



Associated Cement Companies Ltd. (CMP: Rs.176.35)

Under Performer

Stock Statistics

Market Cap (Rs. cr)	: 3016.11
52 week high (Rs.)	: 200
52 week low (Rs.)	: 91
Avg. daily Volume	: 1057604
Avg. daily trades	: 6721
Face Value (Rs.)	: 10
BSE Sensex	: 3678.75
BSE Code	: 500410
Reuters Code	: ACC.BO
Bloomberg Code	: ACC@IN
Industry	: Cement

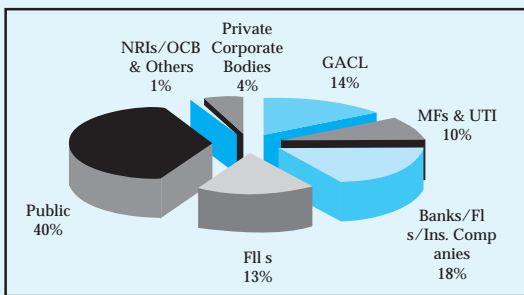
Fully Priced

The performance of ACC is more sensitive to price than volumes. Every 1 percent increase in cement realisation results in 11.28 percent higher EBIT but every percent decline results in lower EBIT by 18.74 percent. In FY'02, even in peak season, cement prices have been declining. The performance of ACC has already been affected in Q2'02 and Q3'02 because of lower prices in South and East respectively. We believe that Q4'02 will at best be marginally better than Q3'02 at PBT level. However, for the purpose of our projections, we have deliberately erred on higher side to clearly reflect the element of overvaluation. With cement prices showing no signs of improvement, we rate the stock **Market Underperformer**.

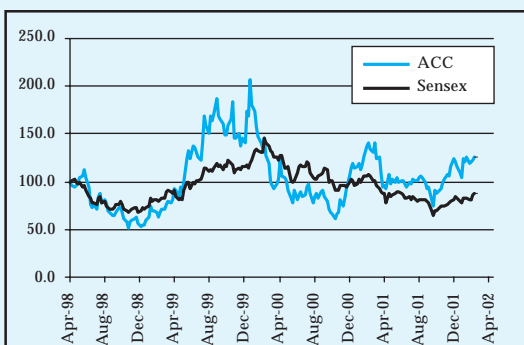
Investment Highlights

- Despite being the largest cement producer in country, ACC is market leader only in Karnataka & Punjab (only states with annual consumption of above 3 million tonne considered). ACC-GACL combine has the highest market share in Eastern Region but even in this region, the combine is not able to control the prices. **On its own, ACC is not a price leader in a single state.**
- ACC is more sensitive to realisation than volume because of its cost structure. Even in peak season prices across the country are declining. ACC will be worst affected among all cement majors with the exception of Southern majors. In Q3'02, despite 27 percent volume growth (Q-Q) and sales tax exemption at Wadi (New)-K'taka charges the highest ST on cement in country-OPM of ACC remained flat compared to the previous quarter.
- ACC is trading at 8.96 X FY'02 EV/EBIDTA and 7.60 X FY'03 EV/EBIDTA. The EV/Tonne works out to be Rs 2973.75 and Rs3028.43 respectively. Considering that GACL managed to put up 2.5 million tonne unit at the capital cost of Rs 2700/tonne and ACC's dependence on cement prices, we believe that the valuations are stretched. For a cyclical with low margins, forward P/E of 29.10(FY02) is unjustifiable.
- In EV/EBIDTA terms ACC is trading in its normal range but the high valuations accorded to the stock, limits the upside even when the performance improves.

