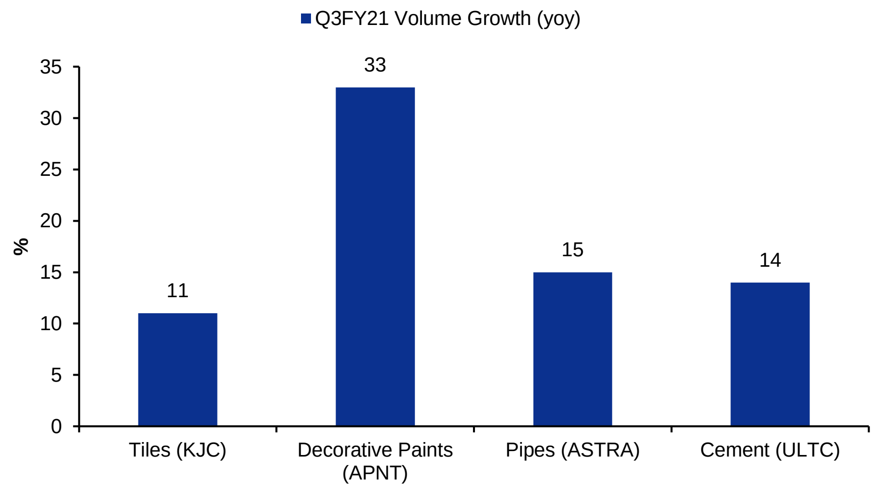
- **Urbanisation:** We expect India to lead the world urban population surge due to rising migration from rural India to urban areas in search of jobs and better quality of life. Urbanisation accelerates the consumption of value-added plywood varieties.
- **Rising per capita income:** Rise in per capita income leads to higher discretionary spending, home pride and demand for superior interior infrastructure products.
- **Changing lifestyles:** Increase in disposable incomes is leading to improved lifestyles, growing brand consciousness and higher discretionary spending. Shifting consumption from conventional to customised and branded interior infrastructure products boosts demand.
- **Nuclear families:** Independent lifestyle and incrementally smaller urban family size drive demand for urban apartments.
- **Growing middle class:** Middle-class households are nearly expected to more than double to 300m by 2030 from 158m in 2018 (Source: Tata Consumer Annual Report 2020).
- **Rural market:** Almost 66% of India's population resided in rural areas in FY2019-20 (Source: World Bank). This represents a large underpenetrated market offering potential sustained consumption growth.
- **Higher home improvement spends:** Vacation/lifestyle spend budgets were not spent during the COVID-19 lockdowns, driving higher home improvement spends since Jun 2020.
- **Urban housing recovery:** The urban real estate market saw demand recovery during the unlock period since Jun 2020 due to factors like a) lowest

"I think this is just the start. We will definitely be delivering on double-digit plus growth for the foreseeable future. We are very bullish on the future, but as I said before, we are committing to double-digit plus growth, but definitely, the aspiration would be to do higher numbers".
– Keshav Bhajanka, Executive Director, Century Plyboard, 3QFY21 earnings call

historical home loan rates; b) monies saved during the lockdowns; c) Central/state government support by way of incentives to boost sale transactions and thereby sector liquidity.

- **Rising share of readymade furniture:** The growing presence of organised retail players in India, led by global majors such as Ikea and indigenous omnichannel brands like Pepperfry and Urban Ladder, is driving customer preference for factory-made furniture.

Figure 308: Strong volume growth recovery post COVID-19 lockdown

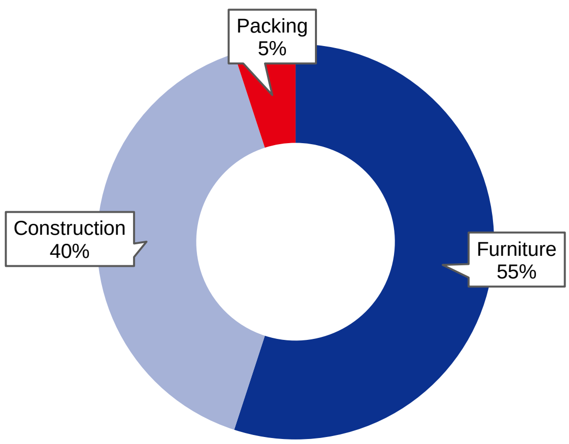


KJC = KAJARIA CERAMICS, APNT = ASIAN PAINTS, ASTRA = ASTRAL, ULTC = ULTRATECH
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Overview of the wood panel industry

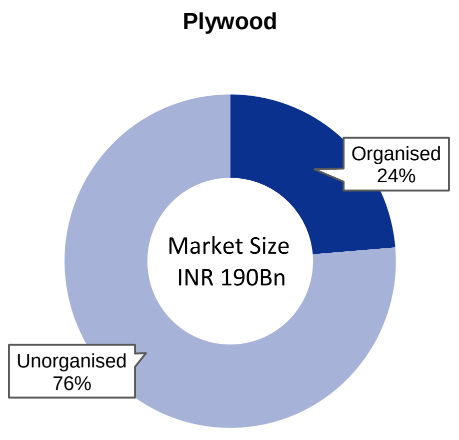
Furniture accounts for 55% of the overall wood panel consumption globally.

Figure 309: Global wood-based panel market share by application (%, 2019)



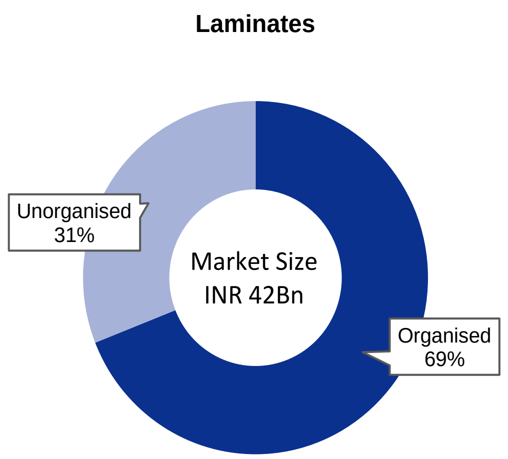
SOURCES: INCRED RESEARCH, GREENLAM ANNUAL REPORT 2020

Figure 310: Indian plywood market structure (FY20)



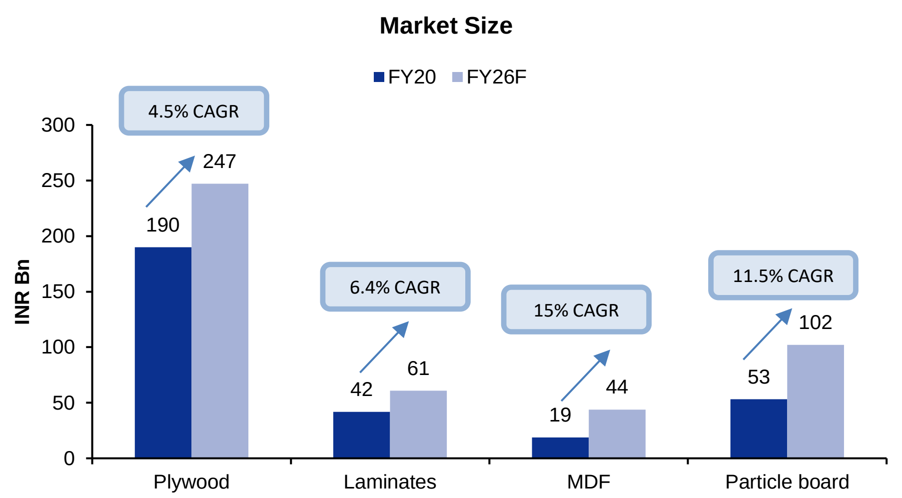
SOURCES: INCRED RESEARCH, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSGIL DÉCOR), GRANDVIEW RESEARCH, MORDOR INTELLIGENCE

Figure 311: Indian laminates market structure (FY20)



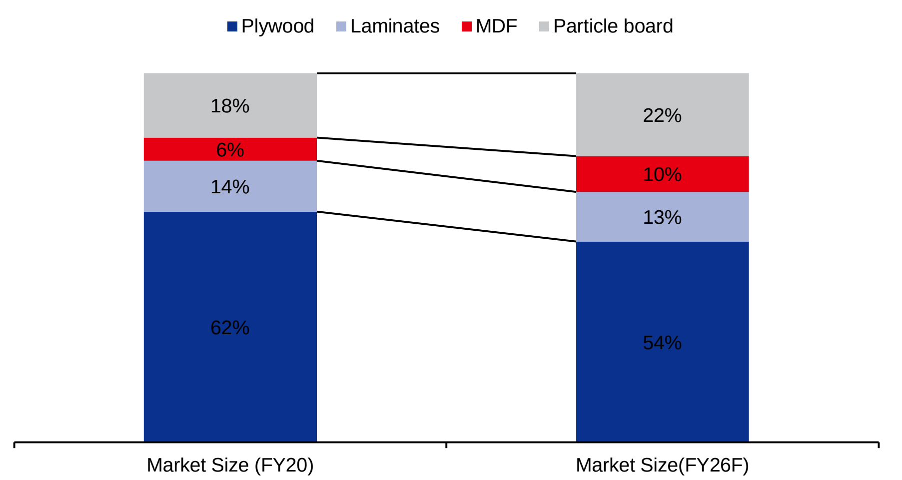
SOURCES: INCRED RESEARCH, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSGIL DÉCOR), GRANDVIEW RESEARCH, MORDOR INTELLIGENCE

Figure 312: MDF and PB are the fastest-growing segments in the Indian wood panel industry



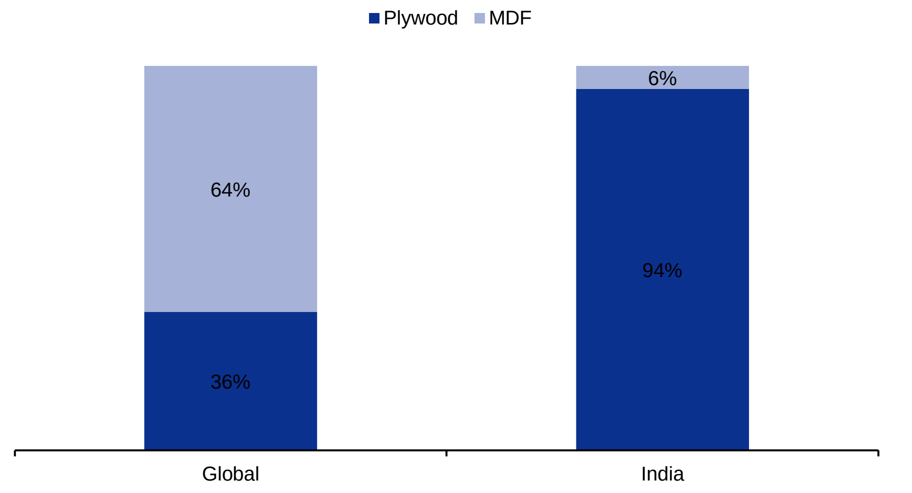
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSHIL DÉCOR), GRANDVIEW RESEARCH, MORDOR INTELLIGENCE,

Figure 313: Share of MDF & PB in India's overall wood panel industry expected to rise



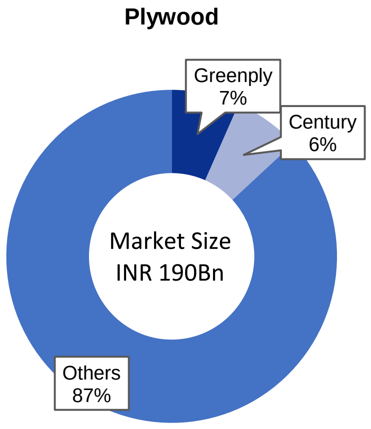
SOURCES: INCRED RESEARCH, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSGIL DÉCOR), GRANDVIEW RESEARCH, MORDOR INTELLIGENCE,

Figure 314: Wide difference in ply and MDF market shares in India and the world (2019)



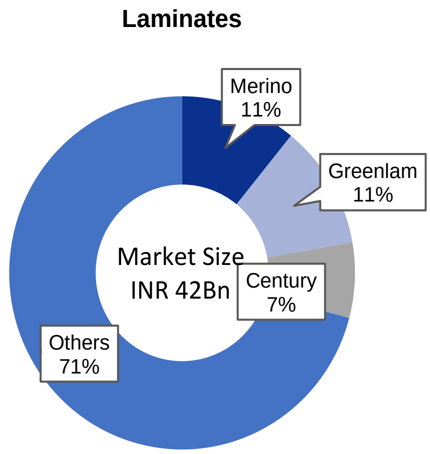
SOURCES: INCRED RESEARCH, PLY REPORTER

Figure 315: India's competitive plywood landscape (FY20)



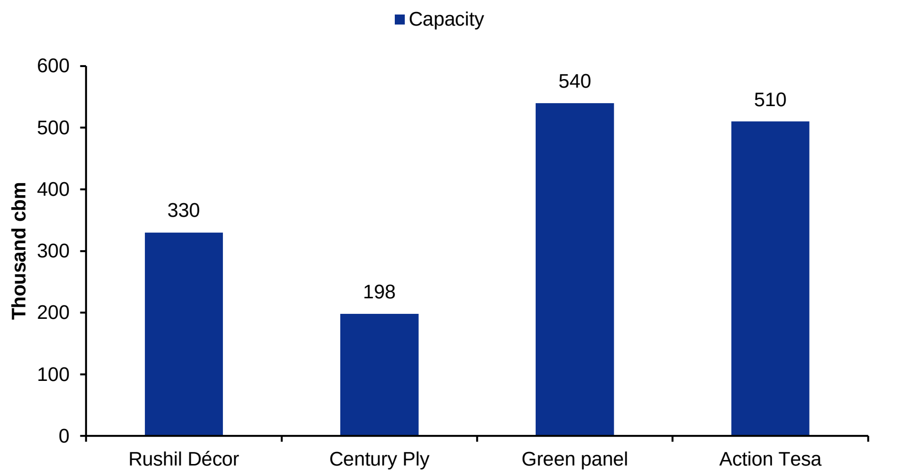
SOURCES: INCRED RESEARCH, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSGIL DÉCOR), GRANDVIEW RESEARCH, MORDOR INTELLIGENCE

Figure 316: India's competitive laminates landscape (FY20)



SOURCES: INCRED RESEARCH, COMPANY REPORTS (GREENPLY GREENLAM GREENPANEL AND RUSGIL DÉCOR), MERINO ANNUAL REPORT FY20

Figure 317: MDF's competitive landscape in India



ESTIMATED RATED CAPACITY AS OF MARCH 2020
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

"Presently, our plants are unable to meet the demand. So, we are very bullish on the demand right now for at least, I can say, the next seven to eight months."
– Century Plyboards, 3QFY21 earnings call

Improving demand-supply balance well supported by government's anti-import levies

In its investor earnings calls corporate management has been highlighting the improving demand-supply scenario for plywood and MDF segments.

In the past, demand had slowed due to poor economic growth coinciding with the Goods and Services Tax (GST) implementation in 2017. The GST pre-implementation phase was marked by key players facing the dilemma of whether to destock in anticipation of the probable tax implication. The GST Council took a more holistic view of the panel products to be treated as necessity than luxury, reducing the applicable GST rate from 28% to 18% in November 2017.

The unorganised sector, which had significant cost advantages over the organised sector, discovered that as a result of tax revision, its price advantage dropped to a mere ~20% (pre-GST: 40%). Following the rate revision, large companies have passed cost benefits to consumers, strengthening offtake and accelerating the shift from unorganised products to credible organised brands.

"Reduced prices in the market have lowered the realisation and profitability in the MDF segment. The average price realisation compared to last year was down by 10% yoy."
– Century Plyboards, 4QFY19 earnings call

MDF pricing pressure and oversupply situation has stabilised

Changing customer preferences towards factory-made furniture, entry of global furniture retailers like IKEA and growing presence of omni-channel players like Pepperfry/Urban Ladder attracted large companies to invest into MDF capacity creation over the past five years. Owing to slowing economic growth and bunching-up of new MDF capacities in 2017/18, MDF oversupply impacted pricing and capacity utilisations across India. Century Ply commissioned its 600cbm/day MDF plant at Hoshiarpur, Punjab, in Nov 2017.

Over time, these capacities have now stabilised (depreciated rupee helped reduce imports) and demand has caught up with supply. As of Mar 2021, India is estimated to have operational MDF capacity of >4500cbm/day with nearly 1500cbm/day of new capacity to commence production in CY21 as per Century.

"In 2Q, yoy growth in MDF is over 20%. Our vision to take the MDF route for growth is proving right."
– Century Plyboards, 2QFY21 earnings call

Excerpts from the Greenpanel Industries 3QFY21 call on MDF demand

"One, we are taking market share away from the cheap plywood segment, which has been significantly impacted by COVID. Many of them have shut down or are operating at reduced capacities. The second part is possibly people are diverting to readymade furniture primarily because they are reluctant to allow carpenters and contractors into their houses to do their furniture with plywood. The third part is, I would say, the constraints which we are facing in exports, namely, non-availability of containers and ships are also impacting imports. And the fourth part is… India is now becoming a hub for furniture exports to US and Europe. So, that has helped to generate demand for MDF." – V. Venkataramani, CFO.

Government playing its part by discouraging imports

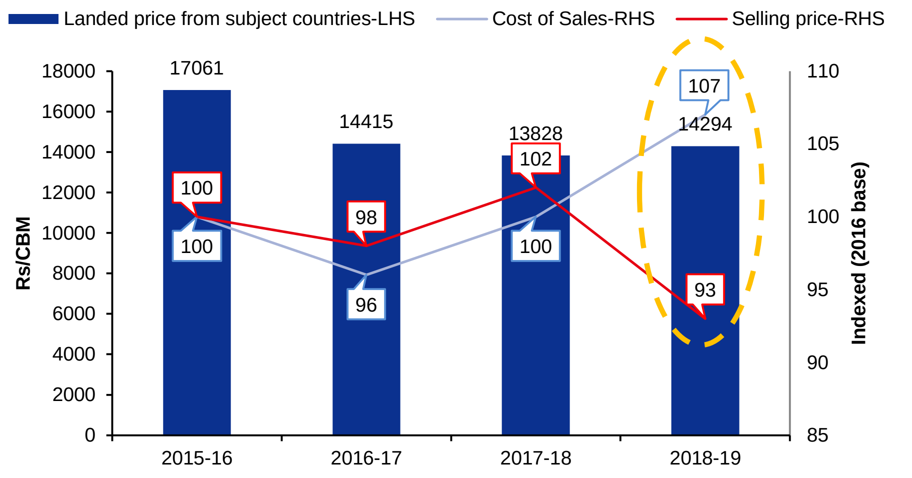
The Indian government has levied anti-dumping duties (ADD) on thin and thick MDF imports from countries like Malaysia, Thailand, etc. In addition to ADD, the Directorate General of Trade Remedies (DGTR) in May 2021 recommended countervailing duty (CVD) on imports of MDF originating in or exported from Malaysia, Thailand, Indonesia, Vietnam and Sri Lanka for five years.

Figure 318: Rising imports from subject countries

Import Volume (cbm)	FY16	FY17	FY18	FY19
Indonesia	47051	37905	35953	36343
Malaysia	23869	46049	53447	73707
Sri Lanka	23263	17247	20590	13854
Thailand	38764	27208	70922	48352
Vietnam	46859	90622	163287	123216
Imports from subject countries	179806	219031	344199	295472
Imports from other countries	40015	38584	40055	35855
Total import volume	219821	257615	384254	331327
% imports from subject countries	81.8	85.0	89.6	89.2

SUBJECT COUNTRIES MEAN INDONESIA, MALAYSIA, SRI LANKA, THAILAND AND VIETNAM, SOURCES: INCRED RESEARCH, DIRECTORATE GENERAL OF TRADE REMEDIES, DEPARTMENT OF COMMERCE, NEW DELHI

Figure 319: Selling price of MDF declined over FY16 to FY19, while the cost increased over the same period, led by dumping from subject countries



SUBJECT COUNTRIES MEAN INDONESIA, MALAYSIA, SRI LANKA, THAILAND AND VIETNAM, SOURCES: INCRED RESEARCH, DIRECTORATE GENERAL OF TRADE REMEDIES, DEPARTMENT OF COMMERCE, NEW DELHI

"I think there are two reasons for the plywood performance. One is pent-up demand, which I think is proving true for most of the industries. The second one, which is much more important and probably long-lasting for us, is ViroKill technology and its media popularisation."

Century Plyboards – 2QFY21 earnings call

Industry well supported by plywood recovery

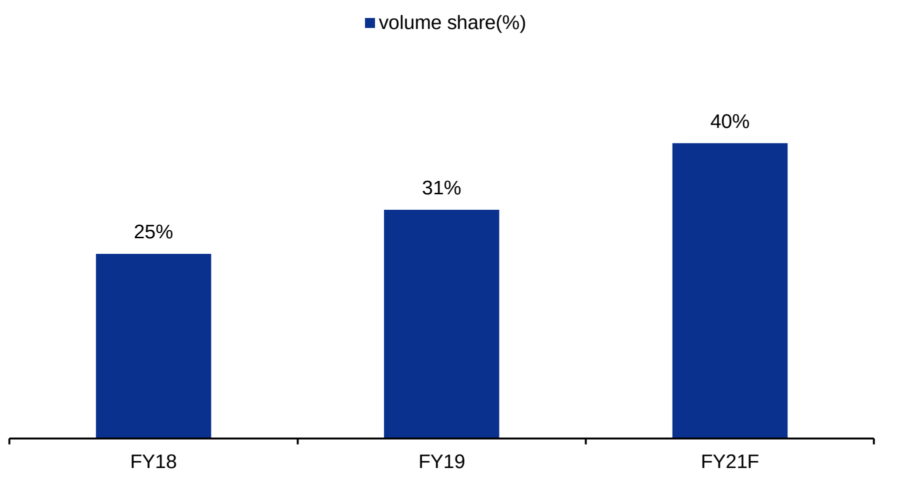
Excerpts from corporate earnings call highlighting plywood demand bounceback

Century Plyboards (2QFY21 earnings call) – "Our earlier estimates were to achieve back to normal or near to normal performance in the last quarter of FY21, but the force and robustness of the Indian economy has really pushed the performance of most industries to near normal in the month of September itself. Plywood sales are doing better and this trend has done even better in October. We again expect our economy to perform very strongly for the next two to three years at least. Even the real estate sector is showing signs of recovery".

Strategic focus on mass-premium product segment

Century launched Sainik in the mass-premium plywood segment, which mainly sells to tier-2 and -3 markets. Over time Sainik's sales volume share has increased, driven by both B2B and B2C demand traction. Sainik branded plywood accounted for 30% and 40% of total revenues and volumes respectively in FY21.

Figure 320: Sainik's share in overall plywood volumes

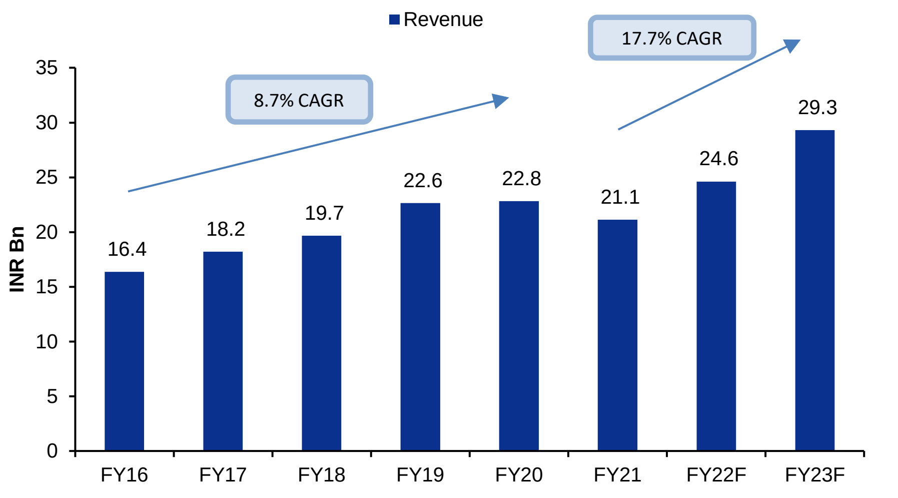


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Combination of factors leading to balanced revenue growth›

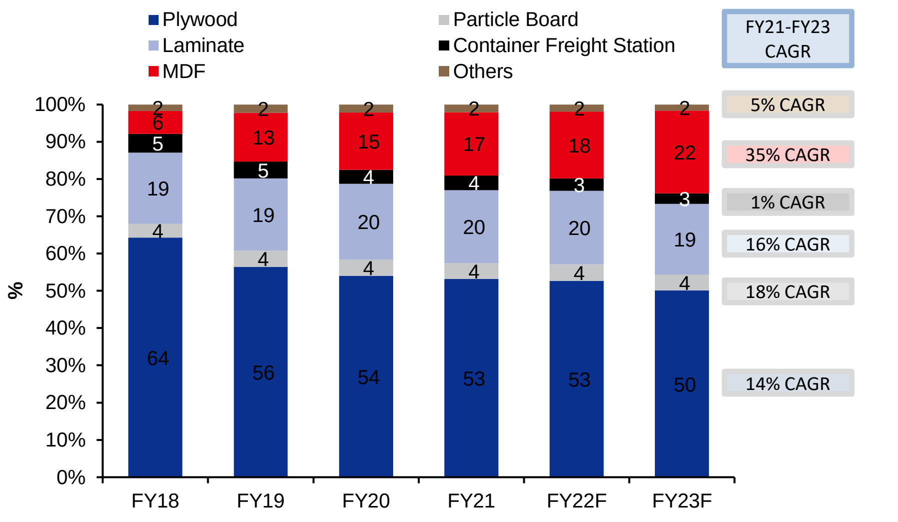
Recovery seen in all three major revenue segments of plywood, laminates and MDF over FY21-23F.

