Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

SRF Ltd

Strong Q3 led by phenomenal chemical biz margin

Speciality Chem		Sharekhan code: SRF		
Reco/View: Buy	↔	CMP: Rs. 2,182	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 38.14

Updated Dec 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. 64,683 cr
52-week high/low:	Rs. 2,864/2,003
NSE volume: (No of shares)	5.9 lakh
BSE code:	503806
NSE code:	SRF
Free float: (No of shares)	14.66 cr

Shareholding (%)

Promoters	51
FII	18
DII	15
Others	16

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-4.8	-16.6	-11.1	-10.8
Relative to Sensex	-2.7	-14.0	-13.5	-11.9

Sharekhan Research, Bloomberg

Summary

- SRFs Q3FY2023 PAT of Rs. 511 crore, up 6% q-o-q, was 11% above our estimate and reflects continued strength in its chemical segment's revenue/margin and benefit of lower tax rate. Chemical EBIT margin expansion by 384 bps q-o-q was led by pricing benefit from contract renewal, softness in input cost, and ramp-up of new product launches.
- Chemical EBIT grew by 35% y-o-y/9% q-o-q and was well above our expectation, led by beat of 4%/410 bps in revenue/margin, given sustained strong traction in specialty chemical/fluorochemicals business. Packaging film's EBIT margin witnessed decent q-o-q recovery of 224 bps to 10%, while revenue remained muted on soft BOPET/BOPP demand/price. Technical textile continues to see earnings pressure (EBIT down 70% y-o-y/46% q-o-q) on subdued NTCF/polyester industrial yarn demand.
- Management remains confident of sustained chemical segment margin in Q4FY2023, given sustained strong ref-gas price and ramp-up of MPP4/Chloromethane plant. Packaging film margin is expected to remain weak, given pressure in BOPET/BOPP spreads. FY2023 capex guidance is maintained at Rs. 3,000 crore and aims for Rs. 2,800-3,000 crore for FY2024.
- The recent sharp 24% fall in the stock price provides a good entry opportunity for investors as earnings outlook remains strong for the key chemical segment and valuation of 24.4x/21.5x its FY2024E/FY2025E EPS has turned reasonable. We maintain our Buy rating on SRF with an unchanged PT of Rs. 2,960. SRF remains our top pick in the specialty chemical sector.

SRF Limited posted strong Q3FY2023 results with 8%/11% beat in operating profit/PAT at Rs. 834 crore/Rs. 511 crore, up 8.4%/6.2% q-o-q, led by stronger-than-expected strength in the chemical segment's earnings and modest recovery in packaging film margin offsetting subdued performance of technical textile. Overall, OPM improved by 339 bps q-o-q to 24% and was 266 bps above our estimate of 21.4%, while revenue of Rs. 3,470 crore (up 3.7% y-o-y; down 6.9% q-o-q) was below our estimate of Rs. 3,611 crore due to higher-than-expected revenue decline of 8.6%/9.6% q-o-q from technical textile/packaging film segments. The chemical segment's performance was outstanding with a strong 23% y-o-y (down 4% q-o-q) increase in revenue to Rs. 1,757 crore (above our estimate) and sharp EBIT margin expansion of 275 bps y-o-y/384 bps q-o-q to 32.1% and, thus, posted 35% y-o-y/9% q-o-q jump in EBIT to Rs. 564 crore. Robust chemical segment's earnings growth was driven by both specialty chemical (strong traction for new production, ramp-up of MPP4, and healthy demand for downstream derivatives) and fluorochemical businesses (strong demand for ref-gas in domestic market, higher international for certain refrigerants in critical international markets, expansion of HFA 134a/P in new geographies, and decent ramp-up of new Chloromethane plant). The packaging film segment posted decent performance despite a challenging environment (soft BOPET/BOPP demand price softness and high energy cost in Europe although witnessed a decline on a q-o-q basis) with 17% q-o-q rise in EBIT, led by 224 bps margin expansion, while the technical textile segment disappointed with a steep 46% q-o-q decline in EBIT to just Rs. 34 crore due to 8.6% q-o-q revenue decline/547 bps q-o-q margin contraction to 8% on account of subdued demand for NTCF/polyester industrial yarn.

Key positives

- Robust chemical segment's performance with 384 bps q-o-q improvement in EBIT margin to 32.1%.

Key negatives

- Steep revenue decline/margin contraction of 8.6%/547 bps q-o-q for the technical textile segment.

