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Coronavirus has wreaked havoc on global markets, but it could prove to be a boon for specialty rubber chemicals player Nocil

*Arunagiri N and his clients own the stock

STOCK PRICE	₹64
M-CAP	₹10 BILLION
FY20* RETURN	-55%
TTM P/E	7.3X
ROE	16%
ROCE	25%
NET SALES	₹6.33 BILLION
PAT	₹1.08 BILLION

*Market data as on March 20, 2020. Financials for 9MFY20; Return ratios as of FY19

Data: Ace Equity

It isn't that hard to choose, and it's a no-brainer. Yes, it's a prim adaptation of the Justin Beiber song *You stick out of the crowd, baby*. But he's singing about his love interest and this is about Nocil, a no-brainer stock, or a deep-value stock.

Is this the best time to be talking about value stocks? Value as a strategy has been under-performing for an extended period of time since early 2018 because of flight to safety and polarised market dynamics. As a result, a value investor is a beast that is vanishing. Even the last man standing is being tested for his tenacity. One needs to be brave to back a value stock. But, do not be mistaken, it is not a 'value for value's sake' kind of stock, rather a 'growth at a discount' stock. Nothing beats value that comes from trying to buy 'quality-cum-growth' at a discount, be it large-cap or small-cap. Of course, in small-caps, such spicy opportunities come more often, because the space is under-researched and under-covered — Nocil is one such opportunity.

Openings in both — successful screenplays and stock research — are crucial. Good opening moves in stock selection usually start with the most critical question, that is, whether there is a competitive edge in the business and, more importantly, where does it come from? The answer to this question will determine whether one takes a deep dive into more due-diligence.

Nocil has established itself as a niche speciality player in the rubber chemicals business

When one has the following factors supporting a product in any business, it invariably has a towering entry barrier or in other words, a durable competitive edge (leaving out the most obvious moats such as consumer brands):

- Highly critical ingredient that contributes to the quality of end product, but at the same time, constitutes a very low percent of the end product in terms of unit value.
- Long lead time for customer approval and stringent approval process.
- Exceptional need for technical know-how and long gestation period for setting up capacity.
- Favourable replacement cycle in the end user markets.
- Few limited specialised players (niche oligopolistic market).

In the industry in which Nocil operates, the economics of business is extremely attractive with dynamics that reflect the above industry traits. Nocil has established itself as a niche specialty player in the rubber chemicals business with a high entry barrier. Rubber chemicals constitute only 3.5-4% as raw material to manufacture a tyre. However, that component is critical to the production of rubber to enhance its key characteristics such as elasticity, strength, durability, hardness, flexibility and resistance to wear. This blend of low unit value with high importance for the end product quality, acts as a critical source of competitive edge for the rubber chemicals industry. Besides this industry-level economics, Nocil also has another significant source of moat. That is, its business enjoys a high level of operational and process efficiency that comes from a long period of specialisation. Now that the opening move has been made, it is time for the main plot.

ATTRACTIVE DYNAMICS

Globally, there are just a handful of rubber chemical players. First, there is a need for advanced technical manufacturing knowhow, high R&D investments and long customer approval process. Besides these, there is another critical factor that makes the industry dynamics attractive. This comes from the nature of the replacement cycle in the end-product (tyres) where rubber chemicals are used. The tyre industry's replacement intensity makes the rubber chemical industry less cyclical in terms of demand volume.

Nocil is the largest manufacturer of rubber chemicals in India with a domestic market share of 40% and a diversified 22-product portfolio in the entire range of rubber chemicals *(See: Many in one)*. It is also the fourth largest in the world, in terms of capacity, with a market share of 5%. Tyre manufacturers prefer to work with such companies with a diverse range, which can assure steady supply.

