

Grasim Industries

Urmik Chhaya (urmik.chhaya@karvy.com)

Market Performer
Rs492.20

We are downgrading Grasim Industries from a Buy to **Market Performer** following acquisition of the L&T Cement division. A primary reason for the downgrade is our belief that Grasim has overpaid for the acquired cement capacity even if valued at Replacement Cost (*refer Exhibit 3*). **The acquisition fails to meet the key criteria of RoCE accretion. Consolidated RoCE of Grasim in FY05(E) is lower than RoCE of stand-alone Grasim in FY05(E) by almost 2 percentage points. Hence, it is clear that acquisition does not add value till FY05 at least.**

Legally and operationally, Grasim will acquire control of L&T Cement division (Cemco) probably in Q1 FY05 but the effective date (as per the scheme to be filed with the High Court) is 1 April 2003. Till Grasim legally acquires control of Cemco, it will be run in trust by L&T. In other words, for any material decision, Grasim will be consulted.

Stand vindicated

Our Goodwill calculations are based on the Standard Methodology (*refer Exhibit 1*). Goodwill gets reflected in the consolidated financial statement (CFS) and even in FY05, RoCE (consolidated) will be lower than unconsolidated RoCE of Grasim. We have factored in gross price hikes of Rs82/tonne and Rs92/tonne over FY03 prices on a YoY basis in FY04 and FY05, respectively.

Our stand has always been that any acquisition unless it adds to RoCE, is meaningless. The EV/E criterion does not carry much weightage as in that only debt gets reflected and not Goodwill, which in this case or in any case is never a book entry as it is excess paid over Book Value either in cash or through stock swap.

Acquisition fails to be EPS accretive if goodwill is written off

The acquisition will not even be EPS positive if Grasim writes off Goodwill, which it does not as it is not required to as per AS-21. L&T writes off Goodwill in 10 years and so does ACC.

Goodwill write off will make it even worse

Following precedence (Grasim did not write off Goodwill on acquisition of Shree Digvijay Cement) we have assumed that Grasim will not write off Goodwill on Acquisition. AS-21 too does not require writing off Goodwill and hence does not prescribe any period within which it should be written off. However, Goodwill cannot continue till perpetuity. Further, if Grasim writes off Goodwill over a period of 10 years as L&T does (did so on acquisition of Narmada Cement), Cemco (demerged Cement division of L&T) will continue to make losses even in FY05 after factoring in freight savings (estimated reduction in average lead distance of 45kms) and gross price hikes of Rs82/tonne and Rs92/tonne YoY in FY04 and FY05, respectively. Considering that the L&T brand will remain valid only till FY04, it effectively means a price hike of Rs95-97/tonne in FY05 for Cemco.

Exhibit 1: Calculation of Goodwill on acquisition of Cemco	Rs Billion
	FY03
Net Worth (including DTL) of Cemco (as on March'03)	15.40
Less: Deferred Tax Liability	5.50
Actual Net Worth (E)	9.90
Net Consideration pd by Grasim (adj for Rs3705.12mn recd. from L&T)	22.79
Amount Invested by Grasim (including subsidiary) till FY03 (A)	10.10
L&T's Equity	2.49
Open Offer for % Equity	38.50
No. of Shares acquired of Cemco (Mn)	95.74
Offer Price/share (Rs)	171.30
Consideration Paid (Rs Mn) (B)	16.40
Total Outgo - (A+B)	26.50
Less: Consideration recd. from L&T	3.71
Net Outgo - (D)	22.79
Equity holding in Cemco (%)	51.10
No. of shares Acquired (Mn)	1.27
Goodwill (D-E)	13.97
Share of Net Worth	7.87
Estimated Dividend Income	0.95

Notes: (1) Net Worth is taken net of DTL as ICAI required cumulative DTL to be adjusted against Net worth.

(2) Goodwill has been calculated net of Dividend Income from L&T in FY03. Since demerger is effective from April'03, dividend income will not materialise and Goodwill will be higher to that extent.

(3) L&T write off Goodwill on Acquisition in 10 years. Grasim does not as Accounting Standard does not prescribe that Goodwill on acquisition should be w/off. Grasim has not write off Goodwill on acquisition of Shree Digvijay Cements.

