ENAM Securities
India Research

Rs 272
Target Price: Rs 350
Potential Upside: 29%

COMPANY REPORT

Zodiac Clothing

Relative to sector: **Outperformer**

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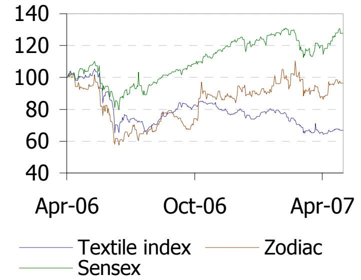
Relative Performance



Source: Bloomberg, ENAM Research

Stock data

No. of shares	: 8.4mn
Market cap	: Rs 2.4bn
52 week high/low	: Rs 342/ Rs 147
Avg. daily vol. (6mth)	: 10,100 shares
Bloomberg code	: ZDC IN
Reuters code	: ZCCL.BO

Shareholding (%)		Mar-07	QoQ chg
Promoters	:	60.9	0.0
FIIs	:	12.7	0.2
MFs / UTI	:	0.0	0.0
Banks / FIs	:	0.0	0.0
Others	:	26.4	(0.2)

An emerging branded retailer

- Zodiac Clothing Company Ltd (ZCCL), known for its premium formal menswear brand "Zodiac" is emerging as one of the fastest growing branded retailers in India. In FY06, the company generated Rs 2.1bn in revenue from two main divisions - local brands (~32% of sales) and exports (~68% of sales).
- The domestic menswear market at ~Rs 367bn grew by 12% CAGR in value terms for the last 2 years. In fact, the growth of premium menswear segment during the last 2 years, at 18% CAGR far exceeded that of the economy, and the low-end segment, which is at 11% CAGR. The fragmented nature of organized apparel brands with not a single mass-market brand reflects the potential brand-led opportunity .
- ZCCL has chalked out an aggressive plan to increase its retail presence and distribution through its own exclusive stores (currently 54 stores) and through national chain stores. The plan includes the roll-out of ~30 exclusive stores per annum for the next 3 years. We have forecasted branded sales to grow by 27% CAGR though FY06-FY09E.
- The management continues to focus on the premium end of the menswear export market, with low presence in the mass-market segment. Due to a greater emphasis and resource allocation to domestic retailing, we expect export sales to grow by 12% CAGR FY06-FY09E.
- Increasing contribution from the high margin brands business & improving store economics are expected to improve operating margins by 100bps over the next 2 years. We expect operating earnings and adj. PAT to grow by 32% and 39% CAGR respectively through FY06 – FY09E. At CMP (Rs 272) the stock is quoting at P/E 8.1x FY08E EPS of Rs 33.5 and EV/EBITDA 6.3x FY08E. We initiate coverage with a sector **Outperformer** rating.

Financial summary – Consolidated

Y/E Mar	Revenue (Rs mn)	Adj.PAT (Rs mn)	EPS (Rs)	Change YoY (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBIDTA (x)	DPS (Rs)
2006	2,220	126	15.1	51	19.0	13.5	17.5	12.4	5.0
2007E	2,644	210	25.2	67	10.0	19.9	23.9	7.3	6.0
2008E	3,103	280	33.5	33	8.1	22.7	26.3	6.3	8.0
2009E	3,572	340	40.7	21	6.7	23.3	28.1	5.0	9.5

Source: Company, ENAM estimates

Business Overview

Zodiac Clothing Company (ZCCL) Ltd has been in the premium formal menswear exports business for over 50 years. The business was promoted by Chairman Mr M Y Noorani in 1954. ZCCL was incorporated in 1984 and came out with an initial public offer in 1994. ZCCL entered the domestic menswear segment in the late 80s, with shirts and ties being the main focus area. Today ZCCL is an integrated design and marketing driven clothing brand with ~3500 employees across 16 office locations and 7 manufacturing units. In FY06, the company generated Rs 2.1bn in revenue from two main divisions – local brands (~32% of sales) and exports (~68% of sales).

