20th April 2007

Cement Sector

- In context of the latest developments (Removal of CVD and SAD on imported cement) in the cement sector we spoke to a number of trade and channel members to assess the ground reality. From our talks, we find that:
  - Cement, by nature, being a bulky commodity with a very low shelf life (about 45 days) is a highly localised commodity. High freight component and infrastructure bottlenecks act as natural entry barriers for imported cement.
  - Besides, any quantity of cement imported into India for trade will require the BIS licence (which will take about 28-35 days) before the cement first comes onshore.
  - Prices to be impacted only if imports are in significant quantities and not on isolated shipments. Though, some builders plan to get together and import cement, these are mere pressure tactics than anything else.
- Meanwhile, prices across regions have been stable since last month with all India average retail price prevailing at Rs. 224 per bag.
- During our Hyderabad visit we met with trade and mini cement players to understand their strategy going forward:
  - With coke breeze shortage, the operations of most of the mini cement players based on VSK have become unviable. Players with capacities based on rotary kilns have realised the need to become a large cement unit for survival.
  - Sagar Cement Ltd., a 0.6 MnT player has currently undertaken a Rs. 2.96 bn capex to expand its capacity to 2.5 MnT by June 2008.
  - Robust demand and favourable prices have helped Andhra Cement, a BIFR company since 1991, with 1.5 MnT capacity to turned around its operations in 3QFY07 post a prolonged period of minimal/no production. Improvement of utilisation levels from current 42% will help improve the margins further.
  - Penna Cement, an unlisted cement player based in Andhra Pradesh with capacity of 2.5 MnT has undertaken a capex worth Rs. 7 bn whereby it aims to increase its capacity by 3 MnT.

Outlook

This abolition of all duties on imported cement clearly underscores the Government's determined efforts to keep cement prices under check, especially with the elections currently on in Uttar Pradesh. Though, this step hampers the domestic industry's competitiveness against imports in coastal areas, it is unlikely to have a major impact in the overall market on account of the practical issues with large scale imports into the country.

The overall outlook seems good with demand-supply scenario expected to remain favourable until December 2008 quarter, while valuations also look attractive given the recent fall in share prices. However, the persistent Government intervention largely due to the ongoing elections in the state of Uttar Pradesh remains the key concern. With the longer term fundamentals remaining sound, we continue to remain positive and recommend considering exposures in the sector with a longer term perspective.

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Import duty removed

The government has removed the Countervailing Duty (CVD@ 16%) and Special Additional Duty (SAD@ 4%) on cement to make them attractive. With the removal of CVD and SAD, the import parity prices at the retail has come down to around Rs. 200 per 50 kg bag in the coastal areas which makes cement imports economically viable in the coastal areas. However, large scale imports of cement are not feasible due to variety of infrastructural and logistical bottlenecks.

From the Horse's mouth

We spoke to dealers across the country to understand their view with regards to this development and following are the excerpts:

Minor shortage of cement

A) **Delhi** – "Import of cement from Pakistan to Delhi and NCR is not viable, as the freight cost will be fairly higher. Moreover, cement or any other goods coming in bulk from Pakistan will require security checks before coming to Delhi and we don't think anybody would want to take any risk if anything happens. Meanwhile, institutional billing is at Rs. 212 per bag and some players have reduced trade margins by Re. 1-2 per bag. This, however, will be compensated through year end discounts. Prices should remain stable as demand is good and also there is some shortage of cement in the market".

B) **Jaipur** – "Demand is strong across Rajasthan and the prices are quite robust. Imports from Pakistan are remote, as cement is a freight intensive commodity. Besides, even if allowed, all permissions and documentation will take at least two months by which there will be the onset of monsoons which will impact trade".

C) **Chandigarh** – "Prices are stable Rs. 225-226 per bag at the retail level and it is a sellers market now. There is a bit of shortage since last two-three months and we are getting less supply than we order. Also, some companies have reduced dealer margin by Re. 1 per bag. Cement import from Pakistan to Chandigarh is very difficult, as the freight will be higher but they are very much possible in Amritsar, as it is very near to the border. However, we have not heard anybody importing cement in Punjab till date".

D) **Kolkata** – "Yes, We have heard about this development and some related inquiries from customers about possible cement imports from Bangladesh. Cemex Bangladesh is looking to export cement from Bangladesh. Cement can be imported from Bangladesh at around Rs. 180-190 per bag at Haldia port but in smaller quantities (600-1,000 tonnes). Prices will be impacted only if imports are in significant quantities and not on isolated shipments.

