Stock Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

SRF Ltd

Stellar Q3; robust growth outlook for chemical biz

Speciality Chem	Sharekhan code: SRF
Reco/View: Buy ↔	CMP: Rs. 2,348
	Price Target: Rs. 2,800 ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

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

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 19.61

Updated Jan 08, 2022

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

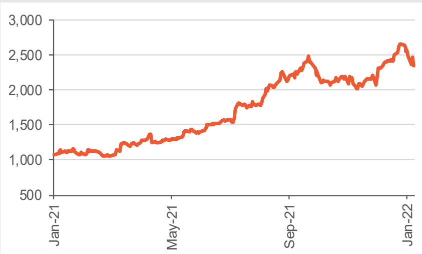
Company details

Market cap:	Rs. 69,607 cr
52-week high/low:	Rs. 2,679 / 1,027
NSE volume: (No of shares)	9.0 lakh
BSE code:	503806
NSE code:	SRF
Free float: (No of shares)	14.60 cr

Shareholding (%)

Promoters	51
FII	19
DII	9
Others	21

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-1.7	10.8	52.1	118.5
Relative to Sensex	-0.6	15.3	42.8	96.3

Sharekhan Research, Bloomberg

Summary

- Q3FY22 operating profit of Rs. 881 crore, up 55.7% y-o-y beat our/street's estimates led by robust growth in chemicals/packaging film business. In-line PAT of Rs. 505 crore (up 55.9% y-o-y) as strong operating performance gets offset by a high tax rate.
- Chemical/packaging film divisions reported stellar revenue growth of 57.7%/59.1%/ and EBIT margin expansion of 706/317 bps q-o-q to 29.4%/19.9%. Chemical segment benefited from strong ref-gas pricing in international markets while improvement in BOPP spreads led to margin recovery for packaging films. Technical textiles division's performance was impacted by weak demand for nylon tyre cord fabrics.
- Management commentary was optimistic with respect to sustained strong growth/high margin in chemical business as ref-gas pricing environment remains robust and specialty chemical to exceed FY22 growth guidance of 15-20% y-o-y. Planned foray into aluminium foil is a positive step given synergy benefit of similar customer segment in packaging segment.
- A 15% correction in stock price from 52-week high provides a good entry opportunity given superior earnings growth outlook while strong FCF and robust balance sheet provides scope for capex led earnings growth. Hence, we maintain a Buy on SRF with a revised PT of Rs. 2,800 (reflects an upward revision in earnings for chemical business).

SRF Limited's Q3FY22 results were above our estimates with 8.6%/9.6% beat in revenue/operating profit at Rs. 3,346 crore/Rs. 881 crore, up 55.9%/55.7% y-o-y. Better-than-expected operational performance was driven by: 1) robust growth in chemical segment (revenue/EBIT margin up by 57.7%/839 bps y-o-y) led by strong demand / pricing environment for ref-gas in international market, positive contribution from Chloromethanes and healthy performance from specialty chemical business and 2) sharp sequential recovery in packaging film segment (revenues rose 59.1%/19.1% y-o-y/q-o-q and improvement in EBIT margin by 317 bps q-o-q to 19.9%) supported by improved BOPET/BOPP spreads. However, the technical textiles division's performance was a tad lower than our expectations with revenue decline of 3.6% q-o-q and margin contraction by 270 bps q-o-q to 21.1% (although per unit margin remained stable), reflecting weak demand for Nylon Tyre Cord Fabrics. PAT at Rs. 506 crore (up 55.9% y-o-y; up 32.2% q-o-q) was in-line our estimate of Rs. 505 crore as a beat in operating profit was offset by higher depreciation and tax rate at 30.8% (versus assumption of 25.2%).

Key positives

- Robust revenue growth of 57.7%/59.1% y-o-y in chemical/packaging film segments.
- Chemical/packaging film EBIT margin increased by 706 bps/317 bps q-o-q to 29.4%/19.9%.

Key negatives

- Decline in revenue/EBIT margin by 3.6%/270 bps q-o-q in technical textiles.