Source: Karvy Estimates

Myth: 30mt Capacity will result in Pricing Power

- The primary issue is that bulk of L&T's capacity is in **Gujarat** (5.30mt excluding Narmada or 31% of capacity) and in **Andhra Pradesh** (2.30mt or 13.5% of capacity). These are the two highest surplus capacity states.
- Prices in the Gujarat market are also impacted by the Rajasthan players, which itself is a surplus state.

Exhibit 2: Market share of Rajasthan based players in Gujarat

	in percentage			
	Q1FY03	Q2FY03	Q3FY03	Q4FY03
Binani Cement	7.96	9.11	8.28	9.20
J K Group	10.52	11.95	11.91	11.66
Others	4.00	4.09	3.56	3.09
Total	22.49	25.15	23.76	23.96

Source: CMA, Karvy Estimates

- Despite having lower capacity than L&T in Gujarat, Ambuja (4mt or effectively 2.5mt as only Gaj Ambuja unit feeds the Gujarat market and Ambuja Cement unit supplies almost exclusively to Mumbai) has higher market share in the state.

- L&T exports clinker from the Gujarat unit (including NCL) and no price increase over the prevailing international price is estimated.
- Shree Digvijay Cement is not in the same grade as L&T or GACL; hence acquisition changes nothing in Gujarat.

Exhibit 3: L&T Cement Capacity and Valuation

Capacity (as per CMA) as on March 2003	Million Tonne
Integrated Units- (A)	12.28
Grinding Units-(B)	4.02
Total Capacity (Mn tonne)	16.29
Capital cost of Maratha Unit of GACL (Rs Bn)	7.08
Capacity (as per CMA) -Million Tonnes	2.00
Capital Cost/tonne (Rs)- (C) of GACL	3541.23
Replacement Cost of Cement Units of L&T (A*C)-Rs Bn (F)	43.47
ACC Gring unit at Tikaria (Mn Tonne)	1.00
Capital Cost (Rs Bn)	1.18
Cost/tonne (Rs) (D)	1180.00
Replacement Cost of Grinding Units of L&T (B*D)-Rs Bn (E)	4.74
Replacement Cost of L&T's cement Capacity (E+F)	48.21
Cost/Tonne (Rs)	2959.07
Exchange rate (Rupee/US \$)-- (Z)	46.30
Cost/Tonne (US \$)	63.91

Notes: (1) Tikaria GU is not yet commercially operational and Capital cost in indicative.

(2) Narmada units can not be valued at replacement cost though we have done so.

Valuation of Equity	Rs Billion
Total Value of Cement division ---($X*Y*Z$)	61.66
Capacity (Mn tonne)-- (X)	16.29
Cost/Tonne (US \$)-- (Y)	81.07
Estimated Debt	18.63
Value of Equity	42.65
Equity Capital	2.49
Value/share (Rs)	171.30

Source: Annual Reports, Karvy Estimates; Exch Rate US \$ =Rs46.4; Debt does not include NCL debt

Andhra Pradesh

In Andhra Pradesh, L&T avails sales tax deferral and this has a direct negative impact on profitability (compared to units with exemption). With a combined marketshare of approximate 10%, the combine remains a non-entity in the state.

Karnataka

The AP unit of L&T supplies more to Karnataka than to AP and it's the plant located closest to Bangalore city. In Karnataka, the combined entity will enjoy a marketshare of more than 1/3. But, the Rajashree-Malkhed unit of Grasim is on ST deferral and only the expanded capacity enjoys ST exemption.

Maharashtra

In Maharashtra, L&T is clearly the dominant player and though it did Sales Tax assignment transactions for its Maharashtra unit, according to the management, for sale

within the state the unit enjoys benefit of exemption. As for Grasim, the grinding unit at Hotgi (accounting for almost 65% of the sale in the state by the company) is on deferral and so is the unit at Malkhed (except for expanded capacity).

North India

In the North, L&T has no presence and hence nothing changes because of the acquisition.

If 2 or 3 majors controlling 45% capacity of the country results in pricing power, UP and Rajasthan should have achieved firm sustainable price long ago. But, that is yet to happen. In **Rajasthan**, Binani (16.3%), JK (21.15%), Shree Cement (12.3%) and Birla Corp (11.2%) enjoy a marketshare of almost 61%. Similarly, in **Uttar Pradesh**, Century Textiles (13%), Jaypee (20.3%), ACC (14.7%) and Prism (10%) enjoy a market share of 58% and yet price hikes don't last.

