Equity Research India

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Godavari Fertilisers and Chemicals Ltd.

CMP: Rs. 78

Initiating Coverage – Market Outperformer

Shareholding pattern (March 2006)	%
Promoters	70.07
FII / NRI / OCB	2.68
Banks/FI/MFs	0.02
Pvt. Corporate Bodies	10.55
Public (incl others)	16.68
Total	100.0

CMP (Rs)	78
52 Week H/L (Rs)	105 / 50
3M Avg daily vol	10532
FV (Rs)	10
Equity (Rs. mn)	320
Market Cap (Rs mn)	2496
EPS (Rs) FY2008E *	16.6
P/E FY2008E EPS*	4.7x

Bloomberg Code	GDVF@IN
Reuters Code	GDVF.BO

A Classic Turnaround Case

Godavari Fertilisers and Chemicals Ltd (GFCL), a part of the Murugappa group, is a classic turnaround case post its takeover from the Andhra Pradesh Government. The management focus towards growing the business is reflected in the various measures taken like cost reduction, diversification into non subsidy products, etc. At the current market price of Rs.78, the stock is trading at 4.7x FY2008E EPS of Rs.16.8 and an EV/EBIDTA of 7.0x FY2008E. We initiate coverage on the stock with a Market Outperformer rating.

- The expected implementation of Abhijit Sen committee recommendations and the revision of freight calculation for the subsidy is likely to be a big positive for the company with its revenues increasing with the increase in subsidy component.
- The strong turnaround of the company post its takeover reflects the management's focus in growing the business and enhancing the profitability.
- Improving production efficiencies and adopting various cost cutting measures like savings in bagging and freight costs is likely to improve the margins for the company.
- Diversification into non-subsidy products will reduce GFCL's dependence on the uncertainties of the government policies and improve the profitability with the entry into high margin water soluble fertilizers and micro nutrient business.
- GFCL has a strong market share in the various states enabled by the strong marketing and building up relationship with the farmers through the model farms.
- As a roadmap to the future, the company is expanding its capacities from 1.1 million tonnes to 1.525 million tonnes enabling a future growth.
- GFCL plans to develop 250 acres of surplus land near Kakinada. The value of land at the current rates is around Rs.1000 million.

Key Financials

Rs. Mn	FY2004	FY2005	FY2006	FY2007E	FY2008E
Net Sales	8971	12001	15200	17587	19656
OPM (%)	3.4%	3.2%	4.1%	5.8%	6.8%
Net Profit	72	171	261	413	537
EPS (Rs.)	2.2	5.3	8.3	12.9	16.8
PE (x)	34.9	14.6	9.4	6.0	4.6
EV / EBITDA (x)	17.5	12.6	11.1	7.9	7.0
ROE (%)	11.0	22.8	29.0	35.1	34.2
ROCE (%)	9.7	12.5	13.8	15.6	15.9

Source: Stratcap estimates

Investment Argument

Abhijit Sen committee recommendations – to make the difference

GFCL is expected to benefit from the potential changes in the subsidy calculation and the phosphoric acid pricing suggested by the Abhijit Sen committee recommendations. The policy changes are on the cards and expected to be implemented from FY2008 onwards.

Current scenario: The subsidy paid to the manufacturers is based on the calculations done during FY2003 adjusted with a price escalation formula reflecting the changes in the phosphoric acid prices, ammonia prices and the foreign exchange rate. The changes in the phosphoric acid prices are determined depending upon the negotiations with the Phosphoric Acid Consumer Group. Currently the price approved for the subsidy calculation is US$461 per tonne (US$445 per tonne in FY2006).

Abhijit Sen committee recommendations: As per the Abhijit Sen Committee recommendation, the subsidy is to be calculated in the following manner:

1. The manufacturers of phosphatic fertilisers should receive concession based on the landed price of imported DAP less the MRP declared by the government.
2. An amount of Rs.1350 per MT for the cost of marketing.
3. An amount between 5% and 20% of the landed imported DAP prices.

