

# VSF rises again; we see 6-months of safety

**Bank of America**  
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Reena Verma Bhasin, CFA >> +91 22 6632 8667  
Research Analyst  
DSP Merrill Lynch (India)  
reena.verma@baml.com

## VSF prices hiked by 4%; 1st discount to cotton in long time

Grasim has reportedly hiked prices of viscose staple fiber (VSF) by Rs6/kg (+4%) in Mar '11. This hike follows a series of earlier increases through FY11, starting in Oct '10. For the first time in a decade, however, VSF prices appear to be at a discount (8-10%) to local cotton prices versus the long-term average of a 40-45% premium vs. cotton. Compared with polyester (PSF), VSF prices are currently at ~30% premium versus LT average of ~24% premium and peak premium of ~75%.

## FY12 earnings up; PO unchanged; we see 6 mths of safety

We expect recent higher VSF prices to sustain for the next 6 months and have lifted FY12 earnings by 10%. Post recent record cotton prices, we conservatively assume that cotton prices will ease during 1H FY12 and VSF prices will ease with a lag. Our sum-of-the-parts-based PO is unchanged at Rs2,510/sh and implies a de-rating of VSF business to 7.5x FY12-PE vs. 9x earlier.

## Cotton continues to spiral; brightest before dusk?

Cotton prices are up ~35-40% in last 2 months versus ~19% rise in polyester and ~10% rise in VSF prices. Industry organizations like the International Cotton Advisory Committee expect cotton acreage to rise in the upcoming sowing season and expect cotton inventory to rise over Jul '11-Aug '12.

## Prefer Grasim over pure cement plays on valuations

Our sum-of-the-parts-based PO for Grasim values its cement business at US\$95-100 per ton, i.e., 20% below the current valuation of UltraTech (Rs1008.7, Underperform). For the VSF business, we have factored a de-rating to allow for a potential downturn in the next 6 mths. On these assumptions, and after factoring a 20% holdCo discount, we expect ~9% stock upside in Grasim. Maintain Neutral.

## Stock Data

Price (Common / GDR)	Rs2,301 / US\$51.12
Price Objective	Rs2,510 / US\$54.92
Date Established	4-Jan-2011 / 27-Jan-2011
Investment Opinion	C-2-7 / C-2-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs1,668-Rs2,510
Market Value (mn)	US\$4,689
Shares Outstanding (mn)	91.7 / 91.7
Average Daily Volume	57,290
BofAML Ticker / Exchange	GRSJF / BSE
BofAML Ticker / Exchange	GRSJV / LUX
Bloomberg / Reuters	GRASIM IN / GRAS.BO
ROE (2011E)	15.1%
Net Dbt to Eqty (Mar-2010A)	-1.1%
Est. 5-Yr EPS / DPS Growth	-9.1% / 7.9%
Free Float	74.0%

## Key Changes

(Rs)	Previous	Current
2012E Rev (m)	220,777.3	224,175.9
2013E Rev (m)	242,396.0	241,162.2
2012E EPS	223.74	246.05
2013E EPS	227.99	225.90

## Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	21,867	27,595	20,156	22,561	20,713
EPS	238.49	300.96	219.83	246.05	225.90
EPS Change (YoY)	-24.4%	26.2%	-27.0%	11.9%	-8.2%
Dividend / Share	30.00	31.51	31.51	39.53	39.53
Free Cash Flow / Share	117.07	370.02	166.90	46.25	(15.22)
GDR EPS (US\$)	5.18	6.34	4.89	5.47	5.02
GDR Dividend / Share (US\$)	0.652	0.664	0.700	0.879	0.879

## Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	9.65x	7.64x	10.47x	9.35x	10.18x
Dividend Yield	1.30%	1.37%	1.37%	1.72%	1.72%
EV / EBITDA*	6.01x	4.50x	5.82x	5.43x	5.26x
Free Cash Flow Yield*	5.09%	16.08%	7.25%	2.01%	-0.662%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 7.

