Distilleries

Initiating Coverage

Pioneer Distilleries

BUY

MF Global
Private Client Group

CMP : Rs.124

Target : Rs.232

Pioneer Distilleries (PDL), a stand-alone distillery started with a capacity of 15mn liters p.a. in 1994. Since then it has come a long way, currently with capacity of 30 mn liters for RS, ENA, Ethanol and 10TPD of CO2, it has become a sizable player in the industry. The company has diversified its product range and expanded capacity to get economies of scale. With increase in demand for ethanol very close to becoming reality and entry of new players in alcoholic beverage segment leading to consolidation in the distillery industry, the developments augurs well for PDL. The expansion drive being undertaken by the company, gives visibility of 102% CAGR in profitability over FY07-FY10E. We recommend a BUY with price target of Rs232 in 12-months time.

Investment rational

Buoyancy in the Industry – Consumption of IMFL has increased by 53% over 2002-06 and many international players have made a beeline to Indian shores, leading to consolidation in the industry. Increase in demand for Ethanol is also on the verge of becoming a reality, which will benefit PDL as it is enlisted with prominent clients in both these segments.

Capacity expansion to drive growth – In FY07 the company completed a capex of Rs250mn to expand its capacities. During the current year also it is undertaking capex of Rs390mn to set up an effluent treatment and 5mw power plant. Further for FY09 it has planned capex of Rs1.1bn, which would add more than Rs1bn to the sales by FY10**.** We anticipate CAGR of 60% in sales and 102% CAGR in profitability over FY07-FY10, as a result of the capacity expansion undertaken by the company.

Focus on forward integration – In FY07 the company added 10TPD CO2 capacity, which is a by-product in the distillation process. In FY08 it would add effluent treatment plant to meet the stringent environment norms with integrated biogas based power plant. In future it plans to add Acetic Acid and Ethyl Acetate for which RS is the basic raw material.

Valuations

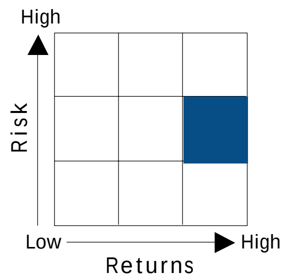
The stock currently trades at 13.5x FY09E and 4.7x FY10E earnings, on fully diluted equity. As a result of new capacity addition, diversification into value added products and biogas based power plants, we expect the business model of the company to become sturdier. At the same time, economies of scale would provide higher bargaining power and better margins (NPM of 22% in FY10) due to value addition at each stage. We foresee an over all improvement in performance resulting in RoCE and RoNW to increase to 21.6% and 34.5% respectively in FY10. As power would contribute 35% to net profit, we have valued the company on sum of parts - power segment at 15x FY10E EPS of Rs9 and the core business at 6x FY10E EPS of Rs15. We have thus arrived at SOTP valuation of Rs232. With an upside potential of more than 87% from current price, we recommend a **BUY** on the stock with 12-months perspective.

Valuation summary

Y/E, 31st March	FY07	FY08E	FY09E	FY10E
Net sales(Rs mn)	**484**	**721**	**908**	**1,994**
Adj PAT(Rs mn)	53	125	152	441
Adj EPS (Rs)	**5.0**	**10.0**	**9.2**	**26.7**
EPS growth (%)	272.2	97.9	(7.5)	190.1
P/E (x)	**24.7**	**12.5**	**13.5**	**4.7**
Dividend yield (%)	NA	NA	NA	NA
RoCE (%)	**15.4**	**18.7**	**13.2**	**21.6**
RoNW (%)	37.1	49.1	21.6	34.5
P/BV (X)	**7.8**	**4.6**	**1.9**	**1.4**
EV/EBIDTA (x)	15.1	10.9	9.8	4.8
EV/Sales (x)	**3.3**	**2.8**	**3.0**	**1.5**

Source: Company, MF Global PCG Research

Risk Return Matrix



Indices

Sensex	20,345
Nifty	6,179

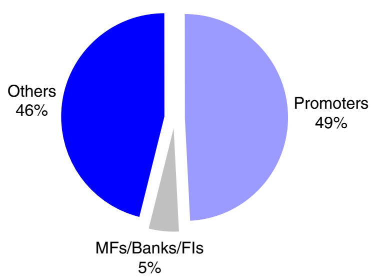
Stock Data

BSE Code	531879
Bloomberg	PND@IN
Reuters	PION.BO
Shares Issued (mn)	11.2
Market Cap (Rs mn)	1,394
52 Wk H/L (Rs)	125/17
Face Value (Rs)	10
Avg. daily vol. (12-mths)	30,280

