investor's eye

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Take Five

Scrip	Reco Date	Reco Price	CMP	Target
Aban Loyd	03-Mar-05	330	**1,262**	1,760
HLL	24-Nov-05	172	**240**	300
ICICI Bank	23-Dec-03	284	**587**	750
Orient Paper	30-Aug-05	214	**438**	675
UltraTech	10-Aug-05	384	**751**	1,000

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Cement

Sharekhan Sector Special

Cement producers on a capex binge

Cement consumption maintains momentum, so do cement prices

The consumption of cement has recorded a healthy growth of 11.7% for the first three months of FY2007. Cement prices have also kept pace by staying firm across the country: The same have risen by 21.6% year on year (yoy) and 13.5% quarter on quarter (qoq).

Cement producers announce big capacity addition plans

Encouraged by the unabated growth in cement consumption and the resultant upsurge in cement prices, cement producers across the country have announced big capacity expansion plans. The total capacity being added, based on the announcements made till August 2006, is a huge 73.8 million tonne. However the total gestation period for these projects is also fairly long with the last tonne of addition coming up in the first half of FY2010. The exhibit below presents the capacity addition plans.

Re-look at supply overhang and capacity utilisation

As a result of a rise in the production capacity, the cement surplus is likely to increase which in turn could affect the capacity utlisation levels and cement prices. We believe that, going forward, much of the growth in the earnings before interest, depreciation, tax and amortisation (EBIDTA) of cement companies is like to come from the incremental volume. Hence in order to gauge till what extent cement prices may remain firm, if not rise, a re-look at the cement demand-supply scenario becomes imperative. Assuming the consumption of cement in the country grows at a compounded annual growth rate (CAGR) of 9.5% for the next four years, capacity utlisation should stay firm till FY2008; but with the huge fresh capacity coming on stream in FY2009, the same is likely to drop below the 90% level. However as some of the proposed expansion projects have yet to achieve a financial closure, we believe the entire incremental capacity of 73.8 million tonne is unlikely to come on stream as per schedule. We estimate that at least 8.5 million tonne of the proposed cement capacities are unlikely to come up on time. If that indeed happens, the capacity utilisation will jump up to 90%. In this scenario cement prices will stay firm without affecting the profitabliity of cement companies.

Outlook: Concrete road at least till FY2009

ACC, UTCL and Madras Cement our top picks

Even though the cement producers have announced big capacity addition plans, the high gestation period for these projects would mean that the capacity utilisation levels would be comfortably placed at least till the end of FY2008. This in turn is likely to maintain the firm trend of the cement prices. Hence the cement companies are expected to report an impressive performance both operationally and

Cement valuation matrix

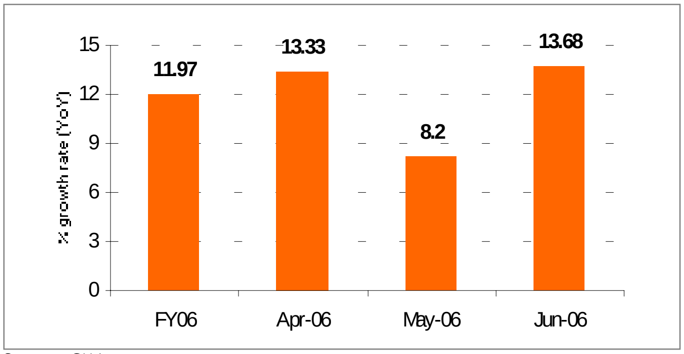
Companies	CMP	PER		EV/EBIDTA		EV/Tonne ($ US/Tonne)	
	(Rs)	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
ACC	915	18.9	16.3	11.2	9.4	184.8	167.4
Grasim	2,229	13.3	11.1	6.6	5.1		
UTCL	750	14.0	12.3	7.3	6.9	131.4	139.1
JP Associates	441	19.3	13.4	8.2	6.6		
Shree Cements	961	12.0	9.5	7.6	5.6	172.9	134.2
Madras Cement	2,922	14.5	11.7	7.8	6.4	127.3	114.4
JK Cement	173	12.6	7.9	5.9	3.5	79.5	58.6
GACL	116	20.0	14.9			185.0	
Birla Corp	280	13.0				80.0	
India Cement	202	13.5	10.4	10.1	8.3	159.0	128.0