Management Commentary

- **Chemical Business –** The management expects specialty chemical business to grow higher than its earlier guidance of 15-20% in FY22 as it registered 47% y-o-y growth in 9MFY22. Pricing/margins are expected to remain firm for the specialty chemical business and Q4 to be a strong quarter. The pricing environment for HFC refrigerants (especially R-125 and R-32) remains strong given ADD by US and India. Management believes HFC volumes to see 20% growth in FY23.
- **Packaging Films -** Despite good performance in Q3, management expects margins to come under pressure as several new BOPP & BOPET lines are expected to become operational.
- **Technical Textiles -** Product margins remain steady and stable and further contract renewals will take place over Q1/Q2 of FY23, which could add to the pricing.
- **New projects/capex guidance –** SRF announced setting up of pharma intermediate plant at capex of Rs. 190 crore and a dedicated plant for key agrochemical products at a capex of Rs. 61 crore. It announced its foray into the aluminium foil segment at an investment of ~Rs. 425 crore. The asset turnover of this would be in the range of 1.75x-2x and IRR would be at 15-17%. This provides synergy benefit of similar customer segment in packaging segment and tap the upcoming EV opportunities. The company guided for a capex of Rs. 1900-2,000 crore for FY22E and Rs. 2,100-2,200 crore for FY23E.

Revision in estimates – We have increased our FY22-24 earnings estimates to factor higher revenue growth/margin in the chemicals business.

Our Call

Valuation – Maintain Buy on SRF with a revised PT of Rs. 2,800: High growth in the chemical business supported by high capex intensity, sustained strong margin for the technical textiles business and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 23%/23%/28% over FY2021-FY2024E and a healthy RoE/RoCE of 21.6%/23.5%. Investment in right areas of specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. A superior earnings growth outlook, strong FCF generation and robust balance sheet keep us constructive on SRF and justify its premium valuations. Hence, we maintain a Buy on SRF with a revised PT of Rs. 2,800 reflecting upward revision in earnings on higher growth/margin assumption in chemical business. At CMP, the stock is trading at 34.3x its FY2023E EPS and 27.6x its FY2024E EPS.

Key Risks

- Slower offtake from user industries and concerns on a correction in product prices can impact revenue growth.
- Input cost price volatility might impact margins.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	8,400	11,315	13,303	15,589
OPM (%)	25.5	25.9	25.0	25.4
Adjusted PAT	1,197	1,759	2,027	2,525
% y-o-y growth	*17.5*	*46.9*	*15.3*	*24.5*
Adjusted EPS (Rs.)	40.4	59.3	68.4	85.2
P/E (x)	58.1	39.6	34.3	27.6
EV/EBITDA (x)	33.5	24.5	21.4	17.4
P/BV (x)	10.2	8.2	6.6	5.4
RoCE (%)	18.5	22.6	22.1	23.5
RoE (%)	20.3	22.9	21.3	21.6

Source: Company; Sharekhan estimates

Q3 operating profit beats estimate on stellar performance by chemical/packaging film

Consolidated Q3FY22 revenues at Rs. 3,346 crore (up 55.9% y-o-y; up 17.9% q-o-q) was 8.6% above our estimates of Rs. 3,080 crore. A sharp beat in revenues was led by better-than-expected revenue growth of 58%/59% y-o-y from chemical/packaging film segments offsetting marginal miss in revenue from technical textiles at Rs. 538 crore (down 3.6% q-o-q). OPM at 26.3% (flat y-o-y; up 257 bps q-o-q) was largely in-line with our estimate of 26.1%. Chemical/packaging film EBIT margin surged by 706 bps/317 bps q-o-q to 29.4%/19.9% but technical textiles EBIT margin declined by 270bps q-o-q to 21.1%. Consequently, operation profit at Rs. 881 crore (up 55.7% y-o-y; up 30.6% q-o-q) was 9.6% above our estimate of Rs. 804 crore. Reported PAT at Rs. 506 crore (up 55.9% y-o-y; up 32.2% q-o-q) was in-line our estimate of Rs. 505 crore as beat in operating profit was offset by higher depreciation and tax rate at 30.8% (versus assumption of 25.2%).

