MICROSCOPIC VIEW ON CINEMA

PVR Cinemas: Light, Camera & Action

Initiating Coverage

Date: 23rd July, 2008

Saurabh.rana@smcindiaonline.com

Recommendation: Buy

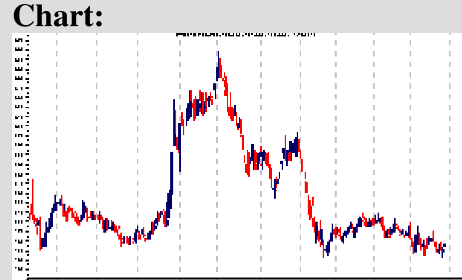
1 year target price: INR 235

2Year target price: INR 317

Vital stats:

CMP (INR)	**175**
BSE Code	532689
52 wk H/L	376/160
Sensex	14942
Nifty	4477

Chart:



Key Ratio:

Key Indicators	2010 E
BV/Shares	113
P/B x	1.54
ROE	15%
P/E x	10.26
EPS	17.34

Investment Argument

- **Robust sectoral outlook:** Improved content, organized rules of financing, increasing participation of corporates, removal of piracy via digitization and robust ancillary revenues will augur well for Film Industry. We believe national wide presence, higher ATPs through PVR Premiere and reduction in ETT in Delhi will be earning accretive for the PVR Cinemas.

- **Owning value chain**: PVR is de risking the business model by backward integrating in the film value chain. We believe backward integration will allow players like PVR to have complete control over content plus exposure to ancillary revenues like (satellite rights to DTH, IPTV). In Indian context, due to fragmentation tendency is to transfer the risk to next link in to value chain rather than to manage overall risk effectively. The stated malady can be avoided in case of integrated players like PVR Cinemas

- **Value unlocking- PVR Pictures:** PVR Cinemas has diluted 40% stake in its wholly owned subsidiary to raise INR 120 crore. The funds would enable the parent firm PVR to become a fully integrated film and Entertainment Company with interests across the entire value chain including production, distribution and exhibition. Management believes to unlock value for the shareholder by listing this subsidiary next year. We value PVR Pictures at INR 136 per share.

- **Management bandwidth:** Management bandwidth and execution capabilities are biggest differentiators for PVR. Strength of management is evident from its strategic organizational plans like focusing on bigger cities, bigger theatres and occupying the right catchments areas like Ambience mall (Gurgaon). We believe at current times of falling occupancy rates above actions will maintain momentum in ATPs.

- **Robust financials:** We expect PVR revenues and PAT are slated to grow 36% and 38% CAGR over next two years at stable EBITDA margin of 20%. Above growth can be attributable to rising advertising revenues, lower ETT in Delhi, greater properties in ETT exemption and lower content cost going forward.

- **Valuation:** Based on SOTP methodology we value PVR Cinemas at INR 317 per share. PVR Cinemas valuation worked out INR 235 per share (38% upside) whereas PVR Pictures valuation (60% stake) worked out INR 82 per share.

PVR Cinemas

Income Statement (Figures in crore INR)

Particulars	2006	2007	2008	2009F	2010F
Operating Income	128.3	198.3	274.50	370.58	500.28
Net operating income	102.9	164	235.6	321.50	438.29
Other Income	3	7.8	9.16	5	5
Total Income	105.9	171.8	244.76	326.50	443.29
Distributor share	27.1	44.2	60.95	77.16	105.19
Consumption of F&B	7.1	11.4	15.79	21.33	28.79
Personal expense	12.1	19.2	24.71	33.76	46.02
ESOPs	0.7	0.2	0	0	0
Operating expense	39.6	63.5	89.49	127.14	173.20
Operating margin %	**16%**	**16%**	**19%**	**19%**	**19%**
EBITDA	**19.3**	**33.3**	**53.82**	**67.11**	**90.09**
EBITDA Margin %	**18%**	**19%**	**22%**	**21%**	**20%**
Depreciation	7	12.4	15.1	17.68	20.38
Interest	3.2	5.4	6.82	9.24	9.20
PBT	**9.1**	**15.5**	**31.9**	**40.19**	**60.51**
Tax expense	3.5	4.6	10.81	13.65	20.61
PAT	**5.6**	**10.9**	**21.09**	**26.54**	**39.90**
PAT Margin %	**5%**	**7%**	**9%**	**8%**	**9%**
Outstanding shares	2.2	2.3	2.301	2.301	2.301
EPS	***2.32***	***4.30***	***8.84***	**11.32**	**17.34**

