Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Carborundum Universal Ltd

Scaling up of acquisitions holds key to growth

Capital Goods	Sharekhan code: CARBORUNIV
Reco/View: Buy ↔	CMP: **Rs. 846**

Price Target: **Rs. 1,000** ↔

↑ 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 28.04

Updated Oct 08, 2022

Medium Risk

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

Source: Morningstar

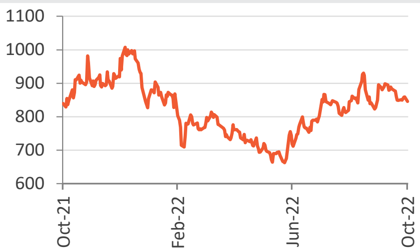
Company details

Market cap:	Rs. 16,066 cr
52-week high/low:	Rs. 1,035/652
NSE volume: (No of shares)	1.74 lakh
BSE code:	513375
NSE code:	CARBORUNIV
Free float: (No of shares)	11.0 cr

Shareholding (%)

Promoters	41.9
FII	9.4
DII	27.4
Others	21.3

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	2.2	8.1	10.7	1.6
Relative to Sensex	-3.7	2.7	6.5	1.6

Sharekhan Research, Bloomberg

Summary

- Carborundum Universal Limited (CUMI) reported a strong top-line driven by contribution from recent acquisitions. However, higher integration cost of acquisitions hit profitability.
- Order book is good in ceramics segment, while abrasives and electro-mechanical may face demand side challenges in the near term.
- Margins are expected to improve from FY24 onwards, helped by easing supply-chain constraints, easing of commodity prices and improved performance of subsidiaries.
- We retain a Buy with an unchanged PT of Rs. 1,000, considering buoyant sales and profitability prospects.

Q2FY2023 consolidated results were broadly in-line with our expectations and surprised positively on operating margins. Its total revenue grew by 33.5% y-o-y to Rs 1,128 crore (vs our estimate of Rs 1,123 crore). Operating profit growth was restricted to 8.7% y-o-y to Rs 163 crore due to higher employee cost and other expenses. The increase in variable cost was led by some integration expenses incurred on newly acquired companies. Consequently, OPM declined by 330 bps y-o-y to 14.5% (but above our estimates of 13%). Adjusted profit after tax de-grew by 9% y-o-y to Rs 89 crore due to higher depreciation and tax rate. The company incurred additional sales of Rs.141 crore from newly acquired subsidiaries - Rhodius and Awuko. Also, Volzhsky Abrasives Works, Russia and Foskor Zirconia (Pty), South Africa registered good growth. Standalone revenues rose 11% y-o-y to Rs. 618 crore; while net profit improved by 14% y-o-y to Rs 72 crore.

Key positives

- All segments – abrasives/ceramics/electro-minerals reported robust y-o-y revenue growth of 49%/~21%/~27%.
- Profitability in ceramics and electro-minerals business improved as PBIT grew by 32%/~46% y-o-y on account of higher realization and a better product mix.
- Subsidiaries also performed well as new acquisitions – Rhodius and Awuko – contributed Rs. 128 crore to total sales.

Key negatives

- Operating profit growth was restricted to 8.7% y-o-y to Rs. 163 crore due to higher employee cost and other expenses led by integration of new acquisitions.
- Despite strong top-line performance, the abrasives segment reported a ~38% y-o-y decline in PBIT to Rs. 28 crore due to integration cost of new acquisitions.
- In Q2, its subsidiary – Rhodius made loss of Rs 9.6 crore (Q1 loss was Rs 6.5 crore).

Management Commentary

- Demand outlook remains optimistic despite global headwinds and India is better-placed as compared to other geographies. While order book is good in ceramics; abrasives and electro-mechanical segments will have demand side challenges in the near-term.
- In Rhodius, the company expects a loss of Rs 9 crore in Q3FY23 and expects it to become profitable from Q4 onwards. In Auwko, it expects Rs 20-25 crore loss in FY23 and expects to break even by FY24.
- The company expects standalone abrasives EBIT margin to reach 13.8%-14% in the next couple of quarters (12.5% in Q2FY23).
- Russian subsidiary – VAW currently has strong demand prospects and is operating at capacity utilization of 90%.

