Stock Idea

Galaxy Surfactants Ltd

Fastest Growing Niche Player in the Chemical Sector

Date: 14th September, 2020

Contents

Snapshot

Galaxy Surfactants is engaged in manufacturing of surfactants and other specialty ingredients for the personal care and home care industries. Their products find application in a host of consumer centric personal care and home care products, including, inter alia, skin care, oral care, hair care, cosmetics, toiletries and detergent products.

Company is one of the leading manufacturers of Performance and Specialty Care Surfactants in the country with 70+ patents and long-term client relationships with major domestic and global FMCG players.

> **"The enterprise that does not innovate inevitably ages and declines. And in a period of rapid change such as the present, the decline will be faster.**
>
> \- Peter Drucker

Market Cap: INR 6319 Cr.	Current Price: INR 1,782.15	52 weeks H/L: 1,027.55 /1,949.50
Book Value: 301.16	Stock P/E: 26.96	Dividend Yield: 0.45 %
ROCE: 23.92%	ROE: 23.70%	Dividend Payout: 2.15%
Face Value: 10	Promoter Holding: 70.93%	Pledged Percentage: 0%
Sales Growth (10Y): 12%	Profit Growth (10Y): 15%	Cash Conversion Cycle: 58.80

Source: Screener.in, As on September 11, 2020

Best Buying Range

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- Galaxy Surfactants' Rs 937-crore IPO was subscribed 20 times during January 2018. The IPO was in a price band of Rs 1,470-1,480 per share. On Feb 2018, Galaxy Surfactants debuts with 3% premium at Rs 1,525.
- Stock made a high of 1700 during listing in Feb 20218 and it was trading around 1700 just before the market crash due to Covid-19. Recently stock price has crossed 1700 levels, hence it is advisable take position in this counter.

- **Total Weightage % in portfolio = 6%**
- **Best Buying Range = Buy 3% between 1700-1800 & average down 3% between 1250-1350 range.**
- **Price Target = Rs 5500 in next 4 years (~ 30% CAGR in next 4 years)**

Investing in Niche Companies

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Dear Friends,

Blue chips are supposed to be the best stocks you can possibly own. These are pretty solid companies overall. They are supposed to be dependable stocks that will deliver steady returns year after year to investors.

However, one should always ask. **Is there an alternative to blue-chip investing? <u>The answer lies in investing in small companies that dominate a niche. These companies specialize in a product or service and control a small but very profitable niche . It is a fundamental tenet of prudent stock investing that market dominance is an important factor in picking companies. Companies, whose dominance in their niche segment appears to be sustainable.</u>** These companies target a particular market niche, perhaps that is not yet recognized by – or is too small to be of interest to larger companies.

By virtue of their dominance in the niche they operate in, these companies are able to retain their competitiveness and margins. In today's cut-throat world, businesses that understand the power of specialization are thriving.

Niche players share a common set of traits. These include a deep understanding of their customers and their customers' needs and the ability to stay engaged with those customers. Ideal niche market companies should consistently produce quality, innovative products and possess a genuine regard for the well-being of their employees.

Niche businesses are not immune to competition, especially from larger market players with substantial resources and economies of scale. So in the face of competition, successful niche businesses will respond with innovation and higher-quality products, rather than cost-cutting measures.

By focusing on one niche, a company can gain credibility with the people in the end industry and can become the go-to resource for that particular market. This has been one of the driving force behind the growth of the company that we are going to discuss in our latest stock recommendation.

Our latest stock recommendation falls under the most talked about and well covered specialty chemical sector. However, not all the segments in this sector have the same growth potential. **<u>Demand for surfactants in India is expected to grow at more than twice the global rate. With a high growth rate and better margins than conventional surfactants, specialty surfactants presents a ripe opportunity in the Indian surfactants space.</u>**

What are Surfactants?

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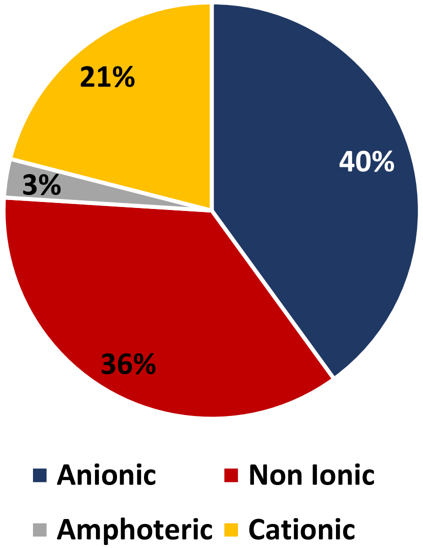
Surfactants or surface active agents are organic compounds that lower surface tension between two liquids or between a liquid and a solid. Functionally, they are used to improve cleaning efficiency, emulsifying, wetting or dispersing actions, solvency, foaming/de-foaming and lubricity of cleaning agents and other products.

