India Midcaps

RESULT UPDATE

CASTROL INDIA

Price hikes drag volume growth

India Equity Research| Lubricants

Castrol India's (Castrol) Q1CY18 revenue, at INR9.3bn, was up 5% YoY driven by ~2.6% YoY volume growth. However, adjusted for a one-off large institutional (B2B) order in the base quarter, volume grew ~5% YoY. Castrol has hiked prices ~3-4% to cover base oil price rise, ahead of competition. We prune CY18/CY19E EPS 3%/4% as rising crude prices is likely to impact margin amidst Castrol's focus on volume growth. Management expects imminent pricing actions by competition and Castrol raising its dealer margins to lead to higher-than-industry volume growth. Hence, maintain 'BUY' with TP of INR239 (30x CY19E EPS).

Subdued volume growth

Net revenue, at INR 9.3bn, was up 5% YoY (11% below estimate) after a strong 24% YoY surge in Q4CY17. Volume grew ~2.6% YoY to 51,500KL during the quarter. However, on like-to-like basis, after adjusting for a one-off large institutional (B2B) order (~1,150KL) in the base quarter, volume growth came at ~5.0%, in line with industry growth; this led to Castrol maintaining its market share. Volume grew in single digit in CVO and personal mobility (PM) segments (in line with industry growth) and industrials segment declined due to slowdown in the wind industry.

Price hikes to cover rising input cost; margin dips marginally

Average realisation increased ~2.5% YoY to ~INR1,80,000 per KL, in line with the ~3-4% price hike effected by the company. The hike was well ahead of competition and across product categories to offset the impact of rising input cost (base oil cost rose ~3% QoQ). EBITDA margin came at 29.6% (29.9% in Q1CY17) and EBITDA came at INR2.7bn, up 4% YoY (11% below estimate). Management has pegged CY18 industry volume growth at 4-5% YoY and is confident of posting above-industry growth led by imminent pricing actions by competitors and Castrol rising its dealer margins.

Outlook and valuations: Positive; maintain 'BUY'

Price hikes precluded Castrol from surpassing industry's volume growth and enhancing market share. However, imminent pricing actions by competitors and the company paying higher dealer margin are likely to lead to Castrol's volume growing at above-industry rate in CY18. Further, led by Castrol's shift in focus to volume growth, GST benefits and strong RoCE of ~150% over CY18-19E, we maintain **'BUY'** with TP of INR239 based on 30x CY19E EPS. At CMP, the stock trades at 23.1x CY19E EPS.

Financials (Standalone)

Year to December	Q1CY18	Q1CY17	*% change*	Q4CY17	*% change*	CY17	CY18E	CY19E
Net rev. (INR mn)	9,271	8,822	*5.1*	9,703	*(4.5)*	35,850	39,455	42,019
EBITDA (INR mn)	2,743	2,633	*4.2*	3,066	*(10.5)*	10,362	10,885	11,612
Adj. PAT (INR mn)	1,818	1,790	*1.6*	1,967	*(7.6)*	6,939	7,301	7,883
Adj. Dil. EPS (INR)	1.8	1.8	*1.6*	2.0	*(7.6)*	7.0	7.4	8.0
Diluted P/E (x)						26.2	24.9	23.1
EV/EBITDA (x)						17.1	16.2	15.1
ROAE (%)						108.7	100.7	96.3

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EDELWEISS RATINGS	
Absolute Rating	**BUY**
Investment Characteristics	Growth

MARKET DATA *(R: CAST.BO, B: CSTRL IN)*	
CMP	: INR 185
Target Price	: INR 239
52-week range (INR)	: 226 / 172
Share in issue (mn)	: 988.1
M cap (INR bn/USD mn)	: 182 / 2,887
Avg. Daily Vol. BSE/NSE ('000)	: 2,104.3

SHARE HOLDING PATTERN (%)

	Current	Q3FY18	Q2FY18
Promoters *	51.0	51.0	51.0
MF's, FI's & BKs	16.8	16.8	20.2
FII's	10.2	10.2	10.4
Others	22.0	22.0	18.4
** Promoters pledged shares (% of share in issue)*		:	*NIL*

PRICE PERFORMANCE (%)

