*2QFY08 Results Update*
SECTOR: TEXTILES

# Arvind Mills

| STOCK INFO. | BLOOMBERG |
|---|---|
| BSE Sensex: 19,978 | ARVND IN |
| | REUTERS CODE |
| S&P CNX: 5,906 | ARMI.BO |

| | |
|---|---|
| Equity Shares (m) | 209.4 |
| 52-Week Range (Rs) | 82/42 |
| 1,6,12 Rel.Per. (%) | 6/25/-40 |
| M.Cap (Rs b) | 15.9 |
| M.Cap (US$ b) | 0.4 |

29 October 2007

## Neutral

*Previous Recommendation: Neutral* Rs76

| 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 |
|---|---|---|---|---|---|---|---|---|---|---|
| 3/07A | 18,449 | 1,196 | 0.8 | -6.0 | 90.6 | 1.0 | 1.1 | 8.2 | 1.8 | 11.2 |
| 3/08E | 22,358 | 325 | 1.6 | 84.5 | 49.1 | 1.0 | 2.0 | 5.4 | 1.5 | 11.0 |
| 3/09E | 25,461 | 855 | 4.1 | 163.4 | 18.6 | 0.9 | 5.1 | 7.1 | 1.3 | 9.4 |

- Arvind Mill's results for 2QFY08 were above estimates. Revenues increased 14.3% YoY to Rs5.6b, driven by strong 36% YoY growth in the branded apparel segment, while EBITDA increased 13.9% YoY to Rs783 (v/s est of Rs727m), EBITDA margin dropped 308bp to 13.9% v/s 17% in 2QFY07. Financials for 2QFY07 are re-stated numbers post merger of Arvind Brands.
- Excluding revenues of Rs1b from the merged Arvind Brands, revenues grew 18% YoY to Rs4.6b.
- Reported PAT increased 22% YoY to Rs105m v/s our est of Rs53m. PAT growth was aided by lower interest cost, which declined 17% YoY.
- Though denim realizations improved for the second consecutive quarter by ~13% YoY to Rs102/meter, the denim scenario remains bleak due to overcapacity and this is unlikely to change in the near to medium term. The management is focusing on rapidly growing its downstream businesses of garment manufacturing, branded apparel and retail to de-risk itself from the vagaries of the denim cycle. In the near to medium term, however, we expect Arvind Mill's margins to face increasing pressure due to the bleak denim scenario, higher cotton prices, increasing energy cost and strengthening rupee.
- The stock trades at 49.1x FY08E EPS of Rs1.6 and 18.6x FY09E EPS of Rs4.1. We maintain **Neutral.**

QUARTERLY PERFORMANCE (Rs Million)

| Y/E MARCH | FY07 | | | | FY08 | | | | FY07 | FY08E |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1Q* | 2Q* | 3Q | 4Q | 1Q | 2Q | 3QE | 4QE | | |
| **Sales** | **4,208** | **4,931** | **4,479** | **4,831** | **5,103** | **5,637** | **5,813** | **5,804** | **18,449** | **22,358** |
| *Change (%)* | *0.1* | *15.2* | *14.8* | *35.0* | *21.3* | *14.3* | *29.8* | *20.1* | 15.6 | 21.2 |
| **Total Expenditure** | **3,376** | **4,094** | **3,769** | **4,159** | **4,382** | **4,854** | **5,017** | **4,996** | **15,398** | **19,249** |
| **EBITDA** | **832** | **837** | **710** | **672** | **721** | **783** | **796** | **808** | **3,051** | **3,108** |
| *Change (%)* | *-27.6* | *-21.2* | *-22.7* | *-22.1* | *-13.3* | *-6.4* | *12.2* | *20.2* | -23.6 | 1.9 |
| *As % of Sales* | *19.8* | *17.0* | *15.8* | *13.9* | *14.1* | *13.9* | *13.7* | *13.9* | *16.5* | *13.9* |
| Depreciation | 404 | 380 | 347 | 302 | 355 | 351 | 356 | 362 | 1,434 | 1,423 |
| Interest | 373 | 407 | 399 | 407 | 438 | 337 | 393 | 343 | 1,579 | 1,511 |
| Other Income | 53 | 2 | 27 | 81 | 52 | 17 | 44 | 63 | 163 | 175 |
| Non Recurring Expense | -56 | 0 | 1,068 | 15 | 83 | 0 | 0 | 0 | 1,020 | 83 |
| **PBT** | **52** | **51** | **1,058** | **58** | **63** | **112** | **92** | **167** | **1,220** | **432** |
| Tax | 6 | 4 | 10 | 4 | 5 | 7 | 6 | 7 | **24** | **25** |
| *Effective Tax Rate (%)* | *11.3* | *8.0* | *1.0* | *7.2* | *5.0* | *5.0* | *7.0* | *4.2* | *2.0* | *5.8* |
| **Reported PAT** | **46** | **47** | **1,048** | **54** | **58** | **105** | **85** | **160** | **1,196** | **407** |
| **Adj. PAT** | **103** | **47** | **-20** | **39** | **-24** | **105** | **85** | **160** | **176** | **325** |
| *Change (%)* | *-77.2* | *-87.3* | *-108.5* | *-81.6* | *-123.9* | *121.5* | *-530.3* | *304.0* | -86.2 | 84.5 |

*E: MOSt Estimates, * Restated Quarterly Numbers*

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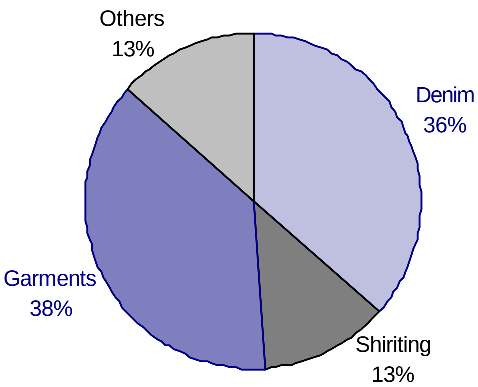
## 2QFY08 results above estimates

Arvind Mill's results for 2QFY08 were above estimates. Revenues increased 14.3% YoY to Rs5.6b, driven by strong 36% YoY growth in the branded apparel segment, while EBITDA increased 13.9% YoY to Rs783 (v/s est of Rs727m), EBITDA margin dropped 308bp to 13.9% v/s 17% in 2QFY07. Financials for 2QFY07 are re-stated numbers post merger of Arvind Brands. Excluding revenues of Rs1b from the merged Arvind Brands, revenues grew 18% YoY to Rs4.6b.

Reported PAT increased 22% YoY to Rs105m v/s our est of Rs53m. PAT growth was aided by lower interest cost, which declined 17% YoY.

REVENUE PRODUCT-MIX IN 2QFY08




Source: Company/Motilal Oswal Securities

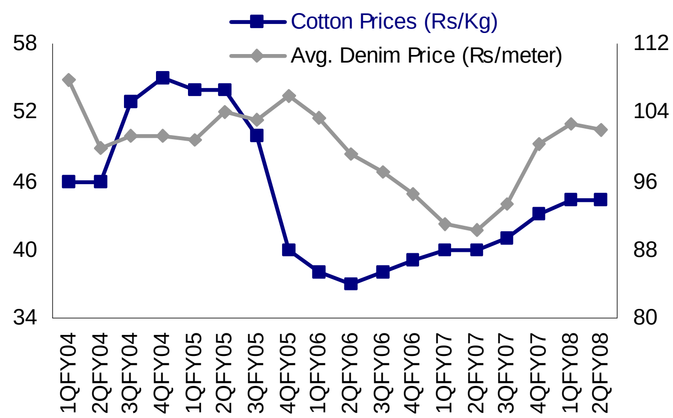
## Domestic denim scenario remains bleak

The denim scenario continues to remain bleak due to overcapacity. However, the outlook for denim is improving in the international market and in 1QFY08 almost ~70% of Arvind's revenues came from exports against just 40% in 1QFY07. Consequently, the company's average denim realization per meter has increased for the second consecutive quarter by 12.8% YoY to Rs102.7/meter.

## Restructuring plans for denim

Arvind Mills' total domestic denim capacity was estimated at 600-630m meters in FY07, while total demand from the domestic and export markets stood at 430-450m meters. We believe that the domestic denim industry is likely to remain depressed over the next 1-2 years, despite the robust 25-30% demand growth, due to the severe overcapacity situation. Hence, it is deliberating several strategies to derisk itself from its high dependence on the denim segment. 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 on several other strategies for turning around its denim division.

DENIM MARGINS REMAIN UNDER PRESSURE




Source: Company/Motilal Oswal Securities

## Denim dependence to decline

The management is focusing on rapidly growing its downstream businesses of garment manufacturing, branded apparel and retail to de-risk itself from the vagaries of the denim cycle. We expect Arvind Mills' revenues to increase from Rs18.4b in FY07 to Rs25.4b in FY09. This would be primarily driven by a CAGR (FY07-09) of 61% in garment sales and 20% CAGR (FY07-09) in branded apparel business.

## Focus on garments and retail increasing

The company plans to expand its garment capacities aggressively from around 12.7m pieces in FY06 to around 42m pieces by FY09. The management expects garment operations to account for Rs10b by FY08-FY09.

## Key developments in the branded retail segment in 2QFY08

Sales without contribution from VF licensed brands grew 36% YoY. Arvind Brands plans to open large format value stores across the country of ~50,000-60,000sf. In this connection, it has already signed up properties in Chennai, Pune and Hyderabad. It has an aggressive expansion plan to sign up several more properties in the coming months and has an internal target to have ~25-30 large format retail stores operational in 20 key cities in India.

## Arvind Brands - expect 20% CAGR over FY07-09

Arvind Brands, which was merged with Arvind Mills in FY07, reported revenues of Rs1b in 2QFY08. Arvind Brands owns Excalibur, Newport, Flying Machine, Ruf N Tuf and Arrow, and runs a multi-brand retailing operation under the Megamart banner. We model 20% CAGR in branded sales, over FY07-FY09 from Rs3.3b in FY07 to Rs4.8b in FY09.

## JV with VF Corp could yield Rs4-5b 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 Corp were transferred to a new JV, 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 years away

As per Arvind Mills' GDR document (July 2005), the company owned close to 3,472,153sqm (857 acres) of real estate and 283,553sqm (70 acres) of leasehold land in India. Apart from this, the company holds close to 5,863sqm (63,039sf) of residential and office space across India. Arvind holds almost 750 acres of land at Santej, Ahmedabad, which is located around 20km away from the CBD area of Ahmedabad. Further, 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, the management believes that over the next three years, as Ahmedabad expands, the value for this property could increase significantly, providing the company an opportunity to unlock value. 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 the books, which is in sharp contrast to other textile companies such as Bombay Dyeing or Century Textiles, where the land value still appears at historical cost in their annual reports.

## Valuation and view

We believe that Arvind has hit a rough patch, as performance of its core business segment - denim - is likely to remain under pressure over the medium term. The management expects the garments and branded retail segments to drive future growth. However, due to slow scale-up in its garments business, near-term margin pressures and the long gestation period in the branded retail business, near-term earnings are likely to be negatively impacted. The stock trades at 49.1x FY08E EPS of Rs1.6 and 18.6x FY09E EPS of Rs4.1. 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.

## Recent developments

- Arvind Brands has been merged with Arvind Mills.
- 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 - is likely to remain under pressure over the medium term.
- The stock trades at 49.1x FY08E EPS of Rs1.6 and 18.6x FY09E EPS of Rs4.1. We maintain **Neutral.**

## 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.

## 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 to the US and EU in the post-quota era.
- Global buyers are focusing on building vendor partners, who have high product development skills.
- There is concern of overcapacity in the industry due to the extension of TUF scheme by five years.

COMPARATIVE VALUATIONS

| | | ARVIND MILLS | ALOK | VARDH. TEXT. |
|---|---|---|---|---|
| P/E (x) | FY08E | 49.1 | 7.5 | 6.3 |
| | FY09E | 18.6 | 6.7 | 5.1 |
| P/BV (x) | FY08E | 1.0 | 2.2 | 0.7 |
| | FY09E | 0.9 | 2.1 | 0.7 |
| EV/Sales (x) | FY08E | 1.5 | 9.0 | 1.5 |
| | FY09E | 1.3 | 8.9 | 1.3 |
| EV/EBITDA (x) | FY08E | 11.0 | 3.4 | 8.3 |
| | FY09E | 9.4 | 2.8 | 6.9 |

SHAREHOLDING PATTERN (%)

| | SEP-07 | JUN-07 | SEP-06 |
|---|---|---|---|
| Promoter | 33.9 | 33.9 | 34.2 |
| Domestic Inst | 13.6 | 15.1 | 14.1 |
| Foreign | 10.8 | 13.5 | 26.9 |
| Others | 41.7 | 37.5 | 24.8 |

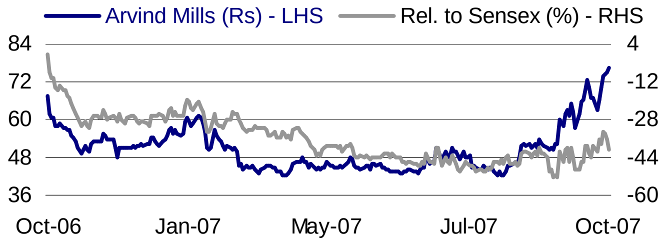
EPS: MOST FORECAST VS CONSENSUS (RS)

| | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|---|---|---|---|
| FY08 | 1.6 | 2.0 | -21.6 |
| FY09 | 4.1 | 3.5 | 18.6 |

TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|---|---|---|---|
| 76 | - | - | Neutral |

STOCK PERFORMANCE (1 YEAR)



| INCOME STATEMENT | | | | | (Rs Million) |
|---|---|---|---|---|---|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E |
| **Net Sales** | 16,789 | 15,920 | 18,449 | 22,358 | 25,461 |
| *Change (%)* | 17.0 | -5.2 | 15.9 | 21.2 | 13.9 |
| Raw Materials | 6,199 | 5,749 | 5,584 | 6,581 | 6,973 |
| Staff Cost | 1,230 | 1,353 | 2,043 | 1,613 | 1,748 |
| Other Mfg. Expenses | 5,600 | 5,428 | 7,771 | 6,533 | 7,356 |
| **EBITDA** | 3,886 | 3,989 | 3,051 | 3,108 | 3,645 |
| *% of Net Sales* | 23.1 | 25.1 | 16.5 | 13.9 | 14.3 |
| Depreciation | 1,491 | 1,551 | 1,434 | 1,423 | 1,335 |
| Interest | 1,179 | 1,300 | 1,579 | 1,511 | 1,535 |
| Other Income | 76 | 225 | 163 | 175 | 175 |
| Extra-ordinary Items (net) | 0 | 0 | 1,020 | 0 | 0 |
| **PBT** | 1,293 | 1,364 | 1,220 | 350 | 950 |
| Tax | 20 | 92 | 24 | 25 | 95 |
| *Rate (%)* | 1.5 | 6.8 | 2.0 | 7.2 | 10.0 |
| **Reported PAT** | 1,273 | 1,272 | 1,196 | 325 | 855 |
| **Adjusted PAT** | 1,273 | 1,272 | 176 | 325 | 855 |
| *Change (%)* | 31.3 | -0.1 | -86.2 | 84.5 | 163.4 |

| BALANCE SHEET | | | | | (Rs Million) |
|---|---|---|---|---|---|
| Y/E MARCH | 2005 | 2006 | 2007 | 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 | 13,832 | 14,132 | 14,966 |
| **Net Worth** | 12,811 | 15,320 | 16,402 | 16,631 | 17,405 |
| Loans | 16,824 | 18,414 | 18,464 | 18,114 | 18,064 |
| Deffered Tax Liability | 46 | 128 | 138 | 148 | 186 |
| **Capital Employed** | 29,681 | 33,861 | 35,004 | 34,893 | 35,654 |
| Gross Fixed Assets | 21,103 | 21,922 | 23,422 | 24,672 | 25,422 |
| Less: Depreciation | 7,286 | 8,826 | 10,260 | 11,683 | 13,018 |
| **Net Fixed Assets** | 13,817 | 13,096 | 13,162 | 12,989 | 12,405 |
| Capital WIP | 1,031 | 796 | 0 | 0 | 0 |
| Investments | 1,530 | 3,481 | 1,400 | 1,501 | 1,502 |
| **Curr. Assets** | 16,016 | 19,373 | 23,277 | 23,640 | 25,341 |
| Inventory | 5,112 | 4,793 | 5,273 | 4,842 | 5,285 |
| Debtors | 3,191 | 3,683 | 3,708 | 4,173 | 4,752 |
| Cash & Bank Balance | 129 | 96 | 813 | 316 | 253 |
| Loans & Advances | 7,585 | 10,801 | 13,482 | 14,310 | 15,051 |
| **Current Liab. & Prov.** | 2,713 | 2,884 | 2,835 | 3,237 | 3,593 |
| Creditors | 1,644 | 1,469 | 1,377 | 1,623 | 1,719 |
| Other Liabilities | 746 | 857 | 926 | 1,065 | 1,225 |
| Provisions | 324 | 451 | 532 | 550 | 649 |
| **Net Current Assets** | 13,303 | 16,489 | 20,441 | 20,403 | 21,748 |
| **Application of Funds** | 29,681 | 33,861 | 35,004 | 34,893 | 35,655 |

*E: MOSt Estimates*

| RATIOS | | | | | |
|---|---|---|---|---|---|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E |
| **Basic (Rs)** | | | | | |
| **EPS** | 6.1 | 6.1 | 0.8 | 1.6 | 4.1 |
| *Growth (%)* | 31.3 | -0.1 | -86.2 | 84.5 | 163.4 |
| Cash EPS | 15.7 | 16.0 | 9.1 | 9.9 | 12.4 |
| Book Value | 62.2 | 70.5 | 76.1 | 77.5 | 81.5 |
| DPS | 1.0 | 1.0 | 0.0 | 0.0 | 0.0 |
| Payout (incl. Div. Tax.) | 17.5 | 18.8 | 0.0 | 0.0 | 0.0 |
| **Valuation (x)** | | | | | |
| P/E | | 12.5 | 90.6 | 49.1 | 18.6 |
| Cash P/E | | 4.8 | 8.3 | 7.7 | 6.1 |
| EV/EBITDA | | 8.7 | 11.2 | 11.0 | 9.4 |
| EV/Sales | | 2.2 | 1.8 | 1.5 | 1.3 |
| Price/Book Value | | 1.1 | 1.0 | 1.0 | 0.9 |
| Dividend Yield (%) | | 1.3 | 0.0 | 0.0 | 0.0 |
| **Profitability Ratios (%)** | | | | | |
| RoE | 10.9 | 9.5 | 1.1 | 2.0 | 5.1 |
| RoCE | 9.0 | 8.4 | 8.2 | 5.4 | 7.1 |
| **Turnover Ratios** | | | | | |
| Debtors (Days) | 67 | 83 | 70 | 65 | 65 |
| Inventory (Days) | 143 | 147 | 125 | 120 | 120 |
| Creditors. (Days) | 97 | 93 | 90 | 90 | 90 |
| Asset Turnover (x) | 0.6 | 0.5 | 0.5 | 0.6 | 0.7 |
| Fixed Asset Turnover (x) | 0.8 | 0.7 | 0.8 | 0.9 | 1.0 |
| **Leverage Ratio** | | | | | |
| Debt/Equity (x) | 1.4 | 1.2 | 1.1 | 1.1 | 1.0 |

| CASH FLOW STATEMENT | | | | | (Rs Million) |
|---|---|---|---|---|---|
| Y/E MARCH | 2005 | 2006 | 2007 | 2008E | 2009E |
| OP/(Loss) before Tax | 1,293 | 1,364 | 1,220 | 350 | 950 |
| Add: Depreciation & Amort. | 1,491 | 1,551 | 1,434 | 1,423 | 1,335 |
| Add: Interest Paid | 1,179 | 1,300 | 1,579 | 1,511 | 1,535 |
| Less: Direct Taxes Paid | 3 | 28 | 15 | 15 | 57 |
| Less: (Inc)/Dec in Wkg. Capita | -4,324 | -3,218 | -3,236 | -379 | -1,395 |
| **CF from Op. Activity** | -1,637 | -538 | -796 | 1,201 | 655 |
| **CF after EO Items** | -1,637 | -538 | -796 | 1,202 | 657 |
| (Inc)/Dec in Fixed Assets & CV | -177 | -1,054 | -2,296 | -1,250 | -750 |
| (Pur)/Sale of Invest. | 66 | 1,951 | -2,081 | 0 | 0 |
| **CF from Inv. Activity** | -1,326 | -584 | -704 | -1,251 | -750 |
| Issue of Shares | -35 | 2,479 | 0 | 0 | 0 |
| Inc / (Dec) in Debt | 3,270 | 1,590 | 50 | -350 | -50 |
| Interest Paid | 1,179 | 1,300 | 1,579 | 1,511 | 1,535 |
| Dividends Paid | 223 | 239 | 0 | 0 | 0 |
| **CF from Fin. Activity** | 2,964 | 1,089 | 2,217 | -370 | 44 |
| **Inc / (Dec) in Cash** | 2 | -33 | 717 | -497 | -63 |
| Add: Opening Balance | 127 | 129 | 96 | 813 | 316 |
| **Closing Balance** | 129 | 96 | 813 | 316 | 253 |

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| Disclosure of Interest Statement | Arvind Mills |
|---|---|
| 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 |