Star Cement (STRCEM IN)

Not a subsidy-driven business model any more

INDIA | CEMENT | Initiating Coverage

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A leading NE-based manufacturer with ambitions to move east
Star Cement is among the leading manufacturers in the northeast region with long-term ambitions to be a holistic east-India manufacturer. It may take time for Star to move deep into the east, but its niche positioning in the NE region will be its long-term advantage.

Its agenda is to sell a brand (not a commodity)
Star's branding expenses are steep, given that its key business strategy is to focus on branding and garner better brand premium. It has the highest relative spends (among all cement manufacturers) on advertisement, publicity and branding, even vs. pan-India majors (Star's expenses are 4-5x higher while its scale is just about 10-15% of these majors) who tend to have a high focus on branding given their scale of operations.

Branding has helped Star differentiate its realisation matrix
Since FY14, Star's average realisations are way ahead of the industry. They are 50% higher than the industry's realisations and over 35% higher than the blended realisations of its only comparable listed peer Dalmia Bharat – who also has a similar scale in NE. Though the realisations premium can be due to the fact that entry is difficult for newer manufacturers in NE, it is also a clear indication that Star has been able to reap the benefits of its significantly high branding expenses.

Driven by realisations, Star's EBITDA/tonne is the highest in the industry
Driven by the gap in realisations premiums, and even after adjusting for subsidy benefits, which Star has enjoyed, over the past five years, Star's average EBITDA/tonne is at a premium of over 25% to the industry's. Its positioning in the 'most premium' category is the only differentiating factor.

Subsidy-oriented business model now collapsed, business dynamics are now competitive
Historically, the cement businesses in NE regions were driven by subsidy and incentives offered by central/state governments. We understand that Star Cement was no different in its initial formation stages. We estimate that the average subsidy available to Star was Rs 700/tonne, which has now collapsed. Despite this, it has maintained its EBITDA/tonne way ahead of the industry – upwards of Rs 1,600/tonne. Star's consistent and concentrated focus on branding helped it develop a niche – difficult for competitors to overcome.

Ambitious to grow in scale, but will limit its presence to the east
Star has already announced a capex of about 2mn tonnes in east India, likely to be commissioned by FY20, which would support its future volume growth and help it to explore new geographies. However, this is unlikely to aid profit margins.

Risks
Limited scalability options and excessive dependence on a single region.

Outlook
We initiate on Star with a BUY and target of Rs140. Its uniqueness and its ability to maintain very high profitability vis-à-vis industry peers, despite adjusting for subsidy benefits, is its unique strength. Hence, Star's valuation premium remains justified. At our target, Star will trade at an EV/tonne of about US$ 160 vs. US$ 137 currently (FY20 earnings).

BUY
CMP RS 127

TARGET RS 150 (+18%)

COMPANY DATA

O/S SHARES (MN) :	419
MARKET CAP (RSBN) :	53
MARKET CAP (USDBN) :	0.8
52 - WK HI/LO (RS) :	351 / 68
LIQUIDITY 3M (USDMN) :	1.4
PAR VALUE (RS) :	1

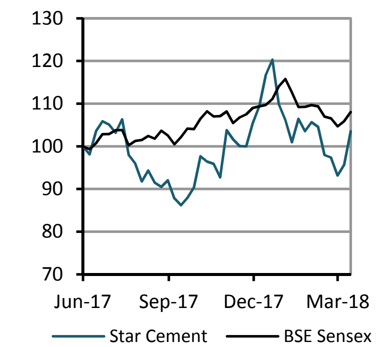
SHARE HOLDING PATTERN, %

	Dec 17	Sep 17	Jun 17
PROMOTERS :	73.3	74.6	74.9
FII / NRI :	2.0	0.4	0.1
FI / MF :	2.6	1.6	1.2
NON PRO :	14.8	15.6	15.8
PUBLIC & OTHERS :	7.3	7.7	8.0

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	7.4	-12.9	Na
REL TO BSE	6.0	-11.0	Na

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY18E	FY19E	FY20E
Net Sales	15,945	17,978	20,270
EBIDTA	4,837	4,980	5,333
Net Profit	2,536	2,963	3,111
EPS, Rs	6.0	7.1	7.4
PER, x	21.0	18.0	17.1
EV/EBIDTA, x	11.9	11.7	11.2
P/BV, x	3.6	3.0	2.5
ROE, %	17.1	16.7	14.9
Debt/Equity (%)	30.7	30.7	32.7

Source: PhillipCapital India Research Est.

