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OMKAR SPECIALITY CHEMICALS LTD

September 09, 2011

BSE Code: 533317 **NSE Code:** OMKARCHEM **Reuters Code:** OMKS.BO **Bloomberg Code:** OSCL:IN

Omkar Speciality Chemicals Ltd. (OSCL) is a Mumbai based producer of speciality chemicals and pharma intermediates, catering to various industries like Pharmaceutical, Chemical, Glass, Cosmetics, Ceramic Pigments and Cattle & Poultry Feeds. With a strong customer base that includes Cipla, Ranbaxy, Glenmark, Dr Reddy's etc, the OSCL derives ~90% of its total revenue from the domestic market. It has basic research capabilities and has recently acquired M/S.Rishichem Research Ltd, as a wholly owned subsidiary to provide a total R&D back-up to the Company for all its future expansion and diversification programmes.

Investor's Rationale

- Omkar is a proxy play to Indian pharmaceuticals. It gratify to the demand of pharma intermediates of drug manufacturers and supplies specialty chemicals for varied end-user industries. The company is expected to witness firm growth backed by the end-user demand.

- Capacity expansion would ensure volume growth, OSCL is aggressively escalating its specialty chemical capacity to over 3,650mtpa by FY'13 from 950mtpa presently, as the latent demand is expected to remain robust on the back of strong growth expected in end user industries.

- The Company is moving on higher ladder with foray into API's with application in high growth end therapeutic markets like HIV & oncology. With intend to produce new molecules for API's, it has acquired 99.82% stake in Rishichem Research Ltd for ₹13 million in FY'10. We expect revenue realization from this segment from Q3FY'12E with higher margins.

- OSCL has successfully demonstrated its aptitude to grow, during Q1FY'12, the company's headline net profit has doubled to ₹40.2 million on yoy basis, on the back of over 90% growth in revenues to ₹425.6 million as against ₹224.2 million during the corresponding period last year. On sequential basis, revenue growth stood at 36% against ₹311.4 million and net profit grew by 34% from ₹29.97 million during Q4FY'11.

- OSCL's product portfolio comprise of more than 90 products and with new product introductions and operating leverage due to the ongoing capacity expansion, we expect net profits to grow at a CAGR of more than 50% over the next two years on the back of 45% CAGR growth expected in its top line.

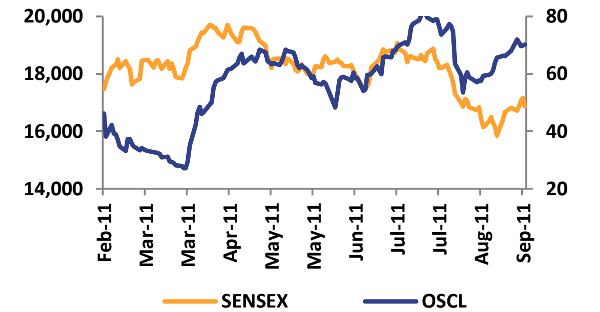
Market Data

Rating	**BUY**
CMP (₹)	70.15
Target (₹)	**90**
Potential Upside (%)	30
Duration	Mid-term
52 week H/L (₹)	101/26.6
All time High (₹)	101
Decline from 52WH (%)	30.9
Rise from 52WL (%)	43.6
Beta w.r.t. Sensex	1.0
Mkt. Cap (₹ mn)	1,138.4
Enterprise Val (₹ mn)	1,444.5

Fiscal Year Ended

	FY10A	FY11A	FY12E	FY13E
Revenue (₹mn)	683.5	1,067.6	1,601.4	2,242.0
Net Profit (₹mn)	95.7	101.4	169.0	238.0
Share Capital (₹mn)	115.3	196.3	196.3	196.3
EPS (₹)	8.3	5.2	8.6	12.1
PE (x)	8.5	13.6	8.1	5.8
P/BV (x)	5.1	1.5	1.3	1.1
EV/EBITDA (x)	6.1	6.7	4.7	3.7
ROE (%)	60.2	11.0	16.0	19.1
ROA (%)	30.9	10.8	14.5	15.9

