

24 October 2011

Produced by: The Royal Bank of Scotland N.V., (India) Office

Buy

Target price
Rs2342.06

Price
Rs2289.55

Equity | India | Materials

Flashnote

Grasim Industries

VSF business stabilises

Recovery in VSF sales volumes and stabilisation in VSF prices were the key highlights of 2Q12. EBITDA in VSF business was ahead by 28%. At its current valuation of 4.9x EV/EBITDA, the stock offers best risk reward. Maintain Buy.

Strong VSF performance led to greater than expected EBITDA growth

- Consolidated net sales grew 27% yoy to Rs56.5bn in 2Q12, mainly due to strong growth in the VSF and Cement businesses. Standalone net sales also grew at a robust 29% yoy to Rs12bn in 2Q12 led by 27% growth in VSF and 60% growth in the Chemical business.
- Consolidated EBITDA at Rs9bn (5.5% ahead of our expectation of Rs8.5bn) in 2Q12 grew 25% yoy. EBITDA margin contracted substantially 1085bps qoq to 16% in 2Q12 from 27% in 1Q12, primarily affected by 756bps qoq rise in raw material cost to sales (25.7% in 2Q12) and 236bps rise in other expenses to sales (16.5% in 2Q12).
- On a standalone basis, EBITDA grew 10.1% yoy to Rs2.9bn in 2Q12 (8.9% ahead of our expectation of Rs2.7bn). Raw material cost inflation led to contraction in EBITDA margin of 1035bps qoq to 24.1% in 2Q12 from 34.5% in 1Q12. Raw material costs to sales increased 479bps yoy and 982bps qoq to 46.4% in 2Q12.

VSF and Cement margins affected by inflationary cost pressure

- Cement sales grew 28% yoy to Rs42.1bn, led by higher realisations. Ultra Tech's average cements realisation improved by 24% on a yoy basis, but fell 5% qoq to Rs4,272/t in 2Q12, reflecting pricing pressure which was largely driven by seasonal factors (monsoons).
- Standalone VSF business grew 27% yoy to Rs10.8bn in 2Q12, driven by 17% volume growth. VSF sales volume grew 17% yoy to 78,959mt in 2Q12 (from 67,488mt in 2Q11). VSF realisations for 2Q12 were Rs124,689/t, posting a growth of 7% yoy from Rs116,465/t in 2Q11. However, sequentially, realisations fell 18% from Rs152,409/t in 1Q12.
- VSF EBITDA margin came in at 28.5%, contracted 334bps yoy (31.8% in 2Q11) and 1034bps qoq (38.8% in 1Q12), impacted primarily by higher input costs. Input cost for VSF increased 21% yoy due to the rise in prices of pulp, caustic soda, sulphur and coal.
- VSF volume growth in 2Q12 was led by a pickup in demand due to depleted inventory in the value chain. The company expects the demand conditions for VSF to remain volatile due to

(Continued on page 2)

Grasim earnings trend

Rs. mn	Consolidated			Standalone		
	2Q12	2Q11	Growth	2Q12	2Q11	Growth
Net sales	56,492	44,390	27%	12,035	9,326	29%
Expenditure	47,464	37,179		9,130	6,689	
PBDIT	9,028	7,211	25%	2,905	2,638	10%
<i>Margin</i>	16.0%	16.2%		24.1%	28.3%	
Profit after tax (normal ops)	5,241	3,627	45%	3,448	2,796	23%
Profit after tax and minority int	4,179	3,234	29%	3,448	2,796	23%
Division wise EBIT						
Cement	4,239	2,259	88%	-	-	
VSF	2,991	2,847	5%	2,819	2,461	15%
Caustic Soda	380	237	60%	380	237	60%
Textiles	98	46	112%	23	9	157%
Others	1	5	-85%	-	-	
Total	7,708	5,393	43%	3,222	2,707	19%

Source: Company data

Important disclosures can be found in the Disclosures Appendix.

