Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

SRF Ltd

Capital allocation aimed at high-growth chemical biz

Speciality Chem	Sharekhan code: SRF
Reco/View: Buy ↔	CMP: Rs. 2,545	Price Target: Rs. 2,960 ↑

↑ 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 20.71

Updated Jul 08, 2022

Medium Risk

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

Source: Morningstar

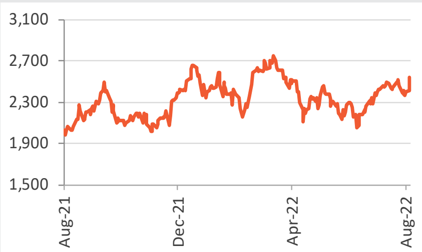
Company details

Market cap:	Rs. 75,427 cr
52-week high/low:	Rs. 2,773 / 1,882
NSE volume: (No of shares)	7.3 lakh
BSE code:	503806
NSE code:	SRF Limited
Free float: (No of shares)	14.60 cr

Shareholding (%)

Promoters	51
FII	19
DII	9
Others	21

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.8	3.3	6.8	25.5
Relative to Sensex	1.4	-3.8	0.9	22.0

Sharekhan Research, Bloomberg

Summary

- SRF's management has guided for five-year capex plan of Rs. 15,000 crore (~83% or Rs. 12,500 crore to be spent on chemical) and indicated import substitution in fluoropolymers and industrial chemical to drive growth. Management sounded confident of sustaining 20%+ revenue growth/ROCE in specialty chemical. SRF targets to take pharma revenue to 20-25% in the next five years versus 14-15% currently.
- Management sees growth opportunities in fluoropolymers, given import substitution opportunity and global customers looking for alternative suppliers. SRF's PTFE plant (completion expected by Q3FY23) would focus on substituting PTFE imports in India.
- Management reiterated its outlook for the packaging film business and believes BOPP and VAP should somewhat help negate the margin decline in BOPET. Technical textile would see small capex of Rs. 162 crore to expand belting fabric capacity by 63% to 1800 metric tonne per month.
- We maintain Buy on SRF with a revised PT of Rs. 2,960, as strong capex plan and China plus one strategy would continue to drive sustained strong earnings growth. At the CMP, the stock trades at 34.1x/28.6x its FY2023E/FY2024E EPS.

We met the management of SRF Limited to understand the company's business outlook and growth plans. Management intends to spend heavily on the chemical segment with capex plan of Rs. 12,500 crore, which is 83% of total capex plan of Rs. 15,000 crore over the next five years. Management sounded confident of growing consistently at more than 20% and sustain RoCE of 20%+ in specialty chemical business. The company is seeing a number of growth opportunities from import substitution in the fluoropolymers space (PTFE plant nearing completion by Q3FY2023), industrial chemicals (would get support from chloromethane expansion), and new business opportunity from Europe could emerge from likely disruption in Europe's chemical industry amid geopolitical tensions.

- **Massive chemical capex plan to drive 20%+ growth in specialty chemical; Targets RoCE >20%:** Management has guided for a massive capex plan of Rs. 15,000 crore over the next five years with majority of capex (Rs. 12,500 crore) aligned towards the chemical business (for specialty chemical and flurochemicals). SRF activated two AI technologies (targets to develop 8-9 AIs), which are under implementation stage and is also working on electronic and battery chemicals. Management expects capex to provide sustainable growth of 20%+ annually and healthy RoE of 20%+ for specialty chemical. With respect to ref-gas, management sees growth opportunities in India and the US (expects to sustain exports volume) in the medium term as no capacities are expected from China and both US and India (R-134A) have ADD on imports from China. Moreover, demand for R-32 is increasing in the US and India, Japan, and South Korea are moving towards R-32 for room air conditioners. HFCs are expected to gradually shift to HFOs but high replacement demand to continue to drive volume growth.
- **Fluoropolymers – Import substation opportunity:** The company expects huge growth opportunities in fluoropolymers as global customers are looking for alternative suppliers and there is a import substitution opportunity in India. Polytetrafluoroethylene (PTFE) plant, although intentionally delayed by one year, is nearing completion by Q3FY2023 and will focus on import substitution, as India is importing PTFE. SRF would move to PVDF post completion of the PTFE plant.
- **Packaging film:** The company is seeing packaging film business from a global perspective and has recently added capacity in BOPP (commissioned Rs. 446 crore OPP Film Line and Metallizer at Indore in August 2022). BOPP's global size is at 10-12 million tonne (3-4x of BOPET) and, thus, its spreads are less volatile. However, addition of new capacities would put pressure on BOPET margin. We believe SRF's focus on VAP and BOPP would provide some cushion from contraction in BOPET spreads. Packaging film business is expected to generate RoCE of 17-18% across cycles. SRF is also foraying into aluminum foil manufacturing (synergy benefit of similar customer segment in the packaging segment) with estimated investment of Rs. 425 crore and has recently incorporated SRF Altech Limited.