Sharholding Pattern (%)



ACC Vs. BSE Sensex (normalised)



Year	Sales (Rs.cr)	PAT (Rs.cr)	Chg (%)	EPS (Rs.)	RoE (%)	ROCE (%)	EV/EBIDTA (X)
March							
FY99	2265.44	76.84	471.73	5.62	7.92	9.99	8.82
FY00	2323.39	-58.85	NA	NA	NA	4.05	14.84
FY01	2576.37	47.48	NA	2.78	4.18	9.63	9.55
FY02 F	2883.42	115.44	143.13	6.06	10.12	11.99	8.96
FY03 F	3135.84	165.58	43.43	8.7	13.21	13.92	7.60

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**Sensitivity-
more vulnerable
to declining
prices & market
share does not
matter much**

Argument & Valuation

ACC is trading at 8.96 x & 7.60 x EV/EBIDTA and at EV/tonne of Rs 2973.75 and Rs 3028.43 for FY'02 and FY'03 respectively. We believe that the stock is steeply valued considering that ACC is market leader in only Karnataka and Punjab and is not a price leader in any of the markets. It has the lowest operating margin among Big Six of cement industry. However, the biggest concern is that ACC is a price follower despite being the largest cement manufacturer in the country. It has the highest sensitivity to price and is more vulnerable to lower prices compared to the benefit of higher prices (See Sensitivity).

We believe that market share related price adjustments will last till the end of monsoon resulting in no material improvement in performance for three quarters (till H1'03) and ACC will be the worst affected.

We believe ACC is expensive on various valuation parameters. ACC should not be valued on replacement cost method due to it's following drawbacks :

- Has the lowest operating margins in the industry and lowest margin among top 6 cement majors.
- Inability to influence prices in any region - Even in regions where it is a market leader eg. In Karnataka where it has a market share of 21.36% which is 5.35% higher than L&T, it is priced lower than L&T
- It's sensitivity to prices ensures that it can never lower prices to gain market share without hurting itself more than the competitors
- Gujrat Ambuja Cement has put up a 2.5 million ton clinkering capacity at Rs. 2700 per tonne, we see no reason as to why ACC should get a premium valuation.

We believe that the stock is overvalued and will **Underperform**.

Every percentage increase in cement realisation results in 11.28% higher EBIT but every percentage decline results in lower EBIT by 18.74%. Because of its cost structure, ACC has the highest sensitivity to cement prices and its fragmented capacity (except in Karnataka) results in not being able to influence the price in any significant manner. Even in Karnataka, despite having the highest market share ACC cement is priced lower than L&T cement. We do not believe that there will be many instances of having 5.35 percentage points higher market share than the nearest competitor and yet being priced lower-particularly in commodity business where price matters more than volume.

In the same manner, in Punjab, ACC enjoys 4.3 percentage points higher market share than GACL but is priced lower.

Sensitivity

	Q3'02	Change in Price	
		1%	-1%
Sales/Income from Operations	732.59	740.52	725.86
Average Realisation (Rs/tonne)	2486.23	2511.09	2461.37
EBIT	70.30	78.23	63.57
Impact in % terms		11.28	(18.74)
Expenditure of Cement division	662.29	662.29	662.29
EBIT(%)	9.60	10.56	8.76

Note: Sales/Income from Operations & EBIT are taken from the published results. Expenditure of the cement division is the difference between sales & EBIT of the division.



Capacity addition hurts

Lower costs-the impact is not visible

The nationwide presence has resulted in ACC being one of the worst affected due to commissioning of new capacities in any region-South, East & West. Capacity addition invariably results in market share adjustments and thereby price war. A classic example is Q3'02 performance. Wadi (New) started commercial production from October-01 and as a result volumes were higher by 27 percent on Q-Q basis. Karnataka charges the highest sales tax on cement in country (18.75%) and the unit enjoys sales tax exemption. Prices in the region were better than the previous quarter and Karnataka accounted for 64 percent of the dispatches from the unit during the quarter. Yet, on Q-Q basis, the OPM remained flat. The reason being price war in East. In Q4'02, the price decline in Maharashtra (other than Mumbai as ACC has marginal presence in Mumbai), which accounts for 16.7 percent of despatches will result in no material improvement over previous quarter at PBT level.

