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CEMENT UPDATE

SECTOR UPDATE

ASK RAYMOND JAMES & ASSOCIATES PRIVATE LIMITED

Sector: Cement

Both sides of the coin

We expect a total surplus of 11 mn tonnes by 1Q FY09E, assuming demand growth of 10% p.a. continues, considering the time element and lower utilization levels. With the regional analysis of the demand supply mismatch, companies having huge market share in the northern region would face maximum impact, as the region would have surplus of 4.9 mn tonnes (45% of total surplus) in FY09E. However, regional players in South (India Cement and Madras Cements) would not have a sharp correction as compared to the northern players, as surplus situation is not seen till FY10E. We expect a mixed bag, seeing both sides of the coin for pan India players.

This surplus situation is driven by addition of 96.6 mn tonnes of cement capacities between FY07-FY10E. The surplus situation would not change even if we presume higher growth rate of 12% p.a. versus our assumption of 10% p.a. growth over the next two years, though the surplus may come down to 2 mn tonnes from 11 mn tonnes in FY09E. However, we still remain positive on Grasim (diversified nature of business) and India Cements (deficit in South till FY09E).

We feel that the current party enjoyed by the cement manufacturers, due to the demand supply mismatch, will not last long. The surplus would lead to price correction impacting the profits of the companies. We will be shortly introducing FY09E earnings estimates and we expect cement realizations to decline by 5-8% YoY in FY09E depending on the region due to over supply, which would have a negative impact on the earnings. Profits for the companies would fall by 15% to 20% YoY in FY09E for pan India players like Grasim, UltraTech, ACC and Ambuja Cements. Considering this reversal in the cement cycle, the companies will not command the premium valuations that they did during the uptrend, resulting in the de-rating.

Exhibit 1: Overall demand supply scenario (mn tonnes)

	FY03	FY04	FY05	FY06	FY07E	FY08E	FY09E	FY10E
Capacity	141	144	151	160	172	200	237	257
growth (%)		2.4	5.0	6.0	7.2	16.5	18.4	8.4
Production	111	118	128	142	152	169	197	221
growth (%)		5.5	8.6	11.2	7.4	11.0	16.6	12.4
Capacity utilization(%)	79	82	84	89	89	84	83	86
Domestic demand	108	114	123	136	150	165	181	199
growth (%)	8.7	5.8	8.1	10.1	10.5	10.0	10.0	10.0
Cement exports	3.5	3.4	4.1	6.0	5.5	5.0	4.5	4.0
% of production	3.1	2.9	3.2	4.2	3.6	3.0	2.3	1.8
Surlpus/(deficit)	**0.3**	**0.3**	**0.4**	**0.2**	**(3.0)**	**(0.8)**	**11.2**	**17.9**

Source: CMA, ASK Raymond James.

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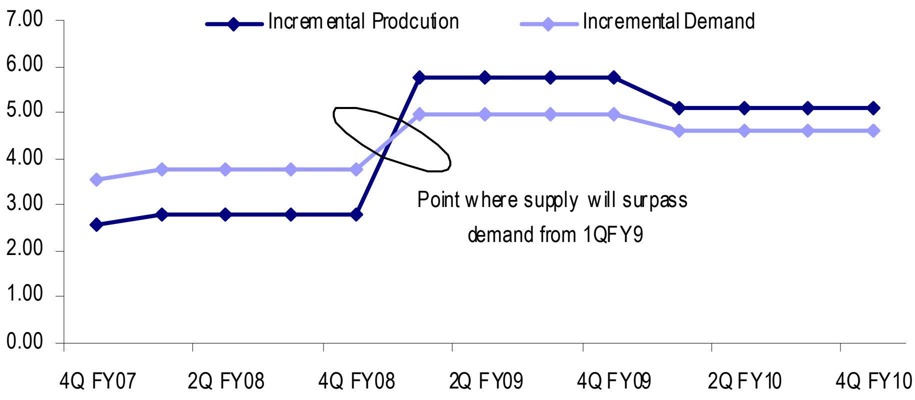
Exhibit 2: Demand supply gap **(mn tonnes)**

