

## Arvind Mills

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,742	ARVND IN
	REUTERS CODE
S&P CNX: 3,156	ARMI.BO

27 July 2006

Neutral

*Previous Recommendation: Neutral*

Rs57

Equity Shares (m)	209.4
52-Week Range (Rs)	144/52
1,6,12 Rel.Per. (%)	-7/-47/-98
M.Cap (Rs b)	12.0
M.Cap (US\$ b)	0.3

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	15,964	1,272	6.1	-0.1	9.4	0.8	9.4	8.9	1.7	6.7
3/07E	18,035	982	4.7	-22.7	12.2	0.8	6.4	7.9	1.5	7.0
3/08E	19,722	1,257	6.0	27.9	9.5	0.7	7.8	7.2	1.4	7.1

- Arvind Mills reported decline in revenues by 16% YoY to Rs3.54b in line with our estimates of Rs3.51b. EBITDA declined by 35% YoY to Rs744m v/s our estimate of Rs774m. However, PAT declined sharply by 85% YoY to Rs67m v/s our estimate of Rs103m, due to forex losses of Rs94m.
- EBITDA margins declined by 637bp YoY to 21%, due to 30% YoY decline in denim revenues.
- Denim division reported weak performance with realizations declining by 12% YoY and volumes declining by 21% YoY. The management has guided for continued subdued performance from the denim division for the next 12-15 months, due to overcapacity in the domestic and global markets.
- During the quarter, garment sales increased by 53% YoY and accounted for 19% of revenues v/s 12% in the corresponding period. Arvind plans to aggressively expand its garment manufacturing capacity from 12.7m/pieces p.a. in FY06 to around 42.2m/pieces by FY09 to de-risk itself from over dependence on denim.
- The average cotton cost in 1QFY07 stood at Rs40/kg, the management estimates its average cotton cost to remain stable at these levels till April'07.
- Arvind's 100% retail subsidiary, Arvind Brand reported 19% YoY increase in revenues to Rs760m. During the quarter, the total number of stores under Arvind Brand increased by 18% YoY to 386.
- We expect Arvind to post revenues and sales CAGR of 11% and -1% respectively, over FY06-08E. The stock trades at a PER of 12.2x FY07 EPS of Rs4.7 and 9.5x FY08 EPS of Rs6. We maintain **Neutral**.

Y/E MARCH	QUARTERLY PERFORMANCE										(Rs Million)	
	FY06				FY07E				FY06	FY07E		
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE				
<b>Sales</b>	<b>4,204</b>	<b>4,280</b>	<b>3,902</b>	<b>3,578</b>	<b>3,546</b>	<b>4,029</b>	<b>4,870</b>	<b>5,591</b>	<b>15,964</b>	<b>18,035</b>		
Change (%)	7.1	1.0	-5.7	-18.8	-15.7	-5.9	24.8	56.3	-4.9	13.0		
<b>EBITDA</b>	<b>1,149</b>	<b>1,061</b>	<b>918</b>	<b>864</b>	<b>744</b>	<b>864</b>	<b>1,111</b>	<b>1,250</b>	<b>3,993</b>	<b>3,969</b>		
Change (%)	29.1	16.1	-5.1	-22.9	-35.3	-18.6	21.0	44.8	10.2	-0.6		
As % of Sales	27.3	24.8	23.5	24.1	21.0	21.4	22.8	22.4	25.0	22.0		
Depreciation	385	387	385	394	372	411	428	466	1,551	1,678		
Interest	335	342	296	330	348	330	357	339	1,303	1,375		
Other Income	67	77	21	60	48	42	44	42	225	175		
<b>PBT</b>	<b>497</b>	<b>409</b>	<b>258</b>	<b>200</b>	<b>70</b>	<b>165</b>	<b>370</b>	<b>487</b>	<b>1,364</b>	<b>1,091</b>		
Tax	45.9	37.2	23.8	-14.7	3.2	13.2	38.8	53.6	92.2	109.1		
Effective Tax Rate (%)	9.2	9.1	9.2	-7.4	4.6	8.0	10.5	11.0	6.8	10.0		
<b>Adj. PAT</b>	<b>451</b>	<b>372</b>	<b>234</b>	<b>215</b>	<b>67</b>	<b>151</b>	<b>331</b>	<b>433</b>	<b>1,272</b>	<b>982</b>		
Change (%)	147.9	84	-36	-59	-85	-59	41	102	-0.1	-23		