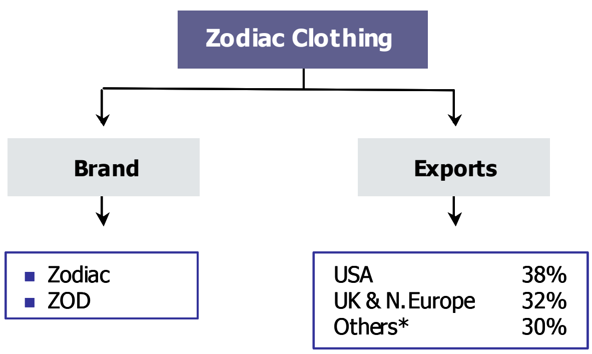
Apparel Brands (27% CAGR over FY06-FY09E)

The flagship brand "Zodiac" is now among the top 3 premium menswear brands in India. The company also introduced "Zod" a trendy and fashionable causal wear brand catering to the niche club wear segment. While shirts and trousers contribute ~80% of branded sales, accessories such as ties, cuff links, belts wallets, socks and handkerchiefs contribute the rest. The companies branded business continues to benefit from the aggressive roll out of owned stores, expansion of organized retail chains and a burgeoning middle class that has a high propensity to spend.

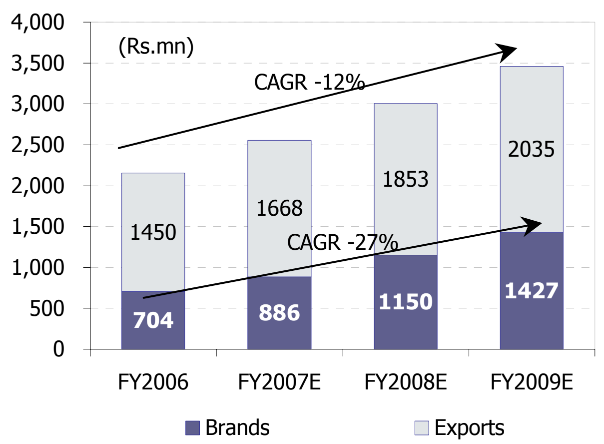
Apparel Exports (12% CAGR over FY06-FY08E)

ZCCL exports classic formal shirts largely constituting private labels i.e. customer brands and to a smaller proportion under the 'Zodiac' brand. The customer base includes premium brands and retail chains in the US, UK, Europe and the Middle East. Client concentration risk is low as no single client contributes in excess of 15% of export sales. ZCCL has manufacturing plants in India and Dubai, with total capacity of ~7.5mn pieces p.a. (7mn shirts + 0.5mn trousers).

ZCCL: Business Segments



ZCCL: Sales Trend



Source: Company, ENAM Research; *includes other European & Middle East countries

Sizing up the branded menswear market

India's apparel market is estimated at Rs 1,013bn (USD ~23bn) and represents 9% of the overall retail market (~USD 270bn). In fact, the share of apparel in organized retail (~USD 13bn) is much higher, at over 37%. The apparel market has been growing at 14.2% CAGR (Source: Images) in value terms for the last 2 years.

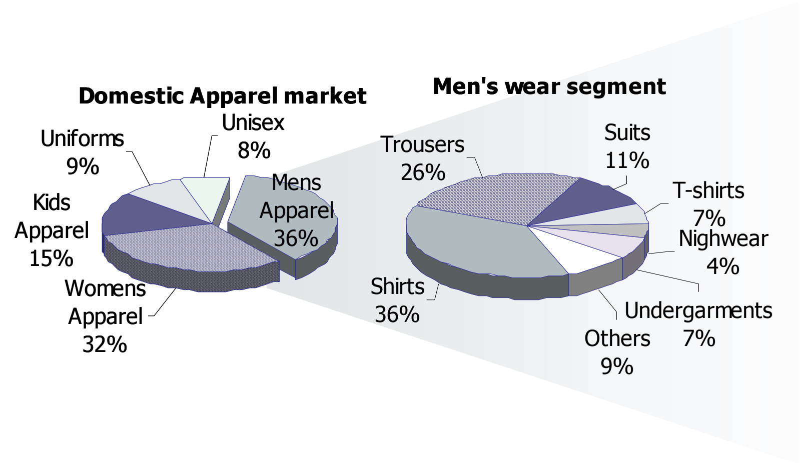
Apparel Retailing Trends – There is a visible shift in the apparel retail sector from traditional retailers and multi-brand outlets (MBO's) to organized retail chains and exclusive brand outlets. While malls are the largest growth driver for apparel retail in India, a large number of domestic and international brands have also adopted franchisee routes as this involves low level of investment. We have tried to analyze some of the key consumer trends that are driving consumer preference towards apparel brands.

