CERA

CSL/2016-17/556
January 10, 2017

BSE Limited Corporate Relationship Department 1st Floor, New Trading Ring Rotunda Building, P J Towers Dalal Street, Fort Mumbai - 400 001. Scrip Code :532443 Scrip ID:CERASAN Fax:022-22722039/2061/2041/2037/3121	The National Stock Exchange of India Limited Exchange Plaza Bandra Kurla Complex Bandra (East) Mumbai – 400 051 Scrip Code : CERA Fax: 022-26598237/38 or 022-26598347/48

Dear Sirs,

RE: CRISIL IER – Independent Equity Research Report

Pursuant to Regulation 30 of Securities Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, we have to inform you that today we have received CRISIL IER – Independent Equity Research Report from CRISIL. We are attaching the same for your kind perusal.

We hope you will find the above in order and take necessary actions in the matter.

Thanking you,

Yours faithfully,
For Cera Sanitaryware Limited,

Narendra N. Patel
President & Company Secretary

Encl: as above

Research

CRISIL
An S&P Global Company

CRISIL IER

Independent Equity Research

Enhancing investment decisions

Cera Sanitaryware Ltd

Detailed Report

Explanation of CRISIL Fundamental and Valuation (CFV) matrix

The CFV Matrix (CRISIL Fundamental and Valuation Matrix) addresses the two important analysis of an investment making process – Analysis of Fundamentals (addressed through Fundamental Grade) and Analysis of Returns (Valuation Grade) The fundamental grade is assigned on a five-point scale from grade 5 (indicating Excellent fundamentals) to grade 1 (Poor fundamentals) The valuation grade is assigned on a five-point scale from grade 5 (indicating strong upside from the current market price (CMP)) to grade 1 (strong downside from the CMP).

CRISIL Fundamental Grade	Assessment	CRISIL Valuation Grade	Assessment
5/5	Excellent fundamentals	5/5	Strong upside (>25% from CMP)
4/5	Superior fundamentals	4/5	Upside (10-25% from CMP)
3/5	Good fundamentals	3/5	Align (+-10% from CMP)
2/5	Moderate fundamentals	2/5	Downside (negative 10-25% from CMP)
1/5	Poor fundamentals	1/5	Strong downside (<-25% from CMP)

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CRISIL
An S&P Global Company

Cera Sanitaryware Ltd

January 06, 2017

Cementing presence across segments

Fundamental Grade: 4/5 (Superior fundamentals) **Valuation Grade: 5/5 (CMP has strong upside)**

Industry: Building products **Fair Value: ₹2,862 CMP: ₹2,093**

As a natural extension of its core sanitary ware product portfolio, Cera Sanitaryware Ltd (Cera) has expanded into faucets and tiles over the past few years. While sanitary ware remains its mainstay, the other businesses are gradually attaining critical mass. In its quest for higher growth, the company is taking several strategic steps across segments, including 1) enhancing presence in the untapped premium segment of sanitary ware, 2) launch of products with innovative designs in faucets across price points, and 3) commission of a tiles manufacturing plant in South India through a joint venture (JV) with Anjani Tiles. We expect these initiatives to augment the company's strong fundamentals and boost growth. While the next few quarters are expected to be challenging, we expect growth to revive in FY18, driven by recovery in demand and the aforementioned measures. Keener competition across product segments remains a threat. We maintain our fundamental grade of 4/5.

Sanitary ware: Premiumisation efforts gathering pace
With well-entrenched positioning in the mass- and mid-market segments of sanitary ware, Cera is looking to bolster its presence in the fast-growing premium segment. It has entered into a marketing-and-distribution agreement with ISVEA, an Italian luxury brand. The company is focusing on high-value products in its portfolio, as reflected in steady growth in realisations. We believe this strategy complements the company's strong presence in the mass- and mid-market segments and augurs well for future growth.

Faucets on steady ground; the new plant in South India to augment growth in tiles
Notwithstanding a slowdown in the faucets segment, we remain positive on the company's growth prospects, given its right steps: (1) launching new products at competitive price points versus Jaquar, the market leader; (2) expanding the distribution network; and (3) bolstering after-sales service. These measures are likely to enhance the brand image and fuel growth. In addition, the newly commissioned tiles plant in the south, where organised players have limited presence, also augurs well for future growth. We expect these segments to continue to boost Cera's growth.

Operating margin likely to expand, but remain below the historical peak of 18-20%
We see limited scope for operating margin expansion, as the benefit of lower gas prices is likely to wane gradually. However, the downside risk to margin is limited, given that premiumisation in sanitary ware, operational efficiency (owing to advance technologies such as 3D printing and automation in faucets) and operating leverage (on higher volume) are likely to offset the impact of higher gas prices.

We raise our fair value estimate to ₹2,862 per share
We revise our earnings estimates for FY17 and FY18, and roll forward our estimates by a year to FY19. Considering the sustained decline in G-sec yields, we revise the cost of equity by 100 bps. Accordingly, we have raised our discounted cash flow-based fair value estimate to ₹2,862 from ₹2,742. At the current price of ₹2,093, our valuation grade is **5/5**.

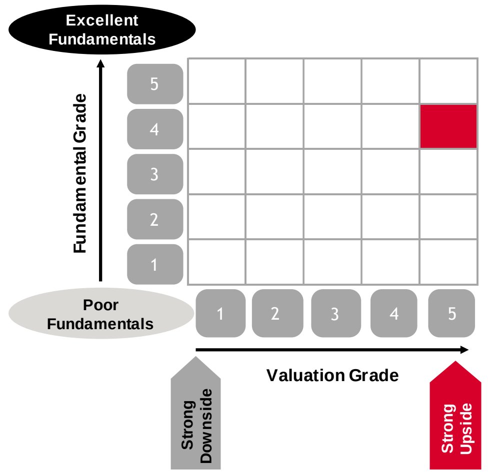
KEY FORECAST

(₹ mn)	FY15	FY16	FY17E	FY18E	FY19E
Operating income	8,234	9,358	10,265	12,360	15,220
EBITDA	1,225	1,439	1,704	2,056	2,516
Adj net income	668	815	1,043	1,301	1,630
Adj EPS (₹)	51.4	62.7	80.2	100.1	125.4
EPS growth (%)	27.6	21.9	28.0	24.8	25.3
Dividend yield (%)	0.3	0.4	0.6	0.7	1.0
RoCE (%)	30.9	29.1	31.6	33.0	33.6
RoE (%)	23.2	21.1	22.5	23.2	24.0
PE (x)	39.9	32.7	25.6	20.5	16.4
P/BV (x)	7.6	6.3	5.3	4.4	3.6
EV/EBITDA (x)	21.8	18.1	14.9	12.2	9.9

NM: Not meaningful; CMP: Current market price

Source: Company, CRISIL Research estimates

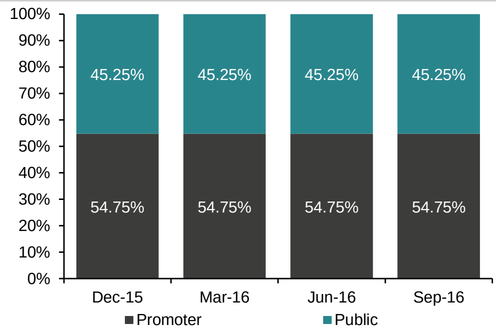
CFV MATRIX



KEY STOCK STATISTICS

NIFTY/SENSEX	8273/26878
NSE/BSE ticker	CERA
Face value (₹ per share)	5
Shares outstanding (mn)	13.0
Market cap (₹ mn)/(US$ mn)	26,691/393
Enterprise value (₹ mn)/(US$ mn)	25,942/382
52-week range (₹)/(H/L)	2,780/1,510
Beta	1.1
Free float (%)	45.3%
Avg daily volumes (30-days)	4,453
Avg daily value (30-days) (₹ mn)	9

SHAREHOLDING PATTERN



PERFORMANCE VIS-À-VIS MARKET

	Returns			
	1-m	3-m	6-m	12-m
Cera	-4%	-17%	-17%	2%
Nifty 500	2%	-6%	1%	7%

For detailed initiating coverage report please visit: www.crisil.com
CRISIL Independent Equity Research reports are also available on Bloomberg (CRI <go>) and Thomson Reuters.

Table 1: Cera - Business environment

Product/segment	Sanitary ware and allied products	Faucets	Tiles and wellness
Revenue contribution (H1FY17)	~62%	~21%	~17%
Revenue contribution (FY19E)	~59%	~21%	~20
Geographic presence	Domestic: 99.7% Exports: 0.3%	Domestic: 100%	Domestic: 100%
Market position	● Third largest player in the organised sanitary ware market, with a share of 23-24%. Over the past few years, Cera's brand salience has grown steadily	● The segment has posted higher growth than the industry; the company is gaining market share (5-6% of the organised market), but is lagging the market leader, Jaquar	● *Ceramic tiles:* Initial traction has been encouraging, but the company remains a small player with <1% share in a highly fragmented market ● *Wellness:* Markets its products with 'value for money' proposition; aimed at price-sensitive consumers
Growth drivers	● The government's emphasis on developing 100 smart cities and improving sanitation is expected to boost growth. Although this is unlikely to directly impact the organised players, it may help expand the addressable market. ● Large players will benefit from a faster shift from the unorganised (30-35% of the market) to organised segment due to: (1) GST implementation, (2) growing affinity for branded products; and (3) rising disposable income. ● The entry into faucets and tiles segments, which have larger addressable markets, is expected to bring rapid growth.		
Sales growth (FY13-16 – three-year CAGR)	15%	43%	71% (from a low base, as the company started trading in tiles from FY13)
Sales forecast (FY16-19E – three-year CAGR)	18%	20%	30%
Key competitors	● *Mass market:* HSIL through Hindware and Raasi brands ● *Mid-market:* HSIL, Roca Bathroom Products ● *Premium/super premium:* American Standard, Kohler, Duravit, Toto, Roca and Groher	● Jaquar and other sanitary ware players, such as Grohe, HSIL and Roca ● Cera faces significant competition from unorganised players in the lower end of the mass market	● *Tiles:* Established players, such as Kajaria, Somany, H&R Johnson (under Prism Cement), Asian Granito, Nitco Tiles, as well as many unorganised players ● *Wellness products:* HSIL and Parryware Roca for the mid-segment; Kohler, Duravit, HSIL, Roca and Toto for the premium segment
Key risks	● Slower-than-expected revival in the real estate sector, with demonetisation likely hampering growth ● Sharp depreciation in the currency can drive up import costs ● Increase in gas prices may impact operating margin expansion		

Source: Company, CRISIL Research

Grading Rationale

Entrenching presence in sanitary ware; other segments attaining critical mass

Cera, a leading organised sanitary ware player, has expanded into faucets and tiles over the past few years. While sanitary ware remains its mainstay, the other businesses are gradually attaining critical mass. In its quest for higher growth, the company is taking several strategic initiatives across all segments – in sanitary ware, it is focusing on increasing its presence in the untapped premium market through a tie-up with the Italian luxury brand, ISVEA. While it is launching a number of innovative products in faucets across price points, in tiles, it has entered into a joint venture with Anjani Tiles to enhance its presence in the south. We believe these initiatives will augment the company's strong fundamentals.

