26 February 2013

Update | Sector: Cement

Ambuja Cements

BSE SENSEX	S&P CNX
19,332	5,855

Bloomberg	ACEM IN
Equity Shares (m)	1,542.2
M.Cap. (INR b)/(USD b)	308.1/5.7
52-Week Range (INR)	221/136
1,6,12 Rel. Perf. (%)	4/-3/17

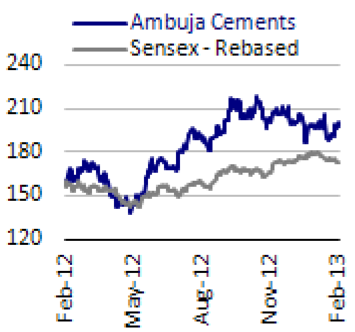
Valuation summary (INR b)

Y/E Dec	2012	2013E	2014E
Sales	96.7	108.9	124.0
EBITDA	24.7	26.4	30.5
NP	15.4	17.4	20.6
Adj. EPS (INR)	10.0	11.3	13.4
EPS Gr. (%)	23.1	37.9	33.7
BV/Sh. (INR)	56.9	63.5	71.6
RoE (%)	18.3	18.7	19.8
RoCE (%)	27.6	27.7	29.2
Payout (%)	49.8	41.3	39.2
Valuations			
P/E (x)	20.0	17.7	14.9
P/BV (x)	3.5	3.1	2.8
EV/EBITDA (x)	10.7	9.7	7.9
EV/Ton (USD)	178	172	157

Shareholding pattern %

As on	Dec-12	Sep-12	Dec-11
Promoter	50.6	50.7	50.3
Dom. Inst	9.5	10.6	13.6
Foreign	32.4	31.3	28.4
Others	7.5	7.4	7.7

Stock performance (1 year)



Investors are advised to refer through disclosures made at the end of the Research Report.

CMP: INR200 TP: INR202 Downgrading to Neutral

Premium profitability to dilute, valuations rich; Downgrading to Neutral

Potential capacity constraints and royalty uncertainty risk to CY15 EPS

- **Lack of timely capacity addition could constrain Ambuja Cements' (ACEM) growth in CY14-15, if demand growth is higher than estimated 8% CAGR for ACEM.**
- **Increase in royalty will hurt CY13E/14E EPS by 3-4%; further upward revision post CY14E not ruled out.**
- **ACEM's superior profitability is diluting as peers catch up and ACEM specific cost-push translate into slower EPS growth.**
- **At an EV of 7.9x CY14E EBITDA and USD162/ton, current valuations factor ACEM's cost leadership and superior profitability. Downgrade to Neutral on likely operational under-performance. Our preferred pick is UltraTech/Grasim and Shree Cement.**

Lack of meaningful capacity addition could restrict ACEM's growth

ACEM's existing clinker capacity of ~16.5mt is only sufficient for annual cement production of ~24mt, which is 9% growth over CY12. Its new capacity of 4.5m tons is expected only in CY15 (orders yet to be placed, awaiting approval from the board). While it would de-bottleneck capacities to meet growth, any higher than estimated 8% CAGR in CY12-14, would restrict ACEM's growth in CY14-15.

Royalty increase to hurt CY13E/14E EPS, risk of further increase from CY15E

Though introduction of royalty fees of 1% (v/s proposal of 2%) to Holcim (in lieu of fixed fees paid) will impact ACEM's CY13E/14E EPS moderately by 3-4%, it introduces uncertainty to ACEM's cost structure as rate of royalty will be revised post CY14. Recent increase in royalty for PT Holcim Indonesia (from existing 1.5% to 5% from CY13) raises the discomfort over future royalty for ACEM.

Profitability edge to dilute, reflecting slow EPS growth

We expect a steady dilution in ACEM's premium in profitability over peers hereon due to (1) limited scope for an uptick in operating leverage and (2) impact of increased royalty to Holcim. Further, potential risk to profitability exists in the form of a) gradual reduction in subsidies over next 4-5 years, b) further increase in royalty from CY15 and c) capacity constraint in CY14/15. ACEM would have lower EPS CAGR of 15.6% (CY12-14E), against 17-20% for its large peers.

Valuations factor premium profitability; Downgrading to Neutral

ACEM is trading at 14%/12% premium to ACC/UltraTech (on CY14 earning valuation). We believe that at an EV of 7.9x CY14E EBITDA and USD157/ton, valuations factor ACEM's superior profitability. We downgrade the stock from a Buy to **Neutral** and value it at 7.9x CY14E EV/EBITDA (v/s 9x earlier) to factor the risk of further increase in royalty, potentially slower-than-industry growth in CY15 and gradual reduction in subsidies. Our target price is INR202.

