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On-line Share Trading

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Every week ICICIdirect research team will select a stock based on fundamental and/or technical parameter, which is likely to return 20% over a 3-6 month perspective.

Varun Shipping (VARSHI)

Current Price: 65

Target Price: 78

Potential upside: 20%

Time Frame: 3-6 mths

Company Background

Varun Shipping is the largest Indian player in the LPG carrier segment with a fleet of 12 LPG carriers. It has a fleet strength of 20 vessels comprising of 3 crude carriers, 4 offshore vessels and a product carrier other than the 12 LPG carriers. Currently, Varun has a presence across four shipping segments, namely LPG, crude oil, offshore and product. In the last two years the company has spent around Rs 1,300 crore on fleet expansion by acquiring LPG, crude and offshore vessels Varun caters to top clientele like state owned oil majors like Indian Oil, HPCL and BPCL. Recently the company has added Reliance Industries to its customer list with the chartering of newly acquired Anchor Handling Tug Vessels (AHTVs).

Investment Rationale

Augmentation of fleet size to catalyze revenue growth

Varun initiated a US$400 million capex programme, of which it has executed US$320 million, in the last two years. It expanded its fleet size from14 vessels in FY05 to 20 in Q2FY08.

Exhibit 1: Recent vessel acquisitions

Vessel name	Type	Acquisition date
Maharshi Vamadeva	LGC	6-Dec
MT Amba Bhargavi	Crude carrier- Aframax	7-Jan
Maharshi Bhardwaj	VLGC	7-Jun
MV Subhiksha	AHTS	7-Jan
MV Sudaksha	AHTS	7-May

Source: Company, ICICIdirect Research

With the new vessels, we estimate a 14% CAGR in revenue to Rs 889.88 crore in FY09E from Rs 672.62 crore in Fy07.

Varun has further announced a capex of US$ 400 million (including the earlier announced capex of US$ 80 million). It is likely to acquire vessels in the offshore segment as it wants to develop a critical mass and have a meaningful size in the segment. The company is not going for new built vessels, but is looking at acquiring second hand vessels as it wants to capitalise on the buoyant charter rates for offshore vessels prevailing at present. Another field that Varun has been eyeing is the offshore drilling segment by acquiring a jack up rig. The company is considering a sale and lease back model as it would free the company's cash flow to an extent an would enable it to fund future vessel acquisitions. We have not factored this in our estimates and would be updating our estimates after the company makes announcements of further fleet addition.

Major presence in niche and less volatile MGC segment

Varun is the largest MGC (medium gas carrier) in India. It operates 10 MGCs with a capacity of 229,044 DWT (dead weight tonnage). The company has a 16% worldwide market share in the MGC fleet. MGC day rates are comparatively less volatile than the large and very large gas carriers as MGCs are used for specific regional routes on which the deployment of larger vessels is technically unfeasible. Moreover, MGC can alternatively be used for ammonia transportation, which is usually traded in smaller quantities and is suitable to be transported by MGCs. 11% of the world's total ammonia production is transported by sea. According to estimates, the sea borne trade in ammonia is expected to increase by 3.1% in FY06-11. Variability in Varun's revenues is likely to be less owing to lower volatility in MGC day rates.

Exhibit 2: Freight rates trend (in $' 000 pcm)

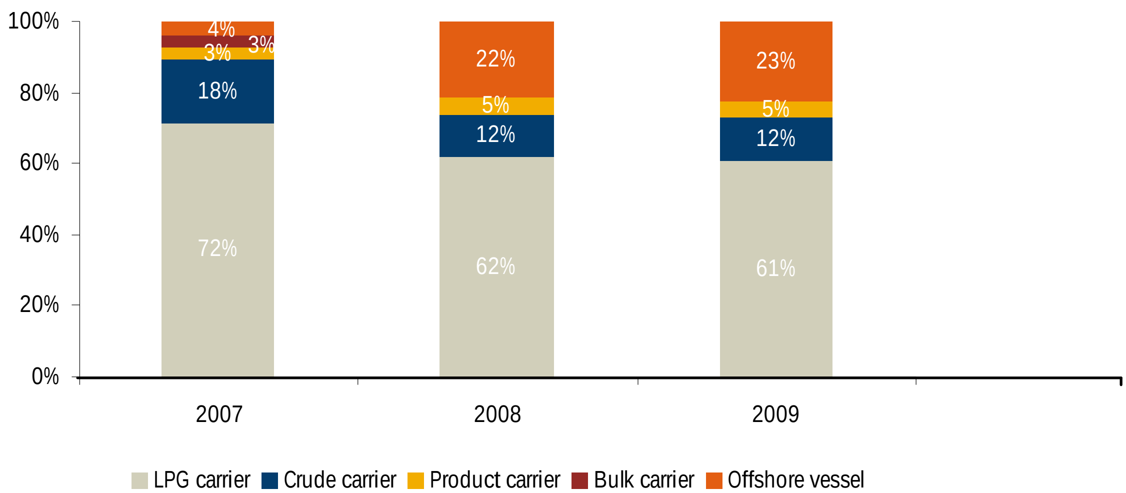
	2005 Average	2006 Average	April	May	2007 June
VLGC - TCE AG Japan	873	1,010	455	600	635
VLGC - TC modern	1,009	1,147	800	800	800
VLGC - TC old	806	806	525	525	550
LGC-TC modern	972	1,096	950	950	950
LGC-TC old	820	919	725	750	775
MGC-TC 35,000 cu.m	**902**	**1,001**	**950**	**940**	**910**
MGC-TC 24,000 cu.m	**795**	**860**	**890**	**880**	**870**

