Company Focus

30 September 2007 | 9 pages

Arvind Mills (ARMI.BO)

Change in opinion ☑
Rating change ☑

Downgrade to Sell: Rupee and Cost Pressures on the Rise

- **What's changed?** — Our downgrade is premised on 1) denim woes continuing; 2) cost pressures and appreciating rupee adversely affecting earnings; and 3) with the stock's 41% run-up over the last three months, valuations that appear stretched at 8.5x FY08 EV/EBITDA. Further, the proposed 24% dilution from the preferential warrant issue could make near-term valuations richer.
- **High denim prices, but outlook sluggish** — Arvind's denim prices are holding at ~Rs100/mtr on rich product mix in exports, but volume outlook is still sluggish. Domestic markets also continue to suffer from oversupply. While the company's efforts to increase its presence in the US and EU should be long-term positive, the near-term outlook remains weak.
- **Rising costs pressures - risk to margins and earnings high** — With expected 5-7% increase in cotton prices in the coming season, sluggish conditions in the denim market and Arvind's rising power costs due to gas shortage, we believe the risk of an adverse impact on margins and earnings is high.
- **Rupee concerns on garment exports building** — Arvind's garment operations (19% of FY08 revenues) have scaled up well, but we expect the appreciating rupee to affect export realization and earnings ahead.
- **Preferential issue to promoters could be a support** — The proposed 50.6m warrant issue to promoters, exercisable at Rs52/share, to fund Arvind's expansion in retail could be a near-term sentiment support.

Sell/Medium Risk	3M
from Hold/Medium Risk	
Price (28 Sep 07)	Rs61.90
Target price	Rs53.00
Expected share price return	-14.4%
Expected dividend yield	0.0%
Expected total return	**-14.4%**
Market Cap	Rs12,960M US$327M

Price Performance (RIC: ARMI.BO, BB: ARVND IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	815	3.89	-27.3	15.9	0.9	6.2	1.6
2007A	239	1.14	-70.6	54.2	0.8	1.6	0.0
2008E	324	1.55	35.6	40.0	0.8	2.0	0.0
2009E	643	3.07	98.2	20.2	0.8	3.9	0.0
2010E	966	4.61	50.3	13.4	0.7	5.6	1.6

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	15.9	54.2	40.0	20.2	13.4
EV/EBITDA adjusted (x)	7.9	9.4	8.6	7.4	6.6
P/BV (x)	0.9	0.8	0.8	0.8	0.7
Dividend yield (%)	1.6	0.0	0.0	0.0	1.6
Per Share Data (Rs)					
EPS adjusted	3.89	1.14	1.55	3.07	4.61
EPS reported	3.89	1.14	1.55	3.07	4.61
BVPS	69.88	75.76	77.31	80.38	83.99
DPS	1.00	0.00	0.00	0.00	1.00
Profit & Loss (RsM)					
Net sales	21,304	21,822	22,503	24,303	26,208
Operating expenses	-18,987	-19,967	-20,471	-21,858	-23,459
EBIT	**2,317**	**1,855**	**2,032**	**2,446**	**2,749**
Net interest expense	-1,718	-1,712	-1,849	-1,900	-1,890
Non-operating/exceptionals	332	194	190	130	115
Pre-tax profit	**930**	**337**	**373**	**676**	**974**
Tax	-106	-33	-37	-68	-97
Extraord./Min.Int./Pref.div.	-9	-64	-11	35	90
Reported net income	**815**	**239**	**324**	**643**	**966**
Adjusted earnings	815	239	324	643	966
Adjusted EBITDA	4,318	3,647	3,841	4,273	4,631
Growth Rates (%)					
Sales	8.6	2.4	3.1	8.0	7.8
EBIT adjusted	-5.2	-19.9	9.5	20.4	12.4
EBITDA adjusted	1.4	-15.5	5.3	11.2	8.4
EPS adjusted	-27.3	-70.6	35.6	98.2	50.3
Cash Flow (RsM)					
Operating cash flow	**228**	**3,384**	**1,816**	**3,194**	**1,866**
Depreciation/amortization	2,001	1,791	1,809	1,827	1,882
Net working capital	-2,253	441	-568	218	-1,638
Investing cash flow	**-4,381**	**-2,201**	**-1,266**	**-1,173**	**-1,219**
Capital expenditure	-6,919	-882	-1,023	-803	-613
Acquisitions/disposals	-985	1,048	-56	-27	-264
Financing cash flow	**4,189**	**-1,278**	**-415**	**-1,900**	**-508**
Borrowings	2,765	-1,326	-415	-1,900	-299
Dividends paid	-209	0	0	0	-209
Change in cash	**36**	**-95**	**135**	**121**	**139**
Balance Sheet (RsM)					
Total assets	**40,787**	**40,356**	**39,955**	**38,352**	**38,394**
Cash & cash equivalent	240	145	280	401	539
Accounts receivable	1,673	1,746	1,913	1,944	2,621
Net fixed assets	23,237	22,328	21,542	20,517	19,248
Total liabilities	**24,856**	**23,410**	**22,729**	**20,376**	**19,876**
Accounts payable	1,552	2,090	1,866	1,602	1,295
Total Debt	21,736	20,410	19,995	18,095	17,796
Shareholders' funds	**15,932**	**16,946**	**17,226**	**17,976**	**18,518**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	20.3	16.7	17.1	17.6	17.7
ROE adjusted	6.2	1.6	2.0	3.9	5.6
ROIC adjusted	6.4	4.9	5.5	6.7	7.6
Net debt to equity	134.9	119.6	114.5	98.4	93.2
Total debt to capital	57.7	54.6	53.7	50.2	49.0