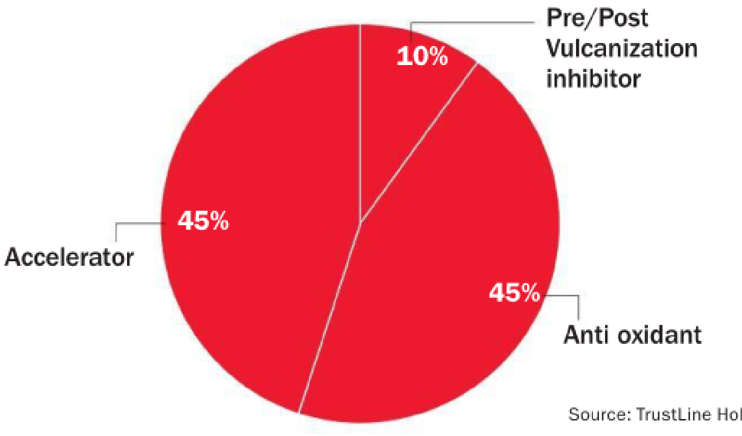
Nocil's expertise in the rubber chemical business spans over four decades, during which it has built business relationships with clients in over 40 countries. Just like its product pipeline, it has a diversified clientele that includes the likes of MRF, Apollo Tyres, Pirelli, CEAT, Michelin and JK Tyres to name a few. The company's 65-70% offtake is consumed by tyre manufacturers and the rest by non-tyre sectors such as latex, cycle tyres, surgical gloves and footwear among others.

GOOD BOOKS

High quality business, check. Leadership in the market, check. With robust fundamentals in place, Nocil's financial ratios paint a pretty picture. From 60% on operating profit to operating cash flow to over 48% on net profit to free cash flow, the company boasts a healthy balance sheet.

Many in one

Nocil is a one-stop shop for tyre companies across the world due to its diversified portfolio



Source: TrustLine Holdings

Nocil enjoys a strong net cash position of ₹1.47 billion (₹8.9/share) as on FY19 and its expansion capex of ₹4.25 billion is completely funded through internal accruals. Its revenue, operating profit and net profit grew at a CAGR of 10%, 27% and 34% over FY15-19, respectively. Its operating profit and profit margins have grown from 15.8% and 7.9% to 28.1% and 15.2%, respectively *(See: Growth formula)*. On the back of its robust earnings growth and cash flows, Nocil was able to clear its entire debt in FY18 (from ₹1.31 billion in FY14) and is currently debt free *(See: Cash is king)*.

In the current fiscal (9MFY20), revenue fell by 21% to ₹6.34 billion due to weak realisation, steep slowdown in domestic auto volumes and no benefit of anti-dumping duty in the second and third quarters. Its operating margin also contracted by over 670 basis points to 22.4% from 29.1% in 9MFY19. As a result, net profit fell by 27% to ₹1.09 billion. However, the management has guided a recovery in volume from Q4FY20 following the commercialisation of Dahej plant and renewed focus on volume growth, which will lead to positive operating leverage. FY21 could be a welcome change given a significant increase in enquiries from domestic and global OEMs on supply disruptions in China.

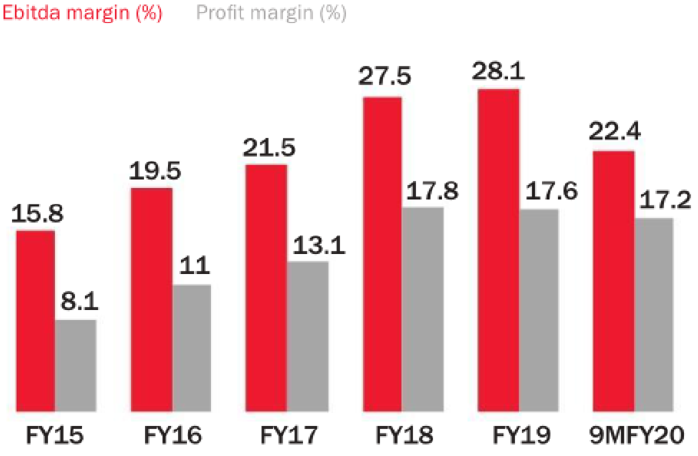
Nocil is the largest Indian manufacturer of rubber chemicals and has a domestic market share of 40%

