

# CONCRETE CALLING

## Headwinds on horizon; North first casualty

India Equity Research | Cement

We perceive 2 recent developments as potential headwinds for the cement industry in the North: 1) the Supreme Court (SC) has upheld ban on use of pet coke (PC) in Uttar Pradesh (UP), Haryana (HR) & Rajasthan (RJ). With other fuels--domestic and imported coal--being 10-40% dearer (on energy equivalent basis) and PC the preferred fuel (75-100% of fuel mix), we envisage cost/t to rise 6-9% for plants in these states. However, since it impacts the entire cluster, cement price hike seems imminent in the near term even as it poses a risk to FY19E; and 2) in a separate ruling, the SC has banned mining at 82 large sand mine blocks in RJ, citing illegality. These blocks are believed to comprise ~75% of operational mines, implying significant impact on demand in RJ. Factoring potential impact on volumes and fuel cost, FY19 EBITDA for coverage companies Shree Cement & JK Cement may dip 7-10% (given high North exposure), while impact on other affected companies Ambuja Cement & UltraTech Cement is likely to be marginal. However, with SC urging all states to review PC usage and sand mining ban in 4 states (including RJ) impacting ~35% of India's demand, industry headwinds could escalate further. We would be cautious on the sector in the near term.

### SC bans pet coke usage in UP, RJ & HR; asks other states to review

Clarifying its October 24, 2017, order, SC has upheld ban on use of pet coke in UP, RJ & Haryana and not just limited to the NCR region. With RJ being a major cluster for North and PC being the preferred fuel (comprising 60-100% of fuel mix for companies), we envisage cost hike of 6-9% to be passed on to consumers in the immediate future. While FY18 estimates may see limited impact, sharp rise in cost poses challenge in meeting FY19 estimates for Shree Cement and JK Cement (refer table 5). The apex court has also urged all other states in India to review PC usage given the concern of high pollution emanating from this fuel. In the event of a pan-India PC ban, the entire industry may see further cost hike as PC usage is high across companies.

### Sand mining restrained on 82 major blocks in Rajasthan

SC, castigating illegal mining, banned mining at 82 sand blocks in RJ, which according to media reports comprise ~75% of the state's production. Sustained low demand in RJ (due to sand shortage) may have wider implications, given that companies may move higher volumes to other states compromising prices.

### Outlook: Near-term cautious

With inclusion of RJ, sand shortage now impacts 35% of India's cement demand as UP, Bihar, Tamil Nadu and parts of Maharashtra are already facing demand pressure, challenging annual demand forecasts. With fuel cost hike imminent for North-based cement capacities and potentially spilling over pan-India, the industry is set to face headwinds. Watchful of future events, we turn cautious on the sector in the near term.

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### Rajasthan vital cluster; pet coke preferred fuel

Given the concentration of limestone, RJ is an important cement cluster in India housing 16-17% of the country's capacity.

The nearest domestic coal mine (of Coal India) for cement players based in RJ is at a minimum distance of 1,000 km plus. Besides the huge freight cost and low calorific value, domestic coal also has its own set of challenges as mentioned below:

**Challenges related to linkage coal:** New linkages are not available for the cement industry. While theoretically, the cost/kcal of linkage coal works out to be cheaper, the coal available is of a grade which can be used only for captive power plants and is not suitable for use in kilns.

**Challenges related to e-auction coal:** Prices under e-auction are 30-40% higher compared to linkage coal. Also, availability of sufficient quantity is a challenge. At current levels, the landed cost of e-auction coal still works out to be 10% higher compared to PC. (See table 1)

**Imported coal cost is high:** In case of imported coal, while calorific value is high, at current prices, landed cost works out to be ~40% higher compared to pet coke (on energy equivalent basis).

