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Sudarshan Chemical Industries Limited

Strong recovery in Q2; Capex to drive long-term growth

Speciality Chemicals | Sharekhan code: SUDARSCHEM | Result Update

Stock Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 470**	
Price Target: **567**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

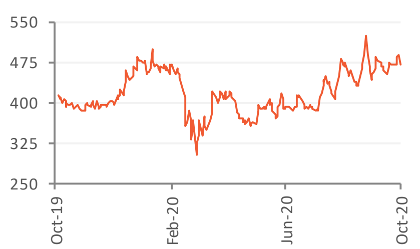
Company details

Market cap:	Rs. 3,255 cr
52-week high/low:	Rs. 538/286
NSE volume: (No of shares)	2.9 lakh
BSE code:	506655
NSE code:	SUDARSCHEM
Free float: (No of shares)	3.97 cr

Shareholding (%)

Promoters	42.7
DII	4.3
FII	8.1
Others	45.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.0	22.1	13.5	13.2
Relative to Sensex	(2.7)	16.3	(12.9)	12.5

Sharekhan Research, Bloomberg

Summary

- Sudarshan Chemical Industries Limited (SCIL) reported better-than-expected recovery in revenue at Rs. 429 crore (up 1% y-o-y versus our expectation of 4.9% y-o-y drop), led by better performance in the domestic business. EBITDA margin was in-line at 15.4% (up 75 bps y-o-y).
- Strong recovery was seen in August-September in the domestic business (up 70% q-o-q) across products especially for coating, plastic, and inks; exports demand remained healthy. Utilisation rate also recovered to 85%-90%.
- Long-term growth outlook intact, given capex plan of Rs. 585 crore over FY2020-FY2022E to augment capacities. Thus, we expect EBITDA/PAT to register a CAGR of 20%/25% over FY2021E-FY2023E.
- We recommend Buy on SCIL with a PT of Rs. 567, given its dominant position (fourth largest player globally), double-digit earnings growth outlook, and strong RoE of 22%. The stock is trading at 17.1x FY23E EPS.

Sudarshan Chemical Industries Limited (SCIL) reported sharp beat in revenue at Rs. 429 crore (up 1% y-o-y; up 21.7% q-o-q) as compared our expectation of a 4.9% y-o-y decline in revenue. Beat in revenue reflects faster-than-expected recovery, as domestic business from key user industries has recovered fully to pre-COVID-19 levels (revenue from the pigment segment at Rs. 402 crore, flat y-o-y versus expectation of a decline) and export demand is also gaining traction. Gross margin witnessed an expansion of 111 bps y-o-y to 44.2%, led by favourable pricing and stable raw-material pricing environment. Consequently, adjusted EBITDA margin came in at 15.4% (up 75 bps y-o-y; up 133 bps q-o-q) and in-line with our expectation of 15.5%. Adjusted EBITDA increased by 6.1% y-o-y (33.2% q-o-q) to Rs. 66 crore, above our estimate of Rs. 59 crore. Adjusted PAT at Rs. 29 crore (down 10.2% y-o-y; up 93.8% q-o-q) was marginally ahead of our estimate of Rs. 28 crore as beat in revenue gets largely offset by higher interest cost and effective income tax rate. The company has seen strong demand recovery in August-September 2020 in the domestic business (up 70% q-o-q) with recovery across product portfolio especially for coating, plastic, and inks; while exports demand continues to remain healthy. Overall utilisation rate has improved to 80%-85% in August-September 2020 versus only 30%-40% in July 2020 (impacted by partial shutdown due to COVID-19 led lockdown). Overall, the management expects good growth in H2FY2021. The long-term growth outlook remains strong given capex plan of Rs. 585 crore over FY2020-FY2022E (already spent Rs. 225 crore in FY2020) to augment capacities (although 6-9 months delay due to COVID-19) to tap growth in the domestic and export market. New products launches would be focused more on high margin specialty product portfolio, plan for backward integration, and reduction in conversion cost, which bodes well for gradual margin expansion. Hence, we expect SCIL's revenue, EBITDA, and PAT to register CAGR of 19%, 20%, and 25%, respectively, over FY2021E-FY2023E along with high RoE of 22%. We recommend Buy on SCIL with a PT of Rs. 567. At the CMP, the stock is trading at 20.3x its FY2022E EPS and 17.1x its FY2023E EPS.

