Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

SRF Ltd

Weak Q2; near-term weakness but decent long-term bet

Speciality Chem	Sharekhan code: SRF
Reco/View: Buy ⇔	CMP: Rs. 2,183
	Price Target: Rs. 2,745 ⇔

↑ 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 38.67

Updated Aug 08, 2023

High Risk

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

Source: Morningstar

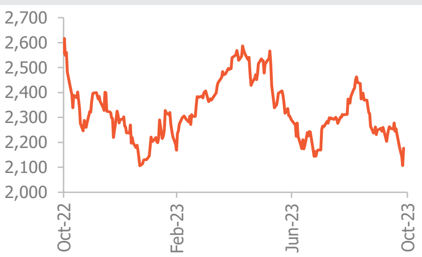
Company details

Market cap:	Rs. 64,696 cr
52-week high/low:	Rs. 2,640/2,050
NSE volume: (No of shares)	5.4 lakh
BSE code:	503806
NSE code:	SRF
Free float: (No of shares)	14.66 cr

Shareholding (%)

Promoters	51
FII	20
DII	14
Others	16

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-2.9	0.6	-14.1	-14.7
Relative to Sensex	-0.3	4.2	-19.0	-20.2

Sharekhan Research, Bloomberg

Summary

- Q2FY2024 results reflect demand/pricing pressure on the fluorochemicals business, inventory rationalisation in specialty chemicals and weak demand for some industrial chemicals. Thus, consolidated PAT of Rs. 320 crore (down 17% q-o-q) was 7% below our estimate.
- Chemical segment's EBIT declined by 24% q-o-q to Rs. 348 crore due to a 14% decline in revenue and a 332 bps q-o-q contraction in EBIT margin to 24.4%. Ref-gas witnessed volume/pricing pressure, while specialty chemical witnessed weak global demand owing to inventory rationalization by certain key customers. Management expects single digit growth in specialty chemical segment which indicates good recovery in H2FY24. From the Ref-gas segment, management expects uptick in the pricing and overall utilization of 85% capacity by end of FY25.
- Management believes that near-term prospects for packaging films business are weak while technical textile to remain stable.
- Near-term issues are likely to persist, given challenges in the chemicals industry. Having said that, SRF is a quality player and its investment in specialty chemicals provides strong long-term earnings growth prospects. Recent weakness in stock price is a good investment opportunity and the stock's valuation seems reasonable at 21x its FY2026E EPS. Hence, we maintain our Buy rating on SRF with an unchanged PT of Rs. 2,745.

SRF Limited's (SRF) Q2FY2024 results were weak with a miss of 3%/4%/7% in consolidated revenue/operating profit/PAT at Rs. 3,177 crore/Rs. 645 crore/Rs. 320 crore, down 5%/10%/17% q-o-q, due to weaker-than-expected performance of the chemical segment because of sluggish ref-gas demand in India, inventory rationalisation in specialty chemicals and weak demand for some industrial chemicals. Thus, the chemical segment's revenue declined steeply by 14% q-o-q to Rs. 1,426 crore (below estimates) and EBIT margin contracted by 388 bps y-o-y/332 bps q-o-q to 24.4%. The technical textiles segment witnessed a sequential recovery in revenue/EBIT margin to Rs. 506 crore/14.8%, up 9%/175 bps q-o-q. Performance of packaging films segment was flat with a 2% q-o-q growth in revenue to Rs. 1,122 crore, while EBIT margin recovered to 6.9% (down 73 bps y-o-y, up 220 bps q-o-q).

Key positives

- Decent recovery in revenue/EBIT margin by 9%/175 bps q-o-q for the technical textile segment.

Key negatives

- Steep revenue decline/EBIT margin contraction of 14%/332 bps q-o-q for the chemical segment.

Management Commentary

- **Chemicals –** During Q2FY24, specialty chemicals business performance was impacted by inventory destocking and rationalization by customers for certain key products. The management is optimist that H2FY24 will be better than H1FY24 for speciality chemical space. Management anticipates an uptick in pricing for HFCs and expects HFC's capacity utilization to 80-85% by the end of FY25.
- **Packaging films –** The management believes that decline in business revenue is mainly due to decline in prices of Key raw material and over-supply situation in the industry. Management also believes that demand and supply is persistently imbalanced which is expected to impact performance for the next few quarters.
- **Technical textiles –** During Q2FY24, the technical textiles business performed well due to higher sales volume from Nylon Tyre Cord Fabric (NTCF).
- The company expected to incur capital expenditure of roughly Rs 2,900 crore to Rs 3,000 crore in FY24 (with similar plans for FY25). Around 85%of capital expenditure will be used to by chemical segment.