Recommendations 1 and 2 are applicable to both domestic manufacturers as well as importers of DAP. The 3rd recommendation of the committee is payable only to domestic manufacturers of DAP to offset the disadvantage to them vis-à-vis the imported DAP. This recommendation is in line with the observations of Gokak committee which says that in the event of ammonia prices becoming very high and DAP prices falling very low in the international market, the domestic manufacturer suffers disadvantage to the extent of 26 – 30%. The above recommendation is currently non-compliant with the WTO norms and will be implemented with certain modifications.

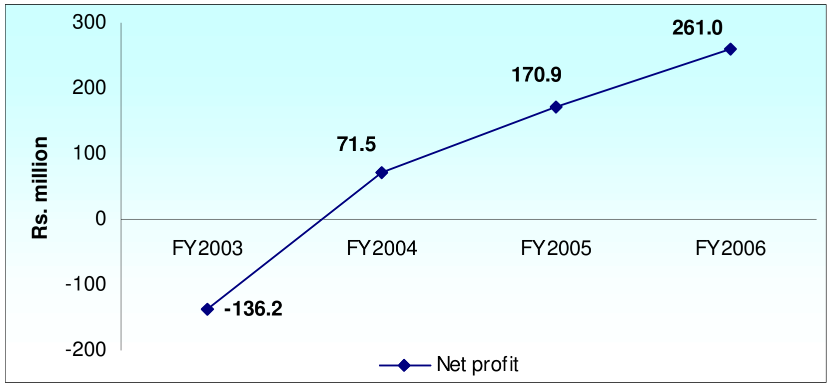
Apart from the subsidy mechanism suggested, the committee has also recommended a formula to calculate the phosphoric acid prices for the subsidy purposes. As per the formula the normative phosphoric acid prices should be linked to the US Gulf FOB prices of DAP. On immediate implementation, the recommendation would lead to around 5% higher phosphoric acid price for the subsidy calculation.

Other benefit: The government is considering to increase the freight component in the subsidy provided considering the recent hikes in the freight rates. The proposal if passed will lead to an additional inflow of Rs.100 – 120 per tonne of fertiliser sold. As per the indications from the company the same is expected to happen by the end of FY2007.

The changes in the policy are expected to lead additional benefits for the phosphatic fertiliser manufacturers leading to an increase in their profitability.

Classic turnaround case: Strong management capabilities

The strong management capabilities of the Murugappa group has led to the turnaround of GFCL post its takeover from the Andhra Pradesh Governemnt. The company was turned green the very next year since the change in management control from Rs.136.2 million loss in FY2003 to Rs.71.5 million profit in FY2004.



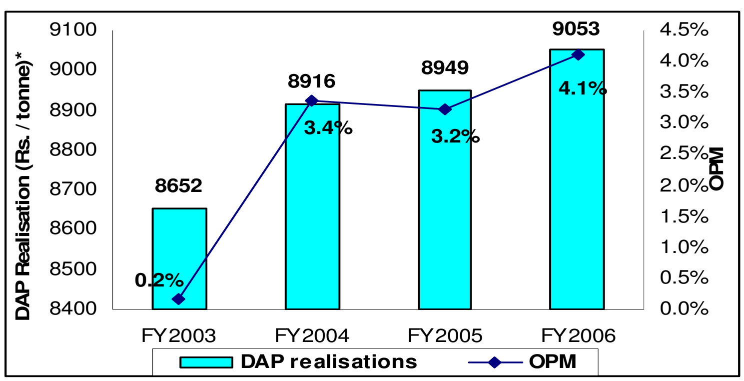
Source: Annual reports

GFCL turnaround can be broadly classified into three parameters viz. cost control and production efficiency, change in product mix and realigning of the distribution channel.

Cost control and production efficiencies:

1. Production Rates: The company improved its production efficiency from around 50 – 55 tonnes per hour to around 70 tonnes per hour. The improvement in the production rates has enabled the company reduce the cost per unit and thereby improve its operating margins.

