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Industry View
Attractive

India Cement

The Beginning of the End?

Capacity Addition Starts in Earnest
Grasim's announcement of an 8mn ton capacity addition (divided equally between greenfield and brownfield) in Rajasthan is the first breach in capacity discipline the top players have been adhering to over the last couple of years. We expect the announcement to be followed by similar announcements from other large players (especially Holcim) as they try to maintain capacity share in the market.

Little Impact on F2007E Pricing Blowout
We estimate any greenfield or brownfield capacity announced by the industry players in future would take around 21-24 months (Jan–Apr 2008) to become operational. Hence, our view of a potential blowout in pricing in F2007E does not change due to capacity addition announcements. The potential upside from pricing, despite a chance of an earnings multiple compression ensures that we remain positive on the sector. We maintain our Attractive view on the industry.

F2009E Bust Will be Bigger Than Expected
We have been calling for the cycle to turn in F2009E as capacity additions (on which we do not have visibility yet) hit the market. We had predicted a decline of 5% in pricing. With the majors starting to add capacity, there is significant downside risk to our F2009E pricing, though it is difficult to quantify at the moment. The risk, in our opinion, will become easier to quantify over the next few months depending on the capacity addition announcements from industry players.

Can Demand Still Keep the Cycle Up?
With corporate capex and infrastructure spending continuing to grow strongly, there is a chance that demand could surprise us on the upside. However, we would need a demand growth CAGR of 9.5% over the next 3 years to keep utilizations at F2006E levels. Given our thesis that housing is going to slow on the back of the interest rate hikes and rising real estate prices, the 150 bps excess demand growth required (over the long term 8% growth rate), while not impossible, does seem unlikely.

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Investment Case

Summary & Conclusions

We believe that the announcement of an addition of 8 million tons of capacity by Grasim (split equally between a greenfield and a brownfield) in the Northern region might be the beginning of a slew of announcements throughout the industry, as the players scramble in an effort not to lose capacity share in the sector. However, we estimate any new capacity (including Grasim's) would take at least 21 months to start producing cement, resulting in little or no impact to our thesis of a pricing blowout in F2007E.

In our opinion, the main impact of this capacity increase will be felt in F2009E, with the forecast bust at that time being greater than our prediction. We believe that we will have more clarity on the pricing decline in F2009E as more capacity announcements happen over the next few months. While it is possible that demand growth still manages to ensure continuation of the cycle, CAGR required to maintain F2006E levels is around 9.5%, and in the backdrop of our thesis of slowing housing growth it seems unlikely.

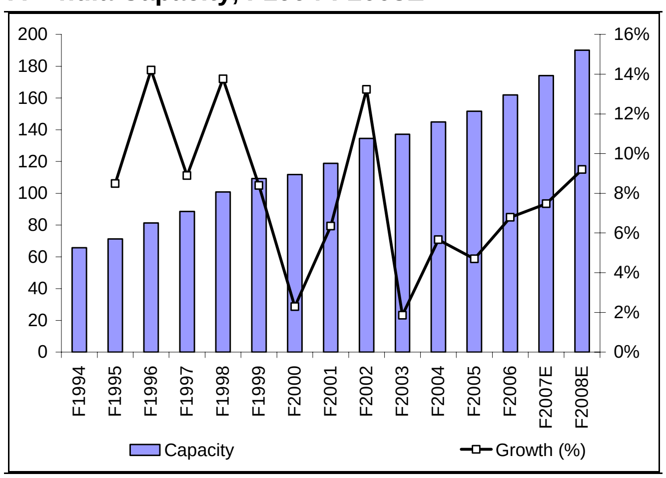
The visibility of the peak of the cycle might lead to a de-rating of the earnings multiples for the sector. However, given the strong leverage to the pricing for our companies (especially our top pick in the sector – ACC [Rs933.80]), we believe that the strong pricing environment could still create significant upside surprise on the earnings front in F2007E. Hence, we would not be sellers into the weakness that we expect will hamper stock prices in the sector over the next few days (on the back of this announcement.

Potential Capacity Addition War in F2009?
Grasim's results were, in our opinion, overshadowed by the company's announcement of an 8 million ton capacity addition. The addition is split up into a 4 million ton greenfield and a 4 million ton brownfield unit, both coming up in the state of Rajasthan. While the Northern region, in our view, is the best region for cement, these two plants will alter the balance in the region, and especially the state.

