Replacement Cost in Indian Cement Industry

March 5, 2009

The cement industry in India has undergone a major shift over the last 6 years. The increased industrial investments, infrastructure boom and revival of the real estate sector in the last 3-4 years (till a couple of quarters ago) caused the demand for cement to grow at a CAGR of 10.6% over the last 5 years. In addition, cement prices kept heading north due to the supply crunch and cement stocks remained in the limelight.

In response to the spurt in demand and supply constraints, the industry added annual production capacities of 40mn tonnes during FY07-09.

The Indian cement industry attracts investors primarily for two reasons:

- Low per capita consumption of cement in India (just 110Kg, vis-à-vis world average of 230Kg), and
- direct correlation of the industry with the national GDP (1.2 - 1.3x GDP)

The cement industry which offers high visibility of revenues and earnings in phases of high growth, typically loses its sheen during times of economic slowdown. Cement stocks in India outperformed the broader market indexes during the high growth period of FY04-06, while they underperformed in the last 3 bleeding years (FY07-09), much ahead of the eventual deterioration in margins and overall profitability of the underlying companies.

Replacement cost - not an ideal valuation tool in the current times

We reviewed the performance of the cement industry during FY04-09, which covers the high growth phase of FY04-06 and the recent bleeding years FY07-09. Our finding are summarised as follows.

Conclusions

1. Replacement cost (EV / tonne) is losing its significance as a valuation parameter for the cement industry in the current scenario of slowdown in demand, as investors' focus shifts to the earnings potential of individual companies and the payback on investments.
2. High promoter holdings are a major deterrent to opportunities for M&A in the cement industry. It is difficult to imagine that a promoter would be interested in selling out at the low valuations, prevalent currently. In spite of strong balance sheets, Indian cement companies are trading at discounts to their global counterparts, viz., Lafarge and Cemex.
3. We believe high visibility of revenues and earnings will ultimately get reflected in cement stock prices. The bear phase in cement stocks began much ahead of the deterioration of financials of cement companies.
4. The current cement industry scenario is hardly exciting, due to the situation of demand slowdown and anticipated oversupply.
5. Valuations are dominated by the quality of earnings and the leverage of individual companies.

Cement stocks underperformed broad market indexes

Post-January 2008, most cement stocks have underperformed broad market indexes, the Sensex and the Nifty.

Most cement companies have been trading in the $20 - $110 (EV / tonne) range, well below their replacement cost or cost of setting up a green-field cement plant, estimated at $120 / tonne, i.e., at a discount of 17% - 96%. The only exception is Chettinad Cement, which is trading at a premium of 152%.

Apart from the slowdown in demand for cement, a few other reasons which led to the "rationalization" of valuations include:

- the anticipated de-growth in earnings,
- high promoter stakes (rendering hostile takeovers difficult) and
- the impending over-supply situation over the next 2-3 years.

All these factors can also be considered as key barriers to the consolidation in the industry.

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Valuations in the cement sector are closely linked to its business cycle. While replacement cost is considered more relevant in boom periods, valuations during recessionary periods are influenced by the operating cash flows generating capacity of an individual cement company.

We analyzed such factors which largely influence valuations of a sector. By identifying historical trends, we attempted to identify companies which are better equipped to survive the slowdown and also understand why they fetch premium valuations over other companies, in terms of p/e multiples.

The valuation ratios we considered are:

