Equity Research

November 22, 2020
BSE Sensex: 43882

ICICI Securities Limited is the author and distributor of this report

Company update and TP change

Consumer care ingredients

Target price: Rs2,298

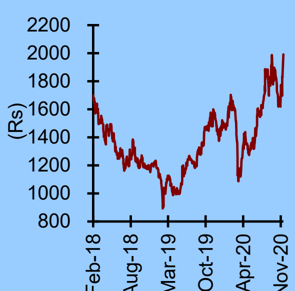
Target price revision
Rs2,298 from Rs2,133

Shareholding pattern

	Mar '20	Jun '20	Sep '20
Promoters	70.9	70.9	70.9
Institutional investors	16.9	16.7	16.6
MFs and others	12.8	12.8	12.9
FIs / Banks	0.0	0.0	0.0
Insurance	0.4	0.4	0.2
FIIs	3.7	3.5	3.5
Others	12.2	12.4	12.5

Source: BSE India

Price chart



Research Analysts:

Sanjesh Jain
sanjesh.jain@icicisecurities.com
+91 22 6637 7153

Sameer Pardikar
sameer.pardikar@icicisecurities.com
+91 22 2277 7637

INDIA

Galaxy Surfactants

BUY
Maintained

EBITDA/kg has an upside risk

Rs1,924

Galaxy Surfactants' gross profit/kg may grow at 2.3% CAGR over FY21-23E to Rs40.6 (6.2% CAGR over FY18-20) on rise in new-age ingredients. EBITDA/kg may rise at 6.3% CAGR to Rs19.6 during the same period (6.3% CAGR over FY18-20). However, H1FY21 performance indicates significant upside risk to our estimates as it has achieved EBITDA/kg of Rs18.4. Our estimates factor EBITDA and net profit growth of 16.6% and 19.4% CAGR, respectively, over FY21-23E, and ROIC reach to 22.4% (up 310bps since FY20) by FY23E. We believe Galaxy's valuations are reasonable at 22xFY22E and 19xFY23E EPS. We raise our target price to Rs2,298 (from Rs2,133) as we rollover our valuations to Sep'22. Maintain BUY.

- **What is driving higher gross profit/kg and EBITDA/kg for Galaxy?** Galaxy has seen its gross profit/kg and EBITDA/kg rise by 4.1% and 12.1% in H1FY21 (YoY) to Rs40.8 and Rs18.4, respectively. Many investors remain suspicious on improvement in profitability, which they believe may have benefited from higher lauryl alcohol prices. The company has denied any benefit from higher lauryl alcohol prices to gross profit. Nonetheless, we have analysed the sensitivity of the movement in lauryl alcohol prices to gross profit/kg since FY13; and we have not seen any relationship as verified by the company. Moreover, large FMCG companies are well-informed customers. These companies are unlikely to allow Galaxy make any transitional profit while they fight cost inflation.
  The analysis of specialty care contribution and gross profit/kg has shown strong relationship during the same period. During FY15-19, 100bps rise in specialty care contribution has added Rs0.8 to gross profit/kg and vice-a-versa. But in the past 18 months, gross profit/kg has improved despite fall in specialty care contribution; the company assigned the benefit from rise in contribution from new-age ingredients.
- **New-age ingredients have long runway for growth.** Preservatives and mild surfactants contributed 35% to specialty care and 13% total revenue for Galaxy in FY21. 1) Regulatory push and rising consumer awareness on paraben-free products (due to suspicion of paraben being carcinogenic) are driving higher demand for non-toxic preservative. Non-toxic preservative adoption has been rising in Europe due to regulatory push; but US and other developing countries may also follow soon; and 2) mild surfactants are sulphate free and have pH equal to skin. The demand for total surfactants is 10mn TPA of which SLES is ~4mn. The contribution of mild surfactants is just 5% of SLES and therefore, it has long runway for growth in next decade. We believe revenues from preservatives and mild surfactants will grow at 2x (15-18%) of Galaxy's growth in next decade.

