Equity Strategy - India

Red Sea Implications: No material impact yet; see disruptions easing gradually

Equity Strategy

02 February 2024

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India

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Red Sea Conflict = Higher freights, shipping delays

Since mid-December, shipowners have been diverting away from the Red Sea and Suez Canal due to attacks by Houthi rebels. As per our analysts, 28% of global container trade, 10%-15% of crude tankers & 5% of global bulk pass through this route. Re-routing by the Cape of Good Hope adds significant cost and delays (7-20 days per leg). Higher lead time reduces effective capacity of global fleet & impacts freight cost (>150% vs Dec'23)

Disruptions could persist but see gradual easing

Despite US (PG) and UK intervention in the region, Red Sea disruptions have continued. US pronouncements highlighted that the strikes have not yet eroded Houthi offensive capabilities. Our analysts estimate, as a best case, Red Sea sailings could resume mid to late 2024. That said, peak disruptions are being witnessed reflecting the pre- CNY uptick in volumes and temporary supply disruption led restocking.

Implications for India:

Industrials (ABB, SIEM, KKC): For product companies in our coverage, EU exports are between 3-8% of their revenue. Margins should be stable given ability to pass through cost escalation. That said, higher freights/delayed shipping could impact earnings by 1-3%. For **LT,** management highlighted - a) GCC capex/ordering isn't impacted, b) possible cost escalations with supply under pressure but no immediate impact (longer execution)

Healthcare: See both exports (60-70% of revenue for large caps) and imports (APIs, intermediaries from China) impacted. Freight cost escalation impact on margins minimal (<25bp). Bigger impact from shipping delays (higher inventory for upcoming launches in key markets like US). Delays on RM imports could impact working capital and lower FCF. That said, most companies have strong FCF generation and are net cash positive.

Consumer Electricals: No material impact for **HAVL** (exports only 2-3% of revenue). Given high value of wires & cables, industry players expect end-users to absorb any freight cost escalations. Contracts quoted in CIF/DAP vs FOB. No order deferments yet.

Ports/Logistics (CCRI): As per **CCRI**, Q3FY24 domestic volumes were impacted due to shipping delays but its customers hinted normalization post first week of Feb'24.

Metals & Mining (JSTL, TATA): Impacts coking coal imports for steel making. Imports from Russia, USA, Canada make upto 29% of the pie. Higher coking coal costs will impact profitability. Higher steel prices in EU on supply constraints augurs well for TATA.

Oil & Gas (BPCL, HPCL): Increase in fuel prices could adversely impact MM for OMCs. That said, currently both companies are not witnessing any impact on crude sourcing.

Autos: Mildly negative for auto OEMs/suppliers with export exposure on higher lead times/freights. Ordering levels from channel partners are being adjusted for delays.

Abbreviations:
PG: Prosperity Guardian
RM: Raw Material
MM: Marketing Margins
EU: European Union
CIF: Cost, Insurance, Freight
DAP: Delivered At Place
FOB: Freight On Board
OMC: Oil Marketing Company
CNY: Chinese New Year
OEM: Original Equipment Manufacturer
ABB: ABB
SIEM: Siemens
KKC: Cummins India
HAVL: Havell
CCRI: CONCOR
JSTL: JSW Steel
TATA: Tata Steel
BPCL: Bharat Petroleum
HPCL: Hindustan Petroleum

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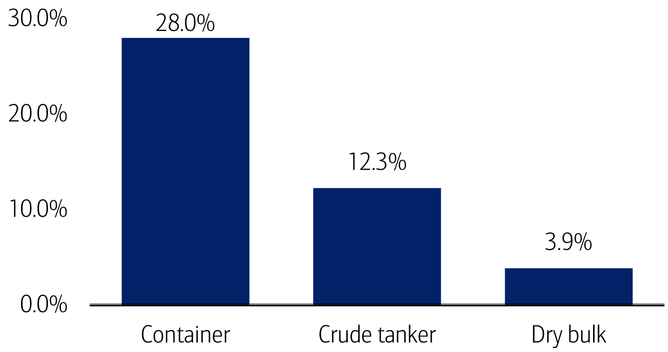
Timestamp: 02 February 2024 08:16AM EST

Focus Charts

Exhibit 1: Shipping volumes using Suez/Red Sea by segment
Container shipping is most exposed to disruption to Suez/Red Sea



Source: Clarksons, BofA Global Research estimates
Report: Building Red Sea tail risks

