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Shree's UAE foray earnings accretive

Analysts expect acquired asset's margins to improve

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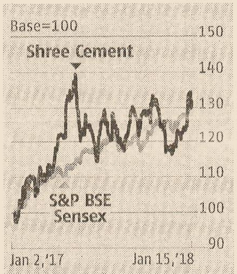
Shree Cement surprised investors last week by reporting a better-than-expected operating performance for the December 2017 quarter (Q3), and making its first international acquisition of UAE-based Union Cement Company (UCC).

The company, which has so far focused on expanding in India, is acquiring about 93 per cent stake in UCC at an enterprise value of $305 million. UCC has a 3.3-million-tonne (mt) clinker and 4 mt cement capacity, translating into attractive deal valuations of $76 per tonne. The deal value is at 17 per cent premium to UCC's market capitalisation, but lower than the price paid by some competitors for acquiring assets in West Asia, said Kotak Securities.

Binod Modi at Reliance Securities, too, says the deal appears attractive, considering costs incurred by select cement companies in West Asia, including JK Cement. UCC reported revenues of $154 million and an operating profit of $34 million in calendar year 2016, about 12 per cent and 15 per cent lower year-on-year (y-o-y).

However, even if a 100 per cent stake is acquired and funded by debt, the deal (assuming 10 per cent interest rate) will not be earnings dilutive, say analysts.



Compiled by BS Research Bureau

In the near term, it may weigh on investors' sentiment, as a similar investment in India would have generated higher returns. Analysts say there is a good scope for margin improvement and earnings growth for UCC. Since 2016 has been a year of downturn for cement demand in West Asia (declining crude oil prices impacting economies), Modi foresees better demand in the UAE, supporting margin improvement.

Further, a close proximity of UCC's capacities to ports offers it a good access to exports markets.

Meanwhile, Shree Cement continues to expand its domestic capacities. During Q3, it lit up a clinkerisation unit of 2.6 mt in Chhattisgarh. Over FY18-19, its capacities will expand 9.2 mt, taking overall capacities to 43 mt by FY19, thereby supporting volumes.

Shree is among the most profitable domestic cement companies.

During Q3, Shree's sales volume grew a good 8.3 per cent y-o-y to 5.33 mt, despite demand weakness in its key markets of Rajasthan and Bihar. Higher-than-expected realisations and a reversal of ₹403 million pertaining to the District Mineral Foundation provisions aided the operating profit growth even as power and fuel costs (up 44 per cent y-o-y and 18 per cent sequentially) surged, primarily because of a ban on petcoke use and freight cost.

Operating profit at ₹5.7 billion was up 22 per cent y-o-y, translating into profit per tonne of ₹1,057 compared with ₹975 a year ago.

As the seasonally strong quarters start, growth should pick up further.

Analysts at Kotak Securities expect Shree's volumes and revenues to grow at a compounded annual growth rate (CAGR) of 11.7 per cent and 15 per cent, respectively, during FY17-20.

Edelweiss, notwithstanding current cost challenges, maintains its long-term positive view on the sector and a 'buy' on Shree (target price ₹22,854), given superior return ratios.