Indian Paint Industry: Are the hues colourful enough?

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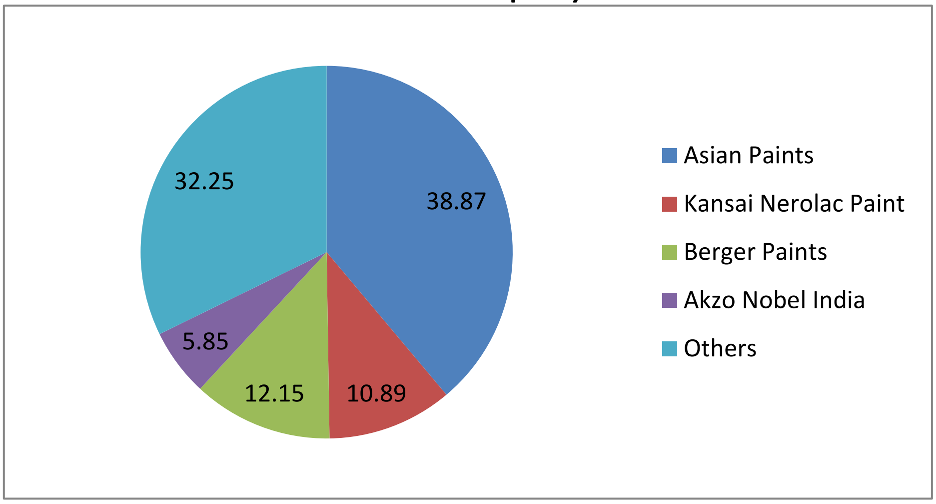
The Paints and Coatings Industry is one of the most heavily regulated industries in the world. The sector consists of manufacturers of paints, varnishes, lacquers, shellacs, stains and a variety of other specialty coatings. The Indian Paint Industry is estimated to be Rs.50,000 Crores industry.

Indian Paint sector is broadly classified into two main segments mainly - Decorative and Industrial. Decorative paints include exterior wall paints, interior wall paints, wood finishes, enamel and ancillary products such as primers, putties, etc. while Industrial paints include automotive coatings, powder coatings and protective coatings. The Decorative segment accounts for the majority of the Paint Industry's value which is around 75% and the Industrial segment accounts for the rest 25%. Of the two segments, the industrial paints segment mainly comprises organised players whereas the decorative paints segment involves unorganised players too as the decorative paints segment is not significantly dependent on technology compared to the industrial paints that involves higher technical know-how.

Till FY17, organised players had a market share of about 65%. However, post GST application, the organised players are recapturing market from unorganised players with share of organised players increasing to about 80% now. The top players in the organised sector are Asian Paints Limited (APL) Kansai Nerolac Paints Limited (Kansai), Berger Paints India Limited (Berger) (CARE A1+) and Akzo Nobel India Limited (Akzo) which together account for about 68% of the market share as depicted in the chart below:-

Chart 1: Market Share of Top Players for 2018-2019

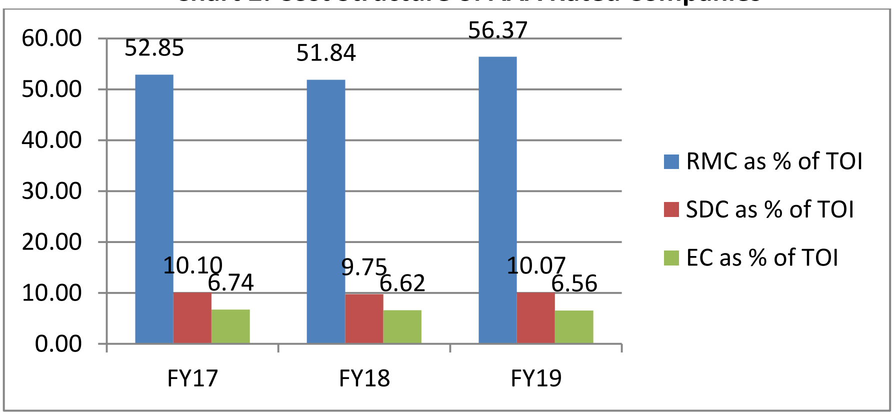


Source: CARE Ratings

Among the organised players, APL is a market leader in decorative paints segment while Kansai is a market leader in industrial paints segment. APL's success is mainly because of its supply chain management and better perceived product portfolio while Kansai is better in inventory management and R&D efforts.

