Orient Refractories Ltd (NSE Code: ORIENTREF) – Alpha/Alpha + stock recommendation for Jan'14

Content Index

Company Snapshot (As on 1st Jan'14)

Current Market Price – Rs 42.10

Dividend yield – 2.38%

BSE Code – 534076

NSE Code – ORIENTREF

Market capitalization – Rs 505 cr.

Total Equity shares – 12.01 cr.

Face Value – Rs 1.00

52 Weeks High/Low – Rs 45.90/ Rs 22.75

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM
	Before De-merger				Post De-merger		
Income from operations	170.16	211.76	219.14	270.74	300.42	359.85	364.08
Gross Profit					129.10	161.51	164.11
Gross Profit margin (%)					42.97%	44.88%	45.08%
Operating Profit					48.38	65.13	68.63
Operating Profit margin (%)					16.10%	18.10%	18.85%
Other Income					4.31	2.04	3.07
Depreciation					2.97	3.79	3.92
EBIT	24.90	40.06	46.18	44.04	49.72	63.38	67.78
EBIT Margin (%)	14.63%	18.92%	21.07%	16.27%	16.55%	17.61%	18.62%
Interest cost					3.88	1.94	1.39
Profit Before tax					45.84	61.44	66.39
Profit before tax margin (%)					15.04%	16.98%	18.08%
Tax expense					15.03	20.05	21.90
Net Profit					30.81	41.39	44.49
Cash flows from operations					28.62	36.42	
Return on Avg. equity					41.05%	40.43%	34.76%

Dear Members,

It's not very often that we get stocks of well-managed companies promoted by MNCs at say a PE of 10 or dividend yield of 2-3%.

Market usually attributes higher valuations to stocks of well managed MNCs as these are in general professionally managed firms with clean corporate governance practices. There are exceptions, but at the moment we are not going to delve much into the same.

Orient Refractories (ORL) is another MNC promoted company which at the moment seems to be trading at reasonable valuations considering the promoter backing and the operating performance.

Orient Refractories Ltd – An Introduction

Orient Refractories manufactures a wide range of Refractory and Monolithic products for the iron and steel industry and its clients include large domestic integrated steel producers and mini steel plants such as Steel Authority of India, Mukund Steel, Tata Iron and Steel Company, RINL – Vizag, Sunflag Iron, Lloyd Steel, Usha Martin and the Jindal Group.

ORL also deploys a large number of refractory specialists on site with customers in order to develop individual complete solutions and provide total refractory management services. The Company has an in-house research and development facility that is recognized by the Government of India.

ORL got listed recently as it entered into a Scheme of Arrangement with Orient Abrasives Limited (OAL) and their respective shareholders for demerger of the refractory business of OAL into Orient Refractories Ltd. The demerger was carried out in Nov'11 and the stock got listed on 9th Mar'12.

Soon thereafter, there was a change in management and shareholding control in the company. In Mar'13, Mr. S G Rajgarhia and other ex-promoters of the company sold their

43.62% stake in the company to Dutch US Holding B.V. at Rs 43/- per share and the latter also acquired another 26% equity shares from public shareholders through open offer.

As on date Dutch US Holding B.V. holds 69.62% equity in the company. It is important to note here that Dutch US Holding B.V. is promoted by RHI AG.

RHI AG is an Austrian company specializing in producing heat-resistant refractory products for the steel, cement, glass, lime and non-ferrous metals industries. It is the largest manufacturer of refractory products with close to 1.8 billion Euros in annual sales.

Thus, the acquisition by Dutch US Holding makes Orient Refractories a part of the largest and probably the best managed refractory products manufacturer.

RHI AG and its strategy 2020

Before we proceed with other details on ORL, it's important to know more about RHI AG, being the promoter with 69.62% stake in ORL.

RHI AG is a Vienna-based Austrian company with focus on production, sale and installation of high-grade refractory products for the steel, cement, glass, lime and non-ferrous metals industries.

