Equity | India | Textiles & Apparel
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Raymond, Welspun look attractive on valuations

Merrill Lynch

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Raymond, Welspun look attractive post underperformance

The Indian textile sector has significantly underperformed the market in the last few months. We believe this should be used as an opportunity to buy select stocks in the sector. We recommend Raymond and Welspun India as our top picks – both trading at a significant discount to their historic avg 1-yr forward PER.

Raymond - branded retail; subsidiary profits key triggers

Raymond is best positioned to capitalize on the branded textile and apparel boom, given 1) strong domestic brand franchise; new brands launched in men's wear, kids and jeans wear; new ones planned in women's wear and inner wear; 2) wide and fast growing network of exclusive brand outlets. Further, the garment exports subsidiary and shirting JV are expected to turn profitable in FY08E.

Welspun - 46% earnings CAGR over FY07E-09E

Key growth drivers are 1) Higher volumes in towels (20% CAGR over FY07-09E) and bed linen (27% CAGR) on expanded capacities and 2) Margin improvement (130bp), driven by higher efficiencies in new bed linen business and power cost savings. EPS for FY07E-09E have been revised upward by 6-7% to factor in the decrease in fully diluted share capital, due to non-conversion of warrants.

Domestic branded textile and apparel boom

Organized textile and apparel retail has grown at 30% pa over the last two years. We expect the robust growth to sustain over the next few years, driven by rising disposable incomes, increased brand consciousness, rising mall space and launch of new brands providing more choice for consumers.

Exports - apparel disappoints, home textiles does well

Apparel exports to the US disappointed, growing at a mere 7% in CY06, despite the quota on China. However, towel exports remained strong (up 28%), with India gaining 450bp market share. We expect apparel exports to pick up but remain short of being spectacular in the absence of any labor reforms.

Overseas acquisitions/JVs - more in the pipeline

Both Raymond and Welspun are actively on the lookout for alliances with an overseas brand, which could be launched in India (as in the case of Raymond) or to extend market reach and move up the value chain (as in the case of Welspun). Synergies from recently formed alliances should start flowing in over 1-2 years.

Modest rise in fiber prices to have a muted impact

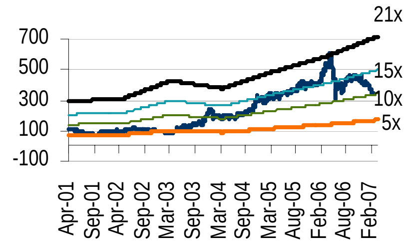
We expect cotton costs to be higher by ~5% for cos in FY08E. A 1% rise in cotton price would impact Arvind's profits by 7.5%, while the impact on Raymond would be muted (0.8%), as it consumes multiple fibers. Wool prices, too, are likely to rule higher for Raymond, but this would likely be offset by soft polyester prices.

Table 1: Valuations and recommendations

Stocks	Reco	Mkt Cap (US$mn)	EPS CAGR FY07E-09E	PER (x) FY08E	EV/E (x) FY08E
Raymond	BUY	467	22%	10	6
Welspun	BUY	121	46%	7	6
Himatsingka	NEUTRAL	254	35%	15	10
Gokaldas	NEUTRAL	191	20%	10	7
Arvind Mills	SELL	228	90%	13	7

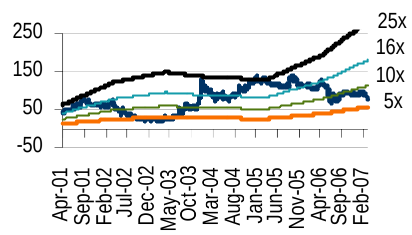
Source: Merrill Lynch

Chart 1: Raymond's 1-yr forward PE band



Source: Merrill Lynch

Chart 2: Welspun's 1-yr forward PE band



Source: Merrill Lynch

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Refer to important disclosures on page 10 to 13. Analyst Certification on page 9. Price Objective Basis/Risk on page 9.

Top picks – Raymond and Welspun India…

The Merrill Lynch Indian textile sector index is down ~10% over the last 6 months while the market (Sensex) has risen ~12% over the same period. We believe investors should use this sharp underperformance as an opportunity to buy into select stocks in the sector. We recommend Raymond and Welspun as our top picks.

