SRF

We always find a better way

Published Date: Sep 28, 2019	Publication: Outlook Business
Journalist: Himanshu Kakkar	Page No: 59-65
MAV/CCM: NA	Circulation: NA

Dual chemistry

After inheriting a technical textiles business from their father, Ashish and Kartik Ram placed winning bets on chemicals and packaging

Himanshu Kakkar

Instead of growing technical textiles, we used it as a cash cow

—KARTIK BHARAT RAM [LEFT]
Deputy managing director, SRF

with ASHISH BHARAT RAM
Managing director, SRF

VISHAL KOUL

It has been a phenomenal run for SRF on the bourses. The stock has surged more than 10x over the past four years, from around ₹220 in 2014 to a high of ₹2,402 in May 2018. During this period, the chemicals-to-technical textiles company saw its sales move from ₹40.18 billion to ₹56.85 billion, and profit surge from ₹1.62 billion to ₹4.62 billion.

But then, the stock market is a fair-weather friend — when the going is good it gets along, but in testing times it often deserts. That's exactly what happened, with the stock falling 34% to hit a low of ₹1,564 on July 20, 2018. The steep fall between May and July can be attributed to the company's lukewarm performance in FY18 — with profit falling 10%, return on equity (ROE) shrinking from 17.33% to 13.69%, and debt-equity ratio rising from 0.75x to 0.88x. The stock, though, has recovered and now trades at ₹1,991.

SRF has been using cash of over ₹20 billion per year from its technical textiles business to finance incremental capital investment in other divisions

While the numbers seem tepid, it is not because of deteriorating fundamentals, but because the company is investing in growth. SRF's sales grew 10.6% in FY18, but profit fell because of 22% year-on-year rise in interest cost owing to higher debt, and 11.4% year-on-year rise in depreciation.

SRF is on an expansion spree. Three new chemical plants have been commissioned in FY18, it is setting up its second BoPET film line and a resin plant in Thailand for $60 million, and a BoPET film line and metallizer in Hungary at an investment of approximately €60 million.

While the company has three main businesses - chemicals and polymers (specialty chemicals, fluorochemicals and others making up 32% of revenue), packaging films (31%), and technical textiles (37%), the chemicals and polymers business had higher net margin of 16.17% in FY18, compared with packaging films business at 12.89% and technical textiles at 13.02%. "Investors have asked me why we are investing in this business, if it is going through such a tough time? (*see: Fuelling expansion*) I tell them, 'If you are looking at SRF as a company that is going to give you quarter-to-quarter performance, then it is the wrong company for you to invest in'," says Ashish Ram, managing director of the Gurgaon-based company.

Ashish, along with younger sibling Kartik, bet on the chemicals business after taking the ₹55 billion group's reins from their illustrious father, Arun Bharat Ram, in 2007. The siblings channelled more resources and focus towards chemicals, and the bet paid off when specialty chemicals witnessed high growth of over 30%, till 2016. Although growth in the chemicals business slowed to -7.8% in Q1FY18, the duo remains steadfast about investing in it. In Q1FY19, the chemicals and polymer business seems to have bounced back, with 34% growth over the same quarter last year.

"We are absolutely certain that, in the long-term, this is an attractive business. So, if it means that we have to invest in the down cycle, with more money invested in capability development, we will continue to do that, like we have over the past two years," says Ashish.

RIGHT CALL

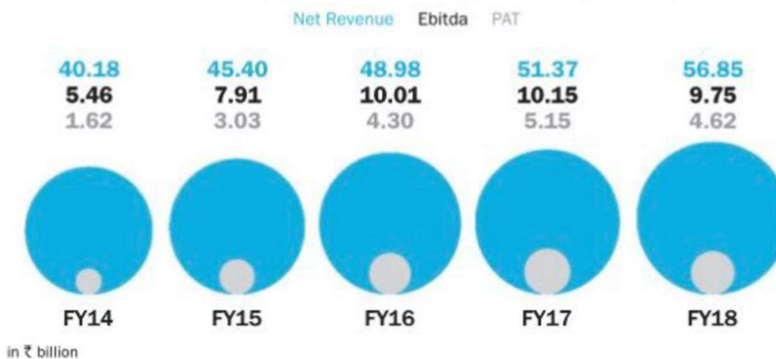
Arun Bharat Ram handed Ashish and Kartik the reins after they had honed their management skills by running various parts of the business. Once they were in charge, Arun permitted them to make the calls, even if the decisions went against his own.

