Cement Sector : Q2FY10 Result Preview

North shines; South disappoints!

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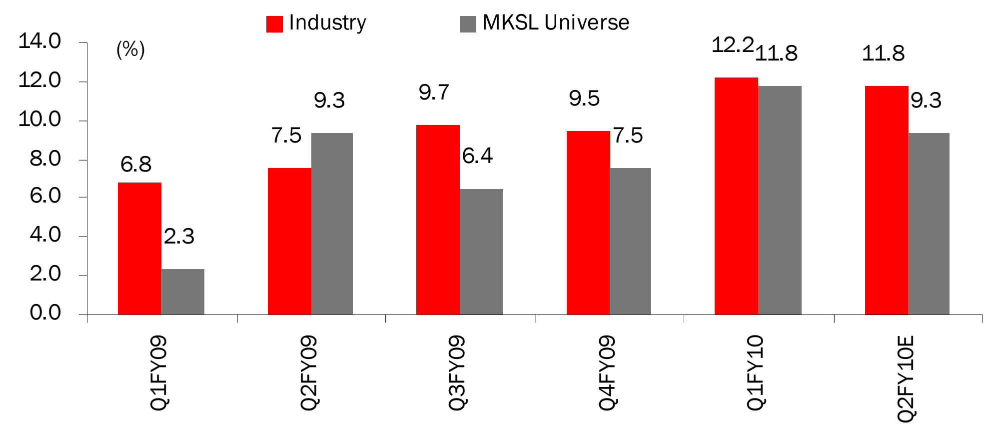
Poor monsoons results in robust volume growth

Cement dispatch growth, for the industry as a whole, is expected at ~12% for Q2FY10E in continuation of a 12.2% growth in Q1FY10. In the months of July and August 2009, cement dispatches increased by 13.5%. However we expect some slowdown in growth in September 2009 on account of improved rainfall, especially in North and East India, and continuation of demand slowdown in South India. **We expect the dispatch growth to further slow down in H2FY10E on account of the high base effect of H2FY09**. The key to watch out in H2FY10E would be the demand pickup in South India and the quantum of increase in infrastructure spending by the government.

The MKSL coverage stocks are expected to report volume growth of 9.3% yoy for Q2FY10E. Most of this growth is being contributed by Shree Cement and Ultratech. On the other hand, ACC, Ambuja and India Cements are the dampeners with 6%-7% yoy growth for Q2FY10E.

Volume growth picks up in line with industry trend



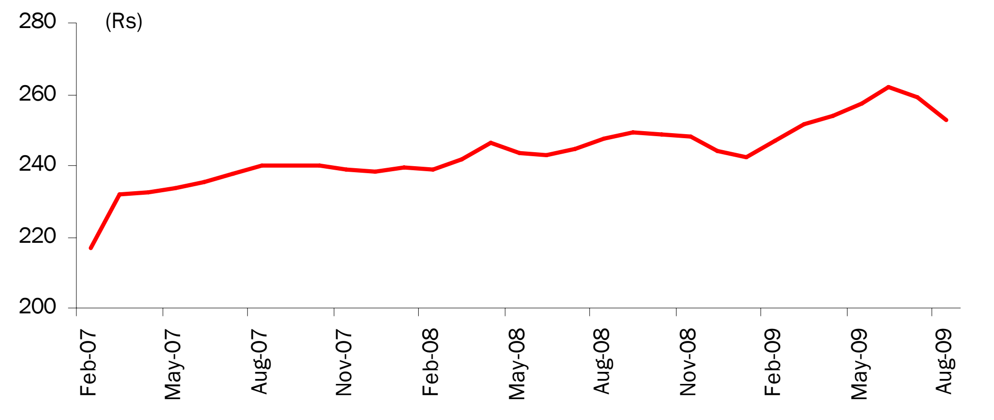
Source: Company, Mangal Keshav Research estimates

Cement prices moderate in Q2FY10

Despite the robust demand scenario, cement prices came under pressure in most parts of the country. The pressure was more evident in South India with pricing decline of 8%-10% due to new capacities coming on stream and demand not picking up as expected. In most other regions, prices moderated by 2%-5% on account of new capacities and heavy rainfall towards the end of August and in September. Thus we expect cement players to report flat to negative realization growth in the quarter. Especially the players operating in South India would report the maximum decline in realizations. We expect the players to report 1%-5% decline in net realizations on a sequential basis.

