investor's eye

Index

Take Five

Scrip	Reco Date	Reco Price	CMP	Target
India Cements	28-Sep-06	220	**227**	315
Infosys	30-Dec-03	689	**2,231**	2,430
Lupin	06-Jan-06	403	**515**	565
Thermax	14-Jun-05	124	**391**	425
UTI Bank	24-Feb-05	229	**501**	*

*Under review

Cement

Sector Update

Cement prices to remain firm

Key points

- Even as the consumption of cement grew at 9.25% in the first six months of the year, capacity addition remained insignificant during the period. As a result, the utilisation of the existing cement capacities remained firm at 95% and cement prices rose by 25% year on year (yoy) to Rs205-210 per bag in H1FY2007.
- With all the three demand drivers, ie housing, industry and infrastructure sectors, showing strong signs of growth, the cement consumption is expected to grow at a compounded annual growth rate (CAGR) of 10-10.5% for the next three years.
- As there are very few cement equipment suppliers around the world and there is an incessant rush for setting up cement plants, the lead-time for the supply of new plant equipment has gone up to 20-24 months from 12-14 months a year ago. Hence the cement capacity additions of 75 million tonne planned for the next 24-30 months are unlikely to meet their respective commissioning schedules.
- We believe a capacity of 60-65 million metric tonne (mMT) can be realistically added over FY2006-09. This implies a compounded annual growth of 12.5-13% in capacity addition over FY2006-09.
- Given that the demand for cement is expected to grow at a CAGR of 10-10.5% and capacity addition at a CAGR of 12.5-13% over FY2006-09, we believe the capacity utilisation will remain firm and cement prices will remain benign in FY2009 as well.
- We have upgraded our cement price projections for FY2007 and FY2008. We now expect cement prices to rise by 22.8% in FY2007 and by another 5% in FY2008. Consequently, we have upgraded our earnings estimates for the cement stocks in our cement universe. ACC and Shree Cement lead the chart of earnings upgrade with 24.6% and 22.4% for FY2008. We have also upgraded our price target for ACC, Shree Cement, Grasim Industries and UltraTech Cement.
- With the recent merger and acquisition (M&A) deals in the sector taking place at high valuations of USD110-125 per tonne, we believe a new valuation benchmark has been set for the cement companies. This should provide a fresh trigger to the cement companies that have under-performed the Sensex in the last three months.
- With the cement capacity addition projects feared to miss their respective commissioning schedules and cement consumption expected to see a strong growth in the next few years, the scenario in FY2009 looks reasonable enough for cement prices to rule firm. We maintain our positive view on the sector and rate Grasim Industries, UltraTech Cement and India Cements as our top large-cap picks in the sector. Among the mid-caps we like Shree Cement and Madras Cement. We also like Orient Paper and JK Cement on account of their compelling valuations, which are much less than the sector average.

Cement valuation matrix

	Price	PER		EV/EBIDTA		EV/Ton ($ US/Ton)	
Companies	target	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
ACC	1,250	18.4	15.2	11.1	8.9	213.7	191.8
Grasim Industries	3,350	13.5	11.4	7.0	5.5		
UTCL	1,100	16.4	14.5	6.7	4.7	158.1	155.4
JP Associates	800	32.2	22.4	12.9	10.0		
Shree Cement	1,700	13.8	10.3	9.3	6.4	245.6	170.6
Madras Cement	4,000	12.0	10.2	7.1	6.1	143.0	129.8
JK Cement	295	9.0	6.2	5.8	4.4	84.7	94.1
Orient Paper	800	8.3	6.0	5.3	4.0	86.4	66.4
India Cements	315	11.4	7.9	8.0	5.6	137.2	108.3

Vibrancy continues in cement dispatches, prices

The over 8% growth in the economy in the first half of the current fiscal maintained the buoyancy in the housing, infrastructure and industrial sectors. As a result cement consumption grew by 9.2% yoy in the same period. The vibrancy in the cement sector was also mirrored in the 10% growth in the cement dispatches in the same period. In the absence of any capacity addition in H1FY2007, the utilisation rate remained firm at 95% and cement prices rose by 25% to Rs205-210 per bag yoy. A fact worth mentioning here is that the prices continued to remain firm in August, when most parts of the country witnessed heavy monsoons accompanied by floods. The same is a testimony of the buoyancy in cement consumption in the country.