Unlike most other segments of specialty chemicals, surfactants are not aligned to any particular end-user industry. They find application across a wide array of industries, including home and personal care (HPC), textile, water treatment, agrochemicals and flavors and fragrances.

The difference across applications, however, lies in the concentration and purity requirements. Surfactants are used most universally as basic cleaning agents in consumer products such as detergents for washing clothes, dishes, floors, as well as shampoos, body washes and toothpastes. Hence, HPC represents the largest end-user consumer for surfactants, consuming ~ 80% of the surfactants produced globally. Consumers in the HPC industry are increasingly gravitating towards premium products in emerging markets like India.

Surfactants are also often classified by the composition of their head – anionic, non-ionic, cationic and amphoteric. Anionic surfactants dominate the market, followed by non-ionic surfactants. Non-ionic surfactants are expected to grow the fastest because of their inherent bio-friendly properties and degradability.

Breakup of global market by volume, based on surfactant type



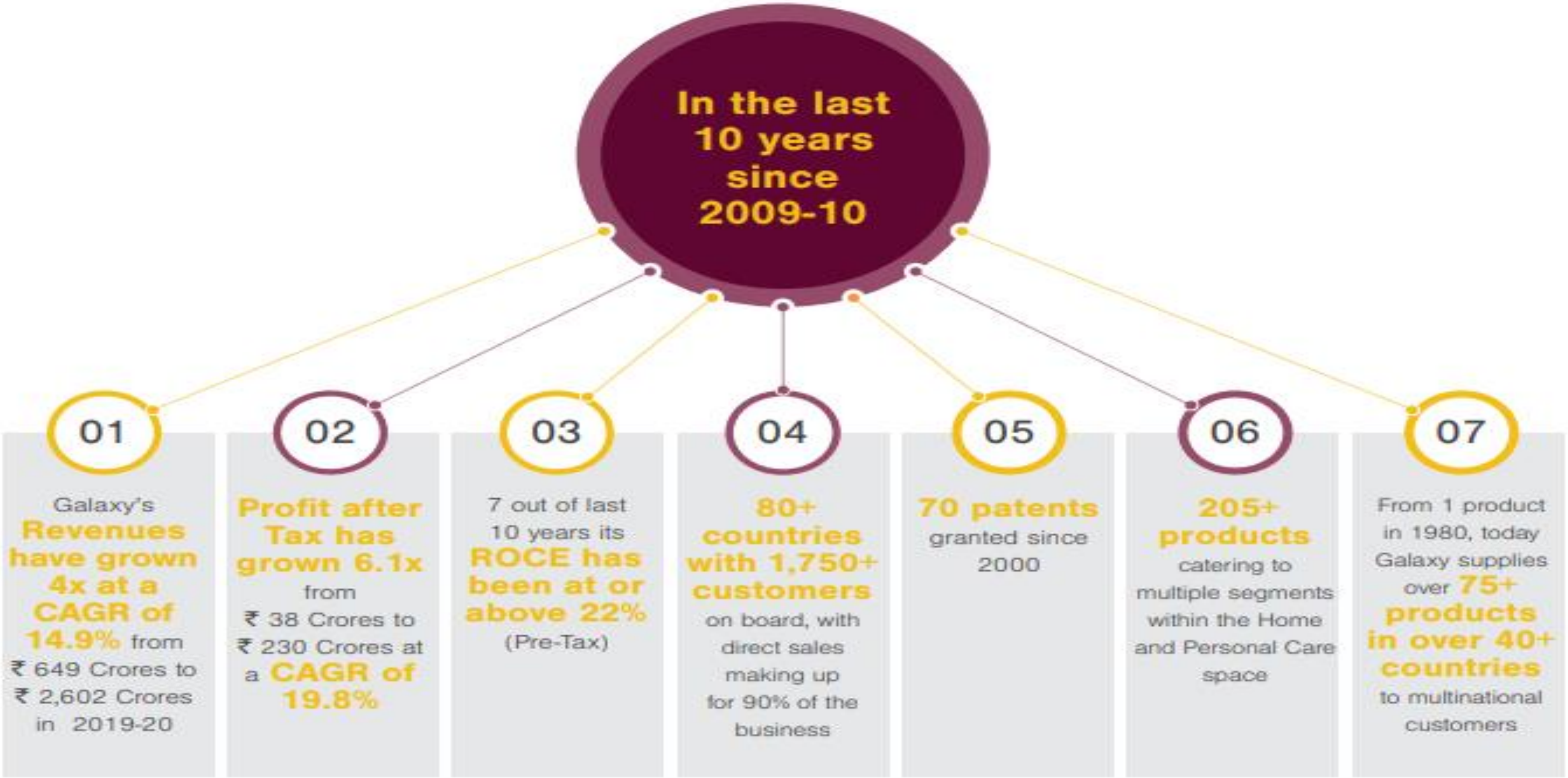
Source: Markets and Markets

Value Chain of Surfactants Industry

Feedstock Suppliers → Ingredient Manufacturers → Applications Specialist → Consumer Product Manufacturers

Company Overview (1/2)

The journey that began in 1980 when 5 friends got together, shall enter its 40th year in 2020. Here is a glimpse of the journey brought to reality by 5 men, who never gave up. Men who stood the test of time, persevered, had the will of steel and the desire to excel at all points of time. A story of commitment, sacrifice, never say die spirit, trust and above all the dream to run a marathon and not just a sprint.



Company Overview (2/2)

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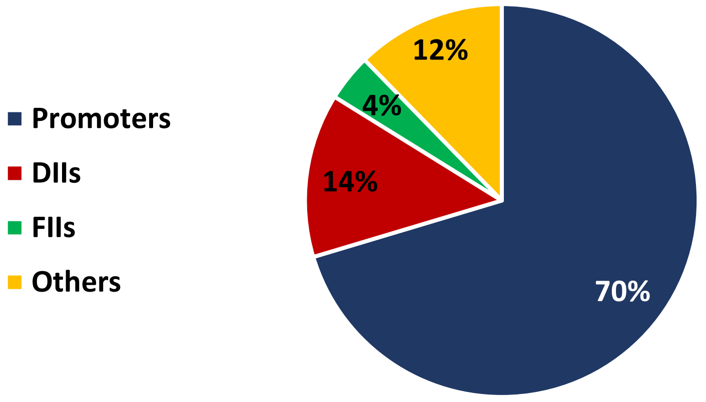
Incorporated in 1986, Galaxy Surfactants Ltd (GSL) (NSE: GALAXYSURF, BSE: 540935) is the leading manufacturer of Performance and Specialty Care Surfactants. These products are used in consumer-centric Home and Personal care products (HPC) like hair care, oral care, skin care, cosmetics, soap, shampoo, lotion, detergent, cleaning products etc.