E) **Chennai** – "Landed cost of imported cement from China is possible at around Rs. 160 per bag at Chennai Port. On this octroi and freight to the city will be additional if it is directly consumed and if resold, dealer margins and VAT (12.5%) will be additional. Also, if the cement comes in bulk form, the importer will require packing unit and warehousing facilities. We have heard some builders planning to get together and import cement, but this seems to be pressure tactics than anything else".

F) **Hyderabad** – "Cement imports are viable in the coastal areas but in the interior areas like Hyderabad imported cement will not be cheaper. Prices in Andhra Pradesh are already lower than rest of the country due to the presence of 2 large clusters (Nalgonda & Yerraguntla) which determine the prices in the region".

BIS licence required for trading

G) **Ahmedabad** – "Demand is strong with a minor shortage in supply. Offtake is good even at the current prevailing prices and hence companies have maintained them. Some groups of builders are contemplating cement import from Pakistan. It is definitely feasible to import via Kandla/Mundhra port and the landed cost of such cement in Ahmedabad would come to around Rs. 185-190 per bag. The saving would be to the tune of Rs. 15-20 per bag as the institutional price is around Rs. 205-210 per bag. However, unless someone takes the initiative and imports, one can't gauge the impact of this development".

"Also, cement imports are easier for direct user as for trading imported cement, the dealer will need a BIS licence (it takes about 28 days for cement strength testing and about 7-10 more days at least to get the licence). If any one does it now then it can be beneficial, as down the line in two months monsoons will set in and the possibility will be remote".

H) **Mumbai** – "There is a minor shortage in the supply. Some large builders will go for imports, as they will be cheaper but large scale imports are not possible as ports are not adequately equipped to handle large quantities of cement imports (except L&T). The cost of imported cement for direct user could come at around Rs. 180-190 per bag. There is news that some dealer has imported cement at Rs. 155 per bag, but trading of imported cement will need BIS licence and it will take at least a month to get licence. Prices are likely to come down once the demand reduces during monsoons".

I) **Pune** – "Prices are stabilising since last month and are at an average of Rs. 250-260 per bag. Some small retailers sell even at Rs. 280 per bag, as there is a shortage of cement. Companies have reduced bulk discounts and have also reduced dealer margins. Imports can lower prices but we don't think large scale imports are possible, as the ports do not have sufficient infrastructure facilities and there would be further difficulties concerning logistics and warehousing".

J) **Bhopal/Indore** – "Madhya Pradesh being in central India is insulated as freight cost and handling charges will be high. Local cement coming from Satna will always be cheaper than the imported cement."

K) **Lucknow/Kanpur** – "Prices are in the range of Rs. 220-230 in Uttar Pradesh. Imports are not possible to UP as we are landlocked. Demand is good but due to state election, there are some disturbances. The prices have been stable since last two months largely because of elections. Increase seems to be remote, as post elections rains will start and plants will be shut for maintenance".

Our view: This latest development clearly underscores the government's determined efforts to keep cement prices under check, especially with the elections on in Uttar Pradesh. Though, this step hampers the domestic industry's competitiveness against imports in coastal areas it is unlikely to have a major impact in the overall market. Imports in large quantities seem unlikely given the lack of infrastructure, the bulky nature of the commodity, the mandatory BIS quality testing (which delays the consumption by a month) and the nearness to the monsoon period.

Dealers' diary

Meanwhile, prices across regions have been stable with all India average retail price at Rs. 224 per bag. This stability is following the industry's informal agreement on a price freeze with the Commerce Minister Mr. Kamal Nath.

Prices stable across regions

North

Centre	Apr. '07	YoY (%)	MoM (%)
Delhi	232	5.5	0.0
Jaipur	215	14.4	0.0
Punjab	225	6.1	0.0
East UP	225	15.4	0.0
West UP	230	16.2	0.0
MP	210	16.7	0.0

West

Centre	Apr. '07	YoY (%)	MoM (%)
Mumbai	255	15.9	0.0
Ahmedabad	225	17.2	0.0
Surat	225	21.6	0.0
Nagpur	225	25.0	0.0
Pune	250	17.9	0.0
Nasik	230	15.0	0.0

South

Centre	Apr. '07	YoY (%)	MoM (%)
Chennai	223	23.9	0.0
Hyderabad	205	24.2	0.0
Bangalore	235	20.5	0.0
Vizag	210	20.0	0.0
Kochi	235	17.5	0.0

East

Centre	Apr. '07	YoY (%)	MoM (%)
Kolkata	222	8.3	0.0
Raipur	190	11.8	0.0
Orissa	217	9.0	0.0
Bihar	225	4.7	0.0

Note: All retail prices are for 50 kg bag (Rs.)

