CLOCKVINE
Capital Advisors

Investment memo – Galaxy Surfactants **Date:16/05/2023**

Mcap (Rs bn)	91	Shares O/S (mn)	35
Promoter shareholding	71%	Price (Rs)	2600
Pre-tax ROCE (5Y average)	22%	Trailing P/E	24

Investment summary

We expect Galaxy to grow its PAT at CAGR of ~12-15% in FY23-25 led by:

- Strong volume growth (8-10% CAGR) in specialty products due to:
    - Commercialization of some of the specialty ingredients of Galaxy, led by product launches by its customers (mostly consumer companies in developed markets) in the coming years.
    - General pick up in consumption of prestige/mass-prestige consumer products in developed markets as inflation eases gradually and consumer spending picks up.
- Our channel checks indicate that Galaxy has created:
    - A franchise which is recognized by top consumer brands, globally, in its areas of expertise.
    - Quality R&D set-up which is evident in the innovative products launched so far.
- We don't know too many Indian companies which have the R&D strength to come up with innovative products which have been proven successful in high spec developed markets (consumer products) after competing with global spec-chem majors like BASF, Croda, Nurion etc.

  Quality R&D setup and an able top management should ensure that the company will keep on growing sustainably at the rate of ~10-12% CAGR (sales) in the long term, led by consistent launches of new innovative products.

Company profile

- Galaxy is a dominant company in the oleo-based surfactants in India and AMET (Africa, Middle East, Turkey). It was incorporated in 1986 by a group of five friends with professional backgrounds. It got its initial success as it was the only domestic vendor for oleo-based surfactants and hence was able to give global MNCs (HUL, P&G) shorter supply chain with similar systems/processes as global RM suppliers. Over time it increased its market share led by: 1) giving customised products to clients based on process innovation to address their problem areas, 2) offering a good price and a supply chain with tight systems/processes (auditable supply chain), not giving a reason for the client to shift to another vendor, 3) comprehensive basket of products not offered by any of its Indian competitors including global companies. Its reach into its clients and consistent spending on R&D has enabled the company to build an extensive portfolio of specialty products (mild surfactants, preservatives etc) which today account for ~40% of sales and more than 50% of gross profit.
- Almost 60% of sales are performance surfactants – SLS (Sodium Lauryl Sulphate), SLES (Sodium Laureth Sulphate). These are mostly commodity products manufactured in a continuous process plant. These products go into relatively premium personal care products – a) SLES goes into all the liquid formulations of soaps and detergents, b) SLS goes into toothpastes, premium powder detergents used in washing machines, soaps etc. Galaxy has 50-60% market share (personal care only) in India in these products, BASF 15-20%, with the remaining market split equally between Aarti and Godrej.

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- Performance products are mostly sold in India and AMET (company has manufacturing plant in Egypt) where the company has production facilities. These are low value-added products and hence can't be transported over long distances.
- EBITDA could range between 4-6%. Within this product basket, SLS margins are much higher versus other products as it goes into products (toothpaste) which go into the mouth of consumer making the brands (Colgate etc) highly sensitive to quality.
- Almost 50% of the performance product volumes are sold to global consumer majors (internally classified as tier-1) like HUL, Colgate, P&G etc, 8-10% of sales are to Indian national consumer majors (tier-2) like Godrej, Dabur etc and remaining sales are to smaller brands like Himalaya., D to C brands etc. Tier-3 customers are growing at much faster rate versus the other two.

- 40% of the sales are of specialty products comprised of –
    - Mild surfactants – Amino Acid based surfactants which go into premium soaps.
    - Preservatives – These are part of liquid products like shampoos to prevent microbial growth. Microbial growth is a problem in these products as water (promotes microbial growth) is a considerable part of the formulation.
    - Betaines -are foam boosters and also help in building viscosity of formulations.
    - Protein extracts – Used in skin and hair conditioners, moisturizers etc.
    - Syndets, transparent bathing bars – Syndets are a blend of various mild surfactants. These are used to make mild soaps with PH balance close to that of skin. Dove soap is a good example. Galaxy also supplies formulation for transparent bathing bars like Pears.
    - Active ingredients for UV protection in sunscreens.

All the above products are high margin products (~25% EBITDA margin). These products are mostly exported to developed markets as consumers there have income levels to be able to afford premium products.