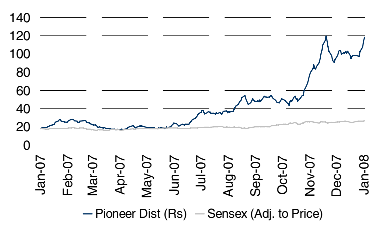
Absolute Returns (%)

	1 m	3 m	12 m
Absolute	20.5	138.1	558.6
Rel. to Sensex	16.1	123.4	511.8

Shareholding Pattern



Pioneer Distil. Vs Sensex (Adj)



Analyst : Sonal Shrivastav
sonal.shrivastav@mfglobal.in
+91 22 6655 1296

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Company profile

Shri K. V. Rajeshwar Rao promoted Pioneer Distilleries (PDL) in 1992, originally known as Ganga Orgchem, subsequently the name was changed to Pioneer Distilleries. It started with a capacity of 15mn liters p.a. to manufacture RS (rectified spirit), ENA (extra neutral alcohol) and SDS (special denatured alcohol) in 1994 at Nanded in Maharashtra, went public in 1996. The company is today actively managed by Mr Sudhir Rao (Vice Chairman) and Mr Suhan Rao (Managing Director). Currently it has an installed capacity of 30mn liters p.a. for RS, ENA and Ethanol and 10TPD for CO2. The company is on an expansion drive to get economies of scale, diversify its product range, with focus on forward integration.

Survived through the rough times

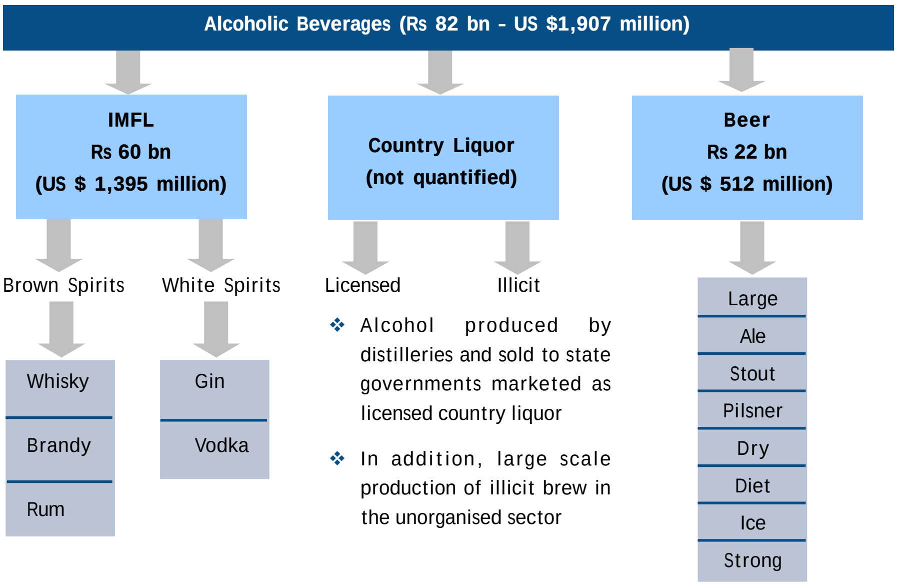
PDL was in losses until FY04, due to under utilization of capacities and high interest costs. The company subsequently underwent a debt restructuring, it paid Rs110mn as one time settlement, Rs 90mn interest was waived off under the OTS. For balance Rs17mn it issued 5% preference shares to IDBI (1.7mn) and LIC (0.65 mn) in lieu of high cost debt. It subsequently expanded its capacity in FY06 & FY07 to 30mn liters p. a. and added capacities for other value added products like Ethanol and CO2, apart from ENA & RS, to get economies of scale and diversify its product base.

