Company Report

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On-line Share Trading

Petrochemicals

March 31, 2007

ICICIdirect Code: FININD

Finolex Industries

OUTPERFORMER

Price	Target Price
Rs 68.50	Rs 95
Potential upside	**Time Frame**
39%	12 mths

Finolex Industries, India's second largest polyvinyl chloride (PVC) manufacturer, is well placed to capitalise on the demand-supply mismatch in the domestic PVC industry. It is also planning to foray into the real estate business by developing its 78 acres of land at Chinchwad, outside Pune. We initiate coverage on the company with an OUTPERFORMER rating.

INVESTMENT RATIONALE

- **Demand-supply mismatch for PVC**

  PVC producers in India are currently in a sweet spot as there has been a shift from excess supply to shortage in the last few years. For the period 2001-06, capacity addition grew at a CAGR of just 2%, whereas demand continued to surge in double digits at a CAGR of 11%. This has resulted in firm PVC prices and high capacity utilisation rates for domestic manufacturers.

- **Timely capacity expansions, cost reduction initiatives**

  Finolex has doubled its PVC resin capacity to 260,000 TPA and is in the process of expanding its PVC pipes capacity from 65,000 tonnes to 85,000 tonnes. It is also undertaking Initiatives like setting up of a 43 MW captive power plant and converting its jetty into an all-weather jetty, which will expand margins going forward.

- **Real estate foray to stabilize earnings**

  The company has 78 acres of land in Chinchwad, which it plans to monetize in partnership with a developer. It has been in negotiations for the last one-year and we expect an announcement from the company shortly. We expect the company to go for a lease model wherein its share of the income would be Rs 72 crore per year.

VALUATIONS

We have used the sum of parts methodology to arrive at a fair valuation for Finolex. We estimate the value of its core PVC business at Rs 58 per share, value of its 14.5% shareholding in Finolex cables at Rs 12 per share and value of its real estate business at Rs 25 per share. Our target price works out to Rs 95 per share, which offers a 39% upside from its CMP of Rs 68.5.

Exhibit 1: Key Financials

Year to March 31	FY08E	FY07E	FY06
Net Profits (Rs Crore)	77.98	66.21	42.31
EPS (Rs)	6.29	5.34	3.41
P/E (x)	10.89	12.83	20.07
Price/Book (x)	1.52	1.62	1.69
EV/EBIDTA (x)	6.11	6.77	7.90
RoNW (%)	14%	13%	8%
RoCE (%)	13%	13%	9%

Source: ICICIdirect Research

Company Profile

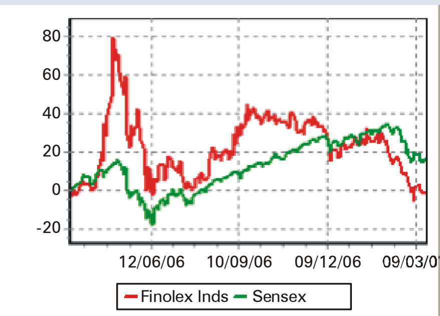
Registered Office
Block D1 Plot No 10,
MIDC Chinchwad,
Pune,
Maharashtra - 411019
Tel: 91-20-27408200
Website: www.finolex.com

Chairman : **P P Chhabria**
Business Group: **Finolex**

Shareholding Pattern as on 31/12/2006	
Major Holders	%
Promoters	18.9
Institutions	5.1
Other Corporates	41.0
General Public	35.0

Stock Data	
Market Cap (Rs crore)	849.4
Shares Outstanding (in crore)	12.4
52-week High (Rs)	129.0
52-week Low (Rs)	64.5
Avg. Volume	127088
Absolute Return 3 mth (%)	-15.3
Absolute Return 12 mth (%)	-2.0
Sensex Return 3 mth (%)	-4.8
Sensex Return 12 mth (%)	16.5

