Equity Research

July 8, 2016

BSE Sensex: 27201

INDIA

Sanitaryware industry

Testing times

Reason for report: Initiating coverage

The Indian sanitaryware industry, currently pegged at Rs35.6bn, is growing in single-digits over the past two years as compared to 13-15% CAGR over FY10-FY14, largely due to significant slowdown in the real estate sector. Further, lower potential for consumer shift from unbranded to branded products and significantly lower replacement opportunities in the sanitaryware space, which have been strong growth triggers for allied products like tiles and faucets, is expected to keep sanitaryware industry growth under check. With the real estate sector likely to see only a gradual uptick, we foresee the sanitaryware industry growth to remain under pressure till FY18. We however expect the mass market focused sanitaryware players to continue to outpace growth over the premium players in such testing times. We initiate coverage on the sector with HOLD rating on Cera Sanitaryware (CRS) with a target price of Rs2,506 per share and ADD rating on HSIL with target price of Rs319 per share.

HSIL
(Rs279 – ADD)
Target price Rs319

Cera Sanitaryware
(Rs2449 – HOLD)
Target price Rs2,506

- **Branded sanitaryware space to grow at a muted pace over the next two years:** The Indian sanitaryware industry is currently growing in single-digits over the past two years as compared to 13-15% CAGR over FY10-FY14 largely due to significant slowdown in the real estate sector. While the increased Budgetary outlay towards drinking water and sanitation programmes and impetus on construction of toilets under *Swachh Bharat Abhiyaan* programme augurs well for growth and scalability of the sanitaryware industry, much would depend on the implementation of these schemes. Also, incremental demand under the aforesaid schemes would largely benefit the unorganised industry. We thus expect growth for the branded players to be restricted to growth in distribution and limited opportunities in terms of consumer shift from unbranded to branded products.
- **Mass market to outpace the premium segment in terms of growth:** We expect the mass market players to outpace growth over premium players due to: a) lower competitive intensity in the mass market space, and b) demand for premium/luxury sanitaryware products slowing down considerably due to sluggish demand in metros and tier-1 cities. Further, intensified focus on affordable housing segment and increasing shift from unbranded to branded products is expected to drive higher demand for mass market *vs* premium sanitaryware products. We thus expect CRS (perceived as the strongest mass market brand) to grow at a faster pace than HSIL over the next two years.
- **Foray into allied products by major players offsetting lower growth in the core sanitaryware segment:** Majority of the branded players – domestic and MNC – have over the past few years forayed into allied products like faucets, tiles and wellness to leverage their existing distribution strength in the sanitaryware space. While HSIL has intensified its focus on faucets and recently introduced consumer products like water heater, water purifier, etc, CRS has over the years been focusing on tiles as well as faucets. Parryware too has expanded its product basket to include faucets, water heaters and wellness.

Valuation Summary

	Rating	CMP (Rs)	Target (Rs)	Upside (%)	Mcap (Rs bn)	Rev. Cagr FY16-18E	PAT Cagr FY16-18E	P/E (x) FY17E	P/E (x) FY18E	RoCE (%) FY17E	RoCE (%) FY18E
HSIL	ADD	279	319	14	20.2	11.4	25.6	18.2	14.4	10.9	12.6
Cera	HOLD	2,446	2,506	2	31.8	16.2	25.0	30.9	24.4	28.3	30.2

Source: I-Sec research

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Prices as on July 7, 2016

Sanitaryware industry dominated by branded players

The sanitaryware industry in India is currently pegged at Rs35.6bn. The top three domestic players – HSIL, Cera Sanitaryware (CRS) and Parryware Roca (PR) – account for ~45% of the industry size and over 65% of the organised sanitaryware space. Over 60% of the market is estimated to be dominated by the organised players which includes MNC brands as well. The unorganised industry accounting for <40% of the size, is largely based out of Morbi, Wankaner and Thangad areas of Gujarat.

Table 1: Market share of top three domestic players

Market share	FY16 Size (Rs bn)	Overall market share	Organised market share
HSIL	6.3	18%	26%
CRS	4.4	12%	18%
PR	5.5	15%	23%

Source: I-Sec Research

The organised industry, which was growing at 13-15% over FY10-FY14, is now growing in single-digits largely due to slowdown in the real estate sector. The industry could be broadly classified into four sub-segments – low-end, mass-market, premium, and luxury –with diverse characteristics and competitive intensity.

Table 2: Segment-wise breakup with price points, industry size and key competing brands

Segment-wise Industry	Low / Basic segment	Standard / Mid-market / Mass segment	Premium segment	Super Premium / Luxury segment
Market Size	Rs12bn	Rs12bn	Rs8bn	Rs3.6bn
Market Mix	34%	34%	22%	10%
Price points	Rs500-1,000	Rs1,000-2,500	Rs2,500-5,000	Rs5,000-20,000+
Organised *vs* Unorganised	10:90	75:25	100% organised	100% organised
Brands	Raasi, Neycer, Johnson, CRS and unorganised players	Cera, Hindware, Parryware, Kerovit and Somany	Kohler, Duravit, Toto, American Standard, Jaquar, RAK, Roca, Parryware, Cera & Hindware Art	Kohler, Duravit, Toto, American Standard, V&B, Jaquar, Artize, RAK, Isvea, Roca, Hindware Italian & Queo
Market Leader	Unorganised players	CRS	HSIL	PR
Competitive intensity	High with 150 unorganised units in this space	Average with three large organised brands dominating the space	High with organised as well as MNC brands competing	High with organised as well as MNC brands competing in this space

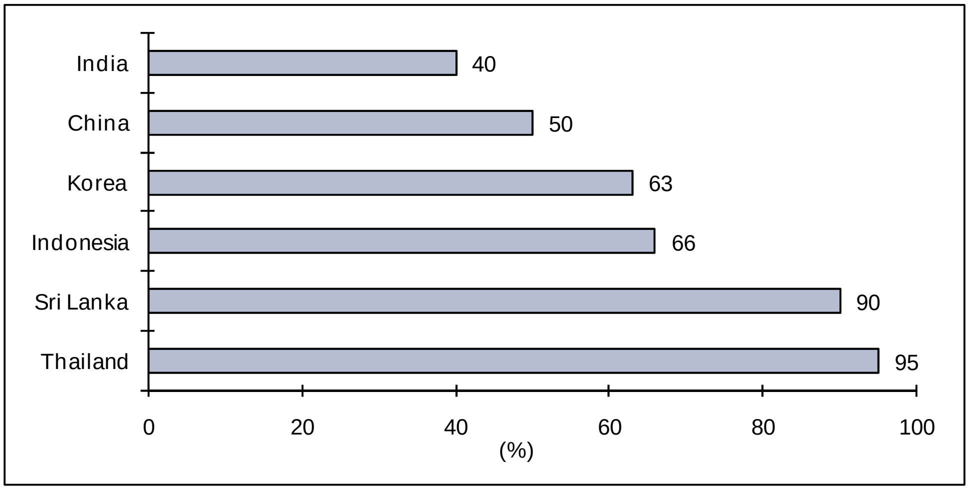
Source: I-Sec Research

Demand drivers

Low sanitation levels in India

India, home to the world's second-largest population, has only 40% sanitation coverage, lowest in Asia. As per **the 2011 Census of India**, rural sanitation coverage stands at 32.7%, which implies that more than 67% of the rural population in India is deprived of basic sanitation facilities. According to the **Ministry of Urban Development (MoUD)**, in notified slums (slums registered by the municipality), 17% of the population is without access to proper sanitation, and in non-notified slums, the average is 51%. As per **UNICEF**, 638mn people in India lack proper sanitation facilities.

Chart 1: Sanitation levels – lowest in India



Source: CRISIL

To increase sanitation levels over the years, programmes of the Central and state governments have been on the rise. **Budgetary allocation for** National Rural Drinking Water Programme (NRDWP) and *Swachh Bharat Abhiyaan* stood at Rs50bn and Rs113bn, respectively.

The increase in Budgetary outlay towards drinking water and sanitation programmes and rising awareness of such schemes augurs well for the growth and the scalability of the sanitaryware industry. However, the incremental demand under the aforesaid schemes would largely benefit the unorganised industry. Incremental demand would come from:

- **New construction activities** driven by increasing housing shortage, shift towards nuclear families from joint families, and rising need for commercial and industrial establishments.
- **Replacement demand** constitutes 10-12% of total demand. It is expected to be a major driver going forward, due to shortening of the replacement cycle. Globally, 80% of total demand accrues from replacement.
- **Increasing urbanisation, higher disposable incomes and discretionary spend** augur well for the industry. Increasing aspiration levels leads to scaling up of the value chain, with growing appetite for new styles and aesthetics.
- **Increasing number of bathrooms** per flat in recently built apartments, even in tiers-2&3 cities.
- **Emergence of concept bathrooms:** The concept of a bathroom has evolved from its primitive utility. Today's bathrooms are equipped with a range of solutions, comprising designer sanitaryware, faucets, and tiles, high-tech shower systems, and more.

Strong entry barriers in sanitaryware industry

- **Brand equity:** Brand creation takes a long gestation period. Any new company would need at least 5-10 years to establish itself as a reputed brand.
- **Distribution network:** Creation of a strong and widespread distribution network is a constant and long-drawn process. It takes many years to create such a network, thus posing a strong entry barrier.
- **Low probability of new domestic players aggressively entering the industry:** The sanitaryware industry is capital- and labour-intensive. Well established domestic players had set up facilities at least three decades back, when costs involved for setting up plants were far lower. With substantial escalation in current costs, new entrants are unlikely to earn RoCEs in excess of 14-18% (depending upon the product mix), which in itself is a huge entry barrier.

RoCE model of a sanitaryware plant with capacity of 1.2mn pieces:

- **Case I:** Product mix – 100% mass market products
- **Case II:** Product mix – 50% mass and 50% premium products

Table 3: RoCE model for setting up a sanitaryware unit

	Case I	**Case II**
Product mix	100% mass market	50% mass and 50% premium
	Rs mn	**Rs mn**
Gross Block / Capex	1,000	1,500
Working Capital (20% of revenues)	216	300
Capital Employed (A) + (B) …………..	**1,216**	**1,800**
Net Revenues	1,080	1,875
EBIDTA margin	**20%**	**22%**
EBIDTA	**216**	**412**
Depreciation (6% of gross block)	50	90
EBIT	**166**	**322**
RoCE	**14%**	**18%**

Source: I-Sec Research

Allied products – Faucets and tiles segments

Faucetware industry

The Rs60bn Indian faucetware industry is currently growing at 12-13% CAGR compared to 15-18% over FY10-FY14. The organised faucet industry accounts for 50% of the size. Jaquar remains the top recall brand, with over 60% and one-third share of the organised and overall market, respectively. The other notable players in the industry include Grohe, Kohler, HSIL, Cera Sanitaryware (CRS) and Parryware Roca (PR).

HSIL, PR, and CRS forayed into the manufacture of faucets to leverage their strong brands and existing distribution network in sanitaryware space. These brands are targeting the mid-market segment where Jaquar does not have much of a presence. Kajaria Ceramics too has entered the faucet segment and has recently set up a manufacturing unit in Rajasthan.

Scalability in the faucet industry is superior to that in the sanitaryware industry, considering the coverage potential of faucets vis-à-vis sanitaryware products in bathrooms besides being used in kitchens as well. The demand drivers include new construction, rising disposable incomes, increasing urbanisation, strong replacement demand and increasing shift from unbranded to branded products. With these drivers, we expect the faucet industry to register 13-15% CAGR over the next 2-3 years, clearly outpacing growth of sanitaryware and tiles segment, with organised industry expected to exhibit CAGR of 15-18%.

Chart 2: Positioning of brands across segments

Source: I-Sec Research

Tiles industry

The Indian tiles industry is currently estimated to be at 756mn-sqm in terms of volumes and Rs240bn in value. The industry, which was growing at 14-16% CAGR over FY10-FY14, is now growing at 8-10% over the past two years on account of slowdown in real estate sector. The top-10 players, which include players based out of Morbi in Gujarat, account for over 45% of the industry. The organised industry currently accounts for 30% of overall volumes and 50% of industry revenues while Morbi (the unorganised tile manufacturers hub) players account for ~70% of total volumes and 50% of revenues.

Majority (90-95%) of the unorganised tiles industry is based out of Morbi (Gujarat) with the balance being based out of Himmatnagar (Gujarat) and Andhra Pradesh. Morbi over the past few years has increasingly been becoming an outsourcing hub for the organised players. The installed capacity of Morbi (which houses close to 650 units) currently stands at 700mn-sqm with nearly 15-20% of the capacity being idle at this point in time.

Table 4: Segment-wise breakup and growth of the tiles industry

Segments	Industry size – FY15		Mix		5-year CAGR
	Volume (mn sq. m)	Value (Rs bn)	Volume	Value	
Ceramic wall and floor	440	105	58%	44%	10-12%
Polished vitrified tiles	266	105	35%	44%	12-14%
Glazed vitrified tiles	50	30	7%	12%	20-25%
Total	**756**	**240**	**100%**	**100%**	**12-14%**

Source: I-Sec Research

Chart 3: Tiles industry volume mix

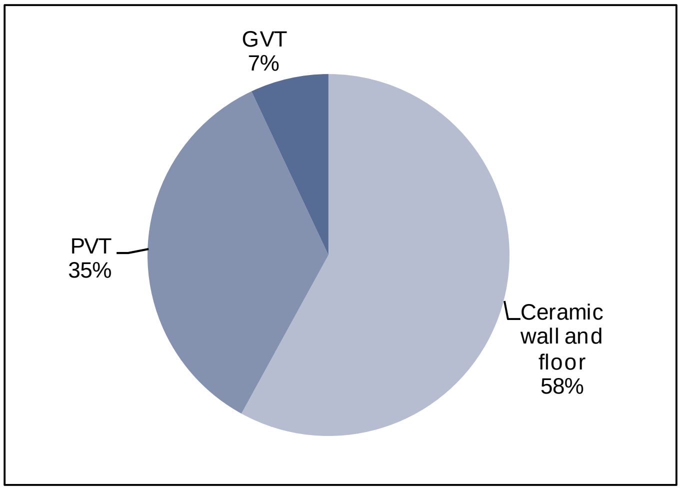
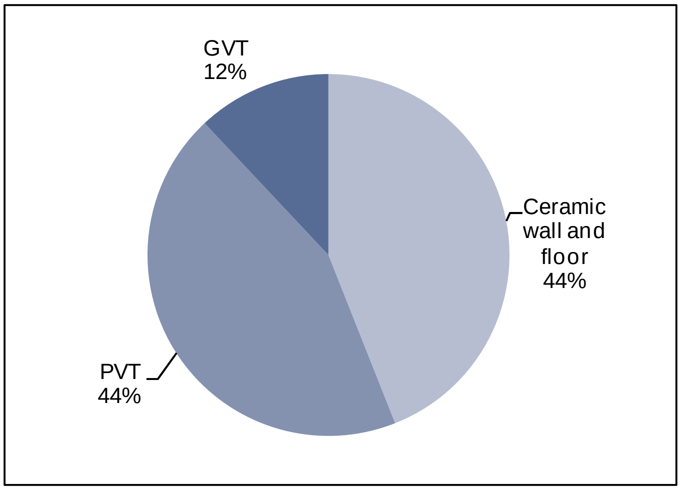


Chart 4: Tiles industry value mix



Source: Company data, I-Sec research

The ceramic wall and floor segment currently accounts for 58% of tile industry volumes and 44% of the overall size. PVT (which includes soluble salt vitrified tiles and value-added double charged vitrified tiles) on the other hand accounts for 35% of the overall volumes and 44% of the size. GVT, the fastest growing value-added tiles, accounts for 12% of the industry size and 7% of volumes.

Demand drivers for tiles industry

Government policy reform – A key trigger: Policy reforms set forth by the Union government, including creation of Smart Cities, 'Housing for All', GST implementation, *Swachh Bharat Abhiyaan*, etc. are expected to stimulate strong demand for tiles

Increasing replacement to traditional materials: In India, 47% of the population lives in houses with mud flooring, 37% with cement flooring, and 11% with mosaic and tile flooring. With higher disposable incomes and tiles being a superior quality and durability material, its increasing acceptance in both rural and urban India is expected to result in sustained demand for ceramic tiles.

Table 5: Percentage of households by flooring material

Flooring options	India			Rural		Urban	
	1991	2001	2011	2001	2011	2001	2011
Mud	67%	57%	47%	72	63	18	12
Stone	0	6	8	5	6	9	12
Cement	21	27	31	18	24	48	46
Tiles/Mosaic	4	7	11	2	4	21	26
Others	8	3	4	3	3	4	4

Source: I-Sec research

Higher disposable incomes: Higher disposable incomes and increasing discretionary spend continue to be a major growth driver. It has been noticed that growing aspirations levels are leading to scaling up the value chain. There is a growing appetite for new styles and aesthetics. India seems to be moving on from being just a 'value-for-money' market.

Increasing preference over natural stone: Tiles have been replacing natural stone due to ease in laying, competitive costs, varying sizes and attractive designs. Like paints, but with a more time lag, there is also a shift being noticed to replace the older set of tiles with newer ceramic (digital) and vitrified tiles such as double-charged and digital glaze. The replacement cycle has considerably shortened (once or twice in a lifetime earlier to once in 10 years due to value addition).

Shift towards nuclear families: The shift towards nuclear families from joint families, apart from increase in disposable incomes, is also adding to demand for housing. This is expected to be a major driver for real estate and building materials going forward.

Increasing applications: New tiling applications that are opening up include exterior cladding, interior walls (apart from bathroom and kitchen) and paver tiles. These would incrementally drive demand for ceramic tiles.

With these demand drivers along with the recent imposition of anti-dumping duty on polished vitrified tiles, we expect the tiles industry to grow at 10-12% CAGR over the next two years. While Kajaria Ceramics (KJC) enjoys the best brand equity in this segment, Somany Ceramics (SOMC) is a rapidly improving brand. HR Johnson, the no.2 brand in terms of revenues, has been consistently losing market share to KJC and SOMC over the past five years.