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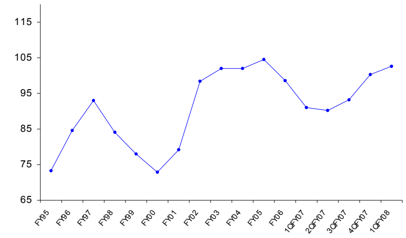
Powered by: dataCentral

Figure 1. Arvind Mills denim price realization trends (Rs/mtr) over FY95-1QFY08



Source: Company Reports

Key Points

High denim prices, but outlook still sluggish

Arvind's focus on richer product mix in exports to US and EU has enabled it to hold denim prices at higher levels of ~Rs100/mtr. However, volume outlook for the company's exports remains sluggish given the slowdown expected in the US and adverse impact of the appreciating rupee. Domestic market also continues to suffer from excess supply. Our channel checks (with domestic denim wholesalers) suggest 1) demand is growing at 10-12%, but excess supply is an overhang; and 2) prices have picked up marginally due to the upcoming festive season, but this is not expected to continue. Further, we believe low-end export goods could find their way to domestic markets in the current rupee scenario, and this could dampen prices. Factoring this, we expect Arvind's core denim business (34% of consolidated revenues) to remain under pressure.

Rupee concerns to affect garment exports

Arvind's garment operations have scaled up well — grown rapidly from 13% of FY07 revenues to 19% in 1QFY08, jeans capacities have doubled, and the company has achieved higher productivity and capacity utilization in shirts and knits. However, we see concerns on growth due to 1) appreciating rupee, 2) intensifying competition from other South Asian countries that have not witnessed similar currency appreciation, and 3) risk of a slowdown in order flows from US (a large market for Arvind) in the event of a scale-back in demand growth. We believe this will adversely affect overall growth, export price realizations and potential earnings of this business.

Rising cost pressures

Arvind is expected to experience increased cost pressures. This is largely on account of 1) expected 5-7% increase in cotton prices (key raw material, ~40% of denim revenues) in the coming season, and 2) rise in power costs from 3QFY08 due to shortage of gas. Building this in, we believe the risk of an adverse impact on Arvind's EBITDA margins and earnings is high.

