Paper Sector

SECTOR UPDATE √

Reams of growth …

Domestic paper manufacturers have been successful in passing on cost increases to customers by hiking paper prices twice in 2007. Paper companies posted increases in their net profits in the range of 3% to 77%. Our coverage of stocks posted an impressive growth of 28.7% in net profits. The June quarter also posed the challenge of increase in wood pulp cost and furnace oil cost, but with a demand-supply gap of paper, most manufacturers were able to pass on the cost-push to the customers.

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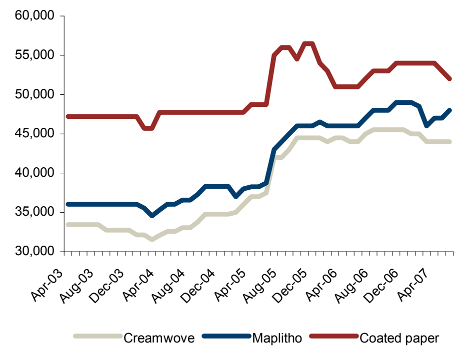
- **Capacity expansion & backward integration**
  Most of the large paper manufacturers have plans for capex of around Rs 15,000 crore for the next four years, which would lead to capacity additions to the tune of 1.66 million tonnes of paper per annum. Apart from additional capacity, manufacturers are focusing heavily on backward integration leading to expansion in margins. As the adherence to Corporate Responsibility for Environmental Protection (CREP) norms is due by March 2008, paper producers are integrating backwards by investing in chemical recovery boilers, ECF bleaching process, in house pulping capacity and captive power plants. Backward Integration is expected to result in margin expansion through cost control.

- **Upgrading products**
  Companies have witnessed a definite demand shift from the low-end paper to writing and printing and high-value added segments. Coated paper is growing at 9%, while the copier paper segment is growing at a robust 15%. To place themselves on a higher level on the product quality standards, companies are investing in specialized technology and better raw material inputs. Most capacities are getting added in these segments and are set to result in improved realizations for the players.

Price Movement



Comparative return metrics

Stock return	3 M	6M	12M
Ballarpur Industries	16.0%	28.8%	18.3%
TNPL	6.1%	14.8%	-2.1%
West Coast Paper	16.1%	12.4%	7.3%
JK Paper	-5.6%	-11.3%	-20.9%

Valuation

We reiterate our preference for big-size players as they are better placed in terms of capacity additions and backward integration. The stocks have traditionally traded at a historic P/E multiple of 8x and are currently available at forward multiples of 5x. Valuations are currently at a three-year low with key operating matrices on the up-tick and strong demand outlook. **Ballarpur Industries** and **TN Newsprint** are our preferred bet in the sector.

Key Financials

Company	Price (Rs)	Market Cap	P/E FY08E	EV/EBIDTA FY08E	RoNW FY08E	RoCE FY08E	View
Ballarpur Industries	144	2674	5.25	4.26	15.82%	15.77%	**Outperformer**
Tamil Nadu Newsprint	100	692	5.93	5.32	18.12%	14.40%	**Outperformer**
West Coast Paper	449	401	5.38	4.06	30.11%	25.25%	**Hold**
JK Paper	39	304	5.05	3.93	14.37%	14.64%	**Hold**

Source: ICICIdirect Research

Ballarpur Industries (BALIN)

STOCK UPDATE √

Current price	Target price
Rs 144	Rs 180
Potential Upside	Time Frame
25.6%	12-15 months

OUTPERFORMER

WHAT'S CHANGED…

PRICE TARGET……………………………………………Raised from Rs 150 to Rs 180

EPS (FY08E)……………………………………………Raised from Rs 18.7 to Rs 27.4

RATING……………………………………………Unchanged

Restructuring growth…

Ballarpur Industries (BILT) is restructuring its subsidiaries with a focus on value unlocking. It will retain the high margin segments and hive-off in its integrated paper units in commodity business along with Sabah Forest Industries (SFI), Malaysia, into a wholly-owned subsidiary. The company has also announced 40% compulsory equity buy back along with stock split. A sum-of-the parts valuation indicates an upside of 25%-92% from the current levels.