We would expect the move to be followed by a slew of capacity addition announcements over the next quarter, as the other large players set up capacity to retain capacity share. We would expect the rush to set up capacity being led by Holcim, the second largest cement company in the world and the controllers of ACC and Gujarat Ambuja. With one of the sector leaders planning to bring in such a strong investment in capacity expansion, we would expect all the fence sitters to put up capacity, recreating a scenario similar to F1996 and F2002, when capacity addition shot up to 14.6% and 14.3% of the installed base, respectively, leading to a slump in pricing. We believe that while it remains unannounced, Gujarat Ambuja has plans to add around 2.5 million tons in the Northern region. We would expect the capacity to come up within 18 months of announcement, given the company's past record of rolling out new capacity quickly.

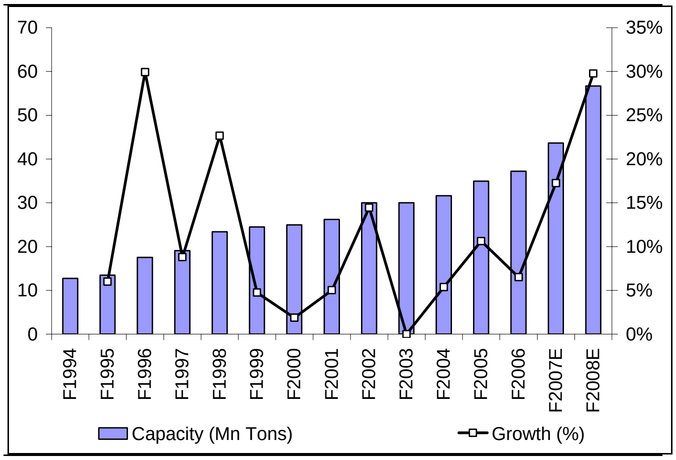
Impact on Rajasthan and the Northern Region
While the North is a deficit region along with the East (both consume more than they produce), the significant capacity addition has the potential to upset the balance. Given the strong capacity addition that was already planned in the Northern region (Exhibit 2), prior to the Grasim announcement we were expecting a balance in demand and supply. The announcement will, in our opinion, push the potential surplus (capacity - consumption) for the region to the highest level of the last 15 years (Exhibit 3). We believe that the Northern region will take some time to digest this 30% capacity addition.

Exhibit 1
All-India Capacity, F1994-F2008E



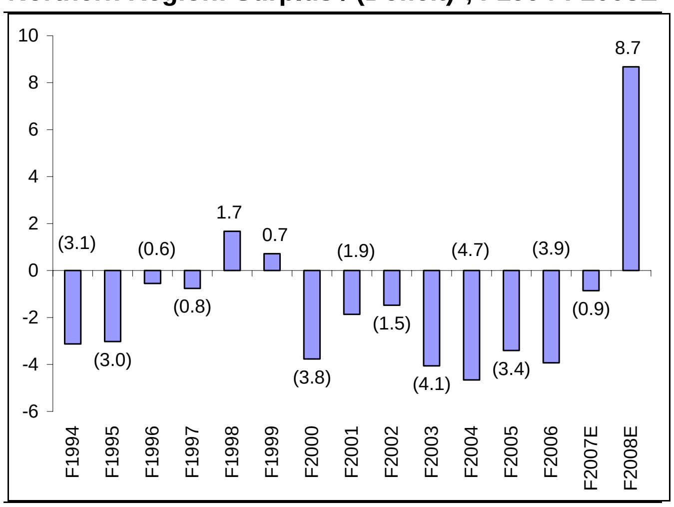
Source: Company data, Morgan Stanley Research

Exhibit 2
Northern Region Capacity, F1994-F2008E



Source: Company data, Morgan Stanley Research

Exhibit 3
Northern Region: Surplus / (Deficit)*, F1994-F2008E



Source: Company data, Morgan Stanley Research
* Assuming 100% utilization

Little Impact to Our View

The capacity announced by Grasim is expected to come up in 21 months from now, in January 2008. None of the companies that have yet to announce new capacity will be able to create capacity before that time, in our view. Thus there will no impact on the potential pricing blowout we expect in F2007E. The next 12 months should remain the best time that the sector has seen in the past 10 years in terms of the potential increase in pricing. While we will see growth in pricing even in F1H08E, we would expect some weakness to come through in F2H08E, even before the bulk of the capacity expansion comes on. However, overall in F2008E, while utilizations will likely slip from F2007E levels at around 93% (Exhibit 9), they should remain stronger than at any other period in the last decade.