Key positives

- Beat in revenue given faster-than-anticipated recovery in domestic pigment demand.
- Adjusted gross and EBITDA margin expansion by 111 bps and 75 bps y-o-y respectively to 44.2%/15.4%.

Key negatives

- Cash flow from operations declined by 33% y-o-y to Rs. 53 crore in H1FY2021.
- Net debt increased by 12.4% y-o-y to Rs. 490 crore.

Our Call

Valuation – Recommend Buy on SCIL with PT of Rs. 567: We have marginally lowered our FY2021 earnings estimates to factor in higher depreciation given capitalisation of project capex and have fine-tuned our FY2022-FY2023 earnings estimates. SCIL's dominant market share (35% share in the Indian pigment market and the fourth largest player globally), de-focus of global players, SCIL's consistent focus to augment capacity (capex plan of Rs. 585 crore over FY2020-FY202E), and likely increase in share of high-margin products (new capex to focus on specialty chemicals) would help SCIL to grow well above the industry's growth rates on a sustained basis. Hence, we model revenue, EBITDA, and PAT CAGR of 19%, 20%, and 25%, respectively, over FY2021E-FY2023E along with high RoE of 22%. We recommend Buy on SCIL with a PT of Rs. 567. At the CMP, the stock is trading at 20.3x its FY2022E EPS and 17.1x its FY2023E EPS.

Key risk

- Lower demand off-take given economic slowdown and delay in completion of expansion projects coupled with increased competition (China has introduced 13% export rebate for chemicals) could impact revenue growth.
- Higher raw-material prices and delay in the ability to pass on price hikes adequately, adverse forex fluctuations, and interest rate movement might affect margins.

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	1,593	1,708	1,759	2,164	2,500
OPM (%)	12.8	14.4	15.0	15.4	15.4
Adjusted PAT	83	131	121	160	190
% y-o-y growth	(1.8)	57.6	(8.0)	32.9	18.4
Adjusted EPS (Rs.)	12.0	18.9	17.4	23.2	27.4
P/E (x)	39.1	24.8	27.0	20.3	17.1
EV/EBITDA (x)	17.4	15.0	14.6	11.8	10.2
P/BV (x)	5.7	5.4	4.8	4.2	3.5
RoCE (%)	16.0	17.2	14.6	15.9	16.3
RoE (%)	16.5	22.4	19.0	22.1	22.3

Source: Company; Sharekhan Research
Note: We now convert SCIL into a Stock Update; It was earlier a 'Viewpoint' under our coverage.

Sharp beat in revenue indicates faster-than-expected recovery; In-line EBITDA margin at 15.4%: SCIL reported sharp beat in revenue at Rs. 429 crore (up 1% y-o-y; up 21.7% q-o-q) as compared to our expectation of a 4.9% y-o-y decline in revenue. Beat in revenue indicated faster-than-expected recovery in domestic operations. Gross margin witnessed an expansion of 111 bps y-o-y to 44.2%, led by favourable pricing and stable raw-material environment. EBITDA margin came in at 15.4% (up 75 bps y-o-y; up 133 bps q-o-q), in-line with our expectation of 15.5%. Consequently, operating profit increased by 6.1% y-o-y (33.2% q-o-q) to Rs. 66 crore, above our estimate of Rs. 59 crore. Adjusted PAT at Rs. 29 crore (down 10.2% y-o-y; up 93.8% q-o-q) was marginally ahead of our estimate of Rs. 28 crore as beat in revenue gets largely offset by higher interest cost and effective income tax rate at 28.6%. Cash flow from operations declined by 33% y-o-y to Rs. 53 crore in H1FY2021, while net D/E increased marginally to 0.76x (versus 0.73x in H1FY2020).

Q2FY2021 results conference call highlights

- **Business update – Demand recovered to pre-COVID level in August; Utilisation at 80%-85%:** Management indicated that operations have ramped up gradually as supply issues have been resolved and domestic demand is back to pre-COVID-19 levels in August 2020 as demand from coatings, plastic and inks has increased sharply. Utilisation rate has also increased to 80%-85% in August/September post weak level of 30%-40% in July as Roha plant remained partly shut in July due to the lockdown. Exports are also healthy with share of exports in revenue at 49% in Q2FY2021 and domestic at 51%.

