VISHAL RETAIL

INR 230-270

Value for money

SUBSCRIBE

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Indian organized retail expected to grow at 38% CAGR over FY06-11E

The Indian retail industry is projected to grow at a CAGR of 7.2% over FY06-11E from USD 290 bn in FY06 to USD 425 bn in FY11E. As per Technopak, in the backdrop of low penetration and steady economic growth, the organised retail will post a 38% CAGR over FY06-11E to reach USD 60 bn in FY11E.

Retailing opportunities moving beyond metros

The total retail market in the top 67 cities in India accounted for about INR 2.6 tn in FY06 and is expected to increase to INR 3.9 tn by 2011E. 87% of this opportunity comes from the top 25 cities. We believe, retailers will now work on wooing mini-metros and tier II, and III cities.

Value retailer with profitable product mix

Vishal Retail (VRL) is a focused value retailer with presence in mainly tier II and III cities in India. Its product mix comprises private and quasi-private label products, which are high on value and low on price. Its average selling price of INR 85 brings out the pre dominant value focus of the company.

Consistent store roll outs at low rentals

VRL is looking to set up 32 stores in FY08 to take its store tally to 80 from the current 50. It has already tied up 13 stores. The company has taken its store tally from 14 in FY04 to 50 in FY07. Additionally, given that 80% of its stores are in tier III cities it enjoys lower rentals in the range of INR 32-34 per sq ft against INR 45-120 per sq. ft. in the tier I cities.

Steady improvement in profitability

VRL has posted consistent improvement in its profitability along with revenue growth. Over FY04-FY07, its revenues have grown at a CAGR of 90%, EBITDA at a CAGR of 185% and net profits at a CAGR of 303%. For FY07, it posted revenues of INR 6.0 bn and net profits of INR 250 mn, a Y-o-Y growth of 109% and 101%, respectively.

Valuations attractive: Recommend 'SUBSCRIBE'

Our rough estimates for FY08E and FY09E revenues are INR 10 bn and INR 14 bn, respectively. We believe that the net margins will drop from the current 4.2% because of higher interest expenses. Our rough estimate of PAT for FY08E and FY09E are INR 340 mn and INR 416 mn, respectively. This translates into EPS of INR 15.2 and INR 18.6 on fully diluted equity. Even if we were to factor in 15-20% dilution before end of FY09 (for future expansion), VRL should make EPS in the range of INR 16.1-15.5 in FY09E. At the upper end of the price band, the stock is priced at PE of 17.8x FY08E and 14.5x FY09E (rough estimates). This valuation is at a significant discount to Pantaloon Retail, the most relevant listed comparable in the retail space (Pantaloon's core retail business trades at 43x FY08E and 32x FY09E). While we believe that VRL should trade at a discount to Pantaloon which is much bigger and has a well diversified model, we feel that the valuation gap is much higher and hence provides an upside opportunity. We recommend 'SUBSCRIBE'

Reuters	:	NA
Bloomberg	:	NA

Market Data

52-week range (INR)	:	NA
Post IPO share in issue (mn)	:	22.4 – 23.1
M cap (INR bn/USD mn)	:	NA
Avg. Daily Vol. BSE/NSE ('000)	:	NA

Share Holding Pattern (%)

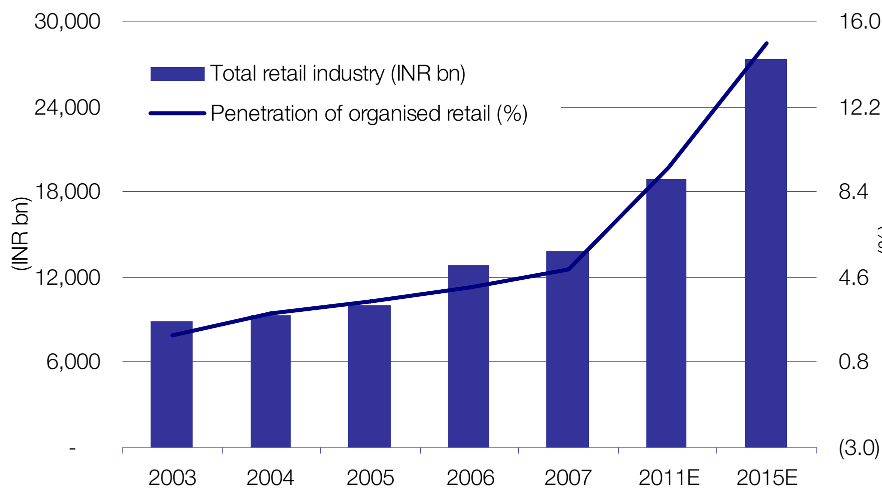
Promoter	:	63.9
Public Investors	:	18.2
Pre-IPO Investors	:	17.9

