Glossary

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| --- | --- | --- |
| **EPA/Sales** |  | Economic Profit to Sales ratio is a measure of excess profit earned after accounting for explicit and implicit costs like cost of equity. Higher the ratio, better it is.  |
| **Operating leverage** |  | Academically defined as ratio of profit after variable costs to profit after all costs. Intuitively, increasing operating leverage is a positive as it implies company is becoming more efficient and leaner |
| **Backward Integration** |  | Ensuring the raw material for this business is also manufactured in-house. This has the potential to cut variable costs at the expense of upfront manufacturing costs. |
| **Gross Fixed Asset Turnover** |  | A metric to “measure” how efficiently the management is able to “sweat” the fixed assets in a business. Calculated as the times annual sales is that of the gross fixed asset. Important metric for manufacturing based businesses. |
| **PBILDT** |  | Profit before interest, lease, depreciation and tax |
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# Industry Outlook/Trends

Misssed asking Ankit on this. Will send him a request to send us a para on that.

# Elevator Pitch

A firm boasting of strong multi-year relationships with International Agrochemical MNCs (Dow, Syngenta, Nissan), backed by successful track record of scaling up. A portfolio of 40-45 molecules gives it a diversified line up to do business with.

Owing to its specialization in higher order chemistry skills, difficult to attain certifications and its world class manufacturing plants, its margins improve with purity and significant entry barriers exist for its competition (more on this in “Business Attractiveness”).

# Business Slotting

It’s a B2B business, with EP margin ~ 4.5%. Additionally, it’s a price-taker and has high working capital intensity.

# Sentiment Dampeners & Valuation Support

Presently this industry is lifted up by industry tailwinds, chiefly the China to India capacity shifting (owing to pollution bans in the dragon country), benign impact of GST in weeding out lower purity production.

However, amongst the investor community, the change undergoing in the business is not quite understood well and investor community has defaulted to suspecting the business of governance issues (related party transactions at 15% of sales) and high management salaries. Yet, management has been taking salaries only in line with the *profit before tax*, which is an encouraging sign. Additionally there were concerns regarding cross-holding with Ravi Kumar Newatia promoted entities.

Yet inspite of all these, the JV with Nissan and low free float (promoters own ~75% of shares) should provide adequate support to the share price.

# Valuation

The prices right now reflect a ***high*** degree of undervaluation. where the value creation is expected to be primarily led by, moving up the value chain. This should translate to earnings growth and subsequently re-rating. The upwards movement in value chain is expected to be driven by fundamental forces- chiefly that of Bharat Rasayan evolving its business model.

So much so that, BR is expected to be a completely different company in the next 3-4 years. A 20-25% earnings growth for the next 2-3 years should be expected out of this business model change.

# Operating Leverage

There is significant operating leverage potential to be reflected in the financial results as business model improves in the next few years. For every rupee of Sales, EBIT will probably run at a faster rate. Operating Leverage is expected to be led primarily by a combination of improving product mix (more of this later), higher gross margin realizations and cost savings through backward integration of the 100cr Intermediate Plant.

To add further color to the current business model right now:

Domestic Non-CRAMS business accounts for 30-40% of the total revenues (including group companies). Patented CRAMS account for 5-10% and B2B sales account for 50% of total revenue. The Management wants to grow the MNC portion of the revenues to 40% over the medium to long term and owing to higher stickiness, and higher margins afforded by such contracts, the “quality” of earnings is expected to improve.

Domestic business on the other hand attracts large degree of competition and paper thin margins.On the flip side, the MNCs have high degree of choice and no-exclusivity clauses in their contracts which may prevent them from “capability-shopping” (i.e. NISSAN may settle for another competitor based on their internal assessment of skills, sustainability and consistency)

The company started climbing on the growth curve, post construction & commercialization of Dahej plant in 2012, which led to a better product mix, higher realizations and expansions in PBILDT margins.

The company is (and has been) actively pursuing CRAMS opportunities from Europe and specifically in the domain of patented molecules. The “winning” of even a single patented molecule manufacturing contract can lead to very long contract lives, highly sticky relationships and consequently better quality of earnings.

Furthermore, the company is actively trying to crack open Brazil as a market- it being world’s largest agrochemical market.

# Risks Discounted in the Valuations

Further downsides cannot be ruled out because of the ongoing COVID crisis and its implications for the business/industry sector becoming clearer within a couple of quarters. However if one were to take a longer time 2-3 year view, a 2-3x upside in the next 2-3years should be expected as the business itself will grow at that rate.