Raymond has fallen 18% in the last 3 months and is now trading at 10x FY08E PER – a significant discount to its historic average. Welspun, too, has fallen 15% during the same period and now trades at 7x FY08E PER even with an expected earnings CAGR of 46% over FY07E-09E.

Table 2: Recommendations & POs

Stock	Reco	Price	Chg in 3m	PO	Upside
Raymond	C-1-7	350	-18%	564	61%
Welspun	C-1-9	76	-15%	127	67%
Himatsingka	C-2-7	120	-7%	NA	NA
Gokaldas	C-2-7	255	-18%	NA	NA
Arvind Mills	C-3-7	50	-2%	NA	NA

Source: Merrill Lynch

Table 3: Comparative valuations

Stock	PER (x)		EV/E (x)	EPS CAGR	PEG	EBIDTA margin	RoE
	FY07E	FY08E	FY08E	FY07E-09E	FY08E	FY07E	FY07E
Raymond	13	10	6	22%	0.5	14%	13%
Welspun	10	7	6	46%	0.1	19%	11%
Himatsingka	20	15	10	35%	0.4	31%	10%
Gokaldas	12	10	7	20%	0.5	11%	20%
Arvind Mills	25	13	7	90%	0.1	19%	3%

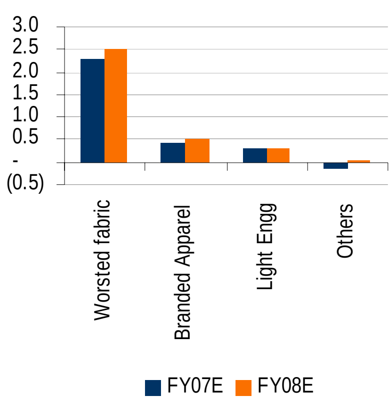
Source: Merrill Lynch

Raymond – a play on domestic branded textiles boom

We expect Raymond to deliver 22% earnings CAGR over FY07E-09E driven by:

- **Continued strong performance in the worsted fabric business –** rise in volumes (at about 8% pa), backed by expanded capacity and improved realizations (about 3% pa), driven by consumer boom in the country.
- **Robust 20% growth in branded apparel retailing business**, driven by the launch of new brands in new product segments and rising retail space.
- **Increased contribution from garment export subsidiaries**, with these subsidiaries turning profitable, as also due to the JV for high-value cotton shirting.
- **Improved profitability in the denim JV (with UCO),** as the synergies from the JV begin to flow in.

Chart 3: Raymond - EBIT breakdown (Rsbn)

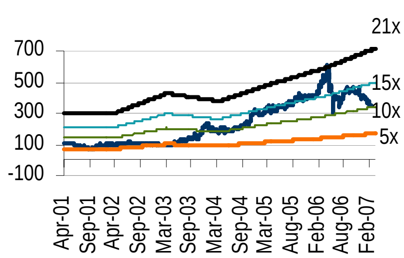


Others include denim / shirting JVs and garment export subsidiaries
Source: Merrill Lynch, Company

Besides the earnings drivers above, Raymond also has **potential upside from value unlocking in realty assets**. The company holds 140 acres of land in Thane, where a part of its worsted fabric facility is under operation. The company plans to shift this facility to a lower cost location – Vapi, – gradually, over a period of time (might take about two years or so).

Our PO of Rs564/share is based on a blended average of sum-of-parts valuation, DCF valuation and target PE multiple of 16x for FY08E – on par with its historic (post quota period) average 1-yr fwd PE multiple.

Chart 4: Raymond's 1-yr forward PE band



Source: Merrill Lynch

Welspun - a play on India's home textiles exports boom

We see the following potential growth drivers in Welspun:

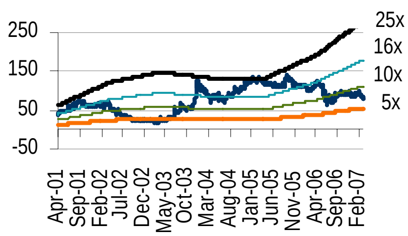
- **Higher volumes in both bed linen (27% CAGR over FY07E-09E) and terry towels (20% CAGR)** from existing expanded and new capacities coming up in 1HFY08.