Table 6: Bathroom solutions industry at a glance

Industry dynamics	Sanitaryware industry	Faucet industry	Tiles industry
Category as a % of building cost	1-2%	2%	5-10%
Market size	Rs35.6bn	Rs60bn	Rs240bn
Organised vs. unorganised	60:40	50:50	50:50
Key unorganised clusters	Morbi	Delhi and Chandigarh	Morbi
Industry growth:			
FY10-14	13-15%	15-18%	14-16%
FY15-16	5-6%	12-13%	8-10%
Top three brands revenue-wise	HSIL, PR and CRS	Jaquar, Grohe and HSIL	KJC, HRJ and SOMC
Replacement potential	Extremely low	High	Average
Key influencers	Consumer/Architect	Consumer/Architect	Architect/Dealer/Consumer
Key USP	Brand and distribution	Brand, after sales service and distribution	Brand and distribution
Fixed asset turn (x)	1-1.5	2.5-3	2-2.5
Outsourcing opportunity	Average	Extremely low	High
RoCE potential	15-18%	20%	25-30%
Capital intensive	High	Average	Low

Source: I-Sec research

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July 8, 2016

BSE Sensex: 27201

INDIA

HSIL

ADD

Best brand, but capital allocation a worry

Rs279

Reason for report: Initiating coverage

HSIL stands out amongst peers in the sanitaryware space led by its: 1) 'top of the mind recall' brand *Hindware*, 2) strong distribution franchise, and 3) focus on quality and premiumisation. However, the company's recent unrelated diversification (consumer products) in the building products division and aggressive expansion in the packaging products division (PPD) in the past have added to its current slowdown woes in the sanitaryware space, leading to a mere 2% PAT CAGR over the past five years – lowest in the building materials space. This has resulted in relatively subdued valuations notwithstanding its formidable core competency in the sanitaryware segment. Besides these valid concerns, HSIL's intended foray into plastic pipes, caps and closures segment over the next 12 months has also enhanced investor concerns about the company's diversification strategies against the backdrop of its early exit from the tiles segment. However, HSIL is expected to see a marked improvement in its profitability going forward, on the back of: 1) likely sustainability of the turnaround in PPD and 2) scaling up of its building product division (BPD) led by traction in consumer products segment. We initiate coverage on HSIL with an ADD rating and SoTP-based target price of Rs319 per share.

- **BPD revenues to gain traction; recent margin pressures likely to continue.** 'Top of the mind recall', strong presence in the premium segment, and a large nationwide distribution network make HSIL the best and biggest player in the branded sanitaryware space. The company's intensified focus on the faucet segment, with thrust on manufacturing, has paid rich dividends, enabling it to grow at >30% CAGR over the past five years and offsetting lower growth in its core sanitaryware segment and the momentum is likely to continue. Besides this, HSIL's recent launches and distribution expansion in the consumer products segment over the past 15 months are also expected to drive BPD revenues. Overall, we expect BPD revenues to grow at 17.2% CAGR over FY16-FY18. BPD margins however are expected to remain under pressure due to higher brand spends, increasing contribution from faucet segment, losses in the consumer product division till breakeven, and start-up costs in the plastic pipes segment in FY18.
- **PPD volume growth a concern; margins expected to remain firm**. With incremental capacity addition in the past by HSIL and Hindusthan National Glass & Industries in South India, and demand taking a subsequent hit due to the macro-economic slowdown, both the players have been unable to utilise their full capacities and increase prices on account of cost pressures, thereby impacting their profitability. However, significantly lower fuel prices and HSIL's improving product mix have enabled a strong turnaround in margins over the past two years, which is likely to sustain. We expect PPD revenues to grow at a muted 3% CAGR while EBIT margins are expected to remain firm at 12% over the next two years.

Market Cap	Rs20.2bn/US$300mn
Reuters/Bloomberg	HSNT.BO / HSI IN
Shares Outstanding (mn)	72.3
52-week Range (Rs)	357/228
Free Float (%)	52.9
FII (%)	11.1
Daily Volume (US$/'000)	338.0
Absolute Return 3m (%)	(6.4)
Absolute Return 12m (%)	(20.5)
Sensex Return 3m (%)	10.9
Sensex Return 12m (%)	(2.0)

Year to Mar	FY15	FY16	FY17E	FY18E
Revenue (Rs mn)	19,806	20,561	22,027	24,830
Rec. Net Income (Rs mn)	854	890	1,110	1,405
EPS (Rs)	11.8	12.3	15.4	19.4
% Chg YoY	129.7	4.2	24.7	26.5
P/E (x)	23.6	22.7	18.2	14.4
CEPS (Rs)	29.1	28.9	32.4	39.9
EV/E (x)	8.4	7.9	7.5	5.9
Dividend Yield (%)	1.0	1.4	2.1	2.8
RoCE (%)	10.9	10.2	10.9	12.6
RoE (%)	7.3	6.6	7.9	9.5

Sanitaryware

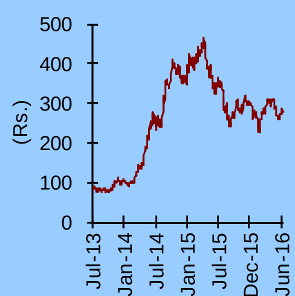
Target price Rs319

Shareholding pattern

	Sep '15	Dec '15	Mar '16
Promoters	47.1	47.1	47.1
Institutional investors	33.7	32.9	33.5
MFs and UTI	22.8	22.1	22.1
FIs/Banks	0.1	0.5	0.4
Insurance	0.5	-	-
FIIs	10.4	10.3	11.1
Others	19.2	20.0	19.4

Source: NSE

Price chart



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BPD revenues to gain traction; margin pressures likely to continue

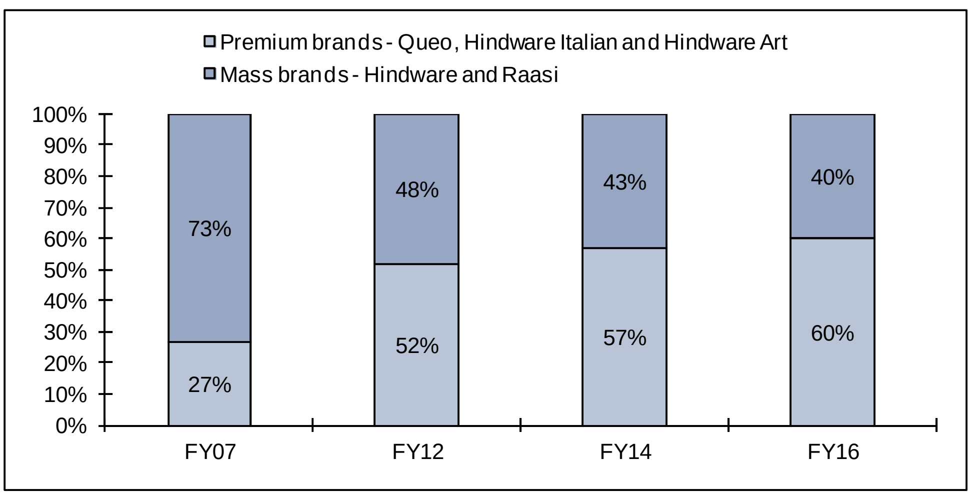
Sanitaryware segment expected to grow in single digits due to sluggish demand

Largest sanitaryware player in India with strongest brand pull: HSIL is India's largest player in the sanitaryware space, with an organised market share of 26%. 'Top of the mind recall', strong presence in the premium segment and large nationwide distribution network make it the best and largest player in the branded sanitaryware industry. HSIL markets its products under the umbrella brand *Hindware.*

Focus on retail: Over the years, with its aggressive brand spends and focus on retail, *Hindware* is perceived as the strongest retail brand in the sanitaryware space. In FY16, retail sales accounted for 85% of the company's sanitaryware segment revenues while the balance consisted of institutional/project sales. Within its branded portfolio, *Benelave* is largely showcased as a project brands while *Hindware*, *Hindware Art*, *Hindware Italian Collection* and *Queo* are largely retail brands. Brand *Queo* is positioned as the luxury brand while *Hindware Art* and *Hindware Italian Collection* are premium brands.

Moving up the value chain through premiumisation: Over the past decade, contribution from premium and luxury products has increased from 27% of HSIL's revenues in FY07 to 60% in FY16. This has resulted in the company having a strong margin profile vis-à-vis its immediate listed peer – CRS, which focuses largely on mass market products.

Chart 1: Increasing premiumisation over the years

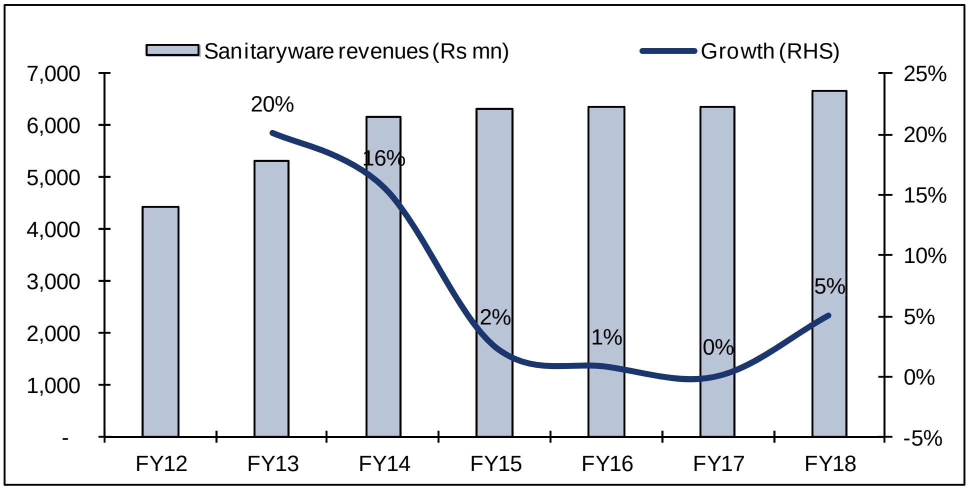


Source: Company data, I-Sec research

With the focus intensifying on brand *Queo*, the share of premiumisation in HSIL's overall portfolio is expected to further increase over the next few years.

Expect sanitaryware segment revenues to grow in single digits on slowdown woes: With the sanitaryware sector slowing down considerably over the past two years due to slowdown in real estate sector, we expect HSIL's sanitaryware segment revenues to grow in single digits led by lower single-digit volume growth and some product mix improvement.

Chart 2: Trend in sanitaryware segment revenues



Source: Company data, I-Sec research

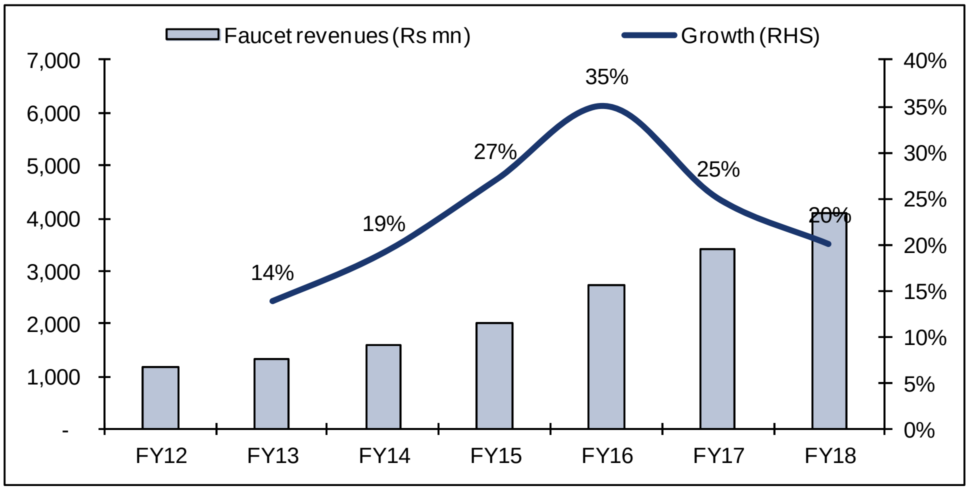
Intensified focus on manufacturing in faucet segment

HSIL is intensifying its focus on the faucet segment, with a thrust on manufacturing over the earlier practice of outsourcing. The commissioning of 2.5mn pieces faucet unit at Kaharani, Rajasthan, in FY15 has scaled up the faucet business further with focus on mass as well as premium products.

Increasing in-house capacities to reduce dependence on outsourcing

In FY16, turnover from own manufacturing constituted 55% of overall faucet sales. With the company extensively focusing on manufacturing, the contribution of manufactured turnover is expected to rise, with a ramp-up in production from the Kaharani plant. The Bhiwadi plant is temporarily shut down and would commence operations as and when the demand environment improves.

Chart 3: Faucet revenues to grow at 22.5% CAGR over FY16-FY18



Source: Company data, I-Sec research

The capacity of Kaharani plant is scalable up to 5mn pieces of faucets, with an incremental capex of Rs600mn-700mn. HSIL expects its faucet business to generate revenues of Rs5bn over the next 3-4 years.

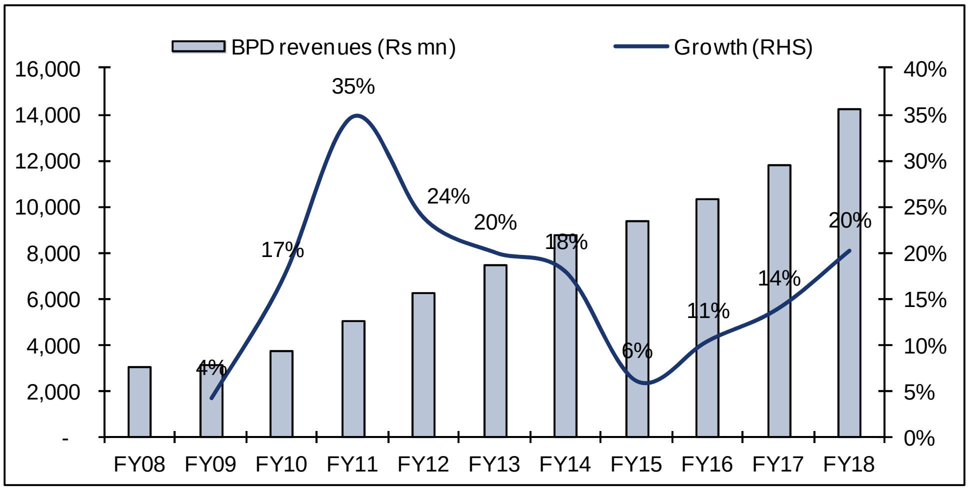
Diversification into consumer product business to drive BPD revenues

Apart from its core products – sanitaryware and faucets – related to bathroom solution channels, HSIL is currently taking initiatives to develop two more channels - a) consumer electrical channel for expanding its recently launched consumer product business and b) hardware channel for launching its plumbing pipe products over the next one year.

- **Consumer electrical business.** The products launched by HSIL under the consumer business including water heaters, air coolers, air purifiers, kitchen chimneys, hoods and hobs, etc. have been well accepted by the market. The company has tied up with Groupe Atlantic of France for water heaters and the Indian subsidiary of The Marmon Group (a subsidiary of Bershire Hathway, US) for water purification products. In FY16, HSIL's consumer electrical business achieved revenues to the tune of Rs600mn. At EBIT level, it suffered a loss of Rs160mn in FY16. The loss is largely attributed to development costs incurred in building a network of around 225 distributors across India and 4,000 active sales touch points. HSIL intends to double the footprint over the next year.
- **Consumer hardware business.** HSIL is in the process of setting up a PVC/CPVC pipes unit in Telangana in South India. The plant is expected to commence operations by Mar'17. The company will be spending Rs1.05bn to build a 30,000tpa plant with 60% catering to CPVC pipes. HSIL expects ~Rs2bn revenues from the business after 3-4 years of commissioning. The company has already entered into an arrangement with Sekisui Chemical Co Limited, Japan, for supply of CPVC resin. For HSIL, the pipes business will be a further extension of its building product portfolio and is expected to leverage the existing sales and distribution network for marketing. The company is already in the process of creating a hardware channel for marketing its plumbing pipe products.

We expect HSIL's consumer product business to grow at a CAGR of 112% over FY16-FY18. We expect revenues from this business to touch Rs2.7bn in FY18 and the segment to achieve EBIDTA breakeven in the same year.

Chart 4: Expect BPD revenues from to grow at 17.2% CAGR over FY16-FY18



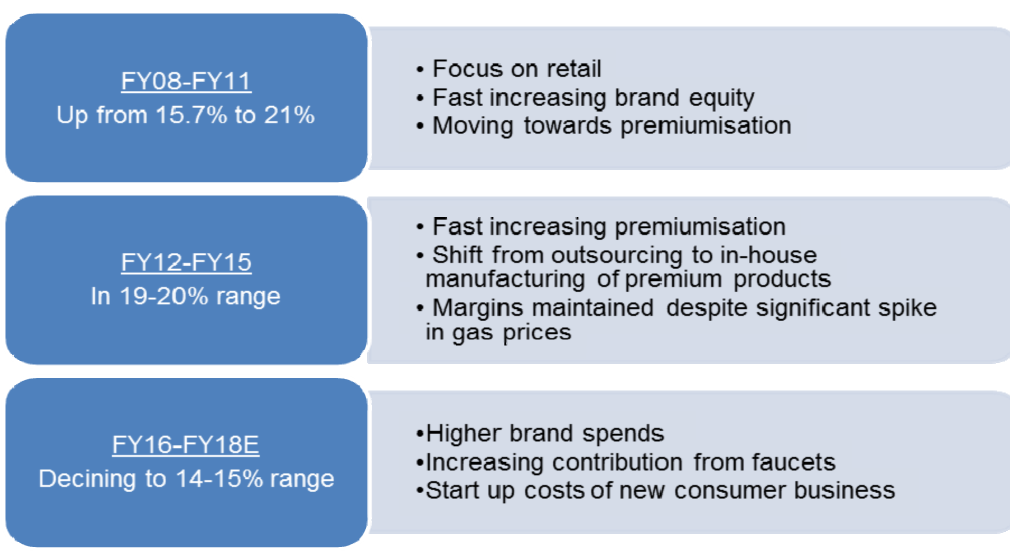
Source: Company data, I-Sec research

Overall, we expect the Building Products Division (BPD) to grow at a CAGR of 17.2% over FY16-FY18. We expect the sanitaryware segment to contribute 47% of the segmental revenues with faucet and consumer product business to contribute 29% and 19% respectively in FY18.