1. EV per tonne
2. EV/EBITDA (x)
3. P/e (x)
4. P/s (x)
5. P/b (x)

In addition, we considered a few other parameters viz.,

1. Shareholding patterns
2. EBITDA margin
3. Debt / Equity
4. Interest coverage ratios

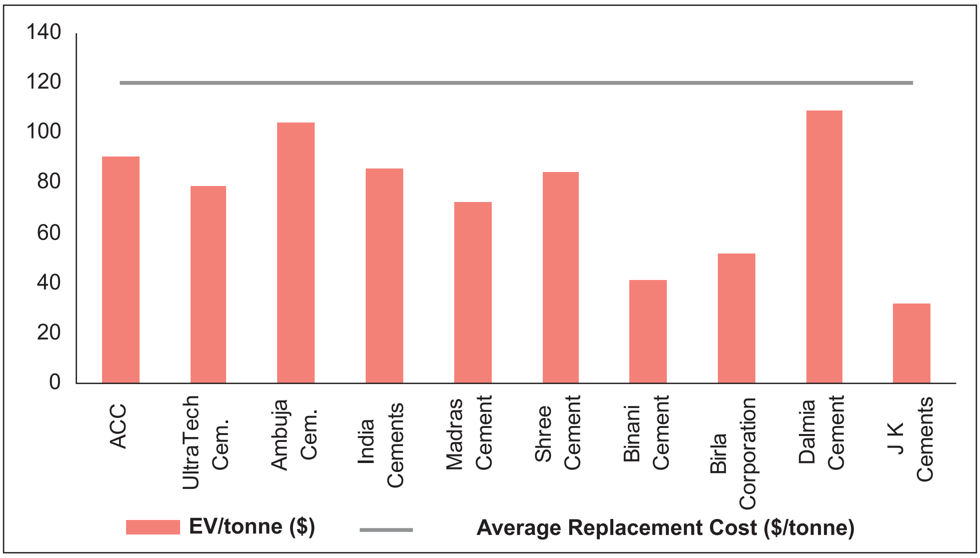
Name of Company	Capacity (mn tpa)	Market Cap (RsCr)	EV/ tonne ($)	P/e (x)	P/b (x)	P/s (x)	EV/ EBITDA (x)	52 week P/e range	
								High	Low
Top 10									
ACC	22.41	10131	90	7.6	1.8	1.2	4.2	16.4	6.3
UltraTech Cem.	19.50	5856	79	5.0	1.8	0.8	3.6	13.0	3.4
Ambuja Cem.	18.50	9661	104	9.1	1.9	1.6	4.6	24.4	7.4
India Cements	9.91	2745	86	5.5	1.1	0.7	4.2	17.5	3.9
Madras Cement	8.59	1415	73	4.6	1.8	0.7	4.2	14.6	3.7
Shree Cement	6.83	1962	85	4.2	2.4	0.6	2.6	12.3	3.1
Binani Cement	6.25	567	42	4.4	1.6	0.4	4.4	16.0	3.6
Birla Corpn	5.78	1201	51	3.1	1.0	0.5	2.5	8.1	1.8
Dalmia Cement	4.00	627	109	3.3	0.6	0.3	4.4	23.5	3.1
J K Cements	4.00	250	32	2.1	0.4	0.2	2.2	10.8	1.9
Middle 10									
JK Lakshmi	3.65	221	33	1.1	0.3	0.2	2.0	6.9	1.0
Sanghi Inds.	2.61	440	105	9.0	1.0	0.7	6.4	27.8	6.6
Rain Commodities	2.50	425	63	11.7	2.9	1.5	8.5	19.1	3.9
Sagar Cements	2.50	211	34	13.5	1.2	0.8	9.0	40.7	8.7
Mysore Cement	2.10	250	25	4.0	1.1	0.6	1.7	11.1	2.1
Chettinad Cement	2.00	1328	179	9.0	3.0	1.1	4.0	11.4	8.4
Prism Cement	2.00	573	58	3.2	0.9	0.6	2.0	13.6	2.5
OCL India	2.00	252	67	2.0	0.4	0.2	2.5	16.1	1.7
Mangalam Cement	2.00	149	21	1.5	0.6	0.2	1.4	6.0	1.4
Saurashtra Cem.	1.50	77	46	0.0	5.6	0.2	8.6	NA	NA
Mini Plants									
K C P	0.66	167	58	3.4	1.0	0.5	2.1		
NCL Inds.	0.63	71	76	2.4	0.7	0.3	3.0		
Anjani Portland	0.40	32	39	2.1	0.9	0.2	2.1		
Keerthi Indus	0.30	124	90	0.0	0.0	0.0	0.2		
Kakatiya Cements	0.30	40	58	2.1	0.5	0.3	2.2		
Barak Valley	0.25	31	50	2.7	0.4	0.4	2.7		
Vinay Cements	0.24	75	74	62.1	1.0	1.7	16.0		
Shiva Cement	0.18	66	86	179.9	1.4	3.0	23.8		

Ownership Patterns of Cement companies well insulated from hostile take-over bids

