

Company In-Depth

17 November 2006 | 7 pages

Vardhaman Textiles Ltd (VART.BO)

Buy: Compelling Valuations

 Rating change
 Target price change
 Estimate change

- Maintain Buy** — The stock trades at compelling valuations of 8.1x Sept 07E P/E, a 20% discount to sector average of 10x. Given leadership in yarn, thrust on vertical integration and strong management team, we see valuations catching-up with industry ones. However, factoring its near-term muted growth, we lower our target price to Rs350 based on 10x Sept 07E P/E, which still offers ETR of 24%.
- Key growth drivers** — 1) Large-scale vertical integration into fabrics as the company adds fabric manufacturing capacity; 2) Thrust on value addition and diversification to a richer product mix in yarn; and 3) sustained growth in sewing thread business with garmenting operations on the rise.
- Expansion progressing as scheduled** — The company commissioned brown field expansion in fabric and spindles in 1H06. The green field integrated expansion at MP will start in phases by Mar'08. This involves capex of Rs20bn over next three years, funded by debt, FCCBs and internal accruals.
- Earnings growth to accelerate in FY07-09E** — With existing plants operating at optimum capacity utilization and near-term margins under pressure, we see muted earnings growth of 9% for FY07E. However, we expect growth rates to accelerate, resulting in an earnings CAGR of 27% over FY07-09E as significant expansion projects are commissioned.
- Subsidiaries EPS accretive** — The company's subsidiaries in yarns (VMT Spinning, 73% stake) and thread (Vardhaman Threads, 100% sub) are doing well and are likely to contribute 5-6% of incremental earnings, currently not factored into our estimates – this would make valuations even more compelling.

Buy/Low Risk	1L
Price (16 Nov 06)	Rs286.30
Target price	Rs350.00
	<i>from Rs405.00</i>
Expected share price return	22.2%
Expected dividend yield	1.7%
Expected total return	24.0%
Market Cap	Rs16,539M
	US\$365M

Price Performance (RIC: VART.BO, BB: VTEX IN)



See page 5 for Analyst Certification and important disclosures.

Figure 1. Statistical Abstract

Year to	Net Profit	FD EPS	EPS Gr.	P/E	P/BV	EV/ EBITDA	ROCE
31-Mar	(Rs)	(Rs)	(%)	(x)	(x)	(x)	(%)
2005	1,208	20.9	100.7	13.7	2.1	7.2	12.2
2006	1,691	29.3	40.0	9.8	1.7	6.7	10.5
2007E	1,843	31.9	9.0	9.0	1.5	6.8	9.1
2008E	2,476	38.6	21.1	7.4	1.1	6.1	9.5
2009E	3,303	51.5	33.4	5.6	1.0	4.9	10.7