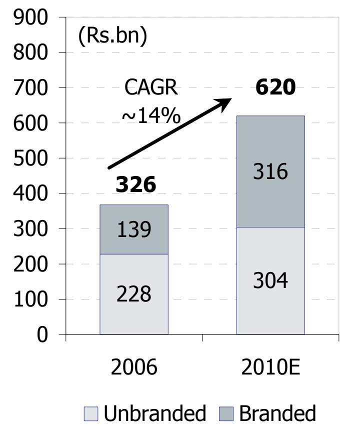
- **Changing consumer preference** from tailor-made to ready to wear (RTW). An estimated 61% of menswear category is now RTW.
- **Brands gaining share** - The RTW menswear category has both branded and unbranded players. The branded players share, currently at ~38% continues to gain over unbranded players, currently at ~62%. Quality, a reducing unbranded pricing differential, increase in design offerings and constant changes in offering are some of the reasons driving this gain.
- **Emerging brand loyalties** - Increasing brand consciousness and loyalty are emerging for apparel brands. Thus brands that are able to increase their category offering alongside promotions can scale up significantly. Globally strong brands that make category extensions have proven successful.
- **Increase in entry of international brands –** Renowned international brands (Benetton, Esprit, Tommy Hilfiger, Levi's, GAS, Benetton etc.) are continuing to enter key urban markets through strategic tie-ups or the franchisee route, thus creating an explosion of choice.

The Menswear Market (~Rs 367bn), with a value share of 36% of India's apparel market, remains the dominant category followed by womenswear (32%) and kidswear (17%). A closer look at the menswear reveals that the category grew by 12% CAGR in value terms over the last 2 years and the primary segments such as shirts, suits and trousers also followed similar growth pattern. We expect the menswear market to grow by 14% CAGR through FY06-FY10E, with branded share moving up from ~38% in FY06 to over 51% in FY10E. Branded apparel sales is expected to clock a growth over 22% CAGR in the next 4 years.

A closer look at the shirts and trouser segment reveals that growth in the premium segment continues to exceed that of the economy and the low-end segment. Customers upgrading to premium shirt brands are driving volumes and a large part of the value appreciation.

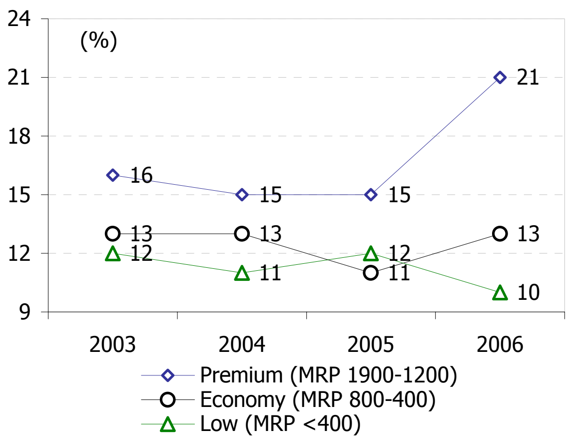
Indian Apparel Market..... **...& Growth in the Menswear Segment**