- The company has grown its sales, EBITDA and PAT (all consol) at a CAGR of 11%, 8% and 12%, respectively, in 2017-2022.

	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**5Y CAGR (%)**	**9MFY23**	**9M Yoy (%)**
Sales (Rs mn)	21,110	23,660	27,680	26,020	27,960	36,970	12%	34,740	31
Performance products	13,550	15,530	17,410	15,870	17,880	22,560	11%	21,600	32
Spec products	7,560	8,130	10,270	10,150	10,080	14,410	14%	13,140	31
Sales (tons)	1,77,479	1,97,429	2,14,711	2,24,237	2,36,164	2,34,217	6%		
Performance products	1,15,392	1,30,596	1,35,337	1,43,521	1,56,153	1,49,194	5%	1,13,501	-
Spec products	62,087	66,833	79,374	80,716	80,011	85,023	6%	59,418	-5.5
EBITDA (%)	12.4	11.8	12.8	14.2	16.1	10.9		12.5	
EBITDA per kg (Rs)	15.1	14.6	16.5	16.5	19.0	17.1		25	
Geographical break-up of sales									
Volume (tons)									
Africa Middle East Turkey (AMET)	75,754	84,213	80,290	87,798	94,997	80,653	1%		-15
India	60,735	69,261	77,619	78,041	86,782	94,939	9%		8
Rest of World	40,990	43,955	56,802	58,398	54,385	58,627	7%		-1
Sales (Rs mn)									
Africa Middle East Turkey (AMET)	7,930	8,518	8,565	8,326	10,066	11,461	8%		
India	6,930	8,281	10,223	9,107	9,786	14,049	15%		
Rest of World	6,250	6,861	8,842	8,587	8,108	11,461	13%		

Nature of the business

1. Performance product volumes (consol) have grown at a CAGR of 6% in 2013-2022. Given that these products go into relatively premium (from perspective of markets like India) personal care products, we expect similar growth trend to sustain in future as well. Some pointers:
   a. As of now, LABSA (older generation/cheaper surfactants) based products still account for 70-75% of the surfactant consumption in India. In US, only 40% of the surfactant sales are based on petrochemical source and 60% are based on oleo-chemicals source. In our view, given that Indian and AMET markets will premiumize (consumer moving towards liquid/premium soaps and premium detergents) over time, growth momentum in performance products should be sustained.
2. Specialty product volumes have grown at a CAGR of 7% in 2013-2022. This segment's growth in the long term depends on consistent investments in R&D to come up with better and greener solutions.
   a. Growth in this segment is not consistent and happen in spurts (2-3 years of higher-than-normal growth followed by couple of years of subdued growth) as: Growth spurt happens as Galaxy commercialises new products as its clients (consumer companies) launch products based on its's new specialty ingredients; after initial spurt in volumes which could last 2-3 years the products (new launches) starts growing at a more mature rate.
   b. Also, products have long development and sales cycles. Typically, the company has to identify long term trends in personal care products and then develop products/ingredients which could possibly become part of consumer products to be launched 3-5 years out in the future, incase, trends play out as per company's expectations. Also, once the company is able to develop new products at lab/commercial scale, it takes couple of years to convince (lot of testing at the consumer level) their clients (consumer companies) of the value proposition, to launch products using these new ingredients. For example – In case of preservatives, Galaxy started developing these products in 2006 anticipating a trend of consumer companies moving towards less toxic preservatives. Govt. regulations (in various developed markets) to ban older generation preservatives started coming out in 2010-2015 which made various consumer companies shift to less toxic preservatives. When consumer companies were looking for vendors to supply the new preservatives, Galaxy was already ready with the product and commercial scale process.
3. Market in performance surfactants is pretty consolidated in India and AMET with Galaxy having a dominant (60% market share in India: ~30% in AMET) position. As per our understanding, Galaxy is the only company in surfactants in India which has been able to create a viable business model with the rest struggling to cover their cost of capital. Reasons:
   a. Even though these are commodity products, entry barriers are high as even a little bit of change in the product can impact the formulation of the brand. Hence, the brands are very sensitive to the quality of supplier; any change in plant, process, RM suppliers needs to be discussed with the OE who could want to carry out an independent audit of the impact of the change proposed. Also, typically brands want to limit the number of suppliers to 2-3 as it becomes easier to manage quality; hence, given that there are already 3 suppliers in India who have been meeting specified SLAs, brands are loathe to add another suppler even if the supplier offers a bit of discount.

