Shree Cement

Buy **Target price: Rs 1,022**

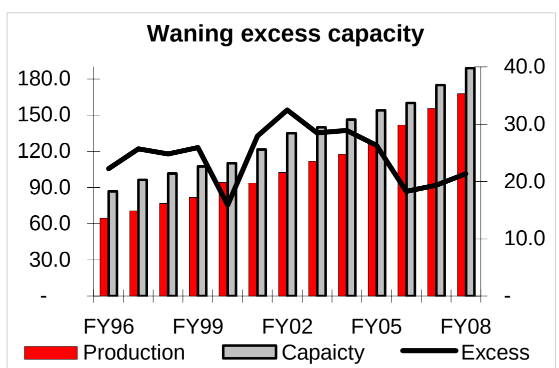
Investment Rationale

- **Attractive valuations:** In the cement sector, we believe that an apt parameter to value a stock would be the Enterprise Value per tonne (EV/tonne)*. It must be noted that if the company were to be bought over, this (EV/tonne) is the likely price at which one would be interested in acquiring it. We are positive on the sector growth going forward owing to the infrastructural activity taking place to support and sustain the current economic growth. However, the upcoming planned capacities are likely to exert downward pressure (the same has started taking place, prices have corrected in the range of Rs 2 to Rs 10 per bag in the northern region) on the realisations. The fall in realisations and rising cost of operations is likely to hurt the margins of the company. Even after factoring these downsides, Shree Cement is trading at an EV/tonne of around Rs 2,047 as per our FY11 estimates, which makes it attractive based on the replacement cost method.

- **Demand and supply, neck to neck:** The cement industry has over the last decade managed an 8% CAGR and we believe this momentum is sustainable (despite the higher base) over the near to medium term. This is on the back of the housing construction boom being witnessed in the country. The importance of the housing sector in cement demand can be gauged from the fact that it consumes almost 70%-80% of the country's cement. Further, as per estimates, there is still a significant amount of unfulfilled demand for dwelling units in the country, which would keep the demand for cement ticking.

  However, investors must note that at the current juncture, not too much should be read into the infrastructure initiatives announced by the government as despite the massive plan outlays for road construction, our interaction with industry sources have revealed that it would lead to only an additional cement demand of 3 to 4 MTPA.

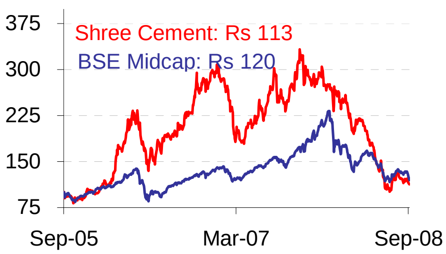
  As you can see in the adjacent chart, the industry had an excess capacity of close to 33 MT a few years back, which had led to a supply overhang in the markets and had a negative impact on realisations. It had also led to poor capacity utilisation. However, with excess capacity declining on the back of increasing demand, the same led to the demand-supply scenario tilting in favour of cement manufacturers.



Market data

Current price	Rs 551 (BSE)
Market cap	Rs 19,195 m
NSE symbol	SHREECEM
BSE code	500387
No of shares	34.8 m
Free float	36.3%
Face value	Rs 10.0
FY08 Div/share	Rs 8.0
52 week H/L	Rs 1695/491

Rs 100 invested is now worth



Stock price performance

	SHRCM*	Index**
1-Yr	-57.8%	-24.6%
2-Yr	-27.2%	1.8%
3-Yr	4.1%	6.2%

*Shree Cement
**BSE Midcap Returns over 1 year are compounded annual averages

Shareholding (June-08)

Category	(%)
Promoters	63.7
Banks,FIs & MF	7.7
FIIs	6.9
Public	10.6
Others	11.1
Total	100.0

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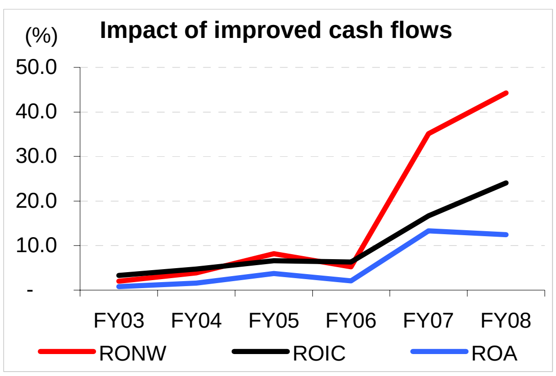
Further, compared to growth in demand, capacity additions happened at a slower rate. Thus, a favorable pricing scenario presented itself to the cement manufacturers in the past two years. Another factor that has changed the landscape of the Indian cement sector is that it is relatively consolidated than what it was 10 years ago. While in 1995 the top 5 cement manufacturers in the country accounted for 26% of industry capacity, now almost 40% is controlled by the top 4 players.

