



## 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	✗	↔	✗

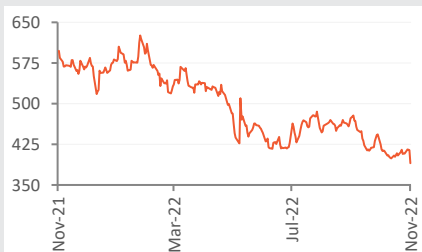
## Company details

Market cap:	Rs. 2,703 cr
52-week high/low:	Rs. 636/388
NSE volume: (No of shares)	1.7 lakh
BSE code:	506655
NSE code:	SUDARSCHEM
Free float: (No of shares)	4.4 cr

## Shareholding (%)

Promoters	35.8
FII	4.2
DII	14.2
Others	45.8

## Price chart



## Price performance

(%)	1m	3m	6m	12m
Absolute	-6.1	-13.2	-15.6	-34.6
Relative to Sensex	-12.1	-15.3	-27.7	-35.8

Sharekhan Research, Bloomberg

## Sudarshan Chemical Industries Ltd

## Weak Q2 on all fronts; muted outlook

## Speciality Chemicals

## Sharekhan code: SUDARSCHEM

## Reco/View: Hold



CMP: Rs. 390

Price Target: Rs. 430



Upgrade



Maintain



Downgrade

## Summary

- Q2FY23 performance was subdued with a 4.7% q-o-q decline in revenues to Rs. 528 crores, due to pressure on pricing and 9% q-o-q decline in volumes. OPM at 8.1% (down 250 bps y-o-y; up 64 bps q-o-q) was in-line with our estimate of 7.9% as sharp miss in gross margins (38.7% versus our estimate of 41%) was offset by benefit of operating leverage. PAT of Rs. 4.5 crore (down 80% y-o-y; down 36% q-o-q) was 57% below our estimate of Rs. 10 crore due to higher-than-expected interest and depreciation and lower-than-expected other income.
- Pigment domestic/export revenues declined by 13%/6% q-o-q to Rs. 235 crore/Rs. 242 crore given the deferment of purchase decisions by domestic customer and subdued global demand. Pigment specialty revenue segment declined by 6% q-o-q to Rs. 331 crore due to weak demand for plastics.
- Capex plan of Rs. 750 crore will be entirely completed by Dec 2022. Ramp up of new products is slow but the yellow pigment launched earlier is performing well with margins set to improve going forward.
- We maintain our Hold on Sudarshan Chemical Industries Limited (SCIL) with a revised PT of Rs. 430 (to reflect cut in earnings estimate) given subdued earnings outlook (expect FY23 PAT to decline by 47%) and see limited upside from CMP. Stock trades at 39.4x/17.3x its FY2023E/FY2024E EPS.

Sudarshan Chemical Industries Limited's (SCIL) Q2FY23 consolidated revenues at Rs. 528 crores (down 4.7% q-o-q, up 6.1% y-o-y) missed our estimate by 6.3% due to pricing pressure and volume de-growth in both domestic and export markets. Pigment division revenue declined by 9.5% q-o-q (up 6.2% y-o-y) to Rs. 476 crore. Pigment export revenues declined by 6.2% q-o-q to Rs. 242 crore due to subdued global demand given the geopolitical scenario and tightening monetary policy while the Pigment domestic revenue declined by 12.6% q-o-q to Rs. 235 crore due to deferment of purchase decisions, given the volatility in polymer prices. Pigment specialty revenue declined by 6% q-o-q to Rs. 331 crore due to weak plastic demand while Pigment non-specialty revenue declined by 16.7% q-o-q to Rs. 145 crore. OPM at 8.1% (down 250 bps y-o-y; up 64 bps q-o-q) was in-line with our estimate of 7.9% as a sharp miss in gross margins (38.7% versus our estimate of 41%) was offset by the benefit of operating leverage. Consequently, operating profit declined by 18.9% y-o-y and was up 3.5% q-o-q to Rs. 43 crore, which was 3.5% below our estimate of Rs. 44 crore. PAT of Rs. 4.5 crore (down 80% y-o-y; down 36% q-o-q) was 57% below our estimate of Rs. 10 crore due to higher-than-expected interest and depreciation and lower-than-expected other income.