Currently, GSL's product portfolio comprises over 205+ product grades, which are marketed to more than 1,750+ clientele in over 80+ countries. Product applications are present across Mass, Mass-tige & Prestige range of Customers. GSL has business operations in all types of surfactants.

The company's products have been classified as essential items as they are used for cleaning and sanitizing purposes. Hence no substantial contraction in the demand of the products of the company is expected. Both Performance & Specialty Care segments logged in growth which was ahead of the Industry growth rate in FY20.

Shareholding % as on June 30, 2020



Source: Company Disclosures

Since 2002, the company has won 70 patents. Presently 16 new patent applications are pending worldwide. The current patent breakup is 16/15/4/8 in India/USA/Europe/Rest of the World respectively. In FY 2019-20, a total of 11 patents were granted to GSL, of which 6 were granted in India, 3 in USA, and 2 in Brazil. The company has 7 manufacturing facilities with a cumulative capacity of ~4,36,500 tonnes. Three facilities in Taloja and one each in Tarapur and Jhagadia. Additionally, it has one facility in Suez (Egypt) and one in New Hampshire (USA). The company exports to Africa, Asia Pacific, North and South America and Europe.

The company has also been able to de-risk its raw material sourcing by having multiple vendors from South East Asia. Fatty Alcohol and Fatty Acids, which are Crude Palm Kernel Oil derivatives are the key raw materials and these make up >50% of the company's total raw material buying.

The Investment Thesis on GSL is based on two major factors: 1). The company is one of the established supplier to major FMCG brands and 2). Its growing focus towards high margin specialty products.

Established supplier to major FMCG brands

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Over the years, GSL has evolved from a local supplier catering to an Indian FMCG company to a global supplier to FMCG companies across major geographies.

The company has a strong customer base catering to big names like Cavinkare Pvt Ltd, Colgate-Palmolive (India) Ltd, Dabur India, Henkel, Himalaya, L'Oréal, Procter & Gamble, Reckitt Benckiser, Unilever etc.

