

Unexciting August, looming interest rate risk

Mixed SSS growth trend in August

Value same store sales (SSS) growth at 14% for August was better than 11% last month and 10% in FY08. The improvement was expected, led by the 5 day discount sales festival in mid-August, which saw record sales and customer footfalls. However, lifestyle SSS growth was disappointing with only 8% growth in August versus 13% last month and 11.6% in FY08.

New area addition run rate slower than expected

Pantaloon added close to 0.2mn sq ft of retail space in August including 5 Big Bazaars (net of 1 Big Bazaar and 4 Food Bazaars closed). This takes the total space (excluding Home Retail) to about 7.8mn. The company needs to add 0.36mn sq ft per month in the remaining months to reach our FY09 yr-end forecast of 11.45mn.

High interest rate sensitivity

While rent and salary costs are beginning to peak off, interest costs are rising sharply. We model FY09 interest rate at 11.5% but believe there is upside risk. We note that earnings sensitivity to interest rates is very high – every 1% change in interest affects our EPS by 14%. Pantaloon aims to grow its area by 3x by June 2012. To achieve this, we forecast its gearing to rise from 1.2x in FY09 to 1.9x in FY10 and further to 2.2x in FY11. Weak balance sheet is owing primarily to high inventory – at 30% of sales.

Rich valuations, Maintain Underperform

Post the sharp 30% correction in the last 6 months, Pantaloon is still very expensive at FY09E P/E of 47x and ex-subs at 37x. We believe macro concerns & consensus downgrades will plague stock performance. Our SOTP based PO of Rs330 is based on Rs227 for stand-alone retail, Rs58 for Future Capital and Rs44 for Home Retail.

Estimates (Jun)

(Rs)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	642	610	1,216	1,257	1,397
EPS	5.42	3.83	7.07	7.31	8.13
EPS Change (YoY)	39.0%	-29.3%	84.6%	3.3%	11.2%
Dividend / Share	0.567	0.500	0.354	0.365	0.406
Free Cash Flow / Share	(34.24)	(66.54)	(82.25)	(97.01)	(110.41)

Valuation (Jun)

	2006A	2007A	2008E	2009E	2010E
P/E	64.57x	91.32x	49.46x	47.87x	43.05x
Dividend Yield	0.162%	0.143%	0.101%	0.104%	0.116%
EV / EBITDA*	54.59x	35.96x	17.21x	12.38x	8.69x
Free Cash Flow Yield*	-8.26%	-17.53%	-23.51%	-29.94%	-34.07%

* For full definitions of *iQmethod*SM measures, see page 7.



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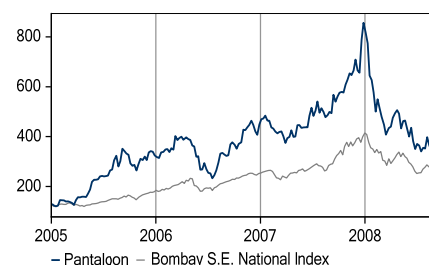
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Stock Data

Price	Rs349.85
Price Objective	Rs330.00
Date Established	13-Aug-2008
Investment Opinion	C-3-8
Volatility Risk	HIGH
52-Week Range	Rs317.00-Rs875.00
Mrkt Val / Shares Out (mn)	US\$1,243 / 159.3
Average Daily Volume	137,451
ML Symbol / Exchange	PFI AF / BSE
Bloomberg / Reuters	PF IN / PART.BO
ROE (2008E)	8.3%
Net Dbt to Eqty (Dec-1899A)	104.1%
Est. 5-Yr EPS / DPS Growth	30.0% / 25.0%
Free Float	57.7%



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*iQprofile*SM Pantaloon Retail (India) Limited

Key Income Statement Data (Jun)

	2006A	2007A	2008E	2009E	2010E
(Rs Millions)					
Sales	18,678	32,367	49,969	74,344	111,719
Gross Profit	6,243	10,273	15,719	23,586	35,197
Sell General & Admin Expense	(4,823)	(8,117)	(11,214)	(17,326)	(26,270)
Operating Profit	1,212	1,787	3,652	4,982	6,889
Net Interest & Other Income	(293)	(872)	(1,796)	(3,078)	(4,772)
Associates	NA	NA	NA	NA	NA
Pretax Income	919	916	1,857	1,904	2,117
Tax (expense) / Benefit	(277)	(305)	(641)	(647)	(720)
Net Income (Adjusted)	642	610	1,216	1,257	1,397
Average Fully Diluted Shares Outstanding	119	159	172	172	172

