Industry Overview

Equity | India | Building Materials
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Profit upturn seems far away

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Exit on short-term rallies; profit upturn seems far away

Anticipation of post monsoon cement price increases, receding risk of government intervention and low stock valuations offer room for a near-term rally in cement stocks, in our view. We recommend that investors exit on possible short-term rallies as any U-turn towards sustainable profit improvement seems far away. Demand growth seems weak (industry capacity utilisation in Aug '08 was the lowest in last 3-4 years), and we expect cement prices to fall from end-FY09 onwards owing to rising industry capacity. ACC is our least preferred pick in the sector.

Capacity additions mostly on track

Our discussions with the industry & equipment vendors point to ~37mn tpa (+26% YoY) of composite capacity additions by Mar '09. Reported industry data suggests ~15mn tpa (8% growth) of new cement capacity was added over the last 6 months by players like Binani (+4mn tpa), Penna (+2mn) and Rain (+2.5mn tpa). Additions in 2H FY09E will include Grasim (4.4mn tpa), UltraTech (4.9mn tpa), Madras Cements (4mn tpa) and Dalmia Cements (~2mn tpa). Capacities delayed into FY10E likely include JPA- Himachal, Grasim-Kotputli and Zuari-Andhra.

Demand appears to be faltering

Domestic volume growth was ~7% in YTD FY09 (Apr-Aug) vs 12% growth in YTD FY08. Demand weakness seems most evident in north India that has grown ~4% in YTD FY09 (Apr-Jul) vs 12% growth last year. South India appears strongest with steady demand growth of ~11-12% YoY. Overall, strong recovery in domestic demand appears unlikely but exports may improve on partial lifting of export-ban.

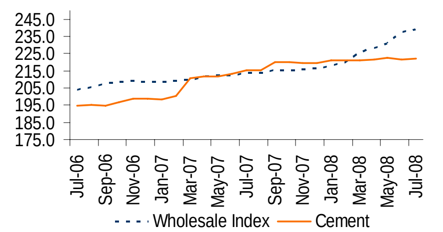
Cost increases may have halted but no celebrations yet

Imported coal prices may get some respite due to lower sea freight and easing in international energy (coal & crude) prices, albeit partly offset by rupee depreciation. Within our coverage, India Cements imports ~65-70% of its coal requirement while ACC imports ~10% of its requirement. However, our discussions with the industry do not offer much cause for celebration as open market prices of local coal continue to reign high and availability of linkage coal is now ~65% of targeted levels vs ~96% a year ago.

Coal poses cost concern for new units

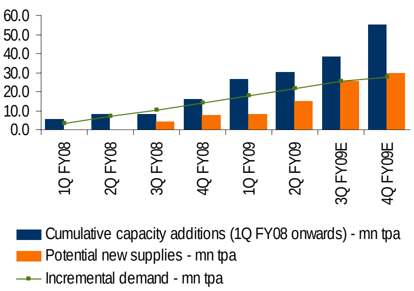
Our discussions with companies indicate that coal availability is not a constraint per se for new supplies. However, reliance on open-market sourcing and imports will likely to push up costs. Many of the companies that we spoke with (e.g. Madras Cements, Dalmia) have planned coal imports to meet their new requirements.

Chart 1: Cement Prices vs Wholesale Index



Source: CMA

Chart 2: New Supplies vs Incremental Demand



Source: ML estimates

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Refer to important disclosures on page 12 to 13. Analyst Certification on Page 10.
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Valuations Of Indian Cement Majors

