Chemicals

Gujarat Alkalies & Chemicals

BUY

MF Global

Mid Cap Research

CMP : Rs.216

Target : Rs.320

Gujarat Alkalies and Chemicals (GACL) is an wholly owned subsidiary of Gujarat Industrial Investment Corporation Limited (GIIC), an industrial development Company owned by the Government of Gujarat. GACL is the single largest producer of Caustic Soda in India and enjoys economies of scale. The company also has its captive power plant of 90 MW at its facility in Dahej.

Investment rationale

Increasing realization to expand margin – GACL offers its product in domestic market at parity of landed cost of imported caustic soda and derivative products. Oil has been scaling new high everyday leading to increase in ocean freight in turn increasing international prices of caustic soda and derivatives products. Domestic price of caustic soda are $450/tonne as compared to $540-550 in US. Due to this realization of GACL are also likely to increase, leading to expansion in OPM.

Capacity expansion – volume growth – GACL is increasing capacity of its products through capex as well as contract manufacturing. Company is already undergoing trial run of new aluminum chloride capacity, full effect of which would be visible in FY09 results.

Captive power – cost saving – Caustic soda industry is very energy intensive industry, GACL already has captive power plant with capacity of 90MW. Going ahead, company plans to set up additional 24MW power plant for captive consumption, which would further lower its power cost.

Carbon credit – continuous other income – Setting up windmill has been earning carbon credits for GACL, which it has been selling in market and generating substantial other income. GACL has generated income of Rs165mn in H1FY08. At current realization of carbon credit company can easily generate additional revenue of Rs150-200mn every year till FY12. USA is still not part of Kyoto Protocol and hence is not present in carbon credit market. Once USA signs Kyoto Protocol agreement, it would be bound to abide by this. USA houses some of worlds most polluting industry. We expect price of carbon credit to shoot up dramatically post USA entry in carbon market and in turn beneficiating companies like GACL.

Valuations

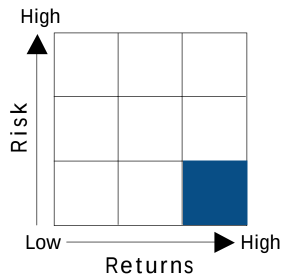
We expect company to grow at 16% and 20% in FY08 and FY09 at Rs12.1bn and Rs14.5bn. EBITDA margins are likely to be higher at 36% in FY08 compared to 34% in FY07. PAT is estimated to grow at 25% and 26% in FY08 and FY09 respectively to Rs2.3bn and Rs2.9bn. EPS would stand at Rs32 and Rs40 for FY08 and FY09. At current price of Rs216 GACL trades at 6.8x and 5.4x its expected earning. GACL has historically traded in range of 5-6x, while it has traded 8-9x when EBITDA margins were at peak. We initiate coverage on GACL with **BUY** recommendation with a one-year price target of Rs320 discounting FY09 earning by 8x.

Valuation summary

Y/E, 31st March	FY06	FY07	FY08E	FY09E
Revenues (Rs. mn)	**9,441**	**10,448**	**12,120**	**14,544**
Net profit (Rs. mn)	1,979	1,867	2,341	2,955
EPS (Rs.)	**27.0**	**25.4**	**31.9**	**40.3**
EPS growth (%)	–	(5.7)	25.3	26.2
P/E (x)	**8.0**	**8.5**	**6.8**	**5.4**
Div. yield (%)	0.9	1.2	1.4	1.6
RoCE (%)	**33.8**	**28.8**	**32.3**	**36.0**
RoNW (%)	27.4	23.2	23.6	24.0
Price/BV (x)	**2.2**	**1.8**	**1.4**	**1.2**
EV/EBITDA (x)	5.0	5.1	3.9	3.1
EV/Sales (x)	**2.0**	**1.7**	**1.4**	**1.1**