1) Tied-up with ISVEA to enhance its presence in the premium sanitary ware market
2) Expanding product portfolio and distribution network in faucets, and
3) Tapping the south through a joint venture with Anjani Tiles

Sanitary ware

- A major player in the mass- and mid-market segments, Cera has a weaker presence in the premium segment. Through its tie-up with the Italian luxury sanitary ware brand ISVEA, the company is planning to enhance its share in the fast-growing premium sanitary ware market
- Focusing on entrenching dealer network in areas such as the eastern and northern states to consolidate market share in the mass- and mid-market segments
- Bringing in operational efficiencies through captive power supply, use of advanced technologies such as 3D printing, and employee schemes which is reflected in improving margins

Faucets

- After establishing the brand in the industry, the company is launching products with innovative designs across price points, and expanding its distribution network. It has scaled up the manufacturing capacity to support growth prospects
- Automating manufacturing processes to reduce the production time and improve efficiencies

Tiles

- The company has set up a manufacturing capacity in Andhra Pradesh through a JV with Anjani Tiles to established its foot print in the region. Also, fewer large players and high share of imports in the region offer large potential for the company to capture market share

Competitive advantages firmly in place

Despite a challenging business environment, Cera has distinctive competitive advantages (detailed below), which are expected to help it in capitalising on the long-term industry prospects.

Cera maintains its competitive advantages – strong brand equity, diversified product portfolio and wide distribution network

- **Strong brand equity** – Leveraging the wide appeal of the CERA brand, the company remains firmly entrenched, particularly in the mass- and mid-market segments of the sanitary ware industry (~90% of total). Despite being a relatively new entrant, its brand recall in the faucets segment has improved in recent years, as indicated by our primary channel checks.
- **Diversified product portfolio** – By continuously focusing on the introduction of new products and product variants, Cera has established a diversified product line,

encompassing the entire range of sanitary ware, faucets and tiles. With presence across categories and price points, Cera has emerged as a one-stop shop for all bathroom-related products.

- **Wide distribution network** – Over the years, the company has expanded its distribution network across the country. It currently has ~1,600 distributors/dealers and 16,000 retailers (vis-à-vis ~600 dealers and 6,000 retailers in FY11). The company also established 10 Cera style studios in metros and tier-1 cities to promote 'concept bathrooms' and enhance its presence in premium category. Although it lacks the scale of market leaders, HSIL (>3,000 dealers) and Jaquar (~2,000 dealers), the wide distribution reach is an advantage vis-à-vis smaller organised players and unorganised players.
- **Robust financials –** These advantages translate into strong financials for the company, characterised by a lean working capital cycle, healthy cash flow generation, superior RoCE and low financial leverage. We believe the company's strong financials keep it less vulnerable to external shocks and provide more headroom for future growth.

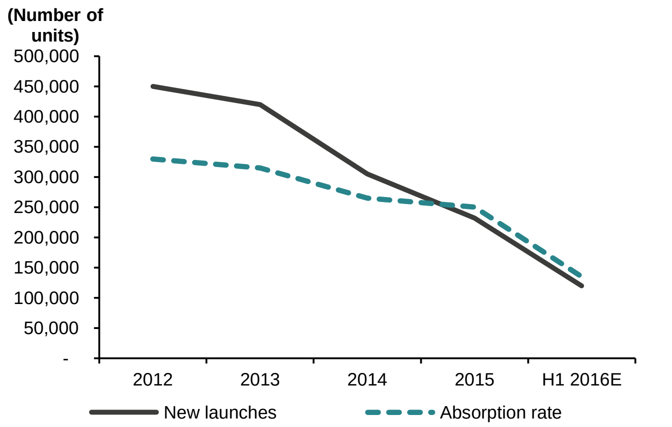
Robust long-term opportunity outshines bleak near-term industry outlook

Prolonged slowdown in end-user demand to mar near-term growth prospects of the building products industry…

High real estate inventory weighs on the growth prospects of building-product players

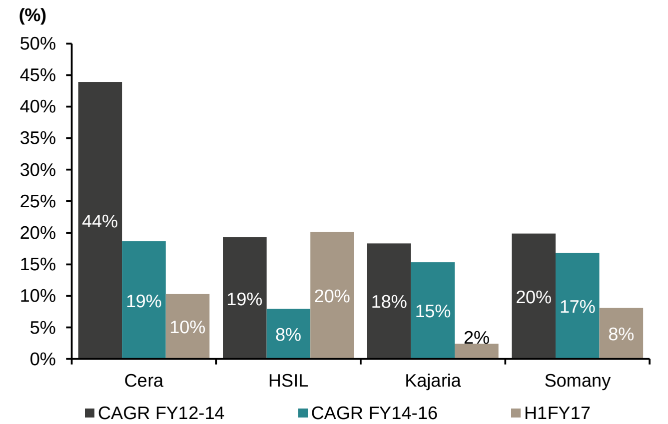
Inventory in the real estate industry has piled up owing to prolonged demand slowdown over the past few years, leading to a fall in new launches, especially in metro and tier-1 cities. Following the slowdown, most building product players witnessed slower growth over FY14-16 vis-a-vis FY12-14 (see Figure 1). Despite moderation in growth momentum, Cera was able to grow faster than its peers, owing to a strong presence in tier-2 and tier-3 cities, where impact of the slowdown was less pronounced. Real estate supply is expected to remain sluggish, especially in metros, owing to high inventory and recent demonetisation, which is likely to curb the flow of unaccounted money into the industry. Consequently, we expect revenue growth for most building-product players, including Cera, to be muted over the next few quarters.

Figure 1: Pace of new launches have slowed down



Source: Industry, CRISIL Research

Figure 2: Revenue growth muted over FY14-16



Source: Company, CRISIL Research

Demonetisation to disrupt short-term consumption

We expect the recent demonetisation to disrupt demand in the short term, especially in the real estate sector.

- **Impact on real estate:** The move is expected to materially pinch the sector, as it ranks high in terms of unaccounted cash transactions. We expect residential real estate demand to decline in the short term. The impact is expected to be more severe in micro-markets/cities where investor demand is high, such at the National Capital Region (NCR) and Mumbai. Also, cities with high inventory, such as NCR and Chandigarh, or large share of unorganised developers, where cash transactions are prevalent, are likely to face further pressure. Moreover, buyers will wait for prices to fall and the price differential between the primary and secondary market to abate. So, a decline in prices along with the Real Estate Bill will improve the sentiment among buyers, leading to a rise in demand in long term.
- **Impact on the building products segment**: We expect demonetisation to impact the building products segment in the near term, because: (1) players will be forced to stretch their working capital cycles, with retailers demanding extending credit period (they will be largely impacted, as their sales are mostly in cash); and (2) consumers are likely to delay non-essential purchases.

…but the long-term growth potential is intact

Despite the bleak near-term prospects, we are positive on the long-term growth potential, as the structural drivers are intact:

Government initiatives

Currently, India faces a severe housing shortage - 107-115 mn, of which ~60% demand is from rural areas. To bridge this gap, the government has introduced several schemes to promote mid-income housing. In the last annual budget, the government announced two central schemes -1) to build 100 smart cities by 2020 and 2) urban development scheme AMRUT, to which it has allocated ₹7.2 bn. The government's focus on housing for all and smart cities is expected to boost the building products industry.

Emergence of concept bathrooms

With changing consumer preferences, bathrooms have evolved into "concepts" from a mere necessity some years back. This is expected to benefit players with integrated operations, providing complete bathroom solutions with innovative and a wide range of products, like Cera

Shift from organised to unorganised segment

Increasing urbanisation, higher disposable income, changing lifestyles and growing brand affinity have led to a shift from the unorganised to organised segment. This trend is expected to continue going forward, driving growth for the organised segment

Replacement demand

Replacement demand constitutes only 10-15% of total demand in India, while globally it accounts for 75-80%. Going forward, with income levels moving towards global standards, we expect replacement demand to follow a similar pattern and lead to shortened replacement period, which augurs well for the sanitary ware and faucet players

Sanitary ware: Maintains the apex position in the mass market; premiumisation efforts gathering pace

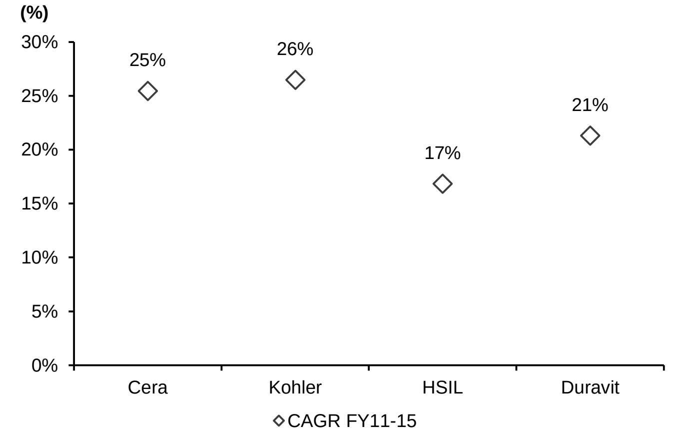
Cera maintains a strong market position in the mass market segment, because of its 'value for money' proposition and a wide brand appeal. Currently, the company derives bulk of its sanitary ware revenue from these segments. Competitive intensity is also relatively lower in these segments because of the lower presence of foreign players. Led by various government schemes, such as affordable housing, and the shift in consumer sentiment towards organised players, we expect this segment to grow at a steady pace.