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Refer to important disclosures on page 8 to 11. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. Link to Definitions on page 5. 11027381

## iQprofile<sup>SM</sup> Grasim Industries

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
<b>(Rs Millions)</b>					
Sales	182,966	199,334	204,618	224,176	241,162
Gross Profit	43,323	57,867	44,759	47,984	49,564
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	34,665	47,920	33,406	35,619	35,132
Net Interest & Other Income	1,401	2,010	2,651	2,531	1,987
Associates	NA	NA	NA	NA	NA
Pretax Income	36,066	49,930	36,057	38,150	37,118
Tax (expense) / Benefit	(9,914)	(15,705)	(10,718)	(11,117)	(10,991)
Net Income (Adjusted)	21,867	27,595	20,156	22,561	20,713
Average Fully Diluted Shares Outstanding	92	92	92	92	92

### Key Cash Flow Statement Data

Net Income	21,867	30,955	20,156	22,561	20,713
Depreciation & Amortization	8,658	9,947	11,353	12,365	14,432
Change in Working Capital	(4,259)	3,040	2,077	(356)	154
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	6,092	3,270	5,677	5,048	5,818
Cash Flow from Operations	32,358	47,212	39,263	39,618	41,117
Capital Expenditure	(21,624)	(13,285)	(23,960)	(35,378)	(42,513)
(Acquisition) / Disposal of Investments	(28,687)	1,693	0	0	0
Other Cash Inflow / (Outflow)	27,533	3,577	0	0	0
Cash Flow from Investing	(22,778)	(8,015)	(23,960)	(35,378)	(42,513)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(3,151)	(3,151)	(3,415)	(4,285)	(4,285)
Cash Flow from Financing	9	(6,089)	(17,367)	5,798	(2,103)
Free Cash Flow	10,734	33,927	15,303	4,240	(1,396)
Net Debt	34,203	(1,842)	(13,730)	(13,685)	(8,004)
Change in Net Debt	(6,429)	(36,045)	(11,888)	45	5,680

### Key Balance Sheet Data

Property, Plant & Equipment	142,190	145,527	158,134	181,147	209,227
Other Non-Current Assets	33,058	31,365	31,365	31,365	31,365
Trade Receivables	8,182	8,803	6,397	7,017	7,519
Cash & Equivalents	24,727	57,834	55,770	65,809	62,310
Other Current Assets	34,522	34,206	30,793	33,545	36,477
Total Assets	242,679	277,735	282,460	318,882	346,898
Long-Term Debt	47,594	49,770	39,412	49,495	51,677
Other Non-Current Liabilities	15,919	20,057	20,057	20,057	20,057
Short-Term Debt	11,336	6,222	2,628	2,628	2,628
Other Current Liabilities	35,547	38,891	35,149	38,165	41,752
Total Liabilities	110,397	114,941	97,247	110,345	116,115
Total Equity	132,282	162,795	185,213	208,537	230,783
Total Equity & Liabilities	242,679	277,736	282,460	318,882	346,898

### iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	15.0%	15.7%	10.9%	10.7%	9.4%
Return On Equity	23.4%	22.9%	15.1%	14.9%	12.3%
Operating Margin	18.9%	24.0%	16.3%	15.9%	14.6%
EBITDA Margin	23.7%	29.0%	21.9%	21.4%	20.6%

### iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	1.5x	1.7x	1.9x	1.8x	2.0x
Asset Replacement Ratio	2.5x	1.3x	2.1x	2.9x	2.9x
Tax Rate (Reported)	27.5%	31.5%	29.7%	29.1%	29.6%
Net Debt-to-Equity Ratio	25.9%	-1.1%	-7.4%	-6.6%	-3.5%
Interest Cover	6.4x	7.3x	4.2x	4.5x	4.5x

### Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 7.

### Company Description

Grasim Industries is a flagship company of the AV Birla Group. It is a monopoly producer of viscose staple fiber (VSF) in India. Grasim also owns 60% stake in Ultratech, which is India's largest cement producer with a total capacity of around 52mn tpa.