- **Results update**

  BILT posted satisfactory FY07 results with consolidated net sales rising 21% to Rs 2,317 crore, exceeding our estimates. The company also recorded a jump of 18.7% in EBIDTA levels. However, operating margins declined slightly by 57 basis points. The company showed a growth of 19.2% in consolidated net profits to Rs 255 crore. Though it witnessed an increase in the raw material and power and fuel costs to the tune of 35% and 32% respectively, it could successfully pass the increase to customers through two price hikes in 2007.

- **Restructuring: Commodity business hive-off to Ballarpur Paper Holding**

  BILT would hive off Bhigwan, Ballarpur and Kamalapuram units into a wholly owned subsidiary called BILT Graphic Paper Products Limited (BGPPL) for Rs 450 crore equity and Rs1,500 crore non convertible debentures as consideration. BGPPL would further be acquired from BILT by its subsidiary Ballarpur Paper Holdings BV (BPH) incorporated in Netherlands in connection with the acquisition of Sabah forest Industries Malaysia (SFI) for an all-cash deal of Rs 1,950 crore. BPH plans to raise funds by selling minority stake to private equity and by raising debt. Since globally paper manufacturers enjoy EV/EBIDTA in excess of 8x as against Indian average if 6x, the hive off is expected to fetch value unlocking in the range of 25%-92% to shareholders.

Valuations

The restructuring would lead to a significant improvement in BILT's return ratios and valuations. BPH is expected to get an EV/EBIDTA valuation in the range of 10-12x while BILT's current EV/EBIDTA is 6x, leading to a greater sum-of-the-parts valuation. Post the hive-off, we expect the scrip to trade in the range of Rs 180 to Rs 270 depending upon the quantum of private equity placement at BPH. At the current price of Rs 144, the stock is trading at P/E of 5.25x FY08E EPS of Rs 27.4. We believe there is an upside of 25%-92% post February 2008, when the private placement is expected to take place. We maintain our OUTPERFORMER rating with a revised target price of Rs180.

Key Financials: Consolidated

Year to June 30	Q4FY06	Q4FY07	y-o-y growth %	FY07	FY08E	y-o-y growth %
Net Sales	528.98	532.46	0.7	2317.78	2468.21	6.5
Other Income	4.71	5.19	10.2	13.73	10.96	-20.1
Total Expenditure	398.31	387.49	-2.7	1735.03	1812.16	4.4
EBIDTA	130.67	144.97	10.9	582.75	656.06	12.6
Interest	21.27	22.55	6.0	100.34	92.31	-8.0
Depreciation	37.54	40.54	8.0	156.54	186.17	18.9
PBT	76.57	87.07	13.7	339.60	388.54	14.4
Tax	9.60	9.60	0.0	37.02	40.58	9.6
PAT	67.88	66.28	-2.4	255.06	305.53	19.8
EPS	3.65	3.57	-2.4	14.06	27.42	95.0

Source: ICICIdirect Research

Tamil Nadu Newsprint (TAMNEW)

RESULT UPDATE √

Current price Rs 100	Target price Rs 135
Potential Upside 35%	Time Frame 12 months

OUTPERFORMER

WHAT'S CHANGED…

PRICE TARGET……………………………………………………………Unchanged
EPS (FY08E)……………………………………………………………Unchanged
RATING……………………………………………………………Unchanged

Pulping growth …

Tamil Nadu Newsprint and Paper Ltd (TNPL) posted a 19.3% increase in its first quarter revenue to Rs 214 crore, while profitability grew 26% to Rs 23.73 crore, which were in line with our expectations. TNPL's improvement of its EBIDTA margins to 24.52% in first quarter of FY08 in comparison to the previous quarter despite the increased raw material prices re-emphasises our conviction in the growth story propelled by backward integration.

