Cement

North/Central India-based players could be favorable bets

Recovery in sight | growth sustainability to revive pricing

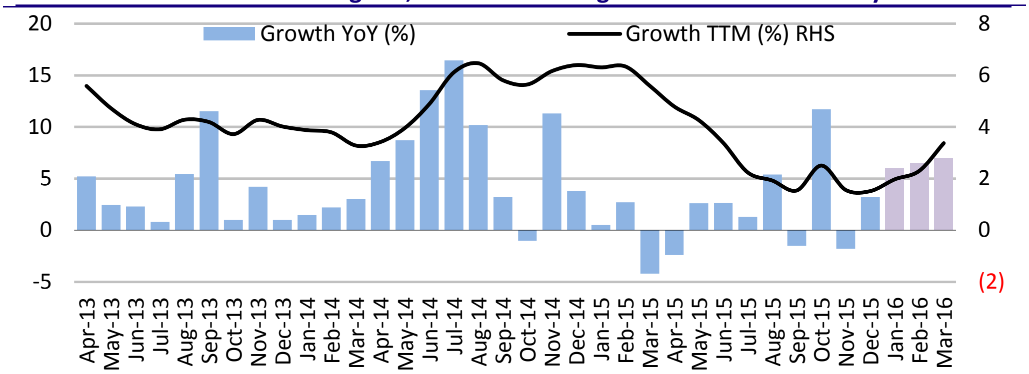
- **Industry feedback suggests signs of demand sustenance in the northern and central regions in January 2016 post pick-up in December 2015.**
- **Fundamentally, these regions are better poised (after the East) with more credible and immediate drivers from infrastructure.**
- **While early phase of demand has been price disruptive, expect strong impetus to pricing from existing dismal levels, if growth sustains for few months.**
- **North-central stocks underperformed on pricing woes and delayed recovery. Any tangible signs of improvement would place them better to re-rate.**
- **Post recent correction, valuation comfort has increased. Upgrade potential is higher as existing price concerns factored in. Watch out for SRCM, JKLC, JKCE (north-heavy) and PRSM, BCORP and HEIDELBERG (central India focused).**

Growth bottoming out; scouting for sustenance

Growth bottoming out, but real catalyst lies in magnitude and sustainability of pick-up

Defying the widely held hope of normalcy, cement demand growth touched a new bottom in 3QFY16, with TTM growth of 1.5-2% (core industry data). 9MFY16 turned out to be subdued, as sporadic uptick in demand failed to sustain, with delay in tangible pick-up in infrastructure spending and crackdown in rural consumption and housing demand. Momentum in road construction is visible, but this cannot lead to sustainable growth normalcy to 7-8% without stabilization of larger demand drivers, namely rural consumption and urban housing.

Exhibit 1: Growth in bottoming out, sector is scouting for sustainable recovery



Source: EA, MOSL

Will recent momentum in North-Central India sustain?

Demand strength visible over December-January in North and Central India could be early sign of sustainable acceleration

Earlier, our industry interaction highlighted sudden surge in demand offtake in North and Central India during the latter part of December 2015. A part of the spike in volumes was then attributable to re-stocking and greater volume focus among the key players (trade-off seen in dismal cement prices). However, we believe there is something more positive to it. Recent updates from the industry suggest continuation of good demand in the month of January as well. This could probably be an early sign of long-awaited greenshoots getting brighter.

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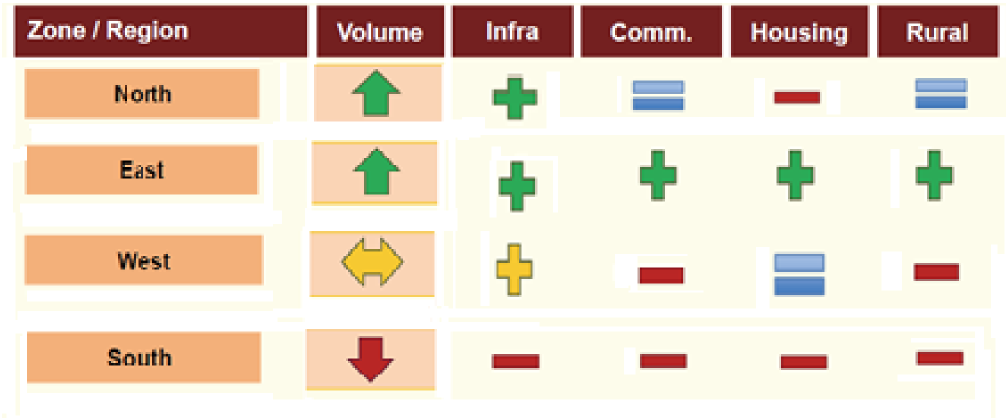
While the East has been witnessing near double-digit growth (IHB demand, low cost housing and rural roads), the South is still de-growing, albeit with imminent recovery in AP/Telengana demand from mid-FY17. The West has been a mixed bag, as early execution in highways and roads is offset by adversities in rural and housing demand. Therefore, North and Central India (38-40% of pan India consumption) render the most credible set of drivers for the near-term with (a) infra demand picking up, (b) stabilization of rural adversity (lesser monsoon hit) and commercial demand, and (c) healthy contribution from UP. Various road projects (along with concretization) have started, while execution of Dedicated Freight Corridor (DFC) project has been more seamless in states like Rajasthan, UP, etc.

