S Kumars Nationwide (SKMK.BO)

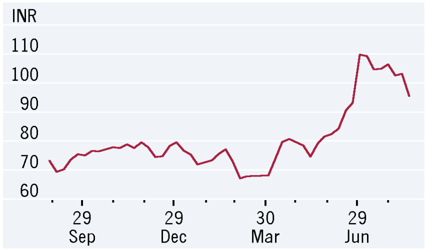
Sell: Rich Valuations a Hurdle

Rating change ☑
Target price change ☑
Estimate change ☑

- Raising target to Rs.101, but maintain Sell (3M) — Growth outlook for company appears strong, recognizing this we increase our earnings 34-38% for FY08-09E and target to Rs.101 based on 10x 12-month forward P/E (at 25% premium to sector average of 8x) and ascribing Rs.10 for likely de-merger of Brandhouse Retail. With the stock currently at Rs.111, upsides seem priced in.
- Margins close to peak in FY08E — While richer product mix and lower raw material consumption will expand margins to 22% in FY08, we expect that to be near peak on margins. Brand promotions and overheads on commissioning of expansions in home textiles and cotton fabric will limit further margin gains.
- Focus on branded retailing continues — Company's continuous focus on growing brand portfolio and efforts to introduce international brands in India are positive. But given stiff competition in retail, high retail rentals and aggressive plans to roll out 470 new stores by Mar'08 vs. 148 stores today, risk of execution delays remains.
- De-merger of retail subsidiary — Brandhouse Retail is to be de-merged w.e.f Jan 1, 2007 at a swap ratio of 5:1 and will list separately. Prima facie this should help scale up its retail foray; however, profitability will be key, as it incurred losses in FY07; we ascribe Rs.10/share based on 1.8x FY08E EV/Sales.
- More capital raised - The company has raised further capital of $79m through a mix of equity ($50m) and debt ($29m) from private equity in 1QFY08, and $10m from promoters for its capex and debt repayment. We have factored in c13% equity dilution from these transactions.

Sell/Medium Risk	3M
from Sell/High Risk	
Price (28 Aug 07)	Rs110.85
Target price	Rs101.00
from Rs67.00	
Expected share price return	-8.9%
Expected dividend yield	0.0%
Expected total return	-8.9%
Market Cap	Rs21,623M
	US$529M

Price Performance (RIC: SKMK.BO, BB: SKUM IN)



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

Figure 1. Statistical Abstract

Year to 31-Mar	Net Profit (Rs)	FD EPS (Rs)	EPS Growth (%)	P/E (x)	P/BV (x)	EV/EBITDA (x)	EV/sales (x)
2006	421	2.59	338.6	42.8	6.7	20.1	3.4
2007	1,198	5.03	94.5	22.0	3.4	13.9	2.8
2008E	1,997	8.39	66.8	13.2	2.7	11.1	2.6
2009E	2,662	9.87	17.6	11.2	2.0	9.3	2.2
2010E	2,717	10.07	2.1	11.0	1.7	9.1	2.1