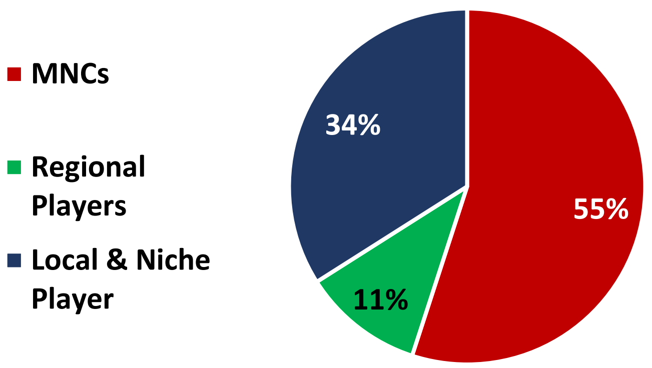
HPC brand owners (FMCG giants) impose strict quality standards on suppliers. GSL is not merely a contract manufacturer but is also closely involved in the HPC product development process with its clientele. This intimate relationship virtually makes GSL a backward integrated facility for a FMCG companies and ensures stickiness of business. GSL has long-term strategic relationships with all of its top 10 customers.

The company has been able to increase its wallet share from existing clients due to its diversified product portfolio, strong R&D capabilities, large-scale manufacturing base, long standing customer relationship and adherence to quality standard.

GSL has successfully diversified its geographical footprint over the years, in addition to consolidating its position in India. The company is present in over 80 countries across key geographies of India, AMET, Americas (North and South) and Europe. This helps to diversify the product risks, geographical risks, economic risks and customer risks.

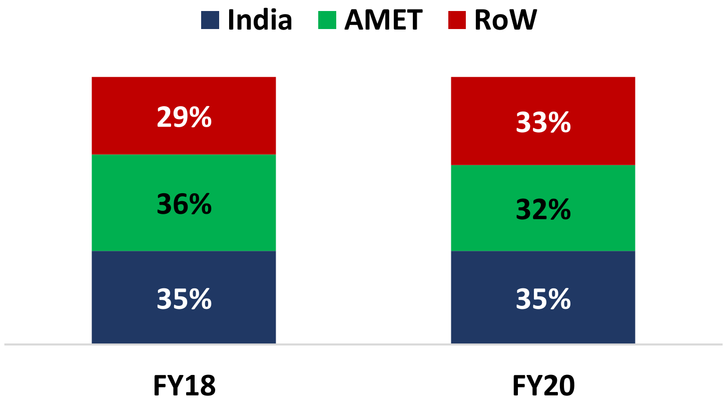
Currently, GSL holds significant ~55% and ~35% market share in India and AMET market respectively in this segment. We believe growth in underpenetrated categories within the HPC industry, higher market share in newer and under-penetrated geographies and ramp up of additional capacity would drive growth in this segment.

FY20 Revenue Contribution



Source: Investor Presentation

Geographical Revenue Breakup



Source: Investor Presentation

Focus on High Margin Specialty Products

GSL's specialty care products have historically offered higher margins vis-à-vis performance surfactants.

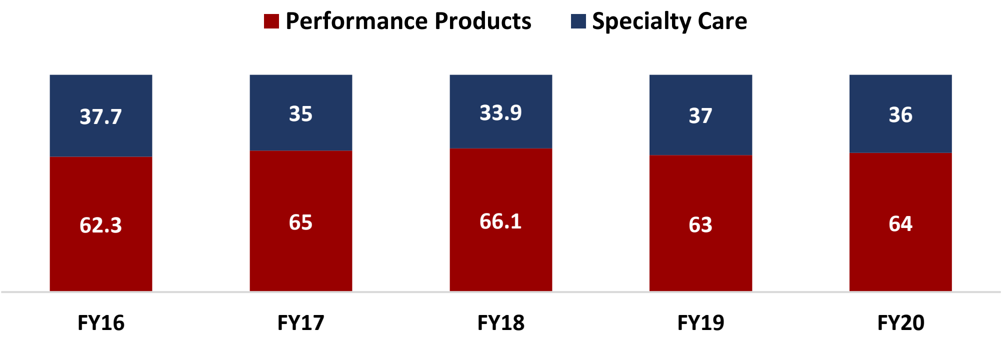
GSL's range of specialty care products currently comprises 160+ products with a number of patents in its final processes. Going forward, the company intends to focus more on increasing the share of specialty care products in its overall sales mix. The company plans to achieve this by cross-selling the same to its existing customers procuring performance surfactants.

The diversity in GSL's product portfolio enables it to provide customized solutions to multinational FMCGs that market varied products across diverse geographies.

