

Vardhman Textiles

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,482	MSM IN
	REUTERS CODE
S&P CNX: 3,081	MHSP.BO

22 May 2006

Buy

Previous Recommendation: Buy

Rs348

Equity Shares (m)	64.1
52-Week Range (Rs)	420/240
1,6,12 Rel.Per. (%)	10/3/-20
M.Cap (Rs. b)	22.3
M.Cap (US\$ b)	0.5

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	18,892	1,694	30.7	49.3	11.4	2.0	20.3	11.9	1.7	9.2
3/07E	23,050	1,797	28.0	6.1	12.4	1.7	14.8	10.4	1.6	9.0
3/08E	25,850	2,109	32.9	17.4	10.6	1.5	15.4	10.0	1.6	8.4

Only FY06 PAT is adjusted

- For 4QFY06, recurring PAT at Rs492m was higher than our expectation of Rs476m. Adjusted PAT stood at Rs762m for the quarter, buoyed by extraordinary items of Rs270m. Revenues increased marginally by 4% to Rs4.9b v/s our estimate of Rs5.5b.
- Other income included extraordinary items of Rs270m, sourced from profits from sale of investments and surplus real estate near Chandigarh.
- EBITDA margins improved by around 90bp YoY to 16.9%, due to better performance of the yarn segment, which accounted for around 67% of total revenues.
- EBIT margins in the yarn segment improved smartly by 729bp to 15%. However, they declined sharply across all other business segments: fabric EBIT margins dropped 900bp YoY, sewing thread EBIT margins declined 520bp YoY while the steel segment reported 1076bp YoY decline.
- Management indicated the fabric division is likely to remain under pressure in 1QFY07 but expect it would stabilize 2QFY07 onward.
- The stock trades at 12.4x FY07E and 10.6x FY08E earnings. We maintain **Buy** with a price target of Rs400.

QUARTERLY PERFORMANCE										(Rs Million)
Y/E MARCH	FY05				FY06				FY05	FY06
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Sales	4,130	4,783	4,835	4,761	4,221	4,596	5,127	4,948	18,509	18,892
Change (%)	16.6	17.1	5.2	-	2.0	-3.9	6.0	3.9	7.7	2.1
EBITDA	674	716	733	764	783	853	958	836	2,885	3,430
Change (%)	11.4	24.0	-0.2	-	16.0	19.2	30.7	9.5	9.9	18.9
As % of Sales	16.3	15.0	15.2	16.0	18.5	18.6	18.7	16.90	16	18
Depreciation	251	248	248	224	251	251	267	244	970	1,013
Interest	172	181	123	116	112	98	91	93	591	395
Other Income	42	58	70	102	12	27	56	120	273	214
Extra-ordinary Income	0	0	0	0	0	0	0	270	0	270
PBT	294	346	433	526	431	531	656	888	1,597	2,506
Tax	115	100	120	54	142	132	143	127	389	543
Effective Tax Rate (%)	39.2	28.9	27.7	10.3	33	24.8	21.7	14.3	24.4	21.7
Reported PAT	179	246	313	472	290	399	513	762	1,208	1,963
Adj. PAT	179	246	313	472	290	399	513	492	1,208	1,693
Change (%)	23.3	43.9	5.5	-	62.0	62.5	64.2	4.2	31.2	40.2

*E: MOST Estimates; * Standalone numbers not merged*

Extraordinary income props PAT

Adjusted PAT increased by 61% YoY to Rs762m in 4QFY06, due to one-time extraordinary income of Rs270m. For FY06, PAT stood at Rs1.9bm, an increase of 63% YoY. Other income at Rs390m in 4QFY06 included extraordinary items of Rs270m, arising from profits due to sale of investments and surplus real estate near Chandigarh. During 4QFY06, the company sold: (1) around 0.3m equity shares of Vardhman Holdings and 0.5m equity shares of Mahavir Spinning; (2) 6 acres of surplus real estate near Chandigarh.

Segmental results analysis

During 4QFY06, Vardhman's revenues increased marginally by 3.9% YoY, led by 18% YoY increase in sewing thread business and 43% YoY increase in the fabric division. EBIT margins in the yarns segment improved smartly by 729bp to 15%. However, EBIT margins declined sharply across all other business segments: fabric EBIT margins declined 900bp YoY, sewing thread EBIT margins declined by 520bp YoY, while the steel segment reported a 1076bp YoY decline.