ACC AGM key takeaways

- ACC is incurring a capex worth Rs. 40 bn over a three year period (CY07-09) so as to enhance its cement capacity to 27.5 MnT. The capex will include scaling up the clinkering capacity at the New Wadi plant with split grinding units in Karnataka region and setting up a 50 MW captive power plant at the total cost of Rs. 14.87 bn. The project to be completed in around 30-36 months will enhance the cement capacity by 3 MnT.
- The company will further augment its grinding capacities at Kymore by 0.50 MnT, at Sindri by 0.4 MnT and Wadi by 1.08 MnT during CY07E. These expansions would take ACC's capacity to 23 MnT by CY07E end.
- In CY08E, the capacity of the Bargarh cement plant in Orissa would be scaled up to 2.14 MnT from the existing 0.9 MnT. Cement grinding capacity at Madukkarai would also be augmented by 0.22 MnT during CY08E.
- Besides capacity expansions, the company is also installing captive power plants of 25 MW at Lakheri and 30 MW at Bargarh which will bring in power costs savings.
- ACC has completed the expansion and modernisation at Lakheri (0.9 MnT) and has augmented its grinding capacity at Tikaria by 0.31 MnT. It is undergoing trial runs and is likely to commence production in the current month (April 2007).
- Among other things, the company also denied any speculation on merger with Ambuja Cements at the moment. Also, Mr. Sumit Banerjee will replace Mr. M.L. Narula as the new MD of ACC, effective April 1, 2007.

Our view

This continuous emphasis from the company to add capacity through de-bottlenecking and brownfield route will help drive better value for the shareholders, as volume growth would be fairly consistent over the years. We expect the company's earnings to post a CAGR of 28% on the back of this volume growth and realisation growth which has already come in. The stock trades at a PER of 10x CY07E and 8.1x CY08E earnings. We maintain our BUY call on the stock.

Shree Cement commissions 1.5 MnT cement unit

Shree Cement's 1.5 MnT line IV at Ras has been commissioned in March along with an 18 MW captive thermal power plant.

Our view: With this expansion, operational capacity for Shree Cement now stands at 6 MnT and the headstart in comparison to the competition will help capture better market share during a tight demand-supply situation. Adjusted earnings growth as a result is likely to remain buoyant (28% CAGR growth) and the stock is trading at a PER of 6.8x FY08E and 5.4x FY09E earnings.

Coal linkage to cement sector raised by 15%

Standing committee on coal linkages has increased the monthly allocation of coal to the cement industry by 15% to 1.06 MnT per month for the June 2007 quarter. Coal linkages to the Southern region has been increased to 0.44 for the June 2007 (up 40% MoM from March 2007 quarter). The coal linkages to other regions stand at: Northern region 0.12 MnT, Eastern region 0.18 MnT, Western region 0.12 MnT and Central region 0.2 MnT.

Our view: With the industry's prices no more being linked to natural market forces, the proposed lowering of coal linkages to the industry have been addressed. This move in fact will make sure that the input cost pressures from coal – the key fuel in cement – will only see a normal price increase.

Hyderabad visit

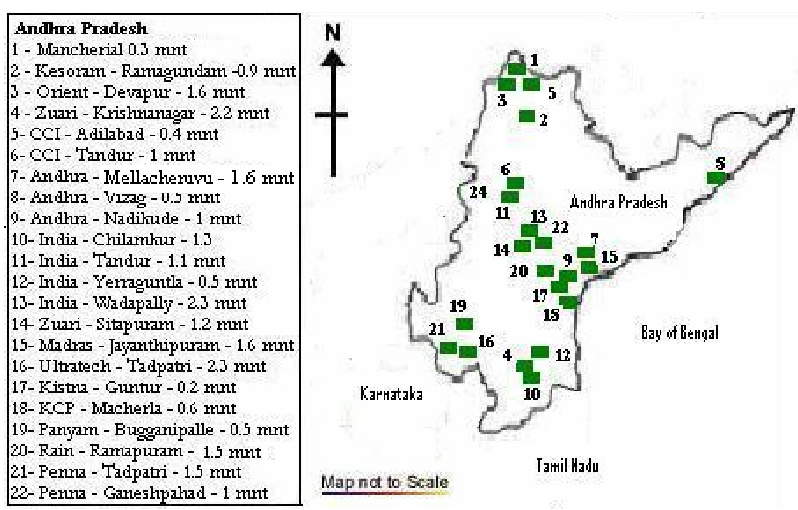
During the month, we visited Hyderabad where we met with smaller cement players and trade representatives based in Andhra Pradesh so as to understand the market in the light of recent government directives. Highlights of the visit are as follows:

A) Andhra Cement Industry – Introduction

Cement demand robust

The largest producer of cement in India is home to two of the biggest limestone clusters – Nalgonda and Yerraguntla. Due to the easy availability of limestone, cement plants of all sizes mushroomed across the state. As on date, Andhra Pradesh market consumes only 48% of its production (about 22 MnT of cement per annum from large cement players and around 2 MnT from mini cement players). Consumption growth is in double digits in the last two years as ambitious Government projects like Indiramma mass housing project (consume about 300,000 tonnes of cement per month) and ongoing road and irrigation projects have given a new thrust for cement demand in the state. Inflow to the state is about 2 MnT. Capacity in Andhra is set to double over the next 30-36 months (though other states in the region are seeing scarce additions), as a slew of capacity additions have been announced. The region (South as a whole), as a result is likely to face an over supply situation in CY09E if all these capacities are commissioned as announced.

Andhra Cement Industry – Plant Location



B) Mini cement players

Only 18 mini players operational

Apart from the large players, the region had around 28 mini cement plants (3 MnT) of which just around 18 (including 6 Vertical Shaft Kiln based) are currently operational (2 MnT). This is largely due to the non-availability of coke breeze which is the key input fuel in these VSK units.

In the earlier cycle it had been seen that due to large number of mini cement players in the region, the industry remained fragmented. This fragmented nature of the industry resulted in very little pricing power remaining with the players. Mini cement players by virtue of their excise benefit, size and the resultant utmost proximity to markets around their plants incurred comparatively lower freight charges. This, infact, enabled these smaller players to undercut their larger peers to capture market share.

However, with few players remaining, pricing in the region has improved and is largely stable across the region. Also, some of the mini cement players like Sagar Cement, Deccan Cement, etc. are also expanding their capacities and would no longer remain mini players after that. My Home Industries commissioned a 1.5 MnT capacity during March 2007.

Upcoming capacities in Andhra Pradesh

Company	Region	Nature	Capacity	Schedule
Current Capacity (Mar'07)	Andhra Pradesh		25.1	
My Home	Mellacheruvu	Brownfield	1.5	Jun-07
India Cement	Chilamkur/Yerraguntla	Debottle	2.0	Dec-07
Penna	Tadipatri	Brownfield	2.0	Mar-08
Coromandel	Nalgonda	Brownfield	0.5	Mar-08
Madras Cement	Jayanthipurum	Brownfield	2.0	Mar-08
Orient	Devapur	Brownfield	0.5	Jun-08
UltraTech	Tadpatri	Brownfield	3.0	Jun-08
UltraTech	Bellary	Grinding	1.0	Jun-08
Rain Ind	Ramapurum	Brownfield	1.0	Dec-08
Dalmia	Cuddapah	Brownfield	2.0	Mar-09
Sagar	Krishna	Brownfield	1.5	Mar-09
Penna	Tandur	Greenfield	1.0	Mar-09
Zuari	Sitapurum Andhra	Brownfield	2.0	Mar-09
Deccan	Nalgonda	Brownfield	1.0	Mar-09
Raghuram		Greenfield	2.0	Mar-09
Total Additions over two years			**23.0**	
Total at Y/E FY09			**48.1**	

Source: B&K Research

Players visited

A) Sagar Cement

Sagar Cement Ltd. is a mini cement player based in Nalgonda cluster in Andhra Pradesh. It has a total capacity of about 0.6 MnT. It has currently undertaken a Rs. 2.96 bn capex to expand its cement capacity to 2.5 MnT by June 2008. This will be partly funded by way of internal accruals and debt (Rs. 960 mn internal accruals and Rs. 2 bn debt). The company's operations have seen a significant improvement with the uptrend in the cement cycle.