Management Commentary

- Management expects continued strong traction in the chemical segment as ref-gas price remains strong and will see benefit of ramp-up of new plants, including MPP4 and Chloromethane.
- PTFE plant commission delayed to April 2023 and management expects decent ramp-up in six months. HFC capex timeline of September 2023.
- The company has announced capex of Rs. 1,700 crore for the chemical segment in 9MFY2023. Recent new projects – 1) Specialty Fluoropolymers project at capex of Rs. 595 crore and is expected to be commissioned in 24 months and 2) agrochemical intermediate project at a capex of Rs. 110 crore and is expected to be commissioned in 10 months.
- Capex guidance for FY2023 maintained at Rs. 3,000 crore and aims for Rs. 2,800-3,000 crore for FY2024. New specialty fluorochemical to have 25-28% IRR, four-year payback period.
- BOPET/BOPP margin pressure to continue on capacity addition; technical textile to see muted NTCF demand and expect demand uptick in the medium term as per discussion with customers.

Revision in estimates – We have fine-tuned our FY2023-FY2025 earnings estimates.

Our Call

Valuation – Maintain Buy on SRF with an unchanged PT of Rs. 2,960: High growth in the chemical business supported by increased capex intensity and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 16%/16%/17% over FY2022-FY2025E and a healthy RoE/RoCE of 21%/22%. Investment in the right areas of the specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. SRF's valuation of 24.4x/21.5x its FY2024E/FY2025E EPS has turned reasonable post the recent sharp 24% fall in the stock price from 52-week high level. This provides a good entry opportunity for investors as the earnings outlook remains strong for the key chemical segment. Hence, we maintain our Buy rating on SRF with an unchanged price target (PT) of Rs. 2,960. At the CMP, the stock is trading at 24.4x/21.5x its FY2024E/FY2025E EPS.

Key Risks

Slower offtake from user industries and concerns about correction in product prices can affect revenue growth.

Input cost price volatility might affect margins.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23E	FY24E	FY25E
Revenue	12,434	14,746	16,947	19,353
OPM (%)	25.5	24.2	25.2	25.5
Adjusted PAT	1,872	2,161	2,648	3,011
% y-o-y growth	*56.3*	*15.5*	*22.5*	*13.7*
EPS (Rs.)	63.1	72.9	89.3	101.6
P/E (x)	34.6	29.9	24.4	21.5
EV/EBITDA (x)	21.2	18.8	15.3	12.9
P/BV (x)	7.6	6.1	4.9	4.0
RoCE (%)	23.0	22.0	23.1	22.3
RoE (%)	24.5	22.5	22.2	20.5

Source: Company; Sharekhan estimates

Strong Q3 performance; PAT beats estimate, led by strong margin in chemical/packaging film

Q3FY2023 consolidated revenue at Rs. 3,470 crore (up 3.7% y-o-y; down 6.9% q-o-q) was 4%/5% below our/street estimate of Rs. 3,611 crore/Rs. 3,641 crore. The revenue miss was due to revenue decline of 8.6%/9.6% q-o-q for the technical textile/packaging film segment to Rs. 426 crore/Rs. 1,203 crore. The chemical/packaging film segment's revenue grew by 23% y-o-y (down 4% q-o-q) to Rs. 1,757 crore (4% above estimate). OPM at 24% (up 339 bps q-o-q) was 266 bps above our estimate due to better-than-expected EBIT margin for chemical/packaging film at 32.1%/9.9%, up 384 bps/224 bps q-o-q. However, technical textile EBIT margin remained under pressure and declined by 1308 bps y-o-y/547 bps q-o-q to 8%. Consequently, operating profit at Rs. 834 crore (down 5.4% y-o-y; up 8.4% q-o-q) was 8%/10% above our/street estimate of Rs. 771 crore/Rs. 761 crore. PAT at Rs. 511 crore (up 1.1% y-o-y; up 6.2% q-o-q) was also 11%/16% above our/street estimate primarily due to robust chemical margin and q-o-q recovery in packaging film margin.

Q3FY2023 conference call highlights

Specialty chemicals business – Strong growth/margin to sustain in the near term

- Specialty chemicals delivered robust performance, led by several factors such as strong traction for new production, ramp-up of MPP4, and healthy demand for downstream derivatives.
- Strong margin performance was led by pricing benefit from contract renewal, softness in input cost, and ramp-up of new product launches.
- Successfully launched four new agro products and one new pharma product in 9MFY2023.
- Engagement with global innovators remains at a high level. The company's focus is on complex and advances products and agrochemicals intermediates (AIs).
- The Board has approved a project for setting up a new and dedicated facility to produce an agrochemical intermediate at Dahej at a projected cost of Rs. 110 crore to meet the growing demand for the product in the future. It is expected to be commissioned in 10 months.
- Management would provide FY2024 growth guidance for the specialty chemical segment in Q4FY2023 earnings call.