SEGMENTAL RESULTS 4QFY06 V/S 4QFY05 (RS M)

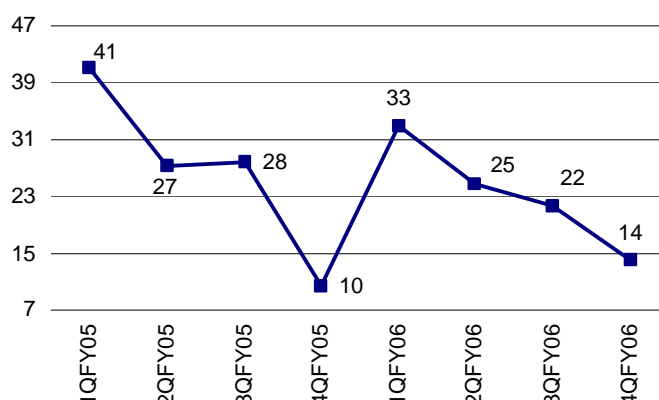
PARTICULARS	4QFY06	4QFY05	CHG. (%)
Revenues			
Yarns	3,305	3,339	-1
Sewing Thread	830	704	18
Steel	699	775	-10
Fabric	975	682	43
Less: Inter Segment Revenue	861	739	17
Total	4,948	4,761	4
EBIT			
Yarns	479	241	99
Sewing Thread	63	90	-30
Steel	122	219	-44
Fabric	79	117	-32
Total	743	666	12
EBIT (%)			
Yarns	15	7	101
Sewing Thread	8	13	-41
Steel	17	28	-38
Fabric	8	17	-53

Source: Company

Lower tax provisioning, going forward

Vardhman's investments of around Rs3.5b in its yarn and processed fabric plants at Baddi in Himachal Pradesh will attract fiscal benefits over the next few years. The company is eligible for tax breaks under Section 80IC for the incremental capex at Baddi, provided incremental investment is more than 50% of its existing plant's gross block. The upside on account of these tax savings would be even higher if the company moved its incremental production to these plants. We have assumed that the company will retain the tax benefits, which in turn would boost its bottomline.

TAX RATES HAVE DECLINED (%)



Source: Company

Value added sales to increase

Vardhman's brownfield capex has increased its fabric capacity to 40m-42m meters in FY06, from 25m meters in FY05. The company is further embarking on a Rs1.9b greenfield project that would expand its fabric capacity substantially by December 2007. It has already acquired land in Madhya Pradesh for this purpose. It intends to increase its fabric weaving and processing capacity from 42m meters to 85m meters and a corresponding increase in its spindle capacity by 180,000 spindles. This will significantly improve the company's prospects and positively impact its margins. The sewing thread business, higher ring frame utilization and productivity are likely to drive FY07 growth.

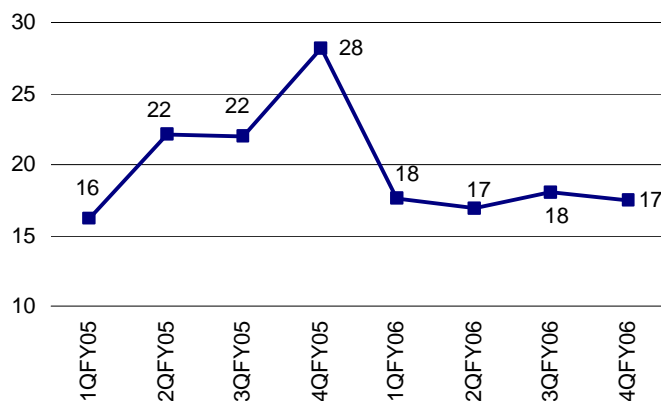
Strong growth in sewing thread business

Vardhman has been witnessing strong growth in its sewing thread business on the back of increased demand from the garment industry in the post quota period. During 4QFY06, the sewing thread segment reported a robust 18% YoY growth in revenues. Vardhman is the second largest player in the sewing thread business and is well placed to capture the potential growth prospects in this segment, in the post quota period.

Steel business stabilizing

Vardhman's steel business reported a 1,076bp YoY decline in EBIT margins to 17% in 4QFY06. We believe the steel division's margins have stabilized at current levels. Our model already accounts for this squeeze in the steel business. We have estimated steel business EBIT to be at 16% in FY07E and 15% in FY08E.