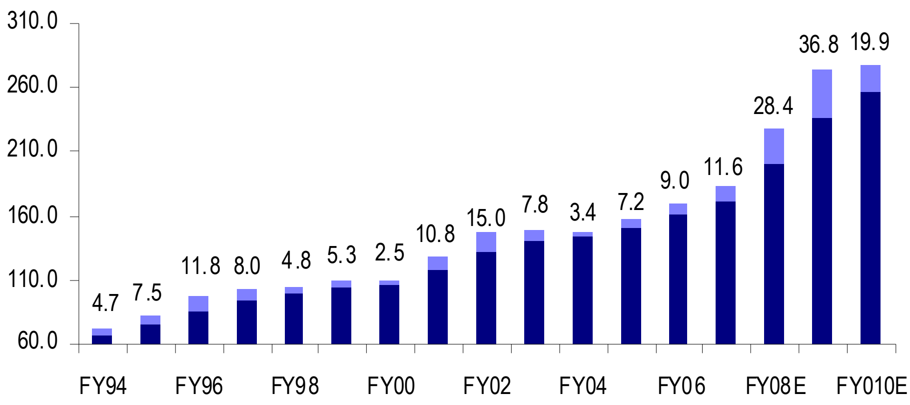


Source: ASK Raymond James.

Highlights

- **Adding approximately 96.6 mn tonnes by FY10E:** After meeting the machinery suppliers and collating the data of the announced capacities by the cement producing companies, we expect a total of 96.6 mn tonnes of new capacities to be added by FY10E (see Exhibit 3). This would also include the additional capacities through debottlenecking and exclude the dead capacities. At present the total capacity excluding the dead capacity is around 160.2 mn tonnes in FY06. Currently KHD Humboltd Wedag (cement machinery supplier) is working on 14.5 mn tonnes new kiln capacities. They mentioned that currently their order book is completely full till FY09E.

Exhibit 3: Incremental capacity addition **(mn tonnes)**



Source: CMA, ASK Raymond James.

- **Higher demand may not change the surplus situation in FY09E:** Demand has remained quite strong and grown by 10% YoY for the period April-January 2007. We expect demand to continue to grow at 10% YoY in FY08E, which would translate in a deficit of 0.80 mn tonne which would drive the prices. Being optimistic with the increasing thrust on infrastructure development and assuming demand grows at 12% for FY08E, we see a huge gap in demand-supply with a deficit of 3 mn tonnes in FY08E. But, if the growth is lowered to 8%, than the surplus is 2.92 mn tonnes. Thus, depending on the demand growth, the outlook for prices is expected to change, however this is likely only till FY08E. In FY09E, with huge capacity addition, even a stronger growth in demand would not help beat the surplus as huge as 12 mn tonnes.

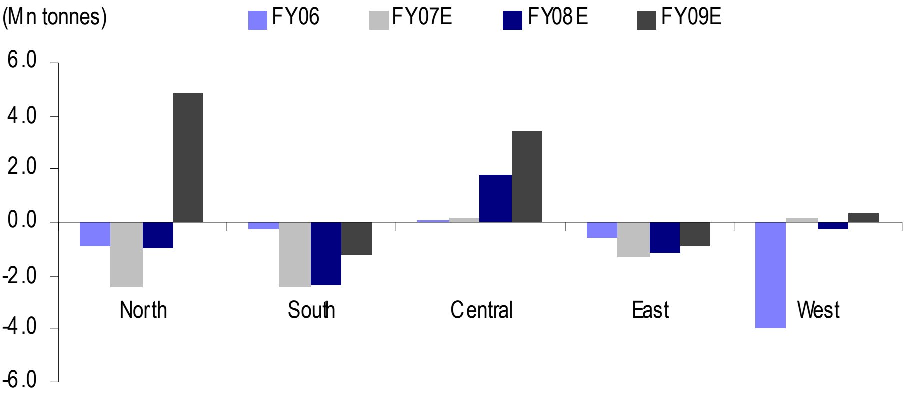
Exhibit 4: Sensitivity to demand

	Production (mn tpa)	Domestic demand (mn tonnes)			Exports mn tonnes	Surplus/(deficit) (mn tonnes)		
		8%	10%*	12%		8%	10%*	12%
FY2006	142	135.6	135.6	135.6	6.0	0.2	0.2	0.2
FY2007F	152	146.4	149.1	151.8	5.5	0.4	(2.3)	(5.0)
FY2008F	169	158.1	164.0	170.0	5.0	5.9	(0.1)	(6.1)
FY2009F	197	170.8	180.4	190.5	4.5	21.7	**12.0**	**2.0**
FY2010F	221	184.4	198.5	213.3	4.0	32.9	18.8	4.0

Source: CMA, ASK Raymond James.