Source: Company Reports and CIR Estimates

Ashish Jagnani[1]
+91-22-6631-9861
ashish.jagnani@citi.com

Karishma Solanki[1]
karishma.solanki@citi.com

~1Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	42.8	22.0	13.2	11.2	11.0
EV/EBITDA adjusted (x)	na	14.3	10.1	7.8	7.2
P/BV (x)	28.0	4.6	3.4	2.3	1.9
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	2.59	5.03	8.39	9.87	10.07
EPS reported	2.59	5.03	8.39	9.87	10.07
BVPS	3.95	24.16	32.55	48.31	58.38
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	8,895	12,295	14,849	17,189	18,613
Operating expenses	-7,955	-10,440	-12,079	-13,787	-15,163
EBIT	**940**	**1,855**	**2,770**	**3,403**	**3,449**
Net interest expense	-451	-609	-627	-511	-529
Non-operating/exceptionals	61	99	165	172	205
Pre-tax profit	**550**	**1,345**	**2,308**	**3,063**	**3,125**
Tax	-102	-113	-277	-368	-375
Extraord./Min.Int./Pref.div.	-26	-34	-34	-34	-34
Reported net income	**421**	**1,198**	**1,997**	**2,662**	**2,717**
Adjusted earnings	421	1,198	1,997	2,662	2,717
Adjusted EBITDA	1,462	2,399	3,265	3,947	4,037
Growth Rates (%)					
Sales	na	38.2	20.8	15.8	8.3
EBIT adjusted	na	97.4	49.3	22.8	1.4
EBITDA adjusted	na	64.1	36.1	20.9	2.3
EPS adjusted	na	94.5	66.8	17.6	2.1
Cash Flow (RsM)					
Operating cash flow	**-440**	**-619**	**3,242**	**1,611**	**1,401**
Depreciation/amortization	523	544	495	545	588
Net working capital	-1,411	-2,395	716	-1,629	-1,937
Investing cash flow	**318**	**-2,599**	**-1,988**	**-2,104**	**-807**
Capital expenditure	-232	-2,507	-1,389	-1,263	-1,042
Acquisitions/disposals	0	65	-599	-841	235
Financing cash flow	**93**	**5,462**	**848**	**4,717**	**558**
Borrowings	-28	1,105	1,034	2,095	559
Dividends paid	0	0	0	0	0
Change in cash	**-30**	**2,244**	**2,102**	**4,224**	**1,152**
Balance Sheet (RsM)					
Total assets	**15,109**	**19,692**	**21,855**	**25,303**	**27,403**
Cash & cash equivalent	177	145	116	132	292
Accounts receivable	4,908	6,087	6,979	8,251	9,120
Net fixed assets	3,828	5,791	6,685	7,403	7,857
Total liabilities	**12,954**	**12,252**	**12,418**	**10,580**	**9,964**
Accounts payable	1,000	1,323	2,201	2,384	2,769
Total Debt	11,721	10,584	9,521	7,442	7,042
Shareholders' funds	**2,156**	**7,440**	**9,437**	**14,723**	**17,439**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.4	19.5	22.0	23.0	21.7
ROE adjusted	na	37.5	29.6	25.6	18.9
ROIC adjusted	na	10.9	13.7	15.6	14.1
Net debt to equity	535.5	140.3	99.7	49.6	38.7
Total debt to capital	84.5	58.7	50.2	33.6	28.8

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Key Points

Retail scale-up – promising, but challenging

The company's focus on growing its brand portfolio (Reid & Taylor, Belmonte, Charmichael House) and efforts to introduce international brands (Stephen Brothers, Escada, Dunhil) in India is positive. However, with competition intensifying in the branded retailing space from both domestic and international players and high real estate costs, we believe these are challenging times for branded retailers scaling-up. While the company has expanded its exclusive retail stores through its sub Brandhouse Retail, considering the delays in FY07 (67 stores rolled-out vs. target of 129 by Mar'07); we believe its plans to roll out 470 stores by Mar'08 vs. 148 stores today are aggressive and risk of execution delays remains.

De-merger - to unlock some value

Prima facie this should help scale up the retail foray, but contribution to profitability from this venture will be key

S Kumars has approved the de-merger of Brandhouse Retail (sub. focusing on exclusive brand retail stores) w.e.f Jan'07 at a swap ratio of 1 equity share of Brandhouse Retail for every 5 equity shares in S Kumars Nationwide and plans to list it separately. This is a step toward funding its aggressive expansion plans of investing Rs.4bn over next three years, independent of S Kumar's growth plans. Besides setting up stores for SKNL's own brands, Brandhouse Retail will also tie up with international brands for marketing their products in India. International brands introduced in India through Brandhouse Retail include Dunhill and Escada. Prima facie this should help scale up the group's retail foray; however, contribution to profitability from this venture will be key, as it incurred losses on revenues of Rs600m in FY07. With planned store rollouts, the management expects revenues to grow to Rs3bn by FY08, which we believe is aggressive. Factoring in the larger store rollout of ~325 stores, we forecast revenues to grow rapidly to ~Rs1.75bn for FY08E, but believe this will be lower than company forecasts given stiff competition.