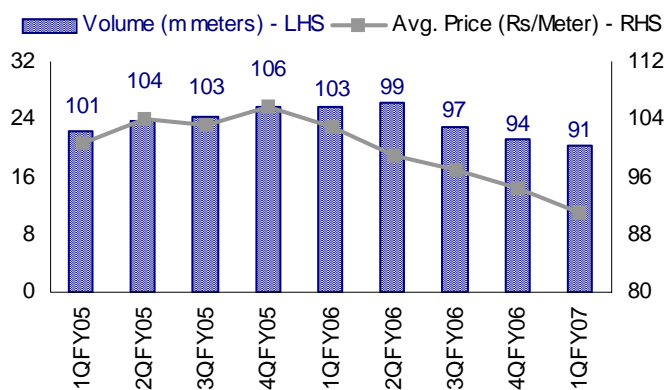
E: MOST Estimates

Note: In the interest of timeliness, this report has not been edited.

**Denim drags down 1QFY07 performance**

Denim division reported very weak performance with realizations declining by 12% YoY and volume declining by 21% YoY, as a result revenues declined by almost 30% YoY to Rs1.8b. As per industry estimates, denim capacity has increased by almost 100% in the domestic market over the last one year. Though the international market is showing signs of recovery, it is estimated that it would take a long time for the domestic demand supply equilibrium to get established. In fact, the management has guided for continued subdued performance from the denim division for the next 12-15 months, due to overcapacity in the domestic and global market.

DENIM PERFORMANCE OVER THE QUARTERS



Source: Company/ Motilal Oswal Securities

**Increasing garment capacities**

The company plans to expand its garment capacities aggressively from around 12.7m/pieces p.a. in FY06 to around 42m/pieces by FY09. Management expects garment operations to account for Rs10b by FY08-FY09. The table below shows the planned capacity additions in its garment division.

PLANNED CAPACITY ADDITIONS IN THE GARMENT DIVISION

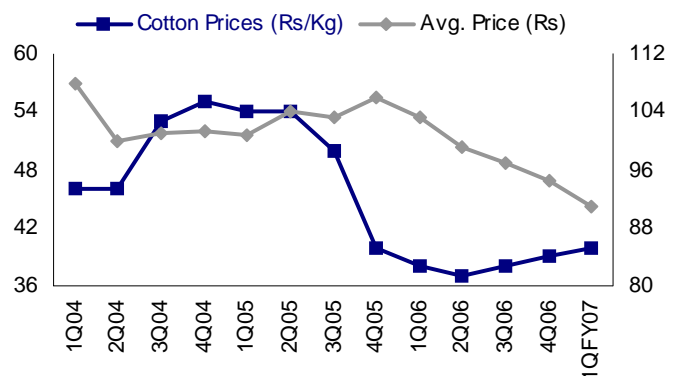
	CURRENT		ADDITIONS		TOTAL (M PIECES)
	FY06	FY07	FY08	FY09	
Jeans	4.0	5.0	5.0	3.0	17.0
Shirts	4.5	0.0	3.0	2.0	9.5
Knits	4.2	1.0	3.0	3.0	11.2
Khakis	0.0	1.5	3.0	0.0	4.5
<b>Total</b>	<b>12.7</b>	<b>7.5</b>	<b>14.0</b>	<b>8.0</b>	<b>42.2</b>

Source: Company/Motilal Oswal Securities

**Cotton outlook**

The average cotton price for Arvind in 1QFY07 stood at Rs40/kg. The management estimates its average cotton cost to remain stable at these levels till April'07, as the company has already covered up its cotton requirement till then.

COTTON PRICE (RS/KG) V/S DENIM REALIZATIONS (RS/KG)

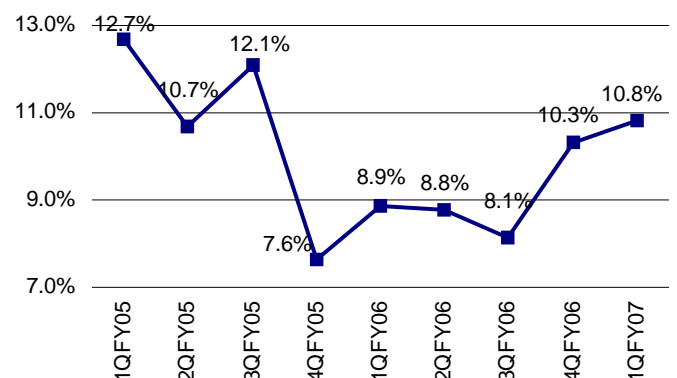


Source: Company/ Motilal Oswal Securities

**Fuel cost to remain high**

Profitability of the company has been severely hit during 1QFY07 due to increased fuel costs, arising from shortage of gas. During the quarter, cost of fuel stood at 10.8% of revenues v/s 8.9% in 1QFY06. This is due to the fact that Gujarat State Petrochemical Corporation (GSPC), with whom Arvind has a gas supply contract, is only able to supply around 805 of the company's requirement. Hence, Arvind is forced to purchase power at much higher rates from the state power grid. Management has indicated that this shortage may continue to negatively impact margins over the next few quarters.