- **Region wise demand-supply outlook:** The analysis shows that the southern and eastern region are likely to be in deficit till FY09E. This is considering when additional capacities come on stream in phases in various regions and also considering state wise demand growth. Whereas northern, central and western regions would be surplus from FY09E.

Exhibit 5: Regional demand-supply scenario



Source: CMA, ASK Raymond James.

- **Southern region in deficit till FY09E:** Considering all the capacities coming in various regions and the strong demand growth, the southern region is likely to be in deficit till FY09E. This deficit of 1.2 mn tonnes is due to strong growth in demand as compared to supply addition (Refer Exhibit 6). From April 2006-January 2007, demand in the southern market grew by 16% YoY. We expect demand to grow by 11% YoY in FY08E and by 11% YoY in FY09E. ACC and UltraTech with 10% market share and regional companies like **India Cements** and **Madras Cements** will benefit.

Exhibit 6: Southern region: Deficit till FY09E (mn tonne)

	FY06	FY07E	FY08E	FY09E
Capacity	51.0	55.5	63.7	72.0
Growth (%)	6.0	8.9	14.8	13.1
Production	44.2	47.9	53.5	61.1
Growth (%)	13.5	8.2	11.8	14.0
Capacity utilisation (%)	86.8	86.3	84.1	84.8
Total demand	44.5	50.3	55.9	62.3
Growth (%)	18	13	11	11
Surplus/(deficit)	**(0.2)**	**(2.5)**	**(2.3)**	**(1.2)**

Source: CMA, ASK Raymond James.

- **Northern region to witness surplus of 4.9 mn tonnes in FY09E:** With major capacities coming in the northern region there is huge surplus of 5 mn tonnes likely from FY09E. Demand in the northern region has grown by 11.8% YoY for April 2006-January 2007. Going forward, we expect demand to remain strong in the northern region due to upcoming Commonwealth Games to be held in Delhi in 2010. We expect demand to grow at 12% YoY in FY08E and 11% in YoY FY09E. But the incremental supply of 22.6 mn tonnes in North in two years will cause a substantial surplus in the region. Regional players like **Shree Cements, JK Lakshmi, Gujarat Ambuja** would be impacted.

Exhibit 7: Northern region: Surplus from FY09E (mn tonne)

	FY06	FY07E	FY08E	FY09E
Capacity	29.3	32.2	45.1	54.7
Growth (%)	6.0	9.7	40.3	21.3
Production	29.7	31.3	37.4	49.0
Growth (%)	11.3	5.4	19.4	31.2
Capacity utilisation (%)	101.4	97.4	82.9	89.6
Total demand	30.6	33.7	38.4	44.2
Growth (%)	11.0	10	12	11
Surplus / (deficit)	**(0.9)**	**(2.4)**	**(1.0)**	**4.9**

Source: CMA, ASK Raymond James.

- **High capacity utilization levels:** The average capacity utilizations for the industry have been in the range of 79-81%. In FY06 the utilization jumped to around 90% and April to January (YTD) utilization has remained at around 92%. Such high utilizations and increase in blending ratio shows tight supply scenario. But, going forward, when all the capacities are on stream and considering the time element and lower utilizations of the new capacities there is huge surplus creating a glut in the sector.