Investment Rationale

✻ Indian organized retail expected to grow at 38% (CAGR) over FY06-11E

The Indian retail industry is on the threshold of opportunity with a projected CAGR of 7.2% over FY06-11E. The industry is set to grow from USD 290 bn in FY06 to USD 425 bn in FY11E. The Indian retail market has traditionally been dominated by *kirana* and mom-and-pop stores, and therefore, is highly fragmented and unorganised. As a result, penetration of organised retail in India is low at 4.1% (implying a size of USD 12 bn). In the backdrop of low penetration, favourable demographics, steady economic growth, easy availability of credit, and large scale real estate development, the organised retail sector is in a sweet spot. As per Technopak, organised retail will post a 38% CAGR over FY06-11E to reach USD 60 bn in FY11E.

Chart 1: Indian retail industry and penetration of organized retail



Source: Technopak, Edelweiss research

The sector, in anticipation of this healthy growth, is expected to attract investments from large corporates like Reliance, Birlas, Munjals, among others, of around USD 20 bn by FY11E. However, given the low penetration levels of organized retail and the huge size of the opportunity, there will be place for quite a few players before the retail space in the country saturates.

✻ Retailing opportunities moving beyond metros

The total retail market in the top 67 cities in India accounted for about INR 2.6 tn in FY06 and is expected to increase to INR 3.9 tn by 2011E. 87% of this opportunity comes from the top 25 cities. We believe, for the next three-four years, retailers will work on wooing mini-metros and tier II, and III cities. These cities will account for 28% of the total retail opportunity in 2011, including 58% of the total households compared to 56% currently. Hence, value retailers like VRL moving to these areas are set to benefit form this enhanced consuming power.

Table 1: Estimate of penetration levels

	Penetration 2006(%)	Penetration 2010(%)
Top 6 cities	20	40
Top 24 cities	15	30
Top 37 cities	5	15
Rest of India	1	3

Source: CRISIL Research

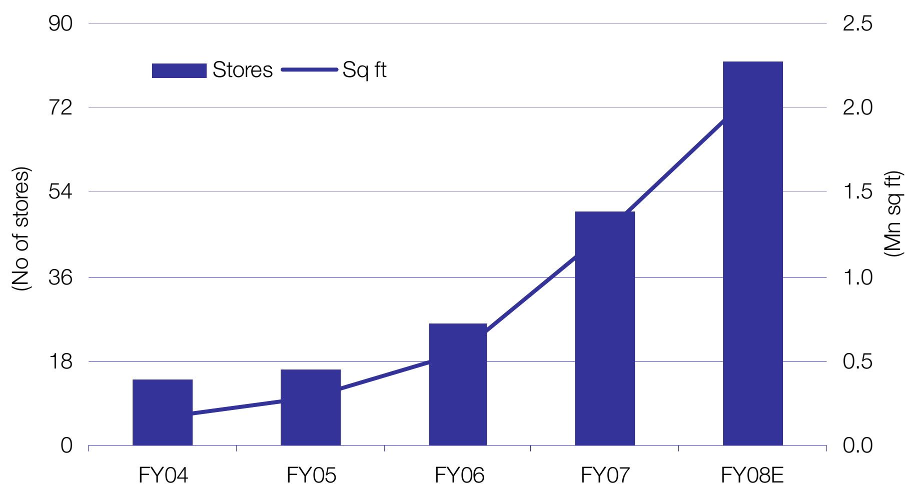
Vishal Retail; a focused value retailing player

VRL's business is modeled on the 'value for money' retailing concept and has established a strong customer connect with the middle and lower-middle income consumer groups. The company's key strategy is to offer quality products, at the minimum possible cost, with a focus on private and quasi-private label products at affordable prices. The discount store format is expected to be highly successful in the long run, as it provides the retailer with quicker stock turns and economies of scale, and the consumer reaps the benefits of variety and convenience. The company's average selling price of INR 85 indicates that its merchandise targets the value-conscious consumer.