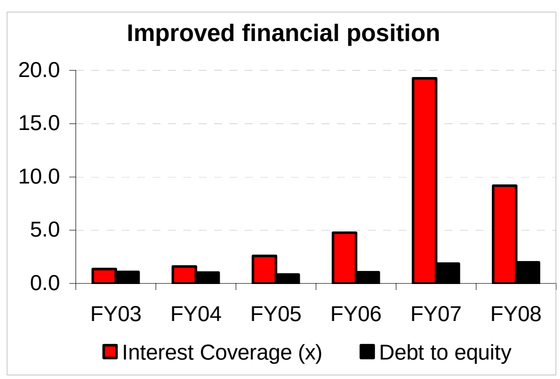
- **Healthier than before:** Post FY04, with the demand inching closer to supply, Shree Cement's realisations improved. Thus, as cash flows improved, the company undertook a debt reduction programme. The debt to equity ratio of the company came down to 0.8 times in FY05 from the highs of 1.1 times in FY03. However, in FY08, the debt to equity ratio of the company went up to 2 times as the company chalked out an aggressive expansion plan. On account of its operational efficiencies and optimal utilisation of funds with a judicious mix of rupee and fully hedged foreign currency loans, the company was able to lower its average interest costs by as much as 550 basis points (5.5%). All of these enabled the company to increase shareholder value as the return on net worth (RONW) improved to 44% in FY08 (5% in FY06). One must also note that the company has been able to improve its physical performance, which is reflected in its improved return on assets.



- **Fares well against the heavyweights:** When compared to Ambuja Cement, which is considered the most profitable cement manufacturer, Shree Cement fares well on the cost front. The cost per tonne of production in FY08 for the company stood Rs 1,899, while for Ambuja Cements the cost of production per tonne stood at over Rs 2,000. This indicates that it is one of the most profitable companies within the sector. In the past 3 years, the company's topline has grown at a CAGR of almost 53%, while the costs grew by 43%. The company's continuous efforts to reduce costs by reducing energy consumed, by seeking alternative use of raw materials and efficient logistics practices has led to operating costs growing at a slower pace.

The company increased its rail despatches on account of truck loading restrictions, increase in diesel prices etc. The company is nearly self sufficient in meeting its power requirements. Improved realisations and efforts to curtail costs resulted in operating profits growing at a CAGR of almost 72% over the past 3 years. However, one must note that going forward, the company needs to de risk its revenues geographically, which it has planned to do, to maintain its current position of being one of the least cost and most profitable cement producers. Considering the need to control costs to further arrest pressure on margins, the company has commissioned a waste heat recovery plant. The move, apart from helping controlling costs, will also enable the company to earn carbon credits.

- **Judicious funding of expansion plans:** The company has raised debt for all its expansion programmes upto Unit VI that is expected to come on stream by FY09. Thus at present, there are no plans for raising any funds in the next 2 years. The company has raised approximately Rs 4 bn in FY08 to fund its expansion plans. The company's average interest cost of additional borrowings has increased by 0.7% to 8.5% in FY08 as compared to 7.8% in FY07. The aggressive plans outlined by the company to scale up its operations necessitated fund raising at a little higher rate. However, its operational efficiencies and optimal utilisation of funds with a judicious mix of rupee and fully hedged foreign currency loans enables the company to lower its risks.



For the period FY08, the interest coverage ratio dropped down to 9 on account of increased borrowings. However, we estimate the company's D/E to hover around 1x as we expect the company to start rationalising its borrowings with improved cash flows.

- **Carbon credits boost earnings:** The whopping growth in other income that gave impetus to the bottomline growth in FY08 will continue till FY10. In FY08, on account of the sale of Carbon Emission Receipts (CER) and income from investments, the company's net profits were inflated by approximately Rs 160 m. The company has the option to sell CERs by July 2010 and hence such income will keep accruing periodically till FY11, giving a boost to net margins.

