
# SUDARSHAN

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# Sudarshan Chemical Industries

## Buy



Initiating Coverage

### The World is their Canvas

**The 68-year old legacy of manufacturing high performance pigments involving environmental perils has helped Sudarshan Chemical (SCHI IN) become the 4th largest Pigment manufacturer globally. Sudarshan Chemical domestic market share (in Organic pigments) stands at ~35% as the company boasts of being a leading Azo Pigment manufacturer in the country. Sudarshan Chemical manufacturers pigments used in Coatings, Packaging, Inks, Plastics and Cosmetics. Pigments are a de facto quasi play on a high growing Paints and packaging market. We believe that the consolidation narrative is likely to benefit an Indian company like Sudarshan Chemical.**

**Market share gains from the incremental demand that may transpire amidst transitioning global supply chains (away from China) would translate into an earnings CAGR of 9.6% over FY20-23E. Backed by a strong capex program (~Rs 5.8bn over FY20-22) the company is well placed to seize opportunities on a global landscape. Introduction of new high performance pigments is likely to be margin/RoCE accretive and will garner superior asset turns (~3.0x on capex earmarked for growth capex ~Rs 4.0bn). We thus believe that RoCE's are set to improve by 100 bps from FY20 to FY23E to 17.2% as assets begin sweating. We like Sudarshan Chemical focused approach on the Pigments business, prudent capital allocation in a much commoditised business, global presence, strong SHE practices and growth opportunities cropping up from consolidation in the global pigments arena. We initiate coverage on Sudarshan Chemical with a buy rating, we value the company at 22x FY23E EPS with a target price of Rs 551/share.**

### CAPEX led growth to boost earnings

Sudarshan Chemical has capitalised Rs 2.5bn in its gross block in FY20. The company has planned a capex of Rs 2.2bn in FY21E and Rs 1.1bn in FY22E. The company expects to derive asset turns of 3.0x at peak utilisation. The capex earmarked for volume growth is ~70% (~Rs 4.0bn) which is expected to add ~Rs 12.0bn to the top-line at peak utilization which can be realized in FY24E or FY25E. The company is expected to reach full capacity utilisation in 3-4years, we thus project a 7.7% CAGR over FY20-23E for which the sales are likely to be at Rs 20.9bn.

### FINANCIALS (Rs Mn)

| Particulars | FY19A | FY20A | FY21E | FY22E | FY23E |
|---|---|---|---|---|---|
| Revenue | 15,930 | 17,082 | 16,120 | 18,506 | 21,249 |
| Growth(%) | 19.8 | 7.2 | (5.6) | 14.8 | 14.8 |
| EBITDA | 2,040 | 2,463 | 2,306 | 2,860 | 3,285 |
| OPM(%) | 12.8 | 14.4 | 14.3 | 15.5 | 15.5 |
| PAT | 809 | 1,317 | 992 | 1,441 | 1,733 |
| Growth(%) | 5.1 | 62.9 | (24.7) | 45.2 | 20.3 |
| EPS(Rs.) | 11.7 | 19.0 | 14.3 | 20.8 | 25.0 |
| Growth(%) | 5.1 | 62.9 | (24.7) | 45.2 | 20.3 |
| PER(x) | 40.6 | 24.9 | 33.1 | 22.8 | 18.9 |
| ROANW(%) | 23.8 | 24.7 | 15.8 | 20.6 | 21.5 |
| ROACE(%) | 7.6 | 13.1 | 9.5 | 12.0 | 13.2 |

| | |
|---|---|
| CMP | Rs 474 |
| Target / Upside | Rs 551 / 16% |
| NIFTY | 12,969 |

**Scrip Details**

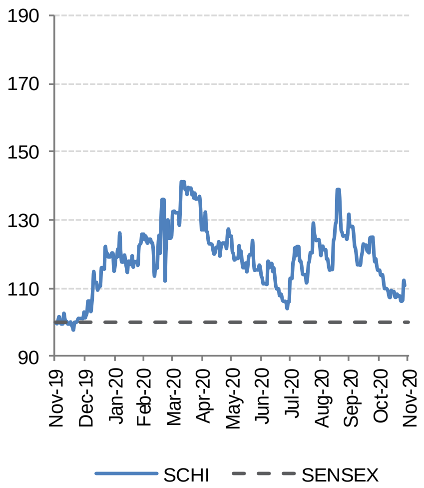
| | |
|---|---|
| Equity / FV | Rs 138mn / Rs 2 |
| Market Cap | Rs 33bn |
| | USD 446mn |
| 52-week High/Low | Rs 538/ 290 |
| Avg. Volume (no) | 247,891 |
| Bloom Code | SCHI IN |

| Price Performance | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (%) | 8 | 6 | 20 |
| Rel to NIFTY (%) | 8 | 8 | 27 |

**Shareholding Pattern**

| | Mar'20 | Jun'20 | Sep'20 |
|---|---|---|---|
| Promoters | 42.7 | 42.7 | 42.7 |
| MF/Banks/FIs | 3.6 | 3.2 | 4.2 |
| FIIs | 8.2 | 8.3 | 8.1 |
| Public / | 45.5 | 45.8 | 45.0 |

**SCHI Relative to SENSEX**

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## Investment Thesis

- Consolidation in the Global Pigments Industry with the 2 biggest manufacturers –BASF and Clariant Chemicals on the verge of exiting the Pigments business.
- Company's focus on high margin High Performance Pigments is expected to be margin accretive and drive return ratios
- Chinese companies which are the major sources of Raw material have relocated and commenced supplies of dyestuffs and intermediates which will help in easing Raw material cost pressure.

## Risk

- China's cost competitiveness on the back of export incentives from the Chinese government might make it difficult for Sudarshan to gain export market share.
- Volatile RM prices due to fluctuating crude oil prices and environmental clampdown in China.
- Dependence on China for raw materials like Aromatics and Naphthalene derivatives which are used in the manufacturing of Organic Pigments.

## Catalyst

- The capex earmarked for volume growth is ~70% (~Rs 4.0bn) which is expected to add ~Rs 12.0bn to the top-line and expected to reach peak utilization in 3-4 years.
- India's global domination in the highly competitive Phthalocyanine blues and greens Pigment Segment.
- Company's focus is on high performance pigments which may not see meaningful margin contraction as Chinese companies continue to manufacture non-specialty pigments.
- Venturing into newer areas like inks for food applications or digital inks where technical specifications, such as narrow particle size distribution are critical.

## Event

- Capex earmarked for volume growth is ~70% (~Rs 4.0bn) which is expected to add ~Rs 12.0bn to the top-line at peak utilization which can be realized in FY24E or FY25E.
- Consolidation in the Pigment industry with 2 biggest players divesting their Pigments business will result in incremental inflows of ~Rs 4.18bn over FY21-23E if the company were to capture 16% of the incremental growing market taking sales to Rs 20.9bn in FY23E assuming a 4% CAGR growth in the pigment market.