	BSE Midcap Index	Stock	Stock over Index
1 month	2.3	(11.1)	(13.4)
3 months	(0.1)	2.8	2.8
12 months	11.3	(14.9)	(26.2)

Shradha Sheth
+91 22 6623 3308
shradha.sheth@edelweissfin.com

Shanmuganandam T
+91 22 6623 3357
shanmuganandam.t@edelweissfin.com

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Q1CY18: Key highlights

Sales growth and margin

- Net revenue, at INR9.3bn, was up 5% YoY (11% below our estimate and 3% below consensus estimate) after a strong 24% YoY growth clocked in Q4CY17.
- Gross margin fell marginally (~50bps) to 53.7%, leading to gross profit growth of mere 4% YoY. EBITDA margin came at 29.6% (29.9% in Q1CY17) and EBITDA came at INR2.7bn, up 4% YoY (11% below our estimate and in-line with consensus estimate).
- Gross profit/KL and EBITDA/KL came in at ~INR96,600 (up ~1.5% YoY) and ~INR53,300 (up up ~1.5% YoY), respectively.
- PAT was up mere 2% YoY at INR1.8bn (13% below our estimate) due to higher effective tax rate (36% in Q1CY18 versus 34% in Q1CY17).

Volume growth

- Volume grew ~2.6% YoY to 51,500KL for the current quarter. However, on like-to-like basis, after adjusting for a one-off large institutional (B2B) order (~1,150KL) in the base quarter, volume growth came at ~5.0%.
- While volume growth was in single digit in CVO and PM segments, it declined in industrials segment due to slowdown in the wind industry since Q4CY17 where the company has significant exposure. Volume growth in CVO and PM came in line with industry growth rates, leading to the company maintaining its market share.
- **Pricing:** Average realisation increased ~2.5% YoY to ~INR1,80,000/ KL, in line with the ~3-4% price hike taken by the company across product categories to offset the impact of rising input cost (base oil cost increased ~3% QoQ). Castrol managed to grow volumes in line with the industry despite taking price hike well ahead of competition.
- **Volume mix:** CVO - ~43%, PM - ~43% and industrial - ~14%. Premium power brands account for ~50% of volumes currently and are increasing. Higher-margin synthetic products' contribution was in single digit and is improving.
- **Volume guidance:** Industry volume growth is expected to be 4-5% YoY in CY18 and management is confident of posting above-industry volume growth as the competition is also likely to take pricing action. The company reiterated its strategy of focusing on profitable volume growth rather than on maximising unit profitability.

Others

- Advertisement expenditure came in at ~3% of sales and was higher by ~20% YoY, in line with the company's focus on branding and customer acquisition.
- **New product launches:** In the PM segment, launched Castrol Magnatec engine oil with Dualock technology providing 50% better engine protection. In the CV segment, launched Castrol CRB Turbomax which delivers up to 2x longer engine life. The company is also launching a brake oil in the space travel segment shortly, which will play a critical role in NASA's mission to Mars.
- **New partnerships:** Built strategic OEM partnerships and inked a three-year contract with Ford India to supply engine and transmission oils for all vehicles produced in India for domestic and international markets.

- While Castrol continues to focus and invest primarily in the PM segment, it is also providing greater thrust on the commercial segment by broadening its participation in select mass market segments.

Impact of EV

- Castrol expects demand for lubricants to peak in 2035. As per BP's 2017 Energy Outlook report, the number of EVs is likely to spurt from 1.2mn in 2015 (0.1% of global fleet) to ~100mn by 2035 (6% of global fleet).
- Around a quarter of these EVs will be Plug-In Hybrids (PHEVs), which will run on a mix of electric power and oil, and three-quarters will be pure battery electric vehicles (BEV).
- With engine oil accounting for ~70% of total automotive lubricants' consumption, demand could be impacted post 2035. However, volumes from industrials and marine will continue to come.
- Further, the company is also investing in start ups in the advanced mobility space.