Looking at the cost structure of large paint companies in the rated space, it is seen that three types of costs dominate the cost structure namely Raw Materials cost(RMC), Selling and Distribution cost(SDC) and Employee Cost(EC). The cost structure of three major players of the industry for last three years is depicted below (for our analysis, we have considered data of APL, Kansai and Berger which together form about 62% of market share and all of these are rated AAA. Akzo remains unrated due to low level of debt)

Chart 2: Cost Structure of AAA Rated Companies

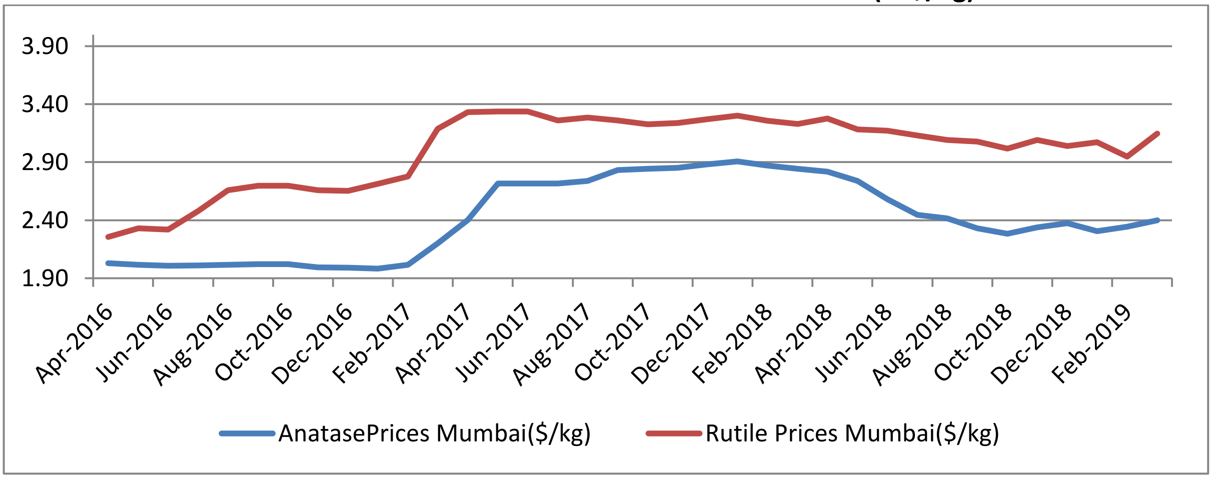


Source: CARE Ratings

The paints sector is raw material intensive, with over 300 raw materials involved in the manufacturing process. The raw materials majorly used are resins (binders), pigments, solvents and additives. One of the key pigments widely used is titanium dioxide (TiO2) which is mostly imported. This along with other raw materials like phthalic anhydride, pentaerythritol, methyl methacrylate, aromatics, etc, which act as binders, solvents and additives, are derivatives of crude oil. The above graph reflects a volatile trend in the raw materials cost as a percentage of total operating income over the previous three years which is mainly due to raw material price linkage with movement in crude oil prices as well as foreign exchange fluctuation. Given that input cost as a percentage of sales accounts for about 50-55%, it is inevitable that any price hikes in the mentioned commodities will have a major impact on the profitability and the resilience of paint and coatings companies.