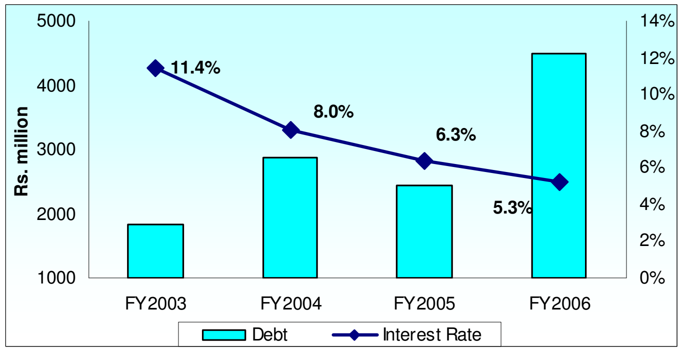
2. Discounts offered: Higher discounts offered during the earlier years had led to lower realisations and profitability for the company. Higher discounts offered were on account competition from players like SPIC, Madras Fertilisers and FACT. However the bleeding of the above players leading to lower competition and a changed discount structure led higher realisations (excluding the subsidy component) for the company. Earlier the discounts offered were to the tune of Rs.800 per tonne which is being reduced to around Rs.250 – 300 per tonne levels.



Source: Annual reports

3. Debt restructuring: GFCL restructured its long term debts leading to interest savings for the company. The interest cost for the long term loans were reset from a high of 14% - 15% to 10% and further reduced to 8%. The restructuring of loans has led to substantial savings in the interest cost for the company.

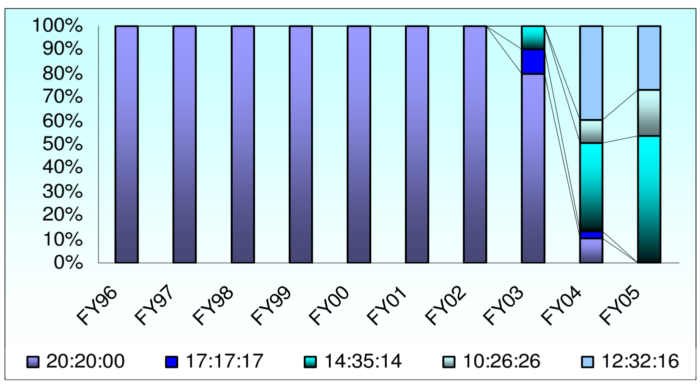
Average Cost of funds



Source: Annual reports

Change in product mix: The new management changed the product portfolio by discontinuing the non profitable products and introducing new profitable products. The company discontinued some complex fertiliser products like 20:20:0 and 17:17:17 and introduced more profitable products like 14:35:14, 10:26:26 and 12:32:16 having more phosphate content. The ratio indicates the proportion of nitrogen, phosphate and potash in the product. The product portfolio rejig has enabled the company improve its profitability.

Complex fertiliser product mix



Source: Company

Change in distribution channel: GFCL has altered its distribution channel with inclusion of more retailers and a reduction of wholesalers. The change in the distribution channel has enabled the company to retain higher margins as well reduce the bad debts. The share of revenues from retail has increased from around 50% in FY2003 to 90% in FY2006. Currently the company has a network of around 6000 dealers majority of which are retailers.

GFCL's turnaround reflects the strong management capability of growing the company in terms of revenues and profitability.

Cost savings – a boost to profitability

The freight element in the subsidy is set on the basis of an economic zone factor which is a 600 km radius of the plant. GFCL is striving towards concentrating its markets within a radius of 200 km of the plant. This will enable the company mitigate the concern of rising freight costs. Sales of products within the 200 km radius gives the company a dual advantage in terms of lower freight cost and the same realisations at a lower cost. Currently the company is marketing its products in the states of Andhra Pradesh, Karnataka, Maharashtra, Madhya Pradesh and Chatisgarh.

GFCL is expected to gain with the potential cost savings in ammonia cost and the bagging costs. Typically 0.228 tonnes of ammonia is required for the manufacture of 1 tonne of DAP whereas it stands at 0.230 tonnes for GFCL. The improvement in the production efficiency rate of ammonia is likely to save Rs.26 million at FY2006 rates and volumes for the company. GFCL has also made changes to its existing bagging unit wherein by changing the unit layout the company has reduced the movement of bags thereby improving the productivity of the unit. The company is also changing the sewing thread used for the bags which is further expected to reduce cost for the company.

The potential cost savings will lead to an improvement in its margins and further enhance the profitability.