Relative Price Chart

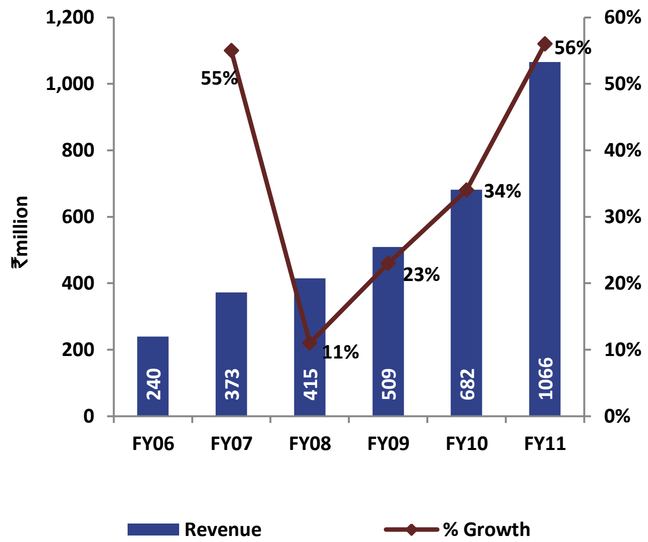


Shareholding Pattern	Jun'11	Mar'11	Diff.
Promoters	58.7%	58.7%	-
Institutional	11.1%	11.1%	-
General Public	18.1%	20.0%	(1.9)
Others	12.0%	10.2%	1.8

Robust Q1 FY'12 headline performance

OSCL reported strong headline Q1FY'12 numbers; the net sales grew by an impressive 90% to ₹425.6 million against ₹224.2 million during the corresponding period last year, backed by enhanced sales numbers and stable realization. Other income of the company increased 17 times from ₹0.4 million in Q1FY'11 to ₹6.8 million in Q1FY'12, resulting 92% growth in total income at ₹432.4 million. Though operating expenses grew significantly by 93% to ₹343.6 million, OSCL managed to double its EBIDTA to ₹56 million from ₹27.8 million last year. The consequential net profit stood at ₹40.2 million, resulting into an increase of 101%, as against ₹20.3 million in the corresponding period of the last fiscal year. Though rising input cost resulted in slight contraction on the operating margins by 40bps at 20.5% from 20.9% in the same period prior year, the net profit margins of the company improved 40bps to 9.3% from 8.9% in the corresponding quarter a year ago.

Exponential top-line growth expected

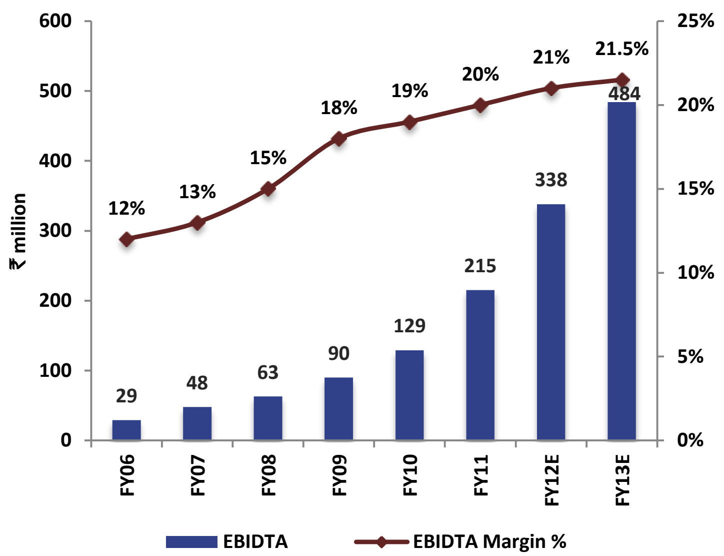


Diverse product array escorted the escalation

OSCL has an assorted product portfolio consisting of a mix of organic, inorganic and organo inorganic intermediates, with more than 90 products in these segments which can be broadly classified into iodine, selenium, molybdenum derivatives and others. It is a major player in iodine and selenium derivatives which alone contributed 88.23% of its gross sales for FY'10.

It is deriving majority of sales growth through manufacturing niche value-added organic and inorganic chemicals like selenium anhydride that finds its usage in the steroid manufacturing, 5-Iodo-2-Methyl Benzoic Acid which has application in anti-diabetic drug where it doesn't have competition. The company is also expanding its product portfolio into retroviral protease inhibitors (anti HIV) & oncology space through its Unit-IV. Further, it is increasing their product range through proposed capacity expansion which would help the company to move ahead in various segments like pharma, glass, cosmetics, ceramic pigments etc.