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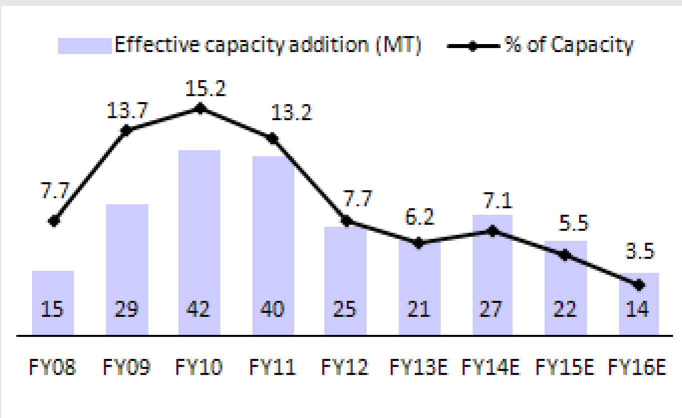
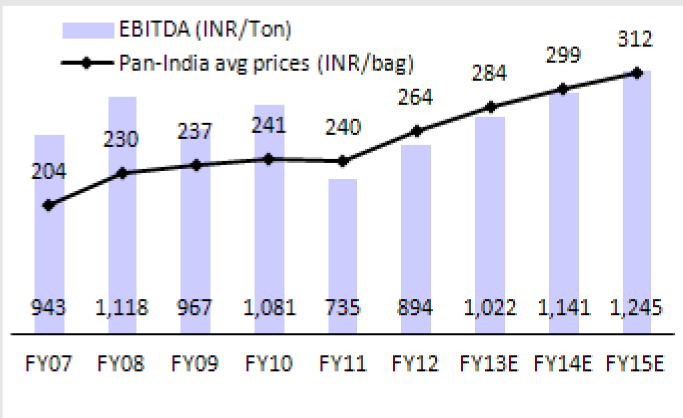
Gradual demand recovery, slowing capacity addition augurs well for the cement cycle

- **Gradual demand to recovery in FY14E-15E:** We expect a gradual recovery in cement volumes, driven by pre-election spend on development work and expected revival in infrastructure investments. Demand could clock a CAGR of 9% over FY13E-15E, against 6% over FY10-12.
- **Pricing outlook to strengthen:** Cement prices have been resilient even during the seasonally weak period. This, we believe, reflects high cost (both opex and capex), implying little risk of any major price correction in the medium-to-long term. Rather, an expected revival in demand over 2HFY13-14 renders a strong outlook for price strengthening, hereon.
- **Moderation in cost-push hereon:** Sustained cost escalation of the last couple of years has begun showing signs of moderation. Most of the cost increases - freight (rail freight hike, rise in diesel price) and energy (coal price hike) - are behind. Prices of imported coal and pet coke are moderating.
- **Supply concerns easing off:** Major capacity addition is behind and new additions (~64m tons over FY13E-16E in the worst case v/s ~105m tons during FY09-12) will be in line with incremental demand, gradually easing the oversupply. While there is limited scope of brownfield capacity addition in existing plants, there are major deterrents in setting up Greenfield capacity: (a) significant escalation in capital cost (currently at USD140-150/ton), and (b) increase in gestation period (due to challenges like land acquisition, approvals etc). Greenfield capacity would require EBITDA of INR1,200-1,300/ton to earn reasonsable return on capital.
- **Utilization to see gradual uptick:** With demand growth (9% CAGR) likely to outpace supply growth (CAGR of 7% over FY13E-15E), we expect capacity utilization to improve gradually from 74% in FY12 to 78% by FY15E. Rising utilization would aid return of sustainable pricing power.
- **EBITDA/ton to post 10% CAGR:** We expect the Indian cement industry to witness consistent improvement in operating performance over FY13E-15E on the back of uptick in profitability and dilution of supply pressure. Realizations would increase by INR15/bag in FY14E and INR12/bag in FY15E, which would drive EBITDA/ton (for our cement universe) to INR1,141/1,245 in FY14E/15E (10% CAGR).

Annual capacity addition to lag incremental demand



Expect gradual improvement in profitability, given no major downside risk to pricing



Source: Company, MOSL

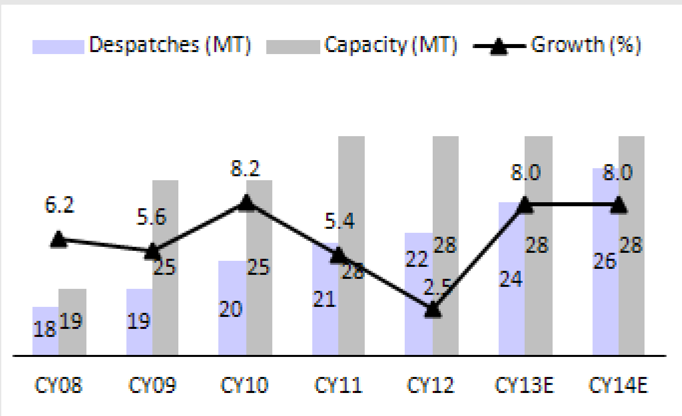
ACEM among the best cement companies in India, with top quartile operating performance