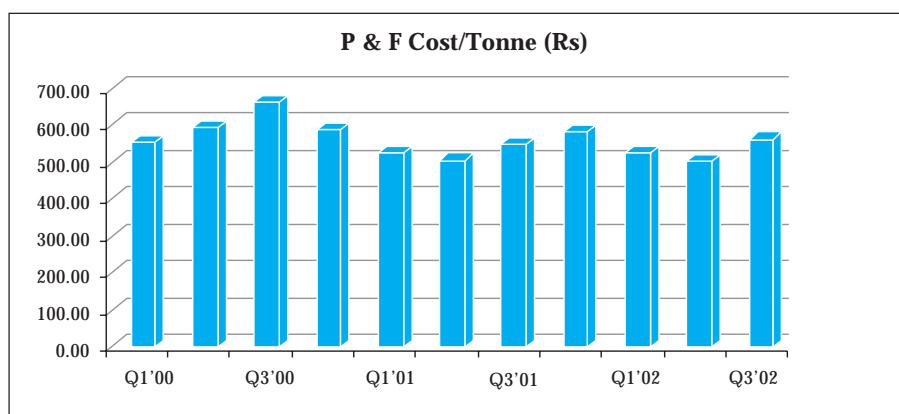
On comparison of direct costs of ACC over the last five years, we notice that on per tonne basis power & fuel cost is still at par with FY'97. The average rate for power consumed (captive and purchased) has remained flat at Rs 2.77/unit in FY'01 against Rs 2.71/unit in FY'97. For our assumptions, we have estimated that for entire FY'03, Wadi (New) will be on captive power. As per the arrangement with Tata Power, ACC will supply the coal and Tata Power will do the conversion job.

Direct Cost Comparison

	(Rs/tonne)				
	2000-01	1999-00	1998-99	1997-98	1996-97
Power & Fuel Cost	568.19	626.80	548.66	574.07	566.41
Raw Material Cost	276.86	277.40	238.47	235.72	195.45
Stores & Spares	104.16	101.84	110.64	112.67	130.71
Total	949.21	1006.05	897.77	922.45	892.57

(Source: Annual Reports)

As is clear from the table, there has been hardly any improvement in direct costs and in any case, the impact of lower costs on ACC's performance is overestimated considering the fact that the single largest cost-Power & Fuel-is flat on per tonne basis over last 11 quarters despite share of captive power (including purchase from Tata Power at Wadi) going up to 60 percent in FY'01 (75 percent including standby capacity).



We have estimated P&F cost/tonne of Rs 508.76 in FY'03 due to commissioning of captive power units at Chanda and Wadi (New). The CPP at Madukarai is expected to be commissioned in Q4'03 and is not expected to contribute significantly to reduction in P&F cost/tonne in FY'03



Higher proportion of blended cement but no impact on material cost

ACC has the 3rd highest PBT margin among majors

Road construction will boost demand

The proportion of blended cement has increased from 60 percent in FY'99 to 77% in FY'01 and is expected to go up to 85% in FY'02. Logically higher proportion of blended cement should result in lower material and power cost. The reason being the ratio of clinker will come down by at least 18% to 77% if only fly ash is used and the power consumption at grinding stage is lower than at clinkerisation stage. The cost of fly ash is transportation from the thermal power plant (Raichur for Wadi). Two reasons why the material cost/tonne for ACC has not come down are:

- > The cost of slag has increased from Rs 371/tonne in FY'99 to Rs 497 in FY'01. This is partly compensated by the fact that proportion of slag cement has gone down from 22 percent in FY'99 to 18 percent in FY'01.
- > The royalty on limestone (1.43:1 is the limestone:clinker ratio) has been hiked from Rs 32/tonne to Rs 40/tonne effective from September 12, 2000.

The PBT margin of ACC is third highest among cement majors after GACL and Grasim. However, the OPM is the lowest among all cement majors.