# Liquidity Stress Test

# Business Attractiveness

A business with a strongly differentiated business model providing it with high entry barriers. Its competitive position getting increasingly stronger versus other competitors. This is achieved not by going head to head with the competitors directly and coming out on tops, but by a canny mix of prudence and “smart-business”- for instance, it has a market leading position in meta phenoxy benzaldehyde, lambda cyhalothrin, Piroxofoppropinyl, Thiamethoxam and Cypermethrin- most of which for the company is a preferred supplier in international markets. The company tries to commercialize 2-3 products every year, but formal registration takes place only when there is concrete orders at hand (read: earnings visibility). This is so because registering chemicals in Western Hemisphere (i.e. US, Europe and Brazil) is significantly time consuming and costly. Increasingly since 2015, the company had been registering molecules that attracts significantly less attention from competition. However management has clarified that low competition, also implies higher margin, even if the volumes are lower.

This kind of business strategy, the analyst feels improves the business attractiveness and strengthens the competitive positions with respect to the competitors. Of course, if the projected strategy of bagging a patented molecule fructifies, this thesis strengthens even further.

This evolution offers with a high degree of visibility regarding the next level of the business- which is, the business moving up the value chain. The business has a negative free cash flow for now, owing to efforts to award higher discounts on the demand side and build supplier loyalty on the supply side. This has depressed its RoE and economic profit margin. This has lowered the overall quality of earnings for the business.

The key growth drivers in the foreseeable future will be the capacity building that is undergoing for the NISSAN JV, improving product mix by transitioning from low margin to higher margin products, leveraging patented CRAMS business and new customer acquisition. On the supply side, reduced China dependency (from current 50% to projected 30%) will be a significant positive for the business.

The ongoing backward integration drive will play into improving operating leverage and impacting profitability positively.

While the business as such is highly working capital intensive, that is further worsened by its conscious policy of aggressively paying down any outstanding dues with the suppliers.

As a result, the payable days are low, that fosters a certain degree of supplier loyalty and offers BRL certain discounts (owing to speedy payment) at the cost of higher working capital. Additionally, since 2018, the entire industry has transitioned into a 120 days credit period from a 90-day credit period- this has further stretched the working capital requirement. Also, BRL purchases all its raw materials on a cash basis. These decisions contribute together to increase the working capital requirements. On the flip side, the internal policy decisions have an explicit and implicit effect of lowering the cost of production thus making BRL one of the most cost-effective players in the business.

The gross fixed asset turnover is 3.5x-4.1x.

# Growth, Scalability and Vulnerabilities

The growth of the business is amplified by three-fold forces – the industry is growing, the market share is poised to grow and the margins will improve. This combination has the potential to trigger “value migration” from other incumbents aided by expansion into newer geographies.



Figure 1"Industry is growing": Value growth reflects strong potential for CRAMS

However, on the flip side, this business also has a significant vulnerability in its production chain owing to its lone plant, at least till its new plant comes online. Incidentally, the technical inputs cost is also on the verge of inching up due to the China factor, but this is mitigated structurally to a huge extent due to MNCs rerouting their demand from China to India in the short term, and scouting for a viable second alternative in a different geography – both of these structural forces augur well for BRL.

On the positive side, no single product is greater than 15% of the sales and top 9 products account for 65% of the sales. This reflects a high degree of diversification among the product basket and is a significant strength.

The current dependency on China is also poised to go down from the current 50% to 30% estimated, owing to its efforts in backward integration. The Domestic non-CRAMS business accounts for 30-40% of the business (missing the part over here)

# Management Quality

The management quality is high enough to warrant a special look into this business, as this management is “ticking” all the right boxes with their focus and strategy. There is a high focus on production efficiency, strategic thinking and ability to navigate downturns smoothly. The management is highly focussed on cost efficiency while attempting to break into new geographies and customers is both ambitious and value accretive. Management is also focused on climbing up the value chain and innovation forms the bulwark of its strategy.

Management had been consistently ploughing cash into the business by lending on an unsecured basis to the company. In addition, the promoter R.P. Gupta is involved in the company on a hands-on basis. The analyst feels the promoter knows the number of each machine installed (!) which speaks volumes of his involvement with the business.

While assessing the plausibility of strategy it’s also important to look at the management’s previous achievement track record. It has brought about a lower volatility in profits and a higher margin mix into an otherwise commodity business. It is right now operating at ~100% utilization, however margins can be improved by changing the product mix which is a positive. Its strategy of forward planning aided by backward integration is inspired from PI Industries which is not a surprise per se, as it aspires to be like PI Industries.

