Sharekhan
by BNP PARIBAS

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Stock Update

Carborundum Universal Limited

Strong Q3; Momentum to sustain

Capital Goods	Sharekhan code: CARBORUNIV	Results Update

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. 427**	
Price Target: **Rs. 540**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

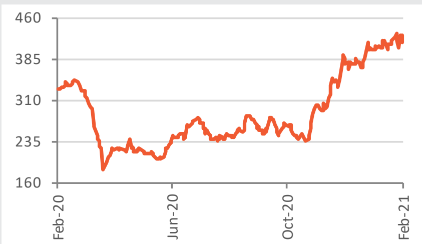
Company details

Market cap:	Rs. 8,107 cr
52-week high/low:	Rs. 446 / 175
NSE volume: (No of shares)	1.8 lakh
BSE code:	513375
NSE code:	CARBORUNIV
Free float: (No of shares)	11.0 cr

Shareholding (%)

Promoters	42.0
FII	6.5
DII	27.7
Others	23.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6	42	75	30
Relative to Sensex	2	17	39	8

Sharekhan Research, Bloomberg

Summary

- We retain Buy on Carborundum Universal Limited (CUMI) with a revised PT of Rs. 540, considering its reasonable valuations and healthy earnings growth profile.
- Q3FY2021 performance remained strong on all parameters (better than estimates), led by improving business sentiment and strong demand across segments.
- Strong domestic operations led by core user industries along with improving overseas operations aided by capacity expansion, success of new products, and being an alternative global supplier are likely to aid domestic and exports growth.
- Strong balance sheet, healthy return ratios and consistent dividend paying record are key salient features.

Carborundum Universal Limited (CUMI) posted strong performance for Q3FY2021, which were better than estimates. Growth was led by improving business sentiment, robust demand substantiated by volume growth across segments, and strong festive season. Consolidated revenue witnessed 13% y-o-y growth (better than estimates), driven by strong performance across segments. OPM jumped by 283 bps y-o-y to 17.7% (better than estimates) due to better margins in abrasives and EMD, led by operating leverage, price hikes, and better domestic performance. Accordingly, EBITDA increased by 34.5% y-o-y to Rs. 130 crore. Higher operating leverage along with higher other income (up 14.1% y-o-y) led to net profit increase by 39% y-o-y to Rs. 88 crore (better than estimates). Management indicated that pickup in manufacturing activity along with demand revival in the auto sector has benefitted the company's industrial and auto ancillary segment, such as bearings and gear grinding, and is expected to sustain. The company has been witnessing strong demand in coated abrasives (catering to mass-market like housing, construction, fabrication etc.) along with market share gains (shift from unorganised to organised), while precision-based abrasives, which gathered steam from mid-quarter of Q2 going strong for autos (pickup in two wheelers and small segment cars) and is expected to continue further, supported by better demand. In electro minerals, domestic business saw volume growth, driven by demand from white-fused alumina; and momentum is expected to continue, led by demand from the refectories industry.

On the export and overseas front, the company has been working on offering reliable and quality products to ensure the shift from China (benefit of having the largest capacity and lowest cost advantage in fused alumina domestically), which is being seen gradually coupled with acquiring new customers in newer regions (US). In ceramics, demand pull from refractory customers and expansion in metallised cylinders are expected to maintain high revenue growth trajectory. Management also indicated that the recent budget remains positive, with focus on infra (benefit cement) and auto (scrappage policy). Capex can possibly flow down to private investment and benefit by way of better demand across all segments for CUMI as it is present in core user industries. Further, opportunities arising from PLI schemes announced across 13 segments augur well for the company. CUMI is emerging as an integrated industrial material player with a wide product portfolio and is eyeing higher volume growth due to capacity expansion and exports along with focus on product innovation and improving reach, which we believe should aid in market share gains. Focus on cost efficiencies and automation with a gradual uptick in economy should aid growth and support earnings going ahead. We have revised our estimates upward, factoring higher revenue during Q3FY2021. The company is currently trading at PE of 26.5x/23.0x on FY2022E/FY2023E earnings, which we believe is reasonable, considering its strong earnings growth outlook and robust balance sheet.