Source: Drewry, ICICIdirect Research

Enhancing presence in the lucrative offshore segment

Varun has enhanced its presence in the high-margin offshore segment by acquiring 2 high-end offshore vessels. These highly sophisticated vessels are used for deep-sea oil exploration in the North Sea, Bay of Bengal and Atlantic Ocean. The vessels are the most powerful with the highest Bollard Pull (A Bollard pull is a value that allows the comparison of the pulling power of a vessel) under the Indian flag. Both these vessels are on long-term charter with Reliance Industries. The contribution from the offshore segment is expected to increase from 4% in FY07 to 23% in FY09E. Margins in this segment are in the range of 60% to 65%, and the increasing contribution would enable Varun boost its margins from 55.9% in FY07 to 58.7% in FY09E.

Exhibit 3: Contribution from offshore segment to increase



Source: ICICIdirect Research

Robust sea-borne trade in LPG and ammonia

The world's largest natural gas reserves are concentrated in the Middle East and North Africa, while major consumption centers are China, Japan, Europe, US and India. This geographical disparity in the production and consumption centers would keep the sea borne trade in LPG and ammonia to remain robust. LPG sea-borne trade is expected to increase by 6.5% in tonnage terms, with the enhancement of the capacity in the Middle East. Sea borne trade in LPG in CY06 stood at 53 million tonnes, constituting 24% of the total LPG consumed worldwide.

High dividend yield

In spite of the cyclical nature of its business, Varun has one of the best dividend paying track records in the industry and has been continuously paying dividends for the last 23 years. For the last six years the company has maintained a dividend yield and dividend payout in excess of 6% and 25% respectively.

Key Concerns

Cyclicality and volatility in demand for LPG

Demand for LPG shipping is marked by cyclicality due to the shifts in demand for LPG. LPG demand is usually higher in the winter months and this leads to higher demand for LPG shipping and better day rates for LPG carriers. On the contrary, in summer months the demand for LPG is slack and results in lower day rates for LPG carriers.

Softening of LPG charter rates

A spate of new building additions between CY07 and CY 09 is likely to keep the charter rates for the LPG carriers under pressure, which could impact the revenues and margins going ahead.

Financials

Varun posted a 3.1% growth in revenues in FY07 to Rs 684.50 crore. Operating margins declined from 58.4% in FY06 to 55.9% in FY07 owing to increase in employee cost-to-sales ratio from 8.0% in FY06 to 11.8% in FY07. Net profit in FY07 declined to Rs144.91 crore from Rs184.01 crore in FY06. The company's Q3FY08 performance has been excellent and instills confidence about the future earnings. It reported a 41% y-o-y increase in revenues to Rs 229.95 crore in Q3FY08 on the back of revenues from newly acquired vessels and higher level of freight rates.

The reduction in bunker expenses-to-sales ratio from 7.6% to 6.6% and repairs and maintenance to sales ratio from 11.5% to 5.0% has enabled the company to report an improvement in EBIDTA margin from 54.5% to 64.2%. Despite depreciation and interest expenses being higher by 43% and 42%, the company has been able to report a robust growth of 85.9% in net profit to Rs 73.69 crore. We expect the company to report a higher net profit of Rs298.92 crore in FY08E and Rs 331.32 crore in FY09E translating to an EPS of Rs 22.12 in FY09E.

Key Financial Ratios

	2007/03	2006/03	2005/03	2004/03	2003/03
EPS	9.9	15.39	7.25	4.74	1.35
CEPS	21.51	26.44	13.26	12.14	8.51
Book Value	50.7	40.47	30.13	30	27.27
Dividend/Share	4.5	4.5	3	1.6	1.2
OPM	55.47	60.25	45.17	39.26	35.27
RONW	12.66	38.09	24.87	15.59	2.65
Debt/Equity	2.48	2.4	1.74	1.23	1.45
Ratio	1.66	0.38	2.05	2.02	1.5
Interest Cover	3.37	5.13	7.24	4.7	3.52

Valuations

Varun will be able to report steady growth in revenues going ahead and we expect it to register a 14% CAGR in revenue over FY07-09. We expect EBIDTA margin to improve from 55.86% to 58.70%. The stock trades at 3.3x FY08E earnings and 2.9x FY09E earnings, making it the cheapest stock in the shipping sector. With steady revenue growth and improvement in operating margin the stock is a strong re-rating candidate. We rate the stock an outperformer with a price target of Rs 78, an upside potential of 20% in the next 6 months.

Technical Outlook

The stock has been on a consistent downtrend ever since it toped out at a high of Rs 110 in January 20098. Howevere, a look at the broader term charts suggests that this drop has not caused much damage to the primary trend. The prices currently are coming down to rest on an old rising trend line on weekly chart which is likely to act as a good support zone. Looking at the daily chart, we find that RSI indicator has remained in the divergence status which is an encouraging sign indicating the diminution of the selling force. This also gives the signals of bottoming out and further reinforces the above statement. A successful pullback from this level may cause some bulls to enter in to the ring and help to turn the prices up. In line with this we also notice a beautiful rounding pattern on monthly chart which in a way tells us that the stock has a bright future ahead. Factoring all these signals on charts, we believe this stock is a buy on subsequent dips near Rs 60 to rise till Rs 74-80 in the coming months. The nearest support is around Rs 57.

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