## Company Background

- Sudarshan started manufacturing pigments in 1952 with a handful of inorganic pigments and with a breadth of products that cover classical azo pigments, high performance pigments, effect pigments and pigment dispersions.
- Company serves coatings, plastics, inks and cosmetics markets
- Active in over 85 countries, Sudarshan employs around 2000 employees and has two production facilities at Roha & Mahad in India.
- The company has sales offices in India, Netherlands, USA, and China and over 170 channel partners globally to achieve a consistently high level of service.

## Assumptions

- Global Pigment market growth rate: 4%
- Considering Sudarshan Chemical captures 10% of the growing market – its Sales/EBITDA/PAT in FY23E would be at Rs 18.07bn/2.96bn/1.49bn, which implies a sales growth of 9.6% over FY21-23E
- 3 scenarios of gains in incremental market (5%-Bear case ,10% - Base case,30% -Bull case) (Refer Exhibit 16 on Page 13) but we are considering ~16% market share which will help them in growing their sales at 15% CAGR over FY21-23E.
- EBITDA Margin Expansion to 15.7%.

# Investment Thesis

## Pigment majors consolidating – a silver lining

The largest of the two Pigment manufacturers are on the verge of exiting the Pigments business. BASF (whose Pigments and Dispersions sales are ~ Eur 1.0bn) is set to divest its Pigments and dispersions segments to Sun Chemicals –DIC Corp for Eur 1.15bn. While Clariant (whose Pigments and Masterbatches sales are ~Eur 1.9bn) has been actively scouting for company to buy its division. We argue that, assuming a 4% CAGR growth in the pigment market (keeping current market share of other players constant), SCHI would be able to add ~Rs 4.18bn over FY21-23E if the company were to capture 16% of the incremental growing market taking sales to Rs 20.9bn in FY23E.

## Focus on high performance pigments to be RoCE accretive

Chinese and Indian manufacturers are known to manufacture Pigments (organic/inorganic) which attract high competition and relatively lower realizations. Whereas, the European and Japanese companies with special offerings have held their forte of high performance pigments with strong R&D and innovations. Sudarshan Chemical's focus on high margin HPP's is expected to be margin accretive and drive return ratios (RoCE/ROE) upwards of 17.2/21.5% in FY23E.

## Raw material cost pressure to subside

Indian chemical industry is deprived of key raw material feedstocks and is dependent on China for a bulk of the raw materials. Similarly, Pigment manufacturers depend on China for key pigment intermediates like bon acid, Beta Naphthol and naphthalene based intermediates. Ever since China started crippling down polluting entities, supply constraints arising from key intermediates changed the cost structures for pigment manufacturers and subsequently crushed their margins. **However, Chinese companies have known to have relocated and commenced supplies of dyestuffs and intermediates which has averted margin pressure with RM prices easing out (Bon acid prices are down by 8.9% YoY, 2B acid prices are down by 17.5% YoY, prices of Naphthol intermediates are flattish on a YoY basis).**

# Key Risks to our call

## China's cost competitiveness is difficult to match

On 20th March 2020, the Chinese government extended benefits for exporters by incentivising companies to the tune of 13% for key petrochemicals and chemicals. Certain Pigments too (largely commodity pigments) will get the benefit of the same. This could have a significant bearing on Sudarshan Chemical as matching China's low cost structures would make it difficult to gain export market share.

## Fluctuating RM prices

As bulk of the organic pigment intermediates are crude derivatives and are largely produced in China. The risk of fluctuating crude oil prices and the inherent environmental clampdowns in China could create supply side concerns and would make it difficult to pass on raw material prices.

## Dependence on China for imports

Since 2017, the entire industry has been feeling the pinch from raw material disruptions caused by the enforcement of environmental regulations in China (known as "Blue Sky" initiatives). Aromatics (benzene, toluene, xylenes) and naphthalene derivatives are the main building blocks of organic pigments; this feedstock are widely produced in Asia due to the cracking of heavier feedstock for ethylene production and also the availability of coal tar (a by-product of coke ovens from steel and aluminum smelting).

India per se, Gujarat which happens to be the largest chemical manufacturing state is not a host to Steel and Alumina production which deprives Pigment companies of basic Napthalene based feedstock necessary for Azo Pigment manufacturing.

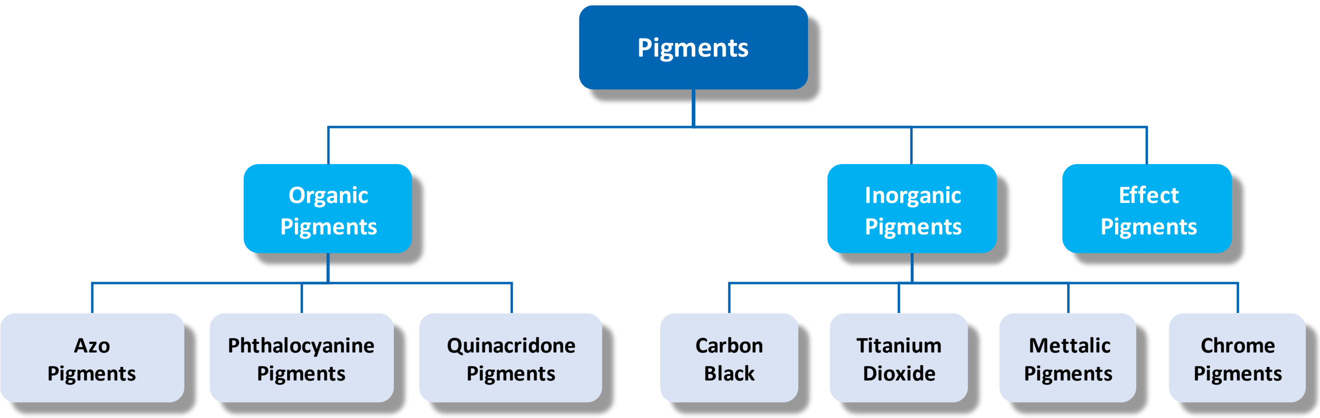
## Global Pigment Sector

The broadest level of classification within Pigments is done on the basis of whether or not a Pigment is a hydrocarbon derivative. Pigments are thus classified as Organic Pigments and Inorganic Pigments.

Inorganic Pigments are typically considered as high volume, low value in nature largely due to Carbon Black and Titanium Dioxide. Titanium Dioxide provides a white color as a pigment and is widely used in paints and coatings, while Carbon Black is also used as a black pigment but a large amount of volumes is used in tires as a reinforcing agent. Other Inorganic pigments are chrome pigments, iron oxides, cadmium pigments, metallic pigments etc.