We expect Rs.10/share based on 1.8x FY08E EV/Sales to be unlocked, when this business lists separately, but timing is still uncertain

This de-merged entity, recently raised USD$25m, a mix of debt and equity (for a 10% stake) at an enterprise value of ~USD$125m through private equity, for funding its growth plans. We believe it is difficult to make this a benchmark valuation, and consider 1.8x FY08E EV/Sales (median of 1.5-2.0x range used for branded retailers in India, given the limited track record) appropriate as the business will continue to make losses in FY08E - this translates into EV of ~USD$79m. Factoring, the debt (~USD$15m) and the swap ratio (1:5), this should translate into incremental value of Rs.10 per share for S Kumar investors, which can be unlocked when this business lists at a later date. However, timing is still uncertain as this is subject to regulatory approvals.

More capital raised

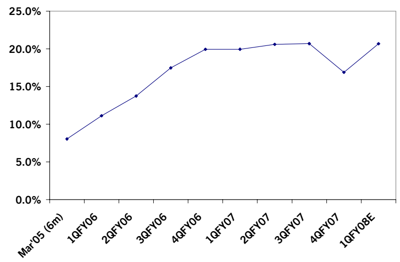
We expect this to result in c13% equity dilution and make valuations richer

The company has further raised capital of USD$79m through a mix of equity (USD$50m, warrants convertible) and debt (USD$29m) from private equity investors in 1QFY08. The equity portion will be raised through a USD$50m warrant issue of 6.625m warrants to investors – each having an entitlement for 4 equity shares of Rs.10 each with conversion at a price of Rs.82.5/share, within a period of 18 months from date of allotment. Further, the company also issued 5.3m warrants to promoters for USD$10m, each warrant entitled to one equity share with conversion at Rs.82.5/share. The company is expected to receive 10% of funds from investors and promoters upfront, while the USD$45mn will be received as debt from investors, which will convert to equity over an 18-month period. While this will be used for reducing existing debt and funding expansion plans, we expect this to result in c13% equity dilution. With warrants already in the money, conversion to happen over the next 18 months – we have taken fully diluted equity for FY09E EPS after adjusting for gains on interest cost savings from funds raised from the warrants.

Margins close to peak

The company plans to improve its product mix with greater focus on high-margin businesses such as luxury textiles, home textiles and total wardrobe solutions, which include the company's branded offerings such as Reid & Taylor, Carmichael House and Belmonte. We expect the richer product mix to result in a 250bps increase in EBITDA margin to 22% in FY08E, but expect the same to stabilize at 22% levels after that – quarterly margins of FY0 7 are early signs of this trend. This will be largely due to the company's higher expenditure on brand promotions, especially its relatively new brands Belmonte and Carmichael House and increased overheads arising from the new expansions of home textiles and commissioning of the new high-value cotton fabric facility.

Figure 2. Quarterly EBITDA Margins (%)



Source: Company Reports and CIR Estimates

Raising our earnings estimates

We are increasing our revenues and EPS estimates for S Kumars by 12-13% and 34-38% respectively over FY08E-09E, to account for better than expected growth in home textile and total wardrobe solution revenues, higher EBITDA margins and lower depreciation costs. We had earlier factored 66% growth for the home textiles business and lower EBITDA margins in the range of 19%. Now, we are assuming higher growth of 88% for home textiles on back of improved sales for Carmichael House, its premium home textile brand. Further richer product mix in consumer textiles has led to higher EBITDA margin estimates by ~250bps to 22% levels. Factoring this, equity dilution (~25%) following $40mn capital raised for funding aggressive acquisition plans in FY07E and recent warrant issue of $50mn (with conversion at Rs.82.5 per share over 18-month period) for reducing debt and expansions expected to dilute equity by FY09E, we expect revenues CAGR of 15% and 26% CAGR in earnings for FY07-10E, large part being front-loaded.