About Star Cement

- Leading cement manufacturer in the NE region
- Current capacity: About 4.4mn tonnes
- Capacity has increased +10x since it commissioned its operations in FY05.
- Most of its current capacities are in the NE region, but its long-term business plan is to be an east-India regional leader.
- 'Branding' is a key focus area. The management's mantra is to never compromise on the brand value and remain a market leader in terms of pricing. We believe Star's management is logical in protecting its brand premiums.

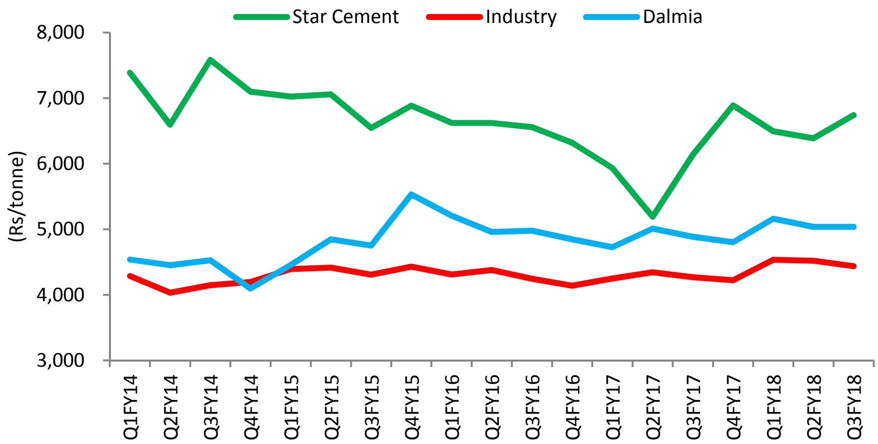
Star's branding expenses are way ahead of peers…

Even though Star's capacity is only 4mn tonnes, a fraction of the capacity of most pan-India majors, its brand expenses (per tonne) is nearly 4x their expenses. While pan-India majors tend to spend Rs 40-60/tonne on branding and advertising, Star Cement's spend remains as high as Rs 160-200/tonne.

…but translate into better 'sustainable' realisations, which is the key

Star's brand spends, to us, appears rational, as its brand realisations are way ahead of industry peers. This is not just about the brand spends, but also its approach – to keep its channel happy. On an average, Star's average realisations are at a premium of more than 50% to the industry and over 35% to its only regional comparable and listed peer, Dalmia Bharat.

Star vs. industry and Dalmia Bharat on blended realisations



Source: Company, PhillipCapital India Research

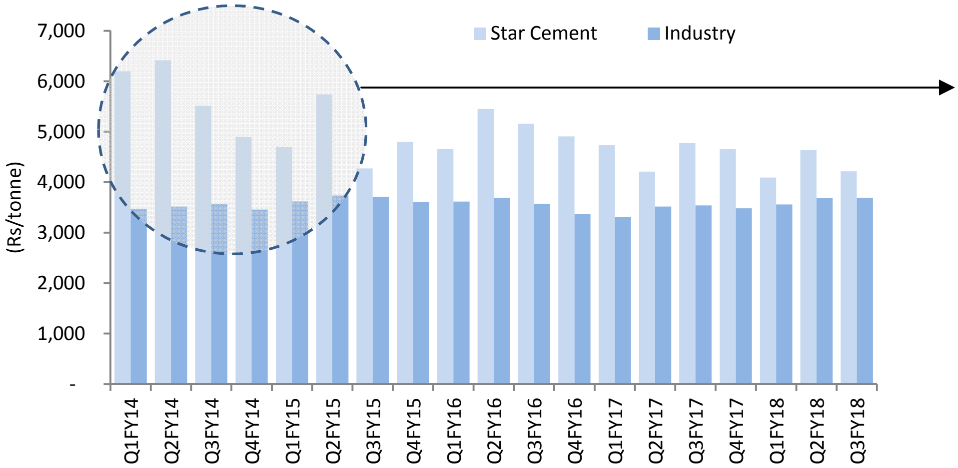
Star Cement enjoys the highest realisations in the industry and this is the key reason for its significantly better EBITDA/tonne – this proves that brand premiums are real and can help differentiate the profit margins

Though a part of this brand premium could come from entry barriers into the NE region and tough operating conditions (which keeps costs high too), it will be unfair to say that there is no competition in the NE. In our visits to NE India, which incidentally constitute less than 4% of the all-India capacity, we found as many as 25 different brands!