- ACEM is among the best cement companies in India, with strong brand equity, focused segment mix (retail/trade), focused market mix (West, North and East), and diversified fuel and transport mix, translating into high profitability, capital efficiency and payout.
- Company has the ability to fund future growth without impacting balance sheet and dividend payout.
- It continues to focus on North, West and East India. Its incremental volumes would be derived from the North and East. It is planning capacity addition of ~3m tons in Rajasthan. ACEM's geographical location (of Gujarat plant) gives flexibility to choose between domestic and export market.
- Company is focused on the retail/trade segment, which contributes ~80% to its volumes (v/s ~60% for the industry). It has a large distribution network of over 7,800 dealers and 25,000 retailers across 24 states, giving it strong positioning in semi-urban and rural markets. It enjoys very strong brand equity and market leadership in its key markets.

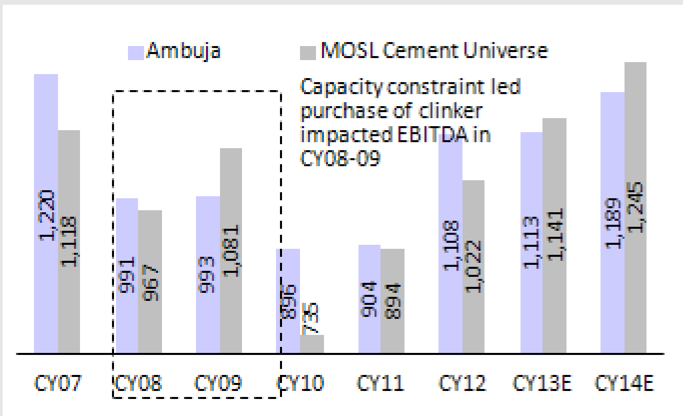
Lack of timely capacity addition could restrict growth in CY14-15

- Post its expansion cycle over CY09-11, ACEM has installed clinker/cement capacity of 16.4m/27.5m tons. While it can further debottleneck clinker capacity to match its grinding capacity requirement, in case of higher than estimated growth of 8% CAGR (CY12-14E), ACEM would be constrained for capacity like in CY08-10.
- Company's existing clinker capacity of ~16.5mt is only sufficient for annual cement production of ~24mt, which is 9% growth over CY12.
- Its capacity expansion of 4.5m tons at Rajasthan would commence operations only in CY15.
- We expect ACEM's dispatches to grow 8% annually in CY13E/14E (implied utilization of 86%/93%). The Manufacturing Process Review (MPR) conducted by Holcim should lead to some de-bottlenecking of clinker capacity (e.g. clinker capacity at Rabriyawas plant would increase to 2m tons from the current 1.86m tons) and drive near term volume growth.

