Titan Industries Ltd.

Company Update UNDERPERFORM

Management meeting reinforces our cautious view

Equity | India | Retailing-Specialty
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Bank of America Merrill Lynch

RESEARCH

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Management: Mixed impact so far, caution near-term

We met with Bhaskar Bhat, MD, Titan Ind. recently. Here are the key takeaways:

- **Impact of high gold prices**: Plain gold jewelry volumes have come down. Margins are now partly linked to gold price and hence profitability is less impacted than sales. Mgmt believes current high gold prices are not sustainable (contrary to BAS-MLe) as Indian demand (key gold consumer) has dried up. Longer term, if volume growth remains low on high gold prices, they could look at launching lower karat jewelry to improve affordability.
- **Impact of economic slowdown:** Tier-II/III towns have still not seen the impact and have outpaced big cities in growth rates in recent months. Also, youth remains largely immune and hence a focus segment for the company.
- **Strategies in current challenging environment:** 1) More cautious approach to store expansion – cash, profitability and sales priorities in that order, 2) More frequent new collections, 3) A number of new formats being piloted - Helios (up-market watch retailing) and Zoya (designer diamond jewelry) to tap the elite and exclusive Fastrack accessory stores for youth.
- **4Q likely a difficult quarter for watches.** January has been dismal for watch sales growth but February has seen an improvement; outlook for March remains extremely cautious.

4Q likely to see a profit drop, Maintain Underperform

We expect 6% drop in profits in 4Q to Rs568mn driven by single digit volume growth and margin decline on a large base. The stock is trading at 13.5x FY10 P/E implying a 50% premium over the market. We believe the premium is likely to reduce as earnings growth starts to come off. Also, we see downside risk to our and consensus earnings as impact of slowdown gets reflected on performance.

Stock Data

Price	Rs712.20
Price Objective	Rs700.00
Date Established	25-Feb-2009
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs695.00-Rs1,347
Mrkt Val / Shares Out (mn)	US$612 / 44.4
Average Daily Volume	221,356
ML Symbol / Exchange	TTNIF / BSE
Bloomberg / Reuters	TTAN IN / TITN.BO
ROE (2009E)	42.2%
Net Dbt to Eqty (Mar-2008A)	34.7%
Est. 5-Yr EPS / DPS Growth	15.0% / 15.0%
Free Float	46.9%

Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	1,117	1,446	2,181	2,382	2,690
EPS	25.16	32.57	49.13	53.66	60.61
EPS Change (YoY)	6.7%	29.5%	50.8%	9.2%	13.0%
Dividend / Share	5.00	7.98	14.74	16.10	18.18
Free Cash Flow / Share	9.18	11.84	22.79	36.71	45.01

Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	28.31x	21.87x	14.50x	13.27x	11.75x
Dividend Yield	0.702%	1.12%	2.07%	2.26%	2.55%
EV / EBITDA*	16.53x	13.59x	9.22x	8.63x	7.82x
Free Cash Flow Yield*	1.29%	1.66%	3.20%	5.15%	6.32%

* For full definitions of *iQmethod* SM measures, see page 8.

Refer to important disclosures on page 9 to 11. Analyst Certification on Page 7. Price Objective Basis/Risk on page 7.

iQprofile SM Titan Industries Ltd.