Source: Sharekhan research and Consensus estimates financially at least for next six to seven quarters. Overall, we believe the southern region is best placed. It has seen a continuous surge in cement consumption. For example, for the first three months of the current fiscal, cement consumption in the region grew by almost 21%. This was on the back of a very impressive 24.9% growth witnessed in FY2006. Hence we like the stocks that are either dominant in the southern region or have a higher exposure to the markets there. We rate Associated Cement Companies (ACC), UltraTech Cement Company Ltd (UTCL) and Madras Cement as our top picks in the sector. We also like Orient Paper and JK Cement on account of their compelling valuations, which are much lower than the sector average.

Growth in cement consumption maintains momentum as do cement prices

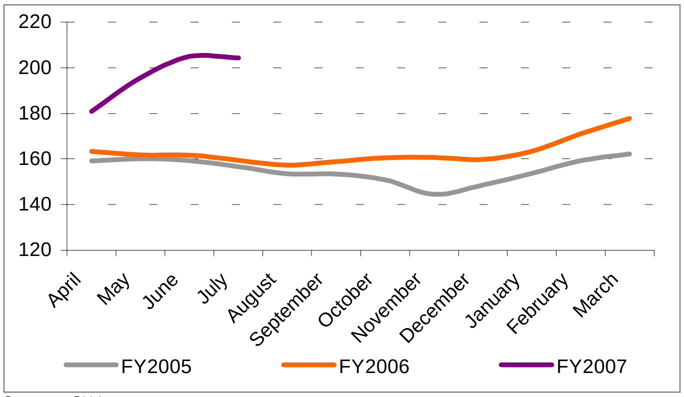
Tracking the hectic housing industrial and infrastructure activity in the country, cement consumption has grown at a scorching pace: It has risen by 11.7% for the first three months of FY2007. This compares favourably with the 11.5% growth registered in the first three months of FY2006. The healthy trend in cement consumption is clearly reflected by the cement dispatches that have grown by 9.5% for the same period. In keeping with the rise in the consumption, cement prices too have stayed firm across the country, rising by 21.6% yoy and 13.5% qoq.

Consumption growth



Source: CMA

Average cement prices

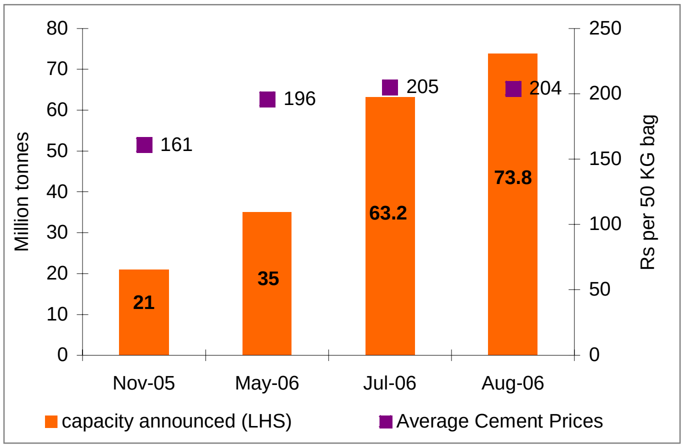


Source: CMA

Cement producers announce big plans to expand capacity

Encouraged by the unabated growth in cement consumption and the resultant upsurge in cement prices, the cement producers across the country have announced big capacity expansion plans. At the current price, cement producers would make super-normal returns on their investments (read our earlier cement sector update dated June 9: "A relook at cement"). The first round of expansion announcements till November 2005 saw cement producers announce the addition of fresh capacity of 21 million tonne. The following round till July 2006 saw the announcement of fresh capacity of 63 million tonne. What's more, encouraged by the Q1FY2007 results, the cement producers have announced additional capacity addition plans. The total capacity expected to come up, based on the announcements made till August 2006, is a huge 73.8 million tonne. However the total gestation period for these projects is also fairly long with the last tonne to be added coming up in the first half of FY2010. The exhibit below presents the capacity addition plans.

