Gujarat Fluorochemicals

Driving a clean biz model

Adopting a clean development mechanism, Gujarat Fluorochemicals (GFL) has not only won carbon credits but traded them to contribute significantly to its revenue. **Pankaj Kumar** analyses the business model and prospects of GFL, the largest manufacturer of Refrigerants.

Global warming is a universal concern for the human society but however the largest manufacturer of Refrigerants (Hydro-chlorofluorocarbons or HCFC) in India, Gujarat Fluorochemicals (GFL) is reaping rich dividends of this global malady. GFL received carbon credits that helped the company to post excellent numbers for the year ended March 2007 where its net profit surged by 151 per cent to Rs 241.87 crore. The surge in net profit is also due to strong treasury portfolio of Rs 600 crore that fetched Rs 55 crore as other income to the company last year.

The question is how sustainable are these numbers? Should the company that is currently trading at Rs 684 (FV Rs 2) and appreciated by 70 per cent in the last one year deserve a place in your portfolio? We do feel that this company has better prospects in the medium to long term where carbon credit business income is recurring. At the same time, its strong internal accruals will help GFL to fund its future diversification (the effect of the same would be seen in this year). This makes us believe that the scrip in the next 12-18 months is likely to achieve a target price of over Rs 1000. The market cap of the company is Rs 3966 crore of which Rs 600 crore is on account of its strong treasury portfolio. Carbon credit is expected to fetch more than Rs 500 crore annually in the coming years. These would make the valuation attractive. The counter is trading at an attractive one-year forward P/E of 11.4x (on the basis of FY08 expected EPS of Rs 60 and CMP of Rs 684) and hence we recommend investors with an 18-month investment horizon to buy this counter.

Business model

GFL has approximately 25 per cent of domestic market share in Refrigerants (Hydro-chlorofluorocarbons or HCFC). Around 90 per cent of GFL's production of Refrigerants is exported to more than 75 countries. Refrigerants are specialty chemical gases that are used as cooling agents in the refrigeration and air conditioning industry. Besides this, HCFC is also used as a feedstock in the manufacture of PTFE, an advanced industrial plastic. The company also drives revenue from the selling of carbon credit in the international market. In the last one year it has adopted the strategy to diversify to de-risk its business from being a single product company to multi-product by integrating up and down the value chain and setting up other chemical manufacturing facilities. It has also diversified into wind farm and multiplex businesses. GFL holds 65 per cent stake in its multiplex business subsidiary, INOX Leisure. It contributes 18.8 per cent and 9.6 per cent to the consolidated topline and bottomline. With such a diversified business model, GFL is expected to perform well.

Refrigerant gas business

Earlier, GFL manufactured both CFCs and HCFCs. However, CFCs, due to their ozone depleting potential, were under a phase-out schedule. As a result the production of CFCs was scheduled to be completely stopped from 2010. However, GFL has taken a pro-active step and actually phased out production of CFCs in early 2006. GFL now produces only HCFCs. Under the Montreal Protocol HCFCs can be manufactured till 2040 because of their much lower ozone depleting potential. GFL supplies its Refrigerant to broadly two categories of customers which are Original Equipment manufacturers (OEMs) and distributors. 134A and 401-family are some substitute products of HCFC. 134A is more widely used but it is a global warming gas whereas 401 family of HFC is a better substitute but it is not in demand by OEMs. Thus HCFC is still a preferable product for GFL to sell in the international market.

