

COMPANY UPDATE

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GUJARAT ALKALIES & CHEMICALS (GACL)

PRICE: Rs.546

TARGET PRICE: Rs.540

RECOMMENDATION: SELL

FY19E PE: 9.1x

Gujarat Alkalies & Chemicals (GACL) stock has rallied ~27% since our initiation date 18th April 2017. The uptick in the stock price was driven by a sharp surge in caustic soda prices, however, the benefit of the same was restricted due to poor demand of chlorine. Going ahead, we believe that 10% increase in caustic soda prices in the last 3 months augurs well for the company. But, excess supply of Chlorine will offset the benefit of the same and hence improvement in the EBITDA margin would be restricted to 100-200 bps for the next two years, as against earlier expectations of over 400bps improvement. Besides Chlorine impact, increase in the cost of production (price of rock phosphate and an increase in power and fuel costs) would also weigh on operating performance. We expect EBITDA to grow at 15% CAGR during FY17-FY19E, with a margin in the range of 22-23%. PAT is expected to grow at 11% CAGR during the same period. We believe that, given the return ratios in the range of 10-11%, the stock is fully valued at 10.2x and 9.1x FY18E and FY19E, revised earnings of Rs53.3 and Rs59.9 for FY18E and FY19E, respectively. Hence, we recommend SELL (earlier BUY), with a revised target price of Rs540 (earlier Rs 590).

Summary table

(Rs mn)	FY17	FY18E	FY19E
Sales	20,702	24,594	26,616
Growth (%)	3.7	18.8	8.2
EBITDA	4,496	5,534	6,122
EBITDA margin (%)	21.7	22.5	23.0
PBT	3,818	4,834	5,395
Net profit	3,085	3,915	4,397
Adj EPS (Rs)	41.8	53.3	59.9
Growth (%)	40.3	26.9	12.3
CEPS (Rs)	57.1	69.1	76.1
BV (Rs/share)	457	505	559
Dividend / share (Rs)	4.5	5.0	5.0
ROE (%)	9.2	10.6	10.7
ROCE (%)	9.9	10.6	10.2
Net cash (debt)	(1,601)	(4,937)	(7,047)
EV/EBITDA (x)	9.3	8.1	7.7
EV/Sales (x)	2.0	1.8	1.8
P/E (x)	13.0	10.2	9.1
P/CEPS (x)	9.6	7.9	7.2
P/BV (x)	1.2	1.1	1.0

Source: Company, Kotak Securities – Private Client Research

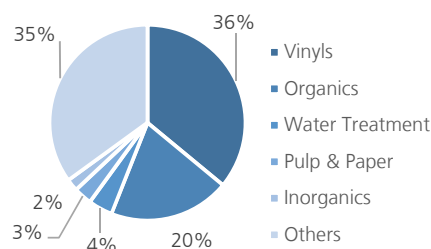
Capacity closure supporting prices...

Caustic soda prices went up by ~10% in the last 3 months. The recent uptick in the caustic soda prices was supported by Tropical Storm Harvey, which disrupted U.S chemical production, resulting into shortages for basic industrial building blocks such as chlorine and ethylene, thereby boosting prices. Disruptions have affected 37 percent of U.S. capacity for making chlorine and caustic soda, as per media reports. In addition, expectations of several large Chlor-alkali plant likely to be closed as a result of phasing out of mercury cell technology in December 2017 in Europe has also supported the caustic soda prices. We expect caustic soda prices to remain firm in the near to medium term, which would support the GACL revenue growth, as the company is already operating its facility at over 90% capacity utilisation. However, excess supply of Chlorine would offset the benefit of higher realisation and impact the overall performance. In future, resumption of the operations in U.S could increase the production (shut due to storm), thereby weighing pressure on the caustic soda prices.