Market Cap	Rs68bn/US$918mn
Bloomberg	GALSURF IN
Shares Outstanding (mn)	35.5
52-week Range (Rs)	1988/1086
Free Float (%)	29.1
FII (%)	3.5
Daily Volume (US$'000)	792
Absolute Return 3m (%)	4.4
Absolute Return 12m (%)	26.1
Sensex Return 3m (%)	15.1
Sensex Return 12m (%)	9.2

Year to March	FY20	FY21E	FY22E	FY23E
Revenue (Rs bn)	26.0	27.2	30.7	34.1
Net Income (Rs bn)	2.3	2.6	3.2	3.6
EPS (Rs)	65.0	72.0	88.9	102.6
% Chg YoY	20.6	10.7	23.5	15.5
P/E (x)	29.8	26.9	21.8	18.9
CEPS (Rs)	82.5	90.9	109.7	125.4
EV/E (x)	19.4	17.2	14.2	12.2
Dividend Yield (%)	0.7	0.7	1.1	1.6
RoCE pre-tax (%)	21.3	23.6	25.2	25.3
RoE (%)	23.7	21.8	22.7	22.2

- **Gross profit/kg and EBITDA/kg will grow at CAGR of 2.3% and 6.3% over FY21-23E.** Last three years' volume growth has suffered from weakness in AMET from currency depreciation in Egypt and Turkey, two key markets, and slowdown in India. We expect demand to normalise in AMET and India over the next two years on favourable base in FY21 due to Covid-19 pandemic. We are assuming volume to grow at 9% and 11% CAGR over FY21-23E in performance products and specialty care, respectively. Gross profit/kg may rise by 2.3% CAGR during the same period to Rs40.6 in FY23 (from Rs38.8 in FY21). This is in comparison to Rs40.8 in H1FY21, thus, we believe our estimates are conservative. We expect EBITDA/kg to grow at 6.3% CAGR over FY21-23E on flattish operating cost/kg, which should benefit from rise in plant utilisation.

Does higher lauryl alcohol price benefit gross profit/kg? – NO

Last three quarters have seen higher gross profit margins for Galaxy Surfactants, and there has been doubt among investors about its sustainability. The suspicion is on account of rising lauryl alcohol prices and inventory gains driving higher margins, which may not sustain. On the contrary, management in earnings call categorically denied any benefit from higher lauryl alcohol prices to gross profits.

Mr U.Shekar, CEO during Q1FY21 earnings call, 'we have said multiple times that we do not play on our raw materials. We always say we have an opportunity to pass it on and that is the reason, because if we were playing on our raw materials possibly then the range (read: EBITDA/te guidance) that we would have talked about will be some say Rs13k to Rs20k, but we have mentioned Rs15k to Rs17k'.

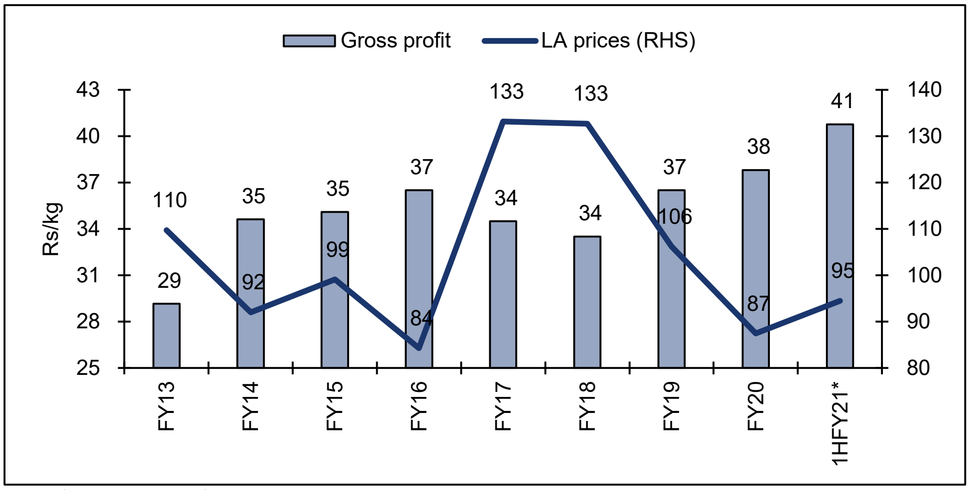
We have analysed historical behaviour of gross profit/kg from volatility in lauryl alcohol price. This is to see if there exists any relationship between lauryl alcohol prices movement and gross profit/kg.