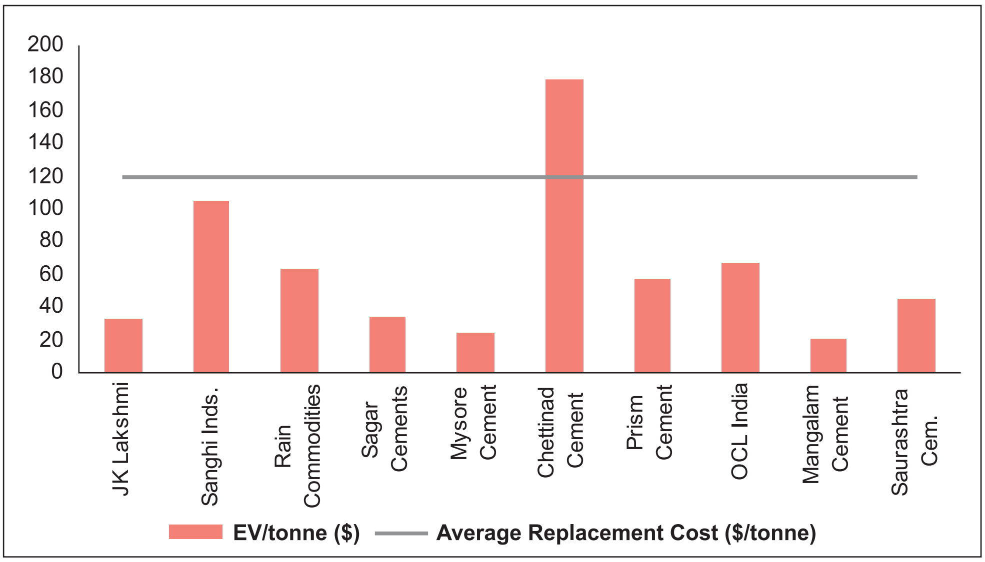
Name of Company	Promoters	Government	Corporates	Institutions	Foreign	Public
Top 10						
ACC	46%	0%	3%	23%	11%	17%
UltraTech Cem.	55%	0%	17%	9%	3%	16%
Ambuja Cem.	46%	0%	1%	16%	27%	10%
India Cements	28%	0%	12%	18%	35%	7%
Madras Cement	42%	3%	11%	18%	3%	24%
Shree Cement	64%	0%	5%	10%	15%	6%
Binani Cement	65%	0%	1%	2%	28%	4%
Birla Corporation	63%	0%	8%	10%	10%	9%
Dalmia Cement	55%	0%	14%	4%	14%	13%
J K Cements	62%	0%	5%	8%	13%	11%
Middle 10						
JK Lakshmi	46%	0%	9%	16%	6%	23%
Sanghi Inds.	51%	0%	4%	0%	29%	16%
Rain Commodities	43%	0%	17%	9%	15%	15%
Sagar Cements	44%	0%	27%	5%	12%	12%
Mysore Cement	55%	0%	12%	5%	3%	24%
Chettinad Cement	85%	0%	3%	6%	0%	6%
Prism Cement	62%	0%	9%	0%	5%	24%
OCL India	70%	0%	15%	0%	1%	15%
Mangalam Cement	27%	0%	28%	10%	11%	25%
Saurashtra Cem.	64%	0%	3%	4%	21%	8%
Mini Plants						
K C P	46%	0%	3%	6%	2%	43%
NCL Inds.	42%	0%	6%	0%	0%	51%
Anjani Portland	61%	1%	8%	0%	0%	30%
Keerthi Indus	82%	0%	1%	2%	1%	15%
Barak Valley	60%	0%	10%	0%	0%	29%
Vinay Cements	75%	0%	7%	6%	0%	13%
Shiva Cement	27%	0%	40%	1%	1%	31%

