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India Cements

Ugly Duckling

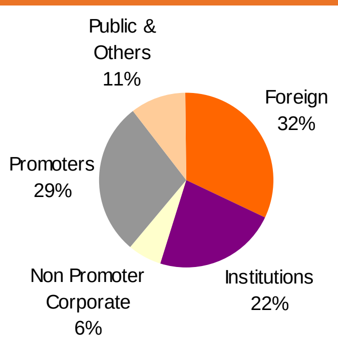
Back in the reckoning

Buy; CMP: Rs220

Company details

Price target:	Rs315
Market cap:	Rs4,840 cr
52 week high/low:	Rs250/76
NSE volume: (No of shares)	1.8 lakh
BSE code:	530005
NSE code:	INDIACEM
Sharekhan code:	INDCEM
Free float: (No of shares)	12.7 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	11.8	46.0	31.8	106.5
Relative to Sensex	4.6	19.1	16.7	40.3

Key points

- **Prime beneficiary of upturn in south:** In FY2006 cement consumption in the southern region grew by 25%. With large infrastructure projects and manufacturing bases of MNCs coming up in the region, consumption is expected to grow at a CAGR of 11% for the next few years. Also fresh capacities here shall come up only in H1FY2009. Hence cement prices are expected to remain firm for the next two years. Thanks to its high leverage to cement prices, India Cements Ltd (ICL) shall benefit the most from this boom.
- **More growth from capex plan:** Encouraged by the improvement in its financials and considering the scope for more improvement, ICL plans to raise its capacity by 2 million tonne by December 2007 at a cost of Rs350 crore. This shall take its total capacity to 11 million tonne. The entire capex shall be funded by the proceeds of a recent FCCB issue.
- **Balance sheet transformed:** With bouts of capital infusion through various routes, viz private placement, debt replacement and GDR issue, ICL's balance sheet has improved in the past few years. Its debt/equity ratio has come down to a much respectable 1.8:1 in FY2006 from 6:1 in FY2005. With a strong free cash flow, we expect the ratio to drop further to 0.3:1 in FY2008. The RoNW should also improve from 4.3% in FY2006 to 27.7% in FY2008.
- **Trading at a huge discount to peers:** At the current market price of Rs220, ICL is trading at 8.8x its FY2008E earnings and 6.1x its EV/EBITDA. On an EV/tonne basis, it is trading at USD109 per tonne of cement. That's a huge discount of 30% to some of its peers who are trading at an average valuation of USD150 per tonne of cement. In view of the steep growth expected in its earnings and the improvement in its balance sheet, the discount is not justified. We recommend a Buy on ICL with a price target of Rs315.

Company background

ICL was established in 1946 with diverse interests in cement, shipping and real estate development. The company has seven plants with the key ones located at Sankarnagar and Dalavoi.

Key financials

Year ended March 31	FY2004	FY2005	FY2006	FY2007E	FY2008E
Net profit (Rs cr)	-95.9	-61.1	35.8	385.2	575.1
% y-o-y change	-	-	-	*976.4*	*49.3*
Shares in issue (cr)	13.9	13.9	19.1	22.9	22.9
EPS (Rs)	-6.9	-4.4	1.9	16.8	25.1
PER (x)	-31.8	-49.9	117.2	13.1	8.8
Book value (Rs)	26.0	24.4	45.1	66.0	91.1
P/BV (Rs)	8.5	9.0	4.9	3.3	2.4
EV/EBIDTA (x)	52.7	45.1	23.5	8.8	6.1
RoCE (%)	2.0	3.0	8.0	23.2	29.4

The promoters currently hold 28.7% of the paid-up equity capital. A spate of acquisitions, viz of Visaka Cement (capacity of 1.2 million tonne) and Raasi Cement (capacity of 1.6 million tonne) has helped it emerge as the largest cement company in the south with a total capacity of 8.8 million tonne. These acquisitions were funded largely through debt. The downturn in the southern cement industry during FY2001-05 took its toll on the company, causing it to suffer losses for four long years and leaving it saddled with a huge debt. But by infusing fresh funds and undertaking a slew of cost-rationalisation measures, ICL has slowly come out of the red. What's more, with the outlook for the cement industry appearing bright, things are beginning to look up for ICL again.