Performance Chart



Kunal Mehta
kunal.mehta@icicidirect.com

ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025

COMPANY BACKGROUND

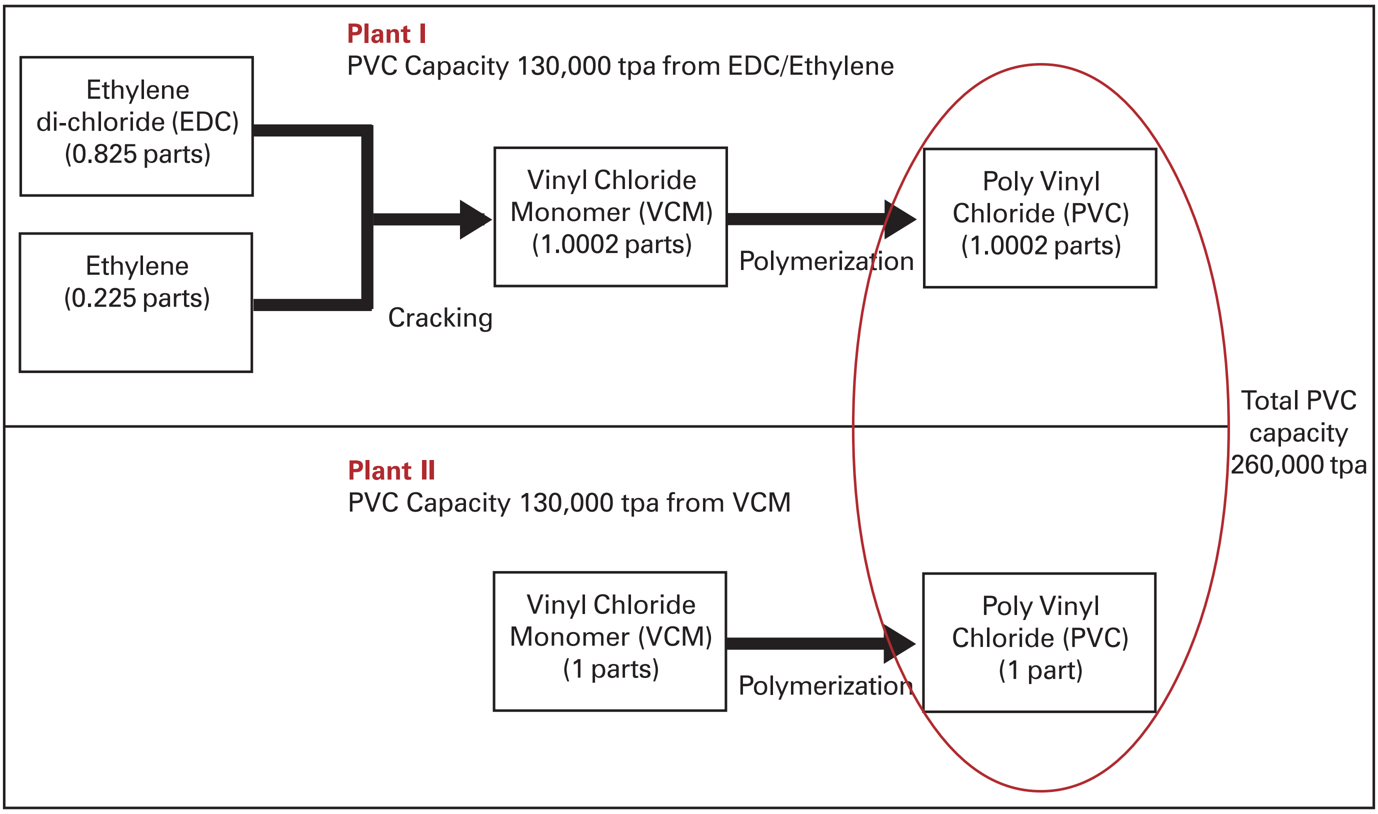
Incorporated in 1981, Finolex Industries is the largest PVC pipe and second largest PVC manufacturer in India. The company is part of the Finolex Group, a leading business conglomerate with interests in diverse areas such as telecommunications, petrochemicals, irrigation and education.

The company started with the manufacture of PVC pipes and later integrated backward to manufacturing PVC resin, which finds application in pipes, fittings, electric cables, packaging film, etc. Finolex has two ultra modern plants at Pune and Ratnagiri, Maharashtra. The current production capacity of PVC resin is 260,000 tonnes per annum.

Finolex has a technical collaboration with UHDE, Germany, for licensing and technical know-how of Hoechst's process to manufacture PVC resin and provide basic engineering. Its pipes division is IS/ISO 9002 certified by the Bureau of Indian Standards. The PVC plant of the company has undertaken work to obtain ISO 14001 (Environment Management System) certification.