Figure 321: Century Plyboards' revenue trend



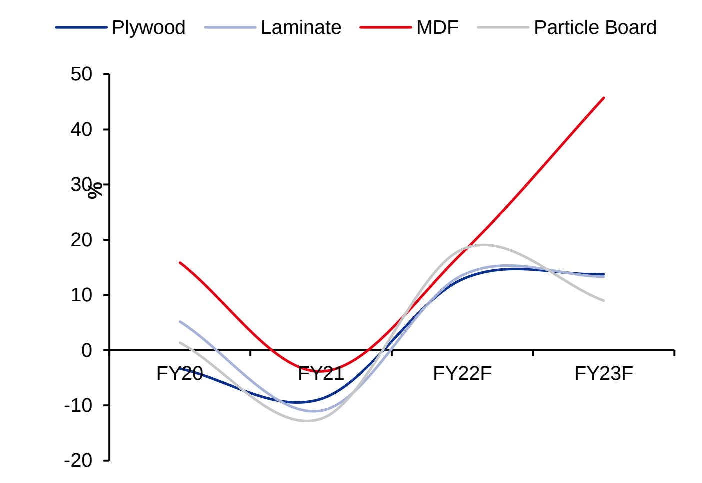
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 322: Century Plyboards' segmental revenue share trend



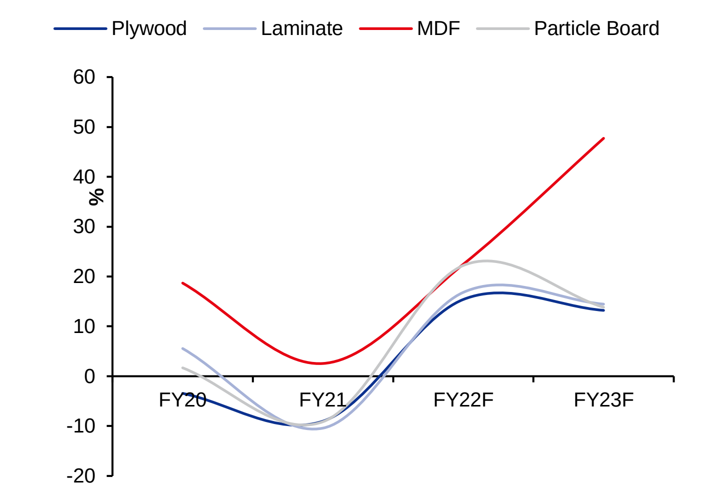
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 323: Century Plyboards' segmental volume growth



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 324: Century Plyboards' segmental revenue growth



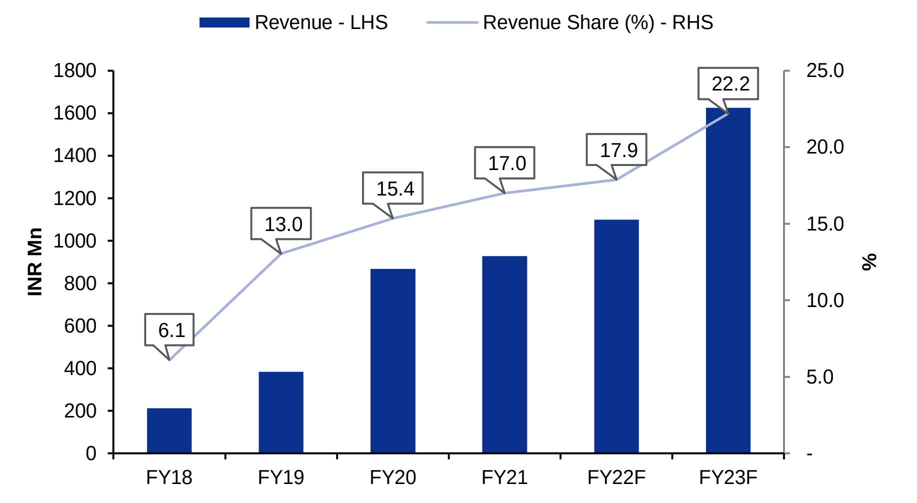
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Improving sales mix, higher volumes and stability in product prices to drive Century's margin growth

MDF and PB earn higher gross and EBITDA margins ›

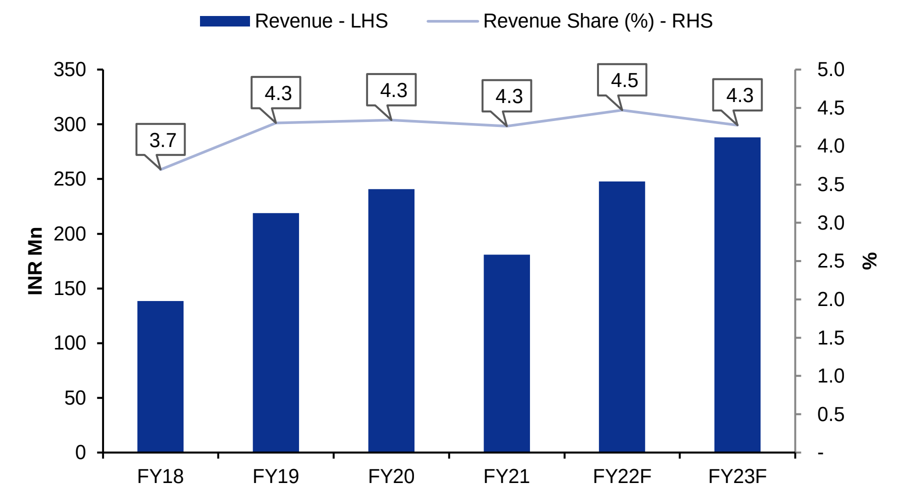
Higher MDF revenue share and overall cost-savings initiatives will improve operating margins going forward.

Figure 325: Century Plyboards' MDF revenue share trend



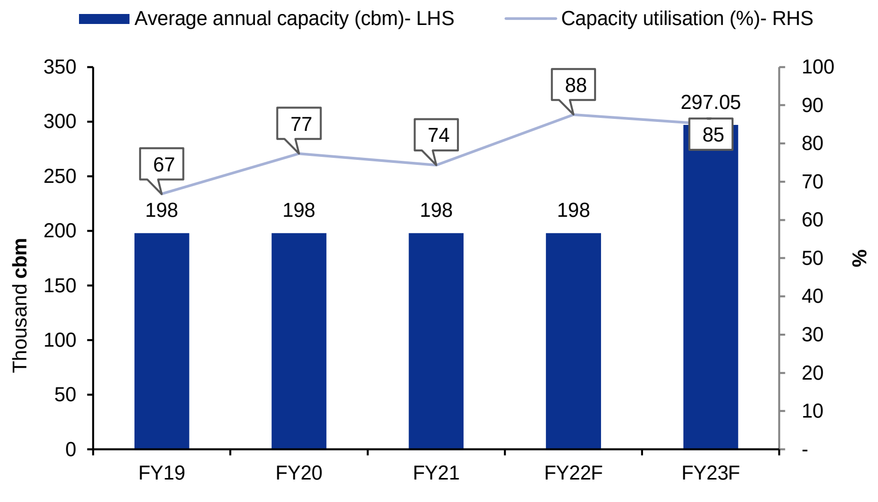
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 326: Century Plyboards' particle board revenue share trend



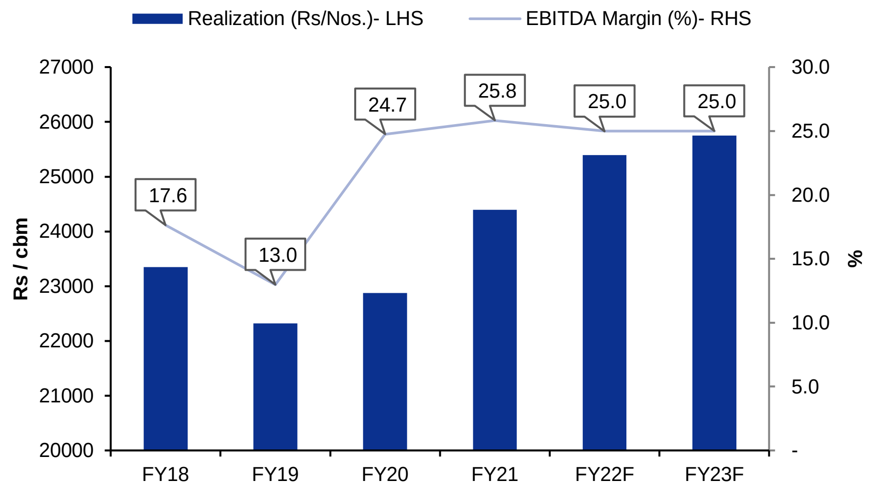
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 327: Century Plyboards' MDF average annual capacity and utilisation



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 328: Century Plyboards' MDF realisation and EBITDA margin trend

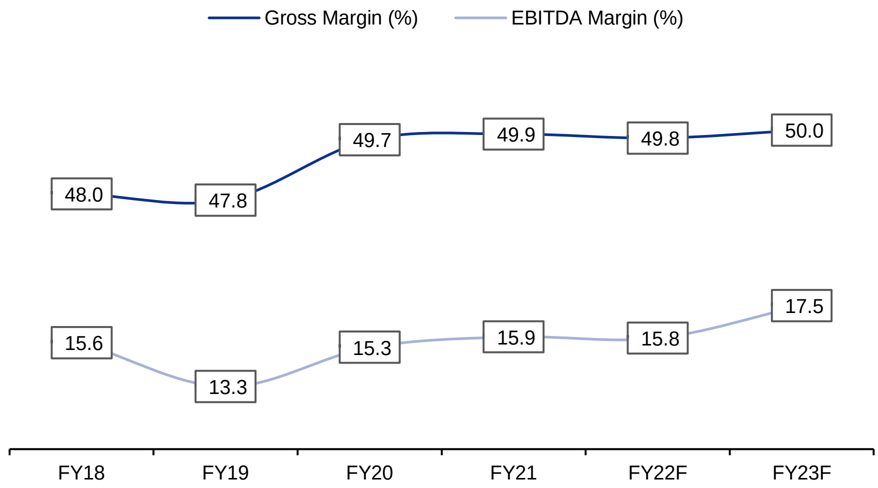


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Steady gross and EBITDA margins across segments ›

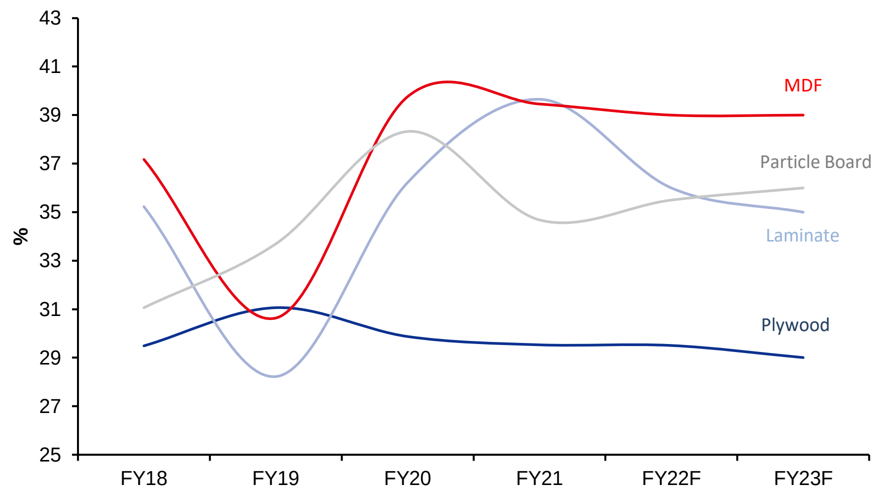
MDF and PB earn higher EBITDA margins than plywood/laminates.

Figure 329: Century Plyboards' gross and EBITDA margin trend



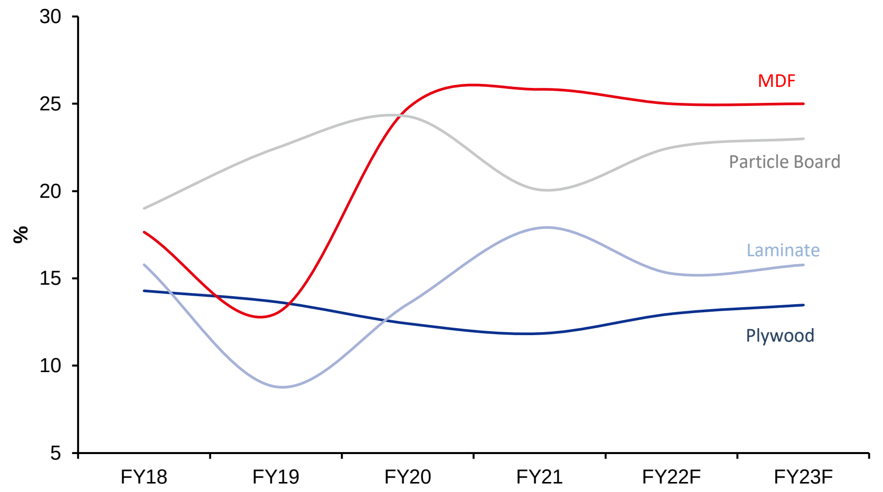
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 330: Century Plyboards' segmental gross margin trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 331: Century Plyboards' segmental EBITDA margin trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Sharp cut in ad spends and discretionary costs in FY21

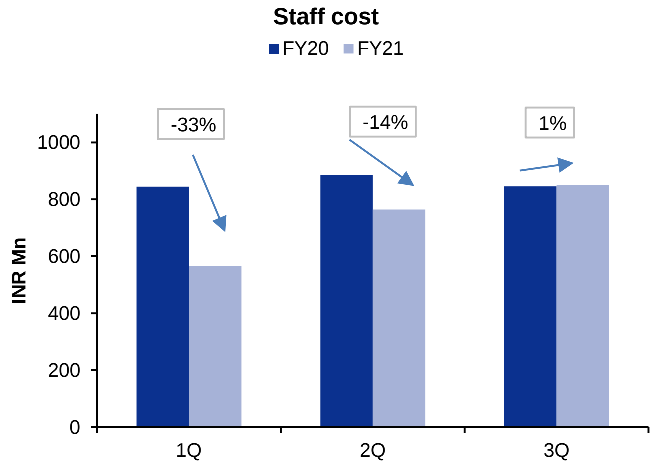
"There have been cost-cutting initiatives that we have taken aggressively over the course of the lockdown."

– Century Plyboard, 3QFY21 earnings call

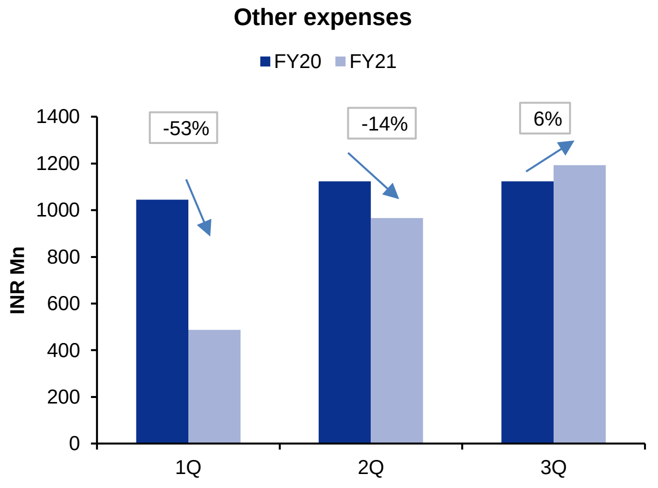
Century Plyboards took price hikes across products during FY21, while discretionary expenses had strict control mechanisms. This resulted in exceptional EBITDA margins of 16.5-18.5% over July 2020-Mar 2021. Century hiked prices on average by ~2% in the whole panel division. Its MDF division saw a 10% hike, while the particle board product prices hike was 8-10%.

Century has been investing in new product launches that contributed to the revival of demand. Some of its latest product developments are highlighted below, along with competitive advertising promotions.

Figure 332: Strict cost control over discretionary spends in 9MFY21 led by COVID-19

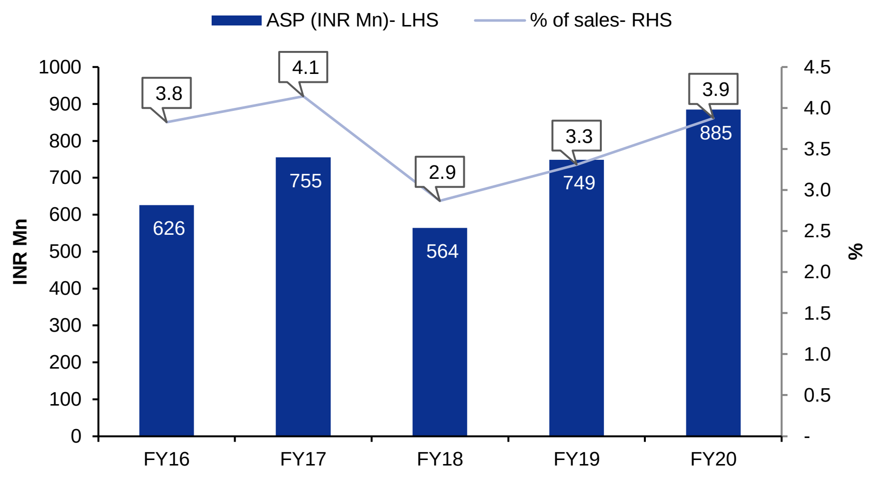


SOURCES: INCRED RESEARCH, COMPANY REPORTS



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 333: Century Plyboards' ASP trend



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 334: Century Plyboards' advertisements

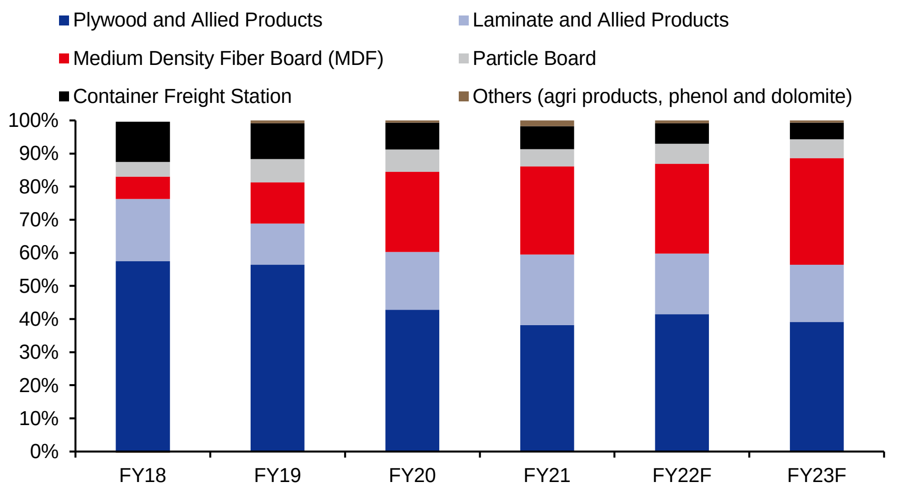
SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Figure 335: Advertisements by competitors

SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

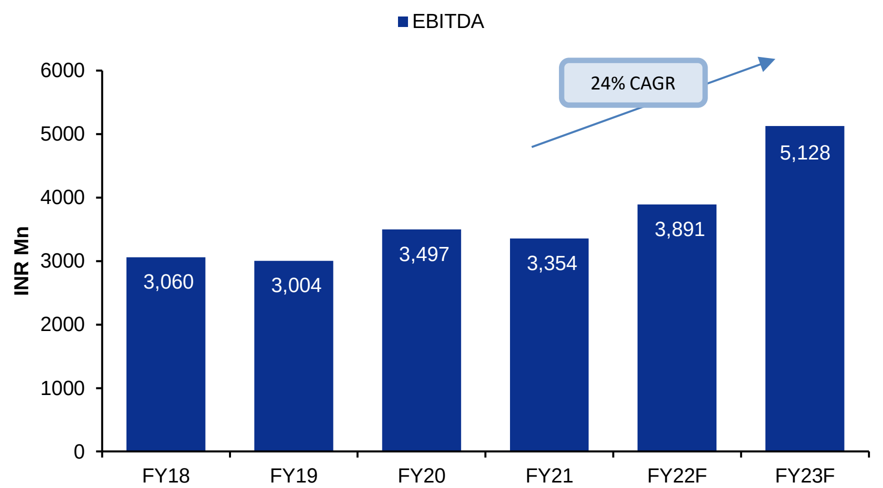
EBITDA CAGR of 23.7% over FY21-23F driven by topline growth and margin improvements ❯

Figure 336: Century Plyboards' segmental EBITDA share



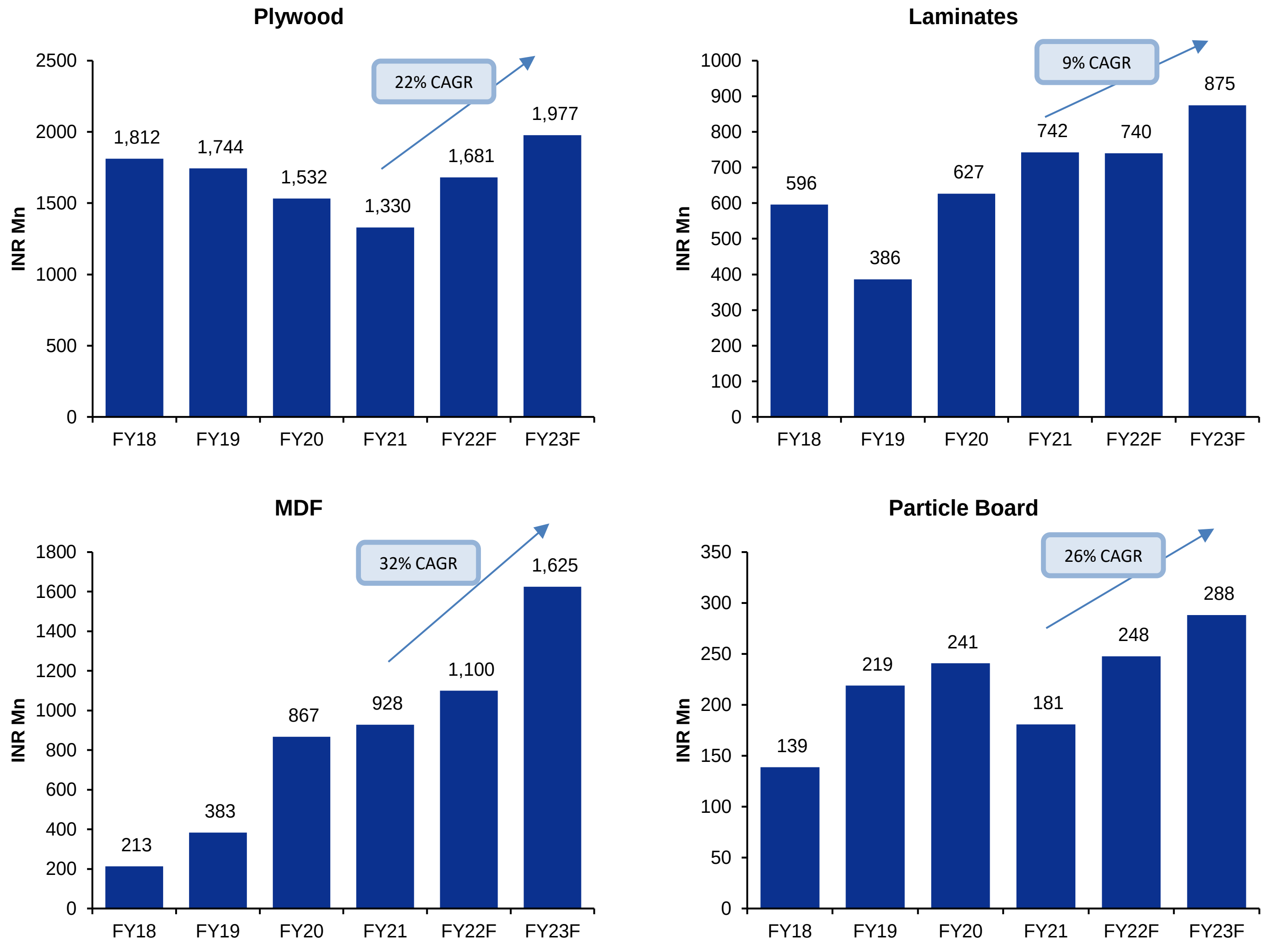
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 337: Century Plyboards' EBITDA trend



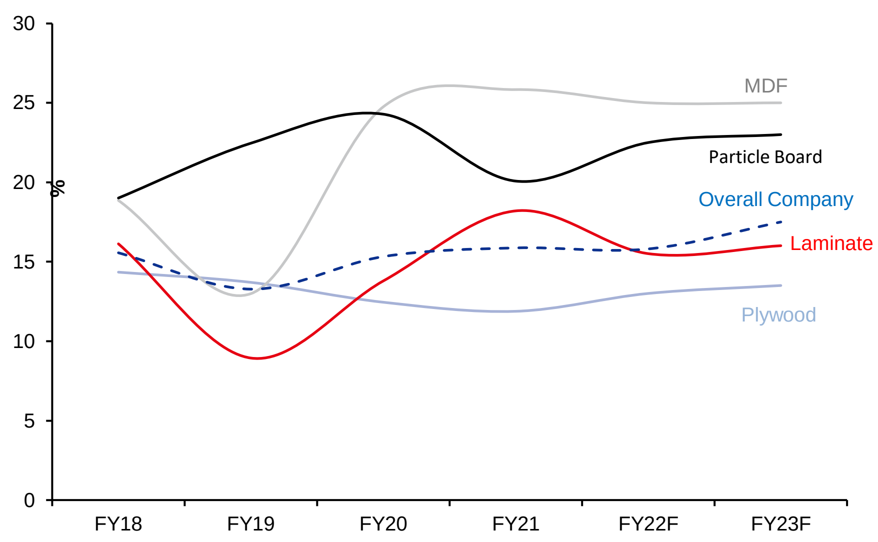
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 338: Segmental EBITDA trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 339: Segmental and company level EBITDA margin trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

MDF expansion upto ~3x of capacity, return ratios to improve on the back of higher capacity utilisation

Substantial MDF capex and production timelines

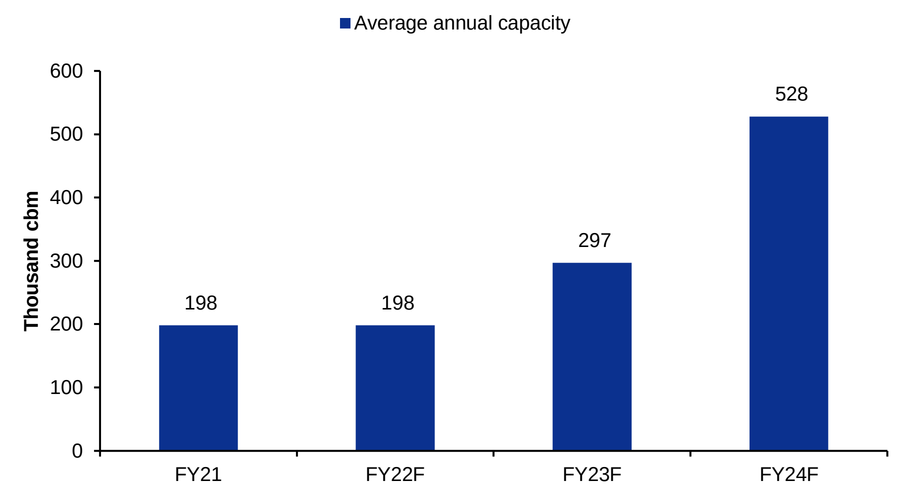
"I am happy to announce the company has taken the decision to expand the Hoshiarpur MDF facility by adding another line with additional capacity of 400cbm per day and involving a capex of around Rs2bn. The plant will take less than a year to commence commercial production. Apart from this, the company is also considering additional MDF facility in different geographies."
– Century Plyboard, 3QFY21 earnings call

Given the stable pricing and balanced demand-supply environment for MDF in India, Century is undertaking a brownfield expansion of 400cbm/day at its existing unit in Punjab. It expects the expansion to complete and commence production by June 2022 and will take the total MDF manufacturing capacity to 1000 cbm/day.