Consistent store roll outs

VRL is looking to set up 32 stores in FY08 to take its store tally to 80 from the current 50. It has already tied up 13 stores and they are likely to be set up in the next quarter; average store size will be around 20,000-25,000 sq ft. We expect the investment per store to be around INR 50 mn. This is based on an assumption of INR 2,000 per sq ft of investment towards both the fixed cost and working capital requirements. Thus, the company will be able to set up 20 stores using the IPO proceeds of INR 1,000 mn and the balance stores will be funded through debt. With the addition of 34 stores, the company's retail space will stand at 2.1 mn sq ft. Given the company's consistent track record of rolling out stores and its focus on tier II and III cities, the planned expansions look achievable.

Chart 2: Store roll out



Source: Company

Relatively lower rental costs due to focus on tier II and III cities

VRL has always focused on tier II and III cities and intends to maintain this strategy gong forward; 43 of VRL's 50 existing stores are located in tier II and III cities. A big advantage of this strategy is that rentals in these cities are much lower than in tier I cities, at around INR 30-34 per sq ft. This has resulted in rental costs being much lower for VRL at 5.4% of revenues, against 6.4% for Pantaloon Retail. VRL has locked in most of its new properties at a rental of INR 32-34 per sq ft. At present, revenues from the North dominate, with a 62% share of total revenues; however, this mix is likely to change soon as most of its new stores are coming up in the West, East, and Central parts of India.

Table 2: Tier II and III locations dominate store distribution

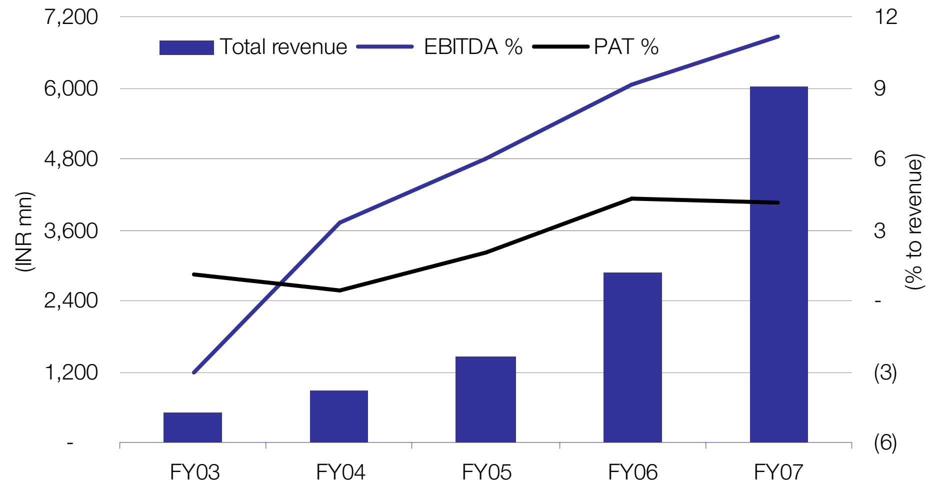
	Existing	Planned	Total	% distribution
Tier I	7	3	10	12
Tier II	3	1	4	5
Tier III	40	28	68	83
Total	**50**	**32**	**82**	**100**

