Stock Update

Sharekhan by BNP PARIBAS

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Kajaria Ceramics Limited

Strong outperformance across parameters

Building Materials	Sharekhan code: KAJARIACER	Result Update

Summary

- We recommend Buy on Kajaria Ceramics with a PT of Rs. 675, considering healthy business outlook leading to 26% CAGR in net earnings over FY2021E-FY2023E.
- Strong outperformance on all fronts, led by volumes reverting to pre-COVID levels as seen in last year and strong rise in OPM.
- Management highlights healthy revenue and OPM outlook for H2FY2021. Key growth triggers such as GST, export opportunities for Morbi players, and low gas prices likely to sustain. Management to scale bathware business over the next three years.
- Kajaria saw strong surge in net cash position and reduction in working capital.

Kajaria Ceramics Limited (Kajaria) reported strong outperformance on all fronts for Q2FY2021. The company saw sharp 2.6x q-o-q rise in consolidated revenue to Rs. 712.5 crore, led by rise in tile volumes (up 2.6x q-o-q), sanitaryware/faucet revenue (up 24% y-o-y), and plywood revenue (up 23% y-o-y). Strong demand emanating from tier 2,3,4 cities along with surge in exports for Morbi tile industry players (benefiting from anti-dumping duty on Chinese imports by US) led to healthy domestic offtake for organised players such as Kajaria. Further, lower power and fuel costs (led by low gas prices) and decline in other expense (low overheads due to savings on travel and ad spends) led to strong beat on OPM (up 544 bps y-o-y) to 20.2%. Hence, operating profit jumped by 36.5% y-o-y. Strong operational performance led to PBT rise of 47.5% y-o-y. However, higher effective tax rate (reversal of deferred tax liabilities in Q2FY2020) led to consolidated PAT dipping by 4.4% y-o-y to Rs. 89 crore (which was much higher than our estimates). Management expects Q3FY2021 revenue to be same as last year, while Q4FY2021 is likely to witness 10% y-o-y growth. Further, the company expects OPM to be at 18% for H2FY2021, led by lower gas prices and reduction in key overheads. Kajaria targets to scale its bathware segment (reported net profit for the first time in Q2FY2021 on Rs. 53 crore revenue), with revenue of Rs. 500 crore over the next three years. The company improved upon its net cash position at Rs. 358 crore (versus Rs. 182 crore/Rs. 108 crore as of Q1FY2021/FY2020). We have increased our net earnings estimates for FY2021E-FY2023E, factoring higher OPM (driven by lower gas prices and reduction in key overheads). We expect revenue/operating profit/net profit to rise at a 15%/20%/26% CAGR over FY2021E-FY2023E. We have a Buy rating on the stock with a price target (PT) of Rs. 675.

Key positives

- Strong beat on net earnings led by higher-than-expected sales and OPM
- Strong sequential rise in net cash position
- Management gives strong OPM guidance for H2FY2021

Key negatives

- Demand from private real estate developers expected to be weak
- Plywood business loss of Rs. 2.6 crore for Q2FY2021

Our Call

Valuation – Recommend Buy with a PT of Rs. 675: Kajaria is expected to benefit from structural growth triggers such as GST implementation along with sustained exports from Morbi players and lower gas prices. The company is also looking at scaling up its bathware business over the next three years. The company is focused on better working capital management, leading to an increase in its net cash position, which could lead to inorganic expansion (if the company comes across attractive opportunities in allied businesses). We have increased our net earnings estimates for FY2021E-FY2023E, factoring higher OPM (driven by lower gas prices and reduction in key overheads). We expect revenue/operating profit/net profit to rise at a 15%/20%/26% CAGR over FY2021E-FY2023E. We have a Buy rating on the stock with a PT of Rs. 675

Key risk

Sustained weak macro-economic environment, pressure on realisation, and increased gas prices are key risks to our call.