As per Century Ply, it is actively pursuing a greenfield MDF plant in South India that would have an indicative capacity of 600 cbm/day entailing capex of ~Rs4-4.5bn.

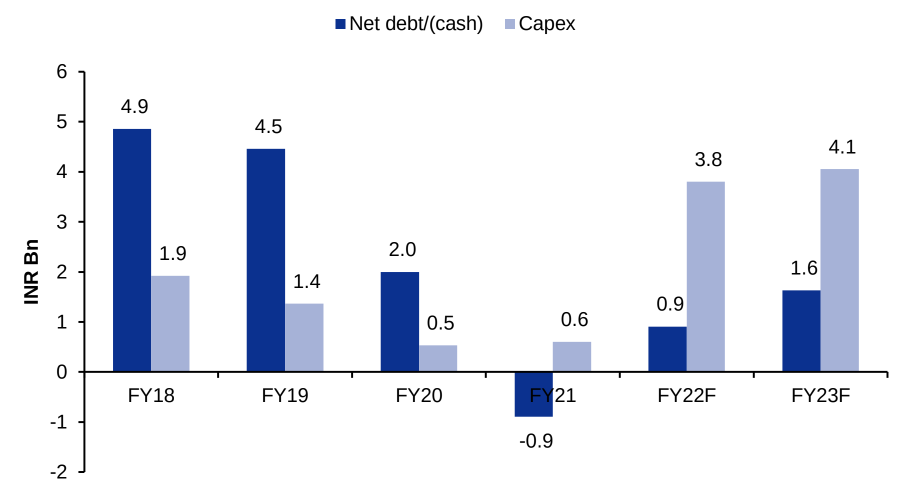
We estimate capex of ~Rs7.9bn over FY22-23F and expect ~Rs2bn of incremental debt drawdown during this period.

Figure 340: MDF average annual capacity available for production over FY21-24F



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

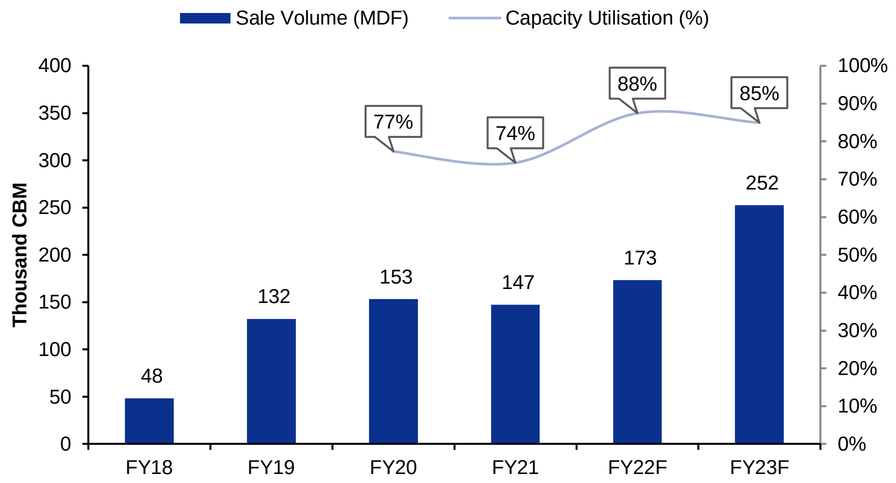
Figure 341: Century Plyboards' net debt and capex trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

"We are aggressively working on the greenfield project. We are focussing on the South at this point. I think the capacity, once we announce the same, once our decision is firmed up, which is likely to take place in the next few months itself, within the space of 18 months, we should be operational with the capacity. This is not going to be a fungible capacity. It is going to be a dedicated MDF plant of 700 plus cubic meters."
– Century Plyboards, 3QFY21 earnings call

Figure 342: MDF sales volume and capacity utilisation



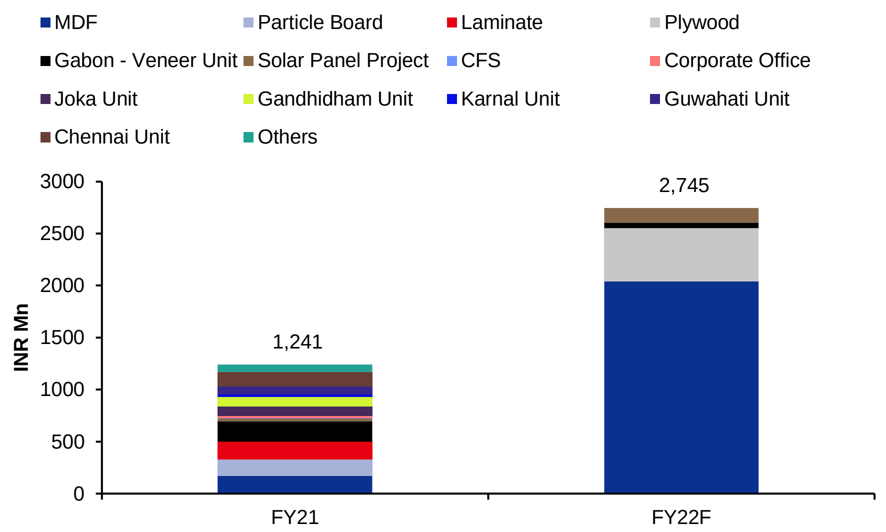
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Adding new MDF capacity of 1100cbm/day (3x of existing capacity) over FY21-23F

We build capex for both MDF expansions in our estimates

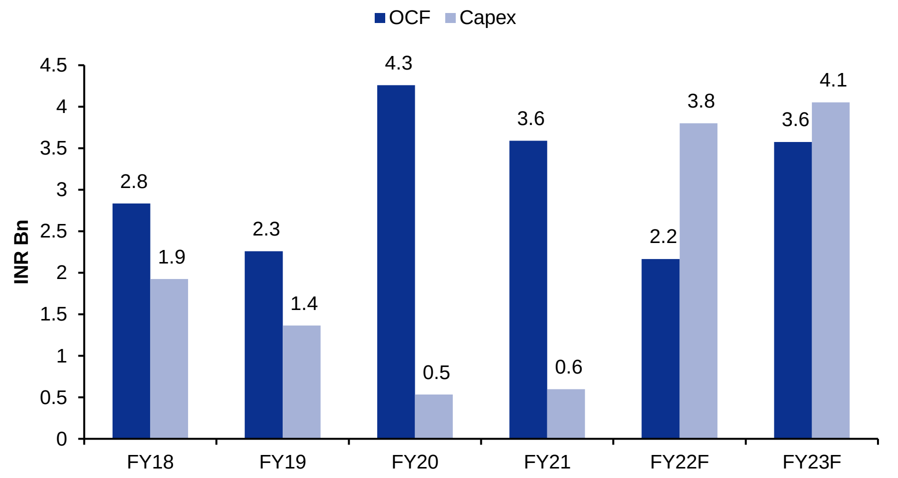
Management has indicated capex spends of ~Rs2.7bn FY22F but has not firmed up FY23F capex plans. We build ~Rs7.9bn of capex over FY22-23F, incorporating the greenfield MDF unit expansion as well.

Figure 343: Century Plyboards' planned capex allocation



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 344: Century Plyboards' OCF and capex trends



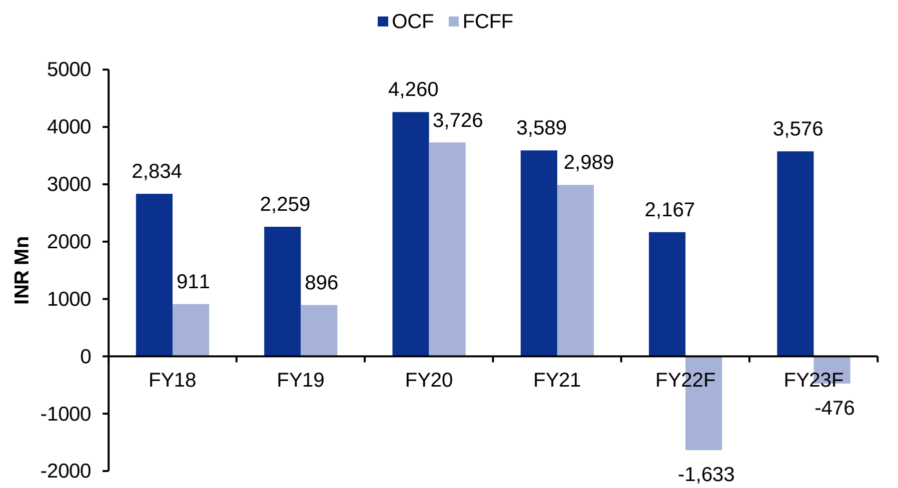
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Steady working capital cycles and return on capital

OCF and some debt should be able to fund needed capex. FCF to increase from FY23F.

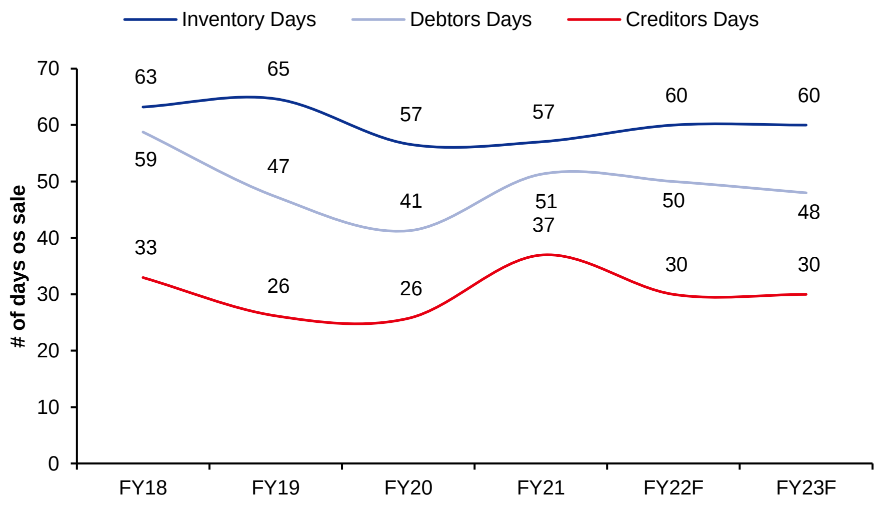
We expect net working capital at ~60 days of sales over FY22-23F, and RoE/RoCE of 18.8%/22.2% by FY23F. We believe high capex would impact FCF negatively over this period due to planned capacity expansions.

Figure 345: OCF and FCFF trend



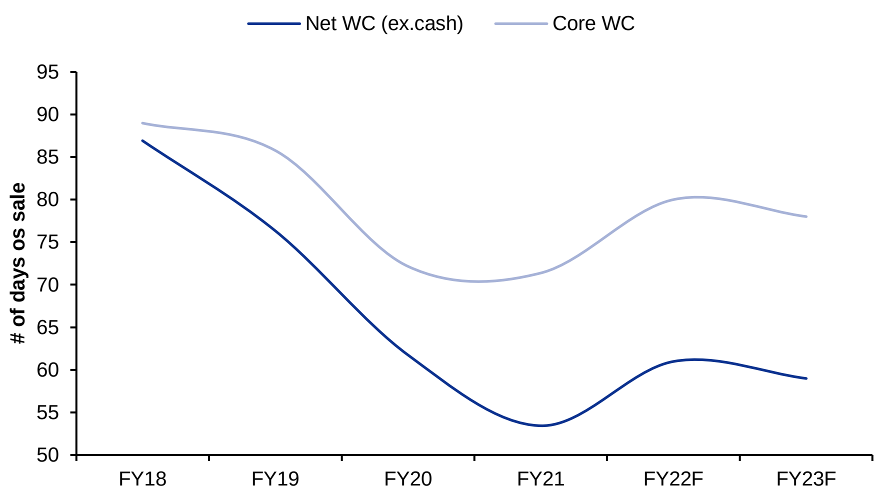
FCFF: FREE CASH FLOW TO FIRM
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 346: Century Plyboards' inventory, debtors and creditors days



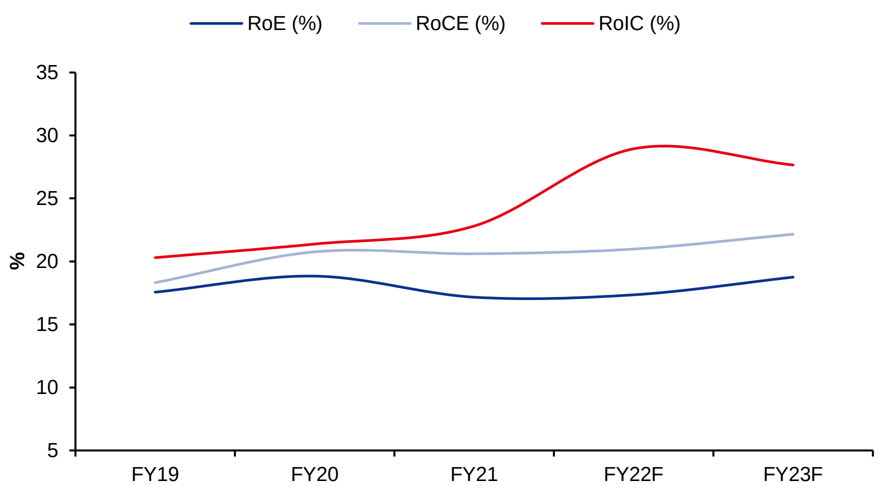
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 347: Century Plyboards' overall and core WC cycle chart



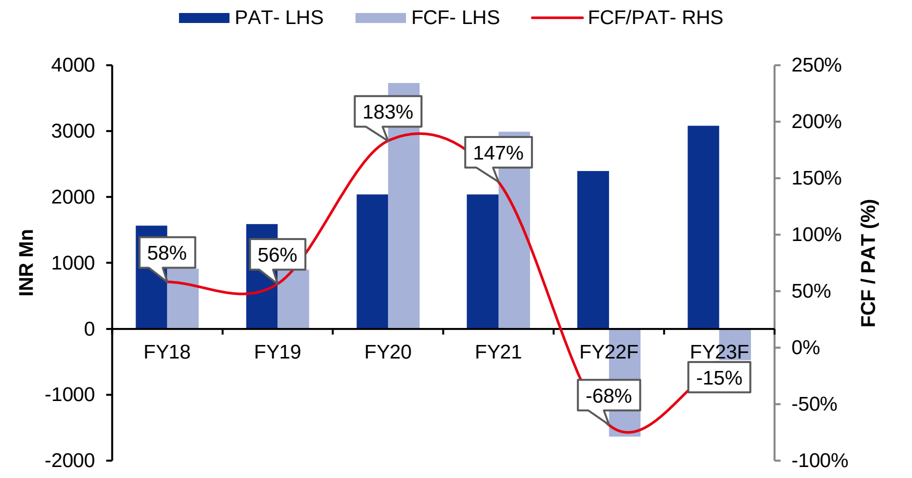
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 348: Century Plyboards' return ratios



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 349: Century Plyboards' FCF to PAT % trend

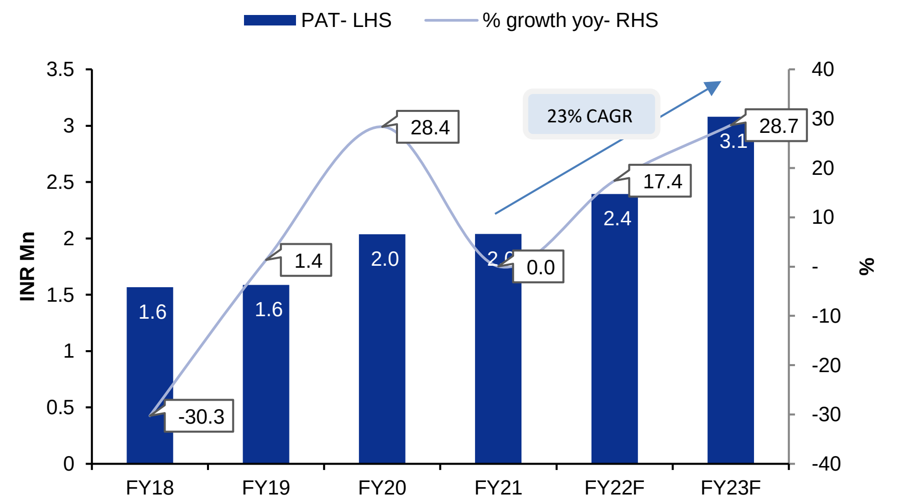


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

EPS CAGR of 23%, lower payouts at ~5% of annual profits

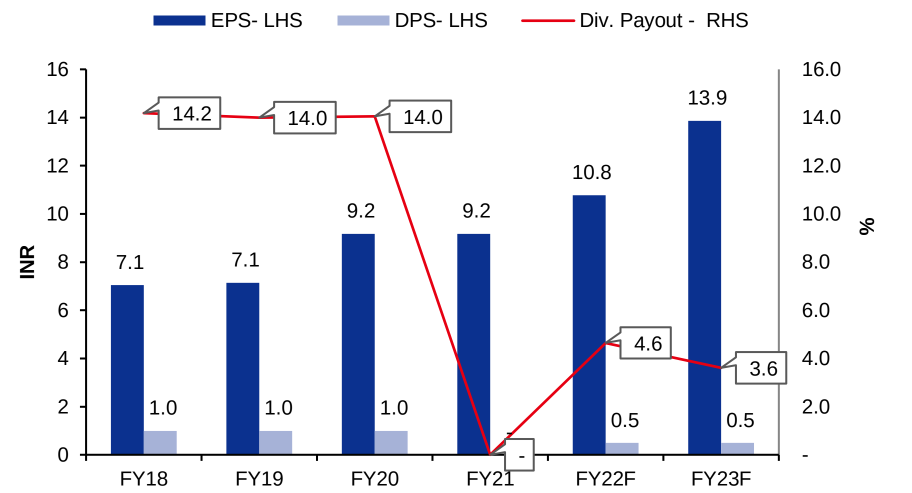
We estimate marginal drop in dividends over the next two years given the company's high capex needs.

Figure 350: Century Plyboards' PAT and PAT margin trend



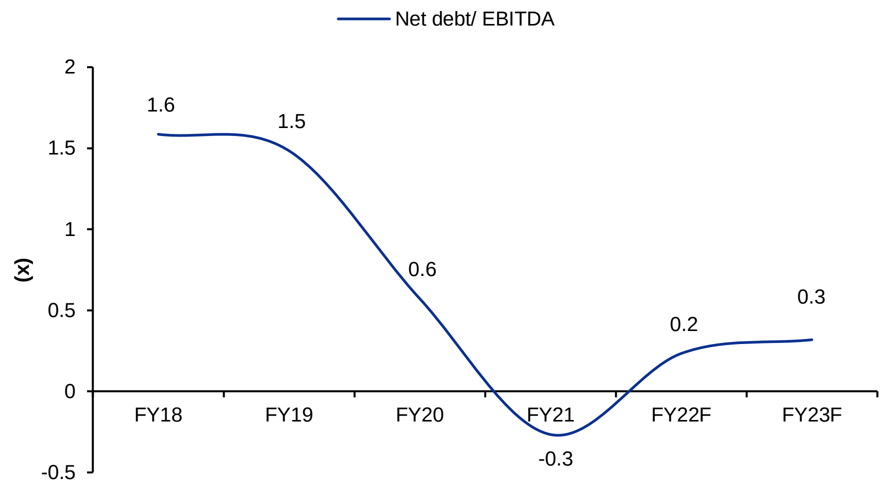
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 351: Century Plyboards' EPS, DPS and payout (%) trends



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 352: Century Plyboards' net debt to EBITDA ratio trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

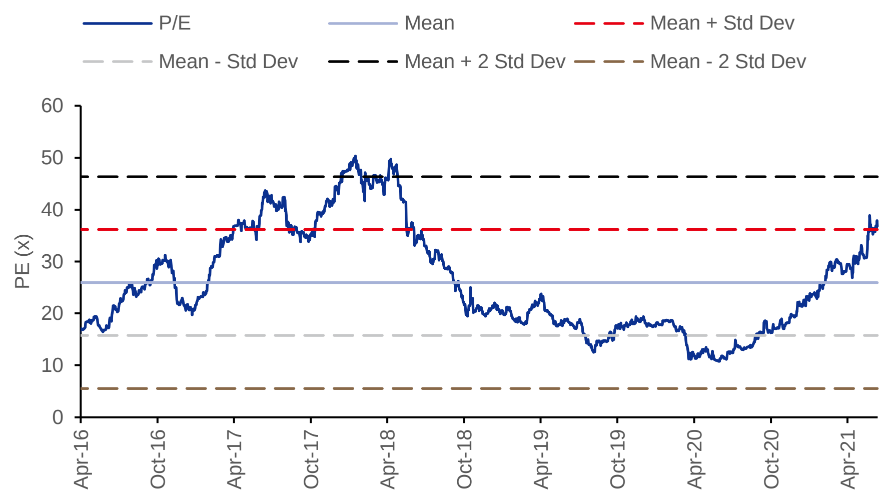
Valuation and risk

Cyclical industry upturn coupled with market share gains ➤

Broad-based growth and robust demand visibility lend support to increasing P/E multiples.

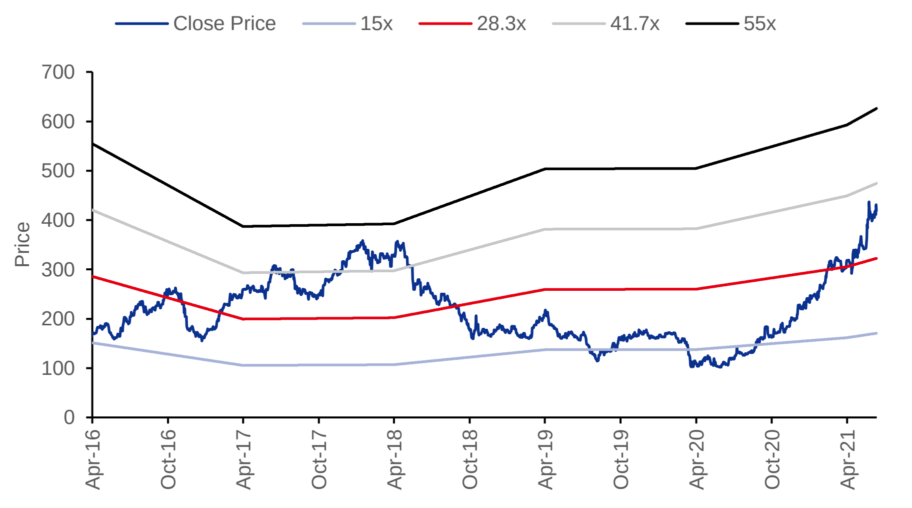
- Early signs of demand recovery indicate a cyclical upturn in discretionary consumption in India.
- Market share shift in favour of larger brands over the past five years accelerated due to the COVID-19 pandemic. Unorganised players will continue to lose competitiveness.
- Long track record of business execution and successful cash flow re-investment history in the same line of business.
- Stock trades at P/E of 30.2x FY23F estimates and EV/EBITDA of 18.5x.
- We initiate coverage on Century Plyboards with an Add rating and a TP of Rs469 based on 34x FY23F EPS, a ~30% premium to its last five-year mean P/E of 26x.
- We think the stock deserves a high premium to historical P/E multiple due to significantly better growth prospects over the next three years. Given low profit growth over the past five fiscals (FY16: Rs1.7bn; FY21: Rs1.9bn) due to unfavourable external and internal factors, the stock was range bound between Rs170-180 over Jun 2016 to Feb 2020. Coming out of a downcycle, the stock P/E could re-rate upwards going forward, in our view.

Figure 353: Century Plyboard trading 1SD above its 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH, BLOOMBERG

Figure 354: P/E Band Chart



SOURCES: INCRED RESEARCH, BLOOMBERG

Downside risks

- **Raw material price inflation:** High prices of critical raw materials like face veneer, design paper, kraft paper, adhesives, chemicals, etc. impact profitability negatively in case of inability to pass to customers by way of price hikes.
- **Adverse FX movements:** Face veneer and kraft paper are 100% imported items. Adverse forex rates could impact gross margins negatively.
- **Capex cost overruns:** The company undertakes greenfield/brownfield expansions to cater to future demand. Execution delays or cost overruns could negatively impact our estimates.
- **Prolonged COVID-19:** Resurgence of COVID-19 infections in India could negatively impact business performance.