Investment Concerns

- **Competitive prices:** On the demand front, we expect the northern region to grow in line with the industry driven in part by the forthcoming Commonwealth games, which will result in increased spending on infrastructure by the government and on account of ongoing construction activity. However, with the growth in the sector and waning demand supply gap, producers have lined up capacity expansion plans either through the brownfield or greenfield expansion route.

  The Cement Manufacturers' Association of India (CMA) has estimated cement consumption to go up to 241 MT by FY12 considering 10% growth in cement demand. This level of demand growth would require new capacity to the tune of 80 to 100 MT. On a conservative basis, capacity additions announced till date will add up approximately 40 MT to 50 MT to the existing capacity (203 MT in 1HCY08), the bulk of which will come on stream from FY09 onwards. Thus, we believe that the cement prices will be further pressurised once the planned capacities come on stream (the industry is expected to face excess supply situation), exerting downward pressure on realisations.

- **Focused player:** Cement is a regional play and therefore it helps if a cement company has diversified presence because adverse market conditions in one region can be mitigated by favorable market conditions in the other. However, since Shree Cement is solely focused on the northern region, it is likely to be at the receiving end in case of lower off take of cement from the region or due to any other growth deterrent. In order to diversify its revenue mix, the company is foraying into the southern region. However, the southern region in the past had been affected by excess supply and hence the move is less likely to help achieve the desired result. Going forward, considering the stiff competition, a pan India presence with proper distribution points would be the best strategy in terms of de-risking revenues.

Background

Shree Cement, promoted by the Calcutta-based Bangur group, is North India's largest cement producer with installed capacity of 6.8 MTPA. The company, apart from being an efficient cement manufacturer, is the market leader in the north, with a market share of over 15% within the region. It is also amongst the least cost producers of cement in India and is almost self sufficient in meeting its power requirements.

Riding on the back of rising demand, improved realisations and reduction in interest outgo, the company has been able to improve its overall performance. With the improvement in its financial position, the company plans to increase its capacity to 9 MTPA by the end of FY09.

Key management profile

Mr. B.G. Bangur, Executive Chairman is a B.Com (Hons) from Calcutta University. He is also the director in The Didwana Industrial Corporation Ltd., NBI Industrial Finance Co. Ltd., Shree Capital Services Ltd., Khemka Properties Pvt. Ltd., and Digvijay Finlease Ltd. He is actively associated with various philanthropic and charitable institutions and trusts.

Mr. H.M. Bangur, Managing Director is a chemical engineer from IIT, Mumbai. His technical expertise is the driving force of the technological excellence achieved by the company. He is also a Director in Marwar Textile Agency Ltd. and The Kamla Co. Ltd. He has been elected as the President of Cement Manufacturers' Association (CMA), the prime body for co-ordination, policy making and cooperation of the cement industry in India.

Mr. M.K. Singh, Executive Director, is a fellow Chartered Accountant and Science and Law Graduate. He joined the company as President in January, 1995, and has worked as a senior professional for thirty years. He is the leader of Indian Cement Sector Task force for Energy Conservation, appointed by the Bureau of Energy Efficiency, Ministry of Power, Government of India. He is a member of Cement Sustainability Initiative (CSI) of World Business Council for Sustainable Development. He is also a member of the Cement Task Force of Asia Pacific Partnership on Clean Development and Climate. He is a President of Rajasthan Cement Manufacturers Association and a member on the Board of Shree Cement Marketing Limited.

Risk Analysis

Note: See the 'Risk Matrix' table on the page 6

Sector: In the last decade, cement demand in the country has grown at a CAGR of 8%, which is around 1.2 times GDP growth during the same period. We expect demand to grow at 8% to 10% per annum in the next three years. But in the case of commodities, supply is as important as demand because of its influence on profitability. Timing, therefore, is very critical when it comes to the commodity sector. Though it is impossible to pinpoint when prices will be favourable and vice versa, one could gauge the trend based on the prospective demand-supply equation. Though we are positive on the sector from a long term perspective, we expect cement prices to soften as announced capacities become operational. Taking both these factors into account, we assign a medium-risk rating to the stock on this parameter.