High promoter holding, a major deterrent for better valuations

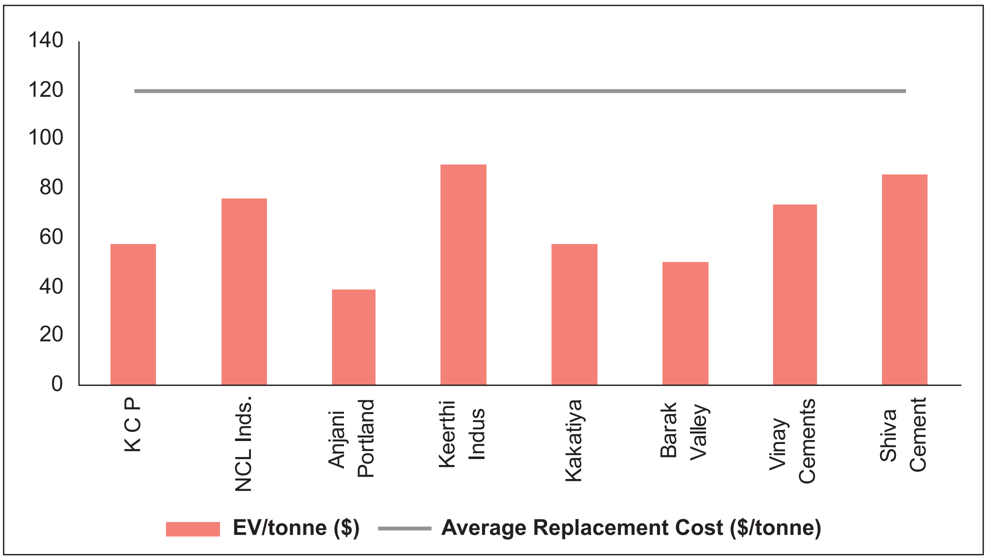
EV / tonne vis-à-vis Average Replacement cost - top 10 companies



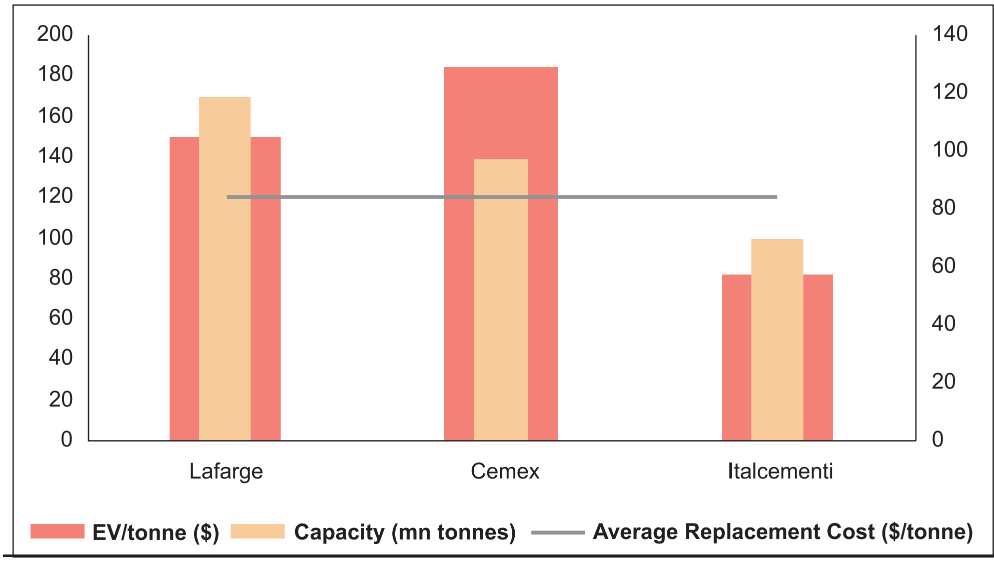
EV / tonne vis-à-vis Replacement cost - Middle 10 companies



EV / tonne vis-à-vis Replacement cost - Mini Plants



Most global leaders in cement trade above Replacement cost



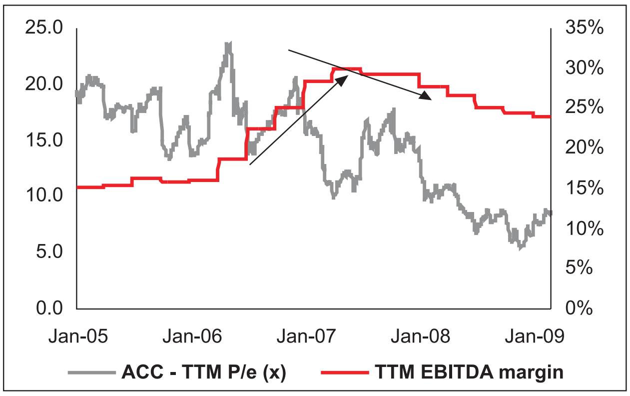
Valuations are closely linked to prospective earnings and cash generation capacity of an individual company in case of slowdown.