Figure 3. Earnings Revision (Rupees in Millions, Percent)

Year to		FY07			FY08E			FY09E	
31-Mar	Actual	Estimate	% Chg	New	Old	% Chg	New	Old	% Chg
Revenue	12,295	11,142	10.3	14,849	13,269	11.9	17,189	15,204	13.1
EBITDA	2,399	2,179	10.1	3,265	2,584	26.4	3,947	2,941	34.2
Net Profit	1,041	908	14.6	1,997	1,321	51.2	2,662	1,596	66.8
EPS	5.0	4.2	20.2	8.4	6.1	37.8	9.9	7.4	34.1

Source: Company Reports and CIR Estimates

S Kumars Nationwide

Company description

S Kumars Nationwide is a leader in uniform fabrics with a 35% market share of the organized sector and is the largest institutional supplier of uniforms. The S Kumars brand is popular in the domestic blended fabric market for suitings, daily wear and work wear. It is the second largest in India in worsted fabric (c.15% market share) given its tie-up with Reid & Taylor, Scotland to manufacture and market worsted fabric under the Reid & Taylor brand in India. S Kumars also has a presence in home-textiles and branded garments, which it is looking to scale up. Its integrated plants, along with a strategy to outsource, have established its presence in the domestic market. Exports make only a small contribution of 2% to revenues. It is the flagship company of the S Kumar Group (a 52% stake) with three plants.

Investment thesis

We rate S Kumars a Sell (3M), with an increased target price of Rs.101 based on 10x 12-month forward PE (at 25% premium to sector average of 8x) and ascribing Rs.10 for likely de-merger of Brandhouse Retail. Although growth outlook for the company appears strong, at valuations of 12x 12-month forward PE- 50% premium to sector, we believe most of the growth in priced in. The company's efforts to transform itself from being a commodity textile player to a retailer in branded textiles are positive, in our view. However, with competition intensifying in the branded retailing space from domestic and international brands, we believe (1) timely execution of new store rollouts will be key, and (2) the gestation period for the retailing business to contribute meaningfully to profitability will be long. That said, given management's aggressive plans to have 470 new exclusive brand outlets (vs.148 today) by March'08 and 1,200 stores and 20 brands by 2010-11, the risk of delays are high. Brand promotion expenses especially for new brands and higher overheads are also expected to restrict margins. Recognizing company's strong growth outlook, we believe it deserves to trade at a 25% premium to sector target valuations. However, with the stock already trading at 50% premium, we believe upsides are priced in. Further, additional equity capital raised is expected to result in c13% equity dilution and make valuations more expensive.

Valuation

Our increased target price of Rs101 is based on 10x 12-month forward P/E (at 25% premium to sector target of 8x) and ascribing Rs.10 for likely de-merger of Brandhouse Retail. Our target multiple still places the stock at a 25% premium to our target sector valuations of 8x 12-month forward P/E, factoring in S Kumars growth potential and focus on the branded retailing business. The sector target is based on 50% discount to our Sensex target multiple of 16.5x 12-month forward PE, given the earnings volatility in the sector due to higher interest rates, appreciating rupee and lower return ratios. The stock is also trading at a ~28% premium to Raymond on 12-m forward EV/EBITDA basis, which owns a larger brand portfolio with much stronger store network. We believe that this premium is excessive. With S Kumars' branded retailing business still to make meaningful contribution to profitability, we believe the current valuations are stretched. Further, its recent equity capital raising would dilute equity by approx. 13% making valuations more expensive.

Risks

We assign a Medium Risk rating (vs. High Risk rating derived by our quantitative risk-rating system, which tracks 260-day historical share price volatility) due to 1) the company's reduction in exposure to commodity textiles from 67% of revenues in FY06 to ~51% in FY07; 2) improved profitability across key businesses, post debt restructuring; and 3) reasonable growth momentum for branded retail and home textile business.

The upside risks to our target price include:

- High valuations of the de-merging retailing business than our estimates would drive stock upside.
- Any long-term outsourcing arrangement for supply of worsted fabrics and garments from its upcoming capacity would be positive and provide a stronger growth outlook than our estimates.
- Better than expected profitability for its branded home-textile and garment business are upside risks to our earnings.

Other risks that support our Medium Risk rating are – a) high-working capital cycle of 280-plus days; and b) outstanding arrears in preference dividend of Rs245m as on FY07 becoming payable over 2009-2014 would dilute cash flows.