Going forward, we expect the cement pricing to come under pressure on account of lower utilization levels owing to the expectant oversupply situation in the industry in Q4FY10E.

Cement pricing witnessed pressure in Q2FY10



Source: CMIE

Demand-Supply scenario to worsen in FY11E

We expect ~40mn ton of new capacity to get added in FY10E. Out of this, ~16mn tons have got added in the first five months of FY10. As the remaining gets commissioned in H2FY10E, the effective new capacity added for the year would be in the range of 23-25mn tons. Therefore, we expect FY11E to be extremely tough for the industry with additional capacities of ~30mn tons getting added thereby bringing down capacity utilization to a low of 82%. We expect, this would put downward pressure on cement prices and are projecting cement prices to fall by 6%-10% in FY11E.

The dispatch growth rate would moderate in H2FY10E on account of high base in the same period last year. We expect dispatch growth of 9.3% in FY10E and 9.4% in FY11E with most of it would be contributed by players like Shree Cement, Ultratech, Grasim, JP Associates, and other smaller players who have added new capacity ahead of others. However, these would be at much lower utilization levels. We also expect ACC and Ambuja cement to continue to lag behind on account of the late commissioning of new capacity as compared to their peers. Also the new capacities of ACC and Ambuja would come on stream during the period of oversupply being witnessed by the industry.

Demand-supply dynamics to deteriorate

(mn ton)	FY08	FY09	FY10E	FY11E	FY12E
Year end capacity	189	218	259	293	310
Effective Capacity	176	205	230	265	290
Production	168	181	198	217	236
Capacity utilization (%)	***96***	***89***	***86***	***82***	***82***
Domestic Demand	164	178	195	214	234
Exports (net of imports)	4	3	3	3	3
Total Demand	***168***	***181***	***198***	***217***	***236***
Growth (%)	8.2	7.9	9.3	9.4	9.2
Surplus / (Deficit) over demand	8	24	32	48	53
As % of Effective Capacity	***5***	***12***	***14***	***18***	***18***

Source: CMA, Mangal Keshav Research Estimates

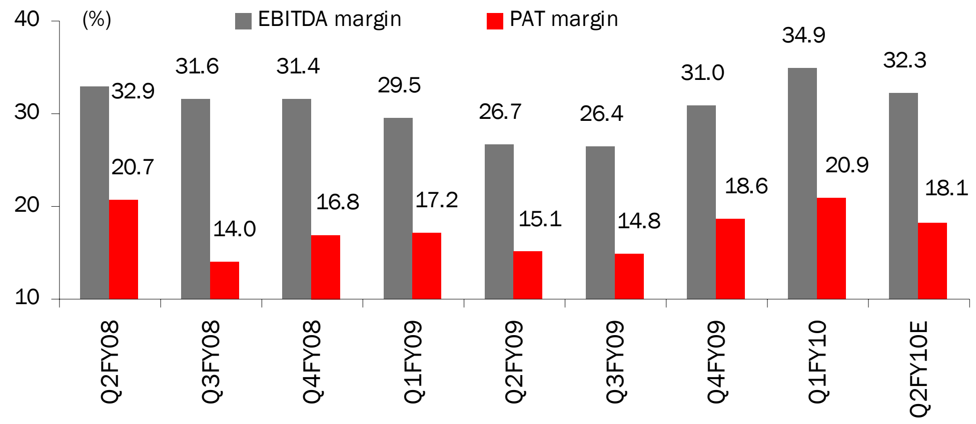
Operating margin uptrend to continue

We expect the good performance of Q1FY10 to continue in this quarter as well. Sequential performance would be weak in the light of evident pressure on cement pricing. However, we expect earnings growth on a yoy basis to be driven on account of

- High volume growth,
- Realization improvement on a yoy basis,
- Lower coal and HDPE prices and
- Poor performance of Q2FY09.