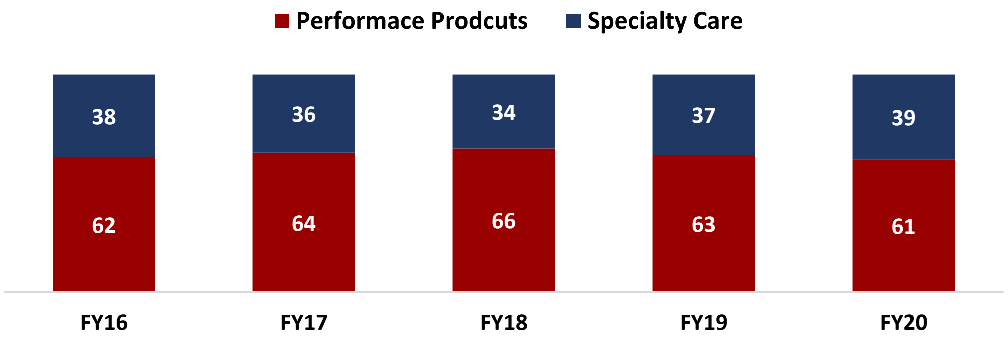
GSL's performance surfactants (65+ products) are primarily utilized as raw materials for end products that can be considered as consumer staples. As these products cater to basic needs such as personal hygiene and sanitation, consumers are often unable or unwilling to cut them out of their budgets regardless of their financial situation. The relatively inelastic demand for these end-products helps ensure a demand for the GSL's products.

On the other hand, specialty care products find applications in end-products designed for the 'prestige' socio-economic segment, where purchasing decisions are often driven by the functionality of the end-product.

Volume Mix (%)



Revenue Mix (%)



Source: 3C Research, Financial Statements

Product Mix

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Category	Product	Examples	Consumer Benefits
Performance Surfactants	Anionic Surfactants	FAES, FAS, LABSA	✓ Foam and Dirt removal properties
	Non-Ionics Surfactants	Ethoxylates	✓ Cosmetics and Personal care products as emulsifiers and solubilisers
Speciality Care Products	Amphoteric Surfactants	Betaines	✓ Dermatological properties to reduces skin irritation
	Cationic Surfactants	Quats	✓ Effective conditioning aids: substantively to hair and antimicrobial properties
	UV Filters	Sunscreen Agents (OMC, OCN &Others)	✓ Absorb or block the harmful radiation, Mild for the skin with Moisturizing
	Preservatives, Preservative Blends	Phenoxyethanol, Preservative Blends, Surfactant Blends	✓ Reduced toxicity & prevent spoilage
	Speciality Ingredients	Mild Surfactants (MS) , Proteins and Syndet & Transparent Bathing Bar Flakes	✓ MS: Cleanse adequately without compromising basic function of skin ✓ Protein: cosmetic industry for conditioning, protection and strengthening of hair/skin, anti-irritancy, moisturization etc
	Fatty Alkanolamides (FA) and Fatty Acid Easters (FAE)		✓ FA & FAE: Foam, viscosity boosters and pearlizer in a formulation
	Other Care Products	Conditioning Agents, Polyquats & Amine Oxides	✓ Improves the quality of another material also called as moisturizers, conditioning benefits to the hair etc

Bifurcation is only for Investor community as every product has different functionality

Source: Investor Presentation

Financial & Business Analysis (1/2)

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	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
Operating Revenue (INR Cr.)	927.50	1,372.50	1,579.57	1,696.67	1,871.79	1,801.43	2,161.34	2,433.91	2,762.99	2,596.38
Operating Profit (INR Cr.)	123.37	117.28	120.82	221.60	194.31	239.50	281.80	297.85	358.05	374.83
Operating Margin (%)	13.30	8.54	7.65	13.06	10.38	13.29	13.04	12.24	12.96	14.44
Consolidated Profit (INR Cr.)	64.69	32.95	0.29	75.25	67.99	101.13	147.62	158.03	190.98	230.41
Net Margin (%)	6.94	2.40	0.02	4.42	3.63	5.60	6.80	6.47	6.89	8.85
Cash EPS (INR)	24.62	17.33	14.18	36.82	31.90	41.28	54.94	58.27	68.32	82.54
Cash From Operating Activities (INR Cr.)	43.33	83.75	54.77	154.67	41.06	169.75	111.04	145.39	282.93	316.15
Free Cash Flow per Share (INR)	-52.36	12.84	1.50	30.87	4.16	39.84	10.40	17.20	20.98	45.78