Key positives

- Strong revenue growth in abrasives (+ 15% y-o-y) and electro mineral division (+19% y-o-y).
- Sharp margin improvement by 283 bps y-o-y, led by cost rationalisation.

Key negatives

- Due to stuck container, the company lost revenue worth Rs. 10 crore in abrasives in the domestic market.

Our Call

Valuation: Retain Buy with a revised PT of Rs. 540: The business is looking up with better-than-anticipated pickup in economic recovery and manufacturing activity. CUMI's growth momentum is expected to sustain, given improvement in domestic economic activity and a strong product line-up for overseas operations. The company's capacity expansion, new product introduction, end-user demand, and geographic diversification are expected to revive its earnings growth trajectory from FY2022. We expect CUMI to report revenue/ operating profit/PAT at a CAGR of 15.1%/17%/19% during FY2021E-FY2023E. We have revised our estimates upward, factoring higher revenue during Q3FY2021. The company is currently trading at P/E of 26.5x/23.0x on FY2022E/FY2023E earnings, which we believe is reasonable, considering its strong earnings growth outlook and robust balance sheet. Hence, we recommend buy on CUMI with a revised PT of Rs. 540.

Key Risks

1) Weak economic environment both domestic and globally; 2) Delay in sale of its loss-making Fosker Zirconia unit.

Valuations (Standalone) Rs cr

Particulars	FY20	FY21E	FY22E	FY23E
Revenue	2,599	2,510	2,942	3,323
OPM (%)	15.3	15.4	15.7	16.1
Adjusted PAT	272	248	304	350
% Y-o-Y growth	*10.0*	*(9.0)*	*22.8*	*15.0*
Adjusted EPS (Rs.)	14.4	13.1	16.1	18.5
P/E (x)	29.6	32.5	26.5	23.0
P/B (x)	4.3	3.9	3.5	3.1
EV/EBIDTA (x)	17.2	16.8	13.7	11.6
RoNW (%)	15.2	12.6	13.9	14.4
RoCE (%)	17.7	15.3	17.1	17.9

Source: Company; Sharekhan estimates

Strong Quarter: CUMI posted strong performance for Q3FY2021, which was better than estimates, led by improving business sentiment, robust demand substantiated by volume growth across segments, and strong festive season. Consolidated revenue witnessed 13 y-o-y growth (better than estimates), driven by strong performance across segments. OPM jumped by 283 bps y-o-y to 17.7% (better than estimates) due to better margins in abrasives and EMD, led by operating leverage, price hikes, and better domestic performance. Accordingly, EBITDA was up 34.5% y-o-y to Rs. 130 crore. Higher operating leverage along with higher other income (up 14.1% y-o-y) led to net profit increase by 39% y-o-y to Rs. 88 crore (better than estimates).

Business looking up: Management indicated that pickup in manufacturing activity along with demand revival in the auto sector has benefitted the company's industrial and auto ancillary segments such as bearings and gear grinding; and this is expected to sustain. The company has been witnessing strong demand in coated abrasives (catering to mass-market like, housing, construction, fabrication etc.) along with market share gains (shift from unorganised to organised), while precision-based abrasives, demand remains strong from autos (pickup in two wheelers and small segment cars) and expected to continue further supported by better demand. In electro minerals, domestic business saw volume growth, driven by demand from white-fused alumina; Growth momentum is expected to continue, led by demand from the refectories industry. On the export and overseas front, the company has been working on offering reliable and quality products to ensure the shift from China (benefit of having the largest capacity and lowest cost advantage in fused alumina domestically) along with focusing on gaining new customers. In ceramics, demand pull from refractory customers and expansion in metallised cylinders are expected to maintain high revenue growth trajectory. Management also indicated that recent budget remains positive, with focus on infra (benefit cement) and auto (scrappage policy). Capex can possibly flow down to private investment and benefit by way of better demand across all segments for CUMI, as it is present in core user industries. Further, opportunities arising from PLI schemes announced across 13 segments augur well for the company.

