

FINOLEX INDUSTRIES

INR 89



Other income saved the quarter; Triggers still exist

BUY

Finolex Industries reported higher than expected Q3FY07 profits of INR 229 mn mainly due to higher other income of INR 190 mn as a result of exchange gains of INR 110 mn and investment gains of INR 70 mn.

On the operations front, PVC resin production was the highest ever as new PVC capacity started running with full utilization. Margins were subdued due to low regional PVC margins, which we believe will remain muted for the next few years.

We have maintained our FY07 EPS estimates at INR 5.5 per share and have reduce the FY08E EPS from INR 8.0 to INR 6.4 per share due to weakening PVC margins scenario. At INR 89, Finolex trades at 13.9x FY08E EPS and 10.4x FY09E EPS.

Though we believe that the current stock price incorporates full value of the core business (PVC), we believe that upsides exist from Finolex monetizing its real estate investments and conversion of the jetty to all weather port. Moreover, after discussions with the industry sources, we believe that the announcements of the real estate venture/sale will come soon, which provides investors opportunity to buy at current levels. We maintain our 'BUY' recommendation on the stock.

* **Revenues increased 68.6% Y-o-Y due to higher sales volumes**

Finolex Industries, Q3Y07 revenues increased by 68.6% Y-o-Y and 50.2% Q-o-Q. Most of the revenues increase was due to increase in PVC resin sales. The increase was mainly driven by higher production and utilization of the new VCM-PVC plant.

PVC resin sales increased by 55.1% sequentially and 59.2% Y-o-Y. Production growth was 59.5% Q-o-Q and 51.2% Y-o-Y. Sales have increased sequentially due to higher production from the increased capacity. New capacity (VCM->PVC) had raw material problems in the last quarter which led to lower capacity utilization.

Sales of PVC pipes division also showed healthy growth as demand of PVC pipes from the agricultural and construction sector were very healthy. PVC pipes sales increased by 48.0% Y-o-Y to 18.2 TMT. Finolex has increased its PVC pipes capacity to 85.0 TMT/PA, in anticipation of further increase in the domestic pipes demand.

Financials

Year to March	Q3FY07	Q3FY06	Growth %	Q2FY07	Growth %	FY07E	FY08E
Revenue (INR mn)	2,946	1,747	68.6	1,961	50.2	10,361	13,124
EBITDA (INR mn)	287	281	2.0	402	(28.5)	1,316	1,755
Net profit (INR mn)	229	147	56.0	200	14.5	678	791
EPS (INR)	1.8	1.2	56.0	1.6	14.5	5.5	6.4
P/E (x)						16.2	13.9
EV/EBITDA (x)						10.6	8.7
ROE (%)						13.1	14.4

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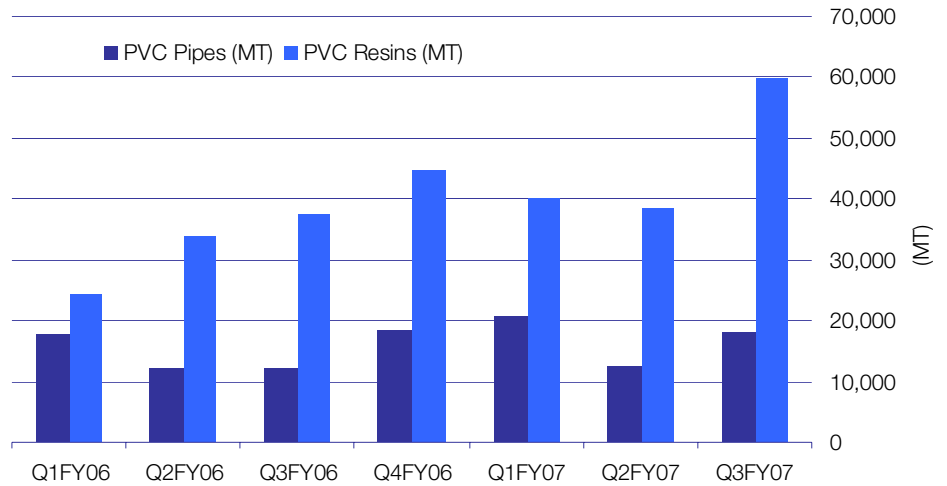
Market Data