PVR Cinemas

Balance sheet (Figures in crore INR)

Particulars	2006	2007	2008	2009 F	2010 F
Share capital	42.8	43	33	23	23
ESOPs	0.29	0	0	0	0
Reserve and Surplus	149.6	157.3	176.19	200.53	238.23
Loan Funds	61.3	60	95	105.00	115.00
D.T.L	4.6	6.4	6.4	6.4	6.4
Total Liabilities	**258.59**	**266.7**	**310.59**	**334.93**	**382.63**
Fixed Asset	136.2	153	174.01	198.36	220.02
Intangible asset	0.35	0.6	0.6	0.6	0.6
Investment	30.9	62.9	62.9	31.5	31.5
Net current asset	**91.09**	**50.14**	73.08	104.46	130.50
Miscellenous expenditure	*0*	*0*	0	0	0
Total Asset	**258.54**	**266.64**	**310.59**	**334.93**	**382.63**

- *Debt schedule is as per Management guidance*
- *Investment in JV Cineplex is factored in FY 2009*

SMC Global Securities Ltd

Cash flow statement (Figures in crore INR)

Particulars	2006	2007	2008	2009	2010
Cash flow from Operating Activities					
Profit before tax	9	15.5	31.9	40.19	60.51
Depreciation and amortization	7	12.4	15.10	17.68	20.38
Loss on sale of asset	0.25	0.12	0	0	0
Interest income	-1.3	-3.3	0	-5	-5
Profit on sale of current investment	0	-0.02	0	0	0
Loss on sale of current investment	0.003	0	0	0	0
Dividend income from current investment	-0.3	-2.6	-5	0	0
Interest expense	3.2	5.4	6.82	9.24	9.20
ESOPs	0.7	0.29	0	0	0
Provision for doubtful debt	0.16	0.2	0	0	0
Provision for pre operative expense				0.37	0.37
Operating profit before working capital changes	**18.713**	**27.99**	**48.82**	**62.48**	**85.46**
Movement in working capital					
(Increase) in sundry debtors	-0.5	-2.8	-1.57	-2.58	-3.50
(Increase) in inventories	-0.24	-0.83	-0.66	-0.86	-1.17
(Increase) in loan and advances	-10.2	-12.2	-41.46	-31.48	-56.58
(Decrease)/Increase in current liabilities and provision	7.6	3.4	30.60	15.80	30.68
Cash generated from operation	15.373	15.56	35.74	43.37	54.89
Less: Direct tax	-2.1	-3.7	-10.81	-13.65	-20.61
Net cash from operation	**13.273**	**11.86**	**24.93**	**29.72**	**34.29**
Cash flow from Investing Activities	**-166.24**	**6.646**	**-37.41**	**-6.01**	**-37.41**
Purchase of fixed asset	-56.4	-28.9	-42.41	-42.41	-42.41
Purchase of investment	-72.2	-302	0	-10	0
Sale of investment	43.9	270.1	0	41.4	0
Loan given to subsidiary	-23.2	-28.8	0	0	0
Loan refunded by subsidiary	0.9	29.8	0	0	0
Dividend received	0.3	2.6	5	0	0
Interest received	0.63	3.9	0	5	5
Fixed deposit with bank placed	-62.3	-1	0	0	0
Fixed deposit with banks encashed	2.2	61.3	0	0	0
Cash flow from Financing Activities	**146.1**	**-13.6**	**15.98**	**-11.44**	**-1.4**
Proceed from issuance of equity	148.4	0.3	0	0	0
Proceed from long term borrowing	36	10.5	35	10	10
Repayment of long term borrowing	-20.1	-11.8	-10	-10	0
Dividend and tax thereon	0	-6.9	-2.2	-2.2	-2.2
Interest paid	-5.9	-5.7	-6.82	-9.24	-9.2
Net increase in cash	**-6.87**	**4.91**	**3.50**	**12.27**	**-4.52**
Opening balance	8.1	1.23	6.14	9.64	21.91
Closing balance	1.23	6.14	9.64	21.91	17.39

.