Limited clinker capacity may curb volume growth…

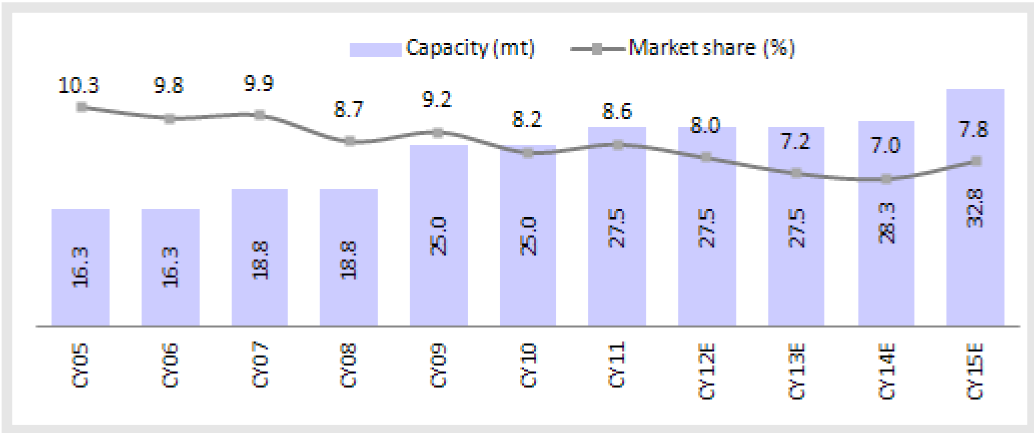


…or impact profitability, like in CY08-10



Source: Company, MOSL

ACEM's share in industry capacity to decline



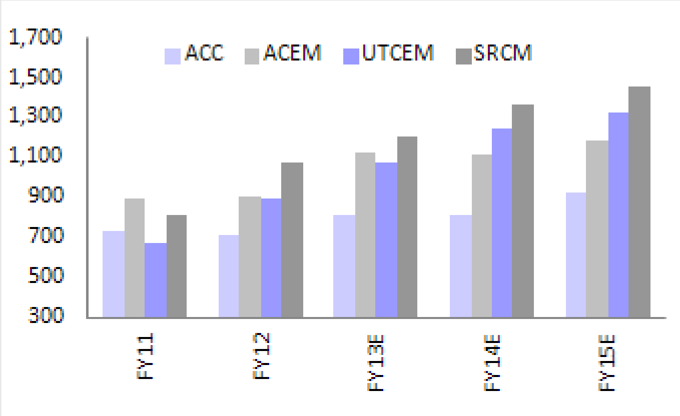
Source: Company, MOSL

- ACEM's share in industry capacity has been diminishing due to slower pace of capacity addition. We expect its capacity share to reduce further over CY13E-14E, given that ACEM has no major capacity additions during this period.
- Any sharp recovery in demand over CY12-14, would test ACEM's ability to grow in line with the market without compromising profitability (like in CY08-10, when it had to buy clinker to maintain volume growth).

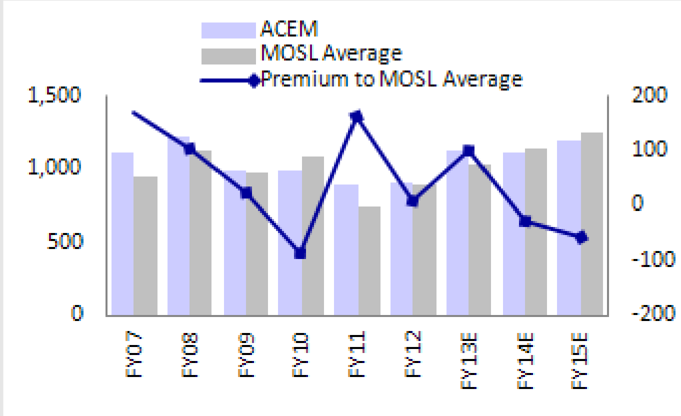
Profitability premium to peers to dilute

- Historically, ACEM has enjoyed superior profitability, driven by (1) focused market mix (North, East and West, with minimal exposure to the South), (2) segment mix (almost 80% in the non-volatile trade segment), and (3) cost advantage in the form of higher blending (~1.4x), diversified fuel mix and freight mix.
- However, we expect a steady dilution in its premium on profitability over peers hereon due to (1) limited scope to uptick in operating leverage, and (2) impact of increased royalty to Holcim.
- Further, potential risk to profitability exists in the form of a) gradual reduction in subsidies over next 4-5 years, b) further increase in royalty from CY15 and c) capacity constrained led lower volume/higher cost in CY14/15.
- Subsidies from the government contributed ~INR4.3b or ~INR200/ton to EBITDA in CY11, which we believe should gradually reduce over the next 4-5 years.
- Cost savings triggers that ACEM could witness are restricted to various initiatives like usage of alternate fuel to reduce consumption rate, manufacturing synthetic gypsum, acquisition of fly ash manufacturer etc.

EBITDA/ton trend v/s large cap peers (INR)



Profitability premium to MOSL average to dilute (INR/ton)



Source: Company, MOSL

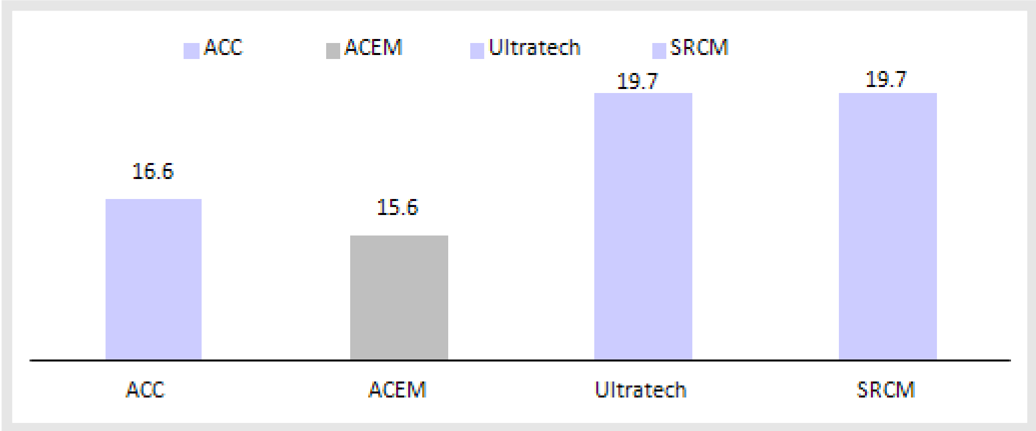
Royalty increase to hurt CY13E/14E EPS, threat of further revision from CY15E