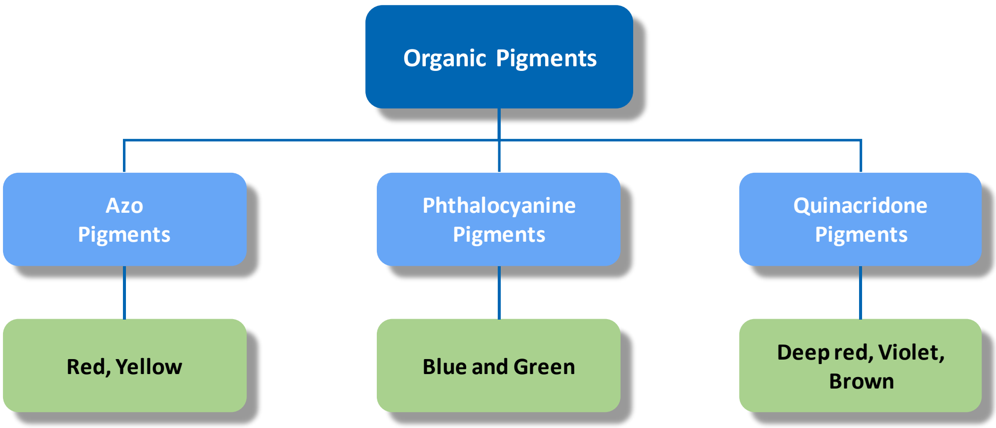
Organic Pigments are further sub classified as Azo Pigments, Phthalocyanine Pigments and Quinacridone Pigments. Also, high performance pigments which are custom made could also be a part of one of the sub classified group.

**Exhibit 1: Pigments Value Chain**




*Source: Industry, DART*

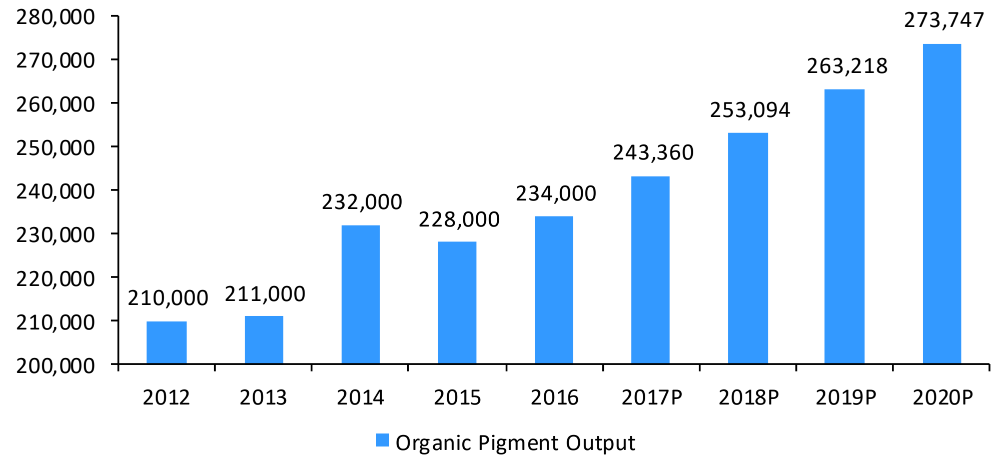
**Exhibit 2: Organic Pigments Value Chain**




*Source: Industry, DART*

China is the largest manufacturer of Azo Pigments – which essentially impart the Yellow and Red pigment. China has been able to make significant strides in building scale of Azo Pigments due to the availability of a key building block – Naphthalene. As per industry estimates, the total output of Organic pigments in China was 234,000 TPA in 2016 which was ~65% of total global pigment output. Naphthalene is used to manufacture pigment intermediates like 2B acid, Beta Naphthol, Bon acid and other Naphthalene based intermediates.

**Exhibit 3: China's Organic Pigment Production (MT)**




*Source: IPO Prospectus of Anshan HiFi Co Ltd (China), DART Research*

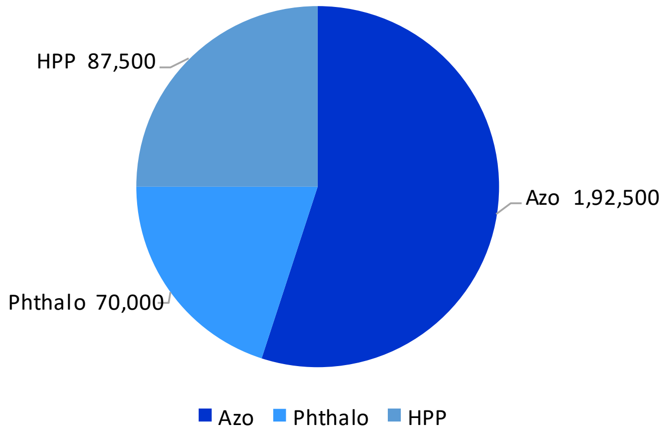
Naphthalene is derived from two sources—coal tar and petroleum. In 2015, over 90% of the world's naphthalene was produced from coal tar; the remainder was from petroleum. Petroleum naphthalene capacity is concentrated in China, the United States, and Western Europe. Over the past decade, China has become the world's largest producer of naphthalene, accounting for 64% of total global naphthalene capacity. In 2015, Chinese naphthalene consumption accounted for 65.7% of global consumption. Thus dependence on China for imports of Naphthalene based intermediates reasonably high. Sudarshan Chemical procures ~25-30% of their RM needs from China.

India, however dominates the Phthalocyanine Pigment production globally.

Phthalocyanine Pigments impart the Blue and Green color with different grades of Copper Phthalocyanine crude(CPC) Green or Blue.

The total global production of Azo pigments stood at ~192,500 TPA, while that of Phthalocyanine pigments stood at ~70,000 TPA and that of high performance pigments stood at ~87,500 TPA in 2016. The total organics pigment market stood at ~USD 5bn in 2019.

**Exhibit 4: Global Demand Split in Organic Pigments (MTPA) (as on 2017)**




*Source: DART, Company*

Breaking down USD 8.6bn into 3 types in which Sudarshan Chemical is active – Organic Pigments is ~USD 5bn (Rs 372bn), Inorganic Pigments is ~USD 3bn (Rs 223bn) and Effect Pigments are ~USD 0.6bn (Rs 45bn). In volumetric terms – Organic Pigments demand is to the tune of 400,000 TPA out of which Phthalocyanine Pigments (Blue and Green) are pegged at 70,000TPA, Azo Pigments (Yellow, Red) are pegged at 195,000 TPA and High performance pigments are at 87,000 TPA.