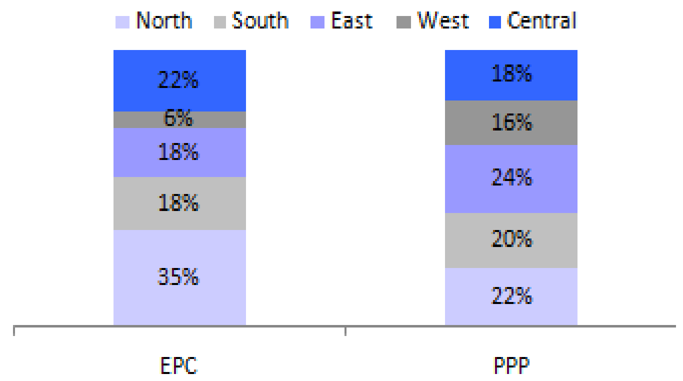
While the East is fastest growing, North (and Central India) have demand drivers most tangibly poised

Exhibit 2: UTCEM's guidance on status of regional demand drivers



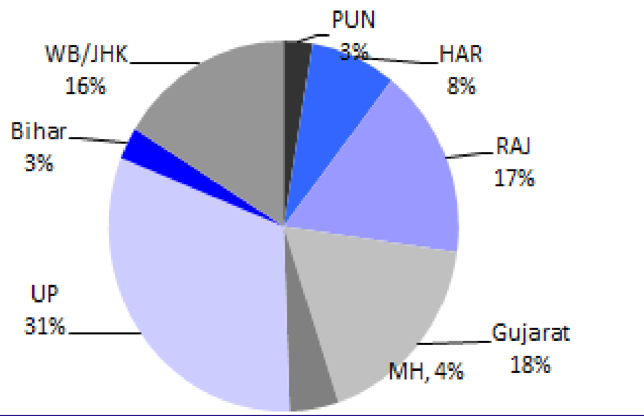
Source: UTCEM, MOSL

Exhibit 3: North and Central India account for 55-60% of NHAI road projects under execution



Source: Company, MOSL

Exhibit 4: DFC project: North and Central states account for major share of demand



Source: Company, MOSL

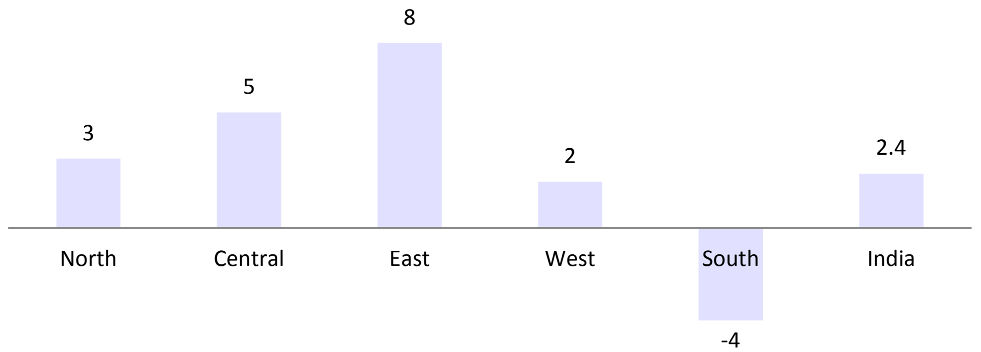
Early demand might be competitive, but what if demand sustains!!

We believe early phase of demand recovery could be competitive, causing volatility in pricing, especially if the pricing dynamics are more economically defying like those in North and Central markets. Given that most players are poised with untapped utilization headroom (consumption utilization ~70% and production utilization 75-80%), the possibility of competitive disruption to grab more market share would be high. It explains the dismal pricing trend in these regions over the past 2-3 months (Exhibit 6).

However, if prevailing demand pick-up sustains for a few months, there would be significant impetus to pricing. Profitability of many North-based players (following fall in pricing 3Q onwards) has deteriorated to unsustainable levels, with transaction pricing in many micro-markets reaching <INR200/bag (near-breakeven). We believe visibility of demand sustenance in North-Central India would induce rationality among players.

