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Phillips Carbon Black Ltd

Riding on Tyres

Phillips Carbon (PCBL), India market leader in carbon black (CB), has aggressive growth plans assisted by an all round restructuring. High growth in user industry (Tyres) caused by increased movement of goods by roads, improving road infrastructure; and shifting of production from developed world to developing countries are some of the major growth drivers.

Fair Value Rs.133 | **Price Rs.44** | **+202%**

The stock currently trades at 7.1 times trailing EPS and 2.6 times EPS for YE Sep-04 (Rs.16.62). We expect its earnings to grow at 180% in YE Sep-03 and at 100% plus in each of the next two years driven largely by capacity expansions, cost reductions and efficiency gains. We estimate DCF fair value at around Rs.133.

Key Data

Market Cap	Rs.779mn
Market Cap at fair value	Rs.2,352mn
Shares Outstanding	17.75mn
52 week High-Low	Rs.58/Rs.6.55
Average Daily Volume	No. of shares
BSE+NSE 365 days	45,995
BSE+NSE 30 days	23,178

Shareholding %

Promoters	52.66
Institutional Investors	21.64
Others	25.70

Major Shareholders

LIC	5.73
UTI	3.45
KSIDC	2.64
New India Assurance Co	2.20
Metal Centre Ltd	2.00

Stock Performance

3 months	+33%
6 months	+167%
12 months	+229%

Multiple Valuation

	YE Sep-03E
EV/EBIT	6.4
Market Cap/Sales	0.14
P/E	5.2
P/BV	0.8

Near Term Likely Triggers

- An agreement to supply Carbon Black to Global Tyre majors -- Bridgestone, Goodyear, and a European company.
- Strong Earnings Growth

Key Investment Points

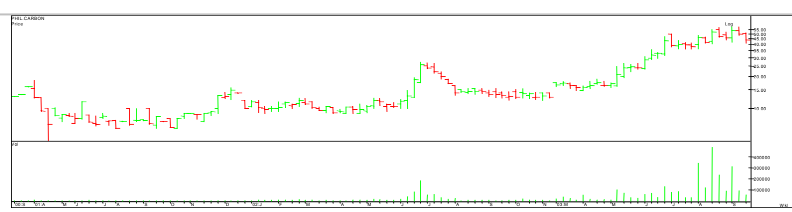
- Major investments in development of roads are leading to increased movement of goods and passengers by road. This trend will continue and this will lead to continued growth in demand for tyres and carbon black, an input for tyres.
- PCBL currently operates at full capacity; major capacity expansion plans to drive growth.
- Stepping up generation of power from off-gas for captive use and direct sale – a very profitable business.
- Labour, power, and interest costs reduced substantially.
- New management team to lead resurgence of PCBL

Value Kickers

- Globally some of the capacities may have to be shut due to environment problems and/or high labour costs, leading to increased business for developing countries.
- Likely long-term agreements for supply of CB to leading global tyre manufacturers like Bridgestone and Goodyear.

Party Poopers

- A sharp rise in price of CBFS, a key input, can impact profits in short term
- Slowdown in tyre production, for any reason, will mean lower domestic sales and higher exports of CB resulting into lower margins
- Any attempt to further increase investments in group companies will not be taken kindly, especially when the company has very high financial leverage.



Business Profile

Product

PCBL is a single product company. It makes Carbon Black. Carbon Black is a fluffy black powder. It imparts properties such as tensile strength and abrasion resistance when mixed with rubber. Carbon black is used as a chemical filler and abrasive agent for tyres and other rubber products like rubber belts. Manufacturers of dyes and pigments also use carbon black. Carbon black is a crucial raw material to produce tyres, while its special grades are used to make accessories and profiles for the automobile sector. Carbon black is used as a reinforcing agent in rubber products such as tubes, conveyor belts and is also used in consumer products. It is also used to manufacture dry-cell batteries, electrodes and carbon brushes.

Process

Carbon Black is produced by subjecting heavy residual oil feedstock (also called carbon black feed stock), a product of petroleum refineries, to extremely high temperatures in a carefully controlled combustion process. Carbon black plants are continuous process plants. Carbon black is typically made by partial oxidation of petroleum-based feedstocks at temperatures in excess of 2000º F.

