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Ambit Asset Management

DISRUPTION SERIES

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GMM PFAUDLER: EXPEDITION FROM GLASS TO DIAMOND?

We at Ambit are constantly trying to stay ahead of the curve by drowning out the noise and looking ahead. In keeping with our long term investment thesis, we like to stay up to date with not just the present impediments faced by your portfolio companies but also long term disruptions which can hit these companies. Hence we will regularly come out with our thoughts on disruptions in your portfolio companies/ sectors and for the 15th volume of this series we have chosen GMM Pfaudler.

A disruptive technology/ innovation is one that helps create a new market and value network, and eventually goes on to disrupt an existing market and value network (over a time period) displacing conventional wisdom or technology.

This note takes a closer look at how GMM Pfaudler has dominated the Glass-lined equipment space in India and how it is striving to evolve to become a global leader in the anti-corrosion landscape. The road to becoming a global powerhouse is seldom easy and we highlight the probable disruptions GMM Pfaudler may face and how the company is positioned for the same.

Background

Gujarat Machinery Manufacturers Ltd (GMM) was formed in 1962 and started manufacturing Glass Line Equipment (GLE) with the help of technology acquired from a Hungarian company Lampart. To keep pace with the evolving technology, GMM entered in a financial and technical tie-up with the world leader in that field – Pfaudler, Inc. USA – in 1988. Subsequently, Pfaudler acquired 40% stake in GMM which it increased to 51% in 1999 post which the name of the company was changed to GMM Pfaudler Ltd.

Pfaudler Inc. – from Parent to Subsidiary

Started in 1884 in US with a production plant in Germany, Pfaudler, Inc. is known for the invention and commercialization of GLE technology which is currently known as Pfaudler Glasteel. Today, Pfaudler is the leader for corrosion-resistant technologies, systems and related services with >20% market share in an Oligopolistic market primarily catering to customers in the chemical and pharmaceuticals industries.

In Aug 2020, GMM along with its promoter – the Patel family – acquired its parent Pfaudler's International business from DBAG, making its parent a subsidiary. The deal structure was as follows –

- GMM (along with its wholly owned subsidiary Mavag) acquired 54% stake for US$27.4mn.
- Patel family acquired 26% stake to re-enforce their commitment in the business and avoid higher leverage in GMM Pfaudler.
- Balance 20% stake remained with DBAG.

This acquisition was followed immediately by an OFS announcement by the promoters – Patel Family and DBAG. While the Patel family looked to raise Cash to fund their stake purchase in Pfaudler international, DBAG wanted to cash-in on some part of their investment **(Refer to Exhibits: 1-3).** The resultant ~33%/~24% stake of DBAG/Patel Family in GMM Pfaudler is currently locked in for a period of 3 years till 2023.

Going ahead, the management has talked about merging Pfaudler International into GMM which would imply further shareholding consolidation and possible stake sell by PE investor DBAG.

Exhibit 1: Post Acquisition of Pfaudler International Business

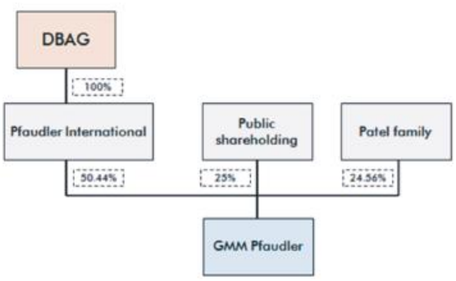


Exhibit 2 : Post Acquisition of Pfaudler International Business

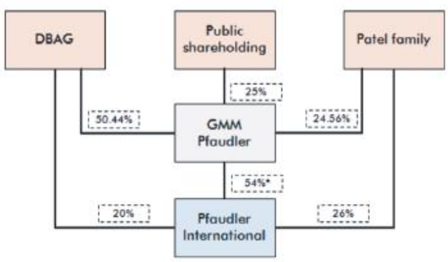
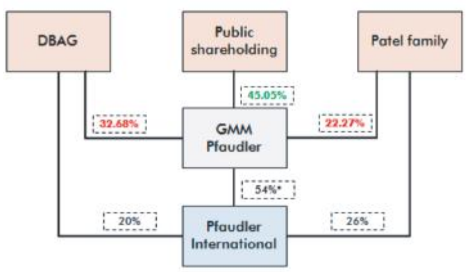


Exhibit 3: Post OFS (20% stake) in GMM Pfaudler



Source: Ambit Asset Management, Company

As a result of the deal, GMM Pfaudler today is the No.1 Global Glass Lined Equipment producer with a 20% global market share in anti-corrosion equipment and >50% market share in GLE in India and ~US$250m revenue, substantially higher than its nearest competitors due to quality products, customer relationship, great management and solid execution. (Refer to Exhibit: 4 & 5).