Financial snapshot **(INR mn)**

Year to December	Q1CY18	Q1CY17	% change	Q4CY17	% change	CY17	CY18E	CY19E
Net revenues	9,271	8,822	*5.1*	9,703	*(4.5)*	35,843	39,455	42,019
Raw material	4,294	4,042	*6.2*	4,388	*(2.1)*	16,660	19,085	20,504
Staff costs	469	498	*(5.8)*	507	*(7.5)*	1,956	2,092	2,143
Other expenses	1,765	1,649	*7.0*	1,742	*1.3*	6,897	7,393	7,759
Total expenditure	6,528	6,189	*5.5*	6,637	*(1.6)*	25,513	28,570	30,406
EBITDA	2,743	2,633	*4.2*	3,066	*(10.5)*	10,330	10,885	11,612
Depreciation	143	123	*16.3*	103	*38.8*	455	538	581
EBIT	2,600	2,510	*3.6*	2,963	*(12.3)*	9,875	10,346	11,032
Other income	228	185	*23.2*	164	*39.0*	837	812	924
Interest	7	3	*133.3*	6	*16.7*	12	12	12
Add: Prior period items								
Add: Exceptional items								
Profit before tax	2,821	2,692	*4.8*	3,121	*(9.6)*	10,700	11,146	11,944
Tax	1,003	902	*11.2*	1,154	*(13.1)*	3,782	3,845	4,061
Minority interest								
Associate profit share								
Profit- Discontinued Ops								
Reported net profit	1,818	1,790	*1.6*	1,967	*(7.6)*	6,918	7,301	7,883
Adjusted Profit	1,818	1,790	*1.6*	1,967	*(7.6)*	6,918	7,301	7,883
Diluted shares (mn)	989	989		989		989	989	989
Adjusted Diluted EPS	1.8	1.8	*1.6*	2.0	*(7.6)*	7.0	7.4	8.0
Diluted P/E (x)							24.9	23.1
EV/EBITDA (x)							16.2	15.1
ROAE (%)							100.7	96.3
As % of net revenues								
Raw material	46.3	45.8		45.2		46.5	48.4	48.8
Employee cost	5.1	5.6		5.2		5.5	5.3	5.1
Other expenses	19.0	18.7		18.0		19.2	18.7	18.5
EBITDA	29.6	29.8		31.6		28.8	27.6	27.6
Reported net profit	19.6	20.3		20.3		19.3	18.5	18.8

Company Description

Castrol India, a 51% subsidiary of British Petroleum plc, is the largest private sector lubricant player in India. The company's history in India dates back to 1910 when certain automotive lubricants from CC Wakefield & Co made an entry in the domestic market. The company was founded as an overseas branch of a British company and started operations as a trading unit. It was later renamed as Castrol in 1960. The company caters to the automotive, industrial and marine & energy segments. It derives majority of its revenues from the automotive segment (~90%), with commercial vehicles segment at ~45%, followed by passenger cars and 2W segments which together contribute ~35% of overall sales. The company is market leader with ~22% share in the automotive lubricant segment that has historically been dominated by PSU companies. Castrol operates 3 manufacturing plants in India and has the largest distribution network of 380 distributors, servicing over 110,000 retail sites.

Investment Theme

Castrol India's (Castrol) premium pricing strategy has led to a structural decline in its market share in CV (45% of sales), and overall volumes decline at 1% CAGR in past 5 years. As a result, overall profits have clocked mere 4.5%CAGR in past 5 years despite of profitability per litre rising ~1.3x led by high margin personal mobility segment. Profitability push in the personal mobility segment at the expense of the price sensitive CV segment has nipped its overall market share by more than 50bps in past 5 years. Hence, the company has underperformed peers across time periods. We believe Castrol will, at some point, be forced to react competitively by curtailing its profit maximisation strategy, which could dent profit margins.

Key Risks

Delay in recovery in key segments: With high exposure to automotives at 90% of overall sales, any slowdown in the economy may impact the already sluggish 2% CAGR.

Volatility in crude oil prices and exchange rate: Raw material costs constitute 57% of sales and major raw materials like base oil and additives (89% of raw material costs) are crude oil derivatives. Sharp volatility in crude oil prices along with foreign exchange fluctuation (~53% of raw materials are imported) could impact margins.

Heightened competition from private players, MNCs, oil PSUs: Castrol faces stiff competition from private players like Gulf Oil Lubricants, Shell, Exxon Mobil, TOTAL, Valvoline, Tide and oil PSUs like IOC, HPCL and BPCL due to its premium pricing.