Industry Structure

The tyre industry accounts for 66 per cent of the total consumption of carbon black. Since tyres account for a large share of the market for carbon black, trends in the production and consumption of automotive tyres have an influence on demand for carbon black. Carbon black accounts for 12% of the total raw material cost of the tyre industry and 6% of the total revenues of tyre industry.

As carbon black accounts for relatively low percentage of cost and revenues, very few tyre makers have backward integrated into making carbon black. Those tyre makers, who in the past gotten into carbon black, now wants to focus on tyres. For example, Bridgestone has carbon black plants in Japan, but it no longer wants to invest further in carbon black. It would rather buy carbon black from others.

Carbon black feed stock (CBFS), raw material for CB, forms a miniscule part of total revenues of petroleum refineries. Hence, none of the refineries is going to forward integrate into making carbon black. PCBL's top CBFS suppliers are Glencore International, Mitsubishi/ Enjat.

Currently there is no substitute for carbon black. However, it is likely that a more environment friendly chemical may be found to replace carbon black. Some of the tyre makers are making efforts to produce environment friendly tyres. However, the environment friendly substitute, if and when it comes, is unlikely to be cheaper than carbon black.

Global Scenario

Carbon black industry has seen good amount of consolidation globally as well as in India. Three companies – Cabot Corporation of USA, Degussa of Germany, Columbian Chemicals Company of USA – control over 50% of the world market. These three companies along with China Synthetics Rubber Corporation of Taiwan (Continental Chemicals) and AV Birla group of India are the top five players globally. Other leading players are Engineered

Carbons Inc, Continental Carbon, Sid Richardson Carbon Co (all three based in Texas), and Tokai Carbon of Japan.

Current global production is 8.1mn tonne and the five-year average growth has been 3.8%. Of this Asia Pacific production is 3.2mn tonne and the five-year average growth has been 5.6%. The global industry body estimates similar growth rates for the next five years as well. Asia Pacific capacities are mainly in China, Japan, and India. China is currently a net importer of carbon black to the extent of 100,000 TPA. Its plants are small with uneconomic size capacity and have outdated technology. Therefore, the cost of production is high in China. In Japan, Bridgestone has CB plants but is bogged by high labour costs and high freight costs to the US tyre plants. With consolidation and growth in tyre industry, Bridgestone wants to remain focussed on tyres. Bridgestone is setting up three new tyre plants.

Indian Scenario

AV Birla group has carbon black plants in India, Thailand, Egypt, and China. The Indian plant is part of Indian Rayon & Industries Ltd. The Thailand plant is the world's largest capacity (160,000 TPA) at a single place. Phillips Carbon Black Ltd (PCBL) has the largest capacity in India spread over three locations – Durgapur in WB, Palej in Gujarat, and Kochi in Kerala. Total capacity of PCBL and Indian Rayon in India is 175,000 TPA and 110,000 TPA respectively. They are currently carrying out expansion of 71,000 TPA and 40,000 TPA respectively. AVB group is looking at acquiring a company in Venezuela and plans to set up capacity in Western India in 2005. Other players in India are Cabot India (capacity 52,000 TPA) and Continental Carbon, which acquired 35,000 TPA capacity of Oriental Carbon Ltd in FY01. PCBL's Kochi plant and Gujarat plant came to its fold through acquisition.

All the three plants of PCBL are close to ports and hence it enjoys inland freight advantage on import of CBFS and export of CB. Indian Rayon's 68% capacity is in the hinterland of UP.

PCBL was the first company to produce carbon black in India and is currently the market leader with market share of over 40%. Indian Rayon is the close second with a little over 35% market share.

Customers

PCBL's top five customers are Bridgestone, MRF, Apollo Tyre, Ceat, and Birla Tyres. Ceat and PCBL belong to same business group. PCBL supplies around 50% carbon black requirement of Ceat. Supply to Ceat accounts for only 10% of PCBL's sales volume. About 80% of its sales are to tyre makers and the balance is for various other applications. In YE Sep-03, exports are expected to be around 10-12% of total sales in value terms and around 20% in volume terms. We estimate that exports will go up to 15% in value and 30% in volume next year and may stabilise at around these levels. PCBL exports to South Asian and South East Asian counties like Sri Lanka, Indonesia, Korea, New Zealand and Australia. Domestic market is more remunerative than exports due to duty protection. Exports take place to utilise excess capacity after meeting domestic demand. All sales take place on spot basis but customers indicate the quantity they are likely to pick up in advance without any legally binding commitment. However, the company may get into long term contract with overseas buyers on take or pay cum supply or pay basis.