As a part of its PVC complex in Ratnagiri, Finolex has set up an open sea cryogenic jetty. The jetty is the first of its kind in the private sector in India and is utilized for importing the feedstock for manufacture of PVC as well as for importing LPG. During the year 2004-05, the jetty became ISPS Code (International Code for the Security of Ships and of Port Facilities) compliant Jetty.

Exhibit 2: PVC process flow



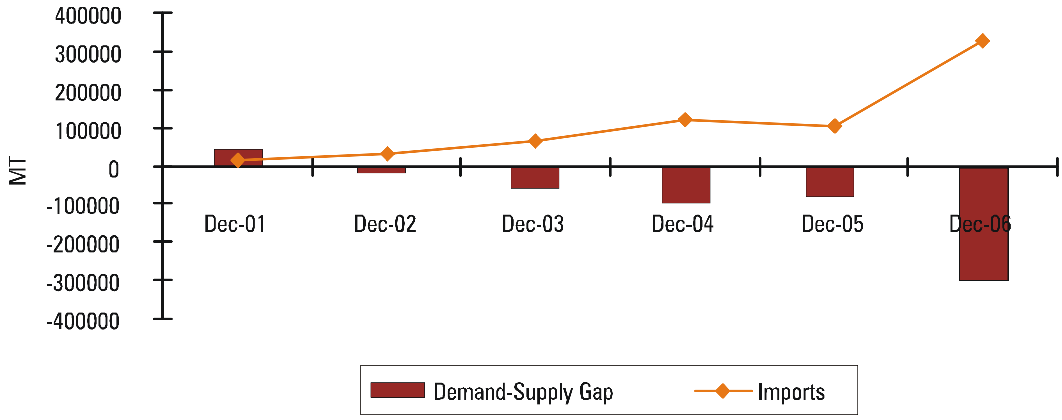
Source: Company, ICICIdirect Research

INVESTMENT RATIONALE

I) Demand-supply mismatch

PVC producers in India are currently in a sweet spot as there has been a shift from excess supply to shortage of PVC in the last few years. During 1997-2001, PVC consumption grew at a CAGR of 15%, whereas production grew faster at a CAGR of 18%. However, during 2001-2006, capacity addition grew at a miniscule CAGR of 2%, whereas demand continued to surge in double digits at a CAGR of 11%. Domestic producers are unable to satisfy demand despite operating at high capacity utilisation rates. Imports have surged to more than 300,000 tonnes in 2006 as the demand-supply gap widens.

Exhibit 3: PVC demand-supply scenario



Source: ICICIdirect Research

Robust demand for PVC pipes

PVC pipes are used for irrigation as well as in sanitation and plumbing systems in the construction sector. The PVC pipes market in India is divided between the organised and unorganized sector. Finolex is the undisputed leader in PVC pipes and has 20% of the organised market.

The government has given a renewed thrust to the rural sector and irrigation industry in the recent union budget. Some of the highlights are

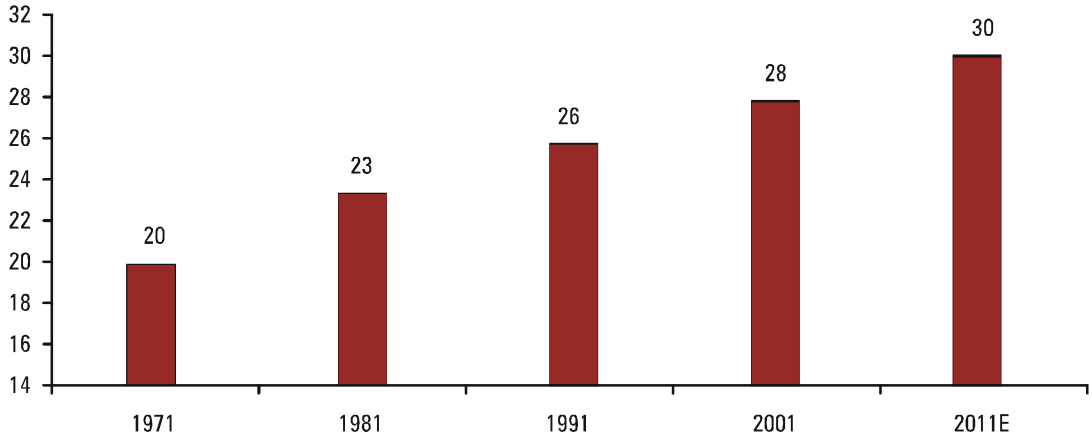
- **Accelerated irrigation benefit programme**: Outlay increased from Rs 7,121 crore to Rs 11,000 crore. About 35 projects likely to be completed in FY07 and additional irrigation potential of 900000 hectares to be created.

