

SEPTEMBER 27, 2018

	26-Sep	% Chg		
		1 Day	1 Mth	3 Mths
<b>Indian Indices</b>				
SENSEX Index	36,542	(0.3)	(4.5)	3.0
NIFTY Index	11,054	(0.1)	(4.4)	2.6
NSEBANK Index	25,376	0.2	(8.8)	(4.6)
NIFTY 500 Index	9,302	(0.0)	(5.6)	0.8
CNXMcap Index	17,921	0.3	(8.3)	(2.9)
BSESMCAP Index	15,240	0.1	(9.6)	(6.5)
<b>World Indices</b>				
Dow Jones	26,385	(0.4)	1.3	9.4
Nasdaq	7,990	(0.2)	(0.3)	7.3
FTSE	7,511	0.1	(0.9)	(1.4)
NIKKEI	24,034	0.4	5.3	7.8
Hangseng	24,034	0.4	5.3	7.8
Shanghai	27,817	1.2	(1.3)	(1.6)

<b>Value traded (Rs cr)</b>	26-Sep	% Chg Day
Cash BSE	3,016	(26.1)
Cash NSE	35,572	(22.3)
Derivatives	1,229,901	(55.0)

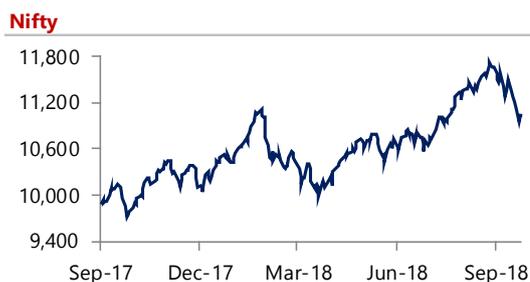
<b>Net inflows (Rs cr)</b>	25-Sep	MTD	YTD
FII	(3,682)	(7,846)	(13,285)
Mutual Fund	1,544	7,684	84,301

<b>Nifty Gainers &amp; Losers</b>	Price	Chg	Vol
26-Sep	(Rs)	(%)	(mn)
<b>Gainers</b>			
Indiabulls Housing	1,000	7.6	13.8
UPL Ltd	698	5.5	3.8
Vedanta Ltd	242	4.8	40.6
<b>Losers</b>			
Tata Motors	233	(3.1)	17.8
Bharti Infra	262	(2.9)	2.6
Wipro	319	(2.8)	7.9

<b>Advances / Declines (BSE)</b>					
26-Sep	A	B	T	Total	% total
Advances	229	514	52	795	100
Declines	201	496	91	788	99
Unchanged	2	21	13	36	5

	26-Sep	% Chg		
		1 Day	1 Mth	3 Mths
<b>Commodity</b>				
Crude (US\$/BBL)	82.3	1.1	7.9	6.0
Gold (US\$/OZ)	1,194.4	(0.6)	(1.1)	(4.4)
Silver (US\$/OZ)	14.3	(0.9)	(2.9)	(9.9)

<b>Debt / forex market</b>	26-Sep	1 Day	1 Mth	3 Mths
10 yr G-Sec yield %	8.1	8.1	7.9	7.8
Re/US\$	72.6	72.7	70.2	68.3