Imports

Import of carbon black in India is miniscule. It is mainly of special grades of carbon black required for some of the non-rubber usages and is imported from SE Asia. In QE Jun-03, import of carbon black surged as domestic carbon black producers hiked price of carbon black. This also explains high EBITDA margin in QE Jun-03. The price has now been reduced. However, PCBL's margins are likely to be maintained, as benefits of debottlenecking are expected to kick in from QE Sep-03.

Forex Exposure

PCBL is a net importer and has forex debt. All imports, exports, and forex debt are denominated in US Dollars. Hence, the recent trend of rupee appreciation augurs well for it. The dominant view worldwide is towards weakness in dollar and therefore rupee depreciation is not much of a concern now.

Technology

All Indian players except Continental have contemporary technology. Continental is now converting to new technology. Technology, however, is not an entry barrier. It is easily available and costs around Rs.20000 per tonne of capacity. PCBL has indigenised and patented own designs for carbon black plant. This has reduced the capital cost of new plants significantly for PCBL. For the capacity expansion currently being carried out, PCBL's capital cost per tonne comes to Rs.8500, whereas that for India Rayon comes to Rs.15000. This gives PCBL a distinct and important competitive edge.

Key Investment Points

Emphasis on road developments augurs well

With the central and state governments laying increasing emphasis on development of world-class road infrastructure, we are witnessing increased movement of goods and passengers by road. This in turn is generating an increase in demand for tyres and carbon black. Road infrastructure is expected to improve substantially with the development of Golden Quadrilateral, East-West Corridor, North-South Corridor, broadening of highways, and development of arterial roads. This will make movement of goods and passengers by road convenient, faster, and economical. This can lead to sustained growth for tyres and carbon black over next 4-5 years.

Tyre demand growth unlikely to be impacted in next economic slowdown

If the economic cycle turns downward during this period affecting demand for automobiles, demand for tyres and carbon black will be impacted only with a lag. Over 75% demand for tyres is from replacement market. Hence, slowdown or decline in new vehicle sales may not have much impact on tyre and carbon black demand. In the economic slowdown, overall movement of goods and passengers too will slowdown, but we would expect road transportation to continue to grow by gaining market share from rail transportation.

Lately Tyre exports have also been rising from India and this implies higher demand for carbon black by domestic tyre makers.

Capacity Expansion

The company has embarked on an aggressive capacity expansion. It is setting up 71,000 TPA capacity for manufacturing Carbon Black at its existing plant site at Palej in Gujarat. It is also setting up two power generation units of 6MW each – one for captive consumption and another for direct sale of power. It is also setting up a 20MW power generation unit at another plant site at Durgapur in West Bengal. About 70-75% of power from this unit will be for direct sale. Direct sale of power has been allowed recently.

The capacity expansion and power plants will cost Rs.1.2bn. This will be funded by a mix of internal accruals and debt. We estimate total interest bearing debt including working capital debt to go up by around Rs.1bn in YE Sep-04. The entire capex is expected to be completed in YE Sep-04. We estimate total debt of Rs.3bn at the end of Sep-04 to reduce to Rs.1.45bn at the end of Sep-07.

The 71,000 CB capacity is expected to commence production in Mar-04. This will be followed by commencement of Palej power plants in May-04. Durgapur power plant is scheduled to commence power generation by Aug/Oct-04.

The increasing interest of global tyre majors like Bridgestone and Goodyear to source carbon black from the company emboldened it to go for aggressive capacity expansion. The company is currently operating at full capacity.

PCBL also resorted to some debottlenecking at Durgapur to raise capacity. The debottlenecking was completed in May-03. Benefits of debottlenecking should be visible in the performance of the current quarter. Of the three lines at Kochi, one was shifted to Durgapur, one was closed down, and one is running. The debottlenecking has compensated for the capacity loss at Kochi. Some of the machineries of the closed line at Kochi will be used for the expansion project at Palej.