BPD margins likely to remain under pressure over FY16-FY18

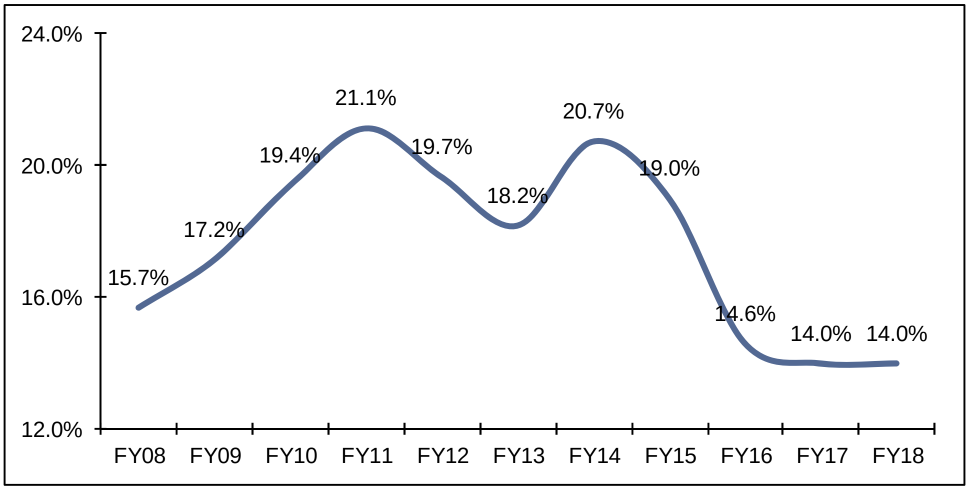
HSIL's BPD margins have been trending lower in past two years after being resilient since FY11. EBIT margins are expected to remain under pressure due to higher brand spends, increasing contribution from faucet division, losses in the consumer product division till it breaks even, and start-up costs in the plastic pipes segment in FY18E.

Chart 5: Changing of margin trajectory in phases



Source: Company data, I-Sec research

Chart 6: Trend in BPD EBIT margins



Source: Company data, I-Sec research

While margins are expected to remain under pressure over the next two years, we expect the same to be at an inflection point in FY19 and again start trending higher towards 17-18% with the new businesses likely gaining significant traction and the core segment too contributing to growth given the macro-economic recovery expected to have panned out by then.

Packaging products division – back to profitable ways

HSIL is the second-largest player in the domestic container glass industry, with ~17% and 19% domestic market shares in terms of revenues and capacity, respectively. The container glass division has two manufacturing facilities located at Hyderabad and Bhongir, Telangana, the largest consumer of liquor, beer, and soft beverages in the country, thereby giving HSIL better headroom for growth than its peers.

Profitability improves significantly in FY16 led by higher margins and debt repayment

FY09-FY12: Phase of strong visibility and superior profitability: HSIL witnessed a phase of strong growth and dominance particularly post the commissioning of its greenfield project in Bhongir (capacity of 425tpd). With South India being the largest consumer of beer and liquor in India and HSIL the largest player in terms of capacity there, the company witnessed strong surge in revenues and EBIT, which grew by 34% and 49% respectively during FY09-FY12. EBIT margins too were up sharply during the period by 800bps from 7.2% in FY08 to 15.2% in FY12, led by higher capacity utilisation and high pricing power.

FY13-FY14: Demand decelerates while capacity enhances – leading to sharp fall in profitability: Immediately post HSIL's aggressive capacity additions in FY12 by way of brownfield expansion (capacity of 475tpd) in South India, it was jolted by a number of issues:

- Over-supply in the South, with HSIL's biggest competitor – HNGIL – setting up a large capacity plant of 650tpd in Naidupeta, Andhra Pradesh, in FY13
- Overall economic slowdown leading to under-utilisation of capacities
- Inability to raise prices despite rising costs, resulting in sharp deterioration in margins

FY15-FY16: Impressive comeback despite sluggish demand: Over the past two years, while the demand for container glass bottles remained sluggish (largely in the liquor and beer segment led by ban on consumption of liquor in a few states), the profitability of the division has drastically improved over the past two years on account of the following:

- **Change in fuel source:** HSIL has changed its source of fuel oil, effective Oct'13, from high-cost furnace oil to fluidised petcoke. This has reduced power and fuel cost to 30% of revenues in FY16 from 42% in FY14, thereby being margin-accretive to that extent
- **Foray into the value-added container glass segment**: HSIL has recently forayed into the manufacture of coloured glass, chemical, and lightweight bottles. It has deployed a sophisticated colouring technique – Forehearth Technology – to emerge as India's sole manufacturer of speciality coloured bottles. These bottles command higher realisations and margins.

Interest cost substantially lower in FY16: HSIL raised Rs2.5bn in Mar'16 via Qualified Institutional Placement (QIP) at a price of Rs400 per share. These funds were used for repaying debt, which reduced interest costs of the PPD division by ~Rs250mn in FY16, thereby aiding higher profitability.

Peak capex behind; strategic capex on Rs1.12bn on caps and closures to add to scale

Over the past few years, HSIL has increased capacities in its container glass division through a mix of greenfield and brownfield expansion and debottlenecking – taking its total capacity to 1,600tpd. Of the total capacity (four furnaces), one of the furnaces with capacity of 300tpd at Hyderabad.is shut since Sep'13 due to excess supply in the South India market.

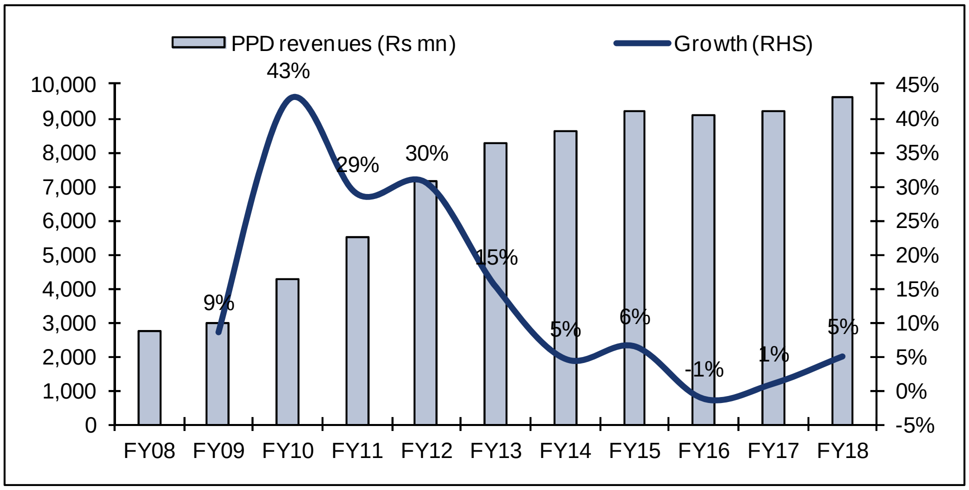
Capacity utilisation of the other three furnaces stood at 90% in FY16, which still offers some headroom for growth. We thus believe the company may not have to expand in this segment for the next three to four years as we expect it to deliver single-digit growth over the same period.

The PPD has however planned further value addition to its existing product profile by foraying into safety and tamper evident caps and closures. The new plant with a capacity to manufacture 720mn pieces of caps per annum at a capex of Rs1.12bn is expected to commence commercial operations by Mar'17.

Volume growth to remain muted

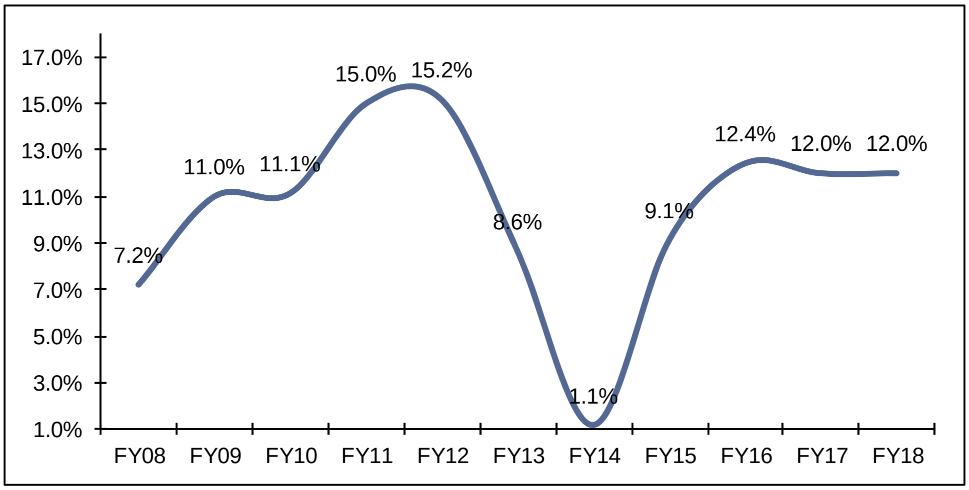
Considering the sluggish demand, particularly in the liquor and beer segment (50% of PPD revenues) led by slowdown woes and ban in consumption of liquor by a few states, we expect volume growth to remain muted over the next two years. Further, with the company finding it difficult to undertake price hikes in such testing times, we expect minimal probability of that in the near future. However, improving product mix would enable realisations to grow at 1-1.5% CAGR over the next two years. We expect PPD revenues and EBIT to grow at CAGRs of 3% and 1.2% respectively over FY16-FY18. More importantly, with minimal capex (post-FY17) and improving cash flow from operations, we expect debt to significantly reduce over FY18-FY20.

Chart 7: Revenue trend in PPD over FY08–FY18E



Source: Company data, I-Sec research

Chart 8: EBIT trend in PPD over FY08–FY18E



Source: Company data, I-Sec research

Strong brand equity with pan-India distribution network

Over the years, HSIL established a strong and widespread distribution network, encompassing over 3,000 dealers and over 19,000 retailers across India. It has presence in all towns with population of 100,000 and above.

HSIL has also established company-owned display centres, exhibiting its entire building products range, under the brand *Hindware Lacasa*. It has also encouraged dealers to open exclusive *Hindware* shops named *Hindware Boutiques* and *Hindware Arcades*, across major cities to sell the entire *Hindware* portfolio. The company also has created *Hindware Shop in Shop* by occupying space at dealer locations for adequate display of its product range.

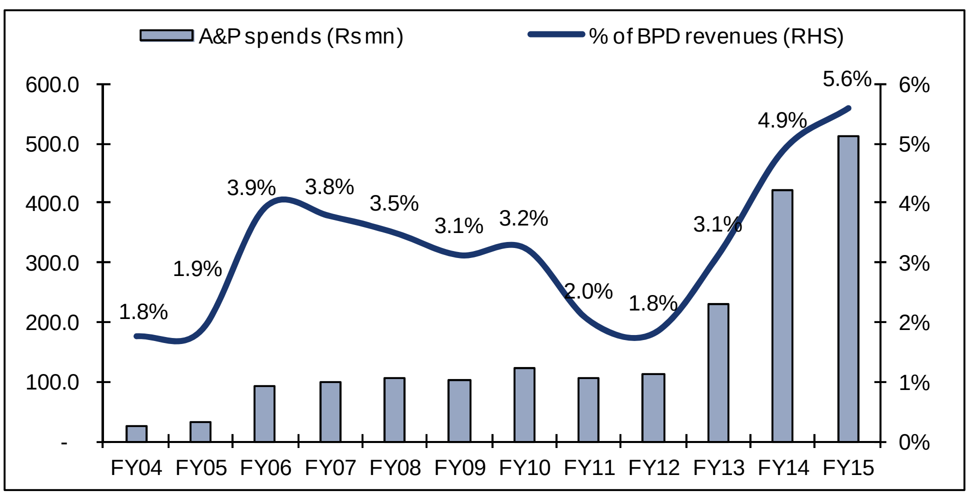
Around 60% of pan-India sanitaryware dealers stock HSIL's products. The company has established 20 service centres across different states, covering 95% of its total sales base. HSIL is further strengthening its presence by expanding its dealer network while focusing on advertising to promote its products and brands.

Table 1: HSIL's deeply entrenched network

Network	Basis	Ownership	Number and location
Hindware Lacasa	600-1,500sqft display centres	Company-owned	Four - Mumbai, Kochi, Bangalore and Ahmedabad
Hindware Boutiques and Arcades	Over 3,000sqft exclusive showrooms	Dealer-owned	125 – across major cities
Hindware shop-in-shops	Dedicated space provided by dealer at his shop for display	Dealer-owned	500 – across India

Source: Company data, I-Sec research

Chart 9: Reaping the benefits of aggressive advertising and promotion spends



Source: Company data, I-Sec research

Hindware, a 'top of the mind recall' brand in the minds of consumers, is largely backed by branding strategies. Historically, HSIL has nearly spent 3-4% of revenues from its building products division towards advertising and publicity. With the company getting aggressive in promoting its premium/luxury brands through celebrity endorsements, we expect advertising and promotion spends to be in the range of 4-6% of BPD revenues going forward.

Key brand spend initiatives by HSIL over the past three years

Chart 10: Bollywood celebrities endorsing HSIL brands

Chart 11: Active participation in various building material exhibitions

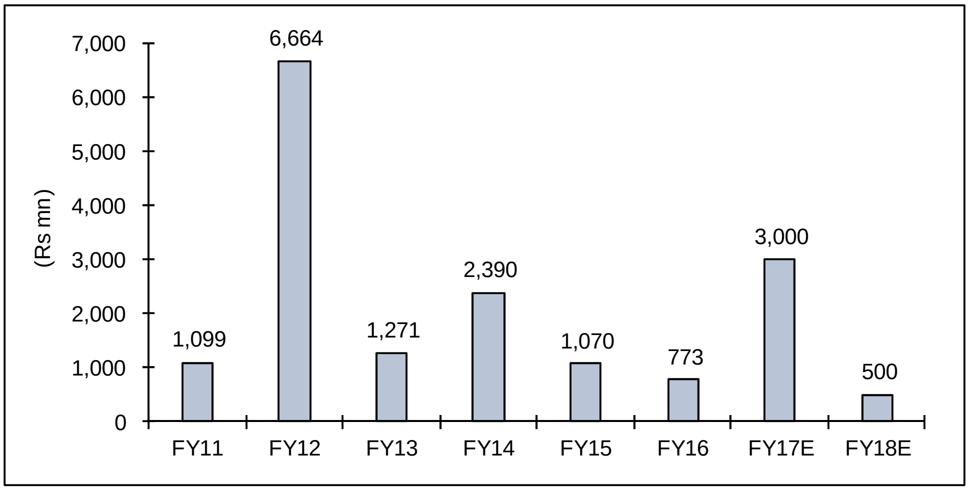
Chart 12: Rich clientele in PPD as well

Liquor	UB Group United Spirits	Pernod Ricard	DIAGEO	Radico	John Distilleries Ltd	
Beer	UB Group	SAB Miller India	Carlsberg			
Food	Unilever	Nestlé	The Global Green Company	GlaxoSmithKline Consumer Healthcare	Parle Agro refreshing India	
Soft drinks	Pepsi	Coca-Cola				
Pharmaceuticals	Pfizer	GlaxoSmithKline	Himalaya Herbal Healthcare	RANBAXY	Piramal knowledge action care	

Large-ticket capex to peak out by FY17

HSIL has spent ~Rs13bn over the past six years, with an average annual capex in excess of Rs2bn. As a result, the company has been unable to generate substantial free cash flow resulting in higher debt on books. Consequently, RoCE has fallen to 10% in FY16 from 15.7% in FY11.

Chart 13: Capex intensity to taper off by FY18



Source: Company data, I-Sec research

Capex plans segment-wise:

- **Sanitaryware:** HSIL is expected to incur capex of Rs450mn for increasing its capacity by 0.4mn units at its existing facilities, which would take its overall capacity to 4.2mn units by FY17.
- **Plastic pipes**: The company is in the process of setting up a PVC/CPVC pipes unit in Telangana in South India. The plant is expected to commence operations by Mar’17. HSIL will also be spending Rs1.05bn to build a 30,000tpa plant, 60% of which will cater to CPVC pipes.
- **Security caps and closures**: PPD has planned further value addition to its existing product profile too by foraying into safety and tamper evident caps and closures. The new plant with a capacity to manufacture 720mn pieces of caps per annum at a capex of Rs1.12bn is expected to commence commercial operations by Mar’17.
- **Maintenance capex**: Management expects the maintenance capex to be incurred across its existing facilities to be in the range of Rs400mn-500mn per annum.

We estimate HSIL to incur capex of Rs3bn in FY17 with majority of the aforementioned capex likely to be incurred in the current fiscal. FY18 capex is expected to be at Rs0.5bn, which would include maintenance capex. HSIL’s decision towards setting up a new sanitaryware plant in Gujarat is being put on hold at the moment and would open up for discussion in FY18E after taking a view on the demand environment. As capex post FY17 is expected to be significantly lower than the average capex over the past six years, we expect the company to start generating free cash and reduce debt meaningfully post FY17.