EBIT MARGINS HAVE STABILIZED (%)



Source: Company

Valuation and view

We expect Vardhman's sales and earnings to witness a CAGR of 17% and 6%, respectively, over FY06-08E. We expect margins in the yarns, fabric and sewing threads business to expand, as upstream products would benefit substantially from the surge in demand from downstream industry (garment industry). Hence, we have a bullish view on upstream companies such as Vardhman Textiles. The stock trades at 12.4x FY07E and 10.6x FY08E earnings. We maintain **Buy** with a price target of Rs400, an upside of 15%.

Vardhman Textiles: an investment profile

Company description

Vardhman Textiles is the flagship company of one of the most respected textile groups in India. It has a large spindlage capacity and is the second largest sewing thread player in India. The company stands to gain substantially from the strong increase in demand from the domestic downstream sector and the robust export market. In our opinion, Vardhman is all set to emerge as one of the most cost competitive textile companies globally by virtue of its large scale capacities, world class facilities and diversified product mix.

Key investment arguments

- ✍ De-risked business model.
- ✍ Superior management quality.
- ✍ Poised to reap benefits of expansion.

Key investment risks

- ✍ Commodity nature of its business.
- ✍ Steel contribution to decline.
- ✍ New capacities to go on stream only in FY08.

Recent developments

- ✍ Has declared dividend of 40% for FY06 on an expanded equity capital of Rs577m.
- ✍ Is eligible for tax breaks under Section 80IC for the incremental capex at Baddi.

Valuation and view

- ✍ Is expanding weaving and processing capacity.
- ✍ We model revenues to post 17% CAGR over FY06-FY08E; earnings likely to register 6% CAGR over FY06-FY08E.
- ✍ We rate the stock a **Buy** with a price target of Rs400.

Sector view

- ✍ Exports from China are likely to be severely constrained due to safeguard measures 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

		VARDHMAN.SPG	WELSPUN	GOKALDAS
P/E (x)	FY07E	12.4	11.5	12.8
	FY08E	10.6	9.4	11.2
P/BV (x)	FY07E	1.7	1.1	0.9
	FY08E	1.5	1.0	0.9
EV/Sales (x)	FY07E	1.6	1.7	1.7
	FY08E	1.6	1.4	1.5
EV/EBITDA (x)	FY07E	9.0	7.8	7.4
	FY08E	8.4	6.5	7.6

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	62.2	62.2	67.7
Domestic Institutions	12.4	11.8	13.4
FII's/FDIs	6.4	5.1	2.4
Others	19.0	20.9	16.4

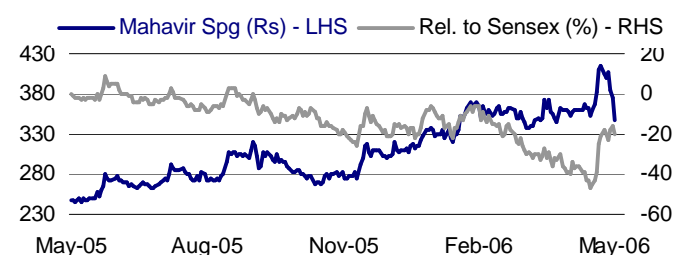
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	28.0	31.0	-9.5
FY08	32.9	38.4	-14.4

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
348	400	14.9	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E					
Net Sales	17,185	18,509	18,892	23,050	25,850					
Change (%)		7.7	2.1	22.0	12.1					
Total Expenditure	14,724	17,126	15,461	17,999	20,201					
EBITDA	2,617	2,885	3,430	4,140	4,834					
Change (%)		10.2	18.9	20.7	16.8					
% of Net Sales	15	15.6	18.2	18.0	18.7					
Depreciation	997	970	1,013	1,369	1,619					
EBIT	1,953	1,915	2,417	2,770	3,215					
Interest & Finance Charges	696	591	395	575	615					
Other Income	333	273	214	200	250					
Non-recurring Items/ Income	0	0	270	0	0					
PBT	1,257	1,597	2,506	2,395	2,850					
Tax	344	389	543	599	741					
Effective Rate (%)	27.4	24.4	21.7	25.0	26.0					
Reported PAT	913	1,208	1,964	1,797	2,109					
Change (%)		32.3	62.6	-8.5	17.4					
Adjusted PAT	913	1,208	1,694	1,797	2,109					

