

## Vardhman Textiles

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,215	MSM IN
	REUTERS CODE
S&P CNX: 2,986	MHSP.BO

24 July 2006

Buy

Previous Recommendation: Buy

Rs266

Equity Shares (m)	64.1
52-Week Range (Rs)	420/250
1,6,12 Rel.Per. (%)	-11/-27/-43
M.Cap (Rs. b)	17.0
M.Cap (US\$ b)	0.4

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	1,964	30.7	49.3	8.7	1.5	20.3	11.9	1.4	7.7
3/07E	23,050	1,797	28.0	6.1	9.5	1.3	14.8	10.4	1.4	7.7
3/08E	25,850	2,109	32.9	17.4	8.1	1.2	15.4	10.0	1.4	7.3

Only FY06 PAT is adjusted

- 1QFY07 results were better than our expectations. Revenues increased 12.7% YoY to Rs4.7b v/s our estimate of Rs4.6b. EBITDA at Rs836m (17.6%) was higher v/s our estimate of Rs811m (17.6%).
- PAT was buoyed by higher other income of Rs62m on account of interest from FCCB cash holdings. Consequently, PAT increased by nearly 29% YoY to Rs374m v/s our estimate of Rs337m.
- Revenue from the Fabric division grew robustly by 47.2% YoY to Rs971m; from the yarn segment, by 17% YoY to Rs3.2b and from Steel, by 5.5% YoY to Rs738m. However, the Sewing Thread division witnessed a revenue decline by 9.6% YoY to Rs625m.
- EBIT margins were flat across all segments except Steel, which witnessed a 273bp decline.
- During the quarter, Fabric capacity increased to 38m-39m meters p.a., and is likely to increase to 42m meters by 2QFY07.
- Post this Fabric division expansion at Baddi, all new capacities would come up in a greenfield project in Madhya Pradesh.
- The stock is trading at a PER of 9.5x FY07 EPS of Rs28 and 8.1x FY08 EPS of Rs32.9. Maintain **Buy**.

### QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
<b>Sales</b>	<b>4,221</b>	<b>4,596</b>	<b>5,127</b>	<b>4,948</b>	<b>4,755</b>	<b>5,302</b>	<b>6,078</b>	<b>6,915</b>	<b>18,892</b>	<b>23,050</b>
Change (%)	2.0	-3.9	6.0	3.9	12.7	15.4	18.5	39.8	2.1	22.0
<b>EBITDA</b>	<b>783</b>	<b>853</b>	<b>958</b>	<b>836</b>	<b>836</b>	<b>950</b>	<b>1,106</b>	<b>1,246</b>	<b>3,430</b>	<b>4,140</b>
Change (%)	16.0	19.2	30.7	9.5	6.8	11.3	15.4	49.1	18.9	20.7
As % of Sales	18.5	18.6	18.7	16.9	17.6	17.9	18.2	18.0	18.2	18.0
Depreciation	251	251	267	244	286	315	356	412	1,013	<b>1,369</b>
Interest	112	98	91	93	110	143	150	173	395	575
Other Income	12	27	56	120	62	46	50	42	214	200
Extra-ordinary Income	0	0	0	270	0	0	0	0	270	0
<b>PBT</b>	<b>431</b>	<b>531</b>	<b>656</b>	<b>888</b>	<b>501</b>	<b>538</b>	<b>651</b>	<b>703</b>	<b>2,506</b>	<b>2,395</b>
Tax	142	132	143	127	126	118	156	197	543	599
Effective Tax Rate (%)	32.8	24.8	21.7	14.3	25.2	22.0	24.0	28.0	21.7	25.0
Reported PAT	<b>290</b>	<b>399</b>	<b>513</b>	<b>762</b>	<b>375</b>	<b>420</b>	<b>495</b>	<b>506</b>	<b>1,963</b>	<b>1,797</b>
<b>Adj. PAT</b>	<b>290</b>	<b>399</b>	<b>513</b>	<b>492</b>	<b>375</b>	<b>420</b>	<b>495</b>	<b>506</b>	<b>1,693</b>	<b>1,797</b>
Change (%)	62.0	62.5	64.2	4.2	29.4	5.2	-3.6	3.0	62.6	6.1

E: MOSt Estimates

### Higher other income props PAT

1QFY07 PAT was buoyed by higher other income due to interest earnings from FCCB funds parked overseas. Other income increased by almost 415% YoY to Rs62m; as a result, PAT increased by almost 30% YoY to Rs375m.

### Segmental results analysis

The Fabric division witnessed robust revenue growth by 47.2% YoY to Rs971m, Yarns segment grew by 17% YoY to Rs3.2b and the Steel division grew by 5.5% YoY to Rs738m. However, the Sewing Thread division witnessed a revenue decline by 9.6% YoY to Rs625m. This was due to a change in the company's accounting policy. Earlier reported revenues in the Sewing Thread division were at pre-discount levels of around 20%, while from 1QFY07, reported revenues were net of discounts.