- **Demand outlook is healthy in domestic and export markets –** Normally Q3 is a softer quarter for SCIL, but given pent-up demand in the domestic market and healthy export demand, management expects Q3FY2021 to be a good quarter and, thus, expects better growth in H2FY2021. However, near-term management remains cautious as it is still to be seen that demand pick-up is just to fill up supply or there is actual demand recovery in the domestic market while export demand looks healthy but there is risk of re-imposition of lockdown in many European countries as new COVID-19 cases have increased recently. Long-term growth outlook remains positive, given shutdown of operations by two global players and China plus one strategy by global customers.

- **Margin outlook –** The company has undertaken cost-reduction initiatives to lower conversion cost and reduce SG&A cost and, thus, expects margin to remain strong in H2FY2021. Management expects EBITDA margin to gradually improve over the next couple of years as new capex would increase the share of specialty chemical products and would have higher asset turnover ratio of ~3x. Moreover, post completion of backward integration, the company's competitive edge is expected to improve as raw material dependency on China would reduce (imports 30%-35% of raw material requirement from China).

- **Capex update –** The company has guided for overall capex of Rs. 585 crore over FY2020-FY2022E, which would be largely focused on growth capex for new product development and ramp-up of exiting products while some part would be also be spent on project for margin expansion and project infrastructure. The company has already spent Rs. 225 crore in FY2020 and plans to spend Rs. 250 crore and Rs. 110 crore in FY2021E and FY2022E, respectively, for capacity addition and new product launches. Capex for backward integration would be soon finalised and is expected to be completed in FY2022. Capex in H1FY2021 stood at Rs. 106 crore versus Rs. 95 crore in H1FY2020.

- **New product launches delayed due to COVID-19 –** The launch of new products has been delayed by nine months due to COVID-19 and management now expects one product launch by March 2021 and second by September 2021. For yellow high-performance pigment, the company has started modification (which was put on hold during March-September 2020) from October 2020 and expects to launch the product by middle of December 2020.

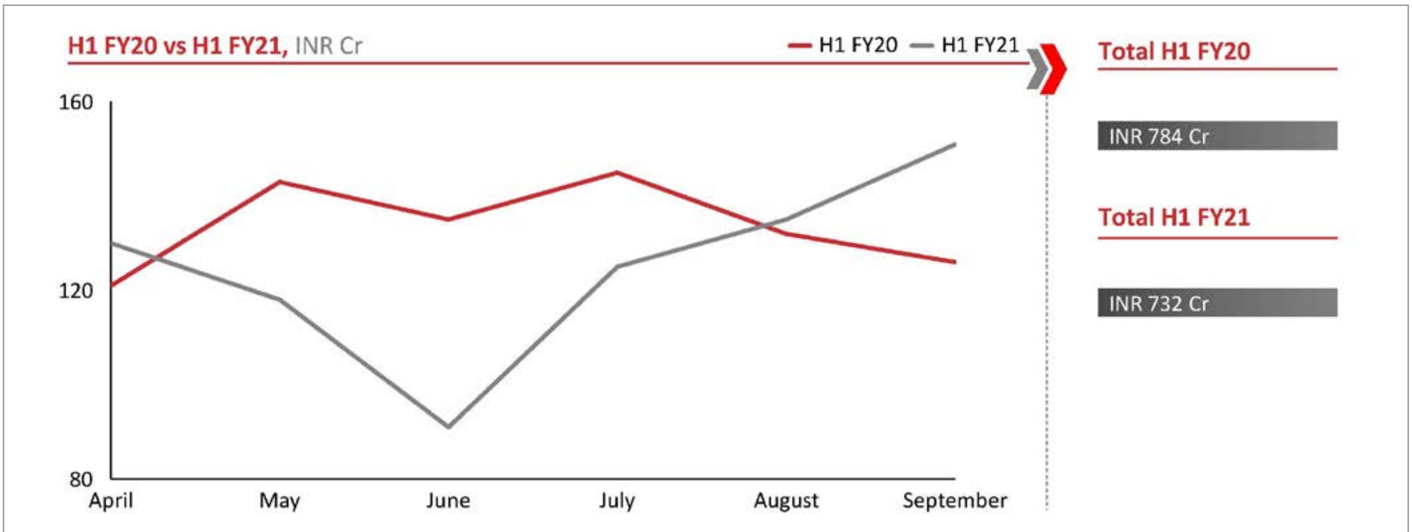
- **Competition –** Management has indicated that China has introduced 13% export rebate for chemicals, while the Indian government has removed 2% export rebate on chemicals. Management has hinted this would impact only low-margin products and does not expect any competition for high-performance specialty chemicals as China does not have much presence in that segment.
- The company's net debt stood at ~Rs. 490 crore as of September 2020 versus Rs. 436 crore as of September 2019.

