

Strategy

India

April 15, 2024

The curious case of the Indian cement sector (revisited)

We continue to be baffled by (1) the market's perennial hopes about meaningfully higher profitability for the cement sector despite large earnings downgrades every year; FY2024 saw an EPS change of +4-(-)68%% from the beginning of FY2024 and (2) the Street's continued usage of 'incorrect' valuation multiples and desire to use 'high' multiples in the face of incontrovertible facts about the capex-intensive, commodity nature of the cement business.

FY2024 has turned out to be no different from previous years

FY2024 was another 'routine' year of sharp earnings downgrades for the cement sector, with large EPS cuts in several companies since the start of FY2024 (see Exhibit 1). As such, FY2024 was no different from the previous years (see Exhibit 2). We note that earnings downgrades also have the unintended consequence of 'inflated' valuations, based on actual reported earnings versus estimated earnings, becoming the benchmark for target multiples.

FY2025 starting with renewed hopes

FY2025E consensus estimates show a sharp increase in EPS versus FY2024 estimates (see Exhibit 3). We are not sure about the reasons for the optimism other than conditioned behavior, fed by perennial optimism. It is perhaps time for the Street to adopt a more realistic approach to the sector. The oft-repeated argument about 'price discipline' resulting in higher profitability seems rather tedious and is dubious anyway, as hopes of 'cartel' pricing (whether or not) should not be a basis for any rational investment thesis, especially in light of the continued large supply-demand imbalance in the sector through FY2026E (see Exhibit 4). We note that our profitability assumptions translate into reasonably healthy CRoCI for the companies (see Exhibit 5).

Cement is and will be a capex-intensive, commodity business

We see a large disconnect between (1) the Street's approach and (2) our valuation approach to the valuation of cement stocks, which takes cognizance of the capex-intensive, commodity nature of the business. The Street seems singularly obsessed with earnings growth and is willing to ascribe high P/E multiples for volume-led growth (assuming stable and reasonable profitability). However, the very nature of the business should lead to lower FCF relative to PAT; any incremental volume will require additional capex. The sector's FCF-to-PAT ratio has been expectedly on the lower side (see Exhibit 6).

Multiples of cement stocks should be about half on a 'first-principle' basis

In our view, the multiples of the cement stocks should be about half of their current multiples on a 'first-principle' basis. We note that the sector has a very low asset turnover ratio (around 1X for expansion projects, lower for greenfield projects), which should automatically cap their valuations. However, most cement stocks trade at 2.5-5X FY2025E BV, which is clearly very high in the context of the low-to-mid-teens RoEs of the companies (see Exhibit 7) despite our assumptions of reasonably high profitability and CRoCI.

Key estimates summary

	2024E	2025E	2026E
Nifty estimates			
Earnings growth (%)	19.9	9.6	12.4
Nifty EPS (Rs)	989	1,087	1,227
Nifty P/E (X)	22.8	20.7	18.4
Macro data			
Real GDP (%)	7.6	6.6	6.5
Avg CPI inflation (%)	5.4	4.5	4.2

Source: CEIC, Companies, Kotak Institutional Equities estimates

Quick Numbers

+4-(-)68% change in FY2024 consensus EPS estimates during the course of FY2024; 19-70% downgrade in FY2023 consensus EPS estimates during the course of FY2023

Cement sector capacity utilization to remain around 70% through FY2026E and we model 16-17% CRoCI for the industry over FY2024-26E

Cement stocks trade at 2.5-5X FY2025E BV for low-to-mid-teens RoE

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Several cement companies saw downgrades in consensus earnings in the past year

Exhibit 1: FY2024E consensus EPS movement for cement companies (Rs)

	FY2024E consensus EPS (Rs)		Change
	Apr-23	Apr-24	(%)
ACC	112	101	(10)
Ambuja Cements	16	16	0
Dalmia Bharat	77	46	(41)
J K Cement	105	109	4
Nuvoco Vistas Corp.	15	5	(68)
Orient Cement	13	9	(29)
Shree Cement	639	642	0
The Ramco Cements	34	20	(40)
UltraTech Cement	256	248	(3)