EBIT margins for Yarns and Sewing Thread was marginally lower by 21bp YoY and 56bp YoY respectively, while Fabric EBIT margins were up by 43bp YoY. However, Steel witnessed a sharp 273bp YoY decline in EBIT margins.

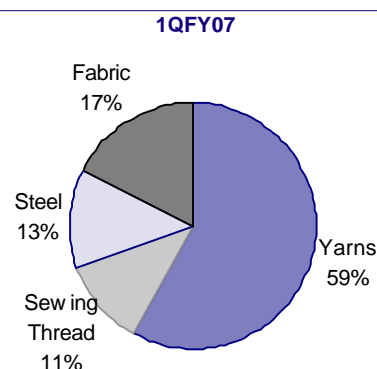
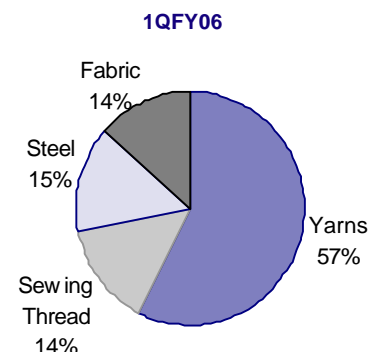
During 1QFY07, Vardhman's Fabric capacity stood at 38m-39m meters p.a., and likely to increase to 42m meters by 2QFY07. Fabric division is currently operating at 80% utilization, management expects Fabric division margins to expand with increase in utilization rates, going forward.

#### SEGMENTAL ANALYSIS (RS M)

SEGMENT REVENUES	1QFY06	1QFY07	% CHANGE
<b>Yarns</b>	2,772	3,244	17
Sewing Thread	691	625	-10
Steel	700	738	6
Fabric	660	971	47
Inter Segment Revenue	602	822	37
<b>Total</b>	<b>4,221</b>	<b>4,755</b>	<b>13</b>
<b>EBIT</b>			
Yarns	338	389	15
Sewing Thread	92	80	-13
Steel	123	110	-11
Fabric	42	66	57
<b>Total</b>	<b>595</b>	<b>644</b>	<b>8</b>
<b>EBIT (%)</b>			
Yarns	12	12	-2
Sewing Thread	13	13	-4
Steel	18	15	-16
Fabric	6	7	7

Source: Company/ Motilal Oswal Securities

#### REVENUE MIX



Source: Company/ Motilal Oswal Securities

### Capacity expansion plans

Vardhman is embarking on a significant capacity expansion spree with a capex outlay of close to Rs20b. Post expansion, its processed Fabric capacity would increase by around 168% to 102m meters over FY06-FY08. Spindle capacity would increase by around 55% YoY to 0.7m spindles over the same period.

#### CAPACITY ADDITIONS OVER FY06-08

	FY06	FY07	FY08
<b>Spindles (In No's.)</b>			
Baddi	170,600	198,200	198,200
Other Existing Plants	307,300	307,300	307,300
Greenfield at MP	-	90,000	234,000
<b>Total</b>	<b>477,900</b>	<b>595,500</b>	<b>739,500</b>
<b>Greige Fabric (Looms in No's.)</b>			
Baddi	430	490	490
Greenfield at MP	-	120	400
<b>Total</b>	<b>430</b>	<b>610</b>	<b>890</b>
<b>Processed Fabric (mm)</b>			
Baddi	38	42	42
Greenfield at MP	-	10	60
<b>Total</b>	<b>38</b>	<b>52</b>	<b>102</b>

Source: Company/ Motilal Oswal Securities

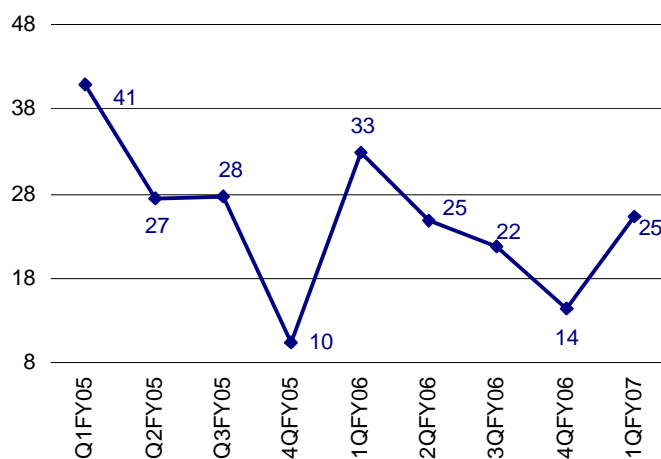
### Value added sales to increase

Vardhman's brownfield capex has increased its Fabric capacity to 38m-40m meters in FY06, from 25m meters in FY05. The company is further embarking on a Rs20b brownfield and 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 102m meters and a corresponding increase in its spindle capacity by 234,000 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.

