Sharekhan by BNP PARIBAS

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Carborundum Universal Ltd

Q4 profitability marred by challenges

Capital Goods	Sharekhan code: CARBORUNIV

Reco/View: Buy	↔	CMP: **Rs. 726**	Price Target: **Rs. 952**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Carborundum Universal Limited (CUMI) reported muted numbers for Q4FY22 particularly on the profitability front. EBIT margins across segments plunged y-o-y.
- The impact of ongoing Russia-Ukraine war on its Russian subsidiary- VAW was not meaningful. On the positive side, due to a ban on exports to Russia by several countries, demand for CUMI's silicon carbide has increased.
- Demand is expected to pick up across segments led by a better product mix aided by recent acquisitions. Although maintaining margins remain a challenge, which is likely to be managed through operational efficiencies.
- We retain a Buy on the stock with an unchanged PT of Rs. 952, considering its healthy earnings growth profile led by strong growth across end user industries.

CUMI's Q4 consolidated results fell short of our expectations mainly on profitability front due to cost pressures and one-time expenses. Its total revenue grew by 15% y-o-y to Rs 869 crore (versus our estimate of Rs 891 crore). Operating profit reduced sharply by 30% y-o-y to Rs 111 crore due to increase in raw material cost and sharp increase in employee cost and other expenses. Employee cost increased due to one-time settlement of Euro 100.8 million (~Rs. 20 crore) to employees of its recently acquired subsidiary-Rhodius Abrasives, Germany. Consequently, OPM declined by 800 bps to 12.8% (vs our estimate of 16.8% y-o-y). Adjusted profit after tax fell sharply by 46% y-o-y to Rs 57 crore (versus our estimate of Rs 94 crore) due to poor operating performance and higher tax rate at ~40%. Segment-wise, Abrasives, Ceramics and the electro-minerals segment reported 14.7%/6.1%/17.4% growth in revenues. Abrasives segment saw the sharpest fall in EBIT margin of 889 bps to 7.9% followed by ceramics at 17.4% (decline of 449 bps) and electro-minerals at 12.9% (down 170 bps). Standalone revenue grew by 15%, while PAT grew by ~8% y-o-y.

Key positives

- Abrasives/electro-minerals reported healthy y-o-y revenue growth of 14.7%/17.4%.
- Subsidiaries' performance on sales and profitability front has been healthy.

Key negatives

- Ceramics reported a relatively slower growth of 6.1% y-o-y.
- Abrasives segment witnessed EBIT margin decline of 889bps to 7.9%, followed by ceramics at 17.4% (decline of 449 bps) and electro-minerals at 12.9% (down 170 bps).

Management Commentary

- Acquisitions of Rhodius and Awuko would provide entry into new products, raw material security for new partners and distribution reach in Europe. The acquisitions would provide entry into resin bonded thin wheels. Rhodius has a robust order book and considerable order pipeline. The company has strong financial track record.
- Drop in margins is due to higher input cost, cost incurred in acquisitions and settlement of ~Rs 20cr to Rhodius employees.
- The company envisages strong infrastructure led growth both in India, the US and other key geographies. Demand remains strong across product segments although maintaining margins is a challenge.
- The Russian subsidiary – VAW has been operating at optimum capacity and domestics sales and exports to India have not been impacted so far. VAW does not have exposure to Ukraine.
- Abrasives segment had one-time provisioning of Rs 32 crore on account of legal dispute with Kerala State Electricity Board (KSEB). Adjusting for the same, margin in the abrasives division would have been at 17.5% for FY22.

Revision in estimates – We have largely maintained our estimates for FY22-24E.

Our Call

Valuation – Retain Buy with an unchanged PT of Rs. 952: CUMI's near-term performance could be impacted by supply side and logistics challenges and the Russia-Ukraine crisis given that its Russian subsidiary meaningfully contributes to revenues and profits. Although the management is confident of strong demand momentum and profitability. Moreover, 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 a strong earnings growth outlook and a healthy balance sheet. Hence, we retain Buy on CUMI with an unchanged 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

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Net sales	2,632	3,325	3,841	4,344
OPM (%)	17.7	16.1	16.4	17.1
Net profit	299	333	414	502
PAT growth (%)	9.7	11.6	24.1	21.5
Adjusted EPS (Rs)	15.7	17.6	21.8	26.5
PER (x)	46.2	41.4	33.3	27.4
P/B (x)	6.5	5.8	5.1	4.4
EV/EBIDTA (x)	26.2	23.4	18.6	15.3
RoCE (%)	19.0	19.1	20.0	21.3
RoE (%)	15.0	14.8	16.3	17.2