The company's announcement is in line with our view that capacity will come through in F2009. Cement is a cyclical sector, and capacity should come in when the going is good for pricing and thus profitability. While this cycle has been extended by the capacity discipline being practiced by the top players, the strong margins in the sector expected in F2007E and pricing blowout was bound to result in capacity additions starting to come through. The capacity that has been announced might trigger further expansions, thus resulting in a larger drop in utilizations than we expect in F2009, which could then result in weaker-than-anticipated pricing for the year (Exhibit 5).

Can A Demand Upside Surprise Lengthen the Cycle?

We would need a demand growth CAGR of 9.5% over the next 3 years to keep utilizations at F2006E levels. For the potential upside on demand we need to break it up into its various components:

1. **Infrastructure spending by government.** We believe that infrastructure spending should ideally increase to US$100 billion p.a. (8% of GDP) by 2010, from an estimated US$24 billion (3.5% of GDP) in 2004, to put India on a sustained growth path of 8–9% pa. With the government starting to focus on infrastructure, we expect investment to pick up to US$47 billion (4.7% of GDP) by F2009 from US$24 billion (3.5% of GDP) in F2005 (Exhibit 4).

2. **Corporate sector capital expenditure.** Despite the good business environment and increased optimism, corporate India has not created capacity in a big way over the last 3 years. Our economist, Chetan Ahya's analysis shows that the stimulus created by the excess liquidity in the system (due to the low interest rates) has been used for increased consumption rather than capital investment. With capex announcements rising in the last few months (Exhibit 6), we stand by our view that spending has started accelerating towards the end of F2006E and will impact cement consumption in F2007E.

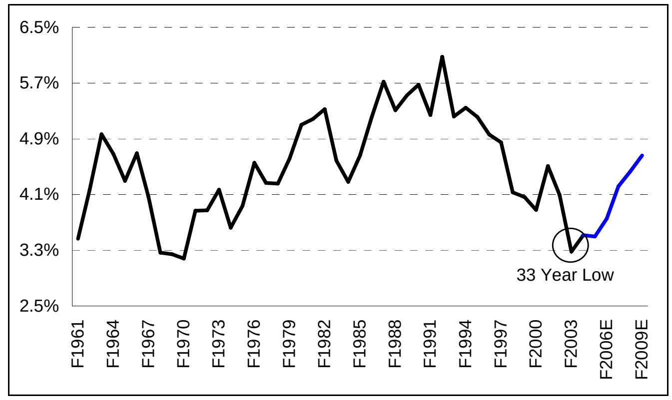
3. **Housing.** This has been the strongest driver of cement demand over the last few years, accounting for around 70% of total domestic demand, on our estimates. In our view, the fall in interest rates has driven the real estate market significantly, as the lower costs have not only triggered the consumers' decision to buy but have also

resulted in buyers upgrading their budget based on the EMI (Equated Monthly Installments) that they were comfortable with. Between June 2001 and April 2004 the yields on 10 year government securities (GSec) in India fell by 460 bps to 5.1%. Over the same period, HDFC's mortgage rates (which we believe are representative of the market) fell by 500 bps to 7.5% (Exhibit 5). Based on the analysis of our banks team, a 100 bps increase in the cost of financing raises the cost of a house purchase by around 5–6% depending on the extent to which the buyer is planning to leverage for the purchase (Exhibit 6). Thus the rising interest rate environment would depress demand as mortgage rates move up too. Over the last 24 months, yields on 10 year government securities and HDFC's mortgage rates have risen by 230 bps and 125 bps, respectively. The Reserve Bank of India (RBI) has also raised concerns in the domestic housing market and raised risk weights (for banks) for mortgages in October 2004, in an effort to keep the real estate market from overheating. This move reduces the ROE on mortgage loans for banks (as banks would have to raise more capital for the same portfolio of mortgage assets) and would result in an increase in the mortgage rate if banks passed the impact on to the consumers (to keep their ROEs intact).

4. **Exports.** Cement exports have grown by 45% YTD, despite the strong 20% growth in F2005 (translating into a large base). Most of the exports have been dispatched to the Middle East with the building boom there. We believe that the construction boom in the Middle East will continue as long as oil prices remain high. Given our global oil team's view on oil "Higher for Longer", we expect exports to continue to grow well over the next 12–24 months. However, the Middle East will see a significant influx of capacity in F2008E, especially if we assume that cement production in Iraq stabilizes by then. Thus, beyond F2008E, we would expect cement exports to reduce in both volume and pricing terms.