- Operating revenue of the company has been growing at a CAGR of 12% during FY11-20. Operating profit and PAT have been growing at 13% and 15% respectively during the same period.
- We believe the company will experience stable margins going forward as any fluctuations in raw material costs are easily passed on to customers. Wide business moats have enabled GSL to generate consistent volume over FY15-FY20, while remaining competitive and maintaining customer stickiness, despite fluctuations in commodity and currency prices.
- The coming capacity expansion and higher utilization would support volume growth. GSL's R&D capabilities position it well to innovate and be part of the premiumization trend.
- The company expects to spend normal maintenance capex in FY21 as currently it has no expansion plan. Further as per the management, Performance Surfactants capacity is sufficient for the next 3-4 years' growth while Specialty Care Products to suffice for a longer 7-8 year horizon. With this major investment milestone, company's free cash flows are expected to improve going forward with lower reliance on debt.

Financial & Business Analysis (2/2)

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	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20
Debt to Equity	1.24	1.73	2.00	1.37	1.25	0.93	0.68	0.48	0.34	0.35
ROCE (%)	26.28	16.22	10.49	23.22	19.46	23.36	25.79	24.51	27.38	23.92
ROE (%)	36.61	15.08	0.12	27.76	20.43	25.21	29.04	24.43	23.94	23.70
ROA (%)	11.92	4.11	0.03	7.61	6.54	9.38	12.39	11.56	12.67	13.65
Debtors to sales (%)	14.32	11.39	11.19	12.05	11.82	13.89	16.06	17.18	15.45	16.92
Asset Turnover	1.80	1.80	1.74	1.79	1.88	1.73	1.89	1.80	1.83	1.54
Receivable days	39.53	36.58	36.64	39.35	39.76	45.99	48.50	56.73	55.81	60.88
Inventory Days	41.14	46.42	45.28	42.98	44.49	46.99	44.91	49.14	46.03	47.54
Payable days	34.48	47.21	53.66	49.01	44.03	42.84	42.91	50.40	48.79	49.62

- GSL has been able to reduce its debt over the years. Cash and cash equivalents stood at INR 54.5 Cr. on March 31, 2020.
- High and consistent return ratios reiterate the fact that GSL is not just an ingredient manufacturer. The company enjoys significant bargaining power with its end customers.
- GSL maintains an inventory of 40-50 days. Further, the company has to extend credit of 40-60 days to its customers.
- We believe that while GSL's working capital requirement would increase on account of the increase in the scale of operations, expectations of healthy cash generation would support the incremental working capital requirement needs.
- Continued growth momentum in performance surfactants across markets combined with growing premiumization trends in emerging markets (EM), would enable GSL to generate healthy cash flow and return ratios.

Q1 FY21 Results and Commentary

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	Q1 FY20	Q4 FY20	Q1 FY21	% Change Q-o-Q	% Change Y-o-Y
Revenue (INR Cr.)	665.00	656.70	607.20	-7.50	-8.70
EBITDA (INR Cr.)	96.10	102.60	90.50	-11.80	-5.8
EBITDA Margin (%)	14.40	15.60	14.90	-	-
PAT (INR Cr.)	52.60	62.80	56.50	-10.00	7.50
PAT Margin (%)	7.90	9.60	9.30	-	-

- Strong demand for performance surfactants (+8% YoY) was offset by lower demand for specialty care products (-26% YoY).
- Increased awareness for hygiene, given COVID-19, led to a spike in volume offtake for the former; however, as discretionary spending reduced during the pandemic, the latter suffered a blow.
- Despite a strong demand, labor shortage and lower production by customers (supply constraints) dragged overall volumes of the company.
- Total volumes declined by 5% YoY to 52,000 tonnes predominantly owing to 26% YoY contraction in Specialty Care volumes to 15,000 tonnes. Performance Surfactants (70% of vol mix) grew 8% YoY to 36,000 tonnes.
- Blended volume growth was driven by the Africa/Middle East/Turkey (AMET) market (mainly, Egypt) that grew 10% YoY (42% of volume mix).
- Indian demand (37% of the Q1 volume mix) contracted 2% YoY. April and May 2020 were poor for the Indian market. However, volumes picked up in June.
- Volume declined 27% YoY from the RoW market (rest of the world) that comprised 21% of the Q1 volume mix.
- We expect a faster than anticipated recovery in volumes with improvements in the Egypt and Indian market and buoyant demand for performance surfactants as Covid-19 acts as a tailwind.

Is the industry structurally attractive (1/2)

Barriers to Entry: High. The company operates in an industry where products have to be tailor made as per the customer's requirements. Long-term client relationships, scale of operations, specialization and technological expertise are the major entry barriers for any new player. Specialization enabled GSL to patent its products which makes it difficult for its competitors to capture market share.