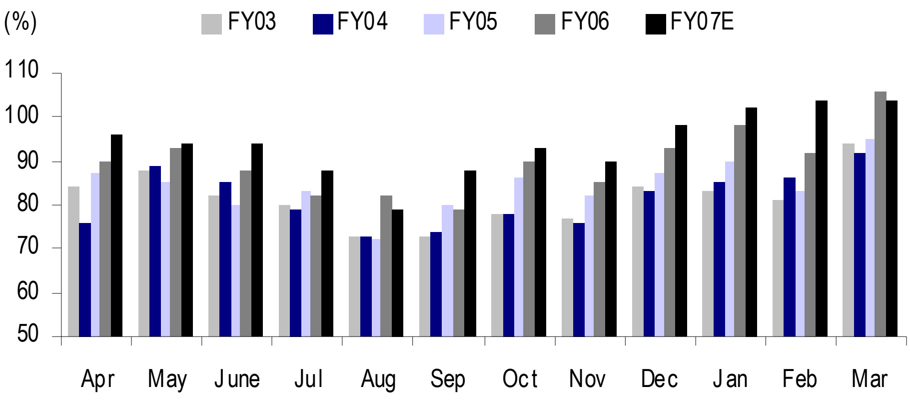
Exhibit 8: Blended ratio (%)

Region	FY02	FY06	Apr-Jan 07
North	36	64	76
East	85	90	92
South	39	54	59
West	9	30	40
Central	58	77	84
All India	44	61	68

Source: CMA.

Capacity utilization levels reaching at more than 100% in FY07E as compared to 82% in FY03.

Exhibit 9: Capacity utilization trends(%)



Source: CMA, ASK Raymond James.

- **Threat of imports minuscule:** Post the announcement of the import duty cut of 12.5% there are threats from imports. But for imports to be feasible, proper logistics (ports facility) is needed, which India lacks. Also cement being a very bulky and perishable commodity requires proper warehousing facility, as the shelf life is not more than 45 days. The Chinese producers prefer to dump in other markets like the Middle East where demand is much higher, as the quantity exported is huge. Moreover the landed cost of cement even at zero import duty works out to be Rs250 per 50 kg bag (see exhibit 10), which is much higher than the average domestic prices of Rs211 per bag.

Exhibit 10: Domsetic prices lower than imports

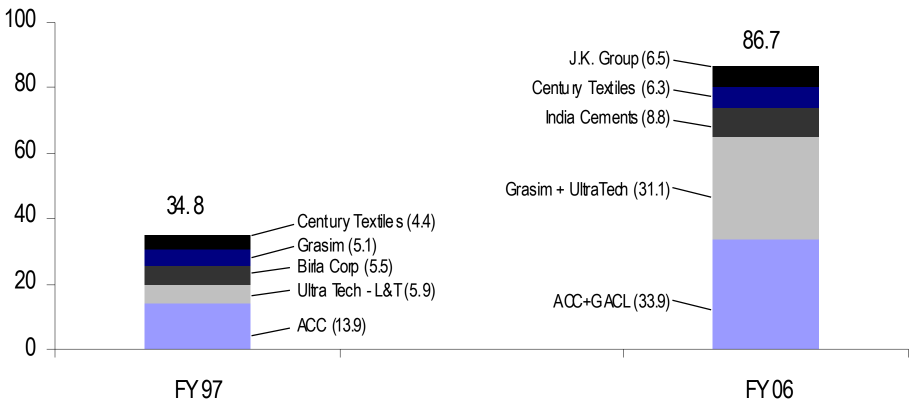
	At 12.5% import duty (Rs)	At zero import duty (Rs)
Cement from Indonesia US$/tonne	45	45
Freight cost from Indonesia to India	27	27
Total cost (CIF) US$/tonne	72	72
Exchange rate (Rs/US$)	44.0	44.0
Total cost (CIF)	3,168	3,168
Handling cost	300	300
Value for customs duty	3,468	3,468
Import duty (12.5%)	434	0
Assessable value	3,902	3,468
Landed cost	3,902	3,468
Countervailing duty (for excise)	408	408
Value for sales tax	4,310	3,876
Value including sales tax of 12.5%	4,848	4,361
Loading and unloading	250	250
Freight	300	300
Dealer margin	60	60
Total selling price (Rs/tonne)	5,458	4,971
Total selling price (Rs/50kg bag)	**273**	**249**

Source: ASK Raymond James.

- **No threat from exports flowing back:** According to machinery suppliers, exports contributed around 4.2% of the overall production in FY06. And with the demand growing in double digit of around 10% CAGR for FY06-10E these would be easily consumed in the domestic market. Moreover, the suppliers added that even after huge capacities coming on stream in the Middle East by December 2007, the rising demand in the Middle East markets would surpass the incremental supply. Thus there will be no major threat of exports flowing back in the domestic market.