- **Rural infrastructure development fund**: Corpus raised from Rs 10,000 crore to Rs 12,000 crore

- **Bharat Nirman program**: Increase in provision by 31.6% from Rs 18,696 crore to Rs 24,603 crore. In FY07, additional irrigation potential of 2.4 million hectares to be created.

The construction sector is also booming due to increasing urbanization and nuclearisation. According to a Crisil study, total expenditure on housing is estimated at Rs 305,700 crore, backed by 1.8 million household formations in the UPNS (urban pucca non-slum segment).

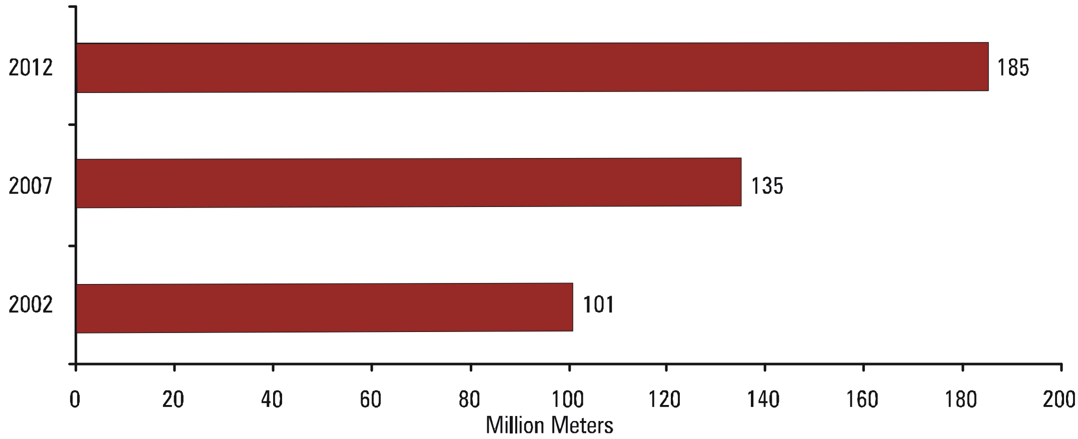
Exhibit 4: Growth in urbanization (% of total population)



Source: Population census

Due to the buoyancy in its user segments the total pipes demand is expected to grow to 185 million meters in 2012.

Exhibit 5: Projected demand for PVC pipes in India

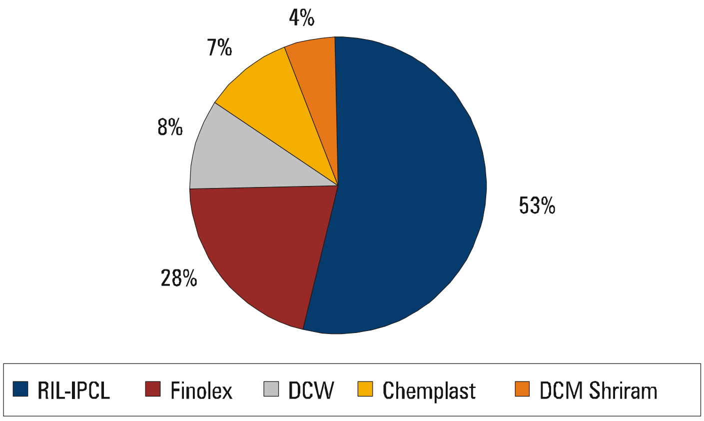


Source: Freedonia Group

II) Timely capacity expansions, cost reduction initiatives

Finolex Industries has doubled its PVC resin capacity from 130,000 to 260,000 in 2006 by setting up a VCM (vinyl chloride monomer)-based new facility. Finolex opted for the VCM based route as the capital expenditure required for this route is only about one-third compared to the EDC/Ethylene route on which its first plant is based. The new plant was setup at a cost of Rs 200 crore and commissioned in February 2006. Although margins by this route are less at US$100-150/tonne, the payback is faster. Many new VCM capacities are expected to be commissioned internationally in the next few years hence VCM supplies will not be an issue. It also derisks Finolex's business, as prices of ethylene have been volatile in the recent past. With this expansion, Finolex has consolidated its position as India's second largest producer of PVC behind the Reliance Industries-IPCL combine.

