Carborundum Universal Ltd

Long-term prospects bright despite Russia-Ukraine headwinds

Capital Goods	Sharekhan code: CARBORUNIV

Reco/View: Buy	↔	CMP: **Rs. 715**	Price Target: **Rs. 952**	↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Carborundum Universal Limited (CUMI) is likely to be affected in the near-term on account of its direct exposure to Russia through its subsidiary VAW, which comprised 23%/30% of consolidated revenues/PAT over FY2019-FY2021.
- Given VAW's exposure to Russia as well as other CIS members including Ukraine, in terms of sales, raw material sourcing and exports from Russia, the ongoing crisis is likely to affect net earnings over near term until the situation gets resolved.
- The company's long-term growth is expected to be aided by domestic capacity expansions and recent acquisitions done in European region.
- We retain a Buy on the stock with a revised PT of Rs. 952 factoring downward revision in estimates and reasonable valuation post recent correction in the stock price.

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 Updated Jan 08, 2022	28.04

Medium Risk

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

Source: Morningstar

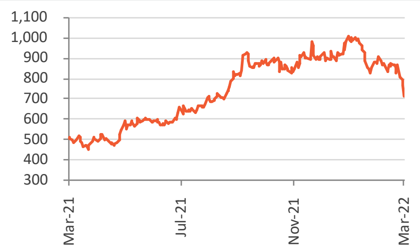
Company details

Market cap:	Rs. 13,574 cr
52-week high/low:	Rs. 1035/439
NSE volume: (No of shares)	3.04 lakh
BSE code:	513375
NSE code:	CARBORUNIV
Free float: (No of shares)	11.0 cr

Shareholding (%)

Promoters	42.0
FII	10.5
DII	25.9
Others	21.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-18.6	-21.3	-12.6	39.0
Relative to Sensex	-9.8	-15.5	-6.5	32.1

Sharekhan Research, Bloomberg

CUMI is expected to be affected in the near term on account of the ongoing battle between Russia and Ukraine, related sanctions imposed on Russia and likely changes in global equation especially between Russian and European countries. CUMI's direct exposure to Russia is through Volzhsky Abrasive Works (VAW, 98% stake), which comprised on an average 23%/30% of consolidated revenue/profit share during FY2019-FY2021. VAW holds a significance in terms of being largest producer of Silicon carbide abrasive in Russia and comprised 39% of overall capex spends in FY2021. Further, 40% of VAW sales is in Russia CIS (including Ukraine) with Ukraine being one of the suppliers of raw materials for the Russian abrasives business. Hence, overall, we expect the ongoing Russia-Ukraine crisis to affect net earnings over the near term.

- **CUMI's direct exposure towards Russia:** CUMI's ~98% Russian subsidiary, Volzhsky Abrasive Works (VAW) manufactures abrasives, ceramics and electro-minerals. VAW is the largest producer of silicon carbide abrasives in Russia, with an installed capacity of 80,000 tonnes p.a. VAW contributed ~23%/30% to CUMI's consolidated Revenues/PAT during FY2019-FY2021. CUMI had spent around Rs. 40 crore (39% of total capex outlay) for its subsidiary in FY21.
- **Geopolitical crisis may affect near-term earnings:** ~60% of VAW's production is shipped to Europe and other countries while 40% is consumed in Russia CIS (including Ukraine). VAW also buys some of its raw materials from Ukraine for its abrasives business in Russia. VAW's high exposure towards Russia and European countries is likely to get affected due to current Russia-Ukraine battle. In addition, it may face logistics issue on shipping products from VAW to such countries, which may stop importing goods from Russia in the near term. Hence, we expect its consolidated net earnings to be impacted in the near term until the situation gets resolved.
- **Capacity expansions ex-Russia & recent acquisitions to aid growth:** CUMI is expanding capacities in India (by 25-30% in electro-minerals division (EMD) by a year or a year-and-a-half and de-bottlenecking in metallized cylinders) and Germany (Rhodius and Awuko acquisitions which would provide entry into new products, raw material security and distribution reach in Europe). Hence, we expect a healthy growth from domestic market and from overseas subsidiaries (ex-Russia) going ahead.