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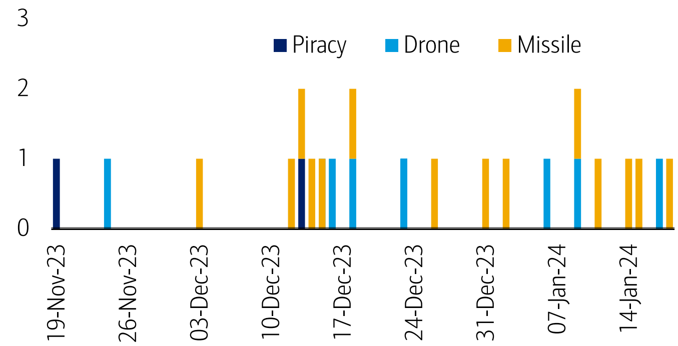
Exhibit 2: Houthi attacks in the Red Sea (#), 2023-24
Red Sea route witnesses continued Houthi attacks January 2024



Source: US Central Command
Refer report here

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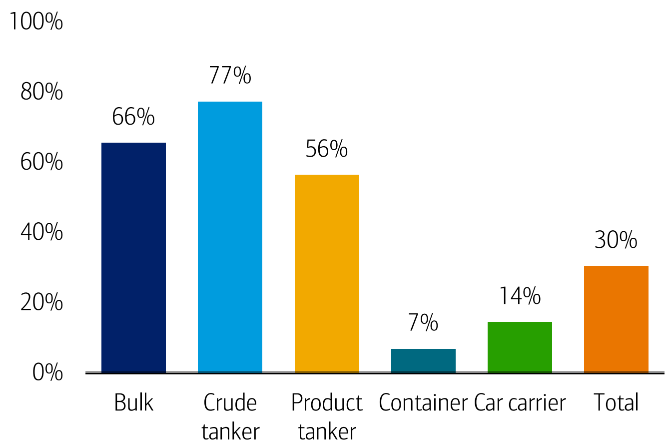
Exhibit 3: Red Sea vessel arrivals - last 7 day MA as % of 1H Dec 2023
Container and car carriers witnessing higher impact



Source: Clarksons, As of Jan'24
Refer report here

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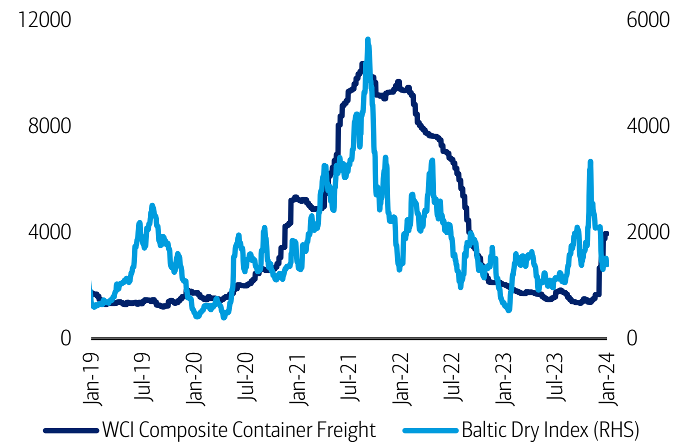
Exhibit 4: Global container shipping costs on the up
Shipping costs are spiking on disruptions in the Red Sea route



Source: BofA Global Research, Bloomberg

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Stocks exposed to the theme

Exhibit 5: Valuation summary of stocks under coverage exposed to the theme
Valuation summary