Q3FY2022 conference call highlights

Specialty chemicals business – Management guided to exceed FY22 growth guidance of 15-20%

- The segment delivered healthy performance led by incremental revenues from exports and domestic markets, expanding product portfolio and higher capacity utilisation for dedicated and multi-purpose plants.
- Capex announcements – 1) Pharma Intermediates plant (PIP) at a cost of Rs. 190 crore with likely completion timeline of 10 months and 2) Dedicated facility of a key agrochemical product at a cost of Rs. 61 crore.
- Launched one new pharma intermediate and successfully completed campaign for two agrochemical products.
- The management now expects to exceed its FY22 revenue growth guidance of 15-20%. The management stated that Q4FY22 would be strong quarter for specialty chemical and margin to see stable-to-improving environment while volume would witness positive growth going forward.

Fluorochemicals – Improved volume/price bodes well for growth

- Fluorochemicals business delivered robust performance supported by higher prices of certain key refrigerant products in critical international markets, increased export volumes of HFC blends and positive contribution from chloromethane segment.
- Dymel HFA 134a/P saw a breakthrough in new accounts across India, Bangladesh, Argentina, and Thailand.
- Key projects (CMS expansion, PTFE, HFCs) are largely on track, minor COVID related delays.
- The management indicated that the HFCs could see 20% higher volume in FY23 and strong margin environment to sustain led by anti-dumping duty in the US and India (SRF would see benefit of India ADD on R32 gas and certain HFC refrigerant blend in coming quarters).

Packaging films – New BOPP & BOPET lines coming onstream and thus expect margin pressure

- The business performed very well led by volume growth owing to additional capacities in Hungary and Thailand coming on stream and higher BOPP spreads.
- Management guided that commissioning of new capacities for BOPP/BOPET would put pressure on margins.
- **Aluminium Foil plant foray –** SRF is foraying into Aluminium Foil segment and announced to invest Rs. 425 crore to set a new plant at Jaitapur, Indore. Foray into Aluminum foil would help leverage existing customer base as one-stop shop for customers with products ranging from BOPP, BOPET and Aluminum Foil and tap upcoming opportunities from electric vehicle (EV). The business is likely to have asset turnover of 1.75-2x and expected IRR in the range of 15-18%.

Technical textiles – Volumes hit led by de-growth in auto industry; per unit margin to remain stable

- The technical textiles business witnessed a decline in volumes primarily due to weak demand for Nylon Tyre Cord Fabrics. However, sales volumes from the Belting Fabrics and Polyester Industrial Yarn segments were healthy.
- Margins remained steady on per unit basis and management expects few renewal of pricing contracts over Q1FY23-Q2FY23.

Capex guidance maintained at Rs. 1900-2,000 crore for FY22E

- The management has maintained its capex guidance of Rs. 1900-2000 crore for FY2022E and expects capex to Rs. 2100-2200 for FY23E. Management expects share of chemical segment in overall earnings would keep increasing as capex would be largely focused on this segment.

Results (Consolidated) Rs cr

Particulars	Q3FY22	Q3FY21	Y-o-Y %	Q2FY22	Q-o-Q %
Revenue	**3,346**	**2,146**	**55.9**	**2,839**	**17.9**
Total Expenditure	2,464	1,580	55.9	2,164	13.9
Operating profit	**881**	**566**	**55.7**	**675**	**30.6**
Other Income	11	22	(50.8)	11	(4.0)
Depreciation	132	117	13.6	130	1.6
Interest	29	28	3.2	23	25.9
PBT	730	443	64.9	532	37.2
Tax	225	119	89.7	150	49.9
Reported PAT	**506**	**325**	**55.7**	**382**	**32.2**
Reported EPS (Rs.)	17.1	11.0	55.7	12.9	32.2
Margin (%)			**BPS**		**BPS**
OPM	26.3	26.4	(3)	23.8	257
NPM	15.1	15.1	(2)	13.5	164
Tax rate	30.8	26.8	401	28.2	261