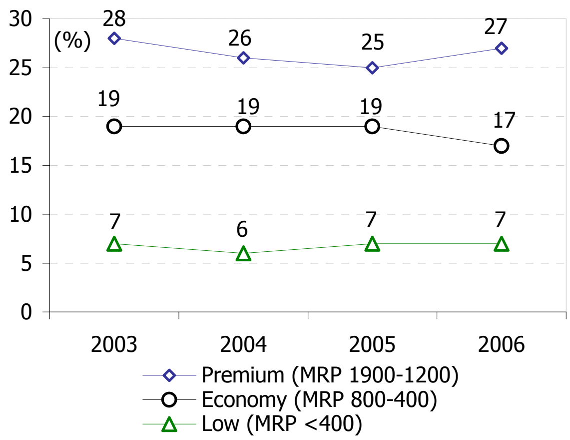




Source: Images, ENAM Research

Men's Shirts Growth trend **Men's Trousers Growth Trend**





Source: Images, ENAM Research

Competitive Landscape

Given the growth prospects and development of consumer base, branded retailers with strong brands and distinctive product offering will outstrip the market growth rate. While branded players such as Raymond's, Zodiac, Madura Garments, Arvind Brands have historical presence in the ready-to-wear segment, the market remains fragmented with the top two players commanding only 0.6% of the market and with only a handful of brands with sales turnover over Rs 1bn. The fragmented nature of organized apparel brands with not a single mass-market brand reflects the potential brand-led opportunity.

There has been an explosion in quality retail space in India, which creates a window of opportunity for apparel companies to scale up their branded retail presence. While low-end brands for the mass-market are likely to gain recognition in hypermarkets, the mid-upper-end brands catering to brand conscious customers, are likely to gain recognition through national chain stores and branded stores.

Competitive Brand Landscape

Category	Competing Brands
Men's formal wear - Premium	Louis Philippe, Manzoni, Arrow, Zodiac, Van Heusen
Men's formal wear - Mid-Low	Peter England, John Player, Indigo Nation
Men's casual Wear - Premium	Allen Solly, Crocodile, Lee, Pepe, Levis, ZOD, Wills Sport, ColourPlus ,Provogue
Men's casual Wear - Mid-Low	Parx, Oxemberg, Blackberry

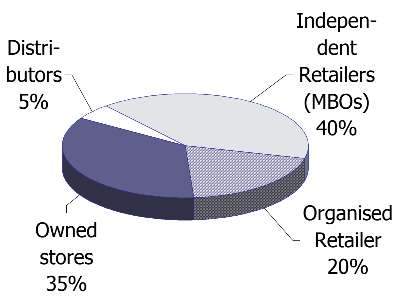
Source: ENAM Research

Brand Profiles

Zodiac - Zodiac is one of the oldest brands in the readymade menswear category in India. ZCCL started off as an exporting firm and launched the Zodiac brand in the domestic market in late 80's. Zodiac targets the executive class. It is focused on the traditional concept of premium formal wear with a high emphasis on quality and designing. The management does not intend to pursue a mass-market strategy. Zodiac also has also an impressive range of ties and it has captured a commanding position in that category.

ZOD – ZOD is a premium casual wear brand positioned as club wear and introduced in 2002. Its positioned in a niche category, targeted at the growing affluent urban class. It currently contributes less than 15% of ZCCL's overall branded sales.

ZCCL has 3 design offices located at the fashion capitals of the world - London, New York & Düsseldorf. It also has a 5000 sq. ft. design studio in Mumbai that employs over 15 trained designers. This enables ZCCL to predict design trends and forecast fashion for menswear lines, thus staying ahead of the curve in predicting trends.



Extending distribution reach – with greater aggression

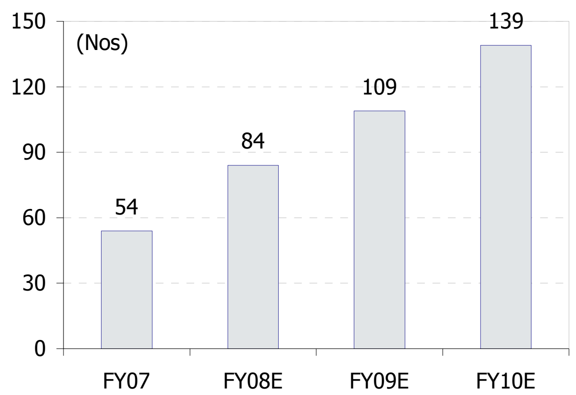
ZCCL retails its domestic apparel brands primarily through 3 distinct retail channels –

- Traditional **independent retailers** also known as the multi-brand outlets (MBO) estimated at ~1000 and contribute 40% of branded revenue. The management has consciously reduced the dependence on MBO's over the years (~55% in FY04). MBO retailers have had greater sales returns and extended receivable cycles.
- **Organized retailers** or national chain stores such as Shopper's Stop, Lifestyle etc contribute to 20% of branded sales.
- Exclusive **owned stores** for Zodiac and Zod. A total of 54 stores (FY07 end) spread across 25 cities in India, contribute approximately 35% of branded sales.