Financials expected to Improve

Chart 14: Trend in revenues and revenue growth

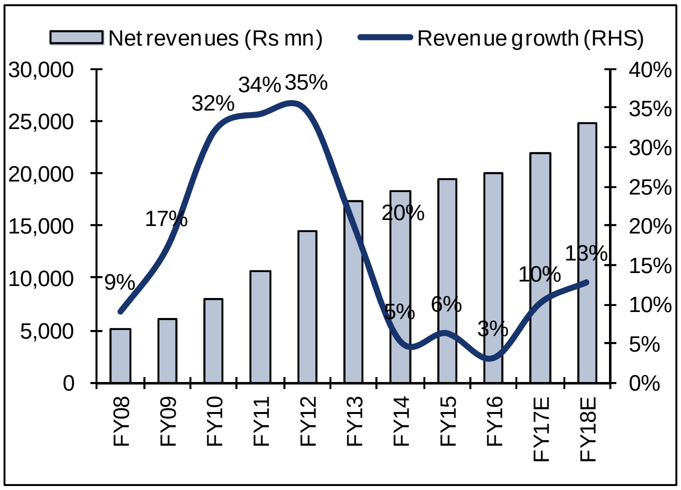
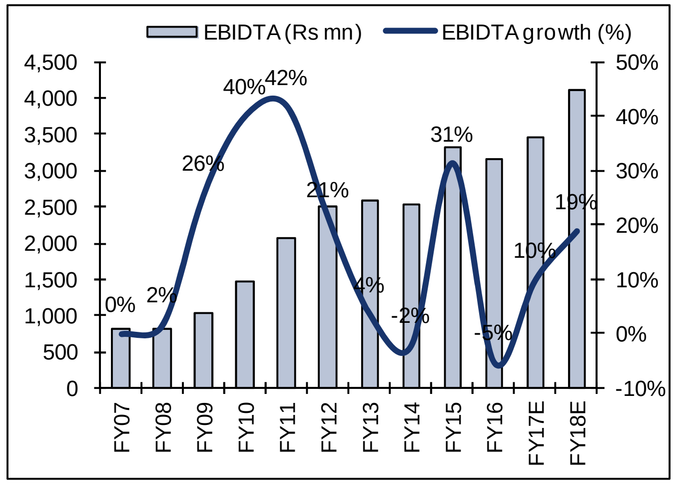


Chart 15: Trend in EBIDTA and EBIDTA growth



Source: Company data, I-Sec research

Chart 16: EBIDTA margin trend

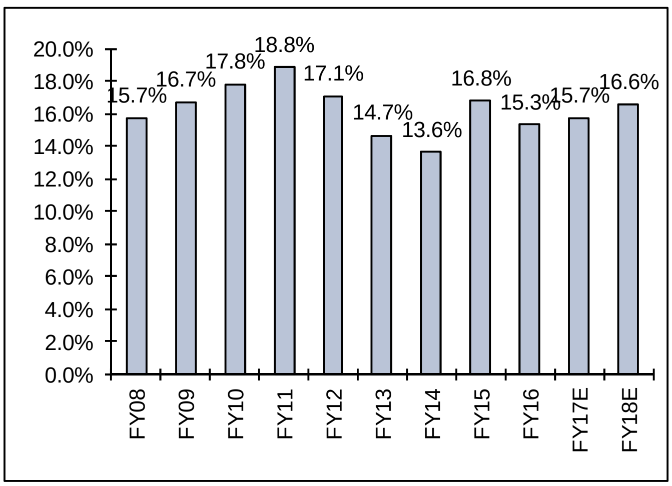
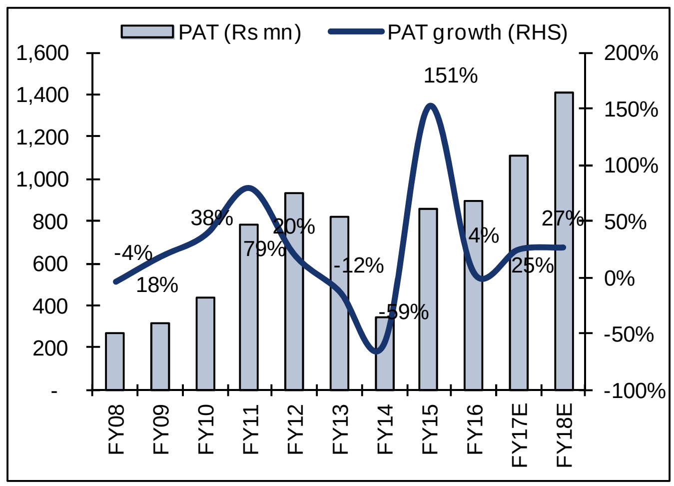


Chart 17: Trend in PAT and PAT growth



Source: Company data, I-Sec research

Chart 18: PAT margin trend

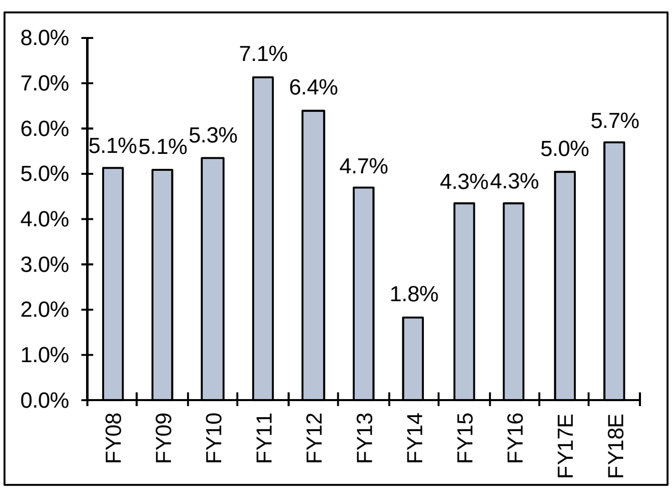
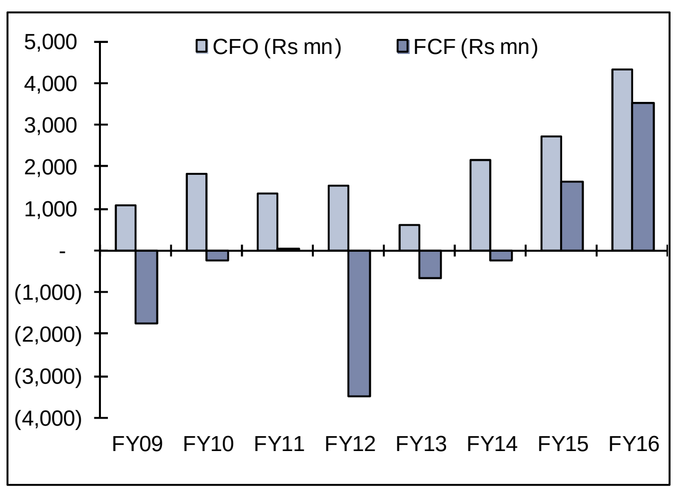


Chart 19: Trend in CFO and FCF



Source: Company data, I-Sec research

Chart 20: Trend in working capital days

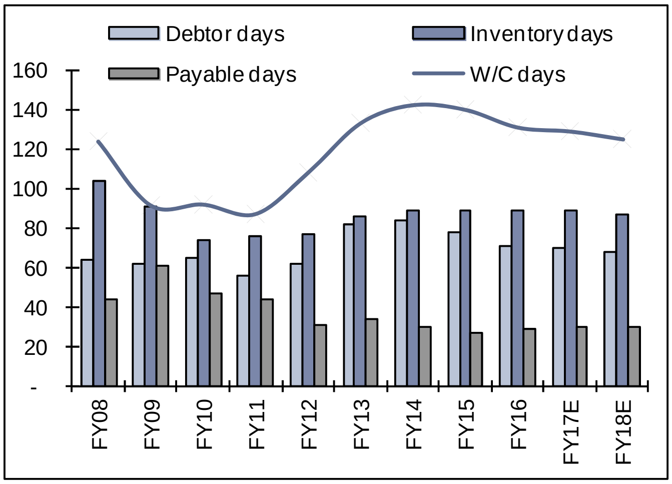
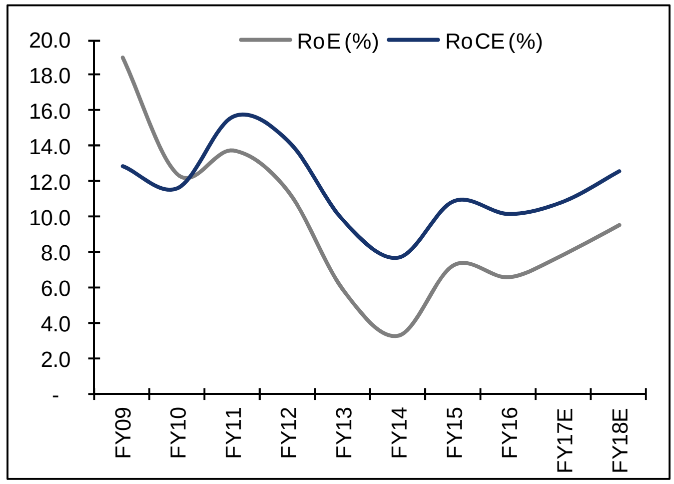


Chart 21: Trend in RoE and RoCE



Source: Company data, I-Sec research

Chart 22: Trend in net debt/equity

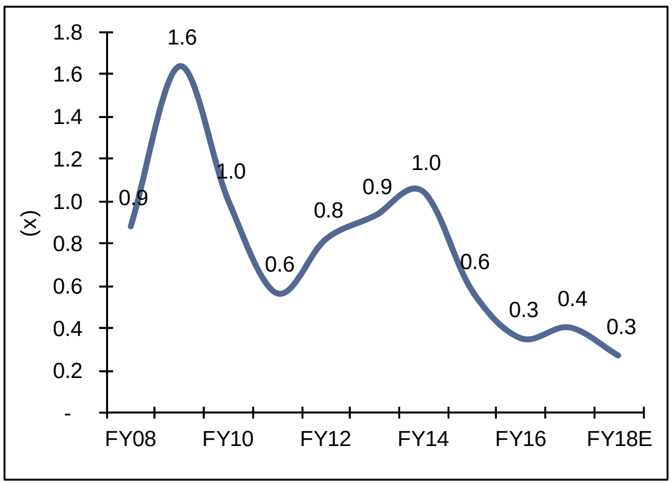
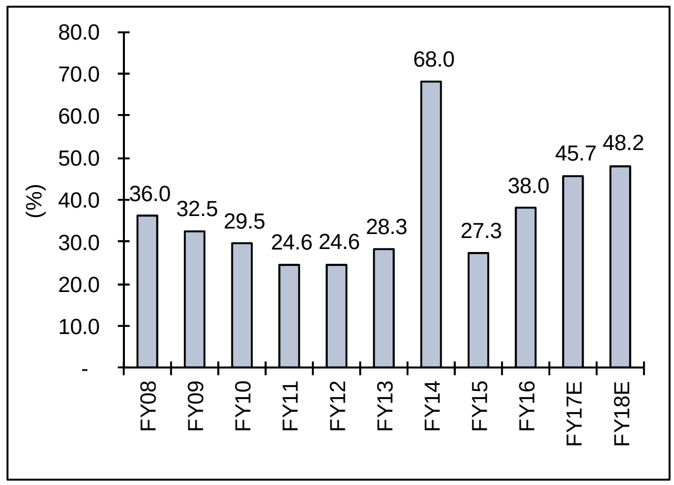


Chart 23: Trend in dividend payout



Source: Company data, I-Sec research

Key concerns

Prices of soda ash remain at elevated levels

Prices of soda ash constitute ~18% of the cost of glass manufacturing. If soda ash prices stay at elevated levels and HSIL remains unable to undertake a price hike particularly in the liquor and beer segment, then this would adversely affect margins of the packaging products division and profitability of the company.

Competitive intensity increasing in the premium segment

Around 60% of HSIL's sanitaryware revenues accrue from the premium / super-premium segment. Competition from MNC players such as Kohler, Duravit, Toto, etc. within this segment has been increasing. Some of these companies have already set up their manufacturing base in India, which could result in high competitive intensity in the segment and therefore pressure on margins.

Home retail furnishing subsidiary continues to bleed

HSIL's home retail furnishing subsidiary, Hindware Home Retail Pvt Ltd, reported losses of Rs110mn in FY16. We however expect the subsidiary to gradually pare down its losses over the next few years with HSIL expected to gradually convert into the franchise model. In the event of losses escalating, it would adversely impact HSIL's consolidated profits.

Valuation

We expect HSIL's overall revenues and PAT to grow at 11.4% and 25.6% CAGRs over FY16-FY18. At the current market price, the stock is trading at 18.2x and 14.4x its FY17E and FY18E earnings, respectively. We have arrived at an SoTP-based target price of Rs319/share, implying an FY18 P/E of 16.4x. We initiate coverage with 'Add' rating on the stock.

We value BPD at FY18E EV/EBIDTA multiple of 9x (30% discount to CRS multiple of 13.2x) to account for weaker RoCEs and capital allocation concerns. On the other hand, we value PPD at FY18E EV/EBIDTA multiple of 4x to factor weaker return ratios and sharp volatility in profitability.

Table 2: Target price works out to Rs319 per share based on SoTP valuations

SoTP valuation	FY17E	FY18E
Building product division		
EBIDTA	1,702	2,160
EV at 9x EV/EBIDTA	15,317	19,440
(30% discount to CRS valuations)		
Packaging product division		
EBIDTA	1,762	1,917
EV at 4x EV/EBIDTA	7,048	7,669
Total Enterprise Value	**22,366**	**27,109**
Less: Net debt	5,766	4,049
Market Cap	**16,600**	**23,060**
No of shares (Mn)	72	72
Target Price (Rs)	**230**	**319**

Source: Company data, I-Sec research

Company background

HSIL, the flagship company of the Somany Group, was the first company in India to manufacture vitreous china sanitaryware. Established in 1960, HSIL is India's largest manufacturer of sanitaryware products, with a 26% market share of the organised industry. Over the years, HSIL has established a strong distribution network, supported by over 3,000 dealers and 19,000 retail outlets. It is also the market leader in the container glass segment in South India and the second largest player in India.

The company has five manufacturing facilities in India – three in Telangana (two container glass units and one sanitaryware unit) and one each in Haryana (sanitaryware unit) and Rajasthan (faucet unit). Apart from manufacturing sanitaryware, faucets, and container glass, HSIL's other activities include manufacturing of PET bottles (via the acquisition of Garden Polymers) and home retail furnishing.

Table 3: HSIL's business model

Divisions	Building products division	Packaging products division
Products	Sanitaryware, faucets, wellness, consumer products like water heaters, air purifiers, water purifiers, kitchen chimneys, hoods and hobs, etc	Container glass and PET bottles
FY16 revenues (Rs mn)	Rs10.3bn	Rs9.1bn
Revenue mix (%)	50	44
FY16 EBIT (Rs mn)	Rs1.5bn	Rs1.1bn
FY16 EBIT margin (%)	14.6	12.4
Distribution model	100% sales through dealers	100% sales to original equipment manufacturers
Pricing power	High	Low
Working capital	Lower	Higher
Cashflow	Strong cashflows on account of sustained growth and lower working capital requirements	Weak cashflows due to dealing with OEMs and higher credit period offerings
Return ratios	High	Low
Raw material import dependency	No	Yes (soda ash)
Commodity vs value addition	60% value addition (premiumisation)	Largely a commodity business
Entry barriers	Distribution network and branding	Capital intensive and requires strong relations with OEMs
Major competitors	Parryware, Cera, Kohler, Duravit, Toto, Jaquar, etc.	HNGIL

Source: Company data, I-Sec research

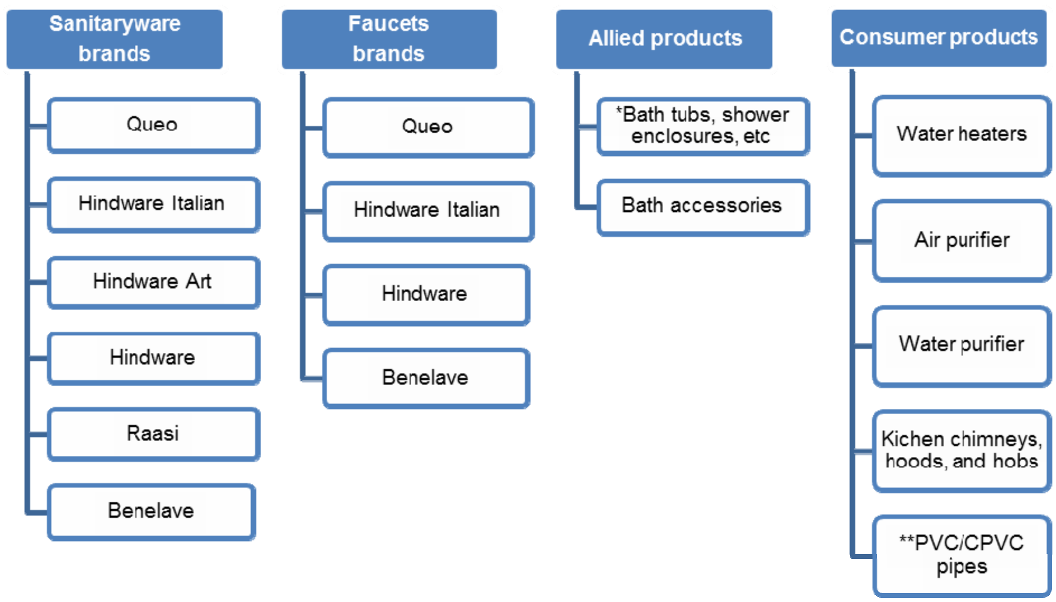
Building products division

Revenue mix: 50% of FY16 revenues

Within the business products division, HSIL manufactures/deals in the following product categories:

- **Sanitaryware:** Manufactured as well as outsourced
- **Faucets:** Manufactured as well as outsourced
- **Consumer products: E**ntirely outsourced
- **Allied products: Wellness and others** entirely outsourced

Chart 24: Building product offerings category-wise and brand-wise



*Wellness products sold under brands *Hindware* and *Amore*; **to be launched next year
Source: Company data, I-Sec research

Sanitaryware and allied products

Sanitaryware and allied products accounted for 61% of BPD revenues in FY16, which is HSIL's core business activity. At present, its capacity in sanitaryware stands at 3.8mn pieces, spread across its two facilities in Bahadurgarh, Haryana (1.8mn pieces) and Bibinagar, Telangana (2mn pieces). The company has separate category brands for different price points: *Raasi*, *Benelave*, *Hindware*, *Hindware Art*, *Hindware Italian* and *Queo*. Over 90% of the turnover is derived from manufactured products while the rest comes through outsourcing. The company outsources its luxury brand *Queo* from Barwood Products, UK and some *Hindware Italian* models from China.

Chart 25: Product offerings:

Wash Basins

Water Closets

Urinals

Bidets

Table 4: Product segments in sanitaryware segment

Product segment	Price range	HSIL brands	Competitors in respective categories
Super premium	Rs15,000–200,000	Queo	Kohler, Duravit, Toto, and Roca
Premium	Rs5,000–15,000	Hindware Italian/Art	American Standard, Toto, Kohler, Duravit, and Parryware Roca
Standard	Rs375–5,300	Hindware	Parryware and Cera
Basic	Rs250–2,000	Hindware	Parryware and Cera
Low-end	Rs200-550	Raasi	Unorganised companies

Source: Company data, I-Sec research

FY16 sanitaryware product mix: The first two categories in the above table account for 60% of turnover with the balance accruing from the last three: standard and basic at 37% and low-end at 3%. Going forward, HSIL would continue to focus on the top two categories by introducing new designs and models, which would help consolidate its position in the premium segment.

Table 5: Sanitaryware capacity location-wise

Location	Capacity (mn pieces)	Capacity addition (mn pieces)	Capacity post expansion (mn pieces)	Month of completion
Bahadurgarh, Haryana	1.8	0.1	1.9	Mar’17
Bibinagar, Telangana	2.0	0.3	2.3	Mar’17

Source: Company data, I-Sec research

In FY16, HSIL touched a capacity utilisation of close to 90% at both plants (Bahadurgarh and Bibinagar). With the incremental capacity addition (0.4mn pieces per annum) expected by Mar’17 and HSIL expected to grow at 5-7% in volume terms over the next three years, the company may not be required to invest in any greenfield project at least for next 2-3 years.

Faucets

HSIL’s faucet segment revenues accounted for 26% of BPD revenues in FY16. This segment is increasingly becoming another focus area for HSIL. The company marked its foray into this segment in FY11 through the inorganic route, when it acquired the faucet unit of Havells India (manufacturing capacity 0.5m pieces per annum) in May’10. However, HSIL relaunched the *Crabtree* brand under a new name – *Benelave* – in Jan’11.