52-week range (INR) : 129 / 66
Share in issue (INR mn) : 124.0
M cap (INR bn/USD mn) : 11.0 / 249.3
Avg. Daily Vol. BSE/NSE ('000) : 910.9

Share Holding Pattern (%)

Promoters : 18.9
MFs, Fls & Banks : 2.3
FIs : 1.8
Others : 77.0

Chart 1: Sales volume of PVC resin and PVC pipes segment



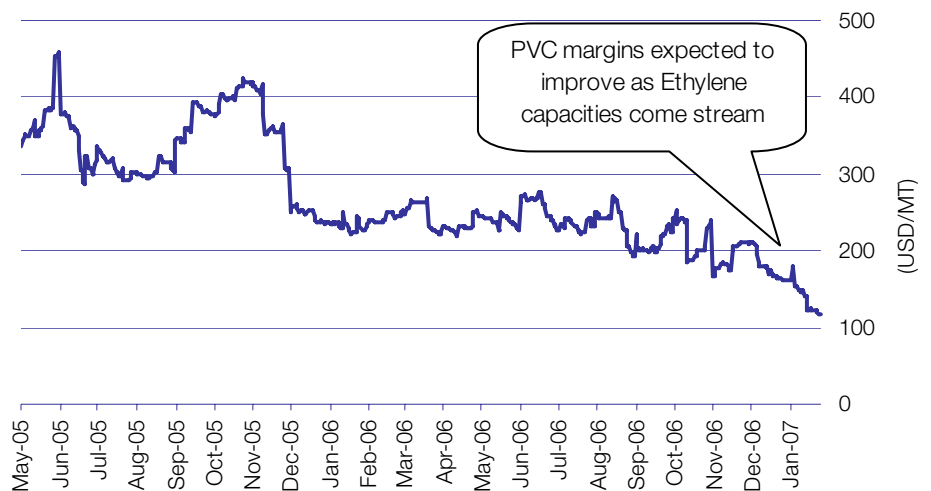
Source: Company, Edelweiss research

* EBITDA margins fell from 16.1% in Q3FY06 to 9.7% in Q3FY07 due to lower regional margins

Finolex’s EBITDA margins fell from 16.1% in Q3FY06 to 9.7% in Q3FY07 due to lower regional PVC margins. EBITDA margins were also impacted due to inventory losses as PVC prices falls along with the fall in crude prices.

PVC margins in the region have been impacted as China has been increasing PVC capacity forcing its previous suppliers in Japan, South Korea, Taiwan and Thailand to seek new markets for these exports. We believe that PVC margins will remain at subdued level for couple of years. However, we will definitely see improvement in the PVC margins as current margins reflect tight market for Ethylene capacities, which we expect to improve soon.

Chart 2: PVC margins



Source: Company, Edelweiss research

* **Higher other income and lower interest expenses led to 76.6% increase in PAT**

Q3FY07 other income was higher by 110.7% Q-o-Q and 232.2% sequentially due to exceptional rupee appreciation gains (INR 110 mn) and booking of investment gains (INR 70 mn). Interest cost fell by 42.2% Y-o-Y and 23.4% Q-o-Q due to reduction in short term debt. Current long term and short term debt are at INR 1.7 bn and INR 2.8 bn respectively.

Finolex PAT of INR 229 mn was higher by 56% Y-o-Y and 14.5% sequentially.

* **Real estate venture may be near consummation**

There have been rumours that Finolex has sold the land to one of the developers for INR 3.1 bn. We are yet to have an official confirmation from the company. The sale may fetch INR 25.0 per share of Finolex as investment gains.

* **Maintain our FY07 EPS estimates at INR 5.5 per share; Re-iterate BUY**

We have maintained our FY07 EPS estimates at INR 5.5 per share and have reduce the FY08E EPS from INR 8.0 to INR 6.4 per share due to weakening PVC margins scenario. At INR 89, Finolex trades at 13.9x FY08E EPS and 10.4x FY09E EPS.

