## Investment memo – Apcotex Industries    Date: 5/01/2024

| | | | |
|---|---|---|---|
| Mcap (in mn) | 26,127 | Share O/S (mn) | 52 |
| Promoter Shareholding | 58% | Price(Rs) | 504 |
| Pre-tax ROCE (%) | 28 | Trailing P/E (TTM) | 37 |

We like Apcotex as:

1) It has strong competitive positioning in its existing businesses:
    a. It is the market leader in India in the SB latex business (~45% of sales). Market is consolidated with Apcotex and BASF India, having ~85-90% market share.
    b. It is the only player manufacturing in India, in rest of its portfolio comprising of HSR, nitrile rubber and nitrile latex, with rest of the market being serviced through imports.
2) In our view, business has strong entry barriers as it requires: a) consistent R&D investments and b) strong technical service, as products are not created as per a 'chemical formula' but as per end-use applications, of diverse set of clients. Hence, the business can deliver sustainable growth and return metrics in the long term.
3) We see a lot of potential to grow. Near term growth would be led by capex of ~Rs2 bn (peak sales potential of Rs6-7 bn) which commissioned in FY24. Longer term growth would require investments into R&D to enter into new or higher-end product applications of existing chemistries. Given the track record on that front, we believe the company can continue to deliver growth in sales at a CAGR of ~15% in the long term; profits should grow at a higher rate (next 3 years) as EBITDA margins have scope to normalise (~15% versus ~11% as of 2Q24).

In our view, the company is poised for delivering ~20% CAGR returns in the next 3-5 years, in line with growth in earnings.

**Company profile**

- Apcotex is the leader in emulsion polymerisation space in India. It was established in 1980, as a division of Asian Paints; Choksey family (one of the founders of Asian Paints) is the promoter of this company. Mr. Atul Choksey (ex-MD of Asian Paints from 1984 to 1997) is the non-executive chairman of the company. In 1991, it was de-merged from Asian Paints and listed on the stock exchange. Mr. Abhiraj Choksey (Bachelor of Science in Economics from Wharton Business School and Bachelor of Science in Engineering, University of Pennsylvania, Age 45 years), Mr. Atul Choksey' son, joined the company in 2005 and became the MD in 2010.
- After becoming MD, Abhiraj took the following steps, which proved pivotal in turning around the long-term trajectory of the company.
    - Beefed up R&D by getting competent people from outside.
    - Better R&D solved quality issues in existing products apart from expanding the portfolio.
    - Strengthened business development team; export sales were beefed up.
    - Acquired Omnova in 2016 and entered into NBR (nitrile butadiene rubber).
- One macro factor, which led to company's business becoming globally competitive has been the rising availability of butadiene (dominant raw material) in India. 10-12 years back, availability was low, as Reliance was the only producer and it used to consume lot of it

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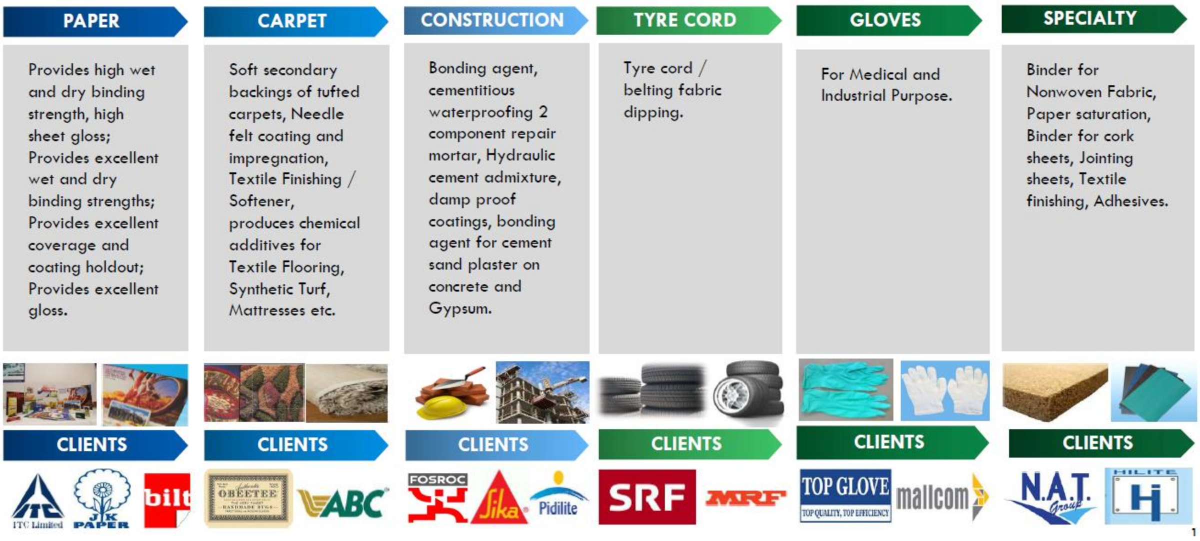
inhouse. Importing butadiene or sourcing it from distant refineries is expensive as the gas is inflammable/hazardous and hence transportation needs to happen under controlled conditions (temperature, pressure etc). 5-6 years back, availability of butadiene started improving as all the major OMCs started producing it in their refineries and hence, as of now, company's cost of procurement of butadiene is competitive with the best in the world. The company now has pipelines which deliver butadiene directly to its plants, from refineries on the west coast of India (company plants are also strategically located close to sources of butadiene and major ports on the western coast of India). Versus butadiene, the other raw materials (styrene and acrylonitrile) are not so difficult to handle and hence can be imported (Apcotex imports 100% of these) relatively easily and hence don't create very adverse impact on cost structure.

- As per our channel checks, in the SB latex business (~45% of sales), company is the market leader in India by a margin; Apcotex and BASF India, have ~85% market share in India with the remaining share accounted for by imports and other small local players. In VP latex (~10% of sales) it has ~50% market share in India with the other player (Jubilant Industries) having rest of the market. In the other product segments (nitrile rubber and latex, high styrene rubber) it is the only local producer in India with bulk of the market being serviced by imports.


- Synthetic latex business accounts for ~55% of sales of the company with the remaining coming from synthetic rubber (HSR and NBR). Rough segment break-up (FY23) of the business (latex only) is: a) ~20% (of consol sales) paper and paper board, b) ~10% construction (water-proofing), c) 10% tyres (VP Latex), d) 10% nitrile latex, e) 8% textiles and carpets.




- On the synthetic rubber side – a) 35% (of overall sales) come from NBR and b) 10% from HSR.
- The company acquired Omnova Solutions in 2016 for Rs360 mn, which enabled entry into NBR market (new product for Apcotex) in India. Omnova was the only company making NBR in India (as of now Apcotex is the only company); the parent company was headquartered in US. In 2020, Omnova (global) was acquired by Synthomer (one of the largest companies in emulsion polymerisation space in the world). Omnova India's sales at the time of acquisition was ~Rs1.8 bn and capacity was 16k tons. Post acquisition, Apcotex invested Rs300 mn in order to modernise the plant and increase capacity to 21k tons. As a result, cycle times reduced and hence, cost of production became competitive, and company turned EBITDA positive in 2-3 quarters only post-acquisition. It invested further Rs40 Cr for a captive power plant to improve consistency of power supply as it was becoming difficult to run a continuous process plant with unreliable grid supply. Altogether, on total capital deployed of Rs1.1 bn (it would be lower as of now considering plant would have got further depreciated), the company could possibly be making EBITDA of ~Rs300-400 mn as of now, implying a reasonable ROCE. Also, the company put up its nitrile latex facility of 50k tons at the same facility as it had surplus land.