Investments arguments

Prime beneficiary of boom in southern market

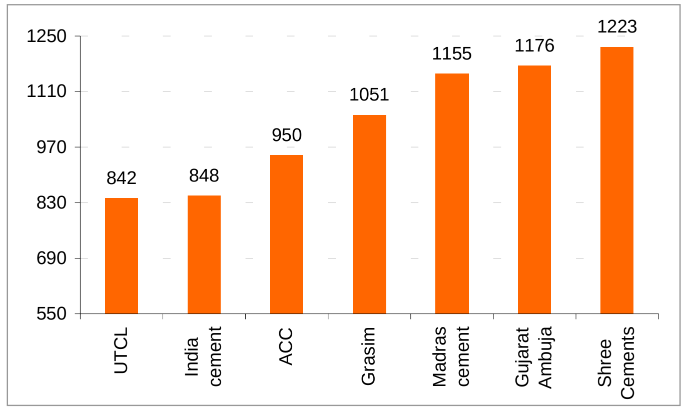
During FY2006 the southern region recorded a massive growth of 25% in cement consumption, outperforming the industry, which grew by a mere 12%. The growth has continued unabated: consumption grew by 20% in the period April- August 2006. As a result, the capacity utilisation level of the cement producers in the south is gradually crossing the 90-92% mark. With large infrastructure projects, eg the Ennore and Vallarpadam port projects, and the manufacturing bases of several multinational companies coming up in the south, the growth momentum in cement consumption is likely to be maintained. What's more, since the region shall not get any fresh capacity before H1FY2009, capacity utilisation of the southern cement companies could reach almost 100% in FY2008. We believe that utilisation levels as high as 100% shall help cement prices to gather momentum, thereby maintaining the uptrend in the region.

Clearly, cement companies in the south with a high leverage to cement prices shall benefit the most from the continued uptrend. We believe being the largest cement manufacturer in the region, ICL is all set to make the most of this boom because of its high leverage to cement prices.

Most leveraged to cement prices

Amongst its peers ICL has the highest leverage to cement prices. This means that in a scenario of rising cement prices, ICL would register the highest growth in its earnings before interest, depreciation, tax and amortisation (EBIDTA). For example, a Rs100-a-tonne (ie Rs5-a-bag) increase in cement prices can push ICL's EBIDTA per tonne to Rs948 per tonne from the existing Rs848 per tonne. That would be an increase of 12% compared with a rise of 9% for a cement producer like Gujarat Ambuja Cement, which has a low leverage to cement prices.

ICL has amongst lowest EBDITA per tonne

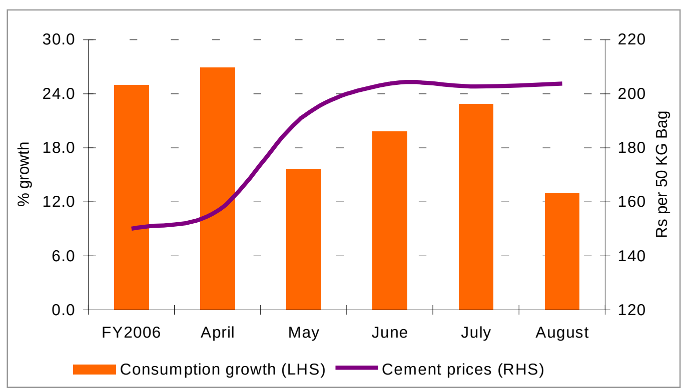


Note: EBIDTA per tonne based on Q1FY2007 figures
Source: Sharekhan Research

Cement consumption rising in south

Frequent bouts of capacity addition during FY2000-02 and a mere 4% compounded annual growth in cement consumption during FY2001-05 in the southern region meant that capacity utilisation levels never crossed even 80% during this period. However in 2005-06, the region saw a turn-around by recording a massive growth of 25% in cement consumption, outperforming the industry, which grew by only 12%. What's more, the good performance has continued and the region has recorded a 20% growth in cement consumption for the period April-August 2006.