Investment in power generation to pay-off handsomely

PCBL is setting up power generation plants at Palej and Durgapur. These plants will use off-gas generated from CB manufacturing process as fuel. Hence, the variable cost of power generation will be negligible. It already has such power generation plant at Durgapur and Kochi for captive consumption. It is now setting up 6MW capacity for captive consumption and 6MW capacity for direct sale at Palej. This is expected to commence generation by May-04. It is also setting up a 20MW power generation capacity at Durgapur. About 70-75% of the power generation from this unit will be for direct sale. This is expected to commence generation by Aug-Oct 04. We estimate a minimum net contribution of Rs.460mn (post-tax) from the total power generation capacity from YE Sep-05 onwards.

Cost Reductions

PCBL has cut costs in many areas. Staff rationalization through VRS has been the main area of cost reduction. So far around 100 personnel have taken VRS and around 40 more are expected to go for it. The company is not only cutting the flab but also replacing some of the existing personnel by personnel with right skills.

For the YE Sep-02, power cost per tonne of CB was reduced by 30% to Rs.392 from Rs.564 in the previous year. In YE Sep-02, 85% of the total power requirement was met from captive generation as against 80% in the YE Sep-01. Electricity units per tonne of carbon black came down from 395 in YE Sep-01 to 375 in YE Sep-02.

Commissioning of captive power plant in May-04 will reduce power costs at Palej CB plant. The power cost per tonne of CB will be lower for the new 71,000 tonne capacity being created at Palej.

Efforts are being made to reduce interest cost by prepaying high cost debts. The company has already replaced high-cost debt amounting to Rs 1.82bn with dollar-dominated borrowings bringing down interest coupon by 5-6 per cent. As the dominant view worldwide is against dollar appreciation, the company is not taking an undue forex risk.

Cleaning up of balance sheet

PCBL has substantially cleaned up its balance sheet and we expect to see more clean up in the balance sheet as at the end of Sep-03. It merged the wholly owned investment subsidiary Transmission Holdings Ltd with itself effective 1st April 2002. Other two wholly owned investment subsidiaries also ceased to be subsidiaries effective 27th Sep 2002. These subsidiaries had investments in group companies. Investments in these subsidiaries were written off against revaluation reserves. The company has also cleaned up a lot of other investments from the balance sheet.

We would like to see PCBL liquidate remaining investments in group companies – mainly its investments in Ceat Ltd.

PCBL has increasingly been providing for unrecoverable receivables. It wrote off Rs.60mn of debtors by june-03 this year and is likely to write off an additional Rs.50mn of old receivables in the current quarter. A good chunk of these receivables were due from Dunlop and Modis.

New Management Team leading the resurgence

Many of the above efforts are initiatives from a new management team. R Venkatesh, VP-Marketing, joined the company three years back from Exide Industries; Alok Banerjee, VP-Finance, joined two years back from ITC; and V K Dubey, VP-Technology rejoined 3-4 months back from Alexandria Carbon Black Co, a joint venture company of AV Birla group in Egypt. He was with PCBL before moving to Alexandria. The team is led by PCBL veteran Sudhir Sahgal, managing director, who has been with the company for 10 years now.

Working capital management improved considerably

Net working capital (NWC) has been reduced considerably over the last two years. Significant improvement took place in raw material inventory and debtors. PCBL imports over 80% of raw material from the US and the minimum economic import size is 30,000 MT, which is about 35 days' consumption. While the numbers below are year-end snapshots, it appears that the average raw material inventory can be brought down to 20-25 days. Debtors have also been brought down significantly – partly because old receivables are being written off and partly because the company is shifting sales to customers who pay faster.

	Sep-01	**Sep-02**	**Sep-03E**
NWC Rs.mn	1,452	1,011	906
% of Sales	29.8	20.5	16.7
No. of days of			
Raw Material	69	51	45
Debtors	115	85	76

Plant closures in Europe

Many of the carbon black plants in Europe may have to be closed down because of high manpower costs and environmental issues. Plants in Germany and Spain are not expected to survive. One plant in Spain has already been closed. UK plants, however, are expected to continue. This is expected to bring business to developing countries like India. PCBL has already tied up with a European company for supply of a large quantity of carbon black.