Capacity addition plans picking up pace



Source: CMA, Industry, Sharekhan research

Re-look at supply overhang and capacity utilisation

With the consumption of cement growing at 12% in FY2006 and at a CAGR of 8% for the last three years, the overall cement supply overhang came down sharply from 10 million tonne in FY2004 to 3.5 million tonne in FY2006 (only operational cement capacity is considered). In percentage term also, the supply overhang came down from 8% of the total cement capacity in FY2004 to 2% in FY2006. This resulted in a sharp rise in the capacity utilisation, which stood at almost 98% for FY2006. This in turn buoyed cement prices to an all-time high level of Rs205 per bag in July 2006. However with the recent announcement of the capacity addition plans, the surplus is likely to increase which could affect the capacity utilisation levels and cement prices. We believe that, going forward, much of the growth in the EBIDTA of the cement companies is likely to come

All-India demand-supply scenario

	FY2005	FY2006	FY2007E	FY2008E	FY2009E	FY2010E
Clinker available	110.3	116.1	125.8	139.3	167.2	170.9
Clinker exports	-5.4	-4.7	-4.7	-5.7	-6.7	-6.7
Net clinker available	104.9	111.4	121.1	133.6	160.5	164.2
Conversion factor	1.29	1.31	1.32	1.33	1.34	1.34
Cement available	135.7	145.8	159.4	177.6	214.3	219.5
Less cement exports	-6.2	-6.7	-6.7	-6.7	-6.7	-6.7
Net cement available	129.5	139.1	152.7	170.9	207.6	212.8
Cement consumption	121.0	135.6	149.2	164.2	179.1	195.4
Cement consumption growth (%)	6.3	12.0	10.0	10.0	9.1	9.1
Overhang	8.5	3.5	3.5	6.7	28.5	17.4
Overhang as % of cement consumption	*7.0*	*2.6*	*2.3*	*4.1*	*15.9*	*8.9*

Source: CMA, Industry, Sharekhan research

Note: Only operational cement capacity is considered

from the incremental volume. Hence in order to gauge till what extent cement prices may remain firm, if not rise, a re-look at the cement demand-supply scenario becomes critical. We present below the possible demand-supply scenario in the next four years, assuming that in this four-year period cement consumption would grow at a CAGR of 9.5% (no growth assumed in cement exports).

Our demand-supply scenarios do not consider an effective supply of cement from the new capacities. For example, for a new 3-million-tonne capacity that is expected to come up in H2FY2008, we have considered the total cement supply to be 3 million tonne. However even if the new plant operates at 100% capacity utilisation, effectively it can supply only 1.5 million tonne (the plant would be operational only in H2FY2008, ie for six months only) to the market. Hence in order to nullify the timing difference, if we assume that all the incremental capacities operate at say 90% utilisation, the effective capacity utilisation is likely to remain above 90% even in FY2009. In this scenario cement prices will stay firm without affecting the profitabliity of cement companies.

Top players could announce more capacity addition

The top four players under two business groups, viz ACC and Gujarat Ambuja Cement in one group and Grasim Industries and UTCL in the other, control about 44% of the effective cement capacity of the country. An analysis of the fresh cement capacities announced till date, shows that the top four players are likely to add only 28% of the incremental capacity. In order to maintain their market share, it is quite likely that these two groups could announce some greenfield projects. If these two groups were to maintain their respective market share, they would have to add another 21 million tonne of capacity together, which is over and above the 21 million tonne of new capacity announced so far by these two business groups. The ACC-Gujarat Ambuja group has not announced any greenfield addition, which again supports our argument that these groups are likely to announce further capacity addition plans.

