Tiles Sector – Multiple growth drivers make it an attractive long term bet

Leaders building a champion franchise; SOMC high conviction BUY; Downgrade KJC to ADD

Tiles industry is one of the largest building material categories (~Rs. 250bn) wherein only a few players have the requisite scale, brand image and balance sheet strength to differentiate and outgrow competition. The top two market/brand leaders, Kajaria Ceramics (KJC) and Somany Ceramics (SOMC) have created a strong franchise and going ahead, we expect their competitive advantages to further strengthen. While we expect the near term demand to remain moderate, we continue to remain excited on the potential opportunities and multiple demand drivers the tiles industry presents over the long term and the capability of the market leaders to capitalize on the same. Tiles industry has grown at a CAGR of 7% over FY13-FY17 (slowed down significantly in FY17) largely due to slowdown in the real estate market. Despite this slowdown and increasing competition from few rising Morbi brands, the top brands, Kajaria Ceramics (KJC) and Somany Ceramics (SOMC) have grown at a superior rate of 14-15% over the last five years, indicating strengthening franchise base. As per our long term industry demand model, we expect tiles industry to grow at a CAGR of 7-8% in volume terms and leaders like KJC and SOMC outgrowing by atleast 200-300 bps. And with aggressive foray into new business (Sanitaryware and Bath fittings) leveraging brand and distribution, we expect both KJC and SOMC to comfortably grow in low to mid teen digit growth over the long term. Broadly, we remain bullish on the prospects of KJC and SOMC.

The key questions most investors ponder is on valuations. Are they expensive or justifiable or sustainable? Both KJC and SOMC have rerated significantly over the last three years and are now trading at premium multiples. KJC currently trades at 32x FY19EPS (15% premium over its three year average) whereas SOMC is trading at 22x FY19EPS (5% premium over its three year average. Valuations for leaders in these categories are evolving. Franchise strength has increased (consistent track record of market share gains), superior RoCE, and cash generation. High FCF generation and high sustainable RoCE (refer slide no 27) in the next few years positions it uniquely to invest ahead of competition in scale, brand and in improving structure – professional management and logistics. While earnings based valuations multiples look expensive but not when analyzed in conjunction with estimated FCF generation. We back-test the multiples based on DCF (refer slide no. 32-34) and conclude the current multiples of KJC are fair and sustainable and expect re-rating for SOMC.

KJC is the brand, market and margin leader in the tiles industry. We expect KJC to post a revenue and EPS CAGR of 13% and 16% over FY17-FY19E. KJC clocked all-time high EBITDA margins of 19.5% in FY17 and going ahead we attach lower probability to its sustenance given its already high value added products mix, low outsourcing mix, and bottoming out of gas costs. We build in 50-60bps reduction in margins by FY19E. While the current multiple of 32x FY19E EPS is sustainable and fair as explained above, we do not see meaningful upsides from current levels. Hence downgrade the stock to ADD from BUY and would enter at lower levels for better margin of safety.

SOMC is the second largest player in the tiles industry. SOMC's scale of operations have increased significantly over the last few years. Further, company is investing in brand/people to increase competitive edge vs its peers. Company's initiative towards re-aligning its product portfolio and foray into sanitaryware business will further lead to expansion in its EBITDA margins and narrow the discount versus Kajaria. We expect SOMC to post a revenue and EPS CAGR of 13% and 28% over FY17-FY19E. RoE gap with Kajaria will shrink in next few years as recently added capacities scale up and PBT margin expands with portfolio premiumisation and scale. We value SOMC at 27x FY19E EPS, a 10% discount vs. KJC's target multiple of 30x. Maintain BUY with TP of Rs. 1,000/share. **SOMC is now one of our preferred picks in the entire building materials space.**

Date	June 27, 2017

Market data	
SENSEX	31,140
Nifty	9,575

Performance (%)	3M	6M	12M
Sensex	6%	21%	16%
Kajaria Ceramics	22%	55%	16%
Somany Ceramics	17%	59%	41%
Century Plyboard	12%	57%	34%
Greenply Industries	14%	34%	46%
Cera Sanitaryware	22%	86%	50%
HSIL Limited	0%	14%	10%
Supreme Industries	18%	41%	41%
Astral Poly	22%	81%	50%

Stock Recommendation

	CMP (Rs.)	TP (Rs.)	Rating
KJC	680	700	ADD
SOMC	775	1,000	BUY

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Valuation Matrix

Company	Revenues (Rs. mn)			EBITDA (Rs. mn)			PAT (Rs. mn)			EPS (Rs.)			FY17-FY19E CAGR		
	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	Revenue	EBITDA	EPS
KJC	25,496	28,111	32,324	4,963	5,332	6,110	2,528	2,799	3,412	16	18	21	13%	11%	16%
SOMC	18,110	19,871	22,940	1,915	2,171	2,642	931	1,183	1,526	22	28	36	13%	17%	28%
CERA	10,066	11,458	13,208	1,716	1,975	2,296	992	1,231	1,479	76	95	114	15%	16%	22%
HSIL	20,750	23,960	28,022	2,893	3,200	3,713	1,030	1,066	1,169	14	15	16	16%	13%	7%
GIL	16,569	18,049	21,777	2,470	2,856	3,635	1,351	1,571	1,748	11	13	14	15%	21%	14%
CPBI	17,825	21,577	25,800	2,920	3,592	4,433	1,856	2,134	2,833	8	10	13	20%	23%	24%
ASTRAL	18,888	22,349	27,008	2,638	3,248	4,014	1,447	1,934	2,527	12	16	21	20%	23%	32%
SI	44,623	51,730	60,179	7,619	8,918	10,486	4,304	4,952	5,886	34	39	46	16%	17%	17%

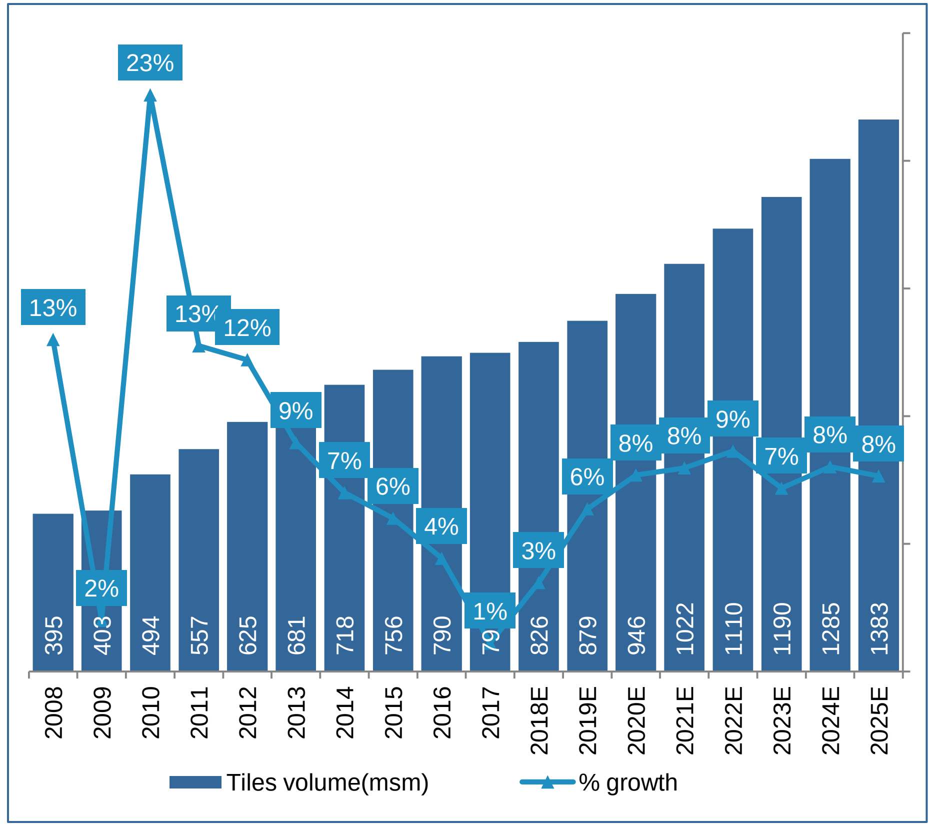
Company	EBITDA margins %			PBT margins %			PAT margins %			RoE%			RoCE%		
	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E
KJC	19.5%	19.0%	18.9%	15.5%	15.8%	16.7%	9.9%	10.0%	10.6%	23.6%	21.9%	22.8%	21.1%	22.0%	23.5%
SOMC	10.6%	10.9%	11.5%	8.2%	9.2%	10.3%	5.1%	6.0%	6.7%	19.6%	20.7%	19.6%	16.1%	17.4%	20.5%
CERA	17.0%	17.2%	17.4%	15.4%	16.1%	16.7%	9.9%	10.7%	11.2%	21.1%	21.5%	21.4%	18.7%	20.0%	20.7%
HSIL	13.9%	13.4%	13.3%	7.2%	5.9%	5.6%	5.0%	4.5%	4.2%	7.3%	7.2%	7.5%	5.7%	6.3%	7.0%
GIL	14.9%	15.8%	16.7%	11.5%	12.3%	11.3%	8.2%	8.7%	8.0%	19.3%	18.2%	17.2%	14.5%	13.0%	13.5%
CPBI	16.4%	16.6%	17.2%	13.1%	12.4%	13.7%	10.4%	9.9%	11.0%	30.1%	26.9%	28.5%	18.1%	17.4%	19.9%
ASTRAL	14.0%	14.5%	14.9%	10.8%	12.0%	13.0%	7.7%	8.7%	9.4%	18.6%	20.6%	22.0%	16.8%	19.4%	21.7%
SI	17.1%	17.2%	17.4%	13.1%	13.6%	14.1%	9.6%	9.6%	9.8%	28.6%	26.9%	27.1%	21.7%	22.7%	23.8%

Company	CMP	MCAP	P/E (x)			EV/EBITDA (x)			Price to book (x)			Rating
	Rs.	Rs. bn	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	
KJC	700	108,428	42.7	38.6	31.7	22.0	20.3	17.5	9.2	7.8	6.7	ADD
SOMC	775	32,823	35.3	27.8	21.5	17.7	15.2	12.4	6.3	5.3	4.4	BUY
CERA	2981	38,769	39.3	31.7	26.4	22.4	19.2	16.2	7.5	6.2	5.2	ADD
HSIL	375	27,097	26.7	25.8	23.5	11.9	11.2	9.7	1.9	1.8	1.7	REDUCE
GIL	276	33,802	25.0	21.5	19.3	14.0	12.8	10.7	4.3	3.6	3.1	BUY
CPBI	301	66,885	34.2	29.7	22.4	22.6	19.4	15.5	8.9	7.2	5.7	BUY
ASTRAL	688	82,441	56.3	42.1	32.2	31.3	25.1	20.0	9.6	7.9	6.4	ADD
SI	1227	155,875	35.7	31.0	26.1	15.0	12.6	10.7	9.1	7.7	6.6	BUY

Indian Tiles consumption to grow by 7-8% in next 8-10 years

Value growth to be higher led by changing consumer preference for high value added tiles

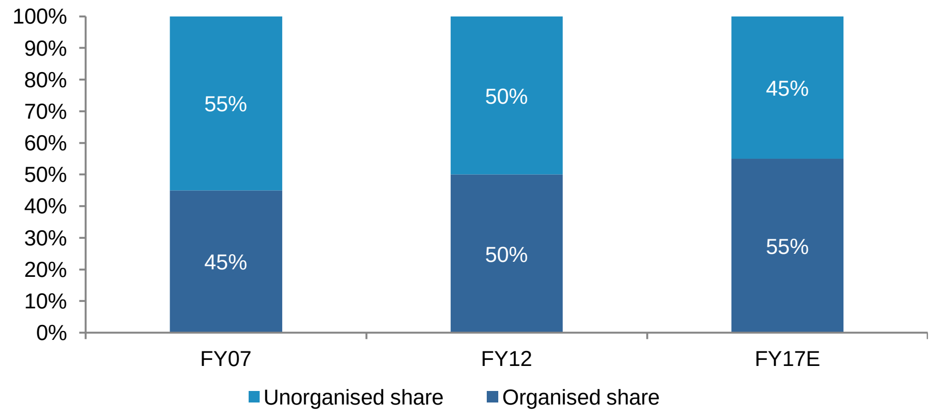
- New usage such as Wall tiles etc
- Tiles for Aesthetics
- Increasing Tiles penetration
- Preference for tiles for flooring
- Nuclearisation
- Population growth



Tiles Industry Landscape

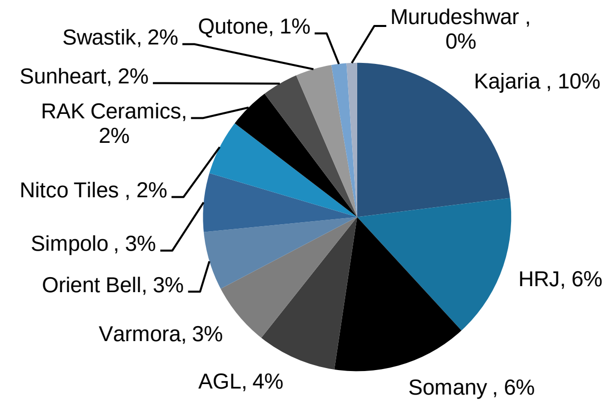
Tiles industry is fairly unorganised and fragmented with share of 45%

Organized vs Unorganized



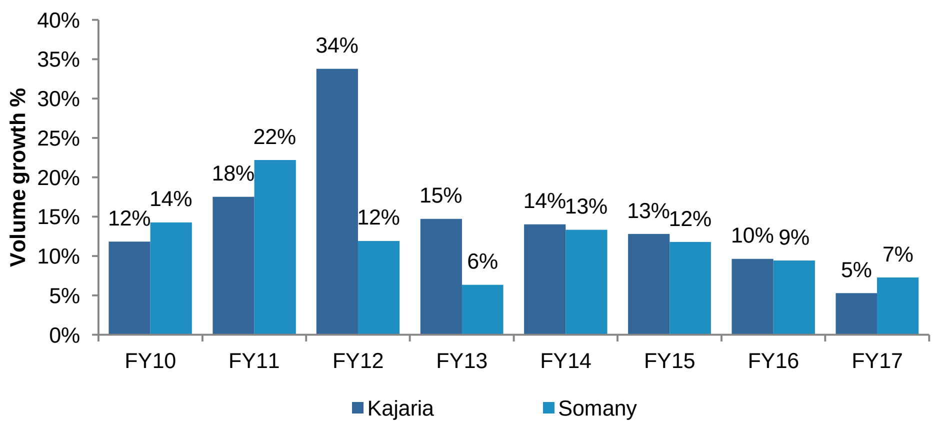
Source: Industry, Spark Capital

Market share of top organized players



Source: Industry, Spark Capital

KJC and SOMC have outperformed industry



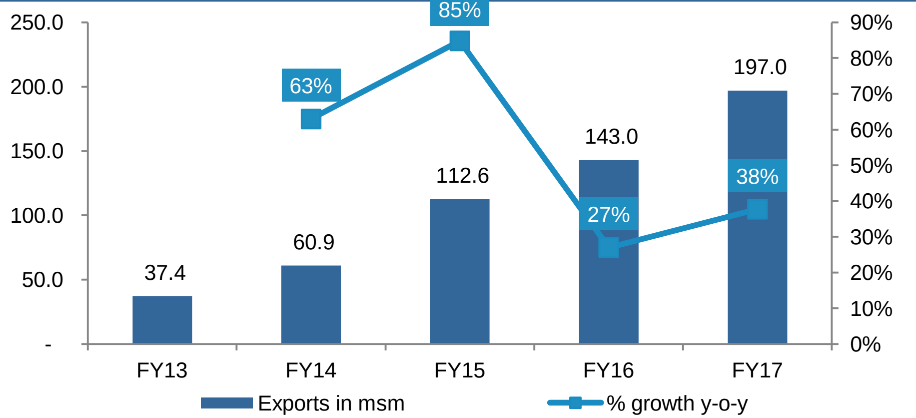
Source: Industry, Spark Capital

- Tiles industry in India is fairly unorganized and fragmented. Organised players market share is just 55% versus 45% in FY07.
- KJC and SOMC have outperformed industry in last ten years and still market share of KJC and SOMC remain 10% and 6% respectively.
- In last five years, lot of Morbi based players such as Varmora, Simpolo and Qutone have been aggresively expanding nad taking market share from old leaders such as HR Johnson, Orient Bell, Nitco and RAK Ceramics