## Key positives

- Resilient OPM at 8.1%, up 64 q-o-q and versus our estimate of 7.9% led by structural cost reduction initiatives.

## Key negatives

- Sharp decline in gross margins (38.7% in Q2FY23 versus 40.4% in Q1FY23) due to high-cost inventory in Q1 and inability to pass through costs in order to maintain market share.
- Muted Pigment export/domestic revenue at Rs. 242 crore/Rs.235 crore, down 6.2%/12.6% q-o-q reflected subdued export demand and deferment of purchase in domestic market.
- Debt increased by 7% q-o-q debt to Rs. 926 crore and interest cost jumped 54% q-o-q to Rs. 9.34 crores.

## Management Commentary

- Decline in pigment segment's domestic and export revenues due to deferment of purchase decisions by domestic customer and subdued demand in Europe and China.
- Company had resilient OPM at 8.1% despite sharp decline in gross margins due to structural cost reduction initiatives adopted by the company.
- Capex plan of Rs. 750 crore will be entirely completed by Dec 2022. Ramp up of new products is slow but the yellow pigment launched earlier is performing well with margins set to improve going forward.

**Revision in estimates** – We have lowered our FY2023-FY2024 earnings estimates to factor lower margin assumptions and higher interest cost.

## Our Call

**Valuation – Maintain Hold on SCIL with a revised PT of Rs. 430:** Weak demand amid high raw material, logistics and energy costs would mean margin pressure and thus we expect PAT to decline sharply 47% in FY23. We maintain our Hold rating on SCIL with a revised PT of Rs. 430 (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 39.4x/17.3x its FY2023E/FY2024E EPS.

## Key Risks

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

## Valuation (Consolidated)

	Rs cr			
Key Financials	FY21	FY22	FY23E	FY24E
Revenue	1,864	2,201	2,465	2,859
OPM (%)	15.4	12.5	10.5	13.2
Adjusted PAT	141	130	69	156
% y-o-y growth	7.6	(7.9)	(47.2)	127.1
Adjusted EPS (Rs.)	20.4	18.8	9.9	22.5
P/E (x)	19.2	20.8	39.4	17.3
EV/EBITDA (x)	11.0	12.7	13.0	9.1
P/BV (x)	3.6	3.2	3.2	2.8
RoCE (%)	17.1	12.5	7.7	15.6
RoE (%)	21.0	16.5	8.1	17.2

Source: Company; Sharekhan estimates

## Weak Q2 on all fronts

SCIL consolidated revenues at Rs. 528 crores (down 4.7% q-o-q, up 6.1% y-o-y) missed our estimate by 6.3% due to pricing pressure and volume de-growth in both domestic and export markets. Pigment division revenue declined by 9.5% q-o-q (up 6.2% y-o-y) to Rs. 476 crore. Pigment export revenues declined by 6.2% q-o-q to Rs. 242 crore due to subdued global demand given the geopolitical scenario and tightening monetary policy, while the Pigment domestic revenue declined by 12.6% q-o-q to Rs. 235 crore due to deferment of purchase decisions, given the volatility in polymer prices. Pigment specialty revenue declined by 6% q-o-q to Rs. 331 crore due to weak plastic demand while Pigment non-specialty revenue declined by 16.7% q-o-q to Rs. 145 crore. OPM at 8.1% (down 250 bps y-o-y; up 64 bps q-o-q) was in-line with our estimate of 7.9% as a sharp miss in gross margins (38.7% versus our estimate of 41%) was offset by the benefit of operating leverage. Consequently, operating profit declined by 18.9% y-o-y and was up 3.5% q-o-q to Rs. 43 crore, which was 3.5% below our estimate of Rs. 44 crore. PAT of Rs. 4.5 crore (down 80% y-o-y; down 36% q-o-q) was 57% below our estimate of Rs. 10 crore due to higher-than-expected interest and depreciation and lower-than-expected other income.