It is noteworthy that China has ~70% of worlds organic pigment capacity. However, European and Japanese Pigment companies have a dominant hold on high performance pigments which are low volume-high value products. **Dolat Capital assumption: China output: ~250,000 TPA, global output: ~350,000 TPA, BASF+Clariant put together control ~50,000-60,000 TPA of HPP market which is high in value, low in volumes, while China+India control only ~10,000-20,000 TPA of HPP market.**

We believe that Chinese manufacturers have a sizeable scale of manufacturing commodity azo pigments. Also, the recent export incentives the Chinese manufacturers might avail – which is to the tune of 13% will make them far too competitive against other manufacturers. However, Sudarshan Chemical focus is on high performance pigments which may not see meaningful margin contraction as Chinese companies continue to manufacture non-specialty pigments. An analysis of Pigment export realisations against Pigment import realisations (in the below table) exhibits that China largely manufactures low value commodity pigments whereas imports high value high performance pigments which are largely manufactured in Europe and Japan.

**Exhibit 5: Average Import/Export Prices in China**

| USD/Ton | 2015 | 2016 | 2017 |
|---|---|---|---|
| Average price of Imports in China | 15,895 | 16,555 | 17,259 |
| Average price of Exports in China | 7,776 | 7,231 | 7,175 |

*Source: IPO Prospectus of Anshan HiFi Co Ltd (China), DART Research*

## Deciphering the consolidation wave

Manufacturers of high performance pigments are inherently dependent on China for important raw material. Key pigment intermediates like Bon acid, Beta Naphthol and Naphthalene based intermediates are largely manufactured in China. Ever since China started crippling down polluting entities, supply constraints arising from key intermediates changed the cost structures for pigment manufacturers and subsequently crushed their margins. We thus believe this forced global companies to divest businesses with a relatively lower margin profile. We make a note of one such incident which rose prices of pigment intermediates in March-2019.

On 21st March 2019, a major explosion in Jiangsu chemical park wiped out ~1500 companies from the supply chain. Key manufacturers of Pigment, Dyes and Pesticide intermediates had to shut-down operations for over a year. Short supply of Pigment intermediates inflated cost structures for the Pigment industry, which could not be easily passed on. However now, it is being known that Chinese manufacturers have resumed production after shifting their bases to less polluted areas. Jiangsu Tianjiayi Chemical Company (JTC) was one of the key supplies of Dyes and Pigment intermediates with the below capacities which went into short-supply back in 2019.

**Exhibit 6: Capacities of key Intermediates of Jiangsu Tianjiayi Chemical Company (JTC)**

| Product name | TPA |
|---|---|
| 1,3-Dinitrobenzene | 30,400 |
| M-Phenylenediamine | 17,000 |
| O-Phenylenediamine | 2,500 |
| Tris(hydroxymethyl)amino Methane | 1,000 |
| P-Phenylenediamine | 500 |
| 3-Hydroxybenzoic acid | 500 |
| 2,4,6-Trimethylaniline | 500 |
| P-Toluidine | 500 |
| 3,4-Diaminotoluene | 300 |
| M-Dimethylaminobenzoic acid | 300 |
| KSS | 200 |
| 2,5-Dimethylaniline | 100 |

*Source: Institute of Public and environmental affairs, China, DART Research*

## Competitive Landscape

Sudarshan Chemical is known to have a 3.5% global market share in value terms and is the 3rd Largest Pigment manufacturer globally (1st BASF- Sun Chemicals DIC Corp, 2nd Clariant Chemicals). However, Sudarshan Chemical has to multiply its sales by ~3.5-4.0x to reach to the 2nd position.

SUN Chemicals – DIC Corp have targeted 2021 sales of ~USD 1.5bn in their Colours & Displays business segment (which hosts pigments) and EBITDA of ~USD 0.17bn. The largest of the two Pigment manufacturers are on the verge of exiting the Pigments business. BASF (whose Pigments and Dispersions sales are ~ Eur 1.0bn) is set to divest its Pigments and dispersions segments to Sun Chemicals –DIC Corp for Eur 1.15bn. While Clariant (whose Pigments and Masterbatches sales are ~Eur 1.9bn) has been actively scouting for company to buy its division.

**Exhibit 7: Key Competitors**

| Competition | Remarks | Annual Sales |
|---|---|---|
| **BASF** | Ranks no.1 in High performance Pigments | ~USD 1.2 bn |
| | Poor integration after M&A with CIBA | |
| | Main supplier of Quinophthalone, Perylene red, Quinacridone | |
| **Clariant** | Major global supplier of Naphthol and other product series | ~USD 900 mn |
| | Strategically joint venture with Chinese companies | |
| | Internal integration and reorganization to optimize production capacity | |
| | Lost on high profit margin markets | |
| **DIC** | Has a dominant position in the U.S. and Japan markets | ~USD 700 mn |
| | Major supplier of Dioxazine Violet and Quinacridone | |
| | The group company is one of the large ink manufacturers | |
| **Lily Group** | The company's main products include classic organic pigments and some high Capable of organic pigments, including Quinacridones, Pyrrolopyrrole Diones, Naphthenes, lake reds, double Organic pigments such as azo yellows | ~ USD 300 mn |
| **Changzhou North America Chemical Group** | In 2011, it was one of the largest classic organic pigment manufacturers in China | NA |
| | Manufacturers classic azo, Phthalocyanine, oil-soluble and other pigments | |

*Source: IPO Prospectus of Anshan HiFi Co Ltd (China), Bloomberg, DART Research*

**Gross margin profiling of Specialty and Non-Specialty Pigments (as on 2017):**

**Exhibit 8: Non Specialty Pigments**

| Product Type | Applications | Market | Gross margins |
|---|---|---|---|
| Monoazo Yellow | Largely coatings, small quantities in Plastics | Surplus capacity | 20-35% |
| Benzidiene Yellow | Largely Inks, small quantities in plastics | Over-capacity in a 10,000 TPA+ Market, China dominated | 15-25% |
| Beta Naphthol Lake | Largely Inks, small quantities in plastics | Over-capacity in a 10,000 TPA+ Market, China dominated | 15-25% |
| Bon Lake | Inks | Over-capacity , China dominated | 15-30% |
| Naphthol | Inks and Paints | Low end market, China dominated | 25-40% |
| Coppper Phthalocyanine | Inks, Plastics and Paints | 70-80KTPA market | NA |

*Source: IPO Prospectus of Anshan HiFi Co Ltd (China), DART Research*

**Exhibit 9: Specialty Pigments**

| Product Type | Applications | Market | Gross margins |
|---|---|---|---|
| Diketopyrrolopyrrole | Plastics, Oils and Paints | >8000TPA | 30-50% |
| Quinacridone | Coatings and Plastics | >4000TPA | 25-50% |
| Dioxazine | PV23 used for inks, plastics and toning pigment | >5000TPA | 30-40% |
| Quinophthalone | Plastics (PVC engineering), coatings, and paints | 1000TPA | 50% |
| Azo condensation | Plastics, Coatings, Inks | 1000TPA | 40-50% |
| Benzimidazolone | Plastics, Coatings, Inks, Chemical fibers | 1000TPA | 50% |
| Isoindolinone | Plastics, Coatings, Inks, Inorganic pigments | >2500TPA | 50% |

*Source: IPO Prospectus of Anshan HiFi Co Ltd (China), DART Research*

# Raw Material Procurement – Top Agenda

In the 1990s the organic pigments industry in Western countries was facing compliance with environmental regulations and uncertainty in raw material availability. Almost three decades later, these themes are being replayed in Asia.