- **Consolidation to help the industry:** The cement sector has been witnessing a lot of consolidation and foreign entrants over the past few years (see Exhibit 11). Lafarge was the first MNC to enter the Indian market. It acquired companies like Tisco Cement and Raymond Woollen in 1999-2000, followed by Italcementi, Holcim and Heidelberg. This would help large players to cut competition from small regional players. Its aggressive acquisition strategy has made Holcim the largest MNC player in the cement sector. Currently Holcim has a total of 34 mn tonnes of capacity through GACL, ACC and ACEL. Heidelberg entered India by acquiring Indo Rama's capacity of 1 MT and has now acquired 2.1 MT capacities of Mysore Cements.

Exhibit 11: Top five players consolidated position (mn tonnes)



Source: CMA, ASK Raymond James.

- **Cement prices frozen at current levels post budget:** Cement prices have risen by 27% from January 2006 till January 2007. Currently national average prices are at Rs211 per 50 kg bag. Prices remained firm during monsoons and currently prices are stable in all regions due to concerns from the government with respect to rising cement prices. In the Union Budget 2007-2008, differential excise duty on cement has been introduced due to which a cap of Rs190 per 50 kg bag is imposed on the prices. Although the debate still continues on how these will be tracked as the prices vary from plant to plant depending on the distance travelled and also accounting for the dealer margins.

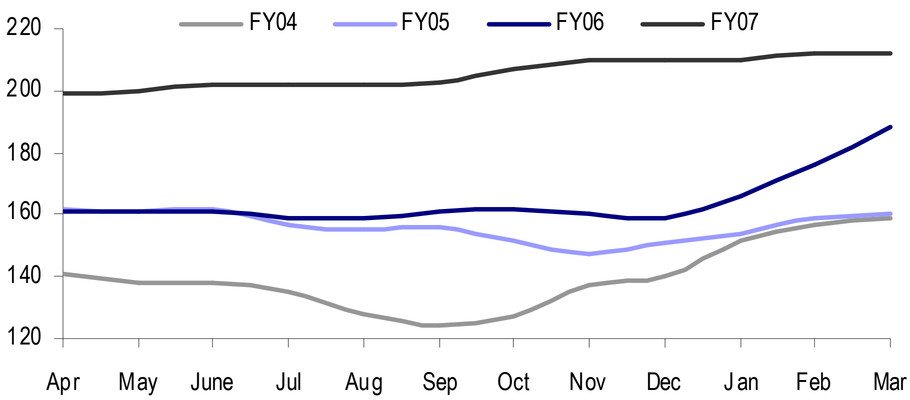
- **Marginal impact to our earnings estimates in FY08E:** We had assumed a marginal increase in average realizations of 2.5%-3% YoY in FY08E which translates to around Rs4-5 per 50 kg bag. This Rs4-5 per bag, along with Rs3 per bag in 4Q FY07E, has already come through in 4Q FY07E, which would have a positive impact on FY07E earnings by 5%. Further to this, after the pass on of the excise duty and the government's interference, the manufacturers have agreed not to raise prices further. Thus the average realizations of the companies are likely to be stable in FY08E. Further, due to strong demand and lag in supply, we believe companies will be able to maintain the prices at current levels in FY08E. This also considers a dip in the monsoons and price correction in the last quarter due to increase in supply. Considering stable price scenario in FY08E and our quick number crunching it will impact our earnings estimates for FY08E in the range of 3-7%. The valuations table below is taking into account the impact of stable price scenario in FY08E.

Exhibit 12: Valuations

Companies	PE (x)		EV/EBIDTA (x)		EV/tonne US$	
	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
Grasim	9.4	9.3	5.7	5.4	140	115
UltraTech	11.7	11.8	7.2	6.8	137	134
Gujarat Ambuja	11.2	12.8	7.4	8.2	189	189
ACC	11.6	11.3	7.8	7.4	143	116
Shree Cement	9.0	7.7	6.2	4.7	145	91
India Cements	8.1	8.1	6.9	6.3	122	92

Source: ASK Raymond James

Exhibit 13: Average trend in cement prices (Rs/bag)



