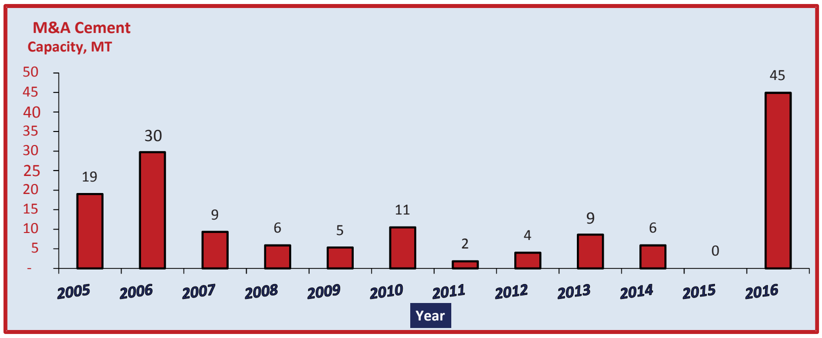
Acquiring to Grow

The Indian cement industry is likely to witness continued M&A activities, albeit on a smaller scale, with focus on strategic and operational competitive advantage.

India ranks second in the world in terms of both cement capacity (+430 million tonnes per annum) and consumption (~290 million tonnes). Cement plays a pivotal role in the construction sector, with the latter being an important constituent of GDP. With the Indian GDP forecast to grow at 7.5 per cent annually (IMF estimates) in the future, India is likely to consolidate its standing as an important cement player globally. Since 1939, there have been around 100 M&As in India, the latest major acquisitions being Reliance Cement by Birla Corp, Jaypee Cement by UltraTech and Lafarge India by Nirma Ltd.

M&A Activities since 2005 (Chart 1)



Important MNC Acquisitions

Holderbank (Holcim) was the first MNC to enter India in the 1990s through collaboration with Kalyanpur Cement, but the venture did not last very long.In 1999, Lafarge acquired Tata Steel's two cement plants in Jharkhand and Chhattisgarh; thereafter, it acquired Raymond's cement plant in Chhattisgarh. In 2000, Italcementi entered India by acquiring a stake in Zuari Cement. Thereafter in 2002, Italcementi acquired Sri Vishnu Cement. Holcim entered India in 2005/2006 by acquiring a stake in Ambuja Cement and ACC. In 2006, HeidelbergCement acquired Indorama Cement and Mysore Cement; recently, HeidelbergCement sold its stake in Indorama to JSW. In 2007, Cimpor acquired Shree Digvijay Cement; and in 2013, Votorantim Cimentos took over management control of this plant from Cimpor, during the division of Cimpor's assets between Camargo and Votorantim.

Vicat picked up capacity in India in two tranches: in 2008 by taking a stake in Sagar Cement and in 2010 by acquiring Bharathi Cement. Subsequently, through a JV with Sagar Cement, Vicat set up a greenfield capacity in Gulbarga, Karnataka. The balance stake was acquired by Vicat from Sagar Cement in 2014. In 2008, CRH acquired a 50 per cent stake in MyHome Industries, which had two plants. In 2013, CRH, through its JV partner, MyHome Industries, acquired Shree Jayajothi Cement (refer to Chart 1).

MNCs in India, including Lafarge, hold almost 100 million tonnes per annum (mtpa) capacity out of the +430 mtpa total capacity, translating into almost one-fourth capacity share. Unlike in many developing countries, MNC presence in India is significant. In the past 12 years, around 35 per cent of the current capacity has changed hands (refer to Table 1).

India going overseas

Some Indian cement companies have also extended operations overseas. Binani has a presence in China and Dubai, JK Cement has set up a cement plant in the UAE. UltraTech has acquired ETA Star Cement and has cement plants in the UAE, Bahrain and Bangladesh.

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Valuation

Recent M&As have taken place in the range of $110-145 per tonne of cement capacity. This translates to $150-200 per tonne OPC equivalent; whereas the replacement cost is around $120-125 per tonne OPC equivalent. A premium is paid for reduction in gestation period and immediate cash flow generation. However, there have been a few exceptions when a higher valuation has been paid by the buyer due to various strategic reasons, like entry of an MNC in India, availability of substantial additional limestone reserves for brownfield expansion, etc.

Rationale for M&A

Each M&A has its own strategic rationale. Some of them may include:

Make vs Buy: Nowadays, setting up a greenfield plant takes five-seven years considering mining auctions, land acquisition, environment clearance, construction time, etc. M&A shortens this period to less than a year and the revenues stream also starts immediately. By buying out a company, the acquiring company also acquires additional market share and an established distribution network.