Source: Company, Edelweiss research

Steady improvement in profitability

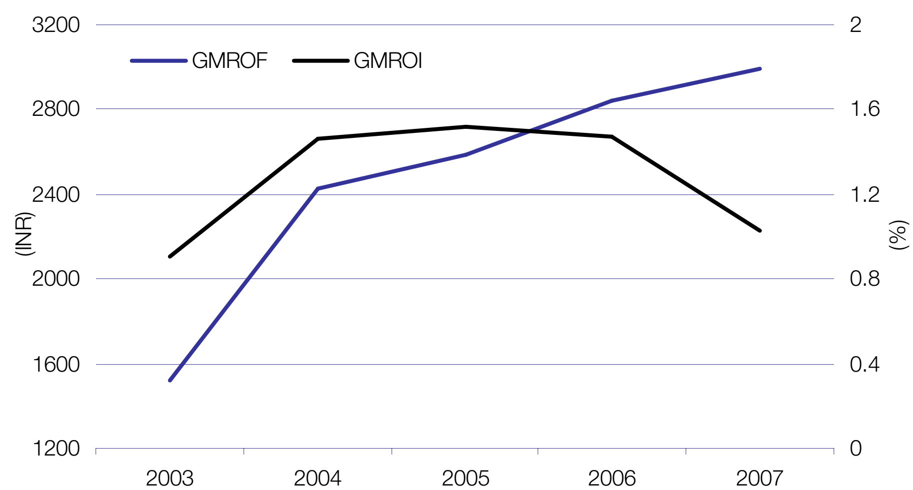
VRL has been consistent in the past in terms of improving operating metrics along with a growing top line. The company's EBITDA margins have expanded from 3.3% in FY04 to 11.1% in FY07 on the back of an improved product mix, integrated operations, investments in logistics and distribution, and investments in internal control systems. Its net margins too have improved from 0.4% in FY04 to 4.2% in FY07. The investments in systems has helped the company optimize the inventory level and maximize the gross returns on inventory and retail space.

Chart 3: Consistent growth in revenues and margins



Source :Company, Edelweiss Research

Chart 4: Efficiency measures



Source: Company

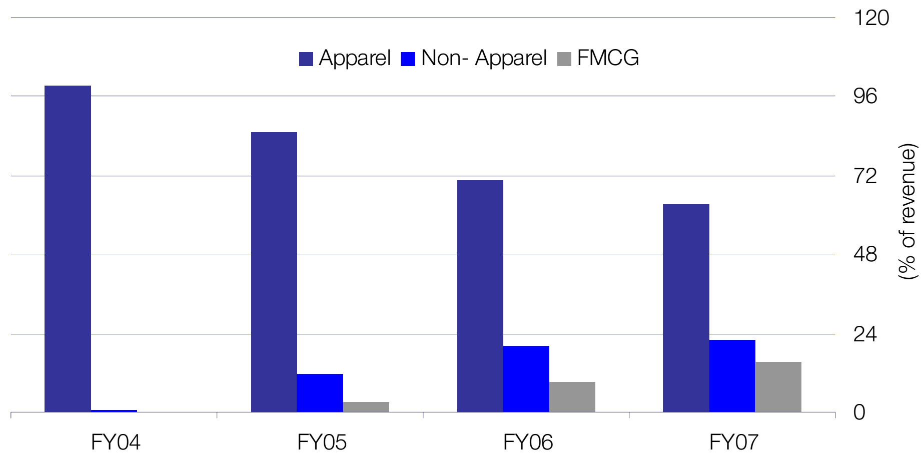
Profitable product mix, tier III locations, and private labels drive margins

VRL's product mix is dominated by apparels, which accounted for 63% of total revenues in FY07. It has a number of private apparel labels such as *Zepplin, Paranoia, Chlorine, Kitaan Studio, Famenne, Fleurier Women* and *Roseau,* which are manufactured in house. In FY07, these accounted for around 10% of revenues.

In addition to private labels, the company houses many quasi-private labels instead of national brands. These are unbranded products, which though unlike private labels, are not manufactured in house, provide better margins than national barands. They are sourced from domestic and international destinations to avail of cost benefits. This mix of private and quasi-private labels is the reason the company enjoys high gross margins (38-40%).

The company is working at increasing the share of non-apparel and FMCG products in its product mix to de-risk its model and also ensure that a complete basket of customer requirements is met at its stores. It is also looking to introduce private labels in these categories to garner higher margins.

Chart 5: Product mix



Source: Company

* In-house manufacturing, logistics, distribution network improve operating efficiency

To reduce costs and take advantage of economies of scale the company has put in place a distribution set up comprising seven regional distribution centres located around Kolkata (West Bengal), Thane (Maharashtra), Jaipur (Rajasthan), Ghaziabad (Uttar Pradesh), Ludhiana (Punjab), Gurgaon (Haryana), and Delhi. It has its own fleet of 41 trucks, which helps transport and deliver products in a cost and time efficient manner. This has helped the company optimize its store inventory.

VRL also has an in house apparel manufacturing capacity of 1 mn pieces per annum at Gurgaon. It is contemplating expansion of this capacity and setting up of a new apparel manufacturing facility at Dehradun. The company has been steadily increasing its gross margin return on the total retail space. The return on inventory too has been steadily improving, but in FY07, there has been excessive build up of inventory.