Our Call

Valuation – Maintain Buy on SRF with a revised PT of Rs. 2,960: High growth in the chemical business supported by high capex intensity, sustained strong margin for the technical textiles business, and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 16%/16%/19% over FY2022-FY2024E and healthy RoE/RoCE of 22%/23%. Investment in the right areas of the specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. Superior earnings growth outlook, strong FCF generation, and robust balance sheet keep us constructive on SRF and justify its premium valuations. Hence, we maintain our Buy rating on SRF with a revised price target (PT) of Rs. 2,960 (valued at 33x its FY2024E EPS; the increase in PT reflects higher PE multiple, given focus on the high-growth specialty chemical business). At the CMP, the stock is trading at 34.1x its FY2023E EPS and 28.6x its FY2024E EPS.

Key Risks

- Slower offtake from user industries and concerns on correction in product prices can affect revenue growth.
- Input cost price volatility might impact margins.

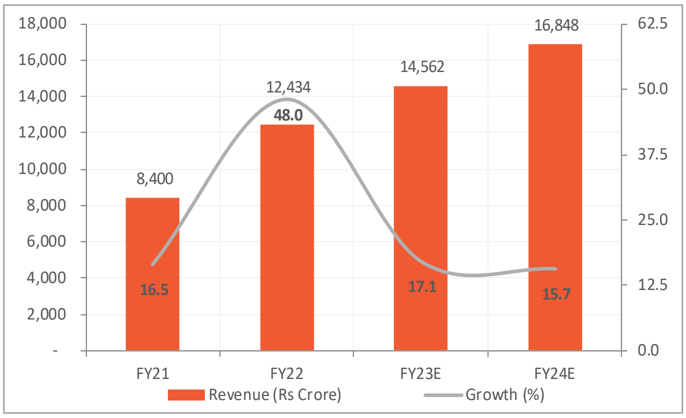
Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	8,400	12,434	14,562	16,848
OPM (%)	25.5	25.5	25.0	25.3
Adjusted PAT	1,197	1,872	2,212	2,642
% y-o-y growth	*17.5*	*56.3*	*18.2*	*19.4*
EPS (Rs.)	40.4	63.1	74.6	89.1
P/E (x)	63.0	40.3	34.1	28.6
EV/EBITDA (x)	36.2	24.6	21.4	17.9
P/BV (x)	11.0	8.8	7.1	5.7
RoCE (%)	18.5	23.0	22.5	23.0
RoE (%)	20.3	24.5	23.0	22.1