### Investment Thesis

We rate Grasim as a Neutral due to the conflicting outlook for its key businesses and a steeper-than-expected holding company discount implied by current valuations. We are bullish on the viscose staple fiber (VSF) business, which constitutes 40-45% of proportionate EBITDA. However, the profit outlook for cement, which constitutes 55-60% of proportionate EBITDA (contributed by its 60% subsidiary Ultratech), is weak. Overall, we see modest upside post a 20% holdco discount.

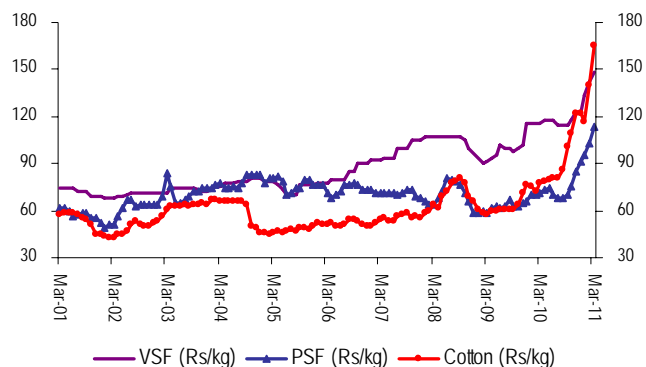
### Stock Data

Shares / GDR	1.00
Price to Book Value	1.5x

### Key Changes (GDR)

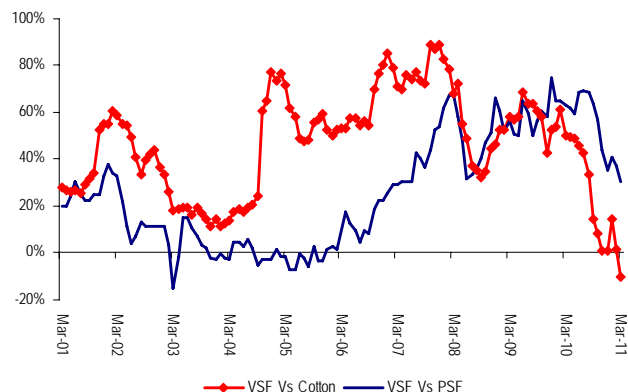
(US\$)	Previous	Current
2012E EPS	4.97	5.47
2013E EPS	5.07	5.02

Chart 1: Trend in VSF, PSF & Cotton prices



Source: Crisinfac, Industry sources

Chart 2: Premium of VSF prices versus Cotton & PSF



Source: Crisinfac, Industry sources

Table 1: Supply-demand outlook for the Indian cement industry

As on 31 March (mn tpa)	FY08	FY09	FY10	FY11E	FY12E	FY13E
Reported Cement Capacity	189	216	256	301	328	353
Effective Cement Capacity	173	202	234	274	314	340
Effective Clinker Capacity	139	167	197	236	275	300
<b>Capacity growth</b>	<b>11%</b>	<b>20%</b>	<b>18%</b>	<b>20%</b>	<b>17%</b>	<b>9%</b>
Cement Demand	168	181	200	211	230	255
<b>Demand growth</b>	<b>8%</b>	<b>8%</b>	<b>10%</b>	<b>6%</b>	<b>9%</b>	<b>11%</b>
Domestic Consumption	164	178	197	208	227	253
<b>Growth in domestic consumption</b>	<b>10%</b>	<b>8%</b>	<b>11%</b>	<b>6%</b>	<b>9%</b>	<b>11%</b>
Cement Exports	3.7	3.2	2.2	2.3	2.3	2.3
<b>Export growth</b>	<b>-35%</b>	<b>-12%</b>	<b>-31%</b>	<b>6%</b>	<b>0%</b>	<b>0%</b>
Cement - Capacity Utilisation	97%	90%	85%	77%	73%	75%
Cement/Clinker Ratio	1.36	1.37	1.36	1.36	1.36	1.36
<b>Blended Cement as % of total production</b>	<b>75%</b>	<b>75%</b>	<b>75%</b>	<b>75%</b>	<b>75%</b>	<b>75%</b>
Clinker - Capacity Utilisation (incl. Exports)	91%	81%	76%	67%	62%	63%
Clinker - Capacity Utilisation (excl. Exports)	89%	79%	74%	66%	61%	63%