- The company has grown its sales, EBITDA and PAT at a CAGR of 15%, 13% and 17%, respectively in 2015-2019 and CAGR of 15%, 23% and 23%, respectively in 2019-23 (FY23 had 2 one-off quarters in which margins were higher than usual).

**Nature of the business**

**Synthetic Latex**

Latex is a dispersion of polymeric particles or droplets in liquid (mostly water); typically, any latex product is ~50% (or more) water. Polymer is formed by reacting two monomers (like styrene and butadiene for SB latex). It is primarily used as a binder to impart properties of strength (paper and paper board), water resistance and/or adhesion (paints, coatings, adhesives etc).

- Companies which make latexes, start designing (making the recipe) the product by understanding end use application of the latex. Constituents of the reaction: chemical, mechanical and process parameters, are tweaked depending on the end properties (degrees of strength, adhesion, water/light resistance, flexibility etc etc) required.
    - Chemical – which monomers/additives to use.
    - Mechanical – shape and speed of the agitator (inside the reactor), time the emulsion is allowed to react, pressure and heat applied etc etc.
    - Process – order in which various ingredients are added.

  Given these nuances, end-product or latex does not a have a consistent molecular weight. Molecular weights are as per a distribution (bell curve). As per our understanding, molecular weight distribution sometimes can vary even if the reactor changes even while keeping the other process parameters same. Hence, for a company which is producing a latex as per spec required for an end-use application it is important to control the reaction so as to ensure that specs are met each time.

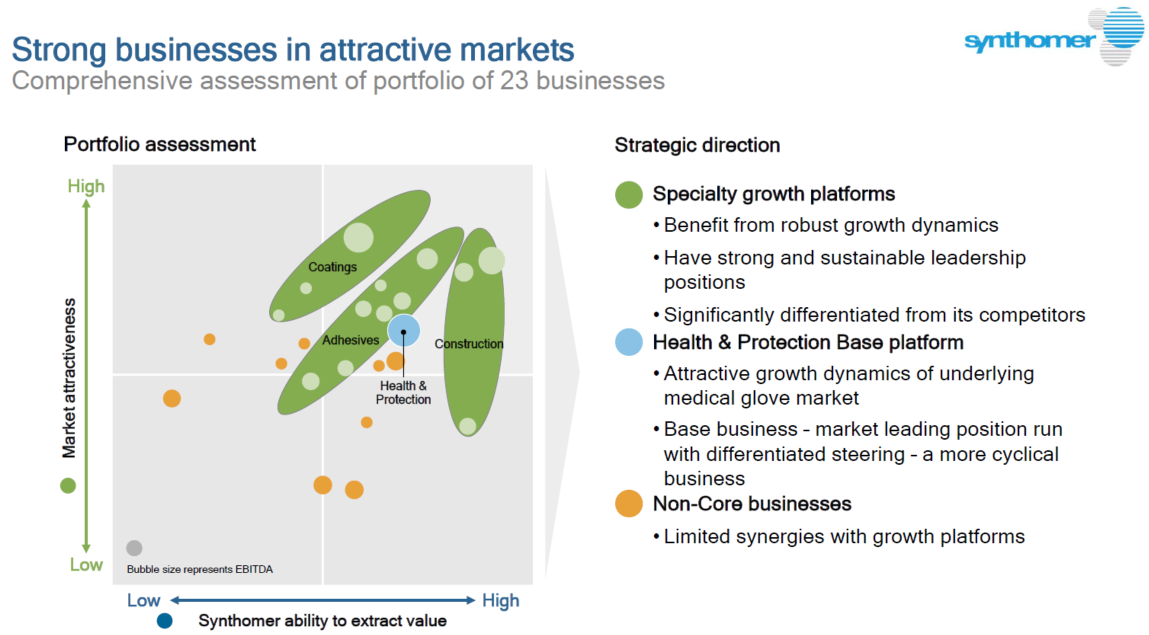
- Given that latex specs are as per end use application, latex business even within a particular segment like SB latex, consists of many tweaked versions of the base product. Apcotex's website lists 44 product grades of latex (across all kinds of latex) for 5 end use applications (paper, adhesives and construction, textile, tyres). These 44 grades of products altogether account for ~Rs5 bn (FY23) of sales.

- The above nature of business creates entry barriers as: a) building scale requires development of number of products for specific end use applications of multiple clients requiring close long-term partnerships, b) this creates requirement of consistent investments into R&D to meet ever increasing specs of clients as clients are also in the journey of premiumisation, c) strong technical service team is required for guiding clients to resolve issues and to demonstrate new products in commercial settings.

- On account of the above reasons, nature of global competition is also different in this business. Given that this is also a sort of 'chemical business' one does not hear about dominant Chinese companies in this business. Globally, dominant companies in this business are: Synthomer (Sales – 2.8 bn Pounds), BASF (scale similar to Synthomer in latex products, as per our channel checks), Trinseo (Sales - $4.9 bn, spun-off from Dow), LG Chem, Nantex (Taiwan), Zeon (Japan), all of which are developed market companies. In our view, this business is not aligned with the typical business model Chinese companies are adept at scaling: a) it does not have large volume of a single chemical product with a defined formula, b) it requires constant engagement with clients, each of which contribute small volumes, to: 1) develop products as per their end use application, 2) solve their problems and 3) constantly strive to improve upon existing products.

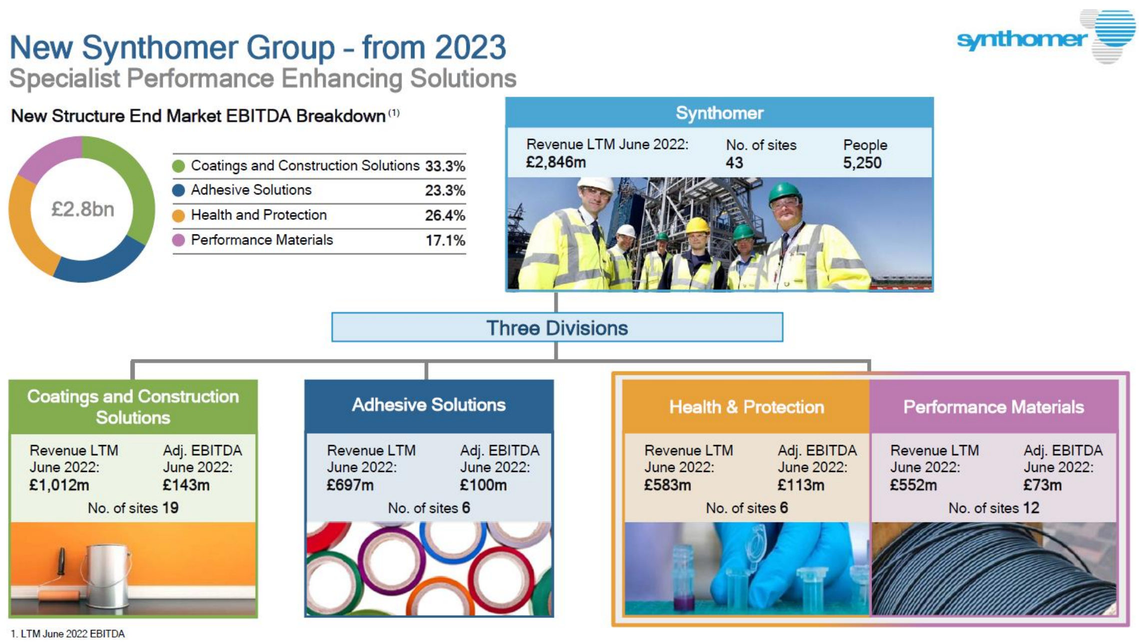
- Apcotex is the market leader in SB latex in India and along with BASF India, both of them have ~85-90% market share in India. Hence, we would tend to believe that scope to drive growth by gaining market share is limited. Also, the end-product segments that are addressed (paper, carpet, construction etc) are fairly mature and hence growth in these segments in India, in the long term, should be around the rate of growth of GDP. The only way for a company, to deliver higher growth is:

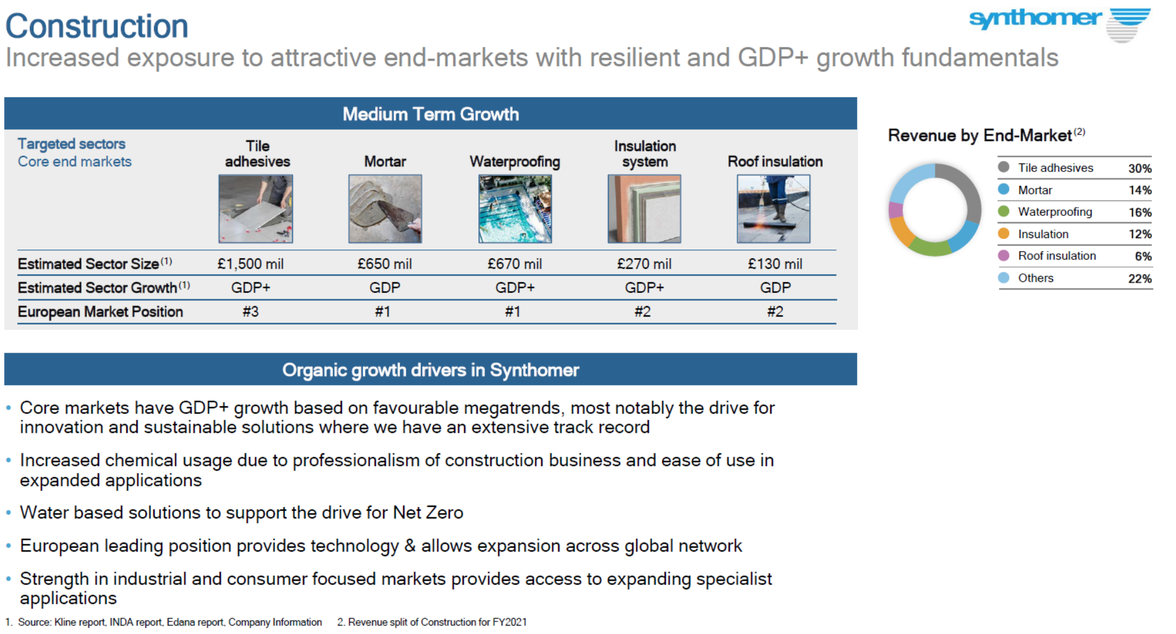
    - Get into new and more high value-added product segments by driving consistent investments into R&D. We see a significant scope to drive growth as:
        - Currently, as per our understanding, Apcotex regards bulk of latex products going into segments like adhesives, paints and construction, as commodity, as most of the brands in these segments (Asian Paints, Pidilite etc) are selling large volumes of plain vanilla products which don't require specialised ingredients and hence, most of the large brands are backward integrated into producing latex products. In our view, as purchasing power in India increases gradually, demand for higher value-added products (in paints, adhesives etc) would increase at a fast clip driving demand for speciality products in latexes which would benefit companies like Apcotex, which are making investments into R&D. For higher value-added products, brands (Asian Paints, Pidilite etc) would procure specialty latexes from specialised players like Apcotex rather than producing inhouse.
        - Our above view is based on data from Synthomer's recent presentations which mention (see below) paints, adhesives and construction as specialty segments.




- Scale up exports. Scaling up exports from India is difficult particularly in low value-added products as freight cost kills the economics, as ~50% of any latex product is water. Hence, in the long-term exports can grow sustainably only as the company starts getting into more and more specialised products. In case of Apcotex, exports have scaled up significantly over the last 5-7 years from almost negligible levels to 30% of sales right now.

- On a very top-down basis, given level of sales of Apcotex from the latex business (~Rs5.5 bn) the business seems immensely scalable, based on data from some of the top global players in this segment. Needless to say, all the potential being highlighted in the below exhibit is available for Apcotex only assuming the organisation is consistently able to scale up its R&D output. Some pointers towards potential of the business:
    - Topline of Synthomer and Trinseo is pretty large. Synthomer – 2.8 bn Pounds, Trinseo (sells US$ 1.2 bn of latex binders annually).
    - Synthomer presentation mentions the addressable market in each of the segments it is present. Size of addressable market seems pretty large versus the market size in India suggesting a huge potential to grow.



# Coatings

Increased exposure to attractive end-markets with resilient and GDP+ growth fundamentals

**Medium Term Growth**

| Targeted sectors / Core end markets | Architectural | Industrial & Metal | Wood | Automotive |
|---|---|---|---|---|
| |  |  |  |  |
| Estimated Sector Size[1] | £4,000 mil | £950 mil | £270 mil | £400 mil |
| Estimated Sector Growth[1] | GDP | GDP+ | GDP+ | GDP |
| European market position | #2/3 | #4 | #3 | #4 |

Revenue by End-Market[2]


**Organic growth drivers in Synthomer**

- Global market share ~5-6% provides platform of regional speciality market positions with significant opportunity to grow globally
- Ongoing regulations and consumer drive to use more sustainable coatings deliver growth opportunities by replacing solvent-based coatings with water-based technology
- Increasing evolution of market to more functional coatings deliver attractive speciality segments with high ROIC and growth
- Strength in industrial and consumer focused markets drives our innovation pipeline for specialist applications
- Ongoing revenue synergies

1. Source: Kline report, KNG Global Paints & Coatings, IPPIC Global Market Analysis, Company Information 2. Revenue split of Coatings for FY2021 .