We have analysed data from FY13 to H1FY21. We cannot see any relationship between movement in lauryl alcohol prices and gross profit/kg even in extreme volatility. For example: In FY17, lauryl alcohol price increased by sharp 58% from Rs84/kg in FY16 to Rs133/kg in FY17; however, during the same period gross profit/kg dipped 5.5% to Rs34/kg in FY17 (from Rs37/kg in FY16). On the contrary, in FY19 and FY20, lauryl alcohol prices dipped 20% and 18%, but gross profit/kg improved by 8.9% and 3.6%, respectively.

A significant portion of Galaxy's revenue comes from tier-1 customers who are well-informed on price moment of raw material. In inflationary scenario, they would be more agile to limit any gross profit margin pressure in their business. It is difficult to believe large FMCG companies will allow Galaxy to earn transitional profits in inflationary scenario. Nonetheless, one may argue of Galaxy benefiting from better pricing mechanism to tier-3 customers, but historical data does not suggest any such trend either. It is difficult to see why the situation will be very different this time.

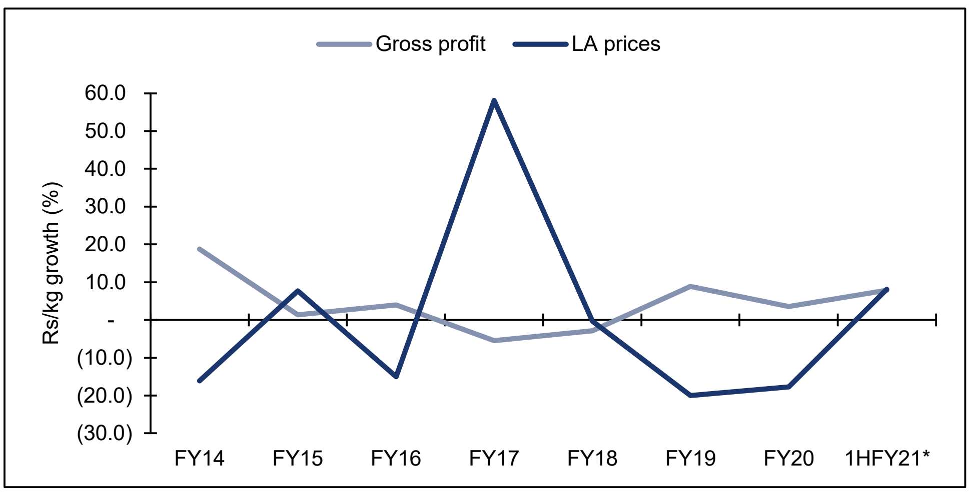
We understand a significant portion of performance products is sold on conversion basis and thus, the pricing is determined on formula basis, which is raw material cost plus conversion charges wherein raw material price is completely pass-through and does not have any bearing on gross profit/kg.

Chart 1: Empirical trends suggest no linkage between gross profit/kg and lauryl alcohol price movement



Note: *LA prices are for only till Aug'20
Source: Company data, I-Sec research

Chart 2: Even during extreme price rise like in FY17, gross profit/kg did not benefit