Stable operating margins expected



OSCL enjoys tenable revenue source on the back of strong clientele

OSCL derives major chunk of its revenue from domestic operation, with Cipla, Ranbaxy, Glenmark, Biocon and Dr Reddy's being its most vital customers in pharmaceuticals segment. Its other prominent customers in chemicals segment are Clariant-UK, Asahi India Glass. Suguna Poultry Farm Ltd. In the company has been able to uphold strong relation with its client by supplying products of highest quality. It is thus well positioned to take a leap into the domestic territory as a force to reckon with in the derivatives of iodine, molybdenum, selenium, cobalt and tartaric acid, which are primarily pharmaceutical intermediates. Thus, it gratify to the needs of the top three companies in the pharmaceutical industry, where turnover of each company exceeds ₹50 billion i.e. more than 10% size of the India's Pharmaceutical industry. With such strong customer base, the reputation and stature of being a specialty chemicals supplier has grown over the years, which will assist in deriving more crème level clientele.

Pharma intermediates and specialty chemicals– growth drivers

OSCL is serving the needs of the customers in two segments, namely pharma intermediates and specialty chemicals. The company excels in supplying products to both the segments which have stringent quality concerns, reflecting its significant supplier credibility. The company derives major chunk of its revenue from domestic pharmaceutical and chemicals companies, 70-75% of its revenues by supplying pharmaceutical intermediates and chemicals to the domestic pharma companies. In addition, the company manufactures and supplies specialty chemicals to various end user segments such as cattle and poultry feeds, glass industry, water treatment, paints, and electroplating etc. It has diversified its product base significantly in the last few years to over 90 products and is in the process of further expanding it. The company’s exposure to the pharmaceutical sector has been the major growth driver in the past and would likely to remain in the future.

End-user industry to boost the demand for Omkar products in coming years

OSCL products mainly cater to the pharma, glass, agrochemicals, poultry, paints and dyes, electroplating, textiles, cosmetics, ceramics, industry and so on.

The Indian pharmaceutical industry pegged at $19 billion in FY’09 and is expected to see strong traction grow at a CAGR of 18% over the next five years to reach $44 billion by FY’14. Majority of this growth is expected to be driven by bulk drug exports, which is expected to grow at five year CAGR of 21%. The overall formulations sales is expected to grow at a CAGR of 15% during the period.

The company derives 10% of its revenues from sale of chemical products to the manufacturers of tinted float glasses. The domestic float glass industry grew by 13% yoy in FY’11 on the back of rebounding economic growth post recession in FY’10 and is expected to grow further at a CAGR of 15-20% over the next three to four years, driven by growth in the construction and automobile sectors.

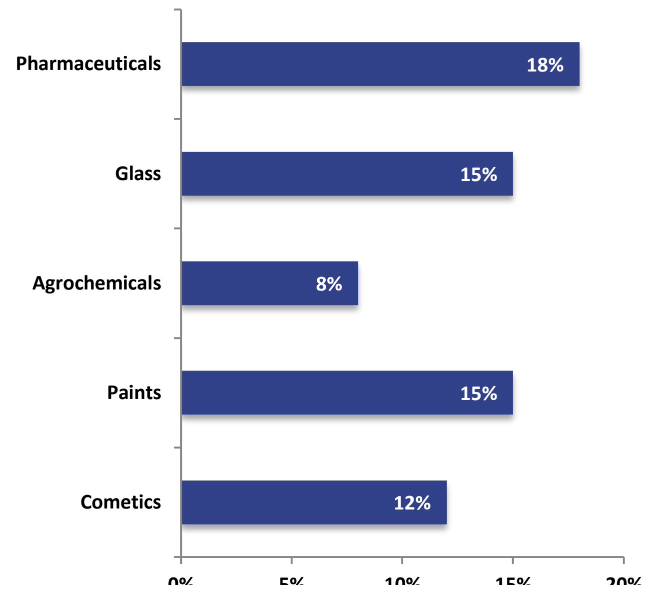
The Indian agrochemicals industry which is 2% of $83 billion domestic specialty chemicals market is expected grow at a rate of 8% over the next few years. Growth will largely be driven by consistently increasing food grain demand and growing exports.