Valuation vis-à-vis profitability

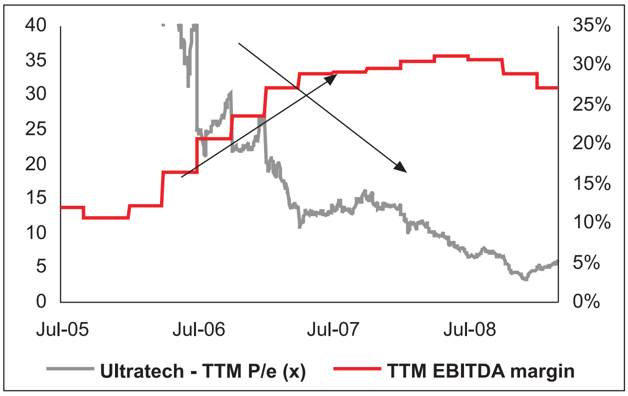
The historical stock performance itself can be an indicator of the future financial performance of a cement company. We observe that stock prices of cement companies started correcting much before financials started deteriorating, due to the oversupply situation and cement price correction getting factored in into prices.

Though realisations and EBITDA margins remained strong for quite some time, investors had started exiting or partly taking profits in cement stocks much earlier in anticipation of the oversupply situation and impending cement price correction. The slowdown in the economy added further fuel to the fire, as the former is expected to lead to a slower demand growth in the industry.