# Adhesives

A global platform established in attractive and growing end-markets

**Medium Term Growth**

| Targeted sectors / Core end markets | Hygiene | Packaging | Durables Assembly | Tapes & Labels | Performance Additives for Tyres | Plastic Modification |
|---|---|---|---|---|---|---|
| |  |  |  |  |  |  |
| Estimated Sector Size[1] | \$2.0 Bn | \$1.4 Bn | \$1.3 Bn | \$1.3 Bn | \$0.9 Bn | \$0.8 Bn |
| Estimated Sector Growth[1] | GDP | GDP / GDP+ | GDP | GDP+ | GDP++ | GDP+ |

Revenue by End-Market[2]

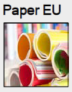

**Organic growth drivers in Synthomer**

- Success factors of product innovation and customer centricity align well with Synthomer
- Cost and revenue synergies from overlapping acquisitions, key accounts and product ranges
- World class innovation delivery, agility and customer intimacy from unified platforms
- High performance water-based polymers displacing solvent borne adhesives in conjunction with lightweighting and circularity trends play to Synthomer innovation leadership
- Efficient development of differentiated local solutions delivered on a global basis

# Health & Protection

Global Leadership position in high growth base business

**Medium Term Growth**

| Targeted sectors / Core end markets | H&P | Paper EU | Carpet EU | Foam Global |
|---|---|---|---|---|
| |  |  |  |  |
| Estimated Sector Size[1] | £3.0 Bn | £455 mil | £469 mil | £109 mil |
| Estimated Sector Growth[1] | GDP+ | GDP- | GDP- | GDP+ |
| Synthomer market position | #2 globally | #3 in Europe | #3 in Europe | #1 in Europe |

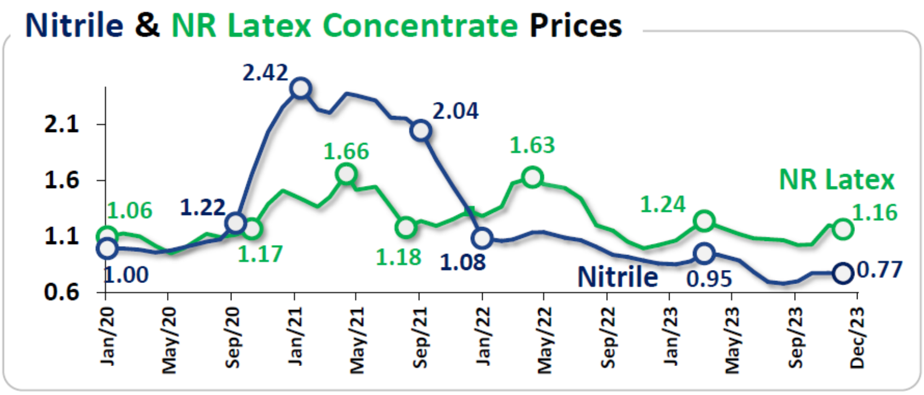
Revenue by End-Market [2]


**Organic growth drivers in Synthomer**

- Synthomer has a leadership position in the strong growth nitrile glove market supported by the mega trends of hygiene and emerging market use
- Nitrile technology continues to expand market share compared to other protective barrier glove technologies
- Synthomer growth will come organically through innovation and process development
- Patented best in class technology delivers high quality, low-cost nitrile with opportunities to reduce the carbon footprint of customers and provide recyclability in re-useable glove market segments

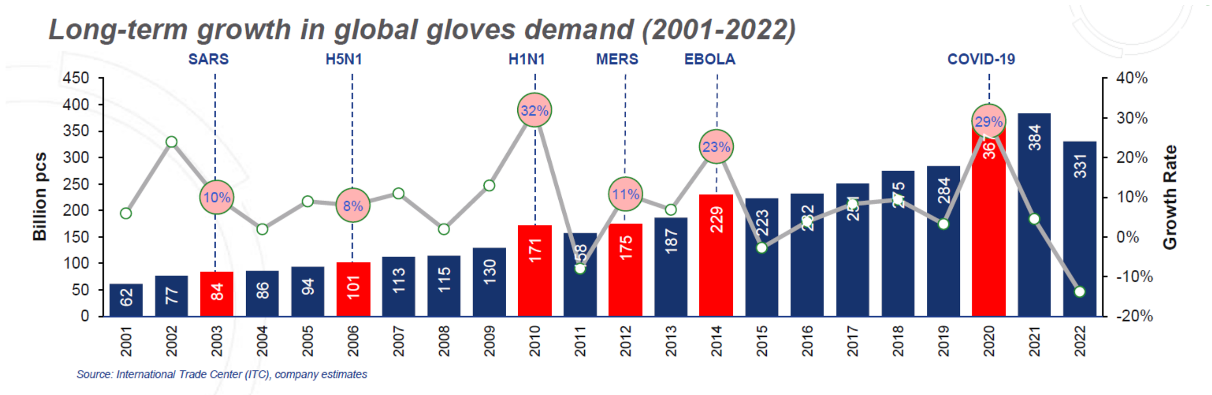
**Nitrile Latex**

- Nitrile latex is a co-polymer of acrylonitrile and butadiene. Almost ~80-90% of nitrile latex manufactured is consumed to make medical gloves. Nitrile latex gloves offer many advantages over natural latex gloves like – a) Nitrile latex does not contain any proteins as it is a completely synthetic material and hence its preferred by medical professionals who are allergic to natural latex, b) it offers more abrasion and puncture resistance, c) it is more resistant to acids and oils, d) it provides higher level of tactile (touch) sensitivity which gives a good feel. Hence, usage of nitrile latex gloves has been increasing over other options even though it is significantly more expensive (3-4X) versus natural latex gloves.
- Total consumption of nitrile latex in CY2018 was ~1.4 mn tons. Consumption increased significantly during Covid which led to shortages and hence price increased almost 3X. Higher prices led to flurry of investments/announcements into capacity expansion (both in gloves and latex) by various players across the world. Demand of gloves and hence nitrile latex (demand is ~1 mn tons in CY23) collapsed as: a) Covid led demand declined rapidly and b) on account of fear of supply chain disruptions, channel inventories of gloves were very high. Given lack of demand and excess capacity, margins in nitrile latex are at significantly lower levels versus pre-covid. As per Apcotex mgmt., if margins in nitrile latex were X pre-covid, they increased to 4X during covid and are at 1/4$^{th}$ of X as of now.




Note: NR is natural rubber latex

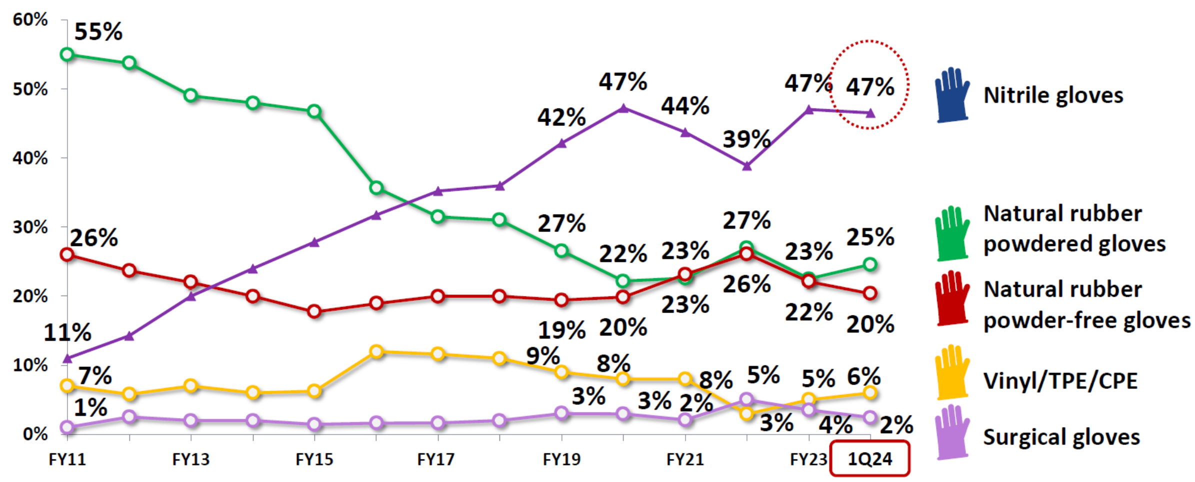
- In our view, demand for nitrile latex gloves should increase at a CAGR of ~10% once the inventory situation normalises. Reasons:
  - In CY15-19, demand for gloves (all kinds of gloves) increased at a CAGR of ~7%. We expect similar trend to return.