### 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.

LOWER TAX PROVISIONING (%)



Source: Company/ Motilal Oswal Securities

### Valuation and view

We expect Vardhman's sales and earnings to witness a CAGR of 17% and 12%, respectively, over FY06-FY08E. 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 the downstream industry (garment industry). Hence, we have a bullish view on upstream companies such as Vardhman Textiles. The stock is trading at a PER of 9.5x FY07 EPS of Rs28 and 8.1x FY08 EPS of Rs32.9. **Maintain Buy.**

## 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 12% 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.TEX.	WELSPUN	ARVIND
P/E (x)	FY07E	9.5	9.3	12.1
	FY08E	8.1	7.6	9.4
P/BV (x)	FY07E	1.3	0.9	0.8
	FY08E	1.2	0.8	0.7
EV/Sales (x)	FY07E	1.4	1.9	1.5
	FY08E	1.4	1.8	1.4
EV/EBITDA (x)	FY07E	7.7	9.1	7.0
	FY08E	7.3	8.4	7.1

#### 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	16.5

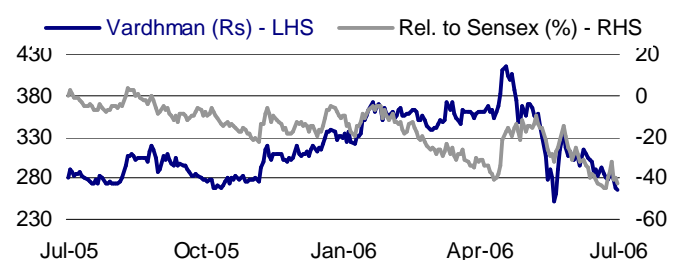
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	28.0	30.4	-7.7
FY08	32.9	38.1	-13.7

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
266	400	50.4	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2005	2006E	2007E	2008E	
<b>Net Sales</b>	<b>18,509</b>	<b>18,892</b>	<b>23,050</b>	<b>25,850</b>	
Change (%)	7.7	2.1	22.0	12.1	
<b>Total Expenditure</b>	<b>17,126</b>	<b>15,461</b>	<b>17,999</b>	<b>20,201</b>	
<b>EBITDA</b>	<b>2,885</b>	<b>3,430</b>	<b>4,140</b>	<b>4,834</b>	
Change (%)	10.2	18.9	20.7	16.8	
% of Net Sales	15.6	18.2	18.0	18.7	
Depreciation	970	1,013	1,369	1,619	
<b>EBIT</b>	<b>1,915</b>	<b>2,417</b>	<b>2,770</b>	<b>3,215</b>	
Interest & Finance Charges	591	395	575	615	
Other Income	273	244	200	250	
Non-recurring Items/ Income	0	270	0	0	
<b>PBT</b>	<b>1,597</b>	<b>2,506</b>	<b>2,395</b>	<b>2,850</b>	
Tax	389	543	599	741	
Effective Rate (%)	24.4	21.7	25.0	26.0	
<b>Reported PAT</b>	<b>1,208</b>	<b>1,964</b>	<b>1,797</b>	<b>2,109</b>	
Change (%)	32.3	62.6	-8.5	17.4	
<b>Adjusted PAT</b>	<b>1,208</b>	<b>1,694</b>	<b>1,797</b>	<b>2,109</b>	

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

E: MOST Estimates

RATIOS					
Y/E MARCH	2005	2006E	2007E	2008E	
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>18.9</b>	<b>30.7</b>	<b>28.0</b>	<b>32.9</b>	
Cash EPS	34.0	42.3	49.4	58.2	
Book Value per Share	123.8	178.4	200.7	227.9	
DPS	4.5	4.5	5.0	5.0	
Payout (Incl. Div. Tax) %	17.4	19.4	20.3	17.3	
<b>Valuation (x)</b>					
P/E	14.1	8.7	9.5	8.1	
Cash P/E	7.8	6.3	5.4	4.6	
EV/EBITDA	8.7	7.7	7.7	7.3	
EV/Sales	14	14	14	14	
Price to Book Value	2.1	15	13	12	
Dividend Yield (%)	17	17	19	19	
<b>Profitability Ratios (%)</b>					
RoE	16.2	20.3	14.8	15.4	
RoCE	11.2	11.9	10.4	10.0	
<b>Turnover Ratios</b>					
Debtors (Days)	41	45	45	45	
Inventory (Days)	145	150	150	150	
Creditors (Days)	13	14	15	15	
Working Capital (Days)	172	206	176	178	
Asset Turnover (x)	1.1	0.8	0.8	0.7	
Fixed Asset Turnover (x)	1.2	0.9	0.8	0.8	
<b>Leverage Ratio</b>					
Debt/Equity (x)	1.03	0.96	1.20	1.26	

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



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**Vardhman Textiles**

- |   |    |
|---|----|
| 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 |

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