- Increase in royalty fees of 1% (v/s proposal of 2%) to Holcim (in lieu of fixed fees paid) will impact ACEM's CY13E/14E EPS moderately by 3-4% (for effective increase in royalty of 0.6-0.7%). However, it introduces a mere uncertainty to ACEM's cost structure as the board is authorized to review and revise future royalty (from CY15 as 1% royalty is fixed for CY13-14).
- Recent increase in royalty for PT Holcim Indonesia (from existing 1.5% to 5% from CY13) increases the discomfort over future royalty for ACEM.
- Initial royalty proposed was ~2%, which was later reduced to 1% on intervention of the independent directors. Interestingly, two of these seven independent directors, viz Mr M.L.Bhakta and Mr Naresh Chandra are stepping down at the forthcoming AGM. While Mr M.L.Bhakta has been on the board since September 1985, Mr Naresh Chandra has been on the board since July 2008.
- Considering these developments, further increase in royalty, post CY14, is a risk and could further dilute ACEM's profitability.

Lowest earnings growth and low sensitivity of earnings to cement prices

- ACEM has the lowest EPS CAGR of 15.6% (CY12-14E) among its comparable peers, which are expected to post 17-20% CAGR.
- ACEM has one of the lowest price and cost sensitivity among large cap peers as seen from the below illustration that delta in EPS caused by 1% change in price, cost and volume.
- ACEM's lower sensitivity reduces earnings volatility in a down-cycle, but also restricts upside in an up-cycle. Top quartile operating efficiencies mean lower scope of improvement in an up-cycle/improving market environment.
- While it has relatively higher sensitivity to volume increase, constraint in clinker capacity could curb the advantage if demand posts positive surprise (as discussed in the earlier section).
- In the backdrop of (a) steady pricing resilience and (b) moderating cost escalations, ACEM is likely to witness the least upside among large caps on account of positive surprises on volume/price/cost.

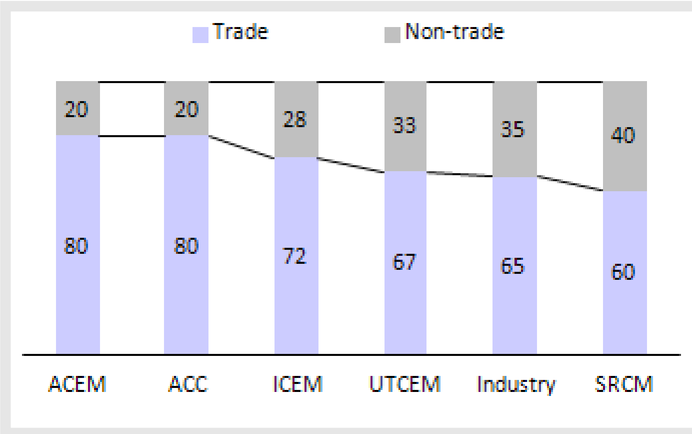
ACEM to witness slowest EPS CAGR (CY12-14E)



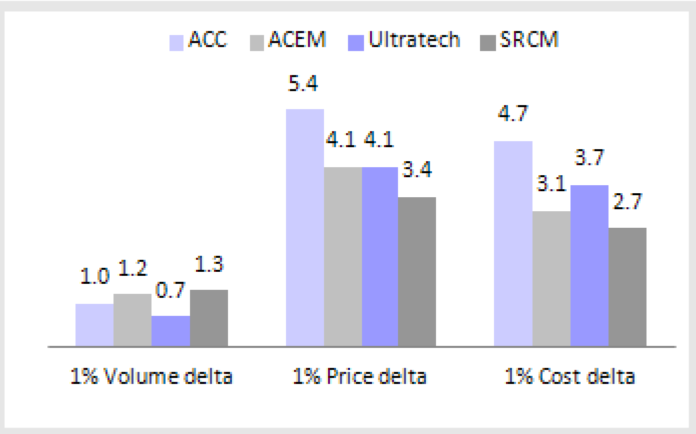
Source: Company, MOSL

Has been a defensive play due to limited scope of operational improvement

ACEM derives ~80% of volumes from trade segment, where prices are less volatile and it enjoys premium pricing



ACEM's lower EPS sensitivity (%) to price/cost offers moderate upside in an up-cycle, while its higher volume sensitivity may face capacity constraint