Key result highlights from Concall

- **Business update domestic:** Domestic business remained strong across the segment, led by strong demand, volume growth, and improvement in realisation (marginal).
- **Overseas business:** Overseas business remained mixed due to various reasons such as 1) second phase of pandemic outbreak along with other strain of Covid; 2) geopolitical tensions; and 3) container shortage globally impacting imports and exports.
- **Abrasives:** Coated abrasives saw demand recovering (mass-market) led by resumption of construction projects, home renovation, and market share gains, while precision-based abrasives remained strong, led by demand from auto and auto ancillaries. As manufacturing picks up in India, led by increased government focus, demand for abrasives is likely to pick up and thereby drive margins. Domestic witnessed 20% volume growth and industry saw 10% growth.
- Domestic abrasives saw 20% volume growth in domestic, while industry grew by 10%. Management expects growth in the segment due to CHINA+1 strategy along with strengthening dollar compared to Chinese currency and industry pressure in China for raw-material price increase being favourable for India
- **Margins to remain at current levels:** Abrasives margins improved, driven by sharp cost-control measures; and margins are expected to be maintained at similar levels despite input cost increases supported by cost-control measures and price hikes to be taken accordingly analysing the situation.
- **Sterling abrasives:** Sterling abrasives specialise in agro processing and industrial processing and related products did well because of improving demand.
- **Electro minerals:** Domestic business saw volume growth, driven by demand from white-fused alumina (input material used in the refectories industry). Speciality minerals have also done well in Q3, further supported by exports.
- **VAW Russia:** VAW Russia has lower volumes (marginal decline) compared to Q3FY2020 due to lower demand from Europe and higher number of holidays, which is a normal phenomenon.
- **Foster Zirconia:** The subsidiary had losses worth Rs. 3 crore.

- **Ceramics:** Domestic business performed well, led by good pick up in core industries, largely because of domestic repairs and maintenance segments. However, it is yet to see product order pick up. Technical ceramics did exceptionally well with uptick in volumes in auto components (spark plug). Moreover, the segment is witnessing good demand in components for clean energy and renewable space. Australian business had a tough Q3 due to geopolitical tensions with China leading to coal mining exports. Further, container shortage is impacting imports and exports.
- **Capex:** The company continues to focus its capex plans on automation projects, capex of Rs. 77 crore at consolidated levels, while Rs. 46 crore on standalone levels.
- **Budget to be positive:** Overall, the budget remains positive with focus on infra (benefit cement) and auto (scrappage policy). Capex flow can possibly flow down to private investment and benefit by way of better demand across all segments for CUMI as its present in core user industries. Further, PLI schemes across 13 segments as announced augur well for the company.

Results (Consolidated) Rs cr

Particulars	Q3FY21	Q3FY20	YoY %	Q2FY21	QoQ %
Revenue	734	649	13.0%	692	6.0%
Net raw material	257	225	14.2%	246	4.5%
Employees benefit	90	89	1.3%	85	5.0%
Power cost	96	90	6.6%	90	6.1%
Other Expense	161	149	7.9%	136	18.4%
Operating profit	130	96	34.5%	134	-3.1%
Other Income	5	4	14.1%	10	-49.6%
Interest	1	1	-43.5%	1	-30.7%
Depreciation	25	27	-7.4%	24	2.3%
PBT	109	73	49.9%	119	-7.9%
Tax	27	18	49.8%	32	-14.1%
Reported PAT	88	63	39.5%	86	1.4%
Adj. PAT	88	63	39.5%	86	1.4%
			BPS		**BPS**
OPM (%)	17.7	14.9	283	19.4	(167)
NPM (%)	11.9	9.7	227	12.5	(54)
Tax rate(%)	24.8	24.8	-	26.5	-