Diversification into new products – moving towards non subsidy high margin products

Water Soluble Fertilisers: GFCL has diversified its product portfolio by entering into non subsidy products like Water Soluble Fertilisers (WSF). WSF are highly productive fertilisers which are generally used in greenhouse, drip irrigation or drip fertigation farming. The use of WSF with drip irrigation (DI) and drip fertigation (DF) leads to a massive improvement the soil productivity.

Fertiliser Use Efficiency (%)

Nutrient	Soil application	DI	DF
Nitrogen	30 - 50	65	95
Phosphorus	20	30	45
Potassium	50	60	80

The improvement in yield led by the above and increased profit per hectare for some of the crops is illustrated below:

Yield and profit comparison

Crop	Yield (tonnes / hectare)			Profit (Rs. / hectare)		
	Conventional	DI	DF	Conventional	DI	DF
Banana	26	30	37	81000	98000	120000
Sugarcane	120	160	207	30000	47000	68000
Tomato	45	56	65	56000	77000	95000

With the increasing use of DI and DF in agriculture, the acceptance of WSF is set to increase. WSF market is growing at 25 – 30% annually. However WSF is **not manufactured in India** and is imported by all the players in India. WSF currently enjoys trading margins of around 20%. **However the same are expected to reduce going forward with new entrants entering the business.**

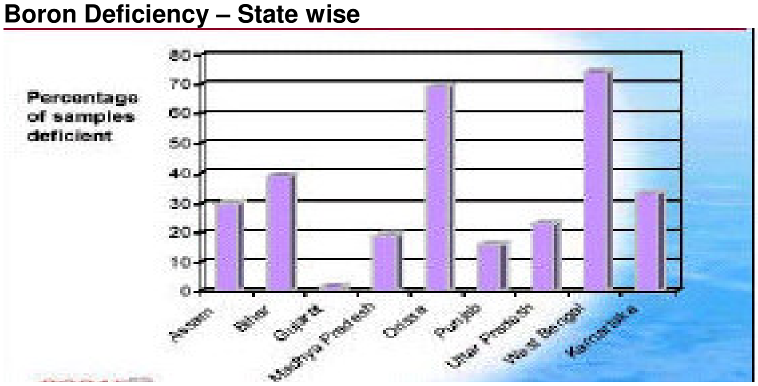
The company is setting up a **pilot plant for WSF** which is expected to be operational by the end of FY2007. The pilot plant if successful will give the company an edge over the other players marketing WSF, as the same is currently not manufactured in India. GFCL is currently marketing WSF in the states of Andhra Pradesh and Maharashtra. WSF is far more expensive than the normal fertilisers which make WSF feasible only to select rich farmers. The company is planning to expand its markets in Punjab and Haryana where the expensive WSF becomes affordable.

Quality at a price: Fertiliser cost comparison

	Rate (Rs. / kg)
Specialty WSF	
Poly feed (19:19:19)	52.0
MAP (12:61:0)	56.0
Multi – K (13:0:46)	40.0
MKP (0:52:34)	75.0
SOP (0:0:50)	34.0
Normal fertilisers	
Urea (46:0:0)	4.6
Potash (0:0:60)	4.4

Micro Nutrients: GFCL is also planning to launch micro nutrients like iron, manganese, zinc, sulphur, boron, etc. Micro nutrients are as essential as the other fertilizers for the crop growth. Addition of micro nutrients to fertilizers in the right proportion ensures sustainability of cropping through balanced nutrition. Currently the Indian soil is deficient in some of the micro nutrients, the addition of which will lead in an improvement in productivity.

Boron Deficiency – State wise



The Murugappa group is in talks with Borax, manufacturer of Boron, to supply Boron for the Indian markets.

Various studies for the impact of micro nutrients on the crop productivity have been done which signifies the importance of micro nutrients in the crop productivity.

Iron: Crop response in Pakistan

Crop	Yield increase (%)
Wheat	9
Maize	6
Rice	12
Groundnut	30

Effect of Zinc Sulphate applied to rice fields in China

Zinc Sulphate (kg / hectare)	Plant height (cms)	Yield (kg / hectare)
0	57.5	7124
7.5	61.0	7620
22.5	61.2	7799
45.0	61.0	7743
75.0	60.0	7653

Micro nutrients and WSF improves the soil productivity and the yield for the farmers. On the other hand, it becomes a profitable venture for GFCL, which will enable it, diversify from the subsidy products. The company will use the model farms, its marketing platform, for the marketing of micro nutrients while also expand its markets to the states like Punjab and Haryana where the affordability of these products is not an issue.

