Sharekhan
by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Grasim Industries Limited

Improving operations & clarity on capital allocation; Upgrade to Buy

Diversified	Sharekhan code: GRASIM	Result Update

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

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↑
CMP: **Rs. 841**	
Price Target: **Rs. 1,010**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 55,348 cr
52-week high/low:	Rs. 848/380
NSE volume: (No of shares)	28.1 lakh
BSE code:	500300
NSE code:	GRASIM
Free float: (No of shares)	38.9 cr

Shareholding (%)

Promoters	40.9
FII	12.6
DII	20.5
Others	26.1

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	10.1	33.8	64.7	14.6
Relative to Sensex	3.6	19.1	25.1	6.7

Sharekhan Research, Bloomberg

Summary

- We upgrade Grasim to Buy with a revised PT of Rs.1010 as we factor in our revised PT of Ultratech, increase multiple for standalone business and reduce holding company discount of subsidiaries.
- Both of Grasim's key verticals witnessed strong sequential improvement in OPM led by demand improvement, lower input costs and fixed cost reduction leading to higher-than-expected standalone net earnings for Q2.
- Divestment of low RoCE Fertiliser business to improve focus on core businesses. Partnership with Labrizol to help increase chlorine integration.
- Confidence in demand environment led to increasing capital expenditure for capacity expansion in both Viscose and Chemical divisions.

Grasim Industries Limited (Grasim) reported better-than-expected standalone operational performance for Q2FY2021 with both its key verticals Viscose and Chemical divisions reporting better than expected margins led by lower key input costs and fixed cost reduction. Its standalone net sales declined by 28.3% y-o-y (up 77.2% q-o-q) at Rs. 3438 crore (which was lower than our estimate). The VSF business revenues declined 30.9% y-o-y (although up 3x q-o-q as capacity utilization touched ~88% in Q2FY2021 vs ~26% in Q1FY2021 as textile markets in India and overseas witnessed strong turnaround post easing of COVID-19 related restrictions). The chemical division (caustic soda) revenues declined 16.4% y-o-y (up 60.4% q-o-q as it saw capacity utilization improving to 80% in Q2FY2021 vs 49% in Q1FY2021 with recovery in demand from textile and paper industries). On the EBITDA front, the Viscose division reported EBITDA margin (including other income) of 11.5% (-418 bps y-o-y) versus operating loss of Rs. 113 crore in Q1FY2021. The chemical division reported EBITDA margin (including other income) of 16.6% (-366bps y-o-y, +1077bps q-o-q). The standalone operating profit declined 39.6% y-o-y to Rs. 398 crore which was much higher than our estimate. Strong operational performance (as compared to our estimate) along with lower effective tax rate led to higher than expected standalone net profit of Rs. 360.2 crore (-31.6% y-o-y). Further, its exit from low RoCE Fertilizer business for a consideration of Rs. 2649 crore is expected to be completed by 9 months which would increase its focus on core business. The partnership with Lubrizol (which would be investing in setting up 100KTPA CPVC plant at Grasim's land at Vilayat) would yield fixed annual compensation for running operations and improve captive chlorine integration for its causticsoda division. The company revised its capex guidance for FY2021 to Rs. 1852 crore versus earlier guidance of Rs. 1615 crore given the improvement in business sentiments in both VSF and chemical divisions. We have fine tuned our standalone estimates for FY2021E-FY2022E and have introduced FY2023E earnings in this note. We upgrade the stock to buy with a revised SOTP based price target of Rs. 1010 as we factor in our revised PT of Ultratech, increase multiple for standalone business due to improved business environment and reduce holding company discount of subsidiaries (as company indicated nil future investments in Vodafone Idea which was a key hangover on the stock).

