Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

SRF Ltd

Weak quarter; H2 to witness improvement

Speciality Chem			Sharekhan code: SRF		
Reco/View	Reco: **Buy**	↔	CMP: **Rs. 2,111**	Price Target: **Rs. 2,430**	↑

↑ 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 19.00
Updated Oct 08, 2021

Low Risk

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

Source: Morningstar

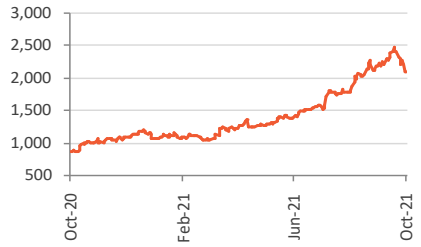
Company details

Market cap:	Rs. 62,545 cr
52-week high/low:	Rs. 2544/854
NSE volume: (No of shares)	3.4 lakh
BSE code:	503806
NSE code:	SRF
Free float: (No of shares)	14.6 cr

Shareholding (%)

Promoters	51
FII	19
DII	10
Others	20

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-5.3	37.8	64.2	141.1
Relative to Sensex	-7.4	21.1	38.9	89.7

Sharekhan Research, Bloomberg

Summary

- Q2FY22 operating profit/adjusted PAT of Rs. 675 crore/ Rs. 362 crore, up 18%/11% y-o-y missed our and the street's estimate due to weaker-than-expected revenue/margin in the packaging film business, higher depreciation, and tax rate.
- Packaging films division reported muted revenue growth/margin decline of 2.9%/599 bps q-o-q given pressure on BOPET spreads. Technical textiles (TT)/chemicals business clocked strong revenue growth of 68%/28% y-o-y, while EBIT margin rose by 869/249 bps y-o-y to 23.8%/22.3%. Chemical margins were aided by better ref-gas prices; logistic issues sustain for specialty chemical players.
- Specialty chemical growth guidance of 15-20% for FY22 with H2 likely to better than H1; ref-gas margin to sustain given better pricing. Company guided for similar utilisation for TT.
- We maintain a Buy on SRF with a revised PT of Rs. 2,430 given sustained high earnings growth outlook and RoE of 20.4%. Favorable dynamics of Indian specialty chemicals space would support premium valuations.

SRF Limited's Q2FY22 results were below our and street estimates with 4%/2%/13% miss in revenue, EBITDA/adjusted PAT at Rs2,943 crore/Rs675 crore/ Rs362 crore, up 35%/18%/11% y-o-y. The miss in earnings was primarily due to weak performance of packaging film business (revenue up only 2.9% q-o-q and EBIT margin declined sharply by 599 bps q-o-q on account of lower BOPET spreads) and higher tax rate. On the positive, technical textiles (TT)/chemical segments posted strong show with a revenue growth of 68%/28% y-o-y to Rs. 558 crore/Rs. 1,126 crore and robust margin expansion by 869 bps/249 bps y-o-y to 23.8%/22.3%. Within chemical segment, fluorochemicals witnessed strong growth supported by higher volumes in the refrigerants, blends, and chloromethanes and improved margin for refrigerants led by better realizations. The specialty chemical business also reported healthy growth led by higher sales from exports/domestic market and contribution from recent capitalisation of projects, but higher raw material prices and logistic issue remained a concern (but situation on improving trend from September/October). Growth in the technical textiles business was driven by higher volume from the nylon tyre cord fabrics, belting fabrics and polyester industrial yarn segments and improved pricing given renegotiation of contracts.

Key positives

- Robust revenue growth of 68%/28% y-o-y in technical textiles/chemical segments.
- Technical textiles/chemical EBIT margin rose by 869 bps/249 bps y-o-y to 23.8%/22.3%.

Key negatives

- Sharp contraction in packaging film EBIT margin by 599 bps q-o-q to 16.7% on lower BOPET spreads.

Management Commentary

- **Specialty chemical/ref-gas** - The management maintained its 15-20% y-o-y growth guidance for FY22E for the specialty chemical business (H2 expected to be better than H1). Margin environment for ref-gas to sustain led by improved pricing given limited capacity additions.
- **Technical textiles** - Capacities are well utilised and expect to maintain the same in H2FY22.
- **Packaging film** - Q3/Q4 expected to witness a pick-up in demand; however, commissioning of new capacities in FY22-23 could put pressure on pricing/margins.
- **Capex** - Maintained guidance of Rs. 2,000 crore for FY22 despite a capex of only Rs. 660 crore in H1FY22 with key projects (CMS expansion, PTFE, R32, HFCs) are on track. Capex costs are rising due to inflation but IRR is likely to sustain

Revision in estimates - We maintain our FY22-24 earnings estimates as strong growth in chemical and TT to drive earnings growth while volume growth in packaging film to offset lower margins.