Cross-border entry for future organic growth: In India, some companies like Vicat, CRH, Italcementi, etc., first adopted the route of acquiring a joint stake in a cement company so as to learn the rules of the game in the market of this complex country. Later, they gradually increased their stake or set up greenfield projects.

Overcapacity leading to undervalued deals: Being cyclical, the cement business witnesses a low phase every decade or so. During the trough, capacity utilisations are low and some companies with inadequate cash flows find it difficult to sustain operations. This offers an opportunity to players with a strong balance sheet to buy out these players at lucrative valuations, thereby expanding capacity, increasing geographic reach and gaining market share.

Synergy with existing operations, cost leadership, etc.: Acquiring a plant offers a competitive advantage to the acquiring company by way of access to additional limestone, blending material sources, technical knowledge, standalone grinding unit near strategic markets and blending material sources, etc. Cases in point are some of the smaller sized M&As that have taken place in recent years. The acquiring companies have plans to optimally utilise the additional limestone reserves to set up brownfield capacities and/or move clinker to the acquired grinding unit in order to increase the clinker capacity utilisation.

Shifts in market dynamics: In periods of increasing demand, limited capacity, and delays in setting up greenfield plants, M&As allow companies to gain momentum quickly.

Exiting business at the appropriate time: From the sellers' perspective, in times of high valuation, it's good business sense to sell cement assets at a good price; particularly if the acquiring company finds high synergy with its existing operations.

Inability to service high debt: Companies like Jaypee, under duress due to their inability to service debt, also take this route to lesser their burden. The only drawback is that in such cases, they may receive a lower value due to distressed sale.

M&A of similar category of players: At times, like the Lafarge-Holcim deal, companies merge in order to create substantial synergy in terms of geographic presence, market share and retain their price positioning; thereby increasing their EBIDTA leading to an increase in ROCE. The only caveat is that a marriage of divergent practices and work cultures, if not delicately handled, may lead to lower returns, thereby negating the objective of the merger.

Diversification into a growing market: Cement companies often geographically diversify to reduce their business risk. Plants in south India are examining the possibility of setting up operations in east/central/ north India where the capacity utilisations are much higher. An M&A in such a scenario usually results in higher EBIDTA/ ROCE for the new combined entity.

Market consolidation leading to stable policies: Highly fragmented markets with unstable policies create chaos in the market. Consolidation is seen to be a way out to create operational synergy, stabilise the market and build stakeholders' confidence.

M&As arising out of divestments mandated by the Competition Commission: The divestment of Lafarge India's assets to Nirma was driven by the Competition Commission, directing LafargeHolcim to divest its holdings in Lafarge India. This offers others an opportunity to pick up divested assets. It is similar to that happening abroad for Heidelberg-Italcementi. However, some implicit government-related policies also act as a deterrent for MNCs to acquire companies in India.

All the M&A rationale are only effective if the end result accrues higher returns to shareholder wealth.

Pitfalls of M&As

Low valuation for sellers during a downturn business cycle phase: While cement companies take the selling route to reduce their debt burden, the buyer is advantaged by receiving a low price from a desperate seller. This leads to a valuation lower than "replacement cost" of a new plant. The seller is left with little capital gain as most of the money received is used to pay back the debt, eroding the seller's shareholder value.

High price for buyer who in course of time cannot recover the investment cost: Acquisitions at a high valuation of say $200 per tonne of OPC equivalent may result in inorganic growth and increase in market share, but the present value of future cash flow often indicates a negative return. This ends up with a negative/low ROE, thereby not justifying the investment. One of the ways out of this is to set up additional brownfield capacities at marginal capex and thereby contribute to increase in shareholders' wealth.

Entrepreneur's vision at any cost: Entrepreneurs often use their vision of the future to expand their business. Vision plays an important role in strategic decision-making that managers sometimes miss out on while evaluating the riskier side of the different aspects of the opportunities for further growth. In the absence of adequate due diligence and analysis to examine synergy between both the companies' operations, the new entity becomes a burden like a white elephant.

Maintaining brand positioning: At times, a player with a lower price positioning acquires a company commanding high brand equity. This makes maintaining brand position of the acquired company a challenge; any loss in brand equity often leads to reduction of price being commanded and thereby the returns of the combined entity suffer.