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view – Outlook encouraging, healthy growth prospects

India's Atama Nirbhar initiative and government's efforts on reviving industrial activities are likely to boost growth prospects. Further, the abrasives business caters to a number of industries such as steel, automobiles, auto components, and general metal fabrication. Thus, the diversified user industry keeps the momentum going further. The abrasives market in India stands at Rs. 3,200 crore and is expected to grow further as the economy further gains steam. Key success factors for abrasives in India are good, consistent quality, cost, right value proposition, innovation and differentiation, service, and capability, which are likely to provide total grinding solutions. Further, with pickup in domestic industrial activities, abrasives are the early beneficiaries due to their diversified user industries.

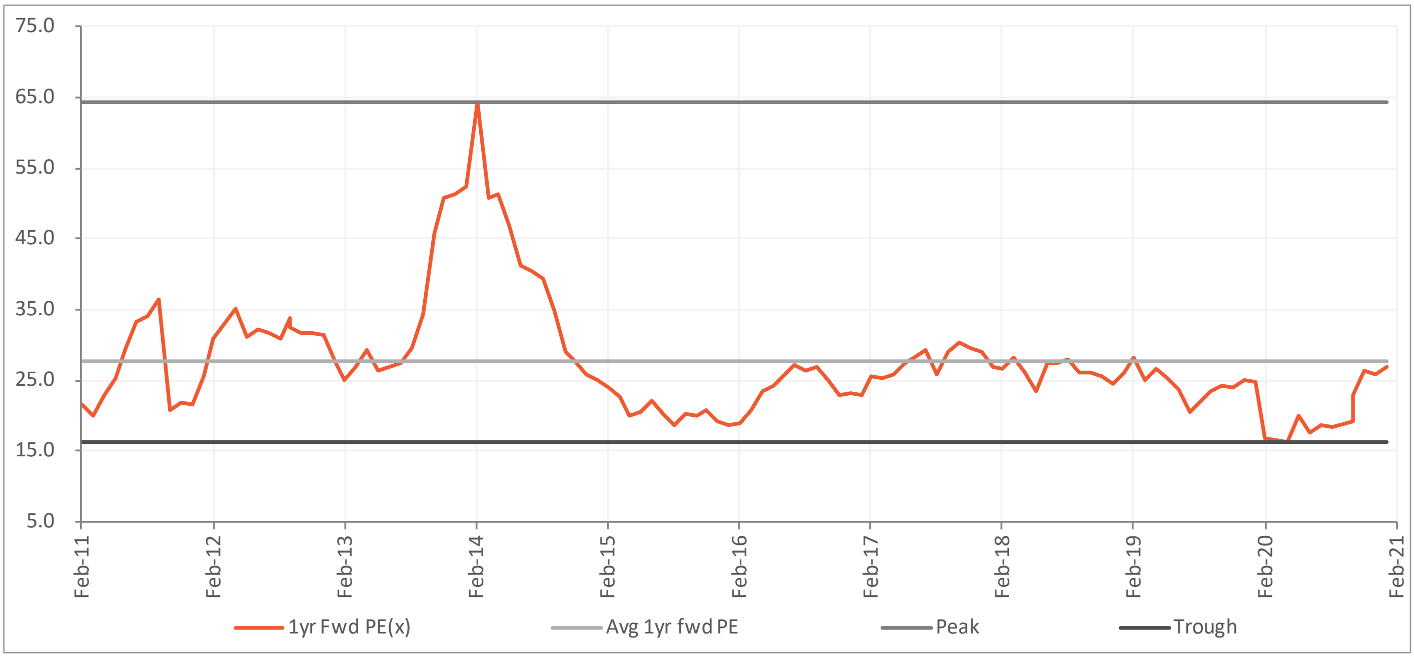
■ Company outlook – Promising outlook ahead