Titanium dioxide pigment, forming around 25% of the total content of paint, is by far the most important material used by the paints industry due to its whiteness, opacity and refractive index ability i.e. its ability to bend and scatter light. It is commercially available in two forms- Anatase and Rutile. Of these two forms, Rutile TiO2 is more durable and stable and is also considered to be more efficient in scattering light; while anatase pigments (less durable in nature) are used mostly in cheap dispersion paints, self-cleaning paints and in road marking paints, application of rutile pigments is much broader and in practice covers all paint types. The following graph depicts the price movements of Anatase and Rutile over the past three years.

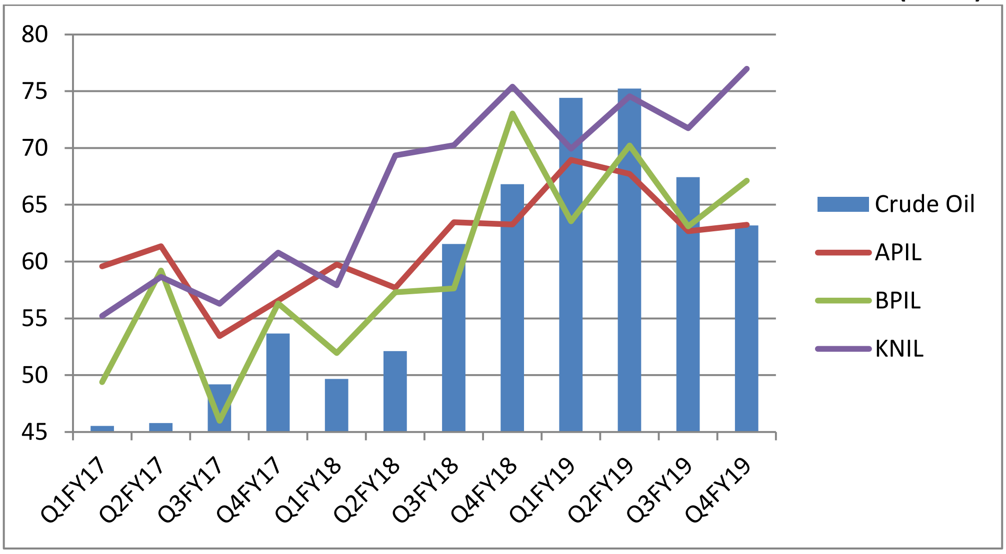
Chart 3: Anatase & Rutile Price Movements in India (in $/kg)



Source: CMIE

Further, it would be interesting to note the impact of movement in crude oil prices on RMC of paint companies. The following chart is depiction of how RMC as a percentage of Total Cost of Sales of three major players in the industry, namely APL, Kansai and Berger are moving with respect to the price movement of crude oil (Brent) in the past 3 years :-

Chart 4: Correlation between RMC as a % of Cost of Sales and Crude Oil (Brent)