Improvement in technology may impact volume growth: Despite strong growth in automobile industry over the past decade, lubricant volume growth was flat. This was primarily due to better technology and investment by the OEMs, which resulted in steady increase in the drain intervals. Oil drain intervals have increased from ~10,000km to ~80,000km.

Financial Statements

Key Assumptions

Year to December	CY16	CY17	CY18E	CY19E
Macro				
GDP(Y-o-Y %)	6.6	6.5	7.1	7.6
Inflation (Avg)	4.5	3.6	4.5	5.0
Repo rate (exit rate)	6.3	6.0	6.0	6.5
USD/INR (Avg)	67.1	64.5	65.0	66.0
Sector				
Auto market (CV)	8.3	14.0	10.0	11.0
Auto market (tractor)	12.5	14.0	12.0	12.0
Auto market (2W) volume growth	6.8	10.0	10.0	10.0
Brent Crude (USD/bbl)	50.0	58.0	65.0	66.0
Auto market(PV)	6.3	10.0	11.0	11.0
Company				
Auto after market (2W)	10.6	8.7	6.3	6.9
Auto after market (CV)	(1.1)	(1.8)	4.3	3.7
Overall realisation growth	(2.1)	3.6	5.0	1.3
Overall volume growth	4.4	2.7	4.8	5.1
Auto after market(PV)	8.0	7.2	6.6	6.7
Auto OEM	3.1	4.0	5.0	5.5
Industrial	11.0	(1.0)	-	3.0
Overall bazaar market share (%)	22.1	21.5	(1.9)	(0.9)
Auto after market (2W)	35.1	36.1	36.2	36.3
Auto after market(PV)	41.6	42.1	42.1	42.1
Auto after market (CV)	17.9	16.9	17.2	17.4
2W aftermarket sales	22.3	23.6	23.9	24.3
PV aftermarket sales	16.9	17.7	18.0	18.2
CV aftermarket sales	41.3	39.5	39.3	38.7
Auto OEM sales	9.4	9.5	9.6	9.6
Industrial sales	10.1	9.8	9.3	9.1

Income statement (INR mn)

Year to December	CY16	CY17	CY18E	CY19E
Net revenue	33,703	35,850	39,455	42,019
Materials costs	15,316	16,667	19,085	20,504
Gross profit	18,387	19,184	20,370	21,515
Employee costs	1,726	1,956	2,092	2,143
Other Expenses	6,613	6,866	7,393	7,759
Operating expenses	8,339	8,822	9,485	9,902
Total operating expenses	23,655	25,489	28,570	30,406
EBITDA	10,049	10,362	10,885	11,612
Depreciation	450	455	538	581
EBIT	9,599	9,906	10,346	11,032
Add: Other income	872.7	837.00	812.00	924.04
Less: Interest Expense	15	12	12	12
Profit Before Tax	10,457	10,731	11,146	11,944
Less: Provision for Tax	3,708	3,793	3,845	4,061
Reported Profit	6,749	6,939	7,301	7,883
Adjusted Profit	6,749	6,939	7,301	7,883
Shares o /s (mn)	989	989	989	989
Adjusted Basic EPS	6.8	7.0	7.4	8.0
Diluted shares o/s (mn)	989	989	989	989
Adjusted Diluted EPS	6.8	7.0	7.4	8.0
Adjusted Cash EPS	7.3	7.5	7.9	8.6
Dividend per share (DPS)	5.0	5.2	5.5	5.9
Dividend Payout Ratio(%)	87.8	87.8	87.8	87.8

Common size metrics

Year to December	CY16	CY17	CY18E	CY19E
Operating expenses	24.7	24.6	24.0	23.6
Gross margin	54.6	53.5	51.6	51.2
Interest Expense	-	-	-	-
EBITDA margins	29.8	28.9	27.6	27.6
EBIT margins	28.5	27.6	26.2	26.3
Net Profit margins	20.0	19.4	18.5	18.8

Growth ratios (%)