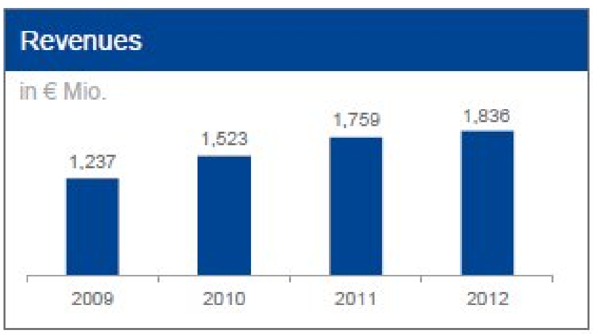
The company has an annual production capacity of 2 million tonnes of refractory products, making it the largest company in the world in this field of activity. The company employs around 8,400 people in 33 locations in 14 countries, and recorded revenues of EUR 1,835.7 million and EBIT of EUR 167.6 million in CY 2012.

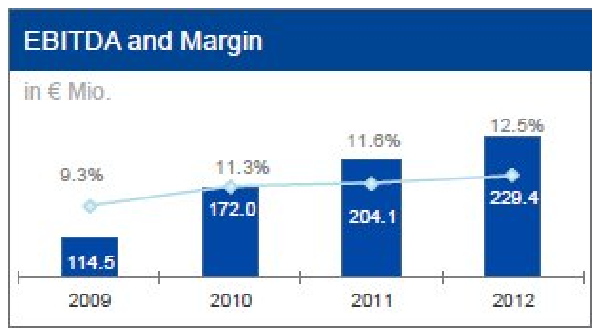
RHI focuses strongly on Research and Development and has more than 1,500 individual patents. The group has close relationship with international research institutes and universities and has more than 160 international experts in its global R&D team.

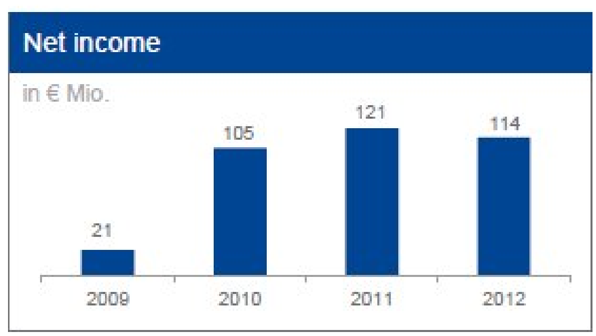
Magnesite and Dolomite are the key raw materials used in the production of refractory products and RHI has strategic mining assets for the two in various parts of the world.

RHI mines 1.3 million tonnes of magnesite and dolomite per year and 130,000 tonnes of magnesia per year from sea-water.

Financial performance of RHI and its strategy for 2020







As can be observed from the above illustration, for CY 2012 RHI reported revenues of EUR 1,836 million and emerging markets contributed 56% of the same.

As emerging markets (Asia, Middle East, Africa, South America, and CIS) have been recording faster pace of growth than the developed economies, RHI has set a target of 70% revenue contribution (up from 56%) from emerging markets by 2020.

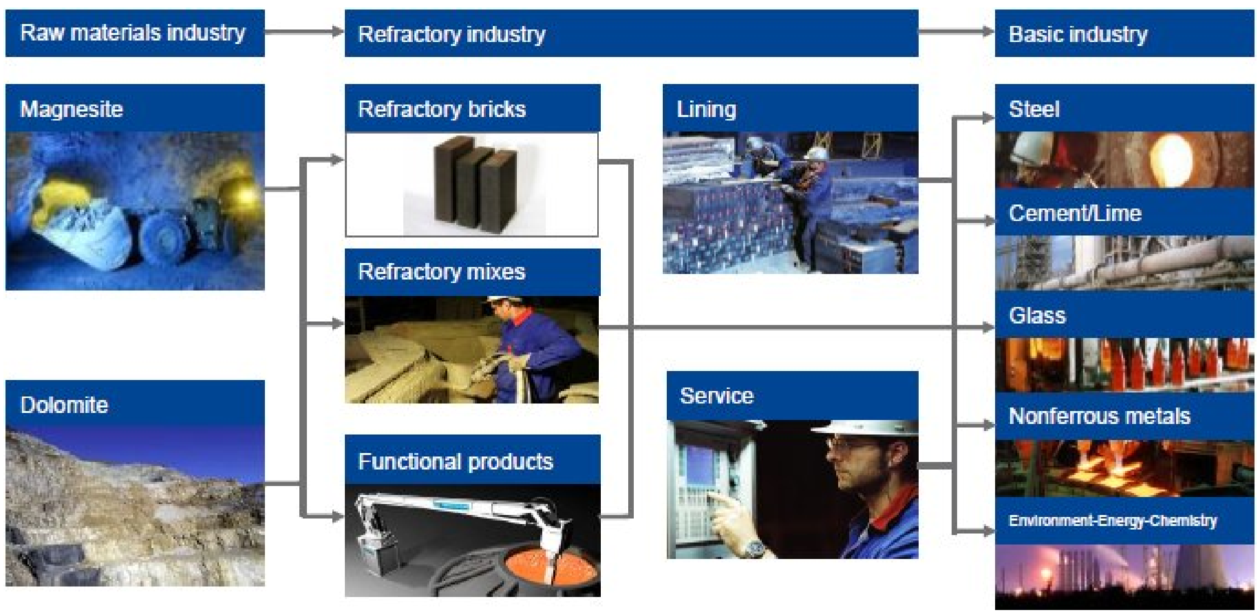
Further, at the group level, RHI is targeting revenue of EUR 3,000 million by 2020 with 80% self sufficiency of raw materials.

