Sharekhan
by BNP PARIBAS

Grasim Industries

Standalone profitability comes under pressure

Sector: Diversified

Result Update

	Change
Reco: **Hold**	↔
CMP: **Rs. 734**	
Price Target: **Rs. 803**	↔

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 48,293 cr
52-week high/low:	Rs. 959/636
NSE volume: (No of shares)	19.0 lakh
BSE code:	500300
NSE code:	GRASIM
Sharekhan code:	GRASIM
Free float: (No of shares)	39.4 cr

Shareholding (%)

Promoters	40.2
FII	17.0
DII	22.1
Others	20.8

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	7.0	4.2	-10.9	-14.8
Relative to Sensex	1.5	-4.2	-18.4	-26.2

Sharekhan Research, Bloomberg

Grasim Industries Limited's (Grasim) adjusted standalone net profit declined by 35.5% y-o-y to Rs. 526.5 crore on account of weak operating profit margin (OPM) in both viscose and chemical divisions. The VSF division was affected by global capacity overhang, elevated further by U.S.-China trade war. Caustic soda also performed poorly on the operational front owing to increased domestic capacity and weak demand. Exit prices for both VSF and caustic soda are lower, which is expected to put pressure on its standalone operations. Going ahead, with its capacity expansion plans in both verticals, the company expects to see gradual improvement in profitability. On the other hand, the key overhang on Grasim related to the funding of Vodafone Idea remains, as management would consider fund infusion at the time it arises. We have lowered our standalone estimates for FY2020-FY2021, factoring weak profitability in the VSF and chemical divisions. On account of increasing losses in Vodafone Idea, its rising funding requirements and little clarity emerging from Grasim's management on funding Vodafone Idea, we continue to maintain our Hold rating on the stock with an unchanged SOTP-based price target (PT) of Rs. 803.

Key Positives

- Lower pulp prices benefits to be visible in VSF profitability in the coming quarters.
- Capacity expansion plans in the standalone business remain on track with longer term view.

Key Negatives

- Exit prices for VSF and caustic soda are down, which may affect profitability in Q3FY2020.
- Clarity on funding Vodafone Idea not emerging yet.

Our call

Valuation – Maintain Hold with unchanged PT of Rs. 803: Grasim's standalone business verticals, VSF and chemical divisions are expected to face pressure on profitability in the near term with exit prices of VSF and caustic soda trading lower. We have lowered our standalone net earnings estimates for FY2020-FY2021, factoring lower profitability of VSF and chemical divisions due to weak demand, capacity overhang and continuing U.S.-China trade war. Management has not been able to clarify on Grasim's funding requirement on Vodafone Idea and will be deciding as and when the need arises. We continue to believe it to be a key hangover on the stock with rising Vodafone Idea losses and increasing funding requirement. Hence, at this stage, we retain our Hold rating on the stock with an unchanged SOTP-based PT of Rs. 803.

Key Risks

Funding requirement of its investment in Vodafone Idea is a key hangover.

Valuation (standalone) — **Rs cr**

Particulars	FY18	FY19	FY20E	FY21E
Revenue	15,786	20,550	20,506	24,493
OPM (%)	19.5	19.8	17.3	17.9
Adjusted PAT	1,897	2,883	2,150	2,668
% YoY growth	21.6	52.0	(25.4)	24.1
Adjusted EPS (Rs.)	28.9	43.9	32.8	40.6
P/E (x)	25.4	16.7	22.5	18.1
P/B (x)	1.1	1.2	1.1	1.0
EV/EBITDA (x)	5.7	5.6	6.5	5.3
RoNW (%)	4.3	6.9	4.9	5.7
RoCE (%)	5.8	6.0	4.4	5.2

Source: Company; Sharekhan estimates

Operating margin pressure on both viscose and chemical dents net earnings

Grasim reported a 6.3% y-o-y decline in its standalone net sales to Rs. 4,797 crore (lower than our estimate) for Q2FY2020 mainly led by pressure on realisation in viscose (down 9% y-o-y) and chemical (down 11% y-o-y). Realisations in viscose remained under pressure owing to softening global VSF prices on account of capacity overhang and U.S.-China trade war. Caustic soda realisation was affected by weak demand in China and Asia along with increased domestic capacity and lower demand. Consequently, OPM contracted by 714 BPS y-o-y to 13.7% as both viscose and chemical verticals reported lower margins. Hence, standalone operating profit declined by 38% y-o-y, which was lower than our estimate. Further, higher interest and depreciation led to adjusted net profit declining by 35.5% y-o-y to Rs. 526.5 crore.

Capacity expansion plan of Rs. 7,749 crore for the standalone business

Grasim is expanding its capacities in viscose and chemical divisions with standalone capex plan of Rs. 7,749 crore, of which it has expensed Rs. 1,136 crore in H1FY2020 (Rs. 2,678 crore in H2FY2020 and Rs. 3,935 crore from FY2021). VSF capacity will be increased to 788KTPA by FY2021 from the current 565KTPA, while caustic soda capacity will be increased to 1457KTPA from the current 1147KTPA. However, incremental capacities will be added during H2FY2021 till which time it will be facing capacity constraint as both verticals are currently operating at near full capacity utilisations.