The cattle and poultry feed contribute over 8% to the company’s revenue. It caters to some of the large domestic players in the industry, including Saguna poultry, Venky’s India etc. The domestic cattle and poultry feed is expected to see double digits growth in next few years.

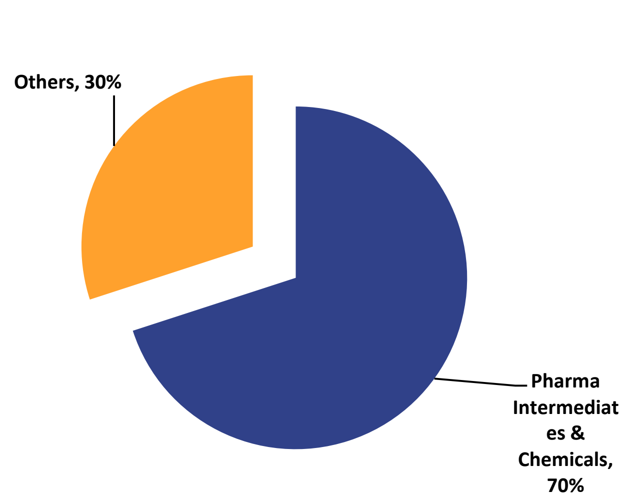
Moving on, cosmetics industry has been growing at a rate of 12% over the past 4-5 years and is expected to grow at a similar rate over the next 2-3 years.

Thus, the company is well poised in the market to cater the needs of the customers in diversified segments of the industry.

Expected growth rate of end user segments in the next 3-5 years



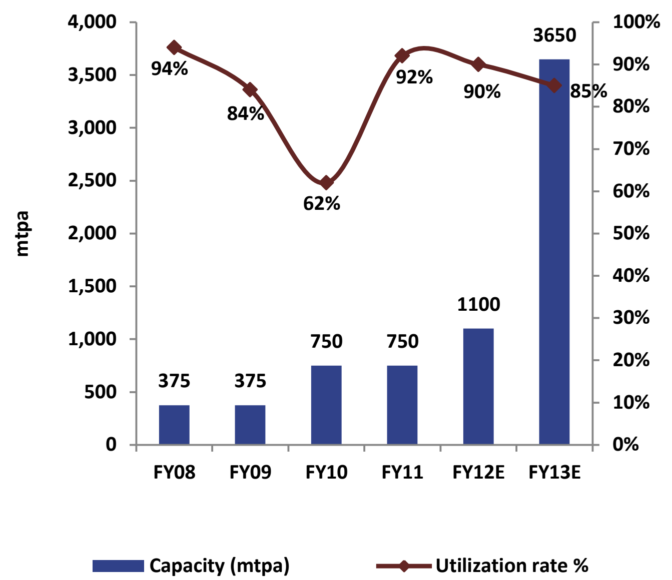
Industry-wise revenue concentration



Capacity expansion would ensure volume growth

OSCL is aggressively ramping up its capacity to over 3,650 mtpa by FY'13 from 950 mtpa currently, to cater to the increase demand expected form specialty chemical industry. The company intends to utilize over ₹700 million to ramp up its capacity. The company operates at utilization rate of 92% in FY'11, reflecting the strong demand for company's products, which is expected to drop to 84-86% post expansion. The domestic specialty chemicals industry is expected to grow at a CAGR of 5% over the next four years driven by strong demand from the end-user segments, which provides enough escalation opportunities for the companies like OSCL to catch on. Company currently has four units, Unit-I, Unit-II, Unit-III and Unit-IV at Badlapur, Thane.

Capacity expansion & utilization on path



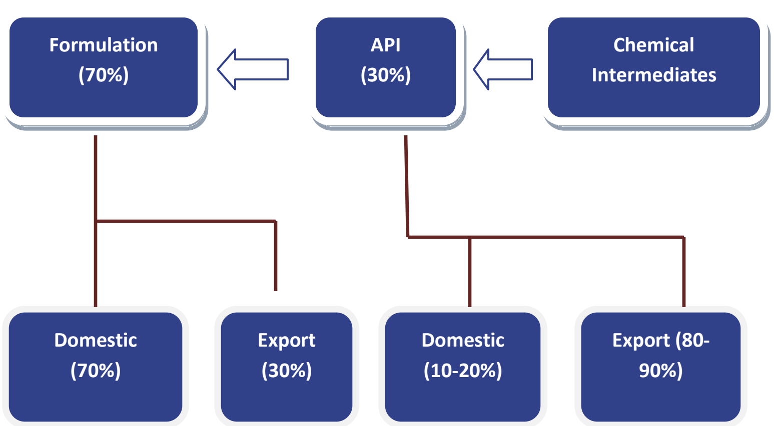
Venturing into API would ensure future growth