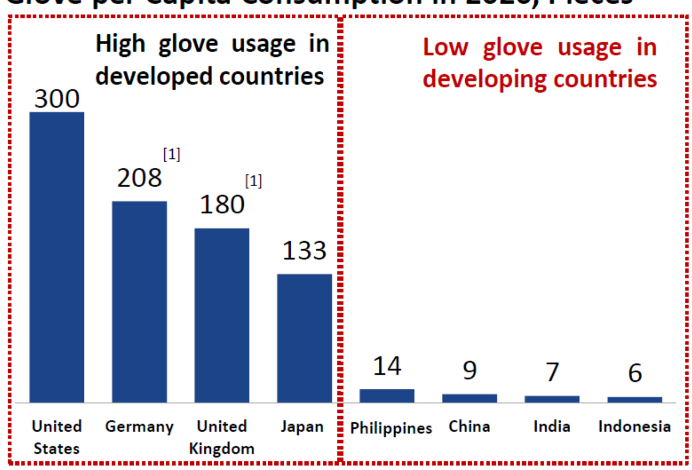
- Demand for nitrile gloves will grow at higher rate (8-10% CAGR) as there is still scope for increased adoption over other kinds of gloves.
  - Pre-covid (2014-2019) sales of Top Glove (one of the largest producers of medical gloves in the world) increased at a CAGR of 16% (US$ terms) primarily led by rising adoption of nitrile latex gloves over other kinds of gloves. EBITDA and PAT (US$ terms) increased at a rate of ~18% and ~15%, respectively, in the same duration.
  - There is significant scope for increased usage in developing markets where usage levels remain significantly below developed markets.

**Product-mix of Top Glove**

**% of Product Mix By Sales Volume from FY11 to 1QFY24**




**Glove per Capita Consumption in 2020, Pieces**




Source: Frost and Sullivan, December 2021

[1] Germany and United Kingdom refer to 2019 data

## Financials of Top Glove, US$ (mn)

**31 August Financial Year End**

| in USD'mil | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|---|---|
| Revenue | 492.8 | 486.8 | 548.5 | 548.2 | 539.2 | 595.0 | 684.5 | 807.9 | 1,000.3 | 1,137.8 |
| EBITDA/(L) | 86.4 | 46.6 | 70.6 | 73.6 | 71.5 | 104.7 | 124.3 | 116.0 | 164.5 | 162.9 |
| EBITDA/(L) margin | 17.5% | 9.6% | 12.9% | 13.4% | 13.3% | 17.6% | 18.2% | 14.4% | 16.4% | 14.3% |
| PBT/(L) | 72.3 | 34.5 | 57.0 | 57.4 | 51.3 | 86.1 | 104.8 | 93.2 | 123.9 | 100.4 |
| PBT/(L) margin | 14.7% | 7.1% | 10.4% | 10.5% | 9.5% | 14.5% | 15.3% | 11.5% | 12.4% | 8.8% |
| Taxation | 12.9 | 7.2 | 7.9 | 9.3 | 7.7 | 19.5 | 18.9 | 12.9 | 21.2 | 13.3 |
| PAT/(L) | 59.3 | 27.3 | 49.1 | 48.1 | 43.5 | 66.6 | 85.9 | 80.3 | 102.7 | 87.1 |
| PAT/(L) margin | 12.0% | 5.6% | 9.0% | 8.8% | 8.1% | 11.2% | 12.5% | 9.9% | 10.3% | 7.7% |
| ROE, % | 22.4 % | 10.1% | 16.1% | 14.8% | 13.0% | 17.4% | 19.3% | 16.4% | 18.0% | 14.4% |

- Due to shortage of medical gloves during covid, demand of gloves and in turn nitrile latex exploded.
  - Exuberance and the fact that glove manufacturing has low entry barriers led to lot of new players into glove manufacturing leading to a capacity glut.
  - On top of that, demand collapsed as: a) Covid ebbed quickly and b) there was excess inventory with customers/channel.
  - In the last 4-5 quarters, both end customers/channel players have been trying to reduce inventory. Also, as the inventory has a finite shelf life (2 years max); hence, everyone wants to get rid of excess inventory before its expiry (in which case entire inventory would have to be written off) and hence, they have been selling at extremely low prices.
  - All this has led to collapse of demand as well as prices/margins in the glove industry as well as the nitrile latex industry.

  On the nitrile latex side also, covid related demand led to significant investments into capacity enhancement. Only saving grace has been that most of the capacity addition (actual and on paper) has come from incumbents only and hence there is high probability that economics (growth, ROCE) of the business should come back to pre-covid levels once inventory situation normalises.

- As per our channel checks, total global capacity of Nitrile latex is ~2 mn tons (as of now). The major players are: a) Kumho (~0.65 mn tons), b) Synthomer (0.43 mn tons), c) Nantex (0.2 mn tons), d) LG Chem (0.2 mn tons), e) BST (Thailand) (0.1 mn tons), f) Nippon Zeon (Japan) (0.1 mn tons). Chinese producers have 8-10% share of the capacity.

- From the profile of competition landscape, where: 1) most of the large producers are from developed markets and, 2) China has a small share, it becomes clear that: a) It is a niche product requiring constant engagement with clients, b) entry barrier is not capital alone and some bit of know how is also involved. Hence, it seems like a good industry where a reasonable ROCE of 15-20% can be sustained over the long term.

- Apcotex is the only producer of nitrile latex in India. Its capacity (~50 k tons) is pretty small in the overall context of the market. For Apcotex, bulk of demand (~90%) would be driven by exports.

- As per Apcotex mgmt., if EBITDA margins in nitrile latex was X pre-covid, it went to 4X during COVID and are now 1/4$^{th}$ of pre-covid margins.

- On a normalised basis, if one were to evaluate Apcotex's ~Rs1.5 bn investment into nitrile latex, with the following assumptions: a) Normalised margins of 15%, b) $1000 per ton realisation, c) 60 days of working capital, and utilisation of 90%, the pre-tax ROCE would come in the range of ~22%.

**Nitrile Butadiene Rubber or NBR**

NBR is a forward integration of nitrile latex. Rubber is manufactured by coagulating polymer molecules suspended in the latex and hence is a kind of forward integration of latex. NBR rubber is used to make parts which require resistance towards oil.

