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CEMENT STOCKS

The foundation is good, but...

The cement industry expects growth to improve to 9-10 per cent this fiscal. But as concerns of excess capacity persist even as valuations have run up sharply, investors should tread cautiously.

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Cement was among the key sectors that delivered riches for investors from the March lows. The basket of 15 key cement stocks has doubled, outperforming the Sensex return of 87 per cent.

A closer look, however, reveals that the mid and small-cap stocks in the space delivered the most gains. Stocks that languished at rock-bottom valuations of 1.5-3 times earnings in March – Mangalam Cement, Gujarat Sidhee Cement, Dalmia Cements, Birla Corporation, Madras Cements, Andhra Cements and JK Lakshmi Cements – were the out-performers.

Frontline stocks Ambuja Cement (up 44 per cent), Ultra Tech (56 per cent) and Grasim Industries (70 per cent return) actually trailed the Sensex. The euphoria surrounding cement stocks appears to be more a function of the fancy for low-PE stocks than runaway optimism about the sector itself. But are the current valuations justified by the sector's fundamentals?

Well, the larger cement stocks look reasonably valued, given the demand prospects. But caution may need to be exercised on the mid-size and smaller companies.

EARLY RECOVERY

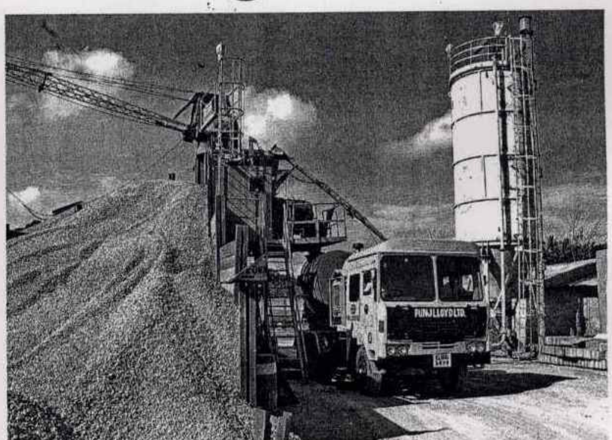
An analysis of despatches and price trends over the past year suggests that cement was among the earliest sectors to show the signs of recovery amid the slowdown. After a blip in August 2008, when y-o-y growth slipped to 4 per cent from 15 per cent the previous year, there was a significant recovery in the months that followed.

The industry ended 2008-09 with an 8.3 per cent growth in despatches, actually higher than the previous year's 8.1 per cent. 2009-10 saw a good start with April reporting 11 per cent growth in despatches. Despatch numbers for May too have shown reasonable growth. If other core sectors, such as steel, didn't do too well, what drove cement consumption?

Players say while demand from the urban centres flagged, it picked up in the rural and semi-urban areas. While construction activity in the realty sector did slow down, public spending on infrastructure, aided by three instalments of stimulus, helped demand.

The last two stimulus rounds were intended mainly to push through projects hit by delays in financial closure. The refinancing of such projects through IIFCL possibly helped speed up progress on some of these projects, helping cement off-take. Grasim Industries and UltraTech Cement capitalised most on this demand spurt.

Over the March '08 quarter, the despatch numbers for March '09 for Grasim Industries were up by 10 per cent. UltraTech Cement too reported 9.3 per cent growth. ACC and Ambuja Cements saw comparatively lower 6.6 per cent and 5.8 per cent growth respectively in the period.



There are an increasing number of drivers for cement demand growth.

NEW CAPACITY, A CONCERN?

The cement industry has grown at an average 8 per cent in the last three years. The industry expects this to improve to 9-10 per cent this fiscal. The expected drivers are many.

One, the National Highways Development Programme, which made slow progress under the previous UPA regime, is expected to get high priority now, and this may translate into much higher cement demand.