- **Improvement in profitability in bed linen driven by higher capacity utilization and improved operating efficiencies.** Currently, EBIDTA margins for bed linen hover at 6-6.5%. We expect them to improve progressively to 13-14% by FY09E.

- **Margin improvement expected from expanded yarn capacity and power cost savings –** both likely to accrue from 1QFY08. Overall EBIDTA margins are likely to expand by 130bp by FY09E.

- **Consolidation of Christy numbers** to be earnings accretive by about 1% in FY09E.Christy's manufacturing facility is planned to be shifted over the course of the year to India. The cost savings on account of this should start reflecting into the consolidated numbers from FY09E.

Chart 5: Welspun's 1-yr forward PE band



Source: Merrill Lynch

At 7x FY08E PE, with 46% earnings CAGR over FY07E-09E, we find the valuations extremely attractive. Our new PO of Rs127/share is based on 11x FY08E PER, close to the lower end of its historic 1-yr forward PE band. Our earlier PO was based on Current 1-yr fwd PE multiple of 12x rolled over to FY08E. Since the 1-yr fwd multiple (which would now be FY08E multiple only) has gone down below the lower end of the PE band, we have taken 11x - which is at the lower end of the historic 1-yr fwd PE band, as the target PE multiple.

...but less positive on other stocks in the sector

Maintain Neutral on Himatsingka on valuations

At 15x FY08E earnings, the stock trades at a 35% premium to other Indian textile companies under our coverage. We expect the premium to narrow, once the company enters the less profitable bed linen business. We find the stock fully priced at these levels, leaving little potential upside for the investors.

Gokaldas: Absence of labor reforms caps growth; Neutral

We remain Neutral on Gokaldas, despite the stock having corrected sharply in the last few days, owing to a weak macro environment and unlikely change in the inflexible labor laws in the near term. These factors will likely constrain growth at 15-20% pa, in our opinion.

Sell Arvind on continued weak denim outlook

The outlook for denim, especially in the domestic market, remains bleak. We expect Arvind's earnings to remain subdued over the next few quarters, on the back of continued pressure on denim sales and rising costs. At a PER of 13x FY08E – a premium of 20% plus over sector average – valuations too look expensive. Sell.

Domestic branded textile and apparel boom

Organized textile and clothing retail, which accounts for 39% of total organized retail, has grown at 30% CAGR over the last two years (Source: India Retail Report 2007). We expect the robust growth to sustain over the next few years, driven by 1) **Demand side factors** – rising disposable income, rising working population and increased brand consciousness, and 2) **Supply side factors** – rising mall space, increased investment and entry of new players.

Table 4: Organized textile & clothing retail - Size & growth

(Rs bn)	CY04	CY05	CY06	CAGR
Total retail	9,300	9,805	10,360	5.5%
Textiles and apparel retail	800	885	980	10.7%
Share (%)	8.6%	9.0%	9.5%	
Organized retail	280	356	475	30.2%
Organized textiles and apparel retail	109	140	185	30.3%
Share (%)	38.9%	39.3%	38.9%	

Source: Merrill Lynch, India Retail Report 2007

Raymond is at the forefront of this opportunity

Raymond, India's leading textile and apparel brand, is best positioned, in our view, to capitalize on the domestic branded textile and apparel boom. Besides, the flagship Raymond brand, which continues to lead in suiting fabrics with 60% market share and the men's wear brands (formal/semi-casual), the company has recently launched brands in other product segments as well. Its range of men's wear includes *ColorPlus, Park Avenue, Parx and Manzoni* – which continue to grow at a decent pace. Its new launches include international premium jeans wear brand, *Gas*, in JV with the Italian company, and the kids wear brand, *Zapp*. Very recently, the company launched a men's wear brand, *Notting Hill,* in the value segment. Raymond plans to enter the women's wear segment as well, which could be through a JV with an international brand.

Table 5: New brands launched recently

Product	Brands	Segment	Launch date	Comments
Men's wear	Notting Hill	Value	Feb 2007	
Jeans wear	Gas	Premium	Nov 2006	50:50 JV with Grotto S.p.A. of Italy
Kids wear	Zapp	Premium	Feb 2006	
Women's wear				Plans to launch soon
Inner wear				Plans to launch soon

Source: Merrill Lynch, Company

Raymond, which already has the widest network of exclusive brand outlets (EBOs) in India with close to 469 outlets (both owned and franchised) and retail space of 1.1mn sq ft (besides other sale points such as multi-brand outlets and departmental stores) plans to go aggressive with its rollout of EBOs. Most of the new store additions are likely to be in the upcoming malls in the country.

Table 6: Raymond's retail footprint

EBOs	FY06A	FY07E	FY08E
The Raymond Shop	330	365	405
Park Avenue, Parx, Manzoni	10	30	60
ColorPlus	44	62	82
Zapp	0	8	23
Gas	0	4	44
Total	384	469	614
No. of sq ft (mn)	0.8	1.1	1.5

Source: Merrill Lynch, Company

Exports – a mixed bag

Apparel exports to the US disappoint…

India's apparel exports to the US have been a disappointment in CY06 – the year after which quotas were reimposed on China. Indian apparel exports grew by a mere 7% YoY as against expectations of high-teens growth, clearly failing to capitalize on the opportunity created by reimposition of Chinese quotas. We cite the following likely key reasons for this disappointment:

- Limited apparel capacities in India; constrained mainly by rigid labor laws.
- Competition from other low-cost countries such as Indonesia, Bangladesh, Vietnam and Cambodia. Each of these countries registered 18-27% YoY growth in CY06 in exports to the US.
- High labor turnover (more than 25%), resulting in existing factories operating at sub-optimal levels.

Table 7: US imports: India's performance vis-à-vis China and Pakistan across categories

	China			Pakistan			India		
US Imports (US$mn)	CY06	CY05	YoY (%)	CY06	CY05	YoY (%)	CY06	CY05	YoY (%)
Textiles and apparel	27,067	22,405	20.8	3,250	2,904	11.9	5,031	4,617	9.0
Apparel	18,518	15,143	22.3	1,412	1,259	12.2	3,187	2,976	7.1
Terry towel	210	176	19.1	205	166	23.6	291	228	27.7
Bed linen	378	244	55.1	418	284	47.0	225	204	10.2
Market shares (%)			YoY (bp)			YoY (bp)			YoY (bp)
Textiles and apparel	29%	25%	390	3%	3%	23	5%	5%	22
Apparel	26%	22%	381	2%	2%	14	4%	4%	12
Terry towel	18%	16%	215	18%	15%	267	25%	21%	449
Bed linen	28%	23%	484	31%	27%	395	16%	19%	(267)

Source: Merrill Lynch, OTEXA

…but home textiles do well

In home textiles, where, we believe, India enjoys a competitive advantage over China and other low-cost countries, it has done reasonably well, gaining 450bp market share in US towel imports. In bed linen, though, the performance has not been as good, with 10% YoY growth and 267bp drop in market share. We expect bed linen exports to pick up, as the new capacities from Welspun and Alok (not rated) stabilize. Home textiles is not as labor intensive as apparel, and hence, growth in this segment has not been constrained by inflexible labor laws.

Overseas acquisitions/JVs – more to come

Most textile companies, including Raymond, Welspun India, Himatsingka and Gokaldas, are actively scouting for acquisition and JV opportunities. Raymond is looking at JVs with international apparel brands – more specifically in the women's wear and inner wear segments – for launch in India. Welspun India and Himatsingka are looking at brand acquisitions in the home textiles space. Gokaldas has plans for a JV with an overseas apparel company for producing a new apparel line.

Most of the acquisitions in the textile space, in the recent past, have taken place at low valuation multiples (market cap/sales of 0.5-0.6x, EV/E of 5-6x). But, in all these cases, the acquired company has also had very low net margins. Hence, while many of these acquisitions may not be significantly EPS accretive in the initial years, they do make a good strategic fit. The strategic rationale for these alliances is to acquire international branding and retailing capabilities, gain access to the US and EU markets, acquire technology and know-how, and international design capabilities as well as product development skills.

Himatsingka pays 0.8x EV/sales for Bellora acquisition

Himatsingka has forged out ~US$15mn for the 70% stake in Bellora. This works out to EV/sales of ~0.8x, which is at a premium over other acquisitions in this space (Weslpun's acquisition of Christy was at ~0.4x EV/sales). We still await the details on Bellora's financials. Given that Bellora is a niche luxury brand there is a possibility that the company might be enjoying superior margins and hence some of this premium might be justified.

Bellora is a premium European bed linen brand with presence in Italy and other parts of Europe. Bellora had sales of Euros 29mn in CY06, of which ~60% came from exclusive stores and the balance from up-market department stores and franchise stores.

The acquisition is in line with company's stated objective of acquiring niche premium bed linen brands in the US & EU. Management has indicated for another acquisition in the same space, post which 50% of its new bed linen capacity could be locked in at realizations of about US$5/meter – a significant premium to the mid-end players (at US$3-4/meter).

Welspun plans to shift Christy manufacturing to India

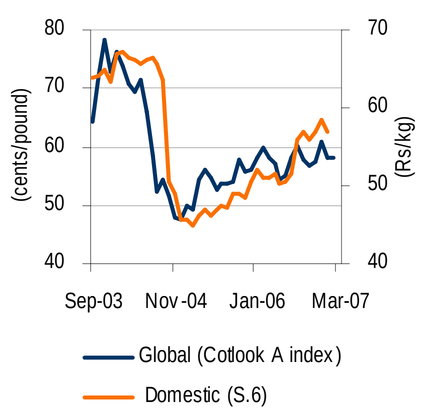
Christy, in which Welspun acquired an 85% stake in July last year, plans to shift its manufacturing facility to India over the course of the current year. This should result in cost savings which should start reflecting into the consolidated numbers from FY09E. As per management guidance, consolidation of Christy should result in about 1% accretion in FY09E EPS.

Modest fiber price rise to have a muted impact

Cotton prices likely to be higher by ~5% in FY08E

We expect about 5% higher cotton prices for textile companies in FY08E (already built into our forecast). International cotton prices have been flat YoY on expectations of a decent crop in the current season. However, domestic cotton prices are currently up 10% YoY, despite record production, as higher export demand is likely to result in a significant drawdown in inventory positions.

Chart 6: Cotton price trend



Source: Bloomberg, Emerging Textiles, Merrill Lynch

Table 8: Cotton Balance Sheet

(mn bales)	2004-05		2005-06		2006-07E		YoY (%)	
Region	Production	End stock	Production	End stock	Production	End stock	Production	End stock
World	120	54	114	54	117	53	2%	-2%
USA	23	6	24	6	22	8	-9%	37%
India	19	9	19	8	21	7	9%	-18%
China	29	13	26	16	31	15	18%	-4%
Pakistan	11	4	10	3	10	3	-2%	-19%

Source: Merrill Lynch, USDA

Table 9: Sensitivity of cotton prices to earnings

	Impact of 1% rise in cotton prices
Arvind Mills	-7.5%
Welspun	-2.0%
Raymond	-0.8%

Source: Merrill Lynch

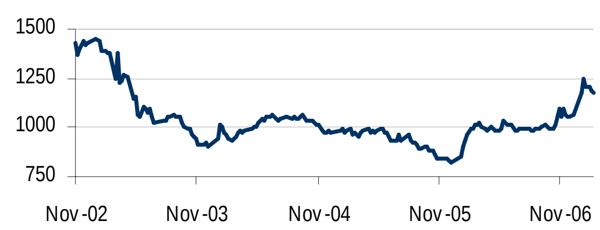
Impact of rise in cotton prices: Arvind - most; Raymond - least

A 1% rise in cotton prices would impact Arvind's earnings the most, by 7.5%. However, the impact would be muted for Raymond, as it consumes multiple fibers (cotton, wool and polyester).

Higher wool prices to be offset by softer polyester prices

Wool prices are up 17.5% YoY, owing to drought in Australia this season, which has impacted wool production. Wool is mainly used in the manufacture of worsted fabrics, which account for 40% of Raymond's consolidated sales. Wool cost as a proportion of worsted sales is a mere 12% for Raymond, and hence even a 10-15% rise in wool prices would not have any significant impact on the company's margins. Further, polyester prices have come off by 17.5% from their peak in Sep 2006. This should help offset the negative impact of rise in wool prices.

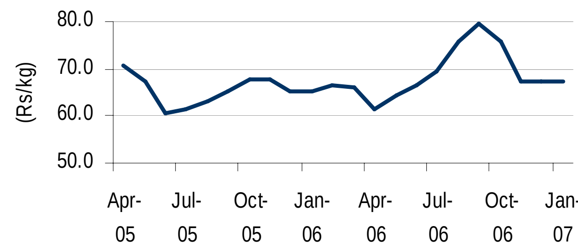
Chart 7: Wool price* trend



*Eastern Market Indicator in A$ for 18.5micron wool

Source: Emerging Textiles, Merrill Lynch

Chart 8: PSF price trend



Source: Merrill Lynch, Reliance Industries

TUFS extension to be positive for the sector

Key measures announced in the Union Budget

- Extension of Technology Upgradation Fund Scheme (TUFS) for the 11th Plan period. Allocation under the scheme has been increased from Rs5.35bn last year to Rs9.11bn for FY07-08.
- Provision for Textile Parks has been increased from Rs1.89bn earlier to Rs4.25bn in the current Budget.
- Reduction in import duty on polyester fiber & yarn from 10% to 7.5%.
- Rentals on commercial properties have been brought under the service tax net.
- Minimum Alternate Tax (MAT) provision extended to income from 100% Export Oriented Units (EOUs).

Impact of Measures

- Positive for cos. with capex plans over the next five years. Most companies under our coverage are through their peak capex phase. Still TUFS extension will lower the cost of borrowings (5% interest cost reimbursed by the Government under the scheme) on any incremental capex they do over the next 5 years.

- Positive impact on textile cos which use polyester as a raw material. Marginally positive (~1%) for Raymond, for which polyester cost is about 8% of its worsted sales, assuming the duty cut flows through into the domestic polyester prices.

- Rental costs for retailing companies would go up. This is marginally negative for Raymond's retail business.

- Marginally negative for Gokaldas and Himatsingka – both have part of their income coming from 100% EOUs. However, this should only impact their cash profits and not reported profits as these companies can claim deferred tax asset credit on MAT.

Price Objective Basis & Risk

Raymond Ltd.

Our PO of Rs564/share for Raymond is based on a blended average of (1) valuation based on a target P/E multiple of 16x for FY08E, (2) sum-of-the-parts valuation, and (3) DCF valuation.

Risks stem from fluctuation in key raw material prices, changing fashion trends impacting company's sales volumes and realizations, exchange rate fluctuation risk and project execution risk.

Welspun India

Our PO of Rs127/share for Welspun India is based on a target PE of 11x for FY08E, which is close to the lower end of its historic 1-year forward PE band.

Risks stem from the fluctuation in key raw material prices, impact on sales volumes and realizations due to competition, exchange rate fluctuation risk and project execution risk.

Analyst Certification

I, Manish Sarawagi, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

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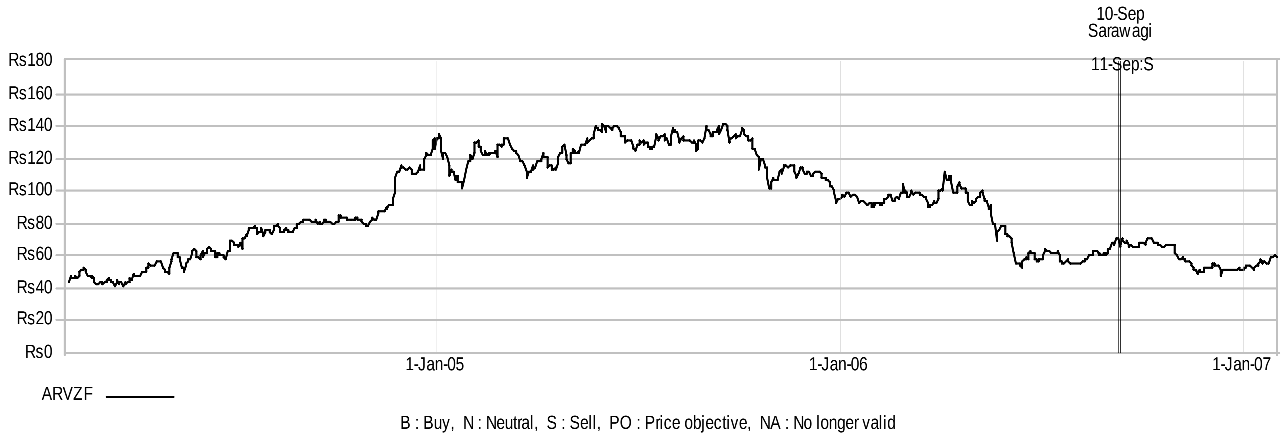
Important Disclosures

ARVZF Price Chart



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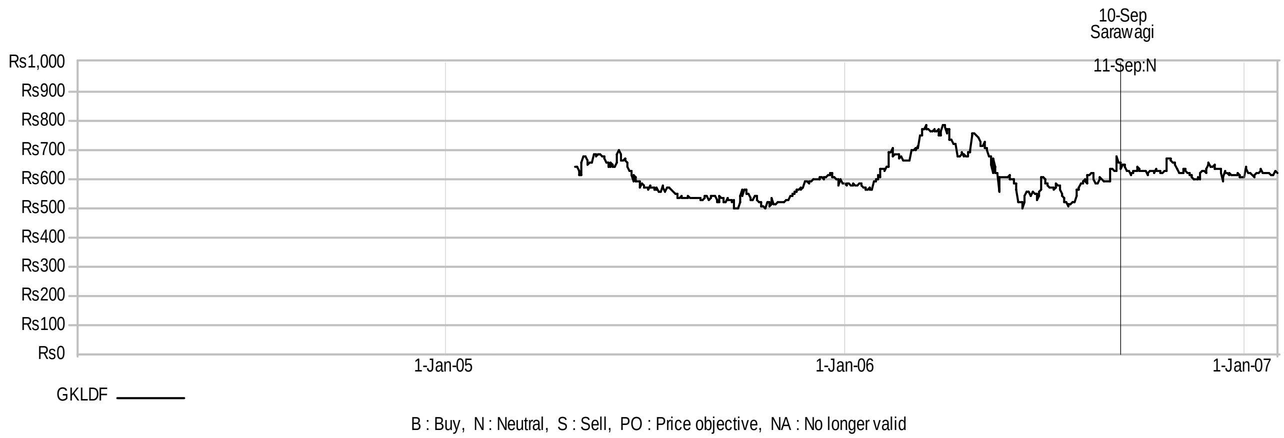
GKLDF Price Chart



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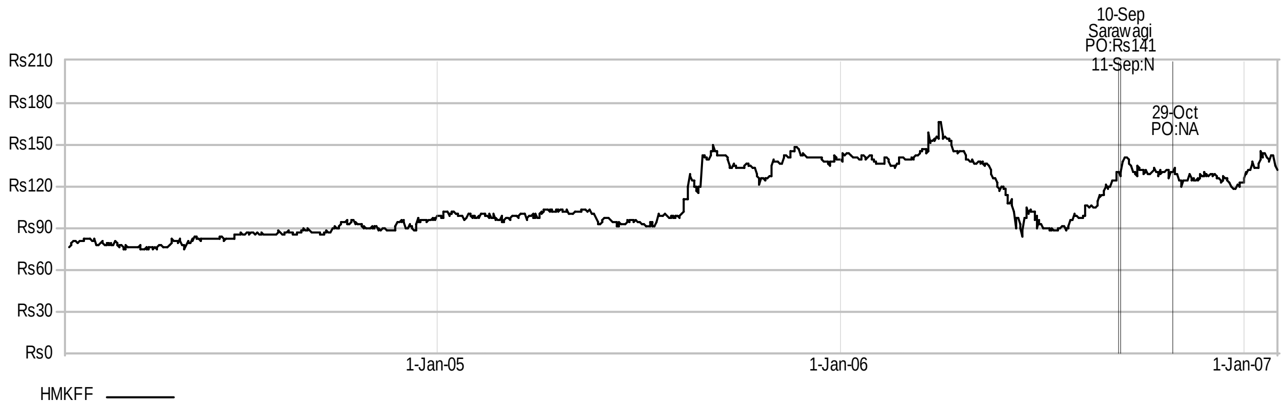
HMKFF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

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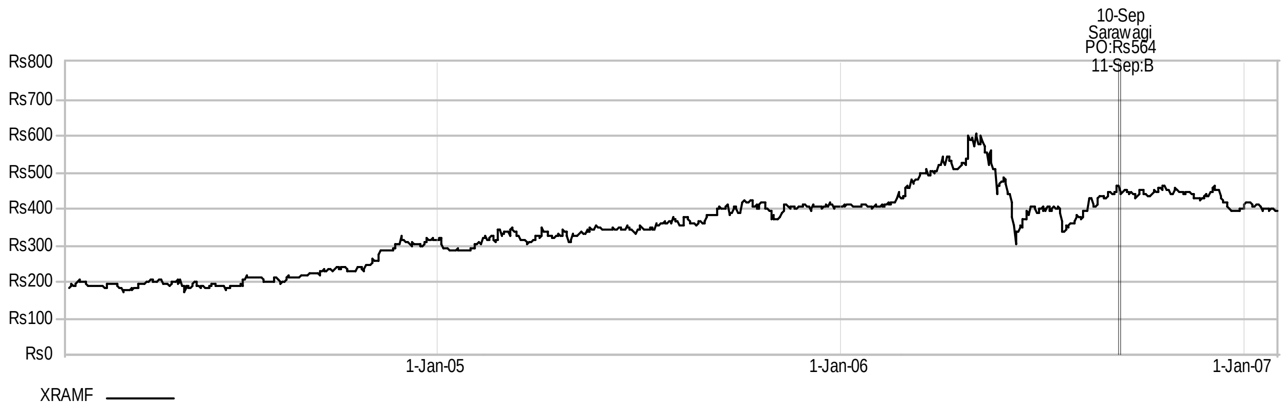
XRAMF Price Chart



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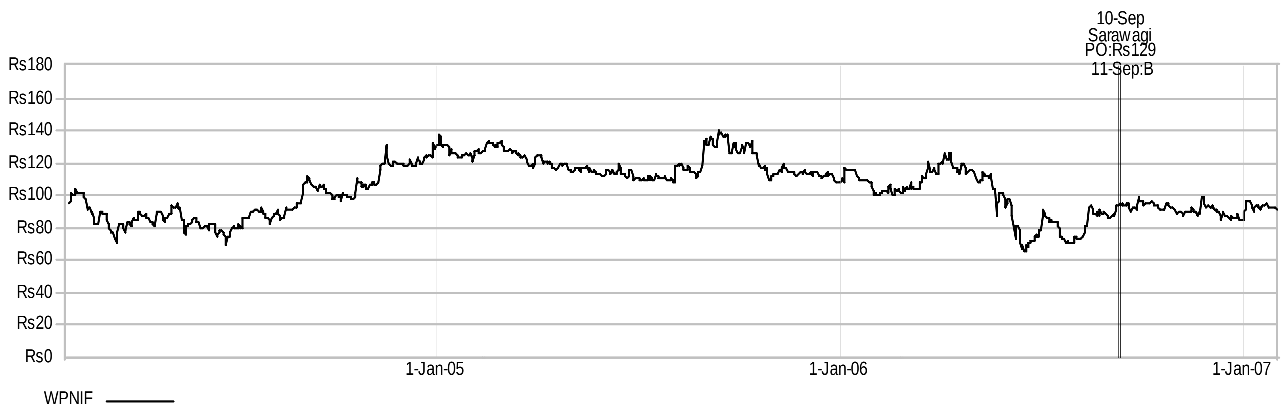
WPNIF Price Chart



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Investment Rating Distribution: Textiles/Apparel Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	13	56.52%	Buy	3	23.08%
Neutral	9	39.13%	Neutral	2	22.22%
Sell	1	4.35%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. VOLATILITY RISK RATINGS, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. INVESTMENT RATINGS, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

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