Chart 26: Product offerings in faucet segment

Faucets

Showers

Stop cocks

Accessories

Having tested the market successfully over FY04-FY10, through outsourcing initially and then via the inorganic route, HSIL is now focusing on this segment in a big way, with a thrust on manufacturing. Its greenfield project at Bhiwadi, Rajasthan, with a manufacturing capacity of 2.5mn pieces per annum, was commissioned in Jul'14.

Table 6: Faucet capacity location-wise

Location	Capacity (mn pieces)	Capacity utilisation
Bhiwadi, Rajasthan	0.5	Temporarily shut down
Kaharani, Rajasthan	2.5	60% utilisation in FY16

Source: Company data, I-Sec research

The Kaharani plant is scalable to manufacture 5mn faucets per annum at an incremental capex of Rs0.7bn. The management intends to start production at the old Bhiwadi plant once it is confident that it would be able to utilise that plant to the fullest extent when the demand environment improves.

Consumer products

Apart from its core products – sanitaryware and faucets – related to bathroom solution channels, HSIL is currently taking initiatives to develop two more channels in the consumer electrical and hardware space for expanding its recently launched consumer products and to-be-launched plumbing pipe products, respectively. Consumer product revenues accounted for 6% of the BPD revenues in FY16.

- **Consumer electrical business:** The products launched by HSIL under the consumer business till date include water heaters, air purifiers, kitchen chimneys, hoods and hobs, etc. The company is expected to launch water purifiers soon. It has tied up with Groupe Atlantic of France for water heaters and the Indian subsidiary of The Marmon Group (a subsidiary of Bershire Hathway, US) for water purification products. Though consumer electrical segment was loss-making for HSIL in FY16, the management expects it to turn EBIDTA breakeven in FY18.

Chart 27: Product offerings in the consumer electrical segment

Water heater **Air cooler** **Air purifier** **Kitchen hoods**

Source: Company data, I-Sec research

- **Consumer hardware business:** HSIL's imminent entry into the pipes business will be a further extension to its building product portfolio. The company will leverage its existing sales and distribution network for marketing the piping products. HSIL is already in the process of creating a hardware channel for marketing its plumbing pipe products. It is setting up a PVC/CPVC pipes unit in Telangana in South India, which is expected to commence operations by Mar'17 at a capex of Rs1.05bn.

Wellness and others

HSIL outsources and sells other products like bath tubs, showers, enclosures, etc., which accounted for 3% of the BPD revenues in FY16. Wellness products are sold under the brands *Hindware* and *Amore*. While mass to premium segment products are sold under brand *Hindware*, the luxury products are sold under the brand *Amore*.

Chart 28: Product offerings in the wellness segment

Massage tub

Shower enclosure

Multipurpose shower enclosure

Shower panel

Packaging products division

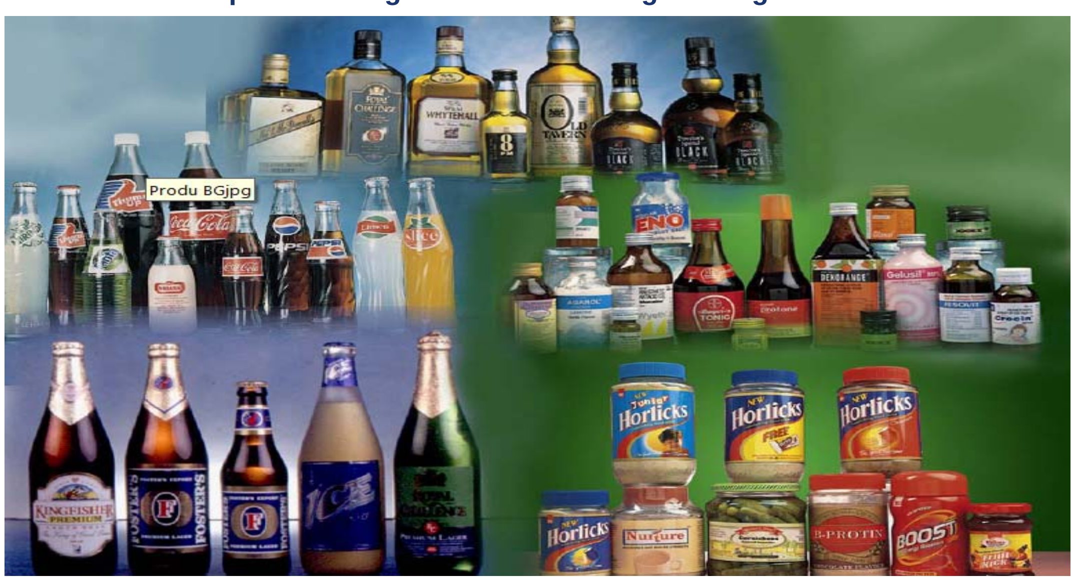
Revenue mix: 44% of FY16 revenues

HSIL's packaging product division comprises of two business segments:

Container glass segment

HSIL is the second-largest manufacturer of container glass bottles in India, with a domestic market share of 17%. It remains the largest manufacturer in the South – India's largest container glass market, with a dominant market share. The company markets its products under the brand name *AGI*. Its product range caters to user industries like beer and liquor, food and beverages, and pharmaceuticals among others.

Chart 29: HSIL's product range in the container glass segment



Source: Company data, I-Sec research

Table 7: HSIL's container glass facilities and installed capacities

Location	Capacity (in tpd)	Furnaces (nos)
Hyderabad, Telangana	650	2
Bhongir, Telangana	950	2
Total	**1,600**	**4**

Source: Company data, I-Sec research

Strategic location of plants: The container glass division has two manufacturing facilities strategically located at Hyderabad and Bhongir, both in Telangana, which is the largest consumer of liquor, beer and soft beverages in the country. The division generated over 50% of its revenues from the beer and liquor segment while beverages, pharmaceuticals and the food segment accounted for the rest.

Since freight cost is an important consideration in this segment and transporting container glass over large distances is not feasible, HSIL enjoys a strategic competitive advantage, with its manufacturing facilities in Telangana – the largest market for container glass. It has the largest installed capacity of 1,600tpd in South India. HNGIL is the other recognised player in the region, with an existing capacity of 1,010tpd. Together, both players constitute 90% of current capacity in the southern region, making it practically a duopoly.

Garden Polymers segment

In Aug'11, HSIL acquired 100% stake in Garden Polymers Pvt Ltd, via a share purchase agreement. Garden Polymers is engaged in the business of manufacturing PET bottles, caps and closures, with plants at Dharwad (Karnataka) and Selaqui (Uttarakhand). It is a leading supplier to premier customers in the liquor, pharmaceutical and FMCG industries, and was merged with HSIL in FY14.

Chart 30: Product offerings

Source: Company data, I-Sec research

This acquisition of Garden Polymers synergised with HSIL's container glass division, which supplies to a similar set of customers. This further strengthens the company's position as a packaging solutions provider. This division reported net revenues of ~Rs1bn in FY16.

Others

Revenue mix: 6% of FY16 revenues

HSIL operates its home retail furnishing business via its wholly-owned subsidiary HHRPL Hindware Home Retail Pvt Ltd. Currently, the company has 13 mega stores under the brand name *Evok*. This segment accounted for 6% of FY16 consolidated revenues. Furniture accounts for ~60-70% of sales and is mostly imported from Malaysia and Indonesia. *Evok* is a chain of specialty home furnishing mega stores, showcasing a range of over 20,000 home interior products. This segment posted a loss of Rs110mn in FY16.

Key milestones

Year	Milestone
1960	• Incorporation of Hindustan Twyfords
1962	• Sets up first sanitaryware plant in Bahadurgarh, Haryana
1967	• Changes company name to Hindustan Sanitaryware & Industries
1981	• Forays into container glass manufacturing through acquisition of Associated Glass Industries
1989	• Consolidates position in sanitaryware through inorganic route, - acquires Krishna Ceramics (Bibinagar, Andhra Pradesh)
1991	• Launches Hindware brand
1999	• Acquires Raasi Ceramics, further expands its manufacturing capacity
2000	• Launches bathroom wellness solutions like bath tubs, showers, etc; Creates building products division
2004	• Business products division expanded to chrome plated bathroom fittings (faucets)
2008	• Enters into home interior retail venture through its subsidiary Hindware Home Retail Pvt
2009	• Changes name to HSIL • Launches Hindware Lacasa display showrooms • Greenfield container glass project at Bhongir commences production, significantly expands capcity
2010	• Acquired i) Bath fittings business of Havells India; and ii) UK-based Barwood Products • Forays into the tiles segment
2011	• Launches luxury brand 'Queo'
2012	• Completes brownfield expansion of faucets at Bhiwadi and sanitaryware at Bibinagar • Completes Phase-II expansion of container glass division at Bhongir • Acquires Garden Polymers Pvt, marking its entry into PET bottle segment
2014	• Changes fuel source in container glass division to fluidised pet coke from high-cost furnace oil to substantially reduce its power and fuel cost
2015	• Exits tiles business
2016	• Enters into consumer business through outsourcing model - Imports and sells products like water heaters, water purifiers and air purifiers. Expects to launch PVC/CPVC pipes by end-FY17

Source: Company data, I-Sec research

Financial summary

Table 8: Profit and Loss Statement

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Net Sales	18,279	19,421	20,019	22,027	24,830
Add: Other Operating Income	303	385	542	-	-
Net revenue	**18,582**	**19,806**	**20,561**	**22,027**	**24,830**
Less:					
Cost of goods sold	6,475	7,315	7,627	8,767	9,874
Employee cost	1,884	2,159	2,510	2,864	3,278
Others	7,689	7,006	7,273	6,932	7,561
Total Operating Expenses	**16,049**	**16,481**	**17,409**	**18,563**	**20,712**
EBITDA	**2,533**	**3,325**	**3,152**	**3,465**	**4,117**
Depreciation	1,101	1,250	1,202	1,235	1,483
Other income	38	36	35	40	40
EBIT	**1,470**	**2,111**	**1,985**	**2,270**	**2,675**
Less: Financial expenses	718	775	412	500	470
Recurring Pre-tax Income	**752**	**1,335**	**1,573**	**1,769**	**2,204**
Less: Taxation	412	481	683	659	800
Less: Minority Interest / Subsidiary loss	-	-	-	-	-
Net Income (Reported)	**340**	**854**	**890**	**1,110**	**1,405**
Extraordinary Items	-	-	-	-	-
Recurring Net Income	**340**	**854**	**890**	**1,110**	**1,405**

Source: Company data, I-Sec research

Table 9: Balance Sheet

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
ASSETS					
Current Assets, Loan & Advances					
Inventories	4,443	4,744	4,901	5,371	5,918
Sundry debtors	4,192	4,138	3,901	4,224	4,626
Cash and bank balances	603	251	199	334	301
Other current assets	39	35	22	22	22
Loans and advances	968	816	935	1,050	1,250
Total Current Assets	**10,245**	**9,984**	**9,957**	**11,001**	**12,117**
Current Liabilities & Provisions					
Current Liabilities	1,502	1,451	1,583	1,810	2,041
Provisions and other liabilities	2,472	2,723	4,428	5,325	6,250
Total Current Liabilities & Provisions	**3,975**	**4,174**	**6,011**	**7,135**	**8,291**
Net Current Assets	**6,270**	**5,810**	**3,946**	**3,866**	**3,826**
Investments	**109**	**109**	**108**	**108**	**108**
Fixed Assets					
Gross block	20,669	22,599	23,707	26,707	27,207
Less : depreciation	5,510	6,752	7,954	9,189	10,671
Net block	**15,159**	**15,847**	**15,753**	**17,518**	**16,535**
CWIP	1,195	335	-	-	-
Goodwill	**35**	**35**	**-**	**-**	**-**
Total Assets	**22,767**	**22,136**	**19,807**	**21,492**	**20,470**
LIABILITIES AND SHAREHOLDERS' EQUITY					
Shareholders Fund					
Equity share capital	132	145	145	145	145
Reserves and surplus	10,151	13,086	13,635	14,237	14,965
Total Shareholders Fund	**10,283**	**13,231**	**13,779**	**14,382**	**15,110**
Borrowings					
Secured loans	7,303	3,884	2,934	2,750	1,750
Unsecured loans	4,027	3,976	2,084	3,350	2,600
Total Borrowings	**11,330**	**7,860**	**5,018**	**6,100**	**4,350**
Deferred Tax Liability	**1,154**	**1,045**	**1,010**	**1,010**	**1,010**
Minority Interest	**-**	**-**	**-**	**-**	**-**
Total Liabilities & Shareholders' Equity	**22,767**	**22,136**	**19,807**	**21,492**	**20,470**

Source: Company data, I-Sec research

Table 10: Cashflow Statement

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Cash Flow from Operating Activities					
PAT	340	854	890	1,110	1,405
Add: Depreciation	1,101	1,250	1,202	1,235	1,483
Add: Other Operating activities	(64)	(182)	(4)	0	(0)
Operating Cash Flow Before Working Capital change (a)	**1,377**	**1,923**	**2,088**	**2,345**	**2,887**
Changes in Working Capital					
(Increase) / Decrease Trade & 0th receivables	(298)	54	237	(324)	(401)
(Increase) / Decrease Inventories	(377)	(300)	(157)	(471)	(547)
Increase / (Decrease) Current liab and provisions	20	199	1,837	1,124	1,155
Others	681	155	(70)	(115)	(200)
Working Capital Inflow / (Outflow) (b)	**26**	**108**	**1,847**	**215**	**7**
Net Cash flow from Operating Activities (a) + (b)	**1,403**	**2,030**	**3,936**	**2,560**	**2,894**
Cash Flow from Capital commitments (c)	**(2,390)**	**(1,070)**	**(773)**	**(3,000)**	**(500)**
Free Cash flow after capital commitments (a) + (b) + (c)	**(987)**	**960**	**3,163**	**(440)**	**2,394**
Cash Flow from Investing Activities					
Purchase of Investments	(0)	(0)	0	-	-
Change in goodwill	-	-	-	-	-
Net Cash flow from Investing Activities (d)	**(0)**	**(0)**	**0**	**-**	**-**
Cash Flow from Financing Activities					
Equity raised/(repaid)	-	2,500	-	-	-
Proceeds from fresh borrowings	989	(3,470)	(2,842)	1,082	(1,750)
Dividend paid including tax and others	(231)	(233)	(338)	(508)	(677)
Net Cash flow from Financing Activities (e)	**758**	**(1,203)**	**(3,180)**	**574**	**(2,427)**
Change in Deferred Tax Liability (f)	13	(109)	(35)	-	-
Total Increase / (Decrease) in Cash (a) + (b) + (c) +(d) + (e) + (f)	(217)	(352)	(52)	135	(33)
Opening Cash and Bank balance	820	603	251	199	334
Closing Cash and Bank balance	603	251	199	334	301
Increase / (Decrease) in Cash and Bank balance	**(217)**	**(352)**	**(52)**	**135**	**(33)**

Source: Company data, I-Sec research

Table 11: Key ratios

(year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Per Share Data (Rs)					
EPS	5.1	11.8	12.3	15.4	19.4
Cash EPS	21.8	29.1	28.9	32.4	39.9
Dividend per share (DPS)	3.0	2.8	4.0	6.0	8.0
Book Value per share (BV)	106.8	138.4	190.6	198.9	209.0
Growth (%)					
Net Sales	5.3	6.2	3.1	10.0	12.7
EBITDA	(2.1)	31.3	(5.2)	9.9	18.8
PAT	(58.6)	151.4	4.2	24.7	26.5
Cash EPS	(17.8)	33.4	(0.6)	12.1	23.1
Valuation Ratios (x)					
P/E	54.2	23.6	22.7	18.2	14.4
P/CEPS	12.8	9.6	9.6	8.6	7.0
P/BV	2.6	2.0	1.5	1.4	1.3
EV / EBITDA	11.5	8.4	7.9	7.5	5.9
EV / Sales	1.6	1.4	1.2	1.2	1.0
Operating Ratio					
Raw Material / Sales (%)	35.4	37.7	38.1	39.8	39.8
Employee cost / Sales (%)	10.3	11.1	12.5	13.0	13.2
SG&A / Sales (%)	8.7	10.3	-	11.0	10.7
Other Income / PBT (%)	5.1	2.7	2.2	2.3	1.8
Effective Tax Rate (%)	54.8	36.0	43.4	37.3	36.3
Working Capital (days)	142.4	139.6	131.6	129.0	125.0
Inventory Turnover (days)	88.7	89.2	89.4	89.0	87.0
Receivables (days)	83.7	77.8	71.1	70.0	68.0
Payables (days)	30.0	27.3	28.9	30.0	30.0
Net D/E Ratio (x)	1.0	0.6	0.3	0.4	0.3
Return/Profitability Ratio (%)					
Net Income Margins	1.8	4.3	4.3	5.0	5.7
RoACE *	7.7	10.9	10.2	10.9	12.6
RoAE	3.3	7.3	6.6	7.9	9.5
Dividend Payout	68.0	27.3	38.0	45.7	48.2
Dividend Yield	1.0	1.0	1.4	2.1	2.8
EBITDA Margins	13.6	16.8	15.3	15.7	16.6

* RoACE for FY17 and FY18 would stand higher by 270bps and 310bps, respectively had Business Reconstruction Reserve been net-off from reserves and surplus while calculating the capital employed of the company

Source: Company data, I-Sec research

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Equity Research
July 8, 2016
BSE Sensex: 27201

INDIA

Cera Sanitaryware

HOLD

Emerging as a focused bathroom solution player **Rs2,446**

Reason for report: Initiating coverage

Sanitaryware

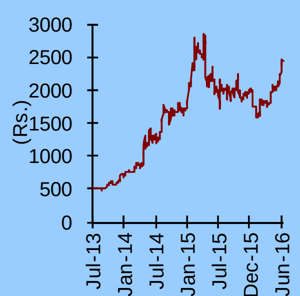
Target price Rs2,506

Shareholding pattern

	Sep '15	Dec '15	Mar '16
Promoters	54.8	54.8	54.8
Institutional investors	20.0	20.3	20.4
MFs and UTI	4.4	4.7	4.6
FIs/Banks	1.0	1.4	1.9
Insurance	0.2	0.1	0.4
FIIs	14.7	14.1	13.9
Others	25.2	24.9	24.9

Source: NSE

Price chart



We are structurally positive on the business prospects of Cera Sanitaryware (CRS) due to its growing brand equity, increasing distribution network, sound management credibility, and scalability of business model. Besides its core expertise in the sanitaryware segment, CRS is fast emerging as a strong bathroom solution provider as it is intensifying focus into allied products viz. faucets through in-house manufacturing, and tiles through a mix of joint venture and outsourcing model. Further, lower gas prices, employee linked productivity measures and increasing premiumisation, higher utilisation in the faucets segment and scaling up of joint venture model in tiles are expected to drive margins and profitability going forward. We expect top line and bottom line to witness CAGR of 16.2% and 25% respectively over FY16-FY18E with ROCEs expected to improve 260bps to 30.2%. The stock currently trades at 24.4x its FY18E earnings of Rs 100.3. We initiate coverage with a HOLD on CRS and target price of Rs 2,506, valuing it at 25x FY18E earnings.

