3QFY07 Results Update

SECTOR: TEXTILES

MOTILAL OSWAL

Arvind Mills

STOCK INFO.	BLOOMBERG
BSE Sensex: 14,283	ARVND IN
	REUTERS CODE
S&P CNX: 4,148	ARMI.BO

27 January 2007

Neutral

Previous Recommendation: Neutral

Rs59

Equity Shares (m)	209.4
52-Week Range (Rs)	114/47
1,6,12 Rel.Per. (%)	10/-33/-82
M.Cap (Rs b)	12.4
M.Cap (US$ b)	0.3

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A	15,964	1,272	6.1	-0.1	9.8	0.8	9.5	8.4	2.0	7.8
3/07E	16,691	300	1.4	-76.4	41.3	0.8	2.0	5.4	2.0	10.0
3/08E	18,258	821	3.9	173.3	15.1	0.8	5.3	5.8	1.7	8.6

- Arvind reported 3QFY07 results below our expectation with EBITDA declining by 23% YoY to Rs710m. This was significantly lower than our estimate of Rs893m mainly due to poor performance of the shirting and denim segments. EBITDA margins declined by 769bp to 15.8% v/s 23.5% in the corresponding period.
- Reported PAT included extraordinary income of Rs1b from sale of 60% stake to VF Corp. in the newly formed branded apparel JV (owns licensee brand rights for Lee, Wrangler, Nautica, Jansport and Kipling brands) and forex gains of Rs57m. Adjusting for these, the company reported losses of Rs20m.
- During 3QFY07, the shirting division reported 24% YoY decline in revenues to Rs618m v/s Rs811m in 3QFY06; the denim division reported a 12.3% YoY decline in revenues to Rs1.9b v/s Rs2.2b in 3QFY06.
- During 3QFY07, garments (including Arvind Brands sales) accounted for almost 31% of Arvind's revenues. Arvind plans to aggressively expand its garment manufacturing capacity from 12.7m/pieces p.a. in FY06 to around 42.2m/ pieces p.a. by FY09, to de-risk itself from the denim cycle.
- We are lowering our FY07 adj. PAT forecasts further by 44% to Rs300m from Rs541m earlier to factor in the continued worsening of denim scenario. The stock trades at a PER of 41.3x FY07 EPS of Rs1.4 and 15.1x FY08E EPS of Rs3.9 and enjoys a P/BV of 0.8x FY08E book value. We maintain **Neutral.**

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Sales	**4,204**	**4,280**	**3,902**	**3,578**	**3,546**	**3,932**	**4,479**	**4,628**	**15,964**	**16,141**
Change (%)	*7.1*	*1.0*	*-5.7*	*-18.8*	*-15.7*	*-8.1*	*14.8*	*29.4*	*-4.9*	1.1
Total Expenditure	**3,055**	**3,219**	**2,984**	**2,714**	**2,802**	**3,074**	**3,769**	**3,752**	**11,972**	**12,953**
EBITDA	**1,149**	**1,061**	**918**	**864**	**744**	**859**	**710**	**876**	**3,993**	**3,188**
Change (%)	*29.1*	*16.1*	*-5.1*	*-22.9*	*-35.3*	*-19.1*	*-22.7*	*1.4*	*10.2*	-20.2
As % of Sales	*27.3*	*24.8*	*23.5*	*24.1*	*21.0*	*21.8*	*15.8*	*18.9*	*25.0*	*19.8*
Depreciation	385	387	385	394	372	383	347	349	1,551	1,451
Interest	335	342	296	330	348	378	399	390	1,303	1,515
Other Income	67	77	21	60	48	6	27	32	225	112
Non Recurring Expense						-46	1068			1,068
PBT	**497**	**409**	**258**	**200**	**70**	**58**	**1,058**	**169**	**1,364**	**1,401**
Tax	45.9	37.2	23.8	-14.7	3.2	2.2	10.2	18.0	92.2	33.4
Effective Tax Rate (%)	*9.2*	*9.1*	*9.2*	*-7.4*	*4.6*	*3.8*	*1.0*	*10.7*	*6.8*	*2.4*
Reported PAT	**451**	**372**	**234**	**215**	**67**	**55**	**1,048**	**151**	**1,272**	**1,368**
Adj. PAT	**451**	**372**	**234**	**215**	**67**	**101**	**-20**	**151**	**1,272**	**300**
Change (%)	*147.9*	*84*	*-36*	*-59*	*-85*	*-73*	*-108*	*-30*	*-0.1*	-76