- **Robust sectoral outlook:** We continue to have bullish stance on Indian Entertainment Industry (IEM). In the past it has almost grown double the pace of GDP growth and robust growth of 19% CAGR can be achieved backed by advertising and subscription revenue growth. Though advertising revenues can slow down due to economy slowing but subscription growth will still register a growth of 22% due to structural changes like digitization of cable distribution and removal of inefficiencies across value chain in Film Industry. Film industry will observe paradigm shift due to corporatisation, organized rules of financing, booming home video entertainment market, healthy overseas market and emergence of multiplexes. Multiplexes will be eventual beneficiary with strong expected revenue growth and improved return on their investment.

PVR Nation wide presence: PVR Cinemas expected to further strengthen its presence in Metros say Delhi, Mumbai and Chennai. By 2009, PVR will have 23 screens in Delhi, 28 in Mumbai (7 screens will get operational in Q2 2009, 6 screens will get operational in Q1 2009, 4 screens in Q3 2009) and 7 screens in chennai (Operation in Q4 2009). PVR Cinemas nation wide presence will enable it to enjoy higher bargaining power against distributors and producer. *Nation wide presence clearly reflects in terms of PVR contribution to overall net box office collection of key movies.*

Net box office collection

Figure in mn, INR	PVR	All India	% Contribution
Jodha Akbar	68	548	12%
Race	59	580	10%
Sunday	20	179	11%
Mithya	15	55	27%
Halla Bol	11	94	12%
	173	**1456**	**12%**

** Net box office revenue earned by Industry as on 27 th April*

Source: Quarterly result, Q4 -2008

Entertainment tax exemption:

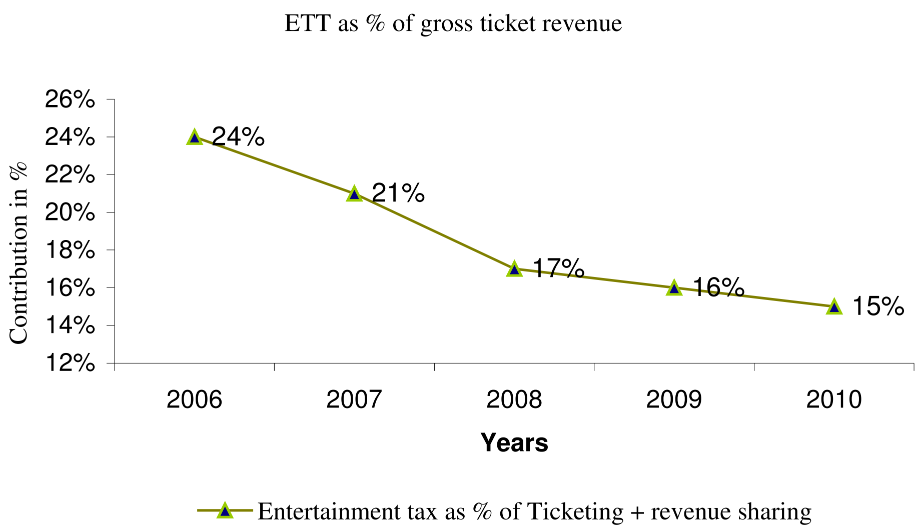
Entertainment tax takes away a proportion of gross ticket sales for multiplex operators. In order to encourage investment in multiplexes, many States exempt multiplexes from the tax, if they meet certain conditions such as offering certain number of tickets at a low entry price or screen regional films, for instance. Multiplex chains, too, have begun to target these States for their expansion, to avail of the exemption. Multiplexes in the Delhi and NCR region are not, however, entitled to such an exemption and the tax rate was steep, at 30 per cent. PVR, which has several multiplexes in the region, has, therefore, traditionally borne a higher entertainment tax incidence compared with its peers. **About 25 per cent of its screens are still located in Delhi, even after a rapid addition of properties**.

18% of projected screens 2009 of PVR Cinemas will be in Delhi

The Delhi Government's move to reduce the entertainment tax on cinema to 20 per cent from 30 per cent earlier will benefit multiplexes in the city. PVR, in particular, which has a dominant screen presence in Delhi, will stand to gain.