Analyst

Mohan Swamy
+91 22 6715 5304
mohan.swamy@rbs.com

83/84 Sakhar Bhawan, Nariman Point, Mumbai 400 021, India

<http://research.rbsm.com>

macro economic conditions and euro zone uncertainties.

- Standalone chemical sales grew 60% to Rs1.9bn in 2Q12 led by good demand from end-user industries. Chemical EBITDA margin at 24% for 2Q12 improved 160bps sequentially.

Capex plan on track

- Cement brownfield expansion at Chhattisgarh (4.8mmt) and Karnataka (4.4mmt) would lead total capacity to 62mmt by 1Q14. VSF expansion in Vilayat, Gujarat (120,000tpa) and Harihar, Karnataka (36,500tpa) are on track with commissioning expected in FY13. Caustic soda capacity expansion at Vilayat (182,500tpa) is progressing well with expected commissioning in 4Q13.
- Grasim spent a total of Rs15bn in 1H12 (Rs7.5bn in 2Q12, with Rs5.4bn spent on cement expansion), towards the capex outlay for FY12 of Rs63.9bn. The company has allocated Rs110bn towards cement capex and Rs34bn towards expansion of VSF business in the next two years.

Near term margin pressure; Maintain Buy

- We expect volatility in cement margins to persist for the next 4-6 quarters due to surplus conditions. Despite operating at 70-72%, the Indian cement industry has been able to sustain largely healthy margins in 1HFY2012. Costs have been rising, but the industry has been able to raise prices by around 20% in 1HFY12 on a yoy basis.
- Grasim has taken an effective increase of Rs5/Kg for VSF after registering an average realisation of Rs125 for 2Q12. We expect this will help to pass the increased cost. Demand conditions to remain volatile with pressure from input costs. We expect margin pressures in the near term.
- However, its valuation at 4.9x EV/EBITDA for FY12F offers the best risk reward. Beyond the cyclical pressures, both its business are preparing for major volume lead growth.

Income statement

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
Revenue	199334	212690	206476	228584	248300
Cost of sales	-117636	-138946	-128521	-149544	-162068
Operating costs	-23831	-26912	-25379	-26700	-27404
EBITDA	57867	46832	52576	52339	58828
DDA & Impairment (ex gw)	-9947	-11384	-11470	-12120	-12735
EBITA	47920	35449	41107	40220	46093
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
EBIT	47920	35449	41107	40220	46093
Net interest	2010	3079	2190	1667	2872
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	3361	0.00	0.00	0.00	0.00
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	53291	38528	43296	41887	48965
Taxation	-15705	-9576	-14288	-13823	-16159
Minority interests	-6631	-6162	-6937	-6298	-8247
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	-0.00	0.00
Reported net profit	30955	22790	22071	21767	24560
Normalised Items Excl. GW	3361	0.00	0.00	0.00	0.00
Normalised net profit	27595	22790	22071	21767	24560

Source: Company data, RBS forecasts

year to Mar

Balance sheet

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
Cash & market secs (1)	2370	2844	8879	14793	20292
Other current assets	43009	55941	49111	51694	54394
Tangible fixed assets	145527	157894	170061	197432	195397
Intang assets (incl gw)	20071	24191	24191	24191	24191
Oth non-curr assets	66759	79345	78358	78358	78358
Total assets	277735	320214	330600	366467	372631
Short term debt (2)	0.00	n/a	n/a	n/a	n/a
Trade & oth current liab	96497	106653	107484	116168	126145
Long term debt (3)	55992	67827	58268	66640	41222
Oth non-current liab	0.00	0.00	0.00	0.00	0.00
Total liabilities	152489	174481	165751	182808	167367
Total equity (incl min)	125246	145734	164849	183660	205264
Total liab & sh equity	277735	320214	330600	366467	372631
Net debt	53622	64984	49388	51846	20931