Our Call

Valuation – Maintain Buy on SRF with a revised PT of Rs. 2,430: High growth in the chemicals business supported by high capex intensity, sustained strong margin for the technical textiles business and focus in value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 19%/19%/23% over FY2021-FY2024E along with good RoE/RoCE of 20.4%/22.2%. Investment in right areas of specialty chemical would improve earnings quality and safeguard SRF from cyclicality in packaging film margins. A superior earnings growth outlook, strong FCF generation and robust balance sheet keep us constructive on SRF and justify premium valuations. Hence, we maintain a Buy on SRF with a revised PT of Rs. 2,430. At CMP, the stock is trading at 35.1x its FY2023E EPS and 28x 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	10,266	12,064	14,135
OPM (%)	25.5	24.5	24.8	25.3
Adjusted PAT	1,197	1,438	1,780	2,236
% y-o-y growth	17.5	20.1	23.7	25.6
EPS (Rs.)	40.4	48.6	60.1	75.5
P/E (x)	52.2	43.5	35.1	28.0
EV/EBITDA (x)	30.2	25.9	21.5	17.3
RoCE (%)	18.5	19.1	20.4	22.2
RoE (%)	20.3	19.1	19.6	20.4

Source: Company; Sharekhan estimates
Note: We have adjusted FY21-FY24E EPS for bonus issue in the ratio of 4:1

Q2 missed estimate on sharp margin contraction in packaging film; Technical textiles/chemical posted strong growth

SRF's consolidated revenues at Rs. 2,839 crore (up 35.1% y-o-y; up 5.2% q-o-q) was 4% below our estimates of Rs. 2943 crore due to miss in revenues (up only 2.9% q-o-q) from packaging film segment. Technical textiles/ chemical segments posted strong revenue growth of 68%/28% y-o-y to Rs. 558 crore/Rs. 1,126 crore. EBITDA margin at 23.8% (down 348 bps y-o-y; down 110 bps q-o-q) was marginally better than our estimate of 23.5%. Technical textiles/ chemical business' EBIT margin witnessed strong improvement of 869bps/249bps y-o-y to 23.8%/22.3% but the benefit of the same was offset by weak packaging film EBIT margin at 16.7% (down 1280 bps y-o-y; down 599 bps q-o-q). Consequently, operation profit at Rs. 675 crore (up 17.9% y-o-y; up 0.5% q-o-q) was 2.4% below our estimate of Rs. 691 crore. Adjusted PAT at Rs. 362 crore (up 11.2% y-o-y; down 6.8% q-o-q) was 13.5% below our estimate due to miss in revenue, higher depreciation cost and tax rate at 28.2%.

Q2FY2022 conference call highlights

Specialty chemicals business – Revenue growth guidance maintained at 15-20% for FY22E

- This segment witnessed strong demand from new as well as existing customers in agro-chemicals as well as pharma.
- Margins in this segment impacted due to high raw material prices and higher freight costs due to supply chain disruptions. However, management expects situation to normalise in coming quarters.
- The company has approved a Capex of Rs. 27.5 crore for increasing the production capacity of products catering to the agrochemical Industry.
- The management maintained its revenue growth guidance of 15-20% for FY2022 and is hoping to revise it in December 2021.
- The management expects H2 to be better for specialty chemical as expectation of normalization (logistic issue) would improve margins.

Fluorochemicals – Improved volume/price aided growth

- Improved performance of the segment was led by enhanced sales volumes of refrigerants, blends, and chloromethane and better realisation (especially for refrigerants) from international markets and benefit of pent-up demand in domestic markets.
- Healthy contribution from chloromethane segment also led to growth.
- Pricing in this segment to remain strong given limited capacity addition and higher raw material costs.
- Key projects like CMS expansion, PTFE, R32, HFCs are on track. However, the cost of capex increased, led by inflation in key items such as steel and cement, but management is confident to maintain IRR.
- Auto market and air-conditioner production remained subdued during the quarter on account of global chip shortage and supply chain disruptions. However, a large replacement market benefited SRF.
- Capacity utilization in Q2FY22 was over 90% and expected remain the same in H2FY22.
- Chloromethanes capacity to be commissioned by March 2022 and additional R-32 capacity of 2500 tonnes by January 2022.
- Fluorocarbon-based refrigerant capacity (swing capacity) of 15000 tonnes would be commissioned in next two years.