SWOT analysis

Figure 355: SWOT Analysis

Strengths

- Long track record and strong brand equity
- Well balanced wood panel portfolio
- Being future ready and investing in right areas

Weakness

- Continuous capex needs
- Balance sheet liquidity
- Import dependence for key raw material

SWOT

Opportunities

- Gain market share from unorganised players
- Capitalize on improving B2C/B2B demand
- Launch innovative new-age products

Threats

- Cheap imports
- Adverse forex fluctuations
- Stronger regional competition

SOURCES: INCRED RESEARCH

Business description and management profile

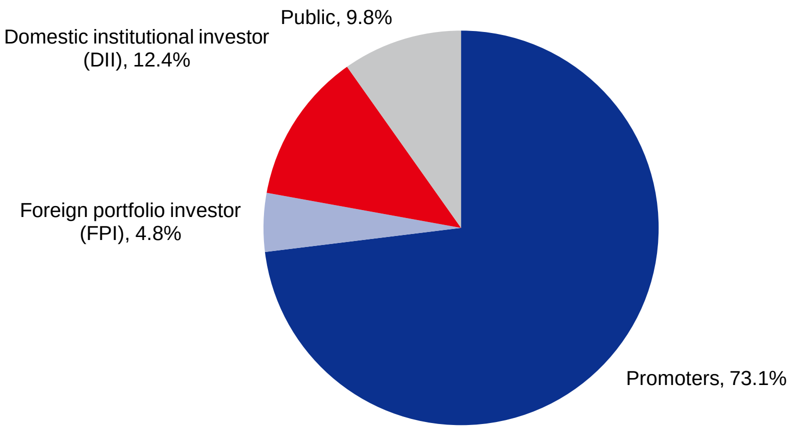
Century Plyboards was incorporated in Jan 1982 by Mr. Sajjan Bhajanka and Mr. Sanjay Agarwal. The company manufactures plywood, veneer, laminates, medium density fibre (MDF), particle board and allied products. The installed capacity of plywood is ~250k cubic metre (CBM). CPIL's plywood manufacturing units are located in Joka (West Bengal), Guwahati (Assam), Kandla (Gujarat), Chennai (Tamil Nadu), Karnal (Haryana), Roorkee (Uttarakhand), Myanmar and Laos. The Roorkee, Myanmar and Laos units operate through subsidiaries. In addition, the company operates two container freight stations in Kolkata. Century Plyboards had set up an MDF board unit at Hoshiarpur, Punjab, which commenced production in Nov 2017.

Figure 356: Key management profile (as at Mar 2021)

Mr. Sajjan Bhajanka Chairman and Managing Director	Mr. Sajjan Bhajanka has a Bachelor of Commerce and has much experience in the plywood and veneers business. He is also the Chairman of the Cement Manufacturing Company Ltd and Shyam Centuryply Ferrous Ltd in Meghalaya.
Mr. Sanjay Agarwal CEO & Managing Director	Mr. Sanjay Agarwal is a promoter director of the company. He has a Bachelor of Commerce degree. He is well-versed in plywood-related businesses, and is the driving force of the company.
Mr. Keshav Bhajanka Executive Director	Mr. Keshav Bhajanka is a member of the board of directors. He graduated with a Bachelor of Accounts and Finance from Warwick University, UK, in 2010. He is the force behind the company's decorative vertical's growth, which includes the successful implementation of new supply chain projects and the foray into new businesses such as MDF, Exteria and Flooring.
Ms. Nikita Bansal Executive Director	Ms. Nikita Bansal graduated in Economics and holds a degree in Business and Mathematics from New York University. She drives the product lines for Century Plyboards' sub brands – Sainik and CenturyDoors. She also leads the procurement and digital marketing strategies of the company and has spearheaded several new initiatives in the HR, IT and Costing departments.

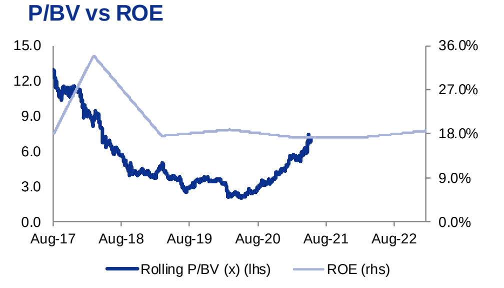
SOURCES: INCRED RESEARCH, COMPANY WEBSITE

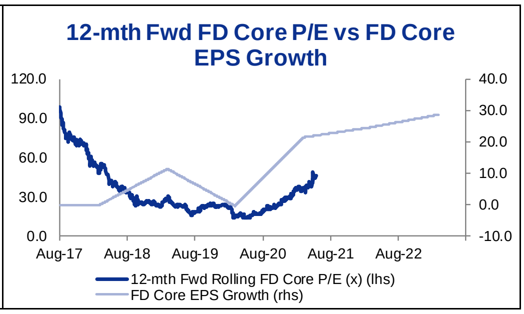
Figure 357: Shareholding pattern (as at Mar 2021)



SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS





Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**22,638**	**22,827**	**21,135**	**24,623**	**29,301**
Gross Profit	**10,823**	**11,344**	**10,541**	**12,250**	**14,650**
Operating EBITDA	**3,004**	**3,497**	**3,354**	**3,891**	**5,128**
Depreciation And Amortisation	(500)	(676)	(626)	(734)	(980)
Operating EBIT	**2,504**	**2,822**	**2,727**	**3,157**	**4,148**
Financial Income/(Expense)	(406)	(358)	(99)	(59)	(137)
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)	20	96	98	102	108
Profit Before Tax (pre-EI)	**2,119**	**2,560**	**2,726**	**3,201**	**4,119**
Exceptional Items		(456)	(118)		
Pre-tax Profit	**2,119**	**2,104**	**2,608**	**3,201**	**4,119**
Taxation	(531)	(522)	(688)	(807)	(1,038)
Exceptional Income - post-tax					
Profit After Tax	**1,588**	**1,582**	**1,921**	**2,394**	**3,081**
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**1,588**	**1,582**	**1,921**	**2,394**	**3,081**
Recurring Net Profit	1,588	1,925	2,008	2,394	3,081
Fully Diluted Recurring Net Profit	**1,588**	**1,925**	**2,008**	**2,394**	**3,081**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	3,004	3,497	3,354	3,891	5,128
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(294)	1,025	631	(1,020)	(621)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	(312)	(240)	(53)	44	(29)
Net Interest (Paid)/Received	406	358	99	59	137
Tax Paid	(544)	(380)	(441)	(807)	(1,038)
Cashflow From Operations	**2,259**	**4,260**	**3,589**	**2,167**	**3,576**
Capex	(1,364)	(533)	(600)	(3,800)	(4,053)
Disposals Of FAs/subsidiaries	38	382	84		
Acq. Of Subsidiaries/investments	63	(601)	(1,746)	1,105	
Other Investing Cashflow	40	10	24	44	36
Cash Flow From Investing	**(1,223)**	**(742)**	**(2,238)**	**(2,651)**	**(4,017)**
Debt Raised/(repaid)	(319)	(2,733)	(1,272)	1,000	1,000
Proceeds From Issue Of Shares					
Shares Repurchased					
Dividends Paid	(268)	(535)		(111)	(111)
Preferred Dividends					
Other Financing Cashflow	(355)	(383)	(110)	(103)	(173)
Cash Flow From Financing	**(942)**	**(3,651)**	**(1,382)**	**786**	**716**
Total Cash Generated	95	(134)	(31)	302	276
Free Cashflow To Equity	**717**	**785**	**79**	**516**	**560**
Free Cashflow To Firm	**590**	**3,145**	**1,243**	**(587)**	**(613)**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	226	212	1,860	1,057	1,333
Total Debtors	2,936	2,582	2,970	3,373	3,853
Inventories	4,010	3,541	3,302	4,048	4,817
Total Other Current Assets	1,052	723	758	740	881
Total Current Assets	**8,223**	**7,058**	**8,890**	**9,218**	**10,884**
Fixed Assets	7,286	6,927	6,534	8,562	12,384
Total Investments	978	1,137	1,169	1,169	1,169
Intangible Assets					
Total Other Non-Current Assets	1,172	1,165	1,278	2,316	1,566
Total Non-current Assets	**9,436**	**9,229**	**8,980**	**12,046**	**15,119**
Short-term Debt	3,363	1,683	727	1,481	2,234
Current Portion of Long-Term Debt					
Total Creditors	1,625	1,611	2,139	2,024	2,408
Other Current Liabilities	1,638	1,374	1,797	2,024	2,408
Total Current Liabilities	**6,626**	**4,668**	**4,664**	**5,528**	**7,051**
Total Long-term Debt	1,323	529	238	484	731
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	20	356	319	319	319
Total Non-current Liabilities	**1,342**	**885**	**557**	**804**	**1,050**
Total Provisions					
Total Liabilities	**7,968**	**5,553**	**5,221**	**6,332**	**8,101**
Shareholders Equity	9,691	10,734	12,649	14,932	17,901
Minority Interests					
Total Equity	**9,691**	**10,734**	**12,649**	**14,932**	**17,901**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	15.9%	0.8%	(7.4%)	16.5%	19.0%
Operating EBITDA Growth	2.9%	16.4%	(4.1%)	16.0%	31.8%
Operating EBITDA Margin	13.3%	15.3%	15.9%	15.8%	17.5%
Net Cash Per Share (Rs)	(20.07)	(9.00)	4.03	(4.09)	(7.35)
BVPS (Rs)	43.62	48.31	56.93	67.21	80.57
Gross Interest Cover	5.62	7.58	25.27	30.78	24.04
Effective Tax Rate	25.1%	24.8%	26.4%	25.2%	25.2%
Net Dividend Payout Ratio	12.6%	10.5%		3.5%	2.7%
Accounts Receivables Days	49.02	44.11	47.94	47.01	45.01
Inventory Days	114.17	120.01	117.88	108.40	110.42
Accounts Payables Days	52.35	51.43	64.60	61.41	55.21
ROIC (%)	20.3%	21.4%	22.8%	29.0%	27.7%
ROCE (%)	18.3%	20.8%	20.6%	21.0%	22.2%
Return On Average Assets	14.7%	17.2%	16.5%	16.7%	18.0%

SOURCES: INCRED RESEARCH, COMPANY REPORTS

Cera Sanitaryware

Steady and consistent performance

- Supportive macro. Tailormade products ensure market relevance, in our view.
- Strategic mix of inhouse and joint venture manufacturing is great, in our view.
- We expect EPS CAGR of 32% over FY21-23F. Initiate coverage with Add rating and target price of Rs5,140.

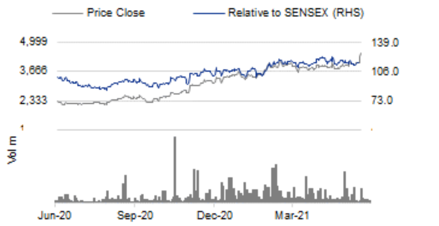
India

ADD *(Initiating coverage)*

Consensus ratings*: Buy 12 Hold 3 Sell 1

Current price:	Rs4,360
Target price:	Rs5,140
Previous target:	NA
Up/downside:	17.9%
InCred Research / Consensus:	39.6%
Reuters:	CERA.NS
Bloomberg:	CRS IN
Market cap:	US$776m
	Rs56,711m
Average daily turnover:	US$0.9m
	Rs66.2m
Current shares o/s:	13.0m
Free float:	45.5%

Source: Bloomberg



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	13.6	10.1	92.9
Relative (%)	5.5	6.5	24.2

Major shareholders	% held
Promoters	54.5
Nalanda India Equity Fund	10.0
DSP Mutual fund	3.7

Sustained demand and customised solutions ensure longevity

Demand for sanitaryware (SW), faucets and tiles is highly correlated to industrial capex by the government and private sector as well as urban and rural real estate demand. Strong bathware demand recovery in Jun-Mar 2021 (COVID-19 unlock period) surprised us positively and corporate managements guided for cyclical recovery and sustainable demand environment over the next 3-5 years. Cera's focus on tailormade customer-centric product solutions and timely innovations ensures market relevance and business longevity, in our view. Consistently declining unorganised competition in India since 2016 augurs well for market share gains. We estimate revenue CAGR of 17%, with faucets growing the fastest at 17.5% CAGR over FY21-23F.

Pan India brand presence and asset-light strategy aids profitability

Cera caters to full customer spectrum with its four national brands – Isvea, Senator, Cera and Jeet. Hence, it has well balanced revenue mix with tier-3/4 markets at 58% (Mar 2021) of revenues while premium products have 50% overall share (Dec 2020). It has an asset-light manufacturing strategy with optimum mix of inhouse and outsourcing partnerships. Nearly 55% of SW and faucets and 65% of tile manufacturing is outsourced to third-party vendors. Inhouse/joint venture capacities are dedicated to premium products. Temporary hiccups due to COVID-19 lockdowns and minor labour issues impacted FY21 EBITDA margins, down 60bp yoy. We estimate EBITDA margin to increase by 210bp (FY23F: 15.0%) and EBITDA CAGR of 26% over FY21-23F.

Focus on capital allocation and cash generation

Cera ventured into the tile business in 2012/13, based on its asset-light strategy. Since then, the company has focussed on core segment growth (SW, faucet and tiles) and built a long track record of disciplined capital allocation. Planned capex remains low at ~Rs350m/year, while the net working capital cycle will be at 50-55 days of sales over FY21-23F. We expect cumulative FCF of Rs4.2bn over FY21-23F and net cash balance of Rs5.7bn by FY23F. We estimate EPS CAGR of 32%, FY23F return on invested capital (RoIC) of 32.3% and dividend payouts of ~15% over FY21-23F.

Valuation and risks

The stock currently trades at FY23F P/E of 32.2x (near its five-year mean). We value the stock at Rs5,140 based on 38x FY23F EPS, a ~20% premium to historical multiples. Balanced revenue mix and working capital improvements are key positives in our view. Downside risks: Tile competition, prolonged COVID-19 and treasury management.

Financial Summary	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue (Rsm)	13,439	12,114	12,243	14,640	16,763
Operating EBITDA (Rsm)	1,906	1,532	1,581	2,050	2,514
Net Profit (Rsm)	1,075	1,010	1,008	1,392	1,759
Core EPS (Rs)	82.6	77.6	77.5	107.1	135.3
Core EPS Growth	13.1%	(6.0%)	(0.2%)	38.1%	26.4%
FD Core P/E (x)	52.77	56.16	56.25	40.73	32.23
DPS (Rs)	12.0	13.0	13.0	16.0	20.0
Dividend Yield	0.33%	0.36%	0.30%	0.37%	0.46%
EV/EBITDA (x)	29.30	36.17	33.40	25.60	20.36
P/FCFE (x)	1,301.89	186.21	575.76	113.29	64.91
Net Gearing	(13.4%)	(19.8%)	(46.9%)	(44.7%)	(49.3%)
P/BV (x)	8.09	7.16	6.35	5.61	4.94
ROE	16.5%	13.7%	12.3%	15.0%	16.5%
% Change In Core EPS Estimates					
InCred Research/Consensus EPS (x)				0.96	1.01

SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS. PRICED AS AT 11 JUN 2021

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Steady and consistent performance

Tailormade innovative products will lead to net sales of 17% CAGR over FY21-23F

Project sales (implied B2B sales billed through dealers) account for ~30% of Cera's business, according to management. The products sold are used in individual or group housing projects in urban and rural markets. Cera offers customised solutions and has been proactive in the launch of tailormade sanitaryware products and faucets for project developers /corporates /institutions /Government customers. Some examples are:

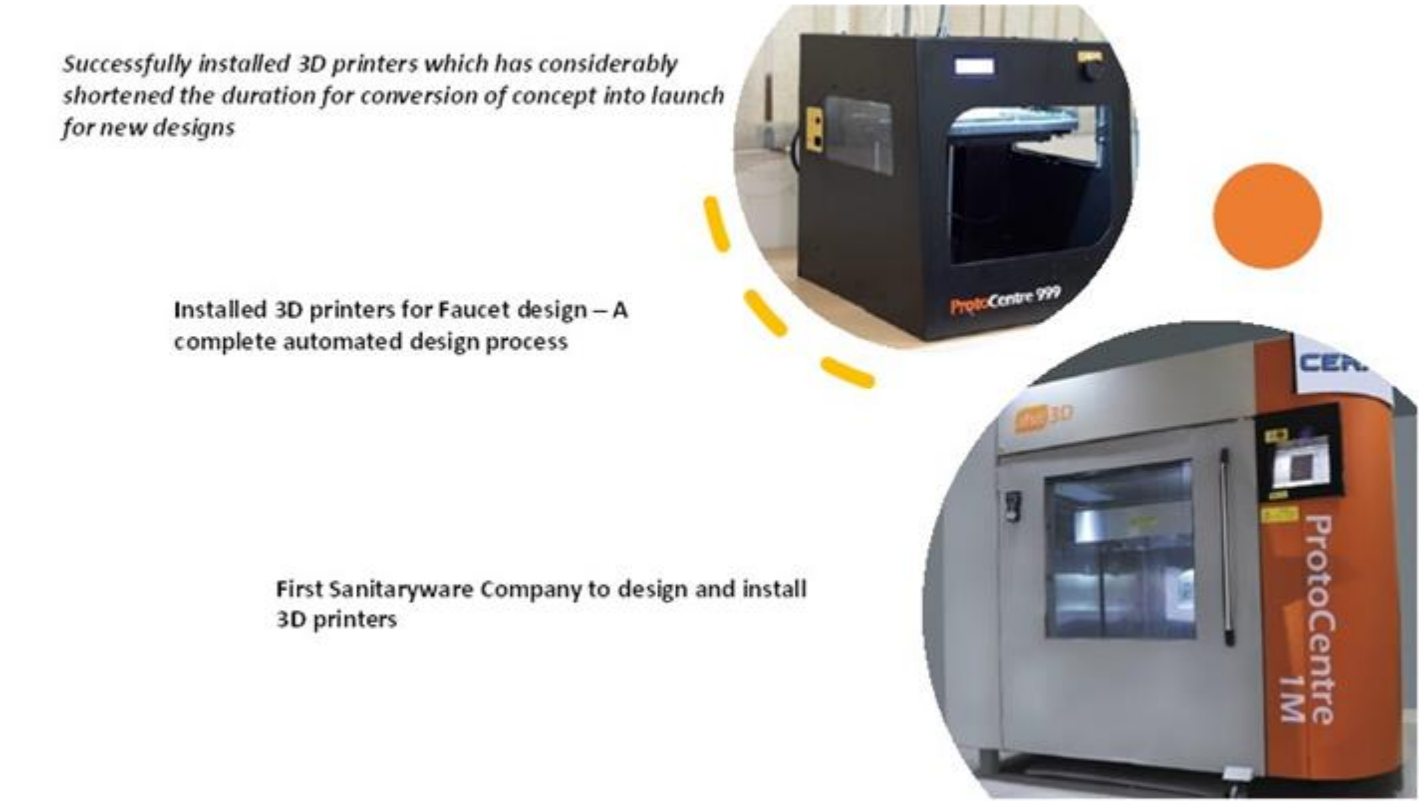
- Cera developed a new flushing system that uses 30% less water (four litres instead of six earlier), maintaining the flush effectiveness.
- COVID-19 resilient products like anti-microbial sanitaryware ensuring zero retention of bacteria after usage.
- Touch-free sensor-based faucets.
- Self-cleaning closets and antibacterial seat covers.
- Cera launched 91 new sanitaryware SKUs (stock keeping unit) in 9MFY21, compared to the 66 new launches in FY20.
- New products launched in the last 18 months account for 20% of SW and Faucet revenues and 67% for allied products like cisterns, seat covers, etc, in FY21.

We believe strong market position and incremental market share gains will be driven by consistent product innovation and offering customised solutions to customers.

Figure 358: Water savings and anti-microbial products have been Cera's pivot for innovation

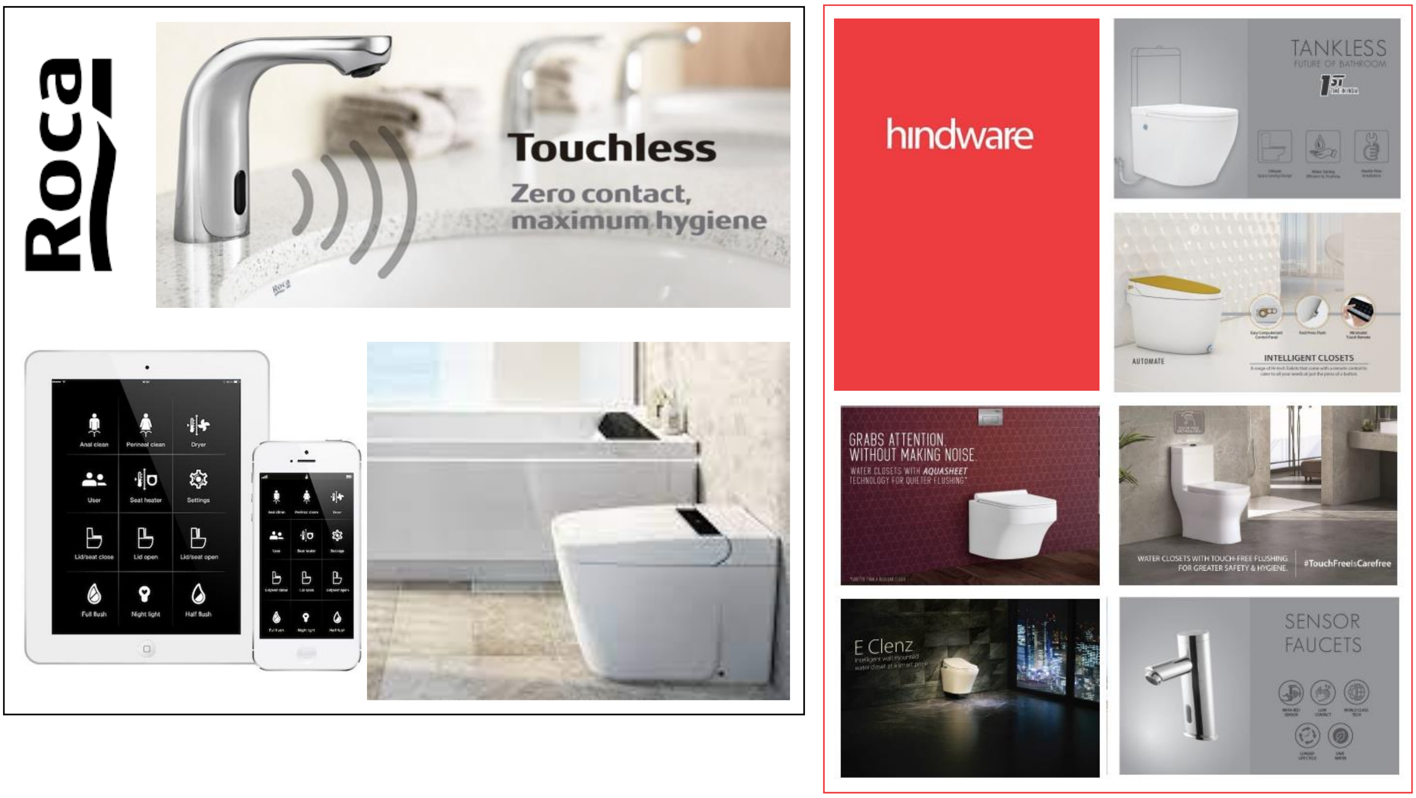
SOURCES: INCRED RESEARCH, CERA PRODUCT CATALOGUE, COMPANY REPORTS

Figure 359: Cera installed 3D printers (in 2019) to reduce the gestation time between concept to launch



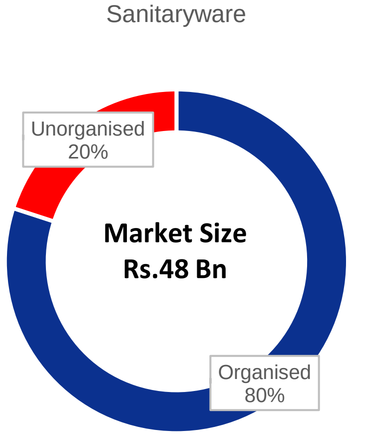
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 360: New product launches by close competitors – Somany Home Innovation (Hindware) and Roca India (Parryware)



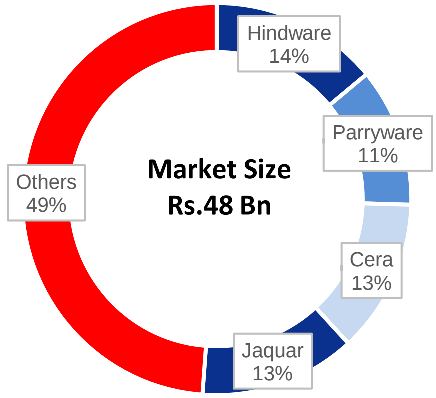
SOURCES: INCRED RESEARCH, SOMANY HOME INNOVATION LTD (SHIL) ANNUAL REPORT 2020, ROCA.IN/

Figure 361: Organised sanitaryware players accounted for 80% of the market (FY21)



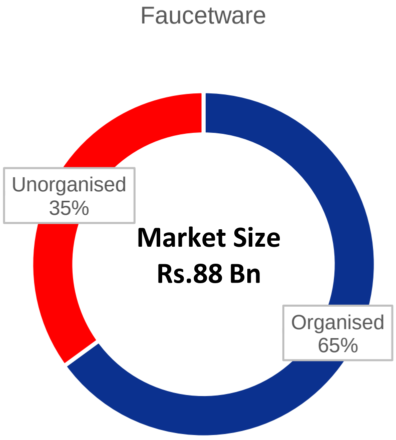
SOURCES: INCRED RESEARCH, COMPANY REPORTS, SHIL ANNUAL REPORT 2020

Figure 362: Top 4 sanitaryware players accounted for ~50% of the market (FY20)



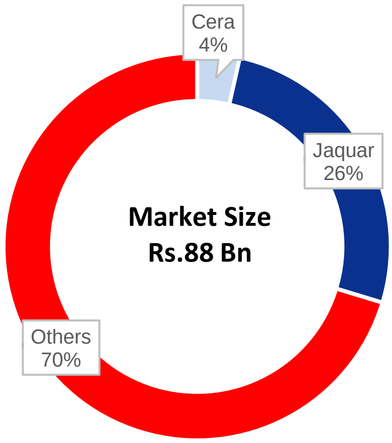
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS, SHIL ANNUAL REPORT 2020,

Figure 363: Organised faucetware players accounted for ~65% of the market (FY21)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, SHIL ANNUAL REPORT 2020

Figure 364: Jaquar leads the faucetware market in India (FY20)

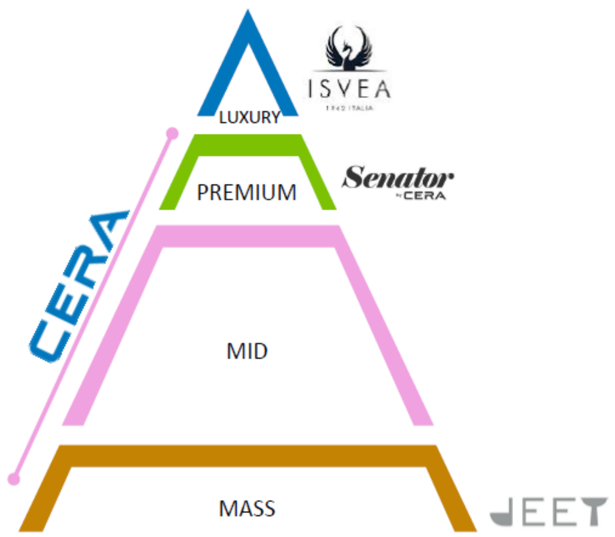


SOURCES: INCRED RESEARCH, COMPANY REPORTS, SHIL ANNUAL REPORT 2020

Brand presence across full market spectrum

Cera's product portfolio encompasses every aspect of the price and design matrix. The company has launched niche brands for deeper engagement with varied customer and market segments. Also, Cera does not outsource after sales services and has over 300 service technicians on its payroll (FY20) to provide quality customer services pan India. The customer and dealer mobile applications also aid addressing issues or solving complaints in a timely manner.