Revision in estimates: We have lowered our FY2024/FY2025 earnings estimate to factor in near-term demand concerns. We have introduced our FY2026 earnings estimates in this report.

Our Call

Valuation – Maintain Buy on SRF with a unchanged PT of Rs. 2,745: Although there are short-term concerns on HFCs and inventory rationalisation in the agrochemicals space, SRF is a quality player (strong collaboration with innovators and dedicated customer contracts) and hold strong long-term earnings growth prospects, given the support of China plus one strategy by global players. We believe the recent weakness in SRF's stock price (corrected sharply by 17% from its 52-week high of Rs. 2,640) is a good opportunity for the investment to accumulate the stock. Investment in the right areas of specialty chemicals would drive a 14% PAT CAGR over FY2023-FY2026E along with healthy RoE/RoCE of 19.6%/19.8%. At the CMP, the stock trades at a reasonable valuation of 21x its FY2026E EPS. Hence, we maintain our Buy rating on SRF with an unchanged price target (PT) of Rs. 2,745.

Key Risks

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

Valuation (Consolidated) Rs cr

Rs crore	FY23	FY24E	FY25E	FY26E
Net Sales	14,870	14,915	17,542	20,448
OPM (%)	23.7	21.4	24.3	25.6
Adjusted PAT	2,113	1,773	2,346	3,093
% y-o-y growth	12.9	(16.1)	32.3	31.9
Adjusted EPS (Rs.)	71.3	59.8	79.1	104.4
P/E (x)	30.0	36.6	27.7	21.0
P/BV (x)	6.3	5.4	4.5	3.8
RoCE (%)	20.9	15.7	17.7	19.8
RoE (%)	22.9	15.9	17.8	19.6

Source: Company; Sharekhan estimates

Q2FY2024 conference call highlights

Specialty chemicals business – Near-term concern of inventory rationalization

- During Q2FY24, specialty chemicals business performance was impacted by inventory destocking and rationalisation by customers for certain key products.
- While some customers have rescheduled some orders, the company has not witnessed any cancellations.
- The management is optimist that H2FY24 will be better than H1FY24 for speciality chemical space.
- The company continues to expand its portfolio and have introduced six products in H1FY24.
- The board has approved capital expenditure of Rs 235 crore for setting up dedicated facility to produce agrochemical intermediary.
- During Q2FY24, agrochemical business witnessed lower volumes and realizations due to seasonally weak quarter in domestic market and dumping by Chinese players.

Fluorochemicals – Short-term pressure to persist for HFCs

- The management anticipates an uptick in pricing for HFCs, especially in the key markets like India, Middle East, Southeast Asia and the United States.
- The company expects demand to remain stable as some large US based customers have already placed ordered for CY24 and CY25.
- Management expects HFC's capacity utilization to 80-85% by the end of FY25.

Packaging films – Margin pressure to continue; expect recovery to be gradual for BOPET

- Management believes that a decline in revenues is mainly due to decline in prices of Key raw material and over-supply situation in the industry.
- Company's board has approved capital expenditure of Rs 275 crore at Indore plant for establishing a dedicated capacitor-grade BOPP line. This line will cater to demand emerging from manufacturer of electronics and EV sector in India.
- Aluminium foil facility is currently undergoing trials, with commercial production expected start soon.
- Overall, the management believes that demand and supply is persistently imbalanced which is expected to impact performance for the next few quarters.

Technical textiles – Stable business environment

- During Q2FY24, the technical textiles business performed well due to higher sales volume from Nylon Tyre Cord Fabric.
- Capacity expansion of belting fabrics and polyester industrial yarn remains on track.
- This segment witnessed healthy demand for Belting Fabrics and Polyester Yarn products due to increased infrastructural spending by the Government.

Other Businesses

- Coated fabrics attained highest domestic sales mainly due to strong demand for products, including value-added products.
- Laminated fabrics segment also achieved record sales in H1, with the plant operating at full capacity. The company expects stable demand for this product due to new capacity additions.

