Shree Cement SHCM.NS SRCM IN

CONSTRUCTION MATERIALS

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EQUITY RESEARCH

Surprisingly high volume growth

Quick Note

August 23, 2012

Rating Remains	**Neutral**
Target price Remains	INR 2906
Closing price August 22, 2012	INR 3258

Shree Cement's reported numbers for their extra quarter of their 15-month year of FY12, which were better than our expectations on all accounts i.e. 1) surprisingly high implied volume growth of 40%y-y; 2) better realisations; 3) lower-than-expected costs, especially power & fuel and freight costs (on per-ton basis) and 4) improvement in power business at EBITDA level. The better-than-expected operating performance for cement business was reflected in EBITDA per tonne turning out at INR 1,311 per tonne, up 33%y-y and 31%q-q and significantly ahead of our estimates of INR 981 per tonne. Bottom line was boosted by much lower-than-expected depreciation as well as tax write back, allowing the company to post a record high profit of INR 3.5bn.

We are surprised at the high volume growth that Shree Cement has witnessed during the quarter which is leaps and bounds ahead of the YoY volume growth of 2%-5% reported by the other companies under our coverage. This especially in an environment of pricing discipline where companies focus more on pricing at the cost of market share.

With cement prices not witnessing any pressure to correct (even the normal monsoon correction has been more muted this time round leaving aside a couple of states) and costs looking much more stable than they have done in the past two years, profitability of cement companies in FY13 could move above the mid-cycle range. Our target price and estimates for Shree Cement are under review.

Cement business – Surprisingly high volume and lower cost

- The company's cement revenue at INR14.5bn (+41% y-y and -2% q-q) was significantly ahead of our estimates of INR 12.9bn, on account of higher realisation.
- As per the company, cement realisation was at INR 190 per bag (or INR 3,805 per tonne), up INR 19 per bag q-q, slightly higher than our expectations of INR 14 per bag. This is the same increase as reported by other companies under our coverage. Based on these realisations, the revenue from cement business at INR 12.8bn would imply volume for the company grew by 40% y-y during the quarter. Volume data for Apr and May'12, available with us, showed a growth of 28% YoY which implies that in June volume was up by 43%y-y, which is extremely surprising to us. June sales volume at 1.2mnT would mean a capacity utilisation of 89%, in line with peak-period utilization.
- On the cost front as well, there was a positive surprise as total cost per tonne at INR 2,494 turned out to be 9% lower than our estimates, benefitting from higher operating leverage as well as lower power & fuel costs and freight cost per tonne.
- Power and fuel cost at INR 616/ton (-10% y-y and +7% q-q) were significantly lower than our estimates of INR 700/ton. We had expected higher power and fuel cost, led by a increase of 15% in international pet coke prices in the Jun'12 quarter along with a 11% depreciation in the INR vs. the USD.

Research analysts

India Construction Materials

Aatash Shah - NFASL
aatash.shah@nomura.com
+91 22 4037 4194

Vineet Verma - NSFSPL
vineet.verma@nomura.com
+91 22 4037 4487

- Shree's freight cost declined on both y-y and q-q basis to INR 699/ton despite a ~20% increase in railway freight in March12. Based on the company's freight mix (Road: rail: 75:25), we has expected an increase of nearly INR 30 per tonne in freight cost from the previous quarter (at INR 710/ton).
- On account of surprisingly higher volumes and lower cost, EBITDA/ton at INR 1,311 per ton (+33%y-y & 31%q-q) beat our estimates by 34%.

Power business – Improvement in EBITDA/unit; new PPA could be at a lower realisation

- For the power business, sales at 390mn units, down 10% sequentially, was lower than our expectations (~450mn units) as we had expected higher offtake in merchant power sales on the back of commissioning of its second 150MW power plant. Realisation at INR 4.3 per unit was in line, but EBITDA per unit improved to INR 0.9 per unit (vs. 0.5 per unit in 4QFY12), benefiting from lower reported pet coke prices, in our view. We believe there is some downside risk to our merchant power sales estimates as there is a lack of clarity as far as future power sales are concerned given that its short-term power purchase agreement (PPA) with state electricity boards expired in Jun 12. The company has not yet announced any further tie-ups for power sales but suggested that a new contract is in the works and could be at an 8% lower realisation than the current one.