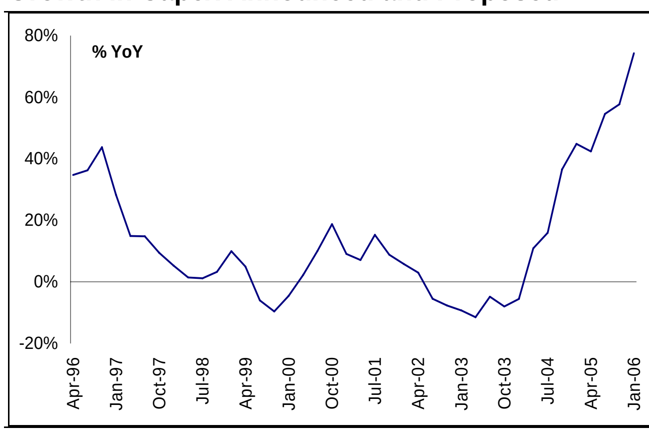
We forecast domestic demand growth of 8.5% and 8% in F2007E, and F2008E, respectively, along with export demand growth of 15% in F2007E. With significant capacity addition coming into play in the Middle East in F2008E, we expect exports to decline 10%. Thus, we expect the cement volumes to grow at a CAGR of 8% in F2007-08E, with the acceleration from the infrastructure and corporate capex being absorbed by the housing slowdown.

Exhibit 4
India: Infrastructure Investment* (% of GDP)



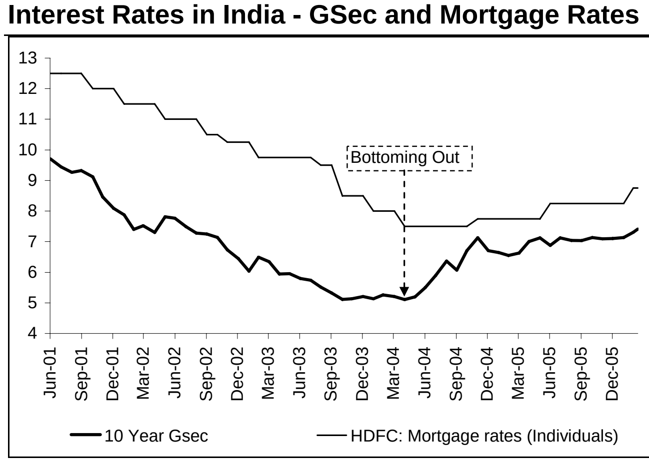
* We have used gross capital formation in energy, airports, seaports, roads and telecom as a proxy for infrastructure spending.
E= Morgan Stanley Research estimates Source: CEIC, Morgan Stanley Research

Exhibit 5
Growth in Capex Announced and Proposed



Source: CMIE, Morgan Stanley Research

Exhibit 6
Interest Rates in India - GSec and Mortgage Rates



Source: Company data, Morgan Stanley Research

Exhibit 7

Impact of Interest Rate Change on Property Price for Buyer Based on % of Purchase Financed

Change in Rates	% Financed		
	100%	90%	80%
50 bps	3.1%	2.8%	2.5%
100 bps	6.2%	5.6%	5.0%
150 bps	9.4%	8.5%	7.5%
200 bps	12.6%	11.4%	10.1%
250 bps	15.9%	14.3%	12.7%
300 bps	19.2%	17.3%	15.4%

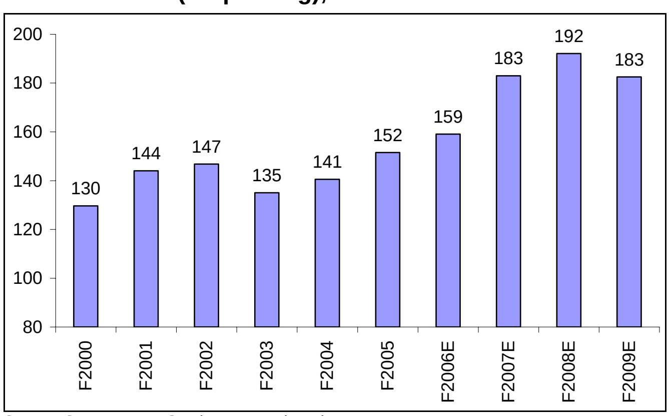
Source: CMA, Morgan Stanley Research Estimates

Valuation De-rating Risk

While we have been expecting the sector to trade at the cycle average valuations (relative to the market), with the cycle peak in sight, the sector might start trading at a discount to the cycle average. However, with the significant potential upside in F2007E in pricing, we are not too worried on this account. Given the high leverage enjoyed by the sector to the pricing scenario (Exhibit 5), there is significant upside risk to our estimates, in the event of a pricing blowout. Even if there the stocks were to start trading at a discount to the cycle average, there is still room left for performance. So we would not be sellers on the sector at current levels, especially since we expect a knee jerk reaction to Grasim's announcement will drive down the stock prices over the next few days.