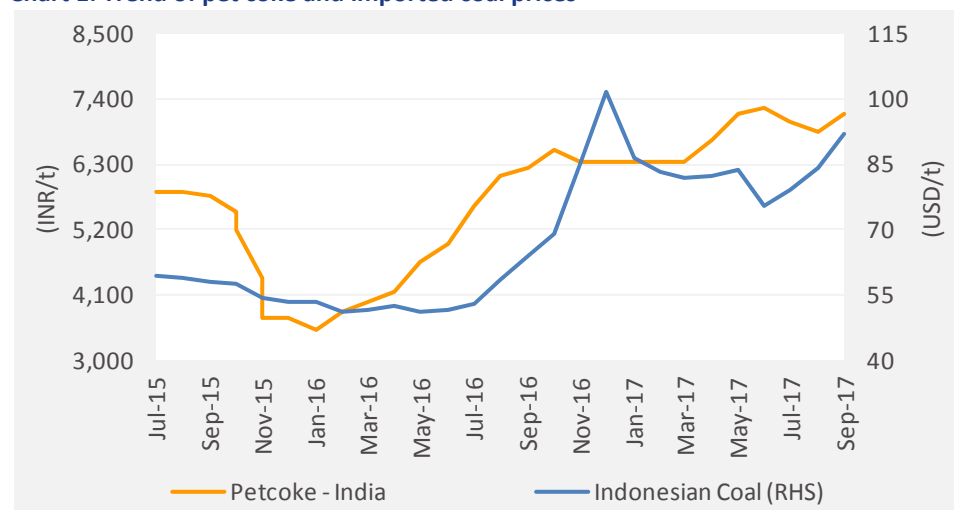
Despite the recent uptrend in pet coke prices, it still remains a preferred fuel for the industry in North given cost competitiveness.

**Table 1: Landed cost of various fuels in RJ**

INR/t At Location	E-auction coal Chandera, RJ	Imported Coal Chandera, RJ	Pet Coke Chandera, RJ
Nearest coal mine/ Source	WCL (Maharashtra), NCL (MP)	South Africa	Jamnagar, Gujarat, US Gulf, Middle East
Nearest port	-	Kandla (Gujarat)	Kandla (Gujarat)
Lead distance assumed (kms)	1,100	650	650
Assumed freight cost/t/km (INR)	2.5	2.5	2.5
Total freight cost (INR) (A)	2,750	1,625	1,625
Coal grade	G -10	-	-
Coal calorific value (GCV) kcals	4,200	6,000	8,000
Coal rate ex-mine (INR) (B)	1,652	-	-
Coal rate/t CIF (USD)		105	105
Coal rate/t CIF (INR) @ USDINR of 65 (B)		6,825	6,825
Royalty @ 14%	231	-	-
DMF @ 30% of royalty	69	-	-
Clean Energy Cess	400	400	-
Miscellaneous	200	200	200
Import Duty @ 2% /2.5%		137	171
Port Handling Charges		350	350
Total Levies and duties/t (C)	901	1,087	721
Landed cost/t (A + B + C)	5,303	9,537	9,171
Landed cost (Adj. to moisture @6%)	5,641	10,145	9,756
Cost/ '000 Kcal (INR)	1.34	1.69	1.22
% Expensive over PC	10	39	

Source: Bloomberg, Edelweiss research

Chart 1: Trend of pet coke and imported coal prices



Source: Bloomberg, Steelmint, Edelweiss research

HR and UP have limited limestone availability and hence capacities based in these states are largely grinding units, except for UltraTech Cement, which has recently taken over a 2.3mtpa clinker unit as part of the cement assets it acquired from JP Associates.

The ban on PC usage will lead to fuel cost escalation in the 22% -30% range for cement plants in RJ. However, depending upon the capacity exposure to the 3 states and also to PC, the cost/t impact will be in the 1-6% range.