Since 2017, the entire industry has been feeling the pinch from raw material disruptions caused by the enforcement of environmental regulations in China (known as "Blue Sky" initiatives). Aromatics (benzene, toluene, xylenes) and naphthalene derivatives are the main building blocks of organic pigments; this feedstock are widely produced in Asia due to the cracking of heavier feedstock for ethylene production and also the availability of coal tar (a by-product of coke ovens from steel and aluminium smelting).

India per se, Gujarat which happens to be the largest chemical manufacturing state is not a host to Steel and Alumina production which deprives Pigment companies of basic Napthalene based feedstock necessary for Azo Pigment manufacturing.
Several producers have seen a shortage of specific pigments such as pigment yellow 74 due to lack of raw materials.

## Looking beneath the commodity layers for growth drivers

It is widely known that the influx of Chinese and Indian producers increased the competitive pressure for pigment producers. Certain pigments such as Phthalocyanine blues and greens are intensely competitive – so much so that India producers now dominate this segment of the market.

Western producers have also optimised their production assets by having production of some pigments in China or India while keeping production of high performance pigments and dispersions in the West.

Over half of organic pigments by volume is used in inks – from a broad view, this is a more commoditised and low growth area for pigment suppliers followed by polymers and then coatings (less commoditised).

However, look beneath the layers and there are still some more attractive areas which tend to attract higher margins e.g. inks for food applications where additional processing is required to reduce the primary aromatic amine content (PAA) or digital inks where technical specifications, such as narrow particle size distribution are critical.

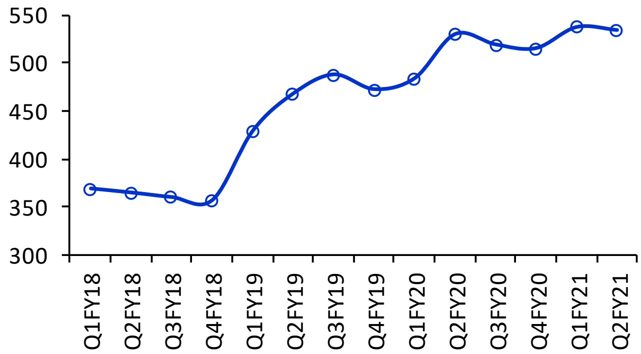
In this now muddled pigments landscape, there is still specialisation required and services valued by customers which differentiate producers. Suppliers must meet customer testing requirements to ensure the technical performance and reproducibility of each batch of pigment. In certain end-markets such as automotive, pigments must have leading performance e.g. high light fastness and heat stability.

## Raw material cost pressure to subside

Indian chemical industry is deprived of key raw material feedstocks and is dependent on China for a bulk of the raw materials. Similarly, Pigment manufacturers depend on China for key pigment intermediates like bon acid, beta napthol and naphthalene based intermediates. Ever since China started crippling down polluting entities, supply constraints arising from key intermediates changed the cost structures for pigment manufacturers and subsequently crushed their margins. **However, Chinese companies have known to have relocated and commenced supplies of dyestuffs and intermediates which has averted margin pressure with RM prices easing out (Bon acid prices are down by 8.9% YoY, 2B acid prices are down by 17.5% YoY, prices of Naphthol intermediates are flattish on a YoY basis).**

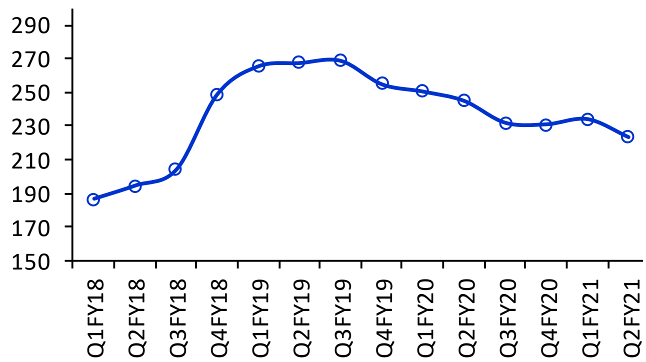
Naphthol ASPH cost is ~8% of total imported raw material costs and is flattish on a YoY basis. Bon Acid is ~7.5% of total import raw material costs and is down 8.9% on a YoY basis.

**Exhibit 10: NAPHTHOL ASPH (3-HYDROXY 2-NAPHTHO PHENETIDINE) (Rs/Kg)**




*Source: DART, Industry*

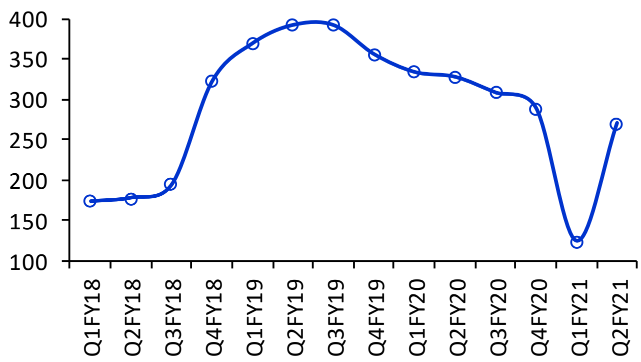
**Exhibit 11: BON ACID (Rs/kg)**




*Source: DART, Industry*

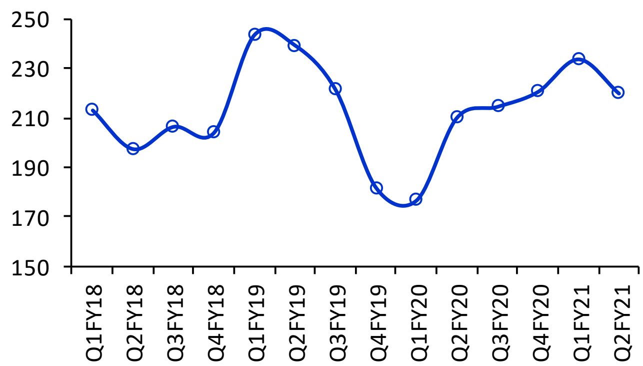
2B Acid forms ~6.8% of total import raw material cost and is down 17.5% YoY while Aceto acetortho anisidide is ~4.6% of total imported raw material cost and is up 4.6% YoY.