Key Conference Call Takeaways

- **VSF realisation decline:** VSF realisation during the quarter was affected by softening of global VSF prices on account of capacity overhang and continuing U.S.-China trade war. Domestic VSF demand was affected by increased yarn imports. The benefit of lower pulp prices will be visible in Q4FY2020 due to lag of six months in sourcing.
- **Chemical realisation declines:** Global caustic soda prices were affected by weak demand in China and Asia. Domestic caustic soda prices saw a steep decline due to increased supply and demand slowdown. Chlorine prices continued to be negative for two consecutive quarters, led by excess supply from new capacities. Management expects chlorine realisation to ease over the next one year. The company would focus on increasing chlorine derivatives to offset lower ECU realisation of the chemical division. Management expects value-added products to go to ~45% from the current 28% share over the next five years.
- **Vodafone Idea:** Management states that Grasim does not have any corporate guarantee or agreement with Vodafone Idea in case any adverse situation arises in Vodafone Idea going ahead. Management also stated that Grasim and UltraTech would not have any rating downgrade impact if Vodafone Idea does not perform. The call on infusing and maintaining stake in Vodafone Idea will be taken at the time when the situation arises.

Results (standalone)					Rs cr
Particulars	**Q2FY20**	**Q2FY19**	**yoy %**	**Q1FY20**	**QoQ %**
Net sales	**4,797**	**5,118**	**-6.3%**	**5,001**	**-4.1%**
Total expenditure	4,138.1	4,049.8	2.2%	4,156.9	-0.5%
Operating profit	**659**	**1,069**	**-38.3%**	**844**	**-21.9%**
Other Income	286.2	283.6	0.9%	84.7	238.0%
EBIDTA	945.5	1,352.3	-30.1%	928.4	1.8%
Interest	86.1	52.2	65.0%	78.0	10.3%
PBDT	859.5	1,300.2	-33.9%	850.4	1.1%
Depreciation	208.5	187.4	11.2%	203.2	2.6%
Extraordinary item	-	2,003.4		237.8	
PBT	**651.0**	**(890.6)**	**-**	**409.4**	**59.0%**
Tax	124.5	296.0	-57.9%	207.7	-40.1%
Reported PAT	**526.5**	**(1,186.6)**	**-**	**201.7**	**161.0%**
Extraordinary item	-	2,003.4	-	237.8	-
Adjusted PAT	**526.5**	**816.7**	**-35.5%**	**439.5**	**19.8%**
EPS (Rs.)	8.0	12.4	-35.5%	6.7	19.8%
Margim (%)			**BPS**		**BPS**
Operating margin	13.7%	20.9%	-714	16.9%	-313
Net Margin	11.0%	16.0%	-498	8.8%	219
Tax rate	19.1%	-33.2%	-	50.7%	-