- Total global NBR demand is ~1 mn tons. Demand in India is ~55k tons. Demand in India has been growing at ~5% CAGR in the last 5-7 years.
- Globally some of the prominent players (with capacity) are: a) Arlanxeo (100% owned by Saudi Aramco) – 140k tons, b) Kumho – 87k tons, c) Zeon – 70 k tons, d) Nantex – 80 k tons, e) Petro China – 80 k tons, f) LG Chem – 65k tons, g) SIBUR (Russia) – 42k tons, h) Ningbo – 65k tons.
- The above competitive landscape where again Chinese companies are not dominant, signifies: a) It is a niche low volume business, b) requires R&D for product development and technical service for solving client problems and c) capital intensity is not the only barrier.
- NBR demand in India is led by: a) 20-25% goes into auto parts linked to the fuel management system of vehicles of all kinds or into parts which come in contact with oil (brake oil, hydraulics etc) , b) ~15% goes into making rice de-husking rolls, c) ~12% goes into making hoses for handling oil and gas, d) rest in myriad products ranging from conveyer belts, shoes , printing rolls, insulating foams etc etc.
- Apcotex has 30-35% market share in NBR (capacity is 21k tons) market in India with rest of the market being serviced by imports. As supply chains got disrupted during COVID, imports to India reduced and hence margins in this business increased to higher than usual levels. With supply chains normalising, pressure from imports has come back. Infact, as per our understanding competition from imports has increased off-late on account of subdued demand in China (demand conditions exacerbated on account of movement away from IC Engines).
- In our view, economics (in terms of ROCE) are similar to the nitrile latex business.
- At the time of acquisition of Omnova, NBR was under anti-dumping duty (~10%). Around 2019, the anti-dumping duty expired which led to under-cutting on the pricing front by Korean players. The company approached the government for re-imposition of duty; DGTR recommended anti-dumping duty of ~20% which was not ratified by the finance ministry. Till date there is no clarity on this matter.
- The company has been running its NBR capacity at more or less full utilisation levels since the last few years.

**Vinyl Pyridine Latex**

It is a polymer of vinyl pyridine, styrene and butadiene. It provides strong bonds between synthetic fibers (nylon, rayon, polyester, glass fiber etc) and rubber compounds. It is used in tyres to coat tyre cord fabrics. It is a specialty product with high technical specifications. Indian market for this product is almost equally divided between Apcotex and Jubilant. For Apcotex, this product contributes ~Rs1 bn to sales. Sales of this product would grow (5-6% CAGR) in line with the growth in volumes of tire industry in India.

**HSR (High Styrene Rubber)**

HSR is pre-dominantly used in manufacture of footwear soles. It is the first product which the company started manufacturing. Given that it is a mature product and hence not expected to grow much and is only ~10% of overall sales, we have not analysed the same in a detailed manner.

- The company has generated average pre-tax ROCE of ~25% in the last 5 years.
  - In our view, asset turnover of the business at full utilisation is close to 3X. In the last 3 years, the ratio has remained in the range of 2-3X. Working capital requirement of the business has ranged between 50-60 days of sales.
  - As per the management, sustainable EBITDA margin of the business is ~15%. However, in the past with the exception of FY22&23, EBITDA margins have been lower. As per the mgmt., EBITDA margins have reached a 'new normal' as: a) the product portfolio and the client portfolio of the company has become more diversified; addition of smaller clients has led to structural improvement in pricing, b) In the past company used pricing as a lever to get entry into large clients; over time, it has been able to improve margins in the business led by gradual price increases, c) rising scale has allowed the company more bargaining power in purchase of raw materials; also in the last 3-4 years, availability of butadiene has improved substantially in India as OMCs (BPCL, HPCL, IOCL) have expanded capacity significantly leading to very competitive price of the same in India.
  - EBITDA margins in FY22 and FY23 were higher than usual, as competition from imports (competition in NBR and HSR comes from imports only) reduced as they became expensive due to very high freight cost (COVID related disruptions) and also supply timelines stretched due to supply chain issues. This is led to higher pricing for company's products (HSR, NBR) and also higher preference versus imports. Also, the company earned super normal margins in nitrile latex (but only on 10k tons capacity) as there was shortage of the same during COVID.
  - In our view, management's assertion on margins has merit as:
    - The company has reported average EBITDA margin of ~12% in the last 4 quarters when its nitrile latex facility is running at very low levels of utilisation and at best is at break-even levels (EBITDA). This implies that long term margins are definitely higher than what is being reported as of now.
    - Current margins also reflect bit of pricing pressure in the SB Latex business as BASF India, recently commissioned its capacity and hence, is trying to increase utilisation leading to a temporary increase in competition.
    - The company is in the process of scaling up utilisation levels in its recent capex investments of ~Rs2 bn. All this investment has been done at existing sites only and hence, as these scale-up (Rs6-7 bn incremental sales at full utilisation), incremental margins on sales would be much higher than usual as there would be limited cost build up as: a) new plants are highly automated requiring minimal addition of manpower to run the plants, b) both expansions are brownfield in nature.

- Hence, we are going as per mgmt. guidance and building 15% as sustainable margins in the business as and when the recent investments scale up to full potential.
- Based on the above argument, we believe that the company should be able to sustain pre-tax ROCE of 25% in the long term.

**Operating and capital effciency parameters for Apcotex (Rs mn)**

| **Margin Profile (%)** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023** |
|---|---|---|---|---|---|---|
| EBITDA(%) | 12 | 11 | 7 | 13 | 15 | 15 |
| Gross Margin (%) | 34 | 31 | 32 | 40 | 37 | 37 |
| | | | | | | |
| **Fixed Assets** | | | | | | |
| Gross (1) | 1,874 | 1,972 | 2,585 | 2,924 | 3,153 | 5,555 |
| Net | 785 | 764 | 1,249 | 1,448 | 1,566 | 3,838 |
| | | | | | | |
| **Working Capital (days of sales)** | 67 | 65 | 71 | 56 | 62 | 48 |
| Debtors | 68 | 65 | 66 | 71 | 62 | 46 |
| Loans and advances | 15 | 23 | 23 | 24 | 21 | 18 |
| Inventory | 34 | 28 | 44 | 38 | 33 | 36 |
| Current liabilities | 51 | 51 | 62 | 77 | 54 | 52 |
| | | | | | | |
| Asset turnover (X) | 2.8 | 3.2 | 1.9 | 1.8 | 3.0 | 1.9 |
| Capital deployed | 1,811 | 2,028 | 2,299 | 2,224 | 3,399 | 5,175 |
| ROCE (pre-tax) | 29 | 28 | 9 | 25 | 37 | 28 |

Note:
1) We have added Rs871 mn to reported gross block as the company wrote-off same amount (along with equal amount of depreciation) in 2017 as one time adjustment as permitted by Indian accouting standards.

**Investment rationale**

- **Company is poised to grow sales at ~15% CAGR in the next 3-4 years; profits to grow at ~20% CAGR.** In our view, growth would be led by:
  - Recovery in nitrile latex segment**.** As explained above, we expect the nitrile latex market to start growing at ~10% CAGR (same rate as pre-covid) as:
    - Inventory de-stocking process has been ongoing since the last 4- 5 quarters. As per Apcotex mgmt., shelf life of nitrile latex gloves is 2 years and hence high levels of inventory accumulated at the end of CY21 should normalise by the end of CY23 and hence market growth (~10% CAGR) should start returning in CY24 (or FY25).
    - As explained above, salience of nitrile latex gloves has scope to increase further based on its better performance (versus other options) and as its consumption increases in developing markets.
    - Gloves are a high consumption item as doctors use a new glove (and disposi it) for every patient they examine during the day. Hence, inventory de-stocking period could be lower than the worst case (2 years).