**Exhibit 12: 2B ACID (Rs/Kg)**




*Source: DART, Industry*

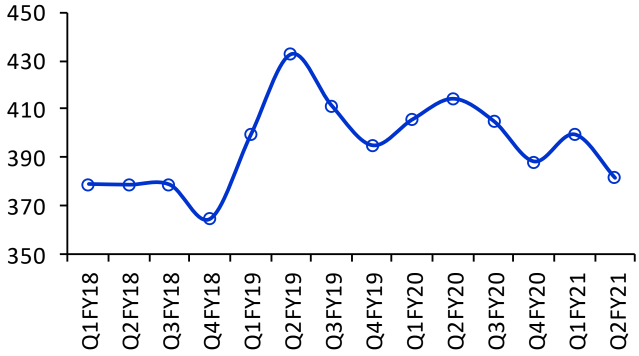
**Exhibit 13: ACETO ACETORTHO ANISIDIDE (Rs/Kg)**




*Source: DART, Industry*

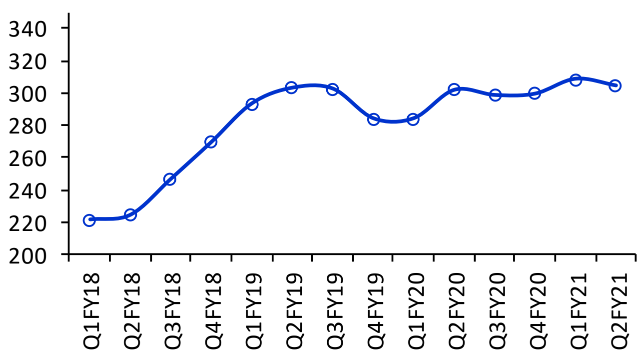
C acid and Naphthol AS are each ~4.3% of the total imported raw material costs and are up 7.2% and 18.1% YoY respectively.

**Exhibit 14: C ACID (Rs/Kg)**




*Source: DART, Industry*

**Exhibit 15: NAPHTHOL AS (Rs/Kg)**




*Source: DART, Industry*

## Assumptions

1. Global Pigment market growth: 4%
2. 3 scenarios of gains in incremental market (5%- Bear case ,10% - Base case,30% -Bull case)
3. EBITDA (%): 15.7%

We argue that, if Sudarshan Chemical captures 10% of the growing market – its Sales/EBITDA/PAT in FY23E would be at Rs 18.07bn/2.96bn/1.49bn, which implies a sales growth of 9.6% over FY21-23E. The stock is fairly valued assuming a growth rate of 9.6% over FY21-23E (EPS: Rs 21.7 @22x on P/E – Fair value: Rs 475/share).

We thus believe that Sudarshan Chemical has to grow at a rate of more than 10% on Sales front to justify its rich valuations, whilst expanding its EBITDA margins to 15.7%.

In our assumption to estimate sales growth, we assume Sudarshan Chemical to have gained ~16% from the growing pigment market, which brings us to a sales CAGR of 15% over FY21-23E.

**Exhibit 16: Assumptions Table**

| | FY21E | FY22E | FY23E | FY24E | FY25E | FY26E |
|---|---|---|---|---|---|---|
| Organic Pigments (TPA) | 395,000 | 410,800 | 427,232 | 444,321 | 462,094 | 480,578 |
| Organic Pigments (Rs bn) | 373 | 387 | 403 | 419 | 436 | 453 |
| Absolute Delta (Rs bn-YoY) | | 15 | 15 | 16 | 17 | 17 |
| Bear Case (5% share) - Rs bn | | 0.7 | 0.8 | 0.8 | 0.8 | 0.9 |
| Base Case (10% share) - Rs bn | | 1.5 | 1.5 | 1.6 | 1.7 | 1.7 |
| Bull Case (30% share) - Rs bn | | 4.5 | 4.6 | 4.8 | 5.0 | 5.2 |
| Sales - Bear case | 15,872 | 16,617 | 17,392 | 18,198 | 19,036 | 19,908 |
| Sales - Base case | 15,872 | 17,362 | **18,912** | 20,524 | 22,200 | 23,943 |
| Sales - Bull case | 15,872 | 20,342 | 24,991 | 29,826 | 34,854 | 40,083 |
| Growth(%) - Bear case | | 4.7 | 4.7 | 4.6 | 4.6 | 4.6 |
| Growth(%) - Base case | | 9.4 | 8.9 | 8.5 | 8.2 | 7.9 |
| Growth(%) - Bull case | | 28.2 | 22.9 | 19.3 | 16.9 | 15.0 |

*Source: DART, Company*

# Financial Analysis

Sudarshan Chemical has growth its Sales/EBITDA/PAT at 6.8/13.9/19.4% over a 5-year CAGR from FY15-20 with pre-tax RoCE's well within 14-19%. ROE's have been stronger over 20% except for FY19 when EBITDA margins collapsed to 12.8% from 14.1% in FY18.

**Exhibit 17: Sales vs Sales Growth**

| Particulars | 2018 | 2019 | 2020 | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|---|
| Sales (Rs Mn) | 13,294 | 15,930 | 17,082 | 16,120 | 18,506 | 21,249 |
| Sales Growth (%) | 3.7 | 19.8 | 7.2 | (5.6) | 14.8 | 14.8 |

*Source: DART, Company*

Gross margins were at as high as 47.1% in FY10, which has seen a downward trend thereon with fluctuations in crude oil prices, product mix and inability to effectively pass on raw material prices. With raw material pricing now under control as mentioned earlier, coupled with introduction of new specialty azo pigments we expect gross margins should be stable at 43% going ahead. Power, fuel and labour expenses form the bulk of total operating expenses, with efficient cost control the company has been able to improve its EBITDA margin to 14.4% in FY20.

**Exhibit 18: Gross Margin vs EBITDA Margin**

| Particulars | 2018 | 2019 | 2020 | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|---|
| Gross Margin (%) | 41.5 | 40.0 | 41.9 | 43.4 | 43.4 | 42.1 |
| EBITDA Margin (%) | 14.1 | 12.8 | 14.4 | 14.3 | 15.5 | 15.5 |

*Source: DART, Company*

Sudarshan Chemical has been able to reduce its cash conversion cycle significantly from 77 days in FY15 to 29 days in FY20 which has in turn made the company reap benefits on operating cash flows wherein the EBITDA to CFO conversion has improved, CFO/EBITDA (%) stands at 119% in FY20.