Though we believe that the current stock price incorporates full value of the core business (PVC), we believe that upsides exist from Finolex monetizing its real estate investments and conversion of the jetty to all weather port. Moreover, after discussions with the industry sources, we believe that the announcements of the real estate venture/sale will come soon, which provides investors opportunity to buy at current levels. We maintain our 'BUY' recommendation on the stock.

Table 1: Replacement cost valuation of Finolex Industries

Description	Value (INR bn)
Existing PVC plant - including jetty	9.0
New VCM-PVC plant	2.0
Working capital	3.8
Replacement Cost	14.8
Current market capitalisation	11.0
Debt on Q3FY06 end	4.6
Cash and cash equivalents	2.0
Value of Finolex Cables (cross-holding @ 20% discount)	1.9
Value of the land	3.0
Option value of jetty	0.0
Implied Enterprise Value of PVC business	8.7
Enterprise Value (as % Replacement cost)	58.8

Source: Edelweiss research

(INR mn)

Financials snapshot								
Year to March	Q3FY07	Q3FY06	Growth %	Q2FY07	Growth %	FY06	FY07E	FY08E
Net revenues	2,946	1,747	68.6	1,961	50.2	7,363	10,361	13,124
Raw material costs	2,148	1,037	107.1	1,113	92.9	4,719	6,960	9,117
Power & fuel	273	231	18.1	257	6.4	815	1,067	1,170
COGS	2,421	1,268	90.9	1,370	76.7	5,533	8,027	10,287
Gross profit	525	479	9.7	591	(11.1)	1,830	2,334	2,837
Employee expenses	69	48	42.3	73	(6.5)	212	273	295
SG&A expenses	170	149	13.7	116	46.2	661	745	787
Operating expenses	238	198	20.7	190	25.8	873	1,018	1,083
EBITDA	287	281	2.0	402	(28.5)	957	1,316	1,755
Interest	32	56	(42.2)	42	(23.4)	254	220	273
Depreciation	136	108	26.0	136	(0.0)	468	543	542
Other income	190	57	232.2	90	110.7	416	419	190
Profit before tax	309	175	76.6	313	(1.5)	651	972	1,130
Total tax	80	28	185.0	114	(29.7)	228	294	339
Net profit	229	147	56.0	200	14.5	423	678	791
No. of shares (mn) (FV INR 10)	124	124	0.0	124	-	124	124	124
EPS (INR)	1.8	1.2	56.0	1.6	14.5	3.4	5.5	6.4
PE (x) (annualised)						26.0	16.2	13.9
as % of net revenues								
Direct costs	82.2	72.6	NA	69.9	NA	75.1	77.5	78.4
Gross profit	17.8	27.4	NA	30.1	NA	24.9	22.5	21.6
SG&A	5.8	8.5	NA	5.9	NA	9.0	7.2	6.0
EBITDA	9.7	16.1	NA	20.5	NA	13.0	12.7	13.4
Profit before tax	10.5	10.0	NA	16.0	NA	8.8	9.4	8.6
Net profit	7.8	8.4	NA	10.2	NA	5.7	6.5	6.0
Tax rate	25.9	16.0	NA	36.2	NA	35.0	30.3	30.0

Company Description

Finolex Industries is the largest PVC pipes manufacturer in India. The company has two divisions: PVC resin and PVC pipes. Finolex is one of the largest PVC resin manufacturers and manufactures suspension and emulsion grade PVC. It has a capacity of 260,000 TPA for PVC resins in the West Coast of Maharashtra. PVC pipes division produces 85,000 TPA spread over its two ultra modern plants at Pune and Ratnagiri. Finolex also manufactures specialty pipes and fittings, namely SWR (Soil, Waste and Rain Water) pipes and fittings for the construction industry.

