Mr. Sachin Gupta, Chief Rating Officer, CARE Ratings Ltd-Live Mint

Cement cos exit H1FY22 with low free cash flows

Harsha Jethmalani
harsha.j@livemint.com

The first half of a financial year is typically slow for cement companies. Volume growth and realizations are muted in the seasonally weak monsoon quarters. This time around things were different from usual. Sales growth was aided by pent-up demand as covid-related disruptions smoothed out, leading to a revival in the real estate sector. On the flipside, severe cost inflation kept margins under pressure. Consequently, the industry's free cash flow generation has taken a hit.

An analysis by IIFL Securities Ltd showed that free cash flows (FCFs) for cement companies under its coverage declined by around 78% year-on-year (y-o-y) to ₹2,150 crore in H1FY22. One of the reasons cited for this fall was working capital expansion against the backdrop of higher fuel prices.

Channel checks by various brokerages showed that the prices of domestic petroleum coke surged by around 90% y-o-y and by 22% sequentially in Q2FY22. Inflation in imported coal prices was steeper with nearly 150% y-o-y and 45% quarter-on-quarter (q-o-q) increase. It should be noted that many cement companies import their fuel requirements.

No wonder then that operating cash flows declined by around 36% y-o-y in H1FY22, owing to increase in working capital by ₹4,200 crore compared with a decrease in working capital by ₹2,000 crore in H1FY21, said the IIFL report. Of course, prices of some of these fuels have started to cool off, but their benefit would reflect with a lag.

Another factor driving down FCFs was the increase in capital expenditure by a slew of large cement manufacturers. "The FCF in H1FY22 is lower, given the significant increase in capex by UltraTech Cement (up 3.5 times y-o-y), Shree Cement (+134% y-o-y), Dalmia Bharat (+111% y-o-y) and ACC (+97% y-o-y), added the IIFL report.

In a post-earnings conference call, the management of Ultratech Cement Ltd said that the company's capacity expansion of around 20 mtpa will be commissioned in phases over FY22-23E. Mtpa is short for million tonnes per annum. Peer Shree Cement announced 6.5 mtpa capacity to be commissioned by FY25. ACC has 3 mtpa clinker line at Ametha and supporting grinding units across central and northern regions to be commissioned in CY22 and CY24 in phases.

"Most cement companies have reported that their capex plans are on track, albeit with a delay of two-three months in some cases due to covid-19. Overall, we are expecting the industry to add 80 million mt of capacity over FY21-24 against similar growth in incremental demand," analysts at Nirmal Bang Equities Ltd said in a report.

Also, some cement companies used higher free cash flows to pare debt and strengthen their balance sheets.

Meanwhile, the demand outlook for the cement sector remains robust, and is likely to be aided by the revival in the housing sector, which is a major contributor to cement demand. However, what remains to be seen is the sustainability of price hikes which have been recently announced across India. Dealers channel checks by various brokerages show that cement prices rose by 7-8% on average at an all-India level in October for one cement bag weighing 50 kg.

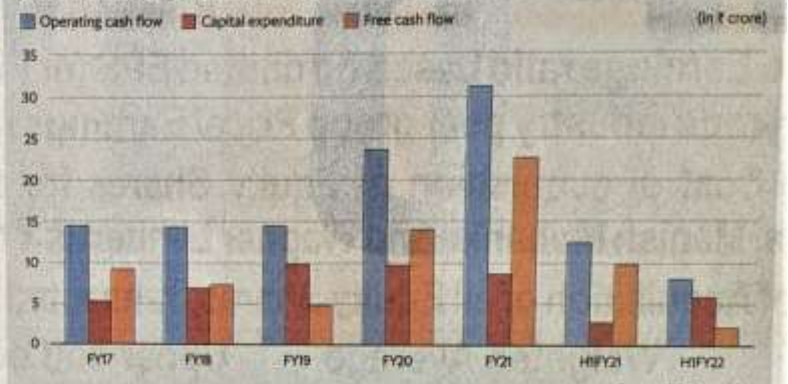
"Most cement companies have already announced a hike in October 2021. A full transmission of the increase in costs seems unlikely, though. We expect mid-teen growth in cement volumes in FY22 y-o-y basis. With demand momentum showing up for industry players they are doing expansions which are backed by strong balance sheets and healthy liquidity," said Sachin Gupta, chief rating officer, CARE Ratings Ltd.

"While free cash flows may be impacted due to margins contraction and ongoing capex, increase in volumes on y-o-y basis would counterbalance the impact to some extent," Gupta added. "Currently, we are seeing some respite in the input prices and raw material availability; still the trend in the movement of key raw material prices and ability of the industry to take further price hikes would be a monitorable."

In other words, movement in cement prices would be a primary factor that would determine the outlook for free cash flows for cement companies.

Weighing down

Higher operating costs and capital expenditure weighed on the free cash flows of cement companies in H1FY22.



Source: IIFL Securities

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LESS FREE

A reason cited for fall in free cash flows was working capital expansion amid a rise in fuel prices

ANOTHER factor driving down free cash flows is the increase in capital expenditure

SOME cement companies also used free cash flows to cut debt and to bolster balance sheets