BALANCE SHEET						(Rs Million)				
Y/E MARCH	2004	2005	2006E	2007E	2008E					
Equity Capital	385	385	641	641	641					
Share Capital	385	385	641	641	641					
Reserves	6,605	7,542	10,784	12,215	13,959					
Net Worth	6,990	7,927	11,424	12,856	14,599					
Loans	9,014	8,164	10,914	15,464	18,464					
Deferred Tax Liability	1,043	1,092	1,240	1,360	1,508					
Capital Employed	17,047	17,182	23,578	29,679	34,571					
Gross Fixed Assets	14,437	14,887	20,387	27,387	32,387					
Less: Depreciation	6,468	7,465	8,507	9,877	11,496					
Net Fixed Assets	7,969	7,421	11,879	17,510	20,891					
Capital WIP	132	132	132	132	132					
Investments	964	925	925	925	925					
Curr. Assets	9,432	10,324	12,328	12,931	14,546					
Inventory	5,962	6,822	6,759	7,417	8,325					
Sundry Debtors	1,918	2,260	2,414	2,850	3,196					
Cash & Bank Balances	267	98	1,612	580	316					
Loans & Advances & Other Curr	1,285	1,144	1,544	2,084	2,709					
Current Liab. & Prov.	1,448	1,620	1,687	1,818	1,923					
Sundry Creditors	316	349	339	403	455					
Other Liabilities	925	1,073	1,020	1,050	1,103					
Provisions	207	198	329	365	365					
Net Current Assets	7,984	8,704	10,641	11,112	12,623					
Application of Funds	17,047	17,182	23,578	29,679	34,571					

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Basic (Rs)					
EPS	14.3	18.9	30.7	28.0	32.9
Cash EPS	29.8	34.0	42.3	49.4	58.2
Book Value per Share	109.1	123.8	178.4	200.7	227.9
DPS	4.7	4.5	4.5	5.0	5.0
Payout (Incl. Div. Tax) %	22.6	17.4	19.4	20.3	17.3
Valuation (x)					
P/E		18.5	11.4	12.4	10.6
Cash P/E		10.2	8.2	7.0	6.0
EV/EBITDA		10.5	9.2	9.0	8.4
EV/Sales		1.6	1.7	1.6	1.6
Price to Book Value		2.8	2.0	1.7	1.5
Dividend Yield (%)		13	13	14	14
Profitability Ratios (%)					
RoE	13.1	16.2	20.3	14.8	15.4
RoCE	13.4	11.2	11.9	10.4	10.0
Turnover Ratios					
Debtors (Days)	41	41	45	45	45
Inventory (Days)	147	145	150	150	150
Creditors (Days)	13	13	14	15	15
Working Capital (Days)	170	172	206	176	178
Asset Turnover (x)	1.0	1.1	0.8	0.8	0.7
Fixed Asset Turnover (x)	1.2	1.2	0.9	0.8	0.8
Leverage Ratio					
Debt/Equity (x)	1.29	1.03	0.96	1.20	1.26

CASH FLOW STATEMENT						(Rs Million)				
Y/E MARCH	2005	2006E	2007E	2008E						
PBT before E.O. Items	1,597	2,506	2,395	2,850						
Add : Depreciation	970	1,013	1,369	1,619						
Less : Direct taxes paid	437	445	479	593						
Incl/Dec in WC	763	423	1,502	1,776						
CF from operations	1,366	2,651	1,784	2,101						
Minority Int. & Share of Associate Profits	0	0	0	0						
CF from Oper. incl. EO Items	1,366	2,651	1,784	2,101						
(Incl)/Dec in FA	-450	-5,500	-7,000	-5,000						
(Pur)/Sale of Investments	-39	0	0	0						
CF from investments	-489	-5,500	-7,000	-5,000						
Incl/Dec in Networth	0	1,942	0	0						
Incl/Dec in Debt	-850	2,750	4,550	3,000						
Less: Dividend Paid	198	329	365	365						
CF from Fin. Activity	-1,048	4,363	4,185	2,635						
Incl/Dec of Cash	-170	1,514	-1,032	-264						
Add: Beginning Balance	267	98	1,612	580						
Closing Balance	98	1,612	580	316						



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Vardhman Textiles

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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 |

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