Tapping the premium segment with the ISVEA tie-up, market share gain is a key monitorable

As highlighted in our previous reports, the company did not have a second brand to cater to the premium market, and the mass-market perception associated with the CERA brand limited its ability to compete with the leading domestic and premium brands. Although the segment accounts for only ~10% of the sanitary ware market, it is one of the fastest growing. The company has addressed this concern through its marketing-and-distribution agreement with the Italian company, ECE Banyo, manufacturer of the luxury sanitary ware brand, ISVEA. We understand that Cera is currently in the process of a pan-India launch of ISVEA's products. While we believe this is a step in the right direction, the company's ability to gain a substantial market share in this highly competitive segment - characterised by the presence of several domestic (HSIL and Parryware) and international players (Kohler, ToTo, Duravit and American Standard) - is a monitorable.

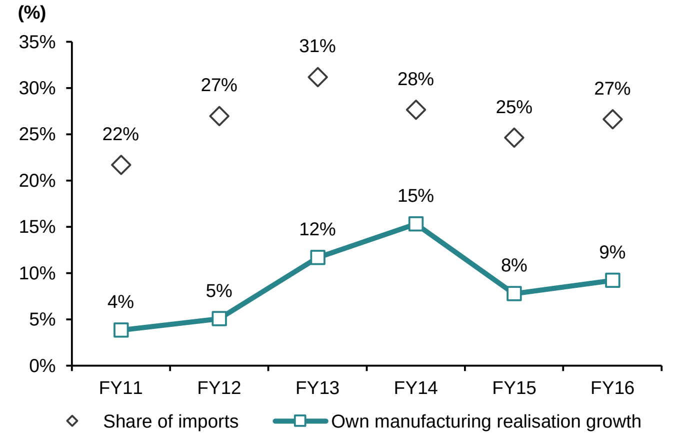
Apart from the tie-up, Cera has also consciously taken efforts to premiumise its product portfolio, by gradually launching products with innovative designs and importing high-end products. This has reflected in the steady increase in the company's realisations of self-manufactured products and share of imports. We believe premiumisation of its product portfolio is a key positive, as it is expected to provide a fillip to revenue and aid margin expansion.

Figure 3: Cera is one of the fastest growing among peers



Source: Company, CRISIL Research

Figure 4: Sustained increase in realisations depicts premiumisation



Source: Company, CRISIL Research

Note: Duravit follows fiscal year ending December.

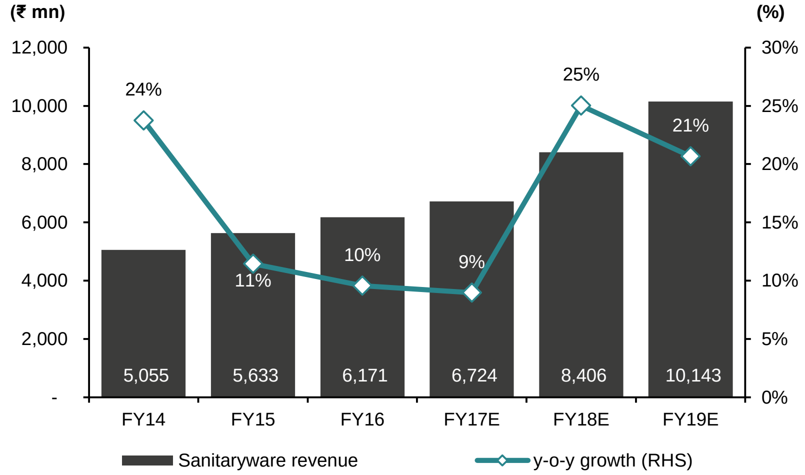
Capacity in place to support 18% CAGR in sanitary ware over FY16-19

We expect demand to gradually revive after a couple of quarters. Given its competitive strength, the company's sanitary ware sales are expected to grow at 18% CAGR over FY16-19E. We believe the company has the adequate capacity in place to support growth.

The company has postponed plans to expand its capacity to 3.3 mn pieces per annum by a couple of quarters, considering the weak demand outlook. We understand that it may further expand capacity, either through a brownfield or greenfield expansion, once demand revives.

Sanitary ware and allied product sales expected to grow at a three-year CAGR of 18%

Figure 5: Sanitary ware segment to pick up in H2FY18



Source: CRISIL Research

GST: Closer to reality; implementation to benefit organised players

The government plans to make the Goods and Service Tax (GST) effective from April 2017. The Ministry of Finance has finalised a four-tier rate structure - 5%, 12%, 18% and 28%. Mass consumption goods are expected to fall in 5%, and luxury goods, tobacco, etc. to fall in 28%, whereas most other goods and services are expected to fall in the 18% category. Some of the key benefits of GST for building products players are highlighted below:

- **Change in the tax structure and input benefits:** The current effective indirect tax rate for most building product companies is in the range of 22-29%, and it does not allow a set-off of tax paid on services. After GST implementation, the effective tax for these companies is expected to go down to 18-20%, as the base rate comes down and also as companies will be entitled for set off benefits. We expect this to be margin accretive for building product players.
- **Warehousing and logistics cost benefits:** Currently, building product companies set up additional depots, employ more C&F agents in different states to bypass CST. With GST, we expect rationalisation of warehouses and an effective inventory/supply chain management. This is also expected to reduce the logistics cost for companies owing to better turnaround time and consolidation of warehouses.

- **Shift from the unorganised to organised segment:** Currently, the unorganised sector accounts for 30-35% of the industry. The GST is expected to accelerate the shift towards the organised segment, as the law is expected to reduce/eliminate tax sops enjoyed by unorganised players, leading to higher compliance. We expect this to create a level-playing field and benefit organised players such as Cera.

Faucets: Growth slowed down in recent quarters, but long-term potential intact

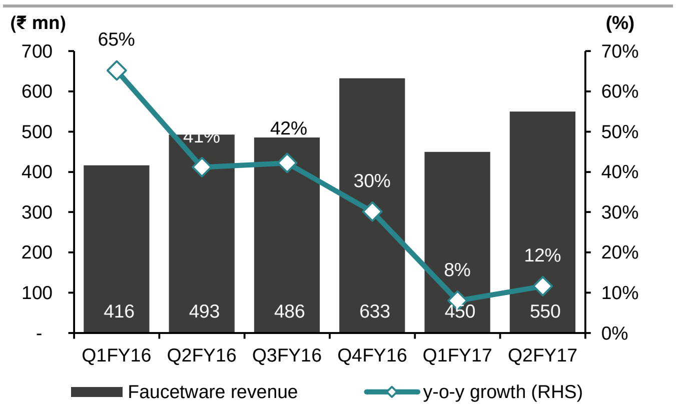
Segmental growth slowed in recent quarters, expected to improve from FY18 onwards

After fuelling growth for the past three years, the segment slowed down in H1FY17 - CAGR of 43% (albeit from a low base) versus 10.5% in H1FY17 – due to the industry slowdown. Despite the slowdown, we remain positive about the segment's growth prospects, as our dealer checks highlight the company's steadily improving brand equity. The segment's growth is expected to revive with demand recovery in the industry.

To bolster its positioning in the faucets segment, the company continues to launch products with attractive designs, prices comparable with Jaquar; currently, it has a wide portfolio, encompassing the entire range of faucets. It has also strengthened its after-sales service, which is a key aspect in this segment. These factors have contributed to the company's steadily improving brand image.

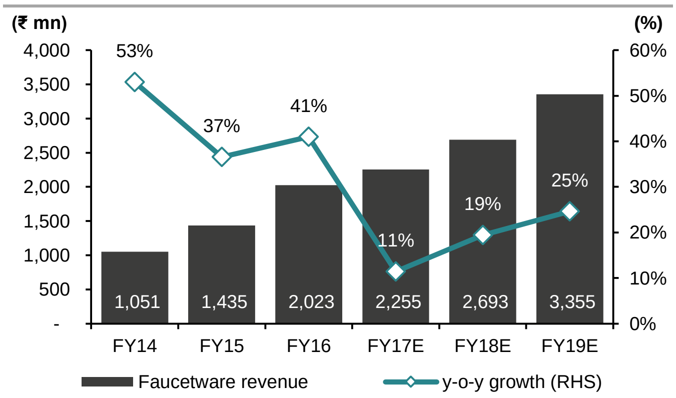
Based on these factors, we believe the company remains on a strong footing in the faucets segment. The addressable market for faucets is large at ₹52-55 bn (Jaquar accounts for ~30% of this market, while numerous other players make up the rest). Cera currently has a ~4% share in faucets, and the factors mentioned above are likely to help it gain share, especially from the smaller players. We expect the faucets segment to post healthy CAGR of 20% over FY16-19. After expansion of its manufacturing facility – to 7,200 pieces/day from 2,500 pieces/day – the company's capacity will be in place to support its growth.

Figure 6: Revenue growth slowed down in recent quarters…



Source: Company, CRISIL Research

Figure 7: …likely to pick up in FY18 as industry revives



Source: CRISIL Research

Tiles: A key growth driver

Facility in the south: A strategic move to leverage strong brand positioning in the region

Cera commissioned a tiles manufacturing facility in Andhra Pradesh through a JV with Anjani Tiles, with a capacity of 3.65 MSM per annum (further scalable to 3-4 times). The unit commenced operations in Q1FY17 and is running at 90% capacity. Cera has infused ₹190 mn for a 51% equity stake in the venture. In conjunction with the industry trend (mentioned below), the company also plans to manufacture fast-growing vitrified tiles at the unit. We understand from our sources that, in the south, a large part of demand is met by Chinese imports – owing to the cost disadvantage of Morbi (Gujarat)-based players and the presence of only a few manufacturing facilities of large players (currently only Kajaria and Mudershwar Ceramics are the organised players with plants in the south). With the government likely to impose higher anti-dumping duties on Chinese imports, demand for indigenous tiles is expected to improve in the south. Hence, Cera is well poised to capitalise on this opportunity, with a facility in the region and by leveraging the established brand recall of CERA in the region (south accounts for ~40% of sanitary ware revenue for Cera). Additionally, the company has also bought a land parcel in the ceramic processing zone in Rajasthan, and may commission a greenfield facility to cater to the north.