Source: Bloomberg

## News Highlights

- ▶ India raised import duty on a range of items including air-conditioners, refrigerators, washing machines, footwear, jewellery, furniture fittings and tableware besides imposing it on aviation turbine fuel (ATF) as the government seeks to rein in the current account deficit and shore up the rupee. (ET)
- ▶ The Supreme Court upheld the constitutional validity of the Aadhaar (Targeted Delivery of Financial and Other Subsidies, Benefits and Services) Act, 2016, but curbed the scope of the controversial biometric identity project by diluting several of its provisions. (BS)
- ▶ The Cabinet cleared a Rs. 55 bn package for the sugar industry, which is facing an unprecedented production glut. (BL)
- ▶ Kharif foodgrains output in 2018-19 is expected to touch a record 141.59 mt, marginally higher than the targeted 141.2 mt, according to the first advance estimates of production of major kharif crops released by the Agriculture Ministry. (BL)
- ▶ The Union cabinet approved the new telecom policy that aims to attract \$100 bn in investments into India by 2022 and create 4 million jobs. (Mint)
- ▶ **NMDC** has increased iron ore prices owing to a rise in demand in the international and domestic markets as well as higher steel and pellet rates. (BS)
- ▶ **Lupin** has started a strategic review of its Japanese operations, people with knowledge of the matter said, as the company seeks to focus on higher-growth areas. (BS)
- ▶ Cash-strapped **Jet Airways** will pay only 75 per cent of August salary to its pilots, engineers and senior management this month. The airline has said it shall "make every effort" to release the remaining 25 per cent by October 9. (BS)
- ▶ **National Aluminium Company (Nalco)** is placing high stakes on downstream aluminium business. The company has pledged an investment of Rs 5.52 billion on a major downstream complex at Kamkhyanagar in Dhenkanal district. (BS)
- ▶ **NBCC (India) Limited** has received in principle approval from Air India to monetize/redevelopment of Air India Land parcel at Baba Kharag Singh Marg, Connaught Place and Vasant Vihar in the national Capital. (BL)
- ▶ **HCL Technologies** has received a five-year infrastructure services deal from UK-headquartered mining major Anglo American. HCL Tech will also continue to provide regional and local service desk support and end-user computing services. (ET)
- ▶ **BSE** has received capital market regulator Sebi's approval to launch delivery based futures contract in gold and silver. Trading of these contracts will be launched on October 1, 2018. (ET)
- ▶ The Executive Committee of **State Bank of India's** board approved the sale of 4 per cent stake in its subsidiary, SBI General Insurance Company (SBI GI), for Rs4.82 bn (about \$66 million). The proposed transaction values SBI GI at over Rs 120 bn. (BL)

## What's Inside

- ▶ **Sector Update:** Paper Industry

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, IE = Indian Express, BL = Business Line, ToI: Times of India, BSE = Bombay Stock Exchange, MC = Moneycontrol

**Sector Update**
**SECTOR UPDATE – PAPER INDUSTRY**

We are upbeat on China's stringent regulation to curb pollution as it has further intensified production cuts spread across six regions. The production cut has helped the prices of various commodities (steel, chemicals, papers, to name few) to remain firm or see a sharp surge even in the lean season. The uptick in the prices in the domestic market is also supported by the rupee depreciation. In the paper industry, restrictions on using waste paper from China (imports of recovered paper declined 50% YoY during Jan-Jul'18), has supported the prices. Besides this, mills having capacity less than a 300KT/year, were forced to stop import of waste paper.

**Key highlights:**

- ❑ China has extended the duration of production cuts during the winter by two months starting from Oct 1 till Mar 31 next year in 28 cities. This compares to the last year period from 15 Nov 17 to 15 Mar 18.
- ❑ China witnessed the permanent closure of smaller non-compliant domestic mills using non-wood or recovered fibres. During FY18, capacities close to 300KT/year were shut down in China due to lack of environmental compliance.
- ❑ China has also restricted and delayed annual import licenses for domestic companies that receive wastepaper as a commodity for recycling. China is the world's largest importer of waste paper, with import volume of more than 60% of the global trade. Top 3 players in China account for 21% market share.
- ❑ China has substantially raised its import of pulp, leading to a spike in pulp prices. Pulp is a substitute for waste paper and its major exporters — Indonesia, Malaysia, Chile – have diverted theirs to China at a higher price.
- ❑ We believe that, given the high cost curve globally coupled with rupee depreciation, Indian paper industry should do well in the near term. Besides, this having access to raw material (wood and waste paper) at competitive rates and no new capacity coming on stream in the near term, shall support the earnings of industry players.

