Sharekhan by BNP PARIBAS

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Sudarshan Chemical Industries Ltd

Muted Q1 on weak margins; downgrade to Hold

Speciality Chemicals	Sharekhan code: SUDARSCHEM
Reco/View: Hold ↓	CMP: **Rs. 455**	Price Target: **Rs. 510** ↓

↑ 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		↔	

Company details

Market cap:	Rs. 3,153 cr
52-week high/low:	Rs. 773/405
NSE volume: (No of shares)	1.5 lakh
BSE code:	506655
NSE code:	SUDARSCHEM
Free float: (No of shares)	4.4 cr

Shareholding (%)

Promoters	35.8
FII	6.0
DII	13.0
Others	45.1

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	6.5	-5.6	-23.4	-34.8
Relative to Sensex	-1.5	-13.6	-24.0	-43.0

Sharekhan Research, Bloomberg

Summary

- Q1FY23 performance was subdued with a 12% q-o-q decline in revenues, due to pressure on volumes/pricing and asharp contraction of 625 bps q-o-q in OPM to 7.5% as company was not able to pass on high energy/logistics cost. Operating profit/PAT of Rs. 41 crore/Rs. 7 crore, down 52%/84% q-o-q missed our estimate by 38%/75%.
- Domestic/export revenues declined by 6%/5% q-o-q to Rs. 268 crore/Rs. 258 crore given the deferment of purchase decisions by domestic customer due to volatility in polymer prices and subdued global demand. Specialty segment's revenue decline by 9% q-o-q to Rs. 352 crore due to weak demand for plastics.
- Q2FY23 would not see major recovery due to weak global demand and high supply, purchase deferment given fall in polymer price and continued elevated energy/logistics cost. Capex is nearing completion but commissioned projects seeing low yield and high manufacturing. We thus cut our FY23-24 earnings estimate by 35%/6% to factor lower revenue growth/margin.
- We downgrade Sudarshan Chemical Industries Limited (SCIL) to Hold with a revised PT of Rs. 510 (to reflect cut in earnings estimate) given subdued earnings outlook (expect FY23 PAT to decline by 25%) and see limited upside from CMP.Stock trades at 32.5x/16.8x its FY2023E/FY2024E EPS.

Sudarshan Chemical Industries Limited's (SCIL) witnessed pressure on consolidated revenues, which declined by 11.6% q-o-q (up 16.9% y-o-y) to Rs. 554 crore (in-line) due to volume and pricing pressure in both domestic and export markets. Pigment division revenue declined by 5.8% q-o-q (up by 16.1% y-o-y) to Rs.526 crore due to volume decline amid subdued demand across geographies and business segments along pricing pressure. Export revenues declined by 5% q-o-q to Rs. 258 crore due to subdued global demand given the geopolitical scenario and tightening monetary policy while domestic revenue were down by 6% q-o-q to Rs. 268 crore due to deferment of purchase decisions, given volatility in polymer prices. Specialty revenue decline by 9% q-o-q to Rs. 352 crore due to weak plastic demand while non-specialty revenue was up by 2% q-o-q to Rs. 174 crore. Operating profit margin at 7.5% (down 561 bps y-o-y; down 625 q-o-q) was 451 bps below our estimate of 12% due to sharply higher other expense (up 18.7% y-o-y; up 8.3% q-o-q) on continued elevated coal and logistics costs. However gross margin remained resilient at 40.4% (down 48 bps q-o-q and slightly above our estimate of 40%). Consequently, operating profit declined by 33% y-o-y and 52% q-o-q to Rs. 41 crore and missed ourestimate by 38%. PAT of Rs. 7 crore (down 73% y-o-y; down 84% q-o-q) was 75% below our estimate of Rs. 28 crore due to sharp miss in margins, higher depreciation and tax rate of 31.9%.

Key positives

- Gross margin remained resilient at 40.4% in Q1FY23 versus 40.8% in Q4FY22 given pass through of raw material cost.

Key negatives

- Sharp miss of 451 bps in OPM at 7.5%, down 561bps/625bps y-o-y/q-o-q due to higher energy and logistics cost.
- Muted export revenue of Rs. 258 crore, down 5% q-o-q due to subdued demand environment in Europe and China.