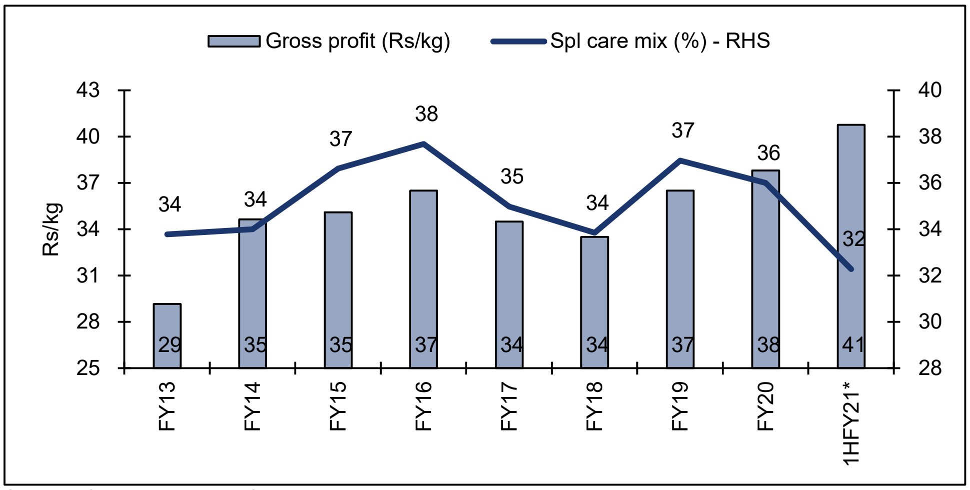


Note: *LA prices are for only till Aug'20
Source: Company data, I-Sec research

Does higher specialty care product mix benefit gross profit/kg? – YES, but has more facts to analyse

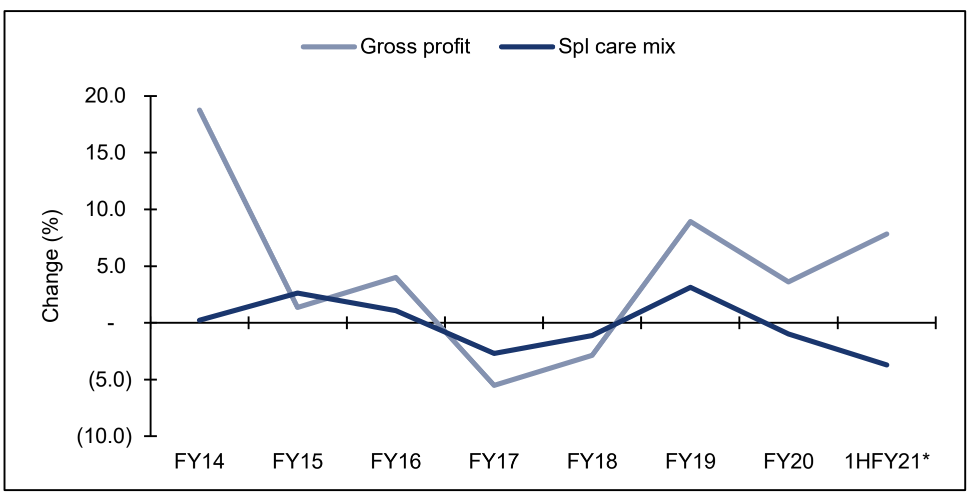
The historical trend does suggest rise in specialty care benefits gross profit/kg as these products earn better profitability compared to performance products. Nonetheless, sensitivity to gross profit/kg from 100bps increase in contribution of specialty has increased. During FY15-19, 100bps rise in specialty care had added Rs0.8 to gross profit/kg and vice-a-versa. This equation has changed in the past 18 months wherein despite a dip in specialty care contribution, gross profit/kg has shown improvement.

Chart 3: Empirical trend shows gross profit/kg benefits from rise in specialty care product mix and vice-a-versa…



Source: Company data, I-Sec research

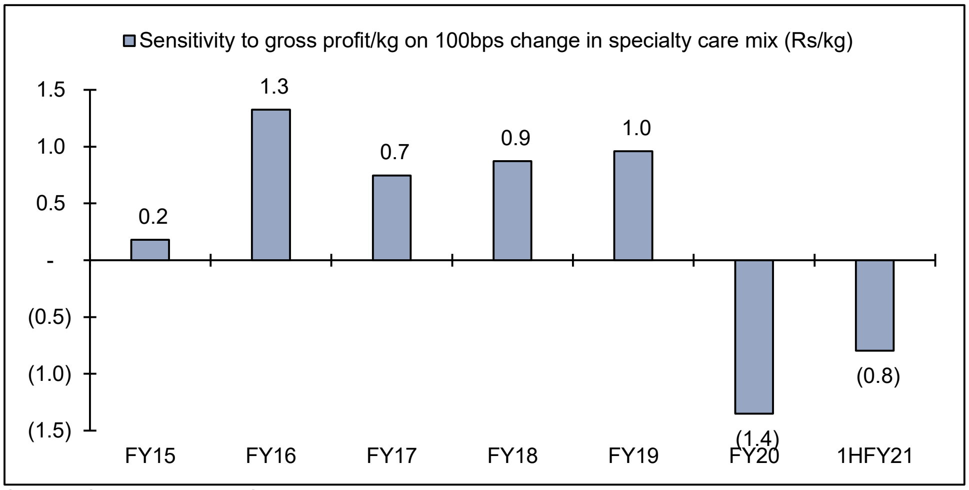
Chart 4: …however, in past 18 months gross profit/kg has shown improvement despite fall in specialty care mix



