Date: 19 January, 2007

Every week, the ICICIdirect research team selects a stock based on fundamental and/or technical parameters, which is likely to give a return of 20% or more over a 3-6 month perspective.

Himadri Chemicals (HIMCHE)

Current Price: Rs 325	Target Price: Rs388
Potential upside: 20%	Time Frame: 3- 6 mths

Himadri Chemicals is the leader in the domestic market for supply of coal tar pitch and other by-products having more than 70% share of the market. The main end user for the company's products is the aluminium industry. The aluminium industry is seeing a major demographic shift to Asia and Himadri has planned an ambitious expansion wherein it is targeting a capacity of 1 million tonnes per annum (tpa) by 2010, which is six times its current capacity.

Background

Himadri Chemicals & Industries (HCIL) was incorporated in July 1987 to manufacture coal tar derivatives. It has consistently expanded capacity to become the country's largest manufacturer of coal tar pitch. Coal tar pitch is used in aluminium and graphite manufacturing. Coal tar pitch is manufactured through the distillation of coal tar, which yields coal tar pitch along with by-products such as mix of oils and naphthalene. Its plants are strategically located to cater to user industries and its main clients include HEG, Graphite India, Nalco, Balco, Hindalco and Malco.

Investment Rationale

User industries are on a roll

The major user industries for coal tar pitch are aluminium and graphite electrode industries, both of which are on a roll. All the major players in these industries have charted out aggressive expansion plans that will result in coal tar pitch demand shooting up.

Demographic shift of aluminium smelter capacity to Asia

Coal tar consumption in the Asian region is likely to increase exponentially over the next decade due to a demographic shift in aluminium production from Europe to Middle East , China and India . All the clients of Himadri in aluminium industry are ramping up their capacities. Demand for coal tar pitch is directly related to the production of aluminium as coal tar pitch accounts for 11.5% of finished aluminium in volume terms and 3% in value terms. Rise in Indian aluminium production capacity would push the demand for coal tar pitch, which is likely to increase from current 123,000 tpa to 283,000 tpa by 2010. With the capacity in place, the company is well placed to capture the opportunity. We believe that the rise in demand along with growth in market share would push its top line at a CAGR of over 65% over FY06-08E to Rs 559 crore in FY08E from Rs 206.98 crore in Fy06.

Demand from graphite industry to remain robust

Production of graphite in India is likely to increase from the current 93,000 tpa to 150,000 tpa by 2010. This would push the demand for QI as well as binder pitch because in graphite industry consumes both the types. Increase in demand of coal tar pitch from graphite industry is likely to push earning more aggressively, as out of the total demand from graphite industry, around 40% is for value added Zero QI pitch, which sells 1.50x the price of normal (binder) pitch. Himadri caters to 87% of total QI coal tar pitch requirement of Indian graphite industry.

Building a moat around the business

Himadri has created a formidable distribution system, which enables it not only to protect its market share from the cheap imports but also helps it to improve its market share. It has created a fleet of temperature-controlled tankers in which the temperature is maintained at 2,400 degrees C. This retains the pitch in the directly usable liquid form while the imports come in solid form and the user need to transform it to liquid form by spending heavily on energy cost.

Going forward, the company plans to build dedicated manufacturing facilities near its major customers plants, which will enable it to provide just in time deliveries besides locking in the customers. Its first such unit is expected to become operational at Korba, Chhattisgarh in March 2007. Moreover, Himadri designs, fabricates and erects plants and machinery in-house to protect its cutting edge technology from proliferation in the market. This enables it to maintain its status of supplier of quality coal tar at lower cost to its clients. By using the better quality coal tar pitch of Himadri, the user industry players have been able to increase their efficiency. The QI pitch of the company has increased the productivity.

Before Himadri developed Zero QI pitch, the QI pitch used by the graphite manufacturers resulted in lower production volume and higher cost. After Himadri developed Zero QI pitch, the efficiency of the Indian producers has increased. Its products are customized for each customer with specific properties thus creating barriers for competition. In order to safeguard itself from volatility in coal tar prices and supplies, Himadri has developed a technology that enables it to switch its raw material to low grade coal tar pitch that is readily available. This also gives it flexibility in switching its raw material depending on their relative prices.

Technology-driven growth

On the back of its strong R&D capabilities, Himadri has become one of the world's three players to have developed Zero QI grade coal tar pitch, which is used in the graphite industry. QI pitch sells 1.50x the price of normal pitch. Moreover, QI pitch is the originating raw material for advanced carbon materials such as carbon fibers, carbon composites, isotropic pitch, needle coke, etc. The company has developed its own technology to produce advanced carbon material and has commissioned the pilot plant. It has also developed US$20/kg product MCMB (micro-carbon meso beads), which is a highly value-added product that is used in lithium ion batteries. Going forward, the company plans to evolve as one of the large suppliers of these advanced carbon materials and is contemplating a 1,500 tpa facility for MCMB in the near future.

Chinese foray to make it a global player

Himadri is planning to make a foray in the Chinese coal tar pitch market through a mix of inorganic and organic route. Chinese consumption of aluminium is expected to grow at a fast pace and aluminium production is slated grow manifold. In addition, there is abundant availability of coal tar in China at attractive prices, which combined with Himadri's cutting edge technology will enable it to corner a formidable market share in China. The company also plans to use the Chinese facilities as a global export hub.

Key Concerns

Coal tar is generated in the steel production process. A slow down in steel industry globally may put pressure on the availability of coal tar and off grade pitch, which are the raw materials for Himadri. In case of rising crude oil prices, Himadri may face crunch in coal tar availability, as steel industry players start using the coal tar generated through the production process as a feedstock for energy generation.

Financials

With traction in aluminium and graphite capacities, the company is likely to see robust growth over coming two years. Top line and bottom line is likely to grow at a CAGR of 64% and 85% over FY06-08E to Rs 559 crore and Rs 82.38 crore in FY08E respectively.

Key Financial Ratios

	2006/03	2005/03	2004/03	2003/03	2002/03
EPS	9.42	2.25	0.97	0.66	0.28
CEPS	11.28	3.35	1.83	1.49	1.01
Book Value	22.79	14.51	12.82	11.85	11.14
Dividend/Share	1	0.5	0	0	0
OPM	21.78	8.54	4.27	5.61	6.04
RONW	41.27	15.52	7.38	5.64	2.52
Debt/Equity	2.21	1.77	1.25	0.82	0.61
Ratio	1.9	2.34	3.07	3.4	2.6
Interest Cover	7.69	3.99	3.13	2.53	2.23

Valuations

At the current price of Rs 325, the stock is trading at 17.81x its FY07E EPS of Rs 18.25 and 12.55x the FY08E EPS of Rs 25.90. On an EV/ EBIDTA basis, it is trading at 10.25x FY07E earnings and 7.89x FY08E earnings. We believe the current stock price does not factor in its near monopoly status in domestic market and exponential future growth. We rate the stock an OUTPERFORMER with a price target of Rs 388, an upside of 20%.

Technical Outlook

The stock has been moving in an upward trend for the last six months. It has gone into a consolidation phase, which make its attractive to accumulate at these levels. The stock has also moved along its short-term 20-day moving averages. The RSI indicators are also moving into the oversold zones. The stock may find good support at around Rs 300 after which the next up-move should begin. Minor resistances may occur at the Rs 360 levels, beyond which we should see the stock moving to higher levels.

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