High limestone transfer rate: Often, the seller claims higher limestone reserves than what is proven. This leads to the acquiring company paying high limestone transfer fee (Rs 64 per tonne) to the government, which in turn makes the M&A deal expensive.

Table 1: Some of the significant M&As have been as follows:

Year	Acquirer	Target	Cement Capacity (MT)
1998	Lafarge	TISCO Cement	2.0
1998/99	India Cements	Raasi & Sri Vishnu	2.4
2001	Lafarge	Raymond Limited	2.2
2001	Italcementi	Zuari (50:50 JV)	2.0
2002	Zuari	Sri Vishnu	1.0
2004	Grasim	L&T	16.5
2005	Holcim	ACC	19.0
2006	Holcim	Gujarat Ambuja & Ambuja Eastern	18.0
2006	Jaypee	UP Cement Corporation	2.6
2006	Heidelberg	Indorama, Mysore Cement	2.9
2007	Cimpor	Shri Digvijay	1.0
2007	Sakshi	Raghuram Cement	5.0
2008	CRH	My Home (50:50 JV)	3.2
2008	Vicat	Sagar	2.5
2009	JSW	Gayatri Cement	4.5
2010	Vicat	Bharathi Cement	5.0
2010	Dalmia	OCL	5.4
2011	Jaypee	Andhra Cement	1.2
2012	Dalmia	Calcom & Adhunik Cement	3.6
2013	UltraTech	Jaypee Gujarat	4.8
2013	My Home-CRH	Sree Jayajothi Cements	3.2
2013	JSW	Heidelberg (Raigad)	0.6
2014	Dalmia	Jaypee (Bokaro)	2.1
2014	Chettinad Cement	Anjani Cement	1.2
2014	Shree Cement	Jaypee (Panipat)	1.5
2014	Sagar Cement	BMM Cement	1.0
2016	Birla Corp	Reliance	5.0
2016	UltraTech	Jaypee	21.2
2016	Nirma	Lafarge	11.0
2016	Heidelberg	Italcementi	7.8

Crystal ball gazing

In the next four-five years, around 30 mtpa of capacity is envisaged to change hands. The total investment in the cement sector during this period is estimated to be $11-13 billion; out of this, investment in new capacity additions is around $6-7 billion, de-bottlenecking around $1-1.5 billion and M&As around $3.5-4.5 billion.

Some of the future drivers of M&A in the Indian cement sector are likely to be as follows:

- Fragmented and underutilised capacity in Andhra Pradesh, Telangana and the north-east: this

(This article has been authored by Jagdeep Verma, Head-Business Consulting, Holtec Consulting, India).

may prompt players with deep pockets to acquire additional capacities at lower valuations.

- External drivers like M&A activities beyond Indian shores may have a secondary impact in India. For e.g., the Heidelberg-Italcementi merger abroad may make the combined entity in India more active in scouting for growth through acquisitions in India.
- MNCs in India with insignificant cement capacity would likely expand their capacity share, particularly given the robust demand envisaged in the next decade.
- New international players planning to enter India may initially use the M&A route.

It is interesting to note that in 2016, India has seen 45 mtpa capacity transferred through M&As: UltraTech-Jaypee (21.2 mtpa); Birla-Reliance (5 mtpa); Nirma-Lafarge (11 mtpa); Heidelberg-Italcementi (7.8 mtpa). This almost equals the capacity of many mid-sized countries.

Future possibilities

With a Herfindahl Index (HI Index) of 0.07 (Holtec's analysis), India stands vulnerable with respect to market fragmentation. With the HI Index varying from 0.06 to 0.24 in the five regions of India, south India is seen to be most vulnerable to M&As, followed by the north-east. In order to command a dominant position, companies may consolidate in a particular region in order to become the dominant player in that geography.

PE firms are also envisaged to fund local players with low EBIDTA/DSCR and make supernormal returns in the up-cycle that is expected in the next three-five years. In the next few years, capacity utilisations are estimated to surpass 85 per cent along with prices increasing by 5-6 per cent pa, leading to a healthy increase in the EBIDTA per MT of capacity.

Given dwindling limestone resources in some plants, some players may acquire nearby cash-strapped plants in order to augment their resources and also set up additional brownfield capacities.

With utilisation of blending material (fly ash and slag) gaining importance, large thermal power plants and steel plants are envisaged to vertically diversify into cement and thus a new category of players is expected to enter the cement industry.

The coming years are likely to continue to witness M&A activities, albeit on a smaller scale, with focus on strategic and operational competitive advantage. ICR