

BUILDING MATERIALS

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Expert call: Demand moderation, cost rise may hurt Q2 margins

- Rising gas costs compelling Morbi ceramic manufacturers to switch to propane (~10% cheaper), with 300 of 850 units already converted
- Tile exports set to improve in Q3FY23 led by better container availability but could lose steam in FY24 owing to new global capacities
- Domestic demand slowdown and rising costs to hurt ceramic margins near term; retain KJC (leader) and SOMC (undervalued) as top picks

Ruchitaa Maheshwari
 research@bobcaps.in

We interacted with Kiritbhai Patel, President – Sanitaryware Division, Morbi Ceramics Association, to gain a perspective on industry prospects and gas costs. Takeaways:

Morbi industry switching from gas to propane: With propane prices at a 10% discount to gas in Q2FY23, the ceramics industry has embarked on a transition to propane-based capacities. Out of the 850 manufacturing units in Morbi, Gujarat, +300 have already moved to a propane-based facility and 400-500 units intend to follow suit (manufacturing remains uncompromised).

Gas cost to remain elevated: Gas cost is hovering at Rs 60/scm (similar to Q1), and the industry expects prices to remain steady in the short run given long-term supply contracts and slower tile demand. However, gas prices are expected to rise in winter on higher consumption in Europe, halting supply from Russia and a depreciating rupee.

Tile exports could rebound to Rs 120bn-150bn in FY23...: India is the second largest tile manufacturer after China with a Rs 500bn market (up >10% from last year), of which Rs 13bn-14bn is branded (40% met through Morbi). Though the Morbi cluster had just Rs 11bn worth of tile exports in Q1FY23, Patel expects resurgent demand to help the industry close the year at Rs 120bn-150bn.

...but likely to slow in FY24: The outlook for FY24 is weaker as new capacities are set to mushroom in markets such as Vietnam, China, Turkey and Saudi Arabia plus increasing ADD (anti-dumping duty) activities in these countries.

Rise of Morbi brands a risk: Morbi is turning aggressive on brands building (Varmora, Simpolo, Lexus, Millennium), aided by foreign investment, which can pose a threat to incumbent domestic brands such as Kajaria and Somany. Further, KJC and SOMC have ~50% of production through job work (outsourcing), which may be unsustainable in FY24 as Morbi might cater to local demand via its own brands amid lower exports.

KJC, SOMC our top picks: We prefer market leader KJC (TP: Rs 1,460, BUY) for its strong brand and ability to hike prices. We like SOMC (TP: Rs 830, BUY) for its ~50% cheaper valuations than KJC, sanitaryware presence and strong demand base.

Recommendation snapshot

Ticker	Price	Target	Rating
KJC IN	1,234	1,460	BUY
SOMC IN	592	830	BUY

Price & Target in Rupees | Price as of 21 Sep 2022



Additional takeaways

- **Monthlong shutdown in Morbi fails to revive demand:** Morbi ceramic manufacturers had shut their operations for four weeks during Aug-Sep'22 amid weak demand and subdued exports. Even so, demand is currently at just 70% of Q1FY23 levels. New real estate inventory is now entering the system and secondary sales (such as tiles) will occur only after a 12-15-month period. As of now, 30% of Morbi capacity is operational which should rise to 100% during Diwali (end-October).
- **Narrowing price differential between Morbi and organised players:** The product price differential has narrowed to 8-10% from 20-25% with the Morbi capacity being increasingly deployed for contract work.
- **Price hikes to support topline growth:** Being under shutdown, Morbi players did not take any price hikes in Q2FY23. On the other hand, KJC raised prices by 2-2.5% in glazed vitrified tiles (GVT) and ceramics in September, which should support its topline growth. However, due to sluggish demand, the company has given a 7% discount on the final product – this coupled with higher gas prices implies margins may remain muted or slightly lower compared to Q1.

Top picks

Kajaria Ceramics: Long-term value play; retain BUY

We believe KJC has long-term structural growth drivers from improving real estate demand in tier-2-and-below towns, domestic market share gains from Morbi and an increasing focus on exports. The stock is trading at an FY24E P/E of 34x vs. its five-year median of 40.6x, which is reasonable given increasing volumes and healthy return ratios. We continue to value the stock at 40x FY24E EPS and retain our TP of Rs 1,460 with a BUY rating given strong growth prospects and attractive valuations.