Tiles Exports- Growing strongly

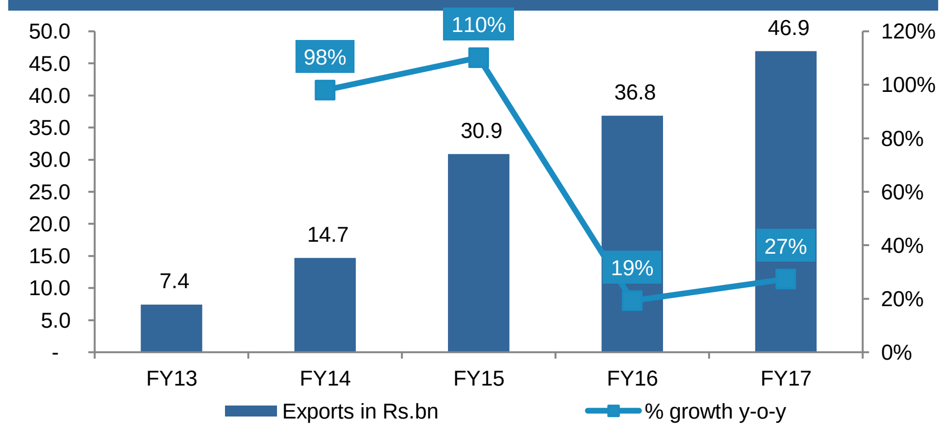
Exports have gained lot of traction post anti dumping duty on Chinese tile by lot of countries

Exports by quantity



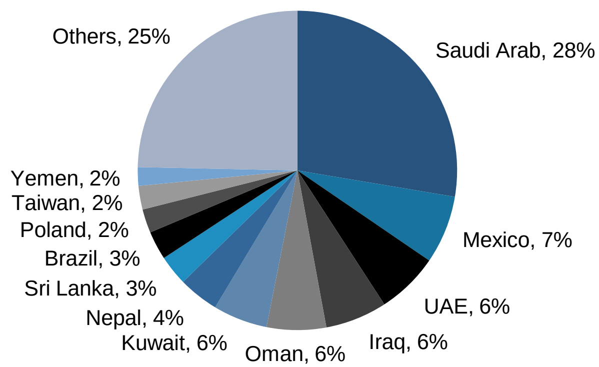
Source: Industry, Spark Capital

Exports by value



Source: Industry, Spark Capital

Exports by country: Middle east is major imported of tiles from India



Source: Industry, Spark Capital

- India has emerged as a key exporter of Tiles to Middle east and Latin American countries.
- The exports have grown at such strong rate due to ability of domestic players to introduce innovative products with same finish as Chinese tiles, lower distance from Gujarat port to Middle east countries and anti dumping imposed by some countries on Chinese tiles.
- Export industry in Morbi has almost trebled in last three years.

Long term demand drivers in place

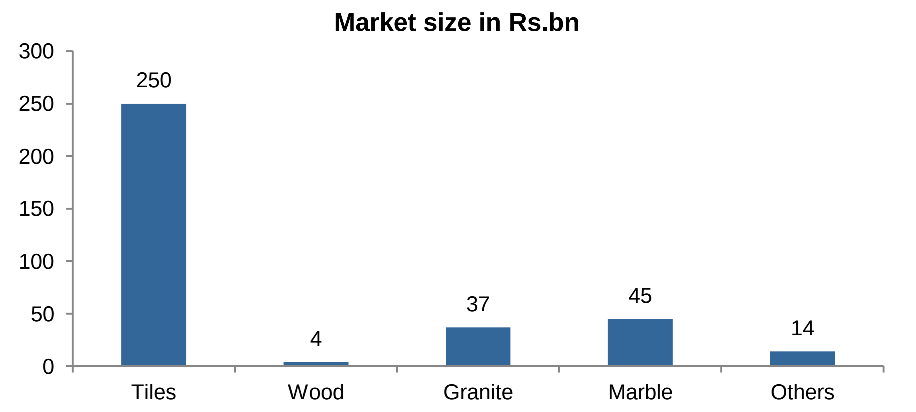
Tiles market share has almost doubled in last 15 years but penetration is very low

New residential housing remains a major contributor to Tiles demand

	India			Rural		Urban	
Type	1991	2001	2011	2001	2011	2001	2011
Mud	67.0	57.1	46.5	72.3	62.6	18.0	12.2
Stone	0	5.8	8.1	4.5	6.2	9.1	12.2
Cement	21.3	26.5	31.1	18	24.2	48.3	45.8
Mosaic/floor tiles	3.8	7.3	10.8	2.2	3.7	20.5	25.9
Others	7.9	3.3	3.5	3	3.2	4.1	3.8

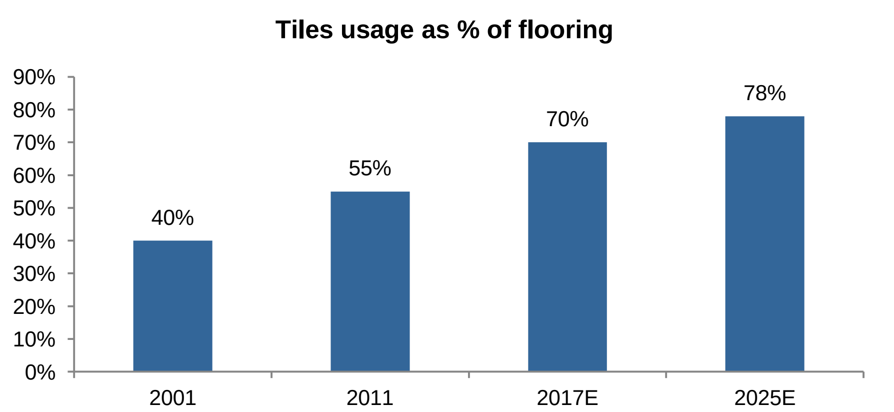
Source: Census 2011 data, Industry, Spark Capital

Housing Floor usage in India – Flooring market size in India (Rs. bn)



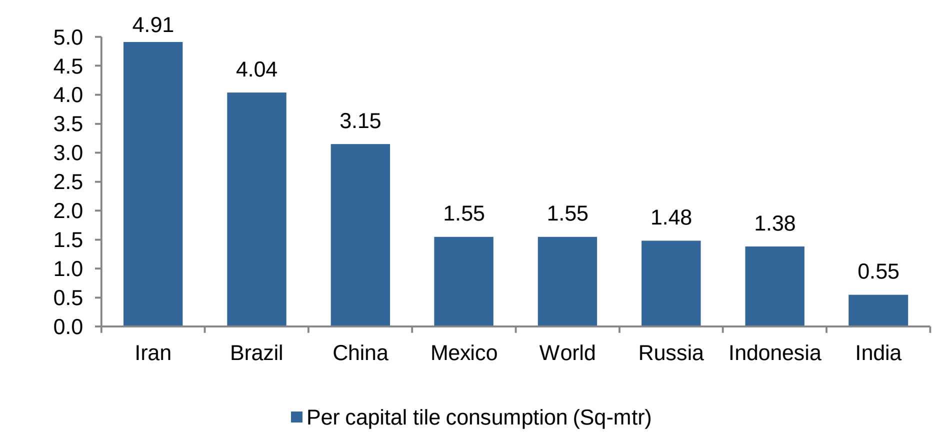
Source: Industry, Spark Capital

Tiles contribution has almost doubled in last 17 years



Source: Industry, Spark Capital

But still tiles penetration is well below world average

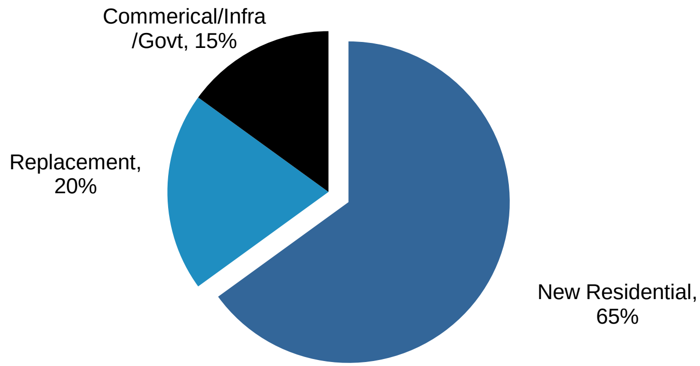


Source: Industry, Spark Capital

Natural Housing demand: Population growth + Nuclearisation

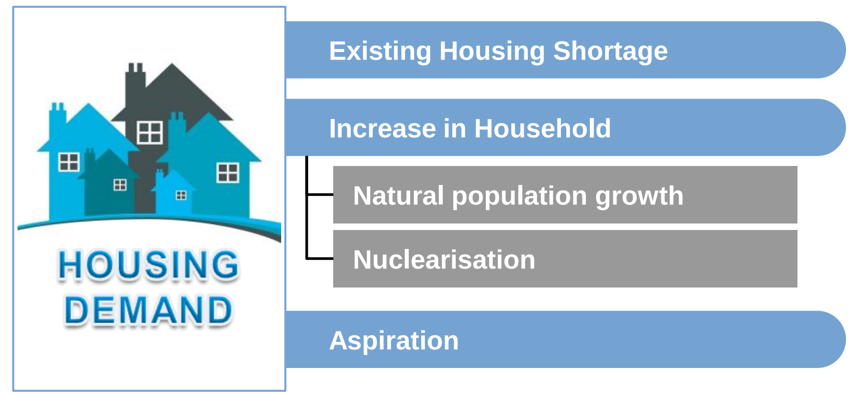
Housing demand contributes the most to Tiles demand

New residential housing remains a major contributor to Tiles demand



Source: Industry, Spark Capital

Breaking down New Residential demand drivers



Source: Spark Capital

Total number of houses grew by 3% cagr in 2001-11

In million	2001	2011	Growth %
Total Population	**1,028**	**1,186**	**1.4%**
Rural	742	816	*1.0%*
Urban	286	370	*2.6%*
Person per household	**5.3**	**4.7**	
Rural	5.4	4.8	
Urban	5.1	4.6	
Total Household	**193**	**250**	**2.6%**
Rural	137	169	*2.1%*
Urban	56	81	*3.7%*
Total Houses	**250**	**331**	**2.8%**
Rural	178	221	*2.2%*
Urban	72	110	*4.3%*

Source: Census 2011 data, Spark Capital

Expect number of houses to grow by 30% to 458mn in next 8 years

	2011	2017E	2025E
Population in bn	1,186	1,276	1,390
People per Household	4.7	4.5	4.2
# of Household	250	284	333
# of Houses	331	365	458

Source: World bank, Spark Capital

"Housing For ALL" – A Game Changer?

Scheme target is ambitious but allocation remains low. Only CLSS component to contribute to tiles demand

PRADHAN MANTRI AWAS YOJANA (PMAY)

Pradhan Mantri Awas Yojana – Urban
Launched in June, 2015

(Ministry of Housing and Urban Poverty Alleviation)

20 million houses by 2022

- 'In Situ' Slum Rehabilitation
- Credit Linked Subsidy Scheme (CLSS)
  - Economically Weaker Section (EWS) (Income up to Rs.0.3 mn p.a) – Interest subsidy of 6.5%
  - Low Income Group (Rs.0.3mn p.a-Rs.0.6mn p.a) – Interest subsidy of 6.5%
  - Middle Income Group-I Rs.0.6 mn p.a-Rs.1.2mn p.a) – Interest subsidy of 4%
  - Middle Income Group – II (Rs.1.2mn p.a-Rs.1.8mn p.a) – Interest subsidy of 3%
- Affordable Housing through Partnership
- Subsidy for Beneficiary-led House Construction

Pradhan Mantri Awas Yojana - Gramin (Rural)
Launched in April, 2016

(Ministry of Rural Development)

30 million houses by 2022

Erstwhile Indira Awas Yojana
To provide environmentally safe and secure pucca houses to every rural household by 2022

- Financial assistance of Rs.0.12mn for plain areas; Rs. 0.13mn for hilly areas
- Provision of toilets at Rs. 12,000
- 90/95 days of unskilled wage labor under MGNREGS
- Additional loan up to Rs. 70,000

Source: Spark Capital Research; pmayg.nic.in; Ministry of Housing and Urban Poverty Alleviation

PMAY Rural and PMAY Urban (Slum rehabilitation) will not be demand driver

Most of states have recommended specification for cement or stone floor

- Judicious use of stone and mud together in the construction technique for this zone which lies in seismic zone II.
- Since in this region neither mud nor stone is suitable for walling material, therefore, hollow interlocking CSEB is suggested for this region. The hollow spaces allow the necessary reinforcemnt in every corner of the room at the same time saves material consumption in the manufacturing process of the blocks. The unique interlocking feature of the block ensures extra safety for the earthquake.

Recommendations for Built Form		
Plan Layout	**Plinth/Floor**	**Roof Profile**
Rectangular structure and linear in the arrangement of their interior spaces. Entry to the building is from longer side. Open to sky verandah is provided in one long side. Future expansion proposed vertically.	Low Plinth level recommended	Flat Roof with vernacular practice for roof

Recommendations for construction systems		
Components	**Recommended Specifications**	**Specific Comments**
Foundations	• Reinforced Stone masonry with cement mortar in a strip foundation. • "bond" stone or the "through" stone is recommended to be provided both horizontally (in every less than 1.2m intervals) and vertically (in every less than 0.6m intervals)	• Optimum use of local material. Mud mortar is replaced by cement mortar for earthquake safety.
Plinth	• Reinforced RCC plinth beam at 450mm height from the ground	
Wall	• Hollow interlocking Compressed Stabilized Earth Block wall. • Reinforcing bars embedded in wall at the corners of all the rooms • Seismic bands provided at ceiling level	• Vertical MS reinforcing bars recommended for openings larger than 0.6 m in width.
Wall Finish	• No wall finish required	
Roof Structure	• Prefabricated reinforced concrete beam at roof level to support the load of the roof.	Bamboo reinforcements in the beam
Roof Cover	• Stone patti with mud phuska as insulation.	• Improving the existing practice.
Floor	• Plain Cement flooring finish over bricks.	

Source: Spark Capital Research; pmayg.nic.in; Ministry of Housing and Urban Poverty Alleviation

Is CLSS a big contributor to tiles demand?

CLSS allocation of just Rs.14bn remains very low to generate any meaningful demand

Potential housing demand through PMAY CLSS	FY18
Allocation in CLSS for EWS and LIG (Rs. Mn)	4,000
Allocation in CLSS for MIG (Rs. Mn)	10,000
Total Allocation for CLSS (Rs. Mn)	**14,000**
Subsidy per EWS Customer (Rs.)	267,280
Subsidy per LIG Customer (Rs.)	267,280
Subsidy per MIG I Customer (Rs.)	235,068
Subsidy per MIG II Customer (Rs.)	230,156
Total houses that can be financed under EWS/LIG (nos)	14,966
Total houses that can be financed under MIG (nos) (on average subsidy)	42,990
Total	**57,956**
Average area in sqft	600
Total potential flooring area in mn sq-ft	35
Total potential flooring area in msm	**3.5**
Increase in Tiles consumption in FY18 in msm	**27.8**
Contribution of CLSS led housing demand to incremental demand	**13%**

The Centre has allocated funds under CLSS only for FY18 and is valid only for a period of one year. It has allocated Rs.14bn under CLSS for FY18 with a hope that this scheme will be extended into future years with an enhanced amount.