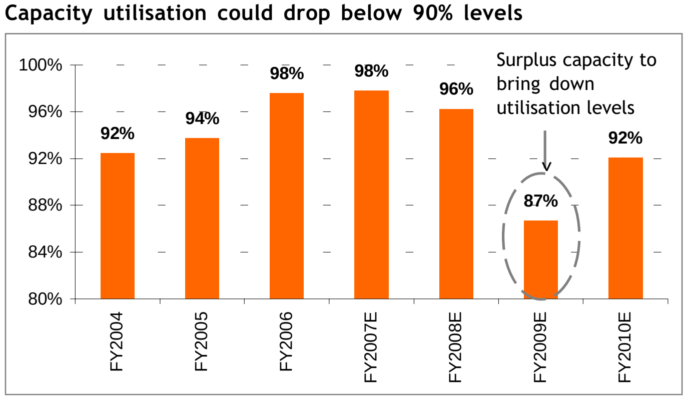
Majority of capacity addition through greenfield mode

The same analysis also shows that almost 75% of the incremental capacity is coming through the greenfield mode and the balance 25% through the brownfield mode. This in effect would support the cement prices because in order to generate a healthy return of 18-20% on the capital employed, cement prices have to rule close to Rs200 per bag (read our earlier cement sector update dated June 9: "A relook at cement"). If cement prices fall below Rs167 per bag, the new capacities may incur a loss at the profit before tax level. Hence in view of the fact that the bulk of the incremental capacity is coming through the greenfield mode, we believe that the cement manufacturers would ensure the cement prices remain at close to Rs200-per-bag levels.

Delay in commissioning of announced capacities could push up capacity utilisation

However since some of the proposed projects have not yet achieved a financial closure, we believe the entire fresh capacity of 73.8 million tonne is unlikely to come on stream as per schedule. We estimate that at least 8.5 million tonne of the proposed cement capacities, which have not got financial closure, are unlikely to come up on time. If that indeed happens and if cement consumption grows at a CAGR of 9-9.5% over the next four years, the capacity utilisation might jump up to 90%.

Capacity utilisation could drop below 90% levels



Note: Only operational cement capacity is considered
Source: CMA, Industry, Sharekhan research

Super-normal growth of 12% could maintain utilisation levels of 90% even in FY2009

Cement consumption growth	FY2006	FY2007E	FY2008E	FY2009E	FY2010E
8% CAGR	98	96	93	83	87
9% CAGR	98	97	94	85	90
10% CAGR (base case scenario)	98	98	96	87	93
11% CAGR	98	99	98	90	97
12% CAGR	98	99	100	92	100

Source: CMA, Sharekhan research

Growth of over 11% in cement consumption could maintain utilisation levels

However if all the projects that have been announced come up as per schedule, only a higher-than-expected cement consumption could improve the capacity utilisation levels. Here are the possible scenarios of capacity utilisation at the various rates of growth in cement consumption.

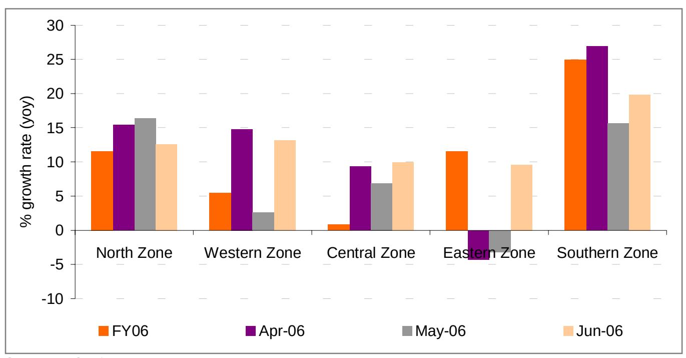
Outlook: Concrete road at least till FY2009

Even though the cement producers have announced big capacity addition plans, the high gestation period for these projects would mean that the capacity utilisation levels would be comfortably placed (96% even at the end of FY2008) at least till the end of FY2008. This in turn is likely to maintain the firm trend of the cement prices. Hence the cement companies are expected to report an impressive performance both operationally and financially at least for the next six to seven quarters.