Exhibit 8

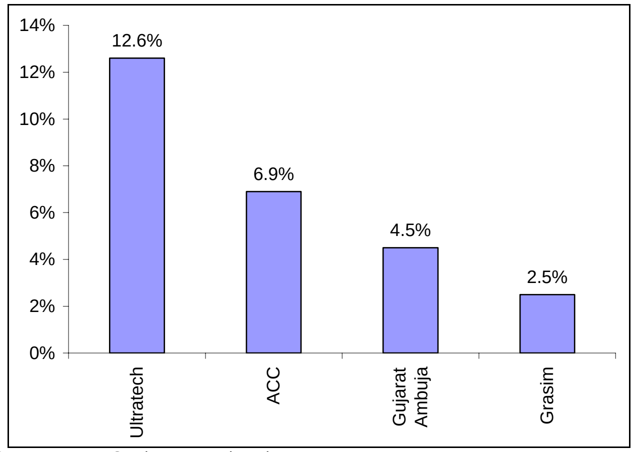
Cement Prices (Rs per Bag), F2000-F2009E



Source: CMA, Morgan Stanley Research Estimates

Exhibit 9

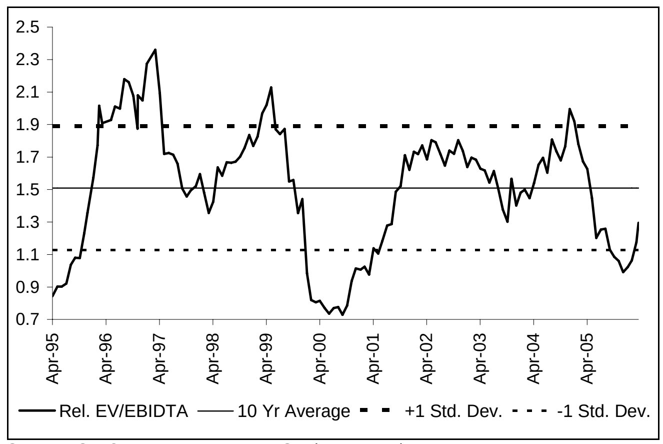
Impact of 1% Change in Prices on F2007 Profits



Source: Morgan Stanley Research Estimates

Exhibit 10

ACC: 12 Month Fwd. Relative EV/EBIDTA



Source: ASA, Company Data, Morgan Stanley Research

Exhibit 11

India: Demand/Supply Model (Excluding Mini Cement Plants)

(Tons 000)	F1999	F2000	F2001	F2002	F2003	F2004	F2005	F2006E	F2007E	F2008E
Year-end capacity	**109,262**	**111,761**	**118,858**	**134,587**	**137,087**	**144,849**	**151,646**	**161,935**	**174,035**	**182,035**
Large Cement Plants (Efficient)	97,817	100,316	109,626	125,355	127,855	135,817	142,614	152,903	165,003	173,003
Large Cement Plants (Inefficient/shutdown)	11,445	11,445	9,232	9,232	9,232	9,032	9,032	9,032	9,032	9,032
Effective Capacity	**106,815**	**110,395**	**114,048**	**127,617**	**136,499**	**144,195**	**149,617**	**156,931**	**164,910**	**179,798**
Production	**81,957**	**94,012**	**93,443**	**102,401**	**111,348**	**117,504**	**126,094**	**138,593**	**150,698**	**161,536**
Large Cement Plants (Efficient)	80,287	92,689	92,463	101,107	110,171	116,197	124,532	137,032	149,088	159,902
Large Cement Plants (Inefficient/shutdown)	1,670	1,322	980	1,295	1,177	1,308	1,562	1,562	1,609	1,633
Inventory Changes and Losses	(135)	(187)	(97)	(10)	(288)	(280)	(955)	0	0	0
Total Supply	**81,822**	**93,825**	**93,346**	**102,391**	**111,060**	**117,224**	**125,139**	**138,593**	**150,698**	**161,536**
Growth (Yr/Yr)	6.8%	14.7%	-0.5%	9.7%	8.5%	5.6%	6.8%	10.8%	8.7%	7.2%
Local Consumption	**79,764**	**91,876**	**90,210**	**99,008**	**107,590**	**113,861**	**121,066**	**132,892**	**144,141**	**155,635**
Growth (Yr/Yr)	7.9%	15.2%	-1.8%	9.8%	8.7%	5.8%	6.3%	9.8%	8.5%	8.0%
Exports	**2,058**	**1,949**	**3,136**	**3,383**	**3,470**	**3,363**	**4,072**	**5,701**	**6,556**	**5,900**
Growth (Yr/Yr)	-23.4%	-5.3%	60.9%	7.9%	2.6%	-3.1%	21.1%	40.0%	15.0%	-10.0%
Capacity utilisation	**76.7%**	**85.2%**	**81.9%**	**80.2%**	**81.6%**	**81.5%**	**84.3%**	**88.3%**	**91.4%**	**89.8%**

