Prabhudas Lilladher

Vishal Retail

Covering more ground

May 27, 2008

Rating	**Not Rated**
Price	Rs698
Target Price	NA
Implied Upside	NA
Sensex	16,276

(Prices as on May 27, 2008)

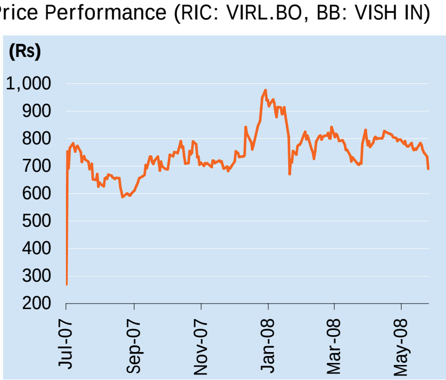
Trading Data	
Market Cap. (Rs bn)	15.6
Shares o/s (m)	22.4
Free Float	36.1%
3M Avg. Daily Vol ('000)	5.3
3M Avg. Daily Value (Rs m)	4.1

Major Shareholders	
Promoters	63.9%
Foreign	9.5%
Domestic Inst.	3.3%
Public & Others	23.3%

Stock Performance

(%)	1M	6M	12M
Absolute	(14.2)	1.2	NA
Relative	(9.3)	16.1	NA

Price Performance (RIC: VIRL.BO, BB: VISH IN)



Source: Bloomberg

- **Aggressive expansion:** Vishal Retail is looking to expand its retail space from 2.3 million sq.ft. (108 stores) to 3.7 million sq.ft. (190 stores) in 2009, 5.5 million sq.ft. in FY10 and to 10 million sq.ft. (500 stores) of hypermart space by FY11. The company is also looking at nine new formats, which would entail smaller standalone stores in categories like apparels, convenience, mobiles, toys, electronics, etc.

- **New subsidiaries:** The company is looking to form four subsidiaries – logistics, education, manufacturing and real estate. The idea to form these subsidiaries is to grow the key value chain activities into competitive business by enabling focused management.

- **Capex plans:** For its growth plans till FY11, the company would require about Rs24.4bn, which the company would fund by about Rs8.0bn from equity in 2-3 tranches and the rest from debt. It plans to maintain a debt equity ratio of 2:1.

- **Financials:** The company's topline grew by 68% to Rs10.14bn in FY08 and PAT grew by 62.3% to Rs406.9m. Profit margin declined marginally to 4%. The company expects revenue to increase to about Rs18.0bn in FY09 and about Rs32.5bn in FY10. It expects to maintain its PAT margin, resulting in PAT of Rs720m in FY09, about Rs1,300m in FY10. At Rs698, the stock trades at 38.4x FY08.

Key financials (Y/e March)	FY05	FY06	FY07	FY08
Revenue (Rs m)	1,463	2,884	6,050	10,145
Growth (%)	*66.1*	*97.1*	*109.8*	*67.7*
EBITDA (Rs m)	88	263	694	1,291
PAT (Rs m)	30	125	251	407
EPS (Rs)	2.0	7.6	13.7	18.2
Growth (%)	*NM*	*271.2*	*80.9*	*32.7*
Net DPS (Rs)	—	—	—	—

Source: Company Data; PL Research

Profitability & valuation	FY05	FY06	FY07	FY08
EBITDA margin (%)	*6.0%*	*9.1%*	*11.5%*	*12.7%*
RoE (%)	*11.7%*	*25.6%*	*25.9%*	*20.5%*
RoCE (%)	*8.6%*	*15.7%*	*13.8%*	*11.1%*
EV / sales (x)	7.2	4.2	2.5	2.1
EV / EBITDA (x)	120.5	45.5	21.7	16.2
PE (x)	342.5	92.3	51.0	38.4
P / BV (x)	34.0	17.1	10.1	5.8
Net dividend yield (%)	—	—	—	—

Source: Company Data; PL Research

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Q: What is Vishal Retail's target segment?

A: Our target segment is the consumer who is value conscious. In terms of demographics, we are not interested in the top 4% of the consumption pyramid and the rock bottom who earn less than Rs3,000 per month. We provide a value proposition to customers and aim to increase our share of the consumer's wallet in the mass market space.