Source: Company; Sharekhan estimates

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 28.04

Updated Jan 08, 2022

Medium Risk

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

Source: Morningstar

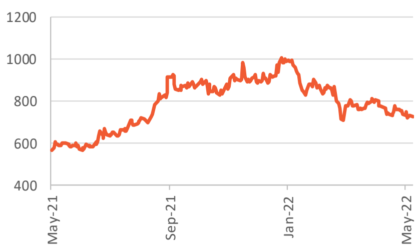
Company details

Market cap:	Rs. 13,787 cr
52-week high/low:	Rs. 1,035/439
NSE volume: (No of shares)	2.70 lakh
BSE code:	513375
NSE code:	CARBORUNIV
Free float: (No of shares)	11.0 cr

Shareholding (%)

Promoters	42.0
FII	10.2
DII	26.3
Others	21.5

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-5.2	-13.7	-21.5	27.9
Relative to Sensex	2.1	-4.8	-8.7	19.2

Sharekhan Research, Bloomberg

Stock Update

Result Update

Low profitability due to cost inflation and one-time expenses

CUMI's Q4 consolidated results fell short of our expectations mainly on profitability front due to one-time expenses. Its total revenue grew by 15% yoy to Rs 869 cr (vs our estimate of Rs 891 cr). Operating profit reduced sharply by 30% YoY to Rs 111crore due to increase in raw material cost and sharp increase in employee cost and other expenses. Employee cost increased due to one-time settlement of Euro 100.8 mn (~RS 20cr) to employees of its recently acquired subsidiary- RHODIUS Abrasives, Germany. Consequently, OPM declined by 800bps to 12.8% (vs our estimate of 16.8% yoy). Adjusted profit after tax fell sharply by 46% y-o-Y to Rs 57cr (vs our estimate of Rs 94cr) due to poor operating performance and higher tax rate ~@40%. Segment wise; Abrasives, Ceramics and Electro-minerals segment reported 14.7%/6.1%/17.4% growth in revenues. Abrasives segment had the sharpest EBIT margin decline of 889bps to 7.9% followed by ceramics at 17.4% (decline of 449 bps) and Electro minerals at 12.9% (down 170 bps). Its standalone revenue for the quarter grew by 15%, while PAT grew by 8% yoy.

Key acquisitions to widen its presence in the long-term

The company has spent Rs 666cr on all the three acquisitions carried out in FY22, most of which have been incurred through internal accruals. 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 mn 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 entered into share purchase agreement to acquire 100% stake in Rhodius Schleifwerkzeuge Verwaltungsgesellschaft GmbH (Rhodius) in Germany for an enterprise value of 55 million euros. 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.

Conference call highlights:

- **Recent acquisitions:** 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 mn 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 entered into share purchase agreement to acquire 100% stake in Rhodius Schleifwerkzeuge Verwaltungsgesellschaft GmbH (Rhodius) in Germany for an enterprise value of 55 million euros. Rhodius is a leading abrasive brand in Europe. Its total sales is around 61 million euro and has ROCE at high-teens levels. These acquisitions would provide entry into new products, raw material security for new partners and distribution reach in Europe. The acquisitions would provide entry into resin bonded thin wheels. The details about acquisition would be discussed in the next earnings call. The company carried out these acquisitions for a total consideration of Rs.660 cr.

- **Uncertainty due to geo-political tensions:** 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 contributes~23% to CUMI's consolidated annual revenues and over 30% to its consolidated net profit after tax. ~58% of VAW's production is exported to other countries while 40% is consumed in Russia. Although the company's products are not under any sanctions, supplies to European countries have been impacted due to logistics issues on account of war. However, there has been strong demand of Silicon Carbide in Russia and therefore the plant is running at optimum level. Therefore, the impact on the subsidiary's performance has been negligible. However, given the uncertainty w.r.t. the war coupled with logistics and supply side challenges, there may be an adverse impact on the company's performance going forward.

- **One time provisioning in abrasives segment:** Abrasives segment had one-time provisioning of Rs 32 cr on account of legal dispute with Kerala State Electricity Board (KSEB). Adjusting for the same, margin in the abrasives division would have been at 17.5% for FY22.

- **Capex and debt:** The capital expenditure during FY22 was Rs.170cr at consolidated level. For FY23, the company plans a capex of Rs 100-200cr. The debt is going to be at similar levels of FY22 at Rs~200-210cr.
- **Capacity utilisations:** The Russian subsidiary is already at optimum utilization. On ceramics, it is looking at de-bottlenecking in metalized cylinders with both lines working over 80% capacity utilisation.
- **Outlook:** Demand environment remain strong across product segments although maintaining margins is a challenge but will be managed by operating efficiencies.