Proposed preferential warrant issue to promoters

The company has approved a proposed preferential issue of 50.6m warrants to the promoters/Promoter group for raising ~Rs.2.6bn. These warrants will be exercisable at Rs.52/share within a period of 18 months. This is largely to fund the company's domestic retail and brand business and manage challenges in the core denim and garment business. While the proposed preferential issue will increase promoters' stake to 46.7% (vs. 33.9% earlier), it will result in significant equity dilution of 24%, which is unlikely to be EPS accretive in the near term. The promoters bringing in significant capital into the company will likely be a sentiment positive though.

Company description

Arvind Mills is one of the world's largest denim manufacturers and one of India's largest textile exporters. Aside from leadership in denim (a 72% market share) in India, Arvind Mills has a presence in shirting, knits, khakhis, voiles fabrics and a wide range of garments. It is an integrated player with a presence across the textile value chain - global capacity of 154m meters in fabrics, vertical integration to garments, strong brand franchise and a distribution network for branded apparels. Arvind's wide product range, scaleable capacities and ability to offer specialty fabrics and high-end garments make it a preferred vendor in the domestic market and to global brands. It is the flagship company of the Lalbhai Group, which owns a 34% stake.

Investment strategy

We downgrade Arvind Mills to Sell/Medium Risk (3M) from Hold/Medium Risk (2M) based on our existing target price of Rs53 on 8x FY08E EV/EBITDA. Our downgrade is premised on 1) denim woes continuing – volume outlook is still sluggish, 2) cost pressures and appreciating rupee adversely impacting earnings, and 3) unfavorable risk/reward with stock's 41% run-up over the last three months and valuations stretched at 8.5x FY08 EV/EBITDA. Further, proposed 24% dilution from preferential warrant issue to promoters could make near-term valuations richer.

Arvind's focus on richer product mix, ability to hold higher denim price realizations vs. industry and growth in domestic branded apparel business are positives. However, we see rising concerns on appreciating rupee and increasing cost pressures to adversely impact earnings going forward. Further with sluggish outlook for core denim business expected to continue, we see downside.

Valuation

Our target price of Rs53 is based on 8.0x FY08E EV/EBITDA. With near-term earnings subdued on account of higher interest costs but operating profits still healthy, we believe EV/EBITDA is a more suitable valuation method. Our target multiple is at 10% premium to sector valuations of 7.3x. This is largely recognizing Arvind's 1) growing branded apparel sales (contributing ~14% of FY07 revenues); 2) strong portfolio of brands like Arrow, Excalibur, Flying Machine, Megamart and recent foray with Diesel; and 3) existing exclusive store network of 154 stores. However, with the stock's 41% run-up over the last three months, and stock trading at 8.5x FY08E EV/EBITDA – a significant premium to the sector – valuations appear stretched. The stock's 3-year EV/EBITDA band is 7-12x, median being around 8x. Proposed equity dilution of 24% will unlikely be earnings accretive in the near term and could further stretch valuations.

Risks

We rate Arvind Mills as Medium Risk, as opposed to the Low Risk rating as suggested by our quantitative risk-rating system, which tracks 260-day share-price volatility. The key reasons for our Medium Risk rating include high earnings volatility due to volatility in denim prices and its vulnerability to forex fluctuations.

The main upside risks to our target price include: (1) strong up-tick in denim prices (greater than assumed 5%) could significantly improve earnings forecasts; (2) new tie-ups with global retailers for sourcing garments could put our conservative assumptions at risk; (3) stronger-than-expected turnaround for its branded apparel division could contribute towards higher growth; and (4) any potential unlocking of hidden value in real estate assets in Ahmedabad and Bangalore would be a positive.