Source: Company reports, BofA Merrill Lynch Global Research estimates

Table 2: Sum-of-the-parts valuation for Grasim

Key value drivers	FY12E benchmark	Share price (Rs)
Ultratech/Cement	-US\$95-100 per ton	1299
Embedded value of Idea Cellular	PO of Rs65/sh of Idea	121
Embedded value of ABNL	PO of Rs850/sh of ABNL	31
Embedded value of Hindalco	PO of Rs245/sh of Hindalco	146
Embedded value of L&T	PO of Rs2280/sh of L&T	96
<b>Total equity value of holdings including cement</b>		<b>1693</b>
<i>less</i> Holdco discount	20%	339
<b>Net equity value of holdings</b>		<b>1354</b>
Equity value of Grasim standalone/VSF business	7.5x PE	1285
<i>less</i> conglomerate discount 10%	10%	128
<b>Target share price of Grasim</b>		<b>2510</b>

Source: BofA Merrill Lynch Global Research

**Table 3: Valuation comparison of Indian cement majors**

	Share Price	Market Cap (US\$ mn)	BofAML Rating
ACC	978	4072	C-3-7/UNDERPERFORM
Grasim	2305	4698	C-2-7/NEUTRAL
Ambuja Cements	123	4147	C-3-7/UNDERPERFORM
Ultratech Cement	1,010	6152	C-3-7/UNDERPERFORM
Shree Cement	1720	1332	C-2-7/NEUTRAL
India Cements	91	624	C-3-7/UNDERPERFORM
BSE30	18223		
<b>Yr to 31 March/Dec</b>	<b>2009/FY10</b>	<b>2010E/FY11E</b>	<b>2011E/FY12E</b>
<b>EV/Capacity (US\$/ton)</b>			
ACC	166	159	121
Grasim-Cement business	94	90	76
Ambuja Cements	179	153	146
Ultratech Cement	138	131	134
Shree Cement	116	95	90
India Cements	65	67	71
<b>Replacement cost benchmark-India (US\$/ton)</b>	<b>120-125</b>	<b>120-125</b>	<b>120-125</b>
<b>RoE (%)</b>			
ACC	29	17	11
Grasim	23	15	15
Ambuja Cements	20	18	15
Ultratech Cement	27	14	11
Shree Cement	43	11	10
India Cements	10	1	1
Local Market RoE	16	18	19
<b>P/E (x)</b>			
ACC	11.7	18.1	25.7
Grasim	7.7	10.5	9.4
Ambuja Cements	15.4	15.2	16.6
Ultratech Cement	11.0	19.6	22.1
Shree Cement	7.7	27.3	27.1
India Cements	8.3	59.9	83.2
Local Market PE	23.3	17.8	14.6
<b>EV/EBITDA (x)</b>			
ACC	7.0	10.9	13.5
Grasim - Cement business	4.6	6.9	6.1
Ambuja Cements	9.5	9.4	9.9
Ultratech Cement	6.5	10.0	10.6
Shree Cement	4.1	7.6	6.8
India Cements	5.7	12.6	10.9
Local Market EV/EBITDA	12.4	10.0	8.4

Source: BofA Merrill Lynch Global Research estimates

## Price objective basis & risk

### Grasim (GRSJF / GRSJY)

We have a price objective of Rs2510 (GDR of US\$54.92) for Grasim. We value the company's dominant cement business at a 20% discount to the industry's current replacement cost of US\$120-125/ton. The 20% discount is in line with the average (rather than trough) discount witnessed through the previous downturn (1997-2002). The VSF business is pegged at an FY12E PE of about 7.5x, implying a sharp discount vs. the local market (BSE 30). A sharp slowdown in VSF demand and an unforeseen rise in energy prices for the cement business present downside risks to our PO. Upside risk could stem from strong and sustained rational pricing behaviour of cement producers across the industry and an unforeseen further rise in cotton and PSF prices.