Power of Suppliers: Low to Medium. Surfactant manufacturers mostly use petrochemicals (and sometimes oleochemicals) as their feedstock. The feedstock is a set of chemicals like ethylene oxide, linear alkyl benzene and linear alpha olefins which are crude derivatives. Typical suppliers include large petrochemical companies like Reliance or Shell. Ingredient manufacturers like Aarti convert feedstock into surfactant by sulphonation or other processes. This, however, has to be modified according to the final application. Such conversion is carried out by application specialists such as Croda, GSL. Most of these application specialists are also backward integrated. Ingredient manufacturers have limited bargaining power with their suppliers since the price of the feedstock is driven by crude oil price. Application specialists may have some bargaining power with the converters and their margins are slightly higher.

Power of Buyers: Low to Medium. The consumers of GSL's products are global FMCG players and have some bargaining power. These MNCs have stringent quality requirements and if breached would lead to loss of business. Since most of the products of companies in the surfactants sector are critical ingredients for the end user industries, MNCs usually have long-term strategic partnerships for supply of products. Complexity of operations and scale keep the no of players in the surfactants sector low.

Threat of Substitution: Low. Since the quality standards in the industry are strict, clients of the company usually do not switch their suppliers unless there is a significant deterioration in quality. Companies like GSL will have to work closely with their end customers in the HPC product development process as each product is custom made keeping in mind the requirements of the customer's final products.

Regulation: Positive. Developed markets are tightening their import regulations due to environmental concerns and also to protect domestic manufacturers. The regulation which has maximum impact on Indian exports is the European Union's REACH (Registration, Evaluation, Authorization and Restriction of Chemicals). While most scaled up exporters are already in the process of becoming REACH compliant, mid to small scale Indian companies are likely to find this difficult. This would separate the well prepared companies like GSL, which exports its products to 80+ countries, from the rest of the pack and would be a key source of differentiation.

Is the industry structurally attractive (2/2)

Competitive Intensity: Medium. In India, competition is largely price driven and based only to a small extent on product attributes. Bio-surfactants are expensive and would provide higher margins but the Indian market has not yet reached a point where consumers would be willing to pay a higher price for similar functionality.

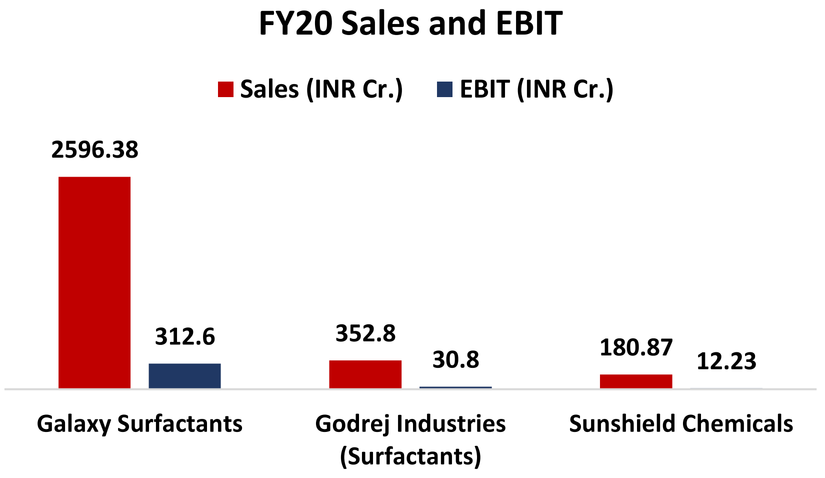
Understandably, for synthetic products, scale and process efficiencies are key to being profitable. Price based competition and accompanying commoditization has driven down margins in many product categories.

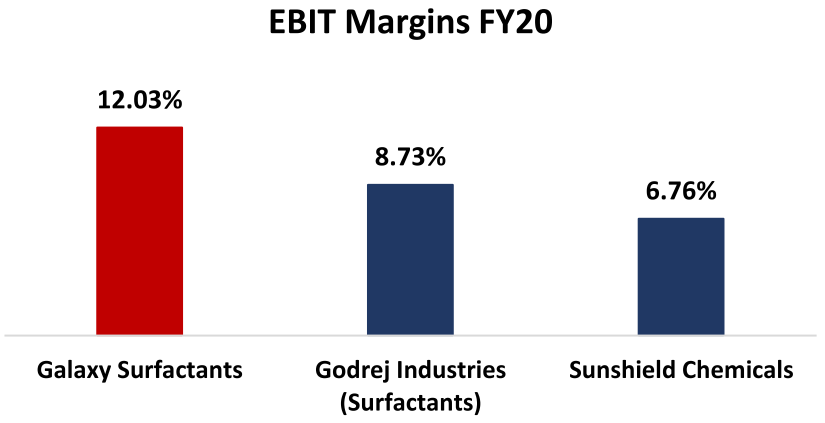
Also, in many cases, scaled up Chinese players with favorable costs structures are affecting the competitiveness of Indian players. In order to survive and succeed in such an environment, scale is necessary to lower unit costs.