We divide Rs.4.0bn under EWS/LIG scheme on the subsidy amount of Rs.267,280 to arrive at the maximum number of houses that can be financed under this category – 14,966.

Similarly for MIG I and II to arrive at 42,990 houses that can be financed.

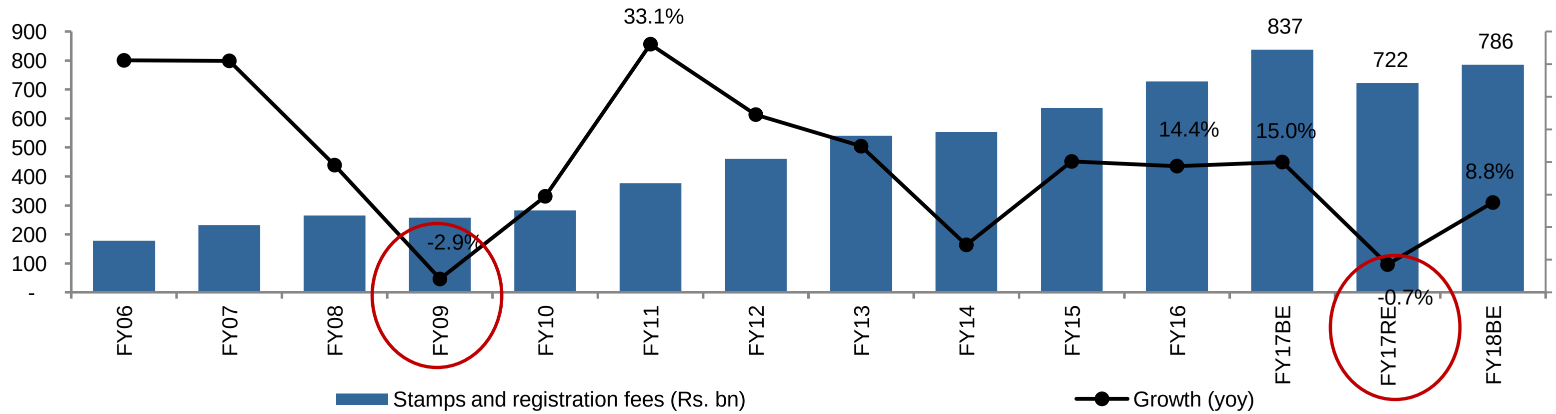
Assuming average area of 60sqm for a unit built under CLSS, we expect potential flooring area of 3.5msm which will contribute to only 13% to overall demand growth of 28msm in FY18

Source: Spark Capital Research; Ministry of Housing and Urban Poverty Alleviation

Individual Housing (Non-Govt) still a drag...

Inventory liquidation and fast project execution post RERA can be a trigger for tiles demand

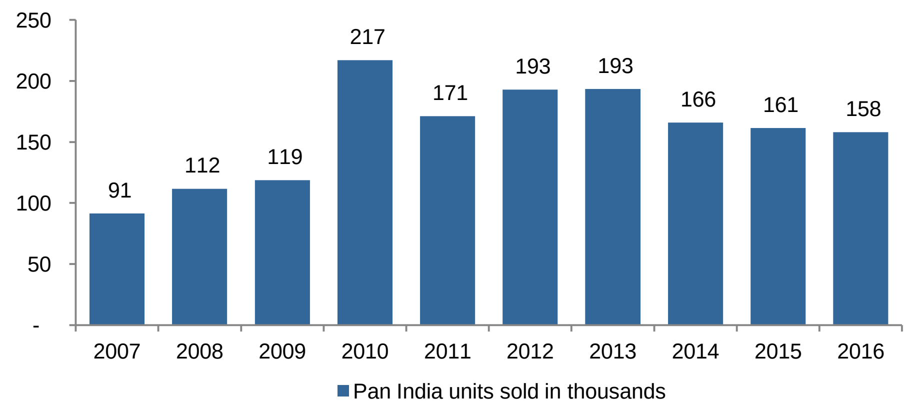
Stamp duty & registration fees collections contracted by 1% in FY17RE, the sharpest decline 8 years, following 14% growth in FY16



The fact that states have budgeted for a moderate 8.8% growth in stamp duty and registration fees in FY18 despite a low base, hints that real estate activities are likely to remain muted in FY18.

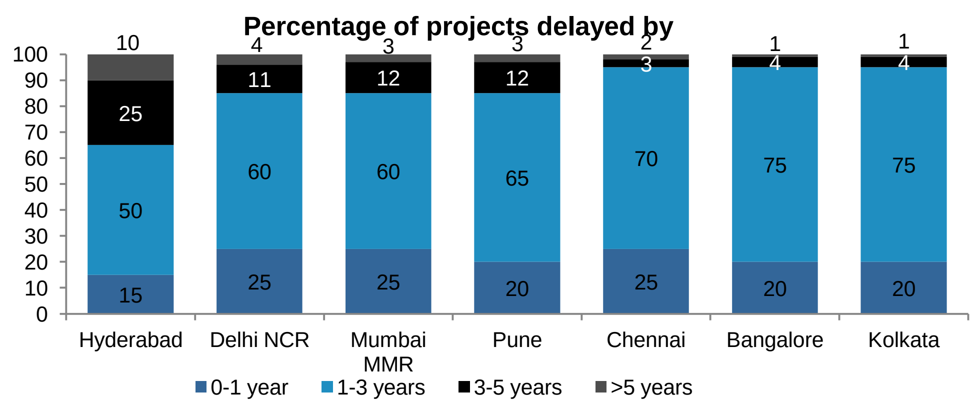
Source: State Budgets, Spark Capital Research

of units sold are falling every year



Source: JLL, Spark Capital Research

Inventory liquidation can be a big contributor untill real estate cycle starts; Building material categories are late cycle beneficiaries



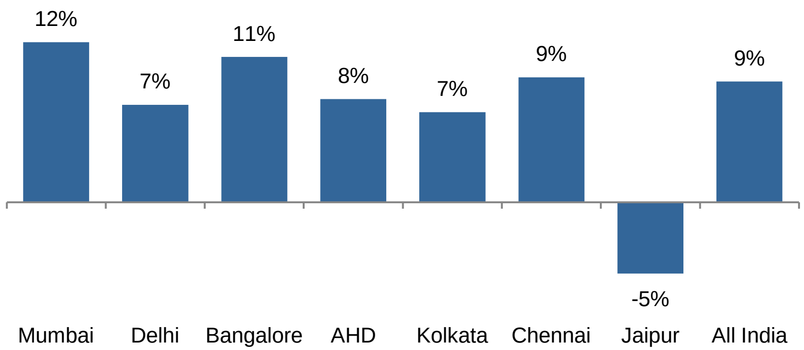
Source: JLL, Spark Capital Research

Real Estate market has not seen meaningful price correction so far

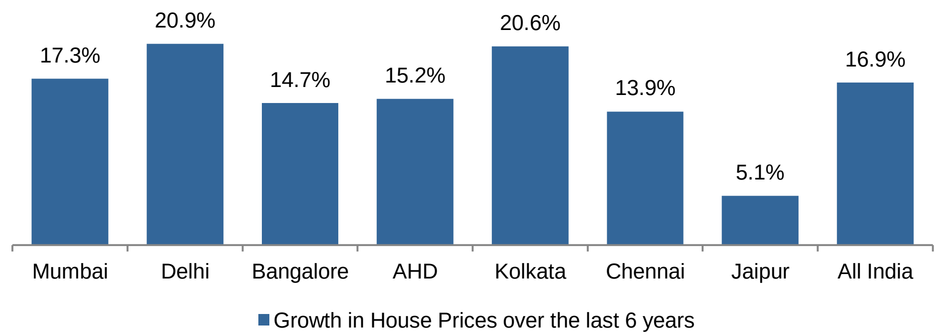
But time correction coupled with lower EMI burden on back of lower interest rate regime can increase affordability in next two years

The CAGR growth in real estate prices in India came in at a paltry 9% over the last two years with all major markets suffering in this phase. Pain in the tier 2 cities and towns seems more acute than the pain in metros.

CAGR Growth in Prices in 3QFY17 over last 2 years

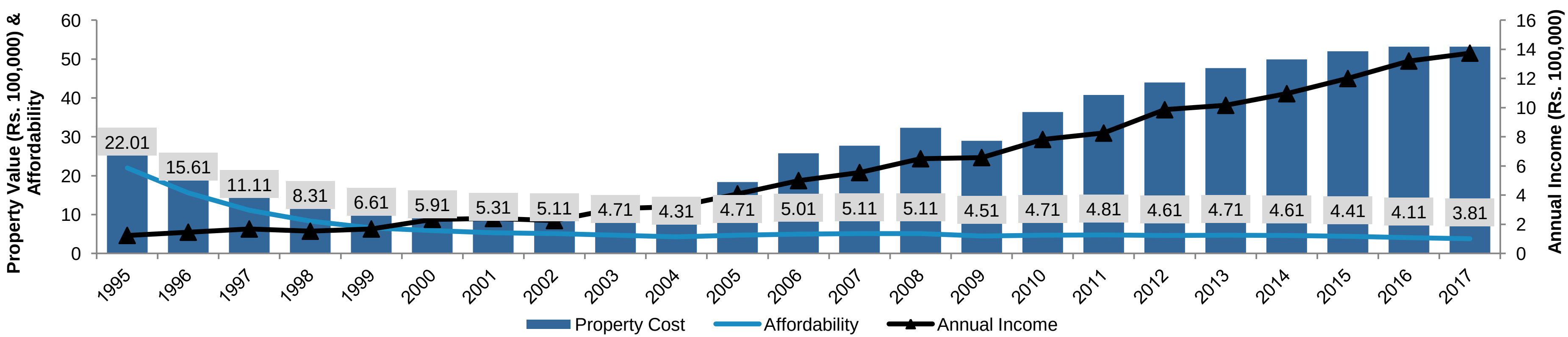


CAGR Growth in House Prices over the last 6 years



Source: Spark Capital Research

Affordability has increased as a result of lower interest rate, high tenor and wage hikes amid moderate Real estate prices increase



Source: HDFC, Spark Capital Research

Tiles Demand model

Tiles industry demand has been tepid in last three years; Expect demand to accelerate from FY19 onwards

We estimate Tiles volume and value CAGR of 7% and 10% respectively over 2018-25E. Value growth led by changing consumption mix from Ceramic tiles to more vitrified tiles

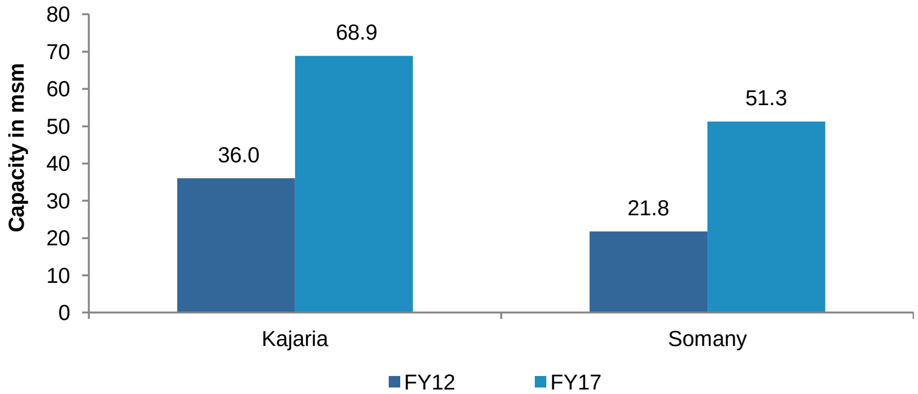
Indian tile industry	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Consumption (msm)	718	756	790	798	826	879	946	1022	1110	1190	1285	1383
% growth	***7%***	***6%***	***4%***	***1%***	***3%***	***6%***	***8%***	***8%***	***9%***	***7%***	***8%***	***8%***
Rolling 3 yr CAGR	*7%*	*5%*	*5%*	*3%*	*2%*	*5%*	*7%*	*8%*	*8%*	*8%*	*8%*	*8%*
Imports (msm)	25	23	20	18	16	16	15	15	14	13	13	12
Market size (Rs.bn)	**208**	**223**	**234**	**240**	**253**	**274**	**300**	**330**	**365**	**398**	**438**	**479**
% growth y-o-y	*7%*	*7%*	*5%*	*3%*	*5%*	*8%*	*10%*	*10%*	*11%*	*9%*	*10%*	*10%*
Rolling 3 yr CAGR	*11%*	*7%*	*6%*	*4%*	*4%*	*7%*	*9%*	*10%*	*10%*	*10%*	*10%*	*10%*
Break up volumes (msm)												
Ceramic (msm)	424	431	442	431	438	457	483	511	544	571	604	636
% change	*2%*	*2%*	*3%*	*-3%*	*2%*	*4%*	*6%*	*6%*	*6%*	*5%*	*6%*	*5%*
Polished vitrified (msm)	259	280	300	311	326	351	383	419	461	500	546	595
% change	*10%*	*8%*	*7%*	*4%*	*5%*	*8%*	*9%*	*9%*	*10%*	*8%*	*9%*	*9%*
Glazed vitrified (msm)	36	45	47	56	62	70	80	92	105	119	135	152
% change	*20%*	*26%*	*4%*	*18%*	*11%*	*13%*	*14%*	*14%*	*15%*	*13%*	*13%*	*13%*
Break up volumes %												
Ceramic	59%	57%	56%	54%	53%	52%	51%	50%	49%	48%	47%	46%
Polished Vitrified	36%	37%	38%	39%	40%	40%	41%	41%	42%	42%	43%	43%
Glazed Vitrified	5%	6%	6%	7%	8%	8%	9%	9%	10%	10%	11%	11%
Market size (Rs. bn)												
Ceramic	98	100	102	100	102	108	115	123	132	140	150	159
Polished Vitrified	89	96	103	107	113	123	136	150	166	182	201	221
Glazed Vitrified	22	27	28	34	38	43	50	57	66	76	87	99
Total	208	223	234	240	253	274	300	330	365	398	438	479
% growth y-o-y	*7%*	*7%*	*5%*	*3%*	*5%*	*8%*	*10%*	*10%*	*11%*	*9%*	*10%*	*10%*
Rolling 3 yr CAGR	*11%*	*7%*	*6%*	*4%*	*4%*	*7%*	*9%*	*10%*	*10%*	*10%*	*10%*	*10%*

Source: Spark Capital

The key differentiators, Scale, Brand, and Distribution

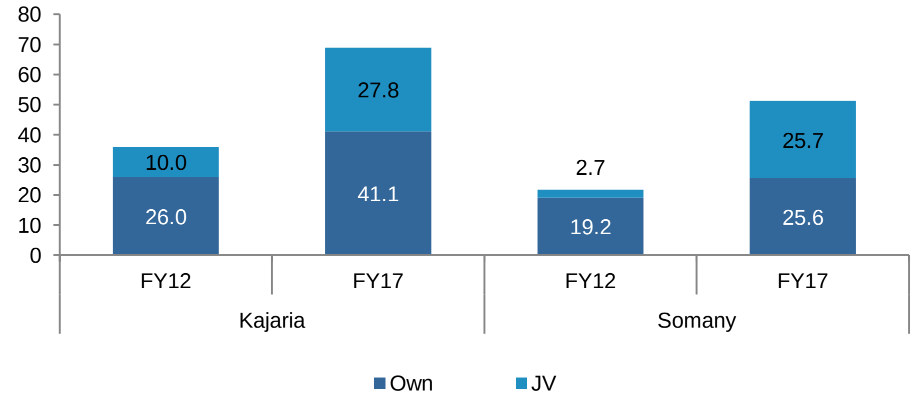
Aggressive Capacity addition through JV led model