We expect the tiles segment to grow at ~30% CAGR over FY16-19E (albeit from a lower base), and its contribution to revenue is expected to increase to 17% in FY19E from 13% in FY16.

Tiles industry to grow at 10-11% CAGR over FY17P-20E; vitrified tiles to grow faster

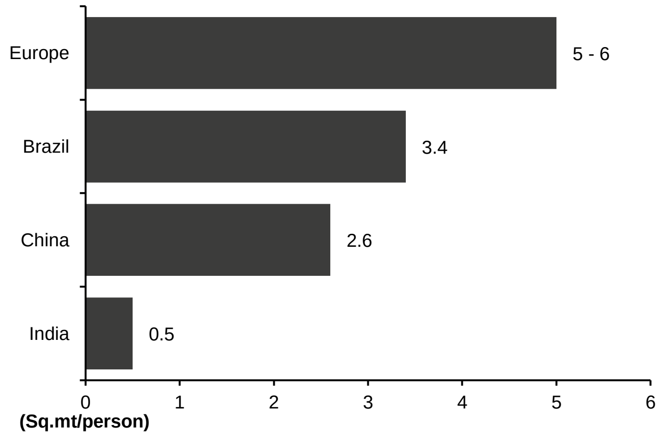
Although the past couple of years have been challenging, the long-term prospects of the tiles industry remain robust. India's per-capita consumption of tiles is much lower by global standards - with only 11% of households using them - depicting the large untapped potential. Aided by the push from government projects, such as smart cities and 'housing for all', and low penetration of tiles in the country, we forecast the Indian ceramic tiles industry to grow 10-11% over FY17-20. At present, of the ₹250-255 bn tiles market, vitrified tiles dominate with a ~54% share. We expect vitrified tiles to grow faster than ceramic tiles, as they are consistent in shape, colour and thickness because of automated production. Additionally, properties, such as high water and chemical resistance are expected to increase demand for vitrified tiles.

Table 2: Vitrified tiles dominate the tiles market

Tiles break-up	₹ bn	MSM	Market share of top 3 players
Glazed vitrified tiles	30-34	45-50	1) Kajaria Ceramics-5-6%
Polished vitrified tiles	100-110	285-295	2) H&R Johnson-4-5%
Ceramic floor tiles	110-120	515-525	3) Somany Ceramics-3-4%

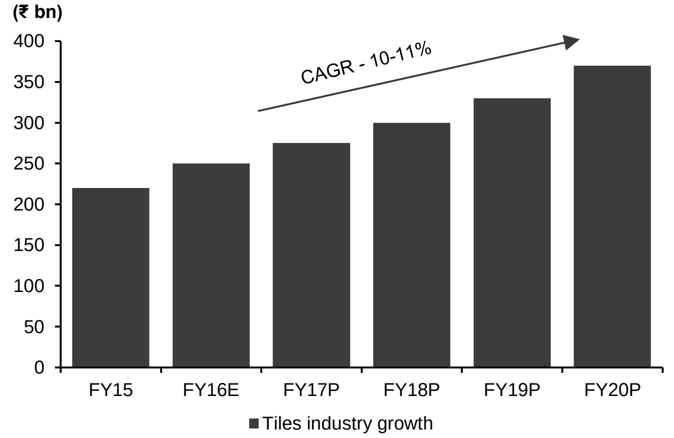
Source: Industry, CRISIL Research

Figure 8: India lags global countries in per capita tile consumption



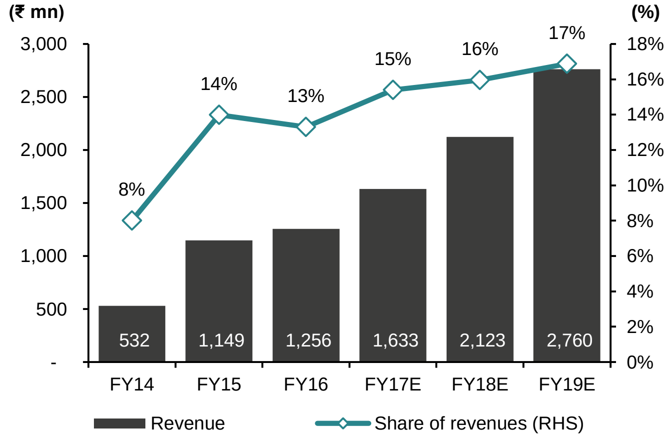
Source: Industry, CRISIL Research

Figure 9: Tiles industry to grow at CAGR of 10-11% over FY16-20E



Source:Industry, CRISIL Research

Figure 10: Cera's tiles segment to grow at ~30% CAGR over FY16-19 aided by in-house manufacturing



Source: Company, CRISIL Research

Imposing higher anti-dumping duty likely to reduce Chinese imports

Currently, about 18-20% of tiles demand is met from imports, especially from China, as the transport cost from China to Chennai is cheaper than that from Morbi to Chennai. In March 2016, the government imposed a provisional anti-dumping duty (US$ 1.37/sq mt) for six months. Despite the duty, imports from China were not largely impacted, as logistics-cost advantage persisted and the presence of fewer large players in south. The tile companies are currently negotiating with the government to reimpose the anti-dumping duty and hike it to US$2-2.5/sq mt. This is expected to reduce the cost adavantage and create a level-playing filed, benefiting the domestic tile players.

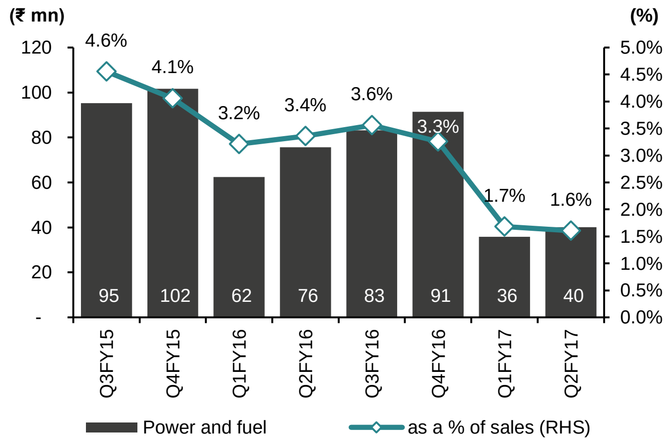
Limited scope for further margin expansion; to remain rangebound over FY17-19E

Power and fuel expenses as a percentage of sales fell to 1.6% in Q2FY17 from 4.6% in Q3FY15. This was driven by a soft APM (administrative pricing mechanism) spot gas prices and internal measures by the company, such as capitve generation of power through installation of solar plants and wind turbines. Lower power costs, coupled with the 'premiumisation' trend in sanitary ware, and cost rationalisation boosted operating margin by 307 bps to 16.8% in H1FY17 from 13.7% in H1FY16.

Low power and fuel costs to aid in margin expansion, but to remain below peak of 18-20% owing to growing contribution from the low-margin tiles segments

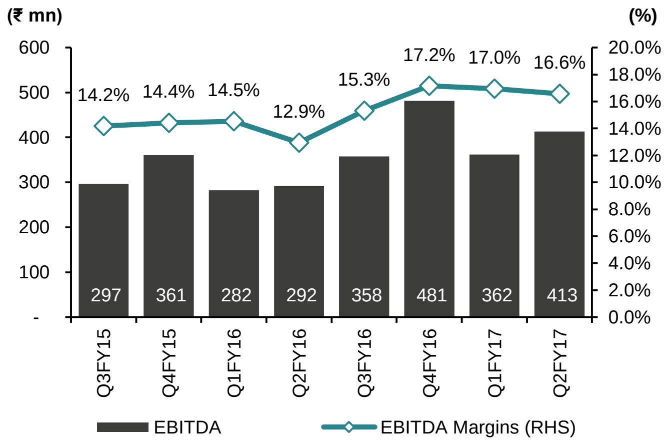
We see limited scope for operating margin expansion, as the benefit of lower gas prices is likely to wane gradually. However, the downside risk to the margin is limited, given the premiumisation trend in sanitary ware, operational efificiency (owing to implementation of advance technologies, such as 3D prinitng and automation in faucets) and operating leverage (due to higher volume) are likely to offset the impact of higher gas prices. Hence, we expect margin to be rangebound over FY17-19E at 16.5-16.6% and remain below the historical peak of 18-20%.