WSF and micro nutrients enables the company diversify from the regulated and subsidy based fertilizers to deregulated and more profitable segments. Also with the scaling up of the above operations, the operating margins of the company are expected to enhance.

Model Farms – a strong marketing platform

Model farms provide a strong platform for the company in terms of marketing its products. The Murugappa group through Coromandel Fertilisers Ltd (CFL) and GFCL has started the concept of model farms wherein the use of various fertilisers manufactured by the group is illustrated to the farmers. The improvement in the productivity levels for various crops through the use of the fertilisers manufactured by the group is illustrated and the choice to buy the fertiliser is left on the farmer.

GFCL has 1263 model farms, majority of which are spanned across Andhra Pradesh and Karnataka, which has enabled the company gain a strong market share across the markets. The company has a 65% market share in Andhra Pradesh for DAP and around 45 – 50% market share in the states of Eastern Maharashtra, North & Central Karnataka, Eastern Madhya Pradesh and Chatisgarh. The market share for complex fertilisers stands in the range of 30 – 50% across the above markets in various product categories.

Model farms enable the company develop a strong relation with the farmers and creates a strong platform for the company to market its products.

Capacity expansion – enabling future growth

GFCL is expanding its capacity to enable its future growth. The company is expanding its capacity from 1.1 million tonnes of phosphatic fertilisers to 1.525 million tonnes of phosphatic fertilisers. The capacity will cost the company Rs.825 million and will be funded in a debt equity ratio of 2:1, the equity portion coming from the internal accruals. The company expects to receive the clearances from the government by December 2006 post which the plant will commence operations within 24 months.

The company is also setting up an ammonia storage tank with a capacity to store 10000 tonnes of ammonia. The tank is built up at a cost of Rs.190 million of which Rs.150 million is funded through term loans. The storage tank should be operational by January 2007. Currently the company has a storage capacity for 60000 tonnes of phosphoric acid and 13000 tonnes of Ammonia.

The capacity expansion will enable the company sustain growth going forward.

Property development – an icing on the cake

GFCL has a total 700 acres of land in Kakinada of which the company can develop 250 acres of land. The management is working out the modalities to formalize the plans to develop the land. Currently the value of an acre of land works out to atleast Rs.4 million which works to an amount of Rs.1000 million for the land to be developed.

The land development is expected to work out as an icing on the cake along with its current business and can rerate the stock with the plans being finalised.

Financial performance

GFCL's path of turnaround in operations continues in the Q2FY2007 performance. The company has witnessed a growth of 26.2% yoy in its revenues from Rs.5781 million in Q2FY2006 to Rs.7297 million in Q2FY2007. The operating profit for the quarter jumped by 129.8% yoy to Rs.577 million as against Rs.251 million in Q2FY2006 led by a 356 basis points jump in the operating margins. Operating margins for the quarter improved from 4.3% in Q2FY2006 to 7.9%.

Lower raw material cost during the quarter led to the jump in the operating margins for the company. Raw material cost as a % of sales decreased from 88.4% in Q2FY2006 to 84.4% in Q2FY2007. Lower raw material cost was on account of the fall in ammonia prices qoq whereas the ammonia cost recovery (subsidy) for the quarter was at a higher price. The subsidy for each quarter is calculated on the basis of raw material prices for the previous quarter. The ammonia cost recovered during the quarter was at US$320 per tonne as against the actual prices of US$260 per tonne.

Interest for the quarter stood at Rs.72 million as against Rs.38 million, a jump of 87.8% yoy. Higher interest expense during the quarter was on account of higher working capital required by the company due to the problems in recovering the subsidy from the government. Depreciation for the quarter was down 36.1% yoy to Rs.17 million as against Rs.26 million in Q2FY2006. Tax as a % of PBT for the quarter stood at 32.9% as against 42.2% in Q2FY2006. Lower tax provisioning and low depreciation led to a higher growth of net profits in comparison to the operating profits. Net profit for the quarter jumped by 188.2% from Rs.115 million in Q2FY2006 to Rs.330 million in Q2FY2007.