Source: Company; Sharekhan estimates

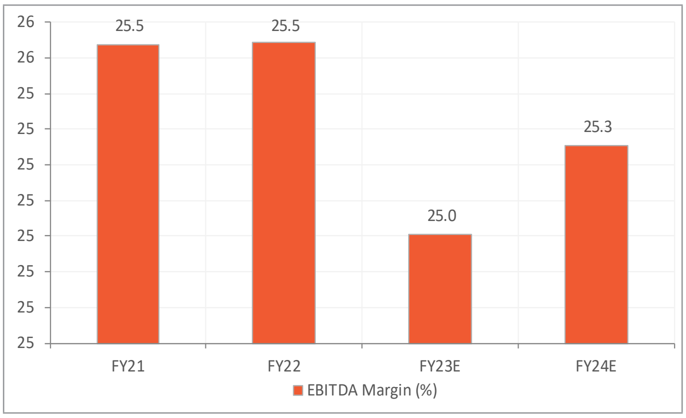
Financials in charts

Scalable and sustainable revenue growth



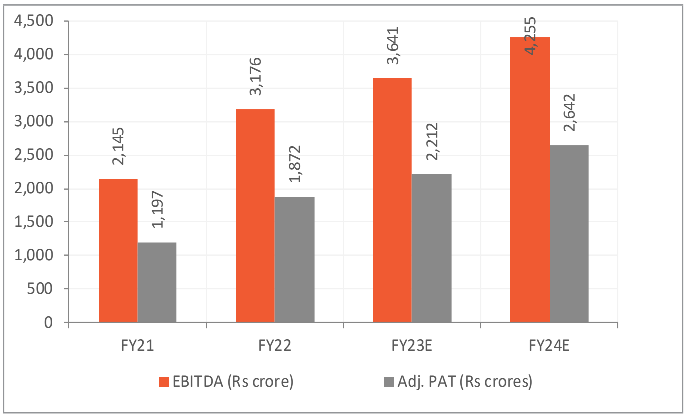
Source: Company, Sharekhan Research

Consistent strong margin profile



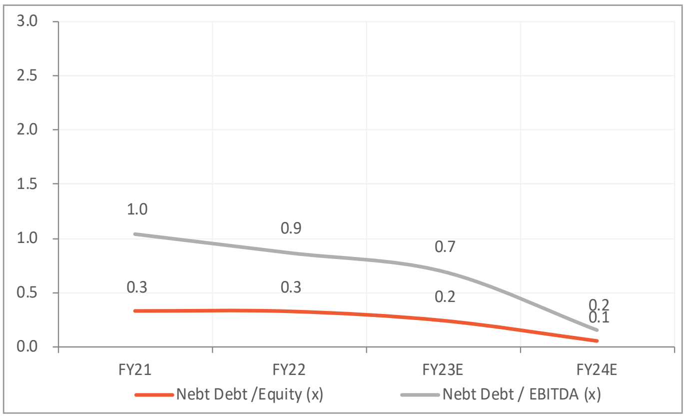
Source: Company, Sharekhan Research

EBITDA/PAT CAGR of 16%/19% over FY2021-FY2024E



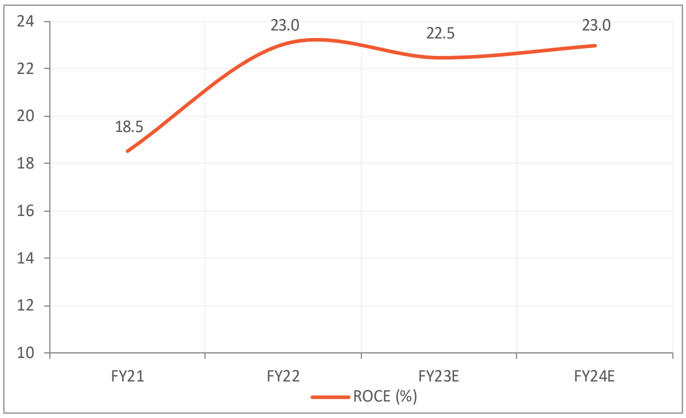
Source: Company, Sharekhan Research

Lean balance sheet to support expansion



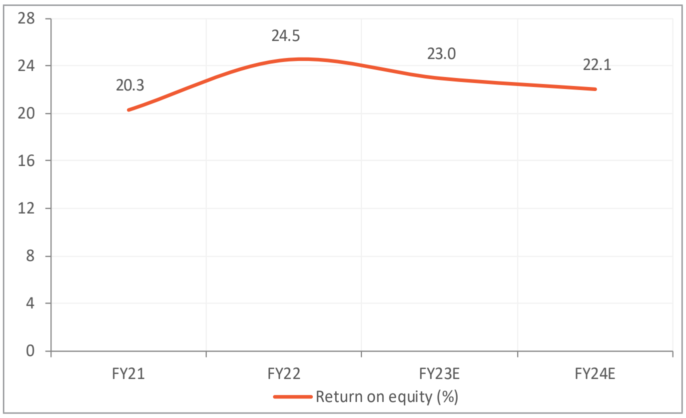
Source: Company, Sharekhan Research

RoCE trend



Source: Company, Sharekhan Research

RoE trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View - Structural growth drivers to propel sustained growth for the specialty chemical sector

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 China Plus One strategy followed by global customers, and favourable government policies (such as tax incentive and production-linked incentive scheme similar to that of the pharmaceutical sector). We believe conducive government policies, product innovation, massive export opportunities, and low input prices would help the sector report high double-digit earnings growth trajectory on sustained basis in the next 2-3 years.