Figure 2. Arvind Mills Income Statement (FY06-10E) (Rs Millions)

Year to 31 Mar	FY06	FY07	FY08E	FY09E	FY10E
Total Revenues	21,304	21,822	22,503	24,303	26,208
YoY Growth (%)	9%	2%	3%	8%	8%
EBITDA	4,318	3,647	3,841	4,273	4,631
Margin (%)	20.3%	16.7%	17.1%	17.6%	17.7%
Depreciation	(2,001)	(1,791)	(1,809)	(1,827)	(1,882)
Other income	332	194	190	130	115
EBIT	2,648	2,049	2,222	2,576	2,864
Interest Inc(expense)	(1,718)	(1,712)	(1,849)	(1,900)	(1,890)
Profit before tax	930	337	373	676	974
Tax	(106)	(33)	(37)	(68)	(97)
Profit after tax	824	304	335	608	876
Pref Dividend	(43)	(31)	(22)	(13)	(13)
Min Int & Share of Ass	34	(33)	11	48	103
Adj PAT	815	239	324	643	966

Source: Company Reports and Citi Investment Research estimates

Figure 3. Arvind Mills Balance Sheet (FY06-10E) (Rs Millions)

Year to 31 Mar	FY06	FY07	FY08E	FY09E	FY10E
Equity Share Capital	2,094	2,094	2,094	2,094	2,094
Pref Share Capital	561	462	330	198	198
Reserves	12,538	13,767	14,092	14,734	15,491
Net Worth	14,632	15,861	16,185	16,828	17,585
Def. Tax Liability	249	163	158	159	160
Minority Interest	739	623	710	950	735
Long Term Debt	14,293	13,260	11,945	9,945	9,346
Short Term Debt	7,443	7,150	8,050	8,150	8,450
Total Debt	21,736	20,410	19,995	18,095	17,796
Capital Employed	**37,917**	**37,520**	**37,379**	**36,231**	**36,474**
Gross Block	33,194	34,398	35,292	36,324	37,137
Depreciation	10,829	12,620	14,430	16,257	18,139
Net Fixed Assets	22,365	21,778	20,863	20,067	18,998
Capital WIP	872	550	679	450	250
Investments	397	1,445	1,389	1,362	1,098
Inventories	7,043	6,983	7,201	7,291	8,387
Sundry Debtors	1,673	1,746	1,913	1,944	2,621
Other Current Assets	8,197	7,709	7,631	6,838	6,502
Cash and Bank	240	145	280	401	539
Current Assets	17,153	16,583	17,025	16,474	18,048
Current Liabilities	(2,871)	(2,837)	(2,575)	(2,122)	(1,920)
Net Current Assets	14,283	13,747	14,449	14,352	16,129
Total Net Assets	**37,917**	**37,520**	**37,379**	**36,231**	**36,474**

Source: Company Reports and Citi Investment Research estimates

Figure 4. Arvind Mills Cash Flow (FY06-10E) (Rs Millions)

Year to 31 Mar	FY06	FY07E	FY08E	FY09E	FY10E
Adj PAT	815	239	324	643	966
Depreciation	2,001	1,791	1,809	1,827	1,882
Changes in W.Cap	(2,253)	441	(568)	218	(1,638)
Pref Dividend	43	31	22	13	13
Other Items	(344)	848	239	540	746
Minority Interest	(34)	33	(11)	(48)	(103)
Gross cash flow	228	3,384	1,816	3,194	1,866
Net capex	(6,919)	(882)	(1,023)	(803)	(613)
Free cash flow	(6,690)	2,502	793	2,391	1,253
Net investments	(985)	1048	(56)	(27)	(264)
Non-recurring items					
Other items	3522	-2367	-187	-343	-342
Net change in Debt	2765	(1326)	(415)	(1900)	(299)
Cash available for div.	(1389)	(142)	135	121	348
Dividends paid	(209)	0	0	0	(209)
Equity issued	1634	47	0	0	0
Inc/(dec) in net cash	36	(95)	135	121	139

Source: Company Reports and Citi Investment Research estimates

Appendix A-1

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Arvind Mills (ARMI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Ashish Jagnani (covered since October 21 2005)

#	Date	Rating	Target Price	Closing Price
1:	20 Oct 05	1L	191.00	113.50
2:	1 Nov 05	1L	*165.00	107.40
3:	24 May 06	1L	*90.00	76.30
4:	17 Nov 06	*2M	*64.00	51.40
5:	29 Jul 07	2M	*53.00	47.85

*Indicates change.

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