Consumption story intact

The housing sector, which accounts for 55% of the cement consumption in the country, is one of the major drivers of the cement industry. The rising disposable income and a lower interest rate regime have fuelled a boom in the housing sector. A shortfall of 33.1 million housing units (as estimated by the National Housing Board) will continue to drive the demand for cement. Further, the overall road development programme envisaged by the National Highway Authority of India (NHAI) involves the construction of roads of length of 51,411 kilometre in seven phases at a cost of Rs251,600 crore. This coupled with a pick-up in the investments in the power, port and urban infrastructure sectors will be one of the major drivers of the growth in cement consumption. We therefore believe the consumption of cement will grow at a CAGR of 10-10.5% over the next two to three years.

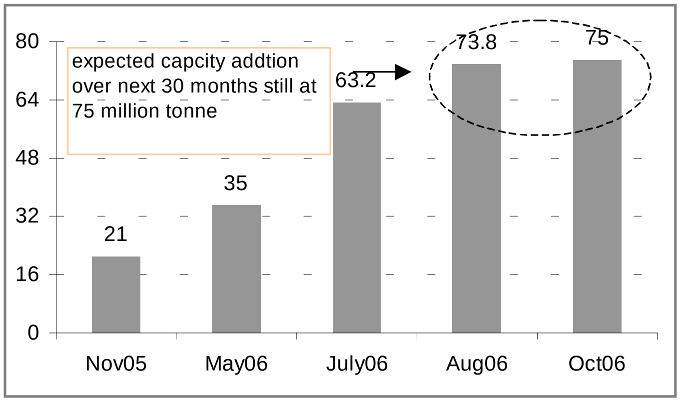
...surprise could come from new triggers like SEZs

Currently there is a lot of uncertainty surrounding the government's special economic zone (SEZ) policy. But what is certain is that 150 SEZs have already been formally approved and another 117 such proposals have received the government's in-principle approval. If even some of these proposals get translated into reality, we could witness a substantial growth in the demand for cement. We also believe that the Commonwealth Games 2010 to be held in Delhi will act as an additional trigger for the cement industry.

Cement capacity addition taking a break

The industry did not announce any capacity addition plans in the past few months. This came as a surprise to us, as we were expecting the larger companies like ACC and Gujarat Ambuja Cement to announce plans to raise their capacity in this period in order to maintain their capacity share.

Announcements on capacity addition

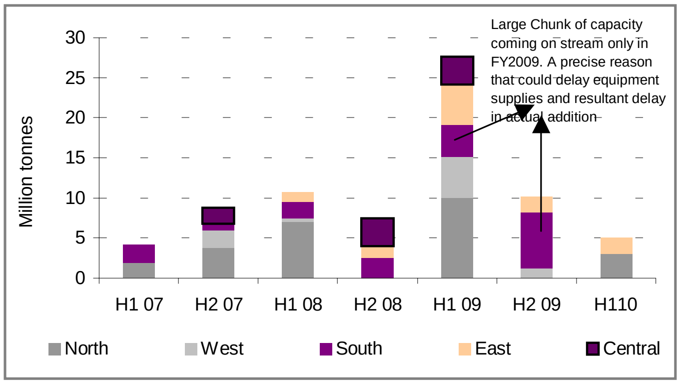


Cement: Industry

Equipment suppliers likely to fall short on deliveries

Our recent discussions with cement manufactures and other industry sources reveal that the leading cement equipment suppliers like KHD Humboldt and FL Smidth have abundant orders and hence are taking new orders only with a lead time in excess of 20-24 months as opposed to 12-14 months a year ago. Given that the lead-time for the delivery of cement equipment has gone up to nearly 24 months, and the installation of equipment and testing also takes six to eight months, the plan to add cement capacity of 75 million tonne over the next 24-30 months is likely to get delayed. We believe that fresh capacity of 60-65mMT could be realistically added in the next few years, ie the industry will have a capacity of around 220-225 million tonne by the end of FY2009. This implies capacity addition at a CAGR of 12.5-13% over FY2006-09. Also these capacities would start producing cement by the end of FY2009, keeping the supply under a tight check. Further any new equipment order to be placed today would start cement production only by FY2010.