INCREASING FUEL COST



Source: Company/Motilal Oswal Securities

## Arvind brands

Arvind's 100% retail subsidiary Arvind Brand reported 19% YoY increase in revenues to Rs760m. During the quarter, the total number of stores under Arvind Brand increased by 18% YoY to 386 stores. Going forward, management plans to merge its 100% subsidiary Arvind Brands, with Arvind Mills. We estimate Arvind Brand's revenues to post CAGR of 30% on the back of aggressive retail store expansion and introduction of new brands.

### ARVIND BRANDS 1QFY07 FINANCIALS (RS MILLION)

	1QFY06	1QFY07	% CH.
International Brands	390	500	28
Own Brands	240	260	8
<b>Total</b>	<b>630</b>	<b>760</b>	<b>21</b>

### ARVIND BRAND FINANCIALS (RS M)

	FY05	FY06	FY07E	FY08E
Sales	2,780	3,365	4,442	5,686
EBITDA	50	138	222	387
Margin (%)	1.8	4.1	5.0	6.8
Interest	130	124	139	160
Depreciation	80	134	141	145
PBT	-160	-120	-57	82

### FUTURE POTENTIAL OPPORTUNITY FOR ARVIND BRANDS

	POTENTIAL SALES (RS B)	EBIT (%)
International Brands	10.0	7.5
Own Brands	3.5	5-7
Private Brands	2.5	5-7
<b>Total</b>	<b>16.0</b>	

Source: Company/Motilal Oswal Securities

## Fresh capex initiative

Arvind has lined up capex plans of around Rs2b for FY07. Management expects to garner revenues of around Rs2.4b in FY08 alone from these initiatives. The table below shows the capex schedule for FY07 across different categories.

### CAPEX PLANS FOR FY07 (RS M)

VERTICALISATION	FY07	POTENTIAL SALES GENERATION IN FY08
Jeans Plant	320	1,690
Knits	30	200
Khaki Garments	110	530
Ammonia	300	
Looms	200	
Retailing and Branding	500	
Routine CAPEX	560	
<b>Total Investment</b>	<b>2,020</b>	<b>2,430</b>

Source: Company/Motilal Oswal Securities

## Management outlook on revenue breakdown ahead (FY08-FY09)

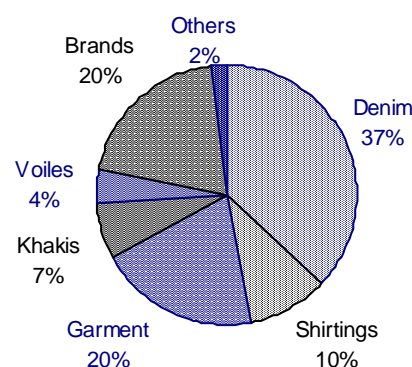
Management has given guidance for revenue growth rate and EBITDA margins in its various businesses, over the next three to four years. The table below depicts the segment-wise sales growth rates and EBITDA margin assumptions in the company's different business segments.

### REVENUE BREAKDOWN AHEAD

	SALES GROWTH RATE	EBITDA (%)
Fabric	10	21
Garments	80	10
Brands	35	10

Source: Company/Motilal Oswal Securities

### MANAGEMENT OUTLOOK ON FUTURE REVENUE BREAK-UP (FY08-09)



Source: Company/Motilal Oswal Securities

## Valuation and view

We believe Arvind has hit a rough patch, as performance of core business segment — denim — accounting for around 55%-60% of standalone revenues, is likely to remain under pressure over the medium term. Management is pinning its hopes on its garment and branded retail segments to drive future growth. However, due to slow scale-up in its garment business and the long gestation period in the branded retail business, near term earnings are likely to be negatively impacted. The stock trades at PER of 12.2x FY07 EPS of Rs4.7 and 9.5x FY08 EPS of Rs6x.

## Arvind Mills: an investment profile

### Company description

Arvind Mills is the largest cotton textile manufacturer and exporter in India. It is also a leading player in the branded garments segment of the domestic market operating through its subsidiaries. The company's principal business is to manufacture denim, shirting, knitted fabric, shirts and garments. It has managed to turn around its operations following a business restructuring exercise. It has also de-commoditized its business by reworking its product mix. Besides, it is establishing long-term contracts with key customers and reducing its financial leverage.