- **Backward integration**
  Post the mill development program, which was slated to come on stream by August 2007, we expect significant improvement in company's margins from second quarter onwards. Paper prices have remained strong as anticipated by us. TNPL had a price hike in copier segment by Rs 400 in June 2007. The company is also reviewing its export prices in the light of rupee appreciation and is expecting to increase export prices by US$50-60 per tonne.

- **Revenue growth**
  During the quarter, the company saw a jump of 19.3% in revenue to Rs 214 crore through conscious product shift towards copier, coupled with robust prices. TNPL could improve its operational efficiencies marginally by 20 basis point q-o-q despite raw material prices remaining firm. The company posted an improvement of 122 basis points in its net profit margins q-o-q to 11.1%.

Valuations

We reiterate our outperformer rating and believe that the stock is available at an attractive valuation with an upside potential of 35% to our target price of Rs 135. Currently, the stock is trading at a P/E multiple of 5.9x its FY08E EPS of Rs 16.87. The company is likely to record earnings growth of 36% during FY07-FY08E. Moreover with an EV/EBIDTA at 5.3x in FY08E, current valuations look even more attractive. Our target price discounts its FY08E EPS of Rs 16.87 by 8x, its historical average.

Key Financials

Year to March 31	Q1FY07	Q1FY08	y-o-y growth %	FY07	FY08E	y-o-y growth %
Net Sales	179.32	214.01	19.3	854.84	897.58	5.0
Other Income	5.10	4.38	26.6	25.56	35.00	36.9
Total Expenditure	135.71	161.53	19.0	665.85	671.37	0.8
EBIDTA	43.61	52.48	20.3	188.99	226.21	19.7
Interest	5.12	5.32	-3.7	20.52	38.50	87.6
Depreciation	15.80	17.13	8.4	66.73	67.00	0.4
PBT	26.87	35.33	31.5	125.03	155.71	24.5
Tax	8.06	11.60	43.9	38.21	38.93	1.9
PAT	18.81	23.73	26.2	86.06	116.78	35.7
EPS	2.72	3.43	26.1	12.43	16.87	35.7

Source: ICICIdirect Research

West Coast Paper Mills (WESCOA)

RESULT UPDATE √

WHAT'S CHANGED…	
PRICE TARGET	Raised from Rs 450 to Rs 475
EPS (FY08E)	Raised from Rs 80.78 to Rs 83.42
RATING	Performer to Hold

Current price	Target price
Rs 449	Rs 475
Potential Upside	Time Frame
5.9%	12 months

HOLD

Potential upside limited …

West Coast Paper Mills (WCPM) posted a 7.3% increase in its first quarter sales to Rs 137 crore while profitability grew by 30.3% to Rs 19.5 crore, which was slightly above expectations. The company witnessed a jump in EBIDTA margins to 19.3% in first quarter of FY08, which is the highest ever touched by the company. This growth can be attributed to the success of passing on cost increases to customers by price hikes. However, with major capex coming on stream only by FY10, we see the medium-term upside priced in.

- **Capacity expansion**
  Currently, WCPM has an installed capacity of around 180,000 tpa of paper and paper board with pulping - capacity of 99000 tpa. The company is planning to expand its paper capacity by 120,000 tpa with 50% focused for copier production and the rest for the current product mix. Pulping capacity is being augmented to 700 tonnes per day. To improve on the operating margins, WCPM would be installing chemical recovery boiler and effluent treatment plant. The expanded capacity is expected to be commissioned by FY10. Post expansion, the company would be seventh largest in terms of paper capacity in India.

- **Revenue growth**
  During the quarter, the company saw a jump of 7.3% in its revenue to Rs 137.38 crore. This revenue growth was achieved through the price hike brought about by the company despite no new addition to its production capacity. WCPM improved its operational efficiencies marginally by 102 basis point q-o-q, despite a 13.5% increase in staff costs. The company posted an improvement of 251 basis points in its net profit margins q-o-q to 14.2% from 11.7%.