We believe, acquisition of ORL by RHI is in line with the latter's "Strategy 2020" of achieving EUR 3,000 million by 2020 with 70% revenue contribution from emerging markets.

Secondly, considering the strong operating performance and steady 15-18% growth across different time periods, we believe ORL can make a major contribution in the growth of RHI in the Asia Pacific region.

Refractory industry and its prospects in India

Refractory products are indispensable for the basic industries like Steel, Cement/Lime, Glass, and Non-ferrous metals. It is estimated that 75% of the refractories that are manufactured find application in the steel industry, 12% in the cement industry, 5-6% in non-ferrous industries, 3% in glass industry and balance in other industries.



Refractories are used either where high temperature or high rate of abrasion/corrosion/erosion is involved. Traditionally, refractories are made of naturally occurring minerals such as bauxite, kyanite, magnesite, fireclay, chrome ore etc. Lately, however, the industry has been using man-made raw materials such as brown-fused alumina, tabular alumina, fused magnesia, silicon carbide, magnesia alumina etc.

The Indian refractory industry enjoys domestic raw materials base. India has substantial reserves of high quality fireclay and Dolomite, refractory grade Bauxite, natural Magnesite, Chromite, Zircon and Sillimanite.

The future prospects of refractory business depend on the growth in steel industry which in turn is highly correlated with economic growth. The crude steel production in India has grown at a CAGR of 10% over the last decade. The long-term demand outlook for refractories remains favorable given the government's focus on infrastructure and economic development. However, the business would remain susceptible to downturn in general economic activity and steel sector in particular which is the key consuming sector.

Trends and developments in Steel sector

Year	Crude Steel		
	Capacity(mt)	Production(mt)	Capacity utilization (%)
2007-08	59.85	53.86	90
2008-09	66.34	58.44	88
2009-10	75.00	65.84	88
2010-11***	80.36	70.67	88
2011-12*	89.29	73.79	83

Year	Total Finished Steel (alloy + non-alloy) (million tonnes or mt)			
	Production for sale	Import	Export	Real Consumption
2007-08	56.08	7.03	5.08	52.13
2008-09	57.16	5.84	4.44	52.35
2009-10	60.62	7.38	3.25	59.34
2010-11**	68.62	6.66	3.64	66.42
2011-12*	73.42	6.83	4.04	70.92

1. India continues to remain the 4th largest producer of crude steel in the world as against the 8th position in 2003 and is expected to become the 2nd largest producer of crude steel soon.

2. The per capita steel consumption has risen from 38 kgs in 2005-06 to 59 kgs in 2011-12, however it is much lower than the world average of 217 kgs per capita and thus there's huge scope for growth of steel and allied sectors in India.

3. Capacity for crude steel production expanded from 51.17 million tonnes per annum (mtpa) in 2005-06 to 89.29 mtpa in 2011-12.