Figure 11: Power & fuel expenses fell to 1.6% of sales…



Source: Company, CRISIL Research

Figure 12: …resulting in EBITDA margin expansion

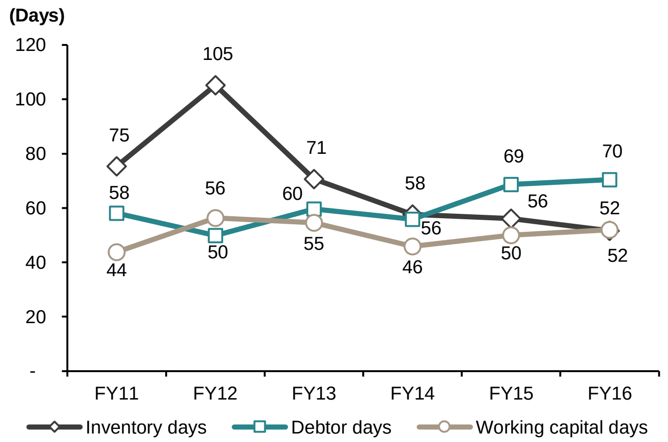


Source: Company, CRISIL Research

Efficient working capital management implies healthy cash accrual and a sturdy balance sheet

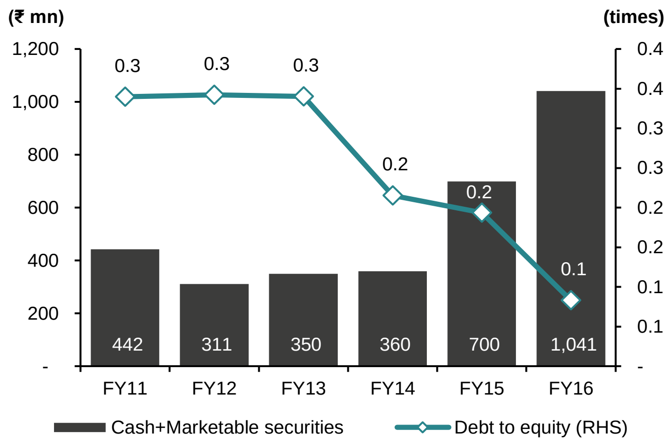
The company's balance sheet quality is robust, driven by an efficient working capital management, low leverage and a healthy cash balance. Working capital days remained at 45-55 days during FY11-16, one of the best in the industry. The efficient working capital management has enabled it to consistently generate positive cash flow from operations and maintain a cash-rich balance sheet. Its leverage declined to 0.1 times in FY16 from 0.3 times in FY11; making Cera almost debt-free. We believe a strong balance sheet provides additional headroom for growth and makes the company less vulnerable to external shocks.

Figure 13: Working capital days range bound



Source: Company, CRISIL Research

Figure 14: Strong cash position and low leverage



Source: Industry, CRISIL Research

Key Risks

Slower-than-expected revival in real estate post demonetisation may hamper growth

A sustained slowdown in the real estate industry may impact the prospects of sanitary ware and faucet players

The prospects of the sanitary ware and faucet segments are linked to the macroeconomic scenario, in general, and the real estate industry, in particular. Real estate supply shrunk over FY13-16 across metros and tier-I cities, impacting growth in recent quarters. Demonetisation is further expected to impact the real estate industry and disrupt consumption in the short term. We expect the move to delay recovery by three to four quarters. However, a slower-than-expected recovery may adversely impact growth.

Sudden increase in gas prices

Gas prices have been trending down for the past few quarters. Since gas prices are linked closely to long-term contract rates, a rise in spot prices is expected to impact the company's profitability.

Sharp depreciation of rupee

Cera imports 20% of its raw materials, stores and spare parts. A sharp depreciation in the rupee could drive up import cost. If the company is unable to pass on the cost increase, its operating margin would be impacted.

Financial Outlook

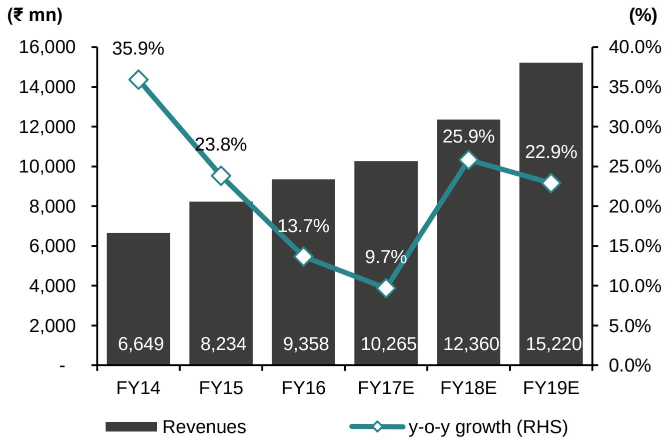
Expect revenue to register ~19% CAGR over FY16-19

Although growth is likely to moderate to 9.7% in FY17, owing to industry headwinds and demonetisation, it is estimated to pick up in FY18, once consumer discretionary spending revives and real estate supply improves.

Revenue is estimated to increase at a CAGR of 19.3% over FY16-19 to ₹15.2 bn, driven by the faucet and tiles segments. Tiles segment is expected to grow 30% over FY16-19E, followed by the faucet (20% CAGR) and the sanitary ware (18%) segments. Consequently, the share of the sanitary ware segment is expected to decline to 57.9% in FY19 from 62.3% in FY14.

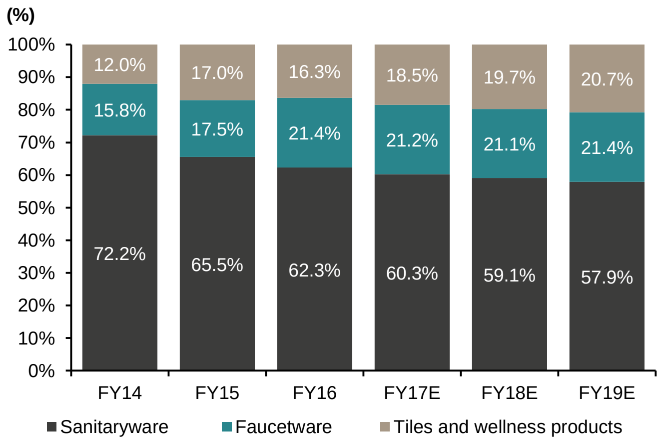
Faucet, ceramic tiles to provide growth impetus

Figure 15: Revenue growth to pick up in FY18



Source: Company, CRISIL Research

Figure 16: Share of sanitary ware to steadily decline



Source: Company, CRISIL Research

EBITDA margin to expand over FY16-19

EBITDA margin is expected to expand 110 bps to 16.5% over FY16-19, driven by: (1) a higher share of in-house manufacturing facility for tiles; (2) premiumisation of the product portfolio, post-marketing arrangement with ECE Banyo and launch of high-end faucets; (3) lower power and fuel costs, following the installation of solar panels and wind turbines, as well as lower crude oil prices; and (4) growth in realisation, once demand recovers in FY18. However, we do not expect EBITDA margin to reach historic levels of 17%+, as growing contribution from the low-margin faucet and tiles segments is expected to contain margin expansion.

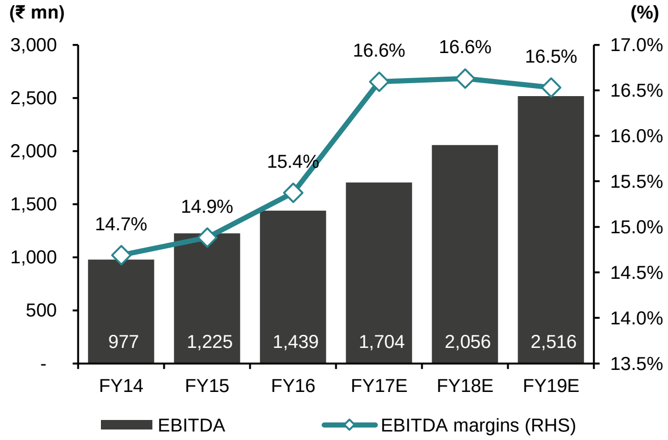
EBITDA margin to expand 110 bps over FY16-19

Adjusted PAT expected to grow at 26% CAGR over FY16-19E

Adjusted PAT is expected to grow to ₹1,630 mn in FY19 from ₹815 mn in FY16 at a three-year CAGR of 26%. Sturdy growth is expected to stem from healthy revenue and EBITDA growth.

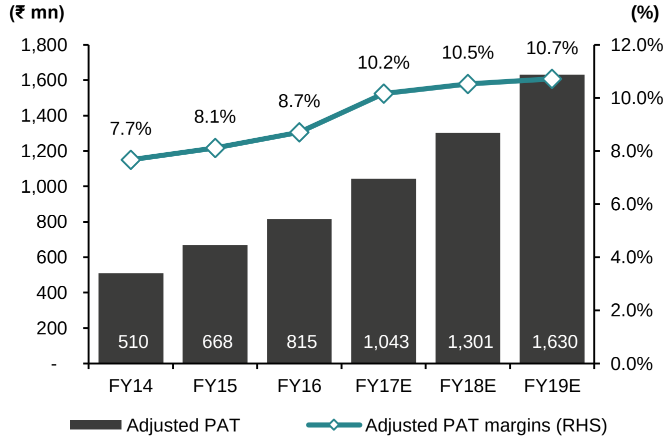
PAT to register healthy growth, driven by higher revenue and EBITDA margin

Figure 17: EBITDA margin to improve in the near term



Source: Company, CRISIL Research

Figure 18: Adjusted PAT expected to post healthy growth



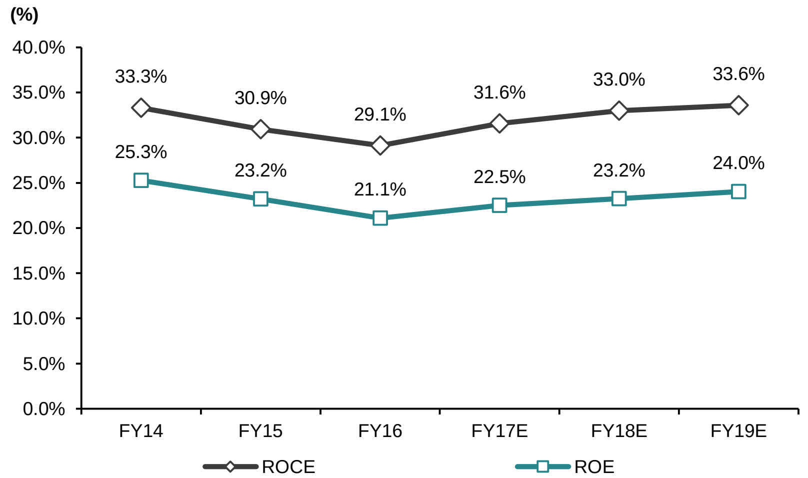
Source: Company, CRISIL Research

Return ratios to improve over FY16-19

RoCE is expected to improve to 33.6% in FY19 from 29.1% in FY16, driven by healthy EBITDA and low leverage. RoE is expected to increase to 24.0% in FY19 from 21.1% in FY16, because of strong PAT margin and faster asset turnover.