The company is venturing into the manufacturing of APIs with application in high growth end therapeutic markets like HIV & oncology. It is indigenously developing new chemical processes of manufacturing these products with an endeavour to make them cost effectual and environmental friendly. The company proposition is to setup a new plant in Maharashtra with the capacity of 1,250 MT for API's and its intermediates. It intends to manufacture new molecules with new technologies consisting of catalytic high-pressure reactions. Further OSCL will captively consume its pharmaceutical intermediates for manufacturing its indigenously developed API products. It will be a significant growth driver for the company as currently it is providing only intermediates and moving into API will provide higher value addition. The company is moving up the ladder with focus to cement its place in India pharmaceuticals industry.

Strong R&D to augment launches of new products

The company has enhanced their focus towards launching research driven chemical products. It is working to develop processes for manufacturing new high value added products and APIs. It has already entered into an MOU with a U.S. based firm for Collaborative Research for Development of Technologies for specialized products in the field of Anti-HIV molecules. OSCL has already developed about 4-5 molecules of niche nature in different therapeutic categories which would be launched during the year. Thus, innovation will give another benchmark to its niche folio and would drive growth.

Indian Pharmaceutical Industry



Risk Factors

- ### Major chunk of revenues come from Pharmaceutical Industry

  Around 70% of the company's revenue comes from pharma intermediates and rest from other industries. So, any slowdown in the industry due to newer regulations by domestic and global authorities or other factors can hinder the growth of the company, thereby impacting the earnings prospective of OSCL.

- ### Working Capital Intensive Business

  OSCL is into a working capital intensive business. Working Capital for FY'11 looks very high primarily due to IPO proceeds and advance given for new office premises.

- ### OSCL is in an investment phase, not FCF positive

  Being in an investment stage wherein the company is undergoing a fourfold increase in capacities, OSCL will not be free cash positive this fiscal. Also Iodine and Selenium compounds forms 87% of revenues of OSCL but we are not unduly concerned about this as it has a niche in this segment with no comparable peers.

- ### Revenue concentration among top 10 customers

  The sales to the top customer accounted to 14.6% of the total revenues as on FY'11. While sales to top 10 customers accounted for almost 60% of the revenues. The company also does not have any long term contracts with the customers. Any change in the buying pattern of the customers will have an adverse impact on its revenue. The company's earnings are sceptical to the earnings prospective of its clients.

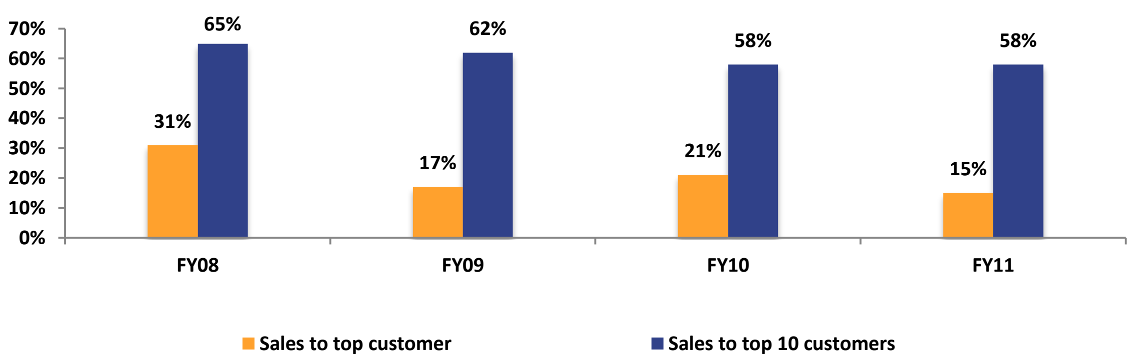
IPO proceeds to fund capacity expansion plan

The company went for public issue of ₹794 million in February this year to raise funds for capacity expansion and meeting working capital requirements. The total capital expenditure required for the planned expansion is expected to be close to ₹700 million. Also, funds raised from IPO proceeds has improved the debt-equity ratio to 0.49x in comparison to 1.7x in FY'10, which we believe will enable it to procure additional debt financing based on future requirement. The company is well poised to reap rich dividend from the escalation prospective available in Indian specialty chemicals industry backed by robust demand expected from end user industry.