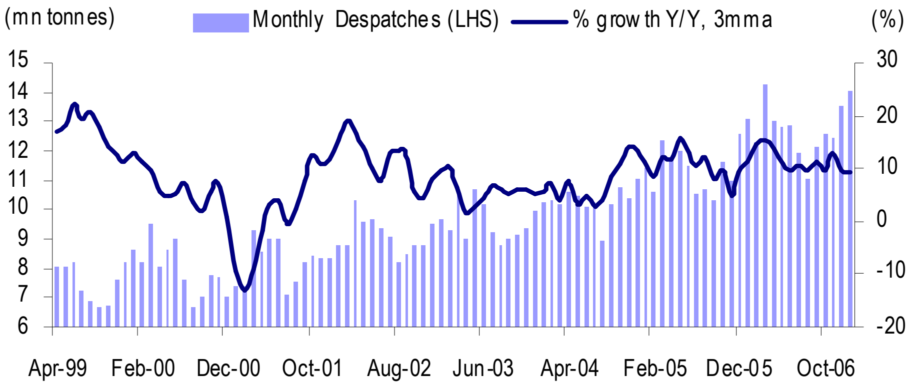
Source: CMA, ASK Raymond James.

- **Glut from 1Q FY09E:** The Indian economy is growing at 9.2% (FY07) and has been projected to grow at 9-10% in the 11th Plan period (2007-2012). Cement sector, being a core infrastructure sector, is expected to grow at more than 9% (See exhibit 15). India is a developing country and so there are good growth opportunities with respect to infrastructure initiatives by the government, boom in the construction and real estate industry and Commonwealth Games to be held in India in 2010, which would drive the demand for cement. But the concern remains that the substantial addition of supply, which is expected to come from early FY09E, will create oversupply scenario.

This would lead to price correction impacting the profits of the companies. We will be shortly introducing FY09E earnings estimates and we expect cement realizations to decline by 5-8% YoY in FY09E depending on the region due to oversupply, which would have a negative impact on the earnings. Profits for the companies would fall by 15% to 20% in FY09E for pan India players like Grasim, UltraTech, ACC and Ambuja Cements. Considering this reversal in the cement cycle, the companies will not command the premium valuations that they did during the uptrend, resulting in the rerating. However we still remain positive on Grasim (diversified nature of business) & India Cements (deficit in south till FY09E).

Three months moving average of the demand growth.

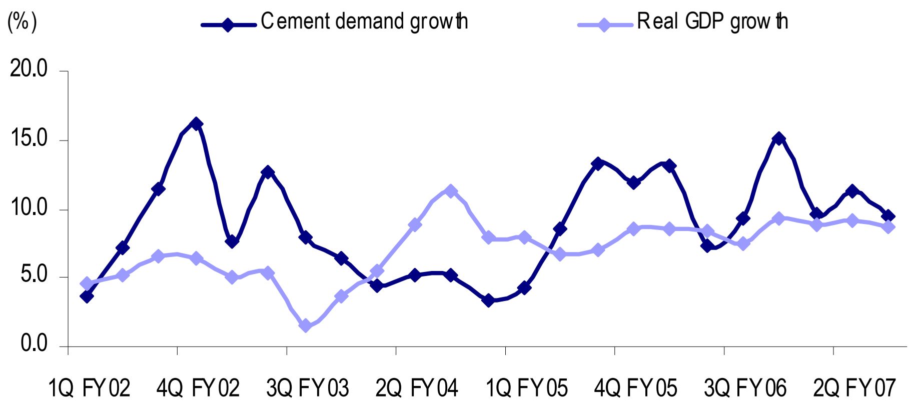
Exhibit 14: Trend in demand growth (3-months moving average)



Source: CMA, ASK Raymond James.

Cement demand to have a direct correlation with the GDP growth. The chart shows the correlation of the quarterly cement demand growth with the quarterly GDP growth from FY02.

Exhibit 15: Correlation between cement demand and real GDP growth



Source: CMA, ASK Raymond James.