Key Positives

- Strong sequential improvement in OPM for core businesses along with increased capex target.
- Divestment of fertilizer business to improve focus on core business.
- Partnership with Labrizol to aid in chlorine integration
- Management's commentary indicated nil future investments in Vodafone Idea

Key Negatives

- Caustic prices remained under pressure due to exports from SE Asia, NE Asia and Middle East

Our Call

Valuation – Upgrade to Buy with revised PT of Rs. 1010: Grasim's stock has over trailing three months run-up over 30% as the domestic demand environment saw a sharp rebound m-o-m with easing lockdown restrictions along with sharp improvement in Chinese textile market which led to healthy demand and pricing environment for Viscose. The improved demand outlook for Viscose and Chemical is expected to sustain going ahead both domestically and in Chinese market. The improved standalone business along with management's clarity on future capital allocation is expected to improve valuation of the company. Hence, we upgrade the stock to buy with a revised SOTP based price target of Rs. 1010 as we factor in our revised PT of Ultratech, increase multiple for standalone business due to improved business environment and reduce holding company discount of subsidiaries (as company indicated nil future investments in Vodafone Idea which was a key hangover on the stock).

Key Risks

Funding requirement of its group companies & weakness in standalone business are key risks.

Valuation (Standalone) Rs cr

Particulars	FY20	FY21E	FY22E	FY23E
Revenue	18,609	14,526	18,136	22,227
OPM (%)	12.4%	6.9%	11.0%	11.8%
Adjusted PAT	1,267	390	979	1,403
% YoY growth	(50.8)	(69.2)	150.7	43.4
Adjusted EPS (Rs.)	19.3	5.9	14.9	21.3
P/E (x)	43.7	141.6	56.5	39.4
P/B (x)	1.5	1.4	1.3	1.3
EV/EBITDA (x)	15.2	31.8	16.0	12.3
RoNW (%)	3.4	1.0	2.3	3.3
RoCE (%)	2.8	0.9	2.1	2.9

Source: Company; Sharekhan estimates

Net earnings higher than expected led by strong beat on OPMs of both the key verticals

Grasim reported standalone net sales decline of 28.3% y-o-y (up 77.2% q-o-q) at Rs. 3438 crore which was lower than our estimate. The VSF business revenues declined 30.9% y-o-y to Rs. 1679 crore (although up 3x q-o-q as capacity utilization touched ~88% in Q2FY2021 vs ~26% in Q1FY2021 as textile markets in India and overse as witnessed strong turn around post easing of covid related restrictions). The chemical division (caustic soda) revenues declined 16.4% y-o-y to Rs. 1126 crore (up 60.4% q-o-q as it saw capacity utilization improving to 80% in Q2FY2021 vs 49% in Q1FY2021 with recovery in demand from textile and paper industries). However, it surprised strongly on the OPM front with 11.6% (-216bps y-o-y) for Q2FY2021. The Viscose division reported EBITDA margin (including other income) of 11.5% (-418 bps y-o-y) versus operating loss of Rs. 113 crore in Q1FY2021. The chemical division reported EBITDA margin (including other income) of 16.6% (-366bps y-o-y, +1077bps q-o-q). Both verticals benefitted from lower input costs and reduction in fixed costs. The standalone operating profit declined 39.6% y-o-y to Rs. 398 crore which was much higher than our estimate. Strong operational performance (as compared to our estimate) along with lower effective tax rate (7.5% vs 19.1% in Q2FY2020) led to higher than expected standalone net profit of Rs. 360.2 crore (-31.6% y-o-y).

Divestment of fertilizer business to increase focus on core business

Grasim has announced the divestment of its fertiliser business by way of slump sale to Indorama India for a cash consideration of Rs. 2649 crore (at almost 1x FY2020 sales and 12x EV/EBITDA) which would help the company in pursuing growth opportunities in its core businesses. The timeline for divestment is estimated to be 9 months. The company's exit from fertilizer business is also seen in good light considering low RoCE due to high working capital requirement given long cycle of receivables (average outstanding subsidy receivables for fertilizer business stood at Rs. 1200 crore for FY2020).