IPO Proceeds

Details of proceeds usage	Amount (in ₹mn)
Setting up of Unit-IV manufacturing plant	322
Expansion of existing plants at Unit I, II, III	147
Working capital requirements	100
General corporate purpose	115
Total Net Proceeds	684

Revenue concentration among customers

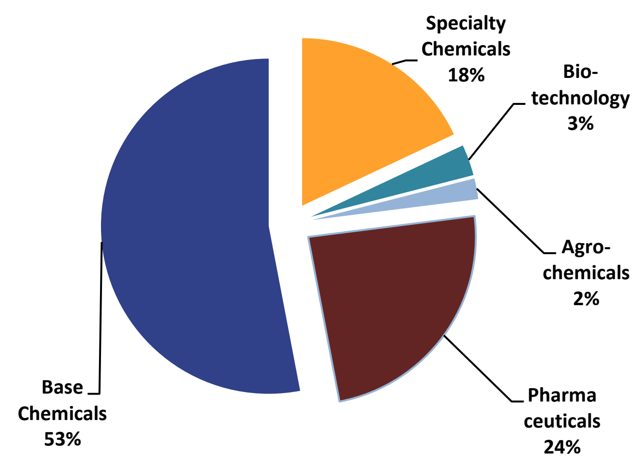


Indian Specialty Chemicals Industry

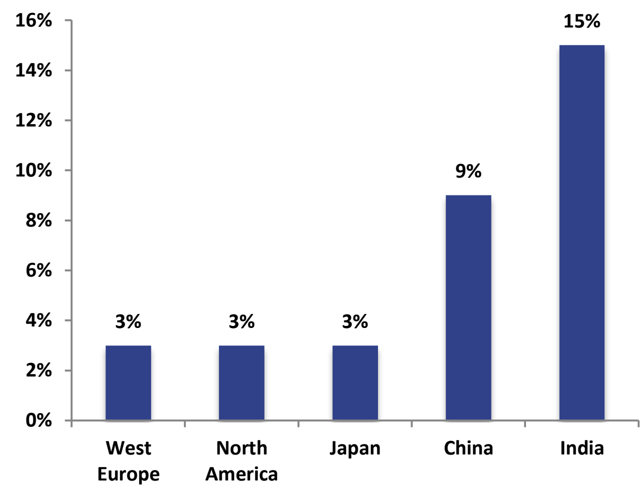
Size & Growth of the Industry

The chemical industry in India which is estimated to be US$83 billion is one of the most diversified and matured of all industrial sectors with thousands of commercial products. Speciality chemicals is generally described as a group of relatively high value, low volume chemicals known for their end user applications and catalyzing properties. In India, the industry is recording a rapid growth of approximate 15% y-o-y which includes fine chemicals, organic chemicals and pharmaceutical intermediates. The usage of specialty chemicals is found in multitude of industries like textiles, paints, inks, plastics, adhesives, flavours/fragrances and also in paper industry. Extensive applications are also found in construction, automotive, electronics and water treatments whereas Active Pharmaceutical Ingredients (APIs) constitutes the largest segment of the specialty chemical industry. Approximately 90% of the total APIs produced in India is exported to Europe, the US and Japan. The Indian Pharmaceutical sector is one of the major export revenue earners of Indian economy. For the five year period ending FY'10 the Indian Pharma exports have grown at a CAGR of 20.36% in rupee terms.

Overall Indian chemical market size - $83 billion



Growth rates of major chemical sectors



Strong demand for Generics & API's driving the growth for Pharma Intermediates

The Indian pharmaceutical industry (IPI) currently ranks 3rd in terms of volume of production (10% of global share) and 14th by value. IPI is expected to be ranked among the top 10 in the world in terms of scale, overtaking Brazil, Mexico, South Korea and Turkey. Over the next few years, generics will continue to dominate the market as the patent laws will provide an impetus to the launch of patent-protected products. Indian pharmaceutical industry is projected to show double-digit growth in near future owing to a rise in pharmaceutical outsourcing and rising investments by multinational companies.