Revision in estimates – We have changed our estimates for FY2022-FY2024E to factor in better sales growth but lower-than-earlier expected margins.

Our Call

Valuation: Retain Buy with an unchanged PT of Rs. 1,000: We expect CUMI's growth momentum to sustain, driven by sustainable demand across segments. CUMI stands to benefit from multiple factors such as uptick in capex in its end-user industries, China +1 strategy, strong government initiatives to support domestic manufacturing, and healthy demand prospects for regular and specialty products. Further, recent acquisitions as well as improving performance of its Russia, India, Australia, and America subsidiaries bodes well for its long-term growth. We remain upbeat on the stock, considering its improving earnings growth outlook and a healthy balance sheet. Hence, we retain Buy on CUMI with an unchanged price target (PT) of Rs. 1,000.

Key Risks

1) Increased input cost and supply-side constraints could impact performance and 2) Delay in turnaround of operations of Rhodius and Awuko could continue to impact its profitability.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Net sales	2,632	3,325	4,190	4,920
OPM (%)	17.7	16.1	14.4	15.8
Net profit	299	333	369	493
PAT growth (%)	9.7	11.6	10.8	33.4
Adjusted EPS (Rs.)	15.7	17.6	19.4	25.9
PER (x)	53.8	48.2	43.5	32.6
P/B (x)	7.5	6.8	6.0	5.2
EV/EBIDTA (x)	30.8	27.4	23.8	18.5
RoCE (%)	19.0	18.9	17.8	21.1
RoE (%)	15.0	14.8	14.7	17.2

Source: Company; Sharekhan estimates

Robust top-line but acquisitions impact profitability

Q2FY2023 consolidated results were broadly in-line with our expectations and surprised positively on operating margins. Its total revenue grew by 33.5% y-o-y to Rs 1,128 crore (vs our estimate of Rs 1,123 crore). Operating profit growth was restricted to 8.7% y-o-y to Rs 163 crore due to higher employee cost and other expenses. The increase in variable cost was led by some integration expenses incurred on newly acquired subsidiaries. Consequently, OPM declined by 330 bps y-o-y to 14.5% (but above our estimates of 13%). Adjusted profit after tax de-grew by 9% y-o-y to Rs 89 crore due to higher depreciation and tax rate. The company incurred additional sales of Rs.141 crore from newly acquired subsidiaries - Rhodius and Awuko. Also, Volzhsky Abrasives Works, Russia and Foskor Zirconia (Pty), South Africa registered good growth. Standalone revenues rose 11% y-o-y to Rs. 618 crore; while net profit improved by 14% y-o-y to Rs 72 crore.

Recent acquisitions, demand for select industries to drive growth, margins may decline y-o-y

The company is optimistic about demand across segments, including subsidiaries, despite global headwinds. In abrasives, demand from the auto sector is likely to be favourable, while the construction and other price sensitive sectors may face near-term headwinds. In ceramics, the company has strong order book but electro-minerals may face some pressure in the near term. Recent acquisitions would also see significant improvement in the coming years on both sales and profitability post establishment of a new team, set up of infrastructure, changes in product mix, easing out of supply-side constraints, and customer acquisition. However, we expect margin to decline y-o-y in FY23E and thereafter pick up from FY24 onwards once the operations at various subsidiaries stabilize.