There would be a positive impact on profitability of the sharp increase in cement prices in the period of February – July 2009 along with only a partial pass through of reduction in excise duties. We expect average pricing for the sector to go up by 5%-7% yoy with the North and East India based companies witnessing the maximum price increases.

Margins continue the upward trend (for MKSL universe)

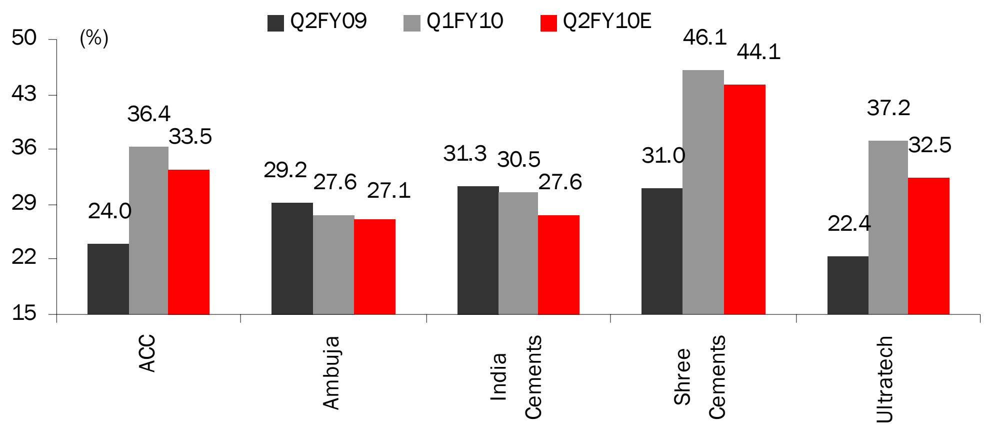


Source: Company, Mangal Keshav Research estimates

We estimate EBITDA margin for the companies in the MKSL universe to increase by 560bps yoy to 32.3% and PAT margin increase by 300bps yoy to 18.1%. The companies leading the EBITDA margin expansion would be ACC, Shree Cement and Ultratech. Ambuja and India Cements would see a weak quarter with decline in EBITDA margins. India Cements would report lower profitability due to the evident pressure on cement pricing in South India. **On the other hand, Ambuja would reel under the pressure of high raw material cost on account of the increased clinker purchases for the second quarter in a row. Clinker production declined by 10% in July and August, thereby forcing the company to procure clinker from outside**.

Within our universe, we expect Shree Cement to report the highest EBITDA margin at 44% for the quarter. It has traditionally been the best performer in the industry and the new power business of the company has much higher operating margins. The increasing share in revenue mix of the power business would ensure healthy operating margins for the company. Also, merchant power sales in this quarter have hit new peak of Rs15-Rs15 per unit with the average pricing being in the range of Rs7-Rs9 per unit. Thus we expect Shree Cement to report higher realizations in the power division, thereby boosting the revenues for the company.

Shree Cement to report highest margins in the sector



Source: Company, Mangal Keshav Research estimates

Valuation

The sector as a whole has outperformed the broader indices in the last 6 to 9months period on account of the better than expected volume growth, sharp increase in cement prices and decline in cost pressures. However, due to the highest growth across regions, North India based companies (both large cap and mid cap) have outperformed the sector and the broader indices. We expect demand growth to remain robust in North India due the increased demand of cement for Commonwealth games along with other infrastructure projects. On the other hand, South based companies have grossly underperformed the sector and the broader indices with India Cements giving 39% return in last 6months as against SENSEX return of 77% in the same period.