Table 1: Key Valuation Comparables

	Share Price (Rs)	Market Cap (US$ mn)	PE Relative (FY09E)	PE Relative (FY10E)
ACC (ADCLF, C-3-7/Underperform)	627	2554	0.7	1.1
Grasim (GRSJF/GRSJY, C-3-7/Underperform)	1885	3757	0.5	0.8
Ambuja Cements (AMBUF/XAAJF, C-3-7/Underperform)	83	2737	0.7	1.0
UltraTech (XDJNF, C-2-7/Neutral)	565	1529	0.5	0.7
Shree Cement (SREEF, C-3-7/Underperform)	557	422	0.3	0.4
India Cements (INIAF/IAMZY, C-3-9/Underperform)	125	707	0.4	0.6
Yr to 31 Dec/31 March	2006A/FY07A	2007A/FY08A	2008E/FY09E	2009E/FY10E
EV/Capacity (US$/ton)				
ACC	131	109	102	100
Grasim- Cement (Consolidated)	117	99	84	80
Ambuja Cements	162	152	134	113
UltraTech	105	99	81	80
Shree Cement	111	58	49	36
India Cements	121	125	74	74
REPLACEMENT COST BENCHMARK (India)	125	125	125	125
RoE (%)				
ACC	42	34	27	17
Grasim- Overall	51	44	28	17
Ambuja Cements	46	31	25	17
UltraTech	56	45	31	21
Shree Cement	71	59	50	28
India Cements	55	36	24	15
MARKET RoE	26	23	21	22
P/E (x)				
ACC	10.6	9.4	9.5	13.0
Grasim- Overall	8.8	6.6	7.3	9.9
Ambuja Cements	8.9	9.3	9.3	11.3
UltraTech	9.0	7.0	7.3	8.3
Shree Cement	5.4	6.5	3.8	4.9
India Cements	5.7	5.1	5.2	6.7
Local Market PE	19.7	16.5	14.2	11.7
EV/EBITDA (x)				
ACC	7.3	5.8	6.0	8.2
Grasim- Cement (Consolidated)	5.4	4.6	5.0	5.2
Ambuja Cements	6.7	6.0	5.7	6.5
UltraTech	5.8	4.8	5.0	5.4
Shree Cement	3.9	2.8	2.2	2.4
India Cements	6.2	4.8	3.8	4.7
Local Market EV/EBITDA	12.2	10.4	9.3	7.5

Source: ML: research

Industry Supply-Demand Outlook

We expect the industry's capacity growth to outpace demand growth over FY09-10E. We hold our 8% demand growth forecast for FY09 but see downside risk.

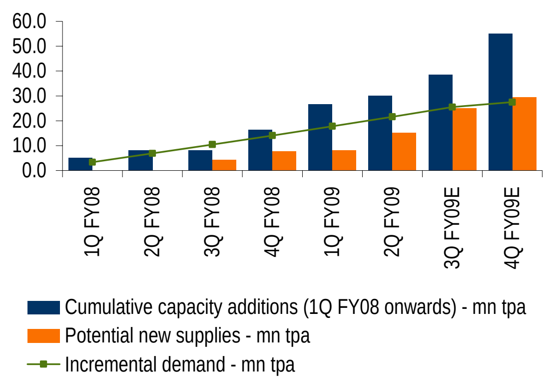
Table 2: Industry Supply-Demand Scenario

As on 31 March (mn tpa)	FY06	FY07	FY08	FY09E	FY10E
Cement Capacity	161	166	189	233	267
Effective Clinker Capacity	126	131	146	184	215
Capacity growth	5%	4%	12%	26%	17%
Cement Demand	141	155	168	182	196
Demand growth	13%	10%	8%	8%	8%
Domestic Consumption	135	149	164	179	193
Growth in domestic consumption	12%	10%	10%	9%	8%
Exports	6.0	5.9	3.7	2.9	2.9
Export growth	48%	-2%	-35%	-20%	0%
Cement - Capacity Utilisation	88%	93%	89%	78%	73%
Cement/Clinker Ratio	1.28	1.33	1.36	1.37	1.37
Blended Cement as % of total production	61%	70%	75%	75%	75%
Clinker Demand					
Domestic	110.6	116.7	123.8	132.6	143.1
Clinker Exports	3.2	3.1	2.4	2.1	2.1
Clinker - Capacity Utilisation (incl. Exports)	90%	92%	86%	73%	68%
Clinker - Capacity Utilisation (excl. Exports)	88%	89%	85%	72%	67%

Source: CMA, ML Estimates

4Q FY09 will likely be the tipping point for cement prices. We estimate that new supplies across the industry will exceed additional demand by 4Q FY09.

Figure 1: Time-sheet of new supplies vs incremental demand



*Fiscal year ending 31 March; Source: Media Reports, ML Estimates

Geographically, downside risk seems high in south & north India. West and central India appear relatively safe.