Source: Company; Sharekhan Research

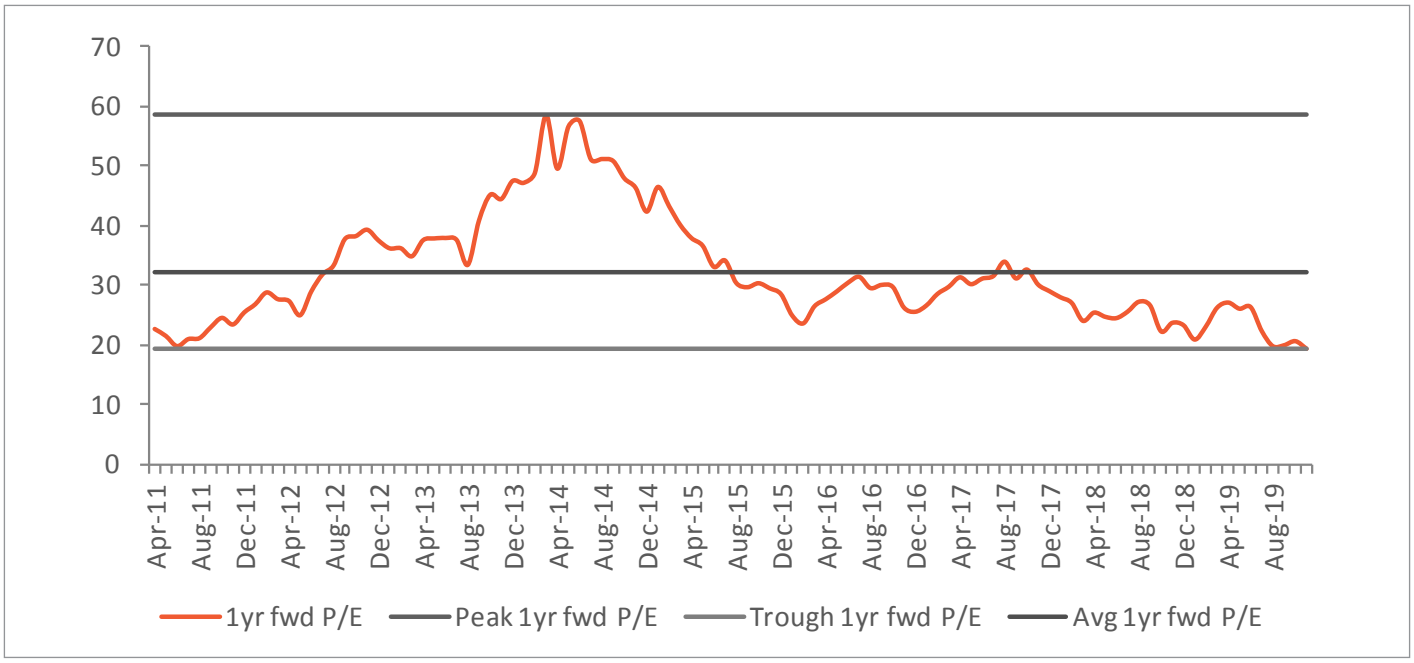
Outlook

Near-term outlook challenging: Lower exit prices for VSF and caustic soda are expected to put pressure on OPM in Grasim's VSF and chemical divisions in the near term. However, lower pulp prices are expected to provide some respite to the VSF division in the coming quarters on account of lag effect of sourcing pulp from overseas. The caustic division may remain under pressure for a year due to incremental capacity additions and weak demand. Management is going ahead with capacity expansion plans for the VSF and chemical divisions, which would commence operations from H1FY2021. The company is taking initiatives to increase contribution from value-added products to wither near-term headwinds.

Valuation

Maintain Hold with unchanged PT of Rs. 803: Grasim's standalone business verticals, VSF and chemical divisions, are expected to face pressure on profitability in the near term with exit prices of VSF and caustic soda trading lower. We have lowered our standalone net earnings estimates for FY2020-FY2021, factoring lower profitability of VSF and chemical divisions due to weak demand, capacity overhang and continuing U.S.-China trade war. Management has not been able to clarify on Grasim's funding requirement on Vodafone Idea and will be deciding as and when the need arises. We continue to believe it to be a key hangover on the stock with rising Vodafone Idea losses and increasing funding requirement. Hence, at this stage, we retain our Hold rating on the stock with an unchanged SOTP-based PT of Rs. 803.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Grasim is the flagship company of Aditya Birla Group. The company started as a textiles manufacturer in India in 1947. The cement business was started in 1985 with capacity of 0.5 MTPA. Aditya Birla Nuvo Limited, an Aditya Birla Group Company, was merged with Grasim w.e.f. July 1, 2017. Subsequently, the financial services business was demerged from the merged entity and was listed on the bourses as Aditya Birla Capital Limited (ABCL) on September 1, 2017. Currently, it is a leading global player in VSF, and is the largest chemicals (Chlor-Alkalis), largest cement producer and diversified financial services (NBFC, Asset Management and Life Insurance) player in India.

Investment theme

Grasim has been underperforming due to its exposure in Vodafone Idea with 11.55% stake. Vodafone Idea's highly leveraged balance sheet, weak telecom outlook and delay in monetisation of assets may lead to further capital infusion by FY2021 from its stakeholders, including Grasim, to retain its stake. This is expected to lead to erosion in liquid investments or higher leverage at Grasim standalone. Further, weak macro environment is expected to lead to underperformance of ABCL (56% Grasim stake) in the near term. Hence, UltraTech remains a safe bet, which comprises major value of Grasim's SOTP. We believe investors can directly have exposure in UltraTech, which has no overhangs and a better earnings growth outlook over the next two years. Hence, we have a Hold rating on Grasim.

Key Risks

- Funding requirements of its other listed entities.
- Pressure on VSF and chemical division's demand and/or realisations affects profitability negatively.
- Higher holding company discounts for any of its other business such as telecom, cement and financial services.

Additional Data

Key management personnel

Mr. Kumar Mangalam Birla	Chairman
Mr. Dilip Gaur	Managing Director
Mr. Ashish Adukia	Chief Financial Officer
Mrs. Hutokshi R Wadia	Company Secretary

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Birla Group Holdings Pvt. Ltd.	19
2	Life Insurance Corp. of India	10.78
3	IGH Holdings Pvt. Ltd.	5.09
4	Hindalco Industries Ltd.	4.29
5	Umang Commercial Co Ltd.	4.07
6	Standard Life Aberdeen PLC	3.98
7	Pilani Investment & Industries Corp.	3.69
8	Franklin Resources Inc.	1.87
9	The Vanguard Group Inc.	1.78
10	BlackRock Inc.	1.58

Source: Bloomberg

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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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