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
(Rs Millions)					
Sales	20,907	30,466	39,436	44,852	50,021
Gross Profit	6,938	9,387	11,977	13,082	14,092
Sell General & Admin Expense	(4,931)	(6,947)	(8,381)	(9,236)	(9,852)
Operating Profit	1,646	2,066	3,236	3,453	3,813
Net Interest & Other Income	(152)	(174)	(164)	(98)	(24)
Associates	NA	NA	NA	NA	NA
Pretax Income	1,493	1,892	3,072	3,355	3,789
Tax (expense) / Benefit	(377)	(446)	(891)	(973)	(1,099)
Net Income (Adjusted)	1,117	1,446	2,181	2,382	2,690
Average Fully Diluted Shares Outstanding	44	44	44	44	44
Key Cash Flow Statement Data					
Net Income	1,117	1,446	2,181	2,382	2,690
Depreciation & Amortization	361	374	360	393	426
Change in Working Capital	(34)	(915)	(979)	(596)	(569)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(118)	30	0	0	0
Cash Flow from Operations	1,326	935	1,562	2,179	2,548
Capital Expenditure	(918)	(410)	(550)	(550)	(550)
(Acquisition) / Disposal of Investments	(36)	293	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(954)	(117)	(550)	(550)	(550)
Shares Issue / (Repurchase)	740	0	0	0	0
Cost of Dividends Paid	(264)	(416)	(769)	(840)	(948)
Cash Flow from Financing	(141)	(791)	(1,012)	(1,629)	(1,802)
Free Cash Flow	408	526	1,012	1,629	1,998
Net Debt	1,967	1,549	1,306	516	(534)
Change in Net Debt	(847)	(402)	(243)	(790)	(1,050)
Key Balance Sheet Data					
Property, Plant & Equipment	2,717	2,877	3,067	3,223	3,347
Other Non-Current Assets	316	23	23	23	23
Trade Receivables	974	993	1,577	1,794	2,001
Cash & Equivalents	510	554	554	554	750
Other Current Assets	7,428	11,488	14,591	16,595	18,508
Total Assets	11,946	15,936	19,813	22,190	24,629
Long-Term Debt	2,478	2,103	1,860	1,070	216
Other Non-Current Liabilities	181	252	252	252	252
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	5,958	9,123	11,831	13,456	15,006
Total Liabilities	8,617	11,478	13,943	14,778	15,475
Total Equity	3,329	4,458	5,870	7,412	9,154
Total Equity & Liabilities	11,946	15,936	19,813	22,190	24,629
iQmethod* SM - Bus Performance					
Return On Capital Employed	22.2%	24.7%	31.1%	29.3%	29.5%
Return On Equity	44.0%	37.1%	42.2%	35.9%	32.5%
Operating Margin	7.9%	6.8%	8.2%	7.7%	7.6%
EBITDA Margin	9.6%	8.0%	9.1%	8.6%	8.5%
iQmethod* SM - Quality of Earnings					
Cash Realization Ratio	1.2x	0.6x	0.7x	0.9x	0.9x
Asset Replacement Ratio	2.5x	1.1x	1.5x	1.4x	1.3x
Tax Rate (Reported)	25.2%	23.6%	29.0%	29.0%	29.0%
Net Debt-to-Equity Ratio	59.1%	34.7%	22.2%	7.0%	-5.8%
Interest Cover	7.7x	9.9x	16.3x	26.2x	NM

Key Metrics

* For full definitions of *iQmethod* SM measures, see page 8.

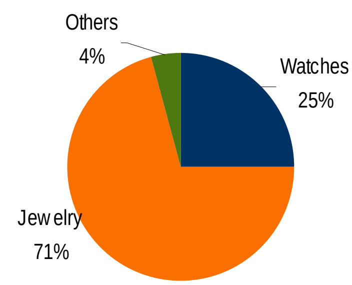
Company Description

Titan Industries, a Tata Group company, is India's leading watches and jewelry retailer. It has a strong brand franchise and a wide distribution network of 300+ exclusive brand outlets. The company has recently made a foray into prescription eyewear.

Investment Thesis

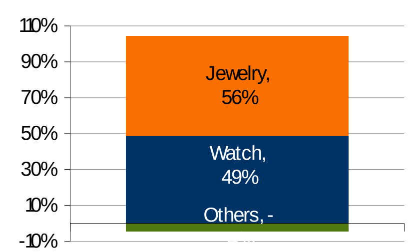
We expect Titan to Under-perform on significant deceleration in earnings growth as watch and jewelry sales, both being discretionary purchases, is impacted by tightening consumer wallets. Surging gold price is an additional concern. However, we remain convinced about the long term investment merit in the stock as a long term growth story focussed on domestic consumption boom, with a strong balance sheet, high quality management and strong brand franchise.

Chart 1: Sales break-down (FY09E)



Source: Banc of America Securities – Merrill Lynch Estimates

Chart 2: EBIDTA break-down (FY09E)



Source: Banc of America Securities – Merrill Lynch Estimates

Stock Data

Price to Book Value	5.4x

Management meeting highlights

We met with Bhaskar Bhat, MD, Titan Industries, recently. While he agreed that it would be difficult to maintain historic growth rates, especially in the current weak macro environment, he highlighted various tactical measures being taken to sail through the downturn. Here are the key takeaways:

Consumption slowdown – Mixed impact seen so far

Titan has not remained immune from consumer slowdown. However, the impact is not uniform across geographies and consumer segments.