Valuations

We are changing our rating on the stock from performer to hold as we believe that it is trading at levels where the medium-term upside looks priced in. Currently WCPM is trading at a P/E of 5.4x its FY08E EPS of Rs 83.42 (revised upwards to adjust for the price hikes). With WCPM's capex traction to come by FY10, current valuations have marginal room for upside.

Key Financials

Year to March 31	Q1FY07	Q1FY08	y-o-y growth %	FY07	FY08E	y-o-y growth %
Net Sales	128.03	137.38	7.3	551.43	569.44	3.3
Other Income	0.55	2.62	376.4	6.33	7.00	10.6
Total Expenditure	104.68	110.93	6.0	458.40	466.65	1.8
EBIDTA	23.35	26.45	13.3	93.03	102.79	10.5
Interest	1.71	1.91	11.7	4.99	4.49	-9.9
Depreciation	5.25	5.10	-2.8	21.00	21.10	0.5
PBT	16.94	22.06	30.2	73.38	84.20	14.7
Tax	1.98	2.56	29.3	8.53	9.62	12.8
PAT	14.96	19.50	30.3	64.85	74.58	15.0
EPS	16.73	21.81	30.3	72.53	83.42	15.0

Source: ICICIdirect Research

JK Paper (CENPUL)

RESULT UPDATE √

Current price	Target price
Rs 39	Rs 42
Potential Upside	Time Frame
8.9%	12 months

HOLD

WHAT'S CHANGED…
PRICE TARGET………………………………………………… Lowered from Rs 48 to Rs 42
EPS (FY08E)…………………………………………………Lowered from Rs 8.43 to Rs 7.73
RATING………………………………………………………Performer to Hold

On a flat pitch …

JK Paper, the largest producer of branded copier paper in the country, posted a 14% increase in its FY07 revenue to Rs 759 crore, while profitability grew by 29.8% to Rs 46.1 crores, which missed our expectations. The company was just about able to maintain its EBIDTA margins at 20% levels for the year and we foresee further margin pressures in FY08 due to increased raw material prices.

- **Capex to venture in high value business**
  JK Paper is one of the principal players in writing & printing paper category. Apart from its existing product mix of copier and uncoated paper, JK Paper commissioned a state-of-the-art coating plant with a capacity of 46,000 tpa. The company has undertaken Rs 250 crore capex to bring in packaging board into its product mix. It plans to produce folded boxboards and other paper packaging products from this expansion. Industrial packaging products are growing at greater pace than the industry average and fetch a premium over the average paper industry realisation. This facility is expected to be functional by the third quarter FY08.

- **Revenue Growth**
  During FY07, JK Paper witnessed a growth of 14.4% in their revenue to Rs 759.48 crore which fell short of our estimates, as it could not pass the entire cost increase to the end customers. Company could reduce the raw material cost as a percentage to sales slightly by 111 basis points, which helped it in maintaining its operating margins at 20%.

Valuations

We change our recommendation on JK Paper from performer to hold as we revise our revenue estimates downwards in line with the numbers reported by the company. Currently, the stock is trading at 5x its FY08E EPS of 8.43. Our target price discounts its FY08E EPS by 5.5x.

Key Financials

Year to June 30	Q4FY06	Q4FY07	y-o-y growth %	FY07	FY08E	y-o-y growth %
Net Sales	183.11	186.86	2.0	759.48	924.15	21.7
Other Income	0.05	3.19	6280	3.72	1.50	-59.7
Total Expenditure	149.41	149.73	0.2	606.85	744.05	22.6
EBIDTA	33.70	37.13	10.2	152.63	180.10	18.0
Interest	7.63	8.47	11.0	34.37	37.08	7.9
Depreciation	11.56	12.71	9.9	50.48	56.24	11.4
PBT	14.56	19.14	31.5	71.50	88.28	23.5
Tax	5.24	6.76	29.0	25.40	27.90	9.8
PAT	9.32	12.38	32.8	46.10	60.38	31.0
EPS	1.19	1.58	32.8	5.90	7.73	31.0

Source: ICICIdirect Research

RATING RATIONALE

ICICIdirect endeavors to provide objective opinions and recommendations. 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.

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