Fluorochemicals – Healthy growth in a seasonally soft quarter; Focus to establish SRF as a large Fluoropolymers player

- The segment witnessed healthy growth despite a seasonally soft quarter, led by strong traction in the domestic market and higher prices for certain key refrigerants in critical international markets.
- Dymel® HFA 134a/P (pharma-grade gas) expanded to new geographies and reported significant growth. New Chloromethanes plant is showing traction.
- PTFE plant commissioning would get delayed to April 2023 due to logistics issues. Management expects significant ramp-up of the PTFE plant within six months of commissioning.
- The Board has approved a project for setting up a range of Specialty Fluoropolymers at Dahej at a projected cost of Rs. 595 crore. It is expected to be commissioned in 24 months. New specialty fluorochemical to have 25-28% IRR, four-year payback period.

- Fluoropolymers overall capacity would be 45,000 tonne.
- Strong demand outlook for HFCs, both in the domestic and international prices. Ref-gas price remains strong currently.

Packaging films – BOPET/BOPP demand/prices

- The segment faced headwinds on account of softness in BOPET/BOPP demand/prices and impact Hungary plant's operations given elevated energy prices in Europe.
- Commercialised two new products in the BOPP segment in Q3FY2023 and focus on VAP to protect margins.
- BOPET margin to remain under pressure in the near term due to significant capacity addition in India and oversees. However, the recent softening of energy prices in Europe would provide some respite.
- Hungary plant is operating at 40-45% utilisation currently due to energy crisis in Europe.
- Aluminum foil project remains on track to start by Q4FY2024.

Technical textiles – Subdued NTCF/polyester industrial yarn demand a near-term concern

- Earnings from the segment were impacted in Q3FY2023 due to subdued demand for Nylon Tyre Cord Fabric and polyester industrial yarn.
- Belting Fabric and Nylon Industrial Yarn segments recorded higher sales YoY with healthy volumes.

Capex guidance

- The company has maintained its capex guidance to Rs. 3,000 crore for FY2023 and aims for Rs. 2,800-3,000 crore capex for FY2024, while Rs. 2,200 crore capex is already doable based on current projects.

Results (Consolidated) Rs cr

Particulars	Q3FY23	Q3FY22	YoY (%)	Q2FY23	QoQ (%)
Revenue	**3,470**	**3,346**	**3.7**	**3,728**	**(6.9)**
Total Expenditure	2,636	2,464	7.0	2,959	(10.9)
Operating profit	**834**	**881**	**(5.4)**	**769**	**8.4**
Other Income	10	11	(6.2)	33	(69.4)
Depreciation	151	132	13.8	139	8.1
Interest	62	29	110.6	44	39.3
PBT	631	730	(13.6)	618	2.1
Tax	120	225	(46.6)	137	(12.4)
Reported PAT	**511**	**506**	**1.1**	**481**	**6.2**
Reported EPS (Rs.)	17.2	17.1	1.1	16.2	6.2
Margin (%)			**BPS**		**BPS**
OPM	24.0	26.3	(232)	20.6	339
NPM	14.7	15.1	(38)	12.9	182
Tax rate	19.0	30.8	-1175.0	22.2	-315.6

Source: Company; Sharekhan Research

Segmental performance (consolidated) **Rs cr**

Particulars	Q3FY23	Q3FY22	YoY (%)	Q2FY23	QoQ (%)
Segmental revenue					
Technical Textiles	426	538	(20.8)	466	(8.6)
Chemical	1,757	1,428	23.0	1,830	(4.0)
Packaging Film	1,203	1,276	(5.7)	1,331	(9.6)
Others	92	107	(13.7)	100	(8.0)
Total	**3,478**	**3,349**	**3.8**	**3,728**	**(6.7)**
Inter Segment	8	3	144.4	-	NA
Net Revenue	**3,470**	**3,346**	**3.7**	**3,728**	**(6.9)**
Segmental EBIT					
Technical Textiles	34	114	(69.9)	63	(45.7)
Chemical	564	419	34.5	517	9.0
Packaging Film	119	254	(53.3)	101	16.9
Others	9	9	6.7	8	20.4
Total EBIT	**726**	**796**	**(8.8)**	**689**	**5.3**
EBIT Margin (%)			**BPS**		**BPS**
Technical Textiles	8.0	21.1	(1,308)	13.5	(547)
Chemical	32.1	29.4	275	28.3	384
Packaging Film	9.9	19.9	(1,006)	7.6	224
Others	9.9	8.0	189	7.6	234
Overall EBIT margin	**20.9**	**23.8**	**(286)**	**18.5**	**243**