Key Cash Flow Statement Data

Net Income (Reported)	642	610	1,216	1,257	1,397
Depreciation & Amortization	208	369	852	1,279	2,038
Change in Working Capital	(3,601)	(6,282)	(8,516)	(8,509)	(9,761)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	0	0	0	0	0
Cash Flow from Operations	(2,751)	(5,303)	(6,447)	(5,973)	(6,325)
Capital Expenditure	(1,852)	(4,461)	(6,651)	(10,707)	(12,660)
(Acquisition) / Disposal of Investments	(1,087)	(1,114)	(2,994)	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(2,939)	(5,575)	(9,646)	(10,707)	(12,660)
Shares Issue / (Repurchase)	2,489	4,541	6,263	6,363	0
Cost of Dividends Paid	(58)	(63)	(52)	(54)	(60)
Cash Flow from Financing	5,583	11,460	15,087	16,701	19,004
Free Cash Flow	(4,603)	(9,764)	(13,099)	(16,680)	(18,984)
Net Debt	5,796	11,366	21,264	31,656	50,721
Change in Net Debt	3,259	6,400	9,883	10,372	19,045

Key Balance Sheet Data

Property, Plant & Equipment	3,955	8,057	13,857	23,285	33,906
Other Non-Current Assets	1,406	2,520	5,514	5,514	5,514
Trade Receivables	170	652	999	1,487	2,234
Cash & Equivalents	218	1,630	609	609	609
Other Current Assets	8,437	15,213	25,380	35,986	49,110
Total Assets	14,186	28,072	46,359	66,880	91,373
Long-Term Debt	6,014	12,996	21,873	32,265	51,329
Other Non-Current Liabilities	279	558	558	558	558
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	2,623	3,596	5,597	8,178	12,289
Total Liabilities	8,916	17,150	28,027	41,001	64,176
Total Equity	5,269	10,922	18,331	25,879	27,197
Total Equity & Liabilities	14,185	28,072	46,359	66,880	91,373

*iQmethod*SM - Bus Performance*

Return On Capital Employed	10.5%	6.7%	7.4%	6.7%	6.6%
Return On Equity	17.2%	7.5%	8.3%	5.7%	5.3%
Operating Margin	6.5%	5.5%	7.3%	6.7%	6.2%
EBITDA Margin	7.6%	6.7%	9.0%	8.4%	8.0%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	-4.3x	-8.7x	-5.3x	-4.8x	-4.5x
Asset Replacement Ratio	8.9x	12.1x	7.8x	8.4x	6.2x
Tax Rate (Reported)	30.1%	33.4%	34.5%	34.0%	34.0%
Net Debt-to-Equity Ratio	110.0%	104.1%	116.0%	122.3%	186.5%
Interest Cover	3.6x	2.0x	2.0x	1.6x	1.4x

Key Metrics

* For full definitions of *iQmethod*SM measures, see page 7.

Company Description

Pantaloon Retail is India's largest organized retailer. It operates over 7mn sq ft in more than 40 cities under various formats, such as Pantaloon (department store), Big Bazaar (hypermarket), Food Bazaar (supermarket), Central (seamless mall) and Home Solutions (electronics, furniture).