Investment Rationale

The Government of India's (GOI) thrust on irrigation, micro-irrigation, water, and housing projects is expected to drive demand for PVC pipes and fittings which account for more than 57% of the total PVC consumption in India and Finolex is well placed to exploit this opportunity directly and through its venture with Plastro and Plasson for drip irrigation projects. The demand for PVC in India is expected to grow at 10% CAGR in the next decade as the per capita consumption of PVC in India is around 0.8 kg compared to the world average of 4.6 kgs. In spite of the robust demand outlook we believe that supply of PVC from China could affect PVC margins in India going forward.

Risks

Supply of PVC from China: Any demand slowdown for PVC in China would lead to higher supply of Chinese PVC in Indian markets driving down prices and margins.

CaC2 technology: PVC resins made through calcium carbide technology could be a cheaper source to manufacture PVC resins and hence risk Finolex's margins.

Financial Statements

Income statement					INR (mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net revenues	8,388	7,363	10,361	13,124	13,319
Cost of goods sold	5,778	5,533	8,027	10,287	9,968
Gross profit	2,610	1,830	2,334	2,837	3,351
Employee expenses	232	212	273	295	319
Other expenses	660	661	745	787	799
Operating expenses	892	873	1,018	1,083	1,118
EBITDA	1,718	957	1,316	1,755	2,233
Other income	195	416	419	190	109
Interest	123	254	220	273	229
Depreciation & amortisation	444	468	543	542	599
Profit before tax	1,347	651	972	1,130	1,515
Current tax	265	217	337	339	455
Deferred tax	123	4	(47)	-	-
Other tax (including FBT)	-	8	5	-	-
Total tax	388	228	294	339	455
Profit after tax	959	423	678	791	1,061
Eq. sh. outstanding - Dil. (mn)	124	124	124	124	124
EPS (INR)	8	3	5	6	9
Dividend per share (INR)	3	3	3	3	3
Dividend payout (%)	39	88	55	47	35

Common size metrics (% sales)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Cost of goods sold	68.9	75.1	77.5	78.4	74.8
Operating expenses	10.6	11.9	9.8	8.2	8.4
EBITDA	20.5	13.0	12.7	13.4	16.8
Depreciation & amortisation	5.3	6.4	5.2	4.1	4.5
Interest	1.5	3.5	2.1	2.1	1.7
Net profit	11.4	5.7	6.5	6.0	8.0

Growth metrics (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Net revenues	19.8	(12.2)	40.7	26.7	1.5
EBITDA	14.8	(44.3)	37.5	33.3	27.3
PBT	(4.1)	(51.7)	49.3	16.2	34.1
Net profit	6.4	(55.9)	60.2	16.6	34.1
EPS	6.4	(55.9)	60.2	16.6	34.1

Balance sheet					(INR mn)
As on March end	FY05	FY06	FY07E	FY08E	FY09E
Preference share capital					
Common share capital	1,240	1,240	1,240	1,240	1,240
Total equity capital	1,240	1,240	1,240	1,240	1,240
Reserves & surplus	3,815	3,797	4,054	4,424	5,064
Shareholder's equity (A)	5,054	5,037	5,294	5,665	6,305
Secured loans	1,878	1,819	1,550	2,450	1,250
Unsecured loans	3,695	3,443	3,157	3,464	3,403
Total debt (B)	5,573	5,263	4,707	5,914	4,653
Deferred tax liability (C)	1,063	1,067	1,088	1,088	1,088
Capital employed (A+B+C)	11,691	11,366	11,089	12,666	12,045
Accounts payable	72	99	100	100	100
Other current liabilities	474	725	1,096	1,202	1,181
Provisions	1,857	2,082	2,999	3,291	3,233
Current liabilities & provisions (D)	2,402	2,906	4,195	4,593	4,514
Other liabilities					
Total liabilities (A+B+C+D)	14,093	14,272	15,284	17,259	16,559
Gross fixed assets	8,903	10,501	10,701	12,851	13,051
Depreciation	4,257	4,714	5,257	5,799	6,397
Net fixed assets	4,646	5,787	5,444	7,052	6,654
Capital WIP	785	269	700	400	1,200
Total fixed assets (A)	5,430	6,057	6,144	7,452	7,854
Investments (B)	4,132	3,673	1,303	1,251	292
Inventories	1,597	1,788	2,999	3,291	3,233
Accounts receivable	270	276	442	485	476
Cash and cash equivalents	843	333	450	450	450
Loans and advances	1,820	2,145	3,946	4,330	4,254
Other current assets	0	0	0	0	0
Current assets (C)	4,531	4,542	7,837	8,556	8,413
Other assets					
Total assets (A+B+C)	14,093	14,272	15,284	17,259	16,559