Out of 41 new screens planned by PVR 11 are in E Tax exemption zone

PVR Cinemas



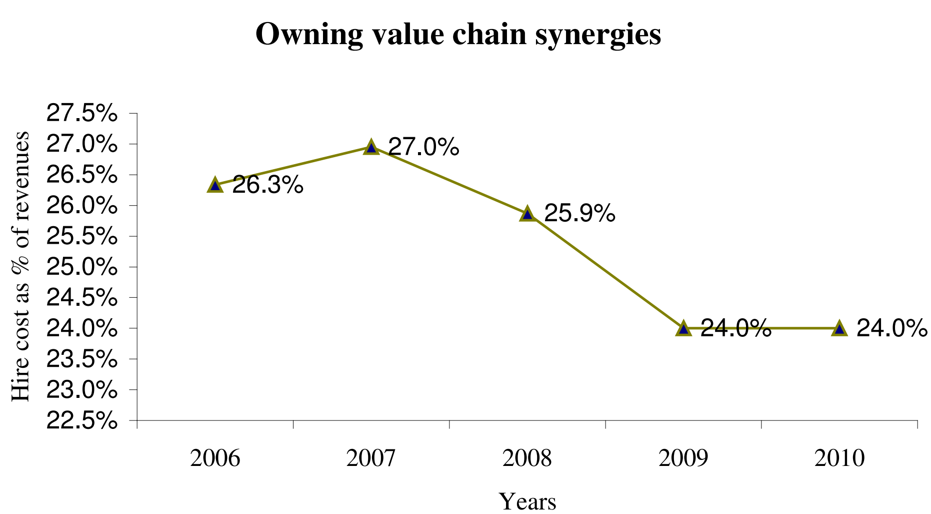
Source: SMC research

Due to incidence of lower ETT in Delhi plus greater properties at entertainment exemption will result in lower ETT as % of gross ticketing revenues.

• **Owning Value Chain :**In Indian context, due to fragmentation tendency is to transfer the risk to next link in to value chain rather than to manage overall risk effectively. Film producer used to make films as per their own fancies and used to sell to distributors who in turn were responsible for marketing of films to cine goers. To avoid above malady exhibitors like PVR Cinemas have successfully ventured into PVR Pictures. The expansion into the production and distribution business through PVR Pictures will create further synergy for the group by leveraging its exhibition circuit. **It plans to increase its film output to 8-10 next year from 4-5 this year.**

<u>Positive affect of owning value chain on hire cost</u>

PVR Cinemas



Source: SMC research

As evident from above graph by owning the value chain PVR Cinemas hire cost as % of net operating income will fall from current 25.9% to 24% by 2010. This fall in hire cost will result in stable EBITDA margin in future.

- **Value unlocking in PVR Pictures:**

ICICI Venture, JP Morgan to invest Rs 120 crore in PVR:

PE Firms valued PVR Pictures at INR 300 crore

JP Morgan and ICICI Venture will each invest Rs 60 crore in PVR Pictures. This transaction will enable the parent, PVR, to become a fully integrated film and entertainment company with interests across the entire value chain including production, distribution and exhibition.

PVR Pictures: Management believes that topline for PVR Pictures will grow at 100% CAGR over next 2 years. This topline will further be augmented with expected film output of 8-9 films per years.

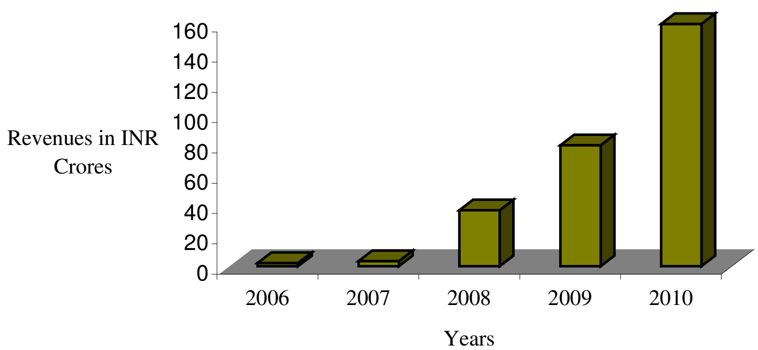
PVR Cinemas

Consolidated revenues(INR,Crore)	2006	2007	2008	2009F	2010F
PVR Cinemas	102.9	164	235.6	321.50	438.29
PVR Pictures	2.1	3.4	37	80	160

Source: SMC research

Based on above one can conclude that by 2010, PVR Pictures will generate roughly revenues equivalent to 37% of PVR Cinemas and 27% of consolidated revenues.

PVR Pictures



Source: SMC research

Assumption:

- Sudden jump in expected revenues in PVR pictures is also due to change in accounting policy. Prior production release revenues like Tare Zameen Par, Jaane Tu Ya jaane na are being reported in Aamir Khan productions and only profit share are being represent ed in EBITDA. Going forward, revenues from production release will be reflected in PVR Pictures books of account.