Table 2: Capacity Exposure to three states, PC exposure and impact on cost/t

Company name	Exposure to pet coke in RJ, HR, UP	% Inc for P&F cost/t due to PC ban	Capacity Exposure to RJ, HR, UP	% Inc for total P&F cost/t	% Inc in total cost/t
Shree Cement	100%	30%	77%	23.1%	6.0%
JK Cement	80%	30%	77%	18.5%	4.3%
ACC	75%	30%	5%	1.0%	0.2%
Ambuja Cement	85%	30%	11%	2.9%	0.6%
UltraTech Cement	90%	30%	16%	4.4%	1.0%
India Cements	90%	30%	10%	2.7%	0.6%

Source: Company, Edelweiss research

Highest impact will be on regional companies like Shree Cement and JK Cement amongst our coverage universe.

### PC ban may spill over pan-India; industry fuel cost may rise further

The SC has also urged all other states in India to review usage of PC given the concern of high pollution emanating from this fuel. The order also has a mention of an appeal by the Amicus Curiae to consider a ban on import of pet coke.

Given the SC concern related to pollution, we cannot deny the possibility of a complete ban on PC usage or a ban on its import into India. In either case, the industry's fuel cost is likely to jump.

According to media reports, India imports ~50% of its PC requirement with balance being supplied by domestic refineries. India's largest refining company Reliance Industries, which supplies two-third of domestic PC, is likely to start a PC gasification project in the coming few quarters requiring self-consumption of PC. Hence, even in case of just a ban on PC imports, domestic industry will have to turn to other fuel sources to meet its requirements, implying increase in cost.

**Table 3: Coverage companies total exposure to PC**

Company name	Petcoke usage in Kilns (%)
UltraTech Cement	76
Shree Cement	100
ACC	65
Ambuja	65
JK Cement	80
India Cements	81

Source: Company, Edelweiss research

### Sand mining ban in Rajasthan; negative demand implications for sector

RJ is the latest to join the list of states which are facing shortage of sand due to court ordered ban on mining activities (citing illegalities). These states are UP, Bihar, Tamil Nadu and parts of Maharashtra. The affected states collectively comprise ~35% of the total cement demand in India and as per regional experts, have seen demand being impacted in the range of 10-30%.

RJ itself is a large cement consuming state with annual demand of ~17-18mt i.e., 30% of the entire North region (as per our estimate excluding UP).

**Table 4: States facing demand challenges due to sand**

States	Annual demand (mt)
UP	26
Bihar	16
Tamil Nadu	19
Rajasthan	18
Maharashtra	20
<b>Total</b>	<b>99</b>
<b>As a % of India's demand</b>	<b>35</b>

Source: Edelweiss research

Sustained ban on mining, not just in RJ but also in other affected states, pose a serious risk to all India demand estimates.

### Cement price hike imminent in near term; FY19 estimates a concern

Given that majority of the players in the North will have cost implications, we expect a cement price hike in the near term. However, sustained low demand in RJ has wider implications in our view, as it may lead to companies looking at other markets for volumes. Divergence of volumes to other states will not only incur increased freight, but may also lead to pressure on cement prices.

Given these challenges, while our FY18E may see limited impact, we see risk to FY19 estimates as below:

**Table 5: Risk to FY18/ FY19 estimates**

(INR mn)

Company name	FY18E			FY19E		
	Likely due to PC ban	Present	Potential impact (%)	Likely due to PC ban	Present	Potential impact (%)
UltraTech Cement	65,858	65,786	0.1	94,701	96,060	(1.4)
Shree Cement	27,482	28,118	(2.3)	37,516	41,943	(10.6)
ACC	18,503	18,659	(0.8)	22,289	22,367	(0.3)
Ambuja	18,862	18,933	(0.4)	23,703	23,732	(0.1)
JK Cement	8,488	8,731	(2.8)	9,816	10,545	(6.9)
India Cements	8,173	8,206	(0.4)	10,986	11,153	(1.5)

Source: Company, Edelweiss research

#### Our view: Cautious in the near term

Cement companies are likely to appeal the SC to review the PC ban order. In the recent past, the Ministry of Environment has favoured PC usage by cement industry (in kilns) given that emissions are controlled.