PBT Margin (%)

	Q3'02					
	ACC	GACL	Grasim	L&T	ICL	MCL
EBIT of Cement	70.30	88.04	55.94	38.20	24.36	2.07
Interest	35.89	26.13	21.03	33.75	50.61	1.95
Profit before Tax	34.41	61.91	34.91	4.45	-26.25	0.12
PBT Margin (%)	5.04	15.51	7.00	0.08	N.A.	0.08

Capital Employed	ACC	Grasim	L&T
Cement	2278.15	1984.45	3500.52
Total of all Divisions	2587.43	4847.76	6872.71

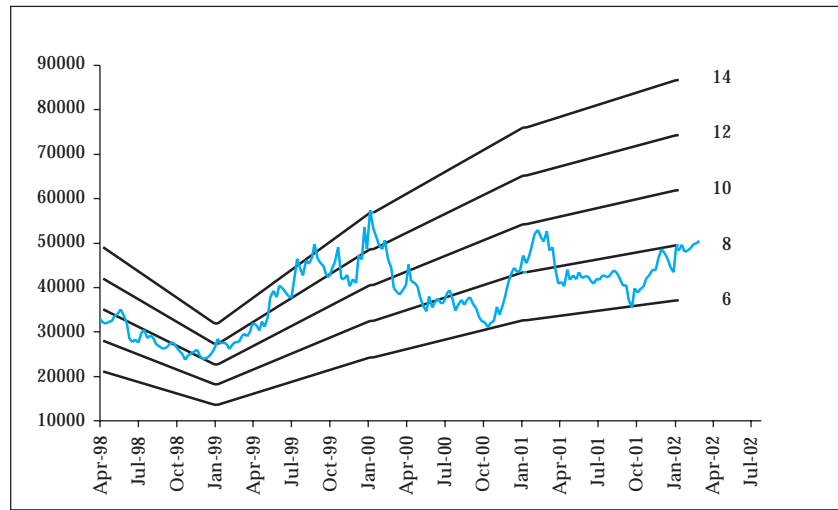
(Source: Published Results)

(Note: Other being pure cement companies have not disclosed Capital Employed)

(Note: Interest allocation on the ratio of Capital Employed).

In our conversation with industry, the view was clear that road projects will generate annual demand for additional 2 million tonne. Volumes will result in better recovery of fixed costs but the realisation will be low and what matters is realisation. Even with road led demand, supply will exceed demand till at least end of FY'03.

EV/EBIDTA (Times)- It is always traded at high valuation



Annexure A :Market Share

Market Share for the period Oct-Dec 01

South	(%)	North	(%)	East	(%)	West	(%)	Central	(%)
Karnatka	21.36	Punjab	32.60	W. Bengal (*)	19.33	Maharashtra	15.12	UP	11.85
AP	5.21	J&K	27.10	Bihar	3.44			MP	7.73
Tamil Nadu	2.09	HP	50.27	Orissa	4.06				
Kerala	11.34	Rajasthan	1.34	Chattisgarh	14.63				
		Haryana	4.48	Jharkhand	30.34				
		C'garh	5.69						
		Uttaranchal	39.60						
Total (%)	9.35	Total (%)	15.64	Total(%)	15.80	Total(%)	9.34	Total(%)	10.81

(*) Including 97.61% subsidiary Damodhar Cement & Slag. Without subsidiary, market share is 12.39%.
(Source:CMA, Karvy Stock Broking Estimates)

Financial Performance

P&L Account

(Rs Crore)