Aggressive capacity additions- Almost 2x in last 5 years



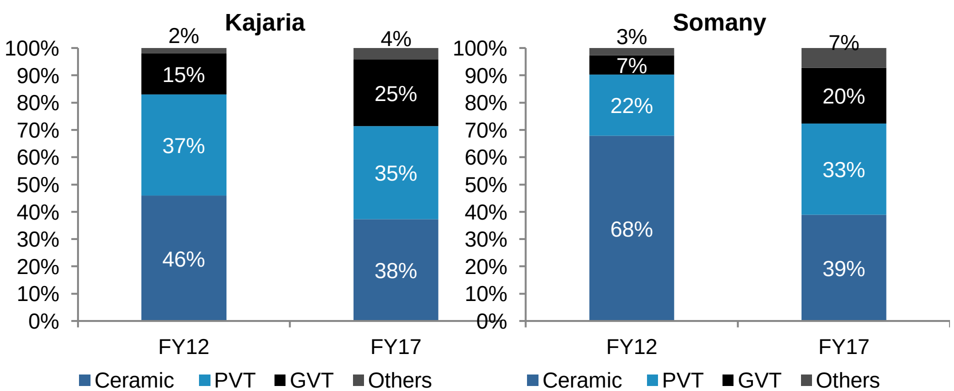
Source: Company, Spark Capital

Capacity addition is mainly through JV model



Source: Company, Spark Capital

Most the capacity addition in Vitrified tiles (PVT and GVT) leading to significant change in Sales mix in last five years



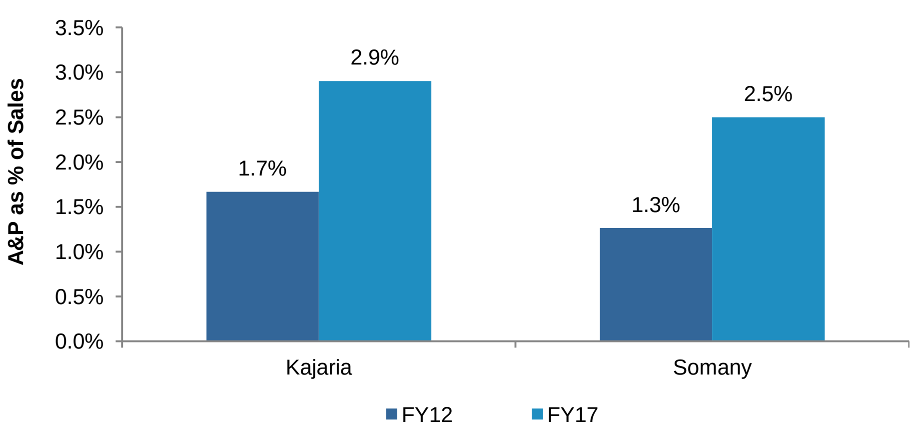
Source: Company, Spark Capital

- KJC and SOMC have been consistently and gradually increasing their capacities, via all routes, own manufacturing and joint ventures.
- JV led expansion is low capital intensive and RoCE accretive model. (see next slides for more detail). This will continue to remain a preferred mode of capacity expansion.
- Companies are setting up capacities in South India to reduce the lead time and logistics cost to reach the end market and hence strengthen their franchise in the region, which is a large and premium tile market of India.

The key differentiator, Scale, Brand, and Distribution

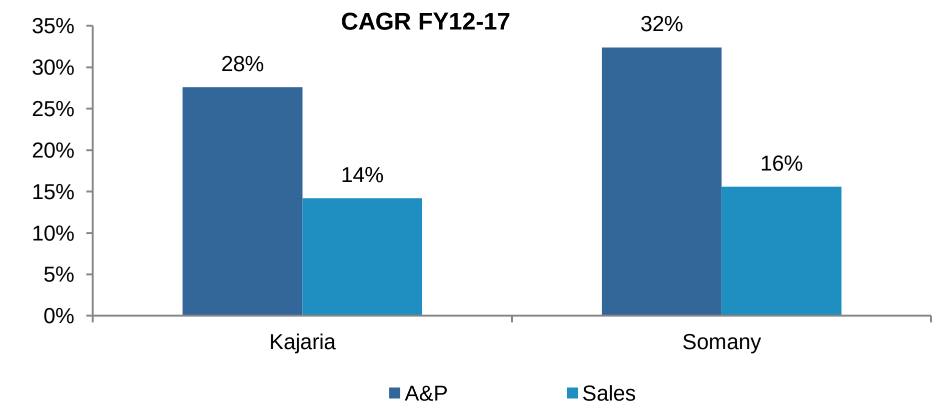
Kajaria and Somany – The Brand leaders

Both KJC and SOMC has almost doubled their A&P spend in last five years



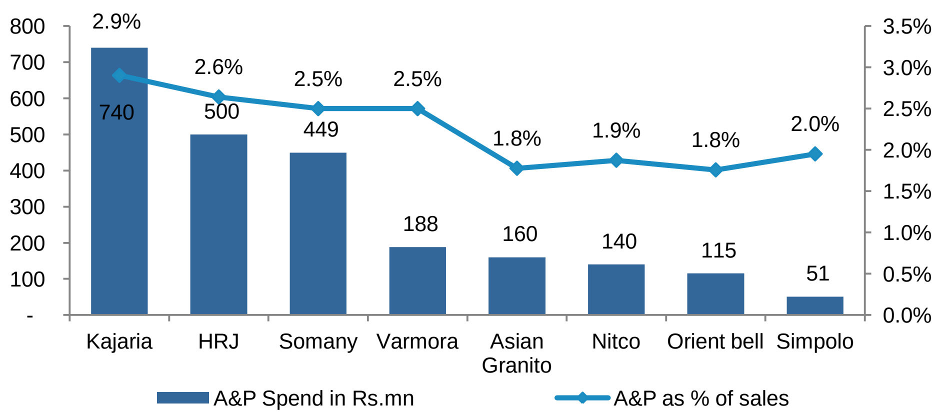
Source: Company, Spark Capital

A&P CAGR vs. Sales CAGR



Source: Company, Spark Capital

Kajaria and Somany A&P spend well above the competitors



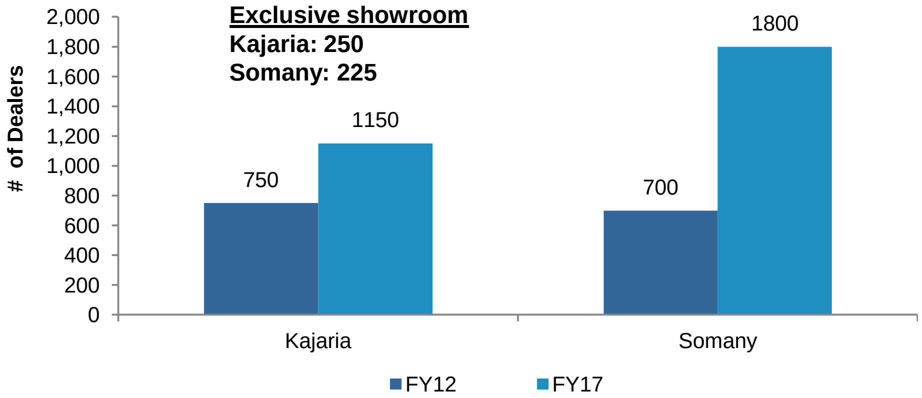
Source: Company, Spark Capital

- Kajaria and Somany are brand leaders in the Tile industry. Except HR Johnson, none spend close to what these top three players do. Going ahead, both KJC and SOMC haven intended to further increase the A&P spends, which will further improve its brand positioning.
- Both KJC and SOMC have spent highest over the past few years, which is clearly visible in higher than industry growth in sales.
- KJC and SOMC aim to spend almost Rs.1.5bn combined on branding and promotion.

The key differentiator, Scale, Brand, and Distribution

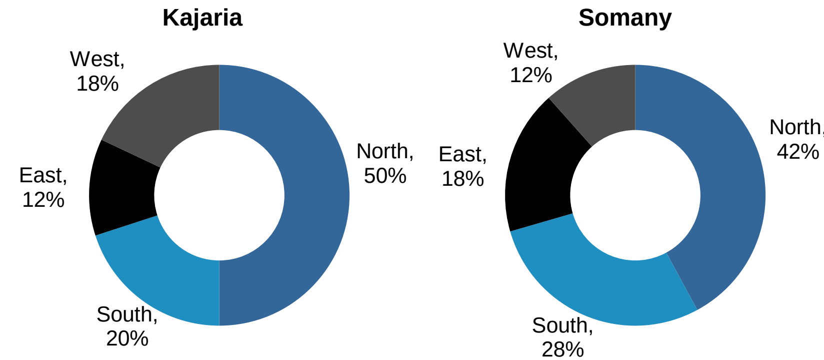
Well geographically diversified distribution and streamlined logistics enable KJC and SOMC to quickly change SKU's

Dealer count and exclusives showrooms count



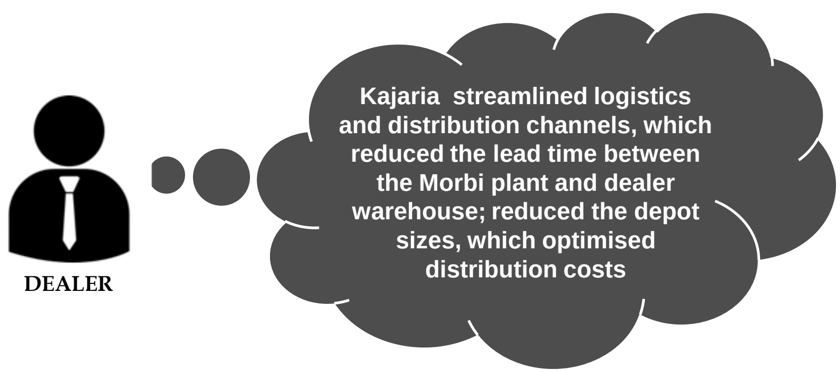
Source: Company, Spark Capital

Revenue mix by region



Source: Company, Spark Capital

Dealer excerpts from AR on superior distribution of Kajaria



Source: Company

KJC and SOMC has focused on distribution along with branding:

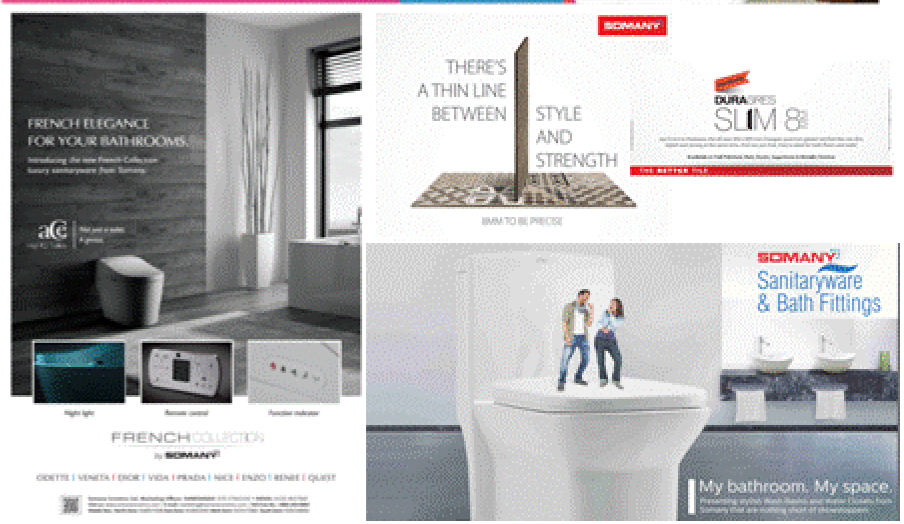
- Exclusive showrooms or other format of showrooms helps the brand the showcase entire range of products and also aids in selling premium products
- Post GST, companies looking to add dealers from informal market. Hence in a way taking market share away from unbranded players
- Close to 60% existing tile dealers also are Sanitaryware dealers. Also sanitaryware business delivers branding visibility for tile brands as it is displayed 24x7x365 inside customer homes
- SOMC has 20 depots across key locations to reduce delivery lag

Branding Initiatives

KJC and SOMC maintain the excitement through branding and consistent product launches

Kajaria roped in leading actor Akshay Kumar for branding recall

Somany introduced innovative solution such as 3D visualizer for tile selection

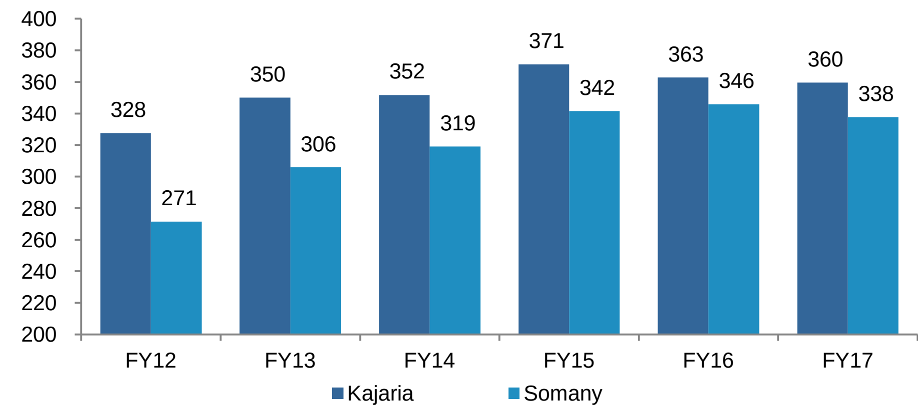


Source: Company

Launch of new products/value added products

Blended realizations for KJC and SOMC up by 3% CAGR led by new high valued added products; Like to Like tiles prices have declined only

Realization growth for Kajaria and Somany have been around 3-4%



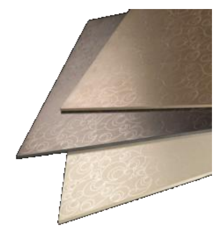
Source: Company, Spark Capital

So the key part of business is to change SKU's by introducing newer designs and size tiles. Below table lists product launches by Kajaria in last five years:

2016	Introduced two new floor tile sizes (60x60 cm and 80x80 cm) in polished ceramic body and new tile sizes in GVT - 30x120 cm with 8 mm thickness in wall tiles and 13x80 cm in floor tile segment for the first time in the country
2015	Introduced an exclusive range more than 200 new designs in existing sizes. Launched two new sizes (80x80 cm and 80x120 cm)I n PVT for the first time in India and 40x80 cm in GVT.
2014	Introduced the Eternity HD Wood range in two sizes, Launched 80x80 cm, 40x80 cm and 20x120 cm Digital Wooden planks
2013	Introduced the 80x80 cm double charged floor tiles ; Launched Digital Wood, Digital Stone and Polished GVT in 60x60 cm
2012	Introduced 5 new wall tile sizes with matching which are digitally-printed tiles having high-end gloss finish, satin finish, stone finish; Launched the digitally printed large format (60x60cm) glazed vitrified tiles for the first time in India. Introduced polished, digitally printed, glazed vitrified tiles

Source: Company, Spark Capital

Below are key tiles SKU's launched in past with prices per sq-ft

Ceramic	PVT		GVT			
	Soluble salt	Double charge	Digital tiles	Large format tiles	Ultra Slim tiles	Wooden planks
						
Rs.35-40	**Rs.40-50**	**Rs.45-65**	**Rs.70-125**	**Rs.125-175**	**Rs.80-100**	**Rs.75-95**

Source: Company, Spark Capital

Entry of newer brands to challenge growth?