Source: Company; Sharekhan Research

Segmental performance Rs cr

Particulars	Q3FY22	Q3FY21	Y-o-Y %	Q2FY22	Q-o-Q %
Segmental revenue					
Technical Textiles	538	367	46.5	558	(3.6)
Chemical	1,428	906	57.7	1,126	26.8
Packaging Film	1,276	802	59.1	1,072	19.1
Others	107	74	45.1	86	24.1
Total	**3,349**	**2,149**	**55.9**	**2,842**	**17.8**
Inter Segment	3	2	45.3	3	(1.5)
Net Revenue	**3,346**	**2,146**	**55.9**	**2,839**	**17.9**
Segmental EBIT					
Technical Textiles	114	68	67.1	133	(14.5)
Chemical	419	190	120.7	251	67.0
Packaging Film	254	212	19.7	180	41.6
Others	9	8	3.8	6	48.0
Total EBIT	**796**	**479**	**66.2**	**569**	**40**
EBIT Margin (%)			**BPS**		**BPS**
Technical Textiles	21.1	18.5	260	23.8	(270)
Chemical	29.4	21.0	839	22.3	706
Packaging Film	19.9	26.5	(656)	16.7	317
Others	8.0	11.2	(319)	6.7	130
Overall EBIT margin	**23.8**	**22.3**	**148**	**20.0**	**373**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view – Structural growth drivers to propel sustained growth for specialty chemical sector

We remain bullish on medium to long-term growth prospects of the specialty chemicals sector, given a massive revenue opportunity from the perspective of import substitution (India's total specialty chemical imports are estimated at $56 billion), a potential increase in exports given a China Plus One strategy followed by global customers and favourable government policies (such as tax incentive and production-linked incentive scheme similar to that of the pharmaceutical sector). We believe that conducive government policies, product innovation, massive export opportunities and low input prices would help sector clock high double-digit earnings growth trajectory on sustained basis in the next 2-3 years.

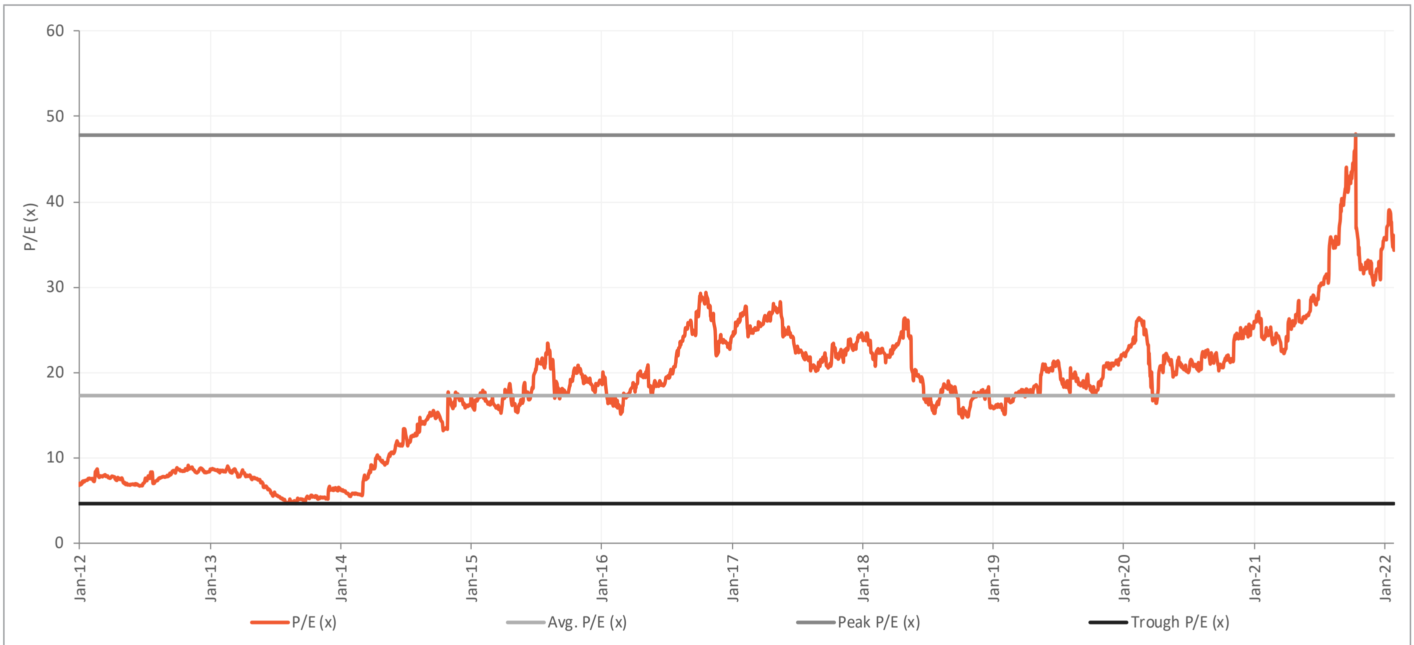
■ Company outlook – Long-term story stays intact, capex momentum to continue