Revision in estimates – We have revised our estimates downward factoring in the likely impact of the Russia-Ukraine war on its Russian Subsidiary for the next couple of quarters.

Our Call

Valuation: Retain Buy with a revised PT of Rs. 952: CUMI's near-term performance could be impacted by the Russia-Ukraine crisis given that the Russian subsidiary contributes meaningfully to its revenues and profits. However, as and when things stabilise, we expect CUMI's growth momentum to pick up driven by demand across segments such as abrasives and EMD along with a strong product line-up for overseas operations. CUMI stands to benefit from multiple factors such as a broad-based recovery in industrial capex, China +1 strategy, strong government initiatives to support domestic manufacturing and healthy demand prospects for regular and specialty products. The stock currently trades at a P/E of 27x on FY2024E earnings, which we believe leaves further room for an upside, considering its strong earnings growth outlook and a healthy balance sheet. Hence, we retain Buy on CUMI with a revised PT of Rs. 952.

Key Risks

1) If the Russia Ukraine crisis is prolonged, it could impact its mid-term performance 2) Weak economic environment both domestic and globally; 3) Delay in sale of its loss-making Fosker Zirconia unit.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Net sales (Rs cr)	2,632	3,262	3,853	4,195
OPM (%)	17.7	17.1	17.2	17.9
Net profit (Rs cr)	299	361	438	500
PAT growth (%)	9.7	21.0	21.3	14.0
Adjusted EPS (Rs)	15.8	19.1	23.2	26.4
PER (x)	45.2	37.4	30.8	27.1
P/B (x)	6.3	5.7	5.0	4.4
EV/EBIDTA (x)	25.6	20.9	17.3	15.0
RoCE (%)	19.0	20.9	22.5	22.5
RoE (%)	15.0	16.0	17.2	17.2

Source: Company; Sharekhan estimates

Geo-political crisis may impact near term performance:

CUMI's ~98% Russian subsidiary- Volzhsky Abrasive Works (VAW), manufactures abrasives, ceramics and electro-minerals. VAW is the largest producer of silicon carbide abrasives in Russia, with an installed capacity of 80,000 tonnes a year. VAW contributed ~23% to CUMI's consolidated annual revenues and over 30% to its consolidated net profit after tax. CUMI spent around Rs 40 crore (39% of total capex's outlay) for its subsidiary in FY21. The subsidiary's performance has shown improvement in the last few quarters with optimum capacity utilisation, favourable product mix as well as product launches in niche segments. Given its exposure to Russia, we believe that the ongoing Russia-Ukraine war may have an adverse impact on the performance of the subsidiary, thereby affecting earnings of CUMI in the near term.

Capacity expansions ex-Russia & recent acquisitions to aid growth:

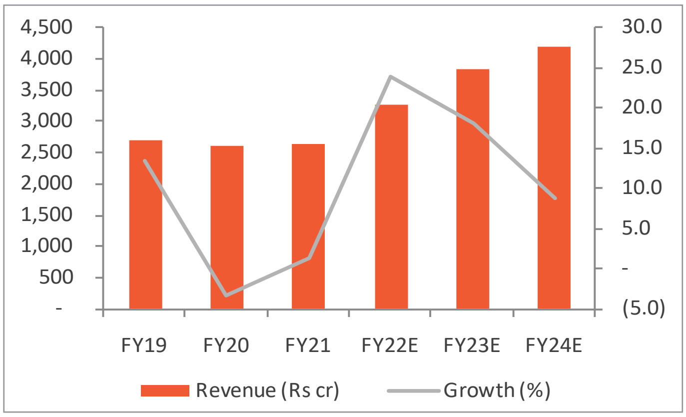
CUMI has undertaken considerable capacity expansion in India (by 25-30% in EMD by a year or year and a half and de-bottlenecking in metallized cylinders) which should aid growth. Further, it acquired two abrasives companies in Germany - Rhodius and Awuko, which would provide thin wheel capabilities for grinding and cutting, enhance distribution network in Europe and enable cross-selling of products between India and Europe. Overall, the demand environment is favourable across product segments, which should lead to strong revenue and earnings growth in the long-term.