We see that a majority of the capacity addition is taking place in the cement-deficient region of the north. As per the proposed capacity addition plans, almost 33% of the addition is taking place in the northern region. However the region is also witnessing a superlative consumption growth, as is evidenced by the 14.8% growth in the first three months of the current fiscal. This growth was achieved on the back of an 11.5% growth witnessed in FY2006. Further, the hectic pace of the implementation of the infrastructure projects, like the proposed Haryana special economic zone of Reliance Industries, the Commonwealth Sports Complex in the suburbs of New Delhi and the SKI city in Himachal Pradesh, are likely to absorb a substantial part of the incremental cement capacity. After a lacklustre year the central region too has shown signs of improvement with a consumption growth of 8.7% as against a mere 1% growth in FY2006. The eastern region however is witnessing a slowdown in demand owing to the slow pace of the implementation of the infrastructure projects there.

Overall, we believe the southern region is best placed to capitalise on the growth opportunities. It has witnessed a continuous rise in cement consumption. For example, for the first three months of the current fiscal, cement consumption in the region grew by almost 21%. The growth came on the back of a very impressive 24.9% growth witnessed in FY2006. Hence we like stocks that are either dominant in the southern region or have a higher exposure to the markets there. We rate ACC, UTCL and Madras Cement as our top picks in the sector. We also like Orient Paper and JK Cement on account of their compelling valuations, which are much lower than the sector average.

Regional cement consumption growth



Source: CMA

Cement valuation matrix

Companies	CMP (Rs)	PER FY07E	PER FY08E	EV/EBIDTA FY07E	EV/EBIDTA FY08E	EV/Tonne ($ US/Tonne) FY07E	EV/Tonne ($ US/Tonne) FY08E
ACC	915	18.9	16.3	11.2	9.4	184.8	167.4
Grasim	2,229	13.3	11.1	6.6	5.1		
UTCL	750	14.0	12.3	7.3	6.9	131.4	139.1
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Source: Sharekhan research and Consensus estimates

Mahindra & Mahindra

Apple Green

Stock Update

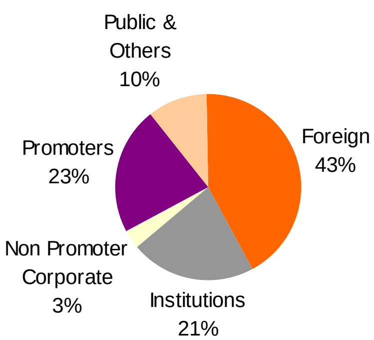
Gains from value unlocking

Buy; CMP: Rs651

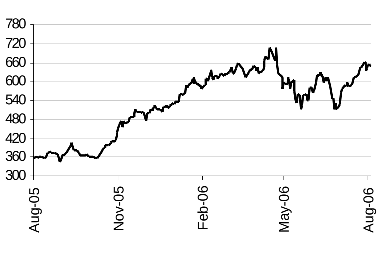
Company details

Price target:	Rs700
Market cap:	Rs15,401 cr
52 week high/low:	Rs719/343
NSE volume: (No of shares)	8.3 lakh
BSE code:	500520
NSE code:	M&M
Sharekhan code:	M&M
Free float: (No of shares)	18.3 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	23.5	10.9	14.6	86.0
Relative to Sensex	11.0	1.3	-0.1	21.3

Mahindra and Mahindra (M&M) is in the process of unlocking value in its subsidiaries. In February 2006 M&M divested its stake in Mahindra and Mahindra Financial Services (MMFSL) and now with the Tech Mahindra initial public offering (IPO), its stake in this subsidiary is also being valued by the public.

These divestments are in line with the company's policy of promoting investments in appropriate businesses and monetising the same at an opportune moment for creating wealth for the company's shareholders.

Investments account for 42% of the company's total capital employed as on March 31, 2006. More than 50% of these investments are in equity shares of its subsidiary companies. The subsidiaries that are witnessing a huge jump in their profitability or improvement in their performances are being divested. Next on the cards for divestment is Mahindra and Mahindra Holiday Resorts.