Quarterly Result

(Rs. Mn)	**H1FY07**	**H1FY06**	**% chg**	**Q2FY07**	**Q2FY06**	**% chg**
Net Sales	9952	7271	36.9	7297	5781	26.2
(Inc)/dec in stock	239	309	(2.8)	1825	1843	(1.0)
Raw Materials	8090	5914	36.8	4337	3267	32.7
Staff Cost	122	95	28.5	56	56	0.1
Other Expenditure	865	648	33.4	502	363	38.1
EBIDTA	**636**	**304**	109.4	**577**	**251**	129.8
Depreciation	33	43	(23.8)	17	26	(36.1)
Other Income	9	25	(63.2)	5	13	(61.1)
EBIT	**613**	**286**	114.3	**565**	**238**	137.3
Interest	157	77	105.1	72	38	87.8
PBT	**456**	**209**	117.7	**493**	**200**	146.8
Current Tax	162	52	214.6	162	52	214.6
Deferred Tax	0	33		0	33	
Fringe benefit tax	2	2	0.9	1	1	0.0
PAT	**29.2**	**123**	136.6	**330**	**115**	188.2

Valuations

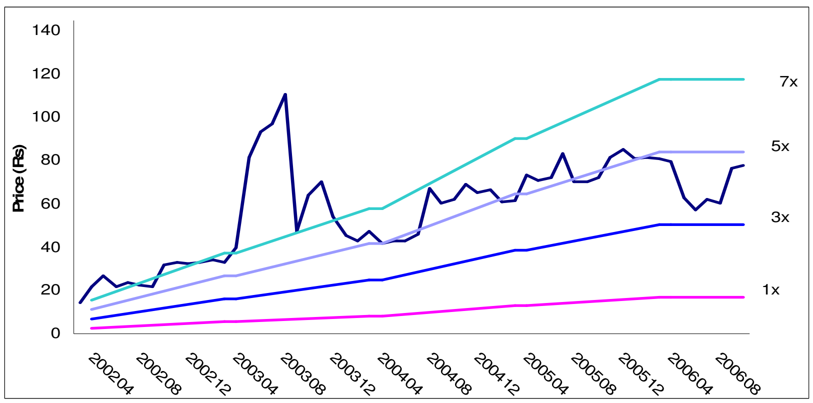
The turnaround in GFCL's operations reflects the strong management capabilities and its focus towards growing its revenues and profits. The management skills are reflected in terms of the actions taken to revive the business. The management is further looking to improve the profitability of the company through various cost cutting measures and the diversification of its product line into non subsidy products.

We have not factored in the following in our estimates:

- The benefits from the change in policy i.e. Abhijit Sen Committee recommendations and changes in freight calculation.
- The cost savings expected in freight, ammonia and bagging costs.

At the current market price of Rs.78, the stock is trading at 4.7x FY2008E EPS of Rs.16.8 and EV/EBIDTA of 7.0x FY2008E. The stock is likely to get re-rated with the implementation of the Abhijit Sen committee recommendations and the property development on the cards. We initiate coverage on the stock with a Market Outperformer rating.

One-year forward P/E Band chart



Key Financials

Rs. Mn	**FY2004**	**FY2005**	**FY2006**	**FY2007E**	**FY2008E**
Net Sales	8971	12001	15200	17587	19656
OPM (%)	3.4%	3.2%	4.1%	5.8%	6.8%
Net Profit	72	171	261	413	537
EPS (Rs.)	2.2	5.3	8.3	12.9	16.8
PE (x)	34.9	14.6	9.4	6.0	4.6
EV / EBITDA (x)	17.5	12.6	11.1	7.9	7.0
ROE (%)	11.0	22.8	29.0	35.1	34.2
ROCE (%)	9.7	12.5	13.8	15.6	15.9

Source: Stratcap estimates

Company Background

Godavari Fertilisers and Chemicals Ltd (GFCL), a part of the Murugappa group, was initially promoted by the Andhra Pradesh government and IFFCO. The company was taken over by the Murugappa group through CFL during 2003 via the disinvestment route of the AP government. The company manufactures 1.1 million tonnes of DAP and complex fertilisers and has a strong presence in the markets of AP, Karnataka, Maharashtra, Chhatisgarh and MP and markets its products under the brand *Godavari*. The company has a dealer network of around 6000 dealers.