Expanding margin to aid RoE and RoCE

Figure 19: Return ratios expected to increase over FY16-19



Source: Company, CRISIL Research

Earnings estimates revised

		FY17E			FY18E			FY19E
Particulars	**Unit**	**Old**	**New**	**% change**	**Old**	**New**	**% change**	**Introduced**
Operating income	(₹ mn)	10,901	10,265	-5.8%	13,746	12,360	-10.1%	15,220
EBITDA	(₹ mn)	1,809	1,704	-5.8%	2,286	2,056	-10.1%	2,516
EBITDA margin	%	16.6%	16.6%	0bps	16.6%	16.6%	0bps	16.5%
Adj PAT	(₹ mn)	1,133	1,043	-7.9%	1,449	1,301	-10.2%	1,630
PAT margin	%	10.4%	10.2%	-23bps	10.5%	10.5%	-1bps	10.7%
Adj EPS	(₹)	87.1	80.2	-7.9%	111.4	100.1	-10.2%	151.2

Source: CRISIL Research estimates

Reasons for changes in estimates

Line item	FY17-18E
Revenue	Decreased to factor in prolonged slowdown in real estate and impact of demonetisation
EBITDA margins	Maintained
Adjusted PAT	Decreased in line with revenue

Management Overview

CRISIL's fundamental grading methodology includes a broad assessment of management quality, apart from other key factors, such as industry and business prospects and financial performance.

Experienced top management…

Promoted by Vikram Somany, Chairman and Managing Director, Cera has a decentralised decision-making process. Mr Somany has over three decades of experience in the sanitary ware business, and has successfully steered the company to become a leading player in the domestic sanitary ware industry. He is ably supported by a professional top management team, headed by Mr Subhash Chandra Kothari, Chief Executive Officer; Mr Atul Sanghvi, Executive Director; and Mr Bharat Mody, strategic advisor.

…aptly supported by a strong second line

Based on our interaction, we believe the company has a professional second line of management, which is well versed with the day-to-day operations. Most of the second line has been with the company for some time.

Successful in executing growth strategies

Successfully ramped up faucets and tiles businesses

Our confidence in the execution capability of the management team has grown over the past couple of years. Management has successfully demonstrated its capability to execute growth strategies by ramping up new businesses - faucets and tiles. Management remains proactive in identifying and executing growth strategies.

Corporate Governance

CRISIL's fundamental grading methodology includes a broad assessment of corporate governance and management quality, apart from other key factors such as industry and business prospects, and financial performance. In this context, CRISIL Research analyses the shareholding structure, board composition, typical board processes, disclosure standards and related-party transactions. Any qualifications by regulators or auditors also serve as useful inputs while assessing a company's corporate governance.

Board processes satisfactory

Board processes and systems are satisfactory. The board comprises eight directors, of whom four are independent, which meets Clause 49 of the SEBI's listing agreement. The company has all the necessary committees – audit, remuneration and investor grievance – in place. Board meetings are held at regular intervals and agenda papers are circulated in advance.

Maintains healthy quality of earnings

- **Healthy earnings:** We believe the quality of earnings is strong, which is reflected in the following parameters:
  - Debtor and inventory days remain largely stable. Cera has consistently generated operating cash flows over the past few years, in line with growth in organic revenue.
- **Treatment of minority shareholders:** Despite consistent capacity addition, the company has maintained a steady dividend payout ratio.
- **Limited related-party transactions:** In our opinion, there are no material related-party transactions or capital allocation issues with the company.

Dividend payout ratio has been below peers'

The company has consistently paid dividends of 11-15% over the past six years, but this is lower than peers'. Given that the company is incurring capital expenditure, it has been focusing on ploughing back the profits into the business.

Dividend payout ratio (%)	FY11	FY12	FY13	FY14	FY15	FY16
Cera	12%	12%	11%	12%	12%	14%
HSIL	22%	21%	24%	58%	33%	32%
Kajaria	29%	22%	20%	20%	17%	17%
Somany	10%	11%	13%	22%	17%	15%

Source: Industry, Company, CRISIL Research

Valuation Grade: 5/5

We have revised our earnings estimates for FY17 and FY18, and rolled forward our estimates by one year to FY19. Considering the sustained decline in G-sec yields, we have revised the cost of equity by 100 bps. Accordingly, we have raised our fair value estimate to ₹2,862 from ₹2,742. Our latest fair value estimate implies P/E multiples of 28.6x and 22.8x FY18E and FY19E EPS, respectively. At the current price of ₹2,093, the stock trades at 20.5x FY18E EPS and 16.4x FY19E EPS. Our valuation grade is **5/5**.

Fair value increased to ₹2,862 on account of roll forward and revision in cost of equity

Key assumptions

We have considered the discounted value of the firm's estimated free cash flows over FY19-28 to sufficiently capture the long-term prospects. In the terminal year, we have assumed a growth rate of 5% and an EBITDA margin of 14.5%. We have assumed cost of equity of 12.1%.

WACC assumptions

	Explicit period	Terminal value
Cost of equity	12.1	12.1
Cost of debt (post tax)	7.4%	7.4%
WACC	11.7	11.7
Terminal growth rate		5.0%

Sensitivity of fair value to terminal growth and WACC

	Terminal growth					
		3.0%	4.0%	5.0%	6.0%	7.0%
WACC	9.7%	2,484	2,693	2,967	3,345	3,900
	10.7%	2,430	2,638	2,912	3,291	3,845
	11.7%	2,379	2,587	2,862	3,240	3,794
	12.7%	2,332	2,540	2,815	3,193	3,747
	13.7%	2,288	2,497	2,771	3,149	3,704

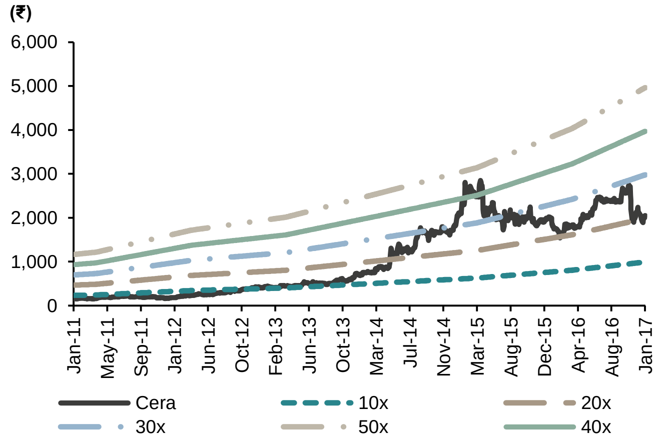
Source: Company, CRISIL Research

Sensitivity of fair value to terminal EBITDA and WACC

	EBITDA margin %					
		14.6%	15.6%	16.6%	17.6%	18.6%
WACC	9.7%	2,659	2,813	2,967	3,121	3,275
	10.7%	2,606	2,759	2,912	3,065	3,218
	11.7%	2,557	2,710	2,862	3,014	3,166
	12.7%	2,512	2,663	2,815	2,966	3,118
	13.7%	2,470	2,620	2,771	2,922	3,073