### Key investment arguments

- Vertical integration helps the company to be a one-stop shop for global buyers.
- It is in a position to leverage its existing strong relationships with global buyers and garment brands.

### Key investment risks

- High dependence on denim business.
- Remains highly dependent on cotton price movements.

### Recent developments

- Acquired ICICI Venture's stake in Arvind Brands for Rs1.06b
- Has raised US\$38.6m through a GDR issue in July 2005.
- Has a Rs2b capex plan in FY07

### Valuation and view

- We expect Arvind to post revenues and sales CAGR of 11% and -1% respectively, over FY06-08E.
- The stock trades at PER of 12.2x FY07E EPS and 9.5x FY08E EPS. We maintain **Neutral**.

### Sector view

- Exports from China are likely to be severely constrained due to safeguard measures imposed by the US and EU.
- India registered robust export growth rates to the US and EU in the post-quota era.
- Global buyers are focusing on building vendor partners who have high product development skills.
- The concern of industry overcapacity causing waves of deflation in prices, is overblown.

#### COMPARATIVE VALUATIONS

		ARVIND MILLS	GOKALDAS	WELSPUN
P/E (x)	FY07E	12.2	11.4	9.8
	FY08E	9.5	9.5	7.6
P/BV (x)	FY07E	0.8	2.1	0.9
	FY08E	0.7	1.8	0.8
EV/Sales (x)	FY07E	1.5	0.9	2.0
	FY08E	1.4	0.7	1.8
EV/EBITDA (x)	FY07E	7.0	7.9	9.1
	FY08E	7.1	6.6	8.4

#### SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	34.2	33.7	37.0
Domestic Institutions	15.4	15.6	17.4
FII's/FDIs	25.9	26.5	22.7
Others	24.6	24.2	22.9

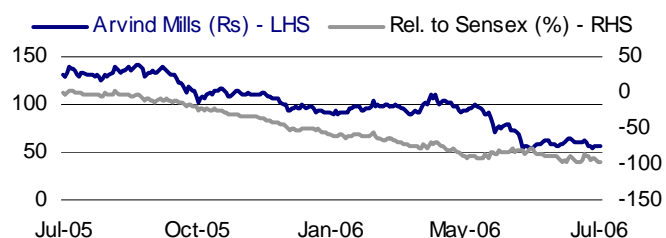
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	4.7	5.1	-8.2
FY08	6.0	6.3	-4.3

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
57	72	14.0	Neutral

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2005	2006	2007E	2008E	
<b>Net Sales</b>	<b>16,789</b>	<b>15,964</b>	<b>18,035</b>	<b>19,722</b>	
Change (%)	17.0	-4.9	13.0	9.3	
Raw Materials	6,199	5,749	6,387	7,141	
Staff Cost	1,230	1,353	1,488	1,607	
Other Mfg. Expenses	5,600	5,428	6,191	7,053	
<b>EBITDA</b>	<b>3,886</b>	<b>3,989</b>	<b>3,969</b>	<b>3,920</b>	
% of Net Sales	23.1	25.0	22.0	19.9	
Depreciation	1,491	1,551	1,678	1,740	
Interest	1,179	1,300	1,375	959	
Other Income	76	225	175	175	
<b>PBT</b>	<b>1,293</b>	<b>1,364</b>	<b>1,091</b>	<b>1,397</b>	
Tax	20	92	109	140	
Rate (%)	15	6.8	10.0	10.0	
<b>Reported PAT</b>	<b>1,273</b>	<b>1,272</b>	<b>982</b>	<b>1,257</b>	
<b>Adjusted PAT</b>	<b>1,273</b>	<b>1,272</b>	<b>982</b>	<b>1,257</b>	
Change (%)	313	-0.1	-22.7	27.9	