Source: Bloomberg, FactSet, Kotak Institutional Equities

Earnings downgrades have been the norm for cement companies over FY2016-23

Exhibit 2: Actual versus 1-year prior consensus EPS estimates for cement companies, March fiscal year-ends, 2016-23 (Rs)

	2016	2017	2018	2019	2020	2021	2022	2023
ACC	(54)	(48)	(19)	(29)	(10)	(1)	4	(55)
Ambuja Cements	(58)	(41)	(11)	(25)	5	25	6	(19)
Dalmia Bharat	(11)	(2)	(70)	(78)	(61)	128	(30)	(53)
J K Cement	(84)	(55)	(32)	(58)	(3)	(5)	(32)	(61)
Nuvoco Vistas Corp.	NA	NA	NA	NA	NA	NA	NA	(36)
Orient Cement	NA	NM	NM	(79)	(29)	27	48	(66)
Shree Cement	(76)	(24)	(34)	(55)	(33)	(11)	(17)	(59)
The Ramco Cements	3	(2)	(36)	(42)	(26)	(14)	(11)	(70)
UltraTech Cement	(21)	(17)	(16)	(24)	58	59	(10)	(27)

Source: Bloomberg, FactSet, Kotak Institutional Equities

Strong EPS growth projected for FY2025 for cement companies by the Street

Exhibit 3: FY2024 and FY2025 consensus EPS for cement companies

	Consensus EPS estimates		Growth
	FY2024E	FY2025E	(%)
ACC	101	120	19
Ambuja Cements	16	18	11
Dalmia Bharat	46	64	40
J K Cement	109	139	28
Nuvoco Vistas Corp.	5	10	115
Orient Cement	9	12	33
Shree Cement	642	741	15
The Ramco Cements	20	31	52
UltraTech Cement	248	313	26

Source: Bloomberg, FactSet, Kotak Institutional Equities

Capacity utilization to remain around 70% through FY2026E

Exhibit 4: Cement demand supply balance, March fiscal year-ends, 2019-26E (mn tons)

	2019	2020	2021	2022	2023	2024E	2025E	2026E
All-India								
Closing installed capacity (mtpa)	483	501	527	546	574	613	643	682
Incremental installed capacity (mtpa)	16	17	26	19	28	40	30	39
Effective capacity (mtpa)	483	501	527	546	574	613	643	682
Incremental effective capacity (mtpa)	16	17	26	19	28	40	30	39
Capacity growth (%)	3.4	3.6	5.2	3.6	5.2	6.9	4.8	6.1
Cement consumption (mn tons)	333	330	326	355	386	419	444	476
Incremental consumption (mn tons)	39	(3)	(3)	28	31	33	25	31
Consumption growth (%)	13.4	(0.8)	(1)	8.6	8.7	8.6	6.1	7.1
Cement production (mn tons)	337	334	331	359	390	423	449	480
Incremental production (mn tons)	39	(3)	(3)	28	31	33	25	31
Growth (%)	13.3	(0.8)	(1)	8.5	8.6	8.5	6.0	7.0
Capacity utilization (%)	70	67	63	66	68	69	70	70

Source: CMA, Kotak Institutional Equities estimates

Cement companies make and will make reasonably high CRoCI on our profitability assumptions

Exhibit 5: Cash Return on Gross Capital Invested for cement companies, March fiscal year-ends, 2019-26E (%)

	2019	2020	2021	2022	2023	2024E	2025E	2026E
Pan-India companies								
ACC	24	19	22	26	14	16	17	19
Ambuja Cements	11	12	14	15	12	13	14	17
Ultratech Cement	12	22	19	17	15	18	19	19
Pan-India average	16	18	19	19	14	15	17	18
Regional companies								
JK Cement	13	17	20	17	14	18	19	19
Nuvoco Vistas Corp.	7	11	10	9	12	10	10	11
Shree Cement	26	29	28	25	20	21	20	19
Regional average	16	19	19	17	15	16	16	16
Overall	16	18	19	18	14	16	17	17

Source: Companies, Kotak Institutional Equities estimates

Cement companies have historically reported significantly lower FCF compared to the reported EBITDA/PAT