Valuation (Consolidated) Rs cr

Particulars	FY20	FY21E	FY22E	FY23E
Revenue	2,808.0	2,465.6	2,920.7	3,266.9
OPM (%)	14.8	16.3	17.2	17.6
Adjusted PAT	255.3	224.0	300.4	357.5
% y-o-y growth	10.3	(12.3)	34.1	19.0
Adjusted EPS (Rs.)	16.1	14.1	18.9	22.5
P/E (x)	35.8	40.8	30.4	25.5
P/B (x)	5.3	4.8	4.3	3.8
EV/EBITDA (x)	21.5	22.3	17.8	15.5
RoNW (%)	15.5	12.5	15.1	15.9
RoCE (%)	15.4	12.5	15.0	15.7

Source: Company; Sharekhan estimates

Note: We now convert Kajaria Ceramics into a Stock Update; It was earlier a 'Viewpoint' under our coverage

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		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 575**	
Price Target: **675**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

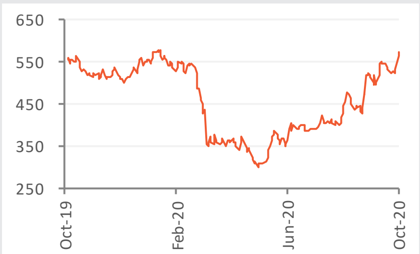
Company details

Market cap:	Rs. 9,134 cr
52-week high/low:	Rs. 594/295
NSE volume: (No of shares)	4.4 lakh
BSE code:	500233
NSE code:	KAJARIACER
Free float: (No of shares)	8.3 cr

Shareholding (%)

FII	23
Institutions	17
Public & others	12
Promoters	48

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	14.6	45.7	57.2	3.3
Relative to Sensex	8.0	38.8	24.8	-0.8

Sharekhan Research, Bloomberg

Strong sequential recovery in volumes with OPM outperformance leads to beat in net earnings

Kajaria reported a 2.6x q-o-q (-0.3% y-o-y) jump in consolidated net revenue to Rs. 712.5 crore for Q2FY2021, led by 2.6x q-o-q (+0.3% y-o-y) rise in tile volumes. Sanitaryware/faucet and plywood revenue grew by 24.4% y-o-y and 22.9% y-o-y to Rs. 53 crore and Rs. 9 crore, respectively. The company's revenue during July, August, and September was 85%, 100%, and 115%, respectively, compared to the same period last year. Strong rise in revenue was led by strong demand emanating from tier 2,3,4 cities. The company surprised positively on the OPM front with 544 bps y-o-y rise to 20.2%, which was led by lower power and fuel cost (down 12.4% y-o-y led by lower gas prices) and lower other expenses (down 22.6% y-o-y led by reduction in overheads such as travel andad spends). Consequently, operating profit grew by 36.5% y-o-y to Rs. 144 crore. Strong operational performance led to PBT growth of 47.5% y-o-y to Rs. 119 crore. Consolidated net profit declined by 4.4% y-o-y to Rs. 89 crore (much higher than our as well as consensus estimates) on account of higher effective tax rate (24.7% versus reversal of net deferred tax liabilities in Q2FY2020).

Strong guidance for H2

The company's asset utilisation in Q2FY2021 was in excess of 90%, which was 78% and 26% in July and June, respectively. The imposition of anti-dumping duty by the US on China has led to strong rise in exports for Morbi tiles industry (around 30-40% of Morbi industry is getting exported), leading to stability in the domestic industry. The tile industry, which was estimated at Rs. 30,000 crore (exports Rs. 7,500 crore, domestic Rs. 22,500 crore) last year, has shrunk to Rs. 25,000 crore (exports improving to Rs. 8,000 crore, domestic shrinking to Rs. 17,000 crore). The company expects exports from the Morbi industry to continue while GST is benefitting organised players such as itself. The company expects Q3FY2021 revenue to be same as last year, while Q4FY2021 revenue is expected to grow by 10% y-o-y. Further, lower gas prices and overheads are expected to lead to 18% OPM for H2FY2021. The company is also targeting the bathware segment's revenue to touch Rs. 500 crore over three years with improvement in OPM.