The sand mining ban also can be termed as a challenge only in the near term as the related slowdown in construction activity not only hurts government infrastructure projects and developmental work, but also impacts economic growth as well as livelihoods of construction workers.

Given the dynamic nature of the challenges motioned above, while we will be watchful of the future turn of events, we turn cautious on the sector in the near term.

**Table 6: Existing Valuations - SRCM and JKCE have large exposure to the affected region**

Company Name	Mkt Cap. (INR bn)	Ent. Val. (INR bn)	EV/EBITDA			P/E			P/CPS			EV/T
			FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY17	FY18E	FY19E	FY19E
<b>India (Coverage)</b>												
UltraTech	1,172	1,317	26.5	20.0	13.7	46.1	41.3	24.7	24.8	29.0	18.4	219.1
Shree Ceent	637	642	27.1	22.8	15.2	47.6	42.9	29.2	28.9	28.9	20.7	255.2
ACC	331	313	22.1	16.8	14.8	52.4	38.4	29.8	24.0	22.4	18.3	144.3
Ambuja Cements	545	542	22.6	19.2	15.5	41.8	33.4	26.0	31.5	24.7	20.3	179.8
India Cements	54	82	9.4	10.1	7.4	31.4	30.5	14.1	6.7	18.0	8.4	81.3
JK Cement	76	93	12.1	10.7	8.8	31.3	22.6	15.6	10.0	13.0	11.2	113.6
<b>Average</b>			<b>20.0</b>	<b>16.6</b>	<b>12.6</b>	<b>41.7</b>	<b>34.9</b>	<b>23.2</b>	<b>21.0</b>	<b>22.7</b>	<b>16.2</b>	<b>165.5</b>

Source: Bloomberg, Edelweiss research

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## Coverage group(s) of stocks by primary analyst(s): Cement

ACC, Ambuja Cement Ltd, Grasim Industries, India Cements, JK Cement, Shree Cements, UltraTech Cement

### Recent Research

Date	Company	Title	Price (INR)	Recos
15-Nov-17	<b>Grasim Industries</b>	On strong footing; bright prospects ahead; <i>Result Update</i>	1,179	Buy
14-Nov-17	<b>JK Cement</b>	Robust quarter in a challenging environment; <i>Result Update</i>	1,077	Buy
09-Nov-17	<b>India Cements</b>	Decent performance despite challenges; <i>Result Update</i>	174	Buy