Figure 365: Cera's brand triangle across the customer spectrum



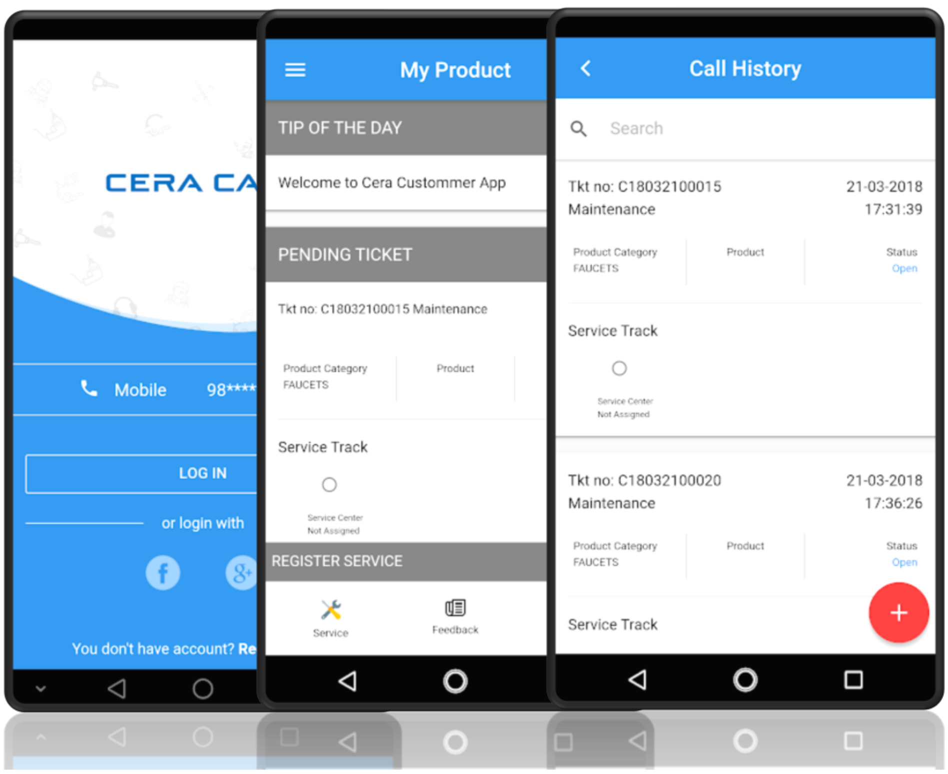
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 366: Cera customer app

Cera Customer App

Cera Customer app enables customers to quickly log a service complaint for any Cera product they may have and monitor its status.

A one-time registration captures basic details such as phone number, address(es), preferred service time and products used.



SOURCES: INCRED RESEARCH, GOOGLE PLAY STORE

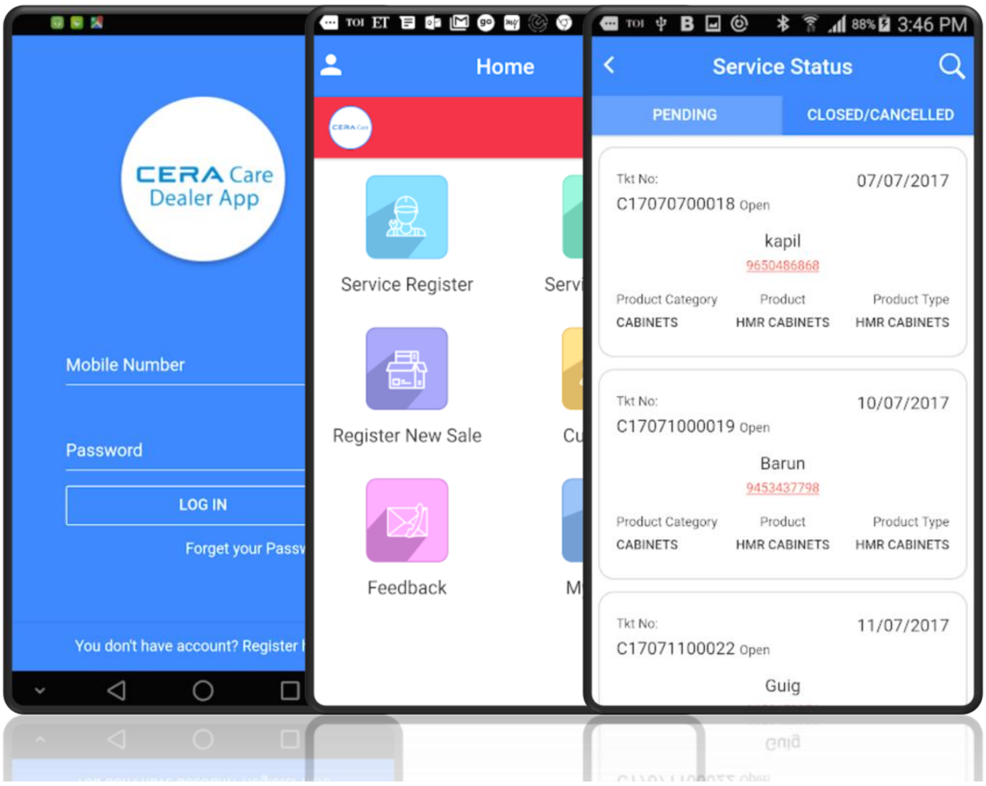
Figure 367: Cera dealer app

Cera Dealer App

Cera Dealer app is another convenient and contemporary tool to enhance its distribution network.

It updates the dealers and sub-dealers with the status of purchase orders.

Allow them to place orders and provide up to date information about the different products available.



SOURCES: INCRED RESEARCH, GOOGLE PLAY STORE

Figure 368: Cera's customer profile (Dec 2020)

SOURCES: INCRED RESEARCH, COMPANY REPORTS

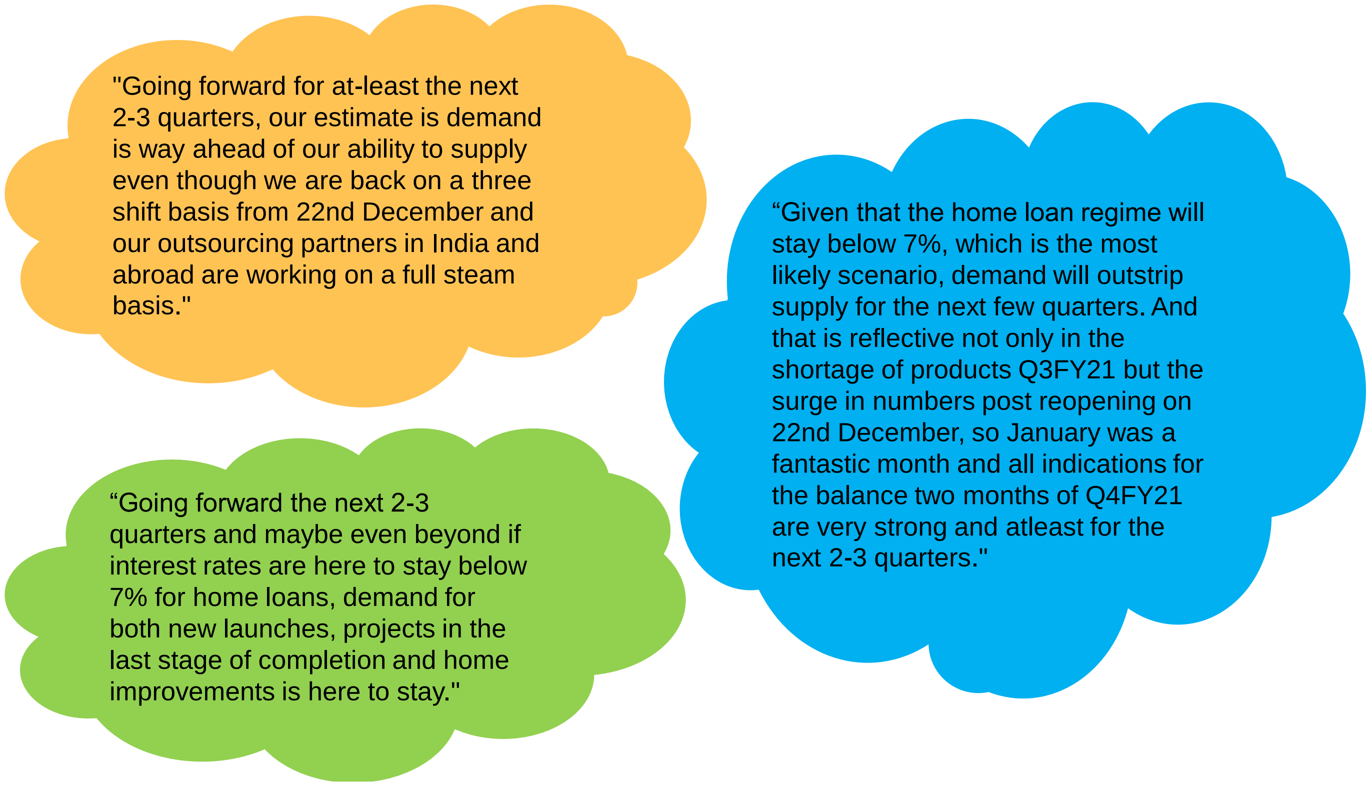
Management confident of sustainable revenue growth based on strong housing pipeline pan India ❯

Management is confident of sustaining growth momentum across revenue segments as seen in the FY21 over the next two to three years. The key reasons cited for a pick-up in urban real estate demand:

- Tapering demand of urban residential and commercial real estate over the past 4-5 years in India
- Historical low home loan interest rates
- State government support to the real estate industry in the form of lower stamp duties and other incentives to bolster demand

- Robust project closure pipeline pan India as per internal studies done by the on-ground sales team over the next two to three years

Figure 369: Recent comments from Cera's management highlighting strong demand ahead



SOURCES: INCRED RESEARCH, CERA ANALYST/INVESTOR MEET TRANSCRIPTS

"We have not seen this kind of demand scenario after 2012. After eight years we are now witnessing a scenario where it's difficult to meet the demand."
– Executive Director, Cera Sanitaryware, 3 Feb 2021 investor call

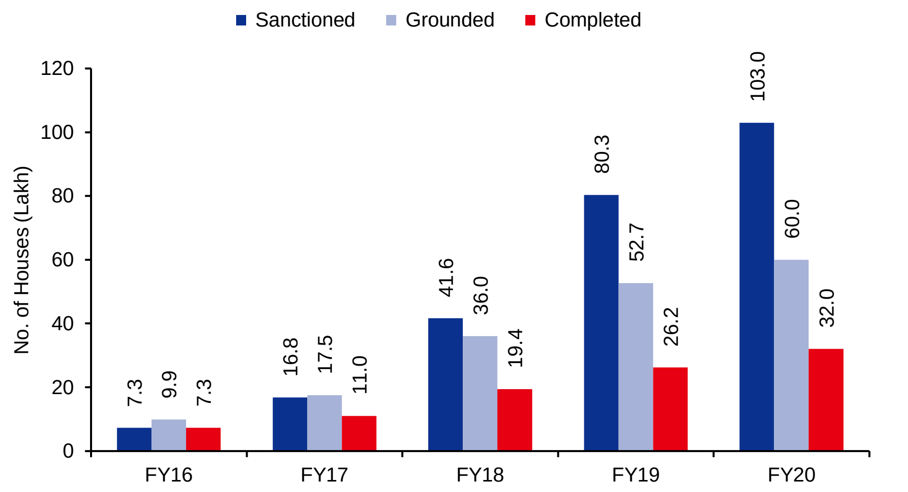
Urban and rural housing construction on the rise, rural demand relatively better than urban markets ›

With the growing urban population, coupled with increasing nuclearisation of families, demand for housing is expected to rise. A report by Royal Institution of Chartered Surveyors (RICS) and international property consultant Knight Frank forecasts that the current housing shortage in urban areas of ~10m units is estimated to more than double at ~25m units by 2030. The ICRA report states 95.21% of the urban housing demand is likely to be driven by the Economically Weaker Section (EWS) and Low-Income Group (LIG) categories, according to Aadhaar Housing Finance Annual Report 2020.

Given the challenges faced by the housing sector and in a bid to fulfil its 'Housing for All' target by 2022, the Indian government announced a slew of measures in the past few years to revive the demand and supply of housing. Some of its key announcements are:

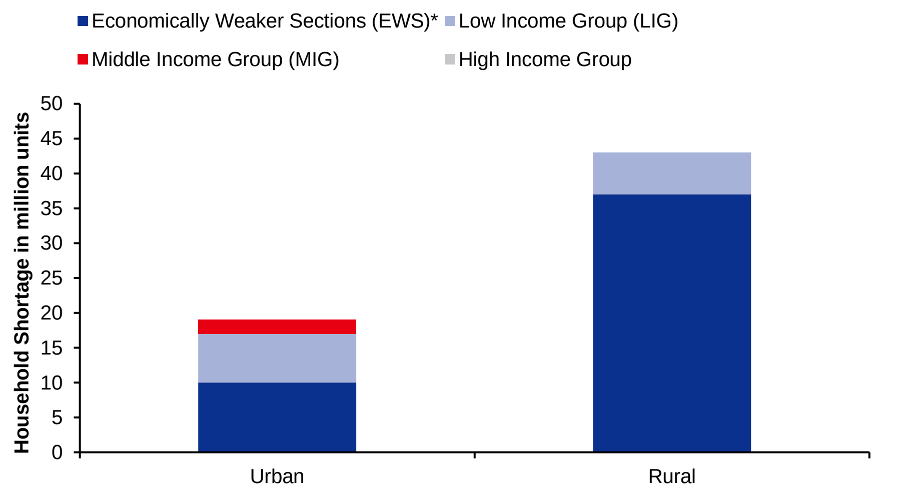
- To boost the supply of affordable housing, it announced an extension of tax holidays to real estate developers on profits they earned on affordable projects.
- Extension of an additional Rs1.5 lakh deduction for interest paid on affordable home loans sanctioned on or before 31 Mar 2021.
- Increased allocation to Pradhan Mantri Awas Yojana (PMAY) from Rs25,328 crores in FY19-20 to Rs27,500 crores in FY20-21.
- Affordable housing has been accorded 'infrastructure status' to ensure access to cheaper institutional credit to developers.
- PMAY has yielded good results, leading to a considerable increase in affordable segment launches.

Figure 370: PMAY has yielded good results, leading to a considerable increase in affordable segment launches



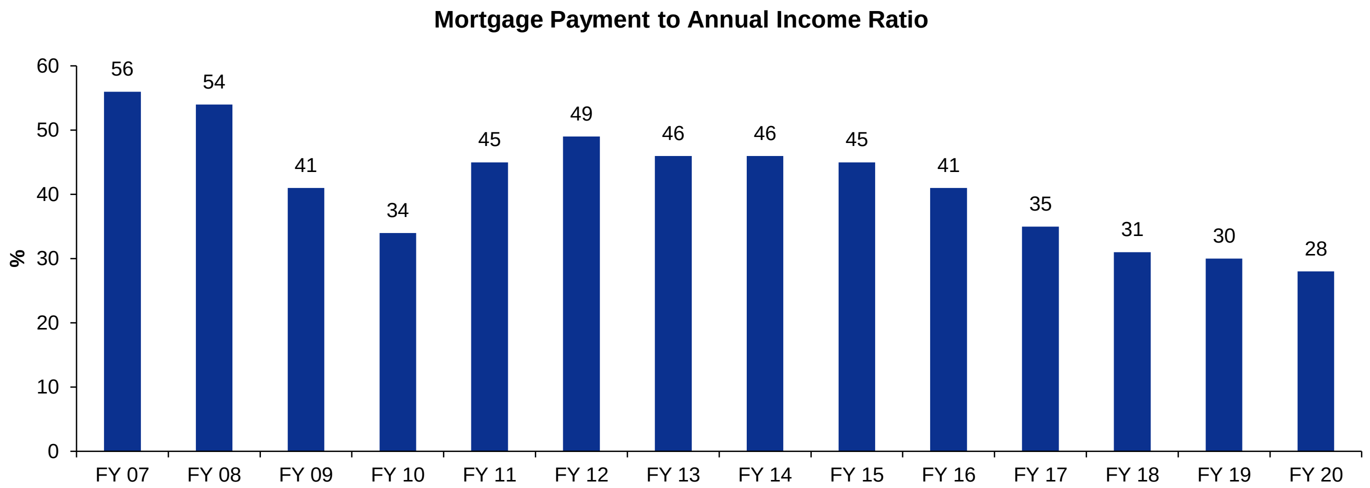
SOURCES: INCRED RESEARCH, ADHAAR HOUSING FINANCE ANNUAL REPORT 2020

Figure 371: Country's housing shortage driven by EWS and LIG categories



*FOR RURAL CATEGORY, ONLY COVER BELOW POVERTY LINE (BPL)
SOURCES: INCRED RESEARCH, ADHAAR HOUSING FINANCE ANNUAL REPORT 2020

Figure 372: Mortgage payment to annual income ratio indicates supportive macro for housing demand uptick



SOURCES: INCRED RESEARCH, ADHAAR HOUSING FINANCE ANNUAL REPORT 2020

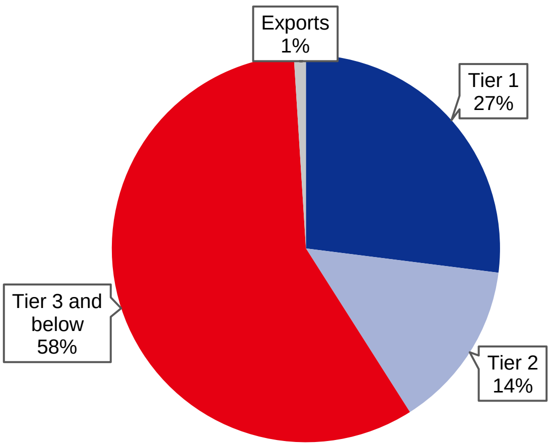
Figure 373: Industry players highlighting better rural demand due to high agri-income

SOURCES: INCRED RESEARCH, COMPANY REPORTS

Well balanced revenue profile across products

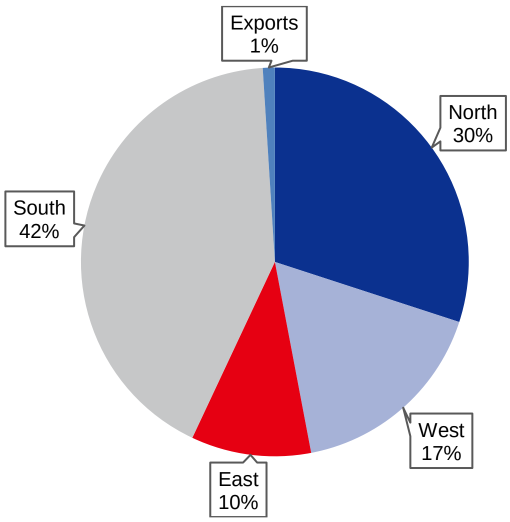
Cera has a well-diversified revenue profile with the premium category accounting for ~50% of total sales for SW and faucets in 9MFY21. The rest comes from the mid (33-37%) and mass categories (13-18%). Within Tiles, glazed vitrified tiles (GVT) and double charged tiles (DC) accounted for a 55% of the total revenue in FY21. With regards to diversity in urban rural markets, the company derives ~55%-60% of overall revenues from tier-3/-4 towns. Implied B2B (institutional/project) sales stands at over 70% of total sales in FY20, according to management. However, 100% billing is being done through the dealer network only without any risks associated to timely collections of receivables from B2B customers.

Figure 374: Tier-wise revenue profile (FY21)



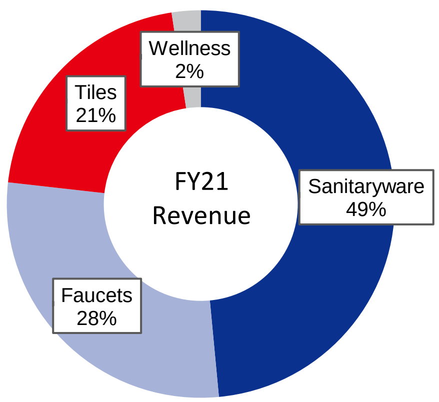
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 375: Zone-wise revenue profile (FY20)



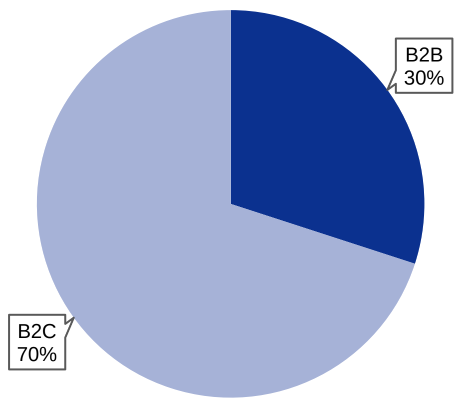
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 376: Segment-wise revenue profile (FY21)



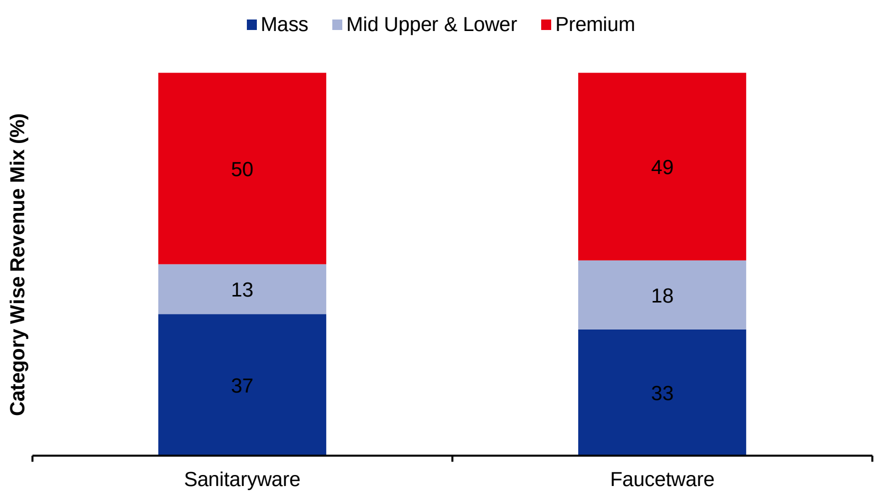
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 377: B2B vs B2C revenue mix (FY21)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 378: FY20 product category revenue mix



SOURCES: INCRED RESEARCH, COMPANY REPORTS

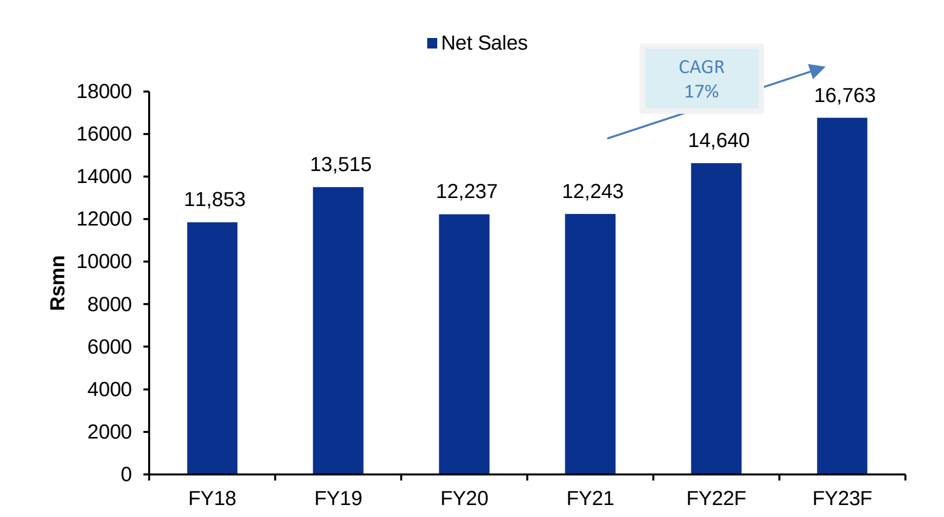
"We have anecdotal information from our frontline dealers and sales force that a lot of households had disposable income, because there were no other avenues like travel, entertainment and other things to spend on, so home improvement became a focus area for a lot of households."

– Cera Sanitaryware, 3QFY21 investor conference call

Revenue growth to return to normalcy

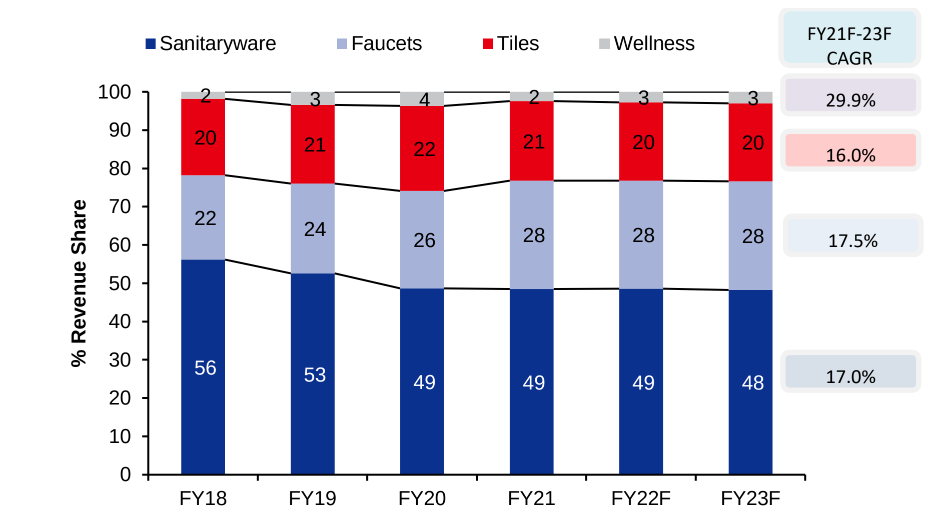
Cera's revenue CAGR was a mere 6% over FY16-20 given multiple hiccups that industry faced during this period. Demonetisation (Nov 2016), roll-out of Goods and Service Tax (GST – Jul 2017), COVID-19 pandemic (Mar 2020) coupled with general economic slowdown hampered business performance during this period. The FY21 recovery is very encouraging and we build in ~17% revenue CAGR over FY21-23F.

