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SRF

Over the last few years China has witnessed wide spread governmental crackdown on its chemical industries due to pollution & environmental concerns, which has resulted in arbitrary shutdown of entire chemical belts (including non-polluting manufacturers). Further, fear of trade wars with the US has led to MNCs looking to de-risk their supply chains.

Indian Chemical players with a track record and culture of environmental compliance, and who have invested to build a technology edge should benefit structurally as India is home to strong chemistry and process development skills, low cost manufacturing & good track record of respect for customers IP. Many players have witnessed a short term growth and margin boost as they benefit from short term supply scarcity. However, in the absence of any unique technology edge, this momentum will fade. SRF is one of few who are very well positioned for future growth.

Fluorine based chemistry is seeing greater application in Agrochemicals & Pharma industry due to its higher efficacy and environmental compatibility. It is a USD 8 Billion Market of which SRF is < USD 100 Mn and other than SRF, there are only 2 players in India who have a meaningful presence. Fluorine is a highly reactive element requiring specialized equipment. The need to develop expertise in handling Fluorine, developing competencies and then building credibility with clients can take as long as 8-10 years. Relationships are sticky as the outsourced process and location becomes part of the client's Drug Master File which is filed with the FDA and acts as a barrier to changing suppliers.

SRF invested money received from Carbon Credits into developing capabilities in Fluorine based chemistry. Approx. 470 Cr was invested into R&D (Cap ex and Revenue) between 2012 and 2018. It is now the clear market leader in India with 135 patents filed till FY 18 and with a rich pipeline of products ready for commercialization. Over 80% of its revenue in Specialty Chemicals is from proprietary process technology.

The last couple of years witnessed a downtrend in the Agri Cycle causing Specialty Chemical Revenues of SRF to decline. However, keeping focus on the long term, SRF continued investing in product development and capacity creation to be ready when the cycle turned. It also used this time period to de-risk its business model with a more balanced customer mix between Innovators and Generic manufacturers. With the Agri Cycle poised to turn and visibility in customer orders, SRF should witness strong growth over the next few years.

The Indian refrigerant market is poised to grow strongly as penetration of ACs and refrigerators increase. Despite being a very hot country, India's refrigerant market is less than a tenth of the US market. SRF is the domestic market leader in refrigerants with > 40% market share and the only Indian player with a basket of all 3 next generation gases (mainly self-developed).

SRF also has two other business lines.

- It is the market leader in Nylon Tyre Cord, a legacy business which is treated as a cash cow
- It has a Packaging Films Business, select parts of which (BOPP) are not very high ROCE "at present" due to lower differentiation vs peers. Management's attempt is to leverage its technology capabilities to introduce differentiated products in Films which will enhance margins over time.

Solidarity believes that businesses should have very strong reasons to diversify from their core. Too often companies open multiple fronts with the risk that the core gets starved of both capital and management attention as too many balls need to be juggled. We hence prefer buying Focused companies.

We however believe SRFs IP track record in Specialty Chemicals gives its Films strategy credibility.

- If the management did not spend money to develop process technologies in Fluorine a decade ago (in what then was an adjacency), it would not have the franchise it has in Specialty Chemicals and Refrigerants today.
- The Chemicals/refrigerants business is not being starved of Capital to expand the Packaging films business.
- Management bandwidth is not a constraint as there are separate CEOs for each business unit.

Key risks to our thesis at SRF is the capacity build up in Specialty Chemicals not translating into growth and continuing to maintain a strong culture of environmental compliance. Management also needs to demonstrate its strategy in Films is working by boosting the Films ROCE to >15%. We hence classify SRF as an Emerging Leader to see more evidence of execution before upgrading to Clear Leader.