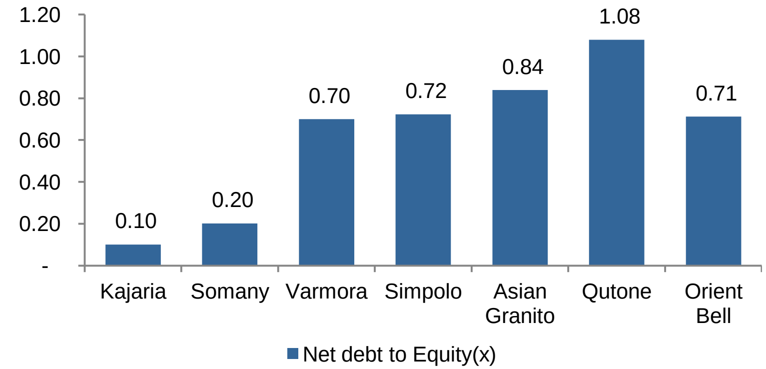
Competitive intensity remains; Kajaria and Somany have meaningful edge and are ahead of the competition

Tiles players such as HR Johnson, Nitco, Murudeshwar and Orient bell have lost market share to Varmora, Simpolo etc

Company name	Tiles revenue (FY16-17E)	Comments
Kajaria	24,350	
Somany	15,000	
HRJ	16,000	Management rejig in FY16 with appointment of new CEO.
Asian Granito	8,787	Total capacity of 33msm. Crystal ceramic acquisition in FY16 to aid in revenue growth and margin expansion due to better product mix and APM gas supply.
Varmora Granito	7,000	One of largest player in Morbi cluster with 35-40% of revenue from exports. Strong in North and West region.
Orient Bell	6,500	Introduced "Glitter series" tiles in Wall Tiles, Double Charge and PGVT/DGVT. Did a JV with Morbi players for vitirfied tiles supply in West and Southern region
Simpolo	6,500	One of largest player in Morbi cluster with 20% of revenue from exports. Strong in South and West region.
Nitco Tiles	6,145	Total capacity of 16msm. Recently strengthened the GVT portfolio with the launch of PGVT and 800x800mm size.
RAK Ceramics	4,600	Revenue decline of 26% yoy in CY16; Tiles segment margins of 15%, Company did management rejig in CY16, Keenly looking out for Morbi JV
Sunheart Tiles	4,000	Export oriented tile player having manufacturing facility out of Morbi. Launched lot of innovative products in large size tiles and digital tiles category under leadership of new CEO Tapan Jena (Ex- COO of Somany)
Swastik Tiles	4,000	Amongst the top 10 ceramic tiles manufacturers and one of the fastest growing company in the country. Has more than 700 distributors in India and also export to more than 33 countries. Company's exports have grown by more than 200% CAGR since 2012
Quoton Tiles	1,666	Niche player with good product profile in large format tiles having marble styles aesthetics
Murudeshwar	1,163	Total capacity of 4.5msm.Promoter infused Rs.220mn via Preferential allotment in March 17

Source: MCA

Net debt to Equity – Ex KJC and SOMC, most have leverage



Source: MCA, Company

Over the past few years, around four to five new players/brands have sprung out of Morbi inspired by the success of top brands (such as Kajaria and Somany) and eager to capture the growing demand for tiles. And the same time there has been a decline in the fortunes of brands like Johnson, Nitco, RAK, Spartek. Hence industry has seen a churn, whereas Kajaria and Somany have gained strength. Going ahead given their increasing scale of operations, A&P spend, dealer additions and balance sheet advantage, we expect both to maintain their leadership positioning.

Entry in newer Category to maintain the growth momentum…

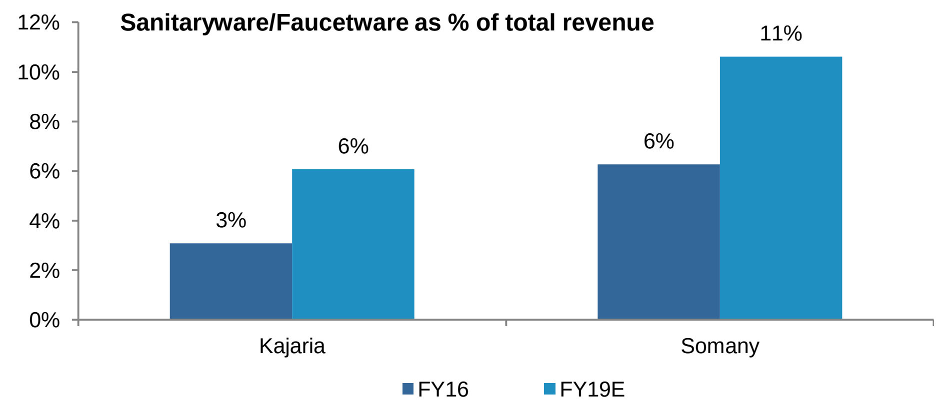
Prefer Tiles Industry over Sanitaryware due to its sheer size and lesser organized players share

Most of the building material players are entering in newer categories…

Company	Core business	Entry/Expansion in new Category
Kajaria	Tiles	Sanitaryware & Faucetware
Somany	Tiles	Sanitaryware & Faucetware
Cera	Sanitaryware	Tiles
HSIL	Sanitaryware	Consumer durable, Retailing
Centuryply	Plywood	MDF and Particle board
Greenply	Plywood	MDF
Astral	Pipes	Adhesives

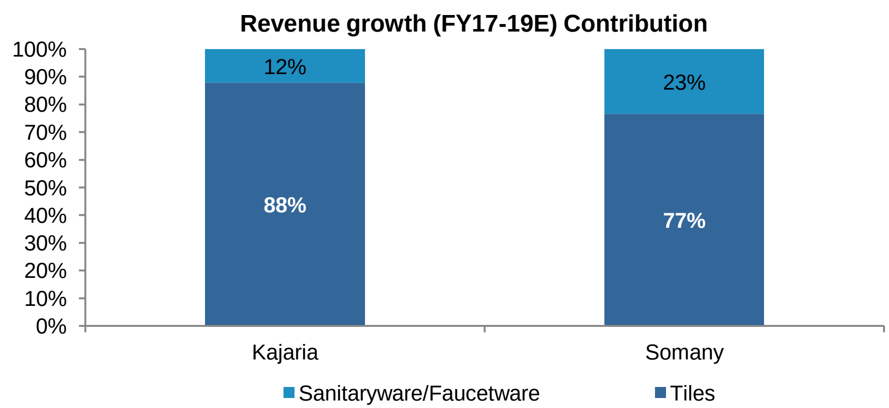
Source: Company

Kajaria and Somany have diversified into Sanitaryware



Source: Company

But both these categories will remain key growth drivers in next five years



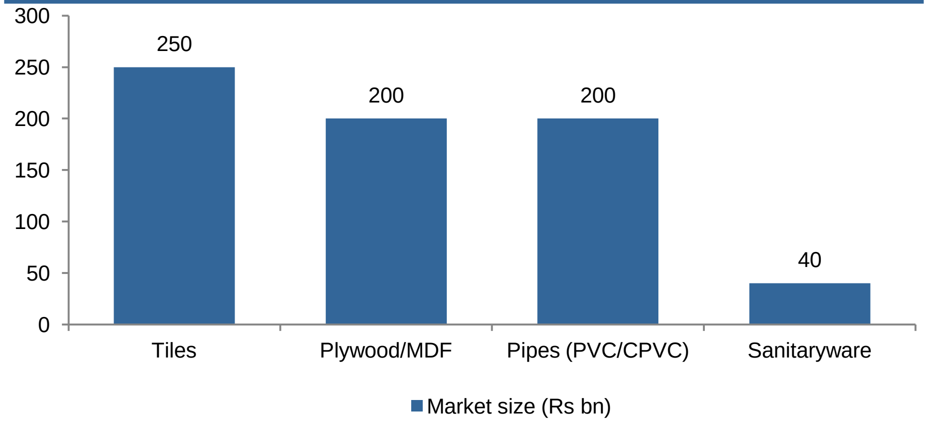
Source: Company

- Sanitaryware and bath fittings segment is a natural extension to the core business of Tiles for KJC and SOMC. As per our industry checks, close to 60-65% of existing tile dealers also stock Sanitaryware/bath fittings. Both Kajaria and Somany have been aggressive in this new line of business and have ambitious plans going ahead.
- We expect both KJC and SOMC to ramp up and have a high rate of success given their credible brand image, overall dealer base, and Pan-India presence.

Tiles over Sanitaryware Industry

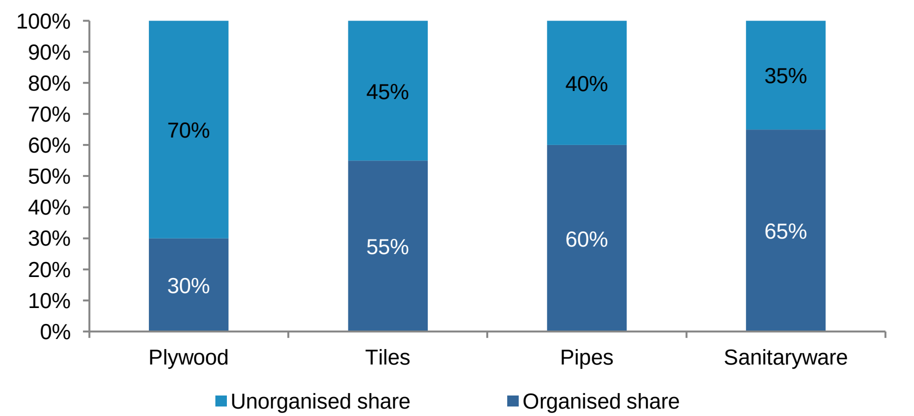
Prefer Tiles Industry over Sanitaryware due to its sheer size and lesser organized players share

Tiles industry size is almost 6x bigger than Sanitaryware Industry..



Source: Industry, Spark Capital

…And is fairly unorganised (55%) unlike Sanitaryware which leaves headroom for growth



Source: Industry, Spark Capital

Sanitaryware Industry: Top organized players and market share

Company name	Sanitaryware Revenue FY17E	Market share %
HSIL	7,050	18%
Parryware Roca	5,500	14%
Cera	4,850	12%
Jaquar	2,250	6%
Kohler	1,800	5%
Grohe	1,000	3%
Johnson	800	2%
Somany	700	2%
ToTo	700	2%
Duravit	650	2%
Kajaria	600	2%
RAK	367	1%
Others	13,733	34%
Total Industry size	**40,000**	
Organised	**26,267**	**65%**
Unorganised	13,733	**35%**

Source: Industry, Spark Capital

Competition intensifies in Sanitaryware

Expect Sanitaryware top players to grow at par with Industry

Credible competition in Sanitaryware segment intensifies; Expect the market leaders tp grow at best inline with Industry

Somany, Kajaria, Jaquar are very strong franchises in its respective core businesses (Tiles and faucets respectively) and given their network and brand image can be leveraged with ease in the sanitaryware business. The challenge will be on the product quality and design. Hence in the medium term, we expect the established players like HSIL, CERA, and ROCA to struggle to outpace industry growth. At best they can grow in-line with industry growth of 8-12% over the next three to five years. We expect Sanitaryware industry to grow at a 10% CAGR over the next 3-5 years. Assuming the top three players (HSIL, CERA, ROCA) grow above industry, say around 12%, they will have to garner a market share of 53% on incremental demand vs. their current market share of 44-45%. However, given Somany's, Jaquar's, and Kajaria's aggressive expansion plans into sanitaryware business, where they have already invested into the business, we expect their revenues to more than double from the current levels. This looks achievable given their low base, strong positioning in its core business, and balance sheet strength. If this happens, this implies an incremental market share of 30% vs, its current market share of 9%.

Market share dynamics in Sanitaryware segment

	Sanitaryware Revenue in Rs.mn				Market share %		Growth CAGR %	Comments
	2017	2018E	2019E	2020E	2017	2020E	FY17E-20E	
Industry	**40,000**	**44,000**	**48,400**	**53,240**			10%	
Somany	700	1,015	1,522	1,979	1.8%	3.7%	41%	Looks achievable. Investments already made
Jaquar	2,250	2,475	4,223	4,645	5.6%	8.7%	27%	Looks achievable. Investments already made
Cera	4,850	5,334	5,974	6,691	12.1%	12.6%	11%	Assuming the top three players grow at 11-12% (+100-200bps above industry). This implies, the other top organised brands (Kohler, TOTO, Grohe, etc) will have to grow at 5-6%, which is 600bps lower than industry growth. Given they have made significant investment into India and a strong brand image, it is fair to assume they should grow atleast in-line with industry.Hence, a case for above industry growth for Top 3 players looks stretched.
HSIL	7,050	7,915	8,865	9,752	17.6%	18.3%	11%	
Parryware Roca	5,500	6,160	6,899	7,727	13.8%	14.5%	12%	
Other organised	5,917	6,818	6,063	6,999	14.8%	13.1%	6%	
Unorganised	**13,733**	**14,282**	**14,854**	**15,448**	**34.3%**	**29.0%**	4%	Assumed unorgainsed to grow at 3%

Source: Company, Spark Capital

Consolidated profit and loss – indexed to 100 last three years

KJC's EBITDA margins are almost higher by 900 bps than SOMC

Profit & Loss a/c comparison between Kajaria and Somany Ceramics

Particulars	Kajaria Ceramics			Somany Ceramics		
Indexed to revenues	FY15	FY16	FY17	FY15	FY16	FY17
Revenues	100.0	100.0	100.0	100.0	100.0	100.0
Raw materials	**38.1**	**35.1**	**36.1**	**60.8**	**59.3**	**54.0**
Power & Fuel	22.2	19.9	17.2	13.2	11.9	11.2
Employee costs	9.5	10.5	11.3	6.6	7.2	8.7
Selling expenses	3.4	3.1	3.6	2.1	2.2	2.7
Other expenses	10.6	12.5	12.3	10.4	11.0	12.8
Total costs	**83.8**	**81.0**	**80.5**	**93.0**	**91.7**	**89.4**
EBITDA	**16.2**	**19.0**	**19.5**	**7.0**	**8.3**	**10.6**
Other income	0.3	0.4	0.6	0.5	0.5	0.8
Depreciation	2.6	3.0	3.2	1.7	1.7	1.9
EBIT	14.0	16.4	16.9	5.7	7.2	9.5
Interest	1.3	1.4	1.3	1.3	1.3	1.3
PBT	**12.6**	**15.0**	**15.5**	**4.4**	**5.9**	**8.2**
Taxes	3.9	5.2	5.6	1.4	1.8	2.8
PAT	**8.0**	**9.6**	**9.9**	**3.0**	**3.8**	**5.1**

Kajaria has industry leading EBITDA margins among the tile manufacturers in India. In comparison to Somany, Kajaria has better margins due to (1) higher volumes from own manufacturing; (2) premium pricing across major markets; and (3) operating leverage given increasing scale of operations; and (4) cost efficiencies and logistics

Margins for KJC around peak; Expect expansion for SOMC

Structural increase in margins driven by lower gas costs and product/manufacturing mix

Kajaria Ceramics – Past and future margins drivers

Margins metrics	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Gross margins%	50.4%	53.6%	57.1%	61.9%	64.9%	63.9%	64.1%	64.1%	64.0%	63.9%
Expansion/contraction (y-o-y)	*6.8%*	*3.1%*	*3.6%*	*4.7%*	*3.0%*	*-1.0%*	*0.2%*	*0.0%*	*-0.1%*	*-0.1%*
Power & fuel as % to sales	16.0%	19.0%	20.3%	22.2%	19.9%	17.2%	17.6%	18.2%	18.7%	19.2%
Expansion/contraction (y-o-y)	*6.2%*	*3.0%*	*1.3%*	*1.9%*	*-2.3%*	*-2.7%*	*0.4%*	*0.5%*	*0.5%*	*0.5%*
Other expenses as % to sales	18.7%	19.4%	21.6%	23.5%	26.1%	27.2%	27.5%	27.0%	26.6%	26.2%
EBITDA margins%	15.7%	15.2%	15.2%	16.2%	19.0%	19.5%	19.0%	18.9%	18.7%	18.5%
Expansion/contraction (y-o-y)	*0.1%*	*-0.5%*	*0.0%*	*1.0%*	*2.8%*	*0.5%*	*-0.5%*	*-0.1%*	*-0.2%*	*-0.2%*

Change in Revenue/product mix%	FY12	FY13	FY14	FY15	FY16	FY17
GVT mix %	**15.0%**	**15.0%**	**17.0%**	**20.0%**	**23.0%**	**25.0%**
Own manufacturing revenues %	67.6%	59.4%	53.0%	49.9%	50.8%	55.2%
JV revenues %	**5.8%**	**18.0%**	**27.3%**	**31.5%**	**37.4%**	**32.9%**
Outsourcing revenues %	56.7%	39.7%	31.5%	21.7%	16.9%	12.0%

Source: Company

Five year margin analysis	FY12-FY17	FY17-FY21E
Gross margins expansion/contraction	13.5%	0.0%
Change in Power % fuel as % to sales	11.0%	1.9%
Change in Other expenses as % to sales	8.5%	-1.1%
EBITDA margins expansion/contraction	3.8%	-0.7%

Kajaria Ceramics is also a margin leader in the industry by miles compared to its peers. Some of the reasons are (1) brand premium; (2) superior product mix; (3) cost efficiencies due to scale; and (4) efficient logistics.