Strong consumption growth buoys cement prices in south



Source: CMA

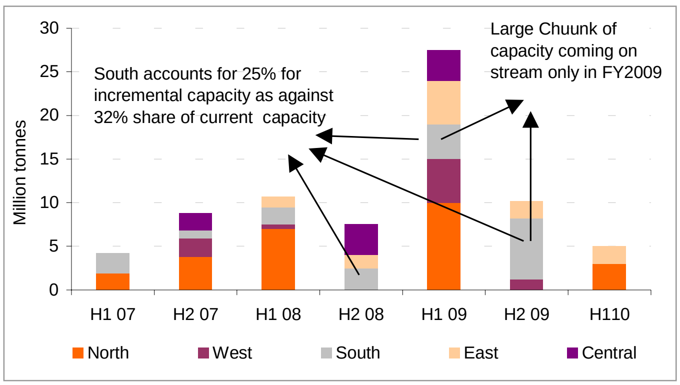
Cement prices buoyant once again

Due to the strong growth in cement consumption and rise in capacity utilisation levels in the recent times as well as the Supreme Court's ban on overloading of trucks, cement prices in the region have started moving up. From an average of Rs157 during FY2006 the price of a bag of cement has gone up to Rs205 in August 2006, ie an increase of 31%. Even in Andhra Pradesh, which has traditionally been a cement surplus zone because of its high limestone reserves, cement prices have skyrocketed to Rs180 per 50-kilogram bag, that is a year-on-year growth of a staggering 39%.

South to witness lower capacity addition

In view of the unabated growth in cement consumption at the national level and the resultant upsurge in the cement prices, which have crossed the Rs200-per-bag mark, cement producers across the country have announced big capacity expansion plans. Based on announcements made till August 2006, a total capacity of 73.8 million tonne is expected to come up in the country in the next few years. Even south-based cement manufacturers have jumped on the capacity expansion bandwagon. For example, both Madras Cement and UltraTech Cement plan to raise their capacity by 4 million tonne. However compared to the other regions, this region is expected to witness lower capacity addition: 25% share of the total fresh capacity addition as against 32% share of the current installed capacity in the country.

South to witness lower capacity addition



Source: Industry and Sharekhan Research

	Share of current capacity	Share of incremental capacity
South (%)	32	25
North (%)	21	35
East (%)	14	16
Central (%)	16	12
Western (%)	18	12
Total capacity (in million tonne)	160	74

Demand-supply equation to remain tight

Large infrastructure projects, eg the Ennore and Vallarpadam port projects, are coming up in the south. Also several multinational companies are setting up their manufacturing base in the southern states. As a result, we expect heightened infrastructure and industrial activity here which shall cause cement consumption to grow at a compounded annual growth rate (CAGR) of 11% for the next three to four years. Due to this and the fact that no new capacity is expected to come up in the region before H1FY2009, capacity utilisation of the south-based players could reach almost 100% in FY2008 (see exhibit below).

Cement prices to firm up further

We do not expect the capacity utilisation levels to drop below 90%. Hence utilisation levels as high as 95-99% shall help cement prices to rise further. We believe being the largest cement manufacturer in the region ICL is all set to make the most of this boom, thanks to its high leverage to cement prices.