We expect the underperformance of the South based companies to continue until there are visible signs of a pickup in cement demand. The North based companies would outperform their peers with robust demand growth and moderate pricing pressure in FY10E. **We continue to maintain our cautious view on the sector with a negative bias for the South based cement companies.** We maintain our **HOLD** rating on ACC, Ambuja Cement, India Cements and Ultratech and our **BUY** rating on Shree Cements.

Sector has outperformed in the short term

	1-m (%)	3-m (%)	6-m (%)	YTD (%)	1-yr (%)
ACC	3.7	7.1	49.9	71.4	31.3
Ambuja Cem	(0.7)	9.1	39.0	40.2	16.5
India Cements	3.2	(4.9)	38.7	36.9	3.2
Shree Cement	4.9	40.0	158.4	257.5	206.8
Ultratech	3.9	10.1	48.1	96.9	37.6
SENSEX	7.4	16.4	77.2	73.9	22.6

Source: Bloomberg

Valuation Comparison

Companies	Rating	CMP (Rs)	TP (Rs)	Upside (%)	P/E (x)		EV/EBITDA (x)		EV/ton (US$)	ROE (%)	Sales gr (%)	PAT gr (%
					FY10E	FY11E	FY10E	FY11E	FY11E	FY11E	FY11E	FY11E
ACC	Hold	823	915	11.2	9.3	12.3	5.4	6.5	110	18.5	2.6	(24.7)
Ambuja Cement	Hold	98	101	2.9	11.8	16.0	6.8	8.2	113	13.3	2.8	(26.2)
India Cements	Hold	134	140	4.7	8.4	11.7	5.6	6.5	79	8.8	5.0	(28.0)
Shree Cements	Buy	1645	1898	15.4	8.0	9.2	3.9	4.1	89	28.3	10.7	(13.0)
Ultratech	Hold	759	834	9.9	7.6	11.9	4.3	5.7	90	15.3	1.1	(36.4)
Average					**9.0**	**12.2**	**5.2**	**6.2**	**96.1**	**16.9**	**4.4**	**(25.7)**