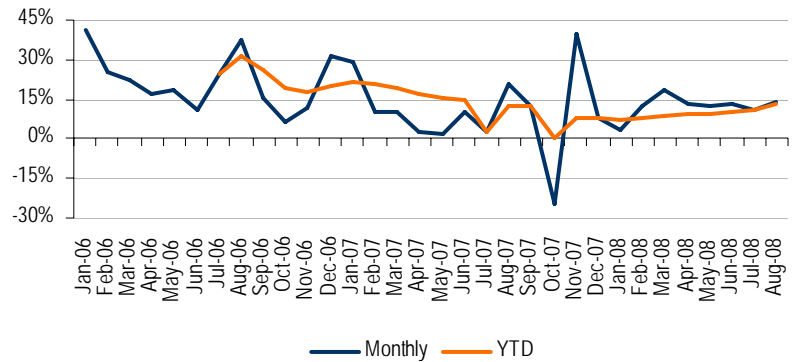
Investment Thesis

We like Pantaloon's speed in store rollouts across formats, management's long-term focus on property lock-ins and industry wide peaking of rent and salary costs. But our Underperform rating is based on risk to earnings owing to high inventory at about 30pct of sales and stretched balance sheet. Our EPS forecasts are far below consensus and we believe the market is overestimating the margin potential. We are also uncomfortable with the company's high gearing and low interest cover.

Stock Data

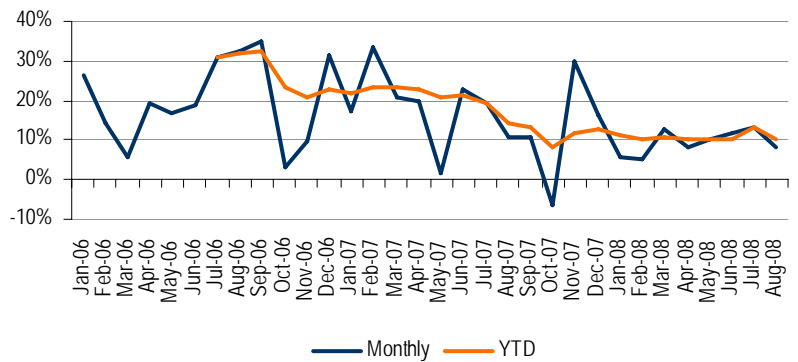
Price to Book Value 3.0x

Value SSS growth at 14% for August was better than 11% last month and 10% in FY08

Chart 1: Value same store sales growth trend


Source: Company, Merrill Lynch

Lifestyle SSS growth saw a deceleration with only 8% growth in August versus 13% last month and 11.6% in FY08

Chart 2: Lifestyle same store sales growth trend


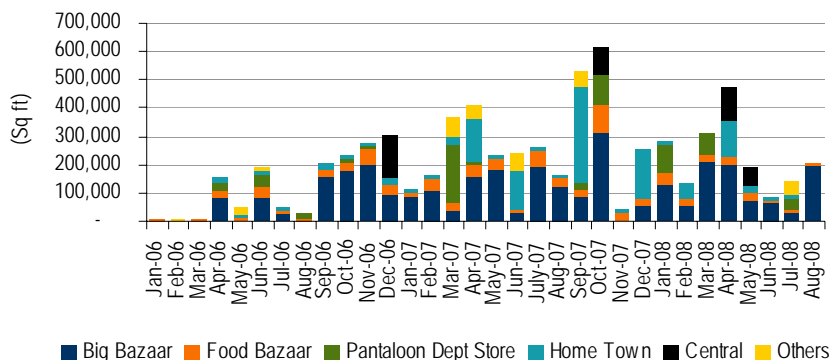
Source: Company, Merrill Lynch

Table 1: Cumulative area across formats (incl Home Retail)

(mn sq ft)	Big Bazaar	Food Bazaar	Pantaloons Dept Store	Home Town	Central	Total
Aug-07	2.8	0.8	0.8	0.5	0.7	5.7
Sep-07	2.9	0.9	0.8	0.8	0.7	6.3
Oct-07	3.2	1.0	0.9	0.8	0.8	6.9
Nov-07	3.2	1.0	0.9	0.8	0.8	6.9
Dec-07	3.2	1.0	0.9	1.0	0.8	7.2
Jan-08	3.4	1.1	1.0	1.0	0.8	7.5
Feb-08	3.4	1.1	1.0	1.1	0.8	7.6
Mar-08	3.6	1.1	1.0	1.1	0.8	7.9
Apr-08	3.8	1.1	1.0	1.2	0.9	8.4
May-08	3.9	1.2	1.0	1.2	1.0	8.6
Jun-08	4.0	1.2	1.0	1.2	1.0	8.7
Jul-08	4.0	1.2	1.1	1.3	1.0	8.8
Aug-08	4.2	1.2	1.1	1.3	1.0	9.0
Growth over last 12 months	51%	42%	44%	166%	40%	57%