Source: Company data, I-Sec research

FY20 and H1FY21 negative number implies, despite dip in specialty care mix, the gross profit/kg has shown improvement

Chart 5: Before FY20, 100bps change in specialty care mix suggested average Rs0.8 impact on gross profit/kg



Source: Company data, I-Sec research

The relevant question is why gross profit/kg increased despite dip in specialty care mix during FY20 and H1FY21?

It could be due to the following reasons:

- Higher margins for performance products, particularly SLES, which we have established may not have changed much due to the nature of business model. It cannot be reasoned for rise in gross profit/kg.
- Better product mix in performance products. However, considering Egypt has been driving higher sales in performance products, we suspect any such favourable change may have occurred in the past 18 months
- **Better product mix in specialty care products. The company has highlighted two facts in past calls – 1) strong growth in phenoxyethanol due to higher demand from Europe which is seeing transition from paraben; and 2) success of new-age ingredients - non-toxic preservative blends and mild surfactants.**

Key points from FY20 annual report on specialty care

- Preservatives portfolio, which addresses the 'paraben free' trend, has grown from Rs200mn in 2008-09 to >Rs2.5bn in 2019-20. Mild surfactants, specialty ingredients, which address the 'sulphate free' trend, have become Rs1bn portfolio for Galaxy.
- Galaxy's new launches GLI 21 – unique patented green mild amino acid based surfactant (mildest of all) and galguard tetra, trident and NT range of paraben, chlorine & formaldehyde free non-toxic preservatives are products for future which shall find application in emerging categories of facial care, baby care, body wash, men's grooming, cosmetics, premium hair care and natural products – disruptive ingredients for the ever changing and dynamic home and personal care.

New age-ingredients have long runway for growth

Regulatory requirement and rising consumer awareness on mild and toxic free products will drive growth of these new-age ingredients in next decade.

- Europe has already implemented regulation to phase out the use of paraben for preservative as it is suspected to be carcinogenic.
- Further, we believe, other countries will also follow, and MNC FMCG companies, which operate across the globe, will start shifting to non-toxic preservatives soon.
- Similarly, mild surfactants, which have pH equal to skin and sulphate free, are in strong demand.
- Moreover, e-commerce enabled niche players with premium offerings are gaining traction globally.

Galaxy is well positioned to grab these emerging opportunities through its patent products in non-toxic preservatives (and blends) and strong no. 2 player in phenoxyethanol, and its green ultra-mild surfactant ingredients.

- Non-toxic preservative trend has just begun and we see US and other developing markets will follow soon. We believe rise in the use of phenoxyethanol in AMET and India market will benefit Galaxy more.
- Total surfactants market is over 10mn te; and SLES is ~4mn te. Mild surfactants should be approximately 5% of total SLES market.

Preservatives and mild surfactants contribute 35% to Galaxy's specialty care revenue; and 13% to total revenue. We see long runway for growth in new-age ingredients and likely rise in contribution for Galaxy. On conservative estimates, these new-age ingredients will grow at least 2x (15-18%) the growth of company for next decade.