4. Crude steel production grew at 8% annually [Compounded Annual Growth Rate (CAGR)] from 46.46 million tonnes in 2005-06 to 73.79 million tonnes in 2011-12.

5. Production for sale of finished steel stood at 73.42 million tonnes during 2011-12 as against 46.57 million tonnes in 2005-06, an average annual CAGR growth of 7.9%.

6. Real Consumption of finished steel has grown at a CAGR of 9.4% during the last six years

Projection Of Steel Production Vis A Vis Requirement of Refractories During 12th Five Year Plan

	2012-13	2013-14	2014-15	2015-16	2016-17
Projected Crude Steel Production (Million Tonnes)	85.90	94.50	104.00	114.50	125.90
Refractory Consumption per tonne of steel (Kg/T CS)	15	15	15	15	15
Projected Refractory Consumption (Tonnes)	1288500	1417500	1560000	1717500	1888500

Estimated requirement of refractories during the 12th Five Year Plan is based on the projected demand for iron and steel and the norm of average consumption of 15 kg of refractories per tonne of steel. This norm has been adopted in consultation with the Refractory Division of SAIL and Indian Refractory Makers Association (IRMA).

As per the above estimates, production of refractories has to be geared up to 1.89 million tonnes by 2016-17 to meet the requirement of refractories derived on the basis of projected steel production. The domestic industry already has the capacity to meet the incremental demand for common refractories. This will support the industry to raise its capacity utilization and also turn more profitable with that.

Imports will be mostly in the high technology and sophisticated product categories with the basic products to be supplied by the domestic industry.

Orient Refractories – Performance Snapshot

Orient Refractories has a very good track record and it's not just for the past few years, it extends over the last 10 years and even more. What is good about the performance is the consistency in growth and the control on margins even during the periods of slowdown.

Particulars (in cr.)	FY 02	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM
	Before De-merger										Post De-merger		
Income from Operations	48.49	60.58	73.91	92.40	108.17	126.24	170.16	211.76	219.14	270.74	300.42	359.85	364.08
Gross profit											129.1	161.51	164.11
Gross profit margin (%)											42.97%	44.88%	45.08%
Operating Profit											48.38	65.13	68.63
Operating Profit Margin (%)											16.10%	18.10%	18.85%
Other Income											4.31	2.04	3.07
Depreciation											2.97	3.79	3.92
EBIT	4.03	7.90	13.49	15.09	16.68	16.75	24.90	40.06	46.18	44.04	49.72	63.38	67.78
EBIT Margin (%)	8.31%	13.04%	18.25%	16.33%	15.42%	13.27%	14.63%	18.92%	21.07%	16.27%	16.55%	17.61%	18.62%
Interest Cost											3.88	1.94	1.39
Profit Before Tax											45.84	61.44	66.39
PBT margin (%)											15.04%	16.98%	18.08%
Tax expense											15.03	20.05	21.9
Profit After Tax											30.81	41.39	44.49
Cash flows from Operations											28.62	36.42	
Return on Net worth (RONW)											41.05%	40.43%	34.76%

There are some important points about the performance of Orient Refractories and those are as below:

- Prior to FY 12, ORL was a part of Orient Abrasives and thus only Income from operations and EBIT is available.

- In the last 11 years, there has never been a drop in sales in any particular year and this is despite the fact that it serves Iron and Steel Industry which is highly cyclical.

- Similarly, in the last 11 years the EBIT has dropped only once (44.04 crore in FY 11 against 46.18 crore in FY 10) and that too marginally.

- For any 3 year cycle, the lowest revenue growth recorded by the company is 12% CAGR (FY 09-FY 12).

- Reasonably good gross margins of 43%-45% and has maintained its margins despite inflationary pressures and volatility in the prices of raw materials.

- Besides strong and steady growth, ORL has also done well on all other metrics such as cash flow generation, return on equity, margins etc. Excluding the impact of other income, the cash flows from operations are in line with the reported profits.

- As will be seen in the "Peer comparison" section, ORL has one of the best return ratios, margins and growth in comparison to its listed peers.

We believe, in order for shareholders to realize gains from their investments, it is important for the company to grow, however what is even more important is the quality of growth and Orient Refractories scores high on quality quotient.