**Exhibit 19: Working Capital Cycle**

| Particulars | 2018 | 2019 | 2020 | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|---|
| Inventory Days | 76 | 72 | 89 | 88 | 88 | 88 |
| Receivable Days | 93 | 81 | 79 | 82 | 82 | 82 |
| Payable Days | 126 | 94 | 139 | 140 | 140 | 140 |
| Working Capital Days | 43 | 58 | 29 | 30 | 30 | 30 |

*Source: DART, Company*

The company's net debt/EBITDA has been range bound within 2.0-2.5x from FY16-20 and is expected to come down to 1.4x in FY23E.

As one can expect introduction of new high performance pigments with some room of backward integration in the planned capex, we believe EBITDA margins and return ratios will gain traction and the planned capex is RoCE accretive. We expect RoCE to jump from 16.3% in FY20 to 17.2% in FY23E.

The company's ROE's have been healthy and justify premium valuations. ROE's as per our DuPont analysis, have been higher due to leverage factor as high as 4.0x in FY15 which has come off year after year gradually to 2.6x in FY20. However, net margins have improved to partly off-set the effect of the leverage factor. Net margins have improved to 7.6% in FY20 from 4.6% in FY15. Asset turns have marginally come down to 1.1x in FY20 due to the on-going capex and expected to improve hereon as the capex to be capitalised has asset turns of ~3.0x.

**Exhibit 20: DuPont Analysis**

| Particulars | 2018 | 2019 | 2020 | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|---|
| Net margin (%) | 6.5 | 4.0 | 7.6 | 6.3 | 7.9 | 8.3 |
| Asset turnover (x) | 1.0 | 1.2 | 1.1 | 1.0 | 1.1 | 1.2 |
| Leverage factor (x) | 3.1 | 2.7 | 2.6 | 2.6 | 2.4 | 2.3 |
| Return on equity (%) | 20.6 | 12.5 | 21.8 | 15.8 | 20.5 | 21.5 |

*Source: DART, Company*

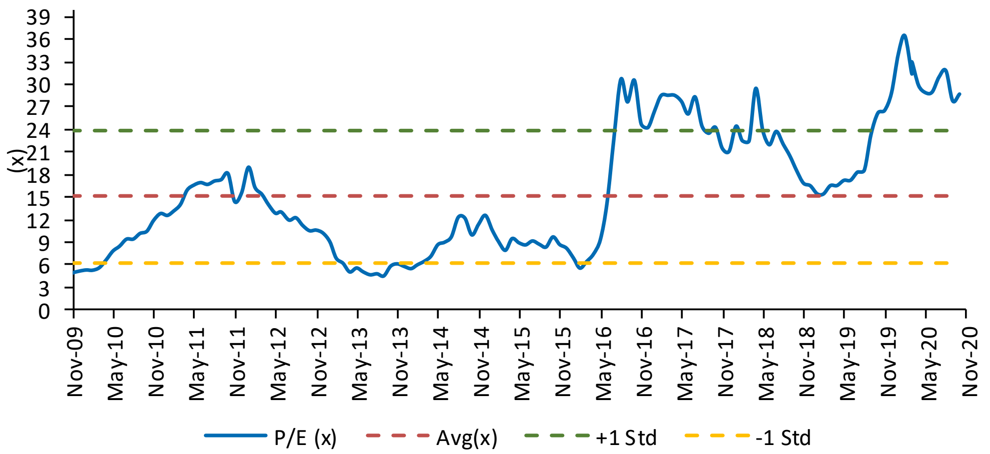
**Exhibit 21: ROE vs ROCE**

| Particulars | 2018 | 2019 | 2020 | 2021E | 2022E | 2023E |
|---|---|---|---|---|---|---|
| ROE (%) | 20.6 | 12.5 | 21.8 | 15.8 | 20.5 | 21.5 |
| ROCE (%) | 15.7 | 15.3 | 16.3 | 12.2 | 15.6 | 17.2 |

*Source: DART, Company*

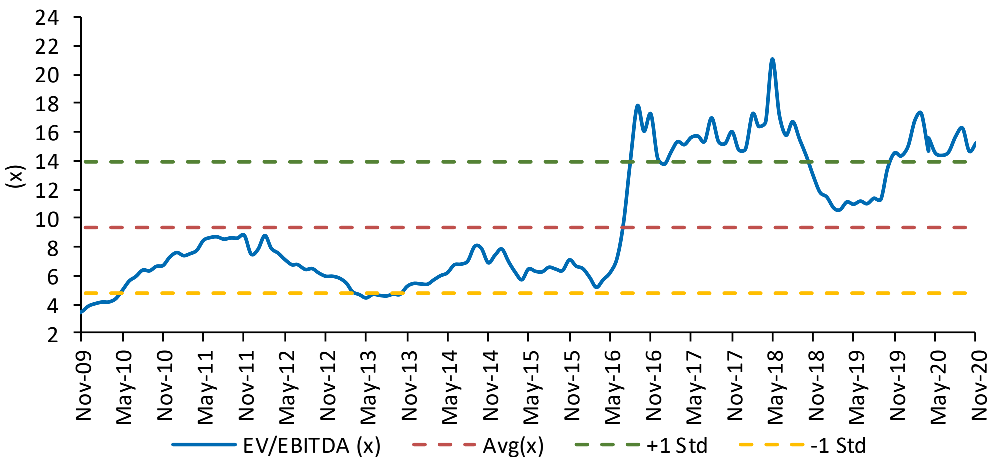
## Valuation bands

**Exhibit 22: 1Y Forward P/E Band**




*Source: DART, Company*

**Exhibit 23: 1Y Forward EV/EBITDA Band**




*Source: DART, Company*

### Profit and Loss Account

| (Rs Mn) | FY20A | FY21E | FY22E | FY23E |
|---|---|---|---|---|
| **Revenue** | **17,082** | **16,120** | **18,506** | **21,249** |
| **Total Expense** | **14,619** | **13,814** | **15,646** | **17,964** |
| COGS | 9,762 | 8,984 | 10,332 | 12,163 |
| Employees Cost | 1,457 | 1,601 | 1,727 | 1,864 |
| Other expenses | 3,400 | 3,228 | 3,587 | 3,937 |
| **EBIDTA** | **2,463** | **2,306** | **2,860** | **3,285** |
| Depreciation | 735 | 860 | 824 | 865 |
| **EBIT** | **1,728** | **1,446** | **2,037** | **2,420** |
| Interest | 142 | 188 | 183 | 182 |
| Other Income | 47 | 68 | 73 | 78 |
| Exc. / E.O. items | 163 | 0 | 0 | 0 |
| **EBT** | **1,796** | **1,326** | **1,926** | **2,316** |
| Tax | 351 | 334 | 485 | 583 |
| RPAT | 1,445 | 992 | 1,441 | 1,733 |
| Minority Interest | 0 | 0 | 0 | 0 |
| **Profit/Loss share of associates** | **0** | **0** | **0** | **0** |
| **APAT** | **1,317** | **992** | **1,441** | **1,733** |