There is excess capacity in the US and some of the capacities have been temporarily shut. These capacities may come back to market, as market improves. However, the US producers are going to Brazil, where labour costs are lower.

Concerns

Investments in group companies

Phillips Carbon had equity investment in Ceat Ltd, an RPG group company, of Rs.190mn and loans to group companies amounting to Rs.84mn at end Sep-02. Of this, Rs.100mn in the equity of Ceat Ltd was invested in the YE Sep-02. Promoters should hold investments in companies directly rather than via other listed companies, especially when the investor company is burdened with large amount of debt.

Very High Financial Leverage

PCBL has always maintained very high financial leverage and this is disastrous in bad times. Debt equity ratio has been in the range of 1.7 to 1.9 during YE Sep-98 to Sep-01. It increased to 2.4 at end Sep-02. We expect it to be 2.1 at end Sep-03 and 2.5 at end Sep-04. As interest rates are falling and business outlook is bright over the next few years, interest coverage is expected to be comfortable at 3.1 and 4.5 times respectively for YE Sep-04 and YE Sep-05. The company should, however, restrain its peak debt-equity ratio to around 1.5 to avoid getting hurt when the business cycle turns downward. We estimate debt-equity ratio to come down to 1.5 at end Sep-05 and 0.5 at end Sep-07 if nor more capex other than the currently envisaged takes place.

Raw material prices can impact performance in short term

Carbon Black Feed Stock (CBFS) is the key input for making Carbon Black. The company imports three fourths of its requirements – mainly from the US. The price of CBFS fluctuates in line with price of petroleum crude oil, as CBFS is an output of petroleum refineries. These fluctuations may impact performance in the short term. The company passes on the change in CBFS prices to customers with a lag of a quarter. CBFS Prices prevailing in the last quarter are used in the current quarter to arrive at price of carbon black. The longer-term performance, however, would depend on the demand-supply balance for Carbon Black.

Reduction in duty protection

Effective protection rate on Carbon Black is around 35-36% at present based on 31% import duty on CB, 26% import duty on CBFS and current contribution margin of 51% for Indian Rayon and 56% for PCBL. We expect significant reduction in effective protection over the next three years. Every 5% reduction in effective protection on CB will lead to 3.7% fall in contribution per tonne if contribution margin remains unchanged.

We have built in reduction in EPR from 35% to 24% in three years. However, the expected reduction in other costs is likely to offset the fall in contribution margin. We therefore, expect EBIDTA margins to be maintained in the range of 14 to 14.5% going forward. EBITDA margin for YE Sep-03 is likely to be 11.4%. It was 14.8% for the QE Jun-03.

Environmental Issues

The company had to close down its Kochi factory for three months in 2001 (Aug-Oct) on the order of Kerala State Pollution Control Board following an accidental release of carbon black smoke. Following this, the company had to make extensive investments in safety and anti-pollution devices.

Requirements for safety and pollution control are increasingly becoming stringent. As the requirements in this regard become more stringent, the company may have to incur additional costs.

The company has, however, taken a few steps towards improving environment protection. The Kochi unit is now amongst the select Carbon Black plants in the world, where sophisticated pollution control equipment monitor pollution round the clock. The Pollution Control Board can online monitor the pollution level at the plant. The company plans to install similar systems at Durgapur and Palej as well.

As the company plans to increasingly use off-gas generated from carbon black manufacturing process to generate power, this will lead to substantially reduction in emission of green house gases in the environment.

Ownership & Management

PCBL is an RPG Enterprises group company, one of the largest business houses of India. Some of the other companies in the group are Ceat, CESC, KEC International, RPG Cables, and Spencer & Co. Promoters hold 52.66% and institutional investors hold 21.64% of the company's equity.

PCBL has lately seen a complete revamp of management team as stated earlier in the report. We understand that personnel at all levels are being replaced by right and bright ones wherever required.

Pricing / Valuation

We estimate fair value of Phillips Carbon Black's stock at around Rs.133 based on discounted cash flow method. Our fair value estimate is mere 1.2 times expected EPS (Rs.35.90) for YE Sep-05.

