Grasim's deal with Century: An earnings-accretive proposition

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Deal will help drive its viscose filament yarn biz without significant investment by the company

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Grasim's deal with Century Textiles, where it gets the right to manage and operate the latter's viscose filament yarn (VFY) business for a period of 15 years, is being looked at in a positive light.

First, Grasim — a holding company for many businesses such as telecom, cement, and financial services — is looking at growing its core viscose staple fibre (VSF) and chemicals business. Growth in the core business will drive stock prices in proportion to its earnings growth, compared to holding businesses' earnings, which are accorded a discount. Second, the move will significantly increase Grasim's presence in the VFY segment without any investments.

The asset-light expansion move more than doubles Grasim's VFY capacity to 46,300 tonnes per annum (TPA) from the current 21,300 TPA, against a one-time royalty payment of ₹600 crore, and a refundable interest-free deposit of ₹200 crore.

Compiled by BS Research Bureau

According to the company, the replacement costs for equivalent size capacity is around ₹2,000 crore.

While Century Textiles' VFY division earned an Ebitda (earnings before interest, taxes, depreciation, and amortisation) of ₹185 crore in FY17 — indicating margins of 19 per cent — on a larger capacity base (25,000 TPA), Grasim can grow it better, say analysts. Grasim's VFY division generated an Ebitda of ₹208 crore in FY17 — a margin of 28 per cent.

Further, even at current levels of profitability, the deal would be earnings-accretive. Analysts at Kotak Institutional Equities estimate incremental earnings' contribution of ₹1.3 per share, after factoring the current profitability, and adjusting for loss of interest, as well as amortisation of one-time royalty payment.

Given land constraints at the existing plant in Veraval, Gujarat, which is limiting Grasim's ability to expand, analysts say the arrangement provides an exciting inorganic growth opportunity in the high-margin VFY business, with strong cash flows for the next 15 years.

This inorganic opportunity complements Grasim's organic expansions. Grasim is growing its VSF and chemical capacities too. While the VSF capacity (45 per cent of standalone revenues) will increase by 12 per cent through de-bottlenecking over the next two years, the chemicals segment (26 per cent of standalone revenues) will also see capacities expand by a third through FY19.

Analysts at IIFL say they expect the VSF volume growth to accelerate to seven per cent over the next two years, against 3/2 per cent in FY17/H1FY18. Though VSF prices might remain volatile due to an increase in cotton production during 2017-18, China's environmental regulations reducing its output by 10 per cent during winters will provide respite.

Meanwhile, caustic soda prices, too, are up 16 per cent year-on-year on supply constraints — lower China and US production.

All these will drive Grasim's growth at standalone level. Analysts peg net profit/Ebitda for Grasim's consolidated business growing at 20-31 per cent annually between FY18 and FY20, led by improvement in key business segments. This can result in the 'holding company' discount reducing, say analysts. Target prices of ₹1,300-1,400 (IIFL and Kotak) indicate decent upside for the stock (up 2.2 per cent after the deal) priced at ₹1,141 levels.

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