North and Central India have been seeing demand relatively better demand after east

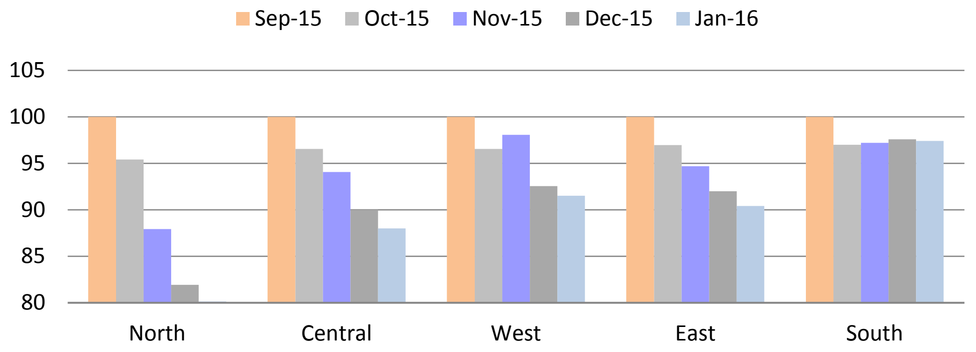
Exhibit 5: 9MFY16 demand growth in various regions (%)



Source: Company, MOSL

Competition has been disruptive in north/central, causing dismal pricing compared to stability in South

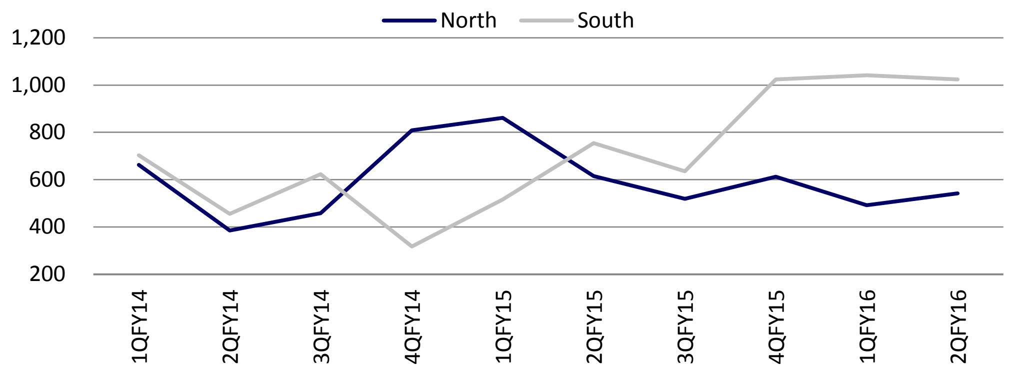
Exhibit 6: Trend in cement prices since September 2015 (100-indexed)



Source: Company, MOSL

Price-led profitability among North/Central based players been has sub-normal, with further deterioration 3QFY16-onwards

Exhibit 7: Dichotomy of cement profitability between North and South (INR/ton)



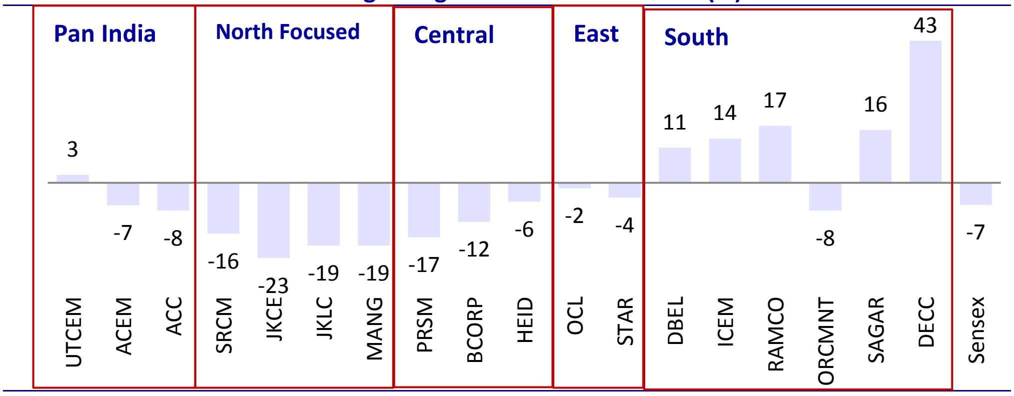
Source: Company, MOSL

Pricing has been better return driver in recent past

With revival hope deferred, better pricing dynamics became the driver for stock in recent past

We find that return in cement stocks in the recent past was driven more by pricing trends than volume pick-up due to (a) lack of visibility in demand sustainability, and (b) low margin of safety in profitability, which is more price sensitive. While stock return in FY15 was driven by better growth outlook, the delay in recovery cycle and pricing volatility gradually shifted the yardstick. This has been the learning from prevailing regional dichotomy between the South (dismal demand + stable discipline-led pricing) and the North (better demand + declining pricing) highlighted in **Exhibit 5, 6 and 7**. The northern stocks underperformed southern peers significantly despite delivering better volume growth.