Source: Company, MOSL

ACEM: CY14E performance sensitivity to cement prices

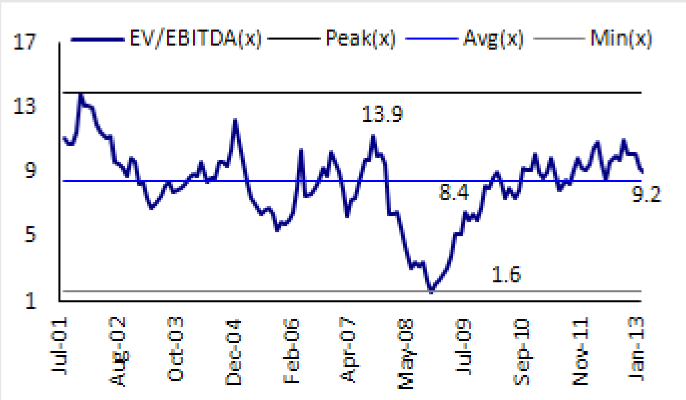
Cement Price chg over CY14 (INR/Ton)	EBITDA/Ton (INR/Ton)	EPS INR	P/E (x)	EV/ EBITDA (x)	EV/Ton (USD)	TP at 9x EV/EBITDA (INR)	Net Debt (INR m)	EV/Ton at TP (USD)
-100	839	9.4	22.4	12.1	177	152	-46,583	123
0	939	10.5	20.0	10.8	176	167	-48,205	137
100	1,039	11.7	18.0	9.7	175	181	-49,827	150
250	**1,189**	**13.4**	**15.7**	**8.4**	**173**	**202**	**-52,259**	**170**
300	1,239	14.0	15.0	8.0	173	210	-53,070	177
400	1,339	15.1	13.9	7.4	171	224	-54,692	190
500	1,439	16.2	12.9	6.8	170	238	-56,314	204
600	1,539	17.4	12.1	6.3	169	253	-57,936	217

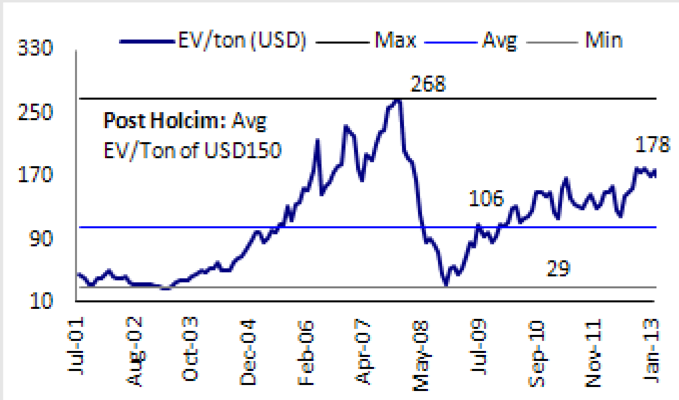
Source: Company, MOSL

Valuations factor premium profitability; Downgrading to Neutral

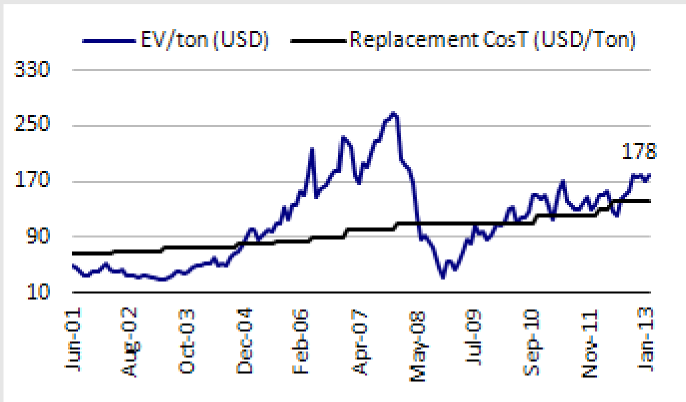
- **Re-rated, in line with expectations:** Due to its cost leadership and favorable business mix, ACEM has been our preferred large cap cement stock (we upgraded ACEM to Buy; refer to report dated 16 May 2012). The stock has outperformed peers and has been re-rated in line with our expectations. It is now trading at 14%/12% premium to ACC/UltraTech (on EV/EBITDA basis), and at par to replacement cost.
- **Business outlook unaltered, but no further re-rating expected:** Operationally, we expect ACEM's strong earnings growth to continue. Its superior profitability and earnings growth also justifies valuation premium. However, we expect no further re-rating going forward, given that current valuations (both in terms of EV/ton and EV/EBITDA) are nearing the upper range. ACEM is trading at premium valuations - EV of 9.7x CY13E EBITDA and 7.9x CY14E EBITDA. Also, asset valuations at USD172/ton for CY13E and USD157/ton for CY14E are at a premium to replacement cost.
- **Downgrading to Neutral on rich valuations; lower target price to INR202:** The low sensitivity of ACEM's earnings to cement prices/input costs and its superior operating efficiency result in limited scope for positive surprise. We believe current valuations are pricing the cost leadership and superior profitability. We downgrade the stock from a Buy to **Neutral** and value it at 8x CY14E EV/EBITDA (v/s 9x earlier) to factor the risk of further increase in royalty, potentially slower-than-industry growth in CY14-15 and gradual reduction in subsidies. Our target price is INR202.