API's are the key ingredients for making drugs and India's emergence as a hub for manufacturing of pharmaceuticals (APIs) has been the key driver for the growth in the specialty chemicals market. With the increase in outsourcing to India by MNCs, the exports market is expected to give another boost to the Indian API market. Some of the crucial pharma intermediates that are typically used in the pharma industry are Iodine derivates, Selenium derivatives, Bismuth derivatives and Tungsten derivatives apart from many others. Iodine is currently produced in 9 countries including Chile, US, Japan. Chilean companies control more than half of world's nominal capacity and around 66% of global production while Japan produces around 29% and the US produces the remaining 5%. The current world market is approx. 30,300 tpa and is growing 6% y-o-y given strong demand in emerging markets and continual demand of new uses.

Balance Sheet (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Share Capital	115.3	196.3	196.3	196.3
Reserve and surplus	43.5	726.1	861.3	1,051.7
Net Worth	158.8	922.4	1,057.6	1,248.0
Loan funds	267.7	453.6	564.1	778.1
Deferred Tax Liability	4.3	6.5	9.0	14.0
Capital Employed	**430.8**	**1,382.4**	**1,630.7**	**2,040.1**
Gross fixed assets	183.9	233.3	355.1	1,097.7
Less: accumulated depreciation	27.9	27.9	53.9	103.3
Net Fixed assets	156.1	205.4	301.2	994.4
Capital Work in Progress	5.7	176.0	448.1	32.7
Investment	0.0	13.0	13.0	13.0
Net Current Assets	268.9	988.0	868.4	1,000.0
Capital Deployed	**430.8**	**1,382.4**	**1,630.7**	**2,040.1**

Profit & Loss Account (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Net Sales	**683.5**	**1,067.6**	**1,601.4**	**2,242.0**
Other income	2.7	5.3	7.4	7.9
Total Income	**686.1**	**1,072.9**	**1,608.8**	**2,249.9**
Expenses	511.5	858.3	1,269.9	1,764.4
EBITDA	**174.7**	**214.6**	**338.9**	**485.5**
EBITDA Margin %	*25.5*	*20.0*	*21.1*	*21.6*
Depreciation	18.5	19.1	26.0	49.4
EBIT	**156.2**	**195.6**	**312.9**	**436.1**
Interest	37.4	48.5	68.0	86.0
Profit Before Tax	**118.7**	**147.1**	**244.9**	**350.1**
Tax	23.1	45.7	75.9	112.0
Profit after Tax	**95.7**	**101.4**	**169.0**	**238.0**
NPM %	*13.9*	*9.4*	*10.5*	*10.6*

Key Ratios

	FY10A	FY11A	FY12E	FY13E
EBITDA Margin (%)	25.5	20.0	21.1	21.6
NPM (%)	13.9	9.4	10.5	10.6
ROCE (%)	36.3	14.1	19.2	21.4
ROE (%)	60.2	11.0	16.0	19.1
EPS (₹)	8.3	5.2	8.6	12.1
P/E (x)	8.5	13.6	8.1	5.8
BVPS	13.8	47.0	53.9	63.6
P/BVPS (x)	5.1	1.5	1.3	1.1
EV/Operating Income(x)	1.6	1.4	1.0	0.8
EV/EBITDA (x)	6.1	6.7	4.7	3.7
EV/EBIT (x)	6.9	7.4	5.1	4.1

Valuation

OSCL has reported strong financial performance in FY11 and would continue to grow at CAGR of 45% over the next 2-yrs (FY12E and FY13E) along with a CAGR of 50% in the net profits. The higher growth trajectory of the company will be supported by production boost from capacity expansion from 950mtpa to 3,650mtpa, along with robust demand for its products. Additionally, the larger product base along with huge growth in end-user industries will lift its future revenues. At the current market price of ₹70.15, we rate the stock as 'BUY', with a 1 year price objective of ₹90. Current market value of ₹70.15 implies a P/E of ~8.1x FY'12 EPS of ₹8.6 and 5.8x on FY'13E EPS of ₹12.1 respectively.

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