**Outlook**

Increasing demand from China for high quality product or intermediate items for finished products and rupee depreciation, has led to shift in focus of various domestic players in the paper industry to the lucrative export market, thereby creating paucity in the domestic market. This has resulted in a sharp surge in paper prices. Besides this, increasing cost curve globally has also supported the final product prices (China imported pulp prices increased by ~29% YoY during Jan-Jul'18 to average of US\$797/tonne). We believe the benefit of the higher paper prices will reflect with a lag of 2-3 months and all the paper companies are likely to remain under focus for the near term, as 3QFY19E number should reflect the benefit of the uptick in the commodity prices. Paper industry in the domestic market will also benefit from consolidation (as per industry, around 20 companies have stressed balance sheet and operating at sub-optimal capacity); and possible imposition of anti-dumping duty.

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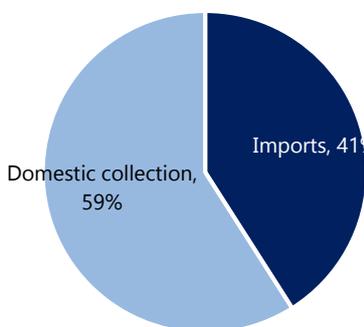
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### China new environmental norms – boon for paper industry

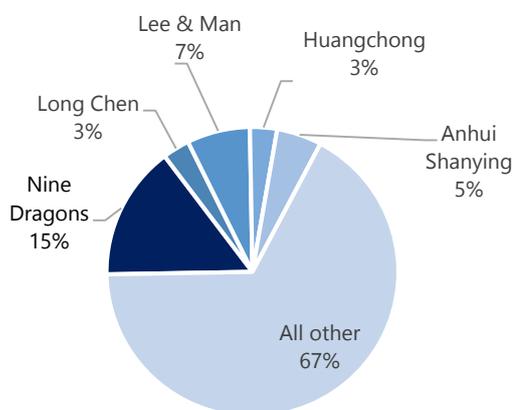
China started a massive environmental overhaul in 2018 to ensure the effective curb of air pollution in key regions which is expected to last until April 2019. Approximately 18,000 environmental supervisors, which is three times the number of supervisors dispatched last year, will be dispatched to discover environmental protection problems in the Beijing-Tianjin-Hebei region and the surrounding areas, the Yangtze River Delta, the Fenhe and Weihe river plains. The Chinese paper industry is heavily dependent on imported waste paper to keep their mills running and accounts for ~60% of the total imports in the global trade. Chinese top 5 largest paper producers rely on imported recovered paper and top 3 producers’ accounts for 21% of the market share, as against 67% in the U.S. In India, the industry is fragmented, with top 3 producer’s accounting for 9%.

#### China’s paper industry is dependent on recovered paper



Source: UN Comtrade

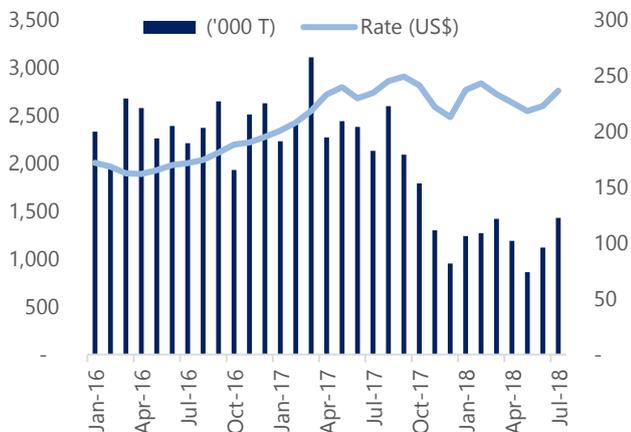
#### 5 largest Chinese producers rely on imported recovered paper