East India

In the East, the combine is *Numero Uno* only in Orissa. However, L&T was always a dominant player in the state but is on ST deferral. In the rest of the states, marketshare is not altered materially. Almost 1/4th capacity is on deferral.

Effectively 23% of L&T's capacity (AP and Hirmi) is on ST deferral and it has no presence in the North. Another disadvantage is that pricing power in Gujarat is more with the Rajasthan-based players.

Key savings in Freight

No reduction in lead distance is estimated in FY04 as acquisition formalities will be completed only in the last quarter of FY04. In FY05, cost reduction (primarily due to reduction in lead distance) is estimated to be Rs1.06bn (cumulative for Grasim and Cemco).

View and Valuation: Why we have not used EV/E?

We have not used the EV/E parameter as it captures only the impact of debt raised for acquisition and does not factor in the impact of Goodwill. In this acquisition, Goodwill is not a book entry but the excess cash paid over the book value of the assets acquired. In this case, Goodwill is created even if assets are valued at replacement cost.

The market is not discounting the decline in RoCE. Purely on EPS, the stock offers an upside (assuming there is no Goodwill write off). Though legally Cemco will become a subsidiary effective from FY05, logically it should be factored in from the date of announcement of the deal as the consolidated results of Grasim for FY04 will include Cemco.

The stock quotes at FY05(E) P/E of 7.5x and P/BV of 1.15x (Consolidated). Considering a CAGR (consolidated) of 11% till FY05 and decline in (Consolidated) RoCE in FY05 of 2% compared to standalone Grasim, the stock offers a marginal upside. In the absence of any triggers, we rate the stock a **Market Performer**.

Grasim P&L (Unconsolidated)

Rs Million

	FY02	FY03	FY04 (E)	FY05 (E)
Net Sales	43719.20	46091.50	48397.09	51312.24
Raw Material Consumption	9961.50	11759.10	11597.32	11781.95
Power & Fuel Cost	7392.80	8555.30	8840.16	9435.66
PBIDT (Excluding Other Income)	8074.40	10086.90	11148.68	12523.89
OPM(%)	18.47	21.88	23.04	24.41
Other Income	1293.40	1329.80	708.40	708.40
Interest	1902.50	1684.10	1661.79	1751.79
Depreciation	2517.00	2541.40	2827.91	3059.53
Profit before Tax & Exceptional Items	4948.30	7191.20	7367.37	8420.97
Exceptional Items				
Loss on sale of shares in MRPL		2086.24		
Employee Seperation Cost	276.00	59.20		
Others	1243.80			
Profit before Tax	3428.50	5045.76	7367.37	8420.97
Provision for Current Tax	565.00	1920.00	1709.23	1953.66
Deferred Tax	515.00	-150.00	353.63	404.21
Tax Provision of earlier years w/back	681.10	400.00		
Profit after Tax	3029.60	3675.76	5304.51	6063.10
Recurring PAT	3868.30	5421.20	5304.51	6063.10
Equity Capital	916.70	916.70	916.70	916.70
EPS (Rs)	42.20	59.14	57.87	66.14
Book Value (Rs/Share)	295.29	324.10	371.40	426.29
RoE (%)	13.38	19.10	16.66	16.61
RoCE(%)	13.16	15.99	14.67	14.74
EV/EBIDTA (x)	7.12	5.86	6.05	5.42
P/BV (x)	1.70	1.55	1.35	1.18
Dividend per Share	9	10	10	10

Notes: (1) Recurring PAT has been calculated by deducting tax (including Deferrred Tax credit from PBT & Exceptional Items.)

(2) Book Value is adjusted for Revaluation Reserves & does not include Deferred Tax liability.

Grasim: Balance Sheet

Rs Million

	FY02	FY03	FY04(E)	FY05(E)
Sources of Funds				
Equity Capital	916.70	916.70	916.70	916.70
Share Capital Suspense	0.20	0.20	0.20	0.20
Reserves & Surplus (Net of RR)	26151.90	28793.50	33129.42	38161.23
Net Worth	27068.80	29710.40	34046.12	39077.93
Deferred Tax Liability	6405.00	6255.00	6608.63	7012.84
Loan Funds	20647.40	20760.70	25647.40	25647.40
Total Capital Employed	54121.20	56788.80	66302.35	71738.37
Application of Funds				
Gross Block	52492.10	54861.20	60492.10	63992.10
Less: Accu. Depreciation	21080.60	23301.10	26658.87	29718.40
Net Block	31411.50	31560.10	33833.23	34273.70
Investments	14160.40	17960.50	26254.06	26254.06
Current Assets, Loans & Advances	15589.70	14956.10	14194.18	18432.52
Debtors	4978.50	4296.50	4496.16	5623.50
Cash & Bank Balance	1483.20	1101.10	359.43	1633.23
Current Liabilities & Provisions	8261.00	8828.70	7979.11	8221.90
Total Capital Employed	54121.20	56788.80	66302.35	71738.37