Gains from Tech Mahindra listing

M&M had offered 4.7% of its stake for sale in the Tech Mahindra IPO. The value of the stake sold at Rs365 per share works out to Rs140 crore. With the stock getting listed today the value of M&M's remaining 46.4% stake at Rs553 works out to Rs2,973.83 crore and Rs125 per share of M&M.

Valuation of M&M's stake in quoted subsidiaries

Subsidiaries	M&M's holding (%)	Value per share	Basis of valuation
Tech Mahindra	46.4	Rs125.0	Current market price
MMFSL	67.7	Rs56.4	Current market price
Mahindra Gesco Developers	40.5	Rs38.2	Current market price
Total		**Rs220.0**	

Outlook and valuations remain attractive

We believe that the IPOs of key companies will increase the visibility of M&M's value in its subsidiaries. The outlook on the core business remains healthy with robust tractor sales, a normal monsoon and an entry into other business areas such as cars, commercial vehicles and auto components. Even amid the rising raw material cost scenario, the company has been able to increase its operating margins owing to its rising efficiencies and cost saving measures. We expect the company to maintain its margins going forward.

At the current market price of Rs651, the stock quotes at 10.2x its FY2008E consolidated earnings. We maintain our Buy recommendation on the stock with a price target of Rs700.

Valuation table

	FY2004	FY2005	FY2006	FY2007E	FY2008E
Stand-alone					
Net sales (Rs cr)	4,873.8	6,511.0	7,977.1	9,524.5	10,899.8
% y-o-y change		*33.6*	*22.5*	*19.4*	*14.4*
Net profit (Rs cr)	322.5	499.5	647.9	711.5	804.7
Shares in issue (cr)	23.3	23.3	23.3	23.3	23.3
EPS (Rs)	13.8	21.4	27.8	30.5	34.5
% y-o-y change		*54.9*	*29.7*	*9.8*	*13.1*
PER (x)	47.1	30.4	23.5	21.4	18.9
Consolidated					
Net profit (Rs cr)	398.3	711.0	1136.2	1300.9	1496.1
% y-o-y change		*78.5*	*59.8*	*14.5*	*15.0*
Shares in issue (cr)	23.3	23.3	23.3	23.3	23.3
EPS (Rs)	17.1	30.5	48.7	55.7	64.1
% y-o-y change		*78.5*	*59.8*	*14.5*	*15.0*
PER (x)	38.1	21.4	13.4	11.7	10.2

The author doesn't hold any investment in any of the companies mentioned in the article.

Sharekhan Stock Ideas

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
Associated Cement Companies
Bajaj Auto
Balrampur Chini Mills
Bharat Bijlee
Bharat Heavy Electricals
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Godrej Consumer Products
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico Industries
Maruti Udyog
MRO-TEK
Lupin
Nicholas Piramal India
Omax Auto
Ranbaxy Laboratories
Satyam Computer Services
SKF India
State Bank of India
Sundaram Clayton
Tata Motors
Tata Tea
Unichem Laboratories
Wipro

Cannonball

Cipla
Gateway Distriparks
International Combustion (India)
JK Cement
Madras Cement
Shree Cement
Transport Corporation of India

Emerging Star

3i Infotech
Aban Loyd Chiles Offshore
Cadila Healthcare
KSB Pumps
Marksans Pharma
Navneet Publications (India)
New Delhi Television
Orchid Chemicals & Pharmaceuticals
ORG Informatics
Solectron Centum Electronics
Television Eighteen India
Thermax
TVS Motor Company
UTI Bank
Welspun Gujarat Stahl Rohren

Ugly Duckling

Ashok Leyland
Deepak Fertilisers & Petrochemicals Corporation
Genus Overseas Electronics
HCL Technologies
ICI India
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
Subros
Sun Pharmaceutical Industries
Surya Pharmaceuticals
UltraTech Cement
Union Bank of India
Universal Cables
Wockhardt

Vulture's Pick

Esab India
Orient Paper and Industries
WS Industries India

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