Both earnings-based (EV/EBITDA) and asset-based (EV/ton) valuations are nearing the upper end

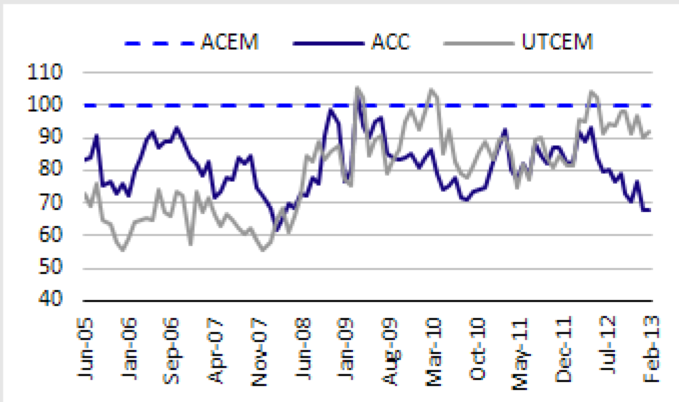




Trading at significant premium to replacement cost

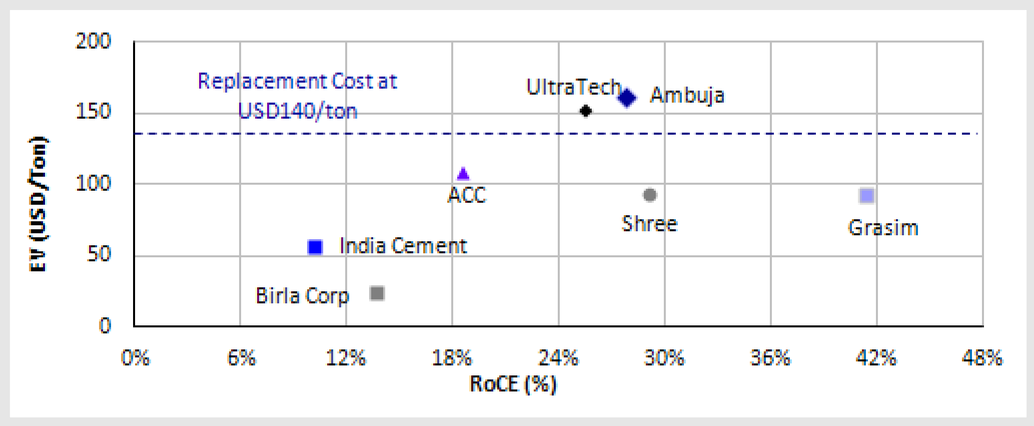


Comparative EV/ton (Indexed to ACEM)



Source: Company, MOSL

Lower upside potential compared to peers



Source: Company, MOSL

Financials and Valuation

Income Statement (INR Million)

Y/E December	2010	2011	2012E	2013E	2014E
Net Sales	**73,902**	**85,043**	**96,749**	**108,894**	**124,018**
Change (%)	4.4	15.1	13.8	12.6	13.9
Total Expenditure	55,666	65,656	72,074	82,467	93,522
% of Sales	75.3	77.2	74.5	75.7	75.4
EBITDA	**18,236**	**19,387**	**24,675**	**26,428**	**30,496**
Change (%)	-2.3	6.3	27.3	7.1	15.4
Margin (%)	24.7	22.8	25.5	24.3	24.6
Depreciation	3,872	4,452	5,373	5,144	5,322
EBIT	**14,364**	**14,935**	**19,302**	**21,284**	**25,174**
Int. and Finance Charges	487	526	757	672	625
Other Income - Rec.	2,476	2,978	4,042	4,600	5,350
PBT before EO Exp.	**16,353**	**17,387**	**22,588**	**25,212**	**29,899**
EO Expense/(Income)	-265	358	3,570	0	0
PBT after EO Exp.	**16,619**	**17,029**	**19,018**	**25,212**	**29,899**
Current Tax	3,532	3,613	6,048	7,059	8,372
Deferred Tax	450	1,127	0	756	897
Tax Rate (%)	24.0	27.8	31.8	31.0	31.0
Reported PAT	**12,636**	**12,289**	**12,971**	**17,397**	**20,630**
PAT Adj for EO Items	**12,434**	**12,547**	**15,435**	**17,397**	**20,630**
Change (%)	4.7	0.9	23.0	12.7	18.6

Balance Sheet (INR Million)