Higher industry margins gives the company lot of room to spend on branding, dealer incentives, logistics, and human resources.

Over the past five years, KJC's gross margins expanded by 14% resulting in EBITDA margin expansion by 4% to ~19% levels. Gross margin expansion was led by product mix (GVT share from 15% to 25%) and lower dependence on outsourcing revenues. Going ahead, given KJC's higher share of value added product mix and low outsourcing mix, we belive KJC's margins have peaked out. Hence we build gradual decline in margins wef from FY18E.

Expect expansion for SOMC led by Gross margins improvement

Structural increase in margins driven by lower gas costs and product/manufacturing mix

Somany Ceramics – Past and future margins drivers

Margins metrics	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Gross margins%	42.1%	41.1%	38.4%	39.2%	40.7%	46.0%	46.4%	46.9%	47.4%	47.9%
Expansion/contraction (y-o-y)	*-6.6%*	*-1.0%*	*-2.7%*	*0.8%*	*1.5%*	*5.3%*	*0.4%*	*0.5%*	*0.5%*	*0.5%*
Power & fuel as % to sales	12.5%	12.4%	13.2%	13.2%	11.9%	11.2%	11.7%	11.6%	11.5%	11.4%
Expansion/contraction (y-o-y)	*0.3%*	*0.0%*	*0.8%*	*0.0%*	*-1.3%*	*-0.7%*	*0.5%*	*-0.1%*	*-0.1%*	*-0.1%*
Other expenses as % to sales	21.2%	20.5%	18.7%	19.0%	20.4%	24.2%	23.8%	23.8%	23.9%	24.1%
EBITDA margins%	8.4%	8.1%	6.4%	7.0%	8.3%	10.6%	10.9%	11.5%	12.0%	12.4%
Expansion/contraction (y-o-y)	*-1.2%*	*-0.3%*	*-1.7%*	*0.5%*	*1.4%*	*2.2%*	*0.4%*	*0.6%*	*0.5%*	*0.4%*

Change in Revenue/product mix%	FY12	FY13	FY14	FY15	FY16	FY17
GVT mix %	7.1%	14.2%	15.1%	15.3%	17.0%	21.0%
Own manufacturing revenues %	53.0%	48.1%	45.7%	35.8%	31.4%	34.9%
JV revenues %	1.5%	13.7%	23.9%	40.2%	48.0%	49.6%
Outsourcing revenues %	42.6%	35.3%	26.5%	18.8%	14.0%	7.9%

Source: Company

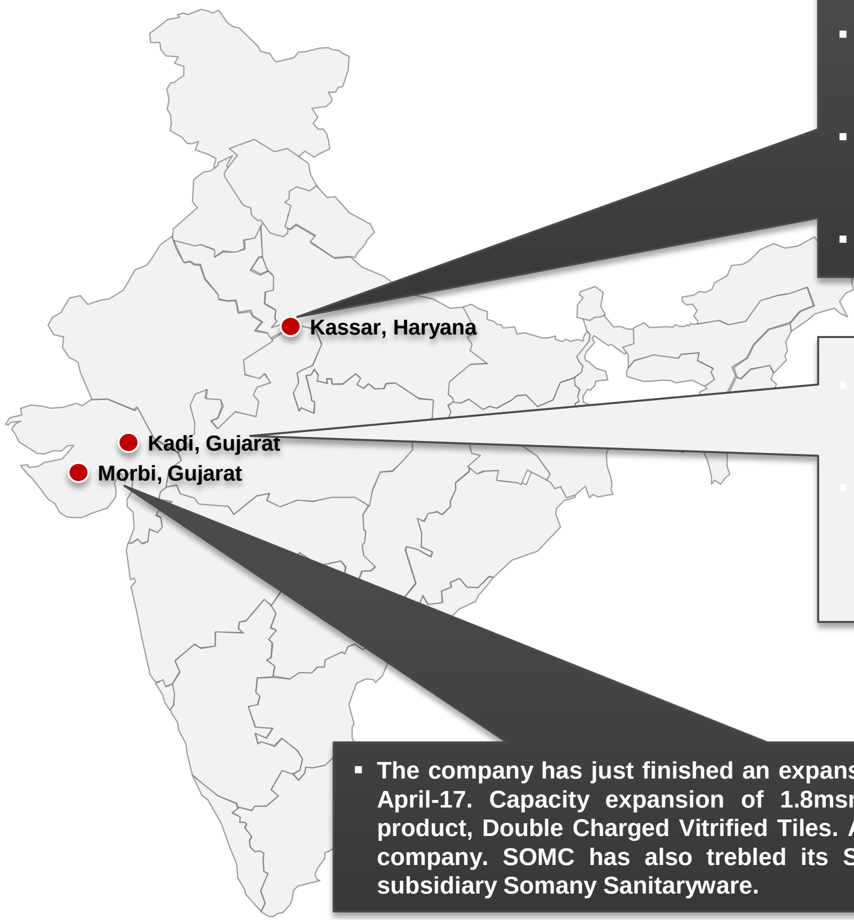
Five year margin analysis	FY12-FY17	FY17-FY21E
Gross margins expansion/contraction	3.8%	2.0%
Change in Power % fuel as % to sales	-1.2%	0.2%
Change in Other expenses as % to sales	2.9%	-0.1%
EBITDA margins expansion/contraction	2.1%	1.8%

Over the past five years, SOMC's gross margins expanded by 4% resulting in EBITDA margin expansion by 2% to ~10 levels. Gross margin expansion was led by product mix (GVT share from 15% to 25%) and lower dependence on outsourcing revenues. While Somany Ceramics has lagged Kajaria in terms of margin expansion over the last five years, we believe this is going to change going ahead. Combination of better product mix (increasing share of valued added capacities as explained in slide no 23) and increasing proportion of sanitaryware business, will aid margin expansion going ahead.

Margins for KJC around peak; Expect expansion for SOMC

Structural increase in margins driven by changing product/manufacturing mix

Company has undertaken a de-bottlenecking/minor brownfield expansion at its own manufacturing units (Kadi and Kassar)



- At Kassar, Haryana where the current capacity is 17msm, the de-bottlenecking process will add 10% to its capacity, i.e. 1.7msm
- The company is adding equipments to produce high quality wall tiles, which can increase their realisations by roughly 25-30% versus its current line (old equipments, setup in 1999)
- The new products which will be manufactured from the above line will come at an incremental gas cost of 10% only, much higher than the incremental expected realizations
- The above line will be operational by November 2017

- At Kadi, Gujarat where the capacity is 8.4msm, the company is replacing an existing line (20% of capacity) from low value product to value added product (Ceramic Polished large format tiles). This project will be commissioned by August 2017
- The above de-bottlenecking/expansion projects will cost Rs.300 mn only, lower compared to similar Greenfield project which would have come at cost of Rs.500 mn. Hence these projects will be margins and RoCE accretive for the company. Broadly, the management expects payback period for less than two years for these projects.

- The company has just finished an expansion at one its 51% JV, Vintage Ceramics in April-17. Capacity expansion of 1.8msm, which will manufacture valued added product, Double Charged Vitrified Tiles. Another margin accretive initiative from the company. SOMC has also trebled its Sanitaryware capacity to 0.3mn pcs at its subsidiary Somany Sanitaryware.

Du-Pont Model

SOMC's RoE differential with KJC to narrow led by margins expansion

Kajaria's Margins expansion helped in sustaining return metric despite dilution…

Kajaria RoE profile	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Tax burden (PAT/PBT)	0.67	0.66	0.62	0.65	0.64	0.64	0.63	0.63	0.63	0.63
Interest burden (PBT/EBIT)	0.71	0.78	0.83	0.88	0.91	0.92	0.96	0.99	1.00	1.00
EBIT margins%	**13%**	**13%**	**13%**	**14%**	**16%**	**17%**	**17%**	**17%**	**17%**	**17%**
Total asset turnover (Total sales/Total assets)	**1.93**	**2.07**	**2.07**	**2.02**	**1.75**	**1.67**	**1.74**	**1.84**	**1.90**	**1.94**
Leverage (Total assets/Total equity)	**2.69**	2.42	1.99	1.70	1.61	1.43	1.27	1.17	1.11	1.07
RoE %	**32%**	**33%**	**28%**	**28%**	**27%**	**24%**	**22%**	**23%**	**23%**	**23%**

Source: Company

…same is the case with Somany but the RoE differential with KJC to narrow in next two years with further gross margins expansion

Somany RoE profile	FY12	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Tax burden (PAT/PBT)	0.69	0.67	0.66	0.68	0.67	0.65	0.65	0.64	0.65	0.65
Interest burden (PBT/EBIT)	0.63	0.71	0.70	0.77	0.78	0.84	0.92	0.96	0.98	0.99
EBIT margins%	**6%**	**6%**	**5%**	**6%**	**7%**	**9%**	**10%**	**11%**	**11%**	**12%**
Total asset turnover (Total sales/Total assets)	**1.74**	**1.83**	**1.85**	**1.91**	**1.79**	**1.61**	**1.60**	**1.72**	**1.77**	**1.77**
Leverage (Total assets/Total equity)	**4.42**	**4.12**	**3.63**	**3.35**	**2.78**	**2.38**	**2.17**	**1.94**	**1.81**	**1.72**
RoE %	**22%**	**23%**	**15%**	**19%**	**19%**	**20%**	**21%**	**22%**	**23%**	**23%**

Source: Company

JV led expansion has led to RoCE accretion

Dissecting Kajaria RoCE's into Own manufacturing and JV/Outsourcing

Kajaria RoCE's on JV investment are better than own manufacturing due to lower capital employed and higher utilisations

	FY14	FY15	FY16
Net revenue in Rs.mn (Standalone)	**18,844**	**22,416**	**24,657**
Own manufacturing	10,023	11,473	12,425
JVs	4,849	6,778	9,409
Outsourcing	3,971	4,166	2,822
Revenue contribution %			
Own manufacturing	53%	51%	50%
JVs	26%	30%	38%
Outsourcing	21%	19%	11%
Gross margins %			
Own manufacturing	70%	75%	73%
JVs	4%	11%	16%
Outsourcing	17%	13%	14%
EBITDA margins%			
Own manufacturing	22%	23%	26%
JVs	11%	6%	7%
Outsourcing	-4%	1%	6%
Standalone	13%	13%	17%
Consolidated	15%	16%	19%
Post-Tax RoCE%			
Own manufacturing	22%	23%	24%
On JV investments	-32%	7%	42%
Standalone Reported	23%	24%	28%
Consolidated Reported	22%	24%	23%

Calculation methodology:

- Gross margins for JV is defined as difference between revenues from JVs and difference in purchase in traded stocks in SL and consol financials.
- Variable costs in standalone financials are apportioned between own manufacturing and JV's only as per their respective revenue contribution.
- Fixed costs (other expenses) is apportioned as per revenue contribution for own, JV and outsourcing.
- Charged 10% of employees costs to JVs and rest to own manufacturing for EBITDA margins calculation.
- Own manufacturing RoCE % is based on capital employed in standalone financials ex JV investment

Kajaria RoCE's have been strong due to higher utilisations and lower capital employed in JV setup. If Kajaria has to grow topline by 10% each year, it will need to add capacity every year.

Given lower inclination of Morbi players to go for JV model, we believe Kajaria may have to go for greenfield expansion which will hurt RoCE in near term, raising question mark on its higher trading multiple.

JV led expansion has led to RoCE accretion

Dissecting Somany RoCE's into Own manufacturing and JV/Outsourcing

Somany RoCE's from JV(with outsourcing) investments are better than own manufacturing due to lower capital employed and higher utilisations

	FY14	FY15	FY16
Net revenue in Rs.mn	12,597	15,410	17,307
Own manufacturing	5,785	5,681	5,647
JVs + Outsourcing	6,812	9,730	11,660
Revenue contribution %			
Own	46%	37%	33%
JVs+ Outsourcing	54%	63%	67%
Gross margins			
Own manufacturing	71%	70%	71%
JV's + Outsourcing	15%	13%	18%
EBITDA margins%			
Own manufacturing	16%	16%	17%
JV's + Outsourcing	-2%	0%	2%
Standalone	6.5%	6.2%	7.1%
Consolidated	6.4%	7.0%	8.3%
Post-Tax RoCE%			
Own manufacturing	16%	14%	11%
On JV/Outsourcing investments	-33%	13%	55%
Consolidated Reported	11%	14%	15%

Source: Company

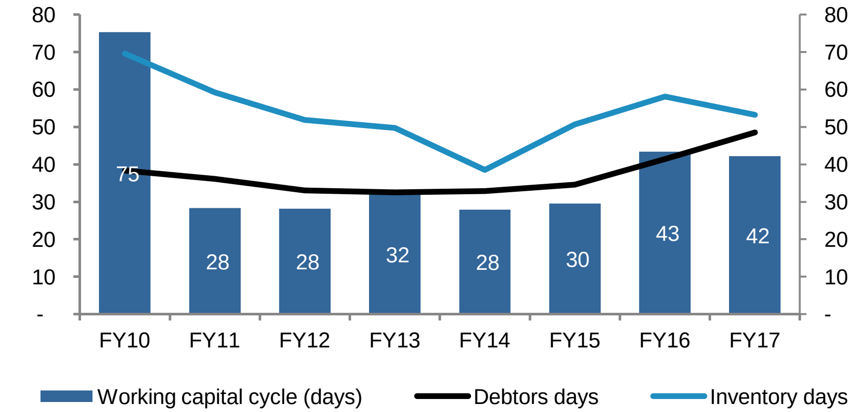
Calculation methodology:

- Analysis is based on revenue contribution from own manufacturing and JV+ Outsourcing together as Somany has JV's with ownership of only 26% and are consolidated as Associates.
- Variable costs including employees costs in standalone financials are apportioned between own manufacturing and JV's only as per revenue contribution.
- Fixed costs (other expenses) is apportioned as per revenue contribution for own, JV+ outsourcing.
- Own manufacturing RoCE % is based on capital employed in standalone financials ex JV investment

Healthy Balance Sheet – Added Advantage over its peers

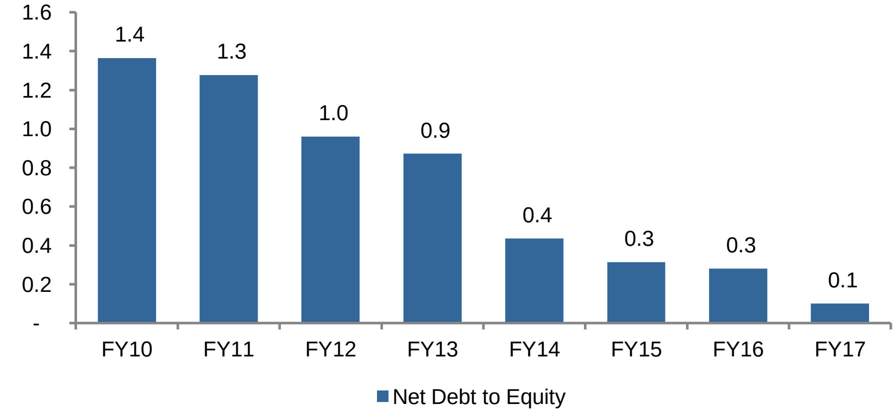
Working Capital and Balance sheet strength