Gap in opex for Star is now substantially bridged

NE is a very difficult terrain to operate in – a tough region. Here, securing local support is very important for successful and smooth operations. When Star Cement was very small and only a pure NE-based manufacturer, the gap in its opex vs. the industry used to be almost double. However, with larger scale of operations, better volumes, and its foray into other parts of east India, we can see that this gap has narrowed greatly. Maintaining the stability of this cost curve will be crucial and an advantage, which will play in favour of Star – if it is able to simultaneously maintain brand premiums.

Star vs. industry on opex



Source: Company, PhillipCapital India Research

Star's gap in opex/tonne to industry has significantly bridged over the past few years driven by its larger and more efficient scale of operations

Star's EBITDA/tonne will continue to be way ahead of the industry
Driven by significantly better realisations and rationalisation of opex (in line with industry parameters), we expect Star Cement's EBITDA at upwards of Rs 1,600 – almost double the EBITDA we expect for the industry.

Star's subsidy driven business model has collapsed
NE is a peculiar region, where numerous state and central government subsidies drove the spree of cement capacity additions. The cement demand of this market is less than 10mn tonnes, and we observed during our ground visits that more than 25 brands are present here. New businesses in this region used to enjoy numerous subsidies such as capital subsidies, interest-rate subsides, excise exemptions, freight subsidies, and income-tax rebates. The revenue subsidy for most players used to vary between Rs 600-800/tonne. Driven by these incentives and availability of limestone reserves in Meghalaya, many cement manufacturers and brands were established. As per our understanding, Star Cement was also established for a similar reason, but since then, its promoters have envisaged making Star the leading cement manufacturer and a brand in the NE region.

Today, the subsidy-driven business model has collapsed for Star. Subsidy benefits are no longer the same as before, and a major chunk of these benefits have already lapsed. Going forward, Star will be just like any other cement manufacturer. Though about Rs 7bn, the balance of subsidy receivable, will flow in for Star, it will no longer be a driving force.

Initiate with BUY: We remain impressed by Star's to command significantly better EBITDA premiums, the only key reason for its rich valuations. We initiate with a BUY and with a potential upside of 18%. We have valued the company at 14x EV/EBITDA. We have valued the subsidy receivables at book value.

Financials

Consolidated Income Statement

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Net sales	**17,280**	**15,945**	**17,978**	**20,270**
Growth, %	1	-8	13	13
Total income	17,280	15,945	17,978	20,270
Raw material expenses	-4,144	-2,900	-3,306	-3,770
Employee expenses	-1,185	-1,094	-1,239	-1,404
Other Operating expenses	-7,863	-7,115	-8,452	-9,762
EBITDA (Core)	**4,088**	**4,837**	**4,980**	**5,333**
Growth, %	2.4	18.3	3.0	7.1
Margin, %	23.7	30.3	27.7	26.3
Depreciation	-1,412	-1,368	-1,487	-1,486
EBIT	**2,676**	**3,469**	**3,493**	**3,847**
Growth, %	17.4	29.6	0.7	10.1
Margin, %	15.5	21.8	19.4	19.0
Interest paid	-780	-641	-188	-302
Other Non-Operating Income	22	24	26	29
Pre-tax profit	**1,918**	**2,851**	**3,332**	**3,575**
Tax provided	-143	-228	-267	-357
Profit after tax	**1,775**	**2,623**	**3,065**	**3,217**
Others (Minorities, Associates)	-59	-87	-102	-107
Net Profit	**1,716**	**2,536**	**2,963**	**3,111**
Growth, %	27.5	47.8	16.8	5.0
Net Profit (adjusted)	**1,716**	**2,536**	**2,963**	**3,111**
Unadj. shares (m)	419	419	419	419
Wtd avg shares (m)	419	419	419	419

