

Techno-Fundamental Stock Pick

September 30, 2009

Company Background:

Finolex Cables Ltd (FCL), the flagship company of the Finolex Group, was established in 1958 in Pune. Today, it is India's largest and leading manufacturer of electrical and telecommunication cables with a turnover of more than Rs.1,200 cr. The company started its operation with the manufacture of PVC insulated electrical cables for the automobile industry. Since then, the company has constantly endeavored to augment its product range to include, PVC insulated electrical wires and Flame Retardant Low Smoke electrical wires, PVC insulated single core and multicore industrial flexible cables, Rodent Repellent Multicore Flexible Cables, PVC Insulated Winding Wires and 3 Core Flat Cables, XLPE 3 Core Flat Cables High Voltage Power Cables (Upto 33 kV), Auto & Battery Cables, Co-axial and CATV cables, LAN Cables, Switchboard Cables, Fibre Optic Cables and others.

The main segments of the company are: **Electrical Cables and Communication Cables**. The company has recently added High Voltage Power Cables to its range of Electrical Cables. Every cable is manufactured using bright annealed electrolytic grade copper – 99.97% pure manufactured in house and is insulated with virgin grade PVC (manufactured by group company Finolex Industries Limited) that is formulated in-house. In FY09, FCL derived about 56% of its revenue from electrical cables (59% in FY08), 19% from communication cables (19% in FY08), 19% from copper rods (18% in FY08) and 6% from others (4% in FY08).

	Products Covered	Application
Electrical cables	1100 V PVC insulated cables	Electrification of residential, commercial and industrial establishments, electrical panel wiring and consumer electrical goods.
	Motor winding PVC insulated cables and 3 core flat cables	Submersible pumps and electrical motors
	Automotive / battery cables	Wiring harness for automobile industry and battery cables for various applications
	UPS cables	For providing power from the UPS to the computer/appliances in the networking environment.
	Heavy duty, underground, low voltage, power and control cables	Connection to the user point from main supply of power,
	Heavy duty, underground, high voltage, power cables.	Infra-city power distribution network
Communication cables	Jelly filled telephone cables	Telephone line connections to exchanges and users
	LAN cables	Indoor and outdoor networking, voice and data transmission, broadband usage
	PE insulated telephone cables (switchboard cables)	Telephone instrument connections to EPABX
	Coaxial cables	Cable TV network solutions, microwave communications, mobile towers.
	Optic fibre	Principal raw material for optic fibre cables.
	Optic fibre cables	For use in networks requiring high speed transfer of large bandwidth due to voice, image and data transmission.
	V-SAT cables	For connecting V-SAT dish to base station.
Copper Rods	CCC (continuous cast copper) rods of 8 mm diameter	Raw material for manufacture of copper based cables
Electrical Switches	Premium & classic switches, sockets, regulators etc	Domestic lighting, hotels, shops, offices, corridors
Compact Fluorescent Lamps (CFLs)	Retrofit & non-retrofit lamps	Domestic lighting, hotels, shops, offices, corridors
PVC Sheets	PVC corrugated sheets, foam sheets and rigid sheets	Industrial roofing, wall cladding, signage boards, partition boards, exhibition display boards and false roofing

(Source: Company Annual Report)

Plants: FCL has set up four modern state of the art plants. These manufacturing plants are located in Pimpri (Pune), Urse (Pune), Goa & Roorkee (Uttarakhand). All these manufacturing plants are well equipped with the latest state-of-the art modern machinery for producing quality product. FCL currently has electrical cables capacity of 1701 CKM (59% utilization in FY09), 48,000 km of optical fibre cables capacity (80% utilization in FY09) and other communication (telephone jelly filled) cables capacity of 10,612 CKM (8.4% capacity utilization in FY09).

Shareholding pattern: Given below is a table showing the current shareholding pattern and shareholders who have a stake of more than 1%.