### Balance Sheet

| (Rs Mn) | FY20A | FY21E | FY22E | FY23E |
|---|---|---|---|---|
| **Sources of Funds** | | | | |
| Equity Capital | 138 | 138 | 138 | 138 |
| Minority Interest | 0 | 0 | 0 | 0 |
| Reserves & Surplus | 5,869 | 6,407 | 7,338 | 8,519 |
| **Net Worth** | **6,008** | **6,546** | **7,476** | **8,658** |
| Total Debt | 4,986 | 5,912 | 5,762 | 5,712 |
| Net Deferred Tax Liability | 694 | 694 | 694 | 694 |
| **Total Capital Employed** | **11,688** | **13,152** | **13,932** | **15,064** |
| | | | | |
| **Applications of Funds** | | | | |
| Net Block | **6,202** | **7,292** | **7,834** | **7,469** |
| CWIP | 440 | 700 | 400 | 400 |
| Investments | 1,017 | 1,017 | 1,017 | 1,017 |
| **Current Assets, Loans & Advances** | **8,637** | **8,432** | **9,487** | **11,687** |
| Inventories | 4,107 | 3,834 | 4,409 | 5,071 |
| Receivables | 3,641 | 3,568 | 4,103 | 4,719 |
| Cash and Bank Balances | 156 | 899 | 824 | 1,724 |
| Loans and Advances | 0 | 0 | 0 | 0 |
| Other Current Assets | 733 | 130 | 150 | 173 |
| | | | | |
| **Less: Current Liabilities & Provisions** | **4,608** | **4,289** | **4,806** | **5,508** |
| Payables | 3,717 | 3,446 | 3,963 | 4,665 |
| Other Current Liabilities | 891 | 843 | 843 | 843 |
| *sub total* | | | | |
| Net Current Assets | 4,028 | 4,143 | 4,681 | 6,179 |
| **Total Assets** | **11,688** | **13,152** | **13,932** | **15,064** |

E – Estimates

**Important Ratios**

| Particulars | FY20A | FY21E | FY22E | FY23E |
|---|---|---|---|---|
| **(A) Margins (%)** | | | | |
| Gross Profit Margin | 42.9 | 44.3 | 44.2 | 42.8 |
| EBIDTA Margin | 14.4 | 14.3 | 15.5 | 15.5 |
| EBIT Margin | 10.1 | 9.0 | 11.0 | 11.4 |
| Tax rate | 19.5 | 25.2 | 25.2 | 25.2 |
| Net Profit Margin | 8.5 | 6.2 | 7.8 | 8.2 |
| **(B) As Percentage of Net Sales (%)** | | | | |
| COGS | 57.1 | 55.7 | 55.8 | 57.2 |
| Employee | 8.5 | 9.9 | 9.3 | 8.8 |
| Other | 19.9 | 20.0 | 19.4 | 18.5 |
| **(C) Measure of Financial Status** | | | | |
| Gross Debt / Equity | 0.8 | 0.9 | 0.8 | 0.7 |
| Interest Coverage | 12.1 | 7.7 | 11.1 | 13.3 |
| Inventory days | 88 | 87 | 87 | 87 |
| Debtors days | 78 | 81 | 81 | 81 |
| Average Cost of Debt | 3.3 | 3.5 | 3.1 | 3.2 |
| Payable days | 79 | 78 | 78 | 80 |
| Working Capital days | 86 | 94 | 92 | 106 |
| FA T/O | 2.8 | 2.2 | 2.4 | 2.8 |
| **(D) Measures of Investment** | | | | |
| AEPS (Rs) | 19.0 | 14.3 | 20.8 | 25.0 |
| CEPS (Rs) | 29.6 | 26.8 | 32.7 | 37.5 |
| DPS (Rs) | 4.7 | 5.3 | 5.9 | 6.4 |
| Dividend Payout (%) | 24.6 | 36.7 | 28.1 | 25.7 |
| BVPS (Rs) | 86.8 | 94.6 | 108.0 | 125.1 |
| RoANW (%) | 24.7 | 15.8 | 20.6 | 21.5 |
| RoACE (%) | 13.1 | 9.5 | 12.0 | 13.2 |
| RoAIC (%) | 16.1 | 12.2 | 16.1 | 18.3 |
| **(E) Valuation Ratios** | | | | |
| CMP (Rs) | 474 | 474 | 474 | 474 |
| P/E | 24.9 | 33.1 | 22.8 | 18.9 |
| Mcap (Rs Mn) | 32,838 | 32,838 | 32,838 | 32,838 |
| MCap/ Sales | 1.9 | 2.0 | 1.8 | 1.5 |
| EV | 37,667 | 37,851 | 37,776 | 36,826 |
| EV/Sales | 2.2 | 2.3 | 2.0 | 1.7 |
| EV/EBITDA | 15.3 | 16.4 | 13.2 | 11.2 |
| P/BV | 5.5 | 5.0 | 4.4 | 3.8 |
| Dividend Yield (%) | 1.0 | 1.1 | 1.2 | 1.4 |
| **(F) Growth Rate (%)** | | | | |
| Revenue | 7.2 | (5.6) | 14.8 | 14.8 |
| EBITDA | 20.7 | (6.4) | 24.0 | 14.9 |
| EBIT | 24.8 | (16.3) | 40.8 | 18.8 |
| PBT | (12.1) | (26.2) | 45.2 | 20.3 |
| APAT | 62.9 | (24.7) | 45.2 | 20.3 |
| EPS | 62.9 | (24.7) | 45.2 | 20.3 |

**Cash Flow**

| (Rs Mn) | FY20A | FY21E | FY22E | FY23E |
|---|---|---|---|---|
| CFO | 3,121 | 2,660 | 1,827 | 2,175 |
| CFI | (3,051) | (2,206) | (1,061) | (495) |
| CFF | 5 | 288 | (840) | (779) |
| FCFF | 70 | 455 | 766 | 1,679 |
| Opening Cash | 81 | 156 | 899 | 824 |
| Closing Cash | 156 | 899 | 824 | 1,724 |

E – Estimates

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**_DART_ RATING MATRIX**

Total Return Expectation (12 Months)

| | |
|---|---|
| **Buy** | **> 20%** |
| **Accumulate** | **10 to 20%** |
| **Reduce** | **0 to 10%** |
| **Sell** | **< 0%** |

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