- PVR Pictures will follow a portfolio approach in production. Production business is highly risky hence margins (both operating and profit) is difficult to compute or predict.

• Valuation for PVR Pictures

BALANCE SHEET- PVR Pictures (INR, Crore)

Balance sheet	2006	2007	2008	2009 F
Share capital	1.5	1.5	1.5	2.5
Reserve	-0.18	0.1	0.86	119.86
Liabilities	1.1	11.8	11.8	11.8
Total	**2.42**	**13.4**	**14.16**	**134.16**
Investment				100
Cash				34.16
Total asset	**2.4**	**13.4**	**14.16**	**134.16**

Source: SMC research

Valuation based on book value:

Based on Price to book we valued PVR Pictures at INR 244 per share. Here we have assumed PBV multiple of .5 times which is at steep discount to average PBV of Mukta Arts for last 4 year. The reason for discount in PBV is on account of new business line, inherent risks and lower experience in production.

Management is looking to unlock value in its subsidiary i.e. PVR Pictures by end of next year

Valuation based on Cash:

Based on cash per share (CPS) we valued PVR Pictures at INR 136. To support its film output, Company is expected to incur capital expenditure of INR 100 crore hence cash balance of INR 34.16 in FY 2009.

Treading on side of conservatism, we valued PVR Pictures at INR 136 per share.

- **Management Bandwidth:**

We believe that management bandwidth and execution ability are the biggest differentiators for PVR. Ajay Bijli, the promoter, has more than 15 years of experience in the exhibition business including his stint at the

Singapore/Australia based multiplex chain Village Road show. Besides this, PVR's management is one of the strongest, as seen from it's much faster than peers' project execution capability.

Management Structure

50% independency in the board

Management Structure	Post	Experience
Ajay Bijli	M.D, Executive	Mr. Bijli has more than 15 years of experience in the film exhibition industry.
Sanjeev Kumar	Joint M.D,Executive	Mr. Kumar has been involved with PVR since its inception and has over 10 years of experience in the film exhibition industry
Sumit Chandwani	Executive	Mr. Chandwani has 13 years of experience in the areas of private equity, structured finance and project finance.
Vikram Bakshi	Independent	Has extensive experience spanning 25 years in diverse businesses like real estate, hospitality and retail.
Amit Burman	Independent	Director on the board of companies such as Dabur India Limited, Dabur Foods Ltd. and Excelcia Foods Pvt. Ltd.
Mr Renaud Jean Palliere	Independent	International experience in the petrochemical and telecommunications industries

Source: PVR Cinemas, Website

Strength of management is evident from its following strategic organizational plans

Focused on Bigger Properties: Management gives paramount importance to theatre capacity rather than screen counts. Bigger theatres with additional movie experience will result in stable or increasing ATPs even at lower occupancy rate.

Examples of bigger theatres that PVR are opening up are as follows:

Phoenix mills, Lower parel will house 1965 seats
Ambience Mall, Gurgaon will house 1194 seats
Oberoi Mall, Goregaon, Mumbai will house 1819 seats

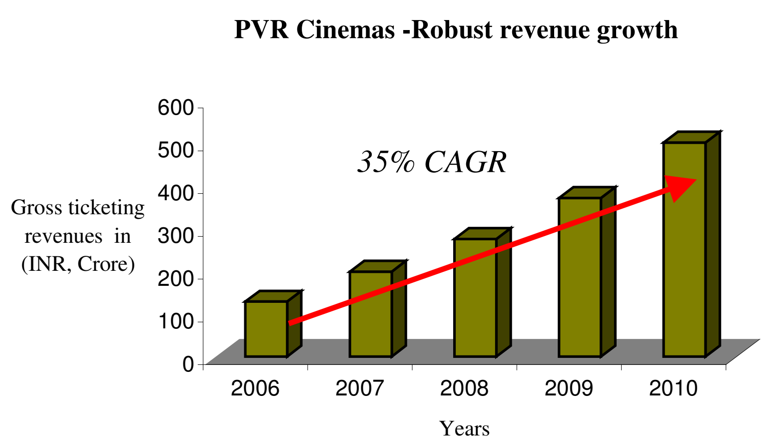
Right catchments Areas:
Management believes pace of execution and occupying the right catchment areas are the key success parameters in the multiplex business. Given Management pedigree occupying right catchments areas will not be daunting task given increasing competition. Bigger theatres will further leverage the management abilities to occupy right catchments area.