Shareholding as of 30 June 2009	% Holding	Shareholder (more than 1%)	% Holding
Foreign	5.6	Templeton Mutual Fund - Franklin India Prima Fund	2.6
Institutions	15.3	Reliance Capital Trustee Company Ltd - Reliance	1.3
Non Promoter Corp Holding	16.9	Diversified Power Sector Fund	
Promoters	35.1	LIC of India	9.1
Public & Others	27.1		



Investment Rationale

Leader in the segment - FCL is India's leading manufacturer of electrical and communication cables with a wide product range. This status not only helps the company in terms of economies of scale, but as a market leader it is well positioned to reach out to new customers, both domestic and international.

The company's products meet the requirement of international standards and thus are capable of geographical penetration. FCL has its presence in the international market for sometime now. FCL has been exporting light duty electrical cables, LAN cables, optic fibre cables, copper telephone cables and a variety of customized cables. Being a technology leader in the segment, FCL intends to increase its focus on exports. Exports were marginally lower at Rs. 77.6 cr in FY09 as against Rs. 77.9 cr in FY08. Exports stood at about 5.9% of net sales in FY09.

The company has, over the years, established its reputation as an innovative leader and quality manufacturer by continuously upgrading technology, modernizing manufacturing facilities and maintaining highest standards of quality and services. FCL is not engaged in the institutional business (based on tendering / fixed price) and can revise prices of its products as and when required.

FCL lays a lot of emphasis on maintaining superiority status in terms of quality and product features through in-house research and development. The company has defined quality assurance processes and strives for improvement in products. This product advantage is one of the key reasons why the company has been able to carve out a niche position for itself in the market. The company is the only Indian cable company, which holds the coveted Super brand status since the year 2004. During FY09, the Super Brand status was further awarded till the year 2009.

Extensive Distribution Network - FCL has created a strong and dependable distribution network of channel partners and dealers, spreading across the country. The distribution network also includes commission agents/dealers appointed in the overseas market. The intention is to service the customer at his doorstep. Not only has the distribution network been built, the company undertakes a periodical review of it for up gradation and expansion. The domestic distribution network is well supported by branch offices and depots opened by the company at a number of locations throughout the country.

Backward Integration - FCL manufactures CCC rods used as principal raw material for copper based electrical and communication cables. The company makes its own compounds using PVC resin of different grades and formulations tailored specially for high performance cables. FCL manufactures FRP rods and draws its own fibre for fibre optic cables. These backward integration measures help in product differentiation and facilitate maintaining desired quality of products for superior consistent performance besides ensuring timely supply of the raw material.

Higher capacity utilization expected in FY10 – FCL commenced commercial production at its high voltage power cables plant (up to 66 KV range) at Urse near Pune during July 2008. In FY09, FCL also obtained its products approved from Central Power Research Institute (CPRI). FCL also obtained approvals from various Electricity Boards, Power utility companies in the private sector, electrical contractors and other major private users. The cables produced were well accepted in the market. During FY09, FCL expanded production capacities of coaxial cables, fibre optic and optic fibre cables at its plants at Urse and Goa. FCL has plans to further enhance the production capacities of these products in coming years. The full impact of the capacity expansions could be felt in FY10. So far, the management has indicated that volumes have been increasing m-o-m.

JV with J-Power systems to offer turnkey solutions in the extra high voltage segment – FCL has entered into a 49:51 JV for manufacture of power cables between 60 KV to 500 KV range and to offer complete services of turnkey installation and commissioning with supply of jointing kits in joint venture with J-Power Corporation, Japan (a joint venture between Hitachi Cable & Sumitomo Electric Industries) is progressing well and is expected to start commercial production in the last quarter of year 2010. Necessary land for the project has been acquired, required permission to start civil construction has been obtained and orders for civil construction and key equipments are placed. Civil construction work started during May 2009. The total estimated project cost is Rs. 176 cr of which Rs. 40 cr has already been invested.