Kajaria- Working capital days



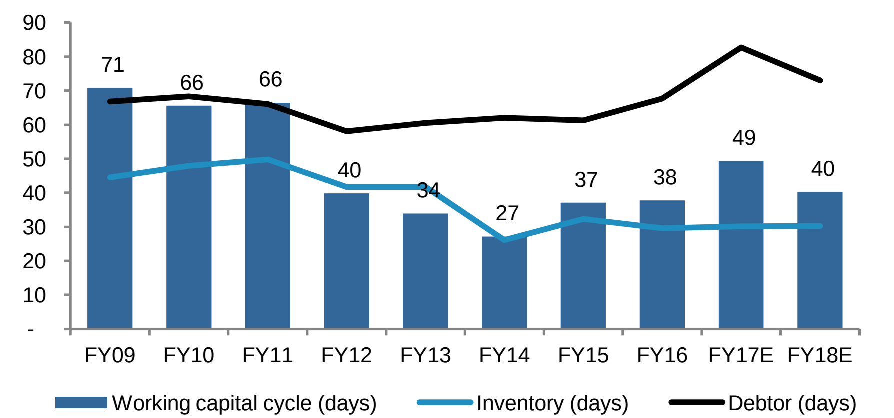
Source: Company

Kajaria- Net debt to Equity



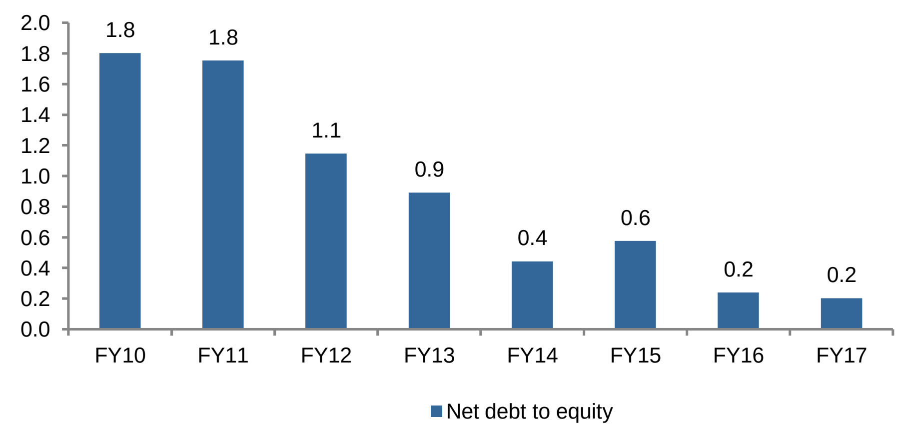
Source: Company

Somany- Working capital days



Source: Company

Somany- Net debt to Equity

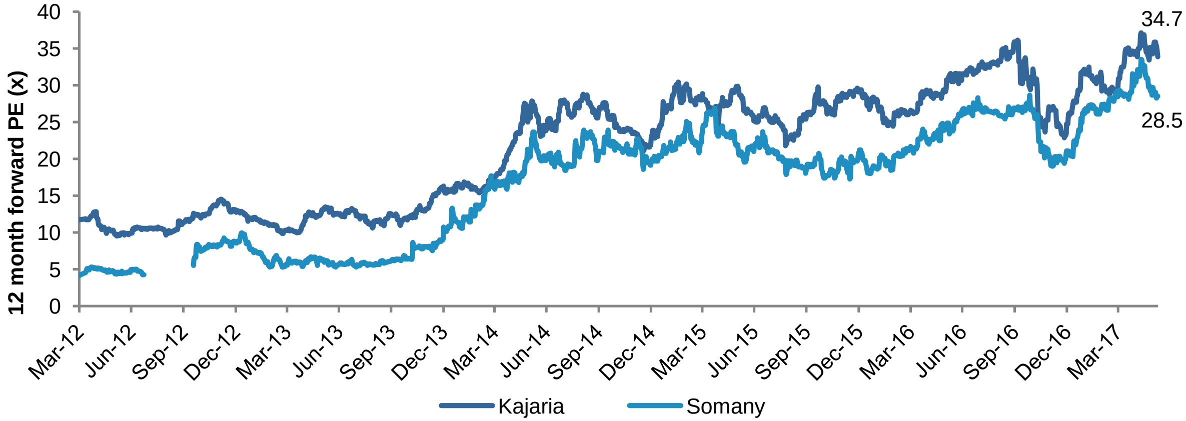


Source: Company

Valuations are perceived to be expensive; Are they justifiable or sustainable?

Earnings based multiples look expensive but not when analyzed in conjunction with estimated Free Cash flow generation

Both Kajaria and Somany trade well above their historic PE multiples



Source: Consensus Estimates Bloomberg, Spark Capital

- KJC and SOMC have rerated significantly over the last three years and are now trading at premium multiples. Valuations for leaders in these categories are evolving. Franchise strength has increased (consistent track record of market share gains), superior RoCE, and cash generation.
- Both KJC and SOMC are entering into a high FCF generation phase which positions them to invest in scale, brand, and people. We believe this will further help their competitive edge and aid ahead of competition growth. Refer below tables for the profile of cash flows in the past and future.

Cash flow profile – KJC and SOMC will enter into high FCF generation phase; Near term earnings based valuations do not reflect the true power of cash flows; Hence we believe its appropriate to also backtest the valuations using DCF based approach

Kajaria's cash flow profile (past, and future trends) Rs. Millions	FY08-FY12	FY13-FY17	FY18E-FY22E
EBITDA	6,465	18,308	35,096
OCF	4,754	12,108	23,027
Capex	(3,030)	(9,924)	(12,000)
FCF	1,724	2,184	11,027
Cash flow metrics			
OCF as % of EBITDA	74%	66%	66%
FCF as % to EBITDA	27%	12%	31%
Capex as % of sales	7%	9%	6%
Capex as % of OCF	64%	82%	52%
Avg capex per year	606	1,985	2,400
RoCE	14%	22%	23%

Somany's cash flow profile (past, and future trends) Rs. Millions	FY09-FY12	FY13-FY17	FY18E-FY22E
EBITDA	2,450	6,090	16,205
OCF	1,818	3,158	10,989
Capex	(1,211)	(3,483)	(6,100)
FCF	607	(325)	4,889
Cash flow metrics			
OCF as % of EBITDA	74%	52%	68%
FCF as % of EBITDA	25%	-5%	30%
Capex as % of sales	5%	5%	5%
Capex as % of OCF	67%	110%	56%
Avg per year capex	242	697	1,220
RoCE %	15%	14%	21%

Source: Company, Spark Capital

Kajaria Ceramics – DCF based valuation

Based on DCF, KJC's current valuations appear fair – The stock trades at 31x FY19 EPS, which is 15% premium to three year average

Kajaria Ceramics Discounted cash flow valuation

In Rs.mn	Assumptions	Remarks
Revenue CAGR % (FY19E-33E)	15%	Expect Tiles industry to grow by 7-8% CAGR in the long term revenue growth. Expect KJC to grow atleast 200-300bps higher than the industry. Further new business initiatives will propel growth in the long term
EBITDA margins average	18%	Expect margins to trend down. Current margins of 19.5% in FY17 is peak.
PAT CAGR % (FY19E-33E)	16%	
Capex as % sales (Average of FY19-33E)	5%	Kajaria Capex as % of sales has been in range of 8-10% in last five years due to lower demand but expect it to come down to range of 5-6% in long term
Working capital days (Average of FY19-33E)	39	Average working capital days in last 5 years
Terminal value growth	5%	Assuming Terminal growth same as long term country GDP growth
WACC	11%	WACC is total cost of equity as net debt will be negligible
Aggregate Discounted cash flow (FY19E-33E)	37,894	Contributes 37% to aggregate DCF
Discounted Terminal value	67,257	Contributes 63% to aggregate DCF
Aggregate discounted cash flow	105,150	
FY19E Net debt	(951)	
FY19E Equity Value	104,220	
DCF per share price in Rs.	**700**	**At 700, the implies FY19 P/E is 31.5x (20% premium to historicals). Hence we believe current valuations for KJC are fair.**

Source: Company, Spark Capital

Somany Ceramics – DCF based valuation

Based on DCF, SOMC's current valuations appear inexpensive; Further with increasing scale and RoCE we expect discount to narrow vs. KJC

Kajaria Ceramics Discounted cash flow valuation		
In Rs.mn	**Assumptions**	**Remarks**
Revenue CAGR % (FY19E-33E)	14%	Expect Tiles industry to grow by 7-8% CAGR in the long term revenue growth. Expect SOMC to grow atleast 200-300bps higher than the industry. Further new business initiatives will propel growth in the long term
EBITDA margins average	12%	Expect margins to increase to 12% from 10.5% currently led by better product mix and increased sanitaryware/faucets revenue mix
PAT CAGR % (FY19E-33E)	16%	
Capex as % sales (Average of FY19-33E)	5%	Somany Capex as % of sales has been in range of 5-6% in last five years
Working capital days (Average of FY19-33E)	40	Average working capital days in last 5 years
Terminal value growth	5%	Assuming Terminal growth same as long term country GDP growth
WACC	11%	WACC is total cost of equity as net debt will be negligible
Aggregate Discounted cash flow (FY19E-33E)	16,861	Contributes 39% to aggregate DCF
Discounted Terminal value	26,050	Contributes 61% to aggregate DCF
Aggregate discounted cash flow	**42,912**	
FY19E Net debt	616	
FY19E Equity Value	42,296	
DCF per share price	**1,000**	**At 1,000, the implied FY19 P/E is 27x vs. current multiple of 21.0x**

Source: Company, Spark Capital

Value from "Inversion"

Reverse DCF: What does current market price implies?

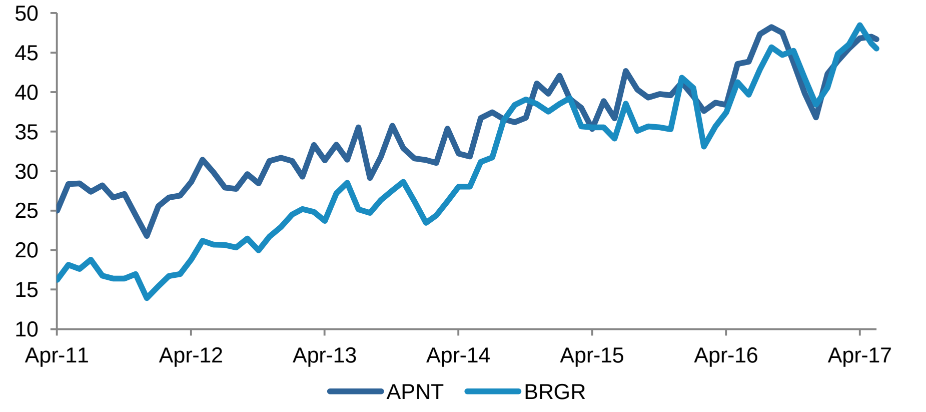
We use DCF analysis to reverse calculate the expected next 15 years normalised Revenue CAGR for KJC and SOMC at current market cap under different margins scenarios								
Company name	PE(x)		Revenue growth		EBITDA margins		EBITDA margins Assumption	Implied 15 year revenue growth at current market cap
	FY19E	Last 3 years	FY17	Last 5 years	FY17	Last 5 years	Average margins in next 15 years	
Kajaria Ceramics	34x	28x	5.6%	14.2%	19.5%	17.0%	**17%**	**18%**
							19%	**15%**
							20%	**12%**
Somany Ceramics	29x	23x	5.8%	15.5%	10.6%	8.1%	**11%**	**18%**
							12%	**15%**
							13%	**8%**

Note: Assumed TV growth of 5%, WACC of 11%. Source: Company, Spark Capital

Can SOMC further bridge valuation gap with KJC?

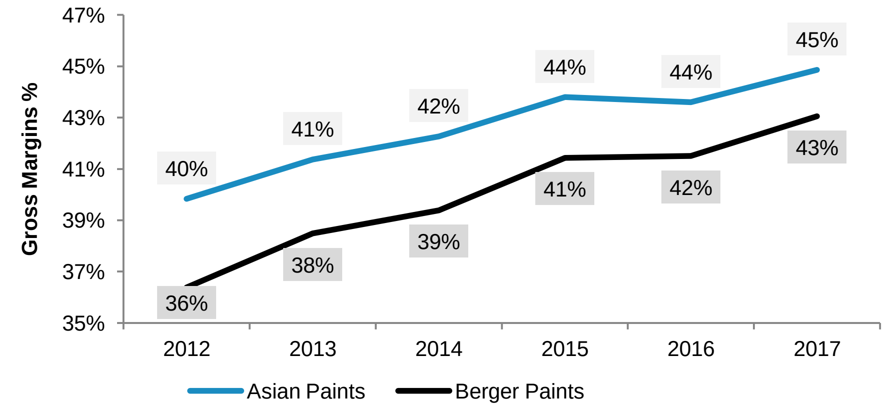
Case Study on how Berger Paints narrowed the valuation discount significantly vs. Asian Paints over the last few years

Asian Paints vs. Berger P/E trends – BRGR is trading at par with APNT



Source: Bloomberg, Company

Gross margins gap has narrowed down to 180bps from 346bps in FY12



Source: Bloomberg, Spark Capital

Berger Paints have expanded its margins led by impetus

	Company name	2012	2013	2014	2015	2016	2017	CAGR / Change %
Revenue in Rs.bn	APNT	96	109	127	142	155	166	**12%**
	BRGR	29	33	39	43	46	50	**11%**
Gross margins %	APNT	40%	41%	42%	44%	44%	45%	**5%**
	BRGR	36%	38%	39%	41%	42%	43%	**7%**
EBITDA margins %	APNT	16%	16%	16%	16%	19%	20%	**4%**
	BRGR	10%	11%	11%	12%	15%	16%	**5%**
RoCE %	APNT	34%	32%	29%	28%	26%	24%	
	BRGR	18%	18%	17%	16%	20%	20%	
A&P as % of Sales	APNT	4%					5%	**1%**
	BRGR	5%					7%	**2%**
Dealers	APNT	28,200					45,000	
	BRGR	16,000					24,000	

Note: RoCE is not comparable due to Ind-AS changes in FY17. Source: Company, Spark Capital

Berger paints strategy in last three years to catch up on market share and growth:

- Berger paints has emerged to be the 2nd largest player consolidating market share along with Asian paints. Infact, revenue CAGR for both the players have been same in last five years.
- Berger dominated in the mass end but increased impetus on premiumization led to gross margins gap reducing to 180bps currently compared to 346 bps in FY12.
- Hence, EBITDA growth of BRGR exceeded that of APNT in last two and five years and RoCE metric difference has narrowed down as well.
- This led to rerating in case of Berger paints reducing the multiple discount with APNT.

Can SOMC further bridge valuation gap with KJC?