Company standing: Shree Cement is one of the most cost efficient players in the domestic cement industry and is a market leader in the northern region. We thus, assign 'medium' rating to the company on this parameter.

Sales: Shree Cement generated average revenues to the tune of around Rs 10 bn (US$ 227 m) over the last five years. Further, the company is expected to generate revenues to the tune of Rs 21 bn (US$ 467 m) over the next three years. We, thus, assign a low-risk rating of 10 to the stock.

Operating margin: Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as raw materials, wages, and sales and marketing costs. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt. The higher the margin, the better it is for the company as it indicates its operating efficiency. Shree Cement's average operating margin for the past five years has been 37.2% and we expect the same to slide to around 25% levels in the next two to three years. We thus assign a rating of 8 on this parameter.

Long term EPS growth: We expect the company's net profit growth to drop considerably with a CAGR of 13.8% during the period FY08-FY11 (CAGR of 107.9% during FY03-FY08). Based on a normal scenario, we consider a compounded growth of over 20% in net profits over a 5-year period as healthy for a company. Given that the earnings predictability for the commodity sector is on the lower side, we assign a medium-risk rating of 4 to the stock on this parameter.

Return on capital invested (ROIC): ROIC is an important tool to assess a company's potential to be a quality investment by determining how well the management is able to allocate capital into its operations for future growth. A ROIC of above 15% is considered decent for companies that are in an expansionary phase. Considering Shree Cement's last five years' average ROIC of 11.7% and projected average ROIC of nearly 16.5% over the next three years, we have assigned a medium-risk rating of 4 to the stock on this parameter.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. The average payout ratio of Shree Cement has been 49.1% over the past 5 fiscals and we expect the company to maintain the dividend payout ratio at around 15% in the next three years. Thus, the rating assigned on this parameter is 6.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of the quarter June 2008, the promoter holding in the company stood at 63.7%. We have assigned a low-risk rating of 10 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. The FII holding in the company at the end of the quarter June 2008 stood at just 6.9%. Therefore, the rating assigned is 8.

Liquidity: The past 52-week's average daily volume of the stock is in the range of 11,460 shares, which indicates that the stock has inadequate liquidity. Thus, the rating assigned is 1.

Current ratio: Shree Cement's average current ratio during the period FY04 to FY08 has been 2.4 times. This indicates that the company is comfortably placed to pay off its short-term obligations, which gives comfort to its lenders. We assign a low-risk rating of 7.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Shree Cement's average debt to equity ratio over the past five fiscals has hovered around 1.3, which is on the higher side. Going forward, we expect the company to maintain debt to equity ratio at around the same levels. Considering these factors we have assigned a high-risk rating of 2 to the stock.

Interest coverage ratio: It is used to determine how comfortably a company is placed in terms of payment of interest on outstanding debt. The interest coverage ratio is calculated by dividing a company's earnings before interest and taxes (EBIT) by its interest expense for a given period. The lower the ratio, the greater are the risks. Shree Cement's average interest coverage ratio has been around 7.5 times over the past five years and we expect the same to hover around 5 times over the next three years. The rating assigned on this parameter is, thus, 7.

EV/tonne ratio: The EV/tonne (enterprise value per tonne) ratio is a measure that indicates set up or replacement cost of the asset in place. Cement is essentially a commodity where a mere 1% or 2% fall in demand can have a significant impact on prices and hence earnings. EV/tonne is an ideal factor that indicates the likely price at which one would be interested in acquiring a company. To set up a greenfield plant of 1 m tonnes, an investment of Rs 3,500 per tonne is required. At the current market price of Rs 551, the stock of Shree Cement is trading at an EV/tonne of Rs 3,211 based on its FY08 numbers. As such, we have assigned a medium risk rating of 6 to the stock on this parameter.

Considering the above analysis, the total ranking assigned to the company is 73 that, on a weighted basis, stands at 5.6. This makes the stock a medium-risk investment from a long-term perspective.

Industry Prospects

The Indian cement industry is the second largest in the world after China and has grown at a compounded annual growth rate of 8% in the last decade. The sector has evolved significantly in the last two decades, going through all the phases of a typical cyclical industry. After having gone through a period of over-supply and massive capacity additions (latter half of the previous decade), the industry is currently in a consolidation phase, with capacity additions coming up to cater to the increasing demand. Demand has been driven by a booming housing sector and increased activity in infrastructure development such as state and national highways. While the demand is growing at a robust pace of 8% to 10% annually, we believe the current scenario of high realisations is likely to reverse in the medium term once the planned capacities come on stream (the industry is expected to face an excess supply situation).