Update on plant operations during Q2FY2021

The company's subsidiary, Jaxx Vitrified (87.37% stake, polished vitrified tiles (PVT) unit in Morbi, Gujarat, with 7.6MSM annual capacity) operated at full capacity during Q2FY2021. Production at Vennar Ceramics (51% stake, 2.9MSM capacity at A.P.) and Cosa Ceramics (51% stake, 5.7MSM PVT capacity at Gujarat) operated at full capacity and 61% capacity, respectively, in Q2FY2021. Kajaria Tiles (wholly owned subsidiary, 5MSM glazed vitrified tiles (GVT) capacity in A.P.) operated at 78% in Q2FY2021. The sanitaryware plant in Morbi, Gujarat, having a capacity of 7.5 lakhs pieces p.a. operated at 53% capacity in Q2FY2021. The faucet manufacturing facility of 1 million pieces p.a. operated at 90% (started production in June 2020).

Key Conference call takeaways

- **H2FY2021 Guidance:** The company expects Q3FY2021 revenue to be same as last year and Q4FY2021 to achieve 10% growth. For H2FY2021, OPM is expected to be 18% (versus 15%/14.3% in Q3FY2020/ Q4FY2020). The company also reversed salary cuts in October due to which 150-200 bps negative impact on OPM is expected for H2FY2021 compared to Q2FY2021.

- **Long-term tile volume guidance:** The company targets 15% volume growth for the next 3-5 years in tiles.

- **Scalability in the bathware business:** For the first time, the bathware segment reported PAT of Rs. 2.04 crore over sales of Rs. 53 crore during Q2FY2021. The company's internal bathware revenue target is to touch Rs. 500 crore over three years. OPM is expected to improve with rise in revenue. The company has enough capacity at plants, will be adding more dealers, and have enough manpower to achieve the targeted revenue for bathware.

- **Revenue improvement m-o-m during Q2FY2021:** July, August, and September revenue was 85%, 100% and 115%, respectively, of that of same period last year.

- **Gas price outlook for H2FY2021:** Management expects gas prices to remain soft till March 2021.
- **Morbi tile industry'sexports to benefit domestic players:** Last year,the total tile industry was estimated at ~Rs. 30,000 crore (exports Rs. 7,500 crore, domestic 22,500 crore). This year, the industry shrunk to ~Rs. 25,000 crore (exports Rs. 8,000 crore, domestic 17,000 crore). About 30%-40% of Morbi production is being exported, thus easing pressure on the domestic front. The trend is expected to continue, which is expected to benefit domestic players like itself.
- **GST to be a game changer:** GST is a game changer for the company as per management. Retail sales are picking up due to GST providing level playing field.
- **Retail demand driving overall revenue during Q2:** Revenue during Q2FY2021 was driven by strong demand getting generated from tier 2,3,4 cities. Retail demand mix is 90%, while project demand is 10% (out of which 3-4% government, 5-6% private builder). The company is taking a conscious call on supplying to only those real estate projects where payment terms are as per expectations.
- **Sanitary ware revenue driver:** Revenue of the sanitary ware segment was driven by launch of high-end coloured collection at very competitive prices.
- **Focus on volumes and gaining market share:** Generally, revenue mix for ceramics, PVT, and GVT is 40%, 30%, and 30%, respectively. The company's focus would be on volume and market share. Pricing has not changed but dealer incentives have changed, which reflects in variations in realisation.
- **Capex for FY2021 and FY2022:** Capex for FY2021 would be in double digits. In FY2022, the company may incur capex of Rs. 100 crore-150 crore. The company's cash balance is over Rs. 350 crore and will be further generating cash flows going ahead. Cash usage will be decided by the board, but management would not use it for unrelated business acquisition.