Exhibit 6: PVC market-share in India



Source: Company, ICICIdirect Research

Finolex is expanding its pipe capacities from 65,000 tonnes to 85,000 tonnes in 2007 at a cost of Rs 15 crore. Besides ensuring captive consumption of PVC resin, overall margins are higher in pipes due to value addition.

Exhibit 7: Pipe manufacturing capacity

Source: Company, ICICIdirect Research

Captive power plant and all-weather jetty to reduce costs

The company is setting up a captive power plant of 43 MW at a cost of Rs 200 crore which will be commissioned by the end of the year. As a result its power cost will be lower by Rs 1 per unit leading to cost savings of Rs 27 crore a year and additional EPS of Rs 2 from FY09 onwards.

Finolex is also planning to convert its jetty into an all weather port. Currently its jetty is not operational in the months of June, July and August. Therefore it needs to stock up on raw materials for 3-4 months which exposes it to price fluctuations besides increasing inventory cost.

III) Value unlocking through real estate foray

Finolex has 78 acres at its Chinchwad unit just outside Pune where it is planning to phase out its manufacturing operations. The real estate scenario is Pune is buoyant on the back of huge investments by IT majors like Infosys, Zensar, IBM, Kanbay, etc. Finolex has been in talks with various developers on how to best monetize this asset as it can develop about 6 million square feet on this property.

The current market price in Chinchwad area is about Rs 4 crore/acre. If it decides to sell this land it will have windfall gains of Rs 312 crore. However, it will have to pay huge capital gains tax in this case. Another option would be to build an integrated SEZ and earn lease income. This will provide steady income which will cushion its earnings which otherwise tend to be volatile due to the cyclicality in the PVC business.

We expect the company to go for the latter option in partnership with a developer. We expect Finolex to post an EPS of Rs 3.87 from FY2010 onwards just from the real estate foray.

Exhibit 8 : Valuation of real estate business

Built up area	6000000 square feet
Net Monthly rental	Rs 20/sq feet
Annual Income (Rs crore)	144
Share of Finolex (Rs crore)	72
EPS	3.87
Per share value of real estate business	Rs 25

Source: ICICIdirect Research

RISK & CONCERNS

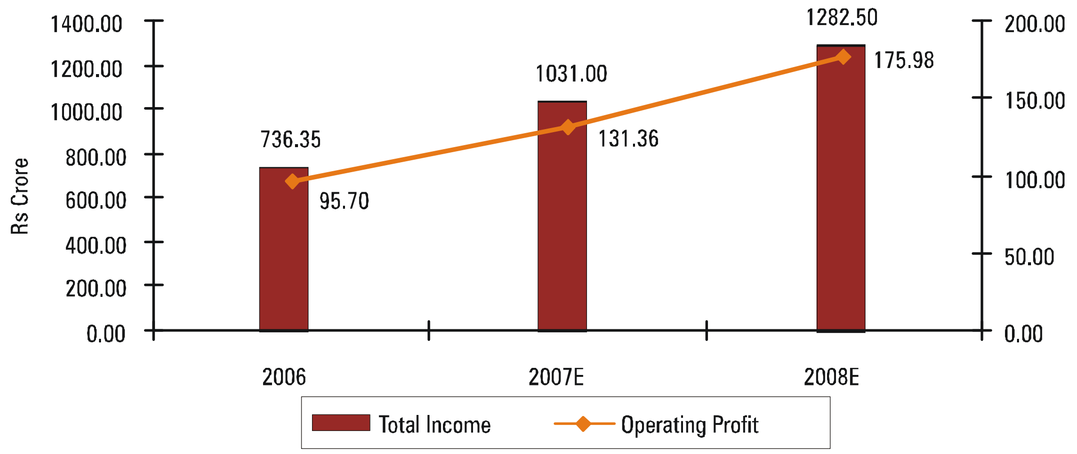
- Till its jetty is converted into an all weather jetty, there is a risk of margin erosion due to unfavorable price fluctuations during the monsoon months.
- Since both of Finolex's production routes are based on crude oil derivatives, there is a risk that other production routes (e.g. calcium carbide route) may become more competitive in case there is a sustained rise in the price of crude oil.