Others

- Net debt increased from roughly Rs 3,250 crore as of March 31, 2023, to about Rs 3,900 crore as of 31 September, 2023 primarily due to capital expenditure of around Rs 1,400 crore in H1.
- The company expected to incur capital expenditure of roughly Rs 2,900 crore to Rs 3,000 crore in FY24. Around 85%of capital expenditure will be used to by chemical segment. For FY25, the company plans to spend capital expenditure of Rs 2900 crore.

Results (Consolidated) Rs cr

Particulars (Rs Cr)	Q2FY24	Q2FY23	YoY (%)	Q1FY24	QoQ (%)
Revenue	**3,177**	**3,728**	**(14.8)**	**3,338**	**(4.8)**
Total Expenditure	2,551	2,959	(13.8)	2,642	(3.4)
Operating profit	**626**	**769**	**(18.6)**	**696**	**(10.1)**
Other Income	29	33	(11.1)	12	147.6
Depreciation	161	139	15.7	157	3.0
Interest	79	44	78.3	66	20.8
PBT	415	618	(32.9)	486	(14.6)
Tax	114	137	(16.8)	126	(9.8)
RPAT	**301**	**481**	**(37.5)**	**359**	**(16.3)**
Reported EPS (Rs)	10.1	16.2	(37.5)	12.1	(16.3)
Margin (%)			**YoY (BPS)**		**QoQ (BPS)**
Operating profit margin (OPM)	19.7	20.6	(92)	20.9	(115)
Net Profit margin (NPM)	9.5	12.9	(344)	10.8	(130)

Source: Company, Sharekhan Research

Segmental performance (Consolidated) Rs cr

Particulars	Q2FY24	Q2FY23	YoY (%)	Q1FY24	QoQ (%)
Segmental revenue					
Technical Textiles	506	466	8.6	465	8.9
Chemical	1,426	1,830	(22.1)	1,661	(14.1)
Packaging Film	1,122	1,331	(15.7)	1,095	2.4
Others	127	100	26.4	119	6.9
Total	**3,181**	**3,728**	**(14.7)**	**3,339**	**(4.7)**
Inter Segment	3		#DIV/0!	0	948.5
Net Revenue	**3,177**	**3,728**	**(14.8)**	**3,338**	**(4.8)**
Segmental EBIT					
Technical Textiles	75	63	19.1	61	23.6
Chemical	348	517	(32.8)	460	(24.4)
Packaging Film	77	101	(23.8)	51	50.6
Others	33	8	336.0	23	42.9
Total EBIT	**533**	**689**	**(22.7)**	**595**	**(10.4)**
EBIT Margin (%)					
Technical Textiles	14.8	13.5	131	13.1	175
Chemical	24.4	28.3	(388)	27.7	(332)
Packaging Film	6.9	7.6	(73)	4.7	220
Others	26.1	7.6	1,852	19.5	657
Overall EBIT margin	**16.8**	**18.5**	**(171)**	**17.8**	**(105)**

Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector Outlook – 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 rise in exports given China Plus One strategy followed by global customers and a favourable government policies (such as tax incentives and production-linked incentive scheme similar to that of the pharmaceutical sector). We believe that 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.