E: MOSt Estimates

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EBITDA margins decline sharply

Arvind reported 3QFY07 results below our expectations with EBITDA declining by 23% YoY to Rs710m, which was significantly lower than our estimate of Rs893m mainly due to poor performance of the shirting and denim segments. As a result, EBITDA margins declined by 769bp to 15.8% v/s 23.5% in 3QFY06. Arvind does not provide segmentwise performance details within the different textile segments such as denim, shirting, garments etc., hence it is not possible to provide segmentwise contributors for this sharp margin decline. Arvind's 3QFY07 results include revenues from Arvind Brands, which if excluded would have limited EBITDA margin drop during 3QFY07 to around 437bp.

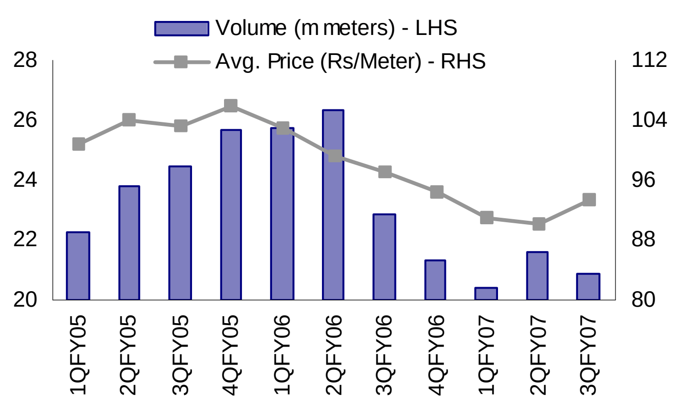
Extraordinary income props PAT

Reported PAT included extraordinary income of Rs1b from sale of 60% stake to VF Corp in the newly formed branded apparel JV (owns licensee brand rights for Lee, Wrangler, Nautica, Jansport and Kipling brands) and forex gains of Rs57m. Adjusted for these extraordinary items the company reported a loss of Rs20m in 3QFY07.

Domestic denim scenario continues to remain weak

Arvind reported 12.3 % YoY decline in denim revenues during 3QFY07. The outlook for denim has improved for the international market; however, outlook for the domestic denim industry continues to remain negative due to excess supply. The geographical sales mix for the company changed substantially during 3QFY07 from a ratio of 60% domestic and 40% exports in 3QFY06 to 70% exports and 30% domestic. Consequently the average realizations per meter also increased on a QoQ basis by 3.3% to Rs93.2/ meter.

QUARTER-WISE DENIM PERFORMANCE



Source: Company/ Motilal Oswal Securities

Restructuring plans for denim

Management firmly believes that the domestic denim industry is likely to remain depressed over the next 1-2 years, in spite of the robust 25-30% volume growth, due to the severe overcapacity situation. Hence, it is deliberating several strategies to de-risk it self from its high dependence on the denim segment. In this connection it has already announced plans to substantially increase its garment manufacturing facility from 12.7m/pieces in FY06 to around 42.2m/pieces by FY09. It is also shifting its focus from the domestic market and concentrating on the high-end exports market. Apart from these stated measures, management is also deliberating several other strategies for turning around its denim division. In this connection, one of the plans the management is seriously deliberating, is to shift a part of its denim manufacturing capacities to Bangladesh and Egypt, as these countries are the final destination for the bulk of Arvind's exports due to the concentration of garment manufacturing capacities in both these countries. However, these plans are still at the deliberation stage and not yet finalized. In our opinion, it would take Arvind another one to two quarters to stabilize its denim operations.

