UltraTech Cement- SELL

UTCEM IN	Rs661	Cement	25 May 2009	Company Update

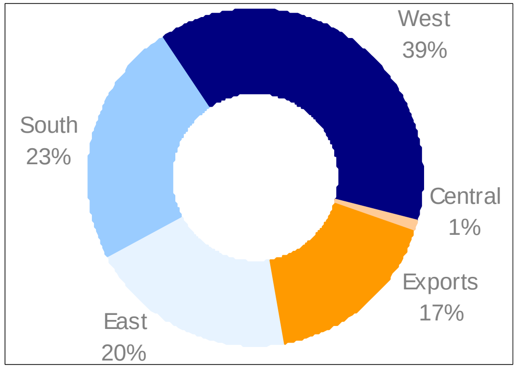
Risky markets, rich valuations

We expect sharp erosion in cement realisation from 3QFY10 in the southern and western regions, due to: i) likely decline in capacity utilisation with new capacities coming in; and ii) waning pricing discipline, with four new players entering in the next six months. The western and southern regions accounted for 62% of UCL's volume sales in FY09 and the proportion is likely to increase further in FY10 and FY11 as volume increases will come primarily from expansion in Andhra Pradesh. We believe that efficiency gains from expansion of captive power plants will not offset the realisation losses. In our view, the stock's P/BV of 1.7x FY11ii does not price in the challenges in UCL's key markets going forward. (In contrast, the stock was trading at a P/BV of 0.8x when we had upgraded our recommendation to ADD in December 2008). We downgrade UCL from ADD to SELL with a target of Rs526.

Four new players in next 6 months—not a good omen for continuation of pricing discipline: In the next six months, 9mtpa capacity from four new producers (Murli Industries in Maharashtra, JK Cement in Karnataka, Jaypee cement in Gujarat and Bharti Cement in Andhra Pradesh) will start production. In addition, the existing producers are increasing capacity by 26mtpa in FY10. All taken, capacity in these two region will increase by 35% in FY10. We expect total demand growth in the two regions at 8m tonnes each in FY10 and FY11. With incremental capacity likely to be sharply higher than incremental demand and new players vying for volumes, erosion in pricing discipline is imminent in these two regions. We expect UCL's realisation to drop 5% in FY10 and 10% in FY11.

62% of FY09 sales from high-price-risk west and south markets: UCL's sales in the western and southern regions account for 62% of its total volumes; the eastern region and exports account for the rest. Export realisations have declined sharply in the past few months as demand has eased. We expect the pricing pressure to continue in the export markets with more capacities expected to commence production in 2009. UCL is not present in the northern markets and the central region accounts for barely 1% of its volumes. With its capacity addition in Andhra Pradesh, volume share of the southern and western regions is set to rise further. We expect the sharp erosion in cement prices in these two regions to impact UCL severely.

Market mix of UltraTech Cement



Source: Industry

Financial summary

Y/e 31 Mar	FY08A	FY09A/ii	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	55,092	63,831	66,856	68,193	73,512
EBIDTA	17,201	17,064	17,605	13,267	13,094
EBITDA Margins (%)	31.2	26.7	26.3	19.5	17.8
Reported PAT (Rs m)	10,076	9,770	9,293	6,508	6,247
EPS (Rs)	80.9	78.5	74.6	52.3	50.1
Growth (%)	28.8	-3.0	-4.9	-30.0	-4.1
PER (x)	8.6	8.8	9.3	13.3	13.8
ROE (%)	45.2	31.0	23.1	13.7	11.8
EV/EBITDA (x)	6.2	6.1	5.2	6.7	6.2
Price/Book (x)	3.2	2.4	1.9	1.7	1.5
EV/ton	124	100	77	75	66

Price as at close of business on 21 May 2009

12-mth Target price (Rs) 526 (-20%)

Market cap (US$ m)	**1,745**
52Wk High/Low (Rs)	706/245
Diluted o/s shares (m)	124
Daily volume (US$ m)	1.2
Dividend yield FY09ii (%)	0.8
Free float (%)	45.2

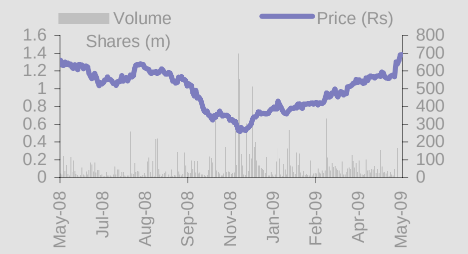
Shareholding pattern (%)

Promoters	54.8
FIIs	2.3
Domestic MFs/Insurance cos	8.9
Others	34.0

Price performance (%)

	1M	3M	1Y
UltraTech Cement	22.0	66.0	1.5
Rel. to Sensex	-5.8	9.6	19.7
ACC	16.0	35.4	10.2
Ambuja Cements	14.0	32.7	-13.1
Grasim Inds	35.1	59.6	-6.7

Stock movement



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Improvement in efficiencies not enough to offset price erosion: UCL has increased its captive power plant capacity from 25% of its total requirement in FY08 to 80% of late. We expect these plants to stabilise in the quarters ahead, and full benefits from these expansions will be evident from the second half of FY10. Cost of coal has also dropped sharply; we expect per-tonne power & fuel cost to decline 22% from FY09 levels. However, we do not expect these savings to offset the fall in realisation for UCL.