Table 1: Galaxy's EBITDA/kg to grow at CAGR of 6.3% over FY21-23E

	FY18	FY19	FY20	CAGR (%)	FY21E	FY22E	FY23E	CAGR (%)
Volume (te)								
Performance pdts	1,30,596	1,35,337	1,43,521	4.8	1,57,873	1,73,660	1,87,553	9.0
Specialty care	66,833	79,374	80,716	9.9	77,891	87,238	95,962	11.0
Total	**1,97,429**	**2,14,711**	**2,24,237**	**6.6**	**2,35,764**	**2,60,898**	**2,83,515**	**9.7**
Revenues (Rs mn)								
Performance pdts	15,530	17,410	15,870	1.1	17,457	19,587	21,577	11.2
Specialty care	8,130	10,270	10,150	11.7	9,795	11,190	12,555	13.2
Total	**24,339**	**27,630**	**25,964**	**3.3**	**27,193**	**30,714**	**34,066**	**11.9**
Realisation/kg (Rs)	*122*	*127*	*114*	*(3.3)*	*114*	*116*	*119*	*2.1*
Gross profit	**6,828**	**8,149**	**8,811**	**13.6**	**9,500**	**10,730**	**11,901**	**11.9**
GP margin (%)	*28.1*	*29.5*	*33.9*		*34.9*	*34.9*	*34.9*	
GP/kg (Rs)	*33.5*	*36.5*	*37.8*	*6.2*	*38.8*	*39.7*	*40.6*	*2.3*
Operating cost								
Cost/kg (Rs)	*18.9*	*20.0*	*21.4*	*6.2*	*21.5*	*21.1*	*21.0*	*(1.0)*
EBITDA	**2,877**	**3,534**	**3,689**	**13.2**	**4,084**	**4,866**	**5,551**	**16.6**
EBITDA margin (%)	*11.8*	*12.8*	*14.2*		*15.0*	*15.8*	*16.3*	
EBITDA/kg (Rs)	*14.6*	*16.5*	*16.5*	*6.3*	*17.3*	*18.7*	*19.6*	*6.3*
Depreciation	485	512	622	13.2	669	738	810	10.0
EBIT	**2,392**	**3,022**	**3,067**	**13.2**	**3,415**	**4,128**	**4,741**	**17.8**
Net finance cost	204	253	179	(6.4)	101	26	5	(78.1)
Tax	607	859	584	(1.9)	762	952	1,099	20.1
ETR (%)	*27.8*	*31.0*	*20.2*		*23.0*	*23.2*	*23.2*	
PAT	**1,580**	**1,910**	**2,304**	**20.7**	**2,551**	**3,150**	**3,637**	**19.4**

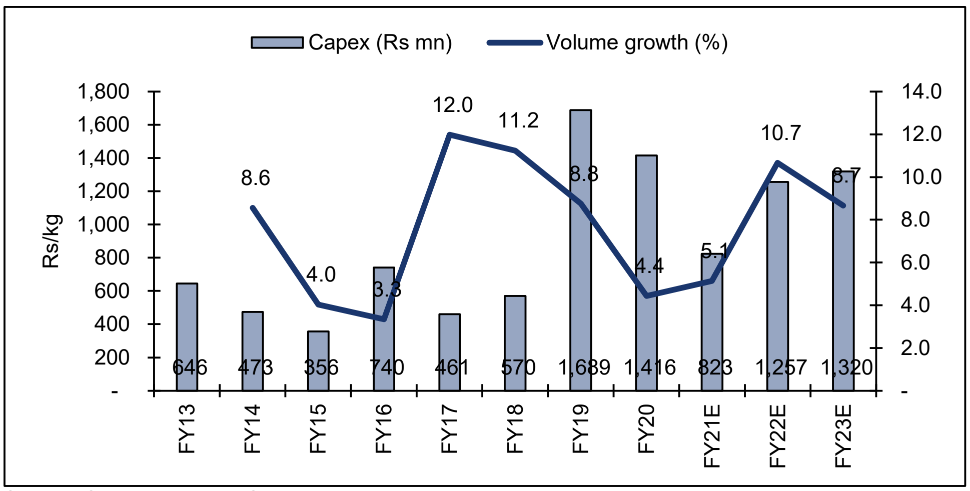
Source: Company data, I-Sec research

Capex at Rs1.2-Rs1.5bn indicates revenue growth of 10-12%

Company expects capex to remain at Rs1.2 to Rs1.5bn for at least next two years. This includes expansion of its R&D facility (Rs250mn) and maintenance capex of Rs300mn pa. Therefore, productive capex in next two years is Rs1.6bn to Rs2.2bn which at asset turnover of 4x can produce incremental revenue of Rs6bn to Rs8.5bn. We understand significant portion of capex will be in specialty care as the company has commissioned one additional sulphonation line in Egypt (50% capacity addition) and two lines in India in past 18 months. These capacities may take 3-4 years to reach peak utilisation and therefore, we do not see much capex for performance products in FY22 and FY23.