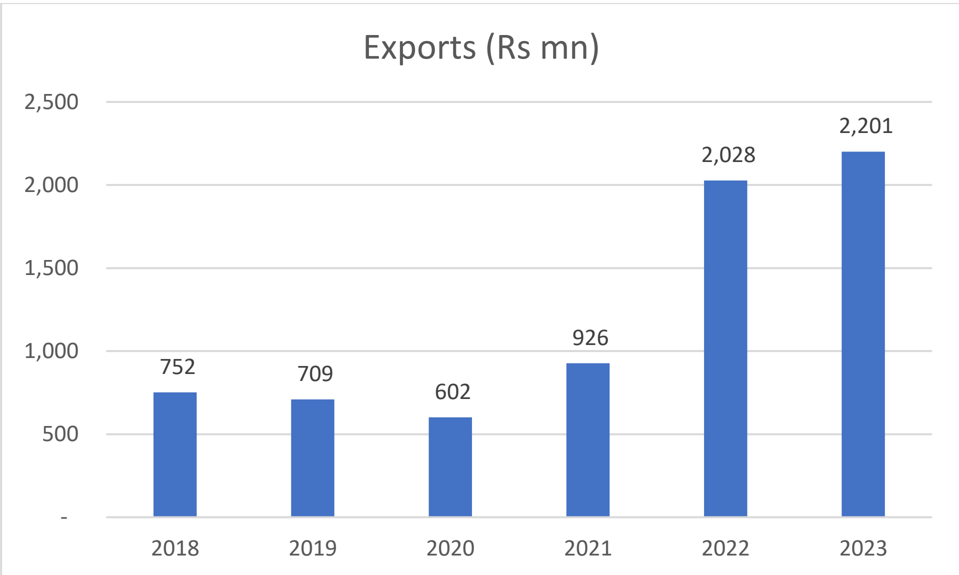
    We expect that the company would be able to fully utilise its 50k tons nitrile latex capacity (running at 20-25% utilisation as of now) in the next 3-4 years as:

    a) Capacity is very small compared to the size of global market (~1.5 mn tons).
    b) In our view, company's competitive position from cost point of view is good. As per the management, it has developed a proprietary process on account of which process cycle

time is lower than usual, which leads to lower cost of production; at the same time, output quality is also better.

c) Most of the competitors of the company are not backward integrated into butadiene and acrylonitrile and hence Apcotex does not have any disadvantage on the RM cost side. For some competitors, acrylonitrile maybe available close to their manufacturing plant (Apcotex has to import 100%) and hence they may be incurring lower transportation and storage cost but that does not create a significant advantage. As far as butadiene is concerned prices in India are very competitive as there is excess supply as of now; also Apcotex's plants are located strategically on the west coast, close to the sources of butadiene.

- Base business of SB latex is expected to continue on its growth path; in our view, the business can sustain past growth trends (~12-15% CAGR) led by:
  - Base business in India growing at 6-8% CAGR.
  - Exports growing at 15-20% CAGR. The company is getting increased traction in South and South-East Asia, Middle East and Africa. In 1HFY24, export volumes are up 120% yoy; impact is not visible on the topline due to lower realisations yoy on account of fall in RM prices. Export mix has increased to ~30% of sales in 1HFY24 vs ~20% in FY23.
  - New products contributing 2-4% each year.




The company has recently completed capex of Rs2 bn (over FY22 and FY23). Out of which 70% of the amount has been spent on 50k tons of nitrile latex capacity and the remaining on 35k tons of SB latex capacity. As per the management, both these projects should yield Rs6.5-7 bn sales (over existing sales of ~Rs10 bn) as and when (we are assuming 3-4 years) they scale up to full utilisation.

- There could be additional growth in case company exercises option to increase capacity (brownfield) of nitrile latex by 60% (additional sales of ~Rs2.5 bn) with an investment of only Rs350 mn. This decision would depend on pace of scale up of utilisation of existing 50k tons of capacity. Needless to say, if this materialises it would lead to higher efficiencies and hence enhanced margins/ROCE.

- The company is also preparing for doubling the capacity of NBR (capacity increase could be 15-20k tons over existing capacity of 21k tons) with an investment of Rs2-2.5 bn. The project is still under evaluation; the mgmt. wants to stabilise capex of Rs2 bn, done over FY22/23, before going ahead with further expansion. Incase, the company decides to go ahead with this project, it would have the potential to add Rs3-3.5 bn of sales. Also, this would improve cost positioning significantly as it would be a brownfield expansion and hence, it would be margin accretive.

- **We like the business and the promoters.**

  We like the following characteristics of the business:

  - The business has reasonable entry barriers:
    - It requires good R&D – R&D needs to partner with clients to come up with new products and to tweak existing products as per end-use specs of the client.
    - It requires good technical service team – this team needs to respond (visit client sites if required) to clients' service requests regarding - issues in the plant or with the latex product, due to which end-product specs could be different from planned. Addressal of issues could require minor tweaks in process (client site) or latex additive. Also, this team needs to visit client plants to demonstrate the product in commercial settings to new clients.
    - The company needs to have a large portfolio of products. Just for a perspective, Apcotex's Rs5.5 bn of sales in latex products is accounted for by 40-50 products going into 4 different major segments (carpets, paper, construction, paints and adhesives)
    - The business is granular from product point of view (as explained above) and from client point of view (business is split across many clients).
    - Clients are sticky. Changing a vendor, is a long-drawn process (3-6 months), as clients need to test the ingredient in the final product extensively, before giving approval to a new vendor. Typically, if a vendor is not overcharging and is good with maintaining quality and consistency of supply, clients usually don't switch for 5-10% lower price.
    - Given the above entry barriers, in our view, the business can earn more than average pre-tax ROCE (~15-20%) characteristic of well-run manufacturing business, where capital is a dominant entry barrier. Hence, in our view, pre-tax ROCE, of 20-25% is sustainable.
    - In our view, nature of the business explained above is reflected in the nature of competition in global markets. Most of the dominant companies in this business are from developed world (Europe, Korea, Taiwan, Japan) and not from China.
  - We like the promoters:
    - First of all, the fact that the average pre-tax ROCE has been close to ~24% from FY15-23, implies that promoters have managed the business well.
    - As explained above, Mr. Abhiraj Choksey took a lot of steps to turn around the business, from 2010 onwards –
      - Beefed up R&D.
      - Addressed quality issues with existing products. Expanded product portfolio.
      - Beefed up business development team. Expanded into export markets.
      - Successfully acquired Omnova and entered into NBR market.

      In our view, he is a hands-on promoter.

    - Over the years, we see that the promoters have been thought-full about incremental capital deployment:

        - In latex products (except nitrile latex) there is limited competition in India. Except Apcotex, BASF India is the only company with reasonable presence. Jubilant Industries is mostly into VP latex (~10% of Apcotex business) where the market share (India) is split equally with Apcotex. There is no competition from imports as freight cost beyond 5-6% of sales can't be loaded onto these products (high volume as ~50% of the product is water).
        - In NBR, HSR and nitrile latex business, the company is the only manufacturer in India. Rest of the market is being serviced through imports.
        - Acquisition of Omnova was smart. The company paid Rs360 mn for ~Rs700 mn of gross block (depreciated to a significant extent). It recovered initial investment in the first year itself through working capital rationalisation, tax benefits of accumulated losses. Also, acquisition gave it entry into new product segment of NBR.
        - Nitrile latex plant investment started in 2019 (well before covid) and hence the project was not conceived looking at exceptional margins during COVID.