The company is on an expansion drive to get economies of scale, diversify its product range, with focus on forward integration

Growth in liquor industry – driving demand for ENA

The distillery industry consists of two major components on the basis of usage, one Industrial alcohol and second Potable alcohol. Industrial alcohol finds usage in manufacture of chemical solvents & intermediates, while potable alcohol is used in IMFL & country liquor. In India the production ratio of Industrial to Potable alcohol is approximately 48% and 52% respectively. But, the industry is highly regulated being the second largest source of revenue to the state exchequer in the range of Rs250bn annually.

Alcoholic beverages industry structure and size



Source: Industry report

Consumption of Indian made foreign liquor has increased by 53% to 115mn cases during 2002 to 2006, while consumption of beer has jumped up by 51% to 105mn cases in the same period

With changing lifestyle and increase in disposable income in past few years, the alcoholic beverage segment has witnessed tremendous growth. Consumption of Indian made foreign liquor has increased by 53% to 115mn cases during 2002 to 2006, while consumption of beer has jumped up by 51% to 105mn cases in the same period. The fast growth in the domestic alcohol beverage industry has caught the fancy of many foreign players. Few of the well-known MNC companies like SAB Miller, Diageo, Pernod Ricard, Moet Hennessey and LVMH have already made an entry in the Indian markets. And couples of others are in the line to get a pie in the fast growing market. Most of these foreign players would focus on product development, distribution & marketing relying on regional distilleries for sourcing ENA. But, as the industry is strictly regulated, for the foreign entrant looking at entering into the domestic market, sourcing economic quantity and quality ENA, will be the key determinant. The entry of foreign players has already triggered consolidation in the industry, which we feel is a positive development for companies like PDL.

Ethanol a new frontier

In India most of the energy requirements are currently satisfied by fossil fuels like – coal, petroleum-based products and natural gas. Domestic production of crude oil can only fulfill 25-30% of national consumption. In fact, the crude oil imports are expected to touch 147 mn tons in 2006-07. With the ever-escalating crude oil prices, if one assumes a price of $57/barrel, the estimated crude oil import bill for 2006-07 would be a staggering $61.7 bn, about 10% of the country's GDP. Thus, bio-fuels are going to play an extremely important role in meeting India's energy needs. Ethanol and bio-diesel are gaining acceptance worldwide as economic substitutes for oil in the transportation sector. Brazil uses pure ethanol in about 20% of their vehicles and a 22-26% ethanol-petrol blend in the rest of their vehicles. United States and Australia also use 10% ethanol blend. India is the fourth largest ethanol producer after Brazil, US and China, its average annual ethanol output amounting to 1,900 mn litres, with a distillation capacity of 2,900 mn litres per year (present capacity is under utilized). For a 5% ethanol blend in petrol nationally, the total quantum of ethanol required would be approximately 640 mn litres of ethanol in 2006-07 and 810 mn litres in 2011-12. As depicted in the table in 2006-07 surplus availability of alcohol was 822.8mn liters as compared to requirement of 640mn liters. Thus current quantity of molasses production is sufficient to meet the requirement of Ethanol and all kinds of alcohols.

The company has got orders from IOC, BPCL and HPCL for evacuation of approximately 3 lakh liters per month, at the rate of Rs21.50 per liter. The rest of the quantity is sold to the chemical industry

Alcohol production (in million litres)

Alcohol year	Molasses Prod.	Production of Alcohol	Industrial Use	Potable Use	Other Uses	Surplus Availability
1998-99	7.00	1,411.8	534.4	584.0	55.2	238.2
1999-00	8.02	1,654.0	518.9	622.7	57.6	455.8
2000-01	8.33	1,685.9	529.3	635.1	58.8	462.7
2001-02	8.77	1,775.2	539.8	647.8	59.9	527.7
2002-03	9.23	1,869.7	550.5	660.7	61.0	597.5
2003-04	9.73	1,969.2	578.0	693.7	70.0	627.5
2004-05	10.24	2,074.5	606.9	728.3	73.5	665.8
2005-06	10.79	2,187.0	619.0	746.5	77.2	742.3
2006-07	11.36	2,300.4	631.4	765.2	81.0	822.8