Recent events:

- **Strategic acquisitions to propel growth:** On October 6, 2021, the company acquired a 72% stake in PLUSS Advanced Technologies effectively becoming subsidiary of the company. The company also acquired Abrasives Wandmacher GmbH (AWUKO) in Germany for a consideration of 8 million euros. Awuko is a 120-year old leading brand in coated abrasives business and is a market leader in leather and wood applications. It also acquired a 100% stake in Rhodius Schleifwerkzeuge Verwaltungsgesellschaft GmbH (Rhodius) in Germany for an enterprise value of 55 million euros. The transaction is expected to complete by March 2022-end. Rhodius is a leading abrasive brand in Europe. These acquisitions would provide entry into new products, raw material security for new partners and distribution reach in Europe. The acquisitions would also help gain entry into resin bonded thin wheels.
- **Rhodius:** The Rhodius acquisition brings about significant change in terms of technology profile, brand profile, distribution network across Europe. It would help CUMI to roll products into India and using Rhodius distribution channel to sell CUMI products.
- **Capex:** The company incurred a Rs. 118 crore capex at consolidated level during 9MFY2022, out of which Rs. 40 crore were spent for the Russian subsidiary – VAW.
- **Capacity utilisation:** The Russian subsidiary is already stretched and adding some fuel cells. In India, it has done work on increasing capacities and de-bottlenecking, which could increase capacity by 25-30% in EMD. In abrasives, with Rhodius CUMI would get thin wheel capacities for grinding and cutting. On ceramics, it is looking at de-bottlenecking in metalized cylinders with both lines working over 80% capacity utilisation. In ceramics, mobility application and thermal products capacities will go up in modular fashion.
- **Outlook:** Demand remains strong across product segments although maintaining margins is a challenge due to increase in fuel and other material cost but can be managed by price hikes and operating efficiencies.