ICL to add 2 million tonne cement capacity

Encouraged by the vast improvement in its financials and considering the scope for further improvement, ICL has lined up a capex plan of Rs350 crore. As per the plan, Rs85 crore shall be spent on converting the wet process plant at Sankaridurg to a modern dry process plant; this will improve the plant's capacity utilisation. The plant's capacity shall also be increased by 0.6 million tonne by the end of FY2007. The balance Rs265 crore of the capex will be utilised to de-bottleneck the Vishnupuram plant, whose capacity shall be raised by 1.4 million tonne by December 2007. Post-expansion, the Vishnupuram unit's total capacity shall go up to 11 million tonne (including the 1.2 million tonne capacity of Visaka Cement). ICL recently concluded its

Southern region witnessing rising capacity utilisation and increasing supply crunch

Particulars	FY2005	FY2006	FY2007E	FY2008E	FY2009E	FY2010E
Clinker available	**34.8**	**36.8**	**38.8**	**42.1**	**50.3**	**50.3**
Net clinker from other regions	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Clinker exports	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Net clinker available	**33.9**	**35.9**	**37.9**	**41.2**	**49.4**	**49.4**
Blending ratio	1.26	1.28	1.29	1.3	1.3	1.31
Cement available	**42.7**	**46.0**	**48.9**	**53.6**	**64.2**	**64.7**
Less cement exports	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Less dispatch to other regions	**-5.0**	**-5.0**	**-5.0**	**-5.0**	**-5.0**	**-5.0**
Add dispatch from other regions	0.8	0.8	0.8	0.8	0.8	0.8
Net cement available	**38.0**	**41.3**	**44.2**	**48.9**	**59.5**	**60.0**
Cement consumption	31.5	39.4	44.1	49.4	54.3	59.7
Domestic supply overhang	**6.5**	**1.9**	**0.1**	**-0.5**	**5.2**	**0.3**
Overall capacity utilisation	**78%**	**90%**	**95%**	**99%**	**94%**	**103%**

High capacity utilisation to firm up cement prices foreign currency convertible bond (FCCB) issue of USD75 million (approximately Rs340 crore) to fund this capex. It also plans to set up a 2-million-tonne greenfield plant at Himachal Pradesh by 2010 and is scouting for mining leases.

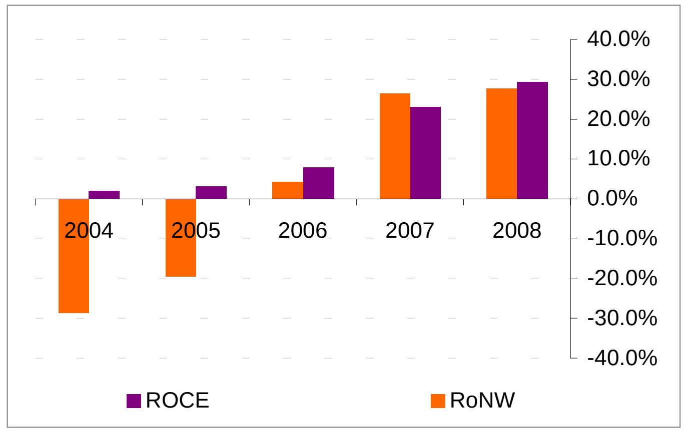
Earnings to grow at a CAGR of 300%

With the double whammy of rising volumes and improving cement realisation, we expect ICL's revenue to grow at a CAGR of 24% from Rs1,542 crore in FY2006 to Rs2,356 crore in FY2008. Due to its high leverage to cement prices and ongoing cost rationalisation exercise, the company's operating profit should grow at an 82% CAGR and the operating profit margin improve from 16.9% in FY2006 to 36.8% in FY2008. The decline in the interest charge should also continue on account of debt repayment (since the capex plan would be funded by the FCCB proceeds, the major chunk of the cash flow would be utilised to repay debt). Therefore, we expect ICL's net profit to grow at a CAGR of 300% over FY2006-08E. ICL should report earnings per share (EPS) of Rs16.8 for FY2007 and of Rs25.1 for FY2008.