Note: (1) Investments (for FY04 & FY05) are Net of consideration to be received from L&T and includes investment in Cemco and group companies.

Grasim: Free Cash Flow Statement

Rs Million

	FY02	FY03	FY04(E)	FY05(E)
EBIT	6850.80	8875.30	9029.16	10172.76
Less: Adjusted Tax	822.83	2393.12	2051.31	2328.03
NOPLAT	6027.97	6482.18	6977.86	7844.73
Inc/(Dec) in Working Capital	-2479.30	-819.20	829.34	2721.75
Inc/Dec in Fixed Assets	228.10	4288.30	4740.70	4500.00
Add: Depreciation	2517.00	2541.40	2827.91	3059.53
Free Cash Flow	10796.17	5554.48	4235.72	3682.51

Note: Deferred Tax, being non cash has been ignored.

P& L Account: Cemco Consolidated

Rs Million

	FY03(E)	FY04(E)	FY05(E)
Revenue	28186.70	30157.97	32830.82
Less: Inter Segment sales	1320.00		
Operating Revenue	26866.70	30157.97	32830.82
Operating Expenditure	23253.37	25854.10	27735.82
Operating Profit (including O. Income)	3613.33	4303.87	5095.01
Interest	1613.34	1543.34	1438.34
Gross Profit	1999.99	2760.53	3656.67
Depreciation	2209.23	2304.04	2358.81
Profit/(Loss) before Tax	-209.24	456.49	1297.85
Tax		91.30	259.57
Profit after Tax	-209.24	365.19	1038.28
Equity Capital	2486.70	2486.70	2486.70

Notes:(1) For FY03, Consolidated EBIT of L&T Cement Division is taken from Segment Reporting for the year. EBIDTA of Cement division is as per the Presentation figures and adjusted for EBIDTA of Narmada Cement, which has extended its financial year to September in 2003. The difference between EBIDTA and EBIT is treated as depreciation.

(2) Inter-Segment revenue is as per Presentation and in any case is Profit neutral.

(3) As per the L&T management, cost reduction in excess of Rs300mn in FY03 has been done for the Cement division. We have estimated savings of Rs315mn. We have not been able to apportion the saving under each head of variable cost and hence it is adjusted against total Variable cost. Variable cost has been calculated based on Form A Data (for P&F Cost) and Quantitative Information on Material Consumption. Packaging cost/tonne has been calculated only on domestic dispatches.

(4) Freight cost/tonne has been estimated at Rs590 (exports are on FoB basis). Assumed lead distance reduction of 45kms in FY05. No benefit has been factored in FY04.

(5) Factored in Volume growth in Cement sale of 8% and 6% on a YoY basis for FY04 & FY05. Increase in Gross Realisation is estimated at Rs82/tonne and Rs92/tonne on a YoY basis in FY04 and FY05, respectively. Clinker Exports estimated to be 2.7 mn/tonnes/year and prevailing price has been kept constant.

(6) Variable cost/tonne has been calculated in above explained manner. Unlike Grasim, L&T does not provide O. Income division-wise in its Annual Report (**See Schedule 22: Information about Business Segments in Annual Report of Grasim.**) Bulk of O. Income of L&T comprises of dividend from subsidiary companies (NCL is a loss making company and does not pay dividend), lease rentals (primarily equipment lease and attributable to E&C division) & Interest from customers & subsidiaries/associate company (marginal, if any, portion from NCL). Difference between Net Sales & EBIDTA (includes other Income) is Total Cost from which Variable cost is deducted to arrive at Fixed cost.

(7) Estimated cost of debt:7%.