Ambience Mall in Gurgaon is perfect example of occupying right catchments areas. It is located next to Gurgaon Toll bridge in one of Asia's biggest mall (1 km shopping distance on each floor)

Slow on PVR Talkies: Last year under PVR Cinemas had launched a new brand of cinema called 'PVR Talkies' to cater the demand of the cinema viewing public in class B & C cities at a lower price range of Rs. 40 to Rs. 60 for an enhanced movie viewing experience. The first of PVR Talkies multiplexes were opened at Aurangabad and Latur in the state of Maharashtra. PVR Talkies, Latur boast of 3 screens and 1136 seats where as PVR Talkies, Aurangabad boast of 3 screens and 1156 seats. But given lower ATPs and rising supply of real estate has made management to go slow on PVR Talkies. We believe exhibition growth will be mostly be seen in top 15 to 16 cities hence going slow on expansion in Tier III cities will be value accretive in long term.

- **Strong financials: PVR Cinemas**

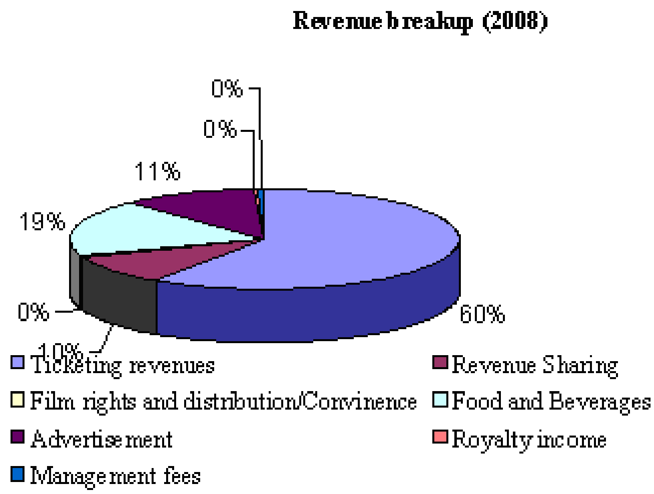
Robust revenue growth

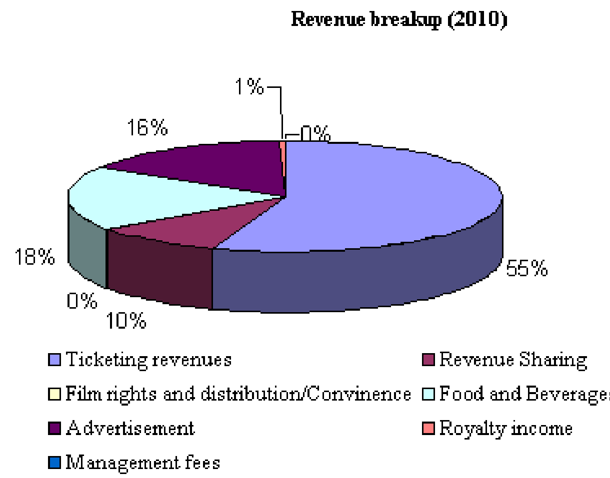


Source: SMC research

As mentioned in above graph, gross ticketing revenues are expected to grow up at 35% CAGR over next two years. We believe advertisement revenues will grow up at **60% CAGR over next two years based on company's plan to monetize ad spaces as well as cinema premises**. Advertisement contribution to gross ticketing revenues will grow from 11.10% in 2008 to 15.59% by 2010.

PVR Cinemas (Revenue break up)





Source: SMC research

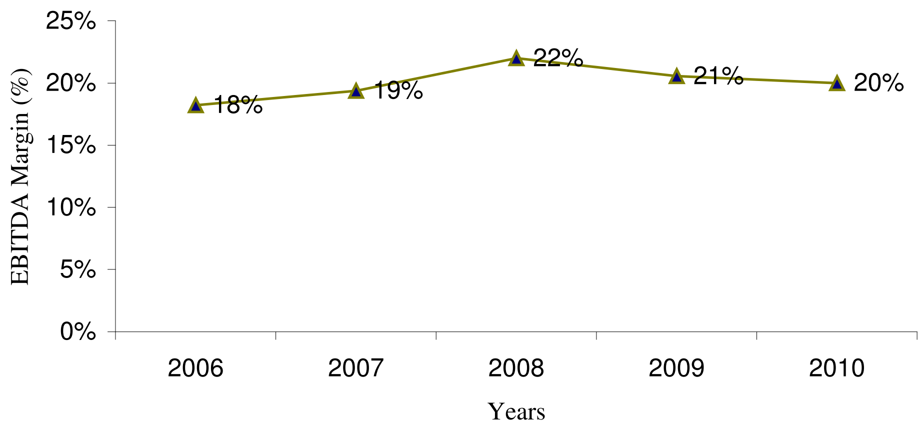
Stable EBITDA Margin:

PVR Cinemas EBITDA Margin will remain stable backed by following drivers:

- **Hire cost as % of revenues:** Due to springing of various production houses, bargaining power will gradually shift to exhibition players like PVR Cinemas in terms of lower hire cost.

- **Rental Charges:** We believe rental expense as % of net operating income will remain constant. We believe looking at inherent strength of multiplex sector; higher rental will be passed on to cinegoers in terms of higher average ticket prices. Currently rental expenses are 12.43% of net operating income.

Robust operating margins- PVR Cinemas

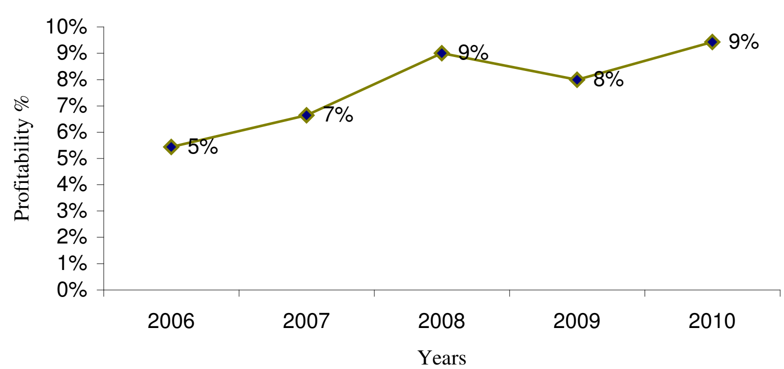


Stable PAT Margins:

PVR Cinemas expected to touch 175 screen counts by 2010:

PVR cinemas expected to operate 31 new screens in FY 2009 and 49 new screens in FY 2010. We believe to achieve above screen count, company must incur capex of INR 85 crore by 2010 partially through debt and rest through sale of investment.

Profitability for PVR Cinemas



- VALUATION: We value PVR Cinemas through SOTP (sum of total part) methodology

SOTP (in INR)	317
PVR Cinemas	235
PVR Pictures	81

Valuation for PVR Cinemas: Globally exhibition industry is valued at 1.5-2 times EV/Sales. We valued PVR Cinemas at 1.5 times to FY 2010 Revenues and after deducting expected debt of INR 115 crore in FY 2010 **we arrive at valuation of INR 235 per share.**

Relatively, stock is quoting at 20 PER on trailing basis. Looking at forward earning, stock is attractively valued at 15 times FY 2009 EPS and 10 times FY 2010 EPS.

Valuation for PVR Pictures: JP Morgan and ICICI Venture will each invest Rs 60 crore in PVR Pictures. Based on cash per share (CPS) we valued PVR Pictures at INR 136**.** To support its film output, Company is expected to incur capital expenditure of INR 100 crore hence cash balance of INR 34.16 in FY 2009. Post dilution to PE players, equity share capital will go up from INR 1.5 crore to INR 2.5 crore (2009) with face value of INR 10 each and PVR cinemas will represent only 60% interest in PVR Pictures. Hence PVR Picture is valued at INR 81 post factoring in PE Player stake of 40%.

Hence long term investor (Investment horizon=2 years) can invest with price target of INR 317.

Valuation for the Sector

Particulars	M CAP(INR)	EPS (INR)	EBITDA (%)	ROCE (%)	PE
ADLABS	1876.8	10.9	48.19%	6.30%	37.43
Cinemax India	243.6	2.9	25.70%	11.35%	30.00
Inox leisure	439.2	4.3	26.70%	10.86%	16.74
PVR	400.2	8.78	17%	8.30%	19.82
Fame India	136	3.84	35.65%	10.27%	10.42

Despite of inherent strength, multiplex sector continues to be heavily reliant on film content to fuels their expanding screen counts. Hence during times of no releases exhibition revenues suffers heavily as in 1Q 2009 when IPL was in its full colour. **Exhibition begins to realize that control over quality content is must to fuel its screens plus capturing ancillary revenues**. Hence we are bullish on players like PVR Cinemas with strong growth in ATPs, increasing screen counts and increasing control on film content through PVR Pictures.