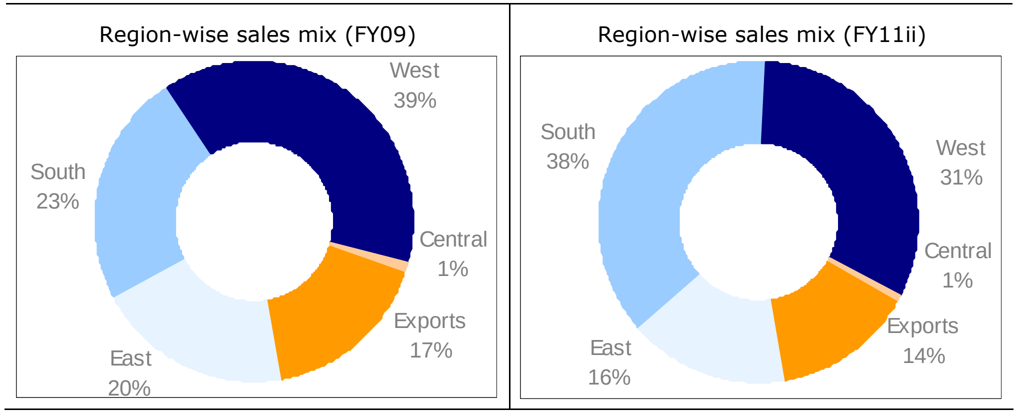
UCL is currently trading at 1.7x FY11ii P/BV; concerns not priced in—we recommend SELL: We believe a sharp decline in cement prices in UCL's key markets will lead to severe pressure on profits from 4QFY10. We expect ROE to decline from 31% in FY09 to 13.7% in FY11. We believe the stock's current valuation of FY11ii P/BV of 1.7x does not price in these concerns. We had upgraded the stock in December 2008 when it was at 0.8x P/BV on account of cheap valuations. We now downgrade it from ADD to SELL to factor in the rich valuation, with a target price of Rs525.

Figure 1: Peer valuation – Grasim with a better market mix is trading at a lower valuation

Company	EV/EBIDTA (x)		PER (x)		P/B (x)	
	FY10ii	FY11ii	FY10ii	FY11ii	FY10ii	FY11ii
Grasim Industries	4.7	4.4	9.9	10.6	1.6	1.4
UltraTech Cement	5.2	6.7	9.3	13.3	1.9	1.7

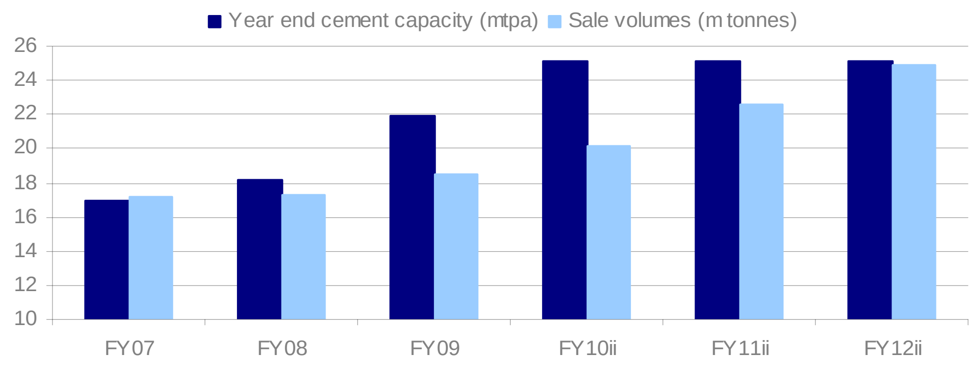
Source: IIFL Research

Figure 2: UCL's volume sales by region—sales from the west and south markets to increase from current 62% in FY09 to 69% in FY11



Source: Industry, IIFL Research

Figure 3: Capacity and sales volume trend—UCL is adding 4.9mtpa capacity in high-price-risk south markets in FY09/FY10