Average EBITDA margins for FY07E have improved to around 39% from the about 7% in FY06. We currently do not have coverage on the stock. At the current price of Rs. 127 per share, the stock is trading at an EV/tonne of US$ 72. The company has recently allotted about 10,00,000 equity shares of Rs. 10/- each at a price of Rs. 190/- share to The India Fund Inc., New York, a private equity investor.

B) Andhra Cement

Andhra Cement, a BIFR company since 1991, is a part of Duncan Goenka Group who acquired the company in 1995. It has 2 plants at Nadikude and Vizag (both in Andhra Pradesh) with a total capacity of 1.5 MnT. The company has just turned around its operations in the 3QFY07 after a prolonged period of minimal/no production and has posted an EBITDA margin of 14%. This has been possible on the back of the much improved pricing environment in its key markets, infusion of equity and restructuring of old high cost debt. With the working capital problems addressed the plants are expected to continue normal production and the EBITDA margin is likely to improve.

We currently do not have coverage on the stock. At the current price of Rs. 31 per share, the stock is trading at an EV/tonne of US$ 65 its current capacity.

C) Penna Cement

Penna Cement is an unlisted cement player based in Andhra Pradesh. It currently has two plants located at Tadipatri and Ganeshpahad with a total capacity of 2.5 MnT. It also operates a 2 MnT plant in Ras Al Khaimah, UAE (50:50 JV with a Dubai-based group). Despatches from the Indian operations for the current fiscal stand at 2.4 MnT (April 2006-February 2007). EBITDA margins for the Indian operations for the company stand at 33% whereas for the UAE operation stands at 50%. The company fetches about US$ 70 per tonne in Dubai whereas for its exports to the Gulf region from India it realises about US$ 50 per tonne. Penna Cement has undertaken a capex worth Rs. 7 bn whereby it aims to increase its capacity by 3 MnT (2 MnT at Tadipatri and 1 MnT at Tandur). Equipment order has been placed wit F.L. Smidth and UBE Japan.

Sector outlook and valuations

Company-wise performance and valuation matrix

Companies	Despatches (MnT)		Growth (%)		Price	EPS (Rs.)		PER (x)		EV/EBITDA (x)		EV/ton	Reco.
	Mar. 07	YTD	YoY	MoM	(Rs.)	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E	(US$)	
ACC*	1.814	18.573	3.9	27.4	788	56.6	75.6	13.9	10.4	9.4	6.9	157	BUY
ACEM^	1.475	16.462	(4.7)	8.4	113	6.5	10.9	17.4	10.4	12.2	6.8	168	BUY
ICEM	0.890	8.763	10.5	15.7	171	18.7	17.5	9.1	9.7	6.2	5.2	111	Sell
MC	0.497	5.422	5.3	21.7	2,825	274.0	339.4	10.3	8.3	6.7	5.6	120	BUY
SRCM	0.472	4.804	17.1	24.0	1,008	105.0	134.1	9.6	7.5	6.0	4.1	107	BUY
UTCEM	1.506	14.666	5.1	14.0	815	63.6	75.8	12.8	10.8	7.8	6.6	151	BUY
CENT	0.638	6.750	1.8	14.3	559	42.2	48.2	13.3	11.6	9.9	8.0	79	BUY
KSI	0.379	3.511	22.7	15.9	371	57.9	72.6	6.4	5.1	5.7	3.6	96	BUY
GRASIM	1.503	15.335	6.8	19.3	2,364	212.2	232.0	11.1	10.2	9.3	8.2	154	BUY
JPA#	0.663	6.656	7.0	9.9	574	18.7	24.9	30.7	23.0	16.0	13.2	103	BUY

*Year ending is December and YTD numbers are for April 2006-March 2007. FY07E numbers denote CY06 and FY08E denote CY07E, respectively.
^Year ending is December and YTD numbers are for April 2006-March 2007. FY07E denote annualised 18M06 numbers and FY08E denotes CY07E.
#Jaiprakash Associates is standalone numbers.

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The overall outlook seems good with the demand-supply scenario expected to remain favourable until the December 2008 quarter while valuations also look attractive given the recent fall in share prices. However, the persistent Government intervention largely due to the ongoing elections in the state of Uttar Pradesh remains the key concern. With the longer term fundamentals remaining sound, we continue to remain positive and recommend considering exposures in the sector with a longer term perspective.

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Analyst Certification

We, Chockalingam Narayanan & Vishal Sheth hereby certify that the views expressed in this report accurately reflect our personal views about the subject securities and issuers. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendation or view expressed in this report.

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