- **Growth in allied products expected to drive overall growth.** The growth in the core sanitaryware segment is expected to remain in high single digits led by the recent slowdown woes. However, by intensifying focus in faucets via manufacturing model and tiles through both trading and joint venture model, CRS is positioning itself as a complete bathroom solutions provider. While sanitaryware and allied products account for 60% of revenues currently, faucets and tiles account for 23% and 15% of overall revenues, respectively. With the company expected to ramp up production in faucet unit and tiles likely to gain traction post the recent commissioning of Anjani Tiles in Andhra Pradesh, these product segments are likely to supplement company's overall growth. We expect CRS to report 16.2% revenue CAGR over FY16-FY18E.
- **Focus back on profitable growth.** CRS witnessed a margin decline from 18.8% in FY11 to 14.3% in FY15 which recovered partially to 15.1% in FY16. We expect margins to gain traction over the next two years led by a) lower gas prices, b) employee linked productivity measures resulting in lower wastages and higher efficiency, c) increasing premiumisation across product categories, d) higher utilisation in the faucets segment, and e) scaling up of joint venture model in tiles. With this, we expect CRS margins to improve by 190bps to 17% over the next two years. Strong operating performance is also expected to drive CRS bottomline by 25% CAGR over FY16-FY18E.
- **Strong financial discipline with impressive return ratios.** The asset light model of CRS has enabled it to generate strong RoCE in excess of 28% over the last five years. With the trend in outsourcing likely to sustain and focus intensifying on profitable growth, we expect RoCEs to improve over 260bps to over 30% by FY18E, thereby sustaining higher valuations.

Market Cap	Rs31.8bn/US$472mn
Reuters/Bloomberg	CERA.BO / CRS IN
Shares Outstanding (mn)	13.0
52-week Range (Rs)	2464/1578
Free Float (%)	45.3
FII (%)	13.9
Daily Volume (US$/'000)	363
Absolute Return 3m (%)	38.3
Absolute Return 12m (%)	33.1
Sensex Return 3m (%)	10.9
Sensex Return 12m (%)	(2.0)

Year to Mar	FY15	FY16	FY17E	FY18E
Revenue (Rs mn)	8,217	9,337	10,764	12,596
Rec. Net Income (Rs mn)	677	835	1,029	1,304
EPS (Rs)	52.0	64.2	79.2	100.3
% Chg YoY	26.8	23.4	23.3	26.7
P/E (x)	47.0	38.1	30.9	24.4
CEPS (Rs)	63.9	76.7	93.6	118.8
EV/E (x)	27.4	22.5	18.6	14.9
Dividend Yield (%)	0.2	0.4	0.5	0.6
RoCE (%)	29.4	27.6	28.3	30.2
RoE (%)	23.5	21.2	21.5	22.6

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Strong brand in mass market space

Over the years, CRS has been commanding strong brand equity in the mass market sanitaryware space. It is perceived as the largest player in this space with HSIL and Parryware Roca's mass market segment mix to overall revenues substantially lower as compared to CRS.

The company commands a market share of 18% in the branded sanitaryware space and ~12% of the overall sanitaryware market. However, in the mass market space CRS commands a lion's share considering its strong domain in the space.

CRS in a sweet spot as competitive intensity higher in premium/super premium and low-end segment

CRS appears in a sweet spot with the company continuing to focus heavily on the mid-market space. Competitive intensity within this space is also on the lower side as it is largely contested by top domestic brands: HSIL, Parryware Roca, and CRS.

Chart 1: Competitive brands in each segment

Source: I-Sec Research

The company continues to enjoy strong brand recall in this space. Going forward, its strategy is to further consolidate its presence in this space. As opposed to CRS, peers in this space - HSIL and Parryware Roca - seem to have shifted their focus more on the premium/super premium market.

On the other hand, premium/super premium market has become highly competitive with MNC brands entering the segment. A few MNC brands have also set-up factories in India like Kohler, Duravit and Toto in Gujarat. These MNC players not only compete amongst themselves but also with the top three domestic brands in this space. The low-end market segment largely comprises unbranded units, which are large in numbers, spread across Morbi, Wankaner and Thangad areas of Gujarat. Competition here is much higher as compared to mid-market or premium segments.

Also, in the current economic scenario, the mass segment is expected to outpace the premium/luxury market led by a) Government's focus on affordable housing; b) increasing infrastructure activities in Tier 2 and 3 cities as opposed to sustained slowdown in Tier 1 cities and metros; and c) increasing shift from unbranded to branded products in the mass market space.

Moving towards premiumisation – premium and luxury segments

In order to have presence across the entire value chain and offer complete bouquet of sanitaryware products, CRS has over the last three years become aggressive in launching premium products to gain some traction in the premium sanitaryware segment. The aggressive branding measures including advertising campaigns and related promotional activities have resulted in increasing contribution from premium products to 30% in FY16 vs. 20% in FY13.

Recently forayed into luxury sanitaryware segment with the launch of ISVEA brand

CRS entered a marketing agreement with ECE Banyo, the owners of Italian Luxury Sanitaryware brand ISVEA for a period of 5 years, which can be extended later, exclusively for sales, distribution and marketing of ISVEA brand in India. Products of ISVEA brand are designed by well-known Italian designers giving it an individualistic and unique aesthetic look. The ISVEA brand was launched by the Company in Apr'16 in India. The agreement between the two brands is not only to market ISVEA's products in India but also promote CRS' products in EU markets.

Chart 2: Recent launch of brand *ISVEA* at the CREDAI NATCON event in Istanbul

Source: I-Sec Research

ISVEA established in 1962 in Italy, is better known for its impressive designers. Most product ranges of ISVEA have bagged design awards, including the prestigious Red Dot. Some technologically advanced products that ISVEA would launch are *CleaRim WCs* (rimless hygienic WCs), *Aquaplus WCs* (water-saving WCs using 2.7 litres of water), *DecorPlus* (printed washbasins), *SmartPlus* (with built-in personal hygiene), *Softclose* (with noiseless closure lids), *SterilPlus* (bacteria-free product) and *e-Motion* (height-adjustable WC and washbasin).

With the company gradually moving towards premiumisation – premium as well as luxury segments, we expect CRS' contribution to premium and luxury segments to increase from current 30% to 40% in FY18E. This would increase the company's realisations and also turn out to be margin accretive over the next few years.

Focus on branding and advertising contributes to growing brand awareness

CRS has been spending ~4% of revenues on branding and promotional activities yearly to create a brand recall in consumers' minds. Three years ago, it roped in Bollywood celebrity Sonam Kapoor as brand ambassador, replacing Dia Mirza. It also launched advertisements in general entertainment channels along with niche branding measures like in-film branding (*Heroine* released in 2012) and co-sponsoring realty shows (*Nach Baliye* 6) to aid its growing brand visibility.

Chart 3: Advertisement and promotional campaigns: Aggression displayed over the last three years

Advertisement campaign in 2010 targeted in select news and business channels

May-12: New TV commercial with Dia Mirza

Aug-12: In-film branding where Kareena Kapoor was shown launching a Cera Bath Studio in movie *Heroine*

Oct-13: TV commercial with Sonam Kapoor as brand ambassador

Co-sponsoring a realty show on a general entertainment channel (*Nach Baliye* 6 being aired on Star Plus)

Promotion of faucets and tiles with brand ambassador Sonam Kapoor

Source: Company

It has also been actively adding Cera Bath Studios (company-owned display or orientation centres) and Cera Style Galleries (shop-in-shop display with dealers) to increase brand recall. The former has made a big impact in rapidly increasing its brand equity over the last three years and been instrumental in complementing sale of its allied products like faucets, tiles and wellness. At present, the company has 10 Cera Style Studios and over 100 dealer-owned Cera Style Galleries.

Aggressive A&P spends expected to continue

Over the last six years in particular, the company has been aggressively spending on advertisement and promotional activities. The following table highlights the A&P spends incurred by CRS over the last decade.

Table 1: A&P spends/revenues

Year	A&P revenues (Rs mn)	A&P spends/revenues (%)
FY06	37.6	4.7
FY07	41.4	3.9
FY08	45.6	3.6
FY09	47.2	3.0
FY10	96.5	5.0
FY11	97.8	4.0
FY12	145.3	4.5
FY13	177.1	3.6
FY14	270.0	4.1
FY15	331.0	4.0

Source: Company, I-Sec Research

The statistics clearly indicate that CRS has been aggressively initiating A&P spends in the quest to increase its market share. We expect A&P spend to remain in the 4-5% range for the next three years, with the company now intensifying its focus on allied products like faucets and tiles and moving up the value chain in the sanitaryware segment.

Increasing reach through distribution

Over the years, CRS has managed to gain significant presence in states like Kerala, Gujarat, Maharashtra (excluding Mumbai), Punjab, and Orissa in particular backed by strong distribution reach and mind recall. But in the last three-to-four years, it has been making significant in-roads into south India which is the fastest growing market for sanitaryware products in India.

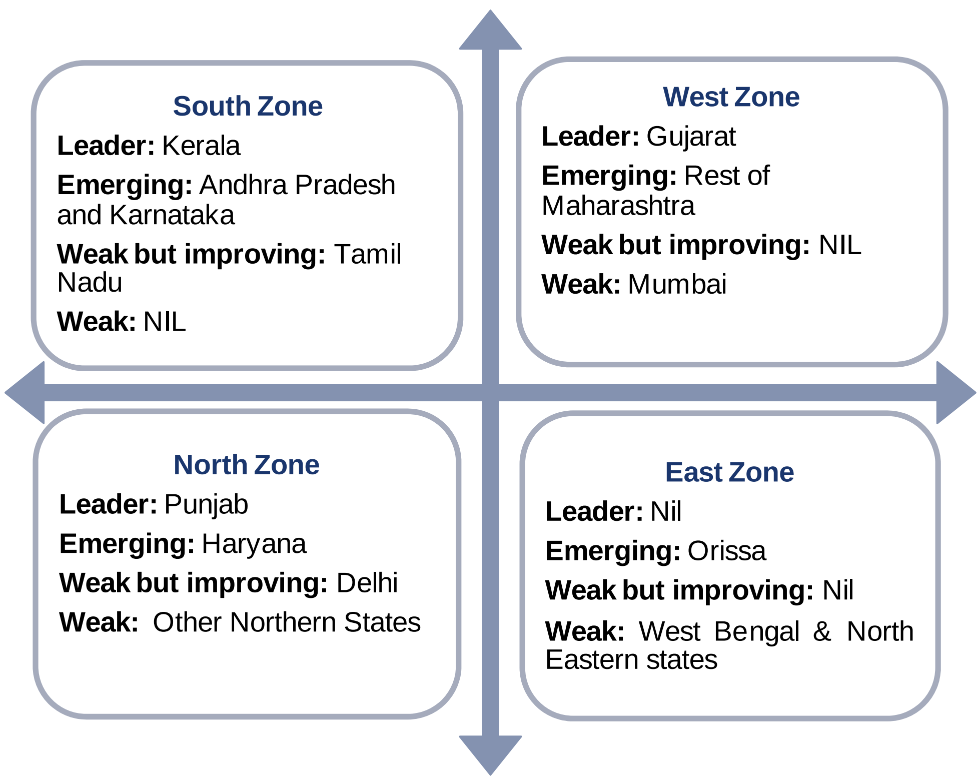
Table 2: Distribution network of key players within the industry

Companies	Dealer network	Retail outlets
HSIL	3,000	19,000
Cera Sanitaryware	1,500	15,000
Parryware Roca	1,000	12,000

Source: Company, I-Sec Research

At present, the company has a wide-spread distribution network encompassing 1,500 dealers and 15,000 retailers. To supplement the distribution network, CRS has 20 major stock points pan-India. It also has 19 zonal offices, 10 Cera Style Studios, and over 100 Cera Style Galleries across the country.

Chart 4: CRS positioning Pan-India



Source: I-Sec Research

CRS is currently focusing on key growth markets like Tamil Nadu, Andhra Pradesh, Karnataka, Maharashtra (ex-Mumbai) by increasing its brand visibility and distribution reach. Besides these markets, we believe there is immense scope for CRS to penetrate further, particularly in East & North East India where the penetration levels are lower.

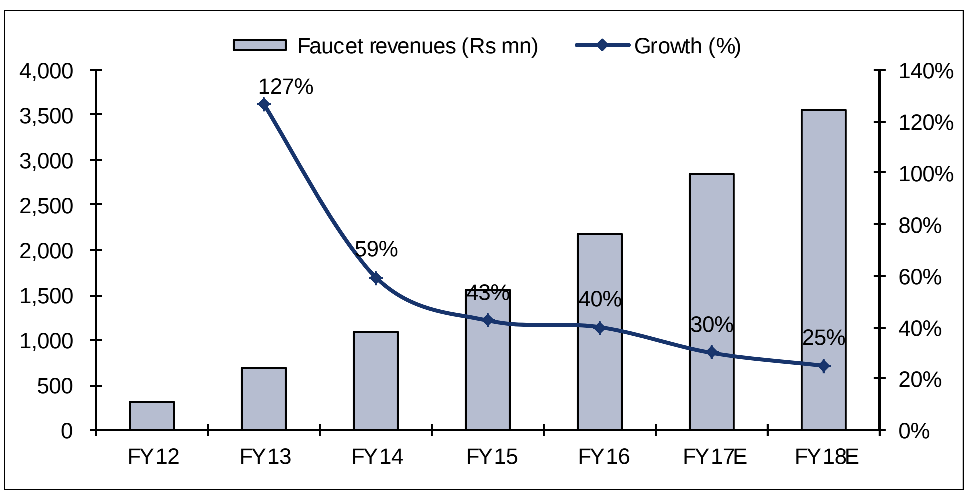
Strong growth in allied products to offset tepid growth in core sanitaryware segment

Currently the core sanitaryware segment (60% of revenues) is growing in higher single digits as opposed to 24% revenue CAGR witnessed over FY12-FY16. This is largely attributed to slowdown in the real estate sector. However, company's increasing penetration and strong growth in the faucets and tiles segment over the past few years is expected to offset tepid growth in core business and drive overall growth going forward.

By intensifying its focus on allied products like faucets (through manufacturing model in the recent past) and tiles (through 51% JV model), CRS is positioning itself as a complete bathroom solutions provider. Currently, while sanitaryware accounts for 60% of revenues, faucets and tiles account for 23% and 15% of overall revenues, respectively. With the company expected to increase capacities in faucets and the newly acquired JV in tiles segment expected to ramp up production, both these categories are likely to supplement overall growth of the company.

Faucet segment: Having test marketed the product initially, CRS ventured into manufacturing of faucets in FY11 at Kadi, adjoining its sanitaryware facility, the capacity of which is scalable to 10,000 pieces per day. The company caters to the upper and lower mid-market segments through its manufacturing and outsourcing model, respectively, while importing some high-end faucets from China to cater to the premium market. The current capacity of the plant stands at 7,200 pieces per day while the company operated at over 75% capacity utilisation in FY16. The faucets revenues in FY16 stood at Rs 2.2bn and have witnessed 64% CAGR over FY12-FY16.

Chart 5: Scaling up in faucets segment over the last five years



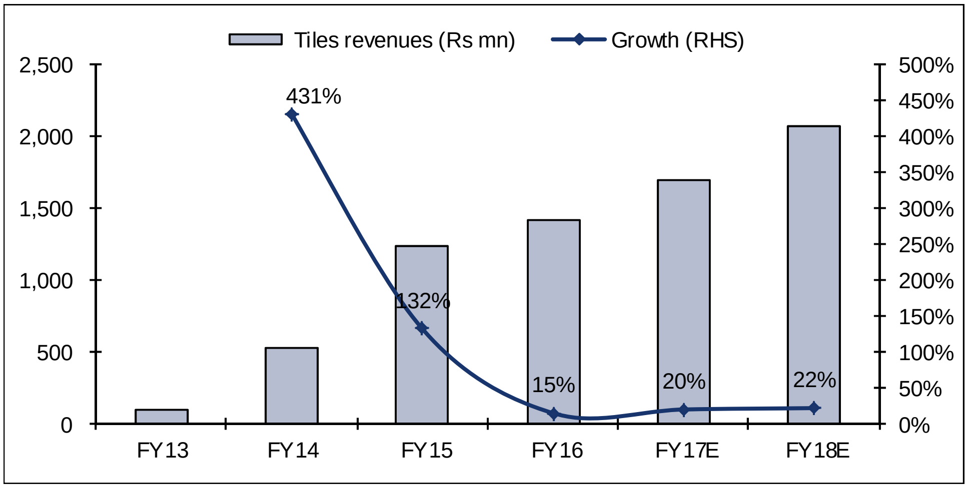
Source: Company, I-Sec Research

We expect the company to increase its faucet capacity to 10,000 pieces per day in FY18E at a significantly lower cost which is expected to be RoCE accretive for the company. Margins too are expected to improve led by increasing premiumisation and higher capacity utilisation.

Tiles segment: CRS ventured into trading of tiles in FY13. Over the last three years, the company has been outsourcing ceramic wall and vitrified floor tiles from Morbi units and selling it through its existing distribution network. After testing the market for three consecutive years with encouraging growth on 'outsourcing' model, management recently acquired controlling stake in a vitrified tiles unit 'Anjani Tiles' based out of Andhra Pradesh and having a capacity to manufacture 10,000 sq-m per day.

CRS acquired 51% stake in ATL with a commitment to buy out entire production to be marketed by CRS under brand CERA through its widespread distribution network. The plant commenced commercial production in Apr'16 and is expected to operate at optimum capacity levels over the next 15 to 18 months.