Figure 4. S Kumars Nationwide Income Statement (FY06-FY10E)

Yr to 31 Mar (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
Total Revenues	**8,895**	**12,295**	**14,849**	**17,189**	**18,613**
YoY Growth (%)	158%	38%	21%	16%	8%
EBITDA	**1,462**	**2,399**	**3,265**	**3,947**	**4,037**
Margin (%)	16.4%	19.5%	22.0%	23.0%	21.7%
Depreciation	(523)	(544)	(495)	(545)	(588)
Other income	61	99	165	172	205
EBIT	1,000	1,954	2,935	3,575	3,654
Interest income(expense)	(451)	(609)	(627)	(511)	(529)
Profit before tax	**550**	**1,345**	**2,308**	**3,063**	**3,125**
Tax	(102)	(113)	(277)	(368)	(375)
Profit after tax	447	1,232	2,031	2,696	2,750
Pref Div	(26)	(34)	(34)	(34)	(34)
PAT after Pref Div	421	1,198	1,997	2,662	2,717
Extra Items	550	(157)	0	0	0
PAT after Extraordinary	**971**	**1,041**	**1,997**	**2,662**	**2,717**
Margin (%)	10.9%	8.5%	13.5%	15.5%	14.6%

Source: Company Reports and CIR Estimates

Figure 5. S Kumars Nationwide Balance Sheet (FY06-FY10E)

Yr to 31 Mar (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
Equity Share Capital	1,627	2,380	2,380	2,698	2,698
Reserves	(984)	3,370	5,367	10,335	13,051
Net Worth	643	5,749	7,747	13,032	15,749
Pref Share Capital	1,513	1,690	1,690	1,690	1,690
Short Term Debt	3,811	4,150	4,250	4,560	4,760
Long Term Debt	7,911	6,434	5,271	2,882	2,282
Total Debt	11,721	10,584	9,521	7,442	7,042
Capital Employed	**13,877**	**18,023**	**18,958**	**22,164**	**24,481**
Gross Block	6,138	6,388	9,986	11,534	12,575
Depreciation	3,109	3,556	4,051	4,595	5,183
Net Fixed Assets	3,029	2,832	5,935	6,939	7,392
Capital WIP	798	2,959	750	464	465
Investments	79	14	613	1,454	1,220
Inventories	3,799	5,037	6,385	6,876	7,631
Sundry Debtors	4,908	6,087	6,979	8,251	9,120
Other Current Assets	2,318	2,618	1,077	1,186	1,284
Cash and Bank	177	145	116	132	292
Current Assets	11,203	13,887	14,557	16,445	18,327
Current Liabilities	(1,233)	(1,668)	(2,897)	(3,139)	(2,922)
Net Current Assets	9,970	12,219	11,660	13,307	15,404
Total Net Assets	**13,877**	**18,023**	**18,958**	**22,164**	**24,481**

Source: Company Reports and CIR Estimates

Appendix A-1

Analyst Certification

I, Ashish Jagnani, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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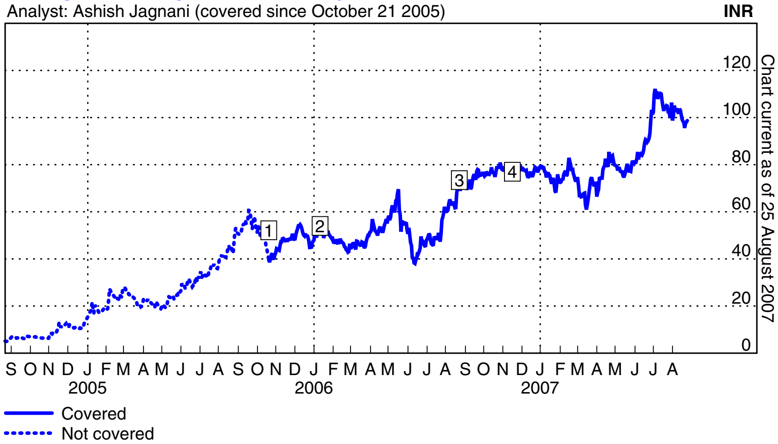
S Kumars Nationwide (SKMK.BO)
Ratings and Target Price History - Fundamental Research
Analyst: Ashish Jagnani (covered since October 21 2005)



#	Date	Rating	Target Price	Closing Price
1:	20 Oct 05	2H	48.00	39.60
2:	11 Jan 06	2H	*61.00	NA
3:	23 Aug 06	*3H	61.00	71.15
4:	16 Nov 06	3H	*67.00	78.60

*Indicates change.

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