Source: Ethanol India

Molasses a key raw material

The fermentation of molasses, a by-product of sugar manufacturing, is the preferred raw material for manufacturing alcohol and ethanol in India. Sugarcane occupies about 4.2% of the total kharif area under cultivation and it is one of the most important cash crops in the country. The area under sugarcane cultivation has gradually increased from 2.7 mn hectares in 1980-81 to 4.3 mn hectares in 2005-06, mainly because of much larger diversion of land from other crops to sugarcane by the farmers for economic reasons. From a level of 154 MMT in 1980-81, the sugarcane production increased to 241 MMT in 1990-1991 and further to 297 MMT in 2006-07 (Sugar India Yearbook). In 2005-06, there were 581 installed sugar mills in the country with a production capacity of 190 lakh MTs of sugar, of which only

As a thumb rule, in the process of sugar production, almost 4% of total cane crushed is recovered as molasses. And per one tone of molasses approximately 220-225 liters of RS is produced

455 are working. These mills are located in 18 states of the country. Around 312 of the total installed mills are in the cooperative sector, 205 in the private sector and 64 in the public sector (Source: Directorate of Sugar). The number of factories in the private sector has increased by more than 15%, which shows the corporatization of sugar production. But majority of the industry is still fragmented with more than 50% of the industry represented by the co-operatives.

As a thumb rule, in the process of sugar production, almost 4% of total cane crushed is recovered as molasses. And per one tone of molasses approximately 220-225 liters of RS is produced. The cost of molasses in India varies widely across different states and a sizeable part of the cost is central excise duty, sales tax, transportation cost, etc., and the statutory controlled sugarcane and sugar prices. Maharashtra has been the most enterprising of the states in starting new factories, which increased from 102 in 2004/05 to 142 in 2005/06. The company's plant is located at Nanded, Mahrashtra in close proximity to Andhra Pradesh and thus it has the flexibility to procure from either of the state at the best available prices.

Currently the ex-factory price for molasses is ruling at approximately Rs1200/ton as compared to Rs2,400-3,000/ton in 2004-05, which was an abnormal spike due to shortage in production and increase in demand. Correspondingly the prices of alcohol had also gone up to Rs38/liter during the high cost of molasses and have since corrected to Rs26-28/liter. In our model we have worked on average cost of Rs2,600/ton for molasses consumed. As molasses production is anticipated to be in surplus, we do not foresee any major increase in molasses prices, also as the increase in prices is pass through we expect there will not be hit on margins for the company.

Prices of alcohol had also gone up to Rs38/liter to reflect the high cost of molasses and have since corrected to Rs26-28/liter

Expansion driven growth

The company has been on aggressive growth drive. It spent approximately Rs250mn to expand its capacities during FY06 in the first phases, which were commissioned in January 2007. The benefits of these expansions are accruing in the current year, in terms of expansion in operating margins and higher profitability. In the second phase the company is spending another Rs390mn to set up a state-of-art effluent treatment plant and 5mw biogas based power plant. In the process it will also expand its existing 1.6mw power generating capacity to 3mw for captive requirement, which would bring down its power cost also. The capex is being funded through Rs280mn debt, Rs50mn central govt. subsidy, Rs37mn through warrants issued to promoters (0.7mn @Rs53) and rest through internal accruals. The project is expected to be commissioned by August 2008.

Capacity expansion to sustain growth

Production capacities	FY05	FY06	FY07	FY08	FY09	FY10
RS (KLPD)	50,000	50,000	1,00,000	1,00,000	1,00,000	2,00,000
ENA (KLPD)	30,000	50,000	1,00,000	1,00,000	1,00,000	1,50,000
Ethanol (KLPD)	–	30,000	30,000	30,000	30,000	1,30,000
Co2 (TPD)	–	–	10	10	10	25
Acetic Acid (TPD)	–	–	–	–	–	30
Ethyl Acetate (TPD)	–	–	–	–	–	20
Power Unit (MW)	–	–	–	–	8	16

Source : Company, MF Global PCG Research

The third phase of expansion is expected to be completed by January 2009, which would add approximately revenues to the tune of Rs1bn to the top line in FY10

PDL has already received the requisite govt. approvals from excise department to double its RS capacity to 2,00,000 KLPD, add ENA capacity of 50,000 KLPD, and increase Ethanol capacity by 1,00,000 KLPD and 8mw power capacity. The facility will also have capacity for Acetic acid, Ethyl acetate and CO2. It would be a parallel project with its own effluent treatment plant. The project is expected to be completed by January 2009, which would add approximately revenues to the tune of Rs1bn to the top line in FY10.