Lubrizol partnership to aid in chlorine evacuation

The company had earlier announced its partnership with Lubrizol. The partnership is to manufacture and supply chlorinated polyvinyl chloride (CPVC) resin. Lubrizol would be fully investing in construction of 100KTPA capacity at Vilayat, Gujarat in two phases. The phase I of 50KTPA is expected by 2HFY2023. It would aid in the evacuation of chlorine and making money from chlorine derivatives. Grasim will supply chlorine and hydrogen and receive fixed annual compensation for running operations while cost variations will be passed through. Grasim will also provide land, materials and utilities. The partnership meets Grasim's objective of improving captive chlorine integration for its caustic soda division.

Firmed up capex plan on gaining confidence

Given the improvement in the business sentiment and the strong financial performance inthe quarter, the company has received additional capex approval of ~Rs.237 Cr. for Chemical and VFY business. With this additional capex, the company's board approved capex spend of Rs.1,852 Cr. for FY21. The capex includes raising capacities in VSF and Chemicals inFY22, apart from ongoing modernisation capex at various plants. The VSF capacity is slated to increase to 801KTPA from current 578KTPA while chemical capacity will be increased to 1457KTPA from current 1147KTPA.

Key Conference Call Takeaways

- **Capital Allocation clarification:** The company will give first preference to its standalone capex requirements. It may put in money in its financial services business to maintain its stake but at this time there is no such requirement. Other than that, it would not be infusing any money in other group entities.
- **Lubrizol partnership:** Lubrizol would be commissioning 100KTPA plant for CPVC resins in two phases. The phase I of 50KTPA is expected by 2HFY2023. It would aid in evacuation of chlorine and making money from chlorine derivatives.
- **Divestment of fertilizer business:** The divestment of fertilizer business would aid in higher focus on core business. The average outstanding subsidy receivables for fertilizer business stood at Rs. 1200 crore for

FY2020. Typically during March and June quarters, the receivables are at peak while in September and December quarters it is at lowest. Also fertilizer business has low RoCE due to high receivable days. There are no other plans of divestment at this point of time.

- **Capex revised upwards:** The company revised capex guidance for FY2021 to Rs. 1852 crore versus earlier guidance of Rs. 1615 crore. It has incurred Rs. 279 crore capex during H1FY2021.
- **Viscose business improvement:** The VSF capacity utilization improved to 88% in Q2 from 26% in Q1. The domestic sales share touched pre-covid level. The share of exports in Viscose volume was 18% in Q2 which had gone to 35-38% in Q1. VSF inventory in China fell to 16 days from 45 days in April. The Chinese plants operated at over 80% capacity utilization in September versus 67% in April. The company made savings of Rs. 116 crore from its average quarterly run-rate in fixed costs. The VSF prices recovery happened at the fag end of Q2 so full impact of higher prices is expected to come in Q3, but input prices have also started to go up but not in same proportion. In Viscose, domestic demand has grown at 14-15% CAGR over trailing two years versus export demand growing at 5-7% CAGR.
- **Caustic soda outlook:** The caustic soda capacity utilization improved to 80% from 49% in June. The pickup in demand in textile and paper industries led to higher demand. Due to excess caustic supply overseas, the prices dipped to $250, the same was being seen in domestic prices due to high imports from South East Asia, North East Asia and Middle East. However, chlorine value added products (VAP) remained high. Chlorine realization remained positive.
- **Speciality chemicals mix:** The share of specialty is at 26-27% of the total capacity of 5,87,000 but it can go up to 35% due to fungibility of lines. Post the expansion also the company will maintain the ratio of specialty.
- **Cost saving:** Lot of cost savings in fixed and variable cost is sustainable. Lower employee costs likely to sustain.