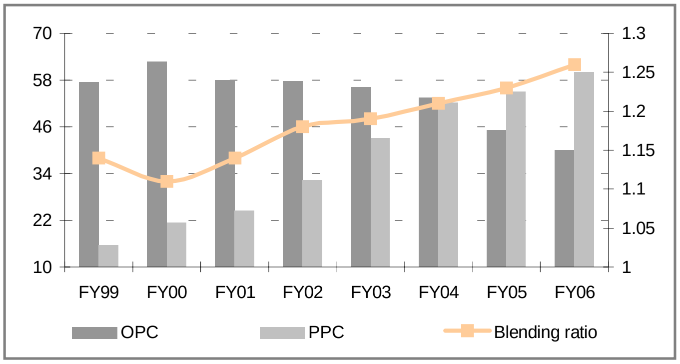
Realistic figure of capacity additions could 60-65 million tonne



(Source: Industry)

Lesser scope for increase in the blending ratio

With the demand growing at a significant pace in the last few years and an increased acceptance of PPC by customers, the cement producers have resorted to blending as a means of scaling up their supplies. Thus we have witnessed the clinker conversion ratio increase from 1.19 in FY2003 to 1.26 in FY2006. Since the blending ratio is hovering at such high levels, we believe the cement companies cannot resort to this route for augmenting their supplies for long.



Source : CMA and Sharekhan Research

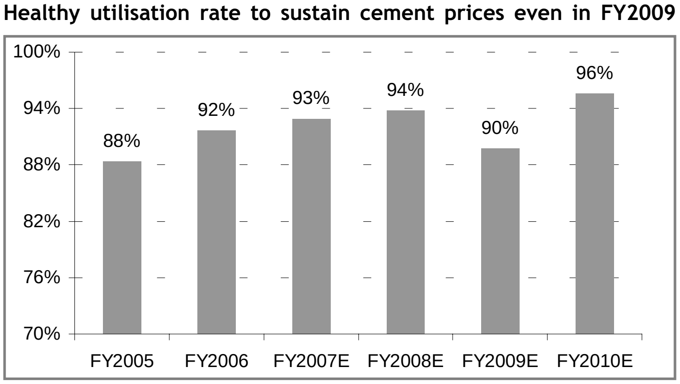
Limestone reserves and land availability could discourage further additions

Our interaction with cement manufacturers suggests that cement players are increasingly getting concerned over the depleting limestone reserves and long-term supply of coal at a sustainable price. Further with the SEZ story gathering pace and foreign direct investments pouring in, there is a rush to amass land. Given this scenario, the cement industry will have to face roadblocks in order to further raise their capacities. This coupled with the already high lead-time for the supply of cement equipment would discourage further capacity addition.

Cement price scenario expected to be benign even in FY2009

Given that cement capacity would grow at a CAGR of 12.5-13% over FY2006-09 and cement demand at 10-10.5% CAGR over the same period, the average capacity utilisation rate would still rule at a very healthy 90-92% even in FY2009. Consequently, we do not foresee any significant drop in cement prices till FY2009-end.

Healthy utilisation rate to sustain cement prices even in FY2009



Source : CMA and Sharekhan Research

Potential delays in capacity creation due to land acquisition, depleting limestone reserves or environmental issues (as witnessed in case of Grasim Industries and Jaiprakash Associates) can further delay the commissioning of the new capacities. In such a scenario, the uptrend in the cement prices may well sustain even beyond FY2009. In view of the above-mentioned demand-supply scenario, we believe the outlook for FY2009 looks good.