Q: Are tier I and tier III towns the focus for presence? And will you be biased towards the north?

A: Our focus is national footprint. We strive to reach to our target segment wherever he is present, whether it is tier I or tier II. In tier I cities, we would like to be present in the catchment areas, unlike South Extension or Connaught Place in Delhi. We have 20 stores in Delhi and three stores in Mumbai. Of the 400 additional stores, about 40 stores can be added in tier I. From the current 70 cities, we would expand to 300 cities by FY11. We would add more stores in tier III and tier IV cities, as we believe aspiration levels and consumption drive in these areas can add to our growth.

Bias towards north will remain. It is not a chosen bias; north has high propensity to purchase. Our plan in the next three years is to have a good geographical mix of stores – 45% in north, 30% in west and the rest in south and east. In the east, aspiration is high, while south is different as larger spending is on FMCG and less on apparel, as it is not brand conscious and has less spending on lifestyle.

Q: How is our operating metrics scaled in terms of per sq.ft.?

A: *Space in sq.ft.:* Currently, we have 2.3 million sq.ft. space, which we are looking to expand to 3.7 million sq.ft. in FY09, between 5 million and 6 million sq.ft. in FY10 and 10 million sq.ft. in FY11. We already have MoU for 1.5 million sq.ft. space, which we are rolling out this year; in addition, we have LoI for 1.5 million sq.ft. space which we would be adding in FY10. Currently, we are booking for our space requirement in FY10. We do not see any problem in garnering our space requirement as we have enough lead time.

Revenue per sq.ft.: It will be maintained between Rs6,000 and Rs7,000. Sales per sq.ft. in tier III is slightly lower than tier I cities.

Store level operation breakeven is in the first month itself. We are able to generate revenue of about Rs550 per sq.ft. in the first month, on which gross profit is about Rs180 to Rs185. Rs120 per sq.ft. is the total cost including corporate expense.

Same store sales growth for FY08 was 7% on 27 stores with at least one year of operation.

Growth is more of hygiene factors, rather than consumption. There would have been concern if footfall or conversion was not increasing. Concern is on customer annoyance / irritation. The key to our business is value proposition, customer experience and customer servicing (only place where we need to get better, as we are a bit below our target levels). We have not instated loyalty programmes; we will be doing that this year. We will also add financial products, and insurance will be added towards the end of the year.

Q: How do you see transaction size going forward?

A: We plan to shift product mix by decreasing apparel to 45%, non-apparels to 30% and FMCG to 25%. Ticket size should not reduce. Our focus is to increase footfalls and increase conversion irrespective of ticket size we should maintain gross margins – apparel (35%), non-apparel (35%) and FMCG (15%).

Q: What is our CAPEX requirement per sq.ft.?

A: We need investment of Rs3,000 per sq.ft. of retail space, of which CAPEX is Rs1,000 per sq.ft., which includes furniture, fixtures, warehouse space, logistics, etc. We need 0.3 sq.ft. of warehouse space for every 1 sq.ft. of retail space. Moreover, we need Rs2,000 of inventory per sq.ft. of retail space. Currently, it is about Rs2,400 per sq.ft. of inventory, which we are targeting to reduce to Rs2,000 per sq.ft. during the year.

Q: What are our operating expenses per sq.ft.?

A: Rent: We have managed to hold rent at under Rs31 per sq.ft. We are getting new properties also at under Rs31. This is primarily because of our negligible presence in malls, where rentals are higher, and also due to our presence across a mix of cities. We may look at malls only when rentals are attractive. Having said that, we believe we would be able to maintain average rent at Rs31 per sq.ft. Our rental agreements are for 12 years, with a built-in escalation of 10-15% every three years. We have the liberty of leaving space with a notice of three months; however, the lessor cannot break the agreement. So, currently, escalation is coming in properties, which we booked before 2005. However, as we are expanding, we will be able to manage our rental cost within Rs31 per sq.ft. Warehousing rental average is Rs8-9 per sq.ft., while average rental for retail space is Rs26 per sq.ft. Moreover, we should have operating leverage on rentals after three years, as warehouse addition will stop.