Source: Mangal Keshav Research Estimates

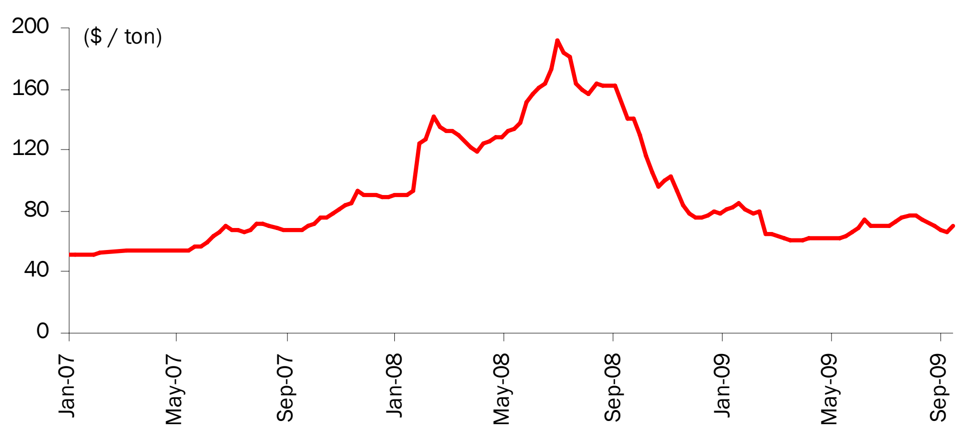
Quarterly Performance Expectations

ACC	Q3CY09E	Q3CY08	yoy (%)	Q2CY09	qoq (%)	Remark
Revenue	20,319	17,972	*13.1*	21,199	*(4.2)*	*Volume growth would be least among large players at ~7% yoy against industry volume growth of and realization growth expected to be flat on a sequential basis. These are standalone figures and thus RMC revenues are not included*
PAT	4,125	2,460	*67.7*	4,856	*(15.1)*	*Margin improvement mainly on account of lower P&F and other expenditure. The other expenditure (as a % of revenues) is expected to decline from 25.6% in Q3CY08 to 19.6% in Q3CY09.*
EPS(diluted)	21.9	13.1	*67.7*	25.8	*(15.1)*	*Due to its all India presence, realizations are expected to be flat as against a sharp decline in realizations in case of South India based cement companies.*
EBITDA mgn (%)	33.5	24.0	*951*	36.4	*(295)*	*RMC business would be a drag on consolidated profitability and would continue to be so atleast for the next 2-3quarters*
Ambuja	**Q3CY09E**	**Q3CY08**	***yoy (%)***	**Q2CY09**	***qoq (%)***	
Revenue	16,517	14,019	*17.8*	18,885	*(12.5)*	*Volume growth at ~7% yoy to lag behind industry growth. Realization growth at 9% yoy on account of the low base in Q3CY08.*
PAT	2,694	2,510	*7.3*	3,247	*(17.0)*	*Ambuja would continue to report high R.M. cost (as was the case in Q2CY09) due to increased clinker purchases. Clinker production for the quarter is expected to decline by ~7% thus the has to rely on clinker procurement from outside.*
EPS(diluted)	1.8	1.6	*7.3*	2.1	*(17.0)*	*Low net debt resulting in high other income and low interest expense. High cash generation to moderate in CY09E and CY10E as huge capex is lined up*
EBITDA mgn (%)	27.1	29.2	*(208)*	27.6	*(47)*	
India Cements	**Q2FY10E**	**Q2FY09**	***yoy (%)***	**Q1FY10**	***qoq (%)***	
Revenue	9,495	9,545	*(0.5)*	9,603	*(1.1)*	*Realizations have been under pressure in South India. We expect a 4%-5% qoq decline in net realizations. Volume growth is picking up after the dissapointment in last 2quarters. We expect volume growth of 6.4% yoy.*
PAT	1,110	1,638	*(32.2)*	1,233	*(10.0)*	*Capacity has been expanded to 14.2mn tons. Management is targetting volumes of ~12mn tons for FY10E, however we feel it would be well short of its guidance.*
EPS(diluted)	4.2	6.2	*(32.2)*	4.7	*(10.0)*	*Margins expected to be under pressure due to the lower realizations, losses in the shipping division.*
EBITDA mgn (%)	27.6	31.3	*(377)*	30.5	*(296)*	*Average coal prices for the quarter would be watched out for, as the company imports ~75% of its requirement and the full benefit of the decline in coal prices would be reflected in this quarter.*
Shree Cements	**Q2FY10E**	**Q2FY09**	***yoy (%)***	**Q1FY10**	***qoq (%)***	
Revenue	8,803	6,471	*36.0*	9,229	*(4.6)*	*Volume growth expected to be ~16% yoy along with marginal uptick in realizations. High volume growth being contributed by the new capacities added by the company.*
PAT	2,215	1,151	*92.3*	2,946	*(24.8)*	*It is selling excess power from its CPPs to the state grid and indian power exchange. We expect it to sell ~55mn units in Q2FY10E at an average realization in excess of Rs7 per unit.*
EPS(diluted)	63.6	30.9	*106.0*	109.2	*(41.8)*	*Significant savings expected in the P&F cost on a yoy basis as there has been a drastic decline in the pet coke prices, key fuel for power generation.*
EBITDA mgn (%)	44.1	31.0	*1312*	46.1	*(197)*	*High EBITDA margin in the power business to support any decline in cement EBITDA in times of oversupply.*
Ultratech	**Q2FY10E**	**Q2FY09**	***yoy (%)***	**Q1FY10**	***qoq (%)***	
Revenue	16,722	14,169	*18.0*	19,689	*(15.1)*	*Volume growth is expected to be in line with that of industry at ~13% yoy on account of the capacity expansion. Volumes have started to come from the expansion in AP and Karnataka.*
PAT	2,872	1,654	*73.6*	4,178	*(31.2)*	*High exposure to South India market would have negative impact on realizations. We expect cement realizations to decline by ~2% qoq.*
EPS(diluted)	23.1	13.2	*74.9*	33.6	*(31.3)*	*It now has access to 236MW of captive power capacity catering ~80% of its total requirement. The impact of it in terms of savings in P&F cost would reflect in this quarter.*
EBITDA mgn (%)	32.5	22.4	*1006*	37.2	*(476)*	*Expansionary mode of the RMC business has been moderated. Low profitability of the business would dent margins to some extent.*