The management sees significant growth opportunities in the agro-chemicals and active pharmaceutical ingredients (developing two pharmaceutical molecules in collaboration with innovators). Moreover, in the fluorochemicals space, SRF is focusing on ramping up utilisation levels at the recently commissioned HFC facilities and it sees demand traction to be strong. Specialty chemicals are likely to continue performing at a healthy pace, while volumes/margins for fluorochemicals would improve as demand is expected to improve. Higher volumes from expanded capacities to drive packaging films volume although margin expected to contract given an oversupply situation. The company generates healthy operating cash flows and hence, largely relies on internal accruals to fund its capex. This strengthens the balance sheet further and helps improve return ratios.

■ Valuation – Maintain Buy on SRF with a revised PT of Rs. 2,800

High growth in the chemical business supported by high capex intensity, sustained strong margin for the technical textiles business and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 23%/23%/28% over FY2021-FY2024E and a healthy RoE/RoCE of 21.6%/23.5%. Investment in right areas of specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. A superior earnings growth outlook, strong FCF generation and robust balance sheet keep us constructive on SRF and justify its premium valuations. Hence, we maintain a Buy on SRF with a revised PT of Rs. 2,800 reflecting upward revision in earnings on higher growth/margin assumption in chemical business. At CMP, the stock is trading at 34.3x its FY2023E EPS and 27.6x its FY2024E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Established in 1970, the company is a chemical-based multi-business entity engaged in the manufacturing of industrial and specialty intermediates. The company's diversified business portfolio covers technical textiles, chemicals (fluorochemicals and specialty chemicals), and packaging films. The company has 11 manufacturing plants in India, two in Thailand, one in South Africa, and an upcoming facility in Hungary. The company exports to more than 75 countries.

Investment theme

Favourable growth prospects across the segment, led by speciality chemicals and fluorochemicals. Management sees significant growth opportunities in agro chemicals and active pharma ingredients (developing two pharma molecules in collaboration with innovators). Continued high capex to expand capacities in high growth areas of specialty chemical business is likely to drive sustained high earnings growth. Moreover, structural high growth cycle for Indian specialty chemicals sector given favourable dynamics (China Plus One strategy by global companies) to support premium valuation for quality players like SRF.

Key Risks

- Slowdown in demand offtake from user industries and concerns over product price correction can impact revenue growth.
- Adverse input cost price volatility might impact the margin profile.

Additional Data

Key management personnel

Arun Bharat Ram	Executive Chairperson
Ashish Bharat Ram	Executive Director
Kartik Bharat Ram	Executive Director
Pramod Gopaldas Gujarathi	Executive Director
Meenakshi Gopinath	Non-Executive – Non-Independent Director
Sanjay Chatrath	President and CEO (TTB)
Rahul Jain	Chief Financial Officer
Rajat Lakhanpal	Company Secretary and Compliance Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Amansa Holdings Pvt Ltd	5.0
2	Kotak Mahindra Asset Management Co Ltd/India	4.1
3	Vanguard Group Inc/The	1.6
4	BlackRock Inc.	1.4
5	SBI Funds Management Pvt. Ltd	1.3
6	HDFC Life Insurance Co. Ltd	1.2
7	SBI Life Insurance Co Ltd	1.0
8	NGUYEN THI HONG	0.9
9	ICICI Prudential Life Insurance Co. Ltd	0.9
10	William Blair & Co. LLC	0.8

Source: Bloomberg; Note: Shareholding as of December 15, 2021

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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