E = Morgan Stanley Research estimates Source: CMA, Morgan Stanley Research

Exhibit 12

India: Blending Analysis (Excluding Mini Cement Plants)

Tons Millions	F1997	F1998	F1999	F2000	F2001	F2002	F2003	F2004	F2005	F2006E	F2007E	F2008E
Effective Capacity	**100.5**	**98.1**	**106.8**	**110.4**	**114.0**	**127.6**	**136.5**	**144.2**	**149.6**	**156.9**	**164.9**	**179.8**
Effective Grinding Capacity	10.6	10.6	11.8	12.8	15.3	19.0	19.2	21.2	23.1	24.2	25.3	27.3
Effective Manufacturing Capacity	89.9	87.5	95.0	97.6	98.8	108.6	117.3	123.0	126.5	132.7	139.6	152.5
Consumption	**69.9**	**76.6**	**81.8**	**93.8**	**93.3**	**102.4**	**111.1**	**117.2**	**125.1**	**138.6**	**150.7**	**161.5**
Blending (% of total)												
PPC	19%	19%	19%	23%	26%	32%	39%	44%	48%	50%	52%	52%
Others	11%	10%	11%	11%	12%	12%	11%	10%	9%	9%	9%	9%
Assumptions												
Blending Ratio - PPC	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Blending Ratio - Others	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%	25%
Impact of Blending												
Blending Impact - PPC	2.7	2.9	3.2	4.2	4.9	6.5	8.6	10.4	12.1	13.9	15.7	16.8
Blending Impact - Others	1.6	1.6	1.7	2.0	2.2	2.5	2.4	2.4	2.2	2.4	2.6	2.8
Consumption adjusted for Blending	65.6	72.1	76.9	87.6	86.2	93.4	100.0	104.4	110.8	122.3	132.4	141.9
Capacity Utilization (%)												
Unadjusted Capacity Utilization	69.2%	78.4%	76.7%	85.2%	81.9%	80.2%	81.6%	81.5%	84.3%	88.3%	91.4%	89.8%
Capacity Utilization adjusted for Blending	65.0%	73.8%	72.1%	79.5%	75.7%	73.2%	73.5%	72.6%	74.7%	77.9%	80.3%	78.9%
Capacity Utilization adj. for Blending & Grinding	76.2%	80.3%	81.1%	89.9%	87.4%	86.1%	85.5%	85.2%	88.4%	92.1%	94.8%	93.1%

E = Morgan Stanley Research estimates Source: CMA, Morgan Stanley Research

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(as of March 31, 2006)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**721**	**36%**	**259**	**40%**	**36%**
Equal-weight/Hold	**879**	**44%**	**300**	**47%**	**34%**
Underweight/Sell	**378**	**19%**	**84**	**13%**	**22%**
Total	**1,978**		**643**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

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Industry Coverage: India Cement

Company (Ticker)	Rating (as of)	Price (04/27/2006)
Akshay Soni		
Associated Cement Cos. (ACC.BO)	O (08/03/2004)	Rs933.80
Grasim Industries (GRAS.BO)	O (08/03/2004)	Rs2366.10
Gujarat Ambuja Cements (GACM.BO)	O (08/03/2004)	Rs116.90
UltraTech CemCo (ULTC.BO)	O (08/25/2004)	Rs827.75

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