Arun had built a large business around technical textiles to a point that before its diversification, SRF was known as a technical textile company. In FY08, the sons took a hard look at their business. "We took a much more dispassionate view about the opportunity in technical textiles, and saw that the business only looked great from a macro perspective" says Ashish.

From a top-down view, tyre companies were growing well for the past seven years. That, however, was more to do with radialisation of bus and truck tyres, rather than bias tyres (which have nylon tyre cord). Bias tyre market growth was flat over the same period, and growth in nylon tyre cords was going to be limited. "Usage was not going to increase, and our biggest strength was only nylon-tyre cord. So, instead of looking at technical textiles as a growth business, we positioned it as more of a cash cow," elaborates Kartik. The com-

Fuelling expansion

While revenue rose, profit has been hit by rise in capital expenditure



pany has been using cash of over ₹20 billion per year from its technical textiles business to finance incremental capital investment in other divisions.

Coming from a technical background, Arun had created R&D capability around specialty chemicals. The idea of developing new molecules excited him. His sons, meanwhile, took it one step further. "In chemicals, we moved the focus from what we can develop to what the customer wants. Instead of the R&D team leading the business, we said that the marketing team will decide what the business needs to do," recalls Kartik.

These strategic calls turned out right. The chemicals business now pulls in ₹18 billion, and contributes 32% to SRF's revenue. More importantly, it registers Ebit margin in the range of 16-20%. The technical textiles business has remained flat at ₹21 billion, but still contributes 37% to the company's topline. The chemicals and packaging film businesses have been driving profitability and topline for SRF.

In the chemicals business, and especially in agrochemicals, SRF has a lot of overseas buyers. Sumant Kumar, analyst at Motilal Oswal Securities, says, "SRF's winning formula flows from its R&D's ability. A customer comes to them with a formula, and asks them to reduce the cost through some process, and they do that successfully."

There is constant development of new molecules, as required by the customer. SRF has an active customer base, which may consist of 20-25 customers. Typically, for long-life molecules, it focuses more on cost, as it has to remain cost-efficient over a long period of time. For molecules with life span of about three years, getting them to market quickly is the priority, in order to make as much money as possible.

Identifying their differentiator, Ashish says, "In the chemicals business, the ability to come up with new molecules and set up plants at faster pace than others has helped us grow." The company spent ₹1 billion in R&D (1.65% of revenue) in FY18, and has worked on 46 molecules, from which 17 products were taken for process development. Besides, the company has been aggressively ramping up its capacity in the chemicals and polymer space, spending ₹8 billion over the past two years. "The time taken to set up a new plant is down to eight months, from 15," says Kartik.

"Within chemicals, flourochemicals has been one of the key growth drivers for SRF during the past one year," says Kumar. These are used as refrigerants in air conditioners and refrigerators. Anoop Joshi, chief financial officer, SRF, says, "Chemicals and polymers business has contributed 6% year-on-year growth with refrigerants being the major driver. However, the growth in specialty chemicals did not take off because of a major downturn in the agrochemicals market and a consolidation of our global customer base, leading to a drop in sales during the year."

The company has been aggressively ramping up its capacity in the chemicals and polymer space, spending ₹8 billion over the past two years

"Creating a brand in the refrigerant business would need immense resources for marketing

—KASHYAP SURESH
Senior consulting analyst, Frost & Sullivan

"Global growth in packaging films is 4-9%, and with new plants, SRF is poised to cash in on this

—ANOOP JOSHI
Chief financial officer, SRF

In the early 2000s, CFCs (chlorofluorocarbons) were banned internationally. The manufacturers had to find a substitute, which was HFC134a. SRF had put up a plant in FY05 to indigenously develop the substitute. "That gave us confidence to develop other molecules, which became part of our speciality chemicals business," says Ashish.