Company Name	BofA Rating	Mkt cap (US$ mn)	P/E (x) FY24E	P/E (x) FY25E	EPS FY24E	EPS FY25E	EPS CAGR (%) FY24-26E	P/BV (x) FY24E	P/BV (x) FY25E	BV CAGR (%) FY24-26E	RoE (%) FY24E	RoE (%) FY25E
Healthcare												
Sun Pharma	NEUTRAL	40,710	30.2	27.5	46.7	51.2	16%	4.8	4.2	13%	17%	16%
Cipla	UNDERPERFORM	13,502	25.5	24.2	54.4	57.3	7%	3.7	3.3	12%	15%	14%
Dr. Reddy's	BUY	12,047	17.2	16.7	347.4	357.9	4%	3.1	2.7	16%	19%	17%
Divis	UNDERPERFORM	11,695	49.2	36.2	74.3	101.0	31%	6.6	5.9	11%	14%	17%
Torrent Pharma	NEUTRAL	10,247	44.0	33.2	57.1	75.8	27%	10.7	8.9	18%	26%	29%
Zydus	NEUTRAL	9,265	21.3	21.2	35.7	35.8	4%	3.4	3.1	12%	17%	15%
Lupin	UNDERPERFORM	8,306	37.5	30.6	40.4	49.4	14%	4.4	3.9	12%	12%	14%
Aurobindo	BUY	7,513	14.8	13.3	72.3	80.3	16%	1.9	1.6	13%	13%	13%
Alkem	UNDERPERFORM	6,995	30.1	26.9	161.1	180.7	15%	5.1	4.5	13%	18%	18%
Gland Pharma	BUY	3,938	25.8	22.2	76.8	89.4	22%	3.2	2.8	14%	13%	13%
Biocon	BUY	3,906	33.4	16.9	8.1	16.0	73%	1.7	1.5	8%	5%	9%
Glenmark	BUY	1,265	17.7	14.9	48.5	57.3	19%	3.9	3.5	13%	24%	25%
Autos/Auto Ancillaries												
Maruti	BUY	40,307	23.4	21.4	455.4	496.0	10%	3.6	3.2	12%	16%	16%
Tata Motors	BUY	35,179	13.8	12.3	63.5	71.6	24%	3.4	2.7	33%	33%	28%
Bajaj Auto	BUY	26,698	27.0	24.0	283.6	318.8	14%	7.8	7.3	6%	29%	31%
M&M	NEUTRAL	24,744	17.3	15.2	95.4	108.7	7%	3.6	3.2	14%	21%	21%
Eicher	NEUTRAL	12,977	24.4	22.9	160.9	171.9	9%	5.3	4.7	15%	23%	22%
TVS	NEUTRAL	11,424	37.3	30.6	53.5	65.2	23%	9.8	7.8	26%	29%	28%
Hero MotoCorp	BUY	11,049	20.0	17.9	229.0	255.9	15%	4.7	4.3	9%	24%	25%
SAMIL	BUY	9,408	19.0	15.6	6.1	7.4	30%	2.9	2.6	12%	16%	17%
Bharat Forge	UNDERPERFORM	6,899	38.5	33.8	31.9	36.4	20%	6.6	5.8	15%	18%	18%
Ashok Leyland	BUY	6,183	17.0	17.2	10.3	10.2	4%	4.2	3.7	17%	27%	23%
Sona Comstar	UNDERPERFORM	4,447	51.6	41.7	12.2	15.1	30%	11.2	9.2	21%	24%	24%
Motherson Sumi	NEUTRAL	3,727	38.9	32.4	1.8	2.2	22%	15.7	12.9	22%	44%	44%
Escorts Kubota	UNDERPERFORM	3,512	28.0	25.3	102.9	114.0	10%	2.8	2.5	11%	12%	12%
Industrials												
Larsen & Toubro	BUY	56,288	28.3	22.7	120.2	149.5	22%	4.3	3.8	12%	16%	18%
Siemens Ltd	NEUTRAL	18,279	57.1	46.6	74.4	91.2	22%	9.1	8.1	13%	17%	18%
ABB India	NEUTRAL	11,609	69.7	51.3	65.3	88.6	25%	13.4	9.6	30%	21%	20%
Cummins India	UNDERPERFORM	7,560	42.5	37.9	53.2	59.6	13%	9.9	9.1	9%	24%	25%
Logistics												
CONCOR	UNDERPERFORM	6,764	34.4	27.8	26.8	33.2	22%	4.5	4.2	6%	13%	16%
Gujarat Pipavav Port	UNDERPERFORM	1,052	22.5	17.5	8.0	10.3	14%	4.0	3.8	4%	18%	22%
Metals & Mining												
JSW Steel	BUY	23,188	12.0	11.3	66.7	70.9	20%	2.1	1.8	17%	19%	18%
Tata Steel	NEUTRAL	19,854	11.7	9.6	11.5	14.0	na	1.6	1.4	9%	14%	16%
SAIL	UNDERPERFORM	5,938	14.0	7.8	8.5	15.3	87%	0.9	0.8	6%	6%	11%
Oil & Gas												
Bharat Petroleum	UNDERPERFORM	13,292	20.2	19.8	25.1	25.7	-24%	1.9	1.8	3%	9%	9%
Hindustan Petroleum	UNDERPERFORM	7,963	10.3	7.8	45.0	59.5	-10%	1.6	1.4	10%	16%	19%

Source: BofA Global Research, Bloomberg

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Industrials

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Industrials (ABB IN, KKC IN, SIEM IN): These companies have Europe exports exposure between 3-8% of the topline. Most other export geographies for them are largely unaffected by the red sea/route change, i.e., parts of Africa, Middle East and LATAM. We do not see any material impact on the margins given their ability to pass on the increased costs due to higher shipping rates/longer rout. That said, overall tightness in supply chain, increased costs, and higher shipping time (35-50 days higher) could affect sales/demand resulting in ~1-2% impact at the earnings level.