Source: Company, MF Global PCG Research

Risk Return Matrix



Indices

Sensex	19,959
Nifty	5,938

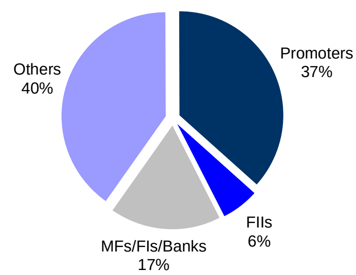
Stock Data

BSE Code	530001
NSE Code	GUJALKALI
Bloomberg	GALK@IN
Reuters	GALK.BO
Shares Issued (mn)	73.4
Market Cap (Rs mn)	15,854
52 Wk H/L (Rs)	217/107
Face Value (Rs)	10
Avg. daily vol. (12-mths)	170,865

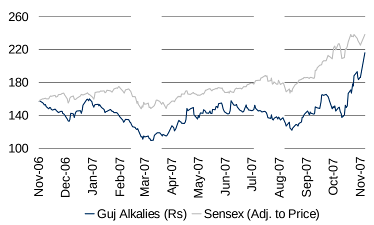
Absolute Returns (%)

	1 m	3 m	12 m
Absolute	45.1	66.1	37.8
Rel. to Sensex	40.3	27.1	(14.1)

Shareholding Pattern



Gujarat Alkalies Vs Sensex (Adj)



Analyst : Sageraj Bariya
sageraj.bariya@mfglobal.in
+91 22 6655 1295

Initiating Coverage

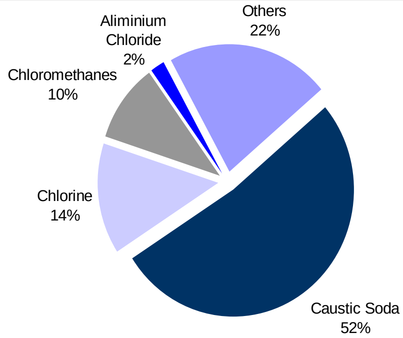
November 15, 2007

Business profile

GACL is a multi-product Company manufacturing 26 chemical products. The Company derives around 66% of its revenues from chlor-alkali business and 34% revenues from the other value added products. The Company has a 17.8% market-share in the domestic chlor-alkali industry. The Company has expanded its capacities for Caustic Soda and Hydrogen Peroxide. Coupled with the economies of scale, the synergy of having 90 MW gas based co-generation power plant at Dahej and its strategic equity participation in Gujarat Industries Power Company at Vadodara to take care of its power requirements, have enabled the Company to remain the most cost effective producer of Caustic Soda in the country. GACL has been able to achieve over 100% capacity utilization for majority of its plants.

GACL is the only domestic company with global size capacity for caustic soda and integrated downstream plant for other products

GACL – Sales mix



GACL – Market share

Product	No of players	% mkt share
Caustic Soda	34	18
Cyanide Salt	2	33
Chloromethane	4	20
Potassium Carbonate	2	80
Hydrogen Peroxide	4	35
Phosphoric acid	2	50
Aluminum Chloride	5	33

Source: Company, MF Global PCG Research

The Company has grown rapidly and made a dramatic turnaround in its fortunes from loss in FY02 to becoming profitable in FY03. GACL has diversified into other derivative products of Chlor Alkali through integrated downstream products to diversify its sales mix. The above-mentioned products are used in various industries like aluminum, pulp & paper, soap & detergents, power plants, steel plants, fertilizers, petroleum refining & petrochemical.

The strengths of the Company are

- Economy of size
- Economical and uninterrupted power from GIPCL at Vadodara and Captive co-generation plant at Dahej
- Integrated down stream plants,
- Proximity to Raw material source

Industry

Globally, Chlor-Alkali industry is one of the largest chemical industries in the world. The industry is driven by demand- supply of Chlorine. In case of India, approximately 45% of the chemical industry is dependent on Chlor-Alkali. There are around 34 units with total capacity of 2.3mn tones per annum. Industry has been operating at average utilization level of 80%. Approximately 0.17mn tons of chlor-alkali is imported. Indian Chlor-industry is driven by caustic soda.