Management Commentary

- **Demand environment**: Management said exports were subdued in Q1FY23 due to weak demand environment in Europe and COVID-19 restrictions in China. It expects demand to dip inthe US market also in Q2FY23and then expect gradual uptick in demand for H2FY23. Domestic customers are deferring their purchases as they expect further fall in prices. Coating and printing segments had good demand in Q1FY23, but the plastics market was down due to non-availability of polymers.
- **Margin outlook:** In Q1FY23, company was able to pass on raw material price hikes to the customers but faced margin pressure due to a steep rise in energy (coal price up 200% over Q1FY22) and logistic costs (2x over Q1FY22) which they were not able to pass on. Raw material and freight prices have started to decline now, and company expects the benefit to be visible in the margins going forward.
- **Capex plan:** The company is nearing completion of its Rs.750 crore capex plan and projects worth Rs. 528 crores have started generating revenues. At present these projects are having low yield, high manufacturing costs andlow-capacity utilization rates and company expects the performance to improve in H2FY23. Projects under implementation (Rs. 202 crore – part of CWIP) have got postponed due to delay in equipment delivery and company expects them to generate revenue by end of H1FY23. Overall, Rs.750 crore of capex is estimated to have Rs.1,500 crore of peak revenue potential over the next three years.
- **Debt Outlook:** Company said they have reached their peak debt level of Rs. 871 crore at end of Q1FY23 and expect it to decline going forward. Management said the net cost of debt is in the range of4-4.5% as it foreign currency loans.

Revision in estimates – We have lowered our FY2023-FY2024 earnings estimates to factor lower revenue growth and margin assumptions.

Our Call

Valuation – Downgrade SCIL to Hold with a revised PT of Rs. 510: Weak demand amid high raw material, logistics and energy costs would mean margin pressure and thus we expect PAT to decline by 25% in FY23. We downgrade SCIL to Hold (from Buy) with a revised PT of Rs. 510 (lowered to reflect cut in earnings estimate) as volume/margin pressure would keep earnings outlook subdued and we see limited upside from CMP.AtCMP, the stock trades at 32.5x/16.8x its FY2023E/FY2024E EPS.

Key Risks

- Upside risk are margin recovery with normalisation of raw material, logistics/energy costs and faster-than-expected ramp-up of new projects/products
- Downside risk are continued stress on amid inability to pass on elevated logistics/energy costs, further rise in price of key material and muted demand for new products amid slowdown in domestic/export markets.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	1,864	2,201	2,465	2,859
OPM (%)	15.4	12.5	11.4	14.1
Adjusted PAT	141	130	97	187
% y-o-y growth	7.6	(7.9)	(25.4)	93.0
Adjusted EPS (Rs.)	20.4	18.8	14.0	27.0
P/E (x)	22.3	24.3	32.5	16.8
EV/EBITDA (x)	12.6	14.3	13.5	9.5
P/BV (x)	4.2	3.8	3.6	3.1
RoCE (%)	17.1	12.5	9.1	16.9
RoE (%)	21.0	16.5	11.3	19.7

Source: Company; Sharekhan estimates

Weak Q1 on margin erosion and higher depreciation and tax rate.

SCIL) witnessed pressure on consolidated revenues, which declined by 11.6% q-o-q (up 16.9% y-o-y) to Rs. . 554 crore (in-line) due to volume and pricing pressure in both domestic and export markets. Pigment division revenue declined by 5.8% q-o-q (up by 16.1% y-o-y) to Rs. 526 crore due to volume decline amid subdued demand across geographies and business segments along pricing pressure. Export revenues declined by 5% q-o-q to Rs. 258 crore due to subdued global demand given the geopolitical scenario and tightening monetary policy while domestic revenue were down by 6% q-o-q to Rs. 268 crore due to deferment of purchase decisions, given volatility in polymer prices. Specialty revenue decline by 9% q-o-q to Rs. 352 crore due to weak plastic demand while non-specialty revenue was up by 2% q-o-q to Rs. 174 crore. Operating profit margin at 7.5% (down 561 bps y-o-y; down 625 q-o-q) was 451 bps below our estimate of 12% due to sharply higher other expense (up 18.7% y-o-y; up 8.3% q-o-q) on continued elevated coal and logistics costs. However gross margin remained resilient at 40.4% (down 48 bps q-o-q and slightly above our estimate of 40%). Consequently, operating profit declined by 33% y-o-y and 52% q-o-q to Rs. 41 crore and missed our estimate by 38%. PAT of Rs. 7 crore (down 73% y-o-y; down 84% q-o-q) was 75% below our estimate of Rs. 28 crore due to sharp miss in margins, higher depreciation and tax rate of 31.9%.

