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Business Standard
Mumbai - Nov 16, 2023

Page No: 9
Page Name: The Smart Investor
Size: 385 sq. cm
AVE: INR 192,592

Type: Newspaper
Language: English
Circulation: 5,620
Frequency: Daily

News monitored for: JM Financial

Near-term headwinds may delay UPL recovery

RAM PRASAD SAHU
Mumbai, 15 November

UPL, the country's largest agrochemical company, had a weak July-September quarter (Q2), reporting a sharp fall in revenues across geographies. Overall, the revenues were down 19 per cent on the back of lower agrochemical prices and inventory destocking.

While the overall volumes were down 7 per cent, prices fell by 15 per cent.

Volume decline in the European market was on the back of high channel inventory and product bans while in India the fall by 27 per cent was on account of muted demand for segments such as cotton and pulses. Among the segments that did well were the differentiated and sustainable product portfolio, which rose 11 per cent, and the seeds business up 10 per cent over the year-ago quarter.

Given the weak Q2 show, the company cut its FY24 revenue guidance from flat to a decline between 1-5 per cent. The operating profit growth too has been cut from 3-7 per cent earlier to a range between 0 per cent and fall of 5 per cent.

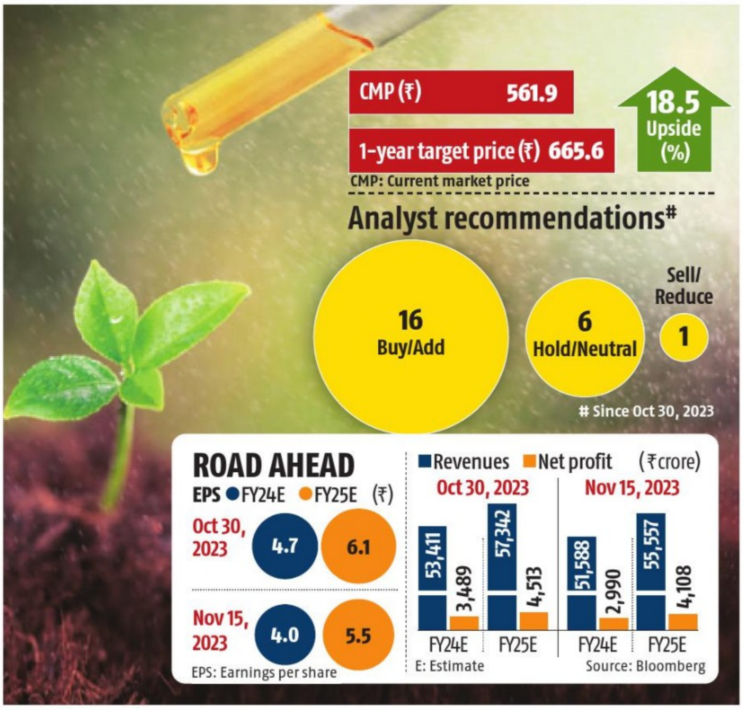
Pricing pressure was the highest in the NAFTA region and Brazil.

In North America, the revenue decline by a steep 57 per cent, according to the company, was on account of a sharp drop in post-patent active ingredient prices, along with channel destocking, tactical purchases, and cash management by distributors. The weak top line weighed on profitability with gross margin falling by 520 basis points year-on-year (Y-o-Y) to 48.5 per cent due to the impact of high-cost inventory, increased sales return especially in NAFTA and Latin America, and rebates to support channel partners.

The margin pressures came despite a higher share of the differentiated portfolio (800 basis points Y-o-Y increase to 38 per cent of sales). Operating profit margins slid 655 basis points to 15.5 per cent.

The company expects volumes to recover in the second half of FY24 while margins could see a recovery and an expansion by the end of the year.

Says Mike Frank, the CEO of UPL Corporation (a subsidiary of UPL), "Going forward, we are optimistic of progressively improved performance in H2FY24 as key geographies of North America, LATAM and Europe enter major cropping season. The elevated inventory levels are expected to gradually subside with the farmgate demand continuing to be robust."



Motilal Oswal Research, which has cut the FY24 earnings estimate by 11 per cent, believes that there would be near-term challenges in the global agrochemical industry due to the accumulation of high inventory as distributors opt for need-based tactical purchases and declining agrochemical prices led by aggressive price competition from Chinese (post-patent) exporters. Considering the short-term challenges, cash flow generation and debt repayments remain the key monitorables, says Sumant Kumar of the brokerage, which has a neutral rating on the stock.

The street will also keep an eye on the debt trajectory. Net debt increased by 7.7 per cent Y-o-Y to ₹30,697 crore.

The company has cut its capex guidance for FY24 to $250 million as compared to $300 million guided earlier. The move is expected to help it conserve cash and achieve a gross debt repayment target of $500 million by the end of FY24. Gross debt stands at ₹33,934 crore at the end of Q2FY24. The company is also looking at going slow on merger and acquisition and improving free cash flow generation in the second half of FY24.

Factoring in Q2FY24 results and commentary, JM Financial Research has lowered its FY24 operating profit estimates by 12 per cent in FY24 and net profit by 28 per cent after factoring in higher finance cost. The brokerage has maintained a buy rating given the value unlocking in the speciality chemical business. Prabhudas Lilladher Research has cut its earnings estimates for the next three years by 25-29 per cent and maintains a hold rating given subdued growth and margin outlook in the near term.

In addition to high inventory levels in key regions, adverse weather conditions impacting demand and falling raw material costs are exerting pressure on realisations and margins.

The share price of UPL, though, has risen by about 4.5 per cent since its results were declared on October 30 compared to a 2.4 per cent.