Earnings upgraded

We have upgraded our cement price projections for FY2007 and FY2008. We now expect cement prices to rise by 22.8% in FY2007 and by another 5% in FY2008. Consequently, we have upgraded our earnings estimates for the cement stocks in our universe. ACC and Shree Cement lead the chart of earnings upgrade with a revision of 24.6% and 22.4% respectively in their earnings estimates for FY2008.

Table of upgraded earnings and PT

	EPS		Upgrade (%)		Price
	FY07	FY08	FY07	FY08	Target
Shree Cement	95.5	127.7	18.4	22.4	1,700
ACC	58.1	70.0	19.6	24.6	1,250
Grasim Industries	199.0	236.0	6.4	7.3	3,350
UltraTech Cement	58.1	71.2	8.2	16.7	1,100

Valuation benchmarks upgraded by recent M&A deals

Buoyed by the stellar performance of the cement companies, the cement industry has witnessed a spate of M&A deals in the last couple of months. The first being the intended takeover of 3.17-million-tonne Andhra Pradesh-based private company, MyHome Cement, by the French group Vicat for Rs800 crore. This translates into an enterprise value (EV)/tonne of USD120-125 per tonne. The second is the cement major Heidelberg's acquisition of a 15-20% stake in Gujarat Siddhi Cement, which has a capacity of 1.5mMT. Gujarat Siddhi Cement's enterprise value has been pegged at Rs700-750 crore, implying EV/tonne of USD111. The valuation of these deals when compared with the earlier such deals tends to be on the higher side (the past deals had been struck at USD90-110 per tonne). Thus we believe the recent deals have set a new benchmark for valuing cement companies and will provide a fresh trigger for the cement stocks that have under-performed the Sensex in the last three months.

Maintain positive view on sector

With cement capacity addition getting delayed and the growth in cement consumption remaining strong, the scenario for FY2009 looks bright enough for the cement prices to remain firm. We maintain our positive view on the sector and believe that the companies that have taken a lead in announcing capacity expansions, such as Grasim Industries, Shree Cement, Jaiprakash Associate, UltraTech Cement and Madras Cement, will benefit the most in this scenario. We rate Grasim Industries, UltraTech Cement and India Cements as our top large-cap picks in the sector. Among the mid-caps we like Shree Cement and Madras Cement. We also like Orient Paper and JK Cement on account of their compelling valuations, which are much less than the sector average.

United Phosphorus

Viewpoint

UPL makes its sixth acquisition

CMP: Rs317

United Phosphorus Ltd (UPL) is clearly on an acquisition spree. It recently snapped up Dow AgroSciences LLC's global propanil herbicide business, marketed primarily as Stam™ herbicide. It is the sixth acquisition carried out by the company in this calendar year so far. Dow AgroSciences is a wholly owned subsidiary of The Dow Chemical Company with global sales of US$3.4 billion.

Cost of acquisition

The total cost of the acquisition is about US$25 million (including inventories). The same translates into 1.3x propanil revenues worth US$18.9 million in CY2005. Moreover, it is a profitable business with net margins of 18.5%. As UPL has not discussed the details of the funding, we assume that the acquisition will be financed by the funds already raised through the external commercial borrowings (ECBs) at the time of acquiring Cerexagri. Deducting the interest cost on the ECB offering of US$1.675 million per year, the remaining amount of about US$1.825 million will directly add to the bottom line of UPL

Product information

Propanil is a selective herbicide, applied for the control of many important annual grasses, broadleaf and sedge weeds during rice farming. Propanil is a global product sold in over 30 countries in North America, Latin America, Europe, Africa and Asia-Pacific. The latest acquisition would thus help UPL to market its whole product basket in these countries. As part of the deal, UPL and its subsidiaries throughout the world can start selling propanil and its formulations with immediate effect.

Strategic benefits

In September 2006 UPL purchased the Bensulfuron-Methyl (BFM) business, a rice and aquatic herbicide from Dupont. BFM is used as an active ingredient with wide applications in controlling rice weeds. The purchase of the propanil business would further strengthen UPL's position in the rice herbicide segment.