Figure 379: Net sales CAGR of 17% over FY21-23F



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 380: Segmental revenue mix and expected growth



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

EBITDA margins will be back to 15.0% by FY23F

Labour strike and COVID-19 pandemic impacted margins

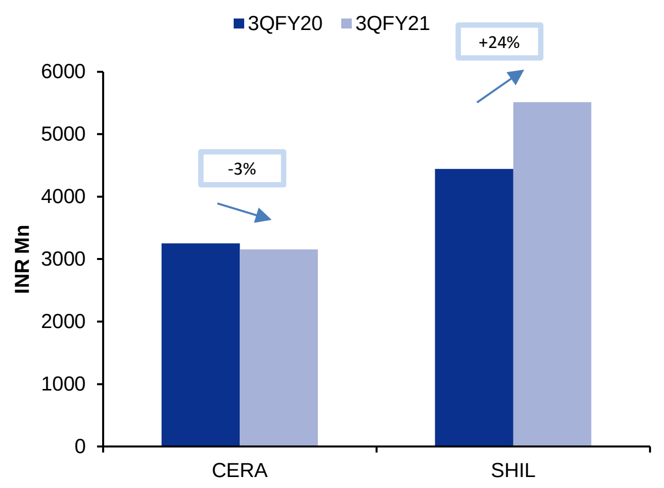
FY21 was an unfortunate year for Cera due to COVID-19 and labour issues, in our view.

- The COVID-19 lockdown resulted in a plant shutdown till 5 May 2020 (zero production for 35 days in 1QFY21).
- A labour union leader wanted an increase in fixed pay and there was a slight production disruption in Sep 2020. The company approached the Labour Department, Government of Gujarat, which on 16 Oct 2020, issued a directive prohibiting the disruption. However, a few workers remained absent to protest the disciplinary action taken by the company against agitating workers asking for unreasonable hikes in fixed pay. Cera's production was disrupted for 82

days in 3QFY21, implying revenue loss of ~Rs650m. Pursuant to the Gujarat High Court order on 21 Dec, workers returned to their manufacturing activities as usual from 22 Dec 2020. There was no change in the wage structure and unreasonable labour demands were not entertained.

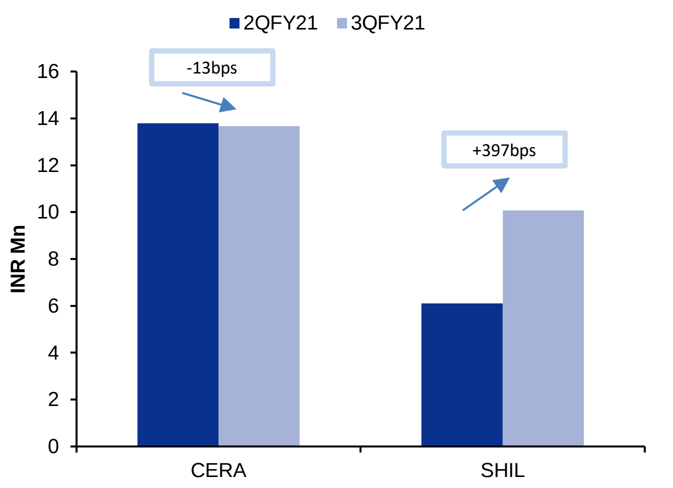
While most of the peer group reported strong revenue growth yoy and improved EBITDA margins in 3QFY21, Cera reported poor performance owing to labour strike issues. We estimate EBITDA margins to recover to 15% by FY23F. Financials of Somany Home Innovation Ltd. (SHIL) (SHILL:IN, CMP: Rs342, Not Rated) have been compared with Cera to showcase key differential in FY21 performance.

Figure 381: 3QFY21 yoy revenue dropped 3% for Cera vs. 24% increase for SHIL



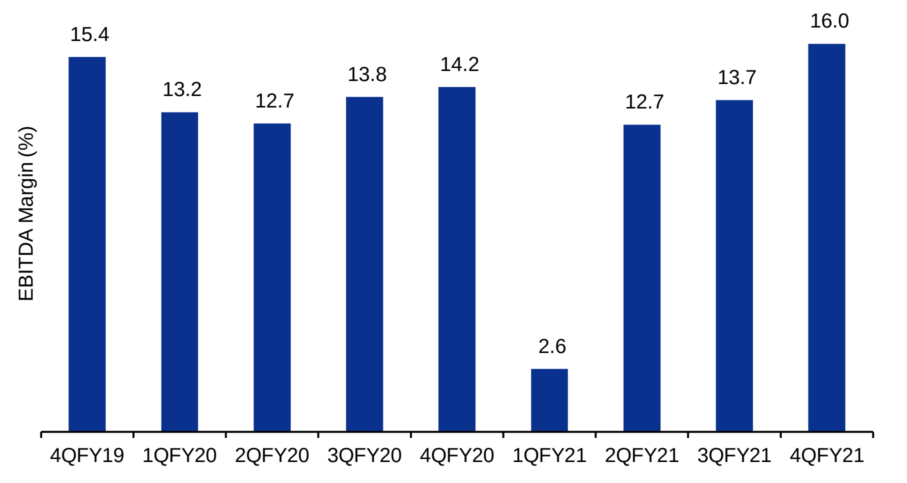
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 382: 3QFY21 yoy EBITDA margin dropped 13bp for Cera vs. 397bp margin increase for SHIL



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 383: Quarterly EBITDA margin trend



SOURCES: INCRED RESEARCH, COMPANY REPORTS

"Zinc, which is 1% of sanitaryware raw material, is up by 10% in nine months. Plaster of Paris again, little more than 1% of sanitaryware RM, is up 7% in nine months. What is up is the freight element in all of this. The freight element is up significantly."

– Cera Sanitaryware, 3QFY21 investor call

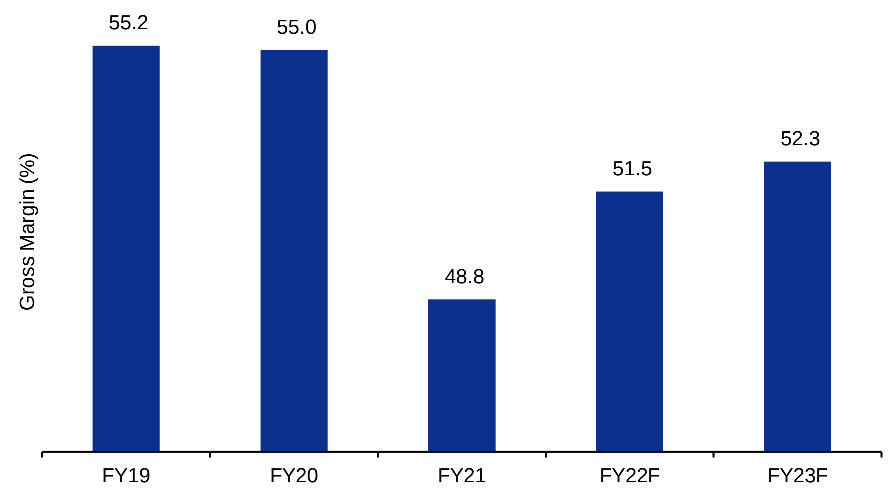
Pricing power and asset-light strategy ➤

Given the input cost inflation related to higher prices of brass ingots and steel as well as very high freight costs led by COVID-19 disruption, Cera implemented price hikes to protect its gross margins. The company raised sanitaryware product prices by 3-5% in Aug 2020 and by 5-7% in Feb 2021. Faucetware prices increased by 8-10% with effect from Feb 2021.

According to management, the price hikes implemented by most large-brand players in the SW and faucet industry were absorbed in the market without meaningful damage to demand trends. Unorganised players losing market share at the bottom of the industry pyramid also helped in the price hike absorption.

Gross margins dropped by 620bp to 48.8% due to lower share of premium product sales and high raw material prices in FY21 as per the company management. We expect gradual recovery over FY21-23F.

Figure 384: Gross profit margin trends over FY18-23F (%)

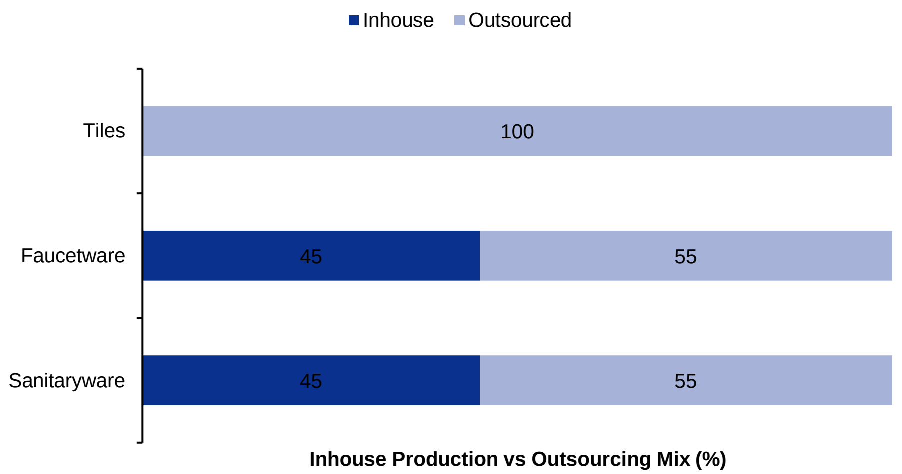


SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Optimum outsourcing mix and joint ventures

Premium category products for SW and faucets are manufactured inhouse while the mid and the mass category production is fully outsourced to third-party vendors. For tiles, 100% production is currently outsourced with full control on product quality and design specifications. The company has been focusing on efficient use of capital and core area of operations resulting in high return on invested capital (FY23F RoIC: 32.3%).

Figure 385: Segment-wise outsourcing vs inhouse sourcing mix (Dec 2020)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

"We can definitely reach a high single-digit EBITDA margin in tiles. And the pluses that we have are very different from other players; you'll have to look at us very differently. We have deployed no capital capacity. We have no capacity on our own balance sheet. So, if you look at the two JVs where we have an equity commitment that caters to 35% of our topline in tiles and the balance 65% are purely outsourced third parties."
– Cera Sanitaryware, 3QFY21 investor call

"Normally we split that 9.5% into two heads, so publicity is normally 4% of the topline and then the balance 5.5% is sales and marketing expenses which includes lot of dealer schemes, foreign trips, incentives, etc."
– Cera Sanitaryware, 1QFY21 investor conference call

Joint ventures for tile manufacturing and backward integration

- **Tile unit** – Cera has two joint ventures for glazed vitrified tile manufacturing with a) Anjani Tiles Ltd at Andhra Pradesh with 51% equity (since 2015) and; b) Milo Tiles LLP at Morbi, Gujarat with 26% equity (since 2019); aggregating to a capacity of 16,000 sq. mt. per day.
- **Packing unit** – A joint venture unit was established in FY17 for the manufacture of corrugated boxes to be used captively as packing material. The products are now available on a just-in-time basis, built to the exact specifications of the company. Cera holds a 51% equity stake in the JV as at Mar 2020.
- **Polymer unit** – The joint venture for polymer products was established in FY19 for the manufacture of seat covers and cisterns. The unit started commercial production in FY20 and production has increased gradually in FY21. Cera holds a 51% equity stake in the JV as at Mar 2020.

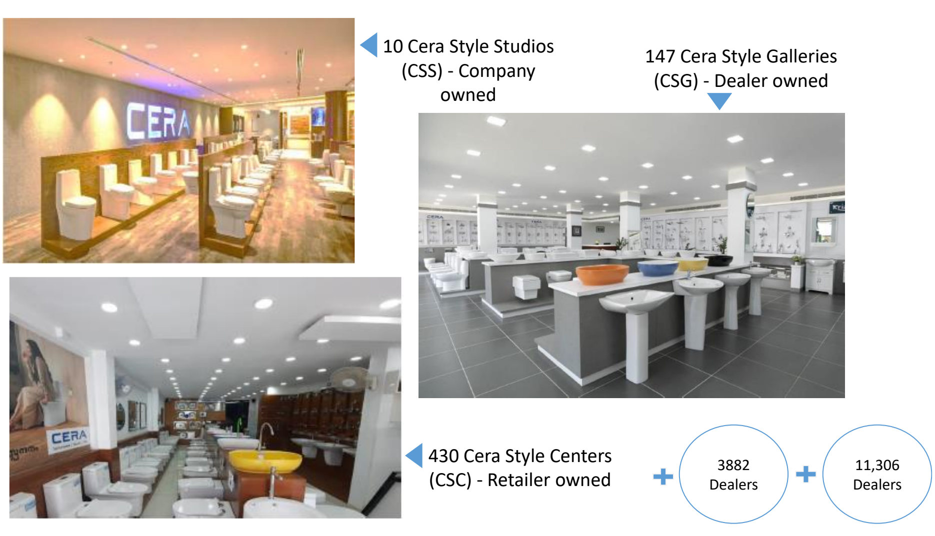
Brand positioning and advertising strategy

Annual advertisement and publicity budget's were 3.5-4% of revenues over FY18-20. Advertising mediums largely include radio, hoardings, and newspapers. Cera was the first sanitaryware brand in India to have Bollywood celebrities as its brand ambassadors to market premium category products.

Also, the company incentivises the trade channel by way of bulk buying discounts, special product promotions, international vacation trips, etc. These are accounted as sales promotion expenditure in the P&L statement and have ranged between 5-6% of annual sales over the past two to three years.

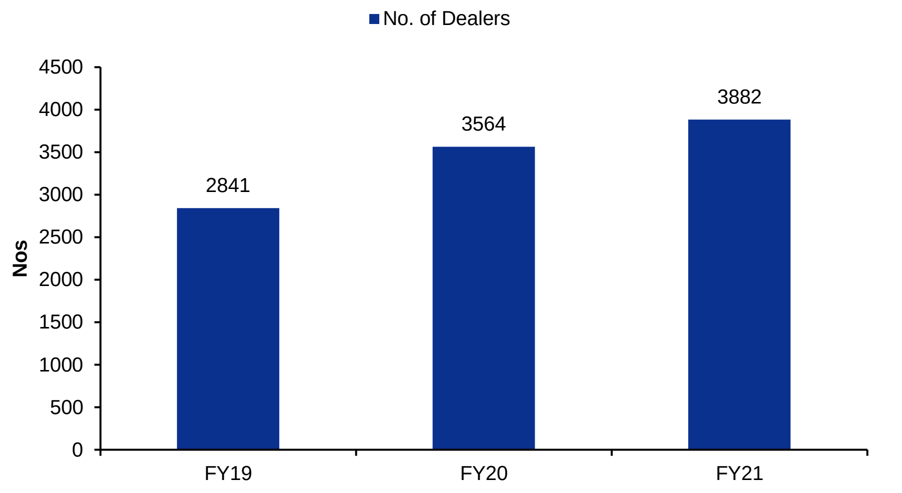
Management has highlighted robust demand outlook going forward and demand to be higher than supply for bathware products in India. Hence Cera would tactically adjust its branding and sales promotion spends over FY22-23F and might spend lower than historical levels.

Figure 386: Distribution reach (Dec 2020)



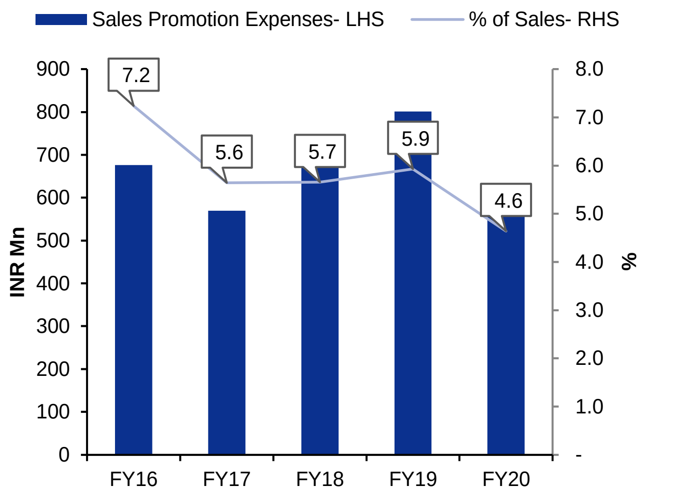
SOURCES: INCRED RESEARCH, COMPANY WEBSITE

Figure 387: Growing distribution



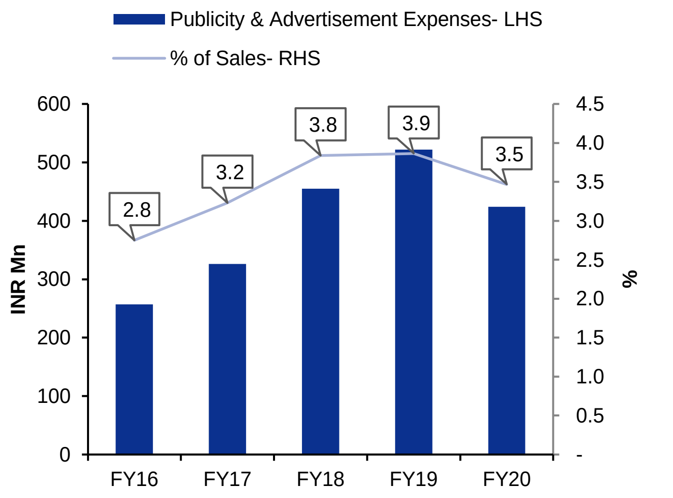
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 388: Sales promotion spends



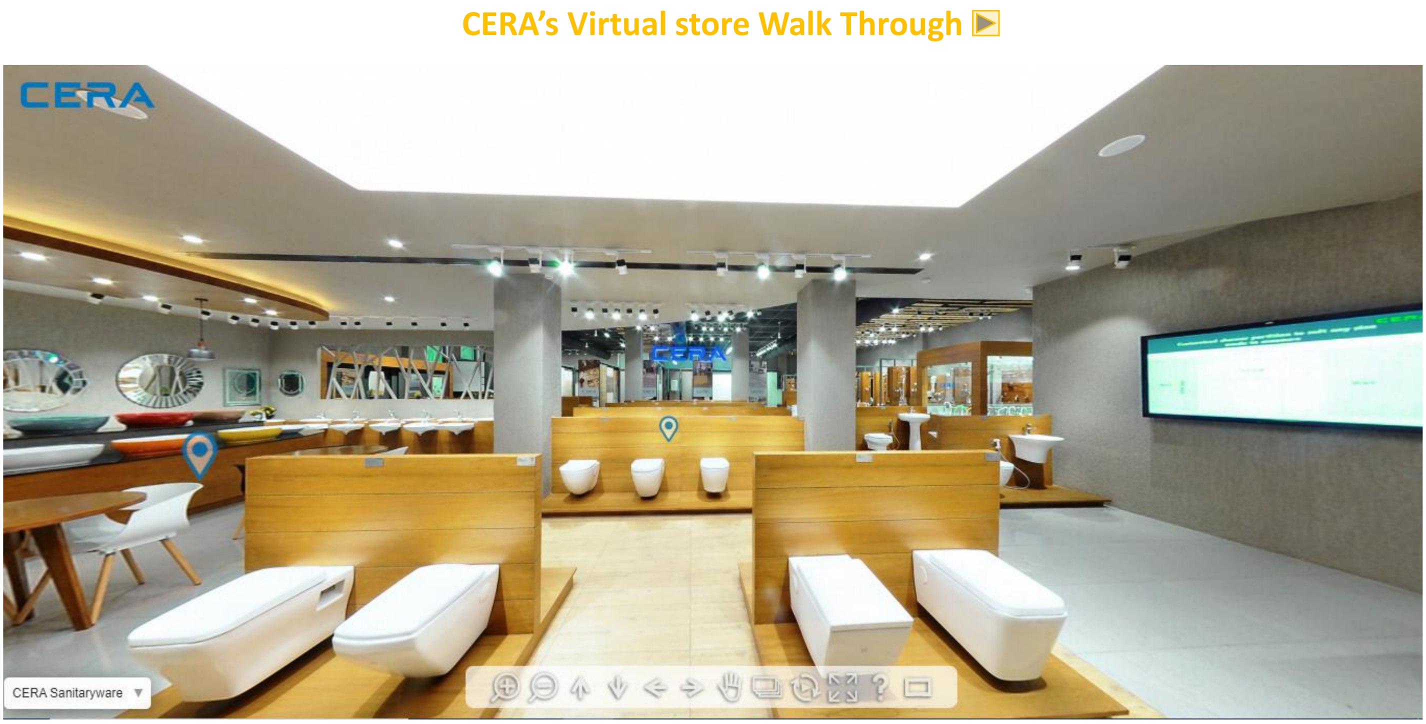
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 389: Publicity and advertising spends



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 390: Cera's virtual store walk through



SOURCES: INCRED RESEARCH, HTTPS://WWW.CERA-INDIA.COM/

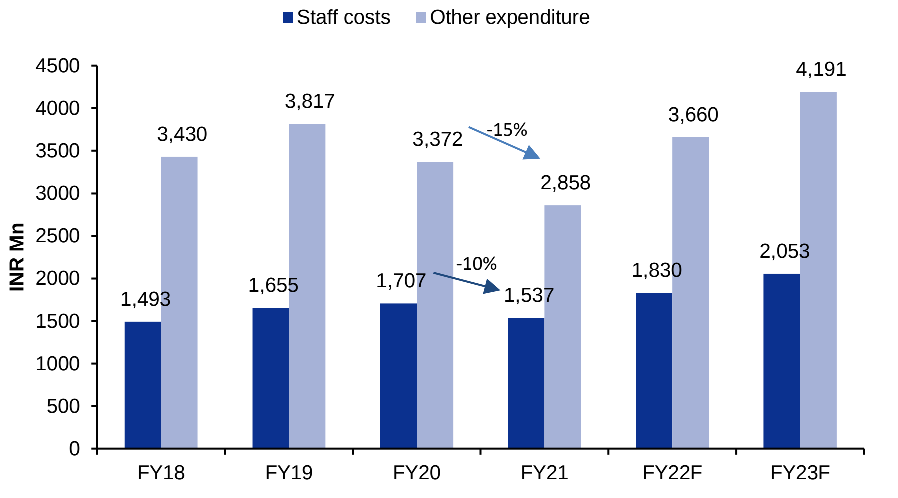
Figure 391: Consistent investments in several branding activities

SOURCES: INCRED RESEARCH, COMPANY WEBSITE, COMPANY REPORTS

Temporary hiccups impacted FY21 performance

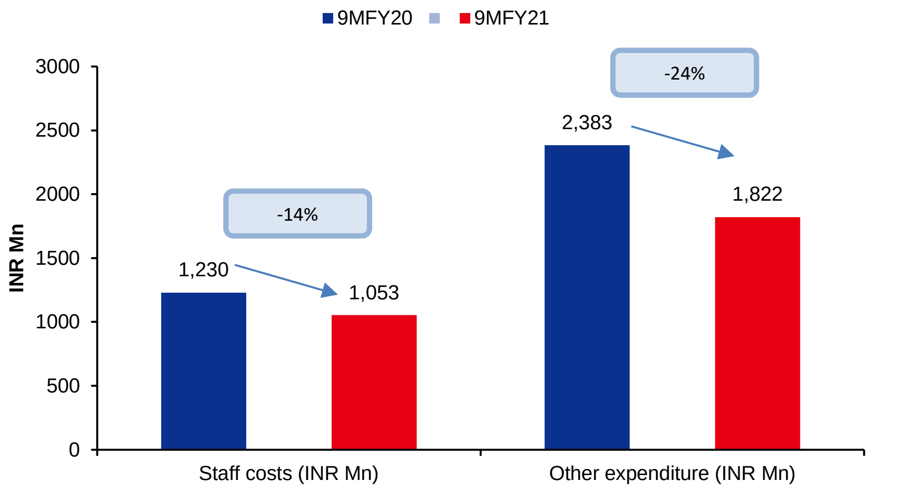
We expect discretionary cost cuts to normalise in next 12 months

Figure 392: Annual staff cost and other expenses



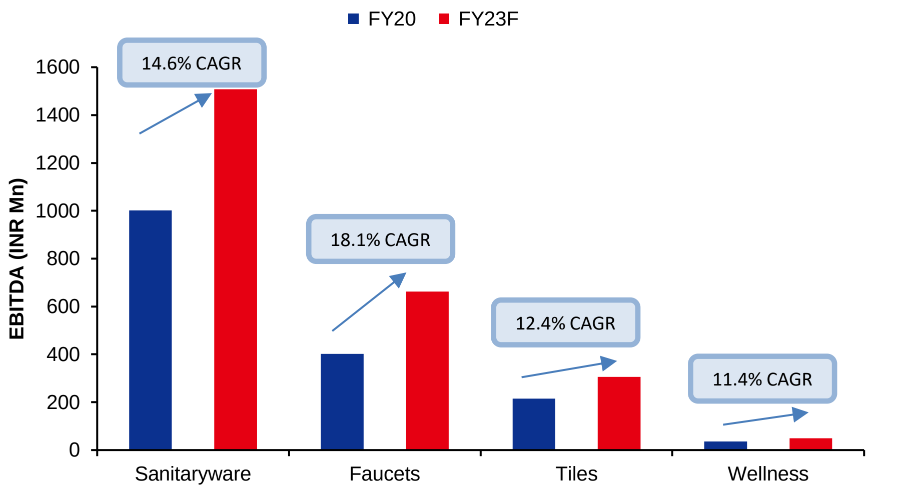
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 393: Sharp cost cuts in 9MFY21 yoy



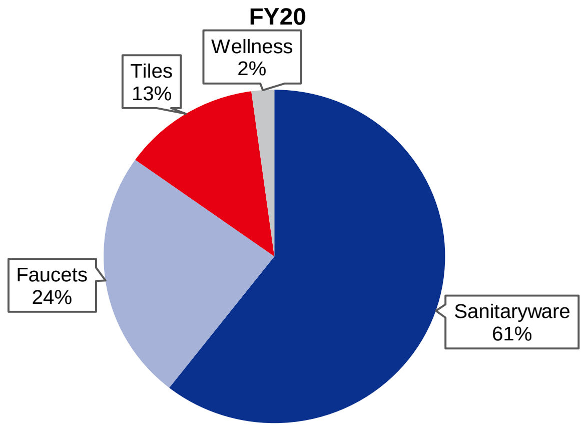
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 394: Segment-wise EBITDA CAGR



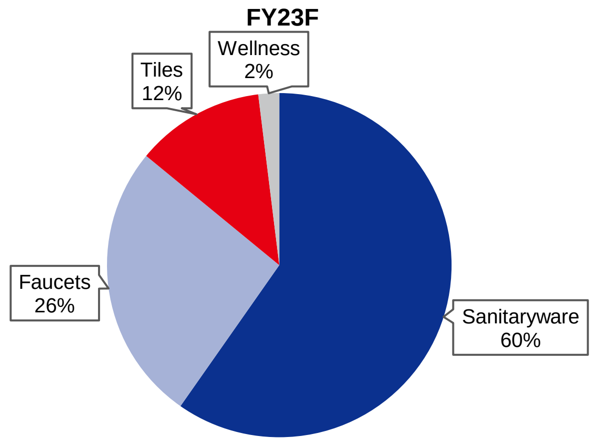
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 395: Approximate segment-wise EBITDA mix (FY20)



SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 396: Approximate segment-wise EBITDA mix (FY23F)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Focus to remain on cash generation, discipline in capital allocation and working capital improvement; PAT CAGR of 32% over FY21-23F ›

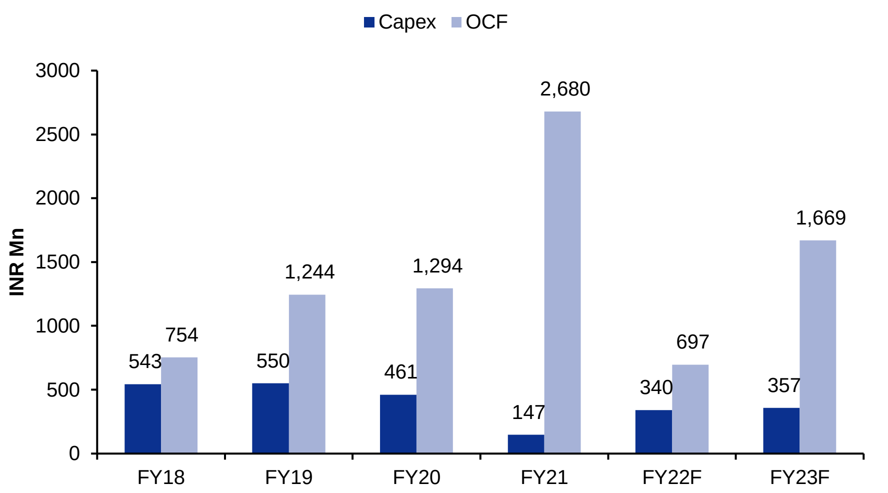
Nearly 55% of SW and faucet and 100% of tiles manufacturing is outsourced to third-party vendors. This ensures less capex on capacity creation while spends are directed towards process automation, IT upgradation, improving supply chain processes, etc, to make the business more resilient and sustainable. We expect as outsourcing closes in to 60% of total revenue share, the company would undertake greenfield/brownfield capacity expansion, likely by end Mar 2022.