Source: Company Reports and CIR estimates

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	13.7	9.8	9.0	7.4	5.6
EV/EBITDA adjusted (x)	7.4	6.8	6.9	5.9	4.7
P/BV (x)	1.4	1.7	1.5	1.1	1.0
Dividend yield (%)	1.6	1.4	1.7	1.7	2.1
Per Share Data (Rs)					
EPS adjusted	20.90	29.28	31.91	38.64	51.54
EPS reported	20.90	33.98	31.91	38.64	51.54
BVPS	207.81	166.47	193.38	249.63	295.17
DPS	4.50	4.00	5.00	5.00	6.00
Profit & Loss (RsM)					
Net sales	18,583	18,937	21,001	25,562	31,170
Operating expenses	-16,593	-16,475	-18,201	-21,740	-25,997
EBIT	1,990	2,462	2,801	3,821	5,173
Net interest expense	-584	-378	-590	-715	-650
Non-operating/exceptionals	191	150	215	195	195
Pre-tax profit	1,597	2,234	2,426	3,301	4,718
Tax	-389	-543	-582	-825	-1,416
Extraord./Min.Int./Pref.div.	0	272	0	0	0
Reported net income	1,208	1,963	1,843	2,476	3,303
Adjusted earnings	1,208	1,692	1,843	2,476	3,303
Adjusted EBITDA	2,960	3,476	3,896	5,311	6,823
Growth Rates (%)					
Sales	71.3	1.9	10.9	21.7	21.9
EBIT adjusted	77.6	23.8	13.7	36.4	35.4
EBITDA adjusted	75.4	17.4	12.1	36.3	28.5
EPS adjusted	100.7	40.1	9.0	21.1	33.4
Cash Flow (RsM)					
Operating cash flow	205	2,378	1,873	1,265	3,526
Depreciation/amortization	970	1,013	1,095	1,490	1,650
Net working capital	-1,972	-599	-1,065	-2,701	-1,427
Investing cash flow	-4,700	-2,913	-8,190	-5,646	-1,205
Capital expenditure	-4,700	-3,302	-6,430	-7,112	-1,369
Acquisitions/disposals	0	273	-1,964	1,388	320
Financing cash flow	4,494	807	6,316	4,381	-2,320
Borrowings	2,275	1,038	6,605	2,031	-1,936
Dividends paid	-260	-231	-289	-320	-384
Change in cash	0	272	0	0	0
Balance Sheet (RsM)					
Total assets	17,923	23,517	30,128	36,282	36,647
Cash & cash equivalent	227	2,715	1,368	608	243
Accounts receivable	2,084	2,220	2,310	3,067	3,429
Net fixed assets	8,087	10,376	15,710	21,333	21,052
Total liabilities	9,920	13,901	18,957	20,286	17,733
Accounts payable	412	491	513	405	487
Total Debt	7,496	11,022	16,280	17,550	15,250
Shareholders' funds	8,003	9,617	11,171	15,996	18,914
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	15.9	18.4	18.5	20.8	21.9
ROE adjusted	18.6	19.2	17.7	18.2	18.9
ROIC adjusted	12.7	11.3	10.2	10.2	11.1
Net debt to equity	90.8	86.4	133.5	105.9	79.3
Total debt to capital	48.4	53.4	59.3	52.3	44.6

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Key Points

Expansion projects progressing as scheduled

With brown field expansion projects in fabric and yarn having been completed in phases by 1H06, Vardhaman is focusing on the greenfield integrated yarn and fabric plant in Madhya Pradesh scheduled for commissioning in phases by March 2008. This will cover yarn requirements for captive consumption and take advantage of increasing demand for high value added and good quality yarn. The entire expansion of around Rs20bn will likely be funded by a mixture of debt (80%, primarily TUF loans), US\$60m FCCB raised in Feb 2006 (convertible at Rs423/share, our assumption to convert in FY08), and internal accruals. With new capacities expected to be phased in over the next few years, we expect healthy growth rates going forward.

Figure 2. Capex roll-out plan

Categories	Existing	Expansion	Total	Exp. Comm.
Yarn - Spindles	500,000	50,000	550,000	4QFY07
		50,000	600,000	1QFY08
		50,000	650,000	2QFY08
		50,000	700,000	3QFY08
		40,000	740,000	4QFY08
Fabric (mn mtrs)	45.0	25	70	1H2007
		25	95	Mar'08
		1,000	9,500	Dec'06
Sewing Thread	8,500	1,000	9,500	Dec'06
		1,000	10,500	mid-2007

Source: Company Reports and Citigroup Investment Research estimates

Vardhaman Textiles Ltd

Company description

Vardhaman Textiles (erstwhile Mahavir Spinning Mills) is a leader in its sector, with 500,000 spindles offering the widest product range in cotton and blended yarn in India. It is the second-largest company with an 18% market share in sewing threads. The company has a vertically integrated business model, giving it a significant presence in fabrics (17% of FY06 revenues). It is also present in special and alloy steel hot rolled products and is a vendor to OEMs in the automotive and engineering space. Its superior quality and wide product range in higher-value-add products make it a preferred supplier to domestic and international manufacturers in textiles and apparels. Direct exports contribute 21% of revenues, excluding the sales to exporters. It is the flagship company of the SP Oswal Group, with the major shareholders owning a 62% stake.

Investment thesis

We maintain our Buy (1L) rating on Vardhaman Textiles with a reduced target price of Rs350, as we roll over to Sept 07E based on 10x P/E, still on par with sector valuations.