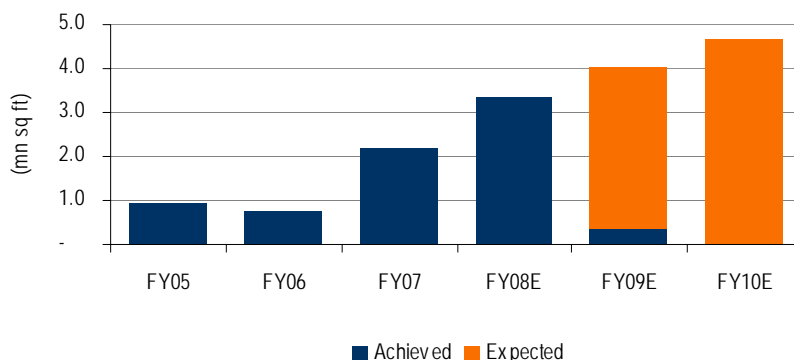
Source: Company, Merrill Lynch

Pantaloon opened 5 new Big Bazaars and closed 1 Big Bazaar in Ahmedabad. Net area addition was about 0.2mn sq ft for August

Chart 3: Monthly area addition trend


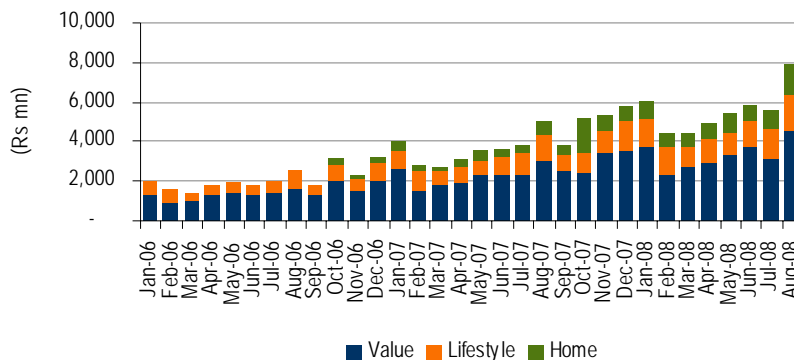
Source: Company, Merrill Lynch

The company needs to add 0.36mn sq ft per month in the remaining months to reach our FY09 yr-end forecast of 11.45mn

Chart 4: Area additions: achieved vs expected for the standalone business


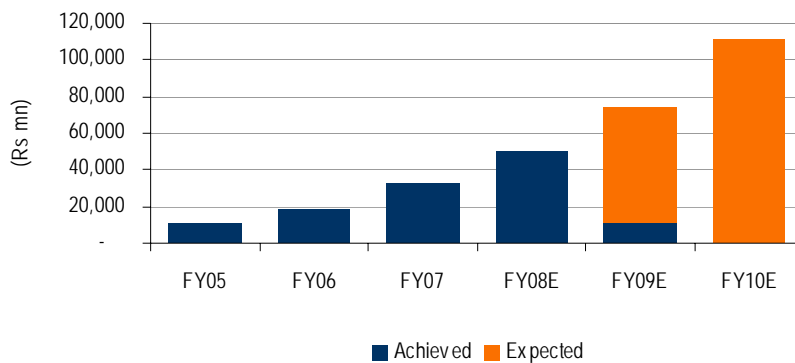
Source: Company, Merrill Lynch

Record sales in August driven by the 5 day discount offer festival in mid-August

Chart 5: Monthly sales trend


Source: Company, Merrill Lynch

Chart 6: Sales: Achieved vs expected for standalone business



Source: Company, Merrill Lynch

Price objective basis & risk

Pantaloon (PFI AF)

Our PO of Rs330 is based on SOTP valuation comprising stand alone retail at Rs227, home at Rs44 and Future Capital at Rs58. Retail is based on DCF using WACC of 13pct, steady state EBITDA margin of 8pct from FY10E onwards and terminal growth rate of 5pct. Home is based on 0.7x FY09E sales owing to high gestation costs in the medium term. Future Capital is based on AMC at 17pct of AUM and consumer credit at P/BV of 1x FY10E. Downside risks: Stiffer competition, store cannibalization in retail, and inability to grow the consumer credit and asset management businesses in Future Capital. Upside risks: Stronger-than-expected consumer demand.