Exhibit 6: EBITDA, PAT, Capex and FCF of cement companies, March fiscal year-ends, 2014-23 (Rs mn)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total 2014-23
ACC											
EBITDA	16,286	15,073	15,372	14,737	19,091	20,392	24,095	24,811	29,981	19,249	199,086
PAT	8,788	8,591	7,447	6,899	9,154	10,006	13,589	15,403	19,179	10,469	109,525
Capex	9,478	15,270	11,681	4,976	5,194	4,951	5,404	7,458	11,754	21,047	97,213
FCF	2,253	(1,053)	3,156	9,077	10,679	6,725	18,243	16,144	18,070	(31,821)	51,473
Ambuja											
EBITDA	16,669	19,284	15,315	16,827	19,278	18,915	21,489	26,466	32,152	32,204	218,598
PAT	12,946	14,964	8,076	9,701	12,131	12,091	15,286	17,901	21,489	27,108	151,690
Capex	7,370	8,202	6,169	3,832	5,428	5,921	11,165	9,855	11,606	21,537	91,083
FCF	4,043	9,077	7,781	13,888	16,418	1,832	21,065	22,051	19,398	(20,333)	95,219
Dalmia Bharat											
EBITDA	3,263	4,546	15,079	19,019	20,360	19,420	21,060	27,700	24,310	23,160	177,917
PAT	(84)	92	1,908	3,448	2,650	3,050	2,680	12,070	8,100	6,290	40,204
Capex	7,059	4,953	4,141	3,366	3,930	9,260	13,450	10,380	17,690	27,090	101,319
FCF	(7,317)	(4,709)	6,877	5,538	5,840	4,510	6,000	22,850	60	(6,770)	32,879
J K Cement											
EBITDA	3,527	4,421	5,453	8,245	7,875	8,345	12,134	15,387	14,823	13,143	93,353
PAT	772	1,436	634	1,777	2,896	2,703	4,964	7,086	6,870	4,263	33,402
Capex	15,576	5,472	3,442	1,256	1,443	6,313	12,428	7,678	15,538	16,114	85,260
FCF	(12,825)	(4,581)	42	1,865	5,027	(1,706)	(982)	6,534	(8,411)	(4,603)	(19,641)
Nuvoco Vistas Corp.											
EBITDA					10,663	9,177	16,804	14,605	15,016	12,104	78,368
PAT					875	(265)	(115)	(259)	321	159	715
Capex					2,687	5,808	5,695	5,473	4,106	4,863	28,631
FCF					3,453	(917)	1,112	5,325	3,016	7,579	19,568
Orient Cement											
EBITDA	65	849	(459)	(1,089)	2,167	3,120	3,829	5,507	5,911	3,645	23,545
PAT	(1,073)	(270)	(1,670)	(3,191)	(443)	476	866	2,142	2,633	1,228	698
Capex	3,297	9,222	3,697	(2,815)	1,470	1,212	766	507	534	1,300	19,190
FCF	(1,628)	(2,401)	(2,632)	1,793	(803)	346	995	5,726	215	(467)	1,144
Shree Cement											
EBITDA	13,126	12,170	14,725	23,567	24,426	26,528	36,745	39,547	36,478	29,423	256,736
PAT	8,563	4,481	4,019	13,390	13,842	11,265	15,702	23,119	23,766	13,281	131,429
Capex	15,829	11,303	7,348	12,947	25,263	18,853	12,941	9,984	19,694	28,053	162,214
FCF	(2,199)	680	2,968	11,836	(43)	1,484	23,586	30,584	8,357	4,971	82,222
The Ramco Cements											
EBITDA	5,639	7,199	10,765	12,077	11,127	10,445	11,475	15,573	12,901	11,856	109,055
PAT	1,377	2,437	5,313	6,542	5,605	5,075	6,044	7,636	8,929	3,420	52,377
Capex	5,875	4,392	4,428	3,048	4,945	12,017	19,195	17,659	18,166	17,658	107,382
FCF	13,290	12,345	17,716	7,203	5,156	(4,917)	(12,919)	(1,390)	(5,378)	(6,668)	24,438
UltraTech Cement											
EBITDA	38,179	41,861	46,195	49,291	61,452	73,469	92,472	115,679	115,144	106,199	739,940
PAT	21,445	20,058	22,898	27,121	25,734	25,169	57,553	55,809	56,623	50,640	363,048
Capex	22,282	63,799	20,534	12,593	180,717	95,482	99,980	18,387	56,134	62,001	631,909
FCF	6,697	(29,640)	17,447	29,738	(145,154)	(49,280)	(24,960)	98,916	22,618	16,924	(56,693)