Table 3: Pro forma Supply-Demand Scenario

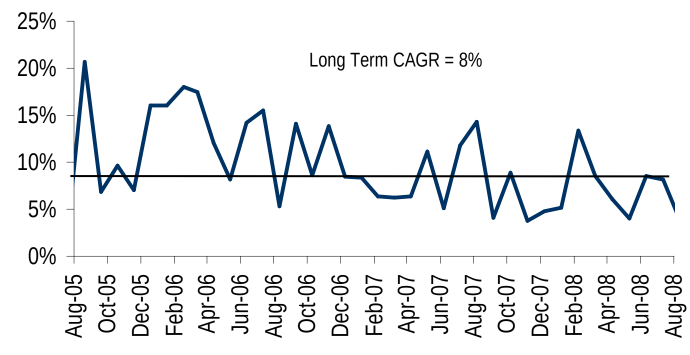
Region (as on 31 Mar)	FY06	FY07	FY08	FY09E	FY10E
North	98%	101%	79%	72%	65%
South	86%	89%	94%	73%	67%
East	83%	91%	86%	84%	75%
West	86%	95%	98%	93%	100%
Central	88%	93%	91%	85%	85%
All-India	88%	93%	89%	78%	73%

Source: CMA, ML

Recent Trends In The Indian Cement Industry

The industry's volume trend appears weak with despatch growth in YTD FY09 (Apr-Aug '08) at ~6% vs long term CAGR of ~8%.

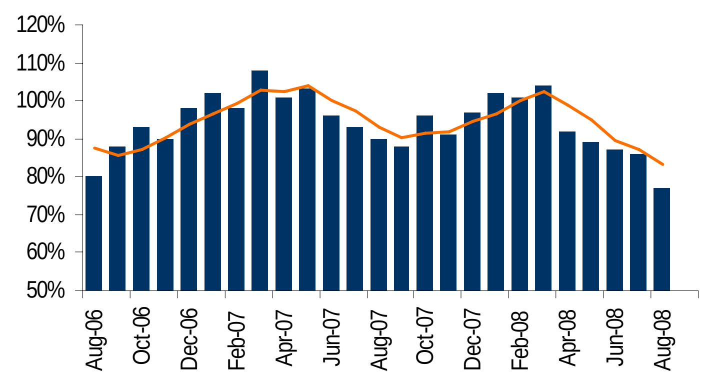
Figure 2: YoY Growth In Industry Despatches Over Last 3 Years



Source: CMA

The industry's capacity utilization averaged ~86% in YTD FY09 versus ~97% last year. This reflects a combination of demand slowdown and capacity additions.

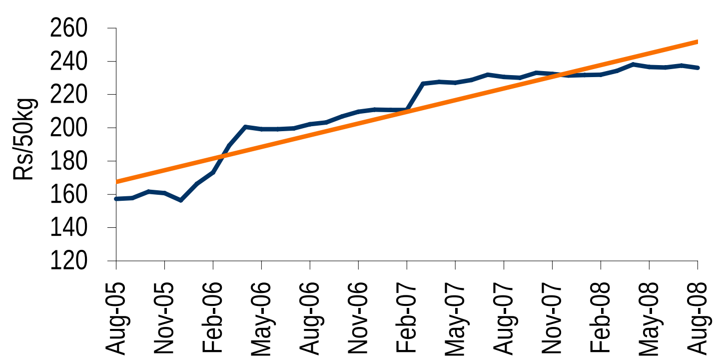
Figure 3: Capacity Utilization Levels & 3-Month Moving Average Over Last 2 Years



Source: CMA, ML Research

Cement prices continue to be firm but increases have been modest over the last year likely owing to fear of government intervention.