Results (Consolidated) Rs cr

Particulars	Q2FY2021	Q2FY2020	y-o-y (%)	Q1FY2021	q-o-q (%)
Net sales	**712.5**	**714.7**	**-0.3%**	**277.6**	**156.7%**
other income	4.8	6.8	-29.8%	2.6	82.8%
Total income	717.3	721.5	-0.6%	280.2	156.0%
Total expenses	568.8	609.5	-6.7%	285.1	99.5%
Operating profit	**143.7**	**105.2**	**36.5%**	**-7.6**	**-**
Depreciation	27.4	26.2	4.6%	25.2	8.5%
Interest	2.1	5.2	-60.2%	3.4	-38.5%
Exceptional items	0.0	0.0		0.0	
Profit Before Tax	**119.0**	**80.7**	**47.5%**	**-33.6**	**-**
Taxes	29.4	-12.4	-337.3%	-0.6	-
Minority Interest	0.5	-0.1		-5.8	
PAT	89.1	93.2	-4.4%	-27.1	-
Adjusted PAT	**89.1**	**93.2**	**-4.4%**	**-27.1**	**-**
EPS (Rs.)	5.6	5.9	-4.4%	-1.7	-
OPM (%)	20.2%	14.7%	544 bps	-2.7%	-
NPM (%)	12.5%	13.0%	-53 bps	-9.8%	-
Tax rate (%)	24.7%	-15.4%	4005 bps	1.8%	2288 bps

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Expect faster recovery in operations

The building materials industry was severely affected by COVID-19 led lockdown during Q1FY2021, which had affected its peak sales period of the year. Additionally, its high fixed cost structure had affected OPM, draggingdown net earnings. However, from June, the sector has been one of the fastest in recovery with easing oflockdowns domestically. The sector witnessed resumption of dealer and distribution networks and a sharp improvement in capacity utilisation levels. Most players have begun to see demand and revenue run-rate reaching 80-90% compared to pre-COVID levels. Scaling up of revenue is also expected to lead to better absorption of fixed costs going ahead, aiding net earnings recovery. The industry is expected to rebound with strong growth in FY2022.

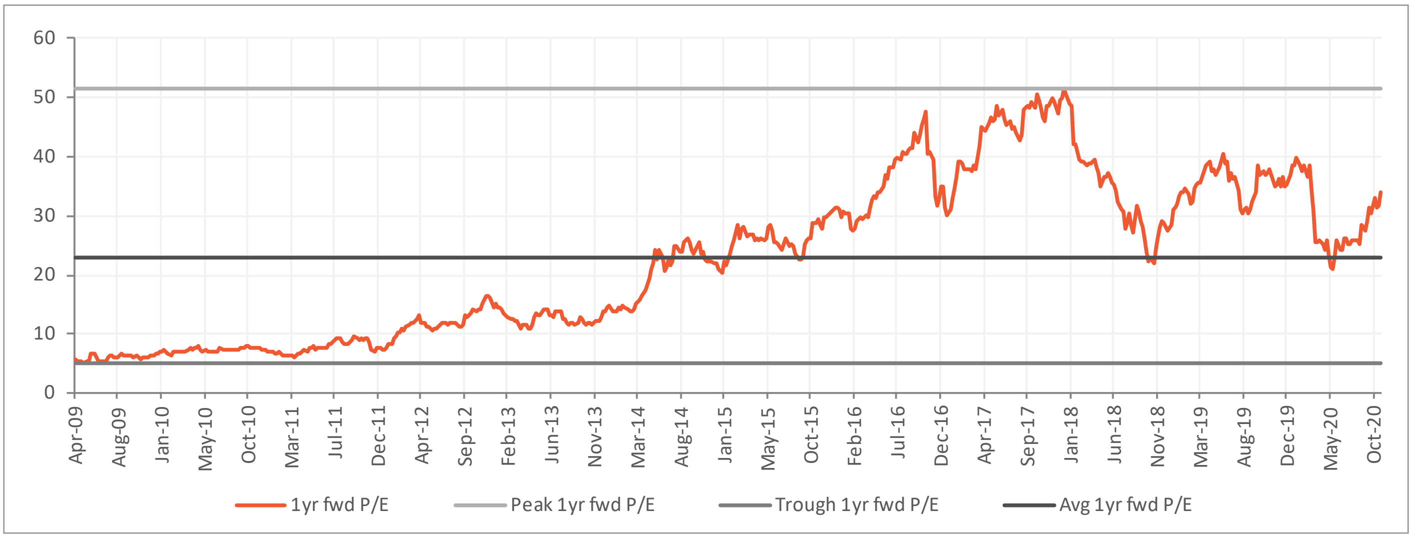
■ Company Outlook – Operations reverting to pre-COVID levels with improving demand