Bottom-line: Record profit; helped by much lower depreciation & tax rate

- On account of better-than-expected performance of both cement and power business, EBITDA at INR 4.8bn (+86%y-y & 29%q-q) turned out 53% and 24% higher than our as well as consensus estimates, respectively.
- Due to better operating performance coupled with lower depreciation and tax write back, the company reported record quarterly profit of INR 3.5bn (+540%y-y & 207%q-q). In the past, the company has exhibited significant volatility in depreciation due to accelerated depreciation on commissioning of new plants.
- Depreciation was nearly INR 1.5bn lower from the previous quarter and was the lowest in the last three years. The company has guided for INR5 bn of depreciation during FY13.
- There was a tax write back of INR 0.6bn on previous year tax provisions which resulted in an extremely low tax rate of 8%. Historically, the company's tax rate has been very volatile and difficult to predict.

Fig. 1: Per tonne analysis

	Jun-11	Mar-12	Jun-12	(y-y)%	(q-q)%	Jun-12F (Nomura estimates)
Volumes	2.42	3.47	3.37	39%	-3%	2.95
Realisation / tonne	3,790	3,432	3,805	0%	11%	3,712
Cost / tonne- Cement	2,805	2,431	2,494	-11%	3%	2,731
EBITDA / tonne - Cement	985	1,001	1,311	33%	31%	981
Cost analysis						
RM / tonne	470	424	404	-14%	-5%	454
Staff Cost / tonne	253	175	221	-12%	27%	234
Power & Fuel Cost / tonne - Cement	793	578	616	-22%	7%	700
Freight Cost on internal material transfer / tonne	186	-	-	NA	NA	-
Freight Cost (finished good) / tonne	737	710	699	-5%	-2%	740
Depreciation / tonne	660	677	243	-63%	-64%	796
Other operating expenses / tonne	366	545	553	51%	1%	572

Note: Freight cost on internal material transfer has been clubbed into other operating expense from Mar12. Volume in million tons. All other INR.
Source: Company data, Nomura estimates

Fig. 2: Snapshot of 5QFY12 results

INRm

	Jun-11	Mar-12	Jun-12	(y-y)%	(q-q)%	Jun-12F (Nomura estimates)
Net Sales	10,340	14,778	14,553	41%	-2%	12,900
Other Operating Income	0	2	-	-100%	-100%	2
Total Income	**10,340**	**14,780**	**14,553**	**41%**	**-2%**	**12,901**
Expenses	**7,749**	**11,048**	**9,741**	**26%**	**-12%**	**9,754**
Change in stock	172	12	39	-77%	225%	-
Raw Materials consumed	966	1,457	1,324	37%	-9%	1,342
Purchase of traded goods	154	1,017	-	-100%	-100%	90
Total Raw Material cost	*1,292*	*2,486*	*1,362*	*5%*	*-45%*	*1,433*
Freight on internal material transfer	449			NA	NA	-
Staff Cost	612	605	746	22%	23%	691
Power & Fuel Cost	2,728	3,611	3,415	25%	-5%	3,755
Freight Cost	1,782	2,459	2,355	32%	-4%	2,185
Other Operating expenses	886	1,887	1,863	110%	-1%	1,690
EBITDA	**2,591**	**3,732**	**4,812**	**86%**	**29%**	**3,147**
Other Income	0	370	322	544815%	-13%	30
Operating profit	**2,591**	**4,102**	**5,133**	**98%**	**25%**	**3,177**
Depreciation	1,598	2,346	818	-49%	-65%	2,350
EBIT	**994**	**1,756**	**4,315**	**334%**	**146%**	**827**
Interest	**318**	**8**	**480**	**51%**	**5677%**	**229**
EBT	**675**	**1,748**	**3,836**	**468%**	**119%**	**598**
Exceptional items	83	28	1	-99%	-98%	
PBT (after exceptional items)	**592**	**1,720**	**3,835**	**548%**	**123%**	**598**
Tax	43	576	320	640%	-44%	120
PAT	**549**	**1,143**	**3,515**	**540%**	**207%**	**478**
Segment reporting				(y-y)%	(q-q)%	
Revenue (net sales)	**Jun-11**	**Mar-12**	**Jun-12**	**(y-y)%**	**(q-q)%**	**Jun-12F (Nomura estimates)**
Net Sales	10,340	14,778	14,553	41%	-2%	12,900
Cement	9,169	11,891	12,823	40%	8%	10,965
Power	1,171	2,888	1,730	48%	-40%	1,935
Power sales (mn units)	**238**	**431**	**390**	64%	-10%	**450**
Realisation per unit	4.3	4.3	4.3	1%	1%	4.3
EBITDA per unit	0.9	0.56	0.9	1%	63%	0.6