However, despite being around for so long, SRF still faces the consequences of ever-changing regulations. Currently, R22 is the most prevalent gas used in ACs and refrigerators. "We are now in a situation where we have to phase down the usage of R22, which is the predominant gas transitioning to hydrofluorocarbons (HFCs). While we are doing that, there is already the Kigali Amendment signed two years ago, which says that we have to transition from HFCs to hydrofluoroolefins (HFOs) in the next 15 years," says Ashish. This means another transition over the next decade. SRF claims that they are one of the few companies in the developing world, building their own technology for HFOs.

"From our perspective, the refrigerant gas market in this country will be very attractive over the next many years. It is a hot country. USA, which is not a hot country, uses 15x more refrigerants than us," says Ashish.

The refrigerants business operates only in the B2B segment, but the brothers are working to change that. "Over the next couple of years, we will transform from just refrigerant gases to a Floron brand business," informs Kartik. For decades, mechanics have carried a large cylinder to refill gas in customers' appliances. SRF has introduced small-sized, branded refrigerant gas cans that are portable. Kartik believes, this will increase brand awareness among the mechanic/customer community.

SRF claims to be one of the few companies in the developing world to be building their own technology for refrigerant gases

Kashyap Suresh, senior consulting analyst, chemicals & materials practice, Frost & Sullivan, says, "It's going to be tough. It still operates at an institutional level — a company supplies gas to a mechanic. Creating a brand in this space would require immense resources in terms of investments and marketing."

The company has already secured supply contracts for R134a, under the Floron brand, from another US retailer other than Walmart, while having commenced sales of R32 and R134a to global air conditioning and auto majors in FY18. The 40,000 MT chloromethanes (CMS) plant also commenced production in Q3FY18, thereby doubling its CMS capacity.

BUILDING RELATIONSHIPS

Packaging films is SRF's third-largest vertical, contributing 31% to its revenue. (*see: Tightly wrapped*) With agrochemicals remaining subdued, this proved to be a significant growth driver in FY18, and especially in Q4FY18, where revenue grew by 39% year-on-year.

While remaining low-cost has been SRF's bedrock strategy, it has also nurtured strong relationships with its clients over the years. "The packaging materials business is a commodity business, and what differentiates us is our low cost and client relationships," says Kartik.

PepsiCo has been a packaging films customer for 12 years. For a player such as PepsiCo, it is next-to-impossible to change the price of their products in line with fluctuating packaging material prices. Ashish Karanjkar, associate director, packaging at PepsiCo, recalls how the association graduated from being a supplier-vendor relation to a strategic partnership. "This industry is notorious for cartelisation. In FY10, there was a shortage of PET material, leading to 100% increase in price. We were one of the rare

organisations that remained insulated because, we did a strategic tie-up with SRF, and locked in the full-year pricing. There have also been times when the PET market crashed, and we honoured the commitment," he says.

Packaging films is a business where MNCs with high-end technology are present. DuPont, Toray and Mitsubishi are the big names in the game. Kartik says, "We look up to them and try to move up the technology curve, making value added products which a lot of companies in the developing world don't do."

PepsiCo, too, has worked with SRF to innovate. "We are working with them to reduce thickness of metallised PET films from 18 micron to 8 microns. With this, cost comes down, and you're sending much less plastic to the dumping ground," says Karanjkar.

Along with technology upgradation, SRF is also bulking up its packaging films capacity. The new plant in Thailand is expected to strengthen SRF's presence in the buoyant South-East Asian region. "Packaging films industry is witnessing improvement in capacity utilisation, and hence provides us an opportunity to tap into this expected growth in demand. Furthermore, with a strong, existing customer base and a favourable tax and duty structure, Thailand presents itself as the best location for us," says Ashish. To be installed at the plant's existing location in Rayong, Thailand, the expansion is expected to be completed in about two years. Following this expansion, SRF will be catapulted to among the top 10 polyester film producers, globally.

Joshi adds, "On the packaging films business side, global growth has been in the range of 4-5%, and with new plants coming up in Thailand and Hungary, the company is comfortably placed to capture any spike in demand. Going forward, the company will be able to bump up its return ratios to healthy levels. Evidence of this can be seen in the Q1FY19 results."

The expansion of SRF's plant at Rayong, Thailand is expected to catapult it to among the top 10 global polyester film producers

FUTURE DRIVERS

Over the next five years, the management believes that their portfolio of businesses is enough to achieve the desired growth. Ashish and Kartik believe that specialty chemicals have huge potential, and agrochemicals is already showing signs of demand recovery. Kumar says, "The global demand for agrochemicals is recovering slowly. There is excessive stock in the market, so that will be cleared first and then new orders will come."