We expect operating cash flow (OCF) to be sufficient to fund all capex internally without resorting to external borrowings.

"The beginning of the year, we had indicated that the capex programme for this year is Rs220m. But of that only Rs60m has been spent. In 4Q, only another Rs60m is being planned to be spent. So, a total of Rs120m is being spent this year out of our allocated budget of Rs220m. So, capex is also low and we have developed an ecosystem where we have agile infrastructure and on tap capacity."

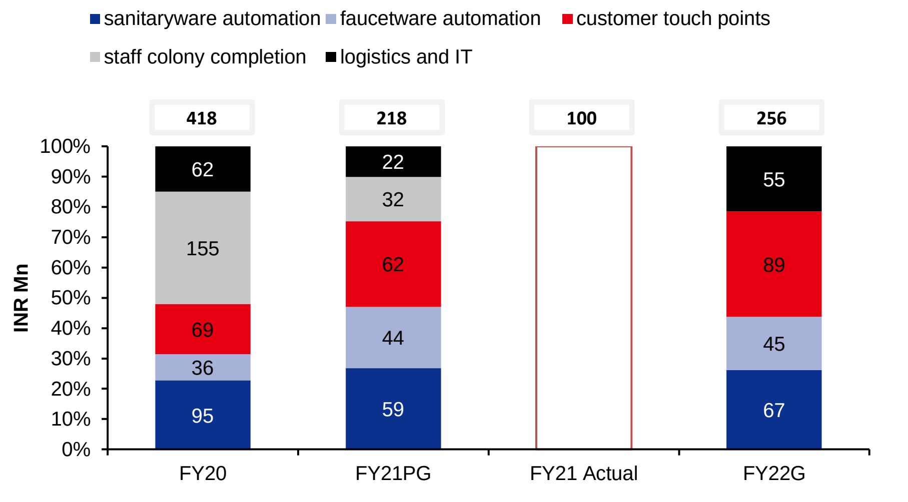
– Cera Sanitaryware, 3QFY21 investor call

Figure 397: Capex and OCF



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

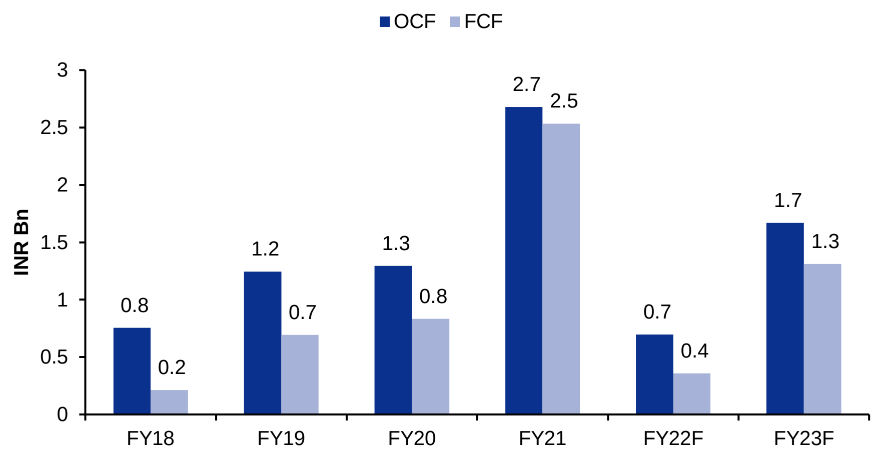
Figure 398: Capacity creation capex low, mostly spent on IT and channel upgradation



P=PREVIOUS G=GUIDANCE
NOTE: GUIDANCE BY CERA MANAGEMENT, SOURCES: INCRED RESEARCH, CERA'S EARNINGS CALL TRANSCRIPTS

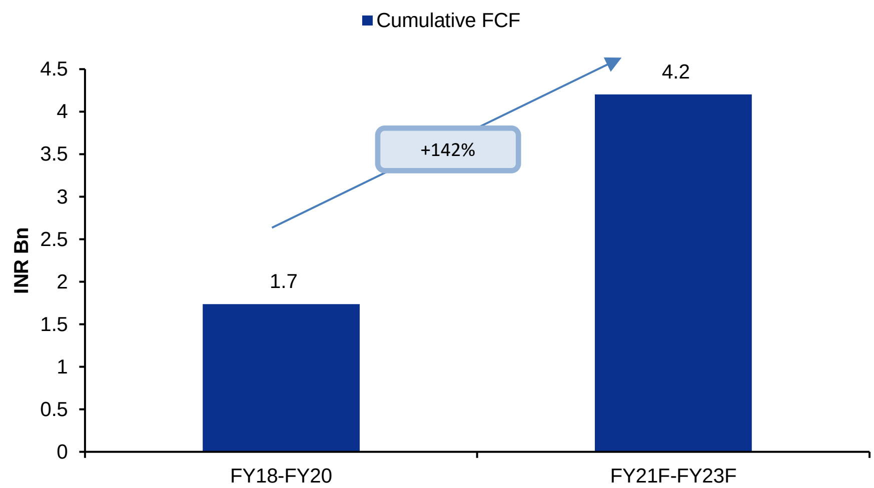
The cumulative free cash flow (FCF) was Rs1.7bn over FY18-20. We expect significantly higher cumulative FCF generation over FY21-23F of Rs4.2bn, driven by higher EBITDA margins, low capex and shorter working capital cycles.

Figure 399: OCF and FCF trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 400: Cumulative FCF over FY18-20 and FY21-23F



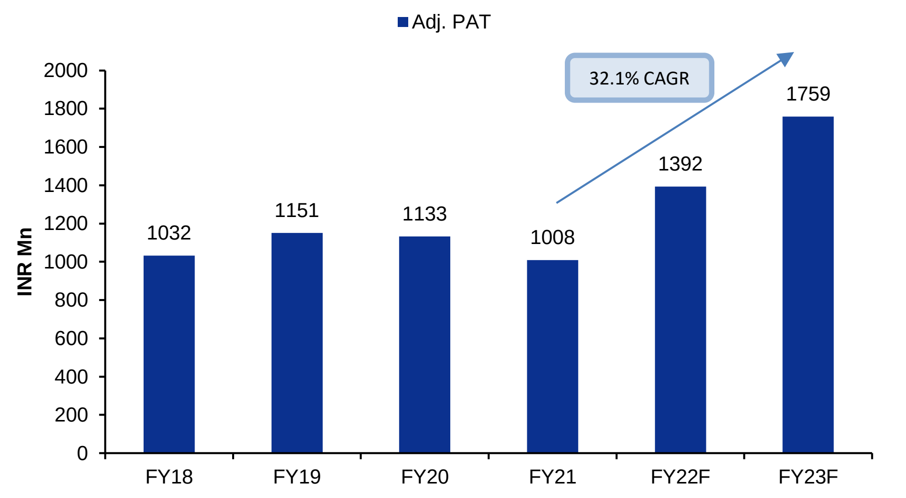
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

"Going ahead, CERA will maintain disciplined credit policies while sustaining the prudent capex outlay to further elevate its robust financial position."
– Cera Sanitaryware, 2QFY21 investor call

Strong recovery in revenue and net profit growth expected

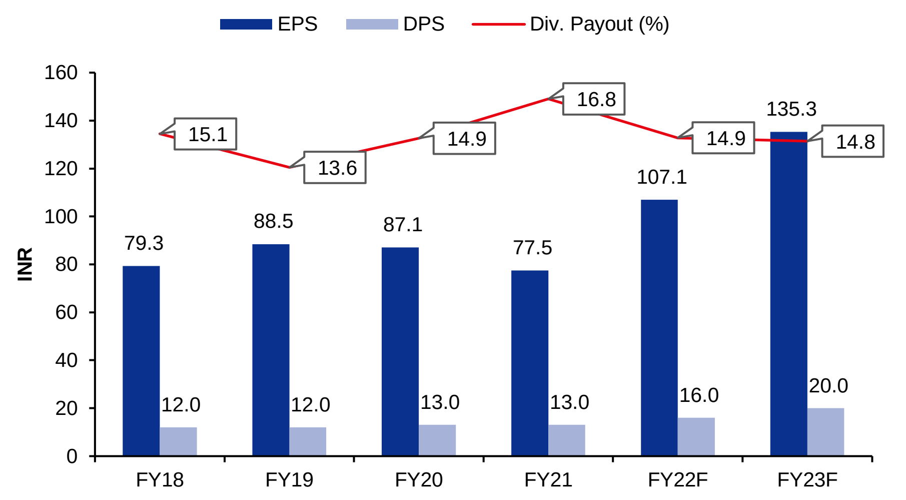
We expect revenue, EBITDA and net profit CAGR of 17%, 26% and 32% over FY21-23F, respectively. This is largely driven by recovery in macro demand drivers, higher home improvement spends, robust project pipeline over the next 2-3 years, recovery in operating margins, low capex intensity and higher treasury income led by higher free cash generation. Though we model dividend payouts of ~15% (similar to past average levels of Rs200m-300m per year) of annual profits over FY21-23F, we think there is scope for the company to increase payouts given net cash balance sheet and high FCF expected over FY21-23F. We expect net cash balances of Rs5.7bn at Mar 2023F.

Figure 401: Adjusted net profit growth trend (excluding exceptional income/loss)



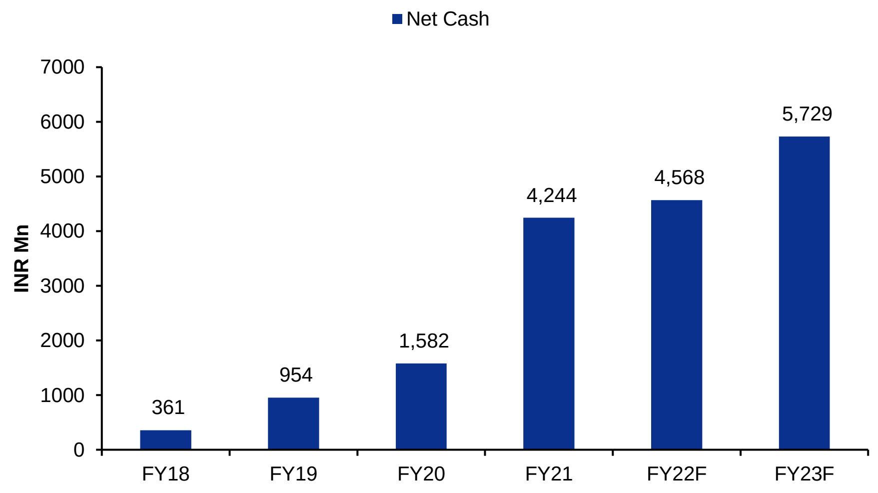
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 402: EPS, DPS and expected payout (%) trend



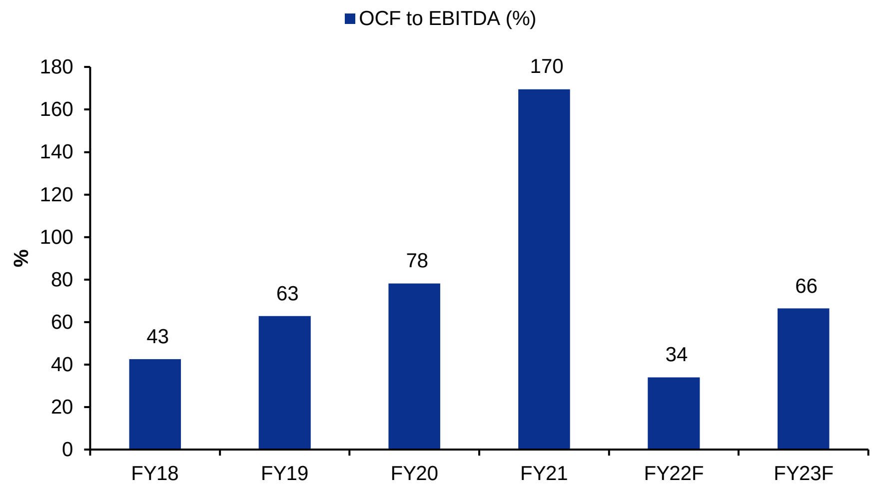
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 403: Higher FCF leading to possibilities of high dividend payouts in future



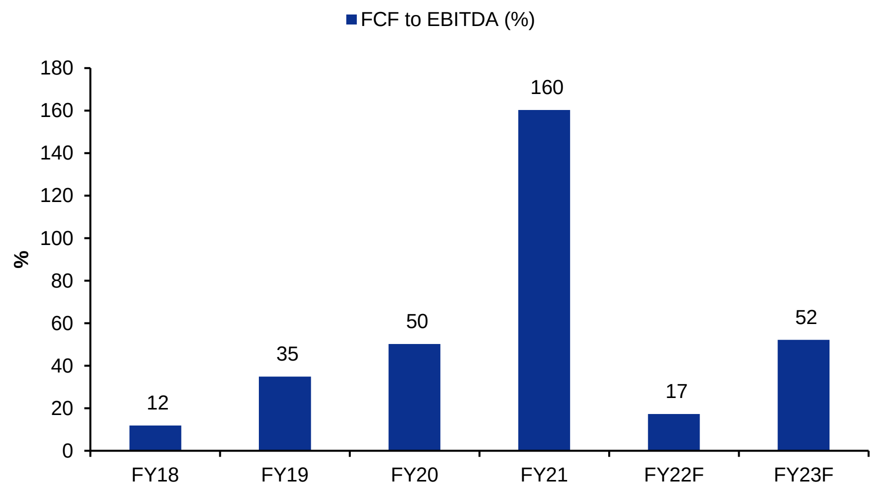
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 404: OCF/EBITDA trend (%)



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 405: FCF to EBITDA (%) trend



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

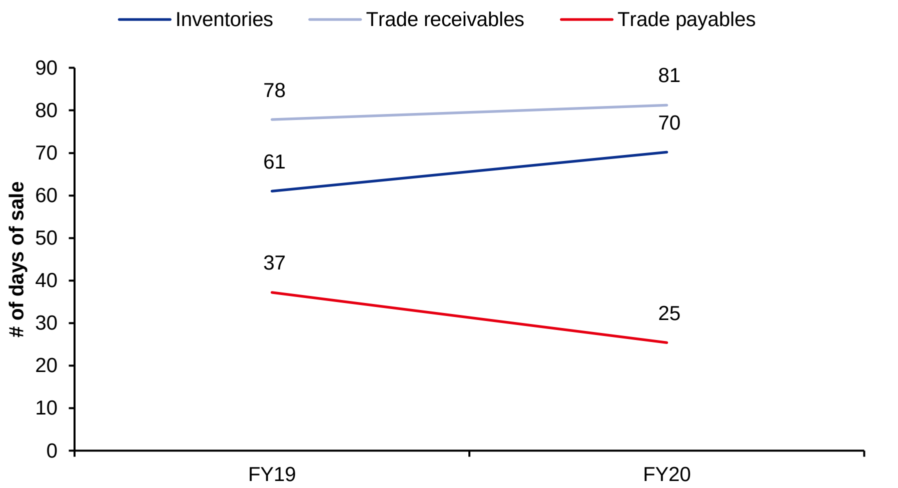
Receivable management has been a focus area for the company, which has required considerable efforts over the last few quarters. Initiatives such as digitisation and established localised warehousing have enabled us to offer 'Just-in-time' inventory to trade partners and large customers. This has enabled debottlenecking at dealer locations and customer sites, leading to faster and smaller billing cycles for Cera enabling better receivables management.
– Cera Sanitaryware, 3QFY21 investor call

Cash conversion cycle at comfortable levels ›

Most large companies in the SW and faucet industry tightened control on working capital management in FY21 owing to COVID-19 pandemic risks. More time and effort were spent on collecting receivables on time, while reducing credit sales to tier-2/-3 customers. With regards to inventory management, Cera focused on just-in-time sourcing for outsourced products while maintaining sufficient inventory at factories and depots for consistent supplies to trade channels in the event of further lockdowns due to COVID-19 infections. As a result, Cera and most companies in our building material coverage universe have freed up working capital and shortened cash conversion cycles to life-time best levels.

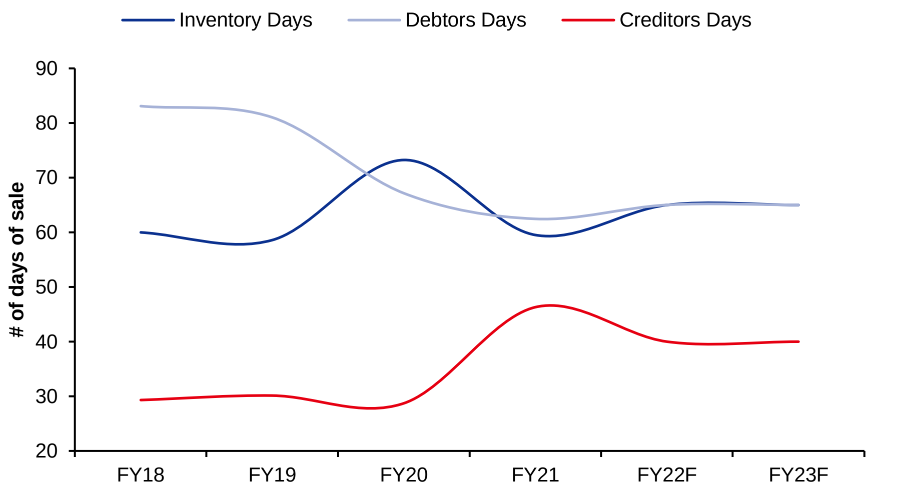
Cera had a net working capital cycle of 70-80 days of sales over FY18-20, but ended FY21F with a net working capital cycle of 35 days. We expect benefits from changes in business practices induced by COVID-19 to be partially retained in the form of shorter cycles going forward and expect working capital to stabilise at 50-55 days of sales over FY22-23F.

Figure 406: Somany Home Innovation: Inventory, receivable and payable days



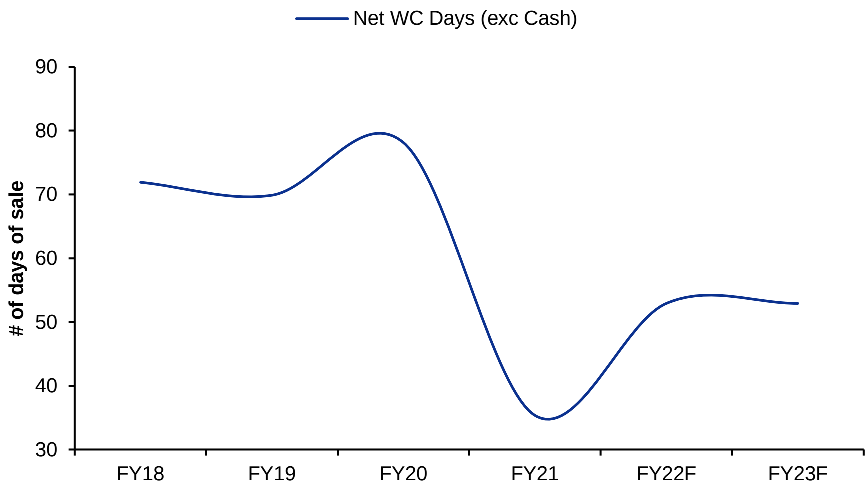
SOURCES: INCRED RESEARCH, SHIL COMPANY REPORTS

Figure 407: Cera's inventory, debtors and creditors days



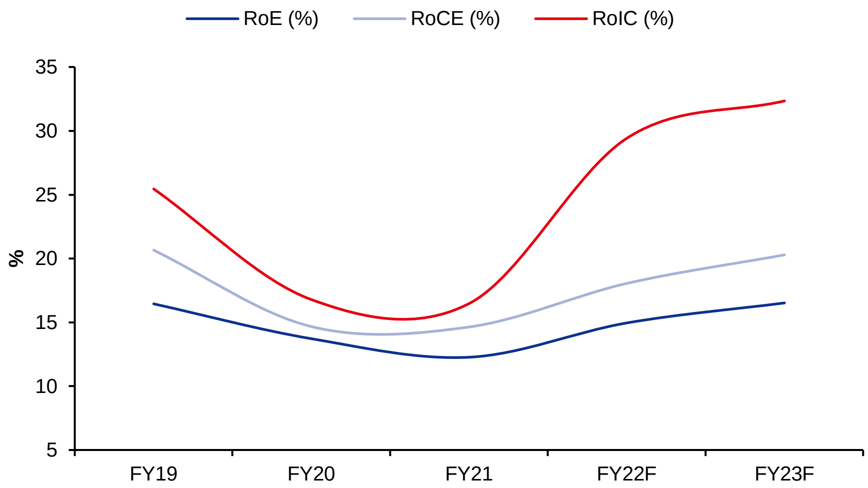
SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 408: Net WC excluding cash and equivalents



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Figure 409: Return ratios



SOURCES: INCRED RESEARCH ESTIMATES, COMPANY REPORTS

Valuations and risks

Track record of consistent business performance and capital allocation discipline has led to stock outperformance ›

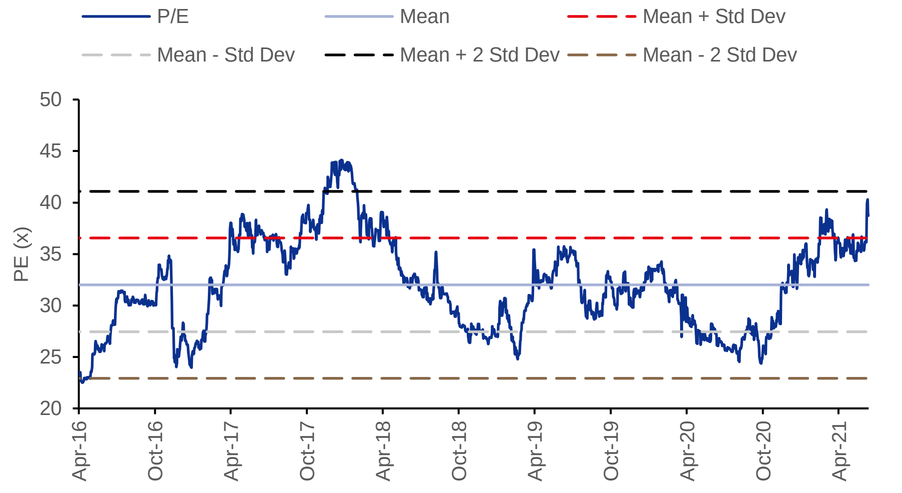
We initiate coverage with an Add rating and a target price of Rs5,140 based on 38x FY23F EPS. Cera Sanitaryware's stock price is at its life-time high and rose ~85% from the Mar-Apr 2020 COVID-19 correction lows (Nifty Smallcap 250 +150%). Most consumer discretionary stocks rose similarly over the past year given the sector tailwinds and broad-based recovery in demand drivers.

We highlight factors that have determined Cera's stock valuation over the years and would continue to influence its stock price even going forward.

- The stock rose over 10x between Apr 2012 and Apr 2017 on the back of revenue CAGR of 20% and EPS CAGR of 22% over FY13-17.
- The business delivered on most qualitative business parameters of consistent market share gains, dominant industry position, high brand recall, pan India distribution presence and low volatility in business performance.
- Even with regards to quantitative investing parameters, the business has delivered on several counts like revenue growth, gross and EBITDA margin expansion, cost control, fully internal funded capex, strict controls on cash conversion cycles, no external borrowings, capital allocation and maintaining high return on capital, in our view.