	1998-99 (A)	1999-00 (A)	2000-01(A)	2001-02(E)	2002-03(E)
Net Sales	2265.44	2323.39	2576.37	2883.42	3135.84
Other Income	138.38	58.61	72.73	35.32	35.32
Total Income	2403.82	2382.00	2649.10	2918.74	3171.16
Raw Material Cost	307.99	339.00	360.43	402.79	421.88
Purchased Power	299.66	350.88	309.12	310.95	339.20
Coal & Oil for Kiln	202.36	278.43	271	272.40	306.46
Packaging Material	77.83	87.94	91.51	104.24	193.90
Freight	335.44	348.68	367.28	410.88	459.62
Staff Cost	178.43	185.17	171.33	184.66	113.75
Other Expenditure	651.56	564.47	672.84	716.99	716.99
Total Expenditure	2053.27	2154.57	2243.51	2402.92	2551.80
Operating Profit (PBIDT)	350.55	227.43	405.59	480.49	584.04
OPM (%)	14.58	9.55	15.31	16.66	18.62
Interest	162.45	161.77	170.18	168.75	166.62
Gross Profit	188.10	65.66	235.41	311.74	417.42
Depreciation	103.76	124.51	141.28	167.53	179.53
PBT & Exceptional Items	84.34	-58.85	94.13	206.53	257.51
W/down of value of assets			-30.00	-20.00	0.00
Provision for Contingencies			-13.00	-7.00	0.00
PBT & after exceptional items	84.34	-58.85	51.13	179.53	257.51
Provision for taxation					
Current	-7.50	0.00	-3.65	13.47	19.31
Deferred				50.63	72.62
Profit after Tax	76.84	-58.85	47.48	115.44	165.58
Equity Capital	136.84	170.88	170.88	190.40	190.40
EPS (Rs)	5.62	N.A.	2.78	6.06	8.70
EV/EBIDTA (times)	8.82	14.84	9.55	8.96	7.60
EV/Tonne (Rs)	2711.52	2812.99	3051.33	2973.75	3028.43
P/BV (Times)	1.71	2.29	2.05	2.72	2.58
RoE (%)	5.26	N.A.	4.46	10.16	13.21
RoCE(%)	14.19	8.95	14.77	11.99	13.92
Debt:Equity (times)	1.43	1.38	1.53	1.35	1.29

Balance Sheet

	Mar-99	Mar-00	Mar-01	Mar-02(E)	Mar-03 (E)
Liabilities					
Equity Capital	136.84	170.88	170.88	190.39788	190.39788
Reserves & Surplus	889.22	961.96	980.86	1060.7048	1192.8312
Net Worth (Adj.for M&M not W/off)	982.41	1045.64	1081.69	1190.52	1315.64
Debt	1401.97	1444.1	1657.17	1607.17	1692.17
Stockists Deposit	35.57	43.24	61.79	80.34	80.34
Total Capital Employed	2419.95	2532.98	2800.65	2878.03	3088.15
Assets					
Net Block	1491.05	1873.14	1867.51	2299.98	2384.75
Capital WIP	403.81	162.97	430.72	46.00	123.50
Investments	146.72	172.21	181.48	177.81	177.81
Current Assets, Loans & Advances					
Inventory	236.90	293.99	312.80	304.81	331.49
Debtors	274.84	257.45	247.63	224.37	230.88
Cash & Bank Balance	51.15	32.78	27.95	45.77	48.91
Others	5.22	5.57	12.81	12.81	12.81
Loans & Advances	298.67	315.97	306.29	306.29	306.29
Current Liabilities & Provisions					
Liabilities	435.35	527.56	503.36	502.74	513.14
Provisions	53.06	53.54	83.18	87.71	87.75
Net Current Assets	378.37	324.66	320.94	303.61	329.48
Deferred Tax	50.63	72.62			
Misc. Exp. (to the extent not w/off)	43.65	87.2	70.05	60.59	67.59
Total Capital Employed	2419.95	2532.98	2800.65	2878.03	3088.15

Free Cash Flow

(Rs Crore)

	1998-99 (A)	1999-00 (A)	2000-01(A)	2001-02(E)	2002-03(E)
EBIT	246.79	102.92	264.31	348.29	424.12
Less: Adjusted Tax	3.03	40.99	46.14	66.49	73.91
NOPLAT	243.76	61.93	218.17	281.80	350.21
(Inc)/Dec in Working Capital	-94.02	45.06	53.71	17.33	-25.88
Operating Cash Flow	149.74	106.99	271.88	299.13	324.34
(Inc)/Dec in Fixed Assets	-454.79	-131.89	-258.90	-215.28	-357.50
Add: Depreciation	103.76	124.51	141.28	167.53	195.24
Free Cash Flow	-201.29	99.61	154.26	251.38	162.07

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