Pick up in demand of Electrical Cables - Electrical cables can be further categorized into light duty electrical cables, power and control cables. Electrical cables are the main focus area of business for FCL. It accounted for 59% of total sales in FY09. The main activities consuming electrical cables in bulk like building industry, automobile industry, agricultural irrigation and electricity distribution showed signs of slow down during H2FY09. However, the slow down was not as severe as that experienced globally and with the timely stimulus packages implemented by the Government of India, the end-use sectors are showing signs of revival. Thus, long term outlook for the demand of electrical cables remains positive. The system of VAT is in place in all the states, which, once harmonized, will generate accelerated business for electrical cables. The macro environment for power cable sector is very strong on the back of improved investment scenario in the country. Large investment is coming in power generation, distribution, rural electrification, upgrading existing distribution network, industrial capacity expansion, construction and the like. These factors could drive demand growth for power cables in India and hence benefit leading players like FCL.

Increasing its product portfolio - Electrical switches and CFLs – The manufacture and sale of these electrical products act as a logical extension of the cables business of FCL. They have the backing of Finolex name, assuring the customer of quality, safety and performance standards. These electrical and lighting products are sold through the existing well-spread distribution network of cables. Other distribution avenues are also being explored to penetrate further in the market. Products have been well accepted by the market.



On its part to contain the effects of global warming, the Government is promoting use of CFLs. CFLs being a green product, qualify as one of the means to reach reduction goals. Additionally State Governments are extending fiscal benefits in the form of reduced VAT on CFLs (Maharashtra has recently announced a reduction in the VAT in its budget for 2009-10). These and similar measures, should lead to substantial growth in the CFL business in the near term. Keeping in mind the expected growth in CFL demand, FCL has been expanding the CFL manufacturing capacities. The second line of CFL is expected to go live in the third quarter of 2009-10 while the third line is expected to do so towards end of 2009-10. With these expansions the CFL production capacity will reach to 30 million pieces per annum. This will be done at a capex of about Rs. 35 cr. It intends to further increase this capacity to 100 mn CFL's in the medium to long term. CFLs have been branded 'Finoglow' by FCL. Finoglow is an energy saving lamp, can save energy consumption up to 80% as against an equivalent incandescent lamp. Finoglow is available in different colours, temperatures, wattages and sizes. Finoglow has a high color rendering index essential for true color lighting. Finoglow is available in retrofit and non-retrofit versions.

Recent Financial Performance

In FY09, FCL reported sales of Rs. 1,316.9 cr, down 3.2% y-o-y. Operating margins fell to 5.5% as against 7.9% in FY08 due to higher raw material costs and lower utilization of expanded capacity. Depreciation increased 46.4% y-o-y to Rs. 38.8 cr due to capex carried out by the company at its Urse and Rorkee plants. Interest costs increased 33.7% y-o-y to Rs. 25.3 cr. FCL reported a loss of Rs. 35.5 cr in FY09 mainly due to Rs. 87 cr of exceptional items. This comprises of losses on account of foreign exchange derivative transactions of Rs. 87.9 cr, losses based on effects on accounts of exchange fluctuation of Rs. 26.2 cr and a credit for reversal of impairment of optic fibre assets of Rs. 27.1 cr due to revival in business. On the upside, FCL managed its working capital very effectively. The company capitalized assets of its Rorkee plant (Rs. 86 cr) and its Urse plant (Rs. 83 cr). In spite of the capitalization of assets, capital employed has not increased due to sharp reductions in debtors and inventory which is positive.

Though most of the outstanding derivative contracts have been booked in FY09, a few contracts are still outstanding, and this could weigh on the stock price movement. However, despite the forex losses, FCL reported a good performance in Q1FY10. The management has indicated that the cable volumes have improved as competition from unorganized players has reduced due to unavailability of bank credit to un-organized players as sharp fall in copper prices in Oct-Dec'08 lead to losses; lower cheap scrap copper import reducing price differentials; and fall in excise duty. Thus, the company expects volumes to increase in FY10 supported by the new power cable plant and the CFL plant getting on stream.