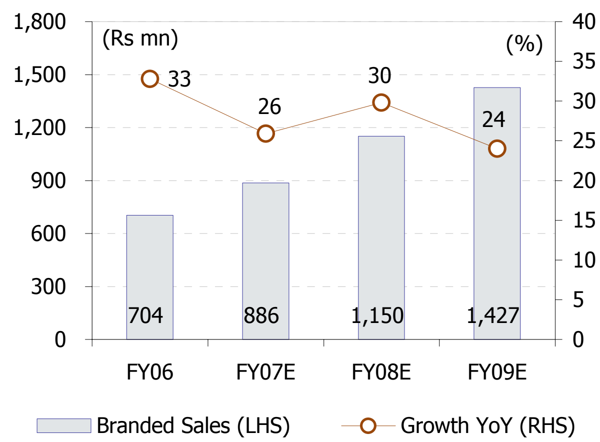
The management has not aggressively expanded its retail reach in the past. The dominance of MBO's and unavailability of quality retail space in Tier-I cities were the key reasons for the conservative approach. However this has now changed with the announcement of planned capital expenditure of Rs 200mn p.a. for the next 3 years to add ~30 exclusive stores every year. The retail stores will be company leased and directly managed by ZCCL. The company has signed agreements for ~67 stores with developers till date.

Zodiac is one among a few apparel brands from India that is retailed in international markets and it now is further strengthening its retail position by setting up exclusive overseas outlets. ZCCL plans to set up its first exclusive outlet in Dubai this year & then extend further into the European and US markets.

ZCCL: Planned owned store rollout



ZCCL: Branded Sales Trend



Source: Company, ENAM Research

We have forecasted branded sales to grow by 27% CAGR though FY06-FY09E. For the 9MFY07E, revenue growth from brands stood at 25% YoY. We believe growth from national chain stores and organized stores will be key incremental revenue drivers going ahead. The organized segment share of branded revenue is estimated to go up from 49% in FY07 to ~65% in FY10E. High store sales and better store economics from organized trade channels, will provide an impetus for operating margins to improve.

PLAYING ON THE NICHE IN APPAREL EXPORTS

ZCCL started exports of shirts & other accessories in the early 60's. In FY06, of the total Rs 1.5bn (68% of total sales) of ZCCL's export revenue, an estimated 69% by value and 80% by volume came from leading retailers and brands in the US, the UK and Europe. The management continues to focus on the premium end of the men's shirts and trouser export market, with low presence in the mass-market segment. An analysis of the average realizations for US importers of men's non-knit cotton shirts, reveals that ZCCL enjoys a premium realization of USD 8 per piece vs. average realization of USD 6 per piece.

ZCCL: Capacity (mn pcs)*

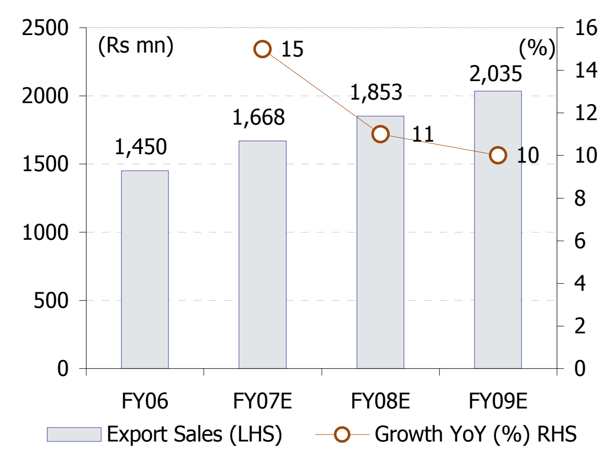
Location	Product	Capacity (mn pcs)
Umergaon	Shirts	0.7
Dubai	Shirts	2.0
Bangalore	Shirts	4.3
Umergaon	Socks	1.0
Bangalore	Trousers	0.5

Source: Company, *Includes the brown field expansion and newly acquired facilities.