Six and counting

The propanil business of Dow AgroSciences LLC is the sixth acquisition made by the company in this calendar year, after Advanta BV, Cropserve, products from Bayer CropScience, Bensulfuron from Dupont and Cerexagri from Arkema early this year. The series of strategic acquisitions made by UPL makes it the biggest player in the business of generic agrochemicals in India, third largest player in the world and second largest in the fungicide business in terms of market share.

On a stand-alone basis, the margins of UPL before the acquisitions were 12.1% in FY2006. The margins of the companies acquired are in the range of 11 %. Hence the overall margins of UPL will decline after the acquisitions.

Valuations

At the current market price of Rs317, the stock is trading at 27.22x its FY2006 earnings.

Valuation table

Particulars	FY2004	FY2005	FY2006
Net sales (Rs cr)	1103.1	1416.3	1795.4
Net profit (Rs cr)	101.6	157.2	217.9
Shares in issue (cr)	14.6	16.6	18.7
EPS (Rs)	6.9	9.5	11.6
y-o-y growth(%)		*36.9*	*22.7*
PER (x)	45.6	33.4	27.2
EV/EBITDA	11.2	16.4	23.2
ROCE (%)	16.0	17.8	13.5
RONW (%)	17.1	20.0	20.8

Company	Month of acquisition	Country	Business	Revenues USD Mn	Profit USD Mn	Cost of acquisition USD Mn
Advanta (seed business)	Feb-06	Netherlands	Seed Business	76.3	6.20	125
Crop Serve	Aug-06	South Africa	Agrochemical Business	10.0	0.75	3.5
Bayer (Crop science business)	Aug-06	Germany	Crop protection product	33.8	6.75	54.5
Du Pont (Bensulfuron-Methyl)	Sep-06	USA	Herbicide Business	10.0	1.80	15
Cerexagri	Nov-06	France	Fungicide Business	250.0	25.00	139
Dow Chemical (Agrosciences)	Nov-06	USA	Herbicide Business	18.9	3.40	25
Total				398.9	43.90	362

Sharekhan Stock Ideas

Evergreen

HDFC Bank
Infosys Technologies
Reliance Industries
Tata Consultancy Services

Apple Green

Aditya Birla Nuvo
ACC
Bajaj Auto
Balrampur Chini Mills
Bank of Baroda
Bank of India
Bharat Bijlee
Bharat Electronics
Bharat Heavy Electricals
Canara Bank
Corporation Bank
Crompton Greaves
Elder Pharmaceuticals
Grasim Industries
Hindustan Lever
Hyderabad Industries
ICICI Bank
Indian Hotels Company
ITC
Mahindra & Mahindra
Marico Industries
Maruti Udyog
Lupin
Nicholas Piramal India
Omax Autos
Ranbaxy Laboratories
Satyam Computer Services
SKF India
State Bank of India
Sundaram Clayton
Tata Motors
Tata Tea
Unichem Laboratories
Wipro

Cannonball

Allahabad Bank
Andhra Bank
Cipla
Gateway Distriparks
International Combustion (India)
JK Cement
Madras Cement
Shree Cement
Transport Corporation of India

Emerging Star

3i Infotech
Aban Offshore
Cadila Healthcare
KSB Pumps
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New Delhi Television
Orchid Chemicals & Pharmaceuticals
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Solectron Centum Electronics
Television Eighteen India
Thermax
TVS Motor Company
UTI Bank
Welspun Gujarat Stahl Rohren

Ugly Duckling

Ahmednagar Forgings
Ashok Leyland
BASF India
Deepak Fertilisers & Petrochemicals Corporation
Genus Overseas Electronics
HCL Technologies
ICI India
India Cements
Jaiprakash Associates
JM Financial
KEI Industries
NIIT Technologies
Punjab National Bank
Ratnamani Metals and Tubes
Sanghvi Movers
Saregama India
Selan Exploration Technology
South East Asia Marine Engineering & Construction
Subros
Sun Pharmaceutical Industries
Surya Pharmaceuticals
UltraTech Cement
Union Bank of India
Universal Cables
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