Figure 4: Trend In Cement Prices Across The Industry Over Last 3 Years

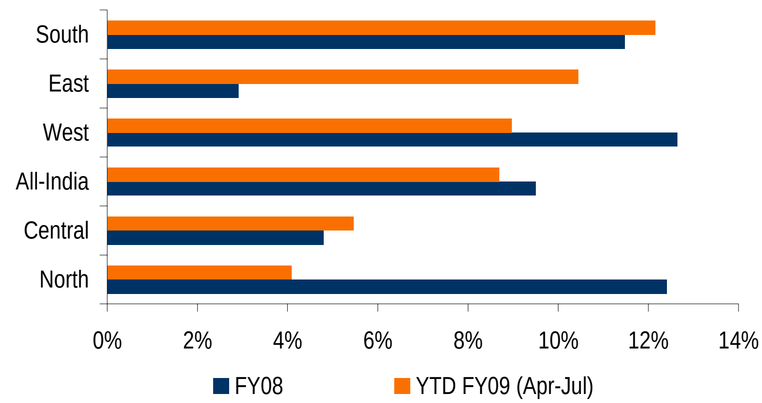


Source: CRIS-INFAC, ML Research

Regional Trends In The Indian Cement Industry

Geographically, south India continues to witness strong demand growth in line with FY08 levels. East has also posted strong acceleration. Demand slowdown is sharpest in north India, followed by West.

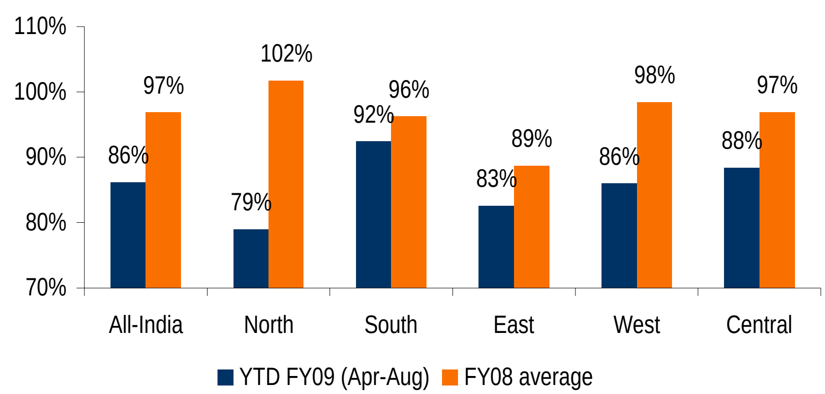
Figure 5: YoY Consumption Growth Across Key Geographical Regions



Source: CMA

Capacity utilization has softened across all regions in YTD FY09. North appears to have the highest overcapacity while south appears to be tightly supplied.

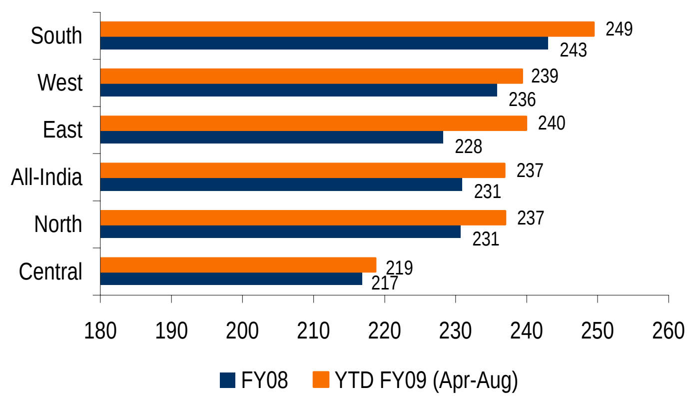
Figure 6: Capacity Utilization Level In Key Geographical Regions – YTD FY09 Vs FY08



Source: CMA, ML Research

Cement prices across India are up 3% in YTD FY09 vs FY08 levels. Prices are highest in south India & lowest in central India. East witnessed the strongest rise while west was a relative laggard.

Figure 7: Average Cement Prices Across The Industry – YTD FY09 Vs FY08

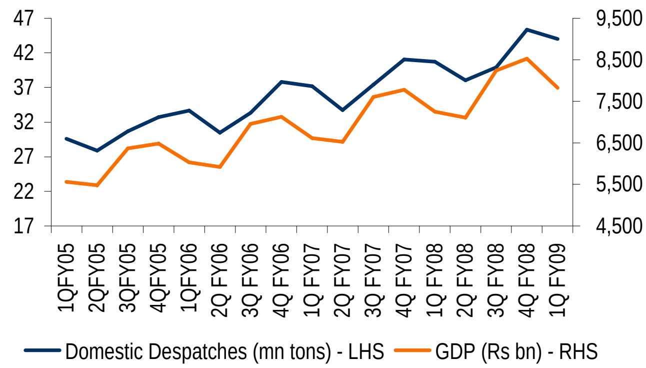


Source: CMA, ML Research

Long-Term Trends In The Indian Cement Industry

Broadly speaking, cement despatches continue to move in line with GDP.