Results (Consolidated) Rs cr

Particulars	Q2FY21	Q2FY20	YoY(%)	Q1FY21	QoQ (%)
Revenue	**429**	**425**	**1.0**	**352.3**	**21.7**
Reported EBITDA	68	66	2.1	53.0	27.8
Adjusted EBITDA	**66**	**62**	**6.1**	**49.6**	**33.2**
Other Income	2	1	24.5	0.3	495.1
Depreciation	22	17	28.2	21.6	1.5
Interest	5	4	39.0	3.9	32.1
PBT	42	47	(9.6)	27.8	52.8
Tax	12	1	NA	9.6	26.4
Exceptional Item	-	-		-	
PAT from Continuing Operations	30	46	(34.4)	18.2	66.7
PAT from Discontinuing Operations	-	-	NA	-	NA
Reported PAT	30	46	(34.4)	18.2	66.7
Adjusted PAT	**29**	**32**	**(10.2)**	**14.8**	**93.8**
Reported EPS (Rs.)	4.4	6.7	(34.4)	2.6	66.7
Adjusted EPS (Rs.)	4.1	4.6	(10.2)	2.1	93.8
Margin (%)	**Q2FY21**	**Q2FY20**	**YoY(bps)**	**Q1FY21**	**QoQ (bps)**
Adjusted EBITDA margin	15.4	14.6	75	14.1	133
Adjusted PAT margin	6.7	7.5	(83)	4.2	249

Source: Company; Sharekhan Research

Revenue trajectory: Coming out of Covid-19 disruption; demand is normalising



Source: Company

Outlook and Valuation

■ **Sector View – De-focus of global players and rising demand to help Indian dyes and pigment to post a 10% CAGR over FY2019-FY2025**

The dyes and pigments segment is the second largest sub-segment with 22% share in the Indian specialty chemicals industry. The segment has registered 7.3% growth from FY2014-FY2019, with a market size of ~$7 billion in FY2019. The dyes and pigments segment is expected to register a 10% CAGR over FY2019-FY2025 and is estimated to reach $12.5 billion by FY2025. De-focus of global players and increased demand for textiles, paints, and plastic would drive strong growth for the dyes and pigments segment in India. Large domestic players are expected to further consolidate their position supported by reliable raw material sourcing, strong R&D capabilities, right product portfolio, strong marketing capabilities, and strong adherence to global environmental compliance standards (given polluting nature of manufacturing process of dyes and pigments).

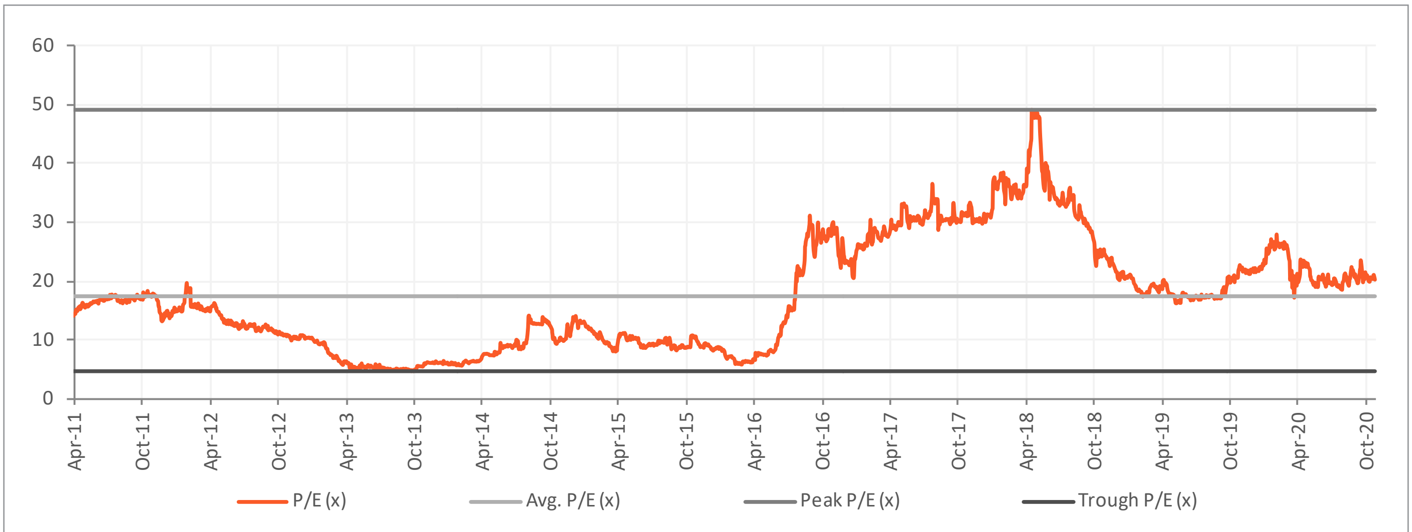
■ **Company Outlook – Robust capex plan to increase capacities to further consolidate position in domestic and help tap exports markets**