BALANCE SHEET		(Rs Million)			
Y/E MARCH	2005	2006	2007E	2008E	
<b>Equity Cap</b>	<b>1954</b>	<b>2094</b>	<b>2094</b>	<b>2094</b>	
Share Capital	2,614	2,688	2,599	2,523	
Reserves	10,198	12,791	13,504	14,497	
<b>Net Worth</b>	<b>12,811</b>	<b>15,479</b>	<b>16,103</b>	<b>17,020</b>	
Loans	16,824	14,724	16,174	15,724	
Deferred Tax Liability	46	110	154	210	
<b>Capital Employed</b>	<b>29,681</b>	<b>30,313</b>	<b>32,431</b>	<b>32,953</b>	
Gross Fixed Assets	21,103	22,103	23,303	24,503	
Less: Depreciation	7,286	8,837	10,515	12,255	
<b>Net Fixed Assets</b>	<b>13,817</b>	<b>13,266</b>	<b>12,788</b>	<b>12,248</b>	
Capital WIP	1,031	1,031	1,031	1,031	
Investments	1,530	1,500	1,500	1,501	
<b>Curr. Assets</b>	<b>16,016</b>	<b>17,085</b>	<b>20,024</b>	<b>21,489</b>	
Inventory	5,112	4,740	5,588	6,277	
Debtors	3,191	2,669	3,107	3,398	
Cash & Bank Balance	129	574	885	300	
Loans & Advances	7,585	9,102	10,444	11,514	
<b>Current Liab. &amp; Prov.</b>	<b>2,713</b>	<b>2,568</b>	<b>2,913</b>	<b>3,315</b>	
Creditors	1,644	1,339	1,487	1,663	
Other Liabilities	746	857	986	1,134	
Provisions	324	372	439	518	
<b>Net Current Assets</b>	<b>13,303</b>	<b>14,516</b>	<b>17,112</b>	<b>18,173</b>	
<b>Application of Funds</b>	<b>29,681</b>	<b>30,313</b>	<b>32,430</b>	<b>32,953</b>	

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>6.1</b>	<b>6.1</b>	<b>4.7</b>	<b>6.0</b>	
Growth (%)	313	-0.1	-22.7	27.9	
Cash EPS	15.7	16.0	15.1	17.0	
Book Value	62.2	71.1	74.5	79.2	
DPS	1.0	1.0	1.0	2.0	
Payout (incl. Div. Tax)	17.5	18.8	24.3	19.0	
<b>Valuation (x)</b>					
P/E	9.4	9.4	12.2	9.5	
Cash P/E	3.6	3.6	3.8	3.4	
EV/EBITDA	7.5	6.7	7.0	7.1	
EV/Sales	1.7	1.7	1.5	1.4	
Price/Book Value	0.9	0.8	0.8	0.7	
Dividend Yield (%)	1.7	1.7	1.7	3.5	
<b>Profitability Ratios (%)</b>					
RoE	10.9	9.4	6.4	7.8	
RoCE	9.0	8.9	7.9	7.2	
<b>Turnover Ratios</b>					
Debtors (Days)	60	60	60	60	
Inventory (Days)	150	145	145	145	
Creditors (Days)	85	85	85	85	
Asset Turnover (x)	0.6	0.5	0.6	0.6	
Fixed Asset Turnover (x)	0.8	0.7	0.8	0.8	
<b>Leverage Ratio</b>					
Debt/Equity (x)	1.4	1.0	1.0	0.9	

CASH FLOW STATEMENT		(Rs Million)			
Y/E MARCH	2005	2006	2007E	2008E	
OP/(Loss) before Tax	1,293	1,364	1,091	1,397	
Add: Depreciation & Amort.	1,491	1,551	1,678	1,740	
Add: Interest Paid	1,179	1,300	1,375	959	
Less: Direct Taxes Paid	3	28	65	84	
Less: (Inc)/Dec in Wkg. Capital	-4,324	-768	-2,284	-1,647	
<b>CF from Op. Activity</b>	<b>-1,637</b>	<b>1,894</b>	<b>244</b>	<b>1,229</b>	
<b>CF after EO Items</b>	<b>-1,637</b>	<b>1,894</b>	<b>244</b>	<b>1,230</b>	
(Inc)/Dec in Fixed Assets & CWIP	-177	-1,000	-1,200	-1,200	
(Pur)/Sale of Invest.	66	-30	0	1	
<b>CF from Inv. Activity</b>	<b>-1,326</b>	<b>-1,000</b>	<b>-1,200</b>	<b>-1,200</b>	
Issue of Shares	-35	1,670	0	0	
Inc / (Dec) in Debt	3,270	-2,100	1,450	-450	
Interest Paid	1,179	1,300	1,375	959	
Dividends Paid	223	239	239	239	
<b>CF from Fin. Activity</b>	<b>2,964</b>	<b>-449</b>	<b>1,267</b>	<b>-614</b>	
<b>Inc / (Dec) in Cash</b>	<b>2</b>	<b>445</b>	<b>311</b>	<b>-584</b>	
Add: Opening Balance	127	129	574	885	
<b>Closing Balance</b>	<b>129</b>	<b>574</b>	<b>885</b>	<b>301</b>	



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**Arvind Mills**

- |   |     |
|---|-----|
| 1. Analyst ownership of the stock                       | No  |
| 2. Group/Directors ownership of the stock               | Yes |
| 3. Broking relationship with company covered            | No  |
| 4. Investment Banking relationship with company covered | No  |

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