Annexure 1: Revenue Model for a Multiplex operator

Key performance indicator	
Number of screens	5
Number of seats	1300
Occupancy rates	45%
ATP	135
Number of shows per day	4.3

Number of shows per day will go up with fall in average length of movie

Figures in INR

Revenue Model	INR Crore	%
Ticket sales	12.40	75%
Food and Beverages	2.5	15%
Other Income	1.7	10%
Total Income	**16.60**	
Entertainment tax	0	0
Distributors share	4.3	26%
Employee cost	1.5	9%
Lease rentals	1.9	11%
Other administrative expense	2.3	14%
Food and Beverages	1.1	7%
EBITDA	**5.50**	**33%**
Depreciation	0.6	
EBIT	4.90	
ROCE (%)	**58%**	

Excellent operating margins

Excellent return on capital

Capital Employed	
Capex per seat(in INR)	65000
Seats	1300
Total Capex(INR Crores)	8.45

Excellent ROCE means further capex by organized players

** In above revenue model ETT assumed to be nil.*

Annexure 2: Business Model for Multiplex players

PVR Premiere ATP stands between INR 150-175

- Bargaining power of buyers:

A) Cinegoers prefers movie watching experience over average ticket prices
B) Standalone theatres are rapidly get converted into multiplexes
C) In short, consumer has low bargaining power

PVR Cinemas got into movie production through Tare Zamen Par

- Bargaining power of suppliers:

A) Greater number of studios will reduce up content cost for multiplexes
B) Value chain integration will reduce up bargaining power of content suppliers
C) Corporatisation will force financiers to provide capital at lower rates

- Competitive forces:

A) Indian market is highly under screened
B) Exhibition sector is highly unorganized
C) Only 7 listed players are available with highest market capitalization stand at (INR 2200 Crore- Adlabs)

Film Industry has been accorded with Industry status recently in 2000

- Entry and exit barriers:

A) Lower capex requirement (capex per seat stands at INR 65000)
B) No entry barriers
C) No exit barriers

Moser Baer DVD s offering content at cheap prices

- Availability of substitutes:

A) Indians love movies
B) Home video growth might affect theatrical revenues
C) DTH still is in nascent stage

Based on porter analysis one can conclude that multiplex operators are on strong footing to enjoy higher earning visibility at stable operating margins.

SMC Global Securities Ltd

Institutional Research Team

Rajesh Jain	Head of Research	rajeshj@smcindiaonline.com	09910165092
Saurabh Rana	Head - Fundamentals	saurabh_rana@smcindiaonline.com	09958028787
Harsh Gupta	FMCG/Textile	harsh_gupta@smcindiaonline.com	09810771175
Arun Gupta	Financial Services	arun_gupta@smcindiaonline.com	09811612948
Preeti Saxena	Media/ Telecom	preeti_saxena@smcindiaonline.com	09971101753
Dipti Paliwal	IT/Retail/Midcaps	diptipaliwal@smcindiaonline.com	09910018869
Rakesh Bansal	Technical Analyst	rakeshbansal@smcindiaonline.com	09999110065

Derivative Team

Dr.Ravi P.Singh	Head Strategist	ravisingh@smcindiaonline.com	09810313561
Nitin Murarka	Head Strategist	nitinmurarka@smcindiaonline.com	09971402111

Institutional Sales Team

G.Venkatramani	Executive Director	vramanig@smcindiaonline.com	9870510383
S.Ramakrishna	Head – Institutions	r.k@smcindiaonline.com	9892420601
Vipul Sharma	Asst.Vice President	vipul.sharma@smcindiaonline.com	9833131144
Jignesh Kanani	Sr.Manager	jignesh@smcindiaonline.com	9870204561
Chintan Pancholi	Dealer	chintan_p@smcindiaonline.com	9821777523

Institutional Desk: 15th Floor, A Wing, Mittal Tower, Nariman Point, Mumbai 400 021. Tel. Nos. 91 022 2029355/56

Corporate Office: 17, Netaji Subhash Marg, Darya Ganj, New Delhi 110 002. Tel No. 011 30111000 (30 Lines).

NOTES