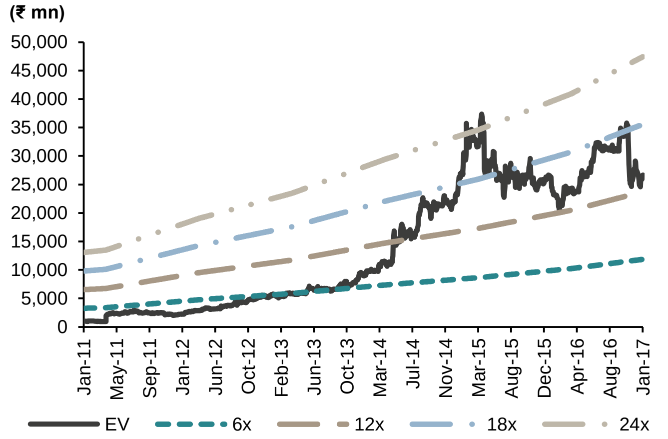
Source: Company, CRISIL Research

One-year forward P/E band



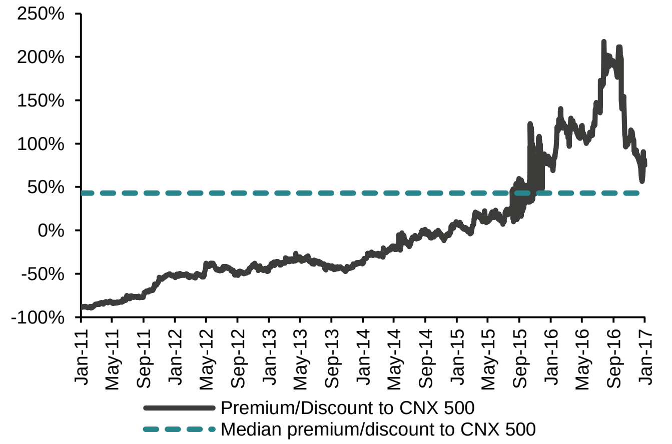
Source: NSE, CRISIL Research

One-year forward EV/EBITDA band



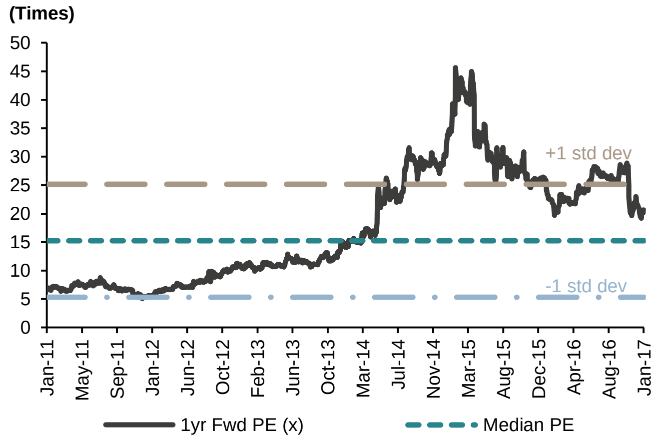
Source: NSE, CRISIL Research

P/E – premium / discount to Nifty 500



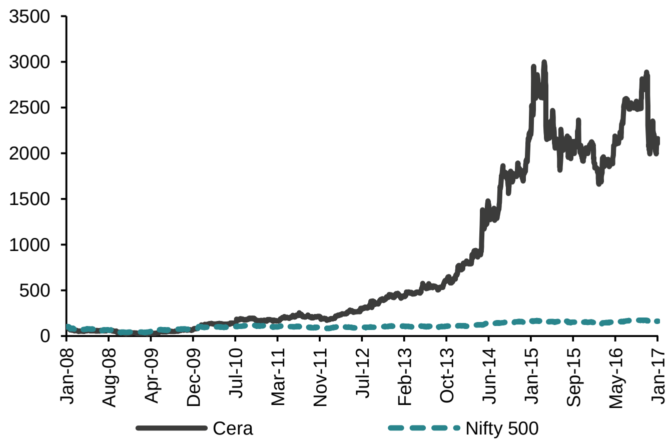
Source: NSE, CRISIL Research

P/E movement



Source: NSE, CRISIL Research

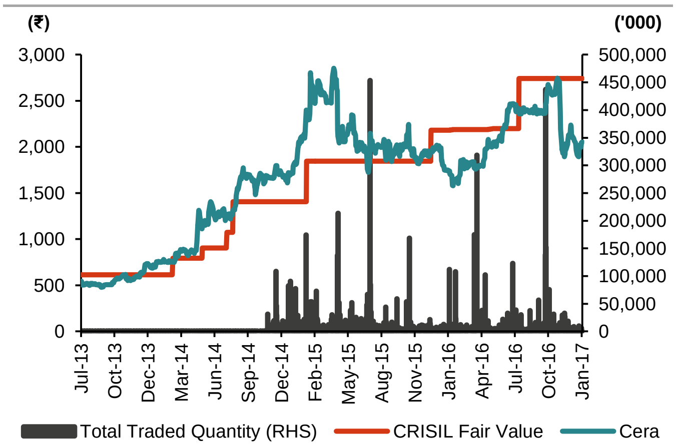
Stock performance vs Nifty 500



-Indexed to 100

Source: NSE, CRISIL Research

Fair value movement since initiation



Source: NSE, CRISIL Research

CRISIL
An S&P Global Company

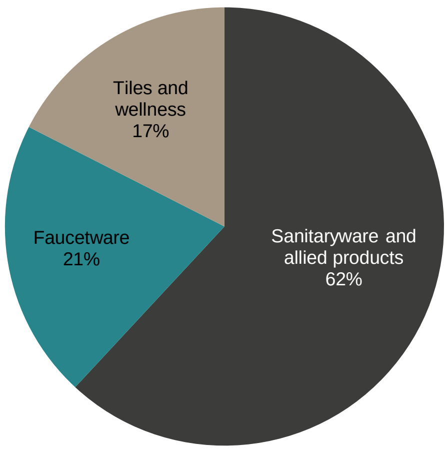
CRISIL IER reports released on Cera Sanitaryware Ltd

Date	Nature of report	Fundamental grade	Fair value	Valuation grade	CMP
07-Aug-13	Initiating coverage	4/5	₹615	4/5	₹511
11-Nov-13	Q2FY14 result update	4/5	₹615	3/5	₹563
28-Feb-14	Q3FY14 result update	4/5	₹794	3/5	₹756
15-May-14	Q4FY14 result update	4/5	₹903	2/5	₹1,139
31-Jul-14	Q1FY15 result update	4/5	₹1,075	2/5	₹1,317
12-Aug-14	Detailed report	4/5	₹1,406	3/5	₹1,543
27-Oct-14	Q2FY15 result update	4/5	₹1,406	2/5	₹1,682
13-Feb-15	Q3FY15 result update	4/5	₹1,846	1/5	₹2,804
05-May-15	Q4FY15 result update	4/5	₹1,846	2/5	₹2,185
06-Aug-15	Q1FY16 result update	4/5	₹1,846	3/5	₹2,004
01-Dec-15	Q2FY16 result update	4/5	₹1,846	3/5	₹1,945
17-Dec-15	Detailed Report	4/5	₹2,181	4/5	₹1,943
12-Feb-16	Q3FY16 result update	4/5	₹2,181	5/5	₹1,578
23-May-16	Q4FY16 result update	4/5	₹2,181	3/5	₹1,954
27-Jul-16	Q1FY17 result update	4/5	₹2,742	4/5	₹2,379
07-Nov-16	Q2FY17 result update	4/5	₹2,742	3/5	₹2,706
06-Jan-17	Detailed Report	4/5	₹2,742	3/5	₹2,093

Company Overview

Incorporated in 1980, Cera has emerged as the third largest player in the Indian sanitary ware industry, with 23-24% market share in the organised segment. Its manufacturing plants for sanitary ware and faucet ware are located in Kadi (Gujarat). The company has increased its installed capacity to 3 mn pieces per annum of sanitary ware and 7,200 pieces per day of faucet ware. It has also entered into a JV to manufacture floor tiles, which were earlier outsourced. The company imports premium sanitary ware products from China and other markets under the CERA brand. The product range includes vitreous Chinese sanitary ware; faucets (chrome-plated fittings and taps); wellness products, such as shower panels, bathroom cubicles, bath tubs, jacuzzi, bath fittings, allied products (PVC cisterns and seat covers); kitchen sinks and bathroom mirrors. Cera has 1,600 distributors/dealers, 16,000 retailers and 21 major stock points across India, along with 10 zonal and service offices.

Figure 20: Segmental revenue break-down for H1 FY17



Source: Company, CRISIL Research

Milestones

1979-80	Incorporated as Madhusudan Ceramics, a unit of Madhusudan Industries Ltd, present in the oil and ceramics segments. Installed capacity of the ceramics division was 0.3 mn pieces per annum
1995-96	Established its outsourcing division, with an initial turnover of Rs 13.7 mn and manufacturing capacity increased to 1.25 mn pieces per annum
2001-02	Demerger of Madhusudan Industries and transfer of the ceramics division to form Cera Sanitaryware Ltd
2005-06	First to introduce the concept of bath studios in Ahmedabad
2006-07	Undertook expansion and increased the capacity to 1.38 mn pieces per annum in sanitary ware
2007-08	Installed captive power plant (gas-based) in Kadi, wind turbine generator and increased capacity to 2 mn pieces per annum in sanitary ware
2010-11	Commissioned manufacturing plant for faucet ware, with an initial capacity of 2,500 pieces per day and scalable to 10,000 pieces per day
2011-12	In the sanitary ware segment, Cera was voted 'Product of the Year' for the second consecutive year
2012-13	Expanded capacity of the sanitary ware plant from 2.0 mn unit to 2.7 mn units
2013-14	Ventured into the vitrified and floor-tiles segments; undertook capacity expansion for faucet ware
2014-15	Tied up with the Italian brand, ISVEA, and entered into a joint venture with Anjani Tiles to set up a manufacturing plant for floor tiles in Andhra Pradesh

Source: Company, CRISIL Research

Annexure: Financials

Income Statement

(₹ mn)	FY15	FY16	FY17E	FY18E	FY19E
Operating income	8,234	9,358	10,265	12,360	15,220
EBITDA	1,225	1,439	1,704	2,056	2,516
EBITDA margin	14.9%	15.4%	16.6%	16.6%	16.5%
Depreciation	155	163	169	194	237
EBIT	1,071	1,276	1,534	1,861	2,279
Interest	77	55	33	7	-
Operating PBT	993	1,221	1,501	1,854	2,279
Other income	4	54	79	117	155
Exceptional inc/(exp)	1	20	-	-	-
PBT	998	1,295	1,580	1,972	2,433
Tax provision	329	460	537	670	803
Minority interest	-	-	-	-	-
PAT (Reported)	669	835	1,043	1,301	1,630
Less: Exceptionals	1	20	-	-	-
Adjusted PAT	668	815	1,043	1,301	1,630

Ratios

	FY15	FY16	FY17E	FY18E	FY19E
Growth					
Operating income (%)	23.8	13.7	9.7	20.4	23.1
EBITDA (%)	25.5	17.4	18.4	20.7	22.4
Adj PAT (%)	31.1	21.9	28.0	24.8	25.3
Adj EPS (%)	27.6	21.9	28.0	24.8	25.3
Profitability					
EBITDA margin (%)	14.9	15.4	16.6	16.6	16.5
Adj PAT Margin (%)	8.1	8.7	10.2	10.5	10.7
RoE (%)	23.2	21.1	22.5	23.2	24.0
RoCE (%)	30.9	29.1	31.6	33.0	33.6
RoIC (%)	23.7	24.1	29.4	32.0	33.0
Valuations					
Price-earnings (x)	37.2	30.5	23.9	19.1	15.3
Price-book (x)	7.1	5.9	4.9	4.1	3.3
EV/EBITDA (x)	20.3	16.8	13.9	11.3	9.2
EV/Sales (x)	3.0	2.6	2.3	1.9	1.5
Dividend payout ratio (%)	12.1	14.0	14.9	14.9	16.5
Dividend yield (%)	0.3	0.5	0.6	0.8	1.1
B/S ratios					
Inventory days	56	52	55	55	55
Creditors days	78	86	85	86	85
Debtor days	69	70	70	70	70
Working capital days	50	52	49	49	48
Gross asset turnover (x)	3.3	3.1	3.2	3.3	3.3
Net asset turnover (x)	4.5	4.3	4.4	4.7	4.7
Sales/operating assets (x)	4.2	4.0	4.3	4.7	4.7
Current ratio (x)	2.1	1.9	2.0	2.0	2.0
Debt-equity (x)	0.2	0.1	0.0	-	-
Net debt/equity (x)	(0.0)	(0.2)	(0.2)	(0.3)	(0.2)
Interest coverage					
EBITDA/Interest	15.9	26.3	51.6	306.4	NM
EBIT/Interest	13.9	23.4	46.5	277.4	NM