Exhibit 4: GMM'S leadership position in GLE...

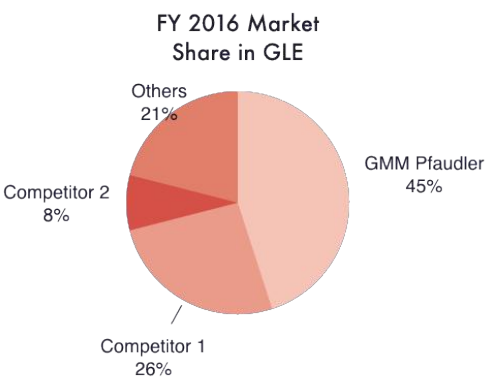
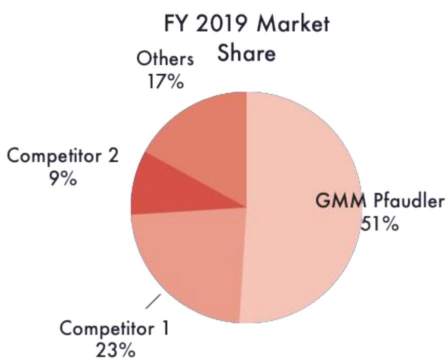


Exhibit 5: ...has only become more dominant



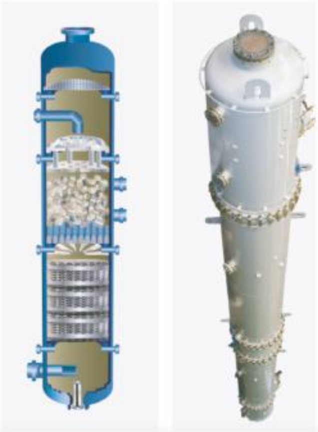
Source: Ambit Asset Management, Company

Glass Lined Equipment – Factuality and Applications

Glass lined steel or Industrial Porcelain Enamel is the use of Porcelain Enamel for industrial application primarily in the pharmaceutical and chemical industries. Porcelain Enamel is a thin layer of ceramic or glass that is applied to the underlying metal (usually Steel). This prevents Steel from being exposed directly to harsh chemicals and subsequently corroding or causing failure.

Apart from being **Corrosion Resistant**, GLE is also **contamination resistant**, much **easier to clean** than unlined equipment and can operate under diverse range of conditions. Therefore, while the initial cost may be high, it tends to be much more cost effective in the long run due to increased service life.

Exhibit 6: GMM's Glass Lined Columns



Source: Ambit Asset Management, Company

Exhibit 7: Glass Lined Reactor

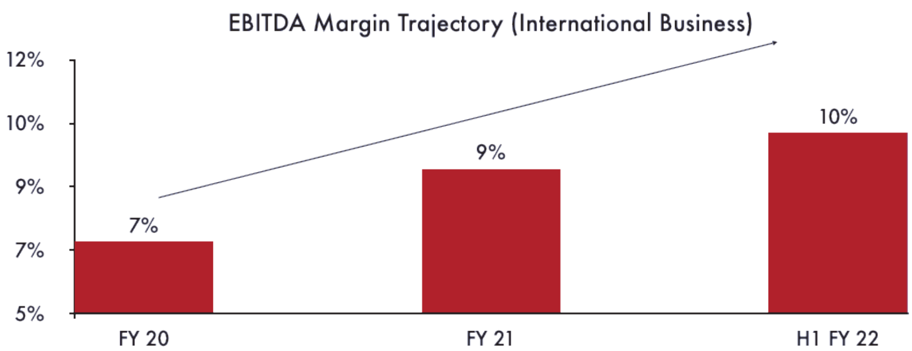
Source: Ambit Asset Management, Company

GMM's Right-To-Win in this highly technical industry

GMM has been a dominant market leader in India and management has taken an array of decisions to accelerate GMM's positioning in the market including -

1. Acquisition of De Dietrich Process Systems' GLE manufacturing plant in Telangana in 2020 for a consideration of ~Rs53Cr (EUR6.25mn).
2. Addressing some of overseas demand via domestic manufacturing capabilities of recently acquired Vatva facility and new furnaces introduced in other facilities which has resulted in improved international business margins **(Refer to Exhibit: 8)**
3. Acquisition of Industrial Mixing division of Sudarshan Chemicals Limited for around ~Rs 29 crores to diversify their product portfolio.