Source: Fisher international report

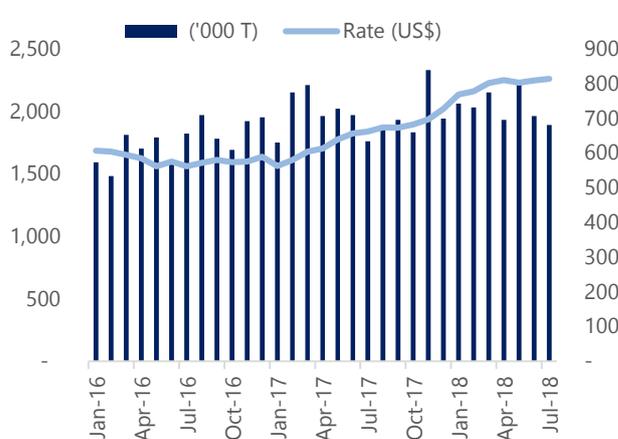
In the last production cuts, as per the industry and media reports, China witnessed the permanent closure of smaller non-compliant domestic mills using non-wood or recovered fibres. During FY18, mills close to 300KT/annually were shut down and facilities having a sub optimal capacity has seen a revision in import licensing to prevent them to apply for import permits of recovered paper.

#### Decline in waste paper imports ...



Source: Industry data

#### ...led to higher pulp imports and pulp prices



Source: Industry data

China is the world’s largest importer of waste paper, with import volume of more than 60% of the global trade. The closure of the facilities and restrictions on import of waste paper has led to oversupply of waste paper in the global market. This has resulted in a decline in waste paper prices. This led to higher imports of pulp has increased in China, resulting in an increase in the average cost of imported pulp by ~29% YoY during Jan-Jul’18.

**Spike in European Pulp prices**



Source: Bloomberg

**Pulp exports by Indonesia and Chile**



Source: Bloomberg

Though, the Chinese paper industry, faced the brunt of stringent environmental regulations, top players gained market share at the expense of the smaller players, resulting in improvement in EBITDA margin and RoCE.

**Chinese company’s profitability**

Company	EBITDA Margin %					ROCE %				
	2014	2015	2016	2017	1HCY18	2014	2015	2016	2017	1HCY18
Nine Dragons Paper Holdings Lt	18.6	16.9	20.7	22.3	26.7	5.8	4.8	3.8	10.4	15.2
Long Chen Paper Co Ltd	10.7	12.7	13.3	14.9	10.8	4.9	4.9	9.2	10.8	9.2
Lee & Man Paper Manufacturing	18.7	21.6	19.0	25.9	23.1	8.9	9.6	11.1	17.5	18.9
Shanying International Holding	14.8	15.5	13.3	20.7	23.7	7.3	6.8	7.4	19.6	25.1
Shandong Chenming Paper Holdin	14.6	20.4	23.2	28.5	27.1	5.4	7.5	10.6	13.5	14.9

Source: Bloomberg

We believe that, Chinese factors are positive for the Indian paper industry, as they will be able to source the waste paper at a low cost when there is increasing cost of production globally, helping the Indian paper manufacturers to garner higher realisation.