Significant growth opportunities are available for players in Southeast Asia, as innovators seek a reliable partner for assured sourcing, as the situation in China remains largely unaltered due to the ongoing government clampdown because of environment and compliance issues coupled with US-China trade war and the recent COVID-19 outbreak across the world. With significant expansion plans of Rs. 585 crore over FY2020-FY2022E and exit of two global peers from the space, the company is scaling up its position in both domestic and global markets. SCIL is investing in the right areas for building capabilities and richer client engagements, which is expected to create a long-term moat in a higher growth pigment industry.

■ **Valuation – Recommend Buy on SCIL with PT of Rs. 567**

We have marginally lowered our FY2021 earnings estimates to factor in higher depreciation given capitalisation of project capex and have fine-tuned our FY2022-FY2023 earnings estimates. SCIL's dominant market share (35% share in the Indian pigment market and the fourth largest player globally), de-focus of global players, SCIL's consistent focus to augment capacity (capex plan of Rs. 585 crore over FY2020-FY202E), and likely increase in share of high-margin products (new capex to focus on specialty chemicals) would help SCIL to grow well above the industry's growth rates on a sustained basis. Hence, we model revenue, EBITDA, and PAT CAGR of 19%, 20%, and 25%, respectively, over FY2021E-FY2023E along with high RoE of 22%. We recommend Buy on SCIL with a PT of Rs. 567. At the CMP, the stock is trading at 20.3x its FY2022E EPS and 17.1x its FY2023E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Established in 1952 and headquartered in Pune, SCIL is India's largest and the world's fourth largest manufacturer of colour pigments. The company has a domestic market share of ~35% and global market share of ~3% in organic pigments. The company's product portfolio comprises organic, inorganic, and effect pigments, serving four main end-uses: coatings, plastics, inks, and cosmetics. SCIL has two manufacturing units – at Roha (established 1973) and Mahad (1993), both of which are located in Raigad district (Maharashtra) with combined capacity of 37,000 tonne per annum (tpa).

Investment theme

SCIL is a leading world-class colour solutions provider focusing on exceptional and sustainable results, which helps in customer retention. Significant growth opportunities are available for players in Southeast Asia as innovators seek a reliable partner for assured sourcing, as the situation in China has not changed much due to the ongoing government clampdown because of environment and compliance issues coupled with US-China trade war and the recent COVID-19 crisis. With significant expansion plan over FY2020-FY2022E and exit of two global peers from the space, the company is scaling up its global rankings. SCIL is investing in the right areas for building capabilities and richer client engagements, which is expected to create a long-term moat in a booming industry.

Key Risks

Lower demand offtake due to the economic slowdown and delay in completion of expansion projects coupled with increased competitive intensity might affect revenue growth momentum. Higher raw-material prices and delay in the ability to pass on price hikes adequately, adverse forex fluctuations, and interest rate movement might affect margins.

Additional Data

Key management personnel

Pradeep Ramwilas Rathi	Chairman
Rajesh Balkrishna Rathi	Managing Director
AshishV. Vij	Whole Time Director/Chief Operating Officer
Nilkanth Natu	Chief Financial Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	BHANSHALI AKASH	8.0
2	RATHI ROHIT K	6.0
3	Amansa Capital Pvt Ltd	3.2
4	RATHI VIJAYKUMAR R	3.1
5	Norges Bank	2.5
6	GOVERNMENT PENSION FUND - GLOBAL	2.4
7	KEDIA VIJAY KISHANLAL	1.9
8	Axis Asset Management Co Ltd/India	1.9
9	ICICI Prudential Asset Management	1.4
10	Goldman Sachs Group Inc/The	1.4

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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