Year to December	CY16	CY17	CY18E	CY19E
Revenues	2.2	6.4	10.1	6.5
EBITDA	12.3	3.1	5.0	6.7
PBT	10.0	2.6	3.9	7.2
Adjusted Profit	9.7	2.8	5.2	8.0
EPS	9.7	2.8	5.2	8.0

Balance sheet (INR mn)

As on 31st December	CY16	CY17	CY18E	CY19E
Share capital	4,946	4,946	4,946	4,946
Reserves & Surplus	1,012	1,861	2,754	3,719
Shareholders' funds	5,958	6,806	7,700	8,664
Long Term Liabilities	141	160	160	160
Def. Tax Liability (net)	(672)	(703)	(703)	(703)
Sources of funds	**5,427**	**6,263**	**7,157**	**8,121**
Gross Block	3,880	4,280	4,680	5,080
Net Block	1,419	1,364	1,226	1,045
Capital work in progress	373	573	573	573
Intangible Assets	50	26	26	26
Total Fixed Assets	1,842	1,963	1,824	1,643
Cash and Equivalents	8,219	4,447	5,437	6,685
Inventories	3,439	3,196	4,961	3,803
Sundry Debtors	2,552	2,850	3,636	3,271
Loans & Advances	2,070	333	333	333
Other Current Assets	79	2,695	2,695	2,695
Current Assets (ex cash)	8,140	9,074	11,624	10,102
Trade payable	6,456	6,066	8,574	7,155
Other Current Liab	6,318	3,154	3,154	3,154
Total Current Liab	12,774	9,220	11,728	10,309
Net Curr Assets-ex cash	(4,635)	(146)	(104)	(207)
Uses of funds	**5,427**	**6,263**	**7,157**	**8,121**
BVPS (INR)	6.0	6.9	7.8	8.8

Free cash flow (INR mn)

Year to December	CY16	CY17	CY18E	CY19E
Reported Profit	6,749	6,939	7,301	7,883
Add: Depreciation	450	455	538	581
Interest (Net of Tax)	10	12	12	12
Others	(720)	(837)	(812)	(924)
Less: Changes in WC	(144)	(1,840)	42	(103)
Operating cash flow	6,633	8,409	6,997	7,655
Less: Capex	358	575	400	400
Free Cash Flow	**6,275**	**7,833**	**6,597**	**7,255**

Cash flow metrics

Year to December	CY16	CY17	CY18E	CY19E
Operating cash flow	6,633	8,409	6,997	7,655
Investing cash flow	293	262	412	524
Financing cash flow	(5,680)	(6,102)	(6,419)	(6,930)
Net cash Flow	1,246	2,569	990	1,248
Capex	(358)	(575)	(400)	(400)
Dividend paid	(5,655)	(6,090)	(6,407)	(6,918)

Profitability and efficiency ratios

Year to December	CY16	CY17	CY18E	CY19E
ROAE (%)	115.2	108.7	100.7	96.3
ROACE (%)	178.8	168.3	153.8	146.1
ROA	124.6	118.7	108.8	103.2
Debtors Days	27	28	30	30
Payable Days	141	137	140	140
Cash Conversion Cycle	(38)	(37)	(32)	(32)
Current Ratio	1.3	1.5	1.5	1.6
Interest Coverage Ratio	648.6	825.5	-	-
Debt / Cap employed (%)	223.0	136.0	-	-

Operating ratios

Year to December	CY16	CY17	CY18E	CY19E
Total Asset Turnover	6.2	6.1	5.9	5.5
Fixed Asset Turnover	22.8	25.1	29.9	36.2
Equity Turnover	5.8	5.6	5.4	5.1

Valuation parameters

Year to December	CY16	CY17	CY18E	CY19E
Adj. Diluted EPS (INR)	6.8	7.0	7.4	8.0
Y-o-Y growth (%)	*9.7*	*2.8*	*5.2*	*8.0*
Adjusted Cash EPS (INR)	7.3	7.5	7.9	8.6
Diluted P/E (x)	26.9	26.2	24.9	23.1
P/B (x)	30.7	26.8	23.7	21.1
EV / Sales (x)	5.2	4.9	4.5	4.2
EV / EBITDA (x)	17.3	17.1	16.2	15.1
Dividend Yield (%)	2.7	2.8	3.0	3.2