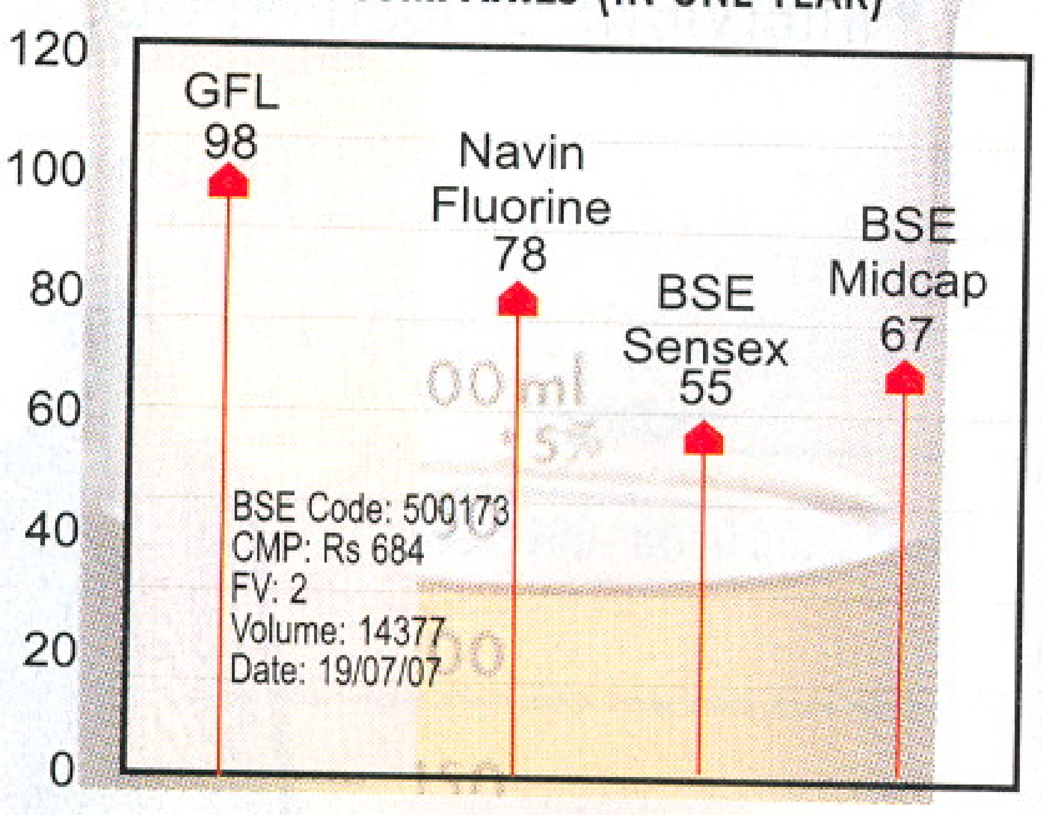
GFL has recently undergone a backward integration that can neutralize the impact of any rise in the raw material prices. HCFC contributed around Rs 200 crore to the topline in FY07 with roughly 16 per cent EBIT margin. We expect that it would sustain the margin in future. The production of HCFC is expected to increase in the next two years. "In FY07 we made around 18000 tonnes of HCFC, and we expect this to grow going forward, in line with past growth trends and our business plan, to reach a full capacity of 25000 tonnes in a couple of years," says Deepak Asher, Executive Director of GFL. According to our calculation the valuation of the existing and the expanded businesses after excluding carbon credit, multiplex and investment portfolio, comes to be around Rs 260 per share (about 40 per cent of CMP).

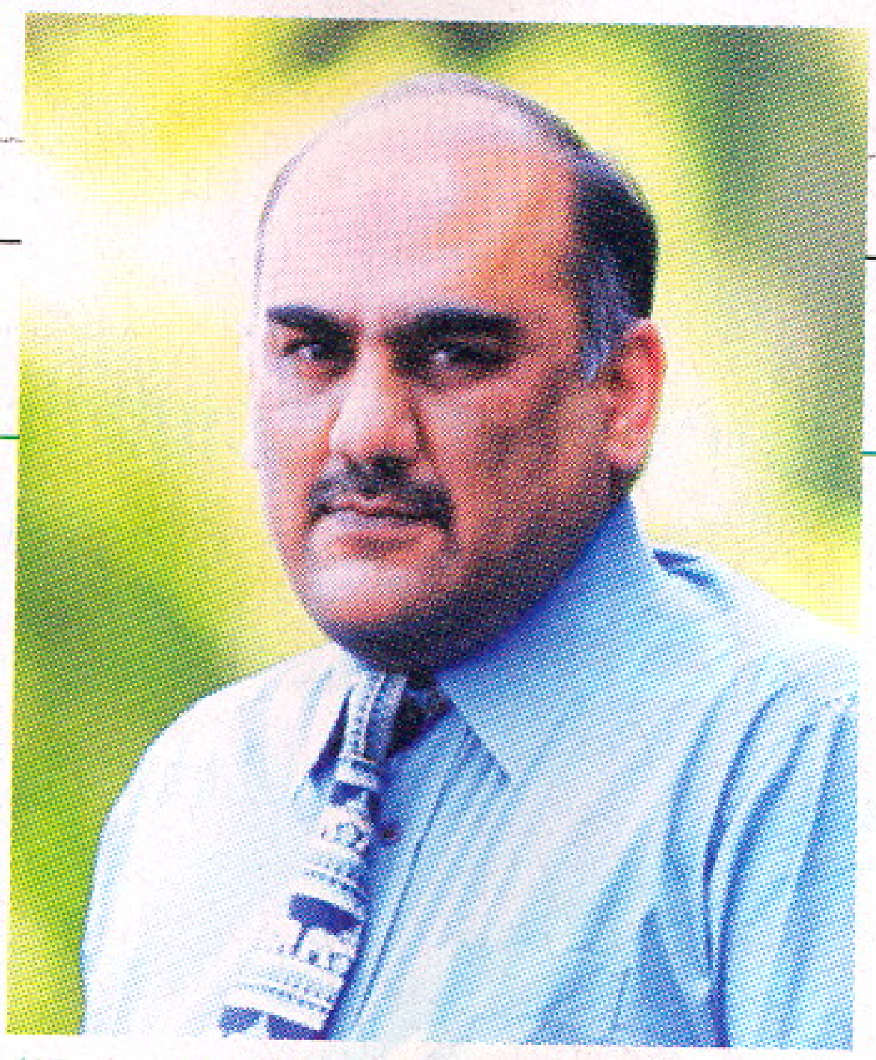
Carbon credit

In the production of HCFC22 a waste product called HFC23 is inevitably generated. Every 100 tonnes of HCFC22 releases approximately three tonnes of HFC23 as a waste product. HFC23 is a potent greenhouse gas, with a global warming potential of approximately 11700 tonnes of CO2. GFL implemented a Clean Development Mechanism (CDM) project which destroys the emission of HFC23 by thermal oxidation. The implementation of CDM project rewarded GFL with carbon credits. The reduction of every one tonne of HFC23 fetches GFL 11700 units of carbon credit. Thus at full utilization level (25000 tpa of manufactured HCFC22) GFL can win around 85 lakh carbon credits per annum. Carbon credits are in demand in the international market and they are traded at different climate exchanges. Currently, carbon credits from CDM projects trade at around 15 Euro, which is expected to go up in future.

The company's CDM project is operational for more than a year. In FY07, the company manufactured around 18000 tonnes of HCFC22 that gave GFL 65 lakh units carbon credits. GFL sold these carbon credits adding Rs 390 crore to its revenues. We expect that the company can sell about 65 lakh units of carbon credit per annum in the coming years. If the prices of carbon credit sustain at this level (15 Euro per carbon credit), then we believe that GFL can earn over Rs 500 crore of revenue in FY08. As per our calculation the value of carbon credit business comes to Rs 235 per share (35 per cent of CMP)

% RETURNS OF GFL INDEX & OTHER COMPANIES (IN ONE YEAR)





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> Executive Director, GFL

Derisking through diversification

GFL has committed around Rs 400 crore of capex for its backward and forward integration cum product diversification projects that include caustic soda cum chlorine plant, chloromethane plant, Poly Tetra Fluoro Ethane Plant (PTFE, an advanced industrial plastic) and a 30 MW of captive power plant. Post completion, the project is expected to generate a maximum of Rs 400 crores to the topline (though many of the products will be consumed internally in the value chain). "We are commissioning these diversification projects in phases. We have already commissioned the caustic soda-chlorine plant, the chloromethane plant and the captive power plant. We now expect to commission the PTFE plant in the current quarter," confirms Deepak Asher.

LAST FIVE QUARTERS (Rs/Cr)

	Mar 07	Dec 06	Sep 06	Jun 06	Mar 06
Sales	172	155	131	117	54
Grth %	221	206	330	145	2
Oth. Income	25	10	7	13	50
Op. Profit	95	83	77	57	4
Grth %	2068	669	1738	230	-51
NP / Loss	82	59	53	47	51
Grth %	62	191	327	268	252
Eq. Capital	12	12	12	12	12
OPM(%)	55	54	59	49	8
NPM(%)	42	36	38	36	49

In FY08, the company is planning to invest Rs 750 crore in the wind farm business by setting up a plant with a capacity of about 125 MW. The project is funded through a mix of debt and internal accruals. It is raising Rs 600 crore of external commercial borrowing at a dollar cost of around seven per cent per annum. The company has already commissioned a 23 MW pilot project with an investment of Rs 160 crore. Power generated through wind farm project would be sold to state electricity boards under a long-term power purchase agreement. These investments will provide GFL with a tax-break on its existing businesses and viable returns going forward.

GFL is also the promoter of the multiplex business subsidiary, Inox Leisure. It has a total of 15 multiplexes with 51 screens under operation. In FY07 it launched five new properties with a fresh addition of 16 screens. Recently Inox has adopted the inorganic route to expand. It is acquiring CCPL which runs '89 Cinemas' and would provide additional nine multiplexes in West Bengal and Assam. In FY07, Inox reported 49 per cent growth in topline and 41 per cent in bottomline to Rs 162.48 crore and Rs 24.79 crore respectively. Post acquisition the financials are expected to grow further.

Financials and valuation

In FY07, the consolidated topline and bottomline of the company grew by 151.4 per cent and 129 per cent to Rs 726.78 crore and Rs 266.6 crore respectively. The company has over Rs 600 crore of treasury portfolios with substantial exposure to the quoted instruments including equity and mutual funds. The value of investment portfolio per share comes to Rs 104 (15.3 per cent of CMP). In FY07 the trading of investment portfolio resulted into strong other income (stand alone) of Rs 55.5 crore. In FY08, we expect standalone topline to be Rs 800 crore and bottomline to be Rs 300-325 crore. On the basis of FY07 consolidated EPS of Rs 45.21, the counter is trading at a P/E of 15x (at CMP Rs 684) whereas its peer, Navin Fluorine International is trading at a higher P/E of 31x. Hence, we recommend investors to buy in the counter. DS