- Tier-II / III cities have not witnessed any slowdown as yet and have outpaced the large cities in growth rates over last few months. Even among the metros / large cities there is a wide variance – Mumbai has definitely been impacted, so have been IT hubs Bangalore and Hyderabad. However Delhi has seen phenomenal growth in last few months buoyed by rise in salaries in Government jobs.

- Youth and women seem to have been least impacted. As a result, Titan intends to focus on these segments near-term with regard to the launch of new collections, advertisements etc.

- February has seen an improvement in growth rates over last few months.

Impact of high gold prices - volumes down, margins intact

Plain gold jewelry volumes have come down. Margins are now partly linked to gold price and hence profitability is less impacted than sales. Also, higher margin diamond jewelry has been growing at a faster rate than plain gold jewelry resulting in mix gains. Management believes current high gold prices are not sustainable (contrary to BAS-MLe) as Indian demand (key gold consumer) has dried up. Longer term, if volume growth remains too low due to high gold prices, they could look at launching lower karat jewelry to improve affordability.

Jewelry growth strategy

In the light of the changed macro environment, we discussed Titan's revised growth strategy for jewelry business. Key highlights are:

- **Increase penetration through 'Gold Plus' in Tier-II/III towns.** Titan has 30 Gold Plus stores to date and plans to open 5-6 stores next year. While sales in Tier-II/III towns have been encouraging, the company has found it difficult to find an appropriate trust worthy franchisee and hence slower than expected ramp up. Gold Plus now has sales of Rs4.5bn, about 16% of FY09E total jewelry sales.

- **Gain city-wise leadership.** While Tanishq has become the largest jewelry brand by a distance in India, it is still not the largest when it comes to individual cities; it's invariably a local player that continues to be the leader. The company aims to change this and plans to shift to larger format stores in Tier-I cities with wider product portfolio.

- **Move up the value chain – Target the elite through 'Zoya'.** Titan has opened two high-end boutique stores (one each in Mumbai and Delhi) named 'Zoya' focusing on designer diamond jewelry on pilot basis. If successful, they plan to set up 10-15 stores over next 5 years.

Starting with Rs150mn in the first year, the company targets to achieve revenue of Rs400mn by fifth year from each store. This could imply about 10% of jewelry sales, in the best case, but the share of profits could be higher given the higher margin profile than Tanishq.

- **US jewelry foray – Pause for now.** Titan had opened two pilot stores in US – Chicago and New Jersey – last year, with an aim to tap the highly lucrative US$70bn jewelry market. Given the recession in the US, the business from these stores has been dull so far. The total investment in the project has been to the tune of Rs300mn while the operating expenses are to the tune of Rs50-60mn per annum (for both stores combined).

Watch growth strategy

Similarly, for watch business key growth strategies to be focused on are:

- **More frequent new collections.** Management believes that the key to achieving growth in watches is launching frequent new collections backed up by advertising spend. This increases footfalls, which ultimately leads to increased sales. Watches, particularly among the youth, has now become a fashion accessory and an impulse purchase and hence the strategy.

- **Focus on youth through Fastrack.** The company has opened 4-5 exclusive ‘Fastrack’ stores on pilot basis focusing on youth accessories like leather bags, belts, wallets etc. besides sunglasses and watches where they were already present. These stores would be small in size – 400-500 sq ft, located in malls or near university campuses.

- **Moving into up-market watch retailing through ‘Helios’.** The company has opened its first company owned multi-brand watch store in Bangalore focusing on up-market brands owned by both Titan and other players. It plans to open one store each in Mumbai and Delhi next year.

- **Slower store expansion:** Management plans to add 35-40 ‘World of Titan’ stores in the next year on a higher base of around 265 stores currently versus avg. 45-50 store additions p.a. over the last few yrs.

Our view: Sharp impact on volumes, mix likely

We expect sharp deceleration in volume growth for both watch and jewelry driven by tightening consumer wallets and in the case of latter, surging gold prices. In watches we expect volume growth of 6% p.a. over the next 2 yrs versus in excess of 10% p.a. last few yrs. In jewelry we estimate volume growth of 10% now versus >30% over the last few yrs.

Further, we no longer expect mix gains in watches and jewelry to come through as premium brands start to be impacted by the consumer slowdown.. Hence we expect EBIDTA margins to fall 60bp over FY10-11.