Results (Standalone) Rs cr

Particulars	Q2FY21	Q2FY20	y-o-y %	Q1FY21	q-o-q %
Net sales	**3,438**	**4,795**	**-28.3%**	**1,940**	**77.2%**
Total expenditure	3,040.3	4,136.5	-26.5%	2,086.2	45.7%
Operating profit	**398**	**659**	**-39.6%**	**(146)**	**-372.7%**
Other Income	282.4	286.9	-1.6%	99.6	183.5%
EBIDTA	680.4	945.5	-28.0%	(46.3)	-
Interest	75.7	86.1	-12.0%	78.4	-3.4%
PBDT	604.6	859.5	-29.7%	(124.7)	-
Depreciation	215.3	208.5	3.2%	212.6	1.2%
Extraordinary item	-	-		53.9	
PBT	**389.4**	**651.0**	**-40.2%**	**(391.2)**	**-**
Tax	29.2	124.5	-76.6%	(122.2)	-
Reported PAT	**360.2**	**526.5**	**-31.6%**	**(269.1)**	**-**
Extraordinary item	-	-	-	53.9	-
Adjusted PAT	**360.2**	**526.5**	**-31.6%**	**(215.2)**	**-**
EPS (Rs.)	5.5	8.0	-31.6%	(3.3)	-
			BPS		**BPS**
Operating margin	11.6%	13.7%	-216	-7.5%	-
Net Margin	10.5%	11.0%	-50	-11.1%	-
Tax rate	7.5%	19.1%	-1163	31.2%	-2373

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Await long term signs for demand to upgrade sector view

Although the company has begun to see a pickup in demand in its key standalone verticals, the visibility of the same is limited to near to medium term as risk of COVIDin both domestic and Chinese economies still remain. A sudden drop in demand and pricing environment in Chinese markets pose a key risk on viscose prices and profitability. Further, imports from South East Asia, North East Asia and Middle East pose risk to caustic soda prices. We await positive signs for Viscose and Caustic businesses over a longer term to upgrade our view on the sector to Green. Hence, at this stage we remain Neutral on the sector view.

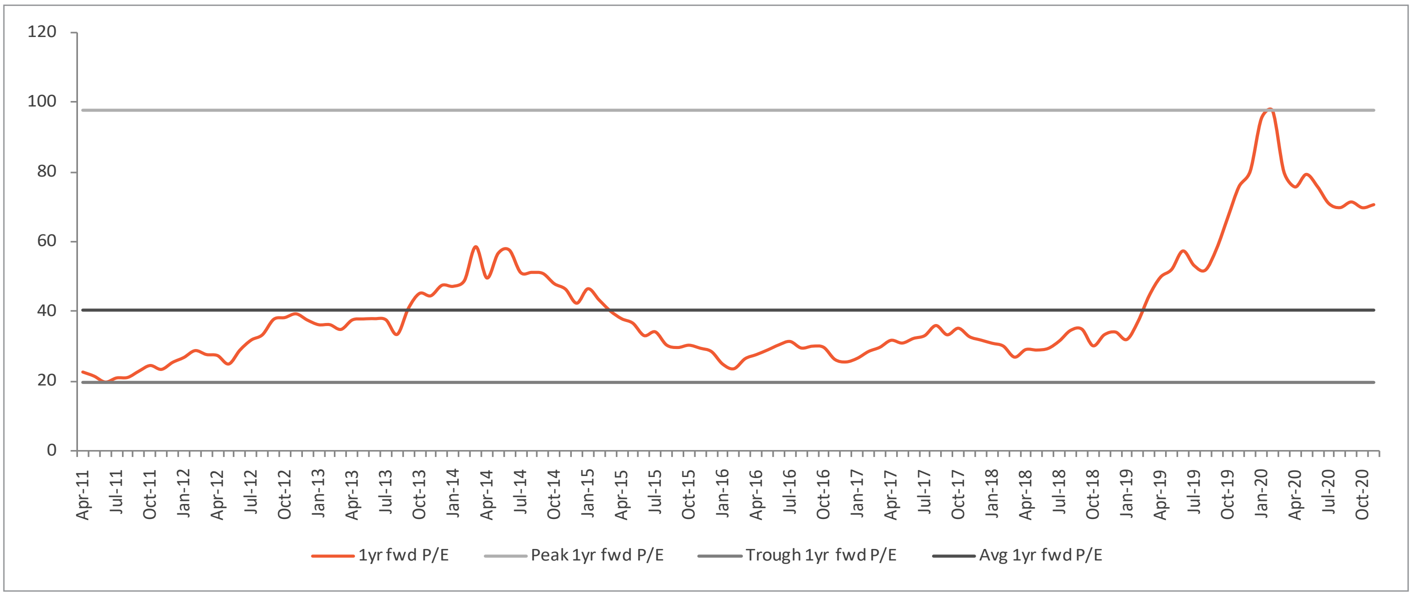
■ Company outlook - Improved business environment and clarity on capital allocation