Balance Sheet

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Cash & bank	201	201	201	201
Debtors	3,995	4,092	5,072	6,287
Inventory	1,612	1,726	2,140	2,653
Loans & advances	9,735	7,843	9,412	11,318
Other current assets	3	3	3	3
Total current assets	15,546	13,865	16,828	20,462
Investments	17	17	17	17
Gross fixed assets	8,632	9,183	10,183	12,683
Add: Capital WIP	549	1,000	1,500	500
Net fixed assets	9,181	10,183	11,683	13,183
Total assets	**24,744**	**24,064**	**28,527**	**33,661**
Current liabilities	4,091	3,809	4,292	4,837
Provisions	49	46	52	59
Total current liabilities	4,140	3,855	4,344	4,895
Non-current liabilities	7,734	4,716	5,625	6,991
Total liabilities	11,874	8,571	9,970	11,886
Paid-up capital	419	419	419	419
Reserves & surplus	11,861	14,397	17,360	20,471
Shareholders' equity	12,869	15,493	18,558	21,775
Total equity & liabilities	**24,744**	**24,064**	**28,527**	**33,661**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY17	FY18E	FY19E	FY20E
Pre-tax profit	1,918	2,851	3,332	3,575
Depreciation	1,412	1,368	1,487	1,486
Chg in working capital	-1,516	1,396	-2,474	-3,083
Total tax paid	-97	-228	-267	-357
Cash flow from operating activities	**1,718**	**5,387**	**2,078**	**1,621**
Capital expenditure	-912	-2,369	-2,987	-2,986
Chg in investments	-1	0	0	0
Other investing activities	10	0	0	0
Cash flow from investing activities	**-903**	**-2,369**	**-2,987**	**-2,986**
Free cash flow	814	3,018	-909	-1,365
Debt raised/(repaid)	-851	-3,018	909	1,365
Cash flow from financing activities	**-851**	**-3,018**	**909**	**1,365**
Net chg in cash	-37	0	0	0
Pre-tax profit	1,918	2,851	3,332	3,575

Valuation Ratios

	FY17	FY18E	FY19E	FY20E
Per Share data				
EPS (INR)	4.1	6.0	7.1	7.4
Growth, %	27.5	47.8	16.8	5.0
Book NAV/share (INR)	29.3	35.3	42.4	49.8
FDEPS (INR)	4.1	6.0	7.1	7.4
CEPS (INR)	7.5	9.3	10.6	11.0
CFPS (INR)	4.0	12.8	4.9	3.8
Return ratios				
Return on assets (%)	10.3	13.4	12.4	11.3
Return on equity (%)	14.0	17.1	16.7	14.9
Return on capital employed (%)	12.7	16.0	14.6	13.3
Turnover ratios				
Asset turnover (x)	0.9	0.8	0.8	0.8
Sales/Total assets (x)	0.7	0.7	0.7	0.7
Sales/Net FA (x)	1.8	1.6	1.6	1.6
Working capital/Sales (x)	0.7	0.6	0.7	0.8
Receivable days	84.4	93.7	103.0	113.2
Inventory days	34.1	39.5	43.4	47.8
Payable days	25.9	28.7	27.6	27.1
Working capital days	237.7	225.6	250.4	277.7
Liquidity ratios				
Current ratio (x)	3.8	3.6	3.9	4.2
Quick ratio (x)	3.4	3.2	3.4	3.7
Interest cover (x)	3.4	5.4	18.5	12.8
Total debt/Equity (%)	61.7	30.7	30.7	32.7
Net debt/Equity (%)	60.0	29.4	29.6	31.7
Valuation				
PER (x)	31.0	21.0	18.0	17.1
PEG (x) - y-o-y growth	1.1	0.4	1.1	3.4
Price/Book (x)	4.3	3.6	3.0	2.5
EV/Net sales (x)	3.5	3.6	3.3	3.0
EV/EBITDA (x)	14.8	11.9	11.7	11.2
EV/EBIT (x)	22.7	16.6	16.7	15.6