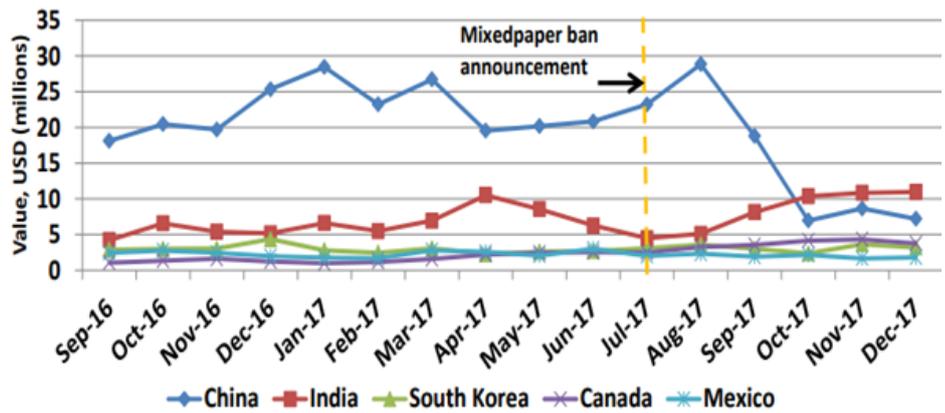
**Way Forward for China**

We are of the view that, Chinese paper and packaging industries could build higher virgin paper mills to meet the higher demand along with meeting compliance & environmental norms. However, this requires an extensive capital investment and procurement of pulp remains a challenge as well. Hence the virgin paper mill appears to be a long term solution and may not happen in the short term. Chinese industries could procure pulp from existing exporters. This would support the pulp prices in the near to medium term, in our view. On the other hand, China’s end users could directly import paper and packaging products, which would support the final product prices. Based on the above observations, we believe that considering the size of China’s paper industry and reliance on waste paper imports as a source of raw material, it might have to relax their restrictions on waste paper imports. However, in the long term, China may reduce their dependency on waste paper and shift to virgin fiber as a primary source of raw material to mitigate the increased risk of landfills.

### Impact on US companies

The ban and restrictions in China has also affected the recovered paper business in other countries. Exports from the U.S to China declined 50% YoY. This led to a sharp fall in waste paper prices, hurting the profits of collectors of waste papers. But, at the same time, this has resulted in windfall gains for domestic consumers of recovered paper in the US and Europe as the capital cost of building and maintaining virgin fiber pulp is much higher compared to recover fiber.

#### Top 5 U.S export destinations for mixed paper



Source: HIS Market GTA database (accessed February 20, 2018)

#### Profitability of US paper companies

Company	EBITDA Margin (%)					ROCE (%)				
	2014	2015	2016	2017	1HCY18	2014	2015	2016	2017	1HCY18
International Paper Co	12.2	14.4	13.0	13.1	14.6	7.4	10.1	12.4	18.1	18.9
Packaging Corp of America	18.5	19.3	19.7	20.5	19.0	11.0	12.4	12.2	16.2	16.6
KapStone Paper and Packaging	19.0	13.0	11.5	11.6	12.3	8.9	5.7	4.6	10.8	11.8
Domtar Corp	13.4	12.3	11.2	0.1	11.6	N.A	5.2	3.6	(5.3)	(5.0)
Neenah Inc	13.9	15.0	15.5	14.0	12.6	17.4	10.7	15.6	15.1	13.5

Source: Bloomberg

### Impact on Indian paper industry

The Indian paper industry is highly fragmented, with top 3 producer’s accounting for 9% of the market share. The domestic industry is also largely dependent on imports of pulp, wastepaper and even pulpwood to meet their raw material requirements. At times, the companies have also paid a premium to secure the same, which impacted their profitability. We believe that, given the stringent regulation by China in place in restricting waste paper imports, possibility of oversupply of waste paper in the near term exists, which can result in decline in overall cost. At the same time, higher imports of pulp from China, is likely to keep pulp prices firm, which will weigh partly on the domestic company’s profitability.

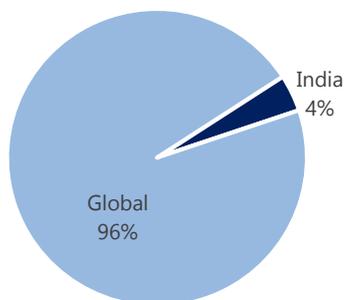
### Domestic player capacity (tonnes) and integration

Company	Installed Capacity	Pulping Capacity	Integration
International Paper APPM	241,000	181,500	94%
West Coast Paper	320,000	232,000	91%
Trident	175,000	125,000	89%
TNPL	600,000	377,600	79%
Seshasayee	187,000	115,000	77%
JK Paper	455,000	276,000	76%
Ballarpur Industries	856,000	420,000	61%
ITC	742,000	350,000	59%
Orient Paper	135,000	62,000	57%
Astron Paper	119,000	-	-
NR Agrawal Ind	306,000	-	-
Shri Rama New	132,660	-	-