Somany Ceramics: Compelling valuations

We expect SOMC to deliver a revenue CAGR of 14% over the next two years led by ramp-up of new capacities and traction in the bathware segment. Further, strong demand from tier-2-and-beyond markets (75% sales) and an estimated rise in sanitaryware margins by 300-400bps over FY22-FY24 will provide the much-needed cushion to financials. Given price hikes by tiles players to offset higher gas cost (SOMC is contemplating a price hike in a few days), a rising share of own manufacturing post completion of capacity expansion, and higher contribution from GVT (+35% in FY24E vs. 30% in Q1FY23), we expect SOMC to sustain 11-12% EBITDA margins.

The stock is trading at 16.4x FY24E EPS vs. its five-year median of 27x – a 50% discount to KJC. We retain BUY with an unchanged TP of Rs 830, based on 23x FY24E EPS, given an improving mix, demand tailwinds and capital allocation towards the core business.

Stock performance

Fig 1 – KJC

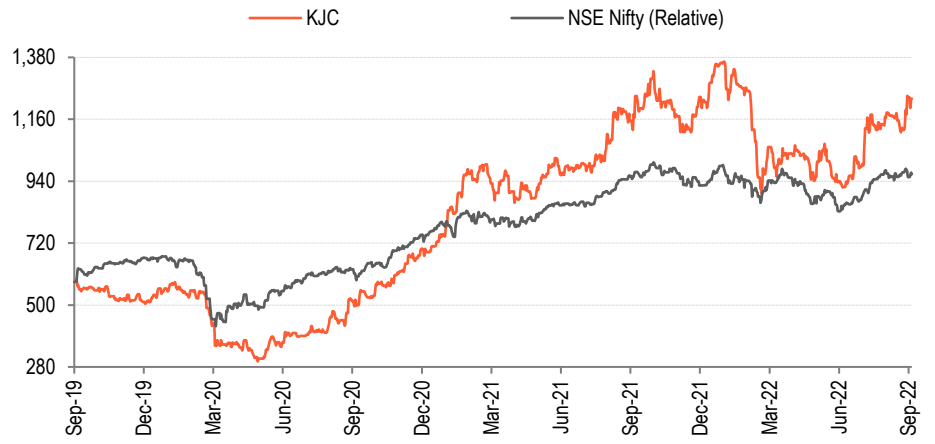
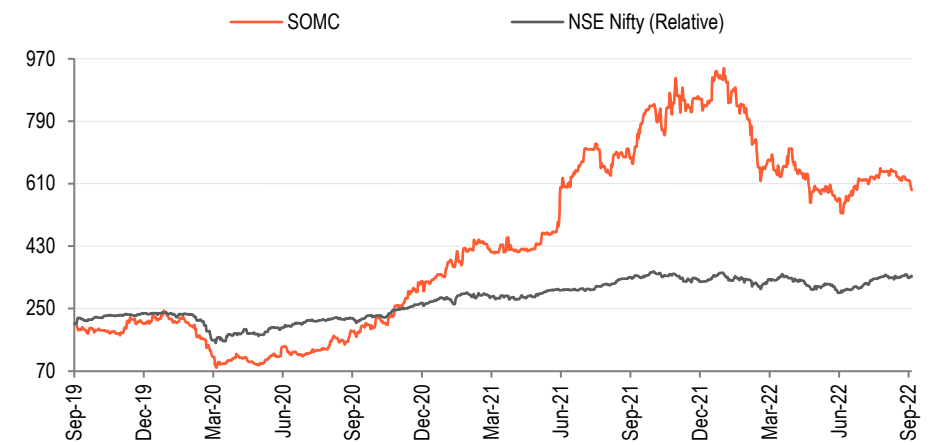


Fig 2 – SOMC



Source: NSE

Financials – KJC

Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Total revenue	28,080	27,809	37,052	43,635	49,791
EBITDA	4,159	5,088	6,107	7,643	9,225
Depreciation	(1,081)	(1,067)	(1,154)	(1,393)	(1,538)
EBIT	3,078	4,022	4,953	6,250	7,687
Net interest inc./(exp.)	(195)	(107)	(127)	(128)	(108)
Other inc./(exp.)	242	213	276	303	334
Exceptional items	0	0	0	0	0
EBT	3,125	4,127	5,102	6,426	7,913
Income taxes	(589)	(1,038)	(1,274)	(1,619)	(1,994)
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	18	(9)	(58)	(96)	(118)
Reported net profit	2,553	3,081	3,770	4,710	5,800
Adjustments	0	0	0	0	0
Adjusted net profit	2,553	3,081	3,770	4,710	5,800

Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	2,105	1,760	2,644	2,891	3,280
Other current liabilities	2,311	2,201	2,741	2,919	3,437
Provisions	288	313	338	363	388
Debt funds	1,171	971	1,279	1,079	879
Other liabilities	731	687	985	1,010	1,035
Equity capital	159	159	159	159	159
Reserves & surplus	16,984	18,530	21,065	22,242	23,692
Shareholders' fund	17,143	18,689	21,224	22,401	23,851
Total liab. and equities	24,386	25,266	29,858	31,407	33,733
Cash and cash eq.	2,350	4,477	4,244	1,464	1,251
Accounts receivables	3,967	4,317	5,133	6,575	7,503
Inventories	5,127	3,731	4,659	7,053	8,048
Other current assets	640	615	1,623	956	1,091
Investments	3	0	0	0	0
Net fixed assets	11,854	11,911	13,947	15,044	15,506
CWIP	257	50	70	80	80
Intangible assets	103	112	112	112	112
Deferred tax assets, net	15	13	0	0	0
Other assets	70	40	70	122	141
Total assets	24,386	25,266	29,858	31,407	33,733

Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Cash flow from operations	2,472	4,963	3,524	3,634	6,433
Capital expenditures	(1,213)	(1,012)	(2,500)	(2,500)	(2,000)
Change in investments	0	0	0	0	0
Other investing cash flows	0	3	0	0	0
Cash flow from investing	(1,213)	(1,009)	(2,500)	(2,500)	(2,000)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	222	(201)	309	(200)	(200)
Interest expenses	(195)	(107)	(127)	(128)	(108)
Dividends paid	(1,150)	(1,591)	(2,827)	(3,533)	(4,350)
Other financing cash flows	(310)	72	1,389	(53)	12
Cash flow from financing	(1,433)	(1,827)	(1,257)	(3,914)	(4,646)
Chg in cash & cash eq.	(174)	2,127	(233)	(2,780)	(213)
Closing cash & cash eq.	2,350	4,477	4,244	1,464	1,251

Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	16.1	19.4	23.7	29.6	36.5
Adjusted EPS	16.1	19.4	23.7	29.6	36.5
Dividend per share	3.0	10.0	14.2	17.8	21.9
Book value per share	107.9	117.6	133.5	140.9	150.1

Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	7.0	7.0	5.2	4.4	3.9
EV/EBITDA	47.0	38.3	31.7	25.2	21.1
Adjusted P/E	76.8	63.7	52.0	41.6	33.8
P/BV	11.4	10.5	9.2	8.8	8.2

DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	81.7	74.6	73.9	73.3	73.3
Interest burden (PBT/EBIT)	101.5	102.6	103.0	102.8	102.9
EBIT margin (EBIT/Revenue)	11.0	14.5	13.4	14.3	15.4
Asset turnover (Rev./Avg TA)	116.7	112.0	134.4	142.4	152.9
Leverage (Avg TA/Avg Equity)	1.5	1.4	1.4	1.4	1.4
Adjusted ROAE	15.5	17.2	18.9	21.6	25.1

Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
YoY growth (%)					
Revenue	(5.0)	(1.0)	33.2	17.8	14.1
EBITDA	(7.5)	22.3	20.0	25.2	20.7
Adjusted EPS	10.3	20.6	22.4	24.9	23.1
Profitability & Return ratios (%)					
EBITDA margin	14.8	18.3	16.5	17.5	18.5
EBIT margin	11.0	14.5	13.4	14.3	15.4
Adjusted profit margin	9.1	11.1	10.2	10.8	11.6
Adjusted ROAE	15.5	17.2	18.9	21.6	25.1
ROCE	13.8	15.3	17.1	19.7	23.1
Working capital days (days)					
Receivables	57	54	47	49	52
Inventory	83	81	56	70	80
Payables	38	31	26	28	28
Ratios (x)					
Gross asset turnover	1.5	1.4	1.7	1.7	1.8
Current ratio	2.1	2.7	2.3	2.3	2.3
Net interest coverage ratio	15.8	37.5	38.9	48.9	71.2
Adjusted debt/equity	(0.1)	(0.2)	(0.1)	0.0	0.0

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Financials – SOMC

Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Total revenue	16,030	16,505	20,945	23,167	27,140
EBITDA	1,299	1,908	2,065	2,442	3,212
Depreciation	(589)	(613)	(640)	(771)	(815)
EBIT	709	1,294	1,426	1,672	2,398
Net interest inc./(exp.)	(494)	(401)	(296)	(327)	(273)
Other inc./(exp.)	125	128	134	141	148
Exceptional items	0	0	0	0	0
EBT	339	1,021	1,264	1,485	2,273
Income taxes	112	(229)	(328)	(374)	(573)
Extraordinary items	(256)	(180)	0	0	0
Min. int./Inc. from assoc.	(45)	(36)	(47)	(111)	(170)
Reported net profit	150	577	888	1,000	1,530
Adjustments	70	134	0	0	0
Adjusted net profit	220	711	888	1,000	1,530

Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Accounts payables	1,729	1,839	2,255	2,475	2,900
Other current liabilities	1,347	1,641	1,749	1,904	2,231
Provisions	98	96	105	162	190
Debt funds	4,981	4,235	5,112	3,335	2,735
Other liabilities	358	321	323	323	323
Equity capital	85	85	85	85	85
Reserves & surplus	5,980	6,323	7,178	8,157	9,554
Shareholders' fund	6,064	6,407	7,263	8,242	9,639
Total liab. and equities	15,519	15,536	17,882	17,406	18,812
Cash and cash eq.	173	1,491	1,486	771	1,245
Accounts receivables	2,798	2,211	2,368	2,856	3,346
Inventories	3,282	2,455	2,737	3,174	3,718
Other current assets	1,085	806	903	952	1,115
Investments	341	898	600	0	0
Net fixed assets	7,779	7,588	7,520	7,386	7,121
CWIP	60	86	2,267	2,267	2,267
Intangible assets	0	0	0	0	0
Deferred tax assets, net	54	0	0	0	0
Other assets	0	0	0	0	0
Total assets	15,519	15,536	17,882	17,406	18,812

Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22A	FY23E	FY24E
Cash flow from operations	1,191	3,168	1,967	1,447	2,029
Capital expenditures	(664)	(414)	(2,779)	(550)	(550)
Change in investments	341	(557)	298	600	0
Other investing cash flows	0	0	0	0	0
Cash flow from investing	(323)	(970)	(2,481)	50	(550)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(750)	(747)	878	(1,778)	(600)
Interest expenses	(494)	(401)	(296)	(327)	(273)
Dividends paid	(204)	(102)	(119)	(218)	(303)
Other financing cash flows	38	56	79	(111)	(170)
Cash flow from financing	(1,411)	(1,193)	541	(2,434)	(1,346)
Chg in cash & cash eq.	(543)	1,004	27	(937)	133
Closing cash & cash eq.	(83)	1,178	1,518	549	905

Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22A	FY23E	FY24E
Reported EPS	3.5	13.6	21.0	23.6	36.1
Adjusted EPS	5.2	16.8	21.0	23.6	36.1
Dividend per share	2.0	2.4	2.4	4.4	6.1
Book value per share	143.1	150.9	171.1	194.2	227.1

Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22A	FY23E	FY24E
EV/Sales	1.8	1.8	1.3	1.2	1.0
EV/EBITDA	22.6	15.5	13.7	11.4	8.8
Adjusted P/E	114.0	35.3	28.2	25.1	16.4
P/BV	4.1	3.9	3.5	3.0	2.6

DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22A	FY23E	FY24E
Tax burden (Net profit/PBT)	64.8	69.7	70.3	67.3	67.3
Interest burden (PBT/EBIT)	47.9	78.9	88.6	88.9	94.8
EBIT margin (EBIT/Revenue)	4.4	7.8	6.8	7.2	8.8
Asset turnover (Rev./Avg TA)	99.6	105.9	124.8	131.0	149.9
Leverage (Avg TA/Avg Equity)	2.6	2.5	2.5	2.3	2.0
Adjusted ROAE	3.6	11.4	13.0	12.9	17.1

Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22A	FY23E	FY24E
YoY growth (%)					
Revenue	(6.3)	3.0	26.9	10.6	17.1
EBITDA	(17.6)	46.9	8.3	18.3	31.5
Adjusted EPS	(55.1)	223.3	24.8	12.6	53.0
Profitability & Return ratios (%)					
EBITDA margin	8.1	11.6	9.9	10.5	11.8
EBIT margin	4.4	7.8	6.8	7.2	8.8
Adjusted profit margin	1.4	4.3	4.2	4.3	5.6
Adjusted ROAE	3.6	11.4	13.0	12.9	17.1
ROCE	5.7	8.5	8.4	9.6	14.0
Working capital days (days)					
Receivables	79	55	40	41	42
Inventory	105	99	68	69	69
Payables	46	45	40	42	41
Ratios (x)					
Gross asset turnover	1.9	1.8	2.1	2.2	2.5
Current ratio	1.2	1.1	1.0	1.1	1.3
Net interest coverage ratio	1.4	3.2	4.8	5.1	8.8
Adjusted debt/equity	0.8	0.4	0.5	0.3	0.2

Source: Company, BOBCAPS Research | Note: TA = Total Assets

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