Source: Company data, Nomura estimates

Appendix A-1

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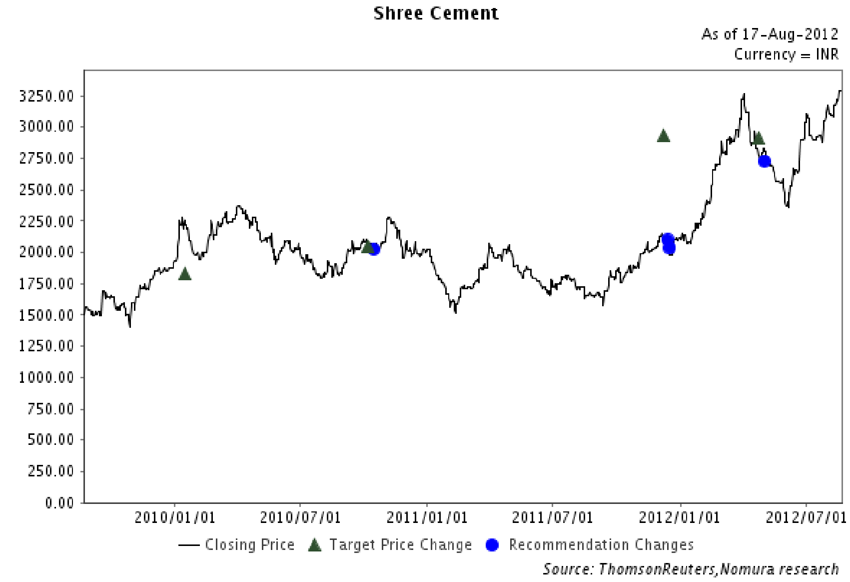
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Shree Cement	SRCM IN	INR 3258	22-8-2012	Neutral	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
Shree Cement	Buy	23-4-2012

Shree Cement (SRCM IN) **INR 3258 (22-8-2012)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
23-Apr-12	Neutral		2,776.20
23-Apr-12		2,906.00	2,776.20
08-Dec-11	Buy		2,086.35
08-Dec-11		2,933.00	2,086.35
05-Dec-11	Not Rated		2,145.65
06-Oct-10	Neutral		2,069.60
06-Oct-10		2,044.00	2,069.60
15-Jan-10		1,829.00	2,220.50

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology We base our target price of INR2,906 for Shree Cement on a sum-of-the-parts valuation. We value its cement business on a mid-cycle multiple to current replacement cost after adjusting for the ratio of one-year forward ROCE to mid-cycle ROCE. Based on this, we value Shree's cement business at a par to current replacement cost. Separately, we have valued its power portfolio (~400 MW) at 6x EV/EBITDA, nearly a 40% discount to that of large power-generating companies.

Risks that may impede the achievement of the target price Due to the geographical concentration of Shree's capacity in north India, any potential slowdown in infrastructure sector/construction activity in the northern region would result in lower sales volume growth/realisation, one of the key downside risks to our estimates. Lower power offtake due to the poor health of state electricity boards (SEBs), lower-than-expected prices for merchant power and dependence on imported coal/pet coke for power generation, would significantly impact power earnings for Shree. Better cement and merchant power realisation would be a key upside risk to our estimates.

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