Valuations

We believe that companies in commodity sectors like cement should be bought at par or below the replacement cost of the asset in place. Even after factoring the above-mentioned downsides, the stock of Shree Cement is trading significantly below its FY11 replacement cost per tonne (Rs 3,500). To be precise, at the current price of Rs 551, the stock is trading at an EV/tonne of around Rs 2,047 as per our medium term estimates. This makes it attractive and hence, we recommend a 'Buy' on the stock with a target price of Rs 1,022 from a March 2011 perspective. The target price translates into a CAGR of 27% or alternatively, a point-to-point return of 85%.

Valuations

(Rs m)	FY08	FY09E	FY10E	FY11E
Net sales (Rs m)	20,659	20,681	21,067	22,007
Net profit (Rs m)	2,604	1,936	1,905	1,670
EPS (Rs)	74.7	55.6	54.7	47.9
Price to earnings (x)	7.4	9.9	10.1	11.5
Price to sales (x)	0.9	0.9	0.9	0.9
Price to B /v (x)	2.9	2.4	2.0	1.7

B/v=Book value

Comparative valuation

Parameter FY08	Shree Cement	Madras Cements	Ambuja Cements*
No. of shares outstanding (m)**	34.8	11.9	1,522.5
Current market price (Rs)	551	2,560	78
Market Cap. (Rs m)	19,195	30,460	118,378
Capacity (m tonnes)	6.8	8.0	18.5
Capacity utilisation (%)	92.9	73.2	91.1
Cement sales (m tonnes)	6.3	5.8	16.8
Sales (Rs m)	20,659	19,247	57,921
Operating profit/ tonne (Rs)	1,362	1,292	1,212
EV/tonne (Rs)	3,211	5,720	5,449
EPS	74.7	343.2	12.1

*CY07 ** As on June 2008

Risk Matrix

		Rating accorded	
Rating	**Weightage* (A)**	**Rating# (B)**	**Weighted (A*B)**
Sector Risk	-	Medium	NA
Company	-	Medium	NA
Performance parameters			
Sales	5.0%	10	0.5
Operating margins	5.0%	8	0.4
Long term EPS growth	10.0%	4	0.4
ROIC	10.0%	4	0.4
Technical parameters			
Dividend payout	5.0%	6	0.3
Promoter holding	10.0%	10	1.0
FII holding	5.0%	8	0.4
Liquidity	10.0%	1	0.1
Safety parameters			
Current ratio	5.0%	7	0.4
Debt to equity ratio	10.0%	2	0.2
Interest coverage ratio	5.0%	7	0.4
EV/tonne	20.0%	6	1.2
Final Rating**		**73**	**5.6**

Rating has been assigned on the basis of the company's performance over the past five years and expected performance over the next 3 to 5 years. Rating is on a scale of 1 to 10, with 1 indicating highest risk and 10 indicating lowest risk. * 'Weightage' indicates the relative importance in percentage terms of the parameter. For instance, for an investor, given all the performance metrics, valuation (say P/E) should be the foremost criteria for buying/not buying stocks. ** The final rating has been arrived at by multiplying the rating/points given on each parameter with the respective weightage

Financials at a glance

(Rs m)	FY08	FY09E	FY10E	FY11E
Sales	20,659	20,681	21,067	22,007
Sales growth (%)	51.0%	0.1%	1.9%	4.5%
Operating profit	8,624	6,719	5,993	5,327
Operating profit margin (%)	41.7%	32.5%	28.4%	24.2%
Net profit	2,604	1,936	1,905	1,670
Net profit margin (%)	12.6%	9.4%	9.0%	7.6%
Balance Sheet				
Net fixed assets	7779	7303	6042	5125
Current assets	10,960	10,583	11,659	12,800
Investments	5,910	5,910	5,910	5,910
Total assets	**24,649**	**23,796**	**23,611**	**23,835**
Current liabilities	4,799	3,330	2,561	2,435
Net worth	6,543	8,159	9,744	11,093
Total debt	13,307	12,307	11,307	10,307
Total liabilities	**24,649**	**23,796**	**23,611**	**23,835**