Two, despatches growth, which benefited mainly from infrastructure building in the last few months may get a boost if the real estate sector does indeed return to its high growth path. Hopes of demand reviving for mid-priced and budget homes, which has spurred realty stocks, are also a positive driver for the sector.

However, even an improved growth rate may not be enough to absorb the scheduled 50 million tonnes per annum of new capacities that are to be added this year. With demand expected to grow at 10 per cent and the despatches for the full FY09 at 181 million tonnes, there will be an excess of almost 32million tonnes in the market by end of 2009-10.

But, again, as new capacities may contribute only in a phased manner, the entire 50 million tonnes may not make it to the market this year. Companies may also mull rescheduling their capex plans if signals of surplus supply start coming in, to avoid significant price cuts.

In any case, if not this year, surplus supply will become a key challenge for cement producers over the next couple of years. While the pockets in the West and North that promise higher off-take with limited additions will be shielded to an extent, one needs to take a cautious view of smaller players, especially those in the southern market.

LOWER COST PRESSURES?

On the positive side, cost pressures for cement companies have eased with coal and oil prices having come down from their highs of last year. The correction in global freight rates has further helped reduce landed cost of coal. The major coal importers in the cement space are Ambuja, UltraTech and India Cements.

With India Cements' March '09 quarter numbers not yet announced Ambuja Cement, Grasim and UltraTech Cement have seen significant sequential expansions in operating margins. In the small-cap space, the OPMs of JK Lakshmi Cement, Binani Cement and Dalmia Cement improved considerably (by over 5 per cent points)in March '09 over the previous quarter. The ramp-up in captive power capacity by most players may also help in significant cost savings. UltraTech Cement commissioned 192 mega-watt thermal power plant in the March '09 quarter (total captive power now at 236 MW).

Grasim Industries has commissioned four thermal power plants with a total capacity of 144 mega-watts (total captive power at 268 MW) this year. Similarly, ACC and Ambuja Cements too have been pumping up captive power. Going forward, the consideration of a price hike by Coal India and de-regulation of oil price by the Oil Ministry might add to costs in the coming quarters.

An early recovery in both volumes and prices prompted investors to begin a re-rating of cement stocks much ahead of the broader market recovery. The larger cement stocks (over Rs 7,000 crore market cap) are now at valuations (trailing PE) of around 10-13 times, with the price-earning ratio rising an average three times since March 9.

ARE VALUATIONS JUSTIFIED?

However, these stocks are at a sizeable discount to their valuations at the highs of 2007. Grasim Industries was trading at 21 times last December and is now at 14 times. UltraTech, then at 16 times, is now at 9. ACC and Ambuja Cements too are considerably marked down. Seen in terms of enterprise value (EV), valuations seem justified. The EV per tonne of the big players is at a moderate Rs 6,400 per tonne, still below the Rs 9,000 per tonne at 2007-end. However, one needs to be careful with the smaller stocks in the sector as they have seen a very sharp run-up (of over 100 per cent) in a short time-frame. For instance, Gujarat Sidhee Cements' PE has risen from three times in March to eight times now.

Similarly Dalmia Cements, Andhra Cements and Prism Cement too saw their PEs jump more than four-eight times.

When the market is flooded with new capacities, smaller players may face greater pressure from lower capacity utilisation, if their region of operations witnesses a surplus. Further, some of these stocks are now either close to, or have already shot up over, their 2007 peak valuation.

There are, however, even now some smaller players that continue to be attractive on an EV per tonne basis. That may serve as a trigger to consolidation. For example, the enterprise value for Gujarat Sidhee Cement is just Rs 1,690 per tonne (Rs 6,275/tonne in December 2007), Mangalam Cement's EV is Rs 2,651 per tonne (Rs 4,384 per tonne in December 2007) and JK Lakshmi Cements is Rs 2,118 per tonne (Rs 2,318 per tonne in December 2007).

As concerns of excess capacity stay, investors should tread cautiously on high PE stocks – whether they belong to the large or mid- and small-cap space.