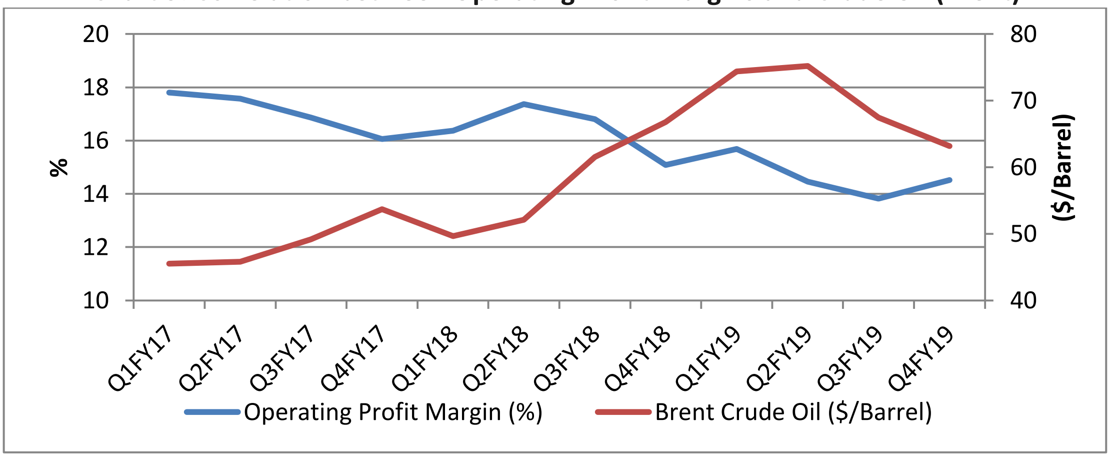


Source: CMIE & CARE Ratings

It can be observed that the RMC for all three companies have moved in tandem with crude oil prices. However, the movement in Kansai have been sharper as compared to the other two players which is probably owing to larger share of industrial paints in its product portfolio where crude derivative content in raw material is relatively higher.

Given that nearly 50% of raw materials used by paint companies are crude oil derivatives and account for about 30-35% of the total raw material cost of the sector, the volatile raw material costs pose a risk to the profitability of paint and coatings manufacturers. As can be seen in the graph below, there is negative correlation between Operating Profit Margins of major players in the industry and the price of Brent Crude Oil.

Chart 5: Correlation between Operating Profit Margins and Crude Oil (Brent)



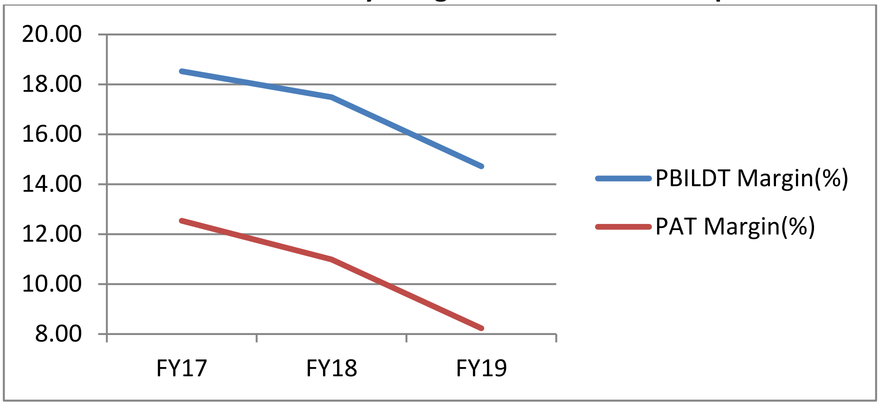
Source: CARE Ratings

Most of the large paint manufacturers, in a bid to offset the increasing costs announce price increase in paints but the same generally happens with a time lag. It has been observed that there is generally a lag of about a quarter when paint prices follow the movement in raw material prices.

Also there's a growing tendency among the paint companies to incline towards manufacturing water based paints which are less sensitive to movement in crude oil prices. Besides, the preference for these paints over solvent paints is also rising among customers because of ease to clean walls and increasing demand of these paints from building & construction and automotive sector owing to their good corrosion protection and high gloss properties, over other types. This has led to focus by most of the paint companies to consistently increase the share of water-based paints in their portfolio which is expected to aid margin growth in the long term. Having said that the demand for oil/solvent based paints will always remain, hence exposure to price fluctuations in crude oil cannot be eliminated completely.

The increase in RMC over the last three years has directly impacted the profitability of three major players of the industry which has been demonstrated below:-