Packaging films – Q3/Q4 likely to be better on demand pick-up, upcoming new capacities to keep margins under pressure

- BOPET margins were under pressure during the quarter due to rising raw material prices offsetting strong demand of BOPP films.
- Started new BOPP film line at Rayong, Thailand, and offers diverse range of specialty packaging films.
- Management guided for commissioning of new capacities over FY22-23 and the same would put pressure on margin. However, Q3/Q4 of FY22 is expected to benefit from demand pick-up while only few plants expected to be commissioned.
- Higher logistics cost due to supply chain disruption and higher raw material price remains a cause of concern for segment.

Technical textiles – Strong utilization to sustain in H2

- The technical textiles business performed well because of higher sales volumes from the nylon tyre cord fabrics, belting fabrics and polyester industrial yarn segments.
- Within the domestic tyre industry, strong momentum was witnessed across all areas, resulting in increased demand in the TCF sector.

- The company is putting efforts to improve operational efficiency and reduce cost in this segment.
- In addition, re-negotiation of contracts with long-term customers contributed to growth.
- Utilization in H2 to remain at the same level as H1 as demand remains robust (especially from tyre and belting fabric industry with the reopening of the mining sector).

Maintained total capex at Rs. 2, 000 crore for FY22E

- The management has maintained its capex guidance of Rs. 2,000 crore for FY2022E (which includes Rs. 1000 crore for chemical business, Rs. 400-500 crore for packaging films, Rs. 200 crore for new projects and the rest for technical textiles).

Power & fuel costs: Overall power & fuel cost has gone up by Rs. 30-35 crore q-o-q in Q2FY2022. The company is contemplating to pass some of the power & fuel cost increase to the customers.

Results (consolidated) Rs cr

Particulars	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)
Revenue	**2,839**	**2,101**	**35.1**	**2,699**	**5.2**
Total Expenditure	2,164	1,528	41.6	2,028	6.7
Operating profit	**675**	**572**	**17.9**	**672**	**0.5**
Other Income	11	10	14.1	14	(19.3)
Depreciation	130	114	14.3	123	6.0
Interest	23	36	(35.4)	27	(15.0)
PBT	532	432	23.2	535	(0.5)
Tax	150	116	28.9	140	7.4
Reported PAT	**382**	**315**	**21.3**	**395**	**(3.2)**
Adjusted PAT	**362**	**325**	**11.2**	**388**	**(6.8)**
Reported EPS (Rs.)	12.9	10.6	21.3	13.3	(3.2)
Adjusted EPS (Rs.)	12.2	11.0	11.2	13.1	(6.8)
Margin (%)			**YoY (BPS)**		**QoQ (BPS)**
Operating profit margin (OPM)	23.8	27.3	(348)	24.9	(110)
Tax rate	28.2	26.9	123.0	26.1	206.4
Adjusted NPM	12.7	15.5	(274)	14.4	(163)

Source: Company; Sharekhan Research

Segmental performance (consolidated) Rs cr

Particulars	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)
Segmental revenue					
Technical Textiles	558	332	68.0	493	13.2
Chemical	1,126	881	27.8	1,114	1.1
Packaging Film	1,072	833	28.7	1,041	2.9
Others	86	57	51.8	54	60.9
Total	**2,842**	**2,103**	**35.2**	**2,702**	**5.2**
Inter Segment	3	2	50.2	2	55.9
Net Revenue	**2,839**	**2,101**	**35.1**	**2,699**	**5.2**
Segmental EBIT					
Technical Textiles	133	50	164.6	134	(1)
Chemical	251	174	43.9	222	13
Packaging Film	180	246	(27.1)	237	(24)
Others	6	9	(34.5)	2	205
Total EBIT	**569**	**480**	**18.7**	**595**	**(4)**
EBIT Margin (%)			**BPS**		**BPS**
Technical Textiles	23.8	15.1	869	27.1	(331)
Chemical	22.3	19.8	249	20.0	233
Packaging Film	16.7	29.6	(1,280)	22.7	(599)
Others	6.7	15.5	(884)	3.5	317
Overall EBIT margin	**20.0**	**22.8**	**(278)**	**22.0**	**(198)**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Structural drivers to propel sustained growth for specialty chemical sector in medium to long term

We remain bullish on the 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 incentives and PLI schemes similar to that of the pharmaceutical sector). We believe that conducive government policies, product innovation, massive export opportunities and low input prices would help the sector clock high double-digit earnings growth trajectory on a sustained basis in the next 2-3 years.

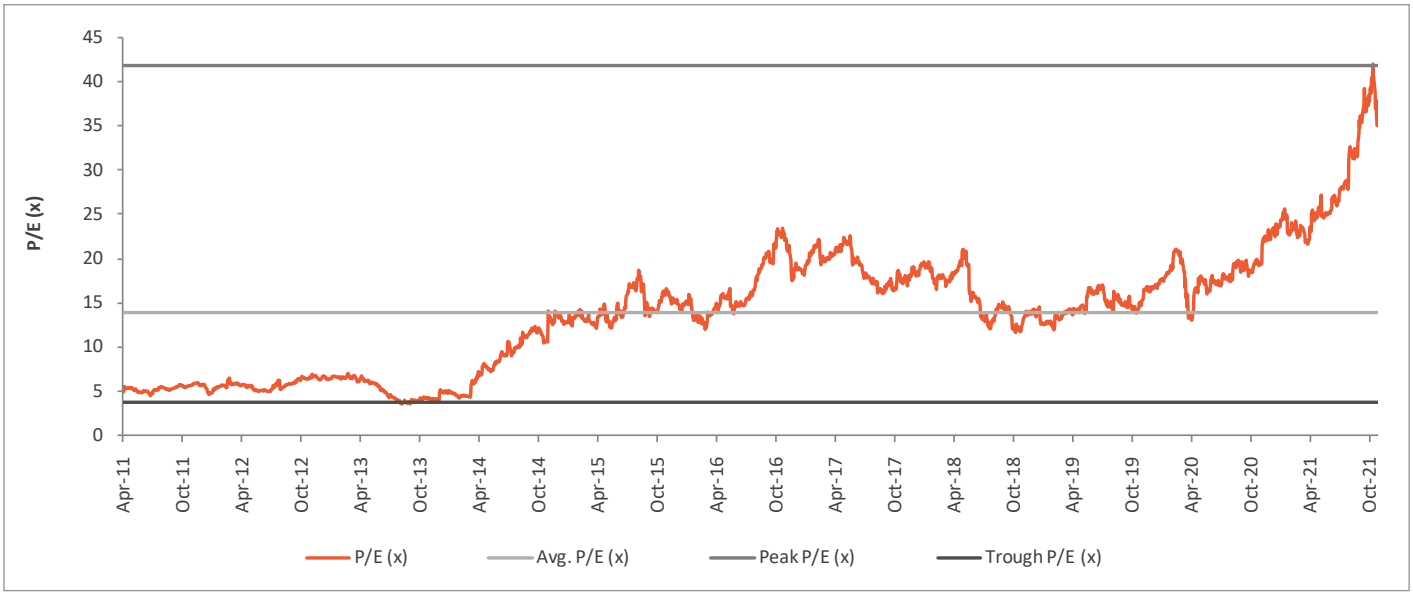
■ Company outlook - Long-term story stays intact, Capex momentum to continue

The management sees significant growth opportunities in the agro-chemicals and active pharmaceutical ingredients segments (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 expects 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. Increased volumes from expanded capacities to drive packaging films volume although margin expected to contract given over supply 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. 2,430

High growth in the chemicals business supported by high capex intensity, sustained strong margin for the technical textiles business and focus in value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 19%/19%/23% over FY2021-FY2024E along with good RoE/RoCE of 20.4%/22.2%. Investment in right areas of specialty chemical would improve earnings quality and safeguard SRF from cyclicality in packaging film margins. A superior earnings growth outlook, strong FCF generation and robust balance sheet keep us constructive on SRF and justify premium valuations. Hence, we maintain a Buy on SRF with a revised PT of Rs. 2,430. At CMP, the stock is trading at 35.1x its FY2023E EPS and 28x 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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Amansa Holdings Pvt Ltd	5.6
2	Kotak Mahindra Asset Management Company Ltd/India	4.5
3	Vanguard Group Inc.	1.5
4	Mirae Asset Global Investments Company	1.3
5	SBI Life Insurance Company Ltd	1.3
6	SBI Funds Management Pvt. Ltd	1.3
7	ICICI Prudential Life Insurance Company	1.2
8	NGUYEN THI HONG	1.1
9	HDFC Life Insurance Co. Ltd	1.1
10	Nippon Life India Asset Management	1.0

Source: Bloomberg

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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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