Focus on forward integration – shift to value added products

As a result of new capacity addition and diversification into value added products like Ethanol, acetic acid for which RS is an input, ethyl acetate, which uses acetic acid as an input and bio-gas based power plant where the net profit margins could be as high as 70%, we expect the company to report stupendous growth in profitability for FY07-FY10.

Diversification in product mix

Sales Breakup (%)	FY06	FY07	FY08	FY09	FY10
RS	11	5	4	14	28
ENA	84	86	87	62	42
Ethanol	5	8	8	17	18
Co2	–	2	1	2	1
Acetic Acid	–	–	–	–	0.5
Ethyl Acetate	–	–	–	–	0.5
Power	–	–	–	6	10
Total	**100**	**100**	**100**	**100**	**100**

Source: Company & MF Global PCG Research

In FY10 the company will have all its capacities running at optimum utilization at the same time it will also have almost 10mw surplus power for commercial sales which would contribute 10% of revenues

In FY10 the company will have all its capacities running at optimum utilization at the same time it will also have almost 10mw surplus power for commercial sales which would contribute 10% of revenues. As the power plants are based on bio-fuel it is eligible for carbon credits, we expect approximately 2 lakh CER would also be available for sale in FY10. As a result of new capacity addition, shift in value added products, savings in power cost, sale of surplus power and carbon credit sales, we expect the operating profit margin would go up-to 35.4% with net profit margin of 22.1% in FY10.

Financial performance

PDL had added 50,000 KLPD of RS and ENA and 10MT of Co2, which got commissioned in January 2007, the benefit of these expansions, would be visible in FY08. For the first half ending September 2007 the company's sales has grown by 42% and profitability has grown by a stupendous 220%. It reported net profit of Rs51.6mn on sales of Rs303.1mn for H1FY08, which is almost equal to FY07 full year profit of Rs52.8mn.

	H1FY08	H1FY07	(%) Chg	FY07
Net sales	303.1	214.2	42	483.5
EBIDTA	91.6	36.8	149	114
OPM (%)	*30.2*	*17.2*	–	*23.6*
Interest	15.2	7.7	97	17.8
Depreciation	17.2	11.6	48	24.7
Other income	2.3	0.7	229	1.6
PBT	61.5	18.2	238	73.1
Tax	9.9	2.1	371	20.3
PAT	51.6	16.1	220	52.8
NPM (%)	*17.0*	*7.5*	–	*10.9*

Source: Company, MF Global PCG Research

It reported net profit of Rs51.6mn on sales of Rs303.1mn for H1FY08, which is almost equal to FY07 full year profit of Rs52.8mn

We expect the company to incur approximately Rs1.1bn for capex in FY09, assuming a 60:40 equity-debt funding for the project, we have assumed a dilution of 32%. We have assumed that some 40mn shares could be issued at Rs150 per share to raise Rs600 mn, to partly fund the cap-ex in FY09. Thus inspite of 26% growth in sales and 22% growth in profitability, EPS growth seems to be muted at only 4.3% in FY09, but then in FY10 we would witness almost 164% growth over FY09. We expect the company would report net profit of Rs441mn on sales of Rs1994mn in FY10.

Concerns

Molasses price volatility – Molasses though abundantly available is a commodity product and had witnessed wide price fluctuations in 2003-2004. Any such volatility in future could put pressure on profitability of the company.

Execution risks – The company with sales of Rs721mn is undertaking a capex of Rs1.1bn. Any delay in execution and commissioning of the project would lead to negative impact on performance.

Financial risk – For its capex of Rs1.1bn we have assumed a 60:40 equity-debt ratio and that it would raise Rs600mn through fresh funds, if the company is unable to raise the funds in due course, our FY10 estimates may not be achieved.

Competition from integrated sugar companies – The company being stand-alone distillery faces competition from integrated sugar companies who have set up distillery and ethanol plants to capitalize on growing demand.