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10 September 2008

India - Consumer Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
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	McLeod Russel India Ltd.	XCVFF	MCLR IN	Manish Sarawagi
	Nestle India	XNTEF	NEST IN	Vandana Luthra
	Titan Inds Ltd	TTNIF	TTAN IN	Manish Sarawagi
	United Spirits	UDSRF	UNSP IN	Vandana Luthra
	Welspun India	WPNIF	WLSI IN	Manish Sarawagi
NEUTRAL				
	Colgate India	CPIYF	CLGT IN	Vandana Luthra
	Dabur India	DBUIF	DABUR IN	Vandana Luthra
	Himatsingka Seid	HMKFF	HSS IN	Manish Sarawagi
UNDERPERFORM				
	Arvind Ltd	ARVZF	ARVND IN	Manish Sarawagi
	Asian Paints	XAPNF	APNT IN	Vandana Luthra
	Gokaldas Exports	GKLDF	GEXP IN	Manish Sarawagi
	Hindustan Unilever	HINLF	HUVR IN	Vandana Luthra
	ITC Limited	ITCTF	ITC IN	Vandana Luthra
	Pantaloon	PFI AF	PF IN	Vandana Luthra
	Radico Khaitan	RKHAF	RDCK IN	Vandana Luthra
	Raymond Ltd	XRAMF	RW IN	Manish Sarawagi
	Shoppers' Stop	SHPSF	SHOP IN	Manish Sarawagi
	Vishal Retail Ltd	XVHLF	VISH IN	Manish Sarawagi

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

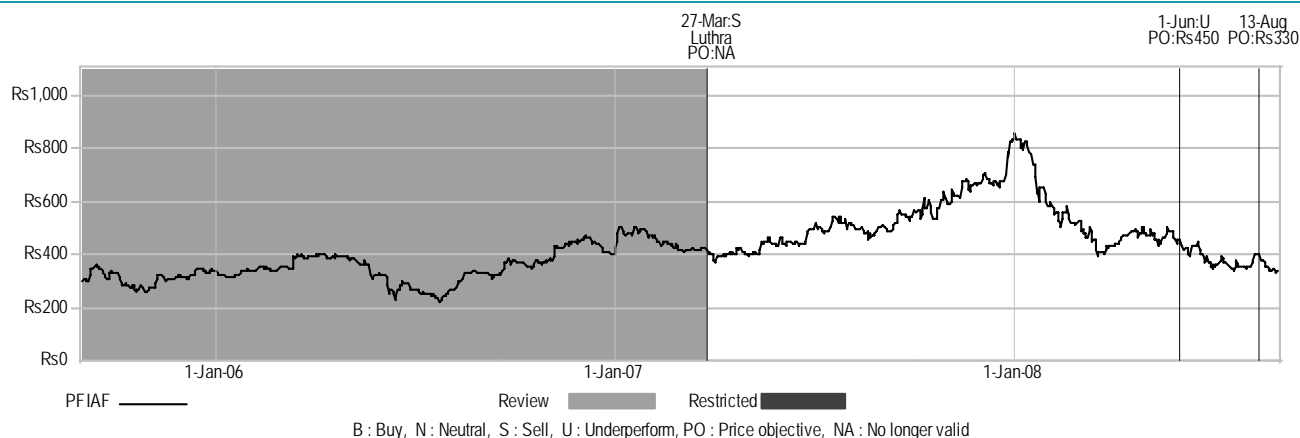
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Investment Rating Distribution: Retailing Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	65	49.62%	Buy	6	9.68%
Neutral	27	20.61%	Neutral	7	29.17%
Sell	39	29.77%	Sell	4	10.81%

Investment Rating Distribution: Global Group (as of 01 Jul 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1664	47.42%	Buy	441	29.46%
Neutral	803	22.88%	Neutral	224	31.46%
Sell	1042	29.70%	Sell	217	22.84%

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Underperform	N/A	≥ 20%

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