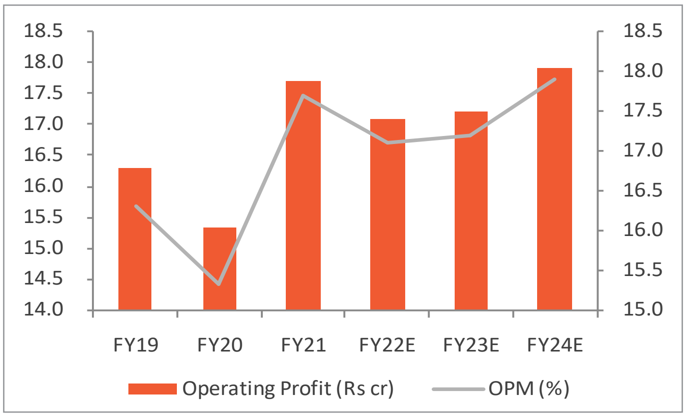
Financials in charts

Revenue growth trend



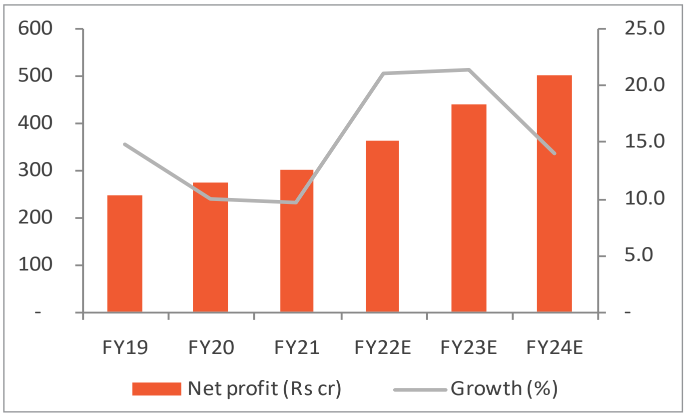
Source: Company, Sharekhan Research

Operating profit and margin trend



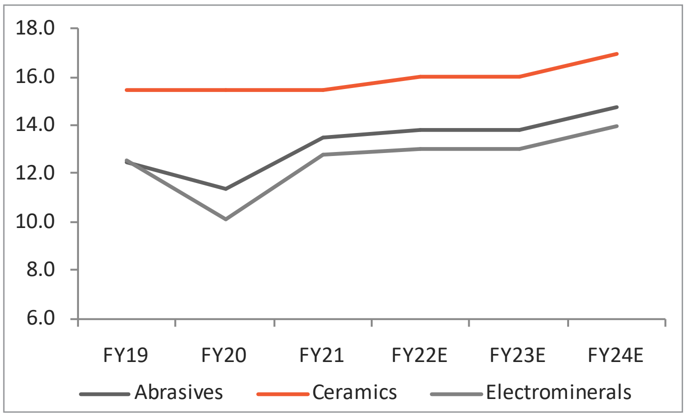
Source: Company, Sharekhan Research

Net profit growth trend



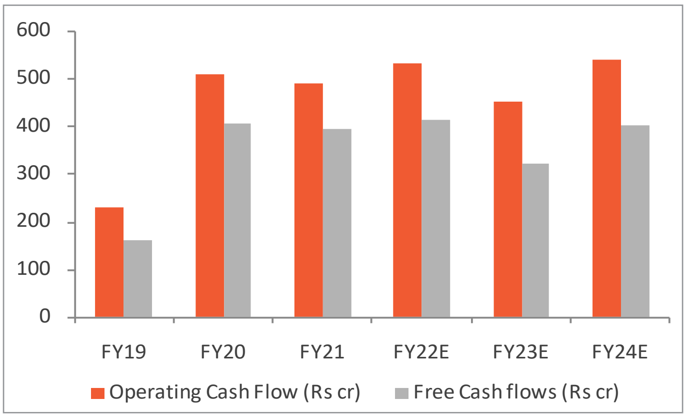
Source: Company, Sharekhan Research

Segment-wise PBIT margin (%)



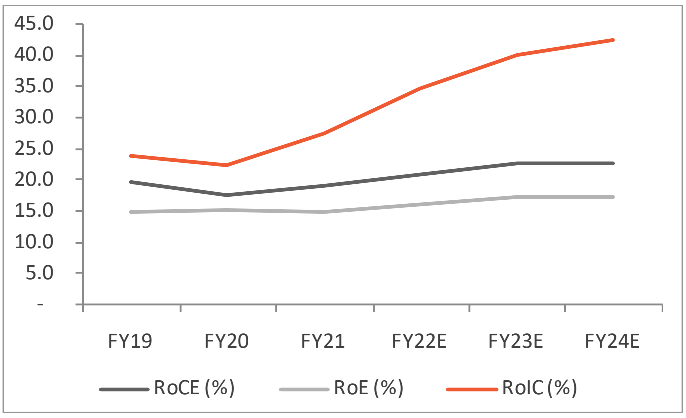
Source: Company, Sharekhan Research

Cash flow trend



Source: Company, Sharekhan Research

Return ratios trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Healthy growth prospects ahead

The *AtmaNirbhar Bharat* 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, a diversified user industry keeps the momentum going further. The abrasives market in India stands at Rs. 3,200cr and is expected to grow further as the economy gains steam. Key success factors for abrasives in India are consistent quality, cost, right value proposition, innovation and differentiation, service, and capability, which are likely to provide total grinding solutions. Further, with a pick-up in domestic industrial activities, abrasives are the early beneficiaries due to their diversified user industries.