CUMI is expected to benefit from early economic cycle recovery in the domestic market along with improvement in overseas operations. The company's ceramics and electro mineral verticals are expected to maintain their high revenue growth trajectory during FY2021-FY2023E. Further, abrasives revenue is expected to revive from low base in FY2020. CUMI's cost-competitive position in electrominerals (being the largest and lowest cost producer domestically and marginal difference with China) is expected to benefit in terms of being a domestic and overseas supplier (countries looking to reduce dependence on China). Overall, we expect the company to return to its high earnings growth trajectory during FY2021-FY2023E with an improvement in domestic operations along with sustained healthy overseas operations.

■ Valuation - Retain Buy with a revised PT of Rs. 540:

The business is looking up with better-than-anticipated pickup in economic recovery and manufacturing activity. CUMI's growth momentum is expected to sustain given improvement in domestic economic activity and a strong product line-up for overseas operations. The company's capacity expansion, new product introduction, end-user demand, and geographic diversification are expected to revive its earnings growth trajectory from FY2022. We expect CUMI to report revenue/operating profit/PAT at a CAGR of 15.1%/17%/19% during FY2021E-FY2023E. We have revised our estimates upward, factoring higher revenue during Q3FY2021. The company is currently trading at a P/E of 26.5x/23.0x on FY2022E/FY2023E earnings, which we believe is reasonable, considering its strong earnings growth outlook and robust balance sheet. Hence, we recommend Buy on CUMI with a revised PT of Rs. 540.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

CUMI was incorporated as a joint venture between Carborundum Company USA, Universal Grinding Wheel Company, UK and the Murugappa, India in 1954. The company manufactures a wide range of abrasives (bonded, coated, and super abrasives), ceramics (wear resistance, lined equipment, engineered ceramics, and metallised ceramics), refractories (fired products and monolithics), and electrominerals (silicon carbide, alumina and zircoania). The company has 30 plants located across seven countries.

Investment theme

CUMI delivered 44.7% earnings CAGR from FY2015-FY2020 and is expected to post strong 21% earnings CAGR over FY2021-FY2023E, led by: (1) jump in realisation led by progress in product value chains across segments; and (2) recovery in abrasives and ceramics margins on improved industrial production growth. We expect revenue to report a 15% CAGR over FY2021-FY2023E, as profitability of the domestic business recovers in abrasives, led by major user industries along with recovery in ceramics, driven by better project investments, improved product mix with increasing contribution of the better profitable metz cylinders in the overall mix, and global tie-ups such as Anderman and Sheffield in refractories. In electrominerals, recovery will be led by moving up the value chain such as micronisation in case of SIC microgrit, finding alternate utilisation to photovoltaic such as diesel particulate filters, and increasing utilisation in metallurgical sales in Volzhsky Abrasive Works (Russia) and monoclinic capacity in Foskor Zirconia (South Africa).

Key Risks

- Highly responsive to growth (or the lack of it) in user industries: Slowdown in user industries could lead to Carborundum Universal's growth contracting.
- Delay in sale of Foskor Zirconia: If management cannot find a suitable buyer, margins would keep shrinking.

Additional Data

Key management personnel

Mr M M Murugappan	Chairman
MR. N ANANTHASESHAN	Managing Director
Mr Ninad Gadgil	President -Abrasives
Mr P S Jayan	Executive Vice President – Electrominerals
MR. P PADMANABHAN	Chief Account Officer

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Ambadi Investments Ltd.	29.59
2	HDFC AMC	9.22
3	SBI Funds Management Pvt. Ltd.	7.27
4	SBI Long Term Fund	5.28
5	Capital Group Company Inc.	3.03
6	ICICI Pru Life Insurance Co. Ltd.	2.70
7	Shamyak Invest	2.11
8	Murugappa EDUCL & Med FDTN	2.01
9	Reliance Capital Trustee Co. Ltd.	1.64
10	L&T Mutual Fund Trustee/India	1.55

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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