However, differentiated players offering specialty surfactants to niche applications such as that in personal care, agrochemicals, paints, textile, oil drilling, etc. are less likely to suffer from margin pressures arising from commoditization.

<u>Demand for surfactants in India is expected to grow at more than twice the global rate. MNCs already present in India (BASF, Croda, Solvay) are focused on consolidating their position, whereas other large global players would look at entering a high-growth market. Building scale and backward integration are two major hindrances most Indian players face in this industry.</u>

Few of the Indian players in the sector are Godrej Industries,, Advance Surfactants, Unitop Chemicals, Venus Ethoxyethers, Sterling Auxiliaries, Sunshield Chemicals (acquired by Solvay) and Viswaat Chemicals.





Source: 3C Research, Financial Statements

Competitive Advantage Assessment

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Sustainable Competitive Advantage: Medium (Global) to High (Domestic) Sustainable Competitive Advantage.

- GSL's long list of clients proves that the company is one of the globally recognised and preferred supplier to leading Multinational, Regional & Local FMCG Brands.
- Since quality, scale, specialization and technological expertise are key differentiations in this industry, GSL stands out as a key player for global MNCs to partner with.
- The company's extensive R&D capabilities is visible in the fact that the company has over 70 patents till date. No of products have increased from 8 in 1980 to 205 in 2020.
- GSL's enjoys wide economic moats from economies of scale and high switching costs due to its specialised nature of operations and products.
- **The last 10 years 2010-20 have seen Galaxy's specialty revenue grow 5x from INR 193 Cr. in 2009-10 to INR 1,000+ Cr. in 2019-20.**
- The company has clearly done the difficult parts like building scale and backward integration. The benefits of these are clearly seen in its industry leading operating metrics.
- These peculiar combinations of technological expertise, patents and long-term client relationships makes the business model of GSL resilient to outside competition.

Risks

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- Any change in negotiations in high MNC customer base can impact margin growth.
- Any disruption in supply chain in raw material pricing and sourcing.
- Delay in capex implementation or plant synchronization (debottlenecking).
- Higher exposure to foreign currency fluctuations as 65% of total volume comes from International markets.

Future Outlook

The segment is expected to witness solid growth, however, profitability would continue to remain challenged in the near term. For Indian players the opportunity lies in the movement towards specialized surfactants. This is also an opportunity for MNCs with capabilities in specialty surfactants to enter the market. With a high growth rate and better margins than conventional surfactants, specialty surfactant presents a ripe opportunity in the Indian surfactants space.

While price competition with Chinese imports is a threat to the domestic industry, the recent developments in **global trade have made more and more companies to look at a China+1 approach.** This provides an opportunity for scaled up Indian players to capture market share from its Chinese counterparts.

GSL over the years has significantly strengthened its business model by improving its R&D capabilities, client relationships, geographical diversification and product mix. This is also visible in the company's stable and constant shift towards high margin specialty surfactants segment.

Growing demand for hygiene products have been a game changer for the company's fortunes. Covid-19 induced lockdown and slowdown have significantly reduced the capabilities of debt ridden and inefficient companies to build scale. As per management commentary, the company does not need capex for both its business segments for the next 4-5 years. This puts GSL in a favorable spot to capture higher market share both in domestic as well as international markets.

Statutory Disclosure

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SEBI Research Analyst Registration No. : INH200006451

1. At the time of writing this article, **the analyst have no position in the stock** covered by this report.
2. The analyst has not traded in the recommended stock in the last 30 days.
3. The research analyst does not have any material conflict of interest at the time of publication of the research report.
4. The research analyst has not received any compensation from the subject company in the past twelve months.
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6. The research analyst has not served as an officer, director or employee of the subject company.
7. The research analyst or research entity has not been engaged in market making activity for the subject company.
8. The research analyst or research entity or its associates or relatives does not have actual/beneficial ownership of one per cent or more in the securities of the subject company, at the end of the month immediately preceding the date of publication of the research report or date of the public appearance.
9. The analyst does not own more than 1% equity in the said company.