### Distribution of Ratings / Market Cap

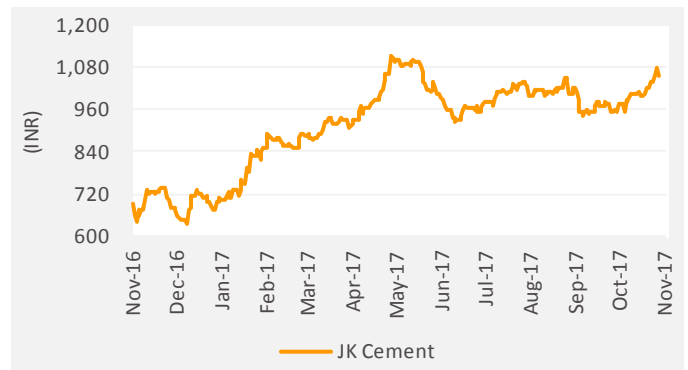
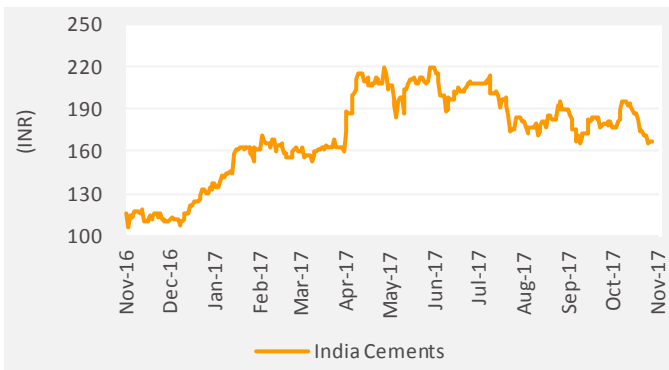
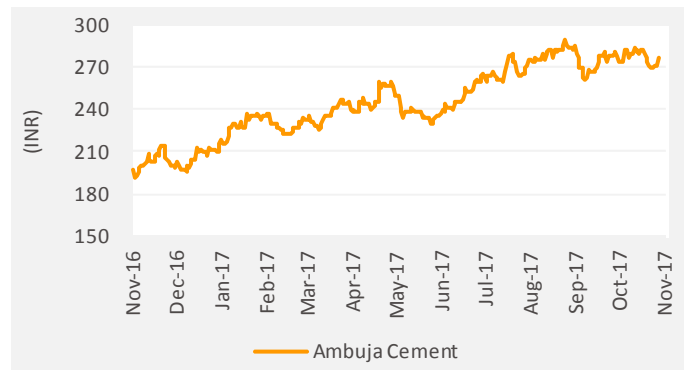
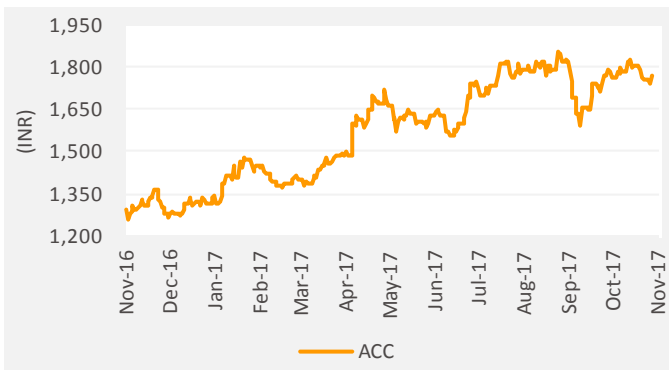
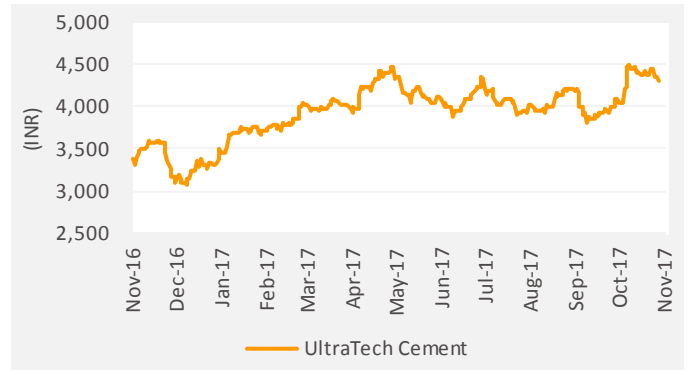
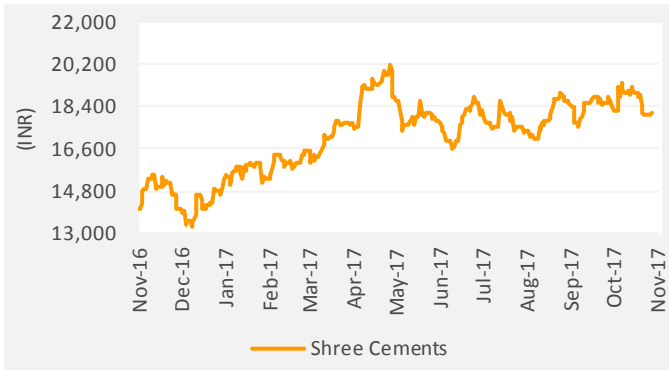
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	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

### Rating Interpretation

Rating	Expected to
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period

One year price chart



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