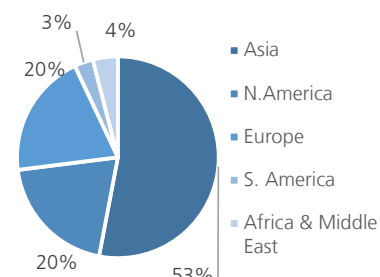
...but excess supply of chlorine is impacting overall performance

Effective Chlorine disposal is a key for continuity of operations of caustic soda. Chlorine is used in the manufacture of paper and pulp, ethylene dichloride (EDC), is used for producing polyvinyl chloride (PVC), manufacture of chlorinated paraffin wax, fertilizers and pesticides. There are 34 manufacturers of caustic soda in India, having aggregate installed capacity to the extent of 3.7 million tonnes, while production in FY17 stood at closer to 3MT. These plants co-produce chlorine in the ratio of 1:0.89. Gujarat is the largest caustic soda producing state with over 2 million tonnes capacities. The application of a caustic soda varies slightly when compared to global consumption patterns as the use of Caustic soda in textiles is relatively more prevalent in India. With respect to chlorine, there is a marked variation when compared to the global scenario. Globally, ~40% of the chlorine produced is used by the vinyl industry, whereas it is ~14% in India. This is due to lack of expansion in PVC production capacity in India. As a consequence, the chlor-alkali industry in India is a caustic soda driven industry unlike the rest of the world, where it is a chlorine driven industry. At times, the industry needs to dispose of the chlorine liquid by paying the end users in the range of Rs2,000-3,000/tonne, the amount went to as high as Rs6,000-8,000/tonne in Q4FY17. Though, we continue to remain upbeat about the caustic soda market in India, but a higher supply of chlorine will continue to drag the performance of the companies operating in the space.

Global chlorine consumption (%)



Region-wise Chlorine Consumption (%)



Source: Industry Data

GACL performance will also get impacted

Maximum captive consumption of chlorine is the key for Caustic Soda producers to insulate itself from the volatility in the chlorine prices. GACL, has effectively managed to either use or dispose of the chlorine produced. Out of the total chlorine production, the company sells 60% directly in the market to the end users and the remaining is partly, consumed captively for manufacturing higher value added products and balance is given outside for job work. The company manufactures total of 18 products, of which 3 of them are outsourced (Aluminium Chloride, Chlorinated Paraffin Wax and Chloro Toluene Products). In order to insulate itself, the company has undertaken an expansion plan to enhance its current product lines through debottlenecking of the existing plants and putting up additional capacities through new plants to consume chlorine captive and bring the sell proportion to 25% from 60% currently. However, this will take some time.

Earnings lowered

GACL, was unable to take the benefit of an uptick in the caustic soda prices in the last 2 quarters, due to excess supply of chlorine and the company was forced to pay the end users to consume the same, we opine. Though, we continue to remain positive on the caustic soda market and expect the prices to remain firm in the near to medium term, which would boost the revenue growth for GACL, but, the resumption of the production in the U.S could put pressure on the pricing. Besides this, payment to end users for consumption of chlorine, could also impact the operating performance. Factoring the impact of chlorine, we revised our EBITDA margin downwards to 22.5% and 23% for FY18E and FY19E, respectively. Our revised earnings now stands at Rs53.3 (earlier Rs.64.7) and Rs59.9 (earlier Rs.65.8) for FY18E and FY19E respectively.

Recommend SELL

Current valuations of 10.2x and 9.1x FY18E & FY19E, seems fully valued, considering the return ratios in the range of 10-11%. Sustaining earnings growth on such a high base will be difficult in the near term, given the excess supply of chlorine. Given the risk of caustic soda prices coming down on resumption of US operations and Chlorine consumption. Our revised target price stands at Rs540, and we see limited upside from the current levels. Hence, we recommend **SELL** (earlier BUY).

We recommend **SELL**
on Gujarat Alkalies &
Chemicals with a price
target of Rs.540

RATING SCALE

Definitions of ratings

- BUY** – We expect the stock to deliver more than 12% returns over the next 9 months
- ACCUMULATE** – We expect the stock to deliver 5% - 12% returns over the next 9 months
- REDUCE** – We expect the stock to deliver 0% - 5% returns over the next 9 months
- SELL** – We expect the stock to deliver negative returns over the next 9 months
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