Q1FY10

In Q1FY10, FCL reported sales of Rs. 320.6 cr, down 19.3% y-o-y mainly due to lower realizations on account of lower copper prices. EBITDA margins expanded to 13.3% from 10.8% in Q1FY09. Depreciation increased due to the full impact of the capex carried out by the company while interest costs fell by about 15.7% y-o-y to Rs. 4.9 cr. However, FCL reported a loss of Rs. 19 cr on derivative instruments which pulled down profits for the quarter. PAT stood at Rs. 22 cr, up 196% y-o-y (In Q1FY09, FCL suffered an extraordinary loss of Rs. 34.2 cr). EPS for the quarter was Rs. 1.4.

Concerns

Commodity price fluctuation – FCL is exposed to vagaries of copper price movements. The company has stated that it normally buys copper on a monthly basis and using the monthly average price, the cost is passed on to its customers. However, there is a time lag of a few weeks.

Competition from unorganized players and overcapacity in the telephone cable segment leading to low capacity utilizations.

Forex fluctuation – FCL reported exports of about Rs. 78 cr in FY09 as against imports of Rs. 140 cr and hence is a net foreign exchange user. FCL has engaged in derivative instruments, which has resulted in losses for the company in the past. In FY09, FCL lost over Rs. 80 cr due to adverse forex movement. Even in Q1FY10, FCL was impacted to the tune of Rs. 19 cr. However, the management has now indicated that going forward, these exceptional gains or losses would taper down and would relatively improve its profits.

Lower than expected sales and delay in capex plans could also impact FCL adversely. FCL is dependent on the realty sector to a large extent and while the sector has shows signs of a revival, its sustainability remains uncertain.

Conclusion

The company's main business, which comprises of manufacture of electrical cables and communication cables is closely linked to the economic development of the country. Addition to power generation capacity, spending on construction, industrialization, urbanization, increase in consumption expenditure, laying, up gradation and modernization of communication network and the like are the indicators for growing cable business. The governmental initiative on rationalizing commercial taxation system like VAT and consolidating different business and commercial taxes into a single point tax system like Goods and Services Tax (GST) should give a business boost to the manufacturers in the organized sector like FCL. Copper rod consumption shall increase due to increase in business of copper based electrical and communication cables. FCL is also desirous of increasing copper rod sale to other consumers. Electrical switches and CFL businesses are steadily gaining firmer roots in the market. The business of PVC sheets is closely linked to the customer preference for a better quality product. As per the management the company would see a 30% rise in revenues this year. On forex losses, the first quarter losses were about Rs 19 cr but FY10 could most likely be that last year of losses and to a lesser extent that FY09. Also, FCL is witnessing good demand for its products with volume and revenue rising month on month.

FCL has a comfortable debt to equity ratio of 0.5, gross block of Rs. 802 cr (sales to gross block ratio of about 1.6x which can go upto 2x over the next two years) and investments worth Rs. 314 cr. FCL has investments worth Rs. 151.8 cr in group company Finolex Industries (the cost price of the shares is Rs. 37.78 while the current market price stands at Rs. 58.4). FCL has another Rs. 128 cr invested in debt / liquid funds.

Historically, the stock has traded in the band of 10-20x but with the market correction it had fallen below its trough multiple of 5x. The stock has since recovered and is currently trading at 9.4x its FY10 (E) earnings of Rs. 5. We expect FCL's P/E multiple to expand to 11x earnings because business momentum has shown signs of improvement in Q409 and Q1FY10 with significant increase in volume growth sequentially as indicated by management, capital employed has not increased in spite of the capitalization of assets of Roorkee and Urse plants due to sharp reductions in debtors and inventory, the management has indicated that most derivative contracts have been closed and losses has been booked in FY09. FY10 might see more losses but the intensity of forex losses should be lower than FY09. Our target price for the stock hence stands at Rs. 55 (11x FY10 (E) EPS).