Kajaria has seen a sharp improvement in operations and demand environment m-o-m during the easing of lockdowns in the domestic market. The company's asset utilisation in Q2FY2021 was in excess of 90%, which was 78% and 26% in July and June, respectively. Further, anti-China sentiments in the US and European countries along with recent cut in gas prices by Gujarat state government have boosted exportsfor the Morbi cluster, which houses around 850 manufacturing units. This has led to improved pricing environment for organised players such as Kajaria. The company expects Q3FY2021 revenue to be the same as last year, while Q4FY2021 revenue is expected to grow by 10% y-o-y. Further, lower gas prices and overheads are expected to lead to 18% OPM for H2FY2021.

■ Valuation – Recommend Buy with a PT of Rs. 675

Kajaria is expected to benefit from structural growth triggers such as GST implementation along with sustained exports from Morbi players and lower gas prices. The companyis also looking at scaling up its bathware business over the next three years. The company is focused on better working capital management, leading to an increase in its net cash position, which could lead to inorganic expansion (if the company comes across attractive opportunities in allied businesses). We have increased our net earnings estimates for FY2021E-FY2023E, factoring higher OPM (driven by lower gas prices and reduction in key overheads). We expect revenue/ operating profit/net profit to rise at a 15%/20%/26% CAGR over FY2021E-FY2023E. We have a Buy rating on the stock with a PT of Rs. 675.

One year forward P/E (x) band



Source: Sharekhan Research

About company

Kajaria Ceramics is India's largest manufacturer of ceramic/vitrified tiles and the world's ninth largest tile manufacturer. The companyhas an annual capacity of 70.4 mn. sq. meterspresently, distributed across eight plants - one in Sikandrabad in Uttar Pradesh,one in Gailpur,one in Malootana in Rajasthan, three in Morbi in Gujarat, one in Vijaywada, and one in SriKalahasti in Andhra Pradesh.

Investment theme

Kajaria, like its industry peers, is expected to be hit by weak demand environment in FY2021, led by COVID-19 led disruption. The company is expected to improve upon capacity utilisation levels by Q2FY2021, while demand environment also show signs of improvement. We expect Kajaria to continue to generate healthy operating cash flows during the next two years, owing to absence of capacity expansion plans marginally getting affected by higher working capital requirement in the near term. We believe the company is fairly valued,considering improving demand and pricing outlook. Hence, we have Neutral view on the stock.

Key Risks

- Increased crude oil prices followed by higher gas prices.
- Pressure on pan-India residential housing market leading to overall lower volume offtake for the industry.

Additional Data

Key management personnel

Mr. ASHOK KUMAR KAJARIA	Executive Director-Chairperson related to Promoter
Sanjeev Agarwal	Chief Financial Officer
R C Rawat	Company Secretary & Compliance Officer
Mr. CHETAN KAJARIA	Executive Director
Mr. RISHI KAJARIA	Executive Director

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	RISHI KAJARIA FAMILY TRUST	16.27
2	CHETAN KAJARIA FAMILY TRST	16.27
3	CK TRUSTEES PVT LTD	16.27
4	RK TRUSTEES PVT LTD	16.27
5	VERSHA KAJARIA FAMILY TRST	8.14
6	VK TRUSTEES PVT LTD	8.14
7	Norges Bank	4.73
8	GOVERNMENT PENSION FUND - GLOBAL	4.63
9	Mirae Asset Global Investments Co Ltd	4.24
10	Franklin Resources Inc	3.73

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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