Exhibit 8: : Stock return according to region since October 2015 (%)



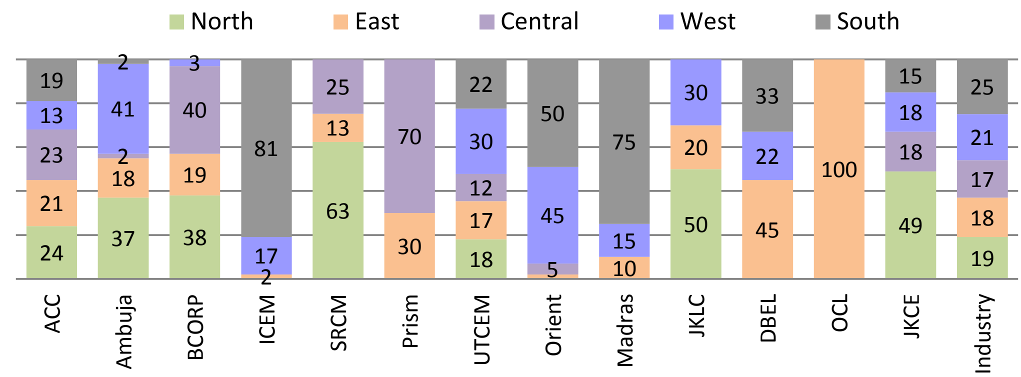
Source: Company, MOSL

Re-rating headroom high in North-Central stocks from demand-price boost

With tangible sign of recovery visibility and strong headroom for pricing boost, North-Central stocks could be favorable bets

After recent correction, North and Central India companies offer better comfort on asset valuations. Ex-SRCM, the North-centric players are trading at 15-20% discount to South-centric players in terms EV/ton. Pricing weakness is largely factored in earnings estimates, and therefore, the possibility of earning upgrades (led by volume-driven pricing boost) is strong. Tangible positive vibes from on-ground demand pick-up should benefit stocks like SRCM, JKLC and JKCE in North India, and PRSM, BCORP and HEIDELBERG in Central India. Valuation weakness driven by interim volatility would provide good entry opportunities.

Exhibit 9: Market mix of key companies (%)



Source: Company, MOSL

Exhibit 10: Comparative valuations

	CMP	TP	Upside	Imp.	PE (x)				EV/EBITDA (x) *				EV/Ton (USD) at CMP*			
	INR	INR	(%)	EV/ton	FY15	FY16E	FY17E	FY18E	FY15	FY16E	FY17E	FY18E	FY15	FY16E	FY17E	FY18E
ACC	1,263	1,391	10	120	27.5	38.7	28.7	16.6	16.0	17.8	14.1	8.9	88	102	95	88
Ambuja	197	240	22	155	23.1	33.9	25.0	15.8	13.6	17.3	12.8	8.7	126	127	124	114
Ultratech	2,809	3,372	20	200	38.3	37.5	29.2	17.8	19.7	18.2	14.7	9.9	182	170	165	158
Shree Cement	10,375	11,634	12	200	77.9	60.4	33.5	23.2	25.9	20.1	15.0	10.7	207	190	183	166
LARGE CAP					**32.5**	**35.6**	**26.6**	**17.2**	**18.6**	**18.2**	**14.3**	**9.6**	**157**	**151**	**146**	**137**
Dalmia Bharat Ent.	727	1,015	40	95	644	43.1	17.3	8.7	26.4	10.9	8.6	5.9	68	85	83	76
India Cements	88	106	21	60		16.1	9.5	5.8	8.2	7.7	6.2	4.5	61	60	58	54
JK Cement	471	743	58	100 (70)	26.3	64.1	17.7	8.8	12.4	11.8	8.4	5.8	68	74	73	68
JK Lakshmi Cement	287	415	45	90	22.5	-180.8	33.5	11.3	13.3	16.6	11.0	7.1	83	79	70	63
Madras Cement	383	433	13	110	37.6	25.2	19.3	14.0	17.4	12.6	10.5	8.1	117	108	100	94
Orient Cement	144	185	28	95	15.1	64.3	40.5	16.2	9.1	21.8	12.9	7.2	79	79	81	75
Prism Cement	78	107	37	90	39	-172.5	21.3	10.0	21.6	16.9	9.4	6.2	149	148	140	135
MID CAPS					**34.4**	**41.4**	**18.9**	**10.1**	**14.0**	**11.8**	**8.8**	**6.0**	**69**	**70**	**61**	**54**
AGGREGATE					**32.8**	**36.5**	**24.9**	**15.4**	**17.3**	**16.0**	**12.3**	**8.4**	**120**	**117**	**108**	**99**

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