At the current price of Rs.44, the stock trades at mere 7.1 times trailing EPS (Rs.6.16) and 2.5 times expected EPS for YE Sep-04 (Rs.17.23). The stock is likely to be a 3-4 bagger in a year's time (one-year forward fair value Rs.156 as against current market price of Rs.44).

Income Statement

Rs. Mn.	Sep-03E	Sep-04P	Sep-05P
No. of months:	12	12	12
Revenues	5,431	6,151	7,919
EBIT	482	695	982
PBT	227	425	729
Adj. PAT	151	306	637
Fully Diluted EPS (Rs.)	8.52	17.23	35.90

Multiple Valuation

	Sep-03E	Sep-04P	Sep-05P
No. of months:	12	12	12
EV/EBITDA x	5.0	3.6	2.7
EV/EBIT x	6.4	4.4	3.1
Mkt. Cap/Sales x	0.14	0.13	0.10
P/E x	5.2	2.5	1.2
Price/Book x	0.8	0.6	0.4

Ratios

	Sep-03E	Sep-04P	Sep-05P
No. of months:	12	12	12
Revenue Growth %	9.7	13.3	28.9
EPS Growth %	179.4	102.3	108.3
RoE %	16.4	27.5	41.5
D/E x	2.1	2.5	1.5
Receivables days	76	76	76
Inventory days - FG	7	7	7
-- RM	45	45	45
Payables (days)	91	91	91

Free Cash Flow

Rs. Mn.	Sep-03E	Sep-04P	Sep-05P
No. of months	12	12	12
NOPLAT	321	500	858
Change in Net Working Capital	(105)	153	313
Operating Cash Flows	***426***	***348***	***545***
Capex & others	212	1,143	(39)
Free Cash Flow	**214**	**(795)**	**584**
Non-opr. Cash flow	4	4	5
Cash Flow to Investors	218	(791)	589

Balance Sheets

Rs. Mn.	Sep-03E	Sep-04P	Sep-05P
No. of months:	12	12	12
Assets			
Net Block	2,296	3,496	3,496
Investments	217	217	217
Net Current Assets	950	1,093	1,395
Liabilities			
Equity Capital	178	178	178
Reserves	782	1,027	1,524
Preference Capital	0	0	0
Debt	1,991	2,985	2,742
Non-Current Liab.	511	568	608

Financing Cash Flow

Rs. Mn	Sep-03E	Sep-04P	Sep-05P
No. of months:	12	12	12
Post-tax Interest	173	198	225
Repayment/ (issue) of Debt	18	(1,029)	314
Equity Share Dividend	27	40	50
Buyback/Redn/ (issue) of equity shares	0	0	0
Increase in non-opr assets	0	0	0
Financing Cash Flow	**218**	**(791)**	**589**

Quarterly

Rs. Mn.	Jun-02	Jun-03	Var
No. of months:	3	3	%
Net Revenues	1,153	1,093	-5.2
EBITDA	125	162	29.6
Depreciation	33	28	-15.4
EBIT	92	134	45.5
Interest	75	51	-31.7
Other Income	3	2	-24.0
PBT	20	85	326.6
Tax	2	30	
PAT	18	55	202.2
Equity Capital	178	178	
EPS –annualised (Rs.)	4.12	12.46	202.2

DCF Valuation

	Rs. Mn.	%
Key Assumptions		
Terminal Growth Rate		1.0
WACC		13.3
Cost of Equity		18.5
DCF Valuation		
NPV YE Sep-03 to YE Sep-07	1,063	
NPV Terminal Cash Flows	3,776	
PV of non-operating assets	400	
Contingent Liabilities @ 100%	178	
Enterprise Value	5,061	
Debt, Pref. Cap, PV of NCL	2,709	
Equity Value	2,352	
Fair Value Range (Rs.)	114 – 152	
Per share Value (Rs.)	**133**	
Stress Value per share (Rs.)	78	

Quarterly Ratios

%	Jun-02	Jun-03	Bps
No. of months:	3	3	Chg.
EBITDA / Sales	10.8	14.8	+397
EBIT / Sales	8.0	12.3	+427
Other income/PBT	12.6	2.2	
Tax/PBT	8.0	34.9	
Material cost/sales	47.2	48.1	+92
Staff cost/sales	5.2	4.1	-109
Sales & Distn / Sales	36.2	34.1	-209

Important Disclosure

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