Financials

(R s cr)	Q1FY10	Q1FY09	% chg	Q4FY09	% chg q-o-q	FY09	FY08	% chg
Net Sales	320.6	397.2	-19.3%	318.7	0.6%	1316.9	1359.7	-3.2%
Other Income	18.0	15.1	19.6%	6.5	179.4%	48.5	58.2	-16.7%
Total Income	338.6	412.3	-17.9%	325.1	4.1%	1365.3	1417.9	-3.7%
Total Expenditure	277.8	354.3	-21.6%	295.3	-5.9%	1244.4	1252.2	-0.6%
Increase / Decrease in stock in trade	-29.0	-24.0	20.5%	36.0	-180.4%	68.1	-14.1	-582.1%
Raw materials	261.3	326.5	-20.0%	209.1	25.0%	988.4	1084.4	-8.8%
Purchase of traded goods	0.4	0.0	2100.0%	0.6	-29.0%	0.8	0.5	54.7%
Employee cost	15.7	15.7	0.1%	13.6	15.7%	53.3	49.7	7.2%
Other expenditure	29.3	36.1	-18.9%	36.0	-18.7%	133.7	131.7	1.5%
EBIDTA	60.8	58.0	4.8%	29.8	103.7%	121.0	165.7	-27.0%
Depreciation	9.5	6.6	45.2%	15.4	-38.3%	38.8	26.5	46.4%
PBIT	51.3	51.4	-0.3%	14.4	255.3%	82.2	139.2	-40.9%
Interest	4.9	5.9	-15.7%	5.6	-12.3%	25.3	18.9	33.7%
PBT	46.3	45.6	1.7%	8.8	426.0%	56.9	120.3	-52.7%
Extra-ordinary items	-19.0	-34.2	-44.4%	0.2	-9590.0%	-87.0	0.0	#DIV/0!
PBT after extra-ordinary items	27.4	11.4	139.6%	9.0	203.7%	-30.1	120.3	-125.0%
Tax	5.4	4.0	34.3%	6.3	-14.6%	5.4	31.4	-82.8%
PAT	22.0	7.4	196.1%	2.7	705.9%	-35.5	88.9	-139.9%
Equity	30.6	30.6		30.6		30.6	30.6	
Face Value	2.0	2.0		2.0		2.0	2.0	
EPS	1.4	0.5		0.2		-2.3	5.8	
OPM %	13.3%	10.8%		7.3%		5.5%	7.9%	
NPM %	6.5%	1.8%		0.8%		-2.6%	6.3%	

Segmental Analysis

Segmental Results (Rs cr)	Q1FY10	Q1FY09	% chg	Q4FY09	% chg q-o-q	FY09	FY08	% chg
Electrical Cables	210.2	231.1	-9.1%	214.1	-1.8%	784.8	828.7	-5.3%
Communication Cables	53.7	55.5	-3.3%	60.1	-10.7%	253.2	273.9	-7.6%
Copper Rods	201.4	254.4	-20.9%	134.4	49.9%	712.6	822.9	-13.4%
Others	9.1	9.6	-5.3%	11.1	-18.0%	36.8	29.2	26.4%
Total	474.3	550.7	-13.9%	419.6	13.0%	1787.4	1954.7	-8.6%
Less Intersegment Revenue	146.6	148.9	-1.6%	92.6	58.3%	445.9	570.9	-21.9%
Total Segment Revenue	327.8	401.8	-18.4%	327.1	0.2%	1341.5	1383.8	-3.1%
PBIT								
Electrical Cables	43.9	41.9	4.9%	24.3	80.5%	87.9	124.4	-29.4%
Communication Cables	8.1	4.8	69.3%	29.9	-73.0%	44.1	18.4	140.1%
Copper Rods	2.2	6.8	-68.0%	1.4	59.9%	10.5	14.3	-26.4%
Others	-0.6	0.9	-167.1%	-1.7	-66.9%	-3.1	-5.6	-44.3%
Total	53.6	54.3	-1.3%	53.9	-0.5%	139.4	151.5	-8.0%
PBIT %								
Electrical Cables	20.9%	18.1%		11.4%		11.2%	15.0%	
Communication Cables	15.0%	8.6%		49.7%		17.4%	6.7%	
Copper Rods	1.1%	2.7%		1.0%		1.5%	1.7%	