Source: Company, IIFL Research

Figure 4: Cement scenario in southern region

	FY07A	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Effective cement capacity (mtpa)	51	54	65	83	102	107
Production (m tonnes)	50	54	60	64	70	77
Capacity Utilisation (%)	97	100	92	78	68	72
Demand including net transfer (m tonnes)	50	54	60	64	70	77
Despatch growth (%)	12	8	10	8	8	10
Possible production (m tonnes)	51	53	61	75	94	98
Surplus/(Deficit) over demand (m tonnes)	1	-1	1	10	25	21

Source: CMA, Industry, IIFL Research

Figure 5: Cement scenario in western region

	FY07	FY08	FY09	FY10ii	FY11ii	FY12ii
Effective cement capacity (mtpa)	29	29	32	34	35	38
Production (m tonnes)	27	29	28	30	32	36
Capacity Utilisation (%)	95	99	90	88	91	94
Demand including net transfer (m tonnes)	27	29	28	30	32	36
Despatch growth (%)	10	5	-1	7	6	11
Possible production (m tonnes)	29	29	31	34	35	38
Surplus/(Deficit) over demand (m tonnes)	1	0	3	4	3	2

Source: CMA, Industry, IIFL Research

Financial summary

Sharp PAT decline in FY11 with decline in cement prices in key markets

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	55,092	63,831	66,856	68,193	73,512
EBIDTA	17,201	17,064	17,605	13,267	13,094
EBIT	15,827	14,870	14,636	10,385	10,412
Interest Expense	-757	-1,255	-1,360	-1,088	-1,088
Depreciation	-2,372	-3,230	-3,769	-3,882	-3,882
PBT	15,070	13,615	13,276	9,297	9,323
Taxes	-4,994	-3,844	-3,983	-2,789	-3,077
Net Profit	10,076	9,770	9,293	6,508	6,247

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A/ii	FY10ii	FY11ii	FY12ii
EBIT	15,827	14,870	14,636	10,385	10,412
Depr & Amortisation	2,372	3,230	3,769	3,882	3,882
Working capital Δ	1,908	236	1,439	856	1,608
Other operating items	-795	0	0	0	0
Operating Cash flow	19,312	18,335	19,844	15,123	15,901
Net Interest/ Tax/ Others	-5,303	-3,294	-5,343	-3,877	-4,165
Capital Expenditure	-14,866	-9,730	-1,710	-8,150	-3,000
Free Cash Flow	-856	5,311	12,791	3,095	8,736
Debt financing/disposal	1,667	5,200	-6,000	-3,000	-3,000
Dividends paid	-890	-722	-722	-722	-722
Other items	191	0	0	0	0
Net Change in cash	111	9,789	6,069	-627	5,014

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A/ii	FY10ii	FY11ii	FY12ii
Cash & Cash equivalents	1,007	10,796	16,865	16,239	21,253
Sundry Debtors	2,166	2,349	2,491	2,637	2
Inventories - trade	6,098	7,526	7,926	8,839	9,723
Other current assets	3,768	3,768	3,768	3,768	3,768
Fixed assets	47,836	54,336	52,277	56,545	55,663
Other term assets	1,709	1,709	1,709	1,709	1,709
Total assets	62,584	80,485	85,036	89,736	92,118
Short term debt	1,256	402	1,626	1,814	-1
Sundry Creditors	11,530	14,231	14,987	16,714	18,385
Long term debt	17,405	22,605	16,605	13,605	10,605
Other long term liabilities	5,424	7,229	7,229	7,229	7,229
Networth	26,970	36,018	44,589	50,375	55,900
Total liability and equity	62,584	80,485	85,036	89,736	92,118

Ratio analysis

Y/e 31 Mar	FY08A	FY09A/ii	FY10ii	FY11ii	FY12ii
Revenue growth (%)	12.2	15.9	4.7	2.0	7.8
Op EBIDTA growth (%)	21.3	-0.8	3.2	-24.6	-1.3
Op EBIT growth (%)	26.3	-6.0	-1.6	-29.0	0.3
Op EBIDTA margin (%)	31.2	26.7	26.3	19.5	17.8
Op EBIT margin (%)	28.7	23.3	21.9	15.2	14.2
Net Profit margin (%)	18.3	15.3	13.9	9.5	8.5
Dividend payout (%)	6.2	7.4	6.7	9.6	0.0
Tax rate (%)	33.1	28.2	30.0	30.0	33.0
Net Debt/Equity (%)	54.5	28.0	-4.4	-8.6	-22.1
Return on Equity (%)	45.2	31.0	23.1	13.7	11.8
Return on Assets (%)	21.8	16.7	15.6	10.7	9.9

Source: Company data, IIFL Research

Return ratios to decline sharply from FY10

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