Y/E December	2010	2011	2012E	2013E	2014E
Equity Share Capital	3,060	3,069	3,084	3,084	3,084
Total Reserves	70,241	77,626	84,966	95,065	107,617
Net Worth	**73,301**	**80,694**	**88,051**	**98,149**	**110,701**
Deferred Liabilities	5,309	6,436	5,483	6,239	7,136
Total Loans	650	466	395	500	500
Capital Employed	**79,260**	**87,597**	**93,929**	**104,888**	**118,337**
Gross Block	87,788	96,118	99,356	102,356	106,356
Less: Accum. Deprn.	31,511	35,158	40,531	45,675	50,997
Net Fixed Assets	**56,278**	**60,960**	**58,825**	**56,681**	**55,359**
Capital WIP	9,307	5,773	5,000	10,000	16,000
Investments	6,260	8,643	16,558	19,478	25,578
Curr. Assets	**31,353**	**40,043**	**43,864**	**49,226**	**56,063**
Inventory	9,019	9,250	9,839	11,934	13,591
Account Receivables	1,282	2,409	2,134	2,983	3,398
Cash and Bank Balance	17,482	20,691	22,537	23,867	27,182
Others	3,571	7,694	9,353	10,442	11,892
Curr. Liability & Prov.	**23,942**	**27,822**	**30,318**	**30,498**	**34,663**
Account Payables	12,976	15,909	15,904	14,686	16,655
Provisions	10,966	11,913	14,414	15,812	18,008
Net Current Assets	**7,412**	**12,221**	**13,545**	**18,728**	**21,400**
Misc Expenditure	5			0	0
Appl. of Funds	**79,260**	**87,597**	**93,929**	**104,888**	**118,337**

E: MOSL Estimates

Financials and Valuation

Ratios

Y/E December	2010	2011	2012E	2013E	2014E
Basic (INR)					
EPS	**8.1**	**8.2**	**10.0**	**11.3**	**13.4**
Cash EPS	10.7	11.1	13.5	14.6	16.8
BV/Share	47.8	52.4	56.9	63.5	71.6
DPS	2.6	3.2	3.5	4.0	5.0
Payout (%)	36.7	46.7	49.8	41.3	39.2
Valuation (x)					
P/E		24.4	20.0	17.7	14.9
Cash P/E		18.0	14.8	13.7	11.9
P/BV		3.8	3.5	3.1	2.8
EV/Sales		3.2	2.7	2.3	1.9
EV/EBITDA		14.0	10.7	9.7	7.9
EV/Ton (Cap) - US$		183	178	172	157
Dividend Yield (%)		1.6	1.8	2.0	2.5
Return Ratios (%)					
RoE	18.1	16.3	18.3	18.7	19.8
RoCE	24.1	23.2	27.6	27.7	29.2
Working Capital Ratios					
Asset Turnover (x)	0.9	1.0	1.0	1.0	1.0
Debtor (Days)	6	10	8	10	10
Working Capital Turnover (Days)	37	52	51	63	63
Leverage Ratio (x)					
Current Ratio	1.3	1.4	1.4	1.6	1.6
Debt/Equity	0.0	0.0	0.0	0.0	0.0

Cash Flow Statement (INR Million)

Y/E December	2010	2011	2012E	2013E	2014E
Op. Profit/(Loss) before Tax	18,236	19,387	24,675	26,428	30,496
Interest/Dividends Recd.	2,476	2,978	4,042	4,600	5,350
Direct Taxes Paid	-3,983	-4,740	-6,048	-7,816	-9,269
(Inc)/Dec in WC	3,617	-1,600	522	-3,853	643
CF from Operations	**20,347**	**16,025**	**23,192**	**19,359**	**27,220**
EO Income	265	-358	-3,570	0	0
CF from Op. incl EO Exp	**20,612**	**15,666**	**19,622**	**19,359**	**27,220**
(inc)/dec in FA	-7,870	-5,600	-2,465	-8,000	-10,000
(Pur)/Sale of Investments	965	-2,384	-7,915	-2,920	-6,099
CF from Investments	**-6,905**	**-7,983**	**-10,381**	**-10,920**	**-16,099**
Issue of Shares	618	846	848	-117	0
(Inc)/Dec in Debt	-534	948	-1,024	861	897
Interest Paid	-487	-526	-757	-672	-625
Dividend Paid	-4,632	-5,741	-6,463	-7,181	-8,078
CF from Fin. Activity	**-5,035**	**-4,474**	**-7,395**	**-7,109**	**-7,806**
Inc/Dec of Cash	**8,673**	**3,209**	**1,846**	**1,330**	**3,315**
Add: Beginning Balance	8,809	17,482	20,691	22,537	23,867
Closing Balance	**17,482**	**20,691**	**22,537**	**23,867**	**27,182**

N O T E S

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