Increasing realization to expand margin

Domestic prices are currently ruling at $430 per tonne as compared to $540-550 per tonne in US. We expect this gap to be bridged benefiting the company

Europe and South America are largest manufacturer of caustic soda, while USA is the largest consumer and is a net importer. Hence, domestic prices are driven by international prices. International crude oil prices have been rising and reaching new peak everyday, which in turn has increased ocean freight rates and landed cost of caustic soda. The company prices its product on international parity level hence from here on we expect company to show expansion in margin.

Growth in user industry

- Alumina production is expected to double by 2010.
- Textile industry is expected to double in the next 5 years.
- Chemicals industry is expected to grow at 12% - 15% p.a over next 5 years.
- Rising literacy levels resulting in the growth of the paper industry
- Caustic Soda is estimated to grow at average annual rate of 8.9%.
- Growth in Paper and Pharma Industries would boost demand for Hydrogen Peroxide & Chloromethane.

Demand growth from user industries like – aluminium, textile, paper, fertilizers and pharma have been strong

Key positive

Low debt-equity ratio – At the end of Mar-07 debt-equity ratio stood at 0.5x, company can easily borrow money and expand at faster pace.

Strong cash flow – The company is estimated to generate cash profit of Rs3bn and Rs4bn in FY08 and FY09 as compared to current market cap of Rs15.8bn.

Commodity cycle on an upturn – Higher demand from domestic user industries, production cuts in Chinese markets and increase in exports of caustic soda has led to firming up of prices. China is putting severe restrictions on this industry because of the forthcoming Olympics. This has pushed up prices of many chemicals in India.

Cost competitive player – GACL is the only domestic player with global scale capacity (giving benefit of economies of scale). Another positive for the company is lower power costs. Power accounts for almost 50% of cost of production, thus captive power plant and lower acquisition cost of power from GIPCL, makes it cost competitive

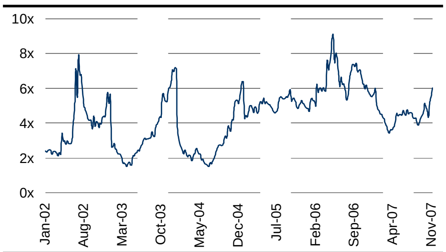
Post FY09 – The company has charted out its growth plan beyond FY09. It plans to add additional capacity of caustic soda (350-500tons per day). Set up additional 90MW captive power plant. Company also plans to expand capacity of Aluminum chloride once the new plant stabilizes.

Signing of MoU with DOW Europe – The Company has signed a Memorandum of Understanding for exploring a long term and strategic business relationship in the area of chlorinated organics with DOW Europe. We believe this kind of partnership would contribute significantly to company's bottom line over long-term.

Valuations

We expect company to grow at 16% and 20% in FY08 and FY09 and stand at Rs12.1bn and Rs14.5bn. EBITDA margins are likely to be at higher side at 36% compared to 34% in FY07. PAT is estimated to grow at 25% and 26% in FY08 and FY09 respectively to Rs2.3bn and Rs2.9bn. EPS would stand at Rs32 and Rs40 for FY08 and FY09. At current price of Rs216 GACL trades at 6.8x and 5.4x its expected earning. GACL has historically traded in range of 5-6x, while it has traded 8-9 when EBITDA margins were at peak. We initiate coverage on GACL with **BUY** recommendation with a one-year price target of Rs320 discounting FY09 earning by 8x.