Peer Comparison

Particulars	5 Yr Sales CAGR	10 Yr Sales CAGR	5 Yr EBIT CAGR	10 Yr EBIT CAGR
Orient Refractories	16.10%	19.50%	20.50%	23.15%
Vesuvius India	11.86%	18.10%	8.90%	13.75%
IFGL Refractories	12.20%	24.65%	(0.03%)	23.05%

EBIT Margins (%)	Mar'08	Mar'09	Mar'10	Mar' 11	Mar' 12	Mar' 13
Orient Refractories	14.63%	18.92%	21.07%	16.27%	16.55%	17.61%
IFGL Refractories	13.24%	7.55%	12.42%	7.40%	10.75%	7.34%
	Dec'07	**Dec'08**	**Dec'09**	**Dec'10**	**Dec'11**	**Dec'12**
Vesuvius India	16.80%	14.55%	15.61%	17.12%	15.58%	14.67%

Return on Net Worth (%)	Mar'12	Mar'13
Orient Refractories	41.05%	40.43%
IFGL Refractories	19.20%	12.21%
	Dec'11	**Dec'12**
Vesuvius India	18.53%	16.24%

As can be observed from the above illustrations, ORL has been the most consistent performer across all the operating parameters. The company's growth in sales and profits has been both consistent and higher across both 5 and 10 years segments, it commands higher margins in comparison to its peers and has delivered higher return on shareholder's funds.

Shareholding pattern

	Dec'13	Sep'13	Jun'13	May'13	Dec'12
Promoter and Promoter Group	**69.62%**	**69.62%**	**69.62%**	**69.62%**	**48.61%**
India					48.61%
Foreign	69.62%	69.62%	69.62%	69.62%	
Public	**30.38%**	**30.38%**	**30.38%**	**30.38%**	**51.39%**
Institutions	0.03%	0.18%	0.26%	0.37%	0.03%
FII	--	0.15%	0.22%	0.33%	--
DII	0.03%	0.03%	0.04%	0.04%	0.03%
Non-Institutions	30.35%	30.20%	30.12%	30.01%	51.36%
Bodies Corporate	5.21%	5.52%	5.61%	5.83%	11.11%
Custodians					
Total	**12,01,39,200**	**12,01,39,200**	**12,01,39,200**	**12,01,39,200**	**12,01,39,200**

From a passive investor's perspective it's important for the ones running the company to have high ownership as it aligns their interest in line with those of minority shareholders and in the case of Orient Refractories the promoters RHI own 69.62% equity stake in the company.

The new promoters acquired the stake at Rs 43/- per share which is also the current price of the stock.

Besides the promoters, Mr. Parmod Sagar, MD, holds 24,698 shares in the company and Mr. S. C. Sarin, Technical advisor, holds 255,427 shares in the company. What is good is that Mr. S. C. Sarin bought the entire quantity in Apr'13 around Rs 29-30 per share. As the two are involved in day-to-day operations of the company, their recent purchases are indicative of their confidence in the prospects of the company.

As on 30th Dec'13, the details of the major shareholders of the company and their stakes are as below:

Name of the shareholder	Category	% stake in Swaraj Engines
Dutch US Holding BV (RHI)	Promoter	69.62%
Gopal Rajgarhia	Public	4.99%
Shakuntala Devi Rajgarhia	Public	1.20%

Dividend Policy

Dividend Payout ratio						
	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13
Dividend Payout ratio					38.99%	29.02%

Prior to FY 12 ORL was a part of Orient Abrasives and therefore there is no specific and distinguishable dividend policy for the period before FY 12.

Since the de-merger, ORL has declared dividend twice, once under Rajgarhias, the erstwhile promoters and recently in Sep'13 under RHI.

As per the agreement between the erstwhile promoters (Rajgarhias) and RHI, the latter will continue paying **minimum Re 1/- per share dividend** as long as Mr. Gopal Rajgarhia continues to hold at least 4% stake in the company. As indicated in one of the illustrations above, Mr. Gopal Rajgarhia holds 4.99% stake in the company.

As ORL is highly profitable, debt free and since the cash flows from operations are good, we expect RHI to continue with a dividend payout policy of 25-30%.