Per share

	FY15	FY16	FY17E	FY18E	FY19E
Adj EPS (₹)	51.4	62.7	80.2	100.1	125.4
CEPS	63.3	75.2	93.2	115.0	143.6
Book value	270.4	323.7	389.5	471.5	571.8
Dividend (₹)	6.3	9.0	11.9	14.9	20.7
Actual o/s shares (mn)	13.0	13.0	13.0	13.0	13.0

Balance Sheet

(₹ mn)	FY15	FY16	FY17E	FY18E	FY19E
Liabilities					
Equity share capital	65	65	65	65	65
Reserves	3,452	4,145	5,000	6,068	7,372
Minorities	-	-	-	-	-
Net worth	3,517	4,210	5,066	6,133	7,437
Convertible debt	-	-	-	-	-
Other debt	682	351	89	-	-
Total debt	682	351	89	-	-
Deferred tax liability (net)	278	344	344	344	344
Total liabilities	4,477	4,905	5,499	6,477	7,781
Assets					
Net fixed assets	2,147	2,253	2,447	2,852	3,668
Capital WIP	157	117	-	-	-
Total fixed assets	2,304	2,370	2,447	2,852	3,668
Investments	73	224	224	224	224
Current assets					
Inventory	1,259	1,322	1,547	1,863	2,293
Sundry debtors	1,614	1,886	2,037	2,447	3,010
Loans and advances	493	617	677	816	1,004
Cash & bank balance	222	566	838	1,107	1,184
Marketable securities	478	475	475	475	475
Total current assets	4,065	4,867	5,574	6,706	7,966
Total current liabilities	1,965	2,561	2,750	3,310	4,081
Net current assets	2,100	2,306	2,824	3,396	3,885
Intangibles/Misc. expenditure	-	5	5	5	5
Total assets	4,477	4,905	5,499	6,477	7,781

Cash flow

(₹ mn)	FY15	FY16	FY17E	FY18E	FY19E
Pre-tax profit	997	1,275	1,580	1,972	2,433
Total tax paid	(253)	(394)	(537)	(670)	(803)
Depreciation	155	163	169	194	237
Working capital changes	(544)	135	(246)	(303)	(412)
Net cash from operations	355	1,179	967	1,192	1,456
Cash from investments					
Capital expenditure	(819)	(234)	(246)	(600)	(1,053)
Investments and others	(360)	(148)	-	-	-
Net cash from investments	(1,179)	(382)	(246)	(600)	(1,053)
Cash from financing					
Equity raised/(repaid)	706	0	(0)	-	-
Debt raised/(repaid)	199	(331)	(261)	(89)	-
Dividend (incl. tax)	(98)	(142)	(188)	(234)	(326)
Others (incl extraordinaries)	1	20	(0)	-	-
Net cash from financing	808	(453)	(449)	(324)	(326)
Change in cash position	(16)	344	271	269	77
Closing cash	222	566	838	1,107	1,184

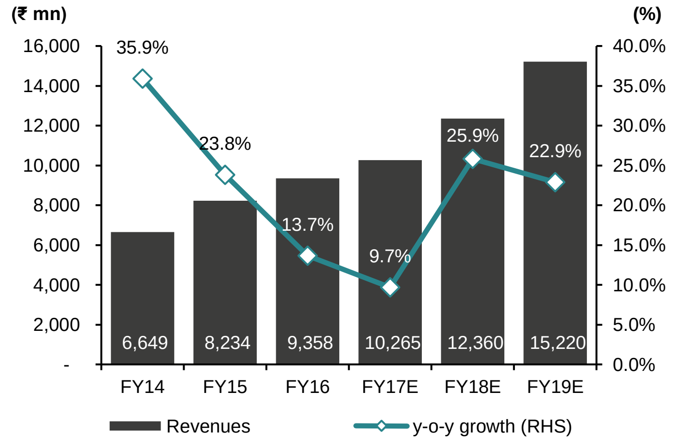
Quarterly financials

(₹ mn)	Q2FY16	Q3FY16	Q4FY16	Q1FY17	Q2FY17
Net Sales	2,253	2,335	2,806	2,136	2,492
Change (q-o-q)	16%	4%	20%	-24%	17%
EBITDA	292	358	481	362	413
Change (q-o-q)	3%	23%	35%	-25%	14%
EBITDA margin	12.9%	15.3%	17.2%	17.0%	16.6%
PAT	179	201	298	214	251
Adj PAT	179	201	298	214	251
Change (q-o-q)	14%	12%	48%	-28%	18%
Adj PAT margin	7.9%	8.6%	10.6%	10.0%	10.1%
Adj EPS	13.8	15.5	22.9	16.5	19.3

Source: CRISIL Research

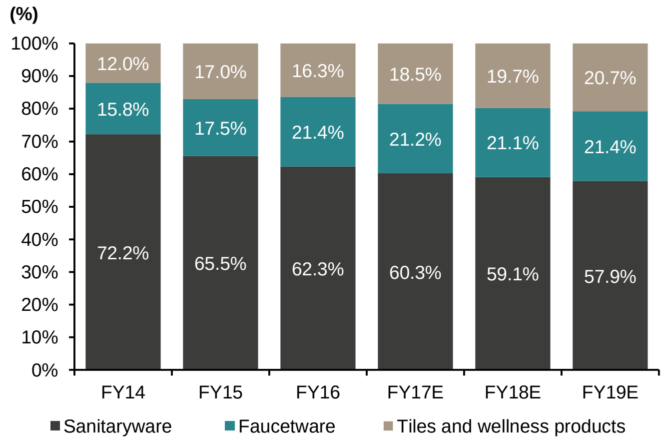
Focus Charts

Revenue growth to pick up in FY18



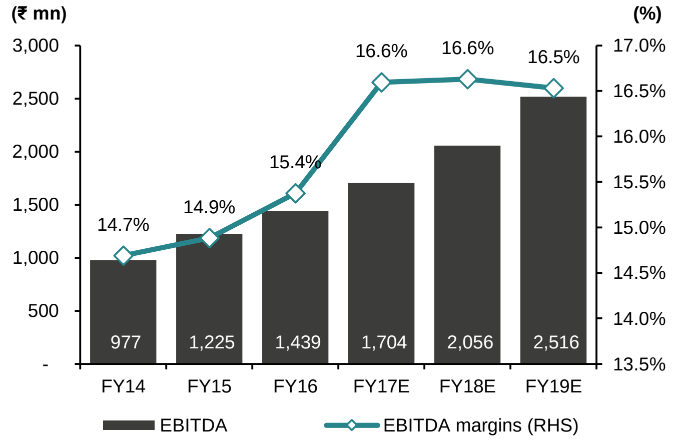
Source: Company, CRISIL Research

Share of sanitary ware to decline steadily



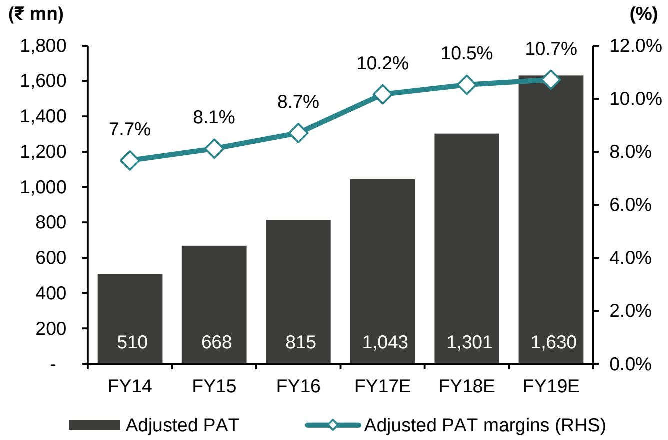
Source: Company, CRISIL Research

EBITDA margin is expected to expand in the near term



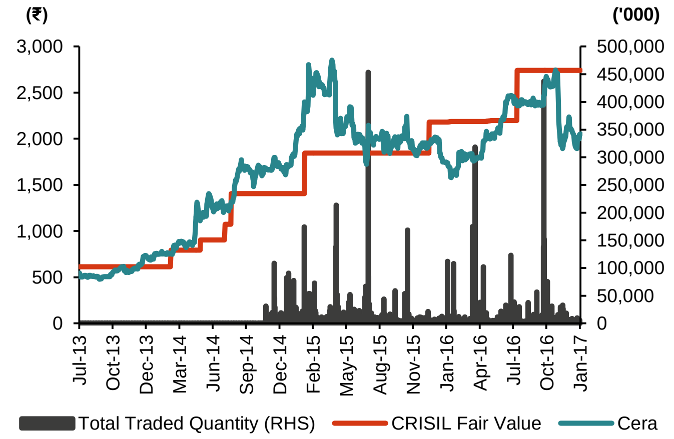
Source: Company, CRISIL Research

Adjusted PAT expected to post healthy growth



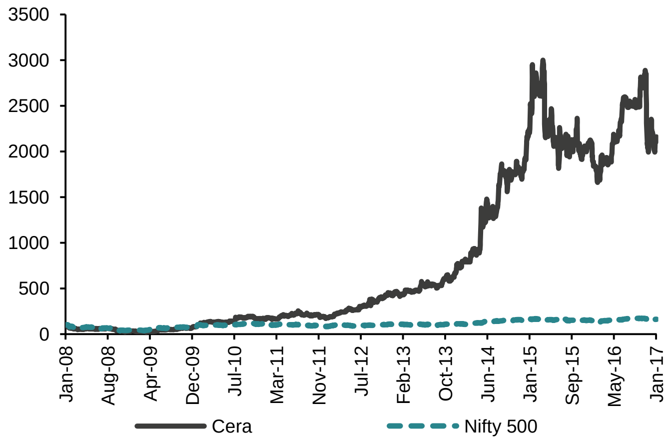
Source: Company, CRISIL Research

Fair value movement since initiation



Source: Company, CRISIL Research

Share price movement vs Nifty 500



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Source: Company, CRISIL Research

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Analyst Disclosure

Each member of the team involved in the preparation of the grading report, hereby affirms that there exists no conflict of interest that can bias the grading recommendation of the company.

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