The company is benefitting from improved domestic demand environment for its key standalone businesses led by a pickup in demand from end user industries. The same has led to increase in capex expenditure and expansion in both the verticals. Further, the management's clarity on capital allocation with first priority to be given to standalone business and nil future investment for listed telecom investment removes a key hangover on the stock. Hence, overall the improvement in standalone business along with clarity on capital allocation is expected to improve upon its earnings and valuation.

■ Valuation - Upgrade to Buy with revised PT of Rs. 1010

Grasim's stock has over trailing three months run-up over 30% as domestic demand environment saw a sharp rebound m-o-m with easing lockdown restrictions along with sharp improvement in Chinese textile market which led to healthy demand and pricing environment for Viscose. The improved demand outlook for Viscose and Chemical is expected to sustain going ahead both domestically and in Chinese market. The improved standalone business along with management's clarity on future capital allocation is expected to improve valuation of the company. Hence, we upgrade the stock to buy with a revised SOTP based price target of Rs. 1010 as we factor in our revised PT of Ultratech, increase multiple for standalone business due to improved business environment and reduce holding company discount of subsidiaries (as company indicated nil future investments in Vodafone Idea which was a key hangover on the stock).

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Grasim is the flagship company of Aditya Birla Group. The company started as a textiles manufacturer in India in 1947. The cement business was started in 1985 with capacity of 0.5 MTPA. Aditya Birla Nuvo Limited, an Aditya Birla Group Company, was merged with Grasim w.e.f. July 1, 2017. Subsequently, the financial services business was demerged from the merged entity and was listed on the bourses as Aditya Birla Capital Limited (ABCL) on September 1, 2017. Currently, it is a leading global player in VSF, and is the largest chemicals (Chlor-Alkalis), cement and diversified financial services (NBFC, Asset Management and Life Insurance) player in India.

Investment theme

The company is benefitting from improved domestic demand environment for its key standalone businesses led by a pickup in demand from end user industries. The same has led to increase in capex expenditure and expansion in both the verticals. The VSF capacity is slated to increase to 801KTPA from current 578KTPA while chemical capacity will be increased to 1457KTPA from current 1147KTPA. The improved demand outlook for Viscose and Chemical is expected to sustain going ahead both domestically and in Chinese market. The improved standalone business along with management's clarity on future capital allocation giving impetus to standalone capital requirement and nil capital infusion for listed telecom investment in the future is expected to improve valuation of the company.

Key Risks

- Funding requirements of its other listed entities.
- Pressure on VSF and chemical division's demand and/or realisations affects profitability negatively.
- Higher holding company discounts for any of its other business such as telecom, cement and financial services.

Additional Data

Key management personnel

Mr. Kumar Mangalam Birla	Chairman
Mr. Dilip Gaur	Managing Director
Mr. Ashish Adukia	Chief Financial Officer
Mrs. Hutokshi R Wadia	Company Secretary

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Birla Group Holdings Pvt. Ltd.	19
2	Life Insurance Corp. of India	11.3
3	IGH Holdings Pvt. Ltd.	5.11
4	Hindalco Industries Ltd.	4.29
5	Umang Commercial Co Ltd.	4.07
6	Standard Life Aberdeen PLC	3.98
7	Pilani Investment & Industries Corp.	3.69
8	ICICI Prudential Asset Management	1.81
9	Vanguard Group Inc	1.77
10	Franklin Resources Inc.	1.44

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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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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