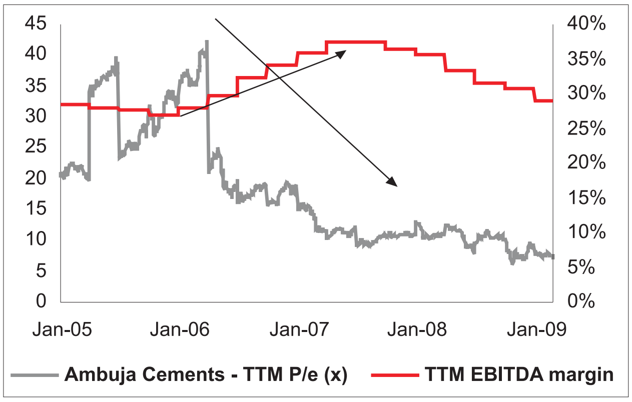
ACC



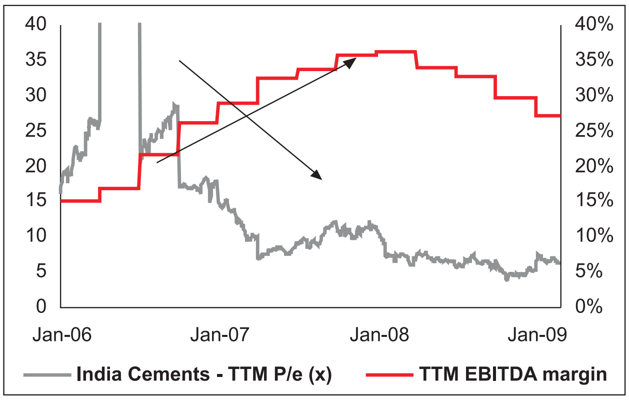
Ultratech Cement



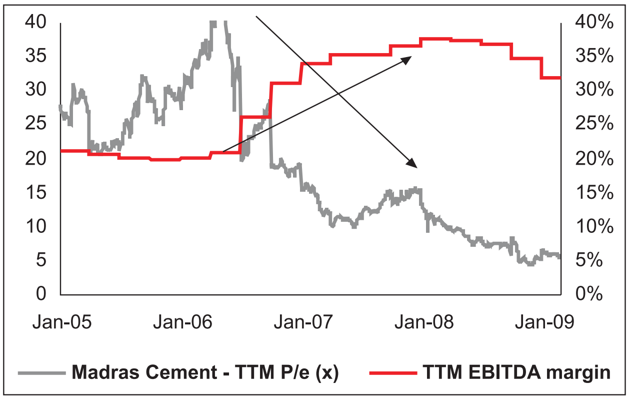
Ambuja Cements



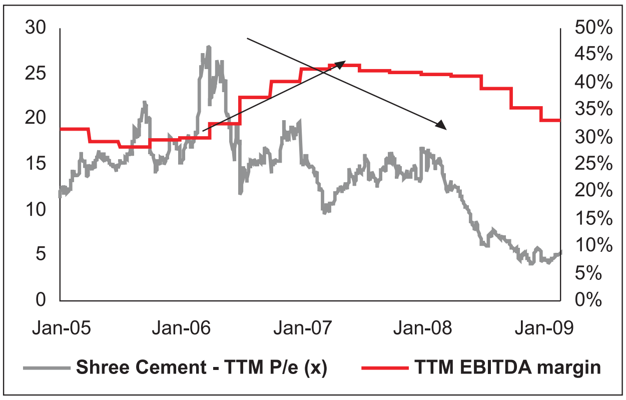
India Cements



Madras Cement



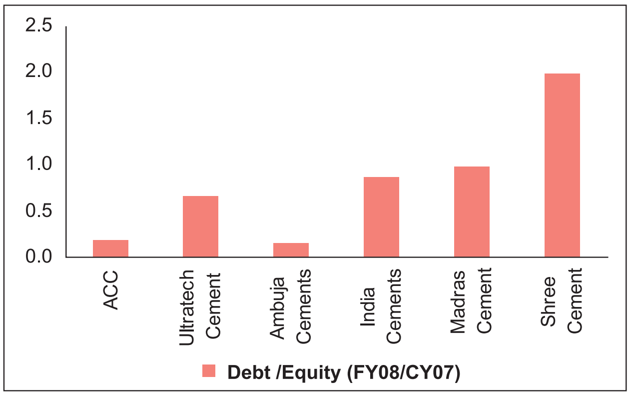
Shree Cement



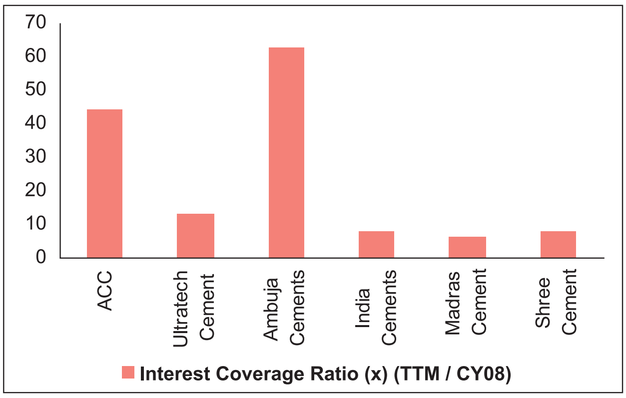
Leverage and debt service capability also determine valuations

P/e valuations are also influenced by the leverage and the coverage of the companies. ACC and Ambuja Cements tradess at a premium vis-à-vis peers, due to better leverage and interest coverage ratios.