Peer comparison valuation

	Market cap	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
Name	(USD mn)	CY18E	CY19E	CY18E	CY19E	CY18E	CY19E
Castrol India	2,887	25.0	23.2	16.3	15.2	100.7	96.3
Gulf Oil Lubricants	669	24.5	21.0	15.9	13.6	36.0	34.1
Median	-	24.8	22.1	16.1	14.4	68.3	65.2
AVERAGE	-	24.8	22.1	16.1	14.4	68.3	65.2

Source: Edelweiss research

Additional Data

Directors Data

S. M. Datta	Chairman	Omer Dormen	Managing Director
R. Gopalakrishnan	Independent Director	Uday Khanna	Independent Director
Rashmi Joshi	Director – Finance (CFO)	Jayanta Chatterjee	Director – Supply Chain
Peter Weidner	Nominee Director	Sashi Mukundan	Nominee Director

Auditors - M/s. S. R. Batliboi & Co. LLP, Chartered Accountants

*as per last available data

Holding Top -10

	Perc. Holding		Perc. Holding
Life Insurance Corp of India	7.79	Aditya Birla Sun Life	1.03
Standard Life Aberdeen	2.15	J.P.Morgan Chase & Co.	1.01
Reliance Capital Trustee Co Ltd	1.51	Vanguard Group	0.87
UTI Asset Management	1.34	Goldman Sachs	0.70
GIC Private Ltd	1.05	DSP Blackrock	0.54

*as per last available data

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
19 Jun 2017	Bp Mauritius Ltd	Sell	541896	411.00
19 Jun 2017	Castrol Ltd	Buy	541896	411.00

*as per last available data

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
20 Jun 2017	Castrol Limited	Buy	541896.00

*as per last available data

Edelweiss Securities Limited, Edelweiss House, off C.S.T. Road, Kalina, Mumbai – 400 098.
Board: (91-22) 4009 4400**,** Email*: research@edelweissfin.com*

Aditya Narain
Head of Research
aditya.narain@edelweissfin.com

ADITYA NARAIN

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Coverage group(s) of stocks by primary analyst(s): ***Lubricants***

Castrol India, Gulf Oil Lubricants

Recent Research

Date	Company	Title	Price (INR)	Recos
05-Mar-18	**Castrol India**	Upbeat on recovering commercial vehicles; *Visit Note*	201	Buy
08-Feb-18	**Gulf Oil Lubricants**	Strong volume outperformance; margins surge; *Result Update*	1,010	Buy
07-Feb-18	**Castrol India**	Strong volume recovery; margin spurts; *Result Update*	187	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

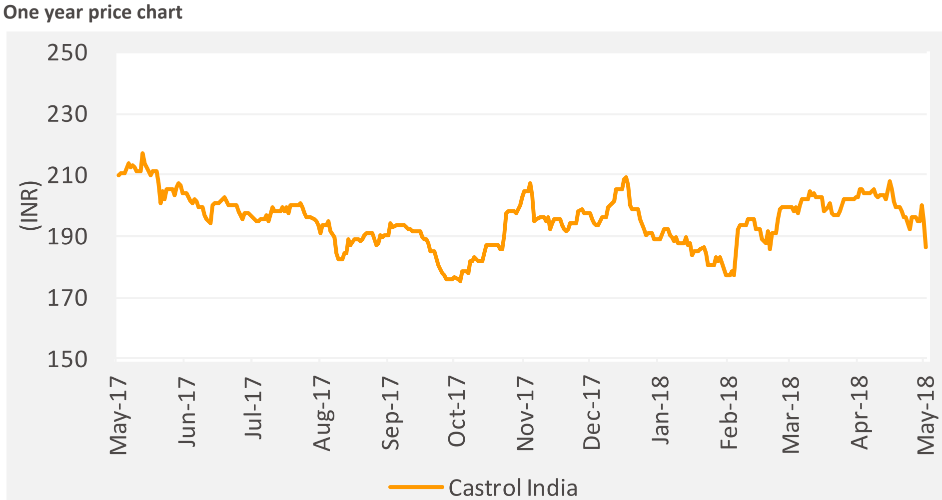
	Buy	Hold	Reduce	Total
Rating Distribution* * 1stocks under review	161	67	11	240

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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