Source: Companies, Kotak Institutional Equities

Cement stocks are trading at expensive valuations on P/B basis in the context of low-to-mid-teens RoEs

Exhibit 7: Valuation summary of construction material stocks under KIE coverage, March fiscal year-ends, 2024-26E

Company	EPS growth (%)			P/B (X)			EV/EBITDA (X)			RoE (%)		
	2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E	2024E	2025E	2026E
ACC	66	22	17	3.0	2.7	2.4	15	12	10	12	13	14
Ambuja Cements	(3)	31	10	3.0	2.8	2.6	18	14	12	8	8	9
Dalmia Bharat	21	60	35	2.2	2.1	2.0	13	11	9	5	7	9
Grasim Industries	10	10	6	1.7	1.6	1.5	10	8	7	9	9	9
J K Cement	84	29	16	6.2	5.3	4.5	17	15	13	16	17	17
Nuvoco Vistas Corp.	(75)	217	45	1.3	1.2	1.1	9	8	8	1	4	5
Orient Cement	35	45	15	2.5	2.2	2.0	11	8	7	10	13	14
Shree Cement	76	14	9	4.5	4.1	3.7	20	17	15	12	13	12
The Ramco Cements	23	50	38	2.7	2.6	2.3	16	14	12	5	8	10
UltraTech Cement	37	36	11	4.7	4.1	3.7	22	18	15	12	15	15

Source: Companies, Kotak Institutional Equities estimates

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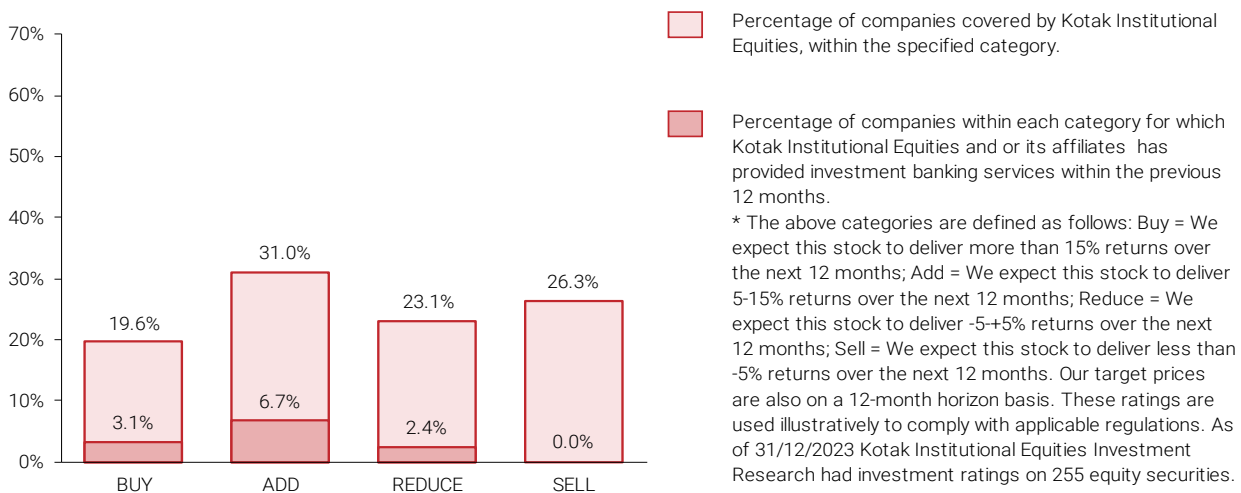
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