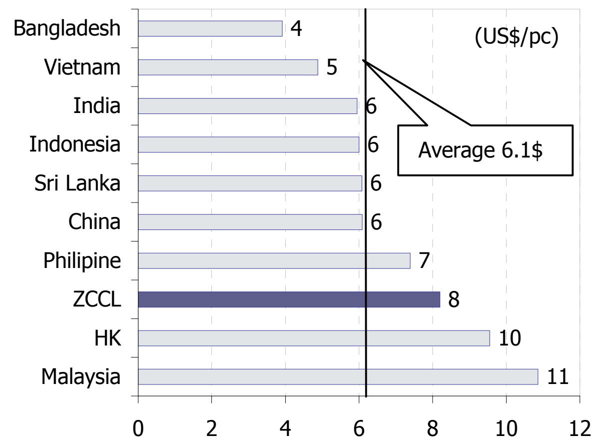
ZCCL's manufacturing capacities are located in India (5.5mn pcs) and Dubai (2mn pcs). Production for the domestic brands business is also undertaken from these capacities, but that requirement is only to the extent of 15% of total capacity. ZCCL through its subsidiary Zodiac clothing company (U.A.E) L.L.C acquired a shirt manufacturing facility in Dubai with a capacity of 2mn pcs p.a in 2005. We believe this provides a location advantage to ZCCL, as it is closer to large markets like the US and Europe leading to lower lead-time. While the current capacity utilization is at 90%, we believe further line additions will be required. Line addition at existing facilities could be expedited to address incremental demand. Further, the management could extend the overtime or increase the number of shifts (currently one shift) to increase production.

With greater emphasis on domestic retailing, we expect export sales to lag in growth terms at 12% CAGR FY06-FY09E. The EU and USA free trade agreement with U.A.E to allow duty free imports from Dubai could potentially provide a large export opportunity. In which case the management might decide to scale up the Dubai facilities. We have not factored this in our estimates.

ZCCL: Export Sales Trend#



US men's cotton shirt imports: Comparative Realization



Source: Company, ENAM Research, OTEXA Note: # growth trend in FY06 is not comparable due to the acquisition of Dubai facility.

RISKS & CONCERNS

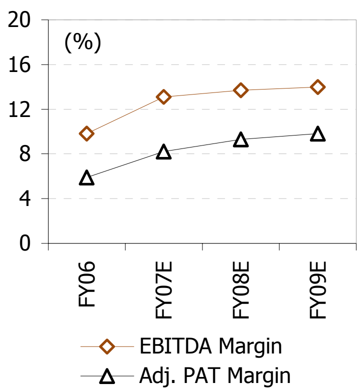
- **Execution Risk –** ZCCL has signed agreements for 67 stores with mall developers. However the rollout of the exclusive branded stores is dependent on the execution capability of the mall developer. Any significant delay in the rollout of malls could affect the revenue and earnings forecast. We have considered a 20% slippage in our forecast for exclusive store rollouts.
- **Service tax –** The recent imposition of service tax on rentals of commercial establishments, is likely to increase rental cost for retailers. ZCCL derives 29% of its branded revenue from leased exclusive stores. While managing such incremental cost in the interim term remain a challenge, ZCCL is trying to work out better terms with regard to service taxes, in order to share the burden.
- **Rupee appreciation –** Currently ~65% of the turnover is in US dollars. ZCCL takes complete forex cover on its exports, at the time of the order booking. An estimated 20% of the forex earnings get a natural hedge from dollar imports of raw materials. However a continued appreciation of the rupee against the dollar will lower export revenue in the short term. Considering the nature of the category exported, we believe pricing will adjust on new season order bookings. However pricing competitiveness has not deteriorated vs. competing exports from China, as the Yuan has also appreciated against the dollar by 5% YoY in the last one year.
- **Safeguard measures will be removed -** The existing safeguard provisions imposed by the US and EU on China's apparel imports will be removed in Dec 2008 and Dec 2007 respectively. This is expected to trigger a pricing competition between China's and India's apparel exporters, especially in the mass-market category. Note that EU region has not imposed safeguard measures on men's cotton apparel imported from China. Considering the premium category positioning of ZCCL's exports and the fact that a ~50% its exports are to the EU region, we expect only marginal pricing intensity in exports to the US, post the removal of these temporary restrictions.