Others	-6.3%	8.9%		-15.5%		-8.4%	-19.1%	
Overall	11.3%	9.9%		12.8%		7.8%	7.8%	
Capital Employed								
Electrical Cables	299.2	386.7	-22.6%	292.1	2.4%	292.1	290.1	0.7%
Communication Cables	213.4	276.9	-22.9%	199.3	7.1%	199.3	255.6	-22.0%
Copper Rods	32.9	83.3	-60.5%	29.8	10.4%	29.8	12.9	130.8%
Others	83.6	49.4	69.1%	76.1	9.9%	76.1	54.1	40.5%
Unallocated Net Assets / Liabilities	269.9	271.4	-0.6%	317.0	-14.8%	317.0	335.9	-5.6%
Total	899.1	1067.7	-15.8%	914.2	-1.7%	914.2	948.6	-3.6%

Technical Outlook

Weekly Chart



FCL touched a high of Rs. 133.50 in the week ended 04 January 2008. Thereafter, the stock started its downtrend and fell about 87% from its high to a low of Rs. 17 in the week ended 6 March 2009. The stock formed a bottom around this level and gradually started moving up. Since then the stock has been making higher highs and higher lows. As can be seen from the chart above, the stock faced stiff resistance at the downward sloping trendline connecting the previous highs. After a few attempts, it broke out and in 3 weeks moved from Rs. 25.6 to Rs. 45. The Rs. 45 level has acted as a crucial support / resistance for the stock on a number of occasions in the past. FCL could not cross the Rs. 45 mark, reacted from the trendline resistance and fell over 6 weeks to Rs. 26.5 (the stock took support around the previous resistance level). From here, FCL once again started moving up and tried to cross the Rs. 45 mark. In the week ended 25 September 2009, the stock has finally broken out of this resistance level with above average volumes. The oscillators are all trading above their averages and the stock is trading well above its short and medium term moving averages, which is a bullish indication.

Daily Chart





FCL touched a high of Rs. 45 on 03 June 2009. It reacted from this resistance level and fell to a level of Rs. 26.5 on 13 September 2009. In the process, it also filled the upward gap created on 21 August 2009. The stock once again started to move up from Rs. 26.5 to Rs. 42.25. It corrected this upmove by about 38.2% and has been moving sideways with an upward bias since then. The stock created an upgap between Rs. 37.8 – Rs. 38.5 as marked on the chart above. This gap remains unfilled till date which is a bullish indication. Over the last 4 sessions, the stock has been attempting to close above the Rs. 45 mark and has been rising with above average volumes. On Friday (25 September 2009), FCL formed a shaven bottom candlestick pattern (the open and low of the day is the same) thus witnessing a lot of buying interest. The stock closed well above the Rs. 45 mark (at Rs. 47.2). In addition, the 8-day SMA crossed the 13-day SMA on Thursday (current values of Rs. 44.18 and Rs. 43.85 respectively), which augurs well for the next move in the stock.

We recommend a buy on FCL in the Rs. 45.5 – Rs. 47.5 price band with sequential price targets of Rs. 52.5 and Rs. 55 (10-15% returns) over the next 4-6 weeks. Maintain a stop loss at Rs. 44 on a daily closing basis.

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