Source: Company, Kotak Securities – Private Client Research

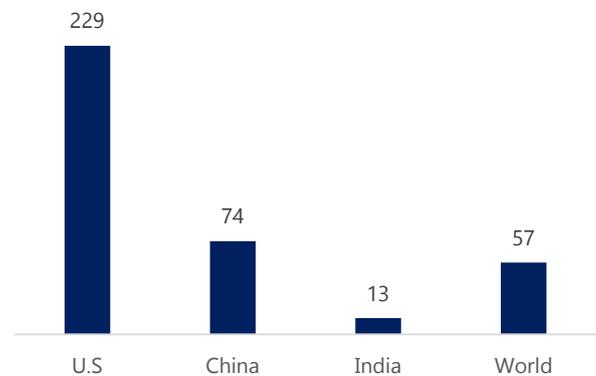
The domestic paper industry, accounts for 4% of the global market share, with per capita consumption of 13kg, as against global average of 57kg. The domestic demand of paper in India has been growing at a CAGR of 6.6% and is likely to touch 18.5MT by the end of FY19E. Printing and writing segment is expected to grow at 4.2% CAGR, packaging paper and board segment is expected to grow at 8.9% CAGR. Packaging production accounts for 49% of the domestic consumption, followed by printing & writing paper with 31%, newsprint with 16% and specialty at 4%.