Results (Consolidated) Rs cr

Particulars	Q1FY23	Q1FY22	YoY(%)	Q4FY22	QoQ (%)
Revenue	**554**	**474**	**16.9**	**627**	**(11.6)**
Total expenditure	513	412	24.5	541	(5.2)
Operating profit	**41**	**62**	**(33.2)**	**86**	**(51.9)**
Other Income	1	1	19.9	2	(51.1)
Depreciation	26	21	22.8	25	4.1
Interest	6	5	28.3	5	11.0
PBT	10	37	(71.9)	58	(81.9)
Tax	3	11	(69.2)	13	(74.2)
Reported PAT	**7**	**26**	**(73.0)**	**45**	**(84.2)**
Reported EPS (Rs.)	1.0	3.8	(73.0)	6.5	(84.2)
Margin (%)			**BPS**		**BPS**
OPM	7.5	13.1	(561)	13.7	(625)
NPM	1.3	5.5	(424)	7.1	(584)
Tax Rate	31.9	29.2	275	22.4	956

Source: Company, Sharekhan Research

Segmental performance Rs cr

Particulars	Q1FY23	Q1FY22	YoY(%)	Q4FY22	QoQ (%)
Revenue					
Pigments	526	453	16.1	558	(5.8)
Others	28	21	35.2	69	(59.2)
Total Revenue	**554**	**474**	**16.9**	**627**	**(11.6)**
Inter Segment	-	-		-	
Net Revenue	**554**	**474**	**16.9**	**627**	**(11.6)**
EBIT					
Pigments	19	46	(57.9)	54	(64.0)
Others	-3	(4)	(32.3)	9	(129.9)
Total EBIT	**16.5**	**41.7**	**(60.5)**	**63.0**	**(73.9)**
EBIT margin			**BPS**		**BPS**
Pigments	3.7	10.1	(645)	9.6	(593)
Others	(10.1)	(20.1)	1,002	14	(2,380)
Overall EBIT Margin	**3.0**	**8.8**	**(582)**	**10.0**	**(707)**

Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector view - De-focus of global players, rising demand to help Indian dyes and pigments segment to report a 10% CAGR over FY2019-FY2025**

The dyes and pigments segment is the second largest sub-segment with 22% share in the Indian specialty chemicals industry. The segment posted a 7.3% CAGR over FY2014-FY2019, with a market size of ~$7 billion in FY2019. The dyes and pigments segment is expected to register a 10% CAGR over FY2019-FY2025 and reach $12.5 billion by FY2025. De-focus of global players and increased demand for textiles, paints,and plastic would drive strong growth for dyes and pigments in India. Large domestic players are expected to further consolidate their position, supported by reliable raw-material sourcing, strong research and development (R&D) capabilities, right product portfolio, strong marketing capabilities, and robust adherence to global environmental compliance standards (given polluting nature of the manufacturing process of dyes and pigments).

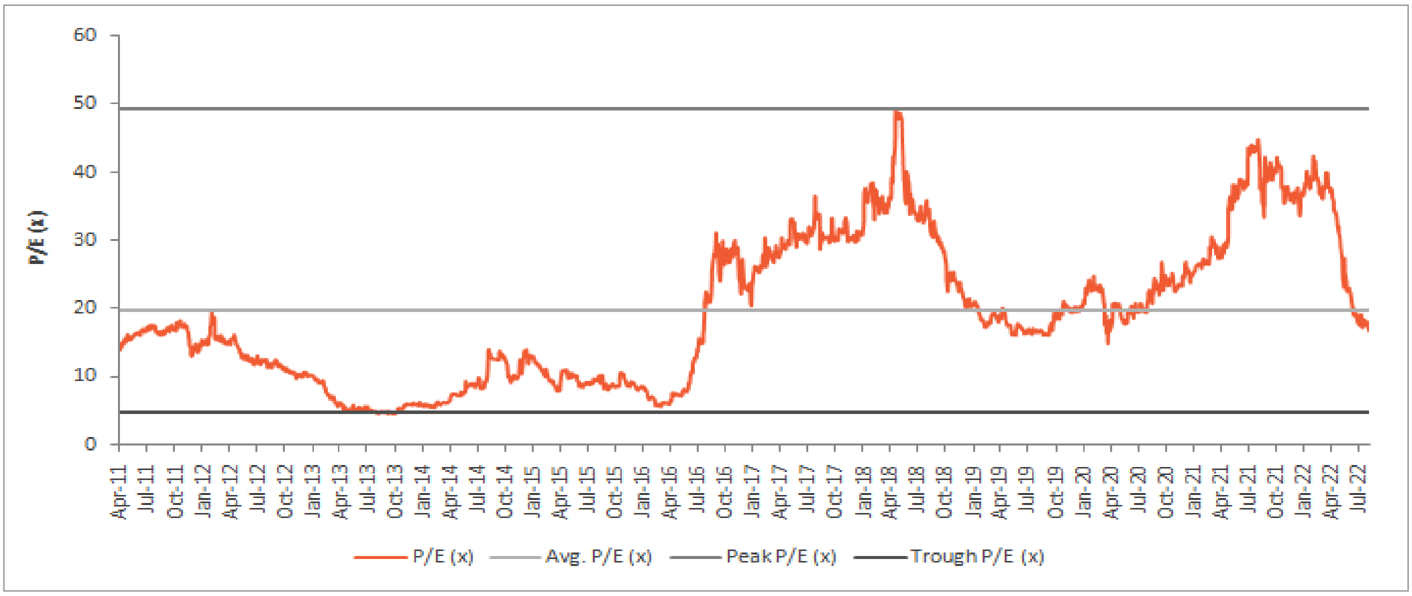
■ **Company outlook - FY23 to see margin pressure; capex nearing completion to drive recovery:**