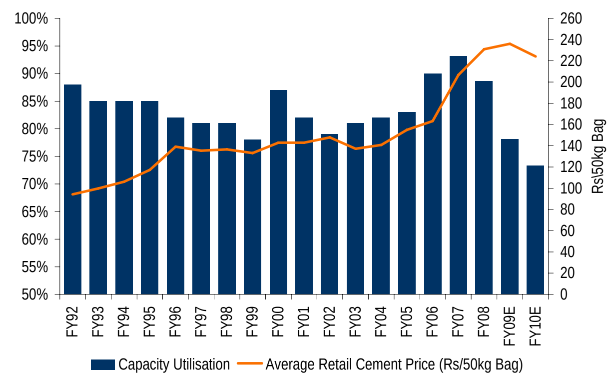
Figure 8: Trend In Domestic Cement Despatches Vs GDP



Source: CMA, CMIE

Capacity utilization is forecast to fall sharply over FY09-10E. Cement prices will likely peak in FY09E; we expect YoY price decline from end-FY09E onwards.

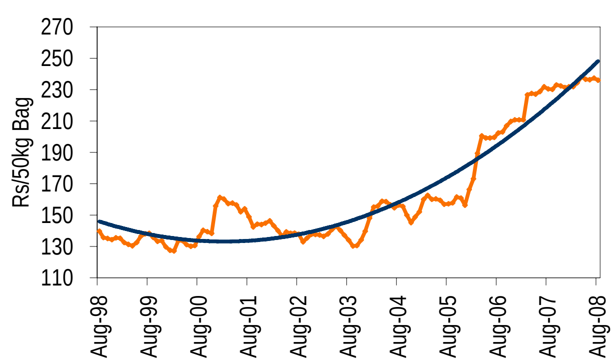
Figure 9: Long Term Trend In Capacity Utilization & Cement Prices Across The Industry



Source: CMA, CRIS Infac

Cement prices continue to be firm but the pace of price hikes has slowed over last 12 months likely owing to fear of government intervention.

Figure 10: 10-Year Trend In Average Cement Prices Across India

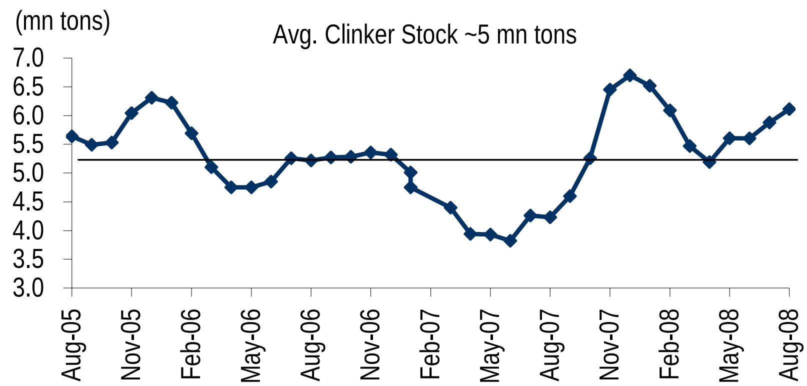


Source: CRIS Infac, ML Research

Long-Term Trends In The Indian Cement Industry

Clinker inventory is trending above the sector's long-term average, pointing to a combination of demand slowdown and capacity growth.

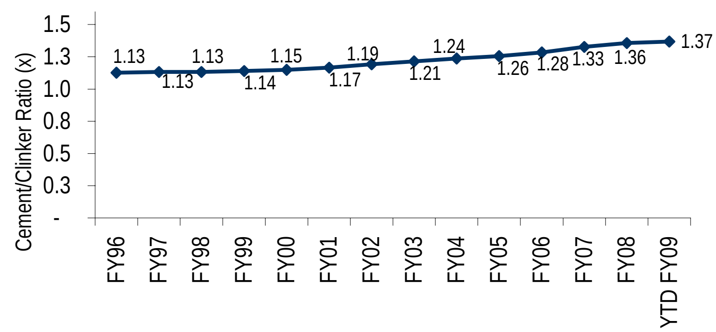
Figure 11: Trend In Clinker Inventory



Source: CMA

The industry's blending ratio continues to rise, in line with the long term trend.