Relationship building and customer trust is one of its stronger repertoires, so important in the business on which it is trying to scale up -CRAMS. Management of BR is highly focused now to deepen customer engagement which bodes well for the business.

Workforce handling is also superior owing to its recognition of “safety” as a key risk. Unsafe work environment not only is a personnel risk, but can also attract regulatory scrutiny, carries a reputational risk and in extreme cases can lead to litigation risk as well. Focus on safety has numerous positive spillovers however few management list it in terms of “key risks”. BRL’s management has explicitly mentioned it in their 2018 AGM.

On a perception side, being a family business, we don’t have many evidences of high shareholder friendliness and perceived corporate governance levels is low, owing to a significant degree of related party transactions. Information sharing is low as are the dividends.

Financially, the current capital turns are at 1.5x-1.75x(low) which is offset by high RoE and Price to Cash Flows. RoE in turn is driven by a 6-11% of net margins, an asset turnover of 1.17x-1.3x and a leverage of 1.85-3.75x.

# Risk Analysis and Possible Mitigation

As highlighted earlier, owing to a single manufacturing unit there is a high degree of risk in disruption of supply chain. This is symptomatic of the risk of “single point of failure” that this business faces.

The nature of operations also can attract regulatory scrutiny owing to its possible impact on environment. This can lead to regulatory action and even litigative action- stemming from any environmental impact that its operations may have. But on the flip side its plants are in designated chemical manufacturing zones, which takes care of many of the regulations from Day 1 itself. However there is a non zero probability of BRL getting affected due to actions of group promoted companies like Bharat Agrotech and Bharat Insecticides.

From an earning sustainability side, Bharat Rasayan has a wide diversification in terms of the clienteles and a contract based relationship to back, which leads to a low degree of client termination risks and ‘client originated’ risks to the business.

# The Road Ahead and Visibility over the Medium Term

There is a significant degree of visibility in earnings owing to completion in the capacity expansion and high degree of orders. Capacity expansion will be driven by the Dahej plant which still has room for growth [brownfield expansion?] and the 420crores NISSAN JV over the next 2 years.

There is a significant degree of visibility in margins, and an uptick in margins is anticipated owing to an increasing operating leverage and higher export sales. This uptick in margins is also expected to sustain owing to the contractual nature of the business and the product mix.

The improvement in operating leverage is expected to be driven by three levers- higher revenue growth, improving asset turns and leaner working capital requirements. The latter two will improve the capital efficiency of the business leading to an improvement in the earning return metrics.

# A Few Words on Financials

The Working Capital/Sales has deteriorated from 23% to 48% over the course of the past 5 years (2014-2019). The creditor days has gone down from 38 days to 16 days, while the gross amount has inched up from 38 crores to 45 crores over the same period. However, there was a 2.5x increase in sales from 360 crores to ~1000 crores as against an 18% rise in working capital, providing an assurance that the sales is actually supported by cash and not accruals.

The fixed asset turns has improved over the previous 5 years average, primarily driven by an improvement in product mix. It turns out, inspite of a decrease in asset turnover, the expansion in net margins have supported the RoE. This reduction in fixed asset turns also plays out benignly in the form of lower depreciation expense as percentage of sales, falling from 5% to 1.75%.

This high RoE also has compensated to a certain degree “the low” economic profit margin it has (~4.5%). Additionally the negative free cash flow margin is not a heartening sight- but for a company that is growing in a challenging environment, a negative cash flow is often possible.

The Gross Margins though have taken a beating in 2019 falling from 34% to 24%, primarily owing to an upswing in the price of intermediates due to the China factor.

# Strategic Allocation

One can allocate with a 2-3 years time horizon for a 2-3x rise in market cap. If it continues to execute well beyond 3-4 years, the business will be at a different level. If it doesn’t falter on Execution, the Management has a great chance to replicate its success over next 10 years.

Expected appreciation of value is 25-40% (depending on the horizon)

# Monitorables

The key monitorables for this business are :

a. Success in bagging contracts on Patented Molecules – as discussed before, this will help in having extremely long and sticky relationships with MNCs; along with a proof of capability that can be used to win more such molecules from other customers. As such CRAMS in patented molecules is really the “crème de la crème” of this business.

b. Success in breaking through into new geographies is also extremely important as it will signal management capability, derisk the business from a single geography and bring diversity in the product basket.