People: Employee attrition is about 22-23% and expects them to be there in a growing organisation. Attrition will not be a problem, challenge will be to get those people and train them. The focus is to have a talent pool of 4x-5x people. It is going to be a challenge as the country does not have enough retail professionals around. We have set-up a retail training institute in Delhi to train people in the retail field, which in turn will be absorbed by Vishal and also other retail players as well. We expect the pool to go up in the next 1 -2 years. We should be able to maintain employees cost at 7%.

Q: What are the supply chain initiatives being undertaken?

A: We have implemented SAP in production and retail modules about five months back. The company spent about Rs75m on the same. We are in the process of stabilisation. Certain supply chain issues are there, we will take three to six months to prune that. We are currently feeding North-East from Kolkata; we need a warehouse in Guwahati. We have 29 warehouses currently in eight cities and will increase to 18 cities. We have a fleet of 98 trucks. Eventually, all warehouse and fleet will be transferred to logistics subsidiary.

Q: Have we seen any signs of degrowth in the last six months?

A: No, we have not seen any degrowth. In fact consumption has increased and rather it is shifting to organised players because of the value proposition and the shopping experience we provide.

Q: What is the store sales curve for a new outlet?

A: Initial for the first two months it is spiky and then it matures. If competition enters, then spike in sales would be visible for them in the first two months, and our sales would marginally come off. Then both stores will mature and have stable sales. We do not have serious competition from small formats as we have small base for FMCG. Though our price proposition in FMCG is better, our customer comes to Vishal not for FMCG alone.

Q: Can you please share Vishal's pricing policy?

A: We follow mark-up pricing policy and we control our margins. In the last few days, we have passed on cost increase to customers judiciously, without hurting their demand. If we have economies of scale equal or better than competition, we are safe even in an inflationary environment.

Q: What is our inventory level and is it valued at cost?

A: Inventory is valued at cost. We do not carry inventory beyond exposure, liquidate them through discount, even store managers are empowered for the same. In apparels, there are two types of merchandise – staple evergreens and fashion; we have cut the calendar into six terms,and fashion merchandise is cleared off at the turn of every term,. We have a designing team of more than 100 people in Delhi.

Inventory right now is Rs2,400 per sq.ft. against our ideal limit of Rs2,000 per sq.ft. This is mainly on account of absence of warehouses in some locations and due to winter inventory. As a retailer, we believe excessive inventory is better than stock out.

Q: Do you see competition coming from recent ramp-up of Subhiksha and other Fresh stores?

A: Convenience store is just one model, which is like Subhiksha; at present fresh contribution is less than 1%. It is not that we decide what we sell, it's what the customers want; and we look at how we can provide a value proposition. Our evaluation is driven by customers. We don't believe that Fresh is a puller at hypermart. As a hypermart format, we regard Big Bazaar as a competition.

Q: How have we seen our procurement efficiency improving?

A: It is improving but lots of work is still to be done. We do not have organised large vendor base; we still procure our FMCG from distributors. We aim to leverage with FMCG giants. Currently we believe it is differential treatment for modern trade by FMCG; however, when modern trade would exceed 25% of market or once private labels would go up – bargain with FMCG companies would yield, as scale is important for FMCG bargains. Today we have 4.5 million capacity for apparels in Gurgaon, Manesar and Dehradun; 20% of apparel is manufactured, 9.5% of total sales is owned produced and sold; we get 5-6% higher margins on private labels as it is mark up pricing; we may get 20-30% higher on some. Shelf space to private labels – issue is on how much we can produce rather than how much we can sell.

Q: Is there any product quality difference at Vishal against other players?

A: Footfalls and conversion speak for themselves. We believe in providing value to the consumers, and we share procurement benefits with them.

Q: What is our future plan?

A: Revenues will grow significantly along with operating leverage. In FY09, our rental space will increase to 3.7 million sq.ft. with 190 stores, in FY10 it will be between 5.5 million and 6.5 million and in FY11 it will reach 10 million with 500 stores. Sales will be in direct proportion to addition of stores. Economies of scale will bring margin expansion; worst case bottomline would move in tandem with revenue. Interest cost should not move up. We see revenue of Rs18.0bn in FY09.

Q: What is the possibility of margins improving?

A: Currently, EBITDA margin is at 12%; we will be able to hold them. Our effort is to improve them by increasing our share of private label, which has about 7.5% margin currently. We expect to take it up to 25% by FY10 and to 55% by FY13. We will strive to draw more value proposition from pricing, sourcing, scale and pass on benefits to customers as consumer benefits remain our mantra.

