Prabhudas Lilladher

Koutons Retail India

Spreading its wings

May 26, 2008

Rating	**BUY**
Price	Rs740
Target Price	Rs1,140
Implied Upside	54.1%
Sensex	16,650

(Prices as on May 23, 2008)

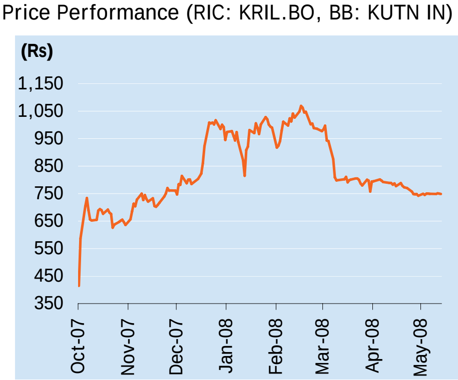
Trading Data	
Market Cap. (Rs bn)	22.9
Shares o/s (m)	30.6
Free Float	33.4%
3M Avg. Daily Vol ('000)	35.2
3M Avg. Daily Value (Rs m)	28.9

Major Shareholders	
Promoters	66.6%
Foreign	21.3%
Domestic Inst.	8.4%
Public & Others	3.7%

Stock Performance

(%)	1M	6M	12M
Absolute	(3.7)	2.2	NA
Relative	(0.9)	15.7	NA

Price Performance (RIC: KRIL.BO, BB: KUTN IN)



Source: Bloomberg

- **Aggressive expansion continues:** Company increased number of stores from 687 in FY07 to 1,175 in FY08. It is looking to expand the store count to 1,800 in FY09 and 2,300 in FY10. This would entail expansion of space from 0.88m sq ft in FY08 to 1.45m sq ft in FY09 and 2m sq ft in FY10.
- **Robust growth:** Company sold about 19.2m apparels in FY08, up from 9.2m apparels in FY07. It is targeting about 30m apparels in FY09 and about 40m apparels in FY10. Average realization price was Rs450 per apparel.
- **New drivers of growth:** Company recently entered into womenswear and kidswear with Koutons Les Femme and Koutons Junior. It would open 100 exclusive stores of each in FY09, and would open 150 Koutons Junior and 200 Les Femme stores in FY10. It would also introduce men's accessories like innerwear, women's accessories like handbags and kids' accessories, besides introducing shoes in FY09. This would help in increasing average sales per store. It would also focus on its recently acquired Upper Class range of womenswear by enhancing relationships at MBOs and open exclusive stores.
- **Entry into Middle East:** Company plans to enter Middle East by tying up MBOs to place Koutons range in FY09. It would be opening 50 exclusive stores of Koutons there in FY10.
- **Financials:** Factoring in 6% equity dilution in FY10, we estimate EPS of Rs35.8 in FY09E and Rs57.0 in FY10E. At CMP of Rs740, the stock is trading at 20.7x FY09E & 13.0x FY10E. We maintain BUY rating on the stock with price target of Rs1,140 (20x FY10E and PEG of 0.3)

Key financials (Y/e March)	FY07	FY08	FY09E	FY10E
Revenue (Rs m)	4,024	7,935	12,101	17,328
Growth (%)	*154.1*	*97.2*	*52.5*	*43.2*
EBITDA (Rs m)	692	1,526	2,340	3,536
PAT (Rs m)	345	691	1,092	1,846
EPS (Rs)	12.6	22.6	35.8	57.0
Growth (%)	*(52.3)*	*79.3*	*58.1*	*59.4*
Net DPS (Rs)	—	—	—	—

Source: Company Data; PL Research

Profitability & valuation	FY07	FY08	FY09E	FY10E
EBITDA margin (%)	*17.2*	*19.2*	*19.3*	*20.4*
RoE (%)	*37.6*	*26.1*	*26.0*	*27.2*
RoCE (%)	*19.8*	*16.5*	*16.6*	*19.0*
EV / sales (x)	5.5	3.3	2.2	1.6
EV / EBITDA (x)	32.0	17.2	11.6	8.1
PE (x)	58.7	32.7	20.7	13.0
P / BV (x)	12.4	6.2	4.8	2.7
Net dividend yield (%)	—	—	—	—

Source: Company Data; PL Research

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Q: Can you please elaborate our business model and a brief history of the company?

A: Koutons Retail India is a New Delhi based integrated apparel manufacturing and retail company. We are in the business of designing, manufacturing and retailing apparel under our brands Koutons and Charlie Outlaw, through a network of 1,175 EBO's (exclusive brand outlets) across India. We have captured a niche in apparel retailing by setting up a large number of retail outlets and offering good quality products at reasonably price. These outlets have become one of the largest integrated men's apparel retail chain in India and caters to the entire range of men's apparel. We have also recently launched a new range of women's wear and kid's wear under brands Les Femme and Koutons Junior respectively.

We started as a partnership firm, M/s. Charlie Creations, with a single manufacturing unit (having a capacity to manufacture approximately 20,000 pieces of apparel per annum) in Delhi in 1993. Charlie was a popular brand in North India, and we sold mainly denims through MBO's till 1997. Post '97 Chinos and Khakis were in fashion and denim went into a recession. So we launched a new brand - Koutons to sell chinos and khakis. Initially Koutons was sold through wholesalers & MBO, since we could not give our complete range in MBO and number of other reasons, we decided to set up our own EBO in 2002 and completely stopped supply to MBO. Charlie was still sold through MBO at that time. We stopped the supply Charlie in MBO's in October 2006 and started our own EBO's in Charlie also.

Our business model revolves around enhancing procurement and selling efficiencies through economies of scale. We target to meet aspirations of huge middle class by providing apparels at affordable price, by being available where our consumers are.

Q: What is our average stores size? What is the sales per sq ft?

A: Our average store size for Koutons is about 800 to 1,000 sq ft per store and Charlie Outlaw is about 500 to 700 sq ft per store. Sales per sq ft in Koutons is about Rs12,000 and for Charlie it is Rs8,000.

We do not believe in same store sales growth. Our operating principle is that a store can address consumers up to a certain capacity, beyond which it results in annoyance/irritation for the consumers. So, when we recognize high potential in a locality, we ask the same franchisee to open another in the vicinity. Thus, we believe it provides growth to the franchisee and also address customer satisfaction. However, to provide same store growth to the franchisees, we are introducing accessories for men, women and kids. We will introduce shoes in FY09.

We shall open about 40 company owned family stores in key locations, which would stock all offerings. The idea of these stores is to act as model stores for franchisees in the nearby location, and also to create a mechanism to reduce dependence on franchisees. However, these stores will also be managed by an entrepreneur at the front end who will be entitled for about 2% commission on net sales.

Q: What is our franchisee model? What are the costs associated?

A: Our franchisee model is unique and the backbone of our company. We regard franchisees are our partners of growth. We operate on minimum guarantee model. We believe that an entrepreneur can fuel the growth of a store faster by employing his salesmen skill and also reduce pilferage at the stores. Franchisees need to deposit Rs0.5m as security deposit, on which he gets 6% interest. We agree on a minimum guarantee which covers 3 expenses –

- 50% - 60% of the opportunity rental costs
- Operating expenses which works about 5% of his prospective sales

- Opportunity manpower costs of franchisee – ~Rs8,000 to Rs12,000 per month

We look for franchisees who own stores and operating apparel retail stores, thereby encashing on his existing relationship. We decide on a minimum guarantee amount mutually, which secures the franchisee of minimum inflow. On any apparel sold, we also earmark a commission amount depending upon the realization from the apparel. If the apparel is sold under any promotional scheme, the commission is less that if it is sold on the list price. At the end of the quarter, his commission is compared with the minimum guarantee, and he is paid whichever is higher. In some cases, franchisee costs might be higher depending upon the sales, but on an average it is between 12% - 13% of net sales.

We have an exclusive agreement with the franchisee for nine years with the contract and minimum guarantee being revised every three years. The franchisee can leave the agreement before nine years by paying minimum guarantee for eighteen months, while the company can leave the agreement by paying three months minimum guarantee.

Q: Why are we entering into womenswear and kidswear? What is our growth plan in this segment?

A: We recognize shift in the dressing habits of women from traditional to western outfits. We have observed that the huge middle class women don denims, but affordability of the same remains their concern, which makes them buy from unorganized channels. We recognize this as a big opportunity, and we will provide a quality brand at their affordable prices.

Kidswear segment offers huge opportunity as there is hardly any national brand at affordable prices. Moreover, the segment warrants quick replenishment as the child grows outfit in about 6 months.

We will operate in the same product segments where we have expertise, and will not offer traditional garments.

We will open 100 exclusive stores each of Les Femme and Koutons Junior in FY09, and in FY10, we will open 200 Les Femme and 150 Koutons Junior.

Q: What is the progress on the recent acquisition? Are you looking at any further acquisition?