1-year forward P/E multiple



Source: Company, MF Global PCG Research

Financials

Income statement (Rs mn)	FY06	FY07	FY08E	FY09E
Net sales	**9,441**	**10,448**	**12,120**	**14,544**
Raw material	2,564	3,242	3,636	4,363
Employee expenses	595	688	800	800
Mfg & other exp	2,434	2,938	3,382	4,000
Total exp	5,592	6,868	7,817	9,163
Op profit	**3,849**	**3,580**	**4,303**	**5,381**
OPM (%)	*40.8*	*34.3*	*35.5*	*37.0*
Other income	276	405	460	510
Depreciation	785	873	1,006	1,234
Interest	394	377	307	236
PBT	**2,946**	**2,735**	**3,449**	**4,421**
Tax	968	869	1,109	1,466
PAT	1,978	1,866	2,341	2,955
Extraordinary item	1	2	–	–
Adj PAT	**1,979**	**1,867**	**2,341**	**2,955**
NPM (%)	*20.4*	*17.2*	*18.6*	*19.6*

Balance sheet (Rs mn)	FY06	FY07	FY08E	FY09E
Equity capital	**734**	**734**	**734**	**734**
Reserves	6,496	8,150	10,240	12,901
Networth	**7,230**	**8,884**	**10,974**	**13,635**
Total debt	4,726	4,006	2,810	2,440
Others	2,133	2,214	2,317	2,494
Total liabilities	**14,089**	**15,104**	**16,101**	**18,570**
Gross fixed assets	16,847	19,290	21,790	24,790
Less: Cum depreciation	8,131	8,992	9,998	11,233
Net fixed assets	8,716	10,298	11,792	13,557
Capital WIP	1,917	1,033	1,033	1,033
Invst & others	1,422	1,516	1,516	1,516
Net current assets	2,034	2,257	1,760	2,464
Total assets	**14,089**	**15,104**	**16,101**	**18,570**

Cash flow (Rs mn)	FY06	FY07	FY08E	FY09E
PBT & extraord. items	2,947	2,735	3,449	4,421
Add: Int, depn. & oth. exp.	1,241	1,232	1,313	1,471
Cash flow from op.	**4,188**	**3,967**	**4,763**	**5,891**
Net chg in w/c, tax, int.	(430)	(868)	(582)	(1,976)
Net cash flow frm op.	**3,758**	**3,099**	**4,181**	**3,916**
Capital expenditure	(2,022)	(1,587)	(2,500)	(3,000)
Sale/purchase of inv	(575)	(61)	–	–
Net cash from inv.	**(2,597)**	**(1,648)**	**(2,500)**	**(3,000)**
Chng in eqty & debt	(672)	(720)	(1,196)	(370)
Interest, dividend & other	(525)	(636)	(393)	(487)
Net cash from financing	**(1,198)**	**(1,355)**	**(1,589)**	**(857)**
Net chg in cash	(36)	95	92	58
Op. cash bal	296	260	355	447
Cl. cash bal	260	355	447	505

Ratios	FY06	FY07	FY08E	FY09E
Growth (%)				
Net sales	4.6	10.7	16.0	20.0
Adj PAT	37.2	(5.7)	25.3	26.2
Adj EPS	37.2	(5.7)	25.3	26.2
Per Share Data (Rs)				
Adj EPS	27.0	25.4	31.9	40.3
Book value	73.8	98.5	121.0	149.5
DPS	2.0	2.5	3.0	3.5
Valuation (x)				
P/E	8.0	8.5	6.8	5.4
P/BV	2.2	1.8	1.4	1.2
EV/EBIDTA	5.0	5.1	3.9	3.1
Performance (%)				
RoCE	33.8	28.8	32.3	36.0
RoNW	27.4	23.2	23.6	24.0

BUY : > 20% **HOLD : > 5-20%** **SELL : < 5%**

Note: Ratings based on expected returns from current market price (on absolute basis).

Analyst Holding in the recommended stock: **NIL**

MF Global Sify Securities India Pvt. Ltd.,
2ND floor, 'C' Block, Modern Centre, Mahalaxmi, Mumbai-400 011, India.
For more copies and other information contact - Vikram Rawat (+91 22 6655 1294) vikram.rawat@manfinancial.in