Valuations

The stock currently trades at 13.5x FY09E and 4.7x FY10E earnings, on fully diluted equity. As a result of new capacity addition, diversification into value added products and biogas based power plants, we expect the business model of the company to become sturdier. At the same time, economies of scale would provide higher bargaining power and better margins (NPM of 22% in FY10) due to value addition at each stage. We foresee an over all improvement in performance resulting in ROCE and RONW to increase to 21.6% and 34.5% respectively in FY10. As power would contribute 35% to net profit, we have valued the company on sum of parts - power segment at 15x FY10E EPS of Rs9 and the core business at 6x FY10E EPS of Rs15. We have thus arrived at SOTP valuation of Rs232. With an upside potential of more than 87% from current price, we recommend a **BUY** on the stock with 12 months perspective.

SOTP Valuation Summary

FY10E	Power	Core
Net profit Rs mn	157	247
EPS Rs	10	15
P/E(x)	15	6
Per share Value Rs	143	90
Target price Rs	232	

1-year forward P/E multiple

Financials

Income statement (Rs mn)	FY07	FY08E	FY09E	FY10E
Net sales	**484**	**721**	**908**	**1,994**
Raw materials	207	326	414	938
Employee expenses	15	19	35	89
Other exp	147	168	151	261
Op profit	**115**	**208**	**307**	**706**
OPM (%)	*23.8*	*28.8*	*33.8*	*35.4*
Other income	2	10	15	25
Depreciation	24	39	77	138
Interest	19	40	76	101
PBT	**74**	**139**	**169**	**491**
Tax	20	14	17	50
PAT	53	125	152	441
Extraordinary item	–	–	–	–
Adj PAT	**53**	**125**	**152**	**441**
NPM (%)	*11.0*	*17.3*	*16.8*	*22.1*

Balance sheet (Rs mn)	FY07	FY08E	FY09E	FY10E
Equity capital	**106**	**125**	**165**	**165**
Reserves	62	214	907	1,319
Networth	**168**	**339**	**1,072**	**1,484**
Total debt	501	801	1,261	1,440
Deferred tax	53	83	123	181
Total liabilities	**723**	**1,224**	**2,456**	**3,105**
Gross fixed assets	696	972	1,713	2,306
Less: Depreciation	145	184	261	399
Net fixed assets	551	788	1,452	1,906
Capital WIP	23	137	495	53
Investments	–	–	10	80
Net current assets	150	300	498	1,066
Total assets	**723**	**1,224**	**2,456**	**3,105**

Cash flow (Rs mn)	FY07	FY08E	FY09E	FY10E
PBT & extraord. items	73	139	169	491
Add: Int, depn. & oth. exp.	43	79	154	241
Cash flow from op.	**116**	**218**	**323**	**733**
Net chg in w/c, tax, int.	9	(91)	(199)	(424)
Net cash flow frm op.	**124**	**127**	**124**	**310**
Capital expenditure	(166)	(390)	(1,100)	(150)
Sale/ purchase of inv	(8)	–	(10)	(70)
Net cash from inv.	**(174)**	**(390)**	**(1,110)**	**(220)**
Issue of eq/pref sh/warr.	82	362	1,059	179
Dividend paid	(30)	(26)	(58)	(75)
Net cash from financing	**52**	**336**	**1,001**	**104**
Net chg in cash	2	73	15	195
Op. cash bal	5	7	79	95
Cl. cash bal	7	79	95	290

Ratios	FY07	FY08E	FY09E	FY10E
Growth (%)				
Net sales	19.8	49.0	25.9	119.6
Adj PAT	295.6	133.4	22.0	190.1
Adj EPS	272.2	97.9	(7.5)	190.1
Per Share Data (Rs)				
Adj EPS	5.0	10.0	9.2	26.7
Book value	15.9	27.1	64.9	89.9
DPS	1.4	1.1	1.1	1.6
Valuation (x)				
P/E	24.7	12.5	13.5	4.7
P/BV	7.8	4.6	1.9	1.4
EV/EBIDTA	15.1	10.9	9.8	4.8
Performance (%)				
RoCE	15.4	18.7	13.2	21.6
RoNW	37.1	49.1	21.6	34.5

BUY : > 20%	HOLD : > 5-20%	SELL : < 5%

Note: Ratings based on expected returns from current market price (on absolute basis).

Analyst Holding in the recommended stock: **NIL**

MF Global Sify Securities India Pvt. Ltd.,
2ND floor, 'C' Block, Modern Centre, Mahalaxmi, Mumbai-400 011, India.
For more copies and other information contact – Vikram Rawat (+91 22 6655 1294) vikram.rawat@mfglobal.in