   b. Galaxy has been able to create sufficient breadth of clients with large global companies giving it volumes to be able to drive economies of scale (though at lower margins maybe) and other clients (large domestic companies, regional companies and DtoC players) giving it higher margins to enable the company to generate a reasonable overall ROCE (~15-20%) in this business. As pointed out earlier, the driving factor for this (client breadth) is the comprehensive portfolio (other companies have limited products) built by the company and adherence to strict quality processes.
   c. Galaxy has used its relationships with large consumer companies to derive insights into future consumer trends and hence drive its R&D unit to come out with products to cater to these requirements as and when they materialise. Hence, over the years it has created a specialty portfolio which generates much higher margins/ROCEs.
   d. With a combination of performance and specialty products to cater to end-to-end requirements of clients, it has emerged as a strategic vendor rather than a raw material supplier. It has today enough heft to be able to get into the product development cycle of large global/domestic consumer companies.
4. Specialty products is a global business with competition coming from companies like BASF, CRODA, Nurion, LG and a couple of Chinese companies. As per our understanding, Galaxy has been able to garner a market share of ~10% in the global mild surfactants market from nil levels in 2017. Galaxy is the third largest company, globally, in preservatives (BASF has ~35% market share; Dow is the second largest). As per our understanding, there is no other domestic company which offers any competition in this segment.
5. As pointed out earlier, EBITDA margins in performance products are in the range of 5-6% and those in specialty products are close to ~25%. Our channel checks suggest that EBITDA margins in performance products in South Asia are one of the lowest, globally on account of: a) overcapacity, and, b) sulphonation plant is continuous process plant and hence it can't be shut down easily. If shut down the cost of restarting is significant and also this whole process is not good for the life of the plant. On account of this some companies might choose to keep producing and selling at very low margins. EBITDA margins in performance products in some of the other geographies (South-East Asia, US etc) are much better (10-12% EBITDA).
6. Post-tax ROCE for the company has averaged 17% in 2017-2022 with ROE in the vicinity of 24%. Asset turnover (sales/gross block) has averaged (2017-2022) 2.6X with working capital at 60-70 days of sales (refer financial summary at the end).
   a. Even though EBITDA margins are lower in performance products at 5-6%, ROCEs are still decent (15-20% pre-tax) given 4-5X asset turns.
7. Lauryl Alcohol, derived from palm kernel oil is the main raw material for Galaxy. Given linkage of palm oil to crude oil prices, there are sometimes significant swings in prices with potentially material impact on margins for the company. The company manages this volatility by:
   a. For large volume contracts in the performance products category, typically with large global and Indian consumer companies, Galaxy passes on 100% risk of raw material price volatility to its clients in lieu of earnings fixed margins per ton of the material.
   b. In the specialty business, there is no automatic pass on of RM prices in contracts and hence company has to take temporary hit to its margins till the time it is able to take a price increase to pass on higher cost.