* Putting systems in place

VRL focuses on acquisition and implementation of advanced information technology systems, processes and business applications to handle its store operations, including inventory management and billing. The company is able to generate detailed daily reports covering various aspects of business such as division-wise sales per store, inventory movement, and position at stores and distribution centres and generation of purchase and delivery orders.

In August 2005, the company entered into a software end-user license agreement with Systems, Applications and Products in Data Processing Private Limited ("SAP India"). It has partly implemented the information technology set up and is currently in the midst of completing the process of upgrading its information technology set up and has entered into an agreement with TCS for providing ERP applications, rendering services inter alia for management information system on reports related to stock management, receipt processing, picking and packing, project systems, merchandise assortment management, pricing and promotion, sales, controlling and financial accounting.

Valuations attractive: Recommend 'SUBSCRIBE '

For FY07, VRL posted revenues of INR 6.0 bn and net profits of INR 250 mn, a Y-o-Y growth of 109% and 101%, respectively. EBITDA margins have expanded by 200bps, mainly on account of lower cost of goods (on account of higher mark up).

Our rough estimates for FY08E and FY09E revenues are INR 10 bn and INR 1.4 bn, respectively. We believe that the net margins will drop because of higher interest expenses. Our rough estimate of PAT for FY08E and FY09E are INR 340 mn and INR 416 mn, respectively. This translates into EPS of INR 15.2 and INR 18.6 on fully diluted equity. Even if we were to factor in 15-20% dilution before end of FY09 (for future expansion), VRL should make EPS in the range of INR 16.1-15.5 in FY09E.

At the upper end of the price band, the stock is priced at PE of 17.8x FY08E and 14.5x FY09E rough estimates. This valuation is at a significant discount to Pantaloon Retail, the most relevant listed comparable in the retail space (Pantaloon's core retail business trades at 43x FY08E and 32x FY09E). While we believe that VRL should trade at a discount to Pantaloon which is much bigger and has a well diversified model, we feel that the valuation gap is high and hence provides an upside opportunity.

Even on comparison with a smaller EBITDA negative player like Piramyd Retail, which trades at a mcap/sales multiple of 0.7 one-year forward, the company's multiple is at a 15% discount. Hence, we believe that in the future, the stock is likely to see an upside on account of narrowing of the valuation gap between the company and the industry leaders. We recommend 'SUBSCRIBE. '.

Management bandwidth

Mr. Ram Chandra Agarwal, (Promoter) holds a bachelor's degree in commerce. He has about two decades of experience exclusively in readymade garments including manufacturing, retailing and marketing. He started the business under the name of "Vishal Garment" with a small store at 9, Lal Bazaar Street, Kolkata. Mr. Agarwal has been ranked as the 28th most powerful person in the Indian retail industry (*Source: Collectors' Issue-Retailer, India Edition, February 15, 2007 to April 14, 2007, volume 2, no. 1*). He is the Chairman and Managing Director of the company and has been on the board since its inception.

Mr. Ritesh Rathi, Chief Operating Officer, 31 years, holds a bachelor's degree in commerce and is a member of the Institute of Chartered Accountants of India. Mr. Rathi has over six years work experience and has practiced as a chartered accountant prior to joining VRL. His responsibilities include overlooking the day-to-day management of the company's operations as well as the IT department.

Mr. Manmohan Agarwal, Head–Supply Chain Management & Men's Ethnic Apparel, holds a bachelor's degree in commerce. He has over 10 years of work experience in the retail industry. Prior to joining VRL, he had been practicing as an independent consultant for six years. His responsibilities include the management and supervision of the supply chain and procurement, production and retailing with respect to the men's ethnic apparel business.

Mr. Dipu Gupta, Head–Men's Apparel, holds a bachelor's degree in commerce. Mr. Gupta has over 10 years of work experience in the retail industry. Prior to joining VRL, he had been practicing as an independent consultant for seven years. His responsibilities include management, procurement, production and retailing with respect to the men's apparel business.

Risks and Concerns

Delays in store roll outs

Any delay in store roll outs, either on the real estate developer's side or the company's side, will be a risk to the company's revenues in the future. Especially since the company has tied up only 12 of the planned 32 stores, any delay could impact revenues.

Escalation of real estate rentals

So far, the company has enjoyed low rentals of around INR 32 per sq ft because of its focus on tier Ii and III cities. However, with many large players looking to enter these cities, VRL could face rising rentals, which could impact its margins.

Entry of big players leading to competition

The entry of large players like Reliance, Birla, Bharti could put significant pressure on the company's revenues and profitability due to heightened competition. This could further cause delays in roll outs and lower sales per sq ft.

Risk of dilution

To fund its capacity expansion plans it is likely that the company will have to go in for further equity dilution beyond FY08E. This will impact future e ESP numbers.

Table 4: Use of IPO funds

Particulars	Value (INR mn)
Expenditure on establishment of new retail stores	1,042
Issue expenses	58
Total issue	1,100

Source: Company

Issue details

Issue size (INR mn)	1,100
No. of shares on issue	4.1 mn - 4.8 mn
Price band	INR 230-270
Issue mode	Book building
Book opening date	11-Jun-07
Book closing date	13-Jun-07
Pre issue no. of shares	18.324 mn
Post issue no. of shares	22.3 mn - 23.1 mn
Market capitalisation upper band - INR 6.0 bn	lower band
lower band	upper band - INR 6.0 bn

Share holding pattern

	Before issue		Post issue (upper band)		Post issue (lower band)	
Share holding pattern	No. of shares (mn)	% holding	No. of shares (mn)	% holding	No. of shares (mn)	% holding
Promoters/ Promoter Group	14.32	78.1	14.32	63.9	14.32	62.0
Bennett, Coleman & Co. Limited	2.05	11.2	2.054795	9.2	2.054795	8.9
Gaja Advisors Private Limited	0.5	2.7	0.5	2.2	0.5	2.2
HDFC Limited	0.2	1.1	0.2	0.9	0.2	0.9
Others*	1.3	6.8	1.3	5.6	1.25	5.4
Public	0	0	4.074	18.2	4.783	20.7
Total	18	100	22.40	100	23.1074	100

** Other shareholders includes 0.5% holding by Burmans and 0.8% by Munjals*

Financial statements

Income statement (INR mn)

Year to March	FY04	FY05	FY06	FY07
Net revenues	881	1,463	2,884	6,027
Cost of goods sold	585	894	1,737	3,463
Rent and lease expenses	36	85	144	328
Employee expenses	30	60	135	274
SG&A expenses	201	336	604	1,291
Total expenditure	852	1,376	2,621	5,356
EBITDA	29	88	263	671
Depreciation	15	29	54	153
EBIT	14	58	210	518
Interest expenditure	2	10	29	148
Other income	1	1	6	23
Profit before tax	13	50	187	393
Provision for taxation	9	20	62	143
Profit after tax	4	30	125	250
EPS (INR) fully diluted	0.3	2.0	7.6	13.6
CEPS (INR) fully diluted	1.5	4.0	10.8	22.0

Common size metrics- as % of net revenues

Year to March	FY04	FY05	FY06	FY07
Cost of goods sold	66.4	61.1	60.2	57.5
Rent and Lease expenss	4.1	5.8	5.0	5.4
Employee expenses	3.4	4.1	4.7	4.5
SG&A expenses	22.8	22.9	21.0	21.4
EBITDA margin	3.3	6.0	9.1	11.1
Depreciation	1.7	2.0	1.9	2.5
Interest expenditure	0.2	0.7	1.0	2.4
EBIT margin	1.6	4.0	7.3	8.6
Net profit margin	0.4	2.1	4.3	4.2

Growth metrics (%)

Year to March	FY04	FY05	FY06	FY07
Net revenues	76.4	66.1	97.1	108.9
EBITDA	291.4	200.8	201.0	154.6
EBIT	159.3	306.6	259.5	146.9
Net profit	(30.2)	690.6	313.0	100.5
EPS	100.1	540.1	271.2	80.4