Weak demand amid high raw material, logistics and energy costs would mean margin pressure and thus we expect PAT to decline by 25% in FY23. Having said that, SCIL is nearing completion of its Rs. 750 crore capex plan and the ramp-of new capacities/products would drive medium to long-term growth for the company. SCIL capex plan would scale up SCIL's position in both domestic and global markets and expected to benefit from exit of two global peers from the space

■ **Valuation - Downgrade SCIL to Hold with a revised PT of Rs. 510**

Weak demand amid high raw material, logistics and energy costs would mean margin pressure and thus we expect PAT to decline by 25% in FY23. We downgrade SCIL to Hold (from Buy) with a revised PT of Rs. 510 (lowered to reflect cut in earnings estimate) as volume/margin pressure would keep earnings outlook subdued and we see limited upside from CMP. At CMP, the stock trades at 32.5x/16.8x its FY2023E/FY2024E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Established in 1952 and headquartered in Pune, SCIL is India's largest and the world's fourth largest manufacturer of colour pigments. The company has a domestic market share of ~35% and global market share of ~3%in organic pigments. The company's product portfolio comprises organic, inorganic, and effect pigments, serving four main end-uses: coatings, plastics, inks, and cosmetics. SCIL has two manufacturing units – at Roha (established 1973) and Mahad (1993), both of which are located in Raigad district (Maharashtra) with combined capacity of 37,000 tonne per annum (tpa).

Investment theme

SCIL is a leading world-class colour solutions provider focusing on exceptional and sustainable results, which help in customer retention. Significant growth opportunities are available for players in Southeast Asia as innovators seek a reliable partner for assured sourcing, as the situation in China has not changed much due to the ongoing government clampdown because of environment and compliance issues coupled with USChina trade war and the recent COVID-19 crisis. With nearing completion of significant expansion plan over FY2020-FY2022E and exit of two global peers from the space, the company is scaling up its global rankings. However, current weak demand environment and margin concern would impact near term earnings of the company.

Key Risks

- Upside risk are margin recovery with normalisation of raw material, logistic/energy cost and faster-than-expected ramp-up of new projects/products.
- Downside risk are continued stress on amid inability to pass on elevated logistic/energy cost, further rise in price of key material and muted demand for new products amid slowdown in domestic/export markets.

Additional Data

Key management personnel

Pradeep Ramwilas Rathi	Chairman
Rajesh Balkrishna Rathi	Managing Director
AshishV. Vij	Whole Time Director/Chief Operating Officer
Nilkanth Natu	Chief Financial Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Profitex Shares and Securities	4.9
2	Axis Asset Management Co. Ltd./India	3.2
3	Amansa Capital Pvt. Ltd.	3.2
4	GOVERNMENT PENSION FUND - GLOBAL	2.4
5	Norges Bank	2.4
6	ICICI Prudential Asset Management Co. Ltd	2.4
7	Bhanshali Akash	2.3
8	ICICI Prudential Smallcap	2.0
9	Mirae Asset Global Investment Co. Ltd	1.6
10	Kedia Vijay Kishanlal	1.4

Source: Bloomberg (old data)

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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