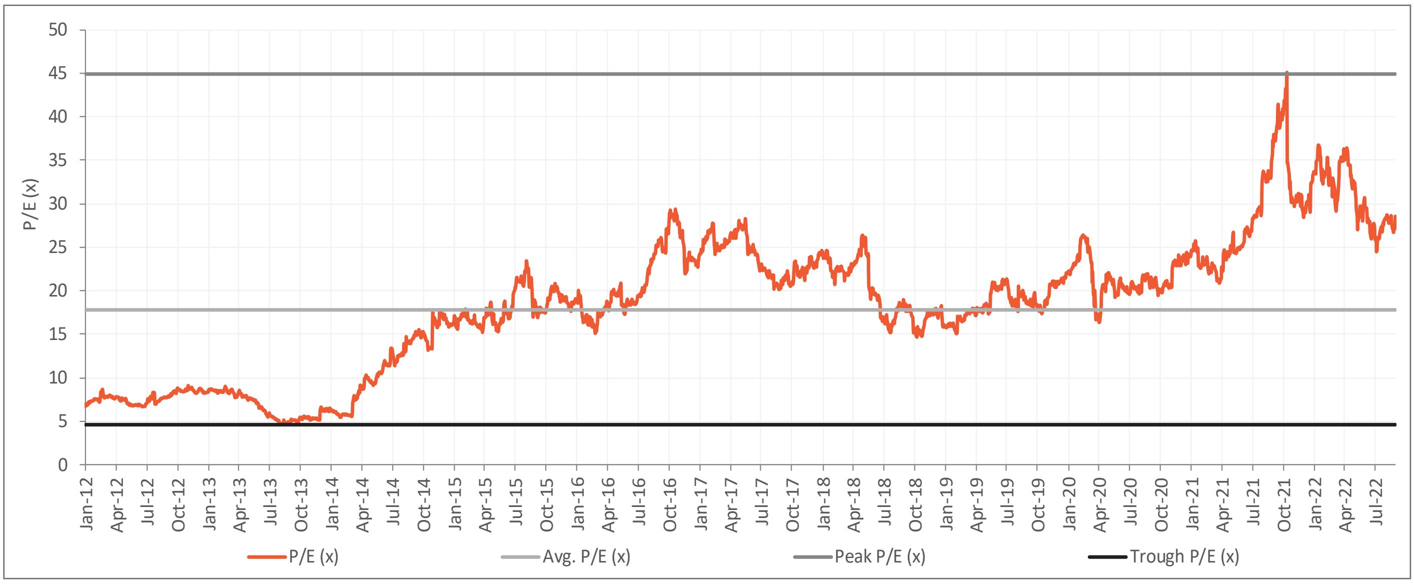
■ Company Outlook – Long-term story stays intact, capex momentum to continue

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 recently commissioned HFC facilities and it sees demand traction to be strong. Specialty chemicals are likely to continue growing at a healthy pace, while volumes/margins for fluorochemicals would improve as demand is expected to improve. Higher volumes from expanded capacities would drive packaging films volume, although margin is expected to contract, given an oversupply 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. 2,960

High growth in the chemical business supported by high capex intensity, sustained strong margin for the technical textiles business, and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 16%/16%/19% over FY2022-FY2024E and healthy RoE/RoCE of 22%/23%. Investment in the right areas of the specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. Superior earnings growth outlook, strong FCF generation, and robust balance sheet keep us constructive on SRF and justify its premium valuations. Hence, we maintain our Buy rating on SRF with a revised PT of Rs. 2,960 (valued at 33x its FY2024E EPS; the increase in PT reflects higher PE multiple, given focus on the high-growth specialty chemical business). At the CMP, the stock is trading at 34.1x its FY2023E EPS and 28.6x its FY2024E EPS.

One-year forward P/E (x) band



Source: Company, 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 the Indian specialty chemicals sector, given favourable dynamics (China Plus One strategy by global companies), should support premium valuation for quality players such as 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 Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Kotak Mahindra Asset Management Co Ltd/ India	4.04
2	Amansa Holdings Pvt Ltd	3.83
3	Blackrock Inc	1.58
4	Vanguard Group	1.56
5	SBI Funds Management Ltd	1.15
6	ICICI Prudential Life Insurance Co Ltd	1.10
7	NGUYEN THI HONG	0.90
8	Nippon Life India Asset Management	0.71
9	Morgan Stanley	0.56
10	Dimensional Fund Advisors LP	0.51

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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