Results (Consolidated) Rs cr

Particulars	Q4FY2022	Q4FY2021	Y-o-Y %	Q3FY2022	Q-o-Q %
Revenue	869	757	14.9%	899	-3.3%
Net raw material	297	251	18.0%	330	-10.0%
Operating profit	111	158	-30.0%	158	-29.6%
PBT	87	140	-38.2%	137	-36.8%
Tax	34	36	-4.1%	30	13.1%
Reported PAT	52	91	-42.2%	107	-51.0%
Adj PAT	57	105	-45.9%	102	-43.8%
			BPS		**BPS**
OPM	12.8	20.9	(818)	17.5	(476)
NPM	6.6	13.9	(738)	11.3	(473)
Tax rate	39.6	25.5	1,408	22.1	1,747

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view – Healthy growth prospects ahead

India's *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. 3,200 crore 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.

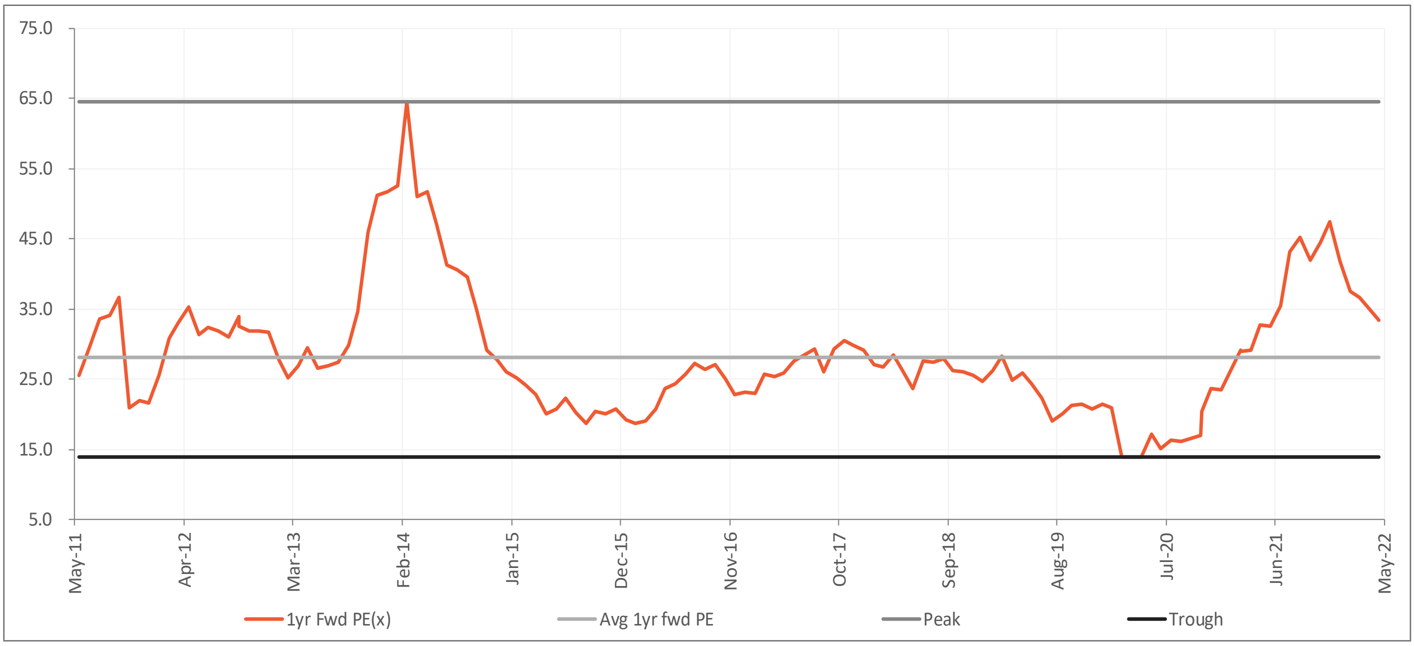
■ Company outlook – Promising outlook

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 likley short-term impact of the Russia Ukraine crisis, logistics and supply side challenges, we expect CUMI to be on a high earnings growth trajectory during FY2022-FY2024E with an improvement in domestic operations along with sustained healthy overseas operations aided by recent acquisitions.

■ Valuation – Retain Buy with an unchanged PT of Rs. 952

CUMI's near-term performance could be impacted by supply side and logistics challenges and the Russia-Ukraine crisis given that its Russian subsidiary contributes meaningfully to its revenues and profits. Although management is confident of strong demand momentum and profitability. Moreover, 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 an unchanged PT of Rs. 952.

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-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 Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Ambadi Investments Ltd.	29.52
2	Sbi Retirement Benefit Fund	8.98
3	Hdfc Large And Mid Cap Fund	4.33
4	Kotak Pioneer Fund	2.66
5	Shamyak Investment Private Limited	2.11
6	Nippon Life India Trustee Ltd	1.74
7	ICICI Prudential Life Insurance Company Limited	1.55
8	L&t Mutual Fund Trustee Limited	1.50
9	Massachusetts Institute Of Technology	1.30
10	Kotak Funds - India Midcap Fund	1.24

Source: Bloomberg; Capitaline

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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