JV with VF Corp could yield Rs4b-Rs5b over 4-5 years

During 2QFY07, Arvind Mills formed a JV with VF Corp., the American apparel group, for sale of 60% stake in the newly formed company, for a consideration of US$33m. As per the agreement, brands licensed from VF Corporation were transferred to a new JV company VF Arvind Brands Pvt. Ltd., (VFABPL) effective September 2006. The brands transferred are Lee, Wrangler, Nautica, Jansport and Kipling. Arvind continues to own 40% of this company, which can be sold over the next 4-5 years, at a predetermined revenue-linked formula. In our opinion, this stake could yield close to Rs4-5b over the next few years.

Arvind's real estate value unlocking 3-4 years away

As per Arvind Mills' GDR document dated July 2005 the company owned close to 3,472,153 sq. meters (857 acres) of real estate in India and 283,553 sq. meters (70 acres) of leasehold land in India. Apart from this the company holds close to 5,863 sq. meters (63,039 sq. feet) of residential and office space across India.

Real estate holdings: Arvind holds almost 750 acres of land at Santej, Ahmedabad which is located around 20km away from the CBD area of Ahmedabad. Furthermore, the existing real estate is located in the industrial district, which the management believes can be converted for commercial and residential use. Out of the 750 acres of land, close to 250-300 acres is presently lying idle; and management does not see any near-term value unlocking possibility from this land. However, management believes that over the next 3-4 years as Ahmedabad city expands, the value for this property could increase significantly, providing the company an opportunity to unlock value from the land. In Arvind's FY06 annual report the value of its freehold and leasehold land already stood at Rs4.6b. Hence, a significant portion of Arvind's real estate holdings is already captured in Arvind's books, which is in sharp contrast to other textile companies such as Bombay Dyeing or Century Textiles, where the land value still appears at its historical cost in their annual reports.

LAND DETAILS

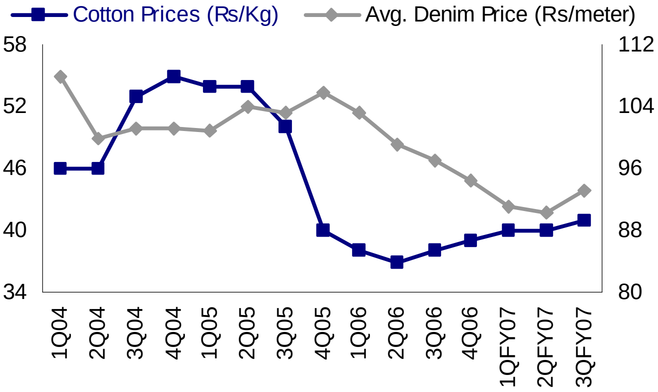
	FY02	FY03	FY04	FY05	FY06
Leasehold Land	1,611	1,608	1,608	1,584	1,753
Freehold Land	3,169	3,169	3,133	3,048	2,934
Total	**4,780**	**4,778**	**4,741**	**4,632**	**4,687**

Source: Company/ Motilal Oswal Securities

Cotton outlook

The average cotton price for Arvind in 3QFY07 stood at Rs41/kg. The cotton outlook looks weak in the near term due to production of a bumper crop in key cotton producing countries. Arvind mentioned earlier that they have already tied up cotton requirement until April 2007 hence the company would be further impacted by any decline in the present cotton prices.

COTTON PRICES V/S DENIM PRICE



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	
Total Investment	2,020	2,430

Source: Company/Motilal Oswal Securities

Focus on garments to increase

Management has stated that they do not have any strategy to address the prevalent problem in the short term, however, over the medium-to-longer-term, they hope to address this problem by aggressively increasing their garment manufacturing capacity and perhaps even relocating their plants to countries with large garment manufacturing operations such as Bangladesh. 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

PLANNED CAPACITY ADDITIONS IN THE GARMENT DIVISION

	CURRENT	ADDITIONS			TOTAL
	FY06	FY07E	FY08E	FY09E	(M PIECES)
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
Total	**12.7**	**7.5**	**14.0**	**8.0**	**42.2**

Source: Company/Motilal Oswal Securities

Valuations

We believe Arvind has hit a rough patch, as performance of its core business segment - denim - accounting for around 55%-60% of standalone revenues - is likely to remain under pressure over the medium term. Management expects the 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.