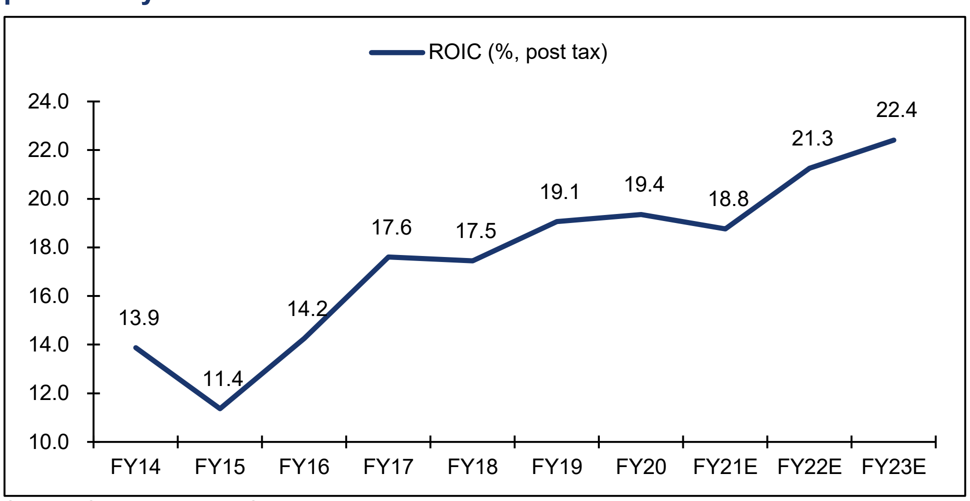
We understand the company is in the process of commissioning fresh capacities in new-age ingredients in Tarapur and Jhagadia. These expanded capacities should help Galaxy drive faster growth in new-age ingredients.

Chart 6: Capex to remain at Rs1.2-1.5bn which should give visibility of 10-12% revenue growth



Source: Company data, I-Sec research

Chart 7: ROIC should benefit from rise in specialty care which is driving higher profitability



Source: Company data, I-Sec research

Financial summary

Table 2: Profit & loss statement

(Rs mn, year ending March 31)

	FY20	FY21E	FY22E	FY23E
Operating Income (Sales)	**25,964**	**27,193**	**30,714**	**34,066**
Operating Expenses	**22,275**	**23,109**	**25,848**	**28,516**
EBITDA	**3,689**	**4,084**	**4,866**	**5,551**
% margins	*14.2*	*15.0*	*15.8*	*16.3*
Depreciation & Amortisation	622	669	738	810
Net Interest	238	163	91	73
Other Income	59	62	65	69
Recurring PBT	**2,888**	**3,314**	**4,102**	**4,736**
Add: Extraordinaries				
Less: Taxes	584	762	952	1,099
- Current tax				
- Deferred tax				
Less: Minority Interest				
Net Income (Reported)	**2,304**	**2,551**	**3,150**	**3,637**
Recurring Net Income	**2,304**	**2,551**	**3,150**	**3,637**

Source: Company data, I-Sec research

Table 3: Balance sheet

(Rs mn, year ending March 31)

	FY20	FY21E	FY22E	FY23E
Assets				
Total Current Assets	9,922	9,963	11,847	14,101
of which cash & cash eqv.	*545*	*142*	*754*	*1,797*
Total Current Liabilities & Provisions	3,242	3,395	3,835	4,254
Net Current Assets	**6,680**	**6,568**	**8,011**	**9,847**
Investments	**58**	**58**	**58**	**58**
of which Strategic/Group	-	-	-	-
Other Marketable	*58*	*58*	*58*	*58*
Net Fixed Assets	**8,138**	**8,292**	**8,811**	**9,321**
Goodwill				
Total Assets	**14,876**	**14,918**	**16,880**	**19,226**
Liabilities				
Borrowings	3,959	1,959	1,559	1,359
Deferred tax liability	240	240	240	240
Minority Interest				
Equity Share Capital	355	355	355	355
Face Value per share (Rs)	*10.0*	*10.0*	*10.0*	*10.0*
Reserves & Surplus	10,323	12,364	14,727	17,273
Net Worth	**10,678**	**12,719**	**15,081**	**17,627**
Total Liabilities	**14,876**	**14,918**	**16,880**	**19,226**