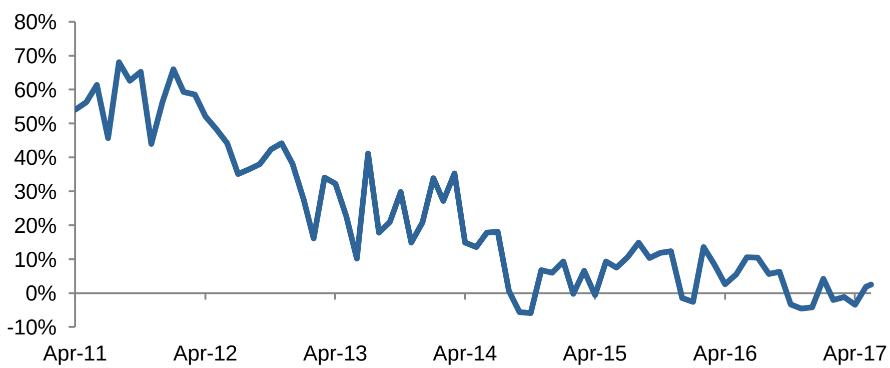
Berger Paints valuations have caught up with Asian paints in last one year on back of higher profit growth and return metrics

Kajaria versus Somany in next 5 years

	Company name	2017	2018E	2019E	2020E	2021E	2022E	CAGR / PPT Change %
Revenue in Rs.bn	Kajaria	25.5	28.1	32.3	37.0	42.5	48.5	**14%**
	Somany	18.1	19.9	22.9	26.5	30.5	35.2	**14%**
Gross margins %	Kajaria	64%	64%	64%	64%	64%	64%	**0%**
	Somany	46%	46%	47%	47%	48%	48%	**2%**
EBITDA margins %	Kajaria	19%	19%	19%	19%	19%	18%	**-1%**
	Somany	11%	11%	12%	12%	12%	13%	**2%**
RoCE %	Kajaria	21%	22%	23%	24%	23%	23%	**2%**
	Somany	16%	17%	21%	23%	23%	23%	**7%**
PE(x)	Kajaria	44.0	39.7	32.6	27.9	24.1	21.3	
	Somany	35.3	27.8	21.5	17.1	14.1	12.0	

Source: Company, Spark Capital

KJC valuations (12 month forward PE) premium over SOMC



Source: Company, Spark Capital

Expect SOMC's valuation gap to significantly narrow down

SOMC's scale of operations have increased significantly over the last few years. Further, company is investing in brand/people to increase competitive edge vs its peers. Company's initiative towards re-aligning its product portfolio and foray into sanitaryware business will further lead to expansion in its EBITDA margins and narrow the discount vs Kajaria.

- RoE gap with Kajaria will shrink in next few years as recently added capacities scale up and PBT margin expands with portfolio premiumisation and scale
- We value SOMC at 27x FY19E EPS, a 10% discount vs. KJC's 30x

Kajaria Ceramics

Financial Summary

Abridged Financial Statements (Consolidated)				
Rs. mn	FY16	FY17	FY18E	FY19E
Profit & Loss				
Revenues	24,135	25,496	28,111	32,324
EBITDA	4,575	4,963	5,332	6,110
Other Income	104	154	169	242
Depreciation	726	814	858	886
EBIT	3,953	4,303	4,644	5,467
Interest	345	340	201	65
PBT	3,608	3,963	4,443	5,402
Exceptionals loss/(Income)	-	-	-	-
Tax	1,247	1,425	1,511	1,837
PAT after exceptionals	2,313	2,528	2,799	3,412
Balance Sheet				
Networth	9,719	11,751	13,785	16,145
Total Debt	2,937	1,706	655	155
Deferred Tax & MI	1,710	1,866	1,866	1,866
Total Networth & Liabilities	**14,366**	**15,323**	**16,306**	**18,166**
Gross Block	15,251	16,626	18,376	20,126
Net Block + CWIP	11,283	11,856	12,748	13,612
Investments	0.8	0.9	0.9	0.9
Net working capital (ex cash)	2,866	2,947	3,025	3,447
Cash	215	520	532	1,106
Net working capital	3,082	3,467	3,557	4,553
Total Assets	**14,366**	**15,323**	**16,306**	**18,166**
Cash Flows				
Cash flows from operating	3,037	3,599	3,779	3,940
Cash flows from investing	(2,651)	(1,379)	(1,750)	(1,750)
Cash flows from financing	(286)	(2,145)	(2,016)	(1,617)
Free Cash Flows	59	2,034	1,997	2,368

Key metrics				
	FY16	FY17	FY18E	FY19E
Operational metrics				
Sales volumes (msm)	64.3	67.7	73.4	83.2
Realisations/ sm	374	376	382	388
Capacity (msm)	68.6	68.9	72.4	78.1
Growth ratios				
Revenues	10%	6%	10%	15%
EBITDA	29%	8%	7%	15%
PBT	31%	10%	12%	22%
PAT	32%	9%	11%	22%
Margins Ratios				
EBITDA	19.0%	19.5%	19.0%	18.9%
PBT	15.0%	15.5%	15.8%	16.7%
PAT	9.6%	9.9%	10.0%	10.6%
Performance Ratios				
Net Debt to Equity (x)	0.3	0.1	0.0	-0.1
RoAE (%)	27%	24%	22%	23%
RoCE (%)	23%	21%	22%	23%
Gross Asset Turnover (x)	1.7	1.6	1.6	1.7
Net Working Capital Days	43	42	39	39
Interest coverage (x)	11.5	12.7	23.1	84.4
Valuation metrics				
Shares Outstanding (mn)	159	159	159	159
Market Cap (Rs. mn)	108,052	108,052	108,052	108,052
EPS	14.6	15.9	17.6	21.5
P/E(x)	46.7	42.7	38.6	31.7
Price to Book (x)	11.1	9.2	7.8	6.7
EV/EBITDA (x)	24.2	22.0	20.3	17.5
Dividend yield (%)	0.4%	0.4%	0.6%	0.8%

Somany Ceramics

Financial Summary

Abridged Financial Statements				
Rs. mn	FY16	FY17	FY18E	FY19E
Profit & Loss				
Revenues	17,116	18,110	19,871	22,940
EBITDA	1,429	1,915	2,171	2,642
Other Income	91	151	199	241
Depreciation	283	350	376	408
EBIT	1,237	1,716	1,994	2,475
Interest	225	233	165	104
PBT	1,012	1,483	1,829	2,372
Exceptionals loss/(Income)	(44)	(41)	-	-
Tax	312	502	604	783
PAT after exceptionals	647	931	1,183	1,526
Balance Sheet				
Networth	4,282	5,212	6,221	7,500
Total Debt	2,089	2,344	1,544	893
Deferred Tax & MI	529	644	644	644
Total Networth & Liabilities	**6,900**	**8,200**	**8,409**	**9,038**
Gross Block	6,320	6,631	7,431	8,231
Net Block + CWIP	3,859	4,114	4,538	4,931
Investments	1,089	1,517	1,317	1,280
Net working capital (ex cash)	1,769	2,448	2,195	2,550
Cash	183	121	359	277
Net working capital	1,952	2,569	2,554	2,827
Total Assets	**6,900**	**8,200**	**8,409**	**9,038**
Cash Flows				
Cash flows from operating	596	869	1,977	1,682
Cash flows from investing	(1,919)	(1,033)	(600)	(763)
Cash flows from financing	1,310	(113)	(1,139)	(1,002)
Free Cash Flows	(1,009)	182	1,210	1,020

Key metrics				
	FY16	FY17	FY18E	FY19E
Operational metrics				
Sales volumes (mt)	46.4	49.7	53.2	59.6
Realisations/ sm	367	361	371	383
Capacity (msm)	51.3	51.3	53.8	58.8
Growth ratios				
Revenues	10.9%	5.8%	9.7%	15.4%
EBITDA	32.9%	34.0%	13.4%	21.7%
PBT	48.6%	46.5%	23.4%	29.7%
PAT	39.5%	43.8%	27.1%	29.1%
Margins Ratios				
EBITDA	8.3%	10.6%	10.9%	11.5%
PBT	5.9%	8.2%	9.2%	10.3%
PAT	3.8%	5.1%	6.0%	6.7%
Performance Ratios				
Net Debt to Equity (x)	0.2	0.2	0.0	0.0
RoAE (%)	19%	20%	21%	22%
RoCE (%)	15%	16%	17%	21%
Gross Asset Turnover (x)	3.0	2.8	2.8	2.9
Net Working Capital Days	38	49	40	41
Interest coverage (x)	5.5	7.4	12.1	23.9
Valuation metrics				
Shares Outstanding (mn)	42	42	42	42
Market Cap (Rs. mn)	32,844	32,844	32,844	32,844
EPS	15.3	22.0	27.9	36.0
P/E(x)	50.8	35.3	27.8	21.5
EV/EBITDA (x)	23.7	17.7	15.2	12.4
Price to book (x)	7.7	6.3	5.3	4.4
Div yield %	0.3%	0.3%	0.5%	0.6%

Kajaria Ceramics – Crystal Gazing

FY11-16 CAGR %			
Revenue	EBITDA	PAT	Price
21%	26%	31%	65%

Expect KJC to continue to outpace industry growth. This will be driven by aggressive capacity additions, new product launches, and better product mix. Further, we expect KJC's foray in to new verticals (Faucets, Sanitaryware) will succeed driven by brand image and dealer network.

Consistent revenue growth of 18%

Market share gain to continue. Expect the margins to remain steady at current levels led by product mix

	FY11	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Revenue	9,533	21,869	24,135	25,496	28,111	32,324	37,043	42,532
Ebitda	1,487	3,541	4,575	4,963	5,332	6,110	6,934	7,881
Margins	15.6%	16.2%	19.0%	19.5%	19.0%	18.9%	18.7%	18.5%
PAT	607	1,756	2,313	2,528	2,799	3,412	3,980	4,606

Increasing operational efficiency result in

Expect the stretched (FY17) working capital days to continue. However, in case of strong pick up in demand, working capital can come down

	FY11	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
RoE	29.5%	27.6%	27.0%	23.6%	21.9%	22.8%	22.7%	22.5%
Leverage	1.28	0.31	0.28	0.10	0.01	-0.06	-0.08	-0.10
Working capital days	28	30	43	42	39	39	39	39
CFO (Rs nm)	1,304	2,098	3,037	3,599	3,779	3,940	4,485	5,070

Consistent growth in business to be rewarded by

Expect multiple to sustain

P/E multiple	FY21E EPS	Price target
28x	29.0	812
30x	29.0	870

Trading History – % of times stock traded					
Fwd PE range	<16x	16x-20x	20x-24x	24x-28x	>28x
	16%	9%	14%	47%	14%

Entry = Rs. 680 @ 32x FY19E

Cumulative Dividends of Rs. 25

EPS CAGR of 16%, exit multiple of 30x FY21E

TOTAL RETURN OF 1.3x

Somany Ceramics – Crystal Gazing

FY11-16 CAGR %			
Revenue	EBITDA	PAT	Price
19%	16%	23%	57%

Expect SOMC to continue to outpace industry growth. This will be driven by aggressive capacity additions, new product launches, and better product mix. Further, we expect SOMC's foray in to new verticals (Faucets, Sanitaryware) will succeed driven by brand image and dealer network.

Market share gain to continue. Expect the current margins to increase led by product mix and more value added products

	FY11	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
Revenue	7,149	15,431	17,116	18,110	19,871	22,940	26,497	30,463
Ebitda	689	1,076	1,429	1,915	2,171	2,642	3,186	3,780
Margins	9.6%	7.0%	8.3%	10.6%	10.9%	11.5%	12.0%	12.4%
PAT	234	464	647	931	1,183	1,526	1,923	2,329

+

ROE's to increase to upwards of 20% with working capital control led by improving macro and housing demand pickup

	FY11	FY15	FY16	FY17	FY18E	FY19E	FY20E	FY21E
RoE	25.4%	19.3%	18.9%	19.6%	20.7%	22.2%	23.2%	23.2%
Leverage	1.75	0.58	0.24	0.20	0.03	-0.02	-0.04	-0.06
Working capital days	66.5	37.1	37.7	49.3	40.3	40.6	40.3	40.1
CFO (Rs nm)	231	248	596	869	1,977	1,682	2,042	2,448

+

Expect multiple to re-rate

P/E multiple	FY20E EPS	Price target
25x	54.9	1,374
27x	54.9	1,484

Trading History – % of times stock traded					
Fwd PE range	<12x	12x-16x	16x-20x	20x-24x	>24x
	41%	27%	7%	11%	14%

Entry = Rs. 775 @ 21x FY19E

+

Cumulative Dividends of Rs. 10

+

EPS CAGR of 26%, exit multiple of 27x FY21E

TOTAL RETURN OF 1.9x

SPARK CAPITAL

Company Factsheet: Kajaria Ceramics (KJC)

Corporate Factsheet	
Company Background	Established in 1986, Kajaria Ceramics is the second largest tile company in India. The company started production in 1988 at Sikandrabad (UP) with 1 million sq. mtr capacity and scaled it to 8.4msm currently. The company commissioned its second plant in 1998 at Gailpur (Raj) with a capacity of 6msm and increased capacity in a phased manner to 68.9msm currently
Presence	The company has Pan India presence. Sales mix is North 50%, East 12%, West 18%, and South 20%
Management depth	Mr. Ashok Kajaria – Chairman & Managing Director Mr. Chetan Kajaria – Joint Managing Director. Head of the ceramic tiles division Mr. Rishi Kajaria – Joint Managing Director. Head of the vitrified tiles division Mr. Ashok Kajaria is the founder and promoter of the company and has over 38 years of in the tile and construction industry. Promoters will own 47.4% in the company.
Business	Kajaria Ceramics has presence across ceramic tiles, polished vitrified tiles, and glazed vitrified tiles and entered in Sanitaryware.
Distribution network	The company has a dealership network of 1150 dealers with around 10,000 sales points. Further the company has 250 exclusive display centres across the country, where the consumers can see all the offering by KJC
Revenue Model	Ceramic tiles (38% of FY17 Revenues), Vitrified tiles (35% of FY17 Revenues), and GVT (25% of FY17 Revenues). Sanitaryware and Fittings contributes 4% to overall revenue.
Capacity & Facilities	Four own manufacturing facilities in Sikandrabad (UP), Gailpur (Raj), Malootana (Raj.) and Vijaywada (AP) with capacity of 41.1msm.. In addition to this, the company has added capacities through JV route with existing small/unorganised tile manufacturers. Over the last five years, the company has added ~28msm of capacities through JV model
Gas arrangements	GAIL at own manufacturing facilities and GSPC at JV facilities
Key Success Factors	Branding, servicing, loyal dealer network, and innovation products/designs
Credit Rating	Long term: A+ (ICRA)

Company Factsheet: Somany Ceramics (SOMC)

Corporate Factsheet	
Company Background	Somany Ceramics was founded in 1968 by Mr. H.L. Somany. The company is currently the third largest tile company in India. The company started production in 1972 at Kassar, Haryana and in 1983 set up second unit in Kadi, Gujarat.
Presence	The company has Pan India presence. Sales mix is North 42%, South 28%, East 18%, West 12%
Management depth	Mr. Shreekant Somany – Chairman & Managing Director Mr. Abhishek Somany – Joint Managing Director Mr. G.G Trivedi – Chief Executive Officer Post dilution, the promoters will own 51.5% in the company.
Business	Somany Ceramics has presence across ceramic tiles, polished vitrified tiles, and glazed vitrified tiles. The company aggressively expanding in Sanitaryware and Faucetware business.
Distribution network	The company has a dealership network of 1,800+ dealers with around 10,000 sales points. Further the company has 225 Somany showroom/studios
Revenue Mix	Ceramic tiles (39% of FY17 Revenues), Polished Vitrified Tiles (33% of FY17 Revenues), Glazed Vitrified Tiles (20%), Sanitaryware and Bath fittings (7%)
Capacity & Facilities	The company has two own manufacturing units, on e in Kassar (Haryana) with a capacity of 17.1msm and other one in Kadi, Gujarat with a capacity of 8.4msm. In addition to this, the company has added capacities through JV route with existing small/unorganised tile manufacturers. Over the last five years, the company has added ~26msm of capacities through JV model
Gas arrangements	Long term firm contract of natural gas with GAIL, IOC, and GSPL at both manufacturing locations
Key Success Factors	Branding, servicing, loyal dealer network, and innovation products/designs
Credit Rating	Long Term: AA-, Short Term: A2+ (CRISIL)

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Absolute Rating Interpretation	**BUY**	Stock expected to provide positive returns of >15% over a 1-year horizon	**REDUCE**	Stock expected to provide returns of <5% – -10% over a 1-year horizon
	ADD	Stock expected to provide positive returns of >5% – <15% over a 1-year horizon	**SELL**	Stock expected to fall >10% over a 1-year horizon

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