Balance Sheet (Cemco Consolidated)

Rs Million

	FY03(E)	FY04(E)	FY05(E)
Sources of Funds			
Equity Capital	2486.70	2486.70	2486.70
Reserves & Surplus	9400.00	9765.19	10803.47
Net Worth (adjusted for Misc. Exp.)	11347.38	11892.34	13110.40
Deferred Tax Liability	6000.00	6000.00	6000.00
Less: Misc. Exp. (to the extent not w/off)	539.33	359.55	179.78
Debt	19749.24	18749.24	17249.24
Total Capital Employed	37635.94	37001.13	36539.41
Application of Funds			
Gross Block	43072.22	44072.22	45072.22
Less: Depreciation	11143.53	13447.57	15806.39
Net Block	31928.69	30624.64	29265.83
Investments	0.00	0.00	0.00
Current Assets, Loans & Advances	9691.39	10070.55	10377.00
Debtors	687.92	702.68	770.97
Stock-in-trade	3711.14	3970.68	4322.60
Cash & Bank Balance	1499.94	1604.80	1491.05
	Loans & Advances	3792.39	3792.39
Current Liabilities & Provisions	3984.14	3694.06	3103.42
Net Current Assets	5707.25	6376.49	7273.58
Total Capital Employed	37635.94	37001.13	36539.41

Consolidated P&L of Grasim (including Cemco)	Rs Million	
	FY04(E)	FY05(E)
Operating Revenue	87153.86	93125.14
Operating Expenses	71704.02	75508.94
Operating Profit	15449.85	17616.20
Other Income	708.40	708.40
EBIDTA (incl. O. Income)	16158.25	18324.60
Interest	3205.13	3190.13
Depreciation	5131.96	5418.34
Profit before Tax	7821.16	9716.12
Provision for Taxation		
Current	1799.90	2212.61
Deferred	353.50	404.08
Profit after Tax	5667.75	7099.44
Less: Loss of JVs/Subsidiaries (excl. Cemco)	-330.00	-330.00
Minority Interest	178.94	508.76
Consolidated Profit after Tax	5158.81	6260.68
Equity Capital	916.70	916.70
Dividend per share	10.00	10.00
EPS (Rs)	56.28	68.30
Book Value (Rs/Share)	434.94	492.01
RoE (%)		16.71
RoCE(%)		12.66
EV/EBIDTA (x)	5.76	5.00
P/BV (x)	1.16	1.02

Notes: (1) It is estimated that Grasim will not w/off Goodwill on Acquisition as AS-21 does not require it and hence does not prescribe any w/off period. L&T & ACC w/off Goodwill on Acquisition of Subsidiary over 10 years period but Grasim does not (Source: Annual Reports)

(2) Loss of subsidiaries/JVs (other than Cemco) has been assumed constant as in FY03. Neither any change in percentage holding is factored in.

(3) RoE (calculated net of DTL) & RoCE for FY04 not calculated because the impact of Cemco on consolidation will make the ratios meaningless as the ratios are calculated on Average Net worth and Average TCE.

Consolidated Balance Sheet of Grasim (including Cemco)	Rs Million	
	FY04(E)	FY05(E)
Equity Capital	916.70	916.70
Reserves & Surplus	38954.15	44185.49
Deferred Tax Liability	12612.23	13016.44
Net Worth (Including DTL)	52483.09	58118.63
Minority Interest	178.94	508.76
Debt	47027.34	45527.34
Total Capital Employed	99689.37	104154.73
Goodwill	16932.16	16932.16
Gross Block (Other than Goodwill)	106590.82	111090.82
Less: Deprn.	40945.65	46363.99
Net Block	65645.17	64726.83
Cap. W.I.P.	0.00	1000.00
Investments	1805.50	1805.50
Net Current Assets	14946.99	19510.46
Cash & Bank Balance	1964.23	1850.48
Misc. Exp. (to the extent not w/off)	359.55	179.78
Total Capital Employed	99689.37	104154.73

Notes: (1) Investment in only group companies has been considered.

(2) Goodwill is the difference between BV of Cemco (as on March'03) and the consideration (Net) paid for it plus the B/F Goodwill of L&T on acquisition of Narmada Cements.

Stock Ratings Absolute Returns

Buy	:	> 25%
Out Performer	:	16 - 25%
Market Performer	:	0 - 15%
Under Performer	:	< 0%

Karvy Stock Broking Limited

131, Andheri Industrial Estate, Off Veera Desai Road, Andheri (W), Mumbai – 400 053. India.
Tel: (91-22) 5695 0204 - 7, 5693 6346 /47.

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