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 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 a high double-digit earnings growth trajectory on a sustained basis in the next 2-3 years.

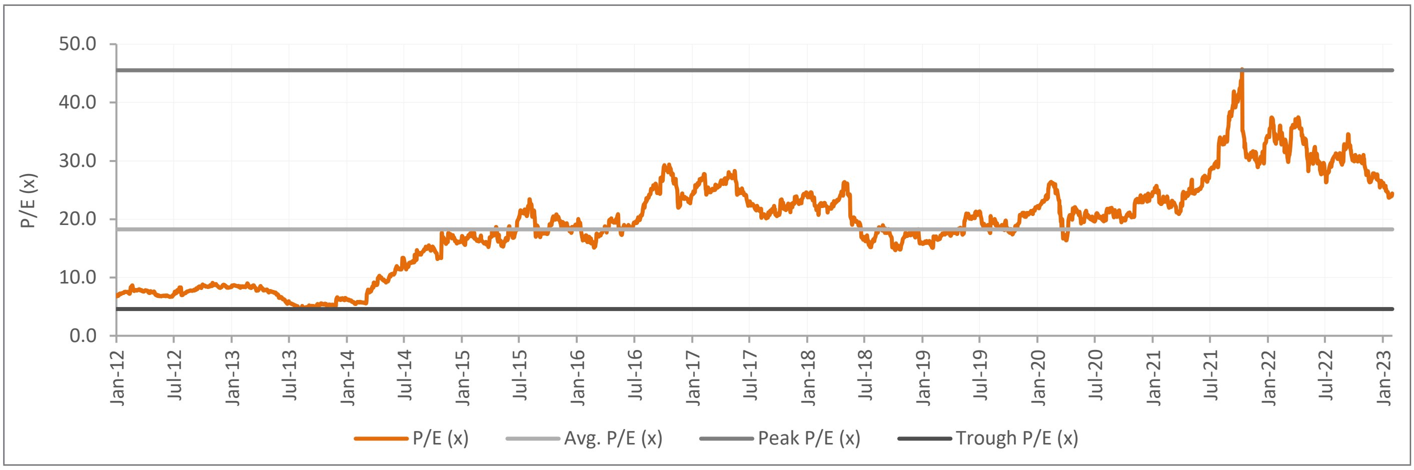
Company Outlook – Long-term story stays intact, capex momentum to continue

Management sees significant growth opportunities in the agro-chemicals and active pharmaceutical ingredients (API) segments (developing two pharmaceutical molecules in collaboration with innovators). Moreover, in the fluorochemicals space, SRF is focusing on ramping up its 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 margins are 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 an unchanged PT of Rs. 2,960

High growth in the chemical business supported by increased capex intensity and focus on value-added products (VAP) in the packaging film business would drive strong revenue/EBITDA/PAT CAGR of 16%/16%/17% over FY2022-FY2025E and a healthy RoE/RoCE of 21%/22%. Investment in the right areas of the specialty chemical business would improve earnings quality and safeguard from cyclical packaging film margins. SRF's valuation of 24.4x/21.5x its FY2024E/FY2025E EPS has turned reasonable post the recent sharp 24% fall in the stock price from 52-week high level. This provides a good entry opportunity for investors as the earnings outlook remains strong for the key chemical segment. Hence, we maintain our Buy rating on SRF with an unchanged price target (PT) of Rs. 2,960. At the CMP, the stock is trading at 24.4x/21.5x its FY2024E/FY2025E EPS.

One-year forward P/E (x) band



Source: 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 API (developing two pharma molecules in collaboration with innovators). Continued high capex to expand capacities in high-growth areas of the specialty chemical business is likely to drive sustained high earnings growth. Moreover, the structural high-growth cycle for the Indian specialty chemicals sector given favourable dynamics (China Plus One strategy by global companies) to support premium valuation for quality players like 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 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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