Investor update and conference call highlights

Segment-wise performance updates:

1) Abrasives: Segmental revenue grew by 49% y-o-y to Rs.484 crore. Standalone abrasives grew by 3% y-o-y to Rs 276 crore. Newly-acquired subsidiaries – Rhodius and Awuko added additional sales of Rs.128 crore to the top-line besides significant growth from American subsidiary. EBIT was lower by 37% y-o-y at Rs.28 crore. The lower profit is due to cost impact in standalone and integration cost related to newly acquired subsidiaries. However, the profits improved by 57% on sequential basis

2) Electro-minerals: Segment revenue was at Rs.410 crore up 27% y-o-y. Standalone electro minerals grew by 21% to Rs 172 crore on account of higher realisation and volumes. EBIT was at Rs.69 crore as against Rs.48 crore of Q2 last year. The growth was due to strong performance at standalone as well as overseas subsidiaries on account of higher realization with increased demand of minerals.

3) Ceramics: Segment revenue was higher by 21% y-o-y at Rs 254 crore. Standalone ceramics grew by 22% y-o-y to Rs 211 crore on the back of strong demand across sectors and geographies. Subsidiaries in Australia and America also registered significant growth. EBIT grew by 32% y-o-y to Rs 65 crore on account of growth in volume, realization and product mix.

Demand outlook: Demand outlook is promising despite global headwinds as many economies are experiencing deceleration in growth. India is better-placed as compared to other geographies. In Q2FY23, diverse revenue mix has helped the company post good performance. Automobile sector is expected to do better given easing supply side constraints on semi-conductor front. Growth is still muted in price sensitive segments like woodwork and engineering. Construction is witnessing improvement driven by capex plans of government and private players. The company remains cautiously positive on steel, cement, power and new energy businesses for demand for its products. While order book is good in ceramics, abrasives and electro-mechanical will have demand side challenges in the near-term.

Domestic subsidiaries' performance: All the domestic subsidiaries except SEDCO did well. SEDCO profit was impacted due to a steep increase in gas prices.

Russian subsidiary- VAW delivered healthy performance: In local currency, (Russian Ruble) sales stood at 1.8 bn resulting in flat growth on y-o-y basis. On a sequential basis, sales dropped by 14%. In rupee terms, the sales have grown by 31% y-oy and down by 2.5% y-o-y given rupee depreciation. Share in the domestic market – Russia increased to 55% (usual run rate of ~40%), while exports were largely to European countries. The subsidiary is debt free and is operating at utilization levels of over 90% and collection efficiency has been strong. Currently, the demand outlook is positive, and the company expects its annual performance to be satisfactory.

Rhodius to turn profitable from Q4 onwards: The company has been making changes in Rhodius by improving infrastructure and hiring experienced professionals at the higher level. The company now has hired new CFO and IT head. Rhodius recorded sales of Euro 14 million and expects full year sales of Euro 68-70 million. Rhodius had EBIT margin of 7.5-8% and high teens of ROCE when CUMI had acquired it. Drop in margin/ROCE is a result of integration cost that the company has to incur post acquisition. The company aims to achieve EBIT margin of 12-14% by FY26. In Q2, the subsidiary made loss of Rs 9.6 crore (Q1 loss was Rs 6.5 crore) and expects full year loss of Rs 19-20 crore. The company had to bear Rs 23 crore as amortization cost of intangibles and Rs 11.5 crore as integration cost. Further, higher cost of input material and logistics impacted the profitability. The company expects a loss of Rs 9 crore in Q3 and expects the subsidiary to become profitable from Q4 onwards. In FY24, the company expects decent profits. The demand is stable for Rhodius products.

Turnaround of Auwko in two years: Auwko exports 70% of its products in Europe and America. Currently, the company is in a process of stabilising business which would take couple of years. The company's coated abrasives capacity has doubled with this acquisition and the company is reconnecting with suppliers and customers to scale up the business. CUMI expects improvement in the business from Q4 onwards. The company has hired a new COO with substantial experience from abrasive industries who should lead the successful integration of Awuko and Rhodius. The company expects a monthly revenue run rate of Euro 1 million and expects to clock sales of Euro 10-12 million for FY23E but sales for Q2 were lower at Euro 1.4 mn. The company expects Rs 20-25 crore loss in FY23 and expects to breakeven by FY24.