For Larsen & Toubro (**LT),** management highlighted that a) GCC capex/ordering hasn't seen any slowdown yet (structural cycle), and b) While there is possibility of cost escalations with supply being under pressure, there is no immediate impact as execution cycle is longer (typically ~3 years) and there is no immediate requirement to import RM.

Wires & Cables (HAVL IN): Exports for Havells is only 2-3% of overall revenue, implying no material impact. For peers, while transport cost, shipping time and inventory costs are likely to increase, these can be passed on easily given a) these are high value items and b) the increase in cost is only up to 1%. Companies believe end customer will likely absorb the increased costs. They have not witnessed any deferment in orders yet. However, contracts are now being quoted in CIF/DAP vs FOB prices earlier.

Ports/Logistics (CCRI IN): Concor has seen some strain on volumes due to red sea conflict in December quarter (Q3FY24) but this was offset by growth in other EXIM volumes. Going froward, its shipping/freight forwarding customers have suggested that this should stabilize post first week of February 2024, as shipping lines and customers align with the new route and pricing. Expect minimal impact on container volumes in Q4FY24.

Metals & Mining / Oil & Gas

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Metals & Mining: For steel-making, India imports bulk of its coking coal requirements. As per Steelmint data for CY23, India imports coking coal mainly from Australia (61% of total coking coal imports) with other major countries being Russia (10%), USA and Canada (combined around 19%). Any increase in coking coal freight costs could impact profitability for steel companies. Commentary from companies – (i) JSW Steel – management have observed higher container shipment rates for its export products and is in the process of switching shipments to break-bulk (used for imports of coking coal), (ii) Tata Steel – company has observed higher steel prices in Europe (likely to benefit Tata's European operations) following the Red Sea crisis which has impacted flow of materials from Asia to Europe.

Oil & Gas: Any increase in crude prices/landed cost of crude as a result of the red-sea disruptions could adversely impact profitability for Indian OMCs (Oil Marketing Companies) as this could put pressure on marketing margins (given that retail auto-fuel pump prices in India have remained unchanged since May'22). Commentary from companies – (i) BPCL - no impact on crude sourcing, (company has covered crude purchases till Apr'24). Russian cargoes are delivered on a Delivered at Port (DAP) basis with BPCL not bearing risk of rising freight rates, (ii) HPCL - no impact on term or spot crude sourcing, although company has observed higher freight rates.

Pharma

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As most Indian pharma companies are exporters (~60-70% of revenue for most large caps) and are also dependent on imports from China for APIs/intermediaries/ KSMs, the ongoing disruption in Red Sea would transit timelines and cost.

While companies have indicated freight cost increase from the Red Sea conflict, the impact to EBITDA margins would be limited (<25 bps). The bigger impact would be from increasing timeline for deliveries that could lead to higher inventory of raw materials as well as finished product in key markets like US for upcoming launches.

While raw material supplies from China should be impacted by conflict, companies indicated fewer ships coming to the ports of western India given the detour as they are now using the route around the Cape of Good Hope (vs Suez Canal before the conflict).

This could increase working capital requirement for markets like the US, therefore leading to lower FCF in the near-term. We would, however, point that most India companies have strong FCF generation and net cash balance sheet.

DRRD for instance, reported FCF of Rs200Mn in Dec-23 quarter vs. Rs14Bn last quarter (on flattish EBITDA) but has ~Rs60Bn net cash on its books. The company in-fact called out its competitive advantage from the rich balance sheet enabling it to better service customers vs. players with lower cash buffer (i.e., leveraged US generic companies).

Autos

Conflict in the Red Sea region is mildly negative for auto OEMs and suppliers having export exposure. Besides, exposure outside Europe will also see impact as lead times and freights have increased.

The Red Sea embargo has caused some delays and freight rates have doubled to many destinations. Alternate routes are already being put in place and ordering levels from channel partners are being adjusted to take note of longer shipping times.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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