A: We acquired 51% of the Upper Class brand of premium womenswear for a consideration of Rs120m. The brand was owned by designer couple Sachdevas, and had their presence through a few standalone stores and through MBOs like Shoppers Stop. The idea of acquiring this brand as it provided us with the designing know how of the womenswear, and also it offered us entry into the premium wear. Moreover, its channel into the Middle East will be exploited for our planned entry for Koutons range of apparels.

We will be able increase the gross margins on these ranges through our scale in procurement, and would pass on higher commission to MBOs, thereby increasing space area in these locations. We would also look at opening exclusive stores for these ranges.

We are open to more acquisitions; however, nothing is in advanced stage for now.

Q: What is the company's plan in the international market?

A: We will enter Middle East by tying up with multi brand outlets for placing Koutons range. We will like to create brand awareness by strategic placement of products, and in the next fiscal, we will look at opening 50 exclusive stores there through franchisee arrangement. We see huge opportunity in Middle East, as huge immigrant population offers high demand for affordable clothing.

Q: Why is the inventory level so high?

A: Koutons is engaged in 3 key activities of the value chain – manufacturing, distribution and retailing. We procure about 45% of raw materials from China and manufacture ourselves. About 65% of fabric to apparel conversion is done in-house, while 100% of apparel to packed apparel is done in house. Our stores are located in all types of towns across India. We are growing at a very aggressive rate . The inventory at any point of time is the inventory not only for the existing stores but also for the stores which we are going to open in next 45-60 days. The inventory also included the store which are opened recently like 15 -20 days before.

Our average inventory at the store level is about 60-90 days, depending upon locations. We also carry 3months inventory for the upcoming stores in the next 3 months. Our inventory is reduced from 11 months to 8 months and we are hopeful that it would come down to about 6.5 months in FY09.

All stores are linked to our central server and at the end of the day all the data is transmitted to the Head Office. We have a sales team whose work is to analyse the inventory lying at the store, and to understand which inventory is moving and which is not. The inventory which is not moving is then shifted to other store where it is moving. We leverage our existence across the country by moving unsold inventory from cities to smaller towns as fashion travels later there. We make sure to sell this kind of inventory during aggressive promotions. In the worst case scenario, we dispose them off to unorganized retailers by making about 10% margins.

Q: What are the risks/ challenges the company is facing?

A: Aggressive me-too competition from the regional brands is a big challenge being faced. However, we believe that these companies would not be able to sustain hit on their profitability for long. We pass on benefits to consumers harnessing our procurement benefits due to large scale. But these regional brands, due to low scale, provide these benefits taking hit in their bottomline. They have also been instrumental in raising rental rates in certain localities as they were looking at relentless expansion. We believe these brands will consolidate in a year or two.

Cash collection from franchisees was another challenge as we entrust our franchisees spread across the country for our entire sales. We have engaged with major banks for cash management services which would expedite our cash collections, and would also mitigate risk of any unscrupulous activity.

Q: What is our future plan?

A: Over the years, we have worked harnessing growth potential of the company with strategic moves.

FY02 : Moved from wholesaling to retailing

: Introduced Koutons range of menswear targeting 25+ age profiles

FY07 : Introduced Charlie Outlaw range targeting youth.

FY07 : Introduced KC range of premium menswear within Koutons stores

: Presence with 687 stores

FY08 : Launched Koutons Les Femme womenswear and Koutons Junior kidswear

: Acquired 51% in Upper Class premium womenswear for Rs120m

: Presence with 1,175 stores

Going forward, we believe that we would continue with our strategic steps and progress ourselves as a revered brand in the global market.

FY09	:	Will rollout Les Femme and Koutons Junior exclusive stores
	:	Will place Koutons range in Middle East through MBOs
	:	Will introduce accessories for men, women and kids
	:	Will introduce shoes
	:	Will expand to 1,800 stores
FY10	:	Will open 50 exclusive Koutons stores in Middle East
	:	Will open Koutons Racks, alike factory outlets at the outskirts of towns, offering higher discounts
	:	Will expand to 2,300 stores

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PL's Recommendation Nomenclature

BUY	:	> 15% Outperformance to BSE Sensex	**Outperformer** (OP)	:	5 to 15% Outperformance to Sensex
Market Performer (MP)	:	-5 to 5% of Sensex Movement	**Underperformer** (UP)	:	-5 to -15% of Underperformace to Sensex
Sell	:	<-15% Relative to Sensex			
Not Rated (NR)	:	No specific call on the stock	**Under Review** (UR)	:	Rating likely to change shortly