FINANCIALS

Strong growth in total income, operating profits

The benefits of capacity expansion will be visible from the current year as production in the new facility is ramped up. Total income is expected to rise from Rs 736.3 crore in FY06 to Rs 1282.5 crore in FY08E at a CAGR of 31.9% on the back of high capacity utilisation in both PVC resin as well as pipes. Operating profits are expected to jump from Rs 95.7 crore in FY06 to Rs 175.9 crore in FY08.

Exhibit 9: Operating income, profits to the rise

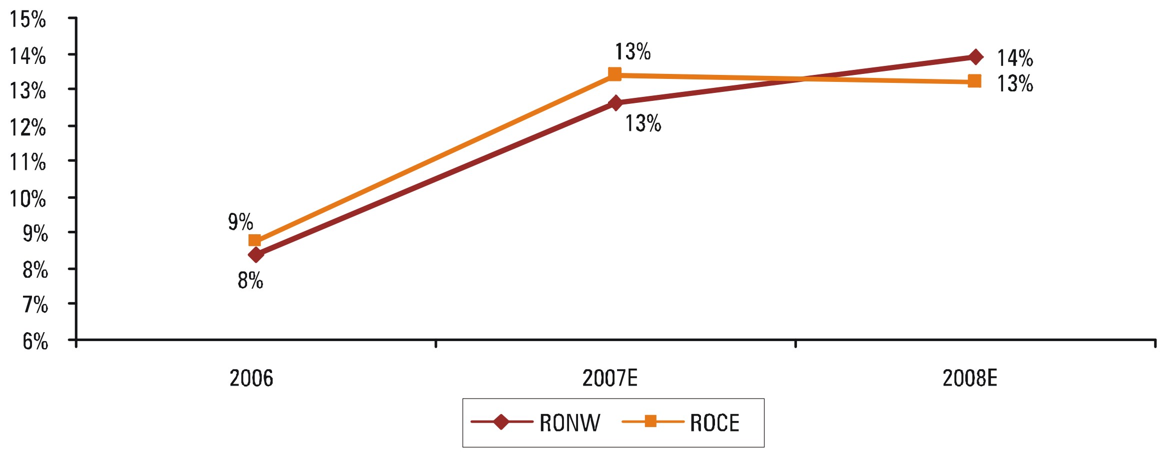


Source: ICICIdirect Research

Return ratio to expand

RoNW and RoCE, which were in single digits in FY06, are expected to jump in FY07 to 13.9% and 13.2% respectively. Their growth in FY08 is expected to be muted as the company once again gets in the investment mode for its captive power plant and all-weather jetty projects, the benefits of which will be visible from FY09 onwards.

Exhibit 10: Improving return ratios



Source: ICICIdirect Research

VALUATION

We have used a sum of parts methodology to arrive at a fair valuation for the stock. We arrive at a target price of Rs 95, which offers an upside of 39% from its current of Rs 68.5.

Exhibit 11 : Sum of parts valuation

Value of core business @ 6x FY07E EBIDTA (Rs crore)	1028.13
Less: Debt (Net Cash & Cash Equivalents) (Rs crore)	311.47
Effective value of core business (Rs crore)	716.66
Per share value of core business (Rs)-A	**58**
Add: Value of 14.5% shareholding in Finolex Cables (20% discount to CMP) (Rs crore)	150.87
Per share value of core business (Rs)-B	**12**
Per share value of real estate business (Rs)-C	**25**
Target Price (A+B+C)	**95**

Source: ICICIdirect Research

FINANCIAL SUMMARY

Profit and Loss Account

Total Income CAGR of 32% over FY06-FY08E

(Rs Crore)