Vardhaman's large-scale expansion, focus on higher value addition and vertical integration into fabric will help de-risk its business model by reducing

dependence on commodity yarn business. We expect large capacity expansions in fabric, growth in sewing thread and thrust on diversifying to richer product in yarn to drive growth. Improving outlook for its subsidiaries manufacturing different yarns and threads for the textile industry would complement overall growth by 5-6%. Expansion in yarn and fabric are part of a strategy to invest in capital-intensive projects taking advantage of TUF (Technology Upgradation Fund). We believe this will differentiate Vardhaman from other Indian companies and maintain focus on core segments in the textile value chain, like spinning and weaving.

The stock is currently trading at 8.1x Sept 07E P/E at 20% discount to sector average of 10x. With future expansion largely driven by fabric and new capacities going on-stream in phases and superior management quality, we see valuations catch-up with those of the industry.

Valuation

We are reducing our target price to Rs350 from Rs405 as we roll over to 10x Sept 07E P/E (12.7x FY07E earlier), on par with sector average. P/E is our primary valuation tool as we think it best captures earnings growth potential. While the company's efforts to move away from the commodity business of yarn and its vertical integration into fabric are positive, earnings growth will be back-ended as significant expansions are likely to get commissioned in phases only by FY08.

The stock is currently trading at compelling valuations of 8.1x Sept 07 P/E, a 20% discount to the industry, towards the mean of its two-year historical trading band (6-10x). With our forecasts of accelerating earnings growth over FY07-09E, the company's leadership in yarns and its strong management team, we see the stock's valuation catching-up with those of the industry in the near term.

Risk

We rate Vardhaman Textiles Low Risk based on our quantitative risk rating system, which measures the stock volatility over a 260-day period. The main company specific risks include:

- Any sharp increase in cotton prices of over 10-12% above Rs48/kg would impact our earnings estimates by 8-9% as cotton is a key raw material for Vardhaman's product range;
- Any fall of more than 2-3% in yarn price realizations, due to the commodity nature of business, would impact the profitability of the company's yarn business by 3-5%;
- Any delay in the commissioning of fabric capacities would further lower our forecasted revenue growth of 19% CAGR over FY06-08E; and
- Lower-than-the-expected 3% CAGR decline over FY05-08E in price realizations of steel alloy business would adversely impact the operating profitability of its steel alloy business (18% of total operating profits).

If any of these risk factors plays out, Vardhaman's share price is likely to have difficulty attaining our target price.

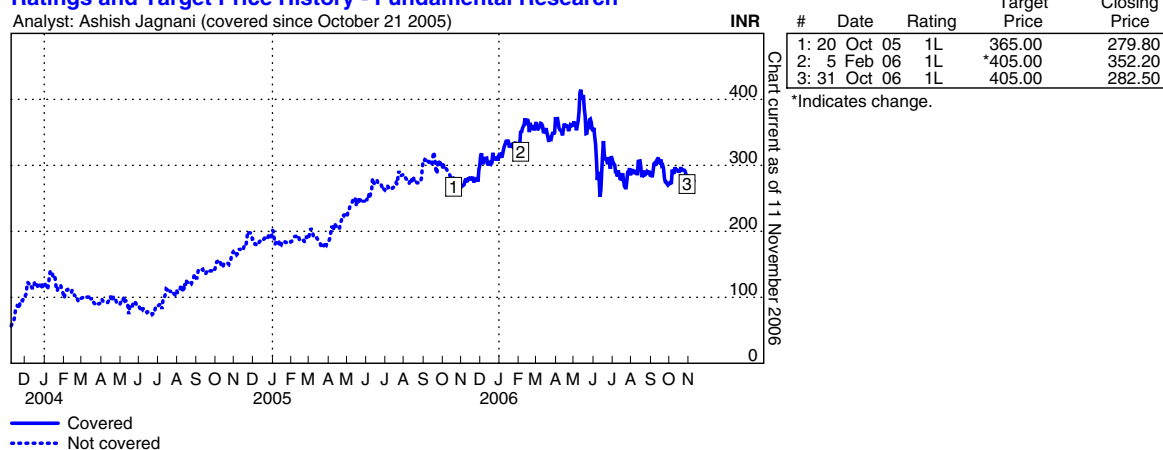
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Analyst: Ashish Jagnani (covered since October 21 2005)



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