We are lowering our FY07 adjusted PAT forecasts further by 44% to Rs300m from Rs541m earlier, to factor in the continued worsening of denim scenario. The stock is trading at a PER of 41.3x FY07E EPS of Rs1.4 and 15.1x FY08E EPS of Rs3.9 and has a P/BV of .0.8x FY08 book value. We maintain **Neutral.**

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 decommoditized 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 a Rs2b capex plan in FY07
- Has formed a JV with VF Corporation and sold 60% stake in this company for US$33m

Valuation and view

- We believe Arvind has hit a rough patch, as performance of its core business segment - denim - accounting for around 55%-60% of standalone revenues - is likely to remain under pressure over the medium term.
- The stock trades at PER of 41.3x FY07E EPS and 15.1x 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	RAYMOND
P/E (x)	FY07E	41.3	14.3	13.8
	FY08E	15.1	11.5	11.4
P/BV (x)	FY07E	0.8	2.5	1.7
	FY08E	0.8	2.1	1.6
EV/Sales (x)	FY07E	2.0	1.0	1.3
	FY08E	1.7	0.8	1.2
EV/EBITDA (x)	FY07E	10.0	9.2	8.8
	FY08E	8.6	7.7	7.3

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoter	33.9	34.2	34.2
Domestic Inst	14.9	14.1	18.0
Foreign	22.5	26.9	23.6
Others	28.7	24.8	24.2

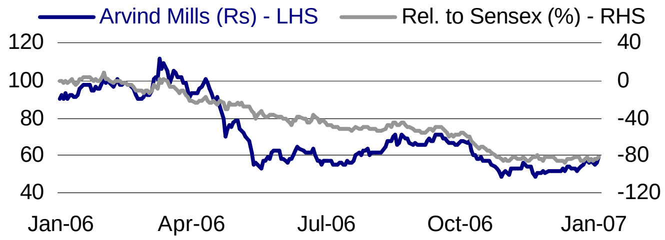
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	1.4	2.8	-49.9
FY08	3.9	4.0	-3.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
59	65	9.9	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	**16,789**	**15,964**	**15,900**	**18,258**	**20,717**
Change (%)	*17.0*	*-4.9*	*-0.4*	*14.8*	*13.5*
Raw Materials	6,199	5,749	5,978	6,718	7,375
Staff Cost	1,230	1,353	1,488	1,613	1,748
Other Mfg. Expenses	5,600	5,428	5,876	6,754	7,649
EBITDA	**3,886**	**3,989**	**3,188**	**3,596**	**3,895**
% of Net Sales	*23.1*	*25.0*	*20.1*	*19.7*	*18.8*
Depreciation	1,491	1,551	1,451	1,745	1,830
Interest	1,179	1,300	1,515	1,114	1,078
Other Income	76	225	112	175	175
PBT	**1,293**	**1,364**	**334**	**912**	**1,162**
Tax	20	92	33	91	139
Rate (%)	*1.5*	*6.8*	*10.0*	*10.0*	*12.0*
Reported PAT	**1,273**	**1,272**	**300**	**821**	**1,022**
Adjusted PAT	**1,273**	**1,272**	**300**	**821**	**1,022**
Change (%)	*31.3*	*-0.1*	*-76.4*	*173.3*	*24.5*

BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Equity Cap	**1954**	**2094**	**2094**	**2094**	**2094**
Share Capital	2,614	2,655	2,571	2,499	2,438
Reserves	10,198	12,665	12,936	13,733	14,496
Net Worth	**12,811**	**15,320**	**15,507**	**16,232**	**16,934**
Loans	16,824	18,414	19,264	18,414	17,964
Deffered Tax Liability	46	128	142	178	234
Capital Employed	**29,681**	**33,861**	**34,912**	**34,824**	**35,131**
Gross Fixed Assets	21,103	21,922	23,372	24,572	25,422
Less: Depreciation	7,286	8,826	10,278	12,022	13,853
Net Fixed Assets	**13,817**	**13,096**	**13,095**	**12,550**	**11,570**
Capital WIP	1,031	796	796	796	796
Investments	1,530	3,481	1,500	1,501	1,502
Curr. Assets	**16,016**	**19,373**	**22,514**	**23,395**	**25,128**
Inventory	5,112	4,793	5,300	5,993	6,663
Debtors	3,191	3,683	3,738	4,130	4,640
Cash & Bank Balance	129	96	117	257	259
Loans & Advances	7,585	10,801	13,359	13,016	13,566
Current Liab. & Prov.	**2,713**	**2,884**	**2,992**	**3,418**	**3,864**
Creditors	1,644	1,469	1,474	1,657	1,819
Other Liabilities	746	857	986	1,134	1,304
Provisions	324	451	532	628	741
Net Current Assets	**13,303**	**16,489**	**19,522**	**19,977**	**21,264**
Application of Funds	**29,681**	**33,861**	**34,913**	**34,824**	**35,132**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2008E
Basic (Rs)					
EPS	**6.1**	**6.1**	**1.4**	**3.9**	**4.9**
Growth (%)	*31.3*	*-0.1*	*-76.4*	*173.3*	*24.5*
Cash EPS	15.7	16.0	9.9	14.6	16.2
Book Value	62.2	70.5	71.8	75.6	79.2
DPS	1.0	1.0	0.0	0.0	1.0
Payout (incl. Div. Tax.)	17.5	18.8	0.0	0.0	23.4
Valuation (x)					
P/E	9.7	9.8	41.3	15.1	12.1
Cash P/E	3.8	3.7	6.0	4.1	3.7
EV/EBITDA	7.7	7.8	10.0	8.6	7.8
EV/Sales	1.8	2.0	2.0	1.7	1.5
Price/Book Value	1.0	0.8	0.8	0.8	0.7
Dividend Yield (%)	1.7	1.7	0.0	0.0	1.7
Profitability Ratios (%)					
RoE	10.9	9.5	2.0	5.3	6.3
RoCE	9.0	8.4	5.4	5.8	6.4
Turnover Ratios					
Debtors (Days)	67	83	78	78	78
Inventory (Days)	143	147	145	145	145
Creditors. (Days)	97	93	90	90	90
Asset Turnover (x)	0.6	0.5	0.5	0.5	0.6
Fixed Asset Turnover (x)	0.8	0.7	0.7	0.7	0.8
Leverage Ratio					
Debt/Equity (x)	1.4	1.2	1.3	1.1	1.1

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2008E
OP/(Loss) before Tax	1,293	1,364	334	912	1,162
Add: Depreciation & Amort.	1,491	1,551	1,451	1,745	1,830
Add: Interest Paid	1,179	1,300	1,515	1,114	1,078
Less: Direct Taxes Paid	3	28	20	55	84
Less: (Inc)/Dec in Wkg. Capita	-4,324	-3,218	-3,012	-314	-1,285
CF from Op. Activity	**-1,637**	**-538**	**-1,360**	**2,110**	**1,445**
CF after EO Items	**-1,637**	**-538**	**-1,360**	**2,111**	**1,447**
(Inc)/Dec in Fixed Assets & CW	-177	-1,054	-1,450	-1,200	-850
(Pur)/Sale of Invest.	66	1,951	-1,981	0	0
CF from Inv. Activity	**-1,326**	**-584**	**-1,450**	**-1,201**	**-850**
Issue of Shares	-35	2,479	0	0	0
Inc / (Dec) in Debt	3,270	1,590	850	-850	-450
Interest Paid	1,179	1,300	1,515	1,114	1,078
Dividends Paid	223	239	0	0	239
CF from Fin. Activity	**2,964**	**1,089**	**2,832**	**-770**	**-595**
Inc / (Dec) in Cash	**2**	**-33**	**21**	**140**	**2**
Add: Opening Balance	127	129	96	117	257
Closing Balance	**129**	**96**	**117**	**257**	**259**

E: MOSt Estimates

N O T E S

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

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