Year to March 31	FY08E	FY07E	FY06
Total Income	1282.50	1031.00	736.35
% Growth	24%	40%	-12%
Operating Profit	175.98	131.36	95.70
% Growth	34%	37%	-44%
EBIDTA	195.98	171.36	137.34
% Growth	14%	25%	-28%
PBIT	139.39	120.59	90.52
% Growth	16%	33%	-38%
Interest	28.00	26.00	25.42
PBT	111.39	94.59	65.10
% Growth	18%	45%	-52%
Adjusted PAT	77.98	66.21	42.31
% Change YoY	18%	56%	-56%

Balance Sheet

(Rs Crore)

Year to March 31	FY08E	FY07E	FY06
Sources of Funds			
Equity Share Capital	123.99	123.99	123.99
Reserves & Surplus	435.78	401.86	379.71
Secured Loans	322.46	175.83	181.93
Unsecured Loans	175.00	200.00	344.35
Others	106.65	106.65	106.65
Current Liabilities & Provisions	383.73	339.50	290.59
Total Liability	**1547.61**	**1347.83**	**1427.22**
Application of Funds			
Net Block	711.38	567.97	578.75
Capital WIP	0.00	100.00	26.95
Cash	50.07	24.36	33.34
Investments	210.00	150.00	367.33
Trade Receivables	50.10	40.44	27.63
Loans & Advances	275.55	222.42	214.49
Inventory	250.50	242.64	178.75
Total Assets	**1547.61**	**1347.83**	**1427.22**

Cash Flow Statement

(Rs Crore)

Year to March 31	FY08E	FY07E	FY06
Opening Cash Balance	**24.36**	**33.34**	**84.31**
Profit after Tax	77.98	66.21	42.31
Dividend Paid	-42.43	-42.43	-42.43
Depreciation	56.59	50.77	46.82
Provision for deffered tax	0.00	0.00	0.35
Cash Flow before WC Changes	92.13	74.55	47.05
Net Increase in Current Liabilities	44.23	48.91	50.37
Net Increase in Current Assets	70.65	84.63	52.11
Cash Flow after WC Changes	**65.71**	**38.82**	**45.31**
Purchase of Fixed Assets	100.00	113.05	109.50
(Increase) / Decrease in Investment	60.00	-217.33	-45.86
Increase / (Decrease) in Loan Funds	120.00	-152.08	-32.66
Increase / (Decrease) in Equity Capital	0.00	0.00	0.00
Net Change in Cash	25.71	-8.98	-50.98
Closing Cash Balance	**50.07**	**24.36**	**33.34**

Ratios

Year to March 31	FY08E	FY07E	FY06
Adjusted EPS (Rs)	6.29	5.34	3.41
Book Value	45.15	42.41	40.62
Enterprise Value	1196.71	1160.80	1085.21
EV/Sales (x)	0.93	1.13	1.47
EV/EBIDTA (x)	6.11	6.77	7.90
Market Cap to sales (x)	0.66	0.82	1.15
Price to Book Value (x)	1.52	1.62	1.69
Operating Margin (%)	13.7%	12.7%	13.0%
EBIDTA Margin (%)	15.3%	16.6%	18.7%
Net Profit Margin (%)	6.1%	6.4%	5.7%
RONW	13.9%	12.6%	8.4%
ROCE	13.2%	13.4%	8.8%
Debt/ Equity (x)	0.89	0.71	1.04
Current Ratio	1.63	1.56	1.56
Debtors Turnover Ratio	25.60	25.49	26.65
Inventory Turnover Ratio	5.12	4.25	4.12
Fixed Assets Turnover Ratio	1.80	1.82	1.27

Reduction in D/E ratio inspite of Rs 240 crore capex

NOTES

RATING RATIONALE

ICICIdirect endeavours to provide objective opinions and ecommendations. ICICIdirect assigns ratings to its stocks according to their notional target price vs current market price and then categorises them as Outperformer, Performer, Hold, and Underperformer. The performance horizon is 2 years unless specified and the notional target price is defined as the analysts' valuation for a stock.

Outperformer: 20% or more;
Performer: Between 10% and 20%;
Hold: +10% return;
Underperformer: -10% or more.

Harendra Kumar **Head - Research** harendra.kumar@icicidirect.com

ICICIdirect Research Desk
ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025
research@icicidirect.com

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