Then, there is a major shift taking place in China, which is likely to favour Indian players in the specialty textiles space. Kashyap says, "After dominating the speciality chemicals space for decades, environmental and cost issues have come up in China. N-1 is a specialty intermediate product for the pharma industry, and China is facing quality and price issues there. So, it has opened up a new avenue for Indian players."

SRF's management, too, believes that they can leverage this opportunity. Ashish says, "We are entering the pharma side of business in the next three to four years."

The timing of a bet is very important, the brothers feel. If the time of an idea has come, the bet must be made, which Ashish and Kartik learnt from Arun's experience.

Interestingly, in the early 90s, SRF had put up a plant outside Bengaluru to make plastic lenses. In those days, the penetration of plastic lenses was less than 1% in India, and there were just glass lenses. "Unfortunately, for the first 7- 8 years, the challenge was in convincing people that plastic lenses are better than glass lenses, but we lost a fair amount of money in that and then finally sold the entity to Essilor. So, Essilor India essentially was built on what SRF did in the early 90s," says Ashish.

But the brothers seem to have learnt from that experience. One hopes they are neither early, nor late with any of their bets.

Tightly wrapped

The packaging films business has been on a roll over the past four years

₹ billion	FY14	FY15	FY16	FY17	FY18
SEGMENTAL REVENUE					
Technical textiles	21.80	20.32	18.99	20.08	20.78
Chemical & polymer	9.56	12.63	16.40	17.21	18.27
Packaging films	8.82	12.45	13.59	14.08	17.80
EARNINGS BEFORE INTEREST AND TAX					
Technical textiles	1.63	1.96	1.81	2.54	2.71
Chemical & polymer	1.91	2.98	3.94	3.27	2.96
Packaging films	-0.05	0.64	1.94	1.97	2.30

Source: Company

The price points in green highlight insider activity

Making a U-turn

Until 2016, Kerala-based Kitex Garments was an investor darling. The textiles company, which currently has a market cap of ₹8.28 billion, once enjoyed a market cap 6x higher. Between FY06 and FY16, the company's standalone net profit grew from ₹40 million to ₹1.12 billion. Gross sales also soared from ₹1.05 billion to ₹4.99 billion. On the back of strong revenue and profit, the company's stock scaled new heights, zooming 40x between FY11 and FY16.

However, post-2016, the company's growth story turned sour. While the stock was hitting new highs, Amit Mantri, a partner at 2Point2 Capital, raised red flags about the company's unbelievably profitable commodity business despite accounting for less than 1% supplies of its top five customers. In his blog, Mantri raised questions over the company's high-cost debt and zero-interest earnings cash. He wrote, "It is not clear why a company would continue to pay high-interest cost when it has cash available to repay the complete debt."

From its record high of ₹755 in July 2015, the stock hit ₹100 in July 2018. While the stock was getting hammered for three years, the company's promoter **Sabu Jacob** finally intervened in Q4FY18 buying 372,807 shares between February 2018 and March 2018 worth ₹90 million as it hit a four-year low. The promoters continue to buy the dips and in FY19 so far, Sabu and Boby Jacob have bought 44,850 shares worth ₹6.1 million. However, deviating from his consistent buying, Sabu Jacob sold 16,800 shares on August 31. Strangely, he bought back the exact amount of shares on September 5 for ₹2.23 million, increasing his stake to 32.81%.

Over the past two years, the company's profit has shrunk, and sales have plunged owing to the loss of two of its major clients. "One of its biggest customers has filed for bankruptcy, and earlier Jockey was also their customer, but it has stopped buying. If you lose two of your biggest customers, then you will suffer. However, the bigger question is why Kitex has not diversified its customer base if it claims it's so cost-efficient and customers love them," asks Mantri.

His scepticism seems justified as last of the mutual funds bolted in March 2017. ValueQuest India Moat Fund, India Capital Growth Fund and Acumen Capital continue to hold more than 1% and overall promoter holding has gone up marginally from 54.24% in June 2017 to 54.81% in June 2018.