### India’s share in global market



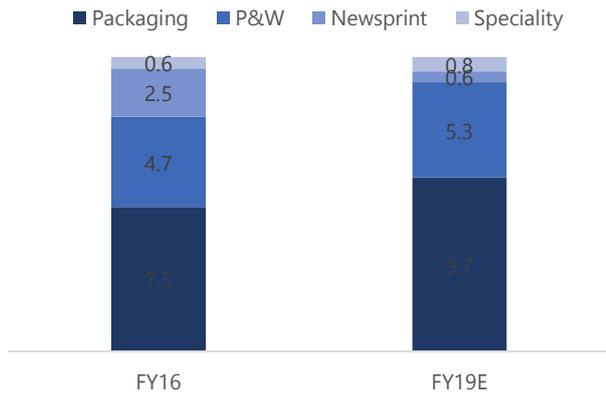
Source: Industry data

### Per capital consumption (kg)



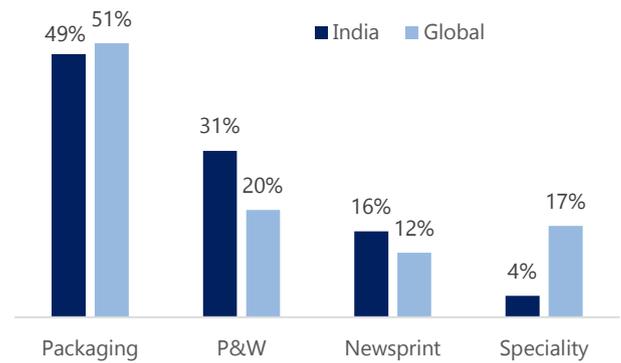
Source: Industry data

**Domestic demand to touch 18.5MT by FY19E**



Source: Industry data

**India vs world: segment wise contribution**

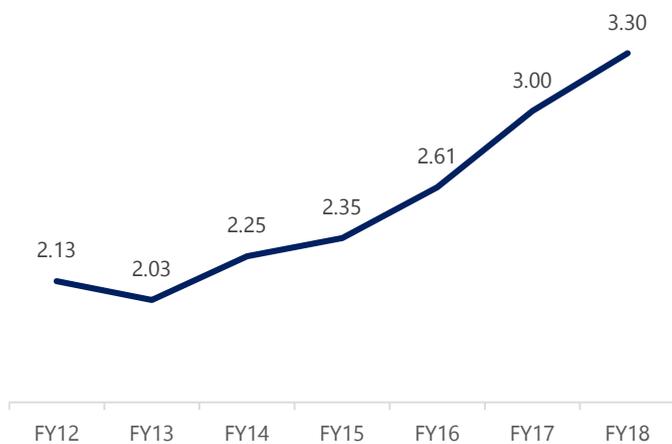


Source: Industry data

**Increasing imports hurting industry**

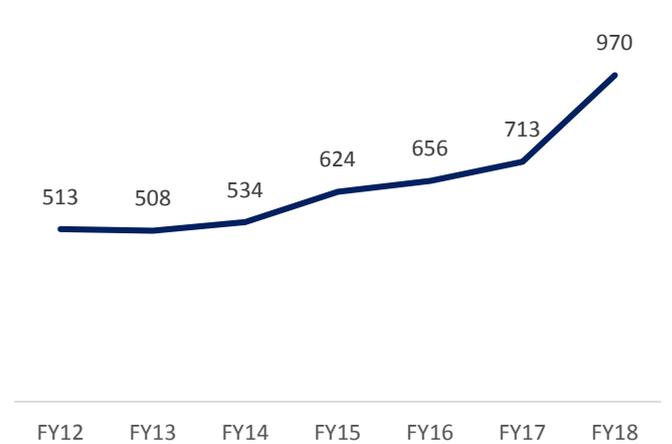
In FY 18, imports of paper and paperboard into India from Asean countries, China and South Korea increased by 32.59%, 56.45% and 57.19%, respectively over FY17 (according to IPMA). In volume terms, imports from China reached 5.1 LT while imports from Asean countries and South Korea were pegged at 3.3LT and 1.5LT, respectively in FY18. The paper industry has played preferential tariffs under FTAs as the overall paper imports touched 1.9MT as compared to 1.4MT in FY17. Including newsprint, total imports touched 3.3MT in FY18. From FY 11 to FY 18, imports of paper and paperboard have increased at a compound annual growth rate (CAGR) of 19.47%, from 0.5MT to 1.9MT.

**Total imports (including newsprint) (MT)**



Source: Industry data

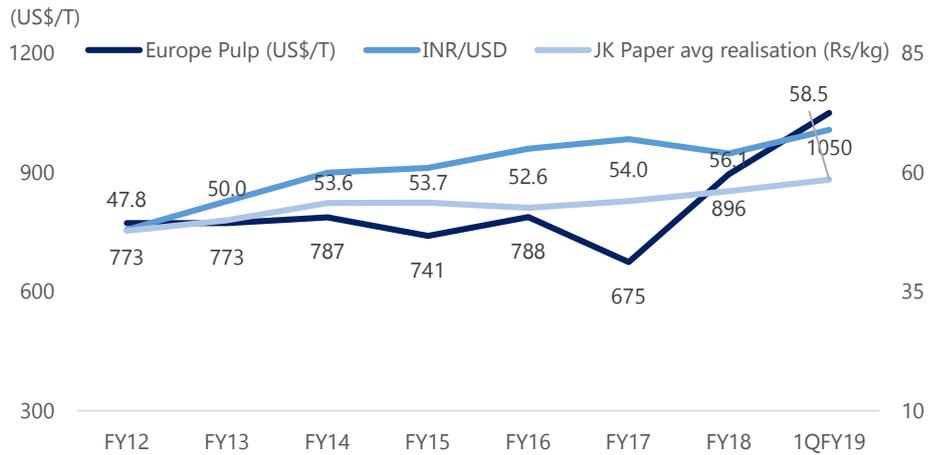
**Exports backed by lucrative realisation ('000 T)**



Source: Industry data

Given the higher cost of production globally, increase in imported paper prices (rupee depreciation) and import of virgin paper or final product by China, domestic manufacturers have started exploring export markets (high realisation), thereby creating some sort of paucity in the domestic market. This has resulted into an uptick in average paper realisation and helped the domestic companies to maintain or improve its profitability even in the rising cost curve scenario.