Cash flow statement					(INR mn)
Year to March	FY05	FY06	FY07E	FY08E	FY09E
Op. CF bef. working cap. changes	1,526	895	1,174	1,333	1,659
(Incr)/Decr in working capital	(615)	(46)	(1,821)	(321)	64
Cash flow from operations (A)	911	849	(647)	1,012	1,723
Net purchase of fixed assets	(786)	(1,083)	(631)	(1,850)	(1,000)
Net purchase of investments	(1,407)	459	2,371	52	959
Cash flow from investing (B)	(2,194)	(625)	1,740	(1,798)	(41)
Net incr./decr. in equity capital	0	0	0	-	-
Net incr./decr. in pref. capital	-	-	-	-	-
Net incr./decr. in debt	2,391	(310)	(556)	1,207	(1,261)
Dividends paid	(420)	(424)	(421)	(421)	(421)
Cash flow from financing (C)	1,972	(735)	(977)	787	(1,682)
Net incr./decr. in cash (A+B+C)	689	(510)	117	-	-
Opening cash balance	154	843	333	450	450
Closing cash balance	843	333	450	450	450

Valuation parameters

Year to March	FY05	FY06	FY07E	FY08E	FY09E
EPS (INR)	7.7	3.4	5.5	6.4	8.6
EPS Y-o-Y growth (%)	6.4	(55.9)	60.2	16.6	34.1
CEPS (INR)	11.3	7.2	9.8	10.7	13.4
P/E (x)	11.5	26.0	16.2	13.9	10.4
Book value per share (INR)	40.8	40.6	42.7	45.7	50.8
P/BV (x)	2.2	2.2	2.1	1.9	1.7
EV/Sales (x)	1.4	1.7	1.3	1.2	1.1
EV/EBITDA (x)	6.7	12.8	10.6	8.7	6.7

Liquidity ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Current ratio	1.9	1.6	1.9	1.9	1.9
Quick ratio	1.2	0.9	1.2	1.1	1.1
Cash ratio	0.4	0.1	0.1	0.1	0.1
Receivable turnover (x)	29.1	26.9	28.9	28.3	27.7
Inventory turnover (x)	4.0	3.3	3.4	3.3	3.1
Payables turnover (x)	79.1	65.0	80.9	102.9	99.7
Receivables (days)	12.5	13.5	12.7	12.9	13.2
Inventory (days)	91.8	111.6	108.8	111.6	119.4
Payables (days)	4.6	5.6	4.5	3.5	3.7
Cash conversion cycle (days)	99.7	119.6	117.0	120.9	129.0

Operating ratios (x)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Total asset turnover	0.7	0.5	0.7	0.8	0.8
Fixed asset turnover	1.8	1.4	1.8	2.1	1.9
Equity turnover	1.7	1.5	2.0	2.4	2.2

Profitability ratios (%)

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Gross profit margin	31.1	24.9	22.5	21.6	25.2
EBITDA margin	20.5	13.0	12.7	13.4	16.8
ROCE	10.1	5.1	7.3	8.2	9.8
ROE	19.8	8.4	13.1	14.4	17.7
ROA	7.7	3.0	4.6	4.9	6.3

Financial ratios

Year to March	FY05	FY06	FY07E	FY08E	FY09E
Debt-equity (x)	1.1	1.0	0.9	1.0	0.7
Long term debt / Cap. emp. (%)	47.7	46.3	42.4	46.7	38.6
Total debt / Capital employed (%)	77.3	81.3	90.1	91.5	85.1
Interest coverage (x)	12.0	3.6	5.4	5.1	7.6

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Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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