Exhibit 8: Improving EBITDA margin trajectory of acquired international business gives confidence of GMM's execution



Source: Ambit Asset Management, Company

Disruption by Global challenges and end-user industries

1. Integration Challenges – GMM Pfaudler's acquisition of 54% stake in its parent Pfaudler's international business brings a lot of integration challenges. While it gives access to superior technology and foreign markets implying higher revenue, it comes with lower EBITDA margins of ~10% compared to 25% for domestic business, due to higher labor cost along with cultural, political and regulatory challenges.

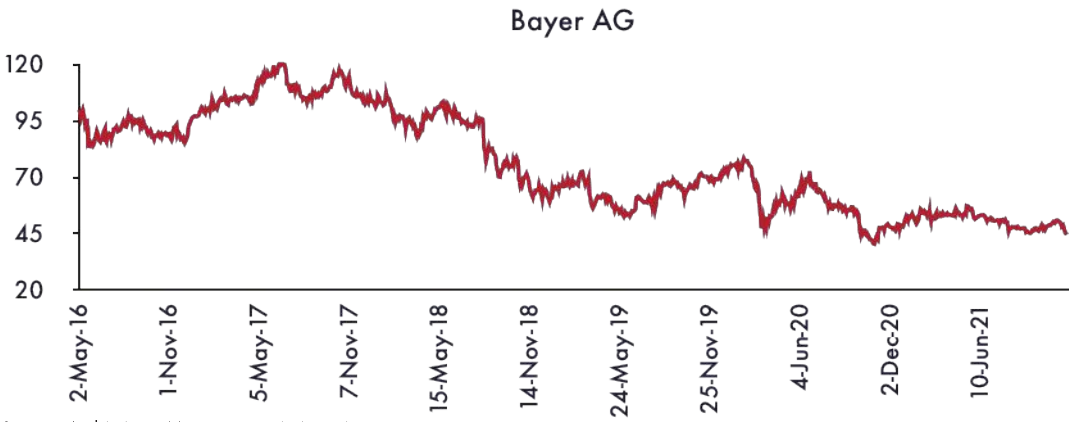
We highlight a few domestic and global examples of M&A integration challenges faced by companies with varied outcomes.

a. Regulatory, Legal and political challenges – Bayer's $63bn all-cash acquisition of Monsanto (a US agro-chemical and agro-biotech company) created a merged entity that was the 2nd largest global agrochemical company.

Bayer paid $63bn to acquire Monsanto in 2018. However, the merged entity's combined Market Cap as of Nov '21 was ~$57bn.

Despite having a decent M&A track record, Bayer failed to assess the liabilities and legal challenges associated with the acquisition which dented the company's reputation and resulted in huge financial loss and investor wealth destruction **(Refer to Exhibit: 9)**. Bayer faces billions of USD in liabilities from claims that Monsanto's herbicides 'Roundup' and 'Ranger Pro' can cause cancer and the alleged carcinogenic properties of glyphosate in these products was not informed to farmers. In June 2020, Bayer attempted to settle >1.25 Lac cases with a US$9.6bn settlement claim which is still on-going.

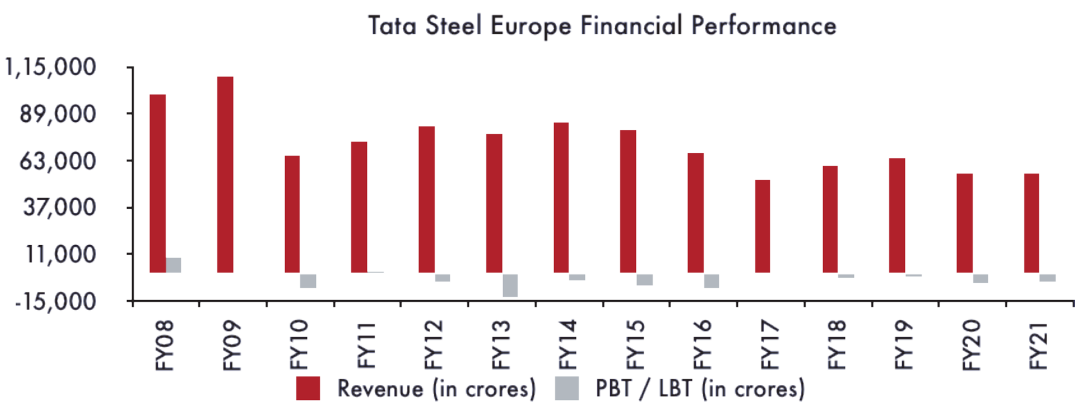
Exhibit 9: Bayer's share price has more than halved post acquisition announcement



Source: Ambit Asset Management, in.investing.com

b. Higher operation cost and overestimation of synergy benefits: Other challenges for a company operating in an emerging market and trying to diversify to the developed markets is that of higher employee costs (due to higher GDP per capita) and adapting to the local culture. Take the case of Tata Steel's ~US$12bn acquisition of Corus Steel in 2007, which came at the peak of previous bull cycle and has struggled to perform since, dragging down the consolidated entity's performance. **(Refer Exhibit: 10).** At the time of acquisition, Corus' revenue was >4x that of Tata Steel, but Tata Steel had a much better profitability. Overestimation of synergy benefits for UK entity, inability to transform the European operations and a difficult political environment compounded problems for Tata Steel.

Exhibit 10: Corus acquisition has weighed in heavily on Tata Steel Europe's financials as the entity continues to bleed post GFC



Source: Ambit Asset Management, Company. Note: FY17- FY21 PBT numbers are before exceptional items. FY 17 numbers include revenue/PBT from continuing operations.

c. Cultural Differences – A cross-country acquisition brings on several cultural related integration challenges. Take the example of Godrej Consumer's (GCPL) acquisition of Darling Group – a hair-extension business in Africa and the idea was the acquisition may give them opportunities to cross-sell their Indian hair products (primarily hair colors) along with a very strong footing in Africa.
Culturally, India and Africa have differences in presence in terms of hair care. While in India hair color is a widely accepted trend, in Africa hair extension market is huge, however there is not a big market for cross-selling the products. In addition to the above macro-economic issues such as currency devaluation, higher fuel inflation, and increase in taxes resulted in very strong integration difficulties. GCPL despite operating in Africa for a while has found it difficult to integrate, consolidate and turnaround the African business.

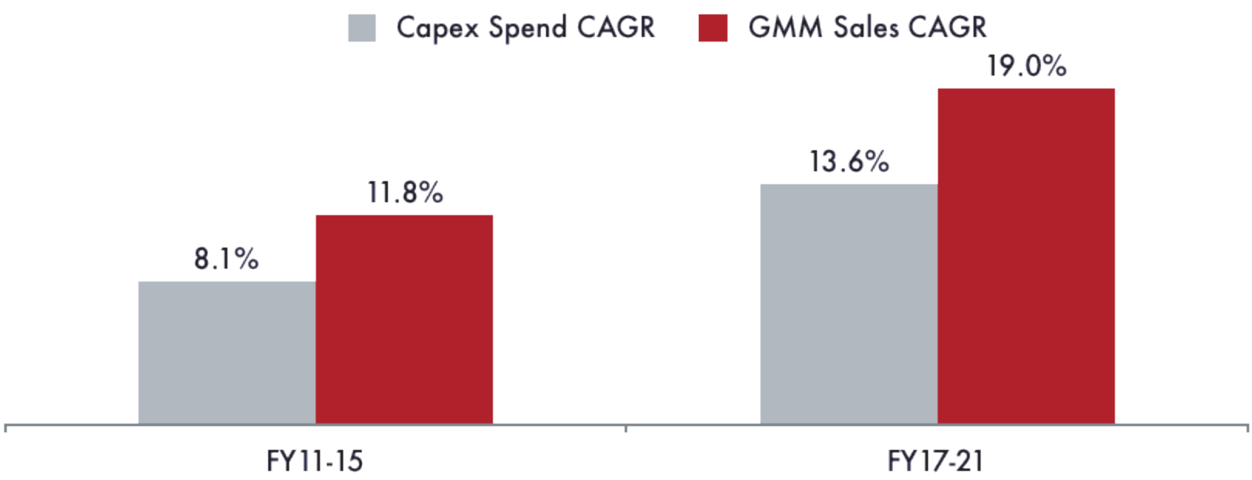
2. Disruption in end-user industries–

a. High correlation to end-user industry Capex cycle - GMM Pfaudler's fortune is dependent on how well the end user industries – its clients in Pharma and Chemical space – are doing. Strong business traction by them would result in higher future capex thus providing tailwind to GMM Pfaudler's revenue. As a result, GMM's revenue growth has shown strong correlation to its clients Capex spend growth. From FY11 to FY15, GMM's revenue grew at a modest pace of 12% CAGR which coincided with ~8% CAGR in its key clients' capex spend during the same period **(Refer Exhibit: 11).** Similarly, 14% Capex spend in last 5 years translated into 19% revenue growth for GMM.

b. Sharp Commodity Price inflation – The key Raw Material for GMM are carbon and stainless steel. While any sharp uptick in these commodity prices may dent GMM's margins; a severe RM inflation in end-user industries – as seen post COVID – could impact their business and push back planned capex.

c. Environmental and Regulatory Challenges - As discussed in our earlier Disruption note on Chemicals, the industry faces several regulatory challenges such as – Product Ban, Withdrawal of Incentive Schemes and Delay in government approval for manufacturing. In addition to these, the highly toxic nature of the end-user industry makes them susceptible to adverse environmental regulations, especially when any accident occurs. In addition to these, environmental clearance for API plants in India is still a cumbersome process. These may often act as a sentiment dampener to investment prospects in these industries and push back or defer planned capex.

Exhibit 11: Strong correlation of GMM's revenue to end-user industry's capex



Source: Ambit Asset Management, Company. Note Capex spends for Major clients for GMM Pfaudler – PI Industries, Aarti Industries, UPL, Sun Pharma and Aurobindo Pharma. Pfaudler International revenues are not included in the above data.

3. Competitive Intensity

While GMM Pfaudler is a leader in the GLE category, it does not enjoy the same positioning in Heavy Engineering and Filtration & Drying segments. Even in GLE, the company faces credible competition both in domestic as well as global market **(Refer Exhibit 12).**

A. In domestic GLE market, GMM's key competitor is HLE Glascoat which too has expanded its global business with the recent acquisition of Thaletec which further strengthened its technological prowess. Other smaller players in the Indian GLE market include Standard Glass and Sachin Industries.

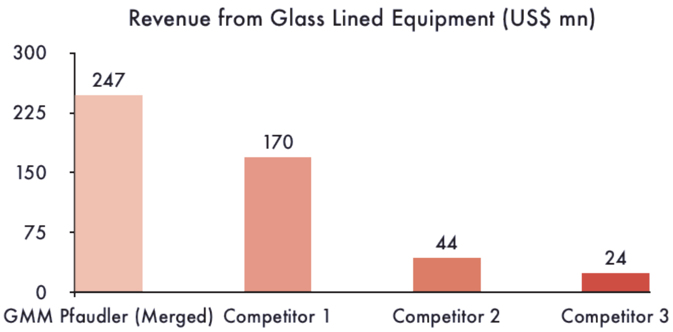
B. In global market, GMM's main competitors include (1) Zibo Taiji Industrial Enamel Company leader in the Chinese market and operates in >50 countries, and (2) France based De Dietrich Process System which is amongst the largest players in Europe, Asia and USA for process equipment, process solutions and engineered systems.

C. It faces strong competition in Heavy Engineering space with formidable players like L&T who is the market leader and has a longer working capital cycle.