## Link to Definitions

### Industrials

Click [here](#) for definitions of commonly used terms.

## Analyst Certification

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Address – Mafatlal Centre, 8th Floor, Nariman Point, Mumbai, India. 400021

Tel : +91 22 6632 8000

07 March 2011

**India - General Coverage Cluster**

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Aditya Birla Nu	ADYAF	ABNL IN	Reena Verma Bhasin, CFA
	Anant Raj Industries Ltd	XNRJF	ARCP IN	Gagan Agarwal
	Brigade Enterprises	XBDGF	BRGD IN	Gagan Agarwal
	Chambal Fertilisers & Chemicals	CHBZF	CHMB IN	Prasad Deshmukh
	Container Corp	CIDFF	CCRI IN	Sanjaya Satapathy
	Coromandel International Ltd	CMDFF	CRIN IN	Prasad Deshmukh
	Cummins India	CUIDF	KKC IN	Sanjaya Satapathy
	DLF Limited	XVDUF	DLFU IN	Gagan Agarwal
	Exide Indus Ltd	XEDRF	EXID IN	Sanjaya Satapathy
	Fortis Healthcare Limited	XFFTF	FORH IN	Prasad Deshmukh
	Havells	HVLIF	HAVL IN	Sanjaya Satapathy
	Housing Development and Infrastructure	XGHSF	HDIL IN	Gagan Agarwal
	Indiabulls Real Estate Ltd	IBELF	IBREL IN	Gagan Agarwal
	Jaypee Infratech	XJAYF	JPIN IN	Gagan Agarwal
	Jet Airways	JTAIF	JETIN IN	Anand Kumar
	Motherson Sumi	XMSUF	MSS IN	Sanjaya Satapathy
	Puravankara Projects Ltd	XPJVF	PVKP IN	Gagan Agarwal
	Renuka Sugars	SRNKF	SHRS IN	Sanjaya Satapathy
	SINTEX INDUSTRIES LTD	SIXDF	SINT IN	Prasad Deshmukh
	Sobha Developers	SBDRF	SOBHA IN	Gagan Agarwal
	SpiceJet Ltd	MDLFF	SJET IN	Anand Kumar
	Voltas	VTSJF	VOLT IN	Sanjaya Satapathy
<b>NEUTRAL</b>				
	Grasim	GRSJF	GRASIM IN	Reena Verma Bhasin, CFA
	Grasim -G	GRSJY	GRAS LX	Reena Verma Bhasin, CFA
	Jain Irrigation Systems Ltd	JNIDF	JI IN	Prasad Deshmukh
	Shree Cements	SREEF	SRCM IN	Reena Verma Bhasin, CFA
	Unitech Ltd	UTKIF	UT IN	Gagan Agarwal
<b>UNDERPERFORM</b>				
	Ambuja Cements	AMBUF	ACEM IN	Reena Verma Bhasin, CFA
	APIL	ANSFF	APIL IN	Gagan Agarwal
	Assoc. Cement	ADCLF	ACC IN	Reena Verma Bhasin, CFA
	Bajaj Hindusthan	BJJHF	BJH IN	Sanjaya Satapathy
	Balrampur Chini	BMPRF	BRCM IN	Sanjaya Satapathy
	India Cements	INIAF	ICEM IN	Reena Verma Bhasin, CFA
	India Cements -G	IAMUY	ICEM LX	Reena Verma Bhasin, CFA
	Jindal Saw	SWPFF	JSAW IN	Sanjaya Satapathy
	Nagarjuna Fertilizers & Chemicals Ltd	NFACF	NFCL IN	Prasad Deshmukh
	Omaxe Limited	XOMXF	OAXE IN	Gagan Agarwal
	Tata Chemicals Ltd	TTCXF	TTCH IN	Prasad Deshmukh
	Triveni Engg	TVIEF	TRE IN	Sanjaya Satapathy
	UltraTech Cemen	XDJNF	UTCEN IN	Reena Verma Bhasin, CFA
	Welspun Corp Ltd	XUQRF	WLCO IN	Sanjaya Satapathy