**India paper prices in relation to pulp price and rupee movement**

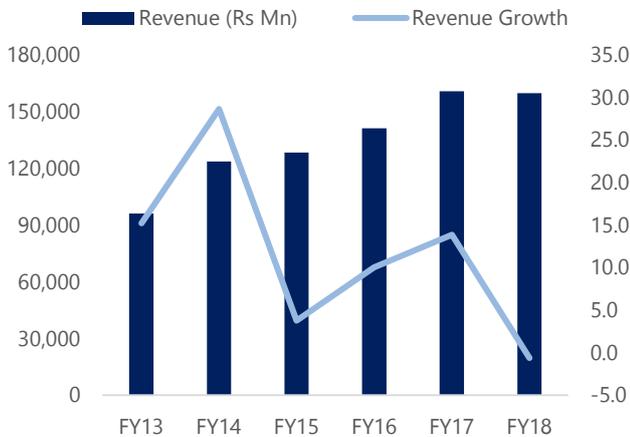


Source: Industry Data, JK Paper

**Performance of domestic paper companies**

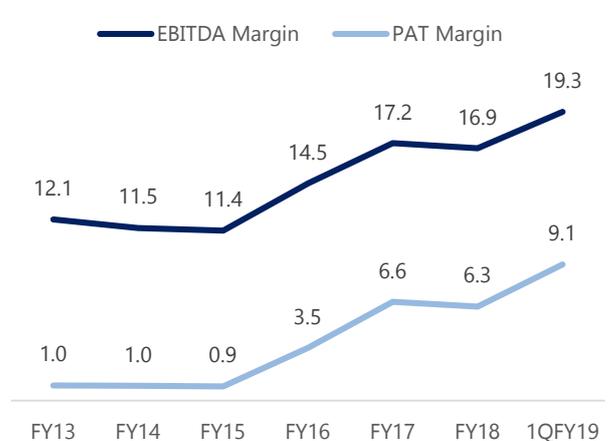
Revenues grew by ~11% CAGR during FY13-FY18 period (for a sample of 15 companies) and at the same time EBITDA and net profit margin expanded sharply by over 500bps. On a y-o-y basis the margin expansion was the highest in FY18 as compared to the previous 6 years. The expansion in profit margins was mainly on account of input decline in cost of production as a percentage to sales and improvement in realisation.

**Revenue Growth (for sample of 15 companies)**



Source: Industry data, Kotak Securities – Private Client Research

**Margin trend (for sample of 15 companies) (%)**



Source: Industry data, Kotak Securities – Private Client Research

**Financial summary**

Company	Installed capacity (Tonnes)	Mcap (Rs mn)	Revenue (Rs mn)	EBITDA (Rs mn)	PAT (Rs mn)	ROE (%)	ROCE (%)	Debt/Equity
Tamil Nadu Newsprint & Papers Ltd	600,000	240,749	30,370	4,385	(422)	(3)	3	1.20
JK Paper Ltd	455,000	237,102	30,697	6,391	2,601	18	15	0.64
West Coast Paper Mills Ltd	320,000	157,692	17,222	3,812	2,227	27	30	0.37
International Paper APPM Ltd	241,000	115,870	12,798	2,267	831	15	12	0.32
Seshasayee Paper & Boards Ltd	187,000	108,370	11,178	2,166	1,229	18	14	0.20
Orient Paper & Industries Ltd	135,000	83,711	6,718	1,231	493	4	4	0.05
Ruchira Papers Ltd	115,425	35,942	4,476	742	382	20	25	0.21

Source: Company annual reports, Kotak Securities – Private Client Research

## RATING SCALE

### Definitions of ratings

- BUY** – We expect the stock to deliver more than 12% returns over the next 12 months
- ACCUMULATE** – We expect the stock to deliver 5% - 12% returns over the next 12 months
- REDUCE** – We expect the stock to deliver 0% - 5% returns over the next 12 months
- SELL** – We expect the stock to deliver negative returns over the next 12 months
- NR** – **Not Rated.** Kotak Securities is not assigning any rating or price target to the stock. The report has been prepared for information purposes only.
- SUBSCRIBE** – We advise investor to subscribe to the IPO.
- RS** – **Rating Suspended.** Kotak Securities has suspended the investment rating and price target for this stock, either because there is not a Sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.
- NA** – **Not Available or Not Applicable.** The information is not available for display or is not applicable
- NM** – **Not Meaningful.** The information is not meaningful and is therefore excluded.
- NOTE** – Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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