- Global market for synthetic latex and rubber products is large. Apcotex can drive higher than usual growth (8-10% CAGR) for a long time. Some pointers:
    - As mentioned above, sales of some of the dominant listed players, in similar segments, are pretty large - like Synthomer (sales – Pounds 2.8 bn), BASF Global (sales of synthetic latex and related products would be similar to Synthomer), Trinseo (sells US$1.2 bn of synthetic latex products).
    - In our view, market for specialty latex products used in paints, adhesives and construction has not even started meaningfully in India and hence represents significant potential for Apcotex. Reasons for our view:
        - Synthomer regards latex products going into paints, adhesives and construction as specialty products with strong growth potential while Apcotex regards the same segment as mostly commodity in India. In our view, bulk of volumes in these segments in India, for the large brands like Asian Paints, Pidilite etc, are contributed by low value products and hence Apcotex regards these markets as commodity (most of the large brands manufacture latex themselves). In our view, as these markets premiumise, scope for a specialist player like Apcotex would expand significantly as the brands would then want a solution from a specialist (with dedicated R&D) rather than doing it internally.
    - Some of the unaddressed opportunities that we could identify in our industry interactions:
        - SB latex is used as a binder for anode in EV batteries. Apcotex is already working with some of the battery players looking at setting up manufacturing in India.
        - High Solid Latex – used in road construction and buildings. Nobody manufactures in India as of now. It is large market ($300 mn global market).
        - SB latex used in masking tapes, pressure sensitive tapes etc.
        - There is also significant opportunity in converting solvent based latex products into water based which are more environment friendly.

    In our view, Apcotex would have to make consistent and increasing investments into R&D to be able to tap these opportunities.

**Valuation and upside potential**

The company is trading at 37.9X P/E multiple on TTM basis. Earnings are a bit understated on account lower than usual margins (~10%) in 1HFY24. In our view, sales will grow at ~15-20% CAGR in the medium term (3 years) as the new plants scale up utilisation levels and a little slower post that. It is not possible to predict long term growth post the next 3-4 years as it would depend on how the company is able to enter into new product segments and markets based on its R&D prowess. However, given the past track record, we would believe that the company should be able to maintain growth at 12-15% CAGR. EBITDA should grow at 20-25% (next 3-4 years) given that we are assuming margins to trend towards ~15% from ~12% (TTM) as of now. Hence, in our view, the stock should compound at 20-25% in the next 3-4 years and maybe at (12-15% inline with growth in sales) post that.

**Risks**

- In our view, the main assumption behind underwriting long term sales growth of ~15% CAGR and sustainable pre-tax ROCE of ~25%, is that the company will be able to make consistent investments into R&D which would enable it to enter into new products/markets. Incase, R&D of the company does not fire, growth (beyond the next 3-4 years) could be quite sub-optimal versus our assumptions.
- The company sells ~21k tons of NBR, accounting for almost Rs3.5 bn of sales. ~25% of its sales go into the auto segment where a dominant part of it is used in parts which are involved in fuel management system and hence the business is susceptible in case there is significant shift towards EVs in the long term. In our view, risk could be limited as: a) the company accounts for only 30-35% of India's demand of NBR and hence there is scope to gain share from imports and offset any volume loss due to EV shift, b) non-auto use of NBR is increasing and c) in our view, NBR capacity can be repurposed to produce any other kind of latex/rubber which requires acrylonitrile, with minimal investment. It can be converted into any other latex/rubber also which does not use acrylonitrile, its just that the capex amount would be higher (Rs200-250 mn).
- Growth in the medium term (next 2-3 years) is heavily dependent on the company scaling up its nitrile latex plant to full utilisation. There are 2 factors which would determine the trajectory: a) pace of normalisation of global medical glove inventory and b) competitive landscape in terms of capacity utilisation levels of global majors. Almost all the incumbents in this business (latex) started making investments into capacity expansion seeing significant demand generated by COVID. In our view, some of these planned expansions would come online and some would be shelved; we don't have significant insight into the emerging scenario. In case, global utilisation levels are low in the coming years, it could be difficult for Apcotex to fully scale up its capacity in the next 2-3 years. In our view, in all probability capacity expansions will adjust with the evolving demand. Incase, demand is lower than expected, in our view, major players will re-purpose (as explained above) their capacities into producing some other latex/rubber product.
- Company's exports have grown significantly (3X) in 2019-23. Some part of the success on the exports front is on account of weak positioning of competing companies in Europe, in FY22/23, on account of high energy prices in Europe due to impact of Russia-Ukraine war. The company got entry into new customers in Middle East and SE Asia as these customers shifted part of their demand from suppliers in Europe. With energy prices on their way to normalisation in Europe, the company could lose some of these clients. In the past, the company has lost market share in some of its export markets as at that time prices of monomers were cheaper in Europe versus India; same scenario could materialise again.
- In our view, it is easy to believe the 'Apcotex' story as the promoter lineage is very strong. It is not easy to read 'capability' of the company and hence it is very usual to give 'benefit of doubt' and

come to the conclusion that the company must be doing something good only. In our analysis, we have tried to evaluate the capability of the company without any bias. We have given 'benefit of doubt' only on the corporate governance side.

**Financial summary**

| **P&L, March fiscal year-ends (Rs mn)** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023** |
|---|---|---|---|---|---|---|
| Sales | 5,262 | 6,257 | 4,960 | 5,406 | 9,569 | 10,799 |
| EBITDA | 638 | 691 | 345 | 699 | 1,398 | 1,585 |
| EBITDA (%) | 12% | 11% | 7% | 13% | 15% | 15% |
| Other income | 83 | 79 | 59 | 52 | 79 | 73 |
| Depreciation | 121 | 118 | 134 | 145 | 141 | 152 |
| EBIT | 517 | 573 | 211 | 554 | 1,257 | 1,433 |
| PBT | 558 | 617 | 246 | 567 | 1,304 | 1,455 |
| PAT | 386 | 466 | 166 | 442 | 988 | 1,079 |
| EPS | 19 | 9 | 3 | 9 | 19 | 21 |
| **Balance sheet** | | | | | | |
| Equity | 2,464 | 2,778 | 2,513 | 3,054 | 3,962 | 4,760 |
| Debt | 174 | 40 | 490 | 144 | 501 | 1,518 |
| Other current liabilities | 733 | 877 | 842 | 1,139 | 1,411 | 1,529 |
| Other non-curent liabilities | 70 | 76 | 124 | 180 | 175 | 227 |
| **Total sources of funds** | **3,440** | **3,770** | **3,969** | **4,517** | **6,049** | **8,034** |
| Fixed assets | 877 | 976 | 1,442 | 1,563 | 1,952 | 3,961 |
| Current assets | 1,577 | 1,784 | 1,682 | 1,842 | 2,792 | 2,854 |
| Non current assets | 160 | 220 | 141 | 138 | 240 | 116 |
| Investment (current & non current) | 827 | 790 | 704 | 974 | 1,064 | 1,103 |
| **Total uses of funds** | **3,440** | **3,770** | **3,969** | **4,517** | **6,049** | **8,034** |
| **Cash flow statement** | | | | | | |
| Cash from operations | 516 | 370 | 350 | 714 | 443 | 1,163 |
| Capex | -121 | -223 | -502 | -237 | -680 | -1,870 |
| **FCF** | **395** | **148** | **-152** | **477** | **-237** | **-707** |
| **Return ratios (%)** | | | | | | |
| ROE | 7 | 1 | 20 | 5 | 13 | 32 |
| ROCE (pre-tax) | 29 | 28 | 9 | 25 | 37 | 28 |

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