Investment rationale

- We expect specialty product segment to start growing at 12-15% (value) CAGR in the next 2-3 years. Subdued growth (-5% yoy in 9MFY23 in volumes) in specialty portfolio is the main reason behind lackluster performance of the stock in FY23; we expect this issue to ease off gradually, leading the company to start reporting better numbers in coming quarters.
    - Galaxy is positioned well in the global mild surfactant market with a market share of 10-12%. What makes it impressive is that Galaxy has clawed this share entirely in the last 5 years against global chemical majors like BASF, CRODA etc; this speaks volumes about the significant R&D capability of the company. As per our understanding, market share gains have not been enabled by usual promise of cheaper price versus global companies but by superior synthesis process (read appendix) which is greener and more cost efficient versus competition. We see the company continuing to gain market share and hence drive growth in this business (6-7% of consol sales) at 25-30% CAGR in the coming 2-3 years.
    - Galaxy's business catering to DtoC brands (Wow, Mamaearth etc) has reached ~10% (50% of business is outside India) of its consol sales. In this business, Galaxy supplies proprietary formulations (mostly mild surfactants) to DtoC (niche, premium products) brands. We expect this business also to grow at ~15% CAGR, driven by market share gains of client DtoC brands.
    - We expect preservative (Phenoxyethanol) and preservative blends (~10% of consol sales) business to grow at 8-10% CAGR, inline with the industry. Galaxy is the 3rd largest player globally in this business (BASF and Dow have almost ~70% of global market). Long term trends in this segment are: a. Developed markets are moving from phenoxyethanol based preservatives to non-toxic green preservatives (Galaxy has developed these products), b) developing markets like India are moving to phenoxyethanol from formaldehyde (carcinogenic) based preservatives.
    - Galaxy as of now is not present in APG (Alkyl Polyglycosides) class of mild surfactants which is a much bigger (1.5X) market than amino acid based mild surfactants (Galaxy is present in this). As per our understanding, Galaxy has been working to develop (at pilot plant scale as of now) this range of products and it is possible that the company will launch these products in the coming couple of years. If that happens, it would open a large market for the company to grow in the long term.
    - Company's 100% sub, Tri-K, in US, has built a credible business (~Rs2 bn sales in FY22 out of Rs5.2 bn) supplying protein extracts to large consumer companies for their premium products. We expect this business to also grow at 12-15% CAGR in the next few years.
    - Betaines is ~8% of consol sales. As per our understanding, this portfolio is growing only at low-mid single digits CAGR; similar growth trend should continue in coming years as well.
    - Galaxy's specialty portfolio growth was constrained in the last year (FY22 and part of FY23) on account of shortage of capacity as covid led to delay in commissioning of new capacities planned 1-2 years ago. As per our understanding, with commissioning of new capacities in 1HFY23, the company is now well-positioned to cater to growing demand in this segment.
    - Specialty portfolio volumes have declined by ~5% yoy in 9MFY23 due to subdued consumption trends in developed markets led by high inflation which apart from impacting growth of existing products also led to deferment of new product launches of consumer companies which in turn impacted demand for Galaxy. With inflation in developed markets easing gradually, we expect consumer demand to come back and product launches (of consumer companies) to pick up pace leading to specialty portfolio

of Galaxy to start growing at reasonable pace. In our view, once the recovery comes, growth in specialty portfolio won't be linear; for 2-3 years it could report much higher than trend growth as new product launches get commercialized and gain scale.

- Improving mix would lead to EBITDA growing at ~12% CAGR in the next couple of years. Galaxy's EBITDA margin on specialty portfolio is ~25% versus ~5% in performance products. We expect specialty portfolio to grow at much higher rate (12-15% CAGR versus ~8% CAGR) versus performance products, in the next few years. Hence, as the proportion of specialty increases in the sales mix, EBITDA would grow at a much higher rate versus sales. This would also improve cash flow and ROCE profile of the business going forward making a case for company to trade at higher multiples versus past.
- Recovery in AMET (Africa, Middle East and Turkey) region would also start contributing to growth once the main economies (Egypt, Turkey) get out of their economic problems. Currency has been depreciating significantly for these countries leading to high inflation and resultant depression in demand. As and when (we can't predict) these economies stabilize, demand should revert. AMET region volumes in FY23 would be ~30% below peak volumes in FY21 and hence as these economies come back there is potential that they could add significantly to volume growth numbers for Galaxy.
- We expect India to report 6-8% volume CAGR in the next few years. Galaxy sells mostly performance products in India which go into relatively faster growing categories within the domain of soaps and detergents, like liquid soaps, more premium detergents like Surf Excel etc. Hence, we are comfortable with the growth trajectory mentioned above.

Risks

- Our positive view on Galaxy is based on growth in the specialty portfolio. Most of the sales of this portfolio are in developed markets of US and Europe. Given slowing economy in these geographies, there is a risk that growth in specialty could be delayed. Typically, specialty ingredients go into masstige/premium products and hence there is a risk that in an inflationary environment consumers might down-trade to cheaper options.
- Some of the promoters of the company are no longer in executive positions and for some of them their next generation also might not be interested in being part of Galaxy. Hence, there is a risk that some of the promoters could want to sell out their stake which could depress the stock price for an extended period of time.
- There could be a risk on some of the large specialty products in case some health concerns (any ingredient or an impurity being carcinogenic etc) develop in future.