Figure 12: Trend In Blending i.e. Cement/Clinker



Source: CMA

Cement exports are down ~45% and clinker exports are down ~13% in YTD FY09 largely owing to export ban by the Govt. Partial lifting of this ban from May '08 onwards should help volumes going forward.

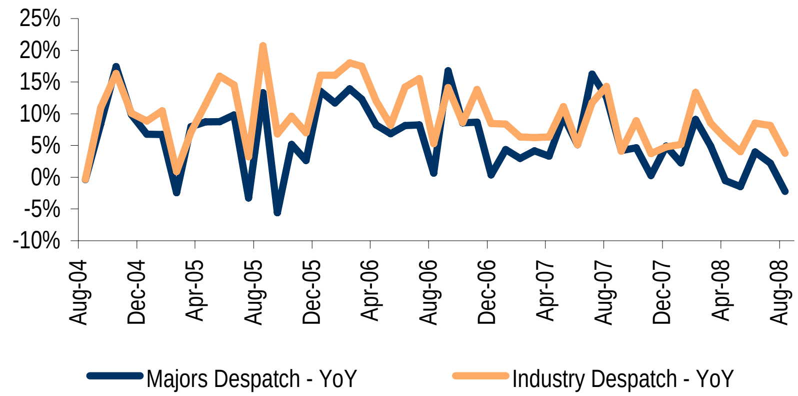
Figure 13: Trend In Cement & Clinker Exports

Source: CMA

Performance of Industry Majors

Cement majors continue to lag the industry's despatch growth. This may be due to capacity additions (and higher volumes) by relatively smaller players.

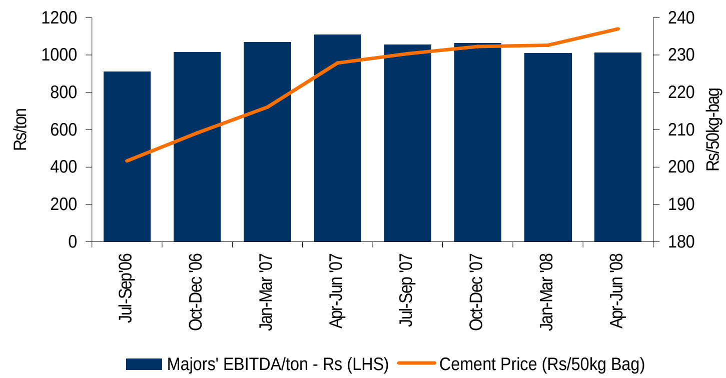
Figure 14: YoY Despatch Growth Of Cement Majors Vs. Industry



Source: CMA

Despite improving cement prices, EBITDA per ton of the majors has been flattish owing to cost pressures.

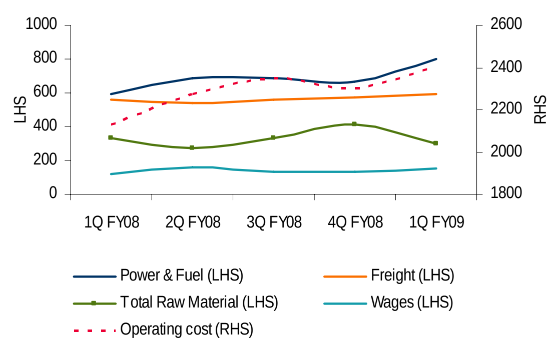
Figure 15: Proforma Trend In EBITDA/ton Of Cement Majors



Source: Company Data, ML Research

The industry has seen an across-the-board rise in costs led primarily by higher coal costs.

Figure 16: Trend in Key Costs for Industry Majors



Source: Company Data, ML Research

Price objective basis & risk

Ambuja Cements (AMBUF / XAAJF)

We have a price objective of Rs85 (GDR of US$1.98) for Ambuja. We value the company at an EV/capacity of around US$125/ton on par with the industry's current replacement cost. Historically, Ambuja's trough valuation was around 25% discount to replacement cost in the midst of the previous down-cycle. Pending greater visibility on capacity additions in the industry we do not factor any discount for Ambuja at this stage.