Sales growth

Division (Rs.mn)	FY06	FY09E	CAGR (%)
Brands	704	1,427	27
Exports	1,450	2,034	12
Net Sales	**2,154**	**3,461**	**17**

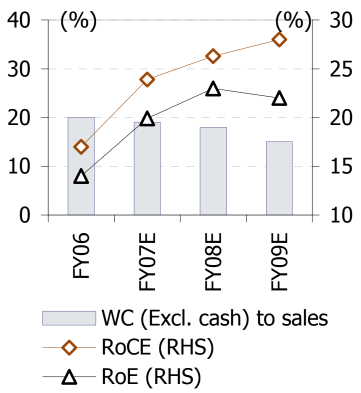
Source: Company, ENAM research

EBITDA margin & NPM trend



Source: Company, ENAM Research

Capital efficiency (%)



Source: ENAM Research

CONSOLIDATED FINANCIAL OUTLOOK

- **Revenue growth** is expected at 17% CAGR during FY06-09E. We believe growth from national chain stores and organized stores will be key incremental revenue drivers going ahead. We have forecasted branded sales to growth by 27% CAGR though FY06-FY09E. For 9MFY07E, revenue growth from brands stood at 25% YoY.
- **Margin drivers:** For the 9MFY07, the EBITDA margin of the standalone Indian operation (excluding apparel exports from the Dubai facility) expanded by 430 bps to 8%. Increasing contribution from the high margin brands business, improving store economics and improving utilization levels in the apparel export business are expected to further improve operating margins. We expect the consolidated EBITDA margin to settle at 13% for FY07E (vs.9.8% in FY06) and further improve by 100bps over the next 2 years.
- **Capex**: Zodiac has planned capex of Rs 400mn during FY08E to FY09E for owned store rollouts. This will be entirely funded through internal accruals and marginal working capital debt. The management expects new stores to break even within the first year of operations. ZCCL has maintained a low D/E at 0.3x in FY06, which could be useful for its renewed retail aggression.
- **Working capital management:** Working capital-to-sales at 20% in FY06 has been well contained over the years. Inventory at 2 months of sales, is likely to be maintained as we expect new exclusive stores to maintain similar level of inventory but with higher sales turns. Most of the new exclusive stores are located in malls that usually have higher footfalls and conversion ratios than standalone outlets. Debtor days at 40 in FY06, have also improved over the years as ZCCL has consistently reduced MBO retailers who have had greater sales returns and extended receivable cycles.
- **Earnings outlook:** We expect operating earnings and adj. PAT to growth by 32% and 39% CAGR respectively through FY06 – FY09E. ZCCL also holds strategic investment in Shoppers Stop, currently valued at Rs 677mn. At CMP (Rs 272) the stock is quoting at P/E 8.1x FY08E EPS of Rs 33.5 and EV/EBITDA 6.3x FY08E

Comparative Valuation

	Branded sales as % total of sales	Mkt Cap	RoE (%)	P/E (x)		EV/EBITDA (x)		DPS
Company	FY07E	(Rs bn)	FY07E	FY07E	FY08E	FY07E	FY08E	(Rs)
Raymond	16	21.0	6.0	28.0	21.0	10.2	8.4	6
Gokaldas Export	1	7.4	19.0	10.0	8.2	7.3	5.8	5
Zodiac Clothing	35	2.4	19.9	10.0	8.1	7.3	6.3	6
Kewal Kiran	94	2.4	22.0	13.0	11.0	6.5	4.1	2
Provogue	55	8.7	12.6	43.0	33.0	28.8	18.3	1

Source: ENAM Research Note: branded sales for Raymond includes worsted fabric sold though retail outlets.