Financial parameters (Rs mn)	2014	2015	2016	2017	2018	2019	2020	2021	2022	9M23
Sales	16,973	18,739	18,019	21,613	24,339	27,630	25,964	27,841	36,857	34,708
EBITDA	2,155	1,897	2,327	2,677	2,877	3,534	3,689	4,488	4,007	4,338
EBIT	1,603	1,446	1,875	2,193	2,392	3,022	3,067	3,749	3,297	3,728
PBT	1,230	1,123	1,635	2,043	2,188	2,769	2,888	3,723	3,293	3,601
PAT	760	675	1,027	1,463	1,580	1,910	2,304	3,021	2,628	2,905
EPS	21.4	19.0	29.0	41.3	44.6	53.9	65.0	85.2	74.1	83.0
Margins (%)										
Gross	30.8	29.4	33.4	29.4	28.1	29.5	33.9	36.3	29.8	29.6
EBITDA	12.7	10.1	12.9	12.4	11.8	12.8	14.2	16.1	10.9	12.5
Balance sheet										
Equity	3,223	3,779	4,478	5,726	7,188	8,767	10,678	13,014	15,744	
Net debt	3,964	4,322	3,957	3,691	3,196	2,721	3,120	1,131	2,944	
Gross block	7,537	7,681	7,859	8,679	8,765	9,979	11,569	11,636	12,432	
Working capital details (no of days of sales)										
Debtors	44	43	51	58	63	56	62	61	63	
Inventory	50	48	48	54	52	46	46	56	70	
Payables	49	35	39	43	49	40	38	49	51	
Net working capital	**44**	**56**	**59**	**69**	**65**	**62**	**69**	**68**	**82**	
Ratios										
Asset turns (X)	2.3	2.4	2.3	2.5	2.8	2.8	2.2	2.4	3.0	
Post-tax ROCE (%)	13.5	11.1	14.0	17.2	17.0	18.6	18.7	20.2	15.0	
ROE(%)	27.0	19.3	24.9	28.7	24.5	23.9	23.7	25.5	18.3	

Appendix:

Galaxy's innovative process for manufacturing amino acid based surfactants

Traditionally, the process of manufacture of Fatty Acid Chloride, which is the primary stage in manufacturing of Amino Acid surfactants, involves use of catalyst named DMF (N, N-Dimethylformamide), which is known carcinogenic.

Therefore, Fatty Acid Chloride manufactured with the help of DMF involves two further steps of manufacturing: 1) A part of DMF which is present in Fatty Acid Chloride is removed through physical separation by decantation, and 2) For removal of the balance dissolved DMF, though present at trace levels, the Fatty Acid Chloride is distilled, which removes DMF. Removal of DMF is an expensive process. Also, cost of disposal of the waste left at the bottom of distillation column is high.

Galaxy came with a breakthrough in Fatty Acid Chloride manufacturing by use of the finished product itself as catalyst. This made the process of manufacturing amino acid based surfactants more cost efficient than competition (Galaxy has patent on this process) since cost of distillation of the Fatty Acid Chloride as well as cost of disposal of the bottoms that come out of the distillation, is avoided. Also, Galaxy's process is 100% green as it is a closed loop process with no waste generation.

As per our understanding, Galaxy has gained market share in amino acid based surfactants globally despite offering these products at the same price as competition, as customers want to move to green chemistry to boost their environmental credentials

Some examples of process innovation (performance portfolio) done by Galaxy in the past

- Galaxy created a process for manufacturing SLES in noodle form versus the powder form it used to be manufactured earlier. The problem its smaller clients were facing was: due to lack of automated RM handling they used to face dusting issues in their plant. With Galaxy's innovation this problem was solved.
- Earlier (pre-2005) Pears (clear soap) was monopoly of HUL in India. In HUL's process it used to take ~21 days to get the required clarity in the soap. Galaxy created granules which could be just melted and cast into a soap by any company with a small manufacturing set up; thereby significantly reducing manufacturing lead time. This process is now the de-facto manufacturing process in the industry.
- SLS (used in toothpaste) has a problem that its taste becomes bitter in the process of drying during its manufacture. Galaxy fixed this problem for its large clients like Colgate.

  Galaxy has used these kinds of small process innovations to gain market share in the performance products segment.

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