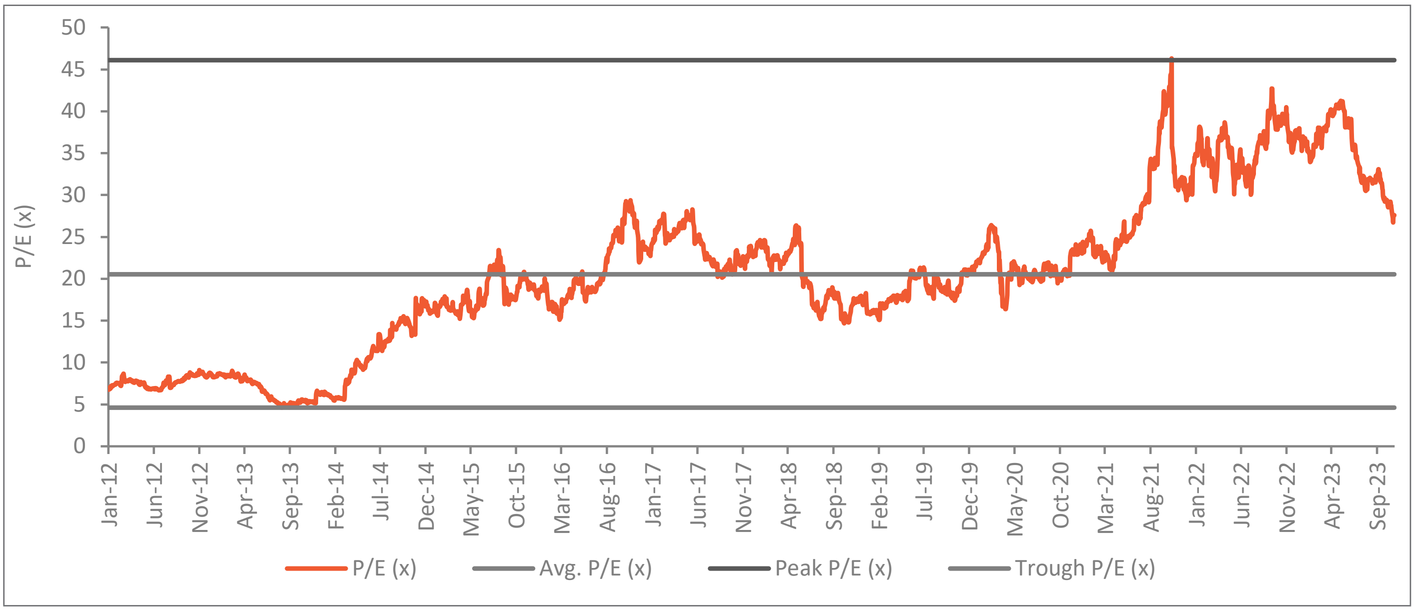
■ Company Outlook – Near-term concerns seem transitionary; capex-led growth story intact

Management indicated near-term concern for the company, given temporary ref-gas pricing pressure and inventory rationalisation along with order delays by customers in agrochemical. The above-mentioned challenges seem short-term in nature and significant growth opportunities are expected in the agro-chemicals as well as active pharmaceutical ingredients (API) segments. Moreover, the management sees strong global demand (especially in the U.S.) for HFCs. High capital intensity toward specialty chemicals makes us confident about the long-term revenue/earnings growth of SRF. Moreover, investment in the right areas of the specialty chemicals business would improve earnings quality and safeguard from cyclical packaging film margins.

■ Valuation – Maintain Buy on SRF with a unchanged PT of Rs. 2,745

Although there are short-term concerns on HFCs and inventory rationalisation in the agrochemicals space, SRF is a quality player (strong collaboration with innovators and dedicated customer contracts) and hold strong long-term earnings growth prospects, given the support of China plus one strategy by global players. We believe the recent weakness in SRF's stock price (corrected sharply by 17% from its 52-week high of Rs. 2,640) is a good opportunity for the investment to accumulate the stock. Investment in the right areas of specialty chemicals would drive a 14% PAT CAGR over FY2023-FY2026E along with healthy RoE/RoCE of 19.6%/19.8%. At the CMP, the stock trades at a reasonable valuation of 21x its FY2026E EPS. Hence, we maintain our Buy rating on SRF with an unchanged price target (PT) of Rs. 2,745.

One-year forward P/E (x) band



Source: Sharekhan Research

About the 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
Prashant Yadav	President and CEO, Fluorochemicals Business & Technical Textiles
Anurag Jain	President and CEO, Specialty Chemicals Business & Chemicals Technology Group
Prashant Mehra	President & CEO, Packaging Films Business, Coated & Laminated Fabrics Business
Rahul Jain	Chief Financial Officer
Rajat Lakhanpal	Company Secretary and Compliance Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Kotak Mahindra Asset Management Co	4.0
2	Amansa Holdings Pvt Ltd	3.5
3	FMR LLC	2.2
4	Vanguard Group Inc/The	1.9
5	BlackRock Inc	1.6
6	Life Insurance Corp of India	1.1
7	SBI Life Insurance Co Ltd	1.1
8	FIL Ltd	1.0
9	ICICI Prudential Life Insurance Co	0.8
10	HDFC Asset Management Co Ltd	0.7

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

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