Table 1: Key operating assumptions

	FY06	FY07	FY08	FY09E	FY10E	FY11E
Jewelry						
Volumes (tonnes)	7,869	10,703	15,681	17,171	18,888	20,777
Change in volume	16%	36%	47%	10%	10%	10%
Realizations (Rs/10gms)	9,865	12,051	12,922	16,234	16,676	16,964
Change in realization	25%	22%	7%	26%	3%	2%
Sales value (Rs mn)	7,763	12,898	20,263	27,875	31,498	35,246
Change in sales value	45%	66%	57%	38%	13%	12%
EBIDTA (Rs mn)	491	913	1,156	1,997	2,134	2,272
EBIDTA margin	6.3%	7.1%	5.7%	7.2%	6.8%	6.4%
Watches						
Volumes (# mn)	8.3	9.0	10.3	10.4	11.1	11.8
Change in volume	14%	8%	15%	2%	6%	6%
Realizations (Rs/unit)	754	823	845	935	937	939
Change in realization	4%	9%	3%	11%	0%	0%
Sales value (Rs mn)	6,086	7,341	8,696	9,767	10,398	11,070
Change in sales value	18%	21%	18%	12%	6%	6%
EBIDTA (Rs mn)	1,163	1,269	1,522	1,744	1,850	1,961
EBIDTA margin	19.1%	17.3%	17.5%	17.9%	17.8%	17.7%

Source: Company, Banc of America Securities – Merrill Lynch

4Q may surprise on the downside

We expect 4Q profits to decline 6% yoy to Rs568mn. This will be led by 20% sales growth and a 100bp yoy drop in EBIDTA margin on a high base last year. However, the results could surprise on the downside led by lower than expected volumes and inferior mix impacting margins more than we anticipate now.

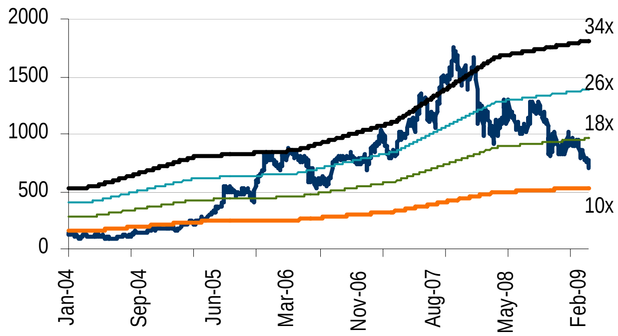
Watches: We estimate 10% sales growth driven primarily by higher realization due to higher product prices as well as mix gains. EBIT margins are likely to fall from 19.5% in 4QFY08 (excld. one off provisions written back) to 17% due to a higher base. The company has earned EBIT margins of 10%, 20% (Diwali quarter) and 12% in the first three quarters of the year.

Jewelry: We estimate sales value growth of 20% driven primarily by higher gold prices. EBIT margins are likely to expand from 5.1% in 4Q FY08 to 6.4% in 4Q'09. This will be driven by change in formula for calculating marking charges – now partially linked to gold prices and also mix gains – diamond jewelry growing at a faster rate than plain gold jewelry (which is likely to see a decline in volumes).

Valuations stretched

The stock is trading at 13.5x FY10 PER which is a 33% discount to its 5-yr average PE multiple. Still, we believe this is stretched for 11% earnings CAGR over FY09-11E. The premium with respect to market has come off a bit recently but is still healthy at around 50%. We believe this could shrink more as earnings growth comes off.

Chart 3: 1-yr fwd rolling PE band



Source: Bloomberg, Banc of America Securities – Merrill Lynch

Chart 4: Premium / Discount to Sensex on PER

Source: Bloomberg, Banc of America Securities – Merrill Lynch

Price objective basis & risk

Titan Inds Ltd (TTNIF)

Our PO of Rs700 is based on DCF, which is based on explicit forecasts until FY11E and thereafter of average free cash flow growth of 15pct until FY17E. In addition, we take a terminal growth rate of 4pct and WACC of 12.8pct. We believe DCF is the best way to value the company as it best captures the long-term structural domestic consumption growth story.

At our PO, the stock will trade at 13x FY10 PE and a PEG of 1.25x, reasonable considering the strong balance sheet and strong brand franchise.

Key upside risks are: 1) Fall in gold prices resulting in spurt in demand for jewelry, 2) Better than expected product mix in both jewelry and watches implying higher margins and 3) Eyewear business achieving break-even earlier than expected.

Key downside risks are: 1) Lower than expected volume growth in both jewelry and watches as consumption slowdown hits demand for discretionary products, 2) Lower than expected margins due to inferior product mix as consumers move to lower value products, and 3) Higher gestation costs for eyewear business.