Source: Company data, I-Sec research

Table 4: Quarterly trend

(Rs mn, year ending March 31)

	Dec-19	Mar-20	Jun-20	Sep-20
Net sales	6,259	6,567	6,072	7,187
% growth (YoY)	*(7.9)*	*(3.7)*	*(8.7)*	*10.8*
EBITDA	821	1,026	905	1,215
Margin (%)	*13.1*	*15.6*	*14.9*	*16.9*
Other income	34	0	7	46
Add: Extraordinaries	-	-	-	-
Net profit	480	628	565	817

Source: Company data

Table 5: Cashflow statement

(Rs mn, year ending March 31)

	FY20	FY21E	FY22E	FY23E
Operating Cashflow	**3,049**	**3,322**	**3,914**	**4,452**
Working Capital Changes	113	(290)	(832)	(792)
Capital Commitments	(1,416)	(823)	(1,257)	(1,320)
Free Cashflow	**1,746**	**2,208**	**1,825**	**2,340**
Cashflow from Investing Activities	**(95)**	**62**	**65**	**69**
Issue of Share Capital	-	-	-	-
Inc (Dec) in Borrowings	562	(2,000)	(400)	(200)
Dividend paid & Others	(2,000)	(674)	(879)	(1,165)
Chg. in Cash & Bank balance	**213**	**(403)**	**612**	**1,044**

Source: Company data, I-Sec research

Table 6: Key ratios

(Year ending March 31)

	FY20	FY21E	FY22E	FY23E
Per Share Data (in Rs.)				
Recurring EPS	65.0	72.0	88.9	102.6
Reported EPS	65.0	72.0	88.9	102.6
Recurring Cash EPS	82.5	90.9	109.7	125.4
Dividend per share (DPS)	14.0	14.4	22.2	30.8
Book Value per share (BV)	301.2	358.8	425.4	497.2
Growth Ratios (%)				
Operating Income	(6.0)	4.7	13.0	10.9
EBITDA	4.4	10.7	19.1	14.1
Recurring Net Income	20.6	10.7	23.5	15.5
Diluted Recurring EPS	20.6	10.7	23.5	15.5
Diluted Recurring CEPS	20.8	10.1	20.7	14.4
Valuation Ratios (% YoY)				
P/E	29.8	26.9	21.8	18.9
P/CEPS	23.5	21.3	17.7	15.4
P/BV	6.4	5.4	4.6	3.9
EV / EBITDA	19.4	17.2	14.2	12.2
EV / Operating Income	2.8	2.6	2.3	2.0
EV / Operating FCF	43.5	30.9	36.6	28.2
Operating Ratios				
Other Income / PBT (%)	2.0	1.9	1.6	1.4
Effective Tax Rate (%)	20.2	23.0	23.2	23.2
NWC / Total Assets (%)	44.9	44.0	47.5	51.2
Inventory Turnover (days)	45.7	45.7	45.7	45.7
Receivables (days)	61.8	61.8	61.8	61.8
Payables (days)	38.4	38.4	38.4	38.4
Net Debt/EBITDA Ratio (x)	0.8	0.4	0.1	(0.1)
Capex % of sales	5.5	3.0	4.1	3.9
Profitability Ratios (%)				
Rec. Net Income Margins	8.9	9.4	10.3	10.7
RoCE (pre-tax)	21.3	23.6	25.2	25.3
RoIC	19.4	18.8	21.3	22.4
RoNW	23.7	21.8	22.7	22.2
Dividend Yield	0.7	0.7	1.1	1.6
Gross Margins	33.9	34.9	34.9	34.9
EBITDA Margins	14.2	15.0	15.8	16.3

Source: Company data, I-Sec research

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