07 March 2011

**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

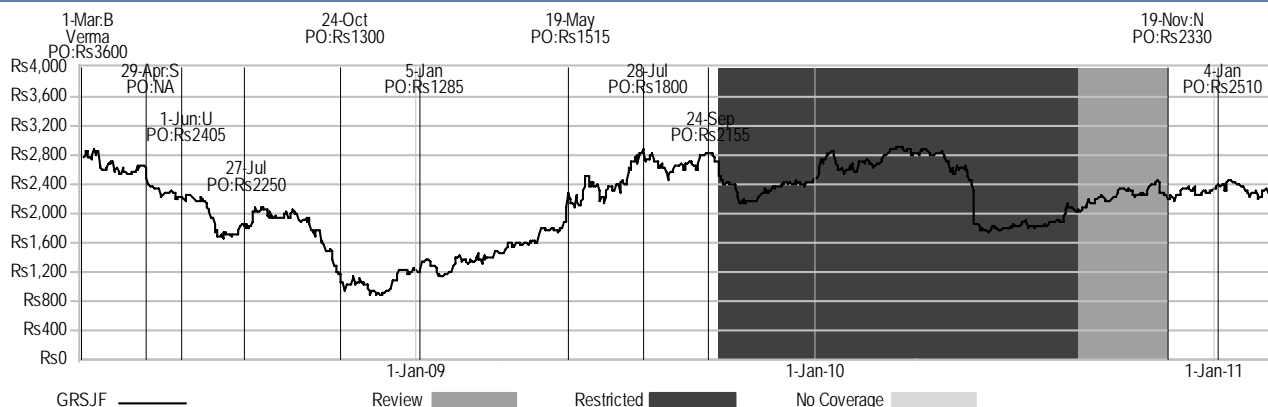
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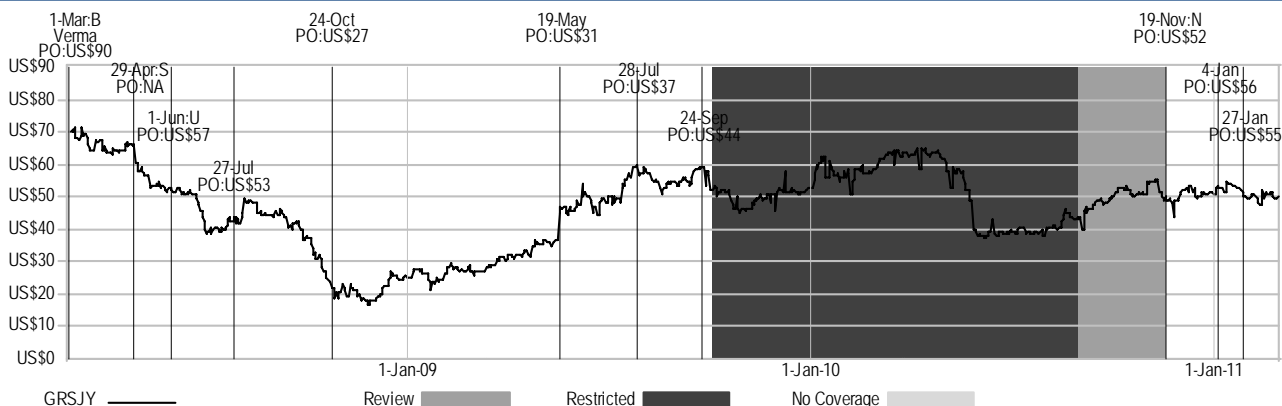
### GRSJF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of February 28, 2011 or such later date as indicated.

### GRSJY Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

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### Investment Rating Distribution: Industrials/Multi-Industry Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	47	58.75%	Buy	24	58.54%
Neutral	20	25.00%	Neutral	9	52.94%
Sell	13	16.25%	Sell	4	36.36%

### Investment Rating Distribution: Global Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2011	53.86%	Buy	874	48.31%
Neutral	925	24.77%	Neutral	444	52.30%
Sell	798	21.37%	Sell	276	36.75%

\* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.



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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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