Concerns

Problems in recovering subsidy

Phosphatic fertiliser manufacturers receive subsidy from the government in 2 tranches. 85% of the subsidy is received immediately on a monthly basis while the balance 15% of the subsidy is received after the state government certifies the same and submits the same to the central government. The first installment has not been received from the government since June 2005 while the payment for the second tranch is pending since the past 1.5 – 2 years.

Delay in payment of subsidy by the government has led to working capital issues for the companies in the segment. The working capital loans for GFCL have gone up substantially due to the problems in recovering subsidies from the government leading to an increased interest burden. Interest for H1FY2007 has gone up by 105.1% from Rs.77 million in H1FY2006 to Rs.157 million.

To overcome the above problems, the Department of Chemicals and Fertilisers have recommended the Ministry of Finance to increase the allocation towards fertilisers from Rs.170 billion to Rs.310 billion.

Monsoon failure

The fertilizer business is highly dependant on the monsoons. A monsoon failure in any year could severely hamper the operations of the company.

Standalone Profit & Loss Statement *(Rs. In mn, March Ending)*

Particulars		FY2004	FY2005	FY2006	FY2007E	FY2008E
Net operating revenues		8971	12001	15200	17587	19566
	Growth %	*21.6*	*33.8*	*26.7*	*15.7*	*11.2*
Expenditure:						
Raw Material		7457	10170	13045	14822	16292
Staff Cost		196	232	198	211	235
Other Expenditure		1015	1209	1330	1528	1702
Total Expenditure		8668	11612	14573	16561	18229
Operating Profit		303	389	627	1026	1337
	Growth %	*2507.5*	*28.4*	*61.2*	*63.8*	*30.3*
	OPM%	*3.4*	*3.2*	*4.1*	*5.8*	*6.8*
Other Income		64	114	57	30	10
PBDIT		367	503	684	1056	1347
Interest		189	169	183	350	449
Depreciation		75	75	80	84	88
PBT		103	259	420	622	810
Tax		31	88	159	209	273
Net Profit		72	171	261	413	537
	Growth %	*-*	*139.0*	*52.7*	*58.2*	*30.1*

Valuation summary

	FY2004	FY2005	FY2006	FY2007E	FY2008E
Per Share Data					
Diluted EPS	2.2	5.3	8.3	12.9	16.8
Diluted CEPS	4.6	7.7	10.8	15.5	19.5
Book Value	21.4	25.6	31.4	42.1	56.1
Valuation					
PER	34.9	14.6	9.4	6.0	4.6
Price / CEPS	17.0	10.1	7.2	5.0	4.0
P/BV	3.7	3.1	2.5	1.9	1.4
EV/EBITDA	17.5	12.6	11.1	7.9	7.0
Returns %					
ROE	11.0	22.8	29.0	35.1	34.2
ROCE	9.7	12.5	13.8	15.6	15.9
Debt/Equity	4.2	3.0	4.5	4.2	3.9

Standalone Balance Sheet *(Rs. In mn, March Ending)*

Particulars	FY2004	FY2005	FY2006	FY2007E	FY2008E
Sources of Funds					
Own Funds					
Share capital	320	320	320	320	320
Reserves & Surplus	364	498	686	1026	1475
Loan Funds					
Secured Loans	2305	2165	2550	3650	4950
Unsecured Loans	565	280	1953	2003	2053
Deferred Tax Liability	45	113	186	254	343
Total	**3599**	**3376**	**5695**	**7253**	**9141**
Application of Funds					
Fixed Assets					
Gross Block	2057	1970	1980	2196	2196
Depreciation	1139	1125	1157	1240	1328
Net Block	**918**	**845**	**823**	**956**	**868**
Capital WIP	1	13	26	0	400
Investments	75	225	75	79	87
Net Current Assets	2605	2292	4770	6218	7786
Total	**3599**	**3376**	**5695**	**7253**	**9141**

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