Chart 6: Profitability Margins of AAA Rated Companies



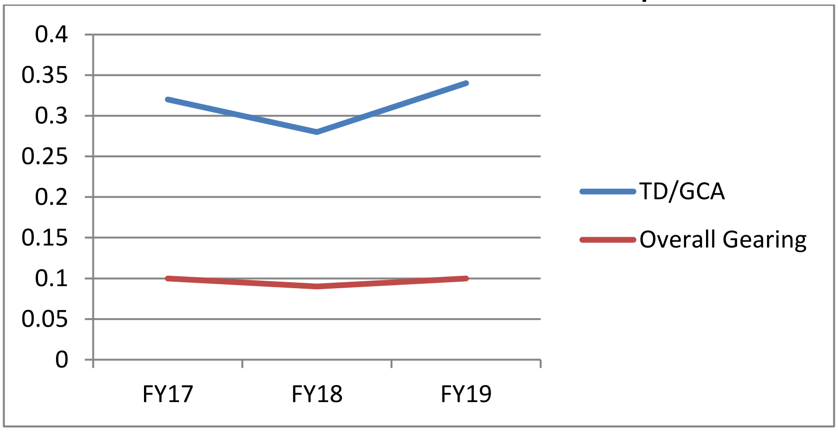
Source: CARE Ratings

The graph above shows that both PBILDT margin and PAT margin for the three companies under analysis have been declining y-o-y. The PBILDT margin has declined from 18.52% in FY17 to 14.71% in FY19 (decline of 381bps) and the PAT margin have deteriorated from 12.58% in FY17 to 8.26% in FY19 (decline of 432bps). The deterioration is primarily attributable to elevated input costs and adverse rupee movement. Further, the auto industry witnessed a slower growth of about 6.5% in sales (including PVs, CVs and two & three wheelers) vis-à-vis a double-digit growth of 14.5% during FY18 which has led to a fall in the demand of industrial paints. Although FY19 had not been that profitable for the industry but going forward government initiatives towards infrastructural development, schemes like Housing for All, reduction in GST from 28% to 18% on the paint industry is likely to boost the demand for paints. Besides, repainting, which constitutes about 70% of the total paint demand, is expected to provide support, as the repainting cycle has shortened from about 6-8 years earlier to about 3-3.5 years now. The future of this industry looks promising but it is highly dependent on stability of crude oil prices and Rupee-dollar movement.

While there has been considerable variation in credit profile of various small paint companies, the balance sheets of large players in organised segment who occupy major share of the market (top four players) reflect healthy liquidity and debt profile backed by decent profitability and cash accruals over the last few years. Though there is competition, these companies are successful in terms of total sales, market share, profitability, etc. while others are finding it difficult to withstand competition. The key factors that contribute to success in the sector are quality of the product, Supply Chain Management efficiency, managing of inventory & stock keeping units (retailers), cost management & competitiveness, brand image and effective advertisement. Accordingly, players who have invested extensively on these critical success factors reflect strong capitalisation, substantial amount of free cash invested in fixed deposits & mutual funds and relatively low level of gearing.

The graph below depicts the capital structure of the three major players under analysis. It is observed that while overall gearing ratio hovered in the range of 0.09-0.10 in the past three account closing dates, the Total Debt to Gross Cash Accrual ratio was satisfactory in the range of 0.28 to 0.34 between FY17 to FY19.

Chart 7: Debt Profile of AAA Rated Companies



Source: CARE Ratings

Outlook-

In FY19, the paint industry has expanded at the rate of 12% in volume terms and about 15% in value terms. Going forward, the growth shall be dependent on a number of factors like disposable income in the hands of public, urbanisation, economic development, regular monsoons, raw material prices, growth in the infrastructure and recovery in the real estate & automobile segment. In FY19, the volume of the paint industry continued to increase but factors like volatile crude oil prices, adverse forex movements, subdued real estate demand and dip in the sales of automobiles were some factors that weighed on the margins. As mentioned earlier, the future of this industry looks promising but it is highly dependent on stability of crude oil prices and Rupee. In the short run, profitability of paint companies may exhibit volatility due to volatility in crude oil price and subdued demand from user industry; however, over the longer term, economic sense is expected to prevail, supporting prices and profitability. Even in the short run when margins may be under pressure, large paint companies are likely to post a reasonable level of profits driven by rise in disposable income of the average middle class coupled with increasing investment on education, urbanization, development of the rural market, relatively low gearing (as a result of high cash accruals in the last few years), efficient cost management and launch of innovative products, like eco friendly, odour free, and dust & water resistant paints as a result of R & D efforts. Consequently, CARE believes that the credit profile of paint companies which invest in innovation, R & D and manage their inventory & supply chain efficiently are likely to enjoy an edge over others.

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