Ambuja appears cheap on PE and EV/EBITDA but high risk to earnings, and forecast YoY earnings downtrend may deter investors from leaning on these metrics. Downside risks to our PO stem from possible introduction of price controls by the government or unforeseen further rise in energy prices. Upside possibilities would stem from unexpected delays in commissioning of new capacities and unforeseen easing in energy prices, especially coal.

Assoc. Cement (ADCLF)

We have a price objective of Rs585/sh for ACC. We value the company at an EV/capacity of around US$100/ton based on a 20% discount to the industry's current replacement cost of US$125/ton. At this stage we use a lower discount versus historical trough pending greater visibility on capacity additions in the industry. Historically, trough valuation of industry majors was around 40% discount to replacement cost in the midst of the previous down-cycle. ACC appears cheap on PE and EV/EBITDA but high risk to earnings, and forecast YoY earnings downtrend may deter investors from leaning on these metrics. Downside risks to our PO stem from possible introduction of price controls by the government or unforeseen further rise in energy prices. Upside possibilities would stem from unexpected delays in commissioning of new capacities and unforeseen easing in energy prices especially coal.

Grasim (GRSJF / GRSJY)

We have a price objective of Rs2250 (GDR of US$53) for Grasim. We value the company's dominant cement business at 20% discount to the industry's current replacement cost of US$125/ton. The VSF business is pegged at a PE of about 10x FY10E, in line with Lenzing AG which is one of the few listed VSF plays globally, outside of the Aditya Birla group. We also value Grasim's 6.5 percent investment in Idea at our target price of Rs125 per share for Idea. Potential de-rating of the VSF business and possible introduction of price controls in cement by the government, present downside risk to our PO. Upside risks are unexpected delays in commissioning of new cement capacities, and unforeseen easing in energy prices.

India Cements (INIAF / IAMZY)

We have a price objective of Rs130 for India Cements (GDR of US$3.05). We value the company at an EV/capacity of around US$80/ton (FY10E) i.e. 35% discount to the industry's current replacement cost benchmark of US$125/ton. Our valuation of India Cements is comparable with the stock's trough valuation historically at 40% discount versus replacement cost in the midst of the previous down-cycle. We think valuations will stay below replacement cost in anticipation of falling returns. The stock appears cheap on PE and EV/EBITDA but high risk to earnings, and forecast YoY earnings downtrend may deter investors from leaning on these metrics. Downside risks to our PO are possible introduction of price controls by the government and consequent inducement of lower-than-forecast returns. Unforeseen further rise in energy prices would also present downside risks. Unexpected delays in commissioning of new capacities and unforeseen easing in energy prices especially coal may offer upside potential for the stock.

Shree Cements (SREEF)

We have a price objective of Rs765 for Shree. We value the company at an EV/capacity of around US$55/ton (FY10E), i.e. 55% discount to the industry's current replacement cost benchmark of US$125/ton. Our valuation of Shree is comparable with the stock's trough valuation historically at 45-55% discount versus replacement cost in the midst of the previous down-cycle. We think Shree will trade at trough valuations sooner than other players owing to complete revenue exposure to north India - the region where visibility of upcoming overcapacity is already high. The stock appears cheap on PE and EV/EBITDA but high risk to earnings, and forecast YoY earnings downtrend may deter investors from leaning on these metrics. Downside risks to our PO stem from possible introduction of price controls by the government or unforeseen further rise in energy prices. Upside possibilities would stem from unexpected delays in commissioning of new capacities and unforeseen easing in energy prices, especially coal.

UltraTech Cemen (XDJNF)

We have a price objective of Rs650/sh for UltraTech. We value the company at an EV/capacity of around US$100/ton based on a 20% discount to the industry's current replacement cost of US$125/ton. At this stage we use a lower discount versus historical trough pending greater visibility on capacity additions in the industry. Historically, trough valuation of industry majors was around 40% discount to replacement cost in the midst of the previous down-cycle. UltraTech appears cheap on PE and EV/EBITDA but high risk to earnings, and forecast YoY earnings downtrend may deter investors from leaning on these metrics. Downside risks to our PO stem from possible introduction of price controls by the government or unforeseen further rise in energy prices. Upside possibilities would stem from unexpected delays in commissioning of new capacities and unforeseen easing in energy prices especially coal.