Source: Company, Mangal Keshav research Estimates

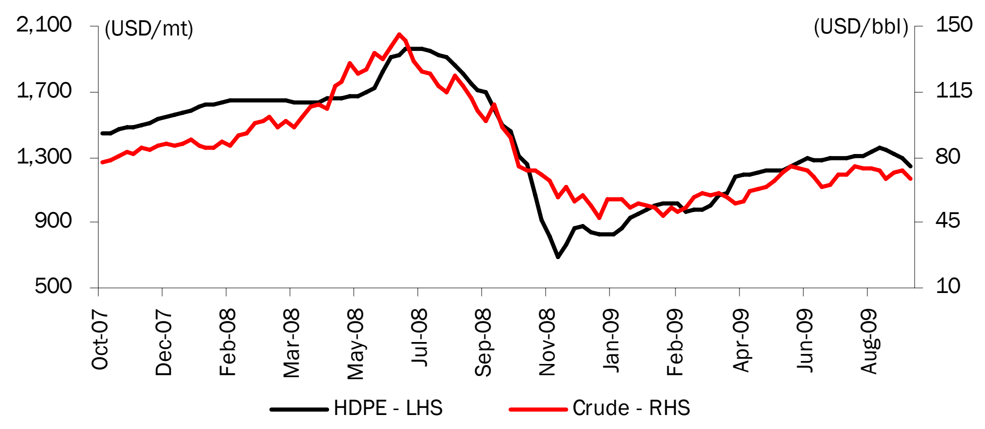
Appendix 1 : Cost pressures building up

Coal Prices



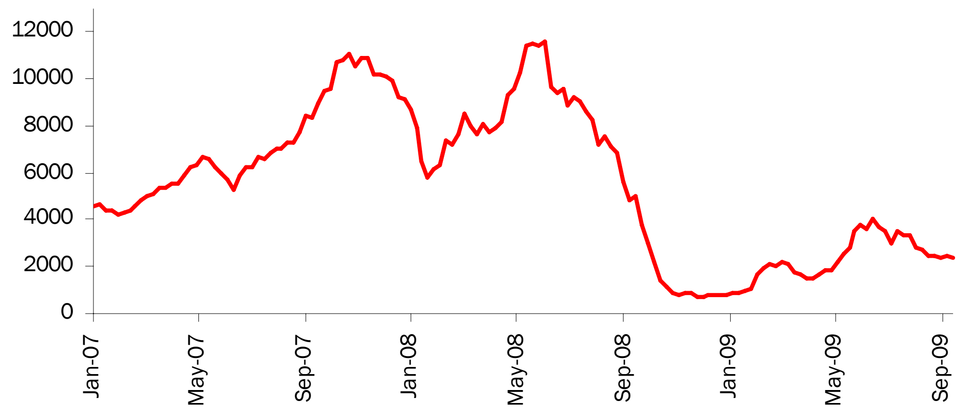
Source: Bloomberg

HDPE Prices



Source: Bloomberg

Baltic dry Freight Index



Source: Bloomberg

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