Q: How are we gearing the organisation to manage the envisioned scale?

A: We are working on segregating our geography into 18 regions managed by a CEO each. Currently we have five regional offices, which would be managing the zones. These zones would be working under the management at corporate level. In the next six months, we plan to implement it. We plan for each region to have three to seven lakh sq.ft. by 2011. Similarly, procurement will become three tiered – central sourcing, offshore and local for low valued, regional tastes and FMCG.

Q: What are the new formats we are planning?

A: We are planning for nine new formats – two categories in apparel, fashion mart (2,000 sq.ft), separate formats for menswear and women's wear have already started at Dahisar, Ashok Vihar and one more in Delhi. These stores would have normal price positioning (not discounted). We have started booking franchisees in the last three weeks and short listed about 25-30. We will start rolling out in the second half of this fiscal. As a strategy, we will have Vishal Fashion Mart in cities where we have a mega mart; it will not cannibalise as the customers come only once a month in a hypermart.

We are working on feasibility of convenience model (small formats through franchisee). With size of about 800-2,000 sq.ft., it would have revenue of 50-60% from FMCG, rest depends on local flavour, toys, bakery, takeaways, beverages, train ticket, mobile top-ups, insurance premium collection, etc.

Another format is with HPCL. It will be more on observation mode for 3-4 months; we will then work out the strategy ahead. We will add 25-30 stores with 1,000 sq.ft. average. It's not a co-branded, it's more of a lessor – lessee relationship, we would pay them a minimum guarantee, which is like rental and beyond three years, if the sales average sq.ft. is higher, there would be some revenue sharing.

Other formats are for electronics, mobiles and toys. All these formats will be standalone stores with average size of 1,000-2,000 sq.ft., and these categories will be on franchisee model. It's the drive to garner higher consumer wallet share, which motivates us to be present in small category stores. They will enable our presence on high streets with more footfalls. Franchisee model will allow scalability. It will be early to speak on the numbers for expansion of the franchise stores as we have to tighten the model.

Q: What are the new subsidiaries we are looking at?

A: We are looking at four subsidiaires – logistics, education, property development and manufacturing. The idea is to grow these value chain activities, which we are currently indulged in, to competitive business of its own. For the same, different talent sets are required, and which we believe can do justice to only as a separate entity.

We will transfer our fleet of trucks, warehouse to this subsidiary, and would have expansion from this subsidiary only. We incur about Rs200-250 per sq.ft. on warehouses. We are currently waiting for the management team to be inducted.

We have opened a retail training school in Delhi and plan to have more chapters across India in the near future. We would transfer this into our education subsidiary. Currently, we have about 200 students enrolled for training programmes.

We would like to carve out our manufacturing facilities into a subsidiary.

Capital structuring of real estate subsidiary is being discussed. It is capital intensive, and we are also talking to real estate developers as it would be a new territory for us. We plan to develop destination spots at 15-20 kms around the periphery of the city. We plan to operate on deep discount model by occupying 48-50% of retail space in such locations, including entertainment zones, and lease out the rest of the space.

Q: What is our fund requirement and how are we looking to finance it?

A: For our expansion plan till FY11, about Rs22-Rs24bn will be required; debt to equity will be about 2:1. We would finance about Rs7-Rs8bn from equity (1st tranche of Rs2bn by private placement to be done shortly) and the remaining in two to three tranches. Rs16bn will be from debt. Currently our interest cost is about 11.7%.

Q: How do we see the intense competition impacting Vishal?

A: Competition would be there; however, Big Bazaar and Vishal are not competing to affect each other. In Kolkata, both are operating in the same area and that also with a common wall, but both of them are having similar footfalls and operating metrics. The market can easily absorb three to four organised players in each city; as during peak hours, every retailer is working at 2x to 2.5x its capacity. Footfalls are high in the evenings for two hours and on weekends. The challenge is to handle them as it results in customer annoyance.

Q: What are the key challenges for Vishal going forward?

A: We are not concerned if growth is possible; we have strong conviction. We do not see rent as a challenge. For us, the bigger challenges are people, supply chain and sourcing development. We are working on each of them.

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly