Specialty Chemicals

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Smooth runway for growth

We held a panel discussion with a large investor, Fairfax India, and its three investee companies Privi Organics, Adi Finechem, and Sanmar. Key takeaways: a) specialty chemicals enjoys multiple growth drivers – import substitution, expansion in domestic consumption, increased outsourcing by global manufacturers, and manufacturing diversification to India given policy curbs in China; b) weaker infrastructure and non-availability of feedstock is a bottlenech in scale-based chemicals product however strong talent pool, eye for quality and better process innovation capabilities make India competitive for skills based specialty chemical products; c) Indian players need to seek growth, organically or inorganically, on four axes – product, process chemistry, product application and chemistry; d) ability to add value-added products, manage fixed costs and make efficient capital investments are key parameters to gauge while investing in this space. SRF (BUY, TP 1750) and PI Industries (BUY, TP Rs800) are our key ideas in this space.

Shift towards customer orientation aiding growth, margins and ROCEs

Experts at our panel discussion said the biggest change over the last few years is the mindset shift of Indian chemical players to customer focus (customization, process innovation) from feature orientation, or focus on product attributes. This implies focus on developing products according to client needs and focusing on overall customer experience rather than just developing certain products with fixed specifications and trying to sell it. Product innovation, talent base and globalization have helped Indian companies develop this customer orientation. The success of IT services, pharma and agrochemicals have clearly aided this shift in mindset of Indian entrepreneurs.

India's unit economics favours low-volume, high value products

The experts noted that India's unit economics - high infrastructure and logistics costs, import dependence on feedstock but good process knowledge, and quality manufacturing - support low-volume, high-value products. On the positive side, strong intellectual capital, trained technical resources, and low-cost labour add to labor competitiveness of the country. Environmental compliance has been a mixed situation with some players having world standards and other seemingly flouting the norms. Indian markets have also become fairly large and a focus market for global players. In terms of capital cost too India is one of the cheapest countries to build manufacturing facilities. Growing costs for Chinese players (specifically given rising costs of environmental compliance) are opening new doors of opportunity for Indian players in the sector.

Multiple growth drivers to ensure growth momentum sustains

Experts noted that India's chemical demand is dependent on multiple drivers such as a) import substitution, b) growing domestic demand, c) new product forays by Indian players, and d) outsourcing of existing products by global players. Even if one of these engines slows, the other will ensure growth. Hence, experts don't believe the sector will see volatility in growth rates as in the recent past.

Prefer cash flows over growth

Specialty chemicals business is inherently profitable and cash generative if capital allocation discipline is exercised. Chasing growth without exercising restraint on unnecessary manufacturing expansion and R&D investment is not useful. For sustainable growth, companies should look to attempt diversification across chemistry, product, clients, and applications, the experts said. Companies should also focus on raw material diversification to sustain margins.

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Exhibit 1: Competitive advantage of India

WHY INDIA? FAIRBRIDGE

	Advantages	Disadvantages
Labour	✓ Strong intellectual capital ✓ Trained technical resources ✓ Low cost labour	
Environmental considerations	✓ Historically lax environmental policies	× Increased scrutiny may create entry barriers going forward × Water table depletion
Raw materials	✓ Abundant supply of natural salts and minerals ✓ Large agricultural base	× Import dependence for petroleum and inorganic feedstocks
Cost of production	✓ Low production costs compared to western countries	× Irregular and high cost of power
Market access	✓ Large domestic market ✓ Perception of quality in international markets	× Poor logistics infrastructure
Unit economics favour low volume-high value speciality products		

Source: Company

Background of three acquisitions done by Fairfax in India

In Nov 2015, Fairfax holdings acquired ~45% stake in Adi Finechem for USD20mn, a specialty chemicals manufacturer of oleo products like fatty acid and glycerine, and nutraceuticals like tocopherol (Vitamin E) and sterol. This transaction valued Adi at USD45mn. An open offer was made in Jan 2016 to acquire an additional 26% stake from the public, which did not work out. Under this investment, Adi is continuing as an independent firm with no changes in management.

In April 2016, Fairfax acquired 30% stake in Sanmar Chemicals at USD300 mn, valuing Sunmar at a staggering USD1bn. Sanmar is one of the largest PVC manufacturers in India besides manufacturing caustic soda, chloromethanes, refrigerant gases, industrial salt, and specialty chemical intermediates. The transaction will enable Sanmar's Egyptian summary to establish a term loan of USD280mn to double its capacity to 400,000 TPA, making Sanmar the world's largest PVC manufacturer (700,000 TPA).

In July 2016, Fairfax acquired 51% stake in Privi Organics at USD55mn, valuing the firm at USD108mn. Privi is a manufacturer of aroma chemicals with 15,500 TPA capacity. Additionally, the boards of Privi and Adi have approved to merge into a new specialty chemicals entity called Fairchem, with Fairfax having 49% stake. This synergy will help Adi gain access to high quality research and development facilities while Privi will gain from Adi's focus on cost optimization and efficiencies.

In the past year, Fairfax invested more than USD1bn in India, of which 38% has been in the chemicals industry.

Exhibit 2: Summary of Fairfax's investments in the chemicals sector

FAIRFAX INVESTMENTS IN CHEMICALS SECTOR FAIRBRIDGE

SANMAR
- Low cost producer in globally competitive PVC industry
- Extraordinary cost and freight advantages in Egypt
- Strong management team with 50 years of track record

FAIRCHEM
- **Vision:** To be a leading **Renewable Speciality Chemicals Company**
- Platform Company for future acquisition

ADI FINECHEM
- In-house technology using waste from oil refining process
- Low cost raw material enables cost competitiveness vis a vis global peers
- Excellent long term customer relationships serves as entry barrier

Privi Organics Limited
- Trusted supplier (for 10 + years) to all of the Top 10 fragrance companies
- Strong in-house Research & Development capabilities
- Processes waste products of paper and pulp industry into high value aroma chemicals

Source: Company

China – rolling back environmentally harmful chemicals

One of the participants cited an example of PVC, where Chinese manufacturing process involved use of coal and mercury (both highly polluting). As Chinese government is putting curbs on such manufacturers, opportunities are rising even in commodity chemicals.

Fairfax to do more acquisitions

Fairfax (a leading Canada based investor with more than US$41.5bn invested assets) will look at acquiring more companies under the Fair Finechem Umbrella (Privi and Adi Finechem) to diversify its product portfolio. Fair Finechem will focus on: a) investing for long-term growth rather than short-term gains; b) prevent excessive leverage; avoid projects which stretch the balance sheet; c) secure sources of raw material supply and invest in backward/forward integration; d) acquire complementary businesses to enhance product diversification along with considering long-term value accretive acquisitions; and e) reduce volatility in cash flow generation.

Where do we go from here?

We continue to believe that specialty chemicals segment is likely to grow at a robust pace driven by increased sourcing from India as well as domestic market growth. While the opportunity is fairly large, there are very few players who seem to be well-positioned to take advantage of this opportunity. Note that in specialty chemicals skill is more important than scale and focusing on a few products or a particular chemistry cannot provide sustainable growth. This implies Indian companies looking to become large have to: a) significantly ramp up R&D efforts to diversify into new chemistries or consistently add products or discover new applications for existing products; or b) acquire niche technology companies and cross-sell their products to their clients. Such initiatives need investments; entry of large investors like Fairfax implies that some players have access to capital and strategic vision to make it large.

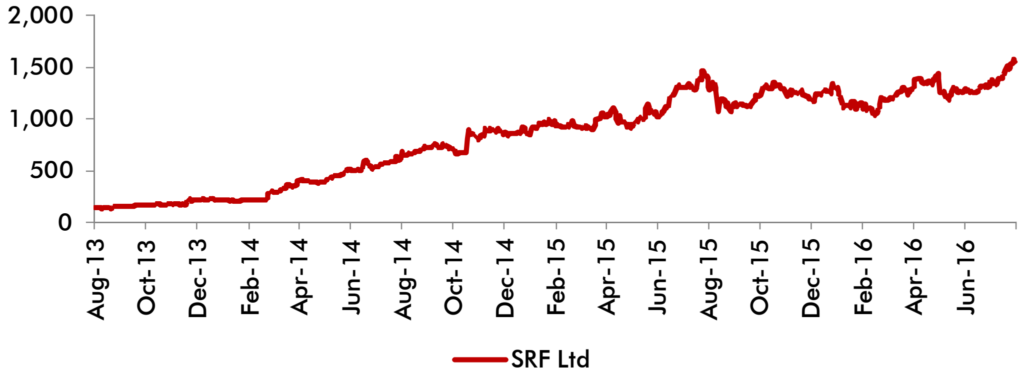
Our top picks are SRF (TP Rs 1750) and PI (TP Rs 800) who have so far demonstrated greater customer association, ability to expand application areas from one space to another (say agri to pharma), and good process capabilities and QSHE compliance.

Exhibit 3: Strengths and weaknesses of key Indian specialty chemicals players

	Strength	Weakness
Atul	Wide range of chemistry capabilities	Perceived lack of aggression
Aarti	Good player with capabilities in Benzene chemistry	Lack of cutting edge technology
Vinati	Good history on capital allocation and focus on green chemistries	High product concentration
Navin Fluorine	Expertise in fluorination	Ability to gain scale still need to be watched out far
Camlin Finesciences	Good growth through backward and forward integration	High WC cycle; getting into capex cycle
SRF	Strong chemistry capabilities in fluorination driving high margins	Asset efficiency has been weak

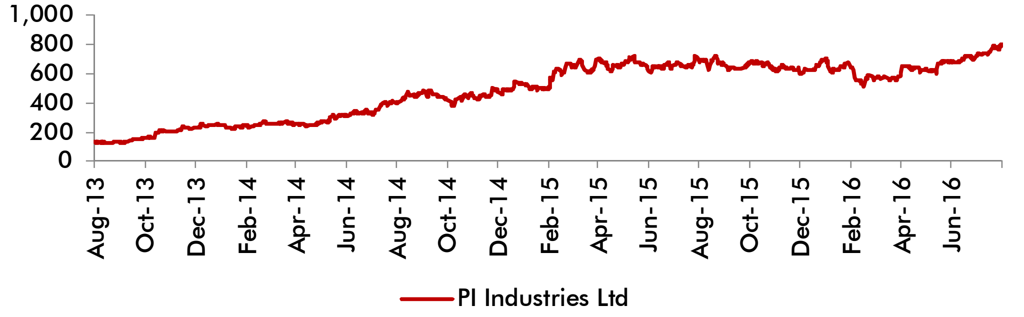
Source: Company

SRF Limited (SRF IN, BUY)



Source: Bloomberg, Ambit Capital research

PI Industries Ltd (PI IN, BUY)



Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month)
BUY	>10%
SELL	<10%
NO STANCE	We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation
UNDER REVIEW	We will revisit our recommendation, valuation and estimates on the stock following recent events
NOT RATED	We do not have any forward looking estimates, valuation or recommendation for the stock
POSITIVE	We have a positive view on the sector and most of stocks under our coverage in the sector are BUYs
NEGATIVE	We have a negative view on the sector and most of stocks under our coverage in the sector are SELLs

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