Massive transformation in the balance sheet

With bouts of capital infusion through various routes, viz private placement, debt replacement and global depository receipt issue (GDR) issue, ICL's balance sheet has undergone a major transformation. Its debt/equity ratio has come down to a much respectable level of 1.8:1 in FY2006 from a high of 6:1 in FY2005. With a strong free cash flow, we expect the ratio to drop further to 0.8:1 in FY2007 and to 0.3:1 in FY2008. ICL's return ratios too have improved significantly, as shown in the following exhibit. We expect its return on net worth (RoNW) to improve to 27.7% in FY2008 from 4.3% in FY2006. The return on equity is also expected to improve to 29.3% in FY2008.

Sharp improvement in return ratios



Source: Company annual report and Sharekhan Research

Troubled times in the past

ICL went through a bad patch in the past few years and reported a negative bottom line for four consecutive years, from FY2002 to FY2005. This was primarily on account of two reasons. One, the company's eagerness to make an acquisition at any cost; this bloated the cost of acquiring Raasi Cement in 1998, resulting in a huge debt. ICL had a massive debt of Rs2,057 crore on its book with a debt/equity ratio of 6:1 in FY2003. Two, due to the excess capacity and subdued growth in cement consumption (4% CAGR) in the southern region over FY2001-05, the business of cement had turned unremunerative. As a result of this ICL's operating profits declined, leaving it unable to service its huge debt burden.

Rs crore	2005	2004	2003	2002
EBITDA	151.2	130.5	32.7	285.3
Interest cost	133.5	161.7	258.5	205.4

Corporate debt restructured

The company was therefore referred to the Corporate Debt Restructuring (CDR) cell in 2003. Since then, in keeping with the restructuring plan, ICL has reduced the size of its workforce and sold off its assets, including two cement units, the shipping business and the other non-core assets. The plan also included a loan extension and waiver of interest cost.

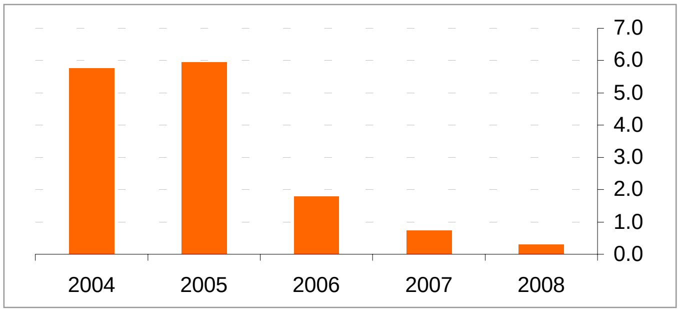
Funds mobilised through private placements

Close to Rs520 crore have also been raised through the placement of a mix of equity/warrant and debt instruments with ADRC, a Hong Kong-based foreign institutional investor, and a Rs490-crore GDR issue. These investments have helped the company to trim its debt component from Rs2,047 crore in 2004 to Rs1,525 crore in 2006 and fund its working capital.

Workforce reduced

As per the restructuring plan, ICL has also been pruning the size of its workforce over the last four years. From 4,462 employees in FY2003, its employee base came down to 3,100 employees in FY2006. The company aims to reduce its workforce further by offering a voluntary retirement scheme in future.

Reducing debt: equity ratio*



* Adjusted for preference capital and revaluation reserves

Source: Company annual report and Sharekhan Research

Trading at a huge discount to peers

At the current market price of Rs220, ICL is trading at 8.8x its FY2008E earnings and 6.1x its enterprise value (EV)/EBIDTA. On an EV/tonne basis, the stock is trading at USD109 per tonne of cement. In other words, it is trading at a huge discount of 30% to some of its peers, viz Associated Cement Companies, Madras Cement and UltraTech Cement, who are trading at an average valuation of USD150 per tonne of cement.