BANKING ON STRUCTURAL GROWTH

The prevailing coronavirus crisis could turn out to be the biggest opportunity for Nocil. Reducing China dependency is no

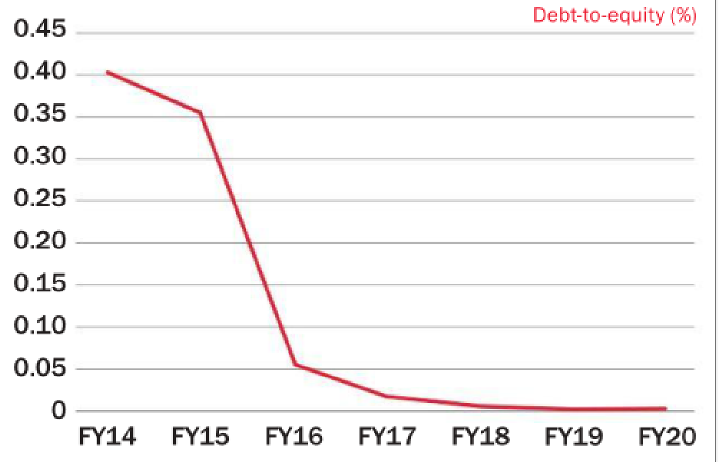
Growth formula

Quality business and market leadership have helped Nocil maintain healthy margins



Cash is king

Prudent cash management has allowed the company to shed all its debt



Source: TrustLine Holdings

longer a cocktail discussion, it is a clear danger facing the boards of all global companies. Buyers everywhere are speeding up their 'China hedging' process, which kicked off post the US-China trade war. India is likely to be one of the potential beneficiaries, in industries such as specialty chemicals where the country is globally competitive.

Right now, Chinese players dominate the global market with over 68% share, but that is likely to change and Nocil is well placed to capitalise on this transition. In fact, it has already done that once. In January 2019, the US imposed additional 15% duty on rubber chemicals from China. We believe this has acted as a trigger for Nocil to capture the incremental wallet share from Chinese rubber chemical players. In addition, the export market remains highly untapped for Nocil. With increased capacity, it can leverage and increase its global market share.

Nocil's current capacity utilisation stands at 45%, which means it has huge headroom for growth. With asset turn of 2x, and given the capex of ₹4.25 billion, the company has the potential to double revenue over the next three to four years. The other triggers that could boost growth are increasing share of radialisation, especially in the MHCV tyres (requires 1.3x-1.4x rubber chemicals compared with regular tyres), expected recovery in Indian automobile sector in FY21 and increasing pollution curbs in China.

With asset turn of 2x, and capex of ₹4.25 billion, the company has the potential to double revenue over three to four years

IT'S A STEAL

Besides an experienced and competent management, a long and complex period of specialisation, attractive industry dynamics with high entry barriers and robust financials make this stock a high quality one from the smallcap space. With a market obsessed with quality and growth, one would have expected the stock to trade at a premium. But due to the overall global uncertainty, that has not happened yet.

Its short-term earnings visibility is in question coupled with removal of anti-dumping duty. Hence, the stock has de-rated to a level where it offers a significant discount to what it is worth. In our estimate, the per-share intrinsic value for the stock, even with a conservative growth and margin assumption, works out to be around ₹220-₹230. At ₹64 per share (as on March 20), it trades at a sharp discount and offers substantial margin-of-safety of over 70%. Over a four-year period, it can provide significant upside to long-term investors as we expect the intrinsic value to grow at a reasonably high rate.

Of course, no investment opportunity comes without any downside risks. In this one, a protracted delay in the recovery of demand in the domestic auto industry could pose a serious risk to earnings in the short-term. Since much of this risk is already in the price, further downside, if any, is likely to be limited.