Date: 10 March, 2007

Every week, the ICICIdirect research team selects a stock based on fundamental and/or technical parameters, which is likely to give a return of 20% or more over a 3-6 month perspective.

Prime Focus Ltd.(PRIFOC)

Current Price: Rs 390	Target Price: Rs 468
Potential upside: 20%	Time Frame: 6 mths

Prime Focus, a post-production and visual effects service house, is well geared to capitalise on the boom in the media and entertainment industry through geographical expansions. It has forayed into the high-margin visual effects (VFX) and animation business, and also equipment rental and film distribution. We believe these initiatives would translate into significant returns for shareholders.

Background

Prime Focus was incorporated as a private limited company in June 1997 and became a limited company in April 2000. It is one of India 's leading integrated end-to-end post- production and visual effects services house. It offers a comprehensive spectrum of services ranging from visual effects, digital film lab (digital intermediate, high-resolution film scanning and film recording), telecine (transferring film to video) editing, and motion control to high-definition production. The company offers post-production services for ad films, music videos, TV shows, feature film promos and feature film special effects in terms of editing, colour correction, visual effects, computer graphics, animation, etc. Besides, the company also provides shooting equipment like cameras (film and video) and lights on hire.

Investment Rationale

Post-production, special effects industry to double by 2007

The special effects industry in India is still at a nascent stage and currently limited to commercials and simple effects in feature films. It is a highly fragmented market characterized by several small studios. At present, most of the outsourced work in India involves 2D animation, which is primarily volume-driven and requires large infrastructure investment. Internationally, the trend is towards outsourcing of 3D animation, visual effects and post-production services.

The Indian post-production industry is currently estimated at Rs 500 crore and is expected to grow to Rs 1,000 crore by 2007. International outsourced work and mainstream films, currently accounts for Rs 65 crore of the total market, and is estimated to grow to Rs 400 crore. The size of the Indian visual effects industry is currently estimated at approximately Rs 3,000 crore and has been growing at approximately 30% over the last few years. Corporatisation and international partnerships as well as tapping of global markets are forcing Indian filmmakers to ensure that the films have an 'international look'. Newer revenue streams such as brand merchandising and in-film advertising have increased spending on visual effects and post-production. The average budget for post- production and visual effects is expected to rise to 25% (up from 15%).

Integrated player, strong brand name

Prime Focus is an integrated player in the media and entertainment space with market share of more than 70% in the post-production activities. The company has expanded its scope of services by entering into equipment rental, VFX and animation business. This bundling ensures overall margin protection to the company and locks the clients for higher volumes of work at a single place. The company operates from its four facilities in Mumbai and one each in Dubai , Chennai and Hyderabad .

We believe Prime Focus is part of every film in one way or the other and its strategic tie-up with Adlabs gives it captive business, increased control over receivables, operational efficiencies and a comfort to clients about safety of their negatives. We also believe the post-production industry is driven by technology and the company has kept pace with the times by adopting the latest state-of-art technologies. This has helped it become the biggest post-production house in India .

Expanding footprints

The company recently acquired a 55% stake in VTR (UK 's third biggest post production company). VTR was incorporated on January 1983 and is listed on the LSE. VTR provides services to the media industry with 20 years of post-production experience and is involved in post-production and graphic design for broadcast, commercials and promos sectors. Prime Focus' presence in London will enable the company to get a slice of the international business.

The company has also acquired Clear, an award winning digital visual effects and computer-generated (CG) animation studio, specializing primarily in the commercials market. We also believe the acquisition of VTR and Clear will be EPS positive for the company. VTR had made losses in the tune of Rs 5.25 crore for FY05 and we expect Prime Focus to turnaround the company in Fy06.

Going forward, we expect VTR to boost the top line and bottom line of Prime Focus substantially as it holds more than 53% in the same. To capture the potential in the Dubai market, Prime Focus is setting up an Rs 10 crore post- production and VFX studio there. It is also in the process of acquiring an existing studio in Los Angeles , US for which the company has raised Rs 15 crore from the IPO.

New VFX studio to act as its global back-office

Prime Focus is currently setting up 200-seater visual effects (VFX) and animation facility in Royal Palms, Mumbai. The facility will be state-of-the-art comparable to the VFX houses worldwide, with high-speed network and storage solutions equipped with cutting-edge software's like Maya, 3ds Max, Shake, After Effects, Combustion, FX plug-ins, etc. Having acquired companies in both the big markets of London and Los Angeles , the company would have a front end marketing office for post-production and visual effects services in these cities.