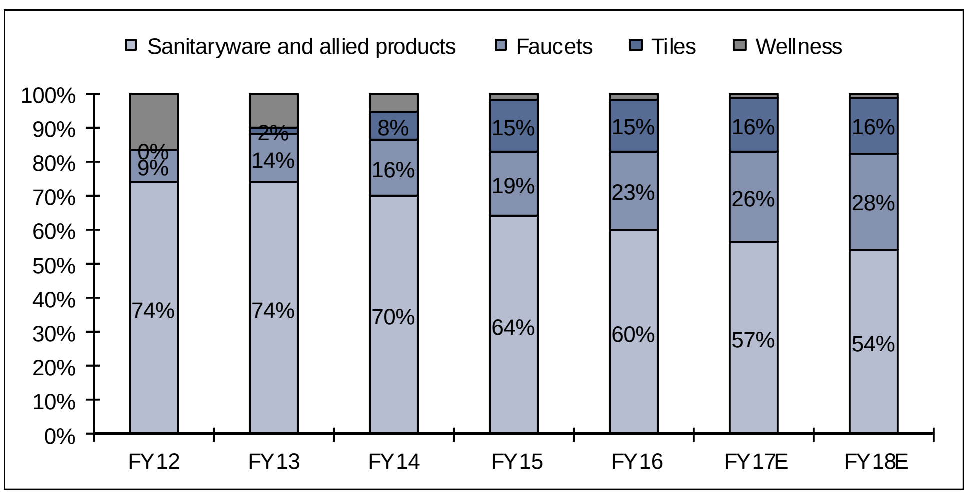
Chart 6: Revenue trend in tiles segment over the last four years



Source: Company, I-Sec Research

With ramp up of production expected in ATL, we expect the manufactured turnover to comprise over 33% of the tiles segment revenues by FY18E. Resultantly, we expect tiles margins (which are currently at 6-7%) to improve by 200bps in next two years.

Chart 7: Allied products to constitute 44% of revenues by FY18E



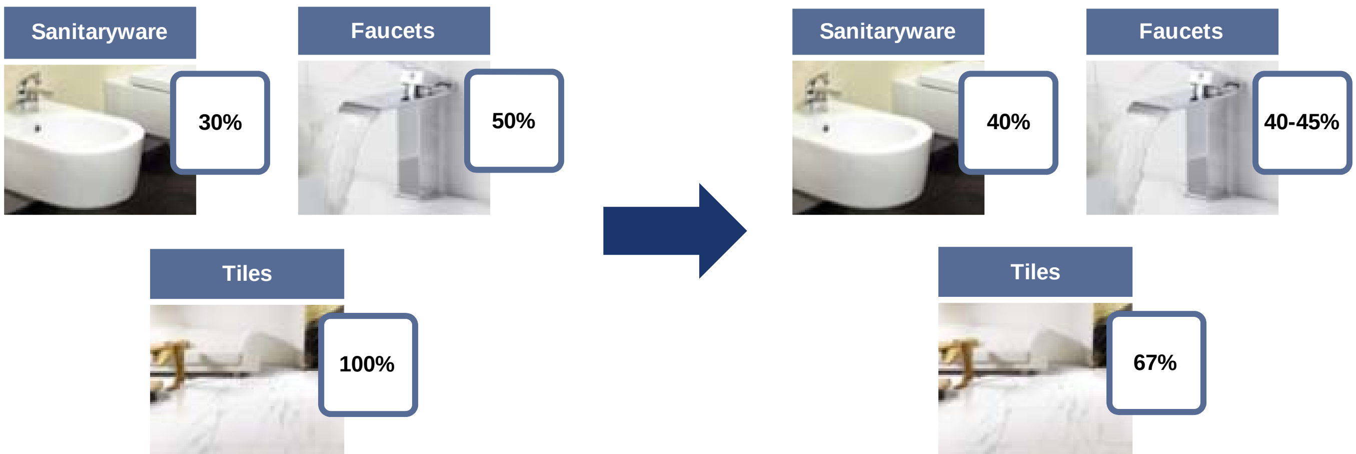
Source: Company, I-Sec Research

Faucets and tiles accounted for 38% of revenues in FY16. With sanitaryware and allied products expected to grow only in single higher digits, the contribution of faster growing allied product segment is expected to increase to 45% over the next two years.

Asset light model leading to strong RoCEs

Over the years CRS has been focusing on the outsourcing model across its business verticals by leveraging its strong brand in the sanitaryware space. In FY16, manufactured turnover in sanitaryware segment accounted for 70% while outsourcing, including imports, accounted for 30% of FY16 sanitaryware revenues. In faucet, outsourcing accounted for 50% of FY16 segmental revenues. On the other hand, the entire tiles segment revenues came through outsourcing.

FY16: Outsourcing trend across categories | **FY18E: Expected trend in outsourcing**



Source: Company, I-Sec Research

Outsourcing strategies in each of its verticals going forward:

Sanitaryware division: Over the last three years, CRS has increased its sanitaryware capacity from 2 mn pieces to 3 mn pieces. Given that the current capacity has almost reached optimum utilisation, it plans to further augment its capacity to 3.3 mn pieces by end-FY17. While the incremental capacity is expected to support volume growth in the near term only, we expect the dependence on outsourcing model to continue both for low-end as well as premium and luxury products (currently sourced from China and Turkey).

Faucets: In FY16, the outsourcing model accounted for 50% of the divisional revenues while CRS utilised 75% of its existing capacity of 7,200 pieces of faucets per day. Over the next two years, we expect outsourced revenues to decline to 40-45% led by a) ramping up of production to achieve optimum utilisation from the current capacity of 7,200 pieces per day, and b) scaling up of the capacity to 10,000 pieces per day.

Ceramic tiles: After test marketing the product for three years, CRS recently acquired 51% stake in 'Anjani Tiles' in Andhra Pradesh; it has a capacity to manufacture 10,000 sq-m per day. With the JV expected to manufacture polished vitrified tiles we expect the company to continue to outsource its ceramic wall and floor and GVT requirements from Morbi units. We however expect the vanilla outsourcing share of overall tiles revenues to decline to 67% over the next two years.

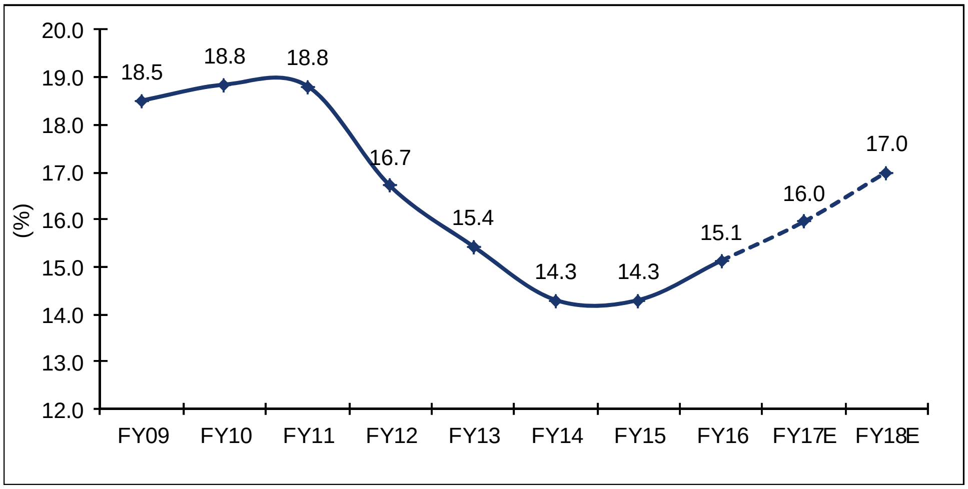
With the sustenance of outsourcing model and CRS' focus on profitable growth, we expect the company to continue to generate impressive RoCEs over the next few years. Over FY16-FY18E, RoCEs are expected to improve by 260bps to 30.2%.

Focus on EBIDTA margins and working capital discipline

EBIDTA margins at an inflection point

CRS witnessed a margin decline from 18.8% in FY11 to 14.3% in FY15. This was largely led by a) steep rupee depreciation making imports costlier; b) higher gas prices; c) time taken to achieve EBIDTA break-even in the new faucets plant; and d) increasing contribution from tiles through vanilla outsourcing model.

Chart 8: Trend in EBIDTA margins



Source: Company, I-Sec Research

Margins however have partially recovered to 15.1% in FY16 largely led by higher margins in faucets and gradually declining gas prices. We expect margins to gain further traction over the next two years led by a) steep fall in gas prices, b) employee linked productivity measures to be initiated over the next two years resulting in lower wastages and higher efficiency, c) increasing premiumisation across product categories, d) higher utilisation in the faucets segment, and e) scaling up of joint venture model in tiles. With this, we expect CRS margins to improve by 190bps to 17% over the next two years.

Control over working capital: Significant scope for improvement

In the quest to gain market share, Cera over the last few years has seen deterioration in its working capital. Our channel checks suggest that debtor days, in particular, have risen due to its liberal/accommodative credit policy with dealers, particularly in the faucets and tiles segment.

Debtor days: With rising brand equity, the company is expected to impose stricter control by phasing out its liberal credit policy (particularly in case of allied products like faucets and tiles) to dealers in a phased manner. With the focus on addition of stronger/cash rich dealers, we expect debtor days to improve gradually over next three years.

Inventory days: Traction in allied products - faucets and tiles in particular has resulted in sharp correction in inventory days at elevated levels. With these products expected to gain further traction, we expect inventory cycle to remain lean. Also, better inventory control in sanitaryware segment through increase in distribution reach may not be ruled out.

Table 3: Trend in working capital days

(In days)	FY12	FY13	FY14	FY15	FY16	FY17E	FY18E
Receivable	52	62	59	72	74	71	68
Inventory	105	70	58	56	53	54	55
Payable	22	21	21	22	26	27	28
Working capital	**135**	**112**	**95**	**106**	**101**	**98**	**95**

Source: Company, I-Sec Research

We expect working capital days to improve conservatively from 101 days in FY16 to 95 days in FY18E largely led by reduction in inventory cycle. If demand environment improves in the sanitaryware segment, further moderation in working capital could be a possibility.

Table 4: Q4FY16 results: Positive margin surprise

(Rs mn)

Particulars	Q4FY16	Q4FY15	YoY (%)	Q3FY16	QoQ (%)	FY16	FY15	YoY (%)
Net Sales	**2,806**	**2,504**	**12.0**	**2,335**	**20.2**	**9,337**	**8,217**	**13.6**
Expenditure	**2,325**	**2,144**	**8.4**	**1,978**	**17.5**	**7,924**	**7,041**	**12.5**
Raw Materials	252	355	(29.0)	57	345.0	695	521	33.3
Cost of traded goods	1,128	902	25.1	1,017	11.0	3,712	3,322	11.8
Staff Cost	296	207	43.3	280	6.0	1,110	917	21.0
Other Expenditure	648	679	(4.6)	625	3.7	2,407	2,281	5.5
Operating Profit	**481**	**361**	**33.4**	**358**	**34.6**	**1,413**	**1,175**	**20.2**
OPM (%)	*17.2*	*14.4*	*280 bps*	*15.3*	*190 bps*	*15.1*	*14.3*	*80 bps*
Other Income	36	22	62.6	16	122.8	100	66	51.4
Interest	14	25	(42.0)	11	29.8	55	77	(29.3)
Depreciation	42	45	(5.2)	45	(4.7)	163	155	5.6
PBT	**461**	**314**	**46.8**	**318**	**44.7**	**1,295**	**1,009**	**28.3**
Tax	163	93	75.7	117	38.7	460	333	38.3
PAT	**298**	**221**	**34.8**	**201**	**48.2**	**835**	**677**	**23.4**
NPM (%)	*10.6*	*8.8*	*180 bps*	*8.6*	*200 bps*	*8.9*	*8.2*	*70 bps*

Source: Company, I-Sec Research

Revenue growth remains subdued

The company reported muted revenue growth of 12% YoY in Q4FY16 to Rs2.8bn as demand environment remains challenging particularly in the sanitaryware segment. For FY16, revenues grew 13.6% to Rs9.3bn. While sanitaryware and allied products constituted 60% of revenues, faucets and tiles accounted for 23% and 15% of the revenues, respectively.

EBIDTA margin up 280bps YoY to 17.2%; big positive surprise

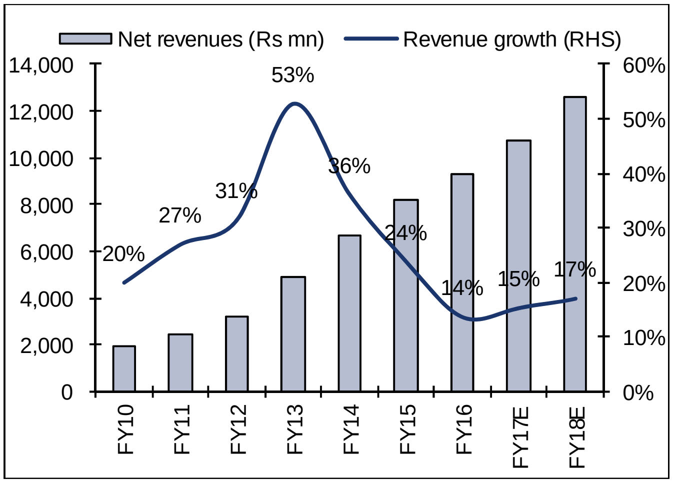
CRS' operating performance in Q4FY16 was very impressive with EBIDTA margins expanding by 280bps YoY to 17.2%. This was the highest margin recorded by the company in last 19 quarters. The positive surprise was largely led by higher gross margins and reduction in power and fuel costs. The higher gross margins are largely attributed to better capacity utilisation in sanitaryware and faucets segment, improvement in product mix led by increasing premiumisation and partial price hikes taken in Dec'15. EBITDA grew 33% to Rs481mn. For FY16, margins improved by 80bps to 15.1%.

PAT up 35% YoY to Rs298mn

The company posted 35% YoY growth in bottomline to Rs298mn as compared to Rs221mn registered in the corresponding quarter of the previous year led by strong operating performance. For FY16, PAT grew by 23% to Rs835mn.

Improving financials

Chart 9: Trend in revenues and revenue growth



Source: Company data, I-Sec research

Chart 10: Trend in EBIDTA and EBIDTA growth

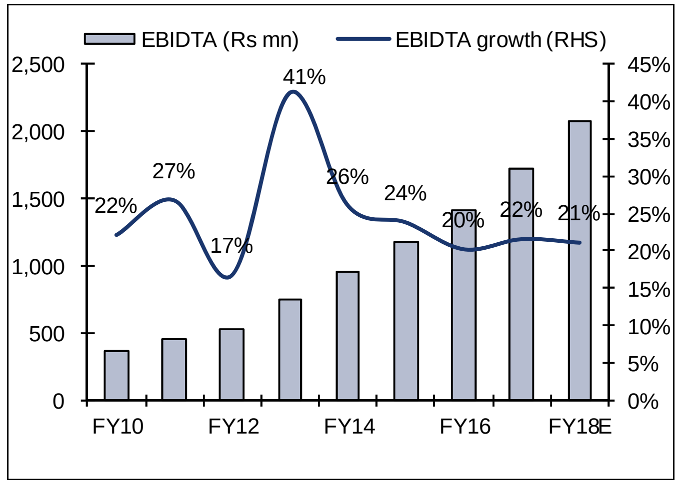
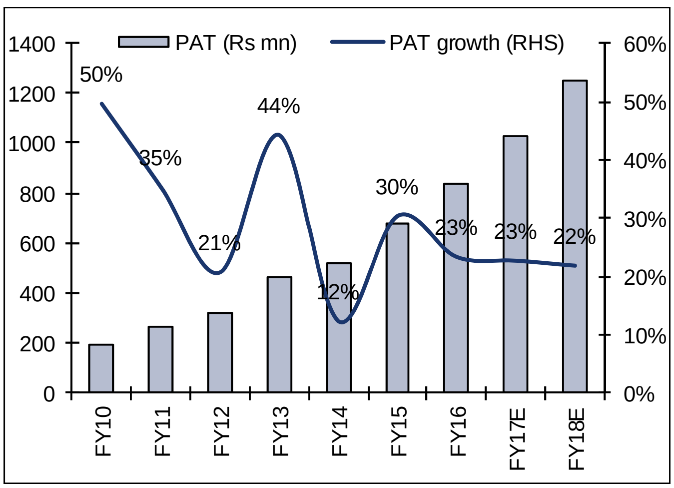


Chart 11: Trend in PAT and PAT growth



Source: Company data, I-Sec research

Chart 12: Trend in CFO and FCF

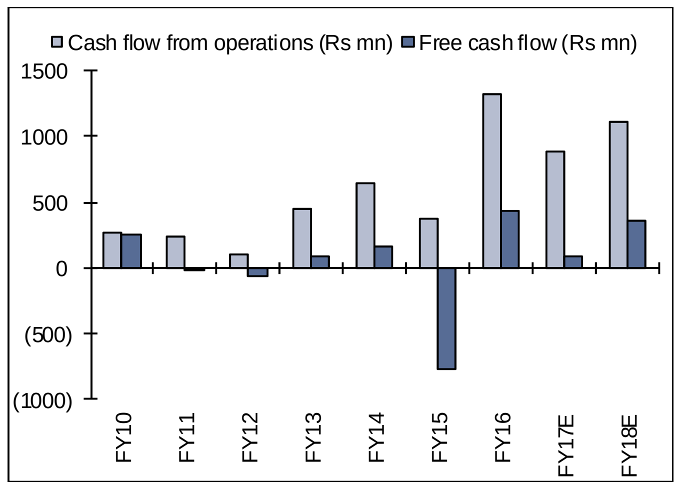
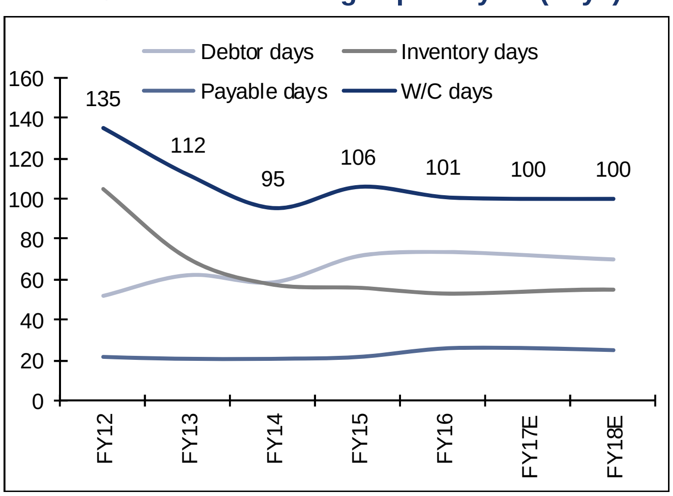