Margin improvement in abrasives: In case of abrasives, raw material prices have increased significantly particularly for bonded abrasives. Bonded abrasives consume grains and the cost push had hit the margin considerably. In the last quarter, while company raised prices; commodity prices also fell leading to correction in grains prices. This led to margin improvement in abrasives. Hence, the company expects standalone abrasives EBIT margin to reach 13.8%-14% in the next couple of quarters.

Anti-dumping duty on resin-bonded thin wheels: The recent anti-dumping duty is largely focused on cutting and grinding wheels coming from China. The prices in this segment have been depressed due to lower cost imports, hence post imposition of duty, local companies would have a level playing field. These products contribute ~12% to abrasives revenues.

Employee cost and depreciation would continue to remain elevated: Employee cost increased by 69% y-o-y to Rs. 170 crore, as it included cost of recently acquired subsidiaries – Awuko and Rhodius. Depreciation also includes cost of the new subsidiaries. The company expects the same run rate of ~Rs 45 crore for depreciation for the coming quarters.

Capex/debt: Capital expenditure incurred during H1FY23 was Rs 177 crore at consolidated level. The borrowings (net of cash) was at Rs.78 crore.

Plans to grow bottom-line by 3x by FY26: The company plans to pursue organic and inorganic growth and expects all the recent acquisitions to stabilize and start contributing to bottom-line in a meaningful way by FY25. Therefore, the company is hopeful of achieving bottom-line of ~Rs 600 crore by FY26.

Results (Consolidated) **Rs cr**

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Net Sales	**1,128**	**845**	**33.5**	**1,140**	**-1.1**
Total RM cost	400	300	33.4	416	-3.9
Employee cost	170	101	69.0	173	-1.5
Power and Fuel cost	125	107	16.9	119	4.9
Other Expenses	269	187	43.9	304	-11.4
Operating profit	**163**	**150**	**8.7**	**127**	**27.9**
Other Income	8	9	-8.1	25	-67.7
Interest	5	1	381.0	4	13.2
Depreciation	45	27	66.3	43	3.9
PBT	**122**	**131**	**-7.2**	**105**	**15.7**
Tax	37	34	10.3	26	43.5
Reported PAT	**94**	**103**	**-8.8**	**86**	**9.0**
Adjusted PAT	**89**	**98**	**-8.8**	**79**	**13.0**
Adj. EPS (Rs.)	4.7	5.1	-8.8	4.1	13.0
Margin (%)			**BPS**		**BPS**
GPM	65.9	64.5	138	63.5	242
OPM	14.5	17.8	(330)	11.2	327
NPM	8.0	11.7	(374)	7.0	99
Tax rate	30.8	25.9	488	25	597

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. 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 pick-up in domestic industrial activities, abrasives are the early beneficiaries due to their diversified user industries.