Company Financials – Consolidated

Income statement

(Rs mn)

Y/E Mar	2006	2007E	2008E	2009E
Net sales	**2,154**	**2,554**	**3,003**	**3,461**
Other operating income	66	90	100	111
Total income	**2,220**	**2,644**	**3,103**	**3,572**
Cost of goods sold	1,536	1,680	1,973	2,281
Contribution (%)	0	0	0	0
Advt/Sales/Distrn O/H	473	628	718	808
Operating Profit	**211**	**335**	**413**	**483**
Other income	34	35	50	60
PBIDT	**245**	**370**	**463**	**543**
Depreciation	42	43	51	56
Interest	36	31	33	27
Other pretax	0	0	0	0
Pre-tax profit	**167**	**296**	**379**	**460**
Tax provision	41	86	98	120
(-) Minority Interests	0	0	0	0
Associates	0	0	0	0
Adjusted PAT	**126**	**210**	**280**	**340**
E/o income / (Expense)	7	6	0	0
Reported PAT	**134**	**216**	**280**	**340**

Key ratios

(%)

Y/E Mar	2006	2007E	2008E	2009E
Sales growth	**37.9**	**18.6**	**17.6**	**15.3**
OPM	**9.8**	**13.1**	**13.7**	**14.0**
Oper. profit growth	232.7	59.0	23.2	17.1
COGS / Net sales	69.2	63.6	63.6	63.9
Overheads/Net sales	21.3	23.8	23.1	22.6
Depreciation / G. block	5.1	3.7	3.9	3.8
Effective interest rate	15.9	10.0	10.0	10.0
Net wkg.cap / Net sales (x)	0.2	0.2	0.2	0.2
Net sales / Gr block (x)	3.5	2.6	2.5	2.5
Incremental RoCE	36.1	39.1	40.4	84.4
RoCE	**17.5**	**23.9**	**26.3**	**28.1**
Debt / equity (x)	29.8	29.2	24.0	13.2
Effective tax rate	24.6	29.0	26.0	26.0
RoE	**13.5**	**19.9**	**22.7**	**23.3**
Payout ratio (Div/NP)	31.3	23.2	23.9	23.3
EPS (Rs.)	**15.1**	**25.2**	**33.5**	**40.7**
EPS Growth	51.0	66.5	33.3	21.4
CEPS (Rs.)	20.2	30.3	39.7	47.5
DPS (Rs.)	**5.0**	**6.0**	**8.0**	**9.5**

Balance sheet

(Rs mn)

Y/E Mar	2006	2007E	2008E	2009E
Total assets	**1,281**	**1,492**	**1,687**	**1,827**
Gross block	836	1,146	1,306	1,466
Net fixed assets	639	906	1,015	1,119
CWIP	6	15	15	15
Investments	113	85	103	103
Wkg. cap. (excl cash)	438	479	541	514
Cash / Bank balance	84	7	13	74
Others/Def tax assets	0	0	0	2
Capital employed	**1,281**	**1,492**	**1,687**	**1,827**
Equity capital	84	84	84	84
Reserves	896	1,050	1,255	1,505
Borrowings	292	331	321	210
Others	9	28	28	28

Cash-flow

(Rs. mn)

Y/E Mar	2006	2007E	2008E	2009E
Sources	**269**	**303**	**275**	**228**
Cash profit	163	312	344	416
(-) Dividends	29	42	50	67
Retained earnings	134	270	294	349
Issue of equity	0	(0)	0	0
Borrowings	138	39	(10)	(111)
Others	(3)	(5)	(9)	(10)
Applications	**269**	**303**	**275**	**228**
Capital expenditure	332	319	160	160
Investments	(132)	(28)	18	0
Net current assets	60	88	92	7
Change in cash	9	(76)	5	61

Company, ENAM estimates

NOTES

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CONFLICT OF INTEREST DISCLOSURE STATEMENT

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