## Q2FY23 conference call highlights

- ♦ **Demand environment** – Pigment revenues increased by 6.2% y-o-y to Rs. 476 crores which were primarily led by price hikes as there was volume de-growth in the quarter both in the domestic and export markets. Customers in the plastic segment deferred their purchases as they expect further fall in polymer prices. Sale volumes in the coating segment were low as the customers had already maintained high inventories in Q1, and demand was low for paints due to the extended monsoon. However, the company has maintained its market share in both plastics and coating segments. Management said exports were subdued in Q2FY23 due to the weak demand environment in Europe and COVID-19 restrictions in China. There are considerable headwinds in the export market, and management cautiously expects the situation will improve from Q4FY23. Domestic demand has seen an uptick in Q2 and company expects the trend to continue in the coming quarters.
- ♦ **Margin outlook** – In Q2FY23, the company faced severe gross margin pressure due to the high-cost inventory in the previous quarter and the company could not pass-through costs because it wanted to maintain its market share. The company achieved favourable operating leverage in the quarter due to structural cost reduction initiatives adopted by the company. The company expects raw material costs to be stable going forward and expects margins to improve in the long-term if company can achieve volume growth in favourable macro conditions.
- ♦ **Capex plan** – The company is nearing completion of its Rs. 750 crore capex plan, and projects worth Rs. 620 crores have been put to use. Projects under implementation worth Rs. 110 crore will be put to use by Dec 2022. Overall, Rs. 750 crore of capex is estimated to have Rs. 1,500 crore of peak revenue potential over the next three years. Projects for new products are being put to use now, but their ramp-up is slow due to subdued demand environment. The yellow pigment product launched in this capex plan is progressing well, and company expects the margins will quickly improve as only the initial costs were high due to teething issues.
- ♦ **Others** – 1) Debt increased by 7% q-o-q to Rs. 926 crore. 2) Provisional ADD of 14-19% has been levied by China on Indian manufacturers.

### Results (Consolidated)

	Rs cr				
Particulars	Q2FY23	Q2FY22	YoY(%)	Q1FY23	QoQ (%)
<b>Revenue</b>	<b>528</b>	<b>498</b>	<b>6.1</b>	<b>554</b>	<b>(4.7)</b>
Total expenditure	486	445	9.1	513	(5.3)
<b>Operating profit</b>	<b>43</b>	<b>53</b>	<b>(18.9)</b>	<b>41</b>	<b>3.5</b>
Other Income	1	1	38.6	1	69.8
Depreciation	27	22	24.9	26	4.4
Interest	9	4	111.0	6	54.1
PBT	8	28	(71.3)	10	(23.1)
Tax	3	5	(32.4)	3	4.2
<b>Reported PAT</b>	<b>5</b>	<b>23</b>	<b>(80.1)</b>	<b>7</b>	<b>(35.9)</b>
Reported EPS (Rs)	0.7	3.3	(80.1)	1.0	(35.9)
<b>Margin (%)</b>			<b>BPS</b>		<b>BPS</b>
OPM	8.1	10.6	(250)	7.5	64
NPM	1.1	4.6	(351)	2.8	(167)
Tax Rate	43.3	18.4	2,489	31.9	1,133

Source: Company, Sharekhan Research

### Segmental performance

	Rs cr				
Particulars	Q2FY23	Q2FY22	YoY(%)	Q1FY23	QoQ (%)
<b>Revenue</b>					
Pigments	476	448	6.2	526	(9.5)
Others	52	50	4.8	28	86.1
<b>Total Revenue</b>	<b>528</b>	<b>498</b>	<b>6.1</b>	<b>554</b>	<b>(4.7)</b>
Inter Segment	-	-		-	
<b>Net Revenue</b>	<b>528</b>	<b>498</b>	<b>6.1</b>	<b>554</b>	<b>(4.7)</b>
<b>EBIT</b>					
Pigments	14	30	(53.4)	19	(27.4)
Others	3	2	47.3	-3	(218.2)
<b>Total EBIT</b>	<b>17.3</b>	<b>32.3</b>	<b>(46.3)</b>	<b>16.5</b>	<b>5.4</b>
<b>EBIT margin</b>					
Pigments	2.9	6.7	(376)	3.7	(72)
Others	6.4	4.6	185	(10)	1,646
<b>Overall EBIT Margin</b>	<b>3.3</b>	<b>6.5</b>	<b>(321)</b>	<b>3.0</b>	<b>31</b>

Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector View – De-focus of global players, the 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 speciality 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 on global players and increased demand for textiles, paints, and plastic would drive substantial growth for dyes and pigments in India. Prominent domestic players are expected to further consolidate their position, supported by reliable raw-material sourcing, strong research and development (R&D) capabilities, the right product portfolio, strong marketing capabilities, and robust adherence to global environmental compliance standards (given the polluting nature of the manufacturing process of dyes and pigments).

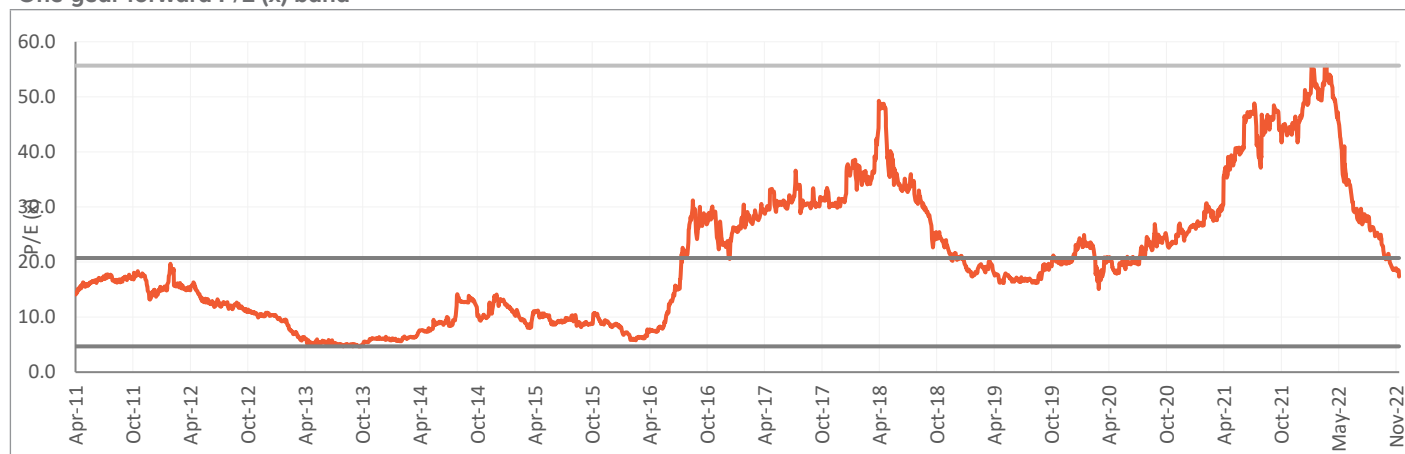
### ■ Company Outlook – FY23 to see margin pressure; Capex nearing completion to drive recovery

Weak demand amid high raw material, logistics and energy costs would mean margin pressure, and thus we expect PAT to decline by 47% 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's capex plan would scale up SCIL's position in both domestic and global markets and is expected to benefit from the exit of two global peers from the space.

### ■ Valuation – Maintain Hold on SCIL with a revised PT of Rs. 430

Weak demand amid high raw material, logistics and energy costs would mean margin pressure and thus, we expect PAT to decline sharply 47% in FY23. We maintain our Hold rating on SCIL with a revised PT of Rs. 430 (lowered to reflect a cut in earnings estimate) as volume/margin pressure would keep the earnings outlook subdued, and we see limited upside from CMP. At CMP, the stock trades at 39.4x/17.3x 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. The situation in China has not changed much due to the ongoing government clampdown because of environmental and compliance issues coupled with US-China trade war and the recent COVID-19 crisis. With nearing completion of a significant expansion plan over FY2020-FY2022E and exit of two global peers from the space, the company is scaling up its global rankings. However, the current weak demand environment and margin concern would impact near term earnings of the company.

## Key Risks

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

## Additional Data

### Key management personnel

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

Source: Company Website

### 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)

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## 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 deteriorating 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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