Chart 13: Trend in working capital cycle (days)



Source: Company data, I-Sec research

Chart 14: Debt/equity trend

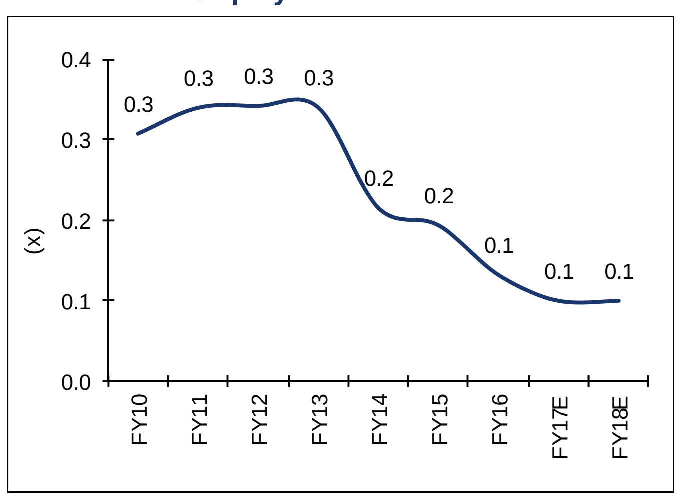
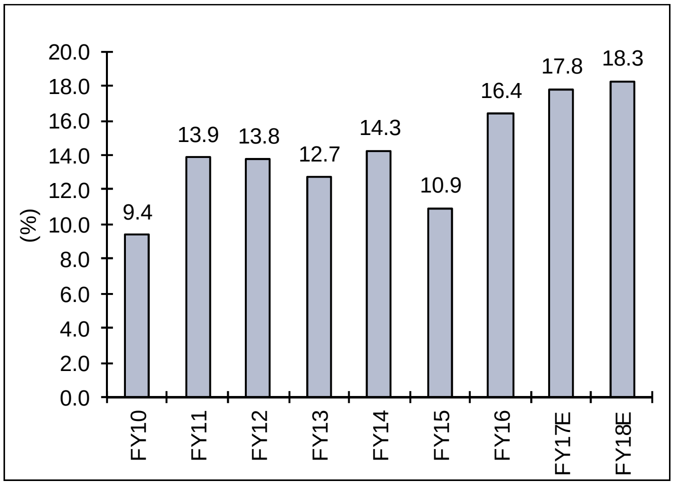
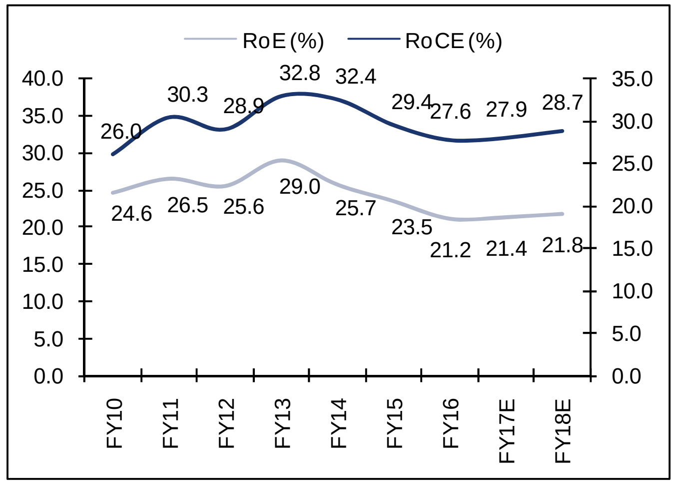


Chart 15: Dividend payout trend



Source: Company data, I-Sec research

Chart 16: Trend in RoE and RoCE



Investment concerns

Reduction in APM gas allocation: CRS' Kadi facility receives APM gas from GAIL for 50-55% of its total capacity. It started receiving APM gas even before priority for power and fertiliser units was defined. While this contract cannot be changed, supply may reduce if the field from which the gas is being supplied starts depleting.

Sudden turnaround in APM/LNG gas prices: Spot gas prices have been on a decline over the past few quarters. Since the spot prices are now linked closer to long term contract rates, any spurt in spot prices is expected to impact the profitability of the company if the same cannot be passed on.

Depreciating INR: 20% of CRS' revenues come from outsourcing via imports model. So, any steep depreciation in INR going forward is expected to put pressure on margins.

Valuations

We expect top line and bottom line to witness CAGR of 16.2% and 25% respectively over FY16-FY18E. The stock currently trades at 24.4x its FY18E earnings of Rs100.3. The asset light model of CRS with continued focus on outsourcing and higher profitability over FY16-FY18E is expected to improve its RoCEs further by 260bps to 30.2%, thereby expected to sustain high valuations. We initiate coverage with a HOLD on CRS and target price of Rs2,506, valuing it at 25x FY18E earnings.

Company background

Cera Sanitaryware (CRS), a Gujarat-based company, is the third largest sanitaryware company in India. It has a state-of-the-art manufacturing plant located at Kadi, Gujarat capable of manufacturing 3mn pieces of sanitaryware products per annum, making it a largest facility at a single location in India. It also entered into manufacturing of faucets from FY11 with a current manufacturing capacity of 7,200 pieces per day, scalable up to 10,000 pieces per day.

CRS has also been trading in tiles through vanilla outsourcing model since FY13. However, it recently acquired 51% stake in 'Anjani Tiles' in Andhra Pradesh; it has a capacity to manufacture 10,000 sq-m per day of vitrified tiles per day. The company also has presence in wellness products (through vanilla outsourcing model) comprising bathtubs, Jacuzzi, steam cubicles, shower partitions, shower panels and allied sanitaryware products like cisterns and seat covers.

It has also added new product categories like mirrors, kitchen sinks and personal care products like hand dryers, hair dryers, soap dispensers, ceramic and chrome plated bath accessories, et al. With this, the company is now positioning itself as a complete bathroom solutions provider by leveraging its growing brand awareness and widespread distribution network.

Table 5: Business model

Segments	Sanitaryware	Faucets	Tiles
Year of launch	1980	2011	2013
Product range	Water Closet, European water closets, wash basins, urinals, squatting pans, etc	Single lever fittings, quarter-turn and half-turn fittings, flush valves and cocks, angle cocks, showers, etc	Ceramic wall and floor and vitrified tiles
Revenues – FY16 (Rs mn)	5,586	2,186	1,417
Revenue mix – FY16	60%	23%	15%
FY13-FY16 revenue CAGR	15.7%	47%	142%
FY16 manufactured turnover mix	70%	50%	Nil
EBIDTA margins – FY16	18-20%	10-12%	5-7%
Capacity (pieces)	3,000,000	7,200 per day, scalable up to 10,000 per day	10,000 sq-m per day scalable by ~4 times
Capacity expansion			
▪ **FY17E**	300,000	Nil	Nil
▪ **FY18E**	Nil	2,500 per day	Nil
Expected revenue CAGR	11%	28%	21%

Source: Company, I-Sec Research

Sanitaryware

The products are sourced from Kadi factory, outsourced/contract manufactured from Morbi companies, and imported from China and Turkey – particularly the premium sanitaryware. CRS' products (manufactured and locally outsourced) are largely targeted at the mass market, where it enjoys a strong brand recall. In FY16, manufactured turnover accounted for 70% of segmental turnover with the balance being met through a mix of outsourcing and high-end imports.

Faucets

CRS started trading in faucets from FY06. With test marketing initiated through outsourced products showing encouraging results, it decided to enter manufacturing of faucets. The faucet facility at Kadi started commercial production in Sep'10. The company initially started with manufacturing of half-and quarter-turn series and has now graduated to producing high-end single lever series as well. In FY16, manufactured turnover accounted for 50% of segmental turnover with the balance being met through outsourcing and some imports. Cera expects to increase its faucets capacity to 10,000 pieces per day in FY18E and from the current 7,200 pieces per day.

Ceramic tiles

CRS launched ceramic tiles through vanilla outsourcing model in FY13. For three consecutive years. it outsourced commodity tiles from five-to-six players in Morbi and imported high end vitrified tiles from China. Currently, vitrified tiles account for 75% of the tiles division while the balance is contributed by wall tiles. The company recently moved to JV model with the acquisition of Anjani Tiles in Andhra Pradesh which is expected to reduce the vanilla outsourcing share to 67% from the current 100%.

Management bandwidth

Cera Sanitaryware was incorporated in 1980 and is currently into its 34th year of operations. The company is mainly spearheaded by Vikram Somany and is run by a dedicated team of professionals within the organisation.

Top management	Designation	Age (years)	Experience (years)	Profile
Vikram Somany	Chairman and managing director	65	40	A visionary and an Industrialist who had set up the ceramic division of Madhusudan Industries (now Cera Sanitaryware)
SC Kothari	Chief Executive Officer	70	41	Retired from board in 2008, however recalled in Sep'12 after the demise of Mr. Vidush Somany
Atul Sanghvi	Executive Director	53	31	Worked as a Chief Operating Officer from Oct'12 prior to which he served the company as president sales and marketing. He was then appointed as Executive Director in Apr'14

Source: Company, I-Sec Research

Key milestones

2016	• Acquires vitrified tiles unit 'Anjani Tiles' through 51% JV model • Brand ISVEA launched in metros and Tier 1 cities
2015	• Tied-up with Italian brand *ISVEA* for marking its entry into luxury sanitaryware segment
2014	• Expands faucet manufacturing capacity to 7,200 pieces per day • Ropes in Ms. Sonam Kapoor as the brand ambassador
2013	• Capacity expansion in sanitaryware from 2mn to 2.7mn pieces • Re-entry into tiles segment through local outsourcing • Vidush Somany, the Executive Director, expires in Aug-12
2012	• New logo unveiled • Aggressive marketing with induction of Dia Mirza as brand ambassador
2011	• Commercialisation of 2,500 TPD faucetware unit in Kadi • Efforts on to increase distribution network in smaller towns
2008 &2009	• Ties up with Italian wellness major - Novellini SpA - to launch premium wellness product range • Capacity expansion in sanitaryware from 1.4mn to 2mn pieces • Introduced the concept of Cera Bath Galleries with its retail partners
2006 & 2007	• Capacity expansion in sanitaryware from 1.3mn to 1.4mn pieces • Fuel efficient kilns installed by the company (Italian technology) • Introduced new products like bath fittings, glass basins, etc
2005	• Introduction of shower products like whirlpools, shower temples, shower panels, et al • Introduced concept of display centres called Cera Bath Studios
2002 & 2003	• Demerger of ceramic division from the company in FY02 to form Cera Sanitaryware • Launched plastic cisterns and seat covers through outsourcing
1980	• Incorporated as Madhusudan Ceramics with presence in oil and ceramics • Inaugrated sanitaryware plant at Kadi with a capacity of 0.3mn pieces per annum

Source: Company

Financial summary

Table 6: Profit and Loss Statement

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Net Sales	6,637	8,217	9,337	10,764	12,596
Add: Other Operating Income	-	-	-	-	-
Net revenue	**6,637**	**8,217**	**9,337**	**10,764**	**12,596**
Less:					
Cost of goods sold	3,055	3,843	4,407	5,145	5,959
Employee cost	743	917	1,110	1,158	1,335
Others	1,889	2,281	2,407	2,744	3,161
Total Operating Expenses	**5,688**	**7,041**	**7,924**	**9,047**	**10,455**
EBITDA	**949**	**1,175**	**1,413**	**1,717**	**2,141**
Depreciation	122	155	163	188	241
Other income	62	66	100	75	88
EBIT	**888**	**1,087**	**1,349**	**1,605**	**1,989**
Less: Financial expenses	64	77	55	57	57
Recurring Pre-tax Income	**824**	**1,009**	**1,295**	**1,548**	**1,932**
Less: Taxation	305	333	460	519	628
Less: Minority Interest / Subsidiary loss	-	-	-	-	-
Net Income (Reported)	**519**	**677**	**835**	**1,029**	**1,304**
Extraordinary Items	-	-	-	-	-
Recurring Net Income	**519**	**677**	**835**	**1,029**	**1,304**

Source: Company data, I-Sec research

Table 7: Balance Sheet

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
ASSETS					
Current Assets, Loan & Advances					
Inventories	1,046	1,259	1,357	1,592	1,898
Sundry debtors	1,066	1,612	1,884	2,094	2,347
Cash and bank balances	307	295	600	421	450
Other current assets	5	3	16	16	16
Loans and advances	418	572	754	950	1,200
Total Current Assets	**2,842**	**3,741**	**4,612**	**5,074**	**5,910**
Current Liabilities & Provisions					
Current Liabilities	377	487	660	796	966
Provisions and other liabilities	1,231	1,479	2,080	2,248	2,398
Total Current Liabilities & Provisions	**1,608**	**1,965**	**2,740**	**3,045**	**3,365**
Net Current Assets	**1,234**	**1,776**	**1,872**	**2,029**	**2,546**
Investments	**121**	**478**	**475**	**475**	**475**
Fixed Assets					
Gross block	2,117	2,879	3,193	4,644	5,394
Less : depreciation	600	732	896	1,084	1,325
Net block	**1,517**	**2,147**	**2,298**	**3,561**	**4,070**
CWIP	52	77	651	-	-
Goodwill	**-**	**-**	**-**	**-**	**-**
Total Assets	**2,924**	**4,477**	**5,295**	**6,065**	**7,090**
LIABILITIES AND SHAREHOLDERS' EQUITY					
Shareholders Fund					
Equity share capital	63	65	65	65	65
Reserves and surplus	2,176	3,452	4,145	4,992	6,067
Total Shareholders Fund	**2,240**	**3,517**	**4,210**	**5,057**	**6,132**
Borrowings					
Secured loans	483	539	208	500	450
Unsecured loans	-	142	369	-	-
Total Borrowings	**483**	**682**	**578**	**500**	**450**
Deferred Tax Liability	**202**	**278**	**344**	**344**	**344**
Minority Interest	**-**	**-**	**164**	**164**	**164**
Total Liabilities & Shareholders' Equity	**2,924**	**4,477**	**5,295**	**6,065**	**7,090**

Source: Company data, I-Sec research

Table 8: Cash Flow Statement

(Rs mn, year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Cash Flow from Operating Activities					
PAT	519	677	835	1,029	1,304
Add: Depreciation	122	155	163	188	241
Add: Other Operating activities	(25)	(53)	(5)	-	-
Operating Cash Flow Before Working Capital change (a)	**616**	**778**	**993**	**1,218**	**1,545**
Changes in Working Capital					
(Increase) / Decrease Trade & 0th receivables	(235)	(546)	(272)	(210)	(253)
(Increase) / Decrease Inventories	(106)	(213)	(98)	(235)	(306)
Increase / (Decrease) Current liab and provisions	379	358	775	304	320
Others	(109)	(152)	(31)	(196)	(250)
Working Capital Inflow / (Outflow) (b)	**(70)**	**(554)**	**374**	**(336)**	**(488)**
Net Cash flow from Operating Activities (a) + (b)	**546**	**224**	**1,366**	**881**	**1,056**
Cash Flow from Capital commitments (c)	**(373)**	**(787)**	**(889)**	**(800)**	**(750)**
Free Cash flow after capital commitments (a) + (b) + (c)	**173**	**(563)**	**478**	**81**	**306**
Cash Flow from Investing Activities					
Purchase of Investments	(107)	(356)	3	-	-
Change in goodwill	-	-	-	-	-
Net Cash flow from Investing Activities (d)	**(107)**	**(356)**	**3**	**-**	**-**
Cash Flow from Financing Activities					
Equity raised/(repaid)	-	706	-	-	-
Proceeds from fresh borrowings	(128)	199	(104)	(78)	(50)
Dividend paid including tax and others	(74)	(74)	(137)	(183)	(228)
Net Cash flow from Financing Activities (e)	**(202)**	**831**	**(241)**	**(260)**	**(278)**
Change in Deferred Tax Liability (f)	40	76	66	-	-
Total Increase / (Decrease) in Cash (a) + (b) + (c) +(d) + (e) + (f)	(96)	(12)	305	(179)	28
Opening Cash and Bank balance	404	307	295	600	421
Closing Cash and Bank balance	307	295	600	421	450
Increase / (Decrease) in Cash and Bank balance	**(96)**	**(12)**	**305**	**(179)**	**28**

Source: Company data, I-Sec research

Table 9: Key ratio

(year ending Mar 31)

	FY14	FY15	FY16	FY17E	FY18E
Per Share Data (Rs)					
EPS	41.0	52.0	64.2	79.2	100.3
Cash EPS	50.7	63.9	76.7	93.6	118.8
Dividend per share (DPS)	5.0	4.9	9.0	12.0	15.0
Book Value per share (BV)	177.0	270.4	336.3	401.4	484.1
Growth (%)					
Net Sales	36.0	23.8	13.6	15.3	17.0
EBITDA	26.0	23.8	20.2	21.6	24.7
PAT	12.3	30.4	23.4	23.3	26.7
Cash EPS	15.3	26.1	20.0	22.0	26.9
Valuation Ratios (x)					
P/E	59.6	47.0	38.1	30.9	24.4
P/CEPS	48.3	38.3	31.9	26.1	20.6
P/BV	177.0	270.4	336.3	401.4	484.1
EV / EBITDA	32.8	27.4	22.5	18.6	14.9
EV / Sales	4.7	3.9	3.4	3.0	2.5
Operating Ratio					
Raw Material / Sales (%)	46.0	46.8	47.2	47.8	47.3
Employee cost / Sales (%)	11.9	11.2	11.2	11.9	10.8
SG&A / Sales (%)	20.8	20.3	-	-	19.5
Other Income / PBT (%)	7.5	6.5	7.7	4.9	4.6
Effective Tax Rate (%)	37.0	33.0	35.5	33.5	32.5
Working Capital (days)	95.4	105.9	100.9	98.0	95.0
Inventory Turnover (days)	57.5	55.9	53.1	54.0	55.0
Receivables (days)	58.6	71.6	73.7	71.0	68.0
Payables (days)	20.7	21.6	25.8	27.0	28.0
Net D/E Ratio (x)	0.1	0.1	(0.0)	0.0	0.0
Return/Profitability Ratio (%)					
Net Income Margins	7.8	8.2	8.9	9.6	10.4
RoACE	32.4	29.4	27.6	28.3	30.2
RoAE	25.7	23.5	21.2	21.5	22.6
Dividend Payout	14.3	10.9	16.4	17.7	17.5
Dividend Yield	0.2	0.2	0.4	0.5	0.6
EBITDA Margins	14.3	14.3	15.1	16.0	17.0

Source: Company data, I-Sec research

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