

Company Flash

1 March 2007 | 6 pages

Vardhaman Textiles (VART.BO)

Buy: De-merging Sewing Thread business, a Positive

- What's new** — Vardhaman Textiles announced plans to de-merge the sewing thread business (14% of FY07E revenues) to its 100% subsidiary Vardhaman Yarns and Threads (VYTL). Additionally, the threads business of another 100% subsidiary, Vardhaman Threads, will also be transferred to VYTL.
- Scheme of de-merger** — Vardhaman Textiles will transfer the sewing thread business along with a spinning unit, all assets and liabilities. Additionally, the threads business of 100% subsidiary Vardhaman Threads (Rs.213mn in sales) including all assets and liabilities associated with this business will be transferred to VYTL with effect from 1 April 2007.
- Swap ratio for de-merger** — 1) Vardhaman Textiles' sewing thread division will be transferred as a going concern on a slump-sale basis for Rs.2.6bn; 2) For every 2 shares held in Vardhaman Threads, equity holders would get one equity share of VYTL and one share of Vardhaman Threads; this remains subject to the requisite approvals of the regulatory authorities.
- Rationale** — This move should consolidate the sewing thread business (~15% of Group revenues) under one entity, and create better control and management.
- Impact** — Prima facie, we believe this de-merger is positive. This would: 1) Re-enforce the focus on growth in the sewing thread business; 2) strengthen its second position with 18% market share; and 3) provide a platform for growing this business through strategic alliances at a later date. We see this contributing towards incremental revenues and earnings, but we await more details.

Buy/Low Risk	1L
Price (01 Mar 07)	Rs223.00
Target price	Rs350.00
Expected share price return	57.0%
Expected dividend yield	2.2%
Expected total return	59.2%
Market Cap	Rs12,883M
	US\$292M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	1,208	20.90	100.7	10.7	1.1	18.6	2.0
2006A	1,692	29.28	40.1	7.6	1.3	19.2	1.8
2007E	1,843	31.91	9.0	7.0	1.2	17.7	2.2
2008E	2,476	38.64	21.1	5.8	0.9	18.2	2.2
2009E	3,303	51.54	33.4	4.3	0.8	18.9	2.7

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Vardhaman Textiles

Company description

Vardhaman Textiles (erstwhile Mahavir Spinning Mills) is a leader in its sector, with 500,000 spindles offering the widest product range in cotton and blended yarn in India. It is the second-largest company with an 18% market share in sewing threads. The company has a vertically integrated business model, giving it a significant presence in fabrics (17% of FY06 revenues). It is also present in special and alloy steel hot rolled products and is a vendor to OEMs in the automotive and engineering space. Its superior quality and wide product range in higher-value-add products make it a preferred supplier to domestic and international manufacturers in textiles and apparels. Direct exports contribute 21% of revenues, excluding the sales to exporters. It is the flagship company of the SP Oswal Group, with the major shareholders owning a 62% stake.

Investment thesis

We maintain our Buy/Low Risk (1L) rating on Vardhaman Textiles with a target price of Rs350 based on 10x Sept 07E P/E, on par with sector valuations.

Vardhaman's large-scale expansion, focus on higher value addition and vertical integration into fabric will help de-risk its business model by reducing dependence on commodity yarn business. We expect large capacity expansions in fabric, growth in sewing thread and thrust on diversifying to richer product in yarn to drive growth. Improving outlook for its subsidiaries manufacturing different yarns and threads for the textile industry would complement overall growth by 5-6%. Expansion in yarn and fabric are part of a strategy to invest in capital-intensive projects taking advantage of TUF (Technology Upgradation Fund). We believe this will differentiate Vardhaman from other Indian companies and maintain focus on core segments in the textile value chain, like spinning and weaving.

Valuation

Our target price of Rs350 is based on 10x Sept 07E P/E, on par with sector average. P/E is our primary valuation tool as we think it best captures earnings growth potential. While the company's efforts to move away from the commodity business of yarn and its vertical integration into fabric are positive, earnings growth will be back-ended as significant expansions are likely to get commissioned in phases only by FY08. The stock is currently trading at compelling valuations of 6.4x Sept 07 P/E, a 29% discount to the industry, towards the lower end of its two-year historical trading band (6-10x). With our forecasts of accelerating earnings growth over FY07-09E, the company's leadership in yarns and its strong management team, we see the stock's valuation catching-up with those of the industry in the near term.

Risk

We rate Vardhaman Textiles as Low Risk based on our quantitative risk-rating system, which measures the stock volatility over a 260-day period. The main company specific risks include: 1) Any sharp increase in cotton prices of over 10-12% above Rs48/kg would impact our earnings estimates by 8-9% as cotton is a key raw material for Vardhaman's product range; 2) Any fall of more than 2-3% in yarn price realizations, due to the commodity nature of the business, would likely impact the profitability of the company's yarn business by 3-5%; 3) Any delay in the commissioning of fabric capacities would further lower our forecasted revenue growth of 19% CAGR over FY06-08E; and 4) Lower-than-the-

expected 3% CAGR decline over FY05-08E in price realizations of steel alloy business would adversely impact the operating profitability of its steel alloy business (18% of total operating profits). If any of these risk factors is greater-than-expected, Vardhaman's share price is likely to have difficulty attaining our target price.

Appendix A-1

Analyst Certification

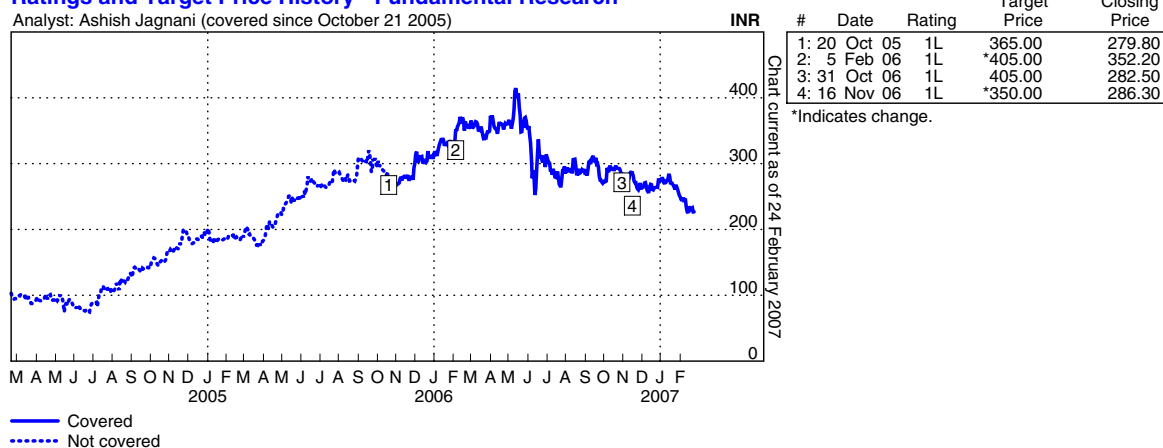
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Vardhaman Textiles Ltd (VART.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Ashish Jagnani (covered since October 21 2005)



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1 March 2007

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