Analyst Certification

I, Manish Sarawagi, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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India - Consumer Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Bombay Rayon Fashions Ltd	BORYF	BRFL IN	Manish Sarawagi
	Godrej Consumer Products Ltd.	XGOCF	GCPL IN	Manish Sarawagi
	Hindustan Unilever	HINLF	HUVR IN	Vandana Luthra
	ITC Limited	ITCTF	ITC IN	Vandana Luthra
	Mcleod Russel India Ltd.	XCVFF	MCLR IN	Manish Sarawagi
	Nestle India	XNTEF	NEST IN	Vandana Luthra
NEUTRAL				
	Asian Paints	XAPNF	APNT IN	Vandana Luthra
	Colgate India	CPIYF	CLGT IN	Vandana Luthra
	Dabur India	DBUIF	DABUR IN	Vandana Luthra
	Himatsingka Seid	HMKFF	HSS IN	Manish Sarawagi
	Pantaloon	PFIAF	PF IN	Vandana Luthra
	United Spirits	UDSRF	UNSP IN	Vandana Luthra
UNDERPERFORM				
	Arvind Ltd	ARVZF	ARVND IN	Manish Sarawagi
	Gokaldas Exports	GKLDF	GEXP IN	Manish Sarawagi
	Radico Khaitan	RKHAF	RDCK IN	Vandana Luthra
	Raymond Ltd	XRAMF	RW IN	Manish Sarawagi
	Shoppers' Stop	SHPSF	SHOP IN	Manish Sarawagi
	Titan Inds Ltd	TTNIF	TTAN IN	Manish Sarawagi
	Vishal Retail Ltd	XVHLF	VISH IN	Manish Sarawagi
	Welspun India	WPNIF	WLSI IN	Manish Sarawagi

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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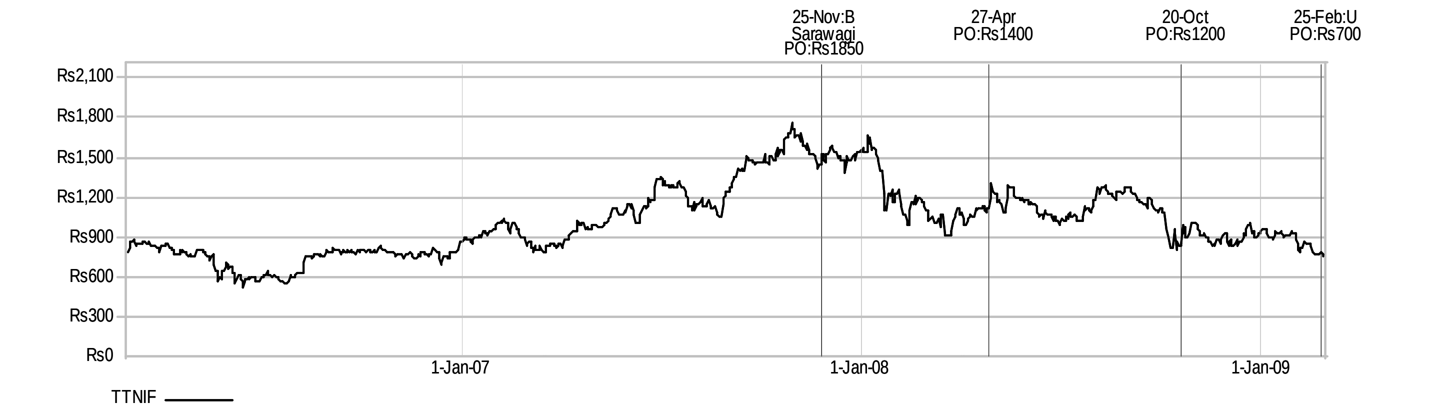
Important Disclosures

TTNIF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

"Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of February 28, 2009 or such later date as indicated.

BAS-ML price charts do not reflect analysts' coverage of the stock at prior firms. Historical price charts relating to companies covered as of February 28, 2009 by former Banc of America Securities LLC (BAS) analysts are available to BAS clients on the BAS website."

Investment Rating Distribution: Retailing Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	64	47.06%	Buy	3	4.92%
Neutral	28	20.59%	Neutral	6	24.00%
Sell	44	32.35%	Sell	9	20.93%

Investment Rating Distribution: Global Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1297	38.46%	Buy	314	26.81%
Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BAS-ML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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