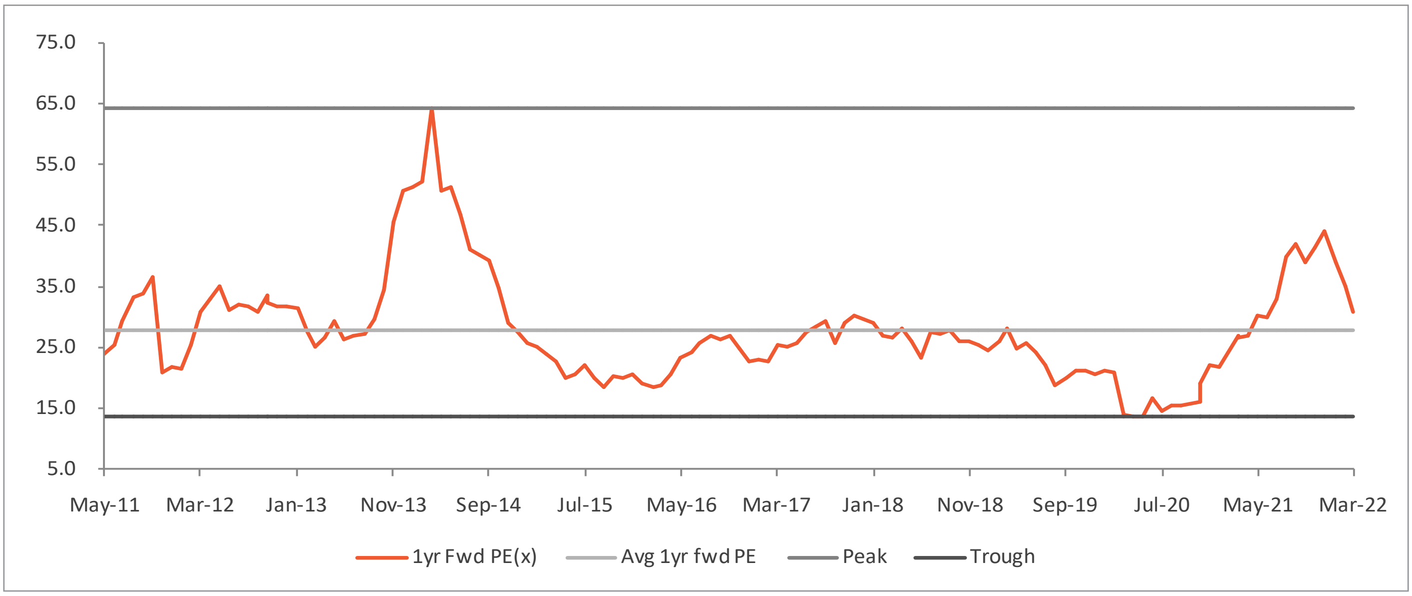
■ Company outlook - Promising long-term outlook

CUMI is expected to benefit from an early economic cycle recovery in the domestic market along with improvement in overseas operations. The company's ceramics and EMD verticals are expected to maintain their high-revenue growth trajectory during FY2021-FY2024E. CUMI's cost-competitive position in electrominerals (being the largest and lowest cost producer domestically and a 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, barring the short-term impact of the Russia Ukraine crisis, we expect CUMI to be on a high earnings growth trajectory during FY2021-FY2024E with an improvement in domestic operations along with sustained healthy overseas operations.

■ Valuation - Retain Buy with a revised PT of Rs. 952

CUMI's near-term performance could be affected by the Russia-Ukraine crisis given that the Russian subsidiary contributes meaningfully to its revenues and profits. However, as and when things stabilise, we expect CUMI's growth momentum to pick up driven by demand across segments such as abrasives and EMD along with a strong product line-up for overseas operations. CUMI stands to benefit from multiple factors such as a broad-based recovery in industrial capex, China +1 strategy, strong government initiatives to support domestic manufacturing and healthy demand prospects for regular and specialty products. The stock currently trades at a P/E of 27x on FY2024E earnings, which we believe leaves further room for an upside, considering its strong earnings growth outlook and a healthy balance sheet. Hence, we retain Buy on CUMI with a revised PT of Rs. 952.

One-year forward P/E (x) band



Source: Company Data; 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 metallized 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-FY2021 and is expected to post strong 18.7% earnings CAGR over FY2021-FY2024E, led by: (1) jump in realisation led by a 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 16.8% CAGR over FY2021-FY2024E, as improvement in the profitability of the domestic business particularly in abrasives, 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 EMD, 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 VAW.

Key Risks

- **Prolonged crisis may affect mid-term performance:** If the Russia Ukraine crisis is prolonged, it could affect CUMI's earnings for medium to long-term.
- **Highly responsive to growth (or the lack of it) in user industries:** Slowdown in user industries both domestic and overseas could lead to CUMI's growth contracting.
- **Delay in sale of Foskor Zirconia:** If the 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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Ambadi Investments Ltd.	29.53
2	SBI Funds Management Ltd.	6.99
3	HDFC AMC	5.80
4	Kotak Mahindra AMC	2.22
5	Shamyak Invest	2.11
6	ICICI Pru Life Insurance Co. Ltd.	2.10
7	Murugappa EDUCL & Med FDTN	2.01
8	Vanguard Group	1.84
9	Kotak Infrastructure	1.77
10	Nippon Life India Asset Management	1.74

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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