Source: Company data, RBS forecasts

year ended Mar

Cash flow statement

Rsm	FY10A	FY11A	FY12F	FY13F	FY14F
EBITDA	57867	46832	52576	52339	58828
Change in working capital	0.00	0.00	811.6	170.3	223.9
Net interest (pd) / rec	-3346	-4056	-5202	-6074	-5220
Taxes paid	-15705	-9576	-14288	-13823	-16159
Other oper cash items	5356	7135	6978	8649	8586
Cash flow from ops (1)	44172	40336	40876	41261	46260
Capex (2)	-6729	-24471	-19728	-39490	-10700
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	-31132	-12574	-559.9	0.00	0.00
Cash flow from invest (3)	-37861	-37045	-20287	-39490	-10700
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-3169	11835	-9559	8372	-25417
Ordinary dividend paid	-3090	-1971	-2956	-2956	-2956
Preferred dividends (4)	0.00	0.00	0.00	0.00	0.00
Other financing cash flow	47.8	-12682	-2038	-1273	-1688
Cash flow from fin (5)	-6211	-2817	-14553	4143	-30062
Forex & disc ops (6)	0.00	0.00	0.00	0.00	0.00
Inc/(decr) cash (1+3+5+6)	99.8	473.5	6036	5914	5498
Equity FCF (1+2+4)	37444	15865	21149	1771	35560

Lines in bold can be derived from the immediately preceding lines.
Source: Company data, RBS forecasts

year to Mar

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

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The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 23 Oct 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	864 (11)	564 (3)
Hold	420 (7)	226 (4)
Sell	89 (6)	50 (0)
Total (IB%)	1373 (9)	840 (3)

Source: RBS

Trading recommendations (as at 23 Oct 2011)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	0 (0)	0 (0)
Trading Sell	1 (0)	1 (0)
Total (IB%)	1 (0)	1 (0)

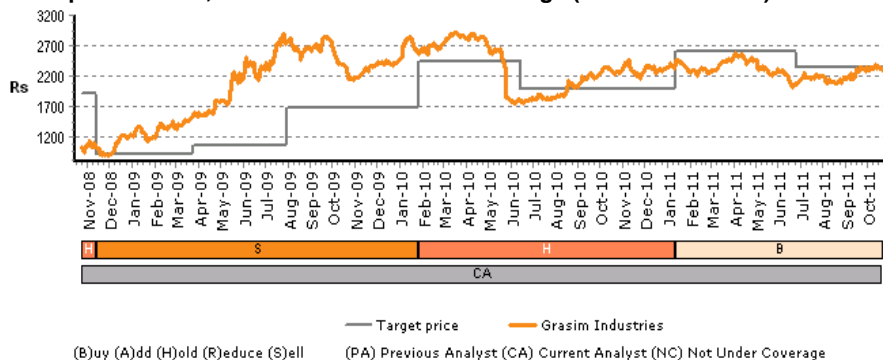
Source: RBS

Valuation and risks to target price

Grasim Industries (RIC: GRAS.BO, Rec: Buy, CP: Rs2289.55, TP: Rs2342.06): Key upside risks to our recommendation and SOTP-based target price include: 1) better-than-expected demand growth in 2010-11; and 2) significant project cancellations, which could reduce capacity creation over the next two years. The key downside risk would be a sharp decline in demand for textile imports from India, which would adversely impact VSF prices.

Grasim Ind coverage data (GRAS.BO, GRASIM IN)

Stock performance, recommendations and coverage (as at 23 Oct 2011)



Mohan Swamy started covering this stock on 5 Oct 00. Moved to new recommendation structure between 1 November 2005 and 31 January 2006. Source: RBS

Trading recommendation history

Date	Rec	Analyst
n/a	n/a	n/a

Source: RBS

Price perf (at Close 21 Oct 2011)

	(1M)	(3M)	(12M)
Price (Rs)	2356	2160	2251
Absolute (%)	-2.8	6.0	1.7
Rel market (%)	-1.2	16.4	22.8
Rel sector (%)	2.7	33.2	18.1

Source: Bloomberg
Market: Sensex
Sector: Diversified Industrials

Regulatory disclosures

None

Global disclaimer

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