The new facility at Royal Palms will cater to this outsourced demand, in addition to the local industry demand, which is also expected to grow at a very fast space. This new studio will work as a global back-office for Prime Focus and help the company to take the low-cost advantage in India and increase margins. We expect this facility to do a turnover of Rs 15 crore in FY08 with an EBIDTA margin of more than 70%.

Capturing the South Indian market

The Tamil film industry is the second biggest film industry in India after the Hindi film industry and is estimated at over Rs 700 crore. It is starting to demand highly specialized services, requiring the latest technology kits for post production and hence Prime Focus has expanded by setting up the latest state of the art technologically, advanced studios to cater to the needs of this growing market. The company had started operations in Chennai in 2005 at the same facility where Adlabs also operates. This will act as a centre for postproduction services for Tamil and Malayalam films.

The company has also set to acquire a studio in Hyderabad . The Hyderabad market is one of the fastest growing markets in the South Indian film industry, with more than 250 movies produces every year in line with the average number of films produced in Hindi and Tamil film Industry. Both the Chennai and Hyderabad facilities are expected to carry out post-production work including telecine, offline and online editing along with other ancillary services similar to the Mumbai studio. The pan-India presence will also ensure that the company will be spreading its risk across different geographical markets, each of which goes through its own cyclical phase of up and down thus ensuring that Prime Focus will not be subjected to the business cycles of a single geographical market.

Key Concerns

There is a shortage of skilled manpower for visual effects and lack of domestic training institutes has led to manpower resource shortage for the animation studios.

There is competition from Korea and China as they have been organized in regards to attracting overseas animation projects and support from their Governments in terms of finance and infrastructure has aided in growth of the industry.

ICICIdirect.com
On-line Share Trading

Financials

Prime Focus is expected to reap the full benefits of its expansion in FY08, as the Royal Palms, Hyderabad and Dubai studios would be operational by then. We expect net sales to grow from Rs 42.39 crore in FY06 to Rs 65.88 crore in FY07E and surge to Rs 107.63 crore in FY08E at a CAGR of 59.34%. The company is also likely to benefit from an increased focus on VFX and animation which is a high margin business that would reflect in its bottom line as PAT is expected to grow at a CAGR of 59.48% from Rs 14.03 crore in FY06 to Rs 35.7 crore in FY08E. We expect the upside to be further on the consolidated level post VTR.

Key Financial Ratios					
	2006/03	2005/03	2004/03	2003/03	2002/03
EPS	13.58	9.34	3.96	5.8	4.46
CEPS	18.84	13.83	7.18	12.15	14.43
Book Value	67.86	35.17	23.5	32.48	23.3
Dividend/Share	0	0	0	0	0
OPM	59.49	57.68	45.19	47.18	56.66
RONW	18.77	26.34	16.86	17.9	19.2
Debt/Equity	0.29	0.52	0.44	0.79	1.01
Ratio	1.59	1.6	1.89	1.23	2.11
Interest Cover	13.53	11.2	6.56	5.02	6.41

Valuations

The company is well-geared to capitalize on the upturn in the media and entertainment industry through geographical expansion and entry into the high margin business of VFX and animation. At the current price of Rs 390 the stock trades at a P/E of 23.73x FY07E EPS of 16.43 and 13.89x FY08E EPS of Rs 28.06, which is well below the average media industry P/E of 16x. We rate the stock an OUTPERFORMER with a price target of Rs 468, an upside potential of 20% in the next 6 months.

Technical Outlook

The stock has formed a pennant pattern, which is uptrend continuation pattern. It has consolidated and is likely to make a sharp move upwards on breakout of the resistance. The stock has the potential to re-test new highs on the breakout with good volumes. The short-term stochastic indicator also signals a buy with the RSI and MACD indicators trading in accumulation zones. The stock has found support just above the 200-day EMA and the short-term averages have reversed.

ICICIdirect Research Desk

ICICI Brokerage Services Limited,
2nd Floor, Stanrose House,
Appasaheb Marathe Road,
Prabhadevi, Mumbai - 400 025
research@icicidirect.com