D.Even in the domestic Filtration and Drying segment, it is HLE Glascoat which is the market leader with ~60% market share **(Refer to Exhibit: 13).**

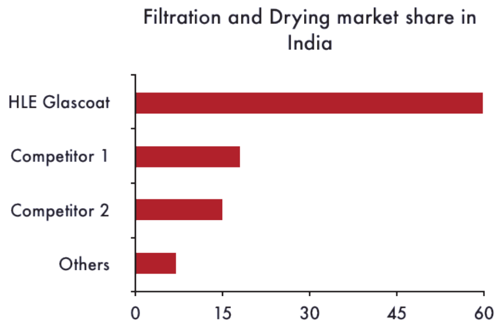
GMM's endeavor to diversify from GLE to complete Corrosion-resistant solutions imply increased focus on highly competitive and lower margin segments like Heavy Engineering and Filtration & Drying. Unlike GLE where the company has been a market leader, the other segments pose a different level of execution risk along with strong competitions and the management will need to be on top of their game to mitigate those risks.

Exhibit 12: GMM Pfaudler is the global leader in Glass Lined Equipment...



Source: Ambit Asset Management, Company

Exhibit 13: ...However it faces tough competition in filtration & drying market in India



Source: Ambit Asset Management, Company

4. Risk of Technology obsolescence

The risk of a newer technology which may replace GLE is a possibility in an ever-evolving world albeit a low one as GLE has been used in chemicals and pharma for over a century. Example - In the past we have seen how PVC pipes have completely replaced GI pipes due to better functionalities such as higher durability and corrosion resistance.

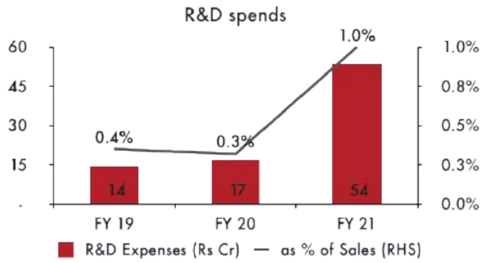
GMM has been investing in R&D and product innovation to mitigate the risk of technology obsolescence. GMM's R&D spends has increased on both absolute terms and as a % of revenue further highlighting their focus on innovation. GMM Pfaudler's focus on innovation, both via accelerated R&D spends and new product launches such as-

a. Smart Glass – Innovative Glass lined technology for reactors with thinner adhesive layers which results in up to 18% energy saving and improved sustainability.

b. Mavasphere Spherical Dryer (Refer Exhibit 15) – A fourth generation drying technology which is a multi-purpose and high-performance equipment for drying of pharmaceuticals (API, HPAPI) and fine chemicals.

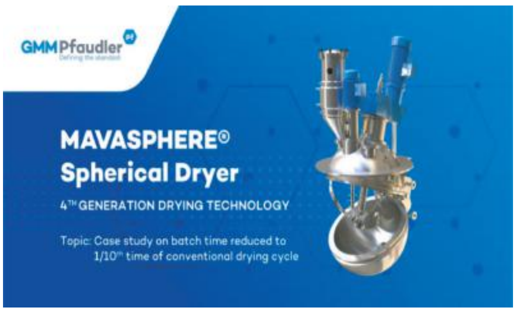
The company has also diversified its product portfolio to Filtration and Drying equipment, Mixing Systems, Engineering Systems and Heavy Engineering to further mitigate the GLE obsolescence risk.

Exhibit 14: Increased trajectory of R&D spends has helped...



Source: Ambit Asset Management, Company

Exhibit 15: ... in bringing innovative products and solutions like Mavasphere Spherical Dryer



5. Management bandwidth

Transforming from an Indian company to a global company adds in a lot of challenges. While GMM's Indian business earlier was primarily run by Tarak Patel, a global expansion now requires additional management bandwidth for successful expansion and de-risk the business of any future Key-Man risk.

To address these, The Company has appointed Aseem Joshi as CEO of India Business. Aseem Joshi has over 20 years of experience in technology, consulting, strategy, sales and manufacturing. Prior to joining GMM Pfaudler he was associated with Honeywell Automation. The company has also continued with Thomas Kehl as the CEO of International business. These appointments have provided much needed bandwidth at top-management, with Tarak Patel now being the MD of the entire business.

CONCLUSION

GMM Pfaudler is striving to become a dominant player in the global anti- corrosion landscape. GMM will face integration challenges, however the initial signs have been very promising with the management being agile in mitigating some key risks. Provided GMM Pfaudler can successfully turnaround, integrate and scale up the business, it may result in a new era of Indian companies disrupting the global landscape.

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