Leverage ratios

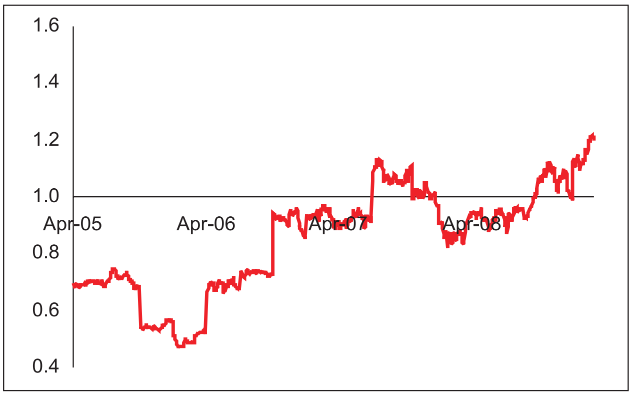


Coverage ratios

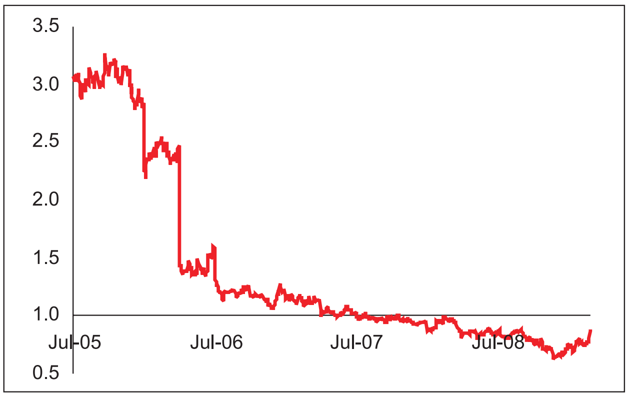


Premium / discount of TTM P/e for top 6 companies vis-à-vis Peer group

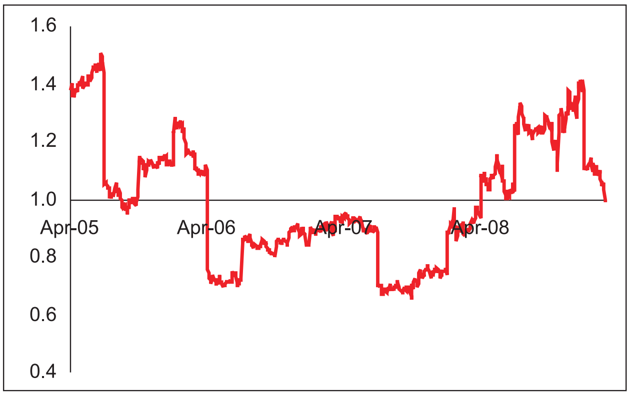
ACC



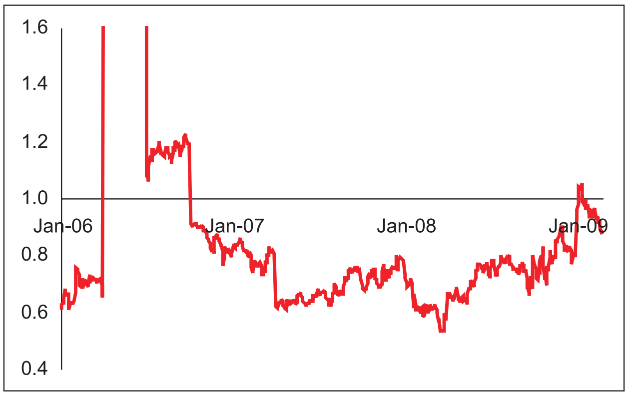
Ultratech Cement



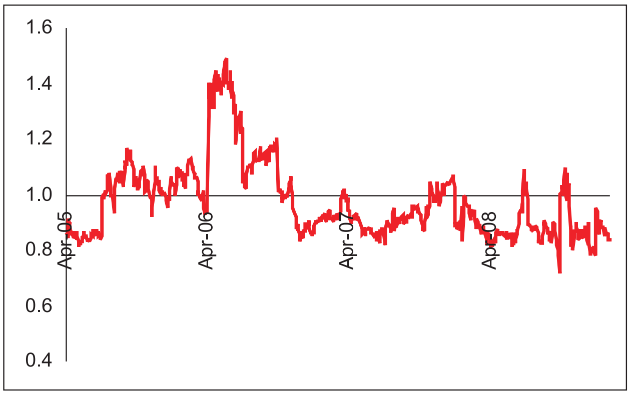
Ambuja Cements



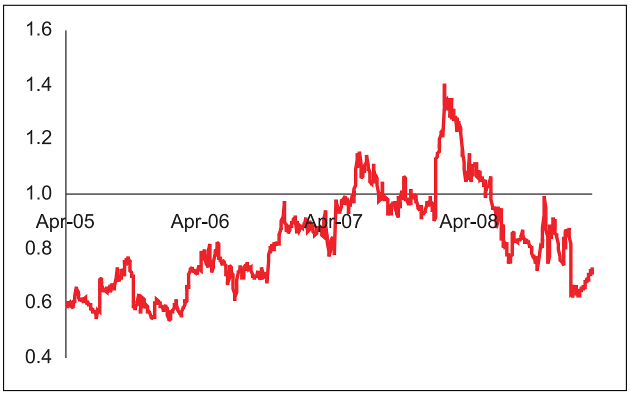
India Cements



Madras Cement



Shree Cement



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