Exhibit 16: Table of capacity additions over FY07E-FY10E

Companies	Month	Additional Capacity (Mn tonnes)
2007-2008		
ACC Wadi (Karn)	Apr-07	0.4
ACC Tikaria (UP)	Apr-07	0.3
Birla Corp (Chanderia, Raj)	Apr-07	0.3
Shree Cement (Raj)	Apr-07	1.5
Guj Amb Cem (Roorkee, Uttaranchal)	Apr-07	1.0
Grasim (Dadri, UP)	Jun-07	1.3
Guj Ambuja Cem (Rabriyawas, Raj)	Jun-07	0.5
Birla Corp (Satna, MP)	Jul-07	1.1
India Cements (TN)	Jul-07	1.0
Binani Cement	Sep-07	3.1
OCL (Orissa)	Sep-07	1.0
ACC (Sindhri, Jhk)	Sep-07	0.3
ACC (Damodar, WB)	Sep-07	0.1
India Cements (TN)	Oct-07	1.0
ACC Wadi (Karn)	Oct-07	0.6
Rain Industries (AP)	Sep-07	1.5
Shree Cement (Raj)	Dec-07	2.0
ACC (Barghad, Orissa)	Dec-07	0.2
Mangalam Cem	Dec-07	0.5
Madras Cement (AP)	Dec-07	2.0
My Home Cement Inds	Dec-07	1.3
Jaypee Cement (HP)	Dec-07	4.0
Jaypee Cement (UP Restart)	Dec-07	1.4
Total for FY08		**26.41**
2008-2009		
Orient Paper (AP)	Apr-08	0.4
Jaypee Cement (UP Restart)	Apr-08	1.0
Gujarat Ambuja Cem (Gujarat)	Apr-08	0.5
Madras Cements (TN)	Apr-08	1.8
Grasim, Kotputli (Raj)	Apr-08	4.0
Jaypee Cement (Sidhi, MP)	Apr-08	1.5
Shree Cement (Raj)	Apr-08	1.5
Burnpur Cement (Jharkhand)	Apr-08	1.0
Grasim, Shambhupura (Raj)	Jul-08	4.0
Jaypee (Gujarat Anjan)	Jul-08	1.2
UltraTech (AP)	Sep-08	4.0
OCL (Orissa)	Sep-08	1.0
Lafarge (Sonadih, Raipur, Chattisgarh)	Nov-08	2.2
Sanghi, Jadhava (Gujarat)	Dec-08	5.0
Chettinad Cem (TN)	Dec-08	2.0
Guj Ambuja (ACEL, Chattisgarh)	Dec-08	2.3
ACC (Bargadh, Orissa)	Dec-08	1.2
Murli Agro Products (Chandrapur, Maharastra	Jan-08	2.1
Total for FY09		**36.8**

Companies	Month	Additional Capacity (Mn tonnes)
2009-2010		
ACC (Wadi, Karn)	Apr-09	3.0
Zuari (Tamil Nadu)	Apr-09	2.6
Grasim (Orissa)	Apr-09	3.5
Penna Cement (AP)	Apr-09	1.6
JK Cement	Apr-09	3.2
Guj Ambuja (HP)	Apr-09	3.0
Kesoram (Andhra Pradesh)	Jul-09	1.5
Lafarge (east)	Jul-09	1.5
Total for FY10		**19.9**

Source: CMA, ASK Raymond James.

Rating Structure

Our Equity Rating Structure is based on Absolute Valuations– based on a Discounted Cash-Flow (DCF) Model, though we also look at PE, EV/EBITDA and other related valuation metrics. Our implicit belief is that stock prices tend to approximate, at one time or another, their true value based on future cash flows, if these estimates materialize.

Our Rating Structure is based on the following levels of expected Absolute Returns:

Rating	**Target Price** *(if the value exceeds the Current Market Price)*
Buy	by more than 14%
Hold	by 6% to 14%
Sell	is below 6%

The Percentage Bands are based on the current Risk-free Rate (RFR) of 6% and the Equity Risk Premium of 8% which are empirically observed in India's Debt and Equity markets. Therefore, for a **'BUY'** recommendation on Indian equities, the minimum under-valuation or expected return in absolute terms must be greater than 14% to compensate for the market risk of equities. Similarly, we think that for a **'HOLD'** recommendation, the minimum under-valuation or expected return must be at least equivalent to the risk-free rate and, ideally, much higher. But if the expected return is below even the risk-free rate or if the stock is over-valued, implying a negative absolute return, then the stock under consideration is a clear **'SELL'.**

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