Analyst Certification

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India - General Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	ABG Shipyard	ABSHF	ABGS IN	Sanjaya Satapathy
	Aditya Birla Nu	ADYAF	ABNL IN	Reena Verma Bhasin, CFA
	APIL	ANSFF	APIL IN	Amit Agarwal
	Bharati Shipyar	BSYDF	BHSL IN	Sanjaya Satapathy
	DLF Limited	XVDUF	DLFU IN	Amit Agarwal
	Exide Indus Ltd	XEDRF	CHLR IN	Sanjaya Satapathy
	HDIL	XGHSF	HDIL IN	Amit Agarwal
	Motherson Sumi	XMSUF	MSS IN	Sanjaya Satapathy
	Puravankara Projects Ltd	XPJVF	PVKP IN	Amit Agarwal
	Renuka Sugars	SRNKF	SHRS IN	Sanjaya Satapathy
	Triveni Engg	TVIEF	TRE IN	Sanjaya Satapathy
NEUTRAL				
	UltraTech Cemen	XDJNF	UTCEM IN	Reena Verma Bhasin, CFA
	Unitech Ltd	UTKIF	UT IN	Amit Agarwal
UNDERPERFORM				
	Ambuja Cements	AMBUF	ACEM IN	Reena Verma Bhasin, CFA
	Ambuja Cem-GDR	XAAJF	ABUJ LI	Reena Verma Bhasin, CFA
	Assoc. Cement	ADCLF	ACC IN	Reena Verma Bhasin, CFA
	Bajaj Hindusthan	BJJHF	BJH IN	Sanjaya Satapathy
	Balrampur Chini	BMPRF	BRCM IN	Sanjaya Satapathy
	Grasim	GRSJF	GRASIM IN	Reena Verma Bhasin, CFA
	Grasim -G	GRSJY	GRAS LX	Reena Verma Bhasin, CFA
	India Cements	INIAF	ICEM IN	Reena Verma Bhasin, CFA
	India Cements -G	IAMZY	ICEM LX	Reena Verma Bhasin, CFA
	Omaxe Limited	XOMXF	OAXE IN	Amit Agarwal
	Shree Cements	SREEF	SRCM IN	Reena Verma Bhasin, CFA
RESTRICTED				
	Indiabulls Real	IBELF	IBREL IN	Amit Agarwal

Important Disclosures

Investment Rating Distribution: Building Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	37	37.00%	Buy	6	17.14%
Neutral	25	25.00%	Neutral	3	14.29%
Sell	38	38.00%	Sell	2	5.41%

Investment Rating Distribution: Industrials/Multi-Industry Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	63	60.58%	Buy	14	24.56%
Neutral	16	15.38%	Neutral	4	28.57%
Sell	25	24.04%	Sell	4	18.18%

Investment Rating Distribution: Global Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1664	47.42%	Buy	441	29.46%
Neutral	803	22.88%	Neutral	224	31.46%
Sell	1042	29.70%	Sell	217	22.84%

* Companies in respect of which MLPF&S or an affiliate 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.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. *VOLATILITY RISK RATINGS*, indicators of potential price fluctuation, are: A - Low, B - Medium and C - High. *INVESTMENT RATINGS* reflect the analyst's assessment of a stock's: (i) absolute total return potential and (ii) attractiveness for investment relative to other stocks within its *Coverage Cluster* (defined below). There are three investment ratings: 1 - Buy stocks are expected to have a total return of at least 10% and are the most attractive stocks in the coverage cluster; 2 - Neutral stocks are expected to remain flat or increase in value and are less attractive than Buy rated stocks and 3 - Underperform stocks are the least attractive stocks in a coverage cluster. Analysts assign investment ratings considering, among other things, the 0-12 month total return expectation for a stock and the firm's guidelines for ratings dispersions (shown in the table below). The current price objective for a stock should be referenced to better understand the total return expectation at any given time. The price objective reflects the analyst's view of the potential price appreciation (depreciation).

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%

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