Balance sheet				(INR mn)
As on 31st March	FY04	FY05	FY06	FY07
Share capital	120	148	165	183
Reserves	92	156	507	1,084
Shareholders funds	212	304	672	1,268
Long term debt	81	227	607	2,432
Deferred tax	7	11	12	18
Sources of funds	300	542	1,290	3,718
Gross assets	123	240	462	1,328
Less: depreciation	25	54	107	258
Net fixed assets	98	186	355	1,071
Capital WIP	-	-	46	11
Investments	10	-	-	-
Current assets	255	457	1,191	3,307
Debtors	-	-	1	1
Cash & bank balance	20	22	83	152
Inventory	203	374	782	2,491
Advances	32	61	325	663
Current liabilities	64	101	303	671
Creditors	*58*	*86*	*224*	*467*
Other liabilities	*6*	*16*	*79*	*204*
Working capital	192	356	888	2,636
Misc expenditure	0	0	1	-
Uses of funds	300	542	1,290	3,718
BV (INR)	17.7	20.5	40.7	69.2

Cash flow statement				(INR mn)
Year to March	FY04	FY05	FY06	FY07
Cash flow from operations	31.4	88.6	263.4	718.4
Cash for working capital	(84.4)	(180.6)	(531.3)	(1750.6)
Net operating cash flow (A)	(53.0)	(92.0)	(267.8)	(1032.3)
Net purchase of fixed assets	(61.6)	(116.9)	(265.9)	(952.8)
Net purchase of investments	(9.5)	10.0	0.5	9.2
Net cash flow from investing (B)	(71.1)	(106.9)	(265.4)	(943.6)
Proceeds from LTB/STB	0.8	135.8	295.1	1154.7
Proceeds from issue of share capital	73.2	28.2	129.5	290.0
Dividend payments	0.0	0.0	0.0	0.0
Net cash flow from financing	74.0	164.0	409.0	2044.7
Free cash flow	(124.1)	(198.9)	(533.2)	(1975.9)

Ratios

Year to March	FY04	FY05	FY06	FY07
ROE (%)	1.8	9.9	18.6	19.7
ROCE (%)	4.8	10.8	16.3	13.9
Debtor (days)	0	0	0	0
Inventory days	84	93	99	151
Fixed assets t/o (x)	7.2	6.1	6.2	4.5
Debt/Equity	0.3	0.7	0.7	1.8
Interest coverage (x)	6.9	5.9	7.2	3.5

Valuations parameters

Year to March	FY04	FY05	FY06	FY07
EPS (diluted) (INR)	0.3	2.0	7.6	13.6
Y-o-Y growth (%)	*100.1*	*540.1*	*271.2*	*80.4*
CEPS (INR)	1.5	4.0	10.8	22.0
Y-o-Y growth (%)	*267.5*	*159.0*	*170.1*	*103.3*

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Naresh Kothari – 2286 4246	Co-Head, Institutional Equities
Vikas Khemani – 2286 4206	Co-Head, Institutional Equities

INDIA RESEARCH			SECTOR
Shriram Iyer	-	2286 4256	Head – Research
Gautam Roy	-	2286 4305	Airlines, Textile
Ashutosh Goel	-	2286 4287	Automobiles, Auto Components
Vishal Goyal, CFA	-	2286 4370	Banking & Finance
Revathi Myneni	-	2286 4413	Cement
Harish Sharma	-	2286 4307	Infrastructure, Auto Components, Mid Caps
Priyanko Panja	-	2286 4300	Infrastructure, Engineering, Telecom
Parul Inamdar	-	2286 4355	Information Technology
Priyank Singhal	-	2286 4302	Media, Retail, FMCG
Prakash Kapadia	-	4097 9843	Mid Caps
Niraj Mansingka	-	2286 4304	Oil & Gas, Petrochemicals
Manika Premsingh	-	4019 4847	Economist
Sunil Jain	-	2286 4308	Alternative & Quantitative
Yogesh Radke	-	2286 4328	Alternative & Quantitative

INSTITUTIONAL SALES		
Nischal Maheshwari	-	2286 4205
Rajesh Makharia	-	2286 4202
Vikrant Oak	-	4019 4712
Shabnam Kapur	-	2286 4394
Abhijit Chakraborty	-	4019 4823
Balakumar V	-	(044) 4263 8283
Ashish Agrawal	-	2286 4301
Nikhil Garg	-	2286 4282
Swati Khemani	-	2286 4266
Neha Shahra	-	2286 4276
Priya Ramchandran	-	2286 4389
Anubhav Kanodia	-	2286 4361
Tushar Mahajan	-	2286 4439
Harsh Biyani	-	2286 4419
Nirmal Ajmera	-	2286 4258
Ankit Doshi	-	2286 4671
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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period