ICL trading at huge discount to its peers

Companies	PER		EV/EBIDTA		EV/tonne ($ US/Tonne)	
	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
ACC	20.0	17.3	11.9	10.0	196.0	177.9
UTCL	15.6	13.7	8.1	7.3	150.9	146.6
Shree Cements	12.8	9.9	8.5	6.2	198.9	138.6
Madras Cement	15.6	12.5	8.9	7.3	146.6	133.7
India Cements	12.9	8.8	9.1	6.1	140.9	108.6

Discount unjustified, recommend Buy

We believe the discount is not justified. We therefore recommend a Buy on ICL with a price target of Rs315, expecting a 43% upside from the current levels. We have valued ICL on the basis of 12x its FY2008 earnings estimates, 9x EV/EBIDTA and EV per tonne of USD150 per tonne of cement. To arrive at the fair value for ICL, we have valued Visaka Cement, a 49.9% associate of ICL, at USD75 per tonne of cement.

ICL's fair value Rs315 per share

Valuation measure	Fair value (Rs per share)
12x FY2008 earnings	301
On 9 x EV EBIDTA	333
EV per tonne (USD150)	308
Average	315

Financials

Profit and loss account Rs (cr)

Particulars	FY04	FY05	FY06	FY07E	FY08E
Net sales	1016.9	1162.1	1541.8	1931.7	2356.3
Operating expenses	916.1	1025.6	1280.8	1280.5	1489.5
Operating profit	100.8	136.5	261.0	651.3	866.8
Other Income	29.6	14.7	7.3	10.0	8.0
EBIDTA	130.5	151.2	268.2	661.3	874.8
Depreciation	81.5	78.8	78.9	93.6	101.5
Interest	161.7	133.5	148.9	134.5	74.5
PBT	-112.7	-61.1	40.4	453.2	718.8
Tax	0.0	0.0	4.7	68.0	143.8
PAT	-95.9	-61.1	35.8	385.2	575.1

Balance sheet Rs (cr)

Particulars	FY04	FY05	FY06	FY07E	FY08E
Share capital	163.6	163.6	215.7	254.0	254.0
Equity capital	138.6	138.6	190.7	229.0	229.0
Preference capital	25.0	25.0	25.0	25.0	25.0
Reserves & surplus	1197.2	1111.7	1527.2	2139.9	2715.0
Shareholders fund	1360.8	1275.3	1742.9	2394.0	2969.0
Total debt	2047.3	1987.2	1525.2	1120.7	620.7
Total liabilities	3408.1	3262.5	3268.2	3514.6	3589.7
Gross block	2889.8	2985.3	3002.8	3118.7	3383.7
Net fixed assets	2235.1	2201.9	2084.0	2106.4	2269.9
C/w in progress	98.8	3.0	31.0	150.0	50.0
Investments	34.7	34.8	34.8	34.8	34.8
Current assets	1308.2	1368.5	1512.4	1712.0	1833.6
Current liabilities	242.8	321.2	387.1	476.3	581.0
Net current assets	1065.3	1047.3	1125.4	1235.7	1252.6
Mis exp not w/o	20.5	21.9	41.7	36.4	31.0
Deferred tax liability	-46.3	-46.3	-48.6	-48.6	-48.6
Total assets	3408.1	3262.5	3268.2	3514.6	3589.7

Key ratios

Particulars	FY04	FY05	FY06	FY07E	FY08E
OPM (%)	9.9	11.7	16.9	33.7	36.8
EBIDTA (%)	12.8	13.0	17.4	34.2	37.1
PAT (%)	-9.4	-5.3	2.3	19.9	24.4
RoCE (%)	2.0	3.0	8.0	23.2	29.4
RoNW (%)	-28.6	-19.5	4.3	25.9	27.9
Debt/equity (X)	5.8	6.0	1.8	0.8	0.3

Valuations

Particulars	FY04	FY05	FY06	FY07E	FY08E
EPS	-6.9	-4.4	1.9	16.8	25.1
PER	-31.8	-49.9	117.2	13.1	8.8
P/B	8.5	9.0	4.9	3.3	2.4
EV/EBIDTA	52.7	45.1	23.5	8.8	6.1
EV/Sales	4.1	5.9	4.1	3.0	2.3
M cap/EBIDTA	19.3	36.9	19.3	7.7	5.8
M cap/Sales	3.3	4.3	3.3	2.6	2.1

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