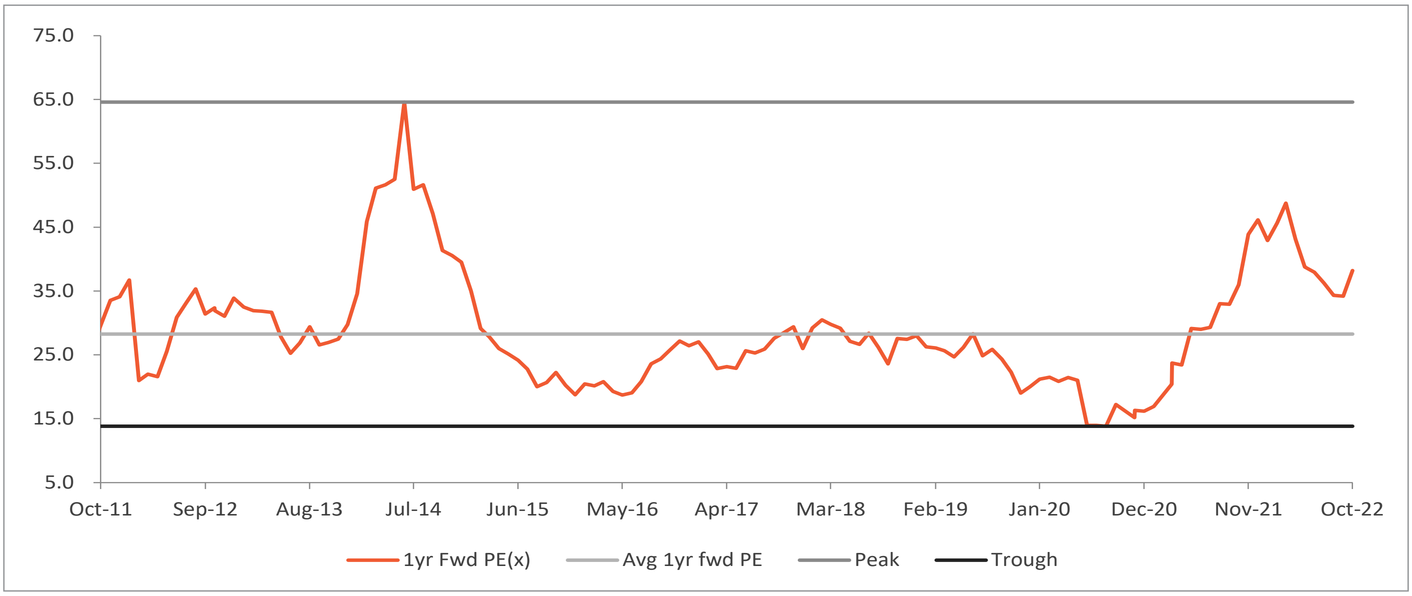
■ Company outlook - Promising times ahead

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 FY2022-FY2024E. CUMI's cost-competitive position in electrominerals (being the largest and lowest cost producer domestically and at 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 likely short-term impact of the Russia-Ukraine crisis, logistics, and supply-side challenges, we expect CUMI to be on a high earnings growth trajectory in the long-term with improved domestic operations along with sustained healthy overseas operations, aided by recent acquisitions.

■ Valuation - Retain Buy with an unchanged PT of Rs. 1,000

We expect CUMI's growth momentum to sustain, driven by sustainable demand across segments. CUMI stands to benefit from multiple factors such as uptick in capex in its end-user industries, China +1 strategy, strong government initiatives to support domestic manufacturing, and healthy demand prospects for regular and specialty products. Further, recent acquisitions as well as improving performance of its Russia, India, Australia, and America subsidiaries bodes well for its long-term growth. We remain upbeat on the stock, considering its improving earnings growth outlook and a healthy balance sheet. Hence, we retain Buy on CUMI with an unchanged price target (PT) of Rs. 1,000.

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 a ~34% earnings CAGR from FY2015-FY2022 and is expected to post healthy ~23% earnings CAGR over FY2022-FY2024E, led by: (1) jump in realisation led by progress in product value chains across segments; and (2) growth in abrasives and ceramics margins on improved industrial production growth. We expect revenue to report a ~19% CAGR (FY2022-FY2024E), given improved profitability of the domestic business particularly in abrasives, better product mix with increasing contribution from subsidiaries, and recent acquisitions in Europe. 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

- Increased input cost and supply-side constraints could impact performance.
- Delay in turnaround of operations of Rhodius and Awuko could continue to impact its profitability.
- Slowdown in user industries – both domestic and overseas – could lead to lower growth for CUMI's.

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	SBI Funds Management	9.75
2	Kotak Mahindra Asset Management	3.48
3	Kotak Infrastructure	3.26
4	HDFC Asset Management	2.33
5	Shamyak Invest	2.11
6	Nippon Life India Asset Mgt.	1.92
7	Vanguard Group Inc.	1.90
8	L&T mutual fund trustee Ltd.	1.44
9	ICICI Prudential Life Insurance	1.40
10	Massachusetts institute of Technology	1.30

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

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Compliance Officer: Ms. Binkle Oza; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

Registered Office: Sharekhan Limited, The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA, Tel: 022 - 67502000/ Fax: 022 - 24327343. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183.