Valuations

(Amounts in Rs. Lakhs)

	Particulars	As at 30 September (Unaudited) 2013	As at 31 March (Audited) 2013
A	**EQUITY AND LIABILITIES**		
1	**Shareholders' Funds**		
	(a) Share capital	1,201.39	1,201.39
	(b) Reserves and surplus	11,600.30	9,037.05
	Sub-total - Shareholders' funds	**12,801.69**	**10,238.44**
2	**Non-current liabilities**		
	(a) Deferred tax liabilities (net)	100.41	127.73
	(b) Other long-term liabilities	78.80	82.40
	(c) Long term provisions	117.22	103.36
	Sub-total - Non-current liabilities	**296.43**	**313.49**
3	**Current liabilities**		
	(a) Short term borrowings	426.74	502.26
	(b) Trade payables	5,063.80	4,358.94
	(c) Other current liabilities	1,201.21	187.48
	(d) Short term provisions	468.95	1,444.64
	Sub-total - Current liabilities	**7,160.70**	**6,493.32**
	TOTAL - EQUITY AND LIABILITIES	**20,258.82**	**17,045.25**
B	**ASSETS**		
1	**Non-current assets**		
	(a) Fixed assets	3,141.22	2,978.18
	(b) Non-current investments	0.57	0.57
	(c) Long term loans and advances	73.38	87.33
	(d) Other non-current assets	234.74	60.02
	Sub-total - Non-current assets	**3,449.91**	**3,126.10**
2	**Current assets**		
	(a) Current investments	1,905.02	600.36
	(b) Inventories	5,787.41	5,697.93
	(c) Trade receivables	7,689.73	7,151.63
	(d) Cash and bank balances	1,175.94	118.86
	(e) Short-term loans and advances	133.17	174.58
	(f) Other current assets	117.64	175.79
	Sub-total - Current assets	**16,808.91**	**13,919.15**
	TOTAL - ASSETS	**20,258.82**	**17,045.25**

Debt free on a net basis with surplus Cash and Cash equivalents (investments in various mutual fund schemes)

Before discussing valuations, let's recall all that we have learnt about Orient Refractories and the refractory industry in the above sections:

- Orient Refractories is now a part of RHI AG which is the leading company in the world in refractory products.
- RHI AG is aiming to increase the contribution of emerging markets in its overall revenue from 56% in CY 2012 to 70% in CY 2020.
- About 75% of the total refractories are consumed in the iron and steel industry. India's steel consumption has reported sluggish growth in the past 2-3 years, however at the same time it seems very likely that we may have bottomed out in terms of deceleration in growth. India's steel consumption growth is expected to accelerate to 8-9% on the back of urbanization and surging infrastructure investment and refractory industry will be direct beneficiary of the same.
- Per capita steel consumption in India is 59 kgs against the world average of 217 kgs.
- Imports constitute ~25% of the Indian refractory industry, wherein a majority of imports is from China. Continuous rupee depreciation against USD is expected to increase the cost of imports thereby increasing domestic demand from players like ORL.
- Strong and consistent operating performance of ORL in terms of growth, margins, return on equity, cash flow generation.
- Debt free with surplus cash to the tune of ~6% of the current market cap.
- Experienced promoters and strong management team with their interests directly aligned with those of minority shareholders.

Despite all the above, at around current price of 42-44 the stock is available at 11 times trailing twelve months (TTM) earnings and ~9.75 times 1 year forward earnings. Vesuvius India is currently trading at 13 times trailing twelve months earnings.

Considering the quality of operations, majority shareholding of RHI and the long term prospects of the industry, we believe there's scope for re-rating of the stock to 14-15 times trailing earnings.

Risks & Concerns

- ORL is a manufacturer of refractories and its products find application in iron and steel industry. Underperformance in the steel industry will have direct impact on the demand of refractories, thus affecting the company.

- Raw materials constitute a major chunk (55-60%) of the total expenses. Substantial increase in raw material cost can impact the profitability of the company as refractory manufacturers don't have very strong bargaining power with their customers.

- The specific consumption of refractories has gone down from 30 kg per tonne of steel about 20 years to 13-15 kg on average for the steel industry as a whole. Further reduction in consumption tonne will be detrimental to the growth of refractory industry and ORL.

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