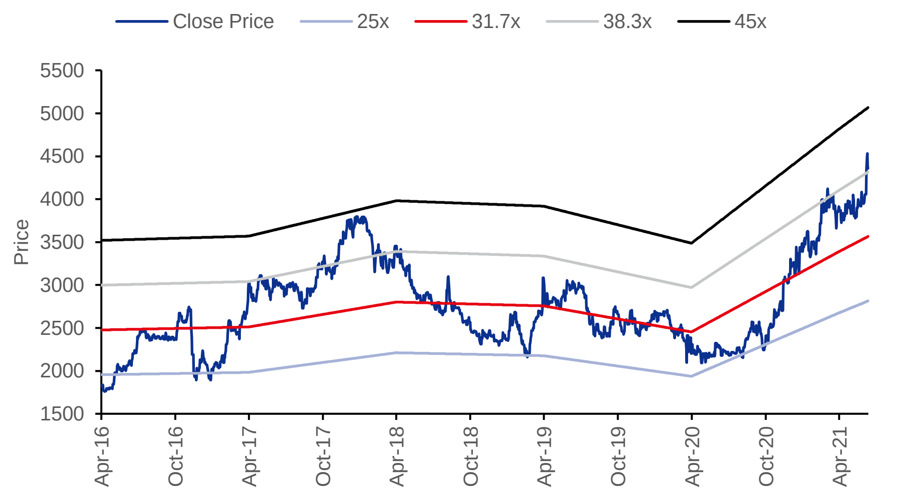
- Cera's stock price rose at ~8.5% CAGR over Apr 2017 to Apr 2021 wherein the revenue and net profit CAGR was 1% and -0.8%, respectively, over FY18-21.
- Stock currently trades at FY23F P/E of 32.2x and EV/EBITDA of 20.4x.
- We value the stock at Rs5,140 based on P/E of 38x FY23F, a ~20% premium to its five-year mean P/E of 32x and initiate coverage with an Add rating.
- We apply a mid-range (20%) P/E premium to Cera and expect the stock to command higher than historical valuations owing to a) demand revival in urban real estate driving bathware sales, b) balanced revenue mix spread across sanitaryware, faucets and tiles, c) higher revenue and EPS CAGR of 17% and 32% over FY21-23F versus 2% and 5% over FY18-20 respectively and d) strict discipline on capital allocation with reinvestments only in core revenue segments.

Figure 410: Cera trading around +2SD its 5-year mean P/E (1-year forward)



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

Figure 411: P/E Band Chart



SOURCES: INCRED RESEARCH, COMPANY REPORTS, BLOOMBERG

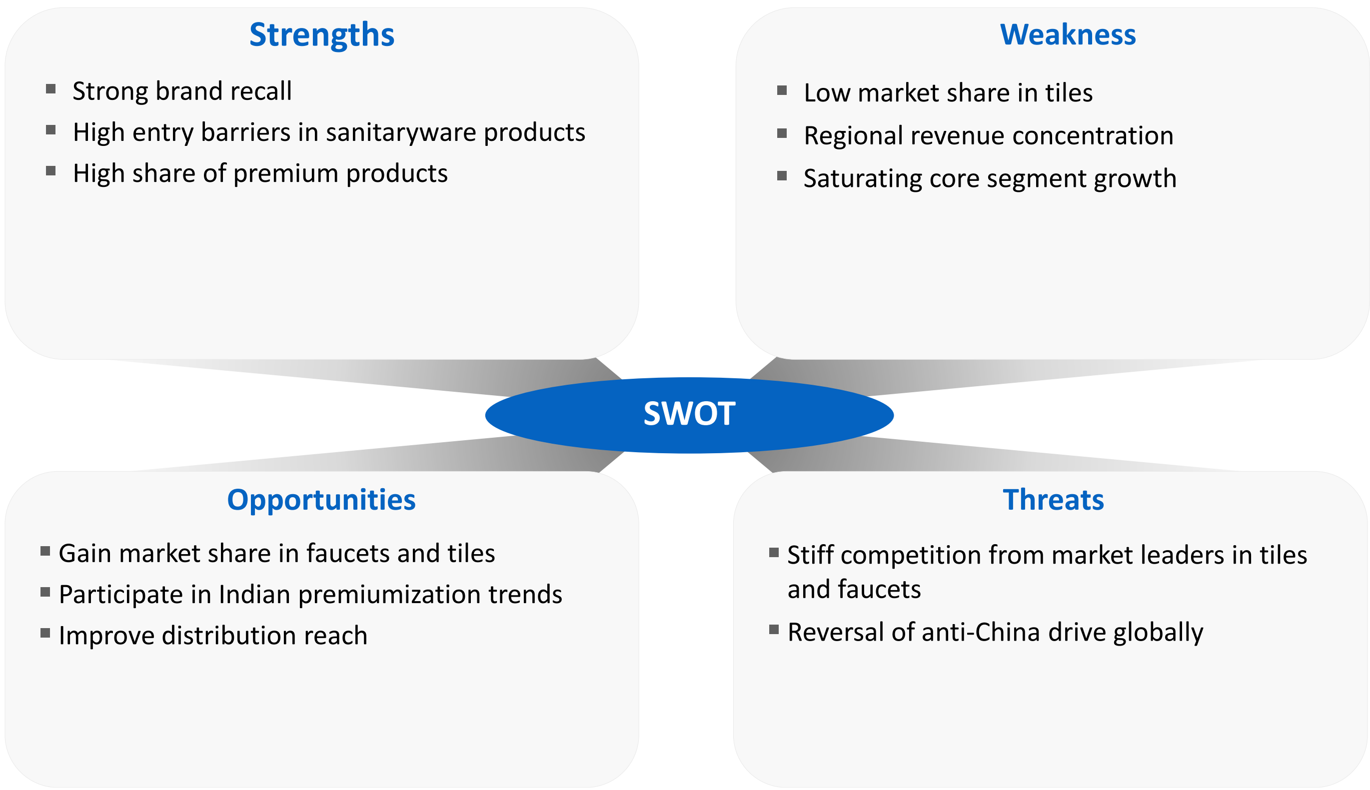
> *"The home improvement theme has been resonating with consumers. Savings and disposable income for consumers due to restrictions on travel and entertainment found its way to upgradation and renovation of homes. The limited impact of COVID in tier-3 and below centres has allowed civil contractors, plumbing contractors, and interior home designers to re-engage with the consumer."*
>
> *– Cera Sanitaryware, 3QFY21 investor call*

Downside risks

- **Are demand trends sustainable?** There is the risk of slowing demand once the COVID-19 pandemic-related lockdown ends as the Indian vaccine inoculation programme achieves wider coverage and mobility restarts. This could impact our revenue growth estimates negatively.
- **Input cost inflation:** Prices of brass and steel have been on the rise due to constrained supply, while domestic freight costs have spiralled. The time lag between cost inflation and pass through by way of price hikes to customers could impact intermittent period EBITDA margins.
- **Labour-related issues:** Cera suffered production losses due to labour strikes at its flagship plant at Kadi, Gujarat, in Sep-Dec 2020. Though 2012 was the last time such an issue had happened, the handling of labour unions and related matters remains a risk impacting our production and revenue estimates.
- **Outsourcing exposes Cera to supply chain risks:** Since Cera sources 45% of its SW and faucet products from third-party vendors, any temporary shutdown/lockdown of factories impacts material supply to the trade channel.
- **Prolonged COVID-19 pandemic:** In case the current pandemic is prolonged, infections will continue to impact human life, and demand for building material products could drop or remain low for a long period.
- **Treasury management:** We expect a meaningful rise in FCF generation going forward. Risk management policies with regards to treasury will be critical. Casual short-term investment decisions or unrelated diversification pose risks to our investment thesis.

SWOT analysis

Figure 412: SWOT Analysis



SOURCES: INCRED RESEARCH

Business description and management profile

Cera Sanitaryware Ltd. is a Gujarat-based company incorporated in 1998 by its current Chairman Mr. Vikram Somany. It manufactures building products like sanitaryware, faucets, high-end showers, steam cubicles and whirlpools. Foraying into a new arena, CERA launched an array of stylish wall and floor tiles. The range includes HD digital wall tiles with matching floor tiles, digital glazed vitrified tiles, and vitrified tiles with nano technology.

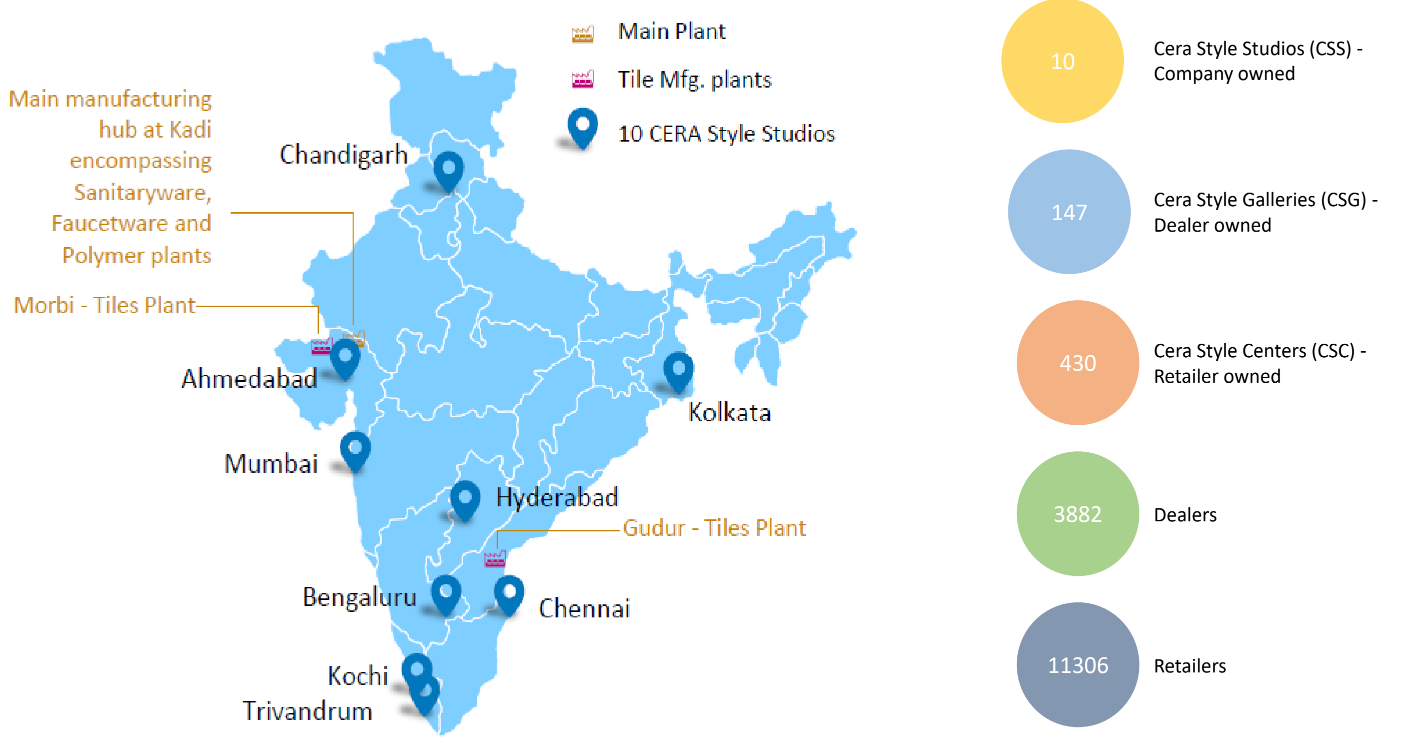
The board of directors consists of six independent and four non-independent directors.

Figure 413: Key management profile (FY20)

Mr. Vikram Somany Chairman and Managing Director	Mr Somany founded the business in 1980. He is involved in the day-to-day operations of the company. He is responsible for the initiation and execution of the company's business strategy. He has a B.Sc. and FCMI (UK).
Ms. Deepshikha Khaitan Vice Chairperson Non Executive	A B.Sc. (Economics) and LLB, Ms Khaitan has been with Cera for over seven years and is actively involved in design innovation, product, R&D, channel outreach and sales. She has been focussing on profitability and product development.
Mr. Atul Sanghvi Executive Director & CEO	Mr Sanghvi has an MBA in Marketing and 34 years of experience. He has been part of the Cera's leadership for over 20 years and in charge of all aspects of manufacturing, marketing and corporate affairs.
Mr. Ayush Bagla Executive Director	Mr Bagla is a graduate from Franklin Marshall College, USA. He has been involved in capital markets, investment banking and mergers and acquisitions for the last 23 years. He joined Cera's board of directors last year and is involved in Investor Relations, equity value creation, and capital allocation.
Mr. R.B. Shah CFO & COO (Finance & Commercial)	Mr Shah is a Bachelor of Commerce and an ACA. He has been associated with Cera for 34 years and handles the finance, commercial, banking, budgeting and cost control functions.

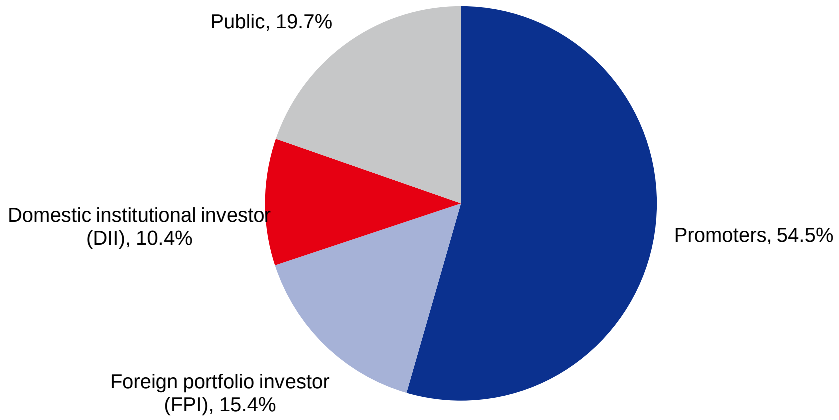
SOURCES: INCRED RESEARCH, COMPANY REPORTS

Figure 414: Cera's geographic footprint as at Dec 2020



SOURCES: INCRED RESEARCH, COMPANY REPORTS

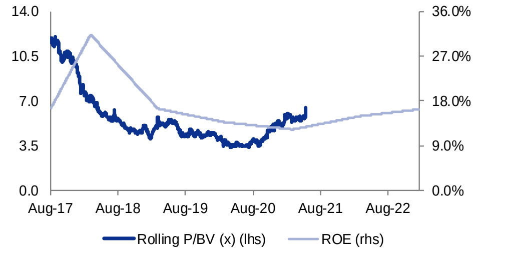
Figure 415: Shareholding pattern (Mar 2021)



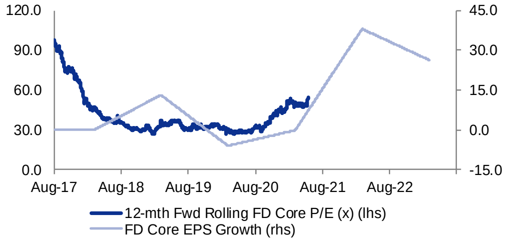
SOURCES: INCRED RESEARCH, BOMBAY STOCK EXCHANGE WEBSITE

BY THE NUMBERS

P/BV vs ROE



12-mth Fwd FD Core P/E vs FD Core EPS Growth



Profit & Loss

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Net Revenues	**13,439**	**12,114**	**12,243**	**14,640**	**16,763**
Gross Profit	**7,378**	**6,612**	**5,975**	**7,540**	**8,759**
Operating EBITDA	**1,906**	**1,532**	**1,581**	**2,050**	**2,514**
Depreciation And Amortisation	(280)	(388)	(396)	(414)	(436)
Operating EBIT	**1,627**	**1,144**	**1,185**	**1,636**	**2,078**
Financial Income/(Expense)	(66)	36	100	178	224
Pretax Income/(Loss) from Assoc.		1			
Non-Operating Income/(Expense)	166	46	55	50	53
Profit Before Tax (pre-EI)	**1,727**	**1,227**	**1,340**	**1,864**	**2,355**
Exceptional Items					
Pre-tax Profit	**1,727**	**1,227**	**1,340**	**1,864**	**2,355**
Taxation	(652)	(243)	(340)	(467)	(590)
Exceptional Income - post-tax					
Profit After Tax	**1,075**	**983**	**1,000**	**1,397**	**1,765**
Minority Interests		27	8	(5)	(6)
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	**1,075**	**1,010**	**1,008**	**1,392**	**1,759**
Recurring Net Profit	1,075	1,010	1,008	1,392	1,759
Fully Diluted Recurring Net Profit	**1,075**	**1,010**	**1,008**	**1,392**	**1,759**

Cash Flow

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
EBITDA	1,906	1,532	1,581	2,050	2,514
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(214)	47	1,316	(936)	(308)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense					
Other Operating Cashflow	(27)	16	15	228	277
Net Interest (Paid)/Received	69	79	65	(178)	(224)
Tax Paid	(567)	(504)	(296)	(467)	(590)
Cashflow From Operations	**1,168**	**1,171**	**2,680**	**697**	**1,669**
Capex	(550)	(461)	(147)	(340)	(357)
Disposals Of FAs/subsidiaries		9	6		
Acq. Of Subsidiaries/investments	(567)	(351)	(2,313)		(500)
Other Investing Cashflow	13	3	30	244	276
Cash Flow From Investing	**(1,104)**	**(800)**	**(2,423)**	**(96)**	**(581)**
Debt Raised/(repaid)	(20)	(66)	(158)	(100)	(215)
Proceeds From Issue Of Shares			49		
Shares Repurchased					
Dividends Paid	(196)	(411)		(210)	(261)
Preferred Dividends					
Other Financing Cashflow	(74)	(75)	(79)	(66)	(52)
Cash Flow From Financing	**(290)**	**(552)**	**(188)**	**(376)**	**(528)**
Total Cash Generated	(226)	(181)	68	224	561
Free Cashflow To Equity	**44**	**305**	**98**	**501**	**874**
Free Cashflow To Firm	**(22)**	**270**	**160**	**535**	**1,036**

SOURCES: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS…cont'd

Balance Sheet

(Rs mn)	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Total Cash And Equivalents	1,860	2,294	4,765	4,989	6,050
Total Debtors	2,984	2,228	2,095	2,607	2,985
Inventories	2,158	2,430	1,997	2,607	2,985
Total Other Current Assets	589	630	464	719	823
Total Current Assets	**7,590**	**7,582**	**9,320**	**10,922**	**12,843**
Fixed Assets	3,845	4,197	4,009	3,939	3,860
Total Investments	81	82	82	82	82
Intangible Assets	9	12	8	8	8
Total Other Non-Current Assets	394	392	358	354	354
Total Non-current Assets	**4,328**	**4,683**	**4,457**	**4,383**	**4,304**
Short-term Debt	510	485	303	244	186
Current Portion of Long-Term Debt					
Total Creditors	1,109	953	1,554	1,604	1,837
Other Current Liabilities	2,047	1,742	1,815	2,206	2,526
Total Current Liabilities	**3,667**	**3,180**	**3,671**	**4,055**	**4,549**
Total Long-term Debt	396	227	218	177	135
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	307	567	542	542	542
Total Non-current Liabilities	**703**	**793**	**761**	**719**	**677**
Total Provisions	436	299	303	303	303
Total Liabilities	**4,806**	**4,273**	**4,734**	**5,076**	**5,529**
Shareholders Equity	7,009	7,915	8,925	10,107	11,491
Minority Interests	103	77	117	122	128
Total Equity	**7,112**	**7,992**	**9,042**	**10,229**	**11,619**

Key Ratios

	Mar-19A	Mar-20A	Mar-21F	Mar-22F	Mar-23F
Revenue Growth	14.2%	(9.9%)	1.1%	19.6%	14.5%
Operating EBITDA Growth	12.7%	(19.6%)	3.2%	29.7%	22.7%
Operating EBITDA Margin	14.2%	12.6%	12.9%	14.0%	15.0%
Net Cash Per Share (Rs)	73.34	121.63	326.28	351.23	440.47
BVPS (Rs)	538.92	608.58	686.23	777.13	883.52
Gross Interest Cover	19.04	11.39	12.24	24.81	40.01
Effective Tax Rate	37.8%	19.8%	25.4%	25.0%	25.1%
Net Dividend Payout Ratio	10.9%	16.3%	12.5%	11.2%	11.1%
Accounts Receivables Days	76.91	78.52	64.44	58.61	60.88
Inventory Days	123.22	152.15	128.88	118.33	127.51
Accounts Payables Days	61.86	68.41	72.99	81.17	78.47
ROIC (%)	25.5%	16.8%	16.5%	29.4%	32.3%
ROCE (%)	20.7%	14.7%	14.6%	18.1%	20.3%
Return On Average Assets	16.0%	9.8%	9.5%	11.6%	13.1%

SOURCES: INCRED RESEARCH, COMPANY REPORTS

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Corporate Governance Report of Thai Listed Companies (CGR). CG Rating by the Thai Institute of Directors Association (Thai IOD) in 2020, Anti-Corruption 2020

ADVANC – Excellent, Certified, **AMATA** – Excellent, Certified, **ANAN** – Excellent, n/a, **AOT** – Excellent, n/a, **AP** – Excellent, Certified, **ASP** – Excellent, n/a, **AU** – Good, n/a, **BAM** – Very Good, Certified, **BAY** – Excellent, Certified, **BBL** – Very Good, Certified, **BCH** – Good, Certified, **BCP** - Excellent, Certified, **BCPG** – Excellent, Certified, **BDMS** – Excellent, n/a, **BEAUTY** – Good, n/a, **BH** - Good, n/a, **BJC** – Very Good, n/a, **BLA** – Excellent, Certified, **BTS** - Excellent, Certified, **CBG** – Very Good, n/a, **CCET** – n/a, n/a, **CENTEL** – Excellent, Certified, **CHAYO** – Very Good, n/a, **CHG** – Very Good, n/a, **CK** – Excellent, n/a, **COM7** – Very Good, Certified, **CPALL** – Excellent, Certified, **CPF** – Excellent, Certified, **CPN** - Excellent, Certified, **CPNREIT** – n/a, n/a, **CRC** – Very Good, n/a, **DELTA** - Excellent, Certified, **DDD** – Very Good, n/a, **DIF** – n/a, n/a, **DOHOME** – Very Good, n/a, **DREIT** – n/a, n/a, **DTAC** – Excellent, Certified, **ECL** – Excellent, Certified, **EGCO** - Excellent, Certified, **EPG** – Excellent, Certified, **ERW** – Very Good, Certified, **GFPT** - Excellent, Certified, **GGC** – Excellent, Certified, **GLOBAL** – Very Good, n/a, **HANA** - Excellent, Certified, **HMPRO** - Excellent, Certified, **HUMAN** – Good, n/a, **ICHI** – Excellent, Certified, **III** – Excellent, n/a, **INTUCH** - Excellent, Certified, **IRPC** – Excellent, Certified, **ITD** – Very Good, n/a, **IVL** - Excellent, Certified, **JASIF** – n/a, n/a, **JKN** – Excellent, Declared, **JMT** – Very Good, Declared, **KBANK** - Excellent, Certified, **KCE** - Excellent, Certified, **KEX** – n/a, n/a, **KKP** – Excellent, Certified, **KSL** – Excellent, Certified, **KTB** - Excellent, Certified, **KTC** – Excellent, Certified, **LH** - Excellent, n/a, **LPN** – Excellent, Certified, **M** – Very Good, Certified, **MAKRO** – Excellent, Certified, **MC** – Excellent, Certified, **MEGA** – Very Good, n/a, **MINT** - Excellent, Certified, **MTC** – Excellent, Certified, **NETBAY** – Very Good, n/a, **NRF** – n/a, n/a, **OR** – n/a, n/a, **ORI** – Excellent, Certified, **OSP** – Very Good, n/a, **PLANB** – Excellent, Certified, **PRINC** – Very Good, Certified, **PR9** – Excellent, n/a, **PSH** – Excellent, Certified, PTT - Excellent, Certified, PTTEP - Excellent, Certified, PTTGC - Excellent, Certified, QH – Excellent, Certified, RBF – Good, n/a, **RS** – Excellent, n/a, **RSP** – Good, n/a, **S** – Excellent, n/a, **SAK** – n/a, n/a, **SAPPE** – Very Good, Certified, **SAWAD** – Very Good, n/a, **SCB** - Excellent, Certified, **SCC** – Excellent, Certified, **SCGP** – n/a, n/a, **SHR** – Very Good, n/a, **SIRI** – Excellent, Certified, **SPA** – Very Good, n/a, **SPALI** - Excellent, Declared, **SPRC** – Excellent, Certified, **SSP** - Good, Declared, **STEC** – n/a, n/a, **SVI** – Excellent, Certified, **SYNEX** – Very Good, n/a, **TCAP** – Excellent, Certified, **THANI** – Excellent, Certified, **TISCO** - Excellent, Certified, **TKN** – Very Good, n/a, **TMB** - Excellent, Certified, **TOP** - Excellent, Certified, **TRUE** – Excellent, Certified, **TU** – Excellent, Certified, **TVO** – Excellent, Certified, **VGI** – Excellent, Certified, **WHA** – Excellent, Certified, **WHART** – n/a, n/a, **WICE** – Excellent, Certified, **WORK** – Good, n/a.

- CG Score 2020 from Thai Institute of Directors Association (IOD)
- Companies participating in Thailand's Private Sector Collective Action Coalition Against Corruption programme (Thai CAC) under Thai Institute of Directors (as of January 30, 2021) are categorised into: companies that have declared their intention to join CAC, and companies certified by CAC.

Recommendation Framework

Stock Ratings	Definition:
Add	The stock's total return is expected to exceed 10% over the next 12 months.
Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

The total expected return of a stock is defined as the sum of the: (i) percentage difference between the target price and the current price and (ii) the forward net dividend yields of the stock. Stock price targets have an investment horizon of 12 months.

Sector Ratings	Definition:
Overweight	An Overweight rating means stocks in the sector have, on a market cap-weighted basis, a positive absolute recommendation.
Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

Country Ratings	Definition:
Overweight	An Overweight rating means investors should be positioned with an above-market weight in this country relative to benchmark.
Neutral	A Neutral rating means investors should be positioned with a neutral weight in this country relative to benchmark.
Underweight	An Underweight rating means investors should be positioned with a below-market weight in this country relative to benchmark.